Restructuring of the Banking System – a Step towards Integration with the European Union

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BULGARIAN NATIONAL BANK

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The Bulgarian Banking System

by Lubomir Filipov

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Various important aspects and recent developments in the Bulgarian banking system were discussed and analyzed in many publications, including the interesting presentations by authors participating in this international conference.

It is neither necessary, nor possible to make an attempt at a broader, more or less exhaustive survey. I believe it would be more helpful if I focus on only two aspects that I find important, and which are of particular significance in the light of Bulgaria's prospects for future integration into the European Union. These aspects are:

1. Harmonizing our banking laws and regulations with European legislation; and

2. Striving to provide favorable conditions for competition in the Bulgarian banking system.

Before going into the details of these two aspects, I would like to note that in latest Bulgarian history, particularly after 1980, a state monopoly existed on banking transactions in Bulgaria. The Bulgarian banking system was of the type typical of centrally planned economies. Three banking institutions existed – the Bulgarian National Bank (BNB) which combined functions of both a central and a commercial bank, the Bulgarian Foreign Trade Bank (BFTB), and the State Savings Bank (SSB). This model started to change with the establishment in 1981 of the first commercial bank in the country – Mineralbank. The process of banking system decentralization continued with the creation in 1987 of eight commercial banks servicing different industries, and at a later stage BNB branches were transformed into commercial banks. In early 1991, the Bulgarian banking system comprised 69 commercial banks, incorporated as joint stock companies, the State Savings Bank and the Bulgarian National Bank.

Resulting from two waves of consolidation of banks with prevailing state ownership, on the one hand, and the licensing of new private banks, on the other, presently there are 22 commercial banks holding full license (for both domestic and overseas banking operations); 19 commercial banks with domestic license (for domestic banking operations only), of which nine are authorized to open current accounts abroad; four offices of foreign banks in Bulgaria; and the State Savings Bank.

Banking transactions are also effected by nonbank financial institutions – 149 financial and brokerage houses, 30 licensed brokers and about 500 exchange bureaus.

Harmonizing Banking Legislation in Bulgaria

From a historical perspective, harmonization in the area of banking in Europe was first effected on the lower banking system tier – lending institutions (i.e. primarily in the area of bank supervision), and much later (after Maastricht, 1992) on the central banking and monetary policy tier. This inductive approach toward the creation of a common European banking system is, to say the least, a cautious one. More deductive was, however, the approach for establishing the legislative framework of the Bulgarian banking system. The Law on the Bulgarian National Bank was passed in early 1991. The Law on Banks and Credit Activity was adopted a year later, followed by the adoption by the central bank of the basic prudential regulations.

Before focusing on the legal framework in terms of the requirements for "steering the monetary policy toward integration into the European Union," please allow me to comment on Bulgaria's modest achievements in introducing European directives on lending institutions.

1. Bulgarian banking legislation meets the requirements of the first banking directive in terms of the principles of the right of establishing and freedom of offering services, and establishes bank supervision as an institution within the central bank.

2. Regulations No. 8 of the BNB is in conformity with the directives on capital elements and capital adequacy ratios. The eight percent ratio was provided for in the Law on Banks and Credit Activity, but our decapitalized banking system has not generally been able to achieve it yet.

3. In the current year, the BNB Managing Board adopted a regulation providing for the creation of deposit insurance scheme, and later on the Parliament passed the Deposit Insurance Law.

4. Last year the BNB introduced a minimum initial capital requirement for the incorporation of a lending institution, amounting to the equivalent of ECU 5 million for domestic operations license, and ECU 8 million for full license, including overseas operations.

5. Regulations No. 7 of the BNB (on big and internal loans) sets a lending limit per a client of 24 percent of the bank's own capital. Any big loan in excess of this limit should be fully provisioned by the bank.

6. In the spring of 1996 the Bulgarian Parliament passed the Law on Securities, Stock Exchanges and Investment Companies.

In spite of the great number of good regulative acts we have to admit that banks' compliance with them, as well as bank supervision are still on a very low level.

I can proceed now with the issues of harmonizing our monetary policy legislative framework with European requirements.

The Law on the BNB was passed by the Grand (Constituent) National Assembly in a period of post-revolutionary euphoria. It provides that:

• the central bank is independent from the government and is accountable before the National Assembly only;

• the Governor and the three Deputy Governors are elected by the National Assembly, and the remaining members of the Managing Board – by the President of the Republic for a five-year term of office;

• the main task of the BNB is to contribute to the internal and external stability of the national currency. For the purpose, the BNB formulates and implements the national monetary policy;

• the BNB is not allowed to finance the government, except temporarily by short-term advances of up to three-month maturity, which should be redeemed within the current fiscal year. The BNB may purchase government securities only if they constitute part of a public issue;

• with the exception of open market operations, which are the main monetary policy instrument, the BNB may refinance commercial banks only against collateral.

Conceptually, with this central bank law we could immediately join the Maastricht Treaty. In practice, the BNB is, however, rather restricted in its activities, first and foremost because of its heavily decapitalized banking system and the burden of domestic and foreign government debts. Since the beginning of 1994, the budget deficit has been financed only through government securities issues and open market operations have become a prevailing instrument of the monetary policy, but further improvement of the BNB monetary policy can be successful only with a concurrent recapitalization and stabilization of the commercial banks and through a better government debt management.

Providing Conditions for Competition in the Bulgarian Banking System

The onset of the radical transition from a centrally planned economy necessitated momentous changes in the Bulgarian banking business, the most important of which being the strive to pursue a policy aimed against any restrictive practices, typical of concentration.

It is a known fact that one of the fundamental principles underlying developed economies, and especially developed European countries, is the principle of market economy based on free competition in various industries, including banking. Furthermore, this is a principle of crucial importance, as competition is seen as an important instrument for enhancing efficiency and performance.

Irrespective of current natural and/or guided and necessary for this phase processes of consolidation, in recent years the Bulgarian banking industry has committed itself to pursue a policy aimed first and foremost against any restrictive practices typical of overconcentration, and dominant market positions or arrangements preventing cooperation. Second, active measures are being taken to provide incentives and expand competition in banking.

In this regard, it is sufficient to mention the elimination of centrally set levels of interest rates, charges, and commissions. Direct management of loans by so-called credit ceilings set on a bank-by-bank basis was also done away with. In principle, a trend is maintained toward despecialization or universality, which allows for better access to various segments of the broad banking services market. Banking activities and products are gradually diversified. Ample attention is paid to easing up on the entry of new competitor banks, both domestic and foreign, into the banking business. The policy of mergers and other ways of consolidation, and general policy pursued in terms of the ownership structure of banks is again seeking to take into consideration the aspect of competition. The goal is to increase both internal and international competitiveness of Bulgarian banks.

In this respect, I would also mention our consistent efforts to improve banking statistics and market transparency in the banking sector, as well as the measures taken for improving this country's payment system.

The major problems we face in this area are, I believe, faced by our colleagues in the developed European countries as well, though different in scale and magnitude: adequate level of competition; conditions for proper operation of market forces; the role of cooperation; international competitiveness; investments protection, etc.

At this stage of Bulgaria's transition to a market economy, all steps in this direction are, of course, very careful and to the extent required. For example, here, as well as in some other European countries there are regulative acts providing for specialized institutions (as is the case of our outdated Law on the State Savings Bank). These, inter alia, impose certain restrictions on the freedom of financial institutions diversification.

Another question raised in Bulgaria, as well as in other more developed European countries is whether price liberalization of banking services (interest rates, charges and commissions) would be sufficient in itself, and to what extent, what other instruments should complement liberalization by other regulations, in view of providing normal operation of market forces.

It is clear that competition between banks should be achieved on a "play level field" basis, in other words, market agents should compete under conditions and with equal rights, so that equality in terms of competitiveness is ensured.

Undoubtedly, in Europe and in this country, competition between banks should be governed by well defined "rules of the game" in the form of a code of behavior, rules of market practices, and principles of market organization.

In Bulgaria, as in all other European counties, club or association agreements which are often helpful in formulating the "rules of the game" and in setting up the appropriate market organization should not be twisted for anti-competition purposes and trust agreements.

In Bulgaria, as in developed European countries, it is necessary to eliminate and rule out any anti-competition outcomes of market concentration and prevailing market shares.

We do share the European understanding that reliance on competition among banks and market forces alone cannot resolve all efficiency issues. Significant co-operation is required in certain areas in view of ensuring the proper operation of market forces. There are at least two areas that undoubtedly require this: the joint activities for improving the effectiveness of the national settlement system; and the role of club (association) agreements concerning market organization.

Bulgaria is relatively small and quite open to the rest of the world. Issues of attracting foreign participants in the market (investors, financial intermediaries, etc.) are of particular importance. Determining the degree (which is a dynamic value) of their participation on an equal basis in the banking services market here is another very important issue in the dramatic transition to a market economy.

As already pointed out at the beginning, strengthening Bulgaria's financial stability at present depends not only on the BNB monetary policy, but also on its integration into a comprehensive program of structural reforms in the real and banking sectors and on the improved management of government debt. Within the framework of this comprehensive process, major guidelines of the BNB monetary policy in 1996 boil down to the following:

• In 1996, the BNB monetary policy is targeted at **curbing inflation** by applying monetary instruments in proportions so that no pressure is exerted on economic growth.

• **Foreign exchange policy** supports the general anti-inflationary goal. The BNB will try to avoid, to the extent possible, serious foreign exchange rate fluctuations, **to prevent erosion of the trade balance surplus** and to maintain **the foreign exchange reserves at a reasonable level**.

• **The interest rate policy** also assists in controlling inflation. The BNB will try to alleviate, to the extent possible, the interest burden on borrowers. The aim is to preserve the **interest rate margin between lev-denominated and forex-denominated deposits positive**, and the BNB will withstand any external pressure and will keep within its conservative policy until the necessary prerequisites for a change are in place.

• To maintain the credibility of the lev and strengthen money demand it would be appropriate for the BNB to keep **real positive interest rates on deposits**.

• The BNB will continue **to restrict money supply growth**, keeping it 4 – 5 percentage points below inflation and the expected growth of GDP in real terms. Various monetary instruments will be used for the purpose (open market operations, interest rates policy, exchange rate, minimum reserve requirements of commercial banks, etc.).

• The BNB will **strengthen supervision** of commercial banks, directing its efforts not only at restricting the amount of extended uncollectable loans, but also at eliminating the causes for this.

• Further **decapitalization of banks** will restrict the possibilities for conducting an anti-inflationary policy. This problem could be solved only within the off-site control effected by the BNB. Therefore a rehabilitation program covering the whole banking system is needed, because necessary financial resources should not come from the BNB as this will have a pro-inflationary impact. An **additional structural budget** will be necessary, and finances should come from different sources: nonbank financing, privatization receipts, external financing, etc.

• In view of supporting its monetary policy, the BNB will assist the competent governmental departments and authorities in the **regulative legislation and practical development of the primary and secondary capital markets** in Bulgaria based on the legislation on securities, stock exchanges and investment funds. This will have a positive effect not only in terms of speeding up privatization but also for increasing the role of market principles in the banking sector.

• The BNB's policy will aim at providing and maintaining the conditions necessary **to conclude arrangements with the International Monetary Fund and the World Bank**.

We believe that only far reaching structural changes in terms of privatization and enforcing financial discipline on all economic and financial entities would provide the necessary prerequisites for further sustainable reduction of inflation through moderately restrictive monetary and fiscal policies.

■

Rehabilitation and Restructuring of the Bulgarian Banking System

by Valentin Tzvetanov

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The speed of implementation of reforms in transition economies in the early 1990s was crucial to the successful transition to a market economy. The aim of this process may be described as a gradual shift from economies with central planning to an active participation of economic entities in a competitive market environment, including the withdrawal of the government from direct governance and strengthening of its regulatory functions.

Regretfully, in the first two years or so following political changes in Bulgaria, the strong politicization and confrontation in society had a negative impact on the economy and impeded appropriate decision-making. The decisions have been taken not so much from the viewpoint of economic logic but rather in line with the expectation of the public for painless transition and in relation to the frequent political elections held during this period. Thus, some important but unpopular decisions which could have given a strong impetus to the changes were postponed for the future.

Of course, it is not possible to expect a radical change in public thinking in a very short period of time when shifting from a social and political system which has existed for decades to a diametrically different one. Public support for reforms and understanding of the need to face certain challenges is of essential importance for their success.

All these circumstances led to a delay in structural reform, and hence to the gradual deterioration of the national economy, and of the banking system in particular. Therefore, a program for rehabilitation of the banks and their complete restructuring was needed as a step towards integration into the European Union. Given the experience of the past five-year period, the Bank Consolidation Company (BCC), jointly with the BNB and Ministry of Economic Development have developed a program which was approved by the government in December 1995. In the beginning of April 1996, it was elaborated to meet the requirements of international financial institutions for the period from 1 July 1996 to the end of 1997. Major points of this program are: creation of adequate regulatory structure; improvement of the legal framework and accounting standards; restructuring of the banking system; rehabilitation of banks; privatization.

Creation of Adequate Regulatory Structure

This issue is fundamental for the development of the banking system in any country. Its importance for Bulgaria has been categorically proven from the experience of the past six years since the start of reform. Although the bank supervision was established at the very beginning, no correct solution to its efficient utilization has been found ever since. In consequence, the bulk of current problems is due particularly to this fact. Main setbacks are:

1. Perfunctory approach when licensing new banks and nonbank institutions.
2. Insufficient number of on-site examinations.
3. Refinancing without commitments.
4. Failing to sanction banks which do not comply to the established regulations as early as at the time of finding out the noncompliance.

As a result, the right moment was missed for creating conditions to strengthen financial discipline as a basic regulator of the behavior of bank institutions and for bringing their activities in line with the economic logic. Banks suspected to be constituted with borrowed capital from other similar banks or companies were licensed. A great amount of internal loans in the case of private banks was tolerated. Actually, quite a small part of the regulations established by the regulatory framework have been observed, regardless of the fact that in general they were in compliance with international standards. Consequently, banks' portfolio quality has become extremely low and pnenomena such as "credit millionaires" and "income privatization" have emerged. Another phenomenon contributing to the erosion of depositors' confidence were the so-called "pyramids," and their managers called "pharaons." In this case, unlicensed companies carried out bank transactions under fraudulent form. On the top of that, extremely high number of licensed financial and brokerage houses and exchange bureaus should be mentioned, which in the recent years had a strong speculative influence on the domestic foreign exchange market and added up to the sharp devaluation of the national currency, though this was not a major problem. The great number of nonbank institutions has objectively made difficult the implementation of on-site examinations due to bank supervision understaffing. Moreover, the regulations do not provide for a method of operative control over these institutions.

On several occasions some banks had been in dire state and were refinanced by the BNB and the SSB without taking up any specific commitments to improve their performance or if they had made such commitments, the failure was not followed by any sanctions. Thus, refinancing was used as a source to extend new loans to loss-generating enterprises, and so the burden has been transferred from the real sector to the banking system.

All this created the impression of impunity of bank management and nonbank financial institutions which used to believe that the BNB or the government would come to their rescue every time they got into trouble since they were too big to be declared bankrupt. This caused a moral crisis and contributed significantly to the decline in confidence in financial institutions resulting in run on banks, whereby assets have been split from liabilities. The population withdrew a considerable volume of foreign exchange deposits from the financial system and preferred to keep them in so-called “jar-bank.”

Therefore, particularly since early 1996, the BNB has started to conduct a restrictive policy concerning refinancing. Several banks have been placed under conservatorship and bankruptcy proceedings have been instituted against five of these banks.

What is the plan for bank supervision development in Bulgaria now?

1. Setting up the structure and powers of regulatory units in the country.
2. Recruitment and training of personnel.
3. Improvement of the legal framework.
4. Setting up an early warning system based on the international accounting standards.
5. Development of interbank system for exchange of information on borrowers.
6. Creation of a system for announcing bank performance on a regular basis, and likely a system for internal rating of banks.

Structure of Regulatory Units

Basic regulatory functions in Bulgaria are mandated to the central bank. After some disputes, bank supervision was established as a structure within the BNB. Decisions in relation to the banks are taken by the Managing Board of the BNB on motion by the Bank Supervision Department. The head of the Bank Supervision Department is a member of the Managing Board, but this is not an imperative requirement. In addition to the laws, the BNB sets its requirements to the banks by its regulations and decisions of the Managing Board. The scope of bank supervision activities comprises licensing of commercial banks, operative monitoring, inspections and conservatorship. Amendments to the Law on Banks and Credit Activity of May 1996 granted more power to the central bank, and bank supervision respectively.

Taking into consideration the specificity of the Bulgarian banking system, keeping the bank supervision within the central bank is an appropriate decision. At the same time, setting up a deposit insurance fund as a second regulatory center outside the central bank should be considered. Thus, the BNB will not be the only institution to bear the responsibility in relation to the regulatory functions of the banking system as some of them are controversial when concentrated in one center of authority. It is evident from world experience that the central bank should support the liquidity of financial institutions but provided their creditworthiness is evaluated, that is a normal credit is extended to a fair borrower who is able to repay it. If, however, the central bank should ensure liquidity of unsound banks in order to rehabilitate them (if it is necessitated by the circumstances), this will contradict its restrictive policy and would expose it to a serious risk of losses.

Therefore, it is necessary to give authority to another independent institution for winding up or supporting a given bank in case of failure. The Deposit Insurance Fund may become an institution, where such actions to prevent or limit the need for recourse to its funds at an early stage would be logical. This fund should also have the power to limit the range of activities to be performed by a bank, that is to impose limits to the license, and also to revoke licenses, to rehabilitate or wind up a bank.

Personnel Recruitment and Training

Currently, a competition for recruiting employees for Bank Supervision Department is underway. More than 40 bank institutions and a great number of financial and brokerage houses and exchange bureaus operate in the country. This makes necessary that the Bank Supervision Department should be adequately staffed in order to be able to provide operative monitoring and carry out on-site examinations. Personnel training is one of the important tasks of the program. Prominent specialists in this field from countries with developed banking systems have been invited for this purpose. Essential part of this training shall be dedicated to the actions which should be taken in case of conservatorship or winding up of banks since we have no experience in this field.

Improvement of the Regulatory Framework

It should be noted that most of established regulations are completely identical with the Basle's standards. Such are the minimum capital adequacy requirement, risk weights of the assets, amount of the required provisions for classified loans, liquidity and big loan ratios, etc. At the same time, there are some deviations, part of which will be adjusted by the end of the year, and others will be put in place early next year. Such is the case with the method of formation of provisions concerning doubtful loans, which to date has been effected up to the amount of the profits before taxation, contradicting the basic idea of provisioning. Upgrading of criteria for loan classification, regulations on bank liquidity and licensing, etc. is put on the agenda.

Unquestionably, the most important pending issue is the Deposit Insurance Scheme. The current law is provisional and covers 100% of individuals' deposits and 50% of deposits of legal entities. This solution has been prompted by the panic among depositors during recent months. The previous regulation provided guarantee amounting to BGL 250,000 and its foreign exchange equivalent for all depositors. Obviously, a scheme sufficiently fair and transparent, which would not nourish expectations that the government would cover deposits beyond the set limit, should be established. It should be aimed at promoting formation of a competitive market environment which in turn should ensure the necessary financial discipline.

Setting up an Early Warning System Based on the International Accounting Standards

Since the current accounting documents prepared by the banks do not allow to find out unequivocally whether they are solvent or not, as well as to easily carry out a verification of the information provided, it was decided that a system for early warning based on the international accounting standards to be established in the beginning of 1997. The intent is to provide a facility for the bank supervision to promptly respond to problems in any bank before a crisis occurs.

Development of an Interbank System for Exchange of Information on Borrowers

The objective is to stop the outflow of capital to loss-generating enterprises by providing access to information on their creditworthiness. Most probably, the system will be located within the BNB. If such a system had been developed as early as at the time of passing the Law on Banks and Credit Activity, the current problems would not have been so serious.

Creation of a System for Announcement of Bank Performance on a Regular Basis, and a System for Internal Rating of Banks

As of 1997, banks will be obliged to make public their results from the first half of the year. In our opinion, this will help individuals and companies in their choice of a servicing bank and will promote competition and action of market mechanisms.

It should be noted that measures concerning strengthening of the regulatory structures and improvement of bank supervision are not viewed as the only way to resolve the existing problems. Supervision would not replace financial discipline underlying market relations, but might complement it. In addition, establishment of an efficient structure is related to the improvement of the regulatory framework, which will require time and funds, and therefore it is impossible to be immediately implemented.

Improvement of the Legal Framework and Accounting Standards

A greater part of the program for rehabilitation and restructuring of the banking system in Bulgaria is devoted to amendment of the regulatory framework.

The first thing which has been done was the amendment of the Law on Banks and Credit Activity where procedures for declaring a bank insolvent and BNB rehabilitation measures in cases of danger of insolvency have been provided for. That was a gap in the Bulgarian legislation since banks were explicitly excluded from the possibility of being subject to a bankruptcy procedure.

Passing of the Law on Securities was another major point of this program. It is aimed at improving the regulatory system concerning securities in view of the possibilities for their individualization and realization; improvement of regulations on collaterals by creating a unified system of registration; improvement of notary public activities regarding entering of mortgages, including legal mortgages and issue of certificates for property weighted averages; adoption of a system for property entries instead of a personal system; regulation of the possibility for acquisition of the security by the creditors by virtue of a preliminary agreement with the debtor.

The program also envisages an amendment to the Code of Civil Procedures in the part dealing with security proceedings aimed at providing better protection of creditors and expediting the proceedings.

Amendment to the Criminal Code is envisaged, aimed at recognizing the acts resulting in intentional bankruptcy and other crimes against creditors.

Amendment to the Law on Transformation and Privatization of State-owned and Municipal Enterprises aimed at improving the mechanism of debt repayment of state-owned enterprises to commercial banks in the process of privatization, exchange of debt against property, etc. is due to be passed.

Adoption of Law on Deposit Insurance, amendment to the Accounting Law bringing it in line with the International Accounting Standards, etc. is pending. In this regard, it should be noted that even now regulatory documents ensuring provisions on banking and accounting are compatible with international standards. Only some details are still to be amended.

Finally, it should be noted that the improvement of the regulatory framework is a necessary but not sufficient condition for the creation of a stable banking system. Therefore, our efforts now will be directed to ensure compliance with the effective regulations.

Restructuring of the Banking System

In order to provide better understanding of the processes which currently take place in the banking system, I will outline briefly the stages of development in the banking system over the last 60 – 70 years.

The first stage includes the period between the 1930s and the beginning of World War II. At that time, over 60 banks operated in Bulgaria, mostly small and only few of them specialized.

The period 1947 – 1948 immediately following nationalization is considered as the beginning of **the second stage.** This stage is characterized by the existence of only one bank – the BNB performing its activities through a well-developed branch network. Later, three more banks were established: the State Savings Bank (SSB) in 1951, the Bulgarian Foreign Trade Bank in 1964, and Mineralbank in 1981.

The third stage started in 1987 with the establishment of seven sector-specific banks: Construction Bank, Biochim Bank, Balkanbank, Electronics Bank, Economic Bank, Transport Bank, and Agricultural and Cooperative Bank. Until 1989, these banks operated as strictly specialized in servicing respective industries. During this period an essential institutional transformation has been made, which is typical of today's banking system. Between 1989 and 1990, a two-tier banking system was established and the BNB became a central bank transforming 57 of its branches into independent commercial banks. At the same time, the above-mentioned seven banks were allowed to operate with physical persons and companies, which made them normal commercial banks. In the first two years following political changes in the country, several private banks were established and the Post Bank was reestablished. Thus, during the third stage, starting in early 1987 with four banks, in 1992 there were 70 state-owned and nine private banks in Bulgaria.

The fourth stage of the banking system development commenced from 1992 by establishing the Bank Consolidation Company and passing the Law on Banks and Credit Activity. Between 1990 and 1992, in parallel to the development of private entrepreneurship in the country's economy, a credit expansion of commercial banks occurred. The first symptoms of "uncollectable loans" emerged. Having analyzed the banking system, Bulgarian and foreign experts came to the conclusion that it should be restructured with a view to reducing the number of bank institutions, since 80 banks were too many for a country like Bulgaria. In addition, it is necessary to initiate a step-by-step privatization of banks. Two phases may be distinguished during the fourth stage – the first from 1992 until early 1995, and the second – from 1995 onward. One might say that the first phase has achieved the targets set for a drastic reduction of the number of state-owned banks. During this period, banks were reduced from 70 to 12, and new seven consolidated banks were established. In 1992, the United Bulgarian Bank was established, consolidating 22 banks, in 1993 Hebrosbank was established, consolidating eight banks (and consequently in 1994 three more banks were established: Expressbank including 12 banks; Balkanbank – three banks, and Sofiabank – four banks; in 1994 Stara Zagora Commercial Bank and Bourgas Commercial Bank were acquired by Bulbank, and in February 1995 Serdica Commercial Bank was established, consolidating four banks). Mineralbank, Economic Bank, Bulgarian Post Bank, Biochim Commercial Bank, and Yambol Commercial Bank remained untouched in the first phase of consolidation. In parallel to the process of consolidation and reducing the number of state-owned banks, during this period there was a diametrically opposite trend of a fast increase in the number of newly licensed private bank institutions. Thus, at the end of 1995 the state-owned banks were 10, and private banks – 35, excluding the BNB and SSB. Losses in the banking system were growing together with the growing number of banks in the country, amounting to about BGL 40 billion at the end of 1995. This was due partly to the fact that most of the newly established banks were rather small to benefit from economy of scale, with unsound regional and/or industry concentration of their loan portfolio, as well as with strong interdependence with other banks and nonbank enterprises.

Consequently, in the middle of 1995, the Bank Consolidation Company initiated a new wave of consolidation, including Biochim Commercial Bank, Sofiabank, and Serdica Commercial Bank. That actually finalized the consolidation of state-owned banks. Subsequent consolidation of the above banks is foreseen only in case it becomes necessary the sound parts of individual banks to be separated from unsound ones in view of rehabilitation of the former and possible liquidation of the latter.

With regard to private banks, the BNB undertook indirect measures aimed at consolidating them by increasing the minimum capital requirement to BGL 1.2 billion for banks with full license to perform foreign and domestic operations and to BGL 850 million for banks with license for domestic operations only. By 1 January 1997, banks must adjust their capital to the required amount. Two consolidations between private banks have been intended but not been effected. In case of danger of insolvency of a bank the amendment to the Law on Banks and Credit Activity of May 1996 enables the BNB to take over the functions of the shareholders' meeting which might be used for forcible consolidation aimed at rehabilitation of a specific bank institution.

As a whole, the program for rehabilitation and restructuring of the banking system implies formation of a core of several stable universal banks, meeting the requirements of banking regulations, which should become the backbone of the Bulgarian banking system. Out of eight state-owned banks, only three or four are to be kept in medium term, and the others should be privatized (at least two should be privatized by the end of this year). Of course, it is impossible to say in advance exactly how many banks should remain in Bulgaria. To a great extent, this will depend on the market and on the efficiency of bank supervision.

Rehabilitation of Banks

Problems of the banking system in Bulgaria appeared more clearly by the end of 1992. Total loss in the banking system increased in parallel to the growth of problematic loans in banks' portfolios, and reached its highest level at the end of 1995. Besides the lack of efficient supervision, lagging structural reform in the real sector and a drop in production in real terms at the end of 1989 also added up to this. A considerable number of state-owned enterprises funded by the banks were generating losses. In many cases, debts of an enterprise considerably exceeded its assets. Quite often it happened that one enterprise was a debtor to two or three banks, and sometimes even to more banks. Corporate credit has significantly increased. Banks have effected a massive expansion by setting up big branch networks and acquisition of fixed tangible assets. This investment exceeded even balance sheet capital, disregarding the level of bank capital adequacy, which means that they also used borrowed funds for this purpose.

In 1993, the government took measures for rehabilitation of banks' loan portfolios by issuing two decrees and the Law on Settlement of Nonperforming Credits (the Bulgarian popular acronym – ZUNK). In essence these measures involved assumption of nonperforming loans of state-owned enterprises extended prior to

31 December 1990 in the balance sheets of banks against long-term government securities denominated in levs and foreign exchange. The lev-denominated long-term government securities as per the Law on Settlement of Nonperforming Credits paid less than the basic interest rate of the BNB, and foreign exchange-denominated securities paying the 6-month LIBOR. Obviously, though enhanced, the yield on banks' assets could not cover the expenditures on liabilities. Therefore, the positive effect was rather short-lived and banks again started to accumulate losses. The lack of adequate control as regards enterprises and fulfilment of the programs which they were to submit after the operation in accordance with the Law on Settlement of Nonperforming Credits, should be considered a weakness. Their approach to the program development was rather perfunctory. At the same time, no requirements have been made to banks in exchange for the support given to them.

At the end of 1994, two of the big state-owned banks – Mineralbank and Economic Bank – began to experience great liquidity difficulties. The problem was likely to intensify further, and therefore in April 1995 the BNB bought out their long-term government securities issued in accordance with the provisions of the Law on Settlement of Nonperforming Credits, whereby they repaid their debts to the central bank and to the SSB. At the same time, the BNB imposed restrictions on the licences of the above two banks. They had to cut their current expenditures, reduce the number of their branches and make redundant part of the staff. They were allowed to lend only to the amount of the revenues from loans. These restrictions were effective until the restoration of their liquidity. This operation also had some adverse effects on the banks. Since both banks had debts to foreign creditors, deduction of the long-term foreign exchange-denominated government securities have placed them in short open foreign exchange position. On the one hand, this hindered strongly servicing of their forex-denominated debts and they were compeled to purchase foreign exchange in the domestic market; on the other hand, this led to losses as a result of exchange rate fluctuations. It should be noted that Economic Bank has managed to handle this situation, despite the difficult conditions, by drastically reducing its expenses and even has succeeded in staying liquid at the time of the liquidity crisis beginning in the second half of 1996 without being able to resolve completely its problems, however. The state of Mineralbank became critical and in May 1996 the BNB placed it under conservatorship, and subsequently initiated a court procedure for declaring it bankrupt.

The main drawback of the banking system rehabilitation initiated in early 1995 was the lack of a general strategy. The actions taken had a one-sided effect and were necessitated by the development and exacerbation of the problems. Therefore, it becomes more and more necessary to develop such a strategy. It should focus on resolving two major problems – outflow of funds to loss-generating companies and accumulation of nonperforming loans.

Since the middle of 1995, the BCC has taken measures intended to master this situation. First of all, it has focused on strengthening the financial discipline in banks where it was a major shareholder. It has introduced a two-tier system of management – supervisory boards and managing boards, with the BCC as one of the members of the supervisory boards, and representatives of the government as the other two members. Thus, the feeling of bank management impunity has been eliminated to the extent that in accordance with the current legislation the supervisory boards had the authority to remove the members of managing boards every time they failed to manage efficiently. Management of almost all state-owned banks has been replaced. The BCC took control over these banks on a monthly basis and set a requirement that from 1 January 1995 their classified loans should not exceed 5% of the total volume of the newly extended loans. At the same time, in order to achieve the capital requirement, some banks increased their capital.

The program approved by the government includes the following steps:

1. Isolation from bank lending of all enterprises which have nonperforming loans.

2. Support to some banks by providing long-term US dollar-denominated government securities totaling USD 400 million to eliminate their capital deficiency, and improve their efficiency in order to restore the confidence of their clients.

3. International audit of banks with negative capital adequacy and banks receiving government support.

4. Ban on lending to banks with negative capital adequacy and permission for crediting within the receipts from loans with regard to supported banks.

5. Signing of a memorandum of agreement between the BNB and banks with negative capital adequacy, where the banks undertake specific commitments to reach a zero capital adequacy until the end of 1996. Fulfilment of the commitments will be reviewed twice monthly. In case bank management fails to fulfil the commitments in three consecutive months, penalties shall be imposed and the banks may be placed under conservatorship.

6. All banks should reach 2% capital adequacy until the end of 1997, 4% until the end of 1998, and 8% until the end of the year 2000. The banks which fail to meet the above requirements will be placed under conservatorship or wound up.

7. Limitation of unsecured refinancing by the BNB.

8. Privatization of at least three state-owned banks until the end of 1996, and funds received from the sale of shares to be reinvested for rehabilitation of other banks.

The approach to resolving the problem of accumulated nonperforming loans is still controversial. The program envisaged the establishment of a special institution, Receivables Collection Agency (RCA), to accumulate nonperforming assets and seek ways for their realization. The opponents of this idea believed that it would involve many risks and so far there has been no positive experience in similar countries. They contended that the banks should make an effort to collect their receivables.

At the same time, the government has published a list of enterprises which were among the largest debtors to the banking system earmarked for liquidation and isolation. In both cases, such enterprises will not service their debts for a long period of time. The liquidation procedure will take at least two years under the current legislation. In this setting, a conflict between the memoranda requirements concerning collection of debts and isolation and liquidation of major debtors may arise.

Therefore, under the circumstances and in view of the big amount of nonperforming loans in the portfolio of the banks, it should be noted that the establishment of RCA is a must and in a very short period of time at that. Unlike banks, such an agency may wait until the time of realization of the assets and at the same time enable the banks to generate a positive income, which will considerably shorten the time for covering the accumulated loss. In addition, realization of assets is also related to some amendments to the regulatory framework in view of expediting the procedures, which also takes time, not available to banks. And there is one more argument in favor of the agency. Expectations concerning receipts from assets realization in view of their quality are not very high. Therefore, a choice should be made whether the government should cover the deposits in case of liquidation of banks or exchange step by step the bad assets for long-term government securities.

In the long run, rehabilitation of the banks is also related to the possibility of their privatization. Therefore, it may be considered as an investment, not a loss. Now, the government has taken radical, though painful, measures since their complete implementation is essential for the banking system, for the economy as a whole, and hence, for the whole society.

Privatization

It has been acknowledged that bank privatization in Bulgaria is delayed. However, it should be noted that no conditions for privatization of banks were created. It is indicative that at present many of the private banks in the country face serious difficulties, and the First Private Bank, the oldest and biggest private bank, has been declared insolvent. This seriously discredits the idea of privatization to the extent that there has been no evidence that private banks were more efficient than state-owned banks. Moreover, in the current setting of crisis the population has more confidence in state-owned banks and has serious misgivings about the new private owner of any of those banks. Three of the banks, where the BCC held a big stake but reduced it down to the minimum capital, currently experience serious difficulties, and one of them is under conservatorship. Four of the five banks declared insolvent are private, and their big internal loans are a major concern.

Above considerations lead to the conclusion that privatization cannot be an end in itself. An efficient privatization involves not only a simple change of ownership, but requires a well established efficient system of bank supervision and sufficient set of instruments to influence banks' behavior. Therefore, the main stress of the measures undertaken is focused on increasing the bank supervision efficiency as a prerequisite for implementation of privatization.

The second problem is finding potential investors and the right approach to privatization. Domestic investment potential is rather limited in the context of banking system crisis, inflation and sharp jumps of exchange rates. Where such potential is available, usually there are doubts concerning the origin of the capital or the integrity of management intentions. The approach also matters in regard to implementation of the privatization. The question is whether a majority shareholder in a bank under privatization will be allowed, or whether there will be several big shareholders and the others small-scale ones. Given the conditions in Bulgaria, one could hardly argue that the approach of voucher privatization carried out in other countries would be successful, especially under the conditions of crisis. The approach where several major shareholders hold about 75% of the capital and the other part is held by the present small-scale shareholders is a more acceptable approach. A joint participation of Bulgarian and foreign strategic investors is also considered. This, however, will require rehabilitation of the banks as a first step in order to make them more attractive.

An important point of privatization is the extent to which foreign banks will be allowed to participate. Under existing conditions this could have adverse effect on Bulgarian banks since foreign institutions would win the confidence of the depositors and they may withdraw their deposits from Bulgarian banks. This would considerably hinder rehabilitation of Bulgarian banks. Therefore, initially foreign bank institutions may be attracted in order to conclude a cooperation agreement with them, which later may be extended to equity participation. Such is the UBB Project with the EBRD, where a bridging loan of USD 100 million is envisaged, which later on may be extended to equity participation.

Another important point of privatization is the creation of a favorable tax environment and development of capital markets and corporate security markets. In this direction, the first step has been made with the adoption of the Law on Securities and Stock Exchanges.

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The Czech Banking System after Six Years of Reform

by Paul Norring

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Why a Czech Based View?

The combination of six plus years of dedicated reform, voucher privatization, proximity to maturity market economies, and a stable macroeconomic environment has resulted in one of the regions most developed banking systems.

The general pattern of CZ development parallels that which is happening elsewhere.

Many of the problems surrounding the current state of the CZ banking system are similar to those beginning to surface in other reforming counties and hopefully participants can benefit by learning from the Czech Republic's success and also avoid the some of their mistakes.

Historical Development of the Czech Banking System

The Czech Republic has come a long way in six years – as demonstrated by its ability to be the first former country with a former command economy to join the OECD.

Phase 1. The Big Bang (jump start to privatization process)

1. Split of the former state bank into smaller/special purpose banks.
2. Segregation of pre-1990 loans into special purpose consolidation bank.
3. Foreign buy-ins to new smaller/special purpose banks (very limited compared to neighbors − only one buy-in at the smallest bank).
4. Granting of new banking licenses to domestic physical and legal persons (approximately 30).
5. Period of lending euphoria (key to overall privatization process).
6. Granting of banking licenses to foreign banks (approximately 15).
7. Voucher privatization.

Phase 2. Creation of Mechanisms for a Self-sustaining System

1. Banking acts and the regulatory authority of the national bank (monetary, exchange rate, Bank Supervision) – legislation closely parallels EU guidelines.

2. Act on Accounting (moved standards closer to IAS and introduction of the concept of prudence).

3. Credit Markets – T and CNB bill and bond issuances set benchmarks and build a yield curve.

4. Development of an active and effective interbank market.

5. Banks establish voucher privatization funds.

6. Establishment of the PSE.

7. System of pension funds established to attract long-term sources of domestic capital.

8. Domestic banks rush to build branch networks.

9. National bank focus primarily on monetary and foreign exchange considerations.

10. Increasing minimum reserve requirements end the era of easy money.

Phase 3. Cracks Appear

1. Many loans to new enterprises turn out to be for nonviable projects.

2. Large instances of graft in early lending (one Charles University professor estimates up to 30% between 1990 and 1992).

3. The problem of new bad loans (30% to 40%).

4. Profit margins narrow – raising funding costs (rediscount rate) and falling lending rates (competition for good credits) – large one-time gains (currency or investment sales) at the largest banks mask trend from migrating to the bottom line.

5. Partial provision causes losses or only marginal profits at small and medium banks.

6. Undercapitalized institutions (ability to meet 8% Basel accord targets – begins to be seriously questioned).

7. Liquidity crises begin to appear at small banks as larger banks reduce interbank exposure.

8. Relatively few bankruptcies and slow restructuring of large domestic enterprises.

9. Large banks not fully privatized – still controlled by the government.

10. Bank controlled voucher funds start building large equity stakes in domestic industry (perception that they prefer to lend rather than restructure).

11. Capital market development suffers lack of transparency (especially compared to Polish and Hungarian neighbors) and low liquidity/trading volumes.

Phase 4. The Reaction and Resulting Fallout (current stage)

1. Moratorium on new bank licenses.

2. Deposit insurance fund established.

3. The national bank places increased emphasis on supervision and issues new

provisioning guidelines – new supervisors are hired and trained.

4. Banks accelerate capital raising initiatives on the domestic and foreign markets (the latter is limited to only the largest institutions).

5. All banks move away from SME lending (which despite the weaknesses in the bankruptcy process are failing) in favor of larger (partially privatized) enterprises which are perceived to be safer (given lack of effective bankruptcy process).

6. The CNB push for full provisioning accelerates failure of small domestic banks – the CNB response is ad hoc.

7. Mergers and consolidation of smaller domestic banks.

8. Larger banks use their voucher funds to raise new equity creating circular ownership structures.

9. Deposit insurance fund begins to run out of money – increased premiums suggested.

10. Losses at two small banks (which are subsidiaries of the former monopoly insurance company) potentially render their parent insolvent.

11. Initiatives/regulations to improve capital market and voucher fund transparency.

12. Investment fund mergers (to achieve critical mass) and conversion into industrial holding companies (to avoid new regulations – contrary argument is that concentration of ownership is finally beginning).

13. Predictions of eventual currency devaluation to counter growing trade deficit, which is partially attributable to the limited restructuring of large industrial enterprises.

14. Foreign banks beginning to expand branch networks and attracting more domestic clients.

Microlevel Issues Currently Impacting Domestic Banks

1. Management reporting capabilities are generally poor – focus is not placed on key business drivers – data is not concise and focused, therefore, emerging business trends are not often spotted – limited commentary on monthly/quarterly results (just the numbers – no explanations) – systems and data organization limits the ability to provide ad hoc investigations – lack of real time information.

2. Credit assessment procedures (Price Waterhouse has prepared a book on this topic) emphasize on collateral rather than project feasibility – financial forecasts and their related assumptions are rarely questioned – little attempt to tailor loans to financial forecasts.

3. Most clients especially SMEs have very poor underlying financial performance – lending typically finances 85% to 95% of total assets – need to have entrepreneurs bring more equity capital to projects.

4. Credit monitoring procedures – subsequent grading criteria are flawed and inconsistent; also very few banks have automated real time systems which can effectively analyze the health and trend of the portfolio – too many clients still dis-

appear with the banks money (loan officer/client contact needs to be more frequent).

5. Limited ability to work out and collect problem loans.

6. Systems – implementation delays – international systems often do not meet rigidity of local accounting requirements, tailoring is difficult – lack of acceptance by users.

7. Workforces then to be bloated in contrast to foreign banks and cannot compete in retaining best and brightest given lack of training and lower salaries.

8. Lack of senior management focus on core business – expensive forays into fringe activities and one-time transactions.

Key Success of the Czech Banking System

Tremendous progress in six years – Czechs should really be complemented.

1. The CNB has instilled significant confidence in the system.

2. Very efficient and reliable clearing system.

3. Highly stable currency, to date.

4. Interbank and foreign exchange market are very well developed – effectively comparable to EU countries.

5. Large syndicated loans packages being granted to large CZ banks.

6. Noteworthy improvements in credit acceptance procedures and the ability to assess credit risk – period of lending euphoria is over – all banks are learning from their previous mistakes.

7. Improvements in general operational efficiency and customer service – more product availability – beginning to see product tailoring.

8. Some domestic banks beginning to benefit from their investments into branch networks and move to consolidate all customer accounts with one bank – many have lower cost of funds than foreign competition.

9. Large percentage of foreign banks are forcing accelerated change at domestic banks (training future domestic bankers).

10. The emerging capital market serves to compliment banking system and serves as a mechanism to increase both banks and their customers equity basis. Bond market also provides a more liquid, competitive alternative to standard loans and diversifying credit risk concentrations.

Key Challenges Still Facing Czech Banks

1. Lack of domestic capital, especially long-term sources (savings rates need to improve – new pension funds need to start reaching critical mass).

2. Tax policy is excessively onerous (limited provision deductibility and taxation of income on nonperforming loans).

3. Bankruptcy policy is ineffective and is not a practical means of collateral foreclosure.

4. The skill base of credit officers still needs to be improved – especially with

respect to financial analysis and recovery skills – most banks do not have personnel which are technically capable of effectively working out problem loans.

5. Although improving, customer financial reporting still does not present the true health of their business.

6. Domestic bank operating procedures, internal controls and information systems are significantly behind their foreign competition – they are often trapped in the former pre-1989 bureaucracy – thus creating a two-tier system where foreign banks often get the best customers.

7. Perception that many banks would actually be successful if they did not have the problem of bad loans to address therefore addressing issues in this area preoccupy management's time and sufficient attention is not given to other areas.

8. The problem of new bad loans will continue to erode future profitability of domestic banks.

Future Reforms

Investment into Further Financial System Infrastructure

1. Bankruptcy reform.

2. Increase domestic saving levels (tax incentives – especially pensions).

3. Increase capital market regulation – although rules exist it is necessary to develop penalties for violations and begin enforcement – enhanced transparency will attract more long-term foreign capital (which is critical for industrial restructuring and retooling).

4. Fines and punishment for financial fraud – need more example cases to prevent continued and future abuses of depositors funds.

5. Encourage the establishment of more reputable domestic mutual funds – eliminate double taxation, simplify structure, and provide incentives for joint ventures with fund managers from mature capital market countries (in general, as seen in Germany, the dominance of universal banks retards the development of capital markets – thus support of capital markets must be more proactive) – the establishment of more venture capital funds is also critical.

6. Accounting standards reform (most particularly adoption of the EC 4th and 7th directives overriding principal of "true and fair" and substance over the legal form) – management and regulators do not have all information required to assess the true health of banks – much less their lending clients. (Simple example about retained losses classified as assets and failure of major business publication to recognizing this when ranking the largest CZ banks by capital base.)

Other areas where accounting standards need to be strengthened, include:

• Loans for shares (deduct from equity and capital adequacy calculations);

• Loans to shareholders (preferential approval criteria and terms) – therefore require continual monitoring and disclosure;

• More emphasis on the clients underlying financial performance in loan classification system;

• Move toward consolidation of subsidiaries and equity accounting for subsidiaries;

• Mark to market and fair value accounting for investment holdings;

• Lower cost or fair value for foreclosed assets;

• Liberalization of standard chart of accounts – CZ balance sheet and IS statement has 200 lines – users can't see the forest from the trees.

Bank Level

1. Supervisory boards/shareholders need to force management to place more focus on core operations.

2. Compensation policies that tie compensation credit officer to the performance of their underlying loan portfolio and for senior management to overall bank profitability.

3. Move to more fee based income – service charges for bank transfers and account maintenance are below break-even levels.

4. Continued initiatives to improve credit officer skill bases – training courses, participation in teaming projects, visits to foreign banks, and joint ventures/strategic alliances.

6. Establishment of workout/recovery departments.

7. Accelerate implementation of information systems and improve management reporting capabilities.

Conclusion

The Czech Republic's success to date gives market participants confidence that the future challenges will be satisfactorily addressed in time.

Strategy of the Polish Banking Sector into the OECD and the EU

by Jan Krzysztof Solarz

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Let me begin by saying that banking has always been a great industry to work in and to be a part of. Banks have had an enormous influence on the course of history. This is true today as it ever was. The banking sector is an important structural component of the economy, the soundness of which has significant implications for macroeconomic policy formulation. For purposes of today's discussion, a sound banking system is defined as one in which most banks (those accounting for most of the system's assets and liabilities) are solvent and are likely to remain solvent. My address is part of a broader ongoing effort to explore the solvency implications of banking and financial sector integration with western structures as the European Union, OECD and NATO.

When asked to look forward in time, Albert Einstein once said: "I never think of the future. It comes soon enough." Einstein was a great scientist, I suspect he would have had trouble as a banker, based on that quote at least. Today bankers who don't think enough of the future and plan for it aren't going to be in business for very long.

Banking systems may exhibit different degrees of vulnerability over time. They may be functioning poorly, or working relatively well now but give signs of probable future problems through low earnings or capitalization. In this introduction I divide and compare experiences of the countries in transition using two criteria. The first criterion is a right to issue own currency during the so-called "real socialism." The second one is a range and depth of reforms in a monopolistic banking system and "economy of shortages." In a comparative perspective Poland's framing of a market oriented banking system is not fully representative of countries in transition.

Before I turn to a discussion of integration issues and how Polish bankers and banks can best position themselves for the future, let me point the key elements of banking reform that I hope were vital. In the early 80's, there was an experiment to unite the logic of a "plan economy" and the logic of a "market economy," called "reform of triple S," which meant: self government, self-dependence, self-financing in running the state-owned firms. It was assumed that banks would discipline state-owned firms in terms of pay rises and in the evaluation of their cred-

Table 1

ComparativeTypology of Experiences in Creating Market Economy System in Banking among Countries in Transition

Criteria of typology	Sovereign issuing own currency	Curtail of the privilege to issue own currency
Reforming socialist economy	Hungary, Poland	PLO
Preserving doctrines of socialist economy	Bulgaria	Estonia

itworthiness. Even such a little margin in economic rationalization of SOE envisaged by the reform required a partition of the central bank administration from the Finance Ministry which took place in 1982 in the form of the Banking Law Act.

As new fields were added to improve defective “plan economy” by market mechanisms, there was a need not only for a new legal framework, but also a need for new performance. Ten years ago, in 1986, the first nonstate-owned bank – Bank Rozowju Eksportu S.A., was founded. “The Program for strengthening Polish zloty,” which was worked out in 1987, introduced the two-tier structure of the banking system. The first step in this direction was the act of separating Powszechna Kasa Oszczednosci (State Savings Bank), which assumed a form of a state-owned bank, from the structure of the National Bank of Poland. In the second step, the Banking Law and the National Bank of Poland Act were prepared in 1988 and implemented in January 1989. In the third step, in February 1989, on the basis of the network of the NBP subsidiaries nine joint-stock banks were established. So it seems that the democratic will to introduce reforms to political system was verbalized only after a series of measures were undertaken in order to bring the banking system in Poland closer to a market economy.

Along with macroeconomic stabilization and privatization, integration into western structures is a central pillar of the economics in transition. On 16 December 1991, Czechoslovakia, Hungary and Poland signed the so-called European Agreements, which covered the themes of political dialogue, economic integration, and cultural and financial cooperation, and which were to establish their association with the European Community. Due to delays in the process of ratification, the agreements went into force on 1 February 1994.

In 1995, a White Paper of the European Commission set out the step involved in the preparation of the associated countries for the integration into the European Union. In 1996, the European Commission asked ten countries on “avisa.” It means to fill in a questionnaire on all issues related to applying the European Union standards in every part of our economy.

Article 45 of the Poland’s agreement stipulates that access of foreign banks to establishing credit institutions in Poland will be fully liberalized only after ten years. During the first five-year transition period, the Polish government may introduce restrictions on foreign banking, which must be phased out during the second five-year transition period. Using this provision, the Polish National Bank imposed in August 1994 a moratorium on issuing new banking licenses, suggesting that banks should seek ways to participate in existing ventures.

There are six broad arguments which are usually cited in opposing the early entry of foreign banks during financial liberalization. First, the regulatory authorities have little means of obtaining information on foreign banks located outside their borders, and the bank supervision cannot adequately assess the risk and the performance of the branch or subsidiary of a foreign bank. Second, foreign banks might transfer capital and profits out of the host economy, rather than take on the role of a domestic financial intermediary. Third, domestic banks could play a vital role in the execution of economic policy. Thus, the presence of foreign banks could mean a loss of control over a host country's policies, and this might impede the success of economic development. Fourth, the entry of foreign banks in the early phase of financial liberalization may weaken the host country's future bargaining position since it cannot use reciprocity as a bargaining tool to help its banks in the future to enter foreign financial markets. Fifth, domestic banks constitute an infant industry which is in need of temporary protection from international competition. This temporary protection would allow banks to build up their capital, increase their know-how, and improve their technology. Sixth, since domestic banks in transition economies generally have lower capital levels than foreign banks, they might experience earlier difficulties than foreign banks.

Since 1989, some of the 18 major international banking institutions established a foothold on the Polish market. The opening and operation of foreign-owned banks are guided by similar rules and regulations as domestic joint-stock banks. The new creation were Amer Bank in 1990, and Citibank, Creditanstalt, IBP and Raiffeisen-Centrobank in 1991. Two licenses to operate branch office were granted to ING Bank and Societe Generale in 1991. In following years new licenses were given to foreigners until 1995, when Dresdner bank/Banque Nationale de Paris, ABN-Amno, Deutsche Bank, Beyerische Vereisbank, Bayerische Hypotheken und Wechselband, and West LB were allowed to start operations.

Actual findings show that foreign banks are playing an increasingly important role in the Polish banking system.

For comparative study in Table 4 are shown various operational indicators in the banking sector in Poland.

Fundamental changes in our political system in 1989 – 1991 created a unique chance to choose a financial system for Poland. Over the centuries models of financial systems have been developed, which are "bank" or "stock exchange" oriented, and could be useful in forming our own system. Within the framework of international technical aid to financial institutions, foreign experts tried to persuade Poland to imitate the state-controlled French banking system, the American system of small and very competitive banks, the Japanese system of surplus of restructuring credits from main banks.

Table 2

Share of Foreign Banks in Polish Banking System in 1994 and 1995

Items	1994 Foreign	1994 Other	1995 Foreign	1995 Other
Share in sector assets	3.3	96.7	4.4	95.6
Share in loans to nonfinancial firms	38.4	30.4	40.4	28.5
Bad loans share of loan portfolio	1.3	30.4	19.7	21.8
Cost/total revenue	72.1	96.7	78.8	84.0
Share in gross profit of banking sector	23.0	77.0	6.2	93.8

Table 3

Gap in Operational Indicators between Banking Sector in Poland, "9" and Foreign Banks in 1995

Items	Banking sector	"9"	Foreign banks
Interest income/assets	5.0	6.2	10.0
Noninterest income/assets	1.5	1.4	6.0
Operating cost/ assets	3.1	2.8	7.0
Gross cost/assets	3.4	3.1	7.9
Gross profit/total revenue	49.3	59.5	50.5
Net profit/total revenue	30.9	38.5	29.4
ROA	2.0	2.9	5.0
ROE	49.9	54.5	315.3

Table 4

Operational Indicators for Banking Sector in Poland 1990 – 1995

Items	1990	1991	1992	1993	1994	1995
Interest income/assets	12.7	9.3	5.3	4.3	4.1	5.0
Reserve on bad debt/assets	0.0	2.1	0.8	2.2	1.8	0.3
Operating cost/assets	2.2	3.0	2.6	2.7	3.0	3.1
Gross profit/assets	12.5	6.0	4.3	1.4	1.0	3.2
ROE	207.3	71.7	54.0	-4.6	-0.1	44.9
ROA	7.2	3.6	2.7	-0.2	-0.01	2.0
CPI	585.8	70.3	43.0	35.3	32.2	27.8

Moreover, our own experts and legislators could not agree upon which model fit our needs. Initially, a thesis that the more the banks, the better for the economy was promoted. Later, it was believed that the development of the capital market would be instrumental in striving for critical mass and irreversibility of the changes of the financial system. On the one hand, the Mass Privatization Program was launched. On the other hand, banking brokers offices were separated from banks.

Financial restructuring of companies and banks act of 1992 realized the Japanese-German model of main banks. Restructuring cooperative banks and the Food Economy Act of 1994 took advantages of banks group. The 1996 Act concerning grouping of SOB is in this same direction.

Within seven years Poland has covered the distance from the American to the German model of banking. The fluctuation indicates that the question which financial system we should adopt still remains open.

■

China's Financial Reform

by Edgardo Barandiaran

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Relation between State Banks and State Enterprises

1. Introduction and Overview

As other transition economies, China is still dealing with the legacy of a large state sector, including over 15,000 medium and large industrial enterprises. Since 1978, the state sector has changed greatly, from a loose system of central planning to a loose system of central control, but the process is far from complete and the government has often repeated its commitment to transform the state enterprises and banks into profit-oriented organizations. It is widely believed that the slow pace of this transformation is due to the persistent softness of the enterprises' budget constraint, in turn the result of relying on the state banks to finance their activities. The reforms notwithstanding, the banks are still financial agents of the enterprises with little autonomy. The transformation into profit-oriented organizations should change the relation: while the banks would become fund managers, acting on behalf of their depositors, the enterprises would be financed entirely on market terms.

In this paper, I discuss the prospect of a new relation between the state banks and the state enterprises. This prospect is very much conditioned on the success of the government's plan for transforming both the enterprises and banks. I emphasize the obstacles posed by the large number, and especially the organizational complexity of the enterprises, as well as the institutional and human capital requirements of the reforms, to conclude that the proposed commercialization of the enterprises and banks will hardly bring about a relation based only on commercial considerations. I then outline an alternative reform which attempts to take account of those obstacles and requirements. The outline is intended only to highlight the main ideas and it does not provide a detailed reform plan.

In the next section, I review the current status of enterprise reform. The review is of interest by itself because the serious obstacles to know approximately the conditions of the enterprises make all but impossible to validate the ideas underlying the government's reform plans. I conclude tentatively that: a) despite the continued growth of the enterprises, there has been an increasing differentiation in their performance and the number of chronic loss-making enterprises has been growing; b) only insiders know the true situation of their enterprises, and in particular the prospects of generating revenue commensurate with the present and expected living standards of their lifetime employees; and c) the government's reform program will hardly succeed in liquidating loss-making enterprises and in forcing profit-making enterprises to pay back their financial obligations.

Financing of the state enterprises has changed radically. The 1984 decision to substitute banks loans for budgetary allocations has already led to a large accumulation of debts with the state banks. Contrary to the experience of most other transition economies, national savings have increased during the reform period to high levels (close to 40% of GNP in the 1990s) and a large share has been mobilized by the formal financial system, still very much dominated by the state banks. The banks are very much tied to financing the state enterprises over which they exercise no control right. In section 3, I introduce the distinction between nonalienable and alienable state enterprises to analyze the relations between each of them and the state banks. I highlight the uncertainty about the status of these relations as a result of the reforms of the past three years.

Despite the loose control system of the state sector, the government has insisted on maintaining state ownership of both the enterprises and the banks and on transforming both of them into profit-oriented organizations. Their commercialization is expected to bring about new relations between the enterprises and banks, but the question of how the enterprises are going to be financed after the state banks become commercial entities has not been addressed directly in the discussion of their reform. In section 4, I assume that the success of commercialization implies that nonalienable state enterprises will be funded by the state commercial banks acting as fund managers rather than financial agents, and exceptionally by the policy banks. Thus, the relation between the state banks and nonalienable enterprises would be similar to that between the banks and all other classes of state and nonstate enterprises. The ongoing reforms assume the feasibility of transforming the state banks into fund managers and the effective separation of the state banks and the state enterprises, but I argue that because these two assumptions will hardly hold, the reforms will have little impact on the relations between the banks and the enterprises.

Sooner or later the government will have to define a state sector with its own centralized system of mobilizing and allocating debt capital. The rapidly growing nonstate sector (including alienable state enterprises) will then have its own decentralized financial system with a diversified ownership structure. There are several ways to move into the direction of a two-pillar financial system, one for the state sector and the other for the nonstate sector. In section 5, I propose to give the responsibility of financing the nonalienable enterprises to one of the existing state banks which could also exercise control rights on the enterprises' management. Concerning the financing of the alienable enterprises, I propose a two-period strategy: in the first period, the emphasis would be on incentives for the enterprises to take the initiative to restructure their debts or to liquidate themselves, whereas in the second one, their relation with the state banks would be largely on commercial terms.

2. The Status of State-enterprise Reform

In this section I review the current status of state-enterprise reform. Given the growing consensus on transferring the decision about the future of small industrial state enterprises to their own managers, the review is focused only on medium and large industrial state enterprises (Figure 1 presents some data on all industrial enterprises). The large number of medium and large state enterprises (hereafter ISOEs) and the great variety of conditions under which they do business make difficult to have a clear picture of both the present status of the enterprises and the direction in which they are moving. In Table 1, I attempt to draw such picture, certainly an oversimplification of reality. Table 1 refers only to areas of reform directly related to the organization and behavior of the enterprises, but it should be noted that reforms related to the opening of the economy and other changes in the external environment of the enterprises have also been conditioning their behavior and performance. In general, ISOEs now face strong competition in many markets for their outputs and inputs, but competition for all types of labor is still weak (in the next section I address the question of competition for capital).

Table 1 classifies the variables into five main categories: commercialization, decision-making process, asset reallocation, labor and financing. Commercialization is the immediate objective of ISOE reform, including a new legal status based on the Company Law, well-defined residual claims on ISOE cash flows, and a change toward profit-oriented organizations even if constrained by other considerations. Much has been done to clarify the idea of commercialization, but except for those few enterprises which are now listed in stock exchanges abroad (and to a lesser extent those listed in the two national stock exchanges), progress has been slow for the several reasons indicated in Table 1. The most important obstacle to commercialization is the vested interest of the legal entities (which are state agencies) with residual claims and control rights on the enterprises, and the insiders (that is, the managers and the lifetime employees) which *de facto* have similar claims and rights. Since commercialization may reduce substantially their claims and rights, those entities and insiders look at it as a government's attempt to repossess the enterprises.

Concerning the decision-making process, the purpose of ISOE reform has been to achieve a new balance between the authority and the responsibility of managers. The devolution of authority to managers has been the single most important ISOE reform since 1979, but this change created the need for new mechanisms to hold managers responsible. The new authority of ISOE managers has not been paralleled by the development of government bodies with an effective capacity to exercise control rights on the enterprises. Several attempts to develop these bodies have failed or are likely to fail, mainly because of the limited progress in the commercialization of the enterprises, aggravated by the bureaucratic tendency to take away too much authority from managers.

Given the many changes in the economy, the reallocation of ISOE assets (part 3 of Table 1) and labor (part 4 of Table I) to their most productive uses has always been a government's objective. To facilitate their reallocation, the central government has relied heavily on financing the expansion and diversification of the enterprises with loans from the state banks. Initially the dominant strategy was to reallocate assets and labor internally, but once its high cost became evident, there was a shift to reallocating them to other enterprises. The latter reallocation has been a major force for creating a great variety of enterprises (most not recorded as ISOEs in the official statistics), always avoiding the liquidation of the old state enterprises. Albeit difficult to assess, the outside reallocation of assets has led to the transformation of many ISOEs into holding companies with a large variety of investments in subsidiaries. Lately, the central government has encouraged this process further by facilitating the takeover of "bad" enterprises by "good" enterprises.

The evidence on the extent and success of the reallocation of assets and labor is still contradictory. On the one hand, the high growth rate of ISOE output in the past 17 years – for all industrial state enterprises, the gross value of output has grown at the rate of around 7% per year – and the large investment of ISOEs in nonstate enterprises – whose output has been growing at a rate much higher than 7% per year – are indicative of a huge and successful reallocation of resources and expansion of output capacity. Also, preliminary studies suggest that total factor productivity of ISOEs has been growing at high but declining rates. On the other hand, the potential for additional efficiency gains from resource reallocation may still be large. For example, the number of redundant employees in ISOEs, estimated at well over 10% of their work force, suggests a potential for large gains because of the relative high skills of these employees. For the reasons given in Table 1, it should be expected that this reallocation process will continue to move slowly. Moreover, since further resource reallocation requires fresh investment in fixed capital (less, perhaps much less, when the reallocation takes place outside the enterprise than when it is inside it), potential suppliers of capital are faced with the dilemma of financing this investment when it is difficult to condition effectively the use of the funds.

Indeed, the financing of the state enterprises has been critical for their reform (part 5 of Table I). Once the government shifted to bank loans to finance the enterprises, the hardening of their budget constraints became a serious issue. The idea of a hard budget constraint implies that the enterprise has strong incentives to take fully into account the *contractual* consequences of its financial obligations, but it assumes that the contracts are complete or at least it is well known to the parties how future conflicts will be solved (in other words, the residual loss of the contracts is minimal). In western countries, the idea of a hard budget constraint is a good approximation of the conditions under which most individuals and private organizations take financial decisions, although contracts are never complete and the parties always have doubts about how some future conflicts will be solved. Western government organizations may face a softer budget constraint than individuals and private organizations, but as shown by the ongoing experiences of many western governments, they can hardly ignore it. In China, notwithstanding the clear understanding of the idea of a hard budget constraint, the central government has been facing great difficulties to harden each state agency's budget constraint. The question then arises as to whether these difficulties reflect a view of contracts fundamentally different from the western concept, or simply they are the result of the central government's limited willingness or ability to enforce a hard budget constraint; because of the limited evidence to support any of the two ideas, none can be ignored.

Since the enterprises have been financed by the state banks, not surprisingly the limited success in hardening ISOE budget constraints has finally affected the quality of the banks' loan portfolios (see part 5c, Table 1). The enterprises could have raised more capital from sources other than the state banks if the government had authorized them to do it, but the central government has limited the enterprises' reliance on sources not under its direct control. Thus, the state banks have been the main source of outside capital to enterprises with budget constraints that only lately have been hardening, at a time in which the enterprises needed substantial amounts of new capital to finance their reform. This situation, rather than the poor economic and financial performance of the state enterprises, is the cause of the so-called bad debt problem.

Today it is widely believed that the pace of reform of ISOEs must be accelerated because of the large, sustained decline in their reported profits (this year the total net profits as reported by all state enterprises may be negative for the first time ever). Notwithstanding a positive view of some of the reforms implemented to make the enterprises more efficient and profit-oriented and some evidence suggesting important productivity gains, the decline in reported profits is taken as indicative of persistent structural weaknesses with a potential for a severe financial crisis, and therefore of the need for additional, radical reforms. The emphasis on reported profits and losses has led in particular to demands for liquidating chronic loss-making enterprises and for halting the reallocation of productive assets through the formation of subsidiaries until the central government succeeds in establishing effective governance structures.

The liquidation of chronic loss-making enterprises assumes an ability to identify them. Given the persistent poor quality of financial statements, the deficiencies of reported profits and losses as indicators of performance and the difficulties to evaluate the options to adjust to changing market and policy environments, it is very costly for anyone other than a few insiders to know well the conditions under which a particular state enterprise will be able to generate a cash surplus to service debts and therefore to assess its solvency. Thus, if liquidation is going to be a serious option, insiders must have strong incentives to do it. So far, the central government has shown no interest in providing such incentives for liquidating medium and large enterprises, but liquidation is becoming *de facto* an option for small enterprises because their insiders are increasingly able to appropriate the liquidation value.

To the extent that the reallocation of productive assets through subsidiaries has been a main reason of the high growth rate of industrial output, the process should be encouraged rather than halted. The government has been issuing strict rules to prevent the reallocation of productive assets because it is concerned about the loss of government revenue and the high probability that the state enterprise cannot pay back its bank debt.

The new rules are hardly enforceable, however, because of the interest of all insiders to ensure the reallocation of their assets to more productive uses.

3. Financial Reform and State-enterprise Financing

In this section, after reviewing the present structure of the financial system and how the financing of the state sector has been changing, I analyze the relations between ISOEs and the state banks. As background to the discussion, it should be noted that in China, sectoral flows of funds differ clearly from those of a market economy and other transition economies because the state still plays a critical role in mobilizing and allocating domestic and foreign capital. Figure 2 highlights the direction of the flows of funds between four sectors – two suppliers of capital (households and foreigners) and the other two net users of capital (state sector and nonstate enterprises) – as well as the complexity of the state sector, broadly defined to include all levels of government, autonomous state agencies, state enterprises and financial intermediaries. Another important difference between China and most other developing countries and transition economies is the large magnitude of sectoral flows of funds: in the past three years, households have been supplying to the other sectors over 17% of GNP and foreigners around 7% of GNP, which have been allocated mainly to the state sector (over 14% of GNP) and the nonstate enterprises (under 10% of GNP).

Since 1984, when its foundations were set, the new Chinese financial system has been growing rapidly and its institutional structure diversifying. Now the formal system consists of several types of deposit-taking institutions (to simplify, I call them banks) and securities and money markets. The system is still very much under government control, exercised through the People's Bank of China (the central bank), the State Planning Commission and other agencies, but also through ownership of most banks. For the purpose of this paper, only the banks under the direct control of the State Council are regarded as state banks; they have been intermediating around 70% of household deposits. Thanks to a large flow of household deposits (close to 14% of GNP in the past three years, with a projected average balance of 50% of GNP in 1996), banks are the main suppliers of funds to the state and nonstate enterprises. Banks, however, play a very limited role in the mobilization of foreign capital which comes mainly as direct investment. An informal financial system has been growing out of a very small base in the early 1980s, but it is still of little significance relative to the formal system.

The state sector has been running a large deficit (over 14% of GNP in the past three years) because of its high level of investment (around 30% of GNP in the past three years), including domestic investment in fixed assets and inventories, as well as the accumulation of international reserves and other investments abroad. In 1996, the average outstanding debt of the state sector is projected to increase up to 68 – 72% of GNP, including the domestic debt with households (54 – 56% of GNP, of which around 50% of GNP is in the form of deposits and the rest in the form of bonds), and the foreign debt. Although the central government's responsibility for this debt may be questionable, *de facto* it is ultimately responsible for most of it (the only clear exception would be the foreign debts contracted without an explicit central government guarantee). State enterprises and other state units which contracted these debts may have a primary responsibility for servicing them, and the central government must ensure that these final borrowers pay back their debts, but as long as the budget constraints of the state enterprises and other final borrowers remain soft, the central government will likely have to assume the repayment of some of their debts (even when this repayment is funded from the state banks' loan provisions, government funds are used).

In the past three years, the financing of the state sector has changed substantially, but large gaps in the rules governing the financing of different types of state units still remain. Figure 3 attempts to reflect the new rules, as well as the persistent uncertainties about the details of the relationships between the final borrower and the supplier of capital. There are three classes of state sector borrowers: the government and the state enterprises, with a distinction between enterprises whose ownership can and cannot be transferred to individuals or nonstate organizations. At present, it appears that only small state enterprises are alienable to individuals and nonstate organizations. In addition, two classes of nonstate enterprises are listed as borrowers, with one of them attempting to capture the special relation that some enterprises classified as collective and town/village have with local governments, in turn the source of preferential access to credit.

In Figure 3, the role of the state banks – a category consisting of the People's Bank of China (PBC), the three policy banks (SDB, ADB and the Ex-Im Bank), and the six largest commercial banks which are under direct control of the State Council – is divided into two main categories. The division depends on their objective: if it is simply to raise funds for the state sector then their role is that of a financial agent, but if it is profit maximization (even if constrained by other considerations), then their role is that of a fund manager. Each category is in turn divided into two types: when financial agent, the degree of autonomy is the important consideration because of the differences in services and skills associated with each type, and when fund manager, the type of claims on which the funds may be invested is the important consideration because of the differences in the institutions and skills needed for managers to succeed.

Today the government, as defined in Figure 3, borrows from the state banks for three different purposes. First, according to the Budget Law passed in early 1994, the government can finance its budget deficit only by issuing bonds and the banks can invest in these bonds. Apparently this year the banks are investing a significant amount of their loanable funds in government bonds, a change due to the limited options for the banks to invest the large inflow of household deposits and to the increasing liquidity of some government bonds. Second, the State Development Bank (SDB), created in April 1994, has been financing an increasing share of the annual plan of state investment projects, and this bank is in turn financed by nontradable bonds placed with the other state banks. This is a very important change in the financing of state investment because SDB (as well as Ex-Im Bank in its limited area of business) is authorized to review some projects and deny them financing. Indeed, it is too early to say how independent SDB will be. Finally, the old system of PBC relending of the bank reserves has been substantially reduced, but there is still some relending, in particular to finance the Agricultural Development Bank (ADB), the third policy bank created in 1994. In the past three years, PBC credit to the state banks net of their reserves with PBC has declined sharply, the main reason for the government's successful control of inflation; this net credit may become negative soon.

In Figure 3, at the other extreme of government as borrower, the category of other nonstate enterprises refers to borrowers which are truly commercial. This is a small but growing category; some branches of the state banks have been searching eagerly for commercial borrowers but they are still the exception. There are at least two reasons for the slow change in the commercialization of the state banks, the declared objective of their ongoing reform. First, despite the appearance of a huge amount of loanable funds, the state banks have very limited amounts of free funds for commercial lending because their loan portfolios are extremely illiquid and the large flow of new loanable funds has to be allocated to other uses, including direct credit and refinancing of interest payments on outstanding loans with the state enterprises. Second, the credit risk of new borrowers is still high because of the persistent deficiencies in property rights which make difficult to get good collateral, the lack of ability and willingness of prospective borrowers to disclose relevant financial information, and the banks' limited skills to evaluate the prospective borrowers.

Between the categories of government and other nonstate enterprises, there are three other categories in Figure 3. Today the differences between these three categories may not be significant; certainly, they are difficult to describe. In principle, all medium and large industrial enterprises (that is, all ISOEs) are in the category of unalienable state enterprises. This is a category of enterprises in which today the state banks play a role similar to SDB's role in the financing of state investment projects: usually the banks accommodate partly the enterprises' demands for new credit, but exceptionally they deny them any new credit, and certainly the banks have no choice but to roll over maturing loans indefinitely. As much as SDB does not play any role in the implementation of the investment projects, the state banks have no control right on nonalienable enterprises. Thus, there has been no attempt to establish a special system of information to allow the banks to monitor the enterprises; actually, it is not clear what information they can request from the enterprises. In sum, although the role of the state banks in the financing of nonalienable enterprises can no longer be described as that of dependent financial agents, it has not changed enough to be described as that of an independent agent.

The relations between the state banks and the two other categories of borrowers in Figure 3 are even harder to describe. Actually, the remaining borrowers may not fit into the two proposed categories; some other classification may be more appropriate. A category of nonalienable state enterprises is justified on the basis of an increasing differentiation in how state banks are related to state enterprises, and the important consideration may be the government's position with respect to the transfer of ownership outside the state sector. Also, a special category of nonstate enterprises is justified because of the direct involvement of local government in many of these enterprises, and the leverage of local governments in the management of the local offices of state banks. As recently as 1993 both categories of borrowers were related to the state banks the same way as the nonalienable enterprises, and the changes of the past three years may have increased the bargaining power of the state banks relative to alienable enterprises, and reduced the authority of local bank of officers to accommodate the demands of nonstate enterprises supported by local governments. The changes have yet to lead to well-defined relationships, however, and the review must necessarily be very tentative.

4. Commercialization: A New Relation between Banks and Enterprises?

In this section, I argue that the ongoing reforms of the enterprises and the banks will have little impact on the relation between them. Notwithstanding the loose control system of the state sector, the government has insisted on maintaining state ownership of enterprises other than the small ones and the banks, as well as on transforming both of them into profit-oriented organizations. The question of how the state enterprises will be financed after the state banks become commercial enterprises has not been addressed directly, implying apparently that this relation would be totally on commercial terms. I discuss first the long-term implications of the status quo, which assumes that the government does not implement any new reform other than those already announced, second the implications of a successful commercialization of both the enterprises and the banks, and finally the serious obstacles to transforming the enterprises and banks into profit-oriented organizations.

The review in sections 2 and 3 showed how much ISOEs and state banks have changed, but they also hinted at how much both would have to change to become commercial enterprises. Since the enterprises and the banks are changing as a result of reforms already implemented, it may be of some interest to speculate about what could happen if the government decided to do nothing else. Albeit impossible to assess, the potential for new spontaneous changes arising from the reforms already in place has not been exhausted. This potential depends heavily on a critical mass of local government officers, bureaucrats, managers and professionals eager to take advantage of the new opportunities created by the reforms; however, whether a given mass is critical or not cannot be judged *a priori*. Thus, there would be two possible scenarios:

a) If a critical mass emerged, the mass should be able to bribe or ignore potential losers and to implement their investment and production plans with the financial support of the state banks. If successful, these plans would imply high growth rates of output and the possibility of growing out of any distributive problem (e.g., the problem posed by the repayment of bank loans if the enterprises failed to pay back their debts despite their good performances), but if the plans failed, either the government would undertake new reforms that would depend on the diagnosis at that time, or conflicts of interest would dominate as in the second scenario.

b) If a critical mass failed to emerge rapidly, conflicts among the state agencies, ISOE insiders and bank managers with *de jure* or *de facto* residual claims on the cash flows generated by the units under their direct control or management would become serious, leading to a slowdown in resource reallocation and investment. In this scenario, sooner or later the government would intervene to prevent a breakdown in social order and/or restore high economic growth, and the only question would be about the form of this intervention.

The two scenarios highlight the dilemma facing the government today. If the government opposes the *de facto* takeover of the enterprises and the banks by a critical mass of local governments, bureaucrats, managers and professionals, the conflicting interests of state agencies and insiders will likely lead to a serious slowdown of economic growth. The takeover is not a guarantee of high rates of economic growth, but the experience of the past 17 years, particularly the past three years, supports the view that it may be a necessary condition. There are at least two economic reasons for the government to oppose such takeover: the loss of budget revenue and the probability of a financial crisis. Both reasons reflect distributive considerations but also a concern for the efficiency losses caused by distributive conflicts (e.g., the government may fail to raise revenue from other sources and therefore to provide public goods which at present only the government can do, or the conflicts of interest in a financial crisis may lead to a serious disruption of the functions of the financial system). Since the government cannot afford to oppose the takeover and let conflicts of interest threaten economic growth, it must respond and a sensible response is to ensure it will share in the benefits of the takeover of enterprises and banks.

The proposed commercialization of the enterprises and the banks may be seen as a government's attempt to share in the benefits of the enterprises and banks taken over by that critical mass. For commercialization to succeed, there should be an effective separation of ownership, control and management, implying well-defined functions for the residual claimants, the control bodies and the managers of each enterprise and bank. Moreover, for commercialization to succeed, each enterprise and bank should be a separate legal entity, with well-defined property rights on their assets, including the protection of contract and tort laws. These conditions amount to expect that China's state enterprises and banks resemble closely the textbook description of a business world inhabited by modern corporations under the rule of law, with the American model or some other variant as a second best. Indeed, in any variant of this business world, the relation between each bank and each enterprise would be entirely on commercial terms, but this relation assumes that state ownership of both parties does not amount to a common objective, even if it is profit maximization; otherwise, there should be some coordination mechanism at a government level higher than the enterprises and the banks (like in complex multi business groups in western countries).

A successful commercialization will change the role of state banks as in Figure 4. In comparison with Figure 3, the policy banks will be independent financial agents with no intervention of PBC in the process of funding these banks, and more important the other state banks will be fund managers able to invest mainly in nontradable claims (i.e., loans) and a limited variety of securities (mainly bonds issued by the government, the policy banks and perhaps a few nonalienable state enterprises). The relation between the state banks and each of the four categories of enterprises will not differ, implying that for each bank the distinguishing characteristics of these categories are no longer relevant. Any new classification of enterprises, of borrowers in general since the banks will be able to lend to individuals and nonprofit organizations for nonproductive purposes, will be based on each bank's lending policy and will be its own decision.

Given the initial conditions, the reform can hardly succeed. Even ignoring the challenge of reforming the internal structures of each of the state banks, some of which employ a few hundred thousand employees and own a network of a few thousand offices, there are good reasons to conclude that the process can hardly succeed. First, despite the attention paid to the development of institutions and skills as a critical prerequisite for the commercialization of the enterprises and banks, the task is much bigger than anticipated. The enactment of laws means little when the new rules of conduct and organization are alien to prevailing social values and behavioral patterns (e.g., western ideas about the disclosure of relevant information about the enterprises as a key element in a fiduciary relationship, or about the ranking of classes of claims in the organization of a bankruptcy procedure). If the laws are going to be enforced cost-effectively, to some extent they have to follow rather than lead the evolution of values and behavioral patterns, which in turn implies that there is no certainty that the emerging legal framework will be supportive of the corporation or any other particular organizational form. In addition, except for some mechanical skills, the development of skills is not independent of the process of institutional development, and occasionally the latter is influenced by the former; indeed, the formation of lawyers is the best example of this interaction. The magnitude of these tasks is easy to underestimate, especially if little attention is paid to the implications of the size and complexity of the Chinese economy.

Second, in all reform processes there is a potential for serious conflicts of interest. In China, as shown by the experience of the past two years, the pace of reform is necessarily slow because it demands the development of institutions and skills, but the longer it takes to succeed, the higher the probability of serious conflicts of interest. The government is then faced with the dilemma of intervening early to contain these conflicts, an intervention likely to be viewed as a step backward in the reform process, or dealing later with the consequences of much larger conflicts, an intervention likely to require severe punishment of some parties and compensation of the losses suffered by others. So far, the government has opted for intervening early, but given the time it will take the process to succeed, the government's ability to fine-tune the situation and its commitment to the reform will be challenged for a long time.

Third, the liquidation of chronic loss-making (or insolvent) enterprises is a serious instance of conflict of interest. Insiders may be benefiting greatly from subsidies that allow these enterprises to keep going. Even if the government is willing to subsidize some of these enterprises to achieve a noncommercial objective, there are many others which are insolvent and the government is no longer interested in subsidizing them. The identification of the latter enterprises has little to do with the reported losses of the past few years and a lot with analyzing their prospective cash flows, but their managers have no incentive to disclose accurate information on which to base this analysis. Because of its concern for the impact on employees, so far the government has rejected plans which could bring about massive liquidation of enterprises, taking then risk of diverting funds from profitable enterprises to loss-making and other profit-making enterprises (very likely, due to the serious difficulties to know the true conditions of the enterprises, most subsidies intended to assist insolvent enterprises are benefiting enterprises which at worst are financially distressed).

Fourth, even if commercialization succeeded, the assumption that state enterprises and state banks do not share a common objective would hardly hold. State ownership may be justified by reasons of public interest and efficacy in the pursuit of this interest, or simply as a means of budget revenue. In western countries, the few instances of state ownership are justified mainly by the public interest, but governments usually rely on regulation and incentives as the most effective forms of intervention; more important, any intervention is usually justified on a case-by-case basis, despite references to general ideas of the public interest. Even when the political and administrative organizations of government make the coordination of all three forms of intervention (ownership, regulation and incentives) difficult, it is always in the interest of the ruling party to ensure some coordination. In China, despite the appearance that state ownership has become mainly a means to raise budget revenue, the pursuit of public-interest objectives will continue to be an important rationale for state ownership and there always will be a need for coordinating the activities of state enterprises and banks. If commercialization succeeded, the enterprises and banks would no longer pursue multiple objectives, but managers would be asked to maximize profits under constraints that reflect the public-interest objectives of state ownership; in particular, bank managers would be very much constrained on their activities, even if instructed to maximize profits. In addition, whereas in western countries government-regulatory constraints on profit-maximization by private corporations are largely in the form of rules with limited discretionary authority of administrative bodies, in China public-interest constraints on profit maximization by state enterprises and banks would continue to be largely the result of discretionary actions of state agencies.

Finally, even if public-interest constraints on profit maximization were not severe, state ownership of the enterprises and the banks would raise the opportunity of noncommercial relationships among them. The strength of the relationships would depend largely on the values and interests shared by the controllers and managers of the enterprises and banks, and depending on their strength they could affect the financial transactions between them. In western countries, the transformation of family businesses into complex multibusiness groups, which typically requires the mobilization of large amounts of capital external to the family, is an example of how personal relationships condition financial transactions: to mobilize capital external to the family and maintain total control of the operating units, the family needs to control important sources of capital, usually deposit-taking institutions. Within these complex groups, the relationships between their own bank(s) and their other businesses may be seen as a solution to the incentive problems of financing the latter with external capital (these problems are largely the result of asymmetrical availability of information between the two unrelated parties to a financial contract), but in principle the solution amounts to transfer the problems to the financing of the bank(s), and proper regulation and effective supervision of the family-owned bank(s) are then needed to solve the incentive problems. The phenomenon of related (or connected) lending, common to complex groups which own deposit-taking institutions, has been an important source of excessive risk taking and consequently an important subject matter for the prudential regulation of banking. If commercialization of the China's state enterprises and banks succeeded, the potential for related lending between them would indeed be large; actually, given that today there exists too much related lending (albeit largely imposed by the central government or supported by local governments), only if both parties were given explicit and clear instructions about the constraints to their future relations, a radical change in the relation would take place. So far, the government has avoided to give such instructions.

5. A Proposal for a New Relation between the Enterprises and the Banks

In this section, I outline a proposal for reforming the relation between the state enterprises and banks which takes account of the initial lessons drawn from ongoing reforms. Since the relation must be seen in the broader context of ISOE and financial reforms, I argue for approaching these reforms on the basis of a clear distinction between at least two sets of ISOEs. The relation of state banks with each of the two sets should differ substantially; for one set the relation should be based on the idea of banks as independent financial agents, and for the other on the idea of banks as fund managers. I then outline a proposal based on this distinction.

The success of many reforms notwithstanding, the government still faces the dilemma of establishing an effective system of control over state-owned enterprises and banks while at the same time consolidating and expanding the authority of their managers. The reforms, especially the devolution of authority to managers, have already brought about a large resource reallocation and expansion of productive capacity with important efficiency gains and increases in output. The government, particularly the central government, is not benefiting much from these developments because deficient control systems have allowed state agencies and insiders to appropriate most of the cash surplus generated by the enterprises and banks. Moreover, since the state banks were originally designed to be only financial agents of the state with little or no autonomy, they still have a limited capacity to assess the financial performance and solvency of the enterprises, and they have not succeeded yet to transform themselves into at least independent financial agents. In the meantime, the banks have been lending heavily to the state enterprises and now their own solvency is very much tied to the solvency of these enterprises. Not surprisingly, the possibility of a financial crisis cannot be ignored, even if it is unlikely in the next few years.

The banks could be free of the responsibility of financing the enterprises, indeed. At any time the government could sever the relation and assume the outstanding debts of the enterprises with the banks. This extreme action would solve little, however, unless the government provided a) the enterprises with new sources of financing, and b) the banks with good claims in exchange for their outstanding loans to the enterprises. Whereas **a** aims at solving a flow problem (i.e., the future financing of the enterprises), **b** aims at solving a stock problem (i.e., the legacy of past borrowings), and many experiences of financial crises have shown that the solution of the flow problem is a prerequisite to solve the stock problem (otherwise, there would soon be another stock problem). Since the government supports the continuation of state-bank financing of the state enterprises, the reform of their relation amounts to solving the flow problem.

In section 4, I described the commercialization of the enterprises and banks as a radical transformation into separate corporations doing business purely on commercial terms. Despite the attractiveness of the model of western corporations, I then argued that the transformation would fail, but even if successful, the relation between enterprises and banks would not be based exclusively on commercial terms. In addition, I argued that the government had no choice but to intervene because the status quo could bring about very undesirable results. Between these two opposites – a radical transformation and the status quo – there are a variety of options based on some classification of the large number of enterprises into a few categories and therefore on different relations between the state banks and each category.

Given the large number and organizational complexity of the state enterprises, some classification is a prerequisite for any reform. The classification should reflect the specific objectives of state ownership. In Table 1, the objectives are classified into three categories: a) several objectives, of which one is profit maximization and the others depend on industrial and social policies; b1) constrained profit maximization for government's general revenue; and b2) constrained profit maximization for earmarked revenue. A classification can then be based on distinguishing between the three categories, or between the first one and the other two (which share the single objective of profit maximization), or the first two categories and the last one, under the assumption that **b2** consists of enterprises which have been taken over by state agencies with different degrees of autonomy (for example, the universities). Independent of which particular classification appears appropriate, the government should prepare a positive list with the enterprises which is ready to protect, for example, a list satisfying either **a** or **a + b1**. To simplify, in the following discussion, I assume that the government has put together a positive list of 1,000 enterprises (the exact number is not important as long as it is kept low relative to the total number of ISOEs) and there are then two categories of ISOEs: the ones in the positive list – equivalent to the nonalienable enterprises of figures 3 and 4 – and the others, the alienable enterprises.

The reform of the control systems should differ substantially for the two categories of enterprises. While the effective control of nonalienable ISOEs by a government agency should be a priority, the control of the other ISOEs should be left largely to market forces which means that eventually their ownership could be transferred (i.e., they are alienable). In principle, the organizational form of nonalienable ISOEs should make no difference to the government's commitment to regain effective control of their management. Actually, most nonalienable ISOEs would likely be those for which the government has been able to keep a high degree of control, relative to others, because of its strong interest in their performance. To regain this control fully, it should be feasible to reform the existing agencies rather than to develop new complex structures; if their reform were not possible, it would be better to grant control rights to the state bank responsible for financing these enterprises.

The financing of nonalienable enterprises should emphasize the similarity with the financing of other government programs and projects (see the top of Figure 4). Because of the government's guarantee of the financial obligations of these enterprises (presently it would not be credible to say that these obligations are not guaranteed by the government), their financing should be shifted to a special institution, as the State Development Bank is now responsible for financing investment projects. Specifically, one of the existing state banks should be given the responsibility of financing these enterprises and denied any other role in the economy. Indeed, this bank would be at best an independent financial agent rather than a fund manager: its function would be to mobilize cheap capital for the nonalienable enterprises. In comparison with Figure 4, this would imply that nonalienable enterprises cannot be financed by commercial banks (through loans or bonds) but by a financial agency similar to the policy banks (there would be a need to clarify the role of SDB in the financing of the enterprises' investment in fixed capital). The financial agency could have some control rights on the enterprises (for example, ratification of their annual budget) but this would depend on the responsibilities given to other government agencies.

Although the control and financing of nonalienable enterprises should be the central focus of ISOE reform, the government has also to create the conditions for improving the control of the management of alienable ISOEs by market forces and hardening their budget constraints. For these purposes, the government should make easy a) for state agencies with control rights to transfer these rights to other state agencies and to any other organizations and individuals; b) for creditor state banks to take over temporarily the enterprises that fail to service their debts (the takeover should be the outcome of an expedient administrative process rather than a judicial one), and c) for other creditors to be paid back through judicial processes, in particular a cost-effective bankruptcy process. For these reforms to be effective, however, the insiders should have strong incentives to cooperate or participate; given the initial conditions, they should be rewarded for taking the initiative to restructure and even liquidate the enterprise. The insiders should be able to collect most of the benefits of restructuring the enterprises or most of the proceeds of liquidating them, but this should be a temporary incentive (for example, they must take the initiative in the next three years); moreover, this positive incentive should be complemented by a negative one: the strict prohibition of contracting new credits before finishing a restructuring agreement with the state banks (the prohibition would be enforced by denying legal status to the new obligations).

The relation between the state commercial hanks (other than the one assigned to finance nonalienable enterprises) and the alienable enterprises will then change greatly. Initially – when insiders would be rewarded for taking the initiative – the banks would have to focus on restructuring their old loan portfolio (these banks would have to sell their loans to nonalienable enterprises to the bank responsible for financing these enterprises at the very beginning of the reform, and the latter would pay with its own claims on alienable enterprises). To illustrate the idea, each bank could have two credit departments – one would manage the old portfolio and the other the new one – but after renegotiating their debts the state enterprises would be shifted from the old to the new credit department (the latter would also have the responsibility of financing all new borrowers). In this initial period, the enterprises should have strong incentives to reach a restructuring agreement rapidly whereas bank management should have incentives to reach a final agreement, that is, one good enough not to have the need to do it again. In this period, liquidation should be a good option for ISOE insiders, and takeover a good one for the banks. After the restructuring of the bank debts, the relation between the banks and the enterprises should be largely on commercial terms, but this would depend largely on the independence of banks from government intervention, the capacity of bank management to allocate funds on commercial terms, and the options the enterprises have to raise capital, as well as on the strength of market control of ISOE management.

In sum, the proposal outlined above amounts to distinguish two types of state enterprises, each one with its own relation with the state banks. Nonalienable enterprises identified in a positive list would have access to a special financial facility (one of the existing state banks which would be given only this responsibility) but the government would regain control of their management. The remaining enterprises, on which at least control rights would be alienable, would be financed by the state commercial banks (but not by the bank responsible for financing the nonalienable enterprises) in competition with other potential suppliers of capital, but during the next few years these enterprises would have to reach a restructuring agreement with the banks and until they reach this agreement they would not be able to get additional credit from any source (to avoid a liquidity crisis until the agreement is reached, in the meantime the enterprises could be allowed not to pay interest on their debts with the state banks). The success of the proposal would depend mainly on the government's ability to prepare a positive list of nonalienable enterprises, which would amount to redrawing the boundaries of the state sector; the independence of financial agents of the state sector (including the policy banks and the bank responsible for financing the nonalienable enterprises); the effectiveness of the incentives for insiders of alienable enterprises to reach rapidly an agreement with the banks or to liquidate the enterprises; and the pace to which the state banks are able to transform themselves into fund managers (their transformation should be facilitated greatly by separating the nonalienable enterprises and giving strong incentives to alienable enterprises to take the initiative for choosing between financial restructuring and liquidation).

Table 1

The Direction of ISOE Reform

Area of reform	Status	Reform
1. Commercialization		
1a. Legal status	After Enterprise Law of 1988, all enterprises are separate legal entities. A Company Law became effective in July 1994, but so far has been applied to few enterprises. The Company Law does not provide with an exhaustive list of acceptable forms of organization, and its application is limited by the need to issue additional regulations relevant only to state enterprises and to identify the specific government unit(s) which will be the shareholder or investor.	Many ISOEs expected to be transformed into corporations according to the provisions of the Company Law and related regulations; these enterprises may have more than one class of shares and shareholders (or investors). Some expected to have a special organization form in which the state will be the only class of residual claimants. Few expected to be transformed into cooperatives or other forms in which the insiders will be the only class of residual claimants.
1b. Ownership (residual claims)	*De jure* only two classes of residual claimants: the state represented by a finance bureau at different levels of government, and state agencies (including government units, autonomous agencies, and other state enterprises) recognized as separate legal entities for purposes other than ownership of the enterprise. Most enterprises are owned by only one of the two classes of claimants. Finance bureaus collect nontax revenue from the enterprises for general purposes (usually they are responsible for preparing the budget at their level of government), and the state agencies collect it for their own purposes (they cross-subsidize their main activities with revenue from their enterprises). *De facto* two other classes of residual claimants; the insiders (i.e., the lifetime employees of each enterprise), and other state agencies to which the enterprises make regular payments based on their performance (or on cash flows).	Well-defined residual claims assigned to finance bureaus and state agencies recognized as legal entities, and exceptionally to private investors with a minority interest. In some medium enterprises, insiders may become the main (perhaps the only) class of residual claimants. Strict prohibition of unauthorized state agencies to collect payments from the enterprises.
1c. Objective(s)	Today the enterprises appear to pursue (a) several objectives, of which one is profit maximization and the others depend on industrial and social policies, or (b) profit maximization as the only objective but constrained by directives that reflect other objectives. The latter can be divided into (bl) constrained profit maximization for government's general revenue (when the finance bureau is the claimant); and (b2) constrained profit maximization for earmarked revenue (when a state agency other than the finance bureau is the claimant). Relative importance of the 3 groups hard to assess but each group includes at least 20% of the enterprises. Achievement of objectives conditioned by conflicts of values between government units in the pursuit of (a), and by conflicts of interests between all residual claimants in the pursuit of (b).	Most will pursue (b), either (bl) or (b2), with a few allowed to pursue (a). A necessary condition for changing from (a) to (b) is that the government's discretionary powers to intervene in ISOE, management is effectively limited. Choice between (bl) and (b2) will depend on government's ability to reform the financing of the activities now cross-subsidized and limit the need for ISOE revenue to finance them.

Area of reform	Status	Reform
2. Decision-making process 2a. Management – Initiative	Devolution of authority to managers, the most important reform of the last 17 years. In 1988, introduction of the contract responsibility system which granted authority in many areas but on a case-by-case basis. At the peak, this system covered 90% of the enterprises, but it was discontinued in early 1994. Devolution process culminated in 1992 with the issue of the State Council's decree on management rights to be applicable to all enterprises, including the rights to decide on: the quantity and composition of outputs and their prices; the hiring of workers, the management of personnel, and the compensation of personnel; the purchase of goods and materials and their prices; the sale of output; imports and exports; investment; the distribution of retained profits; the disposal of assets; the participation in joint ventures, mergers and acquisitions; the internal organization of the enterprise; and the payment of contributions to state agencies other than those established by law. Decree has yet to be fully and effectively implemented, but great progress in most areas.	Full implementation of the State Council's decree but effectiveness conditioned on (a) closure of low-level and sectoral government units that had the authority to take initiatives before the decree but which would become obsolete if the decree were strictly applied, and (b) establishment of acceptable and effective governance structures (see 2b and 2d).
2b. Control − Ratification	After the 1992 decree on management rights, shared *ad hoc* between management and low-level and sectoral government agencies that had authority on the enterprises. Important decisions about the expansion, diversification, downsizng and reform of enterprises ratified by high-level government agencies, and exceptionally by the State Council.	Depending on new organization forms, the responsibility may be shifted to a board of directors (corporations), a special government bureau, or a committee of insiders (plans to shift it to a Japanese-style main bank have been discussed but not approved). A two-tier system may be introduced, including both a board of directors and a special government bureau with authority to oversee a group of enterprises. Better definition of decisions that must be ratified by high-level government agencies and the State Council.
2c. Management – Implementation	Traditional responsibility of managers but substantially expanded with the reforms. Many enterprises have been restructuring their internal structures of authority, incentives and information to improve implementation of decisions. In most enterprises, still ample room for further improvements in these areas.	Other reforms will be an incentive for managers to continue to improve the internal organization, even if this means layoffs of redundant workers. In particular, effective application of State Council's decree on management rights will allow further experimentation with internal structures.
2d. Control − Monitoring	Several *ad hoc* administrative and political processes to punish managers for poor pcrformance and occasionally to reward them for excellent performance, but lack of systematic review. Deficiencies in accounting systems (despite the tentative introduction of new standards) and reluctance to disclose information make this review very costly. Special processes when suspicion of wrongdoing.	Responsibility shifted to the same bodies responsible for ratification, but still complemented by better-defined administrative and political processes for occasional review of performance. All reviews conditioned on progress to implement effectively international accounting standards and to force disclosure of relevant information. Not clear yet which role the financial system (either the state banks through the idea of a main-bank system or the stock market) may play in controlling managers.

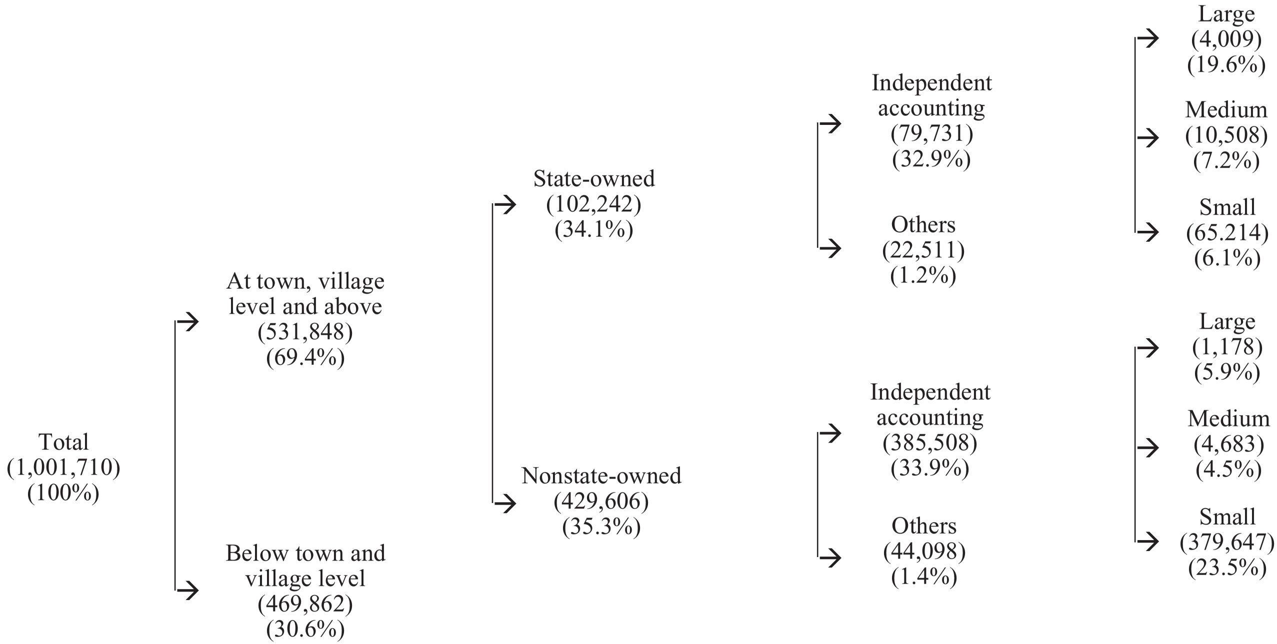
Area of reform	Status	Reform
3. Reallocation of productive assets 3a. Inside the enterprise	Until early 1992, the dominant approach to reallocate assets, leading to both important changes in the composition of output and the introduction of new technologies. In many enterprises, especially when the demand for old products declined sharply, if demanded a substantial fresh investment in fixed capital to increase the productivity of lifetime employees.	Still encouraged by government policies, but few enterprises likely to benefit from further internal reallocation of resources. The main constraint to its effectiveness is the high fixed capital investment needed for labor productivity levels to justify the present compensation levels of lifetime employees (the conversion of military industries to civilian production best but extreme example of this problem). Only if there is a substantial reduction in the compensation of lifetime employees, it will be important again.
3b. Outside the enterprise	Increasingly important until early 1992, thereafter the dominant approach. Facilitated greatly by ISOE access to domestic capital, many assets have already been reallocated to new subsidiaries, some as joint ventures with domestic and foreign investors and therefore classified as nonstate enterprises, as well as through leasing and sale. Also some lifetime employees (or their children when entitled to a job in the old enterprise) reallocated lo new enterprises or employed on temporary basis outside the enterprise through labor services companies. Indebtedness associated with this reallocation may become a serious problem if subsidiaries do not transfer revenue to their parent enterprises which are responsible for the debts with the banks.	Growing concern about this reallocation due to the loss of government revenue as owner and tax collector and to difficulties to collect the debts contracted by ISOEs with the state banks. No clear strategy as to how to control it to take advantage of its potential for enhancing efficiency while protecting government's interests as owner, creditor and tax collector. Future significance depends on strength of management authority and the weakness of the governance structures.
3c. Liquidation	So far liquidation of medium and large enterprises has been avoided. Often argued that this is due to deficiencies of bankruptcy proceedings, but liquidation is not a bankruptcy problem. Avoided due to the difficulties to reallocate lifetime employees and to continue the provision of social services to them. The failure to liquidate enterprises that never will be able to generate profits is an example of sacrificing profit lo other objectives rather than constrained maximization of profits.	Only if lifetime employees have strong incentives to liquidate the enterprise, liquidation will be an option (for insiders, the value of a loss-making enterprise as an ongoing concern is determined partly by the potential to raise funds at less than market cost). Apparently no intention to provide such incentives. The strategy is to encourage profit-making ISOEs to take over loss-making ones which at least in the short run will reinforce the cross-subsidization of activities.

Area of reform	Status	Reform
4. Labor 4a. Lifetime employment	At the end of 1994, out of 66 million employees in all ISOEs, 75% were lifetime. In addition to its duration (lifetime), the relation is characterized by its broad scope (the employees' consumption opportunities depend on their "entitlements" to the enterprise's resources). Compensation based on a cash wage and a variety of in-kind benefits (housing, health, education and others) plus large deferred payments (pension, unemployment insurance and others), with the total annual labor cost determined by a fixed payment plus expenditures which vary with the enterprise's performance and cash flow (i.e., a residual claim). In many ISOEs, growing tension between the lifetime income expectations of the employees (much higher today than at any other past time) and the ability of the enterprise to meet them; in particular, increasing recognition of redundancy has led to job insecurity.	Stricter enforcement of the prohibition to hire lifetime employees. Renegotiation of the implicit contract with lifetime employees on a case-by-case basis with government's role limited mainly to provide social welfare services. Success of renegotiation process conditioned on this provision of services as well as on acceptance (legitimacy) of increasing disparities in the living standards of employees, inter and intra-enterprises.
4b. Social welfare	ISOEs always provided many social benefits as part of the compensation to lifetime employees. In the last 17 years, the portability of these benefits declined *pari passu* with the sharp increase in their value. Many benefits in the form of consumption goods already monetized, and some services transferred to local government agencies, but ISOEs are still main providers of social services to their lifetime employees. Increasing differentiation among cities with transfer of services much harder in company towns. Increasing recognition of difficulties to ensure financial viability of present social welfare services.	Transference of social services to government agencies. Main challenges: the conflict involved in reducing benefits and increasing contributions to ensure the financial viability of the new agencies, and the capacity to provide the services cost-effectively.
4c. Other employment relations	At the end of 1994, 25% of the employees in all ISOEs were contractual (apparently, most contractual employees were in medium and large enterprises). Since 1985, contractual employees have been the main source of employment growth in the state sector. They are hired under contract for a fixed term or the duration of a project. The flexibility of contractual employment may have aggravated the redundancy of lifetime employees.	Any growth in employment will be based on contractual employment. In addition, whenever there is a need or opportunity to replace current lifetime employees, managers will rely on contractual employees: thus their share in total employment is likely to increase.

Area of reform	Status	Reform
5. Financing		
5a. Budget constraint	Increasingly hardened but not hard enough yet to be strictly binding. A soft constraint means that *ex post* cash-flow deficits can be financed by (a) defaulting obligations under the presumption that it is costless, and/or (b) raising funds unconditionally at less than the market cost of capital. ISOEs have been learning that default is costly (notwithstanding the large increase in arrears during the past three years) and additional capital can be raised only at its market cost (indeed they are raising little capital at this cost) or at less than this cost but conditioned on reforms. Budget subsidies have declined sharply and now are of little significance.	Increased emphasis on hardening the budget constraint, for which both the development of cost-effective judicial proceedings to collect debts (including a bankruptcy proceeding) and the legal definition of the sources and terms of outside financing are necessary conditions. State banks will tighten further their conditions to finance ISOEs, but conflicting signals about the *ex post* deficits which the government may finance unconditionally through the budget and the banks.
5b. Outside sources	Since 1984, state banks have been the main source of financing and now most enterprises have accumulated a large debt with them. *De facto* the loans have no maturity and the banks' main concern is the conditions under which interest payments should be refinanced. Very limited reliance on commercial sources of financing but in the last three years large accumulation of arrears with suppliers. In 1993, it was believed that capital markets could provide an alternative source of funds to the enterprises, but despite the listing of some enterprises in the local exchanges and the Hong Kong exchange, it has been of little significance.	Although new experiments based on alternative sources of financing should be expected, the state banks will continue to be the main source. No clear plan to reform the relation between the state banks and the enterprises. The passing of the negotiable instruments law should facilitate the development of commercial paper markets.
5c. Financial restructuring	Widely believed that the bad debts of the enterprises with the state banks have been mounting and already exceed 20% of the banks' loan portfolios. Evidence however is weak; no attempt to analyze borrowers' repayment capacity and strong incentives to claim financial distress. The main evidence of financial distress is the rapid accumulation of debts with the banks.	Government committed to a piecemeal approach to debt relief: it will attempt to identify critical situations and provide with some form of relief: this approach may aggravate the problem by encouraging the enterprises not to repay their debts.

Figure 1

China's Industrial Sector



Note: In paranthesis, number of enterprises and percent share of gross value of industrial output at current prices (in 1994, GVIO amounted to RMB 7,691 billion).

Figure 2

China: Direction of Flows of Funds

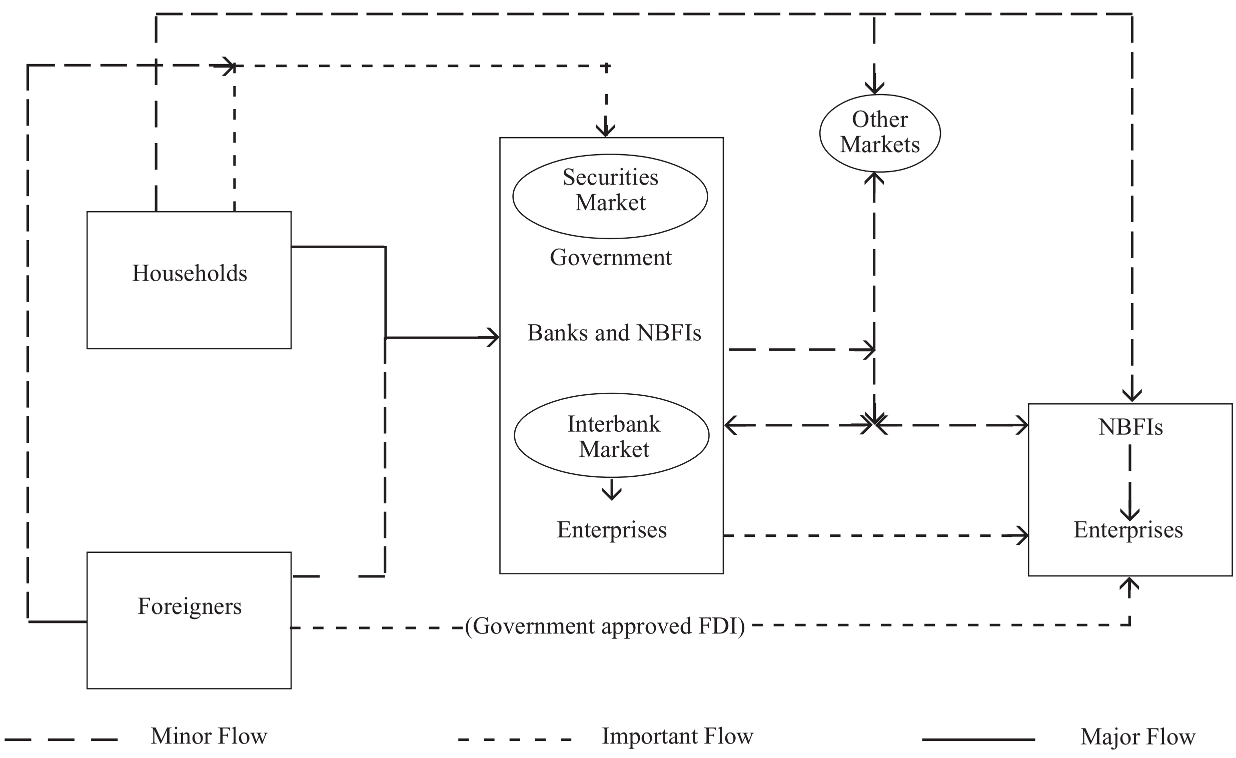


Figure 3

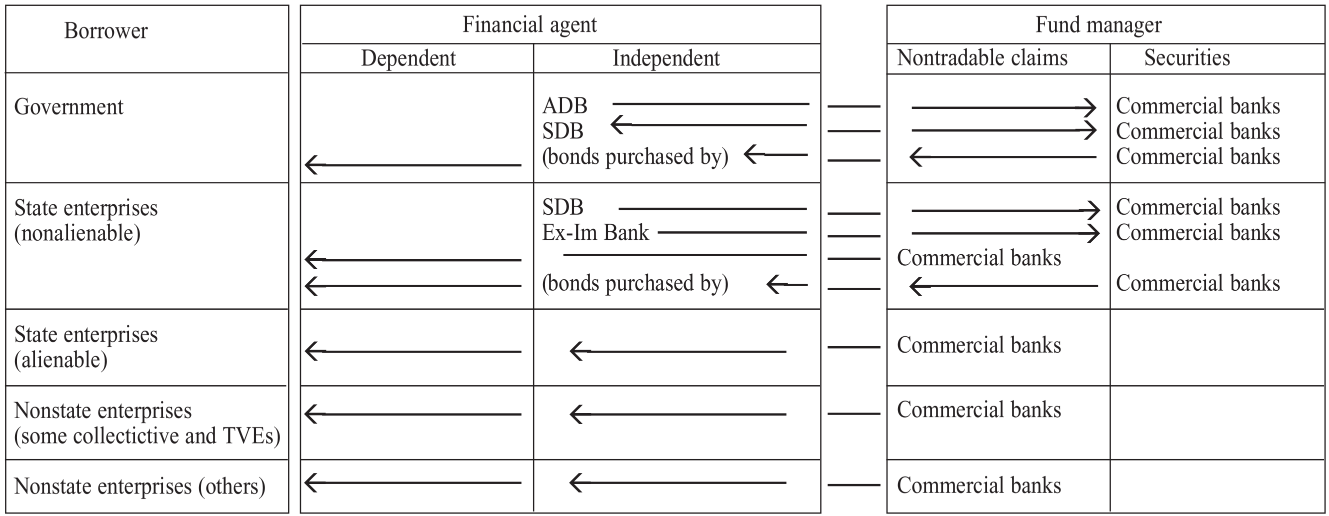
The Role of State Banks – Status

Borrower	Financial agent: Dependent	Financial agent: Independent	Fund manager: Nontradable claims	Fund manager: Securities
Government	ADB ← PBC SDB(?)	SDB (?) (bonds purchased by)	Commercial banks Commercial banks	Commercial banks
State enterprises (nonalienable)	SDB (?) Ex-Im Bank (?) Commercial banks (?)	SDB (?) Ex-Im Bank (?) Commercial banks (?) (bonds purchased by)	Commercial banks Commercial banks Commercial banks	Commercial banks
State enterprises (alienable)		Commercial banks (?)	Commercial banks	
Nonstate enterprises (some collective and TVEs)		Commercial banks (?)	Commercial banks	
Nonstate enterprises (others)			Commercial banks	

PBC – Peoples's Bank of China (Central Bank)
ADB – Agricultural Development Bank
SDB – State Development Bank
Commercial banks: ICBC, CCB, ICB, BC, ABC, BOCOM, CITIC

Figure 4

The Role of State Banks – Reform



ADB – Agricultural Development Bank
SDB – State Development Bank
Commercial banks: ICBC, CCB, ICB, BC, ABC, BOCOM, CITIC

Amendments and Additions to the Law on Banks and Credit Activity

by Valeri Dimitrov

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In May of this year, Amendments and Additions to the Law on Banks and Credit Activity (LBCA), as published in the State Gazette, issue 42 of 15 May 1996, were quickly passed and came into effect.

Amendments and additions to the LBCA are substantial. Their detailed analysis within the framework of a short article is impossible, so here we shall dwell upon some of the most substantial amendments and additions to the legal regime.

General Characterization of the Law on Banks and Credit Activity

An essential feature of the LBCA is that it is a *public law*. The regulation it contains is, as a whole, of imperative and public nature at that. Our law on banks comprises above all administrative prohibitions and obligations addressed to the banks and other participants in commercial bank activities.

Such prohibitions include, for example, that against conducting bank activities without permission, which is at the basis of the public regulation (Article 1, para. 1, Article 17, para. 2, item 5, and Article 58, para. 2), and that applying to big bank loans – regarding the extension of a big loan to one person, or to economically related persons, which exceeds 25 percent of the own funds of the bank, as well as the total amount of the big loans exceeding eight times the own funds as found in Article 28. In addition, prohibitions apply to internal loans both regarding the offer of preferential conditions to persons connected with the bank (Article 41, para. 3), and exceeding the limits of the loans (Article 41, para. 2, item 1, paras. 4 and 5). There are also prohibitions against investment in nonbank enterprises (Article 17, para. 2, and Article 29).

Administrative obligations include that of the bank to maintain own funds in the specified (adequate) amount, structure, and ratios to balance sheet assets and liabilities (Article 21). Banks are required to keep minimum liquid assets (Article 23), and to observe the maximum differential between foreign currency assets and liabilities, or open currency positions (Article 25). In addition, banks must classify uncollectable and doubtful loans, and allocate and maintain mandatory special reserves (statutory provisions) to cover the risks on them (Article 26), as well as announce and apply to the customers of the bank general terms and conditions for deposits and loans with contents specified by the law (Articles 33 and 34).

The administrative nature of the prohibitions and obligations provided for in the LBCA is such that their enforcement is secured by the bank supervisory body in its capacity as the specialized body of administrative control. Respectively, violations of statutory prohibitions found by it and failure to meet obligations are sanctioned by administrative enforcement and administrative penalties (cf. Article 56, para. 1, items 1 – 7, Article 58, paras. 1 and 2).

The public nature of the legal regulation ensues directly from the LBCA. Prohibitions and obligations underlying it, as well as the supervision exercised for their observance, aim at regulating to acceptable levels the risks inherent in bank activities. With money attracted from a wide circle of people, banks perform activities as tradesmen, and effect noncash payments in accounts. Uncontrolled increase of risks in their activities can seriously infringe upon the rights of the depositors, the security of the payment process and the banking system as a whole, and hence the interests of the national economy. Thus the LBCA, through the regime of the prohibitions and obligations it contains, its supervisory nature, aims to protect the security of the deposits, of the payment process, and of the banking system. From this point of view, the LBCA is a *protective law.*[1]

Besides being protective, the LBCA is also a *supervisory law*. A separate set of provisions regulates the supervisory process, and more specifically the powers of the supervisory bodies, and the administrative procedures within the framework through which these powers are exercised. There are provisions regarding powers and procedures for issuance of a bank license (Articles 9 – 15, Article 88, para. 1), obligations to notify the central bank (Articles 48 and 49), those regarding both on-site inspections (Article 55) and administrative enforcement.

General Outline of the Regulation of Bankruptcy of Commercial Banks

The first issue to be emphasized with regards to the regulation of commercial banks is that the amendments and additions to the LBCA highlight its nature as a supervisory law. A substantial part of the amendments and additions are directly concerned with supervision, extending considerably the scope of its application, providing for new powers and procedures (cf. provisions contained in § 9 – 11 of the Amendments and Additions to the LBCA).

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[1] According to the American author Kenneth Sprong, the primary purposes of state regulation of bank activities are the protection of depositors, stability of the monetary system, influence in order to secure efficient and competitive financial system, and protection of consumers of bank services. (cf. Sprong, K. Banking Regulation, Its Purposes, Implementation and Effects. Kansas City, 1994, pp. 5 – 11).

At the same time, a new functional characteristic was given to the LBCA. Besides being a protective and supervisory law, it is also a *special law on bank bankruptcy*. In the amended and supplemented law, a special new chapter fourteen was added, which regulates bankruptcy of commercial banks (cf. § 12). This is an exceptionally significant and complicated matter, and here we shall dwell only upon some general principles.

In broad outlines, the regulation of bankruptcy is built upon the basis of the regime contained in Section Four of the Law on Commerce (LC), which is applied subsidiarily in the cases not regulated in the law on banks (Article 84 of the amended and supplemented LBCA). The capacity of the LBCA as a special law on bank bankruptcy is not contrary to its protective and supervisory nature, which is determined by the public nature of the regulation of bankruptcy as a part of the enforcement process.[2]

General purposes of bankruptcy – the fair satisfaction of creditors, and the opportunity to rehabilitate the enterprise, taking into consideration the interests of the creditors, the debtor, and its employees (Article 607 of the LC) – however, undergo substantial modification in view of the main purpose of the law on banks, chiefly, that of *the protection of the depositors*. In the bankruptcy proceedings of a commercial bank, the interests of the depositors as a main category of creditors, and the interests of the banking system as a whole have priority. It is enough to compare the provisions (Article 722, para. 1 of the LC and of Article 83 of the amended and supplemented LBCA), regulating the procedures of meeting the claims when distributing the cash assets. The first three categories of claims coincide with those legal procedures – namely claims secured by a collateral or a mortgage, claims secured by lien, and claims for bankruptcy costs. However in the law on banks, claims arising from labor relations, and claims for maintenance which are arranged respectively in fourth and fifth places in the Law on Commerce are not present at all. Instead of them, the LBCA arranges respectively in fourth, fifth, sixth, and seventh place the claims coming due after the date of the ruling for enforcement of measures of conservatorship under the new Article 65 and unpaid at maturity (item 4), the claims the Deposit Insurance Fund has been subrogated to (item 5), the claims of depositors, not covered by the Deposit Insurance System (item 6), and the claims of banks (item 7).

The inclusion of the claims under items 5 and 6 in the order of priority is a direct expression of the purpose of the LBCA to protect depositors of commercial banks. In this sense, the conclusion can be drawn that within the framework of the main purpose of the bankruptcy proceedings – fair satisfaction of creditors – the interests of the depositors as creditors come to the fore.

Along with them, however, the law on banks also brings to the foreground *the*

[2] *Cf. Tadzher, V. Bankruptcy under the Law on Commerce. Sofia, 1996, pp. 31 – 32.*

stability of the banking system as a whole. Protection of creditors pursuant to Article 83, items 4 and 7 of the amended and supplemented LBCA is connected therewith. These are creditors, or alternatively depositors, who have given funds to a bank placed under conservatorship in danger of insolvency (item 4), as well as claims of other banks (item 7). Giving privilege to the claims of creditors under item 4 aims to encourage the disbursement of funds to a bank which is in danger of insolvency in order to rehabilitate it.[3] Claims of banks are included in the order of the privileged claims to also protect *the security of the payment process*.

An essential feature of the bank bankruptcy proceedings is that its application may be entered only by the central bank (Article 71, para. 1 of the amended and supplemented LBCA). The power to apply to the court with the request of instituting bankruptcy proceedings for a commercial bank is a power which the central bank exercises in its capacity as a supervisory institution. As such, it monitors and inspects commercial banks, and can surely and competently establish the state of insolvency as well as substantiate and prove it before the court pursuant to the provisions of Article 71, paras. 3 and 4 of the amended and supplemented LBCA.

Characteristic of this power of court referral is that the law binds the central bank to exercise it upon establishment of the insolvency of a commercial bank and, in this sense, binds its competence (Article 71, para. 2 of the amended and supplemented LBCA). This characteristic feature of the legal power is such due to the fact that the established insolvency of a commercial bank excludes the application of supervisory and liquidation proceedings – it necessarily leads to the institution of bankruptcy proceedings even in the presence of other pending proceedings (cf. Article 71, para. 2). This gives exceptional weight to the power of the BNB within its overall competence of supervisory influence.[4] From the point of view of this practice, it is obvious that the request for instituting bankruptcy proceedings will play a much more important role as compared to the most restrictive measure – the revocation of the bank license. With the removal of the prohibition to declare a bank bankrupt (cf. § 22 of the amended and supplemented LBCA), and with the introduction of the legal power of the central bank to require within its supervisory competence the institution of bankruptcy proceedings, the scope of the application of the power to revoke a bank license is sharply narrowed. In practice, the cases where it will revoke the license of a solvent bank will be quite rare.

The narrowing of the scope of application of the power to revoke a bank li-

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[3] *The provision of Article 83, item 4 of the amended and supplemented LBCA is analogous with respect to its destination to Article 722, para. 1, item 8 of the LC. The placement of such a category of claims in a considerably more advanced position in the law on banks is determined by the far greater socioeconomic significance of the rehabilitation of a bank as compared to the rehabilitation of the enterprise of an ordinary tradesman.*

[4] *For further details on the competence for supervisory influence see Dimitrov, V. Legal Regulation of Supervisory Competence Exercised by the BNB Authorities.* ***Bank Review****, 4/1993, pp. 11 – 18.*

cense at the expense of the power to institute bankruptcy proceedings is because the request of these proceedings by the supervisory bodies has the same consequences as the revocation of the license. With the adjudication of the insolvency, which is at the same time a decision to declare the bank bankrupt, *the court in fact decrees an individual prohibition to conduct bank activities, and, in this sense, revokes the license* (cf. Article 74, para. 1 of the amended and supplemented LBCA). Thus, the law does not contain an obligation for the BNB to revoke the license. It must be concluded that the institution of bank bankruptcy proceedings emerges as *the most severe punitive measure* in the range of supervisory measures taken by the central bank.

Bank bankruptcy proceedings are not directed to rehabilitation of the banking enterprise because according to the express provision of Article 79 of the amended and supplemented LBCA, no rehabilitation program may be proposed within them. This is due to the fact that the rehabilitation of a bank precedes the bankruptcy, and is carried out by the central bank at the stage of conservatorship. The main reason for this regulatory solution is obvious and needs no comment. It is connected with the practical difficulties to entrust such complicated and specialized activity to a bank's creditors who normally are many and the majority of them lack the knowledge and experience. For the same reasons, no meeting of the creditors is held in bank bankruptcy proceedings (Article 77 of the amended and supplemented LBCA).

Amendments to the Regime of Statutory Provisions and Extension of Credits by Banks

In the LBCA, two important amendments regarding mandatory special reserves (statutory provisions) and extension of credits by banks were made.

First, fundamentally new legislative regulation is given to *statutory provisions*. In the amended and supplemented LBCA, it is expressly provided for that these reserves are an element of the accounting expenditures of the bank (Article 26, para. 2 of the LBCA). In this way, the law clearly outlines their character and the way they are formed. Provisions are expenditures of the same type as the decrease in the value of the assets within the meaning of § 6, para. 1 of the Law on Accountancy (published in the State Gazette, issue 4 of 1991, amendments and additions published in issue 26 of 1992, issue 55 of 1993, and issue 21 of 1996).[5] On account of this character, they affect the financial results of the commercial bank *regardless of their kind (profit or loss) and amount*. Thus, not only the reserves for nonreimbursable claims (as provided for by item 26 of the National Accountancy

[5] *Pursuant to § 6, para. 1 of the Law on Accountancy, the expenditures (of the enterprise) are formed from the decrease in the value of the assets, payment of remuneration of labor, social insurance contributions, allowances, and others resulting from the activities carried out in the enterprise irrespective of the moment of their payment.*

Standard 16 – published in the State Gazette, issue 111 of 1995), but reserves for all claims classified as risk ones will affect the financial results. In case of no profit, they will increase the loss of the bank. Under these conditions, the provision of Article 11, para. 4, item 3 of Regulations No. 8 on the Capital Adequacy of Banks (published in the State Gazette, issue 39 of 1993, amendments and additions published in issue 19 of 1994, issues 2 and 77 of 1995, corrections published in issue 85 of 1995, amendments and additions published in issues 4, 16, and 58 of 1996), regarding the exclusion of the shortage of statutory provisions from the own funds of the bank, practically loses its regulatory meaning.

The amended regime of statutory provisions comes into effect as of 1 January 1997 (cf. § 26 of the amended and supplemented LBCA).

Of great significance is also the other addition to the LBCA. Pursuant to the provision of the amended Article 36, para. 1, commercial banks are prohibited from *accepting as collateral shares issued by them as well as shares issued by persons economically related to them* (within the meaning of § 1 of the additional provisions of the law). This wording is analogous, for example, to regulatory texts contained in § 41, para. 4 of the *Hungarian Law on Banks of 1991*.

Regrettably, however, the law does not prohibit expressly the widespread practice of granting loans for the purchase of shares issued by them or by persons related to them.

Regulation of the Bank Supervision

The amendments to the law, concerning *supervision*, are significant and extensive. They apply, above all, to bank supervision which is not a conservatorship within the meaning of Chapter Thirteen (Articles 64 – 69) of the amended and supplemented LBCA. Bank supervision not related to enforcement of measures to overcome the state of danger of insolvency can already be called “ordinary, usual” supervision.

Within the framework of ordinary bank supervision, the law provides for substantial amendments to the powers of the supervisory bodies.

The range of grounds for refusal to grant a permit has been extended. Pursuant to the new provision of item 7 of Article 14, para. 1, the central bank may refuse to grant a permit where it finds out that persons who have subscribed more than one percent of the capital have made payments with borrowed funds. Thus, *statutory prohibition to incorporate a bank with borrowed capital* has already been established.

The regulation of the restrictive powers of the supervisory bodies pursuant to Article 56 has been amended.

The possibility for temporary removal from office governors of the bank, the persons who manage and represent it, has been removed. Under the present regulation, removal can be *peremptory*, and is not necessary to give warning or prove culpable violation of the provisions of the banking legislation (cf. the amended item 6 of Article 56, para. 1). From this point of view, the law has taken into consideration to a greater extent the nature of this kind of supervisory influence as an administrative obligatory measure whose enforcement does not require the presence of guilt.

In removing bank governors, the BNB sets a term within which the competent body must empower other persons. If this is not done within the term set, and the number of the remaining governors is less than the minimum required by the law and the articles of association (at least two), as well as a decision of the shareholders' general meeting is required for providing full membership, the central bank also removes the remaining empowered persons (governors). In addition, it appoints, for a term no longer than six months, two conservators who act as deputies for the removed persons until the election by the competent body of new governors who meet the requirements of Article 8, para. 1 (cf. amended para. 2 of Article 56).

New powers have been given to the central bank. First, it now has the power to remove from office all members of the board of directors of the commercial bank and all members of its managing and supervisory boards (see the new item 7 of Article 56, para. 1). Here, too, enforcement of the measure is not dependent on culpable conduct. Second, pursuant to the terms and procedures of the amended para. 2 of Article 56, the supervisory bodies can now remove from office members of a managing body of a bank, who are not its governors, as well as members of any controlling body. The ground is that these persons fall within the range of the negative requirements of Article 51. In particular, this removal can lead (in the hypothesis of sentence 2) to the removal of all members of the managing body of the bank, including the governors, and to appointment of conservators.

Administrative Liability for Violation of the Provisions of the LBCA

Of fundamental importance is another amendment to the LBCA. The new Article 86 which regulates the administrative liability for violation of the provisions of the law falls short of enumerating expressly the regulatory texts, using the blanket wording "for violation of this Law and the regulatory acts issued for the enforcement thereof" (para. 1). On the basis of said text, two conclusions can be drawn.

First, the extension of the "protective range" of the administrative sanctioning is categorical proof of the *public nature of the LBCA*. Within this extended range now falls practically all statutory prohibitions and obligations.

Second, administrative sanctioning covers the violations of the regulations of the BNB. Thus, the public nature of the by-laws on the commercial bank activities is unequivocally underlined.

Conservatorship

With the amendments to the LBCA, the *conservator* receives much more attention. The conservatorship is also set apart in a separate twelfth chapter of the amended and supplemented LBCA.

Above all, a clear answer is given there to the question of who can be a conservator. The possibility for a conservator to be a legal person has been discarded. Pursuant to the text of Article 57, para. 1 of the amended and supplemented LBCA, only a physical person may be a conservator. If two or more persons are appointed as conservators, they make decisions as one body, i.e. unanimously, exercising their powers jointly, unless otherwise provided by the central bank (para. 3). These provisions more clearly highlight the authoritative nature of the conservator.

As a physical person, the conservator must meet a number of statutory requirements. They are analogous or similar to the requirements with respect to both bank governors under Article 8, para. 1 and the trustee in bankruptcy – the physical person in the bankruptcy proceedings (cf. Article 57, para. 2 of the amended and supplemented LBCA, and Article 656, para. 2 of the LC).

More completely, clearly, and systematically specified are both the powers of the conservator and the different circumstances under which they are exercised.

First, conservators (at least two) are appointed when the central bank removes from office governors of a commercial bank (cf. the amended item 6 of Article 56, para. 1 in connection with para. 2). In this case, the conservators accede to the powers of the persons removed (Article 58, para. 3 of the amended and supplemented LBCA).

The second circumstance for the appointment of conservators in a commercial bank is upon removal of all members of the board of directors and all members of the managing and supervisory boards, enforced as a supervisory measure under Article 56, para. 1, item 7, or as measure of conservatorship under Article 65, para. 2, item 7 of the amended and supplemented LBCA. Here, the conservators accede to the powers of the respective managing body (board of directors, managing board) – Article 56, para. 3, and Article 58, para. 4 of the amended and supplemented LBCA.

The third situation for the appointment of a conservator is when enforcing the most severe measure of ordinary bank supervision – the revocation of a license granted to a commercial bank (cf. Article 56, para. 1, item 8 of the amended and supplemented LBCA). If the revocation of the license is not combined with the removal from office of bank governors and other members of bank bodies, the conservator does not directly manage the bank, but only exercises operational supervision over it. Here, the law clearly defines the power as a state supervisor. Expressly set apart are the conservator's fact-finding powers. These are the powers granting free access, and checking and examining all of a bank's transactions (Article 58, para. 1, items 1 – 2 of the amended and supplemented LBCA). Legal regulation also granted the power to collect data and documents concerning persons covered by the deposit insurance system (Article 58, para. 1, item 5 of the amended and supplemented LBCA). More precisely specified are also the conservator's powers to exert influence, connected with the control over the managing body of the bank (cf. items 3 and 4).

Lastly, a conservator is appointed when, as a measure of supervisory influence on the bank, a restriction of a bank's activities has been imposed pursuant to Article 56, para. 1, item 5. In this case, the conservator exercises control for the observance of the restrictions imposed, with the fact-finding powers under Article 58, para. 1, items 1 – 2 of the amended and supplemented LBCA being expressly given to him (cf. Article 58, para. 2).

Review of the amended regulation of the conservator's powers allows a new group of powers to accede to the rights of the bank's bodies (Article 56, para. 3, Article 58, paras. 3 and 4 of the amended and supplemented LBCA). They can be called *subrogated or substituted powers*. The empowerment of the conservator with them is a new feature. In exercising these powers, one goes beyond a limit of fundamental significance. So far, bank supervision, for reasons easy to understand, has not been entrusted with the management and representation of a bank, i.e. with the direct performance of commercial bank activities. Supervision is a kind of state regulation of the commercial activities, and the law forbore for good reasons from extending it to such limits and forms which could be interpreted as an infringement upon constitutionally protected private ownership and free economic enterprise (cf. Article 17, para. 2, and Article 19, para. 1 of the Constitution).

In this case, however, the public interest, and chiefly the *protection of the property of the depositors as consumers of bank services*, which is also constitutionally regulated (cf. Article 19, para. 2), makes it necessary to proceed to direct performance of bank activities.

Granting subrogated powers to the conservator raises a wide range of problems which require careful examination and analysis. Practice will also show the most appropriate forms and manners of exercising such powers. It is indisputable, however, that their realization will be based on several general principles.

Above all, the displacement of the bank's bodies does not mean that the conservator loses his capacity as a state body. He performs his activities in defense of the public interest, and the fact that the private interests of the bank (or of its shareholders respectively) coincide in this case with those of the public does not mean a "loss" of authoritative powers. A proof of this is also the restriction of the right of the owners (shareholders) to directly (cf. Article 221, item 4 of the LC) or indirectly, through the supervisory board (Article 241, para. 2 of the LC), replace at their own discretion conservators in their capacity as governors or as the managing body of the bank (argumentation out of Article 58, para. 4, sentence 2, and Article 63 of the amended and supplemented LBCA). Subrogation of the conservator to the rights of the bank's bodies as a form of supervisory influence is of indisputable authoritative nature because of the fact that it is *obligatory*. The addressee of the subrogated supervisory influence is the commercial bank itself, which has not only to accept it, but also to assist, through all its officials, the conservator (Article 60, para. 2 of the amended and supplemented LBCA). This obligation is moderated in the cases of Article 56, para. 1, items 6 and 7 of the amended and supplemented LBCA through the possibility for the concerned bank to limit the term of the conservator's subrogation by timely replacing the persons removed.

Manifestation of the irreducibility of the conservator to an ordinary member of a managing body of a commercial bank is the limiting of his responsibility only to damages caused intentionally or by gross negligence (Article 60, para. 1, sentence 2 of the amended and supplemented LBCA). The mitigation of the conservator's responsibility is also determined by the fact that upon subrogation his activities as a bank governor or a member of a bank managing body will suffer the adverse consequences of former unlawful and wrong actions of the persons removed from office.

The authoritative nature of the conservator's subrogation manifests itself only within the framework of the supervisory relationship, and not toward the contracting parties (customers) of the commercial bank. To these persons, the conservator is only a person who expresses the will of the commercial bank.

As a rule, the conservator's subrogation is *an exceptional measure of limited duration* (cf. Article 56, paras. 2 and 3, and Article 65, para. 4). The aims as such are to exert influence in order to overcome the violations and the danger of insolvency, and restore the normal activities of the bank, or to protect to the highest degree the interests of the creditors and the stability of the banking system from infringement in case of existing insolvency. These aims of the subrogation also outline the scope of its application. One has to resort to it only when the other possibilities for supervisory influence have been exhausted.

Conservatorship of Commercial Banks

A new basic point in the LBCA is the regulation of the *conservatorship* of the commercial banks. The matter in hand is *a system of administrative measures,* enforced by the Managing Board of the BNB (cf. Article 88, para. 1 of the amended and supplemented LBCA) when the bank has reached a state close to bankruptcy. This is the term "danger of insolvency," defined in Article 64 of the law. Such danger of insolvency exists in the presence of one of the two hypotheses alternatively specified in Article 64. In the first place, where the overall capital adequacy ratio of a commercial bank is below the set minimum level (item 1)[6], and, in the second place, where there is danger, because of the condition of the bank's assets, that the bank may not be able to fulfill its obligations on the day they become due (item 2).

The provision of the new Article 65, para. 2 contains a list of measures which considerably extend the possibilities for influence by the central bank. The first item which creates an impression when analyzing the list of measures of conservatorship under Article 65, para. 2 is the extension of the contents and scope of the restrictive powers of the central bank. Part of these powers are identical with the restrictive ones provided for under Article 56. Such are the powers to enforce the measures under item 3 (restriction of a bank's activities) and item 7 (removal from office of the members of the board of directors and the managing and supervisory boards). Their difference is determined by the ground for their enforcement – the danger of insolvency.

The aims of the restrictive measures under item 4 (the ban to pay dividends) and item 5 (the ban to dispose of property) do not need particular comment. The expediency of such measures is obvious when the bank is in danger of insolvency. The law adds also a civil sanction – nullification of the actions and transactions carried out in violation of the bans imposed with the administrative enactment of the BNB (cf. Article 66, para. 1 of the amended and supplemented LBCA). A consequence of the nullification is the emergence of an obligation to return as unduly paid the receipts from the shareholders and the contracting parties of the bank (cf. Article 34 in connection with Article 55 of the Law on Obligations and Contracts).

The measure under item 8 (temporary suspension of the voting rights of shareholders holding directly or indirectly more than 10 percent of the voting shares) is, as a whole, in the spirit of the regulatory solution contained in *Directive 89/646/EEC of 1989 (The Second Banking Directive)* of the European Communities. The Bulgarian law, however, requires the enforcement of the restriction to be determined not by the probability of possible occurrence of damage to the reasonable and reliable management of the bank (as provided for by Article 11 of the directive), but by the actual occurrence of the harmful consequences. They must have already occurred. This narrows the preventive action of this measure of conservatorship at the expense of the protection of shareholders' rights.

Approximating this measure, but with incomparably greater intensity and degree of infringement of the managing rights of the bank's shareholders, is the temporary suspension of the powers of the general meeting (item 9). This measure is not enforced independently, but in combination with its logical complement – resolution on the part of the central bank of matters within the realm of the general

[6] *Pursuant to the amended para. 2 of § 3 of the Transitional and Final Provisions of the LBCA, banks should achieve the ratio of their own funds to their risk assets under Article 21, para. 2 by the year 2001. Within this period the central bank shall set* ***annually the minimum levels*** *of this ratio to be achieved and maintained by the banks.*

meeting. The accession to the rights of the general meeting means that, together with the conservator, the Managing Board of the BNB as a supreme body of bank supervision is empowered with *subrogated (substituted) powers*. Included, undoubtedly, is the compulsory increase of the capital (item 6), which is, as a matter of fact, a solidification of the power under item 9.

Particular attention as to the measures of conservatorship is deserved to the reduction of interest rates on the bank's obligations to their average market value (item 1) and the suspension of the performance of the bank's obligations (item 2). The latter item may not last more than 30 days unlike the reduction of the interest rates, which can last one year (para. 4). The immediate purpose of both measures of conservatorship is obvious. It is necessary to give the bank a certain "respite" so that it can stabilize its position. At the same time, the measure under item 1 aims at surmounting the attraction of customers through promising unreasonably high interest rates, which is contrary to the requirements of prudent banking. Such a practice in the long run inevitably leads to undermining the financial situation of the commercial bank.

In these cases, the administrative enactments of the Managing Board of the BNB directly affect not only the bank placed under conservatorship, but also the rights of third-party creditors because a one-sided change is made in their relations. This will apply chiefly to depositors. In the case of reduction of interest rates, depositors are affected because they do not receive a part of the guaranteed income promised to them, and in case of suspension of the performance of a bank's obligations, deposits temporarily lose one of their most characteristic features – *claims on deposits executable ahead of schedule*. On account of this, depositors are practically reduced to money lenders, and the bank assumes the capacity of a borrower. Immediately, the question arises as to whether the enforcement of these measures does not contradict the purpose of the LBCA to protect depositors. There exists a certain contradiction, but it is not essential. Because of the specific situation of the bank – danger of insolvency – the law gives relative priority to the protection of *the security of the deposits*, as well as to the other main purpose of the law – stability of the banking system, and security of the payment process. In view of these purposes, whose attainment in the long run protects more substantial interests of the depositors, it is justified that their rights are subjected to a certain temporary restriction.

Both measures of conservatorship are a manifestation of increased state interference in private relations because they give rise to consequences which, as a rule, have to be a result of the will of the affected bank, or of the concerted will of the parties to these relations. On account of this, they are a manifestation of the *subrogated supervisory powers* of the central bank. Specifically, the administrative enactment can supersede declaration of will not only of the bank itself (or of its body), but also of its (and not only individual) creditors. Reduction of interest rates concerns all depositors and other title-holders of money claims. Suspension can also affect all creditors of the bank. In view of the consequence of these enactments, therewith the interest rates are reduced, and the performance of the bank's obligations is suspended, approximating closely characteristics of the general administrative enactments.[7]

In case of suspension of the performance of the bank's obligations, its grave consequences have to be pointed out. The central bank can be accused that with its enactment it has led to a chain of failures to meet commercial obligations. In this case, as well as in the case of reduction of interest rates, claims for damages sustained by the creditors of the bank can be directed to the BNB. Because the matter in hand is a declaration of will and actions of the BNB, which are a manifestation of authoritative powers, the persons, who claim damages, have to duly appeal the legality of the administrative enactments of the central bank as required by the provision of Article 1, para. 2 of the Law on Liability of the State for Damages Inflicted on Physical Persons (published in the State Gazette, issue 60 of 1988, amendments and additions published in issue 59 of 1993). But the presence of such appeals can seriously impede the efficient exercise of the central bank's powers of conservatorship. In view thereof, it is reasonable to adopt the solution con-

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[7] *The general administrative enactment is characterized, on one hand, by solidity and one-time enforceability of the prescription contained therein, and, at the same time, by a wide (indefinite) circle of addressees. (On this category of enactments see Angelov, A., M. Kostov for further details. Financial Plan and Financial Norm. Sofia, 1972, p. 74 ff.; Lazarov, K. Administrative Enforcement. Sofia, 1981, pp. 75 – 78; Lazarov, K. Once More on General Administrative Enactments.* ***Pravna Misal****, 4/1995, pp. 20 – 26.*

There arises also the question of the possibility for the affected creditors of the bank to appeal to the court the enactments under which the measures under Article 65, para. 2, items 1 and 2 are enforced. This question has essential practical dimensions. At first sight, the LBCA leaves the impression that the enactments of the Managing Board of the BNB, under which measures of conservatorship are enforced, can be appealed only by the affected commercial bank (cf. Article 88, para. 3, sentence 2 of the LBCA). Here, however, the crucial role of Decision No. 21 of 26 October 1995 of the Constitutional Court in the constitutional case No. 18 of 1995 (published in the State Gazette, issue 99 of 1995) must be emphasized. The decision rules that physical and legal persons may appeal to the court any administrative enactments, including those which are internal and official, if they violate or endanger their rights or legitimate interests, and are not excluded expressly by law from appeal to the court. The text of Article 88, para. 3, sentence 2 cannot be construed as an explicit prohibition of the appeal of the administrative enactment of the BNB by all other affected persons besides the affected bank. In this situation, the conclusion can be drawn that the fundamental possibility for the enactments of the BNB to be appealed by the ***creditors*** *of a bank placed under conservatorship, with respect thereof measures under Article 65, para. 2, items 1 and/or 2 of the amended and supplemented LBCA are enforced.*

With still stronger reason, this thesis has to also apply to the persons, who have been removed from office (governors, members of the board of directors, of the managing and supervisory boards), to shareholders whose voting rights have been suspended. They, indisputably, have to be constituted along with the bank as parties to the administrative appeal of the decision of the BNB.

On the whole, the subsidiary application of the Administrative Procedure Law to the supervisory enactments of the central bank poses a number of serious problems which have to be the subject of independent analysis.

tained in Article 1, para. 4, and Article 2, para. 7 of the *British Banking Act of 1987*. Pursuant to it, the central bank as well as its managers and officials, are responsible for damages caused in exercising the supervisory functions of the bank only provided that it has been proved that they have been caused intentionally. Introduction of such a provision in Bulgarian banking legislation would be a strong guarantee for the efficient exercise of supervisory powers.[8]

In the case of reduction by the central bank of interest rates, there arises the problem of its scope. The law does not expressly specify that it applies only to future transactions of the bank. In this situation, it is obvious that the provision includes in its scope of application established relations. There emerges, however, the question as to whether the reduction will apply also to due and exigible, yet still unpaid, interest. We are inclined to think that they should not be reduced. The provision of Article 65, para. 2, item 1 provides for power of an exclusive nature and on account of this it must be construed restrictively in order not to infringe needlessly upon the interests of the depositors. The general principle must apply here that the rights and interests of the bank's creditors have to be infringed upon in the lowest degree, and only within the limits necessary to protect the public interest. On account of this, the reduction of interest rates should cover only *interest which is not due*.

In the case of suspension of the performance of the obligations of a bank placed under conservatorship, there arises the question of its essence and consequences. The suspension means, in effect, a moratorium of bank payments to creditors.[9] Suspension of payments is a ban addressed to both the bank and its creditors. But the law does not expressly regulate the problem of interest for delay when the payment of the exigible claims has been suspended. The question is whether the suspension of the performance of obligations exempts the bank from the arrears and the obligation, connected with them, to pay interest for delay. We think that it is necessary to regulate such serious consequences directly affecting the interests of the bank's creditors by express provisions of the law. It is not appropriate to regulate them by an administrative enactment of the BNB. In the absence of legal provisions, it is more reasonable to assume that the suspension of the payment of exigible obligations of the bank does not exempt it from the accrual of interest for delay for the period of the suspension. The claims for this interest, however, will become exigible after the lifting of the moratorium. Here,

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[8] *In British literature on banking law, the significance of these protective provisions of the Banking Act of 1987 is expressly pointed out. They have surmounted the doubts and disputes, which have arisen in the common law, about the responsibility of the central bank in exercising its supervisory functions. (see Elinger, E. P., E. Lomnicka. Modern Banking Law. Oxford, 1994, p. 32).*

[9] *Moratorium is the (period of) delay in the performance of a legal consideration (cf. Apostolov, I. Law of Obligation. Part I. General Principles of Obligation. Sofia, 1990, pp. 154 – 155; Kozhouharov, A. Law of Obligation. General Principles of Obligation Relationships. Sofia, 1958, p. 228).*

too, for the purposes of the protection of the public interest, the principle of minimum infringement upon the rights and interests of the bank's creditors must apply.

Suspension of payments of a commercial bank also poses the problem of one significant gap in our banking legislation. A moratorium on bank payments can be regulated in a fundamentally different way. Thus, for example, the *German law on banks of 1985* expressly regulates the moratorium in the cases where not an individual bank, but the banks in the country as a whole are confronted with financial difficulties which can give rise to a serious danger for the national economy and the normal functioning of the payment process. In these cases, the federal government, after consultations with the central bank, can, with a regulatory act, grant to an individual bank delay of the performance of its obligations and suspend any execution proceedings against it, temporarily close banks, imposing a ban on them to make payments and grant loans, as well as temporarily close the stock exchanges. The government also obligatorily regulates the legal consequences of the enforcement of these measures in the sphere of civil, commercial, company, exchange, and checking law, as well as procedural law (cf. Article 46, paras. 1 – 3).[10]

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[10] *Moratorium is regulated in a similar way in § 78 of the* ***Austrian law on banks of 1993****.*

Provisions regarding this important matter were included in 1992 in the Bulgarian bill on banks and credit activities, but for unclear reasons they were removed during its passing by the National Assembly.

Bank Mergers, Hospital Banks and Other Options

by Geoffrey Russell

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Introduction

- Typical problems of banks in emerging economies
- Fundamental restructuring objectives
- Possible actions
- Conclusions
- Suggested solution

Typical Problems of Banks in Emerging Economies

- Changing economic environment
- Under or nonperforming loans
- Low profitability
- Undercapitalization
- Management inexperienced in modern banking practices
- Poor information systems
- Low pay levels and lack of incentive
- Old attitudes
- Competition

Fundamental Restructuring Objectives

For the State

- to remove the continuing financial burden and to extract value for under or nonperforming assets

For the customers

- to promote a healthy and competitive banking sector

For the banks

- to remove the financial legacy of the past, reengineering the balance sheet and empowering management to enable them to operate in a competitive free market

Possible Actions

- Consolidation and merger
- Foreign investors
- Hospital banks
- Liquidation
- Recapitalization – new equity
- Do nothing – subordinated equity

Consolidation and Merger

Outline
- Aggregation and rationalization of two or more banks as a single legal entity

Condition
- Must be a logical fit of parties

Consolidation and Merger

Pros	**Cons**
• economies of scale and cost savings	• likely to involve job losses
• concentration of expertise and management resources	• may end up with one large rather than two small problems
• reduction in capacity of banking system	• new information systems
• provides broad base for future operations	• closure of parts of operations

Foreign Investors

Outline
- New capital introduced by foreign investor. Investor may then address the problems

Condition
- Bank must be attractive to a foreign investor

Foreign Investors

Pros	**Cons**
• devolving responsibilities	• potential loss of control of bank and control of problem
• low short-term cost	• may be unacceptable politically
• new technologies and techniques	• uncertain cost

Hospital Banks

Outline
- Creation of specialized recovery vehicles to extract maximum value in an orderly fashion from under or nonperforming assets

Condition
- None

Hospital Banks

Pros
- maximum recovery from assets likely
- concentration of problems with relevant specialists
- creates clear separation of problem loans
- permits management to focus on future not past
- ensures that any new equity is not impacted by historic problems

Cons
- hospital bank will require funding and/or guarantee
- cost and structural implications
- customer relations and public perception

Liquidation

Outline
- Realize immediate value of assets and settle liabilities

Condition
- None

Liquidation

Pros
- final solution
- immediate solution
- reduces capacity in the banking system
- dispels myth that central bank will always provide unlimited support

Cons
- job losses
- may not extract maximum value
- capital injection may be required to settle liabilities
- knock on effect throughout economy
- damage to reputation of system as a whole

Recapitalize − New Equity

Outline
- Introduce new capital

Condition
- Resources are made available

Recapitalize − New Equity

Pros
- puts balance sheet of bank on a

Cons
- high cash cost

sound basis

• does not require cultural or working practice change	• new equity likely to be lost
• relatively simple	• does not require cultural or working practice change

Do Nothing − Subordinated Equity

Outline

• Convert any outstanding funding facilities to subordinated quasi-equity

Condition

• Resources are available

Do Nothing − Subordinated Equity

Pros	**Cons**
• easy	• balance sheet remains weak
• does not require cultural or working practice charge	• does not require cultural or working practice charge
	• unlikely to be effective
	• problem likely to recur

Conclusions

• No easy solution
• May be political considerations
• Consideration of available resources
• Best solution is probably a combination of actions
• Maximize pros, minimize cons

Suggested Solution

Banks with underperforming assets
↓
Consolidate and merge
↓
Create hospital bank ⟶ Liquidate some assets
↓
Recapitalize
↓
Attract foreign investment
↓
Bank competing on international market

Bank Mergers

by Vladimir Georgiev

Vladimir Georgiev is
Executive Director of Biochim Commercial Bank.

Situation of the Banking System in Bulgaria before 1990

There were three banks in Bulgaria in the past. The BNB used to perform simultaneously the functions of a central bank and of a commercial bank, servicing the real and the government sectors. The Bulgarian Foreign Trade Bank (BFTB) was specialized in servicing the foreign sector and transactions with foreign exchange. The State Savings Bank (SSB) was specialized in providing basic banking services to the households. Since 1981, a two-tier banking system has been gradually developed in Bulgaria.

At the end of the 1980s there were eight specialized commercial banks, and their activities were limited to a great extent within certain industries of the economy. In 1989, BNB functions concerning the real sector were taken by the newly established 59 regional universal banks. These banks were established on the basis of the former BNB branches and were incorporated as joint-stock companies, owned by state-owned enterprises (mainly their borrowers). (The stage of development of the banking system in 1990 – 1991 is illustrated in Table 2.)

In addition to the problems typical for the banking systems of central and eastern European countries, there were several specific problems: bank capital, assets and deposits were concentrated in the three biggest banks (BNB, BFTB, and SSB); small-size and weak banks prevailed in the group of the commercial banks; the SSB was the net source of commercial bank funding, through the BNB as an intermediary; a continuous deterioration of loan portfolios; lack of legislation for provisioning of nonperforming loans created the illusion of high profitability of commercial banks; undeveloped branch network (with the exception of the SSB); out-of-date settlement system.

Banking Sector Institutional and Structural Development

The steps for banking sector development which were taken in the period 1992 – 1995 were as follows:

Formation of the Legal Framework for Development of Bank Activities

International standards of capital adequacy, liquidity, and lending were introduced.

Establishment of the Bank Consolidation Company (BCC)

In 1992, the BCC was established to resolve the problems accumulated in the banking sector. It was incorporated as a joint-stock company and state-owned enterprises transferred their shares from commercial banks to the BCC. Until early 1995, the BCC completed the following projects for consolidation by merger: the United Bulgarian Bank (UBB), Expressbank, Hebrosbank, Sofiabank, Serdika. Several small provincial banks have been acquired by the biggest commercial banks (BFTB, Balkanbank, Hebrosbank).

The second stage of the consolidation began in the second half of 1995. As a result Biochim Commercial Bank has been established.

The consolidation has resolved some of the problems mentioned in the first part of this paper, especially those relating to the problems of personnel training; development of branch networks with nationwide coverage; introduction of stricter uniform rules concerning lending, liquidity, purchase of fixed assets, etc.; achievement of economy-of-scale in the contacts with suppliers; forming of a general marketing strategy.

The following problems could not find its final solution by consolidations.

First, an increase in capital adequacy. Bank consolidation was made without any additional inflow of capital so the undercapitalization problem was passed over to the new banks. The share of nonperforming loans in the loan portfolio remained at its previous level, irrespective of the exchange of the nonperforming loans extended prior to 1990 for government securities. The main reason behind this was the low lending standards in the period preceding consolidation.

Passing and Enforcement of the Law on Settlement of Nonperforming Credits Negotiated prior to 31 December 1990

This law settled some of the problems related to nonperforming loans. At the same time, problems related to partial servicing of loans have not been resolved and the government securities received by the banks were of lower quality than the market one.

Review of the Results from the Consolidation during 1992 – 1995

Two of the biggest consolidations were the United Bulgarian Bank and Biochim Commercial Bank.

The United Bulgarian Bank

It was established in 1992 as a result of a voluntary merger of 22 commercial banks (including 21 regional banks and one specialized in construction). This was the first consolidation conducted by the BCC.

Biochim Commercial Bank

The bank was incorporated in 1995 as a result of a merger involving Sofiabank Commercial Bank, Serdika Commercial Bank (those two banks have been established at the earlier stages of consolidation) and former Biochim Commercial Bank. As a whole, this bank is a successor of three specialized banks (in electronics, chemical, and pharmaceutical industry, insurance and reinsurance), three main banks of Sofia region and three local banks. At present, in terms of size, this bank ranks third.

Prior to consolidation two of the banks had a negative capital value and incurred current losses. Due to the relatively small size, exposure to major banks was considerable. Two of the biggest banks which took part in the consolidation were rather different in nature – Sofiabank was based mainly on local currency and had a broad deposit base, former Biochim Commercial Bank was mainly forex-based bank with an overexposure of its loan portfolio to several major clients. Serdika Commercial Bank was a smaller, newly established bank with insufficient resources for a successful market expansion. Consolidation decision has been made in consideration of the following advantages: a big national bank with a diversified loan portfolio has been established; experience gained in the field of international settlements became more accessible to a higher number of clients; better possibilities for implementation of modern management techniques have been created; possibilities for more comprehensive use of the information system allowing for transfer of funds have increased. This information system has been purchased by one of the consolidated banks and proved too big for the scale of its operations; head offices of two of the consolidated banks were housed in one and the same building.

Problems that have arisen after consolidation were as follows: the bank was not sufficiently capitalized (the capital base is negative as per the international standards); loss accumulated from previous years was an additional burden for the new bank; loan and investment portfolios comprised a considerable share of nonperforming assets; consolidated banks had different corporate culture.

Since the consolidation was done only eight months ago, available information was insufficient for a full and complete evaluation of its results. On the other hand, the bank commenced its operation under bad macroeconomic conditions and a crisis in the Bulgarian banking system.

Tentative Conclusions

First, implementation of the marketing objectives of the consolidation: market share of the bank in total assets of commercial banks was stabilized as at 31 May

1996; market shares in forex-denominated loans and government securities increased; lev-denominated deposits share remained unchanged, and that of the forex-denominated deposits has been growing; Biochim Commercial Bank changed the balance of competition within the system of commercial banks; branch network covers all major centers with high economic potential; as a result of synergy, strengths of the three banks have been further developed; better positions in negotiations with clients have been achieved.

Second, accomplishment of the financial objectives of consolidation: the Bank ended 1995 reporting operating profit (consolidated banks as a whole reported losses); assets and liabilities structure was optimized; since consolidation was not accompanied by additional capital funding, recapitalization is needed. This will be achieved through the Bulbank Scheme.

Third, fulfilment of the objectives in the field of management. At the first stage after the formal act of consolidation, the bank's management took several steps intended to create a sound basis for future development: development of Management Information System; strict examination of loan and investment portfolios aimed at finding the best possible methods for collection and restructuring of the nonperforming loans; the system of control was improved; framework procedures concerning budgeting were adopted.

The Banking System in Early 1996

The current situation of the Bulgarian banking system is shown in Table 3. Its main features are: reduction of the number and an increase in the size of the state-owned banks; creation of many small private banks, most of which undercapitalized; decrease in the degree of concentration of deposits in the SSB and the BNB and redistribution among commercial banks (see Tables 2 and 3); decrease in capital adequacy ratios; low level of provisioning of "bad loans"; following a fast development of branch networks, private and state-owned banks have approximately equal number of branches.

Future development of consolidated banks shall comply with the measures taken by the government, the BCC, and the BNB.

1. Isolation of sources generating losses in the real sector and implementation of restructuring schemes.
2. Recapitalization of state-owned banks in accordance with the so-called Bulbank Scheme.
3. Changes in the legal framework concerning debt collection.
4. Strengthening bank supervision.
5. Liquidation of nonviable banks to reduce fiscal expenses.
6. Privatization and incorporation of joint companies in the state banking sector.
7. Implementation of measures intended to encourage voluntary merger of private banks.

Short-term objectives of the consolidated state-owned banks under the above-listed conditions might be as follows:

• to resolve the problem of decapitalization of banks (similarly to the situation in Poland[1]);

• to improve bank management with a view to supporting privatization in the real sector.

Establishment of big banks through consolidation cannot always provide efficiency and market presence[2].

In order to avoid possible negative economic and market implications in consolidated state-owned banks, the following strategic targets should be achieved: positive changes in lending policy and reduction of the share of nonperforming assets; further adjustment of bank management to market conditions aimed at developing a market and product diversification, creating peripheral companies, implementing modern information technology, enhancing quality of bank personnel; opening of the banking system to foreign competitors.

■

[1] *Source: "Merger may flaw banks," Central European.*

[2] *Historical retrospection of the development of some major banks in Spain and Greece indicates the real dangers of failure.*

Table 1

Financial Sector in Central and Eastern Europe

Country	Two-tier banking system	Number and type of new banks	Competition	Capital adequacy	Share of bad loans	Money and capital markets	Financing of the budget	Privatization
Bulgaria	Since March 1990	More than 60; mainly regional and too small to be efficient	Weak	Undercapitalized	About 40% of loans	No capital market	Bank loans and bonds	State-owned banks
Czechoslovakia	Since January 1990	Seven major banks and approx. 30 small banks	Weak, but growing	Low	Between 15% and 20%	Money market is under development; capital market is planned for the end of 1992	Bank loans and long- and short-term bonds	Major banks are state-owned
Hungary	Since January 1987	30 commercial banks	Relatively high	After transition period it will achieve BIS Standards	Between 15% and 20%	Active money market; small capital market	Bank loans, long- and short-term bonds	Small part of shares of some banks are in private hands
Poland	Since January 1989	Nine major banks; more than 50 small ones	Limited due to regional concentration	It will try to achieve BIS Standards by 1993	About 30%; 20% to 50% for seven of the major banks	Money market; capital market	Bank loans, long- and short-term bonds	Major banks are state-owned, a number of small banks are private
Romania	Since December 1990	About ten banks; specialized/ universal	Relatively weak	Lower than BIS Standards	Significant part of bad loans have been written off, but the problem is emerging again	Development of money market is planned	Bank loans, long-term bonds are foreseen	Several small private banks

Source: IMF.

Table 2

Financial Sector in Bulgaria in 1990

Number and type of banks in accordance with ownership	Competition	Concentration of capital (share in total capital in the banking system), %	Share of deposits by type of bank, %	Capital adequacy, %	Capital to assets ratio, %	Degree of provisioning	Bad loans to total size of loans ratio, %	Share of branch network by type of bank, %	Banking system personnel and bank management
1. *State-owned* BNB BFTB SSB 8 SCB & 59 UCB – joint-stock companies with shares of BNB, BFTB and state-owned enterprises (major borrowers from above banks)	Weak competition mainly in the field of interest policy, due to lack of product diversification and presence of industry and sector specialization	BNB – 56 BFTB – 13 SSB – 3 0.2 on the average per each SCB, and 2 per each UCB	BNB – 16 BFTB – 10 SSB – 46 SCB – 11 UCB – 17	5	BNB – 12 BFTB – 2.8 SSB – 1.1 SCB – 5.4 UCB – 2.3	There are no provisions (main reason – lack of legal and regulatory framework to that effect)	54	1. *Branches* SSB – 67 Others – 23 2. *Offices* SSB – 95 Others – 5	Lack of commitment of management practice to market business principles and also of qualified banking personnel
2. *Private* FPB BAC									

BNB – Bulgarian National Bank; BFTB – Bulgarian Foreign Trade Bank; SSB – State Savings Bank; SCB – Specialized Commercial Banks; UCB – Universal Commercial Banks; FPB – First Private Bank; BAC – Bank for Agricultural Credit.

Table 3

Financial Sector in Bulgaria in 1995 – 1996

Number and type of banks in accordance with ownership	Competition	Concentration of capital (share in total capital in the banking system), %	Share of deposits by type of bank, %	Capital adequacy (end-1995), %	Capital to assets ratio, %	Degree of provisioning (shortage), %	Bad loans to total size of loans ratio (lev component), %	Share of branch network by type of bank, %	Banking system personnel and bank management
1. *State-owned banks* BNB BFTB UCB – joint-stock companies with shares of BCC, state-owned enterprises and other shareholders	Price competition. Low level of development of financial services	BNB – 58 SSB – 5 SUCB – 26 BFTB/Bulbank – 16 1 on average per other banks of this group PUCB – 11	BNB – 11.2 SSB – 27 SUCB – 44.6 including BFTB/Bulbank – 10.1 PUCB – 17.2	4.62	BNB – 43 SSB – 6.5 UCB – 10.8 (aggregate) BFTB/Bulbank – 17	76	48.5	1. *Branch network* SSB – 22 SUCB – 40 PUCB – 38 Regional expansion of UCB	Unsatisfactory management and inadequate level of personnel training
2. *Private* UCB – 26 including 9 rep.offices of foreign banks									
3. *Other financial institutions*									

BNB – Bulgarian National Bank; BFTB – Bulgarian Foreign Trade Bank; SSB – State Savings Bank; SCB – Specialized Commercial Banks; UCB – Universal Commercial Banks; SUCB – State Universal Commercial Banks; PUCB – Private Universal Commercial Banks; BCC – Bank Consolidation Company.

Dealing with Insolvent Banks

by Stanley Silverberg

Stanley Silverberg is consultant at the World Bank.

Solvency in Socialist Banks

In socialist countries bank solvency may not be very important, and sometimes the issue has not received much attention until consideration has been given to privatizing banks and other business firms. Socialist banks essentially serve as an arm of the government – they provide deposit services, and in so doing, provide a vehicle for financing government activity. Major lending decisions essentially reflect allocative decisions that may or may not be delegated to the bank. Capital accumulation generally is not considered to be important for banks and their state-owned borrowers as long as the government guarantees the bank's liabilities, and those dealing with the bank can rely on such guarantees.[1] When losses are incurred by government-owned banks and a negative net worth arises, that essentially involves a contribution to the government deficit and a contribution to government indebtedness. Sometimes, losses are obscured by uncertainty about whether state-operated enterprises (SOEs) will ultimately service nonperforming loans and whether such loans will be covered by government payments – but if we lump all the units together it may not really matter who has incurred the loss.

The problems with such a system include the relative absence of performance-based decisions regarding the pricing of bank services and loans, decisions related to credit extensions and operating decisions, including branch expansion, hiring policies, etc. Decisions can importantly affect how well the financial system performs and how well the economy allocates resources. Credit judgments are largely made by planners and often without regard to their impact on bank performance.[2] Often, bank lending may be directed by government authorities who are uncon-

[1] There are several examples of insolvent government-owned banks whose liabilities have been readily accepted in international markets because the governments' credit was considered to be sound.

[2] There may be external economies that justify noncommercial decisions. Too often, however, external economies are cited after-the-fact to rationalize bad lending and bad economic decisions.

cerned with its impact on the bank and not fully aware of the ability of the borrower (generally an SOE) to service the debt.

Privately-owned Banks

Ideally, we would like to see banks that are well-capitalized and motivated to operate profitably, rather than being operated to accommodate political goals or to serve other owner or management interests. That makes it especially important that initial paid-in capital requirements are significant, and that capital requirements are subsequently enforced. Unfortunately, when new privately-owned banks were permitted to operate in Bulgaria, as in other eastern European countries, initial capital requirements were modest and quality was sacrificed for quantity. In addition, the government-owned bank or banks were subdivided and given some of the trappings of private banks. However, they generally retained sizable portfolios of nonperforming loans to SOEs. In Bulgaria low coupon government bonds were given to these banks to compensate partially for the hole that existed in these banks. However, in most cases, realistic asset valuations left these banks insolvent.

Banks operate mostly with borrowed funds, principally deposits, and capital provides an important protective cushion for depositors and other bank creditors. At the same time, capital represents a key ownership stake. That stake is especially important where there is little, if any, banking tradition. With little real capital it is easy to view banks as functioning with other people's money. They, not the owners of the bank, are paying for the BMWs and absorbing loan losses. It is easy to view the bank as an institution serving the interest of senior management, whether that comes in the form of salaries and benefits, financing side businesses, financing the interest of friends and family, or buying political favor.

In most developed economies banking is a business, which seeks to profit through its operations. Where the government has protected bank creditors implicitly, or explicitly through deposit insurance, capital ratios and single borrower limits are enforced, self dealing is prohibited, and accurate reporting is required. In the few developed financial systems where bank creditors are clearly on their own, that is understood so that the burden is placed on such creditors to monitor the condition of their bank. In Bulgaria, even before the issue of deposit insurance was addressed, there probably was a general perception that all bank deposits were safe, even though they were exposed to loss of real value. However, this implicit protection, whether real or not, was not accompanied by meaningful supervision.

In making pricing, credit and other decisions, well-capitalized, profit-motivated banks tend to allocate personnel and financial resources in accordance with market forces, and the process generally promotes efficiency and economic growth. However, individual banks, even where they are appropriately motivated, make mistakes, and they may get into difficulty. And, where regulatory rules are bad, where political pressures interfere with business judgments, where government seeks to extract excessive revenue from banks,[3] or where the economic environment is especially bad, many banks – whether privately- or publicly-owned – may get into serious difficulty and become insolvent. (It should be appreciated that it is extremely difficult for banks to operate profitably over an extended period in a very high-inflation environment.)

When banks become insolvent and are permitted to continue to operate because of some form of government complicity, many of the following problems are likely to arise, and these are likely to have serious adverse consequences:

Distorted credit judgments. When a bank is insolvent and bank management appreciates how difficult it is to dig out of the hole, there is a strong tendency to gamble by lending to high risk borrowers who, if successful, will pay high returns. Similarly, there is an incentive to seek equity returns and to take interest rate and foreign currency risk. This *roll the dice* strategy is rationale – it may be the only way to become solvent. However, it is more likely that such a strategy will significantly increase the size of the hole and the cost to creditors and/or the government.

Political as opposed to economic decisions. An insolvent bank is more likely to be concerned with government decisions related to its closure or government action that might keep it alive. In seeking favorable treatment, it may seek political favors by diverting funds or extending inappropriate credits to those with political influence, or it may be more susceptible to making bad loans to financially-weak SOEs in order to curry favors or become "essential." Such behavior is likely to prove expensive for government.

Dishonest reporting and fraud. In order to convince depositors and the market that an insolvent bank is healthy, management has strong incentive to report inaccurately by concealing loan problems and otherwise overstating the value of its assets. Consequently, reporting by troubled banks tends to be suspect, and that problem is most acute where accounting and auditing standards are weak and where criminal penalties are not enforced against false reporting. Where future failure is anticipated, bank staff may be tempted to engage in fraudulent behavior in order to salvage some financial gain before the bank is closed and their jobs are lost.

"Predatory" pricing policies. In order to retain deposits, insolvent banks may pay substantially above prevailing interest rates. This can adversely affect the performance of otherwise healthy banks. Similarly, in competing for business or for experienced staff insolvent banks are likely to engage in pricing policies that are not economic for healthy institutions seeking to price staff and services in order to

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[3] There are many international examples where high reserve requirements, restrictions on bad debt deductions against taxable income and where special taxes applicable to banks or to financial transactions are considered to be politically popular means of raising government revenue. Such practices generally prove to be short sighted. They lead to weak credit markets and to a risky, undercapitalized banking system where self dealing is encouraged and where government is exposed to high costs associated with bailing out insolvent banks.

earn a market return on their investment. The U.S. savings and loan experience in the late 1980s and early 1990s showed how competition from insolvent institutions adversely affected overall bank performance, and how the elimination of those insolvent institutions benefited the performance of the remaining solvent banking institutions.

Cash flow problems. Insolvent banks tend to encounter serious liquidity problems unless they receive continuing funding from the central bank. In the case of Bulgaria such liquidity problems stemmed, at the outset, from the fact that most of the loans of the most insolvent banks generated so little cash flow. Eventually, this led to deposit outflows and massive liquidity problems. If the authorities fail to isolate illiquid, insolvent banks, this can lead to an overall lack of confidence in the banking system, and a shift to a largely cash economy.

Evaluating management performance. When a bank is insolvent, it becomes extremely difficult to gauge how well management is performing. Even where a bank reports accurately and operates effectively under the circumstances, a substantial solvency hole will obscure such effective operation. Thus, for example, in Bulgaria where banks are insolvent to varying degrees, it is extremely difficult to determine who is managing effectively and who is not. Sometimes, the source of the insolvency goes back several years and predates present management. When it becomes necessary to determine which managements should survive, existing insolvency obscures any objective measurement.

These are among the principal reasons why insolvent banks should be closed. Indeed, if there is reasonable transparency, no government guarantee for depositors and no government liquidity support, market forces will inevitably force closure of insolvent banks. The problem, for Bulgaria and other similarly-situated countries is that insolvent banks are such a large part of the system and there appear to be no really good ways to dispose of these banks. Elsewhere (the U.S. has had the most experience – much of which is not altogether relevant for Bulgaria) a number of different options have been employed. These include:

• Private sector acquisitions of failing banks while they still have some value. This preferred solution can be prodded by supervisory action combined with a credible closing threat. However, it only works where problems are addressed early, and where there are healthy banks or strong investors willing and able to assist or acquire troubled banks.

• Purchase and assumption transaction, where an acquirer assumes deposits and agrees to purchase some assets of failing or closed bank. Transaction requires financial assistance from the deposit insurer or the government – but there are few, if any, healthy banks willing and able to undertake such acquisitions. Allowing weak (or less insolvent banks) to acquire more insolvent banks will invite larger, future problems. What may look like opportunities to save money in the short run are likely to prove expensive in the long run.

• Nationalize the bank – but then who would manage it? Part of the bank could be transferred to the savings bank, although this is not a problem-free solution.

• Pay of depositors (insured or all depositors?). Could be a drawn out process that may lead to runs on other banks.

• Slow payoff of insured or all deposits. Closed or intervened banks would cease to engage in lending and other banking function, but would continue to service deposits (insured deposits). Liquidity would come from deposit insurer and/or the central bank. This stretched-out payoff would be less disruptive and may actually be less expensive because deposits would provide relatively low-cost financing. This process was used in the U.S. in RTC conservatorships and in other instances.[4]

Deposit Insurance

Because so many banks are insolvent, and because government policy has contributed importantly to bank insolvency in Bulgaria, it is probably inappropriate to impose losses on some selective depositors. Once this is done, exposed depositors will flee insolvent or problem banks so that the effect of limited coverage will prove to be arbitrary – it will be confined to the first failures. It is too late to look for depositor discipline and express concern about the so-called *moral hazard* problem. Until the banking system is materially improved, virtually all depositors should be fully protected in bank failures. Savings from doing otherwise will prove to be very limited, and full depositor protection will simplify payoffs and the handling of bank failures. Moreover, there is some evidence that concern about runs has become an excuse for not closing banks in Bulgaria.

The Cost of Bank Failures

The cost of bank insolvency in Bulgaria will be (has been) very high – perhaps on the order of 30% of GDP. However, it is important to appreciate that most of the *real cost* has already been incurred. That has happened over a period of several years when banks made bad loans to unproductive SOEs and private firms, whether through government duress, bad credit judgment or self dealing. However, I confess to being surprised by the impact of bank closings in Bulgaria – I had mistakenly assumed that the market already appreciated the extent of the "hole" and that its recognition was a "non-issue" – clearly that has not been the case.

Apparently, the absence of transparency in the banking system had masked the extent of the existing problem, even for sophisticated bank creditors. Also, uncertainty about how much depositor protection would be provided, once deposit in-

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[4] *In the U.S. there is a mechanism called a Deposit Insurance National Bank (DINB) which has been used in the past and less frequently in recent years. The "closed" bank continues to service insured deposits for some period of time – possibly several months. Typically insured deposits are slowly drawn down. The DINB can provide temporary deposit services, especially in communities where no other local banking office is present.*

surance was proposed by the BNB, added to uncertainty. Moreover, the fears of many depositors have been fulfiled through currency depreciation. Recognition of that loss may be painful politically, especially if bank depositors are asked to bear an even larger share of it. If government has to fund the loss, then it will impact the exchange rate and the inflation rate, and it will still be distributed to the public – though somewhat differently. If markets have now fully discounted the loss and government's recognition of it, then any further impact would be minimal. It will have some fall out in job markets. However, from an economic standpoint the *real* loss has arisen through the wasteful use of economic resources. In a sense the banking system has been the vehicle for another category of budgetary deficit and government debt.

Banking Services and the Future

There are more banks than are necessary in Bulgaria today, and some reduction in their number won't materially reduce banking services. However, this process might be carried too far. If all insolvent banks are closed, private sector lending will largely dry up, adversely affecting the economy. The BNB may have to select the best run of the insolvent banks which would be permitted to continue to operate, subject to close monitoring and certain restraints on their activity. Making appropriate selections (determining survivors) and enforcing appropriate restrictions will be difficult tasks – they will require much bolder action by the BNB with strong backing from the government. Those banks that meet capital and other requirements (factoring in realistic asset valuations) would be subject to far fewer supervisory restrictions – but apart from foreign banks, how many banks are well capitalized, or even positively capitalized in Bulgaria today?

Over a period of several years operating insolvent banks should be brought up to zero capital by the government and sold, or if their performance is unsatisfactory, they should be closed. There should cease to be pressure on banks to lend to SOEs – financing of SOEs would be through government or else guaranteed by government. Newly-chartered banks should be required to meet relatively high capital requirements, including high minimum capital requirements, and capital should be required to be paid in up front.

Efforts should be made to make banks more attractive as businesses, and this would be reflected in reserve requirements, taxes, tax treatment of interest payments by businesses, permissible activities, and other considerations. This should include efforts to reach out to potential foreign entrants into Bulgarian banking and to solicit information on what needed legal changes (including those related to title, collateral, etc.) would make the Bulgarian market attractive to foreign banks. There is substantial evidence around the world of situations where financial requirements imposed on banks have been excessive, and this has contributed to high risk, self dealing and, ultimately costs to the government that far exceeded the revenue from burdensome tax treatment.

Finally, it should be noted that a satisfactory banking system is unlikely to develop without a much smaller government deficit, a much lower rate of inflation, and a much more stable currency value.

What are some of the important lessons from the Bulgarian experience?

- Don’t let system get to this point – deal with problems early.
- Dramatically improve bank transparency.
- Enforce capital standards.
- Make foreign entry easy and allow banks to operate profitably.

■

Bank Supervision in a Developing Market

by Roumen Simeonov

Roumen Simeonov is Head of Division at the Bank Supervision Department, Bulgarian National Bank.

Ladies and Gentlemen,

I was invited to present to you issues which from a bank supervisors' viewpoint have been a source of banking instability in the conditions of developing market relations. Although the viewpoints of bankers and of bank supervisors sometimes do not meet, the ultimate goal is one – stable and profitable banks. While for the bankers risk evaluation and management is a dynamic predetermined by the dynamism of economic processes, for the bank supervisors risk evaluation of banks is a movable target.

Thus, I am tempted to highlight three major topics, which I hope would be of common interest.

Macroeconomic Policy and Soundness of the Banks

Bank supervisors would normally be indifferent to the broader context the banking institutions work in. In reality, however, there are important two-way relations between the macroeconomic situation and the banks. Experience from recent years provided a clear example that a weak banking system is unable to provide microeconomic channels, necessary for the efficient development of investments, industry, and employment, as it would reduce prospects for economic growth, delay the results of monetary policy, and may have a serious impact on public finances.

The latest materials of the IMF stressed the importance of "quality" of the financial sector and its impact on growth and efficiency. The analysis has shown a considerable deterioration of the economic situation in countries where banking crises occur.

On the other hand, macroeconomic shocks weaken the banking system rather than strengthen it, thus being a source of instability. History, including our experience, provides many examples of a sudden interest rates increase, collapses of stock-exchanges, unexpected inflation deviation causing difficulties to the banking industry, and sometimes provoking serious crises. Similarly, in countries where privatization and liberalization go faster or lag behind risk management or supervision abilities, a growth of financial markets instability is observed, resulting in negative consequences for the banking system. That is why the state should be involved in the macroeconomic policy and supervision activities if it is committed to promote growth.

The economic system of society. As at the middle of 1996, the economy of Bulgaria represents an unusual mix of a conventional market and still prevalent centralized formation and allocation of the national income. Transition to a market economy proved more difficult for Bulgaria than for the other countries of eastern Europe. The state continues to be directly involved in pricing the basic raw materials and energy, and their liquid fuel derivatives. There is also a direct involvement of the state in the field of telecommunications. As is well known, utilities prices are the main pricing factor of all other goods and services. Price liberalization in this country included only such goods which were not of strategic importance as a pricing factor for the creation of other goods. Moreover, this liberalization was introduced in the beginning of 1991, prior to change of ownership. This policy has not undergone any significant changes to date. Ignoring the market principles in the economy would only postpone and exacerbate problems and would create conditions for a new overall price increase and pauperization of the population. So, the market could be defined as a limited one, considering the reproduction of private ownership. A developed market may exist only in case of prevailing private ownership on the means of production, politically progressive regime and openness of the country to the world economy. As is well known, such conditions in this country are still in their initial, embryonic stage.

Prevalent public moods resulting from politicizing economic and social processes to a certain extent have distorted the ideas of producers, traders, and consumers and have brought them back into the moulds of the past.

The executive, legislative and judicial power will determine rules of the game and will oversee directly or indirectly their compliance. There is a frequent practice in the field of economy to take decisions, to pass and apply laws which are to the detriment of market principles.

As is well known, banking system problems are rather problems of the underdevelopment of market relations and of discipline. Lack of credibility in the banking system means mistrust that the banks would not be able to collect their receivables as a consequence of overall economic conditions, such as high interest rate levels, shocks on the foreign exchange, stock-exchange and commodity exchange markets, limited consumption, etc. Redistribution of the national capital in the hands of suspicious economic subjects and absence of efficient protection for the lenders would demotivate even worthy borrowers to be honest with banks.

Under the prevailing conditions, it is not justified to put the whole blame on the bankers, since they are compeled to work in conditions where lending is a very risky business. Part of the bank managers have made use of this administrative and legislative gap and have been arduously redistributing attracted funds in favor of their own shareholders, not by means of distribution of dividends (which would be a normal practice), but by easy access to resources which they could obtain from their own bank. On the other hand, managers of the state banks did not think that lending to state-owned enterprises should comply to the general principles of prudence.

Thus, performance of the banks during the recent 5 – 6 years was determined by a low level of development of market relations and prevailing state ownership in the major banks. On the other hand, private banks became a secure and relatively cheap source of capital for their big shareholders. As a result of this, a big part of small-scale producers and traders did not get any access to credit resources.

Banks under the Conditions of Market Environment

Market discipline. When internal management structures are unable to prevent irresponsible behavior, discipline should be brought by the market mechanism itself, by competition or by changes and impact of corporate control. Inadequacy of such mechanisms is also another reason for the instability of banks. Insufficient use of various financial products, underdeveloped money and capital markets cannot stimulate the banks to improve their efficiency. Hence, possibilities for risk diversification and overcoming liquidity crises are limited, which in turn leads to instability of the system. In countries where a high concentration of financial services is available, the banks may hide their own inefficiency by exploiting their market strength. Establishing big banks, but weak in terms of capital and profitability may play a practical joke on those who maintain such a policy.

From a theoretical point of view, discipline should also be imposed through the deposits market – discipline imposed through depositors responsive to the signals announcing unreasonable practice. Those who seek a higher interest rate would be among the first to withdraw their deposits. Actually, the depositors are mostly small-scale, diverse, and financially uneducated economic subjects with a very small strength to impose a more prudent behavior. Properly designed deposit insurance schemes, credits registers, external auditors, and market analysts may help in strengthening this form of discipline. As we all are aware, the limited influence which the depositors may impose for upgrading the efficient discipline on the banks is one of the reasons for their public supervision.

Corporate market also may exercise a more efficient influence. Small shareholders may punish unprofitable or irresponsible business management by selling out shares and by calling for the attention of the controlling institutions. The impact proper of corporate control sometimes is sufficient to rectify irresponsible behavior and to prevent crisis. Stock-exchange establishment in this country is still rudimentary and has almost no influence on the banks. Banks' shares frequently are not to be found on the list of official markets; shareholders lack the necessary information; sometimes the structure of owners is so much concentrated, that the new shareholders could hardly exercise any control. In spite of the fact that the stock-exchange is in process of formation, it will not be able to exercise any essential impact on the activities of state-owned banks.

It is striking to observe that in so many countries difficulties have arisen in banks which have been considered to be a good place for investment on grounds that money of the main shareholders would protect them from losses.

Liberal regulation of the market is impossible if the legal and administrative framework of market operation is nonexistent. If the property rights are not well defined, regulations concerning banks shareholders' behavior might be inefficient. If bankruptcy procedures are only outlined or are not available, it would be impossible for the banks to protect themselves against insolvency of the debtors. Rules of transparency and internal control would be inapplicable if the basic accounting principles were poorly determined and problems related to accounting were widespread in the economy. That is why Basle's principles and regulations are the most efficient for such banking systems where, in general, the structural problems as reviewed above have been reasonably and adequately resolved. Achievement of this situation should be a policy goal of any country that desires to strengthen its own financial system and to exert influence by measures for improving the wellbeing of the people.

In the current conditions in this country, the government also performs the role of majority equity owner in major Bulgarian banks. The intentions to dispose of these shares may have influence on the banking system, both in short- and in long-term aspect. Canceling the state guarantee on deposits in the biggest savings institution, the State Savings Bank (SSB), may enhance competition between the banking institutions. Creation of a market behavior is of particular importance for the formation of a sound banking system. The government should undertake certain minimum protection of depositors but cannot afford to provide a full deposit insurance since in such a way it would injure the interests of some taxpayers on account of others.

It is impossible to ward off a detrimental effect on the banking system of a policy directed to preservation of inefficient government structures on the grounds of allegations that their privatization might endanger the national interest. This is the way to maintain production industries which are not in a position to repay their loans, and to prevent their bankruptcy by a covered state protection. A number of banks have large exposure to insolvent state-owned enterprises.

The market and the banking system. Freedom of doing business by economic entities may be manifested solely and only in case of prevailing private ownership on the means of production (including in banking) and a system of government which protects and guarantees reproduction of this ownership. That is, freedom and private ownership are interdependent factors which form the basis of market economy. Political freedom in Bulgaria in the recent years has preceded "introduction" of freedom of economic subjects, based on free movement of capital and property. Immature market relations are the cause for lack of essential difference between the problems of state-owned and private banks with regard to their performance.

That is the way both private companies and banks got to this position to have the same amount of debts as the state-owned ones. It would be too simple on this basis to voice the opinion that "quality" of economy is not determined by the availability of a significant private sector. Unlike politics, economy, however, would not stand populism.

Implementation of the respective mechanisms for control over the banking system is a must, but from the point of view of economic logic it is necessary to exert influence on the original cause of the illness together with the "cosmetics" concerning reforms of the banking sector. First, the economy should be stabilized as a whole, then conditions for upswing based mainly on competition should be established. Banks only facilitate transfer of money and if the production and trading sectors are ailing (low production, unemployment, lack of markets, losses, permanent devaluation of production capacities, shrinking of final consumption, etc.) there is no way for the banks to compensate the losses from bad debts. Normally, problems of an economy surface as actual devaluation of the national currency. In actual fact, supervision is not in a position to exert any influence on the financial state of the banks when the causes of the crisis are of fundamental nature.

Participation of the state in the capital of the banks. As is well known, the state holds a considerable amount of shares in the commercial banks through the BCC (Bank Consolidation Company). This scheme created a lot of conflicts of interests and devolved responsibility. The BNB should abandon this commitment as it is not normal for it to be an owner and supervisor at the same time. Presently, the responsibility of the BNB is divided into two – one in its capacity as co-owner in banks, and the other in its capacity as a body authorized to supervise them, which refers to its previous role. Together with its giving up the function of owner in the banking field, the BNB will provide "opportunity" for the government to take the responsibility for the problems of the state-owned banks which in most cases are poorly managed, and it shall focus on implementation of standard procedures for monitoring and control on all banks, but only in its capacity as supervising institution, not as owner.

Absence of legal grounds for declaring a bank bankrupt. For a long time the Law on Commerce and the Law on Banks and Credit Activity have not allowed for that practice. Legally, it was possible to follow procedures for guaranteeing the depositors' interest as provided for by the Law on Banks and Credit Activity, and to withdraw the license of the respective bank which in turn will allow the procedure for bankruptcy of the respective company to start in accordance with the Law on Commerce. But this procedure may not be realized at the request of the lenders due to lack of legal guarantee for the bank's depositors. Although this option provided for the BNB to withdraw the authority of the executive directors, it has not essentially resolved the matter in case of bankruptcy in the way it was done after passing of the latest amendments to the Law on Banks and Credit Activity.

Competition and market discipline. With a view to stimulating the development of market relations in the field of banking and the national economy as a whole, presence of foreign bank capital is a necessary condition to increase competitiveness of the Bulgarian banks.

The delay in the process of privatization of state participations in banks led to paradoxical situations where a state body (BNB) has declared state-owned banks bankrupt and has requested the Court of Law to declare such banks bankrupt due to the fact that the banks could not collect their due from state-owned companies, many of which did not exist any more. It is not a secret that loans to such enterprises have been extended by instructions of the government or by its subordinate institutions. Actually the state organizes a bankruptcy of a part of itself, instead of gaining some economic and political benefit from the sale of these assets. The market will inevitably impose the need for changing the form of ownership in the field of banking. The faster it is done, the lesser will be the losses of the state.

Regulation of the Banking System and Bank Supervision

Legal and institutional conditions. Another possible source of instability is the legal and institutional framework. Lack or inadequacy of the corporate, liquidation, contract or private property laws would impede proper performance of the banking system in many countries. Poorly defined laws and practices would hinder the bankers to instill respect and discipline when quality of receivables deteriorates.

Reliable accounting practice concerning the banks and other companies is another key requirement for stability. If the financial accounts do not provide possibility for the lenders to evaluate the real condition of the companies, and if there are no (accounting) standards allowing for reasonable comparisons, the banks would not be able to make an efficient selection of potential borrowers. At the same time, supervisors and the public will not have the necessary information for evaluation of the performance and solvency of the banks and will miss the appropriate time for adjustments. The Bulgarian case is typical in this respect. Due to fiscal and other considerations, the balance sheets and financial accounts have been so overstated that the bankers themselves ceased to trust them.

Management and internal control. To a great extent, behavior of the banks is dependent on their internal management structures. Banking shocks would frequently arise due to inadequate control by the owners. This relates to the lack of accurate information and to the fact that shareholders are heterogeneous and small (with some exceptions, where capital is concentrated in the hands of an economic group or individuals), and are not in a position to exert any influence on the managers. Ownership structure (share capital) also may become a source of instability when the bank, whether private or state-owned, is used for funding its owners, if they do not want to service their loans in accordance with the common market conditions. The big internal loans and loans extended to related persons are frequently among the main causes for the banking crises. The possibility for exerting political pressure on the bank managers for extending loans to certain companies should not be overlooked.

Even when owners would give proper guidelines to their managers, banking may also be imprudent due to inadequate internal control. If information is not available or inaccurate, and operative limits and responsibilities are not properly defined, it may be easily assumed that unintentional or incidental risks exist. Poor internal control together with assignment of great authority to directors may destroy any bank.

Regulations and supervision (regulatory framework). Finally, instability may be caused by the supervision itself and by the regulatory framework. As experience shows, the regulatory framework is required for ensuring an accountable and reliable banking system. Sometimes the problem is due to lack of coordination of the national institutions, and in other cases the problem lies in the inability to estimate certain risks or in the unsatisfactory level of knowledge of the complex structure of the banking sector. The banking regulations and the other regulatory framework have fortuitously encouraged rather than prevented risky and inefficient behavior. Strict standards adopted in an inadequate environment being of an exotic nature rather than as a management tool could not be imposed painlessly.

Supervision discipline on banks' behavior might be properly designed and still remain inefficient if the competent authorities have no relevant legal facilities for penalizing and exerting influence.

Capital adequacy. The capital is not only a buffer against losses, but first and foremost it is wealth invested by shareholders for making profit. Capital requirements are a way of ensuring incentive for bank owners and managers to achieve the necessary balance: if considerable funds of the owners are exposed to risk, they will exert influence on the management to act prudently and reasonably. If the bank takes too many risks, it may generate higher dividends for a certain period, but sooner or later this will result in losses which cannot be absorbed. The owners should be faced with the requirement to recapitalize the bank. Shareholders may lose both control over the bank and their investments in it. The supervisory role of capital adequacy is an incentive to take corrective actions prior to assets deterioration beyond recovery.

Instability, bankruptcy, and way out. It will be wrong to consider the supervisory role *a priori* as a cause for the bankruptcy of one or several banks. Regretfully, the consequence of this interpretation in this country is that the supervisors would face public pressure to prevent declaration of bankruptcy of any bank which might have a dangerous effect on our behavior. A supervision or a system of supervision that has a zero factor of bankruptcy is not a good one. Risky banking should also be accompanied by a natural selection of banks. Otherwise, there will be no guarantee for the sound health of the system. Exit of players from the competition arena is part and parcel of the market economy psychology. Proper exit procedures are an important element of the overall security and accountability of the banking industry. Relations ending up in extremes by competition or by current condition do exist where no well defined instruments allowing for timely exit from the marketplace of banks which are beyond recovery are available. Banks which have lost their capital can become a threat to financial stability. They tend to overcome their problems in a gambling way, providing high interest rate on deposits and lowering the requirements when selecting borrowers. Moreover, nonrecoverable banks will frequently play the host of insolvent clients and will continue to extend funds to them or to capitalize the interest due on their loans. As is well known, removal of any bank from the system cannot be left at the mercy of market forces because subsequent sudden bankruptcies may shake the trust of depositors. Regulatory framework in this field (e.g., mergers, conservatorship, and liquidation) should encourage market discipline, not suppress it. In countries where in general there is a fully imaginary or really existing belief that the government will not allow any bank to go bankrupt irresponsible behavior, and in some cases losses, increase (which burden the taxpayers).

The Basle's approach does not fully cover the rules for removal or closure because restructuring schemes vary in different countries. Focus on capital requirements presumes a supervisory intervention substituting internal management of the bank. Quick intervention and clear winding-up regulations are necessary to impose market discipline and this is completely in the spirit of the Basle's approach.

Pressures exerted by the government, the legal system or the public may limit application of market principles and supervisory rules and thus supervisors' responsibilities may not be supported by adequate resources, information and penalizing instruments. Supervisors do need power in order to be able to receive relevant information and to exert influence directly on the banks in certain situations. They should be in a position, where necessary, to impose sanctions, including withdrawal of banking licenses.

Banking crises have raised another issue, directly related to the ownership problem, especially in cases when shareholders of the banks are managers or supervisors. In the progress of banking affairs, managers' interests often come into conflict with the shareholders' interests. It is evident from practice that usually members of the supervisory boards are people holding key positions in the government administration or major shareholders.

In such cases, corporate control will lose its role of a natural barrier which the owner sets up against the management mistakes. Over the recent years, banking practice in this country has witnessed the perfunctory role played by the internal control of the banks. It is a generally known fact that internal control efficiency depends on the quality of management.

Second, the weak internal control in banks may be a consequence of the attitude of major shareholders who usually are also major borrowers. They do not benefit from internal control. In general, at all levels and forms, control is an obstacle to redistribution of capital and that is the reason why some shareholders have been deliberately neglecting their interests as owners on account of their interests as borrowers.

Does regulatory framework help in the development of market relations in the field of banking? The following questions always arise when the regulatory framework is referred to:

a) Is it sufficiently broad so as to guarantee performance of the banks and of the supervisory institution?

b) What are the procedures for preventive control and influence on bank managers exercised by bank supervision?

c) Are the performance requirements related to precisely regulated penalty actions in case of failure to comply?

Such questions will arise and are topical not only in relation to the performance of the banking institutions. Of essential significance is the fact whether overall regulatory framework regulates some rules omitted to be provided for by special laws. For example, current banking regulations do not provide too much power to the bankers to collect their claims on defaulting borrowers. Precarious situation and idleness of the court authorities concerning cases of the banks filed against such borrowers would create difficulties for risk evaluation. In case of defaulting behavior, the blame will lay not only with the bank which has extended the loan, but also with the laws and the juridical system which should guarantee the general principles of integrity of credit relations. Bank management rather should bear the responsibility for incorrect evaluation of the credit risk, for corrupt practices and commitment to certain borrowers, concentration of too many loans in interrelated persons or preferential lending to shareholders of the bank. Such an understanding is not aiming at fully disavowing the bankers' responsibility in order to shift it onto the juridical system and the laws, since the bankers should properly secure the loans they extend.

Any transitional economy should resolve the contradiction between the pretensions, abilities, and the needs of borrowers. Ever growing losses and indebtedness raised doubts about the ability of the banks to collect their debts in due time. Extending loans to state-owned enterprises is risky due to their poor management, absence of direct control by the owner and wasteful practices at all levels. Lack of capital market, labor, goods, and services has been making private companies rather uncertain in their capacity as borrowers. Tens of thousands private firms existed rather on paper than in reality. Cases of open criminalizing of trade, exchange, and some financial services were not rare. Private formations which emerged after 1989 initially were unable to offer real security on the loans. In most of the cases private entrepreneurs could offer as collateral their dwellings, small shops, cars, etc. Process of accumulation of private capital did not give an equal start to all participants and the ones who were close to power and the banks were better placed to easy access to credit funds with no real security.

What should be said about banking regulations? It is a positive fact that the Bulgarian banking legislation is based on the experience of the countries with advanced market relations in banking. Generally, this was determined by the need to establish banking regulations and norms adequate to the international understanding, which should make our banking system more open to the world, easier for defining and forecasting. This, however, occurred in time of great hopes with regard to change of ownership and to redistribution of the national wealth. This relatively satisfactory regulatory framework could not find specific application in Bulgaria.

Hence, a conclusion may be drawn that the regulatory framework in itself does not “create” conditions to regulate normal market relations in the banking field, but only provides outlines, a framework where such market relations will take place. Some of the major prerequisites for a normal functioning of the market are: economic freedom in society; free movement of people and capital; political commitment to protection of owners’ interests; possibility for reproduction of a greater part of the property, etc.

Conclusion

The role of a sound and efficient banking system to support and promote economic growth should not be overestimated.

Decentralization of economic decision-making and reforming of the real and banking sectors, private property and corporate skills are necessary conditions for replacement of the centralized approach by efficient market relations.

No government will benefit from the presence of a systemic banking insolvency, since the banking system is an essential component of each economy. The government should take care of the stability of the banking system by guaranteeing the macroeconomic program implemented by it. Well performing institutions are in a position to guarantee only to a certain extent the stability of the banking system, but they are neither able to change the fundamental causes for the crises, nor to directly exert influence on the macroeconomic policy of the government.

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Strengthening Financial Control and Supervision

by Terrence MacDonald

Terrence MacDonald is Managing Consultant, Ernst & Young, London.

Good afternoon ladies and gentlemen. My name is Terrence MacDonald and I am based in the London office of Ernst & Young specializing in the banking and financial services sector in emerging markets. I have been working with banks in central and eastern Europe for the last four years. My clients include banks in Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Kazakhstan, Kyrgyzstan, Poland, Uzbekistan and Sri Lanka.

This afternoon I should like to share with you some of the issues which are considered important in supervising the condition banks. It is worth noting at the start that these same issues are important to western banks who are looking to develop correspondent banking relationships and possibly looking to invest in local banks.

The supervision issue is of critical importance at this point due to the impending restructuring of the banking sector. You must ensure that certain basic capabilities to supervise the banks are in place first. Otherwise you may find yourself in a situation similar to Hungary in 1993 where they recapitalized state banks to the amount of USD 2 billion only to find that the entire amount had been lost over the next six months.

Introduction

One weakness of the Bulgarian banking system has been the absence of an adequate methodology for the supervision of the banks, as well as a workable policy for dealing with problem institutions.

The purpose of this paper is to review methodologies for measuring the performance and condition of banks and assigning a risk rating. Also I will discuss a range of performance indicators which can be incorporated into a system to provide warning of the deterioration and potential failure of a bank.

However, we do have concerns that methodologies which are employed by rating agencies and supervision departments in other jurisdictions will not be fully effective in Bulgaria due to the special circumstances prevailing in the Bulgarian banking system and to doubts about the availability of reliable bank information.

The process of rating banks in Bulgaria is severely limited by the quality of financial information available. Banks are not currently required to prepare financial statements in accordance with International Accounting Standards, and Bulgarian accounting standards for banks still fall substantially short of realistic reporting. For instance, under Bulgarian accounting standards:

• banks are not required to record the full amount of the calculated loan loss provision;

• banks are not required to consolidate the results of subsidiaries nor equity account for significant investments;

• banks are not required to discount the value of bonds which earn interest at a rate substantially less than the market.

These differences make the statutory financial statements virtually useless for rating purposes since a realistic value of the reported assets cannot be reliably determined.

Monitoring by the BNB

It is the legal responsibility of the BNB to, among others, protect depositors and ensure the stability of the banking system. This can be achieved through a program of identification of weak banks at an early stage and the subsequent monitoring of those banks, coupled with a plan of corrective actions to be taken by the individual banks.

Accordingly, the BNB must implement a monitoring program with the following objectives:

• developing a thorough understanding of each watch-list institution which poses a serious risk of loss to the BNB (as guarantor of deposits);

• early detection of solvency problems;

• early detection of compliance problems;

• contributing to solutions for problem institutions;

• contributing to the development of policies of safety and soundness.

Watch-list Criteria

The indicators of the condition of a bank may be grouped under the following headings:

• capital level and quality;

• asset quality, including loans and investments;

• management and control;

• earnings – income and profitability;

• liquidity and treasury, which cover interest rate, exchange rate, and position risks, liability profile.

These headings are often referred to under their acronym – CAMEL.

Under each heading may be grouped measures or criteria for determining when a bank should become subject to special supervision, due to its heightened risk protile. If the criteria in the list are applied to all banks in Bulgaria today there are likely to be no more than a handful of banks which would not be placed on the watch list.

Rating Methodologies

The methodologies used in rating banks by supervisory, commercial rating agencies, investment underwriters, brokers or other banks commonly focus on the key areas of risk in the business of banking:

- asset quality;
- funding or liquidity risk;
- interest rate, foreign exchange rate, market value or position risk.

The results of a bank's management and control of those risks are reflected in the earnings of the bank and the level and quality of its capital. These measures of a bank's performance feature also in the commonly used methodologies.

Increasingly the attention of rating agencies is focusing on institutional management quality and the effectiveness of the corporate governance and control practices followed by a bank. This is in recognition of the vital importance of an environment of strong corporate governance and internal control to the sound and successful operations of a bank.

Early Warning Indicators

The BNB supervision department can most effectively protect the depositors funds and ensure the stability of the banking system if it is made aware of emerging problems among banks as early as possible, thus being in a position to be influential in the planning of corrective action. This awareness will, in large part, come through the risk assessment unit of the supervision department from its own monitoring of higher risk banks.

Possible Approach

The objective of the monitoring activities will be to confine the risk of loss by assessing the condition of banks identified as weak from the standpoint of determining which banks are suitable candidates for rescue programs supported by the BNB. Since such programs should not be entered into without virtual certainty of success, the underlying analysis must focus on the composition of the bank's assets and their values together with the business plans to correct the deficiencies which gave rise to the problems initially.

There are several factors which are critical to the achievement of those objectives:

- a base of timely and reliable data from banks;
- sound, timely and reliable analysis of the data;
- effective on-site examination of the bank's assets;
- access to wide range of market intelligence;
- the will and ability to act to contain risk.

Presently, there is concern that a number of those critical success factors are present only to a limited extent or are missing altogether.

• On-site examination of banks is limited due to scarcity of resources;

• Off-site analytical supervisory practices are also limited due to scarcity of resources and limitations on the quality and timeliness of data.

In these circumstances, the conventional rating methodologies described in this paper are insufficient to enable the proper monitoring of banks. This is primarily due to the uncertainty surrounding the valuation of banks' assets and hence level of capital. As stated in the introduction, Bulgarian banks do not prepare their accounts in accordance with International Accounting Standards. The major negative result of this is that the accounts do not reflect fully the required amounts of provisions for loan and other credit losses.

Furthermore, even if the provisions were to be fully booked, without regular on-site examinations or other verification programs, there can be no assurance that the asset values are fairly stated. It is well known that as financial institutions encounter difficulties there is a strong tendency to postpone the recognition of credit losses.

Live Examples

Inadequate supervision of banks or inadequate accounting and disclosure requirements can leave individual banks and financial systems open to substantial risk. I would like to highlight this risk by way of a few examples.

Accounting standards:

• Japanese banks do not prepare their accounts in accordance with International Accounting Standards. The major effect is that loan loss provisions have not been fully provided for. Additionally Japanese banks are not required to consolidate the results of subsidiaries. One result is that Japanese banks have tended to move their bad loans into subsidiaries so that they do not have to report the losses.

Over the past few months Japanese banks have made significant loan loss provisions of over USD 50 thousand million. However, there is still a widespread view that the full extent of the bad loan problem has not been disclosed. This is supported by the disclosure last week by the second largest bank in Japan which was required to report its financial results under US regulations. The loan loss provisions reported were 20% higher than that previously reported.

• In Bulgaria, the accounting standards do not allow the banks to make full loan loss provisions unless there is sufficient profit. It is fairly easy to understand the effect of this on the lev loan portfolio. However, the effect on the hard currency loan portfolio is less clear and Bulgarian accounting standards do not provide the bank management with information to make sound business decisions. For example, a bank may have a policy of maintaining a long hard currency position of 5% of net assets and will base this information on the statutory accounts of the bank. However, under IAS, after making provisions against the hard currency portfolio, the bank may have a short position. With the substantial devaluation of the lev recently this bank would have experienced a substantial foreign exchange loss.

Supervision

• During 1994 the Bank of Latvia increased the minimum capital requirements for banks. As a result many banks were required to raise new capital. The largest bank in Bulgaria increased its capital substantially to support its increased asset base. This bank, Banka Baltija, subsequently was placed in administration (Chapter 13) by the Bank of Latvia in May 1995. During the ensuing investigation it was discovered that almost all of the banks capital was fictitious. What had occurred was that the bank would make loans to related parties who would then loan the funds to an existing shareholder. The shareholder would then invest the money in the bank as share capital. The net result was that loans were overstated and capital was overstated.

From a supervision point of view it is worth determining where the funds have come from when a bank increases its capital. This is related to the concept of transparency, which basically means that the operations and decision-making process of banks should be easy to understand.

• Additionally in this bank, which had total assets of USD 400 million, approximately 50% of the assets were fictitious, many of the loans being made to related parties. If the Bank of Latvia had conducted effective on-site supervision, there is a good chance that these problems may have been detected at an earlier stage.

• One other item of note is that the Chairman of this bank had a criminal record. In most jurisdictions there are requirements of individuals holding office in deposit taking institutions. These regulations are there because it is not considered appropriate to have individuals of questionable character be responsible for the savings of the country's population.

Conclusion

The current condition of the Bulgarian banking system indicates that for many banks the methodology described in this paper are not applicable; those banks that are technically insolvent do not require monitoring rather they require restructuring or liquidation.

However, as the banking sector is restructured and recapitalized the monitoring of those hanks will be very important to ensure that the crisis does not recur. To this end, it is imperative that the Government of Bulgaria and the BNB work together to ensure that the financial and human resources are available to perform the necessary supervisory functions and that the regulatory framework is in position to allow the supervision department to operate effectively.

Appendix

Common Assessment Framework
CAMEL
Capital, Assets, Management, Earnings, Liquidity

1. Capital Level and Quality

• Capital levels below the minimum levels required by legislation
• Accumulated deficit
• Absence of capital plan
• Quality of capital – Tier 1, Tier 2, Tier 3

2. Asset Quality

• Additional provisions for losses on loans or write down in the value of investments identified
• Concentration of loans to single borrowers (e.g. loans in excess of 10% of the bank's capital aggregate more than 20% of total loans)
• Concentration of loans by economic sector (e.g. aggregate lending to one sector in excess of 10% more than the normal market share)
• Rapid assets growth, in total or in specific areas
• Absence of formal and adequate credit risk identification and management procedures and policies

3. Management and Control

• High turnover of key managers
• Evidence of inexperienced Board and senior management
• Frequent noncompliance with regulatory requirements
• Evidence of self-dealing or conflict of interest situations
• Absence of strong control environment and culture

4. Earnings – Income and Profitability

• Net losses for more than two consecutive quarters, aggregating to 5% or more of the capital of the bank
• Aggressive income recognition and provisioning policies
• Absence of a viable business plan
• High ratio of operating expenses to total income

5. Liquidity and Treasury

• Inadequate levels of statutory liquidity, and frequent borrowings from the BNB
• Mismatching of positions resulting in gaps which result in unacceptable levels of risk
• Absence of evidence of understanding of treasury-related risks and of appropriate risk management procedures and policies
• High proportion of insured deposits
• High proportion of demand and short term deposits
• Concentration of large depositors

Management in Banks and Its Role in the Restructuring Process

by Pierre Lemaitre

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Introduction

Our experience in training hundreds of bank managers in the previously communist countries of central and eastern Europe tells us a lot about the process of changing management and the conditions required for efficient restructuring. It is this experience that I would like to share with you.

But, first of all, what is management and what is the manager's role?

We often observed that central European country middle managers were at times unsure as to what their actual role in the bank hierarchical structure was. This is largely due to the fact that the status and role of the bank management remains largely undefined in these countries.

Instead of referring to a priori job description of an ideal manager (something we shall describe later), I would start by defining management as "the art of getting things done through people."

The Old Image of the "So-called" Bank Manager

In most banks of nearly every country, traditional managers put emphasis on their technical knowledge and activities and have a tendency to adopt, before all, a policy of close and careful supervision and control. This is indeed necessary, but is by no means sufficient.

• This policy was especially true for most central European managers, who are qualified as engineers, and have, therefore, some tendency to be mainly technical and production-oriented, i.e. concerned with the needs of production and not considering the requirements of the clients, or the necessities of financial equilibrium.

• In the banks of central European countries, many managers have also experienced several years under a central planning system. In fact, for them, after three quarters of a century, these old practices inevitably still persist in their minds. It is thus quite normal that they have a lack of commercial and marketing skills.

There is, however, still a huge amount of training to do to install the necessary knowledge of fundamental marketing practices, understanding customer requirements, targeting clients, presenting the customer's corporate image and developing customer relations.

Thus the need for a better management system within central European banks is obviously required. Even if the western "market economy" language (i.e. profit, free prices, competition, etc.) has been adopted, there is still a huge amount of managerial challenges to face.

In our relations with central European managers, we quite often face:

• little understanding of international operations, western laws, contract arbitration and court proceedings;

• poor quality products and uncertain supplies (due to indifference to errors);

• outdated technologies and traditional organizational forms, disregard of safety factors, and low productivity;

• no cost awareness;

• lack of skills to make microeconomic calculations, price formulations, etc.;

• incompletion of major projects and general bureaucracy.

On the other hand, central European companies must be given merit for the progress that they have achieved.

We often found, for example, high technical expertise, huge amount of good will, fast change achievement, and, at least, some very interesting and useful planning practices.

The Switch to Market Economy: Managing the Changes of Roles When Banks Have to Adapt to New Conditions

Bank managers are now facing new challenges that require four new types of roles to be considered by them:

a) Managing the introduction of new technologies, tools and methods, as well as dealing with organizational changes, an aspect at which most banks have succeeded.

b) Contributing to the improvement of staff competencies, knowledge and skills. In this respect managers have to: define jobs, methods and skill requirements; control manpower, observing gaps between job requirements and the abilities and know-how of personnel to perform the jobs; hire the right kind of staff (considering their skills and motivations), organizing the recruitment of the new staff; develop their staff's capabilities, constructing training programs to improve individual performance and organizing and managing internal on-the-job training.

c) Developing marketing management tools and practices to ensure growth in a competitive environment: knowing one's (potential) clients; updating a network of relationships, conducting market studies (sampling, analyzing and interpreting data, etc.); marketing the offer – something which requires deep personal involvement, highlighting current advantages, constantly referring to selling and commercial policies and practices, negotiating optimum conditions, organizing product delivery customer follow-up, etc.; defining high level objectives given to the team and to individuals and following marketing campaigns and action plans; putting a team together and leading it – choosing the accurate style to be adopted within the hierarchical relationships with the personnel, motivating the staff, etc.; increasing the motivation and dynamism of the employees through accurate incentives and rewards (bonuses and premiums based on performance appraisals), but also through setting challenges, responsibilities, etc. Carrying out personal follow-up (monthly report), performance appraisal interviews and carrying out negotiations on the remuneration and salary progressions.

Many central European banks have proven that they have been able to achieve some of the most important of these required marketing management processes. But there is still a lot to do.

The last aspect highlights the fact that interpersonal skills of the effective manager constitute a topic of major importance.

There remains obviously a need for decentralized organizations adopting a participative leadership style to face difficulties.

d) Managing the permanent improvement of productivity and overall efficiency of the bank thus making it competitive.

Bank managers in charge of profit centers must now increase the economic performance of their units to obtain higher results with limited resources.

They should, therefore, be aware of costs and price formation, be able to carefully manage budgets: forecasts, financial control, income, fees, wages, facilities (buildings and equipment), research, advertising, communications, etc.; be able to implement company objectives by establishing action plans, controlling time tables, etc., and eventual follow-up; be able to develop risk management tools, a necessary part of management control; organize the banks activities through constantly lowering costs and improving productivity; identifying tasks, defining and describing jobs and limits of delegation, setting up complementary teams for various projects, etc.; establish efficient administrative procedures; coordinate different units (departments, branches, etc.); and optimize the overall efficiency of local organizations by:

- restructuring (destaffing, delayering, outsourcing and facilities management);
- reengineering the processes to optimize the systems and procedures.

We can conclude by noting that bank managers, as decision-makers, have a substantial impact on the business restructuring process.

Intermediate/branch managers having a large amount of autonomy certainly influence this change process.

The rising success of banks in central European countries shows that their management policies are improving every day.

Managing a Bank in Tomorrow's Unstable and Ever Changing Environment: The Challenge for Our Banks Is To Sculpture a Management Team That Will Achieve High Performance

It is certain that the banking environment is going to rapidly evolve in the coming years.

Bearing this in mind, we must stress the following critical factors:

1. The major change may be the splitting between the two levels of strategic and operational management:

• The strategic element of management is in charge of defining where the bank should go and why.

• The operational element determines how to get there and how to react to any difficulties that may arise.

It is important to distinguish between them in order to manage the global performance of the bank and increase its competitive advantage.

2. The pressure of the consumer shows that nowadays it is necessary to improve the management of the quality service: identifying and understanding the clients' deep needs, expectations, and requirements; adopting a customer-orientated approach, improving one's reactivity, etc.

3. They should help change cultural values of the firm's personnel. That means that they would deal with cross cultural gaps and manage social and attitude changes (at individual, group, organizational or institutional level). In doing this they would clearly map out future career paths, always keep staff informed, use benchmarking of jobs, etc.

4. Central European managers need to adopt new business practices.

5. Managers should become change facilitators. As flexibility relies on people's attitudes (their willingness to change), it is imperative that they fully understand all aspects of such changes (consequences, etc.) in order to accept them.

Here we see the importance of the communication role of managers, keeping staff informed of every step of this evolution process.

The major challenges we can observe in the development of a bank's strategic management include:

• Defining the role of the considered structure (vision), analyzing the bank and its opportunities, elaborating a diagnosis (prognosis) of the situation and anticipating future evolution, taking into consideration opportunities and threats offered by its environment (challenges); past performances; inner strengths and weaknesses of the bank (distinctive features), designing main orientations of the strategy of the bank, and establishing the priorities of its "business plan"; choosing one's target market; offering the right products, tailored to customer needs; calculating the right prices.

• Setting-up medium-term objectives and projects, deciding investments for the medium and long term, but also combining all the performance criteria (short-term growth and financial results, customers satisfaction and improvement of human resource capital), coordinating the use of financial and technological means, and manpower, choosing the right implementation process (using accurate methods to actually achieve the projects until their completion), etc.

These aspects are obviously becoming more and more important, but we often found it hard to convince central European managers of the significance of this strategic and tactical dimensions of management activity. Of course, this may be explained by the fact that they still often work under great uncertainty.

Nevertheless, one can easily perceive that managers will have to contribute to the future challenges of central European banks, such as changing personnel attitudes toward their work, improving the quality of their services to respond to customer requirements, or contributing to the choice of major strategical options.

The role of management is obviously considerable as regards the performance of banks as well as to the restructuring process of financial institutions.

Conclusion

The role of management is obviously considerable as regards the performance of banks as well as to the restructuring process of financial institutions.

Human resource management, communications, leadership styles are a crucial part of modern management thinking.

We often had to acknowledge that there was a lack of motivation, interpersonal skills and sometimes even total ignorance of what organizational development can produce.

Many central European managers consider as normal the "old hierarchy system," i.e. a system that is mainly administrative, associated with heavy political and economic machinery, use of a central planning system, etc. They perceive themselves as "bosses" (i.e. authoritarian leaders) bothered mainly for things that concern the upper levels of the structure, and not interested enough in the lower levels of activity in relation with clients.

Such managerial attitudes have to be changed. Indeed as things do change so quickly in this environment it seems that it is gradually improving.

Personal initiatives have not been put forward in the past. This system encouraged low personal value or worth and lack of innovation and dynamism. It is thus normal that many central European middle managers find it difficult to take personal initiative and develop independent self-direction and entrepreneurship.

New working methods are to be introduced in order to help central European managers overcome such inhibition factors.

But the real success of the restructuring process will rely on our capacity to identify and create together with local middle managers new management concepts and practices adapted to local individual situations.

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The Regulation of Banking in the EU

by Derrick Ware

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The EEA "Passport"

To create a single market in financial services throughout the European Economic Area (EEA) – which at present comprises the 15 member countries of the European Union (EU) together with Norway – requires the removal of regulatory barriers to firms operating outside their country of origin. The aim is that authorization to conduct a particular kind of business in once EEA country should enable a firm to do so in all such countries; this is the so-called "passport." This necessarily involves mutual recognition of other States' regulatory standards, that is accepting them as adequate, in order to achieve which minimum EEA-wide standards are required and cooperation between national supervisors is essential.

Under the passport a firm authorized in one State (its "home state") and wishing to operate in other States ("host states") will have the choice of delivering services either through branches or on a cross-border basis without establishing a physical presence at all.

The chief benefit of the passport is seen as increasing competition by widening the range of market participants and letting firms choose the most cost-effective means of supplying services to particular markets. An important example is the ability to operate throughout the EEA on a single unified capital base rather than having to establish separately capitalized subsidiaries in each jurisdiction, or to maintain endowment or dotation capital in branches. The passport also increases firms' flexibility in designing management structures and internal systems.

Passports in different areas of financial services are set out in EU Directives; typical components are as follows. The scope of the passport is defined in terms of the type of institution and its activities, sometimes by reference to particular instruments. The importance of this is that the activities which require, say, authorization as a bank vary between countries, so that a Directive which referred only to "banks" would cover a different range of activities in different countries – which would scarcely produce a single market.

Passport Directives require firms to be authorized by their home state, and set out conditions which must be satisfied for a firm to obtain and keep its authorization. Such conditions normally cover three main areas. The management and systems of control must be adequate for the scale and nature of the firm's business; and its owners, directors and managers must be "fit and proper." "Fit" may be summarized as suitably qualified by education, training and experience for a particular position, while "proper" essentially refers to integrity. The home state authority must asses the suitability of large shareholders at the authorization stage and whenever significant shareholding changes are planned.

The third typical condition relates to the minimum level of capital a firm must have to support its business. Minimum capital standards are intended not only to protect those who deal with a firm, but also to reduce the systemic risk to host states' markets which might result from the failure of poorly-capitalized foreign firms; such standards are also meant to "level the playing field" by depriving firms from countries with inadequate capital requirements of an unfair competitive advantage.

I should like to stress the word "minimum" here. In relation not only to capital but other aspects of the passport, each State is perfectly entitled to impose stricter standards on firms incorporated in its own jurisdiction, though not of course on those from other EEA states using the passport to operate in its markets. My own country certainly does so. A closely related point is that the adoption of agreed minimum standards does not mean EEA – wide uniformity in the detail of supervision, which varies between countries as a result of history, culture and institutional structure.

If firms from one state are to operate under the passport in host states' markets, it is crucial that the division of responsibility between home and host state supervisors is clear and unambiguous so as to avoid what is often, and inelegantly, called "supervisory underlap" – something escaping the supervision of both national authorities. The home state is responsible for the prudential supervision of a firm, including all its branches wherever located, and for the "fitness and properness" of its controllers and major shareholders. The host state's responsibility centers on the conduct of a firm's business with customers. The Directives make the sensible point that home and host states need to cooperate, and outline mechanisms for this; perhaps this most important aspect is the definition of circumstances in which supervisors may exchange confidential information.

The Single Market in Banking

Though the single market in banking came into being at the beginning of 1993, its creation was a lengthy process. The first step on a long road was taken in 1977 with the adoption of the First Banking Coordination Directive which applied to "credit institutions," that is firms which take deposits and make loans. It required all credit institutions to be authorized, placed on home state supervisors the duty to monitor the solvency and liquidity of their banks, and made compulsory the authorization of credit institutions branches in other Member States.

The passport itself came in the Second Banking Coordination Directive (usually referred to as 2BCD) which was adopted in 1988 and took effect on 1 January

1993. The scope of the passport is wide; among the activities covered are deposit-taking, lending, money transmission, leasing, issuing securities, credit cards, and trading foreign exchange and securities. Its effect is to give firms freedom to supply throughout the EEA all the activities covered by their home state authorization; and it is supported by an array of common minimum regulatory standards which I will now outline.

2BCD itself incorporates those relating to the authorization and prudential supervision of credit institutions, including a minimum capital base of ECU 5 million. There are also minimum requirements for information about major shareholders and limitations on audit institutions' shareholdings in nonfinancial

Capital adequacy has two directives to itself; one – the Own Funds Directive – defines what my be counted as capital while the Solvency Ratio Directive sets out the weighted risk asset approach originally developed by the Basle Supervisors' Committee and lays down a minimum ratio of 8% for own funds to weighted risk assets. This approach was designed to accommodate, and require capital to be held against, banks' credit risks; market related risks have only quite recently been included in a way I shall describe shortly.

Supervisors have long recognized the danger of concentration of risks in a bank's business, and sought to limit it. National practices in regard to credit institutions' exposures to individual borrowers or groups of connected clients have since the beginning of 1994 been harmonized by the Large Exposures Directive. This relates exposures to the size of a bank's capital base, defining a "large" exposure which must be reported to supervisors authorities as one equivalent to 10% or more of capital. No single exposure or group of connected exposures may exceed 25% of capital, and all of a credit institution's large exposures together may not exceed eight times capital – though a number of countries impose a lower limit on their banks. There are however some exceptions to these rules for good practical reasons, notably in relation to interbank exposures which are mostly generated through activities conducted by dealing rooms within a framework of counterparty limits established by management. UK practice is for supervisors to review these limit structures annually, and individual counterparty limits higher than 25% of the lending bank's capital may be accepted, especially when that bank is small. There are two reasons for this. First, 25% of a small bank's limited capital may be less than the normal marketable amount in interbank dealing; or where a small and uncomplicated bank has no expertise or involvement in the interbank market, it makes more sense for it to place surplus funds with a few big banks.

Another strongly held tenet of supervision is the importance of consolidated supervision of banking or financial groups in addition to the individual supervision of their constituent parts, and so relevant requirements are included in Consolidated Supervision Directives.

A consequence of the banking passport is that should an EEA bank fail, depositors throughout the EEA look to the home state deposit protection scheme rather than those in host states. Thus the Deposit Protection Directive establishes the home state's responsibility and lays down minimum requirements which all schemes must observe but also exceed if a country wishes.

Investment Business

The Investment Services Directive which came into force at the beginning of this year provides a passport for firms whose regular business is to provide investment services for third parties on a professional basis. Investment services are defined in detail, covering transactions in a range of instruments on a firm's own account or for customers; many of the instruments or activities are commonly also undertaken by banks.

Thus there is a clear need to treat investment business in the same way whether conducted by investment firms or banks so that neither group should obtain competitive advantage as a result of different regulatory treatment. This task is complicated by the fact that banks and investment firms differ in several important ways. Banks' assets traditionally mainly comprise long-term nonmarketable loans, whereas investment firms hold marketable assets which are rapidly turned over; hence while credit risk is predominant in banking, investment business features market risk – that of fluctuation in the market price of assets. This is reflected in accounting treatment. Banks account for their loans on a going concern basis, valuing assets at original cost; investment firms in effect account for their assets on a liquidation basis marking them to market frequently. And in terms of funding, banks typically rely in large part on short-term unsecured deposits while investment firms tend towards longer-term funding secured on their assets.

The solution is both elegant in principle and complicated in practice. It is to treat investment business in the same way whether undertaken by investment firms or banks. This requires credit institutions to classify their assets as either trading or banking; the former treated identically under the Investment Services Directive (for investment firms) or the Capital Adequacy Directive (for credit institutions). Both Directives specify minimum capital requirements for investment business in relation to market risks and large exposures. Banking assets continue to be treated as before under the Own Funds and Solvency Directives.

Supervisory Responsibilities and Cooperation

I said that the banking passport and the accompanying mutual recognition of supervisory standards require a clear allocation of responsibilities, the application of EEA-wide minimum standards and mechanisms for cooperation, both formal and informal.

In relation to the division of responsibility, I explained the home state's responsibility for prudential supervision and large shareholdings, with the host state's main focus being on conduct of business. So far as banking is concerned, host state supervisors have long accepted in addition a responsibility to monitor the liquidity of foreign banks' branches in their jurisdiction – and that holds good within the EEA. Given that the home state authorization permits banks operate throughout the EEA, it is vital to avoid doubt and confusion about what home states expect of host supervisors. At the introduction of the single market in banking, this was (we hope) achieved by the negotiation by each country of a bilateral memorandum of understanding with each of the other 15, specifying what each pair of countries undertook to do for the other in the role of host state.

We have discussed minimum standards at some length already. Let me just emphasize one point before introducing a new one. Minimum standards do not mean total uniformity because in relation to institutions incorporated in a country, whether locally or foreign-owned, national authorities are free to go beyond the minima. Something I have not so far mentioned is that all the EEA countries and many others besides are committed to some other minimum standards for authorization put forward by the Basle Supervisors' Committee in mid-1992. The key one is the requirement that foreign banks should only be licensed if their home country supervisors can satisfy the host country that they exercise effective consolidated supervision of their bank's worldwide activities.

Turning to formal cooperation mechanisms, the oldest dates from 1972 and is called the Groupe de Contact; a regular meeting of national supervisors to exchange information, review developments in national practices, cooperate in a practical way and provide a source of technical expertise for both the commission and the Banking Advisory Committee, a higher level body set up in 1979 under the First Banking Coordination Directive as a policy-making forum with what in EU jargon is called a "comitology" role, that is reviewing the operation of relevant Directives and making limited, technical amendments.

But informal cooperation is at least as important as formal in the day-to-day business of supervision, whether in the margins of formal meetings, direct bilateral contacts or sometimes meetings of supervisors from just a few countries about particular banks opening in their jurisdictions. Structures are important but it is people who make them work.

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Regulating Banks: Foundations and Different Opinions

by Pieter Boomsma

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Introduction

Banking law in the European Union (EU) has increasingly taken over the importance of national banking law. At the same time both national and EU banking law have changed and developed. It has taken decades to achieve the present "acquis communautaire." For countries in central and eastern Europe such a long time period is not available. Their challenges are tremendous, but the risks in the process of change are great as well. Banking law is meant to limit the risks. Therefore it is important to develop banking law in countries on their way to a market economy.

EU banking law has developed into an extensive and rather sophisticated number of directives regulations, recommendations and case law by the European Court. In this paper we disregard case law. But even then there is quite some banking law to digest. Rather than focusing on the extent and detail of EU banking law, we will analyze the foundations of modern banking law using details as illustration.

In relation to the foundations we will highlight the different stakeholders in developing modern banking law. Although different stakeholders have different interests, they all have a role to play in developing a banking law that is both balanced in taking into account the different interests, as well as pragmatic enough to be enforced.

We first start with a chapter on the changes in the banking industry and the purposes of modern banking law and a chapter on approximation and the full picture of EU banking law. Due attention will be given to the White Paper presented by the European Commission on approximation of EU laws.

Changes and EU Modern Banking Law

Banking law with respect to the leading financial centers in the world has gradually been changing since the beginning of the seventies. The main purpose of this change is to try to tie it with the evolution which has taken place in the banking industry as a result of internationalization, deregulation, innovation and informatisation.

• As a result of internationalization, the banking business saw an increase in supranational regulation, which means that it is no longer defined on the basis of the national context and needs, and that the policy margin of national authorities in this matter is growing smaller and smaller.

• Deregulation (which creates opportunities for the market and price mechanism by means of enhanced competition) has as a consequence that the authorities can hardly resort to the traditional methods in order to guarantee the security of the financial system, i.e. hedging and segmenting different financial activities and professions.

• Innovation in the financial markets and industries does not only enhance competition and efficiency but also involves typical risks. New solutions had therefore to be found for managing those risks.

• Informatisation yields a rapid exchange of information and increases the flexibility (as well as the complexity) of the new financial techniques and products.

Modern banking law inevitably reflects all these new developments to which it had to adapt itself. Modern banking law is subject to different purposes: monetary supervision, prudential supervision, consumer protection, the promotion of effective payment systems and political integration (EU). Banking law in the EU serves all these purposes.

• Monetary supervision was first coordinated in the Committee of Governors of the central banks of the EU members before it was decided to create the Euro and the European Central Bank.

The Committee was established in 1964 and has been since then the principal forum for cooperation between central banks. The principal task of the Committee was the promotion of cooperation of monetary policies with the aim of achieving price stability. The gradual realization of a single market has strengthened the interdependence between national monetary policies.

Monetary policy was not dealt with in Community law in a way that it was directed at banks (rather at governments and central banks). This may change when the Euro as a single currency is introduced. Already now, European banks have to prepare themselves for the Euro to become legal tender.

• Prudential supervision has been an increasing topic for EU legislation and regulation. Most of the EU ambitions have been achieved, although not all is implemented in all member states of the EU.

• An increasing and continuous attention by the EU is paid to consumer protection, also in the area of the financial sector. The legislation is promoting transparency for the consumer and financial protection vis-à-vis banks and other financial institutions.

• The promotion of effective payment systems at the EU level reflects the responsibility of effective payment systems for the authorities at national level. This implies that at the EU level, especially cross border payments, as well as international standardization and security of payments is promoted.

• The decision on political integration of the Member States for a European Union reflects itself in the creation of a single market for financial services, meaning freedom of persons and of capital to move cross-country, harmonization of laws, a level playing field for financial institutions, home country control and mutual recognition in supervision, freedom of establishment of branches and subsidiaries and freedom of cross-border services.

• Both at the national and EU level banks are faced with competition policy, aimed at preventing restrictive practices in the banking sector. At the EU level (trade between Member States) the competition rules are to be found in the articles 85 (agreements between undertakings and concerted parties) and 86 (abuse of a dominant position) of the Treaty of Rome (1957). The last couple of years the European Commission has activated, in line with the completion of the Single European Market, its competition policy after a long period of caution and nonintervention.

In 1989 the EU adopted the concentration control regulation with respect to concentration having a Community dimension. The point at which jurisdiction over concentrations passes from national authorities to the European Commission is obviously a crucial element. In the case of banks, a merger falls within the EU scope where:

a) one-tenth of the combined aggregate worldwide total assets of all undertakings concerned is at least ECU 5,000 million; and

b) one-tenth of the total assets multiplied by the ratio between loans to the Community and the total of loans worldwide of each of at least two of the undertakings concerned is more than ECU 250 million;

c) unless, each of the undertakings concerned achieves more than two-thirds of one-tenth of total assets multiplied by the ratio between loans within the Community and loans worldwide, within one and the same Member State.

The Community jurisdiction only concerns competition aspects. Bank supervisory aspects remain the jurisdiction of the national supervisory authorities.

• The Maastricht Treaty marked the launch of a new “era” of EU social policy. Since then the number of (draft) laws has considerably increased. The European banking organizations are recognized by the European Commission as social partners at European level. The legislative activities for the banking sector in most cases pay attention to the specific characteristics of banks in the development of social policy laws although they may apply to all companies, banks and nonbanks as well.

Approximation and EU Banking Law

For banking law in an economy in transition towards a market economy there are two options for approximation towards EU banking law:

1. gradual adjustment of their legislation to the EU directives;

2. a one-time integral adoption of the EU directives.

In most cases the first option will be the most realistic one.

The Commission has produced a White Paper how the associated countries of central and eastern Europe could prepare themselves for integration into the Internal Market of the Union. The White Paper does not form part of negotiations for accession and does not prejudge any aspects of such negotiations. The Commission issued an Annex to the White Paper, which comprises a detailed list of Community legislation, broken down into various sectors, relating to the internal market. The associated countries are encouraged to introduce this legislation in two stages; stage 1 and 2. Stage 1 measures are of the highest priority as implementation of such legislation is considered to be a precondition for the effective functioning of the internal market. Stage 2 measures are of second priority. For the sector of financial services advice is given on stage 1 and 2 directives as key measures. For a brief description of the different EU directives and other EU banking law, see Annex.

The directives chosen in the White Paper to form the first stage measures are those which introduce the basic principles for establishment of financial institutions, but there are elements in the second stage measures which it could be beneficial to introduce at an early stage.

In the first stage efforts should be concentrated on implementing the principles laid down in the following directives.

For financial services:

First Banking Directive

Own Funds Directive

Solvency Directive

Deposit Guarantee Directive

Directive on Public Offer Prospectus

Directive on Stock Exchange Listing

Directive on Notification of Major Holding

Directive on Insider Dealing

Collective Investment Funds (UCITS) Directive

Money Laundering Directive

For capital movements:

Long-term capital movements

First Directive of 11 May 1960

Directive 63/21/EEC

Medium-term capital movements

Council Directive 86/566/EEC

The key measures proposed by the White Paper in the second stage will aim in particular to strengthen the prudential regulation for the banks in order to bring them up to international standards.

Some of the key directives which are proposed for the second stage will include provisions directly related to the creation of the Community Internal Market, such as the freedom of establishment and the freedom to provide cross-border services without authorization and the principle of home country supervision. Those provisions could be disregarded in the second stage.

The directives to be supplemented in the second stage would be the following:

Second Banking Directive

Annual Accounts and Consolidated Accounts Directive

Capital Adequacy Directive

Large Exposures Directive

Consolidated Accounts Directive

Investment Services Directive

Collective Investment Funds (UCITS) Directive

The three directives within the sector of financial institutions which are not regarded as key measures are:

• Directive of 13 February 1989 on the obligation of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents. The main purpose of this Directive is to facilitate life for such branches and not to require more information than is necessary.

• Directive of 5 March 1980, coordinating the requirements for drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities of official stock exchange listing.

• Directive of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock exchange listing.

The last two mentioned directives are giving important information to the market but the most important information will already be covered by the directives mentioned as key measures.

The priority to be given to the financial and other sectors depends in the White Paper on the political and economic situation of each associated country. No specific timetables have been set as it is felt that these will be decided by each country in the light of its own situation and strategy and in response to the list of priorities of approximation specifically mentioned in the respective Europe Agreements.

Moreover, it is recognized that the associated countries have not yet fully resolved the problem of adjusting alignment programs to the need to consolidate economic reforms. For example, although the putting in place of basic legislation in the financial services sector is one of the priority issues for the CEEC's, it is recognized that "there are limits on how far the CEEC's can go so long as restrictions on capital movements remain necessary for macroeconomic reasons and banks remain burdened by bad loans from the past."

While the task of enacting and enforcing laws is to be carried out by the associated countries themselves technical assistance is provided by the European Union (e.g., advice from legal and technical experts, help with specific problems, access to administrative, language and specialized technical training, the establishment of a "Technical Assistance Information Exchange Office" located in Brussels, etc.). The Commission has held discussions with each associated country to help clarify their national programs and priorities in the light of the White Paper.

Many countries have already implemented different elements of different EU directives in different pieces of their national legislation. So it is not likely that the proposed stages in the White Paper will be followed strictly. Moreover, the banks in the CEEC's have a number of specific problems to deal with, like recapitalization, privatization of banks and nonbanks, market structures that still reflect the one-tier banking system, bank governance that still reflects past relationships and political influences, etc.

However the picture of EU banking law, as presented in the White Paper, is far from complete. The White Paper focuses on prudential supervision and capital movements. Other banking laws complete the picture:

Economic and Monetary Union
Treaty on Realization of Economic and Monetary Union
Recommendations on Legal Treatment of the ECU and ECU contracts
Regulation on Definition of the ECU
Banking Supervision
Guarantees issued by credit institutions and insurance companies
Winding up and reorganization of credit institutions
Financial Markets
Listing particulars
Regular information
Disclosure obligations
Collective investment funds
Code of conduct relating to security transactions
Social Affairs
Social protocol
Information and consultation
Atypical work
Working time
Collective redundancies
Employee participation
Health and safety
Access to continuing training
Transfers of undertakings
Posting of workers
Insurance
Direct insurance other than life assurance
Life insurance
Annual accounts of insurance companies
Export Credit Insurance

Takeover and General Bids
The pension funds
Investor compensation
Taxation
Tax on stock exchange operations
Turnover taxes
VAT on gold
Direct taxation
Corporate tax
Consumer Credits
Consumer Credits
Mortgage Credits
Payment Cards
Cross-border payments
Unfair contract terms
Comparative Advertising
Contract negotiation at a distance
Embargoes
Iraq
Libya
Yugoslavia
Bosnia-Herzegovina
Sundry
Legal protection of computer programs
Protection of individuals with regard to the processing of personal data and on the free movement of such data
Civil liability for damage caused by waste
Public services contracts

In addition to EU imposed legislation and regulation, banks themselves can develop and implement self-regulation. This is sometimes done on the initiative of the European Commission, as has been the case for a Code of Conduct for credit cards to regulate relations between credit institutions, retailers and consumers. Sometimes it is done by the banks on their own initiative, for instance in a couple of countries banks have agreed on a banking code.

In other instances interbank cooperation leads not to self-regulation, but to information and recommendation. For instance, to prevent financial fraud in the area of payment instruments and payment cards, as well as prevention of attacks on banks.

Foundations of Modern Banking Law

The detail of evaluating banking law will surely differ between CEEC's as it did between Member States of the European Union. Rather than going into this detail, we ask ourselves the question: “What are the present foundations of modern banking law?” This question is relevant for emerging markets and developed markets alike. These foundations may be helpful in developing and specifying banking law in the CEEC’s.

Analyzing the bank legislation for all their different purposes we inventorize six foundations. The first three are traditional and can be found in most textbooks. The last three reflect the interest and participation of all present stakeholders in modern banking law. Not only government and parliament contribute to banking law, but also the banking community, represented by the national banking associations, and the consumers, in most cases represented by consumer organizations.

The Stability of the Financial System is Still the Major Concern

There has never been a greater need for government supervision on the banking business. The ultimate aim of this supervision framework is to ensure the stability and solidity of the financial system and of the institutions in order to inspire savers and investors with confidence, since, without this confidence, the banking industry cannot fulfil its bridging function, which is essentially important for the economy. In short, confidence is the greatest public good which a supervisory authority can provide.

In order to maintain this confidence, the public authorities resorted, in the thirties, to a strategy which consisted of rules that led to a clear delimitation of the banks’ activities as opposed to those of other financial institutions. This strategy had to be given up due to deregulation, which puts the emphasis on the role of competition and the functioning of the market. The new approach is no longer an institutional approach, but gives priority to managing the risks, to which the different players from the financial industry are exposed.

At the same time, there has been a growing awareness that supervision cannot and must not offer maximum security.

• A supervision framework which offers maximum security, would indeed make any kind of dynamism impossible and leave (too) little space for the functioning of the market.

• In fact, banks deal in particular with financial intermediation and the execution of other transactions for their own account and at their own risk. Because they are specialized in those matters, banks have advantages, in doing this business, in the field of transaction and information costs, as well as in the field of risk management. In spite of the growing disintermediation and securitization, those advantages are still the basis for the economic usefulness of the banking industry.

In short, bank failures are no longer considered as something unacceptable, provided the stability of the financial system is not put into danger. Banks which are on the verge of failure do not have to count on the compassion of the bank supervisory authorities.

Although adequate supervision of banks is still the best guarantee in view of protecting the individual savers, the depositor protection in this context has rather been relegated to the background as a result of the new developments. In order to fill this gap, for reasons of obvious equity, one currently resorts to deposit-insurance systems in order to shield small savers from the consequences of a bank failure.

In recent years, attention has more and more been drawn to the fact that the individual saver also has a role to play in maintaining the security of the banking system, which means that possibly he will also have to bear the consequences. Therefore, one rejects a maximum security system for savings deposits, because this would result in a blind confidence in each bank, even if that particular bank takes risks in granting credit. Consequently, the European Directive on deposit-guarantee schemes aims at making the saver aware of his own responsibility by stipulating a kind of franchise to be paid by the saver: a percentage of the deposits is not covered up. However, the Directive allows Member States the possibility not to adopt this franchise system. Apparently, all Member States have used this possibility, which means that the franchise system as provided in the Directive has not been applied in practice.

The Foundation of Market Conformity

Modern banking regulations aim at following as closely as possible the system of free market economy, which means that they tend to let competition play its role freely. This is in sharp contrast with the situation in the past, where state interventions resulted in all kinds of market distorting measures (e.g., in the field of price-fixing). A market which creates room for free competition, ensures an efficient allocation of the financial means available.

This immediately explains the process of liberalization not only within the EU but also on a global level: because financial institutions are active worldwide, the liberalization of financial activities also comes to the fore on an international level (cf. the Uruguay Round, which tends, among other things, at a liberalization of the services sector within the GATT).

The market conformity of modern banking regulations, however, points to a paradox. Since free competition implies a reduction of the costs of financial intermediation, this boils down to a lower spread of income. As a consequence, the profitability as well as the stability of the financial sector is put into danger. Especially the recent experience in the United States has made it clear that unlimited competition can lead to excesses, which forces society to make huge efforts, in the sense of using tax money, to maintain the financial system.

This means that all over the world domestic public authorities are confronted with the necessity of supporting and positioning the competitiveness of their financial industry against that of other countries and/or industries.

Consumer law is often totally in contradiction with the principle which says that regulations should follow market conformity. Attempts nowadays to bring the level of charges for services closer to operating costs often end in failure: not only reactions by consumers, but sometimes also intervention by the authorities have been a decisive factor in this failure. It should be made clear, now more than ever, that banks are undertakings at the service of the public, but not public undertakings. As an undertaking, they must satisfy the imperative requirements of profitability. The relationship between each customer and his bank is a private relationship from which each of the two parties must draw advantages; if the relationship produces a deficit for the bank, it cannot make the community or other categories of customers bear the costs. It follows that the customers and regulators must accept, in a responsible way, the idea that banking services – without exception – must be remunerated at a price which cannot subjectively be considered "expensive" without any knowledge of its cost.

Consumer law in general, in its desire to protect consumers fully against every risk, does not take into account the fact that on the one hand, an increase in security (which is already high) involves enormous costs, much higher than those incurred when calculated risks are accepted, and that on the other hand these costs must obviously be borne by the users of the services. This is the case in particular when, as nowadays, the regulatory approach does not aim anymore at the protection of only the diligent and honest people, but embraces also the negligent and dishonest people. Even if banks are held responsible for the consequences by law, it is clear that the additional costs and losses that they incur, are added to the price of the services.

The Foundation of Equalizing the Terms of Competition

Deregulation must not result, by any means, in situations which make it impossible for banks to cope with the pressure from other market players.

Banking regulations and supervision of banks involve constraints in the field of bank management and organization. Those constraints are reflected in the overhead expenses and costs: they are expensive. This is the reason why the call for a "level playing field" in modern banking regulations is prominent: conditions must be equal for all players. Unequal starting positions cause a distortion of competition, which prevents the market functioning from yielding the results one may expect, and moreover creates the danger of banks that are victims of unequal terms of competition, falling into excesses which have a destabilizing effect on the financial system.

The playing field which must be leveled, is very vast. Equalization must indeed be pursued at different levels.

Between International Financial Centers

Due to the increasing international character of banking business, one should – as has been clearly perceived by the Basle Committee on Banking Supervision – carefully see to it that international banking regulations also create more equal terms of competition. If this is not the case, banks which are established in countries where supervision is not severe, will have to face an almost insurmountable handicap as far as international competition is concerned. It should be stressed that, within the EU, this concern is however not considered to be paramount, since apparently the EU aims at achieving a minimum harmonization which leaves space for competition between the different national regulations, with the possible result of "reverse discriminations."

A problem within the EU to achieve fair competition remains the differences in taxation of banks and their products. Especially the latter difference has important consequences for the allocation of savings in a liberalized European capital market.

In this respect it is surprising to see the tendency in many Member States to create tax heavens for foreign banks even when one of the Member States is their home country. On the tax issue there is still a lot to be done to create a "level playing field."

Between Banks

Whereas the rules of the Basle Committee create a discrimination between international and noninternational banks, the EC authorities seem to prefer to apply one single system to all banks without any distinction – however, with changing success one has to admit (cf. the exclusion of the Post Bank from bank directives).

Between the Institutions of the Financial Industry

Moreover, one must not forget that banks face increasing competition from nonfinancial institutions which develop specific kinds of financial services (cf. payment cards of the distribution industry) and which are free from any kind of prudential supervision.

The Foundation of the Autonomy of the Banking Function

In order to equalize the terms of competition on an international level, it would be preferable to provide objective rules (cf. the quantitative criteria in the field of capital adequacy). This kind of objective rules indeed makes it easier to verify in fact whether everyone respects the agreements that have been made.

This is necessary, but it also has negative effects. First, objective rules of this kind lack sufficient flexibility: generally, they are not sharp enough, as they do not always leave sufficient room for fine-tuning. Moreover, and especially, those rules have a compulsory effect on bank management. For instance, the current emphasis on the banks' capital ratio within the framework of capital adequacy standards could hamper the traditional credit policy, in which the decisive factor was the quality of the individual debtor.

These disadvantages are the reason why banks are afraid to make a general application of this solution. The discussions about the capital adequacy of investment companies are a good illustration in this respect. Whereas the authorities initially had the intention of imposing compliance with coefficients as for market and exchange risks, just as this is already the case for the credit risk, there has been a subsequent switch, at the firm request of banks, to internal models. Instead of the traditional close examination of individual transactions, the authorities will monitor the way in which banks use computers to control risk.

In short, the general conviction at present is that rules governing the supervision of banks should not affect the autonomy of the banking function by taking into account the necessary degree of flexibility. More particularly, these rules should start from the assumption that each bank has already put into place internal mechanisms for risk management, so that one cannot say that there is a void which should be filled by regulations.

No form of supervision can replace good management. Because bank supervisory authorities must not substitute themselves for the bank executives, banking supervision should be rather marginal: supervision must be conceived in such a way that it serves as a complement to market discipline, rather than as a substitute which eliminates the latter completely. Supervisory authorities should therefore focus their attention on the quality of management, organization and internal mechanisms and procedures for supervision.

The Foundation of Transparency

A confidence of this kind as far as bank management is concerned cannot be guaranteed if there is no flux of information towards the bank supervisory authorities. Achieving a sufficient degree of transparency by imposing obligations in the field of reporting becomes more and more one of the key elements in modern supervision schemes. The number of data which have to be submitted, is impressive. Producing those data puts the bank's organization and administration under severe strain and considerably affects overhead expenses.

Moreover, one has the impression that each year brings a new increase in the number of data to be submitted. At any rate, bank supervision authorities are constantly making adjustments to the reporting scheme, which implies a reprogramming of the banks' software systems and consequently additional costs.

There is a danger of going beyond the limits of what is necessary in this respect. It happens that banks are asked to submit certain data, even if there are serious reasons to presume that those data (cannot) will not be used by the authorities! Also, authorities can sometimes show a tendency to set up a system of preliminary supervision, in which reporting is part of a procedure offering them the possibility of having a veto over actions the bank wants to undertake.

Neither can one consider transparency as a panacea, for the transparency which is the result of the reporting obligations should be subject to nuancing. It would be erroneous to think that reading the figures translating the bank's situation is as simple as reading a book.

The Foundation of Democratic Legitimization

In fact, it is very ironic that modern banking law, which puts such an emphasis on transparency, is almost incomprehensible in itself. These regulations suffer from "technicity" and is accessible only to specialists; outsiders, including stakeholders in the process of banking legislation itself, like politicians and consumers, have more and more difficulty in understanding the fundamental concepts on which those regulations are based.

This can lead to Kafkaesque situations. An example of this are the discussions that had been held within the framework of the preparation of the Second European Banking Directive, about the conditions under which banks from outside the European Union would be allowed to claim the European passport. In this respect, the European Parliament initially adopted the position that those banks from third countries would be allowed access to the European market, only if their country would treat European banks in the same way. However, just before it wanted to draw a resolution in this sense, the European Parliament came to the conclusion that European banks themselves had a different opinion. The most important concern of the European banks was not the banks as such but rather Europe as a financial center. They were convinced that as a financial center, Europe can benefit from the dynamism and competition foreign banks bring along.

This example at once shows the importance of communication. Banks and regulators have to find the right formula to help nonexperts understand a subject that is inevitably essentially technical. But communication in this area is not (only) a question of language: rather, it is a long-term effort which must take account of a vast panorama and multiple aspects that vary from one country to another.

Different Stakeholders: Different Interests

The six foundations reflect an analysis of modern banking law in the European Union, as well as the stakeholders that contribute to it.

Especially the last three foundations characterize modern banking law and are less traditional. The more modern foundation of the autonomy of the banking function (number 4) is especially favored by the banking community. Banks should be allowed flexibility and responsibility to have a place for internal mechanisms for risk-management. Supervisory authorities should focus their attention on the quality of the bank management, organization and internal mechanisms. This foundation favored by: banks is accepted more and more by other stakeholders, be it under the condition that the principle of transparency (number 5) is introduced and implied as well.

The foundation of democratic legitimization (number 6) means that in a democratic way all different interests are taken into account. Since banking has increasingly sophisticated itself, democratic legitimization means that even though banking has become complicated and difficult to understand, legislation has to remain democratic. This implies that the legislators should be explained by the banking sector what exactly the different interests are behind a labyrinth of technical issues. One should prevent that legislation occurs in a way that no interest is served, or interests are served in an unpragmatic and very costly way, because of misunderstanding complicated issues.

The different stakeholders have different interests, which is manifested during the process of legislation. First of all the government may have different views from parliament in the legislative process. Second, central banks, in many countries endowed with the responsibility to provide more detailed regulation (based on general legislation), as well as being responsible for supervision, may well have a different opinion from the government and parliament.

Third and most obvious however, is the difference between the banks and the other stakeholders. In general one may say that banks favor flexibility and cost effectiveness. Banks have considered EU legislation in a number of cases not needed, or too detailed, or too early. This no doubt reflects the position of the banking entrepreneur. I remember a president of a commercial bank telling me that as a banker he liked unclear situations and some chaos, because that is where banks can make most of their profits. I would not be surprised if some commercial bankers in central and eastern Europe would agree with this statement. Nevertheless, European banks have always shown their willingness and their readiness to contribute to necessary legislation. Even to the extent that they believe to start performing other duties. For instance, many bankers see themselves as part-time police officers in implementing the (very costly) measures of money laundering.

In the European Union most of the bank legislation has been finished, although there are new openings for future legislation. For instance, on financial conglomerates. The stakeholders are already preparing themselves for this by discussing subtopics like the prevention of double gearing, measures to combat the risk of contagion and ensuring a level playing field between banks and other financial institutions. I would be very happy to talk to you about this topic as well. But let us leave it here. A lot needs to be done already on approximation of present EU legislation. So let us leave future EU legislation to a next conference.

In conclusion it can be said that the "acquis communautaire" of EU banking law is extensive and covers a broad range of issues. In addition to that one has to realize that banks are confronted with national laws as well. All this and the total picture of EU banking law may seen esoteric to the banking sectors in central and eastern Europe. Nevertheless, it is good to know the full picture of EU banking law when we talk about approximation of banking law.

Let me finish with one other area of interbank activity which has not been mentioned in this presentation before. That is bank training. Without qualified bankers, supervisors, central bankers it is difficult to create a developed banking sector even if all EU laws were approximated. The need for training does not even stop there. Training is also needed for the legislators (government officials and members of parliament), the judges and even consumers. The challenge to cover all those training needs is as important as the approximation of laws and should go in tandem with it.

ANNEX

First Banking Coordination Directive

First directive of 12 December 1977 coordinating laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of credit institutions.

Council Directive 77/780/EEC;OJ 322, 17.12.77.

This directive coordinates the laws of the Member States on the authorization of credit institutions with a view, in particular, to facilitating the establishment of branches in other Member States.

The first Coordinating Directive established the right for a credit institution constituted as a company in one Member State to open a branch in another Member State on the basis of host state control.

Although the first Coordination Directive harmonized and liberalized the banking sector, there were still administrative procedures for obtaining licenses. It also did not enable a credit institution in one state to provide cross-border banking services into another Member State.

Second Banking Coordination Directive (Home State Control and the Single License)

Second Council Directive of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.

Council Directive 89/646/EEC; OJ L386, 30.12.89.

Establish the principle of home state control and the single license, whereby a credit institution of one Member State may open branches in, or provide cross-border services into, other Member States.

Home state control means that once a credit institution has obtained its license in the home Member State, it is able to open a branch in each Member State on the basis of the home state license. This is the so-called single license.

Own Funds

Council Directive of 17 April 1989 on the own funds of credit institutions.

Council Directive 89/299/EC; OJ L124, 5.5.89.

This is a technical Directive which determines items which may be included as part of a bank's own funds. In this context, it makes a distinction between elements making up additional own funds. The latter, being of lower quality than the former, may not exceed 100% of original own funds, and for certain items 50% of original own funds. This Directive seeks to harmonize the concept of own funds of credit institutions in order to provide a standard yardstick for prudential supervision of credit institutions.

Solvency Ratio

Council Directive of 18 December 1989 on a solvency ratio for credit institutions.

Council Directive 89/647/EEC; OJ L386, 30.12.89.

The Directive seeks to develop common standards of capital adequacy in relation to assets and off-balance sheet items. It establishes that the solvency ratio, i.e. the ratio between a bank's own funds and its assets weighted according to the level of risk, must be a minimum of 8%.

Consolidated Supervision

Council Directive 83/350/EEC of June 1983.

Any credit institutions with a controlling holding (>50%) in another credit or financial institution is subject to supervision of its financial situation on a consolidated basis with those institutions in which they have such holdings. The balance sheet positions of the subsidiaries should be incorporated into those of the parent company with regard to the parent company supervision.

Council Directive of 6 April 1992 on the supervision of credit institutions on a consolidated basis.

Council Directive 92/30/EEC; OJ L110, 28.4.92.

This Directive replaces the 1983 Directive. This Directive has a broader scope which provides for supervision of groups of credit institutions where the parent company is either a credit institution or a financial holding company.

Large Exposures

Commission recommendation 87/62/EEC.

Recommends that Member States adopt provisions to ensure that large exposures undertaken by credit institutions should not exceed 40% of own funds.

Council Directive of 21 December 1992 on the monitoring and control of large exposure of credit institutions.

Council Directive 92/121/EEC; OJ L29, 5.2.93.

In order to avoid excessive concentration of exposure, limits are fixed in relation to the own funds of lending institutions (10% for the definition of a large exposure, 25% ceiling for any large exposure, 800% ceiling for the aggregate of large exposures). Long transitional periods are provided for to enable credit institutions to adjust to these limits. In particular, small credit institutions – with own funds of less than ECU 7 million – could take advantage of a total transitional period of 13 years.

Deposit-guarantee Schemes

Directive of the European Parliament and the Council on deposit-guarantee schemes.

European Parliament and Council Directive 94/19/EC; OJ L135, 31.5.94.

Sets down a minimum level of compensation and requires all Member States to introduce deposit-guarantee schemes. It also shifts the burden of responsibility in the case of branches from the Member State where the branch is located to the Member State of the head office.

Investor Compensation Schemes

Proposal for a Council Directive on investor compensation schemes.

Proposal for a Council Directive: OJ C321, 27.11.93.

This proposal would create an investor compensation scheme for investment business along much the same line as the deposit-guarantee scheme for banking business.

Winding up and Reorganization of Credit Institutions

Amended proposal for a Council Directive concerning the reorganization and the winding-up of credit institutions and deposit-guarantee schemes. (COM(88) 4 final) OJ C36 1988.

Reorganization and liquidation of a credit institution with its head office in the Community must be carried out in accordance with the rules of the country in which the head office is located. On the other hand, when the head office of the credit institution is located outside the Community, the host country is empowered to take measures to reorganize or wind up branches established in its territory.

Financial Markets

Public Offer of Securities

Council Directive of 17 April 1989 coordinating the requirements for the drawing up, scrunity and distribution of the prospectus to be published when transferable securities are offered to the public. 89/298/EEC; OJ L124 1989.

This Directive requires a prospectus to be provided when securities are offered to the public for the first time. However the content, and procedures for supervision and distribution of the prospectus vary according to whether or not an application has been made for official stock exchange listing. It then permits a single prospectus to be used for issue of securities in the various Member States.

Admission of Securities to Official Stock Exchange Listing

Council Directive of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing. 79/279/EEC; OJ L66 1979.

This Directive provides for minimal coordination of conditions for the admission of securities to stock exchange listing with a view to: obtaining a maximum equivalence of investor protection; facilitating admission to listing in all Member States, as well as the listing of the same security on several Community stock exchanges.

Investment Services

Council Directive 93/22/EEC on investment services in the securities field.

OJ L l41 1993

This Directive is the equivalent for investment services of the banking coordination Directives, but adopts a functional approach: i.e. it regulates the activity, not the investment firm. It permits investment firms authorized by their country or origin to provide certain financial services to offer these services throughout the Community. In principle, this Directive is also applicable to banks.

Capital Adequacy

Council Directive 93/6/EEC of 15 March 1993 on capital adequacy of investment firms and credit institutions.

Council Directive 93/6/EEC; OJ L141, 11.6.93.

The Directive will establish a common framework for the monitoring of market risks in general, and includes the investment activities of banks (and also of credit institutions in so far as they carry out investment business).

Pension Funds

Amended proposal for a Council Directive relating to the freedom of management and investment of funds held by institutions for retirement provision. (COM (93) 237 final – SYN 363) OJ C171, 1993.

Provides for freedom of provision of investment management services. To manage all or part of its assets, a pension fund is free to choose a manager established in the European Community. Member States are prohibited from imposing on pension funds a requirement to: invest in particular categories of assets or to localize their assets in a particular Member State, and; to hold more than 80% of their assets in matching currencies.

Taxation

Tax on Stock Exchange Operations

Amended proposal for a Council Directive relating to indirect taxes on transactions on securities (COM (87) 139 final) OJ C115 1987.

This Directive endeavors to remove indirect taxation on securities transactions in all the Member States.

Corporate Tax

Council Directive of July 1990 on the common system of taxation, applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States Council Directive 90/434/EEC; OJ L225 1990.

This Directive imposes at a Community level the regime already applied by Member States at a national level: capital gains from such operations are not taxed when the operation takes place but only when the capital gains are actually realized.

Proposal for a Council Directive amending Directive 90/434/EEC on the common system of taxation. (COM (93) 293 final) OJ C 225 1993.

This proposal is principally aimed at enlarging the scope of Directive 90/434/EEC to all enterprises in a Member State subject to corporation tax.

Council Directive of July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. 90/435/EEC; OJ L225 1990.

This Directive attempts to eliminate double taxation of dividends paid by a subsidiary in one Member State to its parent company in another: removal of all withholding tax in the subsidiary's Member State and exemption for these dividends – or taxation with a foreign tax credit – in the Member State of the parent company. The parent company must hold at least 25% of the subsidiary's capital.

Proposal for a Council Directive amending Directive 90/435/EEC. (COM (93) 293 final) OJ C 225 1993.

This proposal aims to extend the scope of Directive 90/435/EEC to all enterprises in a Member State subject to corporation tax and allows for the parent company to take account of downstream tax paid by the subsidiary.

Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. 90/436/EEC; OJ L225 1993.

This Convention establishes procedures for ensuring, within certain time limits, elimination of double taxation resulting from differences in assessment by tax authorities of prices charged between associated enterprises.

Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States. (COM (90) 57 I final); OJ C53 1990.

This proposal seeks to eliminate all withholding taxes on interest and royalty payments between parent companies and subsidiaries in different Member States.

Proposal for a Council Directive concerning arrangements of the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States. (COM (90) 595 final) OJ C53 1990.

This proposal permits the deduction by companies of losses suffered by their permanent establishments or subsidiaries located in other Member States. It proposes two methods for recovery of losses incurred by permanent establishments from which the Member States can choose. With regard to losses suffered by the subsidiaries, the method of deduction of losses with later reincorporation is applicable.

Accounting

Annual and Consolidated Accounts of Credit and Other Financial Institutions

Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions.

Council Directive 86/635/EEC; OJ L372, 31.12.86.

This Directive applies the principles of the Fourth Company Law Directive and the Seventh Company Law Directive with suitable adaptations to banks and other financial institutions.

Annual Accounts of Foreign Branches of Credit and Other Financial Institutions

Council Directive of 13 February 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside the Member State regarding the publication of annual accounting documents.

Council Directive 89/117/EEC; OJ L144, 14.2.89.

Branches of financial institutions having their head offices in other Member States cannot be required by the host state to publish branch accounts; they can only be required to publish the accounts of the head office, accompanied by certain ancillary information. The Directive aims to put branches of foreign financial institutions on the same footing as branches located in the same Member State as their head office.

Consumers

Consumer Credit

Council Directive of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit. 87/102/EEC; OJ L42 1987.

This Directive contains minimum regulations on consumer credit with a view to providing greater protection for European consumers on the one hand, and harmonization of competitive conditions, on the other.

Directive of 22 February 1990 amending Directive 87/102/EEC for the approximation of laws, regulations and administrative provisions of the Member States concerning consumer credit. 90/88/EEC; OJ L61 1990.

This Directive establishes the use of standard formula for calculating the annual percentage rate of charge for consumer credit, so that consumers will know immediately the total price of the credit and this facilitates comparison between various offers.

Mortgage Credit

Amended proposal for a Council Directive on the freedom of establishment and the free supply of services in the field of mortgage credit. (COM (87) 255 final – SYN 39) OJ C16 1987.

The objective of the proposal is to remove legal obstacles preventing mortgage credit from being freely offered in the Community. Thus an institution established in a Member State should be free to offer mortgage credit in another Member State in the same way as in its country of origin. The European consumer would therefore have greater variety of choice at his disposal.

Payment Cards

Commission Recommendation of 17 November 1988 concerning payment systems and, in particular, the relationship between cardholder and card issuer.

Commission Recommendation 88/590/EEC; OJ L317, 24.11.88.

This recommendation seeks to set out a detailed code for the conduct of business by card issuers with a view to providing a minimum level of consumer protection with regard to electronic payment systems.

European Code of Conduct for Electronic Payments

Commission Recommendation of 8 December 1987 on a European Code of Conduct relating to electronic payments (relations between financial institutions, traders and service establishment and consumers).

Commission Recommendation: 87/598/EEC; OJ L365, 24.12.87.

This recommendation seeks to establish a Community "Code of Conduct" for electronic payments, and provides an indication as to future regulations which the European Commission may introduce.

Transparency of Conditions and Charges for Cross-border Financial Transactions

Commission Recommendation of 14 February 1990 on the transparency of banking conditions relating to cross-border financial transactions.

Commission Recommendation 90/109/EEC; OJ L67, 15.3.90.

Recommends the establishment of national bodies to handle complaints about institutions which do not respect the six principles set out in the Recommendation. Recommends that institutions carrying out international transfers should ensure that their consumers are properly informed on the price of such transactions and that these are executed rapidly and correctly.

Proposal for a European Parliament and Council Directive on cross-border transfers. (COM (94) 436 final) OJ C360 1994.

This Directive aims at eliminating contractual clauses imposing unreasonable and excessive obligations on consumers. The Directive allows banks when altering the rate of interest on a variable rate contract (loan or deposit) to inform the consumer after the alteration and the latter is free to terminate the contract immediately.

Unfair Contract Terms

Council Directive 93/l3/EEC of 5 April 1993 on unfair terms in consumer contracts. OJ L95 1993.

This Directive aims at eliminating contractual clauses imposing unreasonable and excessive obligations on consumers. The Directive allows banks when altering the rate of interest on a variable rate contract (loan or deposit) to inform the consumer after the alteration and the latter is free to terminate the contract immediately.

Comparative Advertising

Amended proposal for a European Parliament and Council Directive concerning comparative advertising and amending Directive 84/450/EEC concerning misleading advertising. (COM (94) 151 final – COD 343) OJ C136 1994.

This proposal endeavors to harmonize national legislation on comparative advertising. The aim is to regulate its use to protect consumers and improve information provided to them whilst at the same time promoting competition.

Contract Negotiated at a Distance

Amended proposal for a Directive on consumer protection with regard to contracts negotiated at a distance. (COM (93) 396 final – SYN 411) OJ C308 1993.

Endeavors to harmonize laws with regard to contracts negotiated at a distance. A political decision was taken, at the Consumers Council of 17 May 1994, to exclude financial services from the scope of the amended proposal Directive.

Commission Recommendation of 7 April 1992 on codes of practices for the protection of consumers in respect of contracts negotiated at a distance 92/295/EEC; OJ L156 1992.

The annex mentions points which could be covered by codes of practice. Amongst these points, that relating to financial security is of particular note; schemes should be set up to guarantee reimbursement of payments made by consumers at the time of placing an order.

Protection of Individuals in Relation to the Processing of Personnel Data

Amended proposal for a Council Directive on the protection of individuals with regard to the processing of personnel data and on the free movement of such data. (COM (92) 422 final – SYN 287) OJ C311 1992.

Sets out a general framework for the protection of individual privacy with regard to the processing of personnel data.

Amended proposal for a European and Council Directive concerning the protection of personnel data and the privacy in the context of public digital telecommunication networks, in particular the integrated services digital network (ISDN) and public mobile networks. (COM (94) 128 final – COD 188) 03 C200 1994.

Applies the principles established in the general framework proposal (SYN 287) specifically to the telecommunications sector.

Civil Liability for Damage Caused by Waste

Amended proposal for a Council Directive on civil liability far damage caused by waste. (COM (91) 219 final – SYN 2l7) OJ C192 1991.

Establishes the polluter pays principle. The text of the proposal would not prevent a bank which had granted a mortgage loan to a producer of waste from being held liable for damage caused by the polluted or polluting mortgaged property.

Insurance

Reinforcement of Prudential Supervision

Proposal for a Council Directive amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, 73/239/EEC in the field of nonlife insurance, 79/267/EEC and 92/96/EEC in the field of life insurance, and 93/22/EEC in the field of investment firms, in order to reinforce prudential supervision.

Original Proposal: OJ C229, 25.08.93.

The proposal, if adopted, would amend the First and Second Banking Directive, Nonlife and Life Insurance Directives and Investment Services Directive. The result would be to strengthen the powers of supervisors and, thus, better equip them to prevent cases of fraud and other irregularities in the financial services sector.

Export Credit Insurance

Proposal for a Council Directive on harmonization of the main provisions concerning export credit insurance for transactions with medium- and long-term cover. (COM (94) 297 final – 94/0166(ACC); OJ C272 1994.

The proposal establishes common principles of official export credit insurance for; the technical conditions of the guarantee; systems for fixing premiums; and cover policies.

Information Technology

Legal Protection of Computer Programs

Council Directive of 14 May 1991 on the legal protection of computer programs 91/250/EEC; OJ L122 1994.

Deals with copyright protection of computer programs. Reproduction of computer programs is authorized under certain conditions.

Free Movement of Capital Legislation

Liberalization of Capital Movements and Regulation of Exceptionally Large International Capital Flows

Council Directive of 24 June 1988 for the implementation of Article 67 of the EC Treaty.

Council Directive: 88/361/EEC; OJ L178, 8.7.88.

Liberalizes all capital movements between residents of Member States with the exception of existing exchange control regulations on the purchase of a second residence.

Concentration and Competition

Articles 85 and 86 of the EC Treaty

The source of competition law of the European Community is found principally in the Treaty establishing the European Community (the EEC Treaty) signed in 1957 between the original six Member States. EC competition law can be distinguished from national competition law in that whist maintenance of competition in general and of "fairness" in trading are significant secondary considerations, the primary objective of the EC rules on competition is to bring help about Community integration.

Article 85 (1) prohibits agreements or concerted practices between undertakings which may affect trade between Member States and which restrict or distort competition within the Common Market. There are, therefore, three elements: an agreement or concerted practice between undertakings; which affects trade between Member States; and which restricts or distorts competition within the Common Market.

Article 86 prohibits the abuse by one or more undertakings of a dominant position within the Common Market or in a substantial part of it in so far as it may affect trade between Member States. Thus it is necessary to establish: the existence of a dominant position within the Common Market or in a substantial part of it; an effect on trade between Member States (see criteria under Article 85); an abuse of the dominant position.

Merger Control

Council Regulation (EEC) 4064/89 of 21 December 1989 on control of concentrations between undertakings. 4064/89; OJ L257, 21.9.90.

The merger regulation establishes a system of prior clearance by the European Commission of all mergers and acquisitions of a "Community dimension" in order to examine whether they create or strengthen a dominant position in the European Community which significantly impedes effective competition. Since January 1994, this system also applies to such mergers and acquisitions in the EEA.

The Regulation is known generally as the "EC Merger Control Regulation" (MCR). However, its application is far broader than this. In principle, only those concentrations which have a Community wide dimension are caught by the MCR.

Sundry

Preventing of Money Laundering

Council Directive of 10 June 1991 on preventing the use of the financial system for the purpose of money laundering.

Council Directive 91/308/EEC; OJ L166, 28.6.91.

Imposes certain obligations on financial institutions; identification of customers with whom they enter into business relationships; identification of customers carrying out transactions amounting ECU 15,000 or more; conservation of certain documents. There is a requirement to notify about suspicious transactions, involving in particular cooperation with the authorities and training personnel, etc.

Public Services Contracts

Council Directive 92/50/EEC of 18 June 1992 to the coordination of procedures on the award of public services contracts. OJ L102 1992.

This attempts to make public service award procedures compulsory for certain categories of services. All financial services, whether remunerated by fees, commission or other means, and those remunerated by interest are included in the scope of the Directive.

Council Directive 93/38/EEC of 14 June 1993 on the procurement procedures of entities operating in the water, energy, transport and telecommunications sector. OJ L199 1993.

This Directive aims in particular to make procurement procedures in the sectors concerned obligatory for certain categories of services, including financial services. All financial services, whether remunerated by fees, commission or other means, and those remunerated by interest are included in the scope of the Directive.

The European Monetary Union (EMU)

The starting date for the monetary union will be 1 January 1999 at the latest. At the Madrid summit in 1995 this starting date was reconfirmed. In addition, the Council took some important decisions for the preparation of monetary union. It agreed that the single currency would be called the Euro and it determined how and when the Euro would be introduced and replace the national currencies.

There are four key dates in the introduction scenario:

• On January 1999, stage three of the Economic and Monetary Union will start; exchange rates between participating currencies will be irrevocably fixed.

• On I January 2002 at the latest, Euro banknotes and coins will be introduced.

• Six months later, 1 July 2002, the national coins and notes will cease to be legal tender.

The economies of the Member States have to be prepared before they can enter the monetary union.

The treaty explicitly mentions the convergence criteria, such as low inflation and interest rates, and sustainable public finances. But not only the governments of the Member States should prepare for entering monetary union, the banks and other financial institutions, which will be the first who actually use the single currency, must do likewise.

The decision which Member States can join the EMU in 1999, will be taken in the beginning of 1998. Once the decision has been taken, the European Central Bank will be established, so that it can begin its preparations in order to be ready for conducting monetary policy on l January 1999.

In this respect, the Madrid summit (1995) pointed out which matters will have to be resolved in the coming years. One of them is the legal framework of the transition to the single currency. Another one is the exchange rate relationship between the countries that will join the union in 1999 and the countries with a delayed entrance. Also the production of Euro banknotes and coins has to be started.

On 1 January 1999, the exchange rates of the participating Members will be irrevocably fixed. The external value of the Euro will be that of the present basket ECU. The official ECU basket will cease to exist.

The Euro will only exist as book money in the bank accounts. National notes and coins will continue to remain legal tender within the country of issuance until the completion of the changeover process.

By 1 January 2002 at the latest, the Euro banknotes and coins will start to circulate alongside the national currencies. National currencies will be gradually withdrawn in line with the increasing circulation of the Euro.

• All the monetary policy and foreign exchange operations by the European System of Central Banks (ESCB) will be in Euros.

• For those financial institutions which have not been able to equip themselves with the necessary conversion facilities to translate accounts from Euros into national monetary units and vice versa, the National Central Banks could provide such facilities.

• The ESCB will support the coordination of market participants' actions so as to ensure the smooth functioning of an area-wide money market based on the Euro.

• There will be no longer foreign exchange markets, only purely arithmetical conversions.

• The National Central Banks will exchange national banknotes at par value.

National coins and notes will lose legal tender on 1 July 2002 at the latest. By then the changeover process is completed, the entire economy will be dominated in Euro. The national coins and notes may still be exchanged free of charge at the national central banks for a certain period.

Member States that do not fulfil the necessary conditions for the adoption of a single currency at the beginning of 1998, will join the monetary union in a later stage. At least every two years, or at a request of a Member State, the Council shall decide which countries do fulfil the necessary conditions to enter the union.

Code of Banking Practice: An Example of Self-Regulation

The Code is a voluntary one, which allows competition and market forces to operate to encourage higher standards for the benefit of customers. However, for institutions who agree to be bound by the Code, its relevant provisions may be contractually enforceable – by way of its explicit incorporation into all contracts entered into between participating banks and their customers.

All consumers of "retail banking services" could be entitled to similar minimum standards of good practice and service, irrespective of the institutions with which they deal.

A banking practice code is intended to:

• describe standards of good practice and service;

• promote disclosure of information relevant and useful to customers;

• promote informed and effective relationships between banks and customers;

• require banks to have procedures for resolution of disputes between banks and customers.

The governing principles are:

• to set out standards of good banking practice which banks will follow in their dealings with their customers;

• that banks will act fairly and reasonably in all their dealings with their customers;

• that banks will help customers to understand how their accounts operate and will seek to give them a good understanding of banking services;

• to maintain confidence in the security and integrity of banking and payment systems. Banks must recognize that their systems and technology need to be reliable to protect their customers and themselves.

The code requires to provide certain information, expressed in plain language, to customers. Usually this will take place when an account is opened, but this can also be on request or when the terms and conditions will change.

The banks will inform their customers that they have a complaint procedure. In some countries the banks are expected to belong to an Ombudsman or Arbitration Scheme.

Banks will observe a strict duty of confidentially about their customers affairs and will not disclose any information to third parties.

Banks ensure that all advertising and promotional literature is fair and reasonable, does not contain misleading information and complies with all relevant legislation.

Banks will provide customers with details of the exchange rate and the charges which will apply to foreign exchange transactions, and with details of cross-border payments and the services they offer.

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