# Western Rules for Eastern Banking

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**Abstract:**
The banking sector in each of the former socialist countries is undergoing a massive restructuring, two pillars of which are bank rehabilitation programmes and the introduction of a new regulatory framework that follows EU banking directives. The purpose of the paper is to outline the most significant changes in the banking sector and to trace the possible future path for this sector in Central and Eastern Europe (CEE) in the context of competing banking models. The main conclusion of this paper is that despite of transition period the orientation of the banking sector will be towards the government sector (including the central bank). New network of financial interrelations that emerged during transition is characterised by banking sectors' significant net defensive position and creditor passivity. Although CEECs develop their financial systems in line with universal banking model the aggregate balance sheets of their banking sectors reveal a structure that is more in line with other proposed models. Financial relations between households, corporate sector and the state sector intermediated by the banking sector reveals severe retreat of banks from corporate sector in favour of maintenance of government and central bank operations.

## Introduction

For transforming economies, two facts should be stressed: *First,* regarding the transition of the financial sector, the formidable tasks faced may be listed as follows: (1) the rehabilitation of the existing banking system, (2) the introduction of prudential regulation standards in line with those found in Western countries, (3) tightening the liberal licensing laws and low entry requirements found in the early transition period, (4) the creation of an independent central bank and (5) establishing the cost to banks in the rehabilitation process of enterprises. The combined results of this endeavour thus far are: high interest rates, both for lending and for deposits, a credit crunch along with credit rationing and government guarantee schemes - all of which affect the allocation of credit. These results are not unlike those found in western countries after a financial crisis.[1]

*Second*, an adequate definition and measure of the properness of the banking system does not exist. As a matter of experience, definition and measure are *ex post* concepts connected with the dominant doctrinal view at the time the definition is given. What can be said is that the prevailing signal that the enterprise sector has received thus far is to rely heavily on self-financing, rather than bank lending, as a crucial drive for real investment.

The consequences of the second point are not so straightforward for the financial system. They fit within two competing banking models: the first of which is a framework that targets the establishment of a market-oriented, Anglo-Saxon banking system, the second of which calls for the establishment of a universal banking system, such as that found in Germany and Japan. For transition economies, the essence of the argument is not regarding the inflow of external funds into enterprises, but more importantly in the inflow of influence exerted on enterprises in order to induce the necessary adjustments and restructuring. In fact, this aspect, coupled with privatisation, dominates the debate regarding the appropriate type of banking system. The search for a proper banking system is a search for an efficient device for transmission, and for a method for outsiders to exercise control on enterprises (Stiglitz, 1985; Goodhart, 1994). In other words, this is a debate regarding proper corporate governance.

However, the search for a proper model is a search for control on banks, as well. The government has two instruments at its disposal for exercising control over banks: ownership and regulations. Both are understood to be powerful tools regarding the instrumentalisation of government policies. The ideas, practices, and other modernising elements that are currently introduced into ECE countries, either through the advice of consultants or through the imitation of Western practices, concentrate on transforming bank-enterprise relations. However, while recreating this relationship along 'market-oriented' lines is necessary, it is none-the-less not sufficient for the completion of the transformation of the financial sector, for it is not the only relationship being changed. Equally important, the restructuring being undertaken must also concentrate on changing bank-government relations, as the state ends its reliance on central planning and commercial banks move from being instruments of the state into independent entities operating in a market economy. This explicitly means that the state gives up its dominant position as the *owner* of commercial banks and fulfils its role through the means of prudential regulation and supervision.

Although the state must withdraw from the ownership of commercial banks, it still has a large role to play in the successful transformation of the financial sector. From rehabilitation measures which include the restructuring of bank liabilities by (a) the re-capitalisation of banks with both public and private equity (the latter being nearly unknown in current practice), and the restructuring of banks' assets by methods which may include (b) a 'loan hospital', (c) debt-for-debt exchanges, (d) debt-for-equity swaps, (f) a 'good bank-bad bank' structure, (g) a government restructuring institution, (h) loan swaps and (i) government bond-for-bank loans swaps, the dominant position is occupied by government backed actions, not private initiatives. Despite several disadvantages that must be stressed - the government's continued control over the banking system; the consequential transfer of the risk of banking losses to the government; a delay in the realisation of a privately controlled-and-operated banking system; additional regulatory forbearance for the government's banks; a propensity to measures that transfer a portion of the costs of rehabilitation to banks that are not included in the rehabilitation process; liquidity dependency of banks on the activities of the government[2], the government's involvement in the rehabilitation of commercial banks was unavoidable, due to the nature of the system that each country in ECE is transforming from. This will, however, also have a profound effect on the nature of the banking system that is being created. For that reason, even though Western rules and procedures are being adopted, the end result will be distinct, according to the circumstances of the transition: an Eastern banking model emerges.

## Corporate governance perspective

Zysman (Zysman, 1983, p. 55) enumerates three different types of financial systems with various consequences for connections between the state and economy (enterprises, banks and other intermediaries). The first system is a system based on capital market with resources allocated by prices established on competitive markets where the enterprises and the intermediaries operate. The second is the credit-based system with critical prices controlled by the state. The third is the credit-based system dominated by the financial institutions. The state may appear in all three roles simultaneously, even though this brings it into conflicting situations. One such conflict is between government debt financed by subordination of financial intermediaries and the financial regulation. The second interesting conflict emerges when the state decides for a monetary policy of targeting quantity of money, aiming not only at stability of prices, but also at subordination of financial intermediaries.

The mentioned three systems are an important element of connections between the enterprises and the state and between the state and the banks (other financial intermediaries) and their governance. According to Zysman (Zysman, 1983, p. 286) the model of adjustment in the first type of financial system is company-led, in the second type state-led and in the third type negotiated.

Walter (1994) and Story and Walter (1998) offer similar insight into the role of government and the structure of financial system? They distinguish between the equity-market system (Anglo-American), the bank-based system (German), the bank-industrial cross-holding system (Japanese) and the state-centred system (France). In all these models financial system has a central role in resolution of agency problem. From the corporate governance perspective they draw distinction between outsider and insider system.

The outsider system is the closest to the financial system based on the capital market. Individuals are direct owners of enterprises and banks and the indirect owners through investment funds (institutional investors). There is a free market of shares and no cross-holding ownership. The insider system is suitable for both types of bank- or credit-based financial system. Typical of this kind of system are inimical take-overs which affect the response of the managers of enterprises and force them to act according to the demands of the owners. Cross-holding between the banks and the enterprises is allowed in this type of regulation. The banks perform the role of commercial and investment banking and have the control over enterprises. The capital market is not well developed. This type of system does not foresee hostile take-overs against the will of the managers. Hostile take-overs are practically unknown. In each of these types of regulations the state and the economic agents intertwine. The state may pursue a number of policies within the two extremes: from the laissez-faire, where it provides for macro-economic policy only, (the policy of competitiveness and foreign trade policy and leaves all the rest to market mechanisms), to a partial or a complete ownership over corporations, regulation of credit system, and to directives of central planning. Finally, in the state led system, the government is very active on both the capital market and banking intermediation and the dominant focus of lenders and borrowers.

This actually means an implementation of government force to trigger changes in enterprises. In CEECS practice this resulted in actual stratification of rules adopted for dealing with different groups of enterprises and banks and of transformation process as whole. At the heart of the matter was the debt overhang issue. Two main features of the whole process are partially give-away privatisation and give-away government debt as drivers transferring previously incurred losses from business sector to government sector and transferring net wealth to new owners. Yet the restructuring results of expected high outside pressures from newly established investment funds, from banks as senior creditors and from bankruptcy legislation for enterprises and banking sector are still ambiguous. Ambiguity is generated by differentiation of newly created institutions and applied rules on the one side and by possibilities of development of either state ownership or internally governed enterprises and banks, both generated from previous socialist ownership, on the other side. The breaking up of mono- or state bank resulted in creation of commercial banking system blended with a flavour of investment banking. Investment banking in eastern circumstances was predominantly understood as the role of a bank in corporate governance. Basically, it emerged as a vehicle for ownership transformation (especially in voucher privatisation schemes) and not on evolutionary basis.

Due to actual needs of reforming economies one of the most stressed features of universal banking was the establishment of a close relationship between commercial banks and borrowing firms. This marks the beginning of a bank's almost total involvement in an enterprise through short-term financing, fixed-capital financing and equity stakes.[3] The question is, of course that of the relative importance and role of four interconnected factors: (1) historical factors, (2) regulatory framework, (3) economic policy and (4) behavioural responses. From the point of view of reforming economies the second and the third factors are the most important. They are devices employed through the process of transition. And both factors are precisely those vehicles that enable the search for convergence between universal banking and narrow or core banking, irrespective of historical heritage or expected behavioural response. The monetary and exchange rate policies, banks' and enterprises’ capital shortage or a strengthening of regulatory requirements can lead to a contraction of the real sector through a credit crunch, and also to the reorientation of banks towards servicing the government[4] and the central bank.

Arguments in favour of German universal bank model (Steinherr, 1993; Kregel 1992) are as following: Irrespective of banks' ownership, German universal banks provide a full range of both commercial and investment banking services. On the liabilities side, the banks accept short-term sight, time and savings deposits, long-term funds in the form of fixed-term deposits and issues of saving bonds and bank bonds. On the assets side, they grant short-term advances, and medium and long term loans. Banks also provide brokers' services, deal in securities, and accept seats on the supervisory boards of non-banking institutions. In actuality, this description accuarately describes only the ‘Big Three’ German commercial banks - Deutsche Bank AG, Dresdner Bank AG and Commerzbank AG (Smith, 1994). The exception to the general universal banking rule, although they still may fall under the coverage of a *universal bank* system, are specialised banks, operating on narrower fields such as financing of mortgages, instalment sales, postal giro and savings banks and other specialised functions. These banks are often either subsidiaries of a universal bank or are state-owned. But only central institutions of public and co-operative banking sectors are allowed to own equity capital in non-banking institutions. Private sector banks are involved in retail banking. Universality in the German case covers at least three areas. German banks are consequently involved in all markets for financial services. The securities markets consists of bonds and equity. Bonds extend relations to both public debt finance and to housing finance. Equity markets lead to complex relations between the business and banking sector. In the third integrating area, banking meets insurance with *Allfinanz* (a German financial holding company) being the result. According to Kregel (Kregel, 1992: 239) the main advantages of German model is its reliance on strict regulation of maturity matching and active monitoring of detailed balance sheet. Its universality is based on capital adequacy rules, liquidity rules, and exposure limits.

European integration, in which several CEECs are involved at least through obligations from Europe Agreements to form a free trade areas, towards a single market of financial services will be achieved through convergence of banking system in accordance with EU Banking Directives. Among the pillars of this process is a universal banking model. Financial intermediaries with different structures and characteristics, and regulated by different rules, would reshape towards universal model. That is the concept of *credit institution* or a bank defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account. This in turn is subject to supervision and monitoring by authorities of its liquidity, solvency, deposit guarantees, the limiting of large exposures, administrative and accounting procedures, and internal control mechanisms.[5] Activities that credit institutions perform are: (1) acceptance of deposits and other payable funds, (2) lending (consumer credit, mortgage credit, factoring, with or without recourse, and financing of commercial transactions, including forfeiting), (3) financial leasing, (4) money transmission services, (5) issuing and administering means of payment (credit cards, travellers' cheques and bankers' drafts), (6) guarantees and commitments, (7) trading for their own account or for the account of customers in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments, transferable securities, (8) participation in securities issues and provisions of services related to such issues, (9) providing advice on undertakings regarding capital structure, industrial strategy and related questions, and services relating to mergers and the purchase of companies, (10) money brokering, (11) portfolio management, (12) the safekeeping and administration of securities, (13) credit reference services, (14) safe custody services.[6] The Second Banking Directive includes within it the concept of a financial institution other than a credit institution, which is defined as an undertaking that performs all activities listed above with the exception of deposit taking. So, European banking directives which should be implemented by candidate countries for integration in EU, explicitly introduce into these countries the concept of financial universality and not only the concept of universal banking.

We shall focus now on the most relevant issues for Eastern countries: relations between banks and enterprises and between banks and the government. Credit institutions are allowed to have up to 15% of its own funds in non-bank and non-financial entity. The total amount of all such holdings may not exceed 60% of its own funds. Two points should be made. The first is related to debt-for-equity swaps as a way of introducing ownership and control of banks over enterprises. According to the Second Directive, shares held temporarily during a financial reconstruction or rescue operation shall not be counted as qualifying holdings for the purpose of calculating the above mentioned limits, although the bank will be obliged to increase its own capital or to take equivalent measures. This Directive was written for cases where exceptional circumstances created the need for the restructuring of a single or several institutions, not the reconstruction of the whole economy, as found in the transition economies. Nevertheless, it is interesting that the directive foresees a period of 10 years for bank to dispose of excess holdings. The second is related to credit, interest rates and market risks. This directive offers the possibility to exclude from its scope any credit institution that specialises in inter-bank and public- debt markets and that fulfils, together with the central bank, the institutional function of a banking system liquidity regulator, provided that: (1) the sum of its asset and off-balance-sheet items included in the 50% and 100% weighting must not normally exceed 10% of total assets and off-balance-sheet items and shall not in any event exceed 15% before application of the weighting, (2) its main activity consists of acting as an intermediary between the central bank and the banking system, (3) the competent authority applies adequate systems of supervision and control of its credit, interest-rate and market risks.

In view of current Eastern bank rehabilitation methods, or monetary policy practice, both of which influence the foreign exchange exposure of banks, exchange-rate risk should be added as well. In other words, such a bank would not have loans to enterprises or equity stakes on the assets side. It would have to lend to the government, or to entities with government guarantees.

Once again, what is meant as a special case within the directive is a dominant feature of CEECs banking. Government rehabilitation bonds exchanged for enterprises loans and for the re-capitalisation of banks dramatically improve their solvency ratios: completely insolvent banking system becomes highly solvent on after this method is initiated. Further, from the Second Banking Directive we can also assume that the answer to financial universality instead of multi-tier banking could be multi-tier prudential regulation.

**Risk managing perspective**

The first important step for the reform of the financial sector in former socialist economies was the break-up with mono-bank system that introduced a two-tier banking system, in which the state bank or national bank took on activities of central bank and became responsible for the conduct of monetary policy and monetary regulation, while the newly instituted and the state-owned commercial and specialised banks were assigned the functions of deposit mobilisation, lending, payment, and other commercial bank's activities. The second important step that followed were the changes in legal and regulatory framework aiming to change incentive structures needed for building sound banking systems and business practices. The first step just reorganised the intermediation between mobilisation and allocation of resources, the second one added new task of risk trading to intermediation.

Each of the transforming countries has used the Basle guidelines for risk management and the EU banking directives as a template for the reformation of their financial sector. One possible conclusion from this is that after a rehabilitation phase the banking system will be shaped to mirror the Western benchmark. However, neither the Basle recommendations nor the EU directives were established in order to create a model for reforming countries to copy: the Basle agreement was established in order to promote the soundness of banks involved in international business, while the EU guidelines support the creation of a single market in banking and other financial services for member countries. Both the Basle accord and the EU directives were written assuming the pre-existence of a market economy in the countries that abide by these rules. Thus, the situation foreseen by these guidelines is far removed from that found in an economy transforming from nearly 50 years of central planning.

The debate on proper banking model for the former socialist countries was relatively short, but intensive. It was a part of the debate on comparative advantages of different financial and banking systems in developed industrial countries, which included both functions of intermediaries – mobilisation and allocation of resources and risk transformation. As usual, the real life practice exceeded the conclusions of the debate. A brief overview of recent changes in regulatory frameworks and interrelations between banks, enterprises and the state sector in CEECs is available in Table 1.

We can learn two lessons from the table. The first one relates to the starting vintage of legislative modernisation of banking sectors at the beginning of 1990s that introduced new structure of incentives and announced hardening of the budget constraint. Changes and improvements made later (Borish, Ding, Noël, 1996; EBRD 1998) leave the general impression that banking systems in these countries fit to universal model unchallenged. The table reveals that new legislation introduced evaluation of borrowers' risk, concepts of risk weighted assets and risk weighted capital requirements, defined measures of single creditor and total exposure including equity ownership and limits to credit to shareholders, determined supervisory authority. The second one outlines the basic characteristics of rehabilitation procedures for resolving the bad debt problems of banks and enterprises. The state was heavily involved in banking sector rehabilitation and re-capitalisation through the exchange of government bonds for bad debts and without linking rehabilitation of bank with their privatisation. In the same time the direct banking sector involvement in rehabilitation, restructuring and privatisation of enterprises sector was much weaker.

It seems that theoretical arguments in favour of universal banking model for CEECs are less important when compared with real life. The same holds for arguments in favour of universal banking based on level of development of CEECs. More convincing are the observations that the model enters the scene in a manner of "Gulliver" or "neighbour" effect of EU (specifically as result of German influences on CEECs) and that the path towards financial universality serves to maximise size and market power, and ultimately generates non-competitive rents. Both would be consistent with the hypothesis of survival of the fittest, but social implication would be different.

**Table 1: The Regulatory Framework in Eastern European Banking Since 1991**

| | Slovenia | Hungary | Poland | Czech R | Bulgaria | Rumania | Croatia |
|---|---|---|---|---|---|---|---|
| Separation b/w commercial and investment activities | No | Yes | No | No | No | No | No |
| Limits on equity holdings | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Capital adequacy | 8% of risk weighted assets | 8% of risk weighted assets | 8% of risk weighted assets | 8% of risk weighted assets | 8% of risk weighted assets | 8% of risk weighted assets | 8% of risk weighted assets |
| Minimum capital | USD 5 m | USD 13.3[a] | No explicit limit | Determined by Central Bank | USD 10 m | USD 3.5 m | USD 5 m |
| Single debtor exposure | 25% of guaranteed capital | 25% of guaranteed capital | 15% of assets | 25% of capital | 25% of capital | 20% of capital | 30% of guaranteed capital |
| Limits to ownership | Yes | Yes | Yes | No | 1% of capital | No | Yes |
| Loan classification | Yes | Proposed | Proposed | Proposed | Proposed | Proposed | Yes |
| Lending to shareholder | Yes | 5% of guaranteed capital | 5% of capital | Discretion-ary | Authorisa-tion required | 15% of capital | Yes |
| Supervision authority | Central Bank | State Banking Supervision | Central Bank | Central Bank | Central Bank | Central Bank | Central Bank |
| Rehabilitation measures | Govt. bonds exchanged for bad loans and bank recap. | Govt. bonds callable on initiation of liquidation procedures | Govt. bonds exchanged for bad loans and bank recap. | Govt. bonds exchanged for bad loans and bank recap. | Govt. bonds and guarantees | Proposed Govt. bonds | Govt. bonds exchanged for bad loans and bank recap. |
| Bank recap. linked to enterprise restructuring and privatisation | Indirectly | Indirectly | Directly | Indirectly | Directly | No | Indirectly |
| Bank recap. linked to bank privatisation | No | No | No | No | No | No | No |
| Bank involvement in enterprise restructuring programs | Yes | Yes | Yes | No | No | No | Yes |
| Deposit insurance | Yes | Yes | N/A. | Yes | N/A. | N/A. | Yes |

***Source:*** Thorne (1993) and national sources compiled by the author.

[a]For commercial banks only

The basic characteristic of banking sector modernisation is therefore universality. As usual with the definitions, universality is not quite a uniform concept. Story and Walter (Story and Walter, 1998; Walter 1994) identify four basic types of linkages that have dominated the current debate between the corporate structure and competitive performance in financial services:

1. The fully integrated universal bank, capable of supplying all types of financial services from the same corporate entity: the *truly universal* banking, or German-Swiss model.
2. The partially-integrated financial conglomerate, capable of supplying the same set of services but with several (such as mortgage banking, leasing and insurance) provided through wholly-owned or partially owned subsidiaries: the *group universal model,* or *Allfinanz/Bankassurance* model.
3. The bank-subsidiary structure in which the organisation's core is a bank, and a broad range of non-banking financial activities is performed through legally separated subsidiaries: a *financial universal* banking model, or the British model.
4. The holding company model, where a holding company owns both banking and non-banking subsidiaries: an *ownership universal* banking model, or the American model.

These four versions of universality are the results of different regulatory approaches. The most important distinction regards the possibility for enterprises to be owners of banks and for banks to have equity stakes in enterprises. These seemingly competing models have entered the lexicon of reforming economies: the *truly universal* and partially-integrated model through imitation of EEC banking directives and IMF and World Bank's advice, the American model through advisory potential of other American institution. In fact, the universal banking system has become, in one form or another, the typical model in industrial countries. This is true even in countries in which there remains a legal separation between commercial and investment banking activities, as well as legal geographical segmentation, such as in the United States. For reforming countries the concept of an universal bank coincides with that of a commercial bank.

Besides detecting differences between the models stated above, it could be also useful to detect any possible convergence. This convergence may be found:

- through differentiation regarding risk taking and risk aversion,
- through examining the relationship between banks and the state and
- in common attitude towards expansion of financial universality which lies behind each of the four models of universality.

Such understanding of convergence has its foundation on a reasonable ground of common Eastern and Western experiences, namely that the challenges found in the transition include restructuring and re-capitalisation of insolvent banks and reorganising of healthy banks into new institutional categories. Striking enough, the second path of convergence is connected with the question which banking activities should be regulated. Restructuring ideas in the Western world are built around three topics: (1) deposit insurance, (2) competition between banking and non-banking sectors in providing financial services, and (3) an interconnection between banks and non-bank businesses.[7] We shall refer to two current and influential proposals of American origin: concepts of narrow banking and core banking.

Litan (1987) tries to equilibrate the benefits from removal with limitations on risks. He discuses two broad approaches for meeting this requirements. Both would allow banking firms to diversify their product and service offerings. The fundamental differences between them is in regard to deposit guarantees. Under the first alternative, bank subsidiaries could operate by collecting insured deposits and re-lending them to customers, while operating parallel affiliates engage in other financial and non-financial business. Associated risk would be addressed through regulation. The second alternative is narrow banking. In brief, Litan advocates legislation which would provide for the establishment of financial holding companies. These are a variation of bank holding companies, in which a deposit-taking subsidiary would be required to invest only in reserves, government securities or securities insured by the government against default. Lending by these diversified institutions would be separated from deposit taking, and funded through the uninsured securities market.

Litan's proposal has a different goal. With an eye on the inevitable growing intrusion by banks into activities that were not allowed by American legislation and by intrusion of other firms into banking activities, he envisioned two regulatory responses to this process. The first is an inadequate response to abuses and fraud as they arise. The second is a splitting of the transactions functions from the intermediation functions performed by depositories which belong to highly diversified financial service firms. Three of Litan's conclusions are worth mentioning: (1) a possible contamination of the safety of the banking system due to financial deregulation and product diversification, (2) increasing conglomerate economic and political power, and (3) increasing conflicts of interest. They are relevant for transforming economies as well. If one adds accounting practice and abuses to the first conclusion than unexpected convergence between two seemingly unrelated environments emerges.

The essence of Litan's proposal for narrow banks is as follows. Existing (American) bank holding companies should continue if they were willing to undergo further financial product diversification, and for a gradual phasing in of narrow banks. The basic question is how extensively should the government intervene to provide a financial safety net. By suggesting government and government guarantied collateral instead of insurance to protect deposits, it expands but does not exhaust the policy options.

The core bank proposal (Bryan, 1991) as a part of *new social contract* addresses the incentive distortions created by U.S. federal safety net by restricting deposit insurance to a new class of *core banks*. The overall contract would involve an authorisation of a new kind of financial holding company with no restrictions on what businesses it might own or what businesses may own it. The holding company could have both insured and non-insured subsidiaries. The banks would be required to be broken up so as to conform to three new legal categories of financial institutions: *core banks, money market investment banks, and finance companies*. Each would play a distinct role in the economy. In order to transfer the risk to the federal safety net, core banks would be limited to certain traditional banking activities. They would accept deposits in savings accounts, checking accounts, money market accounts, and so on. They would land to individuals (for home mortgage debt, home equity loans, credit cards, instalment loans, and car loans, including home mortgages, credit cards and small business lending), and to business (for accounts receivable financing, equipment leasing, commercial mortgages, unsecured lines of credit). These activity restrictions would be complemented by regulation of interest rates on core bank deposits, which would be pegged to floating rates on Treasury securities. The purpose of regulating interest rates would be to prevent destructive competition among banks seeking to attract deposits by bidding up interest rates. In the absence of such competition, core banks would be under less pressure to engage in high risk lending in order to cover their cost of funds. Regulators could also limit the terms and conditions of loans which could be extended by core banks. Under this proposal, money centre banks, which offer services today beyond those permitted to core banks, would be required to split their operations into two or more entities in order to segregate their core banking operations in a separate corporate compartment. They could continue risky non-core activities based solely on their own financial strength or exit some of the business. Some among this banks could be a giant player in the world capital markets - without government guarantees. Non-core services would be conducted through uninsured and largely unregulated *money market investment banks* and *finance companies,* subject to disclosure-based regulation by the Security Exchange Commission.

The essence of this proposition is to create core banks that would return to those activities that have proven over time to be relatively safe and where banks have demonstrated advantage over non-banks. Creating safe core banks requires imposing strict controls over what they can do. This regulations would include: pegging interest rates, limiting the size of loans core banks can extend, permitting real-estate lending to local developers on strict regulated terms and conditions.

Money market investment banks would serve corporations, financial institutions, and government with a broad array of commercial banking and investment banking products. Their operations would involve trade securities, derivatives, and currencies. They would buy, sell, underwrite, and distribute corporate debt and equity, make loans that could be traded on secondary markets. Unlike the core bank, which would be funded with insured deposits, the money market investment bank would be funded with interbank deposits, uninsured CDs, and other wholesale funds. Each bank would have unquestioned financial strength founded on their earnings stream, the quality of their assets, and their capital base.

Finance companies would provide credit and other banking services that are too risky to be included in the core bank: big corporate loans, financing for highly leveraged transactions and commercial real estate, large lease transactions for capital equipment and aircraft. Their funding source would be strong capital base (as much as 15 percent of their assets). Rating agencies and accounting firms, and not the bank examiners, would be responsible for assessing the quality of the assets. The role of regulators would be to protect affiliated core banks or money market investment banks from being brought down by troubles of the finance company. Beneath these institutions a safety net would not exist.

Policy options are not exhausted with this two proposals. Tobin (1985) for example takes similar position in proposing "segregation" to limit the need for deposit insurance protection and continuous scrutinisation and regulation of assets. Szegö (1993) proposed an organisation of the eastern European financial system along four, strictly specialised tiers: payments services, lending activities, investments, and central banking.[8]

Wijnbergen (1993) and Boot and Wijnbergen (1994) argue that both the need to insure depositors and the need for strong lender regulation and for monitoring managers' investment activities call for transitional separation of deposits collecting activities from investment activities by creating two types of banks: commercial banks, collecting deposits and lending to the government and other banks, and investment banks, borrowing from the interbank bank market, and possibly the government. According to their proposal, all one needs to create such a banking system is to (1) forbid the savings (narrow) bank to lend to corporations, (2) forbid commercial banks to take personal deposits on a significant scale or refuse deposit insurance to such deposits outside the savings bank, (3) require the savings (narrow) bank to invest mostly in high grade assets, which for the time being means government paper and lending to the commercial banks with high capital base. In this system the savings (narrow) bank need not to be monitored, while monitoring of investment bank will be curtailed through higher capital ratio and creditors. Of course, an essential complement to the system is development of interbank market. Also, *The Economist*, August 27th 1994 states: "The German model may not be suitable for economies that are still making a painful transition from central planning to capitalism. One priority should be to create a stable banking system that wins depositors' trust while allocating credit on the basis of market forces. A second should be to encourage a rapid restructuring of the hugely inefficient industries that central planning has created. And a third should be to promote the development of efficient and competitive capital markets. An unthinking dash for a universal-banking system could make it harder to meet any of these priorities."

## An ambiguous outcome: Eastern universality

Several recent studies (Borish, Ding and Nöel, 1996; Anderson and Kegels, 1998) stressed that the state continues to dominate the banking sector of CEECs countries. On a balance sheet basis, for example, in 5 countries (Czech republic, Poland, Hungary, Slovakia and Slovenia) this dominance accounts for about 60 percent of total assets and total loans, and about 70 percent or more of total deposits (Borish, Ding and Noël, 1996, p. 3). According to the same source, banking sectors of these countries still show regional and/or sectoral segmentations dating back to the earlier periods and are still protected by the state from the pressure of market forces. Due to their size, access to household deposit and traditional client basis, privileges such as implicit state deposit guarantees and sectoral/geographical concentration have provided state banks with market advantages and in some cases with direct and indirect subsidisation to offset potential losses. The power of these banks to pass increased costs of intermediation to borrower through higher lending rates remains unchallenged despite their low intermediation rates.

The joint result of the processes is that the size of the private banks, measured by their shares in total banking sector resources on a balance sheet basis, is small. The private banks' average assets in Poland, Czech Republic, Slovakia, Hungary and Slovenia were US$ 369 million, compared to US$ 2,3 billion for an average state owned bank in 1995. Average deposits of private banks were US$ 149 million and US$ 1,4 billion for the state banks. The governments of these five countries also provided nearly US$ 13 billion to re-capitalise the troubled banks: Slovenia US$ 1.4 billion, Poland US$ 2 billion, Hungary US$ 3.5 billion, and Czech Republic and Slovakia US$ 6 billion (Borish, Ding, Noël, 1996, p. 27).

It will be instructive now to examine the changes in balance sheets of West European banks (in the period of 1982-1986) and of East European banks (after rehabilitation measures were introduced) on a highly aggregate level. From the works of Gardener and Molyneaux (1990), Cherubini, Ciampolini and De Felice (1993) and Maccarinelli, Marotta and Prosdocimi (1993) we can draw the following picture on West European banks. On the assets side, West European banks have experienced an increase in their inter-bank deposits, compensated for by a decrease in the proportion of loans in their books, as well as by decrease in cash balances held by the central bank. On the liabilities side, a large fall in the proportion of non-bank deposits, as well as a marginal fall in the holding of inter-bank deposits has been compensated by a substantial increase in borrowing from the central bank, as well as by an increase in bonds and other types of liabilities. The increase in capital and reserves was insignificant. Non-bank deposits constitute more than 50 per cent of banks' liabilities, more than double the size of inter-bank deposits. Looking at large banks only shows that on the liabilities side, decreases in inter-bank and non-bank deposits have been compensated for by an increase in borrowing from the central bank as well as by a substantial increase in capital and reserves. On the asset side, securities and other assets are more important investments for large banks than for other types of banks. For savings banks, the assets structure is dominated by loans and securities, and the liabilities structure is dominated by a greater significance of non-bank deposits, although the dependence from inter-bank and central bank deposits increases as compared to other types of banks.

The picture that is presented from the balance sheets of CEE banks is vastly different. They have a large amount of non-performing loans from State Owned Enterprises (SOEs), both inherited from the old system and newly created, and negligible amount of loans to the emerging private sector. After the introduction of bank rehabilitation measures, commercial banks obtained a large amount of government bonds in exchange for bad loans, in order to improve both the assets and liabilities side of the banks’ portfolios. Although these rehabilitation measures improved their solvency dramatically, there is still some doubt of the soundness of these banks as they suffer great liquidity problems, an exchange rate-interest rate mismatch and an assets-liabilities maturity mismatch. Despite cleaning their balance sheet from the legacy of former system and despite tightening financial discipline, the bad debt problem is still significant (Table 2). Its presence reveals several unwanted developments: sustainability of *creditor passivity* and weak incentives for banks to cope with it.

**Table 2: Non-performing loans, 1994-1997 (in per cent of total loans)**

| Country | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| Bulgaria | 7 | 13 | 15 | 13 |
| Croatia | 12 | 13 | 11 | 10 |
| Czech R. | 34 | 33 | 30 | 29 |
| Hungary | 18 | 10 | 7 | 4 |
| Poland | 29 | 21 | 13 | 10 |
| Rumania | 19 | 38 | 48 | 57 |
| Slovak R. | 30 | 41 | 32 | 33 |
| Slovenia | 22 | 13 | 14 | 12 |

Source: EBRD (1998b, p. 133)

In addition to the creditor passivity the balance sheets reveal also defensiveness of banking sectors. According to Tobin (Tobin, 1982, p. 496) the assets of commercial bank may be divided into two categories: loans and investments, and defensive assets. Defensive assets are assets of very high liquidity and include currency and deposits in central bank and other banks and government bills and interbank loans. They cover primary and secondary reserves. The amount by which bank’s net holdings of defensive assets exceeds its required reserves defines its defensive position. In Table 3 data for four CEECs are re-arranged to present sectoral break-down of assets and liabilites. Data are organised in a manner to extract four sectors: monetary system (cash, central bank, inter-bank lending), government, corporate sector and households, and to obtain information on investments in equity of non-banks and on own resources of banks. Additional two rows are added with estimated data on equity and tradable securities (with exclusion of central bank and government’s short-term papers). The construction of Table 3 enables also additional insight on universality through balance sheet's figures.

**Table 3: Sectoral break-down (in per cent of total assets)**

| | Poland | | Hungary | | Czech R. | | Slovenia | |
|---|---|---|---|---|---|---|---|---|
| | 96 | 97 | 96 | 97 | 96 | 97 | 96 | 97 |
| | Assets | | | | | | | |
| Monetary system | 26,3 | 27,4 | 22,9 | 26,1 | 33,5 | 36,6 | 29,8 | 31,2 |
| Government | 18,8 | 20,6 | 18,6 | 15,6 | 6,8 | 4,4 | 15,9 | 15,9 |
| Corporate sector | 32,9 | 33,4 | 29,5 | 20,4 | 46,0 | 43,4 | 28,3 | 27,2 |
| Households | 5,6 | 7,0 | 4,3 | 3,2 | | | 11,5 | 11,5 |
| Equity and participations | 0,0 | 0,0 | 2,6 | 2,8 | 1,9 | 0,5 | 1,2 | 1,2 |
| (Other tradable securities) | n.a. | n.a. | 2,6 | 1,9 | 6,7 | 3,8 | n.a. | n.a. |
| | Liabilities | | | | | | | |
| Monetary system | 11,4 | 15,2 | 11,5 | 11,2 | 26,7 | 26,1 | 13,6 | 10,2 |
| Government | 3,0 | 4,4 | 4,2 | 3,8 | 2,0 | 1,6 | 8,4 | 8,5 |
| Corporate sector | 15,5 | 15,0 | 15,9 | 17,3 | 45,9 | 47,7 | 17,1 | 17,5 |
| Households | 24,1 | 38,9 | 37,6 | 33,5 | | | 37,0 | 35,5 |
| Equity | 4,1 | 5,1 | 9,6 | 10,2 | 8,3 | 8,4 | 15,8 | 15,3 |
| Bonds | 0,4 | 0,3 | 9,8 | 7,3 | 3,1 | 4,0 | 2,5 | 2,5 |
| Central bank's balance sheet as per cent of commercial banks' balance sheet | | | | | | | | |
| | 45,3 | 46,9 | n.a. | n.a. | 24,1 | 22,0 | 20,2 | 28,5 |
| | Net position | | | | | | | |
| Monetary system | 9,1 | 12,2 | 21,4 | 14,9 | 7,4 | 10,5 | 16,2 | 21,0 |
| Government | 15,8 | 20,2 | 14,4 | 11,8 | 4,0 | 2,8 | 7,5 | 8,5 |
| Corporate sector | 17,4 | 11,6 | 13,6 | 3,1 | 0,1 | -4,3 | 11,2 | 9,9 |
| Households | -18,5 | 31,9 | -33,3 | -30,3 | | | -25,5 | -24,0 |

*Source*s: Calculated from Annual Report 1997 of National Bank of Poland, Annual Report of Hungarian Banking and Capital Market Supervision, Czech NB Banking Supervision 1997 and Monthly Bulletin of Bank of Slovenia 6/99, IMF International Financial Statistics, June 1999

Recent EBRD survey (EBRD, 1998a, p. 26) concludes that the extensiveness of banking and capital market regulations is far more advanced than the effectiveness of introduced rules. .Enforcement of rules and regulations seem to be lagging behind the enactment of sound legal framework and the methods of risk prevention need to be improved. According to the survey the main areas in need of improvement and enhancement include refining of internationally acceptable accounting standards, enhanced enforcement of laws and regulations and greater improvement of the general legal framework that underpins financial transactions.

Therefore, the situation found in the banking sector in transforming countries is different from that in a Western banking sector. The problems faced, and their resolution, indicate that for the foreseeable future the government will play a crucial role in the commercial banking sector in Eastern and Central Europe. Creditor passivity and relative defensiveness of banking sectors are of course in sharp contrast with expected activities of universal banks. It seems that the most important task of banking sector's activities is involvement in central banks and treasuries' activities in redistribution of resources towards less risky activities. It could also be a sign of the centralisation of the monetary system. A rough indicator of such possibility is comparison between central bank's and commercial banks' balance sheet total as was done in Table 4. If this assertion holds then the state – central bank and treasury- is deeply involved in risks transformation outside the banking system and banking system is deep involved in public finance transactions. Furthermore, judging the banking sectors from the perspective of Table 3, gives an impression that they are closer to the narrow or core bank concept than to the universal bank concept.

## Preliminary Conclusions: What remained from the universal model?

The financial system is one of the most important elements of the economic system. An established belief prevails that the role of the financial system is to mediate among units with financial surpluses and units with financial deficits. The narrowness of such an understanding is in neglecting the second important task of financial intermediation - the distribution and/or the exchange of risks. From the beginning of the seventies this second viewpoint is steadily gaining ground, as well as a belief that the essence of financial system or financial companies is the manner of dealing with risks and the control over risks. In general the field of financial services covers collecting deposits, crediting, issuing debtors' and owners' securities, the trade in securities, portfolio management, advising, insurance, operations with foreign currency and with derivatives. The units with excess savings can always invest surpluses directly to deficit units so that they accumulate their securities (ordinary shares, mortgages and other). It is a general characteristic that a smaller part of financial flows run through this channel and that the biggest part of flows run through financial intermediaries. The modern theory of banking and financial intermediation emphasises that such delegating occurs due to the information limitations, which are encountered by the savers/investors. Thus the financial intermediaries are at the same time specialised in producing and providing information services. They have an access to the information of debtors, mediate incentives to lenders, control the debtors. A basic limitation for lenders and borrowers, which is being solved with the help of intermediaries is insurance against liquidity risk. And for this sake in particular the state has an important role in the entire financial mediating. It offers various forms of insurance to reduce the range of risks for the economic agents due to the information imperfections, regulates the obligatory ways of dealing of financial mediators and controls their activity. This is why the financial flows are channelled towards the state (government and central bank) and its direct (budgetary) and indirect (off-budgetary) financial mediation. The four crucial problems encountered by the financial intermediaries and their regulator (the state) are: improving the quality of investments, capital adequacy, increasing dependency on floating interest rate on the liabilities side, and intertwining of balance and off-balance operations. The basic changes occurring in the banking system are shown in Table 5. These changes bring new elements to the relationships between the banking, enterprise, households and the government sectors. So, it could be argued that the functioning of the transitional banking involves a much greater reliance on government's financial intermediation for both the banks and the enterprises. The adopted model has been that of universal banking but due to the specific circumstances of transition, the state plays a greater role than is generally acceptable in a truly universal system.

Literature on transitional banking almost uniformly acknowledges as the most urgent problem to be solved the privatisation of still dominating state ownership of banks. But the ownership structure is not the only significant problem. Balance sheet data effectively show that banking sectors of several CEECs intermediates resources to safe heaven: to monetary system (central banks and other banks) and to government and that they hold quite respectable defensive assets and defensive positions. One possible explanation of such development is the perception of the state as an ultimate anchorage of stability compared with risky corporate sector.

We can now approach the conclusions from passages on universal, narrow and core banks, on imitation of EEC directives and from insights into balance sheets of several CEECs with the help of Figures 1 and 2, which should be a bridge over the differences among seemingly competitive models. Figure 1 translates the universal bank concept to Eastern circumstances, and Figure 2 discusses the idea of a segmented approach to banking. Both figures are drawn to present the conflicts of interests which are found within the focus of different proposals. These are conflicts between deposit taking (with implicit government guarantees or explicit deposits insurance schemes), the payments system, the central bank as a lender of last resort and risk investments. As far as reforming countries are concerned, different banking schemes should be drawn, depending on net creditor positions of the economy-wide sectors, which are changing significantly. As the EFSAL approach introduced by The World Bank in several CEECs countries has been designed to support the resolution of the debt-overhang problem of enterprises and the portfolio problems of banks (both state-owned) through bank-led activities, it was a natural outcome that all countries reported in Table 1 introduced a banking system patterned on the German universal model, supported heavily by the supervisory and regulatory power of outside bodies. As far as prudential bank regulation and depositor protection are concerned, the German system does not restrict the field of activity of financial institutions. Nor does it attempt to regulate specific financial product markets. Instead, it imposes prudent banking behaviour on all institutions. It is also true that active monitoring of detailed balance sheet restrictions can be seen as a substitute for the market segmentation of the US system, which on the other side should be removed by deregulation processes. What is left then to the reforming economies is to observe the changing financial interrelations among economy-wide sectors that are created through rehabilitation and restructuring measures, designed for resolution of debt-overhang problems. These activities (for example, cleaning of balance sheets as a partial monetary reform) are designed to re-capitalise enterprises through self-financing mechanisms, and not through raising outside funds on capital market. The banking system is left to intermediate as the largest holder and issuer of securities, while households' demand for savings deposits increases and the government becomes a net creditor instead of a net debtor. Spontaneous market segmentation can thus develop in line with the German model. If the opposite is the case, then some variety of segmentation is probable. The messages are two: First, specific structure of assets holdings and liabilities which arise from restructuring activities influences the "working" model of banks. And second, the role of central bank and government operations in intermediation and risk transformation processes is crucial.

**Figure 1: Two Universalities**

| **TRUE UNIVERSALITY** | | **EASTERN UNIVERSALITY** | |
|---|---|---|---|
| *(traditional banking activities)* | | *(traditional banking activities)* | |
| cash and reserves | insured deposits | forced cash and FX reserves | insured deposits |
| loans (ceilings on amount and lending rates) | other funds | government guaranteed loans | |
| | debt | *(securities activities)* | other public funds |
| *(securities activities)* | | debt-for-equity swaps | debt |
| government financed equity | capital (amount determined by credit risk, interest rates, exchange rates, other market risks and equity financing) | government rehabilitation bonds | capital (government owned) |

**Figure 2: Functional Separation**

| REGULATED ACTIVITIES | | UNREGULATED ACTIVITIES | |
|---|---|---|---|
| (*traditional banking activities*) | insured deposits (interest rate ceiling) | (*product differentiation*) | uninsured funds (market raised funds) |
| cash and reserves | capital (less) | unregulated investments | capital (more) |
| loans (ceilings of amounts and lending rates) | | equity | |
| government | | securitisation | |

**ENDNOTES**

[1] Bryan (1991, p. 73) writes: " As much as 25 % of the U.S. banking system - representing assets of more than $750 billion - has begun to post such massive loan losses that it must focus on collecting loans rather than making them. Healthy banks, shaken by their competitors' plight (and worried about more intense scrutiny from bank examiners), are losing confidence in their ability to make such loans. This credit crunch has the potential to turn a mild recession into a downward economic spiral that feeds on itself."

[2] It is possible in such circumstances to have a bank under rehabilitation with above the required capital due to injection of government bonds and with complete liquidity dependence from central bank, government deposits or inter-bank market.

[3] The argument in favour of universal banks says that they achieve better performance due to superior monitoring and information collection capacity. When bank takes an equity stake in a firm (instead) of a debt the firm's leverage ratio is reduced and its risk-taking incentives are altered towards less risk-taking. Having both debt and equity stakes in enterprises it can more easily enforce restructuring of enterprises. The concept of the World Bank's EFSAL approach exercised in reforming economies is based on that ( Dervis, Selowsky and Wallich, 1994) . On the other hand, knowing that rehabilitated banks are state owned, with unknown prospects for privatisation, building stakes in enterprises could be just a new wave of nationalisation through debt-for-equity swaps.

[4] This is a controversial issue. Leach writes for the USA: " The irony is that recent regulation has militated against risk taking in general and entrepreneurial lending in particular. The Basle Accord, for instance, by requiring no leveraging offsets for government bond holding and reduced levels of capital for mortgage making, biases banks against commercial lending. For the sake of the economy, very different priorities would seem to be in order. It is hard to believe America can become competitive in the next century if ... our banking regulation gives incentives for commercial banks to buy bonds instead of make loans." Mullins (1993) disagrees with Leach, stating that cutback in loans coincided with economic cycle suggesting that economic fundamentals, more than Basle standards, were an important causal factor. Nevertheless, due to a fact that banks meet intermediation costs which mutual funds don't, he asks: " Still, aren't banks in danger of becoming bond mutual funds? "

[5] Directives 77/789/EEC and 89/646/EEC (First and Second Banking Directive)

[6] Annex to the Directive 77/789/EEC.

[7] According to Bryan (1991): "The credit disaster of the 1980s underscores the essential dilemma of banking reform: how to protect small depositors and the payments system without creating massive credit distortions or interfering with business innovation and healthy economic forces. The essence of the solution is to rewrite the social contract between banks and government based on lessons from history, yet to still embrace the new forces of economics and technology that will continue to reshape banking through 1990s.

[8] It is interesting to note that Slovenia recently abandoned special service for payments system and decided to transfer it to the banking sector.

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