

Poland in the face of integration
of the financial market in the EU

Who will pay for a crisis
on the European financial market?
A host country's perspective



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Introduction

This publication is a collection of presentations made at the 'Poland and the integration of the EU financial markets' seminar held on June 20th 2007 in Warsaw. The aim of the seminar was to discuss issues related to the security of the banking system in the EU.

These issues have been discussed intensively among EU countries from the moment of the euro's introduction and since start of implementing the plan for building a unified financial market, initiated under the FSAP (Financial Services Action Plan), an important element of the Lisbon Strategy.

To date, this debate has been conducted mainly in countries with well-developed financial markets. Financial institutions in these countries currently control the majority of the banking market in the new EU member states, after starting up activities mainly via subsidiary units. These units often have a determining influence on the stability of the host country's banking system, while the parent company does not generate systemic risk in the home country. This is because, for one reason or another, the problems associated with creating new European financial safety net architecture look different from the host and home countries' perspectives.

The current crisis on the US credit market has emphatically shown that the source of a crisis can lie in one country and its effects be felt in other countries. The main channel of passing on crisis effects has turned out to be mortgage securitisation, which until recently was treated as an instrument increasing financial market stability. It turns out that it can also act as a threat to the liquidity of the financial market. Cross sector and cross border contingency has become a fact. This is why the new situation has raised the following questions: who will pay for the bankruptcy of cross-border

financial institutions? Must internationalisation of benefits in a period of prosperity be accompanied by nationalisation of losses in a period of crisis? Is it possible to create a European financial safety net on the unified EU financial market?

In order to gain answers to these questions we invited academic professors interested in the issues related to financial stability and representatives of the Central Bank, Financial Supervisor, Banking Guarantee Fund and Finance Ministry.

We wanted the opening discussion to be a continuation of the 'Poland and financial market integration in the EU' framework (from the portal: www.rf.edu.pl). We hope that this discussion offers you a better understanding of the new EU member states' fears connected with financial security on the single market, as well as a chance to weigh up their proposals in the process of creating new financial safety net architecture in the EU.

Sławomir Stanisław Skrzypek

President of the Board

The National Bank of Poland

The role of the NBP in managing a potential banking crisis on the single European market

seminar 'Poland in the face of integration of the financial market in the European Union', 20 June 2007

PROBLEMS OF FINANCIAL SYSTEM STABILITY

The seminar 'Poland in the face of integration of the financial market in the European Union' touches on important and current problems related to the stability of the financial system. The key questions we are now asking ourselves concern the architecture of a financial system safety net, ways of counteracting the emergence of crisis situations, strategies when faced with banking crises on the European financial market and methods of resolving them. For financiers, an equally, if not more, important question is: who will pay for a crisis on the European financial market? Such matters are important not only for the financial stability of institutions responsible for the financial stability such as central banks and government and financial supervisory bodies, but also for other players on the financial market.

A EUROPE-WIDE BANKING SAFETY NET

The currently observed processes of financial market integration, trans-border mergers, as well as the expansion of banks into foreign markets have led to the creation of complex financial groups operating on the financial markets of many countries. Today about 40 banks operate on the territory of three or more countries of the European Union. This phenomenon is particularly visible in countries such as Poland, where the share of foreign capital in the banking sector is 63.14% of the basic capital of commercial banks and 69.7% of banks' assets. Hungary is similar, where foreign capital has a 62.5% share in assets, Slovakia 89.7%, the Czech Republic 96.2% and Estonia, up to 99.3%. In the countries of the 'Old EU' foreign capital in the

banking sector is on average 12–13% (e.g. Greece 27.7%, Belgium 23.3%, Austria 20%, France 11.6%, Spain 11.5%, Germany 10.6%, Italy 9.5%, Holland 2.3%) This situation creates particular challenges for supervisory and regulatory institutions, especially in those countries with a high percentage of foreign capital in their banking sectors. In such conditions there exists the risk of an easy transfer of disruptions in one financial system across national borders. It is often said that countries like Poland, through a myriad network of connections, are not only importers of stability, but also of possible instability from other countries.

The experience of other countries shows that a financial crisis costs on average 15% of GDP, although there are countries where this cost has reached a level of up to several dozen percent of GDP (e.g. the Czech Republic (in the 1990s) 12% of GDP, Japan (1991) 24% of GDP, South Korea (1997) 28% of GDP, Turkey (2000–01) 30% of GDP, Thailand (1997) 35% of GDP, Chile (1981–86) 42% of GDP, Indonesia (1997) 55% of GDP). The high price society as a whole has to pay for banking crises creates the obligation to undertake action to protect the financial system against instability. To counteract this an entire system of institutional and regulatory connections – a financial safety net – is being created, including the central bank, financial supervisory body, government and deposit guarantee fund. The effective functioning of the safety net as a whole depends on cooperation between institutions and coordination of their actions, especially via exchange of information. This stems from the fact that each institution's safety net has different tasks, different instruments to execute them and plays a different role within the system and has at its disposal different sources of information.

Aiming at improving the organisation of the safety net in Poland, the National Bank of Poland – abiding by the recommendations made by the Economic and Financial Committee and standards applied in other countries – has suggested the application of the following solution with regards to establishing cooperation between safety net institutions in Poland:

- a) Signing an agreement between the Ministry of Finance, National Bank of Poland, Bank Supervisory Committee and Bank Guarantee Fund, thus creating the necessary conditions for effective cooperation – both in calmer times and in the event of a financial system crisis.
- b) Creating the Financial Stability Committee (consisting of high level representatives of the above mentioned institutions) as the platform for

an exchange of information and coordinating crisis management at the level at which specific actions undertaken by particular institutions were agreed on.

The Central Bank has a leading role in an effective financial safety system. Through constant monitoring and analysis of the banking system it is able to react adequately and identify quickly any potential dangers of financial instability and undertake preventive steps at an early stage of a crisis threat. In the event of crisis situation nevertheless arising, central banks will also bear the costs of a crisis resolution. This is why from the point of view of the central bank it is so important to have quick and reliable information on the financial situation both from individual banks and the sector as a whole, especially given that any potential threat may have its source not only in the country, but also abroad. This is why in many countries we have been witnessing a process of setting up and strengthening the supervisory system at the central bank level. In 11 EU countries central banks are the direct bank supervisory bodies. This is the case in the Czech Republic, Slovakia and also in Holland, Spain and Italy.

The leading role that the National Bank of Poland should play in the national and foreign financial safety net can be executed correctly and effectively only when the central bank has effective tools of early warning about a dangerous situation and when it has the possibilities and capabilities to evaluate the scale of a possible crisis. The entity which has at its disposal such instruments is GINB, the General Inspectorate of Banking Supervision. Its liquidation and removal from NBP structures means the central bank may face threats created by delayed reactions in the event of a real threat to financial system stability. This is one of the reasons why I think it is necessary to keep the GINB in the structures of the National Bank of Poland.

CONCLUSION

Financial stability – as a public good – lies at the centre of all economic entities' interests, as well as the interests of the society as a whole. In practice, central banks are the key institutions in the financial safety net and are involved in activities aimed at fostering the stability of the financial system, especially at the stage of preventing the emergence of any risk of disruption in the functioning of the financial system. Along with the changes taking

place in the single European financial market, the cooperation of the central bank and other safety net institutions grow in significance, also in the international context. Because financial stability ceases to be a domain open exclusively to national authorities, setting up a financial safety net at the EU level is at present a fundamental challenge.

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**Who will pay for a banking crisis on the European
financial market?
A host country's perspective**

INTRODUCTION

A trans-national banking crisis is like a catastrophe on a transatlantic passenger ship:

- firstly, both the engineers and the financiers make assurances that the safety system is fail-safe,
- secondly, no-one knows if and when the banking crisis – or the ship's catastrophe – will happen,
- thirdly, no-one knows what or for whom the consequences will be.

The European banking market is in a phase of intensive transformation. Until relatively recently it was an almost completely un-integrated market. Today, about 8,300 credit institutions, mainly small national institutions without any cross-border activity, are active on it. However, the role of increasingly large banks with international branch networks or (and) dependent institutions grows each year. Increasingly more banks are interested in taking advantage of economies of scale at the European – and not only the national – level. This is connected specifically with risk management and centralisation of back office functions. Cross-border mergers and acquisitions, as well as expansion into foreign markets due to limited domestic bank development and lack of virtual channels in the distribution of financial services, means that systemic risk in the EU has ceased to have a solely national character. According to the European Central Bank (ECB), 43 banks in the EU operate on three or more national markets. Nine of them are large, pan-European, banks. System risk exists probably for at least 40 of the largest banks.

The safety net in the EU, however, continues to have a national character. Banking supervision has a national character despite the fact that it is based on the principles of consolidated supervision and the dominance of supervision in the institution's home country. Institutions guaranteeing deposits have a national character, as do crisis management and fiscal responsibility. Bilateral, regional or multinational Memorandums of Understanding between supervisors, central banks and finance ministries do not alter this fact fundamentally, neither do ECB-run crisis management exercises, despite the fact that – theoretically – cooperation between institutions responsible for financial stability has been improved significantly.¹ These agreements have no legal foundation and in the event of a crisis, for various reasons, their value would prove illusory.²

It seems that only the naive believe the current financial safety system in the EU is in a state to handle the challenges arising from the bankruptcy of a large international European bank. There is, however, a lack of political will, despite the fact that currently the creation of a multi-national financial security system does not appear especially difficult as it would affect perhaps only about 40 of the most important trans-border banks. A view increasing widely held is that the EU needs a major banking crisis to break out of this political inertia. The European Commission has underlined the inadequacy of the current regulatory-supervisory structure in meeting the challenges resulting from the level of financial market integration, but proposals as to how to lower the risk of cross-border banking crises in the EU to date have been lamentably weak and reflect more a desire to preserve the status quo than a will to undertake radical reforms.

The key problem does not revolve around whether one integrational or logistical model or another would bring back financial liquidity connected with trans-national crisis management, but an answer to the question of who – and with what remit – would have to bear the consequences, in terms of

¹ For more, see *The EU Arrangements for Financial Crisis Management*, EBC, Monthly Bulletin, February 2007.

² 'Are we prepared to handle a trans-national banking crisis in Europe? Unfortunately the answer is no!', E. Srejber, *Problemy integracji rynku finansowego w UE [Problems of integrating the EU financial market]*, [in:] L. Pawłowicz's (ed) *Polska wobec integracji rynku finansowego w UE [Poland and EU financial market integration]*, Transformacja Gospodarki [Economic Transformation] no. 112, IBnGR, Gdańsk, 2006.

cost, of a banking crisis? Who would pick up the bill for recapitalisation of an insolvent bank, creating system risk on the EU's financial markets? Until answers are forthcoming to these questions the supervisory responsibility of the home or visiting unit's nation – for anything – will have an entirely theoretical character.

One cannot sensibly discuss centralisation of supervision on a pan-European scale, or division of responsibilities between supervisors in host and home countries until the problem of fiscal responsibility is resolved. This is a classic systemic mistake. It is often stressed that centralisation of supervisory responsibilities for trans-national banks must be run concurrently with centralisation of other areas of financial security: crisis management and depositor security. Of uppermost importance, however, is a solution to the issue of covering the costs of banking crises. While there is uncertainty as to how the social costs of bankruptcy of a large trans-national bank should be spread, the possibilities of acting in an emergency situation are fundamentally limited. The effectiveness of a trans-border safety net without any resolution of the question of material responsibility on an EU scale is close to zero. The problem of system risk on a single financial market demands radical and collective solutions and decisions.

Generally, the current financial safety net architecture in the EU is inadequate to meet the extent of financial market integration that exists, especially in terms of banks' cross-border activities and centralisation of risk management. The level of centralisation of risk management in trans-border holding banks will shortly rise as an effect of the introduction of Basel II. Despite attempts to date made to co-ordinate the activities of 27 banking supervisors on the EU's single financial market, the current supervisory architecture does not guarantee security of the overall system. This means that internationalisation of the benefits of financial market integration is also accompanied by risks of nationalising losses in the event of crises. This risk is far higher for host countries than for home countries mainly due to conflicts of supervisory interest with home countries. This appears in a case of parent company insolvency. In this event the national supervisor in the home country, responsible for consolidated supervision of the trans-national holding, has to decide: either to act in the interests of the stability of the national banking system or in the interests of the stability of the trans-national holding? It is also worth bearing in mind that it is easier to improve the financial situation of a parent company at the

cost of its units than vice versa. From the host country's perspective, lack of fiscal responsibility of the home country represents a large barrier to any real integration of supervision over trans-national banks.

The responsibility of a parent bank from one country for a dependent unit in another increases the risk of losing engaged capital and tarnishing reputation. The responsibility of the host country in a situation when the dependent unit in that country has systemic importance is incomparably greater and may reach to over a dozen percent of GDP. Possible supervisory sanctions made by the host country against the parent company include rescinding permission to execute voting rights on the basis of the shares it holds. In this situation there is little surprise that supervisors from host countries are fearful given the lack of responsibility from parent companies, that is responsibility commensurate with the scale of influence on the dependent unit. The material responsibility of the parent company, the strategic investor, only to the extent of its invested capital, is also not comparable to the scale of advantages in relation to other investors. This is why the expectations of supervisors from host countries towards parent companies are higher, especially in the area of responsibility for deposits made in the dependent unit.³

³ Poland's banking supervisor has in recent years asked banks dependent on international capital groups the following three questions:

- On the basis of regulations in the host country does the parent company undertake responsibility for deposits made in the dependent banking unit?
- Does the agreement between the parent and dependent banks oblige the former to meet such guarantees?
- Has the parent company obliged itself unilaterally to such a guarantee?

The replies from all banks were: three times no. Analysing the impact of Basel II on the stability of dependent units, the Polish banking supervisor at the start of 2007 asked dependent banks another two questions:

- On the basis of projected solutions within the group, has the parent company provided the dependent unit with a declaration or guarantee in the sphere of liquidity assistance or raising capital in the event of emergency?
- On the basis of projected solutions within the group, has the parent company provided or intends to provide the dependent unit a declaration or guarantee in the sphere of transfer of collateral in the event of it experiencing immediate additional liquidity?

The replies to these questions for the overwhelming majority of banks (with the exception of two) were also negative.

Most frequently, far greater material responsibility than would be commensurate solely with capital engaged is expected from the strategic investor, usually in the form of guarantees to cover the costs of rebuilding the value of the dependent banking unit if it found itself in a crisis situation.

The question as to what would happen if the parent company or the whole capital group found itself in crisis has basically not been assessed by host country supervisors.

For several years representatives from academia, central banks and finance ministries from various EU countries have been discussing solutions to these difficult problems and several interesting ideas have arisen.

1. DISTRIBUTION OF THE COSTS OF BANKING CRISES, ACCORDING TO THE EUROPEAN CENTRAL BANK'S CAPITAL KEY

The above-outlined proposal assumes the creation by the EU of a common fund to cover the costs of recapitalisation of insolvent banks. The stability of a single financial market is treated as a public good, which is why it has been proposed that the costs of recapitalisation would be covered by all EU countries regardless of the location of any given insolvent bank. Let us call this the federal stabilisation fund. There is no expectation that this will be created ex ante, as that could lead to an unnecessary rise in budget deficits in the event of a banking crisis not occurring. The eventual costs of a crisis would as such be financed ex post by EU countries. The agreement stipulating the principles of cost allocation for returning financial stability would, however, be ex ante.

Bonds would be issued by the ECB to recapitalise the insolvent bank in the event of a crisis situation. The annual costs of servicing the funds would be covered by fund itself, which would obtain them from selected EU countries according to the ECB's 'capital key' criteria, which stress, in line with article 29 of the ECB's statutes, the share of selected national central banks in the ECB's own subscription capital.

The capital key is calculated as the arithmetic mean of the shares of selected countries in combined GDP and the share in the EU's aggregate population total. It is updated every five years or more frequently if new countries are added to the EU. The current capital key has been in place since January 1st 2007 after the accession of Bulgaria and Romania to the EU.

In line with article 49.3 of the ECB statute, at the moment of accession of a new country to the EU the ECB's capital is automatically increased by a figure drawn from the current capital key.

Since January 1st 2007 the ECB's issued capital has stood at EUR 5.76 bln, and EUR 4.13 bln in settlement capital (the 13 countries belonging to the euro-zone must pay capital in full and the remaining 14 must pay a minimum of 7% of the capital). The current capital key is illustrated in table 1.

Table 1.

The European Central Bank's current capital key (from January 1st 2007)

<i>Country</i>	<i>Capital key (%)</i>
Belgium	2.5
Germany	20.5
Greece	1.8
Spain	7.6
France	14.4
Ireland	0.9
Italy	12.5
Luxembourg	0.16
Holland	3.9
Austria	2.0
Portugal	1.7
Slovenia	0.3
Finland	1.25
Denmark	1.5
Sweden	2.3
UK	13.9
Bulgaria	0.9
Czech Republic	1.4
Estonia	1.7
Cyprus	1.3
Latva	0.3
Lithuania	0.4
Hungary	1.3
Malta	0.1
Poland	4.9
Romania	2.5
Slovakia	0.7
Total	100.000

Source: www.ecb.eu/ecb/orga/capital, March 7th 2007

If the proposition is accepted to split the costs of a banking crisis according to the ECB's capital key it would mean that in the event of jointly taken activities aimed at returning banking system stability in the EU **Poland would pay almost 5% of the costs of such a crisis.**

The costs of the average banking crisis can be estimated at about 15% of GDP of the country in which it occurs,⁴ and therefore if it took place in Poland the fiscal cost would be EUR 30–40 bln.

The fiscal consequences connected with the need to return solvency to an average large trans-national bank in the EU are estimated at a similar level.⁵ If in order to bail out a large European bank the ECB issued EUR 30 bln in bonds, assuming a 5% interest rate and the process taking four years, the annual cost for all EU countries is estimated at EUR 5.25 bln.⁶ The annual contribution for Poland would then reach 4.9%, i.e. EUR 257 mln, for Germany 20.5%, or EUR 1.076 bln and for the UK 13.9% and the rest EUR 730 mln.

With the proposition of creating a federal level solidarity fund to cover the costs of crises according to the capital key criteria four main problems would arise.

Firstly, some EU countries may not be willing to participate in the costs of recapitalising a bank which has an EU system-wide importance if that bank does not operate within its jurisdiction.

Secondly, the setting up of the fund at the federal level would generate problems connected with moral hazard. Countries with a weak or very weak banking sector supervision would be relatively privileged in relation to those with restrictive supervision and a healthy banking sector. The connection

⁴ P. Honohan and D. Kliengebiel in the article *The Fiscal Cost Implication of Banking Crisis*, Journal of Banking and Finance No. 27/2003 show the results of empirical research in relation to 40 crisis-hit banks. Their results indicate that the average direct cost of a banking crisis oscillate around 13% of GDP. G. Hoggarth, R. Ricardo and V. Saporta estimate the aggregate costs of a banking crisis at 15–20% of GDP (*Cost and Banking System Instability*, Journal of Banking and Finance No. 26/2002).

⁵ Average arithmetic from the 3 largest European banks (banks with own capital of about EUR 20 bln, assets of EUR 526 bln, of which 55% is held in the home country and 25% in host countries in the EU and 20% in host countries outside the EU.

⁶ For more, see C.A.E. Goodhart, D. Schoenmaker, *Burden sharing in a banking crisis in Europe*, Special Paper Series, LSE Financial Markets Group, London 2006.

between the consequences of a such a crisis and supervisory responsibility would be weak, thus weakening motivation to reliable supervision.

Thirdly, if the majority of EU countries agreed to cover the costs of a crisis by creating a joint fund, those EU countries that did not join up to such a deal would have guaranteed stability without bearing the costs, that is to say, the free rider problem would appear.

Fourthly, ex post financing of the costs of a banking crisis has a pro-cyclical character. The risk of bank bankruptcy in a period of economic downturn increases, and eventually the fiscal costs come to represent a relatively large burden for the budget. The model of financing the costs of a crisis ex post may even deepen and extend any economic slowdown.

2. COVERING THE COSTS OF A CRISIS EXCLUSIVELY BY COUNTRIES IN WHICH TRANS-BORDER BANKS OPERATE

In this conception, proposed by C. Goodhart and D. Schoenmaker,⁷ the costs of covering a crisis are only made by countries in the which the insolvent bank conducts its activities. The key distribution of costs should be an index reflecting the role of the bank in selected countries. The authors of the above conception weighed up the possible advantages of Sullivan's so-called **cross-border** index, which is calculated as an arithmetic mean from:

- The share of foreign assets of the bank in the combined assets of the capital group,
- The share of foreign revenues in the combined revenues of the capital group,
- The share of staff employed abroad of the total staff of the capital group.⁸

In conclusion they proposed, however, that in order to split the consequences of a trans-national bank's insolvency to use an open key in the detailed breakdown of the bank's assets in various countries. In their view the assets of an insolvent bank is in fact the best approximation of the size of the bank and the possible effect of infection that is fundamentally associated with the

⁷ C.A.E. Goodhart, D. Schoenmaker, *Burden sharing in a banking crisis in Europe*, LSE Financial Markets Group, Special Paper Series, London 2006.

⁸ D. Sullivan, *Measuring the Degree of Internationalisation of a Firm*, Journal of International Business Studies Nr 25/1994.

size of the bank. The breakdown of assets of the 30 largest European banks between host and home countries in the area of the EU and host countries outside the EU is illustrated in table 2.

Table 2.
The structure of the assets of the 30 largest European banks in 2004

<i>Bank (country)</i>	<i>Own capital in bln euro</i>	<i>Assets</i>			
		<i>In bln euro</i>	<i>In the country in which the parent company is head- quartered %</i>	<i>In host countries within the EU %</i>	<i>In host countries outside the EU %</i>
HSBC (UK)	49.4	937.4	32	11	57
Crédit Agricole (France)	46.5	912.6	77	15	8
Royal Bank of Scotland (UK)	32.2	821.9	68	10	22
HBOS (UK)	26.9	557.7	90	5	5
BNP Paribas (France)	26.2	905.9	41	28	31
Santander Central Hispano (Spain)	24.4	575.4	37	52	11
Barclays Bank (UK)	23.6	728.4	75	5	20
Rabobank Group (Holland)	22.6	475.1	72	9	19
ING Bank (Holland)	21.1	616.5	48	37	15
UBS (Switzerland)	20.1	1125.5	11	33	56
ABN AMRO Bank (Holland)	19.8	608.6	36	22	42
Deutsche Bank (Germany)	18.7	840.0	25	41	34
Groupe Caisse d'Épargne (France)	18.4	543.9	50	38	12
Société Générale (France)	18.4	601.1	56	24	20
Crédit Mutuel (France)	18.2	387.3	b.d.	b.d.	b.d.

Table 2. (continued from previous page)

Lloyds TSB Group (UK)	16.6	396.7	94	3	3
Credit Suisse Group (Switzerland)	15.9	706.8	21	33	46
HypoVereinsbank (Germany)	15.7	467.4	56	40	4
Banca Intensa (Italy)	15.6	274.6	71	20	9
Banco Bilbao Vizcaya Argentaria (Spain)	14.7	311.1	78	3	19
Fortis Bank (Belgium)	14.3	484.1	57	32	11
Groupe Banques Populaires (France)	13.4	250.4	b.d.	b.d.	b.d.
Unicredit (Italy)	11.9	265.8	70	21	9
Dexia (Belgium)	11.0	389.1	12	65	23
SanPaolo IMI (Italy)	10.9	211.1	79	16	5
Nordea Group (Sweden)	10.6	276.0	30	67	3
Commerzbank (Germany)	10.5	424.9	75	15	10
KBC Bank (Belgium)	9.8	249.2	40	22	38
Bayerische Landesbank (Germany)	9.4	324.8	72	14	14
Caja de Ahorros y Pen. de Barcelona (Spain)	8.4	113.1	b.d.	b.d.	b.d.
Average from 30 banks	19.2	526.1	55	25	20

Source: D. Schoemaker, S. Oosterloo, *Financial Supervision in Integrating Europe. Measuring Cross-Border Externalities*, International Finance No. 8/2005.

The authors of this conception illustrated the division of the costs of recapitalising a bankrupt bank according to the structure of assets on the model of Deutsche Bank, Nordea Bank and HSBC. For the purposes of numerical simulation it was assumed that:

- The real losses of a bankrupt bank represent 150% of its own capital.
- The period for covering the losses was four years.
- The annual interest rates was 5%.

Countries in which Deutsche Bank operates would in a crisis situation have to issue restructuring bonds worth a combined EUR 28.1 bln, including Germany EUR 10.6 bln, UK EUR 8.9 bln and other EU countries EUR 8.5 bln (assuming that countries outside the EU did not take part in the bail out). This would mean that the annual cost associated with servicing bonds would be EUR 1.86 bln for Germany, EUR 1.56 bln for the UK and EUR 1.49 bln for the remainder of the EU countries.

In the event of the bankruptcy of Nordea Bank, and under the same assumptions for simulation purposes, Sweden would issue restructuring bonds of EUR 4.9 bln, Denmark EUR 4.3 bln, Finland EUR 3.5 bln, Norway EUR 2.4 bln and the rest EUR 0.8 bln. This would mean annual costs of servicing the bonds of EUR 0.86 bln for Sweden, EUR 0.75 bln for Denmark, EUR 0.61 bln for Finland, EUR 0.42 bln for Norway and EUR 0.14 bln for the remainder.

The costs of a crisis would be higher in the event of HSBC's bankruptcy, not only due to the size of the bank but also due to its large-scale engagement outside the EU. Under the same assumptions, the UK would have to issue restructuring bonds worth EUR 54.8 bln, France EUR 8.2 bln and the remainder of the EU countries EUR 1.94 bln.

A fundamental problem of splitting the costs of a crisis according to the structure of territorial assets is the situation of the UK, where 24% of the assets of all EU banks are held, while the share of the UK's GDP is 16.6% and the ECB's capital key only 14.4%.

There is a problem also with the relative ease of manipulating the distribution of costs based on the structure of assets via securitisation processes. For example, as a result of securitisation of difficult credits there appears a significant lowering of the book value of assets because they are exchanged for cash at a low percentage of their book value. Furthermore, 'even if the regulations concerning the distribution of the burden in resolving crises are set it will still be necessary to work out a method for avoiding security hazard (...). The ideal situation would be one that stopped a bank threatened with problems depositing all its treasury bonds outside the jurisdiction of the ECB, however, then only irretrievable loans and other types of worse securities would remain within Frankfurt's range of activity.'⁹ This is why

⁹ E. Srejber, *op. cit.*

the authors of the proposal recommended calculating shares on the basis of the banks' recent audits and published balances.

Solutions are also needed for problems associated with bankrupt banks whose home country is outside the EU and where EU countries are the hosts.

3. ESTABLISHING DEPOSIT SECURITY FUNDS FOR THE BIGGEST TRANS-NATIONAL BANKS AT THE EU FEDERAL LEVEL¹⁰

This proposal is composed of setting up a fund with a guarantee or re-guarantee character within the framework of a new European supervisory agency on the model of the Federal Insurance Corporation operating in the US. The fund would be obliged to select the least costly solution in a situation of having to bail out an insolvent bank. This would mean a green light for shareholders to lose money, not security for depositors and creditors. Such a fund would be better diversified compared to the currently functioning national funds, which would enable collection of lower fees or better security in the event of the bankruptcy of a large bank. However, due to the high costs of capitalising a large bank, which would probably exceed the possibilities of a fund such as this, it was proposed that the fund would have the power to raise loans on the capital market. The governments of the 27 member states would need to underwrite this goal. In the event of the fund itself becoming bankrupt it would have the right to accept payments according to predetermined rules in order to pay off its debts on the capital market. The issue of which key would be used to determine fees arises. Usually, European funds guaranteeing deposits finance their expenditures from bank fees in proportion to the guaranteed deposits collected in them. The creation of a federal level security fund for the largest trans-national banks perhaps should be based on similar financial principles as is the case with national underwriting funds.¹¹ There

¹⁰ E. Srejber, *op. cit.*

¹¹ It is also suggested using the IMF's additional financing systems in situations when its actual needs exceed available funds. On the basis of two agreements: *General Arrangements to Borrow (GAB)* and *New Arrangements to Borrow (NAB)*, member states are prepared to start up additional credit lines for the needs of the IMF. The maximum quota available to the IMF on the basis of these two agreements is about \$50 bln and the quota share of specific states is based on their relative economic strengths; www.imf.org/external/np/exr/facts/gabnab.htm, 09.03.2007

is no single solution here and the directive 94/19/WE of May 30th 1994 is in force, which has to date regulated systems of depository guarantees in the EU, leaving nation states with some freedom to choose the funds' means and financial principles, warning only that 'the costs of this financing must be mainly covered by credit institutions'.

Abstracting from the key according to which fees would repayable to the federal insurance fund, it is important to stress that the funds' means would represent the participation of credit institutions in the costs of returning stability to the banking system.

4. PRINCIPLES AND PROPOSALS

A systemic approach to financial security on the single financial market demands detailed and appropriate management of conflicts of interest. These mainly occur when powers and duties do not go hand in hand with responsibilities, specifically material responsibility. Constructing a financial safety net, for example, cannot mean that home country supervisors are practically unpunished in a situation where they do not do enough to save the bank – and non-national units of the company in another country. Conflicts of supervisorial interest from the home country are particularly clear in a situation where there is a simultaneous threat to the stability of the financial system in its own country and a crisis in a foreign bank – companies that are part of the capital group that are being supervised by a consolidated supervisor. It would be hard to expect it to save the bank – a dependent unit in a host country – at the cost of lowering stability in its own country. The situation becomes especially acute when the bank – dependent unit – creates system risk in the country (or countries) in which it is hosted, while the bank – parent company – is not so important in the home country. Until the material consequences for 'taxpayers' in the home countries are limited only to covering the costs of bankruptcy or recapitalisation of an insolvent bank in the area of their jurisdiction, 'national' pressure from supervisorial authorities in the home country will effectively block their activities to achieve stability on the European financial market. It is obvious that in these conditions supervision has a national rather than a European character.

Similar conflicts of interest appear when taxpayers of one state face the prospect of paying out damages for depositors in other states where a bank in their home country has branches.

The institutional model for guaranteeing bank deposits, as with similar supervisors, has a national character and is inadequate to the current level of financial market integration in the EU.

It would appear that centralised fiscal responsibility at the EU federal level via, for example, the creation of a solidarity fund, which would cover the costs of returning stability and would resolve the problem of conflicts of interest.

Such a solution, however, takes away incentives to reliable supervision at the local level as in the event of a crisis fiscal consequences are not connected with the host country's supervision. The classic 'free rider' problem thus arises. This is the same trap as with the lack of fiscal responsibility of the home country in the current system.

The optimal solution should be to accommodate three apparently contradictory goals:

- (material) fiscal responsibility of the home country adequate to the responsibilities of its supervisory authorities.
- (material) fiscal responsibility of the host country adequate to the responsibilities of its supervisory authorities.
- Joint (solidarity) material responsibility for the stability of the single financial market as in the case of other public goods.

This is not an irresolvable task and practise shows that as with similar questions it has already been resolved at the trans-national level. An instructive example is the international convention on covering the costs of emergency nuclear installations. Currently, international regulations are in place in this area, which stipulate three levels of compensation for the costs incurred by a nuclear catastrophe:

- The first to a min. of EUR 700 mln, covered by the operator of the nuclear installation, which is obliged to insure itself or have a credible guarantee.
- The second is covered by the state on the area covered by the installation (up to EUR 500 mln).
- The third is covered by all members of the Nuclear Energy Agency (up to EUR 300 mln).¹² According to the following criteria: 35% in proportion to the share of combined GDP and 65% as a proportion

¹² www.nea.html, 10.03.2007.

of installed capacity of the reactors in any given country in relation to the combined capacity of all installed reactors.

The example of covering the costs of a nuclear catastrophe is instructive for several reasons:

Firstly, a nuclear catastrophe, as in a crisis in a large trans-national bank, has unfortunate consequences not only in the country in which it is located;

Secondly, there is combined responsibility for supervision of installed reactors for the cost consequences of a catastrophe;

Thirdly, there is joint responsibility from all sides for a catastrophe, all of whom work to combat it.

The starting point for building new safety net architecture should be agreement on the principles of distributing costs of a banking crisis. **It seems that firstly it is necessary to define the principles** (with a market and solidarity character), which are acceptable in the EU and to strengthen its competitive position, and **only then in the next step to consider concrete resolving proposals** in line with these principles. I think the following four principles for dealing with crisis situations are sufficiently well known:

1. The cost of a banking crisis should not be borne exclusively by taxpayers. The participation of private capital in the costs of financial security in the EU should be high. As in other enterprises, the costs of banking crises and subsequent rebuilding of value should be borne firstly by shareholders.

2. The criteria for distributing the fiscal costs of a crisis between selected countries should be sufficient to meet the potential consequences of a crisis for selected countries. Political decisions would then be easier.

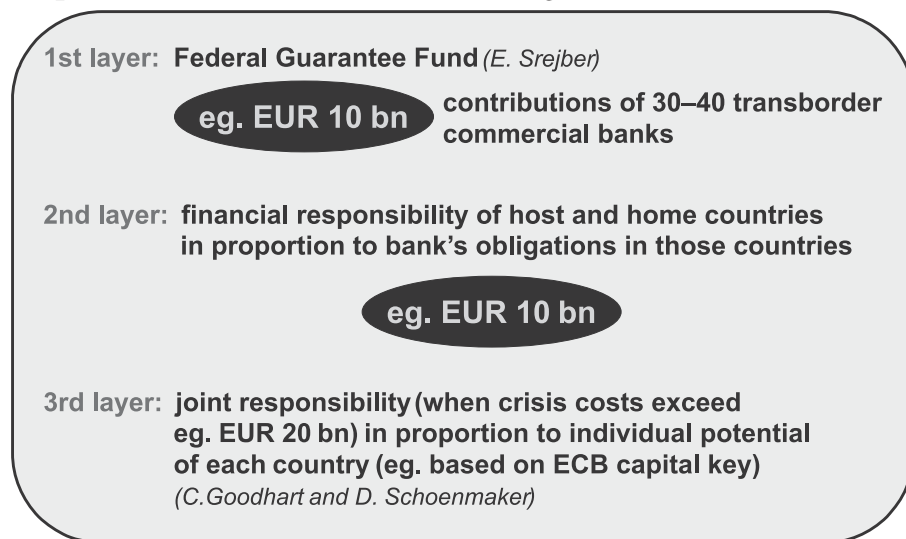
3. There should be joint fiscal responsibility for home and host countries because only then can effective cooperation of supervisory authorities be expected. The responsibilities of supervisors in home and host countries would then be connected with fiscal responsibility.

4. The principle of solidarity of EU member states should be in place because stability is a public good.

5. Taking into account the four above-presented principles in resolving the problem of splitting financial crisis costs could lead to many concrete proposals. One possible one is presented in figure 1.

Figure 1.

Proposed division of the costs of a banking crisis in the EU



Source: own work.

The first level should be a federal guarantee fund created at the EU level by the 40 largest European banks conducting cross-border activities, for example the proposal resented by E. Srejber.¹³ Fees to the fund should be collected *ex ante* because the other way round the system would operate counter-cyclically. Annual fees could be dependent on the bank's rating. They should not be too high so as to cause a lowering of the competitive position of the banks creating the federal fund, but on the other hand they should guarantee a significant participation of the fund in covering the costs of a crisis, for example, at a level of 25–30%. Currently, that would mean the need to collect in the federal guarantee system about EUR 10 bln. The fund would be earmarked to recapitalise a large insolvent bank and not make pay outs for depositors in the event of its bankruptcy, which is why the basic criterion for the fund's financing requirements should rather be aggregate liabilities to non-banking entities (correlated against the weighted risk of the bank's rating) and not excluding the size of its deposits. After collecting a satisfactory level of funds in the underwriting system the fee would then be suspended. The banks

¹³ E. Srejber, *op. cit.*

creating the federal fund should not be obligated to participate and therefore to pay fees in national depository underwriting funds. The affiliation of banks to the depository underwriting fund should remain obligatory. Banks should not, however, have possibilities for arbitrage. In practise that means that the list of banks obligated to take part in the federal fund should be determined by external organs (e.g. the ECB) and periodically verified. The creation of a federal guarantee fund by participants on the financial market that conduct trans-national activity allows for a significant lowering of the use of public funds in resolving the problem of financial security in the EU and therefore makes political decisions easier.

The second level of the financial mechanism would be set up if the possibilities of financing the federal underwriting fund were insufficient to cover the costs of the crisis. This part of expenditures would be financed out of public moneys from the countries in which the insolvent bank operated. The material responsibility of the home and host countries could be determined analogously, as in the proposal of Goodhart and Schoemaker, i.e. according to the criteria based on the territorial structure of the assets of banking groups operating in several countries. However, it might be better to determine the material responsibility of the home and host countries in proportion to the value of the obligations of the parent and its subsidiary companies. In the simplest version it would be criteria based on the division of costs as a ratio of the value of reduced liabilities to own capital value. That could be the value of average obligations from the parent and unit banks' balances for example for 2–3 years before the occurrence of a crisis situation. Accepting the value of obligations as the criterion for dividing the cost of a crisis would be in line with the principle of the commensurability of selected countries' shares in the event of a crisis for those countries. Supervisory responsibility of the home country would then be tied to fiscal responsibility. Recapitalisation of a trans-national bank, regardless of whether or not it affected the parent company or its units with headquarters in other countries, would affect partly taxpayers in the host country and partly in the home country. The consequences of a trans-national crisis would be borne in solidarity according to predetermined principles, which would eliminate conflicts of interest between home and host countries supervisory authorities. Furthermore, it would induce cooperation both in times of system stability and in times of crisis management. The fiscal responsibility of the home

and host countries could be limited (e.g. combined to a level of EUR 10 bln) if a federal stabilisation fund were set up.

The third level of financing the costs of returning security to the European financial system would come into play when the federal underwriting fund's and the states' (where the insolvent bank operated) financial limits were exceeded, for example, over EUR 20 bln. This could be a federal stabilisation fund set up by the ECB, financed from funds from all 27 member states of the EU. As in the proposition by Goodhart and Schoenmaker, it could be set up *ex post*, but it does not seem that it would be appropriate to create it according to the ECB's capital key. A banking crisis occurs suddenly with the loss of the value of a bank's assets and thus the national framework would mean for taxpayers a risk proportional to the value of these assets. There is no reason for which the criteria for financing the consequences of a trans-national banking crisis should be other than the value of assets. The proportions of the financing of the federal stabilisation fund should stem from the size of banking sector assets in EU member states. (In the such a situation corrections in financing ratios should be made only in the case of the participation of the UK, for reasons elaborated earlier).

The three-level proposal presented here for the division of costs of recapitalising insolvent banks in the EU and the principles of participation of credit institutions and public institutions in the financing of a banking crisis is perhaps not the best solution and demands further analysis and a deeper critique. The worst solution, however, is lack of any proposal, leaving the question open as to who would cover the costs of a banking crisis on the single European market. We would then have to agree to the internationalisation of the benefits of the common financial market and nationalisation of losses. It is worthwhile recalling that 70% of the Polish banking sector is made up of subsidiaries and not parent companies. In a crisis situation it is hard to expect the parent company to go bankrupt first.

Poland should as such be very interested in the construction of a new system of financial security in Europe, no less so than in the case of energy security.

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The role of the Bank Guarantee Fund on the integrating European banking services market

INTRODUCTION

The Bank Guarantee Fund (BGF), which began its activity in 1995 on the basis of the Law of December 14th 1994, has to date had great success in constructing a security framework for the functioning of the banking sector in Poland. It would not be an exaggeration to say that the BGF can be considered a model financial institution in Poland. The new conditions of European market integration have enforced changes in the methods of managing the BGF, although proposals formulated so far, especially in the 'Safe Bank' Quarterly, in my opinion too narrowly and one-sidedly define the scope of the necessary restructuring within the BGF. As a result, the significant role of the BGF may be threatened in the sense that it could become a financial institution fulfilling merely the role of a pay box for depositors and lose the intellectual capital it has developed over the years. The second threat scenario could be the BGF undertaking actions lagging behind market changes, thus driving the best specialists to depart and reducing its subjective and objective scope of operations and ultimately reducing the BGF's effectiveness in stimulating banking sector security. To avoid marginalisation of the BGF's position I suggest creating a New Strategy for the BGF. I point here to some methodological aspects related to its setting up. Although I realise that all real decisions concerning the creation of a new strategy (including adopting strategic assumptions with regard to goals, projects and tools) are the responsibility of the BGF Board and BGF Council, it remains useful and highly justified to continue and broaden the discussion about the new role of the BGF.

The structure of this study is made up of five parts. The first three parts cover the factors that favour the building of a new strategy. In the fourth

part I discuss the most important proposals formulated with regards to BGF restructuring and the last, fifth, part presents selected methodological aspects for creating a new strategy.

1. INTEGRATION TRENDS ON THE EUROPEAN BANKING SERVICES MARKET

Integration of the banking system leads to unifying the operating principles of banking institutions in three areas.¹

- a) principles concerning the use of financial instruments and provision of services,
- b) access possibilities for using financial instruments and providing banking services,
- c) equal treatment of players operating on the banking services market.

A study of banking services integration points to three characteristic trends:

- analysing various indicators of financial integration shows a steady increase in the level of integration on the banking market, especially in 1999–2006;²
- differentiation in levels of integration of banking services is particularly high in the interbanking sector and operations performed on the capital market, while retail banking integration is poorly developed;
- cross-border banks are thought to be a key factor in the integration process because of potential benefits in this area: innovativeness, lowering access barriers, risk diversification and strengthening banking system stability. Also visible is the tendency of banks operating on the European market to seek to centralise business functions, including centralising risk management and back office functions.

As well as increasing integration in the banking sector, any changes in the BGF's role will also be influenced by globalisation. An important and well-documented signal indicating the rising impact of globalisation is PriceWatershouseCoopers' report presented at the conference in Davos

¹ *Financial integration in Europe*. European Central Bank, Frankfurt, March 2007, p. 6.

² see – *Integration of financial integration in the euro area*. European Central Bank, Frankfurt, September 2005.

in 2007.³ The report argues that globalisation can no longer be seen as an important factor to be taken into account in all future management decisions in enterprises, but as 'an engine that steams ahead with astonishing speed.' One can assume that the process of globalisation in banking services has so far proceeded rather slowly, given that the number of banks that can be called 'global' does not exceed four.⁴ With this fact in mind, it is worth focusing here on the logic of the connections underpinning the relationships here focused on. In effect, it turns out that – on one hand – banks' results depend on the financial condition of the serviced enterprises, and on the other that any changes in the functioning of enterprises will be reflected in banks' transformation. It is highly improbable that the global corporations that dominate the global economy can do without global financial institutions. Thus the conclusion is that there is a need to create a strategy for the BGF which not only considers the BGF's operations on the European banking market but first and foremost on the global one.

2. THE BGF'S CURRENT POSITION IN THE SECURITY NETWORK

Until 2006 the BGF proved to be an institution exceptionally effective in:

- a) protection of bank clients' deposits,
- b) organising assistance for endangered banks and those in need of restructuring,
- c) conducting analytical work.

For evidence of this one can look through numerous publications evaluating the functioning of the BGF;⁵ national and international seminars⁶

³ P. A. DiPiazza Jr, *10th Annual Global CEO Survey*, Davos 2007, p. 68.

⁴ D. Schoemaker, *The Future Architecture of the Financial Safety Net in the EU*, material from the conference 'Poland in the face of integration of the financial market in the European Union,' Warsaw June 20th 2007, slide 6.

⁵ W. Baka et al, *Systemy gwarantowania depozytów w Polsce i na świecie. Dziesięć lat Bankowego Funduszu Gwarancyjnego (Depository guarantee systems in Poland and the world. 10 years of the BGF)*, PWE, Warsaw 2005; B. Zdanowicz, *Podstawowe dylematy i kryteria wyboru formuły systemu gwarantowania depozytów w świetle teorii i doświadczeń międzynarodowych (Basic dilemmas and criteria for selecting a depository guarantee system in the light of theory and international experience)*, 'Safe Bank' 2007 No. 1 (34).

⁶ In 2005 on October 13th–14th the annual meeting of EFDI took place in Warsaw,

and the participation of BGF's employees at international conferences and in exchanges with its European counterparts.

Despite achievements in the three above mentioned areas, an increasingly stronger need for change in BGF's operational formula to adapt it to new conditions is a key emphasis. Various factors have contributed to this, especially the market structure of banking services, the macroeconomic situation of the country, regulations, the preferred business models of banks, new expectations of bank management boards, as well as internal BGF operations such as its analytic achievements.

The current structure of the banking sector in Poland in a cross-section of functioning banks is very different from the banking structure in the old EU countries. At the beginning of the transformation in Poland, 100% of operating banks were state-owned and revenue came solely from the operations of domestic banks. As the result of the changes an entirely new ownership and subject structure was created. This is shown in table 1, where Poland is placed in the group of countries NMS-10.

It is also clear that during the transformation after 1990 there was a complete change in the entire regulatory environment connected with adjusting banking law and banking operations to European directives. Moreover, if one looks at the institutions supporting the functioning of the banking sector it becomes clear that not only did its number increase, but also the quality, for example the setting up the Credit Information Office. The changes also concerned the structure of income achieved by banks, ways of generating it, technologies used, as well as internal mechanisms stimulating bank growth, e.g. the role of the capital market, management concepts to increase value for shareholders, or the role of credit risk management. Each of those mentioned factors can be elaborated on, but the most important conclusion is that for the next 10 years banks will operate in disparate market conditions, and this will impact the tasks, functions and final role of the BGF in the banking system safety net. Moreover, we will increasingly witness a maladjustment of the BGF to future conditions, which we briefly present in the next paragraph.

focusing on international financial institutions such as the IMF, World Bank and European guarantee institutions. It was a sign of recognition of BFG's activities, see 'Safe Bank', Special Edition, Warsaw 2005.

Table 1.
The level of penetration of trans-border banks in the European Union in %

2005	Domestic banks	Banks of EU countries	Banks of other countries
EU-25	74	18	8
EU-15	75	17	8
NMS-10	35	60	5

NMS – new member countries

Source: D. Schoemaker, The Future Architecture of the Financial Safety Net in the EU, material for the conference 'Poland in the face of integration of the financial market in the EU'. Warsaw, June 20th 2007, slide 5.

3. AREAS OF BGF'S MALADJUSTMENT TO FUTURE CONDITIONS

A hypothesis can be formulated that the maladjustment of BGF activity will stem from three systemic factors:

- a) the national character of BGF activity and dominant share of foreign shareholders,
- b) the potential conflict between the effectiveness of global commercial banks and the competitiveness of the national banking system,
- c) a potential conflict between the competitiveness of commercial banks and economic growth.

ad a)

The dominant share of foreign investors can bring with it plenty of valuable benefits such as a quicker rate of catch up, the introduction of innovative products, implementation of verified work standards, better motivational systems leading to increases in competitiveness and security of the banking sector. Alongside these positive changes, new interests and threats can also emerge, however. For instance, those concerning financing aid for banks threatened with insolvency and realistic ways of covering the costs of a banking crisis⁷. It is understandable that banks with larger foreign capital are less interested in financing aid for less effective banks, with domestic owners and systems of financing not dependent on levels of

⁷ L. Pawłowicz, *System bezpieczeństwa finansowego w UE (The financial security system in the EU)*, Quarterly studies on enterprises, 2007 no. 2.

generated risk. As a result, financing aid tends only to be for cooperative banks, and possible attempts to support PKO BP SA, for example, would not be accepted by commercial banks. Also, foreign banks with branches in different countries are particularly sensitive to national systems of regulation of the banking sector since the benefits resulting from this are one of the key criteria for entering the Polish market in the first place. The General Inspectorate of Banking Supervision (GINB), systematically assessing the level of threat for banks, has radically changed its evaluation and is not always eager to listen to the arguments of banks' management boards that may differ from its opinion. This means creating new channels of communication to ensure that any introduced changes are not treated as one-sided, or – far worse – are introduced without justification, especially with reference to the work of the supervisor, changes in the tax system and employment or training policies.

ad b)

It can be expected that collision, or even an all-out conflict, may occur between the global effectiveness of commercial banks and the competitiveness of national banking systems. Mergers and acquisitions made on the global market may negatively impact the competitiveness of national banking systems, increasing the level of concentration and lowering the level of services. Synergy effects resulting from bank mergers may be obtained at the cost of the Polish banking sector. This is not only a theoretical threat. The take over of the German VHB bank by the Italian UniCredito forced a consolidation of two banks in Poland: PKO SA and BPH. It turned out that some of the planned consequences of mergers (and acquisitions) were strongly contested by the Polish side e.g. mainly related to the scope of employment reduction.

It is somewhat surprising that commercial banks' business models change and are differently executed by trans-border or global banks e.g. in implementing the concept of the social responsibility of business. Economic authorities do not seem much interested in such issues. This then resembles a situation similar to washing powder, when a brand name on its own can guarantee quite different kinds of quality on national and host country markets.

ad c)

There is also the potential danger of a collision or conflict between the competitiveness of commercial banks and the country's economic growth. This can concern, among other things:

- sectors of low competitiveness,
- regions with a low level of economic growth,
- supporting new industrial policy.

Due to the level of risk and the lack of information or communication, a hidden conflict of interest can cause situations where commercial banks are not interested in those projects and companies. I may ask myself the hypothetical question as to whether PKO would be interested in sharing the costs of building the National Stadium in Warsaw within the programme of Euro 2012.

4. STRATEGIC SCENARIOS TO DATE

Various and numerous innovations are being formulated with regards to the BGF's operation after Poland joined the EU. Three proposals merit attention:

- a) Wł. L. Jaworski's proposal,⁸
- b) J. Szambelańczyk's proposal,⁹
- c) B. Zdanowicz's proposal.¹⁰

ad a)

Refers to the BGF's goals and tools on the basis of the first two models: the first – the BGF as the liquidator of bankrupt banks, the second on expanding activity (the anti-trust model).

The main recommendations for the BGF:¹¹

⁸ Wł. L. Jaworski, *The place and role of the BGF*, 'Safe Bank' 2005, no. 1(26), p. 57–62.

⁹ J. Szambelańczyk, *The place and role of the BGF in the financial safety in Poland*, 'Safe Bank' 2005, no. 1(26), p. 72–87 and J. Szambelańczyk, *The future of the Polish deposit guarantee scheme in conditions of integration and globalisation*, 'Safe Bank' 2005, special edition, p. 18–36.

¹⁰ B. Zdanowicz, *Basic dilemmas and criteria for selecting a depository guarantee system in the light of theory and international experience*, 'Safe Bank' 2007 no. 1, p. 162–166.

¹¹ Wł. L. Jaworski, *op.cit.* p. 62.

- operate in the interest of the Polish national economy,
- BGF is a sovereign body,
- Setting up the deposit guarantee fund should not be done at the cost of the aid fund,
- It cannot limit self-reform until the institution supporting banks with payment difficulties is created,
- Maintaining a differentiated banking system at the aid fund and developing instruments (guarantees, subordinated loans, capital involvement).

ad b)

J. Szambelańczyk's proposal presents the BGF as an institution minimising international risk and taking into account the BGF's structural and organisational dilemmas. He discusses at length a broadening of the subject-object scope of the BGF with investment funds and insurance institutions.

It is also worthwhile analysing the formulated vision of phases of development of the deposit guarantee system. In the global perspective the following stages of guarantee are listed:

- Integration at the level of national markets, economic groups following the logic of the Lisbon Strategy,
- Integration of guarantee systems on precisely defined markets or resulting from significant financial transfers (Poland – Ukraine, Turkey – EU),
- Integration of guarantee systems in the transnational set-up.
- Creation of a global guarantee system.

ad c)

B. Zdanowska's complex PhD thesis on the BGF directly formulates three scenarios of changes of the BGF operating formula:

Short-term scenario – the BGF continues working without organisational or internal changes. The RM2 system is in force, which is stable, minimising risk, offering limited value and a scope of guarantee, conducting complex analysis of the sector and monitoring the banks it supports.

Mid-term scenario – changes in the BGF go in the direction of applying advanced RM3 solutions.

This scenario assumes that changes on the single financial market will reduce the superiority of national supervision. New changes can concern

crisis situations or trans-border activity. To prevent this there is the suggestion of using an institution as a trans-border guarantor or setting up a separate system for banks 'too big to go bust.' These changes would not matter too much for the organisational structure of the BGF. It is also thought that EU regulations could impact the features of the advanced models.

The RM3 model is an advanced guarantee system minimising risk, which has a defined guarantee limit and scope, and is often used a co-assurance, as well as advanced methods of restructuring, and has a developed system of analysis and monitoring, has the power to supervise, control and advise banks, uses an ex-ante system, sets rates according to the level of risk and introductory payments for new members.

Long-term scenario – key institutional changes.

This scenario presupposes the possibility of the emergence of two options. One of them is the activity of the BGF, whose area of competence is the national market and which uses the RM3 model and thus room for the services of the trans-border guarantor is created. The second option relies on setting up uniform supervision of the financial services market following the concept of the Financial Services Authority, the institution operating in the UK, and the BGF would be a part of this system with limited functions and tasks of the PBO (simple pay box) related to execution of deposit guarantees.

In my opinion, the proposals so far, however interesting and motivating, do not fully conform to current conditions. Firstly, they are of a cosmetic and partial character. Secondly, they do not have defined goals, which means that so far realised goals are still valid. Thirdly, they assume that integration on the financial services market is only a theoretical concept, while facts indicate a contrary trend. Fourthly, they assume an over-optimistic scenario for adjusting the BGF after the emergence of clear new market signals. Fifthly, they do not recognise the possibility of the BGF outsourcing certain functions nor conducting similar activity by competitive national or European institutions. Sixthly, prepared programmes do not have a clearly defined time frame.

The general conclusion drawn from the considerations so far can be reduced to the BGF's key problem – namely – elaborating a new long-term strategy on the global market. I will discuss those issues in the next paragraph of this paper.

5. THE BGF'S STRATEGY ON THE GLOBAL BANKING MARKET

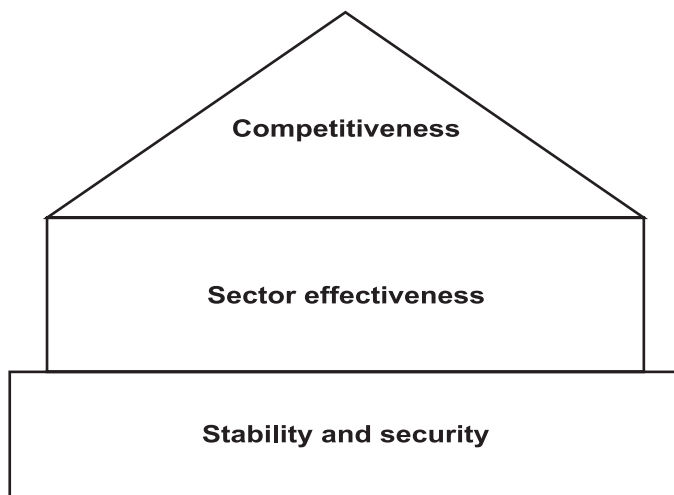
The future role of the BGF in the Polish banking sector as compared with its operations between 1995–2007 can be maintained, increased or eroded. It seems that maintaining the framework of the BGF as stipulated in 1994 Act on the BGF creates significant threats to the BGF's position as an important link in the safety net in a new system of integrating Europe's financial services market. This is why I propose recommendations conforming to the requirements of management theory, which advises the creation of a new strategy for the BGF.

Due to the lack of interest in building such a strategy by the BGF board, banking sector and even less so by institutions interested in the BGF's activity, it would be irrational to undertake such actions. For the BGF to be an effective and efficient institution on the global banking market I will take a position here only on selected methodological aspects i.e. on the 'criteria of building scenarios,' in particular what the future priorities (goals) should be, what the logical order in building strategy should be (courtesy towards inclusion of the uncertainty scale) and how to execute selection of the considered variants.

In the BGF's practice to date the main priorities have been stability and safety, above all protection of the weakest deposit holders. Apart from stability and security of such an institution, the priority should also be effectiveness and competitiveness at the level of the whole sector. In my opinion, concentrating only on strengthening the stability and security of the BGF in the next 10-years is not justified. Poland is too small a player on the European banking and financial services markets and even smaller on the global one. It is not capable of ensuring a satisfactory level of stability and safety on its own, because decisions and regulations of the market are outside its competence and possibilities. Adopting the stability and security priority will only bring higher costs and lead to turbulence on the banking services market. Moreover, the achieved level of stability is high enough. This is why I believe that the BGF's first priority should be stimulating the competitiveness of banking system stability. Figure 1 illustrates this.

Following the logic of this figure, the management of BGF should aim to boost the competitiveness of national banking (or finance) system, and its limits should refer to the effectiveness and stability of the banking sector.

Figure 1.
BGF's strategic priorities



Source: own work.

The scope of change determinants in the banking sector in Poland may stem from various events and it is difficult to define these with sufficient precision over a 10-year perspective. As a result, I posit the idea of creating a strategy in the sequence of: first recognising and analysing uncertainty areas and only then preparing in subsequent steps the outline of strategy building depending on the established level of uncertainty.¹²

The next important methodological aspects which can facilitate the choice of certain strategic variants is selection – on the basis of net quantification – of benefits. This requires recognition of benefits, costs and preparing the formula and algorithm allowing the choice of an optimal strategy for the BGF. Such a move would prevent assuming strategic variants only based on intuition and managers' experience.

¹² Methods of including uncertainty in the process of developing strategy is discussed among others by H. Courtney, J. Kirkland, P. Viguier, *Strategy in the conditions of uncertainty*, 'Harvard Business Review Polska,' August 2004 and A. K. Koźmiński, *Management in the conditions of uncertainty*, Wydawnictwo Naukowe PWN, Warszawa 2004.

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The future architecture of the financial safety net Experts' opinions

*Wojciech Kwaśniak*¹

Advisor to President of National Bank of Poland

SUPERVISING INTEGRATION OF THE EUROPEAN MARKET

Continuing integration of financial markets in the European Union, coupled with intensifying competition between global financial institutions mainly from the US, are incentives for the over forty European banking groups to increase their pressure on politicians to quickly lift barriers to cross-border operations within the EU. This pressure has recently mainly concerned supervision of the market for today's member countries.

At present, there is no uniform model of banking or financial supervision in the EU. There is also a lack of serious recommendations for any future exemplary model of supervision. This problem becomes particularly acute after the EU's expansion into Central and Eastern European countries because of the clear dissimilarity between these countries' banking systems and the local financial markets they control and the financial systems of the other countries.

In Poland – as with the biggest of the new EU countries – foreign banks hold a majority of local markets, controlling for instance from 67% in Poland to 96% of assets in the Czech Republic and as much as 97% in Estonia. Their

¹ This opinion represents the author's private views and is not and should not be identified with the viewpoint of the institution where the author is employed.

subsidiary units have a major impact on the local economies and domestic banking systems. At the same time, their share constitutes only a small part of the assets of the dominating entity. What is more, the entirety of assets of the Polish banking systems is lower than the value of assets of a single foreign bank operating in Poland. To illustrate this with an example, let me say that at the beginning of 2006 the assets of the whole banking sector in Poland made up 49% of UNICREDIT BANK's assets, 15% of ING GROUP's and 12% of CITIGROUP's.

A sound practice from the supervision point of view for increasing market discipline is listing the biggest banks on the stock exchange, including those banks controlled by foreign banks. This practice is additionally important bearing in mind developments on the local capital market, and in particular the reformed pension funds and insurance market.

This is what makes supervision of the banking system fundamental from the point of view of the stability of the Polish financial market and all the countries of Central and Eastern Europe in reforming their economies.

The unsettling experiences of recent weeks on the financial markets force us to work out an optimal solution for supervision in the EU. They also compel us to examine with more attention the postulates of the international bank groups.

The issue of creating an effective model of banking supervision, crucial from the point of view of an effective financial safety net and essential from the point of view of covering a possible banking crisis, becomes a critical concern.

Today, the governing principle is executing supervision at the national level. This is correlated with the national subsidiary's liability for bank deposits and national fiscal responsibility for costs of state intervention during a possible local banking crisis.

Possible state intervention in the event of a serious financial crisis is a fiscal cost, often endorsed by a local parliament, and also at the EU level by the European Commission due to its impact on competition conditions on the common European market. Tax policy in the EU is made by the member states themselves, and thus a decision about raising taxes to finance fiscal costs is an independent decision of a state and should not encumber its citizens. It is also connected to the principle of mother country supervision, which is stipulated by one bank licence and the principle of

responsibility management on the part of the bank authorities in the place of its registration. The experience of Polish banking supervision also specifies the responsibility of banks' local supervision to provide explanations before the investigating committee set up by national parliaments to investigate cases in the banking system.

Political decisions aimed at weakening the position of independent central banks, coupled with the unconcealed intention to build a single European supervision institution, which results from the report of November 6th, 2002 (Report on prudent supervision rules in the EU 2002/2061/INI) have led supervisory institutions operating today to become differentiated in the degree of involvement of central banks in prudent supervision and having a consolidating role – or not – in the supervision of the whole financial market.

In my opinion, the key factor for banking supervision quality is effective cooperation between the central bank and banking supervision in the event of the of a banking system crisis.

Breaking the strong ties between the central bank and the banking supervision opens the central bank to the risk of a delayed reaction in the case of a real threat to banking system stability.

International experience, in the British experience with Northern Rock bank, show that managing a crisis situation engenders much higher costs of restoring banking system stability and those costs, in turn, are paid by all tax payers in the country in crisis.

For these reasons, the European Central Bank stipulates that Article 105 section 5 of The EU Founding Treaty gives the European System of Central Banks (under which fall particular national central banks) the task of prudent supervision of the credit institutions and financial stability that have a crucial importance for the payments system and healthy monetary policy.

An additional lesson learnt from the case of Northern Rock is that mixing, within one supervisory institution, prudent supervision and consumer supervision produces a delayed reaction of the supervision to the risky operations of the chosen financial institutions or to the whole financial system.

The pressure exerted by the banks on the market by banks' shareholders aimed at maximizing capital returns and raising their market value, tends to push bank authorities toward excessively risky moves. Only a quick reaction

from the supervisor not involved in the increasingly developed consumer regulations, combined with its functional independence and a good level of responsibility, does give reason to believe that its reactions to situations appearing on the market would not be delayed.

Such guarantees can be created by building strong ties between supervision and the central bank, because of the today's unquestionable standards of its independence.

The pressure to maximize profits exerted by the market on banks' authorities makes the latter look for economies in group management by promoting matrix management systems in reference to subordinated entities and those quoted on the stock exchange. Authorities of dominating banks try not to notice fundamental differences, especially in terms of responsibility for the deposited savings, between their foreign branches and their subordinated entities. In reality, this approach creates a score of problems for hosting supervision, and in particular in the area of effective credit risk management, cash flow management, outsourcing approach, corporate governance principles or the NUK area in the part relating to group applications for IRB and AMA models.

The available data show that the market position of individual foreign banks through the participation of their subsidiaries in the Central and Eastern Europe markets is higher than their share in their native markets. None of these G10 countries has a market share at the level of 20% or more, whereas in Estonia for instance the market share of the biggest entity dependent on a foreign bank is 59% of all assets, 23% in the Czech Republic and 20% in Slovakia.

Another important issue is the asymmetry between the importance resulting from operational scale, the perception perspective of the entity dependent on the group and the systemic importance of the dependent entity for the local market.

Possible problems with solvency can be of secondary importance to the problems of the dominating bank, but of primary importance for the stability of the local market.

That this is not a theoretical problem is shown in the problems between Croatian Rijecka Banka and German land bank BLB, as well as the Czech Investieni a Postovni Banka and Japanese Nomura Securities, which arose several years ago.

It has to be remembered that foreign banks collect local deposits with the intermediary of the dependent banks, which are locally insured and are not covered by the cash flow or solvency guarantees of these banks. The lion's share of funds constituting the basis of the conducted operation does not come from these institutions' shareholders, but has its source in the local markets, where all formal and economic responsibility is focused.

A foreign bank controlling a dependent bank important for the local market lays down (and is liable for) all its capital involvement and its reputation. In the context of the experience of Rijecka Banka we know today that this liability is illusory. This makes supervisors maintain an effective supervision system over the dependent entities.

This is also why the Polish banking supervisor last year questioned all the banks dependant on international investors: "in the light of the dominant bank's native country's law is the dominant bank is liable for deposits made in the dependant bank or the dominant bank makes a commitment in the form of a signed memorandum with the dependant bank to such a guarantee or the dominant bank commits to such a guarantee in the form of a unilateral declaration? The replies received from all the banks, both from the EU and outside, were negative.

Also, work conducted in 2006 and 2007 as part of the NUK Project did not fundamentally change this grim picture of cash flow aid or the additional bank capitalisation of the dependent bank in the emergency situation, neither did it offer any guarantees in the area of offering transfers of security measures from the group to the level of the dependent bank.

Additionally, even in what would seem a simple matter such as supervision over operations of bank's foreign branches, it is not clear what the fiscal costs would be in the case of bankruptcy of a bank whose foreign markets' branches have a systemic impact on these markets' stability. Local authorities would find it extremely difficult to explain to the local customers of the bankrupt institution that they have no say in anything that concerns these customers' protection and that the bankrupt bank's clients can only rely on the decisions of the supervisory boards and deposits guarantee funds of another country.

It is therefore doubtful whether the mother country would be willing to save the bank on which the stability of the whole banking system and financial system relies in the host country.

These are precisely the problems that in today's instability on the international markets force us to supervise banks and create a model for the future.

This is why in my opinion before the final supervisory system for EU banks is in place, one should:

- not succumb to the increasing pressure of the banks in blurring the boundaries between the management of dependent entities (especially these which are quoted on the stock exchange and which a dominant entity does not own 100%) and its branches,
- cover banks or bank groups with intensive supervision (bank associations) having a systemic impact on the local markets,
- maintain and respect the impact of local supervision on the operations of entities dependent on foreign banks due to their full formal responsibility for possible results of insolvency of dependent banks on their local markets.

The state should maintain its full right in exercising supervision over banks for which in the event of a crisis locally operating banks will pay, and in the most extreme cases taxpayers.

At the same time, future optimal banking supervision for the integrating European market should be built based on a decision as to who is held liable for deposits and financial stability.

In the case of maintaining the principle of liability at the national level prudent supervision should be based on strong ties with national and central banks and their cooperation as part of maintaining the stability with the ECB.

In the case of a transfer of responsibility for deposits of cross-border financial groups at the level of a specially created European Fund, one has to build supervision over these groups based on the ECB and national central banks cooperating with it.

Due to the strong position and independence of the ECB and national central banks and also cooperation within the European System of Central Banks, I think this solution will be more effective than building this type of supervision basing on the European Supervision Agency, which is prone to political pressure.

I think that responsibility for supervision over banks operating locally and these which are not dependent on a foreign bank i.e. they act only in

one EU country and should be local as well as the liability for deposits accumulated and their stability.

For the reasons I listed above supervision over those institutions should also be built based on strong ties with national central banks.

Additionally, also taking into consideration the need to provide effective action in executing from banks stable and prudent operations, banks' prudent supervision should not be combined with consumer supervision in the area of financial services and transparency principles on the capital market.

Prof. Małgorzata Zaleska

President of the Bank Guarantee Fund

DEPOSIT GUARANTEE FUNDS IN THE CONTEXT OF CHALLENGES POSED BY THE INTEGRATION OF FINANCIAL MARKETS IN THE EU

The EU has a system of guaranteeing mother country deposits, which implies:

- possibilities for differentiating the level of guarantees on the territory of a member country,
- the possibility of increasing the scope of guarantees:
 - a) the low probability of a supplementary guarantee in the Bank Guarantee Fund of the credit institutions' branch in Poland,
 - b) the probability of the existence of a supplementary guarantee – agreed with the BGF – of an in-country bank branch operating in the host country (e.g. France, UK or Italy).

The challenge for a deposits guarantee systems is, among other things, the formation of ever larger banks (too big to save) operating on a global scale, as well as banks' cross-border operations. Cross-border banking can be understood both in the broad (colloquial) sense and in the narrow (legislative) sense, i.e.:

- colloquially – providing banking services on the territory of other countries by either creating a new branch or without a new branch,

- according to Polish banking law (article 4 section 1 item 21) – performing, by the credit institution located in Poland or in the host country, all or some of the activities resulting from permission granted, without the participation of the branch of the institution or bank.

The scope of trans-border operations and those performed by branches in Poland has been increasing systematically since Poland joined the EU and as of 20 June 2007 has:

- 167 credit institutions that have declared their intention to conduct trans-border operations,
- 17 credit institutions from the EU intending to operate through their branches.

The trans-border activity of banks creates new challenges for monitoring and guaranteeing deposits, including:

- Monitoring risk transfer in the territory of the host country:
 - a) The host country has limited means of limiting it,
 - b) The source of knowledge of trans-border operations is notifications, which do not indicate the scope of such activity,
- The division of system load among partners from different countries.

Proposals for resolving some of the problems in guaranteeing deposits – to be discussed – are presented below.

1. Increasing the significance of cooperation:

- Exchange of information between security network institutions from different countries is desirable, but:
 - a) Informal exchange – has low effectiveness when problems appear,
 - b) Formal (agreements) – denotes various subject scopes for agreements,
 - c) Standardisation – is a solution to aim for and results in the necessity of standardising the scope of agreements on the EU level (following the model of agreement on cooperation among central banks and bank supervising institutions from different member countries) and it ensures security of transferred data.

2. Appointing regional deposit guarantee systems – the idea was proposed by Scandinavian countries – it is possible at the current stage of EU legislation.

3. Implementation of European System of Deposits Guarantee / Financial Institutions, which means:

- resolving the problem of bank guarantees in trans-border institutions operating on EU territory,
- diversifying risk resulting from the overlapping of one system on to a large number of banks.

However, the above proposals do not solve deposit guarantees on a global scale. The problems to be tackled are among others:

- exchange of information between credit institutions operating within and outside the EU,
- guaranteeing deposits / financial investments in institutions conducting trans-border operations outside the EU,
- the need to establish comparable principles of security network functioning on a global scale.

Prof. Stanisław Flejterski

Director of the Chair of Comparative Banking and Finances

Department of Management and Services Economics

University of Szczecin

WHO WILL PAY FOR A BANKING CRISIS ON THE EUROPEAN FINANCIAL MARKET?

Thanking the organisers, led by Prof. Leszek Pawłowicz, for the invitation to the seminar and panel discussion, I would like to express my appreciation for organising this seminar on this topic by the IBnGR. I have a very high assessment both of the choice of topic for the seminar and the interesting presentations by participants on the plenary and panel debates.

The international financial system is not free from various disturbances resulting from the bad management of banks and other financial institutions (e.g. bankruptcies of Herstatt and Barings banks, financial scandals, the problems with Ambrosiano Bank, the crisis at the American investment fund Long Term Capital Management, etc.) and bad macroeconomic policy (e.g. the Scandinavian, Mexican, Argentinian, Asian and Russian crises). An interesting issue related to globalisation of financial markets is transmission of crisis phenomena (financial, currency and banking crises) on an international scale (so-called ‘infection’).

Issues of strategy and security policy in financial markets, with an emphasis on prevention and financial crisis management, are some of the most

fascinating, highly important, as well as most complex fields of contemporary applied finances. An indirect confirmation of the significance of this field's rank is the rich academic literature (most noteworthy are, among others, the publications of SUERF – The European Money and Finance Forum). The phenomenon of the so-called financial safety net¹ and stability of the 'financial industry' is of a multi-dimensional character. The process of its analysis has to take into account the circumstances and elements of both an objective and subjective nature, economic and non-economic aspects, as well as exogenic and endogenic conditions.

The essence of the fundamental dilemma is the question of effectiveness in guaranteeing the EU financial system (and to its particular components, i.e. the financial systems of particular member states) and touches two attributes simultaneously: safety and stability (the system is the public good, or in another perspective – a set of institutions of public trust) as well as competitiveness and efficiency (bank, parabank, and also 'non-bank intermediary' are all such enterprises). The existing literature most often presents 'soft' rather than 'hard' hypotheses or concrete decisions and recommendations. It is hardly surprising: we are dealing with strictly political phenomena, and politics by definition is resistant to quantification.

It seems unworkable at present to formulate timeless and universal principles i.e. binding in all regions, sub-regions and particular countries. If we were following strictly scientific premises, and by definition rejecting intellectual fads, orthodox or fundamentalist reasoning, then it would not be possible to consider any of the existing strategies and policies as the only binding model, fit for immediate application. The difference between the counties of the 'old' and 'new' Europe is now noticeable and certainly will remain so for a long time, with a clear differentiation in the level of deployment. What follows is also a highly differentiated level of control of foreign capital by foreign banking and financial sector of different countries (within the EU, Germany² is at one end of a spectrum, and countries like Poland on the other).

¹ The financial safety net defines – broadly – the entirety of institutions and regulations protecting interest holders and society against losses resulting from insolvency of banks and other financial intermediaries.

² see e.g. S. Flejterski, I. Romiszewska, *Niemiecki system bankowy. Wnioski dla Polski*

To regulate or not to regulate? – this is the question. The financial system is one of the most strictly regulated sectors of the economy in practically all developed countries, including the USA. Governments control financial markets first of all in order to ensure access to information and stability of the financial system. The debate as to whether commercial banks indeed need any legal regulations has been on going for years. As has the discussion as to whether banks as enterprises really possess a distinct specificity that makes them different from other types of businesses. Twenty years ago, American analyst George G. Benston suggested that it was high time for us to recognise that financial institutions are simply business entities characterised by only a few special features requiring regulation. The author of this thesis felt that institutions keeping deposits should come under regulations in the same way as all other joint-stock companies do. He believed that historical reasons for legal regulation of banks such as levying taxation on banks as monopolists providing money, preventing centralisation of power, protecting banks' solvency in order to minimise the impact of bankrupting banks on the economy and pursuing social goals (e.g. ensuring an adequate supply of banking services, supporting housing projects for families and preventing discrimination and dishonest practices) had ceased to matter. What is more, legal regulations are not free of charge. They spell authentic costs in the form of taxes from money users as well as unproductiveness and constraints for competition.³ Many economists, mainly American ones, think that despite significant progress in liberating banks from the rigid limitations of the legal framework, there is still a lot to do so that banks and their clients can benefit from free competition and the disciplining impact of the market on banks, especially in the field of their risk taking.

Both from a theoretical point of view and in the light of real life examples of many countries, it seems undeniable that pure and extreme solutions of the 'either/or' type will a priori have to be rejected. In each of four cases an alternative formula which really matters can be colloquially called 'both this and that.' In the real world every time the right proportion between one solution and another has to be found. It is never easy. The balance point

(The German banking system. Conclusions for Poland). Warsaw, 2004.

³ see more P.S. Rose, *Zarządzanie bankiem komercyjnym*, vol. I, Warszawa 1997, p. 97–98.

is changing in time, depending among others on level of development and maturity of integration. It concerns among others the choice between full regulation and full deregulation of the banking and finance sector (from another perspective, the choice between the Scylla of 'overregulation' and the Charybdis of 'underregulation'). The alternative of full regulation would bring about some well-known negative consequences, but also complete deregulation would not be free of significant weaknesses (the literature often emphasises that too liberal policy of banking supervision is characterised by a considerable level of crisis incidence). The proposed postulate of a continual search for a *modus vivendi* is hardly consent for a so-called 'rotten compromise.' Neither is it an analyst's escape from responsibility which might be needed to provide a clear and straightforward answer. It means supporting the following views (this means entering the field of so-called normative finances):

- a) 'As much liberty as possible, as much protectionism and interventionism (applied intelligently) as indeed needed.' A lot of evidence weighs in favour of more decisive deregulation of the banking and financing sector, although it does not seem possible to resign entirely (now and in the foreseeable future) from certain significant level of regulation and supervision (also the American financial system is subject to such regulation and supervision⁴);
- b) A desired tendency would be a gradual change, proceeded by thorough preparation, from individualised (specialised) supervision to integrated supervision, affecting the whole banking and finance market (e.g. following the example of the UK institution: the *Financial Services Authority* or German *Bundesanstalt fuer Finanzdienstleistungsaufsicht*). However, this tendency should not be absolutised and it would be worth remembering the value of the old rule: 'you can march apart, provided you strike in unison;'
- c) From the viewpoint of imperatives of globalisation and development of EU integration (among others, pursuing the goals defined in the Lisbon

⁴ According to J. Stiglitz: 'When financial markets are stripped off their unmerited glamour, we will see the basic truth that they are not the fount of wisdom, and what is good for Wall Street may not be good for the rest of society. A country which yields completely to the discipline of financial markets, will do so for its own undoing' (*Szalone lata dziewięćdziesiąte*, Warsaw 2006, p. 242).

Strategy) 'Europeanisation' of regulations and supervision would be desired (changing from 27 national systems to one European system). Such an approach requires taking into account the various serious barriers in the EU (each integrating group is in a way a result of pro-integrationist and anti-integrationist forces). Another closely related issue is the fact that the contemporary economy may well be global, but economic interests are and will remain national. A separate analysis would then be required to understand the interests of countries having on their territory the headquarters of financial holdings (conglomerates) and countries hosting the daughter companies of those holdings, similarly in the case of the so-called 'regulatory arbitrage,' i.e. moving financial intermediaries to countries with lower restrictions of the regulatory systems.

Economic integration, especially if it concerns a large number of countries, which at the same time are at quite different levels of development, has to be a process characterised by numerous contradictions and a certain drama of events. Keeping this in mind, the question arises as to which model – from the Polish point of view – should be adopted to reach the recommended, above-mentioned, four principles of: liberalisation, deregulation, unification and 'Europeanisation.' There are two potential scenarios which count: evolutionary or revolutionary ('escaping forward' or 'shock therapy'). The basis for choosing one or the other should not be an easy analysis of the full costs and benefits that would take into account various viewpoints and allow differentiation of 'the beneficiaries' and 'the aggrieved.'

Prof. Władysław Leopold Jaworski

University of Finance and Management in Białystok

WHO WILL PAY FOR A BANKING CRISIS ON THE EUROPEAN FINANCIAL MARKET?

The cost of a banking crisis can be particularly high in countries where the majority of banks are owned by foreign capital.

Suggestions as to how to create an EU-wide guarantee fund stipulate that the host country should be one of the guarantors.

However, there exists the open possibility for a transfer of losses from a 'mother bank' to a 'daughter bank.' In an extreme case, the host country might be forced to finance the losses of the 'mother bank.'

When they are doing well, commercial banks tend to show high profitability. This results not only from lowering costs, but also improved risk management and above all high interest margin and high commissions. Incomparably high real interest rates with no competition on the market are the source of high profits for commercial banks. Banks with foreign capital maximise profits in order to raise dividends that are later transferred to 'mother banks.'

Banks with foreign capital today send billions abroad. And can we expect aid on the part of 'mother banks' to 'daughter banks' in Poland? This seems somewhat difficult to imagine.

This is why we are faced with a serious problem of how to protect ourselves from bankruptcy of foreign capital-dominated banks, often caused by

their foreign dependency. Shouldn't we demand adequate guarantees from shareholders? Or perhaps we should create a separate crisis fund at the BGF. The fund would then be a contingency source in the event of a banking crisis.

The interest rate for this fund would not expose the bank to too high losses.

It is hard to come to terms with the thought that 'daughter banks' transfer billions to their foreign shareholders, but in the event of a crisis the cost of such banks' bankruptcy would be borne by the host country.

Prof. Małgorzata Iwanicz-Drozdowska

Head of Financial Services Market Institute

Warsaw School of Economics

WHO WILL PAY FOR A CRISIS? IDENTIFICATION OF SOME KEY IDEAS

Discussions on the consequences of pan-European institution's bankruptcy or a cross-border financial crisis have now been on going in Poland for six years. To date, it has not been possible to establish – either on a local or European level – any reasonable guidelines in the event of such a crisis.

Partial solutions were offered by the directives 2001/24/EC (reorganisation and liquidation of credit institutions) and 2001/17/EC (reorganisation and liquidation of insurance institutions), but they do not resolve the issue of subsidiaries' bankruptcy, only regulating procedures for closing down branches in other EU countries.

So, why has it been impossible to work out a solution here? First and foremost because of the sensitivity of the topic. There is the need for political willingness that would allow the authorities of particular countries to seriously engage in solving the problem. This refers not only to host but also to home countries. Secondly, there is no consistency in definitions. We use terms such as 'banking crisis' or 'financial crisis,' but the discussion held in this area have tended to reveal that what we mean here is not a banking or financial crisis as defined in the literature, but the insolvency of particular pan-European financial institutions. It is certainly easier to prepare a one-off solution for a specific

case rather than elaborate procedures for managing a crisis of a systemic scale. Hence, one should focus on an easier task. A solution elaborated by academics in this area could create the basis for discussion at the political level. To date, only very general agreements (MoUs) have been made at the EU level¹ (governments participate only in the agreement concluded in May 2005) and these are related to procedures in crisis situations but do not cover issues of financial responsibility (who will pay?). The emphasis has been put on the exchange of information, conducting stress-tests and certain 'minefield' exercises. The exchange of information is, of course, the basis for decision making, but does not resolve the problem of crisis management, which most often requires allocating the means for restoring a healthy state of affairs.

Unwillingness to deal with financial responsibility may stem from an intention to leave primary responsibility in the hands of the owners of financial institutions and also to maintain full responsibility for supervision and its quality in the hands of the authorities of particular countries.

Apart from MoUs on crisis management signed by all EU countries, there are several regional agreements made by Northern European countries. We have identified three such MoUs:

- between the Belgian Central Bank, the Belgian integrated supervisor and the Dutch Central Bank, with supervisory functions;²
- between the central banks of Denmark, Finland, Iceland, Norway and Sweden;³
- between the central banks of Estonia, Latvia, Lithuania and Sweden.⁴

¹ *Memorandum of Understanding on High Level Principles of Co-operation Between EU Banking Supervisors and Central Banks in Crisis Management Situations*, European Central Bank, March 2003 and *Memorandum of Understanding on Co-operation Between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis Situation*, Informal Ecofin, May 2005.

² *NBB, CBFA and DNB sign a Memorandum of Understanding*, Press Release, National Bank of Belgium, June 2006.

³ *Management of Financial Crisis in Banks with Cross-Border Establishments. Memorandum of Understanding Between Central Banks of Denmark, Finland, Iceland, Norway and Sweden*, June 2003.

⁴ *Management of Financial Crisis in Banks with Cross-Border Subsidiaries or Branches. Memorandum of Understanding Between Central Banks of Estonia, Latvia, Lithuania and Sweden*, December 2006.

These agreements were concluded by countries in which pan-European financial institutions play a significant role. Cooperation between Belgium and the Netherlands is a natural consequence of for example the operation of the Fortis and ING groups, whereas Nordea, for example, has an important position in the Scandinavian and Baltic countries. Those agreements also focused on the exchange of information, especially in crisis situations, but in two of them there was a provision on the insolvency of an institution (apart from the standard regulations on ensuring cash flow to solvent banks). The agreement between Scandinavian countries stipulated that in the event of the insolvency of a parent company or a whole group the sale of subsidiaries would follow to generate the funds necessary to cover liabilities of the parent company. If it is a subsidiary which goes bankrupt, then the financial assistance of the parent company is required. In the MoU signed between the Baltic countries and Sweden it was decided that in the event of insolvency a central bank will immediately contact the Minister of Finance. One can take this to indicate the direct financial responsibility of the designated entities. In the Baltic counties, responsibility was assigned to the ministers of finance of each of them. There are no indications as to what steps the ministry should take, only suggestions as to the local nature of responsibility for subsidiaries. In the case of credit institutions' branches, the responsibility – according to existing regulations – belongs to the home country.

The agreements signed to date do not comment on who really pays for the consequences of a financial crisis or insolvency of a pan-European financial institution. Bearing this in mind it is worth considering two issues:

- what can be done to reinforce safety and soundness on the European financial market, beyond the regulatory and supervisory sphere?
- who would pay for crisis situations?

The increase of safety and soundness may come from tighter market discipline. Pan-European banks operating in conglomerate structures are most often listed on the stock exchange of not one, but several countries. This gives market players in various countries a fair basis for monitoring banks' operations and for enforcing the companies' rational operations. One has to judge this element as indispensable.

The question as to who would pay for a crisis is strictly connected with channels of contagion. What channel(s) can transfer this contagion effect?

The ownership channel we have already talked about, i.e. when a parent company infects a subsidiary company (or vice versa). Apart from this, there are two other threat-posing channels. The first is the channel of interbank exposures. As we know, the European market is highly integrated when it comes to interbank operations in the Euro-zone. This issue did not appear in the discussion, but is of great significance. The other is the information channel. This concerns not only information that can be passed on among specific countries, but also the effects of a contagion within the group. Then the question appears: which contagion effects do we have to deal with? Only those transmitted by the ownership channel? Is it for example necessary to work out mechanisms that could help in managing a crisis if tensions occurred on the integrated interbank market? In order to monitor the possible occurrence of contagion effect it is necessary to have relevant data, which are not gathered at the EU level.

The question of which country will pay for the crisis should be determined by the source of contagion and how it is transferred. These should, first of all, be the owners of financial institutions, and only after can government support be sought. Ultimately, it is taxpayers who would foot the bill. I am not thinking only of the real fiscal costs, but also about the drop in the level of consumption,⁵ which is particularly visible in small open economies where the ratio of debt to income is high. Poland seems to be an example of such a country.

Summing up, there is an urgent need to make a clear distinction between the insolvency of a single pan-European financial institution and a financial crisis. One would firstly need to establish procedures relating to individual problems of financial institutions, only then proceed to describing the possibilities of re-gaining of financial systems' stability after the crisis. It also has to be kept in mind that each crisis has its own features, and practically 'nothing happens twice in the same way.' Collecting data on mutual operations within financial groups and detailed information on exposures on the interbank market have to be considered indispensable. Last, but not least, special effort should be made to enforce the mechanisms of market discipline.

⁵ see e.g.: R. Barrell, E.P. Davis, O. Pomerantz, *Costs of Financial Instability, Household-Sector Balance Sheets and Consumption*, 'Journal of Financial Stability', no. 2/2006.

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WHO WILL PAY FOR A BANKING CRISIS ON THE EUROPEAN FINANCIAL MARKET?

The Lisbon Strategy was founded in the main with the aim of impacting positively on the integration and creation of a single financial market in EU member countries. It was implicitly assumed that an institutional basis, the so-called 'financial system safety net,' had already been structured and that the next stage of integration could follow. At the same time, the transformation processes of financial sectors have been intensified and are now particularly conspicuous in the banking and capital flow sector.

The institutional and legal structure of the safety net shaped by 19/94/EU Directive still maintains its national character, whereas the activity of credit institutions (deposit guaranteeing entities) are increasingly often of a transnational character, in at least three aspects.

Firstly, in the form of branches of credit institutions registered in a mother country and operating in a host country or countries. Secondly, in the form of providing trans-border banking services – without the presence of organisational units of the credit institution in the host country. Thirdly, by the activity of the daughter companies of the credit institutions in the mother country or in

the host countries. In this last case, the situation is made additionally more complex by the capital ownership structure of the daughter company and possible foreign expansion of the company in the form of a branch or branches, provision of trans-border services and finally capital investments in a credit institution in the third countries. All of this creates potential problems in the event of a banking crisis, especially if it happens to be a large scale crisis.

Taking into consideration the formal perspective of certain regulations, we can conclude that in the event of a banking crisis there is no problem with operations of branches in the host country or trans-border operations assuming that the national guarantee systems carry the responsibility for satisfying the claims of deposit holders in the mother and host countries under the conditions projected by those systems. However, such an approach ignores just one fact, namely that only some deposits and only to a certain amount are subject to guarantees and additionally that not all the systems offer financial instruments allowing for a bailing out of problematic banks.

The emergence of such a crisis would mean exporting, to a smaller or greater extent, an insolvency catastrophe by a credit institution from one country to another, or in particular cases even to several other countries. At the same time, we also have to consider the scale of any possible crisis as well as the value of losses and means necessary to satisfy the claims of deposit holders in the context of the financial potential of a national guarantee institution. Relatively frequently do we encounter the opinion that it is naïve to believe that the financial safety net in EU countries can meet the challenges triggered by the insolvency of a large trans-border bank with its headquarters in one of the EU countries. In the presentation given by Leszek Pawłowicz, the problem is reduced to the question of who will pay for recapitalisation of a bankrupt bank that creates or will create risk to the system in the single financial market of the EU countries.

Among the various concepts proposed by academics and practicing professionals of how to solve this problem there are various analogies to a large scale disaster of a safety net for nuclear energy civilian-use. Doubts begin to surface when we pose the question of whether this analogy should only concern a crisis triggered at random by a breakdown of a nuclear installation or should also cover a crisis caused deliberately, which in reference to a credit institution would mean e.g. a deliberate encumbrance of a guarantee institution – and indirectly, taxpayers of the host country – with

the costs of the crisis caused by a bank based in another country. Much as such a scenario may seem highly unlikely, it is still not out of the question. Using available analyses and the adopted analogy of the nuclear safety net we can draw up a scale very different from the widely-held stereotypes. One end of this scale would represent solutions offering no guarantees, only based on the market discipline of customers of credit institutions. The middle of the scale would display solutions formulated by e.g. C.A.E. by Goodhart, D. Schoenmaker or L. Pawłowicz. The other end of the scale would accommodate solutions (if only theoretical) consisting of charging some ex ante fee from credit institutions running trans-border operations to cover their potential liabilities, as formulated by e.g. W. L. Jaworski.

Taking into account the advanced development of the financial safety net in EU countries, we can in practice reject outright very radical market discipline as a disarable solution. According to W. L. Jaworski's concept, prefinancing a potential crisis by the so-called 'trans-border banks' is risky for at least several reasons. One of them could be the risk of transforming existing daughter companies in host countries into branches that would result in the use of so-called 'regulatory arbitrage,' a partial loss of budget income from income tax or a reduction of employment. Considering the low likelihood of the most radical solutions, it seems rational – despite the lack of consent from representatives of member countries and EU organs – to look for moderate solutions in the hypothetical mid scale.¹

Searching for solutions in a situation of lack of headway in constructing a trans-border financial safety net should incline us to shape a complex system covering at least three elements (subsystems) of a firewall type. The first subsystem would focus on building trust in trans-border institutions based on clients' rational behaviour (economic education, transparency of financial situation of banks and banking technology classed by e.g. ratings).

The second subsystem would deal with prevention based on refined cooperation of national supervisory bodies, EU countries or countries forming, cited after L. Pawłowicz, a federal system of guarantees.² It would

¹ Opinion on lack of consent for significant changes in the deposits guarantee system and creation of trans-border institutions is taken from conclusions formulated on the basis of the review of 19/94/EU Directive completed in 2007.

² In a particular case the system could include countries outside the EU or institutions based in such countries.

at the same time be of importance to adequately qualify information about threats coming from the national supervision. Showing disregard for such information could impact the involvement of a relevant national guarantee system. The third subsystem would be charged with restoration of the stability of trans-border banks.

In the subsystem focused on building trust in credit institutions it is useful to develop educational projects informing the general public about: the principles of evaluation of the economic and financial situation of banks, existing ratings³ and the rules of guaranteeing deposits for existing and prospective clients.

The preventive subsystem, next to an efficient flow of information among supervisory bodies, would deal with institutional forms of collecting the means in the event of a crisis. It seems worthwhile creating a cascading set of crisis funds including for instance:

- a fund formed ex ante by trans-border banks (the so-called ‘federal guarantee fund’ – FFG) with a solution of how to transfer fees paid by those banks to national systems,
- funds supporting the FFG and originating in a national guarantee system of a mother country and the country or countries hosting the trans-border bank in question,
- trans-border stability fund (TFS) at the European Central Bank or, when extending it beyond EU structures, at e.g. BIS, created jointly by member countries on the basis of the value of assets of credit institutions.

The FFG might consider applying a mechanism of excluding the participation of a country whose information on a threat is ignored by the system members. The FFG would dispose of the FFG Council made up of supervisory bodies from members countries of the system, and the Board chosen by the Council with the system of voting where each member has one vote.

Endowing the subsystem with stability restoring functions for trans-border banks requires defining methods and instruments of resolving crises and compensation for the means spent on restitution activities. Most briefly, it can be defined as a sequence including the following:

³ The ideas of licensing rating institutions are quite controversial.

- the sale of restored credit institution at the right time,
- settlement of means contributed by the TFS to the restitution programme,
- settlement of means brought into the programme by national guarantee systems,
- transferring the remaining means to the FFG.

This is just a very general outline and it calls for further analyses and – above all – decisions.

Faced with all the problems that need to be resolved before any possible creation of a federal guarantee, it is worth mentioning one more issue that is summed up in the question: who would pay for a banking crisis on the European financial market? This is very important for beneficiaries of the existing national guarantee systems. The core of the issue is execution of deposit holders' guarantees in the event of the insolvency of a credit institution with a branch or branches in a host country or countries or running trans-border operations without its commercial presence. It is relatively easy to introduce a solution consisting of bestowing a national guarantee institution with a representative function among the deposit holders of a host country towards a guarantee institution in the mother country of a bankrupt credit institution.

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BANKING CRISIS COSTS SHOULD NOT FIRST OF ALL BE BORNE BY TAXPAYERS

The sum of the cost of a crisis that may occur on the European banking market, and including also Poland, presented by Prof. L. Pawłowicz is rather shocking. Nevertheless, one has to remark that these costs do not include the consequences of a possible crisis across the entire financial market, also including the capital and insurance markets. Still, (one can sometimes forget) these markets are largely interdependent, which means that the costs of a potential crisis of the entire financial market could be way higher than Prof. Pawłowicz's estimates.

Returning to the question of who would pay for a banking crisis, I would like to express my opinion that costs should, first of all, be covered by the banks themselves and their stake holders, and not the taxpayers of one country, or based on the solidarity rule, by all EU countries' taxpayers (I leave aside the question of why EU taxpayers should cover the cost of banking crisis caused by daughter-banks whose mothers banks are outside the EU, e.g. in the USA or Switzerland?).

For this reason I share the view expressed by Prof. W. L. Jaworski that banking crisis costs should first of all be borne by the banks themselves, and not taxpayers.

Abiding by the rules of a free market economy, the costs of a crisis should first of all be shouldered by bank owners, most frequently by their shareholders. The next group affected by these costs should be the large clients of such banks. As much as the deposits of small clients are protected by the current deposits guarantee system, in the light of the present legislature, bank guarantees do not cover corporate deposits and the entirety of high deposits of retail clients. It can be assumed that corporations and rich retail clients have the possibilities to evaluate the condition of the bank in which they make deposits. A different approach to this issue would, in my opinion, be an incentive to actions that can only be described as 'moral gambling.'

Having primarily the shareholders and, partly, the large clients of a bank cover crisis costs is not synonymous with liquidation of the bank. It seems worthwhile considering the concept of the so-called 'last instance investor.' Such an investor could take over the bank in a crisis situation or support it with capital and after the recovery process, could sell it. In this later case, 'the last instance investor' would play the role of a 'clinic' charged with recovery of 'sick' banks. I think that 'the last instance investor' for a daughter bank should be its mother bank or a bank consortium headed by the mother bank.

In the former case of the recover process for, let's say, a large bank, such a consortium could consist of EU countries' central banks headed by the European Central Bank.

Capitalisation of a bank in a crisis could be financed from a solidarity fund created ex-post by large commercial banks or/and long term bonds. The transitory capitalisation of a bank in crisis could also be shared by international institutions and the treasuries of economically strong countries.

An example of financial 'scaffolding' aimed at overcoming a banking crisis could be the participation of the International Monetary Fund and US Treasury in dealing with the Mexican crisis in 1994–1995.

The acceptance of the above proposals for financing banking crisis consequences would need to be accompanied by changes in both national civil law and in international legislature. It would be indispensable to work

out and have EU law approve specific bankrupting and restoring procedures for banks. It would also be necessary to establish an international tribunal which would arbitrate disputes resulting from bankruptcies and pass sentences towards individuals or institutions that have precipitated the crisis or bankruptcy of a bank or several banks.

Finally, I would like to bring to light one more issue that has not yet been discussed today, namely the problem of the last instance lender. Economic literature underlines that the last instance lender should help banks in cash flow difficulty, but not banks which are insolvent. As other authors have observed, in the first phase of a crisis, the problem is in determining whether we are dealing with a bank in cash flow difficulty or a bank which is insolvent.

Thus one would need to know who in the present-day economy is to play the function of the last instance lender. In the past, the national central bank was thought to fulfil this function. Today the matter is far more complex, especially with reference to banks operating in several countries.

I would like to emphasise that the Maastricht Treaty, which created the framework for central banking in the EU, contains no provisions relating to role of the last instance lender. The statutes of national central banks of EU countries do not provide any guidelines either. This situation, described by E.G. Corrigan, former president of the US Federal Reserve System, and known as the strategy of ‘constructive ambiguity,’ was aimed at counteracting the moral gambling that commercial banks might want to engage in. On the other hand, the lack of reply to the question: ‘who is to play the role of the last instance lender in relation to trans-border banking?’ makes banking systems, to a smaller or larger extent, sensitive to fluctuation shocks. In the present situation national central banks will certainly be unable to perform this function. And who if not central banks? We do not have a clear answer to this question.

Mariusz Zygierewicz, PhD

Director in Polish Bank Association

CONSOLIDATED SUPERVISION AND COST OF FINANCIAL CRISIS IN EUROPE

The financial services industry is becoming increasingly global and competitive. We can notice the growing number of banks which are active on the financial markets in different countries. Particularly great changes can be observed in the European Union where many banks are engaged in cross-border activities. The growing centralization of risk management, internal controls and some parts of banking activity are also important factors which change the structure of banks and have to be taken into account discussing the problem of future banking supervision.

The creation of single financial market in Europe is one of main goals of Lisbon strategy adopted in EU couple years ago. However, until now there are a lot of regulatory obstacles that disturb reaching this goal in near future. The scope of these barriers is relatively broad and embrace a lot of different areas in banking activity. All obstacles were named in the European Banking Federation comments on the European Commission's Green Paper on Financial Services Policy and in the special report of European Parliament concerning financial market integration in 2006.

It is obvious that one of the most important obstacles is the ongoing structure of banking supervision in Europe. Nearly everyone is convinced

that existing structure has not kept pace with the level of integration of markets in the European Union and may hamper the process of creation of the big European banks which could compete on the global financial market in near future. The biggest banks strive for diminishing costs of their activity. One of most important position of potential reduction of costs are expanses concerning bank supervision.

I am convinced that the changes in the structure of banking supervision, particularly the changes in division of tasks and responsibilities for home supervisors and host supervisors and division of cost between Member States should be done on the EU level in near future.

A key feature of framework for supervisory cooperation in Basel Committee documents is that international banking groups need to be supervised on a consolidated basis, covering all aspects of business, domestic and cross-border. Consolidated supervision of international banking groups requires an effective cooperation and information exchange between home supervisors and host supervisors. While communication between home and host supervisors is important, banks have the primary role to play in providing the relevant information to home and host supervisors to allow them to meet their responsibilities. The Basel Committee stresses the importance of providing of information for all supervisors in order to prepare the conditions for meeting the responsibilities of supervision bodies.

The main goal of supervision mission is protection of the depositors (consumer of financial services) and ensuring the financial stability in the area of activity of supervisor. Effective banking supervision is very important factor in banking crisis prevention. The banking supervision is one of key factors of financial safety net. Thanks to the efficient banking supervision the banks have the confidence of their clients. This trust is the value which is very difficult to measure in any currency. In our opinion the banking supervision can not be seen only as additional factor of cost for delivering the services to the clients. Without the efficient banking supervision this cost would be higher for all banks, also for big international banks.

The Polish financial market, as financial markets in other Central-Eastern Europe countries, is in specific situation. The majority share in total assets, own funds of banking sector in Poland have the banks which main shareholders are foreign banks. It is the effect of openness of Polish economy for foreign capital and policy of creation of the same economic

conditions for all investors for many years. It was the situation completely different from the economic policy of few other EU countries where many barriers were created in order to limit the access of foreign capital to the local financial market. We appreciate our economic policy and the positive results of this policy for bigger stabilization and development of financial market in our country. We have also specific problems concerning the maintaining the stability in financial system when important changes in international structure of banking supervision are proposed by regulators and European banking community. Generally nearly all recently proposed solutions regarding the changes on the scale of tasks suitable for supervisors from different countries are better for countries where the biggest share in financial market belong to the domestic banks and the role of foreign banks is not so important and they have only limited influence on financial stability in the local market. That is the reason why Poland has to look for other solutions than growing importance of home supervisor. The simple delegation of tasks between national supervisors can be treated as very good solution for biggest banks because it allows to diminish the cost of reporting and other costs in banks and to increase the tasks of foreign supervisors. But on the other hand such solution can be very risky for financial market in Poland and in other CEE countries because the increased competences of home supervisor mean the smaller possibility of activity for host supervisors. This attitude can create the field for turbulences on local financial markets without rapid and suitable rescue program implemented by host supervisor. All costs of the turbulences have to be covered by host country.

This risk of occurrence of turbulences on financial market is in my opinion the main reason why the problem of delegation of task for supervisors has to be bound with the question of delegation of responsibility for banking stability. There are many reasons why these questions are discussed or presented together in last documents of European Parliament, European Commission, the Basel Committee on Banking Supervision or the Committee of European Banking Supervisors. All these bodies understand that the problem of changes in banking supervision structure on international scale can be solved simultaneously with the solution of following problems: crisis management, lender of last resort, liquidity management, role of central bank or deposit guarantee scheme. These institutions do not put these problems on the table together to make the difficulties in international development

of banks. All these institutions understand the role of financial stability as precondition for development of this branch of economy. The Polish Bank Association shares this view and attaches particular importance to this problem, especially when the risk of international contagion of crisis situation in financial market is high and is growing rapidly.

Under above-mentioned circumstances there could be found some possible solutions of problem of ongoing situation in banking supervision and division of costs of financial crisis.

Firstly, the home supervisor can fulfill the role of unique supervisor for foreign subsidiary of domestic bank if it takes over simultaneously the full responsibility for results of the supervisor activity. In effect, if the home supervisor will supervise exclusively the banking group (including foreign subsidiaries), the state, the central bank and the deposit guarantee scheme suitable for home supervisor and for supervised bank should be prepared to bear the full burden of the financial problems occurring in foreign subsidiaries of bank. It is impossible in modern economy to have the additional rights without taking the responsibility for effects of activity of any institution. This solution is similar to the existing model when bank has the branches abroad. If the existing barriers in supervision policy are so heavy, many banks would decide to convert the form of its activity abroad basing it on foreign branches instead of subsidiaries. Until now we do not observe the massive trend in changes in bank structures of international banks which are active in Poland.

Secondly, until the safety net on international scale is not yet created, the home supervisor cooperating with host supervisors (suitable for foreign subsidiaries of bank) is our favorite solution. The home supervisor can play the role as lead supervisor in that way that it organizes the work of collegiums of banking supervisors from different countries and promotes the supervision culture and practices on consolidated level. In this model the home supervisor is *primus inter pares* and the power of this structure will rely on the building the strong level of trust among regulators in different countries. This should be achieved by expanding the work of regulatory colleges to examine how they would work together facing a capital adequacy or liquidity crisis. This proposal was created by Simon Hill few years ago.

In this solution some additional regulatory changes are necessary in order to diminish the burden of supervision for banks. That is why the Polish Bank Association proposed

the creation of really unique capital and financial reporting standards, the same capital requirements for all banks without any national discretions, creation of one supervision standards, greater exchange of information and experiences among supervisors, common supervision practice, joint controls and training creating the bigger mutual trust and cooperation. This solution guarantees in our opinion the sufficient and quick access all engaged supervisors to all kinds of information which can be necessary in supervision practice. In our opinion bigger harmonization of requirements in the EU will cause lower costs of banking supervision for supervised institutions. Convergence of supervisory practice will allow to eliminate duplication of work. The cooperative framework should be neutral in the sense that it does not provide an incentive for groups to restructure.

Host supervisor should contribute to the supervisory process over banking group, because it has the bigger knowledge of the local banking landscape and local market conditions that are not available to home supervisor. Applying one set of rules for all bank activity may cause that some important message are lost.

Thirdly, the creation of one banking supervisor body for banks engaged in international activity. In our opinion this solution will create level playing field for all large banks in Europe. There is easier for one European banking supervisor to cooperate actively with other international institutions which are (or will be) responsible for safety of financial sector in Europe.

In my opinion all above-mentioned solutions can be implemented in practice. It is probably too early for some banks to promote one supervision body in EU as the best solution for banking community. Nevertheless we should be ready to discuss this far-going proposal in order to find the same solution and the same conditions of doing business for all banks active on international scale in the EU. I strongly supported and support the review of arrangements in the area of liquidity management, lender of last resort issues, deposit guarantee schemes and winding and bankruptcy proceedings in order to adapt them to needs of one financial market in Europe.

The experience of last credit squeeze shows how important and how urgent is the problem of good supervision and division of costs of banking

crisis in Europe. In my opinion, the direct cost of financial turbulence in Europe will be small for banks active in Poland. The Polish banks are not deep engaged in new products on financial market in world. This instruments could be more attractive for banks which have serious problems to reach high return on their domestic investment. Fortunately, today the banks in Poland have a lot of good possibilities to broaden their profitable activity in traditional segments of banking activity and they do not have to look for risky investment abroad. The turbulence can have mainly the indirect effect on banks. We can expect some changes in bank strategies and in the price of money because of lower risk liability of many investors.

Nevertheless, the behaviors of banks and regulators in many European countries show us that the contagion of crisis can be very significant problem and nobody can be sure that the domestic financial market will not be infected by turbulences occurred abroad. In my opinion the different attitudes of European Central Bank and Bank of England to the recent turbulences on financial market have increased the cross-border character of crisis. They show how important is cooperation on international level. The solution implemented by one regulator can have enormous consequences for behavior of banks and regulators in other country.

The events of credit squeeze are still unfolding and there is probably to early to propose new supervisory reactions at this stage. However there is the need to discuss if it is necessary to implement in near future new regulation for bigger safety of banking sector. The division of costs is one of more important topic as well. The recent solution is fragmented in this area and will be insufficient when it is necessary to cover the costs of crisis using public money of the Member States in EU. This uncertainty can strengthen the total cost of the crisis and the turbulences can last longer. The experiences of last months should teach us that we can not wait longer and we should try to find new solution for stability of financial market in 21st century. The first step should be the discussion about one banking supervisor for banks active in different EU countries. Defining the tasks and responsibility of such supervisor, the source of covering the cost of turbulences should be identify. Everyone is convinced that the process of creation of common supervisor on international level will be difficult and long-lasting. That is why it should start as quickly as possible. No changes in the safety net in Europe can cause significant turbulences on financial market in the future.

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EU BANKING SYSTEMS INTEGRATION, SUPERVISORY ARCHITECTURE, AND BURDEN SHARING – SOME REFLECTIONS

Both speakers Dirk Schoenmaker and Leszek Pawłowicz addressed a few important issues. One of them is the level of banking or financial systems integration in European Union (EU). Their conclusion is that due to the fact that the level of integration is high we should change the current architecture of financial system supervision and the mechanism of cross-border banks resolution because it they are not quite adequate. The core element of their presentations was how to deal with a potential crisis in a pan-European banking/financial group, especially in terms of distribution of potential fiscal costs that need to be contemplated in case of a systemic pan-European bank failure.

Let me address first the some elements of the diagnosis of the level of integration as a key premises to proposal of changes to banking supervision set up in EU.

¹ The views presented in his paper reflect author's own position and not necessarily that of the National Bank of Poland where he is employed as deputy director of the Department of Supervisory Policy Department of the General Inspectorate of Banking Supervision.

1. The level of cross-border integration

The diagnosis of the level of integration of banking sectors in EU presented by both speakers raises some doubts. It is true that there is a clear trend of mergers and acquisitions that results in lower number of banks (decline by 9.4% in years 2002–2006) and growth of large pan-European financial institutions, with 45 pan-European banking groups currently operating in a several member states.² The role of foreign banks continues to increase, especially in New Members States (foreign branches and subsidiaries controlled 67.7% of the total assets in NMS in 2006).

Nevertheless, the answer to the question on integration is not easy and much depends on the definition of integration and centralization.

If integration means predominantly growing presence of cross-border financial institutions like banks or insurance companies operating in more than one EU jurisdiction, there is a clear evidence of such trend. This trend is stimulated by mergers and acquisitions in financial sector that most likely will continue. Such integration means development of inter-linkages between markets but does not necessarily mean that the new, much bigger cross-border financial groups are simple amalgamation of various legal entities and centralized as suggested. Most of the foreign banks operating in New Member States (NMS) are in the form of subsidiaries that are separate legal entities, preserve certain degree of necessary autonomy mandated by law. They are obliged by law to respect the interest of local stakeholders (depositors, minority shareholders, borrowers). The support for greater integration in EU which is realized also by the growth of cross-border business should not translate into support for treating subsidiaries as branches, with highly centralized management processes (decision making powers) at group level. From the point of host country it is important to maintain full capacity of local, especially systemic subsidiaries, to operate on stand alone basis. Currently, in many countries, typically in Central and Eastern Europe, local banks, especially the large ones controlled by foreign investors, continue to operate as separate legal entities and not branches, i.e. subsidiaries, closely related to local markets.³ And in case of large foreign banks there are no

² *EU banking structures*, European Central Bank, October 2007.

³ According to ECB “Subsidiaries were the predominant form of foreign establishment in the EU25 in terms of market share in total assets, especially in the NMS, where in

plans to convert them into branches. Many of them are also listed on local stock exchanges, contributing to large degree to its capitalization, and have minority shareholders whose interest are not always the same as majority shareholders. Thus, the local subsidiaries of foreign banks, in most cases formerly operating as major local banks, are also integrated with the local markets, have impact on local stability and their relations are not only with foreign parent companies but with local market.

Being separate legal entities they have to comply with local laws and regulations. In addition, they are subject to close supervision in countries like Poland where many foreign banks have systemic character while their funding comes predominantly (on average ca. 60%) from local deposits and only 5–10% comes from foreign shareholders. Moreover, their presence in local capital markets where they have important share is quite significant. As a result, the real stakeholders in the case of their financial problems of such systemic foreign banks operating in NMS are especially local depositors whose money fund their business.

There is no doubts that there are numerous inter-linkages or integration mechanisms between local foreign subsidiaries and foreign parent banks. They are illustrated by predominant impact of the parent company strategy, selection of management body and defining management structure, defining appetite for risk, influencing local risk methodologies, business culture, as well as dividends policy. Having such substantial impact of local subsidiary, the foreign parent company is also expected and directly obliged to offer support in terms of liquidity or capital injection to a subsidiary in case of financial problems. These integration mechanisms and linkages are always put, in the case of subsidiaries, in a local context and should not be mechanistic and direct but rather conditioned by the corpus of existing local laws and regulations like Banking Act, securities and exchange legislation, accounting, fiscal, and companies laws, bankruptcy laws, and many others. These local laws and regulations should not be perceived as impediment for the integration or efficiency of their business but rather as necessary mechanisms that balance the rights of the foreign parent company and local stakeholders (depositors, minority shareholders, etc). That is why the

2006 61.2% of total assets were controlled by foreign subsidiaries (of which 56.4% had an EU parent)”, „EU banking structures”, European Central Bank, October 2007

management of foreign subsidiaries has to follow local laws, is obliged by local laws to act in the interest of the local company, to respect the rights of minority shareholders, and conduct their business in a safe and sound manner so the safety of the local deposits and local financial system is ensured. This in turn is also positive for the cross-border group as a whole as the safety and soundness of local bank strengthens the stability of the group. In case of parent company not being able to meet its fundamental obligations, for example when a bank becomes affected by the crisis and owners do not react in a timely and adequate manner (e.g. through improving risk management or capital injection), the local supervisory authorities might put such subsidiary under administration and under specific conditions (risk or actual insolvency) even sell the bank to another party.

Such powers vested with host country authorities are entirely justified following the fact that in case of a major problem with the local foreign subsidiary, in the worst case scenario of its insolvency, the stakeholders that are mostly affected are local clients (depositors, bondholders), deposit insurance and possibly the local fiscal budget in the case of state intervention to rescue systemic banks and protect financial stability of a host country.

2. The level of cross-border banks centralization

The speakers also referred to general concept of centralization of management process in the case of cross-border banks. First, this is a clear simplification of the much more complex issue of internal organization of cross-border banks. Cross-border banks represent various styles of managements and opt for various degree of centralization. There are few banks “closely held”, i.e. with very integrated management structure where subsidiaries tend to be treated as almost branches. Such style of management risks to be noncompliant with host country laws and might questioned from prudential perspective. In general, banks differ as regards their degree of risk management centralization. In many cases banks develop at the group level: risk management methodologies, policies, establish general group-wide limits, and then cascade such methodologies (or allocate entity limits) them to their subsidiaries. They also monitor and manage risk on consolidated level which is not equal the elimination of the same processes at solo level (required by host supervisors and necessary from risk perspective) but rather combination of both. On the other hand, daily management of risk stays at legal entity

level, where centrally developed policies are calibrated and endorsed by locals management similarly as locally developed policies. Therefore, it is required by law, expected by supervisors, and a matter of practice that the local management takes independent decisions even if it considers general policies coming from parent company. This is much more complex and nuanced picture than stating that cross-border banks are managed centrally. The evidence to such divergent picture is presented in papers issued by Committee of European Bank Supervisors⁴ and the report published by Banking Supervision Committee at European Central Bank.⁵

From prudential supervision point of view, it is hardly acceptable that banks might transfer some of their core functions, like risk management at group level. Such move would impact in a negative way the ability of a subsidiary to manage its risks in a proper way and being able to continue to operate on stand alone basis even if the parent company might have problems. Risk management function is a necessary element of systems and controls in banks, together with internal audit and compliance function. Therefore, it is expected that banks will not eliminate such functions in the process of risk management centralization or intra-group outsourcing but rather centralization will be defined as a method of sharing modern and risk-sensitive methods developed at group level and disseminated across cross-border group which includes also local calibration of such methods.

In addition, from purely prudential supervision point of view and financial stability of local banking system, it is important that the existing laws protect banks from being deprived of such fundamental management tool like risk management. The arguments relating to the need of having strong enough local management (including risk mgt) function and the importance of a foreign subsidiary to be capable to operate on stand alone basis was discussed elsewhere.⁶ However, it is worth to mention why

⁴ *First part of CEBS' technical advice to the European Commission on liquidity risk management: Survey of the current regulatory frameworks adopted by the EEA regulators*, CEBS, August 2007;

see http://www.c-ebs.org/Advice/documents/CfA_8_LiquidityStockTakesurvey.pdf

⁵ *Liquidity risk management of cross-border banking groups in the EU, EU Banking Structures*, European Central Bank, October 2007.

⁶ Piotr Bednarski, Grzegorz Bielicki *Home and Host supervisors' relations from a Host*

centralization of the risk management processes in cross-border groups is not always the optimal solution. Probably, from prudential supervision perspective a balanced combination of certain elements of group policies and methodologies with strong local risk management function ensures greater stability for the subsidiary and the group as a whole. There are arguments why decentralized management is important. Strong risk management at subsidiary level increases the responsibility of the local managers, ensures due to local staff expertise better understanding of the local market better and better position to evaluate local risks. And especially in a crisis situation each subsidiary is self-sufficient while decentralized risk management systems could be less vulnerable in case of operational risk incidents. Systemic subsidiaries, especially those with a high proportion of local retail deposits, might need getting support from the host country in the case of major crisis and thus the level of requirements on the quality or risk mgt have to be sound and comprehensive so to ensure their ability to operate on a standalone basis.

That is why, centralization which is sometimes a name for transfer of risk management to parent company (caused often by cost cutting) might be qualified as outsourcing of core functions. Such centralization is not considered as a good move from local financial stability perspective and might be deemed against law in some countries. For example, in Poland outsourcing of risk management is prohibited by law.

To conclude, while certain banks have preference for more centralized management style, this is not a uniform trend and triggers many doubts from host country perspective. Thus, it is more exception than rule to see centralized treasury function, internal audit or capital planning at group level with absence of such function locally. In Poland, banks have their own treasury function and develop, in cooperation with parent banks, capital plans. The audit and compliance functions are required by law. These functions cooperate with group-wide equivalent functions, often supported by group functions in specialty areas (like IT audit). Therefore, the functions listed by Dirk Schoenmaker are not eliminated but form part of the local processes and controls. Naturally, depending on the size of bank they might be more

supervisor's perspective, in *Cross-border banking. Regulatory challenges*, G. Caprio, D. Evanoff, and G Kaufman (eds), World Scientific, New Jersey 2006.

or less developed or coordinated with the group/wide functions. Also from prudential supervision point of view it is hardly imaginable that Polish banks, especially large, could not have their well developed local treasury function, internal audit or risk management.

3. Do we really need to re-invent European architecture of financial supervision as suggested by both speakers?

There are not enough strong premises to claim that the level of integration of financial system in EU and the level of problems faced today justifies a radical change of current national based supervisory system in EU. Current supervisory architecture is based on clear alignment of powers and responsibilities of sovereign competent authorities. The proposed system of more centralized supervision (like lead or supervisor with extended powers but not responsibilities) does not meet the criterion of proper balance of responsibilities and powers. The current system of banking supervision is also reflection of the accepted level of political integration in EU, with dominant role of sovereign states, leading role of subsidiarity principle, and powers but also responsibilities for banking supervision remaining at sovereign state level with certain coordination role allocated for consolidating supervisor. And justly so if in the EU, unlike in the US, the EU Parliament does not have powers nor the budget to vote bail out package for rescuing failing pan-European banks. It is sovereign states that eventually pay the bill and therefore they should also continue to be equipped with adequate powers to supervise and regulate banks, within common framework of EU directives.

It is worth remember that unlike in case of branches (EU passport with limited role for host supervisor), in the case of foreign subsidiaries of pan-European groups, it is competent authorities in member states that are in charge of supervision and take decisions. This is coupled with the responsibilities – it is the host and not home country that insures deposits, host central bank that is lender of last resort and host country budget that will pay in case of systemic institution rescue operation. Therefore, there is a legal clarity, balanced division of task and responsibilities which new proposals suggesting greater centralization of powers lack.⁷

⁷ See also Piotr Bednarski, Dariusz Starnowski , 2007, *Home and Host supervisors' relations – a Host supervisor's perspective in Rapid Credit Growth in Central and Eastern*

There is though one exception to this principle. It is article 129 of the Directive 2006/48/EC that introduced Basle II in Europe and upcoming, even more centralistic solution in Solvency II Directive. Art. 129 gives additional powers to consolidating supervisors at the loss of host supervisors, in the case of lack of joint decision regarding approval or disapproval of banks' application to use advanced methods for the purpose of calculation of regulatory capital. This exception, which effectiveness needs to be tested in the current process of supervisory colleges dealing with Basle II, puts host supervisors in a position where the final decision is taken by a consolidating supervisor but the consequences are responsibility of host supervisor. However, such exception and risk related to that solutions might be partially be mitigated by pragmatic cooperation between supervisors, mediation process, and other available tools.

In disagreement with the speakers I would say that what is now needed is not overhaul of the current supervisory framework in EU but rather its evolutionary adjustments to the new developments like growing presence of cross-border banks in EU, and blurring distinction between various financial sectors (at different level in different countries). It worth mentioning that such process of gradual adjustment of the current supervisory architecture have been taking place over last few year through:

- a) better harmonization of the EU wide financial legislation due to more stringent implementation of EU Directives
- b) growing convergence of supervisory practices guided by Committee of European Bank Supervisors standards
- c) growing practical cooperation between bank supervisors: bilateral and through so called supervisory colleges, supervisory operational networks, training, staff exchanges, etc.
- d) harmonization of reporting requirements
- e) coordination of model approval process and likely Internal Capital Assessment Process in cross-border groups
- f) development of crisis MOU and practical arrangement for crisis management, crisis simulation, etc.

Europe. Endless Boom or Early Warning, (ed.) Charles Enoch and Inci Otker-Robe, Palgrave Macmillan and IMF.

These new mechanisms should ensure addressing the developments discussed above.

Major change in the balance of powers and responsibilities postulated by both speakers would necessitate complex re-inventing of the whole architecture of banking supervision with the range of difficult questions how and why that would need to be addressed, including the most fundamental who will pay the bill in case of crisis.

4. Is there an inherent conflict between host and home supervisors in case of crisis in cross-border group as suggested in professor Pawlowicz presentation?

There might some elements of difference of perspective between host and home supervisors as regards impact and importance of identified problems in a parent company and its subsidiary in host country.

It is worth noting that foreign subsidiaries being of the key importance for New Member States in Central and Eastern Europe (CEE) might be immaterial for home supervisors and from parent bank perspective. For example, all banking systems in NMS in CEE, in terms of assets, represent less than 70% of one large EU-15 banking group like ING (as of 2005). The whole Polish banking sector is less than 20% of the ING group in terms of assets. In case of large foreign subsidiaries operating in Poland, while many of them are systemic in Poland and their failure would impact negatively the stability of the overall banking system, from the cross-border group perspective they represents just an immaterial fraction of the group assets (e.g. BRE Bank, one of the large Polish banks, represents over 5% of Polish banking system while it is only 1.7% of Commerzbank group to which it belongs, as of 2005).

Being immaterial such subsidiaries tend to receive much less attention from the parent company and home supervisor due to their low impact on group's position. Less attention sometimes translates into less willingness to support subsidiary in host country, or to respond to host supervisors information needs regarding standing of the parent bank. Moreover, such asymmetric relations as between parent bank and its foreign subsidiary or between home and host supervisor might pose a problem in crisis situation.

However, the real challenge might occur when both parent bank and its foreign subsidiary face crisis situation, not necessarily resulting from the

same causes. In such circumstances, bearing in mind past experience of some cross-border banks that did not support financially their foreign subsidiaries (Rijecka Bank in Croatia, BCCI Hong Kong),⁸ there might be considered potential conflict of interest between parent bank and local subsidiary but not necessarily home and host supervisors. In case of Rijecka Banka crisis⁹ in Croatia that posed threat to the overall stability of host banking system (Rijecka banka was the third largest bank in Croatia), it is worth noting that the triple A rated parent bank – Bayerische Landesbank (BLB) was, at the moment of the crisis in Croatia, quite focused on own local problems stemming from its large exposure to Leo Kirsch media empire that eventually failed. In such circumstances the parent bank – BLB – did not play the expected role of responsible owner involved in resolution of crisis in its own subsidiary and ready to inject capital to its ailing subsidiary but walked away selling its 59 percent share in Rijecka Banka back to the Croatian government, for a price of \$1. Being realistic, we need to remember that the decision to inject capital to foreign subsidiary when it suffers from major losses is a business decision of the owner entity who most likely weights pros and cons, including the price of taking on reputation risk in case of walking away from ailing subsidiary. This case illustrates that owner is not always reliable and supervisors should maintain healthy, constructive scepticism towards parent companies. But this example does not necessarily demonstrate that there is direct and inherent conflict between supervisors. Contrary, there might be much smoother resolution of such conflicting situation if there is more active cooperation and information sharing. One of the answers to such challenges is careful monitoring of a parent bank, open lines of communication between supervisors, having contingency plan in case of lack of support from parent company, and applying stand-alone principle where the local systemic bank should have all necessary core functions (audit, risk management, infrastructure) and solid risk mgt processes and liquidity to maximize possibility of survival in case of problems in the group. Crisis situation of that nature require well developed infrastructure

⁸ *The globalization of financial institutions and its implication for financial stability* in IMF Global Fin Stab Report 2007 *The globalization of financial institutions and its implication for financial stability*, Washington DC 2007.

⁹ *Rogue trader, rogue parent*, The Economist, September 12, 2002.

of dealing with problem banks in host country when in the case of absence of support from parent bank, host supervisors (together with other safety net institutions like central bank and deposit insurance institution) could effectively organize private sector solution of takeover by another bank or some other mechanisms (like bridge bank, re-nationalisation and then privatisation).

5. Last issue concerns the question who should pay for the crisis or the question of burden sharing

I would agree with both speakers that before we start to discuss the key to burden sharing it is worth to discuss overall principles. I completely agree with Dirk Schoenmaker when he quotes the basic principle of public life 'he who pays the piper calls the tune'. If a given country is going to participate in the potential costs of the problem bank resolution it needs to have all necessary legal powers before it takes full responsibility, including potential bill to its Ministry of Finance for the rescuing of systemic bank. These powers, especially banking supervision powers, are necessary to ensure pro-active supervision aimed at, in a preventive way, safety and soundness of banks.

Certain attempts might be observed in EU today to move such powers and instruments to consolidating or group/lead supervisor which might mean dismantling of the current carefully balanced EU supervisory architecture without simultaneous transfer of all financial obligations correlated with powers. Such attempts seem to be hardly unacceptable.

If we deal with cross-border crisis, the authors propose to assume that financial stability is a common good that needs to be protected. As a consequence, all countries should strive to protect this good by contributing, in times of crisis, to timely and smooth crisis resolution in case of cross-border institution operating in their jurisdiction. The idea is quite plausible and sounds attractive up to a point.

It is right to say that financial stability is a common good. On the other hand, it is also true that there are also other competing public goods that need to be considered when we talk about distribution of public money. For example, such values like balanced public deficit or reasonable public spending that are one of the drivers of sustainable growth. Such goods might be affected in the case of the state intervention, especially when host state is expected to contribute substantial amounts in situation when

crisis is not affecting local subsidiary and the crisis concerns other parts of cross-border group. The question emerges why the host country taxpayers should contribute to bail out operation affecting that part of the group that operate outside host country.

It is worth noting in this context that relation between subsidiary and parent bank is not reciprocal or symmetrical. While parent bank, as an owner of local subsidiary, has a clear obligation to support financially its local subsidiary in host country in case of liquidity or solvency crisis, the local subsidiary nor the host country government does not have such obligation. Parent bank exercising predominant impact on subsidiary bank through nomination of the local management, influencing strategic direction and risk appetite of subsidiary through the decisions of supervisory board, benefiting from dividends is also obliged to stand behind its subsidiary in case of crisis. Host country nor local subsidiary of foreign bank do not have usually any impact of policies and incentives of parent bank nor home country. If a parent bank (owner) is not ready or able to meet its obligations towards subsidiary facing major liquidity or solvency problems, host country authorities, there are legal instruments allowing to appoint administrator or eventually sell the ailing bank to another investor.

I agree that it would be nice to have a special fund financed by private sector that would foster private sector solutions in form of a resolution or guarantee fund for dealing with crisis in cross-border institutions. Nevertheless, I believe that creation of such fund might face numerous practical problems, especially if the contributions are ex ante and involving several banks operating in various jurisdictions. Positive examples of such initiatives are very few (LTCM resolution or more recent fund established by leading US banks to deal with subprime crisis) though they might give some hope.

I find problematic the expectation expressed by both speakers that host countries should contribute to rescue operation even if subsidiaries in those countries were unaffected by group crisis directly (though reputation risk always is involved especially with the same brand). Profesor Pawlowicz speaks about the participation in fiscal costs (burden sharing) of the host country based on the potential consequences for the subsidiaries and market in the host country. He also explains that the host country should contribute in relation to its obligations (liabilities?) to some form of solidarity fund

following pre-established key of contributions (GDP or other) and aimed at maintaining stability. I agree that the criterion of potential consequences is quite fair compared with a rigid key like GDP in deciding the amount of contribution. On the other hand, I would agree with Dirk Schoenmaker, who notes that ex post criteria, especially as assessment of potential crisis consequences, are most likely to be ineffective.

The general objections can be also raised from the point of view of structure of incentives. What if a parent bank or sister bank abroad incurred substantial losses that can be explained by particular circumstances in home country. Such situation might happen due to specific incentives of a particular government, for example encouraging or not counteracting excessive policy of loan accessibility to everyone without due attention to credit his or her capacity or accepting more relaxed rules on investing or lending, or not intervening in case of banks taking on very aggressive lending or investment policies in the search for extra profits correlated with excessive risks (investing in complex and risky structured products). Therefore, the question can be posed why then another separate legal entity in the group and host country should bear the costs of such decision (or misbehaviour) taken in another country. Will host country taxpayers accept the idea of taking fiscal costs in the case when neither host country supervisors nor local subsidiary had any impact of the principles applied in other country or behaviour of the parent bank or its foreign subsidiaries. Expectation of a financial contribution by host country to crisis resolution of another part of the group in such circumstances creates bad incentive. No matter how well the host country system of regulation and supervision is organized and no matter how effective are local policies enforcing creation of right incentives for banks (sometimes curbing appetite for potential high but risky profits in efforts to protect depositors and then being subjected to criticism), in case of problems of parent bank or a group, host country needs to participate in costs of rescue operation. Such incentive structure does not motivate to exercise a truly vigilant, and strong supervision as at the end of the day host country would need to pay.

There are a number of other issues that emerge in case of a dealing with state intervention like that which happened in the past (Credit Lyonnais, Bankgesellschaft Berlin and recently Northern Rock). One of them is the

question of EU rules on state aid and conditions established by EU Competition authorities as result response to such aid.

To conclude – burden sharing might be an important idea but seems to be a bit misleading concept. In a way it is against the rule ‘he who pays the piper calls the tune’. It seems also to neglect well established in practice and laws responsibilities from different role played by financial institutions (e.g. obligation of parent company to support its subsidiary), might create wrong incentive structure if not properly designed.