Banking sector consolidation tendencies within EU NMS and new risks

Presented by

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Contents

- ***Different background and structure of financial intermediation - NMS legal environment (especially corporate governance) and foreign investors´ adjustment***
- ***New risks, More visible Regulatory risk***
- ***New Czech and NMS tendencies responding to the emerging EU standards***

Typical NMS Features

- Economic Transition
- High level of financial intermediation in the NMS especially via banks (Bank dependent economy)
- At the beginning: Liberal licensing policy in financial sector, weak legal system and passive financial regulation and supervision

Typical features of New EU Member states (NMS) (1)

- Typical financial sector had to cope with *problems of an economic transition*: i) *in general terms* - weak legal framework of market environment resulting in poor corporate governance with volatile enterprise-client's sector, especially large number of risky either new or gradually transformed privatized enterprises, ii) *in specific terms* - inexperienced staff and *gradually evolving internal institutional set-up, liberal licensing policy* (in CR issued were 59 bank licenses, over 450 investment or mutual fund licenses and 44 pension fund licenses) *and regulation and supervision which was accommodating in the case of banks and absent in the case of non-bank financial institutions.*. In a demonstration of *regulatory risk*, bank supervisors contributed to misguided bank asset allocation and subsequent unnecessary losses by their simplified application of BASEL I capital adequacy regulatory ratios (flat 20 % risk weights for credits to any OECD member country bank including weak domestic banks) . Banking sector was dominated by a few large financial groups led by state-controlled banks surrounded by subsidiaries, combining both creditors´ and shareholders´ roles in a post-coupon privatization enterprise world. Banks´ management, appointed and supervised by government/politicians, were inevitably led by the ambivalent goals (*bank efficiency versus transition growth, nation/region wide vested political interests with underlying implicit contract between the banks and politicians*) and behaved less aggressively and autonomously than required by the principles of prudential banking. The true risk profiles of their asset portfolios therefore diverged from reported ones[1].

[1] See this aspect on government ownership of banks discussed by Bhattacharya (2002), LaPorta,D-Shleif(2001), Barth,Caprio,Levine(2000, 2001), Kudrna (2002) and Kudrna, Mejstřík et al.(2002) at the banking conference.

Typical features of NMS (2)

- iii) Drawing on a previous paper (Mejstřík 1999), lessons are derived from the aftermath of the Czech-biased, bivalent form ("all-or-nothing" form[1]) of corporate governance, which has influenced the emerging Czech financial sector. In conditions of the inevitable uncertainties of transition period and information asymmetry between lenders or investors and borrowers, moral hazard and adverse selection have led to temptations to corruption, bank fraud, dishonesty, resulting in a violation of principles of prudential banking resulting, huge credit risks and high amount of classified loans. That tendency was well-represented by privatization buyouts based on bank loans, where ownership transfers after coupon privatization were enabled by credit, primarily preferably for related clients ("related lending"). Instead of enforcing discipline of largest debtors and pushing towards restructuring, banks became their captives and inevitably opened up a provision gap by granting those debtors further loans regardless of risks. Thus the idealized role of large banks and their investment funds as efficient monitors did not fully materialize and the banks led by prevailing incentive schemes often failed to monitor and enforce debt contracts and eliminate non-viable enterprises.

[1] Large shareholder acts as the only shareholder (partially concentrated ownership is confused with fully concentrated ownership) and controls the statutory boards, dividend payments and even cash flow… [1]

Corporate Governance Models

Anglo-Saxonian approach

Problems:

right to vote limited

high transaction costs

very low liquidity

Single owner

Problems:

limited information

low transparency to business partners

Stakeholder model

Limited in the CR: ex. Sale of blocking minority of local distribut. companies to municipalities

Problems:

Unefficient governance

Loss of interest

“Czech“ transition model

0 or 1 approach: large shareholder behaving as single owner

Problems:

Disadvantageous contracts

“tunnelling“

Typical features of NMS (3)

- iv) Banking cross-ownerships, (sometimes originating in coupon privatization), gave rise to the strengthening role of financial groups´ management and to the *emergence of opaque financial groups,* widely distributing unmanaged financial risks and ownership shareholdings into incestuous groups of subsidiaries and sister companies. *Risks and managers* were thus artificially *entrenched* within these groups. The ad hoc fledgling financial supervision on unconsolidated basis could have had very limited effect.
- Bank policies helped to survive to number of start-ups and viable transformed enterprises but also kept alive number of non-competitive players. Some of the incestuous groups had, however, ended under the twin attacks of recession and tightened fiscal and monetary policies (in CR 1997 – 1999). Improper *law and enforcement* had been gradually improved and poor performance of non-competitive large industrial customers had been disclosed and resulted in their bankruptcies. Large domestic *banks* started to act *more prudentially,* squeezed unwarranted new credits – as newly defined by the regulator - to more standard risk level while many smaller bank went bust in spite of various ad hoc governments bailouts. *Institutional adjustments* were brought on by a *credit crunch* of banks. *Increased money supply* in the economy *was due to FDI inflows, activities of foreign banks and also* by (better secured*) leasing*. However, foreign investors responded to weak legal institutions by *limitations of* elsewhere *abundant foreign portfolio investments to FDI*. [1]

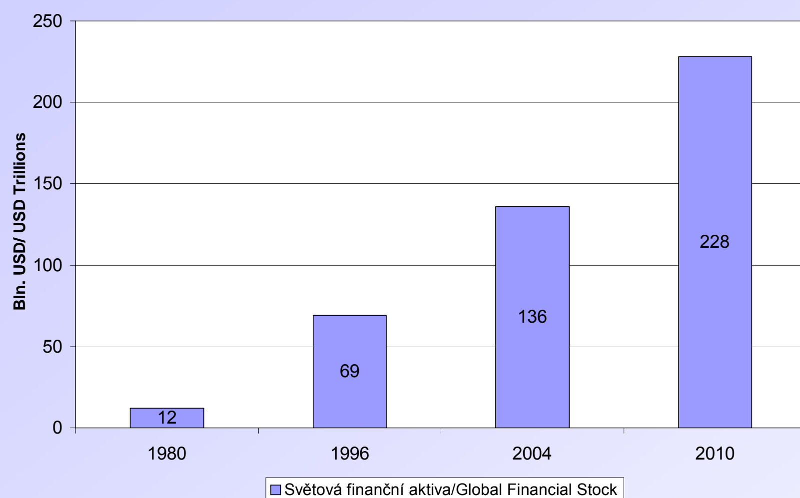
Trends in World Financial Sector (1/3)

1. The global market is enormous with $136 trillion in 2004 and $228 trillion is expected in 2010;
2. The US, the UK, the Euro zone and Japan account more that 80% of global markets;
3. The financial market assets are growing faster than the global GDP, indicating that financial markets are becoming deeper and more liquid;
4. The growth of financial markets is spurred by a rapid hike of private and government debt.

Source: McKinsey (2006)

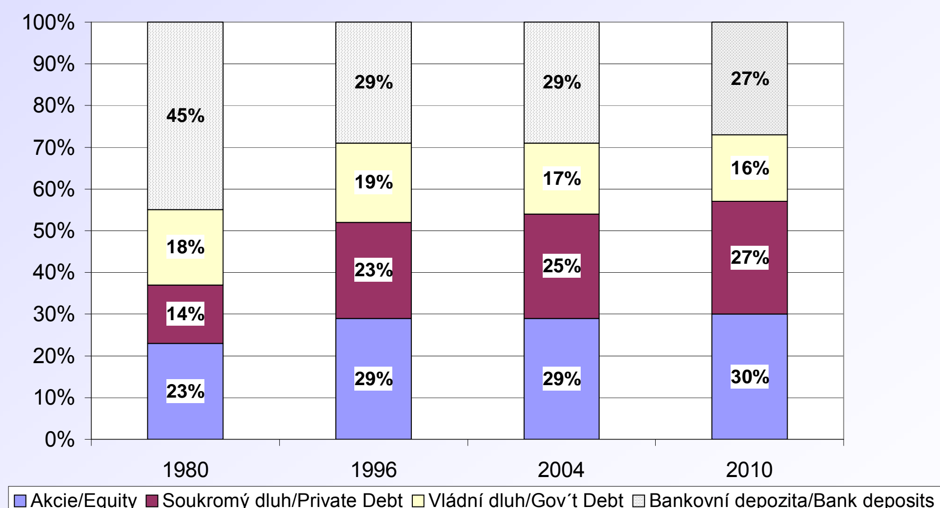
Trends in World Financial Sector (2/3)

The Global Financial Stock Development (1980-2010)



Source: McKinsey (2006)

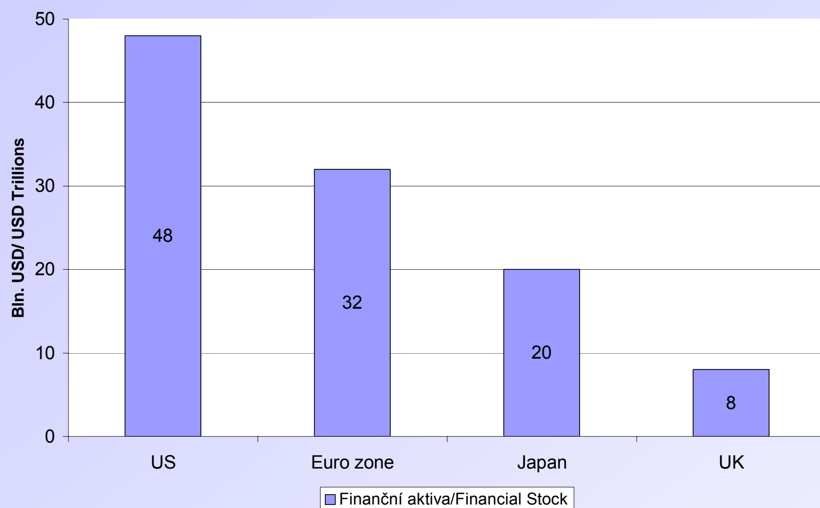
Composition of The Global Financial Stock (1980-2010)



Source: McKinsey (2006)

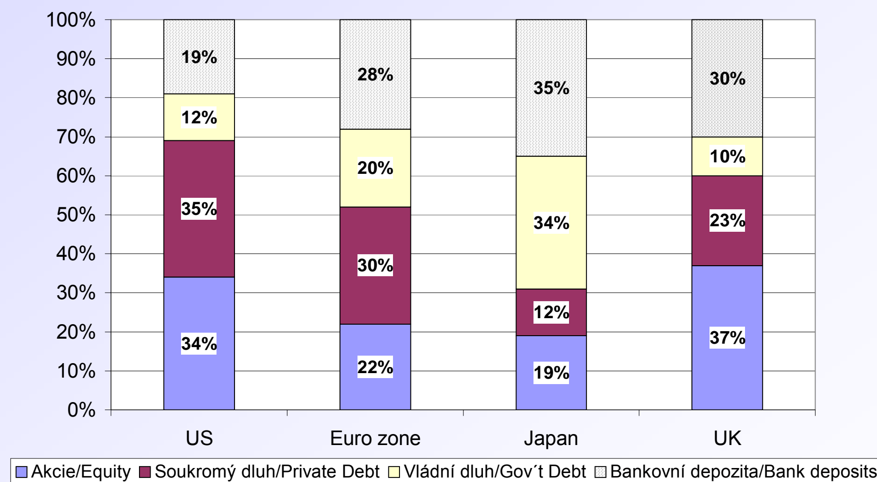
Trends in World Financial Sector (3/3)

The Regional Financial Stock (2004)



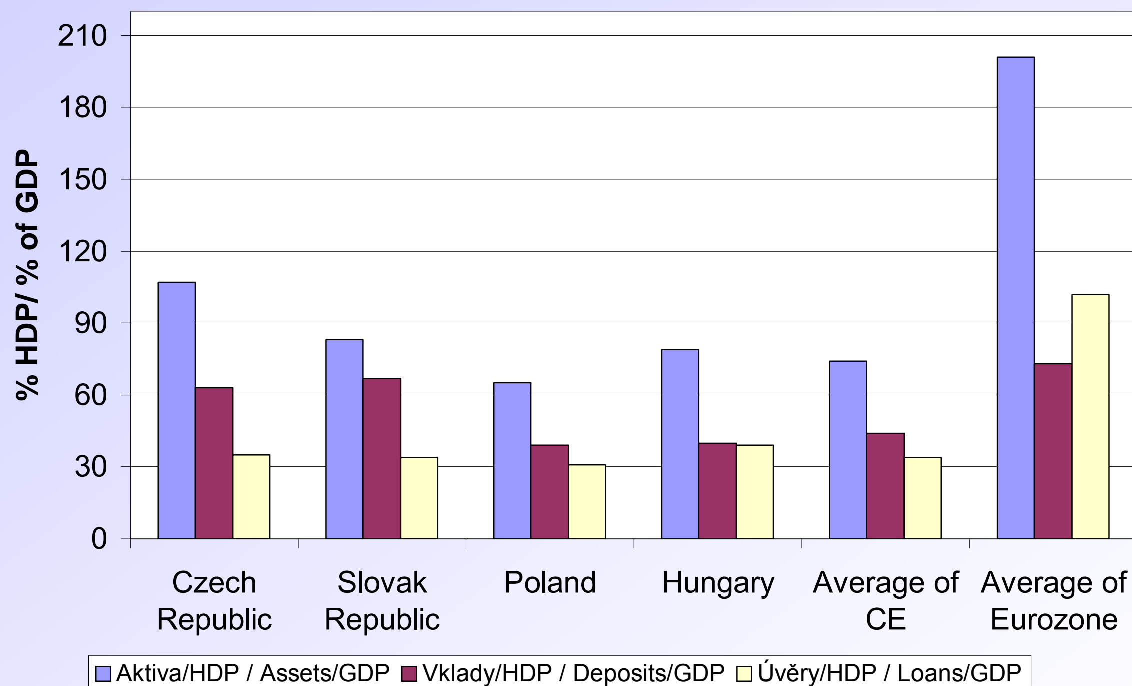
Source: McKinsey (2006)

Regional Composition of The Global Financial Stock (2004)



Source: McKinsey (2006)

Financial Intermediation in Central European Europe

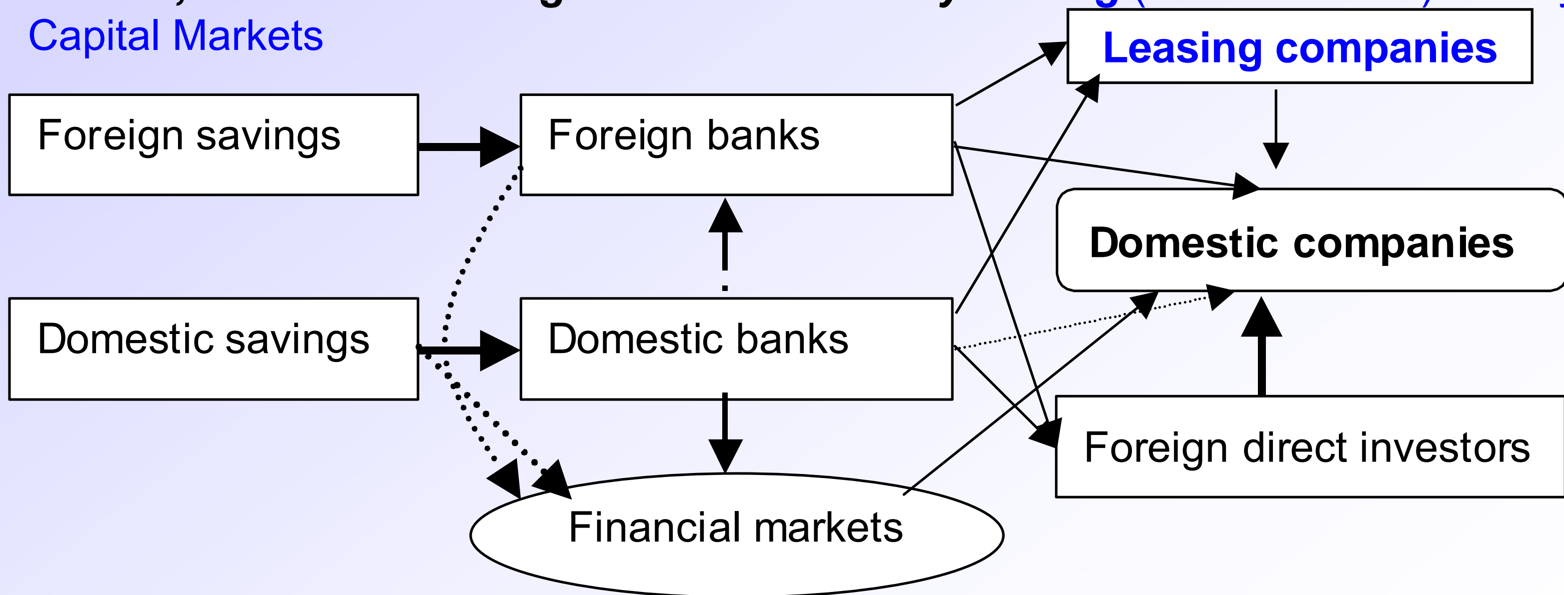


Source: Ness Europe (2005)

Credit Crunch and Institutional Adjustment of Monetary Transmission

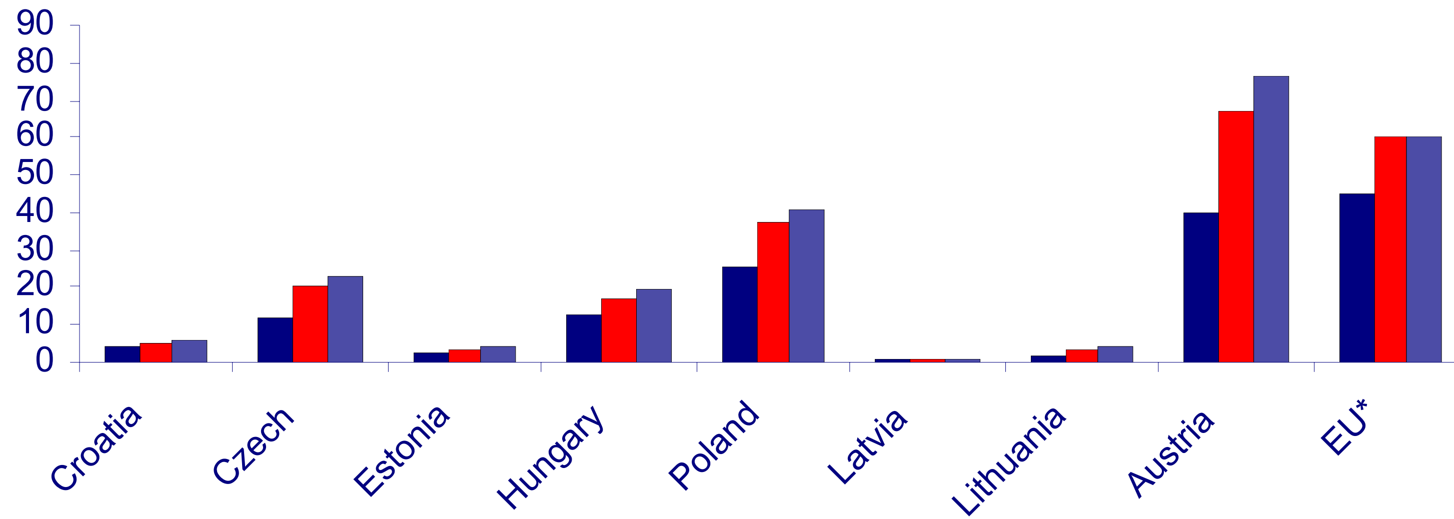
- Large ***domestic banks more prudential***, squeezed new credits given regulators terms

- The ***increased money supply*** in the economy was contributed both ***by the FDI inflows, activities of foreign banks*** and also ***by leasing*** (better secured) less by Capital Markets



SIZE OF EQUITY (and debt) MARKETS still SMALL...

Market cap. In USD bn	2002	2003	Q1 2004
Croatia	4	5	6
Czech	12	20	23
Estonia	2	4	4
Hungary	13	17	20
Poland	25	37	41
Latvia	0	1	1
Lithuania	2	3	4
Austria	40	67	77
EU	4.500	6.000	6.100



Source : Steinbichler(2004)

Banking sector intermediation development – so far the most important financial channel

Banking sector assets in the Czech Republic and selected countries as a percentage of GDP

	1999	2000	2001	2002
Czech Republic [1)]	111,0	113,6	114,9	110,0
Hungary	68,6	68,1	68,4	68,3
Poland	59,2	60,4	63,0	62,6
Slovakia	94,4	95,5	96,3	85,5
Slovenia	75,7	81,4	94,2	87,2
Euro area weighted average	245,0	251,0	258,0	257,0

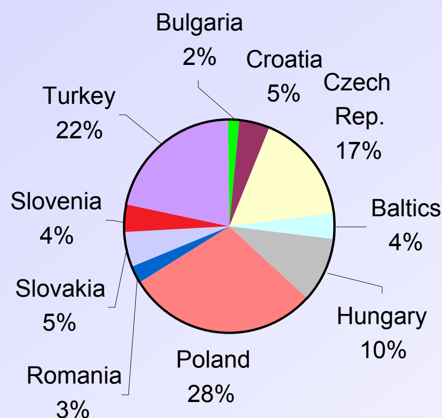
1) Excluding Konsolidační banka and banks in conservatorship

Source: ECB, CEC5

SIZE AND DEPTH – banking sectors very concentrated with fringe

bln Euro **2002**	PL	TK	CZ	HU	SK	HR	SL	RO	BG	NE(12)	EU
Market size											
GDP	199	192	74	70	25	24	23	48	17	702	9,161
Population (mln)	38.6	70.2	10.3	10.1	5.4	4.4	2.0	21.7	7.9	178	377
per capita GDP	5,167	2,731	7,173	6,884	4,673	5,411	11,717	2,232	2,098	3,950	24,300
Banking sector											
Total Assets	138.5	106	81.7	49.1	24.5	22.1	20.0	13.6	7.9	481	24,702
Total Loans	60.8	18.1	28.3	22.5	8.5	13.0	12.0	5.1	3.3	181	9,331
Total Deposits	69.1	72.1	49.7	27.5	18.6	14.2	9.2	9.3	5.3	283	11,148
Tot Assets /GDP %	72	67	113	68	95	94	87	32	48	68	270
Tot Loans/GDP %	32	12	39	31	33	55	52	12	20	26	102
Tot Deposits/GDP %	36	45	69	38	72	60	40	22	32	40	122

NE(12) Total Assets by country, 2002



Source: New Europe Research Network, Cenral banks, ECB

Note: for definitions of variables see notes (1) Source Steibichler (2004)

Many NMS are characterised by a large number of very small institutions with assets below €0.5 billion (see Chart 10). In total, the NMS count 1,033 credit institutions, 32 less than in 2002, with total assets of around €350 billion. By EU-15 standards,[12] banks in NMS are generally "small" in terms of asset size. The main category in terms of size is composed of institutions between €1 and €10 billion (see Chart 11). Only in CZ, HU, and PL are there a few larger institutions with assets between €10 and €20 billion.

Looking at market shares, Chart 12 shows that the top 5 players account for more than 80% of banking sector assets in EE, CY, MT and LT. The market share of top-5 players (CR-5) is the lowest in HU and PL at around 52%. However, the latter still equals the average CR-5 in the EU-15, which shows that NMS banking markets are very concentrated.

Four countries characterise their banking sector as having a medium level of competition in the

11 In EE, LT and MT, no banks are state-owned. With the exception of PL (24%) and SI (19%), state ownership is below 5% in other NMS.

12 See *Banking stability in the EU*, ECB, November 2003, where large banks are defined as having total assets over €120 billion.

FDI inflow- important financial channel

The CEE and especially Czech Republic has attracted one of the highest FDI inflows relative to GDP among the emerging countries in 2000-2002 with FDI exceeding 8% of GDP

Year	FDI into CZ (USD m)	% of GDP	FDI into CEE countries per capita in USD			
			Czech	Hungary	Poland	Slovenia
1997	1 300	2,4	126	214	127	189
1998	3 718	6,0	361	202	165	125
1999	6 324	11,6	615	196	188	91
2000	4 986	9,7	484	170	233	91
2001	5 641	9,9	545	n/a	n/a	n/a
2002	Est 9305	12.2	902	n/a	n/a	n/a
1990-2002 cumulated FDI per capita			3788	3047	1178	2504

Source: Czech National Bank (CNB) web page (until 1997 data included FDI in equity capital, starting from 1998 data on reinvested earnings and other capital have been included in FDI flows) and WIIW Vienna for per capita comparative data estimates

FDI financial channel –profit reinvestment now, profit repatriation in the future ?

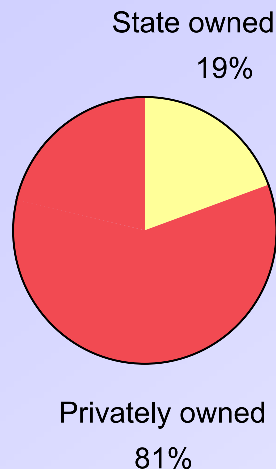
At the end of 2002 Czech overall FDI volume of FDI (equity capital including CNB data on reinvested earnings and credit relations with foreign investors) totaled USD 36.5 billion out of which 71,6% represented accumulated equity capital, **17.3% reinvested earnings** and 11,1% other capital included into FDI flows.

Foreign controlled companies (with average profitability higher than industrial average) financed important part of their development from retained earnings (over USD 6.3 billion in just 5 years, and 2.7 billion just in 2002) rather than paying them out through dividends. Also other contributions to the Mejstrik(2003) confirm growing importance of retained earnings in financing companies with sufficiently high return on equity as this channel represents efficient capital reinvestment. In order to optimize weighted average cost of capital, reasonable debt instruments are, however, irreplaceable so far

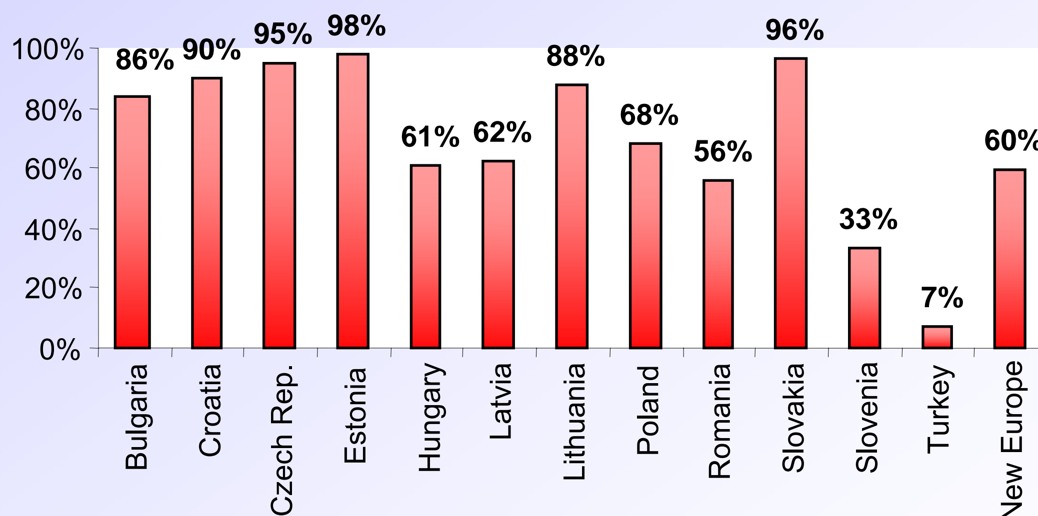
2003 – economic problems in WE markets (demand and parents) – repatriation of profits via dividends – over 0,5 bil USD – FDI inflow and ouflow getting closer and financial and capital account not exceeding sufficiently trade balance deficits

Due to a fast and effective RESTRUCTURING PROCESS, the MAJORITY of banking assets privatized by international financial groups (Cross-border !) controlling around 60% of banking assets in 2002 in contrast to still prevailing avoidance of cross-border deals within the most of EU-15

NE(12) Total assets by ownership, 2002



Market share foreign owned banks (assets), 2002*



- Foreign ownership has been basis for restructuring and transformation of the competitive environment. Still some market restructuring expected as privatisation ends and given further consolidation
- In Turkey HSBC and UCI entered the market in 2002, being among the first large FDIs in the local banking sector

Source: New Europe Research Network Steinbichler(2004) and ECB (2004).

*For details see note (1)

Consolidation of Corporate Governance within Financial and Industrial Sector

- ***M&A with other domestic companies*** – usually ST=one-off game based on contract. incompleteness, a lack of domestic capital, unacceptable risks (IPFs)

- Better ***legislation and enforcement*** *Additional costs of bank regulation and supervision* vs. ***State subsidy***: usually moral hazard and inefficient, but large bank's pre-privatization clean-up ? *State konsolidacni agency owns the majority of non-performing loans. Sales of those assets in selected packages on the market or debt-to-equity swap*

- ***Acquisition by foreign owners*** : repeated LT game - if present value of future business attractive (such as pension funds, insurance, Škoda Auto, cleaned banks) New contractual architecture from inside international corporate standards. But not always positive (inadequate investor, market change) and gradual erosion if not supported by the improvement of weak local contracts.

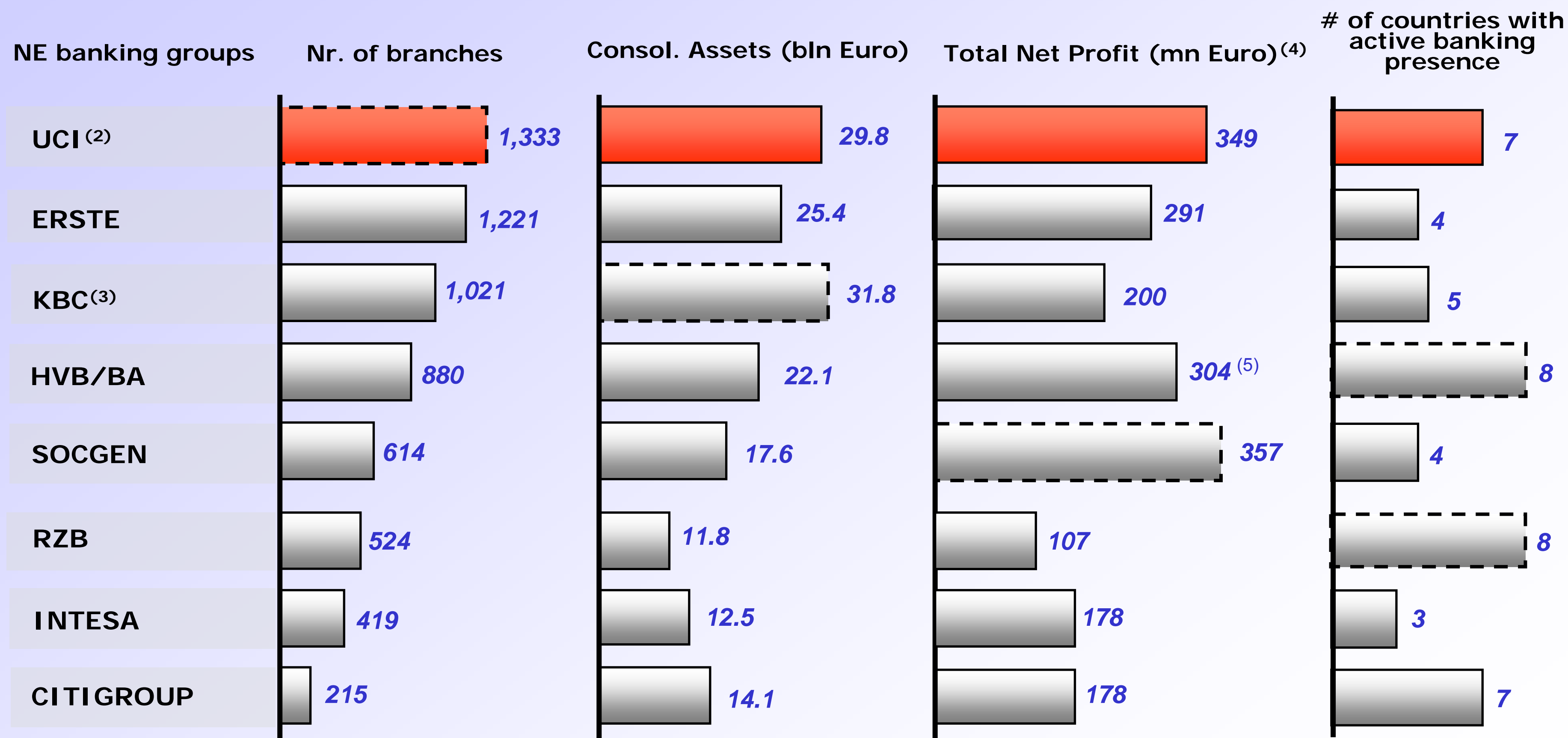
Post-privatization phase in the banking sector: Towards the Integration

Risk-adjusted profit orientation and new contractual corporate architecture and procedures *subject to international competitive standards are at place and should not be taken lightly.* ***Post-privatization performance of the banking sector in post-privatization bank-dependent economy as measured by profitability and prudential indicators seems to be reasonable (contributed also by cleaned-up assets and relevant provisions´ release), with a huge growth potential for bank disintermediation and competition by collective investment and insurance vehicles.*** *The analysis of the development of a new institutional framework in the banking sector indicates to what extent the inherent risks are covered. For situation in NMS see ECB Report on EU banking structure 2004.*

- ***Ownership transformation and consolidation mostly into hands of foreign strategic investors*** contributed to the ***consolidation of bank's corporate governance incorporating standard internal management procedures oriented towards value maximization under uncertainty and risks*** internalizing policies such as:

i) prudential policy including stricter credit policy,

New Europe (area of NMS) is one of few regions in the world with significant competition among CROSS -BORDER commercial banking groups. EU different… Just a few players – regional consolidators will be acquired themselves ?



(1) 100% of total assets and profit after tax for controlled Companies (stake > 50%) and share owned for non controlled companies (I.e. 50% Koc)
(2) Including Koç FS and Zivnobanka without HVB (3) Including Nova Ljubljanska Banka (4) After tax, before minority interest; (5) HVB only pre-tax data available

Source: UCI Economic Research Steinbichler(2004)

Post-privatization phase in the NMS banking sector: Towards the Integration (cont.)

ii) new up-to date products and services (mainly direct and internet banking) compatible with parent banks and EU environment,

iii) increased efficiency incl. gradual lay-offs and cost saving,

iv) standard ROE and investments inc. new EU compatible software,

v) internal controlling and audit complemented by supervision from the parent company located mostly within EU or other OECD country

Challenges:

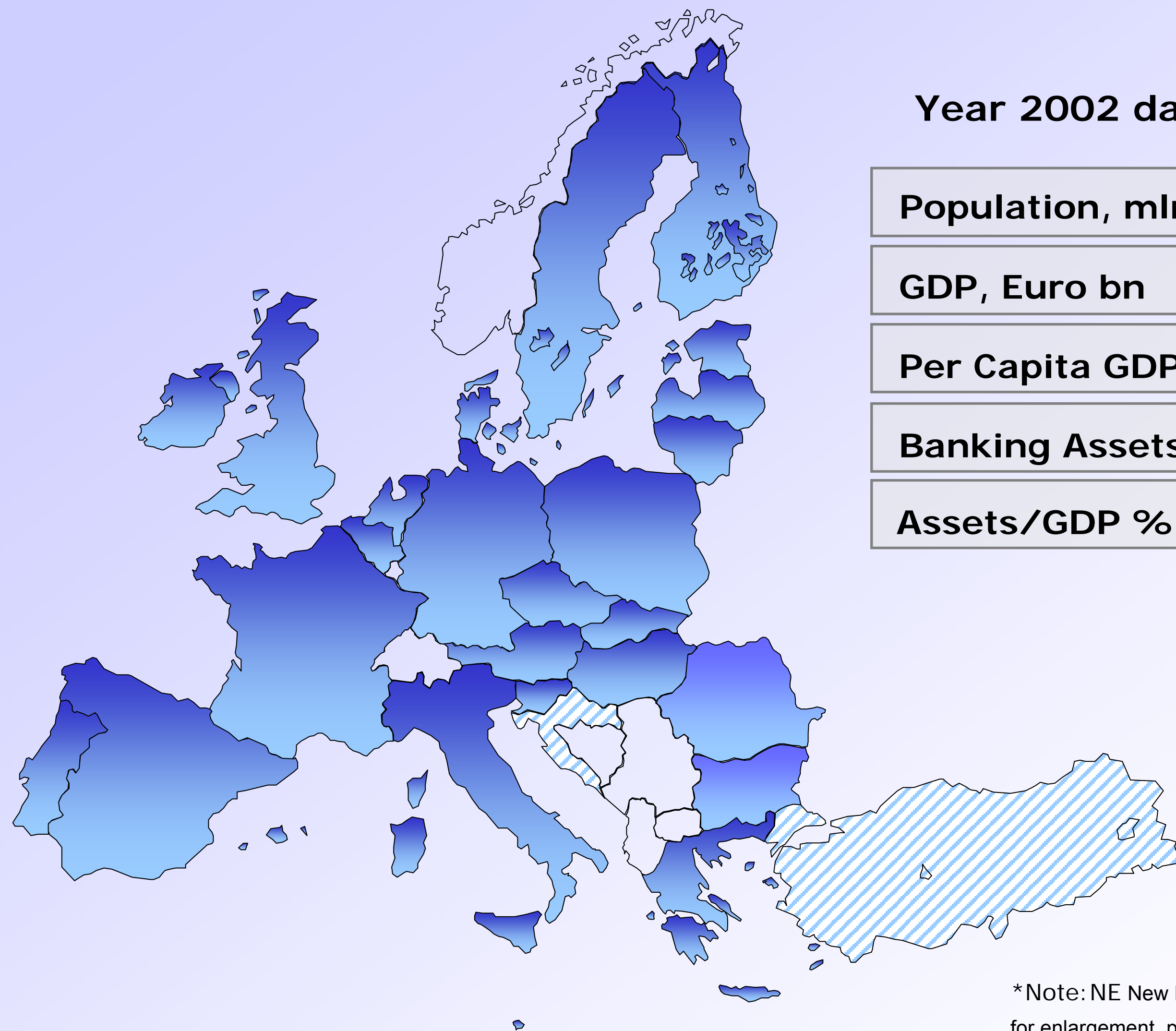
- **NMS banks and other fin. intermediaries will join highly competitive EU market that will test their competitiveness in the long term. Those markets are full of volatility and new risks and the success for all is not guaranteed.**

- **New acquisitions of current foreign owners of banks can happen overnight due to the ongoing consolidation within EU with the goal to utilize sector's potential economies of scale and scope**

Euro, Lamfalussy report and EU Financial Services Action Plan (FSAP): Incentives to reshape the bank-dependent financial intermediation towards the Anglo-American structure

- ***So far, EU markets are segmented at the different extent: the EU Treaty and EU directives are not enough to attain a single market in financial services: securities regulation is intrinsically protectionist, even when it is not discriminatory***
- **The Lamfalussy Report;**
- **EU FASP ,**
- **IMF and WB Financial Sector Assessment Program (FSAP) of the CR 2000 - 2001;**

The „NEW EU MARKET” Economic and banking SHAPE



Year 2002 data	EU	NE(12)*	Total
Population, mln	377	178	555
GDP, Euro bn	9,161	702	9,863
Per Capita GDP, Euro	24,300	3,950	17,771
Banking Assets, Euro bn	24,702	481	25,183
Assets/GDP %	270%	68%	255%

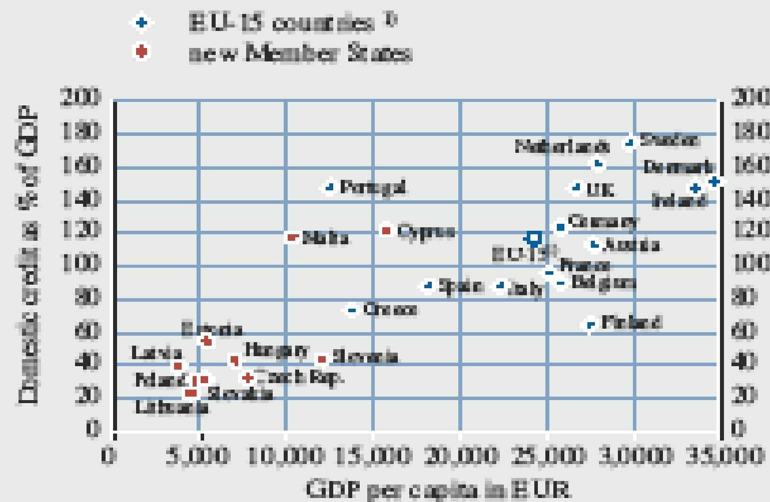
- 50% of current EU population (29% without Turkey) 8% of GDP
- only 2% of banking assets

Source : Steinbichler(2004)

*Note: NE New Europe – NE(12) definition includes all CEE andidates for enlargement, plus Croatia and Turkey, excluding Cyprus and Malta

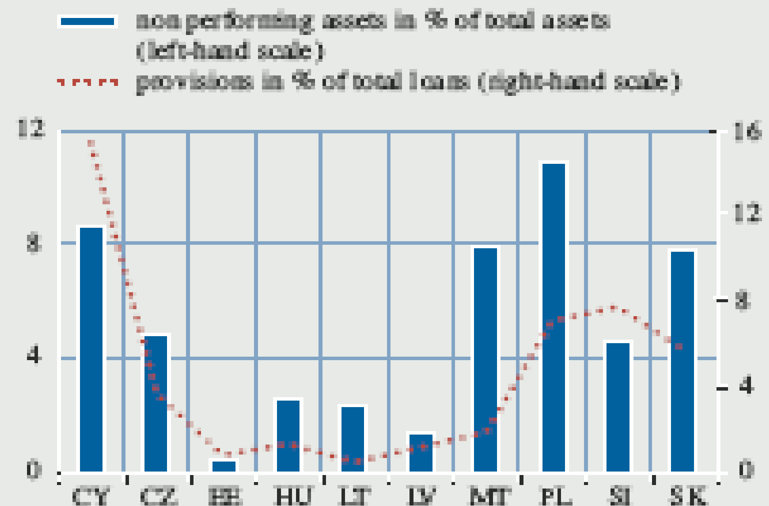
ECB 2004: Existing credit, market risks control improved by NMS banks

Chart 14 Financial versus economic development in 2003: Bank credit versus GDP per capita



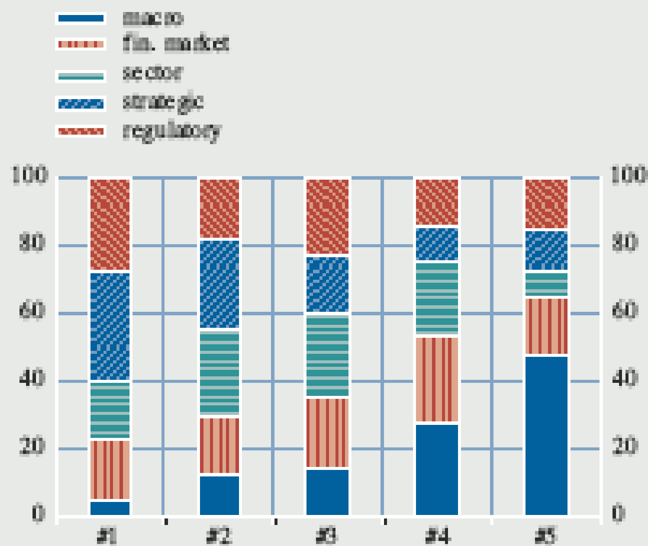
Sources: European Commission and IMF.
1) Excluding Luxembourg.

Chart 15 NPL and LLP in 2003

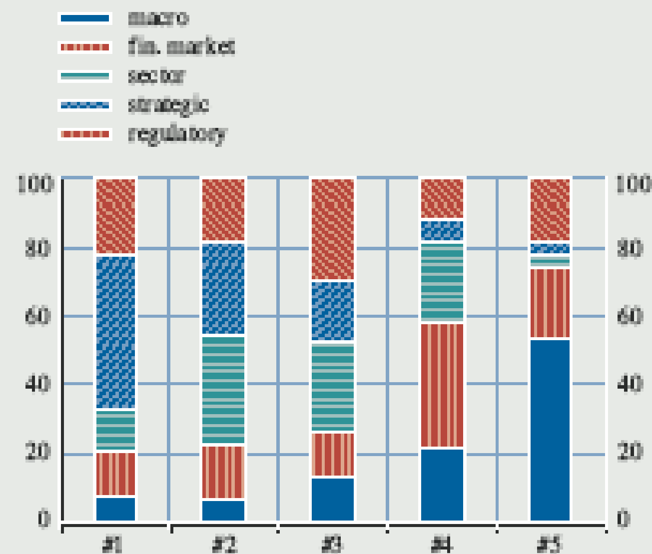


Source: ECB.
Note: See note to Chart 10.

ECB survey on sources of risk in EU 25 – different view of EU-15 and NMS



Source: ECB.
Note: The chart shows the distribution of the broad sources of risks by respondent banks, expressed as a percentage of all answers for each score, ranging from 1 (very low importance) to 5 (very high importance).



Source: ECB.
Note: See Chart 18.

Financial supervision and regulation

New trends:

- ***harmonization*** with the ***EU directives and Basel II – new capital adequacy rules, draft of Capital market undertakings Act, draft of Act on Collective Investment, Act on Bonds, Act on CNB and Act on Banks 5/2002***

- obligatory ownership disclosure and supervision on a consolidated basis

- new obligatory internal rules and procedures along the international standards including rules on capital adequacy and exposure, provision creating

- accounting in financial institutions in line with international accounting standards (IAS)

- Rules on development of ***true market structure***

Challenges:

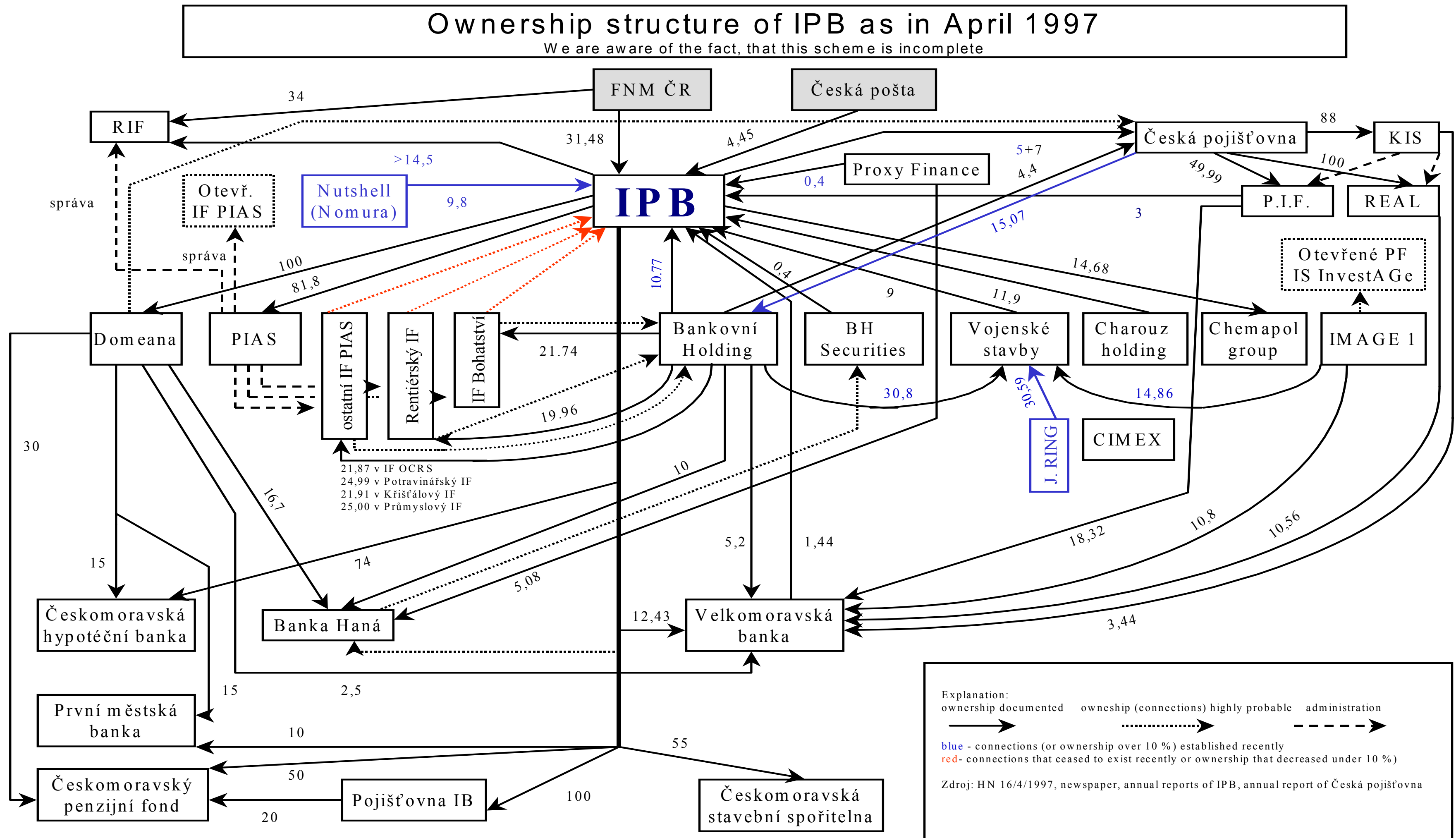
- improvement of co-operation among different supervisory bodies on both domestic (KCP, MoF) and international fields within EU, BIS

- further harmonization and up-dating on the basis on market development

- staff education and stabilization

Emergence of Opaque Financial Groups **Ad Hoc**

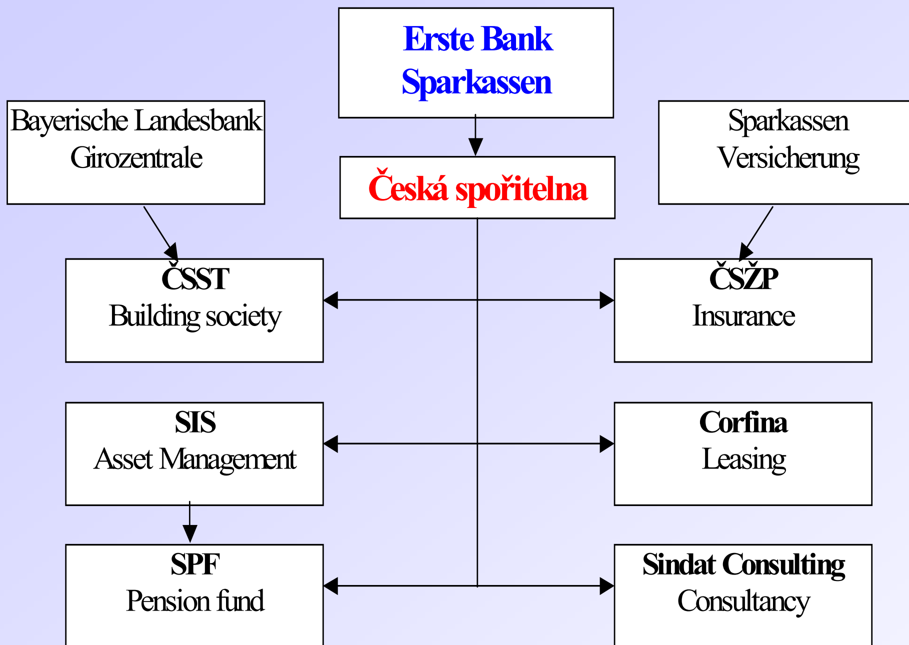
Supervision on unconsolidated basis



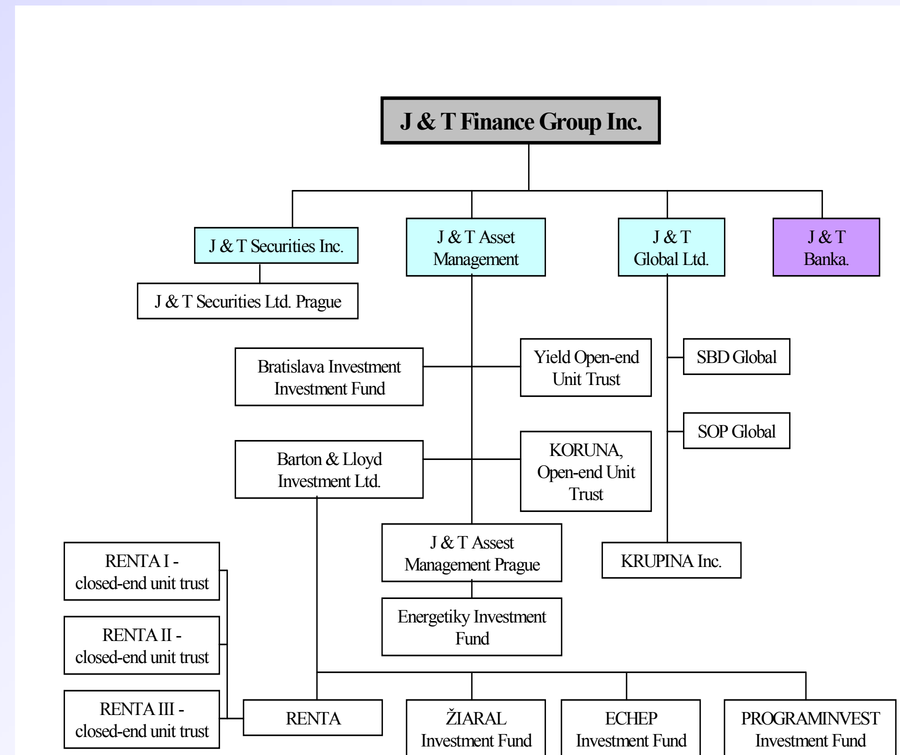
Source: Chmelik, 1997

Supervision on consolidated basis

Until recently only for banking holdings in the CR (financial or mixed holdings supervisory legislation introduced by Act on Banks since May 2002)



triple supervision…



…partial supervision with coordination of supervisors

Regulatory risk in banking (1)

- The completion of bank privatization was a necessary but not sufficient condition to increase (profit-maximizing) incentive for improvement of financial services provided by lenders at the request of borrowers. Another elementary prerequisite represents gradually growing efficiency of bankruptcy procedures forcing intermediaries to enforce repayment of debt contracts (or relevant foreclosures or, at the least, their conversion into equity), limiting the unmanaged increase of asset risk.
- Last but not least, another prerequisite is *an up-to-date structure of financial regulation and supervision that should mitigate the occurrence of market failures in reasonable way not misdirecting or even blocking the bussines activity* – see concern of EIU (2005) and Better Regulation Task Force (2005) .
- In our text we have already mentioned the notion of *regulatory risk* arising from a regulatory failure, (e.g. from simplified BCA/BASEL I application of flat risk weights for banks) with an unintended negative impact on the regulated entity (*provided incentive for banks to engage in excessive risk-taking or moral hazard behaviour*, such as when misallocation of assets of Česká spořitelna in the first half of 1990´s on the interbank market without respect to the rating of the borrowing banks contributed to emergence of loss loans). The related impact can imply both real unintended costs of regulation and opportunity costs (*too restrictive regulation can provide incentive for banks to engage in excessive risk-averse behaviour* contributing to loss of risk-adjusted profit from missed loan granting opportunities).

Regulatory risk in banking (2)

- Bhattacharya, Patel (2002) suggests that public banks under the conditions of Indian environment are also subject to *hysteresis of government involvement* that oscillates within systematic bias from good times ("there is little incentive for the government to change the status quo") to bad times ("due to deepening financial distress the government institutes measures that increase its involvement") and this hysteresis "in turn is the basis of the *cascading moral hazard*, which is driving mechanism for the switch of the leverage coefficient from an accelerator to a decelerator" and "already low levels of notional co-financing are made even more ineffective". Here, adopting traditional so-called "best practices" in management and supervision transferred from developed countries does not bring required results and the above described situation can be described as government/regulatory failure.

New trends and problems in supervision and regulation (1)

- We still consider the *regulatory institutions* as an important component in market-based financial sector activity but in the form of *up-to-date design*. Thorough international research based upon World Bank database on bank regulation and supervision in 107 countries assessed different governmental approaches to bank regulation and supervision and tried to evaluate the efficiency of specific regulatory and supervisory policies[1]. "The results raised a cautionary flag regarding reform strategies that place excessive reliance on country's adhering to an extensive checklist of regulatory and supervisory practices that involve direct government oversight of and restrictions on banks" and are much more consistent with the *grabbing-hand approach to regulation theory* (according which government regulates to support political constituencies) that a *helping-hand approach* (according to which governments regulate to correct market failures).
- The findings of Barth et al. (2001) suggest that *regulatory and supervisory practices that (1) force accurate information disclosure, (2) empower private-sector corporate control of banks, and (3) foster incentives for private agents to exert corporate control work best to promote bank performance and stability and provide incentives for banks to limit their risk.*

[1] Besides Barth, Caprio, Levine (2000,2001a,2001b) we might add again LaPorta,DeSilanes-Shleifer(2001), keeping in mind Bhattacharya (2002). On regulatory risk in general e.g. Ergas et al. (2001)

[2] The Basel Committee on Banking Supervision issued second draft in 2001 and third draft in 2003.

New trends and problems in supervision and regulation (2)

- We still consider the *regulatory institutions* as an important component in market-based financial sector activity but in One of the gradually accepted compromises in regulatory and supervision practices motivated by such an up-to-date incentive design is represented by gradually internationally developed New Basel Capital Accord (NBCA/Basel II) rules that "shifted the paradigm" from its rather narrow original 1988 BCA concept closer to the suggested process approach.
- The Accord rests on the three pillars. The first is "establishment of minimum capital requirements, which aim to motivate banks into improving continuously their risk management and measurement capabilities in market, credit and operational risk. It establishes procedures to ensure each bank has sound internal processes to assess the adequacy of its capital. Second pillar introduces an enhanced supervisory review process of risk measurement and management processes in banks ensuring that banks have processes for assessing the regulatory capital appropriate to the bank risk profile. Third pillar provides incentives to strengthen risk management and internal controls through the forces of market discipline, which requires the transparency, detailed disclosure of capital structure, risk exposures and capital adequacy." It has also raised lively discussion.

[1] Besides Barth, Caprio, Levine (2000,2001a,2001b) we might add again LaPorta,DeSilanes-Shleifer(2001), keeping in mind Bhattacharya (2002). On regulatory risk in general e.g. Ergas et al. (2001)

[2] The Basel Committee on Banking Supervision issued the third draft in 2003 after discussion that included e.g.Danielson (2001) etc..

New issues in BASEL II in transition economies (1)

- The more information transparency is provided to the market by bank, the more advanced and independent approaches to measuring capital adequacy (e.g. internal rating models) are allowed, because the regulation then relies to a larger extent on market discipline, monitoring leaders, and the rule of law. Besides adopting benchmarking standardized approaches, banks are motivated to creatively develop and integrate their own, originally internal methods (e.g. IRB methods). A key part for NBCA is *the responsibility taken by supervisors when evaluating the processes and (back-, stress-) testing the methods adopted. This is very much different and more demanding role from the previous situation especially in transition economies such as Eastern Europe , Vietnam,...*
- At the same time, *regulator accepts the burden of responsibility for decision-making, understanding that regulated entities cannot survive if they invest in risk-free assets only.* The very substance of financial intermediaries one can find also in optimal monitoring and management of risk asset portfolio in order to maximize their risk-adjusted profits within existing environment and funds. This modern regulatory design has incorporated institutions (rules, organization of supervision) as a framework for real economic life of financial intermediaries based upon the existence and management of inevitable risk within stochastic world. *It should generate only reasonable costs of regulation without excessive capital requirements (which might be in average lowered).*
- Without going into technical details, one can question at least three open points. First, in contrast to previous BCA concept, the NBCA regulator relies both upon unbiased data flow but also upon unbiased processes and methods that are safeguarded by the longer assessment periods. In interactive situation when regulator regulates the regulated entity based upon its internal data, process and internal methods submission, the issue of asymmetric information (known from off-site supervision) does not disappear. Just the opposite might be true (e.g. controversial approval of parameters´ changes of already approved internal model), requiring additional regulatory sources and costs.

New issues in BASEL II in transition economies (2)

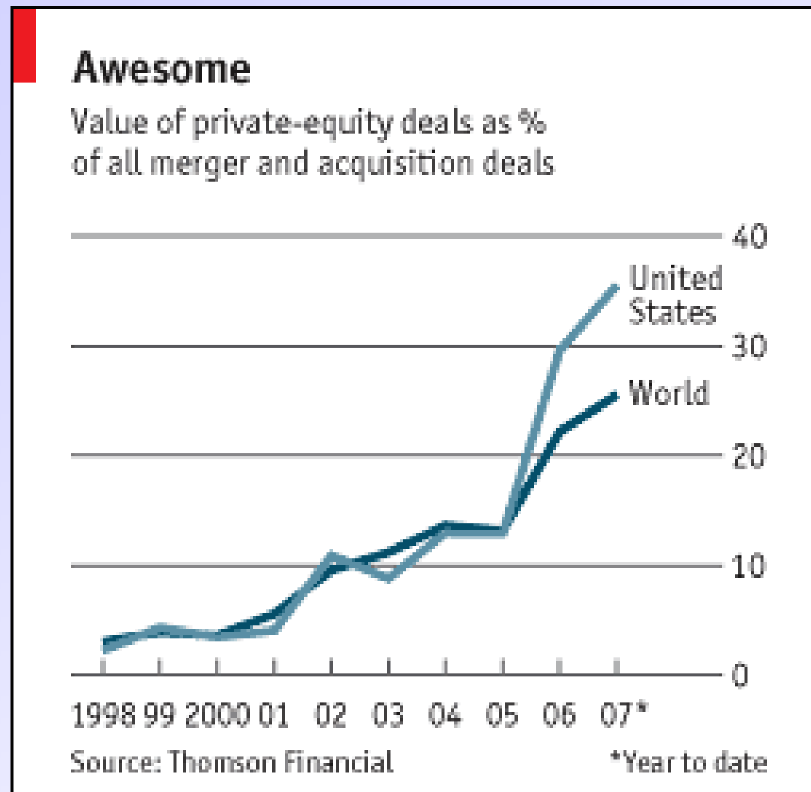
- Second open point might be linked to the issues around weak form of the efficient market hypothesis (EMH). Most of the proposed models and their testing are based upon historical data, but banks look for financing of new viable projects which have no history (such as pro-forma business plans for UMTS phones). Reliance on historically rooted risk assessments in such projects can mislead both the banks and regulators (what happened internationally in UMTS case, the financing of which suddenly turned profitable utilities and banks into insolvency situation in just one year), and reliance upon those generally accepted supervisory tools can imply huge unintended costs of regulation (e.g. cost resulting from implicit quasi guarantee or indemnification contract between banks and the state), demonstrating the inevitable regulatory risk. Problem analogical to the implications of weak form of EMH can be solved only based upon aggregation and diversification of risks. Last open point refers to the issue of mitigation of credit risk. The concept of expected credit risk is based upon properly secured credits, which is often not the case for emerging markets (limited enforcement, vaguely defined guarantees, collaterals, credit derivatives, low recovery rate of collateral etc.). Then the relevant additional capital requirements, based in NBCA on measurement of unexpected credit risk, confuse the measurement of expected and unexpected risk. Banks must be extremely conservative in assessing credit risk mitigants and carefully apply the models developed by their parent banks for their markets. [1]
- [1] Leasing companies could also be included.

New issues in BASEL II in CEE and other transition economies with FDI

- As we see the *harmonization* with the prepared EU directive based upon Basel II will require further research and updating on the basis of specific markets development.
- Returning to the *issue of optimal organisation of the financial sector supervision, so often fragmented in NMS.* E.g. banking supervision (at the CNB) nowadays is the most advanced and best equipped supervising entity in the Czech Republic, but it needs to up-date further its procedures and staff along the amended Banking Act (2002) and Basel II with respect to the up-to-date regulatory design. There are four other areas of supervision - insurance companies, pension funds, and co-operatives supervised in two bodies within the Ministry of Finance, and Securities Commission supervising institutions on the financial market. This complex structure should be simplified into preferably one well established and accountable supervising entities outside the government, supervising both credit and insurance institutions and capital market institutions. *Merging supervision activities into single, independent Financial Supervisory authority* strong enough not to get "captured" by supervised entities, seems to be a matter of careful choice . Czech solution – merged supervision to be concentrated in the independent Central bank - different independent body in Hungary or UK. No universe solution within EU-25.

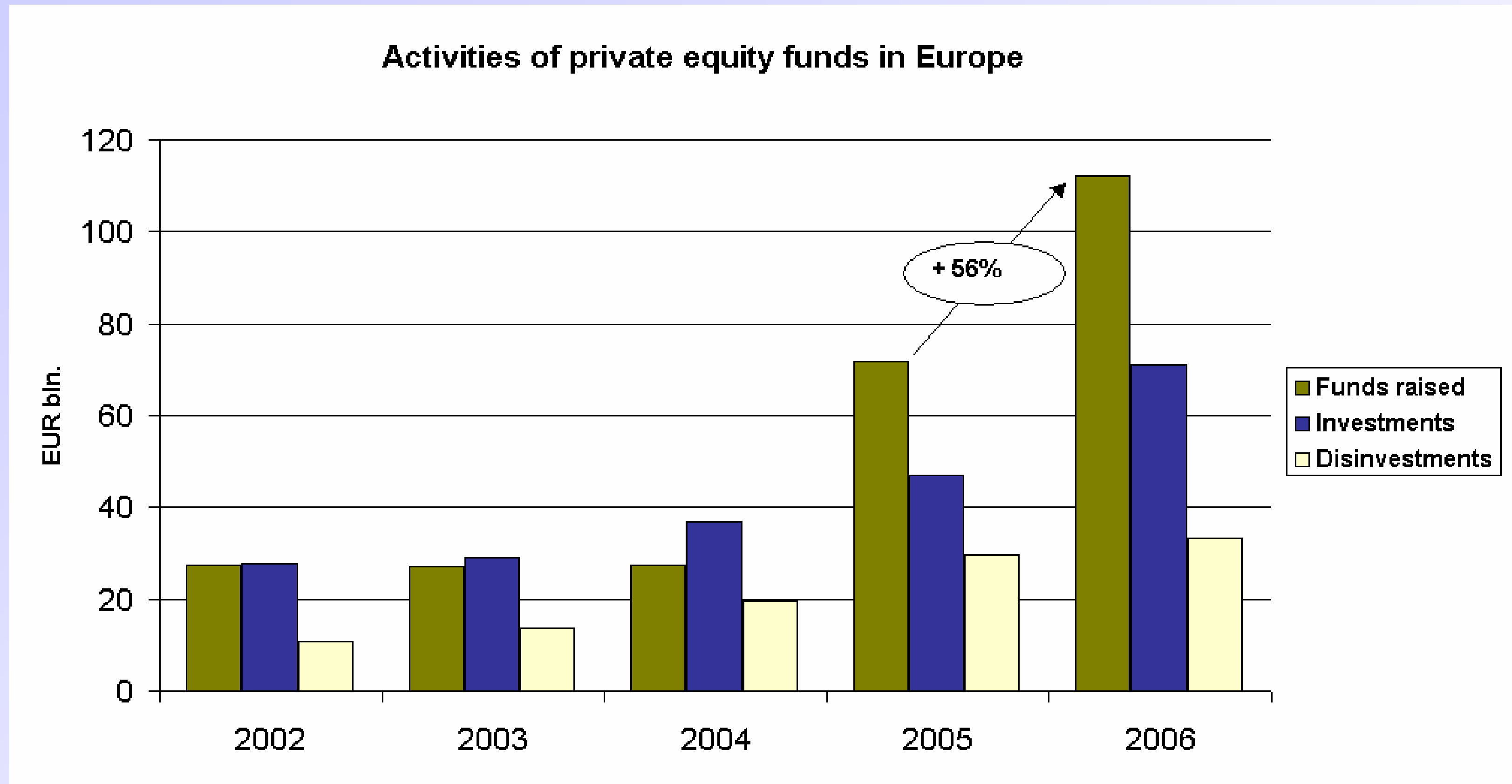
- And, given the type of international owners (regional consolidators in NMS), frequent exchanges of information between banks, their internal and external auditors, and supervisors and between supervisors in different jurisdictions are critical. Central banks have signed relevant agreements and is further deepening its co-operation with other different supervisory bodies on both domestic, cross border, and international fields within EU, IMF/WB, BIS (Blue book, FSAP, Red Book). The deeper co-operation of home and host supervisor is accompanied by deeper responsibility. New takeover of regional consolidators are happening overnight (HVB-UNICR). At the same time, *some parent financial group group can collapse and mechanism of such failure is not fully tested (except of some paper stress testing) both by home and host supervisors. Non-existence of a mechanism of European lender of last resort is a source of certain risk aslo for Czech banking sector due to important EU ownership of Czech financial institutions.*

Importance of private equity (1/3)



Source: Economist (July 5, 2007)

Importance of private equity (2/3)



Source: EVCA/Thompson Financial/PWC

Importance of private equity (3/3)
TOP World Players

Rank	Name	Country	Funds raised January 2002-April 2007 (USD bln)
1	The Carlyle Group	USA	32.5
2	Kohlberg Kravis Roberts	USA	31.1
3	Goldman Sachs Principal Investment Area	USA	31.0
4	The Blackstone Group	USA	28.4
5	TPG	USA	23.5
6	Permira	UK	21.5
7	Apax Partners	UK	18.9
8	Bain Capital	USA	17.3
9	Providence Equity Partners	USA	16.4
10	CVC Capital Partners	UK	15.7

Source: Private Equity International

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Comparison of first and second tier accession countries in 2002 (1)

	Area	Population	GDP in purchasing power standards			GDP percent growth	Inflation rate	Unemployment rate	Current account
Country	1000 km2	Million inhabitants	Billion EUR P.P.S.	EUR/inhab. P.P.S.	EUR/inhab. percent EU average	Percent	Year on year	Percent active population	Balance percent G.D.P.
Bulgaria	111.0	7.9	47.4	5,900.0	25	4.8	5.8	18.1	-4.7
Cyprus	9.0	0.8	14.0	17,400.0	72	2.2	2.8	3.8	-5.3
Czech Republic	**79.0**	**10.2**	**146.9**	**14,400.0**	**60**	**2.0**	**1.4**	**7.3**	**-6.3**
Estonia	45.0	1.4	13.5	10,000.0	42	6.0	3.6	9.1	-12.3
Hungary	93.0	10.2	138.2	13,600.0	57	3.3	5.2	5.6	-4.0
Latvia	65.0	2.4	19.9	8,500.0	35	6.1	2.0	12.8	-7.7
Lithuania	65.0	3.5	34.3	9,400.0	39	6.7	0.4	13.1	-5.3
Malta	0.3	0.4	4.6	11,700.0	55	1.2	2.2	7.4	-3.9
Poland	313.0	38.2	363.0	9,500.0	39	1.6	1.9	19.9	-3.6
Romania	238.0	21.8	128.9	5,900.0	25	4.9	22.5	7.0	-3.4
Slovakia	49.0	5.4	61.3	11,400.0	47	4.4	3.3	18.6	-8.2
Slovenia	20.0	2.0	35.3	17,700.0	74	3.2	7.5	6.0	1.7
Turkey	775.0	69.6	382.9	5,500.0	23	7.8	45.0	10.4	-0.8
EU 15	3,234.0	378.4	9,166.5	24,010.0					
Acceeding 10	739.0	74.3	831.0	11,150.0					
EU 25	3,973.0	452.7	9,997.5	21,910.0					

Note: Malta GDP figures are for 1999, EU 25 per capita PPS is an approximation based on EU 15

Source: EUROSTAT, “Continuing enlargement: Strategy Paper and Report of the European Commission on the progress towards EU accession” (October 2003), p.42

Comparison of first and second tier accession countries in 2002 (2)

	Foreign direct investment	Foreign direct investment	General government budget	Share of agriculture	External trade	External trade	External trade	External trade
Country	Net inflow in percent of GDP	EUR per capita	Balance in percent of GDP	Percent of gross added value	Exports percent of imports	Exports to EU, percent of total exports	Imports from EU, percent of total imports	Balance with EU, in EUR mil
Bulgaria	3.9	273	-0.6	12.5	78.2	55.6	50.2	606
Cyprus	4.3	N/A	-3.5	4.3	12.5	48.0	55.8	2,173
Czech Republic	**13.4**	**2,289**	**-3.9**	**3.7**	**94.4**	**68.4**	**60.2**	**1,673**
Estonia	4.4	2,092	1.3	5.4	71.6	68.0	57.9	847
Hungary	1.8	N/A	-9.2	4.3	91.4	75.1	56.3	-68
Latvia	4.6	978	-3.0	4.7	56.4	60.4	53.0	620
Lithuania	5.3	723	-2.0	7.1	71.0	48.4	44.5	1,290
Malta	8.8	6,418	-6.2	2.8	74.1	46.6	67.0	1,575
Poland	2.2	963	-4.1	3.1	74.4	68.7	61.7	9,165
Romania	2.9	252	-2.2	13.0	77.6	67.1	58.4	1,003
Slovakia	17.0	903	-7.2	4.5	87.1	60.5	50.3	-982
Slovenia	8.3	1,543	-2.6	3.3	94.7	59.4	68.0	1,806
Turkey	0.6	296	-10.0	11.5	69.1	51.5	45.5	2,178

Note: Malta GDP figures are for 1999, EU 25 per capita PPS is an approximation based on EU 15

Source: EUROSTAT, "Continuing enlargement: Strategy Paper and Report of the European Commission on the progress towards EU accession" (October 2003), p.42