Evolution of Banking Regulation and Supervision in Insider Financial Systems

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ABSTRACT

The paper aims to contribute critically to the discussion of international financial integration in Europe by evaluating the role of banks and /or supervisory boards in an historical context and analyzes the impacts of policies which imply shifts and changes in institutional settings. Three insider financial systems are representing the basic three subsystems of bank-based financial systems: Austria, France and Italy. Changes in financial structure are investigated by analyzing developments in regulatory frameworks and supervision on a national level – which is clearly influenced by measures of the European Union, but might differ in transmission into national law. Additionally regulatory changes in two new member states – Poland and Hungary, which are clearly bank based when relying on funding of firms and investments, are analyzed and potential future developments are discussed.

This paper contributes to pluralism in economics by merging historical, institutional and economic point of views in analyzing financial structure development in Europe.

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INTRODUCTION

Due to financial integration in Europe and the increasing role of harmonized policies, like the Basel II agreements, the question of how national financial systems with their distinctive institutional features will be shaped in the future deserves further attention. Economic research in this field concentrated on the quantitative measurement of capital flows and on methods to quantify institutional aspects of borrower-lender relationships under the heading of corporate governance. Corporate governance serves as a generic term for a bundle of institutional settings including measures of banking regulation and supervision. These have a major impact on the classification of national financial systems. It can be shown that the predominance of protective measures, like deposit insurance systems, in banking regulation over preventive ones leads to an insider or bank-based financial system. Consequently internationally coordinated supervisory systems can promote indirectly a change in national financial systems.

Basing on this theoretical research this paper analyzes the evolution of insider financial systems from a regulatory / supervisory point of view. Two research questions will be in the centre of discussion: First, did the banking regulatory frameworks of the three different subsystems of insider oriented financial systems converge over time and did they come closer to an outsider oriented or market-based financial system? Three countries will serve as references for the different subsystems: Austria represents the Austrian/German model of insider systems and France and Italy serve as representatives of their respective model. The second research question emerges out of the enlargement of the European Union: Which institutional setting do quantitatively as bank-based classified economies of the new member states of the European Union show and are disparities in the institutional frameworks caused by differences in the transformation process? To answer this question Hungary and Poland are added to the countries of reference. They are the only transition economies of the new member states that can be fully regarded as bank-based financial systems using the dataset of the World Bank and followed different approaches in the transformation process.

1. STARTING POINT: SUBSYSTEMS OF INSIDER ORIENTED FINANCIAL SYSTEMS AND THE INTEGRATION OF THE NEW MEMBER STATES

When trying to classify national financial systems flow of funds for investment and firms' financing used to the starting point for economists (OECD, 1995:15; Allen and Gale, 2000). Although it turned out that this functional finance approach has its limits due to the minor importance for firms' financing, since the main source of finance are retained earnings (see among others Schaberg, 1999:20; Huffschmid, 1999: 18). Facing these results some authors (among others Corbett and Jenkinson, 1994:74; Mayer, 1988) concluded that a classification according the flow of funds is inappropriate and has to be enriched by qualitative factors which aim to investigation the relationship between creditor and debtor in a national financial system, other (especially the economists of the World Bank, Levine, Demirgüc-Kunt, Beck and others) developed a more sophisticated data base (Demirgüc-Kunt and Levine, 1999) as to measure not only flow of funds but also depth and efficiency by comparing volume and turnover of the banking sector and the stock exchange. Table 1 shows the results for the Member States of the European Union, when applying data set and calculation from Demirgüc-Kunt and Levine (1999) - the results from calculating the specific structural index can be looked up in Springler (2005). Since the outcome is sample dependent, results of various samples are compared. This method is chosen to get an overview of the position of the eight transition economies that joined the European Union in 2004, which are therefore integrated into all samples. Despite banking crises, which occurred in all eight transition economies differences depending on the sample are visible. Lacking more increate information about the importance of the flow of funds approach in transition economies, Hungary and Poland are integrated into the research of this paper as representatives of transition economies, since they turned out to be potentially classified in all samples used and can therefore be regarded as the most bank based of the new member states of the European Union which have undergone a period of transformation. Taking a closer look at the results for EU15 members, which are known to belong clearly to one or the other type of national financial system especially the outcome for Austria is surprising and shows the sample dependence a limited applicability of this approach. Despite this the fact that Austria is classified as market based economy when applying the sample, Central Europe and Transition Economies; it becomes evident that market capitalization and the importance of the stock exchange were increasing in the past decade. This brings us closer to the research question of this paper since it

manifests the importance of enlarging the concept of classification towards more qualitative indicators. As mentioned already above, such an approach has been in favour by many economists, but nevertheless can a lack in studies been observed, trying to implement consequently qualitative indicators.

Table 1: *Classification of national financial systems according to financial funds flow*

	EU25	Central EU&EE	South EU &EE	North EU & EE	EE
Austria	**b**	**m**			
Belgium	b	b			
Cyprus	b		b		
Czech Republic	b	b	b	b	m
Denmark	b			b	
Finland	m			m	
France	**b**	**b**			
Germany	b	b			
Greece	b		b		
Hungary	**b**	**b**	**b**	**b**	**b**
Ireland	m	m			
Italy	**b**		**b**		
Latvia	b	b	b	b	m
Lithuania	b	b	b	b	b
Luxembourg	b	m			
Netherlands	m	m			
Poland	**b**	**b**	**b**	**b**	**b**
Portugal	b		m		
Slovak Republic	b	b	m	m	m
Slovenia	b	b	m	b	m
Spain	m		m	m	
Sweden	m				
United Kingdom	m	m			

Table 2 indicates an enlarged approach towards distinguishing national financial systems integrated qualitative criteria. What is describes as differences in control and ownership relations as well as differences in the connection between firms a creditor within these two different systems can be traced back to varying approaches to regulatory and supervisory frameworks, which enable the evolution of different financial systems. The importance of legal concept, although without implementing these concepts for regulatory and supervisory frameworks has been pointed among other by La Porta, Lopez-de Silanes and Shleifer (1998) and Beck, Demirgüc-Kunt and Levine (2001). Both studies distinguish different forms of legal rules as important factor for the evolution of different national financial systems. These legal frameworks – French-origin, German-origin, English-origin and Scandinavian-origin - incorporate specific

approaches towards shareholder voting rights, investor and creditor rights. Although Beck, Demirgüc-Kunt and Levine (2001:22) enlarge that approach by additionally incorporating political factors and the endowment process, which refers to the colonization process.

Table 2: *Criteria for distinguishing national financial systems*

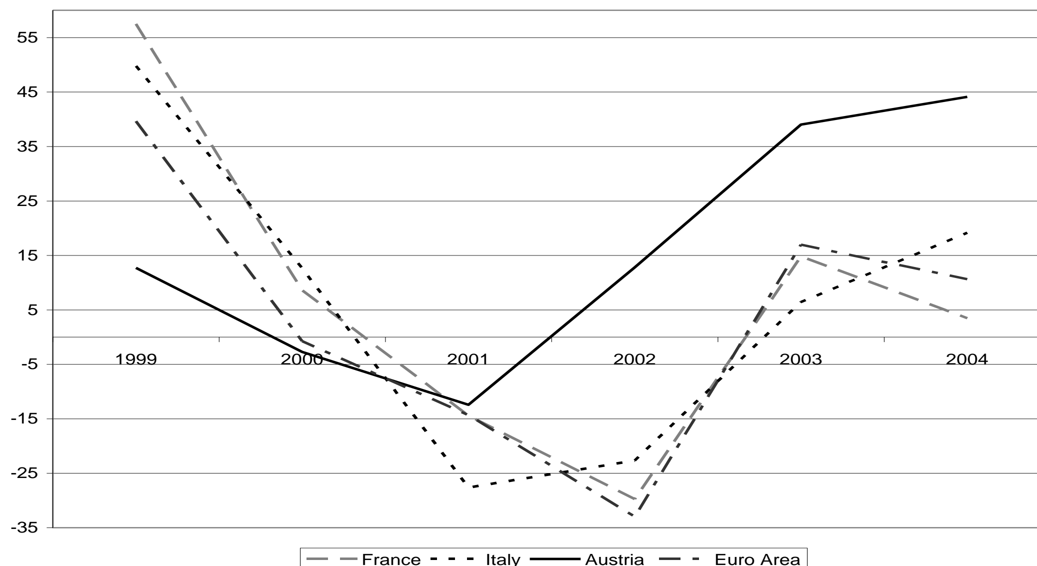
		Bank-based	Market based
Quantitative indicators	Flow of funds	Banks	Stock exchange
Qualitative indicators	Control / Ownership	concentrated	split
	Connections firm / creditor	close	lose
	Time horizon	Short term	Long term

The initial endowment and the ability to settle down have an impact for the formation and evolution of institutions. By distinguishing different colonization strategies – *"settler colonies"* versus *"extractive states"* – the setting up of institutional power can partly be explained. Wherever states serves as "settler colonies" long term institutions were set up and had an impact on economic and financial development. This explains the necessity of analyzing institutional impacts for economic development, but does not explain different institutional settings in the four different legal frameworks.

In combining these elements this paper therefore investigates the evolution of different regulatory and supervisory frameworks by choosing subsystems of the bank based system.[i] Conversely to the categorization into four different legal frameworks above this paper will focus on three different subsystems of bank-based financial system and refers to Italy, which is included into countries with French legal origin as different subsystem, following the analysis of Howells and Bain (1998). European stock exchanges face a strong increase in importance in terms of market capitalization and turnover and firms started to rely more strongly on external financing via participation on the stock exchange.[ii] In Austria stock market capitalization was around 15.8% of GDP in 2000, compared to 71.5% in Italy and 111.7% in France. (OeNB, 2002) This data shows already that although all three countries are regarded to be bank based economies with a stronger emphasis on the banking sector and a rather less developed stock exchange, differences in the level of market capitalization cannot be neglected. When taking development in market capitalization measured as percentage changes into account the same trends for all three economies can be detected, which are also in line with the developments in the Euro area as an

aggregate number. Graph 1 indicates these developments and shows that after the downturns in 2001 and 2002 market capitalization were increasing again. This reflects the overall economic situation after the millennium and is also reflected by losses for households on close market products and shifts of firms towards stronger internal financing and credit financing as means of external finance. The financial stability report (OeNB, 2004a) for Austria for example indicates assessment losses of shares and investment certificates of households of around 7 billion Euros between 2000 and 2002. These losses are now almost offset again by the assessment increase in 2003 and 2004 (OeNB, 2004b). Similarly capital structures of firm were determined by conjunctural developments and led to decreased equity capital of firms (OeNB, 2004ab).

Graph 1: *Market capitalization percentage changes*



Source: ECB, 2005.

Although these data indicates that also bank based economies have an increasing stock exchange, which reacts to global volatilities and needs therefore proper institutional securitization, which might be as well be influenced by international trends, this nevertheless means not that financial systems are converging. Institutional developments, which lead to a change in the qualitative criteria of bank based economies as shown in table 2 on the other hand, could be quoted as indicator for shift towards another financial system. Before starting an operationally investigation of potential qualitative criteria to search for institutional shifts in economic structure crucial

factors for distinguishing the three subsystems in bank-based financial systems have to be analyzed.

Distinction of different subsystems in bank-based financial systems using a structural approach:
Although similar in flow of funds, structural difference can be detected. Financial systems seem to be highly national determined, but nevertheless features for distinguishing three different subsystems can be found. Following the analysis of Howells and Bain (1998: chapter 18, 19) these structural and institutional differences can be made visible by introduction four variables: the *position of the state*, as it regards the issuing of bonds and the ownership of firms and banks, the *specific aims of regulatory frameworks*, which might be more or less close to the goals of market based economies, the main *elements of household portfolio* and *the position and room of manoeuvre of banks* in the economy. Table 3 gives an outline of the differences between bank-based financial systems according to Howells and Bain (1998).

Table 3: *Subsystems of bank-based financial systems*

	Austria	**France**	**Italy**
Position of the state	More centralized than Germany (smaller market); strong state	Stronger position of the state than in Austria	Historical strong interference of the state; most banks state owned
Position of banks	Universal banking	Strong emphasis on specialized institutions although universal banking	High number of small banks; banks limited to raise share capital;
Household portfolio	Low but increasing importance of pension funds	Securities market important due to life insurance policies.	High savings ratios; securities high due to high public debt
Aims of regulatory frameworks	*Reference to Germany*	*Heavy regulation and state interference*	*Close to Glass Steagall Act*

As it regards the *position of the state* differences can be investigated although bank-based economies in general have a comparably stronger influences of the state than market based economies (Allen and Gale, 2000). Despite the introduction of an institutional framework that incorporates similar aims like the Glass Steagall Act, a strong interference of the state followed in the 1930s in Italy (Howells, Bain, 1998). Out of these developments emerged an Italian banking system which consisted on strong state owned banks on the other hand and small regional banks on the other hand. Kofler (1966:102) indicates 6 instituti di diritto pubblico and 3 banche di interesse nazionale, which were state-owned and incorporates 38.8% of all deposits in the system.

Despite the high number of state owned in Italy the state influence was also in Austrian and France high, compared to market based economies and was manifested in a strongly centralized sector. Also today as data in annex 1 shows is centralization further increasing and reaches a level of above 45% of total shares of the 5 biggest credit institutions of the country. This development is encouraged by trend of internationalization on the global banking sector.

For the development of *household portfolio* especially the importance of pension funds as well as the issuing of securities of the state is important to explain changes in portfolio evolution with structural and institutional developments. As mentioned already above is the portfolio of households' changes in the last years according to developments on the stock exchange and current trends in overall economic performance (OeNB, 2004). After the valuation losses of 2000 and 2001 households moved back towards positions of higher liquidity and less market dependence. Despite these changes also households' tend to hold a more diversified portfolio than in the past. Taking a closer look at the elements of change institutional developments can be revealed, which might be responsible for the changes in household portfolio, on the one hand restructuring of the pension funds and the influence of public debt for issuing securities on the other hand. As Howells and Bain (1999) point out and data in annex 1 shows has had Italy also in the past higher ratios of securities issued due to the need of financing public debt than the other two reference countries.

Despite these changes, which follow the international trends in globalized financial markets, ties between creditors and debtors were still regarded to be tight in all these economies. Qualitative indicators (table 2) seem to follow the same lines and emerged towards a strong institutional supervisory framework, which included differences in enforcement modes but implied external control and minimized self-regulatory forces, as the market outcome deserved state intervention (or institutional intervention).

2. THEORETICAL BACKGROUND ON IMPACT AND DEVELOPMENT OF BANKING SUPERVISION

Taking the evolution of national regulatory and institutional frameworks into account, which have a direct influence on the structure of the banking system by distinguishing specific methods of regulation, which aim to shape a more market or more bank based regulatory regime.

Additionally the developments on the national level are enlarged by evolutions on a multinational level and institutional development of such sector, which have an indirect influence on banking structure, like pension systems. This interference between banking structure and pension systems has been pointed out above and opens the floor for further investigation.

Therefore table 4 shows the institutional and structural dimensions of banking regulation. The division of regulative methods into preventive and protective measures serves as core distinction between stronger and weaker institutional influence on banking regulation and supervision. Preventive measures compass all methods to ensure a stable framework by introducing legal procedures and early warning systems which aim to enhance the self-regulation mechanisms of the sector and therefore do no rely in direct institutional or public involvement into regulatory issues (Bernet, 2003). Therefore a supervisory framework which relies strongly on preventive measures can be regarded as being related to market-based financial systems, which reduce institutional influence and open the floor for self-regulation and market driven regulatory procedures. Therefore the hypothesis of this paper can be manifested as the following: *Whenever subsystems of bank-based financial systems move their regulatory frameworks towards preventive measures they reduce institutional influence and therefore aim to emerge towards a more market based financial system.*

Further on preventive and protective measures can be split up into following a qualitative or a quantitative approach. Although this distinction does not lead to a clear definition of a more or less bank based system it can be assumed that qualitative instruments need a stronger institutional background since decisions incorporate specific knowledge of the individual case and can hardly depend on self-regulatory forces. Hence it can be concluded that a high number of proactive measures following a qualitative approach lead to a very strong institutional and thus bank based regulatory framework. Table 4 shows four dimensions joining qualitative and quantitative as well as preventive and protective measures in each dimension. Starting from the direct relationship between supervisory authority and financial intermediaries via *direct operational methods*, the dimension are widened towards a *systemic level*, which is followed by the influences other institutional development might have on regulatory frameworks and the evolution of international financial markets which might also have an immediate influence for the national regulatory financial frameworks. Hence *external institutional settings* and the evolution of state responsibility is integrated into table 4 and focuses basically on the developments in pension

systems, which are interrelated with changes on financial markets as discussed in part 1 of this paper.

Table 4: *Dimensions and forms of banking regulation*

	Preventive measures	**Protective measures**
Direct Operational methods		
Quantitative approach	▪ Norms for liquidity; ▪ Norms for market risk	▪ Deposit insurance systems ▪ Capital requirements
Qualitative approach	▪ Definition of business segments ▪ Organizational norms ▪ Norms for authorization ▪ Norms for transparency and information	▪ Lender of the last resort ▪ State bail outs
Institutional enforcement strategies		
Quantitative approach	▪ Enforcement mode: symbolic punitive enforces	▪ Enforcement mode: moderately punitive enforcers
Qualitative approach	▪ Enforcement mode: Diagnostic inspectorates.	▪ Enforcement mode: Benign "big guns or
External institutional and state responsibility		
	▪ Low State responsibility: funded pension systems	▪ High State responsibility: pay as you go pension systems
International supervisory enforcements		
Quantitative approach	▪ Basel II: Pillar 2 (prudential supervision)	▪ Basel II: pillar 1 (internal ratings)
Qualitative approach	▪ Corporate Governance Codes ▪ Basel II: pillar 3 (Market disclosure)	

Self-Regulation mechanisms	**Co-Regulation mechanisms**

The *international dimension* finally refers to the developments within the European Union and aims of the new Basel II framework, which has to be implemented by the members of the European Union. While the assignment of different operational methods to the category of preventive versus protective measures and qualitative versus quantitative approaches follows clearly the lines of supervisory frameworks (Bernet, 2003) the distinction of different institutional enforcement strategies is less clear. Currie (2003) as well as Adams, Hayes and

Weierter (2003) introduce a continuum of different enforcement strategies of regulatory authorities on a basis of the analysis of Ayres and Braithwaite (1992). The continuum of regulatory enforcement strategies spreads from self-regulation mechanisms which mean minimal sufficiency principles (Ayres, Braithwaite, 1992:39, 49) to command regulation with nondiscretionary punishment, Benign Big Gun. These enforcement strategies can be ranked according to their mode of control - command versus cooperative partnership - and mode of punishment - punitive or non-punitive. (Adams, Hayes and Weierter, 2003) Although methods of cooperative partnerships are classifies as fostering self-regulation in the ranking of Adams Hayes and Weierter (2003) and Ayres and Braithwaite (1992) this seems to need further explanation for the case of banking regulatory framework. The notion of institutional influence this paper used implies a direct and cooperative partnership, which means a qualitative approach. Therefore the modes introduced are further split up into quantitative and qualitative modes to ensure that for strong institutional influence cooperative approaches as well as command and arm's length regulation is a possibility. Apart from the inclusion of external features of other sector implying institutional influence also international developments are integrated by clustering the measures of Basel II according the lines of preventive and protective measures as well as qualitative and quantitative approaches. Similarly methods of Corporate Governance Codes are implemented into the framework, since these Codes clearly aim to increase self-regulation mechanisms for firms (also those not listened at the stock exchange, see for example Austrian Code of Corporate Governance) and are nowadays widely implemented also in bank- based national financial systems. As it regards the integration of the proposals if Basel II it turns out that measures of Pillar 1 can clearly be classified as protective quantitative measures since they deal with minimum capital requirements, conversely can measures of pillar 2 be seen as preventive quantitative measures. Also the third pillar, market discipline belongs to the category of preventive measures, but includes qualitative approaches. This also means that strong institutional features, which would be classified as protective qualitative (means cooperative) measures are not included into the new international framework.

Basing on these categories and modes of intervention the development of supervisory frameworks in the three subsystems of bank based national financial systems is analyzed in the following section.

3. CONVERGENCE TOWARDS AN OUTSIDER DOMINATED SYSTEM

Table 5: *Evaluation of changes in regulatory frameworks*

	Preventive measures	**Protective measures**
Direct Operational methods		
Quantitative approach		
Qualitative approach		
Institutional enforcement strategies		
Quantitative approach		
Qualitative approach		
External institutional and state responsibility		
International supervisory enforcements		
Quantitative approach		
Qualitative approach		

4. IMPACT FOR THE NEW MEMBER STATES

CONCLUSION

Annex 1: *Banking structure on subsystems of financial systems*

	1997	1998	1999	2000	2001	2002	2003
Position of the state and banks							
number of credit institutions							
Austria	928,00	898,00	875,00	848,00	836,00	823,00	814,00
France	1258,00	1226,00	1158,00	1099,00	1050,00	989,00	939,00
Italy	909,00	934,00	890,00	861,00	843,00	821,00	801,00
number of local units (branches) of Cis							
Austria	4691,00	4587,00	4589,00	4570,00	4561,00	4466,00	4395,00
France	25464,00	25428,00	25501,00	25657,00	26049,00	26162,00	25789,00
Italy	25265,00	26283,00	27154,00	28189,00	29267,00	29948,00	30502,00
5 largest CI's in total assets (%)							
Austria	43,87	41,53	40,97	42,77	44,88	45,64	44,20
France	39,50	40,70	42,60	46,84	46,99	44,63	46,69
Italy		25,20	25,60	22,70	29,00	30,50	27,50
Household portfolio							
total assets under management by investment funds (EUR Million) per 10 000 inhabitants							
Austria	60,48	64,91	72,58	77,37	81,58	84,40	89,09
France	75,30	94,03	96,24	109,39	106,47	98,20	114,33
Italy	33,08	64,64	82,14	77,71	66,27	56,16	51,14
total assets under management by pension funds (EUR million) per 10 000 inhabitants							
Austria	3,98	5,87	8,93	9,80	10,02	9,78	11,28
France	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Italy	0,60	0,75	0,74	1,07	1,15	1,44	2,01
gross issues of long-term debt secutrities by non-financial companies (EUR million) per 10 000 inhabitants							
Austria	1,48	0,38	1,26	1,05	2,62	2,38	6,52
France	1,78	2,63	5,91	6,17	9,13	4,94	8,36
Italy	0,25	0,19	0,57	0,70	2,28	1,76	1,13
Total investments of insurance corporations (EUR million) per 10 000 inhabitants							
Austria	56,50	59,04	63,64	67,57	71,56	74,62	77,82
France	95,65	105,38	118,35	129,95	137,84	142,81	154,86
Italy	24,69	32,43	42,61	48,72	52,85	55,63	61,02

Datasource: ECB, 2004

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[i] The term bank-based Financial System serves in this paper as synonym for insider financial systems, in which investors chose according to Hirschman (1974) the voice option, compared to an exit strategy in market based financial systems. Similarly the term „overdraft" economy, which is widely used in a Post-Keynesian framework for the French national system (see for example Renversez, 1996), is used as synonym for bank-based or insider financial systems. All synonymously used terms aim to include qualitative and quantitative criteria when analyzing a specific national financial system.

[ii] Similarly conclusions can be found in Schaberg (1999), which shows the development of gross sources of funds and uses of funds in selected bank-based and market based economies.