Foreign banks, domestic networks and the preservation of state capacity in internationalized financial sectors:

A study of two transition economies

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To what extent has financial globalization compromised the capacity of states to regulate their financial sectors? To what extent has the "Europeanization" process constrained the ability of European Union accession states to introduce financial regulations appropriate for their domestic markets? This paper seeks to answer these questions by examining the reform trajectories of two transition economies and pending European Union (EU) member states.

Hungary and Poland were among the first in the former Soviet Bloc to shed the command economy and introduce two-tier banking. Both suffered banking crises in 1992-4 that required substantial injections of public funds to resolve. Throughout the first decade of transition, Hungary and Poland faced persistent budget deficits, inflationary pressures and domestic capital shortages. Nevertheless, Hungary and Poland declared early in the transition from communism their intention to join the EU. Subsequently, they opened their financial services to foreign investment. Their financial sectors are now highly internationalized with foreign banks securing dominant market shares.

Despite these similarities, the trajectory of "Europeanization" in Hungary and Poland's financial services has been drastically different. In Hungary, the effort to Europeanize its financial services sector led to repeated bank bailouts and rampant corruption. All in all, the costs of financial sector transformation have been much higher for the state and the taxpayer in Hungary than in Poland. Furthermore, important differences remain in their domestic regulatory regimes despite pending EU accession. This degree of variation in Hungarian and Polish financial sector reform is puzzling and demands empirical examination.

An investigation of these two cases demonstrates that the sequencing of foreign bank entry and institutional reform can influence the ability of states to introduce effective adjustment strategies in the financial sector that limit the potential instability and costs

wrought by the convergence to European Union norms and law. States such as Poland that engage in concerted institution building prior to liberalizing foreign bank entry rules will be much better placed to limit the cost of the Europeanization and internationalization of their financial services to domestic taxpayers and to modify international banking laws and norms appropriate for the domestic market. These states will also be much better placed to achieve their broad policy goals in their financial markets. If liberalization occurs, as it did in Hungary, at an early stage of financial reform when state institutions are in their infancy, demands for the preservation of 'national' presence in the domestic banking sector from citizens and the political elite will facilitate "regulatory capture" by the incumbent banks threatened by the foreign competition. In turn, this pattern of state-bank relations will raise the cost of financial sector transformation and hinder effective adjustment strategies.

Sequencing in political science

This argument borrows logic from those scholars who claim that the timing of events is crucial in explaining outcomes in the policy arena. As Paul Pierson notes, sequencing is important "because earlier parts of a sequence matter much more than later parts."[1] The policy process can be fairly open in the early 'critical juncture' phase of a sequence whereby two or more outcomes are possible. However, initial outcomes are prone to institutionalization through a process of positive feedback. Institutionalization means that the cost of pursuing other options that may have been available earlier in the sequence increases the further one travels down the selected path.

Some sequencing arguments focus on how institutions distribute power among societal actors and between the state and society. According to Peter Hall's definition institutions are "the formal rules, compliance procedures, and standard operating practices

[1] Paul Pierson, "Increasing Returns, Path Dependence and the Study of Politics," American Political Science Review. Vol. 94, No. 2. June 2000. p. 263.

that structure the relationship between individuals in various units of the polity and the economy."[2] Institutions can, for example, confer an uneven distribution of power by which some interests are privileged relative to others. Thus, there are often first-mover advantages in institutional design. Actors that fill political space early have distinct advantage over latecomers. They can consolidate position of influence, secure privileged access to the policy arena and can craft rulemaking to lock-in existing policies or at least facilitate outcomes that are favourable to them.[3]

Terry Karl's account of state development and major oil discoveries in Norway, Iran, Algeria, Nigeria, and Venezuela makes a similar argument to the one offered in this paper (although she adopts a more statist view towards government capacity that downplays the contribution of organized interest in the formation of effective policy). She finds that those states that experienced state-building simultaneous to the oil boom are subject to the "petrolization" of their economies characterized by foreign company dominance, massive indebtedness, rampant inflation and persistent economic and political instability. Where state-building occurs prior to the oil boom, states will have the institutions in place to avoid a similar fate.[4]

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[2] Quoted from: Kathleen Thelen and Sven Steinmo, "Historical institutionalism in comparative politics." Structuring Politics: Historical Institutionalism in Comparative Analysis. Eds. Sven Steinmo, Kathleen Thelen and Farank Longstreth. (Cambridge: Cambridge University Press, 1992). p. 2.

[3] James Mahoney, "Path dependence in historical sociology." Theory and Society. vol. 29, No. 4. August 2000. p. 522. See also, Paul Pierson, "Not Just What, But When: Timing and Sequence in Political Process." Studies in American Political Development. vol. 14, no. 1. April 2000. p. 77.
Numerous scholars have pointed to the role of sequencing to explaining a variety of outcomes in political science. Such arguments reflect the logic popularized in political science by Alexander Gerschenkron, who argued the timing of industrialization conditions the role of the state in the economy. States that industrialize late require more state involvement in capital accumulation and intellectual development in their efforts to catch-up to the early industrializers. In such states, the timing of industrialization has lead to greater role for state activism and regulation in the economy. Vogel, for example, uses this insight to explain why Japan's 'deregulation' in the financial sector was state-directed and re-enforced the bureaucracy's capacity to regulate its banks and why Britain's de-regulation led to a decrease in state capacity. Vogel credits Gerschenkron for pointing out that "the timing of industrialization affects both the philosophy of the industrializing elite and the institutional mechanisms of the industrialization process." Steven K. Vogel, Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Economies. (Ithaca: Cornell University Press, 1996). p. 23.

[4] Terry Lynn Karl, Paradox of Plenty: Oil Booms and Petro-States. (Berkeley: University of California Press, 1997).

A common theme in this paper and in Karl's study is that particular historical sequences are crucial because initial processes have lasting consequences, generating particular, persistent and highly consequential organizational forms and institutional arrangements. "We cannot explain many important political outcomes without addressing question of temporal ordering."[5] The argument here is that the sequencing of internationalization and institution-building is crucial to a state's ability to introduce effective adjustment strategies in an internationalized financial sector.

As argued in my dissertation, the most accurate measurement of internationalization in the banking sector is the degree of foreign bank penetration. Little research has been conducted mapping the impact of offshore financial service provision versus onshore financial service provision by foreign banks on the state. Nonetheless, the liberalization of cross-border financial flows and foreign bank entry seem to be 'imperfect substitutes' in measuring the degree of financial sector integration.[6] Although the liberalization of the capital account can produce competitive pressures on domestic banks, the physical presence of foreign banks represents a greater challenge to domestic regulators. Claudia Buch, for example, suggests that:

> (b)orrowing of domestic firms and households from abroad and the possibility of holding financial wealth in deposits abroad link domestic and foreign financial markets. Due to transaction costs involved in cross-border financial flows, however, competitive pressure is more indirect if only the capital account has been liberalized as compared with a situation in which foreign banks are allowed to enter the domestic market.[7]

Foreign banks can be a source of direct competition for domestic banks on two fronts. First, the can compete for domestic clients directly from a subsidiary's capital base. Or they can

[5] Paul Pierson, "Not Just What, But When." p. 77.
[6] Claudia Buch, "Governance and Restructuring of Commercial Banks." Banking and Monetary Policy in Eastern Europe: The First Ten Years. Ed. Adalbert Winkler. (Houndmills, NH: Palgrave, 2002). p. 45.
[7] Claudia Buch, p. 48.

use a domestic presence to drum-up business for the parent. As Hungary and Poland demonstrate, foreign banks often engage in both activities.

Much of the scholarship on banking sector transformation in the post-socialist economies advocates the early liberalization of rules governing foreign bank entry.[8] Foreign banks encourage local banks to re-structure, innovate and improve efficiency whereas barriers to entry can perpetuate the misallocation of financial resources and credits to state-owned enterprise and connected individuals.[9] Entry can also facilitate access to international credit markets.[10]

Scholars advocating the benefits foreign bank entry however fail to incorporate the role of politics in their analyses. This study argues that one needs to factor in public and elite demands for maintaining a strong national presence in the sector. These demands do not dissipate when foreign bank entry is liberalized. In fact, they can be exacerbated. As demonstrated below, the combination of early foreign bank entry, populism and low state capacity can make banking sector reform more expensive.

State capacity in the global economy

The approach to state capacity employed in this paper builds on a crucial insight offered by the statist tradition revived by Theda Skocpol.[11] The traditional statist conception measured state capacity as the state's ability to impose its independently formulated policy objectives on private actors. According to this tradition, a strong state then is one that is

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[8] For arguments in favour of early foreign bank entry in the transition economies see: John Bonin, Laman Mizsei, Istvan Szekely, and Paul Watchel, Banking in Transition Economies: Developing Market Oriented Banking Sectors in Eastern Europe. (Cheltenham, UK: Edward Elgar, 1998); Claudia M. Buch, Creating Efficient Banking Systems: Theory and Evidence from Eastern Europe. (Tubingen: Instut fur Weltwirtschaft an der Universitat Keil, 1996); Istvan Szekely, "Financial Reforms and Economic Integration." Transforming Economies and European Integration. Eds. Rumen Dobrinsky and Michael Landesmann, (Cheltenham, UK: Edward Elgar, 1995). Paul Watchel, Foreign Banking in the Central European Economies in Transition. (New York: Institute of East West Studies, 1995).
[9] Bonin *et al.* p. 69.
[10] World Bank, Global development finance. p. 67.
[11] Theda Skocpol, "Bring the State Back In." Bringing the State Bank In. Eds. P.B. Evans, D. Rueschmeyer, and T. Skocpol. (Cambridge: Cambridge University Press, 1998).

isolated from and can form and implement goals independently of private interests. State capacity is enhanced when networks consist of centralized decision-making and private interests that are unorganized and interest aggregation is diffuse. This is the approached utilized by, for example, Terry Lynn Karl.

Linda Weiss modifies this understanding of state capacity. The statist conception wrongly conceives of state-society relations as a zero-sum game characterized by coercion and conflict.[12] Weiss points out that the above conception of state capacity is a poor predictor of policy outcomes and their effectiveness in complex policy arenas where there is uncertainty regarding the impact of policy outputs, where cooperation of private actors is vital in the downstream implementation and where monitoring costs are high. Strong states may not necessarily produce effective policy outcomes. Weiss further argues that the "more industrialized an economy and the more sophisticated technology becomes, the more critical the policy linkages between the economic bureaucracy and the industrial sector."[13] These linkages increase in importance as firms are increasingly subject to greater competition from integrating world markets.[14] Policymakers are thus "dependent on the cooperation and joint resource mobilization of policy actors outside their hierarchal control" to ensure the competitiveness of domestic industry, domestic employment levels and growth.[15]

Weiss' definition state capacity captures this interdependent relationship between states and private actors. She argues that a state's 'transformative capacity' is "the ability of policy-making authorities to pursue domestic adjustment strategies that, in cooperation with organized economic groups, upgrade or transform the industrial economy."[16]

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[12] Linda Weiss, The Myth of the Powerless State: Governing the Economy in a Global Era. (Cambridge, UK: Polity Press, 1998). p. 30.
[13] Linda Weiss, p. 30.
[14] Lesli A. Pal, Beyond Policy Analysis: Public Issue Management in Turbulent Times. (Scarborough: ITP, 1992). p. 198.
[15] Lesli A. Pal, p. 198.
[16] Linda Weiss, p. 5.

State leadership in these networks is contingent on a rational legal authority within a bureaucracy that is selected on the basis of meritocracy. The capacity to implement goals is moot if the goals are incoherent or poorly construed. There should also be a centralized pilot agency charged with coordinating economic policy among state agencies. Building on Katzenstein's "strong state, weak state" approach, state power is greater when a single agency or bureau is able to "aggregate authority" from the various levels of governments and "draw information" from sector actors, whether firms or interest groups.[17] States are weaker when authority is dispersed across overlapping jurisdictions and where "no one group of officials can take the lead" in formulating and implementing policy.[18] This dispersion of decision-making also increases the opportunities for private actors to infiltrate and capture the policymaking process for their own private ends.

Transformative capacity is also contingent on the organization of societal actors. Industry should be organized into encompassing peak organizations that are able "to participate in the design and implementation of policy."[19] Peak organizations are lobby groups that are organized according to sectors. In this model, they should be encompassing in scope and purpose, internally co-ordinated and have secure resource pools. They should also be able to overcome differences among firms rooted in competition or policy and be autonomous from the short-term interests of its membership. Under these conditions, interest groups are more likely to secure "a guaranteed voice in policy formation", share in "the implementation of selected public policies"[20] and provide a platform for negotiations and coordination with the state to produce policy outcomes that facilitate adjustment and that are beneficial for the relevant sector writ large.

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[17] Michael M. Atkinson and William D. Coleman, "Strong States and Weak States: Sectoral Policy Networks in Advanced Capitalist Economies." British Journal of Political Science. vol 19, no. 1. January 1989. p. 51.
[18] Ibid., p. 51.
[19] Linda Weiss, p. 60.
[20] William D Coleman and Wyn Grant, "The organizational cohesion and political access of business: a study of comprehensive organization." European Journal of Political Research. vol. 16, no. 5. July 1988. p. 483.

Table 1. **Institutional configuration necessary for transformative capacity**

Strong state	***Strong social groups***
-rational legal authority	-encompassing peak organizations capable of aggregating interests and negotiating with state
- merit-driven bureaucracy	
-centralized agency capable of coordinating policy	

Table 1 summarizes the institutional endowments conducive to transformative capacity in the financial sector. With these institutional endowments, the state should be sufficiently insulated from industry and to resist rent-seeking and capture by the banks in its jurisdiction. It should also retain a level of connectedness and "the capacity for social goal-setting and for coordinating policy."[21]

> State connectedness without insulation is likely to breed rent-seeking and distribution coalitions that can smother industrial vitality. By contrast, insulation without connectedness may widen information gaps that encourage policy failure. But states which combine both insulation and connectedness…are equipped with greater institutional assets for minimizing these changes and for achieving policy successes.[22]

This paper acknowledges the presence of structural pressures in the global economy that can constrain regulatory capacity in the financial sector. Internationalization raises the cost of some policies.[23] It also acknowledges the process of Europeanization carries some policy prescriptions. However, the capacity for states to effectively adjust to structural pressures in the global economy and to adapt international norms and laws in ways conducive to domestic conditions is variable. A close examination of financial sector reform in Hungary and Poland reveals that sequencing of internationalization and institution-

[21] Linda Weiss, p. 64.
[22] Linda Weiss, p. 64.
[23] Richard B. Mackenzie and Dwight R. Lee, Quicksilver Capital: How the Rapid Movement of Wealth Changed the World. (New York: Free Press, 1991); Ingo Walter, "Financial integration across borders and across sectors: implications for regulatory structures," Financial Supervision in Europe. Eds. Jeroen J.M. Kremers, Dirk Schoenmaker, and Peter J. Wierts. (Cheltenham, UK: Edward Elgar, 2003); Richard H. Henry and Robert E. Litan, Financial Regulation in the Global Economy. (Washington: The Brookings Institute, 1995); Michael Loriaux, Meredith Woo-Cummings, Kent E. Calder, Sylvia Maxfield, and Sofia A. Perez, Capital Ungoverned: Liberalizing Finance in Interventionist States (Ithaca: Cornell University Press, 1997); For a competing view, see: Steven K. Vogel, Freer Markets, More Rules.

building has an important impact on state-bank relations and thus the level of transformative capacity.

Transformative capacity is the dependent variable in this study. Weiss' definition of transformative capacity as a mechanism of adjustment in the industrial sector needs slight tailoring for the purposes of studying the financial sector. Transformative capacity in the financial sector is defined here as the ability to protect citizens from banking crises, individual banking collapses and fraud and to act strategically to reduce the cost of sector adjustment to taxpayers in financial markets open to competition from abroad. The indicators of this capacity are the ability for states to introduce regulatory burdens on banks conducive to domestic conditions for the sake of sector stability despite a high degree of financial sector internationalization. The ability for states to achieve broad policy objectives such as the maintenance of a strong domestic presence in the financial sector, an original policy goal at the outset of financial in both countries under examination, is also relevant. The next section of this paper demonstrates that Poland has performed much better across these indicators than Hungary.

Hungary, Poland and early financial reform

This study is based on some 70 interviews in Hungary and Poland's foreign and domestic banks, financial regulators and central banks. According to several interviewees in Hungary and Poland, policymakers in both countries shared three related goals at the outset of financial sector reform.

1. To prepare their financial sectors for eventual EU accession;
2. To limit the cost of financial sector transformation to the state budget and to taxpayers, which includes limiting instability, corruption and individual bank failures;
3. To preserve a strong national (and state) presence in financial services despite the obvious need for foreign direct investment.

Regarding the first goal, both Hungary and Poland are European Union (EU) candidates and, as such, are bound by the EU's *acquis communitaire,* including the First (1977) and Second Banking Directives (1989). Although the First and Second banking directives represent the world's most advanced example of interstate regulatory coordination, the EU's approach can be summarized as a system of "mutual recognition accompanied by minimum harmonization."[24] The principle of mutual recognition means that all banks regulated by one member state are free to operate in any member country as holders of the 'single passport.' According to Michael Tison, "the directives do not aim at creating a European 'banking law', which gives an exhaustive account of prudential standards to be applied by the member states."[25] The EU's overall approach to financial regulation thus entails minimum interference with domestic policymaking "subject to the constraint of harmonizing key accounting, supervisory and investor-protection standards."[26] Important to this study is the recognition that regulators in Hungary and Poland are not constrained by EU directives in imposing more burdensome regulations on the banks operating within their jurisdictions.

Borrowing from Fritz Scharpf and Susanne Lutz, it is possible to characterize the EU's banking directives as *'autonomy safe.'* Aside from instituting a set of minimum standards, national regulation practices can "still be continued in the shadow of a quantitative minimum norm."[27] Despite the implementation of the first and second banking directives, banking supervision remains the domain of states in the EU. This fact helps explain the

[24] Martijn van Empel and Anna Marner, "Financial Services and Regional Integration." Financial Regulation: Why, How and Where Now? Eds. Charles Goodhart, Philipp Hartman, David Llewellyn, Liliana Rogas-Suarez, Steven Weisbrod. (London: Routledge, 1998). p. 67.

[25] Michel Tison, "Harmonization and Legal Transplantation of EU Banking Supervisory Rules to Transitional Economies: A Legal Approach." Banking and Financial Stability in Central Europe: Integrating Transition Economies into the European Union. Eds. David Green and Karl Petrick. (Cheltenham, UK: Edward Elgar, 2002). p. 48.

[26] Jean-Pierre Danthine, Francesco Giavazzi, Xavier Vives, and Ernst-Ludwig bon Thadden, The Future of European Banking. Monitoring European Integration 9. (London: Centre of Economic Research, 1999). p. 24.

[27] Susanne Lutz, "Beyond the Basel Accord: Banking Regulation in a System of Multilevel Governance." Paper presented at the 41st International Studies Association Conference. March 14-18, 2000.

persistence of difference in the regulatory regimes of EU member states and the variation in the trajectories in the Europeanization of financial services regulation in the accession candidates. *In short, there is no blueprint of reform for the accession countries.* Similarly, it is realistic to suspect that a large degree of variation in the financial regulatory regimes of the two cases under examination will persist once the accession process is complete.

In Poland, for example, regulators are quick to point out that the EU's regulations are appropriate for markets with much lower degrees of risk.[28] As such, convergence with the EU's *acquis* has proceeded "to take in account the level of development of the domestic banking system."[29] In many cases, Poland has overshot the EU's minimum requirements. Poland's approach is the primary reason why, for example, the head of the domestic banking association has pleaded in the domestic press for the reduction in the Polish regulatory burden to match EU norms.[30] In Hungary, the EU accession process has been felt as a liberalizing force to the detriment of the taxpayer and consumer of financial services. Regulators have rushed to adopt those measures that lower the regulatory burdens for the banks and have delayed to the last possible moment those that raise the burdens. Hungarian policymakers have also set the EU's minimum requirements as their policy targets. The argument here is that the domestic linkages between the state and the banks operating in its jurisdiction crucially affect the capacity for the state to successfully tailor the EU convergence process according to domestic conditions.

Regarding the second objective, there has been substantial differences in the cost of financial sector reform in Hungary and Poland. Taxpayers in Hungary were obliged to pay out nearly 13% of GDP to re-capitalize the banks while in Poland the figure is closer to 6%. Furthermore, as appendix 1 demonstrates, corruption has been rampant in Hungary with 10 major scandals in the banking sector since the banking crisis in 1993 and one major bank

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[28] Interview: Andrzej Reich, Director, Supervisory Policy Division. National Bank of Poland (GNiB).
[29] National Bank of Poland, "The Polish Banking System in the Nineties." Mimeo. December 2001. p. 26.
[30] Waldemar Grzegorczyk, "Potrzebne nowe przepisy." Rzeczpospolita. 07.04/2003. http://arch.rp.pl.

bailout that was a substantial burden on the taxpayer. Weak governing capacity contributed to the 'fire sale' conditions under which Hungary sold much of its banking sector to foreigners. It also allowed the domestic managers of the privatized banks to negotiate highly favourable privatization conditions for themselves.[31] The return on Hungary's banking assets was negligible if one factors in the cost of re-capitalization.

In Poland, corruption in the financial sector has been rare and no major bank failures have occurred since the original banking crisis. The regulator, as demonstrated in Appendix B, is extremely tough. The banks in Poland are obliged to absorb a much greater share of the regulatory and re-structuring burden. As revealed in Appendix 2, the regulatory climate is much more stringent in Poland than in Hungary. Polish policymakers were also able to secure much higher returns on the banking assets sold to foreigners and impose conditions on the buyers designed to retain the "Polish" identity of the banks. The bank association, on the other hand, recognized the value of stringent regulatory climate and have been able to negotiate a gradual decrease in the burden as sector stability improved.

Regarding the third goal, both countries at the outset of reform sought to maintain strategic state-owned stakes and a substantial domestic presence in the banking sector despite the obvious need for foreign direct investment. This goal was a reaction to public suspicion of foreign banks and elite concerns over foreign bank strategy. However, Hungary has been much less successful in achieving this initial goal. It sold its largest retail bank, which is now owned primarily by international institutional investors and has diverted its development finance activities to the Hungarian Development Bank, which is reputed to be the most corrupt bank in the country. Furthermore, the second largest bank in Hungary, Postabank, had to be privatized to foreigners after a collapse brought on by fraudulent management and political interference by politicians that delayed regulatory intervention. Poland, despite

[31] For example, Zigmund Jurai, when CEO of MHB, negotiated a bonus structure as a reward for the successful privatization of his bank to foreign investors. Upon completion of the sale, Jurai received a packet of shares worth millions of forints. Such cases were frequent.

opposition from the International Monetary Fund, the World Bank and other international organizations, has maintained state-ownership of the largest bank, PKO BP. Despite the state presence, PKO has evolved into one of the country's most profitable banks. It will be merged with the largest state insurance company to create a national champion. Table 2 summarizes the success of each country in achieving its original policy goals. Measured together, I argue that these indicate a much higher level of state capacity in Poland than in Hungary.

Table 2. **Indicators of transformative capacity in Hungary and Poland**

	Hungary	**Poland**
EU accession process…	**Decreasing burden on banks**	**Increasing burden on banks**
Cost minimizing	- Deposit insurance coverage not adjusted until accession - Withholding tax not adopted - Money laundering legislation delayed until blacklisted by the Financial Action Task Force. - Securities/banking activities merged 1999. Universal banking permitted 1999. - Regulatory agencies merged in 1999/2001.	- Delayed until accession
Cost increasing	- Delayed until accession	- Gradual increase in deposit insurance - Money laundering legislation implemented in 1994 - Withholding tax adopted in 2001 - Universal banking not permitted until accession
Foreign bank assets to commercial banking assets[32]	**90%**	**70%**
Cost of transformation		
Cost of financial sector bailouts[33]	*13%+ GDP*	*3.5-6% GDP*
Number of financial sector bailouts	*3*	*1*
Cost of public bailouts of major banks since banking crisis	*2.4% of GDP*[34]	*0*
Major corruption scandals since banking crisis - number of cases leading to arrests of CEO	*10* *1*	*1* *1*
Distribution of costs in regulatory arena…[35]	*Minimize cost to banks*	*Minimize costs to state budget*
Revenue from privatization	*"Minuscule"*[36]	*Substantial*[37]

[32] Figures from: Katalin Mero and Marianna Endresz Valentinyi, "The role of Foreign Banks in Five Central and Eastern European Countries" Mimeo. National Bank of Hungary. November 2003. Note that the 90% figure for Hungary does not include the recent purchase of Postabank by Erste Bank of Austria.

[33] Gyorgy Szapary, "Banking Sector Reform in Hungary: Lesson Learned, Current Trends and Prospects." NBH Working Paper 2001/05. December 2001. p. 13. Szapary estimates the cost of re-capitalization in Poland at 6%. According to the National Bank of Poland and the World Bank, the figure is closer to 3.5% of GDP. Gerard Caprio and Daniela Klingebiel, "Episodes of Systemic Borderline Financial Crises." IMF Mimeo. January 2003.

[34] Author's calculations based on Anita Benko. "Audit Office approves Postabank consolidation." Budapest Business Journal. April 21, 2003. Factiva Online. Document wbbj000020030424dz4l00009.

[35] See appendix B.

[36] C.W. Neale and S. Bozik, "How the Hungarian State-owned Banks were Privatized." Post-communist Economies. vol. 13, no. 2. 2001. p. 147. The cost of recapitalizing Budapest Bank was 27.5bn forint whereas the revenue from privatization to GE Capital was 26.8bn forint. The Postabank recapitalization was in excess of US$ 800m. Reuters New Service, "Hungary Postabank says it is ready for sell-off." September 11, 2000. Factiva Online. Document iba0000020010821dw0880o. The bank was recently sold for US$466m. EIU Viewswire, Hungary industry: Postabank sold for healthy premium." October 8, 2003. Factiva Online.

[37] Anonymous Interview: Treasury Ministry, Poland.

Sequencing of internationalization in Hungary

Below, I demonstrate that the arrival of foreign banks early in Hungary's financial reform created a set of domestic interests/economic agents who viewed aid from the state as essential to their individual survival. Foreign bank entry put competitive pressures on bank managers from state-owned banks. Subsequent to the banking crisis, these managers recognized their banks were severely disadvantaged in the competitive marketplace. They had incentive to engage in rent-seeking from the state. Policymaking in the financial sector at this stage of reform was suffering from the absence of a coordinated financial policy, the absence of an independent regulator and a dearth of technocrats necessary to respond effectively. Policymakers in Hungary were nonetheless anxious to maintain a strong domestic presence in the banking sector. These factors combined to institutionalize a pattern of state-bank relations that facilitated regulatory capture by domestic bank managers and undermined the long-term transformative capacity of the state in the financial sector. Subsequent bank reform in the Hungarian banking sector was characterized by bank-friendly regulations that punished the taxpayer, higher levels of corruption, and a weak regulatory agency incapable of protecting consumers and taxpayers. Furthermore the state was unable to achieve is primary policy goals.

Foreign bank penetration in Hungary

As in Poland, politicians and the leading experts in Hungary had initially intended to retain a degree of state ownership and a strong national presence in the domestic banking sector. There was fear that foreign banks could dominate the sector very quickly if existing domestic banks were sold off to multinationals and that this would bring negative repercussions. Lajos Bokros, then Executive Director of the Hungarian National Bank, President of the Council of the Stock Exchange, a member of the Board of Directors of the

State Property agency, and a future Minister of Finance, stated that "(f)oreign capital should be prevented from simply buying up existing banks, and from taking on the customers and networks of the domestic banks…Foreign capital should be directed towards establishing new institutions with their own clients, and to construct networks and new services using their own resources."[38] A proposal to sell 25% stakes in two banks in 1990, OKHB and K&H to a German and German-French consortium respectively, were scuttled after the government refused to guarantee that the foreign banks could acquire majority stakes in the future. As a former Deputy Minister of Finance suggests, "at that time, nobody was willing to accept this condition."[39] It was clear at the very beginning that while foreign banks were welcome to establish greenfield operations, a strong Hungarian presence in the sector was to be maintained.[40] This sentiment was shared across all major political parties.[41]

While the state was initially reluctant to sell existing state banks to foreigners, a liberal licensing policy towards greenfield investment was instituted in 1990. This was designed to attract foreign direct investment (FDI) in other industries and foreign capital to government-issued debt securities. In no way did policymakers see these two strategies (the

[38] Peter Mihaly, "Bank Privatization in Hungary." Central European Banker Online. Budapest: East-West Management Institute. www.ewmi.hu.
[39] Peter Mihaly. "Bank Privatization in Hungary."
[40] One year later, the Antall government considered proposals to sell three large banks to foreigners. But these fell through. Initially, the preferred method of privatization was to sell stakes in the domestic banks via listings on the Budapest Stock Exchange. Interview: Peter Mihaly. Head of Banking Programs, East-West Management Institute. Former Deputy Minister of Finance, Hungary.

The capacity for foreign banks to circumvent regulation was not a concern. According to Peter Mihaly, Deputy Minister in the Finance Ministry from 1990-1994, there was concern that foreign bank entry could harm large enterprises through the write-down of bad debts and the imposition of bankruptcy on large employers. There was also concern that competitors "in the west could use their Hungarian banking connections to prevent access to finance. For example, our steel mills may not get financing from German banks because they compete with German mills." In short, "the sale of large banks was a 'delicate' subject even amongst professional public opinion." Interview: Peter Mihaly.

This sentiment prevailed until 1995-6. By late 1995, the state's position had shifted after repeated bailouts of the banking sector made necessary by a combination of mismanagement, fraud, and deep recession. By year-end, Lajos Bokros, who was so vehemently opposed to selling state banks to foreigners, had orchestrated the sale of Budapest Bank. By the end of 1996, the state had sold six of its state-owned banks representing 31% market share. Thereafter, the government pursued new strategies to protect the Hungarian presence in the sector. It established a maximum 50% market share target for foreign banks. It also decided to privatize OTP, but via the stock exchange so as to keep the management Hungarian. Gyorgy Szapary, p. 15.

The government would not even consider a proposal by George Soros, a Hungarian émigré and billionaire financier, to purchase OTP because of fears about foreign control. Anonymous Interview: Ministry of Finance.
[41] Interview: Laszlo Urban, Former Adviser to Ministry of Finance.

preservation of a national presence and the liberal licensing policy towards foreign banks) as mutually exclusive. As Table 2 demonstrates, greenfield investment by foreign banks reached significant levels by 1993. Foreign banks were attracted by the country's relative stability and by the business opportunities presented by high levels of FDI entering the country. Many banks were dormant at first. Others focused on servicing multinational corporations. Nevertheless, foreign banks were already entrenched by the time the government began privatizing state banks in earnest in 1994 and 1995.

Table 3. **Foreign and domestic bank assets in Hungary compared**

	Foreign banks			*Domestic banks*		
	# of foreign banks	% net assets	% corporate loans	# of domestic banks	% net assets	% corporate loans
1993	20	15.4	15.5	23	84.8	84.5
1994	21	19.7	20.9	23	80.3	79.1
1995	22	39.5	52.2	22	60.5	47.8
1996	22	46.6	58.1	22	53.4	41.9
1997	22	61.8	70.6	22	38.2	29.4
1998	22	62.6	76.3	22	37.4	23.7

Source: Claudia Buch, "Governance and Restructuring of Commercial Banks." p. 62.

Banking crisis

Meanwhile, over the course of 1992-5, the state launched 3 bailouts in response to a mounting bad debt problem. Two of these bailouts were aimed at re-capitalizing the banks. Over this period, the Ministry of Finance, with the Privatization Agency and the State Banking Supervisor in a subordinate role issued nearly HUF 400bn (US$ 4bn) in government bonds to the banks.[42] The first two bailouts were half-measures and cosmetic balance sheet adjustments that failed to solve the bad-debt problem and impose market discipline on the sector. The third, although better designed, was too late to countervail the impression that the state was weak both susceptible to pressures from the vested bank lobby and an unreliable partner in financial sector reform. This impression, once in place, was difficult to reverse.

[42] Peter Mihaly, "Bank Privatization in Hungary." US$ figure based on average value of forint against US$ 1992-1995.

The total cost of the first rounds of the restructuring process topped 10% of GDP.[43] Factoring in later bailouts, the cost to the taxpayer of transfers to the banking sector is around 13%.[44] This has meant a major increase in the debt load carried by the government (and thus the taxpayer). The rescues also meant reduced government capacity to spend money on, in the words of Bonin *et al.* "legitimate social needs."[45] The payouts to the banks contributed to necessity of the deeply unpopular 1995 austerity programme under Finance Minister Lajos Bokros.

Foreign banks, domestic banks and the banking crisis

The banking crises in Hungary and Poland of 1992-5 represented a critical juncture in financial sector reform whereby policymakers had the opportunity to re-cast the regulatory system and boost regulatory capacity. A critical juncture in political science is a branching point on a development trajectory when two or more options are available to policymakers. Once a particular policy is chosen, the other options available at the critical juncture become increasing unavailable. As demonstrated later in this paper, Poland took advantage of this critical juncture and used the banking crisis as a pre-text to centralize regulatory authority, which facilitated the long-term development of transformative capacity, and to impose a stringent regulatory and taxation regime. In Hungary, this opportunity was not seized and little effort was made to craft a centralized agency capable of effectively regulating an increasingly competitive banking sector. The crucial difference in the two cases in the period was the level of foreign bank penetration. In Hungary, the number of foreign banks and the level of competition for the incumbent domestic banks were much higher.

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[43] Istvan Abel and Pierre L. Siklos, "Privatizing A Banking System: A Case Study Of Hungary" (March 2001). http://ssrn.com/abstract=286777

[44] Gyorgy Szapary, p. 13.

[45] Bonin *et al.,* p. 85.

According to former state officials interviewed for this study, competition in the banking sector became fierce once banking services were liberalized in 1989.[46] Foreign greenfield banks, benefited from a) superior reputational capital, b) a more innovative product range, c) clean portfolios that were not burdened by non-performing assets and d) access to more capital. Their superior reputational capital meant that "even households were going to foreign banks because the felt that they were safer than existing Hungarian banks, even if it cost more. Thus, the good clients went to them and the bad clients stayed with the state banks."[47] In 1994, foreign banks controlled nearly 20% of domestic banking assets. More importantly, however, they controlled 29.1% of entrepreneurial deposits and 25.5% of entrepreneurial credits.[48] They also dominated the provision of financial services to multinational corporations. Entrepreneurial deposits and credits represent the emerging business elite and the cream of the Hungarian clients. Equally important, loans to multinationals and entrepreneurs represented the only reliable portion of the loan portfolio while many of loans from state-owned enterprises and retail clients were in arrears.

Another factor for their superior performance was the innovative product mix offered by foreign banks. According to the State Banking Supervision's annual report for 1994-5, foreign banks "put much more stress on services to their customers and…have a proportionately higher income from commissions for their services than large banks."[49] This is important because commission income is more stable and more profitable.[50]

Foreign banks also benefited from the substantial non-performing loans in the incumbent domestic banks. According to the State Banking Supervision, foreign banks

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[46] This impression is corroborated by: Giovanne Majnoni, Rashmi Shankar and Eva Varhegyi, "The Dynamics of Foreign Bank Ownership: Evidence from Hungary." World Bank Policy Research Working Paper 3114, August 2003.
[47] Peter Mihaly; "Bank Privatization in Hungary."
[48] Bonin *et al.* p. 85.
[49] Hungarian State Banking Supervision, Annual Report 1994-5. p. 40.
[50] A regression analysis of the impact of foreign ownership on sector efficiency reveals that the foreign banks' superior efficiency stems from a larger and more innovative product-mix of financial services. Note also that the interest margins were not significantly different among foreign and domestic banks. Giovanne Majnoni, Rashmi Shankar and Eva Varhegyi, p. 19.

represented only 6% of total banking provisions in 1994.[51] This is a disadvantage for incumbent state banks because they need to compensate for past losses with higher interest rate spreads. And, as Claudia Buch suggests, "(h)igh spreads cannot be maintained if market access is liberalized: as the number of competitors rises, the equilibrium loan rate converges to the bank's marginal costs."[52] Downward pressure on interest rate spreads diminishes domestic bank profitability and may compound problems in banks already confronting solvency problems.[53] Majnoni, Shankar and Verhegyi's analysis of the Hungarian financial sector confirms that the bad loans problem was "a crucial factor" in relative performance.[54]

A third, related advantage was foreign bank access to capital and ability to offer hard currency loans. According to Laszlo Urban, an adviser to the Finance Minister of the first FIDESZ government, "the reason why these newly established banks were so successful was that in the early 1990s after the collapse of trading relations and a huge jump in inflation, credit worthy corporate clients wanted to borrow funds in hard currency because the interest rates were a lot lower. These (foreign) banks were simply channelling funds from out of the country to the really competitive enterprises. They basically lured away all the clients who were really worthwhile financing…the state-owned banks were left with the clients who were basically bankrupt. They were left with just junk. This is how Raiffessein, CIB, and Citibank…made all their huge money in the first half of the 1990s."[55] The greenfield banks quickly secured the best Hungarian and most multinational clients. In 1994-5, foreign bank

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[51] Hungarian State Banking Supervision, Annual Report 1994-5. p. 44.

[52] Claudia Buch, "Governance and Restructuring of Commercial Banks." Banking and Monetary Policy in Eastern Europe: The First Ten Years. Ed. Adalbert Winkler. (Houndmills, NH: Palgrave, 2002). p. 47.

[53] The legacy of non-performing loans and the subsequent need to generate provisions are also a contributing factor to the poorer performance of banks privatized to foreigners vis-à-vis foreign greenfield banks. In terms of profitability and cost-effectiveness, the greenfield banks showed a better combined performance than privatized institutions, notwithstanding the higher interest margins earned by the latter. The main reasons for the poor results of the privatized banks are higher operating costs, and more important, *the higher provisioning costs.* (emphasis added) A second factor behind the outperformance of greenfield banks over strategic acquisitions is the length of presence in the domestic market: "A common feature of the greenfield of banks that have achieved an outstanding performance *and* a good market position is the long-standing presence on the Hungarian market." Majnoni, Shankar and Varehegyi, p. 13.

[54] Majnoni, Shankar and Varehegyi, p. 12.

[55] Interview: Laszlo Urban. Adviser to the Ministry of Finance, 1991-3.

revenues grew by nearly 100% where as the income of the large domestic banks increased by only 20%, of which, according to the supervisory agency most "was not even collected in reality."[56] Thus, while banks in both Hungary and Poland were confronting a burgeoning bad-loans problem, banks in Hungary were also hit by a rapid defection of their only profitable clients to thief foreign competitors.

There is considerable evidence that domestic policymakers in Hungary first realized the extent of the threat posed by greenfield banks to domestic strategic banks during the banking crisis. First, interviewees connected to the state at the critical juncture of financial reform noted that there was sudden alarm over the surprising performance of the foreign banks.[57] Second, the State Banking Supervisor's (SBS) 1994 annual report notes that the market share of the 6 large Hungarian banks fell dramatically.

> In 1992 they held 80%, in 1993 75% and in 1994 only 70% of the market. The winner was quite clearly the…group with the important foreign investors - as this group nearly doubled its share in a market stagnating for two years…This corresponds to our statement made in the previous annual report that the (foreign banks) had better opportunities for expansion concerning both market demand and capital than any other members of the banking sector.[58]

The competition from foreign banks had a dramatic impact on bank-state relations. According to a high-level adviser to the Ministry of Finance in 1992-1994, the managers from the state-owned banks' started to panic. They started to lobby for consolidation and recapitalization especially since the sums grew overwhelming and "basically the government did not have any choice."[59] The consumers' flight to foreign banks exacerbated the urgency for state aid and enhanced the incentive among policymakers to re-capitalize the banks and absorb the burden of bad-loan losses and recovery when the banking crisis hit.

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[56] Giovanne Majnoni, Rashmi Shankar and Eva Varhegyi, p. 20.
[57] Interviews: Marta Klemencsis, Ministry of Finance; Laszlo Urban, Adviser to the Ministry of Finance, 1991-3.
[58] Hungarian State Banking Supervision, Annual Report 1994-5. pp. 39-40.
[59] Interview: Laszlo Urban, Adviser to the Ministry of Finance, 1991-3.

Domestic banks used their links to politicians to seek protection in the newly competitive banking environment. According to a government insider from 1991-1994, "(f)rom a bankers point of view, they had no one else to turn to. On the market place, they could not compete. There was no way they could keep their best customers who needed hard currency loans. They could keep part of their portfolios, but they could not make much profit. They definitely had the incentive to turn to politicians either for money or some kind of regulation that would help them…"[60] As one Ministry of Finance official noted… "the banks were not to interested in following the rules. They just came to us and asked us for help – this was easier."[61]

The state reciprocated irrespective of the tenants of sound banking regulation. The national bank had an interest in the bond buying capacity of the banks and their foreign currency reserves. The Ministry of Finance was much more concerned about the large enterprise sector's ability to access credits and the maintenance of a strong Hungarian presence in the sector for domestic populist consumption. The banks were thus able to find protection… "The banks were very clever. They followed a policy of divide and rule. The Finance Ministry protected some bank managers and the Central Bank protected others."[62] These circumstances were significant barriers to effective regulation. The intense competition in the sector and competing interests among the state bodies meant that the supervisor was under a lot of pressure to accept a subordinate role.

According to Katalin Botos, the first head of the independent banking supervision, "it was very difficult for the supervisor to supervise the state" in the critical period leading up to and the period after the banking crisis,[63] At that time, the state banking supervision was isolated politically as it sought to impose a more stringent regulatory environment. During

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[60] Interview: Laszlo Urban, Adviser to the Ministry of Finance, 1991-3.
[61] Interview: Marta Klemencsis, Ministry of Finance.
[62] Interview: Klara Kovari-Csoor, Hungarian Financial Supervisory Authority.
[63] Interview: Marta Klemencsis, Ministry of Finance.

her tenure as head of regulation in the early 1990s, Katalin Botos was locked in conflict with the National Bank of Hungary (NBH) and finance ministry. The crisis did not lead to acquiescence to the regulator's authority. The finance ministry was intent on limiting the capacity of the regulator to impose burdens on the sector and on subverting regulatory authority irrespective of the legislated mandate of Botos' team.

While the aftermath of the banking crisis in Poland was marked by the consolidation of regulatory authority in Poland, the crisis thus prompted a further de-centralization in Hungary. During the crisis, the NBH was given a formal role in monitoring the sector. The State Banking Supervision, which was hived off from the Ministry of Finance in 1991, was given a new address and more *de jure* autonomy. However, the Ministry of Finance refused to forgo its authority in the regulatory arena despite the dubious outcomes wrought by its meddling and retained oversight over the operations of the State Banking Supervision. The result was the absence of a coherent, autonomous and centralized supervisory framework to govern decision-making.[64] This would mark the first of three attempts to re-craft the supervisor since its creation in 1987.

Compounding the problems created by interference from other state agencies, the regulator was experiencing difficulty in retaining senior and mid-level bureaucrats. As Botos recounts, "my people were not so good. This is because the competition between the market and the state sector for employees meant that it was difficult to find the best people."[65] As a new agency nominally independent from the National Bank and the Finance Ministry and as a secondary player among state agencies in the financial arena, the supervisor could not rely on prestige to attract competent employees. Thus, the knowledge gap between the regulated and the regulator was acute. The gap diminished the supervisory agency's prestige and the

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[64] Wording from Terry Lynn Karl, p. 14.
[65] Interview: Katalin Botos, former head of State Banking Supervision.

morale among its employees, which only compounded the difficulties in recruiting competent professionals.

This climate of personalized rent-seeking also stunted the development of the domestic banking association. Despite lip service to the role of the association by some of its members, the association in Hungary, in the worlds of one high-ranking official at the NBH "is just an administrative body…just to scream if the banks do not like something. They do not have an integrator or initiator role. This is missing in the system…They do not have sufficient budget and relevant experts. They are not really proactive."[66] The absence of a viable peak organization ahs frustrated efforts to implement a national credit rating database, legislation on money laundering and to negotiate a increase in the deposit insurance burden leading up to EU accession. This is in marked contrast to Poland where the banking association plays a constructive role in the sector and has been able to secure policy changes that benefit the sector writ large.

According to an official at Hungary's banking supervisor, "individual banks are very powerful, for example such as OTP, but the sector is not."[67]Another official noted that the sector does not have effective representation at supervisory agency. "This is not my job, but I do it. There is no one to do it for them."[68] Also, the foreign banks prefer to ask their politicians in their home markets to lobby Hungarian officials.

In short, early foreign bank entry stunted the development of a centralized, merit-driven bureaucracy capable of coordinating financial sector policy. Early entry also diminished the incentive for banks to form a peak association capable of aggregating the sector's collective interests and of being a viable partner in the formation and implementation of regulatory policy. The resultant pattern of state-bank relations was path dependent and not conducive to the long-term transformative capacity in the financial sector.

[66] Interview: Lajos Barthos, National Bank of Hungary.
[67] Anonymous interview, Hungarian Financial Services Authority.
[68] Anonymous interview, Hungarian Financial Services Authority.

Subsequent outcomes in the sector were marked by an inability to meet the original policy goals. The regulator has been re-crafted at least three times since its formation and the head of supervision has changed five times, usually under a cloud of scandal. Furthermore, the regulator has been subject to persistent efforts by politicians to subvert its authority – leading to a major bank failure and a very recent scandal involving a foreign bank subsidiary and both the governing and lead opposition parties. Appendix A demonstrates the high levels of corruption and high levels of moral hazard in the Hungarian banking sector. This has increased the cost of financial sector transformation for the domestic taxpayer. Furthermore, the capacity to adopt EU directives in a manner conducive to domestic conditions has been diminished.

Efforts to boost regulatory authority in the wake of financial scandals have done little to boost transformative capacity thus revealing the path dependence of initial outcomes in the sector. In 1997, after the Ministry of Finance usurped the supervisor's capacity to issue binding regulations, the supervisor adopted an 'automatized' approach to regulation. As one current employee at the HFSA argues "(i)t is checkbox regulation. My computer can do this job. They say we need this approach to be strict. But we are not being strict because a bank can pay and these costs will be merely passed on to the depositors or the creditors."[69] An independent observer of the Hungarian financial sector agreed with this assessment.[70] The net result has been numerous fines levied against the banks for procedural errors and a high level of antagonism between the regulator and the regulated. In contrast to Poland where fines are infrequent and where discord over compliance is negotiated between the regulator and bank management boards, there were over 200 judicial challenges to the fines in Hungary between 2000-2002. Regulation, according to insiders, has nothing to do with risk

[69] Anonymous Interview: Hungarian Financial Services Authority.
[70] "Mr Szasz, (the current head of the Hungarian Financial Services Authority) had his accountants and sent them to the banks and then if you were late in filing info, he would fine them. He would say, I am a tough guy, I am fining the banks. This has nothing to do with risk assessment and evaluation. There are no sophisticated methods." Interview: Laszlo Urban, Adviser to the Ministry of Finance, 1991-3.

assessment and evaluation.[71] "There are no sophisticated methods" of assessing risk. Again, as the K&H scandal of 2003 and 2004 demonstrates, the climate of rent-seeking, corruption, and risk persists.

Poland

Foreign bank entry occurred much later in the transition from socialism in Poland and only after concerted efforts at institution-building. The late entry diminished the incentives among politicians to protect individual banks and to block the development of an independent bank regulator. The lack of threat to their competitive positions and their shared problems encouraged the banks to cooperate and to form a peak organization capable of negotiating and coordinating policy with the state. Combined, these factors facilitated the institutionalization of the state's lead role in state-bank relations and facilitated the development of transformative capacity.

Like Hungary, Poland did not have a sustained recent history in market-orientated banking. A capitalist banking system would have to be built from the endowments left by the tentative reforms in the 1980s. The initial response by the first post-communist government reflected a perceived need to inject market principles in credit allocation as quickly as possible. The first post-communist government hastened the end of the monobank system and split the commercial banking function from the National Bank of Poland and passed it to nine new regional banks formed out of the NBP's regional offices, two large state retail banks (PKO BP and Pekao SA) that dominated the market in household deposits and a foreign trade bank (Bank Handlowy). The establishment of the two-tier system was codified in the 1989 Banking Law. When the new banks were formed, the managers were selected

[71] Anonymous interview: Hungarian Financial Services Authority.

from a cadre academics and politically connected bureaucrats, most of whom were educated at the Warsaw School of Economics.[72]

In addition, the act established a German model of corporate governance with independent management and supervisory boards accountable for the banks' performance. This regulation was important because it removed the banks from the day to day control of the government, although ownership and the right to appoint board members was retained by the state.[73] According to one Central Bank insider, management boards quickly asserted their independence.[74]

The regulatory framework introduced by the banking law had two fatal flaws. The first was that the licensing requirements were too liberal. New banks could be established with ECU 5m capital, which could be borrowed. The intention of the liberal licensing requirement was to introduce competition in financial intermediation, but the net effect was to contribute to the fragility of the sector.[75] The number of banks jumped from 8 to 75 from 1989 to 1992.[76] Of note here was the fact that the liberal licensing requirements for new banks opened the door for foreign bank entry. Poland was as open as Hungary in granting licenses to foreigners in the period leading up to the crisis. Foreign banks were seen as a further means of encouraging competition in the sector and encouraging foreign investment.

Several measures were introduced to encourage foreign investors. Tax relief was offered (up to the amount of the contributed capital) for the first three years of a bank's operation. The state also allowed the possibility of contributing and holding bank capital in foreign currency.[77] There was not an initial stampede into the Polish market however. Seven

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[72] Interview: Grzegorz Kodolko, Former Finance Minister.
[73] Interview: Ryszard Kokoszczynski, Head of Research, National Bank of Poland.
[74] Interview: Ryszard Kokoszczynski, Head of Research, National Bank of Poland.
[75] Interview: Piotr Bednarksi, National Bank of Poland (GNiB).
[76] M. Iwanicz-Drozdowska, "Polska." Kryzysy bankowe: Przyczyny i rozwiazania. Warsaw: Bank Fundusz Gwarancja, 1999.
[77] National Bank of Poland, "The Polish Banking System in the Nineties." p. 50.

joint-stock companies were formed with the majority participation of foreign investors prior to 1993 and three foreign banks established branches.[78]

However, most of these new foreign and domestic banks were inadequately capitalized and led by managers who were at best inexperienced and at worst, scoundrels. Several new banks had to be closed or merged into other banks. Of the 75 banks on the market in 1992, only 43 remained by 2000.[79] Collapses were not confined to domestic banks. Although Poland managed to attract large international banks with sound reputations such as Citibank and Societe Generale, banks with dubious capital and origins were also licensed. One official at the general banking inspector (GNiB) cites one case in particular, where an American investor established a bank to attract deposits and lend to connected parties. That bank was established in 1989 and by 1991-1992, "suffered from a run and eventually was rescued by the National Bank of Poland (NBP)."[80] The public's faith in the already fragile financial architecture was further shaken by the numerous collapses.

The second flaw of the initial banking act was the emulation of the moral suasion approach to prudential regulation. From 1989 – 1993 regulators adopted a "soft approach" to regulation that relied on "moral suasion," "incentives" and "recommendations typical for British supervision in the 1970s and 1980s…"[81] The approach exacerbated the bad loans problem and contributed to the financial crisis of 1992-3. As Table 3 demonstrates, liquidity and solvency problems were occurring in the other post-communist countries primarily as a result of carry over of bad loans from the communist period and through the continuation of soft loans to politically connected parties. Although the bad loans problem emerged earlier in

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[78] "The opening of banks as branches of a foreign bank required additional agreements between the NBP and the foreign banks (concerning)…two issues: the amount of credit line granted to the Polish branch by the foreign-based head office (playing the role of own funds) and the obligation of the Polish branch to provide access to data relating to its operations, pursuant to the NBP reporting requirements." Andrzej Raczko, "The Polish banking sector and EU regulations," Financial and Monetary Integration in the New Europe: Convergence between the EU and Central and Eastern Europe. Ed. David G. Dickinson and Andrew W. Mullineux. (Cheltenham, UK: Edward Elgar, 2001). p. 313.
[79] Iwanicz-Drozdowska.
[80] Interview: Piotr Bednarksi, National Bank of Poland (GNiB).
[81] Piotr Bednarski, "Evolution of banking supervision in Poland and its future prospects." Mimeo. p. 6.

Hungary, non-performing loans equalled around 30% of total loans by 1993 in both countries.

Table 4. **Non-performing loans/total loans in Poland vs. Hungary** (%)

	1990	*1991*	*1992*	*1993*	*1994*
Hungary	4.4	16.3	13.4	30.0	27.2
Poland	n.a.	11.2	26.5	31.9	29.3

Source: Claudia Buch, Building efficient banking systems: Theory and Evidence from Eastern Europe. (Tübingen : J.C.B. Mohr , 1996). P. 28.

The crisis was a critical juncture in Poland and it prompted the regulator to re-cast regulation: "It became clear relatively quickly that the problems in the Polish banking system required new legislation going beyond the framework determined in the Banking Act and the Act on the NBP."[82] As discussed in detail below, re-casting meant re-capitalizing the banks with taxpayer funds to ensure compliance with the Basel capital ratios and imposing a stringent regulatory regime designed to drastically curtail the sector's discretion in prudential regulation. The crisis also focused policymakers' attention on the need to build institutional capacity in the regulatory arena.

The banking crisis encouraged a change in the management of the NBP. The NBP was also re-confirmed as the lead agency in regulating matters connected to the banking sector. In early 1992, the moral suasion approach to banking regulation was scrapped and the NBP gained the capacity to issue binding legislation on prudential standards.

Table 5. **Foreign and domestic bank assets in Poland compared**

	Foreign banks			*Domestic banks*		
	# of foreign banks	% net assets	% net loans	# of domestic banks	% net assets	% net loans
1993	10	2.6	2.7	77	90.8	90.2
1994	11	3.2	4.4	71	91.5	88.9
1995	18	4.3	5.8	63	90.6	88.7
1996	25	13.7	16.0	56	81.6	77.9
1997	29	15.3	18.2	44	80.2	76.3
1998	31	16.5	21.9	42	79.2	73.1

Claudia Buch, "Governance and Restructuring of Commercial Banks." p. 60.

The new management of the central banks took the lead role in financial sector policy. For example, Hanna Gonkiewicz-Waltz, the newly appointed President, convinced

[82] National Bank of Poland, "The Polish Banking System in the Nineties."

the Finance Minister to ban foreign greenfield bank entry.[83] As current and potential members of the WTO, OECD and the EU, they could not prevent foreign banks from establishing a presence. But they decided that this process would be guided in accordance with the national interest.[84]

The NBP had two reasons for banning greenfield investment. First, Gronkiewicz-Waltz and her advisers wanted to channel foreign bank entry into what they called 'constructive participation,' which meant the use of foreign bank licensing as a mechanism to consolidate the banking sector. That is, the NBP aimed to direct new foreign investment in the banking sector to re-capitalize ailing state banks. Second, according to an NBP publication, there were fears of an "excessive increase in competition against financially weak Polish banks."[85] One former adviser to Hanna Gronkiewicz-Waltz noted that…

> …when you are restructuring, you need to limit somewhat too harsh competition…*You don't allow sharks into an aquarium...*Imagine Citibank, where you have almost limitless own funds compared to banks in Poland. Lending capacity is 100x or higher than the capacity of local banks with weak capital bases...The competitiveness of foreign greenfield banks was too great.[86]

By limiting greenfield investment, the state prevented the poaching of the best domestic clients by foreigners and allowed the domestic banks to cleanse their domestic balance sheets and become more competitive and viable players in the domestic market. As noted, Gronkiewicz-Waltz suggests that the NBP was afraid that opening the market to greenfield investment would jeopardize domestic banks and would lead to mass closings,

[83] Interview: Hanna Gronkiewicz-Waltz, Former President of the National Bank of Poland.
[84] Interview: Hanna Gronkiewicz-Waltz, Former President of the National Bank of Poland; Tadeusz Parys, Adviser to the President, Banking Licensing Division, GNiB. The subject of licensing foreign banks re-emerged as a subject of debate at the Commission for Banking Supervision debate in April 2000. However, "the most appropriate form of a foreign organizations…(remains)…a joint-stock bank." The NBP acknowledges it will eventually "have to enable and ensure a credit institution" authorized by a regulator in another EU state "the freedom to provide financial services in Poland." National Bank of Poland. "The Polish Banking System in the 1990s." p. 37.
[85] National Bank of Poland, "The Polish Banking System in the 1990s." p. 51.
[86] Interview: Piotr Bednarksi, National Bank of Poland (GNiB).

which would not be politically expedient "for a country that was newly independent."[87] According to a former Finance Minister, the government in 1993-4 saw little middle ground between consolidating and keeping the banks in Polish hands and allowing foreigners to take over everything.[88]

The confirmation of the NBP as the lead agency in charge of coordinating policy in the financial sector facilitated the formation of a coherent strategy for minimizing the cost of the banking sector crisis. According to the 1993 Law on Financial Restructuring of Enterprises and Banks, each bank re-capitalized with state funds established a Difficult Loans Division charged with the responsibility of working out bad loans to state owned enterprises (determined by independent audits) and upgraded their loan portfolios as a condition of receiving re-capitalization funds. Banks had several options. The banks could "have the debtor repay the credit, initiate a bankruptcy of the indebted company, sign a court settlement with the debtor, or sell the existing loan on the secondary debt market at the going price."[89] Effective monitoring by the NBP encouraged the banks to abide by the rules of the programme.

The recapitalization programme is generally regarded as a success. The cost of bank sector re-capitalization to the taxpayer across the entire period of sector reform (1989 – 1999) was about 3.5% of GDP, which in comparative terms is quite low.[90] The programme taught the domestic policymaker benefits of a stringent regulatory regime and a proactive approach to regulation and that the domestic banks were capable of withstanding a stringent regulatory regime. The programme encouraged an end to connected lending, more prudent lending behaviour and risk analysis and, as a net effect, dramatically reduced moral hazard in the sector and was an extremely important step in insulating the state from rent-seeking. From

[87] Interview: Hanna Gronkiewicz-Waltz, Former President National Bank of Poland.
[88] Interview: Grzegorz Kodolko, Former Finance Minister.
[89] Bonin *et al.*, p. 120.
[90] Szapary, p. 13.

the perspective of the banks, the programme illustrated that the state was not susceptible to particularistic lobbying and that it would not take responsibility for bank difficulties from imprudent lending. Subsequent bailouts were minimal and financed by the banks themselves.[91]

The period 1993-4 was critical juncture for the Polish Bankers Association (PBA) as well. The events led to the emergence of the PBA as a viable peak association and a partner in financial regulation. The imposition of stringent regulatory environment in 1993-4 created a mini-revolt from the banks that, according to the then President of the National Bank, subsided within one or two years.[92] Participants from both the banking sector and the regulator characterized bank-regulator relations during this period as extremely difficult.[93] As Bednarski notes, the adoption of a "legalistic approach" was a shock for bankers, many of whom had not yet set aside provisions for non-performing loans.[94] The head of the PBA concurred: "we found the lines of communication with our regulator in a very difficult period."[95]

Freed from the direct control of the governments via the 1989 Banking Act, the banks were treasuring their new independence.[96] However the PBA, according to one insider, "realized at the peak of the crisis that you have to go for standards. After 1-2 years it was more peaceful. The banks appreciated the stability relative to other countries." [97] The banks began constructive dialog with the state via the association.[98]

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[91] The largest bank failure since the banking crisis in Poland was Starobank Polski, which was then a relatively minor player on the domestic market. When Starobank collapsed, the Bank Guarantee Fund initiated liquidation and compensated depositors with the contributions to the funds from the other banks in the sector. The cost to the sector was approximately US$ 100m. Interview: Artur Szeski, Analyst from CDM Securities.

[92] Interview: Hanna Gronkiewicz-Waltz, Former President of the National Bank of Poland.

[93] Interviews: Krzysztof Pietraskiewicz, General Director of Polish Bankers Association; Ryszard Kokoszczynski, National Bank of Poland.

[94] Interview: Piotr Bednarksi, National Bank of Poland (GNiB).

[95] Interview: Krzszytof Pietraskiewicz, General Director of Polish Bankers Association.

[96] Interview: Ryszard Kokoszczynski, National Bank of Poland.

[97] Interview: Ryszard Kokoszczynski, National Bank of Poland.

[98] The eventual acquiescence of the banks to the regulatory environment is not inconsistent with research done elsewhere. Natasha Hamilton-Hart, in *Asian States, Asian Banks,* finds that domestic banking sectors in South-

Poland, like Hungary, was fertile ground for rent-seeking and corruption. Bureaucrats from the Ministry of Finance and the National Bank were appointed to bank management and supervisory boards of the state banks formed at the outset of the transition. Many of the banking sector's current managers can be traced to pre-transition bureaucracy.[99] The familiarity within the banking sector can also be linked to their collective schooling. According to the Finance Minister from 1994-7, he and the bankers "all knew each other. We were all from the Warsaw School of Economics."[100] There is evidence even today that the political and banking sector elites remain entwined.[101] Nonetheless, the personalized networks in Poland did not induce rent-seeking and regulatory capture by the banking lobby that is characteristic of state-bank relations in Hungary.

The absence of a significant foreign bank presence meant that the bulk of the banking sector shared similar problems and were affected by the stringent approach adopted by the regulator in 1993-4 in approximately the same way. No banks had distinct competitive advantages in the stringent regulatory climate. The absence of a competitive threat created incentives to invest resources into the development of a sector peak organization to negotiate with the government agencies. Similarly, it diminished the perceived need on behalf of the state agencies to protect certain banks and certain banking segments.

In my thesis, I reveal that negotiated outcomes are visible in all aspects of regulation. The supervisor, in concert with the Ministry of Finance, Treasury and the Banking Association was able to negotiate a temporary regulatory subsidy in deposit insurance and

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East Asia were willing to tolerate a variety of regulatory responses to the Asian financial crises so long they were transparent and evenly applied. Natasha Hamilton-Hart, Asian States, Asian Bankers: Central Banking in Southeast Asia. (Ithaca: Cornell University Press, 2002).

[99] In fact, a former NBP governor had received complaints from politicians from parties on the right that pre-transition era functionaries dominated the management and supervisory boards of the banking sector. Interview: Hanna Gronkiewicz-Waltz, Former President of the National Bank of Poland.

[100] Interview: Grzegorz Kodloko, Former Finance Minister.

[101] For example, former Prime Minister Jan Krzysztof Bielecki was recently appointed CEO of Unicredito Italiano's Pekao SA subsidiary, which is the second largest retail bank in the country. Marek Belka, former Finance Minister and current Prime Ministerial candidate is a member of the board at BIG BG, a Portuguese bank. There are numerous other examples.

mandatory reserves for the remaining state-owned banks, which facilitated these banks' competitiveness. The subsidy was, upon the PBA's demands, temporary but allowed the state to maintain ownership in PKO and an agricultural bank (BGZ).

The association in Poland became the lead partner in crafting the national payment system and in developing a countrywide consumer credit database.[102] The association has been a constructive partner in managing the deposit insurance scheme, in negotiations over mandatory reserves, and in the gradual reductions of burdens connected to prudential regulation and taxation. The presence of the banking association at the policy design stage is also a likely contributor to the absence of fines. The frequent engagement between the association and the supervisor pre-empts the misunderstandings that lead to the high levels of fines for non-compliance in Hungary.

This centralization of regulatory authority under the banner of the NBP established the pre-conditions necessary for transformative capacity. Centralized decision-making reduces the access points for interest groups. While the state's goals are not subject to negotiation, the policy content is influenced by the sector.[103] Centralized policymaking also ensures that the policy outputs emanating from the state agencies are coordinated and complementary. The concentration of regulatory authority in the central bank also enhanced the attractiveness of regulation as a profession. Salaries at the NBP were typically higher than in other state agencies. And, the NBP's role in the shock therapy reform in the early 1990s contributed to its prestige among the financial sector elite. These factors contributed to the development of a 'professional ethos' conducive to transformative capacity.

Compared to Hungary where the regulator saw some five changes in leadership and three major institutional re-designs since the transition from socialism, the leadership at the

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[102] The Polish Banking Association was vital in the introduction of a nation-wide consumer credit database in 1999. Note that as of 2002, OTP in Hungary has persistently declined to participate in the development of a similar database in Hungary.

[103] Interview: Andrzej Reich, Director, Supervisory Policy Division. National Bank of Poland (GNiB).

regulator in Poland has been stable. The President of the Banking Commission and the deputy have only changed once each, and never in the context of scandal. Furthermore, the supervisor has only undergone one major institutional re-design. In 1998, in parcel with a major renovation of Poland's constitution, the supervisor was granted greater institutional autonomy within the NBP.

Table 6 **Configuration of state-bank relations in Hungary and Poland**

	Hungary	**Poland**
Policymaking	***Uncoordinated***	***Coordinated***
Regulator accountable to...[104]	Ministry of Finance	"Public"
Primary agency(ies) responsible for prudential regulation in banking sector	Ministry of Finance National Bank of Hungary Hungarian Financial Services Authority	Commission of Banking Supervision (NBP)
Supervisor has authority to issue legislation	No	Yes
State banks subject to state supervisory authority	No	Yes
Average tenure of supervisors employees[105]	5	9
Number of supervisors (1999)[106]	30	496 (including 325 on-site inspectors)
Inspection method	Off-site/on-site by primarily hired consultants[107]	On-site[108]
Organization of banks	***Diffuse***	***Peak organization***
Regulatory officials cite banking association as important player in policy outcomes	No	Yes
Lobby activity	Particularistic and Uncoordinated (Dominated by managers of large domestic banks)	Coordinated
Foreign banks versus domestic banks	Limited cooperation	Cooperation
Outcomes	***Rent-seeking, capture by dominant domestic banks***	***State-led, negotiated***

Conclusion

Table 6 summarizes the nature of state-bank relations in Hungary and Poland. The institutionalization of an insulated regulatory agency capable of coordinating regulatory policy plus the arrival of the banking association as a peak organization capable of negotiating and aggregating the common interests of the banking sector in the wake of the

[104] Responses to World Bank questionnaire sent to financial regulators throughout the world. World Bank Bank Regulation and Supervision Database.
http://www.worldbank.org/research/interest/prr_stuff/bank_regulation_database.htm.
[105] http://www.worldbank.org/research/interest/prr_stuff/bank_regulation_database.htm.
[106] http://www.worldbank.org/research/interest/prr_stuff/bank_regulation_database.htm.
[107] Interview: Julia Kiraly.
[108] The advantage of the on-site approach according to officials in Poland is that…"if you only read numbers in the reports, or rely only on external auditors you might be sometimes unpleasantly surprised when you find out what is really going on. If you don't go to the banks, you don't feel the banks. You don't see the management process and people who decide about corporate culture and risk management. We have a much more intensive supervision process than many other countries…even according to western standards...Interiew: Piotr Bednarski, National Bank of Poland (GNiB).

1992-4 banking crisis meant that Poland had the institutional endowments necessary for, recalling Linda Weiss, a high level of transformative capacity in the banking sector. The state has retained a larger share of banking sector assets, has preserved a strong national presence in the banking sector despite the need for foreign direct investment, and has imposed measures that diminished corruption and limited the cost of financial sector transformation to the taxpayer. Policymakers in Poland have been much more successful in achieving their original policy goals. In Hungary, the early arrival of foreign banks shortened the time-horizons of the policymakers and undermined the incentive to craft an independent regulatory agency. The banks had little incentive to form a viable peak association capable of aggregating sector-wide interests. As demonstrated, the result has been reduced capacity for the state to achieve its original objectives.

These cases therefore strongly suggest that timing of internationalization is a crucial intervening variable affecting the vulnerability of states to structural pressures in the global economy and their capacity to adapt international laws and norms in ways conducive to domestic conditions. States that internationalize too quickly do so at their own peril.

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Appendix 1**: Instances of corruption Hungary**

Dates	***Circumstance***	***State agencies***	***Cost to taxpayer/consumer***
Agrobank/ Mezobank 1995-6	Bank collapses due mismanagement and fraud. Operated loan scheme whereby the debtor agrees to hand over 25 +1 per cent of the shares bought with the loan to one of the companies established by bank management. György Surányi, the President of the Hungarian National Bank, is linked to the Agrobank's leadership.[109] Bank is merged with Mezobank, which soon after requires an additional HUF 4bn of state aid to shore up capital base.	National Bank/Ministry of Finance	HUF 10.5 bn in capital increase to Agrobank. HUF 10.6 bn capital increase to Mezobank.
Postabank 1998-2002	Second largest bank in assets terms collapses due to fraud and mismanagement. Previous supervisory intervention called off by Ministry of Finance. Several politicians from both major parties and officials at the National Bank accused of accepting bribes. Bank CEO allowed to escape to Austria. Deloitte & Touche is sued for underreporting non-performing loans in on-site audit prepared for State Banking Supervision.	Hungarian Money and Capital Market Supervision/ Ministry of Finance	HUF 236 bn + Budget deficit increased from 4.3% of GDP to 6.7%.[110]
Realbank 1998	Signs of volatility in 1992. No intervention. Bank finally collapses due to mismanagement, connected lending and fraud in 1998. Deposit insurance fund attempts rescue that fails. Deposit insurance forced to compensate depositors. CEO is later appointed to K&H Bank by KBC of Belgium.	Hungarian Deposit Insurance Fund/ Hungarian Money and Capital Market Supervision	None. HUF 3.2 bn from deposit insurance scheme. Deposits up to HUF 1m covered. Others lost.
1998 Numerous brokerages	Under weight of poor asset management and excessive risk-taking, several brokerages collapse. Many citizens lose investment. Accusations of inadequate regulation resonate in the media.	Hungarian Money and Capital Market Supervision	Several brokerages not members of insurance scheme.[111]
Budapest Bank (GE Capital) 1995	Due to lack of "professional expertise", after re-capitalizing bank with taxpayer funds Ministry sells bank to GE Capital of the USA with promise to cover all bad loans stemming from pre-privatization. "Every year, they ask for 10bn forint…they have no incentive to work out that portfolio."[112]	Ministry of Finance/ Privatisation Agency	HUF 27.5bn/revenue from privatization HUF26.8 bn[113]
K&H Bank 1997	Before privatization, CEO was accused of corruption and rent-seeking with previous bank. He manipulates privatization process for personal gain. CEO, in collusion with politicians, reaps HUF 660m.[114] Bank records losses. CEO forced out but remaining management widely believed to be corrupt.	Ministry of Finance/ Privatization Agency	Reduced earnings on privatization.

[109] Open Society Election Archive. http://www.osa.ceu.hu/kampanyarchiv/enx/07.html
[110] Author's calculations based on Anita Benko. "Audit Office approves Postabank consolidation."
[111] About 1,000 small investors lost their money. "The fund had only Ft290 million to cover claims, and has called on its members to replenish the pot as investigations of another seven brokerages may produce another rash of claims. Annual membership fees amount to Ft160 million and any extra payments will generate Ft 480 million at most, officials said." Budapest Sun. "Hard-luck investors rush the bank." October 15, 1998 - Volume VI, Issue 41
[112] Anonymous Interview: Ministry of Finance.
[113] Peter Mihaly, "Bank Privatization in Hungary."
[114] Open Society Election Archive. http://www.osa.ceu.hu/kampanyarchiv/enx/07.html

2001	Despite warning from the Financial Action Task Force (FATF) in 2000, Hungary one of only 17 countries in the world blacklisted for being "non-cooperative in the fight against money laundering."[115] The FATF's main concern was the numerous anonymous accounts, which were scheduled to be phased-out only once Hungary joined the EU.	HFSA	None
CIB Bank 2001	Bank is accused of suspicious illegal offshore dealings with Russian firm. Foreign Ministry official travels to Italy to ask parent bank to dismiss CEO of Hungarian subsidiary.[116] CEO is subsequently appointed to Hungarian Development Bank.	HFSA/Foreign Ministry	None.
Hungarian Development Bank (State-owned) 2002	The state-owned Hungarian Development Bank (MFB) "is reputed to be the most corrupt bank" in Hungary.[117] Due to heavy losses and suspicious government-directed financing. Charter protects bank from public scrutiny and regulation.	Ministry of Finance	"The bank received a capital injection of HUF 96bn in 2002 and by law the state is obliged to re-capitalize it fully in case of further losses.[118]
K&H 2003- (ABN Ambro and KBC Belgium)	Due to fraud and insider trading, millions in investor funds are lost. Accusations that politicians benefited. Head of Hungarian Financial Services nearly beaten to death on street. Ministry of Finance accuses HFSA of incompetence. Committee finds government "main party responsible for scandal."[119] Attempts to curtail HFSA's independence. HFSA seeks moral support from Bank of International Settlements in efforts to protect independence. According to the Economist's Business Eastern Europe Publication, "The K&H scandal is blowing to pieces the argument that foreign ownership will avoid a repeat of the banking problems of the 1990s."[120]	HFSA/ Ministry of Finance	Not known

[115] Financial Action Task Force, "Terrorist financing – FATF checklist." Money Laundering Bulletin. No. 92. April 2002. p. 11.
[116] Anonymous Interview: Ministry of Finance.
[117] The Banker. "Central & Eastern Europe - Hungary - Local Banks Set On Expansion." 1 April 2003. Factiva Online. Document bkna000020030404dz41000b8
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[120] Business Central Europe.

Appendix 2: **Taxation and regulation in Hungary and Poland's financial sector**

	Hungary	**Poland**	**EU**
Structure of commercial banking	90-95% foreign	70% foreign/30% domestic	Foreign bank presence: UK 48%; Belgium 34%; Spain 25%; All others: < 15%
State ownership (2004)	3%	18%	40% Germany; several with >20%
Taxation			
tax status of provisions[121]	Deductible as operating cost	Non-tax ded as operating cost	Norm: tax-ded
withholding tax on deposits	0%	20%	Norm: Low 5%/Max: 20%
Taxation impact of reserve requirements on deposits[122]	1997: 0.5% 1999: 02%	1997: 1.9% 1999: 0.4%	ECB: 0%
Corporate tax:	19%	30%	Avg: 30%
Capital stringency/adequacy			
Capital stringency ratio[123]	4	5	Sweden: 4/ France: 8

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[121] Banks in Poland face an increasingly punishing taxation regime. Loan loss provisions in Poland are not counted as operating costs. They are in the EU, Hungary and across the OECD. And as of 2001, Poland introduced a 20% withholding tax on interest earned on bank deposits to counter the growing budgetary deficit. Withholding taxes, although paid by bank consumers, negatively impact the banks because they are disincentive for citizens to place their money in current account deposits, which are the cheapest form of funding for a bank's lending activities. Thus, banks are compelled to offer higher interest rates on deposits and to offer other financial products that are more expensive to service. To add insult to injury, the government exempted domestic securities from the withholding tax in an effort to boost the share prices of domestic firms listed on the local stock exchange and the attractiveness of the state's debt instruments. This, according to world banking community's flagship publication, "deprived the (banks) of revenue and gave their rivals, non-bank financial institutions, a healthy dose of competitive advantage." (Rick Butler, "Pain of Progress." The Banker. vol. 152, no. 919. September 2002. p. 150.) Furthermore, the banks are responsible for remitting the tax to governments, which carries considerable information technology expenditure and human resource burdens. Initial attempts to impose a withholding tax in Hungary failed.

[122] Koen Schoors, Financial regulation in Central Europe: The role of reserve requirements and capital rules. Universiteit Gent Faculteit Economie en Bedrijfskunde Working Paper 2002/153. September 2002.

[123] Thomas Reininger, Franz Schardax, and Martin Summer. Financial System Transition in Central Europe: The First Decade. Suerf Studies, No. 16. Vienna 2002. p.69.

Provisions[124]			
Calculated Based on	In-house permitted Payment schedule	In-house discouraged Financial standing and payment schedule	In-house permitted Norm: payment schedule
Period until first classification	30-90 days	30 days	Norm: 90 days
Direct bank to bank subsidies	0	0.2% of deposits to assistance funds for weak domestic banks	
Deposit insurance Coverage (average 2000-2003)	5000 Euro	16 000 Euro	20 000 Euro (min.)
Max. rate of insurance premium	0.2%	0.4%	No norm

[124] Provisions are costs that banks absorb to cover actual and projected losses on their loan portfolio. Domestic banking regulators determine when a loan must be classified as non-performing and how much of it must be covered by provisions. The method of classification has an important impact on sector profitability and broad implications for sector stability. In theory, the more stringent the classification rules, the more prudent a bank's lending practices.
Bank Pekao SA, Poland's second largest commercial bank and a subsidiary of UniCredito of Italy, calculated that under international rules, 30% of its loans classified as non-performing in Poland would be considered performing in Italy. This additional 30% reduced Pekao's profit for first-half 2002 by PLN 56m or US$16m. Pre-tax profit for the same period was PLN 305m or US$87m. Similarly, BIG BG, a subsidiary of Portugal's BCP and Poland's fifth largest bank by assets, calculated that its non-performing loans would shrink from 22.5% to 11.8% of the total loan portfolio in first quarter 2002 if provisioning rules were adjusted to international standards. The stringent provisioning requirement was a major factor in BIG BG's US$ 63m loss in 2001 and subsequent need for a US$ 43m emergency capital injection from the parent. Figures from interview with Artur M. Szeski, Banking Analyst. CDM Securities. Extensive interviewing revealed that Pekao's and BIG BG's experiences were typical across the banking sector. Meanwhile, provisioning in Hungary is in line with EU norms. Interviews of bank executives confirmed that provisioning rules are not a source of complaint.