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BANKING REFORM IN SOUTHEAST EUROPE:  
ACCOMPLISHMENTS AND CHALLENGES

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# Banking reform in Southeast Europe: accomplishments and challenges

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## 1. INTRODUCTION

The transformation of the banking industry in transition countries has been one of the most dramatic and far-reaching aspects of the quite dramatic and far-reaching transition process as a whole. As of 1995, foreign bank penetration in the former Communist countries of central and southeast Europe was minimal; by 2002, foreign banks held majority shares, and often overwhelmingly large shares, in 13 of the 15 countries of CEE and SEE. In SEE itself, Albania, Bosnia-Herzegovina, Bulgaria, Croatia and Romania had foreign majority ownership (measured by capital), with Macedonia very close to 50% and Serbia and Montenegro somewhat behind of end-2004.

The transformation of the banking industry has turned one of the most vulnerable and unstable parts of the economies of the transition countries into one of the most advanced sectors, one which at times seems so far ahead of other sectors as to cause certain problems.

With this in mind, this article will spend little time on the relatively researched topics of how and why the foreign banks entered the markets of the transition countries (studied by Konopielko 1999, Haas and Lelyveld, Galac and Kraft 2000). The benefits brought by foreign bank entry will also be dealt with relatively briefly, leaving room for the main theme of the article: an attempt to identify the main challenges facing policymakers, regulators and bankers themselves in the coming period in the SEE countries. The CEE countries will be referred to for comparison purposes where appropriate.

Many of these challenges come from the underdevelopment of key institutional supports for the growth of banking. Above all one must point to weak legal infrastructure, which does not protect creditor rights in a timely, predictable and effective manner. This is one of the causes of a growing retail bias in banking, which, if allowed to continue too long, could ultimately impair the banking system itself. The retail bias also aggravates current account problems, create prudential and macroeconomic policy dilemmas.

Other problems include, inadequately developed securities markets and securities market regulation, and generally underdeveloped non-bank financial institutions. These also threaten to limit the growth of the banking industry and the quality of economic growth in general.

Furthermore, foreign bank entry has often been accompanied by a consolidation process that has increased concentration in banking markets. This may actually increase effective competition, as a small number of strong banks are able to contest markets effectively, as opposed to a large number of very small banks competing against one or a small number of large banks held over from socialism. Consolidation may also enhance financial stability, by creating franchise value that limits risk taking (Beck et al). Still, there are threats to competition from concentration, most obviously the threat of merger between the foreign banks (or their mother companies) and the greater ease of tacit collusion with a small number of players.

In addition, the entrance of foreign banks, while resolving many of the most burning issues facing bank supervisors, creates new challenges as well. Even though most foreign banks have taken the form of subsidiaries, and thus are clearly under the regulatory purview of SEE supervisors, there are important issues regarding information sharing and co-ordination between SEE supervisors and the EU supervisors of the mother banks. In addition, while crisis management responsibilities are relatively clearly defined (more clearly than within the EU in some respects), there are some grey areas regarding the legal reach of third-country courts if the mother bank's subsidiaries their had problems, and major challenges in crisis management for countries with currency boards (and hence no lender of last resort in the conventional sense) and for all countries with weak fiscal positions.

A final set of problems includes operational risk and reputation issues. Several major operational risk incidents have occurred at the overseas subsidiaries of foreign banks. This creates reputational as well as financial risk. In addition, the popular image of foreign banks is often poor, even though customers trust foreign banks. Thus, reputation and image can be problems for the foreign banks in SEE.

The rest of this article is structured as follows: in the second section, I briefly review the main benefits of foreign bank entry. In section three, I discuss legal infrastructure problems and the retail bias issue. In section four, I deal with some of the competition policy issues created by the foreign-bank led consolidation. In section five, I look at supervisory challenges. Section six offers some brief conclusions.

## 2. BENEFITS OF FOREIGN BANK ENTRY

In the early phases of transition, attempts were made to privatize and restructure the banking systems inherited from socialism. However, the transition countries were beset with banking and financial crises, and the fiscal burden of recapitalizing failed banks rapidly became problematic in many countries. In addition, it was difficult to find private bank owners who were not the banks main customers, and who possessed any experience and know-how in banking.

These were the main reasons why most countries in CEE and later in SEE decided to sell their banks to strategic foreign partners. Looking back, several benefits of this decision can be seen.<sup>1</sup>

First and foremost, stability has been dramatically enhanced. Failures of banks sold to reputable foreign partners have been almost unknown. Some exit has occurred in cases where the foreigners changed their business strategy, or where the CEE/SEE ventures proved disappointing. But overall, the overwhelming majority of the foreign banks have earned substantial profits, grown solidly, and, quite simply, provided stability. In addition, in CEE and SEE, as in Latin America, foreign banks have been willing to lend in cyclical downturns, thus playing an important role in dampening macroeconomic fluctuations during the entry and expansion period.<sup>2</sup>

Second, the foreign banks have brought with them rapid improvements in many areas of the banking business. Foreign banks' expertise in marketing and risk management is apparent. Investments in information technology have also been evident in many cases. While it is true that some of this expertise is available on the market through consulting services and the like, it remains true that the foreign banks have engaged in substantial technology transfer. One suspects that such transfers would not have been so substantial if the banks remained in domestic hands, first because much of the knowledge is very likely proprietary to the foreign banks and probably cannot be fully replicated even by consultants, and second because the

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<sup>1</sup> Among the studies on which this section is based are Storf (2000), Galac and Kraft (2000), Kraft (2004), de Haan and Naaborg (2004) Mero and Valentinyi (2003) and Fries and Taci (2002).

<sup>2</sup> See Clarke et al 1999, Crystal et al 2000 and Dages et al 2001 for analysis of the Latin American experience.

large investments need in some areas such as IT would not have been available to the limited resources of domestic banks.

Third, related to the previous point, foreign banks have been very active in the introduction of new products and services, some of which were standardized products already offered in the foreign banks' home markets. Again, it is true that strong domestic banks were able to innovate (see Galac and Kraft 2000 for examples from Croatia), but nonetheless foreign banks seem to have been more innovative in terms of the number and range of new products offered.

Fourth, the arrival of foreign banks brought fresh capital into the transition countries, both in the form of equity investment, and later in the form of lending both from the mother banks to the daughters and from the international markets to the daughters.

Fifth, the arrival of foreign banks has helped consolidate CEE and SEE banking systems, producing waves of mergers and acquisitions that have decreased the number of banks. Later in this paper, I will argue that this consolidation has mainly increased competition, but I will also offer some caveats.

Another way to get a feeling for the transformation in banking is to look at the transition progress indices published by the EBRD. Table 1 compares progress in banking with progress in two related areas, securities markets and non-bank financial institutions, and competition policy.

**Table 1: EBRD Transition Indicators for SEE**

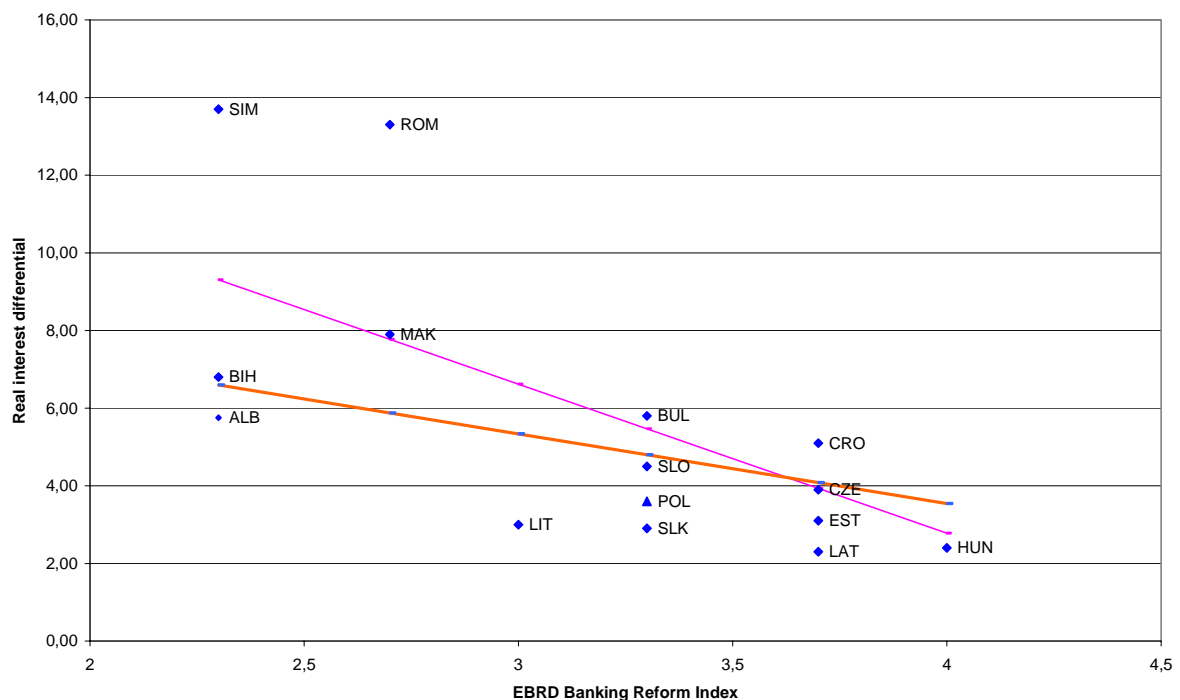
	Banking sector reform		Securities mkts and NBFIs		Competition policy		Total progress
	1999	2004	1999	2004	1999	2004	1999-2004
<b>SEE</b>							
Albania	2,0	2,7	1,7	1,7	1,7	2,0	1,0
Bosnia-Herzegovina	2,3	2,7	1,0	1,7	1,0	1,0	1,1
Bulgaria	2,7	3,7	2,0	2,3	2,3	2,3	1,3
Croatia	3,0	4,0	2,3	2,7	2,3	2,3	1,4
Macedonia	2,7	2,7	1,7	2,0	1,0	2,0	1,3
Romania	2,7	3,0	2,0	2,0	2,3	2,3	0,3
Serbia + Montenegro	1,0	2,3	1,0	2,0	1,0	2,3	3,6

SEE AVERAGE	2,3	3,0	1,7	2,1	1,7	2,0	1,4
CEE AVERAGE	3,3	3,6	2,8	3,2	2,7	2,9	0,8

Several observations can be made. First, progress in banking is substantially greater than in the other areas. The difference of almost a full percentage point in 2004 is huge, since total progress on all three indicators together only barely exceeds one point in most of the countries. Second, two of the SEE countries, Croatia and Bulgaria, are now considered by the EBRD to have banking systems almost meeting minimal EU standards. This is an enormous achievement for countries that suffered significant banking crises in the second half of the 1990's. Third, although progress has been substantial in the last five years, SEE countries still lag far behind the CEE average, with the new EU Member States ahead by a bit less in banking than in the other two areas covered here.

A different way to illustrate the significance of the progress made in banking reform is shown in Figure 1, which plots the difference between real lending interest rates and real deposit interest rates against the EBRD Banking Reform Indicator. The steeper pink line represents a trend calculated using all the observations, and the flatter orange line excludes Serbia and Montenegro and Romania, both of which have much higher inflation and seem to be outliers.

**Figure 1: Banking reform and interest differentials**



Whichever way one calculates the trend, it is clear that banking reform does lead to narrow spreads. In other words, the fruits of banking reform are being passed on to customers.

**Table 2: Indicators of banking sector development**

	Asset share of state-owned banks		M2/GDP		Domestic credit to private sector		Capital share of foreign banks
	1998	2003	1998	2003	1998	2003	2002
Albania	85,6	51,9	48,3	47,1	2,2	5,1	73,6
Bosnia + Herzegovina.*	75,9	5,2	20,5	45,6	8,9	14,6	66,8
Bulgaria	56,4	0,4	28,5	47,8	12,2	25,8	66,6
Croatia	37,5	3,4	41,7	66,8	26,6	48,5	78,3
Macedonia	1,4	1,8	13,3	29,9	17,7	14,9	44,6
Romania	75,3	40,6	24,8	24,4	11,6	9,5	64,9
Serbia + Montenegro**	90	34,1	16,6	20,2	11,2	5,6	na
SEE Average	60,3	19,6	27,7	40,3	12,9	17,7	65,8

\* Asset share of state-owned banks 1999 instead of 1998.

\*\*domestic credit to private sector for Serbia only, 2002. Asset share of state-owned banks Serbia only.

Source: EBRD, except for foreign bank shares, which are from BSCEE (2003).

Table 2 provides some further information about the development of the banking sector. Again, there are impressive gains in many areas, most of all in privatization. In fact, the figures understate privatization accomplishments, since the sale of the Savings Bank in Albania in early 2004, and further privatizations in Romania in late 2003 are not reflected in the data. These transactions bring the level of state ownership below 10% in each country.

Also, growth in M2/GDP in Bosnia and Herzegovina, Bulgaria, Croatia and Macedonia was very rapid in the 1998-2003 period. Domestic credit to the private sector grew strongly in these countries as well, with the exception of Macedonia. Part of the M2/GDP growth certainly was due to the Euro conversion, which attracted large amounts of Euro legacy currency that had been hoarded into the banks.

Large-scale foreign bank presence is a relatively new phenomenon, and it will probably take more time to see its full effects. Further research will certainly be necessary. Nonetheless, I would argue that the broad picture painted here depicts the positive impact of foreign bank entry fairly well.



Rather than stop here, however, I prefer to examine the important new problems and challenges attending regulators and policymakers now that foreign bank entry is a fait accompli in SEE. I begin this task in section 3.

### 3. RETAIL BIAS AND WEAKNESSES IN LEGAL INFRASTRUCTURE

One of the very apparent phenomena that seems to be universal in SEE (and quite widespread in CEE as well) has been the rapid growth of consumer credit. This growth certainly has a rational explanation: if households expect their incomes to rise in the future, it makes sense to borrow in the present and thereby smooth consumption. In addition, the initial stock of consumer credit, and the share of consumer lending in total lending, was quite low in all SEE countries; hence an expansion of consumer credit seems natural from this perspective as well.<sup>3</sup>

**Table 3: Ratio of household loans to total loans (%)**

	Albania	Bosnia	Bulgaria	Croatia	Macedonia	Romania
1997		5.2	10.3	28.9	6.5	4.4
1998	5.1	8.8	20.1	32.5	7.3	4.9
1999	48.1	9.8	18.2	37.9	9.9	4.5
2000	36.2	12.9	17.6	42.3	7.6	4.7
2001	14.3	20.6	19.4	43.8	7.4	5.6
2002	18.3	34.5	19.4	47.5	10.7	8.5
2003	23.1	38.2	22.6	52.7	20.7	17.2

Source: national central banks

Despite this, there are two main concerns about the flowering of consumer lending. The first is macroeconomic. All of the SEE countries are struggling with substantial current account deficits. Rapid growth in consumer lending contributes both via increased demand for imported consumer goods and via the currency appreciation generated by the foreign funding sources often used to underwrite it.<sup>4</sup>

The second concern is institutional. There is some reason to believe that one of the reasons for the intensity of the consumer lending boom is the relative unattractiveness of wholesale lending due to institutional weaknesses, above all the poor functioning of the legal system.

<sup>3</sup> Even in Croatia, which stands out in Table 3, started with a ratio of consumer credit to GDP of 6% in 1995, far below the 50% average in the EU.

<sup>4</sup> For a detailed discussion of the link between lending booms and macroeconomic instability, as well as policy responses, see Kraft and Jankov (2005).

Wholesale lending relies much more than retail on a strong legal system to enforce contracts, seize collateral and provide smooth and effective bankruptcy procedures. While it is true that home mortgage lending does rely heavily on the legal system, repayment rates on home mortgages are almost universally substantially higher than on corporate loans, so that the legal system risk is somewhat compensated for by lower repayment risk. Also, corruption, a major issue in many SEE countries, impacts wholesale lending much more than retail. Furthermore, as the World Bank (2003) points out, high barriers to business start-up and wind-up, weaknesses in corporate governance, unreliable implementation of accounting standards and poor financial disclosure present important hurdles to future business development.

Perhaps the rapid growth in retail lending would have occurred irrespective of the problems facing wholesale lending. It is not entirely clear whether foreign banks' country budgets are constrained by the supply of funds the banks are willing to commit or by estimates of the growth of demand. In any case, I can only echo the point made by the World Bank (2003) that development of wholesale lending and of more sophisticated banking and financial products in general will be stunted if these institutional factors are not sorted out in the near future. (L

#### 4. COMPETITION AND COMPETITION POLICY

The entry of foreign banks has been part of a general consolidation of the banking sectors of SEE. After a period of very easy entry in the early 1990's, failures and acquisitions during and after banking crises brought substantial decreases in numbers of banks. For example, Croatia had 61 banks and 36 savings banks in 1997, but by 2003 it had a mere 40 banks and no more savings banks overall. Bosnia and Herzegovina had 61 banks in 1999, and only 37 in 2003.

Although this consolidation process has certainly increased conventional measures of market concentration, it can be argued that banking markets have often become more competitive rather than less competitive. Allen and Gale (2000) provide a rigorous model of how this could take place. They consider competition between large numbers of unit banks, each operating only one office, as compared to competition between two bank networks. Under very general conditions, they find that the two bank networks provide a more competitive outcome, with prices closer to marginal cost, than the large numbers of unit banks.

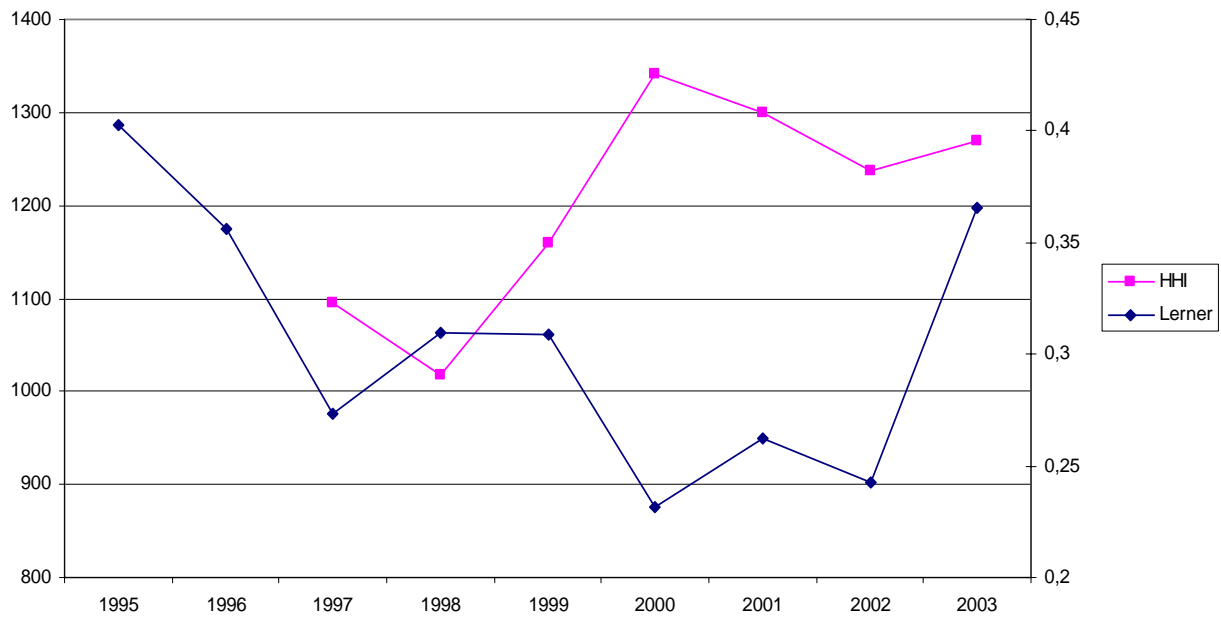
While this argument was designed to describe the reform process in the United States, which actually legally enforced unit banking in many states prior to the 1980's, it would seem to

apply to SEE countries as well. In most SEE countries, many of the new entrants of the 1990's were in fact unit banks or at least banks with a very small number of branches, operating in very restricted local markets. While some of these banks did grow rapidly and form more extensive networks, there is reason to be skeptical about the degree of competition that such banks were capable of providing to the large banks inherited from socialism. That is, outside of former Yugoslavia, each country had a near-monopolist Savings Bank, usually still in state ownership, against which the new private banks were Lilliputian in size. In former Yugoslavia, there were also dominant state-owned banks such as Stopanska Banka in Macedonia, Jubanka in Serbia, Zagrebačka and Privredna Banka in Croatia, but these were not quite as dominant as their Savings Bank counterparts in the other SEE countries.

Privatization of these large players to foreign owners created formidable market leaders in SEE, but the purchase of smaller players accompanied by acquisitions and rapid growth of greenfield foreign banks also provided substantial competition. Thus, banking systems such as those of Croatia, Bosnia and Herzegovina and Bulgaria as of 2004, characterized by 5-10 fairly strong foreign-owned players, may well be more competitive than systems with large numbers of smaller banks seen in these countries 5-10 years before.

Indeed, Claessens and Laeven (2003) estimate the levels of competition in a large sample of countries using the Panzar-Rosse methodology. They find that neither HHI nor CR5 measures are significant predictors of the degree of competition, but that foreign bank presence is, with a positive correlation (greater foreign bank presence correlated with greater competition).

In the same vein, the link shown above between banking reform and real lending-deposit interest rate differentials also suggests that concentration has not impeded competition in transition countries. The Croatian case provides some further evidence in this regard. Figure 2 plots the conventional Herfindahl-Hirschman Index along with my estimates of the Lerner competition index. The Lerner index is essentially a mark-up over marginal cost estimated via a cost-function and accompanying factor-price equations (see Angellini and Cetorelli 2003 for an application to Italian data). Thus, a decrease in the Lerner index indicates more competitive conditions.

**Figure 2: Herfindahl-Hirschman Index vs. Lerner Index for Croatia**

What we see is a substantial increase in concentration after 1998, with the HHI increasing roughly 300 points. This increase occurs to a number of failures during 1999; foreign banks entered en masse during that year and the following year, but with one exception the foreign banks did not make multiple acquisitions, so that their entry by and large had no effect on concentration.

At the same time, we see that the Lerner index falls in 2000, indicating an increase in competitive conditions. However, we also see that the Lerner index had increased in 1998 and later was to increase in 2003. The increase in 1998 was probably due to the beginning of the banking crisis, in which a number of aggressive banks that had offered very high deposit interest rates failed. Most banks lowered deposit interest rates to distance themselves from the failed risk-takers, and thus the mark-up rose.

The situation in 2003 was rather different. In that year, the central bank imposed a sort of penalty on rapid loan growth. Banks whose loan portfolio grew faster than 4% per quarter were required to buy low-yield central bank securities. Banks responded by limiting lending, cutting back on wholesale loans and focusing on more profitable retail business. This portfolio shift also seems to have resulted in increased mark-ups.

Looking beyond these particulars, there does seem to be evidence from the Croatian case that competition increased after consolidation and foreign bank entry. But the picture is not entirely unambiguous.

This suggests to me that, while the initial entry of foreign banks and the formation of a number of strong competitors may have raised competition, it cannot be taken for granted that a high level of competition will be maintained. Moreover, continued increases in competition cannot be taken for granted. Clearly, with fewer banks, the opportunities for tacit collusion will be greater. Also, foreign banks are becoming accustomed to high profits in SEE, and they may not be willing to undermine this with aggressive competition. This is particularly troubling if one believes that the development of the wholesale business, which is closely related to medium-term growth prospects, requires greater risk-taking than the foreign banks have been willing to take so far. Indeed, a study commissioned by USAID criticizes Croatian banks for putting as much risk as possible on clients and failing to develop many business lines that are taken for granted in advanced countries (Porter, Chilsen and Company 2003).

Two other problems deserve mention in the competition field. The first is the danger that, through mergers between mother banks, SEE countries could find themselves faced with unacceptably high levels of concentration. In principle, this problem can be handled through close cooperation between regulatory authorities in the home countries and SEE, and by the licensing mechanism. That is, if a merger occurred between two mother banks in the EU that owned large banks A and B in an SEE country, the licensing authority in SEE would receive a request for a change in ownership in either bank A or B. If it were properly informed, the licensing authority could simply deny the merged mother bank the right to become owner of both bank A and B, and order the sale of all or part of one of the banks. There could be political pressures placed on the licensing authority, but in principle the divestiture option should be adequate to prevent excessive concentration.

Another, perhaps more difficult, issue lies in the enforcement of anti-trust legislation in the more mundane daily business of banks. In some cases, SEE central banks have taken over anti-trust issues in banking from a competition authority. This seems appropriate and relatively straightforward for the issues posed in merger and acquisition cases, but may be more tricky in cases of abuse of dominant position and anti-competitive practices. These latter kinds of cases are more typical of the work of competition authorities, and require legal and

microeconomic analysis that central banks may not possess. In the context of poor anti-trust regulation in general in SEE, this area may turn out to be the most difficult in practice, especially with complex network externality issues such as ATM fees coming more and more to the fore.

It is clear that the small size of the SEE markets is an important hindrance to the development of competition. The EU accession process should help accelerate competition, both by encouraging cross-border financial flows that may compete with domestic banks and limit anti-competitive behavior, and by encouraging further entries by EU banks into SEE markets. In the longer-term, participation in the single European market—even if it is not as unified as we might like—certainly should increase banking and financial sector competition. Still, even in this somewhat distant future, local authorities will continue to be responsible for maintaining competition in their local markets, in the same way that regions in countries like the U.S. must work to maintain competitive conditions in local markets. Learning to analyze local competitive conditions and to devise regulatory remedies, including divestitures, should be high on the agenda of competitive authorities in SEE countries.

## 5. SUPERVISORY CHALLENGES

At the European level, central banks and financial service regulators are facing a very new and daunting set of challenges. The rise of cross-border and cross-industry financial groups has rendered the supervisory structures in place outmoded, and triggered a heated debate on the optimal structure for financial regulation. Numerous countries have responded by unifying financial supervision into a single authority, starting with Norway in 1986. With the establishment of the U.K. Financial Services Authority in 1997, this movement gained momentum, and now single regulators can be found in some 10 EU member states. (Masciandaro and Porta 2004)

The creation of single regulators is meant to address the cross-industry nature of financial integration. The cross-border issues have so far been addressed through the designation of responsibility for bank branches with the home country supervisors, and responsibility for bank subsidiaries with the host country supervisors. This division of labor has been reinforced by a series of Memoranda of Understanding (MOU), which specify the forms of cooperation applicable during normal supervisory processes and during crises.

There is some doubt, however, whether this system is robust enough, especially in the face of large-scale financial disturbances. Lender of last resort functions, like supervisory functions, are still at the member-state level in the EU. This raises some doubts as to whether the existing system would be able to handle a situation where one or several large cross-border institutions had problems in multiple jurisdictions. Furthermore, the MOU's do not have legal force, and have yet to be tested in practice. Conflicts in approach or interest between supervisors in different countries could lead to deviations from the MOU's which could in turn complicate or slow down crisis management.<sup>5</sup>

How will these problems affect SEE countries? Probably not very much in the immediate future. For one thing, with relatively undeveloped capital markets, SEE countries do not really have to deal with financial conglomerates and the supervisory challenges they entail. Even if such firms enter SEE markets, they will mainly be providing banking services in the upcoming years.

For another thing, almost all the foreign banks operating in SEE are operating as subsidiaries. This means that any problems affecting the foreign banks in SEE will be squarely the problem of SEE supervisors, central banks and ministries of finance. While this makes matters simpler, it is not necessarily a sort of great comfort. For it means that SEE countries could be faced with problems as systemically important banks. In two cases (Bulgaria and Bosnia and Herzegovina), currency board arrangements preclude conventional lender of last resort operations. In all cases, relatively weak fiscal positions would make any large bank failures a serious problem for all concerned.

The good news, of course, is that these banks have strong foreign mothers who should be able to stand by them in a crisis. However, even here one must be cautious. The case of Riječka Banka, which experienced foreign exchange trading losses due to a rogue trader, shows that foreign owners may not be willing to recapitalize their subsidiaries. In the Riječka Banka case in 2002, the majority owner, Bayerische Landesbank, walked away from the bank, and returned ownership to the Croatian government. The government then succeeded in very quickly organizing a sale to Erste Bank, thus stabilizing the situation. Although the ending was happy, this tale is a sobering one for SEE policymakers.

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<sup>5</sup> For a more optimistic view of the current situation, see Lanoo (2004). Eisenbeis (2004) and Aglietta (2004) are more skeptical.

A more immediate set of problems relates to information sharing between SEE supervisors and home country supervisors. The SEE operations of most foreign banks account for very small fractions of the banks' total business. Thus it is unlikely that home country supervisors will worry too much about these subsidiaries. At the same time, any information about the mother banks' operations could have substantial market value, so that home country supervisors may be reluctant to risk giving too much information to SEE host country supervisors. This is problematic for the SEE supervisors, who need to know more about the mother banks' financial status and plans. Building confidence and improving incentives for information sharing between supervisors remains a significant practical problem.

Furthermore, there are some ambiguities about cross-border implications of bankruptcy procedures. For example, if bank A, incorporated in an EU country, has subsidiaries in the U.S. and an SEE country, and if the U.S. subsidiary fails, could the U.S. courts try to seize assets from the SEE subsidiary to meet claims of U.S. creditors? Questions like these are currently unanswered, and it is not too far-fetched to think that they will become relevant in the near future.

A final point about foreign banks and banking supervision in SEE is that the pace of Basel II implementation in SEE is not yet clear. For those SEE countries about to join the EU, Basel II implementation will begin shortly after accession. This requires that supervisors make decisions about which of the many menu options in the new Accord they will enforce. There will no doubt be pressure from the foreign banks to allow the use of risk models employed by the banks in their EU home countries in SEE. One can be skeptical about whether enough data exists on SEE risks to make the use of such models advisable in the near future. In other work (Kraft 2005), I have suggested that SEE supervisors avoid any rush to implement advanced risk based capital standards in Basel II, thereby putting aside possible pressure from banks and from international financial institutions or ratings agencies that may view more sophisticated practices as better. On the contrary, I believe that simpler techniques should be maintained as long as necessary.

## 6. CONCLUDING THOUGHTS

SEE countries have accomplished a great deal in the area of bank reform. Entrance of reputable foreign banks, along with improved supervision and macroeconomic stability, has



produced major advances in the banking area. At the same time, however, development of non-bank financial institutions and capital markets continues to lag behind, as does anti-trust regulation and securities regulation. Weaknesses in the legal framework, continued poor corporate governance, inadequate accounting and disclosure, and barriers to firm entrance and exit hinder the business environment and dampen growth prospects.

The bank sector cannot get too far ahead of the rest of the economy. Only a continuation of the broad-ranging reforms undertaken so far can lead to more balanced and sustainable growth. Strong banking sectors can contribute to such growth, but they cannot be the sole motor. Policymakers in SEE still have much work to do.

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