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THE POLISH LISBON STRATEGY FORUM

Integration and stability of the financial market in the light of the Lisbon Strategy*

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It is not possible to achieve the main goal of the Lisbon Strategy, i.e. to make the European Union the most competitive economy in the world, without the single and safe financial market, which would guarantee the efficient operation of capital allocation mechanisms. Thus, the integration and development of financial markets is a condition precedent for the efficient execution of the Lisbon Strategy, described in a detailed way in the Financial Services Action Plan (FSAP). It was presented in May of 1999 by the European Commission[2] and it comprises four strategic goals:

1. To establish the single wholesale capital market. It is the most urgent and ambitious part the purpose of which is to establish commonly binding legal regulations in the securities and derivatives market stimulating cross-border mergers and acquisitions and creating the single market for investors.
2. To establish the open and safe retail market. Here, important elements are new regulations related to so called remote sales of financial services, the protection of consumer's rights in the credit market and the simplification of cross-border transactions for retail customers.
3. To establish modern prudence regulations and the system of financial market supervision.
4. To reduce differences in tax systems and corporate governance. The problem of tax on savings earned by non-residents is an especially controversial issue.

During the meeting of the European Council in Lisbon, it was decided that the liberalisation process in the financial service market was too slow and some accelerating actions would have to be taken. The action plan for financial markets is to be executed by the end of 2005.

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[2] In July 2000, the team of experts chaired by A. Lamfalussy was established to develop a report on possibilities of handling changes in the European securities market based on the existing regulatory mechanisms and to prepare changes to the system. Pursuant to the report recommendations, a year later, i.e. in July 2001, the European Commission established:

- *European Securities Committee* (ESC) composed of representatives of Member states whose task was to consult new legal acts, and, having obtained adequate authorisations from the EU Council and Parliament, to adopt technical regulations related to securities markets,
- *Committee of European Securities Regulators* (CESR), independent advisory body composed of representatives of the national regulatory bodies, whose task is to provide the European Commission with consultation related to technical regulation adoption and to co-ordinate their implementation.

At present, the work is being carried out to establish similar procedures and regulatory institutions for each financial sector, including banking, insurance, pension funds and financial conglomerates. Then, the actions taken to establish the uniform financial market should focus on establishing institutions guaranteeing the efficient enforcement of regulations and protecting investors, customers and policy holders.

It was assumed that an optimum way to increase the value of financial systems for European citizens, business and society, as regards the sustainable and balanced economic growth and the creation of new workplaces, was the integration of financial markets.

Estimated economic benefits from the integration and liberalisation of financial markets are as follows[3]:

- the unification of the securities market and enhancement of procedures for entering this market may bring about the GDP growth by 1.1% in EU, as well as the growth of total headcount by 0.5%,
- the single clearing infrastructure will reduce costs of transfers by 42%-52%,
- the integration of the retail financial market consisting in interest rate lowering may bring about estimated benefits of 0.7% of GDP in EU,
- the unification of the consumer credit market could generate savings to consumers not smaller than 41% of the credit price,
- international mergers and acquisitions could result in the reduction of operating costs by more than 1.2% - 1.3%,
- the liquidation of „ineffectiveness" in the banking sector may result in GDP of 1.4% - 1.6% via capital costs reduction.

The empirical research on consumer prices in the Eurozone and real effects of mergers and acquisitions shows that the above assumptions are too optimistic[4].

Every year, in the first quarter before the meeting of the European Commission, reports on the Lisbon Strategy progress, including the FSAP implementation schedule, are presented.

The seventh report (Brussels, 3.12.2002) on the FSAP implementation evaluates the progress in increasing economic competitiveness as lower than expected. It states that till the end of the Dutch presidency, 31 of 42 FSAP goals were implemented, and their legislative adaptation was generally well evaluated. The report of January 14, 2003[5] observes that only 6 of 8 priority goals planned for 2002 were fully completed. Apart from legislation goals, FSAP also comprises auxiliary initiatives, so called various types of analytic and consultation work (mainly communications), which are the base for legislative proposals, and so called recommendations, i.e. non-obligatory guidelines (e.g. recommendations on audit independence).

Most important initiatives under FSAP have already been implemented in the form of directives or recommendations, including especially regulations related to: international accounting standards, free investment institutions, independence of auditors and market overuse. The most important areas related to the establishment of the single financial market remain, however, open. Furthermore, FSAP has to be completed in the light of the European Union enlargement. As regards the financial market integration, directives on issue prospectuses and investment services have not been finally agreed. A subsequent report on FSAP implementation is likely to be published in the middle of 2003.

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[3] London Economics study for DG International market IVIE; following: Financial Services, Seventh Report 3.12.2002.

[4] See: S. Kleimeier, H. Sander, Consumer Credit Rates in the Eurozone. Evidence on the Emergence of a Single Retail Banking Market, ECRI Research Report No. 2, January 2002.

[5] Implementation Report on „2002 Review of the Internal Strategy – Delivering the Promise", Brussels 14.01.2003.

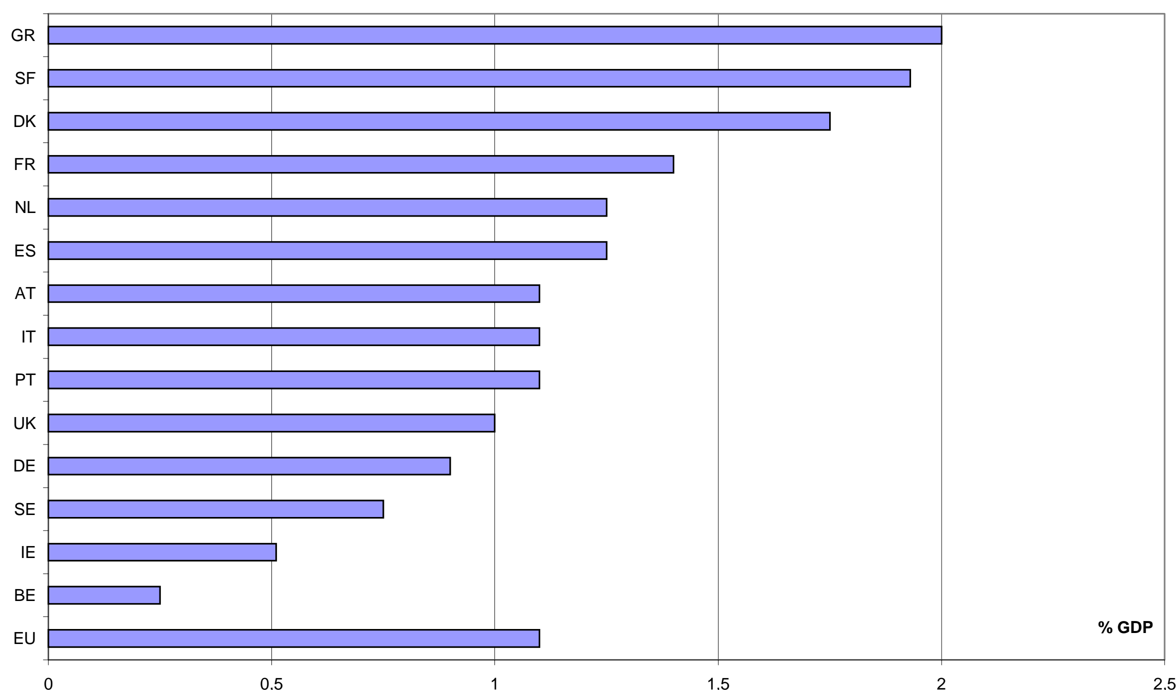
It has been confirmed that there is a will to implement effectively:

- the whole Financial Services Action Plan (FSAP) by the end of 2005
- FSAP's tasks related to securities markets and the Risk Capital Action Plan (RCAP) by the end of 2003.

If the tasks related to the securities market and RCAP were implemented as intended in 2003, it would mean that Poland would not have any formal influence on the present shape of those regulations. In the case of RCAP, they refer to financial support for innovative projects, including especially SMEs and mainly based on venture capital funds. We do not need to justify the significance of these issues for the execution of the National Development Plan and for the unemployment reduction.

The concept of the single financial market in EU is, undoubtedly, a very important factor stimulating economic development, mainly via more effective capital allocation. It is consistent with the interest of each Member State, including Poland, since it lets achieve the competitive advantage of the whole system. Beneficiaries of the financial market integration will be, however, various states to various extent. For example, the estimated average growth of GDP by 1.1% as a result of the capital cost reduction in the single financial market is likely to be significantly diversified. Expected benefits for the existing Member States are presented in chart 1.

Chart 1. Expected long-term benefits from the financial market integration in particular states of the European Union



Source: London Economics and Oxford Economic Forecasting after: N. Walter, Make financial markets a driving force in the EU economy, w EU Monitor. Reports on European integration, No. 1. April 2003

A basic condition to gain some benefits from the liberalisation and integration of financial markets is, however, the stability of financial systems. The liberalisation and integration of financial markets without a new financial architecture, including its integrated supervision, increases the risk of global financial crisis.

The Polish banking market is already, at present, a liberalised market. The market integration is a result of market processes, mostly connected with strategies of international holdings, as well as processes of mergers and acquisitions carried out by strategic investors. The banking market is actually prepared to the complete integration as understood by the Lisbon Strategy and no special protective policy is required.

The regulations on banking supervision seem to be not worse than in most EU states. They are influenced by the Basil Committee's standards. The banking supervision practice is moderately protectionistic (knowledge of language, outsourcing, etc.) and the banking system monitoring is more and more professional.

A characteristic feature distinguishing the Polish financial system from financial systems of the EU Member States is a great share of foreign capital in the net worth of financial institutions. Around 70% of assets of commercial banks in Poland are controlled by foreign capital, and most Polish commercial banks are dependant companies of international holdings. Apart from unquestionable benefits of such a situation (non-political system, know-how take-over, capital contributions, etc.), there may appear some threats that should be minimised by improving solutions, constructing the new global financial architecture and executing the Lisbon Strategy.

The threats refer to consequences of the dominant company's behaviour in relation to its dependant entity in the case of a crisis.

It is connected with competencies and responsibility of the host state's supervision and the mother state's supervision, including the consolidation of supervisory functions and deposit guarantee systems in particular states. These issues were partially discussed by the Basil Committee and there are some proposals of actions related to cross-border banking supervision[6]. These proposals do not seem, however, sufficient to reduce significantly the risk of loss nationalisation in the states being the seat of dependant companies if benefits resulting from the financial market integration are internationalised. The problem of loss nationalisation and benefit internationalisation refers mainly to states that are subject to system transformation and run liberal policy supporting the financial market integration, i.e. especially Poland, Hungary and Estonia.

The existing proposals of regulations related thereto were, obviously, influenced by the countries of capital exporters, thus cross-border banking supervision standards included mainly the mother country's risk. The consolidated supervision is treated as a duty and responsibility of a supervisory institution of a mother country, whereas local supervisory institutions are practically obliged to provide information. However, it is admitted that the information should flow in two directions (between local and mother supervisory institutions) and that all cross-border bank operations should be effectively supervised[7] by mother and local supervisory institutions, but **such a principle is not fully reflected in recommendations made.** It refers especially to possibilities of identifying the risk generated by an international capital group in relation to its dependant company. The Basil Committee confirms that these are „very delicate issues for mother supervisory institutions (both as regards their content and time) and decisions on obligatory information transfer will have to

[6] See: Supervision of cross-border banking, 27/1996
Core principles for effective banking supervision, 30/1997

[7] Effective consolidated supervision is based on three principles:

- no banking activity, regardless of its location, should avoid supervision,
- no multiple capital leverage is allowed,
- guarantee that all types of risks the bank group is subject to, regardless of the place where they are booked, are evaluated and controlled globally.

be made separately in each single case"[8]. Such an approach does not allow local supervisory bodies to monitor the financial standing of strategic investors, which may be a threat to domestic banks' stability in the case of any financial perturbation within international holdings.

It should be pointed out that, apart from threats for capital providers and the stability of the banking system in the dominant company's country, there is also a risk for depositors in the country where dependant companies run their activity. This is a risk that, in our opinion, is not adequately reflected in proposed regulations. The risk of depositors losing their savings is insured by local deposit guarantee institutions. They, and not regulatory institutions from the supervisor's state, bear an actual responsibility for destabilising local financial systems. We are not against suggested new regulations on consolidated supervision (in a horizontal sense, covering the supervision over financial conglomerates and in a vertical sense, covering cross-border supervision), but we have to ask a fundamental question: are there any objective conditions for the single European financial market concept not to comprise a principle of complete integration of regulatory (supervisory) institutions, which would be, for sure, connected with establishing an international supervisory body?

At present, the activeness of the Polish banking supervision should be bigger and a pressure to conclude agreements with bank supervisory bodies of countries where strategic investors come from should be stronger to allow for monitoring the security of capital groups where Polish banks are dependant companies. Barriers are the said „non-partner" solutions proposed by banking supervisory bodies from the countries where dominant companies have their seats.

Thus, the international integration of supervisory institutions is of key importance for the stability of the Polish banking system. At present, local supervisors and their operating methods are different as regards institutional, legal and historic factors, that is why it was decided that international banks were supervised by their mother supervisory institution. However, the integration of financial markets will cause that these factors will be less and less important. **It is the interest of Poland, a host country for many companies dependant on international banks, to promote the concept of the complete international integration of institutions supervising financial markets.** Although the integrated supervision is believed to be an optimum solution, there appears an opinion that „the single supervisory body is not likely to be established due to a political will to maintain the national character of financial sectors"[9]. The national character of financial sectors is against the concept of the financial market integration being the base of the Lisbon Strategy.

The condition (consequence) of the integrated supervision should be the **establishment of international deposit guaranteeing institutions** in the international financial holdings. The goal is to eliminate the risk of loss nationalisation accompanying the process of benefit internationalisation with the integration of financial markets. Thus, the integration of deposit guaranteeing institutions seems to be a logic consequence of free capital flow (including deposits) and eliminates unhealthy auction as regards legal guarantees offered to bank customers.

Generally speaking, the countries where dependant companies, being parts of international holdings, prevail in the banking system are interested in introducing the concept of international integrated supervision. The goal would be to reduce threats for a dependant company resulting from financial perturbations in the capital group, and especially in the

[8] Supervision of cross-border banking p. 30

[9] M. Iwanicz-Drozdowska, Safety of the Polish banking sector in the European banking market in the light of new prudence regulations, copy, IBnGR Gdańsk 2003 .

dominant company. The existing regulations are mainly a result of care for shareholder's interests and the financial stability of the country where the dominant company's seat is located, thus fear against risk generated by dependant companies. The reduction of the dominant company's risk down to the level of equity contributed by it discriminates the countries where banks being dependant companies operate. It is a risk for depositors and tax payers of the countries where dependant companies run their activity.

Thus, Poland is justified to promote the concept of the complete vertical integration of institutions supervising international holdings. The national banking supervision should be fully liable only for the activity of national financial institutions that are not dependant companies, thus especially for PKO BP SA, BGŻ SA, BGK and co-operative banks. Such a solution would depend on the international deposit guarantee institution or the guaranteeing institution from the dominant company's mother country taking over responsibility towards depositors. Whereas, in the case of banks being dependant companies, it could perform supervisory functions on behalf and to the benefit of the international supervisory institution.

The financial market integration entails the integration of prudence regulations. However, FSAP's proposals miss single standards for establishing specific provisions by banks. The lack of such standards favours dishonest competition between banks. Always in such a situation, restrictive systems would replace safer, although more protective, systems. It is the interest of Poland and the European Union to introduce uniform standards for establishing specific provisions quickly, and to unify tax consequences for banks resulting therefrom.

Summing up, the integration of the banking market in the European Union will generate the effects of synergy provided that regulations supporting honest competition are established. It requires especially:

1) the international integration of supervision, strengthening especially the stability of banking systems in countries where dependant companies prevail,
2) the uniform prudence rules with the uniform standards for establishing of and paying taxes on specific provisions,
3) the integrated deposit guarantee system,
4) the uniform system for savings income taxation, which would eliminate the risk of savings outflow from the European Union.

The existing directives and draft directives under FSAP do not guarantee that the above conditions will be met. Poland should be interested in precisely analysing consequences resulting from violating principles of honest competition in the said areas for particular countries in the European Union, as well as the whole group in order to find advocates to support its further initiative.

To execute the idea of the single financial market of the European Union reinforcing the competitive position of the whole Community and particular Member States, the existing action plan has to be expanded and completed. We are convinced that Poland should actively participate in:

- finalising the implementation of FSAP,
- establishing the single regulatory and supervisory infrastructure,
- improving the operation of the single financial market (under post-FSAP).