Banking Reform in Central Europe and the Former Soviet Union

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Jacek Rostowski

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CHAPTER 3

FINANCIAL SECTOR DESIGN, REGULATION AND DEPOSIT INSURANCE IN EASTERN EUROPE

Arnoud W.A. Boot and *Sweder van Wijnbergen*

With the exception of the former republic of Yugoslavia, regular commercial banks did not exist anywhere in Eastern Europe before as recently as 1987. Since then, banks have been created at breakneck speed; Poland has over ninety banks, Russia around 2,000, and so on. Every country in Eastern Europe now has a fully fledged two-tier banking system in place. In most cases, the larger banks are spin-offs from regional offices of the central bank, such as in Poland and the Czech Republic. This core of relatively large commercial banks is in many countries supplemented by a fast growing group of smaller, privately owned banks.

But with emerging banks have come all the problems that plague banking systems in other parts of the world: unserviced loans, fraud, financial scams, panics, taxpayer-financed bail-outs, etc. While the problems may be familiar, the circumstances within which they have to be tackled are not. The regulatory framework and supervision mechanisms are almost everywhere in their infancy; trained personnel are lacking, both in the banks and in the regulatory agencies, and the legal framework within which contracts need to be enforced is often unclear and unfinished. Moreover, the uncertain environment, lack of a civil service tradition and severe decline in income which characterize the region has triggered serious problems of corruption and fraud, problems to which the financial sector by the nature of its business is singularly vulnerable.

All this is serious; if the rest of Europe is anything to go by, banks – much more than stock markets – will eventually have to be the main suppliers of funds to enterprises new and old. Banks will have to play a major role in enterprise governance; and banks will remain the main outlet for private savings for years to come. Thus, continuing

fragility and crisis in the banking system could well develop into a major obstacle to the successful industrial development of Eastern Europe. Hence the importance of the issue of financial sector design, the topic of this chapter.

The objective is clear in principle: a regulatory and legal framework that will allow banks to channel savings to enterprises efficiently and play their role in corporate governance, while minimizing the vulnerability of the system to fraud, corruption and financial crisis. The tendency has been simply to mimic institutions and rules from the West, without much thought about whether that is in fact appropriate.

Yet it is far from clear that simply copying Western Europe's financial structure is the right way to go. To begin with, the whole system itself is increasingly being questioned in the West, as a spate of major banking crises has taken place or is threatening to take place in countries as diverse as the United States, Norway, Israel and Britain. Equally important is the fact that the circumstances in which the financial sector operates in Eastern Europe differ from the West in ways that have an immediate bearing on issues of financial sector design. Information problems loom much larger, with more dramatic change taking place on the borrowers' side while at the same time information systems are much less developed. The prevalence of state enterprises create incentive problems of its own; moreover, the shortage of skilled and experienced bank supervisors and auditors is extreme.

It is against this background that we wish to raise the issue of financial sector design in Eastern Europe, and in particular the Former Soviet Union (FSU). While many of the problems in Central Eastern Europe (CEE) are similar, developments have gone faster there than in the FSU and many choices still open in the FSU have already been foreclosed by decisions made in the CEE region. Deposit insurance is of course a key question. With external capital markets inaccessible for many, and insufficiently accessible for all, domestic savings may well be the key to future growth. Providing a safe outlet for them is accordingly essential, but the issues go beyond the question of deposit insurance. Given the difficulty of implementing proper regulation in East European circumstances, is it possible to design a financial structure that greatly reduces the need for regulation? Those are the questions we will at least begin to discuss in this chapter.

In the first part of this chapter, we start with a brief survey of the role of the financial system (Section 1.1). We then survey some of the recent problems in Western banking (Section 1.2). This part of the chapter ends with a discussion of issues at stake in financial system architecture, and the implications for the design of regulatory mechanisms (Section 1.3), against the background of the problems in Western banking laid out in the preceding section. The second part draws the implications for Eastern Europe. We first provide a brief summary of financial sector developments in Eastern Europe (Section 2.1). The next section sets out some principles for financial system design in Eastern Europe and in particular the FSU and elaborates on a recommended concept, narrow banking. Section 2.3 concludes.

1. Issues in the design of financial systems

1.1 The role of the financial system: stability and competitiveness as joint objectives

The primary function of the financial system is to facilitate the transfer of resources from savers to those who need funds. The objective is to have an efficient allocation and deployment of resources. Efficiency in this context is interpreted broadly and presumes both stability and competitiveness of the financial system. Stability is needed to guarantee the orderly flow, allocation and deployment of resources. It is generally recognized that fragility of the financial system comes at great cost, since disruptions have potentially severe consequences for the economy at large. An efficient financial system should also minimize transaction costs, interpreted broadly as resources that dissipate or evaporate in the process of allocating resources. This generally necessitates a certain degree of competitiveness.

Yet stability and competitiveness are very likely to be conflicting rather than complementary objectives, thus presenting regulators with a difficult trade-off. In the popular view, restrictions on competition would improve banks' profitability, reduce failure rates and hence safeguard stability.

The special status of banks has been called into question after a decade of record-breaking inflation and interest rates, and developments in information technology have undermined banks' protected franchises. These developments made existing regulatory constraints increasingly costly for banks, and simultaneously spurred the growth of non-banking financial institutions, which could largely circumvent the regulatory constraints. This poses an important challenge: how to design a sustainable regulatory environment in banking? We first focus on some of the lessons from the evolution of Western banking. Subsequently, we seek to draw some implications for the regulatory structure.

1.2 Evaluation of the competitive environment of Western banking

There are striking variations in the configurations of financial systems between the different countries in the West. In some countries, such as the United States and Britain, financial markets are very important for the allocation of resources, while in others, such as most continental European countries, banks have played a more prominent role and financial markets are poorly developed. Likewise, in many countries banks do not hold major equity stakes in industrial companies, while in some countries, notably Germany, banks are among the largest shareholders. These differences have a long history and could be purely coincidental, but, more likely, depend on the evolution of the industrial structure in each country. Government involvement could explain some of these differences. This is particularly true in the United States, where rigid regulatory structures have fragmented its banking system.

The US regulatory structure is characterized by a government-sponsored deposit insurance system, a separation of investment banking and commercial banking, and pervasive entry barriers including limitations on the establishment of branches both within each state and outside the home state. This structure dates bank to the 1930s and is contained in the Banking Act of 1933, also known as the Glass–Steagall Act. Complementary legislation sought to reduce competition even further. In particular, regulatory caps, known as Regulation Q, were for a long time imposed on deposit rates.

The three pillars of this Act – federal deposit insurance, restrictions on bank business and entry barriers – guaranteed stability for over forty years. Recent environmental and competitive changes have, however, disturbed the balance provided by the Glass–Steagall Act. The volatile environment made regulatory caps on deposit interest rates too costly for bank depositors, prompting the diversion of savings to the largely unregulated money-market mutual funds that offered competitive interest rates. This forced banks to borrow at more costly market interest rates and was a real threat to the banks' protected franchises. Their traditionally best customers increasingly sought access to equity and bond markets, elevating the risk of the banks' remaining clientele. Higher and more volatile funding costs also coaxed the banks into the business of writing off-balance sheet guarantees and trading all manner of financial derivatives.

Collectively, these changes elevated the banks' risks in virtually all aspects of their business.

Advances in information technology facilitated the circumvention of regulation and tilted the competitive advantage away from the 'opaque' financial institutions, such as deposit takers and insurance companies, towards more 'transparent' intermediaries such as mutual funds, and also to direct financing in the capital markets. As a consequence, there has been a proliferation of specialized non-bank financial institutions.

While oligopolistic practices – see our comments next on Europe – may temporarily hide the competitive deterioration of traditional banking institutions, they soon need to face the new realities. The same is true for the regulatory framework. Under the earlier bank–government nexus, public regulation inhibited both the establishment of new banks and the demise of failing institutions. The latter is still the case as governmental deposit insurance continues to deter bank failures under the banner of protecting depositors. This can no longer be sustained. With the rapidly decreasing costs of computing and communicating, all manner of non-bank financial institutions are successfully encroaching on the banks' traditional markets. Artificial life-support measures and the preservation of inefficient operations are becoming increasingly costly.

With some notable exceptions, such as the Scandinavian countries, other West European countries were spared the banking turmoil. European banks are better diversified, both geographically and functionally, than their US counterparts. They typically operate nationwide, often have substantial cross-border operations, and engage in both commercial and investment banking activities. In addition, the greater concentration among European banks probably facilitates collusive pricing and other oligopolistic practices. Thus, Europe has not yet faced the unbridled competitive pressures that characterize US banking. Moreover, the most recent consolidation and widening of activities among European banks – especially in Spain, Denmark and the Netherlands – can be seen as a pre-emptive response to the threat of increased foreign competition. As a result, the market share of many European countries has reached unprecedented levels with the larger institutions absorbing smaller and often more specialized ones. This means that West European banks have not yet faced the entire effects of a more competitive environment and the imminent dissolution of monopoly rents. 'Europe '92' is likely to imply that they will, however, with all the attendant problems sketched so far.

1.3 Deposit insurance: rationale and implications

The regulatory interference that characterizes banking suggests that banks are considered 'special' or different from other firms. Obviously, regulation has made them special. But what is different about their operations that justifies this 'special' regulatory treatment?

This question needs to be addressed before we can derive the structure of the optimal regulatory response, if any. A starting point is the observation that banks typically have a very fragmented deposit base; bank debt ('deposits') is typically held by many different actors, none of whom holds a very large fraction of the total debt of the bank. This creates a gap in corporate governance; while equity holders have sufficient incentive to monitor the managers when times are good, they do not have so when times are bad, since the benefits of monitoring and imposing corporate governance would in those cases mostly accrue to debt holders. With a normal debt structure, the latter fact will be enough of an incentive for debt holders to start monitoring management. However, with a very fragmented deposit base, obvious free-rider problems would prevent an active role of debt holders in monitoring to emerge. Thus, one should expect bank managers to engage in excessively risky behaviour when times are bad, as the fragmented nature of the deposit base destroys corporate governance mechanisms in those situations (Dewatripont and Tirole 1992).

The special – fragmented – nature of bank debt highlights the lack of corporate governance. It is widely believed that the potential fragility of banks stems from another feature of bank debt, that is, their vulnerability to runs rooted in the withdrawal-upon-demand and sequential service constraint features of the deposit contract. The fear is that excessive withdrawals would force a bank to liquidate assets and incur substantial liquidation costs, which would undermine the bank's ability to honour its remaining deposits. The excessive withdrawals could be triggered by concern about the bank's well-being. However, the bank's demise could then become a self-fulfilling prophecy: once a depositor thinks that others will withdraw, he will withdraw too. This is due to the sequential service constraint feature of deposits: it pays to be first in line. Some have argued that these runs may trigger a system-wide collapse or a panic if runs are contagious.

The potential vulnerability to runs of deposit-funded banks, and the banking system's vulnerability to panics, is often used as a reason for regulation, in particular deposit insurance (Diamond and Dybvig 1983). It is generally thought that private arrangements are beset with free-rider problems and, therefore, could not cope with these problems. So most countries have enacted lender of last resort and deposit insurance (DI) arrangements which guarantee that banks and certain other credit institutions can meet their commitments to depositors. As long as the insurance system is credible and fully guarantees each depositor's funds, bank runs will not materialize.

But deposit insurance, while safeguarding depositors, widens the gap in corporate governance; depositors do no longer have *any* incentive to monitor the bank. It therefore exacerbates the problem of excessive risk-taking by bank managers since only the taxpayer – the ultimate financier of the DI system – bears the consequences of any increase in down-side risk. Thus the existence of DI necessitates further regulation, in particular on the lending side to contain the risk-taking incentives. These arguments quite convincingly explain why extensive deposit guarantees – as observed throughout the world – have induced governments to severely regulate the banks' operations. Banks face restrictions on their activities, minimum capital and liquidity requirements and are subject to extensive examinations and supervision.

The moral hazards created by a fixed-rate, risk-insensitive deposit insurance system are widely acknowledged. There also seems considerable support for the notion that these incentives have contributed to the financial crises as experienced in Western banking. However, this consensus seems at odds with the apparent stability of DI arrangements for most of the 1935–80 period. Various authors, see for example Keeley (1990), argue that the tendency towards risk was restrained for almost half a century by economic rents earned in banking. In recent decades, however, rents were eroded – witness the decade of inflation and volatile interest rates, as well as the technological advances alluded to earlier. This exposed the latent design flaws in deposit insurance.

On a more fundamental level, we may conclude that a system of deposit insurance distorts the relation between a bank and its providers of funds. In particular, it reduces or undermines *market discipline.* Depositors, knowing that their funds are insured, will feel little inclination to monitor their investment by evaluating the banks' activities. While, as we have emphasized, depositors are generally small and may not have a sufficient economic incentive to monitor even in the absence of deposit insurance, it is likely that in a world without deposit insurance market-rooted solutions would develop to

facilitate monitoring. There would also be a real urgency because without these solutions funding might not be forthcoming. One potential solution is the concentration of ownership of debt. This could make (costly) monitoring economically viable.

Another solution is rooted in the banks' incentives to develop a *reputation*; that is, credibility in the funding market. A sufficient reputation could convince the market that a bank would not exploit problems of non-transparency and moral hazard. The bank would then benefit and obtain funds of a lower rate. Once a reputation is established, a bank has a powerful incentive to behave prudently and thus preserve its reputation. While we have linked this mechanism to the funding of banks, it is generally applicable to all firms that seek access to the financial markets. For banks, however, the mechanism has been suppressed!

The important observation is that the banks' reliance on deposit insurance *fixes* their costs of funds at the risk-free rate, and also guarantees the *availability* of funds. Reputation does not lessen the banks' costs or improve the availability of funds, and the banks' incentives to develop good reputations would accordingly be diminished. Their prudent operation would then depend primarily on the regulatory design.

The conclusion is that monopolistic benefits provided banks with compelling incentives to follow low-risk strategies, despite the presence of deposit insurance. Market discipline was not necessary, and regulation and supervision were only of secondary importance; rents were the primary defence against moral hazard! With the disappearance of rents, rigid regulatory structures like the Glass–Steagall Act in the United States were subject to unique challenges. The viability of the financial system became fully dependent on regulation and supervision. As has become clear, the regulatory agencies could not cope with this task.

The questionable sustainability of Western banking structures, held in check only by regulations, suggests that Eastern Europe should not necessarily seek to implement or imitate the Western banking structures as they exist today. Recent experience in Western banking suggests that the tradition of guaranteeing stability by reducing competitiveness is no longer viable. It is thus important to (re)examine the issues of competitiveness and stability. The objective is to design a banking structure and regulatory framework whose sustainability is minimally dependent on regulation and supervision; an objective that is even more urgent in Eastern Europe with its as yet shaky legal and regulatory structure.

There are other reasons as well why Eastern Europe should not solely focus on Western banking models. In particular, it is important to realize that financial systems may well be history-dependent, namely, depend on the development of each country's industrial structure. This may also explain the striking variations in Western financial structures. Not surprisingly, it is therefore impossible to rank different financial systems in terms of efficiency or performance; more than one financial system might be optimal at the same point in time, and optimal configurations of financial systems may change over time.

2. Financial sector reform in the FSU

2.1 Banking in Eastern Europe

In communist Eastern Europe, the government received and dispensed all moneys, and allocative efficiency was not a matter of concern. Thus there was no need for Western-style commercial banks, and no such banks existed (except in Yugoslavia, a maverick communist country in those days). A monolithic central bank, usually assisted by a savings bank to collect deposits, undertook both central bank functions (which were minimal in the absence of free prices and open international exchanges) and extended credit to industry.

Almost immediately after the collapse of communism, and in some cases even preceding it (as in Poland), two-tier banking was established, typically by splitting off the regional branch offices and turning them into commercial banks. In much of Central Eastern Europe, central banks take their newly confined role seriously and refrain from direct lending to the enterprise sector. However, in most of the former Soviet Union and South Eastern Europe, central banks continue to hand out loans to favoured industrial or agricultural enterprises, often at rates far below inflation. This happens sometimes directly, as in the Ukraine, and sometimes indirectly through blanket rediscounting of commercial loans or through unconditional recapitalization of commercial banks endangered by poor loan servicing of state enterprises.

The newly created commercial banks typically inherited a loan portfolio full of loans to troubled state enterprises. Although in some countries a bout of hyperinflation following price liberalization wiped the slate clean, existing customer relationships and government pressure conspired to recreate the same problem in a matter of years. Polish banks, where exactly such a sequence was played out, had about 30 per cent of their loans classified as bad or doubtful by international auditors as late as June 1992, although triple digit inflation in 1989 had pretty much provided them with a fresh start. More recently tighter owners' control over managers seems to have reduced the problems somewhat, but other countries are reported to be in worse shape (Dittus 1993).

Widespread bankruptcies have not occurred (in many countries, of course, there is still no functioning bankruptcy mechanism). Central banks have as yet not imposed the loan classification schemes and capital adequacy requirements that would bring insolvency to light. Insolvency of private and/or public banks would mainly put corporate depositors at risk as most countries' household deposits still largely flow through a dedicated savings bank.

Typically this savings bank is the only bank with a national network of retail outlets as it was the designated recipient of such deposits under the communist regime. This structure is increasingly diluted as commercial banks expand; but for example in the Ukraine, on the liability side of commercial banks, household deposits make up less than 10 per cent of corporate deposits. Considering the presence of (limited) deposit insurance for household deposits, solvency problems could thus have more serious public finance consequences in Central Europe than in the FSU.

2.2 A regulatory structure for banking in Eastern Europe

The question that has occupied much of the Western literature on banking in Eastern Europe, whether Eastern Europe should go to universal banking or not, has become largely irrelevant as countries across the board chose that model. This poses obvious problems for the regulators, to which we will come back; but given that capital markets are likely to play a limited role for quite some time to come, if not indefinitely, allowing the banks a freer role in establishing corporate governance and restructuring has much to say for it and this becomes a great deal easier under the banking model chosen (cf. van Wijnbergen (1993) for a strong argument in this direction).

But with that choice behind us, a question immediately arises, the answer to which will take the remainder of this chapter. Given the clear regulatory problems created by universal banking, and banks thus exposed to more risks and commensurately more difficult to regulate, should deposit insurance be adopted, as it universally has been in the West? Deposit insurance exists *de facto* for the larger commercial banks in most of the countries concerned as they are still owned either by the state or, as in the Ukraine, by state enterprises.

As private banks expand and state banks are privatized, like in the Czech Republic and, haltingly, in Poland, should the state protect depositors in the private banks from the consequences of bank failure?

Whichever way the answer to that question goes, a strong case can be made for a substantially larger direct element in bank regulation than can currently be found in Western Europe.[1] Direct regulation could stipulate that insurance activities and corporate restructurings be placed in separate subsidiaries, which will then fall under specialized regulatory agencies where necessary.

Similarly, one could require that high-risk activities not be undertaken with insured deposits. This is in fact already the *de facto* situation in the FSU (and, until very recently, also Central Eastern Europe); as we already saw, most household deposits flow through a savings bank which typically only invests in government or central bank paper, or in other commercial banks. Most commercial banks rely largely on enterprise deposits and the central bank for their funding.

This situation would considerably reduce the need for deposit insurance, and also reduce the contingent liability (the exposure) of the deposit insurer to a bare minimum. We identify at least two reasons for this. The first is that banks which do engage in risky activities have a much more concentrated deposit base than would be the case with household deposits. For one thing, the savings banks themselves – we envisage several of these in the future[2] – will become major depositors. Such a higher concentration is likely to greatly reduce the problems that make deposit insurance desirable to begin with.

After all, the reason why a bank manager might be taking undue risks is that with a fragmented deposit base no individual depositor has enough of an incentive to monitor the management; and even if he had, free-rider problems would likely prevent him from doing so.[3] But a large depositor may be able to appropriate enough of the benefit of monitoring management to make the effort worthwhile; so a concentrated depositor base would greatly reduce the need for deposit insurance. Similarly (and this is the second reason), the monitoring and discipline induced by a more stable and concentrated deposit base would mitigate the problem of bank runs. The reason is simply that with a concentrated deposit base co-ordination among depositors is easier and depositors are better informed about each other. Bank runs can be excluded altogether by relinquishing the special features of the deposit contract that give rise to them.

[1] See Boot and van Wijnbergen (1994) for an elaboration.

[2] These could be spinoffs from the current savings bank, or newly created ones.

[3] If any given depositor monitors management, all other depositors can 'free ride' on that effort; as a consequence no individual depositor may in the end invest in monitoring activity. This is known as the 'free-rider problem' in economic theory.

Thus having savings banks as major players in the inter-bank market might well be a substitute for deposit insurance. Another consideration is that deposit insurance would then be granted to institutions – the savings banks – that are truly diversified; that is, deposit insurance rests with institutions that could diversify their funds over various, sometimes only regionally active, commercial banks. This would reduce the contingent liability of the deposit insurer and make it insensitive to regional economic downturns.

As to implementation, the critical role of the savings banks presumes that the savings banks themselves should *not* be allowed to engage in risky activities; otherwise *their* management is subject to the very incentive problems that this whole arrangement is set up to solve. Thus cementing the current situation in much of the FSU in direct regulation would make the imposition of deposit insurance for commercial banks unnecessary and would thereby greatly reduce the regulatory burden on the government. Deposit insurance could be granted to the savings banks but their restricted activities would contain supervisory checks as well as the exposure of the deposit insurer.

Such a situation would create two categories of financial institutions, the commercial banks and the savings banks. The commercial banks would operate with little regulatory interference, but would not qualify for deposit insurance, while savings banks could obtain deposit insurance but would face substantial regulatory restrictions.

We can summarize the minimum requirements of the structure that we envisage as follows:

(1) restricting household deposits to the savings banks, or, at least, restricting deposit insurance to these banks;
(2) requiring the savings banks to invest mostly in high grade assets, which for the time being means government paper and lending to commercial banks with a substantial capital base;
(3) not allowing commercial banks to take household deposits, or, at least, publicly refusing deposit insurance to such deposits outside the savings bank.

This set of proposals looks very much like a variant of the 'narrow banking' proposals currently debated in the Western finance and banking literature. Such a structure has a number of clear advantages. First, by putting distance between household deposits and risk activities, it reduces the incentive problems that may lead to excessive risk-taking by bank managers. It therefore reduces the need for deposit insurance and the associated need for lender regulation. A narrow banking structure along the lines proposed here will greatly reduce the regulatory burden on the governments in Eastern Europe.

Moreover, it will keep incentives intact for banks to build reputations for reliability. Such incentives are destroyed by deposit insurance; after all, full deposit insurance makes all deposits equally attractive for depositors irrespective of the bank taking them. So no cost advantages can be obtained by building up a reputation for sound banking and any efforts in that direction will thus be greatly reduced if DI is introduced.

This would be an unfortunate development since in many East European countries efforts to build up a reputation are clearly under way in a significant subgroup of banks. Most of the nine larger commercial banks in Poland have made strenuous attempts to upgrade the quality of their portfolios, as have the privatized banks in the Czech Republic. Similarly, Lamdany (1993) reports the emergence of a group of about thirty medium-sized banks in Russia (out of a total of about 2,000) that clearly are trying to signal their reliability through restricting their risk activities. Deposit insurance would cut such developments short.

There are two potential disadvantages, both of which can (*and should*) be accommodated. The first problem stems from the restrictions banks will face in their funding possibilities. Once large-scale privatization takes place and more regular manufacturing activities pick up, expansion based on the private sector will need bank finance. Household bank deposits will most likely remain the predominant source of private savings for a long time to come. In this way, arrangements that would exclusively channel household deposits to the savings banks could become a serious hindrance for private sector industrial development.

Developing an inter-bank market to which the savings banks could lend is thus an essential complement to the proposals made here for narrow banking. Such a mechanism would still keep savings banks' managers at arm's length from direct risk activities, which after all would reside with the commercial banks. It would add a major

depositor to the commercial banks' deposit base, thus lessening the free-rider problems associated with a fragmented depositor base. Limiting access to such a market to properly capitalized banks will add further incentives for prudent management for bank managers.

A second problem will be clear to anybody who has had to deal with institutions like the Ukrainian or Russian savings bank. Since they had an entirely captive clientele, customers were at their mercy. Competition on the deposit side clearly needs to be introduced to remedy this situation. We envision the creation of several savings banks. Commercial banks could also participate by setting up American-style money market funds. These funds channel deposits into government paper and other high investment grade assets, in a legal structure that protects those assets from problems in the rest of the bank (this also means that banks should not be allowed to use those assets as collateral, for example). This would make them into safe deposits without the need for deposit insurance. Banks would earn management fees and so have an incentive to compete with the savings banks for deposits. Such institutions would also help to create markets for Treasury paper, a market of immense macroeconomic importance. Moreover, this structure would bring the financial system in the FSU closer to the Western concept of a narrow bank, which envisages a symbiosis of safe and risky elements in one bank.

In the future such restrictions on household deposits could be lifted, at which time the countries involved could evolve towards a traditional Western banking system; a necessary precondition for such a change is that the regulatory and supervisory institutions are fully staffed and capable of their task. Alternatively, the banking system could evolve towards the narrow banking concept Western-style. This would also involve lifting the restrictions on household deposits, but would require banks to separate their risky and safe activities and only use funds from household deposits to fund safe activities unless sufficient credit enhancement has taken place. However, the required degree of financial sophistication for the latter operation does not yet seem to exist currently in Eastern Europe.

2.3 Conclusions

At the very moment when Eastern Europe seems set to follow the West in its financial market regulatory design, a series of crises in the United States, Scandinavia, Spain and elsewhere has led many to question its adequacy. In this chapter, we have presented the analytical issues in financial systems architecture so as to shed light on the problems that have been noted recently in the West and draw conclusions for regulatory design in the East.

An analysis of recent developments in the OECD suggests disconcerting conclusions for the trade-off between stability and competition in financial markets. As financial innovation and regulatory reform have swept most countries outside Western Europe, crises have followed; many observers believe that Western Europe has been spared these developments only because competition policy has yet to reach the banks. A comparison of Western Europe with the rest of the OECD suggests that monopoly rents rather than effective regulation have been the main force behind financial stability: protecting future rents is apparently a powerful force for conservatism.

The apparent difficulty in regulating a truly competitive banking system leads us to commend a variant of the narrow banking concept. Such banking structures attempt to put some distance between household deposits and the funding of risky activities. The banking structure that in particular still exists in much of the FSU in fact makes that very easy to implement: with most of the deposits still channelled through a specialized savings bank, narrow banking takes place *de facto* if not *de jure*. Where household deposits are used to fund risk activities only indirectly, we show how the burden on regulatory authorities may be greatly reduced by essentially eliminating the incentive problems that gave rise to the need for regulation to begin with.

Whether in the long run the variation on the narrow banking concept as proposed in this chapter will evolve towards a traditional Western banking system will depend on developments in the East *and* in the West; but since the concept is *de facto* implemented at present in most of the FSU, we strongly recommend that that structure be maintained until more competent supervision than currently exists has been put in place and shown to work.

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