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Harmonisation and legal transplantation of EU Banking supervisory Rules to transitional Economies. A legal Approach

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Abstract

This paper examines how different CEECs (Slovenia, Hungary, Czech Republic) are adapting their banking systems to the acquis communautaire, the effects and possible limits of transplantation of the EU rules to economies in transition. The first part will outline the general principles of the relations between the EU and individual transitional countries, in order to find out to which extent the latter are bound to incorporate the acquis communautaire into their national legal systems.

The second part examines the changing legal environment of banking in the selected CEECs and compares some of its features to the existing European and international supervisory standards.

Part III will analyse the scope, effects and possible limits of transplantation of EU supervisory standards to the CEECs. In particular, attention will be paid to the specific function of EU harmonization in a perspective of market integration, and the question whether these rules should be adapted to the specificities of the market environment in which they will have to operate.

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Harmonisation and Legal Transplantation of EU Banking Supervisory Rules to Transitional Economies. A Legal Approach

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Introduction

The Agenda 2000 programme of the European Commission[1] outlines the main principles along which negotiations between the European Union (EU) and Central and Eastern European Countries (CEECs) should be pursued with a view to possible EU accession, and recommends the opening of negotiations with a selected group of CEECs: Hungary, Poland, Estonia, the Czech Republic and Slovenia.[2] Notwithstanding this two step approach, the signal nevertheless has been clearly given by the European Commission: in the long run, all CEECs should be entitled to join the European Union, and the conclusion of Association Agreements ('Europe Agreements') is to be considered a first step towards a more comprehensive policy of convergence with EU regulations. Countries which were not part of the first group of potential EU member-states (Slovakia, Lithuania, Latvia, Romania, Bulgaria), have nonetheless stepped up their efforts to incorporate EU regulatory standards into their national laws as part of a comprehensive pre-accession strategy. This movement is particularly strong in the field of banking, as a strong and reliable financial industry constitutes an important foundation of a sound economy.

This paper examines how different CEECs belonging to the group of privileged accession candidates (Slovenia, Hungary, Czech Republic) are adapting their banking systems to the *acquis communautaire*, and the effects and possible limits of the transplantation of EU rules to economies in transition. The first part will outline the general principles of the relations between the EU and individual transitional countries, in order to find out to which extent the latter are bound to incorporate the *acquis communautaire* into their national legal systems. The second part examines the changing legal environment of banking in the selected CEECs and compares some of its features to the existing European and international supervisory standards. Part III will analyse the scope, effects and possible limits of transplantation of EU supervisory standards to the CEECs. In particular, attention will be paid to the specific functions of EU harmonisation in a perspective of market integration, and the question whether these rules should be adapted to the specificities of the market environment in which these rules will have to operate.

I. Trade Relations Between the EU and Selected CEECs: Europe Agreements and the *acquis communautaire*

A. From Bilateral Co-operation to Association

Although the process has not been carried out simultaneously in each country, the CEECs examined in this study have at present all entered into 'Europe Agreements' with the European Union.[3] A first wave of Europe Agreements was concluded in December 1991 with Poland, Hungary and Czechoslovakia. Following the splitting up of the latter country into the Czech and Slovak Republics respectively, the Europe Agreements were renegotiated, which led to the conclusion of almost identical agreements with both countries

1 EUROPEAN COMMISSION (1997), p. 138.
2 EUROPEAN COMMISSION (1997), pp. 57-58.
3 For a general overview, see MARESCEAU, Marc (1997), p. 6-7.

in 1993.[4] The Europe Agreement concluded with Slovenia in June 1996[5] constitutes the last in a 'third wave' of agreements, initiated by agreements signed with the Baltic states in 1995. Until completion of the ratification process for the Agreement with Slovenia, an Interim Agreement containing most of the trade-related provisions of the Europe Agreement was in force.[6] The Europe Agreement with Slovenia effectively entered into force on 1 February 1999.

The largely similar structure and contents of the Europe Agreements concluded with the different CEECs leads to the conclusion that, in legal terms, the CEECs are broadly speaking in a similar position as to their relations with the EU. This is the consequence of a deliberate policy of 'global approach' adopted by the European Commission, which however has not always been fully welcomed by the economically more advanced CEECs, such as Hungary or the Czech Republic.[7] The latter countries expressed the fear that the globalising approach would slow down the integration process, as "the slowest ship determines the speed of the convoy".[8] The Agenda 2000 programme of the European Commission seems to have at least partially met these objections, in dividing the applicant CEECs into two categories according to the possible timing of EU accession (see infra).

B. The Europe Agreements and the *acquis communautaire*

Perhaps surprisingly, the Europe Agreements do not contain explicit provisions on the implementation of the *acquis communautaire* by the associated countries. This is due to the fact that the conclusion of these agreements was not initially considered by the European Commission as forming part of a pre-accession strategy. On the contrary, the Europe Agreements, putting into place an association with the European Union, were originally devised as an alternative to accession.[9] The inclusion of the Europe Agreements in a pre-accession process only came later, and was mainly inspired by successive political declarations and decisions taken by the European Council from 1994 on.[10]

The economic part of the Europe Agreements in reality mainly focuses on the liberalisation of trade relations between the EU and the partner country, continuing along the objectives already contained in bilateral co-operation agreements which preceded the Europe Agreements.[11] In fact, the Association will gradually create a free trade area between the European Union and the partner country, leading to abolishment of all customs duties in the field of movement of goods, and to the elimination of all discriminatory treatments in the cross-border movement of workers, services and establishment.

C. The Europe Agreements and Financial Services

1. Liberalisation and its limits

In the field of financial services, all Europe Agreements contain specific transitional rules and derogations from the general principles of (gradual) liberalisation. The exceptions should enable the CEECs to spread the adjustment costs relating to the liberalisation of their financial markets over a longer period of time. The activities covered under the heading

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4 OJ, 1994, L 359/2 (Slovak Republic) and L 360/2 (Czech Republic). This coincided with the conclusion of Europe Agreements with Bulgaria and Romania in the same year.

5 For the text of the proposal, see: COM(95) 341 final.

6 See OJ L 344/3 of 31 December 1996. The Agreement entered into force on January 1st, 1997.

7 See BALÁSZ, Peter (1997), p. 358.

8 BALÁSZ, Peter (1997), p. 373.

9 See MÜLLER-GRAFF, Peter-Christian (1997a), p. 16; Müller-Graff, Peter-Christian (1997b), p. 34;

10 See CREMONA, Marisa (1997), p. 196.

11 See for more information on these early stage of bilateral economic co-operation MARESCEAU, Marc (1989), p. 6-11.

of 'financial services' include on the one hand the direct and life insurance business, and on the other hand banking activities.[12] As for the latter, the Europe Agreements have copied the extensive list of 'banking activities' contained in the Second Banking Directive, which is inspired by the universal banking model. The derogations, which are largely similar in all Europe Agreements, apply to all freedoms at stake (establishment, services and capital movements). A comparative overview of the applicable rules is provided in Table 1.

		Hungary	Czech Republic	Slovenia
Establishment	*Establishment of companies*	National treatment by end of first stage (1 Feb. 1999)	National treatment by end of transitional period	National treatment by end of transitional period
	Operation of established companies	National treatment by 1 Feb. 1999	National treatment	National treatment
	Standstill obligation	Yes, with exception (art. 50)	Yes, with exception (art. 51)	Yes, with exception (art. 52)
	Acceleration of liberalisation	Possible (decision by Association Council)	Possible (decision by Association Council)	Possible (decision by Association Council)
	Prolongation of derogation regime	Exceptionally and for limited period of time (decision by Association Council)	Exceptionally and for limited period of time (decision by Association Council)	Exceptionally and for limited period of time (decision by Association Council)
Services	*Timetable for liberalisation*	Progressive liberalisation through decisions of Association Council	Progressive liberalisation through decisions of Association Council	Progressive liberalisation by Association Council within 8 years
	Standstill obligation	No	No	Yes (no measures which are 'significantly more restrictive')
Capital Movements	*Direct Investments*	Freedom for liberalised establishments	Freedom for liberalised establishments	Freedom for liberalised establishments (Exception: privatised companies)
	Financial Services	- First stage: 'creation of necessary conditions for gradual liberalisation' - Second stage: Possible full liberalisation through decision of Association Council	- First stage: 'creation of necessary conditions for gradual liberalisation' - Second stage: Possible full liberalisation through decision of Association Council	- Full freedom of commercial credits and financial loans; - From fourth year: full freedom for portfolio investment; - First stage: 'creation of necessary conditions for gradual liberalisation' - Second stage: Possible full liberalisation through decision of Association Council
	Standstill obligation	Yes (only after end of first stage)	Yes (only after end of first stage)	Yes

[12] See Annex XIIa Europe Agreement EU-Hungary; Annex XVIa Europe Agreement EU-Czech Republic; Annex Ixc Europe Agreement EU-Slovenia. The list may be amended by decision of the respective Association Councils (e.g. art. 49 Europe Agreement EU-Hungary).

Table 1: Liberalisation of Establishment, Services and Capital Movements in the Area of Financial Services: A Comparative Overview

A first exception relates to the cross-border *establishment* of companies, i.e. the setting-up[13] and management of subsidiaries or branches. The general obligation for the CEECs to gradually grant national treatment[14] to the establishment of EU companies and nationals either at the entry into force of the Agreement (Czech Republic, Slovenia), or at the end of the first stage of the transitional period (Hungary), does not apply to financial services, where national treatment should in all cases be granted only at the end of (i.e., the second stage of) the transitional period.[15] The Agreement nevertheless provides for the possibility of either an accelerated or (in exceptional circumstances) a delayed transition to national treatment in the area of financial services, subject to the decision of the Association Council.[16] In contrast, the *operation* of companies and nationals duly established in the associated country should be granted non-discriminatory treatment from the initiation of the agreements.[17] No derogation applies with respect to financial services.

With respect to *cross-border services*, no specific regime is envisaged for the area of financial services. The Europe Agreements only prescribe the gradual liberalisation of cross-border services by way of decisions adopted by the respective Association Councils.[18] These decisions should take into account the development of the services sector in the associated countries. Despite its apparent similarity with the other Europe Agreements, the Agreement with Slovenia seems much more compulsive in formulating the liberalisation principle in the area of services: for example, it states that the Association Council shall take the measures to implement progressively the liberalisation process within eight years after the enactment of the Agreement. In this case, the Agreement formulates a clear obligation to achieve a specific result, which can be seen as having a direct effect in the member states at the end of the term.[19] It may be submitted that the more stringent approach in the agreement with Slovenia with respect to liberalising cross-border services is due to the more recent date of conclusion of the agreement, which enabled to include in the agreement itself achievements which were already made in the implementation of the agreements with other CEECs by way of decisions of the respective Association Councils.

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13 It is submitted that the notion of 'setting up' does not only include the *creation* of a legal entity, but also extends to the *acquisition* of an existing company in the host state, as a result of which it becomes a subsidiary of the acquirer. This extensive interpretation is particularly important with respect to privatization issues.

14 In the Europe Agreement EU-Slovenia, the notion of 'national treatment' has a broader definition than in the other Europe Agreements, taking as a reference the better treatment offered in either the host state or a third country as the basis for 'national treatment'. This approach in fact combines the notions of 'national treatment' in its traditional understanding, and the principle of 'most favoured nation'.

15 See Art. 44, 1 (i) Europe Agreement EU-Hungary; Art. 45, 1(i) Europe Agreement EU-Czech Republic; Art. 45, 1(I) Europe Agreement EU-Slovenia.

16 Art. 44, 6 Europe Agreement EU-Hungary; Art. 45, 5 Europe Agreement EU-Czech Republic; Art. 45, 6 Europe Agreement EU-Slovenia.

17 Art. 44, 1 (ii) Europe Agreement EU-Hungary; Art. 45, 1(ii) Europe Agreement EU-Czech Republic; Art. 45, 1(ii) Europe Agreement EU-Slovenia.

18 Art. 55, 1 Europe Agreement EU-Hungary; Art. 56, 1 Europe Agreement EU-Czech Republic; Art. 53 Europe Agreement EU-Slovenia.

19 See in particular the case law of the Court of Justice with respect to the direct applicability of the freedoms of the EU Treaty: case 33/74, *van Binsbergen*, judgment of 3 December 1974, ECR 1974, p. 1299.

Finally, with respect to *capital movements*, the Agreements operate a distinction between capital flows related to direct investments and other capital movements not related to current account payments. With respect to direct investments, the Agreements allow free movement of both the investments and the liquidation or repatriation of these investments, as far as the underlying investment (establishment) is liberalised. As a consequence, the derogation for financial services on national treatment for cross-border establishment equally extends to the capital movements connected with it.

As for other cross-border capital movements, a two stage liberalisation of capital flows is envisaged in the Europe Agreements: during the first stage, the contracting parties should take the necessary measures to 'create the conditions for the further gradual application of Community rules on the free movement of capital'. In the second stage, the Association Council will be competent to examine ways of fully liberalising cross-border capital movements at the end of the transitional period.[20] This general regime, which does not create any obligation for the Association Council to remove obstacles to free movement of capital, fully applies to capital movements associated with financial services. Again, the Europe Agreement with Slovenia shows a more prescribed approach: although the Agreement endorses the two-stage approach with respect to capital movement liberalisation, it also stipulates the immediate liberalisation of credits related to commercial transactions and of financial loans. Moreover, capital movements relating to portfolio investment should be free from the fifth year after entry into the Agreement.[21]

2. Banking and financial sector development

Beside some specificities in the different Europe Agreements with respect to the *liberalisation* of financial services, all Europe Agreements also stress the importance of *technical cooperation* in the field of banking and financial sector development.[22] In general, bilateral co-operation should ensure the creation or further development of a suitable framework for the conduct of banking, insurance and other financial activities in the associated country. These co-operation efforts should, acording to the text of the Agreements, focus on both operational aspects of financial sector development and the improvement of the supervisory framework. The cooperation is intended to include the provision of technical assistance and training.

Although drafted in largely similar terms, the relevant provisions of the Europe Agreements with respect to these aspects of cooperation show some noticeable differences, which reflect the different stage of finaniial sector development and the ensuing priorities in terms of technical assistance of the respective associated countries. In Hungary for instance, where the development of the financial sector and the supervisory framework was perceived as being relatively satisfactory, the Agreement mainly focused the cooperation on the harmonisation of the regulatory and supervisory framework with the European practices. In contrast, the Agreement with Slovenia indicates the need for cooperation with a view to strengthening and restructuring the financial sector, which reflects the less advanced stage of transition in Slovenia at the time of conclusion of the Agreement compared to the Hungarian situation. Moreover, the Agreement with Slovenia points to the need to improve supervision and regulation of the financial sector, not simply to 'harmonise' the existing rules and practices. A similar picture emerges in the Agreement with the Czech Republic: as for Slovenia, the cooperation should aim at *establishing* and developing a suitable framework for the encouragement of the financial sector.

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[20] Art. 61 Europe Agreement EU-Hungary; Art. 62 Europe Agreement EU-Czech Republic; Art. 64 Europe Agreement EU-Slovenia.

[21] Art. 62, 2 Europe Agreement EU-Slovenia.

[22] See Art. 83 Agreement EU-Hungary; Art. 84 Agreement EU-Czech Republic; Art. 85 Agreement EU-Slovenia.

Finally, all Europe Agreements provide for technical cooperation with respect to the translation of the legislation of the EU and the partner country. Indeed, the main sources of banking legislation in the countries examined are available in English, which substantially enhances transparency of the regulatory system, and is likely to stimulate market access by EU companies.

D. The 1995 White Paper

An important step towards regulatory convergence between the EU and the CEECs was made by the adoption in 1995 of a Commission White Paper on the 'preparation of the associated countries of Central and Eastern Europe into the Internal Market of the European Union'[23], which was subsequently backed by the European Council at its 1995 Cannes Summit. The White Paper, though a unilateral and not legally binding instrument for the European Community[24], clearly expressed the view that incorporation of the *acquis communautaire* by CEECs would substantially facilitate accession negotiations, even though this has never been formulated as a formal condition for accession.[25] Specifically in the field of financial services, the White Paper proposed a gradual approach to regulatory convergence: the CEECs should as a first stage take the necessary measures required to enhance the confidence of domestic and foreign investors in the financial system: the training of personnel, the enactment of appropriate legislation and the creation of qualified supervisory bodies. It is only in a second stage that the co-ordination measures could be adopted to realise the freedom of establishment and free provision of services in the legislation of the CEECs.[26]

E. Agenda 2000

The Agenda 2000 programme heavily relies on the principles set out in the 1995 White Paper. It stresses the importance of applying *in advance of accession* all the elements of the 1985 White Paper on the Single Market[27], leading to the abolishment of border controls, through a specific set of procedures.[28] This is reflected in the strategy for enlargement which the Agenda 2000 programme puts forward, which is based on two principles[29]:

- the conduct of negotiations between the EU and the applicants, based on the principle that the *acquis communautaire* will be fully applied upon accession;
- a reinforced pre-accession strategy for all applicants, designed to ensure that they take on as much as possible of the *acquis communautaire* in advance of membership.

The above principles also apply in the field of financial services. In the opinion of the European Commission, "strengthening the solidity and efficiency of the financial system in all candidate countries seems indispensable. Financial supervising authorities must acquire the qualifications and capacity to implement fully relevant Community legislation."[30]

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23 COM(95) 163 final of 3 May 1995.
24 See MÜLLER, Peter-Christian (1997), p. 20.
25 See GAUDISSART, Marc-André and SINNAEVE, Adinda (1997), p. 45-46.
26 See White Paper, Chapter 13, pp. 281-304.
27 European Commission, *Completing the internal Market - White Paper from the Commission to the European Council,* COM(85) 310.
28 EUROPEAN COMMISSION (1997), p. 48.
29 EUROPEAN COMMISSION (1997), p. 51.
30 EUROPEAN COMMISSION (1997), p. 118.

Finally, it should be noted that all CEECs have elaborated pre-accession plans and set up a pre-accession institutional framework in the period 1995-97, in order to implement the *acquis communautaire* into their national laws.[31]

By way of conclusion, the analysis of the different legal instruments and political decisions with respect to both liberalisation of trade relations between the EU and the CEECs and the preparation for accession by the latter, illustrate that there is no formal legal obligation for the CEECs to incorporate the *acquis communautaire* into their national legal systems. However, adopting the *acquis communautaire* clearly is considered an important political commitment and *de facto* precondition for serious negotiations on possible accession to the EU.

II. The Legal Framework of Banking Supervision in Selected CEECs Compared to European and International Standards

Banking regulation has witnessed dramatic changes since the CEECs have oriented their regulatory strategies towards incorporating the *acquis communautaire*. In Slovenia, a new Banking Law has been approved by Parliament in February 1999, which adapts the Law on Banks and Saving Banks of 1983 to most of the EU banking directives, even including the principles of single licence and home country control contained in the Second Banking Directive.[32] In the Czech Republic the Act No 21/1992, substantially modified in 1997[33] and the regulations adopted by the Czech National Bank[34] are in line with most of the EU banking supervisory standards. In Hungary, an important move towards European convergence has been made by the adoption of Act No. CXII of 1996 on the Credit Institutions and the Financial Undertakings.

The efforts to incorporate the *acquis communautaire* in the laws of the CEECs should not be seen as a goal on its own. In fact, the European prudential standards in turn reflect commonly accepted prudential principles, as they are being developed within the Basle Committee for Banking Supervision. By incorporating the European *acquis,* the CEECs do not only facilitate their possible accession to the European Union, but at the same time adapt their banking laws to international prudential standards, promoting their integration in the international banking community.

Though not legally binding, the *Core Principles for Effective Banking Supervision*, launched by the Basle Committee in September 1997, constitute a landmark document in the codification of international prudential standards. As the introduction to the document states, "[t]he Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally."[35] This equally applies to the CEECs in the transformation of the legal framework for banking. In fact, some CEECs have been actively involved or associated in the elaboration of the 25 Core Principles (e.g.

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31 See for an overview SOVEROSKI, M (1997), pp. 20-22.

32 The latter principles will however only enter into force upon effective EU membership of Slovenia. The inclusion of the single licence/home country control principles was not initially envisaged in the draft law: see BANKA SLOVENIJE (1997), *Report on supervision of banking operations in the year 1996 and the first half of 1997*, Ljubljana, 1997, p. 45-46.

33 See for an overview of the modifications: CZECH NATIONAL BANK (1997), p. 11-13.

34 The elaboration of most technical rules is delegated by the law to the Czech National Bank, acting by way of 'provisions'. For instance, a provision of 17 June 1999 imposes, as from 1 April 2000, new rules on the management of market risks by credit insitutions, taking over the requirements imposed by the EU Capital Adequacy Directive.

35 P. 2, No 6.

Czech Republic, Hungary), and accept them as current international prudential standards.[36]

A general comparison between the *Core Principles*, the current European prudential standards and the legislation currently in force in the selected CEECs, as shown in Table 2, leads to the following considerations.

First, most of the Core Principles have been more or less incorporated into the European directives, either in a general manner or through more detailed rules, often quantifying the general principles. However, some core principles apparently do not have a clear transcription in the European directives. In fact, one should take into account the specific nature and function of EU harmonisation: 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. EU harmonisation is merely confined to setting the *minimum* standards to be observed by all credit institutions active in a EU member state with a view to granting them the right to expand their activities in other member states. Indeed, the banking directives are based on Article 57, paragraph 2 of the EC Treaty, which empowers the Council and the European Parliament only to adopt the directives which are *necessary* to realise the free movement of services and the freedom of establishment for economic actors.

Second, from a formal point of view, it appears from Table II that the present legal framework for banking in the CEECs under examination already complies to a great extent with both the Basle Core Principles and EU standards. Nevertheless, differences still exist between the different countries. In general, Hungary appears to have introduced most of the EU and BIS standards in its banking law. With some notable exceptions (principle of consolidated supervision; management of market risk and general risk management models), the same can be concluded for the Czech Republic. In Slovenia, the present regulatory framework appeared to lag somewhat behind, but the new banking Law approved in February 1999 has incorporated most of the European directives into the national legal order. As a matter of fact, the Slovenian legislator had the relative advantage of being able to rely on the Basle Committee *Core Principles*. Compared with the present legal framework in the Czech Republic and in Hungary, the Slovenian banking law can at present be considered to most clearly refelct the current international prudential standards.

One should, however, not rely solely on the formal legal framework. It is not sufficient for the regulator to enact formal prudential standards. It is much more important to examine whether and how the formal rules are effectively applied, and how this is reflected in the day-to-day supervisory practice. On the other hand, it is not excluded that the actual supervisory practice in one or the other state is more in line with the Core Principles than is sometimes suggested by the results of Table II, which has been made on the sole basis of the formally enacted laws and regulations. For instance, it is possible that the supervisor actually imposes stringent risk management procedures, although the banking law does not explicitly contain a rule in this sense. Setting the prudential standards by way of formal (legal) rules nevertheless has the advantage of transparency as to the applicable rules and expectations from the supervisory authority.

CORE PRINCIPLES	European Union	Czech Republic	Hungary	Slovenia
Preconditions				

[36] See for instance, CZECH NATIONAL BANK (1996), *Banking Supervision in the Czech Republic 1996*, p. 2.

1. Suitable legal framework for banking supervision	Yes	Yes	Yes	Yes
Licensing and structure				
2. Protection word 'bank'	Yes	Yes	Yes	Yes
3. Licensing criteria: - Ownership structure - Fit & proper directors - Operating plan - Internal controls - Capital base (Mill. EUR)	 Review of 10% shareholders Yes Yes Yes 5	 Review of 10% shareholders Yes Yes Yes 14.26	 Review of 10% shareholders Yes Yes Yes 7.96	 Review of 10% shareholders Yes Yes Yes 5.2[37]
4. Review of transfer of significant ownership in bank	Thresholds: 10, 25, 33, 50%	Thresholds: 10, 25, 33, 50%	Thresholds: 10, 15, 33, 50, 75%	Thresholds: 10, 20, 33, 50 %
5. Review of major acquisitions or investments by bank	Max. 15% own funds	Max. 15% own funds[38];	Max. 15% own funds	Max. 15% own funds
6. Minimum capital adequacy requirements	Solvency ratio: 8%	Solvency ratio: 8%	Solvency ratio: 8%	Solvency ratio: 8%
7. Evaluation of bank's policies with respect to granting of loans	+/-	Yes	+/-	Yes
8. Internal procedures for evaluation of bank assets	+/- Adequate accounting procedures	-	Yes	Yes
9. Restrictions on exposure to single borrowers	25% own funds	25% own funds	25% own funds	25% own funds
10. Lending to related companies at arm's length	+/- (≤ 20 % own funds)	Yes	+/- (Max. 15% own funds)	+/- (≤ 20 % own funds)
11. Monitoring/control of country risk	+/- (Cooke ratio)		+	+/- (Cooke ratio)
12. Monitoring/control of market risk	Yes (CAD)	Limited (Yes, as of 1 Jan. 2000)	Yes	Yes
13. Adequate risk management process for other material risks	-	No	Yes	Yes
14. Adequate internal controls	+		Yes	Yes
15. Promotion of high ethical/professional standards	+/- Money Laundering	+/- Money Laundering	-	-
Ongoing banking supervision				
16. On-site and off-site inspection	+/- (Cross-border inspections)	Yes	Yes	Yes
17. Regular contacts with bank management	-	-	Yes	-
18. Collection of prudential reports	+/-	Yes	Yes	Yes
19. Independent validation of supervisory information	Yes	Yes	Yes	Yes (annual account)
20. Ability to exercise consolidated supervision	Yes	+/-	Yes	Yes
Information requirements				

37 0.94 M euro for savings banks.

38 The law furthermore prohibits banks to acquire control in a non-financial company.

21. Adequate accounting and record keeping	Yes	Yes	Yes	Yes
Formal powers of supervisors	Yes	Yes	Yes	Yes
22. Adequate supervisory measures in case of emergency	+/-	Yes	Yes	Yes
Cross-border banking				
23. Consolidated supervision	Yes	No	Yes	Yes
24. International exchange of information between supervisors	Yes	Yes	Yes	-
25. Adequate supervision of local operations of foreign banks	Yes	Yes (local branches)	Yes	Yes (local branches)

Table 2: Overview of the Implementation of the Core Principles for Effective Banking Supervision in EU Directives and in Selected Central and Eastern European Countries

III. Prospects and Pitfalls of Legal Transplantation of EU Supervisory Rules: General Considerations

A. General Remarks

The incorporation of the *acquis communautaire* with respect to EU banking regulation in the CEECs is not solely a matter of 'legal transplantation'. It is widely accepted in legal theory of comparative law that legal rules are not purely abstract normative instruments, but should always be seen as they operate within their specific legal, economic and sociological environment. Against this background, it may be submitted that the successful reception of foreign legal rules in a legal system generally will be limited. The degree of international permeability of legal rules across different countries however varies considerably according to the nature and objectives of these rules. The move to internationalisation and globalisation of the economy in the past decades has shown that in the field of economic regulation it is relatively easy to elaborate common rules and standards, and to produce co-ordinated or even unified rules. This is not to say, however, that identical rules and standards will produce the same effects and operate as efficiently in all countries. In particular for new 'entrants' in the international economic community, like the CEECs, it will be important to examine to what extent the level of standards and rules are adapted to the local market structure and environment. Like in medical practice, mere 'transplantation' to a foreign body could produce rejection effects, which annihilates the effect of the transplantation.

The same danger exists with respect 'transplantation' of the *acquis communautaire* to the transitional economies: legal transplantation should not be an aim in itself, but rather be examined against the background of finding operative ways to promote economic development and transition to a market economy in the CEECs. Legal transplantation will only be successful when it appears in the end that the rules are effectively applied and accepted by the recipients. Imposing the incorporation of the *acquis communautaire* as a pre-condition for accession will in this approach come down to requiring a sufficient level of economic development and stability in the applicant countries, such as to enable effective operation of the EU rules and standards.

B. Transplantation of EU Banking Supervisory Rules

1. Prospects for Transplantation

Looking specifically at the banking supervisory area, different elements appear to facilitate a successful transplantation of the *acquis communautaire* to the CEECs.

a. Convergence of EU and international prudential standards

First, the high degree of convergence between the EU standards and the Basle Committee *Core Principles*, enhances the permeability of the EU rules to the CEECs. The involvement of some of the CEECs in the elaboration of the *Core Principles* cannot be underestimated in this respect. As appears from Table II above, the banking law reforms in the CEECs under examination have been influenced mainly by both the EU rules and the different recommendations launched by the Basle Committee. As the case of Slovenia further demonstrates, this influence is even stronger for the more recently enacted reforms, which are posterior to the publication of the *Core Principles*: the structure of the new banking law to a great extent follows the format of the *Core Principles.*

b. The EU supervisory standards are 'minimum' standards

Second, the very nature of the EU supervisory rules could possibly facilitate their transplantation to the CEECs: the prudential rules and standards do only constitute a *minimum* harmonisation. In line with the 'new approach' to harmonisation adopted in the 1985 Single Market White Book, harmonisation will be effected at a level deemed sufficient to create the necessary climate of mutual confidence between member states when credit institutions and investment firms wish to expand their activities through cross-border establishments or direct provision of services. The principle of 'minimum' harmonisation has a double advantage for member states: on the one hand, member states are in line with their European obligations as soon as they incorporate these 'minimum' standards. On the other hand, member states remain free to regulate above the minimum set by the European directives.

The principle of mutual recognition associated with the system of the single European licence however prohibits a member state from imposing these stricter rules to a credit institution or investment firm licensed in another EU member state. This paradigm of minimum harmonisation-mutual recognition theoretically induces a form of competition between regulators, with the EU minimum level as bottom line: member states will have to balance the benefit of having stricter supervisory standards imposed upon their domestic financial institutions with the competitive disadvantage these domestic institutions will suffer compared to foreign entrants subject to less strict rules in their home country. Theoretically at least, this competition between regulators should in fact lead to overall convergence of national supervisory standards to the EU 'minimum' level. The same conclusion would be valid for the CEECs.

In line with the principle of subsidiary, member states retain the possibility to subject their domestic financial institutions to stricter rules than the European minimum standard. Being limited to 'minimum' standards, the burden for CEECs to incorporate these standards should be relatively low. Furthermore, the CEECs could equally introduce or maintain stricter standards, reflecting specific regulatory choices. This may be further illustrated with reference to the minimum capital for credit institutions: the legislation of most EU member states imposed relatively low initial capital requirements. When it came to implementing the Second Banking directive, which imposed a minimum capital of EUR 5 M, most member states took over the EU minimum.[39] In contrast, the CEECs under examination provide a less uniform picture: only Slovenia approximately sticks to the EU minimum (EUR 5.2 M). Hungary and the Czech Republic clearly impose higher minimum capital rules (EUR 7.96 and 14.26 M respectively). It may be submitted that these higher

[39] This is the case in, *inter alia*, the United Kingdom, Germany, France and the Netherlands. In Belgium, the minimum level, denominated in BEF, corresponds to EUR 6.2 M.

standards reflect a deliberate policy objective: by imposing a higher initial capital standard, the regulator indirectly influences the market structure, by allowing only highly capitalised actors in the market. As a consequence, the concentration rate on the market will be relatively high, with less but highly capitalised banks, probably of the universal banking model. It is submitted that these policy moves may in part be ascribed to the consequences of the banking crises in these countries, which drove out of the market the small and medium sized banks.[40]

The reality behind the qualification of the EU supervisory standards as 'minimum' might however be somewhat different. Though qualified as 'minimum', a comparison between the EU supervisory standards contained in the banking directives and the pre-existent standards in most member states indicates that the 'minimum' standards in fact very often were higher than the pre-existent standards in the member states. In these cases, implementation of the banking directives in internal law often merely meant increasing the existing standards to the European 'minimum'. The situation is similar in most CEECs which before the transition did not have a comprehensive banking law. Introducing the 'minimum' EU standards thus necessitates a substantial 'upgrade' of the existent regulatory framework. As a result, the CEECs under examination as a rule have not surpassed the EU minimum level.

2. Pitfalls of Transplantation

The specificities of EU harmonisation in the banking supervisory field may not be lost out of sight when it comes to building up a comprehensive system of banking regulation and supervision in the CEECs. Mere incorporation of the EU directives might prove insufficient in this respect, as the directives only constitute a minimum, and moreover mainly serve the specific aim of promoting market integration (a). More important however than the formal regulatory framework is the quality and effectiveness of supervision, which is an essential element in successful transplantation of rules (b). The issue of the quality of supervision becomes even more important in a perspective of stronger integration, with the possible application of the principles of single licence and home country control as a future prospect (c).

a. No exhaustive harmonisation

First, the European directives do not provide for an exhaustive account of banking supervisory rules. When comparing the EU harmonisation with the *Core principles*, it appears that a number of issues listed in the *Core Principles* have not (yet) made the subject of EU harmonisation. For instance, EU prudential standards with respect to capital adequacy impose specific capital ratios to cover solvency, concentration and market risks, but do not contain specific rules on liquidity risks for credit institutions. The lack of EU rules, often due to the impossibility to reach a qualified majority among the member states to have them adopted, does not mean that there is no objective need for supervising liquidity risk, and possibly to elaborate specific prudential ratios in this respect in individual countries. We also witness that a number of EU countries impose a general *gearing ratio*, imposing a minimum ratio of own funds in relation to liabilities. This ratio often is devised as an additional instrument aimed at covering general risks (liability, fraud etc.). Here again, the possible introduction of additional capital ratios should be considered in the CEECs when the risks they intend to cover could occur.

[40] This was the case with the Czech banking crisis of 1995-96 (see Anderson, Ronald W. and Kegels, Chantal (1998), p. 207).

In some fields of banking regulation, such as emergency and winding up measures, no consensus has yet been reached at EU level to adopt a directive. It is clear that the inclusion of this kind of measures in banking regulation is essential for effective banking supervision, as also appears from the *Core Principles*. The EU can therefore not be satisfied with the sole adoption of the *acquis communautaire* by the CEECs, but should in assessing the adequacy of the legal framework also take account of the *Core Principles* as an additional source of regulation.

b. Quality of Supervision

Most CEECs have now more or less incorporated the EU and Basle Committee regulatory standards into their national legal systems. The effectiveness of the transplantation of rules will however be illusory when the regulations are not supplemented by an effective and efficient system of monitoring and supervision. In other words, the quality of prudential supervision is an essential element in building up a sound financial system. The importance of the issue has also been reflected in the Europe Agreements and the Agenda 2000 programme, which also call for specific assistance to the CEECs by the European Union in training of personnel. The main difficulty in implementing this issue is to find objective criteria or references to assess the quality of supervision. The EU directives themselves do not contain any reference to this issue, but are apparently built upon the assumption that all Member states will take up the moral obligation to ensure high quality supervision, and to adapt the number and qualifications of the staff to the tasks and functions of the supervisory authority. A recently conducted external audit of the Belgian supervisory authority has highlighted the problems in finding adequate assessment criteria. In this case, the quality of the internal organisation and exercise of prudential supervision has been assessed by using a benchmark approach, based upon the existing structures and organisation methods in neighbouring countries.

Specifically for the supervisory authorities in the CEECs, continuous technical assistance will be essential in consolidating high quality supervision. The assistance should extend to, *inter alia*, the methods of supervising on basis of records, the ways to conduct on site investigations, to continuously monitor banks facing financial difficulties etc. In assessing the quality of supervision, the specificity of the banking industry in these countries and its higher vulnerability to crises in the period of transition should also been taken into account. The authorities should, probably more than is the case in EU countries, be trained in dealing with emergency situations, bank runs and possible domino effects in banking.

In legal terms, the issue of deficient quality in supervision raises questions as to remedies and sanctions for deficient supervision. The problem has gained importance, as recently bank failures (e.g. BCCI) in different countries have given rise to liability claims formulated by depositors with failed banks against the state or the supervisory authorities for alleged negligent supervision. In different EU countries, when liability of the supervisor or the state was accepted, the legislator has reacted by modifying the banking law to the effect of excluding, or at least substantially limiting the liability of the supervisory authorities to cases of gross negligence.[41] In other countries, this limit has been set by jurisprudence in absence of specific legislation, taking account of the specific functions and

41 See for instance in Germany § 6(3) Kreditwesengesetz (full exemption of liability); in the United Kingdom: section 1(4) Banking Act 1987 (exclusion of liabiliy under statutory law); in Luxembourg: art. 20(2) Law of 23 December 1998 on the creation of the 'Commission de surveillance du secteur financier' (limitation of liability to gross negligence)

objectives of prudential supervision.[42] A third group of jurisdictions does not have any specific rules, so that the general liability principles will apply.[43]

To the extent that the prudential standards are derived from obligations imposed by EU directives, the question arises whether deficient supervision by the prudential authorities of a member state could find a legal basis directly in the EU legal order. Recent case law of the Court of Justice of the European Communities, in particular the *Brasserie du Pêcheur/Factortame* cases, suggests that liability could indeed be based directly on European law, to the extent that negligent supervision is to be considered a non fulfilment by a member state of its obligations under European law to fully implement the EU directives. This conclusion is of particular importance, as claimants could find in European law a cause of action in order to circumvent possible limitations on liability of the supervisor existing in national law. As a matter of fact, a UK Court of Appeal judgement delivered in the aftermath of the BCCI-failure has accepted liability of theank of England and the United Kingdom on basis of the *Brasserie du* Pêcheur jurisprudence, for not having supervised BCCI's operations in accordance with the requirements set by the First Banking directive. It may however be submitted, in view of the conditions set on liability in the *Brasserie du Pêcheur* case, that liability under European law will also be limited to cases of gross negligence by the supervisor in exercising its functions.

The issue of possible liability of the prudential supervisor in the CEECs should be carefully considered in building up the regulatory framework for banking activities. Liability actions will indeed be the ultimate test for assessing the quality of supervision, though left in the hands of the courts. On the one hand, the law could restrict or even exclude liability of the supervisor, with a view to preserving the financial resources of the supervisor and the state. On the other hand, such a restriction could in itself partially undermine the credibility of the supervisors in the market, as they wish to prevail themselves from any consequences of misconduct or negligence in exercising their functions. Maintaining a possible liability could on the contrary be a way to stimulate good quality supervision. In the prospect of future accession and of the incorporation of the *acquis communautaire*, the applicant CEECs should furthermore take account of the possible basis for liability arising from European law, and which cannot be ruled out.

In conclusion, it is clear that the issue of enhancing and maintaining high quality standards in prudential supervision is an essential element in preserving the credibility of the prudential standards contained in the banking laws and regulations. In the absence of clear criteria for assessing the quality of supervision, it could be useful to regularly conduct external audits of the supervisory authority, based on a benchmark approach, and taking account of the specificities of the local banking market. Eventually, the main legal remedy for insufficient quality in supervision lies in the possible liability of the supervisory authority towards aggrieved depositors. A legal basis for this liability might be found in national (liability) law, but possibly also in European law. In the prospect of accession, applicant CEECs should be aware of this liability risk.

c. Prospective evolution: Single licence and home country control

The move to liberalisation of trade relations between the EU and the CEECs following from the Europe Agreements does not, as appeared from the analysis in part I, reach as far as the intra-EU liberalisation: while the Agreements provide for gradual realisation of the freedom of establishment under conditions of non-discrimination, the freedom to provide services in general is much more dependent upon additional decisions

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42 See for instance in France the case law of the *Conseil d'Etat* (limitation to 'faute lourde').

43 This is for instance the case in Belgium

to be taken by the Association Councils. It is clear that this situation is far remote from the level of market integration reached within the European Union: since the entry into force of the Second Banking Directive and the Investment Services Directive, the cross-border establishment and direct provision of services by credit institutions and investment firms operates within the system of 'single licence' and 'home country control': a financial institution licensed in one member state is allowed to open branches and provide services directly in other member states without additional authorisation in the host countries. With a few exceptions, the prudential supervision on the activities undertaken with use of the single licence is allotted exclusively to the prudential authorities of the home country of the financial institution. In contrast, the level of liberalisation between the EU and the individual partner countries in the Europe agreements could be compared to the system which existed after the adoption of the First Banking Directive: the creation of an establishment abroad is subject to non-discriminatory treatment, allowing the host state to impose an authorisation regime similar to the regime applicable to domestic institutions. Furthermore, the host country may exercise its supervisory powers on the branch activities, as it is competent to supervise the activities of a foreign financial institution providing services within its territory without establishment.

It should also be noted that the liberalisation principles contained in the Europe Agreements do only apply to the *individual* relations between the EU and each associated country. The agreements do not institute a multilateral framework for liberalising trade relations between the European Union and the CEECs as a whole. Hence, mutual market access and integration *between* the CEECs is still limited, and in any case is not subject to the same principles as apply in the relations with the EU.

The limited liberalisation imposed by the Europe agreements does not preclude an associated country to unilaterally grant the benefit of the single licence and home country control to EU financial institutions wishing to set up a branch or provide services in its territory. While Hungary and the Czech Republic in this stage still apply the non-discrimination principles, the Slovenian law already endorses the principles of the Second Banking Directive: a credit institution with its head office in a EU member state is allowed to use its single licence in Slovenia under the same conditions as in another EU member states, i.e. without additional authorisation requirements and with application of the home country control principle. The Slovenian law further allows the supervisory authority of the home member state to conduct on site investigations. However, these provisions will only enter into force upon effective EU-membership of Slovenia.[44] The incorporation of the single licence and home country control principles should therefore be regarded as merely symbolic, as it is clear that upon effective accession these provisions will anyway belong to the *acquis communautaire*. Pending the accession negotiations, EU credit institutions will be treated in Slovenia like other foreign credit institutions: banking operations in Slovenia should be conducted through a local branch, which is subjected to the authorisation and supervision by the Bank of Slovenia.[45]

It should nevertheless be pointed out that, as a rule, there is no obstacle for a non EU country, such as Slovenia, to apply the principles of single licence and home country control in favour of EU credit institutions. Its effects will however only work in a single direction: it only applies to EU credit institutions entering the non EU market. In contrast, the market entry by the non EU based credit institution in a EU member state is subject to the general regime of non EU credit institutions[46]: therefore, the creation of a EU branch by a Slovenian bank would require a separate authorisation according to the national law of the

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[44] See Art. @@ Law on Banking

[45] See G. ILC KRIZAJ, 'Slovenian banking sector prepares for EU membership', *Slovenian Economic Newsletter*, March 1999

[46] See Art. 9 Second Banking Directive.

host state, while direct provision of services without establishment would generally not be allowed. The main consequence of the Europe Agreements in this respect would be to guarantee non-discriminatory treatment for branches and possibly a right to provide services without establishment by virtue of a decision of the Association Council. The host EU state is not empowered to grant 'Second Banking Directive' status to the non EU bank, to the extent that this relation falls under the exclusive competence of the EU institutions for the (external) commercial policy (Art. 133 EU-Treaty).

While a EU member state lacks the power to unilaterally grant 'Second Banking Directive' status to a credit institution from an associated country, the Association Council created under all agreements could decide to grant such status as part of the realisation of the freedoms of establishment and provision of services in each Agreement. This would in any case require prior implementation of the EU directives in the field of banking supervision in the associated country, as the harmonisation is devised as a necessary precondition for application of the principles of mutual recognition of banking licences and supervisory regimes. The need for high quality standards in the exercise of prudential supervision becomes even more important in this perspective: the home country control principle requires full confidence by the host country in the adequacy of the supervision exercised by the home country authority on the activities of the credit institution or its branch in the host country.[47] As recent case law of the European Court of Justice and of national courts suggests, the host country is not allowed to unilaterally restrict or revoke the benefit of the single licence if the supervision exercised by the home country allegedly would be insufficient, or if the licence granted to the credit institution in its home country would not be in conformity with the prudential standards imposed by the EU directives.

Illustrative in this context is a judgement of the Belgian *Conseil d'Etat* with respect to the cross-border distribution of units in a collective investment undertaking. The plaintiff, *Fleming Flagship Fund*, was a Luxembourg based collective investment undertaking (UCITS), authorised under Luxembourg law, and benefiting from a European passport under the 1985 UCITS-directive. When applying for distribution of the units relating to a specific compartment in Belgium with use of its European passport, the Belgian Banking and Finance Commission refused to grant authorisation, under the motive that *Fleming Flagship Fund* did not abide by all provisions of the UCITS directive, despite the authorisation granted by the Luxembourg competent authority. Upon appeal, the Belgian Ministry of Finance confirmed the refusal: host state authorities are entitled to refuse the benefit of the European passport to a financial institution authorised in another EU member state, which does not conform to the substantive rules of the applicable directives which constitute the precondition for the right to rely on mutual recognition of home state authorisation and supervision. The action in annulment against these decisions brought by *Fleming Flagship Fund* before the *Conseil d'Etat* succeeds. Relying mainly on the text of the UCITS directive and the Belgian implementing legislation, the *Conseil d'Etat* held that the host state should exclusively make use of the mechanisms provided for in the EU Treaty and the relevant directives when the home country allegedly does not properly authorise or supervise the financial institutions falling under its jurisdiction. Surprisingly, the *Conseil d'Etat* did not deem it necessary to refer a preliminary question on the interpretation of the EU Treaty or the UCITS directive to the Court of Justice. It may however be submitted that the solution adopted by the *Conseil d'Etat* is in line wit the case law of the Court of Justice, and that the same principles will apply with respect to the use system of mutual recognition under the Second Banking Directive.

In the event of alleged insufficient home country supervision over the banking activities conducted in the host country, the latter would only be entitled to file a complaint with the European Commission or bring an action against the home state before the Court of Justice (Articles 226 and 227 EU-Treaty). In case of emergency, the host state could ask the Court to revoke the single licence by way of interim measure (art. 241 EU Treaty). This case law

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47 See also ANDERSON, Ronald W. & KEGELS, Chantal (1998), p. 286.

strongly relies on the assumption that in a system of economic integration the member states should as a rule have full mutual confidence in the quality of each other's supervision. Supervisory practice within the EU seems to show that difficulties sometimes arise, although the strongly institutionalised co-operation mechanisms between supervisory authorities are likely to gradually reduce possible tensions and conflicts. When it comes to extending the principles of the Second Banking Directive to the economies in transition with a limited experience in banking supervision, this issue will become even more important, in light of the far reaching legal consequences of the supervisory system introduced by the Second Banking Directive.

IV. Prospects and Pitfalls of Legal Transplantation: the Case of Deposit Guarantee

The principles set out in part III with respect to the possibilities and limits of legal transplantation of EU banking directives could be further illustrated with reference to the issue of deposit guarantee. At EU level, deposit guarantee has been regulated first by a recommendation, which was replaced more recently by the Deposit Guarantee Directive. The directive is a key legal instrument in maintaining public confidence in the banking industry, as it provides for compensation to — mainly small — depositors in case of bank failure, and therefore could avoid confidence based runs on solid banks. Its implementation and possible transplantation to the CEECs can therefore be considered an important element in building a sound banking system.

A. The Deposit Guarantee Directive: scope of minimum harmonisation

The Deposit Guarantee Directive introduced the obligation to join a deposit guarantee scheme as a formal authorisation requirement for all credit institutions. The maximum coverage granted to a single depositor in case of bank failure should amount to at least EUR 20,000 (EUR 15,000 until 31 December 1999), with the possibility to limit the coverage to 90% of the deposited funds. Further, the directive allows member states to exclude some deposits or depositors from coverage, in order to avoid moral hazard problems and to focus the protection on small depositors. The regulatory approach is, like for the Second Banking Directive, based on the paradigm of minimum harmonisation and mutual recognition: The coverage level imposed by the directive only constitutes a minimum, and does not preclude a member state from introducing or maintaining a higher coverage in its guarantee systems. In line with the principle of mutual recognition, a credit institution will fall under its home country deposit guarantee system for its deposit taking activities undertaken in other EU member states by use of its single licence, i.e. under the regime of free provision of services or through branches. The mutual recognition principle conversely implies that a member state must accept that credit institutions licensed in another member state with a lower level of deposit guarantee than in the host country nevertheless are allowed to offer banking services in its territory, either by direct provision of services or through a branch, without having to join the host country deposit guarantee system.[48] The application of the paradigm of minimum harmonisation - mutual recognition implies that, in the opinion of the European legislator, the directive has laid down a sufficient level of

[48] Mutual recognition is however limited in a double way, mainly in order to prevent systemic distortions as a consequence of competition between deposit guarantee systems of different member states: first, the directive prohibits, by way of transitional provision, a credit institution from exporting its home state guarantee system to another member state where a lower coverage level would exist ('export cap'). On the other hand, a member state must allow a credit institution authorised in another member state which has a lower coverage level, to 'upgrade' its coverage in the host country guarantee system for its branch activities in that member state (so called 'top up option').

harmonised protection such as to create the necessary climate of mutual confidence between member states under a system of mutual recognition of deposit protection schemes.

The scope of harmonisation realised by the Deposit Guarantee Directive is however limited. The directive does not contain detailed provisions with respect to the organisation of the guarantee systems or the legal technique to achieve coverage of deposits (guarantee, insurance scheme etc.): both a self-regulatory scheme resulting from an agreement between credit institutions, and government organised or supervised systems are conceivable, as long as membership of one or the other system is compulsory and the systems provide for a legally enforceable right for compensation in case of bank failure.[49] Neither does the directive lay down specific provisions on the funding of deposit guarantee schemes in the member states. The only principles relating to the funding are to be found back in the preamble to the directive: as a rule, it is up to the credit institutions, and not to the member states, to take up responsibility for funding the deposit guarantee schemes. Shifting the cost of deposit guarantee to the public authorities could qualify as a state aid, prohibited by Art. 87 EU-treaty. Furthermore, the preamble to the directive states that the funding capacity of the guarantee schemes should be proportionate to their potential obligations.[50] Although the community legislator did not deem it 'absolutely necessary' to lay down more detailed rules in this respect, it is clear that the absence of any harmonisation of rules on funding substantially reduces the harmonisation effect of the guarantee systems. Given the wide diversity of systems in the EU countries, achieving a consensus on common funding rules would have been very difficult.

B. Implementation of the Deposit Guarantee Directive in the EU Member States

With respect to the level of deposit coverage, the implementation of the Deposit Guarantee Directive in the EU Member States exemplifies the patterns of implementation described above: on the one hand, member states which did not have a deposit guarantee coverage reaching the minimum imposed by the directive, have in general adapted their internal systems to the European minimum. This is for instance the case in the Netherlands, the United Kingdom, Luxembourg and Belgium. Member states with higher deposit guarantee coverage than the European minimum on the other hand, have maintained this higher level, which seems to confirm the paradigm of competition for excellence in banking regulation. One can not only refer to the French situation, where the limit of approx. EUR 60,000 has been maintained. The German reaction to the directive is also significant: Germany unsuccessfully challenged the directive before the Court of Justice, on grounds of, *inter alia*, incompatibility of the limits on mutual recognition of deposit guarantee regimes with the principles of free movement.[51] Germany wished to preserve its system of almost unlimited deposit coverage under a system of mutual recognition. The non-implementation by Germany of the Deposit Guarantee Directive led the European Commission to bring an infringement action against Germany before the Court of Justice. Moreover, a recent Gemran court decision held the German government liable towards the depositor of a bankrupt bank for failure to implement the Deposit Guarantee Directive on time.[52] In the meantime, Germany has adopted a law providing the framework for the creation of new deposit protection schemes which will have to ensure deposit coverage to a level of not superior to EUR 20,000.[53]

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[49] See recital 12 of the Preamble to the Deposit Guarantee Directive.

[50] See para 23, preamble Deposit Guarantee Directive

[51] See ECJ, case C-233/94, *Germany v. European Parliament and Council*, judgment of 13 May 1997, ECR, 1997, p. I-2405.

[52] See Landesgericht Bonn, 16 April 1999, *ZIP*, 1999, 959.

[53] See Law of 18 July 1998, *Bundesgesetzblatt*, 1998/45, p. 1842. The new law is applicable to

	Deposit coverage ceiling Domestic currency	*Deposit coverage ceiling Euro*	*Annual Contribution or commitments to guarantee fund (in % of total deposits)*
Belgium	BEF 807000	20000*	0.02 0.06
Denmark	DKK 300000	40350	0.2
Germany	DEM 39116	20000	0.03(1)
Greece	GRD 6000000	20000	1.25-0.025
Spain	ESP 2325000	20000*	0.1
France	FRF 400000	60980	0.03
Italy	ITL 200000000	100000	0.4 - 0.8 %
Netherlands	NLG 44075	20000	max. 10% own funds of member bank
Austria	ATS 260000	20000	max. 0.83% risk-adjusted assets
Portugal	PTE 6750000	33750	0.8-1.1
Finland	FIM 150000	25000	0.05 - 1 % of assets
Sweden	SEK 250000	27870	0.4 - 0.6
United Kingdom	GBP 20000	20000	max. 0.3%

Table 3: Deposit Guarantee systems in different EU Member States after implementation of the Deposit Guarantee Directive: coverage ceiling and financial arrangements

Source: European Banking Federation (1997), Tables I & III

(1) As a transitional measure until September 1999; from October 1999 on, the protection schemes established under the new German law of 16 July 1998 will impose their proper contribution criteria

As the organisation and funding of deposit guarantee schemes fell outside the scope of the EU directive, only limited data are available as to the present situation in the EU member states. As appears from Table 3, the directive did not provoke strong convergence between the member states. With respect to the organisation of the protection schemes, most Member States which implemented the directive have opted for protection through the creation of one or several funds. The financial arrangements within the protection systems on the contrary still strongly differ between the member states. While some states impose actual contributions to be made to the fund(s), other systems are based exclusively on commitments to pay from the part of the member credit institutions when the fund has to intervene. Some systems use a mixed funding system, based partly on (annual) contributions, supplemented by commitments which can be called upon by the fund in case of emergency.

Moreover, different systems are applied as to the calculation of the contributions or commitments to pay: in most cases, the contribution/commitment of a single credit institution is expressed in relation to the amounts of deposits held with it. The figures show however substantial differences between the protection schemes, where actual contributions can vary from 0.01 to 1.25 % of the deposit volume. In commitment based protection schemes, the amounts are generally slightly higher (on average 0.6 % of deposits). Some member states use other criteria to calculate the contributions or commitments to be made by credit institutions, such as the amount of own funds (Netherlands) or the total assets (Austria). In Portugal, the amount of the contribution is inversely related to the solvency ratio of the banks. This should be likely to reduce moral hazard from the part of the participating credit institutions, as better capitalised banks benefit from a lower financial burden in contributions to the deposit protection scheme.

When focusing on the capacity of the protection funds to cover deposits in case of bank failures, the figures again show strong differences as to the actual or potential size of the protection funds in absolute figures. More important however is the relative size of the protection fund in relation its potential liabilities, i.e. the total amount of covered deposits. In absence of precise data on the latter, the coverage capacity is extremely difficult to assess. Relating the size of the protection funds in a country to the total amount of non-bank deposits, as shown in Table 4, only provides a partial picture on the coverage capacity of protection funds, as no account is taken of the coverage ceilings in the protection schemes and the exclusion of some deposits from protection. In fact, one should also include in the figures the relative importance of retail deposits in the aggregate of non bank deposits and the average size of such retail deposits. Nevertheless, the figures give some rough indications as to the possible coverage capacity of the protection schemes. Here again, we can see strong disparities between the countries under examination, varying from less than 0.01% to 0.7% In Sweden, the objective of the protection fund would be to attain a coverage ratio of 2.5% of client deposits. This relatively high proportion can probably be ascribed to the experiences from the 1994 banking crisis.

Once more, the conclusion seems to be that the harmonisation at EU level of the minimum protection to be granted to depositors in case of bank failures is not reflected in the actual financial situation and coverage capacity of the protection funds. In most member states, the elaboration of the funding arrangements and the financial objectives of the protection funds do not seem to be based on the assessed needs of the protection schemes themselves, as in most case precise data as to the amount of potential liabilities (covered non bank deposits) do not even exist.

	Amount available in the deposit protection fund (mio Euro) (Actual contributions + commitments)	*Amount of non-bank deposits (in Mio EUR)*	*Coverage capacity of deposit protection fund (%)*
Belgium	334.6	227618	0.147
Denmark	100.9	83452	0.121
Germany	-	1680093	-
Greece	9.2	15223	0.06
Spain	n.a.	n.a.	-
France	381.1	813088	0.047
Italy	1600-3200	490471	0.326
Netherlands	n.a.	333930	-
Austria	1529	n.a.	-
Portugal	259.4	37061	0.7
Finland	n.a.	61226	-
Sweden	2.7 (objective: 2,5% deposits covered)	87902	0.003
United Kingdom	4.55-9.11	843283	0.001

Table 4: Coverage capacity of the deposit protection schemes (situation on 31.12.1996)
Sources: Banking Federation of the European Union (1997), Table IV-V: amount of protection funds
OECD, Bank Profitability (1998): amount of non-bank deposits

The above figures demonstrate that substantial differences still exist between member states with respect to the aspects of deposit protection which were not harmonised at EU level, in particular the rules as to the financial contributions made by credit institutions to the protection funds, and the actual size (in absolute and relative terms) of the protection funds. It may be submitted that in those member states which in recent years were confronted with important banking failures, more attention seems to be paid to the funding capacity of the protection schemes (e.g. Sweden). It is clear that the financial resources of the protection funds in some member states would be insufficient to absorb the failure of even a middle range bank. In this respect, it is essential for the protection schemes to allow for additional contributions/commitments to be made by the banks, in order not to shift the cost of most banking failures to the state.

The main conclusion should be that incorporating the Deposit Protection Directive into national law clearly is not sufficient to create a sound and credible deposit protection system. Member states should moreover assess on economic criteria whether the funding arrangements and the actual size of the protection funds are adequate. In this analysis, an overall sectoral approach of the financial soundness of the banking industry should also be effected, as it could influence the probability of individual banking failures.

C. Legal Transplantation to the CEECs

The issue of legal transplantation of the Deposit Guarantee Directive to the transitional economies illustrates the apparent simplicity and underlying risks of mechanical transplantation of the formal rules of the directive. The Deposit Guarantee Directive has been elaborated in an economic environment where banking failures generally do not frequently occur, and where most guarantee systems were at all times sufficiently funded to cover individual failures of mostly smaller banks.

The situation is highly different in the CEECs under examination. The banking systems of these countries have, at least in this stage of privatisation and transition, not been immune for important banking failures and even widespread banking crises. As the privatisation of state owned banks mostly implied the abolishment of the previously existing explicit state guarantee, the deposit protection schemes became the only safety net for ensuring depositor confidence beside the implicit state guarantee. Most CEECs have indeed made substantial efforts to establish a separate deposit insurance system (Hungary since 1993; Czech Republic since 1995) or are in the process of setting up such a system (Slovenia: effective as from Jan . 1st 2001).[54] The early years of operation of these systems have proved to be difficult. The frequent occurence of banking failures led to a situatin where guarantee funds were virtually exhausted, as happened in the Czech Republic in 1995 after two major bank failures.[55] This means that at present the protection schemes operate under financially precarious conditions. Eventually, the state guarantee for bank failures could well be less implicit than it ought to be.

Discussing the different pros and cons of deposit guarantee systems and the existence of explicit or implicit state guarantee would fall outside the scope of this study. The case of deposit guarantee in the economies in transition — and in general in developing countries — has however gained attention in economic lterature over the past years. These studies stress in particular the need for a system of explicit guarantee system, preferrably through establishment of a separate fund, with limited compensation to depositors.[56] As to the source of funding, some authors would tend to advocate a government sponsored system in developing and transitional economies, as mere bank funded systems would not necessarily ensure depositor confidence.[57] It should be noted that most systems put in place in the CEECs in the recent years adhere to a mere bank sponsored fund. This is also the policy option adopted in the European Union's Deposit Guarantee Directive. In a recnt

54 See for an overview including other CEECs: BORISH, Michael S., DING, Wei & NOËL, Michel (1997), pp. 106-108.

55 ANDERSON, Ronald W. & KEGELS, Chantal (1998), p. 262.

56 See in particular MILLER, Geoffrey P. (1999), p. 51, with further references to other studies.

57 See Talley & Mas, cited in MILLER, Geoffrey P. (1999), p. 55, note 51.

study, Miller[58] advances the possibility of creating a deposit guarantee system based on the use of an assessment system, under which the banks themselves are fully liable for compensation to depositors in case of failure of a peer bank. Practically, payments would be made in first instance by the public authorities, and recovered *ex post* with the banks *pro rata* to their relative importance. According to Miller, such a system would overcome possible underfunding of the protection fund, and stimulate active monitoring by banks of the risk profile of other banks, for which they would be in a good position. It should therefore be considered as a valuable alternative for fund based systems in transitional economies during the transformation process. This assessment based system will in fact underscore the protection regime in Slovenia (see *infra*).

Against this background, the question arises whether mere transplantation of the Deposit Guarantee Directive is likely to create the conditions for sufficient depositor confidence and hence may be considered an adequate instrument in creating a sound regulatory environment. More specifically, the higher vulnerability of the banking systems in the course of transformation requires higher attention for the non harmonised aspects of deposit protection which equally bear on the credibility of the protection schemes. The presumed higher probability of bank failures during the transformation should be reflected in stronger financial arrangements and the formulation of clear objectives as to the funding capacity of the protection schemes.

With respect to the deposit coverage, recent amendments to the banking laws in the CEECs examined have increased the level of deposit coverage ceilings such as to bring them more in accordance with the EU Deposit Guarantee Directive. As appears from Table 5, the coverage ceilings in the Czech Republic is significantly higher than the EU minimum, while in Hungary it is still clearly inferior to it. The limit set by the new Slovenian Law on Banking is close to the EU limit. Convergence with the European directive also appears from other modalities of the protection schemes, as recently amended. For instance, both the Czech and the Slovenian law have now extended the protection to deposits made by legal persons, while they previously were restricted to deposits made by natural persons.

	Structure of deposit protection scheme	*Administration of deposit protection scheme*	*Deposit coverage ceiling (in national currency)*	*Deposit coverage ceiling (in Euro)*	*Annual Contribution to guarantee fund (% of total deposits*
Czech Republic	Public	Deposit Insurance Fund (DIF)	400000	10700	0.5% 0.1% (building savings banks)
Hungary	Public	National Deposit Insurance Fund (NDIF)	1000000	40100	max. 0.2% (Risk adjusted)
Slovenia (As from Jan 1st, 2001)	Public	Central Bank	3700000	18940	commitment proportional to relative share of deposits

Table 5 Deposit Guarantee systems in selected CEECs : coverage ceiling and financial arrangements

58 Miller, Geoffrey P. (1999), p. 53-54.

The funding arrangements of the protection schemes in the Czech Republic and in Hungary are based, like in most EU countries, on regular contributions to be paid by the credit institutions in relation to their deposit base (see Table 5). In the Czech Republic a fixed contribution is imposed by law, the amount of which slightly exceeds the average in the EU countries. The Hungarian scheme has a more flexible approach: as a rule, the annual contribution is determined by the NDIF at a rate which cannot normally exceed 0.2% of the deposit volume of an individual bank, which corresponds to the average level of contributions in the EU member states. However, the NDIF can impose different premium rates according to the risk profile of credit institutions. For instance, in 1996 the NDIF levied a slightly higher premium on banks where the average size of deposits was higher than the maximum coverage offered by the protection scheme (1.9‰) compared to those where the average of deposits was lower (1.6‰).[59] On the other hand, the law enables the NDIF to increase the annual premium for an individual bank to up to 3% of the deposits, depending on the risks incurred by the bank's activities.[60] The Slovenian protection scheme, as introduced by the 1999 Law on Banking and which is intended to replace the system of unlimited explicit state guarantee for deposits, will be fully effective as of 1st January 2001.[61] The protection scheme will be based on commitments by the member banks, which can be called upon by the Bank of Slovenia in case of a bank failure. Uncommonly, the law does not set any ceiling on the commitment of an individual bank. Each bank must guarantee the payment of deposits of a failed bank to an amount equal to the relative importance of the deposits held with the former in the total amount of deposits held with all banks.[62] In order to be able at all times to execute the guarantee, an individual bank must have sufficient liquid assets. Therefore, the law requires each bank to invest assets in government or central bank securities for an amount determined by the Bank of Slovenia.[63]

As appears from Table 6, the coverage capacity of the protection schemes in Hungary and the Czech Republic appears to be relatively high, when compared to the situation in the EU member states. Before drawing general conclusions from this, additional elements should however be introduced in the assessment: first, the presumed higher probability of bank failures in the process of privatisation and transition calls for a relatively strong protection system as a catalyst for depositor confidence. This certainly holds true in light of the policy objective to avoid further government backing of failed banks. Furthermore, the coverage capacity of the protection schemes should be viewed in light of the average size of (retail) deposits, which in turn will depend from the average per capita income. Assuming that the average in the CEECs is inferior to what is common in most EU states, the protection schemes in the CEECs will have to be stronger capitalised, as more full coverage of deposits will have to be granted in case of a bank failure. On the other hand, the coverage ceiling should be fixed at a level which is adequate for ensuring consumer confidence, and precisely taking into account the average size of deposits. In this context, it is interesting to notice that the Hungarian deposit protection system adopts a risk adjusted approach, imposing a higher contribution to the protection fund for those credit institutions where the average size of deposits is inferior to the limit of coverage per depositor. Moreover, as the overall average size of deposits seems relatively low (HUF 169000 or EUR 677), there is no absolute necessity to increase the coverage ceiling to the minimum imposed by the EU Deposit Guarantee Directive. Compared to the *per capita* income, the coverage granted

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59 See National Deposit Insurance Fund, *Annual Report 1997*, p. 13.

60 See section 121(6) and (7) Act No. CXII. of 1996 on the credit institutions and the financial undertakings.

61 See in this respect G. ILC KRIZAJ, "Slovenian banking sector prepares for EU membership, *Slovenian Economic Newsletter*, March 1999.

62 Art. 155 Law on Banking.

63 Art. 156 Law on Banking.

indeed appears to be relatively high.[64] Thus, the elaboration of the Hungarian protection scheme seems to be more balanced and hence confident as it appears to be based on a rational assessment of the domestic economic environment. It may be submitted that the system could be more effective in ensuring depositor confidence than systems which simply transplant the European directive and which do not base their funding and protection arrangements on the particularities of the domestic liabilities and deposit structure of the banking sector.

The situation in the Czech Republic over the last few years illustrates the risk of rapid 'consumption' of the deposit protection fund in case of a major bank failure and the difficulties for the public authorities to eliminate the implicit guarantee for bank deposits: in fact, the fund did intervene only on one occasion, namely after failure of the Ceska Banka. However, all resources available in the fund had to be used to grant compensation to depositors. In all other cases of compensation to depositors, the intervention came directly from the public authorities, and compensation was up to forty times higher than the coverage limit existing within the deposit protection fund. The public intervention was in some cases attributed to political factors — the desire to avoid social tensions before the parliamentary elections of 1996 — and the fear of a generalised run on banks. Since 1997, the fund is being slowly recapitalised, the contributions to be paid by banks to the fund being relatively high (0.5% of deposits).

No further details can be provided for Slovenia, as the new system is not yet in operation. However, it may be doubted whether the existence of funding arrangements based exclusively on commitments, the amount of which is unlimited, is appropriate for ensuring the credibility of the system. The system is likely to be perceived in the public as a persistence of implicit state guarantee, in absence of transparency as to the commitment capacity of the banks. In contrast, most EU countries have at present a system of actual contributions, or at least a mixed system with only a minor proportion of commitments to pay. The setting up of a separate fund with actual contributions to be made by the banks may be considered to enhance depositor confidence, due to the existence of separately held funds specifically affected for deposit guarantee.[65]

	Amount available in the deposit protection fund (mio Euro) (Actual contributions + commitments)	***Amount of non-bank deposits (in Mio EUR)***	***Coverage capacity of deposit protection fund (%)***
Czech Republic	69.628	32420	0.214
Hungary	31.21	10215	0.305
Slovenia	-	7258	-

Table 6: Coverage capacity of the deposit protection schemes (HU: situation on 31.12.1996 - SLO: situation on 31.12.1997; CZ: situation on 31.12.1998)

Sources: Annual Reports of central banks
OECD, Bank Profitability (1998): amount of non-bank deposits

General conclusions

64 See : BORISH, Michael S., DING, Wei & NOËL, Michel (1997), at p. 146: In Hungary the coverage rate would correspond to two year's *per capita* income, while in Poland and the Czech Republic the corresponding figure would be one year. In view of the economic developments in these countries, the figures might however rapidly prove to be obsolete.

65 See in the same sense MILLER, Geoffrey P. (1999), p. 53.

As the theory of comparative law and legal history amply demonstrates, transplantation of laws has been, with variable degrees of success, been effected since Antiquity. In this perspective, the 'export' of the *acquis communautaire* to the Central and Eastern European economies should not be regarded as a unique historical process. Moreover, legal transplantation of rules of economic law seems at first sight to be less burdensome than the 'export' of more fundamental legal institutes which are closer to the cultural and sociological specificities of a nation, such as family law.

This is not to say, however , that the legal transplantation of the *acquis communautaire* to the CEECS, as exemplified in the field of banking, is a non-issue. From the side of both the European Union and the Central and Eastern European countries, the almost mechanical incorporation of the *acquis communautaire* has been regarded as a mainly political move towards possible future EU accession of the latter. It would however be wrong to view the incorporation of the *acquis communautaire* as a strictly formal and abstract process. Introducing economic law, and banking legislation in particular, cannot be isolated from the underlying economic substance: the rules should be adapted to the market structure in which they will have to operate.

This does not mean that the objective of transplanting the *acquis communautaire* should be put into question. In effecting the transplantation, specific attention should however be paid to the specificity of the transitional economies. For an economy in transition, building a sound banking system could for instance in some circumstances require clear transitional rules instead of a mere formal incorporation of high supervisory and protective standards in the lawbooks. Furthermore, it has been stressed that in setting up the supervisory framework for banking supervision, the market should be confident in the quality of supervision.

The case of deposit guarantee harmonisation in the European Union and its possible transplantation to the CEECs, has further demonstrated the limits of transplantation: the European directive mainly was the result of a compromise between the member states which had long established deposit protection schemes, operating in a relatively sound banking environment. Some essential aspects of organisation of the protection systems were not harmonised, but are nevertheless essential in setting up a strong and sound protection scheme. In transplanting the directive to the CEECs, the aspects of organisation may not be overlooked. Moreover, the utility of the EUR 20,000 coverage limit may be questioned in some circumstances, given the present economic environment in some member states. Here again, some applicants for accession could be better off with a clear transitional regime than with a formal system which eventually would not be able to fulfil its obligations under the transplanted directive. The case of deposit guarantee demonstrates that legal transplantation may not be viewed exclusively in political terms. If legal rules have to be effective, they will have to be shaped such as to be operational.

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