



Banking Sector Policy Reform

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Contents

- Introduction
- Liberalization of Trade and Capital Movements
 - unilateral liberalization
 - multilateral liberalization in the context of WTO
 - liberalization in the context of regional integration agreements



Contents

- Banking Services
- EU Rules and Regulations in the Banking Sector
- Banking Sector Policies for Neighborhood Countries
- References



Introduction

- Globalization, defined as a historical process, the result of human innovation and technological progress, refers to the increasing integration of economies around the world, particularly through trade and financial flows.
- Since 1980s we observe two main trends:
 - shifts within countries toward market-driven systems of production, and
 - increasing international economic integration of countries through trade, investment, finance, and migration.



Introduction

- Empirical research has shown that trade openness makes important contribution to higher productivity and income per capita, and that trade liberalization contributes to economic growth.
- Studies further reveal that less restrictive capital controls and higher international capital flows increase investment possibilities, create technology spillovers, and deepen domestic capital markets; and that higher investment, technological spillovers and deeper financial markets are associated with higher growth of per capita incomes.



Introduction

- However, under capital liberalization the risk of financial crisis may increase as long as domestic macroeconomic, financial and prudential policies are weak or inconsistent. Hence, countries opening their capital markets should first satisfy the prerequisites for successful capital account liberalization.



Liberalization of Trade and Capital Movements

- Recently we have seen the number of countries liberalizing trade and capital movements rapidly increasing.
- What are the policy choices facing these countries:
 - unilateral liberalization
 - multilateral liberalization in the context of WTO
 - liberalization in the context of regional integration agreements
 - shallow free trade
 - deep free trade
 - accession with major partner countries



Liberalization of Trade and Capital Movements

Multilateral liberalization in the context of WTO involves:

- Fixing tariffs, mostly at low levels
- Excluding quota restrictions
- Conforming to rules for non-tariff barriers
- Conforming to rules on contingent protectionism
- Opening many service sectors within the context of General Agreement on Trade in Services
- Conforming to rules on intellectual property



Liberalization of Trade and Capital Movements

To study **shallow free trade** in the context of regional integration agreements, we can consider the original EUROMED Agreements signed by EU with e.g. Tunisia and Morocco.

- These agreements add to the WTO conditions only the move to zero tariffs for trade in e.g. the industrial goods in trade with the EU, but excludes to a large extent agriculture and services.



Liberalization of Trade and Capital Movements

In addition to the conditions of shallow free trade, **deep free trade** agreements signed with the EU add:

- for trade in goods, substantial elimination of non-tariff barriers through harmonization or mutual recognition of regulatory rules and technical standards (EU-Turkey Customs Union)



Liberalization of Trade and Capital Movements

- for services sectors, complete or sometimes incomplete but substantial coverage of and convergence on internal market regulatory rules, leading to harmonization or mutual recognition of regulatory standards
- Commitments to EU models and methods of economic governance including competition, public procurement, bankruptcy law, company law, and accounting.



Liberalization of Trade and Capital Movements

Under deep trade, acquis convergence could be carried at different levels:

- the country could try to adopt and implement the acquis in the sector considered priority areas completely. Priority sectors would be determined as those sectors that would make significant contribution to domestic economic development, or



Liberalization of Trade and Capital Movements

- in the non-priority sector the country could adopt the following strategies:
 - in some of the non-priority sectors the country could try to insure that new legislation in these sectors are on the whole EU compatible. In this case all of the rules and regulations in the sector need not be EU compatible.



Liberalization of Trade and Capital Movements

- In some other non-priority sectors which may include environment and labor markets the country could refrain from adopting the EU rules and regulations at its current state of development. The country could adopt these rules and regulations at a later stage of development when income per capita has increased considerably over time.



Liberalization of Trade and Capital Movements

- **Accession to the EU:** In addition to the conditions of deep free trade, accession to the EU would require among others the adoption and implementation of the whole body of EU legislation and standards – the *Acquis Communautaire*, including the acquis on environment, labor markets and the EMU.



Liberalization of Trade and Capital Movements

- Empirical studies of deep free trade and accession to the EU reveal that these policies would bring substantial benefits to the region, generating significant welfare gains and boosting the partner countries' GDPs.
- However, the welfare gains that will be derived from integration will have a price. The price will be the costs associated mainly with adoption and implementation of EU's economic rules and regulations.



Banking Services

- When considering the case of banking services, I will concentrate first on the case of Turkey. In 2001 Turkey faced a financial crisis. The cost of the crisis in the banking sector alone has been estimated as \$53.2 billion amounting to 35.9 percent of GDP.
- It is argued that if Turkey had adopted the legislative, regulatory and institutional framework of the EU banking system at the beginning of the 1990's, and had implemented and enforced these rules, then the banking crisis would not have occurred in the first place, and if it did then the cost of the banking crisis would have been much smaller than \$53.2 billion.



Banking Services

- A recent study on Turkish banking sector shows that adoption and implementation of the legislative, regulatory and institutional framework of the EU would increase competition in the banking system. Increased competition achieved through increased FDI flows will in turn improve the quality and availability of banking services in the domestic market, enable the application of modern banking skills and technology, enhance the country's access to international capital, lower prices for consumers and lead to a larger variety of financial instruments.



Banking Services

- Some of the Turkish banks will benefit from larger markets by concentrating on activities in which they have a comparative advantage.
- Other Turkish banks may be forced to merge with foreign banks or exit from the market.
- As a result of these forces we can expect the net interest margin to reduce, which in turn would lead to an increase in the GDP of the society by about 1 percent.



Banking Services

- Adding to this amount the annual gain from not having financial crisis in the future the annual welfare gain from adopting and implementing EU rules and regulations in the banking sector amounts to 2.2 percent of GDP. Thus the adoption and implementation of the legislative, regulatory and institutional framework of the EU banking system is expected to generate considerable benefits for the Turkish economy.



EU Rules and Regulations on the Banking Sector

The EU rules and regulations in the banking sector can be analyzed under the headings:

- Liberalization of Capital Movements and Interest Rate Deregulation
- Barriers to Trade and Establishment
 - Permitted Banking Activities
 - Requirements for Authorization
 - Conditions for withdrawal of authorization
 - Qualifications founders of banks have to satisfy
 - Home country control
 - Single passport
 - Banks holdings in non-banking activities



EU Rules and Regulations on the Banking Sector

- Internal Control and Internal Audit Systems
- Financial Reporting
- Capital Adequacy
 - Definition of capital
 - Formula for calculation of own funds on consolidated basis
 - Risks (credit risk, position risk, open foreign exchange positions, settlement risk, repurchase agreements and securities lending, OTC derivatives)
 - Calculation of capital requirements



EU Rules and Regulations on the Banking Sector

- Connected lending practices
- Limits on the amounts banks can invests in other businesses
- Loan-loss treatment
- Deposit insurance
- Consolidated accounts and supervision
 - Supervision of the consolidated financial situation
 - Special accounting rules for the financial sector
- Money laundering



Banking Sector Policies for Neighboring Countries

- Without going into detail, one can state that the banking acquis in the EU is highly complex. Turkey since the financial crisis of 2001 has been trying to adopt, implement and enforce the acquis in the banking sector.
- Regarding the adoption of the EU banking acquis we note that considerable progress has been achieved in Turkey. The problem is with implementation and enforcement.



Banking Sector Policies for Neighboring Countries

- Banks as well as the banking regulatory authority need qualified personnel in analyzing market risk, using value at risk models, and making use of quantitative models of banking supervision. This will require additional but substantial investment in human capital.



Banking Sector Policies for Neighboring Countries

- Abstracting from the Turkish case we note, that banking sector in the neighborhood countries of the EU is considered as a priority area under deep free trade, as liberalization of the sector is expected to make significant contribution to domestic economic development.
- Even then the neighborhood countries could follow different strategies depending how developed their banking sectors are:



Banking Sector Policies for Neighboring Countries

- If the banking sector in a particular neighborhood country is sophisticated, the best policy could be to adopt all of the EU rules and regulations in the sector, and implement them as Turkey is trying to do.
- If the banking sector in a particular neighborhood country is not sophisticated, it could see to it that the new legislation adopted in the sector is *acquis compatible*. But the country initially does not have to adopt, implement and enforce all of the EU rules and regulations in the sector. The cost of adopting, implementing and enforcing all of the rules and regulations could be substantial.



Banking Sector Policies for Neighboring Countries

- In the latter case the country could open the sector completely to foreign competition hoping that increased competition through FDI will improve the quality and availability of financial services in the domestic market, enable the application of modern banking skills and technology, enhance the country's access to international capital, lower prices for consumers and lead to a larger variety of financial instruments.



Banking Sector Policies for Neighboring Countries

- Furthermore, as long as the EU banks operating in the neighboring country are supervised by their home regulators, the EU banks are expected to be a vehicle to import better regulation and corporate governance.
- The banks of the neighboring country do not have to comply exactly with all EU directives in the sector. They will comply to only basic and international standards.



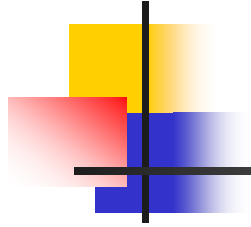
Banking Sector Policies for Neighboring Countries

- If some of the banks of the neighboring country want to have full access to the EU market and obtain the European passport, then they have to comply with all EU directives in the banking sector.
- As time passes and the sector becomes sophisticated then it may try to adopt all of the EU rules and regulations in the sector, and implement them as Turkey is trying to do.



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Many thanks...