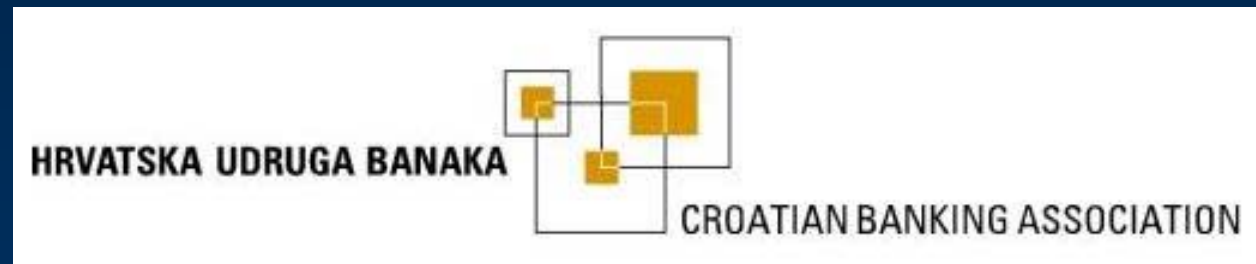


Regulation and Market Growth

Banking Regulation – costs vs. benefits -
and its Impact on the Market

Zoran Bohacek



Bucuresti, 5 April 2006

Regulatory Burden Analysis - Objectives

- Quantify costs vs. benefits – banking industry must respect that any regulatory expense is “paired” with a benefit, while the regulator must respect that any regulatory benefit is “paired” with certain cost
 - Use results to design an approach to dialogue with regulators
 - A study to compare regulatory burden in Croatia and Czech Republic, Hungary, Slovenia, Poland, Austria and Italy
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Measurements

- Net cost = total cost of (measurable) regulation reduced by the assessed social benefits of regulation
 - Opportunity cost = cost of missed earnings on assets maintained in compliance with regulatory measures, in % of assets
 - Marginal cost = the difference between the cost of financing an additional unit of loan with and without regulation, in bps
 - Distortion cost = abandon development of new products or new markets (too complex)
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Scope

- Prudential regulation
 - capital regulation
 - deposit insurance
- Monetary regulation
 - reserve requirement
- Foreign exchange regulation
 - regulation of minimum required foreign exchange liquidity
 - foreign exchange marginal reserve requirement



Outside of the Scope

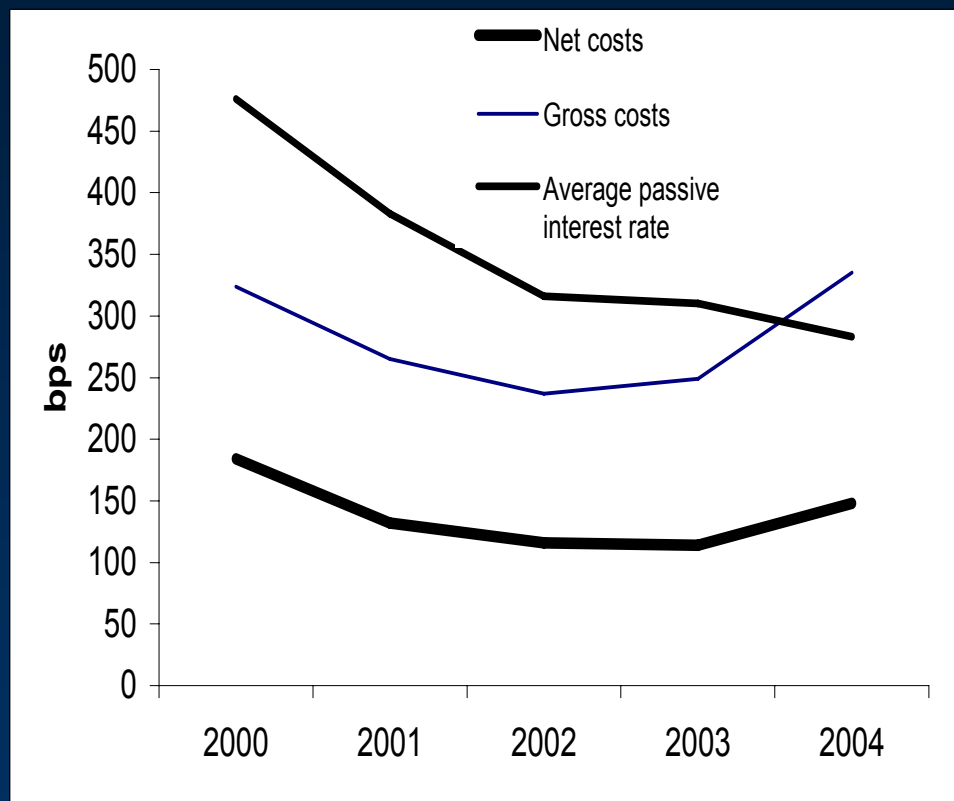
- “Operational” regulatory costs - connected with the operational segment of banks’ business (reflected in their operating expenses)
 - costs of payment system regulation
 - costs related to the reporting
 - labour laws
 - tax laws
 - In countries where the influence of classic types of regulation on the “financial” part of bank operations has been reduced to a reasonably low level, operational costs of regulation take the forefront
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Results - Croatia

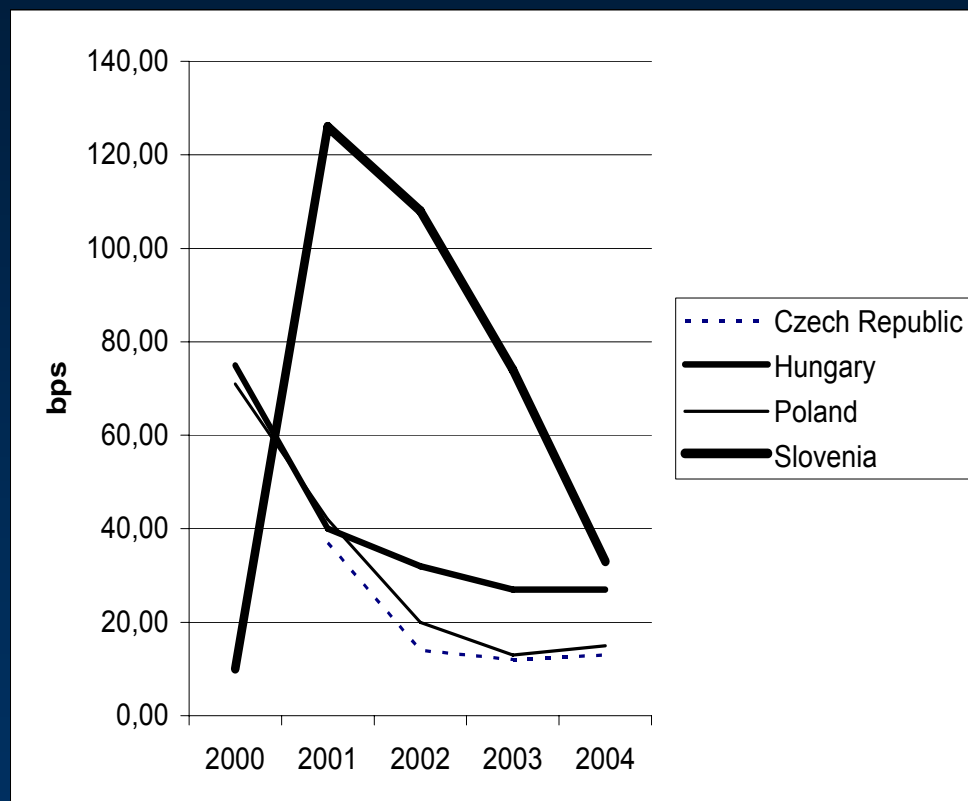
- Net regulation cost is highest in Croatia and growing – long term conflict between cost of regulation and mobility of capital
 - Main regulation components
 - reserve requirement
 - deposit insurance
 - marginal foreign exchange reserve requirement
 - Prudential regulation and regulation of minimum foreign exchange liquidity is not included in the calculation of net cost - justified due to the need to preserve foreign exchange liquidity of the system as a whole
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Marginal Cost of Regulation

Croatia – gross and net



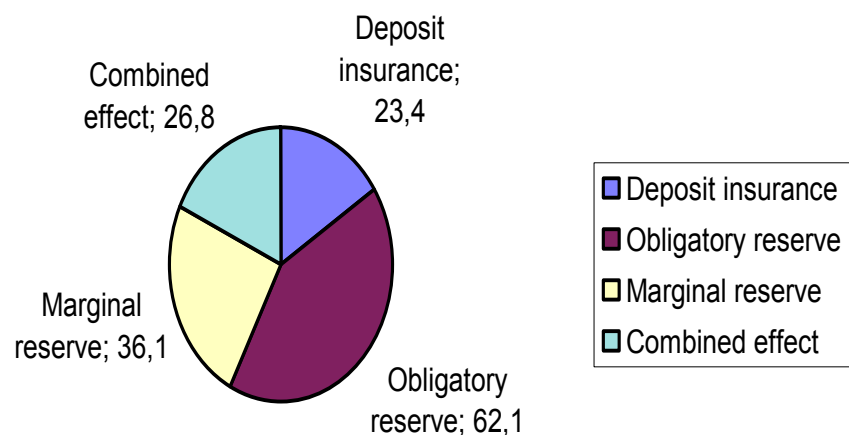
Net marginal cost of regulation



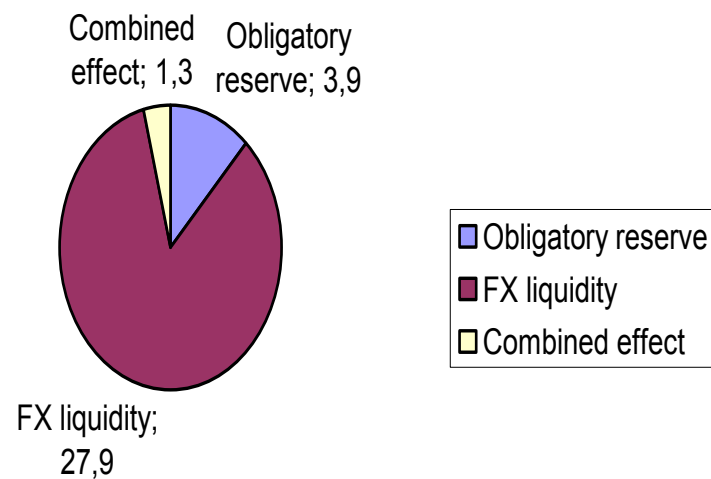
Austria and Italy not shown due to negligible cost

Causes of Costs by Type of Regulation Based on Net Marginal Cost in bps 2004

Croatia

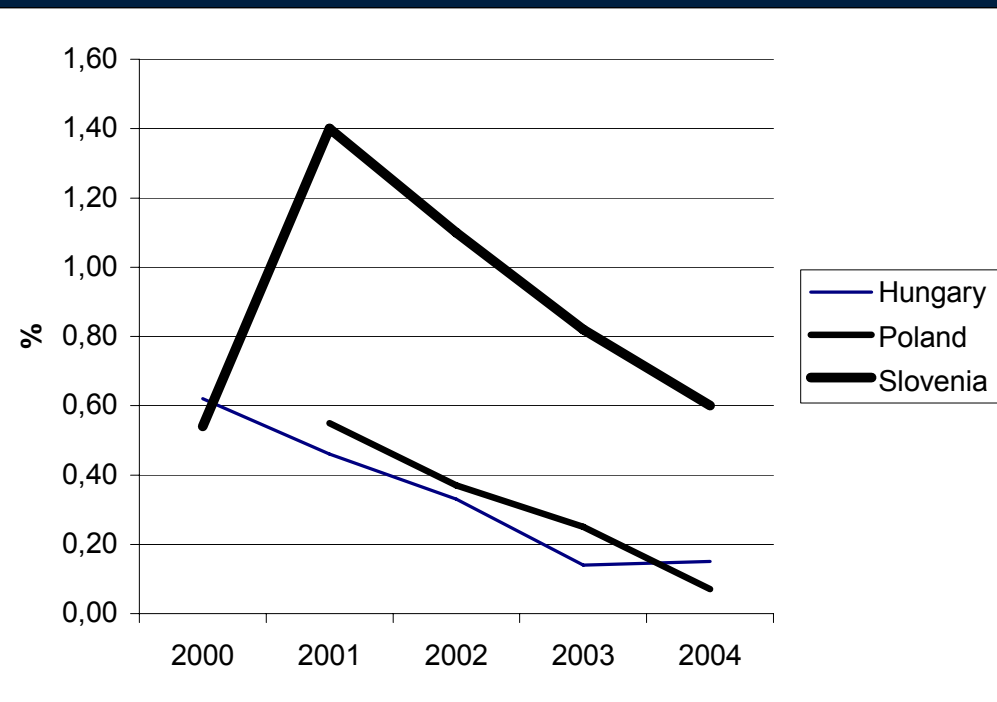
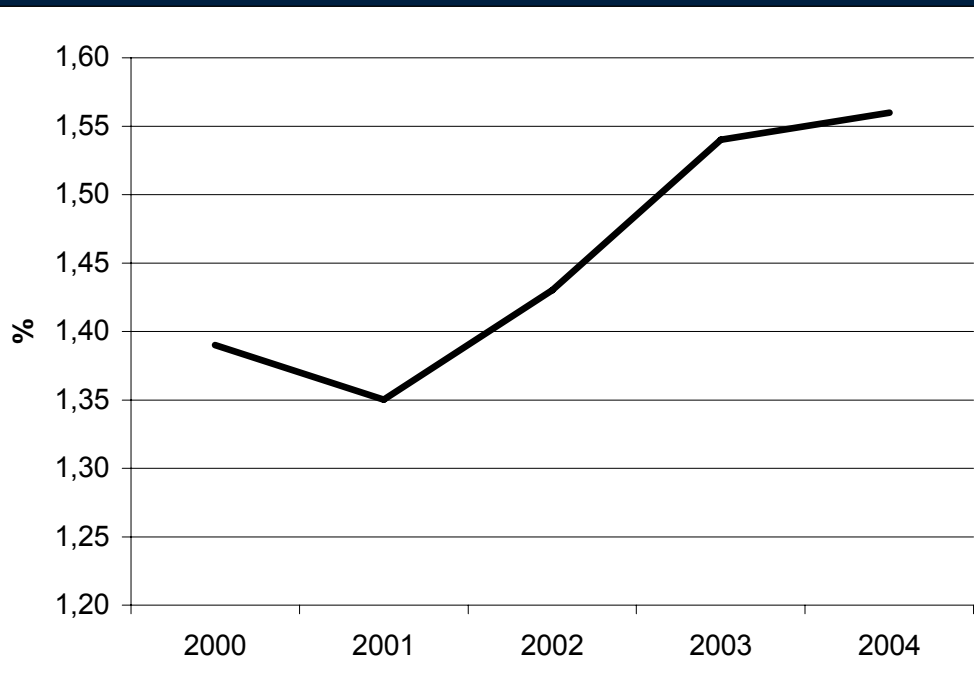


Slovenia



Comparison of Net Opportunity Cost of Regulation

Croatia



Equivalent to approx. 1,3% of assets (2004)

(see *)

Austria, Italy and Czechia not shown due to negligible cost

Future steps

- Use the tool to monitor changes in time
 - Expand the study – invitation to EBF members:
 - Increase the number of countries covered by the study - SEE Europe
 - Widen the scope of regulatory costs to include operational costs (costs of reporting, taxes etc.)
 - Improve the methodology
 - Define the project depending on the interest
 - Possibility of an International conference in Croatia late 2006 – associations, FBE, EC, CEBS
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Examples

- Linear limit of credit growth (Croatia 2003)
 - Affected mainly SME lending
 - Diverted growth from banks to leasing and other financial institutions
 - Enticed securitization – until central bank reacted
 - Marginal foreign exchange reserve requirement (Croatia 2004-5)
 - Attempt to reduce foreign borrowing
 - Wrong target – supply not demand
 - Hitting banks only
 - Didn't lead to desired results nor increase in interest rates
 - Special reserve requirement to be allocated by banks on their liabilities arising from issued securities (Croatia 2006)
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Conclusion

- Regulation must always be evaluated from both sides – costs and benefits (direct) but also side effects (indirect)
 - Administrative measures cannot be successful – banks have too many legal financial instruments at their disposal
 - Possible negative effects to the mortgage market – including slowing the growth due to lack of funds for housing investors and for prospective buyers
 - Similar effects to other sectors of economy
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