Prisoner's dilemma for EU bank groups

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Summary

What happenned after 2007 requires that new kind of instruments applied in order to face the global financial crisis. Non-coordinated actions undertaken by a single bank group have additionally sharpened the effects of the crisis and have resulted in the must of joint efforts which are better known as the "prisoner's dilemma".

Key words: prisoner's dilemma, bank groups, corporate governance
Jel: G34, G21, C71

Introduction

EU enlargement to the Eastern Europe celebrated its first decade. Regardless of the processes of economic integration, the financial system continues to be determined by the complex relationships between countries: the economically developed countries take advantage of the benefits offered by their advantages and provide free financial resources for lending to other economies.

Economists believe that the modern financial system has to be restructured in a new framework. Individual interests must give way to collective actions. The new instruments are based on the application of game theory. Given the convergence of national differences in current practice most often used open-ended games. Great application is being applicable the "prisoner's dilemma" in which one participant can win/lose, all can win or all can lose.

In the early twenty-first century the economic development in the EU grew thanks to the accession of countries from Eastern Europe. Foreign banks were providing know-how, stabilizing funds and large volume credits. On the other hand, foreign banks incurred capital repatriation. From the standpoint of the prisoner's dilemma, all participants reach a collective benefit.

Besides the positive effects of the convergence of Eastern Europe through external financing, the large capital flows led to overheating economies and macroeconomic

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imbalances[1]. In 2009, the banking system in Romania fell into difficulties, which led to the withdrawal of funds from banking groups to reduce risk and meet the heightened requirements of national supervisory authorities. The interests of bank managers and the supervisory authorities of the home country coincided in funds withdrawing to protect their own banks. The ensuing chain reaction caused some uncertainty as to the countries of Eastern Europe and in other Member States.

Under normal conditions, the interests of local stakeholders and foreign banks were leveled by the benefits of efficient, profitable and stable banking sector[2]. During the crisis, short-term interests began to diverge, as parent banks sought to minimize potential losses and local stakeholders were concerned to ensure a steady flow of credit and to increase tax revenues. Such conflict of interests put governments and foreign banks in a situation known as the prisoner's dilemma: a banking group, which first withdraw its financial capital of Eastern Europe, will face lower losses than those who remain bound for a longer period of time because invested funds for the construction of a network of retail banking.

The taken actions aimed to stabilize the financial situation of a particular banking group without taking into account the adverse effects on the economies of Eastern Europe and other banking groups. Notwithstanding the diversity of actions, they can be grouped as follows:

- parent banks withdraw their own funds from Eastern Europe to strengthen the operations of the domestic markets;
- packages of loans granted by the IMF to economies of Eastern Europe are transferred to the country of the parent bank;
- selling of assets to improve the adequacy of core capital and reduction of risk due to regulatory pressure to increase capital buffers, the introduction of the IRB model and the supervisory authority of the home state to expand to overseas subsidiaries the prohibition of allocating local exposures to the parent bank.

To reduce the uncertainty caused by the withdrawal of funds be required to approach "country-by-country". It requires coordination between the competent authorities of the home country and the host country, but also between parent banks and their overseas subsidiaries.

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[1] The European Bank Coordination ("Vienna") Initiative. Report by the Public-Private Sector Working Group on Local Currency and Capital Market Development. 16-17 March 2011, Brussels.

[2] Kudrna, Z. Financial crisis: testing the relationship between foreign banks and the new EU members. Employment and economy in Central and Eastern Europe, 1(1), p. 1.

The pan-European policy for financial stability necessary to establish an initiative to coordinate actions. In 2010, under the auspices of the European Bank for Reconstruction and Development in Vienna held a meeting to decide "prisoner's dilemma"[3].

The main participants in the Vienna Initiative are:

- international economic organizations (International Monetary Fund, European Bank for Reconstruction and Development, European Investment Bank and the World Bank, with the leading role of the EBRD);

- European institutions (European Commission and European Central Bank as an observer);

- regulatory authorities of the home country (Austria, Belgium, Greece, France and Italy) and the host country (Hungary, Romania, Latvia and Serbia);

- large banking groups operating in the region of the European Bank for Reconstruction and Development (EFG, Erste, Intesa, KBC, Piraeus Bank, Raiffeisen International, Societe Generale and Unicredit).

The goals that were set before the Vienna Initiative are:

- limiting large volume and uncoordinated withdrawals from cross-border banking groups in Eastern Europe, not to trigger systemic risks both for individual country and for the EU as a whole;

- public commitment of parent banks to maintain their exposure to their subsidiaries and to recapitalize them;

- conducting liquidity measures by the local central banks;

- local governments commit not to carry out capital controls.

Coordination of actions undertaken led to the success of the Vienna initiative and Eastern Europe do not saw a large outflow of capital. The emerging second wave of the financial crisis, associated with the debt crisis in the eurozone, had a negative effect on the economies of the EU, which were not recovered. That is why we need to start a new initiative called "Vienna 2.0". According to Vienna 2.0 the parent banks undertake to maintain stable debt levels in countries that receive aid from the International Monetary Fund.

The interests of the parent banks and supervisory authorities of the home country coincided. The threat was explained by the fact that Western countries rush to protect themselves from the debt crisis, and banks will reduce costs and activity and it would be a double blow to the economies of Eastern Europe. To all interested parties, it became clear that

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[3] EBRD. Vienna Initiative – moving to a new phase. April 2012.

if one of the banks leave, others will follow and the situation will worsen for all banks[4]. If all remain on the market, the situation will keep stable.

The new initiative aims to reduce credit exposures of the subsidiaries of Austrian banks in Eastern Europe[5]. To deal with the most urgent problems, the guiding principles require Austrian banks, having business in these countries, to suspend the granting of new loans in currencies other than euros of unhedged households and small and medium enterprises.

The systemic risks in 2010 changed the focus of the use of local currency and the development of local capital markets, management of non-performing loans and assessing the impact of Basel III on Eastern Europe[6]. The new initiative is aimed at slowing the pace of withdrawal of capital and avoid a crisis in the provision of financing in Eastern Europe than to hold investments there. The measures are aimed less at parent banks that have subsidiaries in the 10 new EU Member States and more to regulators and the subsidiaries themselves.

Conclusion

The Vienna Initiative is a framework for coordinated crisis management between EU-based cross-border banking groups in Eastern Europe[7]. It redefined from crisis management to crisis prevention. In resolving the prisoner's dilemma are involved stakeholders from the public and private sectors. The EBRD, using unique relationships with both the private sector and governments, promotes the transition and development in the private sector.

The pan-European co-ordinated policy was in response to the first shocks and limit uncoordinated national responses to the negative effects of transition from crisis. The Vienna Initiative provide 24.5 billion Euros to support the financial sector in Eastern Europe through credit lines for financing the recapitalization of banks, development of credit policy to support financial sector reforms. The final result in the countries of Eastern Europe the foreign banks have a leading position and their subsidiary banks continue to have stable credit sources[8].

The effects of the Vienna initiative changed the best corporate governance practices. Traditional participants perform new roles. The shareholder composition is expanded to

[4] Groendahl, B. Greek Plan Modeled on Vienna Program May Buy Time: Euro Credit. Bloomberg, 2011.
[5] Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1).
[6] Statement at the Conclusion of a Meeting of the European Bank Coordination "Vienna" Initiative. Press Release No.12/11. January 16, 2012.
[7] Nagy, P. Vienna Initiative: Timeline for the First Phase and the Start of 'Vienna Plus'. EBRD, 2011.
[8] Claessens, S., N. Van Horen. Foreign Banks: Trends, Impact and Financial Stability. International Monetary Fund Working Paper 12/10, 2012.

include government institutions as majority shareholder, which found application of the continental agency conflict between majority shareholder and investors. The Managers have an increased responsibility for information disclosure on the use of state aid. The auditors are subject to supervision by the home state and only carry out audit services only, the consulting services was separated in a specialized company. The regulators substitute the general meeting of shareholders and actively participate in the exercise of control by exercising the voting right. The tools have been upgraded from reaching the national competitiveness and interests of banking groups to achieve macroeconomic stability and protect the interests of society.

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