IS THERE A FUTURE FOR REGIONAL BANKS AND REGIONAL EXCHANGES?
The Strategies of Selected Austrian Finance Institutions

Four Papers:

D.T. Llewellyn, "The future for small & regional banks in Europe"

R. Ortner, "What future for regional banks?"

H. Stepic, "The Strategy of RZB in Central and Eastern Europe"

St. K. Zapotocky, "The challenges and chances of regional exchanges"

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Is there a future for regional banks and regional exchanges? – The strategies of selected Austrian Finance Institutions
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Contents

Is there a Future for Regional Banks and Regional Exchanges?

The Strategies of Selected Austrian Finance Institutions

Editorial

It has been argued that the combination of technological advance, the European Single Market, the advent of EMU and, more generally, the reality of a global financial community, is undermining the competitive position of small, regional financial organisations, be they banks, stock exchanges or other financial entities. This line of argument leads to the conclusion that there is no viable business future for the small.

This *SUERF Study* offers points of view to the contrary, both from the academic and "practitioners" angle. Professor David Llewellyn contributes the academic view, strongly arguing that size per se is not the issue but rather that efficient, well focused small and medium-sized financial institutions remain viable. Representatives of three regional financial institutions in Austria were asked to discuss elements of their business strategy to substantiate their belief in the viability of their institution's future. The contribution by Reinhard Ortner (Erste Bank) is based on a talk he gave on the occasion of the 22nd SUERF Colloquium in Vienna in 2000, and that of Helmut Stepic (Raiffeisen Zentralbank) on a speech at the Alpbacher Banking Seminar in 2001. The consolidation and concentration process has, of course, also engulfed stock exchanges and many of the small ones have already been pronounced terminally ill. Stefan Zapotocky (Wiener Börse AG) is firm in his view that regional exchanges will have a viable future catering for regional financing needs. His contribution is based on a presentation at the SUERF Salzburg Seminar of 2002, which dealt with the future of regional exchanges.

Eduard Hochreiter
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THE FUTURE FOR SMALL & REGIONAL BANKS IN EUROPE

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Introduction & Context

A distinguishing feature of banking in many European countries is that there is a large number of comparatively small, and often locally or regionally based banks. In some markets such banks compete with very large, global financial conglomerates. A central strategic question is addressed in this paper: is there a viable business future for the comparatively small and regionally-based financial services institution? A key issue is whether, in a world where a major consolidation process is unfolding in the financial sector, there is a future for comparatively small (perhaps regional or even local) financial institutions.

Our conclusion is that size *per se* is not the key issue and that, providing it is efficient, there is a clear and viable future for the comparatively small, regional and focused financial firm.

The following two studies describe the chosen strategy of two successful regionally-based Austrian banks and how they have sought to exploit their competitive advantages in new markets. Before that, this chapter offers a more general overview of the future of regionally-based banks which compete with national and global banks and in a world where economies of scale seem to be increasing. The fourth and final study addresses the future prospects of the small regional stock exchange.

1. The strategy matrix

Two dominant trends in bank strategy (size and diversification) can be represented in a strategy matrix as described in figure 1. The general trend is for financial firms to seek to move from left to right along the horizontal axis of the matrix (i.e. to become larger), and from top to bottom (i.e. to become more diversified). In other words, the global trend is towards the bottom right hand segment of the matrix.

While this has become something of a conventional wisdom, the strategy does not go without challenge in either dimension: scale and diversification. It is not self-evident that economies of scale are dominant in banks to the extent that only very large banks can be competitive, or that being widely diversified (geographically or product mix) is the only route to success. There is scope for small, regionally-based and focused financial institutions to compete alongside large diversified national and global institutions in the pluralistic financial systems that are likely to emerge. Two examples for strategies of small regional banks are presented in the two papers (by Stepic and Ortner) that follow.

1.1 Economies of scale

Three key strategic issues for banks and other financial firms relate to: (1) whether there are economies of scale in banks, (2) if so, the origin of such economies, and (3) how any such economies of scale are to be secured through alternative organisational structures.

An enormous academic empirical literature has attempted to identify and measure economies and diseconomies of scale in banks. For a review of the theoretical and empirical literature on scale economies in banking see Goddard, et al. (2001) and Llewellyn (1999). The traditional empirical literature does not yield unambiguous results and tends to conclude that there are only limited economies of scale in banks. Although there are differences between the studies, almost all suggest there are no significant scale efficiencies to be gained, and possibly some slight scale efficiency losses to be suffered, from mergers and acquisitions involving large banks. As put by Bisignano (1998) in the context of a wave of bank mergers: 'with reference to banks a puzzle exists, since there is little empirical analysis which confirms the existence of significant economies of scale in banking ..... the merger-acquisition wave in banking is difficult to understand.'

Overall, except with comparatively small banks, there seems to be little evidence that large banks have lower average costs than smaller banks, and economies of scale seem to be exhausted at comparatively low levels. There is some evidence that increasing size beyond a certain point has the effect of raising unit costs. The overwhelming conclusion from the empirical evidence is that the major determinant of a bank's cost level is not size *per se* but its own internal efficiency (X-efficiency). In other words, the variation in costs between banks of similar size is greater than that between banks of different size. Overall, there is no firm evidence that size *per se* is a necessary ingredient of success. While many researchers find significant potential economies of scale, it remains the case that most large banks do not fully exploit this.

Many research studies of scale efficiencies in the late 1980s and early 1990s were based on US data from the 1980s. More recent literature is identifying greater economies of scale than in the past. This later research suggests there may be more substantial scale economies. It would appear that the potential for scale economies increased in the 1990s compared with earlier periods. This may in part be associated with the impact of information and processing technology in two respects: modern technology is large scale, and expensive in nature and hence is feasible and economic only for large banks, and processing technology is raising the economies of scale in many bank processes. The cost of technology is very high and has become a major aspect of the cost structure of banks. In this regard, some banks cite the cost of installing new technology as a major motive for a merger.

Economies of scale are increasing in many areas of financial services. However, they tend to be in *processes* rather than firms *per se*. When considering economies of scale, therefore, a distinction needs to be made between banks as firms and bank processes. Individual bank processes (cheque clearing, credit card administration, etc.) do show economies of scale even though it may be difficult to discern in institutions *per se*.

This is an important conclusion as, while competitive pressures are forcing banks to lower their costs, there are other ways of achieving economies of scale in bank processing than by being a big bank. A central strategic issue for financial firms of all sizes, therefore, is how to secure the competitive imperatives of economies of scale. Being big is only one way of securing such economies: other options include establishing joint ventures and shared facilities, outsourcing processes, insourcing processes, co-operative ventures, or creating a confederation of financial firms. In effect, small firms which are unable to secure economies of scale internally are able to secure them externally, i.e. by buying into economies of scale externally. We return to this in a later section.

2. Consolidation in global banking

Several factors account for the growth in merger and consolidation activity in global banking over the past few years: the evolution of technology which has increased the economies of scale in banking (Berger, *et al*., 1999); the increasing focus on shareholder value as the ultimate business focus by bank management's; the increased focus on risk analysis, management and control by banks and the fact that new tools of financial engineering and risk management may be more efficiently produced by larger institutions (Berger, *et. al*., 1999), and consolidation being viewed in many countries whose banks have experienced serious distress in recent years as a solution to excess capacity problems. Also, the generally increased degree of globalisation of the banking industry which has encouraged banks to focus on the scale of their operations, and has induced cross-border mergers and acquisitions on a larger scale than in the past.

The BIS (1992) notes that 'competitive forces are obliging many banks to consolidate ... whether the competition stems from within the industry or outside it, from other financial intermediaries, open capital markets or even non-financial companies themselves'. A 'merger movement' has become a pronounced feature of the US banking industry, and there has also been a marked increase in the number of mergers and acquisitions in banking in Europe (notably Scandinavia), and other parts of the world. Overall, the likely trend in many countries is for a reduction in the number of independent banking units and a concentration into a smaller number of larger units.

It is increasingly becoming the conventional wisdom that, assuming there to be economies of scale in banking, competitive pressures will force more consolidation in the global banking industry (more in some countries than others dependent, in part, upon the starting position).

2.1 Reservations on scale

There are several reasons to be cautious about the conventional argument about the existence of economies of scale as a rationale for bank mergers:

❍ *Limited evidence*. An enormous amount of research has attempted to identify and measure economies and diseconomies of scale in banks. The results are, at best, inconclusive and ambiguous. Overall, except with comparatively small banks, there is little support for the proposition that large banks have lower average costs than smaller banks. Economies of scale seem to be exhausted at comparatively low levels. The overwhelming conclusion is that the major determinant of a bank's cost level is not size *per se* but its own internal efficiency. In other words, the variation in costs between banks of similar size is greater than that between banks of different size. However, some recent research using different econometric techniques, different efficiency concepts, and/or more recent data from the 1990s, suggests that there may be more substantial scale, scope and product-mix efficiency gains available from consolidation. For instance, Berger and Mester (1997) found 1990s data displayed substantial cost scale economies of the order of about 20 percent of costs, for bank sizes up to about $10-25 billion of assets. It would appear that the potential for scale economies has increased in the 1990s than in earlier periods. This may be associated with the development of technology noted in earlier sections.

- *Banks v Banking.* When considering economies of scale, a distinction needs to be made between banks and bank processes. Individual bank processes (cheque clearing, credit card administration, etc.) do show economies of scale. Combining the two conclusions seems to suggest that there are no clear economies of scale in **banks** (in that large banks do not consistently have lower average costs than smaller banks) but they do exist in **banking**.

- *Dis-economies of scale. Emphasis is usually given in public debate to economies of scale.* However, there can also be dis-economies of scale: i.e. average costs rise beyond a certain size of firm. There are many possible reasons for this: inability of management to control a very large organisation; more bureaucratic procedures; weakening of innovation in large bureaucracies, etc. There is nothing in the theory of economies of scale that suggests that the average cost curve continues to fall as size increases.

- *Size is not itself a source of sustainable competitive advantage*. It is an illusion to believe that size in itself creates competitive advantage on a sustainable basis. There are many factors that determine the competitiveness of any financial firm, but size *per se* is not one of them.

In a recent study, the management consultancy firm Mitchell Madison noted that merger activity among European banks has accelerated and yet most mergers in the banking sector have failed to deliver value to shareholders.

2.2 Overall assessment

As in many areas, fashion often plays a role in the evolution of bank strategies: decisions are often made on the basis of very limited evidence and simple assumptions about what is likely to be successful. There is a danger of a conventional wisdom emerging: that only large and highly diversified banks will survive in the strongly competitive environment that will emerge in the next few years. This could be an illusion. Success will be determined mainly by considerations internal to the bank (management efficiency, etc.) rather than applying any particular model on the size-diversification matrix. To think otherwise, and to build strategies exclusively on a particular model, is a delusion, and potentially a dangerous one for it would divert attention away from what really matters: having a clear and credible strategy, and being good at doing what the bank chooses to do.

3. Contract banking

One reason why banks sometimes choose to merge or acquire in order to become bigger is to secure the economies of scale that exist in many banks processes. However, this assumes that such economies can only be secured internally. This is challenged by the trend towards *deconstruction* in many banks.

The process of *deconstruction* involves decomposing services into their component parts which may then be costed and provided separately. These components need not be undertaken by the same firm and if, for any reason, different firms have different comparative advantages in different parts of the process, the logical development is for each process to be supplied separately by the firm which has a comparative advantage in doing so. For instance, firms which have an efficient capability for originating and administering loans may not necessarily be the most efficient at holding assets on the balance sheet.

A major pressure in the financial services industry in the years ahead will be the accentuation of the *deconstruction* process, with institutions concentrating on those parts of the business, and those processes, in which they have a competitive advantage. This will require some firms to adopt a radical approach to their organisational structure.

A key issue (particularly for small banks) is the extent to which competitiveness can be maintained within existing organisational structures, or whether, at some point, further cost management strategies require a major re-engineering of the organisation and process management.

There are several alternative strategies for securing the benefits of economies of scale of which being a large firm is only one. Other options include joint ventures, out-sourcing joint ventures between banks, and the creation of 'confederations' whereby services are provided collectively to several banks within the confederation. An example of the last-mentioned is the Credit Unions Services Corporation in Australia (see Llewellyn, 1997). In the financial services industry, many organisations have sought to achieve economies of scale by out-sourcing processes: in effect, they have bought-in economies of scale by sub-contracting processes to specialist firms (or to other banks) which, because they provide the same homogenised service to several firms, are able to secure economies of scale through spreading fixed costs across a wider range of output.

This is likely to become a more pronounced trend with all financial institutions. The outsourcing firm gains the advantages of economies of scale. Above all, a major advantage of outsourcing is that it transforms fixed costs into variable costs and hence reduces the requirement for, often large, up-front costs in developing and adapting processing facilities. In the same way, the firm also achieves greater flexibility by not being locked-in to a particular technology. There are other advantages to outsourcing: it enables firms to concentrate on their core activities (in which they have a comparative advantage) without the managerial diversion involved in peripheral and support operations which can be supplied equally well, and more efficiently, by outside specialist organisations.

The outsourcing firm also gains more flexibility in the use of technology. Because of the high start-up costs in some technology projects, once a system has been established the firm becomes locked-in to the system because sunk costs are high. This is most especially a problem when technology is developing at a rapid pace.

Although many out-sourcing arrangements involve technology projects, data storage and transactions, etc., it can be extended to encompass a wide variety of processes. These could include call centres, marketing, fund management, etc.

In the evolving competitive market place that will increasingly come to characterise European banking, all financial firms will be under pressure to secure operational economies as a means of maintaining competitiveness. Increasingly, this will imply radical new structures of the financial firm. In particular, the traditional vertically integrated firm will become only one of a wide spectrum of alternative structures. Technology, and the ability to *deconstruct*, therefore has implications for the optimal structure of the financial services firm.

Thus the banking firm can be viewed as a firm which has an interface with a customer base (supplying a range of apparently integrated products and services) while demanding a series of support services in order to supply those services. Under the *Contract Banking* model, the bank defines its products and decides which components are to be supplied internally and which sub-contracted. In effect, a series of contracts are established by the contracting bank with internal and external suppliers. *Contract banking* implies a bank offering a full range of services but where the bank co-ordinates inputs from a wide range of different companies. The core is a contract the bank has with its customers to supply a set of services or products of a particular standard. In turn, the bank contractor has a set of contracts with a range of internal and external suppliers of the components of these ultimate products and services. The value added by the bank contractor is in the management of these contracts. What appears to customers as an integrated product or service is in fact a series of *deconstructed* components which may or may not be supplied from within the bank.

The central strategic issue is which components are to be supplied internally, which are to be sub-contracted, and which are to be exported. Core-competencies of particular banks are relevant in this.

A recent survey conducted by PriceWaterhouseCoopers (PWC, 2001) in the UK amongst twenty five building societies indicated that most Societies (84 percent) claimed to be outsourcing some of their operations the most frequent activities being IT, professional services such as valuations and internal audit, and basic support and infrastructure such as payroll and physical security. There are several reasons why out-sourcing is undertaken and why it has become an increasingly common feature in banking:

- to reap economies of scale that cannot be obtained internally;
- some areas may be too specialised to be undertaken internally;
- a particular expertise may not be available internally and may be uneconomic to acquire;
- to gain increased flexibility in the use of technology;
- to spread (most especially fixed) costs and risks;
- to break an internal monopoly when services are supplied exclusively internally;
- to change the cost structure: lower fixed costs.

As already noted, a major advantage of out-sourcing is that it transforms fixed costs into variable costs and hence reduces the requirement for, often large, up-front costs in developing and adapting processing facilities. Many processes in banking have high fixed and low variable costs which is a classic symptom of economies of scale. If a firm conducts its own processing it pays, and must recoup through the pricing of its products and services, both the large fixed and small variable costs of the process. On the other hand, if it sub-contracts the process it pays the supplier a proportion of the supplier's fixed costs plus the variable costs. The whole procedure is economic if the higher variable and transactions costs through out-sourcing are less than the savings on fixed costs. In addition, the out-sourcing firm may find it economic to out-source even when this condition is not met because of the sharing of risks and the greater flexibility it secures through minimising its infrastructure and fixed costs. In general, firms with low fixed costs are more flexible than those with high fixed costs even if the variable costs are higher.

In a competitive market all firms are under pressure to gain cost advantages wherever they can be secured. In some cases banks may have gone as far as they can in cutting costs without a more fundamental re-engineering of the business such as is implied in *contract banking*. If technology has the effect of increasing the economies of scale, the issue becomes how financial firms can reap such economies. As noted, economies can be secured either internally or externally but in some cases it may require a fundamental re-engineering of the bank.

Bringing together the various strands of the argument so far, it would appear that, with respect to the optimum size of financial firms, conflicting pressures are operating: (1) technology is increasing the economies of scale and hence *prima facie* a need to be large to gain competitive advantage in the market; (2) the same technology is making *deconstruction* of processes more feasible and also widening the range of options for securing economies of scale.

4. Future for small financial firms

At the outset a central strategic questions was posed: whether there is a viable business future for the small, regional financial firm. This section addresses this issue by drawing on the earlier analysis of the paper. There is a conventional wisdom with some, though a diminishing number of analysts, suggesting that only large, diversified financial services firms will be able to compete effectively in the retail financial services markets of the future. This position has been challenged at various points in this chapter.

The central conclusion is that there is a viable future for small, regional firms providing they are efficient and, if necessary, are prepared to change organisational structures to secure the economies of scale externally that they are unable to generate internally. The rationale of this conclusion may be summarised by bringing together the various strands of analysis outlined earlier:

(1) There is considerable doubt about the assertion that internal economies of scale are important in the financial services firm.

(2) The development of out-sourcing means that there is a viable role for the small, focused financial firm in a market and technology environment where many banking operations require large scale to be economic. While there will be a trend towards more consolidation in the financial services industry, there will still be a place for the smaller firm though it may not have the traditional structure. An implication of much of the analysis of this paper is that financial services firms will be under constant pressure to cut and contain costs as a permanent feature of strategy. However, if economies of scale relate predominantly to *processes* rather than *institutions*, the existence of economies of scale does not mean that only large firms can be competitive and survive.

(3) Consumer unbundling of financial services and products enables financial institutions to compete against conglomerate firms providing they are efficient at the limited range of services they offer in the market.

(4) Internet access channels offer advantages to the small firm as they reduce the need for a substantial infrastructure and branch network. The Internet lowers the cost of entry, enables efficient small firms to compete, and

lowers search costs for consumers. In the context of the US, it has been argued that 'in some ways the Internet may level the playing field between large and small banks', (DeYoung and Hunter, 2001).

(5) Securitisation also enables small firms to compete if they have an origination advantage but constrained capacity to hold assets on the balance sheet.

While some financial services firms will undoubtedly seek to merge and become bigger and more diversified, the fact remains that size *per se* seldom gives enduring competitive advantage. This is clearly not an argument that large size is a disadvantage. The central conclusion is the market place will sustain a wide variety of different types of financial firm, and that competitive advantage is determined by internal efficiency rather than taking a particular position on the Size-Diversification Matrix outlined earlier.

5. New organisational structures

There is a viable role for comparatively small and focused financial firms. Many of the traditional arguments about the vulnerability of small and medium-sized financial institutions assume a continuation of the traditional structure of the financial firm. This is an unwarranted assumption. Put another way, the alleged vulnerability of small financial firms is grounded in the 'old economics' of banking.

However, and partly in order to secure economies of scale, success for comparatively small financial firms may require major changes in organisational structure at two levels:

(1) a radical *deconstruction* of processes with firms focusing upon their core competencies and sub-contracting many processes which have traditionally been undertaken 'in-house', and

(2) by forming Confederations of small financial firms to undertake processing collectively for their members while each member retains its competitive independence.

There is a lot to learn in this regard from the experience of countries in Scandinavia, Continental Europe and also Australia. The idea of co-operative solutions is common in these countries most especially within the mutual and co-operative sectors of the financial system. In many European countries and also in Australia, collective arrangements are common. In many ways Credit Agricole (once the largest bank in the world) has operated as a confederation of localised mutual banks though it has recently become more integrated and is in the process of (at least partly) changing its corporate structure.

Perhaps the best example of a Confederation is Rabobank in the Netherlands. Although it is often treated as a single entity, it is in truth in part a Confederation of 350 local Rabobanks each of which has a certain degree of local autonomy. Rather like OKO Bank in Finland, Rabobank has a dual structure: Rabobank Nederland serves clients that are too big to deal with a local Rabobank, and it is an umbrella organisation owned by local banks. As put recently by a senior executive of the bank:

'... it delivers a number of central services, for example in the field of ICT-systems, a group treasury, product development and research ... Rabobank Nederland also acts as supervisor of the local Rabobanks on behalf of the Dutch central bank. Finally, it is the holding company of a number of subsidiaries. The most important are the insurance company Interpolis, the leasing company De Lage Landen (which offers alternative sources of finance for SMEs), Gilde (which offers venture capital) and ... the largest asset management company in the Netherlands, Robeco, which is fully owned by Rabobank Nederland', (Boonstra, 2002).

In Finland, and following the banking crisis of the early 1990s, the many small Co-operative Banks were reorganised and formed into a Confederation under the title of OKO Bank Group. OKO is both a bank in its own right but also serves as the supplier of a wide range of services to local Co-operative Banks which retain a high degree of autonomy. OKO Bank Group is a Co-operative Bank in competition with banks and Savings Banks in Finland. The Group has 244 local Co-operative Banks as members plus OKO Bank itself. The central body (OKO Bank Group Central Co-operative) undertakes strategic planning, marketing, supervision, and other support activities, and is also the owner of OKO Bank which is a listed bank and the central bank of the group. It also owns a number of subsidiaries.

Other examples of analogous Confederations, though without the cross-guarantee system of Rabobank, are Federcasse in Italy (which is owned by, and supplies services to, Co-operative banks in Italy) and the Credit Unions Services Corporation in Australia.

In the context of rising economies of scale, all of these are designed to enable small financial institutions to gain the competitive imperative of economies of scale while at the same time maintaining their competitive independence.

6. Economies of scale again

These developments bring into question the traditional measures and concepts of economies of scale in banking. If there are alternative ways of securing economies of scale in processes by changing the organisational structure of the bank (e.g. by outsourcing), the same economies of scale can be secured by banks of very different size. Under some extreme assumptions (no external contracting costs, perfect divisibility of processing, etc.) the long run average cost curve is horizontal and the same for all banks, though different banks will reach this position through different combinations of internal and external contracts for processing, etc. This is illustrated in figure 2 where AC1 represents the average cost curve of a bank with old technology with only internal contracts. AC2 represents the cost curve with new technology with only internal contracts for processes. This indicates that technology is having the effect of increasing the economies of scale, raising the optimum scale, and raising costs at low levels of output compared with old technology. However, if banks have the option of choosing a mix of internal and external contracts (in the latter case they effectively buying-in economies of scale from outside which they cannot secure internally) the average cost curve becomes AC3. In effect, banks of various sizes can secure the same economies of scale. Thus empirical testing might show banks of various sizes having the same costs which might be misinterpreted as there being no economies of scale in banking. The true interpretation is that economies of scale can be secured by small banks through greater use of external contracts. However, this will not be identified with traditional methodologies for measuring economies of scale in banking.

The structure of financial systems is likely to become more diverse as different firms adopt different combinations of internal and external contracts for processing. The options are represented in figure 3. At one end of the spectrum there will be the fully integrated bank which internalises virtually all of its processes and does everything itself. This is an option only for the very largest banks. At the other end of the spectrum will lie the Virtual Bank which externalises almost everything. In practice, the majority of banks will lie within the box in between the two polar cases.

7. The importance of strategy

This paper has argued against the view, commonly expressed in some banking circles, that only the very large and highly diversified banks will succeed in the emerging competitive environment where economies of scale seem to be growing in importance.

To return to the Strategy Matrix outlined earlier (figure 1), it is unlikely that strategic success will be achieved simply though positioning on the matrix because successes and failures are likely to be found throughout the matrix. Success will be determined more by internal considerations (management efficiency, etc.) rather than in seeking a particular position in the Strategy Matrix.

If positioning on the Strategy Matrix is not the answer, what are likely to be the key ingredients of strategic success in the new competitive environment and newly emerging structure of the financial services industry? In many ways the answer is basic and fundamental:

❍ Above all, it is imperative for financial firms to have a clear and credible business strategy.

❍ Being realistic about the institution's core competencies and being prepared to discard what has hitherto been undertaken internally if there is no obvious expertise or competitive advantage in it.

❍ Being realistic about the markets in which to operate and to operate in those markets where the bank has a demonstrable and sustainable competitive advantage and expertise.

❍ Being good at what the financial firm chooses to do: in many respects, being good at what a firm chooses to do is more important than precisely what it chooses to do.

❍ Maximising to the full its information advantages.

❍ Having a permanent cost management strategy as opposed to one-off cost cutting exercises.

- Being prepared to securitise assets if this is more economic for the customer than holding them permanently on the balance sheet with funding and capital backing.

- Adopting a radical approach to organisational structure if this proves to be necessary: this means having a wider variety of internal and external contracts for the provision of the basic processes that make up the products and services being offered to customers.

It is sometimes the more basic considerations that are the most important in a situation where some seek successful strategy in more exotic ways! Above all, while there is a viable future for comparatively small and regionally-based banks, it is important for such firms to have a clear and credible business strategy which focuses upon their strengths and realistic markets.

In the two chapters that follow, two regionally-based Austrian banks outline their distinctive chosen strategies.

8. Overall assessment

As in many areas, fashion often plays a role in the evolution of bank strategies: decisions are often made on the basis of very limited evidence and simple assumptions about what is likely to be successful. There is a danger of a conventional wisdom emerging: that only large and highly diversified financial services firms will survive in the strongly competitive environment that will emerge in the next few years. This could be an illusion.

Technology is having the effect of increasing economies of scale in bank processes, and competitive pressures will force banks across Europe to find economies wherever they can. There will be a powerful strategic imperative to exploit economies of scale. However, our central theme is that there are many different ways of exploiting economies of scale (both internal and external) and being a large bank is only one way. This has immediate strategic relevance for regionally-based banks and other financial institutions.

Figure 1

A Strategy Matrix

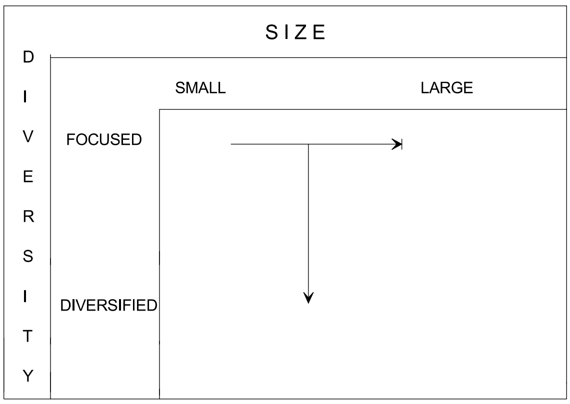


Figure 2

Technology & Economies of scale

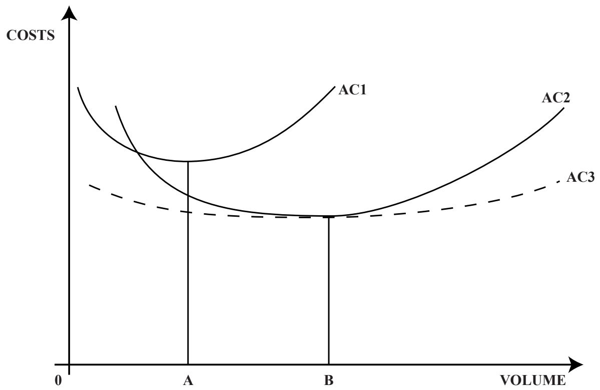
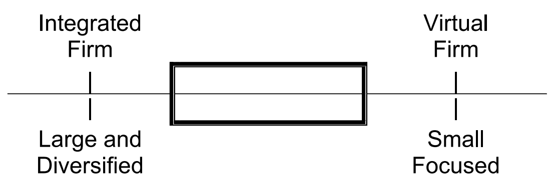


Figure 3

INSTITUTIONAL SPECTRUM



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WHAT FUTURE FOR REGIONAL BANKS ?

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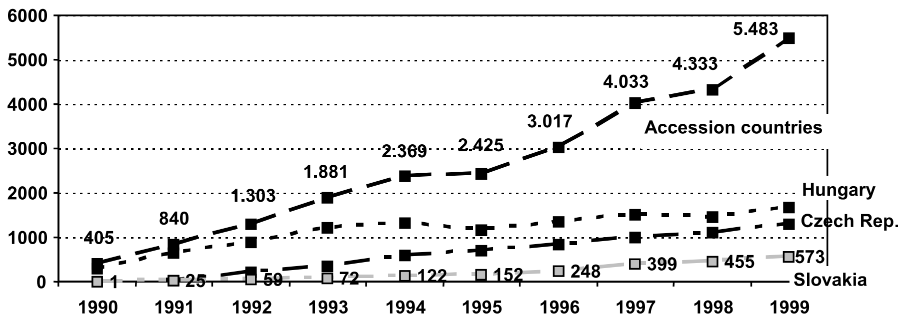
1. Klondike in Europe?

Five years ago, any bank pursuing a strategy of building a retail banking franchise in Central Europe was regarded by other bankers with a mixture of scepticism and scorn. However, times have changed radically: nowadays, it is almost a requirement of good retail banking strategy to have a foothold in the Central and Eastern European countries, or to be on the verge of acquiring such a foothold.

The ignorance still prevailing only a few years ago with regard to the economic, political and cultural situation in the Czech Republic, Slovakia, Hungary, Croatia and Slovenia has given way to what almost amounts to "gold rush" euphoria, reminiscent of the Klondike region of Canada at the end of the 19th century. This applies not only to the banking sector, but also to the automobile industry (for example Skoda or Audi), the beverage industry (Pernod Ricard and South African Breweries) and the telecommunications sector.

Central Europe has turned into a magnet for booming sectors of the economy: this trend can be seen by studying exports and/or direct investments. Such exports/investments, coming from enterprises operating out of the EU countries and directed into the Central European states, have increased dramatically during the past few years.

Development of Austrian direct investments in the years 1990-1999 (in millions of EUR)



Source: Oesterreichische Nationalbank (Austrian National Bank).

The burgeoning interest in Central Europe is not really surprising, considering that, at present, these countries constitute the only real growth market in Europe, and it lies right at the front door of the European Union.

The growth potential inherent in these countries can be deduced from a comparison with the situation in Spain, Portugal or Greece before and a few years after their accession to the Union. Not only the gross national product, but also other measures of growth and prosperity, notably investment activity in those countries as well as exports, have markedly increased or improved. With regard to the most important economic indicators, such as the rate of inflation or the interest rate, a convergence leading to stability within the region was noticeable even before accession.

Central Europe is a sizeable market – even before taking account of Poland, it has approximately 40 million inhabitants. However, it is not the proverbial land of milk and honey. Some areas of the law are in need of reform, the infrastructure only partly satisfies Western standards and the willingness to give service in the tertiary sector has not kept pace with recent development and is still more or less at the level maintained throughout Communist times.

Nonetheless, if one observes how quickly and professionally privatisations are often carried out and how quickly progress in restructuring and technological change is realized, it appears safe to assume that the implementation of the necessary reforms over the next few years will not present any serious problems.

2. Enlargement of the EU

From the point of view of Erste Bank, an enlargement of the European Union is more than a contribution to the political stability of the region. It would have far-reaching economic consequences – most of them advantageous. However, the development of a successful regional bank is not seriously hindered by political frontiers. It is obvious that synergies cannot be exploited as fully across political frontiers as they can be within a unified economic area, but this does not mean that political decisions are an obstacle to expansion.

3. No Pan-European retail bank so far

Retail banking, as we understand it, means a close relationship with customers in two respects: first, geographically, to be present locally near the customer by means of a network of branch offices and alternative distribution channels, and, secondly, to establish local decision-making systems which guarantee quick, customer oriented solutions, regarding loans for example.

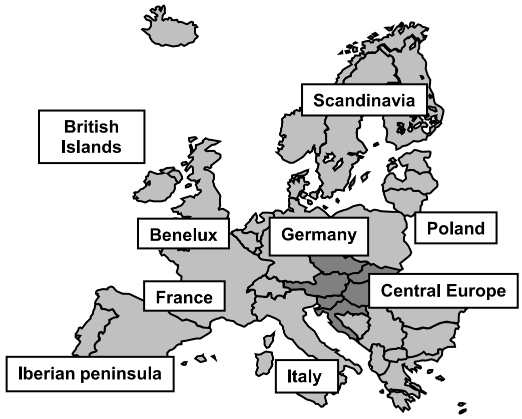
No one knows the structures and requirements of the local industries and retail customer segments better than the employees in branch offices. There is no doubt that adequate control mechanisms are necessary, but decisions regarding loans that are taken in financial centres far away only lead to an alienation from the customer and his needs. If this is regarded as a prerequisite for the successful implementation of a retail strategy, there will be no development leading to a retail bank active throughout all European countries. On the contrary: geographic proximity to the customer requires an easy-to-survey radius of activity, as well as a sufficient number of potential customers.

A study of the development of banking throughout the European countries over the past ten years confirms the above thesis. Several geographical regions have produced profitable retail banking over the past few years: Scandinavia, the British Isles and Ireland. The Iberian peninsula or Germany, taken by themselves, have evolved into large markets, as has France.

Central Europe, with 40 million plus inhabitants, depending on the geographical definition, clearly offers a large number of potential customers by any European standards. We believe this region has the potential to develop into a highly attractive market for retail banking activities.

Erste Bank’s extended home market in Central Europe represents a key new European retail banking region:

Erste Bank's extended home market in Central Europe – one of the key European retail banking regions



The expansion of a bank into Central Europe, a politically stable and economically booming region, leads, on the one hand, to a more favourable distribution of risk in markets showing different rates of economic development and, on the other hand, contributes to a heightened stability of the bank's economic development. While economies in Western Europe stagnate, and politicians are embroiled in futile discussions about the exact duration of the recession, economic research specialists are predicting growth rates of more than three percent for key Central European markets, including the Czech Republic, Slovakia, Poland, Hungary and Croatia. Admittedly, such expectations may be exaggerated, and I consider it likely that these predictions will be modified in the coming months. Nonetheless, the growth story is clear.

Selected economic data:

	GDP % growth		**C/A (% of GDP)**		**CPI %**	
	2001e	2002e	2001e	2002e	2001e	2002e
Czech Republic	3.0	3.5	(5.7)	(4.8)	4.4	4.0
Slovak Republic	3.2	4.0	(8.9)	(6.9)	7.2	4.4
Hungary	4.5	4.8	(3.5)	(3.2)	7.8	5.5
Croatia	4.0	3.5	(3.5)	(3.0)	4.8	4.5
Austria	1.3	1.9	(2.6)	(2.5)	2.6	1.9

Source: Erste Bank Macroeconomic Research Dept.

4. Erste Bank's strategic focus

The strategy of Erste Bank concentrates on business with mass market but good quality retail customers as well as small and medium-sized enterprises. From a geographical point of view, we limit ourselves to the region of Austria and the surrounding countries. These are the Czech Republic, Slovakia, Hungary, Croatia and Slovenia. These countries not only present us with a well-defined economic area with more than 40 million inhabitants, but are also a geographical entity of a size perfectly adapted to the structure of Erste Bank.

5. Customers as the basis for economic success

Western European customers are not, of course, comparable in every respect to those in Central Europe. However, enlargement will render companies active in this market highly interesting to investors looking for equities with a high earnings potential.

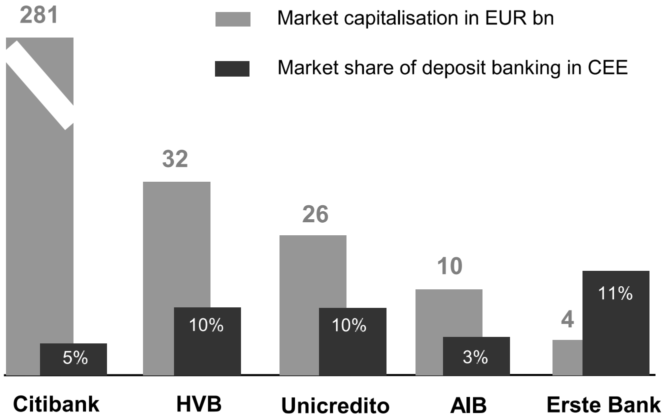
In the Central European region, the acquisition of the customers is more cost-effective than in Western Europe. Erste Bank paid approximately EUR 400 per customer, as compared to a price of EUR 4000 per customer commonly seen in Western Europe.

It is our opinion that, in this context, the key to success is the number of customers serviced by a financial institution. The larger the number of customers to which an institution has access, the stronger its position within the distribution of financial services.

The more customers an institution can boast, the more attractive it will be as a partner for other suppliers of financial services, who may not want to build up their own distribution network or for whom such an investment appears too expensive. An institution with a market share of between 15 and 20% will be a welcome partner for insurance companies and investment companies looking for access to this market. And, as in the grocery trade, any distributor with a sufficient number of customers will have the bargaining power to strongly influence the margins at which it sells third party products.

With the acquisition of the two savings banks in the Czech Republic and in Slovakia, Česká spořitelna and Slovenská sporiteľňa, Erste Bank now has more than ten million customers, the most comprehensive customer base in the region at present. Importantly, this has also given Erste Bank the largest share of deposits in the region. This also brings an advantage that is even more important for a retail bank, namely, access to inexpensive customer funds that will ultimately lead to a favourable refinancing basis on the asset side.

The Market Strength of Erste Bank in Central Europe [1]



[1] including Poland
Source: Bankscope and Goldman Sachs Research

Nowadays, retail banking in Central Europe is less a matter of spreading basic banking services than it would have been only a few years ago. At that time, the focus was still on the low percentage of the population owning a bank account or on the number of enterprises that still handed out their employees' wages in envelopes. In terms of bank account penetration, the Central European countries have caught up with amazing rapidity over the last few years, coming close to Western European standards almost everywhere.

A new world is opening up in Central European retail banking: nowadays, we are more concerned with the cross-selling of banking products.

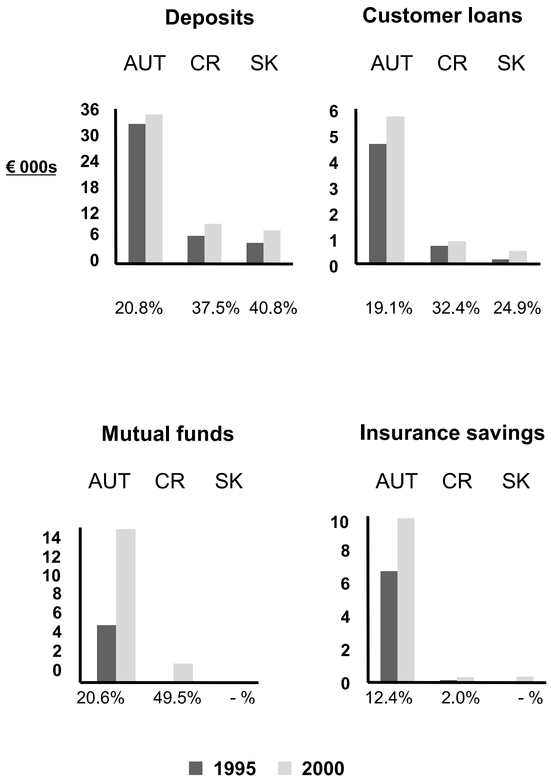
Range of products and distribution channels of Erste Bank

Branch offices		Financial advisor	Callcentre	Internet
Austria (A)	**1.135** [1]	√	√	√
Czech Republic (CZ)	**684**	√	√	√
Slovak Republic (SK)	**441**	-	-	√
Hungary (H)	**66**	-	√	-
Croatia (HR)	**107**	-	√	√

Note:
[1] Including the 863 branch offices of the Sparkassen (savings banks) group

Comparing the market penetration rates for certain key product areas in Central Europe and Austria gives an indication of the enormous growth potential. Drawing on data from the two leading retail banks in the Czech Republic and Slovakia, we find that the ratio of disposable incomes is approximately one to ten (Czech or Slovak relative to Austrian). However, one finds that Czechs still invest much less than their Austrian peers. While each Austrian citizen invests approximately EUR 12,000 of his available income into funds, the corresponding value in the Czech Republic, where Erste Bank subsidiary Česká spořitelna has a market share of almost 50% in the funds area, customers invest no more than approximately EUR 200. The upside potential for Erste Bank in the Czech market is clear, and the situation in Slovakia reveals a similar story.

Growth in financial assets per household[1]



NOTE:
[1] Erste Bank market share
Based on 2000 Financials and market statistics

6. The right moment

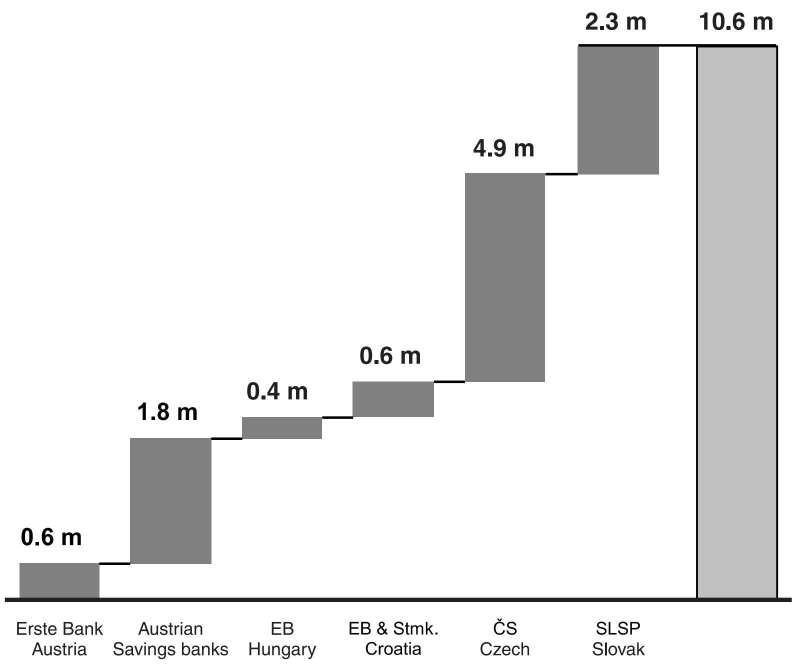
In accessing an emerging market, the question of timing is, of course, always fundamental. In Central Europe, it seems the most important markets – that are, from our point of view, the countries with the largest populations – have already been captured and divided up among the various competitors. A shifting of market shares is only expected in Hungary and Croatia. The privatisation of the large banking firms has been completed in all countries.

As in Western Europe, the three largest market participants in Poland, the Czech Republic and Slovakia, together with their subsidiaries, account for more than 50% of the market. In Hungary and Croatia, a further consolidation step is expected in the next few years that will offer new opportunities to acquire market share. Here, some foreign investors are withdrawing because they are realising that market shares of less than 10% do not constitute investments with long-term profit potential. This means that regional banks of varying financial soundness will be for sale.

In our opinion, retail banking can only be carried on successfully in those economies that have reached a certain level of economic development in terms of average income or per-capita assets. In other economies, investments are too risky or the chances of profit are insignificant, owing to a lack of purchasing power.

Erste Bank succeeded in positioning itself early as one of the leading retail banks within the region. This is true not only with regard to the market shares in important product segments, but also with regard to access to the customer groups that are important for retail banking. We are not late comers, but rather frontrunners in retail banking in the region. We are among the few banks that have succeeded in building up a customer base wide enough to enable us to recoup our investments in the various distribution channels.

Number of customers of Erste Bank in Central Europe



7. Uniform market for customers and employees

An integral component of Erste Bank's expansion into Central Europe is the creation of a uniform geographic market for both customers and employees. This strongly distinguishes our strategy from that of our competitors.

Our focus on a tightly well defined geographic region is expected to pay dividends. For example, Vienna is only about 50 minutes drive by car from the Slovakian capital, Bratislava, with Prague and Budapest less than 4 hours away. Austria is a popular holiday region for Hungarians and Czechs (and not just during the ski season!), and the Croatian coast is also high on the list of favourite holiday destinations of the Central Europeans. The situation is considerably more challenging for financial institutions whose markets are divided by greater distances.

We see key strategic advantages coming from a uniform IT-system, for example enabling the travelling customer to print bank statements in the required language in all branch offices across the region, or to carry out banking transactions in all the branch offices.

In particular, we believe our employees profit from the attractions of a uniform market. Leaving aside for the moment any potential language or skills barriers, it should be no problem to move from one subsidiary of the group to another. An employee of our Slovak investment company will be able to move to an office in Austria or in the Czech Republic, just as a cultural enthusiast working in our Hungarian operation might be able to carry out his job as a customer advisor in festival towns like Salzburg, Vienna, Bregenz or Prague for a few years. These are not utopian ideals: We are well on our way to making this a way of doing business in the Erste Bank Group!

THE STRATEGY OF RZB IN CENTRAL AND EASTERN EUROPE

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1. The development of the banking industry in CEE

It is obvious that with the dramatic political changes beginning in 1989 also the individual economies of the countries in transformation changed drastically. As was the case with the real sector, the finance sector, and the banking industry as the major part of it in these countries, had different ways of adaptation to choose from.

During the central-planning system, the banking sector was doing little more than allocating funds to the various sectors and companies according to the authorities' decisions. Consequently, at the time the transformation process began, the banking sector was characterized by parameters such as:

- Competition practically zero;
- Lack of customer orientation;
- Low degree of management know-how and insufficient technical equipment;
- and last, but by no means least: a very poorly developed loan-culture and risk-awareness.

These features describe not only the desperate state the banking industry was in at that time, they also were perfect reasons for RZB to start working there and build up banks to do things better.

The first step in all transition countries was breaking up the monopolistic, single-tier banking systems. Central banks were established and state-owned commercial banks were split off, on a functional and partly also on a regional basis. Sectored restrictions on specialized banks were lifted and private banks admitted. Banks were allowed to conduct business freely, interest rates liberalised and foreign banks were granted access to the local markets – in short, the environment for "normal" banking business was designed.

The second step was the consolidation and actual bank privatisation, and there, the approaches differed substantially. Countries having started to privatise early were far more successful than the latecomers (e.g. Hungary vs. Slovakia). Also, the selling of substantial stakes to foreign investors has proved to be better for the banks and the economy than privatising broadly via coupons. Furthermore, a very important precondition for a successful privatisation process was the implementation of a modern legal framework.

It is self-explanatory that banks expanding their business from their home-countries to foreign ones do this with one paramount reason: to earn money, to see a good return on their investment. The signposts on the road to that ultimate goal are labelled "higher margins", "less predatory competition" and "larger markets", to name just a few of them. But entering a foreign market is also beneficial for this market's financial community and its economy as a whole, irrespective how this is achieved, by acquisition or "green-field"-projects:

- Only foreign ownership puts a break on strong political pressure.
- Only foreign ownership introduces a new way of banking and consequently competition as the driving force for restructuring and productivity increase. Competition promotes efficiency by ensuring that prices are set at competitive levels.
- Foreign ownership provides access to capital and international distribution channels and to state-of-the-art technology. Raiffeisen Bank Hungary, e.g., has introduced the country's first electronic banking products in CEE as early as 1991. Tatra banka, RZB's subsidiary in Slovakia, was among the first banks in CEE to offer Internet-banking as early as 1997 and has kept this leading edge position by constantly bringing new products online.
- Foreign ownership brings the required know-how and best practice, especially in management and risk management.
- Foreign ownership introduces product marketing, new sales channels and a dynamic extension of the product portfolio.
- Foreign ownership has sizeable macroeconomic effects in medicating current account deficit problems and in stimulating further inflow of foreign direct investments (FDI). Experience shows that the earlier current account deficit problems surfaced, the sooner the countries opted for revenue-generating models of privatisation and FDI-friendly policies.

In a nutshell, the presence of international banks is clearly for the hosting country's benefit. International banks serve as gateway to foreign investors, introduce new products, increase competition and bring in know-how and capital. The other banks have to adjust and improve their services and performance accordingly. Not only customers benefit from it, the finance sector as a whole gains. And only a sound finance industry can secure a sustainable economic development.

2. The strategy of RZB in CEE

To understand RZB reasons for “going east” better, we have to look at the situation at the beginning of the transition process.

- Austria has traditionally maintained close trade links with Central and Eastern Europe – also during the Communist era (around ten per cent of its trade volume). For more than 30 years, one of RZB’s key activities was to assist Austrian exporting companies on these markets.

- As outlined above, the region was under-banked and under-serviced – and the finance industry was characterized by low customer orientation.

- At the same time, an over-banked market, where shakeouts and market realignments hardly happened due to the large share of government-owned banks, characterized Austria’s banking industry.

Then, practically from one day to the other, things changed in 1989 with the fall of the Iron Curtain.

RZB considered this as a unique chance to change its profile by its own strength, to develop from an Austrian niche-player to a well-recognized CEE-specialist within a short period of time. Also, RZB saw the chance to participate in the growth of the newly emerging markets by creating its own network of banks. They in turn branched out in their respective local markets to have access to new market and customer segments.

The most important pillars of RZB’s strategy are the following:

- Wherever Raiffeisen goes, it stays for good. For RZB, CEE is a long-term commitment. RZB has never withdrawn, not even in times of crises, just the opposite: In the wake of the Russian financial crisis in 1998, RZB was the first bank to recapitalize its subsidiary in Moscow, underpinning its firm commitment to the country and the whole region.

- RZB has always preferred start-ups to acquisitions. In doing so, RZB has risk control from the very first moment and avoids the often tedious and expensive process of acquiring an existing local bank from the state and/or numerous other shareholders and then having to shape and reshape it according to its own high standards.

- When acquiring existing banks – which happened for the first time in 2000 with Bosnia and Herzegovina's Market banka – RZB follows clear entrepreneurial principles. Market banka (Raiffeisen Bank d.d. Bosna i Hercegovina as of fall 2000) was already rated the best bank of the country even before its integration into the RZB Group and provided an easy entry into this market, which in turn was and is a valuable part of RZB's network in CEE. In 2001, Hrvatska Postanska Banka in the Herzegovina and Banca Agricola in Romania were bought, both complementing the countries' respective Raiffeisen Banks ideally, above all regarding the retail business. In 2002, RZB purchased more than 97 per cent of Krekova Banka in Slovenia. This was the first time when RZB acquired a banking operation in a country where it was not running a bank yet. Even though this acquisition was of significant importance for RZB's activities in Slovenia it went completely in line with one of its major principles: to offer only prices which reflect the real economic value of a bank. Apart from attractive pricing the previous private shareholders of the bank (which in the meantime was renamed Raiffeisen Krekova Banka) were convinced that RZB is an ideal new owner because both banks share similar corporate values and a similar historic background.

- At the same time, RZB trusts in local experience. Local managers predominantly run all of its banks. It is obvious that they know the market best, their experience increased by assignments with international banks abroad and locally.

- RZB usually started with corporate banking and has then gradually completed its product range to offer universal financial services throughout the region today, ranging from corporate to private banking, from investment banking to leasing, from M&A to private equity management.

- RZB adds more to the benefits of international banks outlined earlier: It not only invests substantially to start its operations, RZB's subsidiary banks also regularly reinvest the profits in the country where they originate. Thereby the basis for further organic expansion and more local jobs is laid.

- With this philosophy, RZB's network in CEE has grown dynamically under its own steam – and keeps growing. It currently covers eleven countries, offering more than 11,000 jobs throughout its banking network of currently some 550 outlets.

The result of the efforts during the past 15 years, RZB's current status, is more than satisfying: RZB is the leading international bank according to all relevant parameters, discounting sheer size.

❍ Earning power: RZB showed in Central and Eastern Europe a Return on Equity ratio in the two-digits range, exceeding several times the 20 per cent landmark, during the last decade (with the exception of 1998, the year of the Russian financial crisis).

❍ Quality: RZB Group received for its engagement in Central and Eastern Europe more than 70 international awards. For example RZB Group was awarded in September 2001 the title "Bank of the Year in Central and Eastern Europe" by the magazine The Banker and in spring 2002, Global Finance chose it for the second consecutive time as "Best Bank in Central and Eastern Europe and Central Asia".

❍ Implementation of new technologies: As outlined before (electronic banking, internet banking) RZB Group is a pioneer regarding the introduction of new technologies. It claims this innovative power for the group and constantly works on new customer-oriented solutions.

❍ Structure: RZB's core is an organically grown network, not purchased and merged like its competitors' groups.

The outlook for RZB's business is promising. The enlargement of the European Union is not a matter of "if" anymore, just one of "when", and it will bring numerous opportunities along, for the respective countries' economies as a whole, for the financial sectors in particular and for RZB especially.

3. Opportunities of the EU-enlargement

RZB is absolutely in favour of the enlargement process, having anticipated it with the consequent expansion of its network banks. The following theses, with a special emphasis on the banking sector, will support this positive attitude.

1. Austria has profited over-proportionally both from the opening of the CEE-markets and from the start of the accession-process.

According to the *Austrian Institute of Economic Research (WIFO)*, Austria's GDP has grown by 3.6 per cent due to the opening of the CEE-markets alone between 1989 and 1997, with 57,000 new jobs having been created. Austrian exports to CEE have more than tripled within the decade following the fall of the Iron Curtain; to the CEEC-4 (Hungary, Czech Republic, Slovakia and Poland) we even saw a 4.5-fold increase. Currently, approximately 16 per cent of all exports go east, with an upward trend. Exports have grown faster than imports, resulting in a positive trade balance that helps compensating the deficit with other countries. Quite contrary to the often-stated argument that CEE-made products will replace Austrian goods, growing exports to these countries had and still have a stimulating result on our economy.

2. The EU-enlargement process not only already led to a significantly faster change-process in the respective CEE-countries and to an economic upswing in neighbouring EU-countries like Austria and Germany. In all, it will be beneficial for the EU-15 countries, too.

The economic advantages will be much higher than the costs (estimated at 60 billion Euro for the first four years after the accession of the first five new members, i.e. 0.18 per cent of the GDP of the EU-15). This of course applies especially for the neighbouring countries. Due to Austria's historical ties to the region, it will profit over-proportionally from the enlargement. High investment needs and growing income will even increase these markets' attractiveness to many sectors of our industry. On the other hand, other EU-countries, the "net-receivers", face reduced payments out of structural and agricultural funds.

3. The candidates' economies will grow over-proportionally compared with Western Europe in the next 10 to 15 years.

The results of a study of accession scenarios (Janos Gács, 1999) indicate a strong pick up of domestic demand, based on a boom in FDIs and inflows from structural funds. Domestic demand and FDIs are expected to be the driving forces for GDP growth in CEE.

From the perspective of a bank, not only the GDP-growth rates in general are encouraging, but specifically the potential of the financial markets, as compared with the situation we face in Austria and the EU, respectively. Indices like "banks' assets to GDP", "loans to GDP" and "deposits to GDP" show this potential clearly. The development of financial markets within the candidate countries as a result of enlargement dynamics will be an enormous asset for European business. Capital markets under EU regulations will expand and are expected to attract even more foreign capital, thereby increasing the potential for banks even more.

4. The process of catching up will lead to a sustained growth in demand for banking products, not only in the corporate field, but also increasingly in retail banking.

The countries of CEE have an enormous need to pull through – or better, to start – restructuring and infrastructure projects, with the dire need to be financed. Apart from this segment, retail banking is widely underdeveloped and will become much more interesting in the coming years, with personal income rising. Relative to Western Europe, retail lending is still in its infancy, showing ample room for growth in CEE.

Retail lending per capita throughout CEE varies between 0 and 330 USD, compared with Austria's 6,850 USD. Medium and long-term projections expect growth rates of up to 15 per cent p.a. Retail deposits per capita in CEE vary between 100 and 3,000 USD, in Austria the corresponding figure is 16,000 USD. Growth rates of about 10 per cent p.a. are expected in the long term for this business sector.

RZB's strategy regarding retail banking is to target primarily high-income individuals, a market of currently seven to eight million persons in the region, forecast to double within the next five to ten years due to the improvement of economic circumstances. This includes self-employed persons like solicitors and doctors. RZB decided to approach a broader customer base on a country-by-country basis, depending on the local environment.

5. Western banks in CEE will show an over-proportional growth.

This growth will not be driven by excessive competition (predatory competition and/or creation of needs), but rather by unsaturated natural demand combined with a vivid market-growth, as opposed to Western Europe. Austrian banks will have a leading market position, due to their largely early market-entries. In particular, this will apply to RZB. With its strong position all over the region, a network of some 550 outlets with a presence in locations no other Austrian or international bank is active, RZB always was and still is perfectly prepared for this development.

6. Networking will become increasingly important.

Globalisation, increasing foreign direct investments in CEE, freedom of establishment all over a growing EU, all this will increase the attraction of the "Network-approach". Corporate customers prefer banks that are active wherever they do their business, wherever they have their own locations and wherever their customers are. In the EU, the enlargement-candidates and in the rest of CEE – although in the long run, they all will be candidates. This further substantiates the last thesis, RZB's perfect positioning for the customers of tomorrow. RZB has noticed this trend already some years ago and has built the necessary infrastructure, above all regarding technology and human resources.

7. Technological infrastructure will become an ever growing success factor

Typically for the development of Emerging Markets, the markets of CEE have already in the past ten years skipped outdated technologies and instead concentrated intensively on the utilization of new ones. For instance, there was practically no business involving bills of exchange and cheques, instead electronic and Internet banking were developed rapidly. It can be expected that this trend will continue and also lead to different behaviour of private individuals and corporations doing their business.

Technological leaders as the RZB Group will take advantage of this development – as shown by Tatra banka for example, offering "b-mail", which informs clients about events on their accounts by SMS (or e-mail). This service generates up to four per cent of the total SMS volume in Slovakia. About 15 per cent of Tatra banka's retail clients' payments are generated by

Internet banking. This is much more than in Austria. In Austria's Raiffeisen Banking Group, the share of retail customers using the net for all kind of banking purposes (including account enquiries etc.) is roughly ten per cent.

8. The physical distribution of the Euro

The introduction of the Euro is expected to have a positive impact on the economies of CEE. The Euro is already the reference currency in the candidate countries, the current exception being Poland, Romania, Lithuania and Latvia, and they also will orientate their currencies stronger to our common currency. The Euro will have positive effects as an anchor of stability for the countries economies and financial markets (reduced inflation and risk-premium). It will also lead to restructuring and rationalization measures (comparable with Austria's hard currency-policy and peg to the DEM, preventing monetary measures like devaluation, but making necessary structural measures instead). After accession to the EU it is expected that the new member-states will quickly join the *European Currency System II*, which is a pre-condition for the monetary union and provides for a fixed peg with a bandwidth of +/– 15 per cent.

4. Concluding remarks

- Enlargement is a win-win situation, economies in East and West will profit from the enlargement. Not every single country of the current member states and not every single sector of their individual economies will be among the "winners". However, the economic advantages will be widely spread among them, while the disadvantages will be concentrated on a few sectors (e.g. agriculture, low-pay industries). The economies in CEE will continue to grow, both due to "home-made" growth and to effects in connection with the enlargement and its anticipation.

- The accession of all candidate countries will provide an additional customer base of some 170 million. The advantages of a larger market will be enhanced by the fact that the economies of the candidate countries are widely complementary to EU economies. Therefore, the potential to increase production levels and achieve economies of scale and higher productivity for European producers will increase with accession.

- Enlargement brings reforms to the candidate countries and demands reforms in the "old" EU. It is the greatest incentive for the political reform process in the CEE region – as it used to be for Western European accession countries just a couple of years ago. Structural reforms within the EU are highly demanded. The further development of the Union and its institutions and the enhancement of decision-making procedures are necessary preconditions for the success of the future enlargement.

- The process of catching up with unfulfilled demands on the consumer side and with growing local investments into production capacity will inevitably lead to an over-proportional increase in banking business.

- The finance-industry in CEE is well prepared for the enlargement. This is clearly due to the presence of Western banks: directly through the acquisition of privatised banks or the foundation of subsidiary institutions, indirectly through the higher level of competition for the customer they have introduced. RZB's strategy to build up local banking networks throughout the region, and beat the competition by going in earlier than anybody else in most of the markets, has been validated by the developments of the last years.

- From the economic point of view, the enlargement has already happened to a large extent. Data from the last ten years prove that there are only few things left, when it comes to completing transition and enlargement, among them political hurdles and a lack of European vision.

- More than a decade after the fall of the Iron Curtain and the Berlin Wall we should not let our views be obstructed by mental walls. Our vision, our mission should be: economical enlargement is done, for all our best – let us do the rest!

THE CHALLENGES AND CHANCES OF REGIONAL EXCHANGES

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1. Introduction

The last decade has seen a long-lasting boom on stock markets, especially in the US, which has led to a problematic development for a number of small regional markets with respect to their function as a source for raising capital:

The large stock markets experienced a surge in the liquidity volumes of large institutional investors, especially of US pension funds, which soon led to the concentration on a few liquid stocks with relatively high levels of capitalization. In Germany alone, for example, about 85% of the trading volume is in the 30 DAX stocks. The phenomenon of the passive index management strategy pursued by large funds with their year-long practice of asset allocation according to the regional and sector weightings of a few international index systems (such as the MSCI, Stoxx 50, etc.) augmented the global concentration on investments in a few hundred, mainly Anglo-American stocks.

At the same time, the outflow of capital from European regional markets that had high concentrations of small caps and mid caps accelerated, affecting precisely markets like the Austrian capital market.

Even after the collapse of the new economy boom (in 2001: Neuer Markt –60.10%, NASDAQ Europe –64.15%, NASDAQ USA –24.54%) several hundred massively overvalued stocks stood in stark contrast to thousands of undervalued stocks.

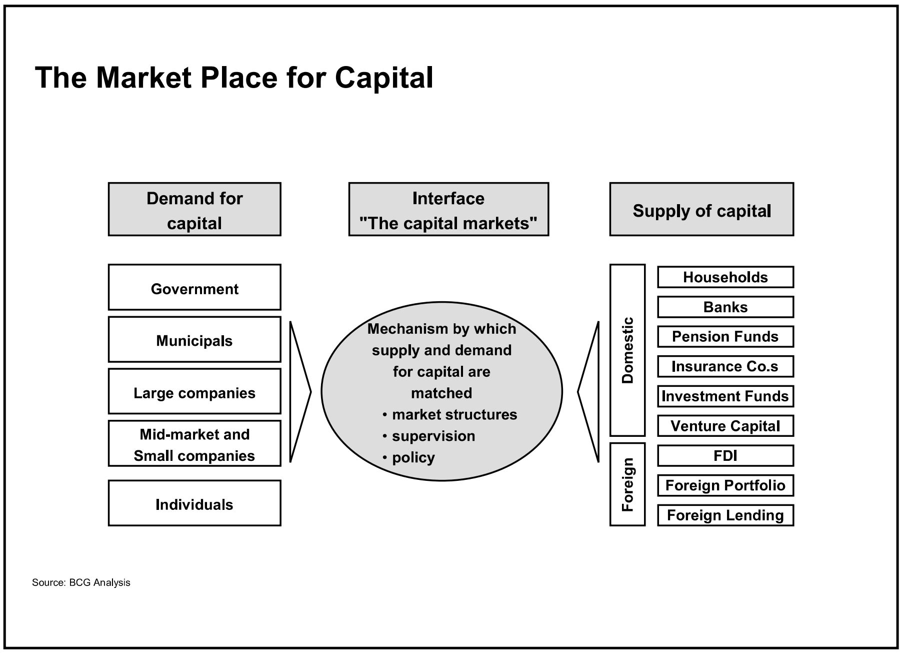
The significant function of (regional) capital markets for the economy and for local policy goals, growth and employment is thus at high risk: this is precisely where the challenges and chances lie for the further development of efficient regional stock markets such as Wiener Börse and the Austrian capital market. In the following, I am going to investigate whether or not the growing trend of consolidation and concentration among international exchanges invariably leads to the dissolution of regional exchanges, especially national stock exchange systems and what alternative strategies are feasible, using the example of Austrian capital market as a model.

Starting out from a general discussion of the major international benchmarks for capital markets and stock exchanges, and the scenarios of how stock exchanges are responding to the current challenges, especially within Europe, I will focus on the starting situation and development possibilities of Wiener Börse as a regional and national stock market.

2. International developments in the stock market environment

2.1 Benchmarking capital markets

Efficient capital markets form the optimal interface between supply and demand for capital:



At the same time, they also make a crucial contribution to wealth creation and corporate government improvement:

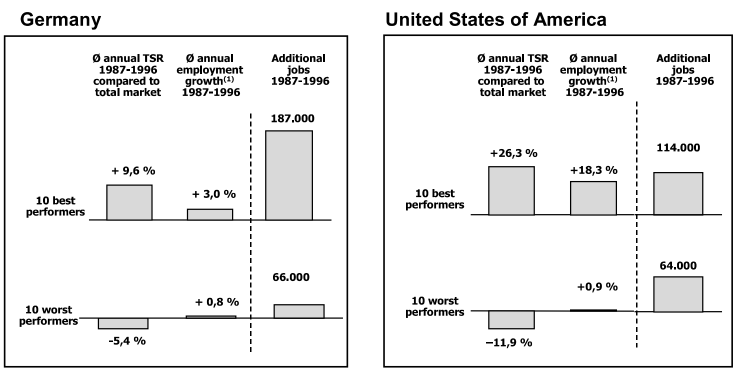
Wealth Creation as well as Corporate Improvements

… Driven by Developed Capital Markets

- ► Long term opportunities for investors to diversify risks and increase returns
- ► Improvement of corporate governance
- ► Companies have increased access to risk capital and more flexible financing choices
- ► New sources of capital based on increased foreign investments
- ► Increased entrepreneurial behaviour

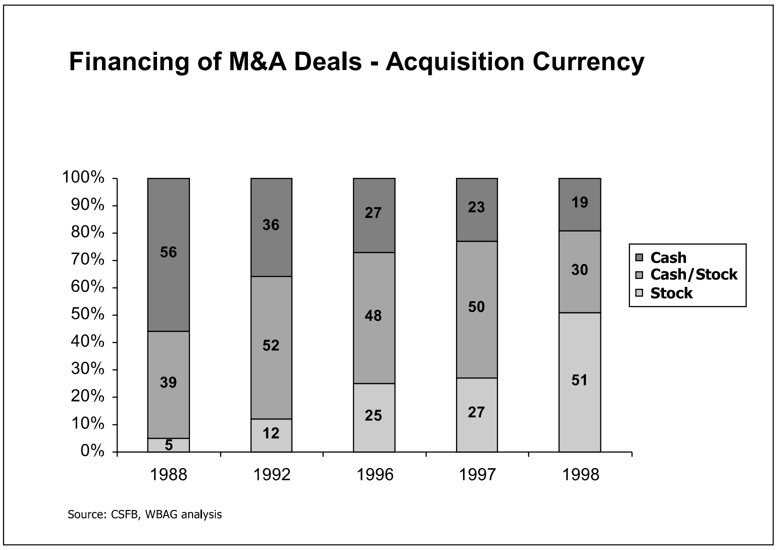
Studies in Germany and the US prove that listed companies with the option of raising capital externally also make a major contribution to the development of the labor market:

Top Performers as Employment Drivers



Source: Datastream; BCG Top Performer Study; BCG analysis; (1) Including acquisitions

Financing of takeover deals is increasingly being done through the exchange of shares – the company with the "stronger" shares often has an advantage over a company of equal value without an adequate exchange listing:



A breakdown by market infrastructure, exchange systems, investors, issuers and financial intermediaries shows the main factors in the ranking of successful European stock markets:

Infrastructure of capital markets

- ❑ The existence of an independent <u>supervisory body</u> with comprehensive and far-reaching powers of intervention and control to prevent market abuse (insider trading, frontrunning, non-disclosure of important company news, etc.).

- ❑ The existence of an independent <u>takeover commission</u> with far-reaching powers of decision in the case of takeovers of listed companies.

- ❑ EU compliant legislation for all aspects of the legal framework of the capital market.

The work in this area will be finalized by 2005 – according to the intentions of the Commission – and will include more or less harmonized rules and regulations for the admission to listing, listing prospectuses and supervisory tasks. I hope that these efforts will not create hypertrophic central authorities, but efficient, optimally harmonized decentralized systems, which will be especially important for the improvement of the framework for the development of regional capital markets.

Stock exchange structure

- ❑ The use of <u>state-of-the art trading und clearing systems with optimized cost structures embedded in international networks and</u> operating in a closely knit and coherent value chain.

- ❑ A market <u>segmentation</u> according to criteria relating to issuer quality (disclosure practice, free float, reporting practice, etc.) and which is easy to understand and use.

- ❑ <u>Attractive range of products on the cash and derivative markets</u>

- ❑ <u>Transparency for all market participants</u>

- ❑ The highest possible <u>market capitalization</u> and a higher free float to achieve:

  - ❍ <u>optimal liquidity</u>

  - ❍ <u>highest possible number</u> of efficient <u>market participants</u> who are optimally equipped

Investors

- ❑ Growing significance of investor protection to prevent violations by intermediaries (dealers) and issuers.

- ❑ Massive increase in the <u>investment volumes of retail and institutional clients</u>. It is precisely this trend that runs against the expansion of investment opportunities and also contributes to the current phenomenon of the overvaluation of few investment instruments.

- ❑ Beside higher investor protection standards, market transparency will play an increasingly important role as a benchmark.

Issuers

- ❑ A stronger focus on shareholder value
- ❑ Ad hoc disclosure of price-sensitive information
- ❑ Use of corporate governance rules modeled after the Anglo-American system
- ❑ More active investor relations
- ❑ More need for new opportunities to raise capital through capital markets (cf. Basel II)

Financial intermediaries/trading participants

- ❑ Liquidity providers and market makers will play an increasingly important role for maintaining markets with high trading volumes. Trading systems without market making commitments are at a disadvantage even now.
- ❑ Direct distribution channels to end customers – especially via efficient brokerage platforms for retail customers and institutional investors trading directly.
- ❑ The higher degree of transparency in markets and the easy comparability due to the euro will increase the pressure to install an optimized fee structure.
- ❑ More competition through trading volumes.

2.2 Capital market trends in the EU

Currently, there are about 30 national – and within states also smaller regional – stock exchanges in Europe that operate about 14 different trading systems. Clearing and settlement is carried out through some 20 different national institutions. Only two of these institutions are focused on international markets or are investing efforts in supranational activities (Clearstream and Euroclear).

Fragmentation and inefficiency are features of today's European stock market landscape

- ► Over 30 traditional national exchanges for stock trading
- ► 12 different trading systems
- ► 20 clearing & settlement institutions

According to a study by Accenture, European stock exchanges (over 30 traditional exchanges) can be grouped into a few leading exchanges (a center field group) and many small niche exchanges with low market shares.

The consolidation that had been expected in Europe for a while now and was believed to result in two central exchanges at most within the next few years has become much less likely than at the time the first 3 to 4 large alliances with differing structures were formed (full merger and use of joint platform, keeping regional independence). Even now, there are signs of group formations:

Alliances in Europe

Only two stock exchange alliances are operative

Euronext
- ► Belgium (BSX)
- ► France (SBF)
- ► Netherlands (AEX)
- ► United Kingdom (LIFFE) – in process
- ► Luxembourg
- ► Portugal

Norex – Nordic Exchange Alliance
- ► Sweden (OM)
- ► Denmark (CSE)
- ► Norway (OSE)
- ► Iceland (ISE)

XETRA-Group
- ► Germany
- ► Austria
- ► Ireland

EUREX (derivatives exchange)
- ► Germany
- ► Switzerland
- ► (Finland)

NEWEX
- ► Germany
- ► Austria

According to the study cited above by Accenture, 70% of all experts interviewed expect to see a common path towards consolidation as regards trading platforms and clearing and settlement institutions.

It is precisely in the area of clearing and settlement that the consolidation pressure to create a more competitive European approach vis-à-vis the US markets is much stronger than in the area of trading systems. The large European stock exchanges that use systems like XETRA and the trading platforms EURONEXT, VIRT-X and OM group already have strong market positions. There is an enormous improvement potential in closing the value chain within the stock markets (from trading to clearing) and within the context of European integration and consolidation of clearing and settlement systems.

Stock exchanges will respond to all these challenges by creating sets of measures of which the main ones are listed below:

Exchange Reactions to Industry Trends I

Binding of Issuers

- ► Implementation of new segments (e.g. Star Segment)
- ► Increased service level (IR support)

Binding of Institutional and Retail Investors

- ► Decline of trading fees
- ► Special programs and services for investors
- ► Increased transparency
- ► Shift to higher level of investor protection through stricter reporting requirements for issuers
- ► Introduction of corporate governance rating
- ► Increased marketing
- ► Special education programs

Exchange Reactions to Industry Trends II

Outsourcing or Leveraging of IT Development

- ► IT outsourcing (e.g. Dublin, Vienna, Helsinki)
- ► Facility management (e.g. DB, OM, SBF)

Product Diversification

- ► Regional offshore markets (e.g. EAGAK, Newex)
- ► New products (e.g. energy, ETF,…)
- ► Value added services (e.g. IT, training, consulting)

Value Chain Integration

- ► Integrated Value Chain – from Exchange to CSD (e.g. DB, Euronext)

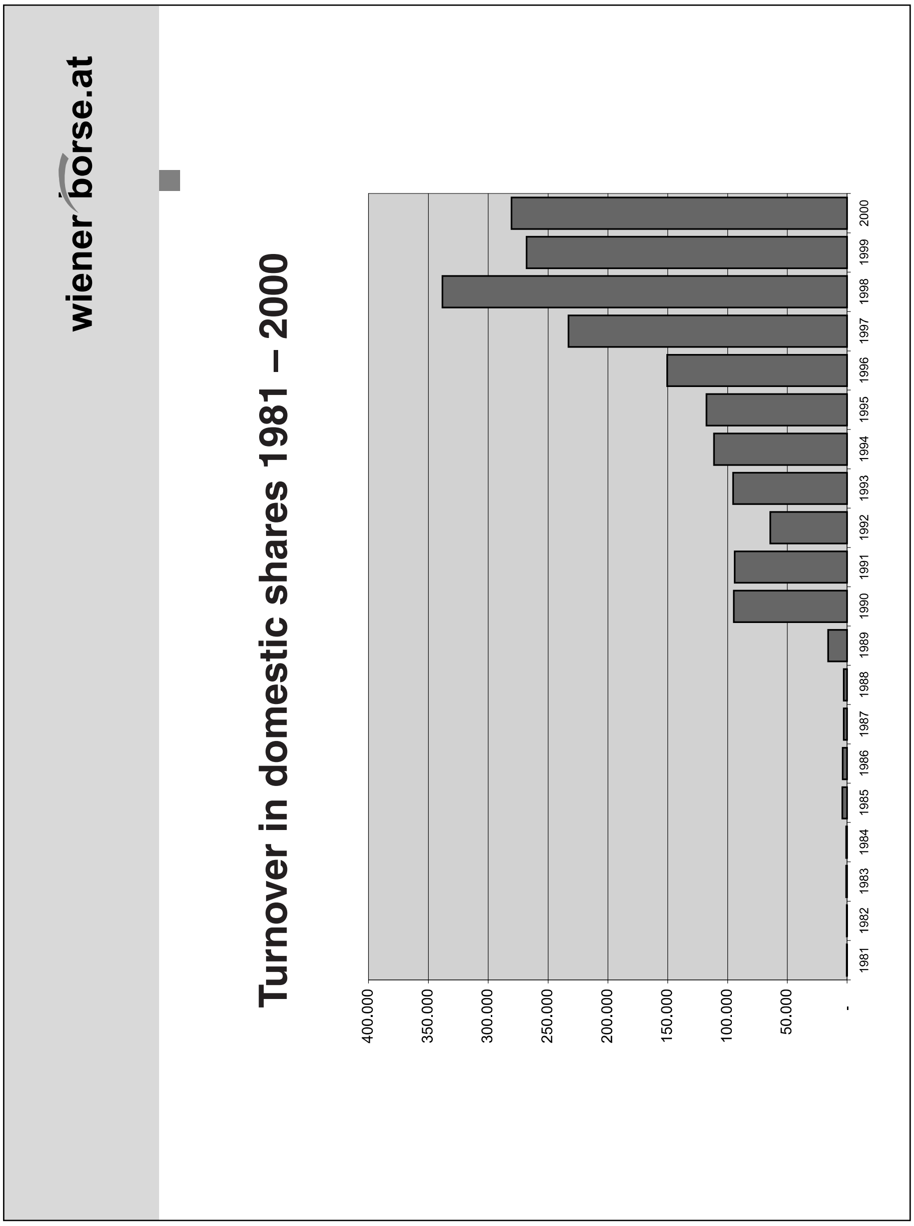
Growing Trend to Alliances – Two Main Forms

- ► Mergers (e.g. Euronext)
- ► Loose form of alliance (e.g. Norex)

3. Developments on the Austrian capital market

3.1 Starting situation

Bonds, which have always dominated the Austrian capital market, especially those issued by the public sector and banks, were supplemented by equity issues only as late as at the end of the 1980s, when a timid revival of stock issues and stock trading on Wiener Börse took place after a break of actually 70 years. The trading volumes and market capitalization in equities started to grow on Wiener Börse only as of 1987, especially due to the privatisation of formerly state-owned companies and a few private IPOs.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Turnover in domestic shares 1981 – 2000
400.000
350.000
300.000
250.000
200.000
150.000
100.000
50.000
-
1981
1982
1983
1984
1985
1986
1987
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1996
1997
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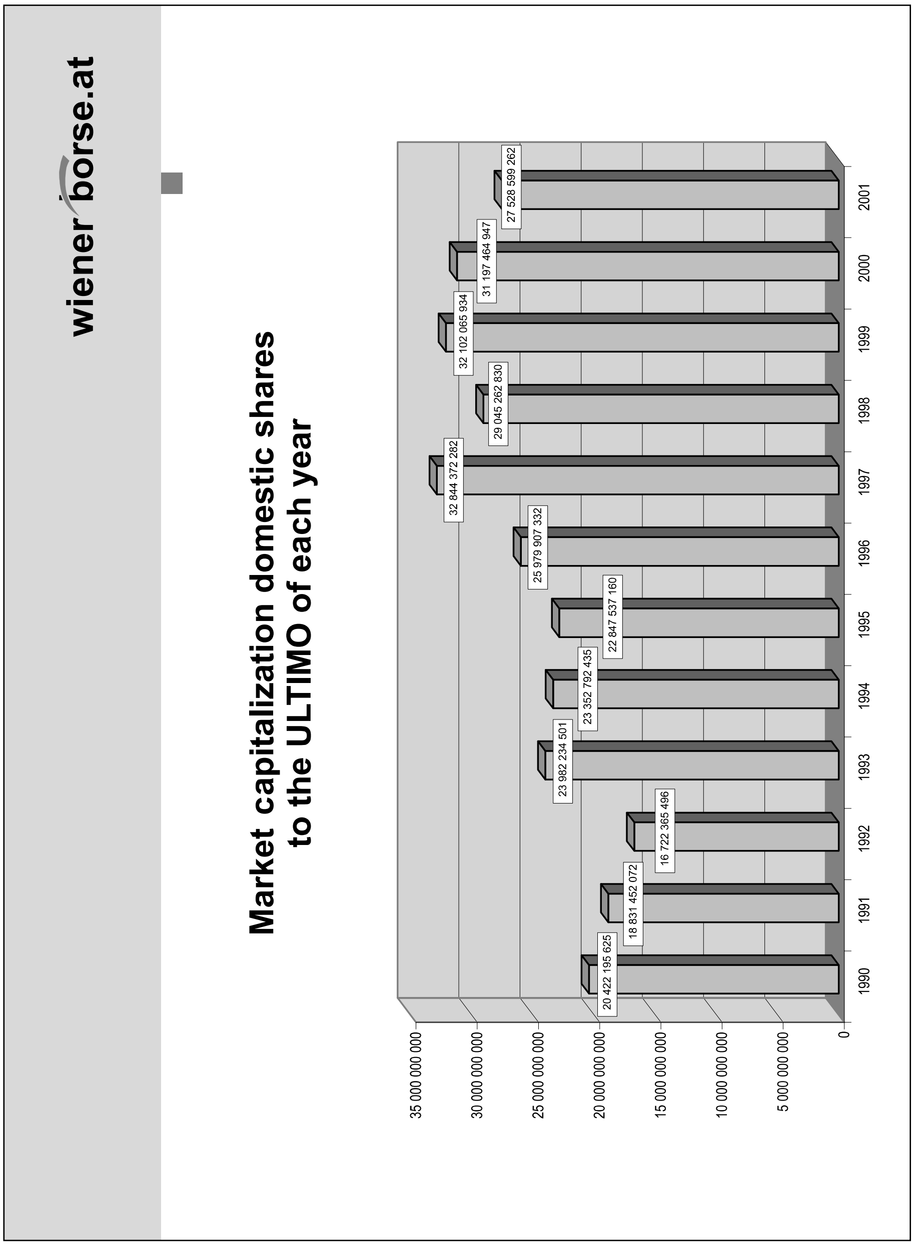
2000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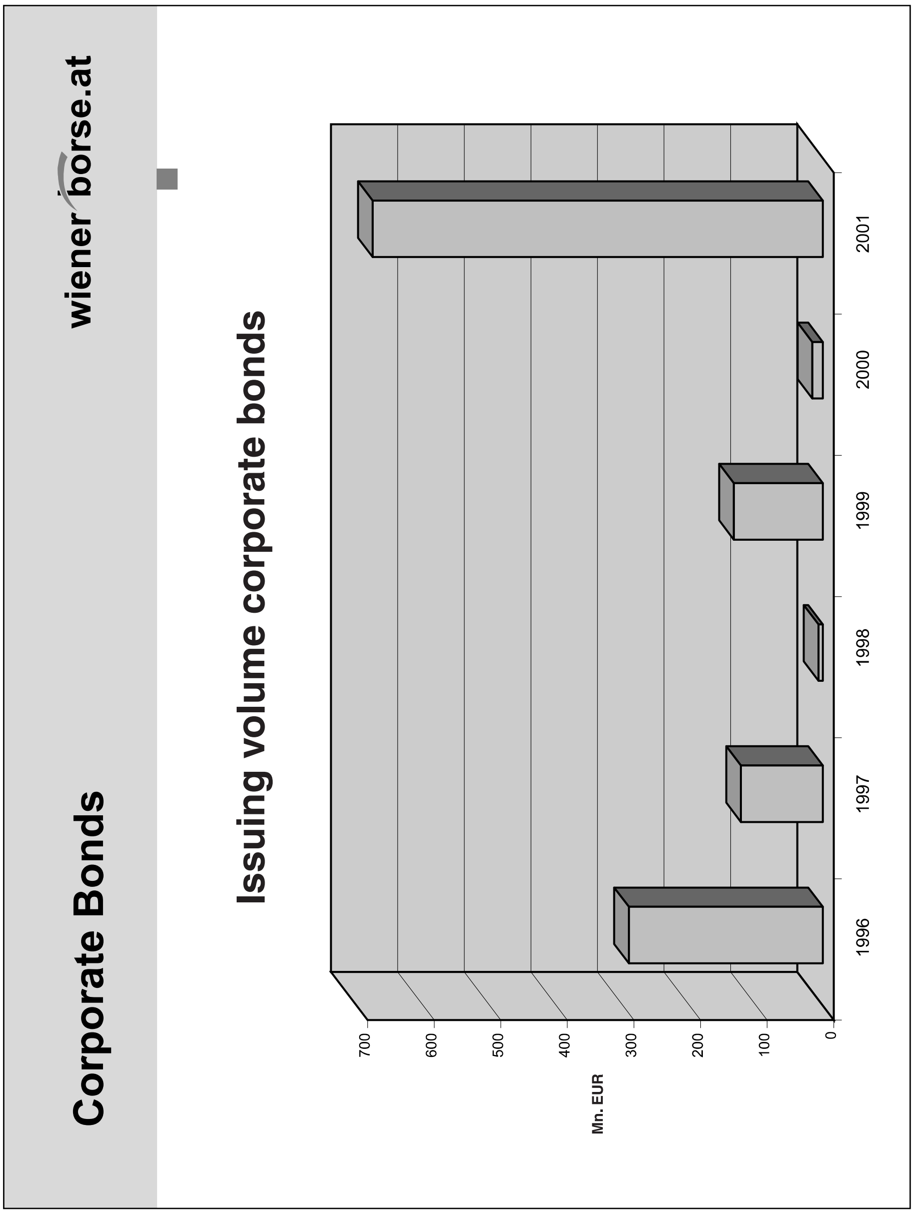
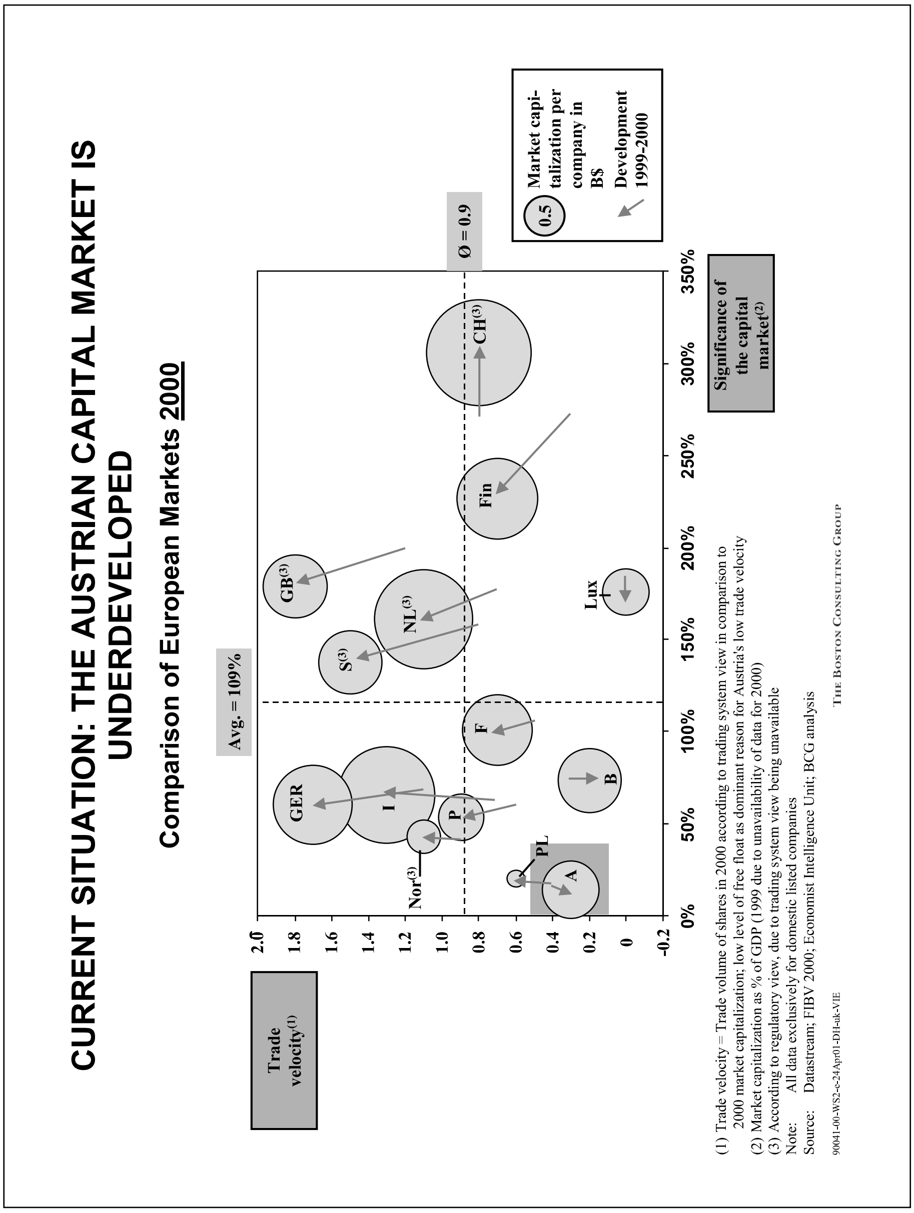
Market capitalization domestic shares
to the ULTIMO of each year
35 000 000 000
30 000 000 000
25 000 000 000
20 000 000 000
15 000 000 000
10 000 000 000
5 000 000 000
0
20 422 195 625
18 831 452 072
16 722 365 496
23 982 234 501
23 352 792 435
22 847 537 160
25 979 907 332
32 844 372 282
29 045 262 830
32 102 065 934
31 197 464 947
27 528 599 262
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001

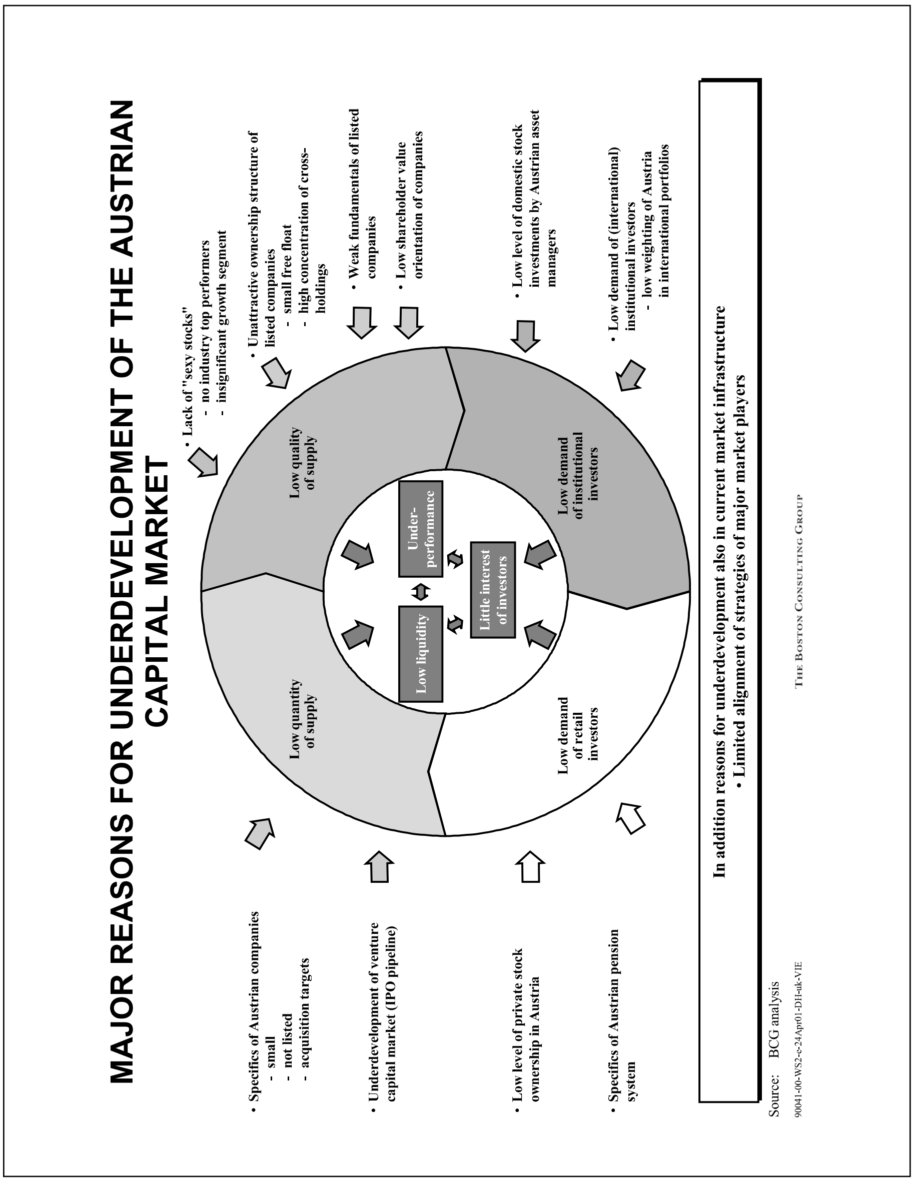
Corporate bonds also experienced a revival, though only as of 2001. This trend will become stronger and take a place alongside the predominant loan financing among businesses due to, among other things, the dramatic changes in risk margins of banks that will become necessary after Basel II:



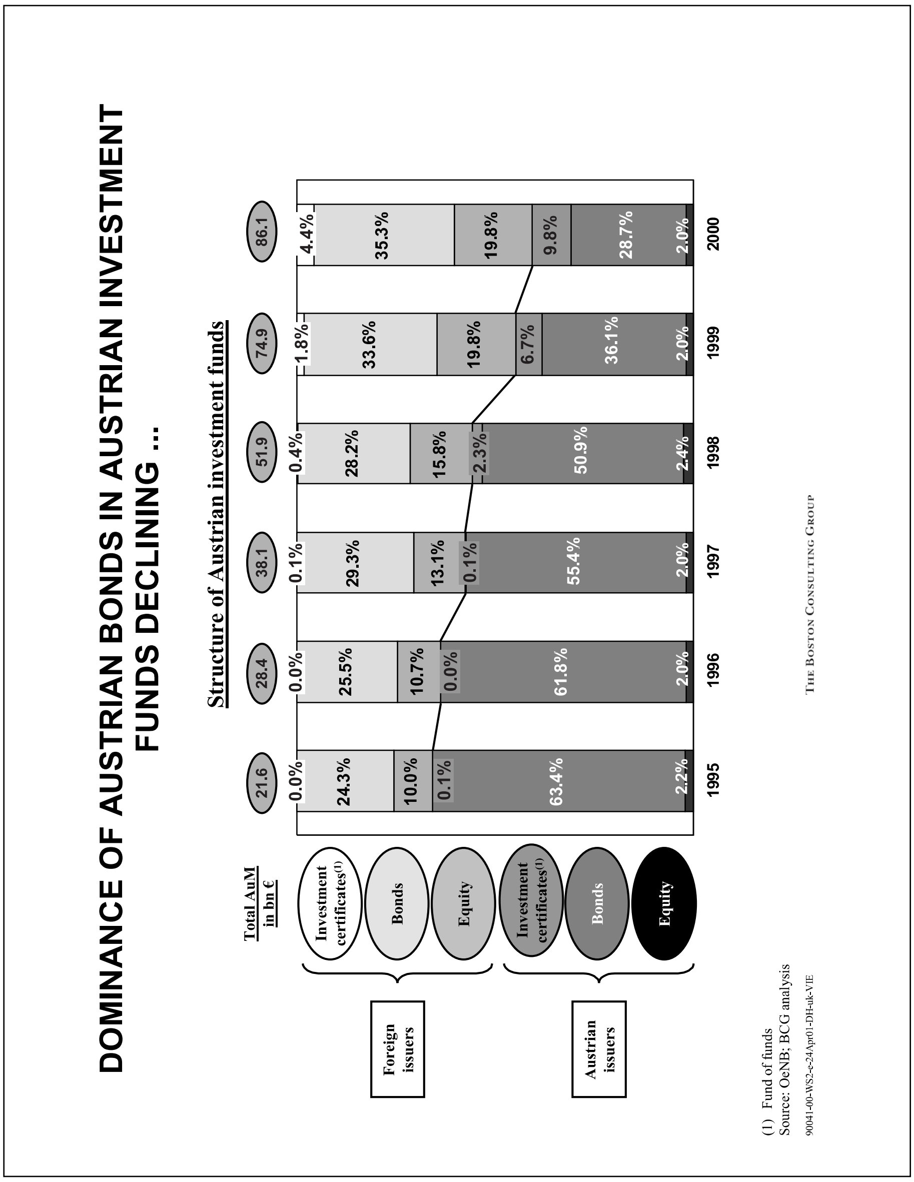
On the whole, the capitalization of the stock market is only 13.1% of GDP (= EUR 30bn) and below average in a European comparison, a situation which is unsatisfactory for the future equity capital needs of the Austrian economy:



A study commissioned by Wiener Börse, the Federal Ministry of Finance and the OeNB conducted by Boston Consulting Group states the following reasons for this situation:



The dilemma of the Austrian market is clearly illustrated by the current structure of Austrian investment funds managed by domestic market participants: less than 2% of the strongly growing volume of money invested in funds is invested in Austrian stocks:



While the amount invested in Austria in domestic stocks is less than EUR 2bn, this share in Germany is at least 13% of German investment funds, for example, which corresponds to at least EUR 90bn. This is 40 times more!

Although successful in steadily raising the interest of private investors (In 1997, the year of the stock exchange reform and the foundation of the new Wiener Börse AG as a single cash, derivatives and commodities exchange, only slightly less than 4% of the Austrian population owned shares[1] and by 2001 it went up to 7% !), a lot remains to be done in order to catch up with the Western European average.

A very positive contribution to the development of an adequate base for further stock transactions on the Austrian capital market was provided by the privatization projects (cf. OMV, VOEST, TELEKOM etc.) and the still small but growing venture capital scene. An attractive, specifically Austrian instrument for promoting the formation of the equity capital base of young companies is the equity capital guarantee of the FGG (Finanzierungsgarantie Ges.), which is considerably involved in preparing Austrian companies for a going public:

[1] excl. funds

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Venture Capital is the main source for IPOs

IPOs	participation VC	VC-Partner of FGG
1999:		
AvW Invest	-	-
CyberTron	✓	✓
Libro	✓	✓
Palfinger	✓	✓
2000:		
BetandWin	✓	✓
Feratel	-	-
JoWooD	✓	✓
Head	-	-
HTA	✓	✓
PerformanceAG	✓	-
Stage1.cc	✓	✓
Telekom	-	-
2001:		
Teletrader	-	-
BLUeBULL	-	-
Euromarketing	✓	-
Andritz	✓	-
CLC	✓	✓
webfreetv.com	✓	-
Admiral	-	-
Σ 19	Σ 12	Σ 8

(source: Factbook 2001)

3.2 Six Hypotheses on the positioning of Wiener Börse as a regional exchange and the Austrian economic region in a single European market

Hypothesis 1

The establishment of a strong capital market in Austria is vital for maintaining and expanding the region as a business location and for securing stability in the labour market. Efficient, tradable instruments of equity and external capital need to be developed in a joint effort with potential issuers and regional retail and institutional investors as well as with domestic and foreign investment banks and trading participants in the Austrian market.

There is no other stock exchange organization that is better qualified than Wiener Börse, being specialized in the regional economic area of Austria, to organize a platform for the listing of new issues and trading in equity and debt capital for the Austrian market. It is also the only stock exchange organization that has a direct interest in the development of the domestic capital market.

Wiener Börse AG will implement the following projects in the future:

- ❑ the organization of an inexpensive market model that optimizes liquidity for trading in the cash and derivative markets
- ❑ Quality segmentation and surveillance of the market (cf. prime market)
- ❑ best possible services offered to regional issuers in the area of stocks and bonds (new growth segment: corporate bonds)
  - support for IR strategies
  - consulting services in preparations for public offerings
- ❑ Optimal support for the market environment for private investors
- ❑ Flexibility in the new design of products

It is precisely the small and medium-sized structure of the Austrian economic area that calls for this type of specialized strategy. The potential for boosting the capital market is high and definitely exists:

The percentage of the population of private individuals owning shares is currently 7.5% and it should be possible to increase it to 12 – 15% by 2005.

The capitalization of the Austrian stock market is currently EUR 30bn and only about 13.1% of the GDP. Further privatisations and IPOs by private companies on Wiener Börse should help to raise the percentages considerably in the next 5 to 10 years.

Hypothesis 2

By using the international trading platform XETRA on the cash market, Wiener Börse is actively involved in the alliance of the XETRA Group of Deutsche Börse Frankfurt. This means that the stock market in Vienna and with it the Austrian capital market is not a regionally limited one, but rather globally accessible.

The trading participants (remote members) are linked either via direct lines to the XETRA system or since October 2001 via the Internet broker system of Wiener Börse. This makes it possible to take advantage of the benefits of the technical and economic aspects of an international stock exchange alliance for a regional market and to create inexpensive structures.

Hypothesis 3

The direct vicinity of regional exchanges to local markets, as in the case of Wiener Börse AG, and the direct broker platforms of the banks and trading participants are used for gaining more private investors by taking customized measures to meet the needs of such regional markets. The additional range of information and marketing services offered by Wiener Börse AG makes it extremely competitive over alternative competitors.

Hypothesis 4

Optimally organized and internationally integrated regional exchanges contribute substantially to improving the quality of decentralized, regional markets. Not only with respect to the ongoing monitoring of quality and disclosure standards for listed companies, compliance with trading norms and the efficient settlement of transactions, but also with respect to the high degree of legal certainty achieved by closely collaborating with supervisory authorities.

Moreover, the activities of a well-functioning, specialized regional exchange are crucial for maintaining many areas of work for the region in the fields of banking and finance industry, law and fiduciary service, consulting etc.

Training and education institutions, especially also universities benefit greatly from these activities. The creation and preservation of jobs in a region that requires highly qualified staff profits in particular from the activities of the local exchange.

Hypothesis 5

The technological revolution in trading and settlement systems and the technical feasibility of inexpensive, virtual "pseudo exchanges" in conjunction with the one-sided arguments for minimal system costs have brought to light the main tasks of an exchange, namely:

- ❑ Optimal framework for local companies wishing to raise capital
- ❑ Full independence from all involved "customer groups" (market participants, investors, issuers) especially from the trading interest of the large global banks
- ❑ Attainment of the highest possible trading volumes in a single security instead of the dispersion of possible volumes across several competing alternative market systems

This should be taken into account all the more considering that a modern regional exchange such as Wiener Börse AG offers the advantages of efficient electronic trading and information systems anyway.

Hypothesis 6

Even in an economically unified Europe with one single currency the specific cultures and languages of the different countries or regions will last. To motivate and mobilize the regional potential will require a future organization that truly represents the unique characteristics of the region. That way an optimally structured regional exchange will be an integrative partner of a European platform and a local marketing specialist with an optimal marketing strategy to meet the local needs of their region.

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