Globalization in East European Banking

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Abstract

Advanced internationalization of East European economies in the first decade of 2000s resulted in increased foreign presence and in several countries credit markets are dominated by foreign-owned banks. This paper analyses the development for foreign ownership and its impact on financial markets in Eastern Europe. Structural and dynamic aspects of foreign banking as well as statistical results are presented. Costs and benefits of foreign banks entry in these countries are discussed and are perceived to be one of the most important factors influencing the shape of banking sectors in East European economies. Although their actions tend to focus mostly on corporate services, the perceived need for support of the client base is also the most important reason for their growth. It can also be argued that the direct benefits from entry are limited and the indirect ones are quite evident, mainly in the areas of corporate finances and foreign trade.

Key Words: International finance, banking, East European banking

Introduction

During the last decade foreign banks have entered several East European (EE) transition countries, though to different degrees. According to the review by Narodowy Bank Polski (National Bank of Poland) several countries regarded foreign strategic investors in their banking system as a means to improve both the quantity and quality of financial intermediation. Sometimes these advances resulted in higher risks for the stability of the financial system, emphasising the danger of a more volatile credit supply. Although research has been done for the other areas – where foreign bank penetration is high as well – the empirical research to date on the role of foreign banks as regards credit stability in a cross-section of EE countries is rather limited. Several authors divide foreign banks into greenfields and takeovers, so as to differentiate between modes of entry, and investigate whether the financial health of the parent bank influences its EE-subsidiaries (Voinea, 2008; De Haan, 2004). They suggested that extent to which foreign bank subsidiaries differ from domestic banks will also depend on their level of involvment in the multinational banking organisation they are part of.

The impact of greenfields and takeovers on host economy may differ because they reflect differing entry strategies of the parent bank. A foreign bank unfamiliar with a country to which its wants to expand may first establish a greenfield to "test the waters". Buying an existing bank may on the other hand reflect a longer-term or more definite commitment. Some parent banks establish greenfields because they want to control all aspects of the new affiliate right from the beginning. Other financial institutions put more emphasis on the need to be a real local bank, and are thus more in favour of taking over an existing bank. Usually, the organisational and corporate governance links between a parent bank and a takeover are usually looser than those between a parent bank and the greenfields ie new subsidiaries or affiliated banks.

This paper is structured as follows. In the following section a brief overview of the literature on foreign banks and financial stability will be presented, after which recent developments in internationalization of EE banking and conclusions will follow.

Banking globalization – some theoretical considerations

The analytical and empirical studies of foreign banking expansion have been attempted from various conceptual angles. Two of them are extensively developed as they provide helpful insight into the mechanism and operation of Western banks in Eastern Europe. First is the theory of multinational firm (Hymer, 1960; Grubbel, 1977; Rugman, 1981; DeYoung and Nolle, 1996) and the other is the heterodox theory of international trade known also as the eclectic paradigm theory (Dunning, 1977; Cantwell and Narula, 2003). According to the first approach banks enter foreign markets based on such fundamentals as bank size, bank rate of return and the globalization strategy. The more recent studies however are more in line with the heterodox theory as this approach emphasizes the location and integration factors rather than on company's motivation for expansion. This approach seems also more in line with the recent globalization trends in world financial markets and fits more with the current ownership-location-globalization characteristics of world economy in particular with the integration of financial markets within European Community.

Among the factors that impact company's decision to enter foreign markets certain groups of factors are regarded more important than others. The first group is the "follow the customer" strategies which includes foreign direct investment and bilateral trade. According to this view banks follow their customers to utilize their data base and to service them in foreign markets. This strategy is also known as "defensive expansion" and is represented by several

empirical studies (Grubbel, 1977; Wiliams, 2002; Goldberg and Johnson, 1990; Miller and Parkhe, 1998). Literature that supports this approach with regard to foreign trade includes Glosse and Goldberg, 1991; Yamori, 1998; Buch, 2000.

The "pecking order theory" emphasizes the structure of capital flows as the foundation of banking expansion. International capital flows influenced by information costs will predict the following order of foreign capital inflows: foreign direct investment (FDI) will cause bank lending will cause portfolio investment. FDI will also initiate the process as it lowers high cost of information required for initial entry into foreign market and as the economy advances and complies with international norms, information costs will be further reduced and more capital inflow will follow.

The other group of factors relates to market complementarity. Including GDP, size and distance, financial structure development and prospects for future profitability and many studies found out that these do have a significant explanatory value. On the other hand, some studies (Wezel, 2004; Sagari, 1992) found that GDP is not a significant factor in external expansion. Financial market development was generally found to be significant but not in a capital - scarce economy as banking capital goes where business opportunities are higher. Studies that support this view include Blealey and Kaplanis, 1996.

The other group of factors is related to various kind of risk (political, banking, currency and institutional factors are placed in the category of market risk because they influence market attractiveness). Hence, underdeveloped institutions are associated with poor economic performance, and such factors as corruption, speculation, grey economy would increase transaction costs. See Papaioannou, 2005 and Bol, 2002 who emphasize the role of institutional reform and regulations in explaining the flow of banking capital. In this group one may also place the proponents of so called "Lucas paradox", which explains why capital would not flow from rich to poor economies. Ineffective regulations, corruption, lack of transparency are the main factors that explain asymmetry in the banking capital expansion (Alfaro, 2003 and Bevan, Estrin and Meyer, 2004).

The expansion of foreign banks into less-developed banking systems is represented by several studies. The majority of this literature focuses on the influence of foreign banks on the efficiency of domestic economy banking systems. Such studies generally find that foreign bank entry has positive efficiency effects (e.g. Claessens et al., 2001; Lensink and Hermes, 2003). However, efficiency gains may be (partly) offset if a sufficient degree of tradeoff between banking efficiency and banking stability is present.

Most empirical literature on foreign bank entry for domestic economy financial stability is not very extensive. For example, there is no single, comprehensive theory of multinational banking, especially in an emerging market or transition country context vis-à-vis various degrees of financial and monetary integration. Certain strategies through which foreign banks may influence the stability of the domestic economy banking system can be identified and they usually state that foreign bank subsidiaries are not completely independent organisations, but form part of a larger bank holding company (parent bank) with an internationally diversified asset portfolio under different risk-benefit scenarios. Their strategies will be influenced by decisions of this (foreign-based) holding company. Parent bank may offer a "back-up facility" or serve as a lender of last resort during crisis periods, or through transfer pricing may manage an internal capital market and centralised treasury operations to allocate capital and financial liquidity over its subsidiaries (Stein, 1997). This may result in a more stable credit supply of the foreign based subsidiary and a supportive parent bank and enhanced funding sources may reduce an overall banking risk of insolvency and financial liquidity in foreign countries. It can also be argued that foreign bank subsidiaries may recover from external disturbances relatively easily, compared to domestic banks, and can maintain adequate credit supply.

There is enough evidence to suggest, that foreign banks' credit supply may be less stable than credit granted by domestic banks. This will be the case if foreign banks are more sensitive to financial cycles and to the changing domestic economy macroeconomic environment. Some authors, (for example, Williams, 1997) argue that internalisation theory provides a cohesive and internally consistent framework within which different theories of multinational banking can be analysed – each focusing on a specific aspect of internalisation theory, so that testable hypotheses can be developed. On the other side, Morgan and Strahan (2002) show that, foreign bank entry may ease the effect of a general bank capital disturbances on firm investment in the domestic economy, since they can rely on parental financial liquidity and capital back up. Also, the impact of a disturbances in the domestic economy may be enhanced, as foreign banks will reallocate their portfolio in response to the expected risk/return ratios. The theoretical aggregated effect of foreign bank entry on domestic economy business cycle volatility thus remains ambiguous.

Another set of variables emerge if foreign bank subsidiaries react not so much to changes in the domestic economy economic conditions ("pull factor"), but rather to changes in the parent bank's home country ("push factor"). Slow down in economic activity in the domestic economy may force a capital-constrained parent bank to reduce activities, including those of foreign sub-

sidiaries and foreign operations may be among the first to be reduced. This would be a positive correlation between the domestic economy business cycle and the subsidiary's credit supply especially when the parent bank's financial condition is unstable. When economic conditions in the home country worsen, parent banks will increase their efforts to expand their activities abroad, since investment opportunities in the host market are scarce. Vice versa, when domestic economy conditions improve, the opportunity costs of limiting home country lending increase and banks may allocate less capital to their foreign subsidiaries (Molyneux and Seth, 1998; Moshirian, 2001). In this scenario there is a negative relationship between the home country business cycle and the subsidiary's credit supply. The latter is more likely if parent banks are financially healthy and bank holding capital is free to prioritize the highest returns.

Foreign banks may be influenced by poor performance or strategy changes by their parent banks. First, a foreign bank may be liquidated if the parent bank experiences problems and decides to close some of its subsidiaries. A recent example of an impact of parent bank problems on foreign banks operating in Eastern Europe was the withdrawal of Dresdner Bank from Romania and the Czech Republic, which was apparently linked to Dresdner's problems at the headquarters. Second, managers of international banks admit to allocating capital to subsidiaries with the highest expected returns (De Haas & Naaborg, 2005). Therefore, even a profitable foreign subsidiary could be closed in order to reallocate capital to even more profitable project in another country.

Differences between foreign and domestic banks are not only related to the fact that a foreign bank subsidiary is part of an international banking organisation, but can also result from other differences in banks' strategies and balance sheet health. For example, banks differ in their credit strategies and planning horizons. Some banks may grant credit on a "transaction-by-transaction-basis" and the credit may be increased to meet the extra demand for finance when the economy improves, and decrease credit supply when economic conditions worsen. Other financial institutions may finance their clients "through the cycle" and will not easily cut off credit lines in case of temporary adverse economic developments. Such relationship lending will be less sensitive to business cycle fluctuations or banking crises, and can therefore be characterised as relatively countercyclical and stable. Most authors suggest that regardless of the ownership structure of a bank, the quality of its balance sheet may be of decisive importance in influencing credit supply. Banks that are in poor condition, will not be able to expand their credit in reaction to positive market signals, but will instead focus on balance sheet repair (De Haas and Naaborg, 2005; Veinea at al, 2008).

The literature on determinants of bank profitability is very extensive. However, the majority of papers focus on markets with a low presence of foreign banks and sometimes the empirical side is ignored. In particular, two factors have not yet been sufficiently explained: first, that foreign banks might be differently affected by certain factors than domestic banks would, and, second, that they can be affected by additional factors, such as home country conditions and strategies of their parent institutions. The one study that addresses this issue is the work of Williams (1998, 1998, 2003), who constructs an empirical model of foreign banks' profit determinants and tests a number of hypotheses concerning profitability of foreign banks in Australia compared with other markets for the great four (ANZ, Westpac, NAB, Commonwealth). The results show that domestic factors do not significantly influence individual banking strategies (Williams, 2003).

Finally, in the analysis of foreign banks in Eastern Europe, it is important to take into account the transition period, which may explain the generic roots for banks' profitability. Interesting study in this field is Berger et al. (2005) where the authors analyze the static, selection and dynamic effects of foreign ownership in Argentina and find that foreign banks select slightly less profitable institutions and do not improve their performance afterwards. Low profitability distribution is also a focus of a study by Peek and Rosengren (1999) focus on the transition period of foreign bank subsidiaries in the US and attempt to explain their poor performance. They show that banks targeted by foreign acquirers show lower profitability prior to acquisition, during the transition period, and in the long run after the change of ownership. Majnoni et al. (2003), suggest otherwise and show that the profitability of Hungarian banks increases in the first four years after acquisition by foreign investors and remains positive in the long run.

A very comprehensive study on foreign banking expansion in East European countries is by De Haas and Naaborg (2005) who analyse foreign banks in transition economies based on focused interviews with managers of foreign parent banks, their affiliates, and central bank officials in the EE. They list a differential number of channels through which the conditions in the home country could have an affect on the profitability of foreign subsidiaries. For example, in the report bt the Narodowy Bank Polski and Bank PekaO (National Bank of Poland) it was suggested that due to the worsening economic situation in Germany, some German banks were transferring subsidiaries' profits to the German head office though unusually high dividends.

Recent trends in foreign banking expansion into East Europe

In the late 1990s and early 2000s due to economic growth and development of financial markets, there has been an expansion of credit to the private sector to the EE economies. A number of factors has contributed to the credit expansion— relatively low levels of financial development in these countries and growth of demand pressures following decades of socialist economic management; better macroeconomic discipline and accession to the European Union (EU), which helped lower the country risk premium; and improved access to foreign capital following the entry of foreign banks and the opening of capital accounts. All in all, rapid credit growth has played an important role by the mechanism of transferring domestic and foreign savings into investment and supporting financial sector development and economic growth in this region.

Macroeconomic conditions have been adequate for credit expansion. With inflation under control and improved economic prospects, both due to income convergence and the business cycle, have helped expand credit demand in the private sector. Real lending rates registered a progressive decline reflecting a more general trend decline in policy rates. In some EE economies such as Poland and Slovak Republic, currency appreciation has been an important factor in stimulating demand for credit. Predictable exchange rates and expectations of long-term appreciation might have created incentives for borrowing in foreign currency and with greater supply of funds available, might have stimulated capital inflows funding credit expansion. In some countries, incentives created by easy monetary and/or fiscal strategies may have contributed to strong growth in bank credit.

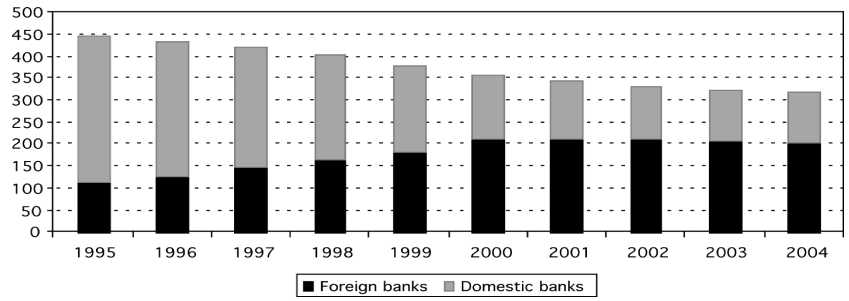
Structural changes in the banking sectors of the EE have created incentives for a rapid expansion of credit to the private sector. A series of bank privatizations in the late 1990s– early 2000s improved the incentive structure for banks, while the entry of foreign banks has brought additional expertise and know-how into the sector. With adequate macroeconomic conditions, increased investor confidence in EE, and EU accession, many foreign-owned banks have considered the EE to be important future markets, where the strategic benefits of expanding market shares justify taking on additional credit risks. Higher profitability of lending in EE markets, compared with other EU markets, was another factor that has encouraged the expansion of foreign-owned banks in the EE in recent years. Also subsidies and tax strategies have stimulated the growth of selected credit markets. Construction saving subsidies have promoted saving

and lending through building societies in some countries, for example, the Czech Republic and Hungary. Another factor was an adequate tax treatment of housing loans, including tax exemption of construction saving yields and the deductibility.

The rapid credit growth has also raised macroeconomic exposure and prudential risks. Quantifying these risks may be premature, since the EE have not gone through a full credit cycle yet, and financial reliability indicators tend to improve in the upward phase of the credit cycle. Experiences in industrial and emerging market countries suggest that credit booms can be associated with unsustainable domestic demand booms, overheating, and asset price bubbles.

Although there are intraregional differences, the financial systems of the EE region share certain structural characteristics. Commercial banks constitute the bulk of East European financial systems, and private sectors there rely considerably more on bank financing than stock market financing. The concentration of banking sectors is higher than the EU-25 average, but this is largely due to the Baltic states (Lithuania, Estonia, Latvia): the share of the five largest credit institutions in the EE countries stands at about the EU average (60 percent), whereas in the Baltic states it is almost 80 percent.

In diagram 1 we present the number of foreign owned banks and domestic owned banks in the whole region for the period 1995-2004. Two characteristic features are clearly visible First, between 1995 and 2004, 28 per cent of total banks in 1995, i.e. 125 banks, disappeared. Second, up to the year 2000 the number of foreign banks increased and domestic owned banks became a minority within the banking sector. It is interesting to point out that foreign bank presence in all EE countries is considerably higher than in the European Union countries, with the exception of Luxembourg (Claessens *et al.*, 2001; Noyer, 2001).



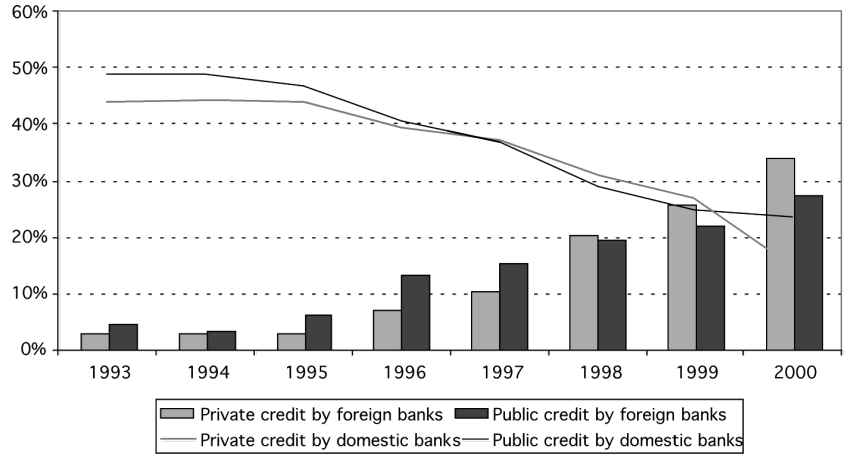
Data include banks from Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and the Slovak Republic.

Source: Central bank survey and EBRD.

Diagram 1 Foreign and domestic banks in East European countries, 1995–2004

More advanced economies of Poland, Czech Republic, Hungary have experienced the biggest inflows of foreign banking capital, while the less developed countries such as Bulgaria, Romania received foreign investment at much lower rate. The share of foreign banks in total assets in non-NMS (European Union new member states) is on average larger (74%) than in NMS countries (64%). According to the data from the European Development Bank (EDB) banking investment as a total share of FDI (foreign direct investment) varies from 10% in Hungary to some 27% in Poland and Slovak republic with the largest foreign investors from Austria, Italy and Greece.

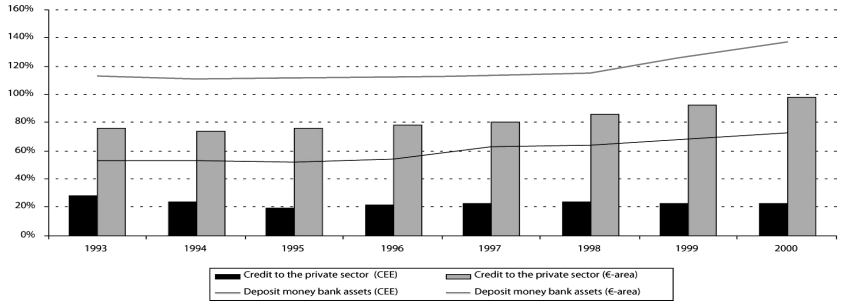
In diagram 2 the dynamics of private and public credit by domestic and foreign banks is contrasted and compared. It shows that credit by domestic banks has been continuously on decline since early 1990s while credits extended by foreign banks systematically increased in absolute and relative terms.



Sources: Central bank survey for data on: a) deposit money bank assets, b) foreign banks' assets/ GDP, c) credit to the private sector by deposit money banks/ GDP, and d) foreign bank credit to the private sector/ GDP. Foreign bank credit to the public sector was calculated by subtracting d) from b). Domestic bank assets were calculated by subtracting b) from a). Credit to the private sector by domestic banks was calculated by subtracting d) from c). Credit the public sector by domestic banks was calculated as a) minus b) minus credit to the private sector by domestic banks. Data include from Croatia, Estonia, Hungary, Latvia, Lithuania, Poland and Slovenia. Source: Central bank survey.

Diagram 2 Private and public credit by domestic and foreign banks in EE economies 1993–2000

Similar trends can be observed vis-à-vis credit and asset expansion in the Euro-area which registered constant growth over the same period. In particular, deposit money bank assets in the euro-area maintained its huge dominance over domestic deposit money bank assets in the period of 1993–2000.



Source: Central banks data

Diagram 3 Credit and asset expansion in EE economies, 1993–2000

In the first decade of 2000s credit to the private sector in most EE countries has been extensively growing. Credit in the Baltic countries expanded at a rate 3 times faster than in the other East European economies during 2002–06 (44 percent versus 14 percent, respectively). In the latter subgroup, the Czech Republic and Poland registered the slowest rate of credit growth to the private sector. Also household credit has been growing more strongly than corporate credit in recent years, and, by end–2005, household loans were almost equal to corporate loans in importance in banks' portfolios. The importance of foreign-currency denominated or indexed lending has varied across the EE. In the Baltic states, the composition of total outstanding loans to the private sector has traditionally been heavily concentrated on foreign currency loans. In 2005, for example, foreign currency loans carried, on average, twice in total outstanding loans in the Baltic countries (above 60 percent) that they did in the other East European economies (around 30 percent). Among them, Hungary and Slovenia have experienced rapid growth in the share of foreign-currency-denominated loans in total loans to the private sector, while the Czech Republic has remained the least exposed, with a further decreasing share. See Tamirisa and Čihák (2006) for an analysis of the factors that contributed to slow credit growth in Poland.

On the other hand, foreign banks' contribution to economic infrastructure and development in non – NMS is much smaller. In this area, foreign banks are more cost-effective but they do not contribute much to credit expansion and have rather very limited contribution to the development of local credit markets. According to Naaborg (2001) this is a typical cherry-picking strategy.

Table 1 shows the number of foreign banks per country. In 1995, 114 foreign banks were present in the countries in our sample, accounting for 25 per cent of total banks. In that year, the Czech Republic, Hungary and the Slovak Republic already showed relatively high levels of foreign bank presence. In the second part of the 1990s, the relative number of foreign banks

Table 1 Foreign banks in Eastern Europe, 1995–2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Bulgaria	7	7	25	50	65	68	74	76	71	69
Croatia	2	9	11	17	25	49	56	50	45	41
Czech Rep.	42	43	48	56	64	65	68	70	74	74
Estonia	26	27	31	50	43	57	57	57	57	67
Hungary	49	57	67	64	67	79	76	71	76	71
Latvia	26	40	47	56	52	57	43	39	43	39
Lithuania	0	25	33	42	36	46	46	50	54	50
Poland	22	31	35	37	51	63	67	76	79	77
Romania	33	32	39	44	56	64	73	77	70	72
Slovak Rep.	55	48	45	41	40	57	57	75	76	76
Slovenia	15	11	12	10	16	21	21	27	27	32
Average	25	30	36	42	47	57	58	61	61	61

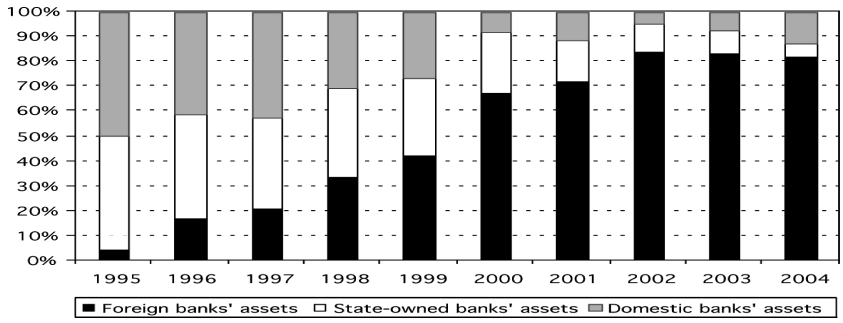
Source: Central bank survey and EBRD.

grew strongly especially in Bulgaria, Croatia, Hungary, Lithuania, Poland, and Romania.

The other way of measuring foreign ownership in the banking sector is to calculate the ratio of foreign banks' assets and the sum of total banking assets, including those of domestic owned banks. Diagram 4 shows the relative asset shares of foreign owned banks state-owned banks, and domestic owned banks in the period 1995–2004. The share of state-owned banks rapidly declined from 51 per cent in 1995 to 3 percent in 2004. After several banking crises hit most transition countries in the mid-1990s (see Caprio and Klingebiel, 2003 for an overview of the different crises), bank privatisation significantly increased foreign participation at the end of the first decade only in Poland and Slovenia governments remained important stockholders of banks. Similarly to state owned banks, domestic banks lost importance with a lowest level of relative assets of 9 per cent in 2000.

Foreign banks' assets reached 84 per cent in 2002 and remained relatively stable at that level. The data also shows the difference between countries regarding the timing of foreign bank entry. Hungary and Latvia were among the first countries were foreign banks' assets dominated domestic bank assets 1/.

Reports by the central banks indicate that the average foreign ownership of banking in Eastern Europe expanded rapidly especially after 2000 (diagram 4). Due to mergers and acquisitions, relative foreign banks' assets spur from an average of 40 per cent up to a 70 per cent level. In Romania foreign owned bank assets are growing gradually few percentages a year. In Slovenia foreign banks are of minor importance in the banking sector. In 1998, the share of foreign



Source: Central banks survey and EBRD.

Diagram 4 Average Foreign Ownership, 1995–2004

banks' assets in Estonia rose to 90 per cent reflecting that its largest banks, Hansapank and Eesti Ühispank, were sold to two Swedish banks: Swedbank and Skandinaviska Enskilda Banken. In 1999, foreign banks' assets in Poland increased from 17 per cent to 49 percent as Allied Irish Banks bought 80 per cent in Bank Zachodni, Italian Unicredito acquired 52 per cent in Pekao in a second stage privatisation and Bank Austria raised its stake with 20 per cent in PKB up to 44 per cent in 1999.[1)]

Foreign exchange market disturbances and the general instability of financial markets in the beginning of the 2000s resulted sometimes in radical changes in banking acquisition strategies. For example in 2001, the Croatian State Agency for Banks bought Rijecka Banka

1) Individual cases of foreign banking takeovers are documented in Voinea, 2008; Claeys, 2006; De Haan, 2004; Naaborg, 2007). For example, 72 per cent of total banking assets, as Bulgarian largest bank Bulbank was privatised and sold to Unicredito. In the meanwhile, foreign banks' assets in Croatia also rise. The increase amounts to 45 per cent points up to 89 per cent of total banking assets, as the third and fourth largest banks Splitska Banka and Rijecka Banka were acquired in privatisation by Unicredito and German Bayerische Landesbank. In addition, Croatia's second largest bank, Privredna Banka Zagreb, was sold in privatisation to Banca Commerciala Italiana. In the Czech Republic foreign banks' assets grew to 89 per cent of total banking assets, as Austrian Erste Bank acquired 52 per cent in privatisation of savings bank Česká Spořitelna, Belgian KBC's Czech subsidiary CSOB took over assets and liabilities of IPB, and German Bankgesellschaft. German banks raised its stake from 47 per cent to 85 per cent in Zivnostenska Banka. A year later, French Société Générale bought Komercní Banka in privatisation and Erste Bank acquired 71 per cent of the preferential shares in Česká Spořitelna. In Lithuania, 78 per cent of banking assets were foreign owned in 2001 as Swedish Skandinaviska The subsequent changes in ownership of Splitska Banka are exemplary for the consolidation that took place in CEE. In 2002, Unicredito sold the bank to Austrian Bank Austria Creditanstalt (BACA) due to anti-trust reasons. Following German HVBs acquisition of BACA, the bank merged with HVB Bank Croatia in 2003. Following the Italian Unicredito acquisition of HVB in 2005, French Société Générale bought Splitska Banka in 2006, again as a result of anti-trust reasons. See the source quoted above.

for € 1, recapitalized, and sold the bank to Austrian Erste and Steiermarkische Bank. There were a number of banking mergers and occasional buy-outs such as the case of Enskilda Banken raising its stake in Lithuanian Vilniaus Bankas to 100 per cent after the latter had merged with Bankas Hermis in 2000, while Finnish Sampo bought majority stake in privatisation of Lithuanian Development bank. In the same year, Estonian Hansapank, owned by Swedish Swedbank, bought 90 per cent in savings bank LTB, Lithuanians second largest bank and merged it with Hansabankas. In Poland relative foreign banks' assets increased up to 72 per cent in 2001 as Citibank bought 88 per cent in Bank Handlowy w Warzawie. In the Slovak Republic, Hungarian OTP Bank bought a majority stake in Investicna a Rozvojá Bank establishing OTP Bank Slovensko and Erste Bank acquired 87 per cent of savings bank Slovensko Sporitelna in privatisation. In 2001, foreign banks' assets in the Slovak Republic have increased up to 78 per cent of total banking assets.

In spite of rapid expansion of foreign banks into EE there seems to be a consensus of opinions that bank intermediation in this region is still below the equilibrium levels consistent with the levels of economic development of these countries and the structural characteristics of their banking sectors. Adjustment toward equilibrium is expected to continue in the coming years, but, its excessively rapid pace may result in macroeconomic and financial instability (Schadler and others, 2004). In fact until 2006 rapid credit growth in the EE has led to a deterioration in financial reliability indicators, but prudential risks appeared to be rising in some countries (Hilbers and others, 2005; and Iossifov and Khamis, 2006). A microeconometric study by Maechler, Mitra, and Worrell (2006) found that, although loan growth generally had been associated with an improvement in the reliability of the EE banks, when it became excessive, loan growth could weaken bank reliability.

Foreign exposure and banking risks in Eastern Europe

Most practitioners and academics agree that, the main risk to bank reliability associated with rapid loan growth is credit risk. Credit risk can arise from a number of sources: inappropriate loan assessments and difficulties in monitoring and assessing risks; aggressive lending strategies; overvalued asset prices or exchange rates; and an excessive concentration of loans. Risks associated with rapid credit growth to households are in many respects similar to those associated with lending to private sector , but the key difference is the much larger number of loans involved (which, on one hand, helps diversification of risks, and, on the other, can make

credit decisions and management more labor intensive) and the lower availability of reliable financial data.

Market risks can also become an issue in an environment of rapid credit growth. Interest rate risk can rise, for example, if rapid credit growth is accompanied by a greater use of fixed-rate or foreign currency instruments without banks' hedging the risk of adverse movements in the prices of these assets. Direct foreign exchange risk may also arise from net open foreign exchange positions and external borrowing to fund credit growth.

Until 2008 financial reliability indicators for the EE were generally favourable and capital ratios, both relative and absolute, were comparable to those in Western Europe, while returns on assets were higher. Although nonperforming loans were higher, the coverage of nonperforming loans by provisions is similar to Western Europe's. Banking sectors in the EEs appear more capitalized than those in the Baltic states, but at the same time asset quality and provisions against bad loans were, on average, lower in the Baltics and profitability was higher. As always, these indicators should be treated with caution as most of them is based on past conditions and not reflecting the current or future market equilibrium.

Eastern Europe has so far avoided the worst of the global financial market crisis of 2008, but that is gradually changing. High current-account deficits and a large trade dependence on Western Europe pose a potential risk of contagion in future as well as the risk arising from the region's strong foreign bank presence. While generally seen as positive for the EE area, this foreign bank presence may have opened the door wider to contagion.

The main factor contributing to the increased risk of foreign banking in Eastern Europe is the concentration of banking capital in individual economies. The market share of majority foreign-owned banks has increased since 2000 and is now 60% to 90% of total assets in most EE countries, as can be seen in the table below. Transmission of disturbances happens there mainly through problems in financial liquidity and/or annual write-downs in the mostly Austrian, Italian, and Swedish parent banks operating in this region.

When ownership of a banking system is highly concentrated in a single foreign country, adverse disturbances to that foreign country could easily spill-over and engulf the domestic economy economy. But if foreign investment comes from various countries not closely interrelated, then the result will be a banking system with the corresponding benefits that come from risk diversification.

As mentioned above, contagion can be a two-way street. The EE region makes up a significant portion of these international banking groups' total assets, and Austrian-based banks

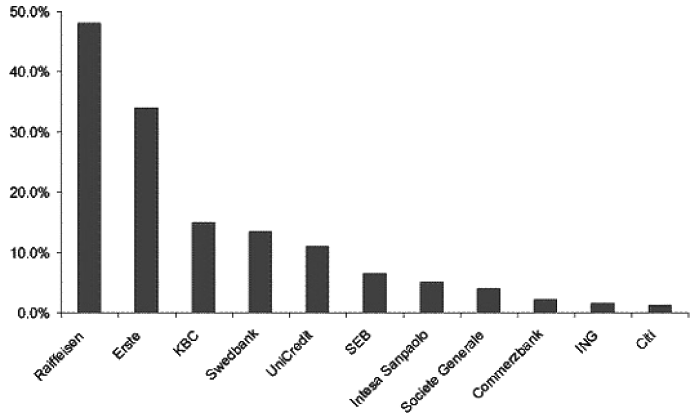
Table 2 Concentration of bank ownership in East European countries

Country	Bank	Foreign owner (>50%)	Origin
Bulgalia	BULBANK	UniCredito Italiano	Italy
	DSK BANK	OTP Bank	Hungary
	UNITED BULGARIAN BANK	National Bank of Greece	Greece
Croatia	ZAGREBACKA BANKA	UniCredito Italiano	Italy
	PRIVREDNA BANKA	Banca Intesa	Italy
	ERSTE & STEIERMARKISCHE BANK	Erste	Austria
Czech Rep.	CSOB	KBC	Belgium
	ČESKÁ SPOŘITELNA	Erste Bank	Austria
	KOMERGNI BANKA	Société Générale	France
Estonia	HANSAPANK	Swedbank	Sweden
	SEB EESTI ÜHISPANK	SEB	Sweden
	SAMPO BANK	Sampo PLC	Finland
Hungary	OTP BANK	*	
	KERESKEDELNI ES HITELBANK	KBC	Belgium
	MKB BANK	Bayerische Landesbank	Germany
Latvia	PAREKSS BANKA	*	
	HANSABANKA	Hansapank	Estonia
	SEB LATVIJAS UNIBANKA	SEB	Sweden
Lithuania	SEB VILNIAUS BANKAS	SEB	Sweden
	BANKAS HANSABANKAS	Hansapank	Estonia
	BANKAS NORD/LB LIETUVA	NORD/LB	Denmark
Poland	PKO BP	Polish government	Poland
	BANK PEKAO	UniCredito Italiano	Italy
	BANK BPH	HVB Group/ BA-CA	Germany
Romania	ROMANIAN COMMERCIAL BANK	*	
	BRD	Société Générale	France
	RAIFFEISEN BANK	Raifeissen	Austria
Slovak Rep.	SLOVENSKA SPORITELNA	ERSTE	Austria
	VSEOBECNA UVEROVA BANKA	Banca Intesa	Italy
	TATRA BANKA	Raiffeisen	Austria
Slovenia	NOVA LJUBLJANSKA BANKA	*	
	NOVAK KREDITNA BANKA	Government of Slovenia	Slovenia
	ABANKA VIPA	*	

Source: Polityka EE Banks Report, March 2009 and other bank reports

Note: The table shows the majority owner of each of the top 3 biggest banks, by assets, in every CEE country. Some banks have no majority owner (*) and their ownership is as follows. OTP BANK is listed. Two private individuals own PAREKKS BANKA. Shareholders of the ROMANIAN COMMERCIAL BANK are the Agency for Privatisation and Management of State ownership APAPS (37%), 5 regional private investment funds (30%), and the EBRD and the IFC (both 12.5%). The Slovenian state (35%) and Belgian KBC (34%) own NOVA LJUBLJANSKA BANKA. Largest shareholder of ABANKA VIPA is insurance company Triglav (33%). Source: June 2006 edition of Bureau van Dijks' BankScope.

Raiffeisen and Erste look particularly exposed to the region. So any slow-down in economic activity there will have a negative impact on the asset quality and ratings of these banks, which might then force them to tighten credit conditions.

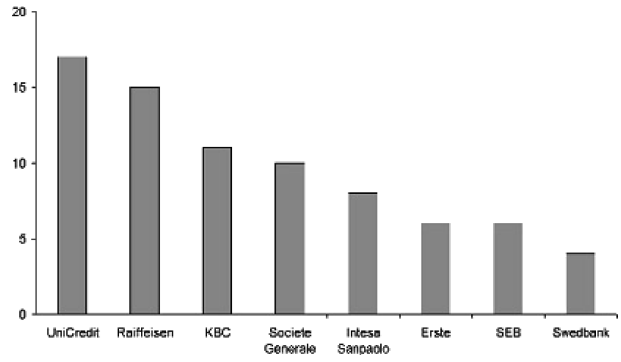


Source: UniCredit Fitch Ratings

Diagram 5 Relative sensitivity to external disturbances in the selected foreign banks

Because international banks tend to operate in several East European countries countries, the chances of cross-contagion are further heightened. As seen in the diagram below, UniCredit, Raiffeisen, and KBC operate in more than ten emerging European countries. A problem in one country could potentially lead these banks to cut exposure to the rest of the region, given the trade and financial linkages between these countries and their similar economic profiles. As indicated by Fitch, a major foreign bank might be willing to bail out a local subsidiary in trouble, but may find it more difficult to help out if faced with similar calls for financing from other subsidiaries in the region.

In the period of 2006–2008 foreign banks, seem to be taking on more financial risks than domestically owned banks, although the strength of their parent banks tends to compensate for the greater risk taking. Market indicators of banking system (see Economist Report on East European banking, 2008) reliability point to moderate macroprudential risks and a wide range of systemic risks According to Fitch's composite indicators of banking system reliability, macro-prudential risk is at medium level in all countries, except Poland. This conclusion is based on an early warning model of above-trend private sector credit growth and takes into account the possibility of asset price bubbles and currency overvaluation. The Fitch's banking system indicator combines the system average of individual bank ratings and a qualitative assessment of



Source: UniCredit data

Diagram 6 Foreign exposure of selected foreign banks in Eastern Europe

systemic risks, taking into account asset quality, capital adequacy, financial liquidity, and foreign exchange exposures, among other things. In four out of the eight EE countries (the Market indicators of EE banks are worse than in major advanced countries but broadly comparable to those of banks from other emerging markets. The exceptions are the market indicators for Czech and Estonian banks, which are stronger[2)].

In the last decade of 1990s, rapid credit growth in Eastern Europe did not appear to have weakened investing banks. In the years 2006–2008, in the aftermath of financial crisis and following recessions in many industrialized countries, this has changed and the granting of credit is becoming increasingly divorced from bank reliability—all banks, including weak ones, seem to be expanding at an equally rapid pace. This suggests that prudential risks are on the rise and became most apparent in the fastest-growing credit markets. These markets include lending to households, foreign currency-denominated or indexed lending, and lending in the three Baltic countries, where weaker banks are expanding at a faster rate than larger banks.

2) For the EE region, published stress test results point to the resilience of these countries' banking systems to credit risk and market risk. A review of stress-testing results presented in the IMF's Financial System Stability Assessments (FSSAs) and Financial Stability Reports during 2001–04 suggests that banking systems should be able to sustain significant macroeconomic disturbances. However, the dispersion of stress testing exercises and results across individual banks might be large in some EE countries. In sum, although stress testing results are fairly positive so far in all countries that disclose them to the public, there are growing concerns about financial risks associated with rapid credit growth. These risks are difficult to quantify given the relatively short credit history of the region.

Conclusions

Credit markets in many Eastern European countries are now dominated by foreign-owned banks. This ownership structure resulted from the liberalization of foreign bank entry in the early 1990s and the privatization of state-owned banks, mainly by selling majority shares to foreign investors. The majority of loans from foreign banks was extended by mergers and take-overs rather than by the newly established banks (*de novo* banks according to the terminology used by certain authors). However, since market entry through acquisition allows acquiring a credit portfolio and a customer base, acquired banks were able to expand their market share much faster than the foreign *de novo* banks. There are also differences in credit costs between new banks and the acquired banks with the reduction in domestic interest rates more evident in the *de novo* banks. The latter ones charge also higher interest rates than foreign acquired banks. This result is consistent with the conventional wisdom according to which competition grows if the foreign bank enters as a *de novo* bank.

Among factors influencing foreign banking expansion into Eastern Europe trade and interest rate differentials are significant as they confirm the strategy of following their customers and exploiting profit opportunities. Direct investment usually lag (2-3 years usually) after portfolio flows and are generated through intra-company banking loans and repatriated profits. On the other hand bilateral trade does not require that kind of lags as it would generate profit instantly. Institutional factors such as banking reform with more transparent regulations and liberalization of local financial markets are also important motives for foreign expansion. Among other factors, distance is not important as the majority of foreign banks come from neighbouring countries usually within the same border of the European Community. In summary – foreign banks seem to be much more interested in speculative investment (interest differential and exchange rate differential) than in productive investment (weaker significance of FDI in explaining foreign banking expansion into this area).

In two-three years after the acquisition, the market share of foreign banks usually starts to grow. Since this happens after the improvements in banks' performance, one can argue that foreign banks succeeded to increase their market share due to their attractiveness to clients. This, in theory, would support the "efficiency" hypothesis and would not result in increased costs of competition. These conclusions seem to be in contrast with findings for developed countries, quoted above, where foreign banks are more likely to sacrifice profits for growth.

The analysis of statistics shows that credit growth in the EE countries during the last decade has reflected financial deepening and various macroeconomic factors, such as strong economic growth, declining real interest rates, and exchange rate appreciation. Bank-specific factors, such as efficiency, profitability, reliability, and the degree of state ownership, have also influenced credit growth. Bank reliability has largely been a function of bank-specific factors (history, size, financial liquidity, and the degree of foreign ownership) and the level of economic and institutional development of the country where the bank is located.

The world financial crisis of 2008 has not weakened European banks significantly so far but it has recently become independent of bank reliability. These findings are broadly consistent with the conclusions based on a general analysis of financial reliability indicators and market indicators for the EE region, which do not point to any apparent signs of a deterioration in bank reliability. As suggested by several studies (quoted before) bank reliability indicators are not pointing to such emerging prudential risks, because they are largely based on system-wide statistics and do not take into account the dispersion of reliability indicators across individual banks. Foreign banks seem willing to take on greater risks than domestic banks, and credit growth through the EE subsidiaries of foreign-owned banks has been largely unrelated to their reliability.

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