FORMS AND DIMENSIONS OF FOREIGN CAPITAL EXPANSION IN THE BANKING SECTOR OF CENTRAL AND EASTERN EUROPE. A REGIONAL PERSPECTIVE

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FORMS AND DIMENSIONS OF FOREIGN CAPITAL EXPANSION IN THE BANKING SECTOR OF CENTRAL AND EASTERN EUROPE. A REGIONAL PERSPECTIVE

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Abstract

The paper deals with the foreign penetration in the capital of bank sector in the countries in Central and Eastern Europe. We start with some methodological issues regarding the real measure of foreign penetration, including both the physical presence of foreign banks in the region and cross-border operations of foreign banks. Then we analyze the foreign, international and local claims of all banks reporting to Bank for International Settlements in relation with Central and Eastern Europe, as well as the distribution of these claims: by the currency of claims denomination (local vs. foreign), by country of capital origin, by sector of destination (public sector, private sector, banks), by destination country. The paper ends with some considerations on the foreign banks' presence in Central and Eastern Europe countries: evolution and present penetration level.

Key Words: foreign capital, bank sector, Central and Eastern Europe

JEL classification: G21, G32

1. Introduction

In order to analyze the degree of foreign bank penetration, we must discern two issues: the cross-border activities of the banks and the activities of the local foreign affiliates in the host countries (Wachtel, 1998). Given the development of the national bank sector in the Central and Eastern Europe countries, we expect foreign banks have played a relative important role in financing the transition economies. To better express the relative importance of: (1) cross-border credit, (2) financing given by foreign banks affiliates and (3) financing given by autochthon banks, we combined the data from the Bank for International Settlements (BIS) on consolidated loans of international banks with the BankScope data on the credit given by both foreign banks' affiliates and autochthon banks in the host countries in Central and Eastern Europe.

Foreign bank penetration in a country can be estimated with two simple measures: number of foreign banks comparative with local banks and the relative weight of assets held by foreign banks in total bank assets. The analysis will be completed with the amount of credit supplied by BIS reporting banks, founded on the data in consolidated statistics. These are expressing the extension of total credit amount supplied by banks with head-office in a BIS reporting country – both cross-border credit and the credit supplied threw local affiliates. Moreover, we are going to analyze the sectoral distribution of credit supplied by reporting BIS countries and also the real cross-border credit from reporting BIS countries, the credit from foreign banks affiliates (both BIS reporting and non-BIS reporting) and the credit from local, national banks. The number of the foreign banks non-reporting BIS is very reduced (at global level, the BIS reporting banks count 95% in the total amount of world banks assets). Regarding Central and Eastern Europe, in the year 2000, between the banks in non-reporting BIS countries, only a subsidiary of a Czech bank was operating in Poland, one Russian and one Korean in Hungary. Moreover, these banks were very small. In terms of total assets, the Czech one was on the 26 position in Poland (over 30 analyzed), and the Russian and the Korean ones on 8, respective 20 position in Hungary (over a total of 23).

As a result, we can build four measurements to reflect the foreign bank penetration, following the methodology used by J. Peek and E. Rosengren to the Latin America case (Peek and Rosengren, 2000). These four indicators allow us to analyze the credit and the deposits made by the subsidiaries physically installed in the host countries, and also the cross-border credit, focusing on the variations observed about the cross-border credit, the credit of foreign subsidiaries and the credit of local national banks. Indeed, the debt flows (loans and securities) were about 50% from the private entries (which also include direct and portfolio investment) in the countries in Central and Eastern Europe. Moreover, the commercial banks have a substantial part of this debt, which is, to a great extent, absorbed by local owned bank sector (Talley, Giugale and Polastri, 1998). However, the BIS data used by these authors to deduce the cross-border consolidated credit include the local claims of foreign affiliates of reporting banks. Thus, local credit can behave differently from the real cross-border credit or the off-shore credit, as we see on Latin America (Peek and Rosengren, 2000) and in Central and Eastern Europe (Badulescu, 2007).

Indeed, the cross-border credit was an important source of the credit supplied by foreign banks in Central and Eastern Europe. For example, in the year 2000, the cross-border credit in Hungary reached 20% of GDP. The traditional measures of foreign banks penetration – the number of banks and the weight of the assets of foreign subsidiaries in total assets – could underestimate the real extension of foreign penetration. As we will see, at the level of the year 2000, cross-border credit was, respectively, 9%, 47%, 22%, 91% and 29% of the credit supplied by foreign banks subsidiaries in Estonia, Hungary, Poland, Slovenia and Czech Republic, so it has to be considered explicitly in order to measure the foreign bank penetration (Peek and Rosengren, 2000).

In order to compute the degree of foreign penetration by broad credit (broad claims measure), we first compute the sum of cross-border claims as total BIS claims plus claims of non-reporting foreign subsidiaries. This sum is divided by the sum of total BIS claims, claims of non-reporting foreign subsidiaries, and claims of all domestically owned commercial banks. This measure takes into consideration explicitly the fact that foreign banks can very well participate in Central and Eastern countries without opening a bank subsidiary or buying one, simply by extending cross-border credit to domestic firms. We notice that this measure of broad credit includes also the credit provided by foreign branches of banks from BIS reporting countries, unlike the foreign subsidiaries, because this credit is included itself in BIS consolidated bank statistics.

Another measure of bank penetration (the narrow claims measure) focuses on the credit provided only through foreign subsidiaries within Central and Eastern Europe countries, ignoring cross-border lending other than that done through foreign subsidiaries within the country. It is calculated as claims of foreign subsidiaries (from both BIS-reporting and non-reporting countries) divided by the sum of claims of foreign subsidiaries and claims of domestically owned commercial banks.

Beside the measures of banks assets (credit supplied), we can build measures of bank penetration based on bank liabilities. We use a limited measure of deposits that includes demand deposits, savings deposits, and time deposits (narrow deposit measure), as well as a more expansive measure that also includes inter-bank deposits, open market funding, and other short-term borrowing (broad deposit measure). For both measures, we compute the penetration share as the ratio of deposits in all foreign subsidiaries to the sum of deposits in foreign subsidiaries and from domestically owned banks. Deposit penetration focuses on foreign operations at the retail level, while measures of credit that include offshore loans may capture the foreign penetration into wholesale bank operations as well. Furthermore, deposit penetration may be particularly responsive to crises, rising to the extent that host country depositors engage in a flight to quality (Peek and Rosengren, 2000).

2. Foreign claims of BIS reporting banks in Central and Eastern Europe

After 1990, slowly in the beginning, but more and more pregnant, Central and Eastern Europe countries became an important destinations of credit provided by foreign banks, cross-border or locally provided, by subsidiaries open in emerging Europe countries. Nowadays, the situation of the claims of banks from reporting BIS countries on different regions is as follows:

Table 1. Foreign claims, local claims and international claims of BIS reporting banks on different categories of countries and regions, March 31, 2005

	Foreign claims (billions of US dollars)	Local claims of foreign subsidiaries denominated in local currency (billions of US dollars)	International claims (billions of US dollars)	On which, to the sector (in %):		
				Non-bank private	Bank	Public
	1	2	3=1-2	4	5	6
All countries	20473.8	6514.3	13959.5	39.7	44.8	14.3
Developed economies	16943.7	5416.7	11527.0	35.1	48.7	14.9
Off-shore centers	1472.2	286.1	1186.1	76.1	22.4	0.9
Developing	1977.0	811.4	1165.6	48.1	30.4	19.6

countries						
Developing countries in Africa and Middle East	242.6	51.1	191.5	49.8	31.3	18.6
Developing countries Asia and Pacific	646.8	254.6	392.4	42.1	38.6	16.6
Developing countries Europe	549.8	187.3	362.5	47.8	30.4	21.5
Developing countries Latin America-Caribbean region	537.8	318.6	219.2	58.0	17.9	22.6

Source: *Consolidated Banking Statistics*, first quarter 2005, BRI, www.bis.org

As we can find, developing countries in Europe (the former socialist countries but also Cyprus, Malta and Turkey) cumulate 2.6% from the total foreign claims and 27% from the total foreign claims on developing countries. We must notice that these claims are realized more and more by local subsidiaries of foreign banks (developing countries in Europe count for almost 5% from the local claims of foreign subsidiaries) and less by cross-border credit (where developing countries in Europe count for 1.5% of the international claims).

Indeed, even we analyze the data for only three countries in region (the bigger destinations of foreign claims flows), we notice clearly the more and more preference in Central and Eastern Europe for physical presence through bank subsidiaries and branches than cross-border credit:

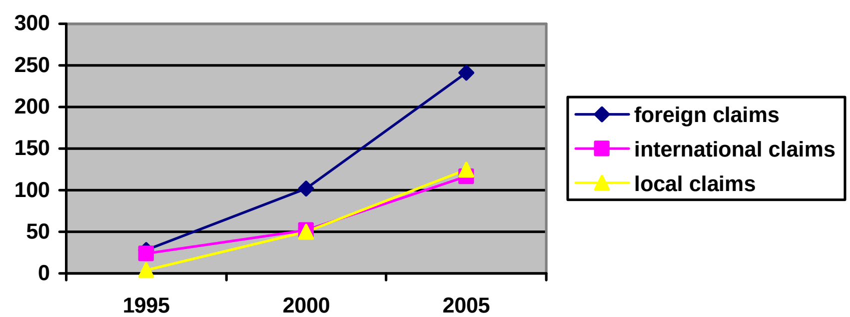

Chart 1. Evolution of the claims of BIS reporting banks on Czech Republic, Hungary and Poland (cumulated), 1995-2005, in billions US dollars

Source: *Consolidated Banking Statistics*, BIS, different years

It looks that Central and Eastern Europe passed the stage of banks implication through financial flows, reaching the stage of direct investment (local subsidiaries and branches), which means of course a bigger financial stability and the expression of a long run involvement in region. If in 1995 local claims were almost zero and 85% of the foreign claims were cross-border, ten years later more than 50% of the claims are local. This is certainly also the result of liberalization and privatization policies, intensified especially after 1995, cumulated with the wave of cross-border bank mergers and acquisitions after 1995:

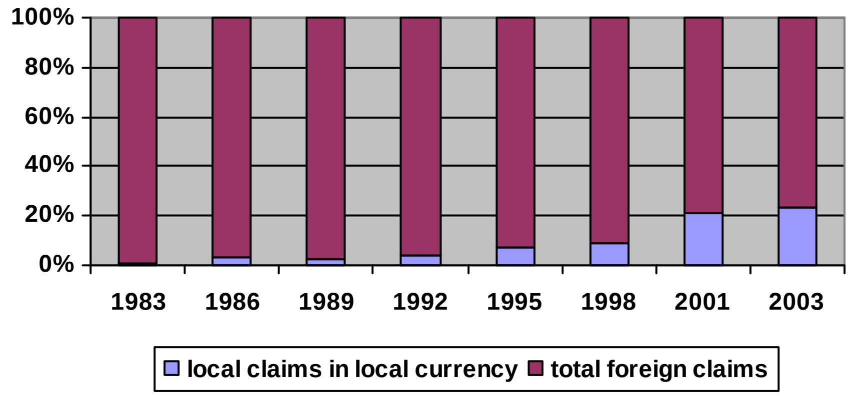

Chart 2. Structure of foreign claims in Central and Eastern Europe

Source: Gallego, S., García Herrero, A. and Luna, C., *Investing in the Financial Sector of Emerging Countries: Potential Risks and How to Manage Them,* BIS, 2005

We can notice that, after 1995, the weight of local claims in total foreign claims began to significantly rise, as a reflection of the process of passing to local, direct provision of credit by subsidiaries and branches of foreign banks implanted in region. We must mention that this phenomenon is characteristic to all emerging countries (however, for Asia and Latin America the passing to local financing occurred after 1980, the process being intensified after 1995) but not to industrialized economies, where the weight of local claims in total maintained constant to 25-28% in the last 15 years (Gallego, S., García Herrero, A. and Luna, C., 2005). This is also a reflection of something we can call "a two speed globalization", at least in bank sector, where developing countries opened massively the bank market toward foreign investors, while big European countries did not do the same.

The main credit supplier banks are, as expected, the European banks, with 87% of total foreign claims on Central and Eastern Europe countries (see fig. 3):

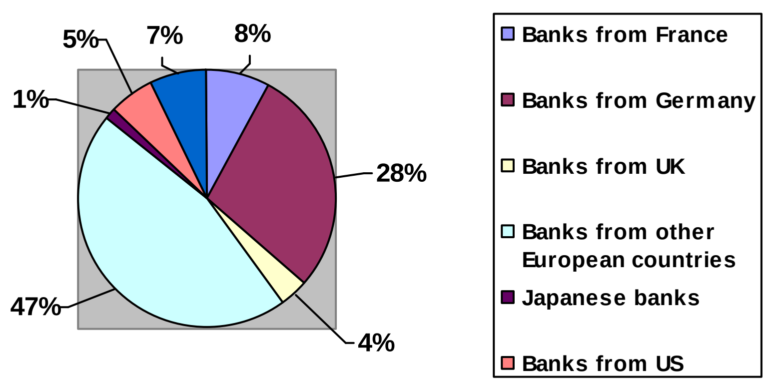

Chart 3. Distribution of foreign claims on Central and Eastern Europe countries, by nationality of reporting banks

Source: *Consolidated Banking Statistics for the first quarter of 2005*, BIS

The structure of the claims of BIS reporting banks on countries in Central and Eastern Europe, by country and category of claim, is presented in the table below:

Table 2. Claims of reporting BIS banks on countries in Central and Eastern Europe, March 31, 2005

	Total foreign claims, in millions of US dollars	Consolidated cross-border claims in all currencies and local claims in foreign currency					Local currency positions of reporting banks' foreign offices with local residents	
		Total	By sector: Banks	By sector: Public sector	By sector: Non-bank private sector	Banks with head offices outside the country of residence	Claims	Liabilities
Romania	18694	13782	2944	3141	7645	192	4912	3948
Bulgaria	9114	6210	1523	789	3896	40	2904	2768
Czech Republic	54983	19516	4567	3321	11233	701	35467	45888
Hungary	70075	48230	14203	16508	17514	120	21845	19326
Poland	116520	48695	7325	17444	23655	61	67825	52018
Slovakia	27561	11714	5076	2941	3520	383	15847	10279
Slovenia	12345	10189	4910	1341	3933	211	2156	1003
Total developing countries in Europe	549813	362535	110054	78074	173234	3928	187278	162766

Source: *Consolidated Banking Statistics for the first quarter of 2005*, BIS

As expected, the major destination of cross-border claims is the non-bank private sector (about 50%), but the public sector has also an important weight.

The situation of these flows by destination countries (see chart 4) reflects the important place of new EU members, followed by the candidate states.

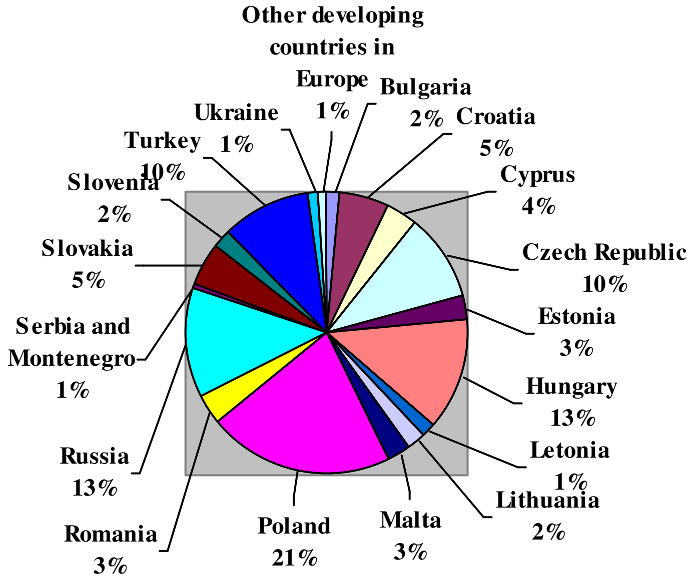

Chart 4. Foreign claims of BIS reporting banks on Central and Eastern Europe, by country, in % of the total

Source: same as table 2

A number of 5 countries (Poland, Hungary, Russia, Turkey and Czech Republic) cumulates two thirds of the foreign claims toward the area of European emerging countries, which proves a consistent concentration on the most advanced economies and, in the case of Russia, economies more interesting in the future than in actual time.

3. Foreign banks' presence in region

Foreign credit to Central and Eastern Europe economies takes place, as we saw, more and more by the physical presence of foreign banks in region.

Operations' evolution – credit and deposits – of multinational banks in Central and Eastern Europe in the last 20 years reflects the rise of multinational banks' activity after 1990, and it's "explosion" after 1995 (see chart 5). The involvement is a little more on credit supplied than attracted deposits, reflecting the net capital importer position of the region, result of the raised financing needs of the economies. If in 1990 Central and Eastern Europe was counting with 5% of the credit supplied by multinational banks in developing economies, in 2005 it reached 23% of these.

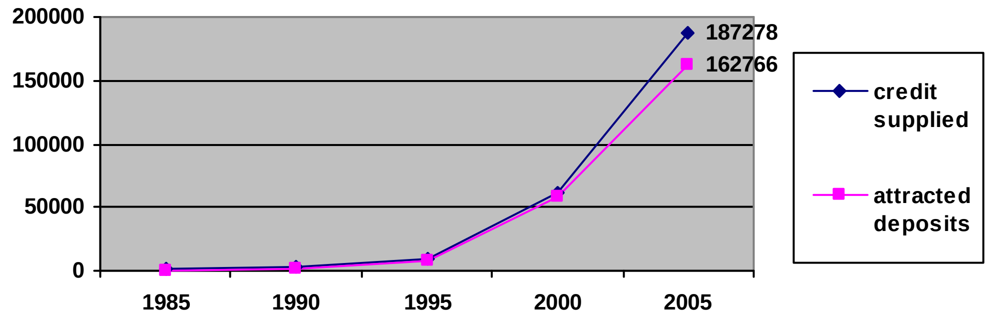

Chart 5. Evolution of multinational banks' activity in Central and Eastern Europe – credit and deposits, in millions of US dollars, 1985-2005

Note: the data for 2005 correspond to the first quarter of the year

Source: author's calculations based on data from *Consolidated Banking Statistics*, BIS, different years

As we see, foreign banks reached to dominate nowadays the national bank market of these countries. After 1994 and to the present, the weight of foreign banks in total credit institutions in Central and Eastern Europe raise from 20% (weight in total number of banks) and 55% (weight in total assets) to, respectively, 60% and 70% (see next chart).

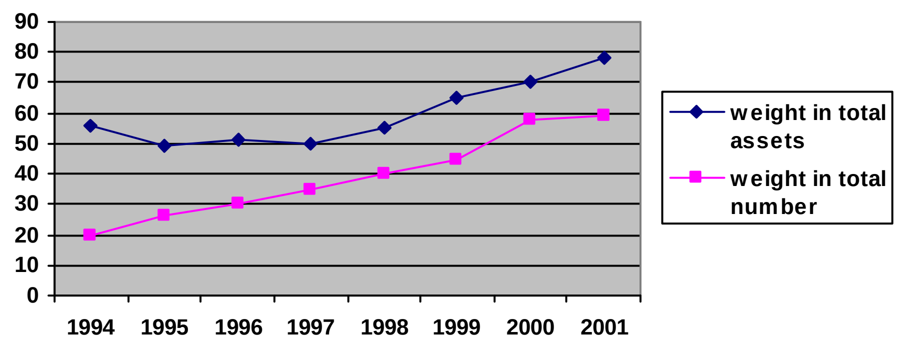

Chart 6. Foreign banks' participation in countries in Central and Eastern Europe, 1994-2001

Source: Uiboupin, J., *Implications of Foreign Bank Entry on Central and Eastern European Banking Market*, in „Kroon&Economy" no. 1/2004

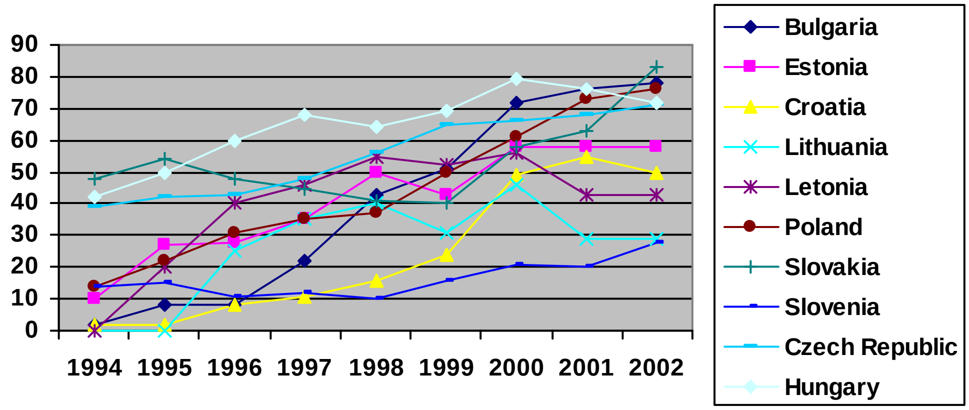

Chart 7. The weight of foreign banks in total number of banks in Central and Eastern Europe, 1994-2002

Source: same as figure no. 6

As we notice, in countries like Estonia, Slovakia and Croatia, domestic banks are essentially owned by foreigners, in Czech Republic, Lithuania, Romania and Hungary the weight of foreign capital is more than 80%. The only important exception is Slovenia, with less than 30% presence of foreign banks. The dominant presence of foreign capital is relied on the privatization of formerly state-owned banks, the most preferred entry way being the settlement of subsidiaries by acquiring local banks and less the creation of branches.

Nowadays, over than 85% of the banking operations are achieved by subsidiaries, which represent 95% of the foreign bank assets (*Banking and Finance Monitor*, 2006, and *Capital,* 1st August 2006). The main foreign banks operational in Central and Eastern Europe at the end of 2005, ranked by the total value of assets in region, are: UniCredit Group (assets of 86.2 billions of euros, present in all countries in Central and Eastern Europe), Erste Bank (assets of 48.7 billions of euros, present in 6 countries in region), KBC Bank NV (assets of 42.7 billions of euros, present in 5 countries in region), Raiffeisen International (assets of 42.3 billions of euros, present in 15 countries in Central and Eastern Europe), Société Générale (assets of 30.1 billions of euros, present in 10 countries in region), Intesa Bank (assets of 22.1 billions of euros, present in 9 countries in Central and Eastern Europe) and, maybe surprising (being a bank from Hungary, not Western Europe, as the others), OTP Hungary (assets of 19.1 billions of euros, present in 6 countries in region) (*Banking and Finance Monitor*, 2006). It is interesting to notice that the first 7 “players” in the banking sector of Central and Eastern Europe concentrate 26% of the market in region.

We can notice a certain regional specialization of foreign banks. The great Scandinavian banks (Swedbank and Skandinavska Enskilda) are practically monopolizing the bank market of Baltic states, while the Greek banks (National Bank of Greece, Piraeus Bank, Alpha Bank, Emporiki Bank of Greece) are involved only in Balkans states. At the same time, the Austrian banks (Erste, HVB before it’s take over by UniCredit, Raiffeisen) control important market shares in all countries in Central and Eastern Europe, except Baltic states. There are also some examples of banks from Central and Eastern Europe buying banks in other countries in region: Hungarian OTP made acquisitions in Bulgaria, Slovakia and Romania, and the Latvian Parex bought the Lithuanian bank Lithuanian AB Industrijos Bankas (*Banking and Finance Monitor*, 2006, and *Capital,* 1st August 2006).

The most interesting countries for mergers and acquisitions are Czech Republic, Hungary and Poland, the main acquiring banks being the banks from the European Union (the American Citibank is a notable exception, but it's involvement doesn't exceed a market share of 8% in total assets in any country in Central and Eastern Europe), probably because of considerations relied on scale economies and limitation of expanding opportunities on their own markets. The acquired banks usually operate on the mother-bank's brand, in order to beneficiate from the reputation transfer. Foreign banks' entry in the bank market of Central and Eastern Europe was more difficult in the beginning of 1990s, when just a few entered, by creating Greenfield banks, because of the absent interest of host countries and because of lack of attractiveness of these countries before the structural reforms. The Greenfield banks followed in the first place their clients, who made investments in region, and than – as the privatization process was in progress – acquired big local banks.

4. Conclusions

As a conclusion, we can state the actual reality of the development degree of the bank sector and of the presence of foreign capital in Central and Eastern Europe countries indicate a penetration degree of 46% (see table below) on the entire region (comparative with 25% in euro area), with many differences on countries, but also levels of concentration indicating a massive preponderance of the first 3 banks in the sector (50%). This means that, if we take out Russia (where the number of banks is very high, anyway) and Turkey (which is not a former socialist country), in the other 13 former socialist countries in region are operating 404 banks: the bigger 39 count for 50% of the assets of bank sector, and the rest of 365 banks count for the others 50%. Consequently, there are enough premises to continue the process of bank concentration and consolidation, through mergers and acquisitions, probably mostly with a foreign buyer. This will rise the degree of foreign penetration on the bank market in Central and Eastern Europe. And we should add that there are still missing the "big players": from the first 7 regional players, only 3 are among the 20 biggest banks in the world by stock capitalization, another reason to continue the consolidation and structural transformations at regional level (see table below).

Table 3. Synthetic data on banking system in Central and Eastern Europe countries, at the end of 2005

Country	Number of banks	Market share of foreign banks (in total assets)	C3 concentration degree (cumulated market share of the biggest 3 banks)	Total assets	
				In billions of euros	In % of GDP
New members of European Union					
Polonia	61	70%	37%	152	60%
Ungaria	34	84%	38%	75	87%
Cehia	36	85%	56%	102	99%
Slovacia	23	98%	47%	37	96%
Slovenia	22	19%	50%	29	107%
Estonia	13	99%	88%	12	112%

Letonia	23	58%	54%	16	123%
Lituania	12	86%	67%	13	63%
Bulgaria	34	76%	34%	17	78%
România	39	88%	50%	35	45%
European Union candidate states					
Croația	34	91%	54%	35	114%
Turcia	31	19%	45%	249	81%
Other states in Central and Eastern Europe					
Rusia	1205	9%	39%	285	45%
Serbia	40	66%	36%	9	48%
Bosnia-Herțegovina	33	89%	54%	6	81%
Total Central and Eastern Europe	**1805**	**46%**	**50%**	**1108**	**66%**
Euro area	**6403**	**25%**	**-**	**17895**	**224%**

Source: *Banking and Finance Monitor*, 2006, http://www.unicreditgroup.eu

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