Banking System in the Central and Eastern European Countries

Management

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ABSTRACT

Due to the socialist system which had prevailed over the CEE countries, the banking sector in these countries had not been developed. Therefore, given the importance of this sector in economic development, the goal of this paper is to analyse the role of banks of the CEE countries, their history of development, the effects of credit growth and the impact of the financial crisis of 2008/09. The banking sector in CEE countries, and particularly in the SEE countries in the early stages of transition (period 1990-2000), was characterized by the participation in large foreign-owned banks, which offered a wide range of products and services to clients. At the beginning of the consolidation of banks, credit growth was greatly expanded, but this was discontinued with the introduction to the recent financial crisis. Credit growth caused the creation of non-performing loans. However, the supervisory authority implemented reforms to avoid non-performing loans (NPL) in the balance sheets of banks. Also, in order for the level of NPL to be lower, banks will have to implement the new rules of Basel III.

Introduction

During the socialist era, a monobank system existed (monobank performed the functions of a central bank and a commercial bank) on all CEE countries. As a reform of the banking sector, these countries abolished the former monobank system and founded the so called two-tier banking system, which is typical of a market economy. Consolidation and privatization of commercial banks have been implemented in these countries (Bancincova, 2012).

The role of foreign banks has become dominant in the CEE, including six SEE countries. Foreign banks penetrated directly in these markets with the establishment of operations in agriculture or taking part in the privatization of local state-owned banks (Košak, Čok, 2008). The following section will present the history of the banking sector development in CEE countries.

According to Haas, Lelyveld, (2004), foreign banks lending has increased significantly from five CEE countries during the study period compared to GDP. When compared to internal credit, the importance of foreign bank loans is increasing gradually. In these countries, cross-border loans decreased compared to household loans in the first years of transition, while foreign affiliates became significant only a few years later. During the transition period, a growing share of all foreign bank loans has been immersed in private non-bank sectors, while foreign loans to the local bank became relatively less important. By opening local branches, foreign banks had started to finance themselves in the CEE businesses and their role was thus shifted from being financiers of domestic banks to being their competitors. Section three presents the impact of rising non-performing loans in the banking sector stability.

Global financial and economic crisis that erupted in full after the collapse of Lehman brothers in September 2008 temporarily halted the quick attaining process which characterized the CEE region in previous decades. Freeze in global credit markets and capital flows at the beginning of last year, was associated with increased fears of investors about a general crisis that includes the CEE region and the banking system in the Eurozone. After a decade of dynamic growth, the inflow of capital to the region came to a sudden stop in the event of the autumn of 2008, along with the deterioration of both domestics and international macroeconomic conditions and a sharp drop in production. In general, the need for a regulation has been most pressing in countries that previously experienced the greatest increase in domestic demand, the largest external imbalances and the highest growth in private sector debt (Revoltella, Mucci, 2011). Section four presents the impact of the financial crisis in the banking sector in CEE countries.

Background of the Banking Sector Development in CEE

The first step in the reform of the banking sector for most countries in transition involved the creation of a two-tier system, namely the shift from a monobank system to two-tier system (central bank and second level banks). Central banks after this period was responsible for the creation and implementation of monetary and credit policy and the supervision of second level bank in order to achieve a stable financial and economic system. A part of the banks had passed into state-owned banks, while the rest of the banks were privatized by domestic and foreign investors, but in the early stages of the transition there has also been establishment of new banks.

Around 2000, most countries had completed the privatization of their banks and some of them had started EU accession negotiations. According to the accession agreements, the respective governments made commitments to align their financial sector regulatory and supervisory standards to that of the EU and to open the banking sector to foreign investors (Fang, Hasan, Marton, 2011).

In 2000, CEE economies went on with further adjustments in order to complete their transition process. After the currency crisis in the spring of 1998, a change was observed in adopted monetary policy, which was documented in a drastic decline of short-term rates and long-term interest rates. This decline was evident in particular in the period before the CEE economies would join the EU in May 2004. Nevertheless, the levels of interest rates in CEE economies had not fallen to very low levels compared to interest rates in the US, Eurozone and other developed countries (Kouretas, Tsoumas, 2013).

This region was considered to be very heterogeneous in the stage of EU integration, economic development level, the degree of financial intermediation and banking sector development. Despite differences among countries, overall size of the banking sector (measured by total assets or loans to the private sector) was small compared with the banking sectors of the EU. As a result, a degree of financial intermediation remains significantly lower than in EU countries, although the region is rapidly developing. Lower stage of development of the banking sector has its roots in the history of political and economic pre-transition. Since the beginning of transition in early 1990, the banking sector has undergone tremendous changes in all economies in transition. However, the starting position in individual countries in SEE6 group was quite diverse. The role of foreign banks has become dominant in the CEE, including, SEE6. In these markets, foreign banks penetrated directly with the establishment of operations in agriculture or taking part in the privatization of local state-owned banks (Košak, Čok, 2008).

In comparison to developed financial systems (which have sustainable economic sectors), the banking sectors in CEE are still underdeveloped, especially in countries in transition. In this context, there has been a lack of innovation in the financial system, mainly due to lower markets of underdeveloped financial, political, economic and credit risk, high rates of poverty, underdeveloped segments of the stock exchange operations, currency fluctuations, high inflation and other macroeconomic indicators (i.e. the trade deficit, a high level of public debt, a relatively small influx of foreign direct investment, etc.). The experiences of countries that have gone through a transition period (Hungarian financial market) have shown that the progress of the financial system, especially insurance companies, pension and investment funds, continues after the development of the banking sector (Bajraktarović, Paunović, Ječmenica, 2013).

Moreover, the data indicate that there are significant differences in all the banks in some of the CEE countries. While some banks do not perform credit, others show only slight involvement in collecting deposits. A comparison between the financial intermediation activities of the largest banks with those of smaller institutions supported the argument that in countries where the current banks still dominate in the deposit market, there is a great candidate specialization in collecting deposits and entry of new banks to issue loans (von Hagen, Jyrgen, Dinger, 2005)

Fang, Hasan, Marton (2011) studied the SEE banking efficiency during 1998-2008. The authors found that the average efficiency of profit in this region is close to the CEE region, but the average cost efficiency leave considerable room for improvement. Two factors may explain the high cost of foreign banks. First, it was their initial disadvantage of local knowledge in the region of SEE. Secondly, after the acquisition of former state-owned banks, foreign banks invested in local operations in branch modernization, treatment and often in branch expansion. At the same time, the domestic banks that were in the market improved the efficiency of their care primarily selected for niches where they held a comparative advantage. Their findings, however, support the findings of the literature of a strong competitive advantage that foreign banks enjoy with their operations in less developed markets. This advantage, compared to domestic-owned counterparts, is clearly the highest efficiency of foreign-owned bank profits. In order for the firms to be big clients of the banks, the performance of the real sector and the improvement in corporate governance is important prerequisites for a stable and efficient banking sector.

CEE markets are close to western Europe in both terms, geographical and cultural, for this reason, financial institutions of western Europe have perceived the closeness of CEE, as a factor behind the lower costs of transactions (in a similar way, the case of banks from northern Europe, establishing their presence in the Baltic States). This is consistent with the theory of FDI in manufacturing sectors. The difference between the interest rate on lending and deposit interest rates in CEE and Baltic countries was higher than that in western and northern European countries. This was due to a lower efficiency and a higher risk of deposits in CEE and Baltic countries, in comparison to Western Europe. When comparing the performance of the banks, it is clear that netted interest incomes in CEE countries were higher than those in Western Europe and that operating costs was higher in the CEE (Banincova, 2012).

Liuhto, Ksõrg, Uiboupin (2006), combined bank micro-level data with macroeconomic indicators and development of the banking sector to assess the effects of the entry of foreign banks in the CEE countries. The main methodological difference with previous studies was that both domestic and foreign banks are included. Results of the authors show that the entry of foreign banks is associated with lower pre-tax earnings, income from non-interest, the average interest rate on the loan and loan loss provisions. The authors have found limited evidence that the entry of foreign banks increased the cost of a bank in the short term. The results generally suggest that the entry of foreign banks onto the market increases competition. Also, the role of the banking sector development was analysed. Assessment results show that in most developed banking markets, entry of foreign banks was less related to the reduction of income and loan loss provisions than in less developed banking markets. In more developed markets, high costs of banks are less likely to increase. Results indicate that banks with higher market share react less to the entry of foreign banks, in terms of non-interest revenues and provisions for loan losses.

The penetration of foreign banks can have positive and negative implication for the stability of bank loans in developing countries and transition countries. The positive side is that well-capitalized foreign banks, with internationally diversified asset portfolios, may be able and willing to keep lending to domestic companies during unfavourable economic conditions in the host country, in comparison to the domestic bank that could possibly reduce their supply of loans. In addition, branches of foreign banks in time of crisis can act as a "safe haven"; thus reducing the flow of domestic funds abroad. On the other hand, it can also be said that foreign banks may also be less inclined to continue their supply of credit in the host country, especially when the economic environment in their country worsens (de Haas, van Lelyveld, 2004).

Non-Performing Loans in CEE

Not surprisingly, non-performing loans were a serious problem for all countries, partly due to the inherent heritage, but also to continued lending practices. The ratio of nonperforming loans to total loans in 1995 was on average 27.2% in the four CEE countries (Poland, Hungary, Czech Republic and Slovakia). Ratio in 1995 was lower for the SEE countries, with the notable exception of Romania. Most governments responded to the failed banks with effort to save them from closing with the recapitalization and the removal of bad loans from their balance sheets. The legal environment has improved in relation to the bankruptcy laws, collateral laws, and trust in law enforcement, further banking regulatory and supervisory skills are developed significantly. The main concern was that the intensification of the credit has come in the form of rapid growth of a mortgage lending and other forms of consumer credit. Lending to households has increased rapidly in many countries (Bonin, Hasan, Wachtel, 2013).

Kiss, Nagy, Vonnák (2006), attempted to analyse the growth of credit in a macroeconomic framework using equilibrium level assessment panel for private lending. Therefore, the authors built three different measures of probability to assess if credit dynamics in these countries can be considered excessive. Loans to GDP ratios were generally below levels justified by macroeconomic variables in the CEE countries. However, the overall results in some new member states of the EU show that credit growth was significantly faster than would be justified along the equilibrium. Sectoral assessment revealed that the concept of equilibrium credit growth was particularly important in the household sector. In the case of enterprises, the model had relatively low explanatory power. The authors also assessed the consequences of ignoring the direct foreign loans. They were not able to determine the net effect of possible distortions that these biased factors cause in opposite directions. Possible policy responses should consider opening the financial markets within the EU and its implication for cross-border financial transactions may significantly limit the effectiveness of national administrative measures. Activity measured was especially important in the case of the most dangerous segments, such as the financing of small firms or providing unsecured household loans.

The regression results suggest that banking stability in CEE countries is on average negatively correlated to the increased lending. This result highlights the problem of rapid expansion of credit over a number of micro risks (loose credit policies and underestimated risks) and macro risks (construction of internal and external discrepancies). Increase of loan provision loss has a negative impact on the stability of banks, mainly through lower indicators of profitability. This finding could mean that the creation of the loser lending provisions in CEE banks during the period was noted more as a reflection of the quality of loans rather than as a prior management threat. The authors also indicate that price stability contributes to reduction of the insolvency risk. This result was mainly driven by the significant negative relation between banking stability and inflation in previous years on a sample of authors who were characterized by high rates of inflation (Ivičić, Kunovac, Ljubaj, 2008).

Eller, Frömmel, Srzentic (2011), explored the determinants of domestic private sector credit development in eleven CESEE countries, mainly CESEE member states to the EU and, Croatia from January 1997 to April 2009. The authors analysed lending to enterprises and lending to households, between short-term supply and long-term demand determinants and sub-periods identified with a different impact of the credit growth determinants. The main results and policy related implication can be summarized as follows: First, there is at least a long-term equilibrium relationship between levels of private sector credit and demand-side on macroeconomic basis in most CESEE countries where economic activity is the most important determinant of long-term macroeconomic credit levels; its positive influence is more eminent for loans to households than for loans to enterprises. Inflation shows a negative relation to credit for most countries, while the rate of lending in some cases shows a negative relation to credit for most countries, whereas the rate of lending in some cases shows a positive counter-intuitive sign, which however, confirms the existing empirical evidence. This evidence also informs us of the importance of the variables from the macroeconomic demand side for the long term financial sector development, information that may be important for long-term economic growth prospects of the CESEE countries examined. Second, the bank related loans supply variables (bank deposits and capital) explain more the variation in the rates of credit growth. Third, for some countries, there is a lack of continuous adaptation of current credit levels to levels of credit balanced (i.e. those established by macroeconomic fundamentals).

Laidroo aimed to investigate the determinants of lending growth and cyclicality in the context of the CEE countries. As expected and reported in previous studies, GDP growth had a positive correlation with increased lending by supporting the cyclicality of lending. Although based on theoretical predictions, we would expect the relationship between credit growth and GDP growth to be stronger when the economy is below trend, but the CEE data shown the opposite: the relation between these two variables was stronger when the economy was above the trend (2004-2008) compared to when it was below the trend (2009-2010). This shows that when the economy was above the trend in lending, the trend may have been driven by supply factors (inflow of money from developed economies to developing economies), and not by demand factors captured by GDP growth. When economic growth declined, banks was not able to attract loan amenities.

The Impact of the Financial Crisis in CEE Countries

The first visible signs of the global economic crisis in CEE countries were present in the financial sector in the form of low liquidity and stringent reforms of financial institutions. Increase of interest rates was one of the first signs that presented potential problems in CEE countries. The negative effects of the first wave of the global economic crisis in 2008 and 2009 made CEE commercial banks approve a more restrictive and cautious lending, strict classification of outstanding loans, increased level of capital adequacy, liquidity maintenance and careful planning. On the other hand, recent economic analyses indicate that the return of confidence in the financial system in the CEE countries is possible only through the implementation of actions that are based on deposit insurance in banks, state support for financial institutions, regulatory measures and government guarantees on new loans for businesses and banks (Boshnjak, 2011) as cited in (Bajraktarović, Paunović, Ječmenica, 2013).

As a result of the financial crisis of 2007-2009, there has been a growing literature in an attempt to provide economic explanations of the roots of this phenomenon. It is by now well documented that the liberalization in financial markets, the creation of complex financial instruments, poor corporate governance, poor performance of rating agencies in some cases, and the dramatic rise of the shadow banking sowed the seeds of crisis. A second source was found in the extended period of low interest rates on the market based economy, which led a significant increase in loans (Kouretas, Tsoumas, 2013).

Banks in CEE have withstood relatively better than other banks in developing markets in earlier crisis but various banking sectors coming out of the crisis were not unharmed. Worsening of the economic conditions began to take a toll on banking profitability in the last quarter of 2008, when international liquidity crisis spread overseas and there was cost of financing and liquidity risk where full banking accelerations were avoided and no country experienced a sharp change in external funding. Concern that foreign parent banks would not support their subsidiaries turned out to be unfounded. Since the crisis, the banking system in CEE has recorded a volume growth model less dynamic than before the crisis. Lower increase of volumes and higher cost of funding, which would match competitive pressures (although less strongly than in the past) means a generation with lower capacity for revenues. Also, the cost of risk has remained at above pre-crisis levels, those levels which were probably artificially low, due to the unexpected development of the market itself, within a very short timeline. In such a context, efficiency remains a priority, meaning the strategy of cost cuts, but also the increase of efficiency and boosting of investment growth. In general, the banking business in CEE will remain less profitable since accuracy still remains a possibility of comparison with more maturer markets (Revoltella, Mucci, 2011).

Kouretas, Tsoumas, (2013), examined the behaviour of bank risk-taking in CEE countries using annual data for the period 1997-2011. The empirical results reveal a positive relationship between bank risk-taking measured in risk assets to total assets, and different definitions of interest rates. However, when the authors deal with non-performing loans as a dependent variable, the relationship of this bank risks measure and interest rates is negative. A plausible explanation for this result, although puzzling, is that loans have declined gradually in the period under review after their soaring during turbulent times in the middle of 1990 for the vast majority of countries in the sample. An increase in interest rates (much lower than in 1990) was interpreted as a sign of a rapidly growing economy.

The stability of the financial sector and provision of regular credit conditions in emerging Europe is in the common interest of the private sector and the host countries. For this purpose, the principle to avoid disorders in financial problems in emerging Europe was agreed by officials and private sector banks in the Vienna Initiative Forum in 2012. The agreement aims to better coordinate banking sector regulation and monitoring processes and contain the negative spread between the Eurozone and emerging Europe. It stresses the central role of the European institutions and international institutions to facilitate this coordination (Vienna Initiative, 2012). The initiative aims to promote coordination between the hosts and the countries in cross-border banking activities. Vienna initiative was originally launched in 2009 at the height of the global financial crisis to help maintain financial sector stability in emerging Europe by including and encouraging cross-border banking groups to maintain their exposure to the region and appropriate levels of solvency for their subsidiaries. The second phase of its activities is a response to renewed risks in the region arising from the international environment. European institutions are to play a central role in supervisory coordination, macro supervision and mediation among national authorities. Regional and also national active banking groups together with European authorities should cooperate closely in efforts to maintain credit conditions consistent with sustainable economic growth. Pressure on European banks by governments and the market, to move NPLs from their books has increased. Banks have not proven to be good traders or managers of non-performing loans, but the situation has motivated better management of bad loans. Firstly, it is costly to keep NPLs in banks, which will gradually have to meet minimum requirements of the new international Basel III capital. Secondly, NPLs have generated problems in credit markets and other intermediaries can serve the need of resolving the NPLs. Discussion of the impact of Basel III rules in Developing Europe and solving the problems of non-performing loans (NPLs) has been put on the current agenda of regulators and bankers (cited in Houbenova-Delisivkova, 2014).

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