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THE ROLE OF FOREIGN BANKS IN FIVE CENTRAL AND EASTERN EUROPEAN COUNTRIES*

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Abstract

During the last decade the development of the banking sectors in CEC5 countries was greatly determined by increasing presence of foreign banks. Foreign banks played a significant role in privatising, re-capitalising and modernising the banking sectors in the region. In this sense they contributed to stability. However the exceptionally high level of foreign ownership also raised concerns whether foreign banks threaten stability by propagating shocks outside the host country, doing cherry-picking or putting too much pressure on already troubled domestic banks. This paper summarises the empirical evidence on those issues. Our major contribution is the presentation of CEC5 countries' experiences based on the up-to-date and rich information provided by individual case studies of the involved central banks. We outline the motives behind the entry of foreign banks, compare their performance relative to their domestic peers. By summarising the latest development in EU countries, we also highlight the differences between them and the accession CEC5 countries.

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I. Introduction

As a consequence of the bank failures of the early 1930s, the banking industry became heavily regulated with serious entry barriers in the aftermath of the Great Depression. These barriers remained almost unchanged until the early 1980s. From the 1980s on, however, we have witnessed extensive liberalisation and integration of banking markets. In certain regions (in particular in Latin America and Central and Eastern Europe) foreign penetration has reached unprecedented levels. This paper focuses on the CEC5 countries, where the process of internationalisation has some peculiarities, which make comparison with earlier experiences difficult. At the end of the 1980s, after the collapse of socialist 'planned' economies, these countries began to develop market economies. There was a need to create the institutions of a market economy in a liberalised international financial environment. Moreover, the transformation crisis caused the depreciation of domestic capital including that of the banking sector as well. The accumulation of capital and development of know-how intensive banking infrastructure required strong involvement of foreign capital.

With the exception of Slovenia, the banking sectors of the CEC5 countries are now dominated by foreign banks. At the same time, there is a noticeable trend of integration on the Single European Banking market as well. Nevertheless, the role of foreign banks is much less dominant than in the accession countries.

The next section presents an overview of the role of foreign banks in countries with less-developed financial systems. In this section, we analyse the benefits and costs of foreign bank entry and the financial stability aspects of the foreign bank presence. International experiences of the impact of foreign bank penetration on the domestic banking sector are also reviewed. The third part analyses the transformation of financial systems in the CEC5 countries, with special regard to the motivations, characteristics and role of foreign banks. This overview builds on the country studies prepared by the CEC5 central banks as well. The role of foreign banks in the EU is markedly different than in the CEC5. Accordingly, the fourth section outlines the current state and recent trends in foreign banking on the Single European Market which the CEC5 countries will soon be joining. The final section presents the conclusions.

II. The role of foreign banks - experiences of less-developed countries

During the last decade there was a substantial increase in foreign bank penetration both in terms of its extent and the number of countries involved. The two regions mainly affected are Latin America and the transition countries in Central and Eastern Europe.[1] This section aims to summarise the findings of various empirical studies, which consider the impact of foreign entry on the domestic banks and the banking system in general. We focus on the experiences of developing countries, which are more relevant to CEC5 countries. The experiences of developed countries are used rather to highlight the differences between developed and developing countries.[2]

We are mainly interested in financial stability, which is affected by foreign entry through various channels: its impact on competition and efficiency, on capital flows (quantity, structure and volatility), and on institutional capacity (transparency, regulation and supervision, market infrastructure).[3] Although there are debates regarding the degree of competition desirable in banking in general, and the relationship between competition and stability, developing countries usually do suffer from a lack of competition and low efficiency. Supposedly, foreign entry enhances competition and increase efficiency, they are likely to benefit in terms of stability. As for capital flows, financial stability is less threatened when capital flows are less volatile, have a balanced maturity structure and their level is manageable. As for institutional capacity (as defined by Kono and Schuknecht (2000)) its improvement undoubtedly contributes to financial stability. Thus, testing the effect of foreign entry on stability can be complemented indirectly, investigating its impact on competition, institutional capacity and capital flows. Empirical studies focus on the first and the third aspects.

[1] Emerging markets in Asia are exceptions, as they did not experience a similar increase in foreign bank penetration.
[2] Even within the developing category it is necessary to differentiate between middle and low income countries, the latter ones being less relevant for emerging CEC countries. See Claessens and Lee (2002).
[3] The relationship between financial service trade and financial sector stability is discussed in Kono and Schuknecht (2000).

Before reviewing the relevant literature it is necessary to clarify some concepts and point out the major issues arising in the empirical investigation of the impact of foreign bank entry.

Although most of the studies refer to foreign entry, we prefer to use the wider concept of internationalization. In relation to banking this refers to the involvement of foreign banks - without discrimination - in the provision of financial services either through cross-border or via foreign bank entry. The concept of foreign bank penetration is also used with the same meaning. Foreign bank entry is defined as the presence of a foreign bank in a host country, either as a subsidiary or as a branch.

The literature reviewed is rather mixed in this respect. Most of the papers concentrate on foreign bank entry, however some papers include cross-border lending as well. Although not always highlighted, each form has its own characteristics and implications for financial stability. For example, cross-border lending tends to be biased toward short-term lending and more responsive to home country shocks than physical presence. Its customer base is limited to multinational or large enterprises. Kono and Schuknecht (2000) also suggest that physical presence (they call it commercial presence) can better contribute to financial stability due to its stronger impact on efficiency and capacity building and less distorted capital flows. Although it may be somewhat less important, there also may be a need to differentiate between branches and subsidiaries. These are typically involved in different bank services, with different implications for their relative performance and impact on domestic banks.

The papers also range widely in terms of the methods employed (case studies versus cross country analysis), the data used (aggregate versus individual bank balance sheet data, survey data on foreign banks), the countries reviewed (Latin American, transition countries, South-European, developed and developing countries) and time periods covered. Methodological diversity is also present, including cross-tables, regressions, and the stochastic frontier approach. Different proxies are used for the dependent variables (measure of foreign penetration as share in number or assets or liabilities, whether offshore lending is included or not). Even the definition of 'foreign' (minimum percentage of foreign ownership: 10, 30, 50 or 70%) varies, as

well as the range of control variables (macro, regulatory, banking structure, etc.). The hypotheses tested are also different. This diversity makes it difficult to compare the papers to each other and to draw general conclusions.

One of the major problems researchers face when investigating the experiences of developing countries is the difficulty of disentangling the impact of banking reforms, the broader process of liberalisation and the transition process and the opening up of the sector. Moreover, the availability of quality data and the length of the time series pose additional difficulties. One must also be very careful to take into account the effect of other than foreign presence variables. Accordingly, when the performance of foreign banks versus domestic banks is compared or the impact of opening up is estimated, one must include all the relevant control variables. For example, profitability and cost efficiency depend on the macro environment (GDP growth, inflation), on the structure of the banking sector (concentration), bank specific variables (activity, size), and on other liberalisation measures aside from foreign entry. Furthermore, there are also country-specific issues that need to be dealt with in the empirical work (e.g. extremely high inflation in Turkey, government ownership).

Because of the nature of this short literature review, only the findings and the general picture emerging from those findings are outlined. However, the reader should bear in mind the caveats and the diversity of approaches found in the literature.

II.1. Why do foreign banks enter?

There are various hypotheses to explain why banks expand their activity abroad. The first such theory introduced into the literature by Williams (1997, 2002) is called the defensive expansion hypothesis. This claims that multinational banks follow their clients abroad (either their trade or investment). Information about the client is one of the main assets of banks. There is, however, no external market for this information, i.e. markets where banks could sell this knowledge. Hence, they have to follow their client if they do not want to loose them. Often the motivation behind following the client is not so much to earn more profit but rather to avoid loss at existing locations. On the other hand, it is also in the interest of the clients, who must bear the transaction costs of changing banks. Although defensive expansion is found to have strong explanatory power in more developed countries, it only provides a partial

explanation. Williams refers to other hypotheses such as regulatory impact, home market sophistication, etc. Banks who follow their clients might restrict their activity to their existing client base, but they can also create a beachhead (see Williams) and try to acquire new clients or enter into other market segments in the host country. Their relative performance and impact on the domestic banking sector is largely determined by which strategy they follow.

In developing countries the defensive expansion hypothesis is suggested to have even less importance. The underlying motivation is also rather different. Whereas in developed countries banks' primarily motive is to keep existing clients, here the need for effective monitoring becomes more important. Financial markets are less developed and mature, the only way to ensure effective monitoring is physical presence. Delegation of monitoring is not an option.

An alternative and more important explanation for developing countries is the existence of host country opportunities (see for example Clarke et al. (2001)). Banks enter other, non-saturated and less developed, less efficient markets where they enjoy comparative advantages – higher quality services, better risk management tools etc. Such markets often offer good profit and growth prospects. Typically, these markets also entail risks not present in developed countries. Therefore, the entry decision is influenced by other factors, such as the development of market infrastructure, standards of regulation and supervision, and political risk. Often foreign banks are attracted by tax relieves and other regulatory exemptions.

In addition to the aforementioned "pull" factors, there are other factors, which "push" banks abroad. Amongst others, Clarke et al. mentions deregulation in the home country (which, for example, pushed Spanish banks to enter Latin American markets), as well as the size and efficiency of the entering bank.

II.2. Why do countries open up their markets?

Typically, the opening up of home markets is part of a broader liberalisation process. In addition, it is often driven by the need for capital and also for expertise during

privatisation or following a banking crisis. It is regarded as an important way of importing knowledge and enhancing competition.

The decision on opening up is based on thorough consideration of its costs and benefits. Benefits cited in relation to developing countries are numerous. It is expected that foreign banks contribute to building a more efficient and resilient financial system by introducing and spreading technology, providing new services and products, raising standards and practices, by exerting competitive pressure on domestic banks and increasing the efficiency of resource allocation. Increased competition lowers the cost of intermediation and leads to cheaper credit for borrowers (see Haas and Lelyveld). It can even lead to stronger regulation and supervision.[4] During turbulent times, foreign banks can also provide a “safe haven” for depositors and a stable source of funds compared to domestic banks (see Peek and Rosengren). Foreign banks might attract other foreign investors in the non-bank sector. On the cost side, Hindley for example summarises the counterarguments under the headings of economic and regulatory. Among the former ones are the followings: domestic banks need time to mature (the so-called infant industry argument); newcomers can engage in cherry picking; in contrast to existing banks they do not have bad loans, and hence a level playing field is not ensured; a lack of commitment to the local economy might cause capital flight. On the other hand, there are fears that regulators cannot control foreign banks properly. Others add to this list (Claessen) the loss of monetary autonomy and increased volatility of capital flows. There are also concerns that foreign banks ignore certain markets segment (SMEs) or propagate shocks originating from their home country.

II.3. The impact of foreign banks

First of all, the impact of foreign bank penetration on the domestic banking sector depends on its mode (offshore lending versus physical presence), the underlying motivation (following clients versus home country opportunities), and the scope of their activity (wholesale versus retail). If banks enter the market to follow their clients, they are not expected to outperform domestic banks or have a substantial impact on the entire banking industry. On the other hand, when banks enter a range of market niches to exploit their comparative advantages they are sure to trigger competitive pressure on domestic banks. However, this effect may be limited to the

market segment in which they are present. It may also happen that foreign entrants provide new, previously non-existent services in the host country, which contributes to better services, but does not exert competitive pressure on their domestic peers.

In general, the studies test different hypotheses on the potential costs and benefits of foreign entry or presence. The most important issues investigated are discussed in the following sections.

II.3.1. The relative performance of foreign banks and their impact

Most of the studies find that in developing countries foreign banks outperform their domestic peers. Their activity mix also differs, as they usually concentrate on new services and the wholesale market, where they enjoy comparative advantages. There is also strong evidence highlighting their beneficial impact on the level of competition and efficiency – even after controlling for other influencing factors. It should be noted, however, that this effect is often limited to the relevant market segments.

There is often a fear that foreign banks put too much pressure on already troubled domestic banks (especially when opening up take place in turbulent times, when capital is most needed), as alluded to with the infant industry reasoning mentioned above. However, most of the evidence on Latin America shows a weak presence of foreign banks in certain areas (such as retail banking) where domestic banks have comparative advantages. Furthermore, several case studies prove that domestic banks are able to meet the challenges and to become more competitive, to enter into new services (see Abel and Bonin, Pastor et al.). Moreover, the increased competitive pressure on domestic banks is related to the whole liberalisation process, not to a single element (opening up) of it.

To start with individual country cases, for Spain Pastor et al. (2000) find evidence of a positive effect of foreign presence on margins, overhead costs and profitability only in those segments of the domestic market where they competed. Spain is one of the few EU countries where foreign penetration is rather high (mainly in terms of number).

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[4] See for example Claessens et. al (2000) and Levine (1996).

Clarke et al. (2000) find that, compared to domestic banks, foreign banks in Argentina typically have better quality loan portfolios, are more profitable and efficient, and lend more to sectors where they have comparative advantages (manufacturing). They also found evidence of increased competitive pressure (declining margins and profits), but only in those market segments where foreign banks were present.

Barajas et al. considers the case of Columbia. Here, foreign banks are characterised by less non-performing loans and higher productivity. They also find strong evidence of increased competitive pressure induced by foreign bank entry. Although increased domestic competition due to financial liberalisation had an even stronger impact. As a result, intermediation spreads came under pressure, the loan quality of domestic banks deteriorated, and cost productivity improved. Evidence of the beneficial effect of foreign bank entry is strong. But the authors also highlight the importance of controlling for other elements of liberalisation. Without it, the role of foreign banks might be overstated.

Denizer (2000) presents evidence on Turkey, which also supports the benefits of opening up in terms of competition and efficiency. Competition intensified mostly in areas where foreign banks were involved (trade finance, corporate finance, etc.). The authors also point out the qualitative impact of foreign banks in banking procedures and standards.

Majnoni et al. (2003) show that in Hungary the profitability gain of foreign banks depends on the duration of their presence and the mode of entry. Lower cost of credit, induced by foreign bank penetration, becomes a benefit only years after entry.

Turning to cross country analyses, in a very comprehensive study of 80 countries Claessen et al. show that foreign banks in developing countries do outperform domestic banks both in terms of profitability and cost efficiency. However, that is not true for developed countries. This evidence supports the argument about different motivations for entry in developing versus developed countries. They also find evidence of the role of foreign banks in enhancing competition–leading to lower profitability and margins of domestic banks. The relationship was significant when foreign presence was defined as a share in number, but not for share in assets,

implying that the number of foreign banks is more important than their size in triggering competition.

Papi and Revolta (2000) focus on 27 transition economies. They argue that transition countries are special cases, where all the arguments for foreign entry are highly relevant. The potential benefits for the host countries are significant; they have strong trade links with developed countries; political and economic stability is satisfactory, etc. Their approach is unique, in that they also include banks with minority foreign stakeholders (at least 10% of foreign equity capital), however they exclude branches. They obtained similar results to those previously found for developing countries, both regarding the differences between foreign and domestic banks and the impact of foreign presence.

A paper on transition countries by Bol et al. (2002) reaches the same conclusion. Based on data for 12 transition countries, they conclude that on average foreign banks are more profitable and efficient than domestic banks. However, the performance of the two groups tends to converge.

Hasan and Marton (2003) use stochastic frontier approach to investigate profit and cost inefficiency of individual Hungarian banks between 1993 and 1998. Their results show lower inefficiency of foreign-owned banks and an improving trend for the entire banking sector. Another paper on Hungary, Kiraly et al., using the same approach, finds mixed results. Only one group of foreign banks was significantly more efficient. In their cross country analysis Green et al. (2003) estimate economies of scale and scope for CEE transition countries. They find a reasonable level of efficiency. However, there is no evidence on foreign banks being more efficient than domestic ones.[5]

The results for transition countries seem to be more mixed than those for Latin American countries. One reason for the mixed results could be that in the observed period the transformation of banking industry was still in progress. Furthermore, we know from other experience that foreign banks need some time to outperform

[5] Despite its sophisticated methodology we regard a major shortcoming of their paper, that the foreign dummies they use do not vary across years. The authors admit it, but they do not see this as a serious problem. However, during the observed period (1995-1999) ownership of banks changed dramatically

domestic banks. Privatised banks also had to undergo reorganisation and IT investment, which pushes costs up during the first years. Many papers on transition countries do not control for other important explanatory variables (size, activity mix, macro variables, etc.). The quality of the data is also troublesome.

II.3.2. Lending to SMEs

There is a concern that foreign banks can engage in cherry picking and might neglect certain market segments (in particular small- and medium-sized enterprises, SMEs) in their lending activity. Physical, cultural and information distance can further aggravate this problem. The Latin American experiences do not seem to support this concern. CEE experiences are very limited, for SME financing is rather underdeveloped in those countries.

There is empirical evidence that large banks face disadvantages in providing relationship lending (for typically small, informationally opaque businesses).[6] Accordingly, small businesses account for a lower share in their asset portfolio, compared to smaller banks. This is true for both developed and developing countries.[7] Since foreign banks tend to be large, they are expected to follow this pattern. Berger et al. (2001) find that in Argentina small businesses tend to get fewer loans from large and foreign banks. However, bank distress does not hurt them more than large borrowers. Berger et al. also suggest, that there may be positive external effects of M&A or foreign entry. Due to increased competition, other small local banks can be forced to target small businesses. Hence, their overall loan supply does not change.

Clarke et al. (2002) studies the case of Argentina, Chile, Colombia and Peru. In all four countries there is a significant difference in lending to small businesses between large and small domestic banks. The authors also compare domestic versus foreign banks according to their size. Although the share of SMEs is smaller on average at foreign banks, large foreign banks lend more to SMEs in Chile and Colombia. The growth rate of SME loans was also larger in case of larger foreign banks relative to their domestic peers. The reason behind this could be that changes in technology

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in most of the countries.

[6] See Berger et al. (2001).

[7] See the review in Clarke et al. (2001).

(credit scoring) lower the obstacles to lending small businesses by large and/or foreign banks.

Clarke et al. (2001) employ survey data on 38 developing countries. They use information on borrowers' perception about access to long-term loans. They find a positive relationship between the extent of foreign bank penetration and access to credit. Even small enterprises find interest rates and access to credit less a constraint on their operation and growth prospects when foreign presence is strong. Large enterprises do however seem to benefit more.

II.3.3. Foreign banks' behaviour during crises

Another concern is that foreign banks might be more responsive to shocks originating from the host country and could also propagate shocks originating from outside the host country (from either the home or a third country where the parent bank has interests). Others argue that foreign banks tend to have diversified portfolios. Therefore, they are less prone to shocks in the host country, and can provide more stable funding during turbulent times.

The overall evidence is inconclusive. There are signs of transmitting external and portfolio shocks to host countries. However, such transmission varies across home countries and levels of exposure in a host country. On the positive side, foreign lending seems to be less responsive to host country shocks. There is no evidence of the feared procyclicality of foreign claims. Claims of foreign subsidiaries are not procyclical, but cross-border claims are more responsive to host country shocks. Regarding the net impact on the stability of lending, most of the papers suggest a rather positive role of foreign banks. Nevertheless, this is an area where future research is much needed.

Most of the studies focus on Latin American countries, which are particularly well suited for investigating that issue. During the 1990s many of these countries experienced the largest increase in foreign bank penetration and were also hit by economic downturns and crises.

As for spill-over of home and third country shocks, most of the papers find some evidence of this. Goldberg (2001) uses micro data of US banks' foreign claims in several countries. In case of Latin America, US bank claims are positively correlated with US GDP growth,[8] which show spillover of home country shocks. However, they argue that this is likely to occur without the presence of US banks. Moreover US banks are not volatile lenders–not even following international financial crises. As for host country shocks, US lending is not responsive to them. Thus, on the whole, they rather have a stabilising role in lending.

Peek and Rosengren (2000) investigate the behaviour of foreign lending after crises in a sample of three Latin American countries (Argentina, Mexico and Brazil). The authors find that financial crises did not cause foreign banks to cut back onshore lending. Being diversified, they are less affected by problems arising in the host countries. Interestingly, they rather increased their presence after crises by acquiring troubled domestic banks. By contrast, offshore lending tended to decrease in turbulent periods. They also highlight the measurement problems associated with foreign penetration. The inclusion or exclusion of cross-border claims, of non-BIS reporting banks, measures based on claims or deposits provide different pictures. But none support the hypothesis on foreign banks withdrawing from troubled countries.

The most comprehensive study is that of Peria et al., covering 10 Latin American countries and their 7 most important foreign lenders. They find further evidence that home country conditions do have an impact on foreign claims, although the magnitude varies across countries. Furthermore, as foreign presence becomes more important than cross-border lending, foreign banks become less responsive to external and portfolio shocks. In respect of host country shocks, these claims do not react excessively to such events. In addition, the larger the overall exposure in a given country, the less responsive – and less procyclical - banks are to shocks in that country. They are also more sensitive to positive than negative shocks.

The only study, which investigates the relationship between foreign bank penetration and bank credit stability in CEE countries, is that of Haas and Lelyveld (2002). Their results are very similar to the Latin American experiences. Although cross-border

[8] However, this is not true for Asian emerging countries.

credits did decline in periods of host country difficulties, this was usually offset by expansion in foreign bank subsidiaries.

III. Foreign banks in CEC5

III.1. The motivations of foreign banking in CEC5

This section reviews the motivations which led the CEC5 to open their banking markets to foreign banking institutions, and the market and regulatory incentives that encouraged foreign banks to enter the banking markets of the CEC5. In analysing these motivating factors, we will evaluate the experiences of the CEC5 on the basis of the academic literature reviewed in the previous section.

For the CEC5, opening their markets for foreign banks represented the only possible way of creating an efficient banking system providing services that could meet international standards. Lack of domestic capital and expertise was made apparent by the massive losses of capital following the implementation of the two-tier banking systems and the subsequent transformation crisis. This could only be remedied by allowing foreign banks to establish business in the region. Under the circumstances, the advantages of opening the banking market appreciated. Opening up the banking markets was not decided upon after careful consideration of the advantages and disadvantages. Rather, it resulted from the realisation that a banking sector, well-equipped with capital, capable of offering state-of-the-art services and introducing a business attitude characterising the advanced market economies, cannot be created without reaping these advantages. Market opening did indeed bring all these advantages, thus contributing significantly to financial stability in the CEC5.

However, one of the typical disadvantages of market opening is cherry picking: powerful foreign banks, selling more sophisticated services and often unburdened by inherited non-performing loans, can easily acquire the best clients carrying the lowest risks, and thus they make it more difficult for the domestic banking systems to gain strength and compete with foreign banks. Possibly, this is one of the reasons why involving foreign owners meant the only way for domestic banks to gain more power and remain in the market. This also might be one of the reasons why the share of

foreign banks reached exceptionally high level in CEC5 countries. Of the disadvantages, the sensitivity to the economic cycles of home countries has not or only scarcely been observed. For example, although German bank owners facing difficulties tightened control of their Hungarian subsidiaries and enhanced cost management, they did not curtail business activities or withdraw capital.

Market and regulatory factors both motivated foreign banks' entry into the market. The business strategy of foreign banks followed a similar pattern in the Czech Republic, Hungary and Poland. In the early stage of market entry, some signs of the defensive expansion hypothesis were demonstrable, as the core business of foreign banks was to serve the clients of their home country. However, the main motivation behind this strategy was not to maintain existing clients, but rather to offer them the same services as they were offered in the home market. At that time, the other target clients were the most solvent large domestic companies.

Later, taking advantage of market opportunities became the major motivating factor. In the CEC5, the volume of banking services is significantly lower than in advanced countries. As the stabilisation of economies was followed by the transformation crisis, the retail and SME markets in CEC5 had significant growth potential, thus orientation towards the SME and retail markets became clearer from the late 1990s. Accordingly, the strategic investors of large local banks, in line with the inherited clientele of privatised banks, had a significantly wider scope of activity, namely, their business orientation gradually extended to SMEs and the retail sector. Lending to households and SMEs has now become one of the most important driving forces behind market growth.

During the 1990s, regulation of the banking sector in the CEC5 gradually approached the relevant international standards. As each of the five countries will join the EU in 2004, alignment with the effective banking legislation of the EU will have to have been completed by that time at the latest. Meanwhile, international banking legislation has also undergone radical changes since the early 1990s. Ever since the Basel Committee established the first capital adequacy ratio at 8% in 1988, banking regulations have had a clear-cut trend of development. Rigorous rules expressed in the fixed “magic figures” are increasingly being replaced by banking regulations based on

internationally accepted standards that make allowances for the peculiar features and standards of risk management, and fit the risk profiles of the individual banks. Actually, the very first step towards this goal was the elaboration of the 8% capital adequacy ratio, which is far more adjusted to the banks' risk profiles than the previously applied leverage ratio. The 1996 Basel recommendation on the capital accord to incorporate market risks was a major move forward, as it allowed the application of audited internal models in relation to market risks, provided that such models had been accepted by the Supervision. Then further progress was made in the Basel Committee's 25 Core Principles of Effective Banking Supervision regarding the assessment of the efficiency of supervision. These developments reached their climax with the Basel II capital requirements resting on a structure of 3 pillars, which clearly require that regulation and supervision be based on co-operation with the banks and an analysis of the risks involved.[9]

With regard to the regulation of foreign banks' activities, it is clear that in the early 1990s the CEC5 offered a far more favourable regulatory environment for foreign banks than their own home countries did, as these countries only gradually brought their regulations into alignment with international standards (e.g. in terms of credit risk capital requirements, market risk capital requirements, large exposure limits or consolidated regulation). Moreover, as banking supervisions were newly founded, they had little experience, and this entailed less strict supervision than in their home countries. Loose supervision was also justified for reasons of resource management within the banking supervision of the CEC5, as the transformation crisis and corporate bankruptcy in large numbers was characteristic of domestic banks. Naturally, foreign banks with no inherited portfolios (greenfield banks) or those that had been purchased (privatised) subsequent to consolidation by the state–and occasionally with state guarantees–bore lower risks than domestic banks. Favourable regulation and looser supervision, coupled with more liberal licensing and a privatisation practice that was more attractive for foreigners, gave a considerable regulatory impetus to foreign banks to increase their involvement in the CEC5 region

[9] In this study the regulatory system's development is depicted through the milestones marked out in the Basel Committee's published recommendations. However, the European Union regulates its Member States in directives. In terms of content, the corresponding EU directives are generally very similar to the Basel recommendations, and are incorporated in the EU legislation either simultaneously or with a slight delay. This process is also indicative of the fact that banking rules are increasingly consistent at the international level.

and made a contribution that can be considered massive even in an international comparison.

By now, regulatory and supervisory advantages have practically disappeared, and any possibly remaining ones will disappear at the moment of accession to the European Union. From that moment on, however, the uniform regulation applicable to the single EU market will add considerable stability to the banking market of the CEC5, just as in the case of other Member States. Owing in large part to these advantages, increasing integration and enhanced foreign involvement can be evidenced in the single European banking market ever since its evolution. In the case of the CEC5, owing to the current substantial foreign share, the incentive power of weak regulation is unlikely to be replaced by the incentive power of a uniform regulation in the promotion of integration. However the advantages inherent in a uniform regulation can be assumed to be conducive to a continuing high rate of foreign presence in banking.

III.2. The main characteristics of foreign banks

III.2.1. Foreign owners by countries

In each of the five countries, the foreign owners of banks are primarily banks of EU Member States. More specifically, it is not infrequent that the banks of neighbouring countries have a prominent share. Just as Scandinavian countries are the largest investors in the Baltic states, for instance, Austrian banks are the most significant participants in the Czech Republic, Slovakia and Hungary.

In the **Czech Republic**, most of the capital (33.2% of the total registered capital of the banking sector) comes from Austria, French capital accounts for 17.2% of the registered capital; Germany’s 7.8% share in the banking sector is also significant; while 5.9% of the capital was contributed by Belgium. In the **Slovak Republic,** the majority of capital comes from Luxembourg (with a 30% share in the registered capital) and Austria (29%). Slovakia is the only country among the CEC5 where other countries from the region hold ownership stakes in banks, as Czech and Hungarian banks have acquired ownership shares in the banking sector there. In the **Polish banking sector**, Germany has the largest share (19% of the total assets), followed by

Italy (15%) and the USA (9%). Based on direct holdings, the largest European shareholders in **Hungary** include Austria (24% of registered capital), the Netherlands (14%), Germany (13%), Belgium (12%), Luxembourg (9%) and France (4%). The USA has a 12% share. In **Slovenia**, all foreign investments in the banking sector are limited to a narrow range of EU Member States (Austria, Italy, France and Belgium). Non-European countries are almost absent in the CEC5, with some US banks as the only the exceptions.

III.2.2. Foreign owners by banks

There is a high degree of overlap observable among investor banks in the CEC5 countries. The most important investors include: the KBC Bank (Belgium), the Erste Bank (Austria) and the HVB Group (Germany). Only one of the largest investors (Bayerische Landesbank – Germany) has a single large subsidiary in one country in the region. The majority of banks with ownership shares in the region have overall strategies relevant to this particular area, focusing on Central and Eastern Europe as a target market. Consequently, they generally have banks in three or four CEC5 countries, and it is not infrequent that they establish subsidiaries in other countries of the Central and Eastern European region as well (see table 1). Strategy is focussed on market presence, while customer-oriented conduct, corresponding to the assumption of defensive expansion, is not characteristic.

Table 1: Market shares of foreign banks' subsidiaries in the region (end-2001 data)*

Foreign banks	Market shares (%)								
	Hungary	Czech Republic	Slovakia	Poland	Slovenia	**CEEC-5 total**	Croatia	Bulgaria	Romania
KBC Bank	*7*	15		3	15	**7.5**			
Bayerische Landesbank	*9*	0.2				**1.2**	0.1		
IntesaBci	*8*		18			**2.3**	14		
HVB Group	*6*	5	4	7	3	**5.9**	6	7	2
Raiffeisen	*5*	1	9	1	2	**2.2**	7	4	4
GE Capital	*3*	3		0.6		**1.5**			
Citibank	*3*	3	3	6		**4.3**			3
Erste Bank	*3*	16	15			**6.0**	7		
Societe Generale		9	0.4		9	**3.3**		5	8
UniCredito			2	8		**3.9**	27	19	0.5
Banking sector total assets (EUR bn) = 100%	***36.7***	**87.1**	**21.6**	**136.4**	**17.9**	**299.7**	**20.1**	**6.3**	**12.7**

* The market shares of individual banks have been defined on the basis of the balance sheet total as a proportion of ownership share. Therefore, the market shares shown in the Table may be different from the ownership share of a given bank. (for example, K&H/KBC Hungary).

Source: BankScope

III.2.3. Entering the market: privatisation vs. greenfield investments

The number of greenfield investment projects in the CEC5 is relatively low compared to the total number of foreign banks. In each of the five countries, greenfield investment was characteristic of the early stages of transformation prior to banking sector consolidation and privatisation.

In Hungary, greenfield investment was also characteristic of the initial years of transition. During this period, there was no supply or demand in respect of the sale and purchase of major banks. In the Czech Republic, a large number of new banks were incorporated in the first half of the 1990s. Both domestic and foreign investors were granted banking licences, while the majority of new banks were locally owned. In Poland, most barriers to foreign investor entry were removed in 1989. Despite the significant tax and licensing incentives, few foreign banks were attracted to the Polish banking market in the period 1990-1992. In Slovenia, the majority of foreign banks appeared soon after the country gained independence, either by purchasing a small bank or founding a new institution.

From the second half of the 1990s in Hungary, the Czech Republic and Poland and from the early 2000s in Slovakia, foreign banks' market penetration was carried out through participation in the privatisation of banks. Foreign banks often started by purchasing a minority share, and acquired majority ownership by raising the capital and purchasing further shares, often over a period of several years. It was also characteristic of several countries and several banks that, in the first stage of privatisation, the EBRD acted as a minority owner, as well as a strategic investor. In the period of economic transition, this reduced the risks to foreign banks and increased the market reputation of the purchased banks. This method contains certain aspects of greenfield investment (e.g. buying a domestic bank means, in most cases, a thorough reorganisation of the bank, building up management and IT systems from almost zero) as well as acquisition (as the bank gains control over another one). Unlike in the previously mentioned other four countries, in Slovenia there was only one example of entry by a foreign bank into the market through privatisation. In most cases, foreign banks bought existing, privately owned banks.

III.2.4. The owners of the three largest banks

The three largest banks of the Czech Republic, Hungary and Slovakia from among the CEC5 are in foreign ownership. The owners participated in the privatisation of banks generally as strategic investors entering at an earlier or later stage. Of these three countries, only Hungary has transferred the majority shareholding of one of the three largest banks (actually the largest one) to the ownership of foreign financial investors. Poland's largest bank is still state-owned, while the second and third largest ones are under foreign strategic owners' control. In this respect, Slovenia is an outlier, as its largest bank is in state ownership, while the second and third largest ones are in domestic private hands.

III.2.5. Profitability and capitalisation of foreign banks

The relevant literature and empirical analyses are rather divided in respect of the profitability of foreign banks in developing markets. In the case of the CEC5, the period available for comparing the profitability of foreign and domestic banks is not sufficiently long, as foreign banks started penetrating the market usually from the second half of the 1990s. During this period, a large number of domestic banks

transferred into foreign ownership as a result of privatisation, but the ensuing change in their profitability was reflected only with a delay. Although the overwhelming majority of bank crises accompanying the transformation crisis of the period are over, in several countries in the region there are banks, which struggle with solvency problems and, depending on the owner of the particular bank, this may have a dominant impact on the profitability of the various groups of domestic or foreign banks. In the relatively more homogeneous period between 1998 and 2002, ROE was significantly higher for foreign banks than for domestic ones than in the Czech Republic and Slovakia. In contrast with this, in Slovenia ROE was higher for domestic banks than for foreign banks every year. In Hungary and Poland, foreign banks alternated with domestic banks in achieving higher ROE values (see the country tables in the Appendix). In general, it can be assumed that cost saving and stringent cost control have a positive impact on foreign banks' profitability, even though the costs of bank transformations may completely offset this effect in the actual ROE outcomes. However, a counter-example can be quoted: the foreign banks active in Slovenia have a significantly higher overhead costs-to-total assets ratio than domestic banks.

Table 2: Profitability and capital adequacy of foreign and domestic banks, 2002 (%)

	ROE		CAR	
	Domestic	Foreign	Domestic	Foreign
Czech Republic	-1.8	28.9	14.9	14.1
Hungary	1.7	18.1	12.1	13.0
Poland	8.1	4.6	11.5	14.9
Slovak Republic	0.9	31.9	24.4	21.1
Slovenia	14.9	5.1	12.1	11.2

Source: National Central Banks.

Generally speaking, foreign banks are very well outfitted with capital. In line with their active market strategies, foreign owners provide sufficient funds to cover the capital requirement of growth for their banks in CEC5 markets. A comparison of the levels of capitalisation between foreign and domestic banks gives a similarly mixed picture. For instance, in Poland the capital adequacy ratio was considerably higher for foreign banks than for domestic ones between 1998 and 2002. In the Czech Republic,

foreign banks were also significantly better capitalised than domestic banks between 1995 and 1999. However, the situation changed between 2000 and 2002: in the wake of the stabilisation of domestic banks' capital position and powerful business expansion by foreign banks, the CAR of domestic banks exceeded the corresponding figure for foreign banks. In Slovakia, consolidation of the banking sector, which followed the transformation crisis, was finished only at the beginning of the new millennium and, as a result, the previously negative value of CAR registered by domestic banks between 1998 and 1999, has been continuously improving since 2000. Meanwhile, foreign banks have been equipped with consistently high levels of capital. In Slovenia, foreign banks were significantly better capitalised than domestic banks in 1998-1999. Their CAR figures evidenced that their owners even provided temporary excess capital in anticipation of the capital needs of a subsequent market expansion. However, the pick-up in the activity of foreign banks resulted in an elimination of differences by 2002. The same developments had already taken place in Hungary, where the period between 1998 and 2002 was characterised by similar levels of capitalisation for domestic and foreign banks. In summary, it may be assumed that by 2002 the CAR of foreign and domestic banks had achieved similar levels throughout the CEC5 region (see Table 2).

III.3. The role of foreign banks

III.3.1. Direct foreign ownership

Foreign bank participation in the banking sectors of the CEC5 is much more pronounced than within the EU. This is clearly reflected by the ownership structure characterising the banking sectors of the CEC5. In 2000, the contribution of foreign capital to the banking sector's registered capital already exceeded 50% in the Czech Republic, Hungary and Poland (see Table 3). In the following two years, this proportion continued to grow. In Slovakia, foreign participation picked up speed between 2000-2002, resulting in the banking sector with the highest level of foreign ownership in the region by the end of 2002. In Slovenia, the year of massive changes in ownership structure was 2002, when the proportion of foreign capital doubled in a single year. However, the level of foreign ownership continues to be much less characteristic than in the other four countries (see Table 4).

Table 3: Ownership structure of commercial banks as a proportion of registered capital, 2000 (%)

	State ownership	Other domestic	Domestic ownership total	Foreign ownership	Dispersed holdings
Czech Rep.	23.6	21.9	45.5	**54.5**	
Hungary	19.3	13.1	32.4	**67.6**	
Poland	14.9	17.4	32.3	**56.6**	11.1
Slovakia	50.9	21.0	71.9	**28.1**	
Slovenia	36.8	51.2	88	**12**	

Source: ECB (2001)

Table 4 Foreign ownership as a proportion of registered capital, 2002(%)

Czech Republic	81.9
Hungary	78
Poland	60.5
Slovakia	85.3
Slovenia	32.5

Source: National Central Banks

The number of foreign banks significantly exceeds that of domestic banks in the region, except in Slovenia. Generally, the foreign owners have majority stakes in the banks, while minority participation is not typical. Due to the relevant regulation and the method of privatisation, a common feature of the Hungarian, Polish and Slovak banking systems was that foreign banks set up operations and entered the market via subsidiaries in the framework of bank privatisation or greenfield investment, while opening new branches played a secondary, if not negligible, role. A little differently from 1992, the Czech Banking Act gave an impetus to establish foreign branches as well. As a result, the number of branches in Czech Republic is more than double that in the other four countries taken together (see Table 5). In Slovenia, there was only one example of entry by a foreign bank into the market through privatisation. In most cases, foreign banks bought existing, privately owned banks.

Table 5: Number of banks by ownership, 2002

	All banks	Domestic owned	Foreign subsidiaries	Foreign branches	Banks with foreign participation*
Czech Rep.	37	5	17	9	6
Hungary	33	7	26	0	0
Poland	59	11	44	1	3
Slovakia	18	3	13	2	0
Slovenia	20	11	5	1	3

* More than 5% and less than 50 % foreign owned.
Source: National Central Banks.

In the Czech Republic, Hungary, Poland and Slovenia, the activities of foreign banks are even more dominant than the ownership structure suggests. This is the result of the remaining minority domestic ownership in predominantly foreign-owned banks. As a consequence, today the banking sector of the four countries in question can be treated as fully foreign dominated. In this respect, the outlier country is Slovenia, where foreign banks' share of total assets is about one half of their ownership interest (see Table 6). There is no significant difference in risk appetite of foreign and domestic banks: the share of private credit in their balance sheet total is about the same in each country.

Table 6: Foreign banks' activities in the commercial banking sectors, 2002

	Commercial banks' assets to GDP	Foreign banks' assets to GDP	Commercial banks' private credit to GDP	Foreign banks' private credit to GDP	Foreign banks' assets as a % of commercial banks assets
Czech Republic	110.0	94.4	32.9	29.1	85.8
Hungary	54.0	49	26.5	23.5	90.7
Poland	57.3	40.7	22.1	16.6	70.9
Slovakia	94.5	90.3	30.8	29.6	95.6
Slovenia	79.8	14.6	37.2	7.3	16.9

Source: National Central Banks

III.3.2. Cross-border banking activity

In addition to direct foreign ownership in the banking sector, foreign banks participate on CEC5 markets through cross-border activity as well.[10] In accordance with the open

[10] In respect to cross-border activity the figures in Tables 7 and 8 contain some double counting. In the case of subsidiaries of BIS reporting banks incorporated in CEC5 and consolidated with the mother institutions the data in the tables refers not only to cross-border activity but to the consolidated activity

economy character of the CEC5 countries, foreign banks' cross-border activities in these countries are quite substantial (see Table 7). Direct foreign bank lending to the corporate sector accounts for about 38%-58% of claims abroad, while interbank lending is lower in the range of 20% to 40%.

In a breakdown by country, foreign bank claims on the CEC5 countries are highly concentrated. The six EU countries listed in Table 8 account for 75%-90% of the claims on these countries. Naturally, banks from the same six countries are also strongly represented as owners in the CEC5 countries.

Table 7: Sectoral breakdown of claims of BIS reporting banks on individual countries (US$ millions),* 2002

Claims vis-á-vis	Consolidated cross-border claims in all currencies and local claims in non-local currencies				
	Total	Sectors			
		Banks	Public Sector	Non-bank private sector	Unallocated
Czech Republic	14,092	4,638	559	7,609	1,286
Hungary	23,462	7,545	7,006	8,911	0
Poland	32,657	6,335	7,492	18,801	29
Slovak Republic	5,223	1,522	1,183	2,476	42
Slovenia	5,625	2,204	997	2,422	2

* EUR/USD exchange rate for 31 December 2002: 1.05.

Source: BIS (2003).

Table 8: Country breakdown of claims of foreign banks on CEC5 countries (in %)

Claims vis-á-vis	Austria	Belgium	France	Germany	Italy	Neitherlands	EU(6)
Czech Republic	6,72	36,78	13,96	25,57	0,83	5,62	89,47
Hungary	5,76	15,84	3,42	44,17	9,39	4,12	82,70
Poland	4,61	9,94	3,09	28,79	18,86	10,11	75,40
Slovak Republic	7,19	13,08	4,48	15,91	42,40	6,56	89,62
Slovenia	12,71	6,35	20,86	39,08	4,89	1,43	85,33

Source: BIS (2003).

of local banks, as well. Consequently, on the basis of BIS statistics one can evaluate only the trends and proportions of cross-border banking activity and not the concrete figures.

IV. The role of foreign banks in the European Union

Regulation of the banking systems of the European Union is based on the 'Single European Passport' principle, which implies that European banks are authorised to freely offer financial services in any member country of the EU. Banking regulations in the European Union have been adopted and used compulsorily by a number of other European nations, in addition to the Member States of the EU. These countries include the former EFTA members, Norway, Liechtenstein and Iceland, except Switzerland. The Single European Banking Passport and prudential supervision of banks based on home country control are equally applied to banks in these countries and in the EU. The EU and the three countries noted above together comprise the European Economic Area (EEA). Its importance for accession countries is explained by the fact that, legally, the domestic banking markets will open for banks of the EEA countries at the time of joining the EU.

The next section presents the activities of banks of the European Union abroad and the presence of foreign banks on the markets of the member states both in form of cross-border entry and building up branches and establishing subsidiaries abroad.

IV.1. Cross-border banking

Cross-border activities of European banks are much more dominated by interbank transactions than lending and accepting deposits (see Table 9). Foreign lending accounts for 40% of total interbank lending. This compares with only 11% in the case of non-bank assets. In addition, liabilities from foreign banks account for 47% of European banks' total interbank liabilities, in contrast with an only 16% share of foreign non-bank liabilities.

In contrast to interbank market, cross-border lending to costumers (especially to households and SMEs) is not characteristic at all, as close proximity to customers is of key importance. The increasing popularity of state-of-the-art distribution channels has not yet jeopardised this tendency: households continue to establish Internet and phone banking connections with well-known local banks. The main focus of EU banks' cross-border activities remains the corporate and private banking segments.

Between 1997 and 2001, cross-border lending rose slightly more strongly than banking activities: lending by banks to euro area customers rose from 2.2% to 3.4% as a proportion of the total, lending to non-euro area customers rising from 6.2% to 7.7%. This change in the ratios indicates that corporate lending has grown increasingly international. However, there have recently been opposing trends in respect of deposits collected from abroad. The percentage share of euro area deposits accepted from abroad has fallen slightly within banks' total deposits, while that of deposits collected from outside the euro area has increased quite robustly. Explanation for this is that confidence in domestic banks of the European Union has strengthened, and depositing abroad has become less attractive. This higher confidence is also characteristic of countries outside the euro area, which has made it attractive for foreign depositors as well to make deposits in euro area banks.

Table 9: Domestic and cross-border activities of euro area banks

Per cent	December 2001
ASSETS	
Interbank lending	
Domestic	59.3
Euro area	18.3
Outside euro area	22.4
Other banking assets (e.g. securities)	
Domestic	63.8
Euro area	19.5
Outside euro area	16.7
Non-bank assets	
Domestic	88.9
Euro area	3.4
Outside euro area	7.7
Non-bank bonds	
Domestic	53.3
Euro area	29.3
Outside euro area	17.7
LIABILITIES	
Interbank deposits	
Domestic	52.9
From euro area	16.4
From outside euro area	30.7
Non-bank deposits	
Domestic	84.3
From euro area	5.0
From outside euro area	10.7

Source: ECB (2002/a).

IV.2. The role of foreign branches

IV.2.1. Presence of foreign branches in countries of the European Union

Closely related to EU banks focusing primarily on lending and accepting deposits locally, a strong presence of foreign banks' branches is not characteristic in the member states of European Monetary Union (EMU). As is shown in Table 10, the market share of foreign banks with the single European licence as a proportion of the balance sheet total is generally less than 5% in the banking markets of EMU. European banks only have market shares above 10% in Ireland and Luxembourg. The number of foreign branches is high in Germany, although associated with a low market share. However, increasing integration is also observable in respect of bank branches: the average number of foreign branches rose from 34 to 42 and their average market share from 4.7% to 5.7% between 1997 and 2000. Although not shown in Table 10, the United Kingdom's banking market is significantly different from those of the other members of the European Union: foreign branches are dominant participants of the UK banking market. In 2001, the balance sheet total of the branches of EEA-country banks in the UK accounted for 23.7% of domestic banks' balance sheet total.

Table 10: EU banks' foreign branches in countries of the EU, 2000

	Number of branches		**Assets of foreign branches as a proportion of total unconsolidated assets of host country**
Host country	From the euro area	From the EU	From the EU. Italics denote percentage shares of assets from the EEA
Austria	12	15	0.8
Belgium	28	34	5.7
Finland	0	0	*7.3*
France	73	93	3.3
Germany	113	145	1.3
Greece	9	13	6.4
Ireland	N/A	N/A	*13.5*
Italy	32	41	3.5
Luxembourg	47	55	*16.6*
Netherlands	0	0	*2.7*
Portugal	18	22	*4.2*
Spain	33	41	3.4
Euro area average			**5.7**

Source: ECB (2002/a).

Third-country bank branches outside the EEA play an even smaller role in the EU banking market. Their market share is only high in the UK (20.9% of domestic banks' balance sheet total in 2001). By contrast, showing a declining trend, market share had fallen below 1% in the rest of the EU countries by 2001. The market share of third-country bank branches relative to the average of domestic banks of EMU dropped from 1.4% in 1997 to 0.6% in 2001.[11]

Usually, foreign bank branches make a choice between two major options for establishing business in the European Union: cross-border bank mergers and formation of own branches. Bank mergers in the EU are characterised by mergers within one country and less so by cross-border mergers. Expansion to countries outside the EU is more dominant via cross-border M&A activities. Opportunities to earn high profits in countries with less advanced banking markets attract banks mainly to Latin America and Central and Eastern Europe.[12] Nevertheless, a typical way of setting up branches abroad is bank mergers. Establishing branches individually is less common.

IV.2.2. Presence of EU banks in other member states' markets through branches

In line with the modest presence of foreign bank branches in the markets of EU Member States, establishment of branches of EU banks in other member states is moderate (see Table 11). Activities abroad of branches registered in other EMU countries account for only 6.6% on average of the consolidated balance sheet total of EU-country banks. In the period from 1997 to 2000, EMU banks strongly stepped up their market presence in the EU: their activities conducted through branches in the EU accounted for only 1% compared with their banking activities in the domestic market in 1997. Against this background, the 6.6% percentage share in 2000 is evidence of a substantial increase in integration among banks. Reflecting the fact that the UK is a primary target country for setting up bank branches, euro area banks' presence in other countries of the area lags considerably behind this ratio, accounting for 0.9% in 1997 and for 0.7% in 2000 relative to their domestic banking activities. Business activities of German and Dutch banks' foreign branches rose particularly strongly in the period. For example, German banks' branches domiciled in the EU increased their

[11] Source: Bikker and Wesselig (2003).

activities from 0.2% to 15.1% as a proportion of their consolidated balance sheet total, Dutch banks' branches increased their activities from 2.9% to 16.6%. (Illustrating these two countries' UK orientation, the share of German banks' branches in the euro area was only 0.4% as a percentage of the balance sheet total, that of Dutch banks' branches being 1.6% in 2000.)

Table 11: Banking by EU banks in other EU countries via foreign branches, 2000

	Number of branches		**Balance sheet totals of foreign branches as a proportion of consolidated balance sheet total of the home country***	
Home country	**Euro area**	**EU**	**Euro area**	**EU**
Austria	14	17	0.3	3.5
Belgium	23	28	0.4	5.0
Finland	1	2	0	0
France	68	83	2.0	7.4
Germany	83	109	0.4	15.1
Greece	6	11	0.3	9.9
Ireland	7	16	0.2	9.0
Italy	41	57	0.9	5.6
Luxembourg	39	40	0	0.0
Netherlands	35	44	1.6	16.6
Portugal	12	16	0.4	3.0
Spain	36	42	2.2	4.3
Euro area average			**0.7**	**6.6**

*The data only include claims by the following countries: Austria, Belgium, Germany, Greece, Italy, Spain, Sweden and England.
Source: ECB (2002/a).

IV.3. The role of foreign subsidiaries

In the market of the European Union, foreign subsidiaries owned by banks domiciled within the EEA are on the whole slightly more active in the provision of banking services than bank branches (see Table 12).

[12] For more details, see ECB (2000).

Table 12: Market shares of foreign subsidiaries, 2001

Host country	Number of subsidiaries from EEA countries	Assets of foreign subsidiaries from EEA countries as a proportion of total assets of domestic banks
Austria	16	18.2
Belgium	22	18.8
Finland	0	0
France	105	7.8
Germany	21	1.8
Greece	2	8.2
Ireland	27	27.9
Italy	7	1.1
Luxembourg	89	69.3
Netherlands	14	7.6
Portugal	9	12.1
Spain	44	4
Sweden	N/A	N/A
England	17	1.2
EU average		**6.8**
Euro area average		**8.6**

Source: Bikker and Wesseling and ECB (2002/b).

Within the EU, it varies from country to country whether foreign banks conduct their operations through branches or subsidiaries. Preferences for the type of organisational unit to be applied in the different countries depend on a combination of factors. Generally speaking, branches predominantly provide their services in corporate financing, trade financing and private banking. Furthermore, branches in a foreign country often cater to the needs of their home country clients. By contrast, services for retail customers are more likely to be provided by the local branch network of banks, that have set up their own subsidiaries. In addition to the type of banking services, another factor strongly influencing preferences is differences in the regulatory framework, particularly accounting and taxation rules or the deposit insurance system. In England, for instance, both the number and balance sheet total of branches are several times higher than those of subsidiaries, while it is the other way round in Luxembourg, where subsidiaries outscore branches by far. In a number of countries, for instance in Austria, Belgium and France, foreign subsidiaries are considerably larger than branches, and these subsidiaries, which are either as many or fewer in number, tend to be more active than the registered branches. However, this is not the case everywhere. In Germany, for instance, for a similar market share, the number of branches considerably exceeds that of subsidiaries.

On the whole, the combined participation in the form of branches and subsidiaries of registered EU-owned foreign banks varies widely even across the banking market of

the EU countries. Luxembourg, with its very favourable tax system, appears to be a unique country with a nearly 90% market share of foreign branches and subsidiaries in the balance sheet total of the country's banking sector. By contrast, the corresponding ratio is below 5% in Germany and Italy. Typical values are in the range of 10% to 25%.

V. Conclusions

The CEC5 countries have witnessed an exceptionally high degree of foreign bank penetration. At the beginning of the 1990s these countries had inefficient, underdeveloped banking sectors. The entry of foreign banks has helped to recapitalise troubled domestic banks, to improve the quality and quantity of financial services, to spread technology and know-how, to exert competitive pressure on domestic banks. Foreign banks played a very important role in the development of a modern banking sector in the region. They did not only follow their customers, but were also attracted by the host county opportunities. Although at the early stage of entry their activity and clientele were rather limited to certain market segments, in many countries they now have expanded into the retail market as well. Foreign banks in CEC5 countries typically are well capitalised and show higher profitability than their domestic peers.
The short history of foreign bank presence in the region, which coincided with the transition and liberalisation period, does not allow the analysis of the behaviour of foreign banks during crisis situations. However, the experiences of other countries highlight the importance of having an ownership structure diversified across countries, which can lower the probability and extent of contagion of home and third-country shocks. Since the extent of foreign bank penetration is unprecedented in CEC5 countries, we do not know how the foreign owners would react to a serious crisis in the region.

As to the form of entry, the number of foreign branches in the region is relatively low. This might change with EU accession, as existing restrictions will be lifted. In addition there might be incentives to turn subsidiaries into branches. For example, branches are supervised by home country authorities. This allows them to engage in larger operations, as concentration limits would depend on the much larger capital of parent banks. Branches may also take advantage of lower cost of funds and lower administrative costs. But there are some counter-incentives as well. In the case of a

subsidiary, it is easier to solve the problems arising during operation. The risk can be limited to the capital allocated directly against the activity of the subsidiary. A withdrawal without loss of prestige is also more manageable. Weighing the arguments, there are no clear expectations for the future institutional structure of foreign banking in CEC5 banking markets.

The entry of the CEC5 countries into the EU will alter the European financial landscape. Foreign bank penetration will rise significantly. This renders the issue of foreign banking and financial integration within the European Union increasingly relevant.

VI. Appendix*

Data for Czech Republic

in %

	1995	1996	1997	1998	1999	2000	2001	2002
1. Commercial bank[1)] average assets as % of GDP	120	113,1	119	113,0	111,0	113,6	114,9	110,0
2. Private credit by commercial banks[1)2)] as % of GDP	58,6	54,3	56,7	52,3	46,1	41,0	36,4	32,9
3. Commercial banks[1)] assets to total financial assets	n.a	77,1	80,9	80,4	78,6	79,5	79,4	78,3
4. Foreign banks[3)] assets as % of GDP	20	23,7	30	31,8	46,5	81,9	102,4	94,4
5. Private credit[2)] by foreign banks as % of GDP	6,9	8,4	11	11,7	17,9	30,4	33,3	29,1
6. Foreign banks assets as share of commercial bank[1] assets	16,6	20,9	25,2	28,1	41,9	72,1	89,1	85,8
7. Number of foreign and domestic banks								
a) foreign banks[3)]	23	23	24	25	27	26	26	26
b) domestic banks	31	24	21	19	14	12	11	11
8. Number of foreign subsidiaries	13	14	15	15	17	16	16	17
9. Number of foreign branches	10	9	9	10	10	10	10	9
10. Number of banks with foreign participation	13	11	10	10	7	6	5	6
11. Return on average assets (ROAA) of foreign and domestic banks								
a) foreign banks	0,70	0,60	0,91	0,62	0,72	0,88	0,73	1,30
b) domestic banks	-0,62	0,28	-0,57	-0,89	-0,93	0,14	0,62	-0,09
12. Return on average equity[4)] (ROAE) od foreign and domestic banks								
a) foreign banks	45,2	36,7	57,6	10,6	10,1	18,0	16,9	28,9
b) domestic banks	-27,8	9,5	-18,5	-12,8	-16,3	2,4	10,8	-1,8
13. Net interest margin (NIM) of foreign and domestic banks								
a) foreign banks	2,03	1,61	0,99	2,2	2,08	2,33	2,71	2,6
b) domestic banks	3,02	2,27	2,56	3,92	3,33	3,05	1,94	1,65
14. Overhead costs as share of average total assets of foreign and								
a) foreign banks	1,82	1,44	1,35	1,64	1,82	1,89	2,1	1,99
b) domestic banks	2,06	2,11	2,11	2,17	2,15	2,06	1,41	1,45
15. Capital adequacy for foreign and domestic banks								
a) foreign banks	16,25	14,97	15,14	17,32	18,59	14,53	15,09	14,06
b) domestic banks	8,30	8,56	8,70	10,84	11,45	15,52	17,99	14,91
16. Non-performing loans as share of total loans for domestic and foreign								
a) foreign banks	3,0	2,4	2,7	6,1	11,8	16,6	14,2	8,8
b) domestic banks	30,0	27,0	25,3	24,8	27,8	27,3	9,0	10,0
Coverage of weighted classification[5)] with reserves and provisions								
a) foreign banks	133,0	154,9	168,2	131,4	69,7	53,2	82,6	112,8
b) domestic banks	57,3	50,0	54,1	60,3	58,4	65,1	70,4	73,9

1/ For banks with licences as of the given date (excluding Konsolidaci banka and banks under conservatorship).
2/ To/from enterprises, MSEs and households.
3/ Inculding foreign branches.
4/ Net profit (loss) / average Tier I.
Note: For banks with licences as of the given date (excluding Konsolidacni banka and banks under conservatorship).
5/ Weighted classification according the CNB Provision (5 % wathc loasns, 20 % substandard loans,
50 % doubtful loans 100 % loss.
Note: For banks with licences as of the given date (excluding Konsolidacni banka and banks under conservatorship).
Source: National Bank of Czech Republic

* In the appendix we use the following definitions:

- foreign banks: at least 50 % of the shares is foreign owned
- banks with foreign participation: more than 5 % and less than 50 % foreign owned
- domestic banks: not foreign banks

Data for Hungary

in %

	1998	1999	2000	2001	2002
1. Commercial bank average assets as % of GDP	57,0	57,0	57,2	56,0	53,3
2. Private* credit by commercial banks as % of GDP	22,1	23,1	26,2	26,7	26,5
3. Commercial banks assets to total financial assets	85,9	82,6	77,3	74,1	71,8
4. Foreign banks assets as % of GDP	35,4	37,7	39,8	39,4	49,0
5. Private credit by foreign banks as % of GDP	15,0	23,1	26,2	26,7	26,5
6. Foreign banks assets as share of commercial banks assets	62,5	68,3	70,1	70,0	90,7
7. Number of foreign and domestic banks	38	37	36	35	33
8. Number of foreign subsidiaries	27	29	30	29	26
9. Number of foreign branches	0	0	0	0	0
10. Number of banks with foreign participation	3	1	1	1	0
11. Return on assets (ROA) of foreign and domestic banks					
a) foreign banks	0,7	0,0	0,9	1,4	1,5
b) domestic banks	-5,9	1,1	1,4	1,5	0,2
12. Return on equity (ROE) od foreign and domestic banks					
a) foreign banks	7,7	-0,2	10,8	16,9	18,1
b) domestic banks	-96,2	17,8	18,9	20,2	1,7
13. Net interest margin of foreign and domestic banks					
a) foreign banks	4,4	3,6	3,6	3,8	4,1
b) domestic banks	5,0	5,0	4,8	5,1	5,0
14. Overhead costs as share of average total assets of foreign and domestic banks					
a) foreign banks	3,9	4,0	3,7	3,7	3,6
b) domestic banks	4,3	4,1	4,0	4,1	4,8
15. Capital adequacy for foreign and domestic banks					
a) foreign banks	15,8	13,8	13,0	13,7	13,0
b) domestic banks	13,7	15,2	16,1	13,9	12,1

* Loans to non-financial enterprises and households

Source: National Bank of Hungary

Data for Poland

in %

		1998	1999	2000	2001	2002
1.	Commercial bank average assets as % of GDP	55,1	56,6	59,9	59,7	57,4
2.	Private credit by commercial banks as % of GDP	16,1	19,5	21,5	22,2	22,1
3.	Commercial banks assets to total financial assets	87,9	86,1	83,3	80,6	75,6
4.	Foreign banks assets as % of GDP	9,6	27,9	43,5	43,0	40,7
5.	Private credit by foreign banks as % of GDP	4,1	10,1	15,5	16,6	16,6
6.	Foreign banks assets as share of commercial banks assets	17,4	49,3	72,6	72,1	70,9
7.	Number of foreign and domestic banks	83	77	73	69	59
8.	Number of foreign subsidiaries	29	36	37	45	44
9.	Number of foreign branches	3	3	2	1	1
10.	Number of banks with foreign participation	14	8	4	3	3
11.	Return on assets (ROA) of foreign and domestic banks					
	a) foreign banks	2,0	1,1	1,3	0,9	0,5
	b) domestic banks	0,3	0,9	0,6	0,9	0,4
12.	Return on equity (ROE) od foreign and domestic banks					
	a) foreign banks	18,2	11,1	15,1	9,9	4,6
	b) domestic banks	5,4	13,1	10,3	21,1	8,1
13.	Net interest margin of foreign and domestic banks	4,7	4,0	4,0	3,5	3,3
14.	Overhead costs as share of total assets of foreign and domestic banks	3,7	3,6	3,7	3,7	3,4
15.	Capital adequacy for foreign and domestic banks					
	a) foreign banks	15,0	15,0	13,9	16,0	14,9
	b) domestic banks	10,7	11,2	9,7	11,7	11,5
16.	portfolio quality for domestic banks	10,5	14,3	14,4	17,2	19,6
	portfolio quality for foreign banks	12,0	13,3	15,9	19,1	22,7

Source: National Bank of Poland

Data for Slovak Republic

	1996	1997	1998	1999	2000	2001	2002
1. Commercial bank assets as percentage of GDP (%)	114,00	109,63	102,74	92,11	93,19	93,89	94,45
2. Private credit by commercial banks as percentage of GDP (%)	58,74	53,93	51,20	48,21	44,03	32,82	30,83
3. Commercial banks assets to total financial assets[1/] (%)	95,28	94,88	94,33	93,90	93,93	93,31	91,83
4. Foreign banks assets as percentage of GDP (%)	27,47	33,42	34,35	30,09	39,19	84,36	90,26
5. Private credit by foreign banks as percentage of GDP (%)	10,82	11,34	10,86	12,21	16,59	25,25	29,63
6. Foreign bank assets as share of commercial banks assets (%)	24,10	30,48	33,43	32,67	42,06	89,85	95,56
7. Number of foreign banks	15	14	12	11	14	15	17
8. Number of domestic banks	14	15	15	14	9	6	3
9. Number of foreign subsidiaries	8	8	7	7	10	11	13
10. Number of foreign branches	5	4	2	2	2	2	2
11. Number of banks with foreign participation	4	4	6	4	2	0	0
12. Return on assets (ROE) of domestic banks (%)	-0,65	-0,76	-1,40	-6,26	-0,42	-1,28	0,07
foreign banks (%)	0,41	1,30	1,44	1,09	1,88	1,32	1,21
13. Return on equity (ROE) of domestic banks (%)	-18,12	-20,65	-33,43	-79,41	-5,21	-6,14	0,93
foreign banks (%)	10,83	36,38	52,68	31,25	56,42	30,97	31,90
14. Net interest margin of domestic banks (%)	-0,24	1,11	-0,16	-1,18	0,69	0,74	2,47
foreign banks (%)	1,52	3,49	3,82	3,98	3,46	2,50	2,70
15. Overhead costs as share of total assets of domestic banks (%)	2,18	2,61	2,81	2,74	2,54	2,89	2,22
foreign banks (%)	1,89	1,56	1,73	2,27	2,32	2,30	2,41
16. Capital adequacy for domestic banks (%)	x	2,34	-0,99	-0,56	13,03	16,07	24,43
foreign banks (%)	x	20,89	19,73	20,45	11,89	20,43	21,09
17. Portfolio quality[2/] for domestic banks (%)	34,07	36,43	41,31	36,13	29,85	49,93	14,90
foreign banks (%)	11,23	30,69	35,51	30,28	22,71	28,59	20,72

1/ In years 1996-2001 financial sector represent banking and insurance companies assets only.

2/ Classified loand to total loans.

x - data not available

Source: National Bank of Slovak Republic

Data for Slovenia

in %

		1998	1999	2000	2001	2002
1.	Commercial bank average assets as % of GDP	65,4	67,7	67,8	72,4	78,5
2.	Private credit by commercial banks as % of GDP	30,9	34,6	35,2	37,0	37,2
3.	Commercial banks assets to total financial assets	67,4	66,3	68,8	71,2	72,2
4.	Foreign banks assets as % of GDP	3,5	3,5	11,4	12,5	14,6
5.	Private credit by foreign banks as % of GDP	1,0	1,5	6,1	6,1	7,3
6.	Foreign banks assets as share of commercial banks assets	4,9	4,9	15,3	15,2	16,9
7.	Number of foreign and domestic banks	24	25	25	21	20
	a) foreign banks	3	5	6	5	6
	b) domestic banks	21	20	19	16	14
8.	Number of foreign subsidiaries	3	4	5	4	5
9.	Number of foreign branches	0	1	1	1	1
10.	Number of banks with foreign participation	3	3	2	3	3
11.	Return on assets (ROA) od foreign and domestic banks	1,2	0,8	1,1	0,5	1,1
	a) foreign banks	0,7	-0,1	0,2	-3,9	0,4
	b) domestic banks	1,2	0,9	1,3	1,2	1,3
12.	Return on equity (ROE) od foreign and domestic banks	11,3	7,8	11,4	4,8	13,3
	a) foreign banks	6,7	-0,8	1,5	-39,5	5,1
	b) domestic banks	11,5	8,4	13,2	12,9	14,9
13.	Net interest margin of foreign and domestic banks	4,6	4,1	4,7	3,6	3,7
	a) foreign banks	3,8	3,3	3,7	3,1	3,3
	b) domestic banks	1,3	4,2	4,9	3,7	3,8
14.	Overhead costs as share of average total assets of foreign and domestic banks	2,4	2,4	2,8	2,6	2,4
	a) foreign banks	2,4	3,1	3,7	3,9	2,9
	b) domestic banks	2,4	2,4	2,6	2,3	2,4
15.	Capital adequacy for foreign and domestic banks	16,0	14,0	13,5	11,9	11,9
	a) foreign banks	30,8	28,8	14,3	12,3	11,2
	b) domestic banks	15,4	13,2	13,3	11,9	12,1

Source: National Bank of Slovenia

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