Main Features of Recent Banking Sector Developments in Selected Southeastern European Countries

A Cross-Country Perspective[1]

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The purpose of this paper is to provide a comparative stock-taking exercise of recent banking sector developments in four current EU candidate countries (CC-4), namely the two acceding countries Bulgaria and Romania and the two negotiating candidates Croatia and Turkey. The paper finds that a strong increase in foreign liabilities allowed boosting domestic lending in particular to households. At the same time, banks' credit risk that results from nonbanks' foreign exchange exposure has significantly increased. Although in recent years (1) banks' profitability has increased, (2) their share of nonperforming assets has declined and (3) their capital adequacy ratios can currently be considered as still sufficiently high (despite the recent domestic credit expansion), considerable risks to macroeconomic and macrofinancial stability may arise if foreign liabilities and domestic credit growth continue to increase at such a rapid pace in the future.

Introduction

The four selected Southeastern European Countries (i.e. the two acceding countries Bulgaria and Romania and the two accession countries Croatia and Turkey, CC-4) have experienced robust economic growth, substantial progress with respect to disinflation, and a deepening of financial intermediation levels. At the same time, current account deficits have been sizeable and foreign indebtedness has been at intermediate to moderately high levels in most CC-4.[2] In this environment, the banking sectors in these countries have gone through a deep restructuring process over the past few years. The European Bank for Reconstruction and Development's (EBRD) Index of Banking Reform in transition economies (which is of course not available for Turkey) provides simple summarizing evidence of this development. It measures reform activities by a broad range of banking indicators and can take values between 1 and 4+, with 1 representing little progress and 4+ representing full convergence of banking laws and regulations with the standards of the Bank for International Settlements (BIS) and the availability of a full set of banking services. Judged by this indicator, the progress of reform between 1998 and 2004 was largest in Croatia. Bulgaria comes second, both in terms of the dynamics of the reform process and in terms of the level of the indicator in 2004. The reform process has advanced continuously in both countries. In Romania, the development of the indicator suggests a more stepwise approach to banking reforms, with

[1] *This paper is primarily based on publicly available information. Additional data were made available to the authors by Hrvatska Narodna Banka, Bulgarska Narodna Banka and Banca Naţională a României.*

[2] *For more details about economic developments in these countries, see e.g. the publication series "Focus on European Economic Integration" of the Oesterreichische Nationalbank.*

Table 1

Structural Indicators of CC-4 Banking Markets (data for 2004)

	BG	HR	RO	TR	NMS-8[1]	Euro area[2]
EBRD Index of Banking Reform	3.7	4.0	3.0	. .	3.6	. .
Bank branches per 100,000 inhabitants	13.9	23.4	13.8	8.5	11.2	46.1
Asset share of private banks[3]	97.7	96.9	93.2	63.1	92.5	. .
Asset share of foreign-owned banks[3]	81.6	91.3	62.0	3.5	77.4	15.5
Asset share of five largest banks[3] [4]	52.2	65.0	59.8	60.0	68.6	53.0

Source: EBRD, World Bank, national central banks, Banking Regulation and Supervision Agency Turkey (BRSA), ECB.

[1] *NMS-8: arithmetic average, "Bank branches per 100,000 inhabitants" excluding Latvia.*

[2] *Euro area: arithmetic average excluding Luxembourg.*

[3] *NMS-8: 2003.*

[4] *Croatia: Asset share of the four largest banks.*

leaps forward in 1999 and 2004, but less progress in the years in between. According to the EBRD indicator, banking sector reforms in Croatia and Bulgaria were more advanced than those in the eight Central and Eastern European Member States of the European Union (NMS-8) taken together, whose (unweighted) average indicator stood at 3.6 in 2004.

The structural changes in the banking system have gone hand in hand with a consolidation process. Between 1998 and 2004, the number of banks fell significantly in Croatia and Turkey, and a more moderate decrease could also be observed in Romania, while in Bulgaria a similar consolidation had occurred already earlier. This consolidation process in the CC-4 banking industry has in part been promoted by banking crises, which shook the banking systems in these four countries at different points in time during the past decade. Several failed banks were closed down or merged with other banks during or after the crisis episodes. In addition, M&A activity has also been motivated by a fight for market share by bank owners, among them foreign investors. Moreover, bank privatization has also contributed to the decline in the number of banks in those cases where investors who already held stakes in banking institutions in the country acquired stakes in a newly privatized bank, which was subsequently merged into the existing holding.

While in 1997 and 1998 the Bulgarian and Romanian banking sectors were overwhelmingly state-owned, the share of privately-owned banks in total commercial bank assets rose to nearly 100% by the end of 2004. In Croatia privately-owned banks accounted for more than half of total banking sector assets already in 1997, and this share rose to nearly 100% by 2004. In Turkey the share of private banks in total banking assets is smaller than in the other three countries, and the privatization process has been less dynamic in recent years, with the share of privately-owned banks rising from 60% in 2000 to 63% in 2004. However, the favorable financial position of state-owned banks makes them attractive targets for private (domestic or foreign) strategic investors.

In Bulgaria, Croatia and Romania, a large number of foreign investors have participated in the privatization process. Consequently, the share of foreign-owned banks in total banking assets increased simultaneously to the share of privately-owned banks. At the end of 2004, foreign-

owned banks accounted for 80% to 90% of total banking sector assets in Bulgaria and Croatia. This share was lower (at slightly more than 60%) in Romania, due to majority domestic private ownership of the country's largest commercial bank, Banca Comerciala Romana. However, in the meantime, the sale of a controlling stake in this bank to Austrian Erste Bank boosted foreign ownership in the Romanian banking sector as well. Banks from the euro area belong to the key players in these banking markets, with Austrian, Italian, Benelux and Greek banks leading the league. By contrast, foreign involvement in the Turkish banking sector remains very limited, with majority foreign-owned banks accounting for only around 3.5% of total banking sector assets. Limited foreign ownership in the Turkish banking sector can partially be explained by the dominance of family conglomerates among privately-owned banks, who until recently have hardly shown any interest in involving foreign co-owners.

The Financial Sector Assessment Programs (FSAP) under the auspices of the International Monetary Fund (IMF) and the World Bank, which were conducted in Bulgaria, Croatia and Romania in 2002 and 2003, provided a first overall assessment of the achievements that had resulted from these structural changes. The FSAPs found that these countries had stable and generally well-capitalized and well-supervised banking sectors, which were to a considerable degree resilient against risks. At the same time, the FSAPs stated that banks needed to close existing gaps in their credit allocation and risk management systems, having a close eye not only on credit risks and market risks, but also on operational risks. In the area of supervision, the FSAPs highlighted the necessity to improve accounting, auditing and disclosure regulation and governance. They also called attention to the importance of regular stress testing for an early identification of systemic weaknesses. Similarly, the need for cooperation with foreign supervisory authorities was highlighted. Concerning the Turkish banking sector, the IMF Staff Report of the 2004 Article IV consultations found evidence that the banking sector had been substantially strengthened following the crisis of 2000–2001 and that the supervisory environment has improved. This notwithstanding, the IMF has identified four key areas which needed further reform or an acceleration of reform. These included (1) the further restructuring and privatization of state-owned banks, (2) correcting existing shortcomings in the supervisory framework to better enforce existing prudential requirements in particular with respect to risk management and capital cushions, (3) asset resolution and (4) reducing financial disintermediation.

Austrian banks have significantly contributed to the transformation of the banking sectors in Bulgaria, Croatia and Romania. Over the past few years, Austrian banks have increased their presence in these three countries by establishing subsidiaries: the value of total assets of these subsidiaries rose from EUR 4.7 billion at the beginning of 2002 to EUR 23.3 billion in September 2005. Austrian banks' subsidiaries in these three countries accounted for around 17% of the total assets of all foreign subsidiaries of Austrian banks. Their share in the pre-tax earnings of all foreign subsidiaries taken together stood at a similar level. The increase

in their total assets has secured the Austrian subsidiaries strong market positions in all three countries: at the end of September 2005, their share in total banking sector assets was at almost 45% highest in Croatia, compared with around 18% in Bulgaria and Romania. Including the acquisition of Banca Comerciala Romana by Erste Bank in December 2005, Austrian banks' market share in Romania has likely increased to around 40%. At the end of September 2005, Austrian banks had no subsidiaries in Turkey.

In addition to operating subsidiaries, Austrian banks have also strengthened their ties with all CC-4 by cross-border lending. The stock of cross-border claims on households and enterprises in the CC-4 (excluding claims on the subsidiaries of Austrian banks) rose from around EUR 2.9 billion at the beginning of 2000 to around EUR 9.7 billion by November 2005. Lending to borrowers in Turkey accounted for around half of this total, followed by lending to customers in Croatia (30%). A further EUR 3.8 billion went to Austrian banks' subsidiaries in these countries, mostly in Croatia. Although the combined value of the assets of Austrian banks' subsidiaries in the CC-4 and of direct lending to clients in these countries by Austrian banks represents less than 5% of Austrian banks' total assets, banking sector developments in the CC-4 are of increasing relevance for financial stability in Austria.

Against this background, the present paper aims at highlighting in a comparative way three main features of banking sector developments in these countries in recent years up to the end of 2004. Moreover, we compare these developments with those in the banking sectors of the eight Central and Eastern European new EU Member States and of the euro area.

First Feature: Acceleration of Domestic Lending (in Particular to Households) Boosted by Strongly Increasing Foreign Liabilities

Claims on households and nonbank corporations[3] play a prominent role in banking assets in Bulgaria and Croatia, accounting for about 55% of total assets at the end of 2004 (see table 2). This share is somewhat lower in Romania (46%), closer to the NMS-8 and the euro area average and significantly lower in Turkey (31%). In Romania, these comparatively low values correspond to a significantly higher share of claims on the central bank than in other countries, and in Turkey to a significantly higher share of claims on the general government, which is mainly attributable to high budget deficits. In turn, the share of total domestic claims in total assets in Romania and Turkey was about the same level as in Bulgaria and Croatia.

From the end of 2001 to the end of 2004, growth of lending to households and nonbank corporations accelerated in the CC-4, and the share of these claims in total assets increased markedly by between 4 and 20 percentage points. Growth of lending to households was particularly strong in all four countries. By contrast, the share of claims on non-

[3] *Nonbank corporations comprise both nonfinancial corporations and financial institutes that are nonbanks.*

bank corporations increased only in Bulgaria, while it remained relatively stable in Romania and Turkey, and decreased continuously in Croatia.[4] Structural changes have supported the shift from lending to nonbank corporations to lending to households over the past few years. On the supply side, privatization has promoted improved management and the technical skills of bank employees, which in turn has contributed to the development of retail lending, while relatively large interest rate margins and better collateral (e.g. in the form of guarantees, real estate) have also made lending to households an attractive new business. On the demand side, rising income levels and subsidized housing loan schemes have generated credit demand, while at the same time the corporate sector has gained better access to alternative financing sources (including financing from retained earnings following the improvement in profitability and financing abroad in the form of FDI equity or cross-border credits). Finally, the removal of bad loans from banks' balance sheets (for example to asset management companies) predominantly affected loans to the corporate sector. These changes in the asset structure and the underlying driving forces display a number of similarities to the developments in the NMS-8 over the last decade.

Lending to the general government plays a significant role only in the Turkish banking sector, which can be attributed to the fact that in the other three countries, the government debt burden is financed to a considerable extent from abroad and, in the case of Romania, that the level of public debt is relatively low.

Table 2

Commercial Banks' Domestic Claims

% of total assets, end-2004

	BG	HR	RO	TR	NMS-8[2]	Euro area
Total domestic claims	74.8	80.7	84.7	78.9	77.0	79.4
Claims on domestic MFIs	11.9	15.2	36.5	7.4	15.2	28.9
Claims on domestic nonbanks	62.9	65.5	48.2	71.5	61.8	50.5
of which:						
Claims on the general government[1]	*8.7*	*10.1*	*2.4*	*40.1*	*14.7*	*9.9*
Claims on the domestic nonbank nongovernment sector[1]	54.3	55.3	45.7	31.4	47.2	40.6
of which:						
Claims on non-MFIs and nonfinancial corporations	*37.4*	*26.4*	*32.7*	*21.4*	..	*22.8*
Claims on households and NPISH[3]	*16.9*	*28.9*	*13.0*	*10.0*	..	*17.8*

Source: NCBs, ECB.

[1] *Excluding Estonia.*
[2] *Arithmetic average.*
[3] *NPISH: Nonprofit institutions serving households.*

[4] *However, it is worth pointing out that in contrast to borrowing from banks, Croatian nonfinancial corporations have heavily stepped up borrowing from the nonbank financial sector (for example from leasing companies) and foreign sources in recent years. This may to some extent be a reaction to the limitations on bank lending imposed by the central bank at the beginning of 2003.*

Claims on banks (including the central bank) ranged between 7.4% (Turkey) and 36.5% (Romania) of total assets, compared with a share of close to 30% in the euro area. Importantly, commercial banks' deposits with the central bank play a much larger role in the CC-4 than in the euro area, as deposits of commercial banks with the central bank account for between 6.5% (Turkey) and 34% (Romania) of banks' total assets in the CC-4 (i.e. for almost the entire amount of claims on other banks), compared with merely 1.4% in the euro area. This is not only attributable to the relatively high mandatory reserve requirement rates in the CC-4 (between 6% and 18%), but also to the structural liquidity surplus of commercial banks on the back of foreign capital inflows, combined with sterilized exchange rate interventions by the central bank, which results in a huge volume of liquidity-draining instruments in the CC-4. At the same time, the fact that the share of claims on other monetary financial institutions (MFI) is considerably lower in the CC-4 than in the euro area indicates a significantly smaller liquidity of the interbank market in these countries.

On the liabilities side, deposits by domestic nonbanks (overwhelmingly households and nonbank corporations) constitute the most important financing source for commercial banks in the CC-4, accounting for around 60% of total liabilities in Bulgaria and Croatia, and for 65% to 68% in Romania and Turkey (see table 3). These values compare to around 30% in the euro area and slightly more than 50% in the NMS-8. This high share of relatively cheap financing, combined with the generally higher interest rate margins in the CC-4, supports commercial banks' profitability in these countries.

The share of domestic deposits in total liabilities was on the rise until 2001 in Bulgaria and Croatia and until 2002 in Romania and Turkey. This expansion was to a large extent attributable to the introduction of euro cash at the beginning of 2002, which led to the depositing of euro legacy currencies with domestic banks, and, likely, to strengthened confidence in the domestic banking sector following the settlement of the banking crises. In Bulgaria, Croatia and Romania, the volume of domestic deposits has increased considerably in real terms also since the end of 2001, i.e. following the introduction of euro cash. At the same time, however, the share of domestic deposits in total assets has been crowded out by the sharp increase in foreign liabilities, which boosted domestic lending in these countries. By contrast, the volume of domestic deposits rose considerably less in real terms in Turkey than in the other three Southeastern European countries between the end of 2001 and the end of 2004. However, as the share of foreign liabilities in total liabilities remained nearly constant, the share of domestic deposits declined only slightly and remained well above pre-changeover levels.

Banks' net positions reveal major differences between the balance sheet structures in the CC-4 and in the euro area at the end of 2004. As the upper part of table 4 shows, in the CC-4, banks had negative net claims on households and nonbank corporations (i.e. an excess of deposits of over claims on these sectors). This contrasts with positive net claims of banks on these sectors in the euro

Table 3

Domestic Deposits with Commercial Banks

% of total liabilities, end-2004

	BG	HR	RO	TR	NMS-8[1]	Euro area
Deposits of domestic MFIs	4.1	0.4	3.0	2.0	3.9	22.0
Deposits of domestic nonbanks	60.0	60.4	64.9	67.9	53.3	31.7
of which:						
Deposits of the general government	*3.9*	*4.2*	*2.6*	*4.8*	*3.3*	*1.3*
Deposits of households and nonbank corporations	*56.1*	*56.2*	*62.3*	*63.1*	*50.0*	*30.4*

Source: National central banks, ECB.

[1] *Arithmetic average.*

area, where debt securities issued as well as capital and reserves constituted the major source of funding for these net claims as well as for the net claims on the general government.[5] By contrast, in the CC-4 (similar to the NMS-8), negative net claims on households and nonbank corporations, negative net foreign assets (except in Turkey) and a comparatively high capital and reserves position provided the funding for the net claims on the general government (except for Romania) and, in particular, for the sizeable positive net claims on the central bank.

Importantly, the striking difference between partly sizeable negative net claims on households and nonbank corporations in the CC-4 and positive such net claims in the euro area cannot be interpreted as the result of banks' hesitation in providing financing to these sectors. Indeed, recalling that the share of claims on households and nonbank corporations in total assets was higher in the CC-4 (with the exception of Turkey) than in the euro area at the end of 2004, it is clear that the negative net position on households and nonbank corporations in Bulgaria, Croatia and Romania resulted primarily from the fact that compared with the euro area, domestic nonbank deposits continue to play a much larger role in banks' liabilities in these countries. The share of domestic deposits of households and nonbank corporations in total liabilities in the CC-4 is even significantly larger than the combined share of such deposits and of the position "debt securities issued" in the euro area. Nevertheless, including that part of the position "debt securities issued," which is held by domestic households and nonbank corporations, when calculating the "net claims on households and nonbank corporations" in the euro area, would result in a net position that is already closer to the corresponding net posi-

[5] *Moreover, in the euro area, the banking sector, i.e. "other monetary financial institutions (MFIs)," had positive net claims on MFIs, although it had a net liabilities position against the central bank (Eurosystem). This results from the fact that "claims" include loans extended to other MFIs as well as holdings of debt and equity securities issued by other MFIs, while only deposits from other MFIs (and not bank securities held by other MFIs) are subtracted to calculate the net position. Thus, the positive net claims on MFIs (6.9% of total assets) consist of the holdings of debt and equity securities issued by other MFIs (7.9% of total assets) minus net liabilities against the Eurosystem (1% of total liabilities).*

tion in the CC-4, in particular in Bulgaria and Croatia, where it is close to balance. In the CC-4, banks have so far issued only a very small volume of domestic debt securities, mainly due to the fact that their domestic corporate bond markets have in general been less developed.[6]

As regards the changes in the balance sheet structure from the end of 2001 to the end of 2004 (see the lower part of table 4), the net position of CC-4 banks against households and nonbank corporations had become significantly less negative since the end of 2001, despite the increase in the volume of deposits in real terms during this period. In parallel, commercial banks' net foreign asset position deteriorated significantly. While banks in all four countries had positive net foreign assets in 2001 (most notably Bulgaria, at 30% of total assets), Bulgarian, Croatian and Romanian banks' net external asset position had turned negative by 2004. The largest deterioration in banks' net foreign position occurred in Bulgaria, which also saw the most pronounced reduction in the negative net claims on households and enterprises. The sharp increase in foreign liabilities, which led to a deterioration in net foreign assets (in % of total assets), caused net claims on households and nonbank corporations to become significantly less negative thanks to two effects: First, it helped finance the considerable increase in the share of claims on domestic nonbanks (in Bulgaria, Romania, Turkey) to levels above those in the euro area (except in Turkey), and second, it crowded out the share of domestic deposits (Bulgaria, Romania, Croatia). If the rapid increase in foreign liabilities that Bulgaria, Croatia and Romania witnessed in recent years were to continue unabatedly over the medium term, this could hardly be considered as sustainable and conducive to financial stability.

On a more positive note, the fact that the capital and reserves position of banks in the CC-4 is significantly larger as a percentage of total liabilities than in the euro area and – with the exception of Bulgaria – also higher than in the NMS-8 deserves particular mention. These large capital positions have been brought about by the privatization of banks and the involvement of foreign investors and are partly ascribable to the lack of banks' funding via the issuance of debt securities. The strong capital base is also reflected in relatively high capital adequacy ratios in the CC-4, compared with the NMS-8 and the euro area.

[6] *However, the issuance of debt securities by banks has strengthened modestly more recently (in connection with the issuance of mortgage bonds), and this trend can be expected to continue in the future on the back of the housing loan business. It is quite plausible to expect part of current domestic deposits of households and nonbank corporations to shift into such securities over the medium term.*

Table 4

Major (Net) Positions of the Commercial Banks' Aggregate Balance Sheet

% of total assets/liabilities

	BG	HR	RO	TR	NMS-8[1]	Euro area
Shares in % at end-2004						
Net claims on domestic MFIs	7.8	14.8	33.5	5.4	11.3	6.9
Net claims on the general government	4.8	6.0	−0.1	35.3	11.4	8.6
Net claims on households and nonbank corporations	−1.9	−0.9	−16.6	−31.7	−2.8	10.2
Net external assets	−1.5	−7.8	−10.2	0.4	−8.1	0.6
Net other assets[2]	1.9	1.1	5.1	8.2	. .	−4.2
Debt securities issued	0.7	0.5	0.0	0.0	2.9	16.4
Capital and reserves	10.5	12.7	11.7	17.5	10.6	5.6
Changes in the shares in percentage points from end-2001 to end-2004						
Net claims on domestic MFIs	2.9	4.3	10.0	3.2	. .	−0.4
Net claims on the general government	−2.4	−4.1	−7.2	−0.9	. .	−0.4
Net claims on households and nonbank corporations	27.7	16.0	16.5	6.9	. .	0.3
Net external assets	−32.4	−15.5	−18.7	−1.7	. .	2.1
Net other assets[2]	2.5	−5.5	−3.3	−3.0	. .	−1.0
Debt securities issued	0.6	0.3	0.0	0.0	. .	0.6
Capital and reserves	−2.3	−5.1	−2.7	4.4	. .	−0.1

Source: National central banks, ECB.

[1] *Arithmetic average.*

[2] *Net other assets include money market funds (on the asset and the liability side), fixed assets, other assets and remaining liabilities.*

Second Feature: Nonbanks' Foreign Currency Exposure Increases Banks' Indirect Foreign Exchange Risk and Thus Credit Risk

Foreign currencies play a significant role in the banking sectors of the CC-4. On the deposit side, this is partly ascribable to households' lack of confidence in the domestic currency (and the domestic banking sector) at the beginning of the transformation process. Later on, when households moved the foreign currency cash they had kept "under the mattress" to domestic bank accounts, households preferred foreign currency deposits.

On the lending side, the large share of foreign currencies can be considered to be a natural hedge of banks' foreign currency liabilities (foreign currency deposits, foreign loans, foreign currency-denominated equity capital paid in by foreign investors). Thus, it may mirror domestic banks' lack of confidence in the domestic currency or banks' efforts to limit their open foreign currency positions. At the same time, following the stabilization of the domestic currency, borrowers have likely been attracted to foreign currency loans by lower interest rates, apparently expecting that the interest rate differential would not be offset by a depreciation of the currency. Moreover, for some borrowers foreign currency-funding provides a natural hedge to their operative earnings denominated in foreign currency.

Foreign currency-denominated deposits accounted for between 41% and 74% of total bank deposits of households and nonbank corporations in these countries at the end of 2004 (see table 5a). At the same time, foreign currency-denominated loans accounted for between 10% and 61% of total bank loans to households and nonbank corporations in these countries (see table 5b). This share was highest in Romania and lowest in

Croatia. However, these figures may underestimate the entire role of foreign currencies in total deposits of and loans to households and nonbank corporations, given that there are also deposits and loans indexed to foreign currencies. Indexed instruments play a substantial role in particular in Croatia, where they accounted for almost 10% of total deposits of households and nonbank corporations and for 66% of total loans to this sector at the end of 2004.

At the beginning of this decade, the share of foreign currency-denominated deposits was boosted in Bulgaria, Romania and Turkey as residents deposited their holdings of euro legacy currencies prior to the cash changeover into euro at the beginning of 2002. The volume of both total and foreign currency-denominated deposits of households and nonbank corporations increased also in Croatia as a result of the depositing of holdings of euro-constituent currencies in these years. However, the share of foreign currency-denominated deposits did not increase further, as it had accounted for 87% of total deposits already beforehand and some part of the foreign currency holdings was converted into domestic currency. After the introduction of euro cash, the share of foreign currency deposits began to erode in all CC-4, and this process has continued since. It dropped to levels below those observed prior to the boost in all CC-4 except for Turkey. This decline may have been supported by heightened confidence in the respective domestic currencies.

On the lending side, the share of foreign currency loans increased in 2002 in all CC-4, probably mainly as

Table 5a

Domestic Foreign Currency-Denominated Deposits

shares in % of total deposits of the respective sectors, 2004

	BG	HR	RO	TR
Share of foreign currency deposits of households and nonbank corporations [1]	47.1	74.2	41.2	50.0
of which:				
Share of foreign currency deposits of households [2]	*54.6*	*84.5*	*40.2*	*50.6*
Share of foreign currency deposits of nonbank corporations [1]	*34.8*	*46.9*	*63.5*	*47.4*

Source: National central banks.

[1] Croatia: Before 2004 including deposits of nonresidents and deposits of the general government.
[2] Croatia: Before 2004 without nonprofit institutions.

Table 5b

Domestic Foreign Currency-Denominated Loans

shares in % of total loans to the respective sectors, 2004

	BG	HR	RO[1]	TR
Share of foreign currency loans to households and nonbank corporations	48.2	9.6	60.8	22.4
of which:				
Share of foreign currency loans to households	*11.0*	*0.5*	*45.9*	*. .*
Share of foreign currency loans to nonbank corporations	*65.3*	*20.2*	*66.6*	*. .*

Source: National central banks.

[1] Claims.

Note: Data do not include loans indexed to foreign currencies, which are significant in Croatia.

a result of additional foreign currency funding through domestic deposits. Thereafter, the share of foreign currency loans in total loans increased significantly further during an ongoing domestic lending boom in Bulgaria, while it markedly fell in Turkey, where decreasing interest rate differentials vis-à-vis the euro and the U.S. dollar apparently played a determining role. The share of foreign currency loans also declined modestly in Croatia.

Banks' foreign currency lending to households and enterprises implies an indirect foreign exchange risk to banks in the CC-4, which constitutes a form of credit risk. Since in particular households and smaller enterprises may not be sufficiently hedged against adverse exchange rate fluctuations (either through natural hedges or by using financial market instruments), a large depreciation of the domestic currency could erode borrowers' ability to service their foreign currency loans and hence lead to loan losses. The situation may be accentuated by the fact that the nonbank corporate sector's foreign indebtedness (as a result of cross-border borrowing) has increased significantly over the past few years in Bulgaria, Croatia and Romania, increasing the exposure to exchange rate risk.

The shares of foreign currency-denominated or -indexed claims on and deposits of domestic nonbanks in total assets (liabilities) of commercial banks' balance sheets are indeed sizeable. At the same time, published data on banks' net overall (on- and off-balance sheet) foreign currency positions (including foreign currency-indexed positions and external positions) show small net positions for all four CC-4, including Romania and Turkey.[7] At the end of 2004, Croatian banks had a long open position of around 1% of total assets. As a result, they would have benefited from a depreciation of the domestic currency, which would have provided some compensation for the credit risk stemming from the potential deterioration of their credit portfolio as a result of the currency depreciation. Romanian and Turkish banks had nearly balanced positions (+0.1% and –0.1% of total assets, respectively), while Bulgarian banks had a small negative position of around 0.3% of total assets (excluding exposure to the euro, in accordance with central bank regulations). These net overall positions are in line with or even smaller than those observed for most NMS.

Third Feature: Improved Profitability and Still Sufficiently High Capital Adequacy Ratios Despite Credit Expansion to Riskier Asset Classes

The profitability of banks in the CC-4[8] has improved considerably over the past few years, boosted by bank restructuring measures and privatization. Return on equity (ROE) amounted to around 16% to 19% in nominal terms in all four countries in 2004. This compares to an unweighted

[7] *Unfortunately, however, in some countries it is virtually impossible to fully trace back the published data on banks' net overall foreign currency positions to detailed data on gross (domestic and foreign) foreign currency-denominated and -indexed positions as these are often published only partially.*

[8] *In order to achieve a high degree of comparability, the profitability indicators have been calculated by the authors using the same standard methodology across countries.*

Table 6

Main Income Statement Items

% of average assets, 2004

	BG	HR	RO	TR	NMS-8	Euro area
Operating income	7.3	4.3	10.0	9.1	4.7	2.3
of which: Net interest income	*4.9*	*3.0*	*4.9*	*6.2*	*2.9*	*1.2*
Net noninterest income	*2.3*	*1.3*	*5.1*	*2.9*	*1.8*	*1.1*
Operating costs	4.2	2.3	6.2	5.3	2.8	1.5
of which: Personnel costs	*1.6*	*1.2*	*2.6*	*1.7*	..	*0.9*
Net costs of loan loss provisioning	0.7	0.3	0.7	0.5	..	0.3
Return (after tax) on assets (ROA)	2.0	1.4	2.4	2.2	1.3	0.4
Return (after tax) on equity (ROE)	16.8	16.0	18.6	16.7	19.4	10.5
Cost-to-income ratio	58.3	54.3	61.6	57.7	60.4	63.7

Source: National central banks, BRSA, ECB.

average ROE of 19.4% in the NMS-8 and of 10.5% in the euro area. However, the picture is more heterogeneous if one takes into account inflation developments. On the basis of return on equity deflated by CPI, Croatian banks performed best in 2004 (13.6%), while Romanian banks (6.0%) stood at the other end of the spectrum. The corresponding values for the NMS-8 and the euro area were 14.7% and 8.3%, respectively.

Despite a general decline in interest rate margins over the past couple of years, net interest income as a percentage of average assets has declined only modestly (Croatia), remained stable (Bulgaria) or even increased (Romania).[9] In 2004, net interest income ranged roughly between 3.0% and 6.2% of average assets in the CC-4 and was thus higher than in the new Member States and exceeded the euro area figure by far. To some extent this reflects higher risks inherent in the lending business in the CC-4, which is also mirrored in higher net costs of loan provisioning, but it predominantly translates into better profitability ratios.

Banks' net noninterest income has declined as a percentage of average assets over the past few years, in particular in Romania, Bulgaria and Turkey. Romanian banks generally had a higher ratio of net noninterest income, which seems to stem from higher earnings from securities and foreign exchange transactions. Despite this decline, in 2004 net noninterest income in the CC-4, with the exception of Croatia, was still higher than in the NMS-8, and in all CC-4 it was (mostly considerably) higher than in the euro area.

Operating income as a percentage of average assets in the CC-4, with the exception of Croatia, was significantly higher than in the new Member States, and in all CC-4 it was clearly higher than in the euro area in 2004. However, operating income as a percentage of assets has declined over the past few years in all CC-4, and this trend may continue in the future.

[9] *The data series is too short for Turkey (available since 2001) to draw far-reaching conclusions. Turkish banks achieved a net interest income of 11% of average assets in 2001, and the value fluctuated between 4.5% and 6.4% in 2002 to 2004.*

Reflecting the impact of restructuring and consolidation measures, banks in the CC-4 have succeeded in increasing their cost efficiency over the past few years. Nevertheless, operating costs as a percentage of average assets continue to be higher in the CC-4, with the exception of Croatia, than in the NMS-8, and all CC-4 countries have higher cost-to-asset ratios than banks in the euro area. Although cost-to-income ratios in the CC-4, with the exception of Romania, were lower than in the NMS-8 and in all CC-4 were lower than in the euro area in 2004, this indicator seems to be subject to more volatility over time.

The cleaning-up of banks' balance sheets during the restructuring process led to high provisioning costs around the period of financial distress in the CC-4. Since then, however, annual provisioning costs as a percentage of total assets have gradually decreased, in parallel with the improvement in the quality of banks' loan portfolios. Nevertheless, the net costs of provisioning in 2004 were modestly above the levels seen in the euro area, especially in Bulgaria and Romania. Banks in these two countries experienced an increase in their provisioning costs in 2003 and 2004. In both countries this may be connected to the rapid expansion of domestic lending activity and precautionary action. In addition, the introduction of tighter asset classification rules also had a tangible impact, necessitating additional provisioning.

Major prudential indicators of banks in the CC-4, such as (1) asset quality as measured by nonperforming loan (NPL) ratios, (2) capital adequacy ratios and (3) liquidity indicators like claims-to-deposits ratios or the maturity structure on the asset and the liability side, show a mixed but overall relatively satisfactory picture.

The quality of banks' portfolios, measured by NPL ratios, in the CC-4 has improved over the past few years.[10] This process has been supported not only by the removal of NPLs from the balance sheets during the bank restructuring process but also by improved management skills, credit processes and risk management capacities. At the end of 2004, the share of nonperforming assets in the CC-4 varied between 3.6% in Bulgaria and 8.1% in Romania. The comparative figure for the euro area was 3.1% in 2004 and for the ten new Member States of the EU (NMS-10) 10.7% in 2003.[11] At the same time, the structure of NPLs has also improved. While the two worst categories, doubtful and loss assets, had a share of around 73% of total NPLs in Bulgaria, Croatia and Romania in 2000 (and in previous years an even higher share in Bulgaria and Romania), the share decreased to 57% in Bulgaria, to 65% in Croatia and to 35% in Romania by the end of 2004. With regard to provisioning, in 2004 banks in the CC-4, with the exception of Romania, were significantly better provisioned than banks in the NMS-10

[10] *In general, cross-country and cross-period comparisons should be used very cautiously, given differences in the coverage of the indicator (in terms of instruments and clients) and in classification rules among different countries and changes in national legislation over time (mostly leading to tighter and more comprehensive classification rules; see e.g. Romania in early 2003).*

[11] *Indicators of NPLs and provisions for the NMS are taken from the ECB's "EU Banking Sector Stability Report" (November 2004), which refers to a weighted average NMS-10 aggregate.*

Table 7

Nonperforming Assets and the Stock of Provisions, end-2004

	BG	HR	RO	TR	NMS-10[1]	Euro area
Nonperforming assets in %[2]	3.6	4.5	8.1	6.2	10.7	3.1
of which: Share of doubtful and loss assets in total NPL	*56.9*	*65.1*	*35.3*	*. .*	*. .*	*. .*
Provisions in %[2]	3.4	3.5	1.3	5.5	4.5	2.2
Provisions in % of NPL	95.5	78.6	15.9	88.1	42.1	71.8
Uncovered NPL in %[2]	0.2	1.0	6.8	0.7	6.2	0.9

Source: National central banks, BRSA, ECB.

[1] *2003.*

[2] *As a percentage of assets under classification.*

and even moderately better provisioned than banks in the euro area. However, this comparison does not take into account possible differences in the structure of NPLs and differences in provisioning requirements across countries (the provisions-to-NPL ratio tends to be higher, the worse the asset quality is, given higher provisioning requirements for lower asset classes).

Banks in the CC-4 seem to have a sufficient capital buffer compared with the risks they have undertaken. In Bulgaria, Croatia and Romania, capital adequacy ratios ranged between 14% and 19% at the end of 2004, while Turkish banks had a capital adequacy ratio of 26%, that is in all cases the ratios were well above national requirements of 8% to 12%. High capital adequacy ratios in part reflect a buffer for future business expansion and an increase in the volume of risky assets. They also offer some cushion for a potential deterioration of banks' asset quality or other shocks on bank capital in the future. Nevertheless, the ratios are trending downwards in the longer run, especially in Bulgaria, Croatia and Romania. This has been attributable to a greater expansion of risk-weighted assets than of the capital base. This process needs close monitoring, especially during periods of rapid credit expansion, when banks face heightened credit and indirect foreign exchange risks. At the same time, declining capital adequacy ratios – as long as they do not fall below critical levels – can also be interpreted as an indication of a more efficient use of capital by CC-4 banks.

Data about the maturity structure on banks' asset and liability sides are unfortunately rather scarce for the CC-4. Deposits of households and enterprises in the CC-4 continue to be dominated by short-term deposits. For example, deposits with a maturity of up to three months (including sight deposits) account for around 80% of total deposits of households and nonbank corporations in Bulgaria and Turkey. At the same time, loans to households and corporations tend to have a longer maturity: loans with a maturity of up to one year accounted for around 40% of total loans in Bulgaria, Croatia and Romania in 2004. This mismatch between the maturity structure of deposits and loans may represent some risk to banking sector liquidity. At the same time, however, given the fact that the share of longer-term loans and deposits with variable interest rates is considerable in the CC-4 (and probably significantly higher than in the euro area), the in-

Table 8

Capital Adequacy Ratio and the Maturity Structure of Deposits and Loans, end-2004

	BG	HR	RO	TR	NMS-8	Euro area
Capital adequacy ratio	16,6	14,1	18,8	26,2	12,8	11,8
Deposits with a maturity of up to 3 months[1]	78,6	..	..	83,2	..	..
Loans with a maturity of up to 1 year[1]	38,8	37,7	44,1	..	..	21,4

Source: National central banks, BRSA, ECB.

[1] *Households and enterprises.*

terest rate risk of banks in these countries seems to be still limited. The shifting of interest rate risk to households and enterprises, however, may become a source of credit risk in the future, if rising interest rates were to adversely impact on borrowers' debt servicing capacity.

Summary and Conclusions

Following financial distress in the late 1990s and early 2000s, the banking sectors in the CC-4 have gone through a significant restructuring process over the past few years. As a result of this process, banks in Bulgaria, Croatia and Romania have been almost fully privatized, with the largest part having been sold to foreign strategic investors. Lending to the private sector has developed rapidly during the past few years. As a result, claims on households and nonbank corporations have now a larger share in total banking sector assets in Bulgaria, Croatia and Romania than in the euro area. Banks in the CC-4 predominantly rely on domestic deposits and equity for financing, to a much greater degree than banks in the euro area. However, over the past few years banks financed strong domestic credit expansion to a substantial extent by incurring foreign liabilities. Foreign currencies play a significant role in the financial system of the CC-4, both on the asset and the liability side. Bank profitability in the CC-4 is on average higher than in the new EU Member States or in the euro area. Higher profitability stems from significantly higher operating income, although this advantage is partially offset by higher operating costs. Over the past few years, improved cost efficiency has helped to counteract the gradual decline in operating income and to maintain high profitability ratios. Despite improvements in recent years, the asset quality of banks in the CC-4, measured by the share of nonperforming assets, is poorer than in the euro area. Nevertheless, banks seem to be sufficiently provisioned. Moreover, the capital adequacy ratios are still comparatively high despite the recent domestic credit expansion to riskier debtors.

Notwithstanding this broadly satisfactory picture, banking supervisory authorities face considerable challenges in the CC-4. Rapid credit expansion to the private sector needs close monitoring as it may have adverse effects on financial and macroeconomic stability. To increase their market shares, banks may be tempted to shift lending increasingly to more risky clients and financial products, which would – in parallel – require an adaptation of their risk management capacities. In this respect, special attention should be paid to foreign currency lending. While commercial banks are generally well-protected against direct foreign currency

risk (according to summarizing information on the open foreign exchange position published by the respective central banks), they face considerable credit risk stemming from indirect foreign exchange risk, as many of their customers, especially households and small and medium-sized enterprises, are likely insufficiently hedged against adverse exchange rate movements. Also, the integration of the CC-4 into the global financial system bears financial stability implications, as – inter alia – financial openness makes it easier for distress in one country to infect other countries. The international aspect of the banking business also highlights the necessity of close cooperation between national supervisory authorities. Central banks in the CC-4 are well aware of these risks. In Bulgaria, Croatia and Romania, they have already moved to rein in credit expansion to preserve macroeconomic stability and to prevent hard-won financial stability from being endangered. Financial regulation, supervisory structures and supervisory practices have also been upgraded over the past few years and are regularly monitored by the IMF. Involvement into the EU financial supervisory framework in the run-up to and upon EU accession should lend further support to financial stability surveillance and thus financial stability.

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