



OESTERREICHISCHE NATIONALBANK

Financial Structure in the New EU Member States (NMS): Status quo and Future Challenges

Presentation

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on The Future for Private Banking

in the New EU Member States of Central and Eastern Europe

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Outline

- **Monetary integration process of the NMS**
- **Key features of the financial sector**
- **Banking efficiency**
- **Concluding remarks**

Monetary integration of the NMS: ERM II and Euro adoption

Stages of economic and monetary integration

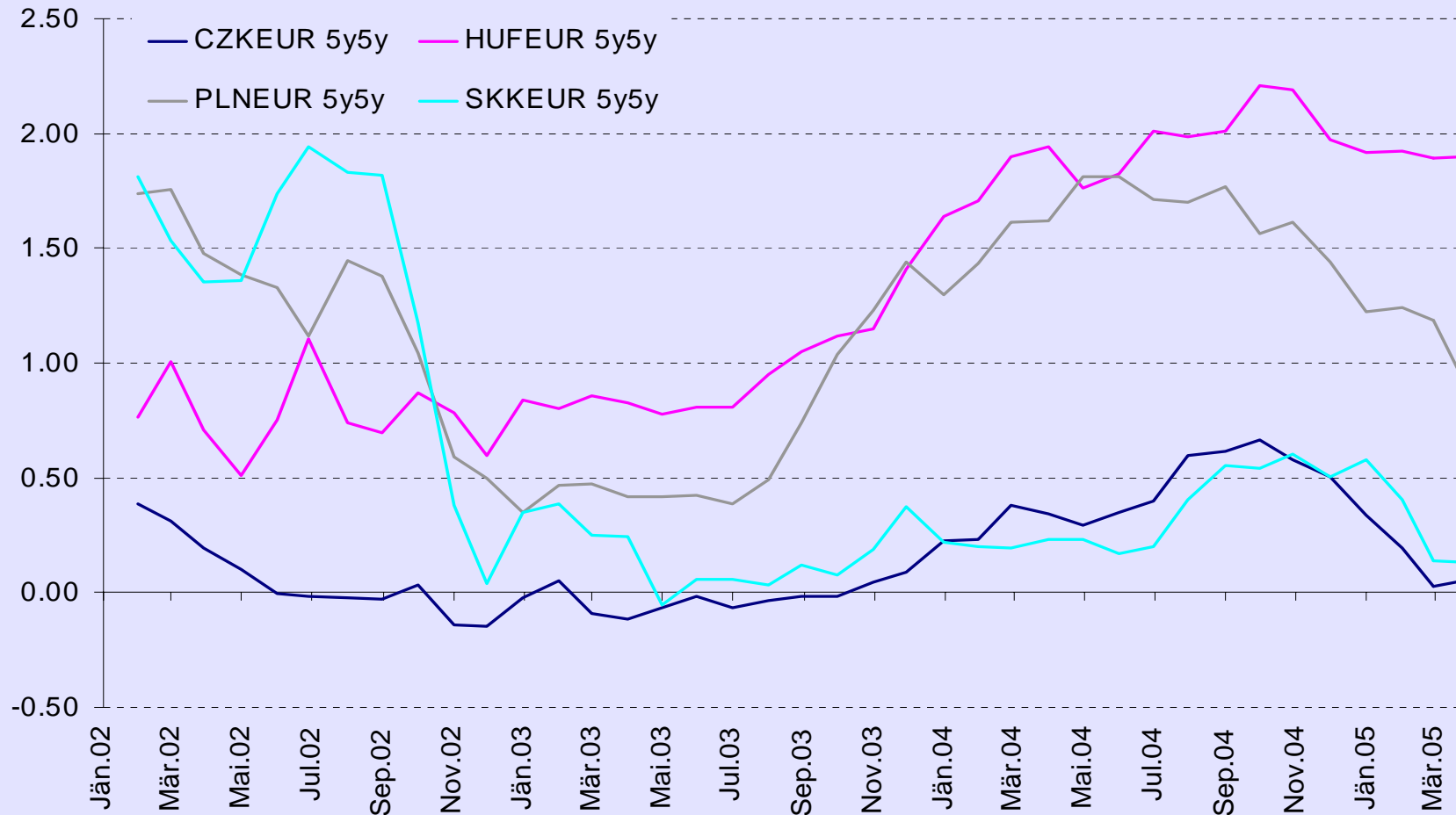
- **Stage 1: EU accession (on 1 May 2004)**
 - Accession as „Member States with a derogation“ i.e. partial participation in EMU
- **Stage 2: ERM II participation (partly already started)**
 - Right of NMS to join ERM II upon request any time (no formal pre-conditions), but subject to multilateral agreement on central rate level & bandwidth
 - Policy position of the Eurosystem
- **Stage 3: Euro adoption**
 - After fulfillment of the EC Treaty's convergence criteria

Official strategies for full monetary integration

		ERM II start date / target date	Euro target date
EE	Estonia	since 28 June 2004	2006 or 1 January 2007
LT	Lithuania	since 28 June 2004	1 January 2007
SI	Slovenia	since 28 June 2004	1 January 2007
CY	Cyprus	since 29 April 2005	as soon as possible
LV	Latvia	since 29 April 2005	1 January 2008
MT	Malta	since 29 April 2005	as soon as possible
PL	Poland	at least 2.5 years before euro target date	2008 or 2009
SK	Slovakia	(2005 or) 2006	(2008 or) January 1, 2009
CZ	Czech Republic	at least 2.5 years before euro target date	2009 or 2010
HU	Hungary	not specified	1 January 2010

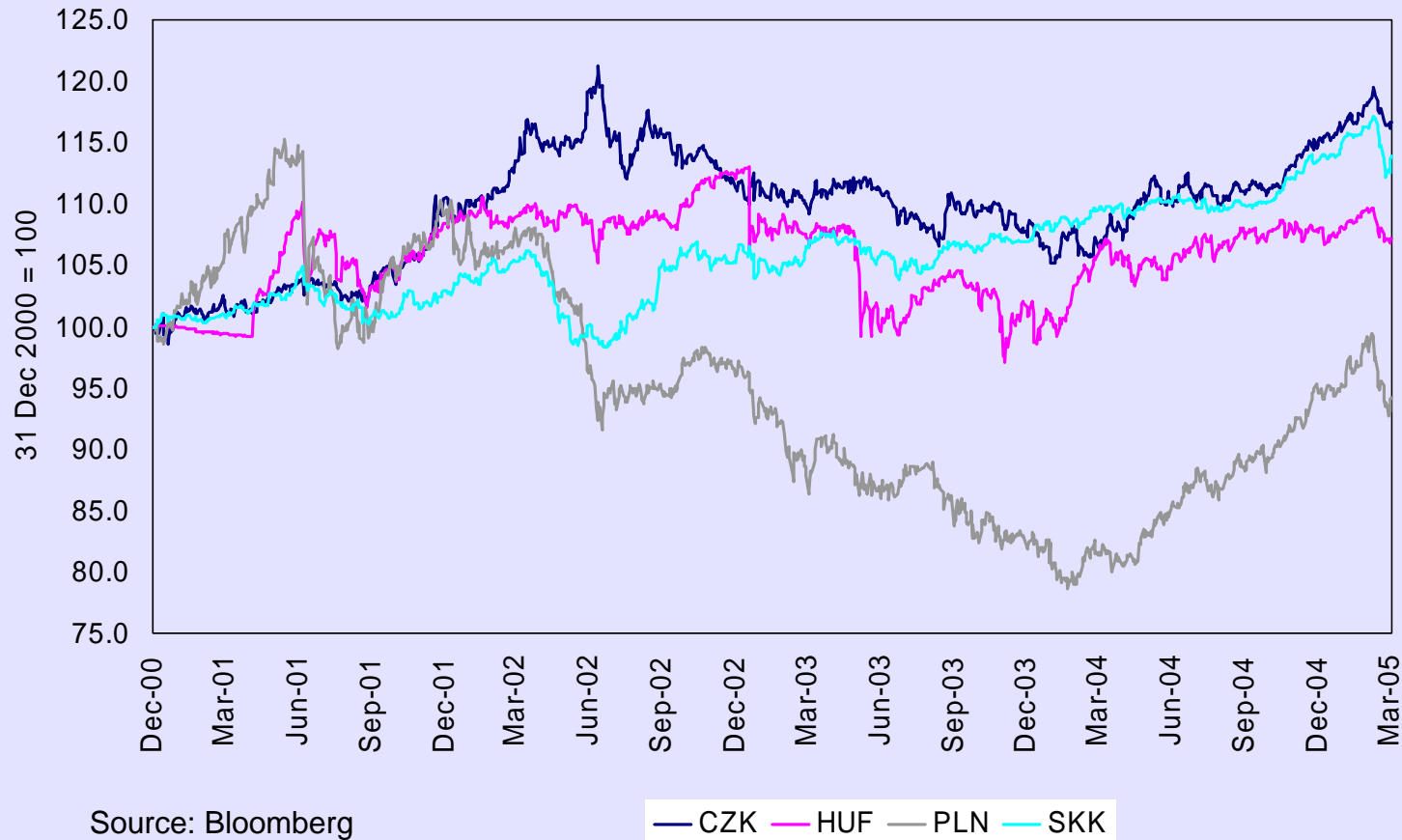
NMS-4: 5y 5y forward swap spreads against Euro

(as proxy for implied market expectation of exchange rate risk in 5y)



NMS-4: Nominal exchange rates against Euro

(Euro per National Currency Unit: increase = appreciation)



**Key features
of the financial sector
in the NMS and in the EU-12/EU-15**

Size of the banking sector and capital markets

	EU-12	NMS-8
	% of GDP	% of GDP
Banking assets (1)	283%	83%
o/w: domestic loans total	170%	50%
o/w: domestic loans to the corporate sector	50%	22%
o/w: domestic debt securities	42%	16%
o/w: domestic equity securities	13%	1%
Domestic debt securities (2) (outstanding nominal value)	119%	44%
o/w: issued by non-financial corporate sector	17%	3%
Domestic equity securities (3) (market capitalization)	58%	28%

<i>Memorandum item:</i>	<i>EU-15</i>	<i>NMS-10</i>
	<i>% of banking assets</i>	<i>% of banking assets</i>
<i>Share of bank assets held by foreign banks</i>	13%	68%

(1): total assets of the domestic banking sector at end-2004; (2): outstanding nominal value at end-2003; (3): equity market capitalization at end-2004.

Financial structure in the EU-12 and in the NMS: Relative size of financial sector segments

	EU-12	NMS-8
	% of Banking assets	% of Banking assets
Banking assets (1)	100%	100%
o/w: domestic loans total	60%	60%
o/w: domestic loans to the corporate sector	18%	26%
o/w: domestic debt securities	15%	19%
o/w: domestic equity securities	4%	1%
Domestic debt securities (2) (outstanding nominal value)	42%	53%
o/w: issued by non-financial corporate sector	6%	3%
Domestic equity securities (3) (market capitalization)	20%	33%

(1): total assets of the domestic banking sector at end-2004; (2): outstanding nominal value at end-2003; (3): equity market capitalisation at end-2004.

Performance of the banking sector

Key ratios, in percent, 2003	EU-15	NMS
ROE (after tax) (1)	9.87	11.56
ROA (after tax) (2)	0.41	0.85
Net interest income (3)	1.38	2.71
Cost-to-income (4)	60.39	64.87
Non-performing loans gross (5)	3.10	10.68
Provisions (stock) (6)	2.06	4.51
Non-performing loans net (7)	16.67	54.52

(1) and (7): in % of Tier 1 own funds; (2) and (3): in % of Total Assets;

(4): Total expenses in % of Total income; (5) and (6): in % of Total loans and advances

(7): Non-performing loans (net, i.e. after deduction of provisions) in % of Tier 1 own funds

Note: EU-15: all domestic banks on a consolidated basis. NMS: all banks under jurisdiction on a solo basis.

Reasons for the higher net interest income in the NMS

- **An OeNB study analyzed the sources of net interest income (NII)**
 - Walko/Reininger, in OeNB Financial Stability Report No 8, Dec 2004.
- → **First reason: Higher margins in NMS than in EU-12**
 - **Deposit margin spreads against EU-12 of particular importance (except in HU)**
 - **Lending and deposit margin spreads particularly high for households**

2004	CZ	HU	PL	SK	EU-12
Average lending margin	2.3	5.9	2.8	3.0	1.8
Average deposit margin	-1.2	-1.7	-3.2	-1.0	0.0
Average overall margin	3.5	7.6	6.1	4.0	1.9
Average lending margin spread against EU-12	0.5	4.1	1.0	1.1	..
Average deposit margin spread against EU-12	-1.1	-1.6	-3.2	-1.0	..
Average overall margin spread against EU-12	1.6	5.7	4.2	2.1	..

Effect of differences in the balance sheet structure on net interest income in the NMS

- **Two factors on liability side tend to additionally support NII**
 - **Second reason for higher NII in the NMS than in EU-12:**
 - **Deposits from domestic residents have higher weight**
=> magnifies the effect of negative deposit margin spreads between NMS-4 and EU-12
 - **Share of capital and reserves is higher**
=> cheaper financing of interest bearing assets
- **However: Two factors on asset side tend to lower NII (cet. par.):**
 - **Claims on general government have higher weight**
 - **Structural liquidity surplus, investment in central bank instruments**

Outlook: The experience of the EU-15

- EU-15:
Overall interest rate margins decreased over the 1990-ies
- Peripheral countries (like GR or PT) in EU-15:
Overall interest rate margins approached EU-15 average
- Lending margins:
fell significantly in the EU-15 between 1997 and 2000, continuing a longer trend
- Factors leading to decline in overall margins:
 - increased competition
 - falling interest rate level and flattening yield curve
 - charging explicit fees for some services
 - reduction in banks' operating costs
 - securitization

Challenges for the banking sectors in the NMS

- **Relatively high margins as incentive for high credit supply growth**
 - in particular contributing to the rising share of household loans in total domestic loans
- **Increasing competition will likely erode margins and margin spreads**
 - in particular in household business and for deposits
- **Importance of tapping non-interest revenues**
- **Reduction of claims against govt/cbk could set free resources to exploit available margins to a larger degree**
 - **But: this strategy implies also higher risk**
 - **Needs caution, given already higher share of NPLs in NMS than in EU-15**
- **Need to boost efficiency to compensate for lower margins**

Banking Efficiency in the NMS

Efficiency: Methodology and Data

- → Efficiency = key to success for NMS banks in the longer-term!
- → A study of the OeNB took a close look at the efficiency of the banking sectors in the NMS-8 and Romania
 - Rossi/Schwaiger/Winkler, in OeNB Financial Stability Report No 8, Dec 2004.
- Stochastic Frontier Analysis with Fourier Flexible Form
- Annual account data from Bankscope over the period 1995-2002

Countries	CZ	EE	HU	LT	LV	PL	RO	SI	SK	TOTAL
Number of banks	39	14	33	12	28	72	34	19	27	278

Banking Efficiency by Country (estimates for overall period 1995-2002)

	CZ	EE	HU	LT	LV	PL	RO	SK	SI
Cost Efficiency	0.58	0.79	0.75	0.78	0.71	0.79	0.75	0.67	0.89
Profit Efficiency	0.57	0.41	0.33	0.38	0.45	0.38	0.29	0.47	0.37

- Significant amount of inefficiency both on cost and profit side
- Efficiency levels well below EU-15 levels
- Country differences in most cases significant
- Cost efficiency levels above profit efficiency levels

Banking Efficiency by Time

	Overall period	1995	1996	1997	1998	1999	2000	2001	2002	Increase 95-02	Mean test
Cost Efficiency	0.75	0.71	0.73	0.73	0.74	0.74	0.75	0.76	0.77	6%	0.061* t=2.59
Profit Efficiency	0.41	0.38	0.40	0.42	0.41	0.40	0.40	0.41	0.42	4%	0.038** t=2.23

- Significant increase of both cost and profit efficiency over time
- Evolution not homogeneous across countries

Management Behavior – Hypotheses

- **Bad management hypothesis**
 - Inefficient banks poorly manage the quality of their loan portfolio
- **Skimping hypothesis**
 - Banks achieving higher efficiency by skimping will see their problem loans rise
- **Bad luck hypothesis**
 - Exogenous shocks increase problem loans, which reduces cost efficiency due to higher monitoring costs.
- **Moral hazard hypothesis**
 - Weakly capitalized banks engage in risk taking behavior

Management Behavior - Results

- **Loan loss provisions granger cause efficiency**
- **Evidence towards bad luck hypothesis, i.e. that external factors increase bad loans, which in turn increases inefficiency**
- **Implications:**
 - **Supervisory priority for controlling banks' exposures and for insulation against external shocks**
 - **Prudent macroeconomic policy management important for banking sector development and stability**

Concluding remarks

- **Financial structure in the NMS**
 - has important similarities to that in the euro area,
 - but private household loans and corporate debt securities are still less developed segments
- **Performance of the banking sector in the NMS**
 - higher ROE, ROA can be traced back to higher net interest income and higher margins (in particular for households)
- **High net interest income ratio**
 - has more than compensated for higher cost-to-income ratio, worse asset quality and generally lower levels of efficiency
 - however, efficiency levels tend to increase over time
- **Management behavior**
 - Evidence for the bad luck hypothesis → policy implications
- **Successful monetary integration will further align financing structures across the enlarged euro area**