The Banking System in the Accession Countries on the Eve of EU Entry

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1 Introduction

In what way will enlarging the European Union (EU) to the east influence the European banking environment? How will European banks react to the expansion of the internal market by an additional 104 million inhabitants and what strategies will they apply in Eastern Europe? How will Eastern European banks cope with the new framework conditions imposed by the Single Market? This study aims at answering these questions and at examining the changes to be expected in this context.

It is a well-known fact that stable financial markets are key to successful and sound economic development. The development of financial markets, in turn, depends on a stable economic environment. While via a series of transmission mechanisms both cyclical movements and monetary and fiscal policies influence the financial sector, financial stability is, in turn, a precondition for sustained economic growth and an efficient monetary policy. Otherwise, the transmission mechanisms would not work.

Just like individual economic policy measures, structural changes and external shocks also bear upon financial market volatility. Both monetary policy features, such as unexpected rises in minimum reserve requirements and inadequate supervisory regulations, and fiscal measures, such as the tax deductibility of provisions for bad loans or bank-specific taxes, may have an impact on the sound development of the financial sector. Financial markets are best protected against unexpected fluctuations through stable foundations, effective prudential provisions and a high degree of independence for the central bank.

In this sense, financial markets play a key role in the convergence process which is necessary for the successful integration of the Central and Eastern European countries (CEECs) applying for EU membership. As defined in the European Union's Copenhagen criteria, a functioning market economy is one of the preconditions for joining the EU. This is to guarantee that enterprises in the new Member States will be able to cope with the competitive pressure and market forces prevailing within the Union. At the same time, access to financing instruments remains a prerequisite for the restructuring and efficient functioning of the corporate sector.

In view of EU accession, therefore, the financial sector plays a key role in funding robust growth in the applicant countries. Only a sound financial sector that has undergone substantial reform will be able to help create stable framework conditions for economic growth. To quote Tobin, it is banks' central task "to supply, allocate and monitor financial funds for investment." The ultimate question will therefore be whether the Eastern European financial sector will be able to fulfill these requirements in the run-up to, and after, EU accession.

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2 Banking Reform in Eastern Europe in the 1990s Successful Despite Difficulties

It must be said right at the beginning that although banking reform has met with considerable difficulties and setbacks since 1990, the accession countries have largely succeeded in reforming their banking systems and overcoming the banking crisis. Let us briefly look back on the situation in the planned economies of Eastern Europe: at that time, the banking sector in the region was not comparable to the Western European banking system – much rather, it resembled a national accounting system where savings were gathered on the one hand while on the other, funds were allocated to enterprises without applying any performance criteria. Given the rather rudimentary separation of central and commercial bank functions alone, the mono-banking system of the centrally planned economies in Eastern Europe was a far cry from Western-style banking systems. It was thus one of the primary tasks in the early years of reform to split the mono-banking system into a two-level banking system with a central bank as the upper tier and commercial banks as the lower tier. This step resulted in a situation where the central bank faced a number of problem-stricken state-owned commercial banks. Apart from the general massive economic downturn in the CEECs, which was of a dimension that would have severely damaged the banking system in any country, the state-owned banks had to cope with a series of particularly unfavorable circumstances: They had all inherited irrecoverable assets from the communist era; management capacities for a Western-style banking system were lacking; and neither were there suitable provisions for risk management and accounting nor any bankruptcy regulations that would have facilitated proper banking operations. It is therefore not surprising that all accession countries experienced one or even several banking crises during the first years of transformation.

In overcoming these crises and restructuring their banking sectors, these countries basically had to deal with four kinds of problems:

– solving the problem of irrecoverable assets inherited from the communist era,
– recapitalizing the banking sector,
– introducing evaluation and accounting standards and adequate supervisory systems, and finally
– privatizing the banking sector.

An ex post analysis shows that the success of banking reform in the individual countries, as well as its economic cost, basically depended on the sequence in which the above problems were solved. Poland, for example, which was fastest and most cost-efficient in reorganizing its banking sector, first introduced new evaluation and accounting standards before transforming state-owned banks into corporations, which were then recapitalized. Polish banks either had to cope themselves with writing off bad loans or had to find strategic partners. Privatization was the final step in the process. Estimated at around 6% of GDP, the overall costs of banking reform in Poland are by far the lowest in Eastern Europe. Another example are the Czech and Slovak Republics, where the first step of banking reform consisted of (voucher) privatization and the removal of bad loans from banks' balance sheets. Owing to so-called soft budget constraints and continued cross-ownership links between financial and industrial corporations, the problem of bad loans was not solved but continued to exist and was even exacerbated, rendering banking reform particularly expensive in these countries. By now, the costs of banking reform in the Czech and Slovak Republics are estimated to have reached 25% to 30% of GDP.

Even though banking reform in the CEECs was a costly and often painful experience, it must be pointed out that by international standards (table 2), the costs of banking reform were by far lower here than in other emerging markets – a fact that tends to be ignored. In the CEECs, the problem of bad loans (table 1) has been solved by removing them (either completely or to a large extent) from commercial banks' balance sheets. However, the corresponding figures are still very high compared to data from Western European banking systems.

Table 1

Bad Loans as a Percentage of Total Loans

	1998	1999	2000
	%		
Czech Republic	26.4	32.1	29.5
Hungary	10.4	8.8	7.9
Poland	10.9	13.7	13.2
Slovak Republic	31.7	23.7	15.2
Slovenia	10.4	11.5	12.6

Source: Wagner and Jakova (2001).

Table 2

Costs of Bank Restructuring as a Percentage of GDP

	from	to	
			%
Czech Republic	1991	2000	33[1])
Hungary	1991	2000	13
Poland	1990	2000	6
Argentina	1980	1982	55
Indonesia	1997	current year	33
Spain	1977	1985	15 to 17

Source: Szapáry (2001).
[1]) Estimation, since the banking reform was not completed yet in 2000.

The countries set to join the EU in 2004/05 have basically completed the restructuring and reform of their banking sectors, even if a number of problems remain to be solved in the near future, in particular with a view to forthcoming EU membership.

3 Characteristics of the Eastern European Banking Market on the Eve of EU Accession

After ten years of transformation it is interesting to take stock of the situation of the applicant countries' banking markets in the run-up to EU accession and to see whether their banking sectors efficiently fulfill their fundamental function, i.e. the transformation of financial funds. Eastern European markets
– are small in absolute figures,
– show a low degree of intermediation,
– report a high share of foreign-owned banks,
– generate high yields despite low productivity, enjoy good prospects for growth, but face tightening competition.

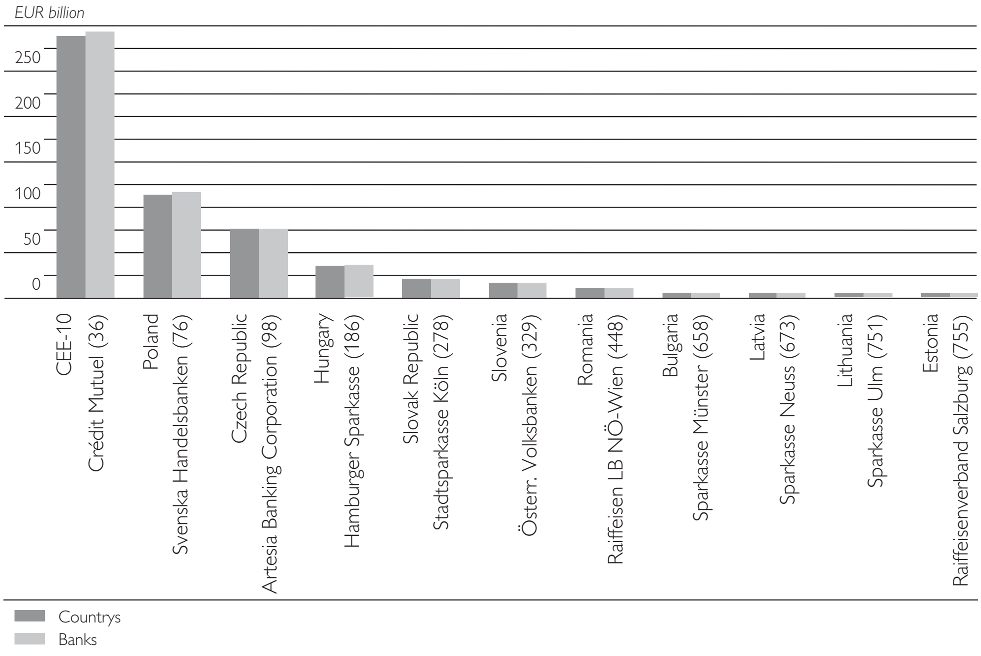
3.1 The Size of the Banking System in Eastern Europe

To understand the role of the Eastern European banking system in the Single Market, we must first of all get a clear picture of its absolute size, which is very small by Western European standards. We will see later that this is true both for absolute and relative figures (GDP, for instance). In 2001, the aggregate total assets of banks in the accession countries came to EUR 324 billion (2000: EUR 287 billion), thus reaching only 1.7% of total banking assets in the Eurosystem, which stood at EUR 18,200 billion in 2001 and at EUR 17,200 billion in 2000. The following comparison is particularly striking: The aggregate total banking assets of the accession countries in 2000 roughly equaled the size of Crédit Mutuel's balance sheet, with Crédit Mutuel not even being a particularly large bank. A look at the sizes of banks' balance sheets in the individual countries is even more revealing. While Polish aggregate banking assets just about equal those of Svenska Handelsbanken, Hungarian total banking assets can be compared to the size of Hamburger Sparkasse's balance sheet. With its aggregate banking assets corresponding to the total assets of Raiffeisenverband Salzburg, Estonia came in last. Even if estimates about the future growth of the Eastern European banking market were relatively optimistic – which would be well justified – its aggregate assets will, by 2005, only roughly match those of the Royal Bank of Scotland in 2000, which illustrates that the Eastern European banking system will hardly have an impact on the competitiveness of Western European banks. An altogether different question, however, is what action Western European banks are going to take on the Eastern European market after integration and what an implication this would have for the Eastern

Chart 1

The Banking Market in the Accession Countries

Comparison of total assets as at December 31, 2000



Source: Bank Austria AG.
Note: The figures in parenthesis indicate the position in a global ranking.

European banking system, its profitability, efficiency and degree of concentration.

This also applies to other balance sheet items such as loans and deposits. In 2001, aggregate loans in the accession countries totaled EUR 134 billion (2000: EUR 122 billion). By comparison, the liabilities of Deutsche Telekom AG alone came to EUR 60 billion at end 2000.

3.2 Financial Markets in the CEECs: Overbanked in Underbanked Markets

Not only is the Eastern European banking market relatively small in absolute terms, it also remains underdeveloped with regard to financial intermediation, i.e. its ability "to supply, allocate and monitor financial funds for investment," to quote Tobin yet again. There are a number of reasons why financial intermediation – which is normally measured by indicators like the total assets-to-GDP, loans-to-GDP or deposits-to-GDP ratios – is still so low in the CEECs. The particular circumstances that characterized the early years of transformation certainly played a role in this context. Economic crises and high inflation eroded banks' balance sheets, insufficient capital resources and bad loans triggered banking crises and substantially restricted banks' lending capacity. The environment Eastern European banks had to operate in during the first half of the 1990s was hardly promising: experience with a commercial banking system was lacking, the population had no confidence in banks, and both the economy's creditworthiness as well as income levels were low. Although the situation has improved over the past few years and indicators have slowly started to point to higher intermediation levels in most accession countries, standards are still far below EU levels. On average, the accession countries' aggregate assets come to around 75% of GDP (table 3), while the comparable figure in the euro area is 220%. For loans and deposits, the situation is quite similar.

Table 3

CEEC Banking Sector Indicators

	EUR billion	*% of GDP*
Aggregate total assets	324	75
Loans to nonbanks	122	31
Deposits of nonbanks	165	43

Source: National central banks, Bank Austria AG.

While the low level of deposits by nonbanks (as a percentage of GDP) is attributable to the low income level and, subsequently, the population's low disposition to save, there are various factors that might explain the low ratio of loans to nonbanks to GDP:

– Bad loans
  The yet unresolved problem of bad loans has inhibited loan expansion and/or increased the risk aversion of banks.
– Legal and institutional factors
  Inadequate collateral/mortgage provisions, insufficient law enforcement and/or slow enforcement of legal titles might also have played a role.
– Structural reasons on the demand side
  Additional factors are foreign direct investment (FDI) and multinational enterprises' direct financing.

In the past, foreign direct investment accounted for the majority of investment in the CEECs, leaving the respective national banking sectors largely uninvolved. Moreover, the CEECs report a high share of international (foreign) enterprises majority-financed by intercompany loans or bank loans from abroad. Furthermore, high real interest rates not only had a negative influence on credit demand, but also prompted enterprises to seek foreign currency funding directly from foreign banks, if possible. In Poland, Hungary and Slovenia, for example, enterprises' foreign-debt-to-equity ratio is almost as high as their leverage with domestic banks. Only in the Czech Republic, the corporate sector's leverage with domestic banks is clearly higher (at just above 60%) than with foreign banks.

Table 4

Corporate Debt in 2001

	Poland		Hungary		Czech Republic		Slovenia[1])	
	EUR billion	*%*	*EUR billion*	*%*	*EUR billion*	*%*	*EUR billion*	*%*
With domestic banks	48.1	55.7	15.8	53.2	16.5	60.2	4.8	52.7
With foreign banks	38.2	44.3	13.9	46.8	10.9	39.8	4.3	47.3

Source: National central banks, Bank Austria AG.
[1]) Data for the year 2000.

– Creditworthiness

The fourth factor that plays a role in keeping the level of loan intermediation low is the lack of creditworthiness (of both small and medium-sized enterprises and consumers).

Loans to households are rare in Eastern Europe (with Slovenia being one possible exception). Even in the "rich" CEECs, household borrowing only comes to between 6% and 7.5% of GDP. In Austria, by comparison, consumer loans amount to around 30% of GDP. The reasons for this development can be found on both the asset and the liability sides. Households' creditworthiness is limited owing to low income levels and any demand for loans to households is thwarted by extremely high real interest rates.

Table 5

Loans to Households as a Percentage of GDP

	2000	2001
	%	
Poland	7.0	7.5
Hungary	4.6	6.0
Czech Republic	x	6.5
Slovenia	12.2	11.8
Austria	29.0	30.0

Source: National central banks, Bank Austria AG.

The low level of intermediation on both the asset and the liability sides of banks' balance sheets is directly reflected in their product utilization statistics.

– Product utilization

Surveys have shown that only around 70% of the population aged 15+ in Central Europe (Czech Republic, Poland, Slovak Republic) has a bank account. In Poland, the by far largest country of the region, this figure is still way below 60% while in the countries of Southeastern Europe it ranges from no more than 19% (Bulgaria) to 34% (Romania). In Austria, by contrast, practically 100% of the population over 15 years of age has a bank account.

The values for other financial products are quite similar: 50% of the population in the Slovak Republic and in Slovenia has savings books, while the comparable figure in Poland comes to a mere 10%; the number of persons holding securities is even lower. Apart from Slovenia, where a remarkable 9% of the adult population holds securities, this percentage is between 1% and 3% in all other countries of the region. 14% of the Polish population has taken out bank loans, compared to 4% in the Slovak Republic and 9% in Hungary.

To put it in a nutshell, banking intermediation is relatively low in all the countries under review, which is attributable to the economic environment (income level and creditworthiness), to persistent inefficiencies (insufficient law enforcement, lack of mortgage-backed collateral) and finally to high real interest rates. It is therefore not surprising that the Eastern European banking market is considered to be a major growth market, which is also why Western European banks have, with a view to EU enlargement, been eager to gain a foothold in this market over recent years.

3.3 Foreign Banks Dominate the Market

Globalization and liberalization of financial markets around the world has driven up foreign banks' shares in the emerging markets. In the 1990s, the emerging markets began to be dominated to an increasing extent by "regional evolvers," i.e. banks focusing their activities on a certain region. This applied e.g. to Spanish banks' commitment in South America, but also to German, Austrian and Belgian/Dutch banks in Eastern Europe and to Japanese and Australian banks in Asia. In the accession countries, the transformation process was completed within only a few years, as the banking crises of the early years of transformation had created a situation where recapitalizing the financial system would have hardly been possible without the help of strategic investors.

As a result of this process, Western European banks currently dominate the banking system in the CEECs. In nearly all the countries of the region, foreign banks meanwhile hold a market share of more than 60%; in Estonia their share

Table 6

Foreign Banks'[1]) Market Share in the CEECs

	1996	1997	1998	1999	2000
	%				
Estonia	2.6	2.3	90.2	89.8	97.4
Latvia	×	×	×	×	69.8
Poland	16.0	18.6	27.9	65.5	65.7
Slovak Republic	13.6	26.0	25.9	31.1	65.4
Czech Republic	11.0	18.2	21.3	49.0	63.0
Hungary	58.0	55.4	59.4	53.9	61.9
Lithuania	×	×	×	×	59.9
Slovenia[2])	5.3	17.4	16.9	16.3	15.7

Source: Bank Austria AG.
[1]) Banks of which foreign banks own at least 50%.
[2]) As of 1997 including SKB Banka d.d.

Table 7

2000 Ranking of Top 25 Banks in the CEEC-5

	Bank	Country	Total assets	Foreign share[1])
			EUR million	%
1	PKO Bank Polski SA	Poland	18,064	×
2	PekaO	Poland	17,803	59.8
3	Československá Obchodní banka	Czech Republic	15,555	89.8
4	Komerční banka	Czech Republic	13,601	71.6[2])
5	Česká Spořitelna	Czech Republic	12,882	62.7
6	OTP Bank Ltd.	Hungary	7,245	×
7	Powszechny Bank Kredytowy SA	Poland	5,941	65.0
8	Bank Handlowy	Poland	5,456	91.4
9	Bank Slaski	Poland	4,955	86.9
10	Bank Gospodarki Zywnoseciowej SA	Poland	4,749	×
11	Bank Przemyslowo-Handlowy SA	Poland	4,722	86.1
12	Kredyt Bank	Poland	4,544	87.5
13	Slovenská Sporiteľňa	Slovak Republic	4,317	87.2
14	BRE Bank	Poland	4,228	50.0
15	Nova Ljubljanska banka	Slovenia	4,237	×
16	BIG Bank Gdanski	Poland	4,216	57.1
17	Všeobecná úvěrová banka	Slovak Republic	3,762	×
18	Wielkopolski Bank Kreditowy SA	Poland	3,525	60.1
19	Commerzbank	Czech Republic	3,237	100.0
20	Hungarian Foreign Trade Bank Ltd.	Hungary	2,966	95.7
21	Citibank Polska	Poland	2,906	100.0
22	Central-European International Bank Ltd.	Hungary	2,576	100.0
23	Bank Zachodni	Poland	2,493	81.6
24	Kereskedelmi és Hitelbank Rt.	Hungary	2,339	98.5
25	HypoVereinsbank	Czech Republic	2,242	100.0
	Top 25, total		158,563	

Source: The Banker, Bank Austria AG.
1) x = Foreign share below 50%.
2) Société Générale took over a 60% share in January 2002.

is nearly 100%. The only exception is Slovenia, where foreign banks still account for no more than 16%.

While at the beginning of transformation, foreign banks tended to establish subsidiaries in the transition economies, in the course of privatization foreign investors increasingly took over the large retail banks in the CEECs. As a result, today 20 out of the 25 largest banks in the applicant countries are majority-owned by foreign banks, hailing mostly from Western Europe. The only non-European bank active in the region is CitiBank (U.S.A.) which, after initial greenfield investments, has now also purchased a large retail bank in Poland. The top 25 banks in the region cover a market share of 60%, with the 20 foreign-owned banks accounting for a total market share of around 46%.

It is therefore justified to say that on the eve of EU accession the banking market in Eastern Europe is dominated by Western European banks.

Table 8

Market Share of the Top 25 Banks in the CEEC-5 in 2000

	Total assets	Market share in the CEEC-5	Share in top 25
	EUR million	%	
CEEC-5	261,775	×	×
TOP 25 in the CEEC-5, total	158,563	60.6	100.0
of which top 20 foreign banks[1])[2])	*120,505*	*46.0*	*76.0*
Top 5 domestic banks[3])	*38,057*	*14.5*	*24.0*

Source: The Banker, Bank Austria AG.
1) Including Komerčni banka and Všobecná úvěrová banka.
2) Majority foreign-owned.
3) Majority domestic-owned.

3.4 Profitability and Efficiency: High Yields, Low Productivity

Banking sector profitability varies considerably across applicant countries, which is, inter alia, attributable to the fact that banking reform commenced at different points in time. Yet, the Eastern European banking system is profitable compared to other emerging markets:[1])

– Banks' balance sheets in the 1990s show high profits (relative to total assets), but also high administrative expenses; loan loss provisioning is relatively low compared with other emerging markets, but still high by EU standards.
– An evaluation of data for 2000 confirms this picture (table 9). High profits are contrasted by high administrative expenses and loan loss provisioning. Still, banks' profit for the year (after tax) is significantly higher in the accession countries than in the EU.

Table9

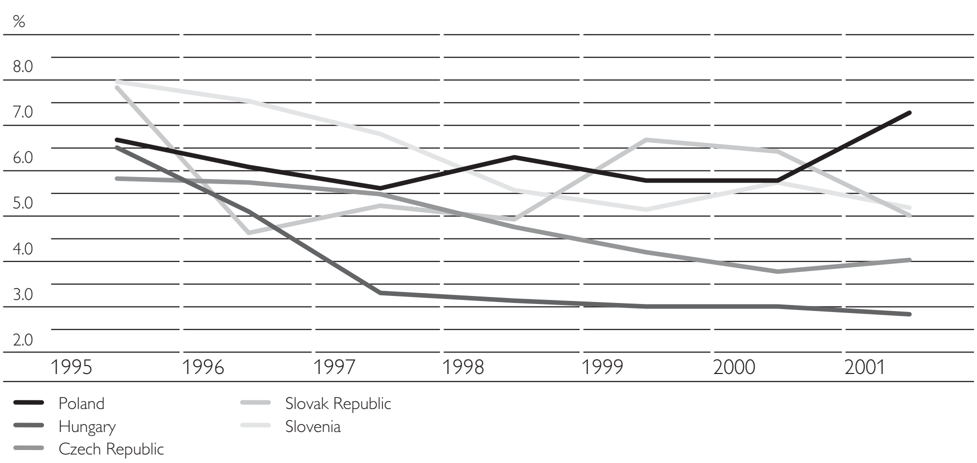
Bank Profitability in Eastern Europe in 2000

	Return on Equity	Interest income	Loan loss provisions	Income from commissions	Trading income	Administrative expense	Cost/income ratio	Other or extraordinary income[1])	Taxes	Net income	Equity
	% of net assets	*% of average total assets*						*% of average total assets*			
Poland	13.3	4.27	–1.09	1.42	1.12	4.36	63.0	0.21	0.46	1.11	8.2
Hungary	11.6	4.09	–0.58	1.00	1.04	3.85	66.1	–0.44	0.23	1.04	9.4
Slovak Republic	6.6	3.74	0.66	×	×	2.54	107.7	–1.21	0.10	0.56	7.0
Czech Republic	6.8	2.02	1.43	0.66	0.39	2.01	99.4	–2.00	0.08	0.57	9.5
Slovenia	6.7	4.19	–1.27	1.29	0.45	2.93	55.3	–0.63	0.43	0.68	9.9
Average[2])											
Top 25[3])	14.4	4.5	0.8	1.7	0.9	3.8	64	– 0.1	0.4	1.8	12.5
18 Western European banks[4])	18.6	1.6	0.2	1.2	0.4	2.2	69.5	0.4	0.3	0.7	3.9

Source: Annual reports, Bank Austria AG.
1) Financial assets, depreciation and amortization of assets, other and/or extraordinary income.
2) Unweighted.
3) CEE banks: see table 7.
4) Western European banks: KBC, Lloyds TSB, Citigroup, Société Générale, Union Bank of Switzerland, ABN-Amro, BNP-Paribas, Deutsche Bank, Nordea, Credit Suisse. UniCredito, Hongkong Shanghai Banking Corp., Banco Bilbao Viscaya Argentaria, Dresdner Bank, Bank Austria, Intesa, Commerzbank, HypoVereinsbank.

Chart 2

Interest Rate Spreads in the Accession Countries



Source: IMF, International Financial Statistics.

1 *See BIS (2001).*

– A comparison of the balance sheets of the 25 largest banks in Eastern Europe and of 18 large Western European banks produces a similar picture: Eastern banks' profits, expenses and net income are significantly higher than those of comparable Western banks. Eastern European banks' lower return on equity (ROE) is chiefly attributable to the fact that their balance sheet equity is many times higher than that of Western banks, i.e. Eastern European banks are less leveraged.
– Other frequently used indicators for banking system efficiency are interest rate spreads. Since 1995, these spreads have narrowed in the applicant countries, owing both to a reduction of risks (and of inflation) and to tighter competition.
  Spreads are narrowest in Hungary, where the banking system was already privatized in 1996/97 and where the majority of banks are foreign-owned.
– Banking sector productivity (as measured by assets per employee) is relatively low in the CEEC-5, with Poland reporting the lowest result at EUR 0.65 million (table 10). On average, banking sector productivity in the CEEC-5 comes to EUR 0.93 million (compared to an EU-wide[1]) average of EUR 8 million).

Table 10

Banking Ratios in the CEEC-5 in 2000[1])

Total assets per employee

	Total assets	Staff	Commercial banks	Average total assets	Staff	Total assets per employee
	EUR billion	*1,000*	*Number*	*EUR billion*	*Average number*	*EUR million*
Poland	111.8	171.2	73	1.532	2.346	0.653
Hungary	31.9	26.7	42	760	637	1.194
Czech Republic	76.9	42.4	40	1.923	1.060	1.814
Slovak Republic	19.3	22.3	23	838	971	0.863
Slovenia	14.8	10.5	25	594	420	1.413
CEEC-5, total	254.8	273.2	203	1.255	1.346	0.933

Source: National central banks, Bank Austria AG.
[1]) Predominantly joint stock banks.

– The strong presence of foreign banks in Eastern Europe has created fierce competition in some areas and, subsequently, put margins under pressure; this applies to corporate and wholesale banking in particular. In retail banking, competition has not been very pronounced, as illustrated by the enormous differences in interest rates on loans to enterprises and to households. The Eastern European banking system's high productivity reserves, however, indicate that net income ratios will continue to be above average also in the future.

On the eve of EU accession, the situation of the applicant countries' banking system can be described as follows:
– After overcoming the banking crises of the 1990s, banking reform has in general been successfully completed in all countries under review.
– By Western European standards, the overall market is small in absolute terms (EUR 324 billion) and the banking intermediation level continues

1 *Average assets per employee for Austria, Belgium, France, Germany, Italy, the Netherlands and Spain. OECD Bank Profitability (2000), own estimation for 2000.*

to be low (with total banking assets amounting to 75% of GDP). Having achieved significant market shares over the past few years, foreign banks now play a dominant role in the Eastern European banking system, accounting for far more than 60% of market shares.

– Despite the low productivity level, Eastern European banks' profitability is higher than in the EU or in the G-3 (U.S.A., Japan, Germany).[1])

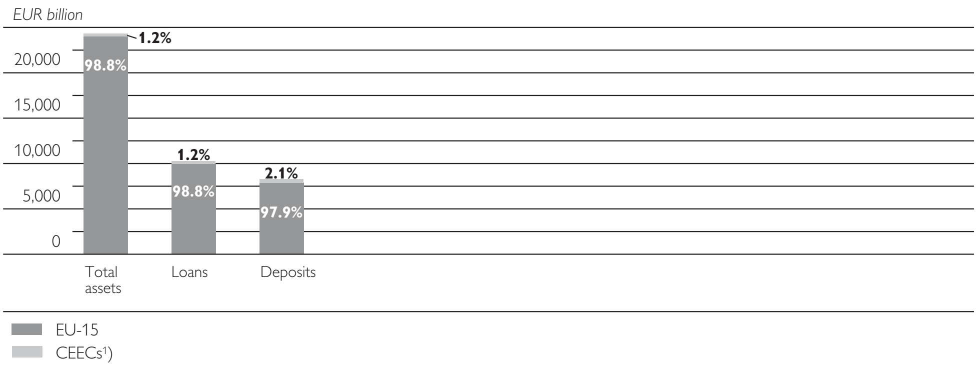
4 Eastern European Banks' Role in the EU's Single Banking Market

4.1 Eastern European Banks' Impact on the EU's Single Banking Market

Owing to its low degree of monetization, the integration of the Eastern European banking system will only have moderate effects on the EU-15's banking market. As mentioned above, the aggregate total assets of banks in the CEE accession countries correspond to the total assets of Crédit Mutuel. Accordingly, their share in total assets, loans and deposits will be equally low in the single banking market of an enlarged EU, coming to 1.2%, 1.2% and 2.1%, respectively. Given the small size of the Eastern European banking system, its integration into the Single Market is likely to have only little overall impact on the EU-15's banking market (e.g. through structural changes or systemic risks). Greater repercussions are only to be expected for individual submarkets or banks/bank groups.

Chart 3

Share of CEECs in the EU's Single Banking Market



Source: National central banks, Bank Austria AG.
1) Excluding the Baltic countries.

Even if Eastern European financial systems currently still have a very low intermediation level and remain inefficient in some areas, one can assume that they are stable as such and that they are, in principle, able to fulfill their intermediary function. We have already pointed out that owing to the absolute size of the accession countries' banking systems, their integration will, in the short term, have no significant effects on the EU banking system, even though the customer potential of an additional market of 104 million inhabitants (28% of the EU's population) will be quite considerable in the medium term. However, Eastern Europe and its banking market are of special importance for

1 See BIS (2001).

individual submarkets within the EU; from a regional perspective, this will certainly apply particularly to Austria.

4.2 Effects on Accession Countries' Banking Markets

While the EU's banking market will remain relatively unaffected by the enlargement process, participation in the Single Market will have a by far greater effect on the new Member States in Eastern Europe. Most likely, this effect will be comparable to the impact the introduction of the single banking market – and subsequently of the euro – had on the EU banking market at the time. In some areas, however, it is difficult to establish whether effects are to be traced to the Single Market, the euro, the advance of international globalization or new technologies. Earlier expectations[1]) that the Single Market would exercise pressure on profits, which would subsequently – through mergers and acquisitions – reduce surplus capacities at the national level and increase internationalization and geographic diversification at the international level, have been fulfilled, albeit to varying degrees.

Moreover, the particularities of the transformation process must be taken into consideration: Having triggered substantial changes in financial market structures (internationalization), the transformation process – as described above – essentially masks the supply and demand of financial products. Any discussion of the Single Market's effects on Eastern European banks must start from the macroeconomic impact of advancing transformation, which will clearly be boosted by EU accession and will result in increased stability and higher income.

– Increased stability and higher income will produce the following effects: Improved access to liquidity will secure the funding of high growth rates anticipated in the short term. This means that the additional liquidity resulting from free movement of capital, reduced sovereign and exchange rate risks (higher rating owing to EU accession, currency pegs within ERM II) and lower debtors' risks (legislative approximation, prudential provisions) will be offered at lower prices than before, i.e. there will be no supply-side factors to restrict above-average asset-side growth of balance sheets (lending business) and the level of banking intermediation will rise in these countries, in particular for loans. Assuming that adjustment will not cause a severe recession, it is realistic to expect lending growth rates to be 7 percentage points (5 percentage points for balance sheets) higher than the respective growth rate of nominal GDP in the years after EU accession.
– Below-average growth rates of government debt (Maastricht criteria) and better funding conditions for the CEECs on international capital markets, in particular, will reduce interest on government bonds denominated in national currencies, which will change the risk structure on the asset side, i.e. raise risks. In addition, supervisory regulations (Basel II) will set new parameters for assessing asset risks.

EU accession and the increasing stabilization of exchange rates will also open a wide range of possibilities for investment portfolio diversification. Above all, however, the stabilization of local currencies will contain dollarization (using

1 *ECB (1999).*

foreign currency as legal tender). The probability that EU accession will trigger capital flight by prompting investors to make investments abroad (freedom of capital) and thus withdraw funds from the national banking system is to be deemed low for the following reasons:

– For the time being, interest on investment is higher in the accession countries than in the euro area or many other countries.
– Confidence in countries' own banking systems has clearly been mounting, given that deposit insurance schemes are being implemented to comply with EU regulations.
– The share of higher-yielding investment (securities, funds, life insurance policies) will primarily be distributed via national markets.

Although the range of investment options will expand, funds are not expected to be shifted directly from savings deposits to equity portfolios; nevertheless, investments are expected to diversify relatively fast since any financial product that has been authorized in one of the Member States (in particular in the securities and funds segment) may be sold throughout the Single Market. Given the currently low level of financial wealth and a slowly increasing tendency to save – precautionary measures against unexpected events such as unemployment currently seem to be more important than accumulating financial assets for the relatively foreseeable and yet far off period of retirement – it is realistic to expect portfolio diversification to proceed only gradually.

Economic stabilization, the increasing stability of exchange rates and the opening-up of money and capital markets will also reinforce the disposition to adjust interest rate levels on the liability side. In the medium term, it is unrealistic to expect negative real interest rates to persist after EU accession.

All in all, the question is whether banks will profit from the stabilization of local currencies (in particular after a possible EU accession) primarily because the volume of managed assets will rise or because they will have new possibilities to use foreign investment channels. Shares and bonds, which caused an enormous international diversification in the euro area during and after the introduction of the euro, do not play such an important role in households' financial assets in Eastern Europe. Moreover, even if a more pronounced diversification of portfolios is advisable in terms of risk-spreading, there is the problem that yields on foreign investment may be lower than on domestic investment (e.g. in the bond market).

– Rising competition – more pressure on profits – stronger concentration?

Aside from the macroeconomic effects of rising stability and higher incomes, EU accession will also affect banking markets through changes in rules and regulations. Taking over the body of EU law will require adjustments of prudential supervision regulations and of banking operations. This chiefly concerns the freedom of establishment and the free movement of capital, which will change the competitive conditions on the CEE market (e.g. by providing easier access for niche players).

The effects of increased competition on banks' profits are difficult to estimate as they depend on banks' ability to adjust to the new conditions.

An initial adjustment process can be identified even today: as competitive pressure reduces the high margins currently prevailing, efficiency will have to rise to keep profits at a constant level. As expense ratios are still rather high at the moment, this should certainly be feasible. However, banks that are less profitable even now will be driven out of the market if they fail to cut costs in line with narrowing margins.

It is doubtful that margins will rise again once the concentration process is completed. Analyses of the EU banking system show that the elimination of nonprofitable banks and the ensuing higher degree of concentration do not explicitly affect banks' margins.[1]) The standardized products prevailing in Eastern European markets today – deposits and loans, mainly to large enterprises – are subject to fierce competition both on overbanked and highly concentrated markets, which prevents margins from rising even in more highly concentrated markets and results in strong pressure to raise efficiency.

Developments in areas requiring greater local know-how (capital financing of small and medium-sized enterprises and households, day-to-day banking operations, e.g. giro account transactions) might be somewhat more differentiated. After enlargement, the advantage of local know-how will become less relevant in the medium term, but having a foothold in Eastern European markets will nevertheless help drive up profits. Banks that are represented in these markets will find it easier to assess local customers and will have more power in setting local prices. As concentration will continue to rise in the future, this is all the more true for the banks "surviving" this process.[1])

Pressure on banks' margins also originates from the fact that any remaining (short-term) restrictions on capital movement will cease to apply and that EU accession will in general reduce both sovereign and borrowing risks (e.g. through legislative approximation). As direct funding from abroad is less risky and will no longer be restricted to – mostly multinational – wholesale customers, it may create pressure on the margins in local currencies.

These are good reasons to expect competition to intensify, thus creating pressure on margins and costs and consequently causing concentration to rise slightly. Pressure on margins, however, can only be compensated via adequate productivity increases (see section 3.4 "Profitability and Efficiency"), which will require corresponding investments in infrastructure. Stringent cost and risk management will, to a greater degree than before, also be required for (Western) banks in Eastern Europe.

Table 11

Banking Concentration in the CEECs

Share in total assets

	Top 5	Top 10
	%	
Czech Republic	64	74
Poland	51	67
Hungary	53	72
Slovak Republic	62	80
Slovenia	63	82
Lithuania	90	×
Estonia	95	×

Source: Banks' balance sheets, national central banks, Bank Austria AG.

1 *Corvoisier and Gropp (2001).*

The pressure on profits and margins will thus, on average, raise concentration. At present, the five largest banks in the CEECs already hold market shares of more than 50%, with the top 10 banks dominating two-thirds to four-fifths of the market. Thus, concentration in the Eastern European markets is far higher now than it was in the EU before the inception of the Single Market. Only very few EU Member States (e.g. the Netherlands) currently report higher banking concentration.

It cannot be excluded, however, that concentration continues to rise even further, not only on account of the competition-induced pressure on profits described above. Mergers between Western European banks also have an impact on market shares in Eastern Europe. In Poland, for example, the affiliates of Bank Austria AG (BA) and Bayerische Hypo- und Vereinsbank AG (HypoVereinsbank) – Powszechny Bank Kredytowy und Bank Przemyslowo Handlowy – merged to form the third-largest bank in the country.

Banking concentration will also rise as some foreign banks withdraw from the Eastern European market. As described above, increasing competition and narrowing margins will trigger streamlining measures intended to raise productivity levels. Given the small size of banks in absolute terms, one can expect that some of the current players will withdraw from the Eastern banking market in the medium term. According to some analyses, foreign banks that fail to reach a market share of 2% to 3% will redirect their activities to other markets.

Finally, as the Eastern European market is very small in absolute figures and the average size of commercial banks (with banks' total assets in the CEEC-5 coming to EUR 1.3 billion) is far below Western standards, possible future efficiency increases based on returns to scale are likely to be limited. This is particularly true for the retail sector, which despite cost-intensive IT investments remains the market segment that probably has the highest market potential, given its rising income levels.

Most likely, however, participation in the Single Market will only slightly increase foreign banks' share in the CEE banking market. Taking the EU as a measure, it is obvious, first of all, that the Eastern European banking market exhibits a higher degree of internationalization (with foreign banks accounting for a market share of 60%) than the EU banking market ever did. Even in Austria, a small EU country with a high percentage of foreign banks, only 40% of banks are foreign-owned. Even if the market share of foreign banks will possibly increase even further in some of the applicant countries, the completion of privatization is unlikely to bring about any major changes.

Altogether, it is difficult to estimate how and, above all, in which order the freedom of establishment and the free movement of capital – which will first of all increase competition, putting pressure on margins and profits – will lead to higher concentration. Moreover, general tendencies prevailing in banking, in particular regarding new products and technologies, render this estimation even more difficult.

4.3 Impact on Austrian Banks

Given the small absolute size of the CEECs' financial market, the applicant countries' accession to the Union will only have minor direct effects on EU financial markets on the whole. There will, however, be implications for individual banks and submarkets. This is particularly true for the Austrian banking sector which, holding a disproportionately high market share in the Eastern European banking market, has a stronger commitment in this region than any other Member State.

- The total assets of Austrian banks' affiliates come to around 16% of CEEC-8 banks' balance sheets[1]) (values for 2000 are based on balance sheet figures for 2000, ownership structures mid-2001), reaching significantly higher levels in the Czech or Slovak Republics.
- Austrian banks' subsidiaries account for around one quarter of the market volume of foreign banks in Eastern Europe.
- Measured by the business volume of Austrian parent banks, this means that regional concentration is very high. In 2000, total assets of Austrian banks' subsidiaries in Eastern Europe came to EUR 46 billion, corresponding to 8% of the aggregate total assets of Austrian banks.
- At the level of individual credit institutions, commitment is exceptionally high: Eastern European subsidiaries of Erste Bank der oesterreichischen Sparkassen AG (Erste Bank) accounted for 25%, those of Raiffeisen Zentralbank Österreich AG (RZB) for 20% and those of BA for more than 11% of the individual group's total assets (values for 2000).
- Eastern European subsidiaries constitute a significant yield factor for Austrian banks (in 2000, BA and RZB generated around 40% of their profits for the year from their Eastern European subsidiaries, with the corresponding figure for Erste Bank coming to even 86%).

Considering these figures, the consequences of enlargement for the Austrian market and for Austrian banks will be twofold: on the one hand, effects will originate at the macro level while on the other, they will result from the abovementioned changes in the market situation in Eastern Europe.

- Reduced risk owing to macroeconomic effects:
  - After enlargement, Eastern Europe will transform from an emerging market to an EU market. The stability provisions the new Members will have to implement in the course of EU integration (the Stability and Growth Pact applies to all EU members) should help reduce country risks.
  - The (expected) integration in ERM II will reduce exchange rate risks, which will generally disappear with the entry into EMU.
  - Legislative approximation and improved law enforcement will reduce default risks.
  - If EU accession drives up growth rates in the CEECs in the medium term, as generally expected, banks' default risk will go down.
- Consequences of market development:
  - Austrian banks are overrepresented in the future EU growth market of Eastern Europe. Provided our estimation is correct, the growth rate of banks' total assets in the accession countries will be 5 percentage points higher than the nominal GDP growth rate in these countries. Annual growth rates would thus come to between 12% and 15%, influencing banking groups' total assets accordingly.

1 *CEEC-8: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia.*

- If EU accession changes the banking environment in Eastern Europe causing foreign banks to remain in the market only if they reach a certain market share (2% to 3%), then the current market presence of Austrian credit institutions suggests that they will be able to maintain or even expand their market shares.
- In the medium term, margins are expected to narrow also in Eastern Europe (see section 4.2). In the future, the size of Eastern European subsidiaries' contribution to Austrian banks' profits will depend on whether they succeed in raising productivity. As the reorganization of their Eastern European subsidiaries has not yet been fully reflected in Austrian banks' balance sheets, it stands to be expected that subsidiaries' contributions to banks' earnings will continue to be high at least in the near future.
- Altogether, EU enlargement will reduce the risks for Austrian banks in these countries and increase their growth potential. Owing to Austrian banks' strong presence in this market, these effects are not only significant for individual banks, but also have an impact on the Austrian banking sector as a whole.

Table 12

Austrian Banks (Subsidiaries) in the CEECs[1]) in 2000[2])

	EUR billion
Total assets of Austrian banks in the CEEC-5 in 2000	46
	%
which corresponds to:	
Share in total CEEC-5 market	16
Share of foreign banks in the CEEC-5	26
Austrian banks' aggregate total assets	8
	EUR million
Profits for the year 2000 of Austrian banks' subsidiaries in the CEEC-5[3])	519
	%
which corresponds to:	
Share in profits for the year of all banks in the CEEC-5	26
Share in profits for the year of all foreign banks in the CEEC-5	35
Share in Austrian banks' aggregate profits for the year	22

Source: Austrian banks' annual reports.
1) Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia.
2) Including Česká spořitelna and Slovenská sporiteľňa.
3) Only for the Czech Republic, Hungary, Poland, Slovak Republic, Slovenia.

5 Conclusion

After completing the transformation of the mono-banking system, banking reform and banking privatization, integration into the Single Market will be the next challenge for the banking system in the CEECs. Although competitive pressure and the degree of internationalization are already high today, the Single Market will squeeze the currently high profits further. As revenues decline, efficiency will have to be increased to secure profits. This will drive up concentration and maybe also raise the degree of internationalization. At the same time, however, some foreign banks will leave the market.

Altogether, the Single Market will have less of an effect on Eastern European banks than it had on the EU's banking system in 1992. The challenge of the further opening of the Eastern European market and a subsequent rise in competition will be enhanced by the expected possibilities arising from EU accession. These factors are expected to improve stabilization – particularly in the monetary field – and raise the level of prosperity, which will open up new opportunities in banking. To profit from these opportunities, however, banks will have to be highly efficient in reducing unit costs while applying local know-how.

For individual submarkets – such as e.g. Austria – and individual subsidiaries, the entry of the Eastern European accession countries into the Single Market will have a significant impact. An enormous growth potential and low risks (macrostabilization) will contrast with shrinking margins and increased competition. It will be a demanding task for banks, from the business management point of view, to adequately react to these new challenges.

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