A Banker's Take on Twenty Years of CEE Banking Sector Developments

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1 Point of Departure

The past 20 years of East-West integration were full of memorable moments including both daunting – sometimes seemingly insurmountable – challenges and resounding successes. Naturally, neither the politicians in the transition economies nor the foreign investors knew at the outset whether this project stood a chance of succeeding in the face of economic turbulence, hyperinflation and poverty as well as several banking crises shaking the region.

And yet, East-West integration proved to be a huge success story at the close of the 20th century. Many decisive and critical events shaped the transition process. As a case in point, the 1998 financial crisis in Russia cast a shadow over the reform project – a spillover to other Eastern European countries with their fledgling banking systems and capital markets would have been disastrous, not least because it would have shattered investor confidence.

On the upside, the EU summit in Copenhagen in 1993 may be considered a catalytic milestone, holding out the prospect of EU membership to countries of Central and Eastern Europe (CEE) and laying down the conditions for accession. In hindsight, one may well debate to which extent the new CEE Member States fulfilled the Copenhagen criteria at the time of accession, but that is not the point here. More importantly, the prospect of membership gave CEE governments the clout to enforce reforms, which in turn had a positive influence on attracting foreign direct investment to these countries. Absent the EU accession perspective, foreign banks would not have invested that heavily in the region in the early days.

During the first years of transition, chaos reigned and severe shocks shook CEE. Following the collapse of the centrally planned economies, GDP per capita plunged by as much as 40% to 50%, and at times hyperinflation ravaged the economies in transition.

The formerly Communist countries lacked a modern banking and financial system and were instead burdened with a huge state-run "accounting machine." The central banks provided the various economic sectors with means of payment, and specialized banks or in some countries central bank departments performed specific functions, such as taking in saving deposits or – in the case of the state-owned bank for foreign trade – managing foreign reserve assets. In 1989, all centrally planned economies featured such a monobank system, except for Poland and Hungary, which had already spun off particular activities into state-owned commercial banks.

The early years of transition were also characterized by substantial volumes of bad loans, which in most countries accounted for 25% to 35% of outstanding loans. Banking reform thus came at a high price (in the Czech Republic e.g. at the equivalent of 30% of GDP) and progressed only at a slow pace. Last but not least, capital controls were in place, which not only applied to foreign bank transactions, but also included a number of investment restrictions for nonresidents, such as the prohibition to purchase real estate or hold majority stakes in companies. Many of these restrictions were lifted only when the Europe Agreements with the applicant countries entered into force.

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This was, in a nutshell, the setting Western banks encountered when they first entered the new markets in CEE. What were their motives, how predictable were the risks they were taking on, how did the situation change over time, and how did the involved banks' business model change as well? These questions are not easy to answer, not even in retrospect.

2 Foreign Banks in CEE in the 1990s: A Time of Greenfield Investments and Acquisitions

With the outcome of the transition process and the various banking crises remaining unclear, foreign banks venturing into CEE more or less went out on a limb. In addition, the legal framework conditions awaiting them did not allow for large-scale market penetration in the first place. Banks initially followed their corporate customers into the region to provide them with basic banking services on site and then worked on gaining a foothold in the new market.

They started out by opening representative offices, later added branch offices and eventually even established banks in their own right. Western banks did not get heavily invested in the region until the massive privatization wave swept CEE, in some countries starting gradually in the mid-1990s, and peaking at the end of the 1990s and in the early 2000s.

It was also only in the mid-1990s that more and more signs pointed to a successful completion of the transition process. At least the countries in CEE had achieved economic stabilization, and while setbacks like that in the Czech Republic in 1998 could not be prevented, they did not reverse the positive trend. The situation in Southeastern Europe (SEE) was not as clear-cut, though, and certainly not in Russia and in the CIS countries after 1998; however, these countries likewise managed to stabilize their economies a few years later.

2.1 The Privatization Wave

With a view to attaining sustainable economic growth, it was imperative for the countries in CEE to swiftly set up a financial system modeled on the Western example not only to attract capital from abroad but also to provide the economy with financial services and with funds. Given the lack of both financial capital and banking know-how in the region, banks were first sold to foreign strategic investors in the mid-1990s. Only Slovenia chose – or rather, was able to afford – not to go down that road.

At the time, the bulk of banks in the CEE-10[2] were still owned by the state, and foreign banks' share ranged from 1% to 15%[3] in all but two of these countries. In 1994, Hungary had already started to sell large commercial banks to foreign investors, and in 1997, eight of the ten biggest Hungarian banks were already majority-owned by nonresidents. The only other country in CEE where foreign banks played a greater role at that time was Slovakia, where their share amounted to 33%. The "bank selloff" commenced in 1997 to 1998 and ended in 2002 to 2003 in CEE (2005 to 2006 in SEE). The swiftness of the selloff is attributable, among other things, to the fact that the (formerly) state-owned banks held rela-

[2] *The ten countries in CEE that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.*

[3] *See Bank Austria (1998).*

tively large market shares; for instance, the four largest Czech banks held a good 60% of the market.

Around the year 2000, the situation stabilized also in SEE, as it became clear that Romania and Bulgaria, and perhaps also Croatia, would soon be able to join the EU. At the same time, the privatization wave also took off in these countries, sending Western banks on a shopping spree in these markets.

2.2 Investors' Strategic Interest

The particular attractiveness of the CEE market for Western banks is traceable to a number of reasons:

- The market displayed high growth potential;
- The market was characterized by a marked underprovision of banking services: Even based on the low GDP per capita, the intermediation rate of the regional banking system was extremely low. In 2000, loans as a percentage of GDP equaled a mere 34%[4] in the CEE countries that joined the EU in 2004;
- The EU membership perspective substantially reduced investment risk, because once accession negotiations had started in 1998, the accession roadmap was likely to be adhered to;
- The large market shares held by the state-owned banks and the small size of the market in absolute terms made it possible for investors to snap up very large market shares in one go (in CEE, the top five banks of a country as a rule had a combined market share of more than 50%);
- The privatization of the large state-owned banks opened up the especially profitable retail business for investors;
- Profit expectations were excellent: The spreads to be earned especially in the retail business were high measured against the risk involved. In the CEE-5[5], the spread between the lending and the deposit rate equaled 6.5% (unweighted average) in 1995 and still amounted to 4.9% in 2000; in the SEE-3[6], the spread ranged between 13% and 21%.[7] The retail spread as measured against the deposit or loan rate versus the money market or swap rate still came to 6 percentage points in 2003 (euro area: 3 percentage points), a considerable margin notwithstanding the higher risk.

In retrospect, market developments actually met all of these expectations. Not only did the economies of these countries boom for years, but the financial market also developed at a greater-than-expected speed. As a case in point, loans and deposits roughly quadrupled in the above-mentioned countries between 2000 and 2008.

The use of banking products has likewise changed dramatically. In 2000, only 70% of the population in the CEE-5 had a bank account, which contrasts with almost 100%, e.g. in Slovakia and the Czech Republic as at year-end 2008. But even in SEE, product penetration has increased substantially since then, e.g. from 19% to 43% in Bulgaria and from 34% to 52% in Romania.

[4] *See Bruckbauer (2004).*

[5] *The Czech Republic, Hungary, Poland, Slovenia and Slovakia.*

[6] *Bulgaria, Romania and Croatia.*

[7] *See Bruckbauer (2004).*

3 Austrian Banks' Strategy

Against the backdrop of the recent financial crisis, Austrian banks are sometimes admonished for having taken on too great a risk with their CEE activities. Yet, their investments in the region basically tie in with the phases described above.

3.1 Market Entry: Greenfield Investments Followed by Privatization

Austria's banks may well be called pioneers in CEE. While individual banks already ran representative offices in several Eastern European countries before 1989, they did not offer banking services in those markets. Austrian banks already began to increase the number of representative offices in 1990, and wherever legally possible, established banks or joint ventures; these, however, catered more or less to corporate customers only. The client base thus consisted mainly of non-resident corporate customers or joint ventures, and retail banking was still in its infancy. With parent banks responsible for refinancing, retail deposits were non-existent or hardly significant, and neither retail customers nor SMEs featured in the market strategy. A few acquisitions of small and medium-sized banks (Tatra banka in Slovakia, Unicbank in Hungary, Nova Banka in Slovenia) notwithstanding, the lion's share of Austrian banks' investments in the early 1990s concerned greenfield projects.

The beginning of the privatization process changed the scene. Erste Bank, which entered the CEE market only in the mid- to end-1990s, took over savings banks in the Czech Republic and Slovakia, thus becoming one of the region's retail banking leaders. Investments in Hungary and later in SEE strengthened its presence in the region. But all the other Austrian banks participated in the privatization wave as well, not only in CEE but also in SEE, where they had yet to establish their presence. Purchasing large banks went hand in hand with a change in the investors' business philosophy, spurring a trend to a universal banking strategy by the late 1990s at the latest. Banks' focus consequently shifted from large corporate customers to retail customers, as the latter were considered to represent the growth market of the future.

3.2 Geographical Expansion

Around 2000, banks' strategy for eastward expansion started to focus on SEE, with foreign investors zeroing in on the most densely populated country after Poland: Romania. Apart from Austrian banks, banks from Italy (Banca Intesa and UniCredit), Belgium and the Netherlands (ING) and Germany (HypoVereinsbank) were bidding for SEE banking jewels.

The bidding contest boosted the prices of the banks up for privatization. While in the 1990s, the savings banks in the Czech Republic and Slovakia had changed hands for less than double their book value, in 2003, the Hungarian Postabank already went for an alleged 2.7 times its book value, still less than the 5.8-fold book value purportedly paid for the Romanian Banca Comercială Română.

In the mid-2000s, Austrian banks broadened their geographical focus further, seeking to expand into the CIS countries. The booming commodity and skyrocketing oil prices raised not only the attractiveness of the Russian market once again (after Austrian banks had suffered sizeable losses there in 1998), but also the investment profile of Ukraine, Kazakhstan and other countries in the area. Highpriced acquisitions followed (e.g. in Ukraine, Ukrsotsbank went for an alleged 5.2 times and JSCB for an alleged 4.7 times their book values).

3.3 Drivers of Austrian Banks' Investments

In their investment activities, Austrian banks were also driven by forecasts of market growth and return expectations (see above). Yet, a number of additional factors came into play.

The fact that Austria shares a border with four countries in CEE (1) fostered a very early and broadly-based (including small banks) market entry, (2) helped set up the client base during the early years, as many Austrian companies invested in the region, and (3) went hand in hand with intercultural understanding.

Small market volumes and high concentration were another incentive. In 2000, banking assets in the CEE-10 and Croatia totaled EUR 287 billion, which equaled 1.7% of euro area banks' total assets or about 50% of Austrian banks' total assets. At some EUR 120 billion, even Poland's banking market only equaled Svenska Handelsbanken's total assets, and Romania's banking assets matched those of Raiffeisen Landesbank NÖ-Wien.

At the end of the 1990s, Austria's major banks had a presence in all CEE countries, but their market shares were small in general. The privatization drive then opened up the possibility of purchasing the branch network of the large state-owned banks and thus entering the profitable retail business. Because the dominant state-run banks in CEE were rather small in absolute terms compared with banks in the EU, Austrian banks, which are also small by international standards, were able to acquire relatively large market shares at a reasonable expense. As a consequence, Austrian banks focused their international business on Eastern Europe, even if this choice meant not being present in other (emerging) markets. Bank Austria, for instance, sold its very profitable participations in South America. All in all, compared with other countries, the Austrian banking sector was the most active player in the CEE privatization process.

As from the turn of the millennium, Austrian banks thus pursued a two-pronged expansion strategy in CEE. In pursuit of market leadership, buying was the first option, and if bids were unsuccessful, banks at least expanded their branch networks to gain market share and become a market leader. All the Austrian banks active in CEE consequently invested in the retail business, a high-growth segment.

Another factor behind Austrian banks' predominance in CEE was that EU accession also changed the banking landscape in Austria considerably. Over just a few years, namely from 1990 to 1996, the three large Austrian banks Creditanstalt, Länderbank and Zentralsparkasse were merged into Bank Austria Creditanstalt; the latter then merged with the German HypoVereinsbank in 2000 following a year-long privatization debate in Austria. In the wake of this merger, the CEE business of HypoVereinsbank was taken over by Bank Austria in 2001, which significantly drove up the bank's exposure in the region.

That is not all, though: Following UniCredit's takeover of HypoVereinsbank, Bank Austria was in charge of large parts of the group's CEE business, while e.g. the Polish subsidiary became a direct participation of UniCredit. These developments impacted the bank's acquisitions and disinvestments of the past years. In assessing investment risk, it was no longer Bank Austria's total assets alone but the activities of the entire group that had to be factored into the equation.

Last but not least, the relatively high business volumes and profits of CEE subsidiaries, which are high compared with those in the Austrian market, are also endogenous. As long as the CEE financial sector, 77% (CEE-10 and Croatia) of which are serviced by foreign subsidiaries, continues to grow at a much faster pace than its euro area counterpart, CEE-based subsidiaries automatically carry more weight in group balance sheets.

Total banking assets in the CEE-10 and Croatia grew from close to EUR 200 billion in 1995 to EUR 800 billion in 2007, i.e. by no less than 300%. The respective growth rate of 130% posted by Austrian banks over the same period pales in comparison. In other words, even if their market shares in CEE had remained unchanged, the CEE business share in Austrian banks' consolidated balance sheet would have increased substantially.

4 Austrian Banks' Position in CEE after Twenty Years

In a nutshell, Austrian banks did not plan to amass such high exposures to CEE from the very outset. Things changed, however, as massive privatization got underway in CEE. It is no secret that in their pursuit of market leadership in the region, Austrian banks were also driven by rivalries at home.

Twenty years later, Austrian banks have come to play an outstanding role in CEE, with a market share in the region equaling a good 20% (excluding Russia). Austrian investment increased most sharply over the past few years. In 2004, Austrian banks' total assets in CEE came to almost EUR 100 billion (somewhat more if Russia is included). Until end-2007, that figure had swelled to about EUR 180 billion (or over EUR 200 billion including Russia), primarily on the back of the substantial growth of the region's financial sector in recent years. In the CEE-10 and Croatia, the banking sector grew by an average 22% per annum after 2004 (1995 to 2004: 9%), in Russia even by 45%, and Austrian banks' subsidiaries flourished accordingly.

Even though the CEE banking sector is still smaller than the Austrian market, the recent explosive growth impacted the ratio between Austrian banks' CEE and domestic business; it increased from 1:6.4 (2004) to 1:4.3 (2007). While they are not measures of profitability or risk, market shares may nevertheless be indicative. We find similar dimensions when we take a look at Austrian banks' exposure to CEE. International banks' combined claims on CEE amounted to EUR 1,186 billion in 2008. According to the Bank for International Settlements (BIS), Austrian banks account for EUR 200 billion of these claims. Once we also include Bank Austria and Hypo Alpe-Adria Bank, which are not classified as Austrian in the BIS figures, as they are majority foreign owned, the figure comes to an estimated EUR 300 billion, i.e. a quarter of the total volume of outstanding claims, which more or less reflects Austrian banks' market share in CEE. Local-currency funding activities of subsidiaries account for about 40% of international banks' total CEE exposure. Another almost 20% are attributable to subsidiaries' foreign-currency lending, while the remaining 40% relate to cross-border loans to banks and nonbanks. These proportions broadly apply to Austrian banks as well, only the subsidiary-related financing percentages are somewhat higher.

This is certainly a big stake for a country like Austria, whose market share in the euro area banking market is comparatively negligible at 4%. With their CEE activities, Austrian banks consciously participated in the enormous growth in the region. And obviously – though this has never been part of the public debate – bank acquisitions with prices of four to six times the book value can only be profitable if investors assume a massive growth potential. High margins and cost savings by rationalization alone would not be sufficient. This implicit growth assumption also proved to be true in the years up to 2008, when the recent financial crisis put an end to this favorable trend.

Based on twenty-twenty hindsight, people wonder whether too much risk has been concentrated on a few countries or a region. As far as the CEE concentration risk is concerned, the question is whether one may still talk about a homogeneous region now that the transition process has largely been completed. For one thing, there are no distinct and pronounced transmission mechanisms that would trigger instant contagion in all CEE countries. For another, Austrian banks' share in the total exposure to some countries in CEE has unarguably become substantial; this is particularly true vis-à-vis the Czech Republic, Hungary, Romania and Slovakia.

Returns on these investments generally developed favorably in the past years, with only the Russian crisis in 1998 inflicting sizeable losses on two Austrian banks. Between 2004 and 2007, the nominal return on equity never fell below 10% in the CEE-10 and Croatia in any one country and any one year, and even clearly topped 20% occasionally.

According to the profit and loss reports Austrian banks submitted to the OeNB, since the year 2000 the return on shares in affiliated enterprises alone, which is traceable primarily to distributed profits (excluding reinvested earnings) from CEE activities, has added up to a total of EUR 15.7 billion. The OeNB time series also shows that over the past years part of the CEE-based subsidiaries' profits was retained. Earnings from shares in affiliated enterprises gradually climbed from EUR 1 billion in 2000 to about EUR 2.2 billion in 2007; in 2008, this figure more than doubled to EUR 5.4 billion. In other words, parent banks repatriated profits they had hitherto reinvested in CEE, most likely also to make the relevant risk provisions in their group balance sheets.

Having said all this, Austrian banks' CEE activities have clearly been a success to date. The current financial crisis has doubtless presented Austrian banks with a formidable challenge. You have to hand it to the banks, though, that they did not capitalize on dubious financial innovations in international markets, but instead helped build up a banking sector and foster lasting values in CEE. Let us not forget, it is not Central and Eastern Europe that poses a threat to the financial sector, but rather it is the global financial turmoil, to which neither CEE nor Austria are immune.

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