Banking Sector Transformation in CESEE

Stephan Barisitz,
Sándor Gardó[1]

Over the past two decades, the transition economies of Central, Eastern and Southeastern Europe (CESEE)[2] have made substantial progress in transforming their banking sectors from operation under a socialist system to operation under a market economy.[3] However, banking reform throughout the region has been anything but smooth, with the 1990s featuring major upheavals and turmoil. In response, thorough restructuring and privatization of state-owned credit institutions was carried out in the second half of the 1990s and the early years of the current decade, thereby laying a solid foundation for the future development of the banking sector. Moreover, bank regulation and supervision have improved substantially. In the process, foreign players have come to dominate the banking sectors of nearly all CESEE economies, and during most of this decade, dynamic financial deepening has taken place. Despite these major achievements, challenges remain, not the least in the context of the current financial crisis that has also affected banks in CESEE and their parent institutions, which are mostly from Western Europe.

1 The Initial Conditions

The Soviet-style centrally-planned economy as well as the Hungarian and Yugoslav systems of market socialism essentially consisted of a state-owned banking system, the so-called monobank system, under which a single bank was responsible for carrying out both central and commercial banking operations. Besides the monobank, a few specialized institutions were at work in most economies. Each of these institutions first and foremost served a particular economic sector (e.g. foreign trade, agriculture, households) as set out in administrative plans (central credit and cash plans). In this setting, banks were required to monitor and facilitate real sector plan fulfillment and payment flows. The aim was also to strictly separate the circulation of "accounting money" (for plan control and investment finance) and "cash money" (for wage payments and the population's purchase of consumer goods). Soft budget constraints were omnipresent, implying that, in principle, no company could go bankrupt or turn insolvent. The collapse of this system – including its political, social and economic subsystems – provided an incisive point of departure for transition. These multiple and simultaneous shocks triggered the unraveling of state power and brought about a sustained weakening of the rule of law and public authority. The shocks also gave rise to transition recessions and caused banking crises, which were followed by important economic reform efforts. In light of credit institutions' crucial role in functioning market economies, in particular the banking sectors soon became a focal point of reforms throughout the CESEE region.

[1] *Oesterreichische Nationalbank, Foreign Research Division, stephan.barisitz@oenb.at and sandor.gardo@oenb.at.*
The authors would like to thank Peter Backé (OeNB) for valuable comments and suggestions.

[2] *This article focuses on the EU Member States that joined in 2004 and 2007 (in some instances, however, without Slovenia and the Baltic states), the two Western Balkan countries with the largest economies (Croatia, Serbia), and the three largest CIS countries (Russia, Ukraine and Kazakhstan).*

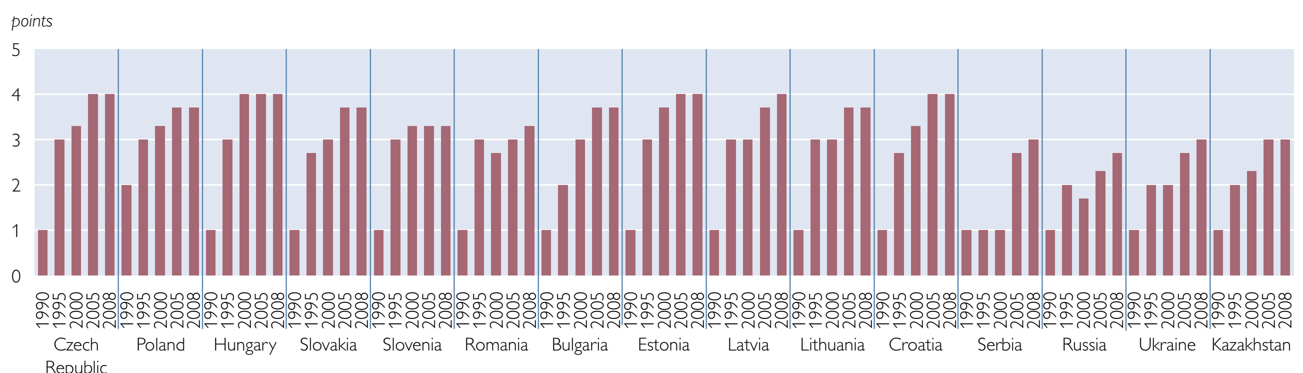
[3] *See also Bokros' contribution "Twenty (Five) Years of Banking Reform in CEE" in this issue.*

2 Salient Features of Banking Sector Transition

Banking reform in CESEE has been a long, drawn-out process with two major reform waves, essential elements of which all countries had to go through to achieve sustainable market-oriented development. In fact, despite country-specific patterns and differences in time frames, the overall path of banking reform has been fairly similar in all countries of the region (see table 1). While the first reform wave largely embodied liberalization, the second one predominantly consisted of restructuring and institution-building. The major expansion of domestic credit to the private sector, triggered in most countries by the second reform wave, was recently interrupted by the global financial and economic crisis, which seems to herald a third wave of banking reform with an increased focus on risk management, regulatory and supervisory issues (in line with global trends) and the sustainability of financial catching-up. Once this severe external shock has been overcome, banking sector development is expected to resume as the convergence process regains momentum.

Chart 1

EBRD Banking Sector Reform Index 1990–2008



Source: EBRD, OeNB.

Note: Reform progress ranges from 1 (little progress beyond establishment of a two-tier system) to 5 (standards and performance norms of advanced industrial economies).

2.1 The First Reform Wave

The first reform wave of the early 1990s essentially consisted of four stages: (1) initial liberalization, (2) some initial restructuring and tightening measures, (3) as a consequence, the emergence of an unsustainable equilibrium, and (4) renewed destabilization and crisis (see table 1).

In all countries of the region, the first wave of banking reform provided for the abolition of central credit and cash plans, price liberalization and the creation of a two-tier banking system with a clear separation of central and commercial banking activities. The first stage of reforms also included the liberalization of bank licensing and the establishment of regulation and supervision regimes, which proved to be lenient. In fact, given the legacy of a state-dominated and monopolized banking system devoid of competition for decades, most countries initially opted for wide-ranging liberalization of regulation and supervision in order to swiftly inject competition into the market. However, in an environment marked by political and economic instability, the stop-and-go character of structural reforms, continuing soft

budget constraints in the corporate sector, and a lack of market-oriented know-how and governance on the part of newly founded banks, many banks soon became severely undercapitalized and faced serious bad debt problems.

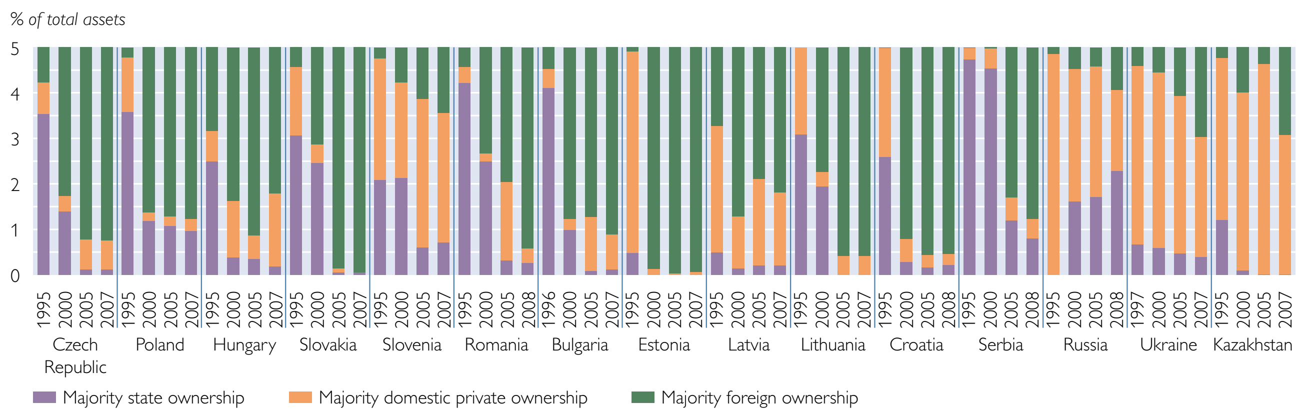
As a result, authorities carried out "up-front rehabilitation measures," typically by across-the-board replacement of bad loans in the portfolio of state-owned banks by government bonds. Such bad loans had not only been inherited from times of central planning (stock problem), but had also accumulated in the early years of transition as a result of imprudent lending to essentially bankrupt state-owned enterprises (flow problem). The nonperforming loans were transferred to a public "hospital bank" (consolidation bank) or debt recovery agency. This exercise resembled a major bookkeeping operation rather than a genuine restructuring measure, as it addressed only the symptoms (bad debts), but not the root causes of the underlying problems (e.g. bad management, inadequate banking supervision). Another popular policy of the time was "surface privatization," i.e. partial, insider or nonconventional privatization of banks and enterprises, including management and employee buyouts as well as voucher privatization. Although expediency and social justice considerations may have argued in their favor, these modes of privatization injected hardly any new capital, expertise and management. In order to combat soaring inflation and improve oversight of credit institutions, some initial tightening of monetary policy and banking regulation was carried out.

Following the deep transition recessions, economic growth reappeared toward the mid-1990s, and in most countries the macroeconomic situation stabilized, while banking sector turbulences moderated and the sector started to consolidate. However, budget constraints in most countries remained rather soft. This included lenient lending conditions and directed loans granted by (former) state-owned banks on instruction of the government to (former) state-owned firms. The sector remained largely state-owned, while new privately owned banks and greenfield startups were relatively small, if numerous. Thus, a temporary and unsustainable equilibrium emerged: The absence of the concept of bankruptcy in socialism was carried over into the market-oriented economy. At the same time, a still fairly weak institutional and regulatory framework (chart 1) favored the widespread phenomenon of connected lending and, in several countries, the mushrooming of "pocket banks," i.e. credit institutions which served as de-facto financial departments of their owner firms. In contrast, market-based lending was quite risky and often unprofitable under such circumstances. As a result, extensive insider lending, excessive portfolio concentrations and bank captivity to owners were not uncommon, with corruption, capital flight and fraudulent activities abounding in this environment. In some countries, financial pyramids came into being and enjoyed their heyday in the mid-1990s.

These underlying perverse incentives favored the reaccumulation of bad loans and were often complemented by new external shocks related, for instance, to adjustments in foreign trade, exchange rates or raw material prices. This set the stage for renewed macroeconomic destabilization, as a consequence of which a number of CESEE countries witnessed a renewed transition shock in the second half of the 1990s and suffered serious financial and economic crises. Often at around this point, deposit insurance funds were established, in some cases in a preemptive manner to calm savers' concerns, create a level playing field, and prepare the sector for another shakeout.

Chart 2

Ownership Structure of the Banking Sector 1995–2008



Source: EBRD, NCBs, OeNB.

2.2 The Second Reform Wave

After the second transition shock, at the latest, the need for deep-rooted banking sector reforms became evident, because credit institutions, burdened by a legacy of bad debt, were unable to act effectively as financial intermediaries and constituted an ever-growing drain on fiscal balances. In short, cosmetic restructuring measures were no longer enough. The following second wave of banking reform consisted of four stages: (1) the introduction of hard budget constraints for banks, (2) the extension of hard budget constraints to the corporate sector, (3) restructuring and the sale of the lion's share of the banking sector to – mostly foreign – strategic investors, and (4) ensuing substantial expansions of domestic credit to the private sector (see table 1).

As systemic banking crises were looming in many countries, CESEE authorities resolved to carry out incisive restructuring and recapitalization measures. As a result, in most countries at least one large bank went under. This sent out a clear signal that bankruptcy conditions for credit institutions were hardening, which corresponded to a necessary break with the past. However, given that hard budget constraints – while now valid for banks – were not yet fully applied to the corporate sector, banks became much more cautious in lending and reshuffled their portfolios toward government securities, central bank bills and foreign placements.

In the wake of restructuring, banking regulation and supervision were substantially tightened and accounting standards improved. Supervision has generally been moving forward from the formal verification of rules to substantive risk-based approaches, while accounting methods have been upgraded toward international standards. This contributed to formalizing hard budget constraints. The renewed turbulences had often proved to be too much for many of the fledgling deposit insurance funds, which were subsequently bailed out and overhauled by financial strengthening and by streamlining of guarantee levels to provide for viability and to adjust incentives. As property, contract and creditor rights strengthened, budget constraints were hardening throughout the region. This constituted a major change: market-oriented lending became possible and profitable.

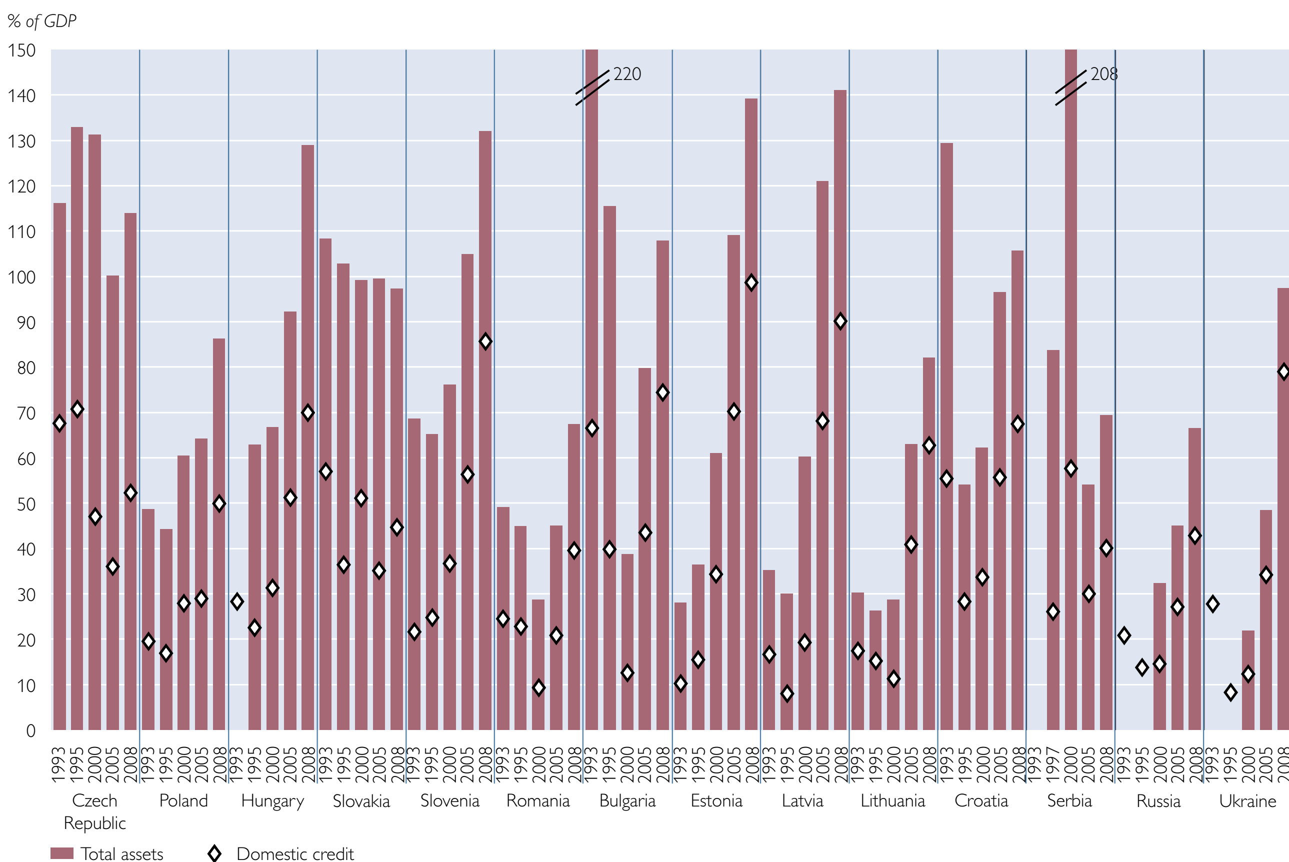
As other strategies proved less effective in bringing about genuine change, the authorities in most countries took the decision to open up their banking sectors to

renowned foreign strategic investors (chart 2), often against the background of severe budgetary constraints. This "in-depth privatization" focused on attracting missing know-how, technology and capital, as well as on raising banks' corporate governance, efficiency and competitiveness. Large numbers of foreign investors entered the market in most countries, attracted by the huge untapped catching-up and profit potential of CESEE banking markets. Around the turn of the millennium, mostly Western European investors, in particular from Austria, Germany, Italy and France, purchased many of the region's largest banks and took over the lion's share of the banking sector in CESEE. Thus, ownership linkups with the EU or within the enlarged EU were created, and Europe-wide banking networks emerged.

Subsequently, lending gathered momentum and turned into swift credit expansions or even credit booms in many transition economies (chart 3). This came not only on the back of improvements in the macrostructural environment, but was also fueled by supply- and demand-side factors. Primarily, strong economic growth, improved macroeconomic conditions with ongoing disinflation and falling interest rate levels, strengthened structural, institutional and regulatory environments, remonetization tendencies and the euro cash changeover in 2001 to 2002 played an important role in kicking off credit growth. Moreover, robust output

Chart 3

Financial Intermediation in CESEE 1993–2008



Source: NCBs, OeNB.

and income growth underpinned credit demand, while at the same time the market entry of foreign banks led to fiercer competition and an increased supply of new financial products. In particular, banks began to refocus their activities on previously untapped market segments such as households and SMEs.

After 2003, however, credit booms also started to give rise to concerns, notably due to financial risks (first and foremost credit and also foreign exchange-related risks, as substantial chunks of domestic credit were extended in foreign currency)

Table 1

Banking Reform Waves in CESEE: A Stylized Sequence of Events[1]

Analyzed countries[2]	HU	PL	CZ	SK	BG	RO	HR	RS	RU	UA	KZ
Point of departure: state-owned[3] banking system, soft budget constraints, regime change, external shocks, weak rule of law	89–90	89–90	90	90	90	90	90–91	90–92	91–92	91–92	92
Transition recession and banking crises	90–93	90–91	90–92	90–93	90–93	90–92	90–93	90–93	90–96	90–97	90–95
First wave of banking reform											
Liberalization of licensing policies, establishment of generous or lenient regulatory and supervisory systems	89–91	90–92	90–93	90–93	90–94	90–94	90–92	90–94	91–94	91–94	91–94
Up-front rehabilitation measures (e.g. swap of inherited and new nonperforming loans for government securities)	91	91	91	91	91–94	91–93	91–92	–	–	–	94–95
Surface privatization of banks (e.g. mass privatization, MEBOs[4])	–	93–96	92–94	92–97	–	–	–	–	92–94	93–94	92–94
Initial tightening of banking regulation and supervision	–	–	93–94	94–95	–	95–96	93–94	96–97	94–95	94	94–95
Temporary stabilization of macroeconomic and banking situation	–	–	95–96	96–97	94–95	94–95	94–97	95–97	96–97	–	–
Accumulation of bad loans and structural problems, sometimes complemented by new external shocks	–	–	92–97	93–98	92–96	93–96	93–97	–00	–98	–98	94–97
Establishment of deposit insurance funds	93	95	94	96	95	96	94	–	04	01	99
New transition banking crises and (or) recession	–	–	97–98	97–99	96–97	97–99	98–99	99–00[5]	98–99	98–99	–
Second wave of banking reform											
Important restructuring, resolution and recapitalization measures: in most cases at least one large bank goes under	92–93	93–96	97–00	98–00	96–97	98–00	98–00	01–02	98–99	98–01	95–97
Establishment of hard budget constraints for banks	92–93	93–94	98–99	99	96–97	99–00	99	02	99	01	97–98
Banks become much more cautious in lending	92–93	93–94	98	98–99	97–98	00	98–99	02–03	98–99	99	97–98
Substantial tightening of banking regulation and supervision, upgrading of accounting standards	92–94	94–95	96–98	98–99	96–97	98–99	98–99	01–02	99–04	00–01	96–03
Strengthening of property and creditor rights, hard budget constraints spread to real sector	95–96	96–97	99–00	00–01	98–99	01	00	03	–	–	–
In-depth privatization (e.g. takeover by strategic investor), FDI boom in banking	94–97	97–00	99–01	01–02	97–03	99–05	99–02	03–	04–	05–	07–
Introduction of credit registers or bureaux	99	–	02	04	00	99	–	–	05	–	04
Bank lending gathers momentum or turns into credit boom	99	98	04	04	01	02	01	04	01	01	00
Authorities' reaction and credit containment policies (e.g. prudential tightening, administrative restrictions)	–	–	–	–	03–09	03–	03–	05–	–	06–	05–

Source: Barisitz (2007, pp. 154–156), table updated.

[1] *Country-to-country comparison: year or period of policy measure/event. For example: 91 stands for 1991, 03 stands for 2003, –98 stands for a policy measure/event going on until 1998, but with no clear starting point, 02– stands for a policy measure/event starting in 2002 and continuing past the cutoff date.*

[2] *HU = Hungary, PL = Poland, CZ = Czech Republic, SK = Slovakia, BG = Bulgaria, RO = Romania, HR = Croatia, RS = Serbia, RU = Russia, UA = Ukraine, KZ = Kazakhstan.*

[3] *In former Yugoslavia: socially-owned banking system.*

[4] *Managment and employee buyouts.*

[5] *In former Yugoslavia: slump triggered by the Kosovo war, which contributed to pushing the banking sector to the verge of collapse.*

and macroeconomic risks (overheating pressures, external imbalances). The authorities, satisfied with the catching-up dynamics, typically reacted with some delay to the continuing booms. They resorted to credit containment policies, including prudential tightening and increases of minimum reserve requirements and/or administrative restrictions. The effectiveness of these tightening measures was not always convincing, though, given the possibilities of circumvention.

The current global financial and economic crisis has brought the fast financial deepening seen during the earlier years of the current decade to an abrupt halt. In particular, as the crisis intensified after the demise of Lehman Brothers, credit dynamics in CESEE collapsed due to both supply and demand reasons. At the same time, foreign parent banks sustained their operations in the region, thereby preventing an even deeper recession.

3 Assessment and Conclusions

To sum it up, all transition countries in Central, Eastern and Southeastern Europe have undergone a period of radical transformation since the regime change from 1989 to 1991 and have made great strides forward in reforming their banking sectors. Two waves of banking reform that all countries went through can be distinguished. The first reform wave included extensive liberalization measures and initial limited restructuring and tightening efforts, while the second reform wave ushered in hard budget constraints, in-depth privatization and a major strengthening of the banking sectors' fundamentals. The market entry of foreign strategic investors has brought about enhanced stability and efficiency, while also strengthening competition. At the same time, a major improvement of the regulatory and supervisory frameworks in line with international and EU standards has taken place. Notwithstanding undeniable progress, a number of countries have not yet fully overcome some shortcomings in the effectiveness of legislation (e.g. weak contract enforcement, difficult access to collateral).

With the benefit of hindsight, one can say that the authorities initially were not fully aware of the time needed to change institutions and allow new structures to emerge that would enable countries to proceed from the formal introduction of new rules to the actual implementation of the rule of law. Thus, the fast demise of old structures created a systemic void that persisted for some years and that various economic agents took advantage of before the new institutions could grow into and occupy that void. A lesson therefore is that early and strong reforms are crucial. They have also proved to be economically less costly than hesitant reforms. Moreover, banks' problems during transition are closely intertwined with weaknesses in the corporate sector. In fact, high (short-term) political and social costs have often hindered a swift and radical reform of the corporate sector, which in turn often delayed the recovery of banks. Therefore, the coordination of banking and enterprise reforms is imperative. However, the capacity of CESEE countries to design and implement reforms was limited during the early stages of transition. Effectively, therefore, there was often little alternative to piecemeal and gradual reforms.

An important feature of banking reforms in CESEE is that Western European FDI has come to dominate the banking sectors of nearly all countries in the region. Where this is not the case (e.g. CIS countries), domestic (private and state) owners have succeeded in maintaining strong market positions. CESEE EU Member

States, candidates or potential candidates have typically been more attractive host countries for foreign strategic investors than countries that do not have an EU accession perspective. The clear requirements and expectations with respect to the rule of law and the observance of the acquis communautaire, which the perspective of EU membership holds, have certainly helped in this regard.

Privatization strategies favoring the sale of banks to foreign strategic investors have turned out to be more successful than other strategies in bringing about genuine change in the banking sectors. While foreign takeovers are not the only feasible way for establishing viable and competitive banks in the region, the necessary accumulation of human and financial capital will probably take longer if financial development is essentially home-grown. While the current global crisis highlighted the risk of cross-border contagion, this risk has not materialized. Rather, a number of domestically owned banks that refinanced themselves on international markets came under severe funding pressures.

The current global crisis has also interrupted the dynamic financial deepening process witnessed in the earlier years of this decade, thereby heralding a third wave of banking reforms, which – in line with global trends – will center on improving risk management practices and beefing up regulation and supervision to support the sustainability of financial convergence. But even if the pace of financial convergence has halted for the time being, the reform measures taken so far in most CESEE countries have created a good starting position for future dynamic development. The relatively low financial depth levels compared with the euro area offer long-term expansion potential, in line with and alongside income convergence. At the same time, future financial deepening will (have to) be less rapid than it was in the years before the current crisis.

References

Adahl, M. and S. Barisitz. 2002. Banking in the Baltics – A Comparative Study of the Development of the Banking Sectors of Estonia, Latvia and Lithuania since Independence. In: Focus on Transition 2/02. OeNB. 84–131.

Anderson, R. and C. Kegels. 1998. Transition Banking – Financial Development of Central and Eastern Europe. Oxford: Clarendon Press.

Andreff, W. 2007. Economie de la transition – La transformation des économies planifiées en économies de marché. Rosny-sous-Bois: Bréal.

Backé, P. and T. Zumer. 2005. Developments in Credit to the Private Sector in Central and Eastern European EU Member States: Emerging from Financial Repression – A Comparative Overview. In: Focus on European Economic Integration 2/05. OeNB. 83–108.

Barisitz, S. 2007. Banking in Central and Eastern Europe 1980–2006 – From Communism to Capitalism. Abingdon/New York: Routledge.

Backé, P., W. Köhler-Töglhofer and F. Schardax. 2002. Fiscal Developments in Central and Eastern European EU Accession Countries – An Overview. In: Focus on Transition 1/03. OeNB. 84–111.

Bonin, J., I. Hasan and P. Wachtel. 2004. Banking in Transition Countries. Bank of Finland Institute for Economies in Transition. BOFIT Discussion Paper 12.

Bonin, J. and I. Szekely (eds.). 1994. The Development and Reform of Financial System in Central and Eastern Europe. Aldershot: Edward Elgar.

Bruckbauer, S., S. Gardó and L. Perrin. 2004. Banking in CEE. BA-CA Xplicit. April.

Fink, G. and P. Haiss. 1996. Finanzmarktreform in Osteuropa – Teil 1: Erbschaft und organisatorischer Aufbau. In: Österreichisches Bankarchiv No. 6. 429–440.

Fink, G., P. Haiss, L. Orlowski and D. Salvatore. 1998. Central European Banks and Stock Exchanges: Capacity Building and Institutional Development. In: European Management Journal 16(4). 431–446.

Gál, P., T. Novák and Z. Szabó. 2006. Interest Rates and Financial Deepening, Trends and Implications. In: Development & Finance. Quarterly Hungarian Economic Review No. 4/06. 32–40.

Gardó, S. 2009. Bank Governance and the Quest for Financial Stability in Central, Eastern and Southeastern European EU Member States. In: Focus on European Economic Integration. OeNB. Forthcoming.

Kornai, J. 1980. Economics of Shortage. Amsterdam. North Holland Publishing.

North, D. 1981. Structure and Change in Economic History. New York: Norton Company Inc.

Reininger, T., F. Schardax and M. Summer. 2002. Financial System Transition in Central Europe: The First Decade. SUERF Studies No. 16.

Sylla, R., R. Tilly and G. Tortella (eds.). 1999. The State, the Financial System and Economic Modernization. Cambridge: Cambridge University Press.