Twenty (Five) Years of Banking Reform in CEE

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Contrary to conventional wisdom, banking systems were far from uniform across the landscape in the former communist countries of Central and Eastern Europe (CEE). It is worth distinguishing among three different models of banking: (1) the classic Stalinist one-tier system; (2) the Polish-Hungarian reformist one; and (3) the regionalist two-tier model in former Yugoslavia.

The classic Stalinist banking system was characterized by the complete lack of risk management at all levels of decision making. Credit was directed and distributed according to the *mandatory targets of the detailed five-year plan* as defined by the central planning office in close coordination with the line ministries. The few banks that existed enjoyed monopolistic positions as their clients – enterprises, local governments and households – were assigned to them and they were acting as quasi departments of the finance ministry. Competition was unheard of, conditions, such as interest and exchange rates, were administratively determined. Hence, adjustment to changing economic conditions was impossible. Shortage of credit together with a huge monetary overhang reflected the extraordinary rigidities built into the system.

The Polish-Hungarian arrangement, which came into being after the reforms of 1968, maintained the one-tier model but credit allocation was more business-like. *Targets set by central planning ceased to be mandatory*, line ministries no longer had the right to give administrative orders to either enterprises or banks. Banks were expected to follow the broad parameters of the macroeconomic plan but had more autonomy in day-to-day decisions regarding the combination of resources other than large investments. Poland and Hungary were borrowing heavily from the West in order to invest in export-oriented ventures and support a higher living standard in what was to be similar to a more open consumer society. A private sector was allowed to thrive in agriculture, small-scale manufacturing and services.

The Yugoslav model followed the two-tier arrangement, with the central bank concentrating exclusively on financing commercial banks and the state. Commercial banks were largely owned by nonfinancial enterprises, which, in turn, were governed by workers' self-management councils and organized on a *regional basis*. The names of banks in all former Yugoslav territories still reflect the strong regionalization of financial services (Nova Ljubljanska banka, Zagrebačka banka, Novosadska banka, Vojvođanska banka, Beogradska Banka, etc.). These banks were more autonomous than their counterparts in any other socialist economy but not necessarily more effective and efficient. They suffered from a *fatal conflict of interest* as their most important clients used to be their principal owners at the same time. As a consequence, they were obliged to offer loans on preferential terms to their corporate owners no matter how creditworthy these latter might have been. Their subsequent losses were typically monetized by the central bank. No wonder that the Yugoslav model was a *highly inflationary one*.

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1 Early Reforms and Transformational Crisis

Preparations for a comprehensive banking reform started in Hungary as early as 1985 and a two-tier competitive system was launched in 1987. This model was later followed by all transition economies in CEE. Several new *state-owned commercial banks* (SOBs) were carved out of the mainframe of the former central bank. These were concentrating either on specific regions (e.g. in Poland) or various *branches of industries* (e.g. in Romania and Bulgaria). Former specialized financial institutions (foreign trade, investment and savings banks) were transformed into universal banks. Administrative rules and regulations were gradually eased, then removed. Banks, while still in state hands, started to compete for customers, created new products, entered into foreign exchange transactions and, finally, were allowed to collect retail deposits. New small private banks and joint ventures sprang to life as well.

Unfortunately, transition economies fell into a *very deep recession* as a consequence of the collapse of thousands of state-owned enterprises. It was no surprise, therefore, that *nonperforming loans* (NPLs) accumulated very quickly in the balance sheets of almost all banks. Most commercial banks became insolvent soon after their establishment and were in need of recapitalization for survival.

The emerging banking crisis was further exacerbated by the deterioration of the loan portfolio of the newly established private banks. The number of these banks rose very quickly and many of them acted like pyramid schemes due to the lack of adequate prudential regulation and effective supervision. Private banks collapsed by the dozens, mostly in the former Soviet Union but also in Southeastern Europe (notably in Albania, Bulgaria and Romania). Others concentrated on financing their owners, nonfinancial enterprises in the hands of emerging tycoons. The latter also benefited from the infamous "loans for shares" schemes, which resulted in the emergence of an *oligarchic class* still dominant in most of these countries even today.

2 Rehabilitation and Privatization of Large State Banks

Large SOBs were considered strategic assets by the fragile democratic governments and many of them were hesitating whether to privatize them or not. The first reaction to the emerging crisis was to rehabilitate the SOBs either by carving out the NPLs or by outright recapitalization (new share issue). Governments realized the *stock problem*, i.e. the inherited NPL portfolio, but failed to grasp the *flow problem*, i.e. the need to change governance in SOBs in order to prevent new NPLs from accumulating again. In many countries several banks were rehabilitated several times by using a huge amount of taxpayer money without any marked improvement in the financial situation of these banks. It is interesting that in the early stages of transition, bank privatization came to the agenda of governments only in the Baltic states, Poland and Hungary – perhaps because of past experience and tradition with private ventures and/or their broad acceptance by society wishing to get rid of all vestiges of the Soviet past.

When privatization was finally considered, it became an outright political issue. Governments wanted to keep some equity stake at least in domestic if not in state hands. But the need for further and substantive recapitalization and the importance of fixing governance in the future finally led to the privatization of large SOBs by inviting large *foreign strategic investors* in most countries. Swedish banks, like Swedbank and SEB, acquired a dominant position in the Baltic states; Austrian banks, like Raiffeisen, BA-CA (later HVB and now UniCredit), Erste Bank and Volksbank, and the Flemish KBC purchased strategic assets in Central Europe; Italian banks, like Intesa and now UniCredit, as well as some Greek and Turkish banks gained important strongholds in Southeastern Europe over time. Overall, 75% of assets across the region (in CEE but not in the former Soviet Union other than the Baltics) are now held by foreign banks – an unprecedented level of penetration worldwide.

Although foreign commercial and, lately, investment banks appeared also in the Commonwealth of Independent States (CIS), as the former Soviet Union minus the Baltic states is now commonly referred to, they never gained prominence, let alone a dominant position in financial intermediation. Ukraine is the only large country where foreign banks now play a significant role in offering financial services alongside big domestic banks, which are typically in the hands of powerful oligarchs.

3 Banking Sector Development in the First Decade of the 21st Century

Privatization of systemically important banks in CEE resulted in a fundamental change of the landscape in financial services. Banks started to offer Western-style quality services to vast segments of society and gradually brought them into the mainstream of finance for the first time ever. Corporate as well as retail customers were able to raise loans en masse for the first time in decades and put their savings into safe and sound institutions. The shortage economy was transformed into a consumer society almost overnight. No wonder that an *unprecedented credit boom* was experienced in almost all countries of CEE, which, in turn, contributed to a substantial overheating of these economies. Credit growth was too quick in many countries and it has now exacerbated the swings in the business cycle. Despite all problems, even today, it is clear that foreign banks are the most solid backbones of the CEE economies and will clearly remain so for the future as well.

Stability and growth of the financial sector were achieved not only by recapitalization and privatization but also as a result of a quite substantial improvement in *prudential regulation and supervision*. For privatization to succeed it was absolutely indispensable to design a Western-style regulatory and supervisory framework, establish a strong regulatory institution largely independent from political interference and in an arms-length relationship with powerful business interests. Incipient domestic arrangements for regulation and supervision were supported and strengthened by growing contacts with Western counterparts and the fundamental requirements of EU accession. The contrast between CEE and CIS countries is clearly huge in this regard. In the latter, regulatory and supervisory institutions are still at the mercy of strong political and business interests and fail to implement prudential rules to prevent systemic risks from contaminating the whole financial sector. (The murder of Andrei Kozlov, first deputy chairman of the Russian central bank, is a brutal case in point and just the visible tip of the iceberg.)

Banking sector development cannot be separated from the evolution of the corporate sector, and that of nonbanking financial services either. The first decade of the 21st century has brought massive changes in this regard, too. Foreign corporations, especially large multinationals, now play a dominant role in exports, manufacturing, trade and services in almost all countries. These companies tend to bank with correspondingly large multinational financial institutions and demand a comprehensive portfolio of financial services, including trade finance, hedging, cash management, insurance products, investment vehicles and retail services for their own employees. These complex services can be offered only by large international financial institutions operating in several countries at the same time. No wonder that international consolidation in banking is advancing in Europe and that it has just been speeded up further by the unfolding global financial crisis.

4 Impact of the Global Financial Crisis on Banking in CEE

One of the most important measures of financial sector development used to be the *ratio of total assets to GDP*. Transition economies were considered underdeveloped a decade ago because in all CEE countries this ratio was well below 100% and in many cases even below 50%. As many tenets of conventional wisdom in economics have now become obsolete, it is clear that banking sector development can no longer be evaluated on the basis of quantitative penetration. The *safety and stability* of the systemically important banks is the most important issue, and it is more related to the *quality*, rather than the quantity of assets in their balance sheets.

Another important lesson to be learnt from the financial crisis is that *macroeconomic policy does matter a lot*. Slovenia and Slovakia, those two transition economies which managed to join the euro area in time, are fully protected against a currency crisis; hence, balance sheets of banks operating in Slovenia and Slovakia are less exposed to risks of both corporate and personal defaults as a consequence of currency mismatch. Nevertheless, the recession in the real sector may prove to be deeper because competitive devaluation is not an option anymore. Countries with flexible exchange rates can better absorb external shocks but their banks are more vulnerable to the renewed accumulation of NPLs. Finally, economies with currency pegs (currency board arrangements) will probably suffer a much deeper recession even if the fixed exchange rate proves to be sustainable. In any case, bank balance sheets are likely to deteriorate in all transition economies; it is only the channel of macroeconomic shock which may be different. Hence, strengthening the capital base as well as the prudential regulation of systemically important banks looks like an indispensable task for governments once again.