FINANCIAL INTEGRATION OF NEW EU MEMBER STATES AND FOREIGN BANKS

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Starting from the idea that foreign banks which have invested in Central and Eastern Europe have an important role in raising the financial integration of the banking systems from the region with banking systems from Western Europe, this paper has two parts closely connected. The first part emphasises the main factors which determined Western banks to extend their activity to the Eastern part of the continent. The second part refers to the implications that foreign banks have on Central and Eastern Europe, positive aspects as well negative aspects being underlined.

Key words: foreign banks, banking systems in Central and Eastern Europe, European financial integration, European Union

1. Introduction

The reorganisation, beginning with the 90's, of the banking systems in Central and Eastern Europe[227] (CEE) and the tendency to globalise the banking activity have created the premises that foreign banks to have an important participation within the banking sector of these countries. A characteristic of the foreign banks involvement in CEE countries is represented by the prevalent presence of the foreign banks which come from the first European Union (EU) member states (before 2004 enlargement).

The causes which determined the foreign banks to adopt such a decision are multiple and vary from the desire to service their clients which have invested in the region to privatization of state-owned banks and the growing potential presented by the banking systems in these countries. Last but not least, the historical and cultural ties between CEE countries and the countries from Western Europe should be mentioned.

After closing the transition period during which the Eastern-European banking systems were, mainly, reorganised and privatized, nowadays, together with the accession process, one could notice the more and more powerful integration with the developped European banking systems. Besides some other factors which have contributed to the financial integration of the new European Union member states an important role was played by foreign banks. Excepting the capital infusion, foreign banks have realised an important transfer of know-how in many domains of banking activity. All these have had positive effects on the efficiency of the local banking systems but also have substantially contributed to the alignment of the banking systems in the host-country to the techniques and practices used in the mature banking systems in the home-country.

2. The determinants of foreign bank participation in new EU member states

In time, the specialty literature has emphasised a series of factors which influence the decision of a bank to make investments abroad. Later on, a synthesis of these factors has been made and their analisis on the specific case of Central and Eastern Europe, as destination market of foreign banks.

2.1 „Follow the clients" motivation

The traditional factor which explains what drives foreign bank participation is represented by the banks' desire to service their clients, nonfinancial firms, which have invested abroad („follow the client" motive). Once arrived on the destination market, the firms need a bank to provide services they ask. Consequently, the banks from home-countries follow their clients which invest abroad, intensifying their activity and maintaining the relationships developped in the home-country. This finding adds new meanings when the financial and banking system from the host-country is not developped. One should underline the fact that also the clients are interested to maintain the relationship began with the bank in the home-country

[227] For the purpose of this paper, Central and Eastern Europe is defined as the following EU member states: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, Bulgaria, and Romania.

because, knowing their history, it can offer credits and facilities more rapidly and more conveniently than a local bank.

After 1990, CEE countries have began an important and ample process of reorganisation and liberalisation of the economy whose effect was, amongst other, raising of the direct foreign investments made on their territory and the intensification of the commercial exchanges with Western Europe. The development of the economical integration of the Western and Eastern countries of the continent was stimulated also by the geographical proximity and by the historical ties and transformations that the Eastern countries have experienced once the accession negotiations to European Union have begun. Under these circumstances, initially, the decision of the foreign banks from Western Europe to extend towards CEE was a normal consequence of extending the activity of its own clients towards the Eastern Europe. In the first phases of transition towards the market economy, this attitude of the foreign banks was necessary also due to the fact that the CEE banking systems were not developped enough.

2.2.The legal conditions

An important factor for a bank to take the decision to extend its activity abroad is represented by the regulations in use on the destination market and the treatment applied to foreign banks. For a long time, the CEE banking systems were closed, and the foreign banks did not have the permission to operate in the region. Once the reorganisation process begun, the restrictions concerning the activity of the foreign banks on the territory of these countries were eliminated, and the process of deregulation which, initially, had taken place in developped countries, was extended towards developing countries, including ex-communist countries.

Goldberg and Saunders (1981) underlines the fact that foreign banks tend to extend their activity especially in countries in which the credit activity is expected to grow and in which important normative liberalization processes take place. Thus, in CEE countries both conditions could be fulfilled, the banking legislation was under an important process of harmonisation with regulations from European Union, and the banking credit had an enormous development potential.

Even the attitude of the national authorities towards foreign banks was different from one country to another or from one stage to another, however, presently, as previously mentioned, the foreign bank participation in these countries is very big. A relevant example regarding the treatment applied to foreign banks is represented by the model applied in Poland. In the first phase of transition towards a market economy (1990-1992), the policy regarding foreign banks entry was quite liberal. Beginning with 1993, the Polish authorities imposed some restrictions. In order to operate on the Polish territory, foreign banks were obliged to invest in already existing banks. As, during that period, many of the Polish banks were in a difficult situation, the foreign banks were not very interested in making such investments.

Cooperation in the banking sector was promoted through a series of twinning agreements between local state-owned banks and foreign banks from Western Europe. These agreements promoted the development of the institutional connections between Polish and Occidental banks, which were even able to participate with Polish banks' capital. Also, technical assistance programmes were perfected in order to disseminate in the Polish banking system the knowledge and experience of the foreign banks. However, the involvement of the foreign banks was not realised as much as it was desired. The first state-owned bank was privatized in 1993, and the process of privatization and consolidation of the Polish banking system accelerated in 1997, when the banking legislation was modified, as to correspond to European Union requirements. The accession negotiations to European Union began in November 1998. The Polish government delayed total opening of the banking sector until 1999, when, according to the agreements with European Union it had to open to foreign competition.

The differences between countries concerning the regulations of the banking activity were another cause which, for a period of time, drives foreign banks participations. The existence of these differences determined the banks from many countries to invest in those foreign markets in which the regulations and the control of the banking activities were less severe than in the home-country. This is the case, for example, of the banks from the USA, which, immediately after the World War II, had to extend their activity abroad in order to evade the restrictions imposed by the American authorities.

Presently, under the circumstances of globalisation of the financial markets, respectively the harmonisation of the banking regulations at international level, the importance of this factor for justifying the foreign bank participation is diminishing. These appreciations are valid also for the foreign banks which invested in CEE, as the accession negotiations to European Union have imposed adopting the *acquis communitaire*, the banking legislation in CEE countries being alligned to legislation in European Union. In this sense, Cull and Peria (2007) mention that a factor which can determine foreign bank participation refers to institutional and regulatory similarities between home and host-country.

2.3. Particularities and opportunities specific for the CEE markets

Focarelli and Pozzolo (2000) underlines that the most important factors which influence foreign banks to choose the destination market are the opportunities they represent, respectively the countries with higher expected rate of economic growth are preferred, and the banks from these countries are less efficient.

The same observation is emphasised by Claessens, Demirgüç-Kunt and Huizinga (1998), which underlines that a reason for which foreign banks extend their activity in developped countries is in order to follow their clients, while, in the case of the developing countries, the foreign banks, which are more profitable than local banks, extend their activity willing to exploit the competitive advantages resulted from a bigger efficiency.

The mentioned conclusions are valid also for the specific case of CEE countries as destination markets for foreign banks. The restructuring process of CEE economy has created the premises that, in this region, the rate of economic growth to be bigger than in other countries.

At the beginning of the transition towards the market economy, the CEE banking sector has suffered fundamental changes. The monobank system was eliminated and the banking system on two levels was established. A part of the new commercial banks were carved out of the old central banks from which they took the commercial functions. Also, some other private local banks were authorised to function. But the lack of experience of the new banks together with a reduced capitalisation were one of the major causes which made them be not so efficient as the banks from developped banking systems. Under these circumstances, the foreign banks could take advantage of the experience they had and obtain supplementary profit.

Later, the majority of state-owned banks were reorganised and recapitalised, so that the consolidation of the privatization process represented another opportunity for the foreign banks. This happens as in their home-countries, the foreign banks were confronted with a harsh competition and limited possibilities to raise traditional banking activities. Also, in the Central and Eastern Europe, the credit market presented a huge growth potential.

The specific factors which have transformed the CEE banking market into prioritary destinations for the banks in Western Europe include economical, historical and cultural ties which have existed in time, between the two regions. This explains, at least partially, the interest manifested towards the Central and Eastern Europe by the Austrian banks, as „descendants” of their predecessors from the Austro-Hungarian Empire, or of the Greek banks to invest in the Balkans. Similar observations regarding the importance of economical and cultural connections between the home-country and the host-country are underlined by Cull and Peria (2007), too.

3. Implications of international investments on new EU member states banking systems

The entry liberalisation of foreign banks in CEE has some **positive effects** on banking systems in the region.

The general accepted oppinion is that, by capital infusion or the know-how they brought, the foreign banks have an important role in modernising the CEE banking systems, in raising the competition and its efficiency, with beneficial implications on the quantity and quality of the services offered, and also on costs. Lastly, those who take advantage of these transformations are the local consummers of products and banking services.

By introducing some new products and services, the modern usage and occidental management methods, and some innovative techniques, such as assessing and monitorising credits or the personeel training, the foreign banks contribute to diversification and improvement the products and services within the destination banking systems and also contribute to strenghtening the banking management. All these lead to raising the integration process of the CEE banking systems with developped European banking systems.

Also, in the first phases of transition, the foreign banks, having an advanced technology, have had the opportunity to offer their clients high quality services compared with local banks. In this context, the local banks were motivated to make important investments regarding technological developement, which resulted in raising the quality of the services offered.

The foreign institutions which have bought shares in state-owned banks have facilitated capital obtaining from the international financial market, which resulted in improving their credit capacity. Also, the foreign banks which invested in CEE due to the fact that they are, generally, important banks, had the possibility to finance themselves from international markets with more reduced costs than local small banks, less known at international level. At the same time foreign banks can obtain cheaper capitals from their home-countries. Indirectly, this is reflected in offering the clients credits with lower interest, with positive effects on economical developement of the host-country.

At the same time, as the foreign banks are, generally, better capitalized than local banks, can more easily satisfy the minimum capital requirements imposed by the regulations in use, as part of the prudential supervision policy envisaged by the national supervision authorities.

Another associated advantage of the foreign banks in the region is represented by the possibility of developement financial markets from the host-country. This advantage is more obvious in the case of foreign banks which did not take over local banks and, consequently, do not have an extended territorial network, which could allow them to obtain deposits. In these conditions, in order to finance their activity, they can use the host-country interbanking market, contributing to intensifying the connections with other banks, to raising the operations volume on this market, implicitly its level of developement.

Even if it is well known the fact that one of the main reasons for which banks invest abroad is to follow their clients from the home-country which extended their activity abroad, though, the reverse can be valid. Thus, the investments of the foreign banks in CEE may attract clients from their home-countries, which feel safer to work with a known bank, which they trust.

Although the host-countries are aware of the role that foreign banks can play in modernising and developement the national banking system, in some cases, and, especially phases, foreign investments were treated with **some reserves**.

The host-country authorities manifested some reserves regarding foreign banks due to the possibility to lose national control on banking systems and raising their fragility. As foreign participation has an important weight, the massive and quick withdrawal of foreign banks from the CEE market could determine the destabilization of the local banking systems. Also, the stability of the CEE banking systems will depend on the stability of the banking systems from countries which invested in CEE, respectively the situation of their parent banks.

Many times, restricting the activity of foreign banks in CEE was motivated by the necessity to protect local banks, which are not developped enough in order to compete with important foreign banks, with international reputation.

Another concern manifested by authorities in CEE countries refers to the possibility that foreign banks could serve the most profitable market share, respectively the best local clients and the big multinational companies, leaving the local banks clients with the biggest risks. At the same time, one may add the fear that foreign banks will attract the most qualified personeel from the local banks.

Another reason of concern is represented by the fact that foreign banks which invested in Central and Eastern Europe could transfer some of the activities to the central headquarters from the home-countries.

Also, we should mention the fact that, generally, the supervision of a foreign bank is more difficult to make than the supervision of a local bank, sometimes, the supervision authorities having difficulties in assessing the risk of the parent bank.

4. Conclusions

An obvious characteristic of the international banking after 1990 was extending the operation of the foreign banks towards CEE, as at the moment the foreign participation in the banking sector of these countries is very important. The banks from Western Europe hold the biggest part from the foreign banking capital in the Central and Eastern Europe.

This orientation was determined by the changes produced in CEE and by the possibility to obtain important profits, as a consequence of the growth potential presented by the CEE banking systems. The phenomenon is due mainly to the privatization process of the state-owned banks. The foreign banks' interest for this part of Europe was also due to the fact that in their home-countries the possibilities to develop traditional banking activity were limited. Last but not least, the foreign banks have made investments in the Central and Eastern Europe countries to serve their clients which invested on these markets.

Besides the positive effects which they have on CEE countries, the foreign banks from Weastern Europe have an important role in raising the financial integration between the Eastern and the Western part of the continent.

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