HAVE THE RECENT CRISIS AFFECTED FOREIGN BANKS' POSITIONS IN CENTRAL AND EASTERN EUROPE? (I – GENERAL OVERVIEW)

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The aim of this paper is to investigate the extension to what foreign banks reacted during recent crisis in supporting their subsidiaries and thus the host economies. The analysis focuses on a brief theoretical overview and an analysis in terms of foreign claims regarding selected Central and Eastern European countries. We are also interested in finding if the entry mode (acquisition of a existing local bank, greenfield investment, non-resident office) did matter in this issue.

Key words: foreign banks, Central and Eastern Europe, economic crisis

JEL Classification: E5, G21

1. Introduction

Foreign direct investments in Central and Eastern European banks have increased considerable in constant high ratio, being considered, by many deciders, as a solution or a panacea for current and structural problems of host countries. Only in a decade, the structure of banking systems of each country of Central and Eastern Europe has dramatically changed, the ratio of foreign capital reached unusual levels, even for west European countries, where the foreign banks came from[354]. For example, at the end of 2008, excepting Slovenia, these figures were between 50-70 % for Poland and Hungary, between 75-90 % for Bulgaria and Romania or even over 90% in Czech Republic, Slovakia, Estonia[355] etc. (see Table 1).

Table 1. Foreign capital in banking sector of CEE countries (share in total assets, %)

Country	2003	2004	2005	2006	2007	2008
Bulgaria	81	80	80	80	75	84
Czech Republic	95	89	94	97	97	97
Poland	72	60	70	68	67	68
Romania	59	63	68	66	89	89

[354] For example, the share of state owned banks in many western European countries was at a high level until the middle of '90, and the foreign capital in banking system of several countries, as Germany, France, Sweden was under 15%. More of that, during of privatisation process, many significant voices asked a privatisation in favor of a national entity, see Gardner, Ed. şi Molyneux, P., *Changes in Western European Banking*, London, Unwin Hyman, 1990, *Consolidation and diversification in the euro area banking sector*, ECB's Monthly Bulletin, May 2005; Daniel Bădulescu, *Globalizarea si bancile. Cu o privire specială asupra Europei Centrale şi de Est şi asupra României* , Editura Economica, Bucuresti, 2007 and Annual reports of European central banks (2004-2009): Sophie Claeys, Christa Hainz (2006). *Foreign Banks in Eastern Europe: Mode of Entry and Effects on Bank Interest Rates*

[355] Raiffeisen Zentralbank Österreich AG CEE *Banking Sector Report* June 2009, UniCredit Research, CEE Quarterly, January 2010

Country	2003	2004	2005	2006	2007	2008
Slovakia	96	96	98	99	96	96
Slovenia	38	38	39	41	29	30
Hungary	81	59	84	81	68	68

Source: Raiffeisen Zentralbank Österreich AG CEE *Banking Sector Report* June 2009, UniCredit Research, *CEE Quarterly*, January 2010

This implication was unanimously seen to have a great achievement, mostly because it introduced stability, new management, financial and human capital, improved risk assessments etc. The foreign banks were capable to give considerable advantages in term of resources and costs: facing slim margins in their home markets, they could borrow consistent loans in host countries with significant margins but advantageous for local clients comparing with the cost of the same loan in national currency. But this trend has turned, the great liquidity flows that have financed the emerging economies and consistent growth rates are a thing of past; the Institute of International Finance, an international standard setting body formed by 375 global banks, estimates that, contrary to previous years, outflows from the region to banks will actually exceed inflows by EUR 27.2 billion. Only two years ago, at the height of western capital inflows, western banks poured EUR 217 billion more in the region than they withdrew from there[356].
The reality of past years is unfortunately dominated by global economic and financial crisis, which strongly affected the economy of this area and consequently, the banks. The purpose of this paper is to see if, in these conditions, the behaviour of foreign bank subsidiaries is to leave, to abandon the existing position in host countries, or to continuing the financial intermediation, in the emerging economies.

2. Have parent banks sustained their subsidiaries during crisis time?

The subject of foreign bank subsidiaries behaviour on host markets and the analysis of their actions under crisis impact is not new and not direct related to these recent developments in Central and Eastern European countries. In the 70s, the issue was studied by several scholars, first on Latin America markets, then on Central Europe or Asia[357]. Taking into consideration that

[356] Arons, Steven (2009). *Weathering the Storm,* in "Finance. Corporate Finance in Emerging Europe", March 2009*,* www.finance-ee.com
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economic activity, including banking, tends to be pro cyclic, especially in crisis periods[358], it is important to notice if this cyclical evolution is more obvious in banks subsidiary activities comparing with local banks, and if, overlapped on the general contraction due to crisis effects, their behaviour is more stable or not for the host countries.

On the other hand, we have to understand that the implication degree of banks subsidiaries and branches on host markets isn't a local decision, but of the parents banks'. In the case that a parent bank decides to reallocate the capital between branches on different markets and countries - on expected opportunity investment basis - , this will lead to instability on subsidiaries position. It was noticed[359] that parent banks preferred to support the subsidiaries evolution, to accept a longest period for consolidation on emergent markets and, in this way, the appeal on parent bank resources to overpass the temporary difficulties means a contribution to the stability of the system in the host country or a region.

According to Morgan's et. al. models or Holstrom and Tirole[360], the multinational banks are capital constraint institutions and risk neutral, the decision in reallocating the capital being taken on the basis of two determinants – internal financial constraint (or internal market) and shocks in real economy, specific for the country where they are implanted. In the first case the things are more clear, this reallocation is made due to an analysis of internal process (different performances between markets, products, units etc., perceived opportunities, even internal fraud or financial losses in subsidiaries or head office), the shocks on real economy are more complex. That means, from parent bank point of view, changes in opportunities generated by economic and political transformation, crisis occurred in host countries, but not directly related with the subsidiaries activity.

The parent bank's possibility to reallocate the resources in internal network is interpreted by De Hass and Lelyveld[361] as a capacity to ensure an effective support to the subsidiaries and this will lead to two effects: *the support effect* – the support of the own units even in less expected performance and, *the substitution effect* – the reallocation of the capital between own units as a reaction on the real economy shocks which modifying the profitability in the host countries.

Analysing a variate and complex database – which comprises 45 multinational banks from 18 home countries with 194 subsidiaries across 46 countries, with most parent banks (83 %) and subsidiaries (73 %) are based in Europe, 14 % of all parent banks and subsidiaries are based in North America, 5% from Latin America, the rest from Africa and Asia (this regions still have limitations on majority foreign bank ownership) – the authors argue that the support effect is very strong, the parent banks are interested to reallocate the capital in favour of those subsidiaries faster growing and generating more return to the group, facts verified for all Central and Eastern European countries, including Romania, in pre-crisis period. Regarding the substitution effect, they appreciate it as quite weak, because the subsidiary has the alternative to seek resources for lending activity in local currency and can relative compensate the scarcity of resources supplied

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[358] De Hass, Ralph (2009). *In defend of foreign banks*, http://voxeu.org/index.php?q=node/3609

[359] idem

[360] Morgan D., Rime, B, Strahan, P.E. (2004). "Bank integration and state business volatility", *Quarterly Journal of Economics* 119; Holstrom, B., Tirole, J. (1997), "Financial intermediation, loanable funds and the real sector", *Quarterly Journal of Economics* CXII

[361] de Haas, R., van Lelyveld, I., *Internal Capital Markets and Lending by Multinational Bank Subsisiaries*, MPRA Paper no. 16164, february 2009, http://mpra.ub.uni-muenchen.de/13164/

by parent bank. But this policy can expose the subsidiaries at various risks and generate a pro-cyclic effect like local home based banks. The support of parent bank is more necessary as this parent bank is a strong bank, able to obtain enough resources, stable and at low costs. The authors show that the substitution effect is more powerful in the case of non-resident offices acting on host countries market, and for green-field subsidiaries.

Likewise the way used to analyse and measure the modalities and forms of penetration of foreign banks on emerging markets, in our approach we shall pursue two aspects: first, the cross border activities of the banks, and second, the non-resident branches locally implanted in host countries, i.e. the distinction between cross border claims granted by foreign banks and local lending activities, by the subsidiaries of foreign banks.

Conceptually, we understand a foreign financial institution as a legally incorporated organisation in a foreign institution in which a significant part of the owner has a foreign origin. Consequently, the foreign banks in Central and Eastern Europe can be defined as banking organisations legally incorporated in a foreign institution or in a organization with a significant foreign part of the ownership. First part of the definition is referring to various organisation forms, from representative offices to branches (foreign entities, directly dependant from parent bank). The second part of the definitions is referring at banking institutions with foreign ownership (individual or legal persons) but, legally registered as internal (domestic) entities. The only difference between this institution and others is that an important part or all owners are from outside the host country. Most often, the foreign representative, office, branch etc. is focused on corporate lending, international trade financing or private banking-wealth management, and less on retail activities, being used by parent banks in order to support the home client's activities from original countries in host countries[362].

The presence of the foreign banks in a country can be evaluated through several indicators: some of low complexity- as the number of foreign banks (both subsidiaries and representative offices) comparing with local banks, and the share of the foreign banks assets in total banking system assets, but other indicators, more complex, based on Bank of International Settlements (BIS)[363] regarding consolidated claims of international banks, and BankScope database[364], regarding credits granted both by foreign banks subsidiaries and by local banks in host countries in Central and East Europe. In this last situation, we consider the total amount of the credit granted by banks with head office based on a reporting BIS country- cross border claims and credit granted by implanted subsidiaries, and sectoral distribution of the claims from reporting BIS countries. We can add in our analysis the evolution of the real cross border credit from subsidiaries of foreign banks (BIS reporting or non reporting banks) and the internal credit (granted by home based local banks)[365].

These measures will allow us to analyse if the loans and deposits made by the subsidiaries implanted in the host country, and both the cross-border credit, suffered or not considerable changes in this period and if they reveal the stability and support of the host economies or these

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[362] see Daniel Bădulescu, op. cit. and Konopielko, L., "Foreign Banks Entry into Central and Eastern European Markets: Motives and Activities", in *Post-Communist Economies*, vol. 11, no. 4/1999, pp. 463-485

[363] www.bis.org

[364] Database covering 24000 commercial banks (consolidated and non-consolidated balance sheets, financial situations etc.), i.e. more than 80% of the international banking activity in the world: http://www.bvdep.com/BANKSCOPE.html

[365] The appeal to these studies for the case of Romania or other Central and Eastern European countries is motivated by the fact that BIS reporting banks cover 95% of the total bank assets and the number and importance of non-BIS reporting foreign banks is insignificant, not influencing the accuracy of reports and analysis

banks abandon these countries, confirming the fears related to the opportunism of this kind of investments and their instability in difficult times.
In Table 2 we present data regarding two different moments: September 30, 2007 – before the crisis starts in Central and Eastern Europe, and two years later, September 30, 2009, the most recent period with available information in BIS statistics. We took into analysis several selected Central and Eastern European countries, covering a large variety of situations, experiences and development levels.

Table 2. Claims of BIS reporting banks on CEE countries at September 30, 2007 versus September 30, 2009 (millions USD)

Country	Total foreign claims A+ E	Total international claims A	Consolidated cross-border claims in all currencies and local claims in non local currencies, on sectors:			Claims in local currency of reporting banks' foreign offices with local residents E	Reporting period
			Banks B	Public sector C	Non-bank private sector D		
Romania	114637	81238	14578	8340	57395	33399	30.09.2007
	117835	79924	9126	13048	56996	37911	30.09.2009
Bulgaria	27309	19373	2901	2446	13632	7936	30.09.2007
	44291	32489	2300	2916	26332	11802	30.09.2009
Czech Republic	157882	40756	8808	8231	22723	117126	30.09.2007
	191384	47868	4794	11486	30741	143516	30.09.2009
Hungary	127597	87032	19234	21903	44497	40565	30.09.2007
	158096	108344	16488	23681	66806	49752	30.09.2009
Poland	218584	98849	13586	30377	53727	119735	30.09.2007
	288805	133242	12213	37227	83075	155563	30.09.2009
Slovakia	64425	22340	4623	5065	7034	8070	30.09.2007
	75827	18164	2589	5246	9921	57663	30.09.2009
Slovenia	34179	22044	10382	2237	9079	12135	30.09.2007
	41882	25487	7561	3063	13910	16395	30.09.2009

Source: own calculation based on BIS data, different years

The analysis of the data allows us to draw the following conclusions:

- All countries experience increase in total foreign claims, in different proportions, from 3% in the case of Romania to 32% in the case of Poland and even 62% for Bulgaria;
- Cross-border claims have different developments, while the flows are still high for Bulgaria (+65%) and Poland (+34%), they are much lower in the case of Czech Republic, Slovenia (+15%, respectively +16%) and even decreases for Romania and Slovakia (-2%, respectively -16%);
- On sectoral basis, there are reported similar developments, regarding both the graduate withdrawal of cross-border flows dedicated to bank units from the analysed countries

(varying from - 46% in the case of Czech Republic, -44% in the case of Slovakia and -34% in the case of Romania, but only -10% in the case of Poland) but even growth of the flows designated for the public sector and respectively for the private non-bank sector in most of the analysed countries. We notice significant differences from sector to sector and from country to country. An exception is Romania, which experiences a stagnation regarding the consolidated cross-border claims in all currencies and local claims in non local currencies dedicated to the non-bank private sector.

3. Preliminary conclusions

The evidence presented above suggests different level of involvement of foreign banks in emergent economy, they attempted to maintain previous position, even affected by crisis. In the second part of the paper we will focused on some developments in the Romanian case.

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