BANKING SECTORS IN TRANSITION

COMPARISONS, EXPERIENCES AND RESULTS

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The task of transforming the banking sector in the New Europe[2] into a stable and efficient system, able to support economic growth, has been one of the most important issues in transition to market economies. Different approaches have been followed through the years and among countries in terms of timing of privatisation, attitude towards foreign banks, restructuring and recapitalisation, as well as management of bad debt problems. Despite such differences, all banking sectors in Central and East Europe share the same convergence path towards EU standards, meaning gradual homogenisation of the legal and regulatory environment and increasing competitive parameters.

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Through the years, foreign banks have achieved a leading role in New Europe and have provided a positive contribution to enhancing stability and efficiency by bringing capital, competencies and know how, thus increasing the operating standards of the market. Leading local banks profit from cooperation with international strategic partners and a considerable level of "indirect integration" of the region into the EU banking sector has already been achieved.

In the next years, banking systems in Central and Eastern Europe will gradually become part of an enlarged and competitive financial system and this will further enhance and speed up their development process. In this environment, and in view of further integration, a comparative analysis of the different banking sectors in the region seems relevant. As practitioners, the aim is to focus particularly on the operative environment and the day-to-day functioning of the banking sector. The data in the following analysis focus on four countries: Slovakia, Poland, Bulgaria and Croatia.

Banking systems in transition

Banking systems in the region have displayed an impressive capacity for structural transformation. Bank capitalisation is healthy and above the 8% minimum BIS standard. Strong restructuring activity generated substantial improvements in terms of product offering, as well as service and credit quality.

The attitude towards privatisation of large banks and entry of foreign financial institutions greatly differed over time and among countries. Full scale large bank privatisation has characterised Hungary and Poland, since the second half of the Nineties. The largest Polish bank, Bank PKO BP is still under public control and whether to sell control to a foreign strategic investor or a domestic one is still open. In the Czech Republic partial large bank privatisation started at the very beginning of transition, but residual State control and corporate governance problems hindered restructuring and transformation. A second process of privatisation, with entry of foreign capital was implemented at the end of the Nineties. In 2000, strong advancement of privatisation characterised Slovakia, Croatia and Bulgaria, while in Slovenia privatisation steps were taken at the end of 2001.

Foreign ownership is now dominant in the region, accounting for more than 70% of local banking assets. Despite occasional reluctance at the beginning, most governments now favour entry of foreign banks in the market as the most viable way to ensure adequate capitalisation of the banking industry and inflow of competencies and know how during the transition process.

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[2] Defined as 10 Central and East European enlargement countries plus Croatia.

[3] Like the Consolidation Bank in the Czech Republic and Slovakia.

Table 1: Market size, banking sector penetration and market structure, bln EUR

	Poland	Slovakia	Bulgaria	Croatia	EU Area
Market size (2000)					
GDP bln EUR	178	20	13	21	8 397
population mln.	38.6	5.4	8	4.4	377
% pop. income >10,000 $ PPP	27.0 %	17.6 %	5.4 %	24.9 %	83.4 %
% of nat. income of above group	60.9 %	44.1 %	26.4 %	44.1 %	95.7 %
Banking sector (2000)					
Total assets (TA) bln EUR	111.4	19	4.5	14.5	23 603
TA/GDP	63 %	91 %*	38 %	70 %	280 %
Loans/GDP	46 %	38 %	27 %	49 %	170 %
Equity Mkt Cap/GDP	19 %	18 %	1 %	18 %	121 %
Market structure					
Mkt share top 3 banks	38 %	53 %	48 %	55 %	9 %
Mkt share public banks	24 %	5 %	20 %	6 %	
Mkt share foreign banks	68 %	88 %	73 %	84 %	

Source: National Central Banks. *Slovak intermediation level after restructuring interventions.

The ratio of net loans over GDP ranges from 27% in Bulgaria, 38% in Slovakia, 46% in Poland, to 49% in Croatia, compared to 170% in the EU market at the end of year 2000. In terms of distribution channels, Poland and Slovakia have 285 and 223 branches per million of inhabitants respectively, while Croatia and Bulgaria have 198 and 98 respectively.

The development of distribution channels in New Europe has been fast and effective, with prompt introduction of new instruments, like electronic and on-line activities. Compared to former EU markets, where banks are burdened by expensive and over-sized branch networks, financial institutions in New Europe could organise organic and coherent distribution networks, leveraging on both new technologies and physical presence, using multi-channel structures. Banks with leading prior experience in multi-channel distribution in their home markets, like UniCredito, have been particularly well positioned to transfer this experience to the New Europe environment.

Coupled with rationalisation of strategies and proper segmentation of operating activities, this shows positive results in terms of customer service, as well as in terms of cost efficiency.

Refocusing of portfolios has been an essential step in developing a stable and efficient financial sector. During the initial phase of the transition process a pattern of lending had emerged, lacking adequate portfolio focus. Following widespread bad debt problems and financial and banking crises, banks adopted more prudent policies, reducing, and in some cases halting, their lending activities. Competition was directed towards the best customers, while some segments of the market were completely neglected. As transition proceeds and economic conditions improve, competition in banking has increased and banks are entering new segments of the market. Refocusing of banking portfolios is thus achieved, with diversification towards retail clients as well as Small and Medium Enterprises (SMEs).

Still, banking sectors strongly differ. In Poland and Croatia retail lending represents 31% and 42% respectively of total lending activities; this ratio is 13% in Slovakia and 20% in Bulgaria.

Retail clients represent the most important source of liquidity for banks in the region. The share of retail deposits over total deposits is above 50% in all countries, being 55% in Bulgaria, 60% in slovakia, 72% in Croatia and 74% in Poland. Development of retail activities is strongly linked to income distribution and wealth of retail clients. In Poland and Croatia the percentage of population

Recapitalisation of banks and work out of bad debts followed different patterns among countries. Strategies ranged from repeated interventions to one off initiatives and from a complete reliance on a "work-out bank" to strong attention to individual banks' incentives to solve portfolio problems. Generally speaking, focus of individual banks' attention to portfolio quality has proven to be fundamental in ensuring restructuring of asset quality. Comparing banking sectors at the end of 2000, important results in asset quality improvement can be observed. The average non performing loans ratio (NPL) in the whole New Europe region decreased from 17% in 1999 to 12% end-2000.

Stability of banking systems and compliance with best international standards is enhanced by the process of EU convergence, both in terms of supervision as well as the legal and regulatory environment. Banking sector transformation requires, however, still a greater focus on the consistent application of newly created legal environments, in order to increase efficiency in the market. Also, the balance sheets of some New Europe banks still reflect a large deposit base, funding long term rehabilitation bonds and liquid assets, while lending to the real economy is still at low levels. Banks have now to transform themselves from pure deposit-taking institutions into proper intermediaries. Following a period of very prudent attitudes, justified by the need of restructuring and restoring financial stability, an expansion of the lending activity and refocusing of portfolio strategies is called for, entering new segments of the market and providing a wider set of services to clients, thus, sustaining economic development, while maintaining appropriate prudence levels.

As evidenced in Table 1 and 2, banking penetration, measured both in terms of loans and deposits over GDP as well as in terms of number of branches, current accounts, credit cards and ATMs (Automatic Teller Machines) per million of inhabitants, is increasing rapidly in all countries.

Table 2 Banking penetration, activities and credit quality

	Poland	Slovensko	Bulgaria	Croatia	EU Area
Banking penetration					
branches per 1 mln in.	285	223	89	196	580
ATMs per mln in.	146	201	75	188	620
Banking activities					
Deposits in FX	19 %	16 %	57 %	76 %	n.a.
Deposits retail	74 %	60 %	55 %	72 %	n.a.
Loans retail	31 %	13 %	20 %	42 %	n.a.
Credit quality					
NPLs	15.3 %	23.5 %	10.6 %	9.3 %	n.a.

Source: National Central Banks

with income above 10,000 USD Purchasing Power Parity - PPP is 27% and 25% respectively, compared to 18% in Slovakia and 5% and Bulgaria. The share of FX deposits in the banking system is above 50% in Bulgaria and Croatia, being 18% in Slovakia and19% in Poland .

Legal and regulatory framework

Development of banks as proper intermediaries in the economy is strongly dependent on the effectiveness of the legal and regulatory environment. With the legal and regulatory convergence towards EU standards, constraints to lending growth are gradually decreasing.

In all countries analysed, however, considerable scope exists to improve the effectiveness of both collateral and bankruptcy law. Settlement period in case of bankruptcy ranges from 2 years onwards. Application of new legislation in the judiciary system is not always consistent, with the experience and number of Judges well versed and trained in economic matters still needing to expand.

Security for loans can be taken on both movables and real estate in all countries. In Croatia a register for movables does not exist, while a new project is underway in Slovakia, to organise such a register at the Notary Chamber. Quality and functioning of registers is often limited by them working off line or by lack of data flow among regional offices. Poland and Bulgaria have focused most on the registers' status. In Slovakia a process of modernisation is underway, which should guarantee working on line and a shortening of registration time.

The quality of the operative environment also is dependent on the existence of a level playing field for market participants, functioning of deposit guarantee funds, reform of the pension system, adequacy of money laundering and banking secrecy laws.

The principle of level playing field is largely implemented in the region. Competitive conditions in the market are equal for all banks in Croatia and Bulgaria. In Slovakia building societies pay a lower contribution to the Deposit Guarantee Fund (DGF). In Poland, some advantages in terms of capitalisation exist for the largest state bank (PKO BP) and for cooperative banks.

Reform of the pension system is a fundamental step for developing active institutional investors in the markets, sustaining capital market developments. Pension reform has been successfully adopted in Poland, where pension funds are experiencing a sustained pattern of growth. Pension reform is expected to be implemented in Slovakia in 2004 and a reform process is underway in Croatia and Bulgaria.

Regarding deposit protection, schemes are in place in all countries, with direct contribution by single banks, based on amount of insured deposits. Contribution fees range from 0.4% of insured deposits in Poland, 0.46% in Croatia, 0.5% in Bulgaria and 0.75% in Slovakia. All deposit insurance schemes provide coverage for customer

Table 3 Regulatory framework

	POLAND	SLOVAKIA	BULGARIA	CROATIA
Supervision	Different institutions: NBP, SEC, SOIS, PFS	Different institutions: SNB, FMA. Towards centralised (Financial Market Agency)	Different institutions: BNB, SEC, ISD	Different institutions: CNB, SEC, ISD, PFISA
Capital regulation	8%, mainly credit risk. Market risk with new law (2002)	8%, mainly credit risk Market risk in the new banking act(2002)	12%, mainly based on credit risk	10%, mainly based on credit risk
Risk management practices	Foreign exchange risk regulated. Recommendations for other risks	Foreign exchange risk and liquidity risk	Foreign exchange risk liquidity risk and partially market risk	Foreign exchange risk, and recommend. for other risks
Non perfomoming loans	Delay 1 M	Delay 3M. Proposal for tightening	Delay 2M	Delay 4M
Provisioning	1.5% standard/watch, 20% substandard, 50% doubtful, 100% loss.	Up to 2% standard, 5% watch, 20% substandard, 50% doubtful, 100% loss	Up to 3% standard, 15 – 25% watch, 30 – 50% substandard, 50 – 75% doubtful,, 100% loss.	1% standard, 10 – 25% watch, 25 – 60% substand, 60 – 90% doubtful, 100% loss.
	Tax deductibility of specific provisions not always guaranteed	Tax deductible	Tax deductible	Tax deductible

NBP: National Bank of Poland; SEC: Securities Exchange Commission; SOIS: Insurance Supervisory Agency; PFS: Supervisory Agency for Pension Funds; SNB: Slovak National Bank; BNB: Bulgarian National Bank; CNB: Croatian National Bank; PFISA: Pension and Insurance Supervisory Agency deposits up to a specified amount, which ranges from € 5,100 in Bulgaria, € 8,000 in Slovakia (from mid-2002), € 13,000 in Croatia and € 18,000 in Poland. In view of future EU convergence and alignment to the acquis communautair, deposit protection is likely to be increased to the equivalent EU level of € 20,000. In terms of banking regulation, substantial effort has been applied by all countries in order to rapidly comply with EU and international best practices. Capital regulations conform to or exceed minimum BIS standards: 8% in Poland and Slovakia, 10% in Croatia and 12% in Bulgaria. Capital adequacy currently is mainly calculated accounting for credit risk, while market risk will be taken into account with the implementation of new banking laws (2002 in Poland and Slovakia). Regulation for foreign exchange risk exists in all countries, while at the moment no provisions for operational risk are in place.

As concerns classification of credit quality, in all countries non performing loans (NPL) are composed by "substandard", "doubtful" and "loss". The definition, however, varies from country to country. Taking only "delay in payment" as a discriminant, substandard qualification results from one month delay in payment in Poland[4], two months in Bulgaria, three months in Slovakia and four months in Croatia. Differences are sometimes related to payment practices. A possible tightening of classification rules in Slovakia is under discussion.

Provisioning requirements are tied to classification at set rates, which vary among countries, as does treatment for tax deductibility of provisions. In Poland, in particular, not all specific provisions are automatically tax deductible. In all other countries tax deductibility of provisions under specific conditions exists. A summary of key parameters is in table 3 below.

Infrastructure for financial sector operations

For banks to be effective intermediaries also depends on the constitution of sound and efficient infrastructure for financial operations. The experience of foreign market participants, transferring their "best practices and procedures", has made a positive contribution both in terms creating adequate support for legal and regulatory initiatives, as well as transferring know how on IT, operating procedures, risk management practices, etc. Two important examples for infrastructure support are Credit Bureaus and effective Small and Medium Enterprises (SMEs) support schemes.

Realignment of accounting rules to the International Accounting Standard (IAS) is a further precondition for full compatibility in the EU competitive framework. In Poland, since Dec-2001, substantial realignment has been achieved. In Slovakia realignment is expected in 2003 and full migration in 2004. In Bulgaria IAS will be required for listed companies as of 2003 and for all after 2004. No precise information is available on Croatia.

Credit Bureaus are important in two aspects: in terms of loans origination they provide a representative picture of the overall exposure of a customer to the local financial sector and also allow to monitor the position of the customer in the market. This allows timely reaction in case of negative trends in the customer position.

In Bulgaria a Credit Bureau operated by the Central Bank is in function, providing information on both retail and corporate clients (all loans above € 5,100 are recorded). In Poland and Slovakia a Credit Bureau for corporate clients is in place, while projects for a retail system are being developed. In Croatia there is currently no system available for ongoing access by banks.

In terms of SMEs, important developments have been registered through the years, with strong support coming from both national authorities and supranational financial institutions. One particularly interesting example of SMEs policy relates to risk sharing. Guarantee Funds, the basic form for risk sharing, provide a partial coverage of the risk borne by the bank creditor, thus, ensuring the supply of credit, at more favourable terms but without creating moral hazard.

In Poland and Slovakia such facilities have been operating for several years, but demand for resources still out-

Table 4: Infrastructures for financial sector development

	POLAND	SLOVAKIA	BULGARIA	CROATIA
IAS	IAS and NAS for listed companies. From Dec 2001 realignment of the two	Only NAS, after 2003 realignment and in 2004 migration	Only NAS. For listed companies IAS after 2003. For all after 2005	Only NAS.
SMEs support	• National Fund Credit Guarantee since 1994 (€ 52 mln) • 17 regional funds • Fund Entrepreneurship Development € 23 mln	• Two major projects: the NARMSP and the Slovak Guarantee Development bank • € 80 mln, overall contribution	• SMEA Act implemented in 1999 with some delays in effectiveness • Different small funds • New fund with € 10 mln in preparation	• Support by 2 projects HBOR and HGA
Credit Bureau	• NBP for corporate •(€ 130 mln and more • BIK retail (testing phase)	• NBS for corporate, testing phase, off line • Project for retail with CRIF	• BNB retail and corporate, above € 5,100.	• CNB runs a system, not for daily consultation

NBP: National Bank of Poland; SNB: Slovak National Bank; BNB: Bulgarian National Bank; CNB: Croatian National Bank

[4] In Poland, classification roles take into account evaluation of profitability of the client and non performing loans arise in case of short term losses.

paces supply with total support provided amounting to € 52 mln in Poland and € 80 mln in Slovakia. In Bulgaria, a new fund is set to start operating in 2002, providing € 10 mln support to SMEs. In Croatia two state run guarantee funds operate (HBOR and HGA).

The experience of the Italian "Confidi" could be an interesting experience to further enhance support for SMEs in New Europe. Confidi are a particular form of risk sharing facility, providing guarantees for bank credits for associate members, on a quasi cooperative, self assuring basis. The guarantee issued by the consortium represents a way of reducing cost of external financing and increasing availability of external funds for SMEs. At the same time, the mutual responsibility of associate members, via the Confidi, represents a strong performance incentive for single debtors.

Supranational financial institutions (like EBRD, EIB, World Bank, etc.) also provide valuable contribution to the SMEs development process. By supporting development of risk-sharing facilities in addition to direct financing, they are improving the available product range in a significant way.

Conclusions

The progress in the restructuring of banking systems in the New Europe countries has been impressive in the last ten years. After rapid but often unfocused portfolio expansion at the beginning of transition, leading to financial instability and bad debt problems, focused restructuring was initiated and this was supported by privatisation, recapitalisation of banks and entry of foreign strategic investors. This has led to the creation of a more stable operating environment and to gradual solution of bad debt problems, two preconditions for efficient banking intermediation and economic growth. This process has been significantly supported by convergence to EU standards.

Growth potential for the financial sector is high, as reflected by the low level of banking penetration in the market, with banking assets averaging only 70% of GDP. Particularly relevant are opportunities related to an increase in lending activity, on a sound basis, as an instrument to support both banking sector and economic development.

Valuable support in this direction comes from improvement in the legal and regulatory framework. Banking operations will have to profit from consistent application of new legislation in the judiciary system. Continued development of infrastructure for financial sector operations, like Credit Bureaus and effective support initiatives for SMEs will ensure the deepening of service quality and competition.

A focused effort by market participants, regulators and lawmakers has contributed significantly to upgrading the operating environment in the financial sector. Foreign banks have played and will continue to play a significant role as responsible corporate citizens. Their investment of capital, transfer of service, know how, IT infrastructure, and significant commitment to human resources development not only makes them stable long term investors, but also active contributors to the of the growth potential of the financial sector and, thus, the economy.