Banking transformation in CESEE 1980-2006

Conference organized by wiiw and IOG, Uni Wien: „Falling Behind and Catching Up – Southeast Europe and East Central Europe in Comparison“

wiiw

23 June 2016

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OeNB


LES PAYS ANALYSÉS
Mer du Barents
Mer du Nord
NORVÈGE
SUÈDE
FINLANDE
ROYAUME UNI
IRLANDE
DANEMARK
ESTONIE
LETTONIE
LITUANIE
PAYS-BAS
BELGIQUE
ALLEMAGNE EST
ALLEMAGNE OUEST
POLOGNE
BIÉLORUSSIE
RÉP. TCHÈQUE
SLOVAQUIE
AUTRICHE
FRANCE
ESPAGNE
ITALIE
SLO
HONGRIE
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SERBIE
ROUMANIE
MONTÉNÉGRO
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KAZAKHSTAN
OUZBÉKISTAN
KIRGHIZSTAN
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TURKMÉNISTAN
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IRAK
SYRIE
TURQUIE
GÉORGIE
ARMÉNIE
AZERBAÏDJAN
CHINE
MNG
L'INDE
ALGÉRIE
TUNISIE
LIBYE
CHYPRE
Mer Baltique
Mer Noire
Mer Caspienne
Mer d'Aral
Mer Méditerranée
Mourmansk
Arkhangelsk
St. Pétersbourg
Moscou
Nijni Novgorod
Kazan
Samara
Volgograd
Rostov-s.-le-Don
Astrakhan
Krasnodar
Iekaterinbourg
Omsk
Novosibirsk
Krasnoiarsk
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Boukhara
Douchanbé
Achkhabad
Kaboul
Islamabad
Kashgar
Urumqi
Téhéran
Bakou
Erevan
Tbilissi
Ankara
Istanbul
Kyiv
Kharkiv
Donetsk
L'viv
Chisinau
Minsk
Vilnius
Riga
Tallinn
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Londres
Dublin
Berlin
Prague
Varsovie
Vienne
Bratislava
Budapest
Zagreb
Belgrade
Bucarest
Sofia
Tirana
Athènes
Rome
Zurich
CH
Alger
Tunis
Tripoli
Mosul
0 250 500 750 1000 km

Overview of history of banking transition (1989-2007) in 14 CEE countries incl. former East Germany:

- The five largest (in terms of population) in CE: Poland, Hungary, former Czechoslovakia – Czech Republic, Slovak Republic, f. GDR
- The four largest SEE countries: Bulgaria, Romania, former Yugoslavia – of which: Croatia, Serbia and Montenegro
- The five largest of the CIS: from the former Soviet Union to Russian Federation, Ukraine, Belarus, Kazakhstan, Uzbekistan

Study analyzes and compares large amount of detailled info on:

- Transformation of the systemic-institutional framework of banking
- Evolution of legal foundations and supervision
- Banks' major sources of assets, liabilities, earnings and related changes
- Banking crises, restructuring and rehabilitation programs
- Role of foreign-owned credit institutions and FDI

Going through the two “banking reform waves” and their consequences: a country-to-country comparison (year or period of policy measure/event)[a]

Analyzed countries[b]	HUN	POL	CZR	SLK	E.GER	BUL	ROM	CRO	S&M	RUS	UKR	BELA	KAZ	UZB
Point of departure: state-owned[c] banking system, soft budget constraints, regime change, external shocks, weak rule of law	89-90	89-90	90	90	89-90	90	90	90-91	90-92	91-92	91-92	92	92	92
Transition recession and banking crises	90-93	90-91	90-92	90-93	90-91	90-93	90-92	90-93	90-93	90-96	90-97	90-95	90-95	90-95
“First wave” of banking reform														
- Liberalization of licensing policies, establishment of generous/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	91-94	91-94[d]
- Up-front rehabilitation measures (e.g. swap of inherited and new non-performing 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)	-	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	94-95	94-96
- Temporary stabilization of macroeconomic and banking situation	-	-	95-96	96-97	-	94-95	94-95	94-97	95-97	96-97	-	97-98	-	-
- Renewed 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	91-	94-97	91-
- Establishment of deposit insurance fund	93	95	94	96	90	95	96	94	-	04	01	95	99	02
New transition banking crises and (or) recession	-	-	97-98	97-99	-	96-97	97-99	98-99	99-00[e]	98-99	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	90-91	96-97	98-00	98-00	01-02	98-99	98-01	99	95-97	-
- Establishment of hard budget constraints for banks	92-93	93-94	98-99	99	90-91	96-97	99-00	99	02	99	01	-	97-98	-
- Banks become much more cautious in lending	92-93	93-94	98	98-99	90-91	97-98	00	98-99	02-03	98-99	99	99	97-98	02-03
- Substantial tightening of banking regulation and supervision, upgrading of bookkeeping standards	92-94	94-95	96-98	98-99	90-91	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	91	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	90-91	97-03	99-05	99-02	03-	04-	05-	-	-	-
- Introduction of credit registers/bureaux	99	-	02	04	91	00	99	-	-	05	-	-	-	-
Bank lending gathers momentum or turns into credit boom	99	98	04	04	-	01	02	01	04	01	01	04	00	-
Authorities’ reaction and credit containment policies (e.g. prudential tightening, administrative restrictions)	-	-	-	-	-	03-	03-	03-	05-	-	-	-	05-	-

[a] 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 not yet over

[b] HUN = Hungary, POL = Poland, CZR = Czech Republic, SLK = Slovakia, E.GER = East Germany, BUL = Bulgaria, ROM = Romania, CRO = Croatia, S&M = Serbia and Montenegro, RUS = Russia, UKR = Ukraine, BELA = Belarus, KAZ = Kazakhstan, UZB = Uzbekistan

[c] in former Yugoslavia: socially-owned banking system

[d] selective and temporary liberalization of licensing policies, but not of central state oversight of banks

[e] in former Yugoslavia: slump triggered by the Kosovo war, which contributed to pushing the banking sector to the verge of collapse

Looking at this historical pattern in more detail and focused on SEE

The first "banking reform wave" in South-eastern Europe

Analyzed countries	BUL	ROM	CRO	S&M
Point of departure: state-owned[a)] banking system, soft budget constraints, regime change, external shocks, weak rule of law	90	90	90-91	90-92
Transition recession and banking crises	90-93	90-92	90-93	90-93
"First wave" of banking reform				
- Liberalization of licensing policies, establishment of generous/lenient regulatory and supervisory systems	90-94	90-94	90-92	90-94
- Up-front rehabilitation measures (e.g. swap of inherited and new non-performing loans for government securities)	91-94	91-93	91-92	-
- Surface privatization of banks (e.g. mass privatization, MEBOs)	-	-	-	-
- Initial tightening of banking regulation and supervision	-	95-96	93-94	96-97
- Temporary stabilization of macroeconomic and banking situation	94-95	94-95	94-97	95-97
- Renewed accumulation of bad loans and structural problems, sometimes complemented by new external shocks	92-96	93-96	93-97	-00
- Establishment of deposit insurance fund	95	96	94	-
New transition banking crises and (or) recession	96-97	97-99	98-99	99-00[b)]

[a)] in former Yugoslavia: socially-owned banking system

[b)] in former Yugoslavia: slump triggered by the Kosovo war, which contributed to pushing the banking sector to the verge of collapse

Point of departure

- State-owned banking system (or socially-owned in former Yugoslavia)
- Soft budget constraints (institution of bankruptcy non-existent)
- Political and economic regime change
  - incl. collapse of centrally-planned economies,
  - breakdown of former socialist economic integration body COMECON)
  - Collapse of former multnational states (USSR, SFRY, CSSR)

→ External shocks

→ Unraveling of state power ⇔ sustained weakening of rule of law

→ Transition recession and banking crises

→ Banking reforms

„First wave“ of banking reform

- Abolition of central credit and cash plans, price liberalization, creation of two-tier banking system
- Liberalization of bank licensing policies, establishment of generous/lenient regulatory and supervisory systems

→ Entry of numerous small private banks

- Up-front rehabilitation measures
  - e.g. swap of inherited and new NPLs for government securities
- „Surface privatization“ (i.e. partial, insider or non-conventional privatization)
- Initial tightening of monetary policy, banking regulation and supervision
- Revival of economic growth around mid-1990s, temporary stabilization of macroeconomic and banking situation

⇔ market-oriented economy re-established

→ Foreign investors enter with greenfield start-ups

„First wave“ of banking reform (cont.)

- However: soft budget constraints retained

\+ continuing domination of sector by (former) state-owned banks

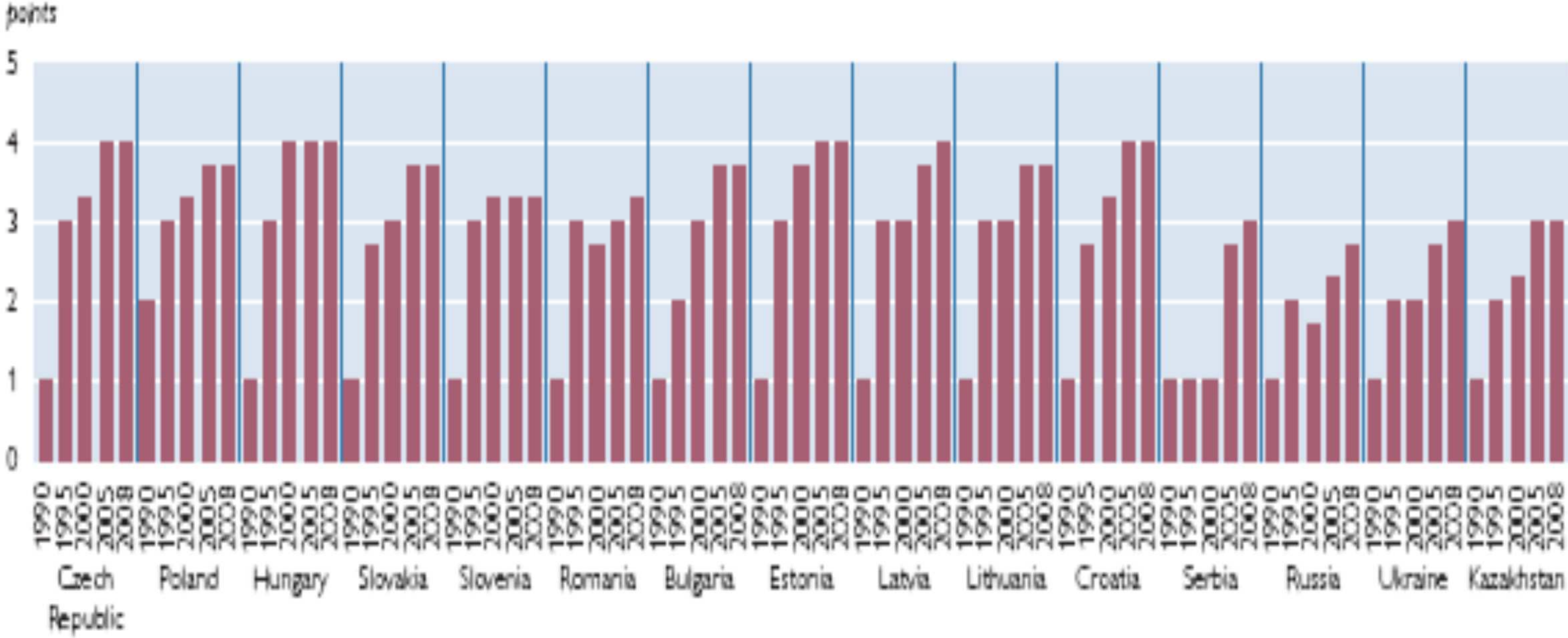
- Emergence of temporary unsustainable equilibrium
- Continued lack of rule of law, of security of property rights, widespread connected lending, “pocket banks”, corruption, capital flight
- Underlying incentives favored renewed accumulation of bad loans, sometimes complemented by new external shocks,

→ contributing to return of macroeconomic destabilization

- Establishment of deposit insurance fund
- New transition banking crises and (or) recession

Chart 1

EBRD Banking Sector Reform Index 1990–2008



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

The second "banking reform wave" in South-eastern Europe

“Second wave” of banking reform	BUL	ROM	CRO	S&M
- Important restructuring, resolution and recapitalization measures: in most cases at least one large bank goes under	96-97	98-00	98-00	01-02
- Establishment of hard budget constraints for banks	96-97	99-00	99	02
- Banks become much more cautious in lending	97-98	00	98-99	02-03
- Substantial tightening of banking regulation and supervision, upgrading of bookkeeping standards	96-97	98-99	98-99	01-02
- Strengthening of property and creditor rights, hard budget constraints spread to real sector	98-99	01	00	03
- In-depth privatization (e.g. takeover by strategic investor), FDI boom in	97-03	99-05	99-02	03-
- Introduction of credit registers/bureaux	00	99	-	-
Bank lending gathers momentum or turns into credit boom	01	02	01	04
Authorities’ reaction and credit containment policies (e.g. prudential tightening, administrative restrictions)	03-	03-	03-	05-

„Second wave“ of banking reform

- Painful restructuring, resolution and recapitalization measures: in most cases at least one large bank went under
- This sent out signal that budget constraints for banks were hardening = break with the past

→ Banks became much more cautious in lending, reshuffled their portfolios toward government securities et al.

- Substantial tightening of banking regulation and supervision, upgrading of bookkeeping standards, confirmed hard budget constraints for banks
- Overhaul of deposit insurance funds (financial strengthening, limitation of guarantee levels)
- Strengthening of property and creditor rights

⇔ Hard budget constraints spread to the real sector

„Second wave“ of banking reform (cont.)

- Strategic decisions of authorities in favor of

  „In depth privatization“ (e.g. takeover by strategic investor), in order to attract know-how and capital, raise efficiency and competitiveness
- Once conditions (rule of law, macrostability) were appropriate

→ Huge catching-up potential triggered FDI boom

- Introduction of credit registers/bureaux
- Bank lending gathered momentum or turned into credit boom

← Strong economic growth/ recovery, strengthened structural/ institutional environment, remonetization tendencies, euro cash changeover 2001/2002

- Credit boom gave rise to concerns with respect to financial and macroeconomic risks
- Authorities‘ reaction and credit containment policies (e.g. prudential tightening, administrative restrictions)
- However, possibilities of circumvention

Financial intermediation in central and eastern Europe (early 1990s, 1999/2000 and 2005)

Central Europe

	Hungary			Poland			Czech Republic			Slovak Republic		
	1992	1999	2005	1992	1999	2005	1993	1999	2005	1993	1999	2005
Banking assets/GDP (%)	75.0	68.1	91.0	52.2[a)]	61.9	66.3	131.4[a)]	124.1	97.9	103.7[a)]	92.7	95.5
Credit to the private sector/GDP (%)	23.4	24.6	44.8	39.0	27.1	27.4[c)]	51.0	44.6	30.4	30.4	48.4	36.3

South-eastern Europe

	Bulgaria			Romania			Croatia			Serbia		
	1992	1999	2005	1993	1999	2005	1993	1999	2005	1993	1999	2005
Banking assets/GDP (%)	123.7[a)]	36.1	78.3	45.0[a)]	34.9	45.4	70.4[a)]	66.1	114.0	.	79.8	46.4
Credit to the private sector/GDP (%)	5.8	10.7	42.3	3.1	10.6	20.9	37.7	35.7	65.4	.	29.6	25.0

Commonwealth of Independent States

	Russia			Ukraine			Belarus			Kazakhstan		
	1997	2000	2005	1996	2000	2005	1994	2000	2005	1993	1999	2005
Banking assets/GDP (%)	30.1[b)]	33.3	45.1	.	21.8	51.1	.	29.5	32.2	.	16.9	60.6
Domestic credit/GDP (%)	9.5	13.1	25.7	1.4	12.4	35.3	17.6	18.6	19.6	49.3	7.6	35.6

	Uzbekistan		
	1993	1999	2005
Broad money/GDP	53.5	13.6	15.1
Dom. credit/GDP	.	22.0	20.4

a) 1995

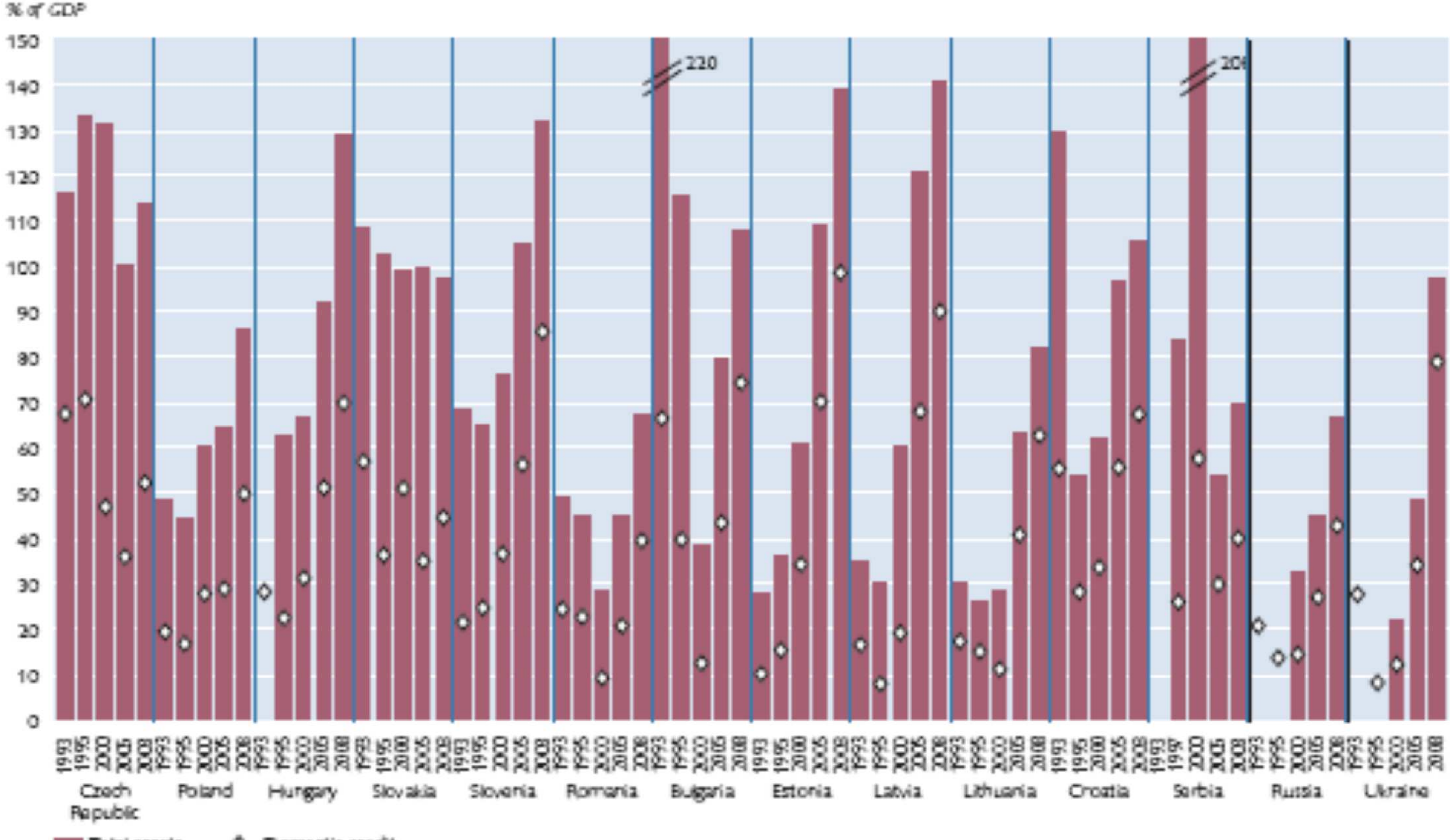
b) mid-1998

c) 2004

Source: EBRD, IMF, Bank Austria-Creditanstalt, Raiffeisen Zentralbank

Chart 3

Financial Intermediation in CESEE 1993–2008



Source: NCBs, OeNB.

Concept of two separate banking reform waves

- Seems to be fully valid for: Czech Republic, Slovakia, Bulgaria, Romania, Croatia, Russia, Ukraine
- Only partly applicable to: Poland and Kazakhstan, where it is difficult to separate the waves, which actually form continuum of efforts and measures
- Very difficult to apply to Serbia and Montenegro, which only started serious reforms at the end of 1990s or in 2000
- Impossible to apply to Eastern Germany, because of enormous compression of many events/reforms there in the swift re-unification with West Germany
- Belarus at least partially launched its first wave before staging a volte-face in the mid-1990s
- Uzbekistan didn‘t get further than making some initial steps
- Hungary brought forward hard budget constraints to first half of 1990s, which created one swift and compact sequence of steps

Conclusions from banking transition experience

- Importance of coordinating bank and enterprise reforms (otherwise, market-oriented banking activity can‘t take off)
- Early and strong reforms are economically less costly than hesitant or delayed reforms (see varying budgetary recapitalization costs)
- Given sheer size of task of privatizing enterprise sector of former socialist country – as opposed to privatizing its banking sector

→ Latter measure was practically always concluded prior to the former

- Privatization to foreign strategic investors turned out to be more successful than other strategies in that it modernized banking sectors in short time

Conclusions (cont.): focusing on FDI

The foreign takeover of central and south-eastern European banking sectors

Central Europe

	Hungary			*Poland*			*Czech Republic*			*Slovak Republic*		
	1995	**2000**	**2005**	**1995**	**2000**	**2005**	**1995**	**2000**	**2005**	**1995**	**2000**	**2005**
Shares of majority foreign-owned banks in total banking assets (%)	41.8	66.7	84.5	4.2	69.5	74.2	15.9	71.8	94.5	32.7[a)]	40.6	97.3

South-eastern Europe

	Bulgaria			*Romania*			*Croatia*			*Serbia*		
	1996	**2000**	**2005**	**1998**	**2000**	**2005**	**1996**	**2000**	**2005**	**1995**	**2000**	**2005**
Shares of majority foreign-owned banks in total banking assets (%)	9.6	67.7	72.8	20.0	50.9	59.2	1.0	84.1	91.2	.	1.4	66.0

Commonwealth of Independent States

	Russia			*Ukraine*			*Belarus*			*Kazakhstan*		
	1998	**2000**	**2005**	**1995**	**1999**	**2005**	**1995**	**1999**	**2005**	**1995**	**2003**	**2005**
Shares of majority foreign-owned banks in total banking assets (%)	6.7	9.5	11.2[a)]	.	10.5	21.4	.	2.9	16.2	.	5.5	7.3

	Uzbekistan		
	1995	**1999**	**2005**
Asset share of foreign-owned banks (%)	.	2.0	3.4

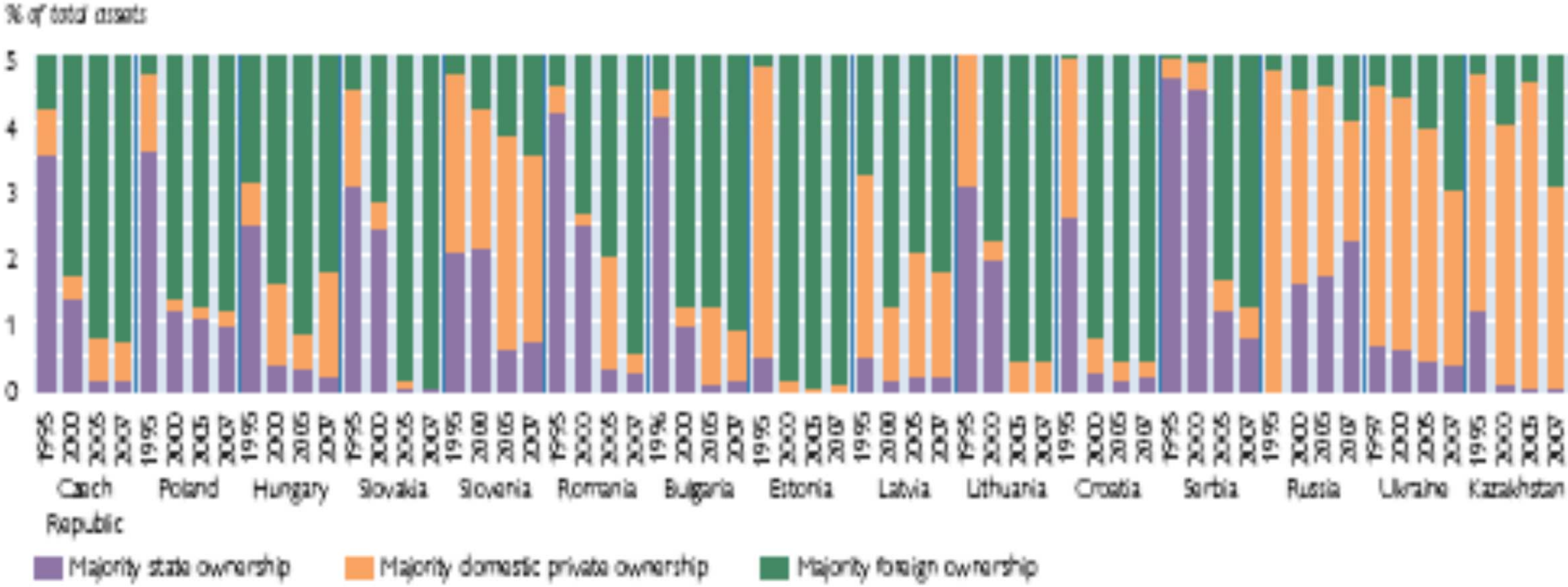
[a)] share in total capital

Source: EBRD, IMF, Bank Austria-Creditanstalt, Raiffeisen Zentralbank

Conclusions (cont.): focusing on FDI

Chart 2

Ownership Structure of the Banking Sector 1995–2008



Source: EBRD, NCBs, OeNB.

Conclusions (cont.): focusing on FDI

- FDI – particularly EU FDI – has acquired dominating positions in all analyzed countries, except in CIS

⇔ New EU members, candidates and potential candidates (incl. Balkan region, e.g. Serbia) seem more attractive for foreign investors than countries that don‘t have these attributes

⇔ Largest privatization deal in economic history of CEE:

2005: sale of Banca Comercială Română for EUR 3.75 billion (multiple of book value) to Erste Bank (of Austria)

- CE + Baltics + SEE is a unique region in the world:

  in no other region is the share of foreign owners of banking sectors so high

- However, strong EU ownership connections may also heighten danger of cross-border transmission of risks and contagion

Summing up results in a nutshell

- **In most countries, 1990s have been decade of major banking upheavals, turmoil and reform**
- **Turn of millennium featured consolidation, or was culminating point of restructuring efforts**
- **First decade of the new millennium witnessed calmer, stronger and more open banking sectors (until external shock of 2008)**
- **Two „banking reform waves“ are detected, salient features of which all countries (need to) run through in order to mature**
- **Why two waves, not one?**
- **Early and strong banking reforms are economically less costly than hesitant or postponed reforms**
- **FDI found to be pivotal – although not necessarily indispensible – for banking modernization**
- **The region – incl. the Balkans – is structurally unique in the world**

Thank you!