Foreign Banks – Solution Or Problem For Central And Eastern-European Countries. The Case Of Romania

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Abstract: *After the collapse of communism, Central and Eastern European countries experienced fundamental macroeconomic reforms aimed at moving from centralized to market-centered economy, where privatization of state-owned credit institutions with foreign capital has had an important role. Since the early 1990s, banks with majority or part foreign capital, as well as branches of foreign banks, have penetrated the banking markets of the countries in transition into a market economy, becoming major players as a result of financial globalization. By imposing on the banking markets of countries in transition to a market economy, foreign-owned banks have come to hold up to 90 percent in some countries in the banking market. The paper analyzes the benefits and costs of the presence of banks with a majority or part foreign capital and branches of foreign banks in Central and Eastern European countries - Poland, Hungary, Croatia, Bulgaria and Romania, with the theoretical arguments of recent researches and empirical evidence quantified in official reports.*

Keywords*:* foreign banks, bank assets, asset profitability, capital profitability.

JEL Code: G20, F3

1.Introduction

To give banks and capital markets - essential gear in the functioning of the economy - attributions in the framework of their allocation of resources in society, became, after 1990, a priority direction of the institutional and functional reform policies in the former communist countries of Central and Eastern Europe, for reasons that mainly concerned Askar Alimkulov, 1999:

- the banking dominance of the financial sector of economies in transition, legacy from the communist regime;
- the key role of banks in financial markets both in terms of providing liquidity to other financial market institutions, and in maintaining confidence in the payment system;
- the informational advantage of banks in the first stages of the transition, compared to capital markets, regarding the performance indicators of the clients, the information on their creditworthiness being easily accessible to banks.

Faced with reality, the implementation of banking reforms, part of the process of institutional and functional transformation of the economy, proved to be a difficult process in terms of its complexity and the extent of change. Although the legal, institutional and regulatory framework for banks was similar in the former communist countries, the strategy for reform was not unitary, the transformation of the mono- banking system, specific to centralized economies, into a market-oriented banking system being carried out in different ways.

Following the change in the general perception that links state-owned banks to a low development level of financial sector and to poor financial performance, able to induce large-scale banking crises, the privatization of state-owned banks was a solution to solve problems stemming from lack of capital and improving the competitiveness and efficiency of the banking sector. Between 1995 and 2003, for example, the number of foreign banks operating on the Romanian territory increased from 4 to 19, in Bulgaria from 5 to 16, in Hungary from 20 to 25, in Poland from 14 to 34. (V Bruno, R Hauswald, 2012). At regional level, in the Central, Eastern and South-Eastern European countries, the number of foreign banks reached almost 70 percent of the total number of banks in the region, in 2008 compared to 27 percent in 1995. (Maria Arakelyan, 2018).

During the almost three decades of expanding banking activity in other countries, particularly emerging or developing countries, extensive specialized studies focused on in-depth analysis and macroeconomic models, adding more information to the experience of financial practice, tried to detect the effects of foreign banks on the financial sector and, implicitly, on the performance of the host countries' economies. Without consensus, the opinions of specialists' highlight both the beneficial aspects and the challenges of foreign investment in the banking sector, differentiated by area and the analyzed time period. The recent global financial crisis has brought about a new perception, the focus being disconnected from the understanding of the determining rationale of the presence of foreign banks outside the home country, to the analysis of their implications for the evolution of the economies of the host countries. (Maria Arakelyan, 2018).

2.Literature review

In the context of the 1990s, foreign investment in the banking sector was a solution designed to contribute decisively to the privatization of the banking sector and to ensure efficiency and profitability by transferring knowledge and performing information technologies while stimulating interbank competition at national and international level.

Literature (Howkins, 2002) has synthesized the experience gained in the practical exercise of privatization in a few distinctive features:

• identifying as a successful method of the privatization process of the one realized through the sale of state banks to strategic partners, mainly foreign banks of international reputation;

• solving the problems caused by bad loans and clearing banks' balance sheets before being included in the privatization programs in order to respond to the desire to properly inform investors about the quality of the portfolio offered and the need for transparency of the process;

• establishing mechanisms to provide investors with guarantees for the possible deterioration of the accepted elements of the bank's liabilities, a practice known as ring facing; with the exception of Poland and Hungary, which did not offer investors guarantees, but cleared banks' balances before selling them, forcing the governments of the other transition countries to offer various such guarantees;

• clarifying the position held by the state in banks by reserving a certain percentage (which may even reach 33 percent) of their shares or, as was the case with OTP Bank's privatization in Hungary, retaining the gold share";

• without a few exceptions, clear implications for the deterioration of the state of health of the privatized bank by the excessive concentration of domestic capital in the hands of foreign banks (the case of Poland and Hungary) or of non-banking financial institutions (the Czech Republic), it seems that there is a potential danger of this trend, which is to block small borrowers from accessing their loans.

The banking markets in the Central and Eastern European countries largely owe their performance to foreign banks, which, through the foreign capital invested, reduced the fiscal costs of restructuring the national banking system, brought expertise and stimulated competition between banks, with effects found in cost reduction and efficiency gains, and have implemented new technologies in the field of fund transfers, interbank settlements and payments. From the perspective of foreign banks, the possibility of expanding their activities beyond the national borders, following their important clients with international activities, in the absence of entry barriers of capital into the host country, have constituted business opportunities, to which were added cultural and institutional similarities, because of relatively limited physical distances, in most cases, between the national territory and that of the host country (Maria Arakelyan, 2018).

Iwanicz-Drozdowska, Smaga și Witkowsk (2017) analyze the effects of foreign banks' presence on banking sector stability in CEEC countries, using a financial strength index (FSI) used by banks and countries on a sample of 20 countries in the 1995-2014-time horizon; and note the absence of a direct, significant relationship between the presence of foreign banks and the stability of

the banking sector in the analyzed countries. Financial stability appears to be dependent on lending policies, regardless of the origin of the banks' (national or foreign).

The analysis of the impact of foreign banks on the financial markets in host countries, conducted on a panel of 7900 bank observations from 80 countries for the period 1988-1995 by Claessens, Demirguc-Kunt and Huizinga (2001), allowed the authors to formulate some interesting conclusions: they found that foreign banks earn higher profits in developing countries compared to domestic banks, while profits made in developed countries are lower than those of banks in host country , and the fact that the entry of foreign banks affects the revenue of banks in the host country in a negative way and also, their profitability. Although the entry of foreign banks may increase the overall costs of host country banks on the short run, the overall conclusion of the study is that the presence of foreign banks generates an increase in competition in the host country's banking market.

Using ROA (the indicator of profitability) on a sample of banks in 51 developing countries for the period 1999-2006, Claessens and Van Horen (2012) found that the profitability of foreign banks was directly proportional to the share of market in the host country, the lack of strong regulation in the host country and linguistic similarities contributing to the improvement of the indicator.

Based on 265 Central and Eastern European bank surveys for the 1995-2003 period, Olena Havrylchyk and Emilia Jurzyk tried to identify the differences between profitability indicators of foreign and domestic banks, noticing that foreign banks and, in particular, greenfield banks register higher profits compared to domestic banks, because they are less affected by the host country's macroeconomic context and possible financial shocks. The profits of foreign banks in host countries even exceed the profits of the parent bank. Regarding domestic banks, the study reveals higher profits in more concentrated banking markets associated with a less competitive environment. The attempt to assess the potential dangers of the presence of foreign banks, taking into account their dependence on parent bank performance and macroeconomic conditions in the home country, finds no real support, research suggesting an increase in parent bank funding subsidiaries in the CEE countries.

Beyond the benefits represented, among other things, by reducing the cost of financial intermediation and increasing its quality, improving the access of firms and households to modern financial services, and improving the economic and financial performance of bank customers, the presence of foreign banks may also exert adverse effects, as follows: (i) the tendency to select and attract the best financial clients to the detriment of domestic banks, which may be affected by the constraint of the granted loan portfolio, with direct implications on the bank's profit; (ii) financial instability induced by the transmission of shocks that affect credit supply in a home market, on a similar market in another country. (Claessens and Van Horen, 2012)

The main benefits and costs associated with the expansion of banking activity across national borders are shown in the table no. 1.

Table no. 1. Benefits and drawbacks of foreign bank presence in CEEC countries

Impact of foreign banks on:	Benefits	Drawbacks
Banking sector of the host country	- improving the efficiency of the banking sector through the contribution of technologies, products, and performing services (A Kladova, L. Parfenova, V Juščius, 2014); (Mohamad Sofuan Mohamad Saleh, 2015) ;(Juan Cárdenas, Juan Pablo Graf, Pascual O'Dogherty,2003); (Levine, Ross. 1996); (Goldberg, L. S. (2004; -implementing new banking management strategies (A Kladova, L Parfenova, V Juščius (2014) ; Mohamad Sofuan Mohamad Saleh (2015); -intensifying interbank competition (A Kladova, L Parfenova, V Juščius, 2014); Mohamad Sofuan Mohamad Saleh (2015); -improving the stability of the banking sector in the host country, especially in times of crisis, through easy access to external financial resources (A Kladova, L Parfenova, V Juščius (2014); -Improving the financial infrastructure and profitability of banking activity through knowledge, know-how, accounting practices and experience in engaging in banking, insurance, brokerage (A Kladova, L Parfenova, V Juščius, 2014); -the involvement of banks in operations on money markets, foreign exchange and capital markets is able to contribute to the development of the national financial markets by attracting the financing of the resources of the domestic clients (A Kladova, L Parfenova, V Juščius (2014); -supplying stable credit sources, the branches of major foreign banks basing their activity on additional financial resources from the parent bank with easy access to the global financial markets. Mohamad Sofuan Mohamad Saleh (2015); -exerting spill-over effects on the banking sector in the host country, an important source of innovation, competition and efficiency (Paola Bongini, Małgorzata Iwanicz-Drozdowska, Paweł Smaga and Bartosz Witkowski, 2017);	-the dangers of giving the economy the power to finance, through bank loans to an entity from another country with the potential to generate a contradiction between the interests of foreign banks to support and promote relations with the country of origin to the detriment of the host country's interests (A Kladova, L Parfenova, V Juščius (2014), (Janek Uiboupin, 2004), -differences between the legal provisions in the banking sector in the host country and the country of origin of the foreign bank (A Kladova, L Parfenova, V Juščius (2014); -fear of foreign control over the allocation of credits from the host country (Janek Uiboupin, 2004); -restrictions on access to credit resources imposed on small and medium-sized businesses (A Kladova, L Parfenova, V Juščius (2014); -the danger of "importing" possible financial crises from the country of origin of the bank to the host country (A Kladova, L Parfenova, V Juščius (2014), becoming a source of contagion, increasing vulnerability by importing economic or financial shocks from countries of origin into host countries (Maria Arakelyan, 2018); -the creation of an unbalanced competition between foreign banks (which bring high performance products, services and technologies) and weakly developed national ones in terms of infrastructure, innovation, information technology, product offerings and banking services (Mohamad Sofuan Mohamad Saleh (2015);

	-mitigating external constraints on access to funding by providing additional funding resources and the consequences of possible national financial crises on business profitability and economic growth (Valentina Bruno, Robert Hauswald, 2012).	-the assumption by national banks of a higher cost by raising higher interest rates on deposits (in order to attract local clients and low-risk companies from the economy in order to compete with foreign banks), given that interest on loans cannot be increased (Mohamad Sofuan Mohamad Saleh (2015); -the outstanding financial performance of foreign banks (part of the global financial network, labor market accessibility in various countries, and top-level information technologies), whose management is oriented towards attracting large corporations with high financial potential (Mohamad Sofuan Mohamad Saleh (2015); -foreign banks may become a source of credit shrinkage on the loan markets of host countries, for reasons of exposure to specific or systemic financial problems of the parent banks (Paola Bongini, Małgorzata Iwanicz-Drozdowska, Paweł Smaga and Bartosz Witkowski (2017)
Banking sector of the foreign country	-relatively easy access to the funding resources of host country (A Kladova, L Parfenova, V Juščius (2014); -the mobilization of foreign direct investment (A Kladova, L Parfenova, V Juščius (2014)	- the lack of real guarantees from the bank parent, the letters of guarantee issued by the bank parent being just comfort letters, with the only purpose to be a moral support (A Kladova, L Parfenova, V Juščius (2014) - limited access to foreign financing sources besides the bank parent. Often enough, the parent bank reduces operational costs by closing foreign financing channels, thus becoming the only foreign financial source. Such actions make the branch more dependent on the parent bank, becoming more vulnerable in crisis situations (A Kladova, L Parfenova, V Juščius (2014); - financial resource inflows may be affected by adverse selection in the context of local opaque credit markets, on which national banks have informational advantages (Valentina Bruno, Robert Hauswald , 2012)

3. The Impact of Banks with Foreign Capital on the Banking Sector in Romania in the Central and Eastern European Banking Context

Analyzing the factors that influence the success of the reform strategy adopted at national level - rehabilitation (aiming at the recapitalization of state banks, while implementing an extensive institutional development process, possibly followed by privatization, on the model of Hungary and Poland) or new entry (which involves the abolition and spontaneous privatization of banks with existing state capital, the entry of many new banks and, even in some cases, the liquidation of old banks, a strategy adopted by Russia and Estonia) - a series of studies (Stijn Claessen, 1996) were identified as key determinants at an international level:

- the institutional inheritance since the beginning of the transition - many Central and Eastern European countries abandoning the mono-banking system since the mid-1980s and having undergone complementary reforms (legal and at enterprise-level) since the early nineteenth decade (Hungary being eloquent in this regard) and

- the macroeconomic development, giving the extent to which the loans are affected by the real negative interest rates thus requiring the recapitalization of banks, with effects found in the strategic approach of the reform and defining the role of the governmental authority in this process.

In terms of concrete facts, between the macroeconomic development and banking reforms a reverse link was identified: the expansion of non-performing loans, due to distortions in the real sector of the economy, inducing a series of macroeconomic environment issues - high inflation and real negative interest rates over time, while the countries whose financial system is strongly developed and have inherited both favorable initial conditions in the real economy, translated into the low volume of non-performing loans as well as performing complementary policies, are facing a lower level of inflation, an environment conducive to a rehabilitation approach.

With the specific national accents given by the initial conditions, the external shocks and the relationship with the reforms in the other economic sectors, the steps taken in the majority of the Central and Eastern European countries, reunified in a model of rehabilitation of the state banks called rehabilitation approach, have targeted the split up of state-owned banks by transforming them into commercial banks owned by the state and recapitalizing them for privatization.

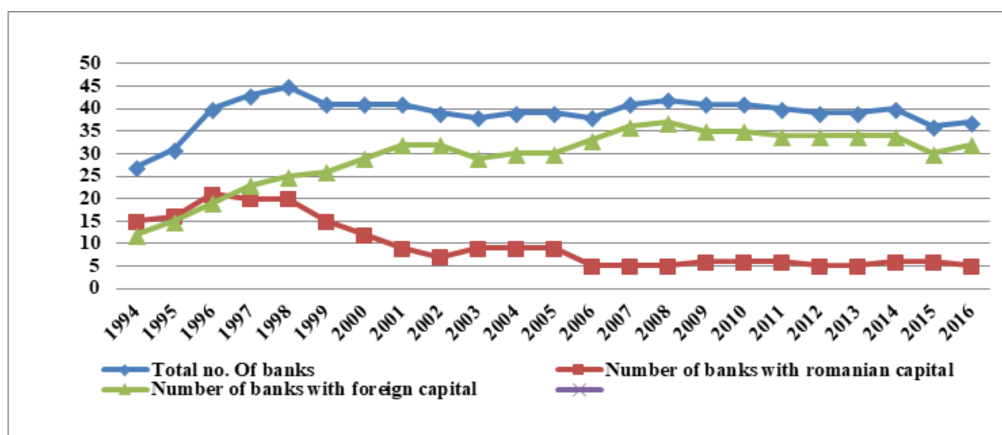
After 1990, foreign banks gradually stepped up their presence in Central and Eastern European countries, accounting for up to 90 percent of all banks operating in some CEE countries.

Hungary was the first country from the privatized area with a strategic investor during the period 1994-1997. After the recapitalization of banks between 1993-1994, the number of foreign banks evolved between 1995 and 2009 from 67 percent to 92 percent from the total number of banks. The Bulgarian authorities decided to privatize the banks in 1997 with a foreign strategic investor after the 1996-1997 banking crisis. Compared to the total number of banks, foreign banks evolved from 22 percent in 1995 to 67 percent in 2009. In Poland the privatization process began in 1993, so between 1995 and 2009 the number of foreign banks evolved from 30 to 69 percent from the total

number of banks. The global financial crisis has caused, through effects and consequences, the repositioning of a number of foreign banks according to the interests of banks in the countries of origin.

In this context, Romania has felt a different experience: before the banking crisis in 1998-1999, loans given by state-owned banks to state-owned firms proved to be ineffective, thus non-maturing loans were generating problems for banks, requiring their recapitalization before their privatization. Foreign capital - branches of foreign banks and banks with whole or part foreign capital, Romanian legal persons - penetrated into Romania and evolved from 12 entities in 1994 to 37 in 2008. The post-crisis period, which marked an obvious tendency of concentration of the banking sector in the European countries, brought with it the reduction of the number of foreign-owned banks, Romanian legal entities and branches of foreign banks, to 32 in 2016 (diagram no. 1).

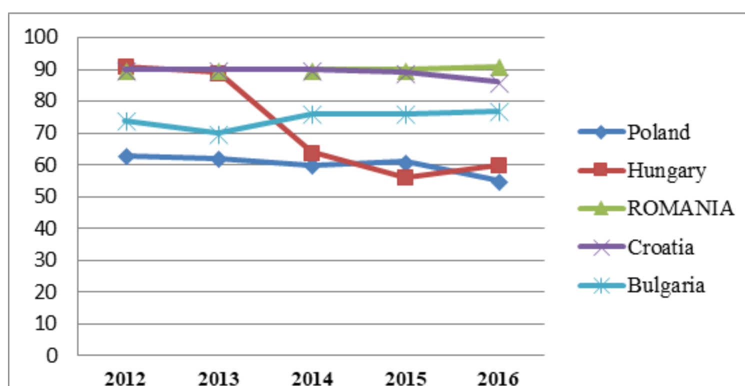
Diagram no. 1. Evolution of banks in Romania, according to the origin of the capital during 1994-2016



Source: own calculations, based on BNR Reports, 1994-2016

Structural developments in the Central and Eastern European countries, especially in the post-global crisis, are the hallmarks of operations that materialize both the need to strengthen the banking market through mergers and acquisitions, transactions or the relocation of small players, as well as increasing the digitization of banking activity, involving substantial investments As a direct consequence of these challenges, the market share of the assets held by foreign-owned credit institutions (including branches of foreign credit institutions) versus total assets, has brought back the market share to the level of 1999 in some countries, with Poland being the most eloquent case: market share declined in the time horizon of 2012 - 2016 by 8 percent, reaching 55 percent in 2016, the same level of 1999 (diagram no. 2).

Diagram no.2. Market share of banks with foreign capital (% in total assets)



Source: the CEE Banking Sector Report, 2017

With a moderate degree of concentration, according to international standards (the BNR Report from 2016), the market shares of banks with majority foreign capital operating in Romania and Croatia maintained around 90 percent of total assets held by credit institutions, while the market share of banks with foreign capital decreased by 31 percent (Hungary) and 8 percent (Poland). In the ranking of the top five credit institutions in the analyzed countries, there are those in Croatia that hold together, 74 percent of the total net assets balance (table no. 2)

Table no. 2. Market share of the five top banks, 2016(% of total net balance sheet assets)

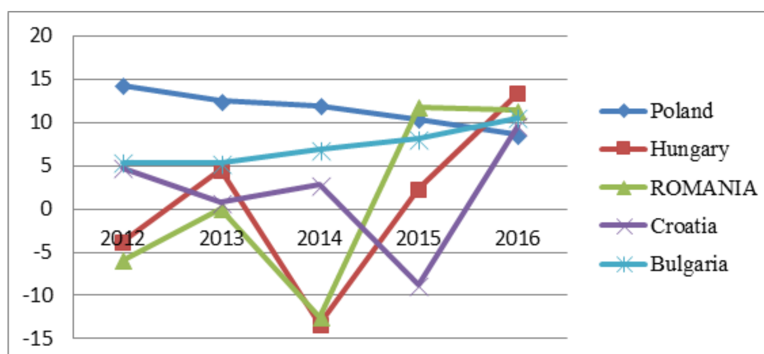
Poland		Hungary		ROMÂNIA		Croatia		Bulgaria	
Bank name	%	Bank name	%	Bank name	%	Bank name	%	Bank name	%
PKO BP	16.7	OTP	21.3	BCR (Erste).	16.3	Zagrebacka Banka (UniCredit)	26.6%	UniCredit Bulbank	20.2
Bank Pekao (UniCredit)	10.2	UniCredit	7.9	Transilvania Bank	13.1	Privredna Banka (Intesa)	18.4	DSK Bank (OTP)	12.6
WBK (Santander + Kredyt Bank)	7.7	Erste	6.1	BRD (SocGen).	12.9	Erste	14.2	First Investment Bank	9.6
mBank (Commerzbank	7.5	Raiffeisen Bank	5.9	Raiffeisen Bank	8.5	Raiffeisenbank	8.0	United Bulgarian Bank	7.4
ING Bank	6.9	MKB	5.7	UniCredit	8.3	Splitska Banka	6.9	Raiffeisenbank	6.9
Total	**49**	Total	**46,9**	Total	**59,1**	Total	**74**	Total	**56,7**

Source: CEE Banking Sector Report, 2017; BNR Annual Report 2016

A series of recent research on the impact of foreign-based banks on financial stability in host countries revealed significant differences between the behavior of foreign and domestic banks in lending activity in the context of financial globalization and the post-crisis financial global reality. Analyzing, on the basis of a sample of 200 domestic and foreign capital banks in 16 Central, Eastern and South Eastern European countries, Maria Arakelyan (2018) found, beyond the specific macroeconomic or microeconomic characteristics (at the bank level), the special importance in the lending activity of the distinctive features of the parent bank and the subsidiary, of which attention is paid to asset quality, capitalization, profitability, liquidity, as well as values of profitability indicators - return on assets and return on capital.

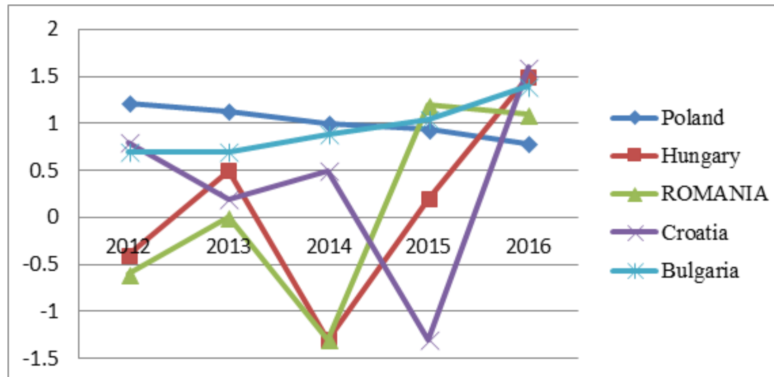
In the Central and South-Eastern Europe region, profitability reflected developments in banking activity, with declines in different time segments, consequence of the macroeconomic context, of European bank regulation aimed at strengthening post-crisis capital positions and the application of new capital requirements by the EU and / or local regulators prudent leverage strategies as well as prudent bank debt strategies. The low level of bank profitability in different periods and countries reflects mainly, the recognition of losses from the global crisis, the restructuring efforts associated with the macroeconomic context and the low interest rates. For example, the lowest ROE in the analyzed period was -13.2%, recorded in Hungary in 2014 (diagram no. 3, and ROA (return on assets) was -1.3% recorded in 2014 in the banking sector in Hungary and Romania, and in Croatia in 2015. (diagram no. 4)

Diagram no.3. Return on capital (ROE), 2012-2016



Source: the CEE Banking Sector Report, 2017

Diagram no.4. Return on assets (ROA), 2012-2016



Source: the CEE Banking Sector Report, 2017

The profitability of the banking sector has registered and continues to show significant heterogeneity among the countries of Europe due to the differences between banks 'and banking sectors' vulnerability to low interest rates as well as significant differences in the magnitude of non-performing loan stocks. Vulnerability to the low-interest environment depends on a number of factors, such as confidence in net income from interest, asset vulnerability to interest rates (the share of mortgages with variable rate), the share of financing deposits, further repayment of deposits, and market structure or degree of banking competition. (Financial Stability Review, Nov. 2016).

Conclusions

The transition from the centralized economy to the market economy involved an extensive privatization of state-owned banks with the help of banks with part or majority foreign capital. Under the impact of financial globalization and given the benefits of the presence of foreign capital in the banking sector for the host country, a number of foreign banks have expanded their activities across national borders by acquiring state-owned banks. With benefits for the host country - improving the efficiency of the banking sector through the contribution of technologies, products, performing services, financial infrastructure and profitability to banking, through the contribution of knowledge, know-how, accounting practices and experience in the whole range of banking operations and services , insurance, brokerage - foreign-owned banks hold a significant share of the banking market in Central and Eastern Europe, up to 90 percent of the total banking assets (Croatia, Romania, Hungary 2012-2013). Besides the benefits of the presence of foreign-owned banks, the banking sector in the former communist countries of Central and Eastern Europe is faced with a number of challenges, including the fear of foreign control in the allocation of host country loans, the creation of unbalanced competition between foreign and domestic banks and financial performance of foreign banks able to attract large corporations with high financial potential to the detriment of domestic banks, may affect the performances of

domestic banks with implications for financing the economy in the host country. The analysis of the bank performance registered in the banking sectors in Poland, Hungary, Romania, Croatia and Bulgaria, reveals a decline in capital and asset returns in the post-crisis period in all countries, regardless of the market share held by foreign banks, in terms of the number of foreign banks assets, assets held from the total assets reported at the banking sector level or banking concentration, which forms the opinion that banking performance depends on bank management, placement policies of parent banks and the macroeconomic context of the host country.

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