ICEG EC

International Center for Economic Growth
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THE EXPECTED EFFECTS OF THE EU ACCESSION ON THE BANKING SECTORS OF THE VISEGRÁD COUNTRIES

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1. Introduction

The purpose of this paper[1] is to summarize the expected effects of the EU enlargement on the banking sectors of the Visegrád countries, the Czech Republic, Hungary, Poland and Slovakia. It follows the structure of the four country specific studies prepared for the ICEG-AMCHAM conference on the same matter.

In the last decade the EU reshaped its financial markets with a gradual wave of liberalization and deregulation, destroying the last barriers ahead of cross-border capital and service flows. These efforts, with standardized financial regulations, led to a stronger international competition in the banking and financial sector with a pressure to gain effectiveness and lower costs.

Meanwhile the banking and financial sectors of Central and Eastern Europe were fighting to survive in the situation of economic transition and in an unfavorable macroeconomic situation. These factors forced development, diversification and modernization of services and an effort to gain cost-effectiveness. The only way to keep pace with the EU markets has been the acceptance of its liberalized standards.

The Spanish and the Portuguese examples show that the following, banking and financial sector related, factors are preconditions of a successful, shock-free accession:

- Restructuring and modernization of the banking and the financial sectors.
- Harmonization of the supervisory system.
- Developing the money and capital market infrastructure.
- Harmonized taxation.
- Harmonized legislation and law.

We can mention Italy as an example for problems arising in/from the banking sector in connection with joining the EU. The lack of fulfilled preconditions led to severe bank crises in the banking sector of Italy after its accession.

All of the Visegrád countries have already demolished the barriers ahead of capital-flows and we can assume that most of the prudential requirements are standardized to the EU ones, however there are still some further tasks to perform. The necessary deregulation and restructuring steps required by the EU have already been introduced and put into practice. So joining the Single Market will not bring any significant changes

[1] Summary of the Studies of the Banking Sector Section, AMCHAM-ICEG Conference on the Expected Effects of the EU Accession on the Visegrád Countries, March 20-21, 2003, Budapest

in the regulation of the financial intermediary systems of these countries. However, the changing regulation in the EU, the New Basle Accord, means constant tasks for the regulators in accordance with the harmonization.

The adoption of the (old) Basle Committee principles resulted in higher effectiveness and quickly growing banking sector in the EU. The growing competition led to narrower margins, with the need of income compensation on skilled and more effective workforce, and technological development with the seeking of new, cheap channels of distribution like Internet or telephone banking. These factors are present on the markets of Visegrád countries as well.

The Visegrád countries all eliminated the barriers faced by foreign banks entering local markets. The aim of this decision was to draw modern banking skills and competition to shake up the sector. Now a significant share of the banking system is in foreign hands, the high foreign ownership is one of the main characteristics of the banking sector of the Visegrád countries. The foreign parent institutes have brought tougher competition, layoffs, more effective employment and new services. The liberalization led to standardization, stronger competition and narrowing margins.

It can be stated that macroeconomic stability, especially low and stable inflation and stable currency, as well as the structural reform of the financial institutions and environment are inevitable for a successful liberalization.

The movements in the banking sectors of these four countries have been mirroring the European market as a result of harmonized regulation. The narrowing margins and growing competitiveness forced the European financial and banking sector to buyouts, mergers and acquisitions.

In the markets of Visegrád countries it meant a parallel activity with foreign privatization of the banking sectors. Foreign capital privatized and concentrated the sector at the same or almost at the same time. This privatization process is already over, so because of the high and growing competition any significant change in the ownership of this sector is not expected. New entrants are not likely to come, because of the competition, the high concentration and the high costs of building a new infrastructure and retail system. But none of these factors appeared in connection with privatization buyouts. Presently we can state that new mergers or acquisitions will happen only in the case of the same integration of parent banks on the European level.

In the EU the introduction of Euro started a new wave of mergers and acquisitions because of the eliminating foreign exchange risks, which made investment less risky. This projects that joining the EMU a few years later than the EU will probably result in further concentration of the market in the CCE and in the Visegrád countries. However, mainly EMU resident institutions own the banking sector of Visegrád countries so the further concentration should happen on the EU level. Therefore the effect of Euroisation of Visegrád countries will be less significant.

Presently the international competition does not effect directly the banking and financial sector of the Visegrád countries, however there is a pressure from the parent institutions which take part in the international contest on keeping being competitive, therefore they try to keep costs of subsidiaries down as well.

2. Characteristics and recent history of the Banking Sector of the Visegrád countries

During the last decade the banking systems of the Visegrád countries were completely restructured. As the first part of this process, after the economic and political transformation, we can say that almost a new, competitive, financial intermediary system had to be built because this existed only partially and sectorally in these countries.

The second major step came into the sight when the new direction of trade and the accession to the EU realized. This process has been a harmonization of the legal and regulatory framework to the EU standards and directives.

We can say that the following problems arouse generally in each Visegrád country during the transition:

- High percentage of bad loans.
- Lack of modern banking skills and well-trained workforce.
- For a while the state ownership was general leading to lack of effectiveness.
- Unfavorable and constantly changing macroeconomic situation.
- Lack of modern techniques.
- Weak regulation and supervision with no enforcing power.

Although the state ownership and control were ineffective, it was inevitable for a while because in the unfavorable macroeconomic environment the competition would have effected the banking sector and the whole economy badly.

These problems have been completely solved by the privatization process, which preferred foreign investment. It has brought competitiveness, technology, management skills, know-how from abroad.

At present the banking system does not play the same role in financing the economy in the Visegrád countries as in the EU. Although the assets to GDP ratio have been constantly rising during the last decade in the whole region, the level of magnetization is still low in these countries. So a rise in this ratio is highly acceptable as the example of Spain or other already joined countries shows. In real terms this process will speed up after adopting Euro.

3. Growth potential

The sector has got a high potential to growth because the depth of the financial intermediation is low all over the Visegrád countries. For instance in Hungary the total assets of the banking sector is only 68.2 per cent to the GDP, while the same measure is between 100 and 300 per cent in the EU countries. For all of the Visegrád countries the same measure is between 60 and 70 per cent. This relatively small size of the banking sector in the economy is partly explainable by the relatively less developed economy. This bears a high growth and convergence potential both in the banking sector and in the whole economy.

And because of the expected fast economic growth in these countries it is highly acceptable that the banking sector will grow dynamically as well.

The indebtedness of the households is very low in the Visegrád countries, while this number is between 40 and 130 per cent in the EU, in the Visegrád countries it is far behind the lower number bearing high potential of growth. It is already on the rise as the effect of lowering interest rates, smaller volatility of inflation and surging of cheap housing loans.

For instance the Czech banking sector has got a high growth potential whilst it possesses more deposits than credits. The surplus is mainly debited in foreign banks and it will mean a substantial opportunity for domestic creditors to raise demand when the interest rates will be on the decrease.

Contrary, in Hungary the aggregated volume of retail credits is already quickly growing resulting in a much higher speed of credit growth than the extension of debits. This process bears some risks because of the restructuring of the structure of assets, the debits of the commercial banks in the central bank are falling.

The EU accession is expected to cause convergence in the relatively low house and land prices. This will lead to further growth in the volume of mortgages and housing credits.

4. Effects on the banking system

After joining the EU the Visegrád countries will have to move towards the Euro-zone with adopting the EU rules on exchange rate regimes, monetary policy and rules of the Maastricht criteria. There is no way to opt out and it is more favorable to join the EMU as early as possible. This will lead hard efforts to achieve the convergence criteria. How will this type of harmonization effect the banking sector?

- Monetary stability, lower interest rates both on the short and on the long term.
- The credit rating will improve.
- Higher FDI-inflow will lead to accelerating growth.
- Whilst the ECB will coordinate the monetary policies the country specific political instabilities will have less effect on inflation.
- If this period is successful these countries will be members of EMU and users of the single currency with the following expected effects:
- the competition on the financial markets will be fuelled by the single currency. The capital will become cheaper because of the lack of exchange rate risks.
- Easier book-keeping for enterprises working on international markets.
- Easing cash-flow management and capital-borrowing.

Without exchange rate risks and country-specific risks wider opportunities will open for investors to diversify their portfolios.

Tougher competition, falling service-prices will enforce modernization and technological improvements.

On the Single Market the SMEs will lose risks of exchange rate movements and this means opening markets to Europe. This will accelerate the economy with a feedback on the banking sector.

Expanding investment market to the pension funds, which will be able to invest in the whole Euro-zone.

The above mentioned lower interest rates will lead to growing aggregated credit volume, especially in the retail and in the SME sector.

In Hungary the interest spread is very wide in the retail sector causing low demand for loans, however, the crediting of retail customers is already on the rise. We expect that not only in Hungary but everywhere in the region this gap will narrow because of strengthening competition. The accession bears in itself an interest rate decrease effect.

The Visegrád countries are planning to use credit registers on the retail sector similar to that is used in the EU. We expect that this will lead to decreasing risks providing friendly environment to crediting the retail sector.

Especially in the Czech Republic and in Poland, but it is true for Hungary and Slovakia as well, the crediting service is a financial source mainly for the corporate sector, and not for the SMEs. In the Czech Republic and in Poland the main but not the only problems with financing SMEs are the weak data and information gathering during the decision process, and the malfunctioning bankruptcy law. However, this situation is already changing. We except that the banking sector can become one the main financial sources for the SMEs in a relatively short time. This is generated by the growing competition that is forcing the banks to higher risk lending, to grant SMEs with loans for keeping up incomes. We know that it is worldwide general that the banking sector finances SMEs.

On the other hand, and on the medium run, we can imagine an other scenario as well. At the moment the private and the venture capital should be the most important financier of the SMEs. These enterprises are generally undercapitalized so the banking sector is not the most suitable solution for financing. But presently the non-banking financial sectors are underdeveloped in the area, partly an effect of the size of the markets that is too small for large companies to originate capital market transactions. They are financed by their parent companies in most of the cases.

Hopefully this situation will change with the accession as well, because there will be a wider access to capital markets, and after the EMU the currency risk will also be eliminated.

In Spain or Portugal the role of domestic financing quickly rose after having joined the EU. So a quickly strengthening non-banking financial sector might be able to play a significant role in financing SMEs besides the new income-seeking banking sector.

As it was mentioned above, there is a pressure to find cost effective distribution channels. The Internet and telephone banking are more and more widespread in the Visegrád countries in accordance with the slowing growth of the number of branches. Rising over-the-counter fees are to force customers to turn to the cheaper channels.

5. Foreign trade

In the 1990s the direction of the foreign trade of Visegrád countries turned to the developed countries especially to the EU. Now the EU is the most important trading partner of these countries. We can assume that both joining the EU and accession to the EMU will open more and more opportunities to the trade, although the competition will rise as well. In this process the banking sector will play a significant role, the cheaper and available more easily loans will help SMEs to background their new opportunities financially.

There will not be any significant improvements on the area of the already highly developed corporate financing.

Presently the exchange rate movements highly affect the trade opportunities of the Visegrád countries. We accept that with entering EU and trying to reach the Maastricht criteria will result in less volatile exchange rates with the effect of safer economic environment for trading companies. This point means lower risk in crediting SMEs and this will lead, in accordance with the new income-seeking in the banking sector, to the running up of SME-financing. The deepening foreign trade will generate growing demand for bank products. The income-structure of the bank sector will change. The growth of incomes in trade will counterbalance the income-decreasing effect of falling interest rates and the lost incomes from currency transformation.

6. The effects of accession on FDI flows

The highest FDI inflow comes from the EU, and it is accepted to accelerate with entering the Single Market, however, speculative capital will lose motivation with the single currency. Some reforms are on the way to help and motivate foreign investment like regulatory reforms or infrastructure modernization. Factors which draw capital are under constant improvement but there are some underdeveloped areas in every Visegrád country which are needed further improvement.

In the past decade the modernization and improvement of the banking and partly the financial sector was backed by the help of foreign capital with the aim to bring skills, capital, technology from abroad. Now the foreign ownership is determining the banking sectors of these four countries. Foreign, mostly strategic, investors own well over than the half of the total equities of the banking sector in all of the Visegrád countries. There is no expected significant change in the ownership structure, although there might be some attempts to gain higher percentage in the already existing ownership with the aim of having stronger control.

Maybe the next excepted change will raise more interest. With entering the single market foreign owners will have the opportunity to transform their subsidiaries into branches. With this step these banks will be able to provide more credits on the base of their parent banks' assets, and that makes easier to fit to the Basle criteria.

However, there are other ways to follow as well. For instance in Poland if a parent institute does not convert its Polish bank institute into a branch, the subsidiary will have the right of priority over the other creditors in bankruptcy proceedings under the Polish Bankruptcy Act.

7. Labour

The banking sector was one of the areas where the employment was badly affected during the transition period in all of the Visegrád countries. The previous state ownership and control generated inefficient bank industry with a waste quantity of unskilled labor.

With the growing pressure on competition and with inflowing foreign capital, the workforce in the sector suffered painful layoffs. In the improving macroeconomic situation the interest rates were falling and in most of the times the only way to gain cost efficiency was to lay off inefficient workforce.

Meanwhile, the need for skilled workforce and management was increasing and now this is one of the best paid areas in the Visegrád countries, that means that the prosperity of the remained workforce have improved. The average wage level is just little higher in the Visegrád countries than one third of the EU levels. Therefore we expect a quick rise in wages. However, wages in the banking sector are well above the average level so in this sector the accession will have weaker pressure on prices and this means moderately rising operating costs without a pressure on laying off workforce.

The university education of banking management has constantly been improving. The high level of mobility of the management spheres facilitates quick spreading of the modern banking skills since a good deal of the managers spend some time abroad at the parent institutes.

In the future we expect no further significant reduction in the banking sector, general layoffs are not likely. However, it is still possible that some of the bank institutes will audit the efficiency of their workforce and this bears the possibility of dismissing some of the employed. In the sector of co-operative banks liquidations and bankruptcies are possible because of the inability to deliver some indexes regulated by the EU, for instance the rule on minimal capital. Although there is a more possible scenario:

mergers and acquisitions of co-operative banks, with no layoffs. For example in Poland this process has already started. Co-operative banks are under derogation until 2008, and this fact marginalizes the possibility of bankruptcies and strengthens the possibility of mergers and acquisitions.

It is clear that seeking of cheap distribution channels will not lead to staff reductions in a short time because the number of branches is still on a slowly growing track. And what will the seeking of cheaper channels cause on the long run? Who knows? The only thing that we can state is that if there are any changes, they will happen in accordance with the same course in the EU.

After all we can state that there will not be any negative impact on the employment, however, the banking labour will find that the need for skills will grow.

8. The effects of the EU accession on the regulatory framework

Adaptation of the acquis had started well before the beginning of the joining negotiations and the most important steps of harmonization had already been finished successfully by that time.

This process had a great impact on the one-way development of the banking sector of the Visegrád countries. Two main principles were the most important areas of the harmonization:

- Freeness of services
- Harmonized monetary policy, independent central bank, free floating,

The tools to constrain the unwanted movements of the exchange rate are the open market operations.

The other main amendment on the regulatory framework was the reform and harmonization of the payment system.

The accession will not affect the regulatory frameworks since the harmonization is already over, and only some smaller changes are still on the way, for instance harmonization of statistics in Poland, but these works will be finished by the accession in most of the cases.

However, the Maastricht criteria and the convergence criteria will have some effects. Without the opportunity of opting out EMU and with the need of being a member as early as possible each joining country will early adapt the ERM 2 system with a 30 per cent wide exchange rate band and a fully harmonized exchange rate mechanism.

What kind of direct steps must be taken on the regulatory framework in connection with the banking systems? What is the background of the necessary amendments?

Defining the necessary steps towards fully liberalized capital flows. In fact we can state that there are no serious lags in the practice of the Visegrád countries.

Technological preparation to operation in the Single Market**.**

Analyzing the competitiveness: will the banking sector be able to keep up in the competition of the Single Market? The institutional infrastructure must be optimalized to the Single Market. Monitoring profitability can highlight problems.

Analyzing the expected effects of the single currency.

The regulation in the banking sector is completely standard with those in the EU but there are still some problems with regulations of other financial areas which were somehow neglected during the 'regulatory competition'. In the Czech Republic the supervisory bodies have not got the same regulatory and enforcement power in every sector. This situation indicates changes. The cooperation among supervisory bodies has to be strengthened both at the national and international levels.

9. The effects of accession on the market structures

In the EU it is general that the banking sector is highly concentrated. In most of the member countries the five largest banks own the 'bigger half' of the market. This situation is also true for the Visegrád countries, especially after an expectedly continuing wave of M&As.

The structure of the financial markets of the Visegrád countries has been assimilating to those in the EU. The assimilation has been determinant since the beginning of the transition of these economies. Strengthening competition, consolidation and tough fights for the market shares are the main characteristics.

In the latter half of the 1990s a consolidation process started in the whole region. Unfortunately this process bears the risks of cost oligopoly situation in some segments of the market. We can find the causes of consolidation in the high foreign ownership:

Mergers and acquisitions of parent institutes draw the same events between their subsidiaries.

As mentioned above the accession will lead to transforming foreign owned banks into branches.

So the accession to the EU will lead to further consolidation, but what kind of effects will the EMU membership bear?

Introduction of the single currency makes creditors able to use the opportunities supplied by the market more efficiently, even with trans-border transactions. We can expect a strengthening course that an increasing number of banks and other financial institutes will turn to the foreign markets to borrow capital. If the domestic interest rates are still higher at the moment of adoption Euro, the vanishing exchange rate risk will force the banking and financial sector to borrow capital in the foreign markets. This will have the effect of quickly falling interest rates.

How will the accession cause further concentration in connection with competitiveness?

As mentioned above the banking sector is forced to further technological development. Larger banks can pay the costs of these developments more easily because these are more effective when more customers use the system.

Larger banks are able to improve cost efficiency even in the area of labour costs and the operational costs.

The opening possibilities of cross-border services are exploited by larger banks more easily.

We have not studied the FDI outflows yet, however, for instance in Poland it looks to be stronger and stronger in the banking sector as a sign of a further strengthening after joining the EU. On the other hand, this process will strengthen but it is not expected to be significant in the short term.

10. Summary

The regulations of the banking sectors in the Visegrád countries are almost fully compatible with the EU directives and regulations so there is no need for significant changes. However, new tasks always arise especially with issuing new regulations in the EU. The New Basle Accord will become part of the acquis as a new Directive.

To remain competitive the banks of the Visegrád countries have to sustain some additional costs on the areas of:

- IT infrastructure
- Improving databases
- Staff training
- Risk measurement and management

However, in the previous years we experienced high expenditures on the side of IT and technical improvement but the general level of technological equipment is still far behind the EU level. Therefore further investments are needed on the area of IT and general technology.

As previous examples of accession show that countries with less developed banking and financial sector and weak macroeconomic positions had to face difficulties after accession. The harmonization of the legislation and modernization of the financial services prior to the accession can solve difficulties. If the banking and financial system is more developed at the moment of accession the free capital flows will bear more benefits.

To become more competitive on the Single Market the broad macroeconomic stability is an inevitable precondition. With unstable macroeconomic indexes previously accessing countries like Spain or Greece could not show as fast growth as it would have been possible otherwise. We think that this widely known fact enforces the pre-accession countries to apply the required measures to fulfill the Maastricht and the convergence criteria with the aim of smooth integration.

We can assume that some institutional problems have not been solved yet in the Visegrád countries, like the less developed and effective financial supervisory system in some of the countries.

Less developed money and capital infrastructure is a general and outstanding problem. The deregulation, full liberalization of money and capital markets, and the overwhelming modernization must be completed prior to the accession.

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