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The development of financial systems in the CEE countries

Institute for Business Development

Warsaw, 2010

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Agenda

- **Financial systems of the CEE countries under communism regime**

- **Financial systems of the CEE countries in the early transition period**

- **Current shape of the CEE financial systems**

- **Recent changes in the CEE financial systems**

Motivation

- Economists hold startlingly different views about the impact of finance on long-run economic growth?
  - Finance promotes growth (Hamilton-Schmupeter):
    - *„banks are the happiest engines that ever were invented for creating economic growth“*
  - Finance hurts growth (Adams):
    - *„banks have done more harm to the mortality, tranquility, and even wealth of this nation than they have done or ever will do good“*
  - Finance follows growth (Robinson)
  - Finance doesn‘t matter (Solow growth accounting):
    - *„growth is mainly due to technological progress, leaving little role for finance“*
  - Finance matters (World Development Report, 1989)
    - *“countries with better-developed financial markets and banking sectors tend to grow faster” (Rosseau and Watchel, 1998; Beck et al., 2001)*

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1. Initial conditions in the CEE countries
Nature of the communist financial system

a) These extensive controls co-existed with an overgrown communist welfare state, which included:

- relatively large transfers in kind (education, health)
- social protection delivered via state-owned enterprises (SOEs)
- artificially low prices for foodstuffs, energy and housing rents
- social safety net, typical of some market economies did not exist as the need for it was sharply limited through of individuals‘ opportunities and risks

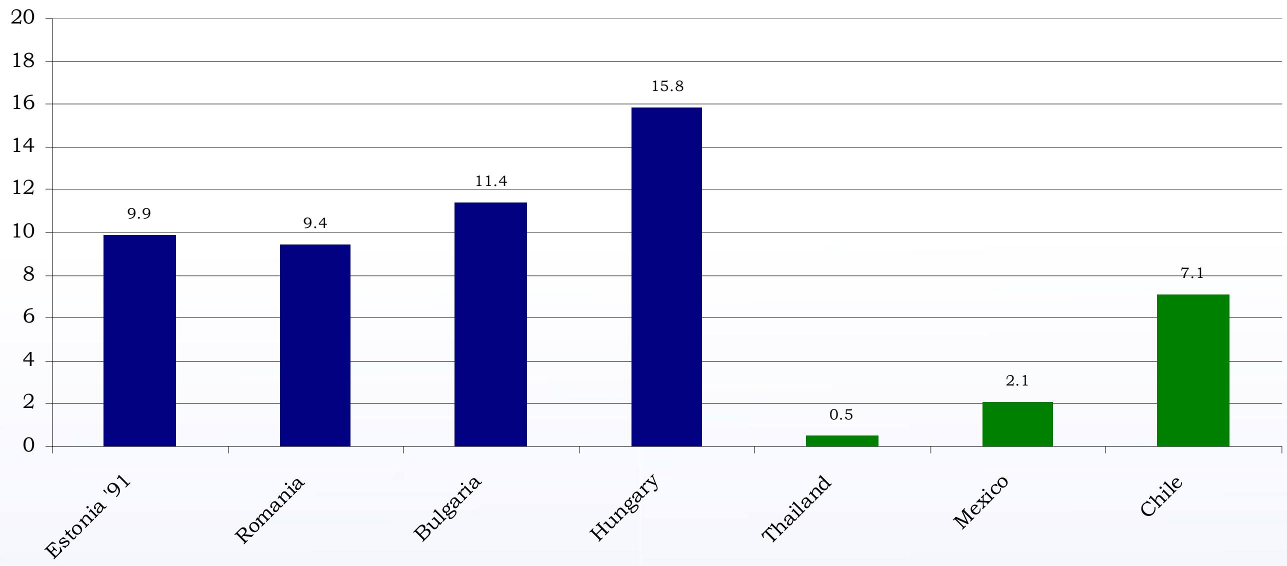
b) The communist state was peculiar with respect to the provision of public goods:

- defense expenditures were excessive and shaped by imperal aspiration of the ruling elittes
- law and order were kept at reasonable level, however, at the cost of practices typical of a police state
- the legal framework and the juridical system crimialised private economic activity and independent political activity, and were till suited to the market economy, rule of law and free society

1. In various other aspects, the communist countries differed from one another. However, when taken together and compared to market economies, especially the developing ones, they showed:

Public expenditure on social security and welfare, 1989 (% of GDP)

- much higher ratio of public expenditure on social security and welfare to GDP



*** Public expenditure on social security and welfare shows compensation for loss of income to the sick and temporarily disabled, payments to the elderly, the permanently disabled, and the unemployed; family, maternity, and child allowances; and the cost of welfare services, such as care of the aged, the disabled, and children.***

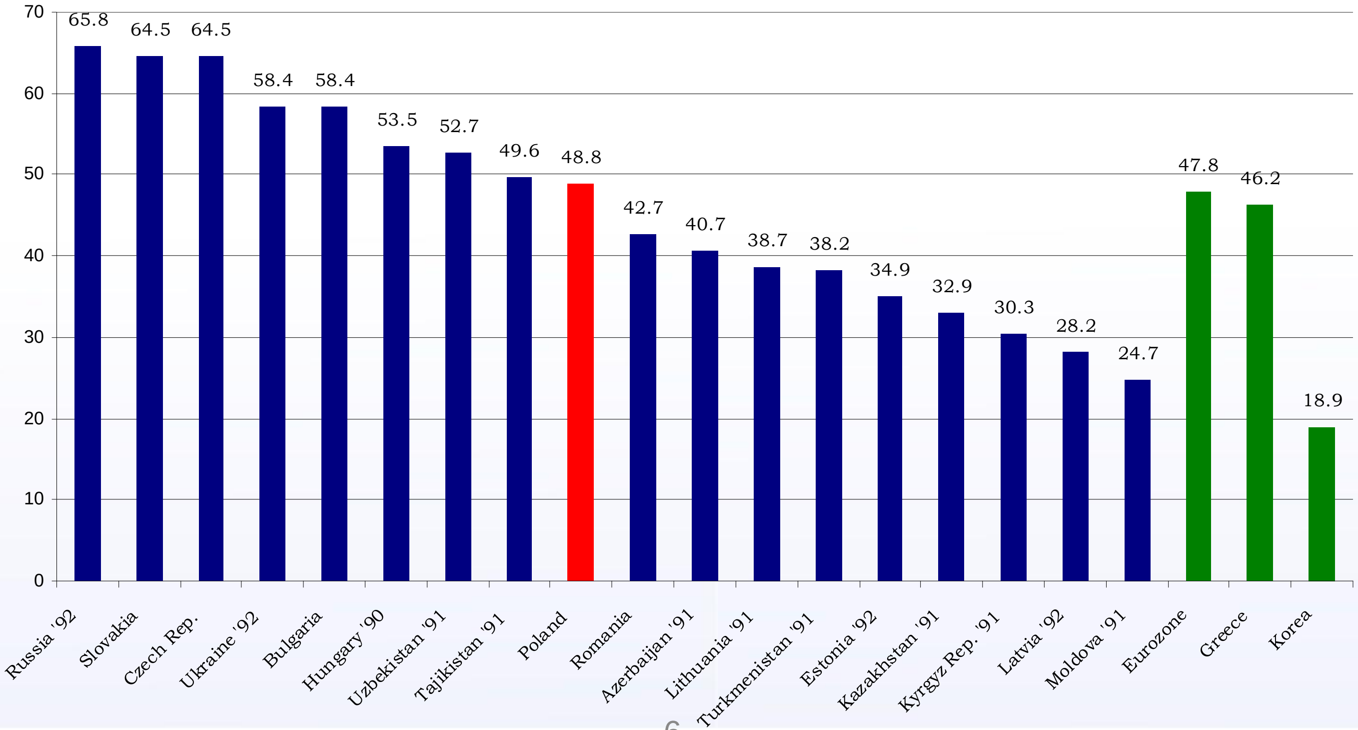
This category approximates social transfers with the exclusion of transfers on education and health.

Source: World Bank, World Development Indicators 2003

1. In various other aspects, the communist countries differed from one another. However, when taken together and compared to market economies, especially the developing ones, they showed:

General government expenditure, 1989 (% of GDP)

- much higher ratio of general government expenditure to GDP



Source: EBRD Transition Reports, OECD Economic Outlook 73

1. Initial conditions in the CEE countries
Nature of the communist financial system

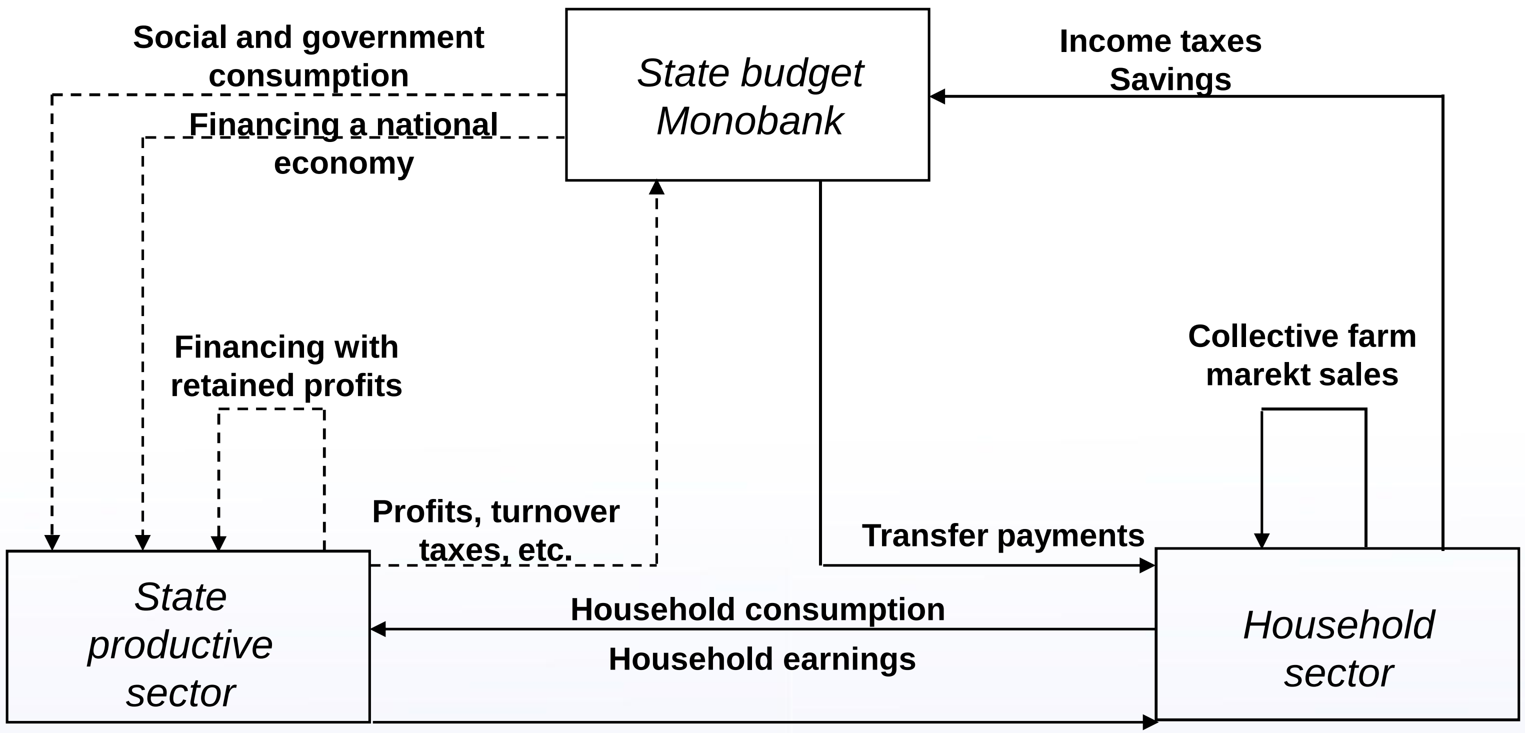
c) In all the communist countries, there existed a monobank system.

- a monobank system was a combination of central bank and monopolicy commercial bank which was simultaneously a financial advisor, the treasurer, the cashier and the auditor of every enterprise.
- the monobank had no counterpart in a market economy, and its role can be only understood in the conext of a CPE
- even it played a role of a central bank, the acitivities of the monobank were different from central bank in a market economy.

- *„ the (Monobank) is an administrative, not a policy making institution. Its function was to ensure compliance with targets set by planning authorities, and it did not set policy in its own right. It was not a „bank of banks“ as found in a market economy. However, with its monopoly position in providing credit to the productive sector, it was a bank of enterprises.“*

1. Initial conditions in the CEE countries
Nature of the communist financial system

Monetary Flows in a Centrally Planned Economy



-------- Payments through bank accounts (enterprise money circut)
——— Cash payments (private money circut)

Source: Haitani (1986), „Comperative Economic Systems:Organisational and Managerial Prespectives“

2. Intial conditions in the CEE countries The situation of the banking sector in the early transition period

- As a consequence of the political changes in the year of 1989 and breakup of the communism era, a creation of an effective financial system was a priority for the new governments in the CEE countries.
- The appriopriate reforms were necessary and their scope included:
    - privatisation of the large and medium-sized enterprises
    - establishment and enforcement of a market-oriented legal system and accompanying institutions
    - labour market regulations
    - institutions related to public unemployment and retirement system
    - restructuring and creating of the banking sectors and appriopriate regulatory infrastructure
- the aim was to implement a market-oriented economy

→ hence, the banking industry was one of the first economic sectors, which underwent a fundamental transformation

2. Initial conditions in the CEE countries The situation of the banking sector in the early transition period

- In most post-communist countries, the transition from a planned economy into a market economy underwent similar:
  - creating the two-tier system and seperating the central and commercial bank activities from national banks
  - national banks were pursuing the monetary policy, including the exachange rate policy and made responsible for the supervision of the banking system
  - the second tier consisted of the specialized, newly created commercial banks and a few of foreign banks
  - the leader was Slovenia (then the part of Yugoslavia) – reforms already in 1971 even before the political changes occured
  - Hungary in 1987
  - Estonia and Poland in 1989
  - Czechoslovakia, Lithuania and Latvia in 1990

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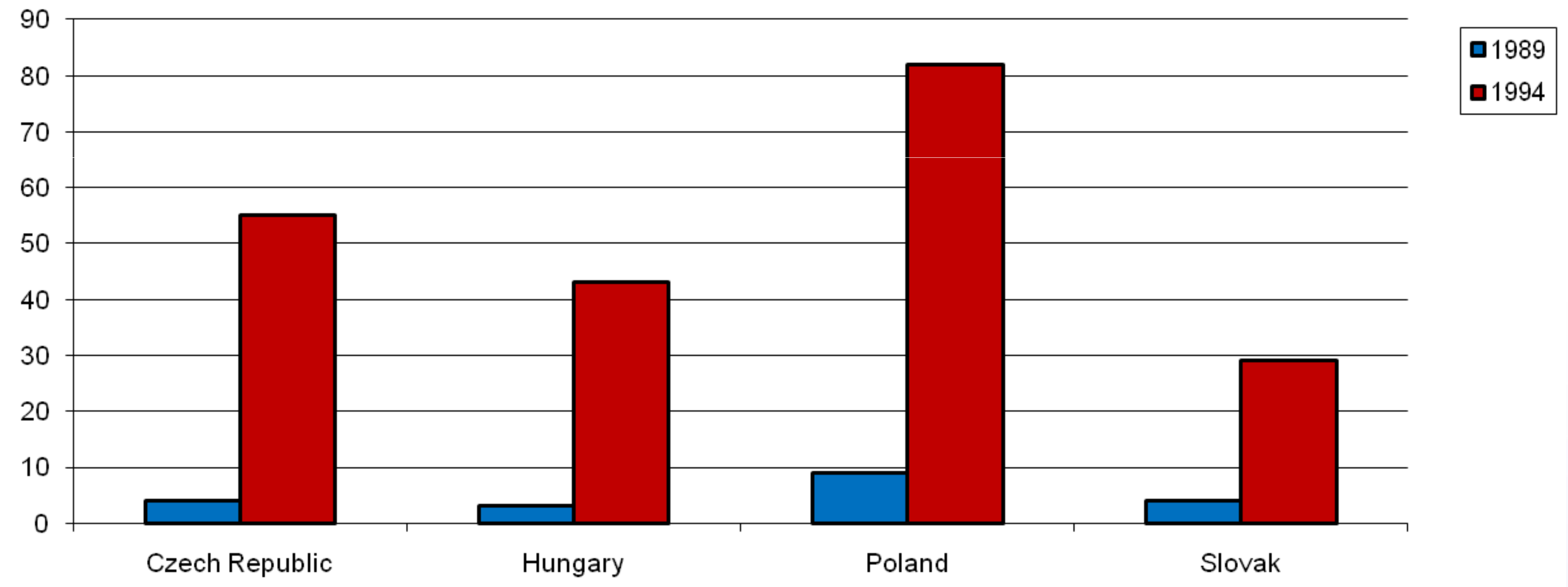
2. Initial conditions in the CEE countries
The situation of the banking sector in the early transition period

- In most post-communist countries, the transition from a planned economy into a market-economy underwent similar:
  - the commercial and retail operations were divested from activity of national banks and transferred to new commercial banks
  - in Hungary – the government set up three new state-owned banks from National Bank of Hungary
  - in Poland - nine banks were created out of the National Bank of Poland
  - in Czechoslovakia – four banks were created
  - these banks supplemented other specialty banks: agriculture banks, foreign trade banks, savings banks

2. Initial conditions in the CEE countries As a result, the number of commercial banks increased significantly in a very short time

Number of commercial banks



Source: National Banks

2. Initial conditions in the CEE countries

First foreign banks that entered the CEE countries…

- At the beginning of the transition all banks entered as *de nova* operations.

Poland

- (1991) ABN·AMRO
- (1991) citibank
- (1991) ING
- (1991) SOCIETE GENERALE
- (1991) Raiffeisen BANK
- (1991) Bank Austria Creditanstalt
- (1994) BNP PARIBAS + Dresdner Bank Die Beraterbank

Hungary

- (1990) Bank Austria Creditanstalt
- (1993) COMMERZBANK
- (1987) Raiffeisen BANK
- (1991) ING
- (1987) citibank
- BNP PARIBAS + Dresdner Bank Die Beraterbank (1991)

Czech Republic

- (1992) COMMERZBANK
- (1993) ABN·AMRO
- (1993) ING
- (1991) SOCIETE GENERALE
- (1991) citibank
- (1991) Bank Austria Creditanstalt
- (1992) Dresdner Bank Die Beraterbank

Slovak

- (1993) ING
- (1995) citibank
- (1994) Bank Austria Creditanstalt

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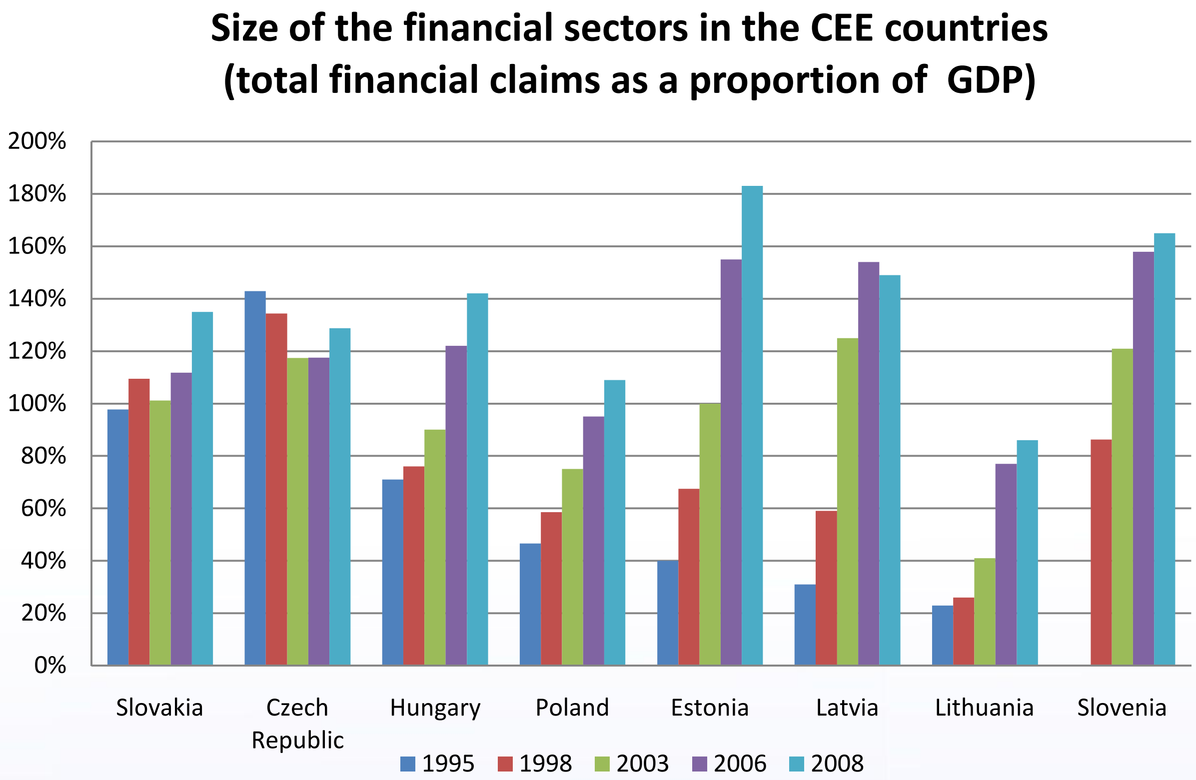
3. Financial sector in the CEE countries



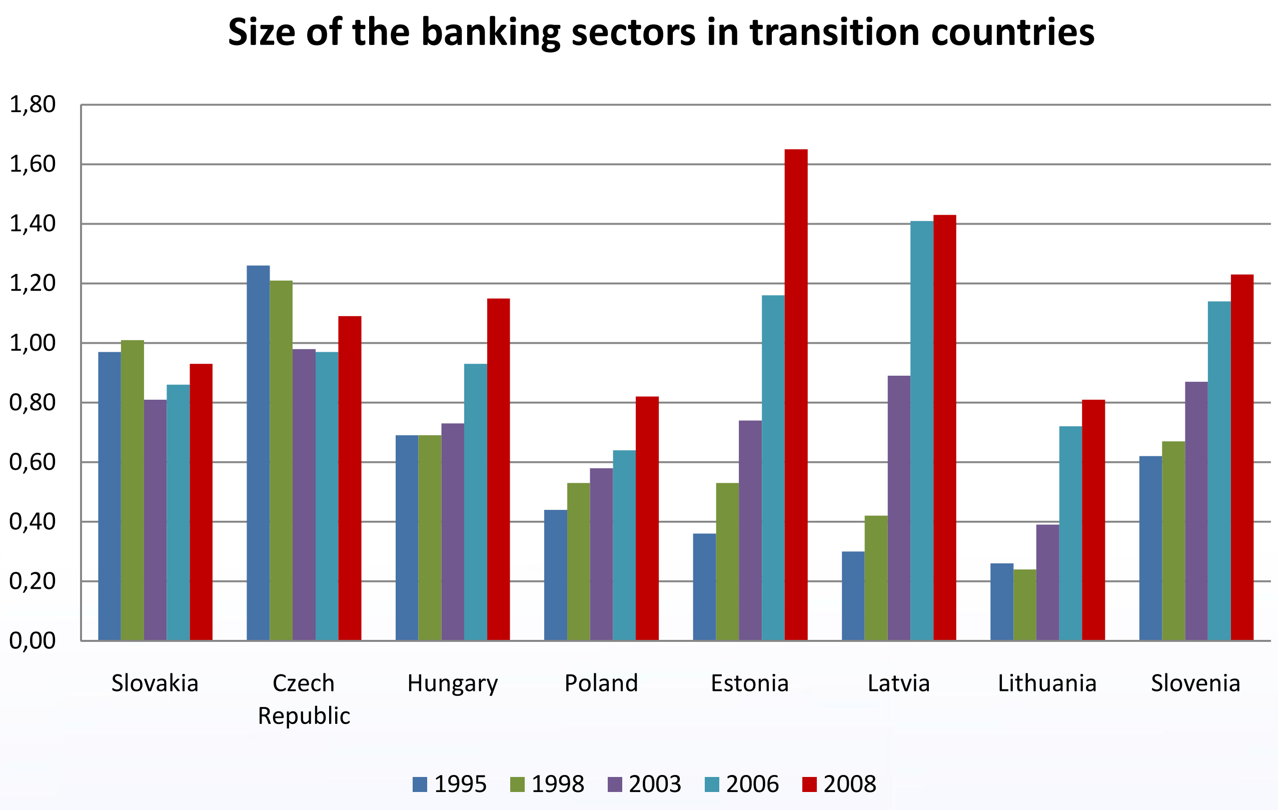
- Overall size of the financial sectors has grown sharply over time in all CEE countries since the beginning of the transition.

- The average ratio of the total financial assets to GDP has risen from around 65 per cent of GDP in 1995 to 1,38 in 2008 on average.

- Slovania has managed to develop the deepest financial sector among the transition couties, whereas Poland the lowest one.

- The Baltic States have experienced the most remarkable development among all transition countries.

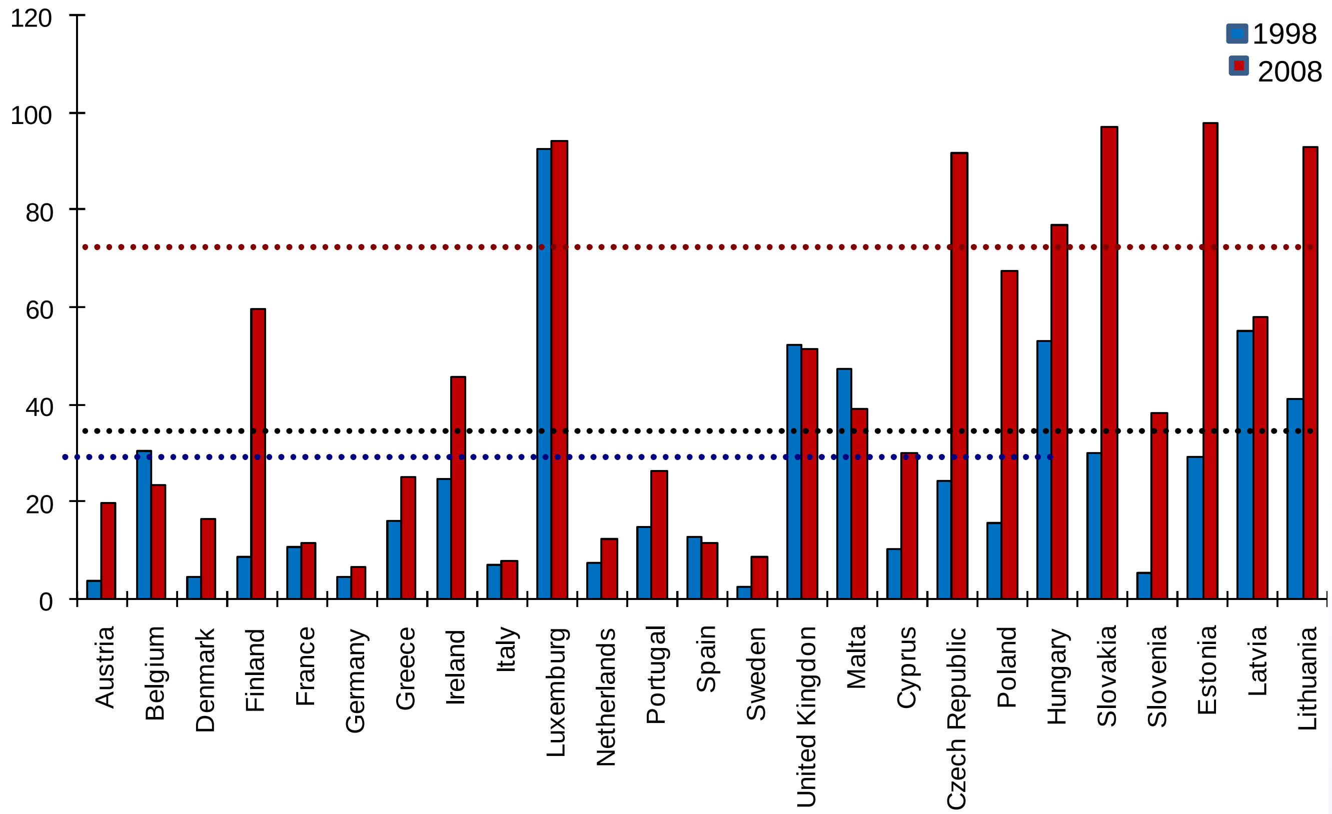
4. Banking sector in the CEE countries



- Overall size of the banking sectors has grown sharply over time in all CEE countries since the beginning of the transition.

- The most remarkable development occured in the Baltic States.

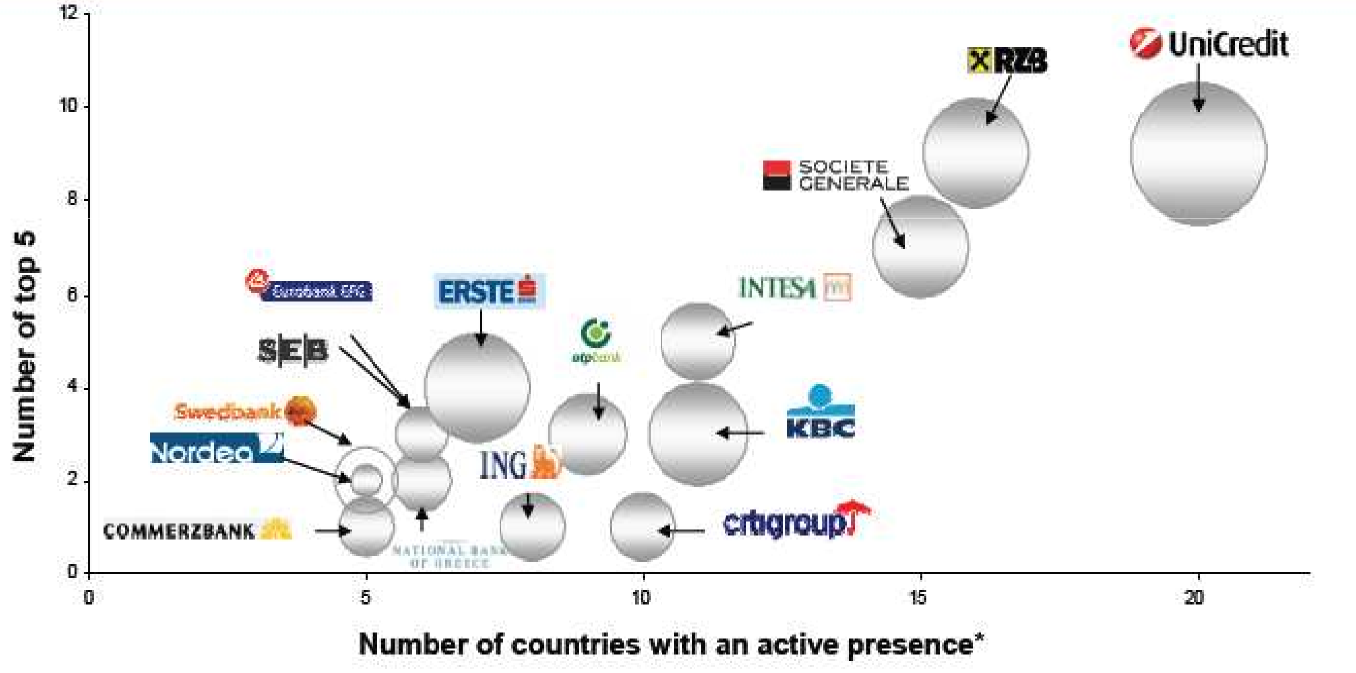
4. Banking sector in the CEE countries



- The foreign ownership assets is high in Luxemburg, Finland and United Kingdon, while low in Germany, France or Italy.
- In developing countries, the foreign banking ownership is high in Slovakia, Czech Republic and Lithua-nia, while significantly lower in Cyprus or Slovenia.

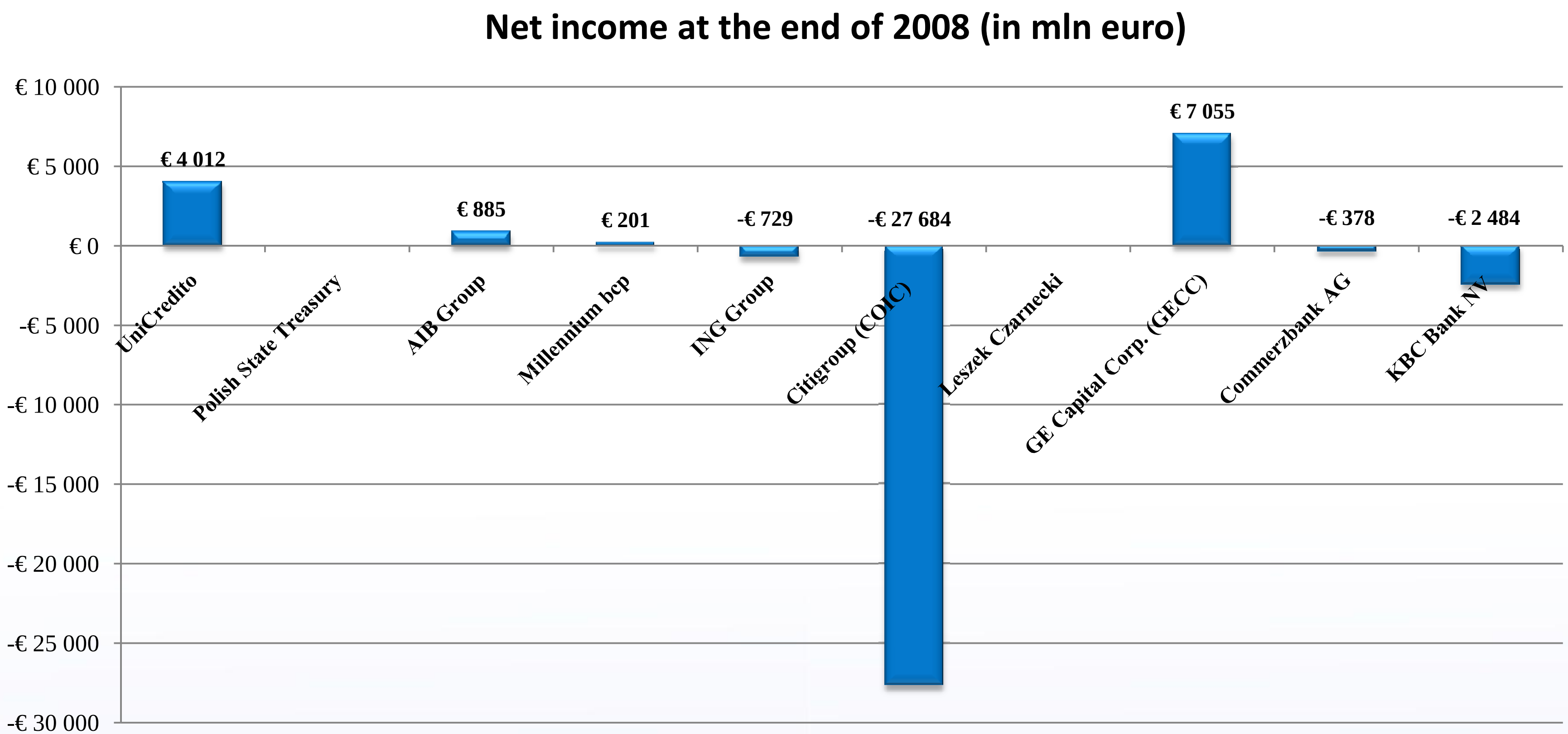
4. Banking sector in the CEE countries

International players' strategic positioning in CEE
(country of operation and size in each market, size = total assets controlled in the region)**



Source: UniCredit Group (*) Inclduding both direct and indirect presence, while excluding representative offfices (**) data as of end 2008

4. Banking sector in the CEE countries



In the past the fact of being controlled/owned by a foreign financial institution could provide some competitive advantages for a Polish subsidiary. Suffering reputation caused by home markets' problems negatively affects the ability of Polish subsidiaries to collect new deposits.

Source: Company data and Bankier.pl Research

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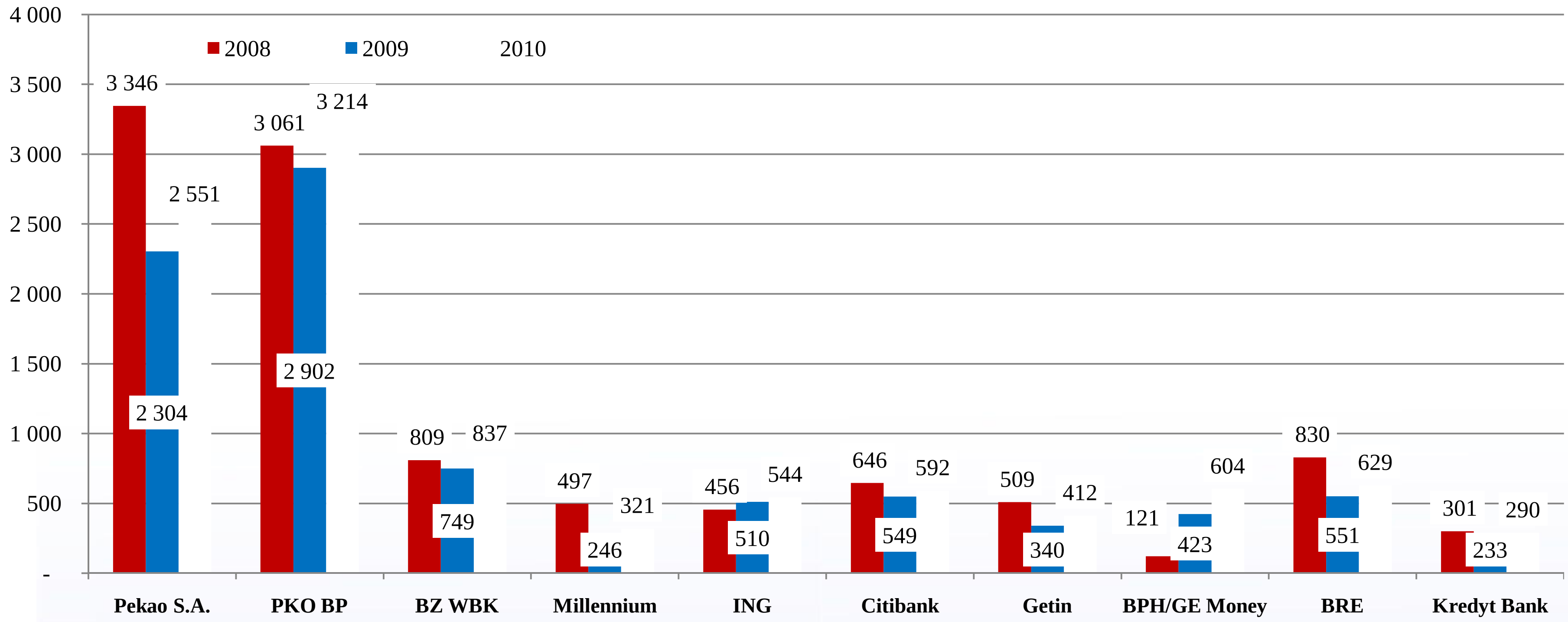
4. Banking sector in the CEE countries

Net income for the peer banks 2008-2010F (in mln PLN)



The banks 2009-2010 earnings will be under threat if volumes slow down more than we expect (+5% YoY for loans, +5% YoY for deposits). We expect the upcoming results to be rather weak as the crisis adversely affected loan origination, deposit pricing, funding costs and especially the cost of risk during the period.

Source: Company data and UniCredit analysis estimation, 2008

4. Banking sector in the CEE countries

Top Tier Polish Banks

Subsidiary bank	Parent	Share	Divestment likelihood
Pekao	UniCredito Italiano	59.3%	Low
PKO BP	Polish State Treasury	51.2%	Very Low
BZ WBK	AIB Group	70.5%	Very High
Millennium	Millennium bcp	65.5%	High
ING	ING Group	75.0%	Low
Citibank	Citigroup (COIC)	75.0%	High
Getin Holding	Leszek Czarnecki	55.5%	Very High
BPH/GE Money	GE Capital Corp. (GECC)	65.9%	Moderate
BRE	Commerzbank	69.8%	Moderate
Kredyt Bank	KBC Bank	80.0%	Moderate

The majority of banks are controlled by foreign shareholders, yet we expect a change in the ownership structure in 2009. According to Deloitte (2009) the banking sector could witness up to eight takeovers amongst its top twenty largest banks. The likely candidates are those banks with parent companies facing liquidity problems, and, or those struggling on the Polish market. Already since 2008 Getin Bank's founder is rumored to be in search for an adequate buyer for his bank for several months already. Also AIB Group may sell its 75% stake in BZ WBK, which has a market value of €1,3 billion.

Source: Company data and Bankier.pl Research

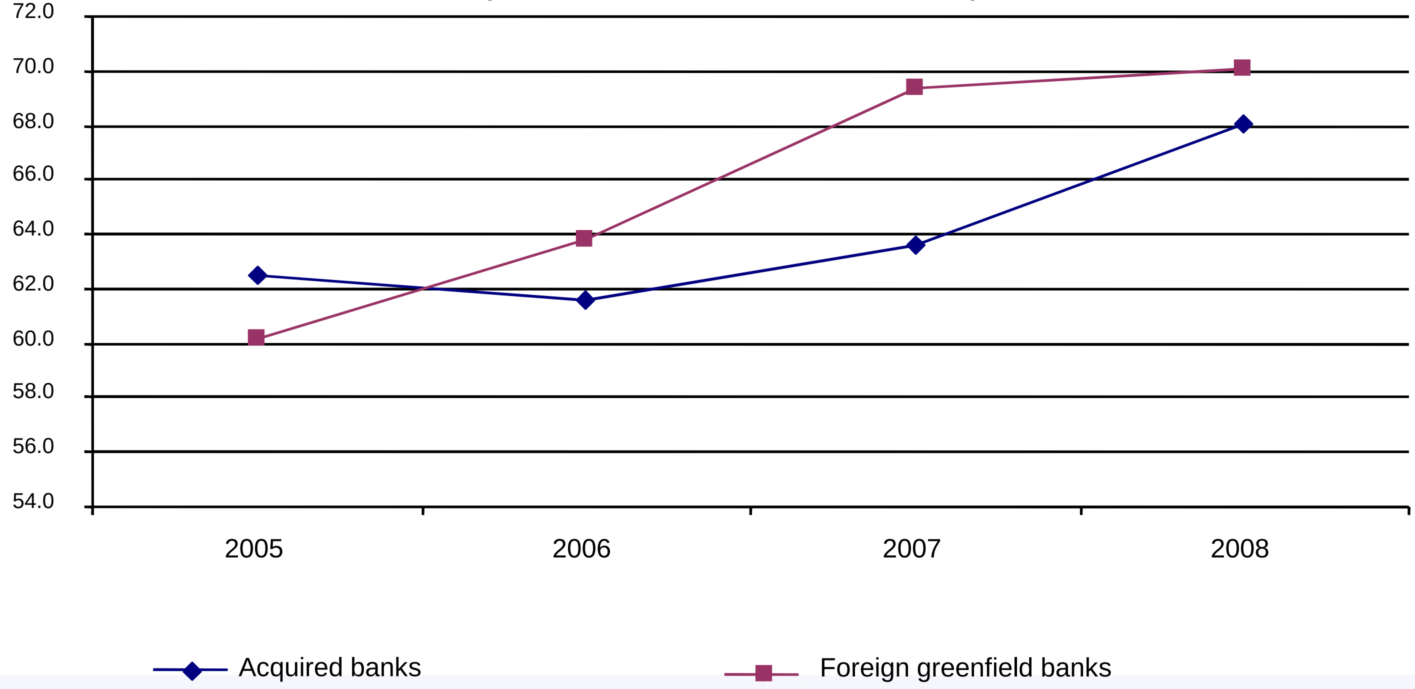
4. Positive effects of foreign banks' participation in transition countries

- Evidences on:
  - Financing obstacles lower in countries with high levels of foreign bank penetration (Demigrüc-Kunt , 2008)
  - Strong evidence that even small enterprises benefit and no evidence they are harmed by foreign banks (Clarke et al., 2002; Berger et al., 2001)
  - Higher competition and better efficiency of the domestic banking sector (Claessens et al., 2001; Clarke et al., 1999; Sullivan, 2003)
  - Greater stability of the financial systems (Demigrüc-Kunt et al., 1998, Levine, 1999; Barth, 2001)
- Latin America study:
  - Foreign banks with small local presence do not appear to lend much to small businesses
  - But large foreign banks in many cases surpass large domestic banks

4. Positive effects of foreign banks' participation in the CEE countries

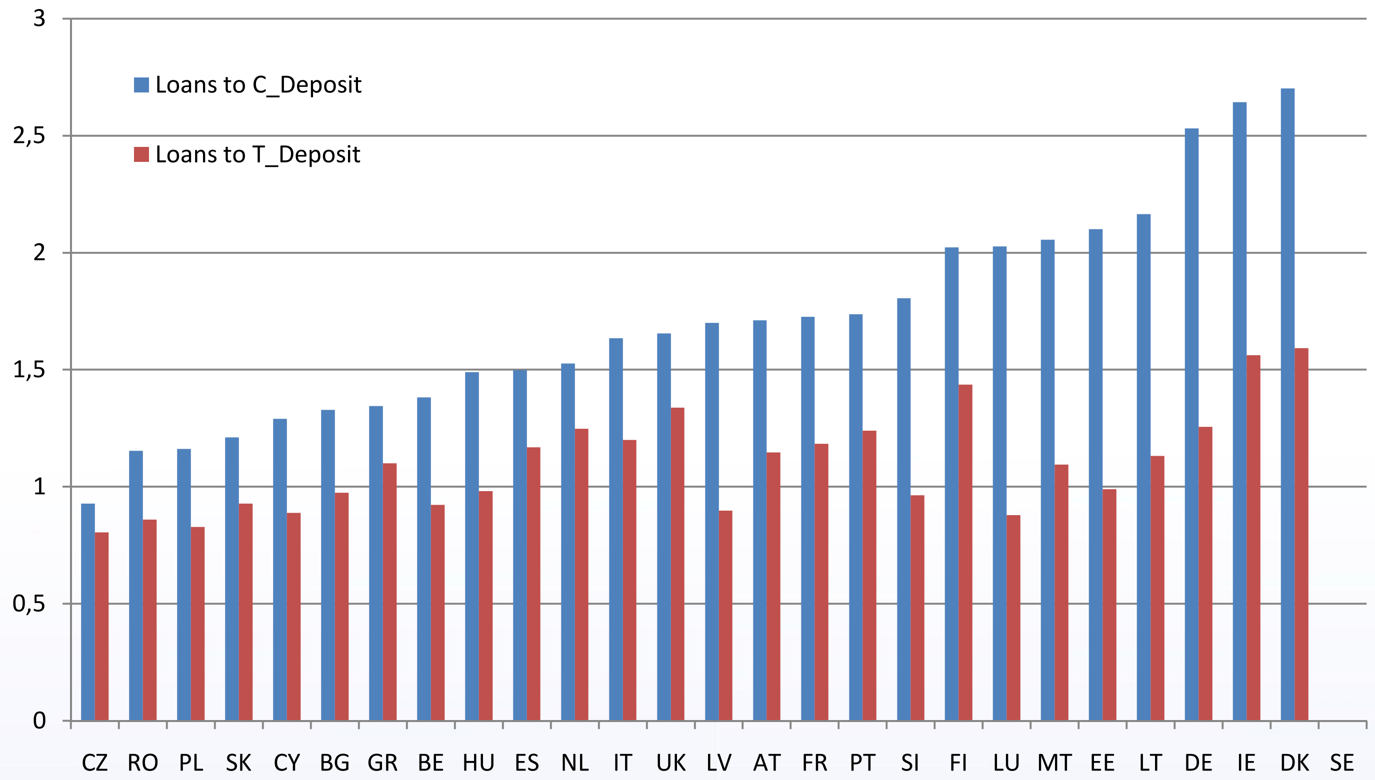
Net loans to assets by entry modes of foreign banks

(The average of seven European emerging countries: Poland, Hungary, Czech Republic, Slovakia, Latvia, Lithuania, Estonia)



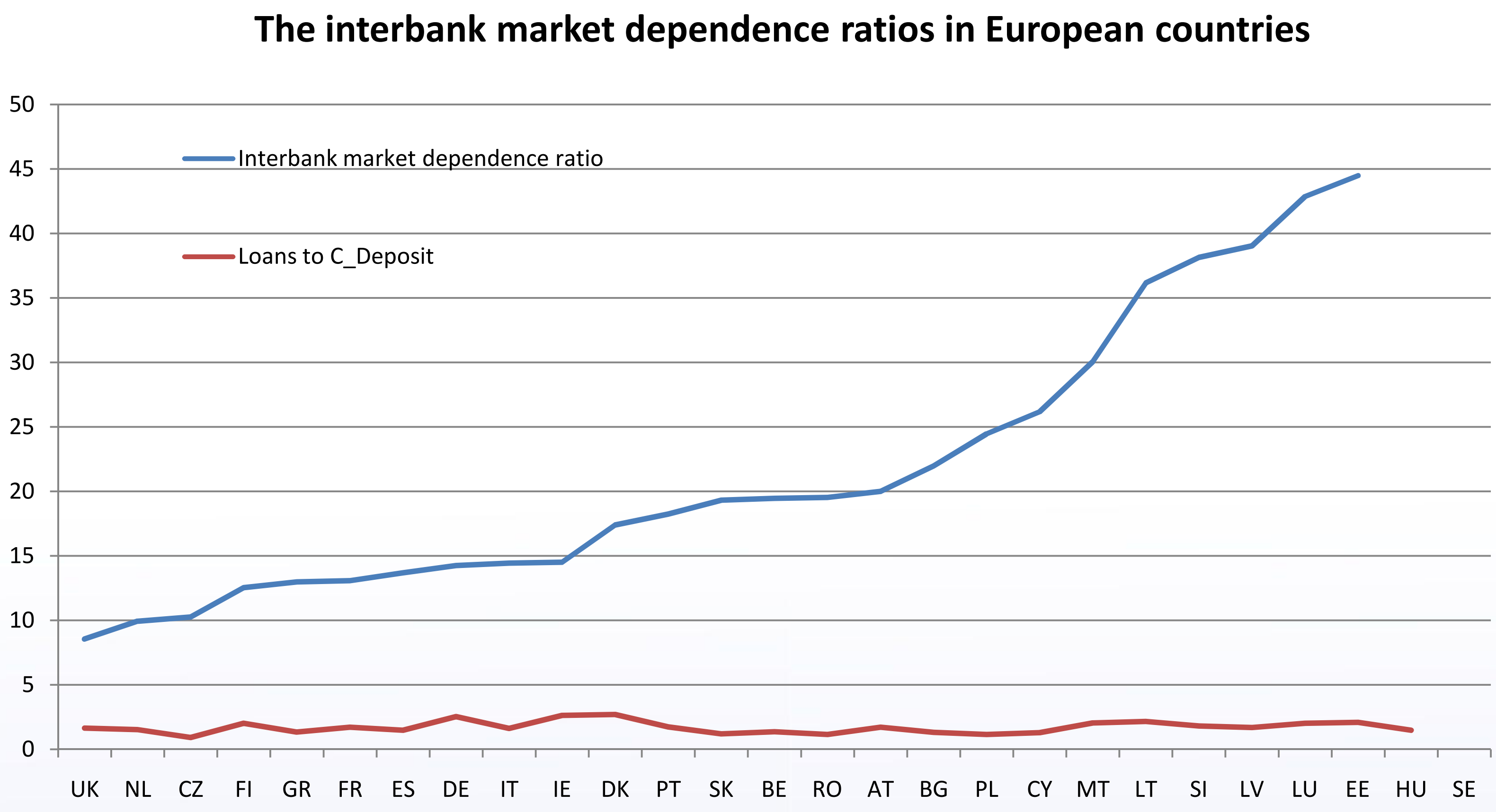
4. Negative effects of foreign banks' participation

Loans to deposits ratios in European countries



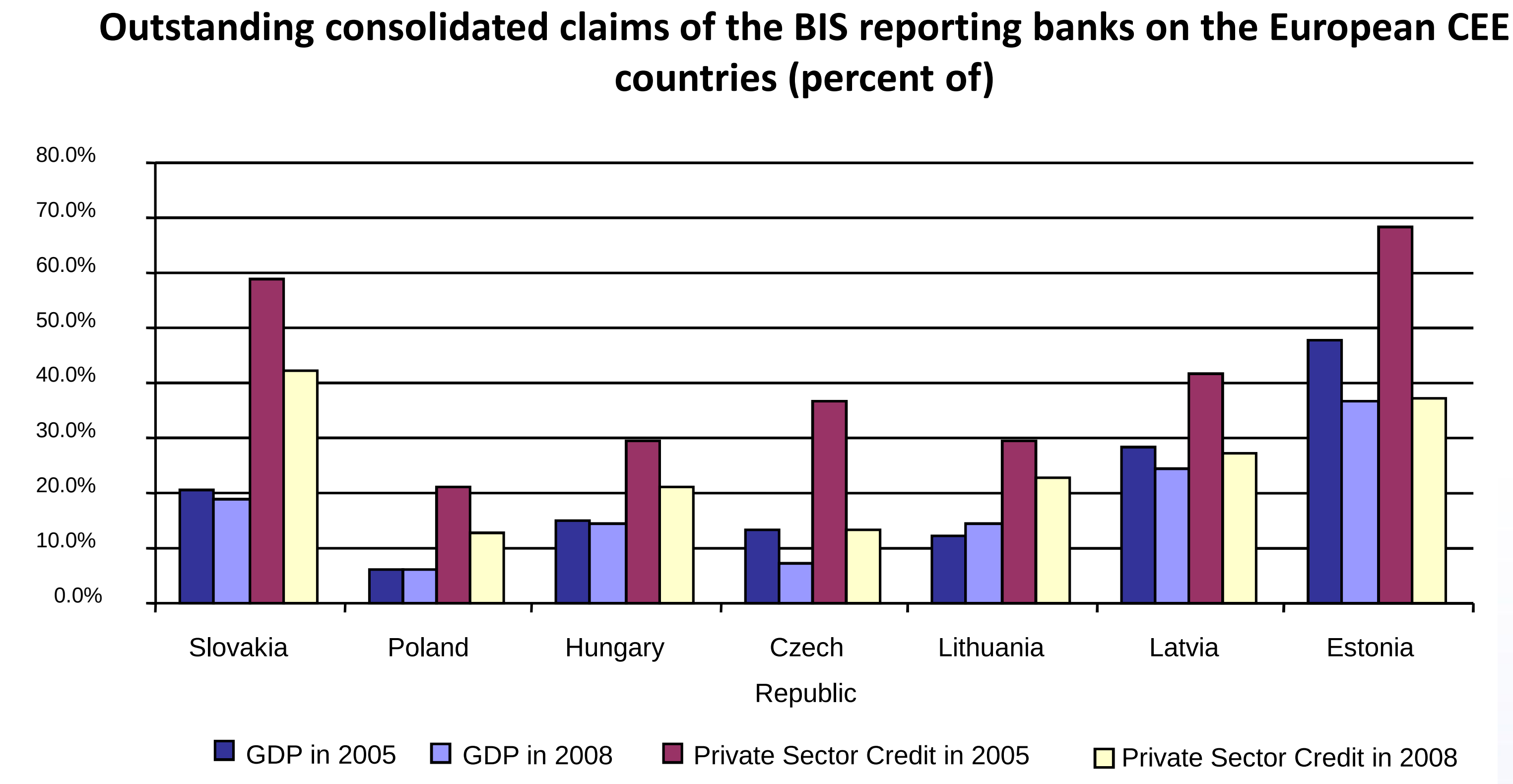
The higher the ratio loans to deposit, the more the bank is relying on borrowed funds, which are generally more riskier and costly

4. Negative effects of foreign banks' participation



The interbank market dependence ratio is defined as the ratio of deposits from credit institutions to total assets.

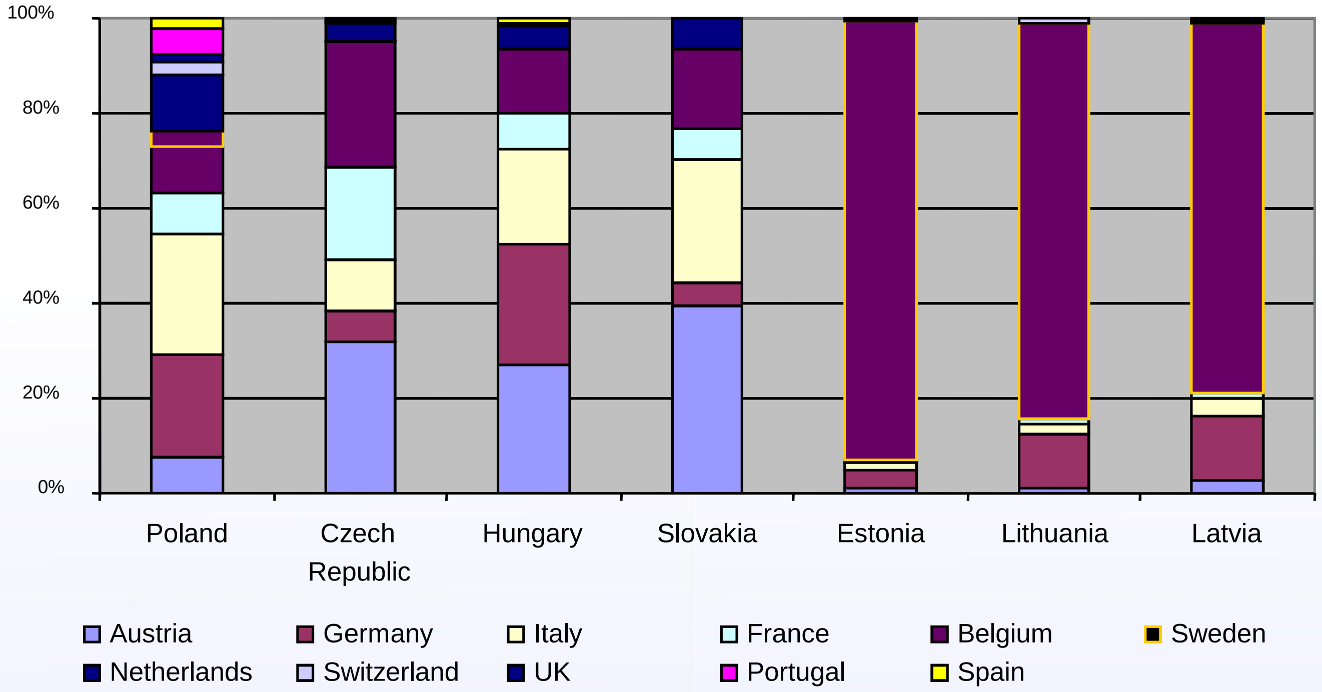
4. Negative effects of foreign banks' participation



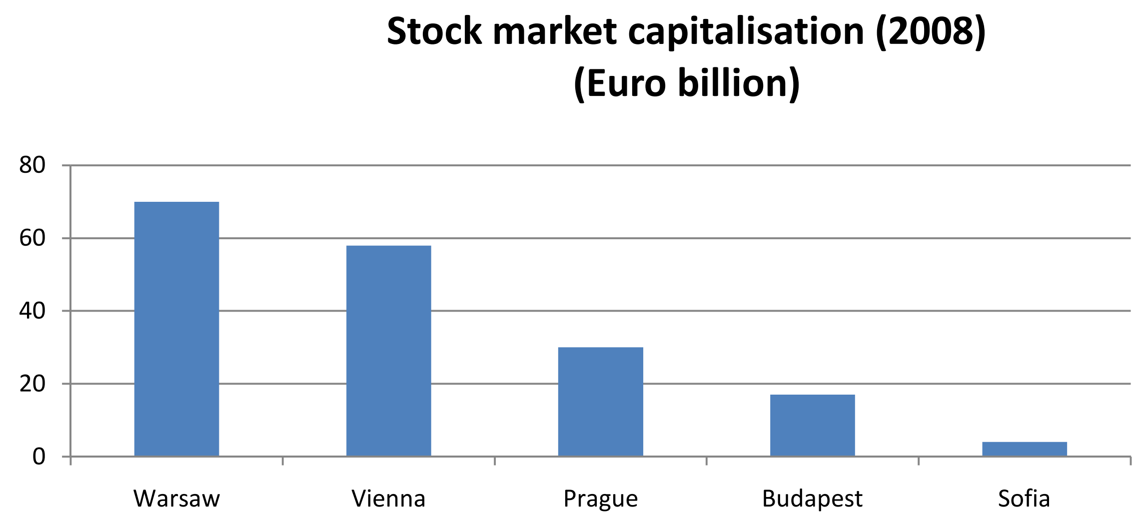
4. Negative effects of foreign banks' participation

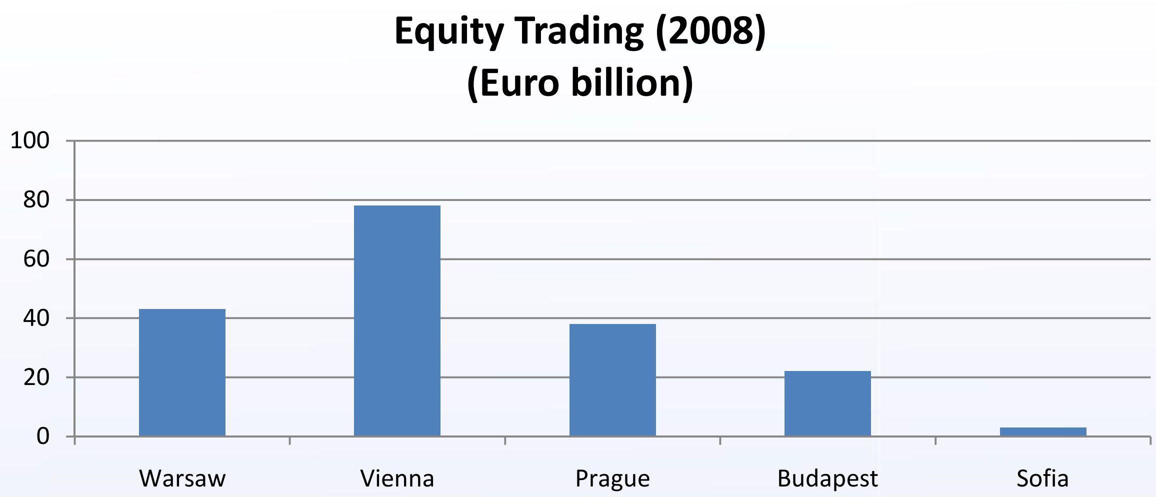
Concentration of Funding Dependence of CEE banks on BIS reporting banks in Western Europe, end 2008

Foreign claims owed by a CEE country to a Western European countries' banks as a share of the CEE country's GDP (in percent to)



5. Capital markets in the CEE countries



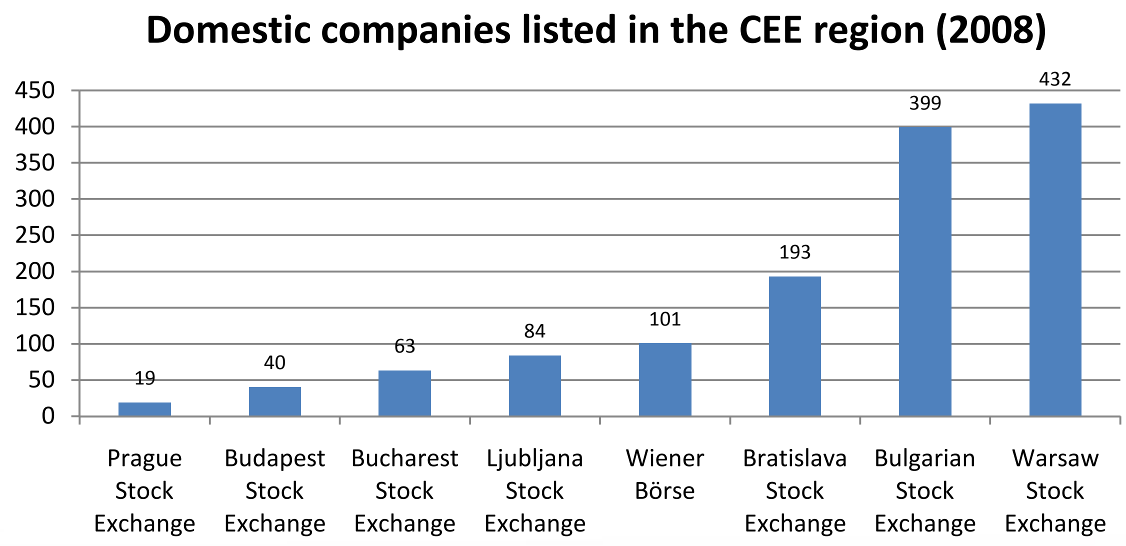


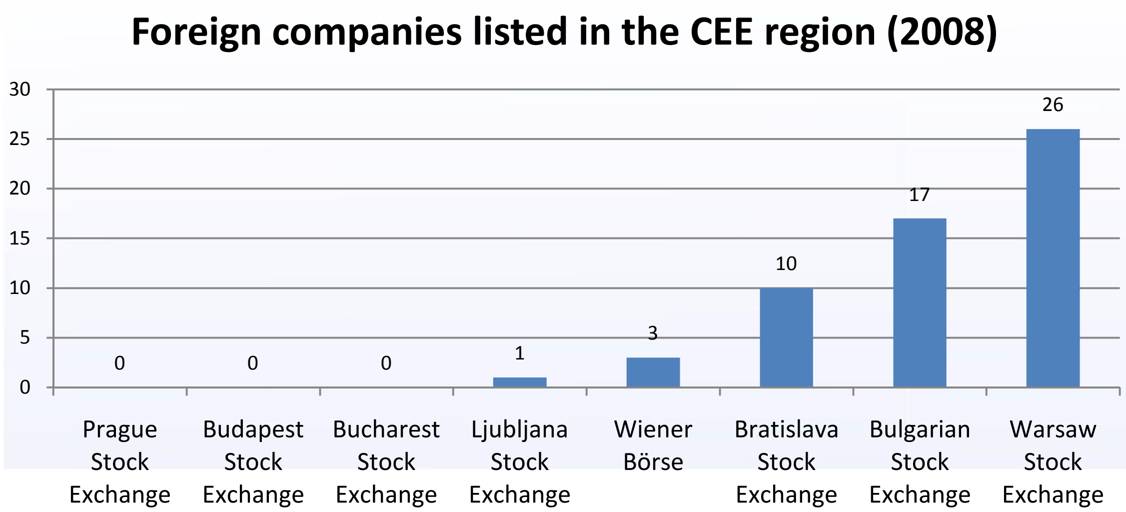
WSE no. 1 in market capitalisation in CEE at the end of 2008 year

WSE no. 1 in equity trading in the region in November and December 2008

and no. 2 in value of turnover for 2008 year

5. Capital markets in the CEE countries





WSE no. 1 in market capitalisation in CEE at the end of 2008 year

and no. 1 in number of listed companies and in number of newly-listed companies

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5. Capital markets in the CEE countries

No.	Exchange	No. of IPOs	Value of IPOs (EUR m.)
1	London	99	8 884
2	**Warsaw**	**94**	**2 502**
3	NYSE-Euronext	65	2 501
4	OMX	26	208
5	Luxembourg	20	314
6	Oslo	13	63
7	Deutsche Boerse	12	330
8	Borsa Italiana	6	129
9	Switzerland	6	424
10	Madrid (BME)	1	292
11	Ireland (ISE)	1	-
12	Wiener Boerse	-	-
13	Athens	-	-

One of the most active IPO markets in Europe in recent years with high number and value of IPOs

WSE no. 1 in terms of numbers IPOs in 4Q 2008

Source: PWC; 2008 data

5. Capital markets in the CEE countries

WSE versus European Markets Index Futures

No.	Exchange	2008 turnover volume (units)
1	EUREX	**511 748 928**
2	Liffe NYSE Euronext	**106 099 616**
3	OMX	**39 304 636**
4	WSE	**11 769 730**
5	SPAIN	**10 575 717**
6	NORWAY	**8 945 538**
7	ITALY	**7 283 666**
8	HUNGARY	**3 603 367**
9	GREECE	**2 832 157**
10	AUSTRIA	**238 851**
11	CZECH REPUBLIC	**3 841**

WSE one of the most active derivatives markets in Europe

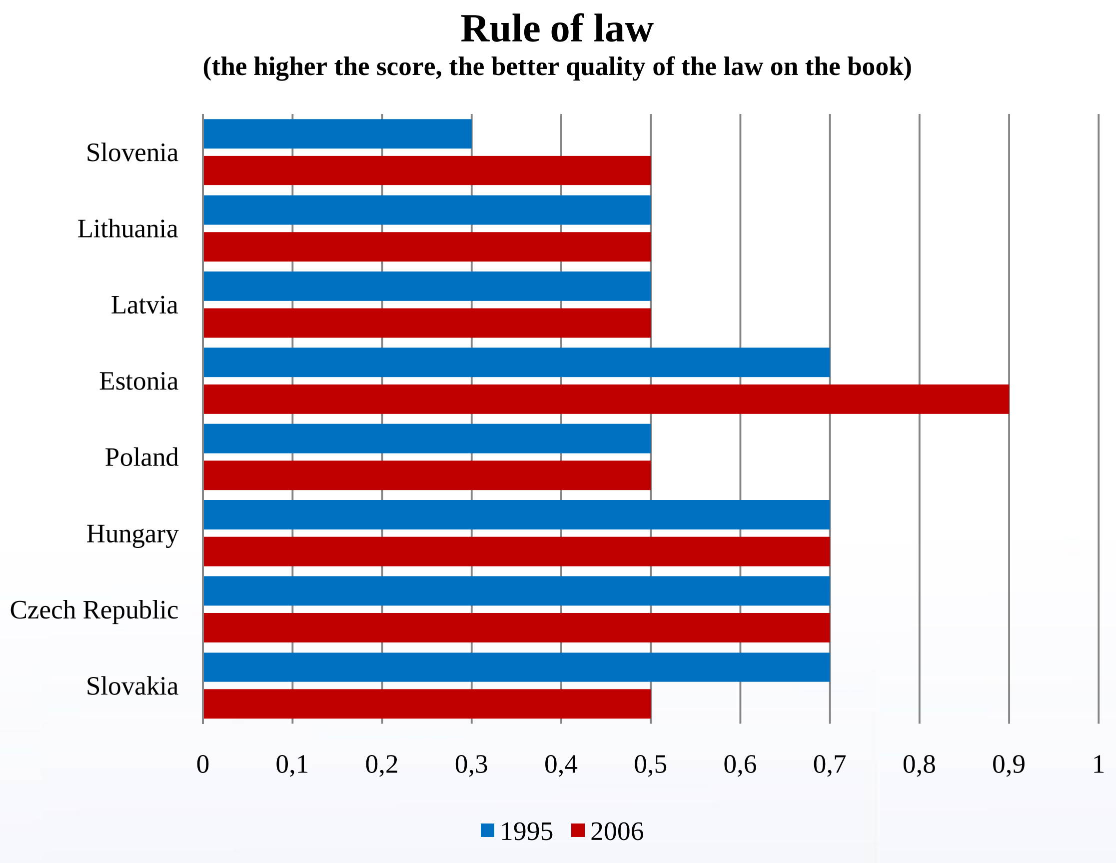
Turnover on Futures Contracts on Particular European Indices – Top 15 Contracts

No.	Exchange	Index	2008 turnover volume (units)
1	EUREX	DJ E STOXX 50	**432 298 342**
2	Life NYSE Euronext	CAC 40	**49 242 000**
3	EUREX	DAX	**49 237 082**
4	Liffe NYSE Euronext	FTSE 100	**42 314 080**
5	OMX	OMXS30	**38 445 687**
6	EUREX	SMI	**17 658 178**
7	Liffe NYSE Euronext	AEX	**12 477 916**
8	**WSE**	**WIG20**	**11 743 240**
9	NORWAY	OBX	**9 195 919**
10	SPAIN	IBEX 35	**7 275 299**

WIG20 index futures no. 8 top index contract in Europe

Source: Internet sites of the exchanges

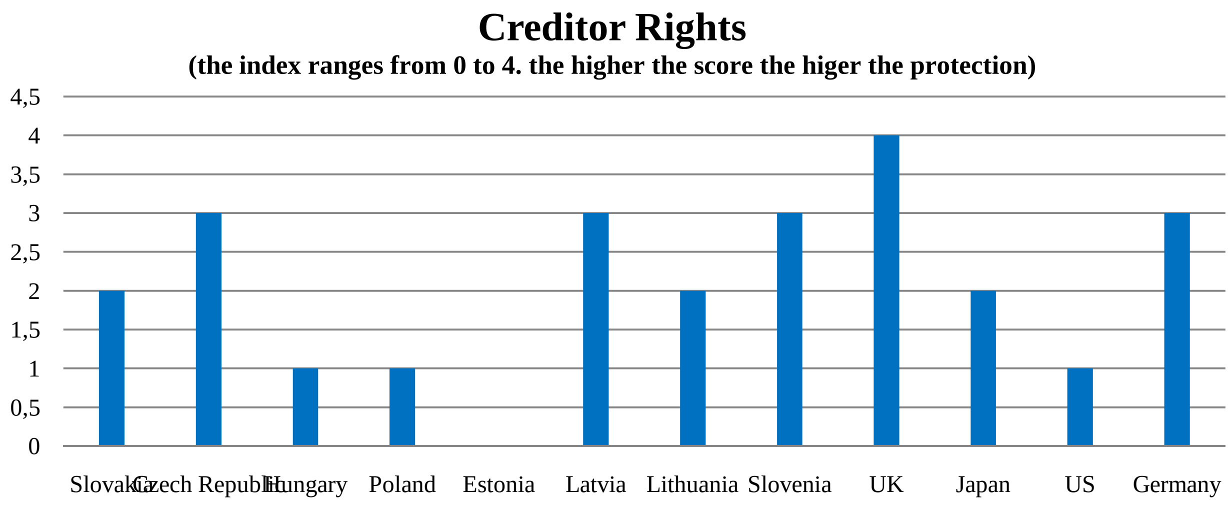
6. Regulatory environment in the CEE countries

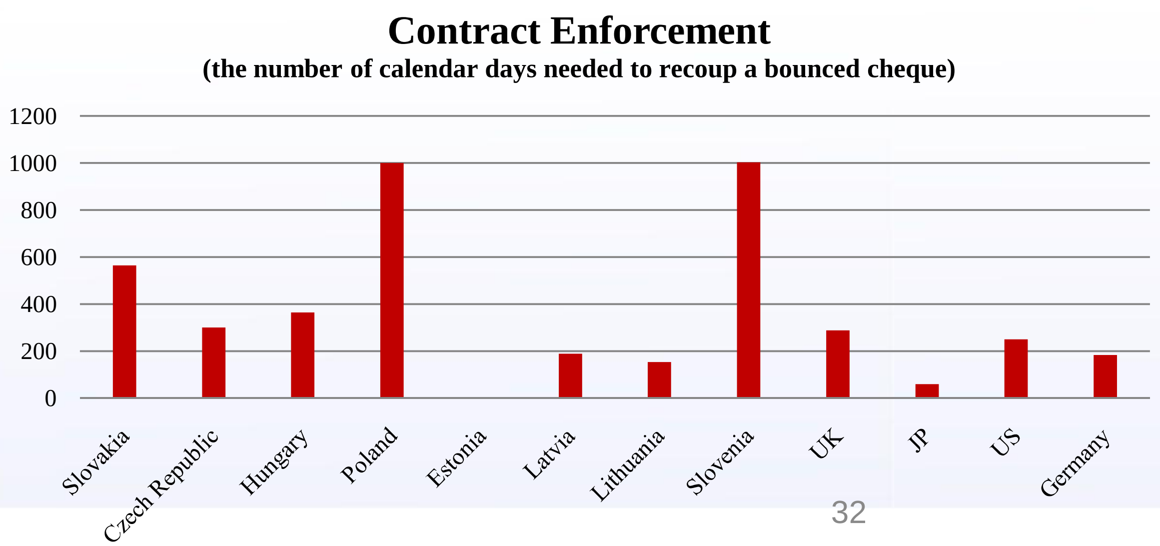


- Most of the CEE countries have reformed their regulatory environment significantly.
- However, the regulatory structure differs among the CEE countries significantly.
- Some of the CEE countries have their „law on the books“ better developed than some Western economies.

Source: EBRD

6. Regulatory environment in the CEE countries

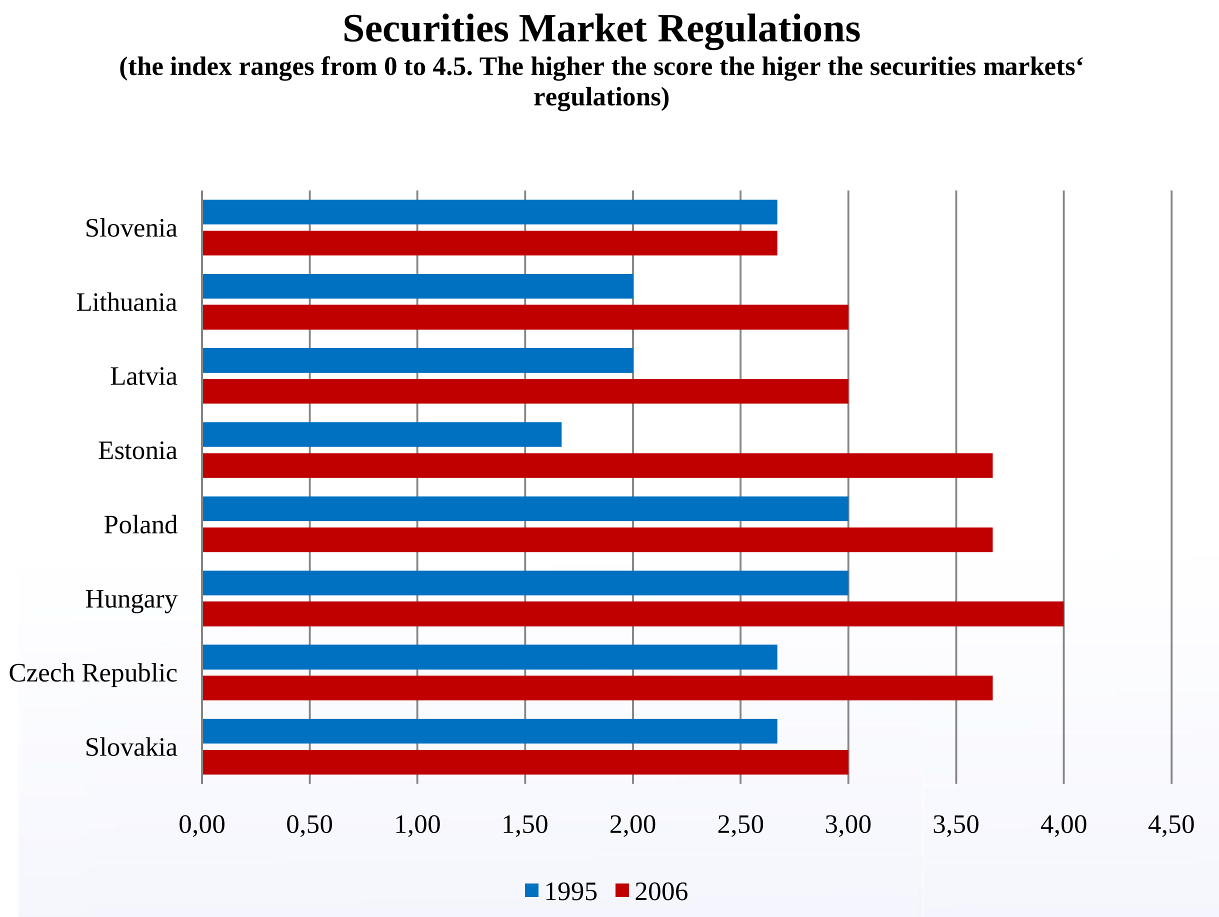




- There are signifiant differences among the CEE countries with respect to their regulatory structure.
- While Czech Republic, Latvia and Slovania have high level of creditor protection, Poland and Hungary have the lowest one.
- On average, the new accession countries show higher level of creditor protection than the EU-15 countries (Allen et al., 2006).
- However, the law enforcement is still very weak and costly for these countries

Source: Djankov et al., 2006

6. Regulatory environment in the CEE countries



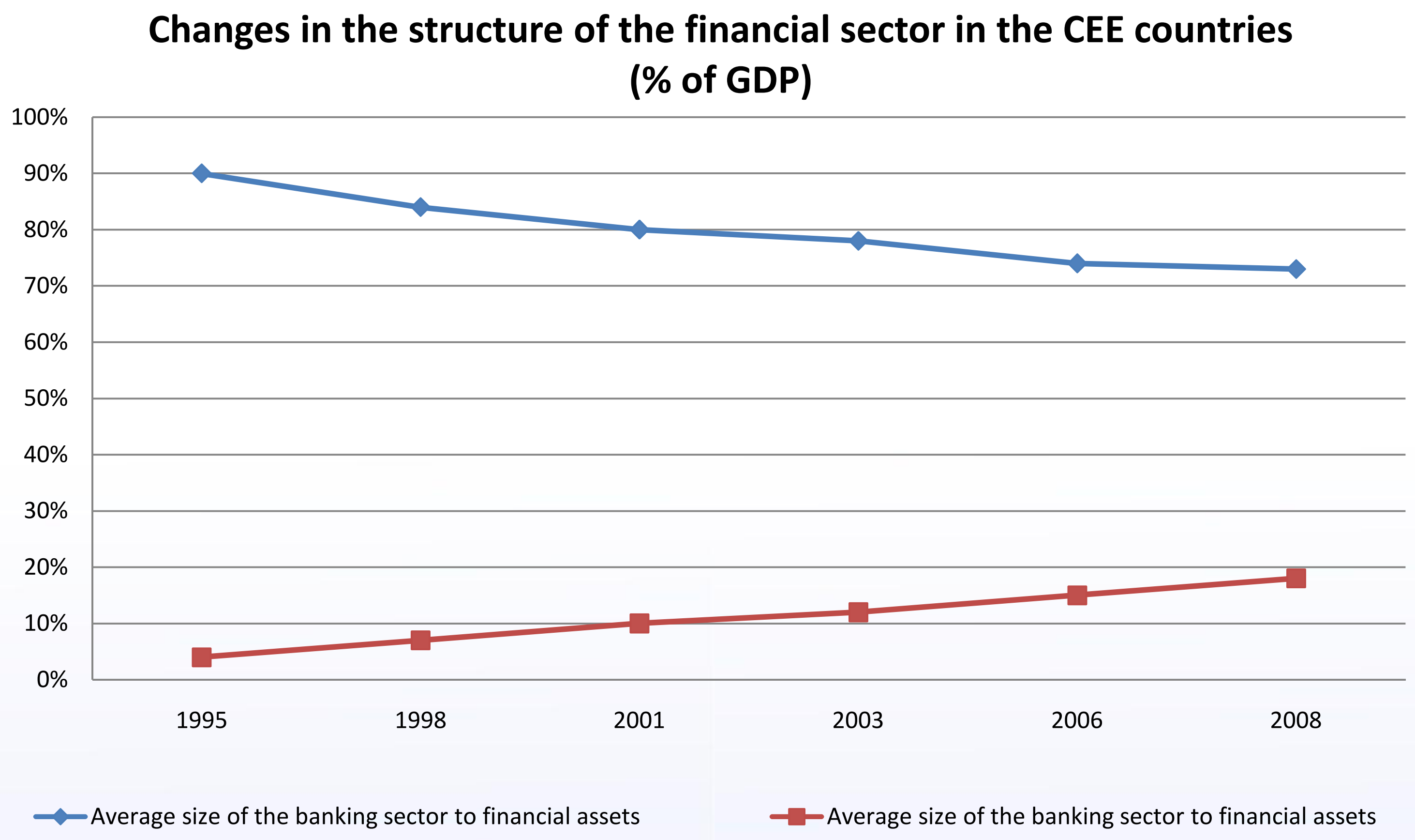
- The CEE countries have also reformed significanlty their securities market regulations.

- Again, there are significant differences between these countries with respect to their capital market infrastructure.

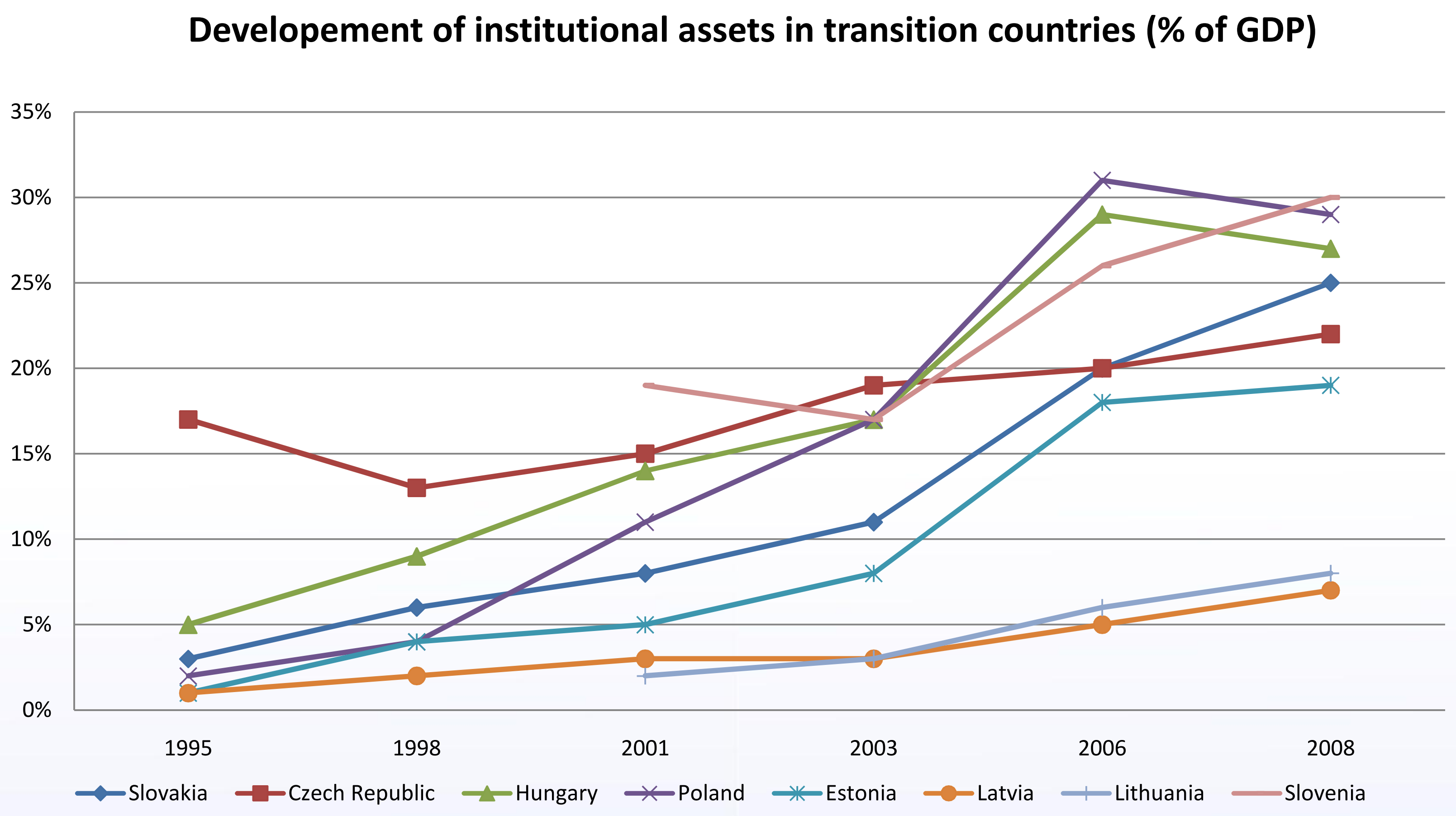
- While, Hungary, Poland and Estonia and Czech Republic have the best quality of securities markets‘ regulations, Slovenia is just at the beginning of their reforms.

Source: EBRD

7. Changes in the structure of the financial systems in the CEE countries

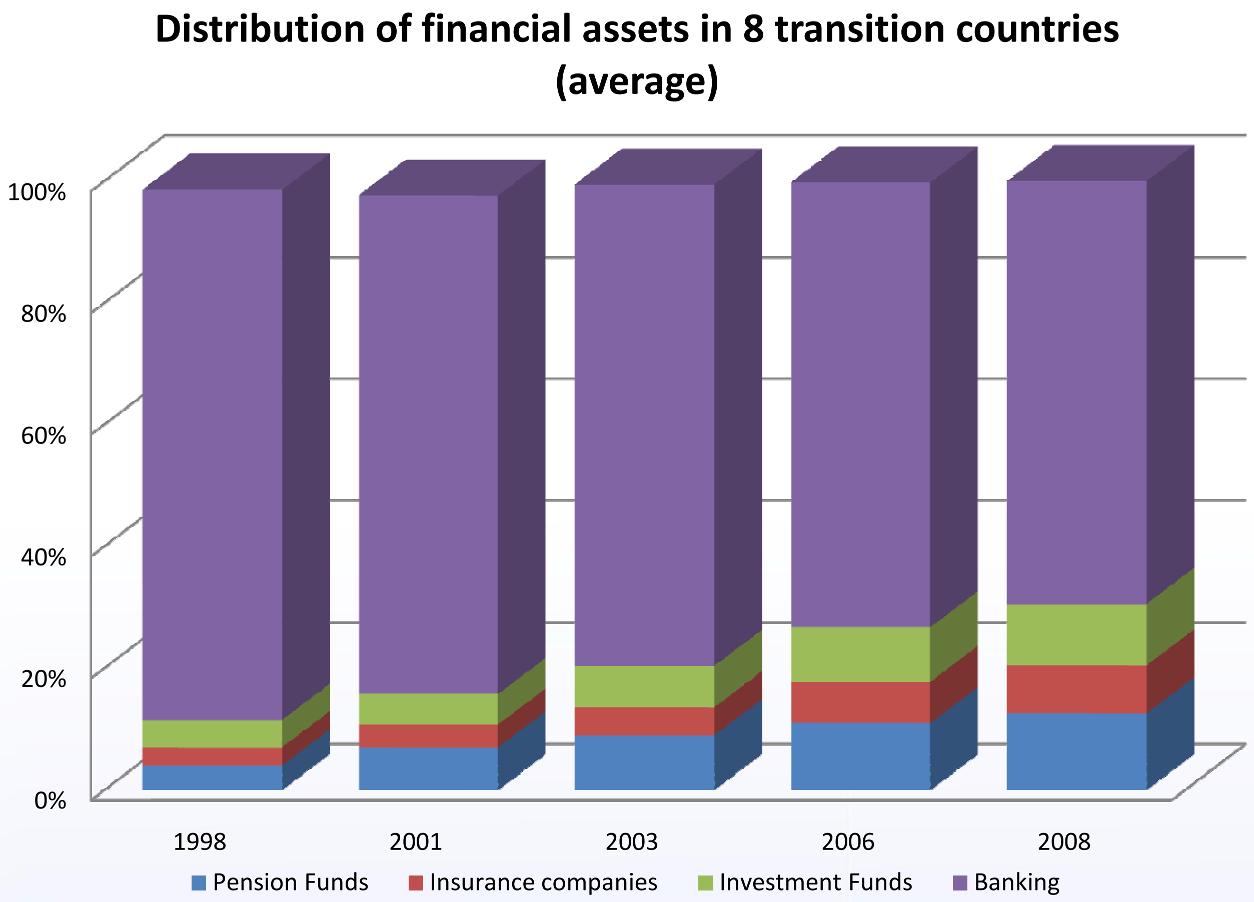


7. Changes in the structure of the financial systems in the CEE countries



Since 2000, there has been a rapid increase in the number of insitutional investors in the financial structures of the CEE countries.

7. Changes in the structure of the financial systems in the CEE countries

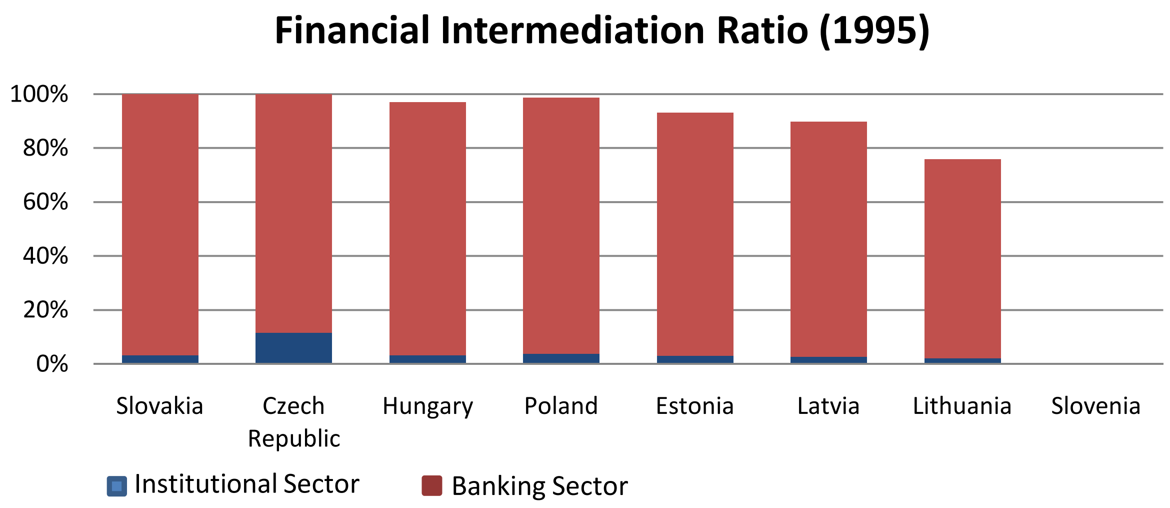


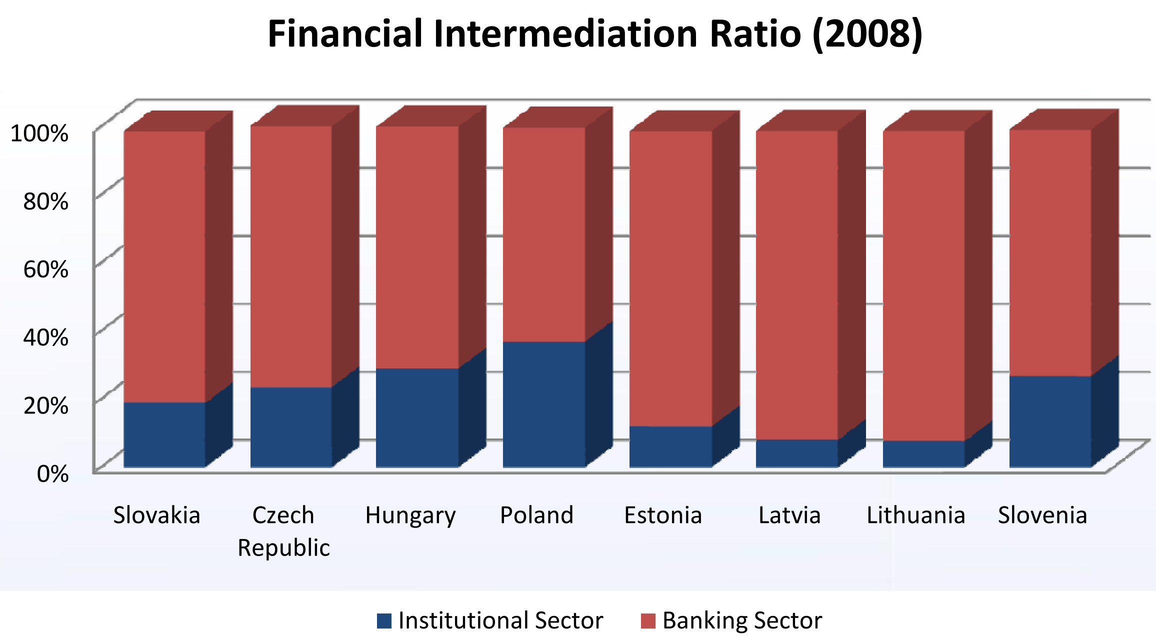
- Institutional assets have grown from 43 billion to almost 200 billion USD in the CEE countries during 2001-2008.

- The pension industry has experienced the most dramatic growth in all CEE countries.

- The investment fund‘s industry has been growing at more rapid pace than other institutional investors recently.

7. Changes in the structure of the financial systems in the CEE countries





- For a very long time, the banking institutions were the only financial intermediaries which had experienced a significant growth.

- They dominated almost entirely the domestic financial sectors.

- Recently, the non-banking institutions have been gaining an importance in the domestic financial sectors.

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7. Changes in the structure of the financial systems in the CEE countries

CEE household financial assets (LC CAGR 2009 – 2011)*

	Bulgaria	Croatia	Czech R.	Hungary	Poland	Romania	Slovakia	Turkey	Russia	CEE
Currency	−6.8%	−1.1%	4.3%	2.3%	6.5%	6.3%	73.6%	13.3%	2.9%	7.2%
Bank deposits	6.3%	2.1%	5.3%	4.4%	7.7%	14.3%	3.0%	13.0%	13.1%	10.0%
Securities	−14.9%	9.3%	37.9%	3.6%	6.6%	−12.1%	–	−7.0%	–	2.0%
Listed shares	−0.1%	11.1%	11.9%	12.7%	9.5%	27.2%	–	35.4%	–	20.1%
Mutual funds	3.2%	−0.4%	7.0%	5.4%	13.7%	86.7%	6.2%	20.6%	10.5%	12.9%
Insurance reserves	4.3%	6.8%	5.5%	9.0%	5.5%	3.2%	7.3%	10.4%	11.3%	8.0%
Pension funds	15.1%	26.2%	7.3%	17.2%	15.8%	76.3%	29.4%	19.1%	30.4%	20.5%
Total financial assets	**4.9%**	**5.2%**	**6.0%**	**6.9%**	**9.5%**	**15.7%**	**11.8%**	**13.8%**	**13.6%**	**11.1%**
Net financial wealth	10.0%	8.9%	3.4%	11.3%	11.1%	52.1%	11.6%	13.2%	21.8%	14.2%

*) Bank deposits in Croatia, Czech Republic and Slovakia include also savings kept in construction banks and building societies
Source: UniCredit Group CEE Strategic Analysis

Source: UniCredito