Aspects Regarding the Motivation and Forms of Foreign Banks' Penetration in Central and Eastern Europe

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Abstract. *The transformation process in the Central and Eastern Europe economies after 1989 has generated considerable changes in the bank sector. In all emerging economies in the region, the foreign capital involvement took place first by the way of cross-border flows, and then by direct investments, e.g. foreign banks implantation. The motivations and forms of their penetration change over time, toward a more local involvement of these banks. Nowadays, the expansion is achieved more and more by taking over existing banks threw the privatisation process or acquisitions of smaller private banks.*

Key words: foreign banks; Central and Eastern Europe; Romania; motivation; form of penetration.

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JEL Codes: G21, F23.
REL Codes: 11C, 17G.

1. Introduction

Foreign capital involvement in emerging post-communist economies was achieved in the general framework of the great transformations in these countries after 1990. The economic liberalization, massive privatization, general opening of the economies were factors which have driven developed economies to consider the CEE region as an interesting opportunity for businesses' extension. However, till middle 90s, entries in CEE countries, except Hungary and Poland, were not significant, and, in the case of Czech Republic, due to the high degree of concentration, foreign banks had taken small niche positions before gaining important shares and positions on market.

2. The general economic framework of the foreign capital's involvement in emerging European economies

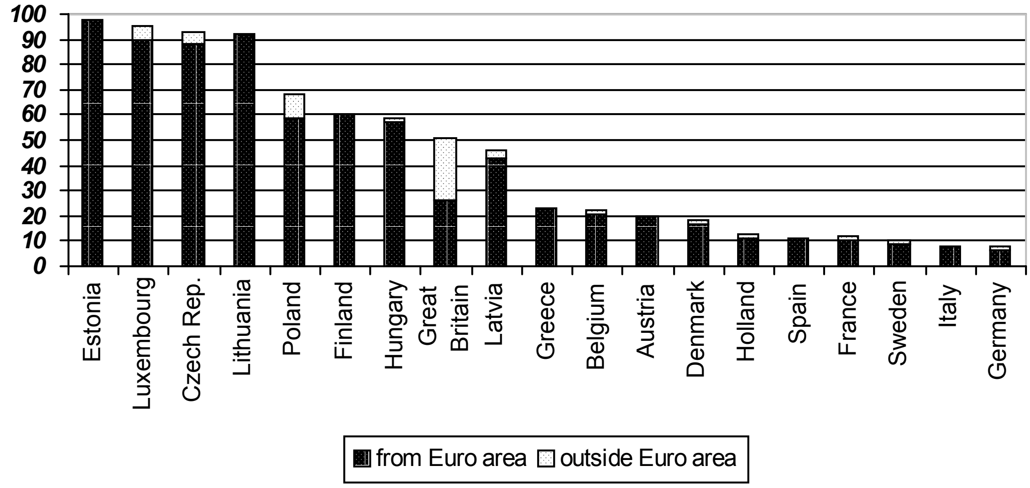
The motivations of this late and hesitant involvement of foreign capital on the CEE markets have to be seeking in many directions.

First, even foreign banks' activity has enormously increased in the last decades; we can say it is a international industry only in a limited sense and since short time. Although the international capital market is very large, the greatest part of the banking activity takes place on domestic markets and the largest number of banking services continue to be purchased inside the national boundaries. The bank industry continues to be significant less international than other industries, such as auto-motive for example. There are many reasons to explain why banking was and, in a great measure, still is more resistant to internationalisation. On one side, the service sector is, generally, less internationally integrated compared to the industrial sector, and, on the other hand, the bank activity in many countries – with an importat exception, USA – is highly concentrated; the state property (in many banks, in many countries) creates an un-competitive environment and thus discourages new entries, foreign or domestic.

Even in Western Europe, a surprisingly large number of free economy states had till recently high quotas of state capital in bank sector. For example, in 1989, the weight of public sector in overall bank assets was 87% in Portugal, 84% in Greece, 68% in Italy, 50% in Germany, 44% in Austria, 42% in France (Gardner, Molyneux, 1990). In the last 10-15 years, in the general context of globalization, de-regulation and financial liberalization, but also on the background of enlarging European economic integration, in Western Europe took place a lot of major changes in bank system, following the EU directives related to the creation of a single market in the financial services. As a result, many Western banks were concerned by the transformations on their own markets, by the necessity of consolidation and focus on survival, as by their own fears[(1)]. After 1990-1995, a lot of national and transnational mergers and acquisitions, minority share participations and strategic alliances between banks took place[(2)]. After this consolidation process, the number of credit institutions in euro area decreased from 9,500 in 1995 to 6,406 in

2004 and 6,130 in 2006 (ECB May 2005, October 2007). Many financial services companies developed strategies to enable themselves to act as multinationals and exploit scale-economies opportunities. It is interesting to compare the weight of foreign banks in overall assets of the banks in euro area with the new member states: if foreign banks detained at the end of 2006 around 27% of the total assets of the credit institutions on the whole EU, the weight were 67.7% in the new member states, respective 17.9% for the countries in euro-area (ECB Report, October 2007) (see also next figure):

Figure 1. .



Source: *EU Banking Structures*, European Central Bank, October 2007.

Second, it has to be mentioned the relatively low interest of the investors for the former communist economies, compared to the interest for other emerging economies. The potential investors, not familiar with a different business environment, accused the lack of banking experience and had shown prudence about the management quality in domestic banks, un-orthodox way to do business, the fear related to potential government' influence and interference in the activity of the new managers and shareholders etc.

In all emerging countries, the involvement of foreign capital was achieved in the first time by the way of cross-border flows (which increased from 500 billion dollars in 1990 to 1500 billion dollars now, according to BIS, June 2006), and only after that by direct investment, respective foreign banks implantation. If between 1990 and1995, on all emerging countries, only 10% of the external claims were local (loans granted by branches and subsidiaries locally implanted), the rest of 90% being external loans; now, almost half of those flows are local claims of foreign banks to emergent economies (BIS, June 2006). Of course, foreign direct investment in banks, e.g. foreign banks' implantation in emerging economies, were not an entirely new thing in 1990, except the Central and Eastern Europe economies. In some emerging economies in Asia, very open economies, foreign banks counted huge weights in the overall assets of those countries. For example, in Hong Kong and Singapore, almost 90% of the bank assets were owned by foreign banks. The same in some Latin-

America economies: in 1990, foreign banks counted 19% of the overall bank assets in Chile, 10% in Argentina, 6% in Brazil (BIS, Dec. 2005). However, foreign direct investment in banks from outside their home country is a very recent situation, after 1995. For example, the overall value of the acquired banks in 1994 in all emerging countries was under 1 billion dollars, but in 2001 it reached 21 billion (later it decreased, in the context of panic generated by the financial crisis (BIS, December 2005). The main countries targeted by foreign capital were from Latin America. The cumulated value for 1990-2003 of buying transactions targeting the banks was 22 billion dollars in Mexico, 14 in Brazil, 6.5 in Poland, 6 in South Korea, 5.5 in Argentina, 5 in Czech Republic etc. (Thomson Financial).

Here is, briefly described, the "wave" of bank globalisation after 1995 (foreign implantations, bank mergers and acquisitions) which, corroborated with the specific macroeconomic framework of the origin countries (oscillation between financial liberalisation and the need for domestic consolidation) and of the host countries (spectacular economic transformations in Central and Eastern Europe), generated the expansion of foreign capital in the region.

3. Theoretical consideration on the foreign banks' entry in region

The transition from a planned economy to a market economy, lasting more than a decade, consistently modified the banking sector in Central and Eastern Europe. If in the communist times the banks were mostly a vehicle, a government tool for resource allocation according to the central plan, in post-communist times, the banks had to make credit decisions based on commercial criteria. Especially in the first years of transition, this new position proved to be a real challenge for most of them. The government' approaches on bank system' reform and consolidation were various, and the results were various as well (E. Zoli shows that the costs associated with a banking restructuring process consistently varied from one country to another (Zoli, 2001)). After almost 20 years after the first reforms, we can now analyse and pertinently evaluate the effects of the followed policies, focusing on different aspects of foreign banks' entry on European emergent markets (motivation, entry mode), as well as on evaluating their effects on the economic environment in the host economies.

Conceptually, by foreign financial institution we understand an organisation legally incorporated in a foreign institution or an organisation supplying financial services with a significant part of the owners having foreign origin. Consequently, foreign banks in Central and Eastern Europe can be defined as organisations with banking functions legally incorporated in a foreign institution or an organisation with a significant foreign participation to the property structure (Konopielko, 1999, pp. 463-485). The first part of the definition refers to organisational forms from representative offices to branches, so it is about foreign institutions supplying financial services(3). The second part of the definition refers to banking institutions owned by foreign persons and organisations, but considered, from a legal point of view, as domestic institutions(4). The only difference between those and other domestic banking institutions is that a part or even all owners are from outside the host country.

Legally speaking, all companies (including banks) paying taxes in one country have to be recognised as domestic entities (Gierszewska, 1996), the frontier between domestic banking and international banking varying according to the analysed issue (Aliber, 1984, p. 662). It has to be pointed out that there is another definition of financial multinational corporations that restrain their field of action only to supplying banking services, so that the existence of a simple representative offices in a given country does not mean the existence of a financial multinational corporations; the representative offices "have more a connection function with the parent company but cannot effectively operate on the host market" (Hoschka, 1993, p. 17). On what we are concerned, we will include also the representative offices in the concept of foreign banks because, unlike the developed economies, in Central and Eastern Europe the representative offices accomplish some banking activities (Konopielko, 1999, pp. 463-485) and, in many cases, they were platforms for following effective entries on these markets. The concept of foreign bank, as we define it, is consistent with the approach the pioneer of the theory of multinational banking, H. Gruber (Gruber, 1977, pp. 349-363), who considers multinational banks as referring to the "ownership of banking facilities in one country by the citizens of other country". Three banking activities can be achieved, in his opinion, and all of them are present in Central and Eastern Europe: retail banking, bank services and wholesale banking.

4. An essay of applying the multinational banking theory to Central and Eastern Europe

The multinational banking theory was initially developed by H. Gruber (Gruber, 1977, pp. 349-363), who opened a new camp for further researches. One of the main pillars of this theory is to identify the source of the comparative advantages in the international banking, e.g. the factors driving the option for a certain location. We think necessary to point out some issues in order to reflect the framework for applying this theory to the post-communist economies' realities.

First of all, the entry of foreign capital in bank sector of the Central and Eastern Europe economies can be defined as the settlement or acquisition of existing banks, which become thus foreign banks. Generally speaking, there are also vehicles for entrance, other that those concerning the direct ownership: the strategic alliances. In the case of Central and Eastern Europe, being the unstable economic situation and the underdeveloped financial structure, foreign capital entry was realised exclusively by the ownership way, e.g. acquisition of existing entities or settlement of new entities.

Second, it has to be made an observation regarding the distinction between the two internationalising ways: inward and outward (Pintjens, 1994). The inward internationalisation describes the situation in which foreign bank institutions enter a country or region and/or that in which the banking activities from a specific country or region are mostly denominated in foreign currency. The outward internationalisation concerns the situation in which bank institutions from a country are establishing their presence in other country. Nevertheless, in the case of Central and Eastern Europe economies, the level of inward internationalisation is high, in some economies even very high, while outward internationalisation is very rare(5).

Third, the analysis of the international banking concerns two subjects: the issue of the patterns for outward expansion of the banks, from a industrial organisation point of view and the issue of banks' role in cross-border financial flows (Aliber, 1984, pp. 661-678). The conditions and main motivations of foreign direct investment are, generally, the following:

- Motivations relying on the efficiency of internationalisation: the imperfections of the output markets (mainly caused by entry barriers and market segmentation), the imperfections of the input markets (related to the comparative advantages that could be obtained by expansion), the scale-economies reached by expansion etc.
- The advantages of certain locations as motivations for entry (the approach being thus focused on explaining the specific location for implantations): existing clients' serving and following in their own expansion, the entry on a growing market, able to supply gain opportunities, and gaining control on some input sources.

All these considerations concern, in general, the foreign direct investment in one economy; we will try to apply them to the bank sector, in order to discover specific features of foreign banks expansion, expansion that means in fact the specific form of foreign direct investment in bank sector.

The first condition, the imperfections in the output market, related to the entry barrier, can be maintained also in the bank sector, if, by this expansion, the investor can enter a particular market. If the entry is successful, they can be obtained rental gains, until the moment of full liberalisation and removing the entry barriers. This kind of situation occurred particularly in the case of early entry (in the first years after 1989), when indeed the new entrants reported gains and advantages superior to those of late entrants. In the first years of post-communist times, some Central European transition economies were particularly very liberal, allowing foreign banks entries. Nevertheless, very soon, the authorities were not so glad of the bank sector developments, the new banks (domestic or foreign) involving in risking activities, in a time when regulation and supervision were not well imposed. Many of the foreign participations were speculative and little capitalised. In Hungary, some foreign banks accumulated great losses, and in Poland and Baltic States were exposed even cases of fraud with the involving of new banks. Subsequently, more strict regulations were imposed, in attempt to control the quality of market entries.

The imperfections on the input markets, related to the comparative advantages, can be an explanation for particular situations: it is the case, for example, of German land banks, who beneficiated of access to government funds with low interest reporting gains that normally wouldn't obtain.

The scale economies are close related to the endogenous conditions of the firm, so it can be assumed that the companies having scale economies inside the national territory can do the same outside their country.

Maintaining the existent clients and supplying for them financial services outside their home country, on the principle of following clients in their own expansion, are valid motivations also for bank expansion, especially in the first years; later, the banks extended their operations and their client portfolio.

The entry on a growing market and the perspective of potential gains are obvious motivations for any outward expansion, including the case of foreign banks, especially for those coming from economies with a small domestic market (Netherlands, Belgium) or very competitive ones.

The last motivation, the access or control on factor markets, can be considered, in the bank sector, as the desire to create a stable client base, risk diversified (in many countries, in more currencies), in order to face the potential shocks on domestic market.

A research conducted between 2001 and 2002 (Uiboupin, Sorg, 2006) reveals the following main reasons for foreign banks' entry in Central and Eastern Europe: looking for new business opportunities (a score of 4.58 on a scale from 5 – the most important reason to 1 – the less important reason), local clients' support (3.68), following the existent clients (3.33), international trade finance (3.3), competition prevention (3.18). As we will notice, in time there were many important changes: even initially foreign banks were focused more on existing clients' support and follow, later they have more and more targeting the local clients, expressing more availability and interest for local economies.

Among the factors favouring the option for a destination country, the same study reveals the importance of the economic and politic stability of the country, the liberal economic policy, the potential to future integration in European Union, the existent and potential local clients. It can be noticed that the general determinants of foreign direct investment are also valid for foreign banks' implantation (Magri et al., 2004).

On the other hand, international banking usually requires a physical presence, so that the main reason for direct investment in bank sector is the need for a direct contact between the bank and their clients (Walter, Gray, 1983, pp. 597-609). At least in the beginning, many banks open branches or representation offices in order to support their clients from the origin countries. These representative offices can establish a physical presence on the market without a clear commitment of foreign capital entry on the host market; many times, this presence relied on the hypothesis that banking will develop. The future development of bank sector leaded to entries by the way of greenfield direct investment, meaning the settlement *ex nihilo* of a bank institution, and also control acquisitions, by purchasing stocks or other capital forms, going from 100% participations to minority participations.

From an institutional point of view, foreign banks entry can take the following forms:

- Offices, representative offices, branches (with no legal personality);
- Participations or minority share acquisitions in domestic banks;
- Strategic acquisitions in domestic banks;
- Subsidiaries settlement and operating[(6)].

The choice of one form or another was decided also in connection with the type of bank expansion. Thus, the specialised banks, such as investment banks, prefer to operate through representative offices or even the settlement of a non-bank financial institution, due to the fact that, usually, these institutions do not accomplish classic bank operations (deposits, loans); in fact, representative offices are sufficient, low risky and less controlled by the state and central bank in the host country. Moreover, as alternative to bank development on markets not particularly open or interesting, foreign banks developed other banking services: consulting, investment etc. The start-up of the operations has also many kinds. For example, Citibank, in many countries, is focusing on international corporate clients or on private individuals. Other banks prefer to get a small capital and avoid involvement in major infrastructure projects, and in other cases the option can be participation and ownership of minority shares in domestic banks. It is difficult to generalise on the involvement of foreign banks, because this is varying from closed entities to full involvement as major player on the banking market.

In Central and Eastern Europe countries, the evolution of the way of entry followed the evolution and pace of the privatisations; on the measure of it's advance, foreign capital in the banks involved less and less through greenfield investment and more and more by acquiring local banks (see figures 2 and 3).

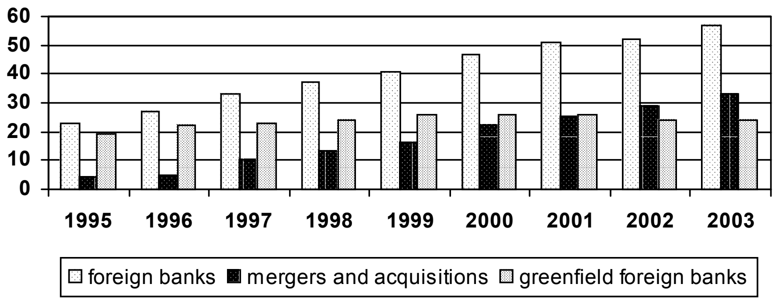


Figure 2. *Foreign banks' position in Central and Eastern Europe, by way of entry (number of banks)*

Source: Claeys, Sophie și Hainz, Christa, *Acquisition versus Greenfield. The Impact of the Mode of Foreign Bank Entry on Information and Bank Lend Rates*, European Central Bank, Working Paper 653/ July 2006.

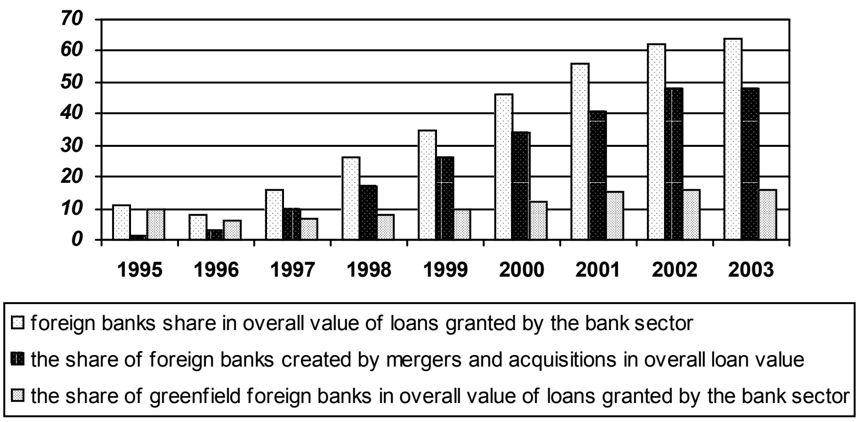


Figure 3. *The market share of foreign banks in Central and Eastern Europe (in overall loans granted by all banks), by the way of entry*

Source: same as Figure 2.

An interesting research, carried out at the end of 1996 among managers from main foreign banks investing in Central and Eastern Europe (Konopielko, 1999, pp. 463-485), revealed some interesting issues, which consisted in the basis for an econometric model to reveal the determinants of the entry process on a specific bank market.

Thus, the main reasons for entry were, in a decreasing order, as follows: support for existing clients, search for new business opportunities, foreign trade finance, the pressure of other banks' competition.

Following the existing clients in their own expansion abroad is the main reason mentioned and probably this is one explanation for the massive presence on the market of this region of players from nearby countries: the Austrian and German banks were among the first entrants, and nowadays they are present in a large number, both big institutions and some considered in their home countries not very expansive abroad (this is the situation for German land banks or the Raiffeisen case). Many foreign banks implanted in those countries with a massive presence of non-financial companies from the same home country. This reason also explains the outward implantations, e.g. intra-regional subsidiaries of banks originated in Central and Eastern Europe, following the region's development and the increasing intra-regional co-operation.

The second reason, e.g. searching for new business opportunities, operates in the case of some banks' expansion, such as Citibank or the Dutch banks, which, even in the beginning, were limited to their own clients' support, later they have been extended the provided services and the clients' portfolio, highly involving themselves on the local market, including in operations not related at all with their initial clients from their home country (*retail banking* for example). The follow-up behaviour was replaced by the client searching process. This is the same situation with the trade finance reason: even in the beginning big banks' gains came from the comparative advantages of their products (by better and more sophisticated services), gradually their comparative advantages diminished, as domestic banks provided similar services; this fact pushed big banks to extend the products and services they provided, and also to extend the clients' portfolio. The case of Citibank Poland is eloquent: in 1995, Citibank Poland was the 20th bank in Poland by equity, but the 2nd in foreign trade finance and related services (Konopielko, 1999, pp. 463-485).

Follow-up the competition was the last mentioned reason, which can be the result of the marginal character of emerging European markets, compared to the Latin-American and South-East Asian ones.

Concerning the way of entry, the research revealed the preference for subsidiaries, followed by take over of existing banks and settlement of branches; the minority participations and representative offices were considered not very relevant ways for entry. It has to be mentioned that, in spite the fact that subsidiaries' opening was the dominant form, in some cases it was preferred the take over of existing banks (the case of Hungary, due to the fast and early privatisation) and branches opening (the case of Czech Republic, due to the very liberal strategy toward foreign branches). Certainly, advancing on the recovery process of domestic banking systems of less advances economies, the progresses on the way of reforms and privatisation and the decreasing suspicions toward the domestic institutions, the most frequently form chosen was the acquisition of a existing bank.

Regarding the operations and activities preferred by foreign banks, the most interesting domains proved to be, in increasing order, corporate finance, foreign trade finance and project financing (in fact, the operations with the greater know-how involved, the less staff requirements and, in the same time, the most profitable), while the less standard operations (bonds and securities, leasing, non-financial operations), as well as retail banking, were considered, in the first place, less desirable. Generally, the retail banking did not constitute motivations for entry (Tschoegl, 1997). The main causes were related to the low purchasing power of individuals, as well as to the high costs (well-represented and extended network, consistent staff) imposed by this kind of banking. It is interesting to notice that, as the development of the market and of the region in general advanced, many banks claiming, in the beginning, their lack of interest for retail banking, started to develop this segment as well. For example, the strategy for Romania of ABN Amro and ING Bank did not include the retail operations (but later both of them reconsidered their position and became highly involved in retail), while the strategy of the same banks on more interesting markets as dimension and consumers' power included from the beginning retail involvement (ING-Bank Slaski in Poland, ABN Amro-MHB Poland).

5. A research about Romania

For Romania, last August we carried out an empirical research, based on a questionnaire launched to a number of 20 top and middle managers of foreign banks located in Romania. The results of this questionnaire, regarding in its first part the motivations and reasons for entering the Romanian market, are as follows:

First, the interview revealed that the main reasons for entry are, in increasing order, as follows: searching for new business opportunities (4.6 points out of 5); the general expansion strategy (3.95 points); supplying banking services to their existing clients and its following in their own expansion (3.25 points). On the other hand, motivations such as: developing a local clients' portfolio (2 points) and competition imitation (1.2 points) were not seen as priorities for the entry process. So, in Romania it is also empirically validated the main motivations revealed by the above mentioned studies. The Romanian market is considered as a growing market, rich in opportunities and it has to be naturally integrated in the expansion strategy. It has to be noticed the gradual integration of the banks in the local environment, serving the existing clients from the home countries is not a reason for entry anymore. However, the development of a local clients' portfolio is not a motivation for entry (especially for Greenfield settlements, because privatised banks present a different approach), but moreover a consequence of the market developments and expansion opportunities.

Second, the research revealed the most preferred operations of foreign banks. Thus, the most preferred activity is mentioned to be corporate finance (4.5 points), followed by foreign trade finance and international operations (4.1 points) and asset management, derivatives, consulting and others (3.15 points). Significantly less interesting were retail banking – individuals (2.15 points) and SMEs financing (1.1 points). So this is an empirical validation of was the literature calls *cherry picking*, e.g. the selection by foreign banks of the most gainful activities and clients. Certainly, in these operations foreign banks exploit their comparative advantages, mainly the access to cheaper funds in foreign currency and thus, the availability to more consistent and lower interest lending, but also their know-how and experience in relatively new operations for the Romanian market. Retail banking, individuals lending, are not among the most preferred operation, even in the last 4 years the retail oriented banks substantially gained after the exponential increase of this sector. SMEs financing is the less preferred operations, but this fact does not mean a give up of such activities (for example, for BRS-GSG the SMEs sector represents 52% of the overall client portfolio, constant share in the last years, according to BRD-GSG, 2001-2006). It is a question of preference, also depending on the investment type (Greenfield or take-over).

Third, another question focused on the motivations for selecting Romania as destination of the foreign direct investment. Among the attractions exercised by Romania were mentioned, very close one to another: the market potential and the development rhythm (3.8 points), expansion opportunities (3.75 points) and consistent gains (3.7 points), which denotes the "opportunistic" character of the expansion (otherwise natural in a pragmatic approach), searching for gains and opportunities. It is interesting the fact that Romania's EU membership was assigned with a barely score of 2.55, while the macroeconomic and political stability only 1.2 points. In other words, Romania is not yet considered a very stable economy, but moreover a fast growing economy. This comes unlike other Central and Eastern European markets, where stability was mentioned among main factors of choice. It appears that, however, this stability is perceived as above a certain necessary critic level, which, together with the increasing market, motivates the entrance on Romanian economy.

6. Conclusion

The reasons and interests of foreign banks certainly changed during the time, leading to a more local involvement of those banks, unlike the initial entries from the middle of 90s. The way of expansion changed too, in the sense that big Greenfield investments were settled 10-12 years ago; in the past 2-3 years, the expansion took place by acquiring existing banks: by the way of privatisation process or by taking-over private small banks. This is the way that 92% of the interviewed managers indicated for further expansion.

Notes

(1) It is interesting to mention the case of Austria, where it happened for long time a particular situation: the fear and opposition against foreign ownership in banks resulted in a stagnation of the privatization process for many years. For example, in the beginning of 1990s, Austria was looking for an investor to sell 49% of the shares of the second domestic bank, Creditanstalt, at the time when this bank became one of the most active banks in Central and Eastern Europe. About this privatisation process, the ex-Austrian chancellor Franz Vranitzky stated that the fact that "the potential investor is Austrian ore has a special relationship with Austria is a very important issue" (Reuters European Business Report, August 1995), and the ex-Austrian ministry of economy, Johannes Dits, said: "The national interest must be taken into consideration. The selling price is not the only criterion. It is important the Austrian influence in this bank to be maintained" (idem)

(2) In Germany, Hypo Bank and Vereins Bank Munchen form HVB Bank; the German company Allianz acquires Dresdner Bank; in France BNP acquires Paribas, ING (Holland) buys Kredit Bank, in Spain Bilbao Vizcaya buys Argentaria Caja Postal y Banca Hipotecario on competition with Banco Santander Central Hispano, each of them being the result of some consecutive mergers and acquisitions etc.

(3) It is the case, for example, of ING branch in Romania.

(4) It is the case, for Romania, of the large majority of foreign owned banks, acting as subsidiaries of foreign parent banks; one important exception is ING.

(5) The case of OTP is one of the extremely rare examples in that way. OTP Bank is a Hungarian bank opening subsidiaries in some countries in region, including Romania.

(6) Legally speaking, the subsidiaries are legal entities of the host country, while branches are foreign entities.

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