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„Foreign Bank Entry in South Eastern Europe: Evidence from Bosnia and Herzegovina“

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IV. List of Abbreviations

%	per cent
&	and
AG	Aktiengesellschaft
B&H	Bosnia and Herzegovina
BAM	Bosnia and Herzegovina convertible mark
CBBH	Central Bank of Bosnia and Herzegovina
CEE	Central Eastern Europe
CIS	Commonwealth of Independent States
DIA	Deposit Insurance Agency
DM	Deutsche Mark
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FIPA	Foreign Investment Promotion Agency of Bosnia and Herzegovina
GDP	Gross Domestic Product
HVB	HypoVereinsbank
IFC	International Financial Corporation
IMF	International Monetary Fund
IPO	Initial Public Offering
M&A	Mergers and Acquisitions
OC	Organization Capacity

OEKB	Oesterreichische Kontrollbank Aktiengesellschaft
OHR	Office of High Representative
OLI	Ownership Locational Internalisation
OLS	Ordinary Least Squares
RBI	Raiffeisen Bank International AG
RBG	Raiffeisen Banking Group
RI	Raiffeisen International Bank-Holding Aktiengesellschaft
RZB	Raiffeisen Zentralbank Oesterreich Aktiengesellschaft
ROAE	Return on Average Equity
SD	Stage of Development
SEE	South East Europe
SMEs	Small and medium enterprises
TCA	Transaction Cost Approach
UN	United Nations
US	United States
USA	United States of America
USD	US-Dollar

1 Introduction

Banking activity has increased to large extent in the emerging markets during the last decade, mainly in Central and South East European countries. A large number of banks stepped into the emerging European market leading the foreign direct investment to rise heavily.
The trend of increasing foreign banks' presence in South East European countries that occurred in recent years was said to continue whereas the situation, in middle of a financial crisis, is telling a different story as banks are withdrawing from the markets. Those banks having its subsidiaries in those countries have to provide big portions of capital and liquidity in order to ensure the survival of their subsidiaries, even the sale or taking over by the government might be necessary whereas this might happen only in case of systemic banks i.e. those being heavily important for the economic development of the country.
Beside the above said, still the banking sectors of many Eastern European countries are dominated by foreign-owned banks which have been motivated not only by large profit opportunities but also from reputation they gained during the years of presence.
The governments that have been hesitant about letting foreign banks enter their market, due to fears of foreign banks threatening the existence of the domestic banks, lost their doubts as, by throwing all decision-relevant factors in a tray the fact that local banking market can benefit and profit from the developed knowledge of foreign banks through learning and spill-over effects, prevailed.
Thus, led by the interest to discover the reasons and motives why the entry decisions have been taken as they appear in those countries and driven by the majority appearance of foreign banks in South East Europe in particular, I have taken the decision to treat this topic in my thesis by having a focus mainly on the Western Balkans, in fact in more detail, on the example of Bosnia and Herzegovina.

Therefore the purpose of this paper is

- to discover the motives of foreign banks (i.e. Western banks) when entering the South East European market
- to learn by what means and in which forms the entrance may take place.
- to subsequently describe the actual situation concerning FDI in South East Europe by using the example of Bosnia and Herzegovina as host country and Raiffeisen Bank International AG as foreign bank entering this market.

The aim is to first give an overview of literature treating the topic of internationalization theory presented in Andersen (1997) that builds the ground for the theory of multinational banking as treated mainly in Williams (2002) and Konopielko (1999). In this connection different theories will be presented to explain motives and reasons of foreign banks' entry according to Andersen (1997) and Williams (1997) as well as their applicability to the South East European market will be presented as per Konopielko (1999), Uiboupin (2005) and Williams (1997). Modes and motives of foreign bank entry will be named and presented according to Agarwal and Ramaswami (1992), Garcia Blandon (1998), Meyer (2001) and Naaborg (2007). Finally the banking sector of South East Europe, thereof especially the banking sector of Bosnia and Herzegovina, will be analyzed with regards to the composition of FDI. Later on the case of Raiffeisen Bank International AG will be presented as example of a foreign bank that succeeded to conduct a successful expansion into South East Europe.

The paper is structured in a way that:
Chapter 2 gives an overview of current literature of theories and frameworks explaining the foreign banks' entry in general whereas those are briefly presented and assorted in a random order not providing information on the importance of any theory described herein;
Chapter 3 shows that while entering those markets the banks use different means of entry and gives an overview of the main forms of entry;
Chapter 4 will specify different reasons and motives of foreign banks encouraging them to enter those markets;
Chapter 5 examines the banking sector of South East Europe by showing the main investors in the region as well as gives an actual overview of FDI in the banking sector of South East Europe and enumerates motives thereto;
Chapter 6, in order to show the extent of foreign banks' activity in those countries, the banking sector in Bosnia and Herzegovina has been consulted.
Chapter 7 finishes with a case study that gives a summary of obtained findings and presents the case of Raiffeisen Bank International AG.

2 Definitions and Review of Literature

2.1 Definition Internationalization

Internationalization could be seen as the "process of increasing involvement of enterprises in international markets". Still there seems not to be a universally accepted definition of thereof

as there are a lot of theories dealing with finding out the reasons why international activities exist. (Wikipedia – Internationalization 2011)

Welch and Luostarinen as well as Calof and Beamish define internationalization as "the process of adapting exchange transaction modality to international markets" (as cited in Andersen 1997, p. 29). The cited definition implies entry mode strategy as well as international market selection. The entry mode can be seen as the institutional arrangement for organizing and conducting international business transactions, for example transfers, joint ventures and wholly owned operations. (Andersen 1997, p. 29)

2.2 Definition Multinational Banking

Williams presents a good overview of the literature outlining the definition of multinational banking and reflecting the history of how the multinational bank came into existence whereas one has to separate multinational banking from international banking which differ from each other in terms of their "taxonomic environment". (Williams 2002, p. 127) According to Konopielko, the theory of multinational banking has, for the first time ever, been treated by Grubel in the year 1977. (Konopielko 1999, p. 464) In his paper Williams says that the two approaches differ from each other in respect of the origination of their services. International banking is considered to be banking services offered out of the home nation through for example cross-border lending whereas multinational banking derived from banking services offered from the host nation or the so-called local market. (Williams 2002, p. 128) In this thesis the concentration will lie on the multinational bank as it is corresponding more to the expansion approach or strategy of many banks into South Eastern Europe.

Buckley and Casson as well as Williams consider multinational banking as an industry best reflected by the "theoretical framework provided by internalization theory due to the importance of information as key intermediate product". (Williams 2002, p. 128) Also to be highlighted is their operational definition of the multinational firms that is considering them as those "owning and controlling undertakings in different countries". (Williams 2002, p. 129) Much wider definitions have been provided by Robinson who defines multinational banking as "… operating a bank in and conducting banking operations that derive from, many different countries and national systems" and by Lewis and Davis who define it as "Multinational banking embraces both the Eurocurrency banking activities of foreign banks and their banking in host country currencies" (as cited in Williams 2002, p. 129). This definition goes closely with the operational approach of Buckley and Casson who define a multinational bank to be "simply a bank that owns and controls banking activities in two or

more countries” (as cited in Williams 2002, p. 129).

The three main economic functions of a multinational bank according to Davis and Lewis are:

1) They adjust assets and liabilities across currencies. Savers and borrowers do not always have same preferences when it comes to currencies, and multinational banks help overcoming the differences in these preferences.
2) “The multinational banks transform preferences across borders.”
3) “The final function is that of transforming the maturity of deposits into the preferred maturity of the borrowers.”

Not all of the multinational banks offer all of above mentioned services as they might offer only one currency (as cited in Williams 2002, p. 130).

2.3 Main theories studying the multinational enterprise

2.3.1 Internalisation theory

This theory is related to the Coasian theory of the firm and location theory and represents an extension of it. In this theory market failure is not only possible in the domestic market but also across the border. While the Coasian approach is concentrated on “why and how the production decision” takes place, the “location theory provides the where”. (Williams 1997, p. 73) Transaction or market costs are one of the main externalities that are considered to influence such a decision whereas different types of such market costs have been defined by Coase (as cited in Williams 1997, p. 73). This theory implies profit maximising as well as overcoming external market failure but organising an internal market and so avoid excessive transactions costs within the multinational firm. The firm is thus not anymore only concentrated on the production of goods but also important fields such as research and development, trains labour, procurement of financial assets and selling within the multinational network become important. Within this internalisation framework there is a knowledge advantage which turns into a “public good within the firm, which can be best exploited by expanding offshore”. (Williams 1997, p. 74)

Applied to multinational banking the theory concentrates mainly on the long-term bank-client relationship that is important to the bank and thus it is prepared to adapt the location mix of its branches to be nearer to the client as the best way to obtain most possible information about the client is via a physical co-location. (Williams 1997, p. 76) Motivating factors for offshore expansion by banks within this theory are considered to be a composition of regulatory arbitrage, market failure and location-specific factors as a multinational bank, according to

Grubel, is considered to be a bank that "develops technologies and management expertise domestically and applies them overseas at lower or zero marginal cost" (as cited in Williams 1997, p. 77) whereas Rugman considers the "internalisation of information as the principal advantage of the multinational bank" as the bank-client relationship is composed "of a set of information flows" (as cited in Williams 1997, p. 77). This flow of information seems according to Buckley and Casson to be best used through foreign direct investments (as cited in Willliams 1997, p. 77). Further advantages of the multinational bank are by Tschoegl considered to be economies of scope that are "exploited by a bank both domestically and internationally" (as cited in Williams 1997, p. 77) and by Casson the "personal contact" (as cited in Williams 1997, p. 77). The personal contact is considered as the information network and infrastructure skills of the multinational bank. (Williams 1997, p. 77) In the US the bank's necessity to set up a physical presence overseas was led by the increase in "firms owned as listed companies rather than family owned". As banking is regarded to be "skill, knowledge and communication intensive", Buckley considers it to be "multinational in the scope of the internalisation theory". Moreover the multinational bank is considered to be a "vehicle for internalisation of transactions costs, with transactions costs being defined in a Coasian sense". (Willliams 1997, p. 78)
Internalisation as it appears in multinational banking mainly results out of the role of information. (Williams 1997, p. 81) Casson argues that "industries that rely on proprietary information" achieve higher benefits from internalisation (as cited in Williams 1997, p. 81) whereas Tschoegl and Yannopoulos see information as very important in banking as the bank-client relationship results mainly out of information flows (as cited in Williams 1997, p. 81).

2.3.2 Dunning's OLI Framework

In his OLI framework or usually called the eclectic framework, Dunning says that "three main factors influence a firm's choice of entry-mode", namely ownership, locational, and internalisation advantages (as cited in Andersen 1997, p. 34). It is the composition of these three factors that leads to a foreign direct investment decision whereas the eclectic theory is considered as a "combination of industrial organisation theory, internalisation theory and location theory" (as cited by Williams 1997, p. 78).

(1) Ownership (O) advantages "usually defined as intangible assets" (Williams 1997, p. 78) are according to Dunning said to be firm-specific assets and skills whereas assets are represented by the firm's size and multinational experience, and skills by the ability of the firm to create differentiated products (as cited in

Andersen 1997, p. 34). A statement of Brouthers et al. says that “ownership advantages need to be both unique and sustainable in order to provide the firm with a competitive advantage in the entry mode selection” (as cited in Andersen 1997, p. 34).

According to Dunning, these advantages are said to be influenced by three factors namely the “access to markets or materials, the access to endowments of the parent at low or zero marginal cost” (as cited in Williams 1997, p. 78) and those factors stemming from the “multi-nationality per se, which allows the multinational to take advantage of any factors unique to the host country” or local market (as cited in Williams 1997, p. 79). Product differentiation, innovation, economies of scope, experience, and favoured access to inputs represent examples of such ownership advantages. (Williams 1997, p. 79)

Ownership advantages, according to Brouthers and Nakos, are said to have the ability to differentiate a firm from its competitors and are viewed as firm-specific resources or capabilities that create a unique advantage to the firm. In case a firm makes the decision to enter a foreign market it may use these advantages to achieve a superior position in that market. (Brouthers and Nakos 2002, p. 49)

(2) Locational (L) advantages shows “how attractive the specific country is” whereas the attractiveness of a country is determined by market potential and investment risk. Those advantages imply similarity in culture of market infrastructures and the availability of lower production costs. (Andersen 1997, p. 34)

Those advantages are “related to both the home country of the multinational firm as well as to the host country” where the investment is planned. (Williams 1997, p. 79) The decision of the location is “interdependent with the ownership and internalisation decisions”. Some examples of locational advantages are barriers to trade, tax regimes, institutional arrangements, the prospects of the economy, and the socio-political situations. (Williams 1997, p. 80)

(3) Internalisation (I) advantages reflect the “costs of choosing a hierarchical mode of operation over an external mode”. (Andersen 1997, p. 34) Williamson describes these costs as transaction costs (as cited in Andersen 1997, p. 34). These advantages result out of a firm’s decision to integrate within its corporate structures activities previously performed by the market. Such

activities include the decision to set up a local manufacturing base as well as the development of a distribution system. In case the resources, a firm needs, are available on the market in an efficient way, the costs of integrating these in the firm then usually exceed the costs of market transactions. When this case appears, a company may decide not to internalise foreign activities, but to take advantage of economies of scale that would come into existence when using the market and avoid the costs of integration. Still the option to conduct transactions through the market might not always result in the lowest possible cost. In many markets, such as CEE markets, the number of firms that provide qualified products and services is limited.

Internalisation advantages are not present in competitive markets where a company has no reason for creating internal structures as a substitute for free market exchanges.

As previously mentioned, the internalisation advantages "are of Coasian form". "The reasons for internalisation are threefold." On the one hand, risk and uncertainty leading the multinational firm to internalise risks and risk management process and, on the other hand, it is the consequence of economies of scale in an imperfect market. Another reason is that the market does not price externalities to transactions. (Williams 1997, p. 79)

The theory implies that the choice of foreign market entry mode is to be based on "trade-offs between risks and returns". Furthermore the advantages may also imply control and resource availability. (Andersen 1997, p. 35) According to Agarwal and Ramaswami, the entry mode choices are to a big extent "a compromise between these four criteria" (as cited in Andersen 1997, p. 35).

The Eclectic framework has been modified and further developed by many other authors, such as Hill et al. and Kim and Hwang, mainly in terms of inclusion of strategic variables and the characteristics of organizational control factors. Furthermore the theory has been used to explain entry mode for small- and medium-sized companies and in the service sector.

Three main theories are reflected within the Eclectic framework (i.e. a multi-theoretical approach) for the explanation of the choice of entry mode, namely international trade theory, resource-based theory and transaction cost theory. The flexibility of the framework allows researchers to define new determinants in order to predict and explain entry mode.

The last point i.e. creating new determinants might lead to problems as by increasing the number of explanatory variables, demarcation lines between the different concepts may be

established thus leading the strengths of the theory to be potential weaknesses at the same time. (Andersen 1997, p. 35)

2.3.3 Stage of Development (SD) Model

The Stage of Development Model is one of the earliest approaches used to explain the way of firm internationalization (Andersen 1997, p. 31) whereas "the entry mode is dependent on the stage of a firm's development" (Decker and Zhao 2004, p. 5). It says that the firm undergoes "the following stages in its development: 1) no regular export; 2) export via independent representatives or agents; 3) sales subsidiaries; and 4) production/manufacturing plants". This model has been developed by Johanson and Vahlne and stems from the resource-based theory from Andersen and Kheam. (Andersen 1997, p. 31) The theory implies that increased market knowledge as defined by Penrose in 1959 leads to increased market commitment and vice versa. The main assumption of this theory is that undertaking "activities creates firm internal assets such as skills and knowledge". (as cited in Andersen 1997, p. 32)

As also some other theories, such as organizational capability perspective and the Eclectic framework, emphasise to some extent on the firm's knowledge the main difference in the SD Model is that the entry mode decision takes place in the form of a "time-dependent process" (Andersen 1997, p. 32) i.e. according to Zaltman et al. it explains a particular state such as entry mode based on some prior state or a sequence of some prior states (as cited in Andersen 1997, p. 32).

The model has been very much criticized for not having included co-operative modes of entry in its establishment chain and furthermore for being deterministic in terms of determining, that a firm will start at a certain stage and will go through certain stages afterwards. At the end Andersen says, that the usage of only one explanatory variable (in this case experiential knowledge) will, with a very low probability, provide a sufficient explanation for a firm's choice of entry. (Andersen 1997, pp. 32)

2.3.4 Transaction Cost Approach (TCA)

The TCA has been established by Andersen and Gatignon in the year 1986 (Decker and Zhao 2004, p. 5) and has gained huge reputation in entry-mode investigations and thus, appears to be very effective in explaining vertical integration decisions as well as predicting entry mode for manufacturing firms as well as service firms. Although studies on foreign market entry modes have made some modifications in using the transaction cost theory, such as including non-transaction cost benefits flowing from increased control or integration. The core

dimensions of the transaction within the transaction cost approach are defined as specific assets, the frequency of economic exchange and uncertainty surrounding the exchange of resources between buyer and seller. (Andersen 1997, p. 33)

According to Williamson, the composition of these dimensions is of high importance and leads to a decision towards the way, how cost efficient governance modes are assigned to the transaction (as cited in Andersen 1997, p. 33).

The theory more or less assumes the transaction cost minimization, whereas the application of such modifications might result in other conclusions with regards to the choice of entry mode than the original transaction cost theory would lead to (Andersen 1997, p. 33).

Furthermore, the dependent variable mode of entry which is used in this approach commonly refers to as "the entrant's level of control (high, medium, low)" and it assumes that the control and integration are closely related this would lead to a pitfall of the TCA (Andersen 1997, p. 33) as it, according to Gatignon/Andersen "does not distinguish well between the different degrees of partnership" (as cited in Andersen 1997, p. 33).

2.3.5 Organizational Capability (OC) Model

The organizational capability model has been developed only in the 1990s and has been used to explore entry mode choice. This model appears to be a combination of two theories namely the resource-based theory and, as there is an emphasis on experiential knowledge, the stage of development model and is said to be an alternative to the TCA. (Andersen 1997, p. 36)

The OC model, according to Madhok, describes the firm as "a bundle of relatively static and transferable resources which are transformed into capabilities through dynamic and interactive firm-specific processes where individual skills, organization and technology are inextricably woven together" (as cited in Andersen 1997, p. 36).

The key consideration of the OC model is the focus on the "value of the firm's capabilities" whereas the model is to an extent restricted if it comes to the predicted modes of entry as it focuses on internalization versus collaboration (Andersen 1997, p. 37).

The OC model nevertheless is used to explore export modes of entry that appears to be most frequently used in the early stage of the internalization process (Andersen 1997, p. 38).

2.3.6 Applicability in explaining Foreign Banks` Activity

2.3.6.1 Applicability of the Transaction Cost Approach

In the 1990s mainly the TCA and the eclectic framework have been used in empirical research on entry modes (Andersen 1997, p. 39).
The stage of development model has been applied to explain the decision of choosing an appropriate entry mode but resulted in the inability to recommend the appropriate entry modes such as it failed to explain why a new company shall enter with a wholly-owned subsidiary rather than with export (Decker and Zhao 2004, p. 5).
Meyer uses the Transaction Cost Approach in order to explain the entry of companies into transition economies such as Eastern Europe (Meyer 2001, p. 357). He outlines that every company needs to adapt its strategy to the host economy and proves empirically that companies which enter transition countries adapt their mode choice "to the specific transaction costs in different institutional frameworks" (Meyer 2001, p. 358).
In principle what reduces transaction costs are institutions facilitating the entry by providing terminology, the formal and informal rules of a market economy (Meyer 2001, p. 359). In recent years right after the communist system in Eastern Europe crashed, market-based institutions have been created step by step which diminishes transaction costs but does not lead to a full disappearance of them (Meyer 2001, p. 358).
Western companies approaching transition countries can expect high transaction costs as there is a "lack of information about local partners, face unclear regulatory frameworks, underdeveloped court systems and inexperienced bureaucracies" whereas also an internal mode of organization faces high costs (Meyer 2001, p. 358). In additional setting up a wholly-owned subsidiary is expensive as well as acquisitions which recently have been only possible by going through a privatization process. Further costs arise when making investments in "restructuring of the post-socialist companies, amending the corporate strategy, organizational structure and culture" as well as "implementing technological modernization and environmental clean-up". (Meyer 2001, p. 359)
The expenses of establishing a fully-owned local operation in a transition economy are severe as Greenfield investments might be too costly because set-up costs may be particularly high considering the bureaucratic procedures and furthermore it could be that they have difficulties to assimilate into the local business networks (Meyer 2001, p. 359).
The empirical study in this paper resulted in findings such as that "institutional progress increases investors' preference for internalization, making full ownership more likely".

Another finding is that German companies rather tend to select wholly-owned subsidiaries compared to British companies as those are more workable and realizable in nearby places. (Meyer 2001, p. 364) Moreover it has been found out that all entry forms except trade are appropriate for technology transfer whereas management transfer appears to rather happen in wholly-owned subsidiaries and joint ventures. With contracts and trade it is rather not possible. (Meyer 2001, p. 365)
Moreover there are authors saying that the usage of the TCA model is limited as transaction costs are hard to measure (Decker and Zhao 2004, p. 5).

2.3.6.2 Foreign Bank Entry in the Eclectic Framework

A lot of theories focus on finding out the reason for a firm's internationalization whereas according to Uiboupin, Dunning's eclectic paradigm is the most general one and says that the Foreign Direct Investment (FDI) decision is made based on three factors, namely ownership, location and internalization (Uiboupin 2005, p. 28). Uiboupin states that Yannopolous in 1983 used the eclectic paradigm to explain the internationalization in the banking sector saying that multinational banks possess locational advantages such as follow-the-client, country-specific regulations and entry restrictions (as cited in Uiboupin 2005, p. 28). The easy access to currency could represent an ownership advantage, whereas informational advantages as well as access to deposit bases could constitute internalization advantages. The existence of ownership advantages is significant as thereby the foreign banks would be able to cope with the advantages the domestic banks had due to incumbency. (Uiboupin 2005, p. 29)
According to Uiboupin, Williams in 1997 argued, that the assumption, that a multinational bank is in need of ownership advantage compared with domestic banks, is false and he furthermore suggested that the internalization would be sufficient to cover ownership advantages. Also he came up with the argument that testable hypotheses cannot be made based on the eclectic theory (as cited in Uiboupin 2005, p. 31).
The first ones to apply Dunning's eclectic theory to banking have been Gray and Gray in 1981, where they explored whether six main conditions could be applied to banking: imperfections in product market, imperfections in factor or input market, economies of internal operation, preservation of established customer accounts, entry into a growing or high-growth market and ensuring control over a raw material source. The first three conditions are connected to internalization efficiencies while the latter three are related to location-specific advantages (as cited in Konopielko 1999, p. 465).

The initial application of the eclectic theory to multinational banking appeared to be too complex and too general thus it was applied to banking activities across borders competing in market segments situated within national borders only. Euromarkets were excluded as they were considered to be a result of an escape motivation and it was presumed that ownership advantages exist whereas economies of scale were not considered as important ownership advantages in multinational banking. This application of the eclectic theory to multinational banking appeared to be too general resulting in an inconsistency and thus being incomplete. That is why the theory was expanded by Yannopoulos two years later. Location-specific advantages are necessary conditions for internationalization but not solely explain why foreign banks are able to effectively deal with the domestic competitors. In this context such location-specific factors are considered to be differences in regulatory structures, the desire of investors to separate currency from political risk, the geographical spread of the bank's client base, labour migration leading to banks following their retail customers, information collection and access to a skilled labour pool. The ownership advantages are crucial in the eclectic framework as they permit the foreign bank to overcome the domestic bank's advantages. (Williams 1997, p. 80) A meaningful "ownership advantage in banking is product differentiation" that according to Yannopoulos is said to stem from the importance of the certain key currencies in international trade and finance (as cited in Williams 1997, p. 81) that represents Aliber's "currency clientele argument" (as cited in Williams 1997, p. 81) on the one side and the importance of non-price competition in the market for banking services on the other side. Currency clientele means that clients favour to cooperate with banks that are situated in the country of origin of the transaction currency rather than with a bank whose office is not incorporated there and who might not be able to conduct the mechanisms for those transactions as the incorporated bank might be able to do. (Williams 1997, p. 81) Though Lewis and Davis say that this advantage could be given via correspondent banking thus the utilization of this advantage would not require a physical presence overseas (as cited in Williams 1997, p. 81).

Yannopoulos said that a multinational bank is able to induce short-term advantages for its own through "product differentiation and longer term advantages through perceived differentiation" (as cited Williams 1997, p. 81). According to Dufey and Giddy, "a long-term product differentiation in international markets" is hard due to the existence of patenting difficulties and as new products are mainly combinations of existing products (as cited in Williams 1997, p. 81). Furthermore it appeared that it is as hard to attract and retain skilled staff due to the labour market pressure for that staff according to Merrett. The perceived

differentiation is connected to a bank's size, its credit rating and the perceived probability of loan renewal (as cited in Williams 1997, p. 81).

3 Modes of Foreign Banks' Entry

It is evident that if a multinational company plans to enter into a new market it needs to align its strategy to the environment in the host country. This resolution has been one of the most important issues to be found out in the international business research thus a lot of concentration and efforts have been put on developing the strategy to the demands of the host country's institutions. Meyer in his paper concentrates on transition economies to investigate the different institutional contexts across countries and their effects on entry strategies. In those countries the institutional framework appears to be rather insecure as a result of the movement from central-plan to a market economy which leads companies, entering into those markets, to align themselves to a destabilized environment. (Meyer 2001, p. 357)

Companies conduct their cross border activities via international trade, contractual modes of co-ordination, or via equity-intensive investments like joint- or wholly-owned subsidiaries. Those modes of entry differ by the dimension of control over their local operations whereas they have mostly been explored with the transaction costs approach as well as some more comprehensive eclectic frameworks. (Meyer 2001, p. 358)

Different levels of resource commitment involved and a bank's decision of a specific mode to enter a certain market make it hard to adjust the initial decision. Thus a change would be time intensive and costly making the entry mode selection being a strategic decision for every company.

Normative decision theory says that the choice of a foreign market entry mode i.e. exporting, licensing, joint venture and sole venture should be subject to trade-offs between risks and returns. It is expected that a firm selects the entry mode that offers the highest possible risk-adjusted return on investment. Indeed a firm's selection may also be based on the resource availability and need for control. The choice of an appropriate entry mode is often seen as a compromise among these four mentioned attributes.

Exporting would therefore be a low resource (investment) and therefore a low risk/return mode of entry as it provides a firm with operational control but lacks marketing control that could be important for market seeking firms.

Contrariwise the sole venture involves high investment and hence is a high risk/return mode while providing a high level of control to the investing firm.

Joint ventures are a much lower investment and involve risk, return and control to the extent of equity participation of the investing firm.
Ultimately, the licensing mode would therefore be a low investment and low risk/return alternative that provides a very low level of control to the licensing firm. (Agarwal and Ramaswami 1992, pp. 1-2)
Dunning, by including firm-specific and market-specific factors that influence these above mentioned attributes (control, return, risk and resources) derived a framework to illustrate the choice among exporting, licensing, joint venture and sole venture modes (as cited in Agarwal and Ramaswami 1992, p. 2). A description of these factors is presented in 2.3.2.

3.1 Modes of Entry

Generally when considering the different degree/level of control over the local operations one can distinguish the following entry modes:

- Greenfield entry
- Control acquisition

From an institutional point of view, the following types of organizational structures can be distinguished:

- representative offices
- bank branch offices
- subsidiaries of a bank (Konopielko 1999, p. 466)
- affiliates or associates (Uiboupin 2005, p. 31)

3.1.1 Greenfield investment

This form of entry refers to the establishment of a completely new institution thus it is nor a take-over or acquisition of any other already existing institution neither any kind of merger. When establishing a new institution from the scratch a capital injection might be necessary for example in case the institution is built up as a subsidiary. In case the new institution has the form of a representative office or a branch no capital might be needed or might be realized only in the form of a human capital transfer. (Konopielko 1999, p. 466)
Buch in 2000 states that under perfect information about future business conditions costs of the Greenfield investment and acquisition are assumed to be the same but under uncertainty a Greenfield investment is likely to cause higher costs (as cited in Naaborg 2007, p. 61). Dell'Ariccia and Marquez in 2004 are of the opinion that the relative cost and information

advantages are the main factors to decide whether a foreign bank can profitably enter into a market in form of a de novo investment whereas empirical studies didn't lead to conclusions yet (as cited in Naaborg 2007, p. 61). Fries and Taci in 2005 argue that privatized banks acquired by foreign banks are more efficient than those that are newly established in form of a Greenfield investment (as cited in Naaborg 2007, p. 61).

3.1.2 Mergers and Acquisitions

In case a foreign bank buys shares or any other form of an institution's capital this is considered to be a control acquisition. The foreign bank has no limitation in terms of size of the purchase whereas the percentage of the acquisition can range from 0 to 100% of the capital of the acquired institution. (Konopielko 1999, p. 466)
International mergers and acquisitions in the financial sector in European transition economies reached the highest level in 2001 whereas since 2000 already foreign owned banks managed to outnumber domestic owned banks. At that time as well as today, foreign owned banks represent more than 80% of the bank assets in this region. (Naaborg 2007, p. 57)
Foreign banks tended to enter into developing economies mainly through cross-border mergers and acquisitions and are expected to continue to do so. (Clarke et al. 2003, p. 48)

3.1.3 Organizational forms

When a bank takes the decision to enter into a foreign market, an important question that appears is which form of representation is to be chosen (Garcia Blandon 1998, p. 2).
From an institutional point of view a foreign bank can enter a country in form of a representative office, an agency, a branch or a subsidiary (Konopielko 1999, p. 466).

3.1.3.1 Representative offices

A representative office can be described as a legal unit that is able to conduct financial advice and is supposed to be an intermediary between the mother bank and local customers to strengthen the communication between local firms and the mother bank. It is not allowed to provide classical retail banking services, such as collecting deposits and lending. The benefit of such an office is that their establishment involves very low investments whereas they are restricted in having no legal right to provide to its customers the full range of banking services and therefore cannot be used by banks that are aiming at gaining market share in a country. (Uiboupin 2005, p. 31)

A representative office is the institutional form which is easiest to be set up but also the one which is limited the most. The limitation is characterized by non-engagement in attracting deposits and extending loans, but generally serves as an opportunity of finding out whether further involvement would pay out. Theoretically, representatives are similar to public relations having little more functions and pay out in situations where regulations are limiting entry or low profit opportunities are given. (Konopielko 1999, p. 466) The representative office is considered to be the most economical of overseas banking organizational forms (Garcia Blandon 1998, p. 2). Theoretically, representatives are similar to public relations having little more functions and pay out in situations where regulations are limiting entry or low profit opportunities are given (Konopielko 1999, p. 466). Normally it is a small commercial office set up in order to support the parent bank and its customers in their financial and commercial activities in foreign markets (Garcia Blandon 1998, p. 2).

3.1.3.2 Agencies

Agencies represent a more expensive foreign banking activity than a representative office and may be useful in case a bank plans to engage in important export servicing with high involvement of the foreign exchange market. An agency allows the bank to also provide commercial loans to customers whereas business which is related to consumer loans or deposits is not permitted. (Uiboupin 2005, p. 32)

3.1.3.3 Branches

The branch constitutes an integral part of the parent and is permitted to provide a full range of banking services. Foreign branches are set up based on the home countries' law and its banking regulations. An important benefit of the branch is that its rating is derived from the parent's one, thus are in a better position than local banks when it comes to borrowing, deposit collecting and trading. (Uiboupin 2005, p. 32)

Foreign branches involve a higher level of commitment than a representative office or agency. The main difference between a branch and a subsidiary is a legal one, as a branch represents a unity together with its parent, and a subsidiary is an independent institution and legal entity. Some other differences are such as supervision, risk and performance. Branches are supervised by the bodies in their home countries and subsidiaries by local supervisory authorities. While subsidiaries are subject to local lending limits which are determined according to their level of capital, branches need no local lending limits as they are using

capital of the parent in form of a consolidation and thus are dependent on the parent's capital. (Konopielko 1999, p. 466)

Principally one can say that a foreign branch actively takes part in the target country banking system whereas a foreign subsidiary is incorporated into it and as such a subsidiary is subject to the same limitations that domestic banks have for conducting their banking activities. Thus it allows the parent bank to develop a wider activity in the foreign market. (Garcia Blandon 1998, p. 2)

Ter Wengel in 1995 argued that size of the entry market's size is a crucial factor which is very much influencing the form of representation. When looking at banks from big countries, they are likely to establish branches unless the host country is as large and as competitive as the home country. (as cited in Naaborg 2007, p. 62)

3.1.3.4 Subsidiaries

Subsidiaries can be defined as independent legal entities that are in majority and mostly fully owned by a foreign bank. They are run on the basis of their own capital and fully supervised and regulated by local authorities. A bank has many possibilities to open a local bank either by taking over an existing one by acquiring majority stake or by establishing a completely new entity via Greenfield investment. The strategies to operate a subsidiary are varying from bank to bank. Frequently local staff is hired as are already used to local conditions by having better knowledge of the customers and business conditions. Contrary some other banks are operating their subsidiaries centrally via the head office thus leaving them little room for independent behaviour. Subsidiaries are mainly an investment opportunity in countries which have liberal capital regulations and high income per capita (Naaborg 2007, pp. 62-63).

3.1.3.5 Affiliates or associates

Affiliates can be defined as independent legal entities that operate locally. Affiliates or associates may also be regarded as strategic shareholdings in which a foreign bank holds less than majority ownership. Foreign banks, in order not to run danger of losing reputation if this bank appears to have financial difficulties, tends to usually leave the local name of such an entity. Still mostly affiliates are used by foreign banks to tap transition markets via a minority ownership that is successively increased whereas such stakes are often bought by banks in times of crises at a lower share price. (Uiboupin 2005, p. 32)

3.1.3.6 Evidence from a survey by Konopielko

According to a survey carried out by Konopielko in 1999 the subsidiary is the most frequently used form of entering the CEE markets. After the subsidiary the take-over of existing banks represents the second most important vehicle of entering into a market whereas generally the attitude towards this mode of entry is being suspicious and reluctant. Setting up a branch and minority stake in a bank are according to the survey on third and fourth rank of the most relevant entry modes. The representative office and the minority stake are said to be the less important and less popular entry modes. The latter is the strategy which is mostly applied by the larger investment banks as well as some other banks that are specialized in export-import or development. A minority stake is mostly used as entry form by banks that are making medium-term rather than long-term investments such as the international development institutions EBRD and IFC which have a clear escape strategy when entering into a bank in CEE with a minority share whereas banks other than development bank might see such a medium-term minority stake as a strategy of gradual increase i.e. increasing the stake in the bank when financial results are ameliorating. (Konopielko 1999, pp. 469-470)

4 Motives of Foreign Banks in entering different markets

FDI has mainly been considered in the context of manufacturing rather than in banking but is now gaining more and more importance in international research.

In order to explain the internationalization of financial services two major theories can be applied: the theory of the multinational firm and the eclectic paradigm approach. Most of the research is based on the eclectic paradigm approach as it puts more emphasis on location and integration factors which helps a lot more in explaining FDI in transition economies. Foreign banks tend to enter foreign markets because of several factors – basically the most important ones being bank size, bank profitability and degree of internationalization.

Factors that influence a foreign bank’s entry into a foreign economy can be summarized into a few groups:

1) “follow the customer”, which contains FDI and bilateral trade. This group of factors is based on the assumption that banks follow their clients to be able to service them in foreign markets which is itself based on the “defensive expansion”. There are several FDI studies which identify “follow the customer” as the main driver for banks operating in specific countries whereas there are also some finding no significance nor for FDI neither for trade. (Mihaescu and Voinea 2008, p. 110)

Also Walter and Gray in 1983 mentioned that one of the main reasons for banks to undertake direct investments into other countries is the direct contact between banks and clients (Konopielko 1999, p. 466).

Another important author outlining the importance of this factor was Grubel in his paper from 1977, saying that according to the defensive expansion theory banks follow their FDI to ensure further existing of relationships with their clients. Most of the studies on foreign entry see the "follow the customer" view as important. (as cited in Naaborg 2007, p. 58).

2) Market attractiveness summarizing factors such as GDP, size, distance, financial market development and profit opportunities. A big part of studies conducted in this connection resulted in finding GDP, size and distance as important factors driving foreign banks to enter into other markets whereas there have been studies not finding this factors as significant for a foreign bank's entry decision. (Mihaescu and Voinea 2008, p. 110)

   Expected economic growth in the host country could offer very profitable business opportunities that might be attractive especially when feeling competitive pressure in the home banking market. Also well developing exchange rates or attractive tax systems could be positively influencing the entry decision. (Naaborg 2007, p. 58)

   Several studies have been conducted in the past outlining the importance of profit opportunities in host countries for the decision to enter a country. One study modelling foreign bank presence across 80 countries in the years 1988 – 1995 found that foreign banks tend to enter markets with low taxes and high per capital income whereas others found similar analogue results for per capita GDP.

   When conducting all these studies it appeared that foreign banks tend to enter developing economies for different reasons than they tend to enter developed ones. In developing countries it appears to be a less important motivation to follow the customer than it is for developed countries. (Clarke et al. 2003, p. 35)

3) Risk such as political, banking crises or currency risk are a set of factors influencing negatively a bank's entry decision (Mihaescu and Voinea 2008, p. 110).

4) Institutional factors which may refer to both the market or the risk factor group as they increase market attractiveness while their non-development or malfunctioning increases as well the risk in the host country. The EU policies may be considered as one institutional factor influencing the bank's entry decision. (Mihaescu and Voinea 2008, p. 110)

> Regulations in a host country are restricting and limiting competition and are protecting inefficient domestic banks thus foreign banks favour to invest in countries with less regulatory restrictions on banking activity. It appears that restrictions on entry are associated with higher costs and furthermore banking crises tend to be more likely in such countries with restrictions on foreign bank entry and ownership. (Clarke et al. 2003, p. 36)

In their recent study from 2008 on motives of why foreign banks enter South East Europe, Mihaescu and Voinea found out that bilateral trade, the lag of FDI (at least 2 years earlier), interest rate differential, and banking sector reform are important determinants for foreign banking activity in South East Europe (Mihaescu and Voinea 2008, p. 110).

Konopielko uses a postal survey and an OLS/logit model of entry determinants to study the application of some theoretical issues of multinational banking to the pattern of foreign bank's operations in Poland, Hungary and Czech Republic. The postal survey has been distributed to the headquarters of important banks investing in CEE and to 70 leading banks at the end of 1996 in order to find out the reasons and main strategies of their entry into this region.

When reviewing the results it appeared that the main motivation for expansion into those countries is a location-specific advantage and was said to be the ability to support the client base which leads us to the "follow-the-client" behaviour as described above under point 1). New business opportunities appeared to be the second most important motivation which is connected to the internalization advantages. Furthermore one considered the ability to offer better and more developed trade finance services as a very important motivation. The importance of meeting competition of other banks is rather low as the markets that are entered by the foreign banks are anyway smaller economies with low capacities to contribute significantly to overall profits and the competition level from other foreign banks and domestic banks is rather low. (Konopielko 1999, pp. 467-468)

5 Banking Sector and FDI in South East Europe

5.1 Overview of the banking sector in South East Europe

In European transition countries the year 2001 was characterized by a maximum number of international mergers and acquisitions in the financial sector. Already since the year 2000 there are more foreign owned banks in European transition countries than domestic ones. Today, the bank assets in the region consist to an extent of more than 80% of foreign owned banks. (Naaborg 2007, p. 57)

In order to illustrate the development of banking assets in European transition countries I will concentrate on South Eastern Europe. South Eastern Europe is a sub-region composed of the EU member states Bulgaria and Romania that entered the EU on 1st January 2007, the EU candidate Croatia and the countries of western Balkans i.e. Albania, Bosnia and Herzegovina, Kosovo, Serbia, Montenegro and Macedonia. Although this area is the most heterogeneous of the three sub-regions in CEE it shows the same pattern when looking at the development of the foreign ownership in the banking sector. (CEE Banking Sector Report 2010, p. 6) The market share of foreign-owned banks has augmented during the past years and led to improvement of banking services and awoke competition (CEE Banking Sector Report 2010, p. 7).

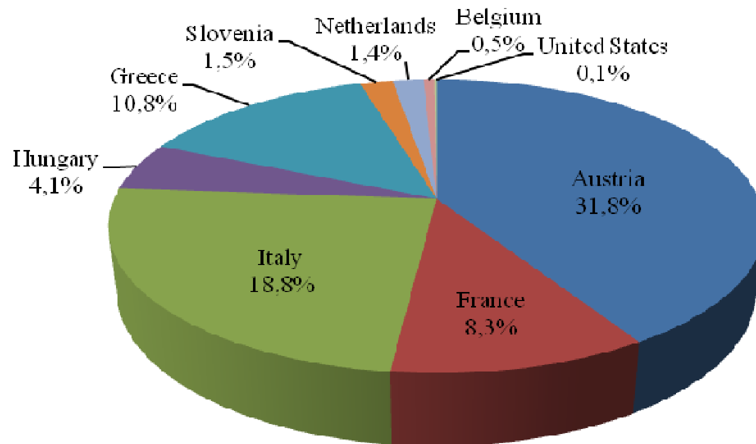
On average, foreign ownership in SEE stands at ca. 85% of total assets and state ownership stands at below 10% of total assets as per year-end 2010 whereas there are significant differences depending on countries. In Slovenia, for example, the market share of state-owned banks has drastically augmented in past few years due to state recapitalisations but is expected to lower again in the light of divestment plans the government has due to worsening fiscal position. (CEE Banking Sector Report 2011, p. 7)

Private sector and foreign ownership structures in the banking sector in SEE appear to be rather homogenous. In all SEE countries, except Serbia, private sector foreign banks' market share with 80-95% of total assets dominate the banking sector whereas the share of state-owned banks remains to be low. In Serbia the state-owned banks still have ca. 20% of total assets and foreign banks' market share amounts to about 73% of total assets that is rather low compared to the other countries in the SEE region. (CEE Banking Sector Report 2011, p. 7)

Some of the countries have very high growth rates whereas the extent of financial intermediation still remains low in SEE with the exceptions Croatia and Bulgaria. What is necessary and could have a positive effect on the development of the SEE economies and their banking sectors are further legal and institutional reforms that are inevitable as they are part of the EU integration process. (CEE Banking Sector Report 2010, p. 7)

The largest investors in South Eastern Europe are Austrian, Italian and Greek banks whereas the Austrian ones are dominating with a market share of one third (Figure 1). A reason for this could be the distance to those markets as Vienna and moreover Austria is close to Eastern Europe and some use to say that it is even building the border to Eastern Europe as it is the nearest Central European country. (Mihaescu and Voinea 2008, p. 108)

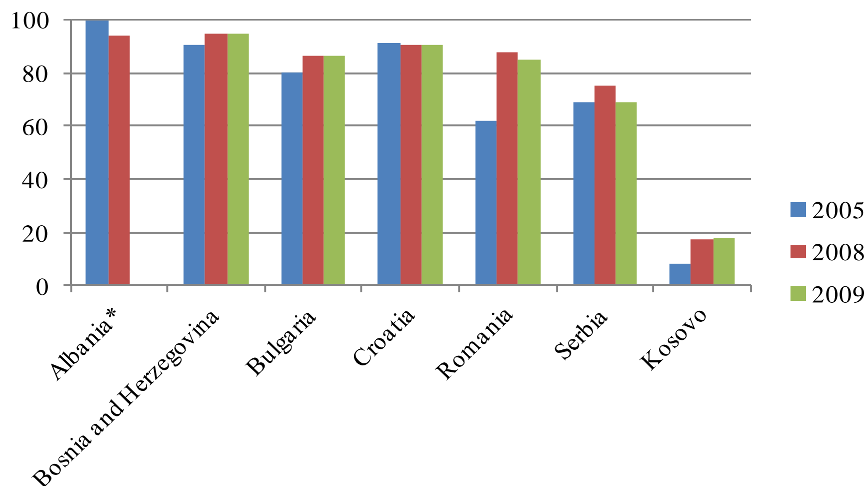
Figure 1: Market share of largest investors in SEE (% of total assets)



Source: CEE Banking Sector Report 2010, p. 56 (own illustration)

Affected by the Lehman Brothers bankruptcy on 15th September 2008 the banking sector in SEE was characterized by de-risking and restructuring throughout the year 2009. This one failure had a global impact and finally had an extraordinary strong impact on the banking sector in SEE. (CEE Banking Sector Report 2009, p. 3) After Lehman most CEE economies were earmarked by decreasing exports, strongly decreased levels of foreign direct investments and moreover the global investors' general aversion to risks (CEE Banking Sector Report 2010, p. 3).

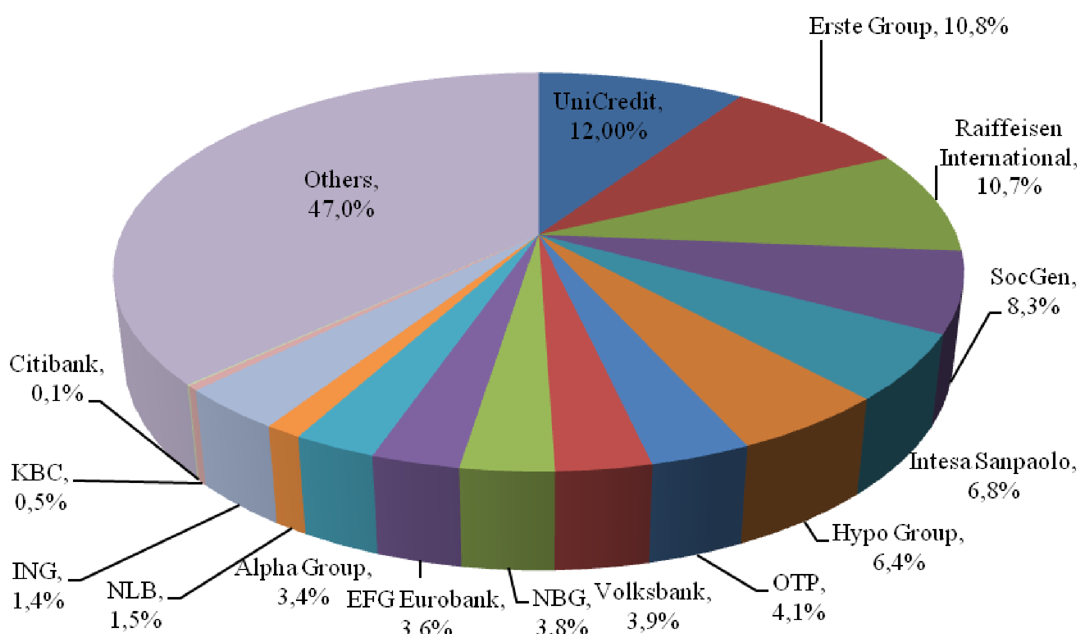
Figure 2: Market share of foreign owned banks (% of total assets)



Source: CEE Banking Sector Report 2010 (own illustration)

When comparing the year 2009, characterized by the financial crisis, with the year 2005, being one of the boom-years, there has not been a lot of fluctuations when considering the market share of foreign-owned banks in SEE. Those market shares rose since 2005 in nearly each SEE country and remained stable in the period from 2008 – 2009. Two exceptions thereto have been Romania and Serbia whereas the decrease in market shares was not worth mentioning as it was a quite moderate (Figure 2). (CEE Banking Sector Report 2011, p. 66)
Still when looking at the market shares of foreign-owned banks in selected SEE countries the impact of the Lehman Brothers collapse followed by the financial crisis has not been too dramatic, at least, when considering the foreign investments in the banking sector (CEE Banking Sector Report 2011, p. 66)
As a logical consequence of their countries' presence in SEE, Austrian and Italian banks are the biggest investors in the SEE banking sector with UniCredit (Italian), Erste Group (Austrian) and Raiffeisen Bank International (Austrian) being the market players in SEE according to total assets (CEE Banking Sector Report 2011, p 66). Most of those foreign banks used a regional strategy to enter into this market (Figure 3) (Mihaescu and Voinea 2008, p. 108).

Figure 3: Market players in SEE (% of total assets)



Source: CEE Banking Sector Report 2010, p. 56 (own illustration)

One of the current surveys conducted by Thomson Reuters & OEKB shows that direct investors assess both, the business situation as well as the future business development in CEE, as slightly more favourable whereas investment projects continue to be characterized by a continuous upward trend when considering the business climate indicator which is observed since mid-2009 and to keep on in 2011. The economic environment will improve the view of the direct investors in the next twelve months as well though not a dynamic economic recovery is expected. (OEKB 2011)

A closer examination of the current results at the industry level shows a mixed picture, in particular in the financial sector. While the satisfaction of the insurance sector with the current business situation at the beginning of 2011 compared with October 2010 decreases, the banks see their current performance levels positive again. A view into the future shows that the two financial sectors will behave differently. The insurance companies screw their business expectations for the coming six months upwards, the banks assess their future prospects, however again more carefully. Overall, in the insurance industry there is still a better business climate, the banking system has, however, caught up noticeably in the current survey compared to October 2010 survey. (OEKB 2011)

5.2 Foreign Direct Investment

Table 1 shows that global FDI flows significantly augmented from USD 59 billion in 1982 to USD 208 billion in 1990 and to USD 648 billion in 2004. Until the year 1990, FDI in developed countries amounted to almost 80% of all FDI. This share diminished in the 1990s to 60%, and even more decreased to below that percentage in 1996 when FDI in developing and transition economies increased. The proportion of FDI in SEE and Commonwealth of Independent States (CIS) countries increased from 1.0% of world FDI in 1990, to 3.8% in 2000 and 5.4% in 2004.

FDI has very much increased for SEE countries and went up from a very low level in the early 1990s to double in 2003. FDI in developing and CIS countries also went up but by much less. More than 50% of the European FDI in 2001 and 2002 occurred in non-European Union countries. Germany and Austria represented the most active investors in CEE, whereas Austrians and Slovenians were the most active in SEE. These numbers are underlying the opinion that CEE and SEE were of most interest to their direct neighbours and a few other countries having a historical interest in the region. FDI in South-East Europe and the CIS counted for USD 35 billion in their fourth year of growth in 2004 representing the highest growth since the start (Table 1). (Babic-Hodovic and Tesche 2006, p. 2)

Table 1: FDI growth (billion USD)

Region	1982	1990	2003	2004
The world	59	208	633	648
Developed countries	47	124	442	380
SEE	-	0.3	8	11
CIS	-	1.7	16	24
SEE and CIS % in the world	-	1.0	3.8	5.4

Source: Babic-Hodovic and Tesche 2006, p. 2 (own illustration)

Trends in inflow FDI differ to some extent when looking at South East Europe and CIS. In SEE, FDI started to increase rapidly in 2003, driven by large privatizations. In 2004, the FDI inflows increased nearly three times from 2000, growing to approximately USD 11 billion. In the CIS, FDI increased from USD 5 billion in 2000 to USD 24 billion in 2004 mostly as a result of high prices of petroleum and natural gas. FDI inflows into the region were expected to increase further over the next few years which turned out to be correct. FDI inflows into SEE per country are shown in Table 2. (Babic-Hodovic and Tesche 2006, p. 2)

Table 2: FDI inflows into SEE (billion USD)

FDI inflows	1999	2000	2001	2002	2003	2004
SEE	3,618	3,628	4,302	3,790	8,365	10,778
Albania	143	204	135	178	343	1,514
B&H	177	150	130	266	382	498
Bulgaria	802	998	803	905	2,097	2,488
Croatia	1,420	1,085	1,407	1,126	2,642	1,076
Hungary	3,065	2,191	3,580	2,590	874	3,653
Macedonia	32	176	439	77	97	150
Monte - negro	-	-	10	85	44	62
Romania	1,025	1,051	1,154	1,144	2,213	5,174
Serbia	112	25	165	562	1,405	1,028
Slovakia	701	2,058	1,460	4,007	549	1,250
Slovenia	59	71	226	1,489	- 139	227

Source: Babic-Hodovic and Tesche 2006, p. 2 (own illustration)

Before 1997 mostly smaller foreign companies made investments in SEE. There were two exceptions namely the Austrian banks that put all efforts in expanding into SEE so did Slovenia. Most of Slovenia's FDI occurred in Croatia but it was one of the countries that also invested in Bosnia and Herzegovina and Macedonia. FDI doubled in Bulgaria and Romania in 2003 when EU accession was near and highly increased again in Romania in 2004. Also in Slovenia in 2002, Serbia in 2003 and Albania in 2004 a similar development in FDI can be traced. FDI in Slovakia has shown exceptions in some years but varies more than the other. (Babic-Hodovic and Tesche 2006, p. 2)

FDI in SEE countries is mainly recognized by growing share of FDI in banking and infrastructure services such as telecommunications, water and electricity. This was mainly driven by the liberalization and disappearance of foreign investment barriers in the banking and financial sectors. In the post-crisis period these barriers were mainly removed to form a stronger, more efficient, financial system and to lower cost levels for bank capitalization and restructuring. FDI inflow for example in Bulgaria, Romania and Croatia grew rapidly after 1997 led by better political and business conditions in the countries due to structural reforms and the expansion and opening of their financial sector to FDI. (Babic-Hodovic and Tesche 2006, p. 3)

FDI growth specifically in the banking area was influenced by the following:

- Globalization of the financial services industry led to a growing competition between different non-bank sources of credits and financial services (especially in the insurance market) that, on the other side, resulted in the consolidation of the banking systems.
- The growing interest of foreign banks' in emerging markets could be to an extent driven by the possible economies of scale or advantages of technology as well as of early entry in product or service life cycles.
- Many banks concentrated on a specific region led by language and cultural connections whereas this strategy is a result of regional marketing orientation. For instance, there are Austrian banks in B&H and Italian banks in Croatia, etc.

FDI in the financial sector in CEE makes up 13.6% of the total FDI in 1999 which represents the highest level of FDI in one specific sector within the transition economies. The reason for this lies mainly in the change of ownership structure in banking whereas foreign banks gained increasing control over bank assets and banking activities in Central Europe. The share of foreign capital in bank assets in CEE countries amounted to around 70% in 1999-2001, but higher than 90% in some countries by 2004.

FDI was expected to grow in future as it is mainly related to growth in lending and deposits that was supposed to grow. (Babic-Hodovic and Tesche 2006, p. 3)

The Vienna Institute for International Economic Studies in June 2011 introduced an analysis of foreign direct investment in 20 Central, East and Southeast European countries based on the latest update of its database.

According to this analysis, FDI still appears to be of great importance for the development of CEE countries, especially as the domestic possibilities of economic growth are still weak, and fiscal consolidation drags on many of the economies. The economic recovery that began in the region mainly stems from external demand as the foreign investors' subsidiaries generate the main part of exports. Overall an increase of FDI of 9% was recorded in 2010. Strong growth could be registered in the Czech Republic, Latvia and Lithuania. Bulgaria, Romania and South East Europe had another year of severe decline, whereas most of the FDI increase in CEE countries took place in Russia where a recovery of the domestic demand could be traced (Table 3). (wiiw 2011)

FDI increase was mainly driven by three factors:

- booming export demand
- improving financial stability in host countries
- the recovery in the financial position of investors

The most important investing countries were the Netherlands, Germany and Austria whereas the ranking has not changed over the past three years, but the position of the Netherlands has strengthened compared to Germany. Austria appeared to be the largest investor in Bulgaria and Slovenia and possesses the second place in Romania and Slovakia whereas it has a weaker position in the Baltic countries and in Poland. In Southeast Europe, Austria is the primary investor in the larger countries such as Bosnia and Herzegovina, Croatia and Serbia, mainly by its banks. (wiiw 2011)

Table 3: Overview of FDI in South East Europe (in million EUR)

Country	2005	2006	2007	2008	2009	2010	forecast 2011
Albania	213	259	481	675	706	827	600
Bosnia and Herzegovina	493	611	1520	636	177	48	100
Croatia	1468	2768	3679	4218	2096	440	1000
Macedonia	77	345	506	400	145	221	200
Montenegro	384	496	683	656	1099	564	600
Serbia	1268	3392	2513	2018	1410	1003	1500
South East Europe	**3903**	**7871**	**9381**	**8603**	**5633**	**3104**	**4000**

Source: wiiw 2011 (own illustration)

6 Structure of the Banking Sector in Bosnia and Herzegovina

The State of Bosnia and Herzegovina was formed after a referendum on independence in 1992 which caused a war that stopped on December 24, 1995 when signing the Dayton Peace Agreement. The Bosnian state consists of two separate entities namely the Federation of Bosnia and Herzegovina and the Republic Srpska whereas also the administration and the constitution are included in the agreement. (Babic-Hodovic and Tesche 2006, p. 1)

The banking system was quite weak in the 90s until after 2000 when reforms were introduced and a fast increase in FDI was observed in Bosnia and Herzegovina after that .(Babic-Hodovic and Tesche 2006, p. 2)

The banking sector in Bosnia and Herzegovina is governed by the entity banking laws that are largely harmonized as well as by the banking agency laws whose main task is the supervision of commercial banks in accordance with the territorial principle. (CBBH Financial Stability Report 2010, p. 37)

Table 4: Assets of financial intermediaries incl. banks

	2008		2009		2010	
	million BAM	Share, %	million BAM	Share, %	million BAM	Share, %
Banks	**20,815**	**80.8**	**20,608**	**82.7**	**20,416**	**84.3**
Investment funds	1,225	4.8	871	3.5	888	3.7
Leasing companies	1,607	6.2	1,416	5.7	1,108	4.6
Insurance and reinsurance	890	3.5	940	3.8	941	3.9
Microcredit organizations	1,213	4.7	1,087	4.4	856	3.5
Total	**25,749**		**24,923**		**24,210**	

Source: CBBH Financial Market Stability Report 2010, p. 37 (own illustration)

The assets of financial intermediaries decreased as well in 2010 whereby the effects of the financial crisis in 2008 in the banking sector reached their peak. Even though one could see an improvement in the credit activities after the 2009 market contraction, the net assets decreased relative to 2009 as provisioning for non-performing assets increased. Increasing provisioning costs resulted in an all-time high loss whereas, as mainly foreign owned, the banking sector remained to be sufficiently capitalized. (CBBH Financial Stability Report 2010, p. 37) Although difficulties appeared in the real sector in the past years, the banking sector remained stable. However, although some banks had problems as a result of underdeveloped credit and other risk management functions, the banking sector as a whole survived without intermissions (Table 4). (CBBH Financial Stability Report 2010, p. 38)

Although there was an increasing negative impact of the global economic crisis in 2010 the banking sector succeeded in maintaining stability whereas the growth of course stagnated. The crisis had its biggest influence on the lending and the quality of portfolios. The banking agencies gave opportunity to the banks to reprogram and restructure loans granted to physical and legal entities in order to facilitate the continuation of business operations and accomplish liquidity problems. (CBBH Annual Report 2010, p. 79)

Deposits that are the main source of financing of commercial banks in Bosnia and Herzegovina increased in 2010. The maximum amount of deposit insurance for individuals was raised to BAM 35,000 from April 1, 2010 on and the number of banks participating in the

insurance program was also raised to 25 as Union Bank d.d. Sarajevo, a state-owned bank, entered into the deposit insurance program.

The Central Credit Registry that contains all data on loans of all commercial banks, MCOs and leasing companies continued its operations efficiently thus reliable assessment of credit risk was possible.

The minimum amount of the bank capital remained at BAM 15 million (EUR 7.67 million) and otherwise there were no further changes in regulations.

The banking sector represents the most important and strongest component of the financial system in Bosnia and Herzegovina. The number of commercial banks diminished as the FBA revoked the banking licence and opened a liquidation process for Una Bank Bihac last year and a part of the bank's property and obligations has been bought by Balkan Investment Bank Banja Luka. (CBBH Annual Report 2010, p. 79)

At the end of 2010, total assets of all banks in Bosnia and Herzegovina stood at BAM 21.07 billion, which means an increase of BAM 157.5 million or 0.8%. The banking sector was characterized by growth trend over the past years that halted in 2009 due to economic crisis. (CBBH Annual Report 2010, p. 81)

In 2010, the banks' asset quality further worsened due to the growth of non-performing claims and regulatory changes in the Republic Srpska. Non-performing assets of banks (NPA, categorized as C, D and E) amounted to BAM 1.66 billion, and augmented by BAM 853.1 million or 105.6%. The share of nonperforming assets in total assets increased from 3.9% at the end of 2009 to 8.1% at the end of 2010. (CBBH Annual Report 2010, p. 87)

The banking sector in Bosnia and Herzegovina was affected by the economic crisis and recession, and one of the main particularities of this sector in 2010 was a decrease in profitability of commercial banks resulting in a negative financial result of BAM 124.3 million, with 23 commercial banks recording profit, and 6 banks reporting loss in business. The losses were brought in by a small number of banks thus one can say that the banking system was not seriously threatened by such a low business output.

The foreign-owned banks recorded the lowest values with ROAE of -6.3%, which was down by 7.0 percentage points compared to the previous year. (CBBH Annual Report 2010, p. 88)

Better reforms and the privatization process of the banking sector lead reputable foreign banks to invest in Bosnia and Herzegovina and the region. Banks such as Raiffeisen Bank and Volksbank (both Austrian banks), Unicredito bank (Italy), Ziraat Bank (Turkey) and Zagrebačka Banka (Croatia) were the earliest to enter the market. After those bigger investments in Bosnia and Herzegovina's banking sector have been conducted by Hypo

Vereinsbank [HVB] (Germany), Hypo Alpe-Adria-Bank (Austria) and Nova Ljubljanska Banka (Slovenia). Mainly the banks entered the market via acquisition of existing local banks under the governments' bank privatization programs. Though, many foreign banks, mainly those from Austria, have entered the market via a Greenfield investment i.e. they opened a completely new fully-owned entity. It is expected that the foreign banks will further try to enhance their competitive position. This in return could represent a risk to financial stability in the region as a growing concentration of ownership in the banking sector could cause problems that could affect the whole region such as the domination by the Italian bank, Unicredito that meanwhile with a large market share is active in four countries in the region namely Croatia, Bulgaria, Bosnia and Herzegovina, and Poland.

Still the people in the region have considered the entrance of foreign banks as rather positive as it resulted in higher confidence in the banking system. At the beginning some of the foreign banks which bought existing banks adjusted themselves to the local operating environment and did not act, as it would have been expected, in accordance with the strict corporate guidelines that are in force in their home countries. Especially in Bosnia and Herzegovina and Serbia and Montenegro this characteristic appeared. Though, as the competition increased, foreign banks tended to implement the expertise from their home offices thus introducing their own corporate culture whereby considerable efforts have been put into staff and language training. Many of the banks hired foreign account officers into the local market, as well as educated the senior local staff in the sense of a wider bank system.

The interest in the banking sector in the region still appears to be big. The investment in the banking system in this region has been profitable due to the fact that the share of banking sector assets to GDP in the region still appears to be relatively low compared to the European Union leaving more room for expansion of the banking sector in the region. (Babic-Hodovic and Tesche 2006, p. 7)

Overall, the increase in FDI in the banking sector in Bosnia and Herzegovina and the region had a positive impact. The higher confidence in the banking system, rising banking deposits and assets as the foreign share has increased, a decline in lending rates and a change in the structure of lending towards households are some of the positive effects. Whereas it did not lead only to positive effects but also to an increased concentration and a regional dependence on a decreasing number of foreign banks with a probable increase in systemic risk and monopolistic behavior. (Babic-Hodovic and Tesche 2006, p. 7)

6.1 The Central Bank of Bosnia and Herzegovina

The Central Bank of Bosnia and Herzegovina has been established under the Dayton Peace Agreement and in accordance with the Law adopted at the Parliament of Bosnia and Herzegovina on June 20, 1997 and started operating as a federal-level institution on August 11, 1997 (Coskun and Ilgün 2009, p. 56).

Central Bank of Bosnia and Herzegovina is acting as a coordinator in banking supervision in accordance with the law on Central Bank of Bosnia and Herzegovina that has been introduced in collaboration with entity banking agencies and is predicated on regular data exchange and consultations on the banking sector (CBBH Annual Report 2010, p. 79).

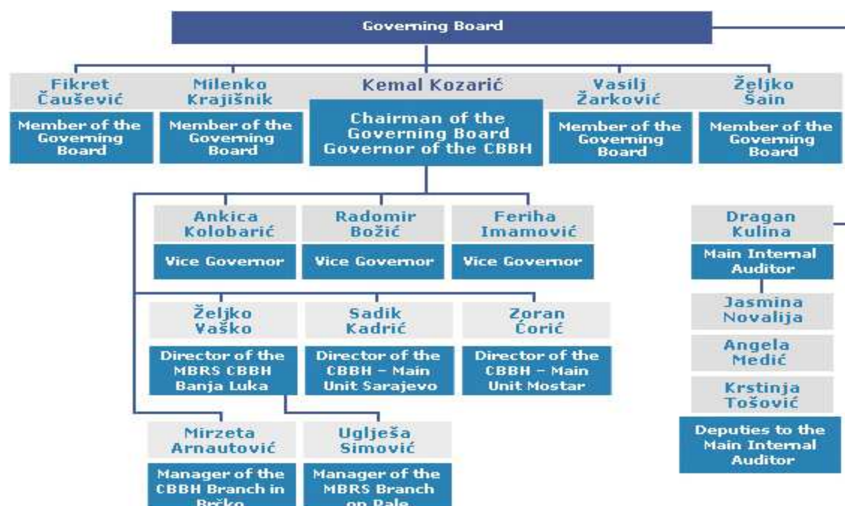
The heading institution of the central bank is the Governing Board of the Central Bank that is by law acting as an independent central financial institution. It's responsibilities are the establishment and supervision of monetary policy, organization and strategies of the central bank for which it is entitled by law. (CBBH (a) 2012) The structure of the central bank is determined by Article 7 of the Bosnia and Herzegovina Constitution (Annex 4 of the Dayton Peace Accords) whereas the "Law on the Central Bank" came into force in June 1997. The Central Bank of Bosnia and Herzegovina is representing the sole monetary authority within the country. The central bank's main tasks are set by law and according to the General Peace Agreement in Bosnia and Herzegovina. The main goals and tasks are "formulating, adopting as well as controlling the monetary policy of Bosnia and Herzegovina" by issuing domestic currency according to the Currency Board arrangement with full coverage in freely convertible foreign exchange funds under fixed exchange rate 1 BAM: 0,51129 EURO and furthermore is supporting and has the responsibility for appropriate payment and settlement systems. The central bank also runs a Currency Board Arrangement based on the Central Bank law and Dayton Peace Agreement whereby "the fixed exchange rate and rule-based approach to monetary policy" are agreed. (Coskun and Ilgün 2009, p. 56)

This means that the Central Bank is not able to apply monetary policy to overcome increasing demand and thus has the possibility to use only few monetary policy tools. In June 1998 the new country-wide currency Convertible Mark (Konvertibilna Marka, BAM) has been adopted and replaced the three different currencies that were previously in use in the different parts of Bosnia and Herzegovina. The Convertible Mark was previously pegged to the German Mark in 2001 after the introduction of the Euro the peg was changed to the Euro at a rate of 1 BAM = € 0.51129. An institution, the Fiscal Council, has been established is responsible for coordination of fiscal policy. (Coskun and Ilgün 2009, p.57)

Figure 4: Organizational structure of CBBH

Source: http://www.cbbh.ba/index.php?id=730&lang=en, last visited on 18.03.2012

Figure 5: Governing board and management structure of CBBH



Source: http://www.cbbh.ba/index.php?id=15&lang=en, last visited on 18.03.2012

6.2 Supervision Agencies

Since the late 1990s new modern banking laws were introduced in Bosnia and Herzegovina. In Bosnia and Herzegovina the Banking Agency of the Federations of Bosnia and Herzegovina, Banking Agency of the Republic Srpska and partly the Deposit Insurance Agency of Bosnia and Herzegovina are responsible for the monitoring and observing of the banking sector. The Federation Banking Agency came into existence and started operating in 1997. The Federation Banking Agency's main tasks are bank licensing and supervision. The Banking Agency of the Republic Srpska was formed out of a conversion of the National Bank of Republic Srpska in mid-1998. In 1998 two laws were passed to set up bank privatization, the Law on the Privatization of Banks and the Law on Opening Balance Sheets for Enterprises and Banks. Supervisory agencies both in the Federation Banking Agency and the Banking Agency of the Republic Srpska are authorized to conduct banking supervision in Bosnia and Herzegovina whereas they are governed by individual entity-level legislation. Both are entitled to grant and revoke licenses and measure banks. The Central Bank of Bosnia and Herzegovina is the coordinator of the activities of the two entity agencies. Principally the Federation Banking Agency and the Banking Agency of Republic Srpska entered into a cooperation agreement among themselves, as well as both of them with the Deposit Insurance Agency. (Coskun and Ilgün 2009, p. 57)

Deposit Insurance Agency of Bosnia and Herzegovina (DIA) has been established by the Law on Deposit Insurance in Banks of Bosnia and Herzegovina in 2002. DIA is an independent, non-profit, legal entity with full authority under the Law of the State. Head Office of the DIA is located in Banja Luka, and there is one Branch Office in Sarajevo and Banja Luka.

In 2009 there are 25 banks which are signed the Contract on Deposit Insurance. (Coskun and Ilgün 2009, p. 57)

6.3 Commercial Banks

Commercial banks in Bosnia and Herzegovina are regulated by the Law on Banks (Coskun and Ilgün 2009, p. 57).

Back in 1996 30 of the 53 banks used to be majority privately owned whereas most of them were situated in the Federation. In the Federation there were exactly 27 private banks with DM 384 million of assets and in the Republic Srpska there were 3 private banks with DM 28 million of assets making up 5% of nominal assets. At the end of 1999 there were in total 44 banks in the Federation of Bosnia and Herzegovina whereas 34 out of them were majority

private owned. The banking sector of Republic Srpska consisted at that time of 18 banks and 7 of those were in majority private ownership.

The minimum level of bank capital was set at BAM 5 million in the Federation at that time and has been raised in 2000 to BAM 15 million – to be reached by end of 2002 for existing banks and by October 2000 for new banks. The Banking Law in the Serb Republic however set the minimum bank capital requirement at USD 1.5 million in 1996 and increased it to BAM 5 million as of January 2000. It was again increased in 2002 to BAM 15 million. (Babic-Hodovic and Tesche 2006, p. 1)

Nowadays most of the banks in Bosnia and Herzegovina are privately owned and foreign-owned banks are the main contributor to credit growth in the country (Coskun and Ilgün 2009, p. 57). Table 5 shows a full list of 18 commercial banks that are currently operating in the Federation of Bosnia and Herzegovina and Table 6 illustrates which 10 banks are active in the Republic Srpska in 2011.

Table 5: Overview of commercial banks in the Federation of B&H in 2011

	Name of the bank	Head Office
1	BOR banka dd	Sarajevo
2	Bosna bank international d.d.	Sarajevo
3	Hypo Alpe-Adria-Bank d.d.	Mostar
4	Intesa Sanpaolo Banka d.d. Bosna i Hercegovina	Sarajevo
5	Investiciono-komercijalna banka dd	Zenica
6	Komercijalno-investiciona banka dd	Velika Kladusa
7	MOJA BANKA dd	Sarajevo
8	NLB Banka d.d.	Tuzla
9	Privredna banka Sarajevo d.d.	Sarajevo
10	ProCredit Bank Sarajevo	Sarajevo
11	Raiffeisen Bank dd BiH	Sarajevo
12	Razvojna banka Federacije BiH	Sarajevo
13	Sparkasse Bank d.d.	Sarajevo
14	Turkish Ziraat Bank Bosnia dd	Sarajevo
15	UniCredit Bank d.d.	Mostar
16	Union banka d.d.	Sarajevo
17	Vakufska banka d.d.	Sarajevo
18	Volksbank BH dd	Sarajevo

Source: http://www.cbbh.ba/index.php?id=7&lang=en, last visited 18.03.2012

Table 6: Overview of commercial banks in Republika Srpska in 2011

	Name of the bank	Head Office
1	Balkan Investment Bank AD	Banja Luka
2	Bobar banka ad	Bijeljina
3	Hypo Alpe-Adria-Bank a.d.	Banja Luka
4	Komercijalna banka AD	Banja Luka
5	MF Bank, a.d. Banja Luka	Banja Luka
6	NLB Razvojna banka	Banja Luka
7	Nova banka ad	Banja Luka
8	Pavlovic International Bank a.d.	Slobomir Bijeljina
9	Unicredit Bank a.d.	Banja Luka
10	Volksbank a.d.	Banja Luka

Source: http://www.cbbh.ba/index.php?id=7&lang=en, last visited on 18.03.2012

In terms of ownership structure of the banks 21 are foreign owned, 7 domestic privately-owned and one majority state-owned at the end of 2010.

Table 7 demonstrates that the share of foreign-owned banks stood at 89.9% as at the end of 2010 meaning a decrease of 0.9 percentage points. (CBBH Annual Report 2010, p. 79)

Table 7: Banking sector assets development

Year	2006	2007	2008	2009	2010
Share in total assets					
By size					
Top 3	43.5%	40.7%	46.4%	46.2%	43.3%
Top 5	59.3%	56.7%	60.8%	59.2%	56.8%
Top 10	79.6%	78.7%	80.2%	79.4%	77.5%
By ownership					
Foreign	90.3%	91.2%	91.3%	90.8%	89.9%
Domestic-state and private	9.7%	8.8%	4.8%	9.2%	10.1%

Source: CBBH Annual Report 2010, p. 79 (own illustration)

In 2010, totally 11 banks were enabled to conduct custody operations, but in December 2010, at the request of Hypo Alpe-Adria-Bank a.d. Banja Luka, the licence to conduct custodial operations, previously introduced by the ruling of the Securities Commission of Republika Srpska, ceased to be valid.

The banking system in Bosnia and Herzegovina is mainly composed of commercial banks with majority foreign ownership and their share was 89.9% of total banking sector system,

whereas state-owned banks and domestic privately-owned banks accounted for 10.1% as at the end of 2010. (CBBH Annual Report 2010, p. 80)

6.4 Foreign Direct Investment

Compared to 2009 foreign direct investment in 2010 has decreased in Bosnia and Herzegovina mainly in the first quarter while the remaining three quarters were characterized by an increase in FDI.

When setting the foreign direct investment in relation to the country‘s GDP, then it makes up only 0.4% of gross domestic product, which represents by far the lowest ratio recorded in the period for which data were available. In total, the value of foreign direct investment in 2010 according to CBBH estimates was BAM 93.7 million, which was considerably less than BAM 358.9 million in the previous year. The main reason for this low value was the repayment of inter-company loans taken earlier (especially with banks) and losses incurred by foreign-owned companies. It is important to note that the equity shares, as the third category of foreign investment, did not decrease in 2010.

Detailed data on investments in the banking sector are given in Section 8.10. (CBBH Annual Report 2010, p. 42)

Foreign direct investment is very important for the development of modern economies and moreover plays a not less important role in globalization as countries which show the most FDI develop more rapidly. In order to get an idea of the effects of FDI both theoretically and practically it is necessary to analyse the development of specific factors in transitional countries as any further economic development of transitional economies is highly dependent on the inflow of foreign capital. One can say that FDI flows have an impact on the economic development whereas at the same time the level of economic development and infrastructure do affect positively the attraction of FDI. (Babic-Hodovic and Tesche 2006, p. 1)

FDI inflows in the banking sector of transitional economies have not only advantages but also disadvantages. De-monopolization of the banking sector and growing supply structure and quality services represent some of the advantages. A disadvantage is the lower standing and positioning of the domestic banks. People tend to have more trust into foreign banks than in the domestic ones that is a result of economic crises transition economies are often suffering from that could even lead to domestic banks being (Babic-Hodovic and Tesche 2006, p. 3) totally controlled by foreign banks (Babic-Hodovic and Tesche 2006, p. 4).

After accessing B&H, foreign banks rapidly raised the supply of retail banking due to the advantage of high level of technological development and matured financial markets in developed economies.

According to Babic-Hodovic and Tesche (2006), the following theoretical elements apply:

- “Increased access to capital markets.” It is easier for a foreign bank to access the international capitals market due to the ability to make use of its networks, connections and positions.
- “Advantages from the transfer of financial regulation.” FDI has an impact on regulatory policy and can lead to improved legal and regulatory efficiency by allowing the adoption of western standards in financial regulations and supervision. A drawback however could be that parts of financial sector, financial markets, institutions and instruments from abroad are honoured without critics as regulations are often adopted without implementing them the same way as in developed countries such as creditor protection.
- “Increased financial strength.” Foreign direct investment is positively influencing the financial strength of banks with foreign capital and facilitates coping with problems of internal efficiency.
- “Increased stability.” Foreign banks can contribute to the stability of the banking sector by providing more stable credit resources and improving the banking sector’s resistance to shocks. (Babic-Hodovic and Tesche 2006, p. 4)

  Stability is given as branches and subsidiaries of big international banks may collect additional funds and capital if necessary.
- “Positive indirect effects” that may disappear in case the increasing presence of foreign banks results in bankruptcy. Competitive pressure of foreign banks and legal restrictions such as capital requirements may lead to mergers and acquisitions between domestic banks and liquidation of some which shows the B&H banking sector reality. The consequence is that the number of registered banks has lowered and led to banking sector consolidation.

Higher concentration in the banking sector could result in the monopolization of the sector. When looking at the 1990s where the number of small banks was rather high, the level of concentration was not yet endangering. Still, it is of high importance for emerging markets to invent anti-monopolistic laws and regulations. (Babic-Hodovic and Tesche 2006, p. 4)

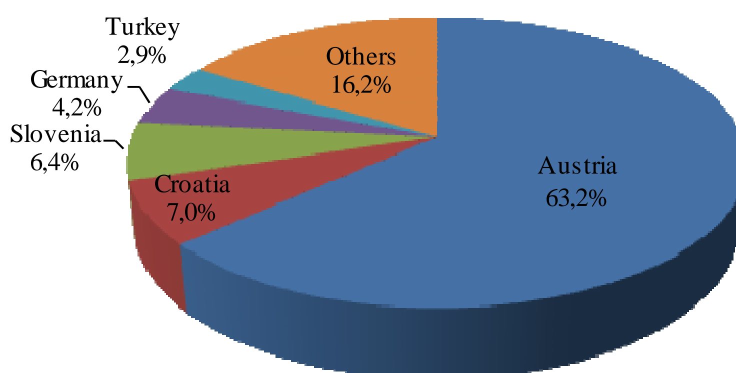
6.5 Current situation and developments in the Banking Sector

In the former Social Federal Republic of Yugoslavia the banking system was quite centralized and most of the banks were in state hands beside some small private banks therefore a reform of the banking system was a very important undertaking that could never be realized due to the ethnical conflict in former Yugoslavia so that most of the planned reform programs couldn't be realized. After the war that took place from 1992 until 1995 and with the support of international financial institutions such as IMF, EBRD, the World Bank, EU etc. the banking sector in Bosnia and Herzegovina had the unique opportunity to reshuffle. Since the formation of the Central Bank in Bosnia and Herzegovina in 1997 and in compliance with the institutional framework the target is to achieve a long-term political, security and economic stability. Decisions have been taken that made the financial system to a bank-based one resulting in the dominance of banks in the financial intermediation.

So far the reforms resulted in an increased privatization and liberalization of the banking sector in Bosnia and Herzegovina mainly raising the confidence in banks and ameliorating terms of extending credits to businesses and households. Nowadays foreign-owned banks are the most efficient of all banks compared to before where state-owned banks had this status. (Coskun and Ilgün 2009, p. 59)

Investments from foreign banks especially from Austria, Croatia, Slovenia, Germany and Turkey made the financial sector of Bosnia and Herzegovina to one of the most advanced in the region (Figure 6). (CBBH Annual Report 2010, p. 89)

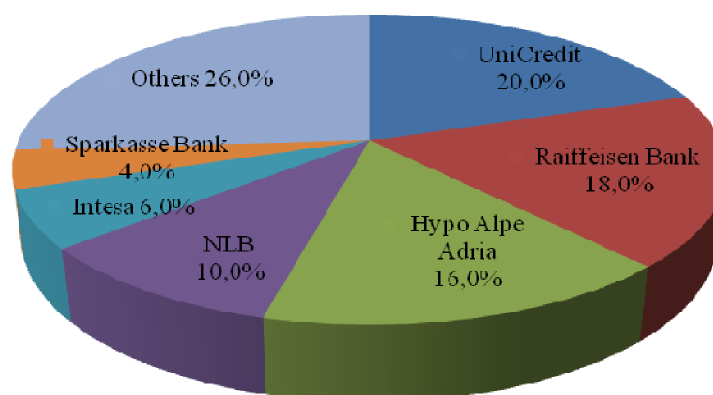
Figure 6: Structure of foreign equity in Bosnian commercial banks by countries



Source: CBBH Annual Report 2010, p. 89 (own illustration)

After foreign investors have been allowed to enter the domestic banking sector many state-owned banks after being ready for privatization have been taken over by those investors. (Coskun and Ilgün 2009, p. 59)
Figure 7 shows the most important foreign investors in the Bosnian banking sector.

Figure 7: Market share of foreign banks (% of total assets)



Source: CEE Banking Sector Report October 2011, p. 57 (own illustration)

Generally speaking the financial system in Bosnia and Herzegovina consists mainly of banks while the non-bank financial sector is rather undeveloped. The consolidation process of the banking sector resulted mainly out of the foreign direct investments through the acquisition of private - or already privatized – banks whereas privatization is not yet completed but already more than 90% of the banks are private of which roughly 80% are foreign-owned. (Coskun and Ilgün 2009, p. 59)
There are 28 commercial banks operating in Bosnia and Herzegovina in 2012 (CBBH (b) 2012) whereas capital is concentrated among few larger banks (Coskun and Ilgün 2009, p. 59).
25 out of total 28 commercial banks in the banking sector are profiting from the state deposit insurance scheme. The investments in the banking sector between 1994 and 2008 are EUR 1.2 billion and make up 22% of total investments in B&H. (Coskun and Ilgün 2009, p. 59)
The country currently has a credit rating of B3 with a negative outlook by Moody's Investors Service that has just been revised from B2 to B3 on April 3, 2012. Standard & Poor's assigned a sovereign credit rating to Bosnia and Herzegovina of B with stable outlook and affirmed on March 28, 2012. (CBBH (c) 2012)

As a result of structural changes in the banking system and the implementation of modern principles of evolving the banking industry, the financial system in B&H became rather bank-based. It is dominated by large foreign banks which are mainly contributing to credit growth within the country. The last decade was dominated by a significant increase in both deposits and loans of the commercial banks in Bosnia and Herzegovina. Total deposits in Commercial banks' accounts was only BAM 1.382,4 million in 1997, while today it is BAM 12.013,2 million which is 769 % more than the amount in 1997 which shows the increasing confidence in the B&H financial sector. Total loans given by the commercial banks was only BAM 2.439,6 million in 1997, while it is BAM 14.561,1 million today i.e. 497 % more than in 1997 which demonstrates the contribution of the financial sector to the development of the B&H economy and households.

The balance sheet volume of the commercial banks in B&H has also been continually increased during the last decade. Total assets of the commercial banks amounted to only BAM 3.336,9 million in 1997, while it is BAM 21.040,9 million nowadays which is 530 % more than in 1997. (Coskun and Ilgün 2009, p. 60)

The country has been characterized by a growing number of newly established private banks over the years. It is no secret that a greater number of foreign investors see the Balkan region as a high risk investment. The reason lies not only in the shaky political situation but also in fragile law enforcement agencies. A higher political stability would show good development and could lead to higher foreign investors' attraction. Overall the B&H banking system seems rather uncompetitive internationally.

Nowadays banks are significant players in the B&H financial system. Several empirical studies have shown a positive relationship between financial sector developments and economic growth. (Coskun and Ilgün 2009, p. 62)

7 Raiffeisen Bank International AG – Case Study

7.1 Raiffeisen now and then

The Raiffeisen Banks came into existence through the efforts of the German social reformer Friedrich Wilhelm Raiffeisen (1818-1888), who established the first cooperative banking association in 1862, and thus built the ground for the global organisation of Raiffeisen cooperative societies. One of Raiffeisen's fundamental principles is self-help whereby the boost of its members' interests is of high priority and represents one of the key components of their business policies.The Raiffeisen Banking Group (RBG) is composed of Raiffeisen

Banks on the local level, Regional Raiffeisen Banks on the provincial level and Raiffeisen Zentralbank Oesterreich AG (RZB) as central institution. Raiffeisen Banks are private cooperative credit institutions, whereas their main and general activity is the retail service. All Raiffeisen Banks within one province are the sole shareholders of the respective Regional Raiffeisen Bank, whereas all Regional Raiffeisen Banks hold approximately 88% of RZB's ordinary shares. (Priorbank 2012)

Raiffeisen Bank International AG (RBI) was formed through a merger between Raiffeisen International Bank-Holding AG (RI) and the principle business areas of RZB in 2010. The newly-merged bank has been boosted in its position as one of the leading universal banks in CEE. RBI represents today the third-largest bank in Austria while considering both CEE and Austria as its home market. The concentration in Austria lies in commercial and investment banking, covering the Top 1,000 companies within the country. Furthermore the bank is a leading universal bank in CEE with the largest network of any Western banking group. (RZB 2012)

Thus Raiffeisen International Bank – Holding AG represented a fully consolidated subsidiary of Raiffeisen Zentralbank Oesterreich AG that owned about 72.8% of the shares whereas the rest used to be free float (RBI Annual Report 2010, p. 18). Both of the two mentioned institutions were regarded pioneers in CEE, having its first activities in the region even before the fall of the Iron Curtain was considered in sight. The first subsidiary was founded in 1986 in Hungary by cooperating with partners that started its operations in the year after. (RBI Annual Report 2010, p. 15)

Shown in Figure 8, according to the RBI Annual Report 2010 RZB holds with 78,5% of the shares the majority in Raiffeisen Bank International AG whereas the other remaining 21,5% are free float trading on the stock exchange (RBI Annual Report 2010, p. 14).

Figure 8: RBI ownership structure

Source: RBI Annual Report 2010, p. 14

The bank is today having around 14 million customers in 17 markets with subsidiary banks in 15 CEE markets, leasing companies and other financial service providers even in 17 CEE markets. Its customers are covered via its around 3,000 business outlets by around 60,000 employees. (RBI Annual Report 2010, p. 14) Its subsidiaries are holding top five market positions in 12 countries. Worldwide it has a presence in 36 countries via its subsidiary banks, branches, representative offices and other financial service providers. (RBI Annual Report 2010, p. 19)

7.2 Expansion of Raiffeisen International Bank – Holding AG

As early movers in CEE, RZB and Raiffeisen International Bank – Holding AG have strengthened their reputation in CEE starting with the establishment of their first subsidiary bank in Hungary already in 1986, three years prior to the fall of the Iron Curtain.

Another milestone in its history was the market entry into Belarus, when Raiffeisen International acquired the majority of Priorbank, nowadays the country's fifth-largest bank according to total assets as of year-end 2010, in January 2003 being the first western banking group to make a strategic investment in Belarus. Also was the bank even able to underpin its position in December 2003, when winning the tender for the privatisation of the Savings Bank of Albania, the country's largest bank whose name was changed to Raiffeisen Bank in October 2004. A further step in its expansion was the acquisition of Bank Aval, Ukraine’s today third-largest bank, in August 2005 that represented the largest acquisition for Raiffeisen International and boosted both its local and regional dominance significantly. The bank was renamed to Raiffeisen Bank Aval in autumn 2006. When acquiring the Russian Impexbank in 2006 its position could even be strengthened via the merger with Raiffeisenbank Austria, established in 1997, making them the number nine in CEE’s largest market Russia. Legallly this merger became firm in November 2007 whereas today the bank represents the tenth-largest bank in the country. Furthermore in July 2006, Raiffeisen International bought 100% of the shares of the well-positioned retail bank eBanka in Czech Republic that merged with Raiffeisenbank in July 2008.

Thus at the beginning of its expansion, Raiffeisen International concentrated solely on founding companies on its own, while since 2000, this was also done via acquisitions.

The newly-established companies became founded under the Raiffeisen brand, which quickly became known and gained reputation in the CEE region, employing highly motivated staff. The help of experts from the network and the head office in Vienna contributed to the quick

integration and the high home country standards. All in all, the group has founded ten banks and acquired another ten during its 25-year market presence in the region. In the case of Raiffeisen the dynamic expansion in combination with acquisitions lead to successful market positioning, making them one of the largest bank in Russia and the CIS following the acquisition of Impexbank. Overall, Raiffeisen is the leading financial brand in CEE. (RZB Group at a glance 2009).

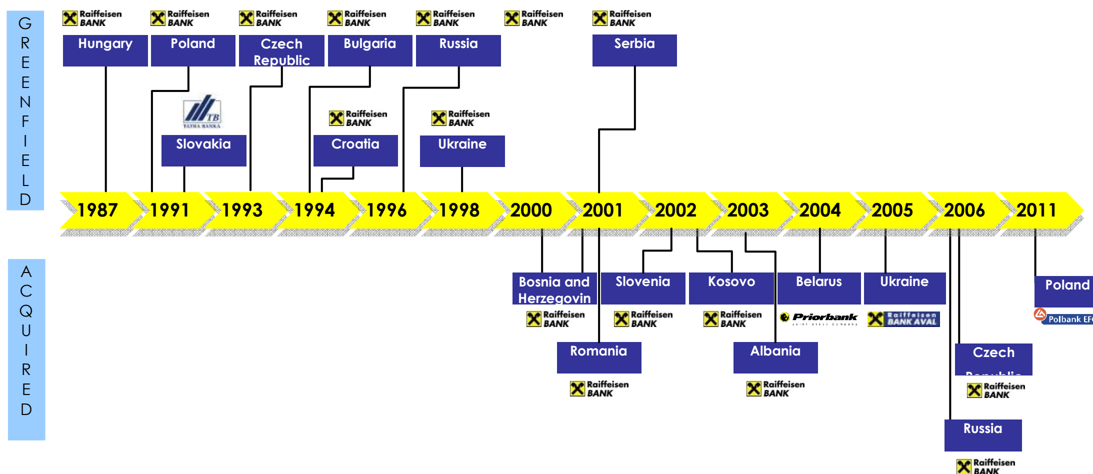
Overview of banks that have been founded via Greenfield investments (Figure 9) (RBI Corporate Presentation 2011):

1) Hungary – Unicbank
2) Poland – Raiffeisen-Centrobank
3) Slovakia – Tatra banka
4) Czech Republic – Raiffeisenbank
5) Bulgaria – Raiffeisenbank
6) Croatia – Raiffeisenbank Austria
7) Russia – Raiffeisenbank Austria
8) Ukraine – Raiffeisenbank
9) Romania – Raiffeisen Bank
10) Serbia – Raiffeisen banka

Overview of banks that have been acquired by, at that time, Raiffeisen International Bank – Holding AG (Figure 9) (RBI Corporate Presentation 2011):

1) Bosnia and Herzegovina – Market banka (2000), Hrvatska Postanska Banka (2001)
2) Romania – Banca Agricola
3) Slovenia – Krekova banka
4) Kosovo – American Bank of Kosovo
5) Belarus – Priorbank
6) Albania – Banka e Kursimeve e Shqipërisë
7) Ukraine – Bank Aval
8) Russia – Impexbank
9) Czech Republic – eBanka
10) Poland – Polbank EFG (subject to regulatory approvals and successful closing of the transaction)

Figure 9: Raiffeisen International's successful expansion strategy



Source: RBI Corporate Presentation 2011

The main focus of Raiffeisen International Bank – Holding AG lied on business with large customers and investment banking. Stepwise the bank widened its field of business to small and medium-sized enterprises (SMEs) and personal banking customers. Since 1999 they gradually expanded the retail banking operations that cover those two customer groups. The bank also offers banking-related services, such as finance leasing, fund management, building society savings and loans, and pension funds, through specialist subsidiaries. The activity of Austria's Raiffeisen Banking Group to spread its all-finance approach to the CEE markets was thus highly successful. (RBI Corporate Presentation 2011)

Supplementary to its banking operations RBI also has several specialist companies in CEE providing solutions, among others, in the areas of M&A, real estate development, fund management and mortgage banking.

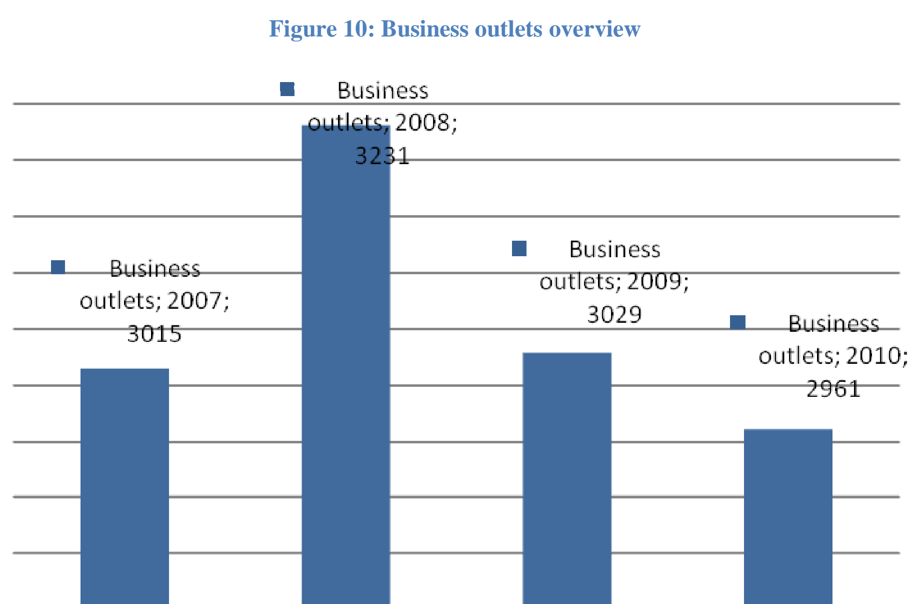
In Western Europe and the USA, RBI runs a branch in London and representative offices in Frankfurt, Madrid, Milan, Paris, Stockholm, and New York. The network in Western Europe is complemented by a finance company in New York (with representative offices in Chicago and Houston) and a subsidiary bank in Malta. In Asia, RBI's second geographical focus, RBI operates branches in Beijing (with representative offices in Harbin and Zhuhai), Xiamen and Singapore as well as representative offices in Ho Chi Minh City, Hong Kong, Mumbai and Seoul. This international presence shows the bank's emerging markets strategy. (RZB Group at a glance 2009)

7.3 Large branch network

Although gradually and continuously developing the internet banking, the branch office prevails as the most important mean of access to customers. As a result, in recent years Raiffeisen heavily invested in infrastructure expansion.

There were more than three times as many business outlets at the end of 2007 than in December 2004. As shown in Figure 10, this number rose in the year 2008, whereas due to financial crisis stagnated in 2009 and 2010. Nevertheless by the end of 2011, Raiffeisen customers were already being serviced by more than 2,900 business outlets. (RI Brochure 2008)

Figure 10: Business outlets overview



Source: RBI Annual Report 2010, p. 2 (own illustration)

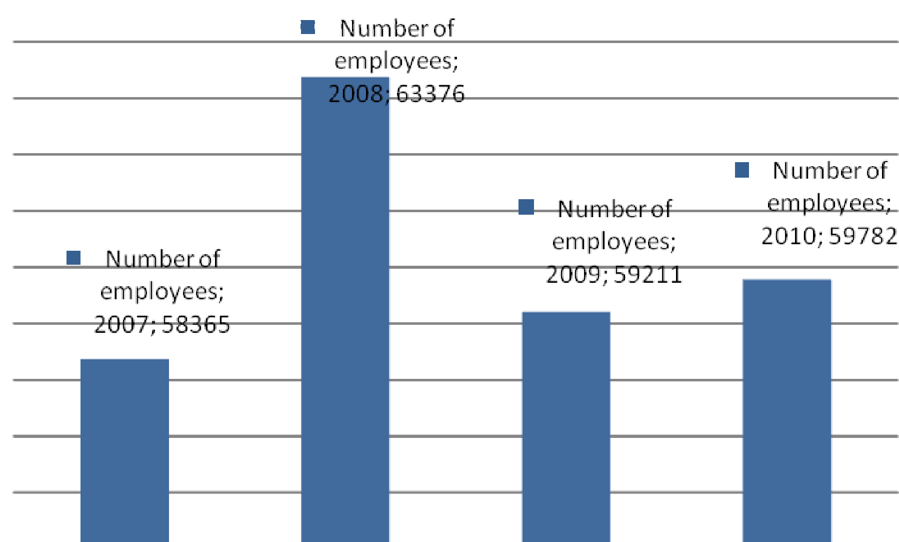
7.4 Most successful IPO in Austria

Raiffeisen International Bank – Holding AG's are listed on the on the Vienna Stock Exchange since 25 April 2005. Investors showed huge interest in this Initial Public Offering (IPO) that was already seen in the subscription phase. The overall order volume stood at 680 million shares that was 22 times more than expected. A volume of around EUR 1.1 billion has been issued that represented the largest IPO in the history of the Austrian capital market at that time. More than 80,000 private individuals, more than in any other IPO in the country, invested in the shares. (RI Brochure 2008)

7.5 Highly motivated staff

Raiffeisen International had more than 58,300 employees at the end of 2007 (an increase of 11% over the previous year) and, as shown in Figure 11, this number of Raiffeisen Bank International AG amounts to more than 59,000 employees as per year-end 2010, making the bank an important employer in CEE. More than 20,000 of those jobs have been created by founding own banks and through the growth of these and the acquired banks. On average, employees at Raiffeisen International are 34 years old. Women count for 69%, and 70% of all employees have a college degree. (RI Brochure 2008)

Figure 11: Number of employees



Source: RBI Annual Report 2010, p. 2 (own illustration)

7.6 Raiffeisen in Bosnia and Herzegovina

Raiffeisen is present in Bosnia and Herzegovina since the takeover of Market Banka dd Sarajevo in the year 2000 whereas today Raiffeisen Bank International AG possesses 96,99% of the shares in Raiffeisen Bank d.d. Bosna i Hercegovina (RBI (a) 2012).

The bank has its head office in Sarajevo with 98 business outlets in the country as of December 2010. The bank is very well positioned in the market being the second largest bank in the country by total assets as of December 2010 employing 1,640 people. (RBI (b) 2012)

Market banka dd Sarajevo was initially created in the year 1992 as a stock corporation of private shareholders holding more than 90% of the shares.

At that time the war was over and reconstruction activities were going on which contributed positively to the development of the bank as the bank could to a big extent enhance the level and the quality of its services.

In the post-war period the bank was on the one hand driven by its growth and expansion within the country and on the other hand could compete with the competitors on the market that contributed to the success and profitability of the bank.

Already before Market bank dd Sarajevo was taken over by Raiffeisen, the bank was able to attract foreign investors' interest thus being in a position to increase its capital base via cash contributions which converted the bank from a local to a foreign-owned one. The institutions that invested in the bank at that time and their respective shareholdings were: European Bank for Reconstruction and Development 23.53%, Futura Investment Ltd. Douglas 13.74%, Soros Economic Development, Delaware 11.80% and DEG-Deutsche Investitions und Entwicklungsgessellschaft mbH Koln 11.57%.

Raiffeisen Zentralbank Oesterreich AG took over the bank by acquiring the majority stake of 89.71% on 21st July 2000 and integrating the bank into the RZB Group.

The following step was the takeover of Hrvatska Poštanska Banka dd Mostar in May 2001 when Raiffeisen Zentralbank Oesterreich AG bought 100% of another local bank that has been renamed to and carried on its operations as Raiffeisen Bank HPB dd Mostar. (Raiffeisen Bank BiH 2012).

Finally on 1st January 2003 Raiffeisen Bank HPB was amalgamated into Raiffeisen Bank dd Bosna i Hercegovina that represented a milestone in the bank's history and built the start of a new era in its business as via this merger the bank was able to gradually expand its network and to further boost its position on the local market.

What contributed the most to Raiffeisen bank's success are the ongoing investments into new technologies, well experienced staff whose skills are constantly developed, concentration on individual customer approach and introduction and invention of new products and services. (Raiffeisen Bank BiH 2012)

8 Conclusion

We have learned that the banking sector of South East Europe is predominantly foreign-owned whereas foreign investors stem mainly from Austria followed by France and Italy.

The beginning of the new millennium brought an increase of international mergers and acquisitions in the financial sector of South East Europe leading to a higher presence of foreign owned banks in the region than domestic ones. Since the Lehman case in September

2008 and the start of the banking crisis, the foreign direct investment dropped due to lack of new investments in the countries whereas most of the existing investors stayed in the region. Investors had a much more positive view and future business development was considered much more favourable in the region at the beginning of 2010 whereas another wave of financial crisis, the sovereign crisis, interrupted an upwards trend in FDI.

Bosnia and Herzegovina has suffered from the war in the early 1990s thus went through many restructurings and re-organizations and so did its banking system.
The banking sector is nowadays mostly foreign owned with more than 21 foreign owned banks resulting in a foreign share of 89.9% as at the end of 2010.
The presented paper shows that Western European investors in Bosnia and Herzegovina rather prefer to form strategic partnerships and joint ventures with foreign partners and keep a controlling share. Nowadays foreign investors can observe only mildly positive to negative effects on economic development and growth while politically the negative signs are overwhelming. This is shown in the recent downgrade of Bosnia and Herzegovina by Moody's on April 3, 2012 from B2 to B3 (CBBH (c) 2012) mainly caused by "the deteriorating fiscal position of the general government, the increased susceptibility of the country's debt service management and poor growth prospects in light of Bosnia and Herzegovina's high unemployment rate" (www.moodys.com, 29.05.2012). The formal beginning of negotiations to join the EU, as Bosnia and Herzegovina signed the Stabilization and Association Agreement on June 16, 2008 (EC 2012), may lead to higher potential of growth in FDI whereas the candidate status has been given already in 2003 (EC 2012) and not much progress could be traced since then.
Although an increase in FDI in Bosnia and Herzegovina can be traced according to FIPA (Foreign Investment Promotion Agency of Bosnia and Herzegovina) in 2011 compared to 2010 (FIPA 2012), still in order to attract further foreign investors and foreign direct investment, to my opinion, much more has to be reached and much more progress has to be made in the political area.
My view is underlined by the recent speech held by Mr. Valentin Inzko, High Representative to the UN Security Council in Bosnia and Herzegovina on May 15, 2012, on the occasion of the celebrations of 20 years admission as a member state to the United Nations:

"…we continue to see a parallel dynamic of the divisive political agendas that have been played out over the last six years. A number of troubling challenges to the Dayton Agreement

and BiH’s territorial integrity have taken place during the reporting period, including a series of statements challenging the statehood of Bosnia and Herzegovina.” (OHR 2012)

Whereas simultaneously he is quite positive about the development of the country:

“At the same time, I am very pleased to be able to report to you that 2012 has started well, with signs of positive change in the country. Allow me to brief you on the most notable positive developments of recent months, developments which I believe offer real hope that 2012 can be a good year for Bosnia and Herzegovina.” (OHR 2012)

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10 Appendix

Country	2005	2008	2009
Albania	100.0	94.0	0
Bosnia and Herzegovina	90.7	95.0	95.0
Bulgaria	80.0	86.3	86.6
Croatia	91.3	90.8	91.0
Romania	62.2	88.2	85.3
Serbia	69.0	75.3	68.7
Kosovo	8.3	17.3	18.3

Appendix Figure 2: Market share of foreign-owned banks in selected SEE countries (in % of total assets) – in absolute terms

11 Curriculum Vitae

Persönliche Daten	Geburtsdatum: 29. November 1983
	Geburtsort: Zvornik, Bosnien und Herzegowina
	Staatsbürgerschaft: Österreich
Fremdsprachen	
Deutsch	Fließend
Englisch	Sehr gut in Wort und Schrift
Italienisch	Gut in Wort und Schrift
	Dante Alighieri, CLIDA P3, Zertifikat über Kenntnis der italienischen Sprache
Französisch	Basiswissen
Bosnisch/Kroatisch/Serbisch	Muttersprache
Berufserfahrung	
Jan. 2011 – Dez. 2011	Teilnahme am Young Professional Potential Programm der Raiffeisen Bank International AG
Seit Juli 2007 - heute	Raiffeisen Bank International AG (zuvor Raiffeisen Zentralbank Österreich AG), Account Manager im Bereich Financial Institutions & Sovereigns CEE
Mai 2005 – Juli 2007	Festspielhaus St. Pölten iA von Group4Securior, Billeteurin (parallel zum Studium)
Juli 2003 – März 2004	Tabaktrafik Gruja, Verkauf (parallel zum Studium)
1999-2003	Diverse Ferialjobs in der Gastronomie
Bildungsweg	
seit Okt. 2003	Studium der Internationalen Betriebswirtschaft am Betriebswirtschaftszentrum der Universität Wien (3. Abschnitt) Schwerpunkte: Internationales Management und Banking
1998-2003	Höhere Bundeslehranstalt für wirtschaftliche Berufe in St. Pölten, abgeschlossen mit Matura
1994-1998	Hauptschule Kirchberg/Pielach
1993-1994	Volksschule Kirchberg/Pielach
1992-1993	Volksschule Stockerau und Semmering
1991-1992	Volksschule Zvornik, Bosnien und Herzegowina

12 Abstract English

Foreign direct investment (FDI) has at a fast pace increased since the early 1990s whereas foreign investors especially eyed the banking sector.
This thesis takes a look at this subject from a briefly theoretical and practical point of view. On the one hand, internationalization and the multinational bank as well as different theories about its process of emergence are presented in theory whereas special emphasis has been given to Dunning's OLI framework. On the other hand, forms of entry into different markets are shown and the motives of investors to enter certain markets especially South Eastern Europe are touched. The banking sector in South Eastern Europe that has particularly been destination of FDI in the past decade is presented and special emphasis is put on Bosnia and Herzegovina in this context. Finally the case of Raiffeisen Bank International AG is taken as an example of a successful bank expansion throughout South Eastern Europe.

Key words: foreign banks, entry mode, foreign direct investment

13 Abstract Deutsch

Ausländische Direktinvestitionen haben seit den frühen 1990er Jahren in schnellem Tempo zugenommen, während das Augenmerk der ausländischen Investoren in diesem Zusammenhang insbesondere im Bankensektor lag. Diese Arbeit wirft einen Blick auf dieses Thema aus einem kurzen theoretischen und einem praktischen Gesichtspunkt. Auf der einen Seite werden die Internationalisierung und die multinationale Bank sowie verschiedene Theorien über den Prozess von deren Entstehung in der Theorie vorgestellt, wobei besonderes Gewicht auf Dunning's OLI Rahmenwerk gelegt wurde. Auf der anderen Seite, werden Eintrittsformen in unterschiedliche Märkte beschrieben und die Motive der Investoren in bestimmte Märkte, vor allem Südosteuropa, einzutreten. Insbesondere ist, in den vergangenen zehn Jahren, der Bankensektor in Südosteuropa Ziel dieser ausländischen Direktinvestitionen gewesen und wird

daher diskutiert und in diesem Zusammenhang besonders das Land Bosnien und Herzegowina beleuchtet. Schließlich wird der Fall der Raiffeisen Bank International AG als Beispiel einer erfolgreichen Bankenexpansion in Südosteuropa präsentiert.

Schlagwörter: ausländische Banken, Markteintritt, Auslandsdirektinvestition