DEVELOPMENTS IN BANKING SECTORS OF CENTRAL AND EASTERN EUROPE AND THREE BALTIC STATES AFTER THE GLOBAL FINANCIAL CRISIS AND EUROPEAN DEBT CRISIS

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This paper focuses on four Central and East European states and three Baltic states that joined the European Union (EU) in 2004. After explaining the common characteristics of their banking sectors, we outline the main developments since the global financial crisis of 2007 and analyze whether the fact that these countries’ banking sectors are foreign-owned was a factor behind the financial crisis. In our analysis we consider it important to distinguish among these states according to the extent to which they have been affected by the financial crisis, instead of referring to the region as a whole. We address the issue of financial stability and explain the factors that supported financial stability in the integrated EU.

A high economic growth, which characterized four Central and East European states and three Baltic states, has supported the economy of the EU as a whole prior to 2007. However, since the global financial crisis of 2007 the economic situation in the EU member states, and in particular in the Baltic states and Hungary, aggravated. Their GDP growth slowed down more than the average of the EU (Table 1). 1)

1. Foreign-owned banking sectors of CEE and Baltic states

Since the late 1990s and between 2000-05 the CEE states and three Baltic states recorded increased inflows of FDI (Foreign Direct Investment) not only in their manufacturing sector, but also in their financial sector (the so-called Financial FDI). Following the liberalization of financial sectors during the EU accession process of these states, banks from EU member states of Western and Northern Europe participated in the bank privatization of the CEE and Baltic states. As a result, the banking sectors of these states have a high degree of foreign ownership; assets of foreign banks on average account for 85-90% of the overall bank assets in these states (Figure 1). While the claims on Baltic states are highly concentrated in Sweden, CEE have a more diversified structure of their main lenders (Figure 2). By the participation of foreign banks, new services have been introduced in these countries in a short time, and compared to the monobank system of the socialist era, banks’ risk management practices and financial efficiency have significantly improved. We will review the main reasons behind the presence of banks from EU member states of Western and Northern Europe in CEE and Baltic states and then focus on the issues of financial stability following the global financial crisis and European debt crisis.

1) Out of the new EU member states (countries that joined the EU in 2004 and 2007), this paper focuses on four Central and East European (CEE) states (Slovakia, the Czech Republic, Poland, Hungary) and three Baltic states (Estonia, Latvia and Lithuania).
1.1 Theory of bank internationalisation

Grubel, Herbert G. (1977) used the theory of comparative advantage (namely the reasons behind different comparative advantages of banks) to explain the process of bank internationalisation. Grubel distinguished the following three categories of multinational banks according to their comparative advantage: the multinational retail banking; multinational banking based on the relationship between the bank and its client in the home country (the so-called “Follow the client” hypothesis, also named “the defensive reaction”); and, the multinational wholesale banking that ensures efficiency of the international capital flows. Since the 1990s, the multinational retail banking has become predominant in both Latin America and the whole East European region.

1.2 Main reasons for European banks’ expansion to CEE and Baltics

According to the ECB (European Central Bank) research, acquiring these strategic markets, expected profitability (particularly in the case of Austrian banks) and traditionally strong trade relations (mainly for German banks) have been the main reasons behind the foreign banks’ presence in CEE. CEE markets are close to Western Europe in both geographical and cultural terms; therefore, financial institutions from Western Europe have perceived the proximity of CEE, as one factor behind lower transaction costs (similarly, the case of banks from Northern Europe establishing their presence in the Baltic states). This is consistent with the theory of FDI in manufacturing sectors. In addition, Haas, Ralph and Iman van Lelyveld (2003) point out the increased capital surplus due to the saturated bank markets at home as one of the factors why banks entered CEE and Baltic banking sectors and increased their market shares there. Furthermore, according to the ECB (2005), many foreign banks present in CEE and Baltic states consider this strategically important region to be their first step towards further expansion eastwards (to Ukraine, Russia etc.).

1.3 Host-country factors

During the socialist era, a monobank system (the monobank performed the function of a central bank and commercial bank) existed in all CEE and Baltic states. In the 1990s financial and capital liberalization proceeded in these countries so that they could join the OECD and the EU. As a reform of banking sectors, these countries abolished the former monobank system and established the so-called "two-tiered" banking system which is typical for market economies. Consolidation of commercial banks and bank privatization were implemented.

By acquiring local banks in CEE and Baltic states, banks from the old EU member states secured market shares in the local bank markets with a high profitability. Difference (spread) between lending interest and deposit interest in CEE and Baltics was higher than that in Western and North European countries. This was due to a lower efficiency and a higher deposit risk.


3) For instance, Belgian banking group KBC states that having had capital surplus at home, it acquired the Czech CSOB in 1999. KBC also listed a strong development potential of Central European bank markets and the objective of KBC to acquire the largest market share in the Czech banking sector amongst the three most important reasons for its expansion to CEE.
in CEE and Baltics, compared to Western Europe. When we compare the bank performance, it is clear that net interest income in CEE was higher than that in Western Europe and that operating expenses were also higher in CEE.\(^4\) Therefore, the most important host-country factors behind foreign-owned banking sectors include: a stable economic growth since the second half of 1990s, a high growth potential of bank markets, and high profitability. Similarly, IMF in its research reports lists privatization in CEE, economic stability in these states, and profitability higher than in Western Europe as the main host-country factors.\(^5\)

1.4 Influence of the EU accession

In order to join the EU, these countries adopted the EU’s Acquis Communautaire, which means that their legislation was adjusted to the existing EU law. For foreign banks expanding into the region meant that the environment for business transactions became transparent and business-related risks have considerably decreased. These countries have adopted a series of laws related to the financial sector, including the EU Banking Directive, into their national legislations. Therefore, their banking sectors and financial services have been integrated into the EU internal market. This also meant that the region has become a part of the EU system of financial regulation and supervision.\(^6\)

As we have described, local banks in CEE and Baltic states were acquired by foreign banks (predominantly banks from EU member states) in the late 1990s and in the first half of 2000s. Credit (lending by these banks towards the private sector) has considerably increased compared to the 1990s. Next, we would like to examine the main characteristics in the behavior of foreign banks in this region in the pre-crisis period.

2. Pre-crisis development in banking sectors of CEE and Baltic States

ECB (2005) draws attention to the credit growth in these states since 2000 and to considerable differences among these states. Since 2003, a very dynamic credit growth distinguished Baltic states from CEE.\(^7\) When it comes to the loan structure, Baltic states showed two distinctive features. Firstly, household loans for housing purchases (mortgage loans) expanded very rapidly in Estonia and Latvia, followed by Lithuania, while all loan types increased on a much smaller scale in CEE.\(^8\) Secondly, foreign currency loans represented a much larger share of loans (especially household loans) in the Baltics than in CEE (except for Hungary) between

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6) Based on the EU Banking Directive, a credit institution (bank) that has obtained a banking license in a member state of the EU is able to establish a branch in other EU member states or directly provide financial services in other EU member states (EU Single Banking License).
7) Generally, credit growth over 20% is considered high (Enoch, Charles and Otker-Robe Inci, editors(2007)). Compared to 2004, credit growth in 2005 was over 60% in Lithuania and Latvia and approximately 40% in Estonia, whereas CEE states recorded a credit growth of 26% or less.
8) For details see Banincova, Eva (2010). Since 2005 mortgage loans to households in Estonia and Latvia have recorded a very high level of 35% of each representative country’s GDP (ECB, EU Banking Structures, 2005 and 2008).
2003 and 2008.\footnote{At the end of 2005, loans denominated in foreign currency accounted for as much as 83% of all corporate loans and for as much as 75% of all household loans in Estonia. Baninčova, Eva (2010).} It is important to point that, in the states with a high share of foreign currency loans (Baltic states and Hungary) foreign currency loans expanded more rapidly than foreign currency deposits. This clearly indicates an increasing currency mismatch. A comparison of house prices shows that, while a housing market bubble has developed in the three Baltic states since 2004, no similar developments were observed in the real estate markets of Hungary and other three CEE states.\footnote{Global House Price Index by Knight Frank Residential Research.}

Therefore, based on the bank behaviour we can distinguish three groups amongst the four CEE states and the three Baltic states. First, banking sector of Baltic states characterized by a dynamic credit growth, with a very high share of foreign currency loans and linked with a real estate market bubble. Second, the banking sector of Hungary characterized by expanding foreign currency loans, but without any bubble occurring in the real estate market. Third, the banking sector of three CEE states (CEE except Hungary) in which the scale of both credit growth and foreign currency loans has, in general, been limited.

How can we explain the differences in the behavior of banks from EU member states? We will focus mainly on the banks’ funding source (in the case of foreign banks this implies the extent to which the bank borrows from the parent bank in its home country).

According to BIS (Bank for International Settlements), in developing countries, especially in Latin America, based on the financial FDI, there has been an increase in “local claims in local currency” held by local branches of foreign banks, as the retail banking becomes important for foreign banks present in the region and as the localization of these foreign banks proceeds.\footnote{McCauley, Robert N., Judith S. Ruud and Philip D. Wooldridge (2002).} When we compare CEE and Baltic states, it is evident that “local claims in local currency” held by foreign banks have increased in three CEE states (the Czech Republic, Slovakia and Poland), whereas the increase has been much lower in Baltic states and Hungary (Figure 3). Foreign banks present in the Baltic states and Hungary hold a relatively high share of “local claims in foreign currency”, which are part of “international claims” (BIS defines that “international claims” consist of “cross-border claims” and “local claims in foreign currency”).

The reason behind the above-mentioned difference is related to foreign banks’ parent bank. Based on the parent bank’s management know-how and its previous experience of foreign expansion, local branches can easily access the capital funds of parent bank in the home country. This means that a stable channel has been established to secure capital funds to meet credit demand in the host country. We have noted a dynamic credit growth in the Baltic states. In the Baltic subsidiaries of Swedish banks the overall size of bank assets increased much more than the bank assets in the CEE banks. For instance, between 2003 and 2006, total bank assets in Baltic subsidiaries of Swedbank and SEB (Skandinaviska Enskilda Banken; Scandinavian Private Bank) increased 2.6-3.1 times, while the bank assets in the CEE subsidiaries of West European banks increased only by 1.4-1.8 times (Table 2). Banks in Baltic states relied on borrowing from foreign parent banks to meet increasing credit demand. Consequently, ROE (Return on Equity) of Swedish banks in several of their Baltic subsidiaries exceeded 30% between

We can therefore conclude that the pre-crisis differences in credit developments are closely linked to the banks’ source of funding. An important indicator to show the dependence on funds from the parent bank is the Loan to Deposit Ratio (Figure 4). The higher the share of foreign currency denominated loans, the higher the Loan to Deposit Ratio. Bank lending in the three CEE states relied mainly on local deposits, while in Hungary it was supported by borrowing from parent banks, which supported the growth of loans in foreign currency.

As evident from this section, CEE and Baltic states can be divided into three groups. In the following section we will investigate what developments characterized these countries after 2007.

3. Banking sectors of CEE and Baltic States after the global financial crisis and European debt crisis

We can basically distinguish 3 major phases of the crisis: Phase 1 (from the BNP Paribas shock in August 2007 until the collapse of Lehman Brothers in September 2008), Phase 2 (from September 2008 until the onset of European sovereign debt crisis in the third quarter of 2009) and Phase 3 (from the third quarter of 2009 until present). The effect of crisis on banking sectors of CEE and Baltic states has become evident since Phase 2.

A decrease in Loan to Deposit Ratios has been observed in the Baltic states and Hungary since 2008 (Figure 5). This is due to the decrease of lending from banks of other EU member states during the crisis. As global financial crisis deepened, parent banks had more difficulty to raise funds, as funding costs increased. On the contrary, Loan to Deposit Ratios in Poland, Slovakia and the Czech Republic continued to be stable after 2008. Banks in these three countries relied mainly on local deposit base as a funding source, which is a stable financing pattern even during a crisis. Dependency on foreign funds clearly made banks in the Baltic states and Hungary more vulnerable during the crisis.

Let us now compare other banking indicators. Tier 1 Capital of banks in the Baltic states and Hungary has decreased since 2008, while that of the three CEE has increased in the same period (Table 2). This reflects the fact that banks in the Baltic states and Hungary were making losses. ROE of banks in these states has dramatically decreased since 2008 (Table 3). However, it is interesting that while in the Baltics banks’ ROE has started to increase in 2010, in MKB (Magyar Kulkereskedelmi Bank; Hungarian Foreign Trade Bank) as well as other foreign-owned banks in Hungary ROE has further deteriorated since 2010.\(^\text{12}\)

In case of the banks in the Baltic states (especially in Latvia and Lithuania), the NPL (non-performing loans) peaked after 2008, with a significant increase in the NPL of corporate lending.\(^\text{13}\) Yet, as the economies of the Baltic states started to recover, the resilience of their banking sectors also began to improve and the ratios of overdue loans started to decrease after

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\(^{12}\) In 2011 Erste Bank Hungary and Raiffeisen Bank Hungary had ROE of minus 90% and minus 69.6 %, respectively. This is a significant deterioration compared to previous year (in 2010 ROE of Raiffeisen Bank Hungary was minus 5%). (The Banker, July 2011 and The Banker, July 2012).

\(^{13}\) IMF (2009), Global Financial Stability Report, October, p.27.
2010 (Figure 6). Consequently, while the Baltic states accounted for a large share of the major Swedish banks’ losses in 2009, the proportion of losses from the Baltics decreased significantly since the second half of 2010 (Figure 7).

As a result of a sharp devaluation of the Hungarian forint in October 2008, the payments for loans denominated in foreign currencies (mainly in Swiss franc) sharply increased and the households have been facing a much higher debt burden as a share of their disposable income. This in turn led to a rise in the NPL and deterioration of banks’ ROE (Figure 8).

However, since 2008 an increase in the NPL has been observed in banking sectors of all the East European countries and if we compare the four CEE states with other East European states, their NPLs are well below levels observed in other East European states (e.g. Ukraine). Moreover, Hungary’s NPL ratio is much lower than that seen in other emerging markets crises (Figure 9).

The deepening of the European sovereign debt crisis put the stability of foreign-owned banks in the CEE states to test again. In other words, concerns were raised that West European banks with exposure to government bonds of weaker Eurozone countries (Greece, Portugal, Spain, Italy) would reduce their lending to the CEE region, or even partly withdraw from the region.

Overall, when we compare changes in foreign liabilities of banks in individual European countries, no major decreases (the so-called deleveraging) were observed in CEE (Figure 10). This means that no major reductions in foreign funding (from parent banks) have been observed. Since Austrian banks account for major shares in CEE bank sectors, this implies the stability of Austrian banks’ funding sources. The Eurozone countries hit severely by the debt crisis (Greece, Portugal, Spain, Ireland and Italy) account for a very limited proportion of Austrian bank’s funding (deposit) base (Figure 11). Compared to Austrian banks, Italian banks have less foreign claims on CEE, which alleviates concerns about a possible risk of reduced funding.14 CEE region has played a role as an important source of profit for the West European banks (Table 5). Therefore, no substantial reductions in foreign funding by parent banks have materialized even in 2012.15 The situation in Hungary was different from other CEE states. Since the Hungarian government introduced an early repayment scheme for loans denominated in Swiss francs, Hungarian banks’ liabilities in foreign currencies and their external liabilities as a whole decreased.16

In addition, according to Kotian, Juraj (2012) and UniCredit (2012), there are several factors that mitigate the risk of deleveraging by West European banks in CEE. Firstly, compared to Phase 1 of the crisis, the dependence of CEE on external financing has decreased since Phase 3 of the crisis. As it was already shown, Loan to Deposit Ratios in the three CEE states have been around 100% or even lower (Figure 4). At the same time, in almost all CEE states the

14) Data in Kotian, Juraj (2012, p. 9) and Erste Bank, Factsheet, (2012, August) are based on cross-border claims of Italian banks. Therefore, in the future research agenda it is important to monitor the developments in local claims of Italian banks in CEE.


16) The effect of the early repayment scheme is mixed. As a result of this scheme, external liabilities decreased. On the other hand, the NPL ratio of the remaining loan portfolio worsened significantly.
current account deficits declined, and since capital inflows to finance the deficits declined as well, the risk of financial instability associated with new capital outflows has been relatively reduced. Secondly, the banking sectors of CEE are much smaller in size than those of the West European states, therefore the possibility of systemic risk stemming from the financial sector of CEE is significantly smaller compared to West or South Europe (Ireland, Spain etc.).

We have shown that the risk of substantial deleveraging in CEE is mitigated by several factors. Besides the European debt crisis, bank behaviour is also affected by financial regulations. Therefore, we will next examine the banks responses and the financial regulation and supervision in the EU.

3.1 Parent banks’ responses to support the financial stability

In the integrated bank market of the enlarged EU, foreign-owned banks in CEE and the Baltics have employed various measures in order to respond to worsened NPLs and to support the financial stability (Tables 4 and 5). One common measure has been strengthening Tier 1 Capital and cost reductions.

In general, the research on the stability of foreign-owned bank systems during the crisis shows that, in the case of bank branches the parent banks have to support the branches, whereas the support by a parent bank is less certain in the case of bank subsidiaries. According to the EU Banking Directive, the financial supervision authority in the bank’s home country is responsible for the financial supervision of branches, while in the case of subsidiaries, the responsibility for financial supervision is placed upon the host country’s supervision authority. There is conflicting evidence regarding this: there have been cases when parent banks supported their foreign subsidiaries during crisis, but also some cases when the support to subsidiaries stopped during crisis.17 Evidence shows that in some cases parent banks sent the so-called “comfort letters” to host country’s authorities to demonstrate their will to support the subsidiaries, yet such measures do not represent real guarantees of support during crisis. However, in the context of the EU, Scandinavian banks have treated the Baltic states as their home market and in official statements they emphasized they had no intention of withdrawing funds from their Baltic subsidiaries. Such long-term commitments have helped to restore confidence of market participants.18

The reasons for the parent banks’ commitment include the strategic importance of the CEE and Baltic bank markets and the market reputation risk (in case banks would stop support to their subsidiaries at crisis). The fact that parent banks can rely on support by their home governments has also played a role (e.g. Swedish government provided a loan guarantee fund for Swedish banks to issue debt with a government guarantee).

17) Cardenas, Juan, Juan Pablo Graf and Pascual O’Dogherty (2003) in their survey of the previous research pointed out that following the Russian currency crisis in 1998, bank groups such as ABN Amro (the Netherlands) and KBC (Belgium) have continued to support K&H, their Hungarian subsidiary; while Southern Behrad (Malaysia) stopped its support to Banco Austral, its subsidiary in Mozambique; and, banks like Scotiabank, Credit Agricole and Intesa stopped their support towards their Argentinean subsidiaries.

18) As different from the standard “comfort letters”, managers of Swedish banks (SEB, Swedbank) actually visited the representatives of government and central banks of the host countries (Baltic states) and officially proclaimed their commitments to their local subsidiaries (author’s interview at a Lithuanian subsidiary of a major Swedish bank, in Vilnius, 17 September 2010).
It is also important that for the West European and Scandinavian parent bank groups, CEE and Baltics represent a relatively small share in their overall foreign subsidiaries. In other words, this is the case when the cross-border bank is only systemically important in the host countries. Therefore the parent bank groups can deal with the increased credit losses in the CEE and Baltics.

It is evident that European banks present in CEE and Baltics have not withdrawn from the region despite the fact that they experienced increased credit losses since 2008. In the EU context, banks have employed various measures to increase the financial stability of the host country where the bank subsidiary is located. This is a contrasting difference from the foreign bank behaviour during the Asian financial crisis in the late 1990s (withdrawing funds and/or closing of branches and subsidiaries) and underlines the stabilizing function of foreign-owned bank systems established within the EU integrated financial market.

3.2 Baltic states and the revealed problems in financial regulation and supervision

Let us now focus on the Baltic banking sector which demonstrated its vulnerability during the crisis. Why did not adequate financial supervision take place to curb the excessive credit growth in the pre-crisis period?

Financial regulation practices in the new EU member states have in general differed from the old member states due to insufficient previous experience with financial regulation at the new members and the new regulatory issues emerging in the period immediately after market transition. Not only had supervisory authorities in the Baltic states very limited measures (e.g. information exchange, moral suasion etc.) to control credit growth, but they were clearly unable to respond effectively to credit growth which became more pronounced owing to the intense bank competition in these markets. As credit booms funded by large borrowings from foreign (Scandinavian) parent banks could not be controlled by financial supervisory authorities, development in the Baltic states took a different path from other new member states.

Based on the recommendations of the De Larosiere Report (February 2009), the EU regulatory and supervision framework has been strengthened, new mechanisms introduced to have an effective crisis control and the ultimate aim was to establish a new European financial regulatory and supervision framework which will ensure the financial stability of the whole enlarged EU region. Years 2009-10 were the preparatory period and 2011-12 were the next stage when

19) Scandinavian banks have changed their strategy towards their Baltic subsidiaries since 2008 by introducing various improvement measures. For instance, the Baltic Division, which was set up for all three Baltic states in 2009, uses new risk management policies. Since there were also cases when customers of a major Swedish bank’s Lithuanian subsidiary, having had difficulties with repayment of mortgage loans, turned to a non-bank consumer finance sector and took up new loans to secure payment of mortgage loans, the Swedish bank started a proactive approach to all customers with debt repayment problems, advising them strongly to consult the bank about a suitable repayment method. In numerous cases, new measures completely different from traditional practices were used. For example, in January 2010 Nordea Bank agreed with Riga Property Management to cooperate in order to support clients with overdue rent (the bank will reappraise their payment ability, while searching for the best possible solution for both clients and proprietors of the real estate). Besides, Nordea Bank also started a job training for the unemployed in Latvia. (Information based on the author’s interview at a Lithuanian subsidiary of a major Swedish bank, in Vilnius, 17 September 2010).

20) Mr. Herbert Stepic, CEO of Raiffeisen Bank International (RBI) described the bank’s commitment to the local CEE market as follows: “RBI has no intention to withdraw from its present Central European bank market, except the case that legislative measures require that”. (The Banker, February, 2012 p.76).
the legal system for ESFS (European System of Financial Supervisors) was to be established. Previously, microprudential supervision had formed the main part of the EU supervisory framework; however, since the macroeconomic surveillance is crucial for the crisis prevention, the De Larosiere Report recommended to set up the ESRB (European Systemic Risk Board) to have macroprudential supervision as a new part of supervisory repair. ESRB (established in January 2011) was to gather information on all macroprudential risks in the EU and through ESRB each member state’s Central Bank should monitor more closely the overall credit growth. Furthermore, the previous decentralized system of EU supervision was reformed and, since January 2011 replaced with the ESAs (European Supervisory Authorities) responsible for microprudential supervision.21)

In the above-mentioned context, the reform of the EU financial regulatory and supervision system has been taking place, based on the recommendation of the De Larosiere Report and before all new EU supervisory authorities were established, authorities in Baltic states have introduced several guidelines related to financial supervision.22) Let us outline the main reforms in the supervisory sphere undertaken by the Baltic states.

1. **Increasing efficiency and strengthening function of financial supervision authorities**

   After the financial crisis of 2008-09, as part of supervisory reform in Estonia, more authority was attributed to Estonia’s FSA (Financial Supervision Authority) aiming to improve the efficiency of financial supervision. Moreover, harmonization and optimization took place in the cross-border based reporting and information exchange. In addition, the need to strengthen risk management became clearer in the Baltics. One principle of risk management was to control or mitigate risk exposures. Therefore, in December 2010, Lithuania introduced rules to control banks’ large-scale exposure towards a single counterparty and to strengthen the efficiency of banks’ risk management and internal control.23)

2. **Quick response of the supervisory sphere at the country level**

   The crisis also re-emphasized the need of a quick response by supervisors, which called for a stronger information exchange among the related parties. One example of improving the response by supervisors in the Baltic states was the arrangement initiated by the Estonia’s FSA (Financial Supervision Authority)- the FSA in cooperation with the Ministry of Finance planned to introduce a legal act related to financial supervision at the time of crisis.24)

   With the objective of crisis prevention, a Memorandum of Understanding (MoU) on information exchange was signed among the Lithuanian Ministry of Finance, the Bank of Lithuania, and the Securities Commission and Insurance Supervisory Commission at the end of 2009. This was another concrete measure based on the Financial Crisis Prevention and Management Plan, which was adopted by Lithuanian government in November 2008 and which

21) ESAs consist of EBA (European Banking Authority), ESMA (European Securities and Markets Authority) and EIOPA (European Insurance and Occupational Pensions Authority).

22) Author’s interview at Latvia’s Financial and Capital Market Commission in Riga, 14 September 2010. For example, between 2009 and mid-2010 Estonia’s FSA issued 6 guidelines related to financial supervision.

23) Author’s interview at Credit Institutions Supervisory Department of Bank of Lithuania in Vilnius, 16 September 2010.

24) Author’s interview at the Estonian Ministry of Finance (Financial Markets Department) in Tallinn, 13 September 2010.
defined procedures for an effective cooperation among the responsible institutions supervising the financial system.\textsuperscript{25)}

The Draft Act amending the Financial Supervision Authority Act in Estonia, which was prepared in 2009 between the Estonian Ministry of Finance and the FSA aimed to improve the responsiveness and effectiveness of financial supervision in crisis. In other words, the new Act was to eliminate restrictions set by the previous legislation which had not allowed the FSA to obtain necessary information from supervised entities in emergencies or crises. Since 2009, the Estonian FSA has thus clearly started a closer cooperation with other administrative institutions in the country.\textsuperscript{26)}

\textbf{3) Stronger cooperation with other Baltic and Nordic supervisory agencies}

Baltic states support the view pointed out by the De Larosiere Report that there should be a more integrated financial supervision system in the EU. Since 2009, financial supervisory agencies of all the Baltic states have engaged in a closer cooperation and increased the information exchange with the Nordic supervisory agencies. Several regular risk-related meetings were organized in 2010 and multilateral cooperation was strengthened to harmonize supervisory practices among these countries and avoid duplicate actions.\textsuperscript{27)}

\textbf{4) Regarding crisis management and crisis resolution}

A new Baltic-Nordic Memorandum of Understanding (MoU) was signed between the Baltic and Nordic countries in 2010 and became valid in August of the same year. Its objective was to strengthen cooperation between Central Banks, financial supervisory agencies and the Ministries of Finance of the Baltic states and their counterparts in Scandinavian states. The MoU is not legally binding, but compared to the previous MoUs, it comprises several concrete principles for cooperation which strengthen common interests.\textsuperscript{28)}

\textbf{4. Conclusion}

Central and East European states (CEE) together with the Baltic states have all experienced Foreign Direct Investment (FDI) in their financial sectors which led to foreign-owned banking systems being established in these countries in a relatively short time period. This paper showed divergent developments in CEE (area integrated into a network of West European banks) and three Baltic states (are integrated in Scandinavian banks’ network) during the global financial crisis and European debt crisis and pointed out to these states’ pre-crisis differences.

\textsuperscript{25} Information based on two sources: (1) Author’s interview at Credit Institutions Supervisory Department of the Bank of Lithuania in Vilnius, 16 September 2010, and (2) Bank of Lithuania (2009), Financial Stability Review, pp.62-63.

\textsuperscript{26} Information based on two sources: (1) Author’s interview at the Estonian Ministry of Finance (Financial Markets Department) in Tallinn, 13 September 2010, and (2) Estonia’s Financial Supervision Authority (2009), FSA Yearbook, p.29.

\textsuperscript{27} Information based on two sources: (1) Author’s interviews at Estonia’s Financial Supervision Authority in Tallinn, 13 September 2010 and at Credit Institutions Supervisory Department of Bank of Lithuania in Vilnius, 16 September 2010, and (2) Estonia’s Financial Supervision Authority (2009), FSA Yearbook, p.42.

\textsuperscript{28} For example, the Annex of this MoU, includes a calculation method for sharing burden costs in case a financial institution collapses. Based on this MoU, a Nordic-Baltic Cross-Border Stability Group (NBSG) was founded. (Author’s interview at the Estonian Ministry of Finance in Tallinn, 13 September 2010).
that explain why the crisis affected these states to a different extent.

The paper distinguished three groups (Baltic states, Hungary, and three CEE states) and illustrated how pre-crisis and post-crisis behaviour of foreign-owned banks (banks’ funding sources and lending practices) accounts for the differences observed among these three groups.

Previous research in international finance has traditionally focused on analyzing the effects of foreign-owned banks on a host country’s bank market. However, there is still a lack of research on the stability of the foreign-bank dominated systems during a large-scale financial crisis. After 2008, the new EU member states in CEE and Baltics have experienced a large-scale financial crisis for the first time since becoming predominantly foreign-owned. In this regard, the paper focused on the financial stability in these states’ banking market within the EU context and showed the following two facts.

Firstly, the financial crisis cannot be attributed to the foreign-bank dominated system which resulted from the financial FDI during the EU accession process. This was clearly shown by the case of three CEE states where West European banks based their lending on local deposits in local currency and therefore financial stability was not affected much by the crisis. In three Baltic states the over-dependence on easily accessible capital from Scandinavian parent banks fuelled credit booms, foreign currency denominated loans and real estate market bubbles. After 2007, these states faced the bubble collapse and currency mismatch; however, the paper showed several mitigating factors within the EU context regarding financial stability (such as foreign banks’ long-term commitment to the host country markets and various policy responses).

Secondly, the case of Baltic state illustrates the salient need to reform the originally decentralized system of the EU financial regulation and supervision. Concrete reforms and active initiatives in this direction have been pointed out (a strong mutual cooperation between supervisory agencies of the Baltic states and Scandinavian states is crucial).

Future research should involve a more detailed investigation of the continuing European debt crisis and its impact on the West European (in particular, Italian) parent banks and their CEE subsidiaries.
Table 1  Real GDP growth rate (as % change on previous year) in new EU member states

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<tr>
<td>Estonia</td>
<td>9.1</td>
<td>10.3</td>
<td>7.7</td>
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<td>3.4</td>
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<td>Latvia</td>
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<td>-14.4</td>
<td>3.1</td>
<td>14.8</td>
<td>3.2</td>
</tr>
<tr>
<td>Poland</td>
<td>3.7</td>
<td>6.3</td>
<td>6.8</td>
<td>5.1</td>
<td>1.5</td>
<td>3.8</td>
<td>4.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Czech R.</td>
<td>6.5</td>
<td>6.7</td>
<td>5.2</td>
<td>2.0</td>
<td>-5.1</td>
<td>2.2</td>
<td>2.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Slovakia</td>
<td>6.6</td>
<td>8.3</td>
<td>10.4</td>
<td>5.6</td>
<td>-5.1</td>
<td>3.9</td>
<td>3.1</td>
<td>1.7</td>
</tr>
<tr>
<td>Hungary</td>
<td>4.2</td>
<td>4.1</td>
<td>0.3</td>
<td>1.1</td>
<td>-6.6</td>
<td>1.5</td>
<td>1.9</td>
<td>-0.2</td>
</tr>
<tr>
<td>Slovenia</td>
<td>3.8</td>
<td>5.5</td>
<td>6.4</td>
<td>3.2</td>
<td>-8.7</td>
<td>0.9</td>
<td>0.4</td>
<td>-1.6</td>
</tr>
<tr>
<td>Cyprus</td>
<td>2.3</td>
<td>2.2</td>
<td>2.6</td>
<td>0.9</td>
<td>-4.5</td>
<td>-1.3</td>
<td>-2.1</td>
<td>-1.6</td>
</tr>
<tr>
<td>Malta</td>
<td>3.1</td>
<td>2.5</td>
<td>3.8</td>
<td>3.2</td>
<td>-2.7</td>
<td>2.9</td>
<td>1.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Romania</td>
<td>4.4</td>
<td>8.1</td>
<td>6.5</td>
<td>7.5</td>
<td>-6.4</td>
<td>-1.5</td>
<td>2.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>6.9</td>
<td>6.8</td>
<td>7.0</td>
<td>6.7</td>
<td>-5.0</td>
<td>1.1</td>
<td>2.7</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: Eurostat home page (latest data, as of end-September 2012).
* GDP growth rate for 2012 is a forecast. New EU member states are 10 states that joined the EU in 2004 (all countries included in Table 1, except Romania and Bulgaria) and 2 states (Romania, Bulgaria) that joined the EU in 2007.
Figure 2 Consolidated Foreign Claims* on individual states by nationality of reporting banks

Source: BIS, *Consolidated Bank Statistics.*
*Foreign claims include local claims and cross-border claims. Data is on immediate borrower basis, as of end-March 2007.

Figure 3 Ratio of Foreign banks’ Local claims in local currency to International claims

Source: BIS, *Quarterly Review.*
Figure 4  Loan to Deposit Ratios (%)

Source: ECB (2008), _EU Banking Structures and BSCEE Review 2003-05_.

Figure 5  Loan to Deposit (LTD) Ratios in international comparison* (%)


Table 2  Selected Bank Performance Indicators of foreign-owned banks in CEE and Baltic states

<table>
<thead>
<tr>
<th>Bank**</th>
<th>Size of Assets (USD mln)</th>
<th>Tier 1 Capital (USD mln)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Swedbank (EST)</td>
<td>8,080</td>
<td>25,536</td>
</tr>
<tr>
<td>Swedbank (LAT)</td>
<td>3,787*</td>
<td>7,171</td>
</tr>
<tr>
<td>SEB (LIT)</td>
<td>3,105</td>
<td>8,045</td>
</tr>
<tr>
<td>CSOB</td>
<td>23,641</td>
<td>36,516</td>
</tr>
<tr>
<td>MKB</td>
<td>5,979</td>
<td>7,333*</td>
</tr>
<tr>
<td>Pekao</td>
<td>16,485</td>
<td>23,262</td>
</tr>
<tr>
<td>Tatra Bank</td>
<td>4,153</td>
<td>7,770*</td>
</tr>
</tbody>
</table>


Table 3  Selected Bank Performance Indicators of foreign-owned banks in CEE and Baltic states

<table>
<thead>
<tr>
<th>Bank**</th>
<th>BIS Capital Ratio (%)</th>
<th>ROE (%)</th>
<th>NPL Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Swedbank (EST)</td>
<td>10.5</td>
<td>14.4</td>
<td>14.6</td>
</tr>
<tr>
<td>Swedbank (LAT)</td>
<td>9.0</td>
<td>13.7</td>
<td>18.1</td>
</tr>
<tr>
<td>SEB (LIT)</td>
<td>8.3</td>
<td>*</td>
<td>10.5</td>
</tr>
<tr>
<td>CSOB</td>
<td>9.1</td>
<td>8.7</td>
<td>15.0</td>
</tr>
<tr>
<td>MKB</td>
<td>10.0</td>
<td>*</td>
<td>12.7</td>
</tr>
<tr>
<td>Pekao</td>
<td>16.5</td>
<td>12.2</td>
<td>16.2</td>
</tr>
<tr>
<td>Tatra Bank</td>
<td>10.3</td>
<td>**</td>
<td>9.1</td>
</tr>
</tbody>
</table>

Figure 6 Late payments in the three Baltic states (as % of total lending)

Figure 7 Major Swedish banks' loan losses (breakdown by geographical area)
Figure 8  Comparison of installment payments of CHF (Swiss franc) and HUF (Hungarian forint) denominated housing loans


Figure 9  NPL (Non-performing loans) comparison (NPL as % of total loans)

Source: RZB Group, Raiffeisen International (2011), CEE Banking Sector Report, October, p.34.
*2013 NPL forecast for Hungary as NPLs are far from their peak according to Raiffeisen Research estimates.
Figure 10  Change in foreign liabilities in selected EU countries  
(March 2011 to March 2012, as % of GDP 2011)

Figure 11 Deposit liabilities of Austrian banks to selected countries (bln EUR, end of quarter data)


Table 4 Effect of crisis on Scandinavian banks present in the Baltics and their response

<table>
<thead>
<tr>
<th>Bank</th>
<th>Profit in the Baltics*</th>
<th>Effects of Baltic subsidiaries on the Bank (Phase 1 and 2 of the crisis)</th>
<th>Bank response</th>
</tr>
</thead>
</table>
| Swedbank | 29%                    | - Credit losses in the Baltics reached 3.3 bln SEK in the third quarter (Q3) of 2009. Total credit losses of Swedbank were 6.1 bln SEK, while in Q3 of 2008 they were 812 mln SEK (7-times increase).  
- Share of impaired loans (as gross % of total lending to public) for the second quarter (Q2) of 2009 was very high (17.9%) in Latvia, followed by Lithuania (8.7%) and Estonia (5.8%) | - November 2008: joined the Loan Guarantee Fund of the Swedish government in order to issue debt with government as guarantor and strengthen its financing (the bank issued 306 bln SEK of debt by June 2009)  
- Raising fresh equity to strengthen Tier 1 capital ratio to 11.4% (Sep 2009) |
| SEB      | 14%                    | - Net credit losses in the Baltics rose to 2.6 bln SEK in Q2 2009. Total net credit losses of SEB were 3.6 bln SEK, while in Q2 2008 they were 448 mln SEK (8-times increase)  
- Share of impaired loans in the Baltics for Q2 2009: gross 5.1% (in Q2 2008 the share was only 0.7%) | - May 2009: joined the Loan Guarantee Fund of the Swedish government to issue debt and strengthen its financing  
- Raising fresh equity to strengthen Tier 1 capital ratio to 13.1% (Q2 2009) |

* As % of group’s operating profits in 2008.
Table 5  Effect of crisis on selected West European banks present in CEE states and their response

<table>
<thead>
<tr>
<th>Bank</th>
<th>Its presence in CEE</th>
<th>Effects of subsidiaries on the bank (Phase 1 and 2 of the crisis)</th>
<th>Bank response</th>
</tr>
</thead>
<tbody>
<tr>
<td>UniCredit (Italy)</td>
<td>• Is present in 15 East European states (in all 4 CEE states and in the Baltics) • In terms of assets, No.2 in Poland, No.4 in Czech R., No.5 in Slovakia • Polish subsidiary generated 13.6% of the net earnings of the parent bank in Sep. 2008</td>
<td>• In Q1 2009, total NPL for its East European subsidiaries (incl. Austria, excluding Ukraine) were 3.3% of total loans • Highest credit risk in subsidiaries in Ukraine, Russia and Kazakhstan • In Q1 2009 no regional subsidiary recorded losses (and the Polish subsidiary was the most profitable)</td>
<td>• Better cost management (less personnel expenses) • Raising hybrid capital up to the total of 4 bln EUR (preference shares from Italian and Austrian governments)</td>
</tr>
<tr>
<td>Raiffeisen Int’l (Austria)</td>
<td>• Is present in 16 East European states (including all 4 CEE states) • Polish subsidiary generated 8.2% of the net earnings of the parent bank in Sep. 2008</td>
<td>• In Q1 2009, total NPL for its East European subsidiaries were 4.8% of total customer loans (mainly due to the Ukrainian subsidiary)</td>
<td>• Better cost management • Raised provisions for loan losses • To strengthen Tier 1 capital, parent company issued 2.5 bln EUR in participation capital</td>
</tr>
<tr>
<td>KBC (Belgium)</td>
<td>• Is present in 9 East European states (including all 4 CEE states) • In terms of assets, No.2 in Hungary and Czech R., No. 4 in Slovakia, No.9 in Poland • Polish subsidiary generated as much as 43.2% of the net earnings of the parent bank in Sep.2008</td>
<td>• In Q1 2009, total NPL for its East European subsidiaries were 2.5% (losses generated mainly in Serbia, Russia and Bulgaria, not in 4 CEE)</td>
<td>• Better cost management (e.g. suspended branch expansions) • Obtained 5.5 bln EUR from the Belgian and Federal Flamish government to strengthen Tier 1 Capital • Officially stated its commitment even to the loss-making subsidiaries (Russia etc.) in May 2009</td>
</tr>
</tbody>
</table>


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