THE IMPACT OF THE EUROPEAN INTEGRATION PROCESS ON THE BANKING SYSTEMS OF THE COUNTRIES OF CENTRAL AND EASTERN EUROPE

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Abstract:
The economic integration process begun in Western Europe after the Second World War has led to the harmonization and compatibility of national banking systems to meet the competition exercised by American and Japanese banks. The historical moment of the "Iron Curtain" collapse resulted in the conclusion of the "Cold War" and the confrontation between the two systems, opened the door to collaboration, integration and in the end of the enlarged EU. The central European countries made good progress towards European integration, long before May 1, 2004, when the largest wave of accessions to the European Union (10 countries) was recorded, and January 1, 2007 when Romania and Bulgaria joined. The evolution of the whole European banking system can not be detached from the general economic situation of countries facing failures at both the microeconomic and macroeconomic levels.

Key words: *impact, integration, development, restrictions, evolution*

JEL classification: *A1, E5, G00*

Introduction

The harmonization and the compatibility of national banking systems were among the important objectives of economic integration and monetary union. The developments recorded until 2000 are characterized by:

- Continuing the restructuring and privatization process;
- higher quality services and public education;
- stimulating the economic agents and the population to attract savings in the banking system;
- the modernization of the payment systems by developing electronic payment system;
- the increased capital market transactions;
- the development of specialized financial institutions for leasing activities, brokerage, insurance, investment banking, investment funds, pension funds.

Steps in developing the legal framework of business banking

The evolution of European banking system shows *the contribution factor* to the integration of banking *legislation,* the *action* enrolled by the legislation factors can be grouped (European Commission and Council of Ministers) in 6 *steps:*

- deregulation of domestic markets between 1957 and 1973;
- various attempts to harmonize banking regulations between 1973 and 1983;
- the directive on a single authority, internal control, mutual recognition and the liberalization of banking services in 1992;
- creating a single currency in 1999;
- Financial Services Action Plan (2001-2005);

- concerted actions against the international financial crisis 2008-2009.

The first phase began in 1957 and corresponded to the objective of the Treaty of Rome which aimed to transform the national markets into a common market. The next step for the harmonization of banking regulations actually began in May 1977 with the adoption of the First Banking Directive (Directive 77-780/EEC) on the coordination of laws, regulations and legislative requirements of credit institutions. The third stage is the process of completing the Internal Market (1983-1992). The fourth stage is creating the single currency - euro.

By 1980 the banking system image is one of a fragmented system, although in 1973 through the Directive 73-183/EEC, *restrictions* were abolished in the organization and provision of banking services and, in fact banking systems of most countries were restricted by a broad set of constraints, particularly those aimed at controlling capital flows. The main *restrictions* were the following: *control of interest rates, capital controls, rules* regarding the participation of banks in securities brokerage activities, restrictions on opening branches abroad, restrictions on new banks entering the market, capping appropriations, mandatory requirements investment, and insurance restrictions.

The most applied restriction was the one that targeted the interest *rate control* applied in all the countries examined except for the Netherlands and Great Britain. The control of the capital flows was practiced by most European countries (among which the most significant are: France, Italy, Spain, Ireland), the liberalization of the capital is only effective in Germany, Luxembourg, Netherlands and United Kingdom. Also, banks were *restricted in the conduct of mediation activities in values securities* in Denmark, Spain, France, Italy, Britain and Portugal and insurance activities were restricted in Germany, Denmark, Spain, France, Italy, Netherlands and Portugal.

Capping credit was used in Denmark, Spain, France, Italy and Portugal and the market entry of new banks was discouraged in Spain, Greece and Italy. We note that countries that acted most restrictions were Denmark, Spain, France, Italy and Portugal and the most liberal were Belgium, Luxembourg, Germany, Britain and the Netherlands, countries which dominate the banking industry nowadays. The Eastern European countries do not have the same recent history as the Western, and, therefore, do not have the same development or capacity to adapt to the environment that banks in developed countries have. And yet they, themselves, are facing a series of "challenges" that, "historically", exceed those of Western European or American banks by the simple fact that they have to deal with the transition to a market economy and challenges that the globalization and regionalization of financial services bring to the market.

Obviously, the financial sector's role is to collect the amounts saved and direct them to those uses that will contribute most to the welfare and also to ensure an effective system of redistribution. The banks compete in a market economy for attracting savings by providing deposits with the most competitive interest structures allowed by their costs and revenue stream. Meanwhile, banks compete in granting loans to reliable customers, with the lowest interest permitted by the general expenses, including interest payments on deposits.

The stages in the evolution of the banking systems in the Central and Eastern Europe

Most countries in Central and Eastern Europe have in recent years sought to create the conditions necessary to meet these requirements by their financial systems. However, it has proved very difficult to strengthen the role of the banks in the former socialist economies. Many *causes* have generated it. A cause is the *dismemberment of the former larger banks,* inherited from the socialist system, so as to stimulate competition. Basically, the division of banks was based on areas of activity or

geographical areas. Although these criteria seem logical, they do not give rise to competition and do not allow a full risk diversification.

Another difficulty is the *poor development of the procedures for the expertise* and other banking procedures. This is understandable, since the banks of the former economic system fulfilled few of the attributes that a bank normally should in a market economy. Therefore their ability to consider loans on a commercial basis is low. A third major issue *is* to cut *subsidies and competition of the import products,* which resulted in lower revenues of many former state enterprises, which could not ensure the payment of the debt service contracted. As a direct consequence, many of the new banks with state capital inherited the debts of these enterprises, having in the portfolio a high percentage of bad loans. To postpone denouement, banks have given new sources of financing to the bankrupt enterprises. This has led to the assumption of losses by banks non-performing loans, reducing the funding sources of new private enterprises, possibly more dynamic and more profitable. An article published in 1993 in EBRD Economic Revue entitled "Banking reform in Central and Eastern Europe" discusses these problems and investigate in more detail some solutions.

The monetary system in a planned and super-centralized economy is based on a single state bank - usually called the National Bank - which combines the functions of a central bank and commercial banks and financial institutions. The main purpose of this bank is to provide the production and investment tasks set by the government annual economic development plan. In the former communist countries, the National Bank fulfilled these functions by providing business loans necessary to meet the planned operations. Both prices and loans were used primarily as accounting tools. Enterprises used cash only for the payment of wages. Settlements between companies were made through the National Bank, through the transfer instructions from a current account to another, instructions that the National Bank executed more or less automatically, allowing the accumulation of arrears. Planned prices were set by the state and were rarely changed. The interest rates also rarely changed had little influence on the profitability of enterprises.

The profit was not allowed to become a motivating factor. Thus, profitable state enterprises surrendered excess profits to the state, while the losses of the enterprises were covered by grants or loans. Individuals were included in a separate monetary circuit. The National Savings Bank, possibly working with a number of small credit unions, ensured their needs by accepting deposits and deposit additional funds to the National Bank. Unlike the deposits made at banks, deposits of individuals (CEC) were converted into cash, the main payment method in the retail trade. Nearly all the countries of Central and Eastern Europe have transformed banking unit in a system with two levels and that since the beginning of the transition to a market economy. The new two-tier system of credit transfer activity and formation of deposits of enterprises in charge of new commercial banks, National Bank granted the only standard functions of a central bank, including currency management, from the beginning. In all these countries, except for the commonwealth of independent states, it was accompanied by a greater or lesser liberalization of the interest rate.

One of the aims of the reforms has been the separation of monetary policy management from the objectives of the allocation of resources determined by the requirements of specific practices to maximize profits through commercial banks. It has been hoped that the emergence of competition should help mobilize savings, to improve the quality of financial services and reduce costs in banking. However, in practice, this separation occurred quickly and in a way that hardly helped to achieve those objectives. The new state-owned commercial banks have inherited the loan portfolios that have been concentrated on certain geographic areas or industries. Among the consequences

of such situations are the risk exposure concentration and the lack of effective competition.

Banks face the problems of capital and the flow problems and these problems are interrelated. The solution of the flow should be based on a criterion of efficient allocation of current and future loans by banks, a prudent risk management and solvency. These objectives can be met through the many instruments of promoting a competitive banking system, opening domestic markets to foreign producers and the emergence of new private banks, improve management, prudential regulation and supervision of the banking system. The objectives will not be met unless incentives are created to change the current structure of state-owned banks' portfolio and boost the competitive phenomenon. Moreover, the reform of the banking system will fail as long as the "problem of the companies" is not solved, that is restructuring or liquidating them to achieve financial viability.

The first objective to keep in mind in addressing the problem of capital is *reviewing the assets and the classification of loan assets* to be passed at a loss, but this will facilitate the assessment of need for provisions for substandard and doubtful assets. Such revisions have been performed (audit) in the countries of Central and Eastern Europe which have started early on the path of reform (Poland, Czech Republic, Slovakia, Romania, Hungary and Slovenia). Later revisions have been performed in Bulgaria and in some Baltic states. The lack of any progress of the rubble, even with regard to this first step in the process of financial restructuring, is a result of financial difficulties on a background of extreme price instability.

The second objective is to *restructure the balance sheet of banks,* so as to answer the distributive question: the destination of the losses, their division between bank owners, bank creditors or other parties. In the late '80s and early '90s bank restructuring and merger process took place in small EU countries, such as Denmark and the Netherlands. This process led to the creation of large national institutions prepared to compete in a single market or as its regional part. In the early 90s, in full Scandinavian banking crisis, mergers and acquisitions have created major institutions in Sweden and Finland. The banks in Britain, not at all small in comparison with similar international financial institutions, experienced a series of mergers and acquisitions in the late '80s and early '90s. In Spain a similar process occurred in the early '90s, involving notably savings banks.

In the same period many countries initiated efforts for the privatization of some large banks public property by attracting private investors. Furthermore, a trend accounts for institutions with a mutual ownership structure, respectively demutualization (in countries such as Great Britain and Ireland, Denmark and Germany) institutions (such as construction companies and savings banks) who had a mutual organization, have abandoned this form of corporate organization and converted into other forms of private property laws, with privatization efforts and "demutualization" the interest in bank mergers and acquisitions increased, together with the number of participating institutions. Whenever they sought opportunities for growth, the large European banks have preferred either domestic or outside the euro area targets. By accelerating the process of mergers and acquisitions will create an even higher banking network, which will be also a challenge to banking giants. In this context there will be some small banks specialized in niche markets, with a role in ensuring the efficiency and increase profitability. With the rapid creation of a single monetary market and the accelerated integration of financial markets after the introduction of the euro, it became clear that financial intermediaries and capital markets were increasingly exposed to external shocks.

The increased competition and worsening economic situation (especially in 1990-1993) increased the number of mergers, acquiring and associations, which resulted

in a considerable increase in the degree of concentration in the banking field, both in number and in size but also in the values employed in such operations. In the banking field, 75 international financial groups chose to open at least a branch in Central and Eastern Europe, but the true giants of the region are "UniCredit", "KBC", "Erste Bank”, Raiffeisen Bank, "OTP" and "Societe-Generale", together they control 50.6% of the total assets of regional banks, being the platoon leader in nearly all European markets. Eight banks in the "top 10" international financial institutions that are the leaders in Eastern Europe are present, with a major share, on the Romanian market. The statistics show, for Romania, a degree of potential banking lower than the potential of the economy, which explains the strategic moves by which international banks have tried to position themselves more advantageously in the system, to reserve a share as high in future market growth.

The consolidation process that took place within Western institutions in 2000 is also likely to alter the banking and financial landscape, having a great impact in Central and Eastern Europe, and, not surprisingly, the major interests of foreign investors manifest in the largest banks or the top 40 institutions ranked by capital rank 1 higher than 100 million USD. Although it is expected that the total banking assets in all key countries in Central Europe to rise from 300 billion in 2001 to over 500 billion in 2009, this increase will be reflected in the figures the mother banks outside the region. Mergers accelerated as banks sought to defend their positions through consolidation. The increased competition lowers the profit margins quickly. We will witness a terrible fight for the best places on all European markets. The fight for market shares will be carries on to another level, that of mergers and acquisitions. Further consolidation, particularly through cross-border mergers and acquisitions, is expected, although the mergers and acquisitions field becomes more nebulous. Mergers among banks, especially between banks in different countries are not always a good thing; the gains in efficiency may be marred by conflicts of cultural interests.

As to the degree of concentration of the banking system of European Union we can say that there is no uniformity. We find both small countries in particular characterized by a high degree of concentration of the banking system (Belgium, Czech Republic, Lithuania, Malta, Netherlands, Finland), as well as countries with a lower degree of concentration (Germany, Italy, Luxembourg, United Kingdom). The extent of the operations performed, increasing funds that are requested by customers, the risks of insolvency of debtors, and the desire to increase profits and power of penetration in other markets and therefore a place in the dominant currency and financial market have led to the increased process of unification of the banks in monopolies, consortia, unions and alliances with banks. The bank merger trend will continue, through mergers and acquisitions across Europe. The big banks and giant financial groups come together, merging, dominating and controlling the entire activity. This is an actual problem with deep implications on the European and international competition; important changes have taken place – and they are not excluded in future - in terms of the power centres of the contemporary world.

The first merger of size, considered the point of inflection in the process of banking consolidation in Europe, remains that between UniCredit and HVB, in June 2005. This transaction propelled the Italian banking group in the elite European banks and the asset size transformed it into the market leader in Central and Eastern Europe. The risks taken were quite high, given the review presented by "HVB" in recent years and the reduced enough capitalization of the new entity. The transaction stake represents a strengthening of competitiveness by expanding the customer base and revenue, achieved due to synergies and reduced costs.

During 2004, “Bank Austria Creditanstalt-Group”, "HVB" published a study on prospects for the banking market in Central and Eastern Europe for 10 years

consecutively (2003-2013). According to this study CEE banks will continue to operate more profitably than those in Western Europe and 14% annual rate of credit growth will exceed the 10% of the deposits, while simultaneously increasing the importance of alternative investment products such as life insurance policies and pension plans. The accession of the states in Central and Eastern Europe to the European Union gave more opportunity to formulating hypotheses and predictions on the evolution of these economies when they joined.

Bank Austria Creditanstalt has realized since the early '90s the growth potential of the region, which is why today is present in 11 countries in the region and has the largest territorial network in CEE. Developing a functional banking system was not easy, because in addition to the lack of performance, the CEE banking systems had to deal with the challenges of transforming the economic environment as a whole. Inevitably, the region's banking systems experienced more or less serious banking crises, which often resulted in significant costs. Currently, most countries in CEE have strengthened and greatly privatized banking systems. However, these systems remain modest in terms of quality, to those in Western Europe. Thus, the banking system in the main CEE countries (Poland, Hungary, Czech Republic, Slovakia, Slovenia, Croatia, Romania and Bulgaria) contains less than 300 banks with total assets of around 350 billion, a figure which represents only 2.4% from the consolidated balance sheet of banks in the European Union.

In terms of profitability, the banks in CEE are much better than those in the euro area. The fact that the return on equity (ROE) is calculated as the average for 31 banks in CEE (9 of Poland, 8 in Hungary, the Czech Republic and Slovenia each 5 and 4 in Slovakia) is slightly above the average in the EU for 50 banks, is due to poor performance of Polish banks and especially the high level of own funds, outlined in the average capital adequacy rates (15% in CEE, compared to only 11% in the euro area). Meanwhile, return on assets (ROA) is three to four times higher in CEE countries (except Poland) to the euro area.

Conclusions

An important performance component is the high interest margin (twice that of countries in Western Europe). This success is recorded even if the net interest income was significantly affected by the provisions established. The net revenues which do not come from interests play an important role in the top banks in CEE, but are placed below the average euro area.

Reducing their funding levels to levels comparable to those of the EU capital adequacy ratio, could lead to significant increases of ROE. The efficiency has much room for improvement, in CEE the assets managed by an employee do not exceed 1.4 million euros, a figure that represents 16% of the existing EU, much less than would be expected, given the difference of incomes (23%).

The market area of Central and Eastern Europe is a market that has grown rapidly in recent years, in the context of an expanding European market. The increased international financial crisis put the spotlight on the relationship between the mother company, usually located in Western Europe and the banks members of the group from the Central and Eastern Europe.

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