THE EFFECTS OF FOREIGN ENTRY IN BANKING SECTORS OF TRANSITIONAL ECONOMIES – THE CASE OF SLOVAKIA

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ABSTRACT

This research project undertook a combined quantitative and qualitative analysis of the foreign entry effects on domestic banking in Slovakia during the first eight years of the country's existence. The research results suggest that straightforward assessing of foreign entry effects is difficult as it largely depends on the specific conditions of the country's financial sector development. Moreover, the organisation of financial markets, bank supervision and regulation as well as legal infrastructure, state influence and past experience plays a significant role in shaping domestic banks' behaviour. The research results have not supported the view that the opening of financial sectors of transitional economies or developing countries could lead to destabilisation or introduces crisis into the systems.

The results of the analysis show that the foreign banks increased their share in all bank activities after the initial testing period. Foreign banks were clearly more profitable and more efficient at operating with less risky loan portfolios and following cautious strategies for involvement in the Slovak economy but increasing the levels of trust within the economy. The results of qualitative analysis tend to corroborate the results of quantitative part however, revealing interesting issues affecting the results and reporting of domestic banks. Domestic banks were more hampered by the organisation of the market, regulation and especially the state influence rather than by foreign entry. Foreign banks were important for exerting competitive pressures, introducing higher quality of services and new products as well as market-based credit and risk management and a different corporate culture and human resources, which was detected as a major spillover effect.

The foreign banks seemed to explore the market upon arrival to decide on future strategies. Once established, however, the banks began to converge in terms of their activities, if not their attitudes. Limited offers of creditworthy customers were quickly substituted with large involvement of their activities on inter-bank and government debt market.

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INTRODUCTION

Introduction

A well functioning financial and banking system is undoubtedly one of the crucial elements of economies' growth. This is even more significant for the economies undergoing the process of structural change or transformation. Financial deregulation, developments in telecommunication and IT technology and globalisation of capital markets are factors which have mainly encouraged foreign direct investments (FDI) in banking in recent years (Moshirian, 2001). Although the benefits of financial liberalization have been broadly investigated, views on the effects of foreign participation are still controversial (Fisher and Chénard, 1997; Chavez et al, 1996; Goldstein and Turner, 1996; Honohan, 1997; Weller, 2000; Weller and Morzuch, 2000). Further, any evidence on behavioural comparisons between foreign and domestically owned banks remains largely undocumented (Dages et al., 2000). While many authors focused on empirical examination of foreign bank entry effects (Claessens *et al.*; 1998, Clarke *et al.*; 1999, Levine, 1996; Demirgüç-Kunt, Levine and Min, 1998; Bonin and Abel, 2000; Buch, 2000), only a few researchers centred their attention on qualitative assessment (Konopielko, 1999, Petrick, 1999, Scott-Green, 2002) and scarcely anyone attempted to combine both methods.

The purpose of this study is to provide a further investigation of the field of foreign direct investments in the banking sector of transition countries, with a particular focus on the case of Slovakia. More specifically, the thesis will examine how foreign entry in

the form of foreign direct investments in the banking sector influenced domestic banks and the stability of the banking sector.

The current study aims to fill the gap in the area of the foreign entry effects in banking. Furthermore, differences in behaviour of various types of banks in the setting of the transitional economy are scrutinised in detail. By drawing attention to the presence of foreign banks and their effects on domestic banking as well as looking at the areas of know-how transfer, organisation of markets and state and competition effects, the study shall broaden understanding of financial market liberalisation and the effects on the local economy. The benefits of foreign bank entry as presented by Dages *et al.* (2000), Levine (1996) or Glaessner and Oks (1994) as well as potential negatives as suggested by Demirguc-Kunt, Levine and Min (1998) or Papi and Revoltella (1999) are examined in detail.

The comparative element of the study across the four different groups of banks enables the research to provide greater insight into the behavioural differences between domestic, specialised and foreign banks and branches. Moreover, using both qualitative and quantitative research methodology enables triangulation of the results and further corroboration of findings. Inductive research approach proves to be complementary to the initial deductive approach where results of statistical analysis are corroborated with findings of semi-structured interviews. The character of the research allowed for enough flexibility so that rigorous empirical analysis provided explanatory results of between group differences while more open interview based research offered explanatory as well as exploratory findings.

The thesis is organised around eight substantive chapters. Chapter one reviews the literature on the role of banks in the economy. Chapter two deals with the role of foreign banks entry reviewing the theoretical framework of FDI in banking and extends focus to the effects of foreign bank entry in developing and transition economies. Path to transition among the four selected Central and Eastern European Countries is discussed in Chapter three including comparisons in restructuring strategies, privatisation and stability and crises including the issue of non-performing loans. Chapter four describes development of Slovak financial system including important effects of privatisation and politics. Furthermore, the level of foreign entry in Slovakia is explored well as process of banking sector development. Chapter five presents the method of the study based on a combination of phenomenological and positivistic approaches and attempts to justify the qualitative and quantitative research methods to a certain extent. Chapter six provides an ethnographic illustration of perceptions of the commercial bank officials and the state and the central bank officials on specified research areas. Empirical analysis of the differences between selected groups of banks was conducted in Chapter seven and further indicators and deposit and loan portfolios' composition were analysed. The results of both parts of the analysis are summarised and discussed in the Chapter eight, where potential policy implications are drawn and limitations of the study are discussed as well as suggestions for further research are explored.

LIST OF FREQUENTLY USED ABBREVIATIONS

ANOVA	Analysis of variance
BCPB	Bratislava Stock Exchange
BIS	Bank for International Settlements, Basel
CBO	Commercial Bank Officials
CCR	Coefficient of credit risk
CCU	Criteria of cautious undertaking
CEE / Cs	Central and Eastern Europe / European Countries
CEFTA	Central European Free Trade Association
CEO	Chief Executive Officer
CMEA	Council for the Mutual Economic Assistance
CPI	Consumer price index
CSOB	Ceskoslovenská obchodná banka (Czechoslovak Trade Bank)
EA	Earning assets
EBRD	European Bank for Reconstruction and Development
EE	Emerging Economies
EU	European Union
FA	Fixed assets
FDI	Foreign direct investments
FSU	Former Soviet Union
GDP	Gross domestic product
HR	Human resource
IBA	Inter-bank assets
IMF	International Monetary Fund
IRB	Investicná a rozvojová banka (Investment and Development Bank)
IT	Information technology
L/D	Loans / Deposits
M2	Broad money - the money in public circulation comprising banknote, coins, and call deposits (i.e., narrow money, M1) plus business and household time and savings deposits in the commercial banking system.
MNB / s	Multi-national bank / banks
MNCs	Multi-national corporations

N/A	Not available
N/AP	Not applicable
NATO	North Atlantic Treaty Organisation
NBS	National Bank of Slovakia
NIS	Newly Independent States (of FSU)
NPF	National Property Fund
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
P	Profit
PKB	Prvá komunálna banka (The First Communal Bank)
PM	Prime Minister
ROA	Return on assets
ROE	Return on equity
SBO	State and central bank officials
Sec	Securities
SIC	Standard industry codes
SKK	Slovak Koruna
SLSP	Slovenská sporitelňa (Slovak Savings Bank)
SME	Small and medium enterpise
SOBs	State-owned banks
SOEs	State-owned enterprises
SR	Slovak Republic
T-bill	Treasury bill
TA	Total assets
TEs	Transitional Economies
UNCTAD	United Nations Conference on Trade and Development
UK	United Kingdom
US	United States
USA	United States of America
VAT	Value added tax
VSZ	Východoslovenské železiarne (East-Slovakian Steelworks)
VUB	Všeobecná úverová banka (General Credit Bank)
WTO	World Trade Organisation

CHAPTER 1.

ROLE OF BANKS

"Whoever controls the volume of money in any country is absolute master of all industry and commerce."

(James A. Garfield, 20th President of the United States, quoted in: Boldt, 1999)

1.1 Introduction

The origins of banking undoubtedly lie in medieval Italy, especially with reference to the first, and once very influential, Medici Bank. Their domestic and foreign business was based on branches that usually started as corresponding agents in leading business centres. Although we cannot say that Medici's presence in foreign countries was a foreign entry into domestic banking markets, seeing as the overall conditions were very different and banking markets had not existed for very long, it still suggests that banking has been, since its early beginnings, a particularly international business.

Despite the fact that Italian bankers did not keep pace with their north-western counterparts, their banking practices were successfully adapted in Atlantic and north-western European financial centres as they evolved over time with the development of long-distance trade (Teichova et al., 1997). Nevertheless, the real breakthrough came later, in Stockholm and Naples, with the introduction of paper money. Banks started backing money with their reputation, which stresses the importance of information as a core reason for the existence of banks. The seventeenth century was also the period when Spain fell back on its leading role in emerging markets due to the close linkage between Sevillan bankers and the Spanish crown. The uncontrolled finances of the Spanish monarchy provided the first example of the negative influence of the state interfering in the banking sector. Regulation of banks had become an important issue. The foundations of central banking and the *de facto* two-tier banking system were laid down by the Swedish Riksbank, which was also the first bank to start issuing its own money backed up by the name of a central bank, and further developed by the Bank of

England which in fact became the backbone of the world's emerging financial centre: London.

Though one would not expect striking innovations in banking in colonial economies, the second half of the nineteenth century meant political and administrative modernisation, as well as evolution of state structures in which the major role was played, according to Marichal (1997), by powerful government banks in Argentina, Brazil, Chile, Mexico and Peru. From Marichal's point of view, banking development preceded the industrial revolution in these countries. It is of interest at this point to look at similarities between Transitional Economies (TEs) and developing countries of Latin America as shown later in Germany and the Habsburg monarchy; furthermore, industrialisation was, to a large extent, supported by private and government banks, backed up by a central bank.

Unlike in the later case of Latin American, the cradle of commercial capitalism – England – started the industrial revolution with entrepreneurs financing themselves from their own resources in the early stages. Growing demand for credit as a result of the quickening pace of economic and technological change put pressure on the banking structure, and in the late 19th century independent provincial banks transformed into branches of London-based deposit banks.

Banking systems matured at the end of the nineteenth century and the beginning of the twentieth century, crystallising into either a market-oriented financial system, as in Britain, where a majority of the funding had been provided through capital markets, or a bank-oriented financial system, as in Germany, where development was financed primarily through bank loans. In the Russian case, Gerschenkron (1962) explains the failure to industrialise as due to draining out the profits assisted by bank financing[1]. As in Austria, banks were interfering in the managerial independence of private enterprises via the creation of cartels. The banks could have been regarded as intermediaries

[1] More recently the Russian banks were accused of not being banks at all, as they do not focus on provision of credit to production firms failing to channel, what is believed, the vast savings of Russian households to production process (Thompson, 2000). However, it is also claimed that it is the environment that presents Russian banks with substantial enticements towards other activities because of the massive political and economic obstacles to intermediation.

between top creditworthy borrowers and foreign capital markets[2]. Nineteenth-century Russia is another example of banks established by industrialists serving entrepreneurs in a more receptive way (Cameron, 1972, pp. 20–21). Gerschenkron claimed that the banking system played an important role in European industrialisation. France developed a centralised banking system corresponding with the centralised character of its state structure: the French Crédit Mobilière served as a role model for the development of universal and investment banking, although it later failed to deal with the illiquid character of long-term contracts with industry. This bank served as a model for many German banks that developed the idea of being an investment source for the long-term needs of industry, as well as introducing current accounts and overdraft business designed to meet the needs of industrial progress. The German "universal bank" system relied on a relatively large holding of guaranteed capital against collected deposits and the back up of a strong central bank. Nevertheless, in the 1930s even this system collapsed as the central bank was not prepared to step in as a lender of last resort. The Crédit Mobilière model was largely applied in Europe: Italy, Switzerland and the whole Habsburg monarchy.

As in Germany, banks in the Habsburg Empire were strongly interlocked with industry, frequently also performing marketing operations for its business holdings. However, with the break-up of the Monarchy after the First World War, eight Viennese banks holding strategic positions in all sectors of industry suddenly held multinationally diversified portfolios of interests and two of them had even become foreign-based institutions (Teichova, 1997). Development of the banking industry in the Monarchy's successor states was much the same due to inherited universal banking traditions. Consolidation arising from the 1930s crises meant increased entry of foreign banks into post-Habsburg Monarchy countries. Foreigners became holders of 75 per cent of Romanian and Yugoslavian banks and 30 per cent in Poland and Bulgaria. Czechoslovakia came out with less than 15 per cent foreign ownership (Teichova, 1991). The better performance of the Czechoslovak economy compared to the Austrian (Weber, 1995) and better collection of primary resources of funds with a longer tradition of savings banks (Hajek, 1986) avoided the crashes typical of Austria. During

[2] For more recent study of financial intermediation in Russia see Thompson (2000) while Schoors (2003) looks at privatisation of Russia's state-owned banks.

the Second World War the Czechoslovak banking system (though split into the Protectorate and the Slovak clerical state) was swallowed by the big banks of the Third Reich, and its prospects developed little even after the war when the banking system was nationalised by the Communist regime and became only an executive tool of centralised planning policy. Returning to Gerschenkron's point about Russia's failure to industrialise due to the draining of the profits assisted by bank financing, one cannot resist questioning the extent to which this was also one of the main factors involved in the breakdown of Eastern Bloc countries, through their large debt to foreign countries (banks).

Over the centuries banks have been gaining in importance, especially since the Industrial Revolution when they became crucial institutions within any economic system. However, in the last two decades, substantial improvements in telecommunications and information technology have intensified the global sense of financial markets and cross-border mergers and acquisitions. Nevertheless, changes of a different nature played a more significant role for foreign investments in general. The era of foreign direct investments (FDI) in financial services was triggered by considerable changes in state policies of developing countries towards liberalisation in the last decade of the 20th century and further stressed by the removal of international barriers, as well as domestic barriers, to capital movements. The most significant was a U-turn in state and economic organisation in the case of the Central and Eastern European countries following the breakdown of the former Eastern Bloc. Though it may seem that FDI in financial services somehow lagged behind FDI in manufacturing, the role of banks in financing expansion of other sectors of the economy is enormous. And returning to the central point of this chapter, controlling money in an economy nowadays means controlling the way the country develops.

1.2 Role of banks

With banks acting as the heart of the market system, their role is to pump surplus financial resources into the business entities that require it. This process, according to neo-classical economists, introduces balance to the market through efficient allocation of capital as a production factor. Banking is not merely the heart, but "the outright core of capitalism" (Braudel, 1979). And therefore, "supported by theoretical justification, in Hilferding's and Schumpeter's view, banking is the engine or 'driving force', not only for economic growth, but also for social development in general" (Lindgren, 1997). However, empirical research has still not proved that any particular organisation of a financial market is more accommodating to economic growth than any other. As Lindgren continues, "the intertwined relationship between the growth of the financial sector and the development of capitalism makes it difficult to determine, with any degree of certainty, whether banking preceded economic growth or whether the causal relationship mainly runs in the opposite direction". To determine the direction of such a causal relationship in transition economies would be an even harder task.

Nevertheless, the role of banks in promoting economic growth is tied to a specific area of the banks' clientele. Banking is often segregated into retail and corporate, where retail banking is related to serving the individual public and small businesses, and corporate banking serves larger businesses and the needs of governments. In this sense, French (1994) offers his view on the role of retail banking and the very reason for the existence of banks: "the important role of banks in financing small business lending is consistent with the recent academic theory of the banking firm. Most recent academic discussions of banking have described the prototypical bank borrower as one who cannot access capital markets directly or can do so only at great cost. This is due to the difficulty the borrower has in conveying credible information about his creditworthiness to other market participants".

The existence of these 'informational asymmetries' is one of the principal reasons for the existence of banks and other financial intermediaries. The role of banks incorporates lending, and especially with its decline in the last two decades, this is now frequently being explained by the 'technology and competition' hypothesis. In this regard, corporate clients have now much easier direct access to capital markets thanks to

progress in information technology and the declining cost of capital market access. It is suggested that this development is caused by lower up-front costs of stock subscription because increased competition and information technology improvements enable the easy storage and transmission of credit information, which moderates the information asymmetry problems. Though the reasons can be numerous, qualitative change in financial markets towards an increased role of non-bank financial intermediaries is often supported. A possible explanation has been offered by the core-deposit theory of Berlin and Mester (1996), who offer the argument that banks have lost much of their comparative advantage to non-bank financial intermediaries due to market forces making them pay market interest rates for the core funds.

The circuit approach offers a different reason for declining core bank business. In this approach, liberalisation has caused declining demand for core deposits forcing smaller banks, in particular, with a smaller base of depositors, to be faced with the higher costs of inter-bank lending resulting from their core lending. Consequently, the banks are forced to hold higher reserves at higher cost. As a result, to gain alternative sources of core deposits, mergers and acquisitions take place.

Though the declining role of banking has been a favourite topic of academic discussions recently, it seems reasonable not to expect that the banks would give up their roles to other financial intermediaries because of two main factors. Firstly, though large companies can establish their own underwriting departments or try to use services of financial intermediaries other than banks, it is the banks' public institutional recognition (or credit rating) and brand name on the world financial markets that makes the difference. Furthermore, these unique features of a bank are very difficult to substitute for a non-bank company and; secondly, again following French (1994), compared to corporate debt, bank loans were more attractive than bond funding in the late 1960s and 1970s, and less attractive from the mid-1980s. Noting the fact that there seems to be no temporal decline in returns on high-quality credit risk, the price of marketable corporate debt can be expected to rise once more making bank loans more attractive again. Certainly, the whole issue can be viewed in terms of the decline in commercial banking only being misinterpreted as a decline in on-balance sheet banking activities, neglecting the shift to off-balance services and offshore banking, as Boyd and Gertler (1994) note.

It is generally accepted that banking forms a part of the service sector of an economy. Banking is a unique sector, which is related to the unique asset it is dealing with: money. Its functions and information intensiveness predetermine the way it develops and the way it expands in the markets. It has been mentioned above that banks have certain special features, which make them different from other firms. Some basic features necessary for their existence, such as taking deposits and offering loans, have been present since the very beginnings of the banking industry, whereas others, such as deposit creation and the issue of paper money, developed later. Bossone (2000), when addressing the question what makes banks special, in his study on banking, finance and economic development, argues that apart from their functions, which are liquidity and payment services, credit supply, and information provision, the really distinctive feature of banks is the public acceptance of their loan claims on their own debts as money.

Let us now look at this issue in more detail. On one hand, banks are defined by Schumpeter (1934) as simple middlemen, as intermediaries with the productive means to those who wish to form new combinations but only under the conditions of the free market without state direction of resources. On the other hand, could one believe that banks are special because regulators treat them as special? (Tobin, 1963; Kareken, 1985). And last but not least, banks emerged as financial intermediaries well before other intermediaries began to be active in the financial sector. Referring to their roles, one group of scholars emphasises banks as suppliers of transaction services, providers of a payment system and a source of liquidity together with being transmission tools for monetary policy (Fama, 1980; Kareken, 1985; Corrigan, 2000). Another group refutes the above points, arguing that even non-financial intermediaries can nowadays provide these functions (Golembe and Mingo, 1985; Goodhart, 1987).

The basic function of a bank is to supply credit. In this sense, the bank acts as an agent for depositors who pool their free financial resources and delegate the bank to monitor the loans provided to borrowers (by observing deposit movements and gaining private information on borrowers, which gives them unique information advantages according to Fama (1985) to overcome information asymmetries. This attribute is regarded by Diamond (1984) as unique to the bank. The banks' special role as information providers to the capital markets has been confirmed by the research of James (1987) and Lummer and McConnel (1989). However, private information on borrowers causes the non-

marketability of loans and their uncertain value (Goodhart, 1987). Banks gather information about the client over a period of time, which offers them a unique advantage in dealing with the client. It enables them to offer more tailored services and to assess a client's credibility in a more efficient way, as they possess information about the client's cash-flow behaviour. Selling or even licensing such information would threaten the bank with losing the client to the competition. Another issue is the market value of the loan. Although bonds represent a commitment to pay the face value of the bond plus the premiums, repayments of loan contracts are usually more difficult to enforce in the case of clients' default. This, together with restraints in selling private information about clients to potential buyers of loans, causes the virtual non-marketability of the loans.

However, banks are unique not only because they accumulate deposits but also because they create deposits. Hicks (1989) signified the fact that banks can lend withdrawable deposits without lending real cash only by increasing their liabilities. Combining the liquidity, credit and payment services, banks create money and become tools of monetary policies. They integrate information-intensive lending and payment services (Goodfriend, 1991), thus lowering the costs of payment services, as these are provided by entities that also offer full credit services using their know-how and in their role of intermediaries. A substantial body of research has been devoted to the role of money and credit in the economy. Keynes and his followers explored the creation of money with the concept of money endogeneity[3] where the demand for credit cannot be substituted for or subsumed in the demand for money. Money is introduced into the economy through production and accumulation via the means of credit.

Adam Smith, and later Schumpeter (1934), pointed out that the creation of money by establishing claims against themselves is a fundamental function making the new combination of factors feasible. Schumpeter laid the foundations for monetary circuit theory by emphasising the circuit and sequential flow of money in the production process (see Schmitt, 1959; Graziani, 1996; Lavoie, 1985). The notion behind circuit theory is that money is initially created by bank credit and ultimately destroyed by the repayment of loans. Incorporating uncertainty circuists claim that any credit constraints

[3] For more on endogeneity of money see Rochon (1999)

operate through creditworthiness criteria. On the other hand, reflecting the work of Keynesians, McKinnon (1973) and Shaw (1973) argue that financial repression reduces both the quality and the quantity of investment in the economy. The conclusion is that financial liberalisation can increase economic growth by increasing investment and its productivity.

The foundations of financial sector analysis in the past twenty years or so lie within the framework of McKinnon and Shaw who rejected the models of Keynes, Keynesians and structuralists on the basis of the study of financially-repressed developing economies "advocating financial liberalisation and development as growth-enhancing policies[4]" (Fry, 1995, p.23). Banks have been found, especially by the second generation of the McKinnon–Shaw school, to have a vital role for economic development (King and Levine, 1993; Levine, 1996 and 1997). Internalising their information advantages, banks bridge the trust gap between savers and capital users by their reputation, which is too expensive to be the responsibility individuals. And further, banks provide unique liquidity insurance services to both depositors and borrowers that are made possible by their fragile capital structure (Diamond and Rajan, 1998). This fragile capital structure is organised thanks to unique know-how about the combination of liquid and illiquid assets as well as assets and liabilities with different maturities (Diamond and Dybvig, 1983).

Schumpeter's argument regarding banks' money creation has vital implications for the role of banks in economic development. This is intensified by Bossone's (2000) argument that banks in fact create money against future real output, which provides the economy with a greater potential for mobilising real resources, compared to where output is needed before new loans are provided. The drawback to this argument is the risk of creating money without real output equivalent. In other words, banks are financing illiquid assets with liquid liabilities. Because of this illiquidity risk, the banks are highly vulnerable to any bank runs from the side of depositors as well as to risks coming from other sectors of the economy. And because their clientele comes from a wide range of sectors, their failures can easily be spread across the whole economy. At this point, policymakers and governments become involved with risk-prevention

[4] Opposing the view of financial liberalisation and development according to the McKinnon and Shaw school, neostructuralists envisage the opposite effect of liberalisation.

policies reflecting the trade-off between cost-efficiency and risk of loans provided. They tend to significantly affect the way financial systems are organised[5].

Financial development in the industrial countries is characterised by two different models. The Anglo-Saxon countries developed systems based on capital market financing with commercial banks providing more short-term finance for trade practising non-interfering policy in dealing with firms – otherwise known as a market-based financial system. The German model involved universal banks supplying both short- and long-term funding for firms engaging in close relationships with their clients – otherwise known as a bank-based financial system. Apart from financing the business sector, banks are often involved in financing governments. There may be a pronounced resemblance between nineteenth-century Europe and many developing countries in relation to bank financing of government deficits. As Cameron (1972, p.21) pointed out, "the privileged position of the government in the capital market, and its penchant for unproductive expenditures – just as that of Austria, Italy, and Spain – made it difficult for the banking system to contribute to industrial development".

The financial systems around the world differ significantly. This is not only because of the level of development but also because of the way they are organised. However, there may be some interdependence between the level of development and the organisation of the financial system. A substantial body of literature deals with financial market development and economic growth at all possible macro and micro levels (see King and Levine, 1993; Levine and Zervos, 1998; Rajan and Zingales, 1998; Demirgüç-Kunt and Maksimovic, 1998). Recent studies show that moving from less developed to developed financial markets means reduced margins and reduced profitability for the banks. Demirgüç-Kunt and Huizinga (2000) focused on the performance of the banking sector across different financial systems. They found that the level of financial development has a very important influence on the performance of banks. One of the interesting outcomes is that banks in underdeveloped financial structures have higher profits and margins. Distinguishing between bank-based and market-based financial systems, Demirgüç-Kunt and Huizinga characterise financial systems as underdeveloped when

[5] For example Stiglitz (1994, p.20) including the occurrence of market failure suggests that "there exist forms of governmental intervention that will not only make these markets function better but will also improve the performance of the economy".

both stock and bank markets are underdeveloped. In the second stage, the financial system is regarded as underdeveloped when bank credit over GDP or total value traded at stock exchange over GDP are less than the sample mean. According to that, the financial system is classified as bank-based or market-based. Their important finding is that in moving from an underdeveloped to a developed financial system, bank profits and margins decline significantly. Further, building on their previous work on the determinants of bank profitability and interest margins, the performance of banks and their relationship to financial structure at bank-level and country-level was studied.

Demirgüç-Kunt and Huizinga's (2000) conclusions bring some interesting points. Controlling for profit over total assets and lagged equity, it seems that well-capitalised banks face lower expected bankruptcy costs, thereby reducing their costs of funding and therefore also reducing the risk of adverse effects on the whole economy. Furthermore, including inflation as a macro-variable suggests that banks tend to profit in inflationary environments. It is also indicated that banks tend to pass some part of their taxes, in a high-tax environment, on to their customers. Furthermore, exploring the role of financial systems on the performance of banks, the results of the study confirm that banks in well-developed bank markets face tougher competition and have lower profitability, but on the other hand banks have greater profit opportunities in well-developed stock markets as a result of the better functioning economy, large clientele and good banking infrastructure. The explanation could be that stock market development makes it possible for firms to be better capitalised, thereby reducing the risk of loan default. A highly-developed stock market also enables banks to better evaluate credit risk. It is also observed that in underdeveloped systems stock market development improves bank profits and margins reflecting complementarities between the two.

The critical moment for developing market economies seems to be the way in which financial markets are organised, especially in the early stages of development. Financial institutions are said to reduce both liquidity and productivity risks for savers and "financial intermediaries are the only source of external funding for small- and medium-sized businesses because information costs are prohibitively high for them to issue equity or bonds" (Fry, 1995, p.75). But generally, because there were no functioning

capital markets in the first years of transition anyway, most of the enterprise financing was provided by banks. Hence, financial markets of transitional economies can be generally characterised as bank-based. Only with increased intensity of trading and securities underwriting did their financial systems start to be more market-based. Ex–communist countries had to undergo the painful process of complete transformation of their economies, and especially of their financial markets. The challenge of building new markets and their institutional structures was enormous. Particular countries have made varying progress in this regard, although this does not always depend on initial conditions. Though the scale of such a transformation is unique, some similarities concerning the under-performing economies and the financial sector liberalisation process can be found among the Latin American countries. Nonetheless, in both cases, development of functioning and stable banking systems is a prerequisite for further development and economic growth.

1.3 Role of banks in Transitional Economies

The role of banks in TEs is very similar to those in a market economy. This has been briefly summarised by Corrigan (1990): "a particularly important function of a banking and financial system in a market economy is to (a) help mobilise a society's savings and (b) to channel those savings rigorously and impartially into the most efficient and effective uses and investments". But Pagano (1993) provides more detailed contribution which stresses the role of banks in providing services such as facilitating the trading, hedging, diversifying and pooling of risk, which stimulates savings mobilization, and allocating financial savings to the most efficient investment projects by screening and monitoring borrowers. Moreover, he points out that financial development may influence the rate of private saving. A ccumulation of deposits and their allocation according to free market economic criteria was a prerequisite for successful transformation of the economy. Or, as Nilsen and Rovelli (1999) put it: "lack of domestic savings is a constraining factor in the growth of developing economies, and of transitional economies in particular". The saving rates were remarkably high in the former Communist Bloc countries of Central and Eastern Europe, reaching an average

35 per cent[6]. As Schrooten and Stephan (2005) indicate, all Central and Eastern European (CEE) countries experienced economic crises early in their economic transformation only to rebound strongly within a few years, especially in the GDP growth rates but also in the saving rates. This may suggest that, apart from the first few years of transition, there were enough resources to fund transition providing credit according to the demand. In order to finance transition, domestic savings were considered to be one of the two crucial components, together with foreign investments. In order to accumulate savings and provide loans, a good banking system with institutions skilfully collecting deposits and efficiently allocating credits needs to be in place.

The critical task for the institutional reform of CEE and FSU (Former Soviet Union) countries was transition from centrally-planned mono-banking systems into fully functioning market-based financial structures. The banks in socialist economies had an accounting role working only as an attachment to the planning process. No competition or independent decision-making existed and the interest, the credit, as well as the collection of savings was set administratively[7]. In order to transform socialist economies into the market-based capitalist system, substantial reforms needed to be implemented that Anderson and Kegels (1998) group into stabilisation, liberalisation and deep institutional building. In newly-created countries, like Slovakia, this involved building many institutions from scratch. Of particular importance was the building of a central bank "responsible for monetary and foreign exchange rate policies, and largely responsible for supervising other banks" (Hare, 1997, p.34). Moreover, the role of the central bank was perceived, by Borak (2000), as the crucial element in intermediation and risk transformation processes in CEE countries. Moreover, Hermes and Lensink (2000) add that the central bank is responsible for the reform and safeguarding of the payment system, while simultaneously maintaining a stable banking system by acting as the lender-of-last-resort. The payment system preservation function is especially important in transition economies, since the payment systems were newly created and totally different to the ones functioning under planned economy settings. The most discussed issue was the question of the central bank's independence, which Grilli, et al.

[6] The question here may arise of whether this was result of very savings-savvy citizens or simply lack of goods and investment products consumers or firms could invest into (see Denizer and Wolf, 1998 and 2000).

(1991) divide into political and economic independence, the former being independence from government influence in pursuing price stability, the latter being independence in determining the amount and price of credit to the central government. Importantly, as Illing (1998) concludes, real independence can only be achieved when a reliable legal and political infrastructure is in place. Apart from a central bank, debt and securities markets needed to be built in order to provide firms with alternative sources of production finance. In the view of Demurguc-Kunt and Levine (1996), stock market development and other parts of financial sector development complement each other. According to Hermes and Lensink (2000, p.511) "liquid stock markets are crucial in stimulating industrialisation", and also may help to avoid problems of asymmetric information (Cho, 1996). However, many stock markets were established too soon, sometimes even without assets to be traded. In some cases, their role had been suppressed because it interfered with the interests of political elites in dividing the 'big national-asset cake'. Underdeveloped, under-equipped and without the necessary know-how, the banking systems of the former Eastern Bloc faced deep crisis.

The task of banks under a planned economy was to enable firms to fulfil the plans and provide companies with financial resources on demand, often without any collateral or any form of security. As a result, with the socialist system crumbling, many firms were not able to service their debts without state subsidies. This development left banks to cope with large inter-enterprise indebtedness, worsened by the attempts of the state to withdraw from subsidising loss-making firms. Another negative factor was that there were no reserves created against the possible defaults. Because of the great moral hazard problem of increased and unsustainable unemployment in the case of bankrupting firms (felt by newly-established democratic governments), banks were forced to lend even to non-credible customers. Hardening budget constraints were expected to solve the problem to a certain extent. These involved limited access to credit for inefficient entrepreneurs, provision of a level playing–field for all participants with special attention to subsidies and taxes, ensuring competitiveness of markets, and the establishment of a credible tax system. Nonetheless, hard budget constraints can do more harm than good if the problem of inter-enterprise debt is not solved. And further, since banks were also required to operate under internationally accepted rules, the

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[7] For more on socialist banking and money see Kornai (1992) or Nutti (1992)

banking systems of TEs became integrated into institutions like the Bank for International Settlements, the OECD and later the EU. However, without the necessary capital support this resulted in high interest rate spreads between deposits and loans, causing loans to be unavailable for all firms, when they were especially needed for innovation and restructuring. Additionally, the compulsory creation of loan-loss reserves decreased profit levels further, shrinking the state's tax revenues. Corporate governance is the third of the issues pointed out by Hare (1997) as crucial for TEs. This is very important for the establishment of functional market mechanisms resulting from the market behaviour of firms. It deserved special attention through a privatisation process that addressed the concerns of insider and outsider privatisation. But the issue of corporate governance is an important determinant of foreign direct investments, which influences the attractiveness of countries to foreign investors (Rueda-Sabater, 2000).

1.4 Conclusion

Financial sector reform in the CEE began with two-tier banking sector separation. In the first tier the central bank has been separated from the mono-bank, and in the second tier commercial banks were established. This reform was to establish a market-economy-type banking system. Banks were expected to play an important role in enterprise and financial sector restructuring and to perform a number of roles connected to privatisation processes. They were to facilitate restructuring of state-owned enterprises (SOEs), to mobilise funds for privatisation or the takeover of SOEs, to provide mechanisms for monitoring and control of management in order to enhance corporate governance, to support securities and equity markets, to increase liquidity and encourage expertise in risk evaluation (Blommenstein and Spencer, 1994). However, such reform certainly was not implemented without problems. Bad loans, low savings and investment ratios, weak institutional and legal frameworks, and personnel lacking skills or experience in viability and risk assessment were hindering the transition process.

Another problem area was illiquid and dysfunctional capital markets. Nonetheless, the impact of capital markets in the early stages had been small as there was almost no experience with capital markets in centrally-planned economies. Furthermore, such

markets were created too soon in some cases, even without securities to be traded. The role of banks under these terms became important, since they were the institutions which were supposed to introduce hard budget constraints, efficient payment systems, market-based risk assessment and, most of all, mobilisation of savings and their efficient allocation. As mentioned earlier, apart from mobilisation of savings, foreign investments were regarded as a crucial component for the effective restructuring and development of TEs. In the view of many policy advisors, transforming economies needed liberalisation of their financial sectors and the opening up of their banking to foreign entry. The fundamental premise was that foreign banks will transfer knowledge and technology, and contribute to competition. Whether this was the case in the Slovak banking sector is one of the reasons for conducting this research. The further motivation of this study is to fill the gap in knowledge about the particular transitional economy of Slovakia and furthermore, to provide corroborative quantitative and qualitative research on the effects of foreign entry into the banking sector of this country. The results of this study will add to the knowledge of this specific area of transition from centrally-planned towards market-economy-based financial systems.

It is worthwhile exploring the theoretical background to foreign investments in banking, which is the purpose of the next chapter. The remainder of the thesis is organised as follows: Chapter 3 describes transformation strategies and differences among four CEE countries; Chapter 4 is dedicated especially to the restructuring and transformation of the Slovak economy and banking system; Chapter 5 outlines the methodology of the research conducted in Chapter 6 which tells the story based on interviews; in Chapter 7, hard data is analysed with the focus on differences between domestic and foreign banks in terms of profitability and portfolio distributions; finally, Chapter 8 concludes the whole work, drawing out points for further research.

CHAPTER 2.

FOREIGN DIRECT INVESTMENTS IN BANKING

2.1 Introduction

The first chapter introduced the role of banks in the economy and particularly their role during the restructuring of the economies of Central and Eastern Europe. An important characteristic of the developing banking markets is the role that foreign banks are allowed to play. Developing countries were often recommended policies by the IMF or the World Bank based on the works of McKinnon and Shaw. However, the financial liberalisation policies were often only reluctantly adopted. King and Levine's (1993a, 1993b) cross-country research only substantiates this aversion, reporting the "disappointing results of financial liberalisation experiments" (Fry, 1995, p.454). In the case of Transition Economies, however, this opening up seems to suggest embracing the liberalisation advice. This chapter will look at the theoretical background to the area of foreign investments in banking, which will be followed by an overview of the literature on foreign entry in developing economies. This chapter concludes with the discussion of the potential positive and negative effects of foreign entry into the banking systems of developing countries and Transition Economies.

Global foreign direct investments (FDI) since the Second World War have risen enormously, promoted by the expansion of multinational corporations (MNCs) in the world economy. MNCs' turnover accounted, according to UNCTAD (1994, p.8) World Investment Report, for up to one-third of world output and two-thirds of world trade. Developing countries faced immense requirements for investments in order to raise their economies, and following liberalisation FDI comprises an important proportion of their investment levels (Perraton et al., 1997). However, the majority of FDI inflows poured mainly into developed economies. In 1998, 71.5 per cent of FDI inflows went into developed countries, 25.8 per cent into developing countries and 2.7 per cent into Central and Eastern Europe (UNCTAD, 1999). Nonetheless, it is not the proportion of global FDI but the rate of growth in developing countries which attracts the attention of

researchers. FDI inflows in developed countries rose between 1989 and 1997 by more than 50 per cent. In comparison this growth was about 500 per cent in developing countries and in Central and Eastern European countries (CEECs) a staggering 3300 per cent. However, it has to be noted that even a small increase from very low starting condition of foreign participation in the host economy means a greater rate of growth in FDI. Albeit finance is regarded as the most mobile production factor, FDI in this sector (including banking and insurance) have not always reached the highest portion of total inflows. Sectoral distribution of FDI in Visegrad countries[8] shows 11 per cent share of banking FDI in Hungary and the Czech Republic, 18 per cent in Poland, 14 per cent in Slovenia in 1997 and 22 per cent in Slovakia in 1998.

Multinational banking changed substantially from its beginnings dating back to the Medici's Italy. As the banking industry and technology developed, it became easier for banks to expand abroad, although expansion depended also on the policies of countries towards foreign investments in the financial sector. The more multinational banking grew in importance, the more it drew the attention of scholars. Thus first publications started appearing in the early 1970s.

Robinson (1972, p.42) primarily defined multinational banking as: "operating a bank in and conducting banking operations that derive from, many different countries and national systems". Aliber (1977) later specified multinational banking as both Euromarket activity and traditional foreign banking. Lewis and Davis (1987) synthesised this into a definition of multinational banking as embracing "both the Eurocurrency banking activities of foreign banks and their banking in host country currencies". But clearly, FDI in banking are performed by multinational banks characterised by Casson (1990) as: "banks that own and control banking activities in two or more countries."

Although a sizeable body of research has focused on explaining FDI, the general FDI literature does not give much consideration banking. The research on FDI has been closely linked to manufacturing rather than the service sector. The majority of FDI theories deal with FDI in the manufacturing sector, and it might seem natural that FDI

[8] Visegrad countries are Poland, Hungary, the Czech Republic, Slovakia and Slovenia

within the banking sector had been approached by the application of the aforementioned industrial theories as suggested by Aliber (1976), Grubel (1977) and Gray and Gray (1981). In a framework for approaching any problem or performing analysis, Rudyard Kipling suggested five basic questions to be answered: 'what, where, when, how and why'. Applying this to the discussed area on a simplified level, 'what' refers to FDI in banking, 'where' refers to the host country as a recipient of FDI, 'when' may refer to timing, 'how' to a mode of entry and 'why' to the motives of entry. To fully understand the FDI phenomena it is necessary to understand the reasons which lead the banks to 'go abroad'. Following the structure described by Reiljan (2000), there are four different types of investors that can be considered in relation to determinants of FDI entry into banking. Although investors have been divided into four groups – market seeking, efficiency seeking, natural resources seeking and strategic seeking – only market and strategic seeking investors can be relevant for the banking sector. Following Reiljan, it can be argued that whereas markets seeking foreign investors are focused on servicing particular markets, strategic seeking investors are involved in acquiring resources – basically human – and the capabilities that will keep or promote their core competencies in regional or global markets. In this sense, Hong Kong can be used as an example where foreign investors have set up foreign branches to gain human resource advantage to service Asian markets, and to be first to harness the new opportunities of a developing China (see Loong, 2000).

With respect to the following discussion of different theoretical approaches, three main motivations of foreign entrants can be specified: 1) 'follow-the-client' motivation to keep the client and prevent competition from servicing the client in the host, and possibly the home markets; 2) 'follow-the-leader' motivation to enter the markets which the bank's clients intend to enter or might consider after having financial support from the banks; 3) 'entering-new-markets' motivation, where being first means significant strategic advantage against competition by having earlier and more detailed market intelligence, being adapted to local, legal and cultural differences and building relationships with domestic clients. Specific motivation can be a regulatory environment, which is the motivation of more favourable host country regulation framework compared to home country regulation structure. However, this is more specifically relevant to the USA in relation to the Interest Equalisation Tax and the

Voluntary Foreign Credit Restraint Program, which restricted the ability of U.S. banks to service the requirements of overseas subsidiaries of existing clients (Williams, 1997). To avoid the impact of these regulations, the U.S. banks expanded offshore in the 1960s. This step was regarded by Brimmer and Dahl (1975) as internalising the existing bank-client relationship. Another specific motivation could be reputation advantage. Again, this is more the 'single-country' motive of Swiss banks, which have distinguished themselves as private investment banks for the wealthy and rich, supported by the advantage of Switzerland being a neutral country. Even though the above-mentioned motivations may have some explanatory value, they need to be incorporated into a wider theoretical framework of FDI in banking.

2.2 Theoretical framework of FDI in banking

The current theory of FDI in banking has developed around two distinctive approaches to FDI in general: Dunning's Eclectic Theory and Buckley and Casson's Internalisation Theory of FDI applied in banking.

Dunning's *Ownership, Location and Internalisation paradigm* (1980) sets FDI as a function of these factors. Gray and Gray (1981) first applied this theory to multinational banking theory. First, Tschoegl (1987) and Yannopoulos (1983) stress the role of information in bank-client relationships within the **internalisation factor** because the information is difficult to obtain from a distance, due to possible information asymmetries; Buckley and Casson (1991) suggest internalising these asymmetries through owning the information collection process. Cho (1985 and 1986) provided a further five groups of internalisation advantages: availability and cost of funds transfers within the multinational bank, efficient customer contacts, transfer pricing manipulation, improved networks for information gathering and potentially reduced earning variability.

Next, under **location factor,** market size is regarded as a good measure of the potential for exploiting economies of scale and lower marginal costs of production. Terrell (1979) has found this factor to be related to growth of MNB loans. Another location factor was recognised as the 'follow-the-client' hypothesis, theoretically approved by Grubel

(1977) and Gray and Gray (1981) and further developed by Goldberg and Saunders (1981) and Aliber (1984). Equally persuasive is Hoschka's (1993) offensive strategy, where banks enter foreign markets if they see good prospects for themselves or if their clients intend to enter those markets. Banks present in foreign markets will have the competitive advantage of providing their clients with local market intelligence, being close in physical proximity and provision of finance. Locational advantages were also specified by Cho (1985 and 1986) as regulatory framework, effective interest rate differences, different economic situation, nationality of banks and socio-economic differences.

Finally, under **ownership factor**, specific banking products seem to be a distinctive feature of MNBs. This product differentiation comes from two sources according to Yannopoulos (1983): 1) certain currencies are especially important in international trade and finance; 2) non-price competition is significant in the market for banking services. The first factor relates to Aliber's 'currency clientele' argument that customers prefer banks incorporated in countries of currencies they deal with. However, Lewis and Davis (1987) questioned this argument, since this advantage does not require physical presence in the market when correspondent banking can be used. The second factor is related to long-term perceived differentiation (Yannopoulos, 1983). This differentiation is connected with the bank's size, its credit rating, and the perceived probability of loan renewal (Williams, 1997). Ownership advantages were again widened by Cho (1985 and 1986) to access to skilled personnel and managerial resources, favourable financial resources, widespread and efficient banking networks, knowledge and experience in multinational operations, expertise in servicing a particular customer type and established creditworthiness and prestige.

Sabi (1988) states: "the theories of multinational banking are analogous to the eclectic theories of FDI in general. In this sense, banks follow their customers and seek local market opportunities to preserve their ownership-specific and location-specific advantages." Further, eclectic understanding of FDI in banking has been made by Hoschka (1993), who applied Heckscher-Ohlin's trade theory of different access to production factors to the case of financial services. Developing Ricardian comparative advantage model of international trade based on differences in production function,

Aliber (1984) in his survey of international financial services searches for factors that provide relative comparative advantage for provision of financial services in a particular country. In his view, costs of capital play this role. Although national interest rate can be used as an explanatory variable due to its correlation to the costs of capital, exchange rate risk needs to be included in the model as it significantly influences the real costs of capital. Or as Hoschka (1993) puts it, "to determine whether a comparative advantage exists it is necessary to undertake a detailed analysis of the economic differences between two countries." But certainly, explains Hymer (1976), there have to exist certain micro factors, which should outweigh the costs of entering into the market. A crucial factor is possession of comparative advantage.

Relating the theories of FDI in banking to Transition Economies, certain features surface, that suggests the use of particular theoretical framework. Starting with the ***eclectic paradigm***, ownership advantages are non-existent in the banking industry and product differentiation is almost impossible. In the initial stages of transition, the ownership advantages of the foreign banks were tremendous, as centrally planned economies with their underdeveloped financial systems began their transition. Because the banking sector was just being created, foreign banks had advantages of 'know-how', marketing and management skills and extensive product portfolios; but above all, the knowledge to price and assess risks in the relatively free market conditions. Their goodwill and public esteem just for being 'western' were high and this was only supported by brand names which were already established.

On the other hand, TEs had a large potential for MNBs either as 'virgin' markets or great potential for banks' clients. But conversely, the initial barriers of entry may have been great, with the additional costs of possible acquisition of the stake in privatised institutions, and completely changing everything, from the organisational structure to working practices, or establishing a 'greenfield' daughter company and hiring and training the staff. Internalisation may have come into question as the knowledge was transferred at low to zero costs and bank-client relationship had not been seriously threatened by the host country competition. But the threat of losing the client to a domestic competitor who operates in a particular developing market, and the impossibility of seeking knowledge about clients due to information asymmetries,

supports the internalisation factor. In the end, the eclectic paradigm can explain FDI in banking in the early stages of the transition process.

Internalisation theory draws upon the Coasian 'firm and location' theory, where the functioning of the perfect market is impaired by externalities, in particular transaction costs associated with negotiating contracts (Williams, 1997). The firm is able to minimise these costs and internalise the externalities by owning complementary assets. According to Rugman (1981), market failure for knowledge is therefore regarded as a key internalisation approach and the optimal solution is where the marginal costs equal marginal benefits. This brings Williams to conclude: "Thus, the multinational bank is viewed as a vehicle for internalisation of transaction costs, with transaction costs being defined in a Coasian sense." The strongest motivation for internalising the market is then within the market for knowledge (Buckley and Casson, 1991). In this regard, specific knowledge of the banking requirements of a particular client is acquired at high cost but can be applied abroad at relatively low marginal costs. Under surplus entrepreneurship theory, Grubel (1977) considered the multinational banks as developing technology and management expertise domestically and then applying this overseas at low to zero marginal cost. In response to the changing location of a client, a bank is willing to adjust its location because the long-term client relationship is most important. This problem cannot be solved by contracting due to information asymmetries. As Grubel argues, a bank therefore cannot sell its knowledge about the client and receive a fair price. The principal advantage of a multinational bank is therefore internalisation of information (Rugman, 1981).

Two distinctive sets of arguments arise if we look at the banking industry from a retail and wholesale perspective. Multinational retail banking offers scope for portfolio diversification and earnings stabilisation that are in effect reasons for a bank internalising market failure (Williams, 1997). For multinational retail banking, knowledge of local conditions and the regulatory structure are important determinants, which incorporate location factors of internalisation theory. These factors are regarded by Tschoegl (1987) as not saleable or as factors which can be sold only in a well-functioning market. The institutionalised role of certain currencies in world trade and finance offers internalising benefits for multinational banks (Grubel, 1977). Wholesale

multinational banks further gain comparative advantage due to dealing with large clients only, which offers the advantage of operation on a lower fixed costs basis. In this sense, another motivation to establish a physical presence abroad has been the increased the need for monitoring of large projects. The banking industry is expected by Buckley (1988) to be multinational on the basis of internalisation theory because it is skill, knowledge and communication intensive. Internalisation theory stresses the importance of information asymmetries, in the form of transaction costs, applicability of existing knowledge across borders at next to no cost, and certainly internalisation of existing customer relationships. This approach gains importance in relation to TEs with the development of financial structures and increasing competition among domestic and foreign banks.

Development of both paradigms has brought some debates. The crucial element in the discussions is the ownership factor, which is regarded by proponents of eclectic theory to be necessary for a firm to go abroad. This unique advantage is developed domestically and should provide a monopolistic advantage over the host country's competitors drawing on Hymer-Kindelberger's theory of additional costs for foreign investments. The internalisation approach, on the other hand, claims that incumbency costs are only a part of the whole cost requirements, and comparisons should be drawn not on incumbency costs versus ownership benefits, but on total costs versus total benefits. This approach seems to entail wider aspects of the FDI process, but attention has to be devoted to identification of corresponding costs and advantages so that they are related to foreign investment. Product differentiation is a crucial factor among ownership advantages.

In the banking industry, it is almost impossible to differentiate the products (i.e. services), as all are information intensive, and licensing and/or imposing copyrights is difficult. In questioning whether to use licensing agreements rather than FDI, eclectic theory focuses on market failures (Hymer, 1976) but fails to distinguish whether market failure is a result of market structure or of transaction costs (Casson, 1987). The benefits of internalisation alone can overcome the Hymer-Kindelberger type costs without the need for a firm to own any other advantage (Williams, 1997). Another reason for internalisation theory dominance is the circumstances under which Hymer developed his

study of foreign investments, and Vernon his product-cycle model. Both were elaborated on the US FDI data with a focus on manufacturing and extractive enterprise and both in the period of the intense expansion of FDI after the Second World War. This creates obstacles in applying these theories under different conditions. Nonetheless, as Williams (1997) says, the issue is not choosing which theory is superior, but which offers better conditions for studying multinational enterprises "with the greater degree of internal consistency". Buckley (1988) argues that it is hardly possible to develop testable hypotheses of both theories because of their abstract nature. But internalisation theory can provide a good framework for applying a particular theory specific to the issue of FDI in banking.

The following theories have been developed by researchers: comparative advantage theory, surplus entrepreneurship theory, defensive expansion theory, multinational wholesale banking theory, international investment theory, theory of horizontal and vertical integration, and theory of oligopolistic competition. It is not the aim of this thesis to argue which theory of FDI in banking is superior to others. Thus, for further reference see Williams (1997).

Nevertheless, a general theory has not yet been developed which would encapsulate the whole of FDI. As Agarwal et al. (1991) note, even the most popular and comprehensive eclectic theory of international production, developed by Dunning (1977, 1988, 1993) falls short of being a general theory of FDI. But overall, any empirical evidence in support of the particular theory has been found either weak or related only to the particular components of the particular theory. In general, the empirical tests lack the effect to proving the credibility of any theory of FDI. It might be reasoned that it is because of the number of influences virtually impossible to capture the complexity of the whole problem. Applying the theories of FDI in banking to conditions of transition economies has certain difficulties. To begin with, all of the theories have been developed under conditions different to those which developing and transitional economies face. In the second place, developments in telecommunications and information technologies have meant a shift in the costs of banks' possible foreign expansions. Moreover, the theories have been more static than dynamic which contrasts with very dynamic developments in TEs. To conclude, it seems that the application of

any FDI theory in banking strongly relates to the conditions and developments in the transition economies' financial, political and even social structure. It may, therefore, be deduced that the theory of FDI in banking in TEs needs to be viewed as a dynamic link between various theories of FDI and the current state where internalisation theory offers the most complex framework for further studies.

Despite the increasing research interests in FDI in banking, due to the lack of data, only a few major country studies have been provided so far. Most of them have focused on U.S., U.K. and German FDI in banking and only recently, on Latin American countries such as Mexico, Colombia and Argentina. The breakthrough in this sense was the cross-country analysis of the effect of foreign entry on domestic banking market by Claessens et al. (1998), analysing 80 developed and developing countries in the period from 1988 to 1995. The results of their study bring some interesting points, especially, that foreign entrants tends to have lower overhead expenses, lower margins and lower profitability than domestic banks in developed countries, while the contrary is valid for developing countries. This indicates that the foreign investors' motivation for entry may differ between developed and developing countries. Empirical investigation further reveals that foreign banks have some negative effects on the operation of domestic banks, reducing their profitability and negatively affecting the overall expenses. Low banking costs and non-interest income are found as other factors for motivation of foreign bank entry.

It is suggested that the 'follow-the-client' strategy is probably more important in cases of developed countries as foreign banks experience lower profits than domestic banks. This may mean that foreign banks in developed countries operate under conditions that are more competitive as well as in the area of wholesale banking rather than retail banking. It may also imply that any technical advantages of foreign banks are not significant enough to overcome the informational disadvantages they face relative to domestic banks. On the other hand, in developing countries, foreign banks excluded from credit allocation regulations and other restrictions experience higher profits. The highest interest margins are recorded for both domestic and foreign banks in Latin American countries and TEs, possibly because of high overhead expenses. Taxation of banking seems to be highest in TEs, but foreign banks pay lower taxes than domestic

banks in these countries. However, Barajas et al. (2000) note that regressions on bank performance indicators performed by Claessens at al. (1998) and several others tended to overstate the impact of foreign entry by not controlling other elements of the liberalization process, such as increased domestic entry, capital inflows and strengthening of banking regulations and supervision.

2.3 Foreign entry in developing countries

Only recently have particular country studies been provided such as Turkey (Denizer, 2000), Argentina (Clarke at al., 1999), Argentina and Mexico (Dages et al., 2000), Colombia (Barajas et al., 2000), Nordic countries (Engwall et al., 2001), Norway (Tschoegl, 1997), Greece (Hondroyannis and Papapetrou, 1996), Japan and Korea (Ursacki and Vertinsky, 1992), Pakistan, Turkey and Korea (Bhattacharaya, 1993) and Australia (McFadden, 1994; Moshirian, 1998). Concerning the Transitional Economies of Central and Eastern Europe, the studies have been mainly focused on banking system failures (Goldstein and Turner, 1996; Honohan, 1997, Hainz, 2005) and financial system development (Honohan and Vittas, 1995; Calvo and Frenkel, 1991; Hermes and Lensink, 2000; Jaffee and Levonian, 2001). The role of foreign investments became important for researchers only later. Papers by Buch (1997, 2000) and Bonin and Abel (2000), both dealing with foreign participation in the Hungarian banking sector, as well as Bonin and Abel (2000) on Hungarian retail banking and its penetration by foreign entrants was later extended by Hasan and Marton (2003) with focus on development and efficiency of the Hungarian banking sector. Furthermore, Weill (2003) looks at the effects of foreign banks on the performance of the banking sectors in transition economies, while Weller (2000) analyses the impact of multinational banks on credit supply in Poland. Moving to more focused studies, Gelos and Roldós (2004), Yildirim and Philippatos (2006b) and Drakos and Konstantinou (2005) extend competition banking literature to developing countries and transition economies and Fries et Al. (2006) provide a cross-country analysis of how market entry and privatisation have affected margins and marginal costs in TEs.

For the analysis of foreign entry effects, and consistency with cost-benefit assumption, definition of positive and negative effects is important. Dages et al. (2000) state the following ***arguments in favour of foreign bank entry***:

1) In compliance with the traditional view of positive effects connected with capital account liberalisation, foreign bank entry means more funds for the economy by facilitating capital inflows. This can further stabilise volatility of lending, especially in a small and/or open economy where foreign banks, adverse to local macroeconomic conditions to a certain extent, provide a stable source of available funds even in the times of adverse economic development. Similar findings were presented by Peek and Rosengren (2000), Goldberg (2001), and Soledad Martinez Peria et al. (2002).
2) Some authors believe (e.g. Levine, 1996) that foreign banks bring a higher standard of financial services in terms of quality, availability and pricing in a direct or indirect way. Directly, foreign banks influence the process through providing such services and indirectly through spillover effects as a competition to domestic institutions.
3) It is also suggested that the financial infrastructure is positively influenced by the presence of the foreign banks in a particular area. This involves improvements in accounting, transparency and financial regulation. Furthermore, "foreign banks can stimulate the appearance of supporting agents like rating agencies, auditors and credit bureaus" (Glaessner and Oks, 1994:15).

Arguments against foreign participation are in general contrary to the arguments in favour (Dages et al., 2000):

1) Foreign financial institutions in fact decrease stability of aggregate domestic bank credit provision. Foreign banks can either enable capital flight or withdraw from the investments made, in case the domestic or the host country crisis worsens rapidly (see Peek and Rosengren, 2000). And further, Morgan and Strahan (2004) find tentative evidence of a positive link between foreign bank presence and economic volatility.
2) An often stressed argument against foreign bank participation is so called 'cherry picking' (or 'cream skimming'), when foreign banks attract only the most lucrative domestic markets or customers which can lead to decrease in lending, cost

efficiency, and welfare (Detragiasche et al., 2006). Domestic banks are then only left with riskier customers, which increases their own risk and in the end 'crowds them out' of the market or even 'crowds out' particular segments of borrowers.

3) Another argument builds up on those previously mentioned. This stresses the importance of the banking sector as a strategic industry, which is best controlled by domestic interests. Those countries that are likely to be negatively affected by financial sector opening usually support this argument.

4) Nonetheless, some studies focused on the pattern of the financial crisis evolving after financial liberalisation. Kaminsky and Reinhart (1999) looked at the causes behind banking and balance of payment problems and Rojas-Suarez (1998) studied the early warning indicators of banking crisis with applications to Latin America. The majority of the studies usually omitted the role of foreign institutions except Demirguc-Kunt, Levine and Min (1998) who found that the presence of the foreign banks was mainly connected with fewer financial crises.

5) Foreign entry can also cause increased cost to domestic banks (because of increased competition) to local entrepreneurs (less access to financial services since foreign banks focus on foreign firms) and government (diminished control of the economy because of less responsive foreign banks) states Stiglitz (1993).

6) The final point of Dages et al. (2000) was the issue of increased financial supervision brought into the market by foreign entrants. However, information asymmetries between the host and home country supervisors and multiple jurisdictions in which MNBs operate raised questions of the feasibility of such supervision.

There are two main reasons why economic researchers failed to provide reliable empirical evaluation of the effects of foreign entry on the domestic banking sector. Firstly, according to Clarke et al. (1999), the lack of comparable cross-country data and secondly, the generally low level of foreign entry. Although the level of foreign entry was modest in the past 20 years (Gelb and Sagari (1990) compute six per cent foreign share in a sample of twenty countries; Levine (1996) estimates a typical ten per cent share), the share in developing countries (especially in those which recently liberalised their financial sectors and opened them to foreign entry) often exceeds 30 per cent (Argentina, Colombia, Greece, New Zealand and some CEECs).

Regarding the final effects of foreign entry, the most reasonable argument, as put forward by Levine (1996), could be that the total benefits (in terms of improved financial services and regulation) should outweigh the potential costs (such as 'cream skimming', foreign market dominance, destabilising rapid outflows of capital), which is also supported by previously mentioned cross-country research on competitive pressures of foreign banks on the domestic sector by Claessens et al. (1998). Another important positive effect was found by a number of authors focusing on banking crises in relation to the increased entry of foreign banks. Demirgüç-Kunt, Levine and Min (1998) suggest that increased foreign presence reduces the probability of systemic banking crises.

Building on Claessens et al. (1998) study, Clarke et al. (1999) take the general cross-country analyses to the settings of a single country and allow the analysis to go into more detail (such as the study of foreign bank entry on different types of domestic banks). Argentina has been chosen for several reasons: a focused period of entry and general structural change in a four-year period in one legal and regulatory setting, commitment of regulatory bodies to ensure a level playing field for foreign and domestic banks, and the exceptional quality of the central bank's data.

From the theoretical point of view, Clarke et al. recognise two views of the role of foreign banks in developing countries. The traditional view is Aliber's (1984) 'follow-the-client' approach, which is broadly supported by a number of empirical results (Feileke, 1977; Goldberg and Johnson, 1990; Goldberg and Saunders, 1981; Goldberg and Grosse, 1991; Ursacki and Vertinsky, 1992; Hondryoyiannis and Papapetrou, 1996). The modern view emphasises the active role of banks in the development of the host country's banking sector, claiming that banks apply their comparative advantage in management technology and marketing know-how in foreign countries at next to no marginal cost (Grubel, 1977; Kindleberger, 1983). This suggests that the effects can be recorded and will further depend on the area which foreign banks entered having comparative advantage. But on the other hand, Levine (1996) finds that these effects are hardly traceable in developing countries. As with any theoretical approach, individual papers are putting forward one view over another, but most scholars accept both these views as important, depending on particular banking sector settings. The crucial

question, however, is: how do foreign entrants affect domestic banks and what effects can be recorded?

There is a considerable similarity found between Argentina's financial sector development in the last 20 years and TEs' financial sector development, though it needs to be noted that Argentina has very different 'legacies of the past' compared to TEs. Colonial history can hardly be compared to different structural organisations of centrally planned economies. Although the motives behind the financial sector development and changes could be different (hyperinflation in the 1980s in Argentina and a completely different structure of financial sectors in centrally-organised countries), the real changes had begun in both cases in the early 1990s with the break-up of the Eastern Bloc in the case of TEs, and the establishment of the Convertibility Law in Argentina. Similarly to TEs Argentina introduced the foreign-pegged currency (to the US dollar), which stabilised the currency and enabled financial system reconstruction. However, the real per capita income remained relatively low. Further still, bank deposits grew steadily over the years accelerating after 1995 when foreign banks entered the market and attracted substantial amounts of deposits. And any decline in the public banks' deposits appeared to be caused by privatisation rather than foreign competition. According to indicators of banking performance, foreign banks in Argentina tended to be clearly different (and better off) than domestic banks. "They tend to be larger and to have better quality portfolios, higher net worth and higher ratios of operating income to costs" (Clarke et al. 1999, p.22).

The results of the study by Clarke et al. (1999) firstly, refuted the hypothesis that banks merely followed their clients abroad. Secondly they found that, domestic banks faced lower profits and interest margins in the areas, which foreign banks penetrated pointing to the 'crowding out effect' of foreign banks on domestic ones. And finally, the areas which have not been entered by foreign participants remained unchanged in terms of profitability, interest margins or overheads for domestic banks. Further, although domestic bank failures occurred, foreign banks did not cause these, as the failed banks were not heavily concentrated in sectors favoured by foreign banks. Analysis by Clarke et al. (1999) of Argentinean foreign entry in the banking sector provides a good starting point for case studies of other countries. However, a slightly different approach may

seem to be more suitable. The study by Clarke et al. (1999) focused on the two main roles of banks in the economy: collection of deposits and provision of loans. Nevertheless, to address the benefits and costs of foreign bank entry, either more variables capturing other measures of bank performance (e.g. profitability, bank efficiency in terms of return on assets, risk or involvement in the host economy) can be included in the model, or a different (qualitative) approach used for the analysis of effects which are not directly measurable, such as improvements in human resource capital, financial supervision, company strategy and/or corporate governance.

Dages et al. (2000) has found evidence that foreign entry led to greater stability of the domestic banking sectors of Argentina and Mexico, increasing the volume and growth of loans yet at the same time reducing their volatility. The motivation behind their study was that: "although a sizeable body of research has explored the potential benefits of financial liberalization broadly defined, few studies have focused on the potential benefits of increasing foreign participation in banking and finance" Dages et al. (2000, p.1). These authors find evidence that foreign entry positively affected the stability of the banking system through increase in loan growth and simultaneously a decrease in its volatility, as foreign banks were less responsive to the macroeconomic changes of the host country. Nonetheless, by comparison with developing countries, TEs are different especially in banking sectors, given the legacies of the mono-bank system and culture of the centrally-planned economy.

Barajas et al. (2000), in their study of Colombia's financial sector, provide evidence of an increased positive impact of liberalization and foreign entry on the domestic banking sector in the sense of increased competition, lowered intermediation costs and improved loan quality. Though recent studies of foreign investments and entry into banking sectors might have been overstated by neglecting the significance of other liberalization factors, they found evidence of improved bank behaviour by enhanced operative efficiency and competition. However, it should be borne in mind that increased competition, especially foreign, may have negative effects in the form of greater risk and subsequent deterioration in loan quality, particularly among domestic banks as pointed out by Barajas et al. (2000). Their paper aims to improve the previous study by providing a direct structural change test and by controlling the other key elements of

reforms. Further evidence proved that simultaneous complementary reforms affect the foreign entry impacts. Changes in bank supervision and reporting lead banks to transfer the majority of increased credit risk costs onto their customers as indicated by changed sensitivity of spreads.

On the other hand, it has not been proved that foreign banks would have any price-setting advantages over domestic banks. Additionally, results of the study provide direct evidence that market power has fallen significantly in the banking sector after liberalization. With regard to the non-financial costs, liberalization appeared to reduce non-financial costs[9] through increased entry and capital inflows, but other factors interpreted as strengthened supervision increased the costs. Nevertheless, domestic banks appeared to be more sensitive to foreign entry than foreign ones, because of the worsening of the loan quality of domestic banks as a result of the entry of both new foreign and domestic banks. In addition, results suggest clients fled to foreign banks. Results also indicated that liberalization, tightening of prudential regulations and the strengthening of supervision tended to improve the loan quality.

In summary, foreign banks operated with higher capitalisation levels and better overall loan quality across all sectors, and tended to be more profitable over time, enhancing them to withstand the widespread banking crisis of the early 1980s. The results of Barajas et al. (2000) suggest that foreign entry had an important role in reducing the excess of intermediation spreads over marginal costs, even after incorporating the previously mentioned elements of the liberalisation process. Lower administrative costs and higher loan quality enabled foreign banks to operate with slightly lower intermediation spreads. Domestic entry seemed to have an even greater impact on non-financial costs in addition to intermediation spreads charged by both groups.

According to the traditional view that foreign banks follow their customers abroad, foreign banks were not a direct competition to domestic banks because multinationals were not likely to use the services of the latter. However, recent studies suggest that this strategy of foreign banks has shifted into more aggressive acquisitions of the host country market shares (Seth, Nolle and Mohanty, 1998).

In relation to the quality of banks following the study of Soteriou and Zenios (1997), the results of their study can be used to relate operating efficiency to profitability of banks. Similarly, the results of the quality and profitability efficiency models can be used to establish the positive relationship between quality and profitability. In other words, the better the quality of banks and their operating efficiency the higher their profitability. The quality of the bank itself is a rather difficult criterion as it nowadays refers more to a customer-perceived quality, especially when dealing with service operations. The outcomes of Soteriou and Zeniose study, however, suggest that to capture the quality of banks, we should control profitability.

This is further supported by Demirgüç-Kunt and Huizinga (2000), who found that moving from an underdeveloped to a developed financial system, bank profits and margins decline significantly in response to declining risks. Financial liberalisation, along with privatisation were the crucial issues of CEECs' transformation. There is a substantial stream of literature dealing with the question of whether foreign bank entry increases fragility of the domestic banking system (Fisher and Chénard, 1997; Chavez et al., 1996; Goldstein and Turner, 1996; Honohan, 1997; Weller, 2000; Weller and Morzuch, 2000).

While many of these authors believe that foreign entry actually increases financial fragility of the domestic banks, Volz (2004) claims that financial liberalisation and financial integration was supposed to improve efficiency of the financial intermediaries and reduce the vulnerability of these markets. Furthermore, some authors believe that foreign banks brought higher stability to the loan and deposit markets of host economies (Clarke et al. 1998; Dages et al., 2000) while concurrently others suggest that one way to avoid the trade-off between short-term risks absorption and long-term health of the banking sector and economy is a higher foreign participation in the banking system (Caprio and Honohan, 2003).

[9] such as employment, i.e. costs that externalise financial costs to other sectors of the economy

2.4. Effects of foreign entry in Transition Economies

The reasons behind the growth in FDI in banking should be looked for in developments within IT technologies, telecommunications and above all in global financial deregulation (Moshirian, 2001). Given the preposition that foreign banks tend to invest in countries whose banking market is large, one could generalise that the way to attract foreign investments is to liberalise financial markets and increase domestic savings. On the other hand, appreciating currencies distract foreign investments from the host country, "since depreciating currency gives foreigners an edge in acquiring the control of domestic assets" (Moshirian, 2001:326). But it is the cost of capital which gives an important advantage to the foreign banks utilising their advantage in sourcing cheap capital on international markets.

The case of Latin American Developing countries (LDCs) can be instructive for the transforming countries of Central and Eastern Europe. Yet it must be noted that the banking sectors of LDCs are different from those in TEs, because of different legacies of the past, different macroeconomic conditions and different cultural backgrounds. In brief, Latin American countries were largely relying on primary commodity exports and weak public finances[10] while TEs managed to grow substantially in terms of GDP per annum after the break-up of the Eastern Bloc utilising their industrial base to provide exports with higher added value. This was coupled with important role of state and institutions and strong public finance. Fries et al. (1999) examined the impact of East-Asian and Russian financial crises on CEE countries stressing the benefits of deep structural and institutional reforms alongside liberalisation and privatisation. This might have been another distinguishing actor between Latin American and Transitional Economies. Hence, although results of opening their banking sectors to foreign entry were in many cases similar, number of differences was also detected.

The implication of Demirgüç-Kunt, Levine and Min (1998) regarding the foreign banks' presence and reduced probability of systemic financial crises might be of particular relevance to TEs as transformation of the banking system brought high risk of

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[10] See Kopits (2002) for more detailed comparison of TEs and Latin American developing countries

banking crises and failures as a result of introducing brand new structures, practices, supervision and rules of undertaking. Hermes and Lensing (2000) analysed the role of independent central banks, deposit insurance systems, and capital market in stabilising the banking system in transition economies. Further, Jeffrey Sachs (1997) provides an overview of stabilisation issues facing TEs. Caprio and Honohan (2002) look at the role of financial system regulation and crises. Schoors (2003) investigates the fate of former state banks in Russia and the Russian banking crisis. Gangopadhyay and Singh (2000) discuss the role of risk-neutral capital in avoiding bank runs in TEs advocating full liberalisation rather than deposit protection schemes and capital adequacy norms.

Bonin and Abel (2000) state that: "domestically-controlled banks with local expertise may have a significant role to play in retail banking in small, open transition economies". When the Central European countries are compared to Latin America in relation to the foreign bank market share, the difference is rather striking. In 1999, only Chile out of all other Latin American countries had comparable 53.6 per cent foreign share to 80.4 per cent in Hungary, 50.7 per cent in the Czech Republic and 52.8 per cent in Poland (IMF, 2000). Hungary allowed both green-field investments and privatisation of large commercial banks to the strategic investors. This meant that foreign banks penetrated quick and deeply into the Hungarian banking sector[11]. However, Hungary has a much longer experience with foreign banks operating in its market since as early as 1980s[12]. For example, Citibank set up an operation in the Hungarian market in 1985 having 80 per cent ownership from the very beginning. Thus, it has to be noted that the overall conditions were still very much restricted, as Hungary still belonged to the block of communist countries and the economy has not been operating under free market conditions.

Hungarian evidence points out the active role of foreign banks in acquiring the prime deposits as a cheap source of funds. Foreign banks therefore tend to buy domestic banks with a well-developed branch system for their 'bricks and mortar', to minimise the costs

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[11] Hasan and Marton's (2003) paper primarily explores the role of foreign banking institutions as competitors and partners of domestic banking institutions in shaping the new environment of the Hungarian banking market.

[12] Although the independent, joint stock, companies were sometimes still de-facto controlled by the state-owned clients.

of creating a brand new branch system. Further, it suggests that once the privatisation of the domestic banking sector is completed and foreign banks have a couple of years experience with operating in the territory, they begin to move into the retail market more aggressively. Indirect evidence in this may be Creditanstalt's recent retail strategy towards high-income clients and Citibank's set-up of small and medium client corporate business and another branch in Slovakia in 2001.

Argentina's case may be instructive for Slovakia for several reasons. Firstly, a similar period of entry in Slovakia can be found following its split from the Czech Republic in 1993 through to 1997. However, as opposed to Argentina, the legal and regulatory settings have been changing significantly due to building some crucial institutions from scratch, such as the central bank, the inter-bank market and the inter-bank payment system. Therefore, the Slovakian case will require disentangling the effects of foreign entry from changes in regulatory treatment. And secondly, the quality of the data on the banking sector at the National Bank of Slovakia is also exceptional (including loan and deposit portfolio distribution of single banks).

Fries and Taci (2002) confirmed that greater foreign bank presence in a banking system has positive spillover effects in promoting the real expansion of credit. Furthermore, Bosco (2001) provides an example of Hungary, where government in search of major efficiency gains (leading to improvement in its performance) and attempts to drive out the enterprises that were not able to restructure or cope with the intense foreign competition, opened up their economy from the first years of transition, thus recording massive inflows of FDI. A strong competition effect has been recorded where foreign firms outperformed their domestic counterparts. This 'market stealing effect' was found to be more significant than any indications of improved research and development or the effect of decreasing average costs due to gains in productive or organisational efficiency (Bosco, 2001). Technological spillovers may not find room to be embedded in local production functions, because the technological gap may be too wide. On the other hand, the analysis is only a five-year period, which might not be long enough to observe significant positive spillover effects from foreign presence.

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Konings, (2001) provided empirical investigation of firm-level panel data on the effects of FDI on productivity performance of domestic firms in three emerging economies: Bulgaria, Romania and Poland. No evidence of positive spillovers to domestic firms was recorded on average. There were negative spillovers to domestic firms in Bulgaria and Romania but none in Poland, which can be explained by too large a technology gap in Bulgaria and Romania. It may be concluded, however, that empirical analysis fails to record any spillovers or externalities related to FDI in TEs. These, however, may be rather important as spillovers from foreign bank netry may be effecting not only the banking sector but also other sectors of the economy if not the whole restructuring process.

The arguments in favour and against foreign participation in host countries were discussed in previous section. Focusing now on TEs, the arguments in favour of foreign entry can be extended with the introduction of the effective risk measurement and management techniques that TEs were lacking in non-market conditions was very important for the TEs. Though it is suggested by Dages et al. (2000) that foreign banks might have imported regulatory and supervisory skills from the home country, this might not be the case for TEs, as governments usually imported the regulatory and supervisory structures. Foreign institutions were not regarded as the only way to facilitate these developments, but it was thought that they could significantly speed up the process.

Papi and Revoltella (1999) add the following benefits: improvements in human capital, reduction in market power of oligopolistic domestic banks, access to international markets and, last but not least, increased financial strength of foreign banks through the capitalisation of domestic institutions. The positive impacts on competition were considered important, where positive externalities as a result of foreign banks' know-how and expertise were considered as the crucial element for competition in the TEs (Anderson and Kegels, 1998; Thorne, 1993). As Kasman and Kirbas-Kasman (2006:130) emphasize: "they [foreign banks] have achieved a leading role and have positively contributed to enhancing stability and efficiency by bringing capital, competencies and know-how, hence increasing the operating standards of the systems". Furthermore,

greenfield[13] foreign banks have had a positive stability effect on total credit supply in Transition Economies (Haas and Lelyveld, 2005). Moreover, a number of papers suggest that foreign entry increases competition and forces domestic banks to operate more efficiently (Terrel, 1986; Bhattacharaya, 1993; McFadden, 1994; Levine, 1996; Kroszner, 1998; Claessens and Jansen, 2000; Claessens et al., 2001). Kroszner (1998) argues that foreign bank presence in TEs improves banking practices, mostly because foreign banks are not as well-connected politically and are less likely to exert self-promotional influence upon regulatory authorities. On the other hand any substantial foreign entry in the Transition Economies usually gave the entering bank a robust position for negotiation with the host country government. Moreover, the international financial institutions such as IMF (International Monetary Fund), BIS (Bank for International Settlements), EBRD (European Bank for Reconstruction and Development) played significant role of advisors and often also financiers of restructuring process and development of financial markets infrastructure.

Also pronounced by Lensink and Hermes (2004) were the positive spillover effects such as new financial services introduction, and modern and more efficient banking techniques. Additionally, foreign banks may improve management of domestic banks if working in joint ventures or takeovers. And finally, foreign banks may require improved systems of supervision of regulation on the one hand, while on the other also reduced government involvement in the banking sector of host country.

For arguments against foreign bank entry, again, Papi and Revoltella (1999) add the following risks: the 'infant industry' issue, or in other words threat of domination of the market by foreign banks, preferring only multinational customers with little interest in domestic clients, and finally, the issue of reciprocity to secure the same treatment for domestic banks abroad (though it may have little relevance for TEs as domestic banks are usually not strong enough to penetrate foreign markets). Another point was raised by Unite and Sullivan (2003) who found that foreign bank entry directly increased credit risk. More specifically, that the increase in loan loss provisions after the foreign banks'

[13] Set-up as virgin banks rather than take-over of existing domestic bank.

entry indicated domestic banks taking on less creditworthy customers as a result of foreign banks' competition[14].

Hence, the effects of the foreign banks entry are still controversial as enhancing the welfare of the host country is threatened by cream-skimming and is threatening the positions of weaker domestic banks. The positive impacts of foreign bank entry on the host country sector can be encountered as improvements in financial services, promotion of competition, speeding up privatisation, and transfer of know-how and new banking technologies (Buch, 1997). However, to experience the effects of foreign entry it is suggested that a certain level of foreign ownership of banking assets has to be reached as measured by market spread developments (Buch, 2000). Furthermore, the active foreign banks seem to have a positive impact on combating the soft lending practices in transition economies.

Under the internalisation approach to the analysis of FDI in banking, the basic intuition is to analyse the total cost-benefit relationship to see whether FDI will take place. That is a microeconomic - multinational firm - point of view. On the other hand, it should be important for the country, which is opening its financial sector to foreign entry, to know what benefits and what negative effects such an action can bring about. The previous sections dealt with the compelling issues of TEs' banking sector transformation and the roles foreign investments can play within this process. Let us hereby summarise the main issues, which form the base for developing the research objectives and hypotheses.

TEs faced the enormous task of restructuring their economies from centrally-planned into market-oriented economies. The crucial point for transition economies was creating an efficient financial structure with quality banks to ensure the availability of finance to facilitate the new organisation of the economy and its further growth. It was believed that entry of foreign institutions would provide not only the necessary competition

[14] It needs to be considered, that the low level of loan loss provisions might have been previously result of complacency or moral hazard of domestic bank's continuous belief that the state would bail them out.

effects[15] by reducing the oligopolistic character of financial and bank markets, but also a transfer of knowledge about operating under market conditions among the newly constituted markets and market players[16]. The question, however, is 'to what extent did this happen?' and 'was the foreign entry only beneficial or had it also some negative effects?'. Foreign entry was also to facilitate and enhance the creation of legal and institutional frameworks (EBRD)[17] in the banking sectors of TEs. Moreover, the results of some studies (see Claessens, 1997) suggest that the quality of banks depends more on the organisation of banking infrastructure and on the internal factors rather than on supervision and regulation. The issue of supervision and regulation has been very important for TEs, since these were in most cases completely re-designing their financial systems. The way financial systems are designed, the organisation of supervision and regulation and the role of the institution are discussed in more detail in the following chapter.

2.5 Conclusions

This chapter attempted to introduce various theories of foreign direct investments in banking. However, the application of any such theory to the banking industry strongly relates to local financial, political and social development. The author believes that internalisation theory offers the most effective framework for further studies in FDI in banking.

A comparative link was drawn between TEs and Latin American countries, although there were significant differences in the past, as well as in macroeconomic and political development, in the periods of foreign banks entering, and the results of various studies may be instructive in the case of TEs. This applies also to the effects of foreign banks' entry that have been explained in more detail.

[15] Drakos and Konstantinou (2005) found the majority of banking systems of TEs operating under monopolistic competition conditions. For more on competition policy, see Vagliasindi (2001)
[16] Foreign banks were considered to be the crucial element of competition providing positive externality due to know-how and expertise. Kasman and Kasman (2006)
[17] see EBRD Transition reports (1993-2000)

In general, most of the empirical research is trying to analyse foreign entry into bank markets in relation to basic bank activities such as deposit taking, loan provision and other investments of funds. Other directions for analysis are attempts to find the impacts of foreign entry on the whole economy by measuring the effects on economic indicators such as GDP, inflation, currency exchange, balance of payments, and others.

However, empirical analyses mostly neglect any spillover effects or externalities in relation to improvement of human capital or know-how[18]. The issue of spillovers is rather significant since foreign bank entry affects not only the particular banking sector but other sectors of the economy as well (through credit provision, improving the levels of trust, posing pressures on legislation and influencing improvements in quality of human resources, etc.). The phenomenological framework[19] to research issues regarding spillovers appears to be a better starting point for analysing these issues.

The whole issue of foreign investments in banking resonates around Levine's (1996) argument, that the benefits of entry in terms of improved financial services and regulation should outweigh the potential costs (cream skimming, foreign market dominance, destabilising rapid outflows of capital). The most crucial and most encompassing is the question of how foreign banks could influence the development of financial systems of a host country and how foreign entry would affect the domestic banks. This is also the main task and motivation for this study.

In general, Levine's approach will be employed in this research project; this states that in order to assess FDI impacts on the domestic economy as positive total benefits should outweigh potential total costs. The intuition behind this approach is that in order to assess positive and negative effects of foreign entry, one needs to employ means of quantitative 'number-crunching' methods where appropriate and combine them with more qualitative methods related to extracting the information which cannot be simply

[18] Maybe with exceptions of Hermes and Lensink (2004) and Gelos and Sahay (2001) although in the case of the latter it is financial contagion spillovers rather than technology, know-how or another form of positive spillovers.

[19] In order to grasp the complexity of spillovers and the potentially unique circumstances of their occurrence, phenomenological research philosophy is suggested appropriate framework (see Saunders, et al. 2000)

captured by numerical data. This especially refers to different settings of TEs and to the different settings of each country as well.

Before explaining the methodology of the research in more detail, the next chapter will be devoted to comparing different paths to transition of four selected Central and East European countries describing the process of transitional banking restructuring. Following chapter will deal with the Slovak banking sector transformation and the role of foreign investments in this process.

CHAPTER 3.

PATH TO TRANSITION IN BANKING OF TRANSITION ECONOMIES (CZECH/SLOVAK, POLISH AND HUNGARIAN)

3.1. Introduction

The specific role of banks in Transition Economies was explained in the first chapter. These institutions were supposed to introduce hard-budget constraints, efficient payment systems, market-based risk assessment and most of all mobilisation of savings and their efficient allocation. Foreign banks were expected to help in this process via introducing competition, new products, management techniques and practices. However, in order to facilitate all the tasks, an efficient banking sector had to be established with the entire institutional and legal framework required. This meant complete restructuring of the existing mono-bank systems into two-tier commercial banking structures. A number of strategies were developed, though their implementation depended on their acceptance by the current ruling government in a particular country. Thus, restructuring paths varied among the countries. EBRD has had an active role in advising transition economies on strategies for financial sector restructuring and the hazards they were likely to encounter. De Juan in Fries (1996) pointed out regulation, supervision, restructuring, privatisation and institutional strengthening as potential pitfalls of building a sound banking system in transition economies.

In the case of Central European countries two distinctive approaches to transformation of the economy were employed. So-called *shock therapy*[20] where all changes to the economy were supposed to be applied suddenly letting market forces create equilibrium, mostly applied by the Czech and Slovak Federative Republic (that later split into two separate countries). This involved fast deregulation of prices and interest rates, quick withdrawal of state from directing the output of enterprises, and rapid liberalisation of

[20] Shock-therapy was enthusiastically promoted by many western economists and politicians (Blanchard and Layard, 1990; Lipton and Sachs, 1990; Bjukenen, 1990; Blanchard et al., 1990; Kornai, 1990).

trade as well as privatisation and financial sector reform. ***Gradual transformation*** involved changes that were applied more steadily (Allsopp and Kierzkowski, 1997) and often with a different sequencing than under shock therapy (e.g. giving greater priority to financial reform before other things are attempted; Rybczynski, 1991), employed first by Hungary. Poland while adopting shock therapy in the beginning switched into the gradual transformation approach between 1993 and 1996[21]. Further paragraphs look at the process of establishing two-tier banking system in the Czech and Slovak Republics, Hungary and Poland[22].

The following sections will survey the restructuring and privatisation strategies as well as issues of stability and crises and their impact on building banking sectors among the Central European countries of Poland, Hungary, the Czech and Slovak Republics.

3.2. Restructuring strategies

Debate about ways of restructuring the banking system of the Transitional Economies became one of the most important issues in the early 90's. Banking reforms were related to the starting conditions of the countries in the sense of macroeconomic development, institutional legacy and legal and enterprise reform that much influenced governments' decisions about how to manage banking reform. In general, two distinctive approaches have been adopted (Claessens, 1997):

1. ***The rehabilitation approach***, based on recapitalisation of state-owned banks and their further institutional development together with limited break-ups, privatisation and foreign or newcomers' entry. Central European countries mainly adopted the rehabilitation approach. These countries were characterised by relatively high financial depth (measured as M2/GDP) and usually a lower extent of bad loans. Higher fiscal revenues and therefore 'softer' budget constraints with lower expected inflation rates made the rehabilitation approach more attractive.

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[21] For more on overall comparison of privatisation and restructuring in CEECs see Schüsselbauer (1999)

[22] For a comparison of two models of transition and on the comparison between Eastern European countries and Asia, see Milanovic (1998). Also for an account of the struggle between radical reforms and gradualists, see Mejstrik and Burger (1993)

2. *The new entry approach*. Countries with worse legacies have chosen this approach, although sometimes it was taken on deliberately (as in the case of Russia). This approach offered the emergence of a new parallel banking system with spontaneous break-ups, privatisation and market entry.

A different distinction of a banking system reform was according to Claessens (1997) ***centralised*** or a ***decentralised*** method depending on the way of dealing with bad loans. Banks were responsible for working out their bad loans problems alone under the decentralised approach, whereas under the centralised approach the state takes a more active role in waiving or restructuring bad loans on a general basis. However, both approaches overlap to some extent with the two approaches mentioned earlier. A complementary factor, which influenced the process of financial system reconstruction, was legal and enterprise reform. These reforms were crucial for monitoring and claim-enforcing as banks relied on collateral recovery and bankruptcy procedures.

The results of the study performed by Claessens (1997) show that the quality of banks differed greatly in their institutional capacity among each other as well as between the countries. The most advanced banking systems of CEECs are comparable to middle-income[23] countries such as Argentina, Venezuela or Turkey. The variation in the quality of banking regulation and supervision and in the quality of banking infrastructure has been found to be much lower than variations in quality among the banks in the sample of 31 countries including developed countries, developing countries and TEs.. This may suggest that the quality of banks depended much less on the banking environment in developing countries than in developed ones such as Denmark, Spain and Greece. Moreover, the quality of the banking system seems to be more influenced by infrastructure rather than banking regulation and supervision (although a vice versa causality is also possible).

According to Claessen's (1997:14) findings, "the rate of institutional development can be faster under the new-entry approach than under the rehabilitation approach". The fact that the better bank segments of new entry reforming countries are now at the same level with rehabilitation reformers suggests that higher ranking of rehabilitation

[23] Measured in per capita income

reformers reflects better starting conditions and not faster improvements in the banking system. Furthermore, it can be suggested that 'New Entry' countries have caught up with the rehabilitation countries because of the benefits of increased competition. This view is further supported by Caprio and Summers (1995) who found that higher market concentration may inhibit the institutional progress. On the other hand, increased competition has distorting effects on weak bank segments, although it may also not have been effective because of protective state policies.

Progress in institution building seems to be faster under the new-entry approach than under the rehabilitation approach. The main lesson should stress decentralised institution-building and handicapping of weak banks. "Because of weak legal infrastructures, problems associated with highly leveraged financial intermediaries, such as political interference, fraud and implicit guarantees, limited institutional development, much uncertainty and inside information, the role of banks will nevertheless still remain limited in many transitional economies" (Claessens, 1997:19). Hence, it was argued, that reliance on self-finance, direct intermediation and settlements among companies and through non-bank financial institutions are in the short run better solutions for many transition economies. As the banks were facing restructuring themselves under the changing business environment which involved radical changes in the legal system and fulfilling the role of financier of the transition for enterprise sector, monitoring of clients became complicated, and political pressures were mounting. According to Claessens (1997:19), these forms of finance are closer to enterprises, have better information, are less susceptible to political pressures, and often have less stringent demands on the legal infrastructure than banks do. They may also help improve the static and dynamic efficiency of the banking system by providing competition and driving out weak financial institutions.

Yet it should be noted that this study has been performed only among the banking specialists of the World Bank and although maximal objectivity was surely requested, a one-sided view of the researchers performing their analysis far away from the actual objects of research might affect the validity of the results. It is, however, quite clear that in relation either to new-entry or rehabilitation, foreign capital was often expected to play an important role which would consist of not only providing funding but also modern technology and managerial and bank-operation know-how under market

economy conditions (see e.g. Klacek, 1990). Moreover, “institutions are widely regarded as a crucial advantage of host countries aiming to attract foreign investors” (Bevan et al, 2004:1). And it has been further argued that the establishment of new institutions is at least as important as more conventional macroeconomic objectives (Kogut and Spicer, 2002; Stiglitz, 1999).

3.2.1 Restructuring strategies in CEECs

The Czech Republic and Slovakia began as one country but quickly separated the activities of the mono-bank - Štátna banka Československá - into three commercial banks and a central bank. Also in 1989 the legal framework of the banking systems has been set up based on three laws (State Bank Law, Banking and Saving Law, and Foreign Exchange Law); however, participation of foreigners was limited to representative offices until 1991 when Citibank was among the first to set up a subsidiary of a foreign bank (Corbett and Mayer, 1991). The initial break-up followed regional lines since the country originally consisted of two republics – Czech and Slovak. The need for a strong banking system and financial institutions was recognised, hence a minimum limit of CSK 300 million (approximately US$11 million) was introduced for the bank's capital. This was the highest among other Transition Economies (alongside Bulgaria and Slovenia) since Hungary required between US$1 and US$10 million and Poland US$6 million (Vit in Fries ed., 1996). Nonetheless, in the first four years of transition the number of banks exploded as a result of lack of prudential regulation. In 1995 a total of 55 banks operated in the Czech Republic, 25 of them foreign-owned. The deteriorating financial situation of both new entrants and major banks forced the Czech financial authorities to strengthen bank regulation later on in order to avoid chain bankruptcies and collapse of the financial system due to the high ratio of non-performing loans on the side of state-owned major banks and the poor capital situation of the new entrants. Thus the Czech central bank decided to revoke a number of under-performing smaller bank licences on the one hand and to move a proportion of non-performing loans mostly inherited from the previous era into the Konsolidační banka, an institution specifically created in 1991 for dealing with such loans. The whole process of the bank portfolios clean-up aimed at privatisation of major banks is described later. The Czech banking system was, as in the neighbouring

countries, dominated by the small group of state-owned banks in the first five years of the transition process.

The same was true of all the other reforming countries of Central Europe – **Poland** also quickly separated the mono-bank into a central bank and commercial banks in 1989. Due to its size, Poland followed the regional distribution of banks rather than specialisation or a large-scale split. Thus nine state-owned but regional banks emerged in 1989. These specialised banks were set for privatisation by the end of 1996. Liberal licensing policies allowed over 100 new banks to become established by early 1991 including some dubious ones which led to number of failures (Corbet and Mayer, 1991). While Poland followed the path of shock therapy transition to the market economy, as in the Czech Republic, deepening recession affecting demand increased the share of non-performing loans of total loans to 31 per cent in 1993 (OECD, 1996). The government decided to shift from the shock therapy that was proving too damaging for Polish conditions into more gradual transformation and implemented the Enterprise and Bank Restructuring Programme. One time recapitalisation conditioned with decentralised resolving of non-performing loans created pressure for banks and their debtors. This action was considered as positive especially since the share of non-performing loans dropped to 9 per cent in 1996 (Palinski, 1999). In fact, it was claimed that the Law on Financial Restructuring of Enterprises and Banks was "one of the most ingenious and comprehensive reforms aimed at simultaneous solving of financial and structural problems of both commercial banks and state enterprises" (Rosati in Fries ed., 1994). Foreign banks were expected to play an important role in Polish restructuring. However, "the Polish authorities were reluctant to grant new bank licences in part as a means of encouraging foreign banks to become strategic partners in banks being privatised (Andreson and Kegels, 1998:135) Thus, only 13 Polish banks had a majority foreign ownership by 1995, although there were more than 60 private banks (some of them set up by state-owned enterprises).

Hungary is to a certain extent a special case, since it had established a two-tier banking system as early as in 1987 consisting of a central bank and three commercial banks offering services to a limited extent. It was at least three years before any changes happened in other surrounding countries. Although three years may not seem like a long time in this respect, it meant that Hungary entered the stage of economic transformation

and its financial system three years ahead. Moreover, Hungary had had long experience of foreign banking. As early as 1979 a joint venture of the National Bank of Hungary and six Western banks established the Central European International Bank Ltd as an "offshore" bank that was dealing in convertible currencies only and later (in 1988 after establishment of two-tier banking) "onshore" bank CIB Hungaria Bank Rt had begun offering commercial banking services also in Hungarian currency. Furthermore, Citibank Budapest had been established since 1986, nine years before the same happened in Slovakia. The banking act of 1991 introduced market-based conditions for the operation of banks in Hungary based on the Basel I Accord[24]. Also set was the deadline for reduction of state ownership in the banks to 25 per cent by 1997. The gradual transformation of the banking system was most transparent in the role of government and in dealing with non-performing loans. Hungary recapitalised its banks four times between 1991 and 1994 (Baer and Gray, 1996) which in a way suggested little incentive to give bad loans. The centralised approach of government provided the three large state-owned banks with 50% guarantee of their non-performing loans and tax incentives to write off bad loans also limiting the distribution of dividends until the problem of non-performing loans was overcome (Sabi, 1996:181). Although each state-owned bank had its team of bad debt consolidators that had the task of making the most out of the non-performing loans, the government organised a so-called credit consolidation scheme under which banks were allowed to swap their bad debt for long-term government and World Bank bonds. Debt classified as "bad" before 1991 had been bought by the government for 50% of its book value while similar debt in 1992 was bought for 80% and the debts of companies set for privatisation at 100% of its book value (Boland, 1993, p.57)[25]. The privatisation of the banks was the final objective of Hungarian banking reform. Hungary was also the first country to decide to sell the majority of its banks to foreign investors early on.

In general, it might have been expected that the banks would be the most active force behind enterprise restructuring. This expectation seldom materialised. The Hungarian government introduced changes in privatisation in the beginning of 1995 but banks were still undercapitalised and the bad loan problem had not yet been completely solved

[24] The Basel I Accord or Basel Agreement refers to Bank of International Settlements criteria of cautious bank undertaking agreed by the signatories. These set bank capital ratio, bank reserves, and share holdings in debtors etc.

(Anderson and Kegels, 1998). All these problems have been solved in the following years and by the end of 1997, "the market share of state-owned banks had fallen to 20 per cent" (Matoušek and Sergi, 2005:11)

Slovakia faced the most difficult situation out of the three countries. Emerging in 1993 as an independent country it had to build many institutions and infrastructure from scratch as the country had been ruled from the capital Prague for the past 40 years. Before 1993 restructuring of the Slovak banking system happened simultaneously with restructuring of the Czech banking system since Czechoslovakia was still a state comprising of two countries but with centralised decision-making in the capital Prague. The reform had begun in January 1990 when the mono-bank (the State Bank of Czechoslovakia) was split into one central bank and three commercial banks. One commercial bank in the Czech Republic, the other in Slovakia and the third bank with branches in both Slovakia and the Czech Republic. Also the pre-existing savings banks were detached from the governance of the mono-bank and the existing foreign trade bank were given the full authority to conduct their activities as freestanding banks. One specialised bank was also set up in 1991 with the purpose of taking on non-performing loans mostly inherited from the previous regime. Thus it could be said that the Czechoslovak transformation of the financial system initially followed the same territorial principles as in Poland.

After initial set up of the two-tier banking system and in order to support competitive banking the increase in the number of banks was the easiest solution to the problem. It was also hoped that the competitive pressures will force the banks to start operating more efficiently. Between 1990 and 1993 the number of banks operating in the Czech and Slovak Federative Republics increased almost six-fold from nine to 52 (Hlavatý and Tkáč, 2003). Whilst the increase seems significant, the reality was that Slovakia had not experienced a major increase in number of banks until the split-up of both countries 1993. There were 23 banks in the Czech Republic and only five in Slovakia by 1991. Significant increase in numbers of banks followed after loosening of entry rules. Thus, on 1 January 1996 the total of banks operating in Slovakia reached 33. A substantial part of this increase was attributed to banks with either 100% or partial foreign share

[25] For additional information on further loan consolidation schemes, see Varhegyi (1994), p.301

(Śtatistická Ročenka, 1998). Nonetheless, the Slovakian banking system remained very much oligopolistic with three state-owned banks accounting for over 60.8 per cent of banking assets.

3.3 Privatisation

Creating market-oriented financial systems in former Eastern Bloc countries involved, above all, privatisation of the banking sector. This process includes not only state withdrawal from the direct governance of banks but also development of an effective regulatory and supervisory framework for the banking system at the same time (Bonin and Wachtel, 1996). It is claimed by these authors that successful transition policy should be based on the five following principles:

1) Governance of the banks must become independent of the state. The essential task is to establish a proper mix between state support (guarantees, recapitalisation and consolidation) and state withdrawal.

2) Apart from independence from state control, independence from insiders' influence is crucial as this can in negative cases result in accumulation of bad debt.

3) Recapitalisation of banks from the revenues of privatisation should be provided directly. Revenues from privatisation have usually gone to the privatisation agency rather than directly to the banks.

4) Development of an institutional framework able to provide efficient regulation and supervision is not a simple and cheap matter, but it is vitally important to keep stability and prevent crises.

5) Ensuring competitiveness of the banking sector is vital by strengthening the financial capabilities of domestic banks and opening the sector to foreign entry. Liberalisation of financial markets and lifting the entry barriers towards foreign banks especially had been expected to put competitive pressure on the domestic banking sector.

Each of the CEECs has chosen a different approach to the privatisation of the banking sector. Hungary has chosen to recapitalise banks first and then to find strategic foreign investors. Hungary has often been put up as a textbook example of bank privatisation. Poland combined the search for investors with subsidised distribution to insiders and initial public offerings with a small and large investor 'tranche'. Czechoslovakia

partially privatised the banks in the first wave of voucher privatisation where the state kept between 26 and 67 per cent of the shares of the largest banks and blocked large foreign investments (Matoušek and Sergi, 2005).

However, transformation had begun even before political transition, when state-owned commercial banks were created as joint stock companies, usually fully-owned by the state, transferring commercial portfolios of the national banks and dividing them along regional lines as in Poland, national lines as in Czechoslovakia or sectoral lines, as applied partially in Hungary already by the end of 1980s. Nonetheless, after creating a two-tier banking system, governments tended to drain liquidity from the banks through their tax and dividend policies preventing them becoming financially stronger at the time when they needed it most. Moreover, the banking sectors were burdened by non-performing loans established on a non-economic basis without any financial compensation (such as loan-loss reserves). Financial sectors suffered from three shocks. These were specifically transition-induced recession, a trade reorientation shock with the demise of the CMEA (Council for the Mutual Economic Assistance) and a relative price shock that strongly affected the quality of the loan portfolios (Doukas and Wihlborg, 1998).

Most of the literature concerned with banking system transformation in transitional economies (TEs) has dealt with bad loan problems. Recommendations included write-offs of inherited non-performing loans from banks' balance sheets (Beggs and Portes, 1993), and the use of bank privatisation to achieve bank recapitalisation (Levine and Scott, 1993). However, the literature offered no sure solutions for policy makers. Even the lessons from the faster reforming economies were inconsistent. Bonin and Wachtel (1996) looked at Hungary in more detail. This country used an interesting way of solving the 'bad loan' problem and privatising the banking sector. The Hungarian Investment and Development Bank first took over about a third of the bad loans, packaged them and auctioned them off in secondary markets. The second major recapitalisation involved a fast-track workout procedure similar to the bank-based one applied in Poland. These authors draw one important lesson from the Hungarian experience: that the search for strategic investors might be lengthy but the benefits are overwhelming. In addition, more than the transaction price, the governance of the foreign investor is important. According to Bonin and Wachtel (1996), the experience

of TEs with recapitalisation of banks offers two recommendations: firstly, banks should be encouraged and enabled to divest themselves from clients once their risk becomes unmanageable or uneconomical, and in order to support restructuring, any recapitalisation should be transparent, not hidden in the balance sheets; secondly, the support they receive should come in one move and should not tie banks closer to the government. Linking recapitalisation and privatisation together improves the probability of introducing and maintaining the independent governance of the banks.

There are several objectives present under bank privatisation policy. The short-term goal for governments used to be maximisation of revenues from the sale of the banks. However, other priorities should be the speedy creation of a banking system independent from government; and the positive effects of stabilising financial markets, creating competition, transferring know-how and enhancing the economy's growth by the efficient allocation of credit facilities. "A competitive banking sector is of broad macroeconomic importance because it leads to an efficient allocation of investment resources", (Wachtel, 1995: 4). In order to increase competition and encourage new entrants, the minimum capital requirement limits and other legal requirements were lax. This had at least two, closely related harmful effects: a large number of poorly capitalised and ineffective banks negatively affecting efficiency of the financial markets; and the destabilising growth of small banks which run into risky operations trying to grab a market share, thus increasing the systemic risk of the whole system.

It is commonly recognised that in TEs foreign banks play an important role in fostering a competitive environment (Wachtel, 1995) and are regarded as a catalyst for the transformation of the banking system. Although foreign banks tend to enter the TEs with little capital, their presence means high international reputation commitment in case of any failure of their subsidiary due to TE market conditions. Above that, modern banking technologies and business practices (e.g. corporate governance) have overall effects on the financial sector. However, the banking sector has been often viewed as a strategic sector and thus protectionism often took place. Nationalistic reasons played a significant role in this resistance.

The question, however, is whether the new bank entities bring higher moral hazards and increased systemic risks, which outweigh the benefits of marginally increased

competition. As Wachtel (1995:8) points out: "new entrants without sufficient experience and corporate governance can harm the whole sector more than a market with a few efficient and contestable players". The main problem could mean the cross-ownership of creditors by debtors, which would not only represent a moral hazard risk but serious risk to the financial system if the bank has substantial market share and fails due to lax credit controls imposed by owners-debtors. Weak regulations and supervision enable these situations and it must be the central task of regulatory institutions to prevent such practices.

The creation of an efficient regulatory structure at the same time as privatising the banking sector is a tremendous task for TEs. The main danger here is temptation from the side of governments to use the regulatory structure for maintaining influence in the banking sector. Thus, the design of an appropriate regulatory structure and institutional frameworks is a problem for developed countries as well, especially with the occurrence of recent international banking crises (see Honohan and Wittas, 1995). The organisation of regulatory bodies can be arranged in three ways: under government, central bank or separate bank regulatory authority (Tuya and Zamalloa, 1994). Location under government obviously imposes threats of potential political influence. In most cases in TEs, (and all cases of CEECs) the regulatory authority is placed with the central bank. Controlling the liquidity of the financial sector, the central bank combines its macroeconomic and microeconomic functions of providing the liquidity to the sector and its regulatory function guaranteeing the amount of liquidity to particular institutions or banks. On the other hand, Tuya and Zamalloa (1994) claim that the regulatory perspective of a banking system should not be the sole responsibility of a central bank, because the macroeconomic goals of the central bank and financial support for the individual institutions can be in conflict; in that case there should be another independent institution that can decide about closure and the licences of the new or troubled banks. Uniform and consistent application of transparent rules regarding deposit insurance can provide credibility for the whole deposit insurance scheme (Demirgüc-Kunt and Detragiache, 2002). International recognition and integration processes can be accelerating factors for the establishment of credible bank regulatory policy. An important issue is when the banks are too big to fall. The prompt response to any signs of possible failures is according to Honohan and Vittas (1995) crucial because bank closure could have politically unfeasible and systematic consequences when total

costs reach beyond the limits of the deposit insurance scheme.

Privatisation was the first step towards establishing the market-oriented banking system in TEs. Not only private ownership but also regulatory framework development is crucial. One way of ensuring an inflow of funds as well as know-how and business practices of market-oriented banks was opening the sector to foreign entry. Foreign entry was expected to introduce competitive pressures on domestic banks as well as to help in facilitating new regulatory and supervisory frameworks. Nevertheless, foreign banks can bring significant threats to the economy in case of banking failures resulting in financial crises.

3.3.1 Privatisation in CEECs

Privatisation of the state-owned banks was recognised as an important step forward among the four TEs of Poland, Hungary, the Czech and Slovak Republic. The process of privatisation varied among the countries[26].

In the **Czech Republic**, the privatisation of banks took rather a cautious pace. Although the clean-up of state-owned banks' portfolios had happened as early as 1993, with the bulk of bad loans being transferred to the specialised Konsolidační banka (Consolidation bank), the privatisation itself was postponed until 1998. While a considerable part of the major Czech banks was sold, these still remained under state control. Following the strategy of shock therapy and the large-scale economic experiment of voucher-privatisation, the four largest ex-state banks were privatised using this method. While it can be said that the banks were privatised, the state kept ownership of over 40 per cent in the three largest banks (Andreson and Kegels, 1998:180). Furthermore, the Czech Republic included banks in the first wave of voucher privatization and effectively blocked sizeable foreign investment (Bonin and Wachtel, 1997). Special vehicles for collecting vouchers from the general public and re-investing them in voucher privatisation were introduced in the form of Investment Privatisation Funds (IPF). The role of these funds was tremendous as the 13 largest funds held 53 per cent of all investment funds in 1992 and of these 11 were established

[26] For a quick overview, see Corbett and Mayer (1991), p.67

by banks (Mejstrik and Burger, 1993). Moreover, even bank-established IPFs were allowed to hold shares in other banks thus creating an entangled net of cross-ownership as well as interlocking ownership between banks and their clients. The banks' continued soft-lending to many of their large voucher-privatized clients resulted in bank performance deteriorating; government bail-outs were needed before foreign investors could be attracted in the second round (Cull et al., 2002). Difficult transformation of the economy with prevailing links between inefficient managements of state-controlled banks and state-owned enterprises had a negative effect on banks' loan portfolios. Czech National bank recorded over 30 per cent of total loans as non-performing in 1997 (CNB, 1998)[27]. Moreover, political reasons for controlling large bank assets, ongoing debate whether to sell the banks to foreigners and fears of increasing unemployment further hampered the process of privatisation. Nonetheless, following the financial turmoil of 1997, the Czech government adopted a privatisation programme for banks in 1998. Thus, by the end of 2000 the four major banks in the Czech Republic had fallen into foreign ownership. There were 40 commercial banks of which five were controlled by state authorities. Nine banks were still controlled by Czech shareholders while 16 were in foreign hands. Ten foreign bank branches also operated on the Czech market. 65.8% of Czech banking assets were controlled by foreigners (see Feakins, 2004)

The privatisation efforts of the **Polish** government had begun as early as 1990. Twinning programmes, where the management of selected western banks were paired with the management of state-owned banks in order to deliver the necessary know-how, technical assistance and commercial banking capacities ran between 1992 and 1994 (Belka and Mullineux, 1993; Slay, 1996; Bonin et al., 1998). The twinning programme required no direct western bank involvement, but did allow western banks to acquire forms of insider knowledge about the state banks' operations, portfolios, practices etc. (Feakins, 2004). In some cases the twinning arrangements did serve as an incubation period, as the western banks later became strategic investors in the arrangements for privatization (Bonin et al., 1998). Alongside implementation of the Enterprise and Bank

[27] Even such a high level of non-performing loans could be maintained without the risk of a banking crisis. This suspects that a neglected factor in understanding the process of privatisation in TEs is trust. Banks, enterprise and state networks, in the context of what we might call a "deep trust", could keep the show on the road because all parties avoided opportunistic behaviour. Clear evidence of this is that the Czech Republic transition did not produce absurdly-rich oligarchs (apart from a few examples). The 1997 crisis did, however, reveal the limits of this strategy.

Restructuring Programme that ran until 1996 was the privatisation of Polish banks. Although the initial plan was to privatise all nine regional banks in Poland by the end of 1996, only four of them were privatised by the end of 1997 (Weill, 2003). Foreign banks were also expected to play an important role in this process, hence were directly asked by the Polish government to participate in privatisation. The same strategy for privatisation of state-owned banks was applied. Firstly, the bank was recapitalised either through a stake taken by the Treasury or through a Financial Restructuring Act applied across the sector. Then a major foreign partner was found to purchase another significant stake (Andreson and Kegels, 1998). At the end of 2000 there were 73 banks operating in Poland of which 66 were private-sector-owned. 44 of private banks were in majority foreign-owned and controlled 69.5% of total banking assets along with 77.6% of capital funds of the banking sector (see Feakins, 2004).

Hungary had a clear view of privatising of its banks into foreign hands from the early stages of the financial system transformation. The Hungarian approach stands out from the other TEs as it was the only country principally relying on selling large parts of domestic banks to foreign institutional investors and it managed to do so successfully over the course of four years (Petrick, 1998). Reforms started with enacting the Banking Act in December 1991 that to a large extent mirrored banking legislation in developed countries. Apart from introducing the Basel Agreement rules of capital adequacy it also restricted government ownership in banks to 25% by the end of 1997. According to Sabi (1996, p.182) " due to lack of funds and of demand for the bank shares on the part of Hungarian households, the entry of foreign banks and of joint ventures has been encouraged". Thus, the total number of banks had grown from 23 in 1988 to 45 in 1994 (Banker, 1995) and almost all of it can be attributed to the entry of foreign banks. Hungary categorized its banking institutions somewhat differently. At the end of 2000 there were 41 commercial banks of which 33 were classified as banks, four as credit institutions and four as home savings and loans. Foreigners controlled 53% of banking capital while the state controlled 21.3%. Hungary took the lead in inviting foreign banks into the country in the late 1980s (Hasan and Marton, 2003). And in fact, by 1998, Hungary had become the first country in the region to establish a privately-owned banking sector that successfully overcame the burden of bad debts, massive undercapitalisation, and high concentration (National Bank of Hungary, 1998). It might have been argued that the government may not have received maximum benefits from

bank privatisation; however, it did lay the foundations of a strong, efficient banking sector in Hungary (Schnatterly and Kormendi, 1998).

Slovakia first used the same method as the Czech Republic, namely "voucher" privatisation, where every citizen received certain number of "vouchers" or "coupons" which he or she could then exchange for shares in particular companies. Selected banks were also sold within the general framework. Thus, two of the four major banks were privatised where 49 per cent of shares of VUB and 48% of shares of Investičná and Rozvojová Banka (IRB) were on offer. A majority stake remained in state hands. Regarding the other two major institutions Slovenská sporiteľna (a savings bank with the largest customer base and the largest branch portfolio) and Slovenská positovna (the only insurance company) remained fully owned by the state. Hence at the end of 1996, the state controlled 40.6 per cent of the total subscribed banking capital (see Olsson, 1999). While the second round of large-scale privatisation went more or less smoothly in the Czech Republic, in Slovakia this became one of the most politically discredited issues. Initially, all four major financial institutions were set for privatisation. But various delays and contradictory statements by the government of then PM Mečiar finally postponed the privatisation of banks infinitely in 1996. The second wave itself was replaced by the so-called "bond method" where each registered individual received a bond of the National Property Fund in nominal value SKK10,000 with maturity at 1 December 2000 (Komínková and Múčková, 1997). The second wave of privatisation and the second chance for citizens to share the national property as originally planned was cancelled. Direct sales prevailed in later years. Therefore, the Slovak banking sector remained dominated by undercapitalised and still state-owned banks. The situation kept deteriorating further and after NBS imposed forced control of IRB and change of government in 1998 it was perceived that the only way forward was to sell the under-performing state-owned banks that held over 50% of the total banking assets in 1999 to foreigners.

3.4 Stability and crisis

Although the 1997 financial crisis spread from Asia over Russia to Latin America, CEECs were surprisingly not much contaminated. This is more striking considering the number of subsequent studies which found that financial deregulation increases the fragility of a financial system. CEECs faced radical changes in financial markets with all the signs of financial liberalisation. It has to be noted that CEECs were undergoing a rather different process than deregulation especially in relation to their structures of loan and deposit portfolios and above all political set-up. However, the risks that financial liberalisation brings are similar to the process of deregulation. Deregulation brings out certain types of risks, which banks have to face. These are greater default, maturity, exchange rate and interest rate risks (Weller and Morzuch, 2000). Banking crises after liberalisation can arise from 'deregulation euphoria': "where credits are expanded to sectors that earlier were constrained which further increases investment and consequently output" (Calvo and Coricelli, 1993:22)[28]. However, some of the credits may be assigned to more speculative projects (Kaminsky and Reinhart, 1996), and more funds are attracted from abroad because of rising real interest rates and expanding financial sectors. Increased capital inflows lead to real appreciation of the currency, attracting even more foreign capital. Thus, the risk to the banks is growing because of more likely borrowers' default as credits are supplied in higher volumes to riskier projects in an overvalued, and eventually slowing down, real sector. However, this was not the only bad loan problem that banks faced. In a number of cases the inherited loans proved to be much more of an obstacle in restructuring the financial sectors of TEs than anything else. When banks finance domestic assets with foreign liabilities, it becomes easier to withdraw funds in case of economic difficulties (BIS, 1997); hence, maturity and exchange risks are growing. Eventually, liberalised economies become more vulnerable to interest rate risk being exposed to outside interest rate hikes. Moreover, as Nilsen and Rovelli (1999:23) argue: "capital inflows have an enormous importance in the financing of investment in emerging and transitional economies. However short-term inflows, intermediated by the banking sector of the emerging economy, may be subject to early withdrawals." This may imply that the more liberalised banking system

[28] Although TEs were not restricted in credit provision in relation to sectors of the economy, fears of general credit-crunch were present.

with an efficiently working payment system enables early and quick withdrawals of short-term funds, thus causing financial crisis.

On the other hand, deregulation brings stabilisation of the banking sector especially through competition reducing the loan exposure of domestic banks. This exposure is even lower when multi-national banks (MNBs) use 'cherry picking' to lend only to reliable and creditworthy borrowers leaving more risky ones to domestic banks. Nonetheless, the trade-off is the fact that domestic banks are therefore marginalised. Weller and Morzuch (2000) study the pre- and post-crisis similarities between emerging economies (EE) of Latin America and CEECs. A number of recent studies pointed to an increased financial system fragility as a result of financial liberalisation (Gallardo, et al., 2006, Knuttsen and Lie, 2002; Nilsen and Rovelli, 2001). On the other hand, a number of papers support the view that financial liberalisation enhances economic growth (Detragiasche, 2001; Levine, 1996). However a different view (Demirguc-Kunt and Detragiache, 1998) suggests that banking crises in developing or developed economies arise from weak macroeconomic fundamentals such as low growth and high inflation as well as high interest rates and vulnerability to payment crises. Furthermore, it was countries with weak law enforcement and specific deposit insurance that were particularly at risk due to a moral hazard problem of risk-taking bank managers. While many elements of a market-based legal framework had been established in TEs in the first half of the 1990s, the implementation of laws was often weak (EBRD, 1999; Murrell, 2001). Llewellyn (2002: 152) concludes that: the "causes of such crises are complex and a myopic focus on single factors (e.g. instability in the macro economy, weak regulation, etc.) misses the essential feature of interrelated and multidimensional causal factors". CEECs have undergone massive changes in their financial systems, which would suggest financial crises are more likely to occur. These radical changes include bank privatisation, easing of entry restrictions, creation of market-based lending rules, or elimination of interest rate ceilings, frequently supported by external liberalisation. All this together with creating more capital mobility and entry opportunities for MNCs (Multi-national corporations) and MNBs (Multi-national banks) was expected to support competitive banking markets. Though financial liberalisation exposes banks to increased default, maturity, exchange rate and interest rate risk, to avoid negative effects, a number of stabilising conditions such as market

transparency and institutions for adequate regulation and supervision have to be in place (Weller and Morzuch, 2000).

The view that 'financial liberalisation causes banking system fragility' is further supported by Fisher and Chenard (1997). The results of their study suggest that "following financial liberalisation there is an unambiguous increase in risk to the banking firm. This is true even if abstraction is made of concomitant structural changes or leftover distortions from the financial repression period. These other sources of risk only complicate the picture further. Because this increase in risk is across-the-board it implies a higher systemic risk and probability of a banking crisis following financial liberalisation. The sign of the change in supply of credit to the real sector, however, is ambiguous. That is, financial liberalisation increases unambiguously the fragility of the banking system and thus the probability of banking failures or a system-wide banking crisis" (Fisher and Chenard, 1997:45). Another argument for liberalisation to cause financial crises is the fact that financial liberalisation is often accompanied by imposition of BIS capital standards that are substantially more stringent than those that existed before or as Lam and Chen (2001:32) observed: "To meet stringent capital requirements, banks were unambiguously encouraged to shift towards more risky projects".

The results of Fisher and Chenard (1997) suggest that it is essential that financial liberalisation needs to be accompanied by a strengthening of the supervision and monitoring of the banking system which lies, not only, in stringent systems of identification of banks prone to fail but also a credible bank failure resolution policy. In fact, the increased supervision capacity should precede initiation of a financial liberalisation process.

In this view, financial liberalisation imposes great risks for TEs and the opening of the banking systems for foreign entry needs to be carefully evaluated and controlled. It needs to be noted, however, that Fisher and Chenard define the term liberalisation in a very narrow sense of elimination of government/state controls on interest rates and credit allocation, not encompassing foreign entry itself. On the other hand, such financial liberalisation (often referred to in Czechoslovakia as 'internal liberalisation') is

preparatory to further 'external liberalisation', i.e. opening the financial sector to foreign entry.

The first half of the 1990s in TEs was a period of fast privatisation, stabilisation of the economy, fast liberalisation and sustaining of financial discipline and opening up to foreign trade and investment, a set of tenets commonly referred to as the Washington Consensus[29]. Williamson (1990, 1993, 1997), Kolodko (1998) and Aziz and Wescott (1997) provided description and analysis of this paradigm. In general it was expected that transferring the ownership of state-owned assets to private hands would lead to newly-established market forces and "demand creation of institutions required for private ownership, thereby locking in the market economy (Zinnes, et al., 2001). The progress and development in TEs, however, led to greater debate (Balcerowicz, 1993; Nellis, 1999; Dabrowski, 1996; Stiglitz, 1998) and proponents of systemic transformation received more attention (Aslund, 1994; Kornai, 1994; Sachs, 1996). Not only transfer of title, but also building institutions have become important issues. In relation to FDI, Bevan et al. (2004) found that several specific formal institutions are found to influence FDI: private ownership of business, banking sector reform, foreign exchange and trade liberalization, and legal development. Hence, establishing institutions in the banking sector coupled with an efficient legal infrastructure reduces institutional uncertainties for foreign investors, facilitates establishment and enforcement of contracts and reduces the transaction costs of doing business. Although by the late 1990s many elements of a market-based legal framework had been established, the implementation of laws was often weak (EBRD, 1999; Murrell, 2001). This is attributed, among other reasons, to the fact that it takes time to establish the informal institutions that need to underpin the law: trained lawyers, independent judges, and general knowledge about laws and legal proceedings. Therefore, one needs to make a distinction between the extensiveness and the effectiveness of legal reform. As North (1990) argued, informal institutions need to complement formal institutions. When a formal legal framework is in place, but the enforcement is only sporadic, or legal costs are high, transaction costs are hardly lowered, and informal institutions, such as

[29] The Washington Consensus got its name because the ideas have been developed by economists around the World Bank Group in Washington D.C.

relationship-based business, prevail[30] (Peng, 2000; Murrell, 2001). Hence, we expect legal effectiveness to have a more powerful effect than legal extensiveness.

Foreign investors appear to react positively to government policy that facilitates both exploitation and augmentation of their own resources and capabilities. Hence, foreign investors and host governments have complementary interests with respect to some policy measures and institutional development, yet conflicting interests on other issues (Rugman and Verbecke, 2001). Bevan et al.'s (2004) study points out where collaboration between foreign investors and local policy makers may foster institutional development, namely in private sector development, banking sector reform, liberalization of foreign trade and investment, and strengthening of the legal framework. (See Scholtens, 2000).

So why have CEECs not been affected in the same way as other emerging economies? Weller and Morzuch (2000) argue that this immunity is more coincidental than structural. The main argument depends upon the assumption that the greater stability of CEECs has been the result of a 'unique constellation of macroeconomic fundamentals' rather than planned structural changes. The low contagion of financial crises in CEECs has been caused by stringent lending policies towards domestic customers; underdeveloped domestic asset markets preventing asset bubbles from having serious impacts; and capital flows into CEECs having been more long-term oriented leaving short-term speculative flows with minor impacts. Exchange rate liberalisation has not been sudden but rather controlled and gradual. Long-term external finance remains the main source for financing together with increasing external trade credit and internal sources of finance. Furthermore, the financial sector seems to keep its level in CEECs in the period before the crisis but deteriorates in emerging economies. Central and Eastern European Countries experience less speculative financing and smaller asset price bubbles than emerging economies

These factors should help to maintain the stability of the real sector in the face of external financial crises, and when combined with low levels of bank credit, thus lowered default risk for bankers. Capital controls are still retained, but surprisingly,

[30] For more on informal institutions, see also Mudambi and Navarra (2002)

despite these controls, FDI has grown rapidly. The reasons underlying this insulation are the different macroeconomic conditions of CEECs at the beginning of the transition process. The main feature is the legacy of the past with internal problems such as bad loans burdens. However since the large share of non-performing loans in portfolios of domestic banks, Weller and Morzuch (2000) support the imposition of hard budget constraints in order to stabilise banks and reduce their bad loan exposures in the real sector.

3.4.1 Non-performing loans

The inherited bad-debt is a specific issue for TEs. Large volumes of inherited non-performing loans can create a moral hazard for burdened banks which can result in either under-lending or excessive risk-taking. Both situations can have adverse effects leading to a banking crisis (Steinherr, 1997). Initially, many borrowers were the same enterprises responsible for non-performing loans from the past. Thus, it was difficult to distinguish whether the increasing bad debt was a result of failure to repay the old debt or newly extended credit. Tighter monetary policies that turned real interest rates into positive numbers coupled with liberalisation and increasing competition affected profitability of state enterprises. However, banks kept extending credit to state-owned enterprises against unspoken guarantee of the state that feared accelerating unemployment making state-owned enterprises too big to fail.

The situation had begun to change with increasing share of non-performing loans. Dittus (1994) claimed that reduced lending to enterprises could reflect a more prudent attitude on the part of banks and might have resulted in credit rationing. Dittus argues that bank behaviour in these countries changed dramatically in 1992 in response to non-performing loans and tighter bank regulations. The share of non-performing loans in TEs was often more than double that of other developing economies that faced financial crises (see Table 3-1 below)[31].

[31] Again already mentioned issue of "deep trust" (see footnote 8) arises which enabled those countries to keep the show on the read

Table 3-1 – The Share of Non-performing Loans on Total Loans (%) in 1995

Country	1995
Czech Republic	39
Hungary (1992)	19
Poland	28
Slovakia	42
Mexico (March)	10.0
Brasil	5.8

Sources: OECD (1999); Capek (1994); International Monetary Fund (1995); Anderson et al. (1996)

Devising the best policies for dealing with bad debt on bank's balance sheets was a theme of early discussions in transition economies[32]. Number of leading economists suggested overall cancelling the bad debt (Begg and Portes, 1993; Blanchard et al., 1991; Calvo and Frenkel, 1991; Dornbusch, 1 991). Their main argument was that cancellation of the inherited debt would remove a burden o f the past from firms' balance sheets without changing the value of state-owned assets, since all firms and banks were state-owned at the beginning of transition. On the other hand, recapitalisation was most commonly used among TEs especially because cancelling bad debt creates a credibility problem. Banks would rely on government bailout via cancelling bad debt in the future if it happened once in the past (Mitchell 2001). However, Mitchel further argues that credibility argument cannot fully explain why policies other than debt cancellation were used, since TEs used both debt transfer and self-reliance policies accompanied by recapitalisation.

Recapitalisation became the main feature of early government action for bank restructuring alongside improving supervision and monitoring, although some fears that recapitalisation may cause a credit crunch were voiced (Anderson et al., 1996). The aim was to improve capital adequacy ratios of troubled banks as well as to compensate banks for writing-off non-performing loans extended before a certain date (Steinherr,

[32] See Begg and Portes (1993), Bonin (1993), Bonin and Schaffer (1995), Brainard (1991), Calvo and Frenkel (1991), Caprio and Levine (1992), Coricelli and Thorne (1993), Dornbusch (1991), Estrin et al. (1992), Levine and Scott (1992), Marrese (1994), Saunders and Sommariva (1993), and Thorne (1993).

1997). Two main approaches to recapitalisation were developed. While one approach supports mutual action among debtors and banks on working-out of bad loans, or through legal bankruptcy proceedings (as in Poland and Hungary), a second approach limits compensation to losses on loans linked to the previous regime (e.g. Bulgaria, former Czechoslovakia, and Romania) using debt-transfer to specialised bank or asset management company[33]. However, as Steinherr (1997:123) points out: "despite recapitalization and loan consolidation, bank balance sheets have continued to deteriorate". Suggested reasons are the lack of privatization, poor regulation and supervision, and a shortage of skilled managers. It was expected that with improved bank regulation, supervision and monitoring coupled with continuous enterprise sector restructuring, the amount of non-performing loans should decline. This however became true only in the case of Poland and Hungary which applied active and consistent approach to solving bad debt problems. In Czech Republic and Slovakia especially coping with non-performing loans was delayed.

Financial system expansion led to a greater chance of banking crises in emerging economies, whereas in CEECs growing deposits helped to stabilise the sector. Maturity and exchange risks are higher in CEECs, while interest rate risk is higher in Emerging Economies. In emerging economies, the chance of banking crises rises with faster growing official reserves (see Kletzer and Spiegel, 1996 and Obstfeld, 1998). Furthermore, greater volatility and political interference in banking were recognised as two main reasons for greater vulnerability to crises of emerging market economies according to Caprio and Honohan (1999).

In general financial crises can be spread through various channels (Gelos and Sahay, 2001). Trade linkages and financial linkages are important channels relating to threats of defaults for countries with close trade ties or sudden withdraw of short-term investments. Exchange market linkages proved to be one of the most dangerous channels for financial crises as historically proved by 1987 attack against British Pound, or in 1997 and 1998 in Czech Republic and Russia who had to abandon their exchange rate peg regime due to external pressures. Slovakia maintained their fixed rate peg

[33] Dziobek and Pazarasioglu (1997) discussed desirability of transferring debt to an asset management company

regime[34] in until October 1998 but floated immediately afterwards. "Hungary and Poland have been maintaining their pre-announced crawling bands" (Gelos and Sahay, 2001: 63).

3.4.2 Comparisons Among the CEECs

Probably every TE faced problem of big volume of bad debt that undermined stability of the whole banking sector. Coupled with fear of large-scale bankruptcies which if forced could set-off domino effect with repercussions over the whole economy the need for restructuring and recapitalisation especially of large state-owned banks was widely recognised. **Poland** in this sense adopted decentralised approach where banks still played primary role in corporate governance and were encouraged to off-court settlements with their debtors called self-reliance method. Hence in every state-owned bank a specialised department was created in 1992 with mission to work-out maximum non-performing loans. The majority of bad loans were partly rollovers of the previous loans and partly new loans provided in order to salvage cash-flow problems of the distressed enterprises (Szekely in OECD, 1997). But while the loans were not inherited, the causes (bank-enterprise relationships) were. As Grey and Holle (1996) point out, most of the problem loans in the basic portfolios of the seven banks involved in the Polish EBRP were short-term working-capital loans. The similar problem was faced by all of the CEE countries. It is recognised that the Enterprise and Bank Restructuring Programme implemented in 1993–1995 was largely a success in terms of economic recovery and growth (Negret, and Papi, 1997). Even more positive in the view of large second-level indebtedness as discussed before is the positive spill-over effects on small and medium-sized enterprises after the creditworthiness of some of the largest enterprises was restored. Polish reform also seems to evade the interest rate risk where high bank interest rate spreads were brought down from 12.3 per cent in 1993 to 6.7 per cent in 1995 (according to the Polish Bankers' Association – see Negret and Papi, 1997).

The **Czech Republic** employed a different approach to solving the bad debt problem, consisting of debt-transfer and self-reliance. Initial attempts were made as early as 1991

[34] against five currencies: Deutschemark, US Dollar, Swiss Franc, French Franc and British Pound

when two-thirds of revolving inventory credits were transferred to Consolidation Bank, the problems were far from solved. The Czech government, rather than employing whole-scale banking reform, decided to get directly involved in the case of minor banks either through revoking bank licences or direct liquidation. Thus, solving the problem of mounting bad-debt in major state-owned banks that also managed the majority of banking assets was left for later and non-performing loans increased significantly (CNB, 1998, Banking Supervision in the Czech Republic in 1997). The Czech Republic (as with Hungary) used a centralised approach to clearing bad debt. However, this proved to be only partly efficient. Banks remained undercapitalised and the fact that the causes of non-performing loans were not resolved meant that banks faced a recurring problem of new bad debt (Matoušek and Sergi, 2005). The Czech consolidation cleared state-owned banks' balance sheets between 1991 and 1993 but future bailouts of state-owned enterprises and cross-ownership created via voucher privatisation and investment funds were creating more moral hazards thus postponing the whole restructuring even further.

The Czech Republic experienced an exchange rate crisis in 1997. An increasing trade deficit and economic slowdown forced the Czech National Bank to intervene and later on abandon the fixed band crawling peg on 27 May and the Czech Crown immediately depreciated by about 10 per cent. Gelos and Satay (2001) found little evidence for spillover effects of the Asian and Russian crises on the stock markets of the Czech Republic, Hungary and Poland but only significant transmission from the Czech to the Hungarian, Polish and Russian stock markets. All of the TEs experienced problems in their banking sectors to some extent. In the Czech Republic, 11 private banks that failed between 1994 and 1997 represented 8 per cent of the country's entire banking capital (The Economist, 21 September 1996). While banking crises in other countries often involve state-owned banks, in the TEs, by contrast, insolvency usually appears in private-owned banks (e.g. Ekoagrobanka and Agrobanka in the Czech Republic) (Steinherr, 1997)[35]. The privatisation of banks was restarted in January 1998 when the state's minority share in one of the largest banks, Investiční and Poštovní Banka (IPB), was sold to Nomura International. However, in June 2000 (when Nomura International was facing serious problems worldwide) bank run on primary deposits and serious

[35] This indicates the effectiveness of ad hoc measures taken in a trust-rich context.

liquidity crises forced IPB into CNB conservatorship and its subsequent sale to CSOB. Later on, in 1999, Belgium's Kredietbank acquired the state's full 66% stake in CSOB and with the sale of 52% of the largest Česka spořitelna to Austrian Erste Bank followed by the sale of the state's stake in Komerční Banka to Societe Generale in 2001 the Czech privatisation of the banking sector was completed (Bárta and Singer, 2006). The total cost of restructuring was estimated at about CZK 100 billion (Havel, 2004).

High deficit of government finances in **Hungary** as well as deficit of current account and foreign debt resulted in introducing a crawling-peg currency regime aimed at maintaining economic competitiveness in 1995 and to keep maintaining pre-announced crawling bands throughout the Asian and Russian crises in 1998. Poland, the Czech Republic and Slovakia overcame similar problems, which were down to foreign capital inflow and high liquidity of the banking sectors. In relation to bad debt, Hungary started off with a centralised loan consolidation programme that was used until 1993. The effectiveness of this scheme was doubtful and since then a switch to debt-transfer was organised using the Loan Consolidation Programme. Alongside this, a number of recapitalisations took place between 1991 and 1994 (as it was pointed out by EBRD, 1995, the first wave of consolidation, in 1992, was a 'hastily-arranged bailout'). Further on, a decentralised approach was used which proved very effective after the new bankruptcy law was enacted with sufficient executive tools. The new consolidation programme was split into three stages aimed at resolving the bad debt problem, improving the capital ratios and preparing the Hungarian state-owned banks for sale into foreign hands. While the consolidation programme was sometimes criticised for being politically motivated (see Csaki, 1996), it is doubtful that a better consolidation scheme could have been introduced at the time of ever-changing transition conditions (Petrick, 2002). Hungary is sometimes used as a textbook example of privatisation where while leaving the OTP bank in domestic hands, the majority of the banking sector was sold to foreigners by 1997 (see Neale and Bozsik, 2001). For an account of bank consolidation in Hungary see Abel (2002). Overall, Hasan and Merton (2003: 2249) conclude that: "early reorganisation initiatives, flexible approaches to privatisation, and liberal policies towards foreign banks' involvement with the domestic institutions helped to build a relatively stable and increasingly efficient banking system".

Slovakia, on the other hand, had the advantage of relatively low capital liberalisation. While it has been, together with the Czech Republic, one of the most opened countries regarding FDI, inflow and outflow of short-term portfolio investments was only allowed from 1 January 2001 (Trajlinková, 2001). Distortion between restrictive monetary and liberalised fiscal policy in the Czech Republic resulted in monetary crisis in May 1997 and transition to a free-floating exchange rate. Slovakia also abandoned the system of the currency basket with a pre-announced intervention band and introduced free float in October 1998. This, however, was not a result of foreign currency attack (although some attempts were fought off by the National Bank of Slovakia - NBS) but result of domestic economic conditions. Indeed, Slovakia, along with Bulgaria, Estonia and Russia had a number of weaknesses in its economic fundamentals (Fries, et al., 1999). Ratio of total external debt was the second highest among CEECs at the end of 1996 as well as domestic credit to the non-governmental sector. Also, ratio of outstanding short-term debt to international reserves was highest in CEECs (BIS, 1998 and IMF, 1998) and current account deficit outlined Slovakia for macroeconomic instability. Failing macroeconomic fundamentals suggest that Slovakia would have been among one of the countries most severely impacted by East Asian crisis had it not been for stringent capital controls (Fries et al. 1999). Gelos and Satay (2001) results point to exchange rate crises after the Russian crises which might have been caused by close trade ties to Russia of some countries (e.g. Slovakia which was forced to float its currency in 1998 as a result of exchange rate pressures).

Restructuring of the Slovak banking sector had begun under the Czechoslovak Republic in 1991. However the split of the country in 1993 introduced new challenges for the Slovak banking system. New institutions had to be built (such as a central bank), new laws enacted and new policy towards restructuring developed. An initial step was the introduction of classified claims provisions in 1993 with update bank claims classification. A substantial rise was observed in 1995 when the National bank of Slovakia (NBS) Provisions Act No. 3/1995 came into force (Komnínková and Múčková, 1997). Commercial banks were also asked to submit their own restructuring projects by 1995 with the aim of removing the bad debts from their balance sheets within three years. However, the legal framework did not work and the lengthy debate about whether to privatise state-owned banks before their restructuring or not resulted in legislation which conserved the existing ownership structure until end of March 1997

thus effectively stopping the whole restructuring process. Moreover, with the second round of voucher privatisation abandoned, there were no means for the privatisation of banks apart from direct sales. Even this option was limited by the Act on Government Interests in Strategic Enterprises and corporations (NC SR No. 192/1995 Z.z.). The situation with non-performing loans was deteriorating further. State-owned banks were not capable of maintaining the capital requirements which had been set by the NBS since 1997 and the proportion of non-performing loans rose to an alarming level. The share of state-owned banks on loss claims was 13 per cent in 1997 but already 68.58 per cent in the first quarter of 1998. Increase in so-called uncovered loss (creation of reserves and provisions) is not keeping pace with the increase in classified (i.e. substandard, doubtful or loss) claims (Tencer, 1999). Although the Slovak banking sector managed to escape numerous bank crises as in the Czech Republic (three failed banks in 1996 were branches of Czech banks, one small private bank was quickly taken over by one of the largest state-owned banks), the third largest bank (state-owned) had to go under NBS conservatorship in 1998 after becoming a victim of a large-scale fraud. Finally, in 1999 and 2000 and after the change of government in 1998, a further slice of non-performing loans was transferred to the Consolidation Bank. In May 1999 the Slovak Government approved a privatisation programme for the four state-owned banks[36] with a view to privatising them by the end of 2001.

3.5 Conclusion

This chapter explored the crucial elements of rebuilding the banking and financial systems of Transition Economies. The best summary of the whole process was provided by Fries et al. (2006:2): "Banking systems were liberalized by freeing interest rates and decentralized by transferring commercial banking activities from the central bank to state banks. State banks were restructured and privatized and new private banks, both domestic and foreign, were allowed to enter the markets. Moreover, to support arms-length lending relationships between banks and their borrowers and to foster the confidence of depositors in banks, the legal frameworks were overhauled (including the strengthening of creditor rights) and systems of prudential regulation and supervision were initiated. In broad terms, the main policy instruments to promote the

[36] Všeobecná úverová banka (General Credit Bank), Investičná a rozvojová banka (Investment and Development Bank), Slovenská sporiteľna (Slovak Savings Bank) and Banka Slovakia

transformation of banking were therefore interest rate liberalization, bank restructuring and privatization, market entry of new banks and fundamental institutional change."

Sudden changes were advocated by a number of western economists and politicians, who quickly became advisors to the new governments of Transition Economies. Any transformation, especially on a country economy level basis, needs to be performed with consistency once the initial conditions were taken into consideration. The most difficult thing is to keep consistence of reforms in a changing political climate where change of government during the transformation process can be hampered because of varying political priorities. Similarly, inconsistent political development, legal structure creation and institution building may hamper the transition process in any country. Out of four CEE countries discussed in this chapter, only two could be regarded as going the whole way. The Czech Republic followed the shock-therapy method using two rounds of voucher privatisation that distributed state ownership into private hands. Hungary, on the other hand, detected early on that sudden transformation does not work well in their conditions and therefore switched to the gradual method. Poland hesitated in applying mass privatisation and applied management buyouts, some public offerings and small participation of foreign strategic investors. Slovakia abandoned the mass privatisation scheme after the break-up of Czechoslovakia and the new government conserved privatisation of large state-owned banks until the late 1990s. However, no matter what strategy each country applied, all financial systems are bank-based with stock markets playing only a marginal role at the beginning of the 21st century.

The paths to transition were not without hazards. The opening up of the banking sectors of TEs brought the possibility of increased fragility of financial systems, including the problem of 'deregulation euphoria' in extended provision of risky credit to the economy. Increased financial integration has brought the risks of financial contagion from crises abroad. However, the effects of such crises were mild in the case of Central and Eastern European countries. Research suggested that TEs experienced low contagion of financial crises due to special macroeconomic conditions. Not only macroeconomic conditions but more importantly idiosyncrasies in legal systems that prevented sudden withdrawals of short-term finance shielded transition economies from adverse effects of Asian and Russian crises. On the other hand, the same legal framework proved to be ineffective in many cases giving few protection rights to

creditors often resulting in an increasing portion of bad loans. The problem of non-performing loans was characteristic of all four TEs. Also, the ways of solving the bad loan problem differed. The Czech and Slovak Republic used transfer to a "bad-loan graveyard", Poland opted for solutions within the financial institutions and Hungary combined both approaches. In most of the cases though increase in bad debt acted as a trigger for a more serious approach to restructuring the banking sectors. It is clear then that postponing solving the problem of non-performing loans as well the ownership structure hampers the financial and enterprise sector restructuring prolonging the old preferential patterns of economic relationships. Finally, it can be expected that as financial integration increases, the risk of external financial crises contagion will grow. To curb such risks Berglof and Bolton (2002) suggest that desirability and sustainability of foreign banks in TEs increases.

CHAPTER 4
FINANCIAL SYSTEM IN SLOVAKIA

4.1. Introduction

Slovakia, after the split from the Czech Republic in 1993 faced the enormous task of building a financial system from scratch. The process of privatisation of national property underlined all number of changes in society and the economy. Banks were expected to be an important element in the process fulfilling the social order as a financier of the whole process. Certainly general economic conditions substantially influenced the whole process of transformation of the economy with the addition of legal and institutional infrastructure building that was determining the business and banking environment.

It should be noted that Slovakia was undergoing turbulent times as any new country would. Although many institutional frameworks were inherited from the previous state, all crucial decisions had been made in the capital of Czechoslovakia, Prague, rather than Slovakia's Bratislava. Thus, all institutions needed to be redeveloped into independent entities ruling the sovereign country. New laws needed to be adopted and adjustments made to previous legislation. Establishing membership in multinational organizations such as the WTO, OECD and regional organisations such as the Central European Free Trade Association (CEFTA) was vital for integrating Slovakia into the world community. Accession to the EU and NATO was declared as the paramount objective although some governments wavered. The main macroeconomic issues in the first three years of existence were: introducing a new currency, the Slovak koruna; stabilising the economy; establishing and operating the stock exchange, updating bankruptcy, banking and competition laws; and most of all, continuing with privatisation. Although some of the goals were achieved in due course, and quite successfully, many others that had a direct impact on the transition process were delayed, hampered or completely abolished. The most significant was cancelling the second wave of privatisation under the 'voucher model' as described later. Also, a change in government in 1994 did not help with stability and the next five years were marked by exclusion of FDI involvement and diversion from the objectives previously set (such as joining the EU and NATO). While macroeconomic indicators offered good potential for further restructuring of the

economy in the first half of the reviewed period 1993–2000, government actions were soon reflected in the deteriorating economic situation in the second half of this period.

The following paragraphs focus on providing an overview of macroeconomic fundamentals development in Central and Eastern Europe focusing on Slovakia, and depicting the conditions under which the Slovak banking system emerged and grew. Liberalisation of the economies of transition was set as one of the major objectives. Foreign investments were expected to play a significant part in the transition. Hence, the dynamics and structure of foreign direct investments in Slovakia are looked at. Later on, the development of the Slovak banking sector is described with particular focus on the establishment of a market structure, legal framework and institutions. The role of stock markets in connection with the banking sector is analysed and the particulars of banking markets' development are further unveiled, also mentioning the problem of non-performing loans. Last but not least, foreign participation in the Slovak banking sector is scrutinised, looking at overall involvement.

4.2 Country comparisons

In order to understand the position of Slovakia among other TEs, an overview of selected countries of the Central European region provides comparison of several basic macroeconomic indicators. The raison d'etre being the fact that Slovakia showed great potential in coping with the break-up of Czechoslovakia swiftly recovering in terms of growth, general government balance, consumer price index and even privatisation revenues. The potential for successful transition was present in the beginning of 90s. Nevertheless, Slovakia later failed to be invited in the first line up for the European Union accession. The following sections will attempt to explain what might have gone wrong.

As presented in the table below, Slovakia was one of the top performers among the TEs until 1997. The first five years of existence of the new country were signified by GDP growth of more than four per cent on average despite negative growth in 1993 which could have been expected as the country was settling after the split from the Czech Republic and faced more tasks than its previous 'sister-country'. The growth picked up in 1994 and 1995 with continuing transformation and liberalisation creating an ever-

larger private sector. Since 1995, government spending rather than real economic performance was the main support of economic growth, especially after abolishing the 'Second Wave' of privatisation, Thus when the government changed in late 1998 and austerity measures were introduced to bring down the budget deficits, GDP growth plummeted to 1.9 per cent, i.e. from the first place among the selected TEs in 1996 to second worst after the Czech Republic.

Table 4-1 - GDP growth (in current prices 1993 - 2000)

GDP growth (%)	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	0.1	2.2	5.9	4.3	-0.8	-1.0	0.5	3.3
Hungary	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2
Poland	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0
Slovenia	2.8	5.3	4.1	3.5	4.6	3.8	5.2	4.6
Slovakia	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2

Source: EBRD Transition Report (2002)

On the other hand, in terms of constant prices of 1989 the growth levels are much less impressive which reflects the extent of the change in the economic systems of each country as well as different starting conditions. Poland, for example, started from a low base and achieved significant growth quite quickly. Slovenia emerged as a sovereign country after the break-up of Yugoslavia in 1991 and was regarded as the most industrialised of all the succeeding countries. Hungary, on the other hand, seemed to be struggling to reach the levels of output of 1989, while Slovakia, an independent country since 1993, almost levelled the gross domestic product of 1989 in 1998.

Table 4-2 - GDP growth (in constant prices of 1989 (1993 - 2000)

GDP growth (1989 = 100)	1993	1994	1995	1996	1997	1998
Czech Republic	85.1	87.4	92.9	96.6	96.9	94.6
Hungary	80.4	82.7	84.0	85.1	89.0	93.5
Poland	87.6	92.1	98.6	104.6	111.8	117.1
Slovenia	81.3	85.6	89.6	92.3	96.5	100.3
Slovakia	75.0	78.6	84.1	89.6	95.4	99.6

Source: Bruchačová (2000)

Only two of the above mentioned countries managed to have positive government balance in 1993, which was also the last year of government surplus for any of the five selected countries. The fiscal deficits in general reflected a weak tax base and legislative enforcement as well as costs connected to structural reforms. From this point of view Hungary put the most effort into structural reforms, together with Poland. The government balance of Slovakia took some spiralling turns in 1997 when, measured in proportion to GDP, it increased almost by 4 per cent. Although it was not the highest government deficit among the selected countries, the sharp increase alarmed the international financial community. However the strong growth of the economy together with the low level of real structural reforms, the low level of foreign investment and the high growth of public investment (especially investment in motorway development) proved apprehensions right (World Bank, 2000). Only after the new government introduced strong austerity measures in 1999, via two packages including freezing public spending and freezing public sector wages together with temporal introduction of an import surcharge, increase of the basic rate of VAT and several consumer taxes, did they manage to stabilise the macroeconomic situation (OECD, 2000).

Table 4-3 – General government balance (in % of GDP) (1993 – 2000)

General government balance (% of GDP)	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.2
Hungary	-6.6	-8.4	-6.7	-5.0	-6.6	-5.6	-5.7	-3.3
Poland	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.7	-3.2
Slovenia	0.6	-0.2	-0.3	-0.2	-1.7	-1.4	-0.9	-1.3
Slovakia	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-3.6	-3.8

Source: OECD Economic Surveys – Slovak Republic (2000, 2001); EBRD, Transition Report (2002)

Much more positive was the performance of the central bank in managing inflation. As shown in Table 4-4 below, Slovakia managed to outperform all the researched countries in 1996, thus supporting monetary stability in the country. The situation changed again in 1999 after introducing austerity measures and immediately inflation rose to the worst position among selected countries. It was suggested by many economists that inflation should be very high in the first years of transition of former Eastern Bloc countries as a

result of price liberalisation and in order to bring the monetary situation to the real terms. Consequently, inflation was expected to stabilise and start dropping, which proved right in most cases. The National Bank of Slovakia (NBS), focusing on monetary policy and inflation targeting, succeeded in reaching the lowest level of inflation between 1996 and 1998. This success was, however, partly the result of loose fiscal policy and the price was high. Interest rates of over 20 per cent per annum and stormy foreign exchange markets further threatened by the Russian crisis led to a free float of the Slovak koruna in October 1998. An increase in utility prices, VAT changes, a second austerity measures package and further lifting of state subsidies made inflation jump by more than five percentage points between 1998 and 2000.

Table 4-4 - Consumer price index (CPI) (1993 – 2000)

CPI	Unit	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	%	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9
Hungary	%	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8
Poland	%	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1
Slovenia	%	32.9	21.0	13.5	9.9	8.4	7.9	6.1	8.9
Slovakia	%	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0

Source: Štatistická ročenka (2001), OECD Economic Surveys: Slovak Republic (2001)

Privatisation revenues in Table 4-5 below may be used for comparison between two models of privatisation used in TEs. Hungarian revenues reaching almost a quarter of GDP in 2000 can be assigned to a more successful gradualist approach as opposed to the shock therapy employed in Czechoslovakia. Slovenia approached any privatisation ideas rather conservatively and a switch in privatisation methods from 'shock therapy' to the 'gradualist' approach affected Poland in 1995. The Czech Republic stuck with the 'shock therapy' method with steadily growing privatisation revenues concluding all the privatisation waves and distributing stakes in large enterprises among the people. Slovakia, from this point of view, seems to be the second best performer in privatisation, even beating the Czech Republic. However, the picture is more complex than it seems, as will be clarified later.

Table 4-5 - Privatisation revenues (1993 – 2000)

Privatisation revenues	Unit	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	% of GDP	na	2.7	4.6	6.3	7.1	7.9	9.3	10.3
Hungary	% of GDP	8.7	12.3	20.8	23.4	27.5	28.6	29.8	30.2
Poland	% of GDP	0.9	1.7	2.6	3.6	5.1	6.4	7.7	11.6
Slovenia	% of GDP	0.0	0.0	0.4	0.9	1.4	2.2	2.5	2.6
Slovakia	% of GDP	4.7	6.7	8.4	9.7	10.2	10.8	11.0	14.7

Source: EBRD Transition Report (2002)

Privatisation in Czechoslovakia was formulated as a two-wave process: in the First Wave, small and medium enterprises were privatised through 'voucher-based mass privatisation'. The First Wave had been completed by mid-1993, where 750 enterprises with a book value of SKK166 billion were put up for sale. SKK80 billion worth of shares in 503 firms were distributed through vouchers, with the rest being sold via direct sales and public tenders. Before the Second Wave took place, the Czech and Slovak Federative Republics split and further decisions on privatisation were left to two independent governments. Schmögnerová (1993) suggested that the share of the voucher scheme was expected to decline in both the Czech and Slovak Republics in the Second Wave of privatisation due to the fact that economic objectives should gain the upper hand over political motives. Subsequent developments opposed this view. The Second Wave of privatisation in Slovakia commenced in September 1994 but was delayed by the change of government at the end of 1994 and by an internal debate over the most appropriate method for privatisation (Tkáčová, 2001). Enterprise restructuring was conveyed mostly via indirect methods using privatisation and tight access to credit and subsidies for enterprises as restructuring tools.

The hard-budget constraints on companies were not yet effective, as the Bankruptcy Laws, passed in August 1991, entailed no possibility for external creditors to force enterprises into bankruptcy. A new Bankruptcy Law from 1993 allowed creditors to bring bankruptcy cases to court after a three-month protective period. In mid-1995 the government approved an amendment[37] to the 1991 Privatisation Act and effectively

[37] Act. No. 190/1995

cancelled the 'mass voucher-based' privatisation that was supposed to continue in the Second Wave (Morvay, 2005). Further amendments were made to the laws regarding investment funds, and parliament adopted a law concerning state interests in enterprises, later called the 'Act on Strategic Enterprises' (No. 192/1995). The law identified over 20 companies that would not be privatised (mainly in gas and electricity generation, telecommunications, armaments and agriculture) and a further 40 which had already been partially privatised but were later listed as 'strategically important' (mainly in mining, chemicals, construction, engineering and the agricultural sectors). All three laws were approved in early September even after president returned the law twice to the parliament. Indirect methods of enterprise restructuring continued to be deployed. In relation to a new bankruptcy law, by mid-1995 almost 1,100 proposals for liquidation were put forward, however only 53 of these were effectively put into liquidation together with one off-court settlements (NPF, 2002). Hence, the hard budget constraints and effective restructuring of enterprises remained a wish.

New legislation towards privatisation meant that 3.5 million voucher holders were issued by the National Property Fund's (NPF) guaranteed five-year bonds at a nominal value of SKK10,000 with interest rates at the level of the discount rate of the National Bank of Slovakia (NBS, 2003). The principal amount fell due at the end of 2000. The advised options for bond-holders included, apart from holding the bond until its maturity: sale of the bond; use of the bond for purchase of shares from the portfolio of NPF; including the bond as part payment for apartments and/or health insurance; or using the bond to pay-off debts to the NPF (NPF, 2002). The NPF preferred using the bonds for purchase of shares of companies held in the portfolio of the NPF or even the latter options, where companies with payables to NPF would buy the bonds from bondholders. The main form of bond retirement was to paying-off the debts by NPF debtors, which was however cancelled in 1997 by Constitutional Court ruling. After that date the only possible way to use NPF bonds was either retirement of bonds to citizens older than 70, retirement of bonds by owners of blocks of flats and sale of bonds for shares from the portfolio of the NPF. The result of these actions was that privatisation continued via direct sales, usually management or employee buy-outs. Typically, the purchaser agreed the sale price of a company with the NPF, with 10–20 per cent down payment and the remaining amount being paid in instalments. Also, a certain amount was agreed that would be used as re-investment into the company, which was allowed

for tax relief according the income tax amendment passed in early 1996. By March 1996 about 600 proposals with a total value of SKK136 billion (US$4.5 billion) were submitted to the NPF which had been two-thirds privatised by the end of 1996 (NPF, 2002).

In relation to "strategic enterprises", a further nine companies were added to the list that could not be privatised and five other companies have been partially privatised but could not be further privatised. The state would retain control either via holding more than one-third of the shares or via a "golden share" which would enjoy special voting rights. This "golden share" concept was however declared unconstitutional by the Constitutional Court on the basis that it violated the rights of other shareholders. In 1997, the three largest state-owned banks and one main insurance company were added to the list of strategic enterprises[38]. These measures were undertaken by the ruling government of PM Vladimir Meciar to strengthen the grip on the Slovak economy and Slovak banking.

Privatisation continued via direct sales, mostly via management buy-outs, where the terms of the sale were in the vast majority of the cases favourable for buyers (Úrad vlády SR, 2006). The favourable terms meant that the real price that had to be paid onto the NPF account was well below 40 per cent of the book value of the assets as a large portion of the total price (which rarely exceeded 40 per cent) was assigned against future investments into the company used as offset payments. Also, most down payments were financed via state-owned banks that suggested that government influence may have played a part. This style of privatisation was heavily criticised for lack of transparency and rightly so. While a number of companies were set aside as strategic enterprises not due to be privatised, certain portions of selected companies were sold to designated people, usually management or people put forward by members

[38] The privatisation of financial institutions was indeed one of the most politicised issues in Slovakia. After the return of the PM Mečiar to government in 1995 he shocked international observers as well as local institutions (like NBS) with the announcement that the financial sector should be privatised by the middle of February that year (BBC Monitoring Service, 1996). Rumours started circulating about the sale of the largest state-owned banks to domestic industrial firms (often debtors of the specific banks). Slovenská sporiteľňa was supposed to be privatised by VSŽ (Východoslovenské železiarne – later US Steel) and VUB would be sold to Slovnaft (refinery). The only reason that this plan fell through seemed to be the disagreements among the government coalition parties concerning who would get what.

of the ruling political parties. Such moves seemed to significantly reduce the interest of foreign investors. Although the pace of privatisation was high in 1996, in the first half of 1997 the NPF released only 26 decisions and assets of over US$1 billion remained to be privatised. The restriction on privatisation of the three largest banks expired in March 1997 and it was then decided that the banks could be privatised. The government also started considering actively encouraging FDI, mostly via tax incentives. It was perceived that many managers-turned-owners were willing to sell all or part of their share to foreigners. This step would have meant a "third wave" of privatisation with the chance of strengthening corporate governance and strategy and further supporting the restructuring of the economy. However, proceedings in the transparency of privatisation and low capital markets regulation distracted any potential foreign investors.

During the period between 1995 and 1998 a total of SKK109.2 billion of property in book value (SOE and shares of joint-stock-companies) was sold by standard methods (NPF, 2002). Purchase prices however formed only SKK30.7 billion (without investments), i.e. 28 per cent. With respect to agreed instalments, the NPF received only SKK19.7 billion by the end of 1998, i.e. 18 per cent of the book value of the property sold (SKK19.7 billion includes payments in NPF bonds to a total of SKK7.8 billion) (Gyárfášová, 2004). The real revenue from the second wave of privatisation thus represents close to SKK12 billion. The ratio of the purchase price to book value of privatised property was constantly dropping. While it was 35 per cent in 1995, in 1998 the ration came to only 23 per cent. As mentioned earlier, the majority of banks financed buyers' down-payments for the NPF, as few privatisers had enough financial resources themselves. Consequently, any failure to fulfil obligations towards the NPF had been also born in many cases by state-owned banks hence increasing classified loans in banks' portfolios. The question remains to what extent it was the result of poor credit risk scoring procedures and to what extent it was the result of state or lobby groups' pressures.

4.3 The political situation and its influence on the Slovak economy

Since the formation of the Slovak Republic in January 1993, the country has moved rapidly from a centrally-planned to a modern market-orientated economy. However, the process of reform slowed between 1994 and 1998 under Vladimir Mečiar's government who built up large public debt as well as a large trade deficit. Any recorded growth under Mečiar was attributable to high government spending and over-borrowing and not to increased economic activity. In fact, Slovakia was initially left out of the list of countries considered for membership of the EU because of lack of democracy, state control of media and dubious methods of privatisation. Also, numerous economic problems were identified, such as the support for non-market mechanisms in price setting and resource allocation, irregularities in economic restructuring (especially in the financial sector), slow progress in implementation of the bankruptcy law, restrictions on market competition and a non-transparent evolution of economic relations (Mikloš, 1997). The opposition to such a rule could have been expected from the business leaders. However, any such antagonism was restricted after "crony capitalism" took hold in Slovakia as many business leaders owed their "success" to the government. Any open opposition to the Mečiar regime threatened the existence of their income. The revitalisation law enacted by the government in July 1997 granted government the power to selectively cancel the debts of enterprises, which was a strong anti-free-market measure. The whole process was controlled by civil servants and by the presidents of banks under the state's control. The effects were far reaching. Furthermore, the unproductive bankruptcy system was ineffective even before the passage of this law and led to preferential treatment of a small group of the most influential enterprises to the detriment of small entrepreneurs and taxpayers. This law was criticised by EU Commission because of lack of supervisory and monitoring authority and transparency.

However the political and economic landscape was transformed with the victory of Mikuláš Dzurinda in the 1998 election. Dzurinda introduced large-scale economic and structural reforms, recognising instability and the unsustainability of the economic situation. Among the key objectives of the new economic policy was a substantial reduction in the fiscal deficit, an increase in regulated prices towards international levels, and an acceleration of the restructuring of state-owned banks and enterprises (OECD, 1999). Bank recapitalisation and privatisation was top of the agenda for the

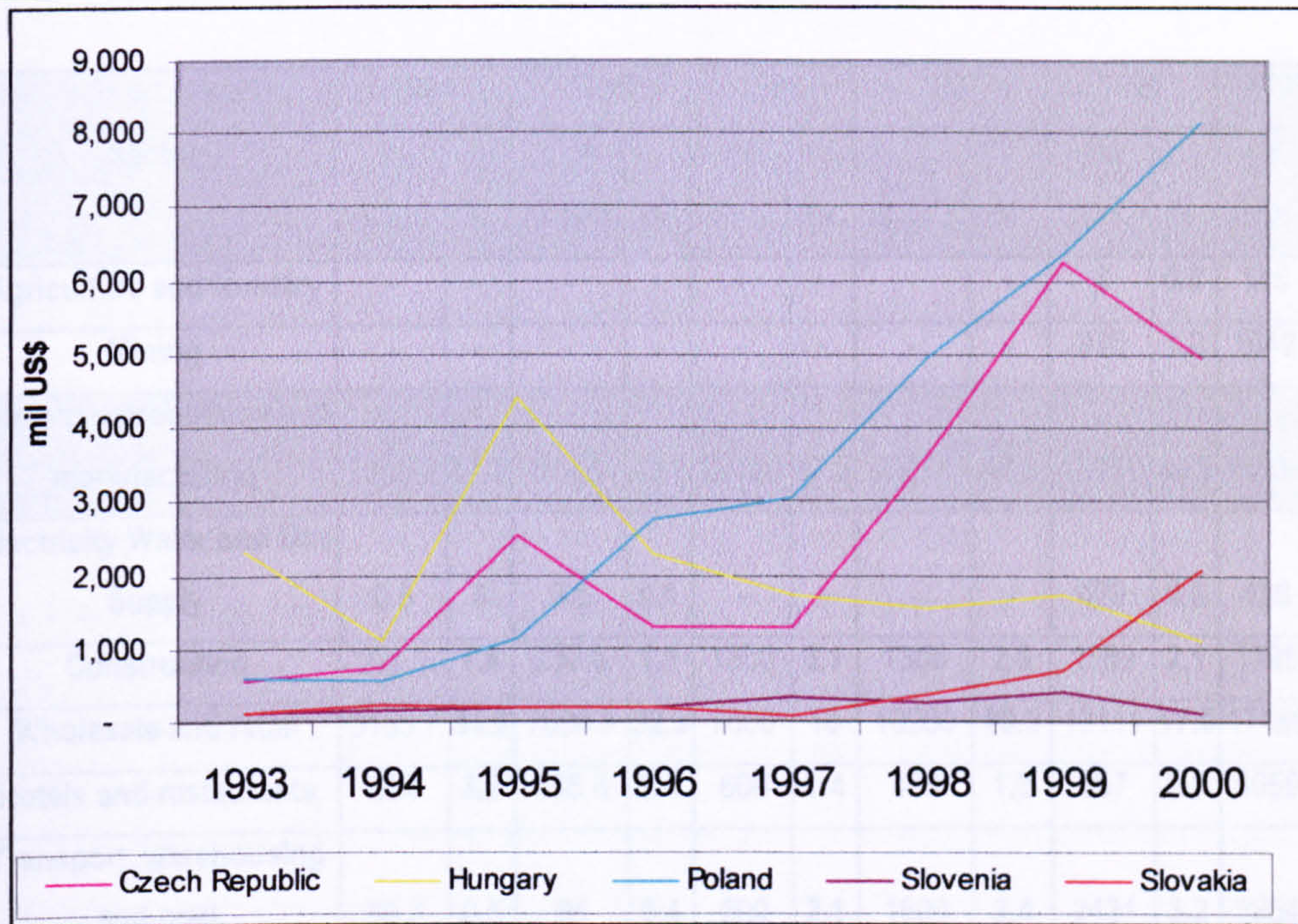
new government. Attracting foreign direct investment to aid this process was regarded as one of the major components of the restructuring.

4.4 Foreign direct investments in Slovakia

Slovakia has assets that can attract foreign investors. The fairly well-developed industrial base focused more on heavy industries, the high level of technical skill in the workforce (which is still cheaper than in other Central European countries) and the advantageous geographical position in the heart of Central Europe. Foreign investments were showing positive dynamics in the first two years of existence growing at a rate of over 100 per cent per annum. The trend slowed down, however, due to changes in government and cancelling the privatisation, which was perceived as an enormous setback for the process of transformation. Apart from political instability, foreign investors voiced numerous other obstacles as hampering attractiveness of Slovakia for FDI (Hošková, 1996) such as: unclear, vague and frequently-changing legislation regulating foreign investments; unresolved ownership rights; an unclear foreign investments stimulation system; a banking system that still did not work properly; insufficient infrastructure; underdeveloped information systems, accounting practices, etc.

As suggested, the levels of net FDI inflows support the view that the current account balance was unsustainable. Net FDI inflows thus registered a dismal US$84 million, 6.6 per cent of the net FDI of the Czech Republic in 1997. Abolition of the second wave of privatisation and declaring several areas of the economy as strategic industries, thus not assigned for privatisation, hampered the prospects of Slovakia as the preferred destination for investment of any kind. Hence in order to catch up with other Central European countries, the new government in 1999 recognised the need for introducing a business-friendly legal framework, a restructured industrial sector, more flexible labour markets, and rigorous financial sector reform (The Slovak Embassy in London, 2002).

Figure 4-1 - Foreign direct investment net inflows (1993 – 2000)



Source: OECD (1996, 2000, 2001), World Bank (2000), EBRD (1993-2000), Author's own calculations

Examining distribution of FDI among sectors of the economy, reveals a significant pattern that suggests banking and insurance became quite attractive for foreign investors after 1996, as portrayed in Figure 4-6. Given the fact that banking was perceived as underdeveloped until 1995 (Hošková, 1996), foreign investors assessed banking as a promising area for investment after the initial wave of failures of small local (Central European – especially Czech) commercial banks. The efforts of the National Bank of Slovakia in establishing a functioning and well-regulated banking system seemed to bear fruit and finance and insurance subsequently became the second largest recipient of FDI. Nonetheless, the initial leap in FDI stock in 1996 was caused by Austrian investment in retail banking – Tatra Banka. Share of FDI in finance kept its second highest position from 1996 with declining share as wholesale and retail kept regaining its share mostly due to the influx of large supermarket retail chains such as the UK's Tesco, the Dutch Ahold or the German Metro. Nonetheless, FDI in finance contributed substantially to the balance of payments and capital formation especially in the years of scarce external sources of finance.

Table 4-6 - FDI stock by economic sectors (1994 – 2000)

Sector	1994		1995		1996		1997		1998		1999		2000	
	mil SKK	%	mil SKK	%	mil SKK	%	mil SKK	%	mil SKK	%	mil SKK	%	mil SKK	%
Agriculture and forestry	-	-	-	-	-	-	-	-	3	0.0	146	0.2	145	0.1
Mining	-	-	-	-	-	-	-	-	910	1.2	1042	1.1	1939	1.2
Industrial production and manufacturing	7809.2	47.2	9546	43.7	20100	47.5	23501	44.6	38159	49.5	46034	49.5	88597	53.5
Electricity Water and Gas Supply	0.5	0	0.5	0.1	-	-	-	-	429	0.6	426	0.5	434	0.3
Construction	227.1	1.4	237.6	1.1	1300	3.1	1300	2.5	1589	2.1	1788	1.9	1658	1.0
Wholesale and retail	5155.7	31.2	7090.7	32.3	7600	18	10200	19.3	13111	17.0	17466	18.8	20632	12.5
Hotels and restaurants	534	3.2	535.6	2.4	600	1.4	400	1.3	667	0.9	1059	1.1	1125	0.7
Transport, warehousing and post	80.3	0.5	85	0.4	900	2.1	1800	3.4	2431	3.2	2854	3.1	25057	15.1
Finance and Insurance	1818.1	11	3429.6	15.7	10840	25.6	13562.6	25.7	16816	21.8	17775	19.1	21562	13.0
Real estate, renting and trade services	819.5	4.9	745.3	3.4	800	1.9	1400	2.6	2531	3.3	3822	4.1	3964	2.4
Health service and social security	-	-	-	-	-	-	-	-	19	0.0	18	0.0	68	0.0
Other public and social services	98	0.6	211.4	0.9	200	0.4	300	0.6	373	0.5	517	0.6	505	0.3

Source: NBS (2003), Štatistická Ročenka (2001), Author's own calculations

While promising good potential for contributing the restructuring process in the first two years of the country's existence due to Slovakia's openness to foreign investments, change in government, slow and lax introduction of crucial laws, high international country risk and especially abolishing the set path of privatisation discouraged potential foreign investors. Although other countries had already switched their privatisation methods (e.g. Poland), arguably most distracting was the way privatisation continued with unclear rules, muddled management buy-outs and government-directed financing by state-owned banks. Despite these negative issues, foreign investment in banking was the second most important of all other economic sectors since 1996. Apart from direct effects on the balance of payments and economic growth, it is an interesting question as to what effects the foreign entry of banks had on forming the transitional economy's financial system.

4.5 Slovak banking sector development

The reform began in January 1990 when the monobank (State Bank of Czechoslovakia) was split into one central bank and three commercial banks[39]: Komerční banka in the Czech Republic, Vseobecná uverová banka (VUB) in Slovakia and Investiční banka with branches in both Slovakia and the Czech Republic. Also the pre-existing savings banks were detached from governance by the monobank and the pre-existing Ceskoslovenská obchodni banka – which was a foreign trade bank – together with Živnostenská banka (which operated along the same lines as the General Banking Trust in Hungary in securing foreign exchange transactions for individuals) were given the full authority to conduct their activities as freestanding banks. One specialised bank was also set up in 1991. Konsolidacná banka was established as a specialised banking institution with the purpose of taking on non-performing loans mostly inherited from the previous regime.

Two laws brought radical changes to the way the banking system operated. The Act on Banks (No. 21/1991) and the Act on the State Bank of Czecho-Slovakia[40] (No. 22/1991) introduced substantial changes in the powers of the central bank, its position relative to the government, monetary instruments, role and position of commercial banks and the whole framework of their activities on the banking markets (Preisinger and Múčková, 1996). In addition to the mentioned changes, four commercial banks were set for privatisation (Act 92/1991 Zb. on the transfer of state property to other persons) and foreign banks were allowed to enter the market. The privatisation took place in 1992 with five then state financial institutions – Komerční banka (Czech Republic), Všeobecná uverová banka (Slovak Republic), Česka sporitelna (CR), Živnostenská banka (CR) and Investiční banka (CR). The state remained owner of 40–50% of the banks but in many cases kept a "golden share" which allowed vetoing of certain

[39] In fact, the basic conception of the new banking system was laid by a Directive for introducing overall restructuring of the economic system that was enacted by the government of the Czechoslovak Socialist Republic No. 29/1988 and Directive No. 196/1988 in 1988 on issuing and credit-commercial role of banking system (Tkáčová, 2001). This suggests that the then Communist government had already planned transformation of at least parts of the economy in the face of deteriorating performance.

[40] Note the name of the country. Between 1989 and 1993 Czechoslovakia had changed its name three times. From the Czechoslovak Socialist Republic into the Czecho-Slovak Republic. Then the Czecho-Slovak Federative Republic and finally the Czech and Slovak Federative Republic before splitting into two sovereign countries in 1993.

decisions by the board of directors. About 3% of the shares were set for restitutions and the rest were set for voucher privatisation, the results of which were discussed earlier. The common feature of the banks was the unstable conditions of the transforming economy, insufficient and unskilled human resources, inadequate technical equipment and hardware infrastructure (Tkáčová, 2001). Furthermore, domestic banks were strongly under-capitalised where the Cooke's capital-assets ratio (bank capital to risk weighed assets) was only 1.72% as opposed to the recommended 8%. However, major change was just around the corner when the country split into two separate entities with two separate banking systems.

Hence the cornerstone of establishing the National Bank of Slovakia (NBS) was laid on January 1, 1993 (Act of the National Council of the Slovak Republic No.566/1992 Zb)[41]. Additionally, two specialised institutions were also created: Konsolidačná banka Bratislava (KBB) and Slovenská záručná banka (SZB). One other bank was already created one year before the break-up of the country when Investičná banka (Investment bank) was divided in two and the Slovakian entity received the name Investičná a Rozvojová Banka (Investment and Development Bank – IRB). This bank took on the long-term enterprise credit from the SBCS. Konsolidačná banka took over Kcs125 billion (US$4.2 bn) of bad and doubtful debt from other state-owned banks, a figure which in 1991 was equivalent to one-quarter of domestic credit liabilities. Finance came from the state bank and other banks at low interest rates (Brom and Orenstein, 1994). Apart from The National Bank of Slovakia Act No.566/1992, new Banking Act No. 21/1992, the Building Savings Act (No. 310/1992), the Act on Securities (No. 600/1992), the Act on Investment Funds and Investment Societies and the Stock Exchange Act (No. 214/1992). The Foreign Exchange Act (No. 528.1990), the Act on Bonds (530/1990) and the Accounting Act (No. 563/1991) introduced under the Czecho-Slovak Federative Republic were left in validity. Further amendments were made to a number of the mentioned legal rules, especially to the Foreign Exchange Act (of 1995) and the Banking Act in 1996. Moreover, a new Act on Deposit Insurance was enacted in 1996. The banking act established the minimum requirements for either a

[41] NBS has the right to issue legally binding rules and regulations that have the same validity as those issued by Ministries and other state executive bodies. NBS determines monetary policy and use of instruments for achieving the monetary targets. The main priority of NBS as an independent central bank is to maintain stability of the Slovak currency and to keep inflation under control. Secondly, NBS ensures a healthy development of the Slovak banking sector.

domestic or foreign entity wishing to establish a bank. A number of criteria are assessed, including minimum equity capital set to SKK500 million and form of Joint Stock Company. There was no different treatment of foreign bank entry from domestic banks. The Act also governs banking operations and conditions under which NBS may revoke banking licences.

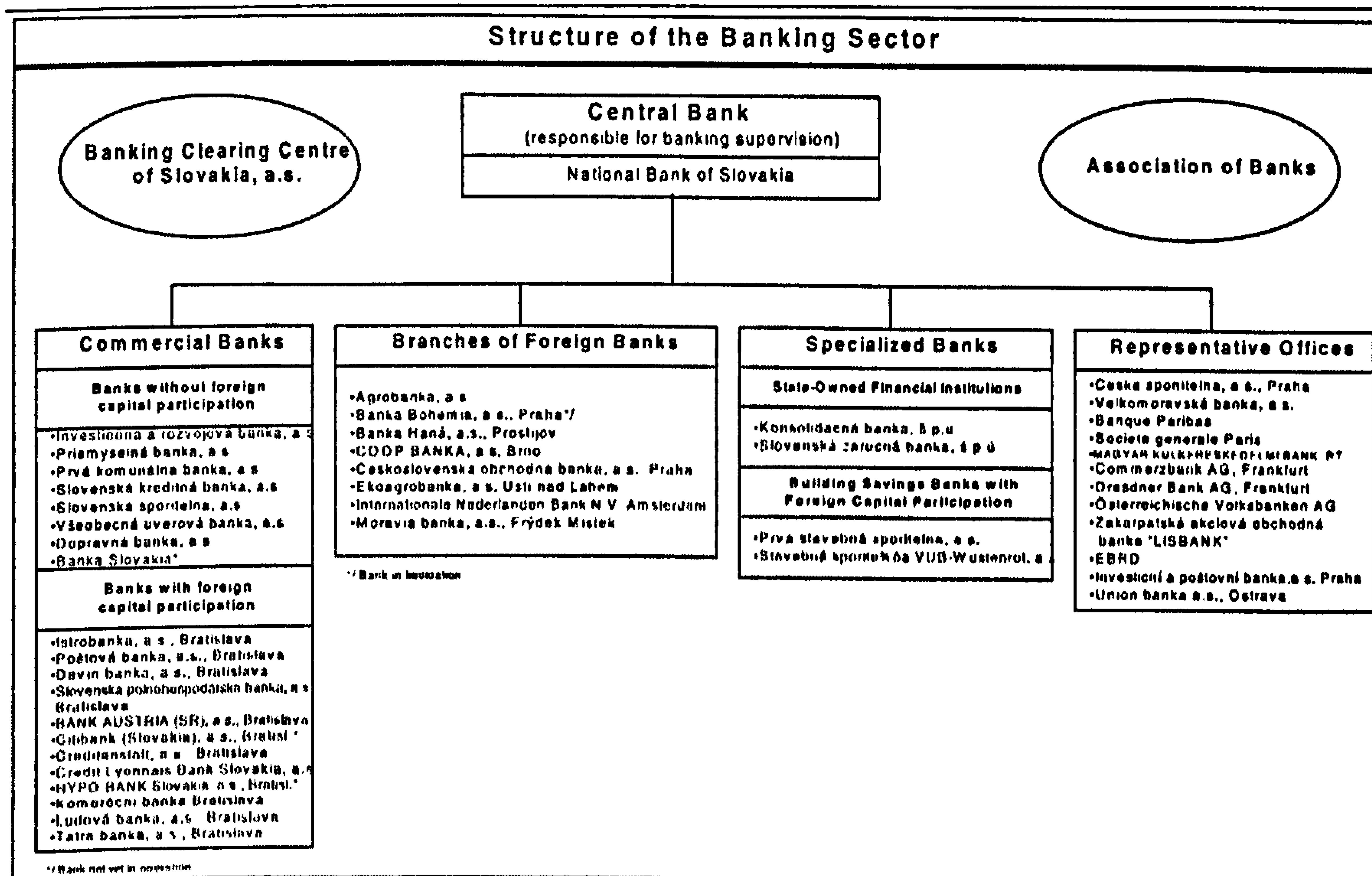
The growth in number of banks in Slovakia was much smaller than in the case of the Czech Republic, not so much due to better regulation but to the process of decentralisation of the government. Nonetheless, there were 18 commercial banks registered by 31 December 1993, of which three were state banks. Of the foreign banks, nine had headquarters in the Czech Republic and one in Holland. The banking market kept developing and following the liberalisation of entry rules the number of commercial banks increased further.

On 1 January 1996 there were 33 commercial banks functioning on the Slovak market. Despite this development, which should suggest increased competition, the market was dominated by the three state-owned giants (all products of the State Bank of Czechoslovakia). Altogether, Všeobecná úverová banka (VUB), Slovenská sporiteľňa (SLSP) and Investičná a rozvojová banka (IRB) held over 60% of banking assets and there was a similar situation in respect to deposit and loan portfolios. VUB inherited from the beginning loan portfolios and a relationship with commerce and industry[42]. IRB's main task was investment banking and as a main creditor to heavy industry. Slovenská sporiteľňa had the dominant position on the retail savings market[43] with over 700 branch offices all over the country and over 50% of deposits in 1993 (World Bank, 1994). A large portfolio of available liabilities in the form of deposits made SLSP also the largest lender on the inter-bank market. Two institutions were also present: the Banking Clearing Centre, responsible for processing of inter-bank payments and settlements and the operation of the banking information systems; and the Association of Banks, with the mission to represent the members of the Association in front the sate administration as well as to deal with current matters. In 1997 another institution joined the banking scene in Slovakia. The state-owned Eximbanka (Exportno-importná banka

[42] VUB was rated as the sixth largest bank in Eastern Europe according to *Central European Economic Review* at the end of 1993, see CEER (1994)

Slovenskej republiky) was established by Act No. 80/1997. The main objective of the institution was to support the maximum volume of export of sophisticated production, especially to the European Union and OECD countries, as well as to developing countries, while ensuring a return on investment through the minimization of risks arising from insurance, credit, guarantee, and finance activities. Eximbanka focuses on enterprises with an annual revenue of less than SKK600 million providing export financing and guarantees as well as special-purpose refinancing loans for commercial banks in order to provide credits to Slovak companies engaging in export. Although it had difficult beginnings, the bank proceeded to become rather successful, growing 19 per cent in total assets between 1999 and 2000. Eximbanka is not included in the analysis, however, due to the very limited focus of operation, as well as insufficient data.

Figure 4-2 – Structure of the Slovak Banking Sector at the end of 1996



Source: Komínková and Múčková (1997)

Newly arrived foreign banks had a long way to go before posing any serious competition to the large domestic banks. Out of all foreign branches, Czech foreign branch of Československá obchodná banka held the largest assets (many of them

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[43] Slovenská sporiteľňa was the only bank that could take savings and issue consumer loans to the public before 1989.

inherited from the past). Tatra Banka has become one of the most serious competitors for domestic banks since 1996, as well as Poľnobanka which was another commercial bank quickly establishing a foothold with a growing branch network.

Table 4-7 – Ten Largest Banks in 2000, 1996 and 1993 (according to total assets)

		Total Assets					
Bank	Ownership	Ranking	2000	Ranking	1996	Ranking	1993
Slovenská sporiteľňa	Domestic	1	190.836	2	172.856	2	132.364
Všeobecná úverová banka	Domestic	2	173.020	1	178.794	1	134.362
Tatra Banka	Foreign	3	78.366	5	32.440	7	4.907
Československá obchodná banka	Foreign	4	52.273	4	51.828	5	27.722
Prvá stavebná sporiteľňa	Foreign	5	42.738	-	-	14	1.520
Poľnobanka	Foreign	6	34.559	6	29.679	6	12.093
ING Bank	Foreign	7	29.365	10	13.333	-	-
Investičná a rozvojová banka	Domestic	8	27.389	3	52.456	3	44.459
Istrobanka	Foreign	9	27.365	7	21.110	12	1.981
Ľudová banka	Foreign	10	26.833	12	11.632	10	2.470

Source: NBS (2003), Author's own calculations from banks' annual reports

Obviously, the oligopolistic nature of the Slovak banking market was a major problem, but it was nonetheless not the only one. Heavy undercapitalisation of domestic banks was hampering their future expansion. Furthermore, the dismal credit portfolios, the dual role as firm creditors and owners (a result of voucher privatisation where the largest investment funds were owned by banks) and the largest banks' continuous state ownership was hampering the restructuring process (Olsson, 1999).

The major problem with undercapitalisation was the fact that all of the large state banks inherited large portfolios of debt from the period before 1989. All their resources being

drained for fulfilling the goals of transition while keeping the economy running meant that there were very little, if any, internal resources left to cope with the amounts of non-performing revolving loans. Certainly, the fact that the banks were all learning-by-doing resulted in many loans extended to the business sector on the basis of weak credit rationing principles. Moreover, the central bank pressed on with the introduction of stringent capital adequacy ratios of 8% by 1 January 1997[44] which further hampered any mobilisation of banks' resources to work out the bad loans. Further increase in new bad debt suggested that banks lacked the tools or access to information for sound credit scrutiny of their clients. The relationships of banks with their clients is another issue worth exploring[45]. The fact that voucher privatisation gave birth to large investment funds owned by banks resulted in banks' indirect ownership of their debtors. Moreover, banks often abused this situation by tying the clients in at non-market conditions. Restricted access to long-term finance for firms further hampered any restructuring or development of other sources of finance.

4.6 Banking and the capital markets

A country's financial system and more importantly its design and performance is one of the most important issues in relation to economic growth, sustainable development and stability as discussed in Chapter 1. Well-performing and efficient financial systems in terms of effective resource allocation and functioning transactions thus condition the economic development of a country. The relationship between banks and non-financial institutions operating in financial markets is the key agenda for design of financial systems of TEs. The main question is whether banks should own or control industrial companies or whether industrial companies should own or control banks (see Walter, 1997). While several models of financial system structure were developed (see Walter, 1993), the two main systems addressing this issue are the equity-market system and the bank-based system. The former being usually exemplified by the USA and UK, and the latter by Germany.

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[44] Laws and regulation were also being formed on the fly as well as re-classification of non-performing loans and provision requirements.
[45] Large credit exposure was limited from 1994 by NBS Provision No. 3/1994 which limits the net credit exposure to a client or economically linked group of clients to a maximum of 25 percent of the bank's capital and 80 per cent for non-bank clients. The total amount of net credit

Under the Anglo-American approach, the major source of external financing for firms is the capital market, while banks provide short-term financing of firms. Shares of corporations (and banks) are held by the public and are actively traded, thus providing a high level of transparency and public control. This equity-market based system is based on the notion that managers act in the interests of shareholders. Supporters of such a system claim that financial systems freely allocating savings to the most efficient users of capital rather than politically-determined investments maximise returns for savers, and they further argue that this system is most compatible with democracy as a system of limited government. On the other hand, the German approach depends on a close bank-client relationship where banks are the main equity shareholders and combined with their role as creditors in corporations banks exert a fundamental control over companies. Equity markets under such systems consequently tend to be underdeveloped and the public prefers less risky investment vehicles. However, one of the most important components of such systems is trust, or as Walter (1997) explains: 'As the bank-based system personalises many of the market functions performed by impersonal capital markets, trust is an essential ingredient of relations among its insider elites'.

In the case of Slovakia, the financial system can be described as bank-based and financial markets and institutions together with legal infrastructure are organised in a similar way to the so-called German model, however, with one crucial characteristic missing. Voucher privatisation, at least its first round, distributed the shares among the citizens; however these were quickly bought up by investment funds, in the majority set up by banks. However, regulations restricted majority ownership of companies held by investment funds or banks. Therefore, although banks were the major source of privatisation funding, this happened mostly via loans and effective corporate control was limited. On the other hand, banks often benefited from good knowledge of privatised companies where management often pursued management buy-outs financed by banks. Close bank-client relationships existed; nonetheless, monitoring and client-credit evaluation techniques had only just been introduced leaving the burden of control and credit decision-making on bank branch managers. It would be interesting to investigate how foreign banks affected these processes in domestic banks.

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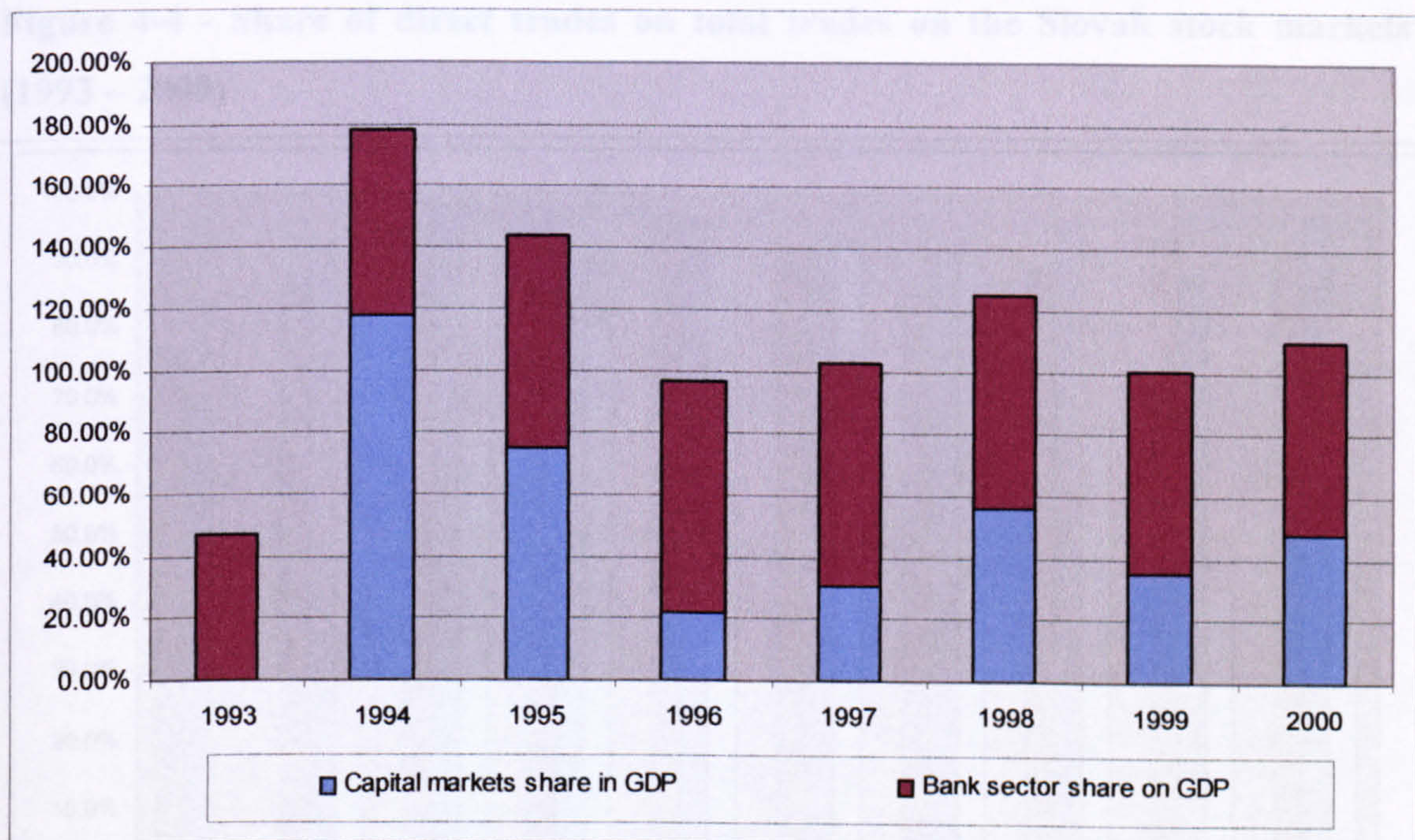
exposure over and above 15 per cent of the bank's capital must not exceed 800 per cent of the

One way of establishing whether the Slovak financial system can be defined as equity-market based or bank-based is through analysing financial markets' ratio of GDP. Measuring bank credit over GDP and total value traded on the stock exchange over GDP determines whether the Slovakian financial market can be regarded as equity-market-based or bank-based. It can be seen from the graph below that Slovakia's financial system is described as bank-based with bank credit reaching an average 65 per cent of GDP as compared to 48 per cent of capital markets. However, 1994 and 1995 are dominated by securities trading as shares from the first round of privatisation continued to be traded on the stock exchange in anticipation of the more important second round. With a change in the privatisation method in 1995, capital markets had begun to play only the insignificant role of ownership transfer settlement vehicle.

Figure 4-3 - Financial markets sector share on GDP in the Slovak Republic (1993 – 2000)



Source: National Bank of Slovakia, (2003); Bratislava Stock Exchange Fact Book (2004), Author's own calculations

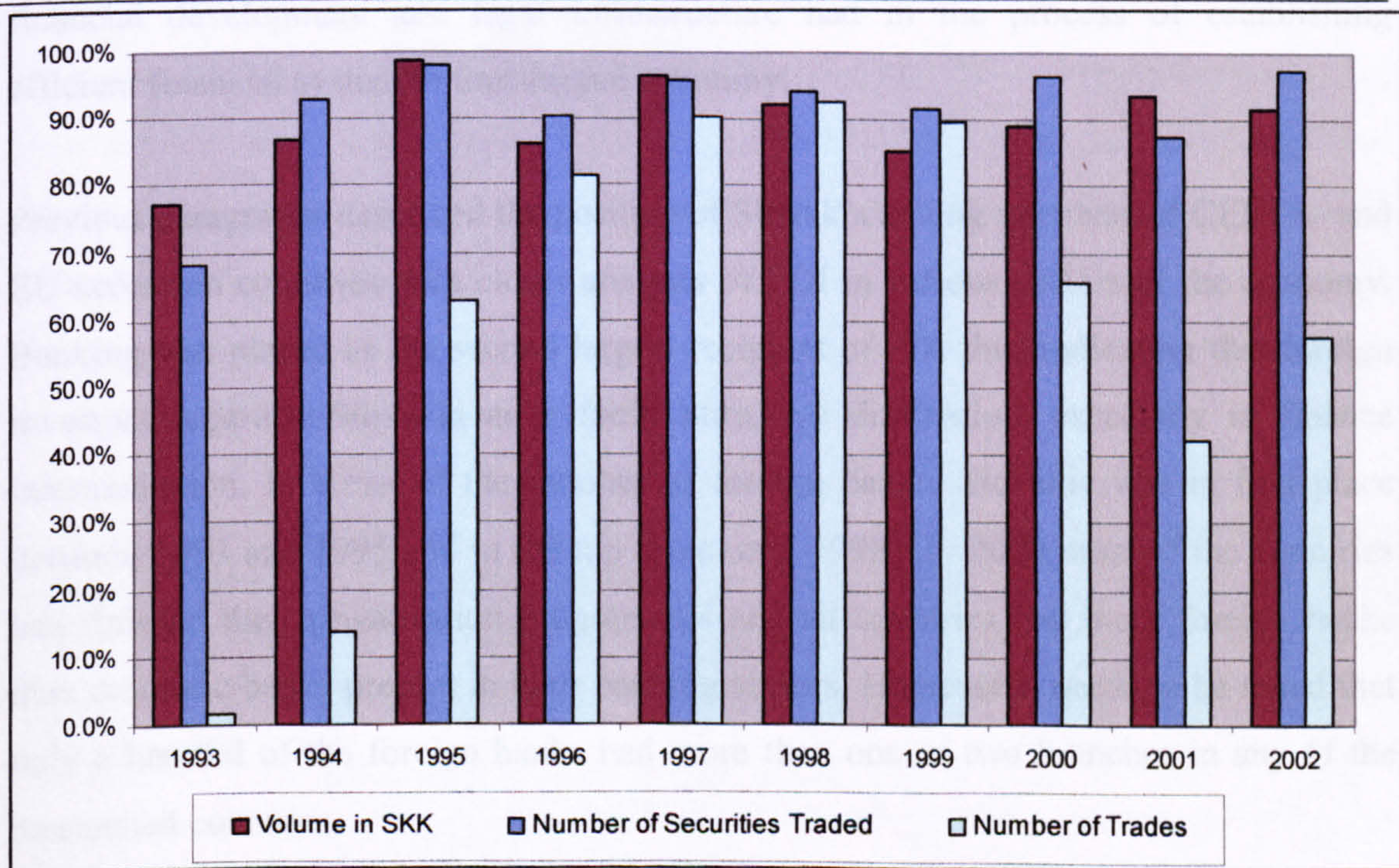
Notes: Capital markets ratio is measured as value of trades performed on the stock exchange. Bank sector ratio is calculated as value of bank credit provided to the economy.

It may seem that capital markets had a fairly large share of the whole financial sector of Slovakia. However, one important issue needs to be clarified, which is the structure and

bank's capital.

quality of trades performed on the stock exchange. Examining historical data of trades on Bratislava Stock Exchange (BCPB) – the main market for securities trading – it is quite striking that the vast majority of trades after 1995 in terms of volume and value are direct trades (Bratislava Stock Exchange, 2004). Direct trades are trades which are pre-arranged and volume and price are agreed beforehand between the seller and the buyer who know each other. Thus no effective market mechanisms are present and no other market players are allowed into the trade with their bids. Market mechanisms are then effectively removed from the stock exchange functioning, and financing of industry via stock markets is non-existent. In relation to number of trades, which better shows activity of stock traders (including private persons), it is quite clear that after the Government's decision to abolish the second wave of privatisation that was based on the voucher method, capital markets became the only means for executing pre-arranged trades and lost their function as another source of finance for the economy.

Figure 4-4 - Share of direct trades on total trades on the Slovak stock markets (1993 – 2000)



Source: Bratislava Stock Exchange Fact Book (2004), Author's own calculations

Notes: Share of BCPB trades on the total volume of trades (including over-the-counter market) is following: 1995 – 69.1%, 1996 – 81.1%, 1997 - 91.1%, 1998 – 97.8%, 1999 – 97.4%, 2000 – 87.4%.

Many financial economists in the past 100 years discussed the potential relevance of bank-based versus market-based systems for economic expansion of developed and developing countries. Numerous arguments in favour of one or the other option were voiced, arguments supporting the role of banks especially in underdeveloped economies (e.g. Gerschenkron, 1962), while others point out that markets support innovation, research and development in industry (Allen, 1993)[46]. However, Beck and Levine (2002) provide evidence that neither the market-based nor the bank-based system is more essential for industry growth and capital allocation. More important emerges the view on connection between financial services and law. Thus the level of financial development in conjunction with the efficient legal system (especially effective contract enforcement) is a determinant for establishing new enterprises and efficient capital allocation. No support was found for the bank-based or the market-based theory; instead suggestions for policy makers to focus on legal reforms that foster the development of financial intermediaries and markets were made. In the case of Slovakia, the fact that industry and the economy as a whole was left to rely on bank finance since capital markets were hugely neglected stresses the importance of an efficient and well-regulated banking system. It would be interesting, nevertheless, to find out what role the financial development and legal infrastructure had in the process of establishing efficient financial system in transitional economy.

Previous paragraphs described the position of Slovakia among members of CEFTA- and EU-accession countries with closer analysis of FDI in various sectors of the economy. Banking was placed as the second largest recipient of FDI thus indicating that foreign investors regarded Slovakia as a fairly attractive destination, especially in finance intermediation. In terms of the number of foreign banks, Slovakia was in first place between 1993 and 1995 and in the top three until 1998. By 2000 most of the countries had finished their privatisation programmes and all countries had more foreign banks than domestic banks present in their banking sectors. However it needs to be noted that only a handful of the foreign banks had more than one or two branches in any of the researched countries.

[46] For detailed discussion of the market-based and the bank-based system, see Beck and Levine

Table 4-8 - Number of banks (1993-2000)

Total number of banks (of which foreign owned)	Unit	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	#	52 (18)	55 (21)	55 (23)	53 (23)	50 (24)	45 (25)	42 (27)	40 (26)
Hungary	#	40 (16)	43 (18)	43 (21)	42 (24)	45 (30)	44 (28)	43 (29)	42 (33)
Poland	#	87 (10)	82 (11)	81 (18)	81 (25)	83 (29)	83 (31)	77 (39)	74 (47)
Slovenia	#	45 (5)	44 (6)	39 (6)	36 (4)	34 (4)	30 (3)	31 (5)	28 (6)
Slovakia	#	28 (13)	29 (14)	33 (18)	29 (14)	29 (13)	27 (11)	25 (10)	23 (13)

Source: EBRD Transition Report (2002)

More important is the share of state-owned banks on total assets as depicted in the table below. Slovakia had the second largest asset share of SOBs until 1997 taking over in 1998 and keeping the share of SOBs at about 50 per cent until 2000. Quite striking is the difference between the Czech and Slovak Republic where the Czech Republic's SOB share on bank assets was increasing up to over 28 per cent in 2000 but compared to Slovakia, was generally less than half. The main reason is the exclusion of the three largest and state-owned banks from any privatisation until 1997 by government decision. After 1997, one of the excluded banks, the Investment and Development Bank went into liquidation being effectively tunnelled by one of its largest creditors that became a shareholder as a result of a loop in legislation and political influence. State-owned banks thus continued to play a most important role in facilitating financial intermediation in Slovakia.

Table 4-9 - Asset share of state owned banks (1993-2000)

Asset share of State Owned Banks	Unit	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	%	11.9	17.9	17.6	16.6	17.5	18.6	23.1	28.2
Hungary	%	76.3	61.5	49	15.3	3.5	9.8	7.8	7.7
Poland	%	86.2	80.4	71.7	69.8	51.6	48	24.9	23.9
Slovenia	%	47.8	39.8	41.7	40.7	40.1	41.3	41.7	42.2
Slovakia	%	70.7	66.9	61.2	54.2	48.7	50	50.7	49.1

Source: National bank of Hungary, Poland, Czech Republic, Slovakia Annual Reports – 1993 - 2001, OECD Economic Surveys (1996, 1999, 2000, 2001)

(2002)

Even more striking is the level of non-performing loans (NPLs) that was the highest among other CEECs since 1998 and deteriorated until 2000 when the new government stepped in as the situation on the Slovak bank market was becoming unsustainable. The level of non-performing loans reached over 44 per cent of total loans in 1998, thus crippling SOBs that had almost a 70 per cent share of the total of NPLs. The situation got so bad that the NBS stepped in and introduced a credit moratorium for the two largest banks that were also SOBs in 1998.

Table 4-10 - Non-performing loans (1993-2000)

Non-performing loans (of total)	Unit	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	%	na	na	26.6	21.8	19.9	20.3	21.5	19.3
Hungary	%	na	na	na	na	6.6	7.9	4.4	3.1
Poland	%	36.4	34	23.9	14.7	11.5	11.8	14.5	16.8
Slovenia	%	na	13.8	9.3	10.1	10	9.5	8.6	8.5
Slovakia	%	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2

Source: EBRD Transition Report (2002)

The problem of NPLs dates back to the early 1990s and is connected to sweeping social reforms and privatisation (Tkáčová, 2001). Repayments of both principal and interest on large numbers of loans arising from privatisation were frozen. Another large part of NPLs was the legacy of the socialist economy in the form of so-called Goods-Circulation-Reserve-Loans provided under centralised economy rules. However, the loans from the previous regime were not the sole problem of the banks. As Tkáčová (2001:13) points out, the causes of bad loans were: "radical changes connected with transformation of the economy, political influence, mistakes of managements and unprofessional attitude of employees as well as standard credit risk". Credit portfolios of commercial banks needed urgent restructuring. The National Bank of Slovakia initiated restructuring by introducing categorisation of receivables that was introduced by measure of the NBS no. 3/1995. The commercial banks started obligatory categorization of their loan portfolios as well as creating provisions and reserves according to required levels[47]. From 1996, the formation of reserves and provisions

[47] The categorisation is as follows (level of provisions in brackets): Standard Claims, Standard Claims with Reservation (5 per cent), Sub-standard claims (20 per cent), Doubtful and Litigious

against classified loans improved significantly and exceeded the growth of classified claims. Nonetheless, formation of reserves still has not ensured that the three largest state-owned banks: VUB, IRB, SLSP and the specialised bank Konsolidačná banka achieved the capital adequacy ratio set by the NBS. Significant growth of classified claims continued in 1997 and into the first half of 1998 as a result of the government's failure to effectively restructure state-owned banks and the enterprise sector. Hence classified claims (including loss generating loans) grew faster than the creation of provisions and reserves against them. During 1998 classified claims grew by SKK25 billion to a total of SKK145.1 billion. The negative trend continued in the first half of 1999 at a faster rate and by 30 June 1999 the amount of classified claims grew further to SKK165.7 billion (Tencer, 1999).

Table 4-11 – Structure of loan portfolios of commercial banks (1996 – 2000)

(total loans = 100)		Unit	1996	1997	1998	1999	2000
Standard loans total		%	41.5	49.3	49.8	46.3	65.1
Of which:	short-term	%	17.9	22.7	23.5	19.2	25.6
	medium-term	%	8.8	13.9	13.5	14.1	29.6
	long-term	%	14.8	12.7	12.8	13	9.9
Non-performing claims total		%	58.5	50.7	50.2	53.7	34.9
Of which:	standard loans with reservation	%	13.1	19.4	14.7	11.3	10.4
	classified claims	%	45.4	31.3	35.5	42.4	24.5

Notes: without government sector, values in 1996 – 1999 as of 30.11. each year, values for 2000 as of 30.6.2000

Source: NBS Annual Reports (1993-2001), Hlavatý (2001), Author's own calculations

The problem of NPLs was most significant in the three largest and commercial state-owned banks. The share of thee three banks of total NPLs reached 68.58 per cent at the beginning of 1998.

Claims (50 per cent), Loss Claims (100 per cent), see Komínková and Múčková (1997), Pleška (2004), NBS various sources

Table 4-12 - Classified loans in three largest state-owned-banks (1993-2000)

SKK mil.	VUB, as	IRB, as	SLSP, as
1993	16,156.4	4,447.3	3,050.5
1994	33,594.9	6,328.9	13,635.1
1995	39,394.0	n/a	n/a
1996	34,152.9	n/a	n/a
1997	35,316.5	n/a	n/a
1998	42,606.1	7,449.4	22,863.7
1999	21,671.2	2,452.5	8,354.1
2000	9,707.3	174.7	1,858.4

Source: NBS Statistics as in Tkáčová (2001)

Notes: n/a – data were not available; In 1998, 1999 and 2000, classified loans are shown net of provisions

Another important issue was compliance of commercial banks with quality criteria set by the regulator – The National Bank of Slovakia. Following International Banking Standards set by the Bank for International Settlement, NBS set the capital adequacy ratio[48] (ratio of the capital to the risk weighed assets and off-balance sheet items) to 6.75 per cent in 1993 (Tkáčová, 2001). All banks managed to achieve the set ratio. However, revised assessment methodology was introduced on 31 January 1994 and only banks established earlier than 1991 were required to attain 6.75 per cent; banks established after 31 December 1991 had to reach 8 per cent capital adequacy ratio. In 1995 all banks reached 8 per cent except three SOBs that were undergoing restructuring (VUB, IRB and SLSP) and reached 7.25 per cent (Tkáčová, 2001). The situation further deteriorated in 1996 when the average for three SOBs came to a alarming 5.40 per cent. Nevertheless, the Slovak Savings Bank (SLSP) over-performed the ratio reaching 8.30 per cent (Tkáčová, 2001). The decline was assigned to expanding business (mainly provision of loans). The NBS set the capital adequacy ratio to 8 per cent for all banks without exception. Again, four banks defaulted (the above described SOBs and Konsolidacna banka (as a SOB – the bad loan graveyard). NBS demanded restructuring projects as a result of the failure in order for SOBs to meet 8 per cent by 1999. Financial results for 1998 recorded another decline in capital adequacy ratio fulfilment. This decline originated in slower growth of capital and increase of unsecured expected loss coupled with rising reserves for NPLs. Ten out of the 12 banks that reported net profits

[48] Provision No. 2/1994, the limit was 8 per cent with some exceptions to transforming banks.

over SKK100 million in 1999 were foreign. As IVO (1999:585) reports: "the cumulative net profit of the banks with foreign capital in 1998 was almost four billion SKK while the aggregate financial results balance of banks largely dependant on Slovak capital (excluding the three state-owned banks and Priemyselná banka) was not enough even to allow them to break even". Moreover, the differences in use of accounting standards make the financial results even more ambiguous. The Slovak banks reported total losses of SKK8 billion for 1998 using domestic standards. However, using international standards this loss would reach SKK20 billion, mainly caused by non-performing loans but also by operating losses in some cases. In June 1999 the banking sector recorded a shortage of over SKK44 billion to meet the 8 per cent capital ratio limit. The three above mentioned SOBs themselves were SKK43 billion shorter. Capital adequacy ratio served as an indicator for the NBS as to whether banks are prone to risky business rather than a reliable comparison to other countries. Despite the changing methodology, it is clear that the problem of non-performing loans should have been solved in the beginning of the transformation of the economy and stringent credit risk assessment policies should have been supported in selected domestic banks. In particular, political influence proved very harmful, with banks increasing the gap between set limit for capital adequacy and actual performance due to accumulation of loss bearing assets. Thus any profits reported were very much distorted, especially because until 1998 unpaid interest from non-performing loans was included in the profits of the three largest banks - SOBs.

4.7 Foreign capital in Slovak banking

It may be regarded as predictable that banks already present in Czechoslovakia would start establishing their presence in the newly-formed Slovak Republic as most foreign banks in former Czechoslovakia had their headquarters in Prague. At the end of the first half of 1996 there were nine branches of foreign banks although two branches had already had their banking licences revoked as a result of mother bank failures (both from the Czech Republic - COOP banka – under administration of the Czech National Bank since 24 April 1996 and Ekoagrobanka in administration since 16 January 1996[49]). Banka Moravia and Banka Hana went bankrupt later in 1998. One domestic

[49] see Matoušek and Taci (2002)

bank was acquired by one of the two biggest due to financial problems (Priemyselna banka went under Slovenska sporitelna) after running into financial difficulties in 1998 and facing conservatorship by the NBS. Also, when the two largest Austrian banks (Bank Austria and Creditanstalt) merged into one in 1997 they created a bank with a capital stock exceeding the volume of capital in the whole banking sector of the Slovak Republic (Paška, 1997) even more improving the standing of their subsidiaries in the Slovak banking sector. Further, in 2000 three domestic banks went bankrupt (Slovenská kreditná banka, AG banka and Dopravna banka) and one foreign bank experienced the same in 2001 (Devín banka).

Figure 4-5 – Foreign capital share in the Slovak bank sector (as of 1 January 1996)

	licence granted	equity cap. Subscribed SKK mill.	of which foreign in SKK mill.	in %	Origin
Banks without important foreign capital participation (below 20%)		1600.00			
Istrobanka, a.s., Bratislava	22.6.1992	1000.00	100.00	10.00	Austria
Poštová banka, a.s., Bratislava	15.12.1992	600.00	74.40	12.40	Austria
Banks with important foreign capital participation (20-50%)		2190.10			
Devín banka, a.s., Bratislava	1.6.1992	640.0	236.80	37.00	Russia
Slovenská polénohospodárska banka,	21.6.1990	1250.1	36.20	2.89	Czech Republic
a.s., Bratislava			250.00	20.00	Great Britain
Stavebná sporitel'na VÚB-Wüstenrot,	17.5.1993	300.0	90.00	30.00	Austria
a.s., Bratislava			60.00	20.00	Germany
Banks with prevailing foreign capital participation (over 50%)		4065.7			
BANK AUSTRIA (SR), a.s., Bratislava	21.4.1995	500.0	500.00	100.00	Austria
CITIBANK (SLOVAKIA), a.s., Bratislava	16.8.1995	500.0	500.00	100.00	USA
Creditanstalt, a.s., Bratislava	20.4.1994	515.5	500.00	100.00	Austria
Crédit Lyonnais Bank Slovakia, a.s.	22.2.1993	300.0	270.00	90.00	France
Komercní banka Bratislava, a.s.	21.4.1995	500.0	500.00	100.00	Czech Republic
Ludová banka, a.s., Bratislava	1.7.1991	448.0	304.20	67.90	Austria
			113.20	25.40	Italy
Prvá stavebná sporitel'na, a.s.,	1.10.1992	300.0	97.50	32.50	Germany
Bratislava			97.50	32.50	Austria
Tatra banka, a.s., Bratislava	1.10.1990	502.2	252.20	50.20	Austria
HYPO-BANK Slovakia, a.s., Bratislava	16.8.1995	500.0	500.00	100.00	Germany
Branches of foreign banks		3752.80	3752.80	100.00	

Source: Kominková and Múčková (1997)

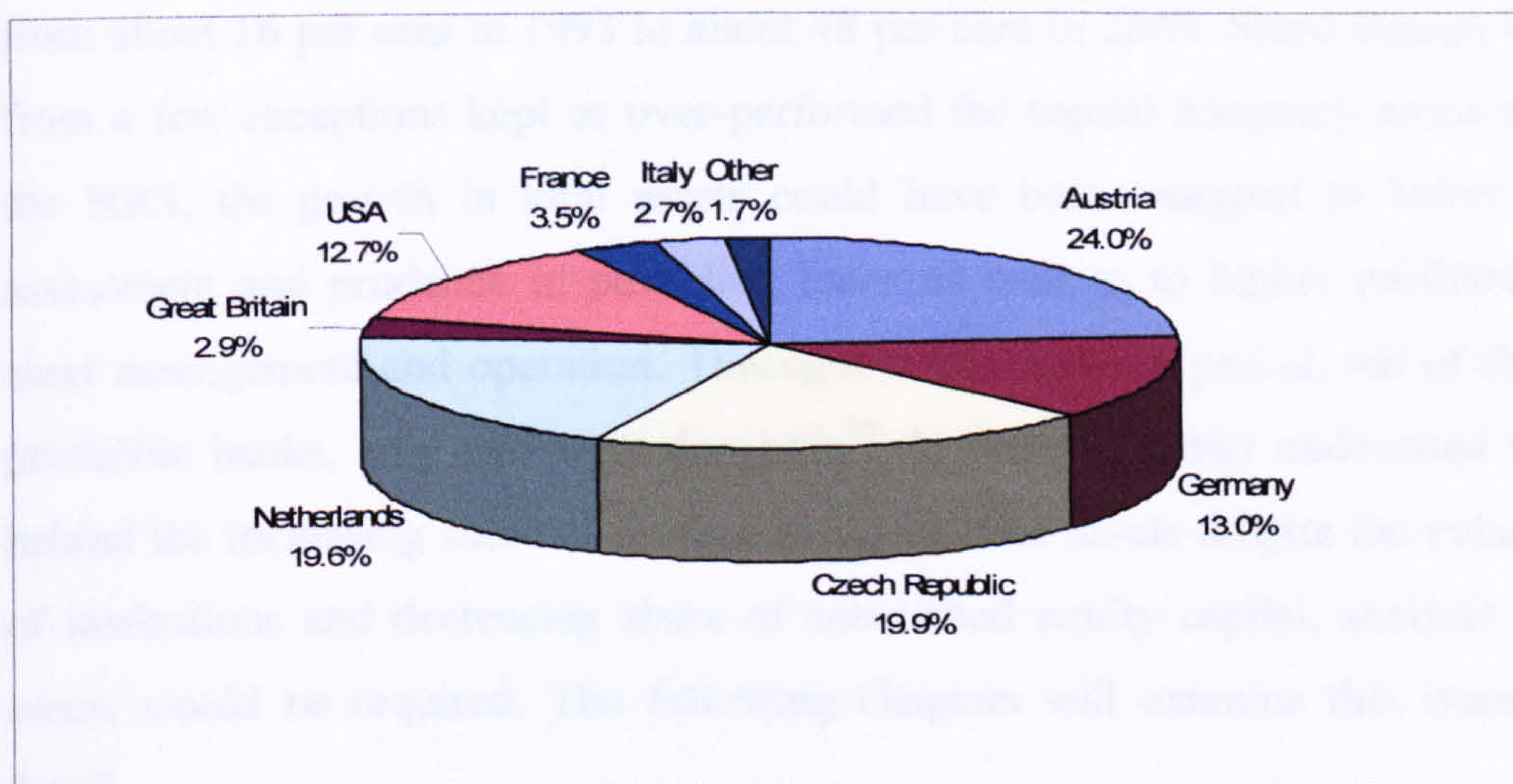
The Czech Republic was leading the way at the end of 1997 with 26 per cent, followed by Austria (22 per cent) and then The Netherlands (19 per cent). Germany came fourth (11 per cent) in the ranking of subscribed foreign capital. The situation somewhat

changed at the end of 1999 when Austria took over the leading role followed by the Czech Republic in the second place, where Československá obchodná banka – a foreign branch substantially contributed to Czech position among foreign participants in the Slovak banking sector. The Netherlands follows closely and Germany and the USA came equal at fourth place with 13 per cent. The Russian share in Devin banka is included among Others. Devín banka was shared by Russian capital with 37 percent and in July 1998 Japanese Goya Japan Co. acquired 9.72 per cent.

Foreign capital used two modes of entry into the Slovak banking sector. In the majority of cases it was setting up a bank with 100 per cent foreign ownership or at least majority stake. In the case of Tatra banka, foreign capital had over 62 per cent majority ownership in 1997 which further increased to 86.4 per cent in 1998 (after VUB sold its stake of 11.5 percent). Specialised institutions, such as building societies VUB Wustenrot and Prva Stavebna Sporitelna, were joint ventures of foreign capital and either of the two largest state-owned banks again, with majority (or at least equal) foreign ownership. Slovenská poľnohospodárska banka that started with Czech capital and an EBRD stake of 20 per cent recorded entry of two Italian investors in 1996 by Unicredito Italiano and Finest S.p.A.. (both acquired 7.5 per cent stakes) which increased its share to 62.09 per cent in November 2000. Similarly, Istrobanka has started as a banking institution set up by Slovenská poistovňa, a.s. (Slovak Insurance Company) holding 72 per cent, Bratislava city holding 18 per cent and Austrian GiroCredit Bank AG holding 10 per cent. GiroCredit Banks' share was transferred into Die Erste Bank in 1999. In 2000 Austrian BAWAG bank expressed interest in purchasing 100 per cent of Istrobanka.

The foreign participation in Slovak banking sector (see Figure 4-5 below) was dominated by the Austrian, German, Czech and Dutch banks with USA trailing close behind. Both Dutch and US were however represented by only by one institution, foreign branch of ING in Dutch case and Citibank Slovakia, as for USA operating with full banking licence.

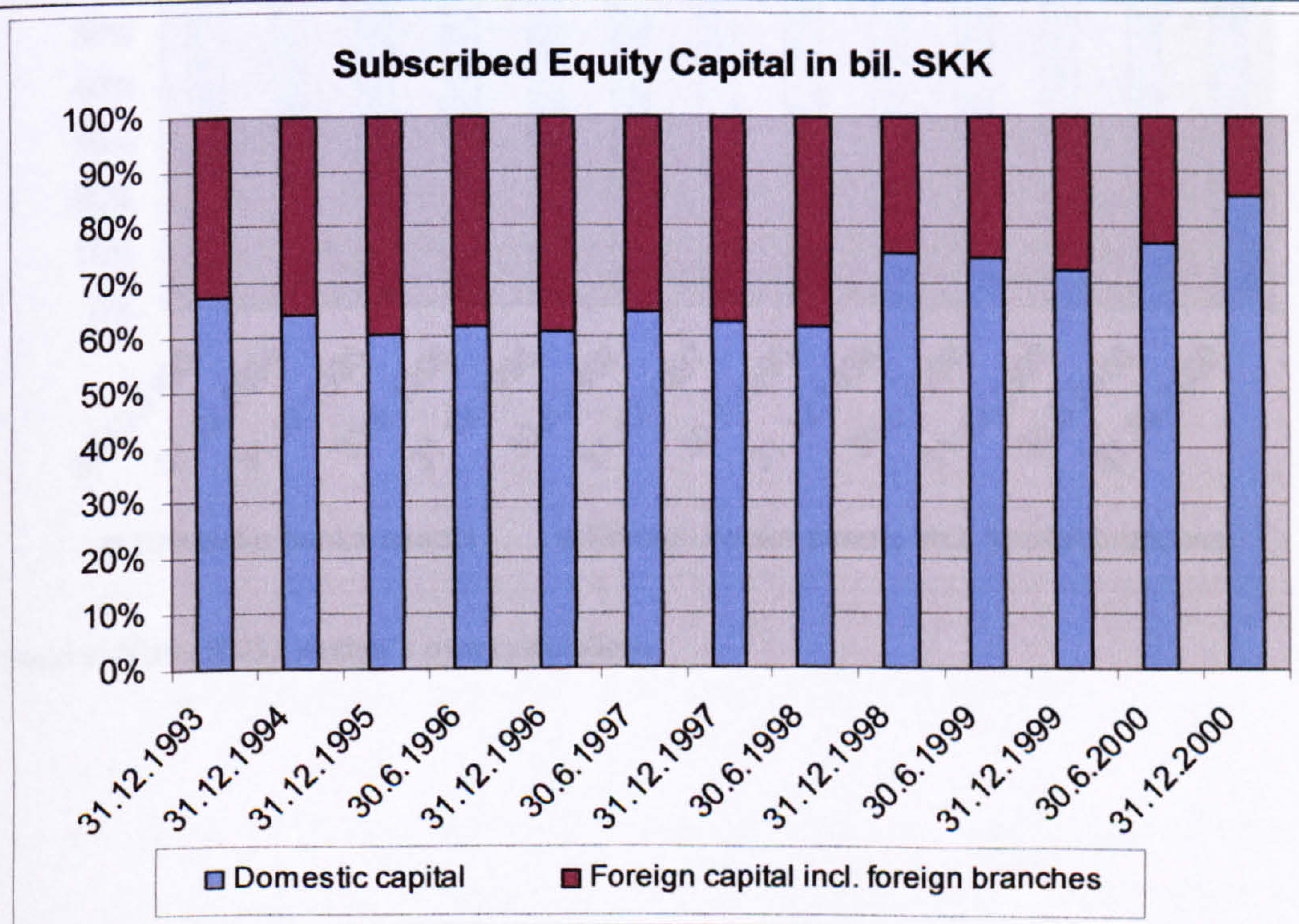
Figure 4-6 – Foreign capital participation in the Slovak banking sector in 1999 (Cumulative FDI)



Source: NBS Annual Report (1999), Author's own calculations

Foreign capital participation in Slovakia developed rapidly in the first three years. While it was just over 13 per cent as of 30 June 1993, by the end of 1995 it was almost 40 per cent. The share of foreign capital in Slovak banking was steady (influenced only by withdrawals of the Czech bank branches) until 1999 when the three largest domestic banks were recapitalised using the NBS reserves.

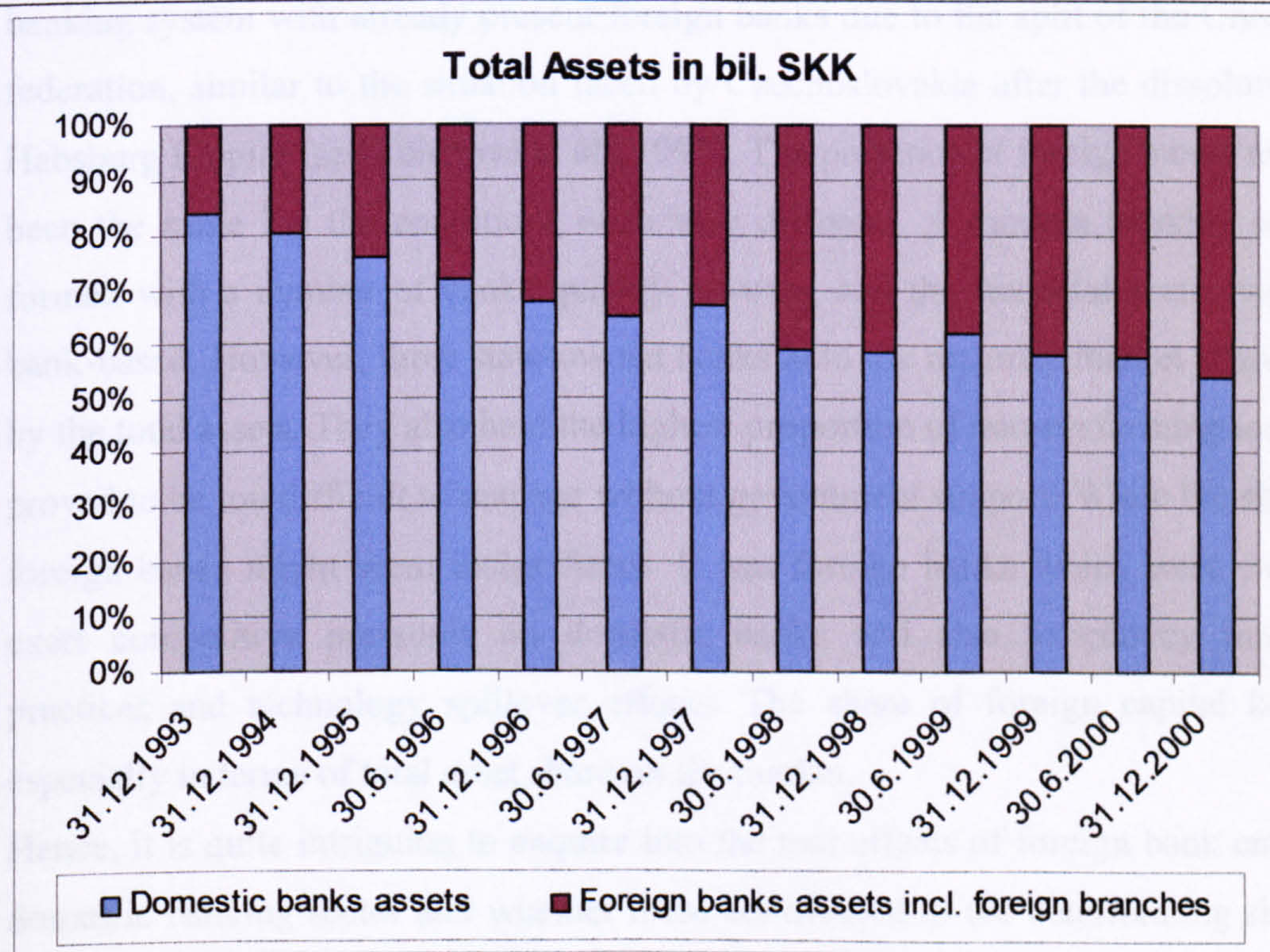
Figure 4-7 – Subscribed equity capital in billions SKK



Source: NBS (2003), Author's own calculations

While the share of foreign banks on subscribed capital in the Slovak banking sector was gradually declining, more important was their share of total assets that kept increasing, from about 16 per cent in 1993 to about 48 per cent in 2000. Since foreign banks apart from a few exceptions kept or over-performed the capital adequacy ratios required by the NBS, the growth in total assets could have been assigned to better credit risk assessment and prudence in providing loans as well as to higher profitability, better asset management and operation. Throughout the research period, out of the ten most profitable banks, only two were domestic[50]. In order to better understand the reasons behind the increasing share of foreign banks on total assets despite the volatile number of institutions and decreasing share of subscribed equity capital, analysis of revenue assets would be required. The following chapters will examine this issue in greater detail.

Figure 4-8 – Total assets in billions SKK



Source: NBS (2003), Author's own calculations

[50] author's own calculations

4.8 Conclusions

When comparing Slovakia to other CEECs, a clear picture is emerging. Even in terms of government balance, Hungary was operating with higher deficits. However, it is the underlying reasons which are noteworthy. Government actions between 1994 and 1998 resulted in high public debt and fiscal deficits. Furthermore, the process of privatisation has been abandoned and restructuring of the banking sector, prepared for already in 1995, has been delayed. In reality, "crony capitalism" emerged with an ineffective legal system in relation to market competition and bankruptcy hampered development. The government grip on state-banks seems to increase the bad debt rather than bring it under control, further deteriorating the situation of the Slovak banking system.

Nevertheless, Slovakia has emerged as a country with a functioning banking system and a strong regulating institution – the National Bank of Slovakia. It has also emerged as a banking system with already present foreign banks due to the split of the Czechoslovak federation, similar to the situation faced by Czechoslovakia after the dissolution of the Habsburg Empire (see Teichová et al., 1997). The presence of foreign banks might have been the same but the conditions were very different. A modern banking sector was formed with a number of banks quickly growing and the financial sector was largely bank-based. However, three state-owned banks held the majority market share measure by the total assets. They also held the highest proportion of non-performing loans which proved to be too difficult to manage without government support. While the share of the foreign banks might seem insignificant, it was foreign banks which were expected to exert competitive pressures on domestic banks and also to convey management practices and technology spillover effects. The share of foreign capital kept rising especially in terms of total asset share on the market.
Hence, it is quite intriguing to enquire into the real effects of foreign bank entry on the domestic banking sector and whether these contributed to the deteriorating situation of domestic banks or whether there were any positive effects that encouraged the formation of functioning financial markets in the Slovak Republic.

From basic collection of financial assets to provision of credit and involvement in other financial operations to institution building and organization of infrastructure, in all these areas the effects of foreign bank entry might have been felt. The following three

chapters attempt to detect and analyse any effects that might have been introduced by foreign entry in the banking market of the Slovak Republic.

Slovakia, as one of the TEs, has opened up its banking sector to foreign entry to a large extent and very recent developments showed its intention to sell the banking sector completely to foreigners. In the view of the aforementioned issues of financial system stability and crises and banking system fragility meticulous examination of the effects of foreign entry and its impact on the domestic banking system becomes a burning issue. More so, because little similar research has been provided so far, and although Slovakia has been in a few cases encompassed in the various TE bank-sector studies (see Bol et al. 2002), availability of data appears to be the main obstacle.

The following chapters will attempt to address a few issues raised in this and previous chapters and to bring more understanding to the effects of foreign bank entry in Slovakia. The next chapter deals with how this analysis will be conducted.

CHAPTER 5.

METHODOLOGY

5.1 Introduction

As described in the first four chapters all transition countries put restructuring their financial and banking sectors in particular as the cornerstone for further economic changes when restructuring their economies. Banks were supposed to facilitate financial flows and privatisation of industry. Numerous threats to successful transition of banking sectors were present and so were the ways to deal with them. While some countries have chosen sudden changes, others opted for a more gradual approach. Building sound and independent regulatory structure was paramount for all. Competition in commercial banking was strongly promoted and foreign banks were generally welcomed. While building infrastructure for host countries proved to be an enormous task, foreign banks had had their infrastructure established for some time (at least in most cases) and their only task was to minimise the risks of operation in uncertain environments. Foreign banks were thus often expected to bring market-based practices and codes of operation, new products and standards of services and most importantly to exert competitive pressures on domestic banks thus making them easier to operate more efficiently.

Many authors have taken the view that developing an effective financial system was a very important first step in the transition process (Hetzel, 1990; Sundararajan, 1992). However as pointed out by Sabi (1996, p.179): "lack of appropriate data has hindered the evaluation of current policies and the formulation of appropriate guidelines in the privatisation of the banking sector in the course of transition."

Current chapter provides description of research methods and issues utilised in analysis of impacts of foreign bank entry in Slovakia. Research objectives and framework is later clarified with author's additions to the Value Chain of a Bank (as described later). Overview of inductive and deductive approaches is presented later that form qualitative and quantitative part of the research using interviews and nonparametric method to analysis of variance together with descriptive statistics as research tools.

5.2 Research methods and issues

The objective of this study is to provide original insights into the banking sector development under conditions of transitional economy, with a focus on the role of foreign banks and their effects on the domestic banking sector. The reasons for choosing Slovakia as a case study are twofold. First, no prior comprehensive research on foreign banks' entry effects on domestic banks in Slovakia has been undertaken. One exception was Hošková and Vágnerová (1998), who briefly describe the mode of FDI into banking and focus on the experiences of employees within foreign banks in Slovakia. Interviews conducted among representatives of three modes of entry – representations[51], branch offices and subsidiaries – dealt with questions on risks, disadvantages and advantages of undertaking, type of clientele, product portfolio and evaluation of the banking system as well as recommendations for outward FDI. Descriptive analysis dealt with basic bank operations with clients providing a description of operations according to resident and non-resident client characteristics. For the present study, access to data and the potential for in-depth interviewing focused on the effects of foreign bank entry on domestic banks due to the researcher's background provided a second motive for conducting the study of the Slovak banking sector.

Most studies dealing with foreign bank entry and its effects on the domestic banking sector build on quantitative analysis of bank performance indicators. The data are in many cases retrieved from second-level sources such as BIS BankScope or IMF Financial Database. Quite often comparative research is undertaken with country comparisons on the levels of financial market development or the performance of foreign and domestic banks. In recent years research more focused on country-level examination of foreign and domestic banks has emerged, but still the majority of cases deal with empirically computable data analysis and easily recordable data uncovering direct effects of foreign bank penetration. Only rarely has research been focused on qualitative data collection and examination, one such exception being Konopielko's (1999) study of determinants and motives for foreign banks' entry as well as the

[51] Representation is defined as the representative office of the foreign bank with no authorisation to provide banking services. It acts solely as a liaison office for reference banking and/or existing or potential clients.

activities in which foreign banks were involved and foreign entry effects. Moreover, using Tschoegl's (1989) classification of foreign entry effects, indirect costs and benefits have rarely been researched in any country setting. The following chapters attempt to provide a framework for evaluating indirect as well as direct effects of foreign bank entry.

With respect to the above-mentioned issues and areas covered by the first four chapters, for an analysis of impacts of foreign entry into the domestic banking sector, two methods of analysis are suggested: firstly, qualitative research, dealing with issues which cannot be covered or which are only partially explained by statistical analysis, namely transfer of know-how, changes in business strategy, improvements of human capital, effects on legal and institutional frameworks, and secondly quantitative research, dealing with the data on performance of bank institutions. While quantitative analysis builds on the works of researchers within a neo-liberal framework familiar from the World Bank's researchers, the qualitative part focuses more on difficult-to-measure effects of foreign entry in the domestic banking sectors. These are described as indirect effects or sometimes as spillover effects and externalities. Nevertheless, it is argued that it is useful, if not essential, to use both methods at the same time, as this approach enables one to draw a more comprehensive and detailed picture of what was or is going on with FDI in banking.

5.3 General research objectives and framework

One of the most important effects of foreign banks entry was enhanced competition. While expectations were positive in terms of increased competition and pressures on domestic counterparts to improve banking services, there were also negative effects in terms of the crowding-out-effect and cream-skimming. Therefore, 1) the first objective of this study is to discover the competitive pressures exerted by foreign banks on domestic banks in terms of profitability, efficiency and quality of deposit and lending portfolios.

2) Stemming from this are behavioural comparisons between foreign and domestically-owned banks in strategic and operational decisions where differences in management styles might be detected. 3) Potential differences in behaviour and management styles or practices can spill over into domestic banks. Such spillovers or transfers of know-how

and technology and therefore improvement of competitiveness in the sector were regarded as very important for restructuring banking sectors. The third objective is to establish whether these spillovers were present and what effect they might have. 4) And finally, the role of regulators in respect to foreign entry and opening-up of the financial sector as a whole will be investigated since building efficient supervision and regulation is crucial for any developed economy.

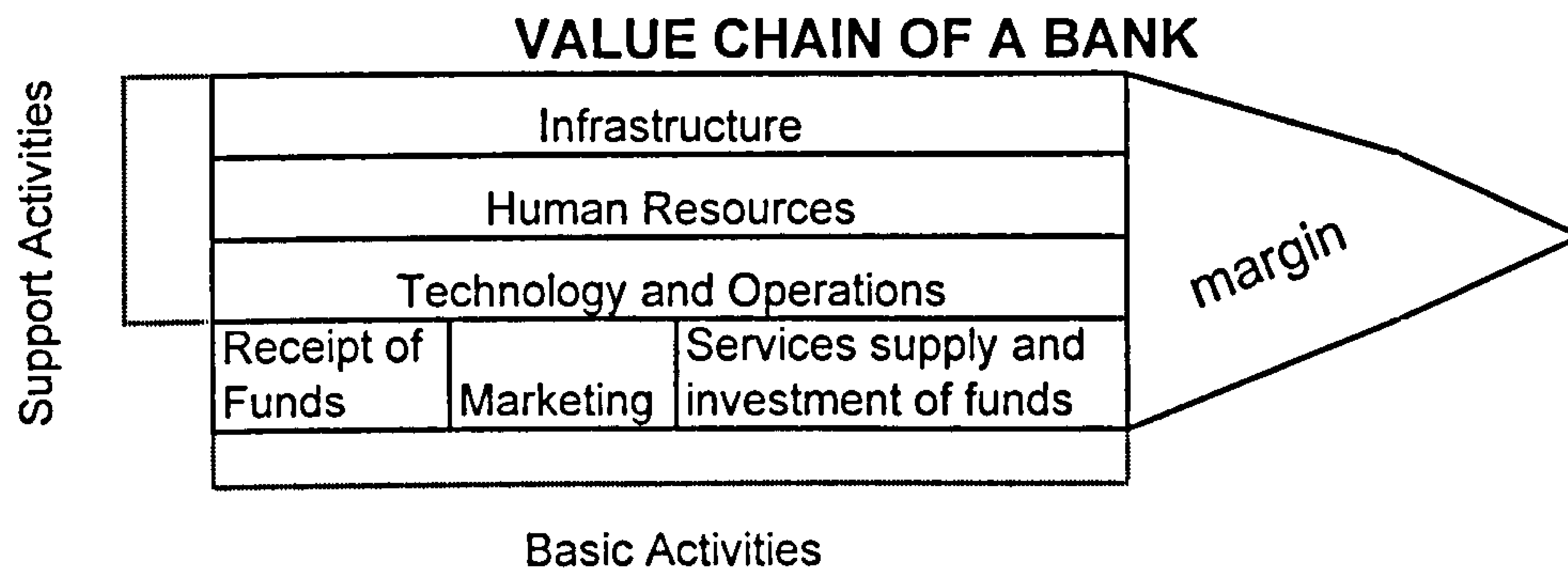
To address the above objectives, a combination of deductive and inductive approaches to the research will be adopted. Combining research approaches and tools, if used with respect to their potential, allows corroboration of results obtained by different research methods, known as triangulation. Both empirical statistical analysis and quantitative research based on interviews will be used as a "multi-method approach, which means that different purposes may be served and that triangulation of results is facilitated" (Saunders et al., 2000:145).

The first part of the analysis primarily focuses on areas specified by Canal (1994), adapted Porter's Value Chain of a Firm to Value Chain of a Bank (see Figure 5-1). It is possible to use this scheme also for the second, quantitative part of the study. Hypotheses that refer to the lower part of the scheme: Basic Activities, Receipt of Funds (deposits) and Services Supply and Investments of Funds (mainly loans) are relatively easy to measure. More challenging is the question of the marketing activities of a bank because these entail a very broad scale of activities and structures from easily detectable expenses on advertising to the branch network, training of employees, and strategic decisions about targeted product segmentation. Interviews in the first part concentrate mainly on the Support Activities of a bank, i.e. infrastructure, human resources, technologies and other (non-financial) bank activities.

The second part of the research focuses on empirical analysis of various micro-indicators of both domestic and foreign banks. Particular attention will be devoted to deposit and loan portfolios of banks looking for the potential impact of foreign entry on changes in deposits and credit offered by domestic banks. The motivation behind this approach is that any impact of foreign banks' operation should be recognisable in deposit and loan portfolio distribution of domestic banks because of the limited number of clients in a particular territory. In other words, there is expected to be a statistically

significant difference between deposit and loan portfolio distribution of domestic and foreign banks. Certainly, if the impact is not recorded, this may suggest that foreign banks behave under a 'follow-the-client' regime and do not represent any threat to domestic banks.

Figure 5-1 Value chain of a bank



Source: Canal (1994)

Description of Basic and Support Activities is as follows:

- **Basic Bank Activities** – receipt of funds (deposits), investments of funds (loans and capital market investments) and marketing activities (advertising a branch, network expenditures, training of employees, and strategic decisions about targeted product portfolio segmentation).
- **Technology and Operations** (non-financial activities of a bank) – bank and management know-how.
- **Human Resources** – quality of employees, investments in human resources development.
- **Infrastructure** – branch network, organisational structure of a bank, organisational structure of bank system.

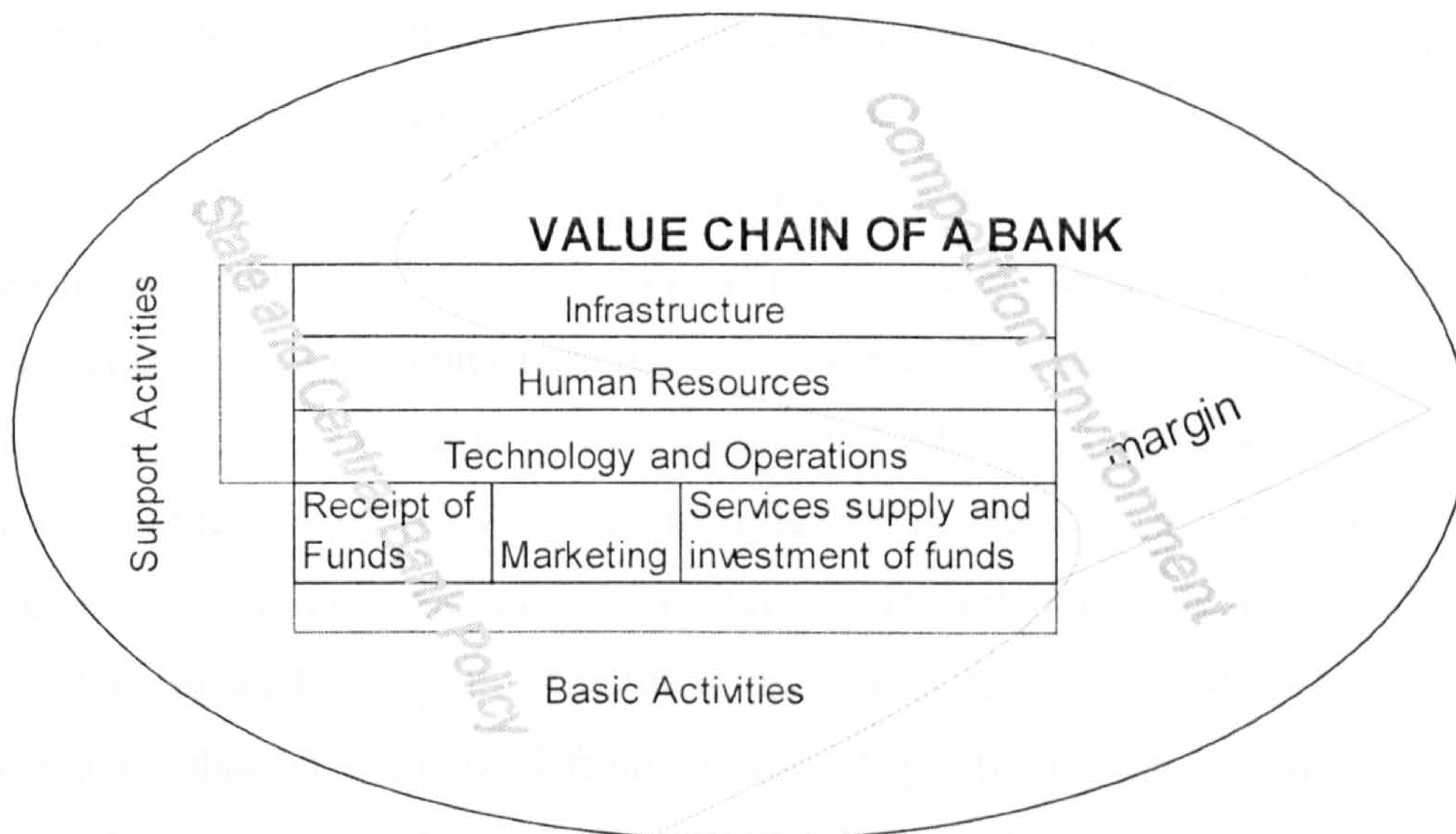
Canal's Value Chain of a Bank clearly represents a micro-view of banking institutions, describing the bank as a stand-alone firm organising various activities in order to provide for the most efficient outcome – the margin. The banking firm in this view is hence affected primarily by the way activities are organised. In real life however, banking is one of the most regulated industries. State and Central Bank policy is one of the major influences on banking sector operations directly affecting its performance, not only through taxation and basic legislation, but also via setting specific requirements for the bank capital, risk management and operation, including the duty to accumulate

reserves and contribute to deposit insurance for the case of bank runs. Moreover, as such regulation affects all banking market participants, the supervision and regulation is also set to protect the market against the failure of a single institution that could have deeply negative repercussions on other participants. In addition, competition also directly affects banks' performance, more so in the transforming economy where foreign competition may bring different practices, products and management styles. In order to capture the potential effects of foreign entry into domestic banks two more areas need to be included in the Value Chain of a Bank capturing for state and central bank policies and competition effects, hence adding macro aspect to the picture. The 'S-shape' division in Figure 5-2 has been deployed in order to capture the fact that both influences of competition and state and central bank policies affect the whole value chain of a bank. Two new areas deal with the external influences (such as legal framework, organisation of bank markets, policy of a central bank and state), as well as competition effects. Four areas will be extended into six as follows:

- **Influences of state and central bank policy** – status and development of the legal framework of the banking sector in Slovakia, influences of state policy regarding privatisation and functioning of the financial markets, influences of banking market organisation (bank supervision and regulation), central bank policy influences in relation to foreign banks' operation and restructuring, or the liberalisation of the banking sector.
- **Influences of competition effects** – competition pressures of foreign banks on domestic banks, reflections of these pressures by foreign bank officials.

Value Added Chain of bank is adjusted as shown in Figure 5-2 below:

Figure 5-2 Adjusted value chain of a bank



Source: Author's adaptation of Canal's (1994) Value Chain of Bank

The whole methodology is for that reason structured around the above diagram, organising the bank's operations and potential effects of foreign bank entry into three broad areas of Basic Activities, Support Activities and Environment effects.

More specifically, the research is focused on:

1. Basic activities including taking deposits, marketing and provision of credit
2. Support activities of technology and operations organisation
3. Support activities of human resources
4. Support activities of infrastructure
5. Effects of state and central bank policy
6. Effects of competition environment

5.4 Qualitative research

The first part of the research focuses on behavioural comparisons of foreign and domestic banks and the role of the state in facilitating foreign entry and development of financial markets. The objective in an inductive approach would focus on the particular context in which foreign investments in banking take place, i.e. the setting of a

Transitional Economy (TE). Primary data collection via interviews focuses on discovering the views on the effects of foreign entry in banking services held by all parties involved. There appears to be little evidence of any previous research on the behaviour of foreign and domestic banks in the Slovakian banking sector. The principal objective of the study is to generate rich descriptive data by seeking answers to questions in the above-mentioned areas. Interviews focus on commercial banks as well as state officials' reflections on foreign entry, competition effects, spillover effects and regulatory effects. This element of the research was based on semi-structured interviews that allow for answers to questions as well as for further explanations of background conditions and the personal views of the interviewee. In character, however, both semi-structured and in-depth techniques were utilised within each interview. Where Wass and Wells (1994) suggest that semi-structured interviews may be used to explore and explain themes that have emerged from the use of questionnaires, a similar approach can be used for a combination of statistical analysis and qualitative data collection. Healey and Rawlinson (1994) point out that even a combination of different interview types may be used within one interview where one part asks more factual questions and the other explores responses using a semi-structured qualitative approach. Hence in the case of foreign bank effects, a combination of two interviews were used in order to explain and understand relationships between variables defined in the quantitative part of the research, engaging a semi-structured style as well as "to find out what is happening and to seek new insights" (Robson, 1993 cited in Saunders et al., pp.2002:245) in an exploratory, in-depth way. Such a combination allowed for corroboration of quantitative analysis results together with cross-examination of opinions and personal reflections on the situation.

Interviews with the top officials involved in the banking system have also been carried out in order to provide insights into the behaviour of foreign and domestic banks, and their view on the mutual effects in operation. This area still remains largely unexplored. Interviews focused on banks' reflections of foreign entry, competition effects, spillover effects and regulatory effects. While the term spillover in foreign bank entry has been already used several times, it is necessary to define the understanding of the author for the purposes of further analyses: spillovers in foreign banking penetration have numerous effects on all the six areas as defined in the Adjusted Value Chain of a Bank (Figure 5-2). These are: *Process Improvements* (in credit risk analysis, bank know-how

– management of the different time-lagged assets and liabilities, acquisition of deposits, marketing methods), *Technology Improvements* (competitive advantages, managerial and bank know-how), *Human Resource Improvements* (HR training, performance and productivity), *Infrastructure Improvements* (within the bank as well as the sector and possibly the whole economy – organisation of institutions and markets), *State Control and Monitoring Improvements* (decision-making independence), *Market Improvements* (competition, sustainable growth and stability effects). In order to analyse the indirect effects, qualitative methods are most appropriate.

A qualitative approach shall be adopted to investigate the following research questions:

- Were there any differences in acquisition of funds and their use among foreign and domestic banks? What were the effects of foreign bank entry?
- Had foreign entry helped domestic banks with improving their credit risk techniques and bank know-how by transfer of technologies and knowledge?
- Are foreign banks better prepared for the conditions of TEs than domestic ones?
- To what extent has the presence of foreign banks enhanced and supported the transition of the Slovak economy in such a crucial sector?
- Have foreign banks helped with financing the restructuring companies, which were in desperate need of funds?
- Have foreign banks supported the creation, internally as well as externally, of the market economy and competitive banking sector in Slovakia? Or were they more harmful, negatively affecting the competitiveness on the market by their own failures and bankruptcies?
- Was the banking sector in Slovakia fully privatised only 11 years after the beginning of the reforms[52] because it was regarded as a crucial sector for supporting the transition process and the reform governments, or due to the fact that banking was the most difficult to restructure because of its strict centralised organisation in the past? Or was it just coincidentally the best moment for gaining surplus income to fund the reforms of the current government?

[52] Announcement of the stabilisation and reform programme by Poland on 1st January 1990 was regarded to be the beginning of the reforms and transition process. (see Bruchacova, 2000).

- Were there any negative effects exerted by foreign banks due to their inefficiencies or failures?

5.4.1. Data source and descri ption sample

It is recognised that "a number of quality issues can be identified in relation to use of semi-structured and in-depth interviews, related to reliability, forms of bias, validity and generalisability" (Saunders et al., 2000, p.249). The main issue behind reliability is how easily a research project and its findings can be replicated. While some authors claim this non-standardised approach is not even intended to be repeatable given that it shall reflect dynamism of situation (Marshall and Rossman, 1999), others (Saunders et al., 2002, p.251) suggest that the value of a qualitative approach lies in "flexibility that can be used to explore the complexity of the topic". As described before, the main motivation behind using a non-standardised approach is: firstly, to corroborate qualitative data findings and potentially uncover reasons behind that statistical analysis; secondly, quantitative techniques can hardly be used in situations where data are barely recordable in numbers and the researcher can only work with primary data that are recognised as participants' perceptions of situations. Moreover, even hard data can be deceiving especially in economic terms that depend on the use of different methods and approaches for their recording (such as accounting standards, etc.); and finally results always need to be explained where potential bias of the researcher reporting the results may interfere.

Interviewer and interviewee bias is another debated quality issue and deals with the way interviews are conducted. A great deal of attention has been devoted to researchers' readiness for the interview in terms of information gathered about and supplied to interviewees, behaviour and appearance, and conducting the interview in terms of opening questions, nature of comments, attentive listening skills and recording of data. A further problem is one of generalisability and the validity of interview-based studies. Validity very much depends on the level to which the interviewees share their experiences, knowledge and meanings with the researcher. Support on this issue is provided by Healey and Rawlinson (1994, p.89): "the main reason for the potential superiority of qualitative approaches for obtaining information is that the flexible and responsive interaction which is possible between interviewer and respondent(s) allow

meanings to be probed, topics to be covered from a variety of angles and questions made clear to respondents". In terms of generalisation, qualitative semi-structured or in-depth interviews will allow one to make generalisations about the entire population if the sample is based on a small, unrepresentative sample (Saunders et al., 2000). Non-standardised methods may provide supportive evidence for generalisation of quantitative research results, or uncover important issues that need to be considered for generalisation of any type of research.

Due consideration was committed to overcoming the data quality issues highlighted above. Beginning with decisions about the type of interview employed and developing the initial set of interview questions, to selecting the interviewees and preparation for conducting the interviews, all aspects of data quality threats were evaluated and the ways to overcome them thoroughly planned.

Two sets of interview questions have been prepared for the two groups, the first being Government and Central Bank Officials and the second being Commercial Bank Officials. Each interview included 18 questions broken down into six areas, building on Canal's Value Chain of Bank with the addition of two further areas dealing with the external environment of a bank as described before. Both interview shcedules were structured in a very similar way, up to the point where either commercial or state and central bank officials would not be able to respond to the question because of their particular knowledge. Slight adjustments were made to such questions, in one case substituting the question that state officials would not be able to answer. In total 42 people were selected to be approached for an interview, incorporating an equal number for state and central bank sector and commercial bank sector, as well as people with unique knowledge of the Slovak banking system, such as economic reporters and analysts.

Officials of the following institutions were interviewed (number of individuals in parentheses):
Government of the Slovak Republic (1)
Ministry of Finance (1)
Ministry of Privatisation (1)
National Bank of Slovakia (NBS) (1)

Institute of Monetary and Financial studies at NBS (2)
Slovak Academy of Sciences (1)
Economic Press Reporters and Analysts (1)
Foreign Commercial Banks (5)
Domestic Commercial Banks (5)

Because of the sensitive information being conveyed and due to specific demands from certain interviewees, the identities of the interviewees will not be disclosed. Although in some cases interviewees approved disclosure of their identity, in other cases it was only that because a promise had been given not to disclose name and position, unique and often "behind-the-curtain" information was retrieved. Thus, in order to keep uniformity of research all interviewees' details are undisclosed. The decision was taken not to use a tape recording device as it was felt that this could unduly influence the validity of responses given and so possibly introduce bias into the research. Written notes were therefore taken during the interviews, always with the permission of the interviewee. Furthermore, generally within one hour after the interview, the notes were reviewed and any additional information recorded into electronic form for future analysis. Questions were open-ended, allowing for personal reflection on subjects covered by the question. Explanatory questions were further asked where it was necessary to find a consensus on terminology or to encourage sharing of information. The interviews typically lasted approximately one hour, although in some cases they lasted 40 minutes and in others even several hours spread over two weeks. The interview period was April to September 2002.

5.4.2 Interviews and issues

Interviewing was undertaken in three phases.

In **Phase One**, initial questions were developed reflecting research questions in six areas as described in Supplemented Value Chain of Bank interviews. Originally 20 questions were prepared. Both Commercial Bank Official (CBO) and State and Central Bank Official (SBO) versions of the interview were piloted among employees of the Institute of Monetary and Financial Studies (IMFS) at the National Bank of Slovakia (NBS) who were able to provide insights for both views on the basis of their current and

previous working experience. In the case of the CBO version the danger of bias from the side of IMFS employees was mitigated by the previous working experience of an interviewee at a commercial bank and further extensive research of the commercial bank sector. Ambiguous or hard to answer questions were excluded or altered and the final version of the interview, with 18 questions, was developed.

In **Phase Two**, several potential interviewees were selected on the basis of general knowledge about their roles and recommendations by IMFS staff and other sources. The initial number of potential interviewees came to 42.

Further attention was devoted to ways of recording the interviewees and potential contact techniques as well as preparation of how to conduct the interviews in order to receive as much information as possible. In relation to recording responses it was decided that only handwritten notes, with permission of interviewees, would be used so as not to frighten interviewees by potential leaks of information to the public. This strategy later proved successful. All interviewees were further assured that their responses would be treated in a confidential way only for the purposes of further analysis and that their identity would not be disclosed at any stage. In many cases only this assurance ensured receiving any information or personal perception.

In **Phase Three**, a total of 18 respondents agreed to be interviewed and their responses were recorded. Respondents included top government officials, top bank managers, as well as people with the best knowledge of processes that take place during the transition of banking systems and with the best knowledge about the current state of banking in Slovakia, such as academic researchers at the Slovak Academy of Science or economic reporters focused on reporting on the financial system of Slovakia. The results of interviews and analysis are provided in Chapter 6.

The following chapter presents the results of empirical analysis performed according to chosen research strategy described in section 5.3. Examining the basic bank activities as the first step, the purpose of the next chapter is to measure and compare the performance and effectiveness of domestic and foreign banks in Slovakia in the process

of transition into a market-oriented economy. The second step will provide analysis of changes within deposit and loan portfolios of four groups of banks.

5.5 Quantitative research

The purpose of this chapter 7 is to measure the performance and effectiveness of domestic and foreign banks in Slovakia with the aid of various indicators and measures, as described later. Moreover, more detailed attention is devoted to differences in loan and deposit portfolios of domestic and foreign banks as these operations form a cornerstone of bank activities, being the basic indicators of input and output of a bank. This has a direct impact on the economy, among other factors such as inter-bank trading and equity trading.

"The field of statistics is divided into two parts, descriptive statistics and statistical inference. Descriptive statistic methods work with summarizing the information in data on one or more variables, and it provides the methods for estimating the values of various parameters, including coefficients of an econometric model. Statistical inference is concerned with the relation between these estimates and the true value of the parameters, and it provides the basis for testing hypotheses and for assessing the errors that are always present in estimation." (Mirrer, 1988, p.43)

The second part of the research focuses on the empirical analysis of foreign direct investments in the host country sector using tools of statistical analysis, and is based on the work of Clarke et al. (1999) which builds on Claessens et al.'s (1998) cross-country analysis and is further extended by Barajas (2000) who focused on another Latin American country: Colombia. The rationale behind these studies is that any impact of foreign banks' operation should be recognisable in deposit and loan portfolio distribution of domestic banks because of the limited number of clients in a particular territory (country). In other words, the basic research hypothesis is that there is a statistically significant difference between deposit and loan portfolio distribution of domestic and foreign banks. Certainly, if the impact is not recorded, this may suggest that foreign banks work under a 'follow-the-client' regime and do not represent any threat to domestic banks. Next, it may be expected that the foreign entry will affect the operation of domestic banks. Empirical analysis of the share of foreign banks in total

number in relation to profitability, bank expenses, before tax profits and interest margin spreads is expected to disclose effects of foreign bank entry on the operation of domestic banks.

5.5.1 Hypotheses

Various methods of bank performance and efficiency measures were developed over time. Starting with some simplistic measures, methods for analysing bank performance involve descriptive analysis of data and coefficients developing through more sophisticated parametric and non-parametric deterministic methods. A variety of approaches were employed in measuring output productivity and efficiency of financial institutions. At a practical level, share of financial sector in national accounts can be measured. While it provides some measurement in terms of value added, this method faces problems in relation to questions of including interest receipts. Interest exclusion may thus lead to underestimates of financial sector share on the GDP. However, most studies of the banking sector apply production and intermediation approaches, based on banks as producers of accounts and transactions (under a production approach), or banks as intermediaries of capital thus accounting for assets, deposits and loans or other indices. Colwell and Davis (1992) provide a critical survey of empirical literature on bank productivity. However, in the case of developing banking markets, such sophisticated methods often face problems of retrieving reliable data, as a result of changing accounting methods and standards. Furthermore, such methods are usually susceptible to extreme observations and measurement errors. Thus, more simplistic indicators seem to be more suitable for conditions of developing banking markets. The two most used indicators for assessing banks' performance are return on assets (ROA) and return on equity (ROE). As suggested by Sabi (1996), ROE is the best indicator of banks' performance because it reflects the market's evaluation of it. As is the case of Hungary, where banks' shares were not traded publicly in the first years of transition, return on equity cannot be used for Slovakia as the stock market is not-functioning (as described in Chapter 3). Hence ROA, which is calculated as net profit after taxes divided by the average assets of a bank, can be used as one of the crucial indicators for measuring a bank's performance. Furthermore, Strauss (1998) argues that ROA works better in less developed environments.

In addition to ROA, available data were examined for more performance indicators that could better capture differences between foreign and domestic banks. It appeared that a number of proxies could be employed. These variables were grouped into seven categories as listed below[53].

1) Basic scale and scope indicators

Hypothesis 0 (H0: Foreign banks have higher profitability, lower fixed assets as well as total assets and earning assets and are more involved in securities and inter-bank trading. Their loan and deposit takings are lower than those of domestic banks.

1. Total Assets (TA) - Size of bank
2. Profit (P) - Profitability of bank
3. Securities (Sec) - Stock held and traded
4. Inter-Bank Assets (IBA) - Loans to other banks
5. Earning Assets (EA) - Interest and profit-producing assets
6. Fixed Assets (FA) - Bank involvement in economy
7. Loans - Credit provided to the economy
8. Deposits - Accumulation of savings by the economy

2) Efficiency and risk indicators

H0: Foreign banks in TEs are more efficient in terms of return on assets than domestic banks because of their superior management and practices. Foreign banks have a higher coefficient of credit risk because they are competing against domestic banks with established portfolios hence are left with high-risk projects and less creditworthy clients.

9. ROA (Profit // TA) - Basic measure of efficiency of a bank. Explains how 1 unit of currency is effectively utilised for producing profit. Ideal ratio is 1. The higher the ratio, the more efficient the bank.

   ROA = Profit // Average total assets at the beginning and the end of reviewed period

[53] A number of these measures have been previously used in studies of foreign banks' operation, for example Sabi (1996), Bol et al. (2002), Clarke et al. (1999), Dages et al. (2000), Barajas et al. (2000), Demirgüç-Kunt and Huizinga (2000) and others.

10. Coefficient of Credit Risk (CCR) - Risk coefficient of loans. The higher the coefficient, the more risky the banks' loan portfolio
    CCR = 0*standard loans + 0.05*standard loans with reserve + 0.2*non-standard loans + 0.5*dubious and disputable loans + 1*bad loans (loss) / ∑ loans (Preisinger, 2002, p.6)

3) Structure of earning assets indicators

H0: Foreign banks have lower Loans to Total Assets ratio because of their cautiousness towards new clients from TEs. Securities and inter-bank assets over total assets is expected to be higher than that of domestic banks.

11. Loans // TA - Indicator for structure of earning assets. The higher the ratio, the more important a particular asset is for production of profit
12. Sec // TA - Indicator for structure of earning assets. The higher the ratio, the more important a particular asset is for production of profit
13. IBA // TA - Indicator for structure of earning assets. The higher the ratio, the more important a particular asset is for production of profit

4) Selected direct benefits indicators

H0: Foreign banks are expected to have less employees and higher efficiency ratios than domestic banks. Fixed assets over total assets should be lower as foreign banks do not usually build extensive branch networks.

14. Number of employees - Employment growth among domestic and foreign banks
15. EA // Employees - Efficiency of employees. The higher the ratio the less educated and effective is the human capital of a bank needed to acquire and manage the earning assets
16. Fixed Assets // TA - Bank involvement in economy

5) Basic activity indicators

H0: Foreign banks are assumed to maintain low Loans to Deposit ratios hence keeping their liquidity in check.

17. Loans // Deposits - L/D ratio shows the extent to which the bank has lent its deposits. Higher L/D ratio results in lower liquidity. In addition it implies that banks use a lower level of debt financing than that of deposits

6) Loans – structure of loans to various sectors of economy

H0: Foreign banks are more likely to offer loans to sectors where they have comparative advantage over domestic banks, such as international trade, etc.

18. Loans to private sector enterprises - indicating which sector was most supported by bank financing
19. Loans to public sector - indicating which sector was most supported by bank financing
20. Loans to households - indicating which sector was most supported by bank financing

7) Deposits - structure of deposits to various sectors of economy

H0: Foreign banks were presumed to collect deposits from specific sectors where their advantages enabled them to collect most deposits, thus crowding domestic banks out of the markets.

21. Deposits of private sector enterprises - indicating which sector most contributed to the accumulation of capital and capital formation
22. Deposits of public sector - indicating which sector most contributed to the accumulation of capital and capital formation
23. Deposits of households - indicating which sector most contributed to the accumulation of capital and capital formation

5.5.2 Data source and description sample

Quantitative research methods benefit from standardisation and statistical theoretical background developed over the years. Advances in information technology greatly supported developments in quantitative data analysis, and the vast sets of statistical data can be analysed using elements of quantitative analysis incorporated in basic or more sophisticated software. Nonetheless, such advances do not protect secure data quality.

As Robson (1993, quoted in Sanders et al, 2000, p.310) states: "quantitative data analysis is a field where it is not at all difficult to carry out an analysis which is simply wrong, or inappropriate for your purposes. And the negative side of readily available analysis software is that it becomes that much easier to generate elegantly presented rubbish". In order to avoid inappropriate analysis of secondary data collected, due attention was devoted to step–by-step analysis of the secondary data, especially in terms of establishing data type, their distribution and description. Next, statistics to examine relationships between the data were chosen with the view that the goal of this part of the data analysis was to establish whether three or more groups were statistically different. Potential for further analysis is limited, however, by the sample size, which effectively covers the whole population (total number of banks) that was divided into four separate groups. The total dataset incorporates four bank groups, 17 variables and 14 time-periods coming to a total of 775 observations[54]. Due to this fact, further analysis used descriptive statistical methods rather than more sophisticated methods of regression analysis. The same applies to loan and deposit portfolios.

It is obvious that for such analysis, the data source is of major importance. It was therefore crucial to have access to detailed portfolio data to be able to test the effects of foreign entrants more directly. A major data source for collecting the secondary data is a comprehensive database of various banks' reports, which are collected by the National Bank of Slovakia. Furthermore, analyses of the Slovakian banking sector, provided by the Institute of Financial and Monetary Studies (IMFS), offers a very valuable source of some already processed data, such as ROA and CCR.

The dataset is divided into four groups according to the characteristics of the bank. The first two groups are domestic and foreign commercial banks where the foreign bank is defined as any bank with over 10 per cent of foreign capital. The third group is foreign branches, which should be included under foreign banks; however, the data set retrieved from IMFS does not allow for inclusion of foreign branches under foreign banks due to inability to recalculate indicators such as ROA and CCR for the groups. The fourth group is specialised banks where two specific state-owned bank institutions are involved: firstly, the Consolidation Bank, the 'graveyard' for bad loans of the pre-

[54] The difference between the expected 952 observations and the gathered 775 observations is attributable to the missing data.

reform era or bad loans resulting from privatisation needs, and secondly, the Slovak Guarantee and Development Bank established in order to provide state guarantees for projects under financing schemes of international institutions such as EU programmes, EBRD schemes, etc. Two more banks are included, these being building societies. Although both are foreign banks (established as joint ventures between the two largest and state-owned domestic banks and Austrian building societies), their primary focus was collecting deposits for the purpose of offering mortgages and loans exclusively for purchase or properties. The law restricts any other credit provisions by building societies.

The dataset is created including the data of selected indicators for four groups of banks over a seven-year period. Only data for the period 1993 to 2000 were available. Data are recorded on a semestral basis, thus in total 14 time points are available (reporting the data begun in 1993 and only end-of-year data are available for 1993, 1994 and 1995). However, in some cases missing data were reported or impossible to obtain and the number of time spots varies between six and 14 for various indicators. Objective measurement was also impeded by changes in accounting standards over the sample period.

5.5.3 Tools and issues

Before analysing the data, it needs to be established whether they meet the criteria of linearity, homoscedasticity and normality. Should the data have normal distribution, firstly one-way analysis of the variance (ANOVA) will be used to test for the differences between multiple groups. However, should the assumptions behind the standard ANOVA (as listed by Hays, 1994 in Saunders et al., 2000) be invalid or 'suspect' or the distribution not normal, an alternative nonparametric test will be used to test the difference between domestic, foreign, foreign branches and specialised banks. The use of non-parametric methods in case of large deviation of distributions is further supported by Coakes and Steed (2000, p.29) who state, "if distributions deviate dramatically, non-parametric techniques may be used." In such a case, the Kruskall-Wallis statistic does not assume normality of distribution and thus can determine

whether there are significant differences between multiple groups for variables structured into the seven categories as described above.

One-way between groups ANOVA – before conducting this analysis of variance, it must be ensured that the necessary assumptions are met.

1. Population normality (Kolmogorov-Smirnov // Shapiro-Wilks test)
2. Homogeneity of variance (Levene's test)
3. Independence of measures

In order to assess whether population is normal, "the Kolmogorov-Smirnov statistic with a Lilliefors significance level for testing normality is produced with the normal probability and de-trended probability plots. If the significance level is greater than .05 then normality is assumed. The Shapiro-Wilks statistic is also calculated if the sample is less than fifty" Coakes and Steed (2000, p.35).

Levene's test is produced to check whether another condition for using parametric tests, the homogeneity of variance, is present. The significance level of more than .05 confirms that homogeneity of variances is present and the second condition for the use of ANOVA parametric test is met.

Should the above-mentioned assumptions not hold for the tested groups, the Kruskal-Wallis statistic does not assume normality of distribution and thus can determine whether there are significant differences between independent multiple groups, regardless of their normality in distribution or homogeneity of variance. The Kruskal-Wallis test is a nonparametric equivalent to one-way ANOVA that tests whether several independent samples are from the same population. The threshold value for determining whether several independent samples are from the same population is the asymptotic significance value of more than .05. The Kruskal-Wallis test is effectively an extension of the Mann-Whitney U test. The Kruskal-Wallis test assumes that there is no a priori ordering of the k populations from which the samples are drawn.

Next, attention will be devoted to analysis of particular bank groups in the collection of deposits and the provision of loans. More specifically, distribution of deposit and loan

portfolios across the sectors of the economy will be analysed and development over years will be assessed. Descriptive analysis will be used for initial analysis and multiple line graphs will be used as a means of presentation, together with contingency tables.

5.6 Conclusions

The combination of research approaches, methods, and tools is believed to produce highly valuable output that using the method of triangulation would produce reliable depiction of the effects of foreign bank entry on domestic banks in Slovakia during the researched period. Furthermore, personal responses are expected not only to corroborate the results of empirical research but also to reveal factors that might have influenced results of quantitative analysis. While in some cases the results of statistical analysis can provide results with ambiguous explanations, qualitative analysis may point to a specific exogenous authority that influenced the data. Hence, the research improves the quality of understanding of the phenomena of foreign entry effects in Transitional Economies.

CHAPTER 6.

INTERVIEWS - THE STORY TOLD BY PEOPLE

6.1 Introduction

The previous chapters have set out the theoretical context of foreign entry into banking and potential effects of foreign entry on domestic banks. The purpose of this chapter is to focus on the areas of the Adjusted Value Chain of Bank[55] that cannot be directly measured by the quantitative methods. Quantitative analysis in the following chapter is focused on the first area of the research described in Chapter 5 as the Basic Bank Activities (i.e. sourcing funds and use of funds). It also may shed light on the second area of the Technology and Operations Organisation in terms of bank know-how and management. The main focus was to establish differences and potential effects of foreign bank entry. Under Tschoegl's (1989) classification these may be described as direct foreign entry effects, which are econometrically quantifiable.

However, the presence of indirect effects is also recognised. Indirect effects are not easily computable since they cannot be attributed to a single bank and have more general character (such as government policies, although effects of these can be to some extent quantifiable). While quantitative methods can be used for analysis of the first area and help to understand differences in the second area, for analysing effects in the support activities of Technology and Operation, Human Resources, Infrastructure and Effects of the State and Central Bank Policy, as well as Effects of the Competitive Environment, qualitative methods are necessary. It is the opinion of the author that rich qualitative research can often corroborate quantitative analysis results in a process called triangulation (see Chapter 5). Thus the qualitative part of this study focuses on all six research areas.

[55] see Figure 5-2 in the previous chapter

6.2 Qualitative interview analysis

The research approach was based on "grounded theory", first formulated by Glaser and Strauss (1967), since grounded theory offers an open approach to analysing non-standardised data produced by qualitative studies where the data analysis is problematic, as formulated by Easterby-Smith et al. (1991).

The data gathered via interviews were critically analysed using the seven main stages of grounded theory analysis as presented by Easterby-Smith et al. (1991): Familiarisation, Reflection, Conceptualisation, Cataloguing concepts, Recoding, Linking, Re-evaluation. The use of software packages for transcribing and analysing the data (such as NUDIST or Nvivo) was considered. However, such software was not utilised because, in the author's opinion and experience, the use of such packages that are based on statistical methods for evaluating qualitative data often fails to grasp the richness of the data. Furthermore, identification of patterns, relationships and categories still has to be done by the researcher.

The interviews were recorded taking notes and transcribed into table processor Microsoft Excel in order to assess and compare the answers of the commercial bank (CBO) and the state and the central bank (SBO) officials. Findings are presented in two groups for the commercial banks and the state and central bank officials to enable comparative analysis of the findings. The issue of confidentiality was carefully considered. Majority of interviewees were concerned with confidentiality and thus names of interviewees are not revealed. This allowed for greater accuracy and richness of the data collected. Due to the confidentiality issues and the limited size of this study restriction in identifying interviewees was imposed and the findings are presented in an epigrammatic form. Encrypted references were used for identity of each interviewee. List of these encryptions and interviewee's institutional assimilations follows: MrT – Government Official; FN – Government Official; RG – Domestic Institution Economic Analyst; ROA – International Financial Institution Official; PTV – Domestic Institution Economic Analyst; SEB – Government Official; DO – Central Bank Official; HOI – Central Bank Official' BAC - Central Bank Official; ORD – Foreign Bank Top Official; MIM – Domestic Bank Top Official; SCR – Domestic Bank Top Official; TB – Domestic Bank Top Official; KBZA – Foreign Bank Branch Official; JAI – Foreign Bank Top Official; BL – Foreign Investment Bank Official; CDrJ – Foreign Bank Top Official; MASI – Domestic Bank Branch Official

6.3 Basic bank activities

The first research area attempted to answer the question of whether there was a difference between foreign and domestic banks in terms of the availability of deposit products and provision of loans before and after foreign bank entry, and also whether any changes in provision of banking services were experienced.

6.3.1 Basic bank activities in the views of commercial bank officials

The main theme of the respondent's replies was that the general economic conditions influenced domestic banks in provision of the basic bank activities. Domestic banks were first restricted by NBS (the National Bank of Slovakia) to offer loans in the first years after the creation of the Slovak Republic (in order to prevent 'credit crunch') and also:

> Because of the high ratio of bad loans from the first privatisation wave when domestic banks continued to offer loans in order not to lose existing ones and the bad loans ratio reached 60 per cent, domestic banks were hindered by the high ratio of bad loans from the past and commitment to fulfil the Criteria of Cautious Undertaking (CCU) applied by the NBS[56] [MASI, 15.4.2002]

On the source of funds side, the collection of deposits and supply of credit is not regarded as being influenced by the foreign entry itself. It is rather the introduction of the new banking products and competitive pressures that were viewed as beneficiary:

[56] Capital requirements were set to 8% by NBS Provision No. 2/1994, Liquidity was set to ratio of assets and liabilities payable within one month to equal or higher than 100 per cent, by Provision No. 7/1997, Credit commitments set to maximum 25 per cent of the bank capital for non-bank clients and 80 per cent for bank clients. Net aggregate credit commitments over 15 per cent of bank capital must not exceed 800 per cent of the bank capital set by Provision No. 3/1994. Unsecured foreign exchange positions were regulated by Provision o. 11/1997 and Claims classification was regulated by Provision No. 3/1995.

> Foreign banks played an important role in exerting competitive pressures through increased and varied offers of banking products on both the deposit and loan sides and most importantly by their quality. [BL, 12.8.2002]

Furthermore, an introduction of the market based risk and credit management and analysis was crucial. The requirements of foreign banks when attracting the customers were viewed negatively:

> In the beginning, foreign banks required new clients to transfer all their accounts even personal ones should the requested loan be provided. [CDrJ, 3.5.2002]

Hence, foreign banks imposed a negative pressure in the first years of existence of independent Slovak banking sector where provision of credit was conditioned by transferring all of the client's finances (even personal) to the foreign bank offering credit. Nonetheless, foreign bank entry is generally viewed as the positive factor for the emerging banking market. New products and the quality of services, competition pressures, better credit management and pressure on interest rates, a shift toward an active customer approach and modernisation pressures exerted on the domestic banks were seen as the positive effects. On the other hand, negative factors also emerged, such as: drastic cuts in the number of employees not reflecting the true situation of the local economy, not understanding and not knowing the local environment resulting in the implementation of global strategies not always being successful. Also highlighted was the opinion that it was not the foreign bank entry but the increased competition and management pressures caused by the number of banks on the market that have brought positive effects for the customers especially in the improved level of services and available products.

6.3.2 Basic bank activities in the views of state and central bank officials

In the view of the central bank and the government officials, it is difficult to assess this question, especially because any effects of foreign entry are recordable usually only after a few years of foreign presence. But more interestingly:

> It may not have been the influence of foreign banks. More crucial was the adaptation of the local entrepreneurs to the local market conditions. Local businessmen had the wrong ideas and were not ready to disclose information about their businesses[57]. [HOI, 22.4.2002]

This may suggest that the local enterprise sector was at first lacking behind banking sector development. But domestic banks were probably hurt more by foreign entry because there was a transfer of loans towards foreign banks due to domestic state-owned banks being in difficult situation and the NBS even stopped any lending activities of the domestic banks in 1997-98 because of the threat of insolvency due to the high ratio of bad loans in domestic banks' portfolios:

> There was certainly a fundamental shift in the lending policies but domestic banks later virtually stopped lending to locally-managed companies. Later on even some MNCs re-routed their borrowing activities through Slovak banks because of favourable interest rate differentials. [ROA, 22.8.2002]

It would seem that the main problem associated with bad loans was the incapability of domestic banks to assess the risk. This resulted in the problems of 1999 when domestic banks virtually stopped fulfilling CCU criteria. Important too, however, was not the entry but the qualitative change of the markets. Loans were much more available from 1992 to 1994 (mostly for financing privatisation), which, nonetheless, resulted in high bad loans ratios. The dynamics of bad loans growth was unmanageable in 1998:

> Domestic banks became uncompetitive due to the interest rate differentials in 1998. Foreign banks engaged even more in sourcing the funds and focused on taking over the retail clientele. Foreign banks used their stability and credibility. The reform of the banking sector came late and was expensive and all this affected loans and deposit products provision. [DO, 30.7.2002]

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[57] As a result of the previous 40 years of 'covering the reality' under the centrally-planned economy.

The general notion is that all foreign banks came with their own economic objectives and were looking for expansion; therefore certain caution from the regulators was present. It was even set in the conception of the strategic development of the Slovak banking sector in the early 90s that the FDI in banking shall not reach more than 30 per cent. Any potential negative views, however, are not supported by strong arguments. The main positive issue is that:

> The foreign banks enabled functioning of inter-company financial flows in the economy and more importantly financed the development loans. Nevertheless, the final effect was not as positive as it could have been because the ROA of the bank debtors was very low. [Bac, 30.7.2002]

The most negative factor on domestic banks' operations was perceived to be the influence of government on decision-making in the biggest domestic banks. The three biggest domestic banks were fulfilling the political order of firstly privatisation, and secondly social transformation. Because of the high ratio of bad loans and in order to minimise the risks, domestic banks had to focus on a government debt market while commercial loans were directed politically. The *sine qua non* seems to be that the foreign banks could have invested their capital more effectively:

> Foreign banks did not really create competitive pressures but abused the bad situation of domestic banks and their instability and lent on the inter-bank market to domestic banks at high interest rates. Domestic banks worked on the condition of "uncovered loss" [overvalued collaterals thus effectively lower classified loan reserves and provisions] and all banks made business with interest rate profit but operating loss (foreign banks because of their better loan portfolio, undervalued collaterals and over-covered risks and domestic banks because of reporting uncollected interest earnings from the non-performing loans and the state imposed regulation on fees). [Bac, 30.7.2002]

Foreign banks were also negatively affected by the regulation, as they had to support the Deposit Protection Fund at the same level as domestic banks without respect to their

strength, stability, credibility and size. The involvement of the current government in provision of loans was viewed as the most damaging:

> Very negative is the political influence in the management of domestic banks[58]. [DO, 30.7.2002]

6.3.3 Conclusions on basic bank activities

It was the view of the majority of the interviewees that it was not the foreign bank entry that had a significant impact on provision of loans and sourcing of deposits in Slovakia. It was more down to the conditions of the economy and the regulations, which either supported or hindered the loan and deposit markets. Foreign banks were important for exerting competitive pressures, introducing higher quality of services and new products. The most important issue was the introduction of market-based credit and risk management that helped to teach domestic entrepreneurs conditions of acquiring external sources of funding. Most damaging to domestic banks was the state influence, through exerting political pressure on the provision of loans to selected enterprises, demanding to stand by the state's financing needs through purchase of bonds when the market conditions suggested otherwise (e.g. foreign banks were not attracted to government bonds in particular periods) and regulation to keep the fees down for citizens. Foreign bank entry is, however, evaluated as beneficial to the domestic banking market but only if the entry is sufficient in scale and only if the market conditions promote equal opportunities for growth of both domestic and foreign banking institutions.

6.4 Technology and operations

The second research area attempted to answer questions dealing with issues of competitive advantages and disadvantages and the transfer of know-how. It establishes whether there were any effects resulting from foreign entry and whether these effects can be described as positive or negative for the domestic banks and for the internal

[58] Interviewee was referring to the period between 1994 and 1998 – Author's comment

organisation, product portfolios, marketing or strategic management and bank know-how.

6.4.1 Technology and operations in the views of commercial bank officials

One view is that the foreign entry supported domestic banking know-how and marketing but only indirectly. It is supported by the notion that there is still not a real competitive environment on the Slovak banking market. So far it was more the issue of mutual influencing and gaining the knowledge rather than recordable pressures from the side of foreign banks. Domestic banks had the advantage of knowledge of local conditions as well as information about clients' histories. More developed branch networks and widely-recognised names on the local market ensured more business for domestic banks in the beginning. Interviewees highlighted further advantages, for example:

> An advantage for domestic banks was also building the institutions from scratch – especially valid for IT networks, when it was possible to buy the most up-to-date products and implement them straight away, whereas long-established banks in the West had a much more difficult situation when the IT systems had to be implemented over existing ones. Big domestic ones also had the advantage that they were building their IT systems at the time when electronic banking was coming into popularity and they could adjust their systems towards this trend easily. [BL, 12.8.2002]

Foreign banks on the other hand were better off because of better foreign currency links, brand names and possible safe havens for deposits in the view of customers at the later stages. Their books were not burdened by bad loans and although the deposit interest rates were not higher than with domestic banks, the quality of service was better. Knowledge of operating under standard market conditions and market-based banking know-how (especially credit risk assessment), which enabled its quicker implementation in conditions of the Slovak Republic and better elimination of risks, were suggested as the main advantages in bank management know-how for foreign banks. The big advantages were also the clearly set and drafted management processes. Foreigners also brought corporate governance and culture. Among disadvantages for foreign banks,

especially at the beginning was the fact that the state-owned companies had only one account in one bank, which made it difficult for foreign banks to compete in the beginning.

Although the majority view is that know-how transfer occurred, some interviewees voiced the opinion that real knowledge transfer had not happened. This was supported, on the one hand, by the wage differential factor:

> It is questionable whether the people sent abroad for training by the large domestic banks were the right ones as the banks themselves were rather disorganised, with low-quality personnel audits. [ORD, 12.6.2002]

It is suggested that some know-how transfers might have occurred simply via reconnaissance. However, the argument against this option was that any real transfer had not happened, not because domestic staff could not learn but because domestic managers were falling behind. The problem seemed to be to transfer the ideas from paper into reality. Another view was that the transfer of know-how has begun only recently with foreign banks becoming more involved in the sector. Most interviewees, however, agreed that transfer has happened, although in some cases this could have been a two-way process, where domestic banks learned the processes about operating under market conditions and foreigners learned the conditions of the environment. One way of the knowledge transfer was reconnaissance mostly based on personal contacts when employees that left domestic banks stayed in touch with their former colleagues and informally exchanged opinions and experiences. Also important was the fact of who introduced new processes first. The most important know-how transfer benefits were recorded by the client approach, marketing and quality of management. However, foreign management culture is not always coherent with the environment:

> Know-how 'twinning programs' under the Phare programme[59] where domestic banks were 'twinned' with foreign ones and the first important strategies of

[59] The Phare programme was one of the three pre-accession instruments financed by the European Union to assist the applicant countries of Central and Eastern Europe in their preparations for joining the European Union. (official EU website EUROPA, 2004). The

> restructuring were set also supported transfer of know-how. These were however limited because of the depth where foreigners were allowed in a particular domestic bank. [TP, 20.5.2002]

In relation to changes of strategies, respondents mostly viewed that substantial changes had not been undertaken to any great extent. On the contrary, when there is a strong bank entering or growing on the market, it is changing the environment itself. The real changes though happened only now, after privatisation of large banks. Bank strategies nowadays focus more on retail and the direct approach of customers.

6.4.2 Technology and operations in the views of state and central bank officials

The basic notion is that domestic banks had an advantage in knowing the market, whilst foreigners had better know-how. However, it should be the clients that rule over the character of the banking and other financial markets. Sometimes the opinion is that domestic banks had virtually no advantages against the foreign ones, who were usually strong financially and closely connected to parent companies. Then again, domestic staff had the local knowledge which was considered to be major advantage and:

> Foreigners were then buying local people with knowledge about the market and clients specifically. [MrT, 21.6.2002]

Most named advantages of the domestic banks were: knowing the clients and their preferences, having established branch networks and regional coverage, having long-term relationships with their clients, clients' trust and certainty about receiving their deposits, expected support from the state as the requests by issue of government bonds were fulfilled as well as loans provided where it was directed. Big banks had long-term relations with any currently ruling government and they were also recipients of the majority of state guarantees. Foreign banks were regarded on the other hand as having the advantage of strong financial backing by parent companies, better managerial know-how, much higher quality of service, much better and more sophisticated credit risk

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twinning programmes were of the similar sort as in Poland (see Chapter 3.3.1. – Privatisation in CEECs)

management resulting in 'cherry picking', a better position to exploit the situation on the market (because of better quality loan portfolios and better financial situation), and high credibility. Stability and clear decision-making structures; new and complex products as well as higher corporate culture were regarded as the most important competitive advantages. However, also articulated were the disadvantages on both sides, whether domestic or foreign:

> Domestic banks were hardly hit by the need for restructuring, low quality of services and product scale and non-functioning on-line payment processing systems as well as low capital strength [liquidity] at the beginning, [PTV, 17.9.2002] as well as over-employment and domestic majority shareholder, that was not interested in increasing the capital of a bank but in dividends only were proving to have adverse effect on domestic banks financial health. [Bac, 30.7.2002]

State support, as well as the high interest rate levels, was viewed as strongly disadvantageous for domestic banks. Foreigners, on the other hand, had to build from scratch, did not know the environment and had no information about the clients or relationships. Nonetheless, not only domestic banks made mistakes during the process and foreigners also had to learn their lessons. This occurred by implementation of credit risk criteria to loans that were unrealistically harsh, which was also influenced by legislation and jurisdiction. In relation to transfer of know-how, it was mostly the infrastructure that benefited – software, cash machines etc, although managements play important role in transfers of know-how. It was suggested that the quality of bank management was often higher in the case of domestic banks rather than foreigners:

> There should be some know-how transfer recordable but it often seemed that the quality of domestic managements was higher than that of foreign; the only missing substance [for domestic banks] was the knowledge of operating in the market environment. [HOI, 22.4.2002]

The local knowledge therefore always seems to play an important role. So does moral codex and trust especially in the banking where foreign banks were believed to bring

certain codex of behaviour – principles of undertaking, which had positive effects on the domestic sector. Any managerial or banking know-how could have been transferred by the exchange of staff and maybe some market learning (reconnaissance). The main transfer of know-how was directed to products, which enabled standardisation of the environment. The internal infrastructure of banks was also improved. When the local people went to foreign banks, they brought with them the know-how of local conditions, methodical procedures tailor-made to the environment (including legal norms and regulations) and knowledge of where to invest. Special knowledge of individual cases (deals) was also transferred. While domestic banks had locally well-oriented staff:

> Foreign banks have on the other hand higher corporate culture, know-how and products. [SEB, 2.6.2002]

Foreign bank presence though is perceived as necessary for the domestic banking sector. Yet the organisation of the market was not correct as the governments were hampering the foreign bank entry by not privatising the major domestic banks and waited with privatisation until the problem with domestic banks was unmanageable:

> Total sell out is, however, also no good. It means another extreme. Foreign banks can have positive effects but these are never absolutely positive! It is a question of a quality of the entering banks. [RG, 17.7.2002]

Foreign banks brought technological advances in particular [on-line systems] and also big domestic banks had a reason to work hard and improve. But on the other hand, in relation to cash card business, domestic banks even outperformed the foreign ones and Slovakian card business was much more advanced than in the other Transition, even Western, countries. The view is that the changes had to be introduced especially relating to 'product price optimisation' and market strategies, introducing competitive pressures. Tatra banka [Austrian foreign entry] in particular had a positive effect on the sector.

6.4.3 Conclusions on technology and operations

Both domestic and foreign banks had their advantages and disadvantages to cope with, and getting the edge over others was not really the case in the first years of transition. The effects of foreign entry on domestic banks in terms of technology and operation seemed to be more indirect and mutually influenced. Domestic banks were, however, more hampered by the organisation of the market, regulation and especially by the past, as the problems of non-performing loans were not solved. Further, large domestic banks, holding a majority of the market in relation to total volume of deposits, loans and banking assets, fulfilled the political and social order of financing the transformation of the economy and privatisation and were much influenced by the shareholder (state) that had its own political interests. The real benefit of foreign banks was in encouraging a different corporate culture to the sector that also influenced domestic counterparts.

Transfer of know-how was regarded to be hardly traceable. Domestic banks were regarded as capable of learning the techniques and processes of market-oriented operation themselves. Learning capacities of domestic banks were even praised by foreign participants. Foreign banks on the other hand had a beneficial effect in introducing new products which domestic banks had to develop or adapt, introducing a higher quality of service towards clients and imposing competitive pressure on domestic counterparts. For any know-how transfer, experienced employees seem to be crucial. Foreign banks especially, benefited from acquiring domestic experts who had intimate knowledge of the clients' past, needs and preferences but also local conditions in terms of legislation and regulation. Maintained interpersonal relationships between former employees of domestic banks that moved to foreign institutions were voiced as probably the most important way of transferring know-how, more on the middle management level than elsewhere.

Domestic banks had a big advantage when building their IT infrastructures as these were built from the scratch enabling them to use the latest technology as opposed to the long established foreign banks with existing technology. Furthermore, foreign entrants had to learn their lessons as well when applying their Western-based credit risk criteria to local businesses preventing them from attracting more business. Moreover, the quality of

foreign managements was sometimes questioned. Certainly, there needs to be a substantial share of foreign capital in the sector for any changes to be recordable but the total sell-out of domestic banking sector is not generally regarded as the best way of opening-up of country's financial system. Nonetheless, the notion was that the Slovak government failed to restructure large domestic state-owned banks and waited until their problems became critical was the main reason for privatisation.

6.5 Human Resources

The third research area deals with questions about the quality of human resources and the role of investments into human resources before and after foreign bank entry. It establishes whether foreign entry might have influenced the quality of human resources and eventually what form of investment was most beneficial.

6.5.1 Human Resources in the views of commercial bank officials

It was not really the better skills that foreign banks introduced to local human resources but better motivation when requiring higher efficiency. Foreign banks preferred employing young people unburdened by the past experiences of a different type of economy. Domestic banks adjusted only in the long-term. For example, average age in one of the large state-owned banks, VUB, was 50 in 1992; in 2000 it was only 35. This development was intended to increase overall productivity of domestic banks:

> Laying off in over-employed institutions after acquisition by foreigners created pressure on human resources and implementation of internal working standards and procedures that brought change in employees' attitudes and increased productivity. [BL, 12.8.2002]

Older people with more experience were preferred for higher management; otherwise younger people were preferred for middle and lower positions. Personal experience suggests that bank employees were less experienced and less educated than the entrepreneurs they were supposed to service[60]. However, the general notion is that

[60] There were number of cases in the early 90s when local entrepreneurs detected flaws in legal framework in creditors' rights and received large loans that they never intended to pay back.

foreigners have brought higher quality to human resources and better motivation is often stressed:

> Salaries in banks were generally higher than in other sectors of the economy but the productivity was not that high in the past. Now the foreigners kept the same respective level for salaries but require higher productivity from their employees. [KBZA, 8.7.2002]

After foreign entry, two groups of staff usually emerged: firstly, those that understood there was a change for the better and, secondly, those who were refusing to accept any changes. The view is that people have to be forced to learn. But the foreign investors were quite tolerant if they see efforts being put forward. The quality of local managers was proved, for example, in PKB [Prva komunalna banka, a.s. later sold to French Dexia] where five or six top management positions out of eight remained occupied by locals.

The benefits could have also been felt across other sectors when bank managers were spilling over to other industries where top managers were sometimes not older than 25-26 years old (though this was the exception). A different notion was that foreigners have brought in firms specialised in training, while for the NBS it was more ad hoc training, reacting to the developments in the bank sector. Foreign banks usually involved employees into training programmes, although domestic bank training institution Sporitelnicna akademia (the Savings Bank Academy), the institution established by one of the big domestic banks in order to improve the knowledge and skills of its employees, was also highly acclaimed:

> Even foreign advisors highly appreciated the level of education capacities of some local banks. The transfer happened mostly through interpersonal relationships and opened attitudes of foreigners at the early stages of transition. At the later stages domestic banks had to adapt to Western conditions if they wanted to remain competitive. [SCR, 12.9.2002]

The investments in human resources increased substantially and in some cases even doubled. With state-owned banks these were important, especially towards internal risk and credit analysis of a client and retail employees, although the amount invested does not have to be the most important measure because quality is the important factor. Short-term training has little effect; long-term training is more preferred. Tatra banka was one of the important driving forces towards education of employees. However, the amounts invested differed among the banks. Decision-making mechanisms are viewed as more important. One of the strategies was to pick trainers from each branch to disseminate knowledge and train on the spot. Though, in order to train effectively, specific local knowledge is needed and support from the centre is crucial:

> A transition period lasted longer than expected which influenced everything and it is felt across the sector that there is not sufficient support for branch managers from the head offices. [KBZA, 8.7.2002]

In partly- or fully-owned foreign banks it very much depends on the character of communication between the institution and the parent. It was viewed as most important to have high quality top and middle management positions and then to provide sufficient training and access to information for retail employees. The right motivation is again decisive factor.

6.5.2 Commercial bank officials on the quality of the top managements

Domestic banks were generally over-employed and human resources were covering up for low technical capacities. Only in the last three to four years [1996-2000] has the situation started to change (when technical infrastructures become sufficient):

> Domestic managements had their connections and political influence where 'tribes sometimes ruled'. There were, however, good people in the second line but without principles it was tough to undertake. [ORD, 12.6.2002]

Foreign banks especially brought know-how in credit business, and in relation to corporate culture there are similarities between Austria and Slovakia, for example, the

workforce is not very mobile. Top managements, however, were very different from bank to bank:

> They [foreigners] usually left the bank running and started to influence only when something went wrong. [MIM, 10.9.2002]

It was often viewed that foreign managers were the second tier, sometimes using placement abroad as a career step. An example of this is Hungary, where the second tier management was sent to one of the institutions and when that failed, the top quality managers were sent to rectify the situation. In some banks, on the other hand, the choice was confirmed after seven years of successful operations with the majority of local top managers.

6.5.3 Human Resources in the views of state and central bank officials

Human resources were very weak in the view state and central bank officials, especially at the beginning of 90s. But with the entry of foreign banks that acquired some of the domestic banks' staff and creation of new banks the quality of workforce improved. But it is also viewed that there was quality and good potential already present in the local workforce and also that a good system of education has been established. One notion is that the level of knowledge and understanding of principles has grown substantially, especially when development over the last six years is reviewed:

> While in the beginning, the basic principles had to be taught, these days trainers have to keep up with the students. The fresh graduates are better prepared and have better knowledge. [Bac, 30.7.2002]

Investments in HR are having positive effects and banks have to invest. In one opinion, the overall quality of HR is, however, still low although there are some domestic specialists. Investments have increased and foreigners focus on young people that are not burdened by the past. It is felt very important to motivate the employees to be willing and to want to learn new things. When comparing whether it is better to send people abroad first or only after initial learning about the local conditions, the latter

option is felt to be more appropriate, although in domestic banks it was sometimes the case that political preferences and clientelism were a factor. However, a combination of domestic training and experience abroad is regarded as the best way. In the views of some state and central bank officials, however, the amount of investment has not increased dramatically because of the incoming foreign investments while in the view of others, it has improved considerably. Weight was put on domestic education and training facilities either at NBS or on the latest privatisation projects. The question was also perceived by few to be one-sided because the whole process depends on the time since the opening up of the economy, availability of literature, the Internet and hunger for knowledge. Also important was the pressure to adapt to new accounting standards, legislation, supervision and the whole framework towards integration into various organisations. There was external, as well as internal (from the NBS), pressure towards standardisation of risk management. Foreign banks required training and education and locals understood this need; many courses emerged as a response to this need:

> However, when foreign banks sometimes organised the courses, domestic people were returning with the feeling "they think we are still monkeys on the trees over here". [Bac, 30.7.2002]

Any other programmes, like Phare, were viewed mostly as 'the Western money going through the East back to the West'. Most important were suggested foreign placements of local people with their own views and experiences that can recognise positives and negatives in approaches. And the most effective would be the combinations of teams with foreign experienced people and domestic unburdened specialists.

6.5.4 State and central bank officials on the positive effects to employment and quality of top managements

Foreign entry was supported but not because of the expected effect on employment although some effects can be recorded in the long run through enterprise sector. The problem was especially felt through 1996-1997 when local managements started to support short-term goals. It was felt that foreign entry threatened the largest domestic banks that were not fulfilling the CCU criteria. In one view, foreign institutions acquired

and produced the best of the Slovak management (current vice-governor of NBS and CEO of Credit Lyonaisse in Slovakia). EBRD's view was that government was conscious about banking sector needs but was afraid that foreign banks would jeopardise development. But foreign presence is important for the survival of the economy and privatisation was the fastest way to do it, which was also confirmed by the experiences of other Central and Eastern European countries:

> Yes, positive effects were imposed when foreign banks were buying out the local specialists that had to be substituted by new people that needed to be trained. The truth is that foreigners usually sent the second-tier of managements. [PTV, 17.9.2002]

The effects on employment were expected to be negative after letting foreigners in because of over-employment in the sector but the laid-off workforce shall be integrated back into the economy soon. Foreign entry was supported with the view that they would bring knowledge and procedures from the standard environment applying rational behaviour free from external pressures and long-term personal connections that have been hampering the development of locals.

The change in managements (even middle-executive managements) had to come in order to break personal connections or competence structures. The signs of this development are positive – improving financial health of banks but the credit involvement is still low. The effect is not yet adequate to the spent public costs. The issues that are still being addressed seem to be the effects, not the causes. However as mentioned already in the previous section about the quality of foreign managements:

> Sometimes the total change of the previous domestic management brought uncertainty and very unfortunate is if the foreign top management is only of second tier quality. [FN, 5.4.2002] Their quality, however, depends on the original position [the managers held] in the institution abroad. [SEB, 2.6.2002]

New banking law introduced requirements for minimum level of education for top managements (which was not always favourably welcomed by commercial bank

officials). The general view is that nowadays the quality has been influenced substantially but the local potential is already of a high quality. Most of the good local managers had been brought up from the middle positions but most of the top managers in foreign-owned banks were foreign. Foreign entry was said to surely influence the quality of human resources when in the beginning there was only a small number of quality employees while currently the situation changed. Moreover, foreign banks are expected to improve the levels of human resources:

> Although they may feel exploited these days, the foreign banks shall start repaying the debt [of the new opportunities available to them after Slovak financial market was liberalised] by educating the local workforce. [RG, 17.7.2002]

6.5.5 Conclusions on human resources

It is felt both between CBO and SBO that foreign entry has brought and increased the quality as well as volume of investments into human resources in the Slovak banking sector. Where CBO prove the quality of local managements by the number of top managers that remained at the posts, SBO generalise that the overall quality of local HR was good. That is also in relation to training capacities and capabilities. The issue was the level of motivation that was increased either on the financial side or simply due to the pressures to improve imposed on the pre-existing workforce by foreigners. Certainly, in the beginning the local workforce had to learn everything from scratch, but domestic educational capacities seemed to be catching up with needs. Entering foreign banks supported the creation of some institutions and also provided some facilities and knowledge for training. On the other hand there were instances when foreign banks underestimated local workforce and misunderstood the local conditions.

A combination of a foreign workforce with knowledge of standard market procedures and local specialists that are not burdened by the past is suggested as the best way to disseminate the knowledge. Also, foreign placements of local employees that know the local conditions and can bring good but critically assessed ideas from abroad were suggested. Foreign managements were often regarded as the second tier. Nonetheless,

the general notion is that the quality of the local workforce has improved; the only question is to what extent this was supported by foreign entry and to what extent this reflects the general opening up of the economy. An important argument was that, in the case of state-owned banks, the long-term personal relationships and political connections (as well as competence structures) had to be broken up by the complete exchange of top managements.

6.6 Infrastructure

The questions in the fourth research area examine the current status and possibly the strong or weak sides of existing infrastructures. It tries to establish potential pressures to external infrastructure[61] as well as internal infrastructure of domestic banks and possible influences on market organisation, regulation and supervision.

6.6.1 Infrastructure in the views of commercial bank officials

Technical and electronic infrastructure is by and large viewed as quickly transformed and well-developed, also because it was implemented only recently incorporating the state-of-the-art technologies. IT infrastructure is viewed as 'on a par' with the West although the breakthrough came after the introduction of intranets. However, low penetration of the Internet and limited use of emails for communication were felt as factors that obstructed efficient management at local banks and branches. For example, foreign banks rely more on conference call meetings, which may speed up management decision processes.

The biggest hindrance overall was recognised to be legislation and banking supervision. Legislation was 'lagging behind' in the sense that the Act on Banks (No. 21/1992), and acts on other financial institutions were not sufficiently regulating the environment. More importantly, late introduction of Acts on bankruptcy and debt recovery hindered the development and transition of the banking sector. Domestic banks in particular had

the majority of non-performing loans in their portfolios and felt the worst effects of the holes in the legal system, leaving them unable to solve the problem of the bad loans by sending the debtors bankrupt. Non-conception with passing the laws and frequent changes amongst the top management positions in the state banks brought on frequent fights of political lobbyist groups to take control over the big domestic banks. To avoid such development:

> an early privatisation seems to be the best option. [TB, 20.5.2002]

Of course this is rather simplified statement although Hungary proved that early privatisation was possible. On the other hand Hungary had history of two-tier banking and clear aim to sell majority of their banks to foreign hands whereas in Slovakia no such conception was endorsed by the government. Moreover, problems of non-performing loans were being solved with the help of government and parliament, in terms of legislation. Often discussed was the role of the central bank, especially in connection with the bank supervision:

- Bank supervision proved to be ineffective. It should have not come to the bankruptcies of some banks. Their controls on-site are too deep and precise in many cases, so why had a couple of banks failed? Why do commercial banks also have to pay off the NBS failures by contributing to the Deposit Insurance Fund? [CDrJ, 3.5.2002]

This critique is based on the fact that foreign banks had to pay similar contributions to the Deposit Insurance Fund although their financial strength was much higher than that of domestic ones. Furthermore, political influence played major role in number of the failed banks. Moreover, NBS faced the similar problem of learning-on-the-go as other domestic banks. A further critique of the central bank was that there were too many employees (about 1500) to supervise 18 banks and insufficient communication with the

[61] External infrastructure is described as: the market organisation, market institutions, legislation and regulation and supervision. Internal infrastructure is: management organisation structure, technical infrastructure, especially IT, branch network, human resource organisation.

sector. While certain shortcomings of bank supervision unit were acknowledged, the fact that it improved was stressed.

The New Banking Act (adopted in 2001) is viewed as not really ideal but in the view of others it should have been introduced in 1993. It seems to many interviewees to be an effort to implement EU legislation at all costs and banks expect even more changes in legislation with the coming accession to the EU. But another view is that:

> The new Act is not too hard; a lax approach has already cost us a SKK105 bill. [in costs of restructuring] [MIM, 10.9.2002]

In one (foreign) view, the legislation and jurisdiction is still outdated and without democratic control:

> People at the Ministry of Justice have not learned yet, and first-class lawyers operate under no supervision. Level of legislative know-how seems to be even declining and the whole system is largely bureaucratic. [ORD, 12.6.2002]

In general, however, the foreign entry is viewed as beneficial as it brought a better quality legal environment when foreigners required the same level of law enforcement and conditions as in their home countries. Whether it happened is another question and the repercussions of low enforceability of law could have been felt in foreign bank's shifting the focus on other activities than provision of credit to enterprise sector.

6.6.2 Commercial bank officials on influencing legislation

It was initially suggested that the lobbying or other influences on creating the legal environment by the banks might have occurred only at an informal level. The main vehicle, in an official way, was supposed to be the Association of Banks. But the informal pressures were confirmed from other sources (in some cases even being negative towards domestic banks). The Association of Banks was heavily criticised from both sides, foreign and domestic banks:

> The Association of Banks works but it is run by the former state bank employees. [ORD, 12.6.2002]

The new Act on debt recovery was regarded as a strong step forward and a result of lobbyist pressures both from the side of domestic and foreign banks as it was crucial for solving the non-performing loans and extension of new credit. Clear lobbyist involvement (both domestic and later foreign) was result of government restriction for only domestic banks to deal with customs guarantees (billions of SKK):

> Another example was the wrongly implemented Act on customs guarantees restricting involvement to foreign banks. Nationale Nederlanden – ING group intervened through Dutch Prime Minister. [KBZA, 8.7.2002]

Foreign entrants were trying to remove any non-systemic solutions and to adapt the local conditions to home country conditions. But foreign CBO refused such a view referring to the Association of Banks that should have such a role but was regarded by many as completely under-performing. On the other hand, local managers suggested that any influence happened only at a formal level.

6.6.3 Commercial bank officials on the foreign entry effects

Foreign entry is by and large regarded as beneficial for the domestic sector especially from the state point of view. Sale of domestic banks means revenues from privatisation as well as beneficial effects for the clients and economy acting as a guarantee of healthy market functioning. Moreover, competitive pressures on only on the side of banking sector but also towards the enterprise sector were articulated:

> It also created pressure on local enterprises that enabled credit allocation to get to a healthy base and increased pressure onto restructuring of the enterprises. [TB, 20.5.2002]

Banks in this sense were viewed as conveyors of restructuring. It is however recognised that real competition begins only with 'levelling the playing field' and that the industrial and enterprise sector still needs systematic restructuring led by the state[62].

6.6.4 Infrastructure in the views of state and central bank officials

The Slovak banking sector was regarded as well developed with an established competitive environment, market know-how and functioning central bank at the beginning of 2000. Technical and legislative infrastructure had the standard Western character which was confirmed by the positive comments of Italian and Austrian investors. Although being regarded as highly developed, additional views on infrastructure of the Slovak banking market brings forward the utilisation of good working infrastructure by lacking domestic banks:

> The question however is: to what extent is this high level infrastructure utilised. The ratio of fixed costs and operating costs is too high in relation to total costs. The banks did not manage to utilise their real estate assets when domestic ones after foreign entry and outflow of clients held large real estate assets without their utilisation. [Bac, 30.7.2002]

Outsourcing and real estate potential has become utilised only at the end of 2000 when number of large domestic banks begun to rent parts of their real estate assets mostly to other financial institutions (like insurance companies etc.). Excessive employment and

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[62] The government of PM Meciar declared support of small and medium enterprises (SMEs) (MESA 10, 1998). Specialised financial institution was supposed to be established (which never happened). Moreover, access to the external sources of funding for SMEs deteriorated as expansive government fiscal policy that requested restrictive monetary policy by NBS increased not only demand for loans but also interest rates. Moreover, public sector was acquiring majority of the credit increase which further restricted access to credit for SMEs. Cheaper foreign credit was available only for large enterprises and SMEs were often required to provide guarantees equalling 200 even 300 per cent of the value of the loan. Furthermore, the average interest rate on loans for enterprise sector went from 13.27 per cent in 1996 to 20.49 per cent in 1998 (NBS, 2000). Hence SMEs were in majority left to rely on internal funding that became also limited due to deteriorating profitability. Complicated legislation (tax laws were updated more than 70 times) was exerting more hindrance to undertaking than promoting it.

mismanagements on the cost side were coupled with weaknesses with the institutions and market organisation:

> Technological and legislative infrastructure nowadays has a standard character. It is organisation of the market and institutional infrastructure that is lagging behind. [HOI, 22.4.2002]

Current implementation of the new banking act is similar to the implementation of laws in the past. After the law is passed, it is only later that the loopholes are discovered. Thus legislation only responds to the situation and is being adjusted to the reality where:

> Only through functioning emerges so-called 'secondary legislation'. [DO, 30.7.2002]

The main problem with generating transparent and reality-reflecting laws was taking on board comments of Anglo-Saxon lawyers, as opposed to those from the perspective of the European type of law under which the Slovakian legal system is working. The main problem related to how specific the explanation is, and that is where the Association of Banks was supposed to step in (which it did not). The Association is again viewed as a failing institution that missed an opportunity to comment on new laws and take a pro-active approach towards the government:

> The laws were after all passed only after some bank bankruptcies and bankruptcies of other non-financial institutions [DO, 30.7.2002] where the NBS could have acted quicker. [ROA, 20.8.2002]

The speed of reaction to potential problems of banking sector is however difficult to assess without intimate knowledge of the problem. The quality of central bank personnel may be one facet of the problem but influence of state and legal infrastructure compose the other facets. That is where harmonisation of the Slovak legal system with the EU regulations could have improved the situation. Harmonisation is generally regarded to be high as the creation of laws was to a great extent influenced by the EU legislation and Aquis Communitaire for joining the EU. The latest changes in legislation

were significant and also conditioned by the World Bank's criteria for approval of the EFSAL loan, the loan for restructuring of the financial and banking sector. While this framework is established:

> The legal harmonisation is one side of a task, but its implementation is another story. Market organisation and institutional infrastructure give the impression of being idle. A suggestion for further development will be the creation of credit risk agencies. [Bac, 30.7.2002]

In respect of the potential future development of the Slovak banking market, it was suggested that the characteristics might involve the small banks to either: first, cease to exist, second, merge or third, specialise in products or regions. This would be the result of decreased interest rates of the state bonds and T-bills that the small banks survive on. The low revenues from the government bonds and T-bills will not be able to cover the costs of fixed assets [in the future]. The research suggests[63] that for SKK5 billion of bank capital, the bank's assets need to be SKK40 billion in order to cover the operating costs.

The overall characteristics of the market were reported to be good in terms of competitiveness but not significantly positive in relation to the high number of universal banks with the whole country coverage. On the other hand, the state-owned universal banks are focused on retail although with 20 per cent unemployment in some regions this might be a problem. There is a potential in the market but the economy does not create good conditions for growth. It is therefore inevitable to bring down the fixed costs and spur the active business.

6.6.5 State and central bank officials on influencing legislation

The notion that the Association of Banks has failed completely in the crucial task of forming legislation is present also among state and central bank officials. Association was either aiding in sorting of internal problems of the banking sector or only reacting to

[63] Various documents and discussions with NBS staff

any wrongdoing. Influences on creation of legislation were recognised as largely untraceable and any positive lobbyism was even missing.

In the view of a domestic state official, the foreign banks could have done more. EBRD stated that it was supporting legal reform by funding lawyers involved by preparation of laws. Also supported were the policy dialog and the legislation- and institution-building. A special case of lobbyism, however, was at NBS when one of the vice-governors in 1997-1998 was an ex-president of one of the large state banks and he had brought personal connections with him. That enabled the creation of a buffer in terms of neglecting the pricing of collaterals and risks for domestic banks in order to meet the criteria that had to be met CCU):

> Even auditors were cautioned to be soft by audits and writing reports. [Bac, 30.7.2002]

However, had the NBS followed strict protocol, majority of the state-owned banks would have to be immediately placed under conservatorship of the NBS effectively crippling the economy. Hence this special case of lobbyism was not a single sided act but more a result of necessity in the current political environment where state-owned banks were left to fend for themselves. Out of everyone, only the top managements were able to agree and exert pressure on the state through the Association of Banks or even directly. This was limited since the top management of the largest domestic banks had the closest contacts with the Association. If there were any pressures on legislation recorded, these were coming from within.

6.6.6 State and central bank officials on foreign entry effects

Foreign entry was perceived by the SBOs as generally positive since it brought diversification of the market even though mergers were expected. Thus, opinion that Slovak banking market needed consolidation was becoming more and more pronounced. Foreign banks were expected to play significant role in this development but cautious attitude toward foreigners might have been recorded especially after a few financial scandals:

> When, for example, Creditanstalt and ING enabled tunnelling the VSZ [large steel foundry conglomerate in Kosice]. [ROA, 20.8.2002]

The negatives were, however, only seldom voiced. If the ambitious plans of foreigners fail (as in the case of Crédit Lyonnaise which aimed at providing much more government financing than in reality happened), banks are frequently degraded even to the level of branches or representative offices. The weight was not given to the arrival of foreign banks but to overall opening up of the economy and to adjusting to the conditions of transition. The process of restructuring went more its own way, building on its own experiences from the real market economy building. The entry of foreign banks was not decisive and did not really influence the financial market in Slovakia. It was more the case that foreign banks knew the conditions and knew what kind of a market they were entering. Foreign banks were thus using the existing structures for maximisation of profits:

> Foreign banks were even happier that the bank supervision is after specific four criteria and not really going deeper in their audit. [Bac, 30.7.2002]

For example, the higher coefficient of the credit risk does not necessarily mean that the bank is worse off. The key question hence is: "How does it change the creation and distribution of internal resources of a bank?". In other words, more important is the balance sheet stability and profitability [measured by ROA]. The reasons supporting this view are: first, how long the bank can hold to its resources; and second, what are the criteria by which one can evaluate the assets?

6.6.7 Conclusions on infrastructure

The level of 'hardware' infrastructure is assessed as high by both CBO and SBO. In some cases this proclaimed to be even higher than in the West. The reasons were that domestic banks could use the latest state-of-the-art products when building their internal infrastructure networks. Electronic banking had especially high credit among foreign banks. Though the question also arose as to what extent this high-level of technical

infrastructure is utilised. The situation with the organisation of the market was very different. The Central Bank was often criticised due to late involvement with some bank failures. Bank supervision was especially condemned in the beginning. Foreign banks were praised for bringing different corporate cultures into the market. Any influence on creation of legislation was more on the hypothetical level. The Association of Banks largely failed to provide any guidance or conception and lobbying was not generally used, only in some rare cases. Foreign banks were taking advantage of the existing (or non-existing) legislative framework. Latest developments, however, meant striking change towards better legislation as well as central bank and supervision functioning. This, however, happened only after some big banks were sold to foreigners, though it was also said that the change in legal framework was more a result of pressure from the long-established Tatra banka than from other new entrants.

Certainly, foreign banks came with much better bank and managerial know-how and internal organisations adapted and developed under conditions of functioning market economies where the credit risk assessment that enabled them to swiftly detect profitable and prospective clients (which they targeted and effectively carried out the 'cherry picking' in TEs) whereas domestic banks had to learn these techniques. The most important positive effects of foreign entry were described as creating competitive pressures, where customers benefited most, furthermore bringing certain codes of practice and corporate culture and also the guarantee of a healthy and stable bank market functioning. However, foreign banks were more exploiting the market situation focusing only on profits and not being ready to offer credit to small- or medium-sized enterprises, although the financial situation enabled them to do so as they were not burdened by portfolios of non-performing loans. Foreign entry influence was not evaluated as strictly beneficial but it appears that thanks to involvement of foreign banks, Slovakian banking sector kept functioning.

6.7 Influences of state and Central Bank policy

The questions in the fifth research area concern the state influence imposed on domestic and foreign banks. The legal conditions and the ability of institutions to enforce the laws or react to the weak sides of the legal framework are investigated further. Moreover,

functioning of the market institutions and expectations from the foreign entry were scrutinised.

6.7.1 State pressures in the views of commercial bank officials

In terms of any negative pressures from the government, these could have been more psychological, described as the 'selling off the family silver'. The negative pressure in the view of foreign participants, however, was state involvement in restructuring of the state bank loan portfolios which was perceived as very non-market and discriminating tool. But it was also recognised that political influence of the government damaged the position of the domestic state-owned banks. Although these may be, to a certain degree, expected as the government faces the enormous task of restructuring the economy:

> Politicians have often mistaken domestic banks as sources of free finances. [SCR, 12.9.2002]

In order to refrain from the political pressure in domestic banks its privatisation was suggested as the only possible solution. Another example of an unfortunate influence of the state on domestic banks was the decision to place the customs debt (importing and exporting companies paying customs duty) specifically to foreign banks. In the view of some domestic bankers, if it had not been for this, the overall costs of restructuring would be much lower.

It is difficult to establish the best means of transformation of the financial sector from centrally planned to market-based. While some argue that immediate sale to foreigners is the best solution, especially to prevent political pressures, (Buch, 2000) others support a view that the local banks need some time for restructuring and limited involvement of foreign capital is beneficial (Kaminsky and Reinhart, 1996):

> I can imagine that the transformation would go solely through foreign banks. But not exclusively; one domestic bank could remain which would function for domestic [government] purposes. [SCR, 12.9.2002]

This suggestion very much resembles Hungarian case where although involvement of foreign banks is very high. One large bank (OTP) was kept as majority domestic. This bank proved to be rather successful and later went on to acquire one of the three large state-owned Slovakian banks (IRB). When being privatised, various types of investors have risen to the challenge. Quite frequently, individuals or private groups asserted their interest in local banks. However, the question of motivation was the crucial one:

> Unfortunately, there was no private group that would be interested in correct functioning and undertaking on the Slovak banking market. [SCR, 12.9.2002]

Hence attempts of private groups were often viewed as attempts to secure means to quick enrichment. The issue of trust here becomes more pronounced. While the National Bank of Slovakia was, for many years, perceived as one of the most trustworthy institutions by the citizens and some foreign bank managers, the government in the other hand often recorded low levels of trust. State-owned banks often benefited from close links with the government:

> Every government preferred a certain bank. For example paying out the deposits by the bankruptcy of some banks was assigned to one bank (SLSP) with one exception. This way it immediately gained customers. Further, when paying out the bonds from the second wave of privatisation was assigned to SLSP, billions of SKK were held and managed in one institution and it boosted on customers credit this way. [MASI, 15.4.2002]

Influence of state decisions was felt to be a very uncompetitive measure and decisions to use only state banks for repayment of privatisation revenues or payment of guaranteed share of deposits of the failed banks from the Deposit Guarantee Fund left a lot of bad feeling among other commercial banks that were contributing to the Fund with the same shares. Especially foreign banks felt they were left out of this process giving domestic banks competitive advantage.

6.7.2 Commercial bank officials on the current legal framework

Enforcement of law is crucial issue for any infrastructure to function. It was not so much the laws themselves but more the way they put legal framework into practice and enforce the legal code:

> Establishing functioning institutions is most important during transformation of an economy. [MIM, 10.9.2002]

It appears that initial recommendations of World Bank Group advisers to create private ownership and let market to take care of the rest have not played well. The lassaiz-faire policy might have worked in the markets with already established strong institutions (such as UK or USA in the late 1800s) but in the case of Transition Economies the very institutions needed to be built. This issue was actually acknowledged by one of the advisors for Czechoslovak voucher privatisation Jeffrey Sachs (see Zinnes, Eilat and Sachs, 2001). However, those institutions shall not only fill the space that legislation creates but also help by changing people's thinking:

> Most important is to change people, not the laws! [KBZA, 8.7.2002]

In general, however, the jurisdiction is recognised as lagging behind the legal framework and any reporting regulators seen as being very bureaucratic. In the process of transformation of the economy, however, it is difficult if not impossible to create laws covering all the aspects of the turbulent times. While criticisms of failing legal framework may be many times substantiated the factor of time and adjustments to the new conditions is also needed to be considered.

6.7.3 Commercial bank officials on the institution functioning

While it is perceived that the NBS finally duly reacts to environment, it does not influence or change the economic policy of the state. The tasks of transformation were met; the competition was created; market know-how was in place; integration into European structures had begun and the important thing was that the difficulties were left

in the past and not rolled out into the future. A quite contrary view, however, was that the bank restructuring should have commenced before and not after the crisis:

> Crooks often ran banks and there was actually nothing regulators could do about it. The only question is whether regulation in its current shape was introduced on time? [ORD, 12.6.2002]

It is the ever repeating problem of the legislation following and reacting to changes in environment, rather than creating that environment. Particularly under conditions of transforming financial markets, both regulators and market players are learning and where law leaves too much space, strong institutions are required to provide guidance and explanation. Should this not happen, the application of laws and regulation may become twisted and:

> The debtor may become the owner as happened in the past[64] [TB, 20.5.2002]

This situation is of course most dangerous for any financial system and failure to prevent it could result in serious repercussions that might be felt all over the economy.

6.7.4 State pressures in the views of state and central bank officials

In the view of state and central bank officials, the state influence on the Slovak banking sector was reported to be present although only at the beginning of the transformation.

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[64] The case of the third largest state-owned bank IRB where the widespread suggestions claimed that its major debtor VSZ (Východoslovenské železiarne, Košice) already (maximum) 15 per cent stake holder acquired through various unclear business connections (numbers of limited companies affiliated VSZ) further 29 per cent and managed to siphon out substantial amount of cash which sent the bank into direct administration of the NBS in December 1997 after becoming illiquid only confirms the dangers of legal loopholes. Major changes in management in 1997 also had not supported the situation. In reality NBS had asked two largest shareholders, The National Property Fund with 35 per cent and VSZ with 15 per cent to increase the bank's capital by at least SKK 1 billion during 1997 (since the capital adequacy was reaching only 1 per cent of the required 8), but this request has not been met (OECD, 1999). Recording substantial losses for 1996 and first three quarters of 1997 bank turned to money-market for funds but other banks became unwilling to lend and NBS also turned down request for liquidity loans. Bank run by depositors was looming and NBS had to place IRB into conservatorship.

The Central Bank was assessed highly, although probably while sacrificing the bank supervision for the currency policy control. To an extent this may explain perceptions of commercial bank officials in respect of lacking bank supervision. It also suggests government influence in the so far independent institution of the Central Bank. However, there seems to be a trade-off between NBS and government when free hand in monetary policy was accompanied by 'a turned head' in case of a few banks.

Concerning foreign banks' operations, it was suggested that the foreign banks could have more benefit from the system because they knew how to behave. On the other hand, the deposit protection system was clearly unfair because it was set in such a way that everyone paid maximum rates. Now foreign banks had to pay for failures of the domestic banks, although this is sometimes compensated for by tax holidays. The negative policy of state towards transformation and the role of banks were voiced strongly:

> Banks were in general used to solve the problems of the economy whereas the problems of banks were never solved. The reasons were, on the one hand, weak understanding of the situation, and strong state pressures on the other. No one knew how to manage banks in the market economy and a badly trained workforce with bad shareholders made its fouls. Banks had to provide loans where the shareholder decided and dictated. [PTV, 17.9.2002]

The political influence in the state-owned banks becomes increasingly apparent. The state seemed to have used its influence to order large banks to provide credit where deemed necessary. Political pressures were serious and the basic bank activities were fraught:

> Loan provision was not made on commercial principles. Big loans went through domestic banks (large state-owned) and were made on political decisions. Also the Ministry of Finance provided state guarantees mostly to domestic banks but seldom to foreign. This has, however, finished now. [DO, 30.7.2002]

The role of foreign banks was hence viewed as a stabilising factor, although abusing the situation foreign banks provided finances on inter-bank markets for domestic banks with bad loan portfolios that were undertaking with 'uncovered loss' (collaterals to assets were overvalued, interest charges were not collected but entered into accounts as profits); domestic banks thus did not meet a single Criteria of Cautious Undertaking set by the NBS and had hidden guarantees from the state. Foreign banks thus only accelerated the situation and the deteriorating conditions in domestic banks. The whole situation around big domestic banks should have been solved in 1993-96 and the costs would have been a maximum SKK60 billion, not SKK105billion or SKK130billion as reported nowadays[65]. Slovenska sporitelna virtually financed the small privatisation and VUB the large privatisation. Their role hence also had a political-social motive in maintaining the functioning of the economy and promoting transformation.

6.7.5 State and central bank officials on the current legal framework

Also the state and central bank officials recognise the strong state influences of the past, especially through the unfortunate 'Act on Strategic Enterprises'. Any influences diminished, though, towards the end of the researched period. Furthermore, the quality of the bank supervision was questioned. The problem of failing Czech banks was accentuated by the view that the know-how was lacking in any transitional economy. Additionally:

> It is difficult to assess the health of foreign banks as these are usually daughter companies. [RG, 17.7.2002]

The current legal framework is, however, regarded as sufficient and up-to-date. Legislation even overtook the current market environment in one view. And the legislation has also been drawn with the view of joining the EU. The capacities of the institutional framework to cope with such changes have been questioned:

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[65] Estimated total costs of domestic bank restructuring connected with privatisation of the large state-owned banks

> However, the abilities of the institutions are not high enough to absorb and adjust. [Bac, 30.7.2002]

Hence one suggestion is that the legal framework should overtake the environment but also be easily adjustable to copy the current situation, otherwise it will be 'loop holed'. This is, though, easier said than done as the processes of economic transformation could not be rigidly controlled by the government. Furthermore, the process of introducing laws has also not been miraculously swift not mentioning the enforceability. Thus, building strong and correctly functioning institutions becomes more important.

6.7.6 Expectations of state and the Central Bank regarding foreign entry

Bank supervision was regarded to be very weak, with unqualified personnel. There were efforts to create an integrated supervision body by the Ministry of Finance (like the UK's FSA) as a response to increased integration and globalisation of markets. The NBS opposed this intention being afraid of losing its current authority. Any such changed were only deemed possible after the election period of the current governor finishes (in 2006):

> Even the current Minister of Finance would not support an independent integrated watchdog because he comes from the NBS and would like to return after the election period. [HOI, 22.4.2002] Hence, through the bank supervision, the sector was kept in a state of chaos. [MrT, 21.6.2002]

Certain shortcomings of bank supervision unit were also pointed out from within. The bank supervision unit has not had and still has not implemented a system for evaluation of the dynamic side of banking performance indicators (time series analyses etc.):

> They still work on basic static side looking and percentage improvements (anyone could do it) but it is trends and causes that need to be looked at, for example Altman's model where correlation coefficients show developments. . [Bac, 30.7.2002]

Important therefore is the control to commence when anything seems wrong. But the tools for supervision are not shaped in a way such that they could predict problems. Fulfilling the CCU (Basel I) criteria was taken as a fetish – with attitude that 'paper can stand anything'. Most important therefore is overall quality performance and sustainable development, though non-standard environment requires non-standard criteria for evaluations. Basel I is good with standard functioning accounting and a legal frame and it is only suitable for transition economies if all mentioned frameworks function correctly. This is, however, seldom the case. The Central Banks needs to knew intimately the problems that local banks face and not to linger on fulfilling the international criteria in the first stages of transformation. It seems there was no specific strategy until 1998 in regulation of the banking sector. Only after 1998 was the imperative to separate political influence from the management of state commercial banks and to create a functioning bank sector.

It was also regarded as important to attract foreign entrants into the market in order to create a fully-functioning sector and to promote competition in particular. Although recent legal acts improved the conditions, this was not reflected in increased provision of loans. What government was looking for were strategic investors, where price-income was not the most important factor. Rather, support of the environment of a productive economy was prioritized. The view of some interviewees is that the current market is well-organised but for the price of learning by ones own mistakes – the government's, the Central Bank's and domestic commercial banks' as well.

6.7.7 Conclusions on the influences of state and central bank policy

It was largely felt by commercial bank officials that any state-led restructuring of state bank loan portfolios was a very non-market and discriminatory tool but also, that the state had very negative effects on these banks, using them as pools of funds to finance either state bills or serve as financing institutions for the individual interests of political élites. In this sense it was felt that the only way out was the sale of domestic banks to foreigners because they bring a clear ownership structures and legal environment and support change in government policies. Domestic banks were often favoured by the state especially when redistributing deposits of the failed banks under deposit insurance

schemes or paying out the government bonds of the second wave of privatisation. On the other hand, there was no private group interested in correct undertaking on the Slovak banking market; therefore foreign entry seemed to be the only solution. In state and central bank officials' notions, banks were often used as problem solvers for the economy, except the problems of those banks were never solved. While domestic banks had to provide loans where instructed by the government, they also had the advantage of financing the large projects directed by the state. Thus, generally, while domestic banks were very much influenced by the political motives of the current governments and had to fulfil the social order of restructuring, foreign banks had the advantage of knowledge of undertaking under market conditions and healthy portfolios which then enabled them to finance domestic banks at high interest rates. In relation to the legal framework, both groups agree that current legislation fulfils the requirements of the market conditions sometimes even exceeding the requirements. It essentially seems to be the view that establishing functioning institutions is most important during transformation of an economy. This proves to be as problematic as when trying to implement the new laws under a non-functioning judiciary framework.

Current institutions are largely felt to be working effectively, although at a cost of previous failures. Banking supervision is still viewed as not well-established with a lack of well-trained personnel. The broad tasks of transformation were met and full integration into European structures has begun since the change of government in 1998. In relation to the state and central bank officials' expectations from foreign entry, it seems there was no specific strategy until 1998 in the regulation of the banking sector. Only after 1998 was the imperative to separate political influence from the management of state commercial banks and to create a properly functioning bank sector. It was also regarded as important to attract foreign entrants into the market in order to create a fully functioning sector.

6.8 Influences of competition effects

The questions in the final, sixth research area explores the effects of foreign entry on the market size and distribution. Moreover, potential increased outflow or inflow of capital is investigated. It is important to establish whether the competition supported increased stability of the bank sector and transformation as well as economic growth.

6.8.1 Market size and distribution in the views of commercial bank officials

The Western financial markets are globally one of the most developed ones reaching the pinnacle in saturation. Changes in Transition Economies were hence welcomed by the West since it was opening new markets. Developing economies offered good potential for business since profit margins were known to be higher than those in the developed countries (see Demürguc-Kunt and Huizinga, 1999). Foreign banks might have had edge over their local inexperienced counterparts in terms of lower cost, clean loan portfolios, better know-how and management. Competition was welcomed by the TEs governments and institutions since it was believed to bring higher standards of services and in the end lower prices of financial product. However, it is still perceived that real competition will only commence as foreign banks are entering markets in larger volumes towards the end of 90s. A certain level of foreign involvement necessary for any effects to take place was further supported:

> The effects were visible as the market developed and especially are expected after privatization of large domestic banks. [TB, 20.5.2002]

Nevertheless, it is now questionable how many foreign banks or domestic banks can survive on such a small market since like Slovakia when they are all in search for quality assets but these are all limited. Number of CEECs banking markets has become over-banked with domestic and foreign banks in the mid 90s. Poor capital structures of some of the newly emerged domestic banks (that later failed) and mergers and acquisitions on international scene of foreign banks consolidated somewhat these markets. The motivation of increasing value of a company (bank) by entering and

buying relatively smaller banks in TEs has been confirmed[66]. An important notion is that the foreign banks could afford to 'skim-the-cream' thanks to their clean portfolios:

> When the big banks (especially VUB) had to completely stop offering loans due to failure to comply with the CCU, Tatra banka and Ludova banka (Volksbank) jumped in to fill the market space. 2000 has recorded a boom in retail – current accounts as well as consumer loans for foreign banks. [JAI, 4.7.2002]

Nonetheless, the Slovak market is very much influenced by overall European characteristics. Foreign entry certainly leads to changes in market size distributions. However, it is also clear that some banks have not managed to benefit from their long-term presence on the market while others managed to beat even domestic giants in a relatively short period of time. It was claimed though, that overall, foreign entry had no substantial effects on large domestic banks due to their size. However, large state-owned banks were only effectively maintaining their underperforming loan portfolios and foreign banks were the ones that could extend new credits to viable entrepreneurs promoting growth and development. Loan and deposit distribution was certainly affected by foreign bank entry but only to a limited extent because a large proportion of deposits lay with the SLSP and a large share of loans was with VUB. Rather surprisingly, the attitude of the IMF towards financial assistance for Small and Medium Enterprise (SME) development was criticized, where many programmes supporting SMEs in Slovakia were not functioning due to:

> An obsession with quantitative credit criteria that proved ineffective when the whole market conditions are more important. [MIM, 10.9.2002]

The inherent conditions of transition economy seemed to be neglected by the international financial institutions as the criteria set for granting the credits were not reflecting specific conditions but were rather set on conditions of fully developed Western financial systems mostly supporting exporting industries or projects. On the

[66] Such foreign bank can increase its value for potential takeover by its larger competitor which might have been the case for some Austrian or Italian banks.

other hand, these credit links were often maintained by the large state-owned banks that were coping with their own problems.

6.8.2 Commercial bank officials on capital outflow and inflow

Foreign entry probably influenced capital flows as entering banks discovered the market, which influences flows of capital. Without foreign banks there would be no short-term capital (portfolio investments and inter-bank trading), which on the one hand was good for strengthening the balance of payments, but on the other hand harmed domestic banks by restructuring, draining their profits via high inter-bank interest rates. Foreign bank presence was more positive than negative, especially with respect to syndicated loan markets, but the positive effects by attracting more foreign direct investments were hardly traceable in the view of some:

> In general, foreign banks were returning their invested funds into the economy and if there was any outflow then this was represented only as profits [paid out as dividends]. [SCR, 12.9.2002]

6.8.3 Commercial bank officials on the increased stability of the sector

It has been largely perceived that foreign entry increased the stability of the sector as well as citizens' trust in the banks. Foreign banks helped to increase the stability of the market, they brought know-how but they also had their own motivation, i.e. the efficiency and profitability of their own operations. Further, foreign banks supported the internal stability of the market, as motivation for privatization, and the external stability of the market, in the sense of integration into European business structures. Confirming the view of Bonin and Wachtel (1996) that governance of the banks must be independent from the state is the following:

> Foreign capital supports independence of banks when political relations are broken and lobbyist relationships are reduced. [JAI, 4.7.2002]

Capital assistance from parent firms and implementation of harder-line credit policy also supports the healthy functioning of banks.

6.8.4 Commercial bank officials on support of growth and transformation

Foreign bank entry was believed to be the supportive element for transformation and adjustment to foreign competition and market conditions. Even if foreign banks were not present on the market, the overall growth of the economy would not be higher, although on the other hand their presence eliminated potential problems. Banks until 1997 provided senseless credits until the credit moratorium imposed by the NBS. Since 1998 the situation has changed dramatically as the state decided to withdraw from the two largest banks. An assessment of the restructuring process was offered in the following statement:

> Yes, use and employment of funds, getting deposits and lending to government at 25 per cent rates – everyone loved that! Tatra banka had the first-class loan portfolio and now is the biggest lender not only for the state! The question might be, what would it be like if Tatra banka was stronger? Loans would be offered more aggressively and the attitude of state towards banking would change. The main mistake of the governments was to delay restructuring of the banking sector. Look at Hungary, Poland or the Czech Republic; their cases were successful. [ORD, 12.6.2002]

On the other hand, the opposite view was that any effects have not yet showed up because of the way the privatisation was performed. Banks have only had a small effect on the restructuring of enterprises and the business environment since it was claimed that the difference between nominal and market price of banks' assets is actually difference and price of restructuring the enterprise sector. A more important mistake was the lack of a long-term strategy for the economic development of the Slovak Republic with the outlooks for 10 to 15 or 20 years and also a more specialised strategy for individual sectors:

> Banks now have to change their strategies because within the next three to five years the price of funds will be stabilised and a fierce fight for clients will take place. [JAI, 4.7.2002]

It should be noted that there was a period in the second half of 90s when the banks turned their attention towards government bonds and securities rather than towards financing the real economy because of the high interest rates offered. Banks were replacing their risky exposures to enterprise sector with secure government bonds at higher rates that enterprise sector was able to pay. Under these circumstances the state itself was draining out financial assets that could have been used for promoting enterprise sector (including SMEs) at the time when it was needed most. The growth of the economy was instead secured through public sector growth including large infrastructural investments that certainly were necessary in the long-run but could have been arguably managed in a better way[67]. To sum up the development of Slovakian banking sector and the role of foreign banks:

> Generally, in 1993-4 the influence was very weak; in 1995-7 the political influence overwhelmed; 1997-8 brought a 'sobering up' from the credit expansion and later years brought a significant inflow of foreign direct investments [not only in banking] [JAI, 4.7.2002]

6.8.5 Market size and distribution in the views of state and central bank officials

It is said to be too soon to evaluate whether foreign banks have brought substantial changes in market distributions. Certainly Tatra banka is in a better position because it came to the market sooner:

> There was certain 'breathe-out' of the market after the sale of big banks and 'ordnungs-politik' and 'process-politik' occurred when more order and shaping

[67] Instead of borrowing money from abroad at more favourable interest rates, it was argued (OECD, 1999; MESA10, 1998; Miklos, 1997) that Meciar's government had difficulties to get any such loans hence had to turn to domestic banking sector for financing, paying high cost.

> of the market as well as implementing detailed processes of bank business took place. [HOI, 22.4.2002]

Foreign bank entry certainly brings changes to market distribution but the two largest banks have kept their shares. That was quite understandable because foreign banks were too small and too weak to influence the existing market in the first years of existence. Following changes in market shares distribution was supported by falls of some of the domestic banks (IRB). So far, it was impossible to increase the fees of the two largest banks because of the pressures from the shareholder (state) and now increased competition in this sense is expected:

> The most important benefit was the creation of competition, which has a dynamic effect. [DO, 30.7.2002]

The question arises about the viability of the foreign banks' goals (because the market is limited). Domestic banks suffered in the past due to the political connections of top managements. Foreign entry, unburdened by such influence, could focus on their own goals:

> Yes, foreign banks had positive effects; not only because of bringing know-how and because domestic banks lost their monopoly but foreigners brought a certain style of undertaking and sophisticated products. Their goal, however, was not investing the funds into an area that was hungry for finance but investing into revenues at minimal risk. Foreign banks knew they would survive on government bonds and securities as well as the inter-bank market and foreign-finance – they financed export of their home countries to Slovakia. Plus they benefited from tax relief and supportive 'Phare funds'. [Bac, 30.7.2002]

The main negative was that state enterprises and bad loans remained with domestic, state-owned banks. The adverse effects of foreign entry showed later, when foreigners used their know-how to make sure their portfolios stayed healthy and started luring clients and employees – a process described as 'cherry picking'. Privatisation of the latest two banks has brought stabilisation to Slovak banking; however, there are high

fixed operation costs of the largest two banks at present. It is expected that properties and other assets of these banks will be sold. There are still also high operating costs per employee involved, which suggests inefficiencies are still present. Furthermore, foreign banks found it hard to compete against the large branch networks of these banks as well as the historical relationships with the industry.

6.8.6 State and commercial bank officials on capital outflow and inflow

The general notion is that the presence of the foreign banks has not influenced the capital inflows or outflows. One argument stressed the dominance of big domestic banks that could not be influenced by any foreign banks; the other stressed the fact that both foreign and domestic banks were well established on the market. Though foreign banks preferred foreign clients offering higher comfort, the real effect on capital flows was not that big. It cannot be said that foreign banks played a central role in capital outflows or inflows. Nevertheless, it is expected that the capital flow will certainly increase after accession to the EU. Only the FDI may be noted as important and foreign banks play a role in attracting this type of investment:

> The main effect of FDI in banking in Slovakia was that foreign banks that came have not immediately pressed down the interest rates, but maintained and substituted domestic banks for financing the state (because domestic resources were drained due to pressure to meet the CCU and due to privatisation). Foreign banks effectively exploited state indebtedness and their main effect was attracting FDI. [Bac, 30.7.2002]

6.8.7 State and central bank officials on the increased stability of the sector

Foreign banks had influence on the stability of the sector and played a crucial role in financing the governments. The situation for mobilisation of deposits was more negative because the motivation of the people to deposit savings into banks was diminishing. Quite an opposite opinion was expressed by some interviewees in so much that foreign banks were merely servicing the financial flows that would flow into the economy in any case. Furthermore, it was not really foreign entry but state banks' restructuring, new

risk management and the removal of political influence that effected the change. But certainly foreign banks supported competitiveness of the market and customer choice. The question is whether there will be further consolidation of the market. Currently profitable and healthy banks suggest that stability has increased substantially also because the NBS was sorting out liquidity problems with big domestic banks:

> Internal stability is still more threatened especially because of the economic situation we are in. There are seven to eight small banks with between SKK20 billion and SKK30 billion that should be product-specialised. There cannot be so many universal banks for such a small market as Slovakia. [Bac, 30.7.2002]

Further difficulties are expected to arise when privatisation revenues from the Slovak Gas Industry are used, as is expected, not for foreign debt pay-off but for reducing internal debt. That would increase the volume of disposable resources of banks which would trigger reductions in interest rates and increased credits. But this would need to be carefully monitored because it might trigger bank bankruptcies caused by lack of investment options. In relation to external stability, Slovakia is a small and undercapitalised economy, which is further threatened by the process of liberalisation. This path was, however, unavoidable. Pressure for domestic banks to fulfil the CCU criteria strongly disadvantaged them.

6.8.8 State and central bank officials on support of growth and transformation

Of further importance was (and still is) the linkage to the economy and its revitalisation. Foreign banks financed the healthier part of the economy and thus helped to crystallise the healthier companies. Also, they had capital strength to offer credits corresponding to the real conditions of the market. Another influence was crisis management, when Mudrik – then vice-governor of the NBS – had 'given an order' in 1996 to 1997 that foreign banks can have a maximum 30 per cent of the market so that the banking sector could maintain and support the economic policy of the state. One threat to the Slovak economy is the huge regional differences (e.g. in regional unemployment). If the Slovak banking sector became 100 per cent foreign-owned, it was claimed that the differences would start to deepen. In order to reduce the regional differences, the banks that would

offer credit into such regions - into tourism or production development should be supported[68]. Contrary to some other views that foreign entry has not had significant impact is, that foreign banks supported the process of restructuring and stabilisation of the banking sector:

> Foreign entry definitely supported and actually 'created' transformation. [PTV, 17.9.2002]

The real growth is expected only now (after privatisation of the big state banks) and credit expansion shall be the catalyst of development. But on the other hand, the growth is very much influenced by the small, state-governed area in which foreign banks operate. This question needs to be addressed carefully with consideration of the market shares of domestic and foreign banks. Moreover, evaluation needs to consider certain combinations of transformation support and profit maximisation motives. But undertaking on the market was influenced by conditions where foreign banks focused on financing the state although they could have offered credits on better conditions than domestic banks. Certainly, foreign capital inflow was beneficial but the negative aspect came in the draining of the state and domestic banks. Nonetheless, evaluation of the effects of foreign bank entry on the domestic economy is very complex.

6.8.9 Conclusions on the influences of competition effects

The most beneficial feature of foreign bank entry was creation of competitive pressures on the domestic banks. Extended portfolio of new products had to be matched by domestic banks shall they stay competitive. Marketing improved as well as the retail and corporate services from which clients benefited greatly. The overall trust in the banking sector was also enhanced by foreign entry. However, it is recognised that a certain level of foreign involvement is needed in order for significant competitive pressures to be traceable. In relation to the two largest banks, their position was not greatly influenced by foreign entry in the view of both the commercial bank and state and central bank officials. It is interesting that while some foreign banks have managed to benefit substantially from entry into the Slovak bank market, some have not managed to break

[68] By, for example, tax concessions on interest earnings in certain regions

through substantially. Criticism of IMF policies towards financing small and medium enterprises was pronounced which was based on the institution's rigid rules.

The effect of foreign banks on capital outflows and inflows was regarded generally as positive although difficult to account for with limitations to benefits for the local banking sector. Restricted portfolio investments of which banks would be conveyors played significant role. Foreign entry was perceived as largely positive, increasing the stability of the Slovak banking sector. Moreover, foreign banks supported the integration of Slovakia into European business structures and the independence of domestic banking institutions. Foreign entry is seen as a supportive element of transformation, although the view that the overall growth of the economy would not be greatly different was expressed. Many stressed the importance of early restructuring of domestic banks. If there were any negative effects, foreign banks were recognised to employ 'cherry-picking' strategies within the client selection as well as human resource acquisitions. Foreign banks also exploited the situation of domestic banks and instead of bringing down the interest rates due to their potential, maintained the levels and replaced domestic banks in financing the state at a later stage reaping substantial profits.

6.9 Conclusions on the interviews chapter

It is apparent that foreign entry can have any number of substantial effects only if it reaches a certain size and market share. Certain foreign banks also followed the strategy of buying out CEEC banks in order to increase their value for potential sale, though this has not been the case in general. Foreign banks could to afford 'skim-the-cream' thanks to clean portfolios. When the big banks (especially VUB) had to completely stop offering loans due to not fulfilling CCU other foreign banks 'jumped in' to fill the void.

The explanation of how the domestic banks managed to fulfill the CCU criteria by overvaluing collaterals and involving un-collected interest into the profit thus increasing the required capital levels was instructive. Creating a competitive market is considered to be the main positive effect. Domestic banks suffered in the past due to the political connections of top managements. Foreign banks had positive effects, not only because they brought know-how and because domestic banks lost their monopoly but also

because foreigners brought certain styles of undertaking and sophisticated products. Foreigners used their know-how to make sure their portfolios were healthy and started luring clients and employees – 'cherry picking'. Furthermore, the state's influence on domestic banks was very harmful and only supported the advantageous position of foreigners. Generally speaking, there is a pervasive notion that foreign entry brings stability to the banking sector. Foreign capital also supports the independence of banks when political relations are broken and lobbyist relationships are reduced. In relation to capital flows, it cannot be clearly argued that foreign banks were any significant element.

Foreign entry supported and actually 'created' transformation. But foreign banks' undertaking on the market was influenced by conditions where foreign banks focused on financing the state rather than the real economy. They later focused on inter-bank financing where certainly risk criteria supported this decision but it also meant foreign banks' dominance and effectively removal of the competition. On the other hand, and maybe quite surprisingly, none of the established foreign banks bought the existing large domestic banks that went into privatisation. Certainly, foreign capital inflow was beneficial but the draining of the state and domestic banks through high interest rates on inter-bank markets, which kept domestic banks alive but at the cost of profits transferred, was greatly harmful. This further delayed domestic banks' restructuring.

Foreign banks, however, financed the healthier part of the economy, investing into development loans and, in the view of some interviewees, actually created the transformation. On the contrary, some suggest that rather than foreign entry, restructuring of the state banks, new risk management techniques and removal of political influence from the largest state-owned banks have effected the real change in late 90s. The question however is whether this has not come too late as the number of small and medium entrepreneurs has lost interest to extend their business activities due to the lack of external financing between 1995 and 2000.

CHAPTER 7.

EMPIRICAL ANALYSIS - THE STORY TOLD BY NUMBERS

7.1 Introduction

While the previous chapter presented results of qualitative research into the effects of foreign bank entry in Slovakia, this chapter will attempt to corroborate or undermine some of the findings by empirical research. The purpose of this chapter is to measure and compare the performance and effectiveness of domestic and foreign banks in Slovakia in the process of transition into a market-oriented economy. The main task is to reveal whether or not the differences are to the disadvantage of the domestic economy. This chapter is divided into two sections. The first section statistically analyses the hypotheses by using the Kruskal-Wallis statistical analysis, previously employed by Sabi (1996) on the Hungarian banking sector. After analysing the original hypotheses, further attention is devoted to analysing the structure of deposit and loan portfolios of banks which are divided into four groups: domestic banks, foreign banks, foreign branches and specialised banks[69] over a selected research period, which forms the second section. The second section is based on descriptive analysis of trends in the distribution of banks' deposit and loan portfolios among sectors of the economy, including a discussion of the hypotheses, and a discussion of the significant and non-significant results.

This chapter will then discuss whether the differences are to the advantage or disadvantage of the domestic economy.

7.2 Implementation of statistical techniques

Firstly, summary statistics for performance measures and number of staff are employed in order to establish differences in scale and scope between the groups. Table 7-1 presents the results of such an analysis.

[69] Based on classification by NBS

Category A – Performance measures include:

1. Total assets (TA) - Size of bank
2. Profit (P) - Profitability of bank
3. Securities (Sec) - Stock held and traded
4. Inter-bank assets (IBA) - Loans to other banks
5. Earning assets (EA) - Interest and profit producing assets
6. Fixed assets (FA) - Bank involvement into economy
7. Loans - Credit provided to the economy
8. Deposits - Accumulation of savings by the economy
9. Number of employees - Differences in level of employment among various types of banks

Secondly, various ratio indicators are used, since ratio analysis compensates for the disparity created by the differences in bank size. Efficiency and risk indicators, together with structure of earning assets and selected indirect benefits as well as basic activities indicators are analysed. In total seven indicators are examined; since the data for employees were not available for all groups of banks, the indirect benefits indicator of earnings assets over employees is therefore not included in the analysis. The following description of indicators refers to hypothesis formulated in Chapter 5, Section 5.5.1 Hypotheses. A discussion of limitations follows after each indicator.

Category B – Efficiency and risk indicators include:

1. Return on Assets (ROA) - This is the basic measure of efficiency of a bank. This explains how effectively one unit of currency is utilised for producing profit. The ideal ratio is one. The higher the ratio, the more efficient the bank is.
   ROA equals profit over average total assets where average total assets are calculated as the average of the total assets at the beginning and at the end of the reviewed period.
2. Coefficient of Credit Risk (CCR) - Risk coefficient of loans. The higher the coefficient, the riskier the loan portfolio of banks.

CCR = 0*standard loans + 0.05*standard loans with reserve + 0.2*non-standard loans + 0.5*dubious and disputable loans + 1*bad loans (loss) / $\sum$ loans (Preisinger 2002:6).

Category C – Structure of earning assets is represented by:

3. Loans/TA – The exposure of a bank towards the provision of credit to the economy. The higher the ratio, the more important the loans are for the total earnings of a bank.
4. Sec/TA – The involvement of a bank in stock markets. The higher the ratio, the more important securities are for the production of profit.
5. IBA/TA – The involvement of a bank in inter-bank lending. The higher the ratio, the more a bank is involved in inter-bank trading and the more important this particular asset is for production of profit.

Category D – Selected indirect benefits indicators incorporate:

6. EA/Employees - The efficiency of employees. The higher the ratio, the more effective the human capital of a bank is in acquiring and managing the earning assets.
7. Fixed Assets // TA – The bank involvement into the economy

Category E – The basic activity indicator is:

8. Loans/Deposits (L/D) – Loans over deposits ratio shows the extent to which the bank has lent its deposits. A higher L/D ratio results in lower liquidity. In addition, it implies that banks use a lower level of debt financing than that of deposits.

Should the data have a normal distribution, one-way analysis of variance (ANOVA) would be used to test for a difference between multiple groups. However, since the assumptions behind the standard ANOVA are suspect, since the data for each group do not have the same variance and the distribution is not normal (Table 7-2), an alternative nonparametric test is used. In order to test the difference between domestic, foreign,

foreign branches and specialised banks Kruskal-Wallis K statistics does not assume normality of distribution and thus can determine whether there are significant differences between independent multiple groups for variables structured into five Categories of A – E as described above. The results of the Kruskal-Wallis test are presented in Table 7-4.

Next, attention will be devoted to the analysis of particular bank groups in collection of deposits and provision of loans. More specifically, distribution of deposit and loan portfolios across the sectors of economy[70] will be analysed and development over the years will be assessed using the procedure of ratio indicators analysis as described above. Descriptive analysis will initially be used; multiple line graphs will be used as a means of presentation. The analysis is focused in general on the following areas:

Loans - Structure of loans to various sectors of the economy

- Loans to private sector enterprises: Analysis will reveal which sector was most supported by bank financing.
- Loans to public sector: Examinations are expected to expose which group of banks focused on financing of the public sector.
- Loans to households: Analysis should indicate which group of banks focused on retail banking.

Deposits - Structure of deposits to various sectors of the economy

- Deposits of private sector enterprises: A closer look into private sector deposits should indicate which sector contributed most to accumulation of capital and capital formation
- Deposits of public sector: Analysis will reveal whether the public sector contributed to capital formation in Slovakia
- Deposits of households: Structure of household deposits will indicate which group of banks focused on retail banking adding to accumulation of capital in the economy

[70] As specified by the National Bank of Slovakia Standard Industry Codes

7.3 Results of descriptive statistics

Table 7-1 (see Appendix D.) shows means and standard deviations for the selected basic scale and scope indicators for a varying sample of nine domestic and twelve foreign banks, seven foreign branches and four specialised banks. The total number of banks in each group varied throughout the time due to failure, mergers or change in ownership of particular banks. So while domestic banks started with six institutions in 1993 and peaked with nine in 1997-1999, the number of domestic banks was recorded as five in 2000. Similarly, where five institutions at the beginning of the researched period represented foreign banks, the total number peaked in 1997-1998 with 12 banks and reduced to 11 in 2000, mainly due to mergers initiated by parent banks. Specialised banks are the most consistent group with four participants two of which joint-ventures of either equal or majority foreign ownership by foreigners, established by the large state-owned banks. On the other hand, foreign branches had the most dramatic development, starting with seven participants and finishing with two in 2000.

Although the aforementioned facts strongly affect the results of the analysis, it still provides a reflection of reality. It is apparent from Table 7-1 that domestic banks have a much larger scale of operation and larger staffing. The sum of domestic banks' assets SKK5,313.672 million is significantly larger than assets of any of the examined group of banks. In terms of employment, domestic banks employ almost four times more staff than the next largest group, the foreign banks but large branch networks of big state-owned banks need to be considered. On average, domestic and specialised banks show enormous losses, whereas foreign banks and foreign branches show mean profit of SKK0.976 billion and SKK0.441 billion respectively. There is a striking difference in profitability of foreign banks and domestic banks: domestic banks and specialised banks recorded mean losses at the level of SKK-2.352 billion and SKK-1.735 respectively, while foreign banks outperformed their domestic counterparts with mean profit of SKK0.976 billion. The situation would be even worse for domestic banks if specialised banks were to be divided into domestic and foreign banks, since foreign specialised banks are two building societies, which are joint-ventures with domestic banks but show significant profits over the whole researched period. While foreign branches were mostly affected by entry and drop out of competitors which was often caused by failure of the parent company, specialised banks' performance was very much affected by the

'bad loans graveyard': the Consolidation Bank. Thus the sum of losses over a reviewed period comes to SKK23,559 million for specialised banks due to large portfolio of non-performing loans held by this institution. Staggeringly, the sum of losses for domestic banks is even higher (although much less significant) if compared to total assets. Foreign banks are clearly the most profitable group of banks in Slovakia between 1993 and 2000. What is rather interesting is the standard deviation of total assets. Standard deviation compared to mean value shows very low levels for foreign branches, rather small levels for foreign banks but high levels for domestic and specialised banks, suggesting that foreign banks and branches had better or more sustainable asset management than their domestic counterparts suggesting consistent provision of loans.

However, any conclusions for structure of assets and profitability are hard to draw from descriptive statistics, as quite low variation for assets is also shown for foreign branches. However, the sum of profits recorded positive values. Domestic banks are also largest in their involvement to loans and deposits, securities and inter-bank assets. Whilst the share of domestic banks within inter-bank assets shows less than 49 per cent, among fixed assets, domestic banks held over a 74 per cent share. In terms of employment, domestic banks with their average staff of 16,575 compare to almost four times less for foreign banks, which seem thus to be over employed. Clearly, involvement of domestic banks in the economy is very large, especially in terms of fixed assets, deposits, loans and employment, but moderate for foreign banks and branches.

7.4 Results of differences between groups analysis

As advised by Coakes and Steed (2000:29):

> "The first step in the analytic process is to explore the characteristics of the data. Data may have been incorrectly entered or distributions of variables may deviate from normal."

To test differences between groups either parametric or nonparametric methods can be used. For comparison between three or more groups, one-way analysis of variance or

one-way ANOVA is most commonly used. There are three general assumptions behind the one-way ANOVA F-test (Beck, 1999:55):

- The trait measured should be normally distributed for the underlying populations
- These distributions of scores should be much the same (homogeneity of variance)
- The measures should be independent

Table 7-2 (see Appendix D) presents the results of the tests of normality. Following Coakes and Steed (2000:35) if the significance level is greater than .05 then normality is assumed. The Shapiro-Wilks statistic is also calculated if the sample is less than 50. The reason for this is that both Kolmogorov-Smirnov and Shapiro-Wilks test results show six out of eight indicators with significance less than .05, which suggests that normality condition does not hold. Thus, rather than analysis of variance, the Kruskal-Wallis test for independent samples is suggested, given that non-parametric tests do not assume for normal distribution of the sample. The results of the Kolmogorov-Smirnov and Shapiro-Wilks test suggest that the ratio indicators are not normally distributed.

Another condition for using parametric tests is homogeneity of variance across groups. Table 7-3 (see Appendix D) presents results of Levene's test. In all but one case, significance levels are less than .05, thus homogeneity of variances is not confirmed and the second condition for use of the ANOVA parametric test is not met.

The third condition of independence of observation is also confirmed since measures are recorded independently on performance of other members of population. Nonetheless, since there is a serious concern about normality of distribution, the non-parametric test is used to explore whether there are significant differences between the four groups of banks.

Table 7-4 reports results of the Kruskal-Wallis statistics[71]. The results indicate that differences between the four groups of banks are highly significant for both measures of efficiency and risk since the observed asymptotic difference is less than .05. Thus for

[71] Similar results were produced using the parametric ANOVA test although conditions for using parametric test do not hold in two cases. The ROA ratio indicator was found not to be significantly different using the ANOVA F-test which may be result of unequal group size.

example in case of the ROA, only two cases per 1000 can occur where Chi-Square is greater than 9.289. The conclusion that all groups of banks are different also holds for structure of earning assets and basic activity indicator on the basis of asymptotic difference being less than critical value of .05.

Table 7-4 - Kruskal-Wallis test - ratio indicators [a, b]

	ROA	CCR	Loans/ Deposits	Loans/ TA	Securities/ TA	Inter-Bank Assets/TA	Earning Assets/ Employees	Fixed Assets/ TA
Chi-Square	9.289	26.042	12.330	15.293	19.359	17.431	21.357	32.886
df	3	3	3	3	3	3	2	3
Asymp. Sig.	0.026	0.000	0.006	0.002	0.000	0.001	0.000	0.000

a Kruskal Wallis Test

b Grouping Variable: Bank Type

Relating descriptive statistics to non-parametric tests of mean differences between groups brings some interesting suggestions. Since all groups of banks are significantly different in efficiency and risk indicators, the profitability and risk of their operation will depend on structure of earning assets. The structure of earning assets is also different for all bank groups. However, omitting specialised banks due to the presence of the 'bad loans graveyard' bank, foreign banks recorded overall profit of SKK12,684 million, while domestic banks showed SKK 23,525 million losses. Foreign branches contributed to overall profitability of foreign presence with SKK5,736 million. Thus, foreign banks seem to concentrate their portfolios in the highest quality assets that may indicate 'cherry-picking' behaviour or using better credit risk-scoring techniques. There are significant differences between banks in coefficient of credit risk indicator with a mean value three times higher for domestic banks than for foreign banks. Domestic banks continued their operation, with a substantial amount of dubious debts continuing to finance unprofitable domestic firms. Foreign branches also score highly probably due to the large involvement of the Czech banks within this sector. Certainly, specialised banks have the worst average credit risk ratio due to the amount of inherited bad debts, although the final score is mitigated by the presence of two foreign-owned building societies with excellent credit risk ratio scoring.

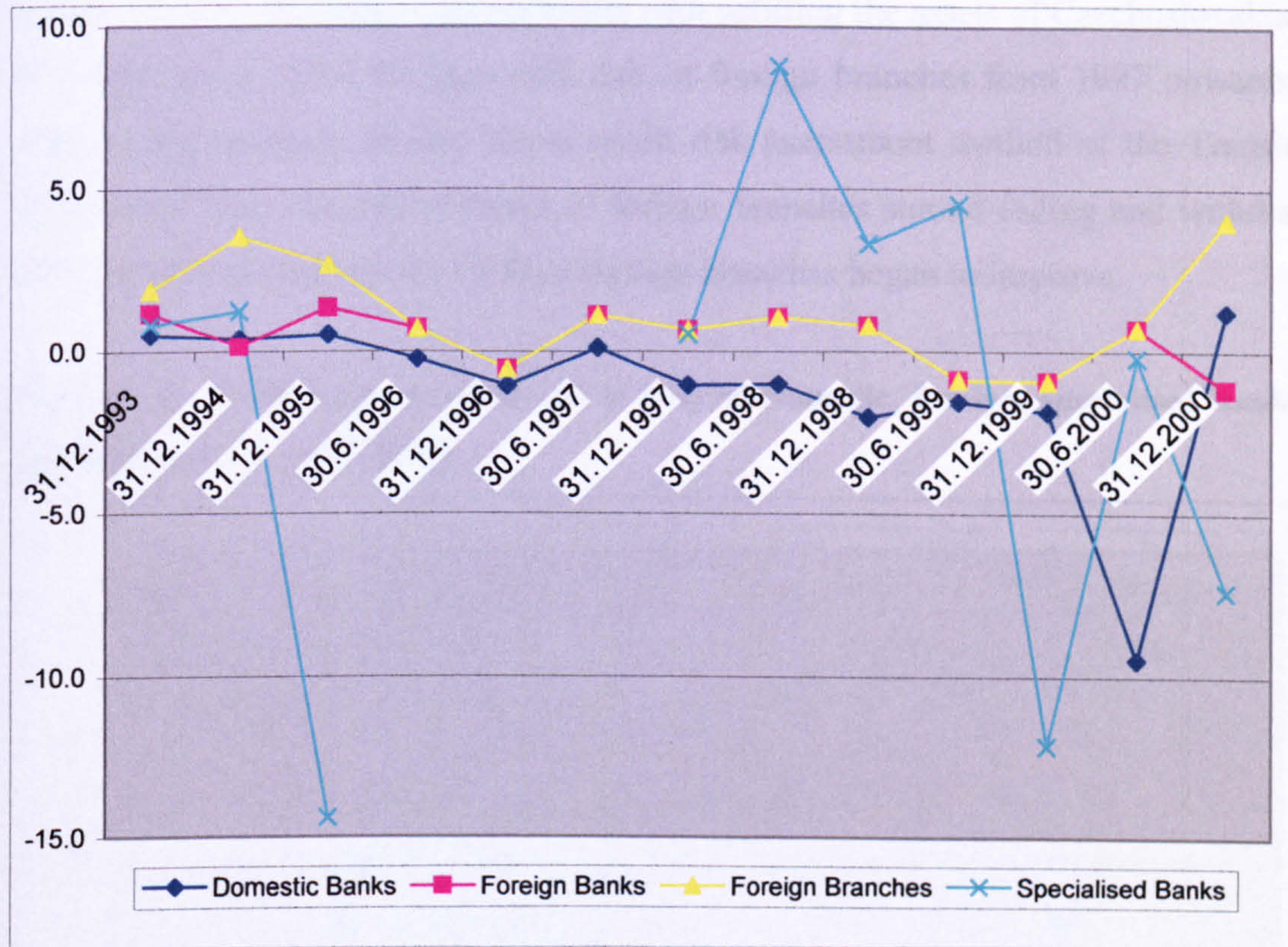
7.5 Comparative ratio indicators: descriptive analysis

Once differences between the bank groups were established, each ratio indicator deserves detailed examination, especially in terms of between-group comparisons over the researched period.

7.5.1 Return-on-assets (ROA)

The main profitability indicator, Return-on-assets or ROA, indicates how efficient the management is in converting the bank's assets into net earning. While profitability of domestic banks was gradually deteriorating, foreign banks (and foreign branches especially) managed to score positive results for most of the years, outperforming domestic banks from 1994 until the second half of 2000. High volatility of specialised banks was caused mainly by bad debt portfolio of the Consolidation Bank that was compensated for by the very good performance of mortgage houses especially over the period of 1997-1999. The main reason might be large involvement of mortgage houses in inter-bank trading, with large deposit portfolios that were collected from mortgages (a condition for the provision of credit was a certain amount deposited with the mortgage house). The situation changed however at the end of 2000 when the government decided to solve the deteriorating situation of domestic banks by stripping them of the bad and doubtful loans inherited from the past or created as an aftermath of privatisation. The government also prepared the two largest domestic banks for privatisation, which was viewed as the only option for saving the banks in the end. Overall, foreign banks together with foreign branches proved to be more profitable than their local counterparts.

Figure 7-1 - Return on assets (ROA) of domestic, foreign, specialised banks and foreign branches (1993 – 2000)



Source: Author's calculations, NBS-ABS (1994-2001)

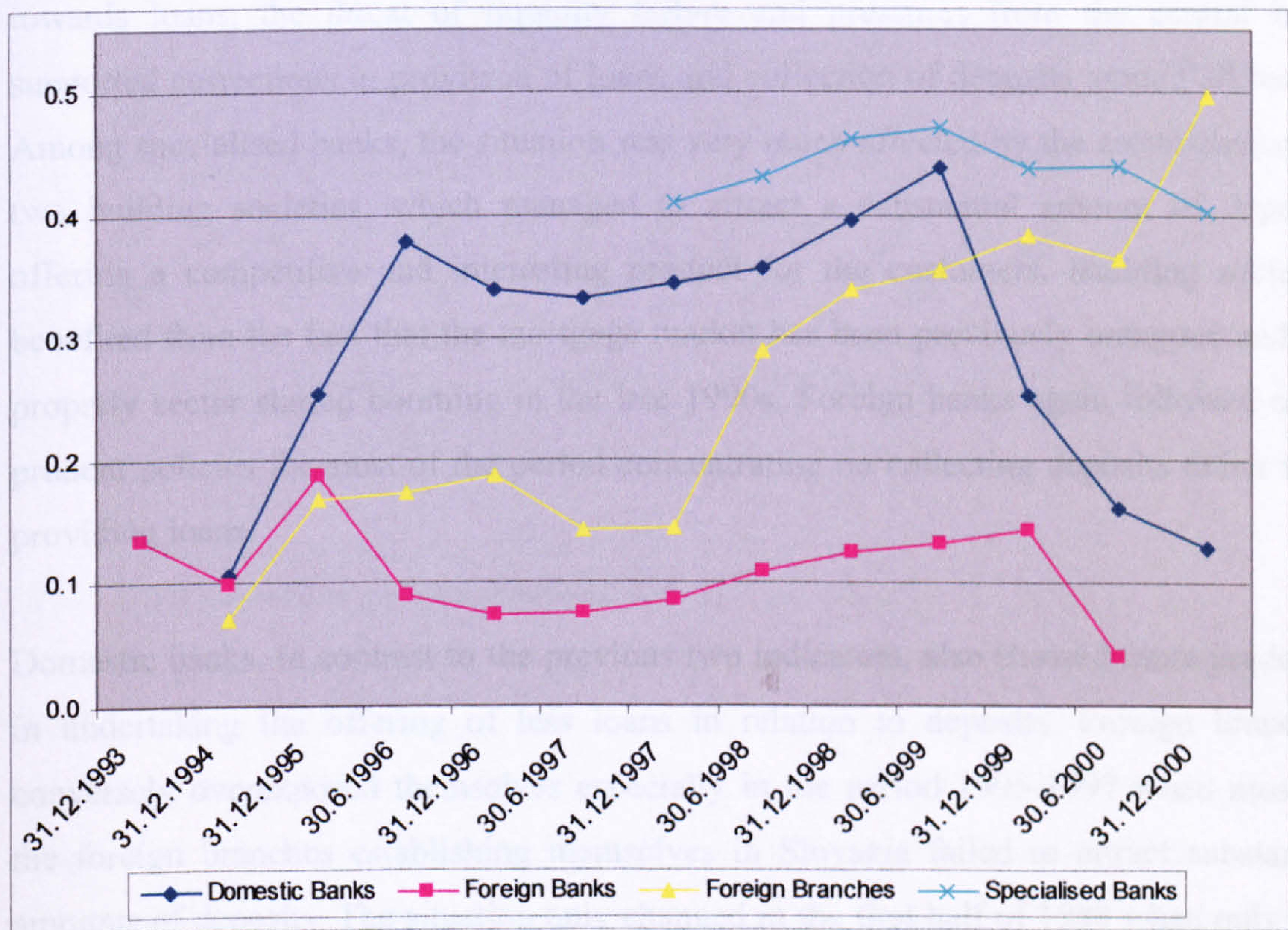
7.5.2 Coefficient of credit risk (CCR)

Coefficient of credit risk (CCR) measures bad loan credit exposure of a bank following the rules for creation of provisions and reserves against classified or loss loans. The higher the ratio, the riskier the bank loan portfolio is. An explanation is provided by the differences in risk evaluation of loans for particular groups of banks. Striking differences in CCR to a certain degree explain performance of domestic, foreign and specialised banks as well as foreign branches. Foreign banks were clearly very cautious in offering loans and maintained the lowest credit risk throughout the 1993-2000 period. It may be suggested that foreign banks applied more sophisticated credit assessment methods towards clients than domestic banks, which can also support the theory of 'cherry-picking' only the most credit-worthy customers.

Foreign branches managed to keep the CCR under control until 1997, which is when credit risk of foreign braches increased substantially. It needs to be noted that the majority of foreign branches were Czech banks. A high CCR ratio in the beginning of

the period was influenced mostly by Československá obchodná banka (Czechoslovak Trade Bank - CSOB), which inherited a large portfolio of bad debt from previous years and was further influenced by problems with splitting the assets of Czechoslovakia after the break up in 1993. Rising credit risk of foreign branches from 1997 onwards may support the rationale for the worse credit risk assessment method of the Transitional Economies[72]. As the parent banks of foreign branches started failing and withdrawing from the Slovak market, the CCR of foreign branches began to improve.

Figure 7-2 - Coefficient of credit risk (CCR) of domestic, foreign, specialised banks and foreign branches (1993-2000)



Source: Author's calculations, NBS-ABS (1994-2001)

[72] The Czech banks.

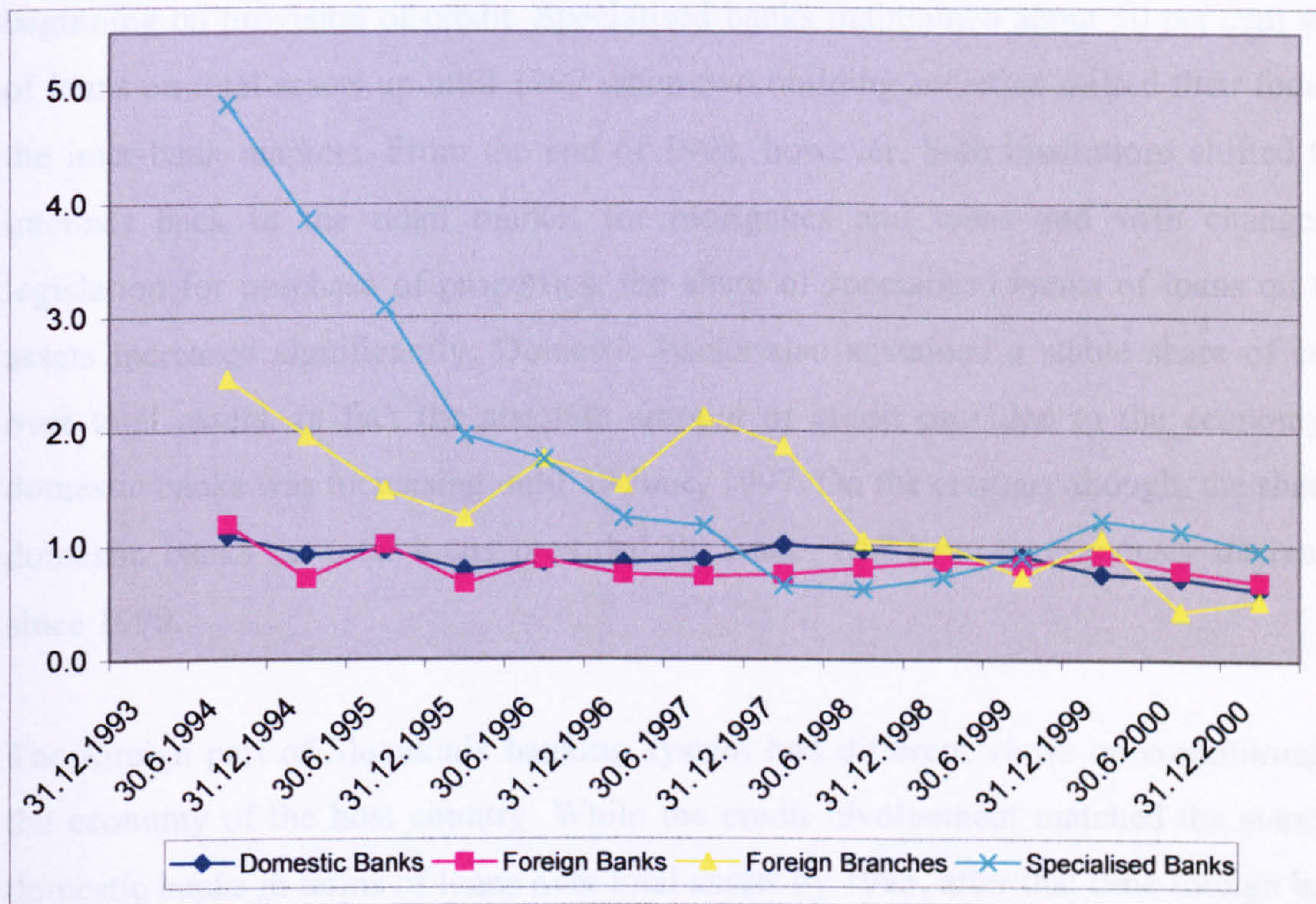
7.5.3 Loans over deposits (L/D)

The loan over deposit ratio is an indicator of both the liquidity and the credit risk of a bank. Ideally, banks should lend out only resources they have, thus the L/D ratio should ideally be less than or around one. A high ratio indicates a potential source of liquidity difficulty since the liabilities received do not correspond to the assets provided to clients, and a potential risk of illiquidity arises. In addition, the loan portfolio includes risky assets; therefore a high rate will increase the bank's credit risk.

The results of analysis indicate that although all banks started with overexposure towards loans, the threat of liquidity failure and pressures from the central bank supported corrections in provision of loans and collection of deposits among all banks. Among specialised banks, the situation was very much affected by the establishment of two building societies, which managed to attract a substantial amount of deposits offering a competitive and interesting product for the customers. Building societies benefited from the fact that the mortgage market has been previously untapped and the property sector started booming in the late 1990s. Foreign banks again followed more prudent policies for most of the period concentrating on collecting deposits rather than providing loans.

Domestic banks, in contrast to the previous two indicators, also showed more prudence in undertaking the offering of less loans in relation to deposits. Foreign branches conversely overexposed themselves especially in the period 1995-1997 when most of the foreign branches establishing themselves in Slovakia failed to attract substantial amounts of deposits. The situation only changed in the first half of 1998 when only two foreign branches remained and both followed stringent bank prudence rules. Specialised banks benefited from the successful strategies of building societies and from the increased market for mortgage loans towards the end of the researched period.

Figure 7-3 - Loans over deposits (L/D) of domestic, foreign, specialised banks and foreign branches (1993-2000)



Source: Author's calculations, NBS-ABS (1994-2001)

7.5.4 Fixed assets over total assets (FA/TA)

Fixed assets over total assets show involvement of a bank in the economy as well as to a certain degree the efficiency of a bank in terms of the volume of fixed assets needed to acquire and utilise earning assets. As depicted in Figure 7-4, domestic banks worked with the highest share of fixed assets on total assets, suggesting that the managerial know-how of domestic banks in terms of management of assets was considerably worse than that of foreign banks. On the other hand, domestic banks were affected by the history of servicing the citizens and enterprises under a mono-bank system. With the introduction of market-based banking, domestic banks focused on building an extensive branch network focused on servicing the whole of the Slovak Republic. Foreign banks started also with a high share of fixed assets on total assets as the entry period required investments before growth in earning assets. Once the infrastructure was established, foreign banks focused on earning asset management, thus bringing FA/TA to less than a half of domestic banks in 1998. This may suggest that foreign banks exercised better

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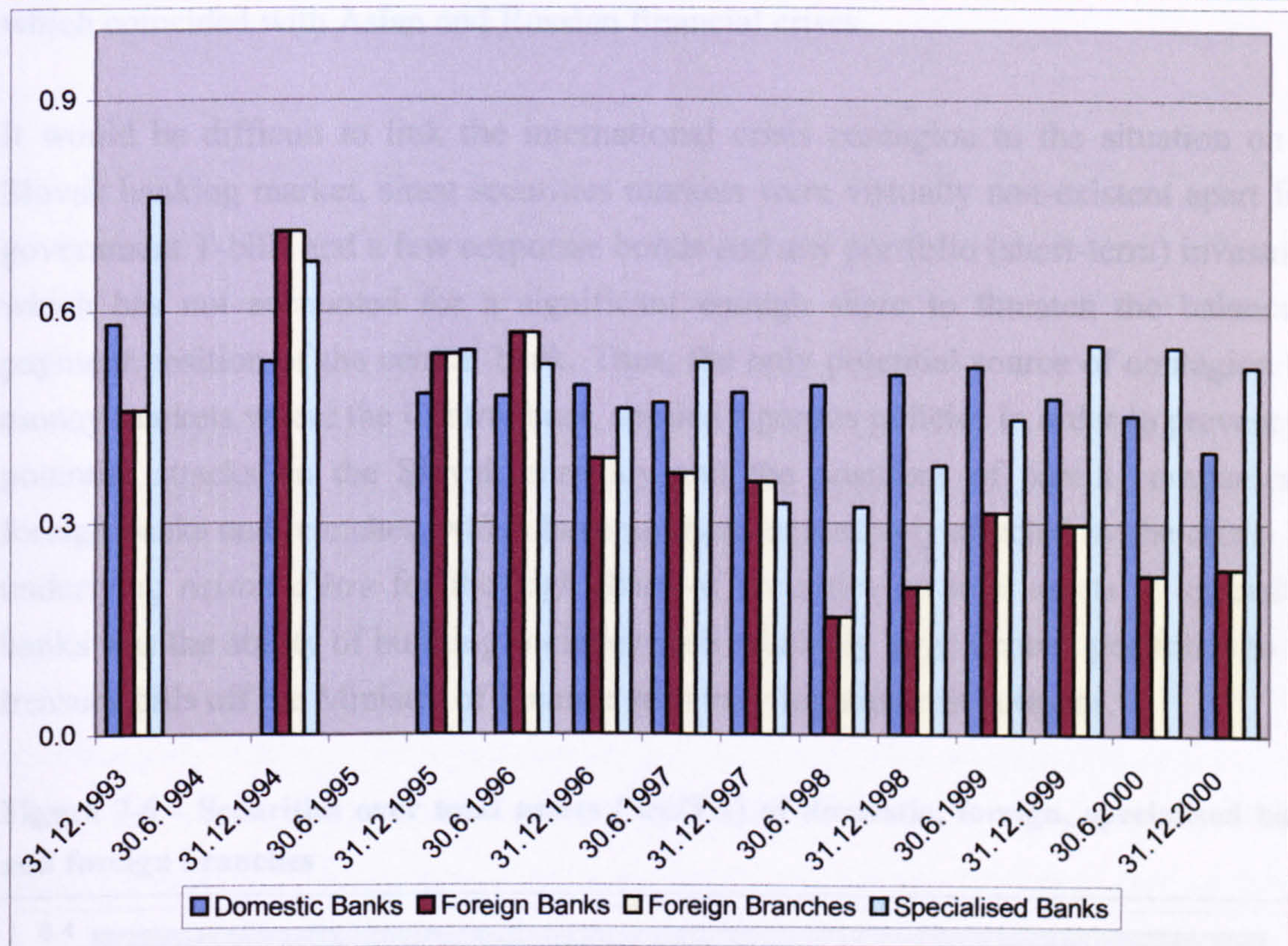
banks were still consolidating their portfolios from the past mono-bank system rule. A high share of loans for foreign banks and foreign branches pointed towards foreign institutions' interest in getting established in the Slovak market, concentrating at the beginning on provision of credit. Specialised banks maintained about 50 per cent share of loans on total assets up until 1997 when two building societies shifted their focus to the inter-bank markets. From the end of 1998, however, both institutions shifted their interests back to the retail market for mortgages and loans and with changes in legislation for purchase of properties, the share of specialised banks of loans on total assets increased significantly. Domestic banks also sustained a stable share of credit over total assets. In fact the absolute amount of credit provided to the economy by domestic banks was increasing until 30 June, 1997. On the contrary though, the share of domestic banks on total loans provided by banks had been continuously decreasing since 1999.

The foreign part of Slovakia's banking system had different views on commitment to the economy of the host country. While the credit involvement matched the stance of domestic banks in terms of loans over total assets by 1995, after that time foreign banks directed their activities towards other earning assets. Foreign banks and foreign branches very much copied each other's credit exposure, suggesting that they both applied similar management techniques towards management of assets. The breakthrough came in 1998 when all but one of the Czech branches withdrew from the Slovak bank market and the amount of credit immediately fell by 22 per cent. Foreign banks' credit exposure thus fell from over 56 per cent in 1993 to just 27 per cent in the first half of 1998. The large drop between 1997 and 1998 coincided with the contagious Asian and Russian financial crisis. Although real effects were never felt in Slovakia (apart from a few currency attacks that the National Bank of Slovakia managed to sustain), the foreign part of the banking sector appeared to brace itself against any potential adverse effects by re-arranging their asset portfolios. Interestingly enough, the amount of credit provided to the economy increased in absolute terms in the first half of 1998. There follows an analysis of credit portfolios that will bring more insight into this situation.

Figure 7-5 - Loans over total assets (L/TA) of domestic, foreign, specialised banks and foreign branches (1993-2000)



Source: Author's calculations, NBS-ABS (1994-2001)

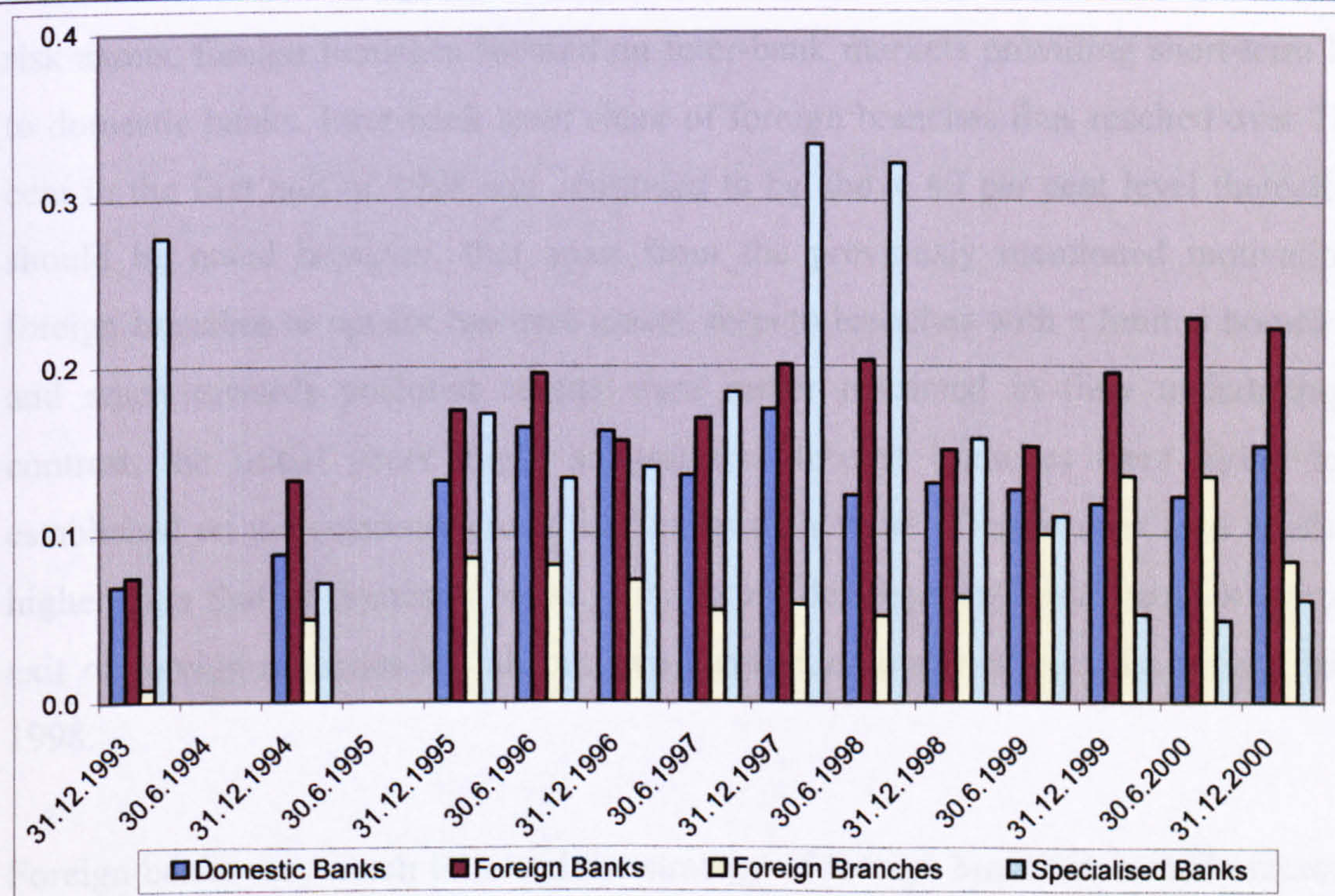
7.5.6 Securities over total assets (Sec/TA)

Securities over total assets is another indicator that shows the bank's style of asset management and involvement into the economy. It should be noted that the Slovak capital markets were and still are largely under-developed with hardly any real trading apart from out-of-the-market pre-arranged deals being undertaken. Banks could thus be involved mostly in central bank treasury notes, treasury notes of Ministry of Finance and government bonds (with the addition of a few corporate bonds issues). As described below, the share of securities seldom reached 20 per cent of the total assets and if so, then only for foreign banks. Although the Slovak securities market is regarded as under-developed, foreign banks opt for this type of earning assets against loans outperforming all other banks. The short break came during the period of 1997 to 1998 when specialised banks (building societies) poured a lot of their funds into central bank and government treasury notes. After some consolidation in 1998/1999 when all the banks were awaiting the results of elections, foreign banks seemed to support the policies of the new government by the highest ever share of securities to their total assets at the end of the reviewed period. After the stringent policies towards government spending and a number of remaining large state-owned enterprises were privatised, foreign banks and

branches showed support for the government by increasing their share in government bonds and T-bills. Securities held by specialised banks shot up to over 32 per cent, which coincided with Asian and Russian financial crises.

It would be difficult to link the international crisis contagion to the situation on the Slovak banking market, since securities markets were virtually non-existent apart from government T-bills and a few corporate bonds and any portfolio (short-term) investment which has not accounted for a significant enough share to threaten the balance of payment position of the central bank. Thus, the only potential source of contagion was money markets where the Central bank applied rigorous policies in order to prevent any potential attacks on the Slovak currency and the positions of parent companies of foreign banks and branches, which have not been excessively affected by the crisis. The underlying *raison d'être* for the high share of securities on total assets of specialised banks was the ability of building societies with relatively large deposit portfolios to buy treasury bills off the Ministry of Finance with very high interest coupons.

Figure 7-6 - Securities over total assets (Sec/TA) of domestic, foreign, specialised banks and foreign branches



Source: Author's calculations, NBS-ABS (1994-2001)

7.5.7 Inter-bank assets over total assets (IBA/TA)

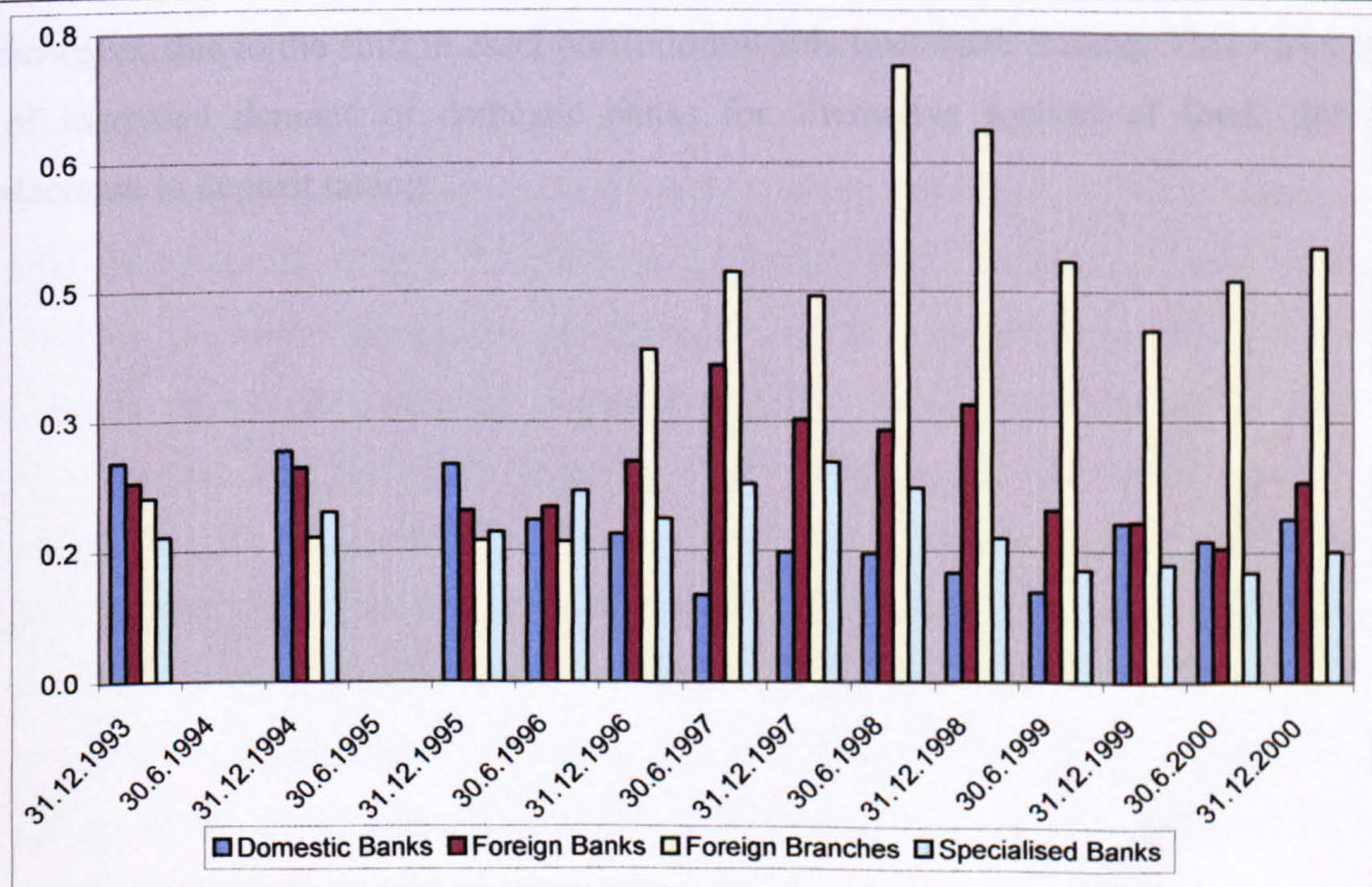
The final assessment of bank asset portfolio distribution sheds light on questions arising from previous analyses. Inter-bank Assets over total assets ratio indicates involvement of market participants in inter-bank trading, therefore revealing the confidence of particular institutions about the country's bank market and bank institutions functioning. The first six years of the Slovak bank market operation were characterised by a relatively small involvement of foreign bank institutions in provision of banking services. Foreign banks had to establish their presence on the Slovak banking market and build their asset portfolios to have a notable impact. Some exception might have been the established Czech banks that built on their linkages with clients from the communist era. Nonetheless, with the market situation evolving, foreign banks and branches focused their activities away from capital markets trading or credit provision to inter-bank trading. While average inter-bank assets of foreign banks and branches accounted for about 20 per cent of the total assets in the first five years, since 1996 the asset distribution had begun to change especially for foreign branches. Opting for low risk assets, foreign branches focused on inter-bank markets providing short-term loans to domestic banks. Inter-bank asset share of foreign branches thus reached over 71 per cent in the first half of 1998 and continued to be above 40 per cent level thereafter. It should be noted however, that apart from the previously mentioned motivation of foreign branches to opt for low-risk assets, foreign branches with a limited branch base and reach towards potential clients were rather restricted in their undertaking. In contrast, the initial years might suggest that foreign branches were trying to get established on the customer credit market, as their share of loans over total assets was higher than that of domestic banks. Yet, future developments and frequent entry and exit of foreign branches left all but two institutions inactive from the second half of 1998.

Foreign banks very much followed the strategy of foreign branches, steadily increasing their share of inter-bank assets from 1996. Nonetheless, foreign banks, being more involved in local economy (as shown by ratio of FA/TA and sum of loans), have approached the inter-bank market with little more caution. Domestic banks were restricted in their asset management by a high share of local credit and also a high share of non-performing loans. With such a high involvement in riskier assets, higher

involvement in inter-bank trading was unattainable. Between 1993 and 1995 the surplus of deposits and low involvement of domestic banks in securities trading allowed domestic banks to actively participate in inter-bank markets.

However, increasing share of loans provided to the economy and increased necessity to create reserves towards non-performing loans limited domestic banks' inter-bank trading especially between 1996 and 1999 when share of IBA/TA reached in average just over 13 per cent (compared to an average 28.8 per cent for foreign banks, 52.2 per cent for foreign branches and 19.8 per cent for specialised banks). Much more serious however, was the decline in the amount of deposits since 1996, which worsened the situation for domestic banks, which needed to keep increasing deposit sources in order to keep their minimum capital requirements and cover for reserves to non-performing loans. Foreign and specialised banks, and foreign branches especially thus abused the deteriorating situation of domestic banks. This further burdened the risky loan portfolios of the domestic banks and the declining mass of deposits forced them into the difficult situation of providing liability resources to cover assets, thus turning towards inter-bank markets to get secondary sources of financing.

Figure 7-7 - Inter-banks' assets over total assets (IBA/TA) of domestic, foreign, specialised banks and foreign branches (1993-2000)



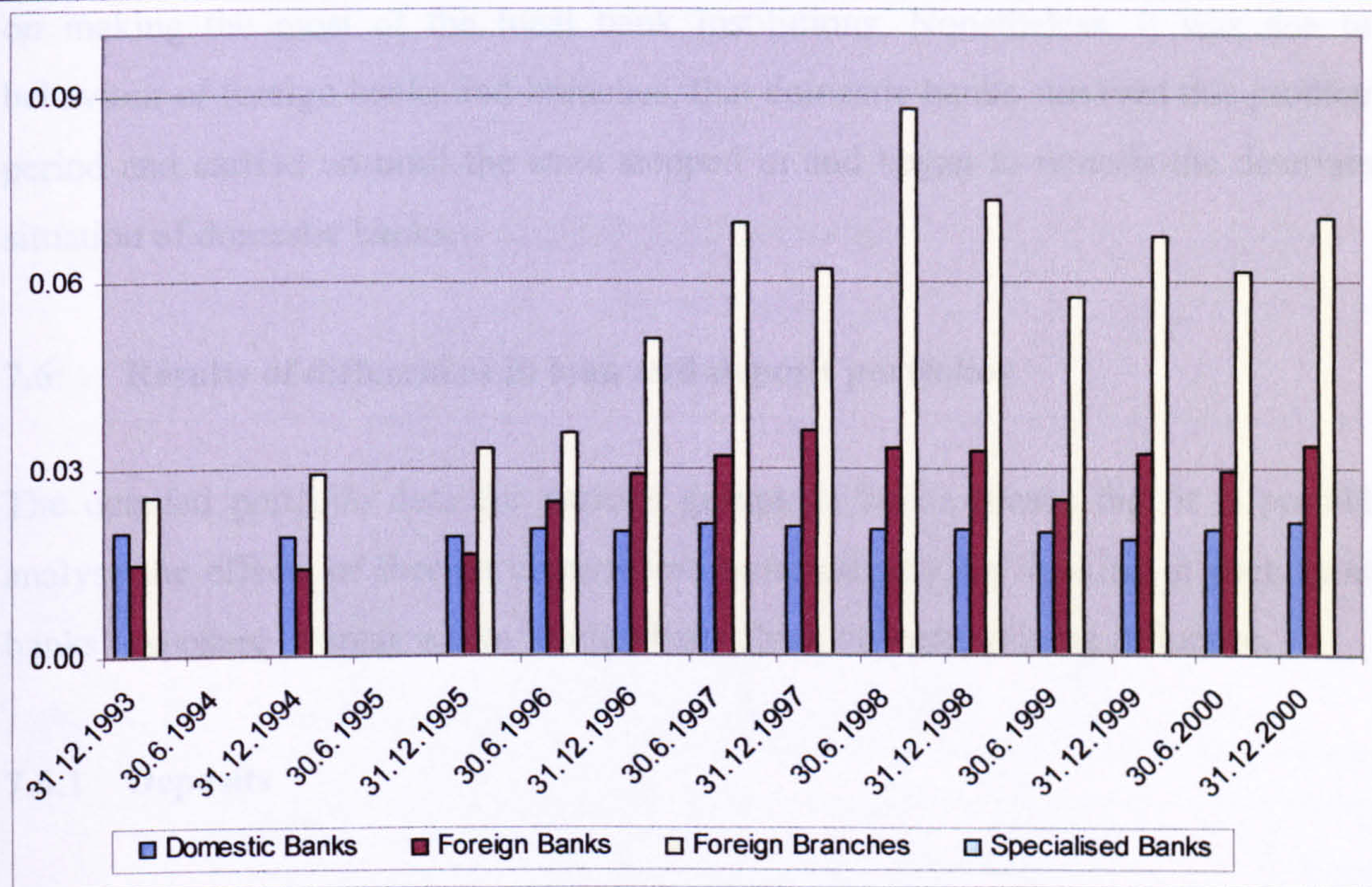
Source: Author's calculations, NBS-ABS (1994-2001)

7.5.8 Earning assets over employees (EA/Employees)

The final indicator for the assessment of differences between domestic, specialised and foreign banks and branches is Earning Assets over Employees. As is clear from Figure 7-8, foreign banks and branches always operated with lower employment levels compared to earning assets under their management. Hence, while domestic banks record stable levels of earning assets per employee, foreign banks, and foreign branches especially, seem to dramatically increase the volume of earning assets managed by their employees. Although it needs to be taken into account that characteristics of domestic and foreign banks may vary in terms of their focus (for example, a couple of foreign banks focused more on corporate and government debt rather than the consumer market), the differences are quite significant.

The results of earning assets over employees analysis thus suggest that foreign banks and branches employed better bank management techniques in terms of human resource requirements for management of bank assets. The differences between domestic and foreign banks were not so obvious in the first years when foreign banks had to get more integrated into the market. However from the second half of 1996 and in 1998 especially, foreign banks and branches outperformed domestic banks almost three times in terms of employee efficiency. Earning assets in that period sharply increased, however, due to the shift in asset portfolio towards inter-bank trading. This was a result of increased demand of domestic banks for alternative sources of funds due to a decrease in deposit taking.

Figure 7-8 - Earning assets over employees (EA/Employees) of domestic, foreign, specialised banks and foreign branches (1993—2000)



Source: Author's calculations, NBS-ABS (1994-2001)

7.5.9 Conclusion on comparative ratio indicators descriptive analysis

The comparative ratio indicators analysis presented offered further insights into the differences between domestic, specialised and foreign banks and branches. Striking differences in bank profitability, risk assessment and management as well as asset portfolio management supported the view that foreign banks and branches operate under different 'know-how' models and apply different bank strategies. Foreign banks and branches were more profitable and operated with less riskier loan portfolios than their domestic counterparts, although foreign branches in the early years were affected by the large presence of Czech bank branches whose parent banks faced similar problems to those of Slovak banks. Nonetheless, analysing asset distribution, significant differences are observed. Both foreign banks and foreign branches gradually decreased their credit involvement in the economy, which does not support the theory of increased provision of capital by foreign banks. Furthermore, they focused their activities on inter-bank trading where low-risk assets at a high rate of return were traded. Foreign banks and branches took advantage of the situation of domestic banks, which had to turn to secondary markets to acquire capital, while primary sources (deposits) were declining.

Foreign banks and branches especially have not committed themselves to the Slovak economy especially in terms of fixed assets, e.g. building branch networks, but focused on making the most of the local bank institutions. Nonetheless, it was due to the behaviour of foreign banks and branches, that domestic banks survived this problematic period and carried on until the state stepped in and began to remedy the deteriorating situation of domestic banks.

7.6 Results of differences in loan and deposit portfolios

The detailed portfolio data for various groups of banks means that it is possible to analyse the effects of foreign competition more directly, by looking at each group of banks' exposure in areas where foreign banks had, or were, gaining influence.

7.6.1 Deposits

Table 7-5 presents the results of the tests of normality for bank deposits. Referring to previous analysis of ratio indicators, normality cannot be assumed since the significance level is less than .05. The condition of normality does not hold for all sectors of industry. Hence again, the Kruskal-Wallis test for independent samples is suggested given that non-parametric tests do not assume for normal distribution of sample. The results of the Kolmogorov-Smirnov test of normality suggest that the ratio indicators are not normally distributed.

Homogeneity of variance across groups is another condition for using parametric tests. Table 7-6 presents the results of Levene's homogeneity of variances test. In all cases significance levels are less than 0.05. Thus homogeneity of variances is not confirmed and the second condition for use of the ANOVA parametric test is not met.

The third condition of independence of observation is also confirmed since measures are recorded independently on performance of other members of the population. Nonetheless, since there is serious concern about normality of distribution, the non-parametric test is used to explore whether there are significant differences between four groups of banks.

Table 7-7 reports results of the Kruskal-Wallis K statistics[73]. The results indicate that differences between the four groups of banks are extremely significant for all sectors of the industry since the observed asymptotic difference is less than .05. Therefore, based on the results of the Kruskal-Wallis test, a conclusion can be drawn that there are significant differences between the structure of deposit portfolios of domestic, foreign and specialised banks as well as specialised branches.

Table 7-7 - Kruskal-Wallis test - deposits

	Non-financial corporations	Public sector	Non-profit organisations	Small enterprises	Citizens	Non-residents	Unsorted
Chi-Square	40.576	43.982	47.503	46.268	40.000	31.264	42.387
Df	3	3	3	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000	0.000	0.000	0.000

	Agriculture, hunting & fishing	Forestry	Mining	Industry production	Food and tobacco	Chemical	Foundry and machinery
Chi-Square	47.816	48.587	44.000	39.856	42.614	35.436	36.186
Df	3	3	3	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000	0.000	0.000	0.000

	Electrical engineering	Textile and leather	Other	Electricity water and gas supply	Construction	Wholesale, hotels and restaurants	Tourism
Chi-Square	42.000	45.076	37.880	47.709	41.045	35.000	29.286
Df	3	3	3	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000	0.000	0.000	0.000

	Transport, warehouse and post	Finance and banking	Insurance	Other total
Chi-Square	31.601	27.272	39.096	21.250
Df	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000

a Kruskal-Wallis Test

b Grouping Variable: Bank Type

[73] Similar results were produced using the parametric ANOVA test although conditions for using the parametric test do not hold in two cases. The ROA ratio indicator was found not to be significantly different using the ANOVA F test, which may result from the unequal group size.

7.6.2 Loans

Similarly to deposits, all necessary tests for establishing whether there are significant differences between groups of banks were performed. Results of the test of normality of distribution in Table 7-8 again prove that normality cannot be assumed since the significance level is less than .05 for all industry sectors. Again, the Kruskal-Wallis test for independent samples is suggested given that non-parametric tests do not assume for normal distribution of the sample.

Homogeneity of variance across groups is another condition for using parametric tests. Table 9-9 presents the results of Levene's homogeneity of variances test. In all cases significance levels are less than .05. Thus, homogeneity of variances is not confirmed and the second condition for use of the ANOVA parametric test is not met.

The third condition of independent of observation is also confirmed since measures are recorded independently on performance of other members of the population. Nonetheless, since there is serious concern about normality of distribution, a non-parametric test is used to explore whether there are significant differences between four groups of banks.

Table 7-10 reports the results of the Kruskal-Wallis K statistics[74]. The results indicate that differences between the four groups of banks are extremely significant for all but one sector of the industry since the observed asymptotic difference is less than .05; what is not significant at α equal .05 is tourism. A possible explanation could be the small involvement of any bank group in credit to the tourism sector and the very selective provision of any such credit, since the state has not supported this sector in any form. However, in general, based on the results of the Kruskal-Wallis test, a conclusion can be drawn that there are significant differences between the structure of deposit portfolios of domestic, foreign and specialised banks as well as specialised branches.

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[74] Similar results were produced using the parametric ANOVA test, although conditions for using the parametric test do not hold in two cases. The ROA ratio indicator was found not to be significantly different using the ANOVA F test which may be result of the unequal group size.

Table 7-10 - Kruskal-Wallis test - loans

	Non-financial corporations	Public sector	Non-profit organisations	Small enterprises	Citizens	Non-residents	Unsorted
Chi-Square	47.559	38.599	46.528	49.607	32.000	24.434	39.278
df	3	3	3	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000	0.000	0.000	0.000

	Agriculture, hunting & fishing	Forestry	Mining	Industry production	Food and tobacco	Chemical	Foundry and machinery
Chi-Square	48.009	44.453	32.000	44.450	44.207	45.362	40.482
df	3	3	3	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000	0.000	0.000	0.000

	Electrical engineering	Textile and leather	Other	Electricity water and gas supply	Construction	Wholesale, hotels and restaurants	Tourism
Chi-Square	44.000	44.330	40.513	47.327	44.868	37.000	7.778
df	3	3	3	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000	0.000	0.000	0.051

	Transport, warehouse and post	Finance and banking	Insurance	Other total
Chi-Square	45.279	32.146	43.350	41.447
df	3	3	3	3
Asymp. Sig.	0.000	0.000	0.000	0.000

a Kruskal-Wallis Test

b Grouping Variable: Bank Type

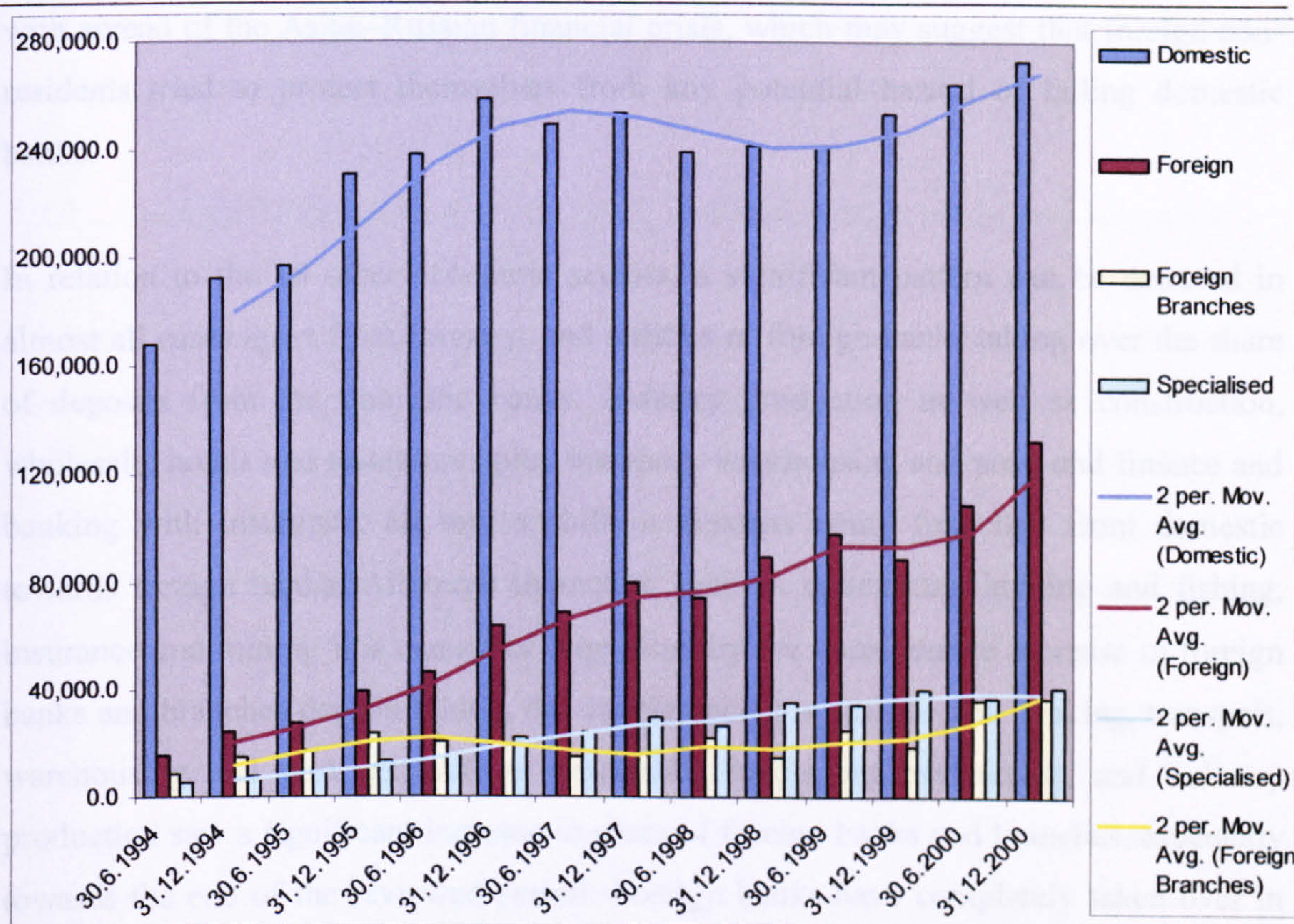
7.7 Analysis of loan and deposit portfolios by sectors of the economy

After establishing the statistical significance of differences in loan and deposit portfolios between selected groups of banks, it is worthwhile to analyse in more detail exposure of selected groups into particular sectors of the Slovak economy. This analysis is expected to provide insight into the behaviour of domestic, specialised and foreign banks and branches.

7.7.1 Deposit portfolios of domestic, specialised and foreign banks and branches

In absolute terms, domestic banks held the largest share of deposits throughout the research period. Domestic banks with large branch networks and a traditional focus on household deposits benefited from stable deposit portfolios in the first four years of the Slovak Republic. Foreign banks followed with share of only 8 per cent in the beginning but this increasing steadily to a 27.5 per cent share of all deposits at the end of 2000. While domestic banks stalled in deposit-taking between 1997 and 1999, foreign banks continued to grow stronger in terms of primary sources apart from in the second half of 1998 and the second half of 1999. Also positive (though not as significant as for foreign banks) was the growth of deposits for specialised banks supported again by two foreign building societies. Foreign branches with varying performance, mostly due to limited branch expansion and frequent withdrawals since many banks were from the neighbouring Czech Republic, recorded the lowest share of deposits with 7.7 per cent at the end of 2000. The result is, however, quite positive since only two foreign branches operated in Slovakia after 1998. Foreign banks and branches and specialised banks recorded average growth rate of deposits of around 18 per cent. Domestic banks on the other hand managed to grow on average only 4 per cent during the seven-year period. The share of foreign banks on deposits thus grew by 250%, while domestic banks saw their share drop by a third. Patterns of described developments are shown in economic sector deposit distributions as follows:

Figure 7-9 - Deposits of domestic, foreign, specialised banks and foreign branches (in mil. SKK) (1994-2000)



Note: data available only since 30.6.1994
Source: Author's calculations, NBS-ABS (1994-2001)

7.7.2 Sector distribution of deposit portfolios

Public Sector[75] deposits in domestic banks rose sharply between 1994 and the first half of 1997 as the government continued restructuring the economy, and obviously favouring domestic banks ahead of any other banks for management of the state finances. Since the end of 1997, however, deposits as in many other sectors declined significantly from over eight per cent to just four per cent of the total deposits.

Obviously, domestic banks mostly served small enterprises, although towards the end of the millennium foreign banks stepped in acquiring increasing share of deposits in this sector. This may suggest a shift in foreign banks' strategies. Another such shift can be detected in citizens' deposits where domestic banks held over 50 per cent at the beginning of the research period, coming down to 40 per cent at the end. Foreign banks and specialised banks and branches on the other hand managed to increase their share

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[75] For figures of deposit portfolios distribution among economic sectors see Appendix B.

from almost zero to over 12 per cent. Foreign banks mostly served non-residents as might have been expected. A sharp increase in deposits of this sector in 1997 coincided with spread of the Asian–Russian financial crisis, which may suggest that foreign non-residents tried to protect themselves from any potential hazard of failing domestic banks.

In relation to the 18 other economic sectors, a significant pattern can be detected in almost all cases apart from forestry, and utilities of foreign banks taking over the share of deposits from the domestic banks. Industry production as well as construction, wholesale, hotels and restaurants plus transport, warehousing and post, and finance and banking with insurance, all saw a shift in deposits being funnelled from domestic towards foreign banks. Although in sectors such as agriculture, hunting and fishing, insurance and mining this cannot be supported by the considerable increase in foreign banks and branches deposit taking, the developments in finance and banking, transport, warehousing and post, as well as wholesale, hotels and restaurants, and industry production saw a significant increase in share of foreign banks and branches, especially towards the end of the reviewed period. Foreign banks have completely taken over in the food and tobacco industry, the chemical industry and other industries. Foundry and machinery, electrical engineering and leather and textile production saw more or less a level share of foreign and domestic banks on deposits. Mining was a sector that diminished throughout the reviewed period while tourism (which had been previously largely neglected) showed signs of a revival in 2000, with a sharp increase of foreign branches' deposits. Such a move may indicate detection of a market for foreign branches since in other sectors foreign branches struggled to get their share. Specialised banks strongly participated in deposit taking in the Slovak banking sector, as a result of the successful strategies of collecting citizen's deposits by two foreign-owned building societies.

Overall it is difficult to conclude that foreign entry had any negative effects on the collection of deposits for domestic banks since the trend in acquiring deposits by foreign banks copied the trend of domestic banks and reflected the situation in deposits by non-financial corporations (that involve all 18 SIC sectors). It could be suggested though that since foreign banks (including foreign branches) reached over 30 per cent of the total assets share of the Slovak banking sector, deposits of industry in domestic

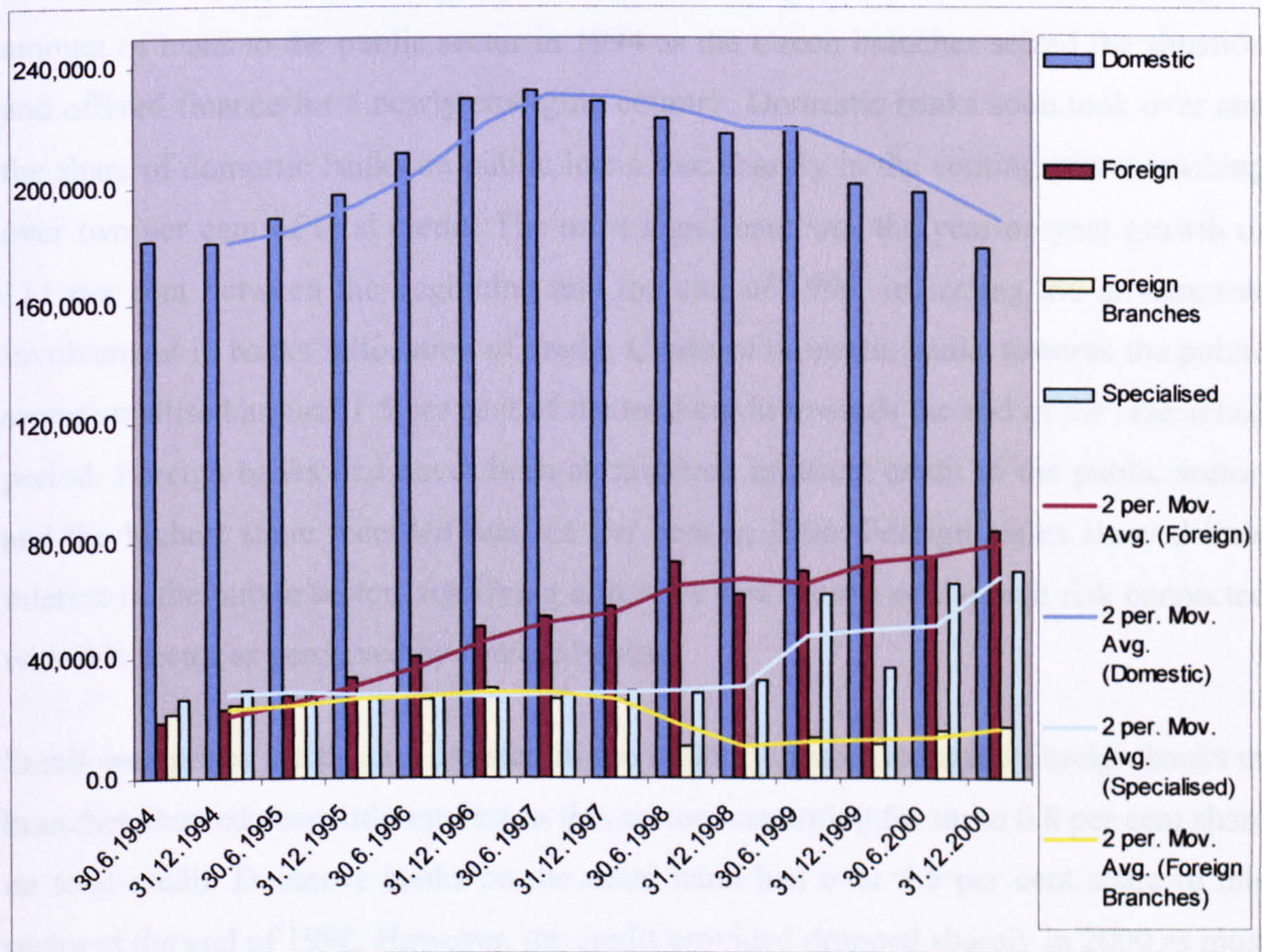
banks started to decrease and never recovered to the levels seen at the end of 1996. Specialised banks were only involved in mortgage savings, thus increasing their deposits steadily. Foreign branches were most affected by a drop in citizens and industry depositing money in banks after 1997.

7.7.3 Loan portfolios of domestic, specialised and foreign banks and branches

A similar situation to deposits can be identified with total credit provided into the Slovak economy by banks. While foreign banks enjoyed steadily increasing amounts of loans, domestic banks also managed to record important growth especially from the high levels of 1994. Foreign banks grew at an average rate of 22 per cent between 1994 and 1996 but the growth was from this low basis. Foreign branches varied in performance from year to year, coming to average growth rate of 7.5 per cent in the same period. Specialised banks have not recorded any noteworthy increase in credit provided since existing specialised domestic banks were only serving as a 'bad loans graveyard' from the past, and intermediary and guarantor for international credit facilities until foreign building societies stepped in with increased provision of mortgage and building loans. The provision of credit changed at the end of 1997 when domestic banks had control for the loans provided, due to decreased intake of deposits and the deteriorating bank capital situation caused by high levels of non-performing loans and rising losses. While foreign banks were also affected by dropping deposits, their lending activities continued to rise; a situation quite opposite to the domestic banks. Having better loan portfolios, lower fixed assets and higher profits, it may be suggested that foreign banks operated with better bank 'know-how' and management techniques. Foreign branches were again very much affected by frequent mergers or withdrawals due to parent bank failures as many of them were from another transitional economy. Specialised banks recorded only a small increase in provision of loans mostly connected to the supply of mortgages by building societies. Nevertheless, the increase in mortgage lending was not so significant by 2000. An increased volume of loans by specialised banks is related to bailout of the three biggest domestic banks by the government. Overall, foreign branches recorded average growth of just below 2 per cent (although 12.5 per cent from 1998 when only two branches remained). Specialised banks worked with an average 11.94 per cent growth rate in credit but recorded balanced growth if transfer of bad loan portfolios from domestic banks to the

Consolidation Bank is not taken into account. Domestic banks recorded a meagre 0.4 per cent average growth in provision of loans, as compared to foreign banks with the best growth rate, an average of 12.87 per cent. Foreign banks thus proved a substantial contributor to the domestic economy as a stable source of finance when domestic banks failed.

Figure 7-10 - Loans of domestic, foreign, specialised banks and foreign branches (in mil. SKK) (1994-2000)



Data available only since 30.6.1994
Source: Author's calculations, NBS-ABS (1994-2001)

7.7.4 Sector distribution of loan portfolios

For the purpose of this analysis, this research focuses on the areas where there is a statistically significant difference between the portfolios of foreign and domestic banks (see Tables 7-7 and 7-10). In this case, all but one sector (tourism) is statistically different. All other sectors being equal, it may be that those domestic banks that concentrated their deposit taking and lending activity in certain sectors faced greater competitive pressures from foreign banks. Domestic banks thus might have been crowded out of the market, which may have affected their profitability and efficiency[76]. Examining credit provided to the public sector, foreign branches provided the highest amount of loans to the public sector in 1994 as the Czech branches seized the situation and offered finance for a newly emerging country. Domestic banks soon took over and the share of domestic banks on public loans rose sharply in the coming years, reaching over two per cent of total credit. The most significant was the year-on-year growth of 111 per cent between the beginning and the end of 1996, indicating the government involvement in banks' allocation of credit. Credit of domestic banks towards the public sector stabilised around 1.5 per cent of the total credit towards the end of the researched period. Foreign banks had never been as involved in direct credit to the public sector, and the highest share recorded was 0.6 per cent in 1996. Foreign banks showed little interest in the public sector, signifying either the low returns or the high risk connected with this sector as perceived by foreign banks.

Small enterprises were again assisted in the main by domestic banks. Foreign banks or branches showed very little interest in this sector accounting for up to 0.8 per cent share on total credit. Domestic banks on the other hand had over 4.5 per cent share in this sector at the end of 1998. However, the credit provided dropped sharply in 2000 as most of the loans to small enterprises were classified as non-performing and were transferred to the Consolidation Bank.

Loans to citizens were, until 1998, almost solely issued by domestic banks. Foreign banks showed very little interest and foreign branches totally neglected consumer credit. However with legislation being the problem, this area of bank assets was largely untapped until 1998. With new laws on creditors' rights the banks started to offer loans again and mortgages especially became the favourite choice of citizens for borrowing,

which benefited two building societies thus bringing share of specialised banks from nothing to over 8.5 per cent at the end of 2000.

Domestic banks rather surprisingly provided credit to non-residents for most of the period. Contrasting to this is the fact that foreign banks and branches rather than domestic banks held the bulk of the deposits of non-residents. Non-residents were, in all probability, opting for better rates of borrowing at domestic banks. However, by the end of the period foreign banks took over the lead from their domestic counterparts. It needs to be noted that the share was less than a half of a percentage point of total credit, and even a small change would have a significant impact on the distribution of this sector.

Agriculture, hunting and fishing were initially strongly supported by domestic banks. However, funding of this sector diminished gradually dropping by 80 per cent between 1994 and 2000. Agriculture was perceived as an area that faced many difficulties especially in terms of government support and profitability. While foreign branches tapped the area in the beginning with a small amount of credit, their support moderated throughout the period. Foreign banks on the other hand kept relatively stable levels of credit, accounting for just over half a percentage point of the total credit share. The only other bank group with significant share on credit were specialised banks; though the credit provided refers to loans from the past and non-performing loans.

Forestry was another sector where foreign banks showed little or no interest and the entire sector was left relying on domestic credit. The levels were very low although Slovakia has vast resources of this natural building material. Domestic banks largely dominated this area, although the credit provided started falling after 1998 as with many other sectors.

Domestic banks provided the most import source of financing for mining, with the first year (1994) accounting for over three per cent of the total credit. However, immediately within the next year this funding dropped to 0.5 per cent and remained at similar levels until 1999 when it declined further. Noteworthy is the fact that all the banks were involved in financing mining and after 1999 at similar levels. Nonetheless, the real levels constituted only about 0.3 per cent of the total credit provided to the economy and many mines were closed due to high fixed costs and dropping revenues.

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[76] For figures of loan portfolios distribution among economic sectors see Appendix C.

The bulk of the funding was funnelled to industrial production. Similar to many other sectors this was dominated by domestic banks' credit, which peaked in 1995 with almost 25 per cent involvement. Domestic banks continued to keep the high levels of credit to industry until 1998. The deteriorating situation in bank capital, falling deposits and high level of non-performing loans, however, pushed the involvement down in 2000 dropping threefold from the peak in 1995. Foreign banks, on the other hand, were steadily increasing their contribution in loans to industry from above two per cent at the beginning of the period to almost nine per cent at the end. In fact, foreign banks were the major creditor to the industry at the end of 2000. Participation of specialised banks was mostly connected with the Consolidation Bank, hence inherited bad debt from the previous regime. Foreign branches managed to compete with foreign banks only in the first year of the reviewed period and their share on loans to industry never reached three per cent threshold.

By disentangling industry into particular sectors, the pattern of increasing foreign involvement becomes more obvious. Steadily increasing provision of loans by foreign banks in the food and tobacco industry resulted in the majority of loans being provided by foreign banks in 2000. Domestic banks though held a share of loans which was three and a half times higher share than their foreign counterparts as late as 1998, which was a pinnacle for domestic bank involvement. Neither foreign branches nor specialised banks managed to establish a significant presence in this sector. A similar situation to tobacco and food occurred in the chemical industry although the highest share of domestic as well as foreign banks before 2000 occurred in 1995. Since then domestic banks', rather than foreign banks' credit declined significantly resulting in foreign banks taking over the financing of industry in 2000. A similar pattern for domestic banks' credit can be traced in foundry and machinery production. Nevertheless, foreign banks were increasing their share progressively from the low levels of 1994. Foundry and machinery is the core of Slovakia's production, with the second highest share of credit to total credit for most of the banks. It was also the sector most burdened by bad loans as shown by the high levels of specialised banks' credit.

Electrical engineering was signified by a rapid increase of foreign bank involvement especially at the end of 1996 and 1999 when foreign banks reached about half the

involvement of domestic banks. While the share of both domestic and foreign banks was fluctuating, the specialised banks' share was decreasing suggesting that the non-performing loans of this sector were being resolved from their own resources. Foreign branches had been quite active until 1997, when after many withdrawals and mergers the credit involvement of foreign branches consolidated and began to increase. In the second half of 1999 the share of domestic and foreign banks' loans towards electrical engineering levelled but the year 2000 confirmed the trend of foreign banks taking over financing the Slovak industry.

The textile and leather industries proved unattractive for foreign banks, and domestic banks managed to keep the major role in lending despite a drop in the amount of credit. Loans to other industrial sectors recorded increasing share of foreign banks, the same as many other cases, resulting in domestic banks having the same level of involvement as foreign branches at the end of 2000, after the bulk of non-performing loans from the three largest domestic banks was transferred to a specialised agency and the Consolidation Bank. The dominance of domestic banks in certain sectors of the economy was demonstrated in utilities, where foreign banks gained a significant share only after non-performing loan transfers from domestic banks. Foreign branches failed to get any foothold and electricity, gas and water also benefited from low levels of bad debt, thus a low level of specialised banks' credit share. Construction was another sector where domestic banks' supremacy in providing credit was demonstrated, however only until 1998 when state support for large infrastructure construction projects was halted due to the increasing negative government balance. Domestic banks held a higher share of loans to total credit until June 2000. Foreign branches rarely succeeded in supplying credit to construction businesses.

Hotels, restaurants and especially wholesale were the areas where foreign banks had already achieved a significant share of credit since 1998, and subsequently foreign banks also kept an even share of credit. Domestic banks' share on the other hand dropped to half that of foreign banks in the second half of 2000. Foreign branches were quite successful in seizing some of the market in the first two years of the researched period, but dropped subsequently for the reasons explained previously. Tourism experienced some turbulent times as all groups of banks exchanged as the main providers of credit throughout the period. Starting with specialised banks as the sector

was experiencing rather tumultuous transformation, foreign branches soon took over, seizing the market gap between 1995 and 1996. Domestic banks replaced foreign branches the following year and exchanged the lead in share of loans to total credit with foreign banks several times. It needs to be noted, however, that the share of credit provided by banks to businesses involved in tourism was rather low.

Transport, warehousing and post was one of the four economic sectors[77] where foreign banks maintained the leading share in provision of credit. Although foreign banks kept increasing their share considerably, loans to transport, warehousing and post fell substantially in 2000. The share of specialised banks continued to decrease from 1995 and foreign branches recorded only one year with some significant share in financing this sector. Finance and banking was the only area where foreign branches dominated in supply of credit. Since the outset the foreign banks' involvement in medium- to long-term financing of domestic banks was at least four times higher than the involvement of any other group of banks. The abrupt change came in 1998 after the withdrawal of most of the foreign branches in the previous years. Foreign banks immediately replaced foreign branches in the provision of the majority of credit to failing domestic banks. Domestic banks, diverting their assets from more risky sectors of the economy, also increased their involvement in loans to other financial institutions, however in the end they could not compete with the healthier foreign banks.

The last sector analysis is insurance, where domestic banks entered the period with substantial involvement but were overtaken by foreign banks as the only competitor here. The other loan portfolios represent loans to citizens, non-residents, public sector and others that are analysed as the first four but not officially included in the 18 SIC sectors[78]. As seen in Appendix C, the movement of domestic banks is in the majority, especially at the beginning and at the end of the researched period. The 'other' sector represents the majority involvement of banks in the domestic economy because of its structure as described before. Specialised banks were the only ones that challenged domestic banks' involvement at the end of the period, with increasing mortgage lending by two foreign building societies.

[77] according to Standard Industrial Codes of the National Bank and Statistical Office of the Slovak Republic

[78] according to the National Bank of Slovakia and Statistical Office of the Slovak Republic.

Foreign banks showed little interest in the public sector, signifying either the low returns or the high risk connected with this sector as perceived by foreign banks.

7.8 Conclusions of quantitative analysis of bank performance, ratio indicators and deposit and loan portfolio structure of domestic, specialised and foreign banks and branches

The results of empirical analysis found significant differences between domestic, specialised and foreign banks and branches. Furthermore, it uncovered striking differences in profitability, portfolio risk, and structure of banks' assets. Developments of the first three years of existence of the independent Slovak banking market seem to confirm Buch's (2000) pronouncement that a certain level of foreign ownership of banking assets need to be reached to measure for differences in behaviour.

The results of empirical analysis suggest that foreign banks operated with better 'know-how', higher employee efficiency and a more cautious approach to bank undertakings. Domestic banks were heavily involved in supporting the domestic economy and still fulfilled the role of the main financial source for operation of the economy as confirmed by share on volume of both deposits and loans.

7.8.1 Results of descriptive statistics

Domestic banks were the largest group of banks in terms of total assets, with a mean value of over SKK408 billion. Foreign banks were the second largest group with an average total assets of more than SKK161 billion, followed by specialised banks with SKK68 billion and foreign branches with almost SKK61 billion. However, in terms of profitability, foreign banks outperformed domestic ones by far with average profits of SKK0.976 billion, again followed by foreign branches making in an average SKK441 million. This result may be consistent with Claessens et al. (1998) who suggested that foreign banks in developing countries operate with higher profitability than domestic banks. Specialised banks that consisted of two state-owned banks (of which one was a non-performing loans graveyard and the other only posing as a guarantee provider) were boosted by the profits of two foreign-owned building societies, thus recording average

loss of SKK1.735 billion. Domestic banks were not the worst, with an average loss of SKK2.352 billion.

Domestic banks showed the largest involvement into the economy, with the largest sum of fixed assets over the researched period coming to SKK200.771 billion, while foreign banks recorded only SKK57.346 billion. Foreign branches and specialised banks followed with over SKK7 billion and SKK10 billion respectively. Also, in terms of employment, domestic banks were heavily involved in the domestic economy offering employment in total to 248,632 while foreign banks employed in total only 66,476.

Domestic banks were badly affected by the previously described deterioration in profitability since profits were the most important part of the restructuring strategies of the domestic banking sector. Thus, overall losses have not provided sufficient resources for fulfilling the minimum capital requirements of the National Bank of Slovakia. Both foreign banks and foreign branches were more profitable (with an average ROA of 0.323 and 1.136 respectively) and had less risky portfolios of loans (with a mean CCR of 0.108 and 0.260 respectively). Domestic and specialised banks, on the contrary, were evidently inefficient with ROA of –1.197 and –1.492, as well as facing higher risks for their loan portfolios with CCR of 0.290 and 0.437 respectively. Such a development confirms Clarke et al.'s (1999) findings that foreign banks tend to have better quality portfolios. Foreign banks were very cautious in the provision of loans to domestic clients and it can be suggested that foreign banks selected the best performing clients, thus applying the 'cherry-picking' strategy.

7.8.2 Results of comparative ratio indicators analysis

Initial 'credit crunch' has been moderated quickly especially for domestic and foreign banks when loans over deposits already dropped to a sustainable level of below one at the end of 1994. Foreign banks, however, confirmed their cautious approach in offering credit only at 79 per cent of collected deposits. The situation further deteriorated in terms of provision of credit, as foreign banks clearly focused on collection of deposits, which is reflected in loans forming only 63.5 per cent of collected deposits at the end of the researched period.

Foreign branches alternatively pursued a policy of extensive credit provision as loans over deposits ratio moved from 130 per cent to 170 per cent between 1995 and 1997. With the withdrawal of the Czech branches, however, the loans to deposit ratio dropped to the lowest levels of all banks, and suggested that foreign branches were previously overexposed in their credit provisions supported by the funds of parent banks. The two remaining foreign branches were much more cautious in their approach having aggregated loans below the 48 percentage points. Specialised banks were positively affected by the undertaking of the building societies, bringing the loan to deposit ratio for specialised banks to ideal levels of below one in 1997 and 1998.

Domestic banks had the highest involvement in the economy in terms of fixed assets over total assets. But also with average values of five per cent fixed assets of total assets also showed the lowest efficiency in volume of fixed assets needed to utilise earning assets. Foreign banks operated in the region of about three per cent, which may suggest that foreign banks applied better bank managerial 'know-how'. On the other hand, foreign banks faced the task of establishing a branch network, which takes time. Foreign branches operated at even lower levels of FA/TA: just above one per cent. Specialised banks recorded an average FA/TA ratio of 1.8 per cent mostly affected by the minimum branch network of domestic specialised banks, as opposed to the increasing branch network of building societies.

Analysing earning assets distribution, the domestic and specialised banks kept steady levels of loans to total assets. Foreign banks and branches, however, continuously decreased their involvement in offering credit to the local economy from over 56 per cent share of loans on total assets in 1994 to a meagre 27 per cent in 1998. The involvement of foreign banks and branches never recovered until the end of the researched period and kept below the 36 per cent. Securities owned by foreign banks and branches followed more or less the same pattern until 1999 when their share increased to 10 per cent of the total assets and kept rising up to almost 14 per cent at the end of 2000. Encountering the problems of low-level business sector transformation, ineffective legislation for creditors and limited number of creditworthy clients (according to western credit scoring methods), foreign banks and branches turned to secure and high earning assets on inter-bank markets. The domestic banks' falling deposits made them turn to other sources of funds, and foreign banks were quick to

assist large domestic banks with short-term inter-bank credit facilities. This was especially foreign branches that failed to establish a significant foothold with loans focused on inter-bank markets that required virtually no fixed assets or acquisition of information about clients and offered high returns at next-to-no risk.

Foreign banks and branches appear to be more efficient in terms of the human resource requirements for management of earning assets. While domestic banks kept the level of approximately SKK2 billion per employee, foreign banks reached SKK3 billion per employee threshold. Foreign branches were even more efficient with an average SKK6 billion. This was arguably mostly affected by the high involvement of foreign branches with small staffing levels on large-value, inter-bank markets. Although the indicator of earning assets per employee may be difficult to interpret, it is clear that domestic banks kept the same levels of employee efficiency, while foreign banks and branches doubled the value of the indicator, suggesting better efficiency and management techniques.

7.8.3 Results of deposit portfolio analysis

Domestic banks drew on their local knowledge and extensive branch networks, thus managing to seize to the market for deposits in absolute terms for the whole period of 1993 to 2000. Foreign banks, nevertheless, increased their share of deposits significantly, taking almost one-third of all deposits in Slovakia in 2000. What is also important is that while domestic banks recorded decreasing deposit takings since 1997, foreign banks continued to grow strongly during that period, suggesting a shift in clients' preferences. It needs to be noted, though, that non-financial institutions that were offering high interest rates (of above 30 per cent in some cases) abused the loophole in current legislation and attracted a large share of deposits. Also, failing foreign branches and some domestic banks affected the trust of depositors in domestic banking institutions in 1998. After consolidation of the turmoil in 1998, remaining foreign branches focused on high-income depositors reflecting their branch scope. Building societies benefited from the limited market for mortgage savings, and also the state support of six per cent per annum of the saved amount added to each client's account every year. Interim loans provided for rebuilding or purchase of flats from the state ownership further supported the interest of people to deposit their money in building societies.

Domestic banks benefited from close relations with the state, and the public sector was one of the largest depositors in domestic banks. Domestic banks also supported small local enterprises and deposits of this sector dominated domestic banks' portfolios. Foreign banks managed to get a stronger foothold in citizens' deposits, especially towards the end of 1999 and 2000. In most cases, foreign banks overtook the share in deposits from domestic banks. While some sectors of the economy saw a significant increase in foreign banks' receipt of funds, which could suggest selective marketing strategies or changes in client behaviour, a decreasing share of domestic banks mostly affected other sectors. Specialised banks were represented again especially by foreign-owned building societies. Foreign branches seemed to try to fill the gaps in the market by focusing on sectors where other banks were less active.

7.8.4 Results of loan portfolio analysis

Domestic banks sharply increased the volume of loans provided in the economy during the first three years of the researched period, suggesting a 'credit crunch'. Industrial sectors as well as wholesale, hotels and restaurants, together with insurance and also the public sector recorded an increased provision of credit by domestic banks between 1994 and 1996. Domestic banks were much more involved in public sector credit especially since 1996, which suggests an increased role of state influence. The support of domestic banks for the Slovak economy is also represented by the levels of loans to Small Enterprises and above all in consumer loans whose foreign banks or branches were completely ignored. This supports Bonin and Abel's (2000) view that domestically-controlled banks with local expertise may have a significant role to play in retail banking in small, open transition economies. The levels of loans offered to non-residents may be rather surprising, where high foreign participation might have been expected. Foreign banks and branches seemed to follow the strategies of the 'cherry picking' as increased involvement is recorded in various sectors of the industry leaving the less attractive sectors of agriculture, mining and forestry to domestic banks. Domestic banks, with only a few exceptions, held the highest share in loans to sectors as a result of past credit relations with local enterprises and also a high share of doubtful or non-performing loans inherited from the past and from the 'First Round' of privatisation.

Foreign banks and branches seemed to focus on the sectors where turnover was fast as depicted in shares in wholesale, hotels and restaurants and transport, warehousing and post. The increased entry of foreign insurance companies is reflected in the levels of credit provided into the insurance sector by the foreign banks. Foreign branches attempted to find a niche in funding specific sectors where neither domestic nor foreign banks established a strong foothold, such as in tourism, finance and banking. A high share for foreign branch credit was also documented in 1994, where the Czech banks stepped into the market, financing the new independent Slovak Republic. This move supports a motive for entry on conditions of comparative ownership advantage, for example knowledge of local conditions. Specialised banks were represented by high shares of non-performing loans at the Consolidation Bank, and increased provision of credit to citizens towards purchase of flats and houses and re-building interim loans that represented the initial mortgage market.

7.9 Conclusions on the empirical analysis

This chapter attempted to provide an insight into the operation of four different groups of banks using the secondary data and tools of econometric analysis. Drawing on, and extending, the work of other researchers empirical analysis of the various indicators of bank performance, profitability, risk, and earning assets structure provided valuable and unique[79] insights into the behaviour of the domestic banks , specialised banks, and foreign banks and branches. Empirical analysis focused on the selected performance measures and more importantly on allocation of earning assets, as well as the distribution of loan and deposit portfolios, which facilitated detection of differences between the foreign and the domestic banks. Moreover, careful use of statistical techniques supported the view that domestic and foreign banks can be regarded as the different groups. Hence, the role of foreign banks and branches in the transformation of the Slovak financial sector has been examined in detail.

However, the liberalisation and transformation process is enormous and to make simplistic conclusions about the role of foreign banks in the Slovak banking sector may result in omitting significant impacts of other elements of the transformation process,

[79] As stressed by Dages et al. (2000)

such as infrastructure building and influences of the State and the Central Bank, as well as other competitive effects. As Barajas et al. (2000:8) point out; empirical analysis tends to overstate the impact of foreign entry by not controlling for other elements of the liberalization process.

Judging by the descriptive analysis of deposit portfolios, foreign banks seem to affect the domestic banks' receipt of funds from deposits significantly. Nevertheless, it is difficult to conclude that foreign entry has a negative impact on the collection of deposits since other unaccounted factors might have been involved in the distribution of the deposit portfolios of different groups of banks such as government decisions about use of particular bank (SLSP) in connection with paying out the bonds of the National Property Fund or decision to keep the account of customs guarantees strictly within domestic banks. Some symptomatic conclusions on bank behaviour can nonetheless be drawn.

The effects of foreign banks on the behaviour of domestic banks seem to support the findings of Claessens et al. (1998) who suggest that foreign entry may have some negative effects on the operation of domestic banks, reducing their profitability. And furthermore, increased competition does not provide for better quality loan portfolios as was suggested by Barajas (2000). In case of Slovakia, however, it is difficult to argue that decreasing profitability was result of foreign entry. Local banks had to deal with large portfolios of non-performing loans for which they have not had state support to deal with. Hence, supporting the findings of Chapter 6, local banks were more affected by non-performing loans rather than direct foreign entry. On the other hand, foreign banks were extending credits to local enterprises competing with domestic banks and sometimes reducing their credit involvement thus reducing profitability.

Drawing upon conclusions derived above, and all else being equal, it may be that those domestic banks that concentrated their deposit taking and lending activity in certain sectors faced greater competitive pressures from foreign banks. Domestic banks thus might have been 'crowded out' of the market, which may have affected their profitability and efficiency[80]. Then again, foreign banks maintained the growth levels of

[80] For figures of loan portfolios distribution among economic sectors see Appendix C.

credit supply to selected sectors supporting the findings of Dages et al. (2000) that foreign entry increased the growth and volume of loans and decreased its volatility.

In terms, of deposits, domestic banks successfully applied their competitive advantage in knowing the local environment. Domestic banks managed to collect highest share of deposits in most of sectors of the economy until 1998 apart from non-residents and mining sectors. The fact that foreign banks collected highest share of deposit for non-residents supports the view that domestic banks lacked the trust of non-residents to safeguard their finances. Disentangling the industrial sector, foreign banks outperformed domestic ones in wholesale, hotels and restaurants already since 1996 suggesting selective strategies. Also in tourism foreign banks were favoured more, especially foreign banks towards the end of the researched period which may suggest shift in strategy. It is obvious from analysis of deposit portfolios that competition increased their share on collecting deposits since 1998 especially in industrial sector (which might have also been connected with increased inflow of FDI especially since 1999).

Increased role of domestic banks in financing the state is confirmed by level of credit to public sector. While domestic banks claimed large share on loan market for the most of the overviewed period, the quality of their credit portfolios is doubtful. While extending the large shares of credit to industrial sector in 1995, the fact that their market share more or less levelled with foreign banks and branches after removal of large portions of non-performing loans in 1999 and 2000 suggests that their dominance was artificial. Non-performing loans thus had enormous impact on profitability and efficiency of domestic banks. While foreign banks focused on increasing their share in industrial sectors, possibly suggesting the cherry-picking strategies, domestic banks kept the role of financier of the state as well as infrastructure and citizens. There is a strong argument that foreign banks supported stability in provision of credit to number of sectors either by increasing the share of financing or keeping it while domestic banks recorded more volatile changes in their loan portfolios. Foreign banks and branches played important role in financing the domestic banks as proved by shares on loan portfolios for finance and banking sector.

CHAPTER 8.

CONCLUSIONS, LIMITATIONS AND FURTHER RESEARCH SUGGESTIONS

8.1 Introduction

The thesis proceeded looking at the relevant literature chapters one and two and then by comparing the economic situation among selected transitional economies in chapter three. Further, the level of foreign entry in Slovakia was explored in chapter four. Chapter five presented the method of the study, based on a combination of positivistic and phenomenological research philosophies. The combination of quantitative and qualitative research methods was used in an attempt to enhance triangulation and to corroborate both the deductive and the inductive approach. Chapter five provided an ethnographic illustration of perceptions of the commercial bank officials as well as the state and the central bank officials on specified research areas. Empirical analysis of the differences between selected groups of banks was conducted in chapter six and further particular indicators and deposit and loan portfolios' composition were analysed. The results of both parts of the analysis are summarised and discussed in the current chapter. This chapter is the final chapter of the study in which the main findings are presented, and potential policy implications are drawn. Furthermore, limitations of the study are discussed and suggestions for further research are explored in the closing part.

8.2 Research Structure

As a combined quantitative and qualitative analysis, the aim of this research is to detect and explain the effects foreign entry has had on the host country bank sector. The experiences of a transitional economy are believed to be an important addition to knowledge, especially on the effects of financial liberalisation, privatisation and transformation of the economy as a whole, and can help draft policies for countries willing to open up or restructure their financial systems. Ultimately, the author believes it is not the fact of liberalising financial systems but the effects such a step will have that are important.

The research was structured around the four research areas, which were based on Canal's Added Bank Value:

1. Basic activities including taking deposits, marketing and provision of credit
2. Support activities of technology and operations organisation
3. Support activities of human resources
4. Support activities of infrastructure

Four research areas were then enhanced by the author with two more areas capturing the interactions of the environment and foreign entry:

5. Effects of the state and central bank policy
6. Effects of the competition environment

8.3 Major findings

Banks were expected to play important role in restructuring the Transitional Economies. Slovakia confirmed these expectations especially after the role of stock-market became secondary when government of PM Mečiar cancelled the Second Round of Privatisation that was planned back while Slovakia was part of the Czechoslovakia. This Second Round , however, gone through quite successfully in the Czech Republic which further strengthen the role of stock markets in this country. Although voucher privatisation was a great experiment in economic theory the results are doubtful as all of the CEE countries have bank-based financial systems where banks provide majority of external financing to the sectors of the economy. Certain deregulation euphoria might have been detected in the first years of independent country existence leading to evermore deteriorating loan portfolio of inherited and newly extended credit in major state-owned banks. Three state-owned banks held majority of the market shares in collection of deposits, provision of credit and in total assets thus creating oligopolistic banking market. Not even increased competition introduced by increasing foreign entry could have supported development of the Slovak financial system since government via Act on Strategic Enterprises prevented further privatisation of the major state-owned banks.

Foreign banks proved to be rather prudent in their activities mainly because of failing legal infrastructure that was not supporting creditors' rights. Same problem prevented domestic banks from dealing with their portfolio of classified loans. Rather than

extending credit to enterprise sector, foreigners focused on financing exporting industries or large enterprises thus crowding out domestic banks as well as on financing the government which was running high fiscal deficits and on financing domestic banks whose financial situation was deteriorating mostly because of bad debt. A limited offer of creditworthy customers was quickly substituted with large involvement of their activities on the inter-bank and government debt market.

Where Poland opted for bad debt solution within the financial institutions and Hungary opted for combination of this approach with transfer of bad debt to specialised institution Czech Republic and Slovakia solely followed the second option. Whereas Czech Republic consistently followed the method of transferring non-performing loans to a specialised bank, Slovakia wavered under political pressures. However, whether it was consistent or inconsistent application of one or the other method, all countries of CEE now have majority foreign-owned banking system.

Foreign banks have brought competition pressure to which domestic banks had to adapt to a certain degree, as well as, new managerial practices and improvements in human resources. The competitive pressures could have been felt especially by the clients with improving quality of service offered by both domestic and foreign banks. At the same time as foreign bank presence provided stabilising factor for provision of loans and collecting of deposits, it also supported levels of trust in the economy. They also stepped-in financing the needs of state and needs of large domestic banks, saving them when it was needed but on the other hand, further slowing any potential restructuring.

Slovakia experienced a few adverse periods that coincided with foreign financial crises, however was spared of serious repercussions mainly thanks to slowly developing financial liberalisation towards portfolio investments. Hence unhurried development of legal infrastructure provided positive externality on one hand, but hampered the process of transition on the other. Furthermore, strong institution of independent central bank managed to curb any banking failures of either domestic or foreign banks so that it did not seriously threaten domestic banking system. However, this might have come at a cost when successful monetary policy was sacrificed for a few political cases of "turned head" away from problems in domestic banks. Consistency in restructuring strategies

and political-economical goals is hence, highly required for any restructuring economies.

The current study aimed to fill the gap in the area of the effects of foreign entry in banking and the behaviour of various types of banks in the setting of TEs. By drawing attention to the presence of foreign banks and their effects on domestic banking, as well as looking at the areas of know-how transfer, organisation of markets and state and competition effects, it is hoped that the study broadens understanding of financial market liberalisation and the effects it can bring to the local economy. Derived from the findings of the research, the importance of state withdrawal from the state-owned banks is emphasised, together with sound bank supervision and regulation. The main benefits of foreign entry created the competitive environment, improvements in human resources and increasing stability of the banking sector. Although the pressure of foreign entry may seem to harm domestic banks in terms of decline in provision of credit in a number of economic sectors, it was more the political influence of the state rather than competition that caused problems for domestic banks.

8.4 Interview results

Qualitative research was conducted in order to account for the effects of foreign entry, which are not easily quantifiable, as well as to try to corroborate the results obtained by empirical analysis. Semi-structured in-depth interviews were aimed at managerial perceptions that were then analysed within the grounded theory framework. This type of research has been rarely used for the analysis of financial sectors and the effects of foreign entry. However, it proved to be extremely valuable since many results of the empirical study were explained and backed up by information that was not easily available.

In relation to Basic bank activities, the majority of the opinions expressed that foreign entry has not had a very significant impact on provision of loans and sourcing deposits in Slovakia. Basic bank activities were more hindered by the conditions of the economy and regulations, as well as by the damaging influence of the state exerting pressure on the provision of credit. Foreign banks were important for exerting competitive

pressures, introducing a higher quality of services and new products as well as market-based credit and risk management.

For both the areas of basic bank activities and technology and operation, it was recognised that there needs to be a substantial share of foreign capital so that any effects were recordable. Domestic banks were more hampered by the organisation of the market, regulation and especially by the past, as the problems of portfolios of bad loans were unsolved. Furthermore, large domestic banks fulfilled the political and social order of financing the transformation of the economy and privatisation, and were much influenced by the shareholder (state) that had its own political interests. Better credit risk assessment techniques enabled foreign banks to quickly detect the most profitable clients, but on the other hand one of the spillover effects was bringing a different corporate culture that also influenced domestic banks. Any know-how transfer could have happened more on an interpersonal level where trained professionals were crucial. The benefits of knowledge transfer were however mutual, as foreigners benefited from locally experienced specialists while domestic banks benefited from the Western trained professionals.

Foreign bank entry is perceived to improve both the quality and the volume of investments in human resources. While the local workforce had to learn everything from scratch, local learning capacities seemed to cope well. Foreign bank entry was said to support the creation of institutions, and also provide facilities and knowledge for training, but it was often felt as an underestimation of the local workforce and a misunderstanding of the local conditions. Combining a foreign workforce with local employees was suggested as the best way to disseminate the knowledge. An important argument was that in the case of state-owned banks, the long-term personal relationships and political connections had to be broken up by complete exchange of top managements.

The level of 'hardware' infrastructure was assessed as very high, even higher than in the West. State-of-the-art products were used when building the domestic banks' new internal infrastructure networks, which gave them advantage of 'leap-frogging' over stages of development previously followed by Western banks. This was especially true of electronic banking, which had high credit among foreign banks. A far different

situation is with the organisation of the market. The Central Bank was often criticised due to its late involvement in relation to some commercial bank failures. Foreign banks were appraised for bringing a different corporate culture into the market. Any influence on creation of legislation was more hypothetical. Foreign banks were further taking advantage of the existing (or non-existing) legislative framework. The benefits of foreign entry were recognised by bringing in certain codes of practice and corporate culture, and their presence was also a guarantee of a healthy bank market functioning and stability. However, foreigners benefited more from the market situation, knowing the conditions of the market they were entering well and using this to their own benefit.

State-led restructuring of the domestic banks' loan portfolios was non-market and a discriminating tool, but also the state influence in these banks was damaging, using them as pools of funds to finance either state bills or serve as financing institutions for the individual interests of political elites. In general, banks were often used as problem solvers for the economy, but the problems of banks were never solved. It is however, a double-edged sword, and state influence can also mean financing the large state projects. In relation to the legal framework, both groups of officials agree that current legislation fulfils the requirements of the market conditions, sometimes even overtaking the current conditions. Establishing a functioning institution is the key component during transformation of an economy. Currently existing institutions are recognised to be working effectively, although at the cost of previous failures.

Any competitive pressures created by foreign entry are expected only later as it is recognised that a certain level of foreign investment is needed in order for such pressures to be accountable. What is interesting is the notion that while some foreign banks managed to benefit substantially from entry into the Slovakian bank sector, some did not. Criticism of the International Monetary Fund's policies towards financing the small and medium enterprises programme was also pronounced. Foreign entry was perceived as largely positive, increasing the stability of the sector. Moreover, foreign banks have brought know-how, a certain level of competition, and have supported the integration of Slovakia into European business structures supporting the independence of domestic banking institutions. Foreign entry is seen as a supportive element of transformation, although the view was expressed that overall growth of the economy would not be very much different without foreign participation. Many stressed the

importance of the early restructuring of domestic banks. If there were any negative effects, foreign banks were recognised as employing the 'cherry-picking' strategies in client selection as well as human resources acquisitions. Foreign banks were also acknowledged as abusing the situation of domestic banks, and instead of pressing down the interest rates due to their potential, they maintained the levels and substituted domestic banks in financing the state at a later stage. Foreign banks however financed the healthier part of the economy investing in development loans and in the view of some interviewees actually created the transformation. On the contrary, some officials who were interviewed suggest that rather than foreign entry, restructuring of the state banks, new risk management techniques and removal of political influence from the largest state-owned banks have effected the change.

8.5 Empirical results

The empirical study was aimed at the Basic Bank Activities that are empirically measurable and testable by statistical methods. First of all, non-parametric analysis showed that there are significant differences in selected indicators as well as in the structure of deposit and loan portfolios of the four groups of banks. This result itself suggests that there are differences in banking strategy and behaviour as well as potential differences in bank management know-how and its application.

Further descriptive analysis revealed that the foreign banks were more profitable and efficient, operating with higher quality (i.e. less risky) loan portfolios, and provided a stable supply of credit into the economy. It also showed that the growth of deposits was much stronger than the growth of loans, suggesting that all banks focused on sourcing funds rather than active banking business in terms of credit provision. In addition, employees' productivity seems to be higher at foreign banks and branches, although this is suggested by a high ratio of earning assets per employee.

In terms of behaviour, this was best reflected by the changes in the structure of earning assets. Foreign banks and branches retreated from offering loans to the economy bringing the share of loans on the earning assets down substantially. Instead, foreign banks focused on securities (in the Slovakian case the focus was on government bonds

and T-bills) while foreign branches together with the foreign banks dominated the inter-bank market supplying liquidity to domestic banks.

The distribution of deposit portfolios was affected by foreign entry as observable in Appendix A. Foreign banks gradually increased their share in the majority of economic sectors leaving domestic banks to dominate less attractive sectors such as forestry, small enterprises that were largely undeveloped, the public sector, and citizens where foreign banks could hardly compete with the dominance of the large branch networks of the two largest domestic state-owned banks. Foreign banks on the other hand focused on areas where they clearly had comparative advantage, such as deposits of non-residents, and where the cash turnover was high.

The distribution of loan portfolios copied the development of the deposit portfolios, although domestic banks kept a high share of funding of many sectors quite late. Foreign banks focused on industrial production, thus completely neglecting citizens and hardly penetrating the utilities owned in the majority by the state and privatised at a later stage. The public sector shows rapid growth credit provided by the domestic banks suggesting the involvement of the state in direct credit from domestic banks. The development in deposit portfolio, and especially in loan portfolios distribution, was to a great extent affected by the decision of the government to restructure domestic banks' loan portfolios, and to improve their capital ratios by transferring a large portion of non-performing loans to a special institution, coupled with an injection into the banks' capital with a view to privatising the banks.

8.6 Limitations of the study

Awareness of different approaches, optional methods and alternative conclusions is immensely important within any research. This study is no different, although a combination of approaches and methods was used in an attempt to corroborate the results.

Firstly, the qualitative research approach of undertaking in-depth semi-structured interviews was adopted in order to attempt to corroborate the results of empirical analysis, as well as to extend the understanding of the effects of foreign entry and other factors influencing domestic and foreign bank behaviour. Although initially 42

interviewees were approached, after careful selection only 18 of them agreed to give an interview. A small number of interviews may have limited reliability of the information received. In order to attempt to assure the maximum generalisability of the study, an interview guide with 18 questions structured around six research areas was used. Moreover, use of notes rather than recording the interviews may prove to be a limiting factor, although due care was given to the immediate transcription of the notes into full interview notes. On the other hand, the use of notes in many cases ensured that interviewees freely expressed their opinions and experiences without fear of being cited in this study or in the press. Note-taking thus actually enabled much richer data to be obtained.

Secondly, the empirical analysis of quantitative data retrieved from secondary sources was conducted. The best option would certainly be retrieving the data from primary sources; however this is conditioned by their availability. It is highly unlikely that the majority of single institutions would offer a researcher access to their confidential data. The type of data and indicators available further limited empirical research. It can be argued that detailed information about costs and/or interest rate spreads of each group of banks would shed even more light on their efficiency and behaviour characteristics. This would also enable corroboration of results from other developing economies such as Argentina (Clarke et al. 1999) or Mexico (Dages et al., 2000). The size of the population for each type of researched indicator in this case limited the use of statistical methods. Such limitation was multiplied by a relatively short time period of available data, conditioned by the emergence of the independent Slovak banking sector. Analytical tools of statistical analysis were carefully chosen with the above-mentioned limitation considered. Furthermore, regarding the fact that the difference of domestic and foreign banks was somehow automatically ascertained without firstly considering whether such a difference really exists (on the basis of statistical methods), the only case known to the researcher is the work of Sabi (1996) which supported the chosen method of analysis. As it is not known whether other analytical work on differences between domestic and foreign banks or on the effects of foreign entry on domestic banks in Slovakia has been commissioned before (apart from internal and confidential analysis of the NBS, that however had not had the same focus as the thesis presented here), it was perceived as the better option to start from the bottom up, and use the basic statistical methods which can later develop into more sophisticated ones, once the

differences are established and initial conclusions are drawn. Thus, further use of more advanced statistical methods for the analysis of the effects of foreign entry can provide more understanding of the phenomenon and enhance or develop the current research work.

Thirdly, since one researcher conducted the whole research, the potential bias in data interpretation may have arisen. The risk of the bias nevertheless reduced the use of multiple sources of information (for example press information, corporate information, corroboration of results with existing research, etc.), and frequent discussions about the identified themes and results with colleagues. The employment of only one researcher also had advantages with respect to sensitivity of the topic under investigation and easier access to the data.

Fourthly, the focus of the study was restricted only to Slovakia. Conducting similar research in other countries would greatly enhance the validity and reliability of the results obtained.

Fifthly, various types of banks were approached in the study ranging from universal banks focused on the retail savings sector to the investment banks. This was a concession made in order to maximise the number of interviews within such a small banking sector.

Finally, the language of the interviews could be considered a limitation of this study, especially in the case of interviews conducted in the Slovak language. However, due attention was also paid to this fact, and firstly notes and later transcripts of the interviews were recorded in the language spoken. Only during analysis of the ethnographic data was translation used in order to minimise loss of any important information due to translation inaccuracies.

8.7 Policy implications

The results of the research supported the view of Buch (2000) and Bonin and Wachtel (1996), that governance of the banks must be independent of the state to prevent political pressures. Such pressures may prove harmful for domestic banks in case pressure is exerted to provide funding for particular firms or states.

In the event that governments of transition or development countries are interested in increasing the involvement of banks in financing the domestic economy, it may be suggested that apart from the restructuring of domestic banks and removing the influence of state or politics, provision of incentives for foreign banks' involvement (in particular sectors of public funding) could help to create a healthy competition for credit to the public sector, from which the economy would benefit.

The importance of sound institutions and transparent laws and supervision also proved to be very important for banking sectors in transition. As such both regulation and supervision infrastructure, functioning and effective tools to demand compliance with regulations in order to protect against bank failures are necessary.

For this type of research, the combination of a quantitative and qualitative research approach proved to be highly efficient as it revealed important information about domestic and foreign bank behaviour and their compliance with rules and regulations. It also provided insight into the particular settings of a country. Moreover, the findings of such research can be used for drafting country-specific policies preventing the use of a single policy type supposedly suitable for any setting. The International Monetary Fund was often criticised for this approach (Stiglitz, 2002) and current findings also revealed the use of such a policy in Slovakia.

Rather substantial is the aspiration of the Slovak Republic to join the Euro-zone. One important issue is that Slovak commercial banks already lost protective effect of measures imposed to protect newly emerging banking sector. Hence Slovak banks now face even tougher cross-border competition. So far its position was rather disadvantageous being in EU but operating yet beyond Euro zone thus still facing foreign exchange risk. However, all Slovak banks that intend to compete on European market need to prepare in advance their European strategy, especially on behalf of their clients. Further adjustments in information systems, training of human resources, new services, and conversion in product portfolios as well as in legal framework will be necessary.

8.8 Suggestions for further research

Several issues have arisen from the current research that deserve further attention. Firstly, the current study adopted the internalisation theory approach to foreign investments in banking. Building on the works of neoclassical economists this research focused more on the microeconomic effects of foreign entry in banking; some overlap with the macro economy has been attempted via the analysis of credit provision and the effects of deposit collection, as well as the external infrastructure and organisation of bank markets in the case of the Slovak economy. An alternative view of the role of foreign investments in banking sectors following the Hymer-Kindelberger tradition (that is continued in Eclectic theory of foreign investments) could be adopted. The effects of foreign entry thus could be studied with more focus on the business cycle, and the role of costs of operating in a foreign environment.

Secondly, it is believed that more detailed information about costs and/or interest rate spreads of each group of banks would shed even more light on their efficiency and behaviour characteristics.

Thirdly, the size of population for each type of researched indicator in this case limited the use of statistical methods. Such a limitation was multiplied by a relatively short time period. It would be valuable to repeat the research after some time gaining a larger time data set.

Fourthly, further use of more advanced statistical methods for the analysis of the effects of foreign entry can provide more understanding of the phenomenon and enhance or develop the current research work.

Fifthly, conducting more interviews (for example with all the banks on the market) would bring more understanding to changes in their behaviour based on a larger account of perceptions.

And finally, further research could encompass the use of methods described in this thesis in the settings of different transitional or developing countries and thus enable comparison of the effects of foreign entry in other countries.

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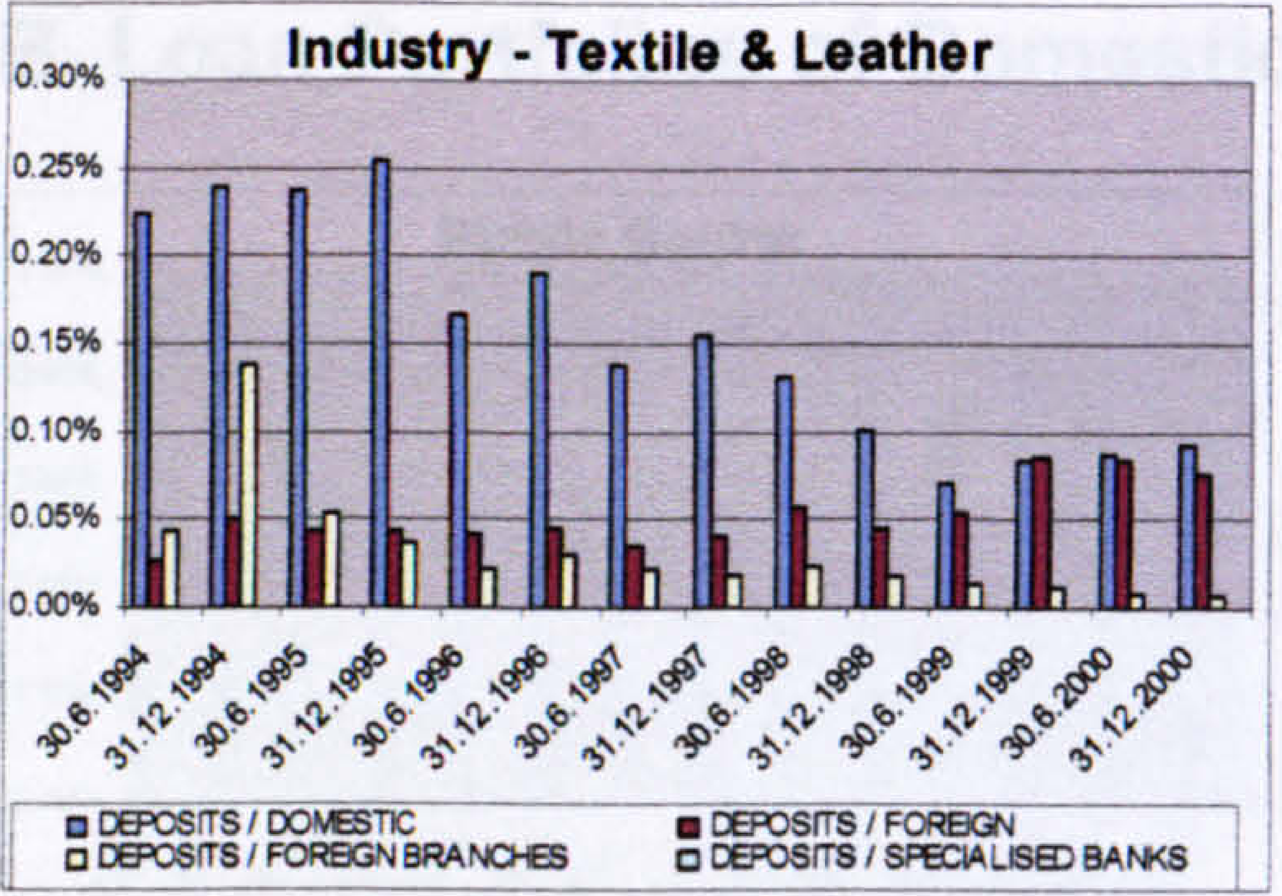
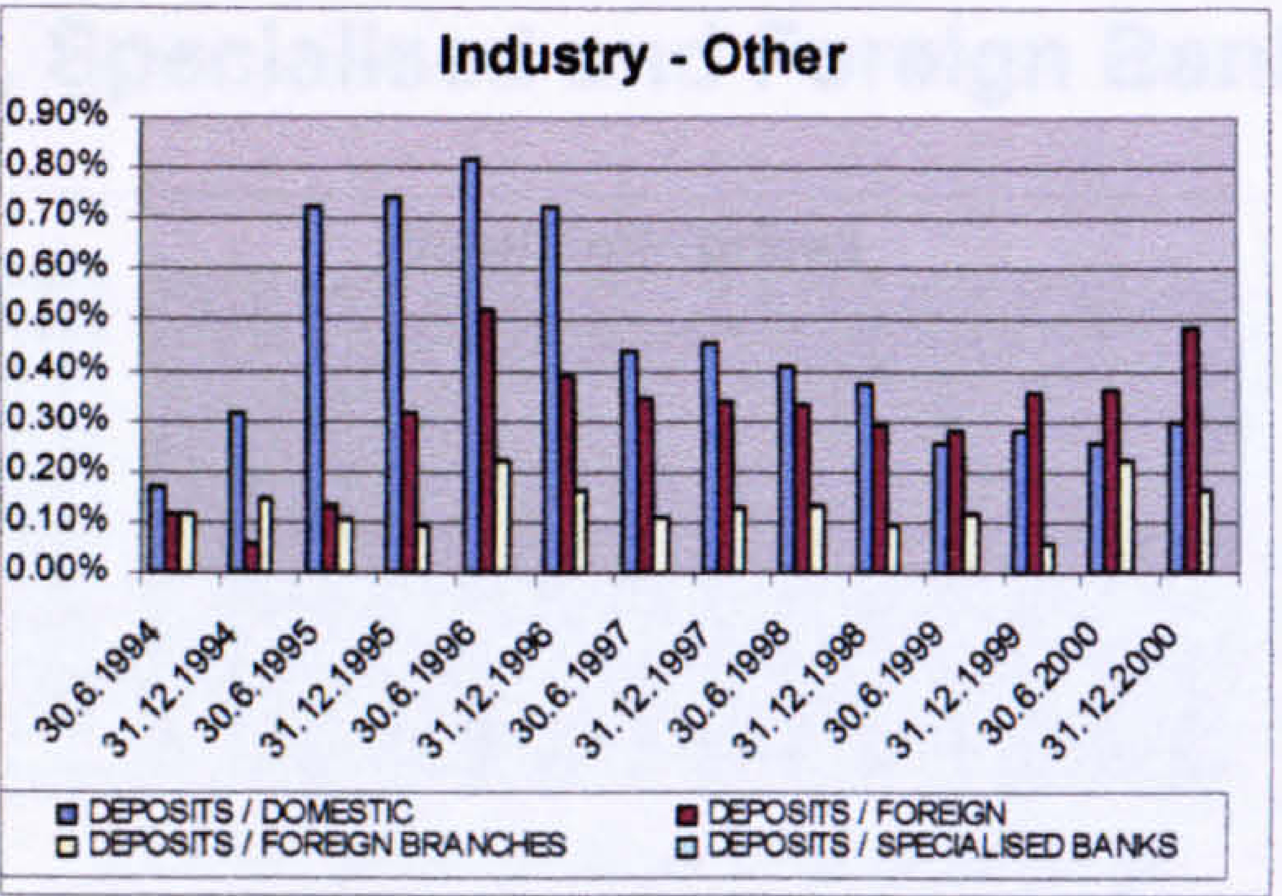
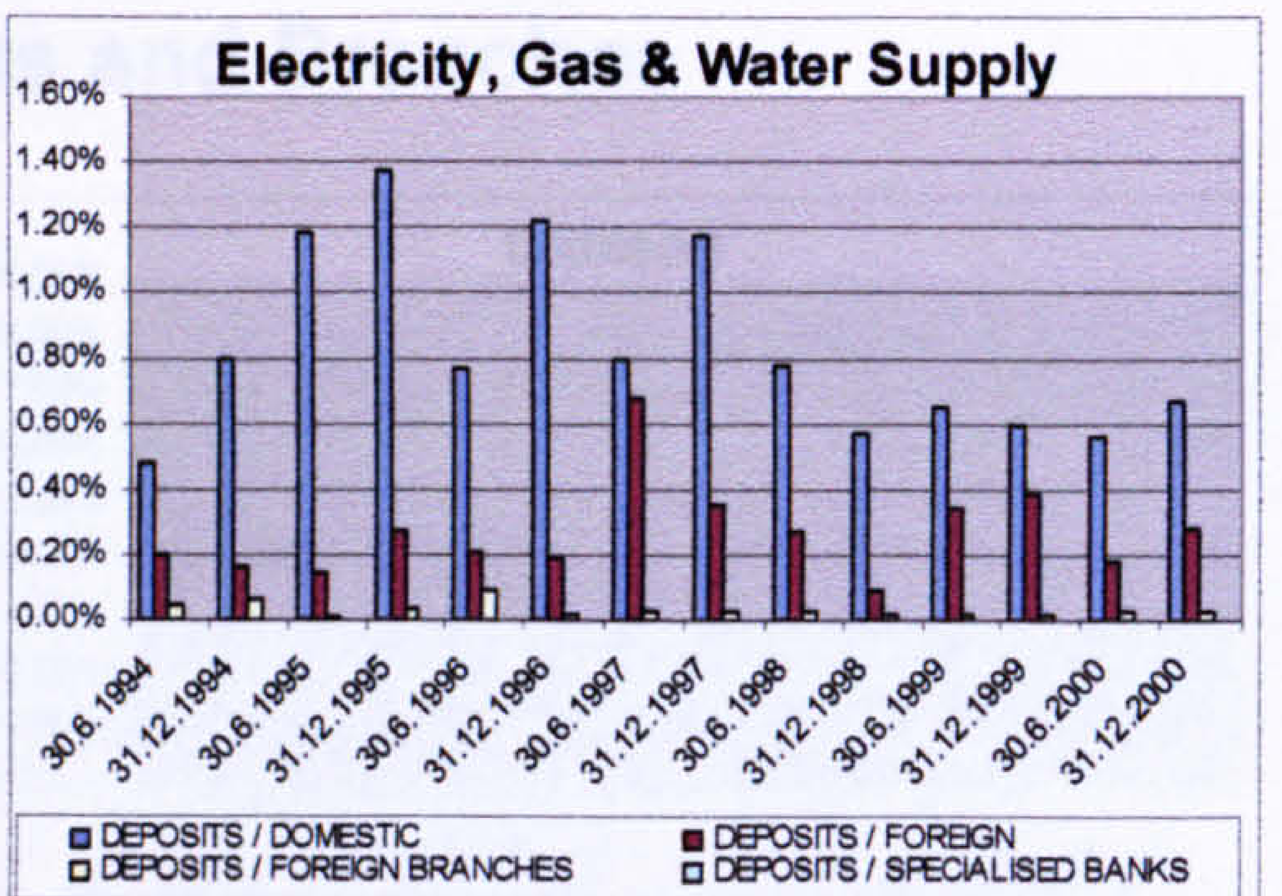
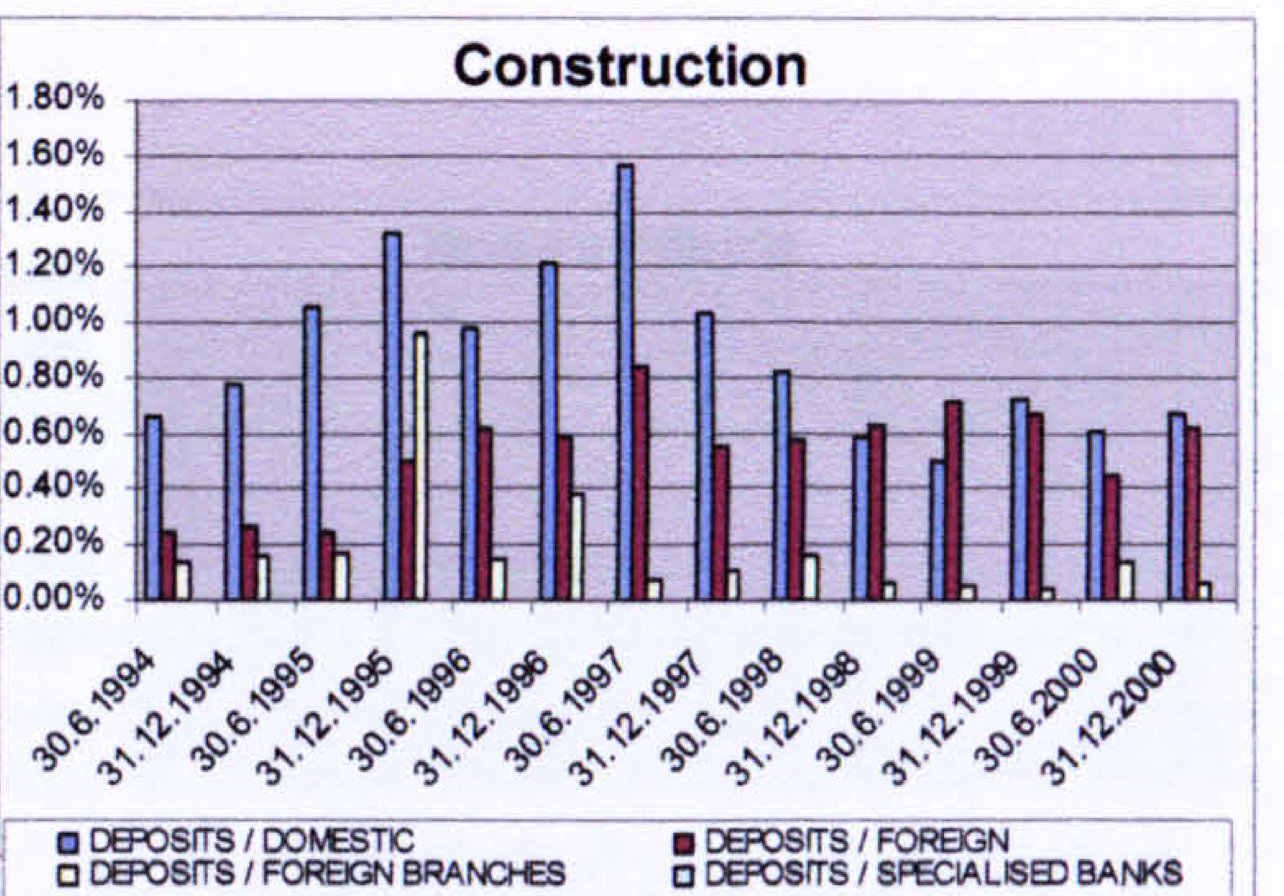
APPENDIX

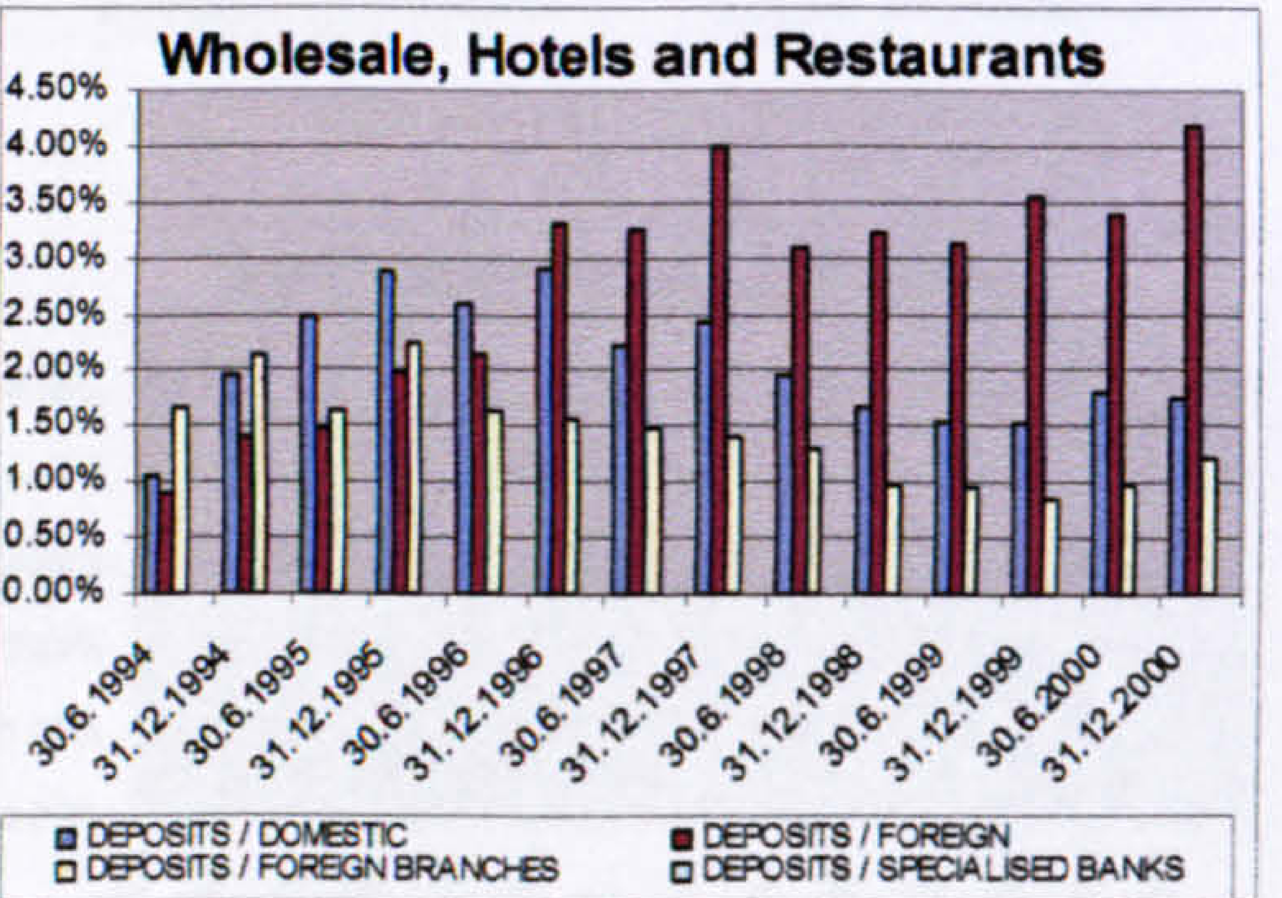
A. Deposit Portfolios of Domestic, Specialised and Foreign Banks and Branches

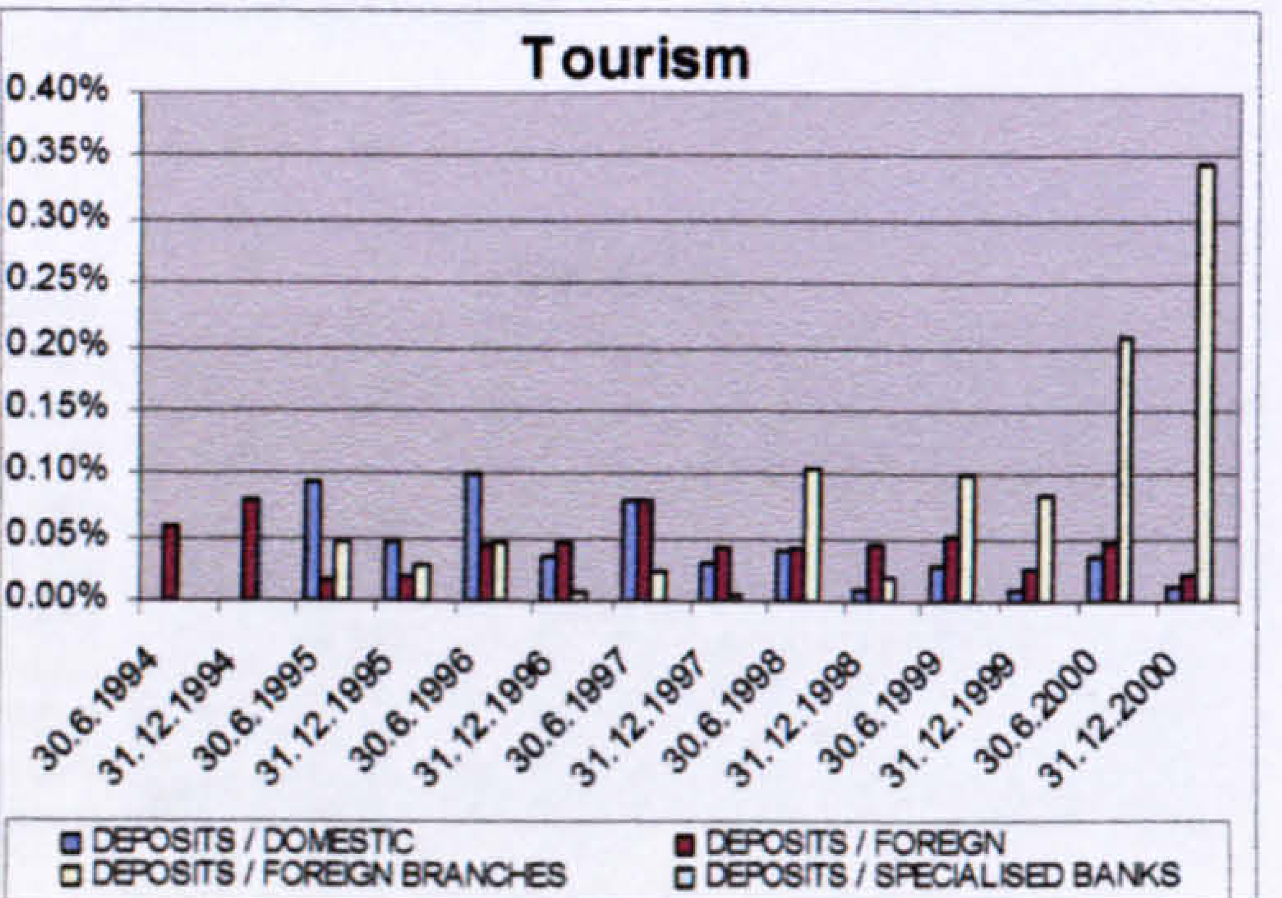

Industry - Textile & Leather
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS

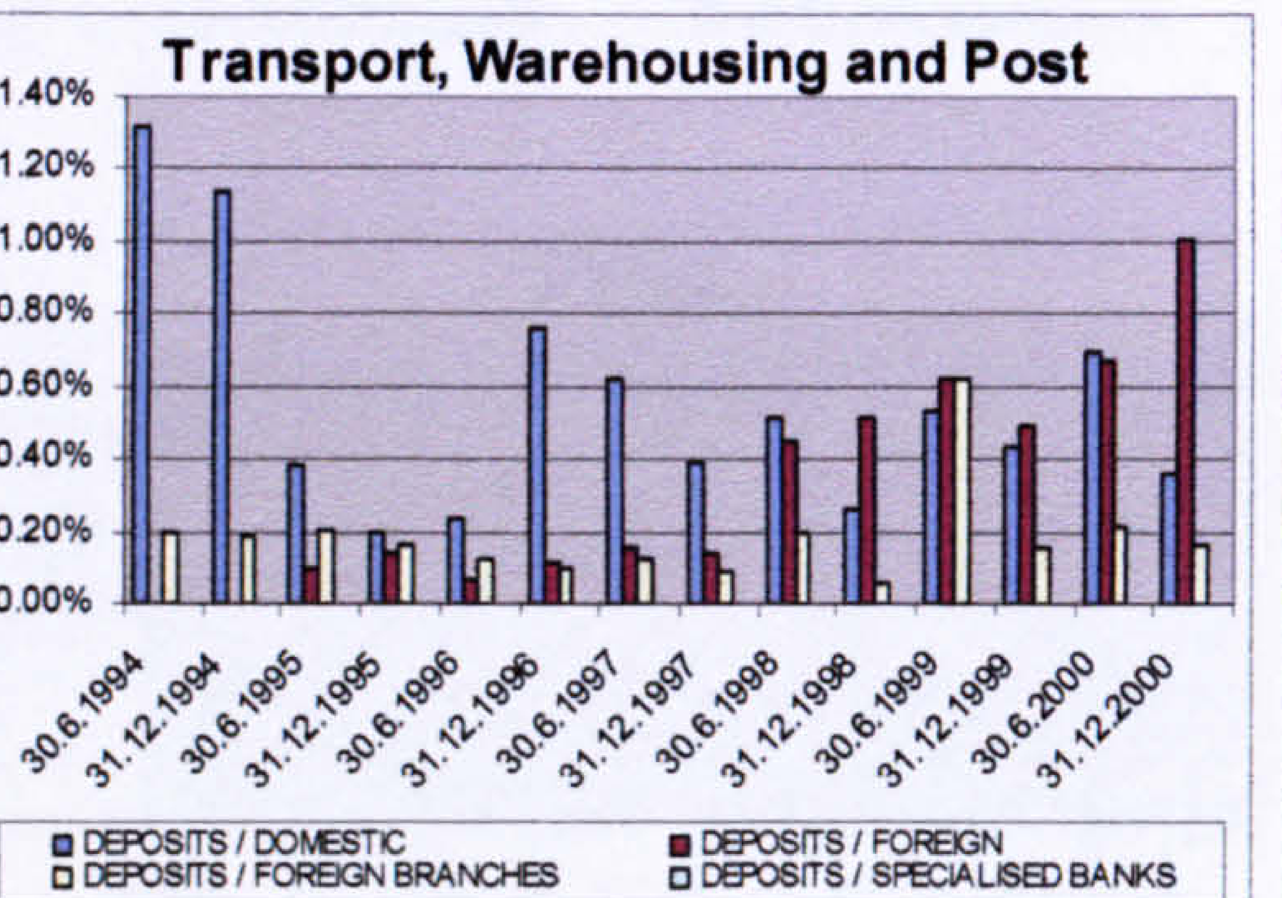

Industry - Other
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS

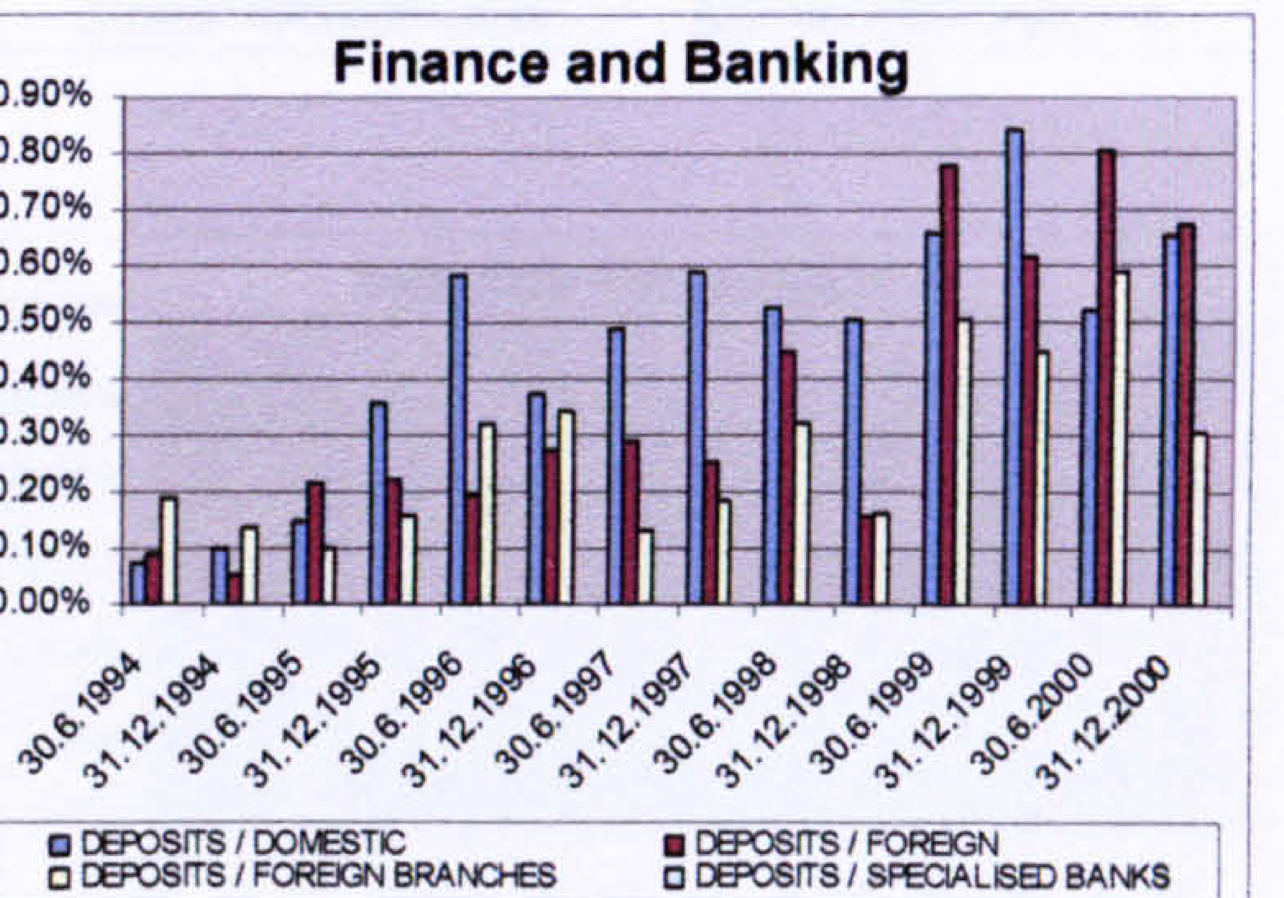

Electricity, Gas & Water Supply
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS

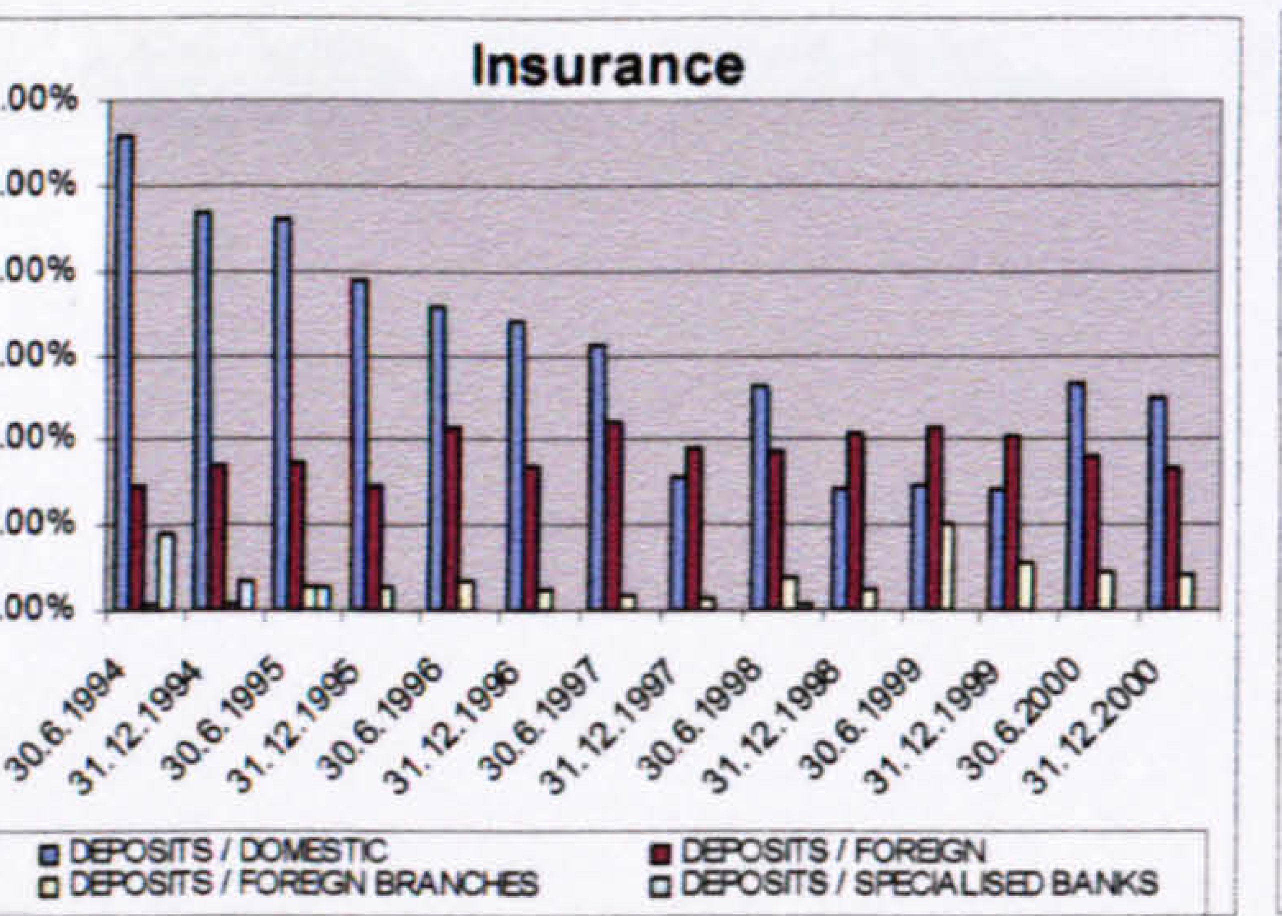

Construction
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS

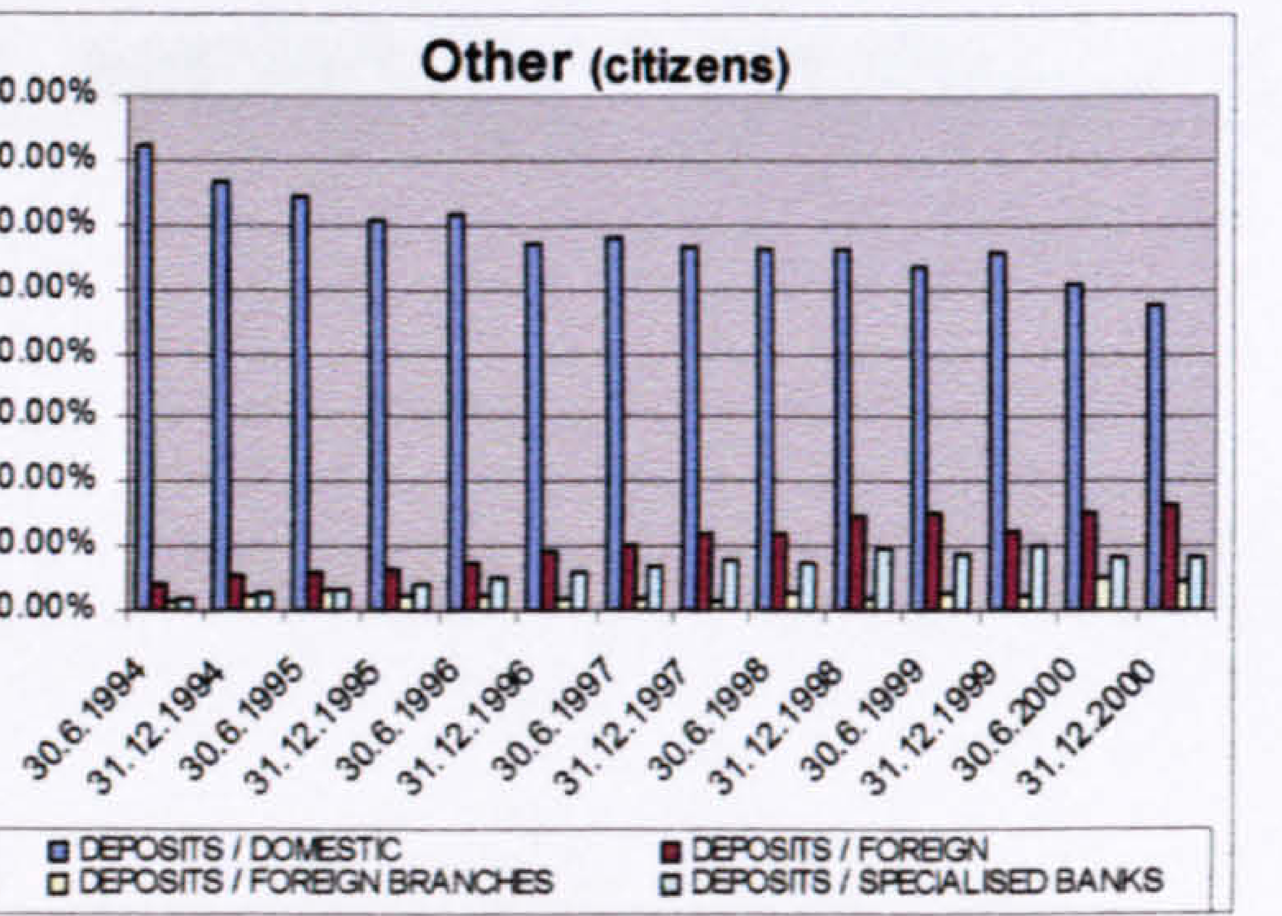

Wholesale, Hotels and Restaurants
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS


Tourism
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS


Transport, Warehousing and Post
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS


Finance and Banking
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS


Insurance
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS


Other (citizens)
DEPOSITS / DOMESTIC
DEPOSITS / FOREIGN
DEPOSITS / FOREIGN BRANCHES
DEPOSITS / SPECIALISED BANKS

B. Loan Portfolios of Domestic, Specialised and Foreign Banks and Branches

Public Sector

Small Enterprises

Citizens

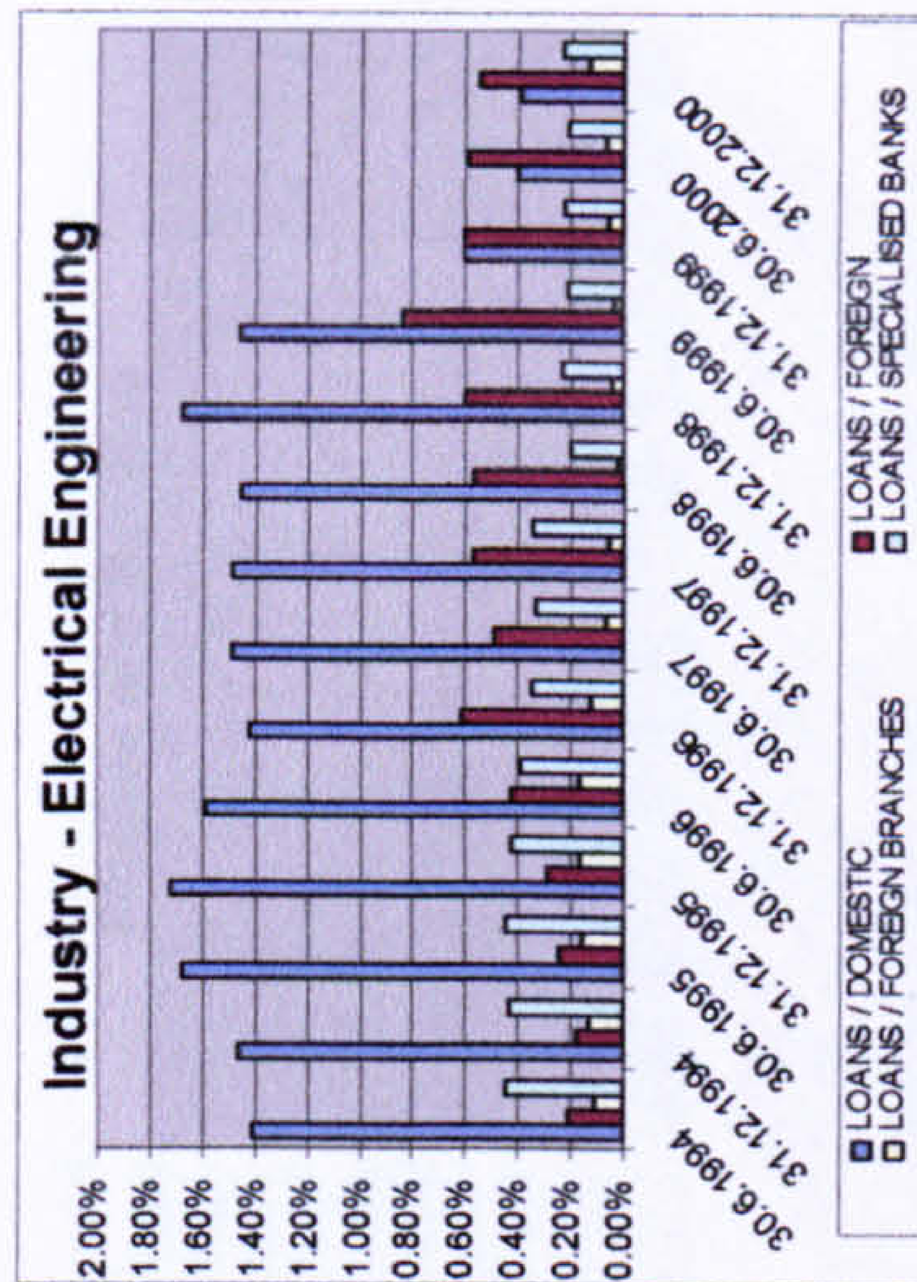
Non-residents

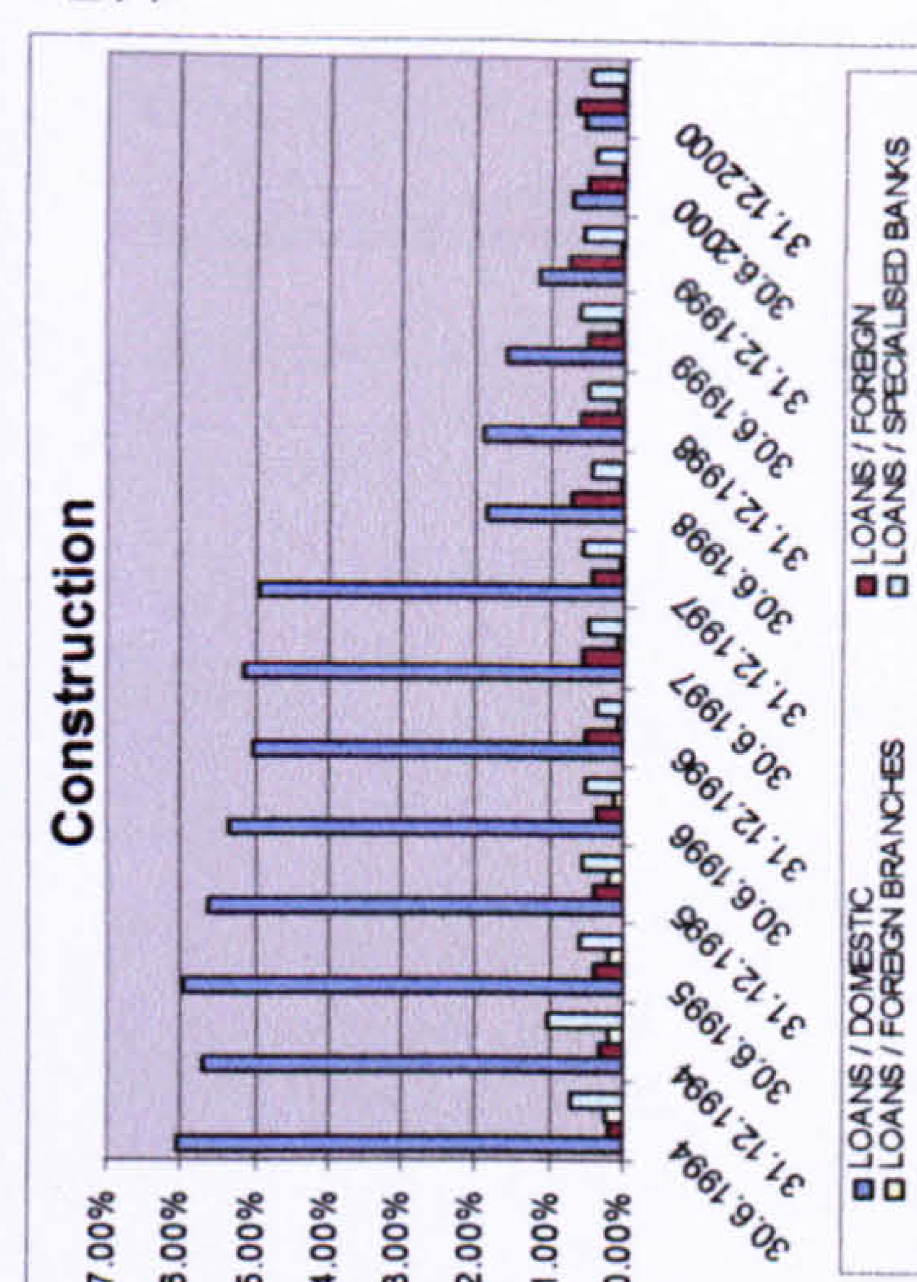
Agriculture, Huntin & Fishing

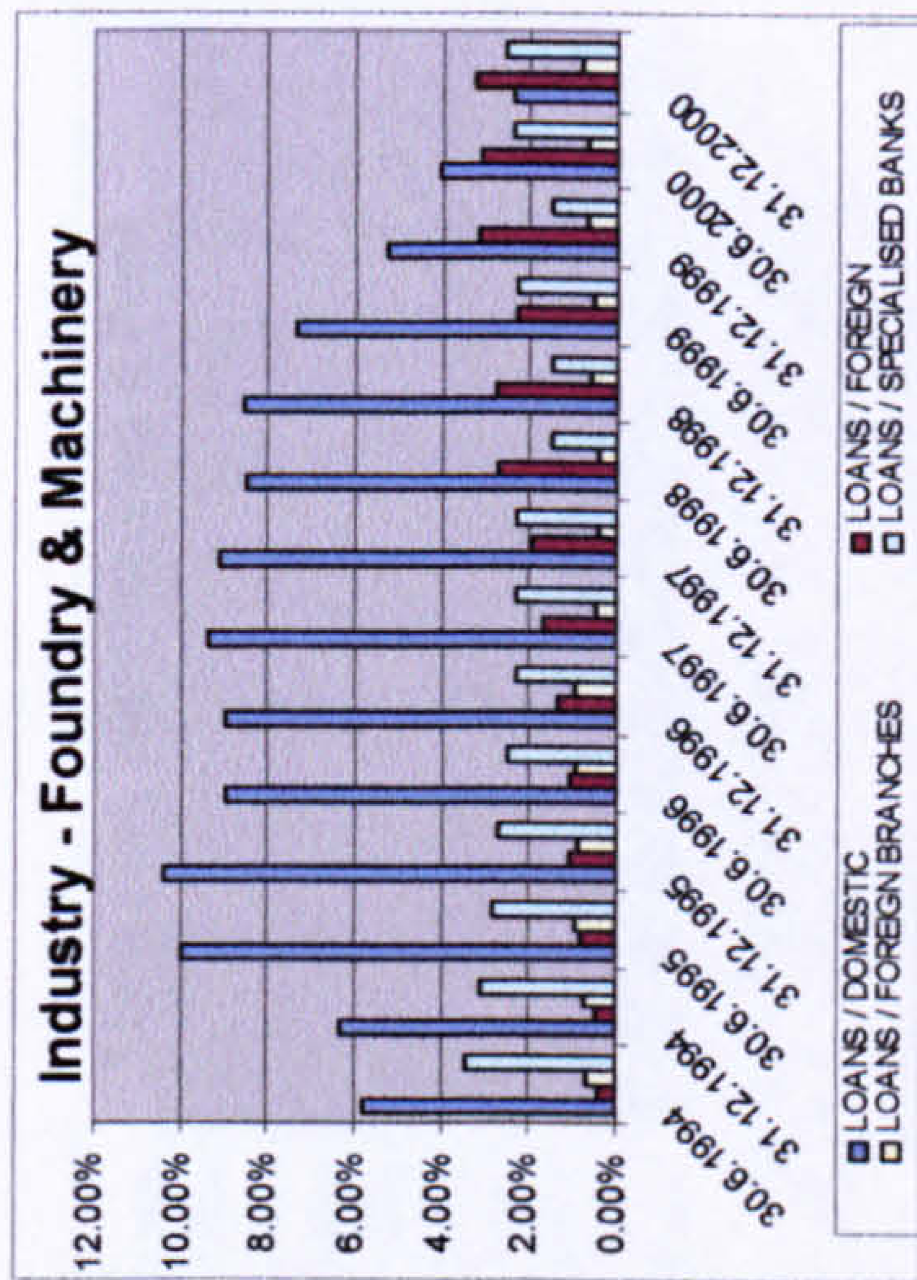
Forestry

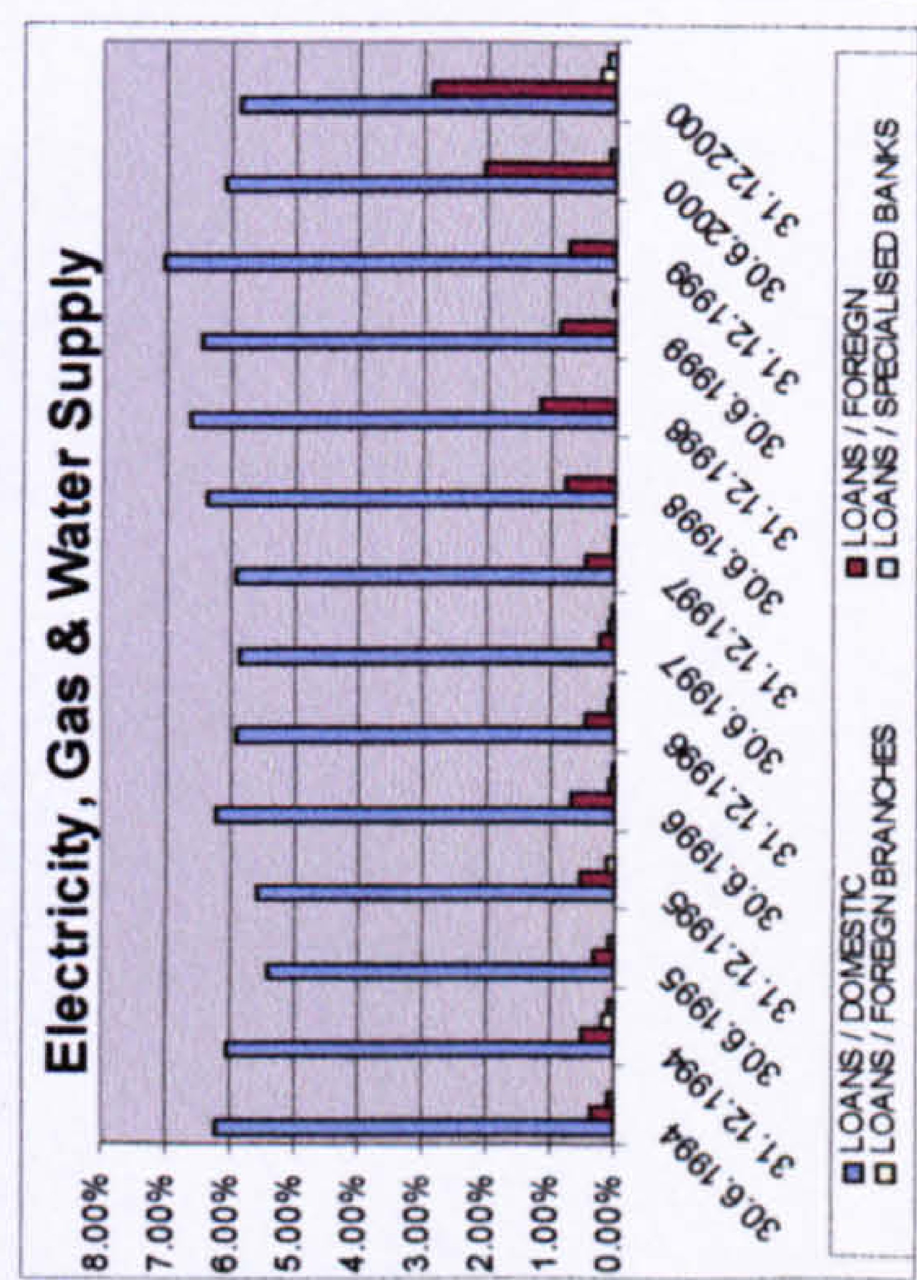
Mining

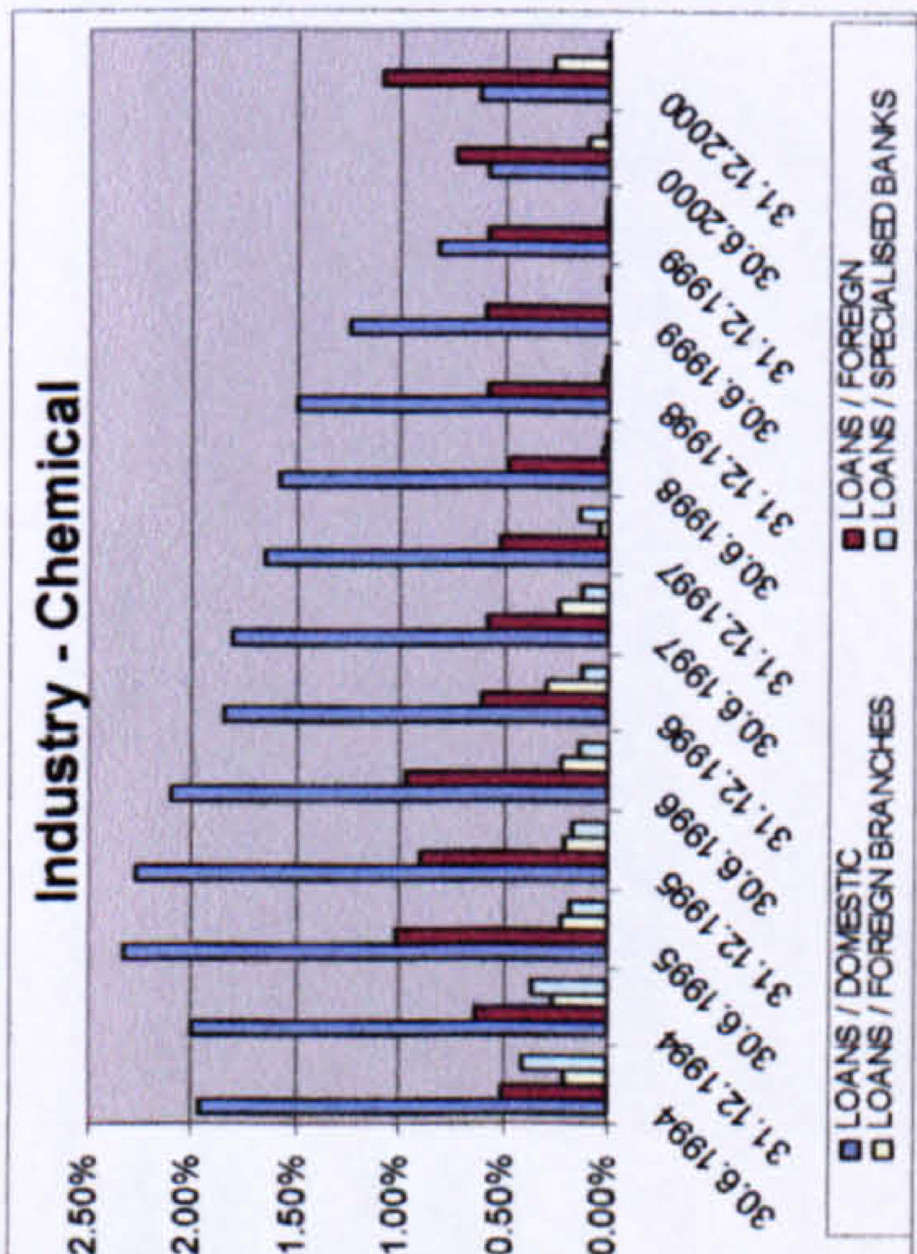
Industry Production

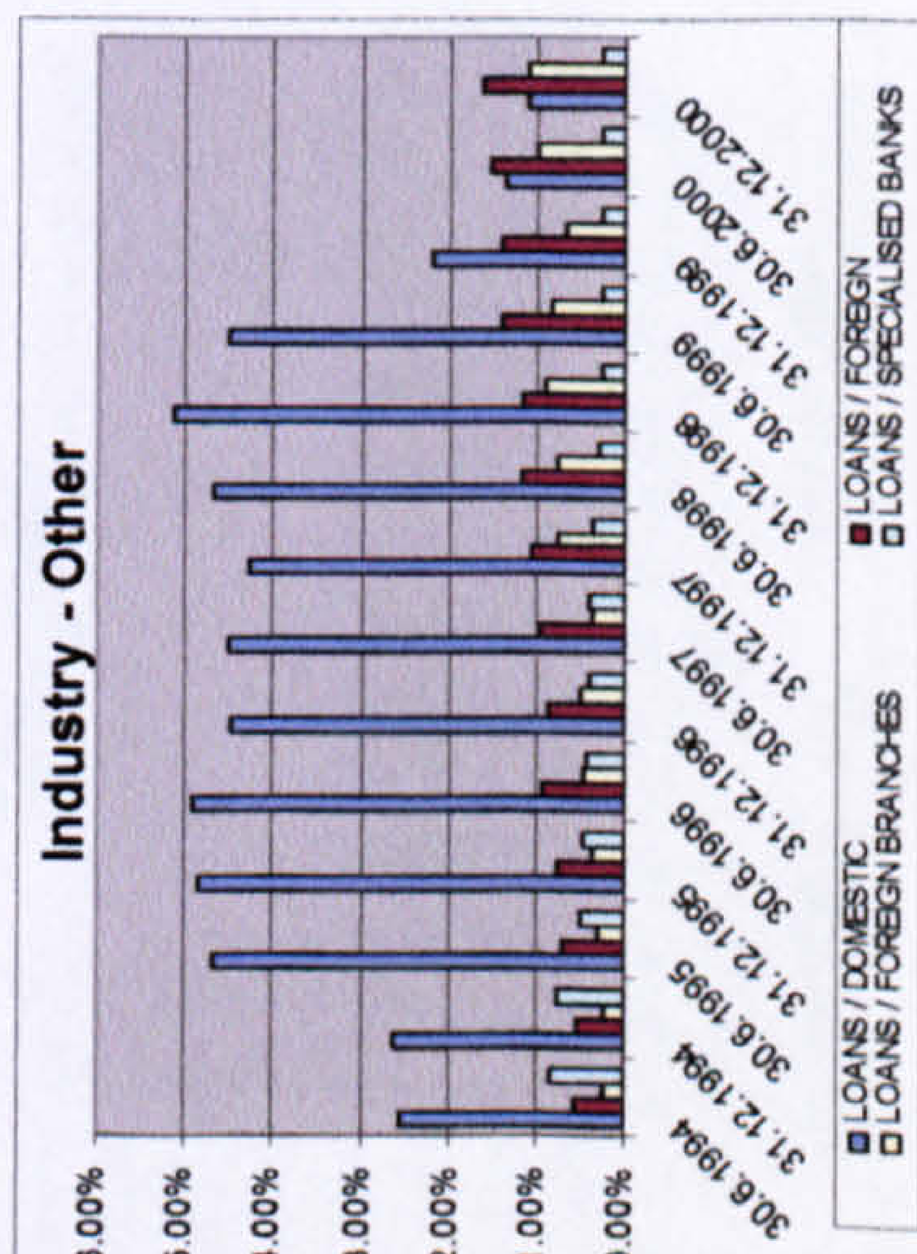

Industry - Electrical Engineering
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

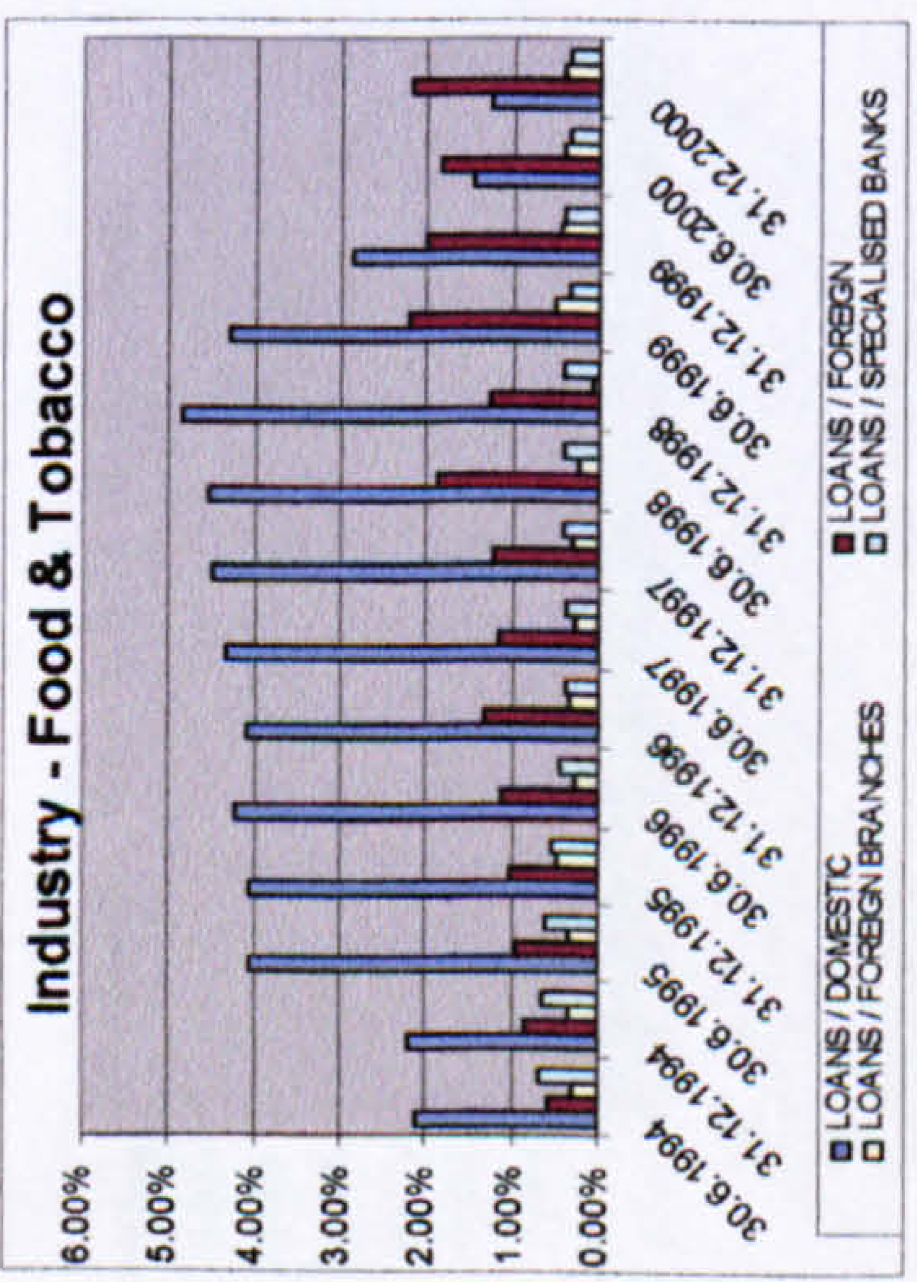

Construction
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

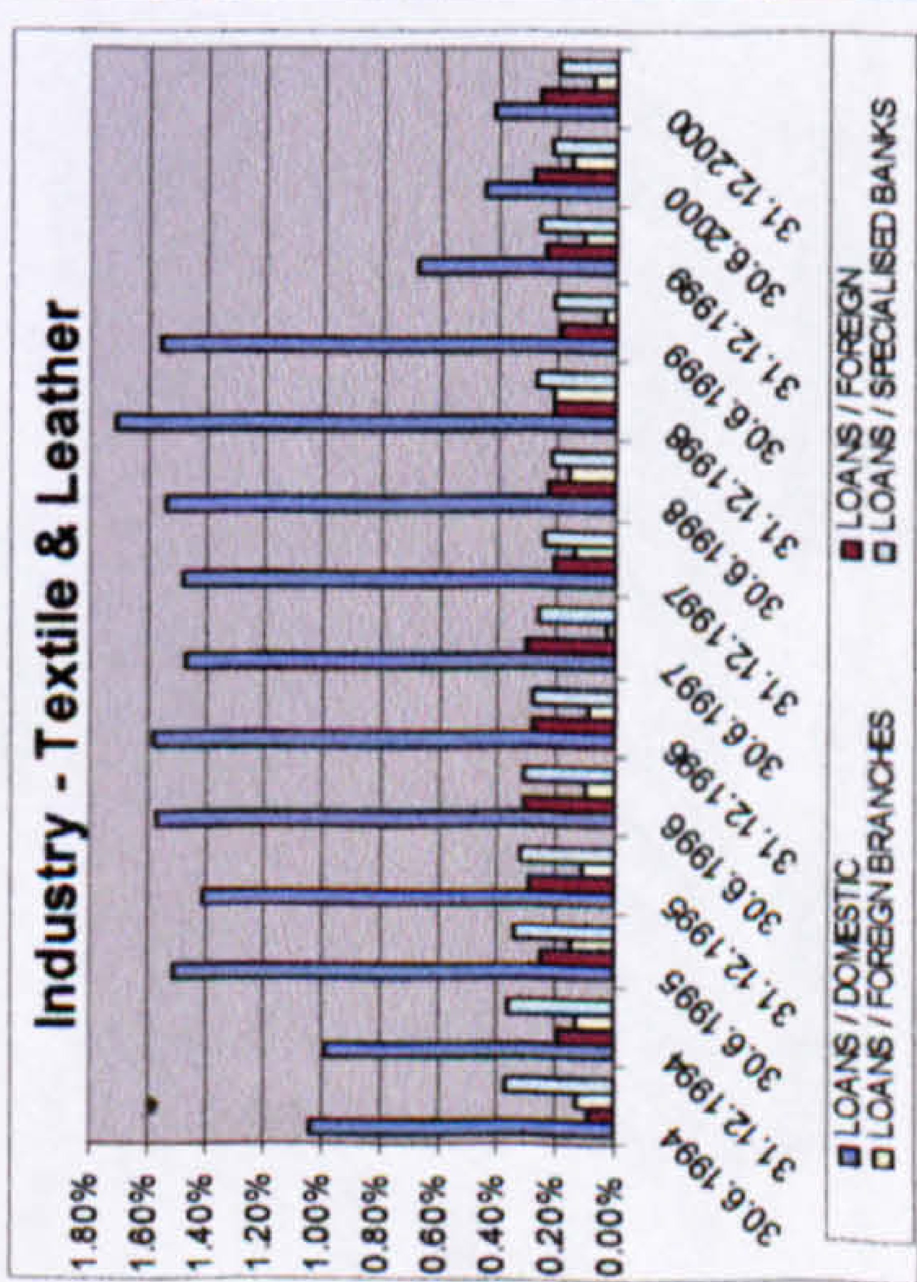

Industry - Foundry & Machinery
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

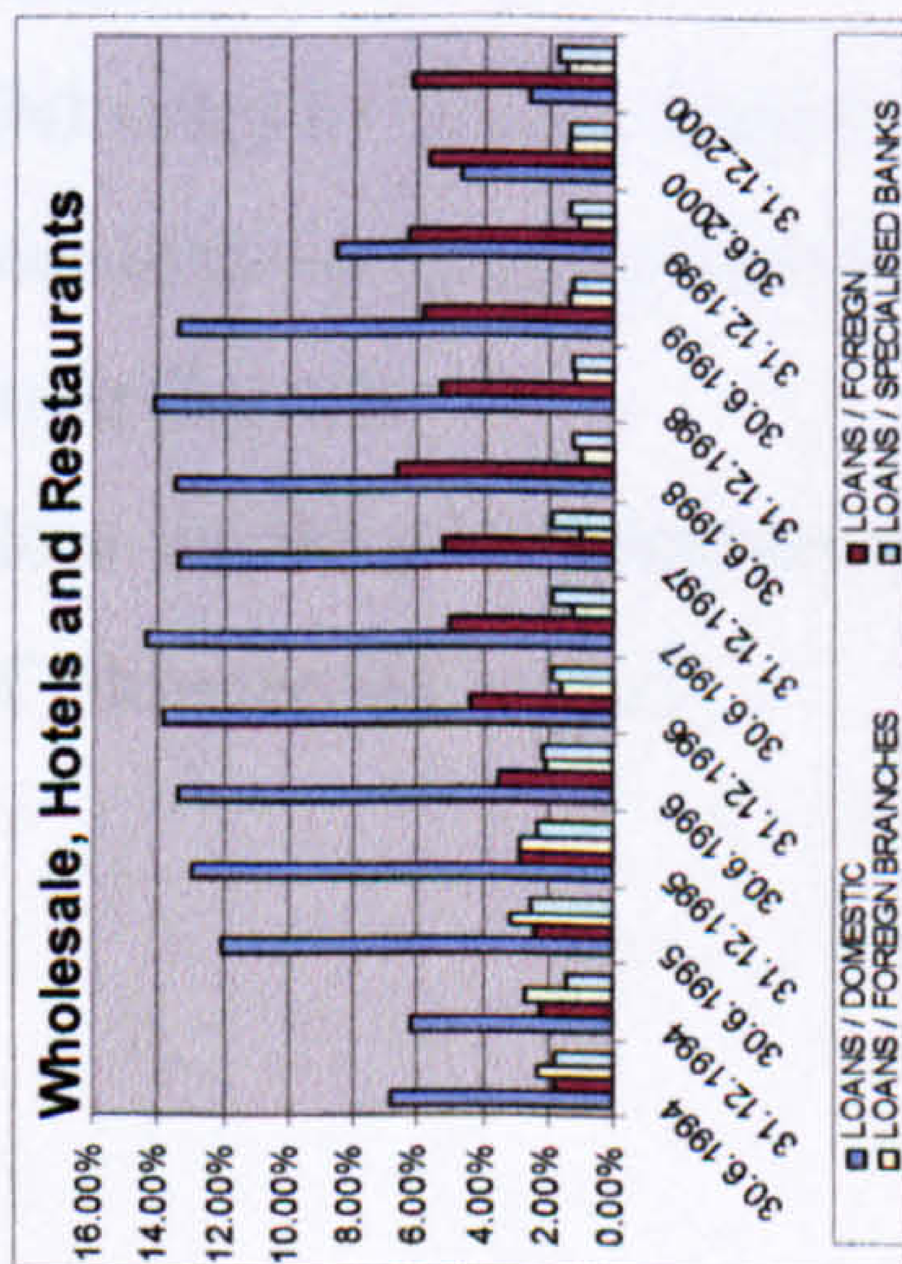

Electricity, Gas & Water Supply
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

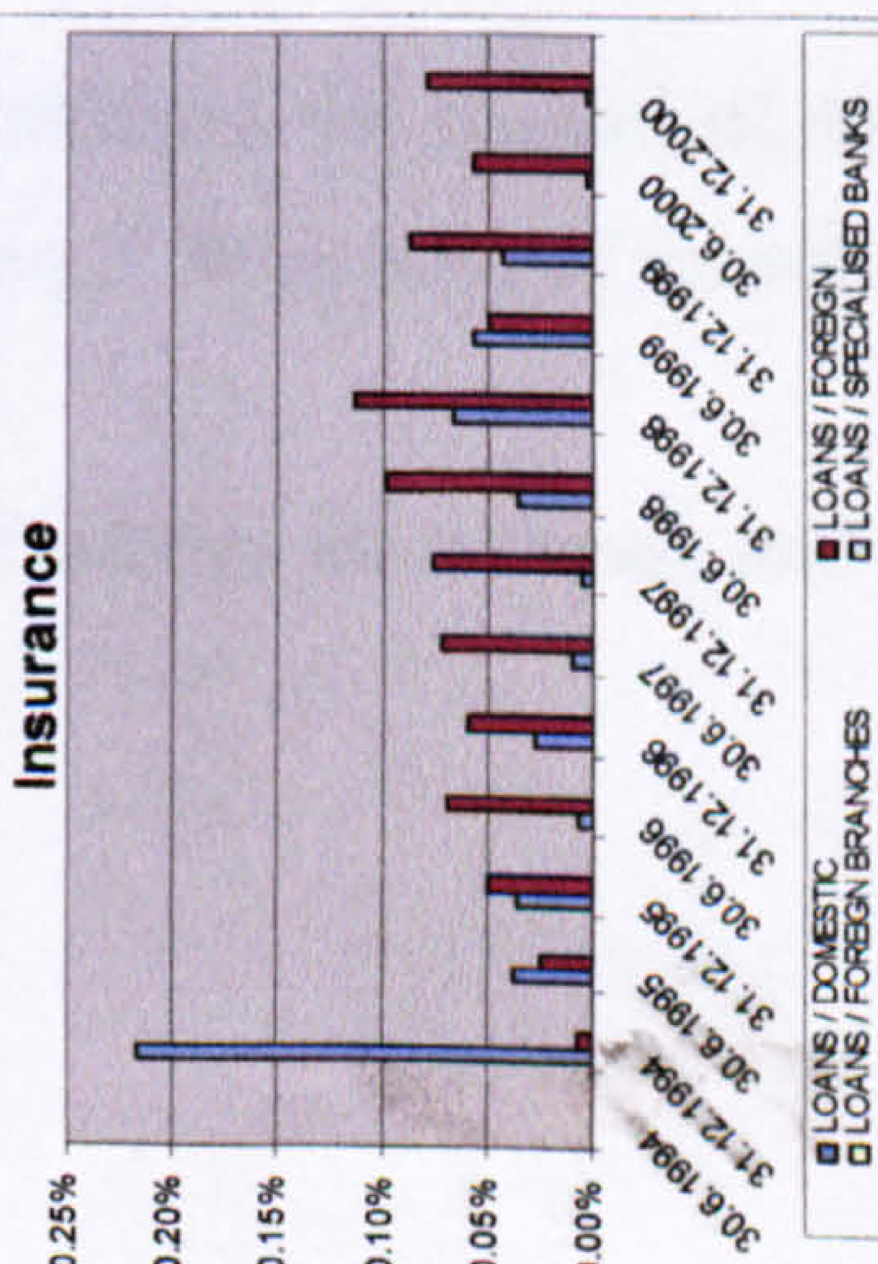

Industry - Chemical
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

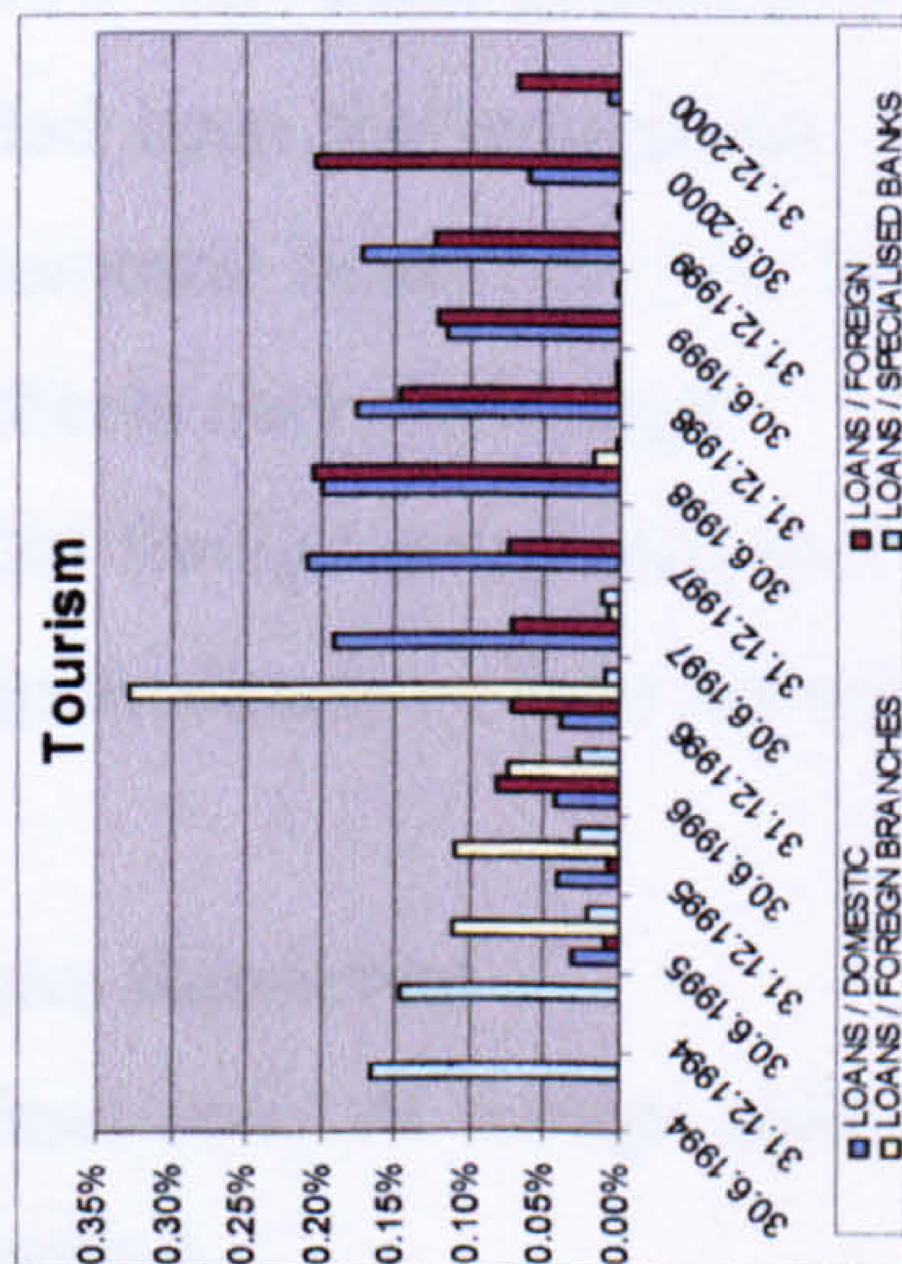

Industry - Other
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

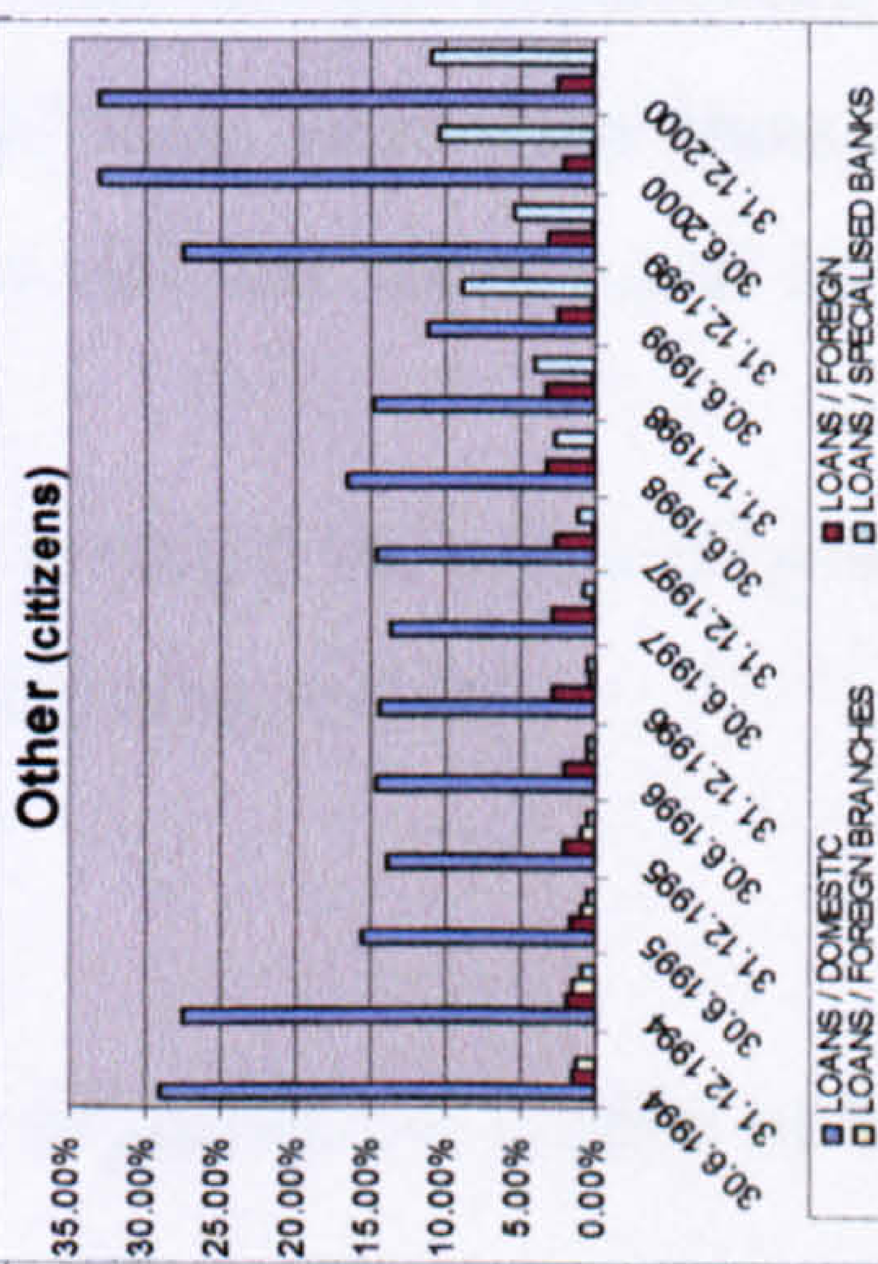

Industry - Food & Tobacco
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

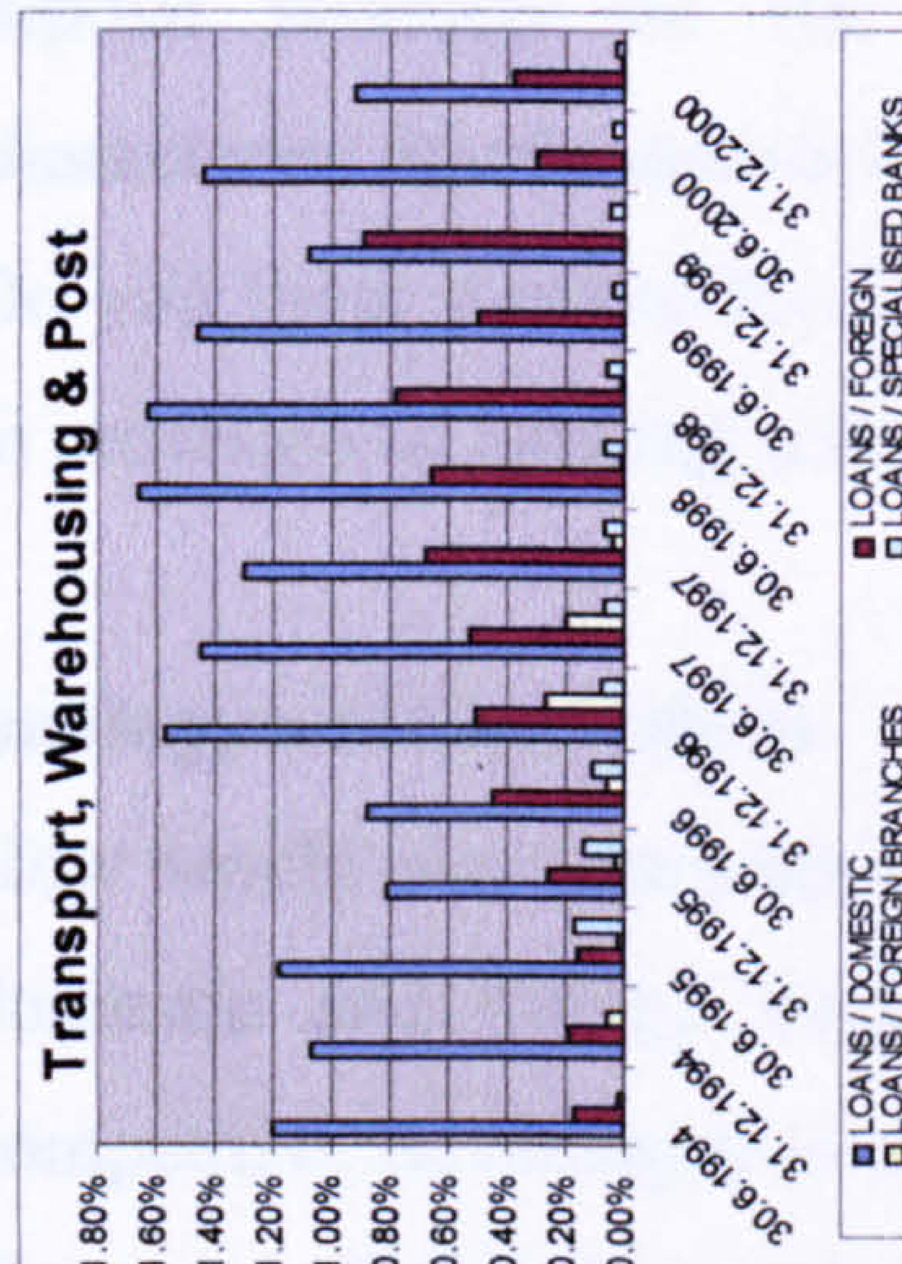

Industry - Textile & Leather
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS

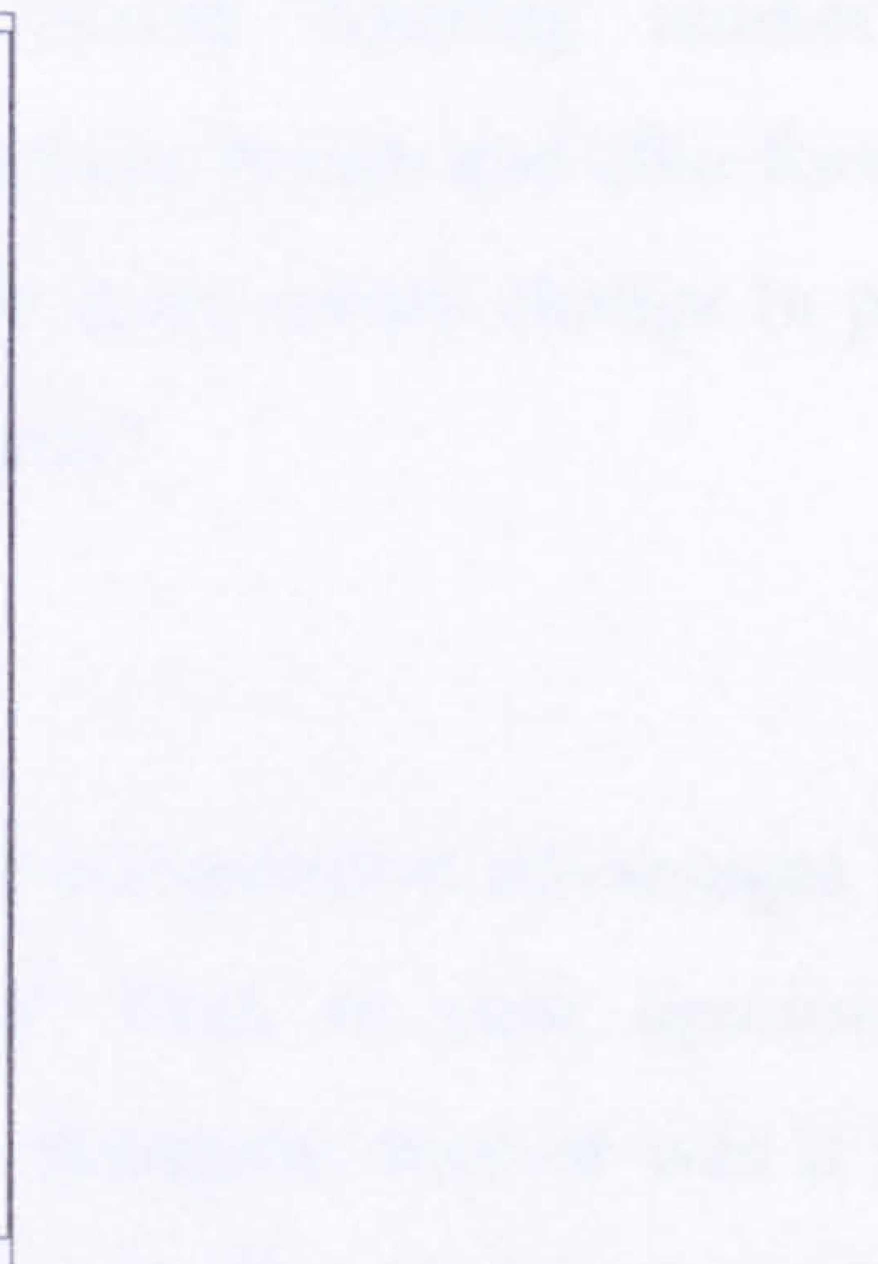

Wholesale, Hotels and Restaurants
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS


Insurance
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS


Tourism
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS


Other (citizens)
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS


Transport, Warehousing & Post
LOANS / DOMESTIC
LOANS / FOREIGN
LOANS / FOREIGN BRANCHES
LOANS / SPECIALISED BANKS



APPENDIX C. - INTERVIEW QUESTIONS

Commercial Banks' Officials

- **Basic Bank Activities**
  1. How do you think did the foreign entry affect availability of loans and deposit products on the Slovak banking market? How would you characterise developments in these before and after foreign entry?
  2. Do you think that the foreign entry meant change (a positive or a negative) in provision of banking services?

- **Technology and Operations**
  1. How would you characterise competition advantages (or disadvantages) of domestic and foreign banks? Had, in your opinion, foreign banks any competitive advantages over domestic ones or was it the other way round? How were these advantages/disadvantages experienced?
  2. Had been the managerial and bank know-how transferred from foreign to domestic banks? If yes, how did this happen and are positive or negative effects overwhelming?
  3. Did foreign entry influence strategic decisions of your bank? If yes, when (immediately or later on) and to what extent?

- **Human Resources**
  1. Does entry of foreign banks influence the quality of human resource in the sector?
  2. Did entry of foreign banks influence the amount of investments into human resources (training, courses, etc)? What kind of investments do you regard as more important?
  3. How would you characterise quality of domestic and foreign top-managers of commercial banks?

- **Infrastructure**

  1. How would you characterise the status and development of financial markets infrastructure (by infrastructure we mean organisation of the market, institutions, legislation, as well as technical and informational infrastructure and regulation and control)? What do you regard as weak and strong sides of the infrastructure?
  2. Do you think that foreign entry influenced legal and regulation structure of domestic banking sector? If so, to what extent?
  3. Do you think that foreign entry into Slovak banking sector, as transforming economy, is beneficial or harming from the global view of financial markets operations in Slovak economy?

- **Influences of state and central bank policy**

  1. Do you think that some pressures from the side of state (e.g. guarantee of state in certain banks) could have been felt as "protectionist" by foreign banks? Respectively, were there any pressures imposed, either to influence all banks or just particular domestic or foreign ones? Or were there any effects to protect domestic banking sectors recorded?
  2. How would you characterise the status and development of banking legislation in Slovakia? How would you characterise ability of related institutions to impose legislation or react to its weaknesses and strengths?
  3. How would you assess functioning of the state and that of central bank in relation to banking market operation and regulation?

- **Influences of competition effects**

  1. With respect to characteristics of Slovak banking sector with relation to concentration ratio, did foreign entry substantially influence distribution of market forces or eventually the full characteristics of the bank markets?
  2. Had foreign banks substantial influence on capital inflows and outflows of the Slovak economy? (We mean capital in any form – i.e. domestically created, foreign investments – direct as well as portfolio, etc.)
  3. Had foreign entry increased stability of the Slovak banking sector? (Stability of the sector is understood as persistence of the sector against external

financial crises as well as internal problems such as single bank bankruptcies, stability of loan provision and deposit availability.)

4. Do you think that foreign banks' entry supported economic growth and transformation of the economy in Slovakia? Please give reasons for this opinion.

State and Central Bank Officials

- **Basic Bank Activities**

1. How did foreign entry influence availability of loans and deposit services at the Slovak banking market? How would you assess development before and after foreign banks' entry?
2. Do you think that foreign entry had any effects (positive or negative) for provision of financial services?

- **Technology and Operations**

1. How would you characterise competitive advantages (or disadvantages) of domestic and foreign banks? Had foreign banks, according to your opinion, any direct competitive advantages over domestic banks or was it the other way round? How were these advantages experienced?
2. Had been the managerial and bank know-how transferred from foreign to domestic banks? If yes, how did this happen and which effects, positive or negative, dominate?
3. Did foreign entry influence market behaviour of domestic banks? If yes, how and why do you think so? If not, why not?

- **Human Resources**

1. Does entry of foreign banks influence the quality of human resource in the sector?
2. Did entry of foreign banks influence the amount of investments into human resources (training, etc)? What form of investments do you regard as most important?
3. How would you characterise quality of domestic and foreign top-managers of commercial banks?

- **Infrastructure**

1. How would you characterise the status and development of financial markets infrastructure in relation to strong and weak sides? (Infrastructure is characterised as market organisation, which is institutional as well as legal, further technical and informational

infrastructure, regulations and supervision of the market, etc.) What do you recognise as weak and strong sides of existing infrastructure?

2. Do you think that foreign entry has been influencing legal and regulation structure of domestic banking sector? If so, to what extent?
3. Do you think that foreign entry into Slovak banking sector, as transforming economy, is beneficial or harming from the global view of financial market functioning in Slovak economy?

- **Influences of state and central bank policy**
  1. Was there any intention to impose pressures from the side of a state in relation to „protection policy of domestic banking sector" on foreign sector? How did this manifest?
  2. How would you characterise the state and development of legislation in relation to strengths and weaknesses?
  3. What were the state/central bank expectations from the foreign entry into banking sector? Have these been met?

- **Influences of competition effects**
  1. Had, according to your opinion, foreign entry influenced distribution of market powers or eventually the whole characteristic of the bank market?
  2. Had foreign banks substantial influence on capital inflows and outflows of the Slovak economy? Capital is understood in its all forms, i.e. capital created within domestic economy, foreign portfolio or direct investments, etc..
  3. Did foreign entry improve stability of the Slovak bank sector? Stability in the means of resistance against external financial turbulences, internal problems such as bank failures, stability in loan provision and deposit availability.
  4. Do you think that foreign banks' entry supported economic growth and transformation of the economy in Slovakia? Please give reasons for this opinion.

APPENDIX D. – EMPIRICAL ANALYSIS RESULTS

Table 7-1 - Summary statistics for basic activity, risk and efficiency and indirect effects indicators

Domestic Banks	N	Minimum	Maximum	Sum	Mean	Std. Deviation
Total Assets	13	315.041	462.612	5,313.672	408.744	43.432
Profit	10	-15.413	8.302	-23.525	-2.352	5.810
Securities	13	21.767	77.523	706.031	54.310	15.733
Inter-Bank Assets	13	42.740	94.233	908.547	69.888	15.441
Earning Assets	13	291.381	391.693	4,381.095	337.007	30.112
Fixed Assets	9	20.211	24.223	200.771	22.308	1.229
Loans	15	166.839	219.953	2,968.288	197.886	18.528
Deposits	14	167.713	272.930	3,251.666	232.262	29.809
Employees	15	14,492	18,594	248,632	16,575	N/AP
ROA	13	-9.492	1.220	-15.563	-1.197	2.691
CCR	12	0.106	0.439	3.486	0.290	0.109
Valid N (listwise)	9					

Foreign Banks	N	Minimum	Maximum	Sum	Mean	Std. Deviation
Total Assets	13	24.694	275.391	2,095.821	161.217	80.982
Profit	13	-1.474	3.144	12.684	0.976	1.238
Securities	13	1.838	61.546	392.891	30.222	18.189
Inter-Bank Assets	13	5.677	73.877	516.181	39.706	22.561
Earning Assets	13	22.089	229.592	1,788.678	137.591	67.277
Fixed Assets	9	4.997	9.749	57.346	6.372	1.678
Loans	15	13.217	89.955	779.060	51.937	26.976
Deposits	14	15.823	132.825	965.889	68.992	34.573
Employees	15	1,509	6,796	66,476	4,431	N/AP
ROA	13	-1.150	1.340	4.195	0.323	0.881
CCR	12	0.040	0.189	1.229	0.108	0.040
Valid N (listwise)	8					

Foreign Branches	N	Minimum	Maximum	Sum	Mean	Std. Deviation
Total Assets	13	35.880	95.554	884.453	68.035	17.351
Profit	13	-0.924	2.664	5.736	0.441	0.931
Securities	13	0.281	9.321	67.359	5.181	2.401
Inter-Bank Assets	13	6.977	68.005	382.819	29.448	18.020
Earning Assets	12	27.598	90.549	795.986	61.230	17.424
Fixed Assets	9	0.742	0.876	7.451	0.828	0.043
Loans	14	15.160	35.511	354.090	23.606	7.018
Deposits	14	8.745	36.999	283.999	20.286	8.106
Employees	15	846	1,532	17,431	1,162	N/AP
ROA	13	-0.904	4.020	14.765	1.136	1.544
CCR	10	0.070	0.496	3.114	0.260	0.129
Valid N (listwise)	8					

Specialised Banks	N	Minimum	Maximum	Sum	Mean	Std. Deviation
Total Assets	13	36.097	88.485	790.898	60.838	14.435
Profit	13	-11.710	1.822	-22.559	-1.735	4.008
Securities	13	3.143	20.163	117.398	9.031	5.395
Inter-Bank Assets	13	5.999	14.879	139.452	10.727	2.423
Earning Assets	10	33.395	65.795	497.025	49.073	9.153
Fixed Assets	10	0.685	1.609	10.449	1.161	0.315
Loans	15	19.276	48.940	447.303	29.820	7.849
Deposits	14	5.444	40.645	348.784	24.913	12.686
Employees	0	N/A	N/A	N/A	N/A	N/AP
ROA	10	-14.390	8.803	-14.919	-1.492	7.446
CCR	7	0.404	0.472	3.060	0.437	0.025
Valid N (listwise)	0					

N/A: data not available

N/AP: results not applicable

Table 7-2 - Test of normality - ratio indicators

	Kolmogorov-Smirnov[81]			Shapiro-Wilks		
	Statistic	df	Sig.	Statistic	df	Sig.
Fixed Assets/TA	0.182	24	0.038	0.878	24	0.008
Return on Assets	0.243	24	0.001	0.635	24	0.000
Coefficient of Credit Risk	0.195	24	0.019	0.893	24	0.016
Loans/Deposits	0.283	24	0.000	0.745	24	0.000
Loans/TA	0.127	24	0.200*	0.949	24	0.256
Securities/TA	0.125	24	0.200*	0.956	24	0.372
Inter-Bank Assets/TA	0.184	24	0.035	0.908	24	0.031
Earning Assets/Employees	0.289	24	0.000	0.647	24	0.000

** This is an upper bound of the true significance.

* This is a lower bound of the true significance.

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Table 7-3 - Test of homogeneity of variances – ratio indicators

	Levene Statistic	df1	df2	Sig.
Fixed Assets/TA	2.305	3	33	0.095
Return on Assets	12.463	3	45	0.000
Coefficient of Credit Risk	11.533	3	39	0.000
Loans/Deposits	13.206	3	52	0.000
Loans/TA	5.370	3	48	0.003
Securities/TA	6.845	3	48	0.001
Inter-Bank Assets/TA	9.969	3	48	0.000
Earning Assets/Employees	5.630	2	33	0.008

[81] "The Kolmogorov-Smirnov statistic with a Lilliefors significance level for testing normality is produced with the normal probability and detrended probability plots. If the significance level is greater than .05 then normality is assumed. The Shapiro-Wilks statistics is also calculated if the sample is less than fifty" (Coakes and Steed (2000:35)).

Table 7-5 - Test of normality - deposits

National Bank of Slovakia Sector of Industry Code	Kolmogorov-Smirnov		
	Statistic	df	Sig.
Non-financial corporations	0.196	52	0.000
Public sector	0.283	52	0.000
Non-profit organisations	0.224	52	0.000
Small enterprises	0.256	52	0.000
Citizens	0.259	52	0.000
Non-residents	0.224	52	0.000
Unsorted	0.281	52	0.000
Agriculture, hunting and fishing	0.247	52	0.000
Forestry	0.284	52	0.000
Mining	0.247	52	0.000
Industry production	0.137	52	0.016
Food and tobacco	0.225	52	0.000
Chemical	0.178	52	0.000
Foundry and machinery	0.137	52	0.016
Electrical engineering	0.144	52	0.009
Textile and leather	0.208	52	0.000
Other	0.158	52	0.002
Electricity water and gas supply	0.250	52	0.000
Construction	0.222	52	0.000
Wholesale hotels and restaurants	0.126	52	0.038
Tourism	0.318	52	0.000
Transport, warehousing and post	0.237	52	0.000
Finance and banking	0.233	52	0.000
Insurance	0.420	52	0.000
Other total	0.276	52	0.000

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Table 7-6 - Test of homogeneity of variances - deposits

National Bank of Slovakia Sector of Industry Code	Levene Statistic	df1	df2	Sig.
Non-financial corporations	6.461	3	48	0.001
Public sector	10.917	3	48	0.000
Non-profit organisations	30.608	3	48	0.000
Small enterprises	21.736	3	48	0.000
Citizens	12.104	3	48	0.000
Non-residents	20.216	3	48	0.000
Unsorted	9.820	3	48	0.000
Agriculture, hunting and fishing	18.630	3	48	0.000
Forestry	10.930	3	48	0.000
Mining	7.412	3	48	0.000
Industry production	10.455	3	48	0.000
Food and tobacco	20.292	3	48	0.000
Chemical	9.750	3	48	0.000
Foundry and machinery	13.933	3	48	0.000
Electrical engineering	14.127	3	48	0.000
Textile and leather	9.531	3	48	0.000
Other	9.216	3	48	0.000
Electricity water and gas supply	13.981	3	48	0.000
Construction	7.070	3	48	0.000
Wholesale hotels and restaurants	22.366	3	48	0.000
Tourism	8.519	3	48	0.000
Transport, warehousing and post	13.488	3	48	0.000
Finance and banking	6.221	3	48	0.001
Insurance	11.904	3	48	0.000
Other total	8.437	3	48	0.000

Table 7-8 - Test of normality - loans

National Bank of Slovakia Sector of Industry Code	Kolmogorov-Smirnov		
	Statistic	df	Sig.
Non-financial corporations	0.239	54	0.000
Public sector	0.243	54	0.000
Non-profit organisations	0.245	54	0.000
Small enterprises	0.285	54	0.000
Citizens	0.330	54	0.000
Non-residents	0.337	54	0.000
Unsorted	0.388	54	0.000
Agriculture, hunting & fishing	0.227	54	0.000
Forestry	0.319	54	0.000
Mining	0.312	54	0.000
Industry production	0.230	54	0.000
Food and tobacco	0.223	54	0.000
Chemical	0.172	54	0.000
Foundry and machinery	0.250	54	0.000
Electrical engineering	0.201	54	0.000
Textile and leather	0.357	54	0.000
Other	0.255	54	0.000
Electricity water and gas supply	0.318	54	0.000
Construction	0.366	54	0.000
Wholesale hotels and restaurants	0.236	54	0.000
Tourism	0.207	54	0.000
Transport, warehousing and post	0.225	54	0.000
Finance and banking	0.272	54	0.000
Insurance	0.293	54	0.000
Other total	0.288	54	0.000

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Table 7-9 - Test of homogeneity of variances - loans

National Bank of Slovakia Sector of Industry Code	Levene Statistic	df1	df2	Sig.
Non-financial corporations	13.168	3	52	0.000
Public sector	36.007	3	52	0.000
Non-profit organisations	16.249	3	52	0.000
Small enterprises	11.225	3	52	0.000
Citizens	30.224	3	52	0.000
Non-residents	34.869	3	52	0.000
Unsorted	5.815	3	52	0.002
Agriculture, hunting & fishing	13.024	3	52	0.000
Forestry	15.596	3	52	0.000
Mining	10.003	3	52	0.000
Industry production	43.828	3	52	0.000
Food and tobacco	27.892	3	52	0.000
Chemical	9.534	3	52	0.000
Foundry and machinery	33.547	3	52	0.000
Electrical engineering	17.434	3	52	0.000
Textile and leather	42.285	3	52	0.000
Other	42.752	3	52	0.000
Electricity water and gas supply	12.762	3	52	0.000
Construction	150.262	3	52	0.000
Wholesale hotels and restaurants	30.580	3	52	0.000
Tourism	2.884	3	50	0.045
Transport, warehousing and post	33.355	3	52	0.000
Finance and banking	25.099	3	52	0.000
Insurance	9.015	3	52	0.000
Other total	18.544	3	52	0.000