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## IMPACTS OF EURO ADOPTION ON BANKS IN THE NEW MEMBER STATES

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**Key words:** banking sector, EMU, new member states.

### CONCLUSIONS

Banking systems of the NMS are strongly linked to those of the EU15 Member States. Accession of NMS to EMU will likely to act, in the medium to long term, as a catalyst to strengthen already existing developments and trends in the banking systems of these countries. Accession to EMU will likely to strengthen the pressure for the reduction of existing excess capacity in the banking sector of the NMS. Further on, it is expected to put profitability under pressure and lead to increased geographical diversification and internationalisation, as well as to increased conglomeration and mergers and acquisitions. Overall, competition in banking within the euro area is likely to increase considerably after the NMS join EMU. When assessing any potential outcomes or challenges arising from the EMU presence of NMS banks, banks shall automatically take part in an adjustment process where, ideally, they redefine their roles and restructure, if necessary, their strategies for participation in an enlarged euro area market. In the preparation stage, banks in the NMS shall increase their awareness of challenges EMU can bring and here experiences of the present EMU Member States can be a major asset. In theory, changeover to the euro in NMS might represent a risk in the banking systems (revenue and cost implications of the transition to the euro). In the medium term, the negative effects of the structural adjustment process in the EU banking systems could be concentrated in strategically unfavourably placed banks that may not cope with the risks and difficulties associated with the adaptation to that process. Nevertheless, in the longer term, the adjustment process should result in a stronger and fitter banking sector and generate customer gains due to increased competition. In addition, the transition to a stable monetary environment should bring positive effects to the banking systems in the NMS. This shall be mostly felt by those banking industries that previously operated in a relatively high inflationary environment.

### ABSTRACT

In recent years, economic environment in which banks operate has been rather favourable in the New Member States. Even though price competition intensified, profitability improved significantly due to high interest margins and lower provisioning costs, as well as

growth in lending. EMU is expected to act in the medium and long term as a catalyst to reinforce trends already prevailing in the banking industry of these countries. On one hand, EMU will likely strengthen the need to reduce existing excess capacity and put profitability under pressure. On the other hand, it will most probably result in further interna-

tionalisation and geographical diversification and lead to further mergers and acquisitions, as well as to increased conglomeration. Thus, overall competition in the banking sector is set to increase in the enlarged euro area. Finally, via a more stable monetary environment, the adjustment process of the banking sector of the New Member States should create stronger and sounder banks and generate customer gains in the long run.

## INTRODUCTION

Banking sectors in the New Member States (NMS) have in recent years operated under rather favourable macroeconomic conditions, characterised by progress in both real and nominal convergence (Soós – Farkas-Fekete, 2005; Soós, 2006). GDP growth in these countries has exceeded those prevailing in EU15 countries and, at the same time, inflation fell significantly in almost all NMS to euro area levels. As these countries are on their road to EMU, some of them must challenge large current account and/or fiscal deficits. Moreover, macroeconomic stability must be maintained on a sustainable basis. During the past 10-15 years, transformation of the economies and the reforms resulted major achievements. Capacity for prudential regulation and supervision has been developed in all NMS and a single supervisory authority (either the central bank or a separate authority) is responsible for the supervision of commercial banks, in line with EU15 standards. Soon after EU accession, NMS presented their national euro adoption plans, marking their first visible sign of intention to join EMU as soon as they fulfil all convergence criteria. By spring 2006, there is evidence that NMS shall enter EMU in multiple steps (Soós, 2006). Nevertheless, the ongoing developments in the banking sectors of these countries shall

be more interesting to look at in the light of future EMU accession. This paper's goal is to briefly touch upon potential impacts of euro adoption on banks in the NMS. The structure of this paper is as follows. First key characteristics of banking sectors in the NMS are presented. Second, potential impacts of EMU on banks in NMS are assessed. In this, different effects on banking activities, banking structures, banks' strategies and banking risks are covered.

## KEY CHARACTERISTICS OF THE BANKING INDUSTRY IN THE NMS

Since most of the NMS followed similar paths in consolidating and strengthening their economies, banking sectors, overall, share common characteristics. Though enjoying an upward trend, the level of financial intermediation is low when compared to EU15 levels. As for the financial structure, NMS are more dependant on bank finance than direct market finance, which is in line with EU15 trends. Banking systems in the NMS are dominated by commercial banks with an approximate 90% share of total banking sector assets. In some countries also small cooperative banks, as well as specialised financial service providers, such as mortgage banks, building societies or international banking units play important role. Foreign presence is significant in most NMS, mainly in the form of subsidiaries of foreign banks. In 2004, on average, more than 70% of assets were foreign-owned. Banks of the NMS have a limited presence abroad, though some of them have equity participations in foreign banks. Relatively high concentration is a characteristic of the market structure of NMS, the largest 4-5 banks, on average, hold close to  $\frac{3}{4}$  of total banking sector assets. Taken high concentration into account, competition-related concerns may

arise, however concentration and margins are negatively related, i.e. margins are among the lowest in highly concen-

trated markets and are the highest in markets with lower concentration.

**Table 1**

**Number of credit institutions and branches in the NMS (2001, 2004)**

	Number of credit institutions		Number of branches	
	2001	2004	2001	2,004
Czech Republic	172	68	1,751	1,785
Estonia	7	9	210	203
Cyprus	43	43	528	500
Latvia	23	23	590	583
Lithuania	54	74	156	758
Hungary	230	213	2,950	2,987
Malta	17	16	58	63
Poland	711	653	4,080	5,006
Slovenia	69	24	717	706
Slovakia	20	21	1,052	1,113
NMS10	1,346	1,144	12,092	13,704
Greece	61	62	3,134	3,403
Ireland	88	80	970	909
Portugal	212	197	5,534	5,408
EU12 (EMU)	7,213	6,403	175,203	167,846
EU25	9,363	8,374	206,265	199,606

Source: ECB 2005a

As for the balance sheet structure, the loan-to-asset ratio is catching up rapidly with that of EU15 banks due to rapid lending growth in many countries. Household lending (in particular, mortgage lending) has been the fastest growing area in most of the NMS. However, it represented only  $\frac{1}{4}$  of banks' loans in 2003, while loans to non-financial corporations made about half of the total loan portfolio. Customer deposits are the most important funding source for banks in the NMS, with  $\frac{2}{3}$  of total assets. Debt

securities remain insignificant in most NMS. Benefiting from favourable macroeconomic conditions and high lending growth, banks improved their performance in recent years. Despite the improving trend in the quality of the banks' assets, the ratio of non-performing and other doubtful loans was substantially higher than that of EU-15 countries.

Strong ownership links between old and new Member States may give rise to a risk transmission channel within the EU. As regards potential negative impacts,

adverse impacts resulting from ownership links could be quite asymmetric for home and host countries. Whereas the impact for EU15 banks should be limited, the transmission of shocks from EU15 countries is more likely to have an impact on systemic risk in the NMS. As for the banks of EU15, positive effects from an increased presence in the NMS may have outweighed the negative effects. Banks in

the NMS had significant contribution to the profitability of EU15 banks in recent years. Banks in the NMS have taken advantage from their close links with EU15 banks through, among others, knowledge-transfer, which in the medium and long run will have a stabilising effect on banking systems in these countries.

Table 2

**Bank ownership structure and total banking sector assets**

	Number of banks		Number of state-owned banks		Number of foreign-owned banks		Total banking sector assets (EUR billion)
	1997	2003	1997	2003	1997	2003	2003
<b>CY</b>	12	14	2	2	4	6	27.2
<b>CZ</b>	50	35	n.a.	2	24	27	79.5
<b>EE</b>	12	6	n.a.	0	4	3	5.8
<b>HU</b>	45	36	n.a.	1	30	29	54.4
<b>LT</b>	12	13	3	0	5	10	6.4
<b>LV</b>	32	22	n.a.	1	15	9	8.5
<b>MT</b>	n.a.	16	n.a.	0	n.a.	10	16.8
<b>PL</b>	83	60	n.a.	6	29	46	103.7
<b>SL</b>	34	22	n.a.	2	4	6	21.6
<b>SK</b>	29	21	4	2	13	19	23.8

Source: ECB 2005a

**POTENTIAL IMPACTS OF EMU ON BANKS IN THE NEW MEMBER STATES**

Taken the experiences of and developments in the banking sector of the present EMU Member States, as well as looking at the main features of the banking sector of the NMS, this paper covers potential impacts of EMU on the banking sector of the NMS in the following order

- impacts on banking structure;

- impacts on banking activities;
- impacts on banks' strategies;
- impacts on banking risks.

**Effects of EMU on banking structure**

As it was the case in the present euro area Member States, EMU is expected to reinforce the current tendency in the banking industry of the NMS towards a reduction of banking capacity. Despite the problems of measurement, there are

reasons to assume that excess capacity exists in the NMS. This can be considered as the result of imperfect competition and/or regulation. There have been reductions in capacity in some NMS over the past years, however, the introduction of the euro is expected to put forth, via increased competition, further pressure to reduce excess capacity. In particular, the branch network and staffing levels, given the existing marked differences across countries, are expected to be affected, thus enabling banks to achieve efficiency gains.

EMU is also likely to speed up disintermediation in the NMS, i.e. reducing the share of banks in the borrowing or saving activities within an economy, which is already under way in the EMU banking sectors. In recent years, the relative importance of credit institutions has decreased in most of the EU Member States in favour of institutional investors,

such as investment and pension funds, as well as insurance companies. Among these investors, investment funds achieved the highest growth. Institutional investors are expected to continue to grow also in the NMS, mainly as a result of demographic and social changes. As for the relative importance of the financial instruments, disintermediation is at an early stage and it is a challenge to foresee any possible impacts of EMU. One consideration may be that some NMS must execute consolidation efforts in their public finances on the road to EMU and, as a result, reduction in the issuance of government bonds in these countries is likely to take place. Another aspect is that the introduction of the euro will increase market liquidity and the resulting lower costs related to bonds or commercial paper are expected to trigger additional issuance of these instruments, thus boosting disintermediation.

Table 3

**Banking sector structure  
(types of financial institutions, number of branches and staff) (2003)**

		Number of banks	Number of branches	Number of staff	Market share
CY	Commercial banks	11	459	7,744	87.4
	Cooperative banks	1	5	201	9.2
	Special purpose	2	7	111	3.4
CZ	Commercial banks	20	1,636	36,392	79.9
	Foreign branches	9	19	857	9.6
	Building societies	6	15	1,755	10.5
EE	Commercial banks	7	194	4,204	100.0
HU	Commercial banks	31	1,147	26,549	85.0
	Cooperative banks	182	n.a.	n.a.	6.5
	Mortgage banks	3	8	316	7.6
	Building societies	2	7	302	0.9
LT	Commercial banks	13	117	n.a.	100.0
LV	Commercial banks	22	206	8,112	100.0

<b>MT</b>	Commercial banks	16	103	3,411	100.0
<b>PL</b>	Commercial banks	60	3,119	124,096	94.7
	Cooperative banks	600	1,275	27,161	5.3
<b>SL</b>	Commercial banks	20	1,176	11,397	98.7
	Savings banks	2	16	58	0.4
	Cooperative banks	8	16	26	0.9
<b>SK</b>	Commercial banks	18	55	19,147	94.2
	Building societies	3	0	650	5.8

Source: ECB 2005a

### Effects of EMU on banking activities

With the approach of accession to EMU, interest rates prevailing in the NMS will further convergence (decrease) to those of the euro area. In the short term, this is beneficial to banks due to capital gains and increased income from maturity transformation. In the long run, however, interest rates will reduce the earned margin. Entering EMU would mainly reinforce the prevailing trends in the banking industry of the NMS. One can assume that banks will expect their overall profitability to be negatively affected after the changeover to the euro. This expectation can be stronger among small and medium-sized banks. EMU is expected to affect the activities undertaken by banks in different ways.

1. Substantial reduction in *foreign exchange activity* shall be regarded by NMS banks as one of the main negative impacts of accession to EMU.

2. However, banks are likely to increase their *money* and especially *securities market activities* to even out lower revenues from foreign exchange trading. The introduction of the single currency and monetary policy will provide a favourable environment for the setting-up of liquid and deeply integrated money and capital markets that will, in turn, generate growth, but shall, at the same

time, trigger further competition in this field. The lowering of gross government debt owing to fiscal consolidation in the light of future participation in EMU is likely to support the spreading of other securities and, possibly, the securities activities of banks.

3. *Retail deposit business* may be affected in a way that the establishment of a low interest rate environment would urge customers to look for alternative investment products to deposits.

4. *Lending* may be boosted by the more stable macroeconomic environment brought about by EMU, but the expected further securitisation and disintermediation might operate in the reverse direction. Experiences of some participating Member States show that in times of interest rate convergence, lending is on the rise and can easily boom. Lending booms are considered to be potential dangers for the banking sector because periods of rapid credit growth have often come together with banking crises. An examination done for the Czech Republic, Hungary and Poland has, however, come to the conclusion that in spite of a dynamic growth in lending, no significant risk to the banking sector of these countries should be expected (ECB, 2005c).

5. *Correspondent banking services* are likely to fall due to the centralisation of treasury functions at larger banks.

Taken all elements into account, the final impact on banking activities will depend on the interaction among all the above factors that is difficult to predict.

### Effects of EMU on banks' strategies

EMU will create an even more competitive environment and put further pressure on banks' profitability in the NMS. Responding to these challenges, banks have already adopted or are in the process of making a decision on appropriate strategic steps. Among these, there are three ones to mention

1. improvements in services and procedures (risk management and internal control, efficiency improvements, IT, quality of services);

2. changes in products (giving consulting a more prominent role to operating services, focusing on development of alternative income sources) and

3. mergers, strategic alliances and co-operation agreements (cost and efficiency improvements (economies of scale and scope), product diversification, new distribution channels (electronic banking) and geographical expansion.

In EMU further internationalisation of the NMS banking systems can be expected. The level of internationalisation of most EU banking systems is relatively low. Market share of foreign branches and subsidiaries in the EU was close to 25% in 2004, while the same was over 70% in the NMS and 15% in the euro area, respectively. A higher degree of internationalisation might help banks to ensure a sound preparation for future waves of competitive pressure. As for mergers and acquisitions (M&As), it is difficult to assess the extent to which these activities shall be triggered in the NMS by the approach of EMU since similar developments can be observed in other markets. Nevertheless, many credit institutions in the NMS may reconsider their strategies also in light of joining EMU. Such moves by NMS banks, however, can be expected to be moderate and will not lead to major realignments in the market. In recent years, two main types of mergers were observed in the present EMU Member States. First, strategic mergers, involving at least one large player, with a view to reposition in the euro area. Second, mergers to eliminate excess capacities, notably in smaller banks. One can expect that similar developments may happen in the NMS in case M&As will play a role.

**Table 4**

### Largest acquirers ranked according to deal values (1990-June 2004)

Rank	Acquirer	Target countries	Number of deals	Deal value (EUR million)
1.	Erste Bank (AT)	CZ, SK, HU	8	2,141
2.	KBC (BE)	CZ, PL, HU, SL	16	1,983
3.	Société Générale (FR)	CZ, SL	2	1,329
4.	Citigroup (US)	PL	3	1,038



5.	Bayerische HypoVereinsbank (DE)	CZ, PL	7	932
6.	SEB (SE)	LT, EE, LV, PL	14	568
7.	IntesaBci (IT)	SK	1	440
8.	Bank Przemyslowo-Handlowy (PL)	PL	2	400

Source: ECB 2005a.

Finally, accession to the euro area shall require a revision of the concepts of „local”, „regional” and „national” markets.

### Effects of EMU on banking risks

EMU is presumably to have a significant impact on the risks incurred by banks in the NMS. The stable macroeconomic environment resulting from EMU accession is expected to moderate credit risk. However, other factors could have reverse direction. In a very competitive environment, banks might shift their business towards more profitable but, at the same time, more risky business. Individual small and medium-sized enterprises may face the risk of not being adequately prepared with regard to their systems and strategies concerning EMU with possible spillover effects into the banking system. Finally, the possibility exists of a concentration of likely „EMU losers” among individual banks’ debtors that could increase credit risk. Market risk under EMU is expected to decrease, especially in the fields of foreign exchange and interest rate risk. It is likely

that banks will seek to replace a part of their lost foreign exchange business with new or increased involvement in non-EMU markets with the possibility of increased country risk. Liquidity risk is likely to decrease due to deeper and more liquid markets within EMU.

Legal risks and operational risks may be relevant in the short run owing respectively to the overall new legal environment in the euro area and the necessary system adaptations for the transition to the euro. Upon EU enlargement, the entry of foreign branches or transformation of subsidiaries into branches may lead to regulatory challenges. A foreign branch in the NMS may have systemic importance in the host country even though it represents only a modest share of the group’s total operations. In such a setting, potential conflicts may emerge between home country control in micro-prudential supervision and host country responsibility in safeguarding financial stability. To handle such risks, enhanced coordination between host and home supervisory authorities shall be necessary.

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