EXAMPLES OF EFFECTIVE CONSOLIDATION
THE BALTICS AND POLAND

CHAPTER 6: BALTIC STATES CASE STUDY

Introduction

1. The Baltic states—Estonia, Latvia, and Lithuania—have significantly consolidated their banking sectors in the 10 years since their independence, with the total number of banks operating in the region falling from a peak of 110 in 1992/93 to 39 now (mid-2002). In all three countries the first consolidation phase could be described as acutely traumatic, as banks accounting for roughly 40 percent of total banking sector assets failed. This happened in 1993 in Estonia, 1995 in Latvia, and late 1995 in Lithuania. In each case some of the larger (sometimes the largest) banks were affected, and often the leading private banks, which previously had been seen as the flagships for market reform, got into the most trouble. After some initial attempts to soften the consolidation process, the regulatory authorities of all three countries' started to take a relatively ruthless approach to troubled banks, withdrawing licenses unless a credible rescue by a stronger institution could be arranged. By the second half of the 1990s market pressures had become the driving force for consolidation.Periodic exogenous shocks (the Asian and Russian crises particularly) often provided the trigger for actual consolidation and foreign capital the means. Although this later phase saw a number of bank failures, the effect on overall banking sector confidence was much less than during the first phase, with little or no interruption to the financial deepening process. This may be a reflection of the growing presence of high-quality foreign involvement in the remaining banks, but foreign capital's role appears to have been more to underpin a locally driven consolidation process's effectiveness than to bring it about. The end-point for the three Baltic state banking markets was the emergence of a number of significant regional players, all foreign-owned, that increasingly compete in a pooled market. Competitive advantage now seems to be expressing itself in the ability of stronger banks to acquire a better position in the other parts of the region rather than build it organically.

Economic Overview

2. The three Baltic states emerged from the breakup of the former Soviet Union with no particular economic advantages except their proximity to Western Europe and strong regional support from the Scandinavian and Nordic countries. In some ways the break with former economic structures was even more abrupt than for the other CIS economies that at first tried to maintain them. The first manifestation was a rapid move to currency reform and cooperation with international financial institutions, led by Estonia, which in June 1992 went straight from the Ruble Zone to re-launching the kroon at a fixed peg to the deutsche mark under a currency board mechanism. This was followed a year later by Latvia and Lithuania (although they issued intermediate currencies under central bank control before they too relaunched their independent

prewar currencies in 1993). Early stabilization aided by currency reform and central bank independence (but to varying degrees undermined by attempts to ameliorate the fiscal budget constraint[1]) brought about rapid disinflation (first evident in Estonia, soon following in Latvia and later in Lithuania). Rapid underlying market reform (again to varying degrees undermined by the delayed privatization of large state-owned enterprises) saw the output collapse typical of post-Soviet economies but followed by relatively rapid resumption of real growth. The overall economic dimensions of transition for these three countries are summarized in Table 6.1, which shows the degree of contraction in GDP and savings in dollar terms (as measured by per capita broad money holdings) and the degree to which recovery eventually reversed initial falls.

Table 6.1. Comparisons of GDP per Capita and Broad Money per Capita

	Estonia	**Latvia**	**Lith.**	**Russia**	**Ukraine**	**Kazakh.**	**Armenia**
Pre-reform levels (1989):							
—GDP per capita (US$)	8,351	8,541	7,047	10,346	7,167	6,088	7,233
—Broad money per capita (US$)	4,758	4,946	5,301	8,370	5,372	n/a	4,309
—Relative prices (US =1)	0.99	0.91	0.80	0.63	0.69	0.39	0.60
Most recent levels (2001):							
—GDP per capita (US$)	10,284	7,658	7,995	10,622	4,412	6,966	3,160
—Broad money per capita (US$)	3,818	2,301	1,823	2,339	793	1,009	417
—Relative prices (US =1)	0.38	0.42	0.43	0.20	0.17	0.21	0.19
Percent change (1989–2001)							
—GDP per capita (US$) (%)	+23	-10	+13	+3	-38	+14	-57
—Broad money per capita (US$) (%)	-20	-53	-66	-72	-85	n/a	-90
—Relative prices (US =1)	-62	-54	-46	-68	-75	-45	-68
Trough year(s)/peak declines	1992	1992	1992	1999	1995	1995	1993–96
—GDP per capita (%)	-80	-87	-84	-83	-60	n/a	-95
—Broad money per capita	-91	-96	-96	-95	-95	n/a	-99

Source: ???

Note: All figures are P**urchasing Power Adjusted**

3. Table 6.1 shows that by 2001 output per capita in Estonia was 1.23 times pre-reform levels and accumulated savings per capita (as measured by money balances) were almost back to pre-reform levels: but now on a voluntary rather than a forced basis Latvia and Lithuania lag Estonia both in terms of the output recovery and even more in terms of rebuilding their economies' savings base. Estonia's lead appears to reflect its earlier stabilization and an early first consolidation phase, which seems to have mitigated the degree of collapse after the break from the Soviet Union and raised the potential for recovery. However, Latvia's and Lithuania's degree of recovery should not be underestimated. Both countries suffered the same sort of output and savings collapse as the other CIS countries in this study, but generally have done better in terms of restoring output and beginning to rebuild their savings base/monetary. All three Baltic states have roughly the same relative price index, about two to three times typical CIS levels.

4. This end point of the economic transition process is that all three Baltic states are now clear candidates for EU accession, with well-established internal and external currency stability, reasonably sound public finances, and functioning market economies in which state involvement has been or is being significantly reduced. Estonia was identified early on as a first-wave candidate, Latvia soon was identified as borderline first- or second-wave candidate, and

[1] However, the degree of slack involved never reached that seen in CIS countries.

Lithuania rapidly caught up (and in some respects surpassed the other two in degree of preparation)[2].

Overall Size of the Banking Sector

5. Like almost all former Soviet satellites, the three Baltic states were all highly monetized and banked before their reforms began. The ratio of total banking sector deposits to GDP stood at 40–45 percent in Estonia and Latvia and 66 percent in Lithuania. A large part of the population was receiving salaries through banks, and almost all were using banks to pay bills and state levies and receive many state benefits. Use of cash (again relative to GDP) was about twice euro-zone levels but quite low by developing country standards. All three countries saw this high monetization level collapse when reform began, and the ratio of cash to deposits soared (by the mid-1990s in each of the three economies cash circulation was equal to around two-thirds of total banking sector deposits). In Estonia and Latvia the deposits-to-GDP ratio fell by three-quarters (from 40–45 percent to 11–12 percent) in three years, and in Lithuania the fall was even more dramatic (from 66 percent to 5 percent).

6. Since then, as already noted, Estonia has done most to rebuild monetization and with it the banking system's deposit base (deposit-to-GDP ratio rising to 32 percent from a low of 12 percent, about three-quarters of where it had been in 1989). The recovery of this ratio has been relatively steady since 1993. The Estonian banking system faced the double blow of hyperinflation and a banking crisis in the first two years of reform, and since then its underlying growth momentum has been very fast. Not only did the deposit-to-GDP ratio rise threefold, but the lead in real economic growth that Estonia achieved over the other two Baltic states was even more marked in nominal than in real terms, at least during the second half of the 1990s.

7. Latvia's experience was very different. Between mid-1992 and mid-1994 the deposits-to-GDP ratio rose from 12 percent to 20 percent, but by mid-1996 (after the first acute consolidation phase had worked through) it was back to 12 percent. It then started to recover rapidly, but this was interrupted by consolidation's second major phase, triggered by the Russian crisis. This resulted in a leading private bank with a major retail branch network having to go into temporary administration. Only since that crisis has the deposits-to-GDP ratio begun to rise strongly again (from 16 percent in mid-1999 to 21 percent by mid-2001). The less rapid growth of deposits relative to GDP, combined with lower nominal GDP growth than Estonia, meant that between 1994 and 1999 the Latvian banks' share of pan-Baltic banking sector assets fell from nearly half to just over a third. It has since recovered sharply (see Table 6.2).

Table 6.2. Total Banking Sector Assets by Country and as a Share of Pan-Baltic Total (US$ millions)

	1994	1995	1996	1997	1998	1999	2000	2001	Mid-02
Estonia	754	1,128	1,666	2,946	2,976	3,417	4,198	3,867	4,765
%	19	26	30	35	34	34	34	30	31
Latvia	1,931	1,459	1,992	2,972	2,934	3,383	4,648	5,421	6,330
%	48	34	36	35	33	34	38	41	41
Lithuania	1,354	1,682	1,837	2,460	2,966	3,196	3,517	3,809	4,342
%	34	39	33	29	33	32	28	29	28

Source: ???

[2] These distinctions became superfluous once the EU Commission opted for "big bang" admission of almost all potentially eligible candidates rather than the initially indicated phased approach.

8. A similar pattern is evident in Lithuania. After a very sharp jump in the deposit-to-GDP ratio between 1992 and 1993 (from 5 percent to 11 percent), the ratio rose more steadily between 1993 and 1995, to reach 14 percent just prior to the first wave of consolidation. At this level it was still well below Latvia's ratio and had already been overtaken by Estonia's recovering ratio. The bank failures of late 1995 and 1996 took Lithuania's ratio down to 10 percent, but since 1997 it has risen steadily to 17 percent as of mid-2001, still well below Latvian and Estonian levels. During the early and mid-1990s the slower recovery in deposits relative to GDP probably reflected the greater undermining effects of higher inflation relative to the other countries, but since 1997 this cannot be said to be the case. Lithuania's nominal GDP growth has been only half as fast as Estonia's and Latvia's. Consequently, Lithuanian banks overall have significantly lost share in the pan-Baltic banking market.

9. Even at this aggregate level it is possible to draw some conclusions about the efficacy of the various consolidation processes. Certainly it seems to have been easier for Estonia in 1993 to recover from its early and very sharp crisis-driven consolidation than the similar but later crisis-driven consolidations in Latvia and Lithuania. Moreover, emerging earlier from a systemic banking crisis left the remaining Estonian banks much better placed competitively to gain scale and ultimately acquire significant market presence in the other two Baltic banking markets. This is evident from Table 6.3, which shows the average bank balance sheet size in each of the three Baltic states and how they evolved through a combination of growing markets and a declining numbers of players:

Table 6.3. Evolution of the Number and Average Size of Licensed Commercial Banks

	Estonia			Latvia			Lithuania		
	Sector size (US$ billion)	**Number of banks**	**Average size (US$ million)**	**Sector size (US$ billion)**	**Number of banks**	**Average size (US$ million)**	**Sector size (US$ billion)**	**Number of banks**	**Average size (US$ million)**
1991		25			16			23	
1992		43			51				
1993	0.46	21	22	0.96	63	15	0.83	26	32
1994	0.75	22	34	1.93	55	35	1.35	22	62
1995	1.13	18	63	1.46	38	38	1.68	15	112
1996	1.67	15	111	1.99	34	59	1.84	12	153
1997	2.95	12	246	2.97	31	96	2.46	12	205
1998	2.98	6	496	2.93	27	109	2.97	12	247
1999	3.42	7	488	3.38	23	147	3.20	12	266
2000	4.20	6	700	4.65	21	221	3.52	11	320
2001	3.87	6	644	5.42	22	246	3.81	9	423
mid-02[3]	4.76	6	794	6.33	22	288	4.34	9	482

Source: ???

10. In some respects attaining larger scale is self-reinforcing; especially if a country's banking system has consolidated effectively as described in the earlier chapters.. The increasingly large banks emerging from the consolidation process must manage their capital adequacy carefully if they are to keep gaining market share. They can either do this through organic capital growth—the self-capitalization process described in chapter 3—or by generating

[3] In fact, the number of licensed banks in Lithuania was 10 at the end of June 2002, but one of these was a specialist mortgage bank subsidiary of Vilnaius, the largest bank.

at least enough of a return on equity (ROE) to justify shareholders subscribing for more capital. By the second half of the 1990s the not only were the Estonian banks generating significant retained profits but were also able to raise significant amounts of new capital through rights issues. To a lesser extent this was true in Lithuania, whereas new capital market sourcing was a marginal activity in Latvia.

Structure of the Banking Sector

11. As with all economies emerging from the Soviet system, large numbers of new banks were created in all three countries. The starting point was branches of Gosbank and specialist state banks (typically savings, agricultural, construction and industry, social and trade), and apart from the savings banks these were usually absorbed into the newly re-established central bank of each country. This left the central banks operating on a dual basis: as both central monetary institutions and banking institutions. The first challenge to each country was to establish a proper two-tier banking system. For the most part this was done by the end of 1992. The standard method was either to group together several central bank branches and reestablish the resulting entity as a commercial bank, or sometimes allow individual branches to become stand-alone licensed institutions (as happened with the Estonian Agricultural Bank). Alongside this approach, the newly reestablished central banks had to manage the licensing of a rapidly growing numbers of private banks. Overall, the total number of licensed institutions in each of the three countries evolved as shown in Table 6.3.

12. In addition to these institutions there are a number of credit unions (more than 20 in Latvia and more than 50 in Lithuania) and some branches of foreign banks (one each in Estonia and Latvia and four in Lithuania).

13. Judging the effect of the involvement of foreign capital in the Baltic states' banking systems is complicated by the need to differentiate banks that are ultimately part of recognizable foreign banking groups, from the essentially local banks with private shareholders that choose to be registered abroad. Another complication is that some major foreign investors in the Baltic states tend to use some of their investments as vehicles for investing in other regional markets. Other major players invest directly in each market. The best estimates of the share of total banking system assets accounted for by banks with "real" foreign shareholders is Estonia, 97 percent; Latvia, 52 percent[4]; and Lithuania, 87 percent.

14. State involvement is now limited to full control of the Latvian Mortgage and Land Bank and roughly a third of the Latvian Savings Bank's share capital. These two banks account for 8 percent of total Latvian banking sector assets. Estonia by the mid-1990s effectively had sold control of all its state banks, apart from a small specialist investment bank that it used as a vehicle to nationalize one of the larger failed private banks during the 1998 mini crisis, before privatizing the merged institution in 2000. Lithuania disposed of the last of its remaining three state banks in spring 2002.

15. Not surprisingly, such strong consolidation has brought about very high concentration ratios in Estonia, to a slightly lesser degree in Lithuania, and much less so in Latvia:

[4] Estimates of total Latvian banking sector assets controlled by banks with foreign shareholders more typically show a figure of 75 percent because of the inclusion of one large bank with Latvian Russian shareholders, whose ownership is technically registered abroad.

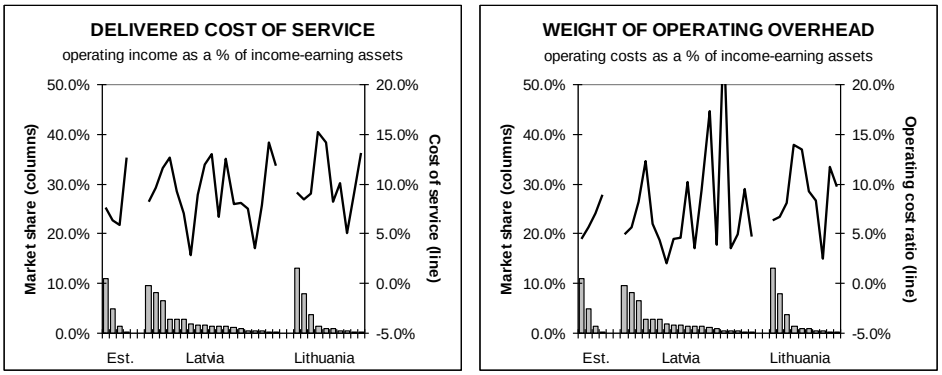
- Estonia's largest bank (Hansa) accounts for some 60 percent of total Estonian banking sector assets, and the top two banks (both foreign-owned) together account for nearly 90 percent;
- Lithuania's three biggest banks (all foreign-owned) account for just over 80 percent of total Lithuanian banking sector assets; and
- The three biggest Latvian banks (two foreign-owned) account for 55 percent of total Latvian banking sector assets.

16. Concentration on a pan-Baltic scale is only slightly less marked. By mid-2002, the Swedbank group (Hansabank Group of Estonia and its acquired Latvian and Lithuanian subsidiaries) held 32 percent of total pan-Baltic banking sector assets, while the SEB group (Uhis in Estonia, Unibanka in Latvia, and Vilniaus in Lithuania) held another 26 percent. The next largest group—the Latvia-based Parex bank, with a Lithuanian but not an Estonian subsidiary—accounted for only 9 percent of total pan-Baltic banking sector assets.

Financial Performance of Banks

17. The consolidation process and the ensuing concentration has created some very large banking groups, but the degree to which they exploit their market power to extract higher profits from customers generally is limited, and very often the merged groups arising out of consolidation extract a smaller profit margin than did the acquiring bank prior to the merger. As figure 6.1 makes clear, the largest banks in each component market neither charge their customers significantly more for services nor carry a higher weight of overheads (often a sign of monopolistic complacency) than their smaller competitors. Indeed the reverse is often true, suggesting that many of the smaller competitors are subscale.

Figure 6.1. Comparisons of Bank Financial Performance by Bank Size and Country



18. Looking at the returnsthe banks earn on assets, the very largest banks typically earn more than medium- and smaller-sized competitors, and this is most marked in Estonia where concentration is greatest, but there is huge variation in this performance indicator. The same pattern is evident from the self-capitalization indicator described in chapter 3. Because the dominant banks tend to extract higher returns they typically create enough capital from their new business to continue growing at least as fast as their market (thus maintaining their dominance) and in some cases further increase their market share. Put another way, it is often difficult for smaller banks to mount a significant competitive challenge because creating the capital needed to finance rapid gains in market share would require extracting above-market spread or fee yields from customers. This is because those smaller banks typically have a higher weight of operating overheads.

19. Table 6.4 tries to abstract from the volatility of individual bank-by-bank data by averaging bank groups, first by ownership (Table 6.4a) and then by domicile (Table 6.4b). On this basis it definitely cannot be asserted that the two big Scandinavian-backed groups that now dominate the pan-Baltic banking markets extract any significant overall monopoly profit. The table also shows that even if the largest banks in each individual market do extract some very slight monopoly profit from their dominant home market positions, the overall average weight of operating overheads and the aggregate spreads and yields extracted on earning assets are much lower than in other CIS case-study countries, and reasonably comparable with the more developed Visegrad markets.

Table 6.4a. Performance by Ownership

	Scandinavian	Other Foreign	Larger Local	Smaller Local
Number of banks in sample	10	5	4	16
Market share end-2000 (%)	54	6	19	14
Change since 1998 (%)	6	-1	1	3
Efficiency of asset deployment (%)	99	104	96	98
Weight of operating overhead (%)	6.1	6.7	6.8	8.2
Spread/fee yield on earning assets (%)	8.7	7.4	9.2	10.3
Return on assets (ROA):				
Gross (%)	2.2	0.8	2.1	2.2
Net (%)	1.6	0.4	1.6	1.7
Capital adequacy (%)	11.1	11.5	7.5	11.6
Self-capitalization capacity (%)	-1.3	-1.7	-1.4	-1.9

Source: ???

20. Another perspective on the issue of whether the high concentration that can emerge from aggressive consolidation, particularly in small banking markets, is given by comparing bank performance by country, as in Table 6.4b. What is clear here is that Estonia—where one bank now accounts for more than half of total banking sector assets and extracts significantly higher returns than its competitors—actually has a lower average weight of operating overheads and extracts lower overall spread and fee yields than do the less concentrated Latvian and Lithuanian banking markets.

Table 6.4b. Performance by Country

	Baltic Average	Estonia	Latvia	Lithuania
Number of banks in sample	35	4	21	10
Market share end-2000 (%)	93	18	46	29

Change since 1998 (%)	n/a	0	4	5
Efficiency of asset deployment (%)	91	109	99	91
Weight of operating overhead (%)	6	5	7	7
Spread/fee yield on earning assets (%)	8	7	9	9
ROA				
Gross (%)	2	2	3	2
Net (%)	1	2	2	1
Capital adequacy (%)	10	15	9	11
Self-capitalization capacity (%)	-1	0	-2	-2

Source: ???

21. Offsetting some of the concentration and market power concerns is the rise of Hansa Group, a truly regional champion bank (ironically based in the smallest of the three Baltic economies). This banking group offers a full range of financial services, extending well beyond traditional banking to include insurance, leasing, fund management, and investment services. Its balance sheet equaled US$3.25 billion in 2000 (more than US$4 billion now). This would have ranked it number two in Hungary (at about half of OTP's size and 1.5 times the size of the next largest Hungarian bank); and number 10 in Poland (ahead of Bank Zachodni and just behind Kredyt and BRE). Perhaps the most striking comparison is with Russia—a country with 100 times Estonia's population but only two larger banks (Sberbank and Vneshtorgbank)—where Hansa Group would rank ahead of all the "large" private banks.

The First, Crisis-Driven Consolidation Phase

22. The earliest consolidation period in all three Baltic states was driven by each country's banking crisis—in Estonia in 1992, Latvia in early 1995, and Lithuania in 1995–1996.[5] As already noted, all three crises involved banks representing about 40 percent of total banking system assets. In the cases of Latvia and Lithuania the leading private banks failed the most spectacularly.

23. In all three countries the banking crises had a multiplicity of causes (some systemic in nature) and each had been working on the banking systems' fabric for many months or even years. In all three countries private banks were primarily involved in the crises. In each country, different events led to the crises and different triggers brought them to a head. A number of specific factors were also at play in each:

- In Estonia, the proximate cause was the freezing in Moscow of the assets of two important banks, coupled with the drying up of cheap Bank of Estonia credit, which had previously endowed Estonian banks with significant profits and liquidity. The crisis was ultimately triggered by liquidity difficulties.
- In Latvia, the proximate cause was the drying up of highly profitable trade-financing opportunities to and from Russia and general mismanagement and corruption in bank operations (particularly evident in Bank Baltija). The crisis' trigger was Bank of Latvia's requirement that banks be audited properly, using IAS principles. A liquidity squeeze ensued as doubts about the solvency of several banks grew.

[5] This section merely summarizes the three crises, which are covered in greater detail in Fleming, Chu, and Bakker, "The Baltics—Banking Crises Observed," World Bank Policy Research Paper 1647, September 1996.

- Banks in Lithuania, as in Latvia, suffered compressed profits due to the contraction of lucrative trade financing opportunities. An additional factor in Lithuania, however, was the government's role in pressing some banks (both state-owned and private) to finance quasi-fiscal expenditures. Th trigger in this case was leaked results from on-site examinations of two banks, which led to runs on each bank and liquidity shortages.

24. All of these crises served to tighten banking regulation and supervision and encouraged the authorities to be less lenient in tolerating poor banking performance. Moreover, a better balance was established between the resources available to supervise banks in these small countries and the number of institutions to be covered. The crises also dramatically improved average bank management quality in each country, creating clear leaders in each:

- In Estonia, Hansapank, Uhispank and Hoiupank emerged, each with 15–20 percent of total banking sector assets, while three smaller banks (ESTIB, Forekspank, and Tallinapank) each took about 5–7 percent of the market by 1997. Not all of these banks were strong enough to survive the double blow of the Asian and Russian crises, but in the years between 1993 and 1997 they brought significant competitive dynamism to the market. The seeds of Hansa's ultimate dominance were laid early after the first wave of consolidation; it quickly established an ability to earn an extra 2–3 percent in spread/fee yield on earning assets over its major competitors despite carrying the same or slightly lower operating overheads. Hansa also took a strategic stake alongside EBRD in Hoiupank, the former state savings bank, which ultimately became the platform for Hansa absorbing that bank and establishing its dominant market share.
- In Latvia, the two big banks that still compete for top position, Parex and Unibanka, emerged as clear leaders (with Rigas Komercbanka and Rietumu as strong followers), but themarket shares of these banks were much lower than their Estonian equivalents (13 percent each for the top two and just over 8 percent each for the second two). As in Estonia, a vibrant second tier also appeared, not all of which emerged from the Russian crisis in strong condition (indeed, some failed) but in the intervening two years they added a significant competition element.
- In Lithuania, the situation that emerged after the 1995–1996 crisis was similar to that in Estonia. Two strong private banks emerged—Vilnaius and Hermis—sharing 20 percent of the market between them but both behind the two large remaining state banks (LTB, the savings bank, and LZUB, the agricultural bank[6]), with a third of total banking sector assets between them. LTB could compete with Vilnaius and Hermis, partly because of its dominance in the fast-growing household deposit market, but the agricultural bank stagnated due to a protracted privatization. A vibrant second tier also emerged, all of which survived the immediate impact of the Russian crisis because strong regulation largely kept them out of investing in Russian government securities –GKOs - and the like.

25. At this stage it is already possible to draw the conclusion that the three crises, despite their very serious magnitude, actually ended up strengthening the Baltic states' banking systems.

[6] In fact, a third state bank, the State Commercial Bank, also survived into 1997 but was so weakened by bad debts that its liquidation probably represents the close of the 1995–1996 crisis.

The Second, Market-Driven Consolidation Phase

26. Through the mid-1990s the first signs of *market-driven* consolidation began to emerge and with two exceptions—the rescue of Latvia's Rigas Komercbanka and Estonia's Forekspank after the Russian crisis—the state was no longer directly involved (although it did provide some impetus through a gradual approximation to EU minimum capital standards).

27. In Estonia Hoiupank absorbed the former state industrial bank explicitly to buy assets to deploy its burgeoning deposit base and utilize growing capital. Hansa established a bridgehead in Latvia by buying first the fifth-ranked Deutsche Lettische (which had emerged solvent but weakened from the 1995 crisis) and about one year later the ninth-ranked Zemesbanka.

28. By 1997 Hansa's arms-length strategic stake in Hoiupank no longer was tenable. Swedish investors were beginning to enter the market and EBRD involvement was no longer really needed. The situation became more fluid during the liquidity squeeze that followed the Asian crisis in autumn 1997, and various unauthorized Hoiupank management share dealings played into Hansapank's hands. The end result was that Hansa "merged" with Hoiu to take about half the market, while at the same time Uhis acquired Tallinapank to take about a third of the market. The re-positioning of the Hansa-Hoiu shareholdings was taken as an opportunity for EBRD to sell out to Swedbank, which then followed through with a full bid for the combined Hansa-Hoiu Group. The role of foreign capital is discussed in more detail later but at this stage could not be said to have driven consolidation. Rather it closed out the process in Estonia. The Russian crisis one year later triggered the completion of the process, with ESTIB taking over the larger but compromised Forekspank with state support before the combined group was privatized as Optiva in 1999 and sold to Sampo Group of Finland in 2000.

29. This market dimensions of this process are best illustrated by looking bank by bank at positions before 1997. Winners and losers clearly emerge in Table 6.5 when Hansa is compared to all other banks apart from Hoiu. (It is not clear that the latter should have been taken over on economic grounds, although the corporate governance problems that triggered its loss of independence were serious.)

Table 6.5. Estonian Banks 1994–1998

	Hansa	Hoiu	Uhis	Tallina	ESTIB	Foreks
Market share (%)						
End-1994	20	14	16	6	. .	2
1996	24	19	16	9	5	7
1998	52	. .	33	. .	8	. .
Operating efficiency in 1997 (%)						
Efficiency of asset deployment	107	109	99	111	109	115
Weight of operating overhead	5	5	6	9	1	6
Spread/fee yield on earning assets	13	10	10	12	6	12
ROA (%)						
Gross	7	6	4	3	4	6
Net	5	3	3	1	3	4

Source: ???

30. The Russian crisis also stimulated a further wave of consolidation in Latvia, with one mid-sized bank that dealt primarily with offshore Russian customers being allowed to fail and a

number of small banks disappearing because they failed to meet tightening minimum capital requirements. The crisis also severely compromised Rigas Komercbanka—number three in Latvia's banking system—which was rescued only with central bank support. The bank was rehabilitated partly by converting its larger deposits into equity and ultimately through its sale to Norddeutsche Landesbank. Its share of the Latvian banking market has diminished sharply, from 8–9 percent pre-crisis to just 2.5 percent in 2000 (although 2001–2002 data suggest some recovery). Rietumu, the other major medium-sized bank to emerge from the first consolidation wave, also lost share after 1997. In contrast, Hansabanka gained share rapidly, and by 2000 the top three banks had gained their dominance organically rather through acquisition to stand at 20 percent for Pareks, 17 percent for Unibanka, and 14 percent for Hansabanka.

31. As already noted, the Russian crisis had very little effect on Lithuania, but by 1999 competition between Hermis and Vilnaius had reached the point where the former was no longer strong enough to hold share. Hermis had lost is cost advantage over Vilnaius, was earning a significantly lower spread/fee yield on its assets, and its net margin on total assets had disappeared. Perhaps most significant, Hermis had lower capitalization and its growth was reducing its capital adequacy faster than at Vilnaius, even though the latter was the faster-growing bank. The Vilnaius takeover of Hermis for shares was very much domestically driven, and although SEB took control of Vilanius not long after, as in Estonia, this should be seen as closing out a domestically led consolidation. The result was a bank with nearly 40 percent of the market and a clear cost and profitability advantage over nearly all of its home-market competitors.

Baltic Bank Consolidation and the Role of Foreign Capital

As already noted, the infusion of foreign capital into the Baltic banking system rounded off what was already an effective, locally driven consolidation process. Its greatest contribution probably has been cross-border consolidation, but the approaches chosen differ very markedly among Swedbank, SEB, Sampo, and Norddeutsche Landesbank:

- Swedbank first took stakes in Hoiupank and through merger, Hansa around 1997 and by 1998 controlled the whole Hansa Group. Hansa had already funded the acquisition of a significant presence in the Latvian market, but Swedish capital almost certainly helped sustain a very rapid organic growth strategy that consumed a considerable amount of capital. Hansa also opened a modest startup operation in Lithuania in 1999, but Swedish backing must have been important to the acquisition of the re-privatized state savings bank LTB. Swedbank through Hansa now has about one-quarter of that market, and a rapid rehabilitation program is under way to bring performance indicators (particularly cost) in line with Hansa group standards.
- By contrast, the other three major foreign investors, SEB, Sampo, and Norddeutsche, all bought directly into each of the Baltic markets. SEB gained control of Uhis in 1998 and Vilnaius in 2000. Sampo bought two specialist state investment-type banks which were necessarily quite small but growing fast. Norddeutsche has gone for two large retail banks in Latvia and Lithuania, both to some degree troubled (particularly in the case of Rigas Komercbanka, now rebranded as Pirmabanka). Such a strategy is inevitably long-term in nature, but as already noted the Latvian investment is beginning to show a return and strong growth.

- Vereinsbank opened a Riga branch in 1997 and converted its Vilnius representative office to a branch in 2001. The Riga operation definitely made a significant competitive impact—rapidly picking up 3–4 percent of the market to match many mid-tier banks—but market share seems now to be slipping a bit.

Box 6.1. Bank Consolidation and SME Finance in Estonia

The SME Market

SME development is at a high level in Estonia. SMEs accounted for approximately 50 percent of GDP in 1999, not including sole proprietors' output. (As of January 2001, 15,577 sole proprietors were listed in the Commercial Registry, representing slightly under 25 percent of the total 65,650 entities registered.) SMEs also employed approximately 51 percent of the working population in 2000.

The Estonian government historically has taken a laissez-faire attitude toward SME development. However, the government indirectly facilitated SME development by aggressively pursuing a privatization strategy that resulted in 90 percent of GDP being produced by the private sector as early as 1995. SME development has become a more prominent issue recently, however, in part because of concern that SMEs could be harmed by EU accession. SMEs are also being recognized as a possible regional development tool. As a result, an SME Advisory Council to the Ministry of Economic Affairs was recently created and, in 2001, several agencies were united to create Kredex, an agency whose functions include facilitating SME finance.

According to the Ministry of Economic Affairs, the main constraints to SME growth are limited finance, particularly for startups; inexperienced labor and management; and the excessive burdens of registration and licensing, in addition to changing tax policies.

Lending

No official statistics are kept on SME lending, although there is information on SME deposits. As of end-2002, SMEs held a total of 165,000 bank deposit accounts, with total account balances of 28 billion EEK. Non-SME companies (larger companies) had a total of 700 accounts, with balances of 7 billion EEK. Although the average deposits of large companies are much larger—1 million EEK compared to 170,000 EEK for SMEs—the sheer number of SME accounts underscores this market's importance to the banks.

The responses of Estonia's two largest banks reflect this sector's attractiveness. Hansabank's 2001 objectives include focusing on SMEs (and affluent private clients) as the second of a list of seven objectives. As of end-2000, Hansabank had 58,000 SME clients. Eesti Uhisbank developed the Vitamin product in 2002 in conjunction with Kredex; this product enables SMEs to obtain finance without collateral, provided that equity accounts for at least 20 percent of the company's balance sheet. In addition, Kredex provides a partial guarantee.

Conclusions

Estonia's small size introduces complications into SME market analysis; a small country with a small domestic market would be expected to have a large number of SME companies. Furthermore, it would be difficult for a bank to grow by focusing only on the larger company sector, especially since this sector accounts for only 700 deposit accounts and is therefore clearly quite small. However, this argument does not apply for the foreign investors in Estonia's two largest banks; these investors have a regional perspective and could have chosen to focus just on a particular sector, such as Estonia's blue chips or the consumer market. Instead, however, their investee banks are actively pursuing the SME market. Therefore, Estonia is another case in which bank consolidation seems not to have harmed SME financing.

Source: Unless otherwise noted, information in this summary is from the Organisation for Economic Cooperation and Development (OECD), *Estonia Country Assessment*, Forum for Enterprise Development: Baltic Regional Programme, May 2002.

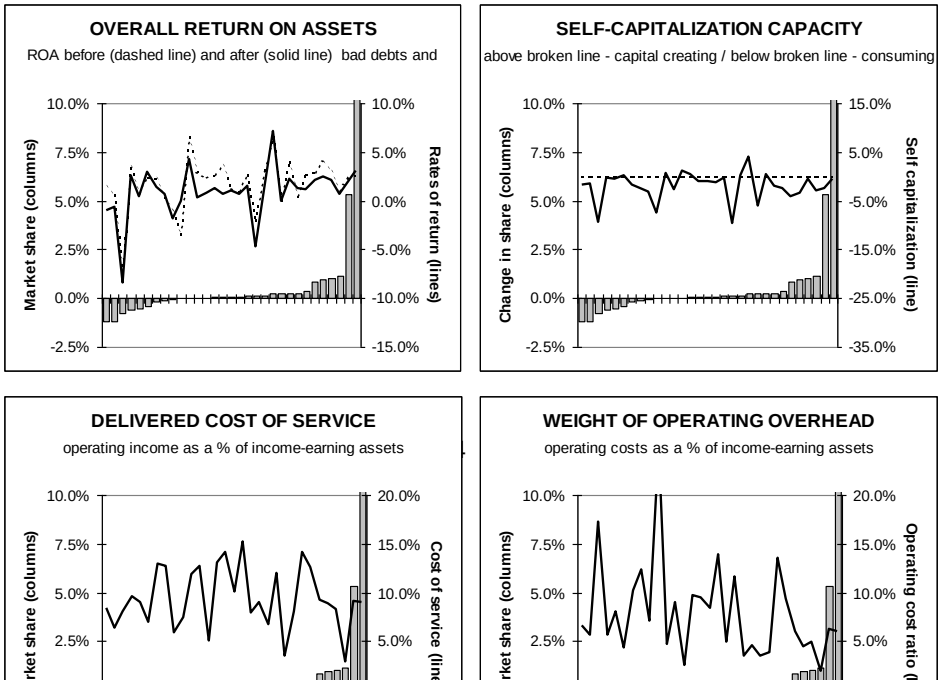
32. As for the future, the main driving force will be the stimulus of joining the European Union—all three countries are strongly committed to this and now have a fixed accession date. This stimulus manifests itself in two ways:

- A firmer commitment to financial sector legal, regulatory, and supervisory reform that has led to a firm trajectory for minimum capital (this has already served as a direct stimulus to consolidation in some cases). This has been combined with closer bank supervision and less tolerance for poor performance. The authorities have been more forthright in intervening quickly in problem banks.
- An already demonstrated openness to foreign banks' entry, as described above.

33. Estonia's banking sector is now very concentrated and dominated by the two Swedish-owned banks. Bank restructuring therefore appears to be complete, and the system's structure is likely to be stable from now on.. To a slightly lesser degree the same can be said of Lithuania, where some smaller and medium-sized banks will probably find themselves unable to continue generating enough capital to sustain market share. In Latvia the situation is more complex because of distortions arising from higher volumes of offshore banking activity for CIS clients compared to the other two Baltic states. The Latvian authorities are very sensitive to criticisms that the banking system remains too fragmented, and believe that smaller banks serve a purpose and, provided they are properly capitalized and managed, should continue to exist. Nevertheless, the level and pace of financial re-deepening is not as high as might have been expected for such a well-regulated banking system.This does point to some incompleteness in the consolidation process.

34. Overall, the consolidation process so far in the Baltic states has delivered the largest market share gains to banks that lead the market in terms of cost efficiency and as a result a superior ability to extract profits and build capital without having to charge excessive spread/fee yields on earning assets. This is shown in figure 6.2, which compares gains in market share on a pan-Baltic basis to various performance indicators. In these charts, the Hansa Group has been consolidated and its share gain includes the acquisition of Lithuania's LTB. The other foreign groups' investments are not consolidated as they are run more independently, as previously described.

Figure 6.2. Bank-by-Bank Performance Indicators Ranked by Market Share Loss/Gain



Conclusions

35. Some conclusions have already been drawn:

- Estonia recovered more easily from its early (1993) and very sharp crisis-driven consolidation than did Latvia and Lithuania from their similar but later crisis-driven consolidations; and
- A relatively strong conclusion is that the three first-phase crises, despite their very serious magnitude, actually ended up strengthening the Baltic states' banking systems.

36. Other conclusions are:

- Even where consolidation has created high levels of bank concentration, provided market power accrues to banks that lead the market in terms of cost efficiency and as a result a superior ability to extract profits and build capital without having to charge excessive spread/fee yields on earning assets, this concentration does not seem to undermine the market's overall efficiency; and
- Foreign capital is neither a necessary nor a sufficient condition to start an effective consolidation process, but foreign capital undoubtedly played an important role in consolidating earlier, locally driven consolidation in the Baltic states and now is almost certainly the driving force for pan-Baltic consolidation (an issue likely to gather more importance as EU accession approaches).

37. Overall, it would seem to be a fair appraisal that consolidation has worked well in the Baltic states, delivering reduced intermediation costs. This in turn has contributed to the financial re-deepening seen in these countries during the last decade. The authorities have shaped and facilitated this process but have not driven it. In Estonia and Lithuania the process of effective consolidation definitely has been fully internalized by market participants. Whether this is true in Latvia is less clear: the banks with the best performance indicators have a much lower combined market share (12 percent) than the other two countries' best banks (around 50 percent), but that share is rising. These conclusions are the basis for the Baltic states' positioning in the schema described in chapter 3.

CHAPTER 7 : POLAND

Introduction

38. The banking sector's consolidation and concentration in Poland have evolved out of the state's early focus on and general approach to banking sector privatization. Administrative initiatives led the process that ultimately led to consolidation. However, the state also established appropriate and credible incentives so that the market quickly internalized the process. The process is ongoing, and both privatization and banking sector consolidation are contributing to the desired outcome of increasing banking sector competitiveness. The bank merger and acquisition market is very active and the largest banks, which are those leading the consolidation process, are also the most profitable. These banks are also majority foreign-owned however, andthis is a source of political sensitivity.

39. Three key factors have contributed to the success achieved to date. The first was the state's ability to create a credible commitment to banking sector and overall economic privatization at the outset of the reform period. The second was Poland's firm intention to "rejoin" the West, bolstered by signing the Europe Agreement with the European Union in 1991 as a first step toward full EU accession. The third was active foreign bank involvement in the banking sector, also from the beginning of the reform period.

40. Poland is positioned in this study's taxonomy firmly in segment D (figure 3.1, middle right). This position reflects the authorities' proactive early involvement and the market's effective internalization of the consolidation process.

41. This case study is organized as follows. The second section briefly overviews the general aspects of Poland's economic situation that are needed to understand the banking sector. The third section outlines's the main characteristics of Poland's banking sector and summarizes recent financial trends. The fourth section discusses the nature of the crucial administrative measures taken to support consolidation during the past 10 years. The fifth section attempts to assess how these trends are likely to develop in the future. The final section offers key conclusions and recommendations.

The General Economic Background

42. Poland is one of the most successful of the central European countries in its achievement of transition to a market economy and also the first ECA country to resume growth after the disruptions of the late 1980s. GDP growth averaged 5.5 percent in the second half of the 1990s, and inflation, which was the early 1990s' predominant concern, declined to 3.6 percent by the

end of 2001. The Polish zloty was floated in April 2000 and has subsequently remained stable. The initially daunting external debt burden was reduced from more than 84 percent of GDP in 1990 to 38 percent of GDP by 2002. The private sector produces more than 70 percent of GDP, despite some delays in finalizing the privatization of state-owned enterprises .[7] At the same time Poland has been more successful than most European transition economies in achieving the emergence and growth of small enterprises.

43. Poland's most striking challenge is an unemployment rate nearing 20 percent, exacerbated by an economic slowdown that began in 2001. GDP growth fell to 1.1 percent in 2001 and is estimated at 1–1.5 percent for 2002. The factors behind this decline include a general slowdown in EU markets and a tightening of monetary policy that at one point resulted in real interest rates exceeding inflation by almost 10 percent. A growing budget deficit, expected to have reached 5 percent by the end of 2002, also causes concern in its own right and also because it restricts the government's options in addressing unemployment.[8]

44. The government's challenge is to resolve these problems while maintaining sufficient domestic political support for Poland to join the European Union, scheduled for 2004[9]. The labor unions and farmers are prominent players in Polish politics, as are the managers of the remaining SOEs. All have suffered from the economic slowdown, and some feel they have more to lose than to gain from EU membership. In an effort to address these issues, Finance Minister Kolodko introduced an "anti-crisis" package in July 2002 that focused on reviving the economy and reducing unemployment.

The Banking Sector

Overview

45. The most striking characteristic of Poland's banking sector, as shown in Table 7.1, is the dominant share of foreign-owned banks. As of the end of 2001, 46 of Poland's 71 banks[10] were controlled by foreign investors. These banks accounted for 80.2 percent of banking sector capital and 69.2 percent of banking sector assets.[11] Not only are the foreign banks the largest by size, but Pekao, purchased in 1999 by UniCredito Italiano, is considered to be the pacesetter in terms of overall performance.

46. A second characteristic is that direct state ownership of banks has been reduced so that today only two important commercial banks involve some state ownership—PKO, the savings bank, and BGZ, formerly the agricultural bank and now effectively the bank for cooperative banks. The third directly state-owned bank, Bank Gospodarstwa Krajowego (BGK), is a smaller bank founded in 1924 and is now used to service state debt issues and finance state construction and transportation projects. As of the end of 2001, the three directly state-owned banks accounted for 21.3 percent of banking sector assets and 10.6 percent of banking sector capital.

[7] The Polish state still holds majority or controlling shares in companies that account for 17 percent of GDP and has divested itself of less than half of the initial portfolio. of state-owned enterprises."OECD Economic Surveys, 2001–02: Poland." (Paris: OECD, 2002), pp. 122–23.
[8] EU accession requires a maximum budget deficit of 3 percent of GDP.
[9] The referendum that supported entry was held on June 8th 2003
[10] Poland also has 642 cooperative banks, accounting for 4.5 percent of banking sector assets at end 2001.
[11] National Bank of Poland, "Summary Evaluation of the Financial Situation of Polish Banks, 2001," (Warsaw, May 2002) p. 7.

Four other banks that the Treasury indirectly control account for a total of 1.5 percent of banking sector capital.[12]

Table 7.1. Banking Sector Market Share, End-2000

	Ownership (%)	Assets (%)	Loans (%)	Deposits (%)	Equity (%)
1. Pekao S.A.	UniCredito Italiano, 53.2	16.2	15.46	18.17	15.82
2. PKO BP	State-owned	16.0	14.16	22.49	6.94
3. BPH PBK*	Hypovereinsbank, 71.1	10.0	10.21	10.65	13.7
4. BZ WBK*	Allied Irish Bank, 70.5	5.25	4.91	6.23	5.79
5. Bank Handlowy	Citigroup, 87.8	4.87	5.19	3.66	8.9
6. Bank Slaski	ING, 74.7	4.49	5.42	4.94	4.65
7. Kredyt Bank	KBC Belgium, 76.5	4.39	5.77	5.29	3.58
8. BGZ	State owned	4.23	4.22	4.56	2.49
9. BIG Bank Gdanski	Banco C'l Portugues, 42.8	4.22	3.18	4.53	4.6
10. BRE SA	Commerzbank, 50	3.76	3.36	2.79	5.8
Other banks		42.79	43.58	34.85	43.54
Total banking sector, US$ 000		13,892,643	48,519,000	66,618,073	8,556,430

Source: Hubert Kulikowski, "Polish Banking Sector: EU Convergence Play," Fox-Pitt, Kelton, March 4, 2002, excerpts from figure 38, p. 40. Ownership information is from John Gibling and Alise Ross, "Bank Industry Risk Analysis: Republic of Poland," Standard & Poor's, June 19, 2001, Table 2, p. 5, as well as from the text of the Kulikowski article. Note that the ownership information is updated from 2000 to include the merger of BPH and PBK and the merger of Bank Zachodny and WBK. Note also that this table does not reflect the merger of Bank Handlowy with Citibank's Poland operations. The exchange rate is 4.1432.
*Figures are pro forma.

47. It had been expected that the anticipated PKO and BGZ privatizations would generate further merger and acquisition activity. However, in June 2002 the government announced that the Treasury would retain a controlling stake in both banks. With most of the Polish banking sector foreign-owned already, it is not difficult to understand the political reasoning that led the government to its decision. Foreign investment has proven to be a sensitive topic prior to the referendum on European Union accession in(June 2003), particularly in the context of Poland's high unemployment rates. It now seems likely, as a result of these considerations, that a minority PKO share will be sold through a public offering aimed at the general public—not to a strategic shareholder—while a minority share in BGZ might be offered to the cooperative banks. Both PKO and BGZ are undergoing restructuring prior to these partial privatizations, which are scheduled to begin in 2003.[13]

48. A third important sector characteristic is that 16 Polish banks, representing 42.8 percent of total authorized banking capital as of the end of 2001, are listed on the Warsaw stock exchange. These banks accounted for 42.6 percent of the exchange's year-end 2001 capitalization. This figure increased from 27.4 percent in 2000 as a result of banking sector merger and acquisition activity.[14] This high proportion of bank listings makes an important contribution to the sector's overall transparency.

49. As regards bank consolidation and concentration , Table 7.2 shows the evolution of the sector's concentration since 1996. While concentration has increased, the extent of that change in

[12] NBP, "Summary," p. 6
[13] Andrzej Rataczyk, "No Strategic Investor," *The Warsaw Voice*, online version, June 23, 2002.
[14] NBP, "Summary," p. 9.

bald statistical terms has been quite limited. However, the changing ownership structure of many of the largest banks is not adequately revealed by these summary data: in fact the ownership structure has changed considerably during this period. Most notably, of the 87 banks that existed in 1993, 29 had a majority public-sector ownership structure. As of 2001, only 7 of Poland's 71 banks have majority public sector ownership.[15]

Table 7.2. Concentration (%)

	Total assets	Deposits	Loans
5 largest banks			
— 1996	48.8	52.3	43.8
— 2001	51.0	55.5	47.9
15 largest banks			
— 1996	78.2	81.8	76.5
— 2001	81.9	85.0	80.8

Source: Excerpted from NBP, "Summary," Table 10, p. 30. Bank size is measured on the basis of total assets.

50. Table 7.3 indicates that the overall concentration of the sector can be considered to be quite low (HHI < 0.10), except for deposits, where it would be considered moderate (HHI < 0.18). One characteristic that should be noted, however, is that Pekao and PKO together account for more than 40 percent of the system's deposits.[16]

Table 7.3. Hernfindals Hirschman Index (HHI)

	End-Dec 2000	End-Dec 2001
Deposits	0.1017	0.1012
Loans	0.0648	0.0680
Total assets	0.0705	0.0786

Source: NBP, "Summary," pp. 10–11, including excerpts from figure 3.

51. To conclude this brief overview of the structure of the Polish banking sector, Table 7.4 provides an ownership and size-based categorization of the banks.[17]

Table 7.4. Banking Sector Categorization

	Description	No.	% of BSA (approx.)
Group One	Large, foreign-owned universal banks	8	37
Group Two	State-owned banks	7	22
Group Three	Medium-sized, foreign-owned banks	36	32
Group Four	Small, specialized, Polish-owned banks	20	4
Group Five	Cooperative banks	64218	5

Source: Bednarski and Osinko (as above), the NBP Summary Evaluation (footnote 11) and author estimates.

[15] NBP, "Summary," p. 21, Table 1.

[16] PKO has 1,000 branches and 1,000 agencies, accounting for approximately 15 percent of the sector's branch network. Pekao's branch network is the second largest and accounts for approximately 10 percent of the network.

[17] This categorization is based on, but does not exactly follow, Piotr Bednarski and Jacek Osinski, "Financial sector issues in Poland," in Christian Thimann, editor, *Financial Sectors in EU Accession Countries*, European Central Bank, July 2002. The authors are employees of the National Bank of Poland.

[18] All but one cooperative bank is affiliated with a larger commercial bank. It is anticipated that mergers among the affiliated banks will ultimately result in three cooperative banking groups. During 2001 the number of cooperative banks dropped from 680 to 642, largely as a result of mergers and acquisitions. The minimum capital for cooperative banks will increase to euro 500,000 at the end of 2005, from its current level of euro 300,000.

Financial Overview

52. The following discussion of financial performance in Poland's banking sector notes the trends toward increased intermediation; a general decline in net interest margins and overall profitability, countered by a search for other revenue sources and efforts to reduce costs; and growth in capitalization levels.

53. Table 7.5 shows that Poland's banking sector has shown a steady increase in intermediation levels, as measured by the ratio of banking assets to GDP. There is a generally high level of confidence in the banking sector as a whole, bolstered by sustained economic stability and an effective deposit insurance program. These have encouraged a steady growth in funding provided to the banks. For example, between 2000 and 2001, corporate and retail deposits rose by 13 percent.[19]

Table 7.5. Intermediation

	Banking assets/GDP	Loans/banking assets
1993	n/a	30.1
1994	n/a	27.7
1995	48.8	29.6
1996	51.1	34.2
1997	52.8	37.7
1998	58	37.5
1999	59.4	41.5
2000	62.5	41.1
2001	66.1	38.9

Source: NBP, "Summary," excerpts from Table 11, p. 31, and Table 42, p. 50.

54. The loans/assets ratio tells a slightly different story. This ratio increased until 1999 but then fell off as the economic slowdown led to increased loan loss provisions as well as a cutback in lending. ("Loans" here exclude loans to the government and to financial institutions and loan loss provisions.) While this response is to be expected, it is noteworthy that the ratio was relatively low even before the cutback: the 41 percent ratio in Poland in 1999 compared to say, Kazakhstan's 59 percent.[20] One possible explanation for this relatively low rate is the high merger and acquisition activity that Poland experienced during the past few years. The costs of absorbing these substantial ownership changes (see below) may account in part for the low lending ratio. A related explanation could be that the foreign ownership of most Polish banks has led to a conservative approach to loan portfolio growth.

55. The impact of Poland's economic slowdown can also be seen in Table 7.6, which shows the growing ratio of problem loans to total loans. The increase in the proportion of "loss" loans is also noteworthy. It should be noted, however, that part of the increase in problem loans is due to a new loan rating system introduced in 1999. In some cases this system is stricter than standard international practice.[21]

[19] NBP, "Summary," from Table 27, p. 40.

[20] In Russia, for example, the loans/banking assets ratio is 48 percent, while in Kazakhstan it is 59 percent. (These figures are taken from the Russia and Kazakhstan case studies. The Kazakhstan figure is for a group of banks representing the majority of the banking sector.)

[21] For example, loans guaranteed by the state or international parent companies are still rated nonperforming if the

Table 7.6. Loan Quality

	Problem loans/ total loans	Loss/total loans
1997	10.2	5.2
1998	10.5	4.7
1999	13.3	4.8
2000	15.0	5.5
2001	17.6	8.1

Source: NBP, "Summary," excerpts from Table 23, p. 36.

56. Net interest margins (NIMs) have been declining in Poland, both as a result of competition and larger loan loss provisions (see Table 7.7). It is anticipated that ongoing competitive pressure will continue to shrink these margins and that they will eventually approximate the EU average of less than 2 percent. They are already very much lower than those of most banks in the other countries included in this study.

Table 7.7. Net Interest Margins (NIMs)

1998	4.04
1999	4.68
2000	4.03
2001	3.31

Source: NBP, "Summary," excerpts from figure 9, p. 17.

57. The banks are responding to falling net interest margins in five ways. First, they are seeking less expensive funding, in particular by expanding their retail outlets. Activity in this area includes more than 6,000 new automatic teller machines (ATMs) during 2001 alone.[22]

58. Second, banks are looking for higher-yielding loans, such as in the retail lending market. On average, Polish retail loans' yield is 280 basis points higher than corporate loans. Furthermore, although retail lending has increased at a compound average growth rate of 53 percent since 1995, retail lending in Poland is the equivalent of less than 1 percent of GDP, compared to the European average of 6 percent.[23] The search for retail business can also be seen in bank card (debit and credit) growth, which increased by 27.4 percent to almost 14.4 million during 2001.[24] Again, these are tendencies that are occurring far more rapidly in Poland than in most other Central European and FSU countries.

59. SME lending also has attracted attention as a higher-yield product; it now accounts for an impressive 52 percent of total lending. Both the cooperative banks, on one end of the spectrum, and large banks such as Pekao and PKO, on the other, lend to this sector. Kredyt Bank deserves particular note for building itself into a top-10 bank on a strategy focusing on SMEs.

borrower's condition deteriorates. Alise Ross and John Gibling, "Rollercoaster Ride Envisaged for Polish Banks," Standard & Poor's, February 27, 2002, p. 6.

[22] NBP, "Summary," p. 6

[23] Kulikowski, pp. 19, 24, 30, 32.

[24] NBP, "Summary," p. 6.

60. A third response to declining NIMs has been to focus on increasing non-interest income (NII). For the five listed banks covered by brokerage firm Fox-Pitt, Kelton, NII accounted for 56.2 percent of total income in 2001. Approximately one third of the NII came from trading on the banks' own account. These results resemble those of banks in developed market economies.

61. A fourth response to falling loan revenue is to expand into other financial markets. According to Fox-Pitt, Kelton, most Polish banks have a link with a domestic or international insurer, and most of the major listed banks have introduced some mandatory coverage bundled with their products. Banks also control approximately 9.5 percent of Poland's pension fund assets, with BIG Gdanski and Pekao playing the most prominent roles. BIG Gdanski is also active in the leasing market, as is BRE.[25]

62. Reducing costs is a fifth response to shrinking margins. Table 7.8 highlights the striking performance of Pekao, which, following the 1999 UniCredito investment, implemented an efficiency improvement program that included an approximately 28 percent reduction in staff. As of the end of 2001, Pekao's cost/income ratio had fallen to 50.6 percent, from 70.1 percent in 1999.

Table 7.8. Cost/Income Ratios

	1998	**1999**	**2000**	**2001**	***2002 est.***
Pekao	66.7	70.1	60.0	50.6	*47.1*
BPH PBK	49.6	63.0	60.1	66.3	*59.5*
BZWBK	77.1	62.1	70.1	79.5	*68.7*
BIG BG	77.8	61.7	92.9	84.2	*73.6*
BRE	45.7	26.4	57.7	57.8	*53.8*
Average*	**63.4**	**58.5**	**66.4**	**63.4**	***57.2***
Europe avg.	**65.0**	**63.8**	**63.8**	**65.4**	***62.8***

Source: Kulikowski, excerpted from figure 30, p. 33.
* The average figures are for the five banks in the table.

63. Because of investments in automation and other infrastructure, the cost/income ratios of other banks' have in some cases increased rather than decreased. BIG Gdanski, BPH PBK, and BZWBK, for example, are all in the process of implementing restructurings similar to Pekao's. As the table shows, Fox-Pitt, Kelton, estimates that these investments will begin to be realized in 2002. For the five banks, the average cost/income ratio already was lower than the average 2001 European ratio, and it is expected to show further improvement in 2002. For the banking sector as a whole, staffing dropped 3.6 percent and average staff compensation increased only 1.3 percent in real terms.[26] Total employment in the Polish banking sector is now lower than in 1996.[27]

64. The net impact of these factors —increased loan loss reserves, shrinking margins, and future cost savings investments—had an inevitable impact on the sector's overall 2001 profit performance. Banking sector ROA declined from 1.1 to 1.0, while ROE declined from 14.5 to 12.9.[28]

[25] Information on NII and product diversification is from Kulikowski.
[26] NBP, "Summary," p. 17.
[27] NBP, "Summary," p. 6.
[28] NBP, "Summary," p. 17.

65. On a more positive note, the capitalization of the Polish banking sector grew by an impressive 23 percent in 2001. (It should also be noted that the increased capital contributed to the ROE decline, as the banks did not have a full year to put their additional capital to work.) Approximately 10 percent of the capital increase was due to the allocation of earnings to capital. In addition, 19 banks issued new shares, while several others obtained subordinated loans and two new banks began operations. As a result of these and other factors, average risk-based capital rose from 12.9 percent to 15 percent as of the end of 2001.[29]

66. This overview of financial trends in the Polish banking sector provides a preliminary indication of the success of the Polish government's privatization strategy. Not only is the banking sector now majority privately owned, but these private owners have made their sector competitive, as demonstrated by intermediation growth, decreasing net interest margins, efforts to expand revenue sources and reduce costs, and healthy capitalization levels. As will be discussed below, there also has been active merger and acquisition activity, as the banks seek to optimize their market position.

The Administrative Push to Banking Sector Consolidation

67. Poland has been relatively successful in creating an administratively-initiated consolidation process that the market has then sustained. This section explains the relevant steps the authorities took to achieve this success.[29]

68. Poland initiated banking sector reform, as well as its overall economic reform program, in 1989. At that time the Polish banking sector consisted of 7 state-owned banks[30] and 1,663 small local cooperative banks affiliated with Bank Gospodarki Zywnosciowej (BGZ), one of the state-owned banks. The initial banking reform program had three elements. First, nine state-owned banks were created from the National Bank of Poland's (NBP's) 400 branch offices, as the first step toward these new banks' ultimate privatization. Second, the 1989 Banking Act enabled the creation of new, privately owned banks. Third, tax incentives were introduced to encourage foreign banks to operate in Poland.

69. The reforms achieved an almost immediate impact in increasing the number of Polish banks and creating a more varied ownership structure. In addition to the 9 new state-owned banks, 70 new Polish-owned banks opened during the next three years. Seven banks with majority foreign ownership also opened in Poland, the first in December 1989. However, most of the new banks were relatively small, and as of early 1993, state-owned banks continued to account for approximately 85 percent of total banking sector assets.

70. Particular attention focused on ensuring that the nine new state-owned banks would become attractive privatization candidates. Although owned by the Ministry of Finance, each newly created bank was assigned an independent supervisory board in an attempt to create an appropriate corporate governance structure. It was also made clear to the banks that privatization was a near-term reality, with WBK Poznan and Bank Slaski first on the privatization schedule.

[29] NBP, "Summary," pp. 13–14.

[30] Bank Handlowy, the foreign trade bank; Pekao, the retail foreign currency exchange bank; BGZ, the cooperative bank serving the food and agricultural ministry; PKO, the retail bank; BGK, a bank of limited operations established in 1924; BRE, a foreign trade bank established in 1987 by several Polish ministries, banks, and state-owned enterprises; and Lodzki Bank Rozwoju, a regional bank also established in 1989. (The Banking Act of 1982 allowed for the creation of new banks.)

And as an important part of the process, the World Bank established a Financial Institutions Development Program (FIDP) in 1991, under which foreign banks partnered with the nine new banks to help with overall institutional strengthening. The program also gave the partnering banks a hands-on opportunity to consider developing longer-term partnerships, including taking ownership stakes. The twinning program proved invaluable in introducing foreign expertise at an early stage in the development of Poland's banking system.

71. There were also several other related developments in the early 1990s. In December 1991 Poland signed an agreement with the European Union (effective in 1994), outlining a 10-year period during which Poland would bring its legal system and economic policies into line with EU requirements. Economic growth resumed in 1992, making Poland the first ECA country to recover from a transition-induced recession.[31] These two developments enhanced confidence that the government's policy measures were bearing fruit.

72. As for banking, the minimum capital level was raised from 2 million zloty to 7 million in the second half of 1992. The criteria for calculating capital were tightened as well, including making borrowed funds ineligible. Second, a new chart of accounts, compatible with that of the European Community, was introduced.[32] Third, banks were allowed to fail, demonstrating that there would be no cushion for management errors. Finally, the NBP's supervisory capacity was enhanced.

73. However, in spite of this impressive range of policy measures, it was impossible for government bureaucrats from the former state banking system to become commercial bankers overnight. One problem was that the managers of state-owned banks did not cease lending to troubled SOEs, many of which were confronting severe government funding cutbacks.[33] As a result, by fall 1992 the banking sector's bad debts level had reached at least 20 percent of loans outstanding. The nine new state-owned banks held most of this debt, almost 70 percent of the US$7.5 billion in debt that had been extended to the SOEs.

74. Unique among all of the case-study countries, however, was the fact that the Polish authorities did not wait until the burden of bad loans had become a crisis. Instead they responded immediately to the growing problem. The government was able to do so because it had the US$1 billion stabilization fund that had been created to support Poland's currency reform but had not been used. The comprehensive Enterprise and Bank Restructuring Program (EBRP), introduced in 1993, had been designed both to strengthen the banks and enforce hard budget constraints on the SOEs.[34] The program covered seven[35] of the new state-owned banks on a mandatory basis, with the other banks having the option of using the program's debt resolution provisions.

[31] Poland also had the mildest recession in the ECA countries (6 percent over two years).

[32] Daniel Hogan, Elisabeth Rhyne, and David P. Dod, "Poland's Emerging Financial System: Status and Prospects," prepared for USAID. (Bethesda, Md.: Development Alternatives, Inc., August 1993) p. 1. Further progress was made with a new accounting act that was passed in September 1994.

[33] Subsidies to SOEs decreased from more than 16 percent of GDP in 1986 to 3.3 percent in 1992.

[34] For fuller descriptions and analysis of the program, see Cheryl W. Gray and Arnold Holle, "Bank-Led Restructuring in Poland: An Empirical Look at the Bank Conciliation Process," Policy Research Working Paper 1650, Policy Research Department, Finance and Private Sector Development Division, World Bank, September 1996, and Fernando Montes-Negret and Luca Papi, "The Polish Bank Experience with Bank and Enterprise Restructuring, Policy Research Working Paper 1705, Financial Sector Development Department, World Bank, January 1997. Note also that the general view of the program was that it was more successful in restructuring the

75. The principle characteristics of the EBRP programwere:

- It was an integrated program to (a) re-capitalize the banks and prepare them for privatization and (b) restructure the over-indebted enterprise sector.
- It introduced workable, streamlined procedures for restructuring problem loans, including out-of-court conciliation procedures managed by the banks and the option of converting debt to equity.
- The imposition of hard budget constraints on the SOEs was made credible by state warnings and up-front exclusion from the program of especially critical SOEs that eventually would have required exceptions.
- Banks were provided with incentives: (a) banks were enabled to retain loan recoveries above the estimated problem loan amounts[36]; (b) bank re-capitalization did not take place until the bank had taken concrete measures to restructure its loans; and (c) bankers were given the right to participate in their banks' ultimate privatization at preferred terms.

76. The privatization process was initiated while the EBRP program was still under way. The initial bank privatization strategy was based on three shareholders groups, each of which would hold approximately 30 percent in each privatized bank. Foreign investors were allowed an investment of up to 30 percent, although it was intended that they would play an active management role on the basis of a management contract. The state would retain approximately 30 percent, with the option of further divestments, and approximately 30 percent would be sold to the public.

77. The privatization process's first critical steps were:

- 1992: BRE, a state-owned bank predating the 1989 spin-offs, was sold by initial public offering (IPO) to individual investors.
- 1993: WBK Poznan was privatized by IPO, with the EBRD taking the foreign investor role.
- 1994: Bank Slaski Katowice was privatized by IPO, with ING Bank becoming the strategic investor. (Also in 1994 ABN Amro took over the troubled Interbank's operations.)
- 1995: BPH Krakow was sold by IPO to a diverse range of investors, while Polish enterprise BIG became the strategic investor in Bank Gdanski, also through an IPO. 1995 was also notable because of two second-generation investments: Allied Irish Bank took a stake in WBK Poznan, which had been initially privatized in 1993, and Commerzbank invested in BRE.[37]

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banks than in restructuring the enterprise sector.

[35] WBK and Bank Slaski were not covered by the program, because they were scheduled for privatization in the near term.

[36] In addition, the government agreed to step back from its position as senior creditor, did not play an active role in the debt restructuring process, and agreed to accept the debt reductions agreed to by other creditors.

[37] NBP, "The Nineties," Table 6, pp. 56–57.

78. Another important step in 1995 was the introduction of a comprehensive deposit insurance system. The program covers all deposits up to the equivalent of euro 1,000 and, as of 2002, 90 percent of deposits up to euro 17,000.[38] Although deposits in state-owned banks continued to be fully insured, this relatively high level of coverage helped level the playing field.

79. Using these various interventions in the first half of the 1990s, the Polish state successfully initiated a bank privatization and consolidation process. However, later actions also played a role in strengthening that process. In 1996, the authorities remained concerned that most of Poland's banks remained relatively small. In response to this concern, in 1996 the procedures for privatizing and consolidating state-owned banks were expanded by enabling state-owned banks to merge by creating banking groups. The holding company, which can also be a bank, must own more than 50 percent of the group's entities and must control more than 50 percent of each entity's votes at their general meetings. The group structure must last for at least five years and each group member must guarantee the other members' liquidity. One result of this new law was Pekao's 1996 merger with three smaller regional banks. These mergers laid the groundwork for Pekao's present status as Poland's largest bank.

80. In 1997, the ability to create group banks was further extended to include privately owned banks. A number of private sector banks took advantage of this opportunity, notably Kredyt Bank, the only bank in the current top 10 that began as a privately-owned Polish bank. Several foreign banks also used the merger legislation to make investments. A notable example is Citibank's 2001merger with Bank Handlowy. During this period the state also raised the minimum capital level to ECU 5 million (January 1998) and relaxed the 30 percent limit on foreign investment per bank. As a result of the latter move, 1999 was a turning point in banking development, with foreign ownership jumping to 72 percent of total assets in 1999, compared with only 46 percent at the end of 1998.[39]

Outcomes and Performance

81. These developments can be examined more systematically by examining the performance of 38 banks that in 2000 accounted for some 89 percent of total Polish banking assets. In figure 7.1, each bank's market share in total banking assets is plotted against various banking performance indicators.

[38] The upper limit will increase to euro 20,000 in 2003, in order to comply with EU norms. Ross and Gibling, p. 12.
[39] Michael Borish and Company, Inc., with Barents Group LLC/KPMG, "An Assessment and Rating of the Polish Banking System," a study prepared for the U.S. Agency for International Development, September 8, 2000, p. 118.

Figure 7.1. Size and Bank Performance in Poland (2000)

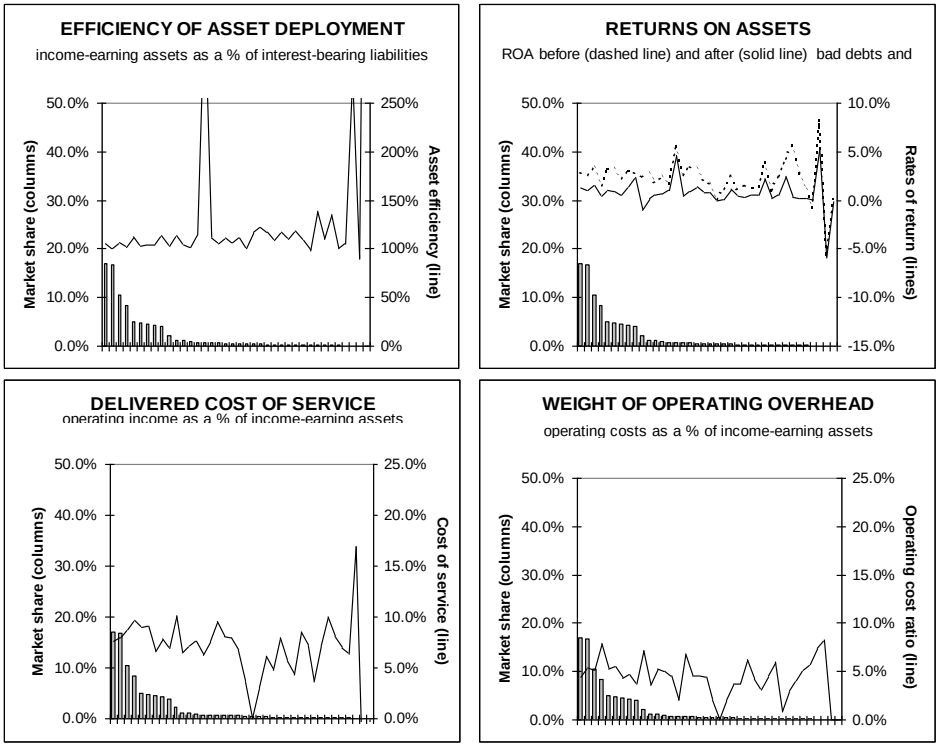


Figure 7.1 indicates generally efficient performance levels: around 100 percent of assets being productively employed in most banks; spreads typically lower than 10 percent; and operating cost ratios generally around 5 percent. These numbers are generally much better than the corresponding numbers in the other case-study CIS countries. However, they do not indicate any very systematic advantage in these performance dimensions for those banks having larger market shares. This absence is broadly confirmed by reviewing the numbers reorganized to separate the different bank ownership categories (see Table 7.9). The main point to note is the very limited difference in performance between the foreign and domestic Polish banks. The most visible difference is the foreign banks' slightly higher ROA and their slightly higher capital adequacy rates.

Table 7.9. Bank Performance by Type of Ownership

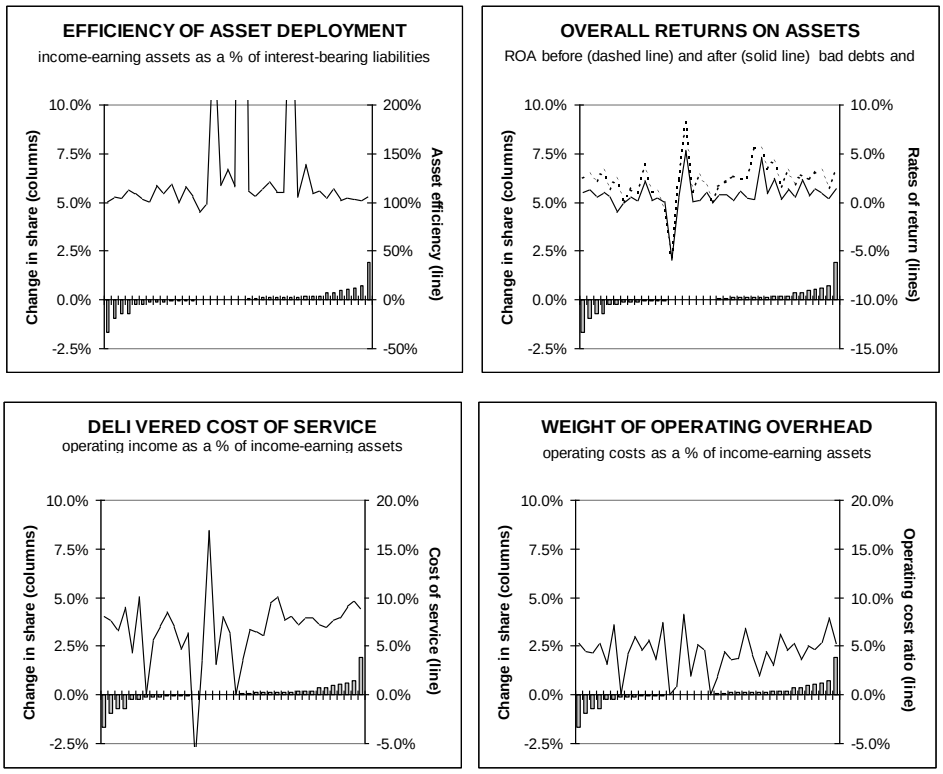
	Domestic Banks	Foreign Banks	Survivors From 1996	Exited Since 1996
Number of banks in sample	16	22	38	22
Market share end-2000 (%)	53	36	89	36
Change since 1998(%)	-6	5	30	5
Efficiency of asset deployment (%)	109	105	108	108
Weight of operating overhead (%)	5	5	5	5
Delivered cost of service (%)	8	8	11	13

ROA				
Gross (%)	2	3	5	6
Net (%)	1	1	3	3
Capital adequacy (%)	8	11	8	13
Self-capitalization capacity (%)	0	-1	0	-2

Source: Bureau van Dijk data

82. Figure 7.2 shows the same performance indicators as figure 7.1, but this time plots them against changes in market share during 1998–2000. Except for some good and bad banking performances in the middle of the distribution, these data also suggest a great deal of similarity between banks. The banks that have been the major market share gainers during this period do not appear to have had markedly better performance in the four key indicators than do the banks that were the worst market share losers. This suggests that at least during the period covered by our data sample, the Polish banking system had become highly competitive.

Figure 7.2. Changes in Market Share and Bank Performance 1998–2000



Future Developments

83. During 1999–2002 significant ownership changes have taken place in all eight of the majority foreign-owned banks that are included in Poland's 10 largest banks. However, despite

their being among the largest banks, their individual market shares are still relatively low, with the third-largest bank accounting for only 10 percent of banking sector assets. Therefore it seems likely that this group of banks will continue to generate merger and acquisition activity by buying smaller banks and merging with larger banks.[40] The fact that the shares of these banks are publicly traded also will facilitate an active merger and acquisition market.[41]

84. What is the likely result of such continuing consolidation activity? Table 7.10 separates the banks into four groups, representing 87 percent of banking sector assets as of the end of 2000:

- The two large state-owned banks;
- The eight large foreign-owned banks;
- Fourteen of the smaller foreign-owned banks, and
- Ten of the remaining Polish-owned banks (privately and publicly owned).

85. These results suggest that the group of large foreign banks is the most profitable, both in terms of net operating margin relative to total assets (defined as the difference between delivered cost of service and the weight of operating overhead) and average net ROA. It is also noteworthy that the large foreign banks achieve the highest level of revenue (spread plus fee income) per earning assets (8.6 percent), which more than compensates for their higher average costs relative to the other groups. The net result seems to favor the large foreign-owned banks. Therefore, a possible conclusion is that market share increases by this high-performing group of banks will continue to improve overall sector performance. The caveat is that the foreign banks' performance advantages do not apply equally to all the group's individual members. Considerable performance variation puts some of the foreign banks below some of the state banks and the other Polish banks. A second caveat is that even in terms of group averages, the performance differences between the foreign banks and the other groups is quite small (for example, 1.0 percent ROA versus 0.8 percent and 0.56 percent for the state and the other Polish banks respectively). These differences are not sufficiently pronounced to predict that any one group will dominate the others in future merger and consolidation activity.

86. This broad conclusion is reinforced by the evidence regarding the self-capitalization capacity. The banks that have gained the most in terms of market share since 1998 have reasonably sound capitalization levels (figure 7.3, upper right segment). But they have also shown some stress in their abilities to self-capitalize, both in absolute terms and relative to some other banks that have been less successful in building market share. This suggests again that there is no guarantee that the acquisitions and growth patterns seen through 2000 will continue in the future, but this may not matter given significant access to foreign capital and fully functioning domestic capital markets.

[40] For example, the 2002 BPH and PBK merger was the result of their parent banks (Bank Austria and Hypovereinsbank) merging.

[41] An important incident happened in 2000, when BRE's attempts to take over Bank Handlowy were thwarted by minority investors who considered the price too low. Bank Handlowy was subsequently acquired by Citibank for a higher price. Michael Borish and Company, Inc., p. 118.

Figure 7.3. Self-Capitalization Capacity

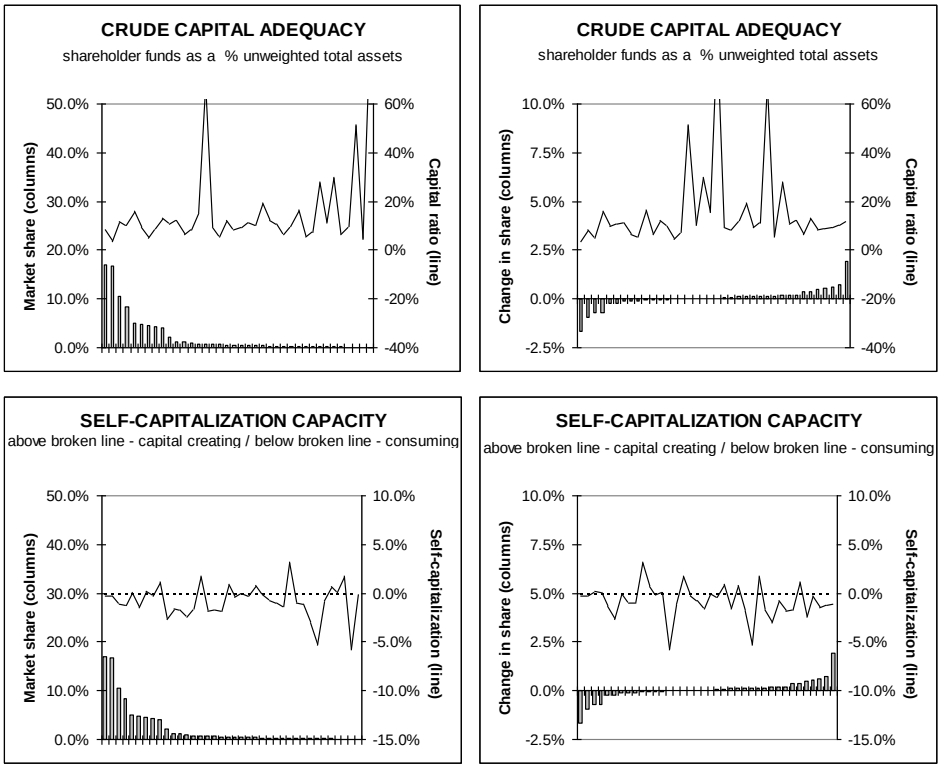


Table 7.10. Selected 2000 Financial Results (%)

	Share of 2000 Tota Ass./Liab	Av. Ne ROA	Delivered Cost of Service	Weight of Operating Overhead	Op. Margin /Earning Assets	Capital as % of Total Assets
PKO	16.8	1.0	8.0	5.3	2.7	4
Bank Gospodarki Zywnosciowej BGZ	4.4	0.6	6.6	4.3	2.3	5
Average for state-owned banks	11.6	0.8	7.3	4.8	2.5	4
Bank Pekao	17.0	1.2	7.6	4.4	3.2	8
BPH-PBK	10.5	1.5	8.7	5.1	3.6	12
BIG Bank Gdanski	8.4	0.4	9.6	7.9	1.7	10
Bank Handlowy w Warszawie	5.1	1.0	9.0	5.2	3.7	16
ING Bank Slaski	4.7	0.9	9.1	5.4	3.6	9
Kredyt Bank	4.3	1.3	7.9	4.7	3.2	9
BRE Bank	4.0	2.3	6.9	3.7	3.2	13
Bank Zachodni WBK	2.3	-1.0	10.1	7.2	3.0	11
Average for large foreign-owned banks	8.0	1.0	8.6	5.5	3.2	11
Raiffeisen Bank Polska	1.1	0.5	7.2	5.3	1.9	6
Fortis Bank Polska	0.8	0.7	7.6	5.0	2.6	8
Deutsche	0.8	1.1	6.3	4.6	1.7	16
GE Capital Bank	0.6	0.4	9.5	6.8	2.7	9
ABN Amro Bank (Polska)	0.6	0.7	6.7	4.4	2.2	8
Westdeutsche Landesbank Polska	0.6	0.8	3.6	2.0	1.7	9
American Bank in Poland Inc.	0.5	0.0	3.1	2.0	1.1	10
BNP Paribas Bank (Polska)	0.4	1.1	6.1	3.7	2.4	19
Rabobank Polska	0.3	0.5	4.4	3.1	1.3	10
Credit Lyonnais Bank Polska	0.3	2.2	8.5	4.5	4.0	16
Bankgesellschaft Berlin (Polska)	0.2	2.4	7.2	3.0	4.2	28
AIG Bank Polska	0.2	0.3	10.0	4.1	5.9	11
Nordea Bank Polska	0.1	0.2	8.1	5.1	3.0	30
Bank of America (Polska)	0.1	5.3	16.9	8.2	8.7	52
Average for smaller foreign-owned banks	0.5	0.7	4.6	2.7	1.9	17
Gornoslaski Bank Gospodarczy	0.6	1.0	8.1	4.5	3.6	6
LG Petro Bank	0.6	1.3	7.9	4.6	3.4	12
Bank Wspolpracy Europejskiej	0.3	0.4	4.7	3.7	1.1	12
Bank Inicjatyw Spoleczno-Ekonomicznych	0.3	0.3	7.9	6.3	1.7	11
Gospodarczy Bank Wielkopolski	0.3	0.5	5.6	4.2	1.4	6
Gospodarczy Bank Poludniowo – Zachodni	0.3	0.2	7.1	6.0	1.1	5
Bank Przemyslowy	0.2	0.5	3.6	0.9	2.8	8
Bank Unii Gospodarczej	0.1	0.2	6.9	5.7	1.2	6
Cuprum-Bank	0.1	0.0	6.4	7.4	-1.0	10
Bank Czestochowa s.a. w Czestochowie	0.0	-5.9	-6.7	0.0	-6.7	4
Average for other Polish-owned banks	0.3	-0.1	4.7	3.9	0.8	8

Source: Excerpts from Bureau van Dijk data.

Conclusions and Recommendations

87. Poland represents a case of an administratively initiated consolidation but with a twist: the state initiated banking sector privatization, which ultimately evolved into consolidation and

to some extent increased concentration. Poland also is a clear example of a case in which the market internalized the state's incentives and developed its own momentum in changing banks' ownership structure and performance parameters. The Polish case is particularly interesting because the market is also very dependent on entities controlled by foreign investors.

Box 7: Bank Consolidation and SME Finance in Poland

The SME Market

The Polish SME finance market is one of the best developed in the ECA region. .Poland has approximately 1.82 million active SMEs a figure that grew by 60 percent from end 1995 to end 2001.Polish SMEs accounted for approximately 55 percent of GDP in 2001, compared to 30 percent in 1995.SMEs also accounted for 50 percent of Polish exports and two-thirds of imports. As of end 2001, 65 percent of Poland's working population worked in SMEs

SMEs surveyed in 2001 cited two primary growth constraints:(a) high taxes and other fees and (b) low demand (linked the slowdown noted earlier)

Lending

Because of their importance to the Polish economy, SMEs represent an attractive market. As of end 2001, loans outstanding to Polish SMEs totaled 73,441 million zlotys, 52.6 percent of total corporate bank loans. Deposits from SMEs were 7020.6 million zlotys, or 49.2 percent of total corporate bank deposits.

Of the SMEs surveyed in 2001, 42.1 percent of the medium-sized companies used zloty loans and 8.2 percent used foreign currency loans. Of the small companies, 27.5 percent used zloty loans and 4.9 percent used foreign currency loans. The survey did not identify major shortcomings in provision.

Conclusions

Because substantial consolidation has already taken place in the Polish banking sector, it is a useful case for considering what impact this had on SME lending. Further research would be required to determine whether consolidation has led to increased SME lending; among other factors, it would be necessary to control for variables such as economic growth in the SME market itself. However, based on the existing limited information, there is a strong presumption that the development of a larger more competitive banking sector has been sympathetic to the growth of significant SME activity (see arguments in chapter 3). There is no reason to think that SME lending in Poland has suffered as a result of banking sector consolidation.

Based on SME Marketing, Market Research Team, "SME Sector in Poland," Bank Handlowy w Warszawie SA, January 2002.

88. Because all eight of the privately-owned banks in Poland's top ten are majority foreign-owned, there are no relevant counterparts against which to compare these banks in order to identify the foreign-owned banks' specific contributions to overall sector performance. Clearly they have raised competitiveness, as shown by their financial performance and the fact that all eight banks experienced significant ownership changes during the past three years. The impact of competition also can be seen in overall sector characteristics, such as increased intermediation, innovation, and capitalization levels. However, in the absence of counterfactuals, one is left to make assumptions about the uniqueness of the foreign bank contribution. One unique contribution clearly has been capital; few of the other case study countries have had sufficient domestic capital to support adequate banking sector growth. The second unique contribution arguably is speed. While Polish-owned banks sooner or later would have improved in areas such

as efficiency and innovation, foreign banks brought their own procedures and jump-started this process.

89. Given the present level of banking sector development, it seems inevitable that sector consolidation and increasing concentration will continue (unlike Estonia where some sort of end-point has been reached. Although the current economic situation generally has generated government crisis plans, the long-term growth prognosis, including for the banking sector, is positive. Assuming that the EU accession process continues, it is estimated that EU structural adjustment funds could add as much as 1.0 percent per year to GDP growth.[42] EU accession also should lead to more foreign investment and hence more funds for the banking sector. The growth of the pension fund markets, following Poland's 1999 adoption of a three-pillar program, should also benefit Polish banks. Not only will the pension funds be a source of bank funding (via the funds' investments in bank equity and debt issues), but the growing pension market should also provide banks with opportunities for product diversification. Finally, room remains for Polish banks to expand their loan portfolios. Their capital levels are high and the sector ratio of loans/banking assets is relatively low. Presumably, lending levels will begin to rise as economic growth accelerates and the banks absorb their recent mergers and acquisitions and reap the gains of their investments in increasing efficiency.

90. PKO's and BGZ's prognoses are not positive; PKO in particular is vulnerable to continued retail client loss as this sector becomes more interesting to the private banks. However, PKO's and BGZ's fate is arguably the inevitable result of their being the last two banks slated for privatization. Continuing state control over these banks should not noticeably dampen overall market competitiveness. Unlike Russia's large state banks, these two are not big enough relative to the total market to significantly impair competitiveness overall.

91. In summary, the Polish approach to banking sector privatization and consolidation should be considered a success to date. While the extent of foreign ownership has become a source of political concern, particularly as a scapegoat for Poland's present economic problems, the privatization and consolidation process would not have occurred as quickly without foreign involvement and the current capitalization levels would not have been reached. However, because the Polish model has given rise to a high degree of competitiveness and sound performance in most of the country's banks, it is difficult to predict how exactly the next consolidation phases may unfold.

92. The Polish model generates four lessons that could be useful to other countries considering a state-initiated banking sector consolidation process:

- *State credibility is key*. The Polish case demonstrates that the incentives governing bank behavior will change, and an administratively initiated process will convert into one that is sustained by the market, only when the banks realize that there is no option except compliance with state policy. The Polish state had a particularly noteworthy advantage in enforcing its credibility, because the 1991 EU agreement gave policymakers and politicians a solid deadline and an external monitor for the required legislative and regulatory reforms. Policymakers considering a consolidation program should consider

[42] Kulikowski, p. 14.

using similar external commitments to bolster the credibility of their commitment to effective consolidation.

- *Foreign bank investment can accelerate an effective process*. Foreign bank investment can contribute to the consolidation process because it creates a market mechanism that forces domestic banks to focus on increasing their competitiveness. Enabling foreign bank investment is also a way for the state to heighten the credibility of its commitment to increasing competition, because it introduces a third actor that is accustomed to the dynamic of market economies. Poland's strategy of allowing only 30 percent foreign investment in the initial privatization process and using management contracts to facilitate a more significant management role for foreign investors is a possibly effective way of responding to political sensitivities by introducing foreign investment only gradually.
- *IPOs can lead to greater competition*. One way Poland facilitated banking sector consolidation was using IPOs as the primary privatization method while at the same time ensuring that strategic investors would uphold corporate governance principles. Largely as a result of this approach, today 16 Polish banks are listed on the national stock exchange, including the 8 largest privately owned banks. This has contributed to overall sector transparency and competitiveness. Not only is comparative information about banks readily available, but the risk of hostile takeovers provides ongoing incentive to bank managers to maximize performance.
- *Enterprise reform should be taken into account*. One unusual aspect of Polish banking sector reform was that it was done in tandem with enterprise reform, with banks being given both the tools and the incentives to restructure their loan portfolios.[43] This is an important lesson for countries further to the east, such as Ukraine, where lackluster enterprise performance continues to complicate the task of developing sound banks.

[43] Although it is generally considered that the program was more successful in restructuring the banks than the enterprises, it is also agreed that the banks' positive outcome could not have been achieved without addressing enterprise issues.

TWO CASES OF UNDERMINED CONSOLIDATION:

UKRAINE AND RUSSIA

CHAPTER 8: UKRAINE

Introduction

93. The Ukrainian banking sector today is small in absolute size but still comprises a large number of banks relative to total banking transactions (154 banks as of May 2002 share total assets of UAH 50.4 billion (US$8.9 billion).[44] In addition to the 152 operating banks, 34 banks today are in various stages of liquidation. Most bank exits to date have involved very small banks and have had little impact on sector concentration measures. However, this was not the case for four significant bank failures during 1994–1996 and the 2001 failure of Bank Ukraina which had accounted for about 10 percent of total bank assets.[45] A significant number of surviving banks are small and some are probably too weak to survive as independent banks once the new minimum capital requirement (euro 5 million) is enforced from January 2003. Until 1999 the country was severely under-monetized; the banking system as a whole mobilized only small volumes of savings and loaned even smaller amounts to support productive purposes. This has changed significantly in the two years leading to 2003.

94. Although the number of banks today is lower than in the early 1990s, the pace at which banks have exited the system has been very slow—many of the 32 banks currently in liquidation have been in that state for several years. By contrast with some other countries in this study, the Ukrainian authorities have not articulated or enforced a particularly active policy towards failing banks. Their approach has typically involved long delays in problem recognition and similarly slow liquidation decision-making and enforcement processes. This has been especially true in the case of larger and politically well-connected banks. In this and other ways a significant level of regulatory forbearance has dulled the normal market forces that could have brought faster consolidation. Three new private banks that grew fast and achieved top-10 positions by 1994—Inkobank, Vidrodzhennya, and Gradobank—ceased to operate by 1996–1997. These departures had a significant effect on the sector's structure at the time because the private banks were just beginning to win market share from the five legacy banks—the Savings Bank, Ukreximbank (both still under state ownership), Prominvestbank, Bank Ukraina, and Ukrosotsbank.

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44 Since the breakup of the Soviet monobank in the late 1980s, Ukraine has had a large number of banks and NBFIs, with as many as 279 banks registered by the early 1990s. Many of these were nonstarters, and the number of banks that survived long enough to be noticed is normally given as 190–200. Another 70 banks since have been removed from the register after their liquidation or reorganization into new banks.

45 Bank Ukraina was formerly the Ukrainian branch of the Soviet Agroprombank and one of Ukraine's five significant legacy banks.

95. The first main proposition emerging from this case study is that there has been no systematic administrative lead to the bank consolidation process of the type that was seen in most of the other case-study countries. The National Bank of Ukraine has gradually improved its bank regulation and supervision capabilities. It also has succeeded in recent years in liquidating a number of once significant banks. However, such actions were always taken with reluctance and after various politically less costly alternatives had been tried and failed. The second main proposition is that the market forces that might have encouraged faster consolidation are seriously undermined by various factors disabling the effect of market pressures on banks. Hence relatively poor-performing banks have been able to survive and often achieve rapid growth while better banks, including several foreign banks, have struggled to hold on to market share. These two propositions suggest that Ukraine could greatly increase the depth and efficiency of its financial intermediation by adopting a more strategic approach to consolidation that would favor good-quality bank performance and more decisively sanction poor and failing banks. They also place Ukraine in chapter 3's taxonomic segment A. The evidence suggests that Ukraine, even more than Russia, has failed to create an environment in which efficiency-raising changes in banking sector structure can occur.

96. This case study is organized as follows. The second section surveys the general elements of Ukraine's economic situation that are needed to understand its banking situation. The third section outlines the key characteristics of Ukrainian banking and also summarizes recent financial trends. The fourth section discusses how banking sector consolidation has developed during the past 10 years. The fifth section attempts to assess how these trends may develop in the future. The final section offers some key conclusions and recommendations.

The Economic Background

97. It took Ukraine nine years from its 1991 independence to see the end of the economic recession that began with the breakup of the Soviet Union. Inflation was brought under reasonable control by 1996, largely on the basis of a tight monetary policy. However, the high real interest rates associated with that policy created an ongoing damper on investment and growth. Fiscal policy was relatively loose in spite of a series of International Monetary Fund (IMF) programs beginning in 1994, which were not sufficient to stimulate positive growth. The situation worsened markedly with Russia's August 1998 financial crisis, which triggered a similar crisis in Ukraine later that year and further boosted already high nominal and real interest rates.

98. The year 2000 marked a turning point, with positive GDP growth at last being realized. The more competitive exchange rate achieved by the crisis-linked devaluations supported strong growth of exports, which also was helped by Russia's more buoyant economy (Table 8.1). Real GDP growth increased by 6 percent in 2000 and 9 percent in 2001. Inflation declined to about 6 percent. The budgetary situation also strengthened in 2000/01. In 2002 the improved macroeconomic performance was sustained, although with somewhat slower growth. Real GDP increased by 4.3 percent while inflation was lower. The current account surplus increased to US$1.3 billion, or 3.7 percent of GDP and international reservces rose to over $5 billion

99. Ukraine's difficult transition from the socialist system was associated with an especially severe output contraction, high inflation, and balance of payments weakness. These difficulties created an environment that was severely negative for banking. In particular, the financial

situation of the enterprise client base was radically undermined, with more than 50 percent of all enterprises becoming loss-making: a situation that is only marginally better today High real interest rates made credit appraisal difficult and posed huge adverse selection risks. Household and corporate money demand collapsed in response to the near hyper-inflation of the early 1990s, depleting the resources available to extend bank credits. Demand for other financial assets also collapsed. Although some recovery began in the mid-1990s, the 1998–1999 debt crisis represented a major setback from which the financial system is only now recovering.

100. Notwithstanding recent good macroeconomic performance, the financial system remains susceptible to a range of potential shocks. In particular, the economy is open[46] and dependent on Russia and other export markets. A slowdown in these markets would be felt rapidly. Ukrainian exports also are concentrated in highly cyclical sectors, so export performance would suffer in the event of a more severe global recession. Once a downturn occurs, the risk of deteriorating credit quality will intensify. A further source of concern is that interest rates on hryvna-denominated loans have remained high, despite much lower inflation. As a result, the ex-post real lending rate rose to more than 20 percent in early 2002, imposing high costs on borrowers. Low liquidity on the inter-bank money market has kept short-term interest rates volatile, complicating banks' liquidity management and necessitating the maintenance of high and costly liquidity.[47] This instability offsets the apparent stability coming from the National Bank's (NBU) perceived de facto exchange rate targeting. Developments that would necessitate increased interest rates, such as resurgent inflation, could rapidly put additional pressure on credit quality. Finally, the economic recovery's sustainability is called in question by ongoing doubts about the quality and stability of Ukraine's political arrangements.

Table 8.1. Ukraine: Selected Macroeconomic Indicators, 1997–2001

	1997	1998	1999	2000	2001
Real Sector					
GDP (% change)	-3.0	-1.9	-0.2	5.9	9.1
Consumer price index	10.1	20.0	19.2	25.8	6.1
Private savings ratio (%)	21.5	22.5	23.5	25.0	21.6
Monetary and credit data					
Broad money (M3)	36.8	25.3	40.4	45.4	42.0
Domestic credit	32.3	34.5	38.0	23.5	19.1
NBU Discount Rate	24.6	61.6	50.0	30.6	19.7
Public finances (% of GDP)					
Central government financial balance	-5.4	-2.6	-2.3	-0.1	-1.7
General government financial balance	-5.4	-2.8	-2.4	-1.3	-1.6
External sector					
Hryvna per US$ (end of period)	1.9	3.4	5.2	5.4	5.3
Trade balance	-4,205	-2,584	-482	779	198
Current account	-1,511	-1,296	834	1,481	1,402
Foreign direct investment (net)	581	744	479	587	772
Gross official reserves (US$ billions, end period)	2,375	782	1,090	1,469	3,075
Public sector external debt (%of GDP)	19.0	27.5	39.4	33.1	26.9

Source: ???

46 The exports and imports of goods and services accounted for 100 percent of GDP at the end of 2001.

47 Private banks must offer relatively high interest rates on deposits to compete with the Savings Bank in obtaining liquidity. These costs are passed on to borrowers.

The General Banking Situation

101. The overall structure of Ukraine's financial sector and the position of banks within that structure are summarized in Table 8.2. Although the absolute size of the banking sector and the share of bank assets in GDP are both relatively small, the dominant position of banks in the overall structure of finance is clear.

Table 8.2. Structure of Financial System (end of year)

	Dec. 99	Dec. 00	Dec. 01
Number of banks	162	153	152
Total assets (UAH million)	25,603	36,827	47,204
% of GDP	19.6	21.7	23.4
Number of insurance companies	263	283	328
Total assets (UAH million)	-	-	3,007
Total premiums (UAH million)	1,164	2,136	3,031
Number of investment/mutual funds	229	397	362
Total assets (UAH million)*		373	
Number of pension funds		21	
Total assets (UAH million)		23	
Number of credit unions		>350	
Total assets (UAH million)		37	
Number of leasing companies		n/a	
Total assets (UAH million)*		327	
Number of securities traders	835	839	859
Number of securities custodians	75	84	86

Source: National Bank of Ukraine, Ministry of Finance, Securities and Stock Market State Commission of Ukraine.
* Estimated.

102. Table 8.3 shows how banking activity is presently divided between the main bank categories. It indicates that banking system concentration today is high in terms of most measures (total assets, capital, deposits). Specifically, 48–56 percent of total business belongs to the top 7banks[48] and 65–73 percent belongs to the top 20 banks[49]. This high concentration level is not new—it has been relatively stable for several years. However, in the period of very rapid banking growth period since 2000, these concentration measures conceal considerable switching in relative positions between the largest banks. For example, Aval Bank, the largest bank by assets in 2001, was only the fourth largest in 1999. Prominvestbank, the largest bank by assets in 1999 (another legacy bank), has since been overtaken by two newer private banks. Some of the largest banks in 1999 have since completely fallen out of that group.

48 as defined on 1999 data by the NBU
49 Table 2 shows various measures of concentration and their trends over the past three years.

Table 8.3. Banking System Structure (% shares)

		First-Tier Banks	Second-Tier Banks	Total Top 20 Banks	Third-Tier Banks	Fourth-Tier Banks
Assets	1999	45.8	15.5	61.3	15.9	22.8
	2000	46.8	16.4	63.3	16.7	20.1
	2001	47.7	19.8	67.5	19.6	12.9
Loans	1999	45.1	16.9	62.0	15.9	22.2
	2000	46.6	18.0	64.6	15.9	19.5
	2001	44.2	21.1	65.2	21.2	13.6
Deposits	1999	55.3	11.7	67.1	16.0	17.0
	2000	54.5	14.2	68.7	17.3	14.1
	2001	55.9	17.5	73.4	17.7	8.9
Capital	1999	34.5	13.48	48.0	17.13	34.90
	2000	34.4	13.52	47.9	20.03	32.04
	2001	33.4	13.71	47.1	24.62	28.27

Source: NBU data
Top-tier banks are the seven largest seven banks defined by total assets.
Tier 2 are next 13 banks.
Tier 3 are remaining banks with assets over UAH 150 million.
Tier 4 are all remaining banks (assets below UAH 150 million).

103. It also is significant that the largest banks in terms of assets do not command so a large share of total banking system capital. For example, the top seven banks handle 48 percent of all credits and 44 percent of all loans but have only 33 percent of total capital. This reflects in part the Savings Bank's serious under-capitalization but also of some other larger banks' relatively low (but still adequate) capital levels. The substantial inter-bank differences in terms of both balance sheet growth rates and capitalization levels raise questions as to whether the recent rapid growth is likely to stress the system and could trigger further concentration or consolidation. This matter is discussed in greater detail later.

104. Some of the now evident concentration of Ukraine's banking system is the result of either the banks' historic origins or of their ongoing political connections. For example, until 2000, all five legacy banks—Oschadny (Savings Bank), Ukraina, Ukrosots, Prominvest, and Ukreximbank—figured prominently in the banking top tier. This is still largely true, although Bank Ukraina's liquidation, which began in 2001, removed one of these banks and 10 percent of bank assets from the picture. Despite its poor financial condition, Oschadny has so far been able to retain a top tier position (fourth in terms of total assets as of January 2002), in part because of its privileged state guarantee for all its household deposits liabilities. Fifth-ranked Ukreximbank has also remained there in part because of some significant regulatory forbearance for a few large non-performing loans. The Savings Bank and Ukreximbank are both state-owned and thus may escape some market discipline. But several other "private" banks also benefit from their connections to quasi-state institutions. These include the Post Office and the State Pension Fund, which are intimately linked with Avalbank, and the Kiev municipality (Kreschatykbank) with its links to the state railways and oil and gas operations.

105. Many other banks also base their performance at least partly on various forms of political connections, favors, and protection. This can take several forms: one is for key shareholders to be members of Parliament (Rada). Alliances between major banks and certain political factions also occur with results that are at best opaque. But whatever form it takes, the ability of certain banksto capitalize on political advantage to enhance commercial performance also dilutes the pressures for consolidation that would otherwise come from market forces. For example, some large but financially relatively weak banks (state-owned and private) are probably resistant to potential takeovers because of their political muscle. Smaller and more vulnerable banks have been known to safeguard their futures by seeking protective political rather than commercial alliances. Interview evidence suggests that these practices are widespread in Ukrainian banking, and as a consequence consolidation and greater concentration are delayed. It also means that the distinction between state and private banks is not as meaningful as sometimes supposed, and that privatization as an instrument to change performance may be an extremely blunt instrument. Some larger private banks that claim greater political independence continue to enjoy protection by means of key shareholders in the Rada or other ways. Smaller banks with less obvious political muscle often seek greater influence by associating with Rada members or local administrations. In the remaining state banks, Article 7 of the new Law on Banks and Banking Activity has effectively removed governance structure control from the government. In at least one case, the Supervisory Council appears to have acted in ways that would seem to contravene good banking practice.

106. Another factor is the presence in the top 10 banks of a number of powerful regional banks, such as Privatbank from Dnepropetrivsk, which often focus on servicing local business clients, especially the strong regional industrial groupings from industrial areas such as Donetsk and Dnepropetrivsk. Various degrees of integrated banking and non-banking activities in these groups also dilute the competitive pressures that some of these banks might otherwise face.The more successful of these banks increasingly have a national presence and account for a rising share of total deposits. In some cases, successful geographical diversification has been linked with the banks' strong political connections.

107. Consolidation has not yet become a significant feature of Ukraine's banking sector. Indeed, words such as "consolidation" and "merger" have somewhat negative connotations and are rarely discussed as part of strategic planning. Nonetheless, increasing the minimum capital requirement to euro 5 million (since January 2003) has left some banks with no choice but to merge, limit their presence to a single region (become a regional bank) or exit the market.[50] Most bankers interviewed for this study expect a significant reduction in bank numbers in the next few years even though neither the market pressures nor the administrative mechanisms that might bring this about are yet clearly perceived. There have been some cases of weaker banks approaching their larger brothers, hoping for a voluntary merger.

108. This relatively limited structural change in Ukraine's banking sector has coexisted with an apparently significant upgrading of the NBU's regulatory powers; much of this linked to the World Bank's Financial Sector Adjustment Loan (FSAL) (1998–2001). In particular, the new Law on Banks and Banking Activity introduced many new, radical requirements on banks in

50 The deadline for this is January 2003. The Bankers Association has forecast that some 15-20 banks will fail to meet this target. The NBU's aspiration to double the minimum capital requirement to Euro 10 million would cause further exit from the market were it to be enforced.

terms of capital, internal control, risk management, and disclosure. However, the political will to enforce these new powers without fear and favor is still lacking. As a consequence, sector policy can be characterized as lacking vision and systematic guidance. A prominent example of this was the 2000–2001 failure of a joint attempt by NBU and the banking community to draft a three-year strategic sectoral policy framework[51]. The effort foundered because of the failure to reach agreement on substantive issues such as minimum capital, consolidation, the need for banks to become more competitive, and the future role of the existing state banks and possible new ones. The hope for the future is that the stronger efficient banks in the system will increasingly demand and achieve a fairer and more transparent environment in which to conduct business and that this in turn will catalyse improved NBU enforcement of the strong regulatory powers it already commands. In the absence of such new lobbying pressure, the present dysfunctional and politically colored competition is likely to persist.

109. The small size of the banking system overall as well as the and typical bank, is readily explained by various aspects of the sector's malaise. After large direct losses from early bank and NBFI failures and massive indirect losses as a result of inflation, the Ukrainian public and enterprises have preferred to hold much of their savings offshore or in cash, including dollars, rather than in domestic banks. Only since 1999 has this lack of confidence begun to be corrected and bank deposit volumes to increase. However, these are still low in per capita terms. Banks' involvement in the payments system is also far lower than would be normal in a well-functioning economy. Payment in cash, barter, arrears, or mutual offsets remains more prevalent in Ukraine than would seem normal. The Ukraine's cash-to-money ratio is still more than 40 percent in spite of a sharp decline during the past two years.

110. The banking sector as a whole saw only very slow business growth between 1991 and 1998. In the early part of this period, inflation and foreign currency instability were both extremely high, and banks in many cases were able to generate significant profits from various speculative activities. Hence banks were readily able to enhance the limited capital with which most started life by the re-investment of retained earnings to match their growth. From 1996 to 1999 this became progressively more difficult, and banks generally had to look to their mainstream banking performance – e.g. cost competitiveness - to retain profitability. In general this was relatively unsuccessful and profits were insufficient to underpin any significant sectoral expansion. The conditions for expansion also remained problematic. Low levels of public confidence in banks continued to hinder deposit expansion. Widespread difficulties in the productive system continued to restrict the number of good-quality lending clients. The 1998 Russian crisis intensified all these problems.

In this broad context of limited growth, the existing banking structure and the markets for banking products became entrenched because there was no growth margin within which the few effective banks could capitalize on their superiorities. It can be hypothesized that the lower profitability after 1996 also locked banks into even greater reliance on political machinations as a means to gain market position in the face of generally weak growth. Although there is no direct way to confirm this, indirect evidence emerges from the interviews with bankers conducted for this study. Ukrainian bankers refer to the intense competition that they face. But the hard evidence of wide variation in performance

[51] Such a strategy document has now been issued in draft but only in 2003

indicators (e.g. costs) across banks suggests that there is insufficient competition to eliminate such discrepancies. The resolution is found in the fact that banks compete hard for business as much in the lobbying and political arena as in the arena of cost competitiveness. If they succeed in this arena they can preserve inefficient cost and other performance characteristics and still thrive. This situation as regards the slow growth of banking (but not the politically-colored modus operandi) changed dramatically after 1999, when real economic growth resumed after almost a decade of recession. Since then, banking sector growth has been very rapid. The overall loan portfolio has expanded by almost 50 percent per annum for the past three yearsRecent Changes in the Banking Structure

111. In the context of the recent rapid overall growth of banking business, some individual banks have seen their market shares rise or fall by very significant amounts, and the system's inertia has been substantially jolted. With the major exception of the absorption of Bank Ukraina's assets by other banks, this structural shift cannot be categorized as consolidation. There has been little merger and acquisition activity, and has it not yet produced any significant increase in concentration. However, the shift has significantly changed the' rankings of individual banks. This emerging structural shake-up is illustrated in a limited manner in figure 8.3 below , which presents individual data for the largest 20 banks for 1999-2001 The differences in growth are significant: 10 banks have achieved annual average growth rates of loans of more than 80 percent while 7 of the top 20 have seen annual lending growth of lending of less than 40 percent. The third-tier banks had lending growth rates averaging 74 percent, which is close to the top 20 banks' average. Within this group too there have been huge growth variations. However, the fourth-tier, smaller banks have seen average credit growth of only 20 percent. This has resulted in the substantial losses of market share for these smaller banks as reflected in Table 8.3 which was shown earlier.

Box 8 Bank Consolidation and SME Finance in Ukraine

The SME market

In the absence of official data, the size of the Ukrainian SME market is estimated for this study to be less than 20 percent of GDP. This size corresponds with that of other transition economies in which government has not identified SMEs as an important growth sector. Anecdotal evidence from banks lending to the sector suggests that the number of entrepreneurs is growing, but this cannot be verified: many are in the gray economy. It is generally argued, however, that the new unified tax code adopted in 2001, which simplified calculations and applied a flat tax, has encouraged a number of entrepreneurs to emerge from the gray economy.

The impediments to SME growth are similar to those in other distorted ECA countries: corruption, bureaucracy and low availability of finance. However, with the exception of the recent tax reform, Ukraine appears to be slower than many of the other ECA countries in recognizing the growth potential of SMEs and making a concerted effort to facilitate that growth.

Lending

Given the lack of official data, the following discussion is based on information from the Ukrainian Micro Lending Program (UMLP), a joint project of the EBRD and the German-Ukrainian Fund (GUF). This program accounts for most lending to small entrepreneurs. It should be noted that this program focuses on micro and small entrepreneurs (MSEs). It provides loans of Euro 100 to 25,000 to companies with as many as 20 employees and small loans of Euro 25,000 to 100,000 to companies with as many as 250 employees.

As of the end of August 2002, the outstanding MSE loan portfolio was US$43 million in more than 9,500 loans, with an average size of US$5,800.The outstanding MSE loan portfolio represents approximately [XXX percent –] of all loans outstanding.

The MSE major participants are Ukraine's two largest privately owned banks, Aval and Privat. The Micro Finance Bank of Ukraine, founded in 2001 by six development organizations, is also rapidly increasing its market share.

While small banks were not contacted for this research, the large banks that were interviewed did not cite small banks as significant MSE competitors, even in the regional markets. There is a general perception that most smaller banks focus on meeting their shareholders' needs. The active MSE lenders interviewed, which included some of Ukraine's most rapidly expanding banks, were unanimous in their belief in the sector's future growth. Specific factors cited included:

- MSE lending is a way to find new clients and develop a binding relationship with them by helping them grow.
- MSE lending is an important tool for maximizing return from a bank's branch network.
- MSE lending is higher yielding than lending to large corporate clients.

One of Ukraine's largest banks stated that it expects MSE lending to account for "tens of percentages" as a proportion of the bank's overall loan portfolio.

Impediments cited in MSE lending include the need for an external evaluator and NBU's requirement that the collateral's value be at least twice the loan's value.

Conclusions

Ukraine is one of the more slowly consolidating countries in this study, which makes it difficult to draw conclusions about any relationship between banking sector consolidation and MSE or SME lending. However, because Ukraine's largest banks are taking an active interest in this market, it appears unlikely that consolidation would result in reduced lending to this sector. On the contrary, given several banks' observation that MSE lending is an important product for maximizing the return from their branch network, lending could benefit from faster banking sector consolidation.

112. In short, the past three years have seen substantial bank repositioning. This has involved movements between tiers, with smaller banks losing to the largest and to mid-sized banks. It has also seen substantial repositioning within individual tiers; some of the larger and mid-sized banks have grown as much as twice as fast as some of their competitors. A key question for this study is whether the highest growth rates have been concentrated on the banks with the soundest financials that can absorb the high growth safely. If this is the case, then we might expect the growth differentials to be self-sustaining—higher growth enabling the successful banks to build retained profits and capital and gradually ease away from their competitors to establish larger and more secure market shares. But it is more likely the case, as in 1994–1996, that some of the fastest growing banks have already exceeded their safe lending capacities. If this is the case, then the unprecedented growth of 1991–2002 may have preceded another wave of bank failures that could accelerate the reduction in the number of banks and and the sector consolidation process.. Paradoxically, this type of consolidation would derive mainly from the failure and exit of some of the larger banks and not, as long predicted, from the marginalization of smaller banks. For the moment, the NBU's supervisory authorities see no need to act to arrest the potentially damaging consequences of the extremely rapid credit growth observed.

113. In order to examine the connection between banks' growth and their performance quality, the next paragraphs use data from a sample of 29 banks from across the size spectrum. The data set is taken from the Bureau van Dijk database and accounts for 66 percent of bank assets in the year 2000, including Bank Ukraina. The approach is that described in chapter 3, of comparing each bank's annual market share gains (or losses) to the six selected financial performance measures:

- Interest-earning assets as a percentage of interest-bearing liabilities;
- Operating income as a percentage of interest-earning assets;
- Operating costs as a percentage of interest-earning assets;
- Gross and net returns on average total assets;
- Shareholder funds as a percentage of total assets; and
- The self-capitalization indicator.

114. Figure 8.2 shows bank-by-bank levels of market share and changes in market share for 1998–2000, each plotted against the first four performance indicators. Figure 8.3 shows each bank's market share levels and changes in these against the last two capitalization indicators.

Figure 8.2. Market Share and Bank Performance 1998—2000

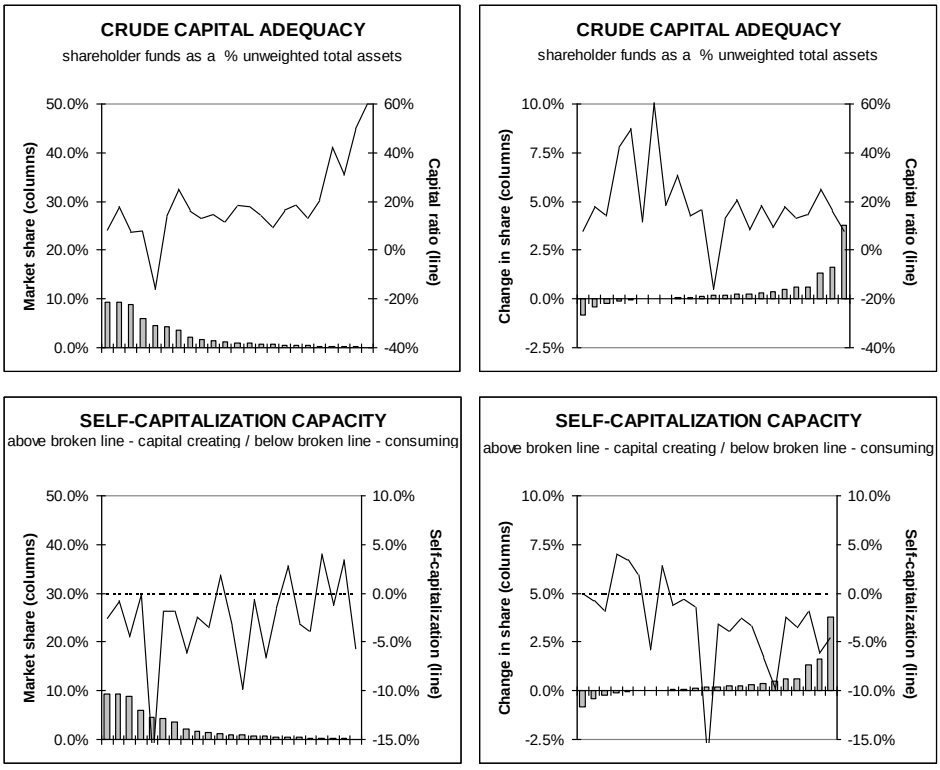
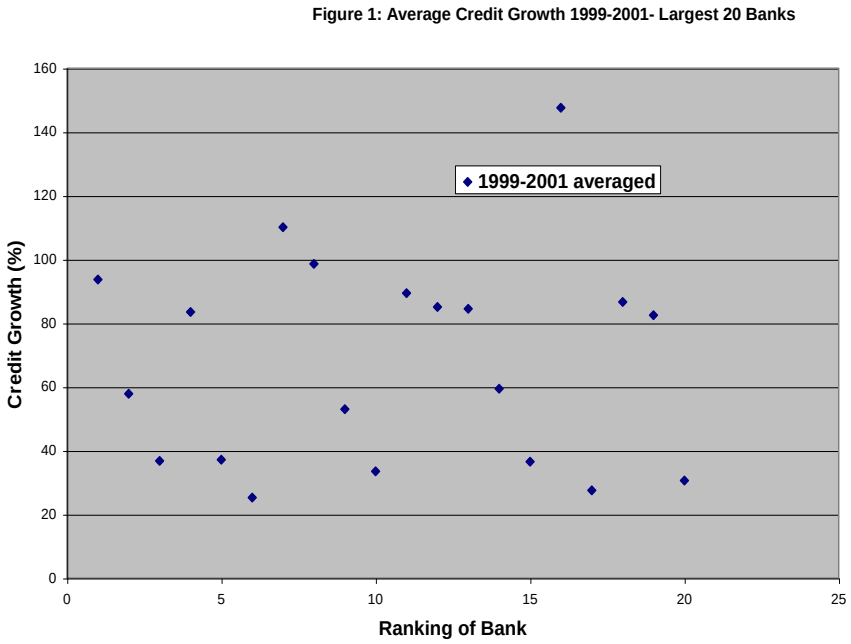


Figure 8.3. Market Shares and Capitalization Potential 1998–2000



115. The concept of capital creation and consumption is important. For a period of time, banks can consume capital to support a growth strategy that is expected to yield longer-run profitability gains, but only to the degree that they have adequate surplus capital to start with. If they continue to consume capital to the point where capital adequacy begins to be insufficient, they will eventually have to approach their shareholders for new capital injections, and this introduces a new dimension of uncertainty. By contrast, a capital-creating bank can justify the continued pursuit of its growth strategy because it need not call on its shareholders for new funds. Indeed it creates a surplus that can eventually be distributed back to them. These distinctions are very important in the Ukrainian case because the data in figure 8.3 indicate that (a) the banks that had the largest market shares in 2000 and (b) the banks that achieved the greatest market share gains during 1998–2000 are both characterized by significantly negative self-capitalization capacity levels. In other words, they are rapidly consuming unused capital.

116. Equally important for bank consolidation analysis is the fact that the largest market share gainers have no better capital adequacy than the banks that lost market share. They also have worse capital adequacy than those banks maintaining share and an absolute level of capital consumption that could reasonably be described as huge. This is clearly not sustainable and ought to be a major concern for bank supervisors. It also appears from the previous section that among the gainers, the faster-growing banks have higher costs, higher prices, and poorer asset deployment than the slower-growing banks. This is creating a situation where the capital increases required to support 2000–2001's rapid system-wide expansion are unlikely to be come from sound sources.

117. Given the situation described here, the future structure of the sector seems unlikely to be driven by a process in which more efficient and profitable banks gradually acquire less-efficient banks, leading to overall bank efficiency and deeper intermediation.[52] Two less desirable futures seem more likely. In the first, the large capital consumption of the "successful" banks of the past few years leads at least some into a severe capital and liquidity crunch. If this affects ongoing viability, it will have systemically serious consequences given the substantial size of some of these banks and their strong involvement in household deposit mobilization. In the second possible future, the "successful" banks of the past few years might escape the consequences of their difficult capital positions by drawing on their non-banking interests (including political ties) to win either regulatory forbearance, genuine new capital, or second class capital such as subordinated debt Neither escape route would be particularly positive from the perspectives of future banking efficiency and intermediation growth.

Conclusions and Recommendations

118. On the basis of this study, the Ukrainian banking sector seems to be a special case in terms of its lack of progress in achieving sounder structure via a consolidation process. The efficiency gaps between the good and the other banks in the system are larger than in any other case-study country (see figure 8.2 above). The authorities so far have taken a largely passive approach to this situation in spite of their greatly enhanced regulatory powers. The strong administrative pressures for change seen in other case-study countries have been absent. Indeed, the sluggishness of the authorities in dealing with incontrovertibly failed banks such as Bank Ukraina has signaled to other banks that regulatory forbearance can be made available to delay consolidation. Nor have market forces been allowed to exert a strong influence in driving consolidation. The key to this second failure was the regulatory forbearance for weaker banks combined with the various nontransparent devices (including links with industrial groups and political factions) that have enabled some banks to achieve market share gains without being financially strong.

119. Much needs to change in banking regulation and the workings of the markets to reform this unsatisfactory situation. The first priority must be a more efficient system for resolving weak and failing banks' problems. This system must be guided by the principles of prompt corrective action, least-cost reorganization, and deposit safety. The new 2000 Law on Banks and Banking Activity gives the NBU the adequate laws and regulations. Now the NBU must consistently act as soon as it has an indication that a bank violates prudential and regulatory requirements. The NBU should require banks, without exception, to rectify any failure to meet prudential requirements, under threat of increasingly onerous penalties. In particular, it should not support seriously under-capitalized banks unless a viable restructuring plan is being implemented and new or existing shareholders are willing to support the plan financially. If the bank fails to make an adequate response, the NBU must take decisive action.

120. Beyond this, the NBU also must become more proactive in bank policy oversight and monitoring, especially credit policies. It should do this not only on a static basis but also with a forward look at, for example, rapid credit growth and its bank capitalization consequences. It should become more vigilant in detecting potentially dangerous positions to keep today's

52 Throughout the former Soviet Union there have been examples of banks lending to informally connected companies in order to forward these funds to bank shareholders to reinvest as increased capital.

"healthy" banks from becoming tomorrow's problem cases. Such vigilance would also give the NBU a better idea of from where in the banking sector efficient intermediation growth is most likely to come. Above all any mergers policy of the NBU should strictly prohibit any banks from taking over a second bank if the first bank has serious or prospective capital adequacy problems. The biggest danger in the present situation is that the fast growing banks of the recent past will be adjudged "successful" just because of that growth and in spite of the possible stresses on their capital that growth may have caused. Because of this they might be allowed to expand further by acquisition. But this would be disastrous because it results in a larger part of the whole banking system falling under the control of banks that lack financial stability.

121. These and other more specific regulatory changes will require that the NBU's political credibility be enhanced by any means necessary. This is partly a question of winning more respect from the commercial banks: for example, asking them for less information overall but more information that would be relevant to assessing their true risks. It is also partly a matter of the NBU allying itself more actively with those larger banks that genuinely seek a more transparent competitive environment and are willing to lobby politically to achieve it. It is also partly a matter of political will to create a stronger banking system, even if this means upsetting certain politically vocal lobbies. This objective can be prosecuted by ensuring that rules are enforced without exceptions and by passing new legislation to ensure that bank liquidators, provisional administrators, and staff involved in banking supervision have full legal protection for actions taken while discharging their duties in good faith.

122. These improvements in the conduct of and respect for the regulatory process would in turn support radically improved corporate governance at the level of individual banks. Improvements needed include better management, management systems, and controls; more qualified boards that can hold executive management to account; and higher standards of accountability to stakeholders, including greater and more serious scrutiny of the bank's conduct by depositors, creditors, investors, regulators.

123. This combination of more effective and credible regulation and improved governance at the bank level will not itself purge Ukraine of the dubious practices that have delayed banking sector development. But they would certainly move it in a direction where the quality of an individual bank's performance would start to have more influence on its market position.

CHAPTER 9: RUSSIA

Introduction

124. Russia's banking sector consolidation has been slow and the number of banks has diminished only slowly in recent years: the 2,552 banks operating in 1997 declined only to 2,113 by the end of 2000. But one intriguing aspect of the consolidation that did occur is that it was mostly market-initiated. The authorities, despite owning large segments of the banking sector, have not actively encouraged consolidation, but neither have they discouraged it—their position can reasonably be described as neutral. One explanation for this at least in recent years is that the 1998 financial crisis led to a marked preference for stability and the restoration of the status quo on the part of both government and bankers.

125. There are some signs of intensified interest in this subject. Most notably, several of Russia's largest banks have developed new, acquisition-based expansion strategies. Several other banks have announced their readiness to diversify their ownership structure or have already implemented such changes. On the regulatory side, the new CBR governor appointed in March 2002 and his team have committed themselves to revitalizing Russia's banking sector and are likely to have strong views on consolidation.

126. Although our taxonomic positioning of Russia seems correct (moving toward B1; market forces being increasingly internalized but not in a predictable manner), several factors cast doubts on this classification. First, no matter how much consolidation activity the privately owned banks generate, the dominant role of Russia's state-owned banks seems capable of dissipating the impact of these changes on the banking sector overall. Second, because of the system's relatively low capital level, increased consolidation or concentration is unlikely to have a significant short-term impact on Russia's historically low intermediation levels. Third, although the two most actively expanding banks were among the 20 most profitable as of the end of 2000, one of these banks is majority-owned by the government of a Russian republic, while the other bank's controlling owner also has significant industrial holdings.. It is also far from clear that these corporate structures are ideal models for Russia's longer-term banking sector development. These and other issues discussed in this case study lead to the conclusion that the CBR's more proactive involvement will be required to ensure that Russia's market-initiated consolidation process leads to sustainable and desirable results.[53]

[53] This would be a move toward segment "D" in figure 3.1's taxonomy.

127. This case study is organized as follows. The second section surveys general elements in Russia's economic situation that are needed to understand the banking situation. The third section outlines key characteristics of Russian banking and summarizes recent financial trends. The fourth section discusses how banking sector consolidation has developed during the past decade. The fifth section attempts to assess how these trends could develop in the future. The final section offers some key conclusions and recommendations.

The General Economic Background

128. Following the 1998 financial crisis, Russia has enjoyed its longest period of relative economic stability since the breakup of the Soviet Union. GDP growth has been positive since 1999; inflation has been stabilized at less than 20 percent; the exchange rate has been relatively stable; and the government achieved budget surpluses in 2000 and 2001. This period of economic stability, together with the political stability introduced by President Putin's assumption of power at the beginning of 2000, has given policymakers and citizens improved confidence that Russia can succeed and even thrive in a post-Soviet world.

129. This confidence is important because Russia continues to face significant economic challenges. High oil prices were the primary driver of the country's positive economic results after 1998, but this reflects an uncomfortably high level of vulnerability to world oil prices. Furthermore, stalled reforms in such key areas as energy, transportation, and land reform keep economic growth below its potential. There is also some apprehension that the ruble's real appreciation will contribute to future economic slowdown. Finally, the dominance of Russia's "oligarchs" remains a cause for concern: it is not clear whether their interests are best served by greater economic growth and deepening democracy or by maintaining the status quo.[54] Either way, the rumored close relationships between Russia's business leaders and government organs at all levels continue to confuse interpretations of the motivations and efficiency levels of some of the country's largest industrial organisations.

130. Government efforts to sustain and accelerate economic growth have led recently to greater attention to the banking sector. The banking sector's remarkably low and unsatisfactory intermediation levels may even have played a role in the unexpected change in the CBR governorship in early 2002. Unfortunately, there are no quick solutions for ensuring a higher economic growth trajectory or enhancing the role of Russian banks in the process. As this case study will discuss, the groundwork is being laid, but it is a painstaking process.

The Banking Sector

Overview

131. Russia's banking sector has four key characteristics:

- The two banks dominating the sector—Sberbank and Vneshtorgbank (VTB)—are majority state-owned.[55] Together they account for approximately 35 percent of banking sector assets. As of the end of 2001, Sberbank held no less than 72.6 percent of the

[54] Boone and Rodionov argue that Russia's largest private business groups now have an incentive to improve Russia's investment climate. Peter Boone and Denis Rodionov, "Rent seeking in Russia and the CIS," Brunswick UBS Warburg, mimeo, September 2002.

[55] The CBR has 63 percent of Sberbank voting shares. It also owns 99.9 percent of Vneshtorgbank, although the ownership is being transferred to the Ministry of Finance during 2002.

system's retail banking deposits,[56] a result of its state guarantee and an extensive branch network (1,168 of Russia's 3,342 branches currently belong to Sberbank[57]). Sberbank's access to this pool of inexpensive funding, representing 53 percent of the system's total retail and corporate funding, in addition to its role in distributing pension payments, gives it overwhelming funding advantages compared to competitors. The Russian investment bank Renaissance Capital (RAS) estimates that as a result, Sberbank can charge 4–7 percent less for its loans than other banks.[58]

Table 9.1. Banking Sector Assets at Year End 2001

Bank	Ownership	Total assets (US$ million)	Capital (US$ million)
1. Sberbank	State	26,823	3,213
2. Vneshtorgbank	State	5,303	1,498
3. Gazprombank	Ind. group	4,059	728
4. Alfa Bank	Ind. group related	3,891	743
5. Mezhprombank	Ind. Group	3,541	901
6. International Moscow Bank	Foreign	2,465	158
7. Rosbank	Ind. Group	2,218	247
8. Bank of Moscow	City	2,165	171
9. Surgutneftegazbank	Ind. group	2,105	53
10. Trust and Investment Bank	Ind. group	1,390	134
11. Citibank	Foreign	1,342	173
12. ICB St. Petersburg	Ind. gp. related	1,157	105
13. Menatep St. Petersburg	Ind. group	925	103
14. Uralssibbank	Republic gov't	860	140
15. Raiffeisenbank	Foreign	832	85
16. BIN Bank	Ind. gp. related	831	114
17. Petrocommercebank	Ind. group	766	180
18. Eurofinance	Ind. gp. related	680	121
19. Avtobank	Ind. group	600	62
20. Zenit Bank	Ind. group	587	101
Total		62,542	9,030
Total banking sector		**96,531**	

Source: Nikolai Mazurin, "Ne v den'gakh schastye," *Vedemosti* supplement on banking, March 4, 2002, p. B2.
Note: All figures are calculated on the basis of Russian accounting standards (RAS).

- Because of their absolute and relative size within the system, the future structure of Russia's whole banking sector will depend heavily on what happens to Sberbank and VTB. A body of opinion within the government favors building up a state-owned Sberbank competitor. The supporters of this viewpoint achieved a breakthrough in early 2002, when it was agreed that VTB would merge with Vnesheconombank (VEB), a non-bank entity responsible for managing Soviet-era debt, which was formerly under the auspices of the Ministry of Finance.[59]

[56] CBR Deputy Governor Kozlov, "Questions Concerning the Modernization of Russia's Banking System," presentation at the XI International Banking Congress, St. Petersburg, June 6, 2002.
[57] Situation as of mid-2002.
[58] Richard Hainsworth, "Russian Banking: System Missing, Now Installing," Renaissance Capital, September 16, 2002, p. 12. Also, Russia's Antimonopoly Commission has been investigating Sberbank's pricing policies for more than one year.
[59] Discussions continue with the EBRD about its possible investment in VTB but the merger has postponed this.

- More than half of the top 20 largest banks are closely held and tied into an industrial group, often in the natural resources sector. These banks historically have had strategies that derived largely from their group interests. A particularly relevant statistic is that inter-group loans account for approximately 40–45 percent of all Russian bank lending, excluding that of Sberbank and VTB.[60]
- Although the process has been gradual, foreign banks are assuming a larger presence in Russia's banking sector. The data in Table 9.1 are based on Russian Accounting Standards (RAS) figures and therefore understate foreign banks' relative size. However, foreign banks, of which International Moscow Bank (IMB), Citibank, and Raiffeisenbank are the largest, have been expanding their operations, raising performance standards, and introducing new products. One foreign bank has achieved approximately the same market share of foreign trade finance as the lead Russian bank in this market. Also, three foreign banks have announced plans to open Russian subsidiaries during 2002.[61] Clearly, the market's attractions for foreign investment have not been exhausted.
- Finally, Russia has long been known for its large absolute number of banks. As of June 2002, Russia had 1,920 licensed credit institutions, of which 1,872 were banks. Many of these banks are so small that they are not relevant to the overall banking sector, except in terms of the magnitude of the CBR's regulatory task. Also, although the banks are too numerous and too small to merit in-depth analysis, it is generally assumed that many of them are focused narrowly on serving their founders' financial requirements. However, one aspect of these numerous small banks is quite pertinent to this study: their high number alone illustrates the lack of incentives, either from the market or from regulatory forces, for banks to consolidate.

132. Despite the 1998 financial crisis and the large structural shake-up that it was expected to provoke, the actual degree of concentration in Russia's banking sector has changed remarkably little since 1998. Table 9.2 shows that the market share of Russia's five largest banks, based on total assets, has remained in the low 40 percent range from just before the crisis until now. The primary (arithmetic) reason for this relative stability is Sberbank's and, to a lesser extent, VTB's dominant role. Relative market share changes by the next three largest banks do not have a significant impact on the five-bank concentration ratio.

Table 9.2. Banking Sector Concentration

Million Roubles	Total Assets	Total (5 largest banks)*	Share of 5 largest (Banking Sector)
July 1998	309,094	753,820	41.0
July 1999	572,572	1,309,024	43.7
July 2000	826,710	2,005,380	41.2
June 2001**	1,133,832	2,753,104	41.2
July 2002	1,589,155	3,656,080	43.5

[60] Kozlov presentation.

[61] There has been some discussion of allowing foreign banks to open Russian branches, instead of the separately capitalized subsidiaries currently required. It is not clear what impact this would have on the market, although it is possible that depositors would feel more confident that their money was protected by the foreign bank's full capital base.

Source: *Bulletin of Banking Statistics,* various.
*Banking sector assets.
**July data are not available.

133. We conclude this overview of the structure of the banking sector with Table 9.3, which provides a useful categorization of Russia's banking sector.

Table 9.3. Banking Sector Categorization

Category	Number	Approximate share (%)
State-owned banks*	4	40
Large Moscow and SP banks**	14	25
Foreign banks***	36	10
Significant medium banks****	200	15
Other*****	More than 1,000	10

Source: Reanaissance Capital and author estimates.
*Owned by the CBR or Ministry of Finance. Banks owned by other ministries or regional or local governments are not included.
**Banks whose capital exceeds US$100 million or total assets exceed US$600 million, according to RAS. Uralsibbank is also in this category.
***Twenty-four banks have 100 percent foreign ownership and 12 have controlling foreign ownership.
****Defined as banks with capital of at least US$5 million.
*****Renaissance Capital estimates that Russia's 1,115 smallest banks have equity of US$5 million or less, with average US$8.5 million total assets and average US$3.5 million deposits. Kim Iskyan and Andrei Besedin, "Russian Banking Sector: A Desert of Reform—But Hope Persists," Renaissance Capital, October 5, 2001.

Financial Overview

134. Having considered the sector's broad structure, we now turn to its status in terms of intermediation, profitability, and capitalization.

135. Levels of intermediation in the Russian banking sector have been unsatisfactorily low since the beginning of reform. The monetization ratio fell rapidly after the Yeltsin price reforms of January 1992 and has remained below 20 percent of GDP since then. Before the 1998 crisis, it was simpler and more profitable for banks to invest the limited funds they were able to mobilize in government securities, which at times yielded 100 percent or more, and were thought to be safe, rather than make loans to industrial and other productive enterprises. One characteristic of the different post-1998 environment is that it has forced banks to focus more on lending as a core activity, because there have been few, if any, profitable alternatives.

136. Table 9.4 illustrates these developments, showing that loans relative to GDP have grown from 8.5 percent before the crisis to 13.5 percent as of April 2002, while loans relative to banks' balance sheets rose to 38.4 percent as of April 2002, up from 28.1 percent pre-crisis. Correspondingly, securities as a proportion of bank balance sheets have fallen from 31.7 percent of pre-crisis banking sector assets to 17.9 percent as of April 2002.

137. One key factor explaining this overall increase in lending has been Sberbank's new aggressive lending strategy: as of the end of 2001, Sberbank accounted for 31.7 percent of all loans outstanding, compared to only 14 percent as of the end of 1997. If Sberbank's growth is excluded, the lending changes appear much smaller.

Table 9.4. Selected Measures of Bank Intermediation

	July 1998	April 1999	April 2002
Banking sector assets/GDP	30.1	41.1*	35.3
Loans**/GDP	8.5	12.2	13.5
Loans/BSA	28.1	29.8	38.4
Securities/BSA	31.7	22.4	17.9

Source: Kozlov presentation.

* This figure may be large relative to 2002 because the banks had not yet fully recorded their postcrisis bad assets.

** Loans to the real sector, including past-due loans.

138. A key factor in the banks' ability to increase intermediation levels is the availability of funding availability, which has also been increasing extremely rapidly since early in 2001 at the same time as the sources of funds have undergone some change. Table 9.5 shows that funding from legal entities increased from 19.2 percent of pre-crisis bank liabilities to 26.6 percent as of April 2002. While retail funding has declined as a proportion of total liabilities, it has nevertheless increased relative to the cash income of the population.

Table 9.5. Banking Sector Funding

	July 1998	April 1999	April 2002
Retail*/Banking sector liabilities	25.2	17.9	22.7
Retail/cash income	11.9	11.7	14.5
Legal entity/BSL	19.2	27.4	26.6
Legal entity/GDP	5.8	11.3	9.4

Source: Kozlov presentation.

* The equivalent of "physical persons."

139. As has been noted Sperbank, the main state-owned bank benefits from a state guarantee on retail deposits. A number of efforts have been made to introduce a more broadly based deposit insurance system, most recently in 2002, on the assumption that such insurance would create more equal bank funding conditions. Whether deposit insurance would actually achieve these results will depend at least partly on the final program's credibility and how (if at all) Sberbank is merged into the new system. The CBR has also proposed to mitigate the potential moral hazard caused by deposit insurance by specifically approving banks for program participation. Such an approval process would presumably enhance the insurance's credibility and encourage some consolidation among banks judged ineligible for inclusion. However, this institutional change has yet to occur.[62]

140. Returning to the lending side of intermediation, the inevitable challenge of the recent very rapid growth of the loan portfolio is a decline in loan quality. Russia, having experienced 84.3 percent growth in corporate and retail lending in the 18-month period ending June 2002,[63] will not be immune to this challenge. The CBR reports net overdue loans of approximately 2.5 percent as of June 2002. This figure is on a worsening trend, but cannot be analyzed in detail because the CBR's data nets out loan recoveries.[64] A recent World Bank analysis of Russia's banking sector, which does not refer specifically to the recent results, warns more generally that

[62] World Bank, **[2002]** *Building Trust: Developing the Russian Financial Sector*, Washington, D.C. 2002, Chapter 10.

[63] Table 4.3.1, "Corporate, Interbank and Personal Loans," *Bulletin of Banking Statistics*, No. 9 (112), p. 89.

[64] Chart 21, "Dynamics of Debt on Credits Extended," *Bulletin of Banking Statistics*, No. 9 (112), p. 90.

most Russian banks are "significantly under-provisioned."[65] And similar rapid loan growth in neighboring Ukraine is known to be associated with a rapidly worsening bad loan ratio in some banks.

141. The Interfax Rating Agency has also highlighted the weakening loan portfolio trend and notes in particular that as of the end of June 2002, 24 of Russia's 100 largest banks reported past-due loans of more than 2 percent of their portfolios, compared to 11 banks six months earlier. These 24 banks together account for 53.7 percent of banking sector assets. Interfax further notes that the migration to foreign markets of Russia's "blue chip" borrowers' will continue to make the Russian lending market more challenging.[66] The pace of new lending slowed to 17 percent in the first six months of 2002, suggesting that the banks were also becoming concerned.

142. Profitability has risen since 2000, with a 2.62 percent ROA for the year to June 2002, as shown in Table 9.6. If this is annualized, the ROA of 5.3 percent represents a clear improvement over 2001's 3.69 percent. However, weakening loan portfolios make it unlikely that the end-2002 results will be this straightforward if proper allowance is made for bad and doubtful loans. Furthermore, it is to be expected that interest rate margins will shrink as competitive pressures on funding develop. Interest rate spreads[67] declined from 26.0 in 1999 to 17.9 in 2000, but still have a long way to go before they hit the much lower levels seen in other case-study countries (for example, 2000 spreads of 8.4 in Bulgaria and 5.8 in Poland).[68]

Table 9.6. Banking Sector Profitability

Year	ROA
2000	1.34
2001	3.69
June 2002	2.62

Source: *Bulletin of Banking Statistics*, various.

143. Some banks are anticipating this trend by developing new higher-yielding loan products, such as consumer finance, mortgage lending, and lending to the small and medium-sized business sector. However, all of these products are still relatively new to the market. There is also an emerging differentiation between banks in terms of their cost base, as seen in Table 9.7. Progress in developing fee-based income, another means of boosting yields, is less evident.

144. As for banking costs, Tablethe IAS sample of banks for the year 2000 in Table 9.7 indicates that regional and small banks are the weakest performers: their operating costs relative to income earning assets (operating cost efficiency) average 15 percent. However, the regional and small banks also achieve the highest rates in terms of operating income relative to income earning assets (delivered cost of service). As a result, these banks also show the highest net operating income relative to income-earning assets—10 percent—of all the four categories of banks. However, the large private banks are not far behind, with a net operating income to income earning-assets ratio of 8 percent. Because of their lower cost base, the large banks can

[65] *Building Trust*, p. 155.
[66] Interfax Banking Agency, "Trend toward Deterioration in Quality of Bank Loans Intensifies," Vol. XI, Issue 35.
[67] Defined as lending rates minus deposit rates.
[68] "Building Trust," Table 13.3, p. 317.

afford to chase after the higher-yield lending of the regional banks', even as they inevitably push down their own yields by doing so. Clearly, the regional and small banks will suffer relatively more from this process.

However, the foreign banks show the most impressive cost performance, an average 4 percent ratio of operating costs to income-earning assets, close to the level found in the leading OECD countries. The large private and state banks, both with an average ratio of 9 percent, will have a considerable challenge in matching their costs with those of the foreign banks.

Table 9.7. Costs in Different Bank Categories

	State Banks		**Large Private**		**Regional/Small Moscow**		**International**	
Number of banks in sample	3		20		14		7	
Market share end-2000 (%)	33		15		2		5	
	Best	*Average*	*Best*	*Average*	*Best*	*Average*	*Best*	*Average*
Operating cost efficiency (%)	5	9	4	9	7	15	3	4
Delivered cost of service (%)	5	14	6	17	8	25	4	9

Source: Excerpted from Bureau van Dijk data.

145. A related challenge facing many banks is that the growth of bank capital has lagged asset growth during the immediate pre-crisis period from early in 1998 until the present. Table 9.8 shows that total bank capital has grown slightly in proportion to GDP, but has declined in relation to banking sector assets in spite of the good recovery from the lows of the immediate post-crisis year. These figures are a cause for concern, particularly because it is widely assumed that the bank capitalization figures are overstated by RAS. Deputy CBR Governor Kozlov has expressed the intention to address this issue.[69]

Table 9.8. Bank Capitalization

	July 1998	**April 1999**	**April 2002**
Capital/GDP	4.6	2.1	5.1
Capital/BSA	15.2	5.1	14.6

Source: Kozlov presentation.

146. In summary, although Russia's banking sector has seen increased levels of intermediation, increased loan loss provisioning should be expected in the near term as a result of the rapid loan growth of the past two years'. This provisioning will put additional pressure on profitability and further differentiate between those banks that are lowering their cost bases and those that still rely heavily on high-interest margins for their profits. The banking sector's relatively low capital base, even when accounted for using RAS, allows little room either for significant loan loss problems or for more soundly based intermediation growth. The following section discusses the implications of these tendencies' for Russian banking sector consolidation.

[69] Igor Moiseev, "Dva kapitala," *Vedemosti*, September 9, 2002.

Banking Sector Consolidation—The Record to Date

147. Consolidation in Russian banking sector can best be understood by dividing it into three time frames: (a) prior to the 1998 crisis; (b) the immediate post-crisis period, concluding at approximately the end of 2000; and (c) the current period.

Pre-crisis

148. Banking sector consolidation was not particularly significant either for policymakers or banks during the first development phase of Russia's banking sector, from the early 1990s to 1998. On the policymaking and regulatory side, the predominant concerns during the early 1990s were the monetary and banking issues associated with the Soviet Union's demise. These included shrinking the ruble zone's borders back to Russia; the need to revise monetary policy to suit a transition economy rather than a command economy; and the many issues associated with the Soviet-era state-owned banks, whose assets now were being claimed by the newly created independent states. Thousands of new banking licenses were issued during this period, but this practice was far from being at the forefront of policy-makers' concerns. The reasons for issuing so many new licenses ranged from genuine belief that more banks would lead to more competition, to more cynical calculation that the licensees would be beholden to the license-issuers.

149. From the bank perspective, enormous profits were available in activities unrelated to the banks' standard intermediation role. The manner in which the planned economy collapsed[70] created extraordinarily lucrative profit-making opportunities in raw materials and currency arbitrage. For some years banks were positioned to facilitate or even initiate these opportunities. Banks could also play a profitable role in transferring assets from state-owned to privately owned entities (including themselves) even before the privatization process formally began. Another profitable activity for banks in the second half of the 1990s was investing in government securities, particularly as their yields far outstripped inflation. Finally, on the funding side, managing government budgetary funds was a much more attractive funding source than building up a deposit base. The lack of any clear demarcation between private and public interests, a legacy of the Soviet period, often resulted in joint efforts between government entities and privately owned banks to maximize their potential returns from this range of activities.

150. Some banks grew remarkably quickly on the back of these activities and began to figure in the top 20 Russian banks in the years leading up to 1998—even outdistancing some of the legacy banks from the old Soviet banking system. As their balance sheets grew, so did their political influence, building on the government-private sector culture that had emerged in the early 1990s. The culmination of the banks' role was the notorious loans-for-shares program, in which some of Russia's "oligarch" banks acquired large state-owned assets in such sectors as nickel, oil, and gas for extraordinarily low prices.

151. This brief discussion of a complex period cannot do justice to the varied experiences of Russia's more than 2,000 banks. In fact, given the period's distorted incentive structure, it is remarkable that some Russian banks actually did focus on developing a traditional lending

[70] Including only partial price liberalization, meaning that some Russian prices, notably energy, did not fully adjust to world levels immediately but instead created an arbitrage opportunity in regard to world prices for those able to control cheaper local supply sources.

business. However, the main point is that consolidation was not a relevant concern to most Russian banks; their profitability did not depend on maximizing economies of scale and building market share. Some limited consolidation and greater concentration did occur, but it was a mere by-product of the exploitation of the peculiar opportunities existing at that time. This process said little about increased banking efficiency.The build-up of monopoly positions that did occur: could be and were achieved mainly through political influence and did not necessarily require greater size. Furthermore, had any Russian policymakers or regulators wanted to initiate a consolidation policy, they would have quickly been over-ruled by the more powerful banks and their supporters.

Post-crisis

152. A form of collective paralysis characterized the post-crisis period after August 1998. Politicians believed they could not afford bank failures, bankers did not want to lose their jobs, and the CBR defined its role as restoring "stability." As a result, between the end of 1997 and the end of 2000, the number of registered credit institutions declined only from 2,552 to 2,113, in spite of the huge financial stresses and losses the crisis provoked.[71]

153. Most significantly in terms of impact on banking sector incentives, some of the most prominent pre-crisis oligarchs were able to create "bridge banks" by shifting their banking business to other entities and thereby avoiding their obligations to creditors.[72] The ability of many oligarchs not only to benefit from perverse incentives but also to avoid the full extent of their associated losses has created considerable cynicism among banks and the population. Similarly the lack of major changes in banking structure in the aftermath of such a major crisis is not only very unusual but also clear evidence of the absence of normal competitive market pressures.

154. However, one significant development during this period was that Sberbank was quickly able to build market share in the retail market to way above the pre-crisis level after losing share in the period prior to the crisis.. Although the public's renewed interest in the explicitly guaranteed state-owned banks was understandable, official policy also encouraged this shift. Specifically, the CBR encouraged depositors in failing banks to move their deposits to Sberbank, and both Sberbank and VTB were re-capitalized.

155. In summary, there were remarkably few changes in Russia's banking sector in the two years following the crisis. There was no policymaker interest in encouraging consolidation of the type that is a common sequel to a financial crisis: in their eyes this would have only delayed the return to pre-1998 "stability." As a result, the environment was inimical to initiatives by the banks themselves, which in any case focused more on crisis recovery and for which the aberrant pre-crisis incentives were more familiar than those associated with normal, mature banking.

156. These patterns of behavior in the period up to 2000 can be studied more systematically by examining the key financial ratios for a sample of 44 Russian banks, the characteristics of which are summarized in Table 9.7. Figure 9.1 compares each bank's market share in terms of assets

[71] *Bulletin of Banking Statistics*, various.

[72] Although the bridge banks now operate on a reduced scale, this is at least partly because their owners have shifted their attention to their natural resource and industrial assets, which now have substantially more earning potential than their banking assets.

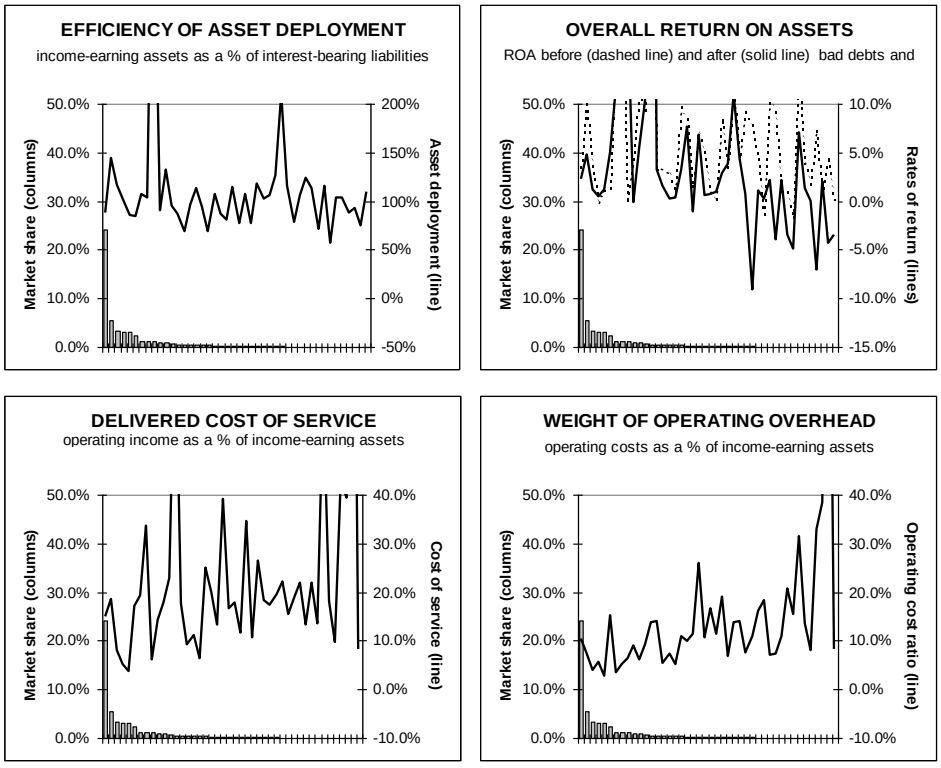
with four key financial performance measures: rate of asset deployment, ROA (gross and net), spread, and operating costs.

157. These 44 banks, which accounted for 55 percent of the whole 2000 banking system (as measured by assets), had average operating costs and spreads that were exceptionally high by international standards (averaging 15 percent and 23 percent of assets respectively). The data also reveal very large variation in performance from bank to bank. However, figure 9.1 does suggest that the direction of the correlations between performance indicators and market share convey the correct signs: the bigger banks tended to be more cost-efficient and to charge less (have slightly lower spreads) but still managed to be more profitable (as measured by overall rates of return) than smaller banks.

158. Apart from the extremely poor absolute levels of the various efficiency measures,, the most striking feature of the data is the huge inter-bank variations in performance shown in figure 9.1. There is no real consistency, and the broad tendencies mentioned in the previous paragraph are no more than that—there are many individual banks whose performance contradicts any idea of a robust link between market share and performance quality. All the simple correlation coefficients (market share to individual performance indicator) are extremely low. The evidence from figure 9.1 as a whole argues against theRussian banking system of 2000 being one that has internalized market-led pressures for consolidation. The limited positive correlation between size and overall rates of return could be as much a consequence of official favors for certain larger banks as a result of any market forces.

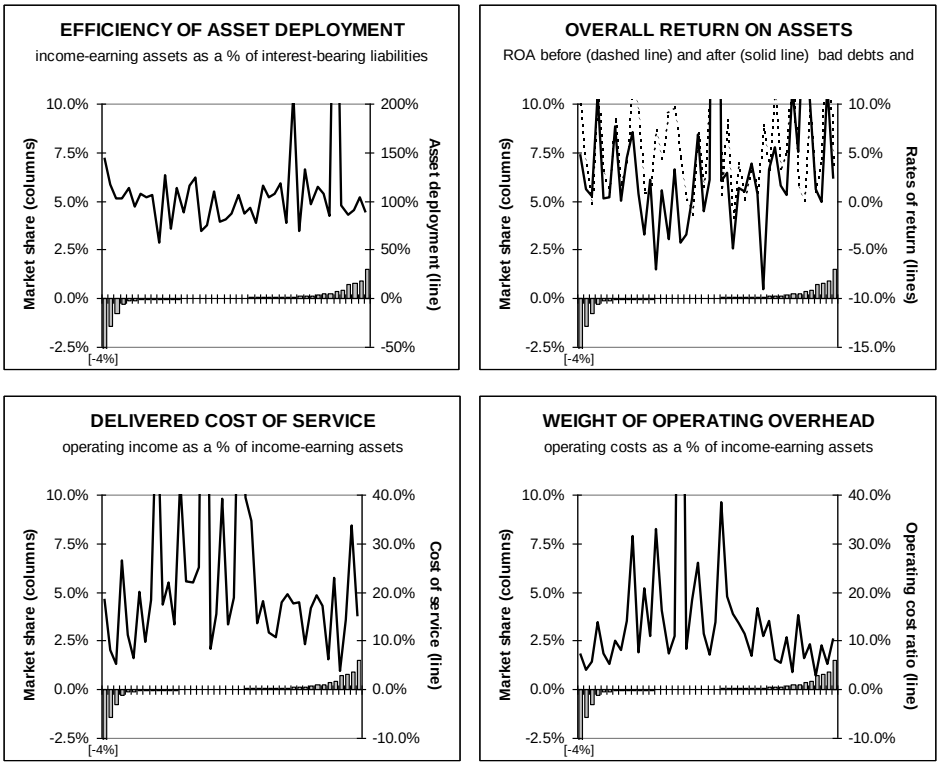
159. In the light of this finding, it is useful to look again at the various performance indicators for banks grouped by ownership, as summarized in Table 9.7. These comparisons indicate a large operating cost advantage to the subsidiaries of international banking groups . Some of this advantage (between 2 and 11 percentage points) was passed on to customers by way of lower charges (at least 1 percentage point lower comparing the delivered cost of service with the state banks), but the banks retained some themselves as increased overall rates of return (at least relative to the state banks). By comparison, both state-owned and large private Russian-owned banks had operating cost ratios twice those of the internationally owned banks but passed them on to customers by way of a much higher delivered cost of service (the spread). Regional and small Moscow-based banks had even higher operating cost ratios and charged even more for their services.

Figure 9.1. Size and Bank Performance in Russia



160. A similar absence of a robust pattern emerges when examining the changes in market share for the same 44 banks in the period 1998 to 2000 (figure 9.2). A close examination of this evidence suggests that banks gaining market share to any visible degree tended to have lower operating cost and income ratios than those not gaining share, but broadly the same ratios as banks losing market share. Calculating the cross-correlation only for banks either maintaining or gaining share gives the coefficients (between changes in market share and individual performance indicators) the correct sign and raises the magnitude from zero to -0.20 for both operating costs and delivered cost of service. This may point to the limited beginnings of market internalization of the need for consolidation..

Figure 9.2. Changes in Market Share and Performance in the Russian Federation



Recent Developments

161. Signs of change emerged at the beginning of 2001, when several large banks began to acquire other banks. The two banks with the most articulated acquisition strategies are MDM Bank, which acquired controlling shares in 10 banks as of the third quarter of 2002, and Uralsibbank (formerly Bashkreditbank) which acquired 4 banks. Other large banks, such as Industrial and Construction Bank St. Petersburg, BIN Bank, and Menatep St. Petersburg, also have bought or are rumored to be buying regional banks, but the scale of their activities has been smaller.

162. Because of their potential impact on the structure of the Russian banking sector, it is relevant to describe MDM Bank and Uralsibbank in greater detail. MDM Bank emerged as a significant presence in Russia's banking sector following the 1998 crisis. It had been a medium-sized bank pre-crisis, but its more conservative pre-crisis investment policy enabled it to weather the crisis better than most of its larger competitors. The controlling owner of MDM Bank is an individual whose holdings also include 50 percent of MDM Group, a holding company with stakes in coal, metal, chemical, and pipe-manufacturing activities. According to Standard &

Poor's, MDM Bank does "little business" with the industrial assets.[73] MDM Bank's growth strategy has been markedly successful on the basis of asset growth; its assets increased by 74.2 percent in the first half of 2002 alone, positioning it as the sixth-largest bank in terms of assets.[74]

163. Uralsibbank (originally called Bashkreditbank), is the largest bank in the Republic of Bashkortostan, accounting for approximately 60 percent of the republic's net banking sector assets.[75] It was established in 1993 by the government of Bashkortostan; currently the bank is 66.3 percent owned by the Cabinet of Ministers and the Republic of Bashkortostan. The bank's charter requires government ownership to stay at a minimum level of 50 percent plus one share.[76] Uralsibbank's total assets increased by 47.4 percent in the first half of 2002, resulting in it becoming Russia's 14th-largest bank by assets.[77]

164. The year 2002 also witnessed a number of ownership changes among Russia's 20 largest banks. As of the third quarter of 2002, three have changed owners, two have announced that they are seeking foreign strategic investors, and two have announced plans to diversify their business to reduce their reliance on their primary shareholder.

Possible Explanations

165. Although it is difficult to trace the reasons for these developments, it appears that a major impetus was generated not by Russian banks but by their clients. As Russia's "blue chips" began to compete more actively in international markets, they needed world-class international banking services and products. Not only did Russian banks lack international banking expertise, they did not have sufficient capital to provide the funding needed. A telling example is Gazprom, whose annual borrowing needs of billions of dollars outstrip even the capacity of Sberbank (RAS total capital US$3.2 billion). The high cost bases of Russian banks also prevents them from competing with international banks on price. As a result, Russia's large banks, even including those for which the top-tier companies were part of their initial financial-industrial grouping, have had to turn to other market sectors.

166. This search for new markets has initiated a minor domino effect, because the large Russian banks inevitably displace the other banks that were already in the newly desirable markets, such as the regional corporate market.[78] This displacement effect is forcing some of the regional and small banks to rethink their strategies. Although the impact should not be overstated, the net effect has been an increased level of acquisition activity. The magnitude and likely duration of thistrend should not be over-estimated: one potential acquirer estimates that of the approximately 20 regions that his bank has targeted for expansion, only 12 have at least one bank with total assets of more than US$30 million. In fact, at least three large banks were actively interested in one regional bank that was acquired in the first half of 2002.

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[73] Ekaterina Trofimova, "MDM Bank," Standard & Poor's, January 2, 2002.
[74] Yelena Berezanskaya and Igor Moiseev, "Pliusy regional'noy expansii," *Vedemosti*, August 30, 2002.
[75] Informational brochure provided by Uralsibbank.
[76] Uralsibbank web page. **[www.uralsibbanm.com]**
[77] Yelena Berezanskaya and Igor Moiseev, "Pliusy regional'noy expansii," *Vedemosti*, August 30, 2002.
[78] International Moscow Bank's (IMB's) and Bank Austria Creditanstalt's (Russia) 2001 merger also had a market impact. Not only did IMB, one of Russia's largest banks, gain a significant retail presence; it also introduced international consolidation into the Russian market, because it was driven by the merger between the Russian banks' European parent companies.

167. None of these acquisitions to date has been an actual merger; they have either been majority-share acquisitions or "accessions." [79] Although all of the possible methods for changing ownership are complicated, the merger process is considered the worst, because of the need to create a completely new legal entity. Both MDM Bank and Uralsibbank have structured their acquisitions into holding companies; in fact, in some cases other MDM Bank shareholders rather thanthe bank itself, hold the acquiree bank's shares.[80] In another case, Rosbank and its related bank MFK announced their intention to combine simply by transferring MFK's assets and liabilities to Rosbank.

168. A related and parallel trend to that of acquisitions is one involving some decline in the pocket bank culture of the past. As the business of banking has become more challenging and "house" banks have started to lose their competitive advantage in serving their house clients, these banks are becoming less useful to their owners. The large banks with major industrial company relationships that have already announced their willingness to diversify their shareholder structure include Gazprombank, Petrocommercebank, Alfa Bank, and Rosbank.

Regulatory Developments During the Current Period

169. Post-crisis developments also have benefited from several important regulatory changes. First, an "IMF package" of legislative amendments was adopted in 2001. Although there have been delays in implementing the changes, the fact that these amendments have become law is the critical first step. The amendments address key areas including increased bank manager and shareholder accountability, heightened CBR authority to intervene in deteriorating banks, and capital adequacy as a criterion for bank insolvency.

170. Second, a joint government-CBR strategy for developing Russia's banking sector was adopted in December 2001. The creation of this five-year strategy, and the fact that it was agreed jointly with the government, were both significant steps forward from the post-crisis period. Elements of this strategy particularly relevant to this present study are:

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[79] There are three processes by which banks can be combined:

- Acquisition: One bank purchases a controlling share of another bank's stock and establishes control.
- Merger: A new bank is established on the basis of transferring all of two existing banks' rights and obligations (whose licenses are then terminated).
- Accession: One of two banks transfers its rights and obligations to the other bank (the "principal" bank), its shares are converted into the principal bank's shares, and the transferred bank's license is terminated.

The acquisition method's significant advantage is that the acquired bank maintains its identity. In addition, any legal liabilities are confined to the acquired bank's assets. This can be an important consideration for the acquiring bank, which can thus protect its assets from unforeseen legal claims against the acquired bank's past actions. The acquisition method has two disadvantages. One is that the acquiring bank cannot use more than 5 percent of its capital to acquire any single entity (or more than 25 percent in total to acquire a number of entities). Second, according to RAS, the purchase amount is deducted in calculating the acquiring bank's capital. Mergers do not appear to have any obvious advantages compared to the other consolidation methods. The primary disadvantage is that a completely new entity must be created, with all of the attendant registration and licensing requirements. Also, the existing banks must be liquidated, a time-consuming and expensive activity. No bank mergers have occurred in Russia to date. Accession is the logical alternative to mergers, because of the convenience and cost savings of maintaining one bank as an ongoing legal entity. However, a significant shortcoming of the accession regulations is lack of clarity regarding legal liability transfer from the liquidated bank to the principal bank. The IMB-Bank Austria Creditanstalt (Russia) combination was done using the accession method.

[80] Trofimova, "MDM Bank."

- Introduction of IAS effective at the end of 2003;
- Phased introduction of deposit insurance, with participation mandatory only after the IAS introduction;
- Minimum capital requirement of Euro 5 million for all banks (effective 2007);
- A target for the ratio of banking sector assets/GDP of 45–50 percent, banking sector capital/GDP ratio of 5–6 percent, and real sector lending/GDP ratio of 18–20 percent;
- Divestiture of the government's ownership stakes in banks where it holds less than 25 percent of shares[81];
- Enhanced government control of Sberbank activities, including improved risk management; and
- Attraction of further foreign investment to the banking sector.

171. The relatively modest quantitative goals of this strategy are a striking acknowledgement of the deep challenges facing Russia's policymakers. Banking sector capital was 5.1 percent of GDP as of the first quarter of 2002, compared to the strategy's 5–6 percent ratio (Table 9.9). Although the goals for lending are somewhat higher, the relatively low capital increase indicates that there will be greater risk-taking by the banks. The intermediation goals are somewhat higher than they first appear, because the five-year results will be based on IAS figures. Nevertheless, even this level of growth will not have a significant impact on overall economic growth.

Table 9.9. Intermediation Goals

	April 2002	**Five-year Targets**
BSA/GDP (%)	35.3	45–50
Capital/GDP (%)	5.1	5–6
Lending/GDP (%)	13.5	18–20

Source: ???

172. The very slow pace set to increase minimum capital is also notable, with a system-wide minimum of Euro 5 million planned only for 2007. In this regard, it is relevant to quote the World Bank's observation that "the strategy reflects continued hesitancy on the part of the authorities to use the powers already at their disposal to consolidate the banking system."[82]

81 There are estimated to be approximately 250 such banks.
82 *Building Trust*, Box 5.3, p. 139.

Box 9.1. Bank Consolidation and SME Finance in Russia

The SME Market

Depending on the data used, Russia's SME development would be considered either low or intermediate. Official data on the Russian SME market covers only those companies with up to 100 employees (less than 30 employees in the retail sector). Based on these data, SMEs account for less than 20 percent of Russian GDP. By contrast, the EU SME definition includes the self-employed and companies with up to 250 employees. Applying this broader definition, EU-Tacis estimates that Russian SMEs account for at least 40 percent of total Russian sales revenue and at least 45 percent of total employment.

Much has been written about the problems facing Russian SMEs, of which official corruption appears to be the most pervasive. However, arguably one of the most impressive characteristics of the Russian SME market is that it has developed at all under such adverse circumstances. The sector got a significant boost from President Putin's personal interest, which has helped to push through a simplified tax code, reduced licensing requirements, and streamlined inspection authority. Although more progress has been made in introducing these changes than in implementing them, the fact that the changes were made is an important first step.

Lending

There are no official SME lending data; however, estimates can be made based on information provided by Russia's largest SME lenders—Sberbank (the savings bank) and KMB Bank (an SME-dedicated bank established by international development organizations in 1999)—as well as participants in the EBRD's Russia Small Business Fund (RSBF in which Sberbank and KMB also participate). Although the SME lending definition varies, as of the end of 2001 approximate total combined SME lending by these entities was US$1.18 billion, or much less than 10. percent of total lending to corporates and individuals in Russia (US$44.4 billion).

There are several constraints on further expanding SME lending in Russia. One is the CBR's strict collateral requirements for lending, coupled with shortcomings in the process of registering collateral and taking possession of it when necessary. A second constraint is concern that the risks of lending to small entrepreneurs outweigh the rewards.

Conclusions

It is not possible at this stage to identify a relationship between Russian banking sector consolidation and SME lending. Although there is some sign of increasing consolidation activity in Russia: only one of the two large and actively consolidating banks—Uralsibbank—cites SME lending as a significant line of business. However, SME lending is currently at such a low level overall that it would not be significantly affected by one or two banks' actions, regardless of whether they emphasized or de-emphasized SME lending.

Future Developments

173. How will Russia's banking sector evolve over time and what impact will it have on the economy? Because the main sources of ownership change and expansion have been in the large Russian (ownership) banks, it is useful to focus on this group. The following discussion, covering Russia's 20 largest banks, is based on 2000 IAS data. The IAS data should be interpreted with caution, because some banks introduced IAS 29 (hyperinflationary accounting) during 2000.

174. Of Russia's 20 largest banks at the end of 2000, 11 increased market share during 1998–2000, 4 maintained their position, and 5 lost market share (see Table 9.10). Of the 11 expanding banks, 4 achieved a ratio of net operating income/interest earning assets of more than 10 percent, compared to 3 "non-gaining" banks that achieved that result."[83] Moreover, two of the four most

83 Furthermore, one of these banks' financial results are not relevant for comparison, because at the time it was going through a post-1998 restructuring that yielded unusual financial results.

profitable expanding banks in 2000, on the basis of this ratio, are the two banks that subsequently developed the most explicit expansion by acquisition policies—MDM and Uralsibbank. Citibank is also in this category, lending support to the argument that foreign banks can play a role in furthering competition. The fourth bank acquiring smaller banks is Industrial-Construction Bank St. Petersburg (ICB SP).[84]

Table 9.10. Market Share Gainers and Losers, 2000

	Mkt share chg, 98–00	Mkt share end-2000	Op cost/ IEA	Op inc./ IEA	Gross op. margin	IEA/IEL	Net ROA	Self cap.	Cap/TA
Sberbank	1.5	24.2	10.4	14.8	4.4	88	2.2	0.6	8
MDM	0.9	1.2	5.1	33.4	28.3	103	11.8	-6.1	21
Menatep	0.8	0.9	9	14.2	5.2	90	-0.1	-7.7	6
IMB	0.7	3.2	2.6	3.7	1.1	85	1.1	1.1	5
Uralsibbank	0.4	0.8	9.2	22.8	13.6	95	10.3	6.8	13
Nikoil	0.4	1.2	6.2	6.1	-0.1	464	20.2	12.4	66
Alfa	0.3	2.3	15	16.9	1.9	84	4.9	-1.4	7
Citi	0.2	1.2	3.5	19.3	15.8	107	11.5	8.5	11
Petrocommerce	0.2	0.6	5.3	9.2	3.9	95	1.6	-0.9	11
ICB SP	0.1	0.9	6	17.8	11.8	132	5.4	6.1	28
Eurofinance	0.1	0.6	13.9	17.6	3.7	68	3.2	-0.3	13
Avtobank	0	0.6	13.8	77.3	63.5	86	96.8	106.5	6
Conversbank	0	0.3	11.2	13.3	2.1	87	-1.1	-4	22
ING	0	0.4	9.9	19.8	9.9	107	7.6	8.4	16
Zenit	0	0.4	10.7	24.9	14.2	68	3.2	-1.3	19
Guta	-0.1	0.5	7.2	11	3.8	112	0.2	0	18
Vozrozhdenie	-0.1	0.5	5.1	6.3	1.2	93	0.3	-1.1	12
VEB	-0.8	3.2	5.5	5.1	-0.4	101	0.4	0.1	5
Gazprombank	-1.4	3.4	4	7.9	3.9	117	1.2	-1.8	18
VTB	-3.6	5.5	7.2	18.5	11.3	144	4.8	-5.4	36

Source: Excerpts from Bureau van Dijk data. [**IEA= income earning assets; , IEL = income earning liabilities, and TA = total assets]]**

175. It is also noteworthy that the key contributor to the high net profitability in three of these four high-profit cases is their costs: with the exception of Uralsibbank these are relatively low. Therefore, even though the operating income figures may be inflated periodically by positive trading or other one-time results, the fact that these banks have their operating costs under control should help them continue to perform well.[85] Looking at the two relevant high net operating income banks in the non-gainer category, it is noteworthy that only one (VTB) has a net operating cost ratio of less than 10 percent.

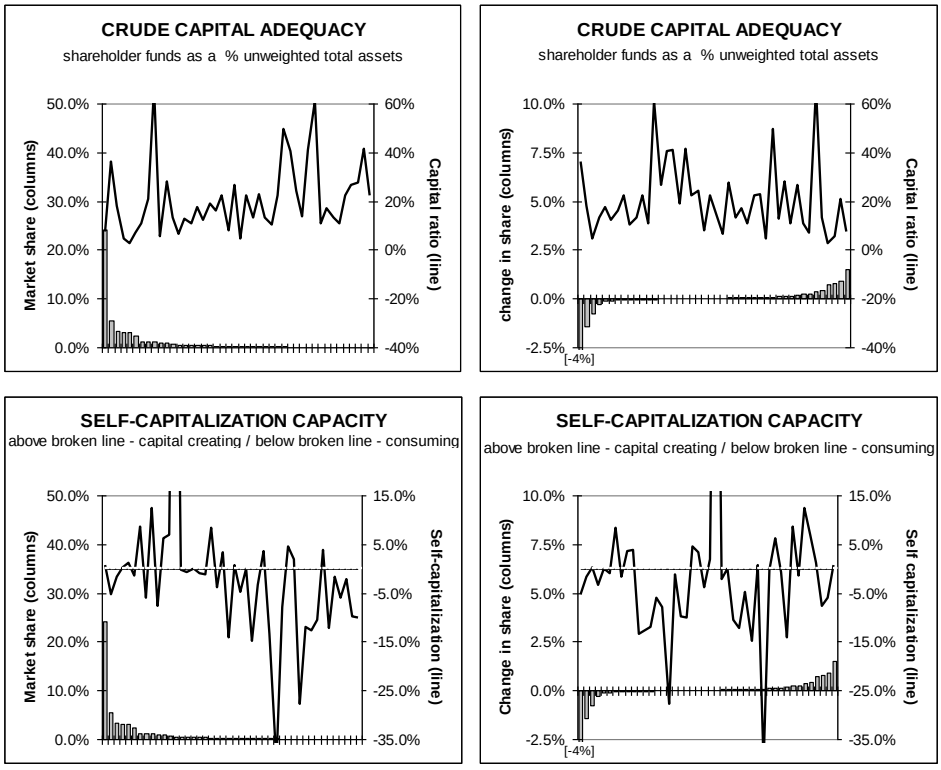
176. The table also indicates that three of the four expanding and most profitable banks have a sufficient capital base to continue to expand at the same pace as in 2000. The only bank of the four with a negative self-capitalization ratio is MDM Bank, which has increased its capital since the end of 2000. Other expanding banks with sufficient capital to continue their 2000 growth rate are Sberbank, IMB, and Nikoil Bank. The overall situation for the 44 sample banks in terms of

84 Nikoil Bank shows the highest net ROA, but this is a nonstandard result related to the bank's very high capital level. As a result, the bank has a high level of income-earning assets and a low level of interest-bearing liabilities.

85 Standard & Poor's notes, for example in the case of MDM Bank that "Significant gains from one-off transactions, such as distressed debt purchases and equity stake purchases for third parties, brought MDM Bank's profitability above the sector average in 2000 and 2001."

their self-capitalization ability is summarized in figure 9.3, where the left side indicates the 2000 market share level and the right side changes in market share between 1998 and 2000.

Figure 9.3. Capital Sustainability in the Russian Federation



177. Banks that gained significant market share tended to be capital-creating but with two or three marked exceptions (see figure 9.3 bottom right).

178. In summary, the 2000 results indicate that some of Russia's largest and most rapidly expanding banks were among the most profitable. However, these results should be interpreted with caution: they are for one year only, and during this year some banks introduced IAS 29, which somewhat distorts the comparisons. Nevertheless, it is noteworthy that two of the four banks in the most profitable category have subsequently developed growth strategies based on expansion by acquisition. As of the end of 2000, all but one of the four had sufficient capital to sustain further expansion, while the fourth subsequently increased its capital. Although these results would seem to be encouraging in terms of their implications for increased competition, we discuss several important caveats in the conclusion.

Conclusions and Recommendations

179. In a banking sector that was long considered moribund, it is heartening to see signs of change. It is particularly unexpected to see this change originate from the banks themselves, arguably in response to their major clients' market-driven actions. It was not readily predictable that Russia's banking sector consolidation process would be market-initiated.

- The fact that some of Russia's most rapidly expanding banks are also the most profitable, at least on the basis of their 2000 results, would seem to augur well for further banking sector growth based on adequate capitalization. However, there are three important caveats. One is Sberbank's and to a lesser extent VTB's dominant role. The non-market advantages these banks enjoy dissipate the impact of increasing competitiveness among the privately owned banks. Also, the privately owned banks are still too small to challenge the state-owned banks, and are likely to remain so. Insofar as the largest banks' results were achieved with operating costs and spread ratios that are very high by normal international standards (see figures 9.1 and 9.2), this signals continued sub-par performance in terms of efficiency.
- For the same reasons, even if consolidation reflects increased competition among Russia's large private banks, it seems unlikely to address an equally important economic challenge: namely the unacceptably low level of intermediation.
- Although the two most actively expanding banks were among the most profitable of Russia's 20 largest banks in 2000, their corporate structures raise questions about their long-term potential to lead Russia's banking sector in terms of efficiency and competitiveness. Uralsibbank is majority owned by government (of a republic) and worldwide experience demonstrates that publicly owned banks are not generally as efficient as privately-owned banks. MDM Bank's controlling owner also has significant industrial holdings. Although Standard & Poors has noted that MDM Bank's industrial company financing is relatively low, the history of Russia's banking sector inevitably raises questions about this bank's long-term strategic focus and transparency.. Furthermore, even if these two banks manage to mitigate the shortcomings of their corporate structures, it is far from clear that these corporate structures are ideal models for other Russian banks.

180. In light of these three caveats, the fact that market-initiated consolidation has begun in Russia does not mean that a laissez-faire policy is desirable. In fact, the CBR should take a more active role in monitoring the various processes detailed in this case study and use the resulting information to guide if not actually lead future consolidation:

- As a first step, the CBR should streamline the merger and acquisition process to ensure that it remains relevant. The current cumbersome system inevitably creates significant incentives to circumvent the rules. In addition, the holding company structure that several banks have implemented needs to be be evaluated in terms of corporate governance implications and especially the protection of minority shareholder rights.
- Second, the CBR should determine whether the banks that have taken the lead in the acquisitions seen thus far represent the models that it would like to see replicated and, if so, how to ensure that the potential strengths of these models outweigh their weaknesses.

- Third, because market-initiated consolidation alone cannot address anticompetitive overhang of the large state-owned banks, policymakers must take responsibility for creating a more level playing field.[86] These banks gain tremendous competitive advantage from their sheer size, and it is hard to justify policy interventions that intensify such advantages. A truly competitive banking system in Russia will be one in which the next tier of banks can grow (possibly via mergers) to compete on more equal terms with today's largest banks, including the dominant state banks. Policies should be used to help this process.

One possible route to achieve greater competition more rapidly would be to attract more foreign investment to the sector. This is not the panacea that it is sometimes made out to be since foreign banks have certain disadvantages in difficult operating environments such as Russia. However, it would be one way to accelerate the efficiency gains that might not come so readily from purely internal competition. It also could be a more rapid route to the enhanced banking intermediation levels that Russia certainly needs.

86 This issue is discussed in detail in *Building Trust*, Chapter 7.

TWO CASES OF OVERADMINISTERED CONSOLIDATION:

BULGARIA AND ARMENIA

CHAPTER 10: BULGARIA

Introduction

181. Bank consolidation in Bulgaria has been an essentially administratively led process so far. The authorities' interventions began in the 1992–1994 period, in response to the overall weaknesses of thebanking sector. Bulgaria chose an unusual vehicle to address these problems, creating the Bank Consolidation Company (BCC) to assume the ownership of and restructure a large group of banks. However, the underlying sector weaknesses were not resolved, leading to the pivotal 1996 financial crisis.

182. The crisis was serious enough to lead to a dramatic revitalization of political will to reform Bulgaria's economy. The resulting introduction of the currency board, and commitment to an IMF program that included bank and enterprise privatization have begun to have some positive impacts. Nevertheless, Bulgarian banks have not internalized the state-initiated consolidation processes begun in 1992. The most striking contrast is with the Baltic states and Poland, where the authorities also played a key role in the early reform stages, although with a higher initial level of credibility. In these countries, the consolidation process has now become market-led. The current stage of consolidation in Bulgaria taxonomically positions Bulgaria in the bottom left C segment of Figure 3.2. The key issue in this case study is to identify whether the lack of market internalization is a matter of time (the sample data only extended three full years beyond the end of the 1996-97crisis) or reflects a tendency by the Bulgarian authorities to over-administer the consolidation process.

183. This chapter starts with a brief overview of general elements in Bulgaria's economic situation and an overview of the pre-reform monobank system. Then it reviews the consolidation process since the early 1990s in two stages: first the process up to and including the immediate aftermath of the 1996–97 crisis and then how the process has evolved from 1998 onward. Finally, we draw conclusions about likely future developments in the consolidation process.

The General Economic Background

184. Bulgaria's turbulent economic development record during the 1990s is illustrated by the selected indicators shown in Table 10.1.

Table 10.1. Macroeconomic Indicators for Bulgaria: 1991–2001

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP at constant	-11.7	-7.3	-1.5	1.8	2.1	-9.4	-5.6	4.0	2.3	5.4	4.0

prices (% change)											
Annual inflation % (average year-on-year)	339	91	73	96	62	122	1058	18.7	2.6	10.3	7.4
Exchange rate BGN/US$ end year	0.02	0.02	0.03	0.07	0.07	0.49	1.78	1.68	1.95	2.10	2.22

Source: ???

185. Economic recovery from the recession of the early transition years was evident by 1994/95 but was sharply disturbed by the 1996 crisis events. Stability already was questionable before the crisis because of inflation and debt. The crisis period itself was characterized by rapid currency depreciation, high inflation, spiraling government debt, and the output decline shown in Table 10.1. However, beginning in 1997, Bulgaria's macroeconomic situation has shown significant improvement and greater stability.[87] The improvement was achieved after the 1997 introduction of a comprehensive reform program supported by the IMF and the World Bank. The program including adoption of a currency board (CB) arrangement and prudent fiscal and income policies. Also, the reform-oriented government of the United Democratic Forces initiated radical structural reforms. As a result, the macroeconomic climate improved substantially: GDP grew by 4 percent in 1998, general inflation declined sharply after hitting more than 1,000 percent in 1997, and the consolidated budget deficit was entirely eliminated by 1998.

186. This radical macroeconomic improvement gave Bulgaria a valuable platform from which to address the substantial legacy of necessary restructuring.[88] The country quickly achieved significant progress with privatization. As of the end of August 1999, 42.3 percent of total public sector assets (compared to 18 percent as of the end of 1997[89]) had been privatized. Some major privatization deals included the airline company Balkan, the oil refinery Neftochim, the steel giant Kremikovtsi, the copper smelter MDK Pirdop, and the sale to strategic foreign investors of four Bulgarian banks. In the first 6 months of 1999, total privatization deals amounted to US$281 million,[90] while foreign direct investments reached US$220 million[91]. The structure of foreign investment reveals the relative attractiveness of different sectors, with wholesale trade attracting significant investment, followed by mineral processing, pharmaceuticals, and paper manufacturing. Germany continues to be Bulgaria's leading investor, followed by Greece, Italy, and Belgium.

187. However, the Kosovo crisis of 1999 significantly disturbed the region's economic environment and prevented Bulgaria from attracting more foreign investment and concluding more privatization deals. The crisis combined with the accelerated structural reforms, especially public sector downsizing, to cause weaker economic performance in 1999. Bulgaria again registered a negative GDP growth rate (-0.7 percent year-on-year[92]) during the first quarter of

[87] OECD. 1999. *OECD Economic Surveys: 1998–1999 Bulgaria*. OECD 1999, p. 23.
[88] *Ibid.*
[89] *Bulgaria: the Economy in the First Half of 1999*. 1999. Agency for Economic Analysis and Forecasting (Business Survey Series), p. 27.
[90] The World Bank Resident Mission Bulgaria. 1999. *Economic Report: Review of the First Half of 1999 and Recent Developments*, p. iv.
[91] *Bulgaria: the Economy in the First Half of 1999*. 1999. Agency for Economic Analysis and Forecasting (Business Survey Series), p. 48.
[92] The World Bank Resident Mission Bulgaria. 1999. *Economic Report: Review of the First Half of 1999 and Recent*

1999. However, despite these unfavorable external shocks, the private sector registered a cumulative growth rate of 0.5 percent and contributed to 1.6 percent year-on-year GDP growth in the second quarter of 1999.[93] This broadly favorable conjuncture of declining inflation and strengthening growth continued through 2001, although popular discontent with the way in which the benefits of reform were being shared became more vocal.

Banking Sector Developments Prior to the 1990s

188. The foundations of Bulgaria's banking sector were laid shortly after Bulgaria was liberated from Turkish domination in 1879, and when the Bulgarian National Bank (BNB) was established as an independent credit institution. Its Act of Incorporation defines its role as a facilitator of trade relations and a regulator of domestic credit and economic activity. In 1885, BNB was also granted emission functions.[94] Moreover, until 1906, BNB was the only deposit-credit institution that provided nationwide general credit. For many years, its resources were of utmost importance in providing credits to both the private sector and existing agricultural funds.[95] However, in 1915 BNB's relations with private banks and its crediting activities were significantly undermined when the Ministry of Finance took over its emission functions and reserves management.

189. After the 1923 economic stabilization, BNB regained its regulatory and stabilizing functions and was granted total control over the country's foreign exchange operations. From that date, it managed the entire trade with foreign payments instruments and also determined exchange rates. BNB also resumed its financing to private banks through discount operations and special current accounts.[96] By the end of the 1920s, conditions were ripe for further development of the system, and after 1926 these developments were accompanied by a clear tendency toward bank mergers and banking system concentration. Bulgaria was on the road to establishing a well-functioning banking system. However, this situation deteriorated sharply with the 1930s' global crisis and World War II. By the end of the war, the country's economy was completely decapitalized because of extremely high inflation. This led to the so-called "monobank period" when the state gained monopoly over all banking activities after nationalizing the existing private banks. BNB merged its emission and crediting functions and was given full control over the country's balance of payments. The monobank period lasted from 1947 until 1989.

190. After the centrally planned economy collapsed, Bulgaria, in common with most transition economies, adopted a two-tier banking and monetary system. The new law of 1991 granted BNB the classical functions of a modern central bank's. At the same time, 59 BNB branches were spun off and transformed into joint stock companies. A new legal framework enabled free entry and, at that time, unregulated banking operations. As a result, by early 1991 there were 69 commercial banks, established as joint-stock companies along with the three existing ones.

191. The rapid emergence of so many new banks posed obvious and substantial risks for the financial sector's soundness, especially in the light of the absence of proper bank supervision and

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Developments, p. 1.

[93] Ibid., p. 1.

[94] Avramov, R., Petrov, B., Ianovski, H. 1999. *120 Years Bulgarian National Bank: 1879–1999*. BNB press and BNB. 1929. *Anniversary Collection of the Bulgarian National Bank.* Sofia state press, p. 13.

[95] BNB. 1929. *Anniversary Collection of the Bulgarian National Bank.* Sofia sate press, p.99.

[96] Ibid., p.104.

regulation. Moreover, there were few if any qualified professionals to manage the banks in the new economic situation. Individuals with banking knowledge and culture acquired under the socialist system were suddenly asked to take on completely alien functions. As a short-term consequence, credit allocations continued to be determined according to established practices and without much regard for risk considerations. One inevitable consequence was that the banks were quickly weakened by large bad loan portfolios and sustained substantial decapitalization.

Administrative and Policy Developments 1991–1998

192. The large number of state-owned banks in the early 1990s and the significant decline in their financial condition created serious problems for the embryonic regulatory authorities. In an early attempt to bring some order to the situation, in 1992 the authorities established the Bank Consolidation Company (BCC). On the authority of Ordinance No. 26/March 1992, the Council of Ministers ordered that all shares of commercial state banks in possession of state-owned enterprises and other state institutions be transferred to BCC.

193. BCC's initial priority was to reduce the number of state-owned banks through voluntary mergers or acquisitions. BCC's first consolidation project was concluded in the second half of 1992. Then BCC encouraged a merger among Doverie Commercial Bank, Stroybank, and 20 other small banks. The resulting United Bulgarian Bank (UBB) was established at the end of 1992.[97]

194. This administered consolidation process continued in 1993 when BCC helped create Expressbank by sponsoring a merger of 12 state banks and established Hebrosbank by a merger of another 8 state banks. In both of these projects BCC applied a mix of administrative and economic measures to enforce the mergers.[98] Then in 1994 BCC encouraged the voluntary merger of Hemus Commercial Bank, Sofia Commercial Bank, Elektronika Commercial Bank, and Kazanluk Commercial Bank to create Sofiabank. A year later, Sofiabank merged with Bank Biochim and several smaller banks and to become Biochim Bank. Biochim Bank was the last of the administratively consolidated banks during this stage.[99]

195. The authorities expected that these banks' mergers would lead to stronger, more efficient banks. However, this expectation was not realized, and many of the state banks' financial positions failed to show material improvement. In many cases, since the banks were initially weak, their mergers merely led to bigger but equally weak banks. The banking sector's real problems, such as its generally low capital base and inefficient management, were not addressed

[97] Jotev, P. 1998. "A Review of Bulgarian Privatization: the Consolidation, Rehabilitation and Privatization Process of Bulgarian Banks". OECD Publications, p. 2

[98] OECD. 1997. "The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future". *OECD Proceedings,* p. 130

[99] Biochim's recent history: 99.59 percent of Biochim bank was sold for EUR 82,5 million in 2002 to the Bank Austria Creditanstalt Group. Biochim is now Bulgaria's fourth-largest bank, with a market share of about 5 percent. By the end of March 2002, Biochim's share capital was BGL 44 million. The Bank Austria Creditanstalt established itself in Bulgaria in 1996 via HypoVereinsbank. In 2002 the HVB Bulgaria subsidiary was established. After its purchase of Biochim, that subsidiary's assets are expected to merge with those of Biochim, to produce a 7 percent overall market share. In Central and Eastern Europe the Bank Austria Creditanstalt operates the largest banking network: including Biochim, the network contains 970 offices in 15 countries in this region, and its total assets amount to 26 billion Euros. The buyer plans to preserve the bank's name and managerial staff.

by the administrative measures employed. The reasons for this are explored further in the next subsection.

The Bad Loan Settlement

196. From the outset, the Bulgarian authorities chose an easy but ineffective approach to "nationalizing" the non-performing bad loans extended by banks prior to 1990. This was done without any complementary structural reform measures for the banking sector. The estimated amount of bad loans taken over by the state at that time was the equivalent of about 7 percent of GDP. Similar volumes of bad loans were also written off by the government in 1992–1993.[100] But this approach substantially eroded financial discipline in the economy's banking and real sectors. Practically all SOEs got the message that they no longer needed to service their old bad loans, and they continued to make imprudent loans. None of the explicit incentives for banks built into the reform in Poland, for example, were incorporated into the Bulgarian restructuring. So it was no real surprise that by the end of 1993 the Bulgarian banking system was experiencing substantial losses.[101]

197. In an effort to recapitalize the ailing banks, in December 1992 Parliament approved the ZUNK law (the name comes from the Bulgarian acronym). Under this law, the state assumed all non-performing bank loans issued before 1991, placing bonds of equivalent value in the portfolios of affected banks. The nominal value of these bonds' was the equivalent of 35 percent of GDP.[102] However, the ZUNK law also suffered from critical design flaws. Above all, it addressed only the stock aspect of the bad loan problemand completely disregarded the problems associated with new lending.

198. The banks were adversely affected by the fact that ZUNK bonds offered below market rates of return, which exacerbated their liquidity difficulties. They needed to pay higher interest rates on their liabilities than they earned on the ZUNK bonds. In order to cope with this problem, the bank managers resorted to methods that further worsened their financial difficulties: higher spreads, higher deposit rates, and increasingly expensive BNB refinancing.

199. Above all, the unconditional bank bailouts provided under the ZUNK law failed to enforce any changes in the imprudent lending practices of banks. Extensive risky and insider lending continued. New bad loans quickly accumulated, with the total rising to almost 15 percent of total bank assets by 1996 (Table 10.2).

Table 10.2. Portfolio Development of the Bulgarian Banking Sector (1994–1998)

	1994	1995	1996	1997	1998
Total banking sector assets (BGL million)	861	1 087	3 631	7 410	7 685
Bad and doubtful loans (% of total assets)	6.8	12.6	14.6	12.9	16.1

Source: BNB, EBRD, IMF.

[100] OECD. 1997. "The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future". *OECD Proceedings*, p. 102
[101] Ibid., p.123
[102] *Bulgaria's Banking System and Bulbank.* 1998. Merrill Lynch: Draft Report, p. 5

200. These negative banking sector trends, the real sector's continuing recession, and the lack of SOE restructuring led to the 1996 banking crisis. It is clear with the benefit of hindsight that the bank consolidation measures introduced at the early stages of Bulgaria's banking "reforms" were largely ineffective. They certainly failed to encourage changes in banking behavior of the type needed to create sound banks and avert the crisis of 1996.

The Banking Crisis of 1996

201. The banking crisis was induced by both economic and political factors. First, the overall economy was poor. GDP decreased by nearly 10 percent in 1996 (see Table 10.1). This was mainly due to a drop in state industrial and agricultural output.[103] SOE-bank relationships also played a key role. At that time private firms, mainly in retailing and services, close to the government thrived on parasitic relations with the SOEs. One result was that many state enterprises were stripped of their assets and experienced substantial financial losses. Given the incentives described above, most stopped servicing their bank loans.

202. At the same time, the government exercised political pressure on commercial banks and encouraged them to finance enterprise losses by granting new loans even though many of these would undoubtedly become non-performing.[104] By the end of 1995, loans classified as "standard" constituted only 25.9 percent of all loans in the consolidated balance sheets of the banks[105]

203. A further aggravating factor was bank managers' propensity to indulge heavily in insider lending—much of it almost certainly corrupt. It is estimated that some 25 percent of total bank assets were irretrievably lost in the form of bad loans granted to enterprises close to bank managers. Private banks were implicated in at least some of these bad practices. As of the end of 1995, non-performing loans extended to private companies amounted to 5 percent of Bulgaria's GDP.[106] As for the total banking sector, poor banking practices resulted in severe decapitalization. By early 1996, the Bulgarian banks reported negative equity of around US$1.3 billion, the equivalent of 13 percent of GDP.[107]

204. It was almost inevitable that these disastrous financial results would arouse public concerns about deposit safety. There was a run on five banks and on the currency in general in spring 1996. BNB's response was to increase the base interest rate (to 108 percent in May), but this only temporarily quieted the demand for dollars.[108] Toward mid-1996, people massively started withdrawing their bank deposits, precipitating a full-scale run on the whole banking system. By September 1996, time deposits withdrawn had amounted to US$840 million.[109] The BNB had to take further expedient measures in response to this crisis.

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[103] EIU. 1997. *Bulgaria: Country Report 1997-1998*. The Economist Intelligence Unit Publication, p. 21
[104] *Bulgaria's Banking System and Bulbank*. 1998. Merrill Lynch: Draft Report, p. 4.
[105] BNB. 1995. *Bulgarian National Bank Annual Report 1995*
[106] OECD. 1997. "The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future". *OECD Proceedings*, p. 104.
[107] *Bulgaria's Banking System and Bulbank.* 1998. Merrill Lynch: Draft Report, p. 4.
[108] OECD. 1997. "The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future". *OECD Proceedings*, p. 114.
[109] *Ibid*., p.105.

205. By the end of 1996, 16 commercial banks (state-owned and private) were placed under special supervision, and bankruptcy procedures were initiated against several of these.[110] The banking crisis resulted in the closure of 19 banks that together accounted for more than 30 percent of the banking sector's assets.[111]

Legal Framework

206. The 1996–1997 banking crisis made a significant contribution to strengthening the political will for economic and democratic reforms, resulting in a new political consensus, reached in 1997. This consensus was associated with the change of governments. In 1997, the Union of Democratic Forces (UDF) took over from the former socialist, non-reform-oriented government. UDF then led a radical reform program, including privatizing the banking sector. This political consensus was crucial for general progress in transition and particularly banking sector reforms: it also created the basis of Bulgaria's current political stability.

207. One outcome of the new consensus was amended banking legislation, which contributed to structural changes in banking. The basic Law on Banks was replaced by a new law in July 1997. As a result, BNB's regulatory power was considerably expanded. The legislation granted BNB the right to close a bank and even obliged BNB to revoke a banking license in case of insolvency. Neither the courts nor the bank in question can now contest BNB's decision. Moreover, the Law on Banks makes banks, as well as borrowers, liable and subject to legal prosecution for any inappropriate lending.[112]

208. Armed with these new powers, BNB quickly placed 16 banks in receivership and petitioned the courts for their bankruptcy. By early 1998, one merger had taken place, while the 15 other banks were declared bankrupt.[113] Prudential regulations were also strengthened in 1996 and 1997. Commercial banks' minimum capital requirements were increased from BGL 2.2 billion to BGL 10 billion (DM 10 million) and minimum capital adequacy increased from 8 percent to 10 percent in 1998.[114]

209. Another important legislative change was the new deposit insurance system introduced in January 1998. It provided limited guarantees, such as 95 percent on deposits up to BGL 2 million, 85 percent on deposits between BGL 2 million and BGL 5 million, and nothing above this level.[115] The deposit insurance is funded from a 0.5 percent annual contribution paid by banks on all personal deposits.[116]

The Currency Board's Stabilization Effect on Banks

210. The last important institutional change that helped to remedy some of the failings of the early 1990s bank restructurings was the adoption of a currency board system. The introduction of the CB in mid-1997 put an end to the BNB's refinancing power, including its ability to lend to troubled banks. This statutory restraint was critical to the credibility of the state's commitment to

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[110] *Ibid.*
[111] *Bulgaria's Banking System and Bulbank.* 1998. Merrill Lynch: Draft Report, p. 4.
[112] BNB. 1998. *Banking Laws and Regulations*, Chapter V.
[113] OECD. 1999. *Bulgaria: Economic Report*. OECD Publications, p. 28.
[114] BNB. *Bank Regulations.*
[115] Ibid., p.15
[116] OECD,. *Bulgaria: Economic Report*. OECD Publications, 1999. p. 29.

banking sector reform. The CB also played a leading role in stabilizing the overall financial sector.

211. Undoubtedly, "the currency board has been a crucial factor in the success of the country's stabilization program."[117] Introduced in July 1997, it provided the right conditions for the implementation of a successful stabilization program: credible, rule-based exchange arrangements with legal and structural measures that addressed pressing banking sector and fiscal issues.[118] Its provisions were conducive to lowering inflation and eliminating large-scale monetary financing of the budget. This new top-down discipline has been sustained by the central bank's more prudent and proactive regulatory and supervisory activities. As a consequence, the financial state of banks improved substantially. The commercial banks in general were able to restore their capital positions as theirtheir profitability increased.[119] This broadly satisfactory performance of commercial banks as a whole in the CB's early years is shown in Table 10.3.

Table 10.3. Financial Indicators of Bulgarian Commercial Banks (%)

	June 1997	June 1998
Total capital adequacy	16.0	34.1
ROA	1.1	2.8

Source: Sources include BNB annual reports and estimates made by Yitzov Victor, Nikolay Nenovsky, Kalin Hristov, Boris Petrov, and Iva Petrova, "The First Year of the Currency Board in Bulgaria", *Discussion Papers*/1/1998, September 1998.

Developments Since 1998

212. Currently, 34 commercial banks operate in Bulgaria.[120] The sector is dominated by the three large legacy banks—Bulbank,[121] DSK, and United Bulgarian—which together account for

[117] A. Gulde, "The Role of the Currency Board in Bulgaria's Stabilization," *Finance and Development* (IMF quarterly magazine), 1999, vol. 36, p.1.

[118] The lev was fixed to the peg currency, the deutsche mark (1,000 lev per 1 deutsche mark). On January 1, 1999, the fixed exchange rate to the deutsche mark was converted to the euro. The choice of the euro as a peg currency was influenced by Bulgaria's political objective of EU accession and future integration into the Economic and Monetary Union. (See *Joint Assessment of Bulgaria's Economic Policy Priorities*. 1999, www.government.bg). Under the CB's rules, the central bank cannot lend to the state or to any state agency, except against purchases of IMF special drawing rights. Furthermore, the central bank can finance commercial banks only if the financial system's stability is endangered (see R. Avramov, B. Petrov, and H. Ianovski, *120 Years Bulgarian National Bank: 1879–1999*. BNB Press, 1999. p. 275).

[119] *Ibid*., p.3 2.

[120] OECD, *Bulgaria: Economic Report*, OECD Publications, 1999. p. 30.

[121] In 1998 Bulbank's privatization began. The share capital of the bank was raised eleven-fold and divided into 166,370,160 ordinary shares of BGL 1,000 face value each. Bulbank's privatization was completed on October 2 **2000** with the transfer of BCC's shares to UniCredito Italiano S.p.A and Allianz AG, which acquired 93 percent and 5 percent of Bulbank's share capital respectively. Bulbank also sold its participations in Corporate Commercial Bank (99.9 percent), UBB (35 percent), and HypoVereinsbank Bulgaria (49 percent). In 2001 Bulbank began a deep redesign of its business model, seeking to become more open to its customers and improve its efficiency and financial performance. Accordingly, a new organizational structure was introduced. Bulbank's major shareholder UniCredito sold minor stakes to the Italian SIMEST S.p.A., Rome, and the International Finance Corporation—2.5 percent and 5.3 percent of share capital, respectively.

some 55 percent of total bank assets. Approximately 24 percent of total bank assets were sold to strategic foreign investors by the end of 1999; , including two of the big three banks,

213. The state first parted with the United Bulgarian Bank (UBB), accounting for 10 percent of total assets. In August 1997 a consortium of the EBRD (35 percent), Bulbank (35 percent), and the U.S. Oppenheimer Co. (30 percent) bought UBB.[122] Shortly after the acquisition, BCC reported that the new majority shareholders had made a "significant capital infusion."[123] At a later stage, Bulbank sold out as part of its own privatization, and Oppenheimer followed. The bank's present owner is the National Bank of Greece (89.90 percent of UBB's equity, the remaining 10 percent is still held by EBRD).

214. The next year (1998) saw the start of Bulbank's privatization, but this took until 2000 to complete. This meant that the Bulgarian Post Bank (BPB) was Bulgaria's second privatized bank: 78.23 percent of its total equity was sold to American Life Insurance Company (ALICO) and Consolidated Eurofinance Holdings (CEH). The buyers also increased the bank's capital with US$20 million being provided within 12 months of the sale. They also took the obligation to preserve their stake in the bank for at least seven years and pay to the BCC or the government 10 percent of their after-tax profit within the next five years.

215. On September 24, 1999, BCC sold 98.9 percent of Expressbank's capital to the French Societe Generale. According to the head of BCC, the major criteria for this deal were the price and the need for a strategic investor. The reported price was US$39.1 million. Later that year the sale of Plovdiv-based Hebrosbank to Regent Pacific Group was agreed, with the buyer getting 97.57 percent of the bank's capital for a price of US$23.5 million in cash.

216. As already noted, Bulbank's privatization was finally completed in October 2000, with the sale being made to UniCredito Italiano S.p.A and Allianz AG, which acquired 93 percent and 5 percent of Bulbank's share capital, respectively.

217. By early 2002, the last of the mid-sized banks under BCC control—Biochim Bank—was sold for euro 82.5 million to Bank Austria Creditanstalt Group. Later that year the first privatization stages began for the only remaining state-owned bank—DSK, the State Savings Bank—this was expected to be completed during the first half of 2003.

218. It is evident that until very recently the performance of individual bankswas affected by some combination of the administrative measures used to guide their various restructurings and the difficult macroeconomic circumstances that have persisted for most of the 1990s. It is nonetheless useful to examine the performance of individual banks in greater detail to try to see whether any obvious patterns emerge. We did this for a sample of 23 banks using data for the 1998–2000 period. In 2000 these banks accounted for 92 percent of total banking system assets. Figure 10.1 plots each bank's market share in 2000 against various banking performance indicators. Figure 10.2 does the same for changes in market share during 1998 to 2000.

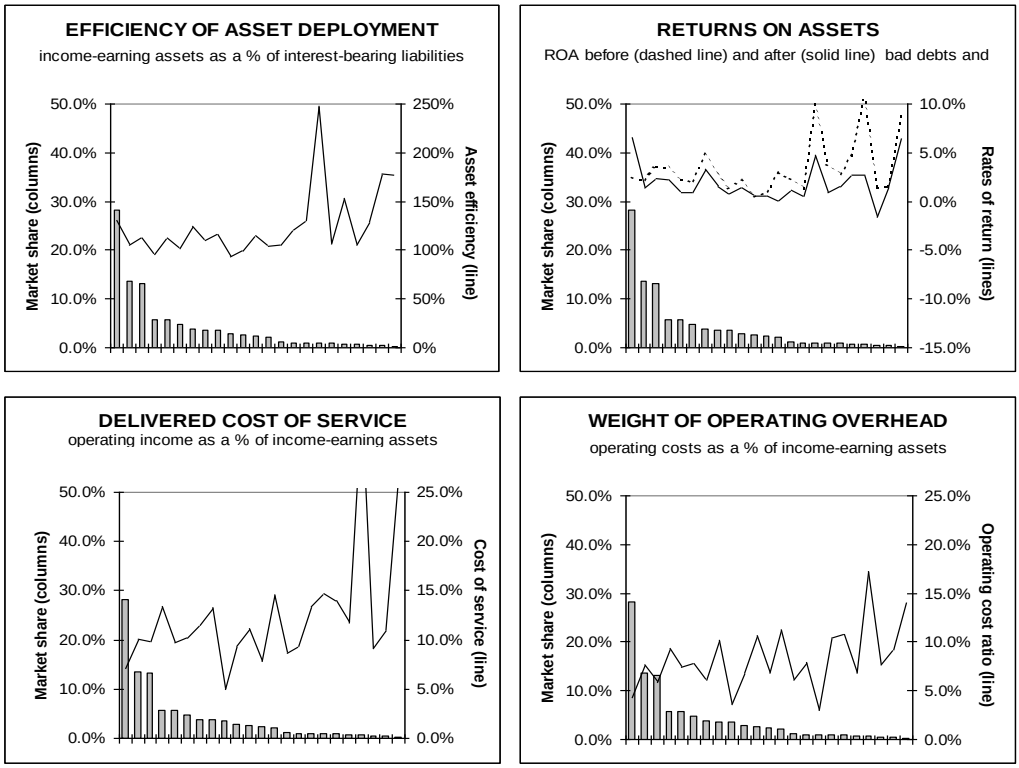
219. The data in figure 10.1 indicate that the crude mean values of the cost overhead and income ratios are, at 8.3 percent and 12.4 percent respectively, both very much lower than Ukraine and Russia but still substantially out of line with those found in the advanced economies. As for the efficiency of asset deployment, most Bulgarian banks are quite effective at

[122] B. Petrov, *Bulgarian Financial System Under a Currency Board Arrangement,* BNB, Publications, 1999. p. 8.
[123] BCC, *Information on the Bank Privatization Process in Bulgaria.* BCC Press Release, January, 14, 1999. p. 1.

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committing their borrowed resources to income-earning assets. Several of the smaller banks in particular have very high capitalization levels, which means that they can commit more than 100 percent of their interest-bearing liabilities to generate income. There is not much evidence in these data of wasteful resource use in excessively large real estate investments or high ratios of non-performing loans, as in Ukraine. However, when the evidence on operating income—delivered cost of service—is studied, then even the largest banks in the Bulgarian sample have ratios close to or more than 10 percent, which is much higher than the average even in Latin America. Most of the banks have operating income ratios of well over 10 percent, and in some cases much higher. For operating overheads the picture is similar. The largest bank in the sample achieves an operating overhead ratio of 4 percent (close to the U.S. or German average) but the next largest bank has a ratio almost twice that (on a par with the Latin American average). The degree of correlation between size and operating overheads is in the correct direction (negative) but low (0.37). The standard deviation of operating overheads is high (3.3 percent points compared to crude mean of 8.3 percent).

Figure 10.1. Size and Bank Performance in Bulgaria (2000)

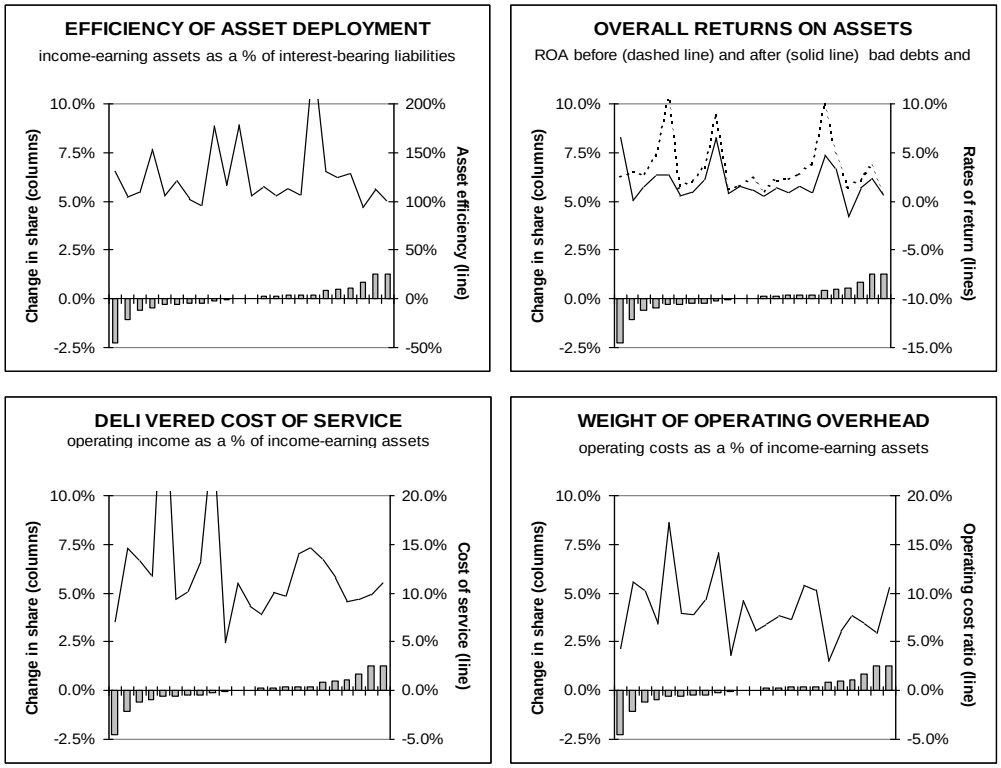


220. In general, Bulgaria's banks, including the larger ones, seem to have avoided the chronic inefficiencies found in some FSU banking systems. However, there is substantial performance variation across banks of different sizes, suggesting that a tightly competitive banking

environment such as is increasingly evident in the Baltic states and Poland is still to emerge. This general picture is reinforced by the market share changes data shown in figure 10.2.

Figure 10.2 indicates that the banks achieving the largest market share increases include some that demonstrate superior financial performance by Bulgarian standards. For example, three quarters of the market-share gainers have operating cost overhead ratios generally lower than the Bulgarian average of 8 percent, and the same is true of the delivered cost of service (typically around 9–10 percent, compared to an average of 12.5 percent, of course still high by Western banking standards). Unfortunately, the magnitude of the market share gains for these banks is small compared to the fluidity of market positions in other case-study countries. Moreover, some of the strongest performing banks relative to the chosen indicators are losing market share, although, as in Russia this might be due to special factors. Specifically, the biggest loser is the former specialist foreign trade bank, which has a proportionately higher foreign currency balance sheet than most banks. Relative to ROA, the top market share gainers have generally operated with low returns—typically 1–2 percent of assets. This suggests that competitive forces have played some part in their gains. The large performance variation across the range of "successful" and less successful banks again supports the argument that market-based processes are not dominant in Bulgaria's banking sector.

Figure 10.2. Changes in Market Share and Bank Performance 1998–2000



Conclusions and Implications for Consolidation

221. Long-delayed privatization and a sustained period when Bulgaria's banks were not subject to serious market and competitive pressures help to explain the still poor levels of many of the performance indicators across the sample of banks in 2000. During the first seven transition years, Bulgaria experienced constant political instability due to frequent changes of government. None of the governments demonstrated serious commitment to economic reforms. Moreover, various interest groups close to political elites purposely impeded effective banking sector reform in the hope of future self-enrichment, by taking advantage of lax lending policies and nontransparent privatization procedures.

222. In these circumstances, the financial condition of banks remained weak, with a heavy burden of non-performing credits in their portfolios and no proper supervision. Although the authorities instituted nominally strong bank consolidation measures, the potential beneficial effects of these were wholly overwhelmed by failure to eliminate distortions and perverse incentives that both banks and SOEs faced at least until after the 1996 crisis. The limited interest of foreign investors in taking stakes in banks during this earlier period was further compromised by the absence of legal provisions granting banks the ability to collect collateral, or to pursue bankruptcy through the courts.

Box 10.1. Bank Consolidation and SME Finance in Bulgaria

The SME Market

Bulgaria is at an intermediate level of SME development. As of the end of 2000, SMEs accounted for almost 30 percent of gross value added in the economy; this figure has been on an upward trend for two years. SMEs also accounted for 50.7 percent of employment.

SMEs consider the two most significant constraints to further growth to be lack of demand and insufficient finance. The government is playing an active role in supporting the SME market, including creating the Encouragement Bank AD (with German government assistance), whose mission is to finance SMEs.

Lending

It is estimated that total SME lending from 1999 to 2001 was BGN 753.8 million. This three-year SME lending figure represents only 18.9 percent of BGN 3,991.8 million in corporate and retail loans outstanding at the end of 2001. Nevertheless, SME lending is on an upward trend, as a result of banking saturation in the larger corporate market, a more stable business environment, and new lenders entering the market. Two of the latter include Encouragement Bank and Procredit Bank, both of which were founded to finance SMEs. Increased foreign assistance also plays a role. Foreign donor funding increased from US$16.2 million in 2000 to US$23.4 million in 2001.

A survey of SMEs indicated three constraints on further SME borrowing: (a) high interest rates; (b) high collateral requirements; and (c) lengthy processing time. Nevertheless, 31.2 percent of the SMEs surveyed applied for bank loans in 2001, and 22.6 percent received loans. This proportion of successful loan applications does not indicate significant borrowing problems.

Consolidation

As Bulgaria has reached an intermediate level of banking sector consolidation, the key question is whether increased consolidation will help or hinder SME lending. Until recently, with the exception of the Bulgarian-American Credit Bank, founded by the Bulgarian-American Enterprise Fund, the banks with the largest SME portfolios have been state-owned (DSK and BPB). There is therefore a possibility that privatizing these banks could result in less SME lending. On the other hand, as SME lending is considered a new market sector, and one that is actively supported by the government and foreign agencies, new owners might well find this an attractive sector for further development. An important test case will be BPB, which has recently been acquired by Greek investors.

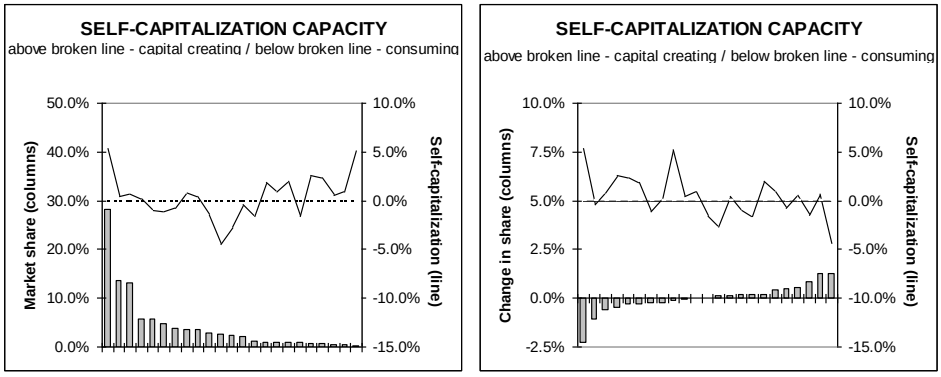
Source: This summary is based on Agency for Small and Medium-Sized Enterprises, *Bulgaria: Report on Small and Medium-Sized Enterprises, 2000-2002,* Sophia, 2002.

223. It was only belatedly, after the UDF came into office in 1997, that significant banking sector restructuring was able to begin. Given the financial impairment of that time, the driver once again had to be administrative measures, with the CB helping to enforce sustainable financial discipline. In addition, the IMF-supported program gave a decisive start to bank privatization and created a viable second tier of some five banks that may ultimately pose a real competitive challenge to the three large legacy banks that emerged dominant after the first crisis-driven consolidation phase. Unfortunately this process will have taken five years to reach its completion, and evidence from individual banks suggests that at least by 2000 the effects of these improved arrangements had only partly worked through into bank performance.

224. Competitive and regulatory forces have helped to force down spreads and costs—at least relative to the levels found in some FSU countries—but they are still absolutely high by Central European standards. Moreover, wide performance variations across surviving banks is evidence

of significant slackness in the competitive process, and it is still to be demonstrated that the second-tier banks are operationally and financially strong enough to challenge the legacy banks. The capital that these second-tier and smaller banks can deploy in mounting their challenge will be critical to the future shape and further consolidation of the banking sector. Certainly, looking at the organic capacity to self-capitalize shown in figure 10.3, the second and third tiers of banks are not strong enough to mount a sustained, significant challenge, and the smallest banks appear to be focusing on maximum equity extraction. It is therefore crucial that the assumption behind government banking policy that privatization to strong foreign investors will finally improve competition be realized. By 2000/01 it was too early to say whether this would be so, but as already noted, the market's competitive stasis may have begun to loosen in 2002.

Figure 10.3. Bulgarian Banks' Self-Capitalization Capacity



225. No one can fault the willingness of parts of the Bulgarian state to address systemic bank failure and the need for consolidation, but to date this has not been manifested in a fully effective consolidation process. With the benefit of hindsight, the Bulgarian experience points to the following lessons:

- An administratively initiated consolidation process that lacks credible enforcement tools, such as sanctions against banks with weak lending policies, will not change bank behavior and therefore will not be internalized by market participants.
- Another important aspect of an administratively initiated consolidation process concerns the consolidated banks' ownership. In the case of Bulgaria, ownership by the BCC, a state agency, meant that the consolidation process was so internalized into the public sector that market internalization was bound to be delayed.
- Although the currency board structure and bank privatization both have enhanced the credibility of the state's commitment to reform, the understandable desire to maximize prices at privatization has prolonged state sectoral involvement and further delayed market internalization of the consolidation process.
- Finally, Bulgaria is another case that shows how a financial crisis can be beneficial in creating support to implement changes that would not be politically acceptable in a more stable financial environment.

226. On the basis of these findings, the Bulgarian consolidation process is positioned as *not yet internalized by market participants.*The evidence presented indicates some *tendency to overadminister* the process. This has affected bank behavior long after the authorities made it clear that they were withdrawing from direct participation in the banking sector.

CHAPTER 11: ARMENIA

Introduction

227. Armenia, like the other two trans-Caucasian states, Azerbaijan and Georgia, has had a particularly traumatic transition from a planned to a market economy, severely exacerbated by war and economic blockade. In these extreme circumstances, banks proliferated during the early 1990s, from 6 at the time of separation from the Soviet Union to 74 by early 1994. Through a combination of strictly enforced bad-debt classification and provisioning requirements and pragmatic use of flawed banking legislation (since significantly improved), the Central Bank of Armenia (CBA) managed a strongly administered consolidation process between 1994 and 1996 that halved the number of banks. With a few further closures between then and the end of 2000 the number of banks was reduced to 29, including 7 small banks under CBA-initiated curatorship. Significant improvements to the bank bankruptcy law in 2001 enabled CBA more quickly to put an additional four troubled banks, including two of the largest locally owned banks, under direct CBA administration. The two groups of banks now under CBA administration together account for about a quarter of total banking sector assets and inter-bank activity but a third of sector-wide lending and deposit-taking. Further consolidation pressure comes from the fact that the market is still overpopulated relative to its small real size and from rising minimum capital requirements. In this context, the self-capitalization issue identified in chapter 3 is particularly important. Armenia's banking sector almost certainly is on the threshold of significant maturation; administered consolidation has weeded out connected companies' and the grossest abuses of the pocket bank, but only a market-internalized consolidation process will enable the development of a competitive banking system.

Economic Overview

228. Armenia emerged from the breakup of the Soviet Union with possibly one of the worst political economy frameworks within which to manage the transition to a full-fledged market economy. Landlocked, recently devastated by a massive earthquake, and rapidly descending into war with neighboring Azerbaijan, Armenia found itself embargoed by two neighbors: problems further compounded by civil war in its western neighbor Georgia. With such pressures, it was hardly surprising that currency reform was delayed and that Armenia, was one of the last of the CIS states to stop free ruble circulation ahead of the ruble zone collapse. This resulted in a very small economy being flooded with large volumes of worthless currency, hugely exacerbating hyperinflationary pressures. Table 11.1 shows the magnitude of the economic collapse—PPP-adjusted dollar GDP per capita fell to 5 percent of the pre-reform levels, and the economy's savings base, measured by broad money per capita, fell to just 1 percent of the pre-reform levels.

In some ways the magnitude of the collapse was exacerbated by the monetary consequences of the 1988 earthquake, which created a temporary reconstruction boom and brought significant volumes of hard currency into Armenia as the diaspora rallied to provide support (at a time when the economic value of hard currency within the Soviet system was rising rapidly). Perhaps the most graphic indicator of the stresses of transition has been the impact on population; adjusting for the inclusion of Nagorno-Karabagh's population, the recent 2001 census indicates the departure of about 750,000 people: 20 percent of the late 1980s levels[124]. Against the context of such an extreme transition, the progress made since the mid-1990s has been dramatic. GDP has grown steadily in real terms, slowed but not reversed by the 1998 Russian crisis (which probably cost about half of one year's growth). Currency and price stability also survived the Russian crisis, with the Armenian dram falling by less than 10 percent against the U.S. dollar, and with modest deflationary price trends continuing through 2000 and beyond.

Table 11.1. Comparisons of GDP Per Capita and Broad Money Per Capita

	Armenia	**Azerb.**	**Georgia**	**Russia**	**Ukraine**	**Kazakh.**	**Baltics**
Prereform levels (1989):							
GDP per capita (US$)	7,233	n/a	n/a	10,346	7,167	6,088	7,803
Broad money per capita (US$)	4,309	n/a	n/a	8,370	5,372	n/a	5,198
Relative prices (US$=1)	0.60	n/a	n/a	0.63	0.69	0.39	0.88
Most recent levels (2001):							
GDP per capita (US$)	3,160	3,268	3,003	10,622	4,412	6,966	8,322
Broad money per capita (US$)	417	157	147	2,339	793	1,009	815
Relative prices (US$=1)	0.19	0.21	0.22	0.20	0.17	0.21	0.42
Percent change (1989–2001) (%)							
GDP per capita (US$)	-57	n/a	n/a	+3	-38	+14	+7
Broad money per capita (US$)	-90	n/a	n/a	-72	-85	n/a	-56
Relative prices (US$=1)	-68	n/a	n/a	-68	-75	-45	-53
Trough year(s)/peak declines (%)	*93–96*	*1992*	*1992*	*1999*	*1995*	*1995*	*1992*
GDP per capita	-95	n/a	n/a	-83	-60	n/a	-84
Broad money per capita	-99	n/a	n/a	-95	-95	n/a	-96

Source: ???
Note: All figures are PPP-adjusted.

229. One specific feature of Armenia's economy is the dichotomy between public sector and private sector compliance with international norms. In many areas government and state regulatory bodies have fully incorporated international standards into both the legislation underpinning regulation and its practice. This particularly applies to the CBA as the banking sector regulator. By contrast, Armenian enterprises appear to apply international standards only selectively, and where there is a direct economic incentive for them to do so; an example being where inward strategic investment is involved.[125] Therefore, although international accounting standards are virtually fully incorporated into Armenian accounting law and audit standards are about to be fully incorporated, often they are still treated as mechanical transformations of old Soviet account charts and revision practices, rather than part of a fundamental transformation in the way that companies should be run. Connections between companies and their shareholders

[124] The much talked-about declines in the Russian Federation's population are measured in single percentage points, and even the Baltic states have only lost 10 percent of their preindependence population levels.
[125] As opposed to much diaspora financial investment, which often appears to be done on the basis of personal contacts.

are also rarely transparent and often span the gray border between recorded economic activity and the informal or illegal sectors. This makes it very easy for owners to shift capital and resources from registered enterprises into unregistered economic activity to shield them from legitimate creditors. This combined with a high degree of politicization of economic activity and the sluggish privatization of major state-owned enterprises creates an extremely complex background for both regulating the banking system and managing its consolidation process.

Overall Size of the Banking Sector

230. The Armenian banking system is small by any standard, with total assets at the end of 2001 of just over US$400 million and total capital less than US$40 million. There were 30 banks operating in the country at that time, ranging from HSBC with assets of US$69 million (the largest, 70 percent owned by the HSBC Group) to Ria Bank with assets of just US$1.7 million. Table 11.2 highlights the significant capital and profitability reduction seen in the sector during 2001. Most of the losses were due to additional provisioning and writing off bad loans: the banks already moving toward liquidation (under curatorship) have large aggregated capital deficits, and the group of banks put under temporary administration in 2001 are likely to see their remaining capital wiped out by write-down or provisioning against their loan portfolios.

Table 11.2. Selected Annual Indicators: Commercial Banks

	1995	1996	1997	1998	1999	2000	2001
Number of Banks	37	36	34	31	31	29	30
Total Assets							
AMD million	42,324	69,327	108,575	162,143	194,128	225,773	232,269
US$ million	105.3	159.3	219.3	310.6	370.6	412.1	408.8
Total Capital							
AMD million	7,983	10,674	17,371	26,375	33,048	34,182	20,415
US$ million	19.9	24.5	35.1	50.5	63.1	62.4	35.9

Source: ???

231. The banking system's small size is due chiefly to the severity of the early 1990s' economic and financial dislocation, and significant progress had been made since currency reform in the mid-1990s.

232. AS was the case in almost all former Soviet satellites, Armenia was highly monetized and highly banked before reform started. The ratio of total banking sector deposits to GDP was 45 percent; a large part of the population was receiving salaries through banks, and almost everyone was using banks to pay bills and state levies and receive many state benefits. Cash use (again relative to GDP) was about four times eurozone levels, possibly reflecting funds disbursement to finance post-earthquake reconstruction. By 1996, when the dram began to stabilize, the deposits-to-GDP ratio had fallen to less than 3 percent and the amount of cash circulating in the economy was 1.33 times as large as the total stock of banking sector deposits.

233. The year 1996 marked the turning point. By this time the banking system had been purged of its worst operators and a reform program was established for the former state-owned banks. As already noted, the currency also began to stabilize. Progress between 1996 and 2000 was dramatic, with the deposits-to-GDP ratio rising nearly threefold (2.7 percent to 7.8 percent) and the cash-to-deposits ratio falling sharply. Table 11.3 puts this progress into a wider context; Armenia, from being a relative laggard among former Soviet states, has caught up with Belarus

and Ukraine and is beginning to catch up with Latvia, Lithuania, and Russia. Problems with selected leading banks since the middle of 2001 appeared to throw this process into reverse, with the deposit-to-GDP ratio falling and the cash-to-deposits ratio jumping sharply. This may be partly seasonal but will need careful monitoring.

Table 11.3. Armenian Monetary Development Compared to Other Transition Economies

mid-2001 data	Armenia			Central	Russia/	Ukraine/	Rest of
	mid-96	mid-01	end-01	Europe	Lat./Lit.	Belarus	FSU
Deposits as % of GDP	2.7	8.7	8.2	39	15	9	7
Ratio of cash in circulation to deposits (%)	134	51	61	16	32	56	59

Source: ???

234. The potential economic significance of the problems that emerged in 2001 can be seen in Table 11.4, which looks not only at trends in deposit volumes but also bank credit supply to the wider economy. This went into sharp reverse in 2001, especially overall net credit, in spite of continued positive net supply of donor-funded medium-term credits via banks.

Table 11.4. Flows of New Depositing With Banks and New Credit Supply and Withdrawal

	1996	1997	1998	1999	2000	2001
Deposits from NBNGS—end-year (US$ million)	45	65	104	127	167	190
% of GDP	2.7	3.7	5.6	6.6	8.3	8.7
Net new deposit mobilization in year (US$ million)		23	40	23	41	24
% of GDP		1.4	2.1	1.3	2.2	1.2
Gross credit to economy—end-year (US$ million)	85	124	167	201	251	233
% of GDP	5.0	7.0	9.0	10.4	12.6	10.6
Net credit supply/withdrawal in year (US$ million)		43	45	34	54	-17
% of GDP		2.6	2.4	1.8	2.8	-0.8

Source: ???

* Nonbank, nongovernment sector—that is, deposit money holders.

235. The critical issue addressed in this chapter is how quickly the banking sector can recover from 2001's problems and what sort of further consolidation will be required. With deposits equal to just under 10 percent of GDP and credits just over this level (but falling back relative to growing GDP), maintaining 30 banks at an average balance sheet size of US$13 million and average capital of barely US$1 million[126] appears impossible. A market-driven consolidation will be vital to restoring real credit supply growth. Even with the impressive gains in the ratios to GDP of outstanding deposits and credits up to 2000 (Table 11.4), net new deposit mobilization and net new credit supply remained disappointing when expressed as a percentage of GDP. Faster-reforming transition economies such as Estonia and Poland typically record new business volumes at 5 percent or more of GDP each year.

[126] Even after excluding the troubled banks that have a net capital deficit.

Structure of the Banking Sector

236. As with all economies emerging from the Soviet system, many banks were created in the first three years after the Soviet Union's breakup. In 1991 Armenia had 6 banks—5 state-owned banks and 1 commercial bank—which became 74 by the end of 1993. Most of the new banks were "pocket" banks owned by large state enterprises, essentially to make loans to and provide payments services for their shareholders rather than operate as Western-style commercial banks intermediating deposits and making loans on an arms-length basis. In the absence of a legal and regulatory framework in the early 1990s, the rapid proliferation of commercial banks' generally was accompanied by weak bank management, indiscriminate lending practices, and an associated build-up of poor-quality assets. The banking system's fragility was further exacerbated by the Armenian economy's collapse in 1992–1994 in the wake of the FSU's trade and payment system's collapse, war with Azerbaijan, and the Azerbaijani-Turkish blockade. A major purge of the banking system between 1994 and 1996 halved the number of banks from 74 to 36, and by the end of 2000 this number had fallen to 29 (but rose with the opening of one new foreign-owned bank in 2001).

237. In parallel with the reductions in the number of commercial banks, the share of state and former state banks declined sharply, from more than 70 percent of total banking sector assets at the end or 1993 to just under 30 percent in 2000–2001. Nevertheless, all but one of the state/former state banks still are among Armenia's top 10, and 2 of the top 3 banks are formerly state owned.

238. Foreign capital is involved in roughly half the remaining banks and two-thirds of total banking sector assets, but only three banks are fully foreign-owned (although one of these—HSBC Armenia—is the largest player in the whole sector). As is the case with the other small-countries addressed in this study, defining foreign-owned or foreign-controlled banks can be difficult as capital nominally registered as foreign often has strong domestic connections. Even diaspora capital does not always behave in the same manner as genuinely strategic inward foreign capital investment (although some of the largest inward diaspora investments in the banking sector do appear to have been made on fully commercial terms).

239. As for concentration, the CR3 ratio shows the top three banks controlling less than one third of total banking sector assets. A more useful ratio might be the CR5 (45 percent of total banking sector assets), because the fifth-largest bank is nearly twice the size of the sixth. Clearly on either measure the Armenian banking sector is not as concentrated as other case-study countries.

240. This may reflect the way in which administratively driven consolidation happened in Armenia. Until 2001, relatively weak bank bankruptcy laws meant that the CBA could only petition for a bank to be put under curatorship, often—at the court's nomination—under the bank's existing management and shareholders. Nevertheless, the CBA was determined that only genuinely sound banks should be allowed to take deposits. The result has often been prolonged but relatively orderly liquidation, which in a fast-growing banking market means that problem banks rapidly lost share.

241. The new legislation allows for much more active temporary administration and, in combination with capital infusions to restore solvency, the CBA provided secured liquidity support for the two larger banks that got into trouble in 2001. There also appeared to be some

renegotiation of terms with larger depositors to prolong the effective maturity of their funds. Despite the different approach, however, the net effect seems to be the same The banks concerned appear to be frozen in size until fully restructured to CBA's satisfaction.

242. Table 11.5 summarizes the structure of the Armenia's banking system at the end of 2001. It shows the ambiguous economic benefits of a major international bank dominating a small domestic banking market. HSBC undoubtedly sets asset and management quality standards that its depositors evidently appreciate, because they accept lower rates on deposits. As a result, HSBC has garnered nearly a fifth of the deposit market despite being only borderline top quartile on both the weight of operating overheads and overall spread and fee yield. Moreover, it recycles barely 5 percent of deposits mobilized by way of lending.

Table 11.5. Key Banking Indicators

End Dec. 2001 US$ millions/% share of total	Total assets	Gross loans/inv.	Client deposits	Interbank liabilities	Total capital	Net profit (after tax)
1. Banks in curatorship	19.1	14.1	38.1	3.7	-25.2	-32.8
	4	7	12	6	-61	-99
2. Banks under temporary admin.	82.5	52.3	59.8	11.6	8.6	-1.8
	19	27	20	19	21	-5
3. Rest of banking sector (e.g., HSBC)	258.1	122.3	148.2	43.9	50.6	0.5
	60	64	49	73	122	2
4. HSBC	68.3	3.0	58.9	0.7	7.4	1.0
	16	2	19	1	18	3
Whole sector	428.0	191.7	304.8	59.9	41.4	-33.1

Source: ??

243. As already noted the issue this chapter addresses is how hard the authorities should strive to rehabilitate the four banks now under temporary administration, and what scope there is for small banks to sustain their market position against a background of rising minimum capital requirements and very mixed self-capitalization capacity.

Banks' Financial Performance

244. The overall average weight of operating overheads and the combined spread and fee yield on earning assets (13 percent and 17 percent, respectively) are high in Armenia, but the performance of the best quartile of banks in the Armenian banking system is much closer to that of best quartile banks in other case-study countries, as is clear from Table 11.6.

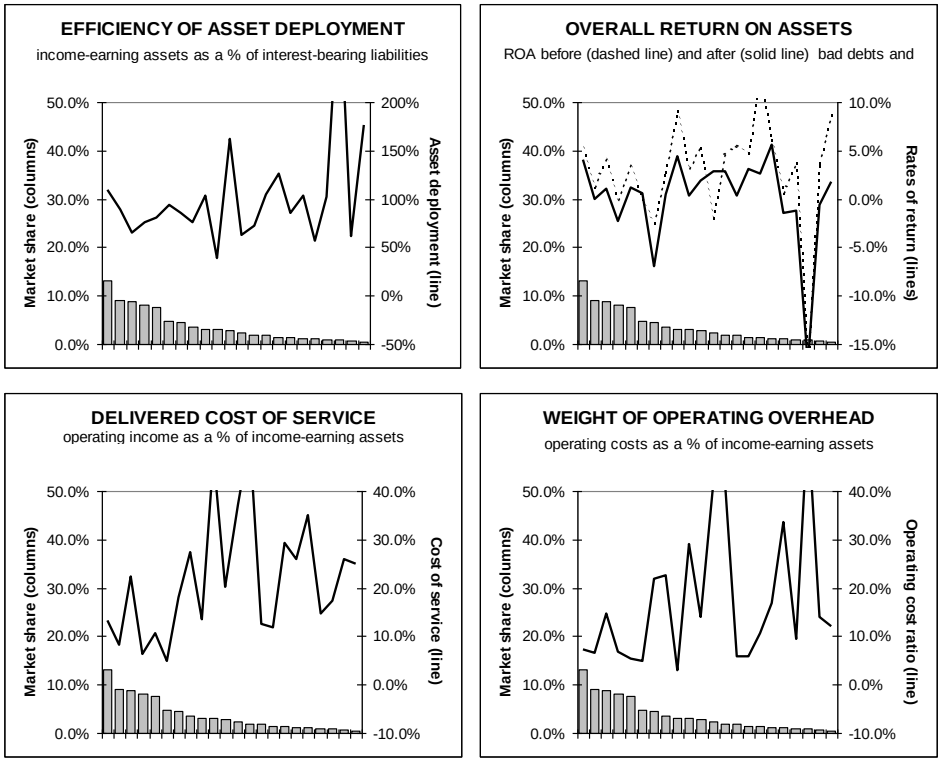
Table 11.6. Armenian Bank Performance Compared to Other Transition Economies

2000 data	Deposit to GDP ratio (%)	Weight of overheads		Overall Spread/Fee Yield		Net ROA	
		All bank average (%)	Best banks' average (%)	All bank average (%)	Best banks' average (%)	All bank average (%)	Best banks' average (%)
Hungary	35	7	2	9	5	1	2
Poland	34	5	3	8	7	1	2
Bulgaria	21	7	5	10	8	3	6
Baltics	19	7	4	9	7	2	4
Russia	14	9	5	15	13	4	8
Ukraine	9	18	5	25	18	0	2
Kazakhstan	8	10	6	14	10	2	4
Armenia	**8**	**13**	**7**	**17**	**12**	**1**	**3**

Source: ??

245. Nevertheless, it is clear from figure 11.1 that size appears to confer little advantage in terms of overall profitability, and the cross-correlation between cost and income ratios (0.67) is lower than in many other case-study countries. Moreover, there does appear to be a systematic inverse, although weak, relationship between size on the one hand and operating overheads and delivered cost of service on the other.

Figure 11.1. Size and Bank Performance in Armenia



The First, Crisis-Driven Consolidation Phase (1994 to 1996)

246. In the absence of a legal and regulatory framework for banking activities in the early 1990s, the rapid proliferation of commercial banks was accompanied by generally weak bank management, indiscriminate lending practices, and an associated build-up of poor-quality assets. The banking system's fragility was further exacerbated by the collapse of the Armenian economy in 1992–1994 in the wake of the FSU's trade and payment system's breakdown, war with Azerbaijan, and the Azerbaijani-Turkish blockade.

247. Between 1993 and 1996 it became clear that any comprehensive macroeconomic stabilization program had to be accompanied by a bank reform and consolidation program.

Under this program, the CBA set up the legal and regulatory framework for banking activities, tackled a large number of problem banks, and prepared the ground for introducing new accounting standards.

248. The reform program was intensified in 1996 with a major overhaul of banking system legislation and regulatory norms. (see chapter 1 for an overview of legislative reforms). On the regulatory front, two key reform elements were the introduction of loan classification and provisioning guidelines and the tightening of prudential standards for bank activities. The guidelines, introduced in January 1996 and phased in over two years, forced banks to recognize problem loans and appropriately provision for them. During 1996 and 1997, banks provisioned for and wrote off as losses about dram 7 billion worth of loans, equivalent to about 12 percent of their aggregate loan portfolio at end-1997. While this took a toll on banks' profits, it enabled them to clear up the problem loan backlog by the end of 1997, with the stock of classified loans reduced from about 50 percent of gross loans in early 1996 to about 10 percent at the end of 1997.

249. As part of banking sector reform, the CBA took action to close a large number of small, nonviable banks. Between 1994 and 1996 the CBA withdrew 20 banks' licenses for noncompliance with prudential regulations and 12 banks returned their licenses, either by way of self-liquidation or merger. As a result, the number of banks fell from 72 (58 domestic and 14 foreign bank branches) in early 1994 to 36 (33 domestic and 3 foreign) by the end of 1996.

Further Administratively Driven Consolidation (1997 to 2000)

250. Despite associated improvements in the loan portfolio, ongoing lending activities still led to new problem loans accumulating, mostly because of enterprises' still poor reporting and governance systems and the weak credit environment described earlier. As a result, nine banks were put into curatorship between 1997 and 2000, a form of CBA-controlled administration but with many limitations. While the existing bank bankruptcy law allowed CBA to petition for curatorship, it left the courts with the discretion of who to appoint as curator. Very often previous management or the shareholder nominees were given this responsibility, leading to significant conflicts of interest, particularly regarding the timeliness of liquidation. Still, once in curatorship, a bank's ability to do new business was severely constrained and the CBA had some control over creditor prioritization. The net effect, as noted, was at least to prevent problems getting significantly worse..

251. Further but rather limited pressure to strengthen the banking system also came from rising minimum capital requirements after 1996. The CBA introduced a medium-term schedule for a phased-in increase in existing banks' minimum capital, from US$1 million by January 2000 to at least US$1.3 million by July 2001, US$1.65 million by July 2002, US$2 million by July 2003, and ultimately US$5 million by January 2007. The US$5 million floor applied immediately to newly created banks. While this differentiated minimum capital requirement at least prevented the further proliferation of small, undercapitalized banks, it did rather blunt the incentives for existing banks to consolidate. The CBA justified this by referring to the inadequacies of the pre-2001 banking law—no allowance was made for small institutions to lose their banking licenses but reconstitute themselves as non-bank finance houses: the only legal option was liquidation via the curatorship process.

252. By the end of 2000 just 29 banks remained in existence, and only 22 of these were operating unfettered. The seven banks still in curatorship accounted for 16 percent of total banking sector assets.

Box 11.1. Bank Consolidation and SME Finance in Armenia

The SME Market

Armenia's SME sector is estimated to account for 30 percent of GDP, ranking Armenia in the "medium" category. The Armenian government is making increased efforts to encourage SME growth, including a simplified tax regime introduced in 2000 and an SME Development Center established by the Ministry of Trade and Economic Development. SME development has also been a topic of considerable interest to foreign donors and IFIs.

Constraints to SME growth include (a) the high poverty level, which restricts the domestic market for goods and services; (b) lack of finance; (c) tax officials' harassment of SMEs; (d) unpredictable regulatory enforcement; and (e) a work force with outdated skills.

Lending

Armenia is a striking example of a country in which SME lending as a proportion of total lending is lower than SME output relative to GDP. Estimated SME lending of US$15 million in 2001 accounts for approximately 11 percent of total private sector lending of US$140 million; these figures put Armenia in the "low" SME lending category.

One factor constraining additional SME financing is a shortage of collateral acceptable to the banks. Another important factor is that foreign donors and IFIs are limited in their ability to provide on-lending lines through Armenian banks, because the banks tend to be small and thinly capitalized. A third factor is that because the banks are small it is difficult to achieve the economies of scale necessary for SME financing to be sustainable.

Conclusions

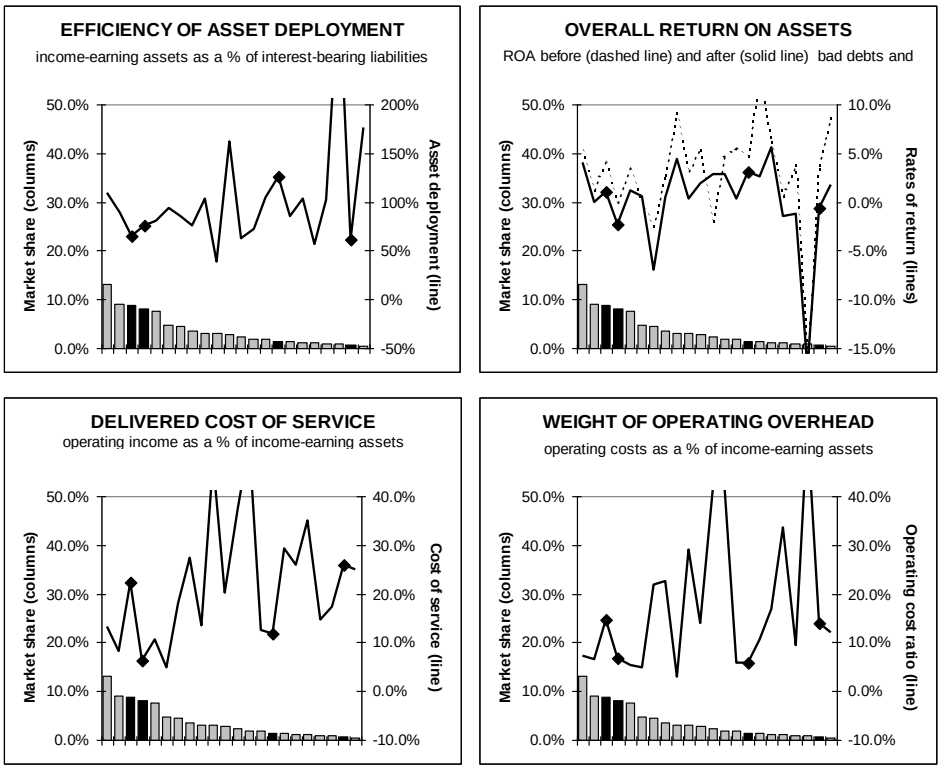
SME lending in Armenia is on so small a scale that it is difficult to imagine banking sector consolidation having a negative impact. Some positive impact could result from the creation of one or more larger and better capitalized banks that could attract larger on-lending lines from IFIs and donors and eventually achieve sufficient scale to continue SME financing on their own.

Source: Principal sources consulted were Shorebank Advisory Services, "Feasibility Study," May 31, 2000; Luboyeski, Victor, Stephanie Charitonenko and Arthur Khachatryan, *Market Assessment for Microenterprise Services in The Republic of Armenia*, USAID Contracting Vehicle: SEGIR, Chemonics International, Inc., February 2002; and PriceWaterhouseCoopers, "USAID-Armenia, *SME Sector Assessment*, USAID Contracting Vehicle: SEGIR, July 15, 2000. Information was also provided by the International Executive Service Corps, Yerevan office.

Armenian Consolidation Going Forward (2001–Onward)

253. The 2001 reform of the banking and bank bankruptcy laws could not have been more timely. By the end of the year two leading banks, Ardshin and Credit Yerevan, and two smaller ones, Adana and Credit Service, had found themselves facing liquidity difficulties. Ardshin's and Adana's problems were reportedly linked. As part of a strategy to encourage favorable merger terms, tiny Adana (ranked 21 out of 22 at the end –of 2000) somehow became third-ranked Ardshin's main inter-bank creditor. As Ardshin's credit quality problems (plus some element of fraud) turned into liquidity problems, Adana also started to suffer liquidity problems. Credit Yerevan and Credit Service were classic cases of rolled-up credit quality problems eventually emerging as liquidity problems. Figure 11.2 shows the relative market positions and performance indicators for these four banks, highlighted in solid black, at the end of 2000. The figure indicates that while these four banks have reasonable performance standards they all have close competitors that at least nearly match if not outperform them.

Figure 11.2. Relative Performance of Troubled Versus Other Operational Banks in 2000



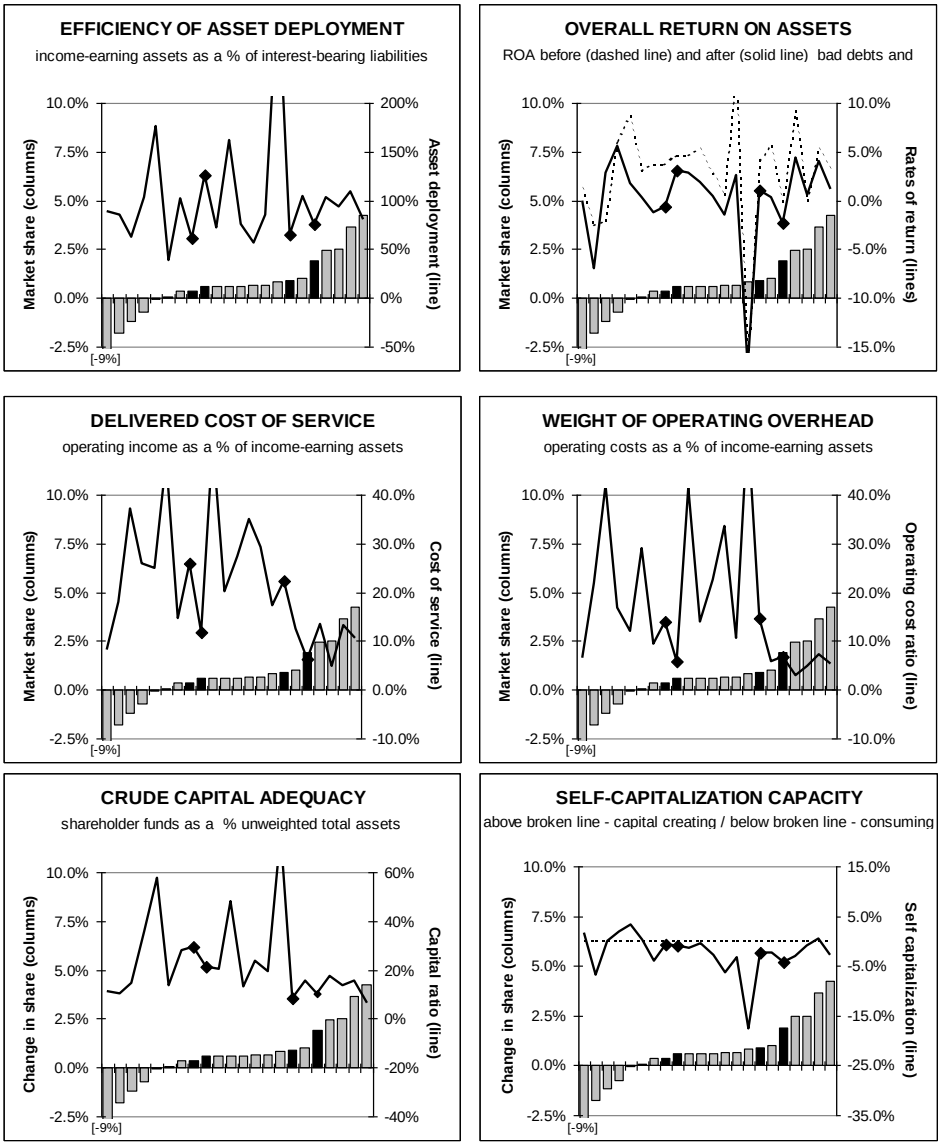
254. None of these banks were in fact vital to the banking system's effective functioning. An orderly transfer of sound credits and genuine third-party deposits to other sound banks would have facilitated more effective banking system consolidation. This broadly seems to be happening with Credit Yerevan and another smaller bank progressing towards liquidation, while the good assets and supporting deposits in Arshin/Ardana are being consolidated into a new bank. This bank, Ardshin Invest, was re-floated and effectively capitalized by tender. It is somewhat regrettable that a bank that was not performing particularly well has been preserved as a separate entity in this over-banked market.

255. Figure 11.3 compares banks gaining and losing market share and suggests that Armenian banks may in any case be ready to internalize the consolidation process.

256. These charts show that the banks gaining share most rapidly tend to be more cost-efficient and extract a lower overall spread and fee yield than the smaller banks that are making much more modest gains in market share. They also display a noticeably smaller negative wedge between gross and net returns on assets and at least as good self-capitalization as the smaller gainers, suggesting better asset quality. However, these banks do not demonstrate markedly

better performance than the banks from which they are gaining share, although interestingly the three banks most rapidly losing share are all legacy banks and anecdotal evidence suggests they may have some embedded asset quality problems.

Figure 11.3. Banks Gaining Market Share Versus Banks Losing Market Share (1998–2000)



257. Figure 11.3 also puts relative position of the four troubled banks' into a more dynamic context than figure 11.2. With the possible exception of Credit Yerevan none of these four banks

appear to be particularly important players in the competitive realignment that took place between 1998 and 2000. Certainly there are banks with better performance indicators that account for more significant market share movements during the three years shown.

Conclusions

258. Armenia clearly needs further consolidation; a banking system holding total assets equivalent to less than 20 percent of a relatively small GDP (and total deposits equivalent to less than 10 percent of GDP) does not need more than 20 operating banks. Some of the smallest banks should withdraw from taking deposits and become wholesale-funded NBFIs. As a result any corporate connections these institutions have with industrial and trade groups would become less problematic and the minimum required capital needed to support such business would be less than the growing requirements that are being placed on banks through 2007

259. Among the remaining banks, significant market share gains are already accruing mostly to relatively efficient banks that extract below-average (albeit still relatively high) spread and fee yields from their customers and appear to be close to a reasonably sustainable self-capitalization position. Unfortunately, most of these gains are at the expense of banks that demonstrate similar but not quite as good financial performance indicators. However, since the banks with worse performance indicators that are still making small market share gains tend to be the smaller ones, encouraging some of them to become NBFIs might help correct this.

260. Finally, the economic consequences of strictly limiting the rehabilitation of the four banks put under temporary administration in 2001 are likely to be both small and short term; there is every indication that the Armenian banking system has not yet internalized an effective consolidation process but may be on the threshold of doing so. The main risk to this would be some late attempt by political forces to pressure CBA to protect and sustain banks that are not necessary to this process. It would have been better for the restructured sound assets from Ardshin to have been sold to the better-performing existing banks rather than having Ardshin re-floated as another bank. For these reasons, Armenia was positioned in the chapter 3 taxonomy as not having firmly broken away (as of 2000/01) from a tendency to over-administer the consolidation process.

TWO CASES OF INCOMPLETE CONSOLIDATION: KAZAKHSTAN AND HUNGARY

CHAPTER 12: KAZAKHSTAN

Introduction

261. A reform-minded central bank management team established an original consolidation blueprint in 1993, the year that the number of Kazakh banks peaked at 203. As of mid-2002 the number of banks had been reduced to 41, with 3 privately owned banks accounting for approximately 58 percent of banking sector assets. The beginnings of the market internalizing the consolidation process can be seen in the ongoing bank ownership changes and increasing foreign involvement that affected both the Big Three banks and some smaller banks. There is also a clear trend toward increased intermediation, abetted by several successful policy measures that have increased the availability of bank funding.

262. Kazakhstan therefore provides an example of a strong administratively initiated consolidation that banks have begun to internalize. However, this process has yet to become fully effective, because at least through 2000 there was no complete correlation between Kazakhstan's most aggressively expanding banks and its most efficient banks. While some of the expanding banks also showed good efficiency and profitability results, it is particularly noteworthy that AMB, with relatively weak year 2000 results, subsequently acquired Halyk Bank, one of the Big Three but also characterized by low efficiency and profitability.

263. This case study is organized as follows. A brief overview of general elements in Kazakhstan's economic situation is followed by an outline of the key characteristics of the country's banking system and a summary of recent financial trends. It then discusses the main features of the consolidation process during the past decade and attempts to assess how these trends may develop in the future. Finally, we present key conclusions and recommendations.

The Economic Background

264. Oil, gas, and semi-processed metals account for approximately one third of Kazakhstan's GDP. Largely as a result of the former, GDP grew 9.6 percent in 2000 and 13.2 percent in 2001. The growth has been managed well, partly due to a decision to float the tenge in April 1999, as well as sound money market management by the National Bank of Kazakhstan (NBK). Inflation has been brought down to single digits; the budget was essentially balanced in 2000 and 2001; and a National Oil Fund has been created to conserve part of oil revenues. Even with oil prices declining , the long-term prognosis for continued growth is good, as Kazakhstan continues to access more of its substantial oil and gas reserves. The two clouds on the economic horizon are a

foreign debt level that currently exceeds 50 percent of GDP and the economy's high dollarization level, which blunts the state's economic management tools.

265. Political power is intertwined with business interests, and several rather opaque business groups have emerged, centered on the oil, gas, and metals industries. Furthermore, the state continues to be an important economic player privatization stalled with the state still owning 51 percent of medium-sized enterprises and 33 percent of large enterprises. Kazakhstan is therefore noteworthy for a partial vacuum in the privately owned mid-sized corporate sector, such as consumer goods manufacturing and other light industry. However, small business is estimated to account for approximately 21 percent of GDP and to be on an upward growth trend.

266. The NBK stands out in the former Soviet territory for its consistent commitment to banking reform during the past decade. Although Kazakhstan's banks were historically too small to be significant players in major export sectors and therefore not a major focus of politicians or businessmen, NBK has nevertheless demonstrated considerable resolve in implementing its policies: closing banks of any size is never a popular activity. NBK's challenges appear to be increasing. For example, because there is still a relatively high number of state-owned firms but little state-owned bank activity, it seems probable that directed lending still exists.[127] Furthermore, business groups and possibly individuals close to the president are said to be becoming more involved in banking.

Banking Sector Structure

267. Kazakhstan's banking sector has four defining characteristics. The first, as shown in Tables 12.1 and 12.2, is a high concentration level. As of mid-2001, the Big Three banks accounted for approximately 58 percent of banking sector assets, and this has been on an upward trend. The Big Three also account for approximately 43 percent of banking sector capital[128] and own approximately half of the sector's 399 branches (of which 166 belong to the former state savings bank, Halyk).

Table 12.1. Assets and Capital by Bank as of June 30, 2001

	Total assets		Capital*	
	US$ 000	**%**	**US$ 000**	**%**
1. Kazkommertsbank	1,112,236	25	125,089	19
2. Bank Turan Alem	745,011	17	64,557	10
3. Halyk Savings Bank	711,480	16	55,403	8
4. ABN Amro Bank Kazakhstan	196,977	5	33,832	5
5. Citibank Kazakhstan	178,053	4	23,571	4
6. CenterCredit Bank	168,561	4	16,830	3
7. Almaty Merchant Bank	167,180	4	15,903	2
8. Nurbank	139,999	3	28,522	4
9. Temirbank	98,569	2	12,989	2
10. Eurasian Bank	88,503	2	27,991	4
11. HSBC Bank Kazakhstan	52,184	1	14,708	2
12. Tsesna Bank	31,817	1	6,010	1
13. Neftebank	20,241	-	4,826	1
Aggregate 13 banks, IAS	3,7108,16		430,238	
Total banking sector, KAS	4,375,862		669,714	

[127] SOURCE STILL TO BE CITED

[128] The Big Three capital figure in the chart is adjusted to allow for the difference between Kazakh and IAS.

Ratio of 13 banks to banking sector (%)	85%	64.2%

Source: Roy A. Karaoglan and Milana Gorshkova, "The Banking System in Kazakhstan," IFC, January 15, 2002.
* Does not include subordinated debt.

Table 12.2. Trends in Concentration

Tenge billion	Apr.02	Jan.02	Jan.01	Jan.00
Total assets of three largest banks	473.5	483.9	292.5	176.4
Total assets of whole system	817.8	816.6	527.9	341.2
Three largest/whole system (%)	57.9	59.2	55.4	51.7

Source: NBK, "Current Situation of the Banking Sector," various.

268. A second important characteristic is that the state no longer has a significant ownership role. Not only are the three largest banks all privately owned, but the state has made concerted efforts to reduce its share of banking sector ownership, having recently sold its remaining 33 percent share in Halyk Bank, after privatizing Bank Turan Alem (BTA) in 1998. Currently the state's only significant banking sector holdings are the State Development Bank, created in 2001, and the Rehabilitation Bank, created to hold problem assets after the 1995 banking sector crisis.[129] The State Development Bank is small and the Rehabilitation Bank is largely non-operational.

269. Third, foreign banks have made significant inroads into the banking sector, with ABN Amro and Citibank occupying the top fourth and fifth positions as of mid-2001. Not only have these two banks achieved significant market share, with Citibank only having commenced operations in 1999; but as will be discussed, they have helped to set cost control standards in the sector. It is also noteworthy that ABN Amro has been the most aggressive foreign bank to date in the pension industry.

270. Fourth, despite effective NBK policymaking, intermediation remains at a relatively low overall level in terms of banking sector assets as a proportion of GDP. As of the end of 2001 banking sector assets relative to GDP were 24.9 percent, in contrast to the 35.3 percent achieved in Russia, a country where banking sector policy generally has been much weaker. Loans relative to GDP resemble Russian figures, but this is because Kazakh banks lend a relatively high proportion of their assets. However, because Kazakhstan's largest companies are too large to be served by Kazakh banks, there is a higher level of borrowing in the country than is captured by these figures.

271. Table 12.3 below concludes this overview of the structure of the Kazakh banking sector with a categorization of the main groups of Kazakh banks.

Table 12.3. Banking Sector Categorization

Category	No. of banks	% of total assets
Big Three	3	58
Second Tier*	5	13
Foreign	15**	15–20
Third Tier	19	9–14

[129] An unsuccessful attempt to sell state-owned Eximbank ended with it being merged into the Rehabilitation Bank.

Source: Author's estimates based on "Current Situation of the Banking System" reports and Karaoglan and Gorshkova (2002) op. cit.
* The second-tier banks are those with at least US$100 million in total assets, a significant branch network, and proactive strategies. These are CenterCredit (19 branches), Temir (18 branches), Almaty Merchant Bank (10 branches), Nurbank (8 branches), and the former agricultural bank, Nauryz Bank (75 branches).
** This figure does not include the 22 banks with some foreign ownership, such as ABN Amro's investment in BTA.

Developments Among the Big Three Kazakh Banks

272. Kazkommertsbank (KKB), which has been privately owned since its creation in 1990 and is 63.5 percent management-controlled, is considered to be the most sophisticated of all Kazakh banks. KKB's historic strength has been in corporate lending, but it has now embarked upon a retail strategy. Although its relatively small (22) branch network is considered to be a disadvantage, KKB has been increasing its deposit base. As of June 2001, its share of the deposit market had grown to 24 percent, almost a doubling in absolute terms. KKB has been growing aggressively in other areas as well; total assets increased by 57 percent in 2001 and the loan portfolio doubled. One historic cause of market concern about KKB was its financing of transactions undertaken by its commonly owned sister company, Central Asian Industrial Investments (CAII). KKB has declared that it will not finance CAII in the future.[130]

273. Standard & Poor's (S&P) upgraded KKB's long-term obligations to B+ in April 2002: positive factors included KKB's good provisioning policy, growing commission income, and its increasingly diversified funding base. On the negative side, S&P noted that KKB's funding and loan portfolio are still concentrated. S&P stated that the rating could be downgraded if KKB continues to grow without increasing its capital or participating in financing group projects.[131] S&P also noted concern about KKB's corporate governance, related especially to bank management control.[132]

274. It was widely expected in 2001 that KKB would buy the state's remaining 33 percent share of Halyk Bank, leading to the two banks' eventual consolidation and KKB's clear dominance of the banking sector. However, a minority stated-owned company in the oil and gas industry unexpectedly bought the shares, which were then sold to AMB, a mid-sized bank.[133]

[130] Particularly noteworthy was KKB's 1998 loan of US$73.7 million to CAII to finance the purchase of a 30 percent stake in Kazakhtelecom. The unpaid portion of the loan has been provisioned. Magar Kouyoumdjian and Scott Bugie, "Outlook on Kazakhstan-Based Kazkommertsbank's Ratings Revised to Positive; Ratings Affirmed," Research, Standard & Poor's, December 19, 2001.
[131] Standard & Poor's, April 17, 2002.
[132] Kouyoumdjian and Deripasko, Standard & Poor's, May 20, 2002.
[133] The initial buyer, Mangystaumunaygas, is 30 percent state controlled and 60 percent controlled by an Indonesian company, Central Asia Petroleum Ltd. The block of Halyk shares was purchased for US$35 million and then resold for US$41 million to a group of companies controlled by Almaty Merchant Bank. Mangystaumunaygas cited declining world prices and the need to make additional investments in Halyk as reasons for the sale.

275. BTA was founded in 1997 as the result of a forced merger of Turan Bank and Alem Bank, both of which had been facing severe financial difficulties since the 1995 crisis. Alem Bank had been the state-owned foreign trade bank, while Turan Bank was the successor to the Soviet-era state-owned industrial and construction bank. The state merged and re-capitalized the two banks and placed them under the Ministry of Finance's ownership until they were privatized in 1998. Major shareholders at present include the Astana Holding group, a large Kazakhstan conglomerate;[134] ABN Amro; and a consortium led by the International Finance Corporation (IFC) that includes Raiffeisenbank, EBRD, and others.

276. BTA has historically been the country's second most active retail bank, following Halyk, although BTA's network of 23 branches is essentially the same as KKB's. However, BTA is further along than KKB in implementing a two-pronged corporate and retail business strategy. BTA has a clear growth strategy; its share of banking sector assets increased from 15.1 percent in 2000 to 19.9 percent as of the end of 2001. BTA's loan portfolio has more than tripled since the end of 1999, and as of mid-2001 its share of the deposit market had grown to 17 percent. BTA does not appear to face immediate capital constraints: in March 2002, its shareholders approved a 160 percent increase in charter capital.[135] S&P in upgrading BTA's long-term obligations to B+ noted the positive changes in BTA's shareholder structure and the growth in its loan portfolio, retail business, and fee-based income. However, S&P also noted BTA's relatively short track record and "fairly weak core capital," due to its subordinated debt funding.[136] The capital increase should help address the latter point.

277. Halyk is the former state-owned savings bank; its dominant branch network makes it the sector's natural retail bank. Like most former state-owned savings banks, Halyk faces the challenge of upgrading its competitiveness in products and services. While its retail network is an advantage as a base for funding and client outreach, it also represents a major cost burden. Furthermore, Halyk faces increasing competition for those retail deposits: as of June 2001, its share of banking sector deposits had fallen to 22 percent, compared to 30 percent six months earlier.[137] On the lending side, S&P considers Halyk's asset quality "fragile." It also noted Halyk's weak capital base. S&P rates Halyk's long-term obligations as B, lower than its Big Three competitors.[138]

278. Given the challenges facing Halyk, it would seem that the optimal buyer of the state's holdings would be an experienced, well-capitalized bank that could address these issues.[139] Therefore, the purchase of these holdings by an oil company and their subsequent sale to a smaller bank not noted for its efficiency is a cause for concern. Halyk's other shareholders each own less than 20 percent and are not in the banking sector.

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[134] As noted later in the case study, the Astana Group was the controlling shareholder in Temir Bank, although this was not publicly acknowledged until pressure was successfully exercised by NBK.

[135] Interfax Center for Economic Analysis, Volume XI, Issue 34 (575), August 28, 2002.

[136] Standard & Poor's, April 17, 2002.

[137] It appears that Halyk was not successful in attracting the new funding that entered the sector, as discussed under "Financial Overview."

[138] Magar Kouyoumdjian and Scott Bugie, "Summary: Halyk Savings Bank of Kazakhstan," Research, Standard & Poor's, March 5, 2002.

[139] This comment is not intended to imply that KKB would have been the preferred investor. In fact a KKB investment would have raised concentration and corporate governance issues.

Financial Overview

279. This section assesses Kazakhstan's banking sector in terms of intermediation, profitability, and capitalization. Two particularly noteworthy trends are declining capitalization as intermediation has increased and declining profitability, partly as a result of increased competition for loans and funding.

280. Intermediation in Kazakhstan has been increasing steadily, as can be seen in Table 12.4. The absolute lending increases are particularly noteworthy; loans increased in absolute terms by 76 percent in 2000 and 89 percent in 2001. The increased interest in lending is partly due to the tenge's relative stability, which has resulted in a decline in foreign currency earnings, in particular from balance sheet translation gains.[140] In addition, returns on government paper have declined, with Kazakhstan treasury notes showing a declining annual yield of 20 percent as of the end of 1999, 13 percent as of the end of 2000, and 11 percent as of the end of 2001.[141]

Table 12.4. Intermediation

	Jan 99	Jan 00	Jan 01	Jan 02
Loans/TA	51.8*	45.3	51.7	63.3
TA/GDP	11.3	16.9	20.3	24.9
Loans/GDP	5.9	7.7	10.5	15.7

Source: "Current Situation of the Banking Sector," various.
* This figure is presumably high because banks still had not fully written off the problem loans that resulted from Russia's 1998 financial crisis.

281. There is some cause for concern that intermediation levels may be growing too quickly. In particular, 51 percent of the sector's loan portfolio as of the end of 2001 consisted of medium- and long-term loans. Not only are such loans more difficult to assess than short-term loans, but problems typically arise later in the loan cycle. Furthermore, dollar borrowing accounted for 71 percent of all 2001 borrowing. As the largest exporters are too large to borrow from Kazakh banks, this figure implies currency mismatches on the part of many borrowers. As will be discussed later, provisioning by the large banks continues to dampen their profitability. On the positive side, liberal provisioning regulations allow for tax deductibility for provisions on up to 50 percent of a bank's loan portfolio, and this provides a strong incentive for banks to report loan performance accurately.

282. There have been three major developments favorable to intermediation from the funding side. First, a 2001 capital amnesty program resulted in US$480 million (approximately 13 percent of end-of-2000 banking sector assets) being repatriated. Second, the retail deposit insurance program introduced in February 2000 has led to significant retail deposit inflows.[142]

[140] Balance sheet translation gains were particularly high at the end of 1999, as a result of a 30 percent tenge devaluation in April 1999.

[141] Yields were even lower during the year but rose at year-end as banks composed their year-end balance sheets.

[142] The details of the deposit insurance program are complex, but its main characteristics are a maximum guarantee of 400,000 tenge (US$2,663) for tenge-denominated retail time deposits, 50,000 tenge (US$666) for tenge-denominated retail demand deposits, and 360,000 tenge (US$2,397) for dollar-denominated time deposits. Maximum interest rates are associated with each type of deposit. The dollar equivalents are calculated at year-end 2001 exchange rates. Although this is not the case study's focus, it should be noted that the IMF and World Bank have identified certain deposit insurance fund characteristics that diverge from international best practices.

Total consumer deposits have increased from US$395 million at the end of January 2000 to US$1.2 billion at the end of 2001.[143] Finally, pension reform has brought US$1.2 billion in pension fund assets into the banking sector. Recognizing the demand of pension funds for long-term assets, several Kazakh banks have successfully issued seven- to nine-year subordinated bonds, which count as tier two capital.

283. Table 12.5 shows that despite increased lending sector-wide profitability is falling. The declining ratio of loan income to lending is particularly noteworthy. Banks are responding to shrinking margins by more aggressive treasury dealing, which is also evident in the table. They also are expanding into higher-yielding loan products. Consumer lending grew from 5.3 percent to 6.3 percent of total lending in 2001, and home mortgage lending is of increasing interest, helped by the creation of a state-owned mortgage agency that purchases mortgage loans from the banks. It is also noteworthy that lending to small and medium businesses held steady, at an approximately 25 percent share, despite the 89 percent increase in overall lending during 2001;[144] keeping pace with such an increase represents an enormous number of new small loans.

284. Prospects for developing fee-based services also appear promising, particularly with the introduction of a new pension system in which individuals can select the fund to which they can allocate part of their pension payment. Banks can serve as custodians and establish asset management companies. Two of the biggest players to date are Halyk Bank and ABN Amro Kazakhstan.

Table 12.5. Profitability

	Jan 00	Jan 01	Jan 02
ROA*	2.8	1.5	0.91
Loan income/loans	14.7	12.1	11.3
Int. expense/liabilities	44.9	4.3	4.4
Dealing income/net income**	52.7	136.5	123.0

Source: "Current Situation of the Banking Sector," various.
* Net earnings before tax.
** Before tax.

285. The banks' expense levels also challenge profitability. As can be seen in Table 12.6, all four bank categories in 2000 had a relatively high average ratio of operating costs to income earning assets (the weight of operating overhead). The foreign banks achieved the best average cost performance. The best single foreign bank performance (Citibank) was matched by the best performance by a Big Three bank (KKB), while the best performance overall was by a second-

[143] Consumer deposits accounted for 27 percent of banking sector funding at the end of 2001, compared to 21 percent at the end of 2000. Another indication of the program's success is that the consumer deposit market share of the 21 banks that participate in the program has increased from 92.7 percent to 97.9 percent. However, these also are the banks with the largest branch networks. The deposit insurance program experienced a credibility boost in early 2002 with the failure of Komir Bank, a significant second-tier bank. Not only were depositors expeditiously reimbursed by the deposit insurance fund, but they were covered for the full deposit amounts, not just the amounts covered by the insurance program. While this precedent could create longer-term problems in the short term it can only encourage more confidence in the banking sector. However, depositors in Business Bank, a bank that was not part of the deposit insurance program, were not covered.

[144] Note that some sources cite SME lending as representing 15 percent of total lending. In any case, SME lending is an important market sector for the banks.

tier bank (Nurbank). These results indicate the role of foreign banks in contributing to the sector's overall competitiveness.

Table 12.6. Operating Costs

	Big Three		2nd-Tier Kazakh		3rd-Tier Kazakh		Foreign	
Number of banks in sample	3		4		5		2	
Share of sample at end-2000 (%)	62		16		6		10	
Weight of operating overhead (%)	**Best** 6	**Average** 9	**Best** 4	**Average** 11	**Best** 9	**Average** 11	**Best** 6	**Average** 7

Source: Excerpts from Bureau van Dijk data.

286. Finally, capitalization levels are declining, as capital growth has not kept pace with intermediation growth. Table 12.7 also shows the declining ratio of capital relative to bad loans.

Table 12.7. Capitalization

	Apr. 02	Jan. 02	Jan. 01	Jan. 00	Jan. 99
Capital/RWA*	0.19	0.19	0.26	0.28	0.30
Capital/Bad loans	9.1	11.2	16.9	7.5	9.1

Source: "Current Situation of the Banking Sector," various.
* Risk-weighted assets.

287. In summary, Kazakhstan's banking sector has shown marked progress in intermediation, helped by several policy measures that have attracted more funding to the sector. However, the pressure to attract new borrowers and new funding sources is shrinking margins and raising costs, leading to declining profit levels. Higher intermediation levels had led also to lower capitalization levels: an issue that must be resolved if intermediation is to continue to grow.

The Administrative Lead for Consolidation

288. Because of NBK's success in initiating the consolidation in Kazakhstan, it is important to review the steps that it has taken to do so. In addition to the concrete steps outlined later in this chapter, two more general factors should be highlighted. First, NBK initiated its consolidation strategy relatively early in Kazakhstan's economic transition. It could be argued that political fluidity at that early stage enabled NBK to pursue policies that would have been more difficult once political positions and alliances had become entrenched. Second, because NBK was able to capitalize on this initial reform period and lay the groundwork for long-term banking sector development, it was able to create a track record and self-perpetuating cycle of increased credibility. These have helped NBK to maintain some autonomy even as reform overall has slowed down and the power of business groups has increased. An important turning point occurred during the 1995–1996 banking sector crisis, when NBK took harsh but ultimately successful measures to close some banks and merge others.[145]

289. More recently, NBK has been using "moral persuasion" to force banks to disclose their true ownership structures. One of the more noteworthy successes was Temir Bank, where former minister Ablyazov (now under arrest) indirectly held 86 percent of the bank's shares, although

[145] NBK's credibility has also played a role in its being given responsibility for supervising Kazakhstan's pension and insurance industries. These responsibilities, in turn, give NBK a more comprehensive view of the financial sector and a more extensive set of reform tools.

this was not actually reported.[146] Temir Bank's ownership structure has been reorganized subsequently. [147] Another example of NBK's ongoing activities was its revoking of Komir Bank's license, a significant medium-sized bank, in early 2002.

290. However, despite this and other successes NBK continues to face significant challenges. The clearest example relates to the sale of Halyk's shares to an oil and gas company and that company's subsequent sale of the shares to a medium-sized bank. There was a notable lack of transparency associated with this transaction.

[146] However, Ablazov's loss of power reduced his ability to resist NBK's efforts.
[147] The Astana group, which was the main ownership vehicle for Ablyazov, is also a shareholder in BTA.

Box 12.1. Bank Consolidation and SME Finance in Kazakhstan

The SME Market

SME development is at an intermediate level in Kazakhstan: SMEs accounted for 21 percent of GDP in 2001, including 15.7 percent of agricultural output and 2.5 percent of industrial output. It is estimated that SMEs employ between 500,000 and 1.5 million people: the latter figure represents approximately 20 percent of the country's work force. In an economy still dominated by large firms in the extractive industries, SMEs are a vibrant sector, particularly in the absence of a significant tier of medium-sized manufacturing and service companies.

The Kazakh government officially supports the SME sector, but there are mixed signals about that support's effectiveness. During 2000-01, SMEs reported that opaque and complicated tax regulations were the greatest single constraint on their business. The second most important constraint was fear of economic instability and the consequent difficulty in making long-term plans.

Lending

The SME sector is popular with Kazakhstan's banks. SME loan yields are higher than those on other corporate loans, the sector's repayment history is good, and SME lending provides portfolio diversification. Also, SME lending is actively supported with credit lines and technical assistance from a number of IFIs and donor agencies.

As of the end of 2001, total sectoral lending was US$519 million. US$254 million of this was in medium- and long-term lending. Kazakhstan's three largest banks are also the three largest SME lenders. SME lending accounted for almost 39 percent of Halyk Bank's 2001 lending. As of the third quarter of 2000, SME lending accounted for 20.1 percent of BTA's lending. SME lending by KKB is thought by the market to be comparable in amount to that of Halyk and BTA.

Lending is cited as the third most significant SME constraint (after the two noted above), although this constraint has declined in severity since 1999. High interest rates and relatively short tenors are problems for borrowers, but the more intractable problem is the lack of collateral especially in more economically depressed regions'. The lack of a common business understanding between many SMEs and Kazakhstan's banks is noted as a further constraint.

It is noteworthy that as of the beginning of 2002, 73 percent of all medium- and long-term and 50 percent of all short-term SME loans had been provided to firms in Almaty. Almaty and the Eastern-Kazakhstan region account for almost 47 percent of the country's registered SMEs.

Conclusions

SME lending is unlikely to be hurt by further consolidation of the Kazakh banking sector and may even be helped. The fact that the country's three largest banks are also the three most active SME lenders implies that it would be illogical for them to acquire smaller banks and not continue developing these banks' SME business. Furthermore, there is clearly room to expand SME lending beyond Almaty. Such expansion is most likely to be undertaken by the large banks as they attempt to improve their branch networks' return.

Source: Most data cited in this summary are from Andrey Chursov, *Small and Medium Size Enterprises in Kazakhstan*, BISNIS, January 30, 2001. (The document is dated January 2001, but because year-end 2001 data are cited in the document, the document is presumably misdated.)

291. NBK has taken the following key steps since its creation of a consolidation and reform strategy in 1993:

- Introduced phased-in minimum capital requirements in 1993 and clearly demonstrated in 1995–1996 that these requirements were not negotiable by, among other actions, closing one of the largest banks in the country (Kramds) and forcing two other large (state-owned) banks, Turan and Alem, to merge.

- Took the initiative to obtain a Presidential Decree (1995) that enabled NBK to bypass the judicial system to liquidate nonviable banks.[148]
- Centralized banking supervision responsibility at the head office to relieve banks from potential political pressures from regional government (1995).
- Introduced an International Standards Bank program (1996) designed to ensure that all banks converted to IAS accounting standards and prudential norms before the end of 2000 and created "Group 1" banks, which were given a deadline of the end of 1998. The requirements include minimum capital of 1 billion tenge (US$6.7 million at the end of 2001) and a minimum ratio of equity to risk-weighted assets of 12. Banks were required to develop written action plans to demonstrate how they were going to meet these requirements.
- Demonstrated that state-owned and group-related banks were not subject to special treatment, by such actions as the forced merger of Turan and Alem in 1995 and the withdrawal of Komir Bank's license in 2002.
- Raised the limit on foreign bank capital from 25 percent of total banking system capital to 50 percent (1998). Prior to the increase, ABN Amro was the only foreign bank to play a notable role in the sector. Following the increase, Citibank, HSBC, and others have entered the sector and established significant market positions. As of January 2001, foreign capital accounted for 23 percent of total banking sector capital.
- Introduced an alternative license to enable banks that cannot meet the increased capital requirements to become "credit partnerships," which have the right to make loans but cannot take retail deposits. This alternative to liquidation reduces incentives to increase capital artificially.
- Required all state-owned enterprises to maintain accounts in three banks, weakening historic bonds between state-owned enterprises and former state banks.
- Introduced deposit insurance to a select group of eligible banks, creating pressure for non-eligible banks to improve their status in order to join the program (2001).
- Successfully campaigned for the right to supervise banks on a consolidated basis, in order for NBK examiners to be able to identify the ultimate owners of banks' and rout out hidden related lending (2001).
- Quickly established the credibility of the deposit insurance programby promptly reimbursing depositors in the first failed bank (Komir, 2002) and not reimbursing depositors in Business Bank, which was not a participant in the deposit insurance program.

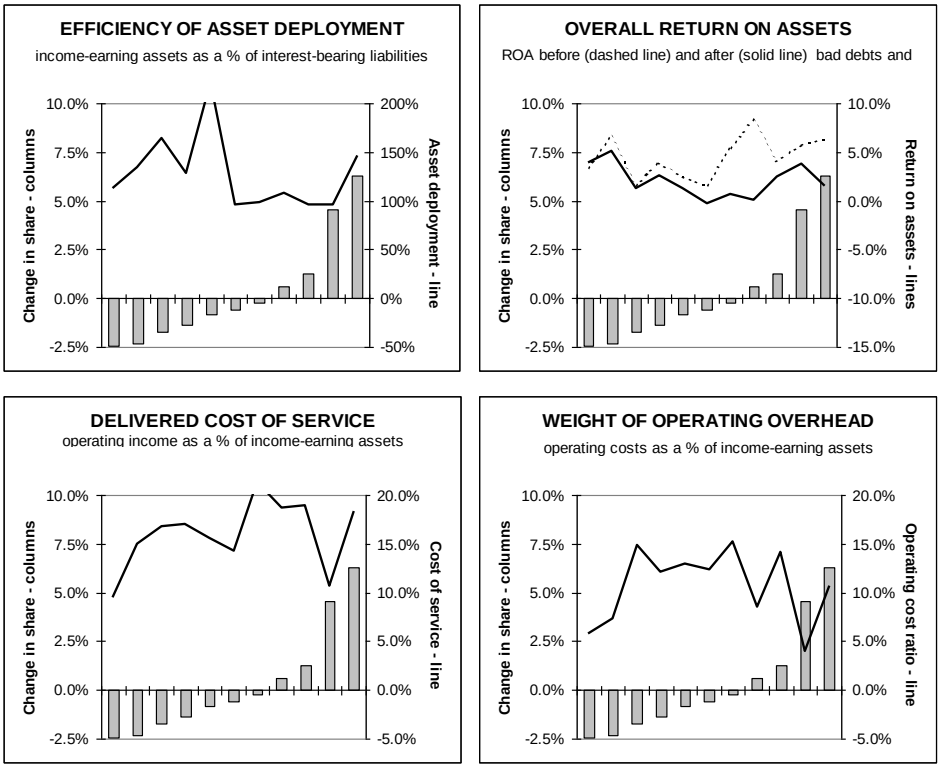
[148] This authority was successfully challenged in 1998 and management of the liquidation process reverted to the judicial system. However, a large number of banks had been closed by that time.

Future Developments

292. The beginnings of bank internalization of Kazakhstan's administratively initiated and supported consolidation strategy can be seen in some of the rapid market share and bank ownership changes of the recent past. In addition to the Halyk Bank transaction, other significant developments over the past several years have included CenterCredit's acquisition of the former Social and Housing Bank; Nauryz Bank's acquisition of the agricultural bank; and Temir Bank's announcement of interest in attracting a strategic investor. Because the most significant acquisition activity has occurred in the Big Three and second-tier groups, it is useful to evaluate these two groups in greater detail to understand the sector's potential future trends.

293. Data on a broad sample of banks are summarized in figures 12.1 and 12.2. Figure 12.1 shows market share gains and losses during 1998–2000, plotted against four financial performance measures. Figure 12.2 shows 2000 market share and market share gains against existing capitalization and each bank's self-capitalization. Table 12.8 displays the same data for seven banks that lost market share and five banks that gained market share in that period.

Figure 12.1. Changes in Market Share and Performance in Kazakh Banks 1998–2000



294. A review of market share gainers and losers as of 2000 yields several key findings. First, of the five market share gainers, AMB and BTA had notably weak operating cost figures.

AMB's were a very high 14.2 percent of earning assets, while BTA's were 10.7 percent. AMB's case is particularly noteworthy, because it subsequently acquired Halyk Bank, which has the group's highest operating cost level. AMB and BTA both recorded medium-range net ROAs—2.4 percent for AMB and +1.5 percent for BTA, helped in both cases by high operating income. Although AMB and BTA both had negative self-capitalization capacity at the end of 2000 (figure 12.2), they have both had subsequent capital increases. BTA in particular has attracted foreign shareholders with extensive capital resources.

Table 12.8. Market Share Gainers and Losers

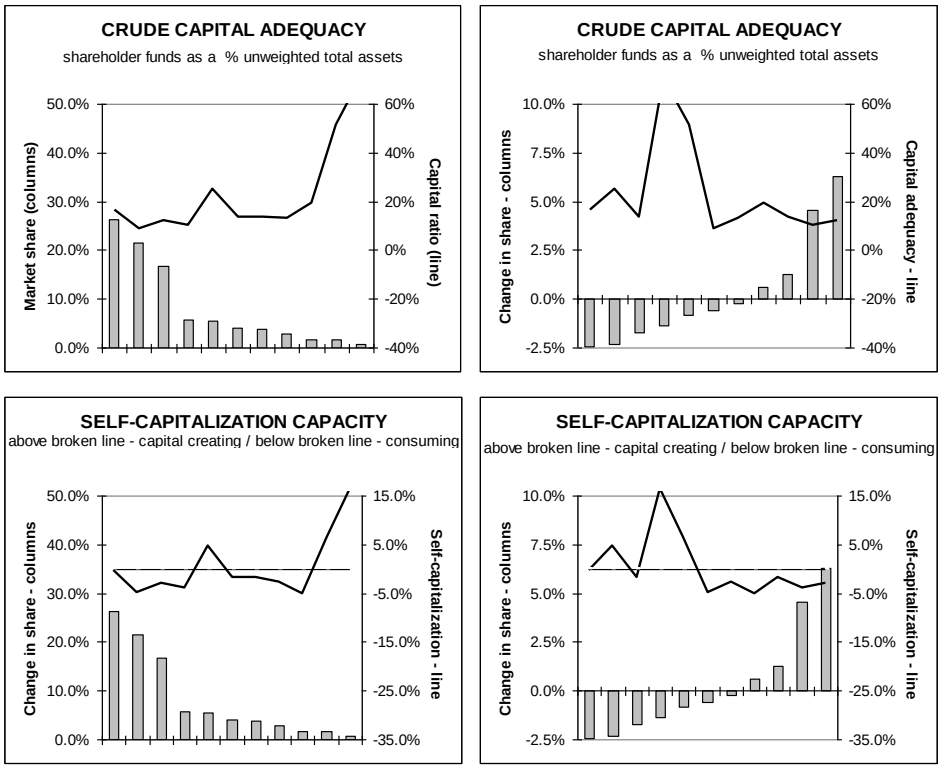
	Change in Share 1998–2000 (%)	Share of 2000 Total Ass./Liab. (%)	Efficiency of Asset Deployment (%)	Net ROA (%)	Delivered Cost of Service (%)	Operating Overhead Weight (%)	Capital as % of Total Assets	Self-Cap. Capacity (%)
Losers								
KKB	-3.7	25.0	113	3.9	9.5	5.7	16	-0.2
ABN Amro	-2.6	5.3	134	5.1	15.0	7.4	25	4.7
Center Credit	-1.9	3.8	164	1.3	16.7	14.8	14	-1.6
Halyk	-1.6	20.6	95	-0.3	14.2	12.4	9	-4.7
Demir	-1.4	0.6	128	2.6	17.0	12.1	70	16.5
Eurasian	-0.9	1.5	221	1.3	15.6	13.0	51	6.4
Temir	-0.3	2.7	99	0.6	21.4	15.2	13	-2.7
Gainers								
Komir	0.5	1.5	108	0.1	18.6	8.6	20	-5.1
AMB	1.1	3.7	96	2.4	18.9	14.2	14	-1.7
Citibank	3.9	4.9	102	2.9	9.3	5.7	13	-4.6
Nurbank	4.3	5.5	96	3.7	10.7	3.9	10	-4.0
BTA	5.5	16.0	147	1.5	18.3	10.7	12	-3.0

Source: Excerpts from Bureau van Dijk data.

295. Second, only two of the market share gainers had good results in terms of efficiency and profitability. Most notable of these is Nurbank, which increased market share by 4.3 percent between 1998 and 2000 and has since remained firmly in the second tier of banks.[149] Nurbank achieved the lowest operating costs in 2000 (3.9 percent of earning assets) and the third-highest net ROA (3.7 percent) despite relatively low operating income. Nurbank has also increased its capital since the end of 2000, when it had a negative self-capitalization capacity. Nurbank would appear to be the only second-tier bank with the potential to significantly challenge the Big Three. (It is noteworthy that Mangystaumunaygas owns 10 percent of Nurbank. This is the same company that bought the state's Halyk shares and then sold them to AMB.)

[149] Nurbank was founded in 1992 by the regional government of Atyrau, an oil and gas region, in order to finance local projects. The bank was privatized in 1996; none of the current shareholders owns more than 10 percent of the bank's shares. Nurbank has a specific strategy to become one of Kazakhstan's largest banks, including attracting a strategic investor. The bank has historically focused on corporate lending, particularly to companies in its region (some of which became its shareholders when it was privatized). Because of its history and small branch network (9), Nurbank's funding base is concentrated among its corporate clients as well. The bank plans to address this issue by opening 10 to 20 new branches. In January 2002, S&P rated Nurbank's long-term obligations at B-. As positive attributes, S&P cited Nurbank's good financial performance, including its capital base; strict lending controls; and growing market share. As negatives, S&P noted the concentrations in Nurbank's lending and funding and its relatively short history. Standard & Poor's, January 22, 2002, and April 5, 2002.

Figure 12.2. Changes in Market Share and Bank Capitalization



296. Finally, Citibank's results are noteworthy because of its ability to achieve the second best cost performance, behind Nurbank and on a par with KKB, and among the highest net ROAs. It achieved these results despite a relatively low operating income.

297. As has been noted, the license of the fifth market share gainer, Komir Bank, was revoked in early 2002.

298. As for market share losers, Halyk stands out for its high operating costs (12.4 percent) and the lowest net ROA of all banks—negative 0.3. KKB stands out for a different reason, because of its relatively low operating costs (5.7 percent) and second-highest net ROA (3.9 percent) after ABN Amro.

299. The three significant sector-tier banks that lost market share—Temir, Eurasian Bank, and CenterCredit—performed relatively poorly overall. At least based on 2000 results, it may be that their relatively small size, despite their being in the second tier, harms them in terms of economies of scale. Furthermore, as the only one of the three with a positive self-capitalization

ratio (6.4 percent) at the end of 2000,the capital of a Eurasian Bank of approximately US$28 million (mid-2001) would enable it to challenge the Big Three only by merging with another bank, not by acquisition.[150]

300. Although 2001 data are not available for the entire sector, it is useful to review the available results for the Big Three and Nurbank (as a potential Big Three competitor) to see how the trends are evolving. Table 12.9 provides selective 2001 results. It shows clear improvements in cost controls for Halyk and KKB during 2000–2001.[151] However, Halyk still has a long way to go, with an operating expense to operating income ratio of 63 percent, compared to 49 percent for KKB. Nurbank's expansion appears to have caught up with it in 2001, as shown by the rising expenses ratio, although this declined again in the first 10 months of 2002. However, when loan loss provisions are included in the operating expenses figure, it becomes clear that all of the banks are finding it more difficult to make money. These stresses can also be seen in the declining ROA figures.

Table 12.9. Selected Results for 2001

Operating Cost/Operating Income (%)	**1999**	**2000**	**2001**	**Oct. 2002**
KKB	51	58	49	
BTA	na	na	na	
Halyk	92	87	63	
Nurbank	na	58	66	52
Operating cost + Provisions/ Operating Income (%)	**1999**	**2000**	**2001**	**Oct. 2002**
KKB	116	72	85	
BTA	na	na	na	
Halyk	111	100	98	
Nurbank	na	80	88	99
ROA (%)	**1999**	**2000**	**2001**	**Oct. 2002**
KKB	-	3.24	2.72	
BTA	1.62	2.70	1.37	
Halyk	0.01	neg.	1.37	
Nurbank	na	2.52	5.31	2.74
Capital/Total Assets (%)	**1999**	**2000**	**2001**	**Oct. 2002**
KKB	na	14.0	12.6	
BTA	11.9	13.7	10.7	
Halyk	9.4	6.7	5.4	
Nurbank	na	16.7	18.8	18.7
Growth in Total Assets (%)	**1999**	**2000**	**2001**	**Oct. 2002**
KKB	61	53	57	
BTA	154	70	104	
Halyk	44	83	24	
Nurbank	343	185	-9	15

Source: Figures for KKB, Halyk, and Nurbank are derived from their annual reports. The BTA figures are from Interfax Center for Economic Analysis, Volume XI, Issue 34 (575), August 28, 2002.

* The ROA figures differ from those in Table 12.8 because those figures are net ROA.

[150] Demir, a third-tier bank by size, performs better than these two second-tier banks but is too small to be relevant to this discussion.

[151] The generally downward trend between 1999 and 2000 is significantly due to the 1999 tenge devaluation, which generated substantial balance sheet translation gains in 1999.

301. The results also conform with overall sector data by showing a decline in capitalization: in this case the ratio of capital to total assets.[152] Most noteworthy is Halyk, with a ratio of only 5.43 and 6.9 billion tenge of total capital, compared to Nurbank, with a ratio of 18.7 (as of October 2002) and 5.4 billion tenge of total capital. Given these numbers, Nurbank clearly has additional growth capacity.

302. Finally, the data show varying growth results. BTA's growth has been consistently the most aggressive, while KKB's growth was steady and Halyk's growth declined noticeably in 2001. Nurbank showed the very high growth rates in 1999 and 2000 that gained it substantial market share and appears now to be absorbing that growth. Therefore, although all four banks have defined growth strategies, their implementation capacities clearly vary.

303. In summary, the 2000 and 2001 results show that Kazakhstan's Big Three banks continue to dominate the sector in terms of size and growth. Nurbank is the only second-tier bank that shows signs of being able to challenge the Big Three, while the foreign banks have the ability to do so should they choose. The key issues facing these banks, also reflected in the overall banking sector data, are how to sustain growth by increasing capital and also manage costs. Judging from the sector's dynamics, the environment seems to be sufficiently competitive to be forcing the banks to proactively address these issues. It is unfortunate that an opportunity was missed to increase competitiveness even more by means of the Halyk Bank sale.

Conclusions and Recommendations

304. Kazakhstan has been one of the most successful ECA countries in grappling with a banking system that veered out of control in the early post-Soviet period, with a peak of 203 banks in 1993. The NBK reasserted regulatory authority with an approach that included a specific plan to instigate sector consolidation. As of mid-2002, the number of banks has dropped to 41; there is active competition among the banks, including mergers and acquisitions; intermediation levels have increased; and NBK has clearly sustained its authority.

305. Looking forward, the major challenge facing the sector's ability to sustain these trends is the relatively low capitalization level, which hampers the sector's ability to increase intermediation. Of the Big Three banks only BTA, with its foreign investors, has a clear source of future capital. KKB is majority management owned, which makes its source of future capital unclear, while AMB presumably stretched its resources to assume its position in Halyk.

306. Two potential capital sources are pension funds and business groups. Some of the latter already hold interests in the major banks, with varying degrees of transparency. However, both potential sources raise significant corporate governance issues. Given the lack of transparency associated with the Halyk Bank sale, any weakening in corporate governance would be a particular cause for concern.

307. As a result, one of the important lessons from the Kazakhstan case study is that even when market participants start to internalize an administratively initiated consolidation policy, the regulatory authority still has an important role. NBK is certainly continuing to advance banking reform, yet the Halyk sale did not conform with the high standards that might have been expected based on NBK's track record. Perhaps the final outcome was designed to avoid KKB's

[152] Subordinated debt is not included in the capital calculation.

purchase of Halyk and the high level of banking sector concentration that would have resulted. But the Estonian experience suggests that this need not have been a problem if the acquiring bank itself was relatively more efficient. (see Chapter 6). In any case, it is to be hoped that NBK and the market will apply pressure to encourage Halyk to catch up with its competitors.

308. Second, this case study reinforces the lesson that crises represent a valuable opportunity to introduce and deepen reforms. This lesson was demonstrated twice in Kazakhstan: first when NBK introduced a consolidation and reform strategy in 1993, and second during the 1995/96 banking crisis, when it reinforced the strategy by closing banks as appropriate and forcing other banks to merge.

309. A third lesson, also seen in other case studies, is that foreign bank activity can play an important role in increasing banking sector competition. Not only have foreign banks in Kazakhstan helped to set cost efficiency standards, but their holdings in one of Kazakhstan's largest banks can only help that bank increase its own competitiveness. The fact that some of the foreign banks appear to be positioning themselves to expand their role in the sector, including by means of such investments, itself encourages further competition.

CHAPTER 13: HUNGARY

Introduction

310. In the first years of transition from the monobank to the two-tier system, the Hungarian banking sector operated in an environment with many financially distressed clients, high levels of non-performing loans, weak and imprudent managements, and lenient regulatory and supervisory rules. As a result the portfolios of the banks quickly deteriorated, with bad loans reaching close to 30 percent of total loans by 1993.[153] These adverse trends induced the authorities to undertake a series of measures toward bank consolidation. This centrallyled consolidation took the form of portfolio clean-ups, recapitalizations, and bad debt workouts during 1991–2000. Its cost was extremely high: estimated at 13 percent of GDP,[154] However, it paved the way to the successful and early privatization of some banks to strategic foreign investors.

311. Currently, the Hungarian banking sector is a stable and mature financial market, with nearly two-thirds in foreign ownership. However, it is still overpopulated (42 banks) for two main reasons. First, the former state banks were privatized in a relatively fragmented form. Second, many new foreign-owned "greenfield" banks opened and this enlarged the population of banks. A further consolidation stage, this time entirely market-driven, would be a logical development as Hungary moves towards financial integration into the European Union. However, this probably needs to wait for mergers and acquisitions initiated by parent foreign banks. Recent mergers in Hungary present evidence that this second stage and market-driven consolidation may have started.

312. This case study aims to facilitate a better understanding of the earlier centrally administered bank consolidation undertaken in preparation for privatization and to analyze the role of foreign ownership in shaping the process of consolidation in a highly internationalized economy. It starts with a brief overview of certain general elements in Hungary's economic situation, followed by an outline of its banking sector's characteristics. The main features of the privatization and consolidation process during the past decade are then described. This is followed by a review of the financial performance of the newer banks that emerged from that process compared to that of foreign-owned banks operating by the end of the 1990s. Finally, the

[153] National Bank of Hungary statistics.

[154] G. Szapary, "Banking Sector Reform in Hungary: Lessons Learned, Current Trends and Prospects" National Bank of Hungary Working Paper, May 2001. p.13.

sustainability of the current situation and possible future trends are discussed and lessons from the Hungarian experience are drawn.

The Economic Background

313. Hungary has been one of the best performing transition economies in terms of its ability to implement far-reaching institutional and structural reforms. Hungary's GDP followed a steady growth path during 1997–2001, averaging 4.5 percent per year, while inflation was brought down from 18.5 percent in 1997 to 9.1 percent in 2001. Until recently Hungary also had stable fiscal and current account balances. 80 percent of the economy and 75 percent of total banking sector assets are privately owned. Hungary's ability to attract foreign investment was also particularly strong and accounted for about one-quarter of all FDI in CEE through the 1990s, with approximately 70 percent of Hungarian exports now generated by multinational firms operating in the country.

314. The European Commission acknowledged Hungary as a functioning market economy in 2001, paving the way for the subsequent decision at the October 2002 European Summit that Hungary and nine other countries would become EU members in 2004. In the light of this imminent EU membership, Hungary is concentrating efforts on bringing its living standards close to the EU average levels (GDP per capita was 51 percent of the 2001 EU average[155]). In addition, considerable public spending is being allocated to improving infrastructure to reduce the country's regional divides. However, prospects for stronger GDP growth become bleaker with recession in Germany, the biggest market for Hungarian exports. This risk illustrates one of the main challenges facing Hungary, given its small, open, and highly globalized economy. External shocks could well be the main challenge to sustainable economic growth and future successful financial sector performance.

Overview of the Banking Sector

315. As of end 2001, there were 42 commercial and specialized banks in Hungary. Three key features dominate the banking sector: (a) the relatively low level of intermediation;; (b) the low degree of state and the high degree of foreign ownership ; and (c) relatively high concentration, but with signs of increasing competition.

Overall Banking Sector Size

316. For a country so advanced in its transition to a market economy, the size of the Hungarian banking system relative to the economy it supports is surprisingly limited. Deposits from the non-bank, non-government sector (a traditional measure of financial sector depth) amounted to only 35 percent in 2001, a level obtaining (give or take 1 percentage point of GDP) for six years, and also one that is below pre-reform levels. Hungary ranks sixth among ECA transition economies in terms of the ratio of deposits to GDP and in terms of PPP-adjusted per capita GDP it ranks third. The contrast is best illustrated by a comparison with the Czech Republic, whose PPP-adjusted per capita GDP is as high as Hungary's but whose deposit-to-GDP ratio is nearly twice as high. Combining the two gives the Czech banking system a US$100 billion deposit base (PPP-adjusted) compared to just under US$50 billion for Hungarian banks, even though both countries have roughly the same population (10 million).

[155] European Commission, "EU Regular Report on Hungary," 2002.

317. There are three possible reasons for this discrepancy:

- Hungary has the most developed, genuinely functioning non-bank financial sector of any of the ECA transition economies, with substantial pension and investment funds that are more than just the nominally repackaged privatized shareholdings of major state enterprises'.
- The nature of Hungary's transition, with its early start long before the Soviet bloc's collapse may have shifted more national output to the sort of small enterprises that do not expect to use banks as a major source of investment or working capital.
- Heavy foreign ownership may mean less reliance on domestic funding, although this is not likely to be a very significant factor as the ratio of total banking assets to GDP (around 67 percent) is in line with that of Poland, which has an almost identical deposit-to-GDP ratio despite a significantly lower PPP-adjusted per capita GDP.

Low Government Ownership and Foreign Dominance of the Banking Sector

318. As of the end of 2001, public ownership accounted for 25.6 percent of registered capital while 62.2 percent was in foreign hands (Table 13.1). It is worth noting that the large foreign presence is also the result of various sector investments. The new government intends to divest its stake in the Postabank, Konzumbank, and FHB (Land Credit and Mortgage Bank). Table 13.1 also illustrates that the most notable changes in ownership structure has been in domestic privately owned banks, which have declined from 16 percent to 8.9 percent of total assets since the end of 1998.

Table 13.1. Banks' Ownership Structure (% of registered capital)

	Dec. 98	Dec. 99	Dec. 00	Dec. 01
Public	20.7	19.3	21.3	25.6
Domestic Private Ownership	16.0	12.8	9.4	8.9
Foreign Ownership	60.6	65.4	66.7	62.2
Preferential and Repurchased Stocks	2.7	2.5	2.6	3.3
Total	100.0	100.0	100.0	100.0

Source: HFSA.

High Concentration in the Retail Sector With Increasing Competitive Pressures

318. Market asset concentration has decreased somewhat in recent years, although it still remains high. The market share of the five largest banks accounted for about 57 percent of total assets at the beginning of 2001, compared to 80 percent in 1993. There is also noteworthy concentration in the retail (household) sector: 40 percent of all household deposits are concentrated in one bank, and the five largest banks account for 70 percent of household deposits.[156] Corporate banking, by contrast, shows relatively low concentration, with a Herfindahl index of just above 600 for corporate credits and deposits. There is also evidence of growing competition in that market, in the form of declining interest margins.

Bank Restructuring and Privatization in Hungary

319. As early as 1992, Hungary initiated an entirely centrally led banking sector consolidation in order to rescue the rapidly decapitalizing and loss-making banks and prepare them for

[156] IMF Country Report No. 01/112. June 2002.

privatization. The deteriorated financial state of many banks at that time was due to several factors: bad loans inherited from the monobank system;' the continuing financial distress of enterprises after the collapse of the Council for Mutual Economic Assistance (CMEA); an inadequate regulatory and supervisory framework; and weak and imprudent managements. The authorities addressed the problems and consolidated the sector through a number of measures that were implemented in two main phases: portfolio clean-up followed by recapitalization. The state also addressed corporate sector problems by cleaning some of the enterprises' portfolios and encouraging schemes to work out bad loans.

Portfolio Clean-Up

320. The portfolio-cleaning phase replaced assets worth HUF 104 billion with HUF 80 billion in government consolidation bonds[157]—negotiable, 20-year maturity, adjustable-rate bonds indexed to the market-determined treasury bill interest rate. The government's partially centralized portfolio cleanup applied to banks with capital adequacy ratios (CAR) less than 7.25 percent. Fourteen commercial banks and 69 savings cooperatives participated. In March 1993, these banks could sell bad debts from their portfolios to the state. Assets classified as bad prior to 1992 were purchased at 50 percent of par value; those classified as bad only in 1992 were purchased at 80 percent.[158] In certain cases, in order to speed up the bank privatization process the state bought claims at full price.

321. The portfolio clean-up program substantially improved the situation in the affected banks as well as the total banking system's aggregate indicators. By the end of 1992 the total problem loan portfolio of the banking sector had declined from HUF 288 billion to HUF 186 billion and bad loans had declined from HUF 186 billion to HUF 84 billion.[159]

322. Moreover, the CARs of most banks participating in the program, at least according to Hungarian accounting and banking regulations, became positive. Without this portfolio clean-up program the 14 banks would have lost eventually two-thirds of their solvency capital and their aggregate CAR would have been 1.0 percent instead of the 7.25 percent prescribed by the Banking Act.[160] According to BIS standards, 12 banks would have lost their entire capital and reported a negative CAR. So many immediate bank failures were avoided as a result of the state intervention.

323. However, this rehabilitation effort did not really touch the banks' organization, management, or operating systems. Thus there was no solution to eliminate the potentially huge moral hazard rooted in relieving bank managers of their responsibility for prudent lending decisions.[161] As a result, at the end of 1993, the value of bad and doubtful assets amounted to HUF 418 billion (bad debts alone were around HUF 243 billion).[162] An additional factor

[157] J. Rostowski, . "Banking Reform in Central Europe and the Former Soviet Union. Central European University Press," 1995. p. 72.
[158] I. Abel and L. Szakadat, "Bank Restructuring in Hungary". *Acta Oeconomica*, vol. 49, 1997–1998. p. 177.
[159] KPMG, "Privatization in the Banking Sector," Draft Report, 1999. p. 44.
[160] Abel and Szakadat, p. 176.
[161] I. Abel and J. Bonin, " Financial Sector Reform in the Economies in Transition: on the Way to Privatizing Commercial Banks". Paper presented at the International Conference on Development and Reform of the Financial System in Central and Eastern Europe, October 1993, Vienna, Austria.
[162] G. Suranyi, "Restructuring the Banking Sector in Hungary," National Bank of Hungary, 1998. p. 8.

contributing to these worsening results was the newly introduced use of IAS to evaluate loan portfolios.

324. As a result, bank privatization was not considered to be a realistic near-term prospect. Instead, at the end of 1993 the Hungarian government undertook a further rehabilitation program, this time focused on recapitalizing banks.

Bank Recapitalization

325. Taking into account the recommendations from international organizations, the Hungarian government introduced another rehabilitation program by the end of 1993. This one aimed at recapitalizing banks instead of merely cleaning up their portfolios. The recapitalization was implemented in three steps. In the first step, at the end of December 1993, eight banks received consolidation bonds in the amount of HUF 114.5 billion.[163] This capital injection enabled them to raise their CARs above 0 percent. In the second step, May 1994, the government offered additional capital (HUF 18 billion)[164] to the banks participating in the program so that they could reach 4 percent CAR. The four largest banks' recapitalization process was completed in 1994, when they were granted HUF 15 billion in subordinated loans in the form of equity in order to reach 8 percent CAR. By the end of 1994, HUF 330 billion worth of consolidation bonds had been issued under the recapitalization scheme, an amount equivalent to 9.4 percent of 1999 GDP.[165]

Bank Privatization

326. Having spent the first half of the 1990s cleaning up the state-owned banks' balance sheets, the authorities could then start privatizing the restructured banks. The highlights of this stage of reform included:

- OTP, the former state savings bank, was privatized just short of 50 percent to foreign institutional investors and the rest to a mix of domestic institutional and retail investors, plus some self-holding and a nominal (less than 1 percent) holding retained by the state privatization agency. The bank is now listed on the Budapest and various German stock markets.
- Just under 80 percent of the much smaller Bank of Hungarian Savings Cooperatives was sold to DZ Bank AG of Germany, with remaining shares held by local savings co-ops.
- Mezobank absorbed Agrobank, then the two recapitalized and sold to Erste of Austria in 1998.
- Hungarian Foreign Trade Bank Ltd. was sold 100 percent to a two-bank German-Austrian consortium led by Bayerische Landesbank Girozentrale.
- Commercial and Credit Bank, the second-largest of the privatized state business banks, was sold 100 percent to a two-bank Belgo-Dutch consortium headed by KBC.
- Budapest Bank was sold to GE Capital supported by EBRD.

[163] Abel and Szakadat, p. 180.
[164] Suranyi, p. 8.
[165] Suranyi, p. 9.

- General Banking & Trust was sold to a group of Russian and local investors, led by Gazprom Bank.

327. Hungarian Development Bank and its subsidiary Konzumbank, Hungarian Eximbank, and the postal savings bank Postabank were not privatized.

The Banking System's Financial Performance by the Late 1990s

328. The Hungarian banking sector's profitability has improved steadily during the last three years to reach a sector-wide ROE of 20.2 percent in 2001, but this was from a previously low base, with much of the 1990s characterized by ongoing losses. The banks still face considerable challenges to maintain this profitability in the future, particularly as a result of shrinking corporate lending interest margins that arenow as low as 2 percent.

329. In 2001 the capital adequacy ratio of commercial banks' stood at 14.2 percent of risk-weighted assets, representing a slight improvement over the 2000 figure of 13.5 percent. However, a number of banks still have CARs close to the 8 percent minimum; they are being closely monitored by the Hungarian Financial Supervisory Authority (HFSA). Table 13.2 summarizes these and other selected banking sector financial indicators.

Table 13.2. Main Financial Indicators for the Hungarian Banking Sector, 1997–2001

(%)	Dec. 97	Dec. 98	Dec. 99	Dec. 00	Dec. 01
Capital Adequacy					
Regulatory Capital to Risk-weighted assets	17.3	16.5	14.9	13.5	14.2
Asset Quality					
Sectoral distribution of loans to:		31.3	29.2	27.2	27.1
Manufacturing		19.4	20.8	20.2	18.6
Trade, maintenance		15.9	16.5	16.1	18.1
Financial Intermediation					
FX loans to total loans	17.8	20.4	23.3	18.9	20.6
Earnings and Profitability:					
ROA	0.1	-2.0	0.6	1.3	2.0
ROE	7.6	-26.7	6.7	15.1	20.2

Source: IMF Country Report of June 2002.

330. It is useful in this analysis to distinguish between the financial performance of former state-owned banks and the foreign-owned banks that have entered the market. The former state banks are demonstrating slightly worse results, but privatization to foreign shareholders does not appear to have conferred a very strong advantage when compared on a like-for-like basis. A number of the privatized banks have retained their original national identities (OTP, Foreign Trade, Savings Coop Bank) even where they have become majority foreign-owned, but most foreign-owned banks are now branded as part of their parent groups (not least because they were established as such as greenfield operations). Table 13.3 shows that full integration into a foreign parent's brand delivers a very slight cost, price, and profitability advantage, but that average overhead and income ratios still remain high relative to the standards of parent (major industrialized) country banks. . However, a sub-divisions of the results for foreign-controlled banks shows that the cost advantages of foreign-branded banks' come largely from four of the oldest greenfield banks that have been active in Hungary since the 1980s, only one of which is locally branded. Together these banks account for as much of the market as the new foreign-owned banks established since 1991. Separating them out shows no difference on average in

performance indicators for banks privatized to foreign strategic investors and the group of new greenfield banks. (However, some of this latter group have established niches in consumer and asset finance, thereby at least qualitatively increasing overall market competition.)

Table 13.3. Grouped Performance Results for Hungarian Banks

	All Banks in Sample by Ownership/Branding		27 Foreign-Owned Banks by Original Genesis		
	State/National	Foreign Branded	Privatized (excl. OTP)	Old Greenfield	New Greenfield
Number of banks in sample	12	19	8	4	15
Market share end 2000 (%)	69	31	37	17	13
Change since 1998 (%)	-4	4	1	2	1
Efficiency of asset deployment (%)	89	103	97	109	99
Weight of operating overhead (%)	7	6	6	5	6
Delivered cost of service (%)	9	7	7	7	6
ROA:					
Gross (%)	1	1	1	2	1
Net (%)	1	0	0	2	0

Source: ???

331. This points to the at best mixed benefits of privatizing a fragmented banking system in the way the Hungarian authorities did in the second half of the 1990s. Most of the banks were sold, having been restructured as distinct entities, to different foreign shareholders, and this appears to have blunted pressure to compete and consolidate locally. Detailed bank-by-bank analysis shows no evidence that foreign-owned privatized banks with a retained national identity are any more efficient than the remaining state banks (see Table 13.4). Moreover, because state-owned and nationally branded foreign-owned banks dominate the Big Five banks that control just over half the market and have slightly inferior performance indicators than smaller, typically foreign-branded greenfield banks, there is actually a weak positive relationship between size and both operating overhead and income ratios, as shown in figure 13.1 below

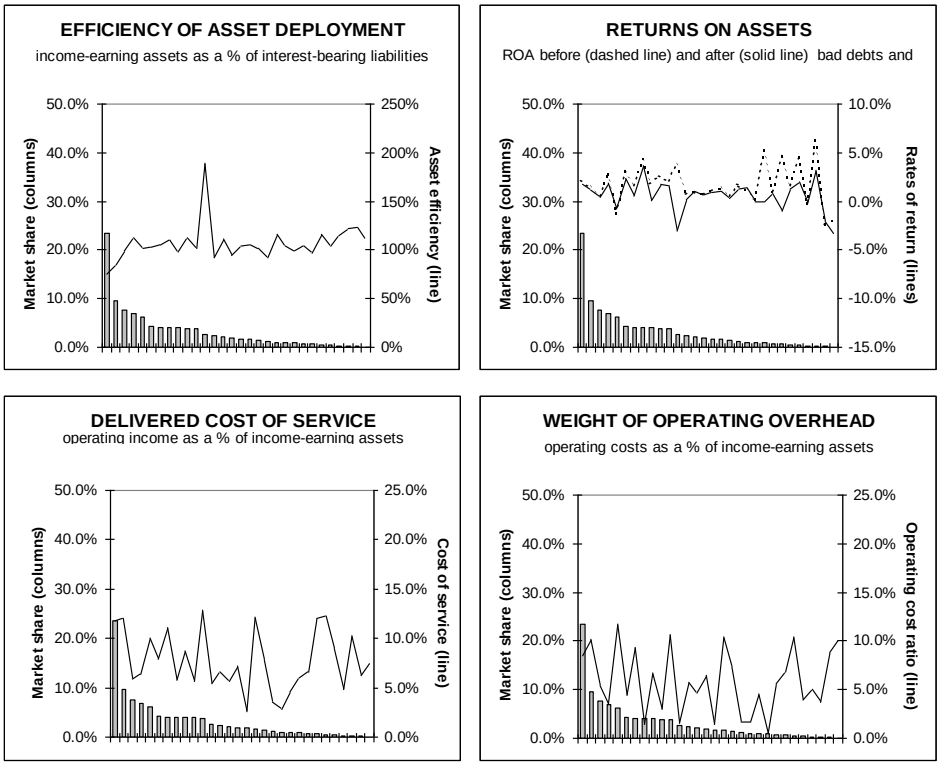
Table 13.4. Comparison of Performance State/Former-State Banks by Ownership (%)

	Ownership	Share Total Assets end-2000	Change in Share 1998–2000	Av. Net ROA	Delivered Cost of Service	Weight of Operating Overhead
OTP	50 F. instit.	23.6	-2.1	1.8	11.8	8.5
Hungarian Foreign Trade Bank	100 F. strategic	9.7	0.2	1.1	12.0	10.2
Commercial and Credit Bank	100 F. strategic	7.6	-0.7	0.4	5.9	5.4
Budapest Bank	90+ F. strategic	4.1	-0.2	0.6	11.1	9.4
General Banking and Trust	60+ F. strategic	4.1	1.4	3.6	5.8	1.5
Postabank	100 State	4.1	-1.9	0.1	8.7	6.7
Hung. Development/Konzumbank	100 State	3.4	-0.9	-2.6	6.9	2.7
Inter-Europa	60+ F. mixed	1.9	-0.2	0.7	7.2	6.4
Bank of Hungarian Savings Coop.	80 F. strategic	1.4	-0.3	0.4	7.7	7.3
Hungarian Eximbank	100 State	1.0	0.1	1.3	2.8	1.7

Source: ???

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What does "F." mean in this table?

Figure 13.1. Size and Bank Performance in Hungary



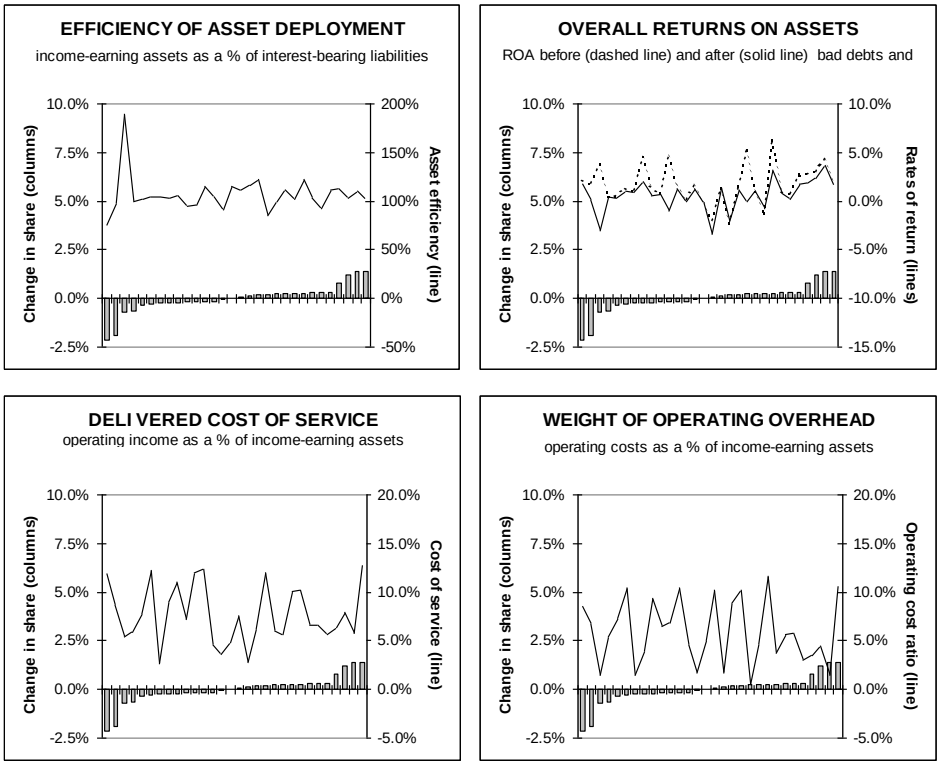
332. Figure 13.1 illustrates considerable volatility in the various performance indicators and very nearly as strong a cross-correlation between operating overhead and income ratios as in any of the less developed case-study banking systems. This suggests that some of the foreign-owned banks may have very specifically segmented markets and considerable scope to pass on high costs to clients. If this is the case, it might explain why the higher overhead state-owned and nationally branded banks are only slowly losing share to lower-overhead foreign-branded banks.

Future Developments

333. Although Hungary's bank rehabilitation program was very expensive—and arguably unnecessarily so—it did lay the groundwork for the successful sale of a number of state-owned banks to foreign investors. An unusual characteristic of Hungary's present banking sector, however, is that the foreign-owned privatized banks and the large number of new foreign-owned greenfield banks have not yet had an impact of the sort they have had in Poland in terms of improving the competitive environment. In the case of Hungary, foreign investment to date has actually resulted in the creation of many more banks and not the consolidation around a smaller number of more efficient players.

334. Indeed an argument can be made that the very high and fragmented foreign penetration of the market could have blunted, or at least delayed, market consolidation pressures, because of the deep pockets of the foreign investors. This is confirmed by looking at which banks are gaining and losing market share in Hungary. Two-thirds of the share-gaining banks and three of the four big share-gainers had average or worse than average overhead ratios, as shown in figure 13.2. Of the five-high share-gaining banks, all were wholly foreign owned and three were loss-making. The foreign-owned banks' deeper pockets enable them to buy market presence at the expense of profitability.

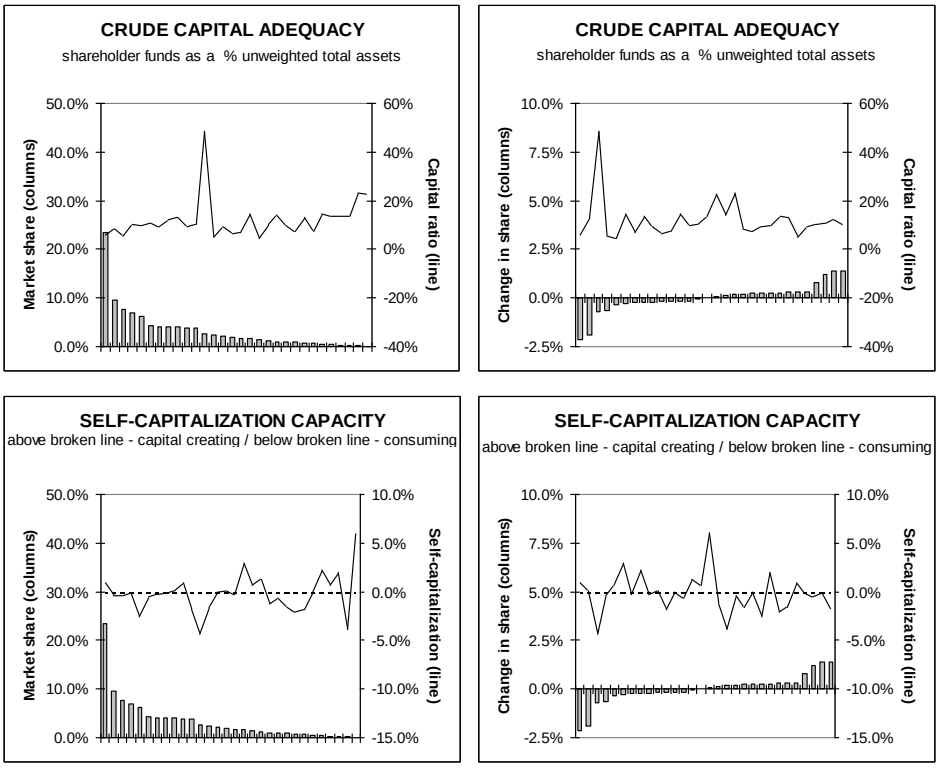
Figure 13.2. Changes in Market Share and Performance in Hungary



335. In terms of capital sustainability, the results are similar to those already discussed. Larger banks tend to have slightly lower capital adequacy and seem as a result to be following (with one exception) broadly neutral self-capitalization strategies. Market share gainers tend to consume capital whereas losers tend to be protecting or building capital adequacy, but the correlation is very weak (-0.12). This almost certainly reflects the blunted key capital constraint, critical to effective consolidation, that happens when foreign shareholders take a strategic marketing decision that they "must" retain a presence in an important transition economy. In these circumstances shareholders (particularly in greenfield operations) are prepared to cover inadequate profitability with continued capital infusions to stay in the Hungarian market, even though their operation may fail to achieve a profitable scale. This almost certainly means that

deeper Hungarian banking market consolidation will have to await EU banking markets consolidation, where most of the parent banks have their origins.

Figure 13.3. Capital Sustainability in Hungary



336. This EU effect is just becoming visible. The first such merger took place between Belgium's KBC's and ABN Amro Bank's Hungarian operations and resulted in the creation of Hungary's second largest banking group, K&H Bank. The second merger, in September 2001, combined the Hungarian subsidiaries of Bank Austria-Creditanstalt and HypoVereinsbank, which were merging at the parent company level. The new bank is HVB Hungary. In addition, in summer 2000 Citibank acquired ING Bank's Hungarian retail banking business as the latter reconsidered its emerging market strategy.

Lessons Learned

337. The Hungarian experience illustrates the need for banking sector reform to be enforced with a willingness to address both the stocks of bad debts and the flows of potentially new bad loans. Failure in this area meant that the first efforts to restructure and clean-up portfolios in the early 1990swere quickly followed by further bad lending. This is a common lesson from the case-study countries: witness the contrast between the Polish and Bulgarian restructuring efforts in this regard.

338. The Hungarian case also provides another useful contrast to the Polish case. Both bank privatization programs led to majority foreign banking sector ownership, but in Hungary it is clearer that foreign bank investment is not a panacea for banking sector inefficiencies and low intermediation levels. It is particularly worth noting that Hungary's proliferation in bank numbers was entirely foreign driven and that the new foreign-owned greenfield banks by and large perform no better than the privatized legacy banks. The fact that the best performing banks are longer-established foreign-owned greenfield banks with more than a decade's experience in local operating conditions suggests that efficiency is a domestically driven competitive force that basically cannot be imported. This issue needs further investigation as it involves foreign investors' management and governance strategies, and has recently been reviewed in a preliminary draft by Majnoni, Shankar and Várhegyi.[166]

339. It remains to be seen how the banking sector will evolve, especially as developments in the sector are taking place very quickly. Preliminary evidence emerging from bank-by-bank analysis shows that the major state banks privatized to foreign strategic investors are no more and no less efficient than banks where the state retains control. This is almost certainly because, as the Majnoni, Shankar, and Várhegyi paper describes, new foreign owners tend to raise significantly other elements of the cost bases of the former state banks in a way that offsets the significant staffing cuts that they also typically make. It might have been expected that the extra expenditure would have raised quality of service in a way that permitted higher pricing, but this is not evident from the data used for this study. Nor is there any evidence by way of significant differential business growth that might be expected to come from significant investment in improved quality. This provides an additional validation for the focus in this study on the importance of a competitive cost ratio—if competition does not result in lower intermediation costs, it probably will not result in significantly increased intermediation volume.

340. Perhaps the biggest lesson from Hungary is that when public authorities are restructuring troubled state banks, they must go considerably further than just cleaning up bank balance sheets before privatization. In addition, they need some way to improve bank management structures and lower their cost bases before selling them to foreign investors.

[166] Giovanni Majnoni, Rashmi Shankar, and Éva Várhegyi, "The Dynamics of Foreign Bank Ownership: Evidence from Hungary," preliminary draft February 2002.