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EUROPEAN BANKING GROUPS IN CEE COUNTRIES: EXPOSURE AND POST-CRISIS STRATEGY

В статті розглядається процес консолідації банківської системи в Європі та роль країн Центральної та Східної Європи (ЦСЄ) в ньому, визначається роль країн ЦСЄ у діяльності основних банків-лідерів регіону і зміна їх стратегій в результаті світової фінансової кризи.

The article deals with consolidation in European banking and focuses on the role of the Central and East European Countries (CEE) in this process. The author defines the role of CEE in the activities of leading European banking groups in the region and elaborates on changes of this role as a consequence of the world financial crisis.

Key words: bank consolidation, European banking groups, Central and Eastern European Countries

In 1990-2000s bank consolidation gained a foothold in the world due to financial system deregulation, liberalization of international trade and capital flows and technical progress that reduced the costs of mergers and acquisitions (M&A). Bank consolidation had above all domestic character, as most M&A deals involved domestic banks. This led to almost twofold decline in the number of banks in the USA and EU between 1990 and 2006 [15,1]. Although smaller in number than domestic, international bank M&A started to gather pace, involving the largest financial groups in the USA and Europe.

The topic of bank consolidation is widely studied both in Ukraine and abroad. In Ukraine this topic was researched by Z. Vasylchenko, V. Mistchenko, A.Shapovalov, N.Sheludko, B.Gubskiy, A. Philipenko. Foreing scholars, who studied bank consolidation in Europe and Central and East European countries, are A.Berger, S. Claessens, R. G. Gelos, J. Williams, M.Fritsch, T.Poghosyan, D.Schoenmaker and others. This paper builds on the research of the named scholars and uses their conclusions and methods to measure post-crisis exposure of the European banks to CEE based on the most recently available data.

The goal of this research is to define the role that Central and Eastern European (CEE) countries play in the European bank consolidation and the activities of the largest European banking groups in the region. With respect to the recent financial crisis, the article highlights, how this role has changed or might change as a result of the financial distress in Europe. This research helps to answer, whether CEE region is strategic for the EU banking groups and whether they are here to stay, or might exit, because of the difficulties caused by the crisis. By discussing post-crisis changes in the banks' strategies in CEE, this research falls thematically into a broader topic of the post crisis structural changes of the world economy.

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The methodology we use is literature review of articles, annual financial reports of the European banking groups and their presentations. We calculate the exposure of EU banking groups to CEE region based on three indicators (assets, revenue and employees) that measure the share of bank activities in the CEE as a percentage of total activity of that bank. This method is a modified Transnationality index of Schoenmaker that he used to estimate cross-border activity of banks. The difference is that we focus only on the banks activity in the CEE, instead of studying all their foreign activity.

By creating Single Market and deregulation of capital flows between Member States, the EU has sought to strengthen the consolidation "... towards an integrated, open, inclusive, competitive and economically efficient EU financial market" [19, 4]. The European Union's 199 Financial Services Action Plan established a legislative regulation for single financial market with improved prudential regulation and adequate financial supervision [5, 27]. However, despite the favorable regulatory and economic environment, domestic mergers and acquisitions of banks prevail in the EU as well as in the U.S. and. In 1993-2004 domestic M&A took a 74% share in total number of bank M&A in the EU and a 70% share in total sum of M&A transactions. Moreover, consolidation had largely the character of horizontal integration, as took place most often between commercial banks [5, 33].

However, 'regional component' of bank M&A in the EU was much larger than in NAFTA and ASEAN countries. Schoenmaker calculates this regional component as a share of bank activities (assets, revenue and employees) inside the union to total activity of that bank. According to Schoenmaker in 2005 the regional and global components of bank activities were 23% and 25% in the EU versus 9% and 13% in NAFTA and 5% and 9% in ASEAN.

Thus, consolidation between banks in the EU countries is much higher than in other regions of the world, but it is approximately equal in magnitude to the global expansion of the European banks. A large share of bank consolidation in the EU happened between the banks in Scandinavia and the Benelux countries. Those banks consequently became the large universal banks, whose businesses include commercial banking, investment banking, insurance, asset management and other. In addition, after the accession of CEE countries to the EU regional M&A gained momentum, although the share of CEE in the total number and value of the EU M&A transactions was small and averaged at 4% in 1990-2005 (see Figure 1). During 1996-2005 the European banks made around 27 agreements on the acquisition bank shares in Central Europe, 26 in the Balkan countries and 3 in the CIS countries and spent around 27 billion euros [4, 11], [6, 23]. This led to a significant increase in the share of foreign banks ownership in CEE countries, which in 2005 ranged from 56% in Hungary to nearly 100% in Estonia and according to the European Central Bank, these shares did not change a lot till 2010, because the banking systems of CEE have already been saturated after the arrival of key foreign banks in early 2000s.

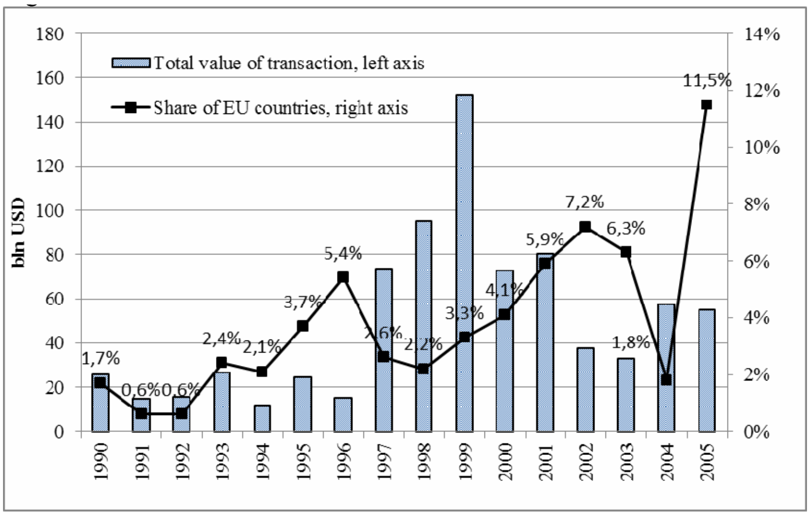

Figure 1: Share of CEE countries in the total value of EU banks M&A
Source: Fritsch M., Gleisner F., Holzhauser M. Bank M&A in Central and Eastern Europe. - Working paper #2007-418. - E-Finance Lab, Frankfurt, p. 21

The key reasons that motivated European banks to buy banks in CEE are the following:

- A large proportion of European banks' clients doing business in CEE, what encouraged banks to acquire local financial institutions to optimize customer service.This is indirectly confirmed by the fact that the largest banks in CEE are owned by their major trading partners in the EU.
- Due to high competition in the domestic market and consequently low profitability European banks wanted to use the potential of growth and profitability of the underdeveloped financial systems of the CEE countries. Indeed, banks in CEE are more profitable than banks in old member states, however, as we will show below, the largest portion of the income of the biggest banks in CEE comes from their business in advanced countries, including their domestic markets.
- Shareholders of European banks are interested in increasing the market value of the banks through acquisition of banks in developing countries, in particularly in CEE.
- Given little possibilities for expansion in domestic markets, European banks are seeking the opportunities to utilize their competitive advantages in CEE.
- European banks strive to diversify their own business. However, diversification can lead to decrease in market value due to erosion of profits of banks.

Why European banks were more interested in acquiring banks in CEE countries, than in other developing countries? Economists explain this by including such factors as geographic proximity, cultural and linguistic similarity and the similarity of legal structure (due to EU accession and harmonization of legislation [8]. In fact, the Austrian banks adapted quickly and took advantage of geographical proximity; cultural similarity and common historical past in formulating its new investment strategy targeted at Eastern Europe [20, 2].They also followed the Austrian business, which also began to actively invest in the CEE countries.

As a result of consolidation the major banking groups operating in the CEE countries are Unicredit (Italy), Raiffeisen International (Austria), Erste (Austria), KBC (Belgium), Societe Generale (France), Intesa Sanpaolo (Italy) and OTP (Hungary). These groups are the leaders or one of the largest banks in their domestic markets. Societe Generale, Unicredit and Intesa Sanpaolo belong to top 10 the largest banks by assets in Europe. In addition, almost all of these banking groups (except OTP and Erste) also do business through its offices outside Europe (in the U.S. and Asia), acting as global banks. All listed banking groups are not limited in its strategy by only CEE countries that joined the EU, and after entering these markets, continued expansion to Balkan and former Soviet Union countries.

For Societe Generale and Intesa SP the market of CEE countries is not strategic, as it takes a small share of their total assets, total employees and revenues (see Table 1). SocGe and Intesa are powerful universal banks (4th and 8th place in Europe by assets, 5th and 8th by market capitalization [9, 8]) that receive income from commercial banking, corporate banking, investment business, asset management, insurance and other financial services. Moreover, Societe Generale receives the largest share of its revenue from corporate and investment banking (32% for 2010), services in domestic (French) market (28%) and from banking services of its international units (22%, this includes CEE countries, Mediterranean and Africa, and others) [14, 43]. Societe Generale is the leader in Italy, where the key business of the group is concentrated (78% of total revenue) [9, 27]. Intesa gets major profits from commercial banking services in Italy (58.1%), corporate banking and investment banking (20.3%) and subsidiary banks in CEE (here CEE, the Balkans and the CIS), Greece and Egypt (13,5%) [9, 27]. Thus, for these banks CEE countries are important for the aim of business and income diversification primarily through the provision of traditional (commercial) banking services.

Table 1:
Indicators of the largest EU banks' exposure to CEE[1]

	Assets in the region, bln euro 2008	Presence in CEE, number of countries (2008)	Number of branches in the region (2008)	Share of CEE in total assets % (2008)	Share of employees in the total number[2], %	Share of CEE in total revenue[3], %
Unicredit	121,6	19	4005	12	29%	18%
Raiffeisen	85,4	16	3231	54	52%	39%
Erste	79,3	7	2099	39	60%	58%
KBC	71,6	12	1940	20	58%	51%
SocGen	65,9	16	2609	6	<30%	<18%
IntesaSP	42,5	11	1781	7	NA	3%
OTP	35,2	9	1573	100	100	100

Source: [2, 18]: Calculated based on the Annual reports of the banking groups for 2008-2011

KBC is the second largest Belgian financial group engaged in banking and insurance foremost on the domestic market and in the CEE countries. Before the financial crisis KBC received the most portion of revenue from financial services in Belgium (44% of all profits in 2007) and corporate, investment banking and other services (28%)[4] . However, against the huge losses from the later, the share of revenues from commercial banking and insurance in Belgium and CEE countries in 2008 and 2009 increased to 48% and 53% and to 69% and 51% respectively[5]. In 2009 the group received substantial income in Belgium. The business of KBC in CEE are less diversified than in most of the named financial groups, as the group primarily focuses on the new EU member countries (Czech Republic, Slovakia, Hungary, Poland and Bulgaria) and in addition on Serbia and Russia. Despite the losses in CEE in 2009, the region plays more important role for the group than for Societe Generale and Intesa, as well as provide greater and more stable share of income especially against the poor results of corporate and investment business during the crisis.

The share of the CEE countries in the business of the financial group Unicredit is also relatively small, as it accounts for only 12% in total assets of the group, 29% in all employees and 18% in total revenue. However, Unicredit has positioned itself as the largest bank in CEE, which has a strategic interest in its presence in these countries. The bank is a leader in CEE not only by assets, but also by the number of branches and countries of presence, including new EU Member States, the Balkans and CIS countries. The interest of Unicredit in CEE is explained by high profitability of business in these countries. Indeed, Unicredit after 9 months of 2010 received 56% of profit before tax in the CEE countries. The largest contribution to the income of the group gave Poland, Turkey (the bank considers this country as part of the region), Russia, Croatia and Czech Republic [7, 5]. Apart from CEE Unicredit is active in Italy, Germany and Austria, which provides retail and corporate banking services. The shares of Italy, Germany and

[1] Indicators in the table are not comparable.
[2] Data is taken from 2008-2010. Where possible, we tried to exclude Russia, Turkey, and Central Asia countries from calculations.
[3] Data is taken for 2008-2010. Where possible, we tried to exclude Russia, Turkey, and Central Asia countries from calculations. Depending on the availability of the information the revenue indicator for different groups stands for operating profit, operation revenue or total revenue
[4] Annual report 2007
[5] Annual report 2009

Austria in the retail banking business of the group are 13.3%, 3.3% and 15.9% of all outstanding mortgage loans respectively (for comparison in CEE such share is 6.9%)[6]. Income from investment banking of Unicredit significantly decreased because of the financial crisis: the share in total revenues fell from 6.4% in 2007 to 4% in 2008. This business became the most lost-making [12].

Raiffeisen and Erste - Austrian banking groups for which the CEE region is strategic by assets, employees and income. Raiffeisen has a wide presence in Central Europe, Balkan countries and former Soviet Union, while ERSTE is more focused on the new member states of the EU plus Croatia and Ukraine. For Raiffeisen CEE countries bring more revenue than its domestic, the Austrian, market: in the first 9 months of 2010 operating income in Austria amounted to 7.2%, and for Central Europe, Balkans and CIS countries to 27.9%, 25.6% and 27.1% respectively [13, 25]. Raiffeisen is competing for leadership in the CEE region with Unicredit. Unlike Raiffeisen, Erste is less focused on increasing physical presence in the CEE countries and aims at getting the largest market share in the countries of presence. In Austria, the Czech Republic, Romania and Slovakia Erste holds top 1-2 market position in various types of banking services, and in Hungary and Croatia holds top 2-3. CEE countries brought in 2010 and 2009, approximately 58% of total operating income of ERSTE [17, 3-7].

OTP is the only exclusively regional bank that originates from Hungary and works only in the CEE. The key business is located in the domestic market, the Hungarian market, which share in the group revenues in 2008 amounted to 66%, and in 2009 the parent bank in Hungary was the only profitable, while foreign subsidiaries showed losses. In Hungary, OTP business is the most diversified, as the bank provides retail, corporate, insurance services and asset management services. Besides domestic market, the largest share in OTP revenue comes from Bulgaria, Ukraine and Russia - 11.3%, 10% and 9.1% respectively[7]. Despite the fact that the financial crisis has hit the region hard and the large losses of subsidiary banks in Ukraine, Slovakia and Serbia, OTP managed to remain profitable due to its domestic market and Bulgaria.

Having analyzed the activities of major banks in the financial markets of the CEE countries, we can conclude that the role of these countries in the process of banking consolidation in Europe was, first, to provide opportunities for expansion of universal banking group, the leaders in their domestic markets in the Western Europe (Unicredit, SocGen, IntesaSP and KBC). These groups were interested in diversification of business by traditional banking services in the growing markets in the region. High entry barriers and saturation of the markets in other countries of the Western Europe on the one hand, and relatively low cost of banks in CEE, on the other hand, made CEE countries attractive to increase its capitalization and the value of the groups. Due to the expansion into CEE the banking groups were able to establish itself among top 10 largest financial groups in Europe. Second, bank consolidation, with the participation of CEE countries has led to the formation of regional banking groups (Erste, Raiffeisen and OTP), for which the CEE countries have become a strategic market.

All the banking groups, including regional, in their strategy are not limited by their presence in Central Europe, but also extended their activities in the Balkans and CIS countries. Moreover, for Unicredit, SocGen and IntesaSP expansion to the CEE markets was followed by the expansion to other non-European developing countries, and expansion of investment and corporate banking to the U.S. and Asia, implying their global ambitions. The same thing is for the large European banking groups operating in CEE, but we have not mentioned in the articles because they are less represented in the region: BNP Paribas, Credit Agricole and ING Bank.

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[6] The information is retrieved from the official Unicredit website: http://www.unicreditgroup.eu/

[7] Annual report 2009

In the pre-crisis years, the growth of liquidity in global financial markets, high risk appetite of investors and expanding global banking groups, pushed ambitious European group that had already taken root in the new EU member states and the Balkan countries, to the riskier markets of CIS countries, including Ukraine. In 2005, Raiffeisen bought Ukrainian Bank Aval with a multiplier the price to book value (P/BV) of 3,2, and already in 2006-2008 European banks bought Ukrainian often even at higher price: BNP Paribas bought Ukrsibbank with a multiplier of 3,4; Credit Agricole bought Index bank with an extraordinary high multiplier of 7,2; OTP bank acquired Raiffeisen Ukraine at 5,2; Unicredit bought Ukrsotsbank with a multiplier of 5,6; Intesa bought Pravex Bank of with a multiplier of 5.2 [16, 128].

High interest of the banking groups in the pre-crisis years in highly profitable retail banking services under conditions of high liquidity in international financial markets and high growth economies of the region contributed to the credit boom in these countries. As a result of the accumulated private sector debts that in some countries was mainly denominated in foreign currency made the banks vulnerable to devaluation of the national currencies [3, 3].

All listed banking groups were strongly affected by the crisis and received multi-state aid from their countries [2, 20]. Banks have suffered huge losses in their investment, insurance departments, and in retail banking in some CEE countries. However, banks in CEE avoided bankruptcy and they remained well capitalized [18, 47]. Parent banks continued to finance their daughters in the CEE countries, and the amount of funding increased in relative and absolute values by providing direct loans and currency swaps [1, 22-23]. This was achieved thanks to the help from international organizations. Indeed, EBRD, European Investment Bank and the World Bank pledged to provide 25 billion euro to the financial companies operating in the region. In its turn, the IMF has provided loans to the most affected countries - Hungary, Latvia, Romania and Ukraine [3, 10], which also helped to stabilize the situation.

Currently the banking groups in the region are increasing their efficiency and optimizing their business operations. They reduce the number of branches and optimize the number of employees. Raiffeisen is downsizing and closes offices in Romania, Bulgaria, Ukraine and Russia. Due to the crisis Erste has postponed plans to expand business in Ukraine and has announced plans to cut 15% of workers in the region [20, 8]. Unicredit cut about 5.9 thousand employees in Ukraine, Kazakhstan and Poland in the first quarter of 2008 [7, 8]. OTP Bank in 2009 cut branches in the countries with the largest losses: 45 divisions in Serbia, 23 divisions in Ukraine and 12 departments in Slovakia [11]. In some CEE banks shrink lending activity and introduce more tight loan conditions. This happens due to the high share of non-performing loans. Thus, the Austrian National Bank expects that one-fifth of all loans issued by the departments of the Austrian banks in CEE will be written off. As for the second quarter of 2009 Raiffeisen had 20% of problem loans in Romania and 18.2% as of June 2009 in Ukraine [20, 10].

Because of the crisis regional expansion through acquisition of expensive large banks is no longer the best way to develop business in CEE. At least, not in the short to medium term [20, 7]. Inside the region, the banking groups are increasing investments into the units that have proved best throughout the crisis, and are careful with the units in the countries most affected by the crisis.

Raiffeisen suffered great losses in Ukraine and that is why, despite the fact that the bank intends to maintain its position in the country, the group at the end of 2009 did not plan to substantially cut investment to the country even considering the unstable economic and political situation. Moreover, in some other countries of the region Raiffeisen makes selective opening of the new offices to meet the new business opportunities arisen. Erste said that it increased investment into less risky countries to the new EU members, such as Slovakia and the Czech Republic, was reducing the business in non-EU countries with high potential but high risk, such as Ukraine and Serbia [20, 9]. KBC is most radical in their optimizing plans and claims to focus on their core products and markets in the banking, insurance and sale units in Serbia and Russia [10, 9]. Unicredit cut funding of units in Russia, Kazakhstan and Ukraine, because of lower demand for loans in these countries. On the other hand the group's units in Poland and the Czech Republic have proved being sustainable [7, 20]. SocGen says that it will continue development of retail banking services in the region, in particularly in the promising countries like Russia, Romania and the Czech Republic [14, 9].

To conclude, this article identifies the banks with strategic interest in CEE and the banks that are here above all to diversify their business. However, regardless of the role of CEE region in the strategies of the EU banking groups, most of the banks want to maintain and develop their business in CEE, despite of the losses caused by the crisis. Even more, if the conditions in the EU improve and CEE economy is stable, a new wave of bank consolidation involving CEE might take place to use the new opportunities the crisis unleashed.

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