Financial Institutions and Services

Challenges of the Banking Integration Process in the Case of the New EU Member States

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Abstract: The creation of the single European market represents a 50 years long process which aims at developing the most advanced economy in the world. In order to achieve this, political actions must be accompanied by economical and juridical changes in order to stimulate and foster the creation of the single European market. A key component of this process is represented by the integration of the financial sector. While several component of it have registered major transformations and achievements in the integration process, one of the least integrated parts is represented by the European banking sector. Most of the European economies are funded directly through the banking sector, thus the integration of this sector represents a major benchmarks in the European integration process. This problem becomes more complex in the context of the European Union enlargement to 27 member states. Thus, the *aim of this paper* is to underline the progresses achieved by the banking sectors of the European Union new member states from Central and Eastern Europe in their integration process. In order to achieve this *we will use* an empirical analysis based on the *Law of One Price*, which will underline the progress made by the banking sectors of the panel countries: Poland, Czech Republic, Slovenia, Slovakia, Romania and Bulgaria. The results of the research will provide an overview of the main achievements registered by these countries, while also underling how national particularities of these sectors affect their integration.

Keywords: integration process; banking sector; law of one price; new member states

JEL Classification: F15; F36; E59

1 Introduction

Taking into account the historical evolution of the European Union we can acknowledge that the European integration process and implicitly the financial integration process represent a strategic component of the whole European project, this fact being underlined by the central role that the European legislative initiative regarding this matter are having at the Union level. The basic framework of the whole European financial integration process has its roots in the Treaty of Rome, beingafterwardsalso enclosed in the Treaty of Maastricht and in the Lisboan Treaty, and through which the European Union aims at: *developing the most advanced knowledge based economy in the world, capable of sustaining long term economic growth which will offer better employment opportunities and a higher degree of social cohesion*.

The European Union Council held on March 2002 in Barcelona acknowledge that financial services represent a fundamental component that will help the achievement of the Lisboan Agenda because: „*only through an integrated financial market the consumers and the enterprises will be able to fully benefit from the adoption of the single currency. Competitive financial markets will provide additional financing options and also will diminish the price that the investors may have to support, providing also adequate protection measures*."

The adaptation of the single European currency and also the legislative measures taken in the last years at European level have led to an acceleration of the financial integration process, at least in the euro zone area. Thus, according to some empirical studies undertaken in the last period () are suggesting that wholesale financial services (e.g. money markets, corporate and government bonds market, investment banking sector) tend to be almost fully integrated at European level, the benefits of this process being already visible: the diminishing of finance costs, at least in the euro area, the diversification of the investment products offered on European markets and also the drop of the fees and taxes charged for the providing of investment banking services.

Despite these developments, the European banking sector tends to remain still nationally fragmented, which in turn hinders a deepening of the European financial integration process. The European banking sector tends to be mainly focused at a domestic level, being surpassed only by the media and telecommunications sector as one of the least Europeanized economic sectors. Only 27% of the sales made by the top 22 banks in the European Union are at European level, this fact being illustrated in the table below.

Table 2The Europeanization rate of the assets held by the main companies in different economic sectors of the European Union

Sector breakdown of Europe's top 100 listed companies	Europeanization Rate
Life sciences	84%
Consumer products and services	74%
Manufacturing and business services	66%
Oil, gas and mining	57%
Insurance	53%
Energy and water utilities	31%
Banking	27%
Telecommunications and media	24%
Overall Europeanization avrage	49%

Source: Own simulation based on data retrieve from Bureau Van Dijk Amadeus and Bankscope databases (https://amadeus.bvdinfo.com/; https://bankscope2.bvdep.com/)

We must take into account the fact that the European Union has almost doubled its members through the two waves of adherence that took place in 2004 and 2007. Most of the new member states are former communist countries, which mean that their economies have gone in only 15 years through two major phases of transformation: first the transition period to a market economy and afterwards the European economic integration process which was necessary in order to ensure that there are able to join the Union.

The impact of these developments on the economies of these countries was tremendous, especially if we take into account the changes that have arise in the banking sectors. Thus, the banks from these countries had not only to adjust to the requirements imposed by the transition process to a market economy but also needed to face the high external pressures which were determined on the one side by the enhancement of the competition and on the other by the structural changes in the banking activity prompted by the technological and financial progress (the mass usage of electronic payment methods, the usage of internet banking, the development of regional and pan-European business models which raised challenges for bank in regard to their possibility to correctly assess risks, the development and implementation of new techniques and methods for risk assessment and risk management).

This is the reason why we considered the opportunity to analyse the changes that took place in the structure and the dynamics of the banking sectors of the new member states, while also underlining the challenges that these are facing in the deepening of the European banking integration process. Our panel is composed by Poland, Czech Republic, Slovenia, Slovakia, Romania and Bulgaria. We choose these countries as they are former communist countries, which had to transform their centralised economies into market economies and afterwards to align them with the European standards in order to be able to join the European Union.

Taking these aspects into account we have organised our research in five parts. The first part contains introduction remarks regarding the study undertaken, the second part presents the characteristics of the methodological approached used, while the third part is focused on the dynamic development of the banking sectors from the panel countries, part four provides an overview of the main challenges that the panel countries are facing in the deepening of the banking integration process and the fifth part contains the final conclusions of the study.

2 Methodological Considerations

The European banking sector has suffered in the last decades o series of deep changes, which have been the focus of a large body of academic literature, these researches using both quantitative and qualitative approaches (see: Gual,2004). The liberalisation and deregulation of the European financial markets, prompted by the London Stock Exchange Big Bang in the eighties, followed by European initiative aimed at enhancing the integration process and the development of pan-European payment systems, both for grows settlements and retail transactions, have put a tremendous pressure on the traditional way in which European banks carried out their activity.

Faced with these new challenges, the European banks have tried to adapt their business model by diversifying and universalising their products and services lines, offering both to retail and corporate costumers along with traditional instruments:

insurances, the possibility to buy investment funds units, private banking instruments and the possibility to manage investment portfolios. Nevertheless, the outside competition has also grown as insurance companies and investment funds have developed their own products and services which offered viable alternatives for saving and investment in regard to the banking offer (Goddard et al., 2007). These developments have lead to a blurring of the demarcation line between banks and other financial intermediaries (see the study of Rajan and Zingales, 2003). At the same time, because of the changes determined by the European integration process, banks have developed a more widen pan-European network of branches and subsidiaries, which have helped the development of the overall European banking system thru an enhancement of the completion level, especially in the case of the new member states (Lensink & Hermes, 2004, p. 5).

Despite the many legislative initiatives at European level in order to harmonise the integration of the European banking sector and match the achievements from the monetary and bonds markets (Baele et al., 2004; Manna, 2004;), most of the academic literature underlines modest progresses in this direction (Dieckmann, 2006; Staikouras et al, 2008).

The main challenges identified by the academic literature that prevent the deepening of the banks integration process, especially in the case of the new member states, are represented by the particularities of the local business environment, the cultural and linguistic barriers that exist which are enhanced by the different legal and fiscal systems which are in place in these countries and which tend to be very heterogeneous (ECB,2010; Buch & Heinrich,2002;).

In order to underline the progresses made in the integration of the banking sectors from the new European Union members countries from central and eastern Europe we will use the methodology set for law of one price.

In order to underline the progresses made in the integration of the Romanian banking sector we will use the methodology set for *the law of one price*. Thus, according to the law of one price, as a result of the integration process the nominal interest rates should converge toward the most low registered level (for detail methodological considerations regarding the law of one price see the paper of Baele et al., 2004).

In order to completely underline this complex process we will also take a look at the changes that have been registered in the competition level from the analysed banking sectors, as a deepening of the integration process should point out to an increased competition level, as entry barriers are removed and the cost for accessing these new banking markets drops significantly.

In order to underline the annualized growth of the banking sectors we will use the *CAGR index* which is calculated based on the formula:

$$CAGR(t_0, t_n) = \left(\frac{V_{(t_n)}}{V_{(t_0)}}\right)^{\frac{1}{t_n - t_0}} - 1$$

where V_{t0} represents the starting value and V_{tn} is the last value, $t_n - t_0$ represents the number of years. The *CAGR Index* deepens the effect of volatility of periodic variations that can render arithmetic means irrelevant.

In order to establish the dynamics of the competition on the banking sectors from the new European Union meber states we will take in to consideration two main indicators.

The firs indicator that we will use is the *CR5 Index*, which represents the percentage that the top five banks are having in the total assets of the system and which reflect the concentration degree of the market. The indicator is calculated based on the formula:

$$CR5 = \frac{A_1 + A_2 + A_3 + A_4 + A_5}{AT} x100$$

where A_1, A_2, A_3, A_4 and A_5 represent the value of the assets held by the top five banks in the system and A_T represent the value of the total assets of the banking system. It can take values between 0.1% and 100%, where the low value represents a highly dispersed market and 100% represents an oligopoly or monopoly.

The second index that we will use is the *Herfindahl Index*, which underlines the degree of competition which exists on the market and is calculated based on the following formula:

$$\mathrm{H} = \sum_{\mathrm{i}=1}^{\mathrm{N}} \mathrm{s}_1^2$$

where s_i is the market share (in our case the value of banking actives) of firm (bank) i and N represents the number of banks that exist in a certain market. It can take values between 0 and 10000. If the values are below 100 it underlines the existence of a highly competitive market, if the value is below 1000 it reflects a dispersed market, if the vale is between 1000 and 1800 it indicates a relative moderate concentration in the market and if the value is above 1800 indicates a highly dense market.

3 Characteristics of the Banking Sectors of the New Member States

As mentioned before the new member states from our panel have underwent through a transition process form centralised economies to fully functional market economies. The fact that these countries have managed to join the European Union underlines the fact that these economies have achieved tremendous structural economic reforms and important progresses regarding the creation and functioning of a functional market economy. The economic growth that these counties have managed to achieve in the period before the economic crisis has surpassed the one registered by the euro area while the inflation has dropped significantly from two digit values to levels comparable to the average of the euro zone. Despite the successful achievements of progresses by these states in the convergence process of their economies, still their GDP per capita ration remains low, when compared with the euro zone average.

As we can see from Chart 1 the panel state based their financing of the economy more on the banking sector and to a lesser extent on direct financing through the stock market.

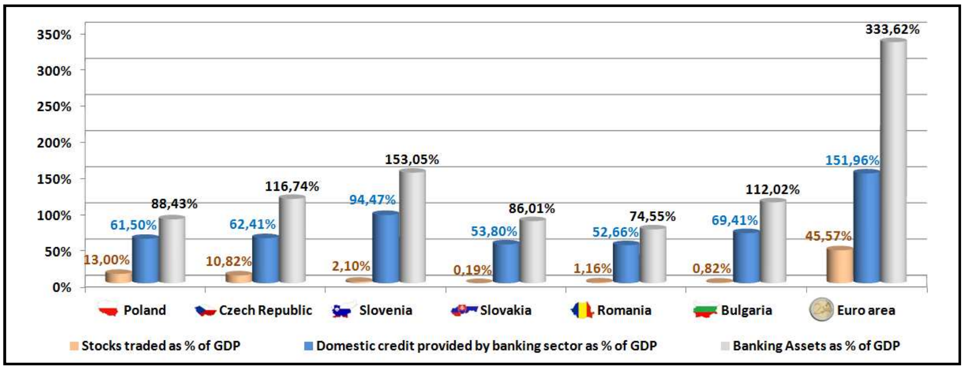

Chart 1. Development of the banking sector in the analysed countries in 2009

Source: Own simulation based on data retrieved from the World Bank (*http://data.worldbank.org/*) and the European Central Bank (*sdw.ecb.europa.eu*)

Despite this fact, the overall assets held by the banks in the case of the panel countries, as showed in Chart 2, are below the euro zone average, pointing out the potential for further development of these banking sectors.

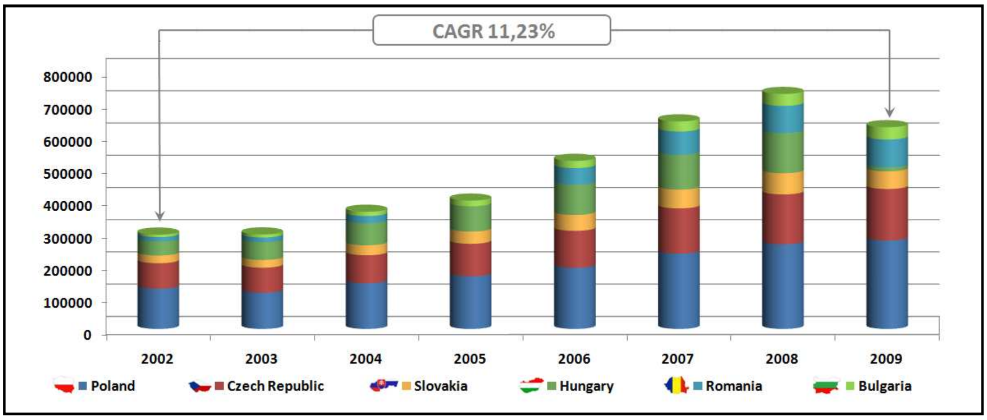

Chart 2 Evolution of the banking assets in the case of the analysed countries between 2002 and 2009

Source: Own simulation based on data retrieved from the European Central Bank (sdw.ecb.europa.eu)

Most of the banking sectors from the analysed countries are dominated by commercial banks, which owned in 2010 approximately 85% of the assets in these banking markets. In countries like Hungary and Poland there are also several important cooperative banks. As the European integration process deepened the number of banks presents in these countries tended to decline. Despite the fact that there were several bankruptcies that took place in these countries, most of the banks that disappeared from these markets were the subject of mergers and acquisitions both at local and pan-European level. Mostly, the banks from the EU-15 states were the ones which acquired local banks in these markets as a way to extend their operations in the new member states. This is underlined also by the fact that almost 87% of the whole banking assets of these countries are owned by foreign banks, either through subsidiaries of branches that operate in these markets. The concentration ratio of these analysed banking markets is relatively high as a result of the entering of the foreign banks, especially the ones form EU-15 countries and as a result that most of the former state owned banks have lost a significant market share. In general the CR5 index varies in the case of the analysed states from 43,9% in the case of Poland to 72,1% in the case of Slovakia.

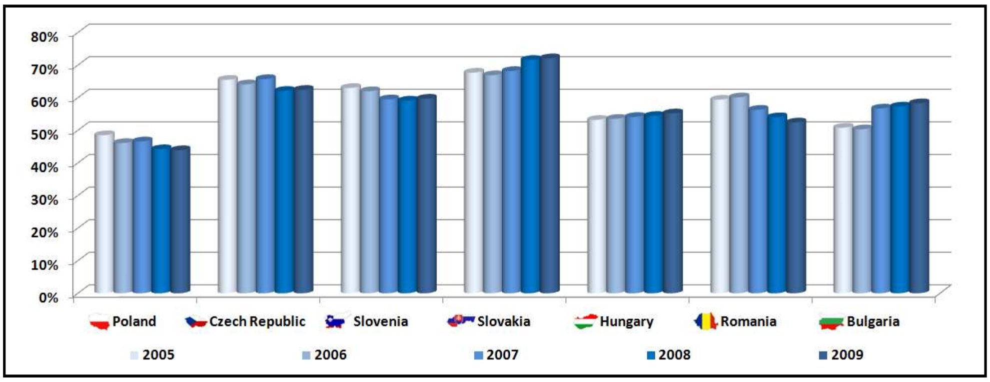

Chart 3. Evolution of the concentration level (CR-5) in the case of the analysed banking sectors

Source: Own simulation based on data retrieved from the European Central Bank (sdw.ecb.europa.eu)

From our analysis we can see that that the analysed banking sectors have registered a consolidation of the activity, as a result of the diminishing of the competition level. Most of the bigger banks present in these markets have undertaken several aggressive campaigns which have solidified their presence making it more difficult for smaller competitor to develop lucrative niches. We can also observe that as a backlash of the financial crises and of the economic depression that has hit these new member states since the mid of 2008, the share of the top 5 banks has dropped, but the Herfindahl index has registered approximately the same values.

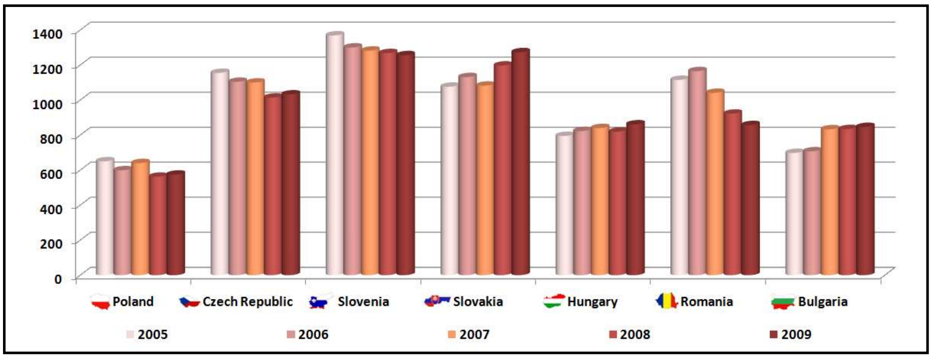

Chart 4 Evolution of the competition level (*Herfindahl index*) in the case of the analysed banking sectors

Source: Own simulation based on data retrieved from the European Central Bank (sdw.ecb.europa.eu)

Taking into account these developments we can argue that the banking sectors from the analysed countries have registered a strong development in the last period, which can be partially attributed to the European integration process. Nevertheless we consider important to underline the fact that the banking sectors from these countries are far from reaching their full potential for development, especially taking into account that these sector can benefit from the latest technological advancement in this field and thus having the possibility to compress development stages through which they need to go.

In regard to the evolution of the bank's credit activity, this has registered a period of strong development between 2002 and 2008, especially as a result of the aggressive promotion of the consumer credits in most of the analysed countries. This period of boom was followed by a freeze in the loaning activity in 2009 as a result of the financial crisis and economic depression which has hit most of the new European Union member states. Moreover the projections made by the European Central Bank suggest an average contraction of the lending activities of the banks from the panel countries with about 6% in 2010, as a result of the depreciation of the economical and financial environment of these countries.

Despite of the negative impact of the financial crisis we can observe form the analysis of the convergence of the nominal interest rates a deepening of the integration process of the banking sectors from our panel, which tends to confirm the *law of one price* – at least until 2006.

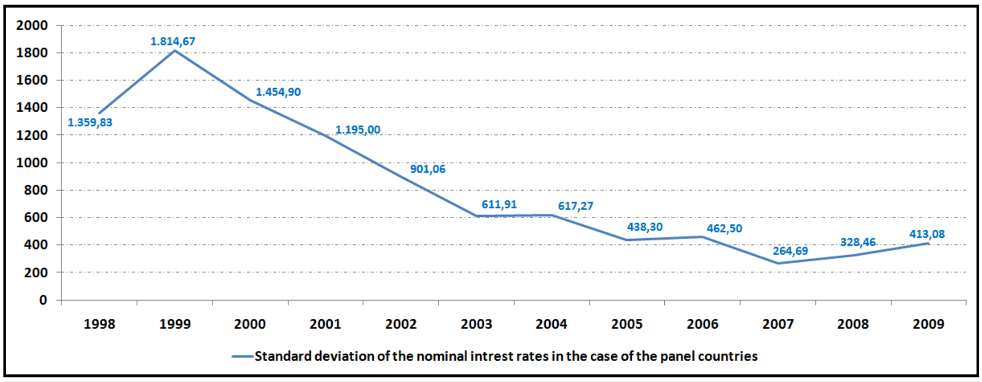

Chart 5. Convergence of the nominal interest rates in the case of the panel countries

Source: Own simulation based on data retrieved from the World Bank (http://data.worldbank.org/) and the European Central Bank (sdw.ecb.europa.eu)

Despite these, the standard deviation of the nominal interest rates still remains high, taking in to account the values registered in the euro zone or in the case of money markets or bond markets. Still, the progress is remarkable and is mostly the result of macroeconomic stabilisation and development which has been achieved by these countries starting with the end of the 90 and the firm engagement to join the European Union.

4 Challenges for the Deepening of the Banking Integration Process

Despite the strong development of the banking sectors in the last 20 years in the case of the analysed countries, there is still sufficient space and potential for further development and enhancements of the banking activity. In another train of thoughts we must take into consideration the fact that the banks from the panel countries are facing for the first time in their existence a global banking crisis which has affected them directly and at multiple levels, diminishing their short term potential for growth and development. Also, in the context of the economic downturn the banks have adopted an extra caution attitude, which has been translated into a raise in the divergence of their interest rates. In this context, the main challenge in the face of the deepening of the European banking integration process in the case of the panel countries is represented by the way in which the banks will be able to surpass the financial and economic crisis which at the moment is in full swing in the European Union. The depreciation of their balance sheets as a result of bad credits and a negative economic perspective can only have a negative effect on the integration process. Banks must act as soon as possible in order to clean their balance sheets and restore their lending activities. Authorities must provide also the financial incentives in order to stimulate the landing activity and provide the necessary arguments and measures for the private sector in order for it to re-launch its productive activities.

Also a major obstacle for the deepening of the banking integration process in the case of the analysed countries is represented by the low level of completion that exists on these markets. Despite the fact that several major foreign banks are present here, competition never picked up. The high economic growth registered for several years before the economic crisis and the ever expansion of businesses and individual consume, allowed banks to expand their business rather easy and without a real challenge, as the same market share provided each year addition incomes in the context of an expanding market. The financial crisis provides the right opportunity for the banking systems to rethink and re-evaluate their growth and development strategies. Banking margins are relatively high and opaque, allowing banks to obtain additional profits as the market has been mainly driven by the suppliers and not the consumers. Better services and low interest rates, will provide the willing banks the right tools in obtaining critical market share while also closing the gap, between the euro zone and the new member states in regard to lending rates and services quality.

We can thus conclude that on the short and medium term the main challenge for the deepening of the banking integration process in the context of the panel countries will be represented by the return to a normal and sustainable banking activity, which will provide the incentive for further deepening of the banking integration process.

5 Concluding Remarks

We must underline the fact that the deepening of banking integration process in the case of these banking sectors, and at the European Union level in general depends now much more on the decisions of the market players and also to some collateral factors and to a lesser degree to issues which can be regulated and harmonised away by pan-European legislation initiatives. *This is the reason why we consider that the integration and development of these banking sectors is a process still underway, far from being complete, which has just entered in the fundamental changes phase, which will take some time to be achieved but surely will provide greater benefits*.

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