Challenges for the new European Union member states banking sectors in the context of European integration

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Abstract

One of the least integrated components of the European financial system, according to the European Central Bank is represented by the European banking sector. As the European Union has extended its membership to 27 members, since 1st of January 2007 we consider important to underline the progress that has been achieved in the integration of the banking sectors from these new member states. Thus, the aim of our research is to present in a non-exhaustive meaner the main dynamics and achievements that have been made in the development and integration of these banking sectors. In order to achieve this we have used an analyses based on the law of one price and the studying of the competition level that exists on the new European Union member states banking sectors.

Keywords: European integration; banking sectors; law of one price.

1. Introduction

The development of a common European market for goods and services – including that of an integrated retail banking sector – represented a main focus for the European Union in the last decades.

The creation of a common European single market for goods and services has represented the main focus at the European Union level in the last decades. In order to archive this, European institutions (like the European Central Bank or the European Commission) have argued that the integration of the goods and services sectors must be accompanied by the integration of the financial sectors, which will provide the backbone for the achievement of a dynamic European economic which would be able to sustain long term economic growth. The banking sector represent one of the least integrated components of the whole European financial sector, the challenges in its integration being enhance by the enlargement of the Union to 27 member states.

Taking these into consideration we consider the opportunity for a study that will underline the main dynamics regarding the development and integration of the banking sectors from the new European member states from Central and Eastern Europe (our panel is composed from Poland, the Czech Republic, Slovakia, Hungary, Romania and Bulgaria).

In order to archive this we have organised our research as following: 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

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provides an overview of the main achievements registered in the integration process of these sectors and the fifth part contains the final conclusions of the study.

2. Methodological considerations

The European banking sector has suffered in the last decade’s 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 [1]. 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 [2]. These developments have lead to a blurring of the demarcation line between banks and other financial intermediaries [3]. 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 [4].

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 [5, 6], most of the academic literature underlines modest progresses in this direction [7, 8].

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 [9, 10].

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. Thus, according to the law of one price, as a result of the integration process the nominal interest rates should converge toward the lowest registered level (for detail methodological considerations regarding the law of one price see 5).

For completely underlining 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 emphasise the annualized growth of the banking sectors we will use the *CAGR index* which is calculated based on the formula:

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

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 tow main indicators.

The first 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 base on the formula:

$$CR5 = \frac{A_1 + A_2 + A_3 + A_4 + A_5}{AT} x100 \quad [2]$$

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:

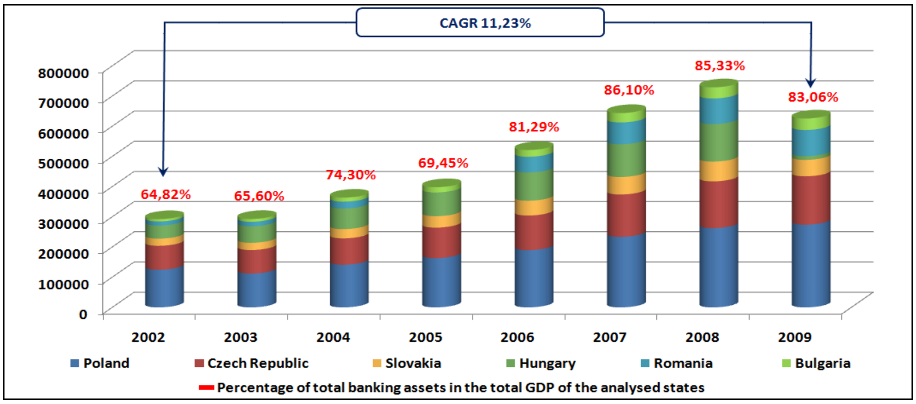
$$H = \sum_{i=1}^{N} s_1^2 \quad [3]$$

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. Development of the banking sectors from the new EU member states

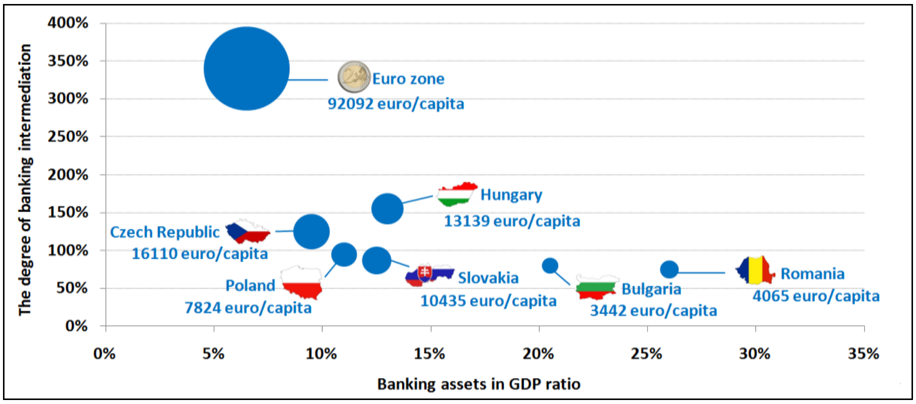
In the context of the global financial and economic crisis we can say that the banking systems from the new member states are at a cross-road. The impact of the crisis on these banking systems, cooped with the economic depression that followed has lead to a depreciation of the banks' portfolio which are active in these markets. Despite the low percentage of bad credits, the high rate of late payments related to the existent loans has raised the pressure on the bank's ability to obtain profits, mainly because of provisions that they must constitute taking in to consideration the current developments. In this context the main focus of the banking activity in the analysed states has been shifted since the start of the economic down turn from the expansion of the credit activities, which characterised the period prior to the summer of 2008, to a strategy concerned with the management of the existing loans portfolio. Alongside all these developments, there is a constant pressure on the banks from the analysed markets to diminish their costs which has pushed many of them to re-evaluate their operational network capacities, their cost structure, their credit portfolios and also their medium term business plans.

The total assets of the banking sectors from the analysed countries were at the end of 2009 at 83,06%, registering a fall from the previous year with 2,27%.



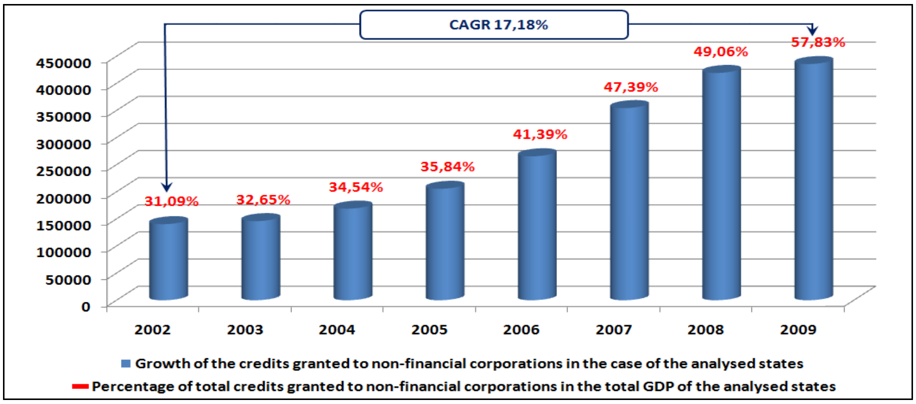
Source: [Own simulation based on data provided by the European Central Bank]
Fig. 1. Growth of the banking assets in the case of the analyzed countries

If we analyse the per capita ratio, then at the end of 2009, we can see that the values are much dispersed, with Bulgaria registering the lowest value and the Czech Republic the highest.



Source: [Own simulation based on data provided by the European Central Bank]
Fig. 2. The dispersion of the per capita banking assets in the case of the analyzed countries

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.

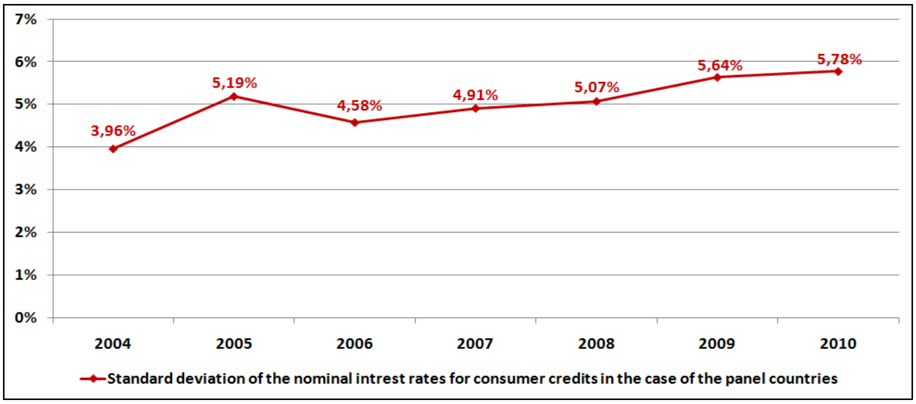


Source: [Own simulation based on data provided by the European Central Bank]
Fig. 3. Growth of the credits granted to non-financial corporations in the case of the analyzed countries

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.

4. Achievements and challenges in the integration process

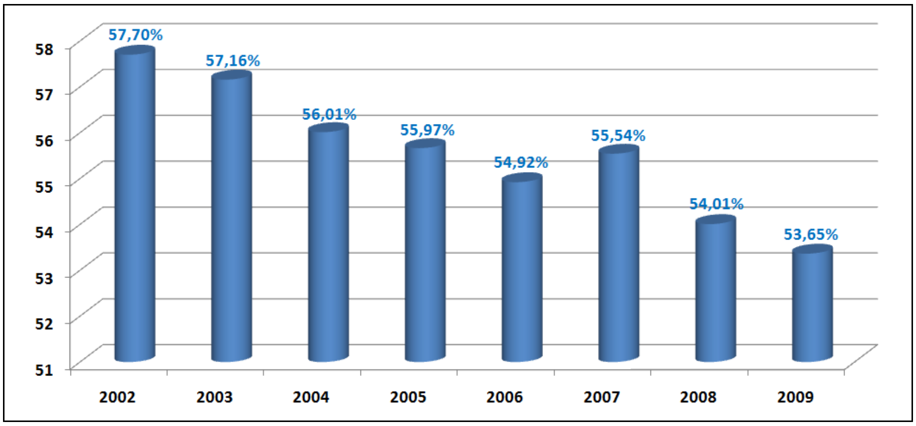
We will start our analysis by comparing the convergence of the nominal and the real interest rates for retail credits, more exactly general purpose credits. We have taken in to consideration these interest rates because the general purpose credits represent one of the main categories of credits granted by the banks operating in the analysed countries.



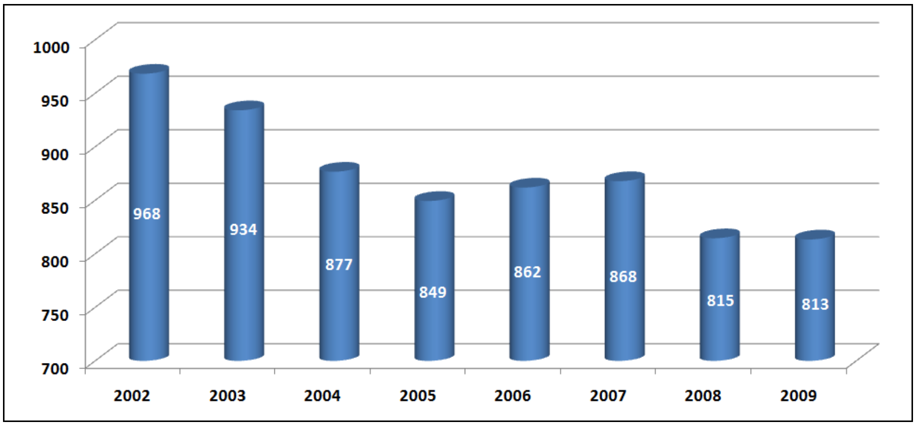
Source: [Own simulation based on data provided by the European Central Bank]
Fig. 4. Convergence of the nominal interest rates for consumer credits

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.

In this context it becomes interesting to analyze the evolution of the competition level that exists in these banking markets.



Source: [Own simulation based on data provided by the European Central Bank]
Fig. 5. Evolution of the concentration index (CR-5) in the case of the analyzed countries



Source: [Own simulation based on data provided by the European Central Bank]
Fig. 6. Evolution of the Herfindahl index in the case of the analyzed countries

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. This indicates a relative stability regarding the competition level on the market, while the banking assets have been spread around more. This is an effect of the rationalisation of credit by the bigger banks, which have diminished their share of the market in relationship with the consolidation of the smaller competitors which have tried to freeze and solidify their assets.

5. Conclusions

Correlating the results of the two analysis undertaken we can conclude that the integration process of the banking sectors from the analysed countries is a present process which fell short of expectations. However, 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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