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Did foreign banks stay committed to emerging Europe during recent financial crises?☆

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Our objective is to investigate empirically the behavior of foreign banks with respect to real loan growth during periods of financial crisis for a set of countries in which foreign banks dominate the banking sectors due primarily to having taken over large existing former state-owned banks. The eight countries are among the most developed in emerging Europe, their banking sectors having been modernized by the middle of the last decade. We consider a data period that includes an initial credit boom (2005 – 2007) followed by the global financial crisis (2008 & 2009) and the onset of the Eurozone crisis (2010). Our two innovations with respect to the existing literature on banking during the financial crisis are to separate foreign banks into two categories, namely, subsidiaries of the Big 6 European multinational banks (MNBs) and all other foreign-controlled banks, and to take account of the impact of exchange rates during the period. Our results show that bank lending was impacted adversely by both crises but that the two types of foreign banks behaved differently. The Big 6 banks remained committed to the region in that their lending behavior was not different from that of domestic banks supporting the notion that these countries are treated as a "second home market" by these European MNBs. Contrariwise, the other foreign banks active in the region were involved in fueling the credit boom but then decreased their lending aggressively during the crisis periods. Our results also indicate that bank behavior in countries having flexible exchange rate regimes differs from that in those in (or effectively in) the Eurozone. Our results suggest that both innovations matter for studying bank behavior during crisis periods in the region and, by extension, to

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other small countries in which banking sectors are dominated by foreign financial institutions having different business models.

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1. Not all foreign banks are the same

The European countries that either emerged from the shadow of the Warsaw Pact after the fall of the Berlin Wall or were created from provinces seceding from the Yugoslav Federation looked westward to the European Union (EU) with aspirations to become members as quickly as possible. A crucial aspect of this integration would be the development of modern financial systems from banking sectors that had been subservient to the government planning bureaucracy in many of the countries. Over approximately a decade, virtually all of the state-owned banks in the region, which is commonly referred to as Central, Eastern, and Southeastern Europe (CESE) by the IMF, were privatized and eventually acquired by foreign financial institutions. In addition, foreign banks set up greenfield subsidiaries in these countries and new domestic banks were born as entry requirements were relaxed to engender competition at the beginning of the economic transformation. Foreign banks brought expertise and technology to a backward sector in need of rapid modernization. At the beginning of the new millennium, foreign banks dominated the banking sectors of most CESE countries having asset shares as a group of over 40% in all but one of the eleven countries that would become part of the EU in the subsequent decade. Indeed, foreign banks had assets shares of over 65% in seven of these countries by 2000.[1]

Foreign dominance of the banking sectors is not the only special characteristic of these eleven countries. Due partly to mergers and acquisitions among parent banks, the landscape became dominated by seven multinational banks (MNBs). Swedbank is the main foreign bank in all three Baltic countries that are now members of the EU. Six banks, namely Raiffeisen and Erste (both Austria), Intesa Sanpaolo and UniCredit (both Italy), Societe Generale (France) and KBC (Belgium), are active in the other eight new EU member countries. Although Raiffeisen entered early by setting up greenfield subsidiaries, it has a strong commitment to the region. Raiffeisen operates in all eight countries and ranks in the top five banks by market share in six of them. The other five European MNBs acquired existing banks during the privatization of state-owned banks. Erste focused on acquiring former state-owned savings banks while Unicredit took over the greenfield subsidiaries of Bank Austria/Creditanstalt in a European merger but also acquired banks in the region during the privatization process. Bonin (2010) and Epstein (2014) argue that these six MNBs treat the region as a "second home market" having staked reputational capital on the success of their subsidiaries in the host countries. This commitment was tested recently during both the global financial crisis (GFC) and the Eurozone crises (EZC). The reaction of these banks to both crises provides important evidence for evaluating the net benefit of foreign takeover of banking sectors in small countries.[2]

The empirical literature treats all foreign banks in the region alike by incorporating them into a dummy variable for banks having controlling foreign ownership. In this paper, we recognize the special character of the six European MNBs (Big 6) operating in some or all eight new EU member countries (EU 8), namely, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Our focus is on the time period immediately preceding the GFC through the onset of the EZC in 2010. We consider three sub-periods: first a credit boom that continues from 2005 to 2007 in all eight countries, followed by the GFC in 2008 and 2009, and finally the initial effects of the EZC in 2010. The credit boom was essentially fueled by banks taking advantage of the nascent and profitable retail credit markets in these countries, including the home mortgage business. Much of the funding for this lending came from wholesale markets or through the internal capital markets of the large MNBs. The GFC provided a stress test for this business model. In addition, the EU 8 countries were buffeted by a second shock when the Greek crisis exploded in 2010 leading to the EZC. Empirical work attempting to discern the role played by foreign banks in the region during the crisis period basically concluded that foreign banks reduced lending during crisis years more than their domestic counterparts. However, by failing to distinguish between the Big 6, which as a group were the dominant foreign presence in most of these eight countries, and other foreign banks, in particular Greek banks that were active in the southern-tier countries, the literature conflates two different business models.

For the most part, the empirical literature uses bank-level data from Bank Scope denominated usually in US dollars.[3] Normally this would not be problematic but, during this time period, the countries in the region have distinct characteristics regarding exchange rate regimes and dynamics. Throughout the period, Slovenia is a member of the Eurozone and Bulgaria has a currency board using a fixed peg to the euro. In addition, Slovakia joins the Eurozone in 2009. Complicating the

[1] Bonin, Hasan, and Wachtel (2015) provide an overview of this development with the relevant data on p. 968.

[2] The dominance of Swedbank in the Baltic countries makes these three countries, Estonia, Latvia and Lithuania, different enough for us to exclude them from consideration in this paper. In our opinion, these countries should be treated as a separate group (see Bonin (2010) for further discussion of this point).

[3] Data in euros are now available from BankScope but the publication uses US dollars primarily for comparability across banking sectors throughout the world.

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