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The Foreign Banking Sector in the Wake of Globalization. Evidence from Bulgarian Banking Market

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ABSTRACT

Some of the countries (Romania, Bulgaria) in the South East European region are still in a process of transition from a planned economies to capitalist market economies. This transition is accompanied by modernization and convergence needs. Part of the structural reforms was the privatization process. Especially in some sectors, such as the banking sector in Bulgaria, more than 75% of the industry has already been sold to foreign financial institutions (BNB, 2006). Seen from on perspective one side this fact creates sense of financial stability, which was of the greatest concern during and after the three observed banking crisis in 1994-1997 's. On the other hand, questions arose of whether the domestic capital has now difficulties to be profitable in financial banking operations. However, by reducing the uncertainty and reaching a proper level of price stability through stable financial system, Bulgarian authorities were successful, so far, in creating environment where predictability is a fact. Concentration levels in a financial sector are moderately high. Despite the predictions for further consolidations there is room for arguments that new comers could be observed at the market. In this respect, question of whether domestic banks could grow and to be competitive to the international financial rivals in Bulgaria, is considered as a potentially interesting area of research.

Keywords: *Financial liberalization, privatization, market*

1. INTRODUCTION

This paper analyzes the developments in the banking sector in Bulgaria during 2005-2012 period considered, as transitional period. The work particularly focuses on foreign banks and the role they play in developing the banking sector of the economy. The goal is to provide and analyze data about several aspects of development structure. Performance figures of both foreign and domestic banks are compared and statistical methods are employed on the base of identical methodology, with the aim the complete banking market to be studied. The work evaluates bank performance, focusing on profitability and efficiency of domestic and foreign banks separately. The paper studies the performance of the banks in relation of macro environment also. In this respect, the conclusion should be in position to interpret the results accordingly. Despite the facts of similar work performed for different world regions, this paper is one of the first to analyze the Bulgarian banking market, as per the presented methodology and approach. Definitions and statistical methods used are in line with those proposed by Claessens et al (2001) [5], Demirguk and Huizinga (1997) and latter by Naaborg et al (2004). The first two studied a sample of banks spread trough the world (not including Bulgaria), the last work performed similar study of countries from Central and Eastern Europe region for the 1995-2000 year period. Naaborg et al (2004) compares the performance figures, but does not employ any statistical methods to detect the actual impact of foreign bank presence. In this respect, the following study expands the way of approaching and reaching the researched objectives. Trends of the dynamics of the numbers will be also discussed. This will give an idea of the importance of their presence.

2. HIGHLIGHTED REFERENCE SOURCES

The fact that strong consumption appetite observed in Bulgaria, including deposits and loans products will keep fast rising growth rates, could support the view that this market could attract investors. Many authors, Bonin et al (1998) [2], Tschoegl (2003), [7] Clarke, G. and Cull, R. (1999) [1], Barth at al (2001) are addressing the potential benefits of entries of foreign banks, directly, or trough acquisitions. Levine (1996) [12] argues that foreign banks may improve the quality of financial services in the domestic market by increasing the competition, would enable application of modern banking skills and IT, and would provide the business with enhanced access to the international capital markets and others. In this respect, any local player should employ a proper strategy and specific skills in order to be competitive to the other market participants. The developments in financial and banking sector in economies in transition period have attracted the academicals researches. Bonin and Wachetel (2002) support the view that concentration and foreign participation in the banking sector is effective and most probably inevitable. Similar view is expressed by Cukierman (2002) and arguments are provided that poorly capitalized banks have negative systemic effect that outweighs advantages of competition at the financial market. This view is shared by the current governor of the Bulgarian Central Banks (Iskrov, I. 2004).

3. DRIVING FORCES AND BARRIERS BEHIND THE FOREIGN BANK'S STRATEGY TO EXPAND INTERNATIONALLY

Recent years have seen the effect of globalization and growing importance for many bank institutions to become international.[7] They could achieve such goal either by taking over established international banks, or by establishing their own subsidiaries and opening branches overseas. These processes are supported also by the liberalization and harmonization of financial markets and the legal frame work worldwide. The East European countries, particularly those planning to be, or those which are already EU members, now increasingly allow banks to be foreign owned. Financial liberalization of this kind attracts academicals research on potential gains and correspondent losses to domestic banking institutions. According to Tschoegl (2003), foreign banks may enter for two different purposes. Traditional operation, the first one, leads the foreign banks to enter other countries by establishing branches, or their own small subsidiaries. Their activities are in a form of providing general international banking services, such as, international payments, documentary business, finance trade, foreign exchange and lend to big corporation. The innovation, as a second purpose, drives the innovators to enter in order to explore opportunity investment, better returns, investment in restructuring businesses and others. In the post crisis countries, it is considered that the traditional foreign banks could behave, as an innovator. Branching operation provide flexibility to head quarters to adopt different business strategies, low cost in managing the risk and liquidity and full control over the management decision taking processes. [6] The subsidiary or joint venture structures require capital participation, due to host regulations and corresponding funds to insure the capital adequacy. Also, additional separate structures are needed to control and manage the business activities.

In this respect, this approach is more expansive for the foreign capital, but provokes adopting of strategies in order to maximize the profits. Heather (2003) finds that foreign subsidiaries provide the most robust loan growth and the least volatile lending cycle in the post crisis countries. New product innovations are considered, as a main competitive advantage for the foreign banks. The foreign bank entry in Central and Eastern Europe has another reason also, which is related to the privatization process during the transition period from a centralized economies to the market based economies, as one of the efforts to be recognized, as EU members. [13]The driving forces behind the decision to enter particular market have been subject of many studies. Despite the fact that incentives for multinational companies to go abroad and those applied for the banks could vary, overlapping exist and some generalization can be afforded. Critically thinking, if multinational companies expand in particular region, international banks move should be also expected to follow. Nevertheless, there are different reasons for foreign entry for companies in general and different reasons for foreign banks' entry. In order to clarify the issue, this section examines also the incentives for the international companies to enter, looks for overlapped incentives and differences. Considering the companies, Meyer (1996) argues that the local market is the dominant factor. He performed a study on British and German companies operations in economies in transition and provides some conclusions considering foreign investors from this region. [8]The purchasing power of consumers, as per his findings, plays very important role for the decision from market oriented investors. Results of this survey give lower priority and secondary role to the labor cost, which differs with the findings in other surveys performed in Bulgarian region and cited latter in this review. Benacek V et al (2000), [2] concludes that: ".. .market size and growth potential have been the driving force behind FDI, with factor cost advantages playing lesser, but still significant role. Macroeconomic and political stability are also taken into account" (p. 198). Bitzenis (2004) quotes a survey conducted by Federation of Industries of Northern Greece within the framework of its involvement in Southeast European Cooperative Initiative (SECI) in 1998. Summary of the facts shows that the Greek companies would prefer Bulgaria, Romania and FYROM, because cultural and geographical closeness, existing trade relations and common religion beliefs. The survey finds that Greek companies would like to use those countries as an initial investment platform with the possibility to expand later to Russia and to economies from the Black Sea region. Further, Iammarino and Pitelis (2000) focused on their survey on the Greek investment incentives considering business activities in Bulgaria and Romania.

Most of their findings are in line with the above stated, although prioritization slightly differs from those found in Central Europe. Expectation of higher economical growth, geographical location and labor costs in their study are the most important incentives for the FDI. The authors conclude that for the Greek investors cultural similarities, historical links and political and economic climate have limited importance. The earlier performed survey by the consultancy team of KPMG International (1998) identified key factors for major incentives, or barriers for foreign investors in Bulgaria. The skilled labor force has been one of the driving consideration (although might not be applicable for the financial sector explicated), low labor costs, strategic geographical location and good local market. In relation to the "following the customer" behavior, we could argue that foreign banks will increase the activity when incentives for foreign companies to expand in particular region prevail. In his work, Bitzenis (2004) discusses the differences between foreign banks and companies to enter and summarizes for Bulgarian case in particular that ".. .high risk environment, market risk and bureaucracy have been considered similarly either by foreign banks or by any other multinational enterprises participating in Bulgarian business environment. On the other hand, macroeconomic instability, unstable legal frame work slow transition progress and lack of managerial skills have been highly considered by foreign banks as negative factors..." (p. 109). Focusing on foreignWnk incentives, Altzinger (1999),[1] Lankes and Venables (1997) in the different surveys reached similar conclusions, that market size and market potential are the most important factors for foreign bank entry. It is interesting to know is there any relationship between the national income and foreign banks asset share. Claessens et al (2001) [5] make interpretation on the empirical findings of their study and concluded that the differences in national foreign penetration are primarily due to national differences unrelated to national income, something which appears rather unknown fact for the policy makers. The incentives for the foreign banks to expand internationally depend on potential for higher profit available on domestic markets and existing regulatory environment in the host country. Focarelli and Pozzolo (2001) find that foreign banks are investing, or taking part in bank privatization process in countries with expected higher real growth rate. Also, the authors noted that attention of such investors is attracted in regions with inefficient, low-concentrated banking sector and lose regulations. Additionally, the authors found, that the banks, which are investing internationally, are large, mostly profitable with headquarters in developed country. In the case of Bulgaria, in order better to understand the force behind the decisions of entry from neighborhood foreign banks the results from Arthur Andersen (1994) survey can be accepted as meaningful. The strong historical relationship and links, for instance, with Czech Republic and Hungary gives priority to geographic proximity for the Austrian banks to take decision to invest in this region. In order to rank the importance of factors behind the investor's decision in the case of Bulgaria, we can rely on findings of survey performed by Bitzenis A. (2004). He concludes that: "...the low cost of skilled labor force together with the theory "following the clients", lack of local competition and existence of international/globalization pressures were significant incentives for foreign bank in order to enter Bulgaria" (p. 123). "Follow the customer" strategy is found as a main reason for foreign bank expansion by Goldberg and Saunders (1991), Brealey and Kaplanis (1996), Konopielko (1999), Bush (2000), Moshirian (2001) and Williams (2002). [16] Nevertheless, Bitzenis (2004) stresses to the importance of progress of economic and institutional reforms, which constitutes the essence of transition process in Bulgaria particularly. Furthermore, most of those surveys indicate cautious among the foreign investors, when they have to take investment decision considering Bulgaria, because of factors, such as, unstable legal system, bureaucracy, political and economic instability, limited purchasing power, slow transactional process, corruption and others.

4. THE BENEFITS OF OPENING UP THE BANKING SECTOR FOR FOREIGN PARTICIPATION

Several authors have studied potential positive effects of foreign bank entry for the domestic economy. Walter I. and Grey P. (1983) and the detailed studies of Levine R. (1996),[12] agree on higher economy efficiency and better resource allocation observed in the countries with significant foreign bank participation. Levine (1996), in essence, concludes that foreign banks, as per his findings, improve the quality and availability of financial services, because the evidences of increased bank competition, ability to provide the domestic market with more modern banking skills and technology, provocation and stimulation of the overall bank supervisory and associated legal framework and, in result, improved overall industry access to the international financial markets. Further, Bonin et al (1998) add and systemize expected benefits of foreign bank entry providing the following arguments: (i) foreign banks will offer extended range of products and services, because they already do so in their own lend and they most likely will employ the correspondent know-how methodology and techniques; (ii) they would better benefit of economy of scale effect by employing large bank technology needed and also taking participation in acquisition and merger processes among the domestic banks; (iii) they would provoke development of the domestic financial markets by providing deeper knowledge and by stimulating the customers to employ more sophisticated financial techniques and access to enhanced financial product range; (iv) the foreign banks could convince foreign non- financial companies to invest and to increase the FDI to the economy, increasing this way the available financial sources.

Worldwide performed studies provide evidences considering the impact to the domestic economy and particularly to the local banks performance, although the benefits are presumed and some of them are still not materialized.[15] Foreign bank entry in Australia, for instance, is reviewed by McFadden (1994). As per the findings of the study, the author argues that this process have lead to the improved domestic bank operations. Argentina, in many respects is a ideal study of the effects of foreign bank entry on domestic banks. It provides a focused period of entry of foreigners (1994-1997) during one regulatory and legal setting. So, possible effects due different regulatory treatments could be avoided. Further, the academicians could enjoy the exceptional data provided by Argentina Central Bank. In the study for Argentina's banking market performed by Clarke, G. and Cull, R. (1999), the authors find that foreign banks are focusing on areas where they had a competitive advantage, as landing to manufacturing firms, mortgages and government debt. Domestic banks concentrating on those areas were affected, but those sectors enjoy a better competition. At the same time, there were sectors available to the local players that foreign banks did not enter. Those important findings are in line with the results reported from Sagari (1992) [1] and latter from Bush (1999) for different geographical regions. Based on the empirical researches conclusion are stated that foreign banks often concentrate in specific market niches and do not always compete 011 the broadest market sectors. In this respect, the outcome from this dissertation work should be in position to indicate how applicable is this for Bulgarian banking market and to provide some suggestion for opportunities for domestic banking institutions to grow and to be competitive to the international rivals. Bhattacharaya (1993) performed study on specific cases in Turkey, South Korea and Pakistan and concludes that foreign banks helped domestic projects to get access to foreign funding. Further, consistent with some of the above stated arguments, Engerer and Schrooten (2004) report their findings, that foreign banks entry to the European Monetary Union (EMU) plays substation role in respect to the institutional development and the reduction of non-performing loans. Nevertheless, as per their findings this role is questionable in term of providing credits to the private sector. This dissertation aims to provide research on Bulgarian banking sector in relation to the impact of foreign bank presence. In this respect, it should be highlighted that this presence has more contribution in Central, Eastern Europe and Latin America measured by loans provided than in Asia. It is considered that the degree of restrictions of the domestic regulators is a very significant factor affecting the role of foreign banks in the host economy. Politicians could advocate needs of some restrictions to protect the domestic bank of losing competitiveness to the foreign rivals [9]. Central and Eastern Europe countries are the best examples with fewer restrictions to the foreign bank presence. Heather (2003) studies and provides facts that 90% of the banking assets in countries in Central and Eastern Europe are controlled by foreigners. In the case of Latin America, this presence is increased from 15% in 1990 to almost 30% in year 2004. In respect to the overall banking stability, which considers both, the banking business and the host economy, Barth at al (2001) highlighted the results from their study, that countries with fewer limitations on foreign bank entry and ownership were less frequent on events of major banking crises. Overall, the empirical results in most of the stated studies support the assertion that foreign bank penetration improves firms' access to credits.

5. CONCLUSIONS

On the nominal convergence criteria, could be considered that Bulgaria is the best performer in the region considering euro adoption story. The currency board is stable and remains in place. The suspicions over the commitment to the euro/ lev peg during the last parliamentary elections disappeared. The significant FDI flows are able to offset the current account deficit, which was under consideration lately. Overall, it is considered that the budget remains under control and the fiscal position most likely will be in the positive territory over the coming years. The government debt is well below 40% of the GDP despite the continuing economic growth. The only risk observed so far is the inflation rate. Keeping in mind the absence of independent monetary policy due to the currency board regime, could be argued that can be difficult to control the inflation pressure in the following years. So, this fact could put into risk the hope of meeting the strict Maastricht criteria in 2009. The favorable external conditions and the solid growth momentum backed by the domestic demand could keep the pace of GDP growth strong during 2006-2008. Macroeconomic fundamentals, however, remain strong broadly based on expected favorable impact of entry of EU single market. Prospects of imposing sanctions will continue to exercise pressure on Bulgarian politics. Those observations are mirrored by the latest credit ratings assigned by the international agencies: Moody's Long Term Foreign Currency rating is Baa3/ stable; S&P Long Term Foreign Currency rating is BBB/ positive and FITCH Long Term Foreign Currency rating is BBB/ stable (the data is updated on the 30th October 2006). The studied 5 years period is characterized with the similar environment and the macro indicators reflect the picture. In this respect, both the foreign and the local banks enjoyed favorable macro-environment and have not been forced to deal with major internal crisis. Furthermore, this was a period of building a trustable relationship among the banks and their customers slowly healing the wounds left by the banking crisis during 1995-1997.

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