

## EPFSF Briefing: Financial Services and New Member States

### Highlights

On 1 May 2004 ten new member states joined the EU: eight of them located in Central and Eastern Europe and emerging from almost fifty years of centrally planned economies; two located in the Mediterranean basin and already during the last decade evolving into market economies.

The following figures highlight the standing of the new Member States (NMS) within the EU:

- **Population:** NMS represent over 20% of the overall EU population after accession
- **GDP** (at nominal): EU10 NMS will add 5% of GDP to the EU GDP
- **GDP per capita** (at PPP) in NMS accounts for 51% of EU15 average
- **Average GDP growth rate** in NMS between 1999 and 2003 is 3.2% (EU15: 2,0%)

The banking and the financial services industries, especially in the Eastern and Central European countries (CEEC), underwent extensive reforms, as part of the overall process that governments adopted in the Nineties to transform their centrally planned economies to market oriented ones. The reforms were carried out on the basis that functioning and efficient banking and financial systems are a prerequisite for sustained economic growth and macroeconomic stability.

### BANKING

Reforms took place in nearly all NMS, resulting in modern, sound and consolidated banking systems: i) privatisation and restructuring of the formerly state-owned banks and ii) consolidation of the banking sectors due to M&A and crisis of some banks in some NMS.

#### i) Privatisation and restructuring

The extensive privatisation process, prompted a significant flow of direct foreign investment from EU15 and other foreign banks, which thus gained control of most credit institutions in nearly all NMS. On average, more than 70% of NMS bank assets are held by foreign owned institutions; the Czech Republic, Lithuania and Slovakia the ratio reaches 96% and in Estonia even 97%.

Investment by EU15 banks was of the FDI-type, i.e. not just portfolio investments. In fact, they moved into those countries essentially to develop and expand their business in an economic environment that was more favourable than their already saturated, low-margin home markets. The main reasons for their early investments were certainly the prospect of EU accession, the considerable economic growth potential low level of development in the CEE region and the existence of wide margins.

As far as feasible in their economic and legal environments, local supervisory authorities have tended to foster and promote foreign direct investment.

Foreign investors, while making significant investments in the NMS, have transferred know-how, technology, risk management techniques, best practices and human capital. This led to an increase in the operational capacity of local banks to the benefit of local customers, gaining slowly but progressively access to new products and services designed to meet their evolving financial needs, and to local businesses to whom these banks can lend more efficiently.

#### ii) Consolidation and concentration

The consolidation of the sector has led to more concentration: by 2003, the aggregated market share of the 5 largest banks (CR5 ratio) varied between 52% in Hungary and Poland and 98% in Estonia, averaging at 72%<sup>1</sup>. The sector's reshaping occurred according to the pattern of the universal banking model brought to the NMS by the banks' new shareholders. It is regulated by the relevant European legislation.

The main indicator of the sector's depth is the ratio of domestic credit to the private sector as a percentage of GDP. While in the EU15 the average ratio is 117%, in the NMS it is 35%<sup>2</sup>. This gap is

<sup>1</sup> Source: Banking structures in the New EU Member States, ECB, January 2005, page 21.

<sup>2</sup> Source: Banking structures in the New EU Member States, ECB, January 2005, page 14.

still significant, despite the improvement of this ratio in the NMS (29% in 1995). Presumably, this gap will progressively be bridged by the NMS' strong economic growth.

As a consequence of the universal banking model, finance of companies is still overwhelmingly dominated by bank loans, which, however, has some negative effects on the potential of the securities markets.

### **FINANCIAL SERVICES**

In the wider area of financial services, data suggest that the financial sector, at least in the 8 CEEC, is small both in nominal terms and relative to GDP, and is not very developed<sup>3</sup>. Financial institutions like insurance companies, pension funds, mutual funds, leasing and factoring companies, and venture capital firms remain largely underdeveloped in aggregate terms compared to the EU15, although they are slowly but constantly growing.

The development of a sound and efficient financial services industry is crucial for the economic development and thus for NMS prosperity. It is acknowledged that financial services play a pivotal role in the allocation of resources in the economy to the benefit both of companies and investors.

Banking and financial services complement each other and offer synergies that are beneficial for the economy as a whole. Non-bank financial institutions can provide valuable sources of financing either to corporate or to retail clients, thus improving their access to finance, particularly for long-term maturities. This adds to the spreading of risks in the market among a larger set of players and hence to the benefit of the system's stability.

#### **Insurance**

Available data testifies the relatively early stage of development: the sector's total assets are 10% of GDP (EU15: 65%). Demand for more sophisticated insurance products is expected to increase. Two thirds of premiums cover non-life products (casualty, motor vehicles, property) (EU15: one third). Premium allocation in the insurance sector differs markedly. In the NMS, two thirds of premiums are raised in the non-life area (casualty, motor vehicles, property) and one third comes from life insurance. In the EU15, the ratio is the reverse: life insurance dominates by 2:1.

While the banking sector in most NMS has been largely privatised, the same has not (yet) happened for insurance companies. Large state-owned (hence by definition domestic) units still dominate the NMS' markets; EU15-driven consolidation has not yet started everywhere.

#### **Pension funds**

This sector's development very much depends on the structure of national pension schemes and on the existence of tax incentives to attract savings to private sector schemes. Progress is mixed across the CEE countries, but none can be classified as very mature. Among the CEEC, Hungary, Poland and the Czech Republic have the largest number of pension funds.

At less than 5%, the aggregate level of pension assets compared to GDP is low. However, the EU15 ratio is not homogeneous, as most have under-developed 2<sup>nd</sup> and 3<sup>rd</sup> pillar pension schemes. Due to ageing population and national budget constraints this sector is likely to grow and evolve.

#### **Mutual funds**

Also this industry shows a comparatively low ratio of assets managed to GDP. Data collected by the World Bank show that this ratio is below 10% of GDP for NMS (EU15: 50%). This industry is also expected to grow in line with the NMS's economic development.

Hungary, Poland and Slovakia account for the largest number; in terms of percentage of assets managed to GDP, Czech Republic, Hungary and Estonia led with ratios of 4.3-5.0%.

#### **Leasing**

Leasing is one of the NMS's most developed non-bank sectors, with leasing assets close to the EU15's in relative terms and in some countries (Czech Republic, Estonia) even higher. The main reasons for the advanced position of this sector are the weakness of the legal protection of creditor rights in many NMS and the overall better pricing of leasing finance compared with bank loans.

<sup>3</sup> Source: Development of Non Bank Financial Institutions and Capital Markets, World Bank Working Paper, 2004.

### **Factoring**

In 2002, volumes of NMS accounted for less than 2% of GDP (EU15: 6%). The use of this financing instrument will increase in the coming years with the progressive development of the NMS's corporate sector.

### **Venture capital**

The absence of a number of critical factors has prevented this industry reaching levels of activity comparable to the EU15. These include: the lack of deep and efficient equity markets providing opportunities for early stage investors to realise their investments; the lack of efficient foreclosure procedures; insufficient numbers of companies of sufficient size to attract venture capital from abroad; the lack of a favourable tax environment. These impediments can progressively be overcome with the creation of wealth and by adapting the institutional legal framework in order to promote the development of this industry.

### **Equity markets**

The level of market capitalisation as a proportion of GDP is less than one third of the EU15, and varies greatly from country to country. Among the NMS, the Warsaw Stock Exchange has the largest market capitalisation ahead of Prague and Budapest).

Equity markets were established with the aim of carrying out the massive privatisation processes of the Nineties. These markets experienced an impressive start with a large number of listed securities, which however, were often not liquid. In the end, the privatisation process in most CEEC resulted in a significant flow of foreign direct investment (FDI). Many of the NMS's leading companies consolidated domestically or became fully owned subsidiaries of EU15 groups and were consequently de-listed. In some cases, eager privatisation programmes exclusively targeted foreign markets (e.g. in the form of GDRs) while ignoring home market and local exchange. Restrictions on over-the-counter trading resulted in a lack of financial institutions willing to provide liquidity on the central exchange.

As economic growth continues and new SMEs emerge, accessing equity markets as source of raising capital is likely to increase.

The regional structure of stock exchanges is likely to further change as some struggle to reach or maintain critical mass while support by the public hand diminishes. Concentration rules, where still applied, will fall with the entry into force of the MiFID. The three Baltic exchanges are already operated by the Finnish/Swedish OMX Exchanges group; Vienna Stock Exchange has recently acquired a majority stake in Budapest which itself has been linked to the German XETRA system. Finally, some small but fast growing NMS based companies might opt to list on alternative markets such as existing or future specialised SME or growth markets in the EU15.

### **Fixed income markets**

While fixed income markets have grown substantially in the last 5 years, they still account for less than a third of EU15 volumes in terms of GDP. NMS bond markets are still dominated by government bonds with 93.29 % of the total (EU15 54.44%). Bonds issued by the private sector are still modest compared to the EU15 and vary greatly from country to country: Czech Republic, Hungary and Slovakia, according to 2002 data, have the deepest markets for corporate bonds in the NMS<sup>4</sup>.

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<sup>4</sup> Ibidem

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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