COMPETITIVE IMPACT OF FOREIGN BANKS ON FINANCIAL MARKETS IN TRANSITIONAL ECONOMIES: THE CASE OF UKRAINE

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Abstract. *The scale, the major economic indicators and the competitive impact of foreign banks on the national banking system of a transitional economy, based on the case of Ukraine, are studied.*

The banking sector development of the transitional economies differs from that of developed countries. Transitional economies have the bank-centered financial systems with the prevailing banking sector, a rapidly growing demand for banking services, booming credit supply, weak institutional and regulatory policies causing problems with banking stability. The intensive entry of foreign banks and their increasing market share have a significant impact on banking competition and performance.

The paper argues that the foreign banks' entry by the acquisition of Ukrainian banks' shares is competitive by nature (demand-side competition and supply-side competition on the entry stage and post-entry market competition). The entry competition influences the relatively high price indicators of the Ukrainian banks shares in comparison with neighbouring countries. The post-entry competitive position of foreign banks is based on utilizing their competitive advantages and the post-entry market strategy. The foreign banks utilize capabilities to increase capitalization, assets and liabilities management and gaining a substantial market position, and offer more competitive products and services in all major market segments.

Keywords: *transitional economies, banking sector, foreign banks, bank share price, banking competition.*

Introduction

The internationalization of banking services is one of the major trends in the global economy. It has a different extent and implications in the developed, emerging and transitional economies. The foreign banks' entry is one of the common features of the financial systems' structural changes in transitional economies. The intensity, time frame, mode, extent and implications of the foreign banks' entry into national markets vary depending of the macroeconomic, monetary, demand, institutional, regulatory and other conditions in different transitional economies.

Studies of the banking sector development in transitional economies concentrate mostly on the banking system institutional reforms, credit boom and banking stability, foreign banks' entry and their market share, institutional and regulatory issues.

The aim of the research is to study the foreign banks' entry competition and post-entry implications for the competitive environment in the national banking system of a transitional economy, based on the case of Ukraine.

The research objectives are:

- to overview research approaches to banking competition and its international dimension;
- to identify the key economic indicators of the foreign bank entry in a transitional economy;
- to study the competition aspects at the stages of foreign bank entry into transitional markets;
- to evaluate the major competitive impacts of foreign banks' entry on a transitional economy banking market.

Methods

Competition in the banking sector is studied by using different research methods and models. The most commonly utilized research methods are:

- measuring the degree of banking concentration using the Herfindahl–Hirshman index or other methods and based on that to assess how a higher degree of concentration pursues a more intensive competition, influencing the banking behaviour and through that the banks' performance;
- evaluation of perfect competition, monopoly and imperfect competition models of banking (after Matthews and Thompson, 2005);
- studying the scale and scope of economy as a complex source of the banks' competitive advantages and therefore a more effective performance (after Heffernan, 2004);
- modeling X-efficiency as bank management ability to control cost (cost X-efficiency) or profit (profit X-efficiency) in response to competition challenges (after Heffernan, 2004);
- application of different performance assessment methods to evaluate the degree of competition impact, including the efficiency of assets and liabilities, deposit–loans margin, cost–profit ratios, performance comparative indicators, rating models, for example, CAMELS, etc;
- studying competition as a driving force of banking and financial innovations and spillover and market effects.

Economic indicators and the impact of the foreign banks' entry on transitional markets are studied using the structural comparative analysis of the entry and the post-entry competition, its economic measuring. The foreign bank entry causes structural changes within the national banking sector and through that influences the competition, as argued by Claessens and Laeven (Claessens, Laeven, 2003, 2006). Such a structural approach could be developed as comparative and time-fashioned, specifying different dimensions of entry and post-entry competition, economic indicators and their impact on different stages of foreign banks' behaviour in transitional markets. Supply and demand conditions for Ukrainian banks' shares at the foreign banks' entry stage, the relative market power should also be taken into consideration. The case of Ukraine as a middle-income and mid-size transitional economy is used in the study in comparison with the experience of neighboring countries.

Foreign banks in Ukrainian transitional economy: entry conditions and competitive impact.

Cross-border banks mergers and acquisitions (M&A) are a way of the foreign investments, capital consolidation as well as institutions' and markets' internationalization. Cross-border M&A account for a substantial part of the international capital flows and feature as an important direction of the European and global financial integration.

The data for euro area bank cross-border M&A show that the overall and medium values of deals are increasing, indicating consolidation of the financial services sector. At the same time, foreign investments play a different role in the banking sectors of the EU-15 countries and EU new member states (NMS). Foreign entities account in NMS for 70.3% of total banking assets, while in the EU-15 countries such figure is 27.8% [ECB 2008b, p. 11].

NMS and transitional economies are more perceptive for foreign investments into the banking sector, primarily due to its underdevelopment in comparison with the EU-15 countries and the excessive demand for finance which could not be covered by domestic sources. At the same time, the foreign banks' entry is motivated primarily by the growth potential for most lucrative services such as consumers and mortgage loans, which drives import increase and a negative impact on the BOP current account and exchange rates.

Financial systems of transitional economies are bank-centered with comparatively weak stock markets and comparatively less developed non-banking financial institutions. In Ukraine, the share of banks assets in consolidated assets of the financial system grew up from 86.1% in 2005 to 92.1% in 2007 (our calculation based on official banking and financial statistics). Such a large and growing share of banks could be considered as a specific structural asymmetry of the transitional financial system. Non-banking financial institutions play a limited role in the market competition due to their low switching capacity and limited attractiveness for the financial services customers. Therefore, the banking sector competitiveness and efficiency play a key role in the overall performance and stability of the financial system.

Foreign banks' entry into the Ukrainian market takes place in a competitive en-

Table 1. ***Bank M&A in the euro area***

	2000–2004	2005–2008
Value of deals (Euro billions)	182	269
Number of deals	485	274

Note: Deals involved 10% share capital and more; for 2008 – data for the first half of the year.

Source: Cross-border bank mergers & acquisitions and international investors. ECB Monthly Bulletin. October 2008. P. 71.

Table 2. ***Ukraine: major macroeconomic indicators, 2001–2008***

	2001	2002	2003	2004	2005	2006	2007	2008F
GDP nominal prices, US$ Bln.	38.0	42.4	50.2	64.9	86.2	106.5	140.5	171.0
Real GDP growth rates, %	9.2	5.2	9.6	12.1	2.7	7.3	7.3	6.5
Nominal GDP per capita, US$	781	878	1,049	1,367	1,830	2,278	3,027	3,695
Industrial production real growth, %	14.2	7.0	15.8	12.5	3.1	6.2	10.2	8.5
Capital investments real growth, %	6.0	3.4	22.5	20.5	3.9	18.7	21.9	18.0
Consumption real growth, %	9.3	5.0	10.0	9.7	15.7	11.9	14.0	10.0
Net FDI inflow, US$ Bln.	0.8	0.7	1.4	1.7	7.5	5.7	8.2	9.5
CPI annual change, %	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	14.0
BOP current account, % GDP	3.7	7.5	5.8	10.7	2.9	-1.5	-3.3	-4.5
Official reserves, US$ Bln.	3.3	4.4	6.9	9.7	19.4	22.4	32.2	37.5
Exchange rate, UAH/US$	5.37	5.33	5.33	5.32	5.12	5.05	5.05	5.05

Sources: Ministry of Statistics of Ukraine. 2008F – median of different forecasts.

vironment due to the supply and demand conditions and information asymmetry. Supply and demand conditions, information asymmetry and a lower, in comparison with mature markets, level of market competition influence foreign banks' motivation for entry.

The demand for the bank shares is driven by the foreign banks' estimation of the market potential and therefore by specific requirements to the targeted Ukrainian banks. The demand-side competition for the stocks of the Ukrainian banks has been rapidly increasing since 2004 due to the growth potential of the dynamic market – a high growth potential of economic and banking services, a moderate banking competition and a relatively lower cost of investments for the market share development.

The major factors of competitive demand for Ukrainian banks' shares are the valuation, monetary, macroeconomic, structural and market factors:

a) the remaining undervaluation of assets in the Ukrainian economy, including banking assets, determines the potential of their fair market valuation upon financial markets liberalization and therefore gaining a marginal income from the increase value of assets. Mid-term prospects of increasing its market valuation are due to Ukraine's joining the WTO, establishing a free trade zone with the EU and financial market liberalization;
b) the economic growth potential in Ukraine remains quite high. Its macroeconomic developments demonstrate a balanced and stable economic growth, a good adjustment capacity to the external shocks, moderate currency stability, but a relatively high inflation as for a transitional economy.

High rates of economic growth, capital investments and consumption cause a growing demand for banking services – commercial, corporate, investment and private. Growing incomes feed consumer spending, deposits and consumers' borrowing capacity. It becomes a major cumulative demand factor for banking services and one of the key motives for the foreign banks' entry;

c) the growth potential of banking services is quite high in their scope and future value. The banking sector in Ukraine since 2002 demonstrates extremely high rates of growth due to the rapid monetization of economy and high economic growth. Both the supply and demand of money remains attractive for foreign investors. The average annual growth rates of nominal banking assets in 2003–2007 we have estimated at 50.2% and banks' claims at 44.5%. On the one hand, credit growth supports the economy, but on the other hand it may result in higher risks for financial stability and requires the further capitalization of the banking system and a better management of financial risks.

The rapid growth of banking services in 2002–2007 did not fully saturate the market, therefore, the remaining growth potential motivates foreign banks' entry. The banking services market has a good potential for growth in the medium and long-term perspective. The market growth potential is determined by the macroeconomic fundamentals such as high economic growth, investments and consumption. The banking market growth potential is driven by structural factors such as moderate concentration and competition, the starting phase of consolidation, lower investments for increasing the market share, a good marginal income, relatively low market penetration, room for spillover of new financial products and technologies, a low competition from the non-banking financial institutions. Such a potential is determined by the remaining difference from neighbouring countries in the relative indicators of banking services penetration:

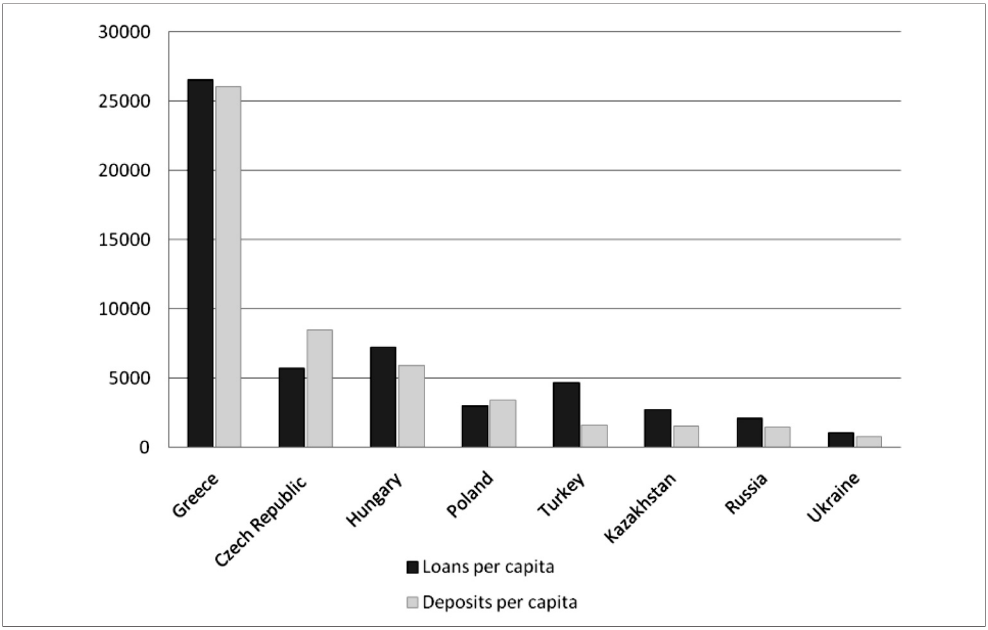

Figure 1. ***Loans and deposits per capita in selected countries, 2006, $US***

Source: National Bank of Ukraine, Ministry of Statistics of Ukraine.

The data show that the penetration ratio of both loans and deposits in Ukraine remains twice lower than in Russia and Kazakhstan and 3–10 times lower than in selected CEE countries. The prospects of reaching comparable penetration ratios in 3–5 years and a respective increase of the major segments of the banking market could be considered as the growth potential of banking services. It reflects the effect of so-called "accelerating growth" from a lower starting position towards the level more advanced than the country's level of economic growth.

The competitive demand from foreign banks is concentrating on the acquisition of large Ukrainian banks with the established market position and a good growth potential. It has usually been determined based on the home–host bias and a set of quantitative and qualitative criteria.

Typical aims usually stipulated by foreign banks for targeted Ukrainian banks and therefore playing the key role for competition with other bidders on the M&A market are the following: a network of 50 branches and more; presence in all major regions of the country; the share capital book value of $US 100 mill. and more; credit history with foreign banks; a full banking license for all banking services, etc.

The major features of the demand competition for the large Ukrainian banks' shares acquisition are the following:

1. The demand is concentrating on the largest Ukrainian banks because the major buyers are large international financial institutions and their aim is to get through acquisition a substantial share of the Ukrainian banking market. Foreign banks are represented by the largest diversified global financial group, and their behaviour determines competitive demand conditions for Ukrainian banks' shares.
2. Foreign banks mostly target at the acquisition of 90–100% of shares and thus at getting an ultimate control over the acquired banks.
3. Large Ukrainian banks with a wide network of branches and a large number of customers are the most attractive target for foreign banks. Such large banks are the key targets for acquisition competition among foreign banks, and their share prices are higher than of smaller banks.

The economic indication of such competitive demand for large Ukrainian banks could be assessed as a higher evaluation of the bank shares (as the price to book value ratio) in comparison with neighbouring countries. The relative level of price reflects the current prevailing market trend – focusing acquisition competition on the specific targets such as large banks. In other words, the relatively limited supply under a strong competitive demand from the global financial institutions caused price increase of the shares.

Our calculation shows that the weighted average P/BV for Ukrainian banks is 4.2 for the period 2004–2007. A similar ratio for Russia is 2.75. It indicates a higher relative market valuation as a result of a higher competition for the Ukrainian banks' shares, reflecting a better growth potential and improving regulatory conditions.

The supply-side competition is directed towards increasing the offering value and

Table 3. ***Major economic indicators of the Ukrainian banks' shares acquisition by foreign banks, 2004–2008***

Buyer	Target bank	Shares	Price, mill. $US	P/BV
Vilniaus Bankas (SEB group member)	Agio	95%	27.5	1.6
Raiffeisen International Bank Holding AG (Austria)	Aval	94%	1028	3.2
Sberbank (Russia)	NRB-Ukraine	100%	150	3.7
BNP Paribas (France)	Ukrsibbank	51%	367	3.4
Vneshtorgbank (Russia)	Mrija	98%	70	1.6
Credit Agricole (France)	Index-Bank	98%	260	7.2
OTP Bank (Hungary)	Raiffeisen Ukraine	100%	827	5.2
EFG Eurobank (Greece)	Universalny	99%	50	3
Erste Bank (Austria)	Prestije	100%	104	1.8
Marfin Popular Bank (Cyprus)	MTB	99%	137.4	5.1
Getin Holding (Poland)	Prykarpattya	82%	n/a	n/a
Volksbank International (Austria)	Electron	98%	75	3.8
Swedbank (Sweden)	TAS-Komersbank	99%	735	4.5
Piraeus Bank SA (Greece)	International commercial bank	99%	75	4.9
UniCredit Bank (Italy)	Ukrsotsbank	95%	2200	5.6
Bank of Georgia(Georgia)	UBRP	99%	74	2.7
Commerzbank (Germany)	Forum	60%	600	5.1
SEB (Sweden)	Factorial	97%	120	4.3
Bank of Cyprus (Cyprus)	Avtozaz	95%	76,1	4
Bank Hapoalim (Israel)	Ukrinbank	76%	135	2.2
Inteso Sanpaolo (Italy)	Pravex	100%	750	5.2
Alpha Bank(Greece)	Astra	90%	120	1.5

Source: bank's information, various sources. P/BV – share acquisition price to its book value.

share price of the banks utilizing pre-acquisition value enhancement strategy to get acquired by foreign investors. Such a strategy is employed by the medium-size banks with a limited capability to increase capitalization and compete with large institutions. From the supply side, competition is directed to getting an offer from a good international bank, selling shares with the highest possible P/BV ratio and a close transaction at the time of better market conditions. Medium-size banks utilize different pre-sell policies to increase their market value and get attractive competitive offers from foreign banks:

- borrowing from the international banks in order to increase the credit portfolio and assets;
- developing alliance-type relations with major international banks, such as: trade finance facilities, letter of credit and bank guaranties confirmation facilities, interbank standing facilities;
- developing long-standing relations with

network clients, for example, through joint card products with mobile services operators, major supermarket chains, airlines, etc.;
- minority shares sell to EBRD in order to improve bank corporate management and rating;
- minority shares sell on IPO or private placement in order to get price quotation on international markets;
- getting a subordinated loan from the EBRD or other international institutions in order to increase the share capital;
- improving credit rating by the major international rating agencies;
- international bonds or Eurobonds placement;
- branch network development;
- developing the retail market share;
- improving balance sheet profitability.

Mid-size bank pre-sell policy sometimes makes them attractive for global banking groups interested in getting a starting platform for developing a sizable market share. In several cases, as a result of the effective pre-sell strategy and competitive offers from international banks, medium-size banks got a successful sell of shares with the P/BV ratio close to or above the average for the large Ukrainian banks.

The number and the market position of the foreign-owned banks in Ukraine has been growing in the last three years, with the possibility to occupy up to 50% of the market in 2008–2009.

Foreign banks may become dominating on the market in case of privatization of the two remaining large state-owned banks – Oschadbank (Savings Bank) and Ukreximbank (State Export-Import Bank).

The post-entry competitive impact of foreign-owned banks on the Ukrainian banking market could be evaluated based on different criteria, including scale, scope and performance indicators, profitability, ratings, etc. The structural comparative approach gives the possibility to identify the areas in which foreign-owned banks have competitive advantages and utilize them to gain comparatively better results than their market position measured by the ratio of the share capital.

For this purpose, it could be possible to use a comparative analysis of the ratio of structural components of the foreign banks' assets, liabilities and share capital relative to the same indicators of all banks and to assess the areas of competitive advantages of foreign-owned banks. Relative measurements for asset structure and effective management of liabilities could be used as

Table 4. ***Foreign-owned banks in Ukraine, 2003–2008***

Foreign-owned banks	1.01.2003	1.01.2004	1.01.2005	1.01.2006	1.01.2007	1.01.2008
Banks number	20	19	19	23	35	44
% of all banks						
% of all banks' share capital	13.7	11.3	9.6	19.6	27.6	33.0

Source: National Bank of Ukraine.
Foreign-owned banks – banks in which 51% and more shares are in foreign ownership.

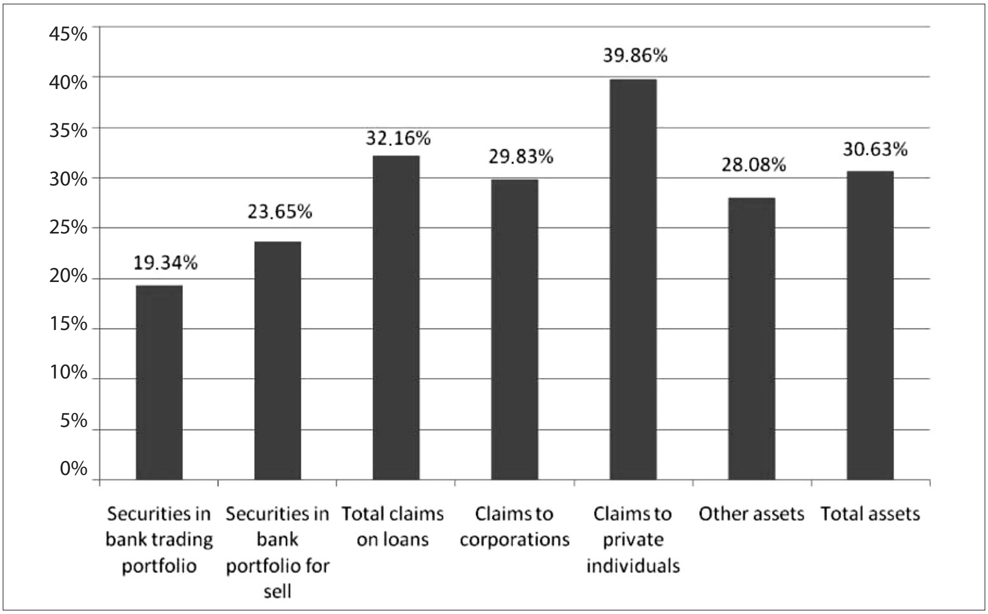

Figure 2. ***Assets structure of foreign-owned: the ratio of foreign-owned banks to all banks in Ukraine, 2007***

Source: National Bank of Ukraine.

a complex approach for evaluating the post-entry impact of foreign-owned banks on the banking sector structure and competition.

The comparative structure of the foreign-owned banks' assets indicates that banks utilize the competitive advantage in retail services such as consumer and mortgage lending. Foreign-owned banks' share in retail lending of all banks (claims to private individuals) is estimated at around 40%, which is higher than its relative weight in the total banks' share capital (33%).

The development of retail banking services is supported by the foreign-owned banks' competitive advantages such as access to long-term financial liquidity and securitization technologies. At the same time, the retail banking services are most profitable in the long run and generate a higher accumulated profit in comparison with other services. Therefore, now four foreign-owned banks hold approximately 80% of the mortgage financing in Ukraine. The complementary effect is that at present, foreign companies concentrate more than 50% of the life insurance market in Ukraine, mainly thanks to a demand for such services from the mortgage-lending banks.

The foreign-owned banks hold a similar competitive position in other profitable segments of retail services such as car loans and consumer loans. Such services also require employing access to long-term financial liquidity, insurance and securitization technologies. Other innovation spillover on the retail market are bank cards with debit and deposit management functions, cards for small business commercial borrowing.

Foreign-owned banks' liabilities management indicates that the structural factors also play a significant role in enhancing competition in banking.

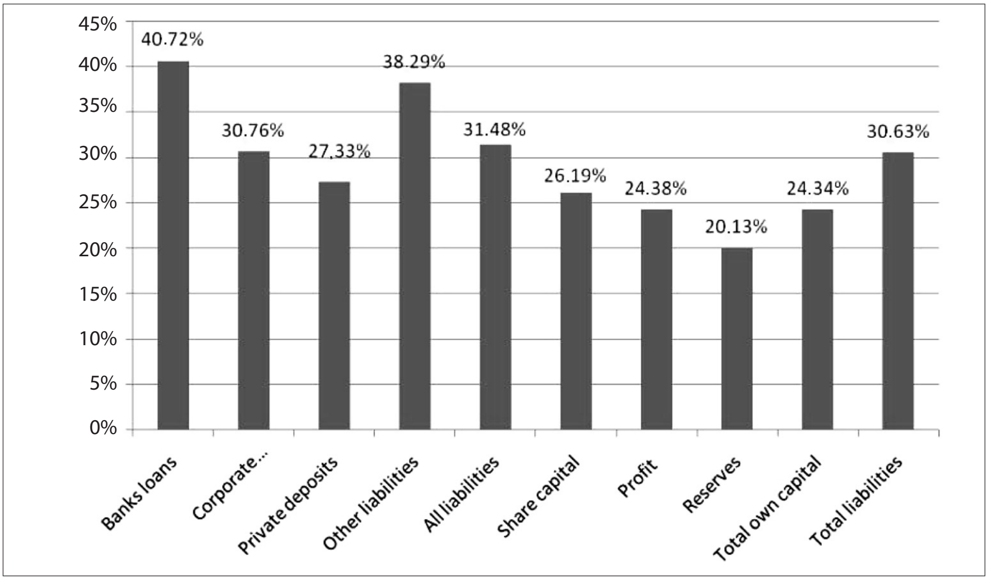

Figure 3. ***Liabilities and own capital of foreign-owned banks: the ratio of foreign-owned banks to all banks in Ukraine, 2007***

Source: National Bank of Ukraine.

On the liabilities management side, the foreign-owned banks' competitive advantages are dominating sources of liquidity as banks loans (primarily from the parent bank) – around 41% of all banks versus their weight in share capital of 33%. The higher weight of other liabilities, which mostly comprise documentary operations with the parent bank, such as bank guaranties, trade financing, etc., also reflect a comparative advantage in sourcing financial liquidity and its effective utilization. Foreign-owned banks hold comparatively less deposits because they use parent bank liquidity as the main source of lending; for the similar reason they hold comparatively less reserves.

Conclusions

The study demonstrates that foreign-owned banks' activities exert a structural impact on the market of banking services in transitional economies and thus enhance competition. The results show the lasting economic effects of foreign-owned banks, mainly due to capitalization, services diversification, cross-border banking and influence on the development of the financial system. On the foreign banks' entry stage, the demand-side and supply-side competition for acquisition of the Ukrainian banks' shares has a significant effect on increasing the selling price of shares and the P/BV ratio. At the post-entry stage, the foreign-owned banks utilize their competitive advantages and get a comparatively higher market position in the key segment of assets development and liabilities management.

An advanced analysis of the structural impact of foreign banks' entry into the national banking market should cover the issues of entry cost and profitability, entry impact on banks' capitalization, the quality of investments and services , banking system stability and adjustment to external shocks.

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