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The Impact of the Accession of Macedonia in the EU on the Banking System

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Abstract

The aim of this paper is to examine the impact of the accession of Macedonia in the EU on the banking system. EU enlargement is a complex process with enormous impact on the economy of the new member countries. The financial system of the new member country, and the banking system as part of it, faces the challenge of integration in the EU financial system. The best evidence of the EU accession impact on the banking system is the analysis of the basic characteristics of banking systems of the countries that have become members in the last 20 years. The future banking development in the new EU member countries will very likely follow some main patterns known from the old EU members. In a way, banks from candidate countries can see their own future by observing the current developments in the Western European banking. The process of restructuring in the banking system through consolidation which has led to increased concentration has been one of the main drivers of changes. The existence of this process in new EU countries will be examined together with the structure of the Macedonian banking system. It is important to examine whether significant efficiency improvements have been achieved in the banking systems of the new EU countries and if they are a result of the bigger market power or some other factor. Also, there have been changes in the funding sources of the banks from the new EU countries with a lot of potentials for alternative funding. The financial crises has made these potentials evaporate, but on the long-term horizon, those opportunities will appear again. The low level of financial intermediation in new EU countries leaves space for increasing the range of financial services and their scope.

Keywords: European Union, banking sector, financial system, new member countries, funding, financial intermediation

Introduction

The process of enlargement of the European Union (hereinafter: EU) is a complex one with a strong impact on the economy of the country that will access it. Stable financial markets are key to successful and sound economic development. Their development depends on a stable economic environment and vice versa, financial stability is, in turn, a precondition for sustained economic growth and an efficient monetary policy. Therefore, the role of the financial markets in the process of convergence is of great importance. Only a solid financial sector can create stable framework conditions for economic growth.

One way of predicting the impact of EU accession on a banking system of a country is the idea that possible forthcoming developments in the banking system are to a large extent determined by the developments in banking sectors of the "old" EU members (Ribnikar & Kosak, 2006, p.2). In a way, the banks from candidate countries can predict their future transformation by observing the current developments in Western European banking. This paper will analyze the impact of the accession to the EU of the new EU countries on the banking system according to the process of consolidation of the EU banking system, the level of concentration and the level of financial intermediation. Then, based on the characteristics of the Macedonian banking system the possible effects could occur to the Macedonian banks are analyzed and there will be given the answer to the question if the Macedonian accession to the EU will improve the efficiency of the banking system.

Concentration in the Banking Sector in EU

The European banking system is in a continuous process of consolidation. The consolidation in the banking industry starting from the nineties was a global phenomenon (Ribnikar & Kosak, 2006, p.2). The number of financial institutions was decreased through mergers and acquisitions. Prior to the establishment of the euro, both the suppliers and users of financial services undertaking cross border activities faced risks and costs associated with national currencies (Ekkayokkaya, Holmes, & Paudyal, 2005, p 17). As such, competition in the bank M&A market was limited. The introduction of the euro saw the withdrawal of national currencies and, hence, the removal of this key element of risks and costs. Thus, with the introduction of the single currency, cross-border activity became more attractive and competition within national markets was expected to increase. The key efficiency that determines the M&A in the financial sector lies in the achievement of economy of scales and the opportunity to cut costs by overlapping operations and consolidating back office operations. Despite the enlargement of the euro area through the accession of Greece (2001), Slovenia (2007), Cyprus and Malta (both 2008), Slovakia (2009) and Estonia (2011), the number of monetary financial institutions (MFIs, 2011) in the euro area has decreased by 20.2% or 1,991 institutions since January 1, 1999 (Figure 1). On January 1, 2011 Germany and France accounted for 40.8% of all euro area MFIs, a share similar to that recorded on January 1, 2010. On January 1, 2011 there were 9,921 MFIs resident in the EU, a net decrease of 271 units (-2.7%) since January 1, 2010. Compared with the situation on January 1, 1999 (10,909 MFIs in the EU), there has been a net decrease of 988 units (-9.1%), despite the addition of 1,608 MFIs on May 1, 2004, when ten new Member States acceded, and of a further 72 MFIs on 1 January 2007, when Bulgaria and Romania joined the EU.

Figure 1

Number of MFIs in EU / Euro area in the Period 1999-2011
Source: European Central Bank. (2011), MFI statistics 2011, ECB, Frankfurt

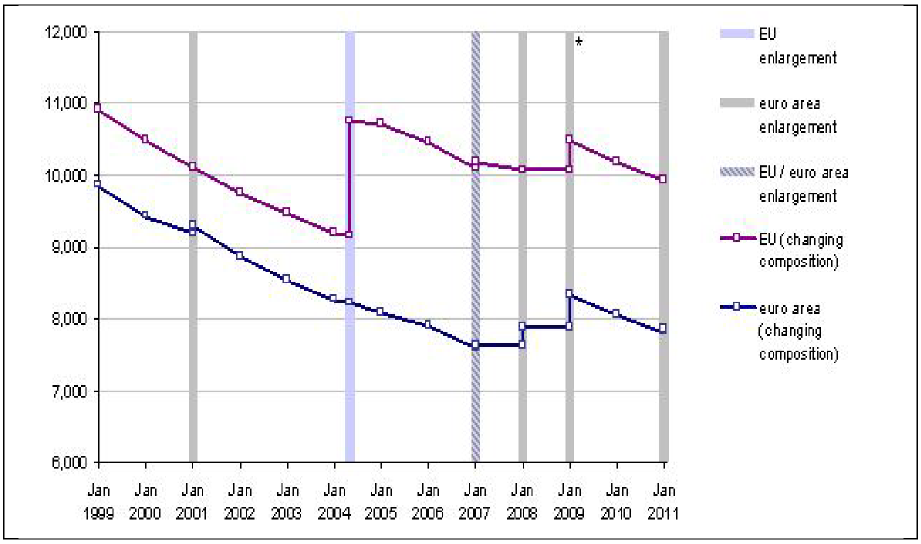
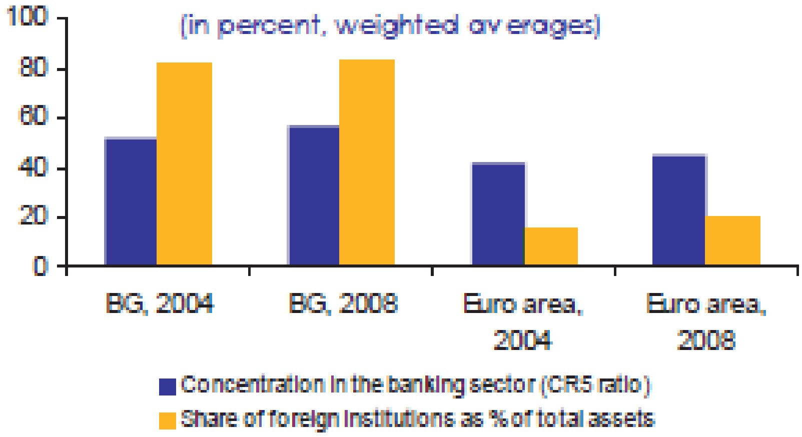


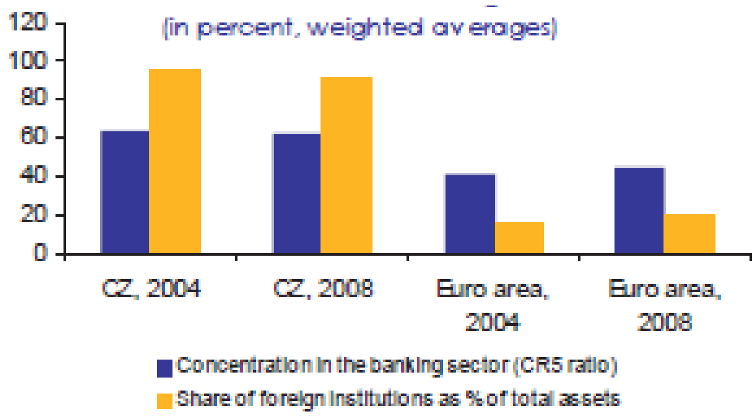
Figure 2

Concentration and Share of Foreign Institutions in the Banking Sector of Bulgaria, Romania and Czech Republic

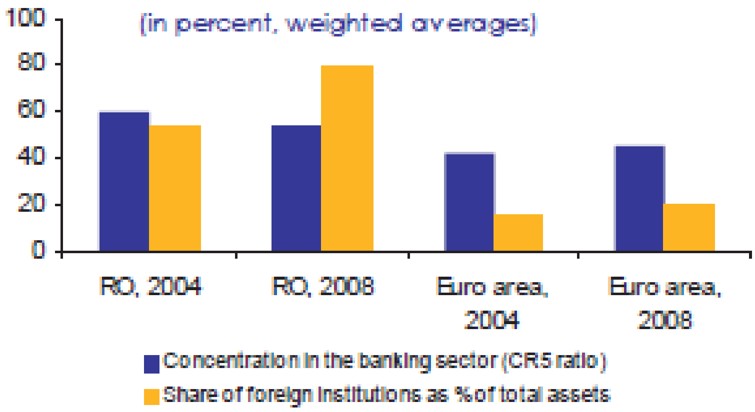


Source: ECB, Structural indicators for the EU banking sector, January 2010.

What is important is that 78% of the total M&A are done by institutions from the same country (Campa & Hernando, 2005, p.9). Over the last decade there has been no evidence of significant cross border deals in the EU suggesting that banks have prefered to consolidate their market position within the national borders. Certainly, this tendency has had its implications on the concentration in the banking sector. From 1997 to 2003 the banking sector experienced a 23% reduction in the number of banks operating in the EU which led to a moderate increase of the concentration on the European level. In Spain the level of concentration (C5) increased from 32% to 44%, in France from 40% to 47%, in Germany from 17 to 22%, and in Italy from 25% to 27% (Campa & Hernando, 2005, p.12).



Source: ECB, Structural indicators for the EU banking sector, January 2010.



Source: ECB, Structural indicators for the EU banking sector, January 2010.

According to Charles Movit the concentration in "new" EU countries (countries that became members in 2004) before there accession to the EU was higher than in the above-mentioned EU countries. (CR5 in Czech, Bulgaria and Romania in 2004 was higher than 60%) This is why accession to the EU didn't have a great impact on the concentration level. The other reason is that in the process of privatization European banks have already bought significant parts of their banking systems. So with their accession they already had a significant market share. The comparison between CR5 in 2004, when these countries became member states, and 2010 shows almost the same level of concentration (Figure 2). The level of concentration can only be changed by the consolidation at a global and European level. Because a dominant part of the banking sector is owned by foreign institutions, possible changes in consolidation of the parent company can have an influence on the concentration in these countries.

Level of Financial Intermediation in EU

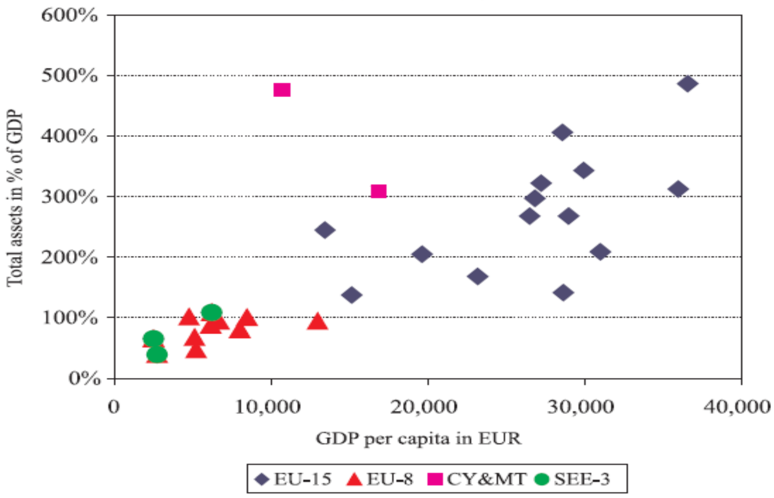
Financial intermediaries have an important role in spurring growth (Bagehot, p.873; Schumpeter, 1912). The empirical studies show that "there is positive relationship between financial intermediation and growth, which show that financial development is a good predictor of future growth" (King & Levine, 1993, p.20). These studies confirm the existence of a strong, positive contribution of the exogenous component of financial development to economic growth.

The level of financial intermediation can be measured with different indicators, and the proportion of total banking assets in GDP is considered the basic indicator. There is significant variation of this indicator in the 27 EU countries (Ribnikar & Kosak, 2006, p.3). Banking systems in the "old" EU countries with average total assets to GDP value of 272% clearly dominate new member states with 84%. According to Ribnikar and Kosak the explanation of these differences lies in the differences of the degree of economic development. Comparison between the degree of financial intermediation (total assets to GDP) and the degree of economic development (GDP per capita) of individual countries can confirm this relationship. On average, countries with higher GDP per capita experience higher total assets to GDP ratios. So major movements can not be expected in the level of financial intermediation because GDP per capita can't change over night, on the contrary these changes can happen only in medium or long term prospects (Figure 3).

The dependence between the level of development and financial intermediation can be confirmed if we analyze this ratio five years after the accession of the new EU countries in the Union. As can be seen from Figure 4 the level of financial intermediation is almost on the same level as from five years ago.

Figure 3

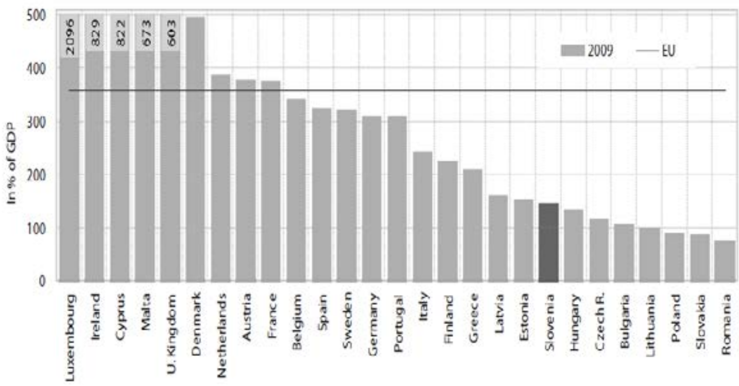
Total Banking Assets in % of GDP (vertical) vs. GDP per capita in EUR (horizontal) for Selected pool of EU member and Candidate Countries (2004 end of year data)



Source: Ribnikar, I. and Kosak, M. (2006). Development prospects of the banking industry in the new EU member countries and forthcoming member countries, Faculty of economics, Rijeka.

Figure 4

Total Assets of Banks in EU member States in 2009, as a % of GDP



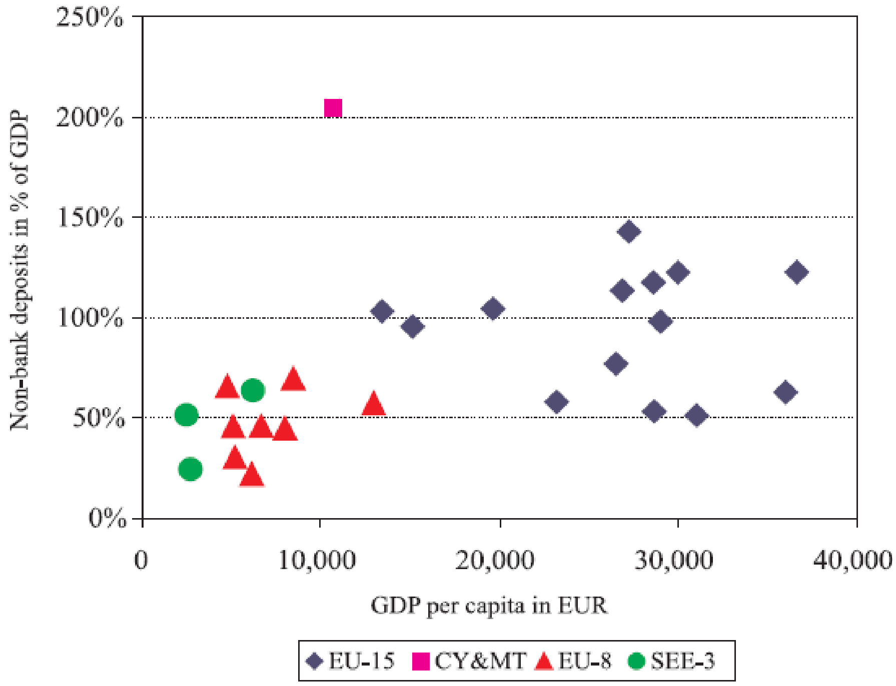
Source: European Central Bank. (2010). Financial stability report. ECB, Frankfurt.

Also higher deposit correlation is associated with higher economic and financial development as measured by GDP per capita, the amount of electricity use, the availability of explicit deposit insurance and better credit environment (World Bank, 2011, p.3). There are smaller differences between the “old” and “new” EU member states in the share of non-bank deposits in the GDP indicator compared to assets/GDP ratio (Figure 5). A pretty much straightforward explanation for the differences between the total assets/GDP indicator and non financial deposits/GDP indicator lies in the development characteristic of the modern financial systems. The market share of the non banking sector is increasingly rising, and those alternative ways of saving are the main force to decrease the share of deposits in total liabilities in the banking sector. Accordingly banks will be forced to switch gradually from predominantly deposit based funding to different types of market based funding, which means that they will need to compete for funds in the market. Low levels of deposits by non-banks (as a percentage of GDP) in the candidate countries for EU accession is “attributable to the low income level and, subsequently, the population’s low disposition to save there are various factors that might explain the low ratio of loans to non-banks to GDP” (Kager, 2002, p. 103):

- Bad loans. The yet unresolved problem of bad loans has inhibited loan expansion and/ or increased the risk aversion of banks.
- Legal and institutional factors. Inadequate collateral/mortgage provisions, insufficient law enforcement and/or slow enforcement of legal titles might also have played a role.
- Structural reasons on the demand side. Additional factors are foreign direct investment (FDI) and multinational enterprises direct financing.

Figure 5

Deposits from Non-bank Depositors in % of GDP (vertical) vs. GDP per capita in EUR (horizontal) for Selected Pool of EU Member and Candidate Countries (2004 data)



Source: Ribnikar, I. and Kosak, M. (2006). Development prospects of the banking industry in the new EU member countries and forthcoming member countries, Faculty of economics, Rijeka

Efficiency of the EU Banking System

In order to see if the accession to the EU has an impact on the efficiency of the banking system, using indicators, a comparison will be made of the efficiency of the banking system before and after entering the EU. For the efficiency of the banking system after entrance into the EU data for 2001 and 2008 will be used (Table 1 and Table 2) to abstract the impact of financial crisis.

According to Kager (2002, p.107) a comparison of the balance sheets of the 25 largest banks in Eastern Europe and of 18 large Western European banks produces a similar picture: Eastern banks profits, expenses and net income are significantly higher than those of comparable Western banks. Eastern European banks lower return on equity (ROE) is chiefly attributable to the fact that their balance sheet equity is many times higher than that of Western banks, i.e. Eastern European banks are less leveraged. Banking sector productivity (as measured by assets per employee) was relatively low in the new EU countries, with Poland reporting the lowest result at EUR 0.65 million. On average, banking sector productivity in the new EU countries in 2001 was EUR 0.93 million compared to an EU- average of EUR 8 million.

Table 1

Bank Profitability in Eastern Europe in 2001

	Return on equity	Interest income	Loan loss provisions	Cost/Income ratio	Net income	Equity	Total assets per employee
		% of average total assets					EUR milion
Poland	13.3	4.27	-1.09	63	1.11	8.2	0.653
Hungary	11.6	4.09	-0.58	66.1	1.04	9.4	1.194
Slovak Republic	6.6	3.74	0.66	107.7	0.56	7	1.814
Czech Republic	6.8	2.02	1.43	99.4	0.57	9.5	0.863
Slovenia	6.7	4.19	-1.27	55.3	0.68	9.9	1.413
18 Western European banks	18.6	1.6	0.2	69.5	0.7	3.9	8

Source: Marianne, K. (2002). *The Banking System in the Accession Countries on the Eve of EU Entry*, Bank Austria AG, Bank Austria AG, Vienna

Table 2

Bank Profitability in Eastern Europe in 2008

	Return on equity	Interest income	Cost/Income ratio	Net income	Equity	Total assets per employee
	% of net assets	% of average total assets				EUR milion
Poland	22.94%	3.21%	60%	1.90%	7.77%	3.88
Hungary	19%	4.60%	42.60%	1.50%	7.68%	2.96
Slovak Republic	13.90%	4.50%	56.10%	0.90%	8.50%	2.95
Czech Republic	21.60%	4.70%	40%	1.16%	7.20%	2.6
Slovenia	16.28%	3.79%	52.72%	1.36%	8.60%	2.86
Macedonia	12.50%	8.10%	62.20%	1.40%	11.50%	0.67

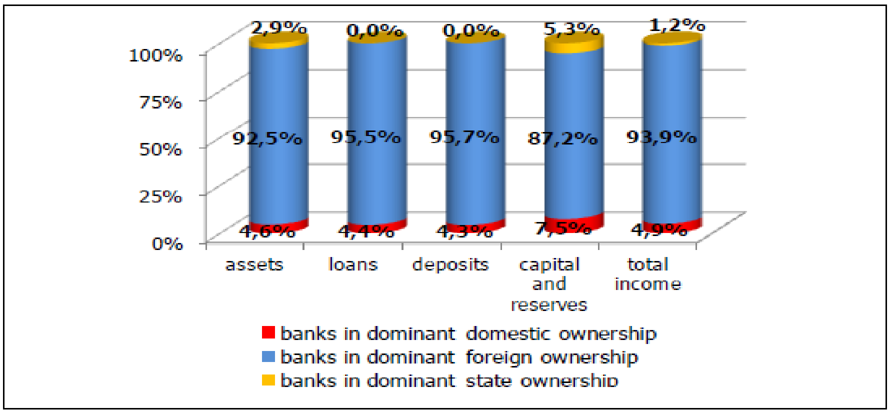
Source: Central banks for sample countries

Five years after the accession to EU (Table 2), banking systems of the new EU countries have improved their efficiency. The return on assets has increased and as a result of the increased leverage, the return on equity records multiplying. Banking operations are more efficient and the ratio of assets per employee increased for several times. Certainly, this is tightly connected with the increased lending activity after EU accession. Also the operational efficiency of the analyzed banking sectors has increase and the cost to income ratio in some countries is two times smaller.

Structure of the Banking System in the Republic of Macedonia

The banking system in the Republic of Macedonia at the end of 2011 is comprised of eighteen banks and eight savings houses (National Bank of The Republic of Macedonia, Report, 2011, p. 10) Thirteen of the total numbers of banks have foreign shareholders as dominant owners. Banks with a dominant foreign ownership have above an 87% share in the total capital of the Macedonian banking system and above 92% share in total assets (Figure 6). From the foreign owners, 78% are from EU member countries. This composition of the banking sector has been stable as of 2006.

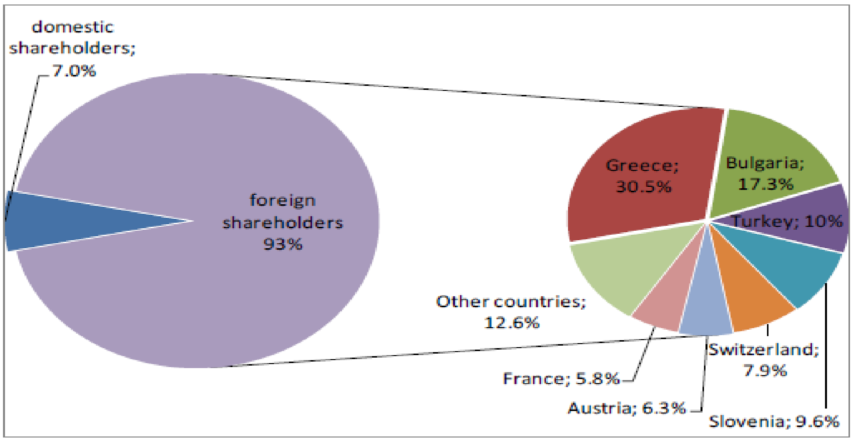
Figure 6.
The Structure of the Balance Sheet Positions According the Banks' Ownership on 30.06.2011



Source:National Bank of The Republic of Macedonia, (2011) Report on Banking System of the Republic of Macedonia in the second quarter of 2011, NBRM, Skopje

The analysis of the structure of the banking system by dominant shareholder points to Greece and Slovenia as well as foreign portfolio-investors as owners with a dominant share in the total assets of the banking system in the Republic of Macedonia. Thus EU countries are already dominant owners of the Macedonian banking system (Figure 7).

Figure 7.
Structure of Banks' Capital by Countries on 30.06.2011



Source:National Bank of The Republic of Macedonia, (2011) Report on Banking System of the Republic of Macedonia in the second quarter of 2011, NBRM, Skopje

Although Greek banks own more than 30% of the Macedonian banking system, the obligatory limit is exposure to the parent Greek banks to be maximum 10% of the bank capital. Also Macedonian banks don't have investments in Greek securities and the deposits are invested in Macedonian companies and citizens (Bogov, 2011, p.1) which make Macedonian banks resilient from the developments in Greece. The structure of the Banks' assets and liabilities indicates that the Macedonian banks' business model is traditional. The dominant banking activities are collecting deposits and granting loans. On the liabilities side as of December 31, 2011 the deposits of non-financial entities with 70% are a dominant source of financing (NBRM, 2012, p.23). The assets side is dominated by loans on non-financial entities whose share in the total assets is 55%. This kind of structure makes the

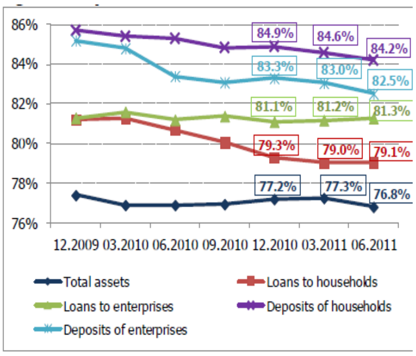
Macedonian banking sector resistant to direct influence of the world financial markets that was confirmed during the global financial crisis.

Concentration according to the CR5 ratio is high in all segments of banking activities, being highest in household deposits, and lowest in total assets. There aren't any big movements in the concentration level. The five largest banks as of June 30, 2011 occupy over 75% of all segments of banks' operations. The market share of individual banks is stable. However, in thirteen out of seventeen banks the individual share in the total assets of the banking system is less than 5%, whereas in eleven of them it is below 3%. In contrast, only in three banks the individual share in the total assets of the banking system is greater than 19%.

The analysis of the capital adequacy ratio by individual banks (Figure 10) shows that big banks are constrained in their credit growth from their capital. The market distress leads to circumstances where it is difficult to ensure their recapitalization which leaves space for credit growth amidst the smaller banks.

Figure 8.

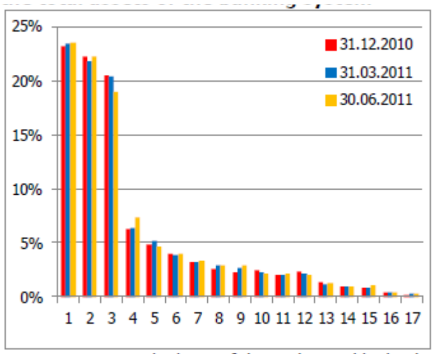
Dynamics of the CR5 Ratio



Source: NBRM, on the basis of data submitted by banks.

Figure 9.

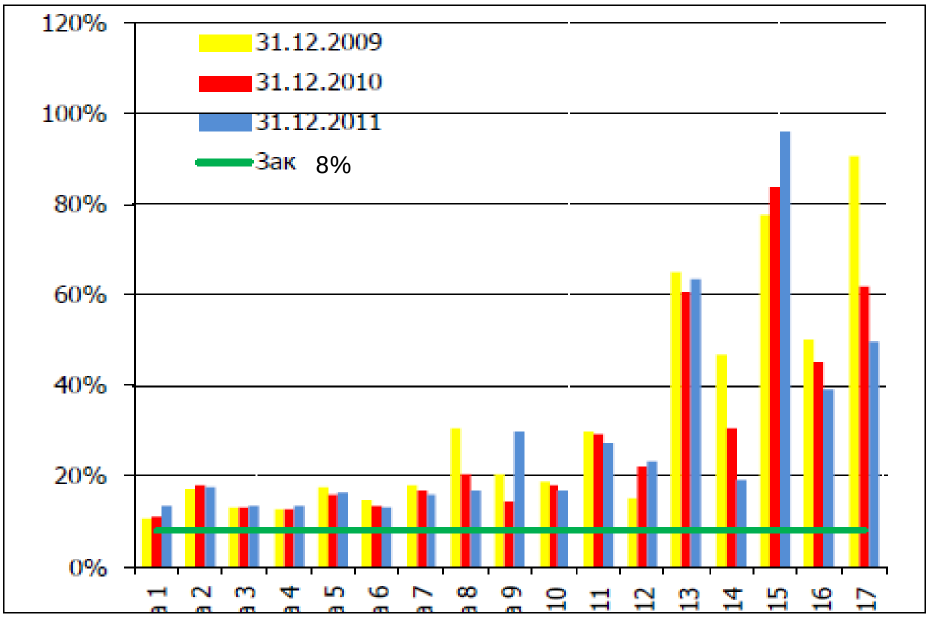
Market Share of Individual Banks in the Total Assets of the Banking System



Source: NBRM, on the basis of data submitted by banks.

Considering the current concentration in the banking system, the EU accession, like in the other east European countries probably won't have an impact on the structure of the banking system. With three main competitors that hold more than 65% of the market, the biggest three banks are market leaders and there isn't a place for further increase of the concentration. This practically oligopoly structure has a strong influence on the pricing of the banking activities. Considering the current structure of the banking system, a relatively high concentration and relatively large number of banks, there is need for consolidation of the banking system through acquisitions and /or mergers in the segment to other banks and thereby creating larger banks, which will increase the level of competition and contribute to reducing interest rates and spreads.

Figure 10
Capital adequacy ratio by individual bank



Source: National Bank of The Republic of Macedonia, (2012) Report on Banking System of the Republic of Macedonia for 2011, NBRM, Skopje

Level of Financial Intermediation in Macedonia

The banking system has a dominant role in the financial system of the Republic of Macedonia. This is why the impact from accession of the country in the EU on the financial system will be most felt in the banking system. With a 90% share in the total assets of the whole financial system, the banking system has a dominant role in financial intermediation. Until 2008, when the Macedonian economy and the banking sector were influenced by the world financial crises, there was a continual trend of strengthening the role on the banking sector as a financial intermediary.

Table 3

Structure of Total Assets of the Financial System of the Republic of Macedonia

Structure of total assets of the financial system of the Republic of Macedonia						
	2005	**2006**	**2007**	**2008**	**2009**	**2010**
Depository financial institutions	**90%**	**90.%**	**91%**	**90%**	**90%**	**90%**
Banks	88%	88%	90%	89%	88%	89%
Saving houses	2%	2%	1%	1%	2%	1%
Non depository financial institutions	**10%**	**10%**	**9%**	**10%**	**10%**	**10%**

Source:National Bank of The Republic of Macedonia, (2011) Report on Banking System of the Republic of Macedonia in the second quarter of 2011, NBRM, Skopje

Despite the positive movements, the financial intermediation in the Republic of Macedonia is still on the lowest level relative to some countries from the European Union, the EU average and the Euro zone average (Table 4). This is another confirmation that the level of financial intermediation is determined by the level of development. According to GDP per capita and the level of financial intermediation, on Figure 10 Macedonia is placed on the bottom. The accession to the EU in medium term won't change the level of financial intermediation, like it didn't have impact on financial intermediation in "new" EU countries.

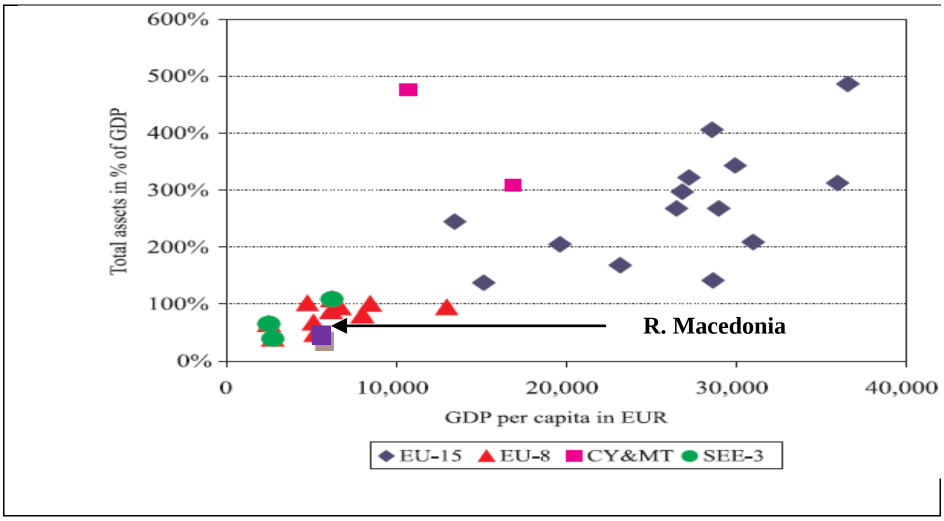
Table 4
Level of financial intermediation in the banking system of R.M.

Country	Assets/GDP	Loans/GDP
Romania	75%	43%
Poland	88%	57%
Lithuania	98%	72%
Slovakia	86%	49%
Hungary	136%	79%
Bulgaria	112%	78%
Czech rep.	117%	58%
Slovenia	153%	102%
Estonia	155%	114%
Latvia	161%	70%
Cyprus	822%	341%
Malta	721%	373%
EU	334%	141%
R.Macedonia	72%	44%

Source: National Bank of The Republic of Macedonia, (2011) Report on Banking System of the Republic of Macedonia in the second quarter of 2011, NBRM, Skopje

That trend continued in 2009 and 2010 but with smaller speed. The banking sector has a crucial role in the financial system through channelling on the financial resources to the deficient economic agents.

Figure 10
Total Banking Assets in % of GDP (vertical) vs. GDP per capita in EUR (Horizontal) for Selected Pool of EU Member, Candidate Countries and R.Macedonia



Source: Ribnikar, I. and Kosak, M. (2006). Development prospects of the banking industry in the new EU member countries and forthcoming member countries, Faculty of economics, Rijeka

Efficiency of the Macedonian Banking System

As can be seen in table 2, the efficiency of Macedonian banks is smaller than in new EU countries and far smaller than the EU average. The return on equity is smaller than the EU average which is due to the small leverage and the high adequacy ratio. Also the Macedonian banking sector although it has a higher interest margin, yet the operating efficiency is poorer. The asset per employee ratio is on a 2000 level in Poland or Czech Republic and there is still room for enhancement of the operational efficiency through improvement of this ratio. The operational efficiency can be further improved which will result in a decline of the cost to income ratio.

The banking system is a mirror to the real economy and every recession is imperceptible in the financial world with a certain time lag. Best evidence for the condition in the economy is the level of non performing loans. As can be seen from table 5, if we analyze the NPL to total loans ratio until 2008, accession to EU had an influence on the decrease of this ratio. There are three main reasons: high credit growth, GDP growth and restructured banking system with EU owners. This trend further increased the efficiency of the banking system in “new” EU countries.

If we compare the NPL level in 2008, before the financial crises, the Macedonian banking system has the biggest NPL share from all selected countries. This implies that on that point the Macedonian banking system was less efficient than the banking system of the “new” EU countries. Stated otherwise, from a 1 euro loan the loss on the Macedonian banks was bigger. But, the financial crises also showed that although EU accession of the “new” EU countries had a positive impact on the non performing portfolio, i.e. their banking system is more vulnerable to financial crises. The non performing ratio in almost all “new” EU countries is above the EU average. The conclusion that follows is that as a result of the new funding sources and GDP growth the accession to the EU has an effect on increasing the efficiency of the banking system.

Table 5

Bank Non- Performing Loans to Total Loans

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Euro area	2.6	2.6	3	2.8	2.45	2.25	2.1	1.8	2.5	3.6	5.55
European Union	3.8	2.8	2.9	2.6	2.25	2.1	1.95	1.8	2.7	5.15	6.8
Austria	2.4	2.3	3	3	2.7	2.6	2.7	2.2	2	2.3	
Bulgaria	17.3	3.3	2.6	3.2	2	2.2	2.2	2.1	2.5	6.4	7.8
Czech Republic	29.3	13.7	8.1	4.9	4	3.9	3.7	2.8	2.8	4.6	4.9
Estonia	1	1.3	0.8	0.4	0.3	0.2	0.2	0.4	1.9	5.2	5.6
France	5	5	4.2	4.8	4.2	3.5	3	2.7	2.8	3.6	
Germany	4.7	4.6	5	5.2	4.9	4	3.4	2.6	2.8	3.3	
Greece	12.3	5.6	5.5	7	7	6.3	5.4	4.5	5	7.7	9
Hungary	3	2.7	2.9	2.6	2.7	2.3	2.6	2.3	3	6.7	7.8
Italy	7.8	6.7	6.5	6.7	6.6	5.3	4.9	4.6	4.9	7	
Latvia	4.6	2.8	2	1.4	1.1	0.7	0.5	0.8	3.6	16.4	17.9
Lithuania	11.3	6.7	5.3	2.4	2.2	0.6	1	1	4.6	19.3	19.2
Luxembourg	0.5	0.4	0.4	0.5	0.3	0.2	0.1	0.2	1	1.3	0.5
Macedonia			23.1	22.4	17	15	11.2	7.5	6.8	8.9	9.9
Poland	15.5		21.1	21.2	14.9	11	7.4	5.2	4.5	7.6	
Portugal	2.2	2.1	2.3	2.4	2	1.5	1.3	1.5	2	3.2	3.3
Romania		3.3		8.3	8.1	2.6	2.8	4	6.5	15.3	17.5
Slovak Republic	13.7	11.1	7.9	3.7	2.6	5	3.2	2.5	2.5	5.3	5.8
Slovenia	6.5	7	7	3.7	3	2.5	2.5	1.8	1.8	2.3	2.5
Spain	1.2	0.9	1.1	1	0.8	0.8	0.7	0.9	3.4	5.1	5.5
United Kingdom	2.5	2.6	2.6	2.5	1.9	1	0.9	0.9	1.6	3.5	

Source: World Bank data,
http://data.worldbank.org/indicator/FB.AST.NPER.ZS.

As it was mentioned earlier the financial intermediation in the Republic of Macedonia is still on the lowest level relative to EU members if we use Loans to GDP ratio. This also has effects on the efficiency of the whole financial system and the banking system as a part of it. If we use the Deposit/GDP as an indicator for financial intermediation the Macedonian banking sector has a better position than the comparison with Loans to GDP ratio. This is due to more developed other parts of the financial system apart from the banking system which creates possibilities for further development of the non banking financial activities in Macedonia.

Conclusion

The banking system in Macedonia will face many new conditions, requirements and challenges of the EU-market. The competition from banking and non banking financial institutions is expected to increase. This will emphasize the need for innovations among the traditional banking products that banks offer now and creation of new banking products will gradually replace a part of traditional products.

Regarding the process of consolidation that is present in the EU, the level of concentration in the Macedonian banking sector is high. With three main competitors that hold more than 65% of the market, the biggest three banks are market leaders and there isn't place for further increase of the concentration. However, consolidation can be expected of the small and medium banks in order to survive the domestic oligopoly structure and the new foreign competition.

Dramatic changes in the level of financial intermediation can not be expected. This variable depends on the level of economic development and the empirical examples show that the accession to the EU hasn't had an impact on financial intermediation in "new" EU countries. Further improvement can be expected in the efficiency of the banking systems. These two trends will decrease the interest margin and interest rates. Finally, the accession to the EU will require restructuring and reorganization of the economy as a whole, and the banks will be part of that process.

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