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Foreign Direct Investment In The Banking Sector In New EU Member States: Social Responsibility Of Banks

Abstract

This paper discusses the performance and strategies of banks with foreign participation in the new EU Member States and their attitudes towards so-called 'socially responsible finance'. The banking sector in the analyzed countries (Czech Republic, Poland and Slovakia) is dominated by foreign capital. The global financial crisis caused a decrease in new annual FDI inflows into the financial intermediation and banking sector of these countries. Some disinvestment occurred in Slovakia and Poland. The foreign-owned banks already operating in the analyzed countries undertook some organizational and financial adjustments to the global economic crisis that allowed them to secure their own position in recipient countries. They are involved in socially responsible activities in the field of culture, sport, environmental protection etc. As trust-based financial institutions. they also showed a kind of responsibility in the field of finance when the crisis occurred.

Keywords: *Foreign direct investment, banking sector, social responsibility, the New EU Member States*

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1. Introduction

Theoretical discussion of the role of foreign direct investment in less developed host countries points out both positive and negative potential effects of its involvement in the banking sectors of these countries. The new EU Member States are in a situation of foreign capital dominance in their banking sectors, a consequence of privatization strategies within the systemic transformation processes which took place in these countries. The behavior of banks with foreign capital participation was of crucial importance for these economies during the global financial crisis.

The aim of the paper is to examine and evaluate the performance and strategies of banks with foreign participation in the new EU Member States and their attitudes towards so-called 'socially responsible finance'. The more detailed tasks of the paper are as follows:

- to present theoretical aspects of foreign investors' activities in the banking sectors of recipient countries,
- to present the transformation of the banking sector in the selected New EU Member States during the pre-and post-accession period,
- to analyze the scale of involvement and performance of foreign-owned banks in the new EU Member States,
- to examine the reaction of foreign investors in the financial intermediation/banking sector in the new EU Member States to the global financial crisis,
- to discuss the social responsibility of a banking sector, using the case of Poland.

The geographical scope of the analysis will be limited primarily to three countries, i.e. the Czech Republic, Poland and Slovakia. It will include also the case of Hungary to the extent data is available. This limited scope is justified by the access to data bases.

2.Theoretical aspects of the financial behavior of TNCs

The issue of foreign investors' activities in the banking sectors of recipient countries should be seen in the broader context of the financial behavior of transnational corporations (TNCs).

The main observations related to this issue are as follows (UNCTAD 1999, pp.158 -173):

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- Transnational corporations (TNCs) doing business abroad use a wide variety of internal and external financial sources. One of possibilities at their disposal is taking loans from banks in both host and home countries. TNCs are able to borrow on international financial markets at low spreads.
- The relationship between a parent company (TNC) and its foreign affiliates in the area of financial matters is strongly centralized. Affiliates are usually not autonomous when it comes to taking decisions about the choice of financial sources and strategies.
- According to the financial strategies of a parent company, affiliates can raise funds through bonds, loans etc. from sources external to their corporate system, including both the domestic markets of host countries and international markets.
- TNCs can easily outcompete domestic firms in host-country financial markets.

Financial strategies implemented by TNCs directly and indirectly affect domestic investment in host countries. Direct positive effects occur when TNCs raise the investment rate and expand the stock of capital located in a host country (UNCTAD 1999a, p.31). The scale of this impact depends on the sources of funds and entry modes (greenfield investment versus M&A). Apart from this, TNCs can bring about some indirect effects, i.e.: either crowding out or crowding in domestic investment.

TNCs can crowd out domestic investment by raising funds on the financial markets of host countries. As financial resources are scarce, their behavior causes a rise in domestic interest rates and borrowing may be unaffordable for some domestic firms. Crowding out can take place regardless of the industry and can have an adverse impact on total investment in the host country (UNCTAD 1999, pp.171-174).

Large inflows of FDI may lead to an appreciation of the exchange rate, affecting the competitiveness of exports from the host country. This can discourage investment into export markets. Exchange rate appreciation through FDI inflows encourages domestic consumption, which in turn diminishes domestic savings (UNCTAD 1999a, p.31-32).

Crowding in effects occur when investments made by foreign investors stimulate new investment in downstream or upstream production by other foreign or domestic entrepreneurs, or increases the efficiency of financial intermediation. The final impact of FDI inflows on the domestic investment rate depends on both the direct and indirect effects mentioned above.

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3. Crowding out and crowding in effects and foreign investors' activities in the banking sector of recipient countries

The problem of crowding out seems to be even more serious in situations where foreign investors are dominant players in the domestic banking sector in host countries. On the one hand, banks with foreign capital participation can limit the access of smaller domestic firms to credit transactions. The lending strategies of such banks could be oriented on less risky businesses, i.e. large enterprises, firms with foreign capital shares, firms originating from their home countries. Domestic SMEs could thus face strong financial barriers to their development (UNCTAD 1999a, p. 38, Thorne 1993).

On the other hand, the entry of foreign investors into a banking sector may improve an underdeveloped domestic financial sector, especially in countries transforming their economies from centrally-planned to market systems. Competition within the banking sector could bring benefits for domestic firms. The improvement of financial intermediation services should increase the availability of credit to domestic firms. However, foreign–owned banks in transforming economies can also overuse their special position in these countries and behave as typical dominating entities in industrial branches (Witkowska 1996). In a crisis situation, foreign–owned banks might adjust to the global strategies of parent banks rather than to needs of recipient countries (Jaworski 2000).

It is difficult to predict the net result of the impact of these contradictory factors. However, a statistical analysis could help answer some questions related to this issue.

4. The transformation of the banking sector in the new EU Member States in the pre- and post-accession periods

The EU treats banking services as part of the Single European Market. The main provisions relating to the banking sector include the introduction of a single banking license and the harmonization of deposit guarantees. The Single European Market was completed at the beginning of the 1990s, at the same time candidates for EU membership started reforming their banking sectors. The East-European countries introduced fundamental changes into their banking sectors, i.e.:

- Two-tier banking systems, consisting of central banks and commercial banks,
- Banking supervision systems and prudential rules,
- Guarantees for depositors.

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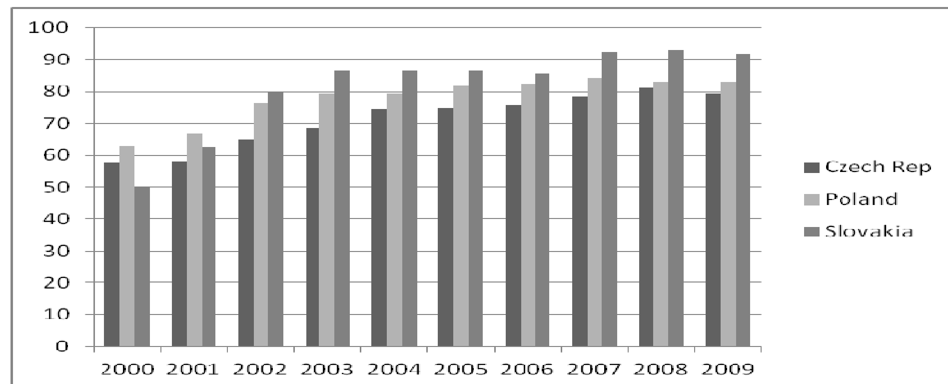
At that time there was an unsettled controversy about the proper scale of foreign capital involvement in the domestic banking sectors of transition economies, and its proper role in their functioning and development. During the pre-accession period the analyzed countries decided to open their banking sectors to foreign capital to such an extent that foreign–owned banks gained a dominant position. This is confirmed by data on the shares of foreign-owned banks in:

- the total number of commercial banks in these countries,
- the total financial assets of commercial banks,
- the total number of employees in commercial banks.

The share of foreign-owned banks in the total number of commercial banks in the analyzed countries grew during 2000-2009. The most spectacular processes of expansion of foreign investors in a banking sector and consolidation were observed in Slovakia, where 18 banks operated in 2000, of which 9 were foreign-owned banks, i.e. 50%. In 2009 only 12 banks functioned, of which 11 belonged to foreign investors, i.e. 92%. In Poland this same share grew from 63% in 2000 to 83% in 2009 and in the Czech Republic from about 57.5 to 79.5% respectively[1]. (There is no data for Hungary). (See Graph No 1).

Graph 1. The shares of foreign-owned banks in the total number of commercial banks in the Czech Republic[a)], Poland and Slovakia, 2000-2009, in %



a) In the case of the Czech Republic the share was calculated as a percentage of the total number of the other monetary institutions.

Source: OECD data base and own calculations.

The foreign–owned banks have a predominant position, as measured by their shares in the total financial assets of commercial banks in the analyzed

[1] In the case of the Czech Republic the share was calculated as a percentage of the total number of the other monetary institutions.

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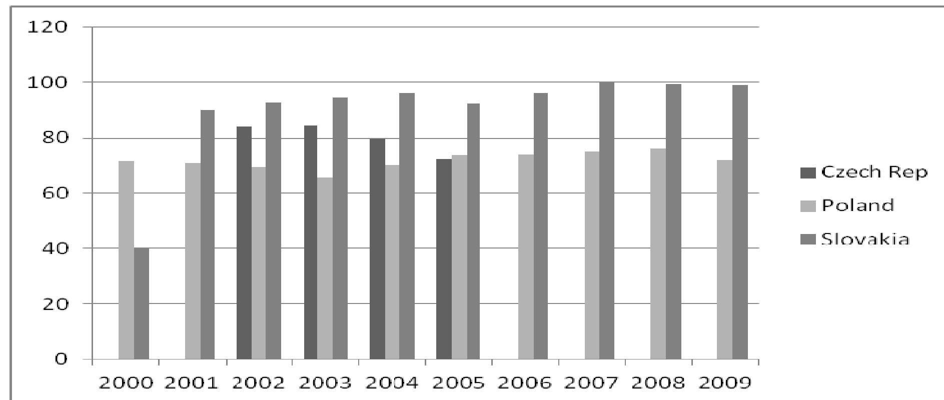
countries. These shares ranged from 70% in Poland to 99% in Slovakia in years 2004-2009 (OECD and own calculations - see Graph 2). They accounted for the similar shares in the levels of employment in the banking sector as well (see Graph No 3).

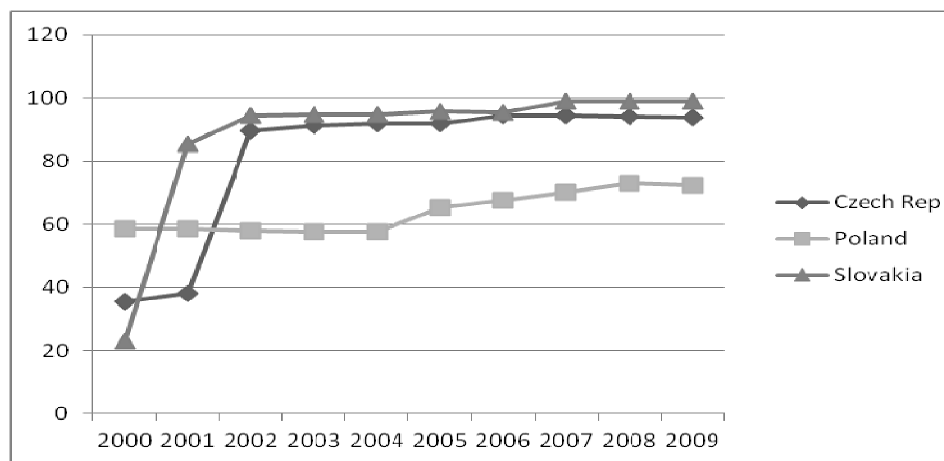
Graph 2. The shares of foreign-owned banks in the total financial assets of commercial banks in the Czech Republic[a)], Poland and Slovakia, 2000-2009, %



a) In the case of the Czech Republic the share was calculated as a percentage of the total financial assets of the other monetary institutions.

Source: OECD data base and own calculations.

Graph 3. Shares of foreign-owned banks in the total employment in commercial banks in the Czech Republic[a)], Poland and Slovakia, 2000-2009, %



a) In the case of the Czech Republic the share was calculated as a percentage of the total employment in the other monetary institutions.

Source: OECD data base and own presentation.

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5. The involvement of foreign investors into financial intermediation/ banking services in the context of their overall activities in the new EU Member States

The most important change in the branch structure of FDI inward stock in the analyzed countries was a shift towards services. The share of FDI stocks located in services in total FDI stocks ranged, in 2011, from about 48% in Slovakia, 53% in the Czech Republic, 57% in Poland to 75% in Hungary (OECD 2013 and own calculations). At the same time, foreign investors increased their involvement in modern services, i.e. in financial intermediation, real estate, renting and business activities.

Over 20% of the total FDI stocks was located in financial intermediation in Poland, the Czech Republic and Slovakia in 2011. Hungary was an exception, with the same share totaling 7.5%. FDI stocks located in the banking sector amounted to about 17-18% of the total inward FDI stocks in Poland, the Czech Republic and Slovakia. Again, in the case of Hungary this share amounted to only 6% (OECD 2013 and own calculations).

Financial intermediation/banking services are of growing importance for foreign investors in the new EU Member States, constituting about one-fifth of their total involvement in these countries.

6. The reaction of foreign investors in the financial intermediation/banking sectors in the new EU Member States to the global financial crisis

The global financial crisis caused some changes in the annual FDI inflows into the financial intermediation and banking sectors in the analyzed countries, as well as changes in the activities of foreign–owned banks already operating in this area.

All the analyzed countries experienced a decrease in annual FDI inflows into financial intermediation in years 2009-2010 (see Graph 4). The global situation did not encourage investors to invest in this sector. In the case of Slovakia and Poland even disinvestment occurred. FDI inflows into the banking sector diminished as well. A radical decrease in these inflows was observed once again in the cases of Poland and Slovakia (see Graph 5).

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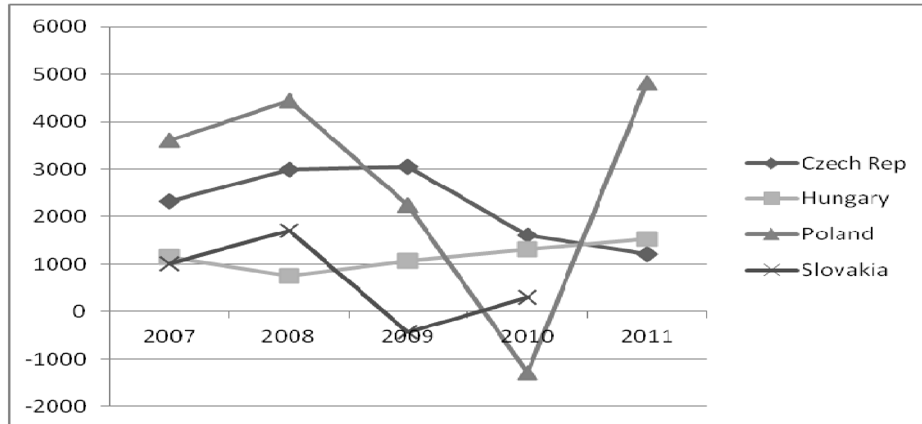
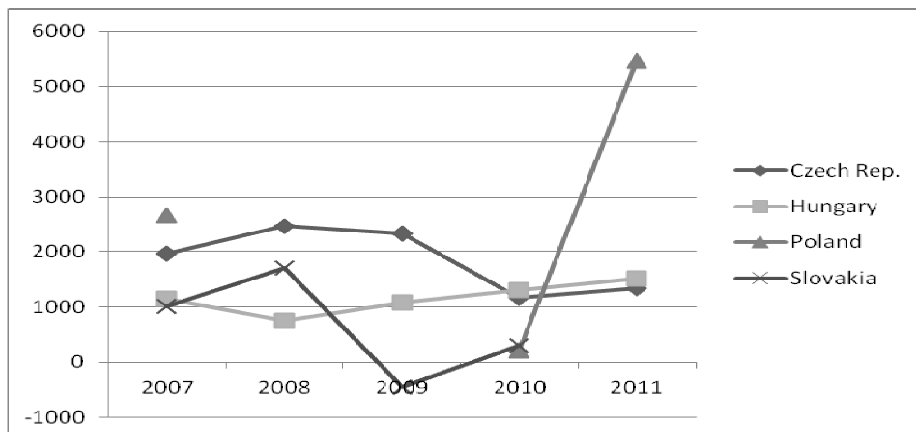
Graph 4. FDI inflows into the financial intermediation sector in the new EU Member States, 2007-2011, USD Million



Source OECD Data base and own presentation.

Graph 5. FDI inflows into the banking sector in the new EU Member States, 2007-2011, USD Million



Source OECD Data base and own presentation.

In turn, foreign-owned banks in these countries undertook some adjustments to the new situation. Some reductions in the number of banks, their branches, and employees were observed in 2008-2009. In Slovakia two foreign-owned banks and 57 branches were liquidated or consolidated, and employment in these banks decreased by two thousand jobs. In Poland there were two fewer foreign-owned banks in 2009 in comparison to the previous year, but 395 more branches. At the same time the reduction of employment in foreign-owned

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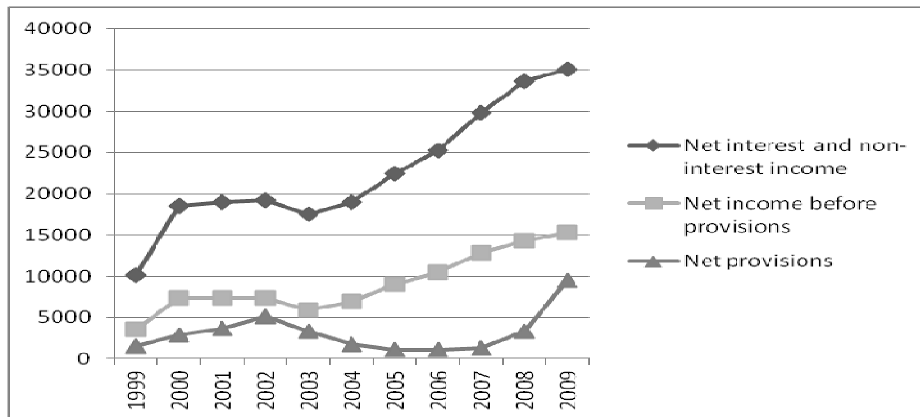
banks amounted to about 6,500 jobs (OECD data base and own calculations). (There is lack of data on Hungary and the Czech Republic).

The crisis in the global economy has also had an impact on the financial situation of foreign-owned banks, which can be examined in the case of Poland. The analysis of their income statements and balance sheets (OECD data base and own calculations - see Graphs 6-8) shows that:

- in years 1999-2009 the net interest and non-interest income of the foreign-owned banks – as a total sum – was positive and growing (except for the year 2003) as well as the net income before provisions (except the years 2002-2003). The net interest and non-interest income increased 3.5 times in the years 1999-2009, operating expenses grew by three times, and the net income before provisions - 4.3 times, respectively.
- the net provisions changed over the analyzed period, growing rapidly in 2009 when they increased as much as three times in comparison to the previous year
- the income before tax increased systematically from 2002 to 2007, but diminished in 2008-2009 because of growing provisions on loans
- the net income after tax in 2009 was influenced to a great extent by the increase in provisions on loans. While the income tax showed a decreasing trend, the foreign-owned banks drastically limited their distributed profits in years 2008-2009; in 2008 they amounted to only 2% of the net income after tax, and rose to only 30% in 2009.

Graph 6. The financial situation of foreign-owned banks in Poland - income statements, 1999-2009, PLN Million



Source: OECD Data and own elaboration.

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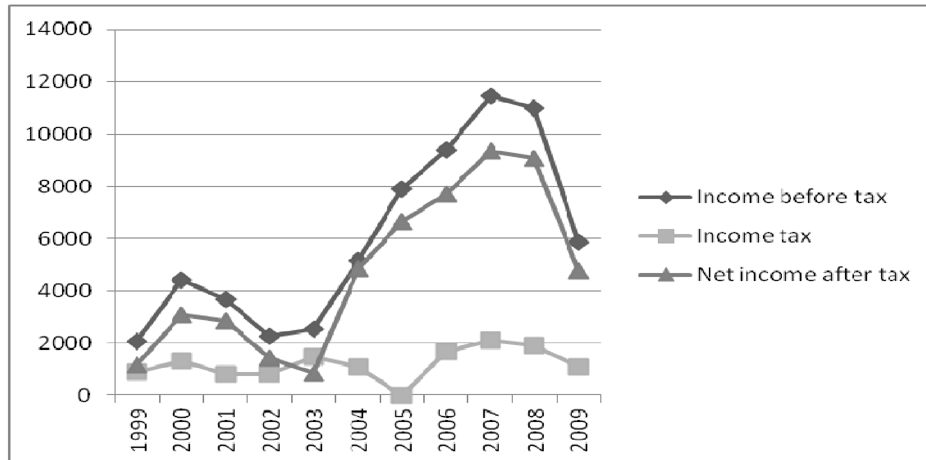
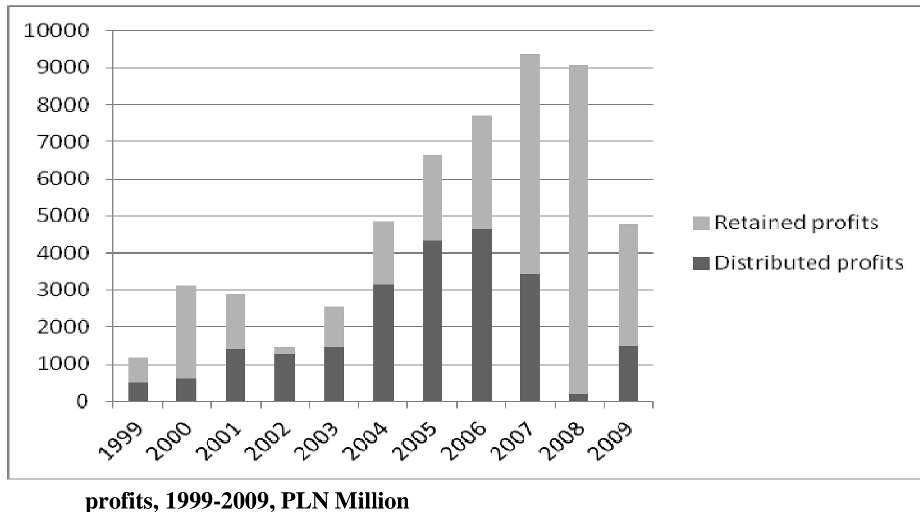
Graph 7. The financial situation of foreign-owned banks in Poland- income before and after tax, income tax, 1999-2009, PLN Million



Source: OECD Data and own elaboration.

Graph 8. The financial situation of foreign-owned banks in Poland, retained and distributed



profits, 1999-2009, PLN Million

Source: OECD Data and own elaboration.

These data seem to confirm that foreign-owned banks, faced with a crisis situation in the global economy, introduced some financial precautions that were much more serious than organizational adjustments. One can suppose that they adjusted to the global strategies of their parent companies rather than to the

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situation in Poland, which did not experience a collapse in economic growth during that time.

This statistical analysis does not allow for confirmation of the crowding out and crowding in processes in the Polish economy. Two periods, i.e. 2002-2003 and 2009, were characterized by a decreasing amount of both interest income and expenses, which would suggest that credit operations were not extended or were even restricted during these times. Having in mind that SMEs complain about facing financial barriers, we can suppose that some crowding out processes may have occurred. It is worth noting that the reference interest rates of NBP (National Bank of Poland) were decreasing during these periods (NBP 2013).

7. Social responsibility of foreign-owned banks – the case of Poland

The Corporate Social Responsibility (CSR) of banks has two dimensions. On the one hand banks are trust-based financial institutions (Baker, Nofsinger 2012, Łukasiewicz-Kamińska 2011). Stakeholders expect that banks will observe banking laws and applicable ethical norms, introduce good banking practices, avoid useless risks, and maintain responsible lending standards. On the other hand banks are treated as typical corporations, aiming at maximization of profit/shareholders' welfare. Banks as corporations can also be socially responsible in a more traditional way (environmental responsibility, responsibility towards workers, local societies etc.)

Foreign-owned banks in the new EU Member States implement CSR practices typical of other corporations (see, for example, the CSR practices of Bank Pekao S.A. in Box I below). They use sponsorship and patronage for achieving marketing goals. The question arises if they are responsible as trust–based institutions in the field of finance, as broadly understood. The case of Poland shows that foreign-owned banks should be treated in a formal sense as responsible. They took special financial precautions in the face of a potentially difficult situation in the banking sector in Poland during the crisis, i.e. higher net provisions, higher proportion of retained profits. However, they used financial sources to solve problems arising elsewhere as a result of imprudent activities or predatory lending. These special measures were used at the cost of local stakeholders: local firms – less availability of credit; workers – job reductions; shareholders – retained profits; the central budget – moderate tax payments; local societies – less engagement in social issues.

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Box I: CSR practices of Bank Pekao SA

Bank Polska Kasa Opieki (Pekao) SA was founded as a commercial bank in 1927 by three state financial institutions. Before World War II its aim was to serve Polish migrants, hence it established foreign affiliates in France, Argentina, Tel Aviv and the USA. After World War II the State Treasury took over the majority of its assets. At the beginning of the systemic transformation the Bank reoriented its activity from exchange operations towards universal banking operations. In the mid-90s the government decided to consolidate some banks and established the banking group Pekao SA, which also included three smaller banks.

The privatization of the group started through Warsaw Stock Exchange in 1998. In 1999 the State Treasury sold 52.09% of shares to the Italian-German consortium of UniCredito Italiano S.p.A and Allianz AG. As a result of further consolidation of the group UniCredit with the Bank HVB, Bank Pekao SA took over part of the Bank BPH SA in 2007. In 2008 the UniCredito Italiano SPA accounted for 59.28% votes in GAM. Assets of the group amounted to EUR 1045.6 billion in 2012.

Bank Pekao SA is actively involved in **traditional CSR activities** such as sponsorship and patronage. The major fields of these activities are:

- 'high culture' – support for music festivals, operas, museums, theaters, the Polish PEN Club, and young artists
- sport – support of UEFA EURO 2012
- environmental protection – support for protection of endangered species like European bison
- social actions

Bank of Pekao SA established its own charitable foundation (Dr M. Kanton Foundation). The appreciation of the Bank's involvement in CSR is reflected in the prizes that it has been awarded, for example *The Patron of the Arts in 2011*, awarded by the Ministry of Culture and National Heritage.

Social responsibility of the Bank in the financial area could be judged by its behavior during the financial crisis. Dividends paid by the Bank increased 2.5 times in years 2001-2007 and amounted to 9.6 PLN per share in 2007. The total amount of dividends reached a record level of PLN 2.5 billion, which was equal to 125 % of the profit achieved in 2007. This caused a controversy over the rules and practices concerning transfer of profits abroad, as payment of dividends is the only legal way to transfer profits abroad. The behavior of the Bank was interpreted as an element of a supporting strategy for the parent company, i.e. the Italian company, by its foreign affiliate. The case was examined by the Commission for Financial Supervision. In 2008, dividends were not paid and in 2009 amounted to only 2.9 PLN per share, which totaled PLN 0.7 billion.

Sources: Historia banku Pekao SA, http://www.pekao.com.pl/print/?r.main,docId=18162&r; Społeczne zaangażowanie banku,

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8. Conclusions

1. FDI may have an adverse effect on the investment rate in a host country and its development if the financial behavior of foreign investors leads to a situation when crowding out processes are stronger than crowding in ones. The dominance of foreign capital in banking sectors of recipient countries can increase crowding out effects in their economies. However, an improvement of financial intermediation through the presence of foreign capital may occur in these countries, having a positive impact in terms of better access to financial funds for domestic firms.
2. The new EU Member States opened their banking sectors to foreign investors through privatization processes in the pre-accession period. The banking sector underwent ownership transformation, and as a result foreign investors gained a dominant position. The controversy over this issue still remains unsettled.
3. Financial intermediation/banking services constitute one-fifth of the sector/branch structure of FDI inward stocks in the new EU Member States analyzed (except Hungary). These services are of growing importance for foreign investors. However, the global financial crisis brought about a decrease in annual FDI inflows into the financial intermediation and banking sector in the new EU Member States. Some disinvestment occurred in Slovakia and Poland.
4. The foreign-owned banks already operating in the analyzed countries undertook some organizational and financial adjustments to the global economic crisis, which allowed them not only to secure their own position in recipient countries but also to help their parent companies (in the case of some banks in Poland).
5. Although the statistical analysis does not allow for confirmation of the above-mentioned crowding out and crowding in processes in recipient

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countries, the decrease in interest income and expenses of foreign-owned banks in the crisis years might be connected with their lower propensity to offer loans. Domestic firms, especially SMEs, might suffer from the implementation of such lending strategies.

6. Foreign-owned banks in the new EU Member States are involved in socially responsible activities in the fields of culture, sport, environmental protection etc. As trust-based financial institutions they also showed a kind of responsibility in the field of finance when the crisis occurred. However, these aspects require further research.

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Streszczenie

BEZPOŚREDNIE INWESTCYJE ZAGRANICZNE W SEKTORZE BANKOWYM NOWYCH KRAJÓW CZŁONKOWSKICH UNII EUROPEJSKIEJ: SPOŁECZNA ODPOWIEDZIALNOŚĆ BANKÓW

Przedmiotem artykułu jest ocena stanu i strategii banków z udziałem kapitału zagranicznego w nowych krajach członkowskich UE oraz ich podejścia do kwestii tzw. „społecznie odpowiedzialnych finansów". Sektor bankowy w analizowanych krajach (Czechy, Polska, Słowacja) jest zdominowany przez kapitał zagraniczny. Globalny kryzys finansowy spowodował zmniejszenie się rocznych strumieni BIZ napływających do sektora pośrednictwa finansowego i sektora bankowego tych krajów. W Polsce i Słowacji wystąpiły nawet dezinwestycje. Banki z udziałem zagranicznym podjęły organizacyjne i finansowe dostosowania do sytuacji kryzysowej w gospodarce światowej. Pozwoliło im to zabezpieczyć swoją pozycję w krajach przyjmujących. Banki te są zaangażowane w społecznie odpowiedzialne działania sferze kultury, sportu, ochrony środowiska itp. Jako instytucje zaufania publicznego wykazały się również odpowiedzialnością w sferze finansów, kiedy ujawnił się kryzys.

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