# Foreign Bank Profitability in Central and Eastern Europe

Performance of greenfield banks is superior to the other types of banks

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What determines bank profitability? What is the impact of ownership structure and mode of entry on bank performance? Clearly, compared to domestic banks, foreign banks may be differently affected by some common factors. For example, they may be less sensitive to the structure of liabilities and local economic conditions. At the same time, they may be influenced by additional factors compared to local banks, for example, home country economic conditions and the strategies of parent institutions.

Foreign banks are not a homogeneous group, and they differ according to the mode of entry: greenfield banks (foreign banks newly established in a country), and takeover banks (domestic banks sold to private foreign investors). Greenfield banks are closely integrated with parent institutions, depend on them for capital and apply approved risk and portfolio management techniques. In contrast, when taking over a bank, foreign investors inherit personnel, infrastructure and client portfolio, and have to spend time and money to modernize the target. Additionally, as domestic banks offered to foreign buyers are often illiquid and burdened with non-performing loans, cleaning up and restructuring costs fall, too, on the new owners.

We examine the sources of profitability using data on 419 commercial and savings banks from 11 Central and Eastern European countries (CEE), namely Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia, between 1993 and 2004. This region has the world's highest share — 71% — of foreign investors in the banking sector, with both greenfield and takeover banks operating in all countries.

We decompose banks' profits into net interest margin, net non-interest income, loan loss provisions and overhead costs and examine their relation to a set of domestic and international factors. This allows us to see whether being a part of a multinational financial institution matters for the foreign banks' performance and whether the performance of different types of banks converges over time.

## Greenfield Banks More Profitable

First, our results clearly show that the mode of entry for foreign banks is an important determinant of their performance. Profitability of takeover banks is not different from that of domestic banks, whereas greenfield banks earn 0.95 percentage points higher return on assets than other banks. Higher profitability results from the lower costs of greenfield banks, and not from higher interest or non-interest margins. Loan loss provisions and costs in an average greenfield bank are lower by 6.43 and 1.23 percentage points, respectively, than in a domestic bank. Greenfield banks' better quality of loan portfolio might be due to their superior skills in screening potential borrowers and their subsequent monitoring. Alternatively, greenfield banks may also target different market segments, namely the largest and most transparent enterprises, leaving riskier clients to domestic banks.

*Costs in a greenfield bank are lower by 1.23 percentage points*

Second, we find that the mode of entry determines foreign banks' vulnerability to local and international conditions. Greenfield banks are not sensitive to domestic factors, such as the structure of their balance sheets, GDP growth and interest rates. At the same time, they are affected by the health of their parent institutions and interest rate changes in the EU. This reflects very tight links between greenfield institutions and parent banks, which support their subsidiaries in CEE. Interestingly, the profitability of takeover banks depends on their own level of capital, and is not sensitive to either the local macroeconomic environment or international factors.

Third, we find that the entry of foreign banks (both greenfield and takeover) has important spillover effects on the performance of domestic banks in CEE. As the participation of foreign banks increases, the costs of domestic banks rise. This can be viewed as a "negative" spillover effect, but is explained by the fact that in countries with a low level of economic development the costs of domestic banks rise in response to competition from foreign banks, because they have to invest in new technology and human capital to be able to compete.

Over time, however, a certain degree of convergence occurs between banks with different ownership structures. The profitability of greenfield banks decreases, as their costs rise. This is a sign of a positive spillover effect: with time, domestic banks become more competitive, and greenfield banks can no longer earn abnormal profits.

## Conclusions

Thus, our analysis shows that the performance of greenfield banks is superior to the other types of bank, which is the result of their modern management and lending techniques, superior reputation, and support from parent institutions. None of these factors appears to improve the performance of takeover banks, but this could be due to the short time that has elapsed from the change of ownership and the significant burden of bad loans that these banks inherited.

Foreign banks' entry has a positive impact on banking sector stability, since they are less sensitive to the domestic economic environment compared to domestic banks. Moreover, greenfield banks enjoy support from parent institutions.

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