National Bank of the Republic of North Macedonia
Financial Stability, Banking Regulations and Resolution Department

SURVEY

ON THE EFFECTS OF THE ENTRY OF FOREIGN BANKING GROUPS INTO THE DOMESTIC BANKING SECTOR

July 2019

The activities of international banks and their impact on the financial and economic systems of developing countries are subject to extensive discussion in the economic literature. This topic became especially important after the global financial and economic crisis considering that the financial integration was one of the channels of spillover of the crisis from advanced to developing countries. The crisis pointed to some of the risks associated with the presence of foreign banks in the developing countries, which are basically materialized through increased exposure to international shocks and risk of sudden withdrawal of foreign capital. However, the presence of these risks does not reduce the benefits of the entry of foreign banks, which are assessed as multiple, primarily related to the increased stability and resilience of the system to banking crises, strengthened corporate governance and enhanced banking practices, improved competitiveness and efficiency, as well as increased financial inclusion and access to financial services of the private sector. Moreover, an important lesson that can be drawn from the global crisis is that the sustainable cross-border banking, which will maximize the benefits and minimize the associated costs, requires financial independence of subsidiaries and their moderate reliance on funding from parent banks, thereby promoting a culture of responsible risk management and prevention of potential crises[1].

In the Macedonian banking sector, foreign capital becomes more important in the beginning of the 2000s and the process of privatization of domestic banks, and in the next period it occupies the most important place in the domestic banking sector. Thus, out of a total of 15 banks that currently operate in the domestic banking sector, 11 are predominantly owned by foreign shareholders, and 6 are foreign bank subsidiaries. At the end of 2018, banks that are mostly foreign owned account for about 71% of the total assets and the total capital and reserves of the banking sector. Within their framework, the largest share is that of the foreign bank subsidiaries which account for 57.8% and 61.5%, respectively, in the assets and capital and reserves of the total banking sector. This points to greatest impact of foreign banks on the overall performances and the profile of the domestic banking sector.

Considering this situation, in order to see the perceptions of the effects of the entry of foreign banking groups into the domestic banking sector, the National Bank conducted a survey among domestic banks. The Survey was conducted during January 2019, and covered the six foreign bank subsidiaries operating in the country and one bank owned by an international financial holding[2]. As previously suggested, these banks have the largest market share in the Macedonian banking sector[3], while their individual significance within the banking group to which they belong is different and ranges from 0.04% to 10.1% of the total consolidated assets of the parent entity.

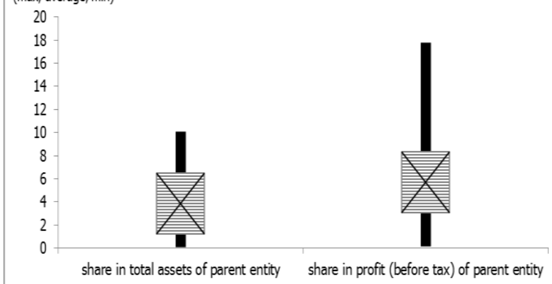
[1] See IMF, Central, Eastern and Southeastern Europe Regional Economic Issues, April 2013; Allen et al (2011) "Cross-Border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies", CERP, 2011; IMF, Financing Future Growth: The Evolving Role of the Banking Systems in CESEE: Technical Notes, April 2013.

[2] The National Bank expresses gratitude to the banks for their contribution and participation in the conducted survey.

[3] The seven banks that were covered by the Survey account for 63.5% and 66.2%, respectively, in the assets and capital and reserves of the total banking sector.

According to the size differences, they also make a different contribution to the profitability of the banking group. The profit before taxation of the domestic bank ranges from 0.1% to 17.8% of the total profit before taxation of the parent entity[4]. The Survey contained 15 questions, which aimed to provide information on the banks' perceptions of the advantages and weaknesses of the entry of foreign banking groups into the domestic market, the relations with parent entities and their impact on the domestic bank's operations, as well as the effects of the global and the European debt crisis and the need for adjustment of the post-crisis financial regulations.

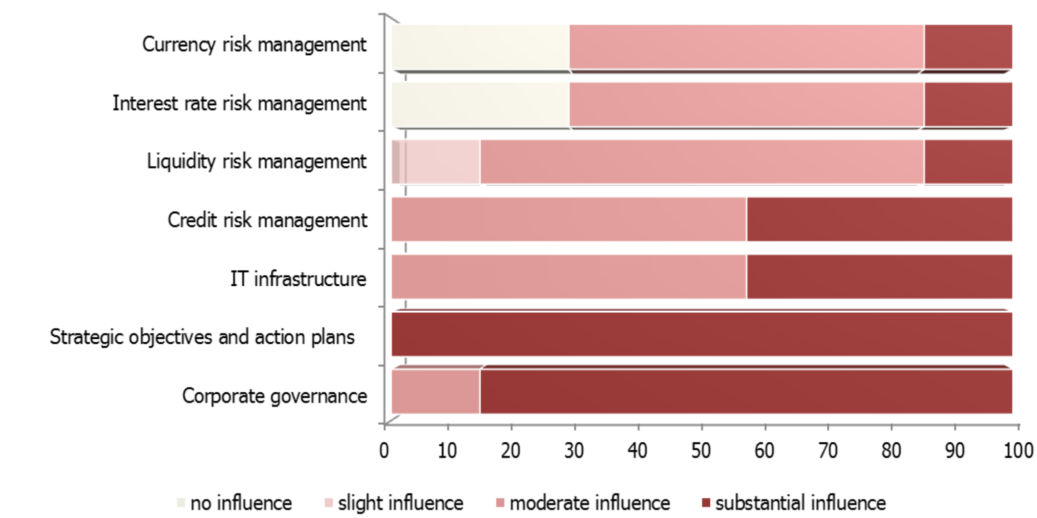
Chart 1. Share of the domestic banks in total assets and profit of the parent entities
(max, average, min)



Note: Data refer to 2017 and include the six domestic banks that are subsidiaries of foreign banks and one domestic bank owned by international financial holding that participated in the survey.
Source: National Bank, based on the responses submitted by surveyed banks.

Below, we analyze the results of the Survey, which are presented and analyzed in aggregate form of the responses of individual banks[5].

Chart 2 Impact of the parent entity on certain segments of the domestic bank's operations



Source: NBRNM, based on the responses submitted by the surveyed banks.

The results of the Survey confirm the important role of parent entities for the strategic and operational position of the domestic subsidiaries and the continued support to subsidiaries by transferring knowledge and good practices. Looking at individual segments of operations, the Survey shows that parent entities have the greatest impact when defining strategic plans of domestic banks and on corporate governance. Thus, according to all banks, the parent entity has a significant influence on defining the strategic

[4] The data on the share of domestic banks in the total consolidated assets of the parent entity and in the total profit before taxation of the parent entity refer to 2017, and were submitted by the surveyed banks.
[5] The charts that summarize the results of the Survey represent the number of banks that gave a certain response expressed as the share in the total number of surveyed banks (seven), in percentage. The label NP shows the percentage of banks that assessed the question as inapplicable, i.e. did not report data.

goals and tasks and measures and activities for their achievement. All this indicates strong connection of subsidiaries with parent entities and harmonization in the operations with the joint corporate strategy of the banking group. The second most important area is corporate governance, for which 86% of the surveyed banks assess that it is significantly influenced by the parent entity. Given the importance of good corporate governance to devising an appropriate organizational structure and strategic guidance of the bank toward accomplishment of the defined goals, the involvement of parent entities in this area, by transferring good practices and experiences, can significantly contribute to improving the internal capacities of domestic banks, improving the efficiency in the operations. In the area of the risk management and IT infrastructure, slightly more than half of the banks (57%) point to moderate impact of the parent entity. Regarding the liquidity risk management, this percentage is larger and amounts to 71% for moderate impact, while 29% of the banks reported absence of any impact by the parent entity in the area of managing the currency risk and the interest rate risk in the banking book.

Chart 3 Average share of the funding from the parent entity in the total sources of financing of the domestic bank (excluding capital and reserves)

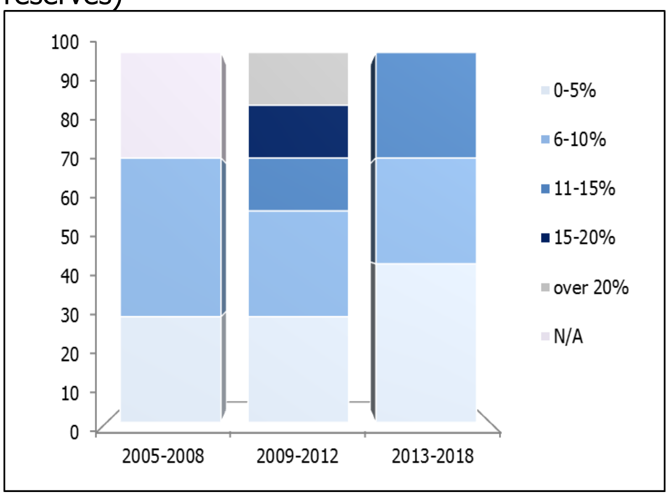
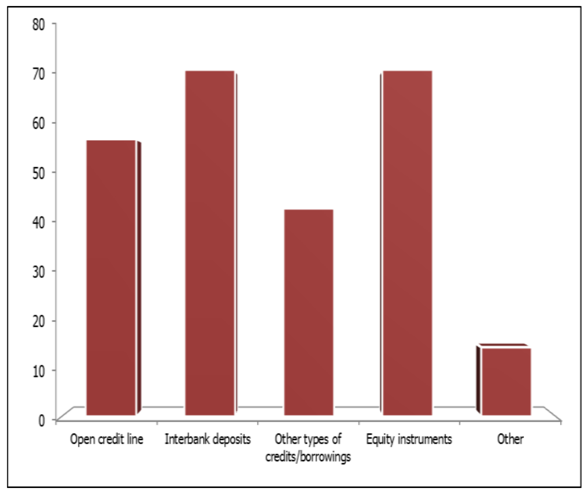


Chart 4 Types of funding that the domestic bank uses or has used from the parent entity



Source: NBRNM, based on the responses submitted by the surveyed banks.

The results of the Survey indicate a relatively high financial independence of domestic subsidiaries in relation to parent entities, which corresponds to the selected business model of domestic banks, which is primarily based on collecting deposits on the domestic market as a main source of funding the banking activities. Thus, a significant part of the banks (43%) reported that in the post-crisis period (2013-2018) the funding from the parent banks accounts for between 0 and 5% of the total sources of funding, which is a moderate reduction in the volume of funding from parent entities, compared to the post-crisis period (2005-2008) when 43% of the banks reported a share between 6 and 10%. In any case, this is a relatively low reliance of domestic banks to parent entities for funding, which is also confirmed by the reasons for this funding, which is mainly intended to support the growth and development of domestic banks, and in a somewhat smaller part for liquidity needs. The need for achieving the target credit growth stands out as the main reason for funding from parent entities, with which all surveyed banks agree. Most of the banks (57%) direct the funding from parent entities to seize new opportunities and develop new products. 43% of the banks used this source to overcome unexpected shocks in the deposit base, and only 14% to cover liquidity needs caused by restricted access to financing on the domestic market. In accordance with such purpose, the structure of sources of financing from parent entities is dominated by capital instruments and interbank deposits (which were selected by 71% of the surveyed banks), followed by open credit lines from parent entities (57%) and other types of credits/loans (43%).

Chart 5 Main reasons for funding from the parent entity

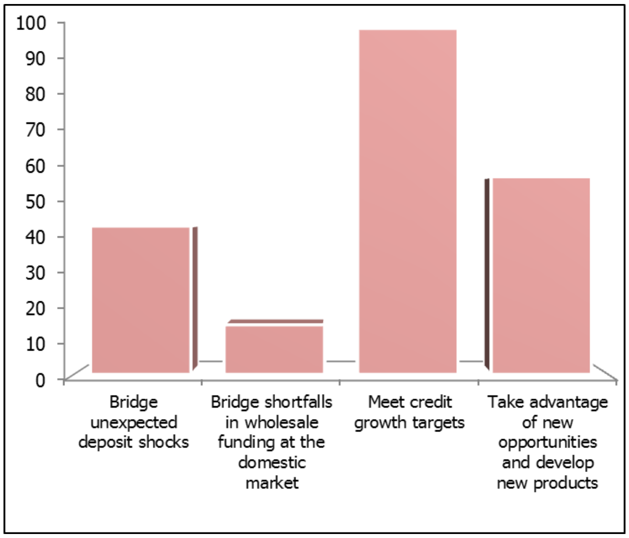
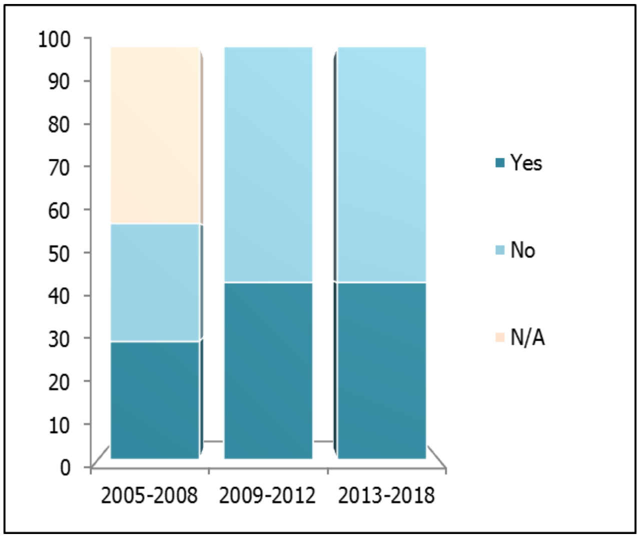


Chart 6 Funding from the parent entity is mainly a cheaper source of financing, compared with deposits and market financing on the domestic market



Source: NBRNM, based on the responses submitted by the surveyed banks.

The financial independence and the independence when managing the liquidity of domestic banks in relation to parent entities is also confirmed by the treasury desk applied by the parent entity, which according to 67% of the banks is set up on a decentralized basis. The global crisis has emphasized the advantages of a decentralized treasury, which implies financially independent subsidiaries of parent entities and appropriate valuation of sources of financing at prices close to the market prices, thus promoting greater discipline and prudent risk management by banks' subsidiaries. Most of the banks (57%) agree that the funding from the parent mainly does not represent a cheaper source of financing, compared with deposits and financing on the domestic market. Also, 86% of the banks responded that they have not approved a loan to the parent bank, which also applies to the period of the global and the European debt crisis. This situation is also due to the prudential domestic regulations that provide exposure limits of shareholder with qualified holding and persons connected thereto, in the amount of up to 10% of the domestic bank's own funds. Such prudential setup of domestic regulations, the legal and financial independence of subsidiaries from parent entities, as well as the low exposure of domestic banks to abroad were important factors that contributed to the resilience of the domestic banking sector to the global crisis.

Chart 7 Parent entity treasury desk

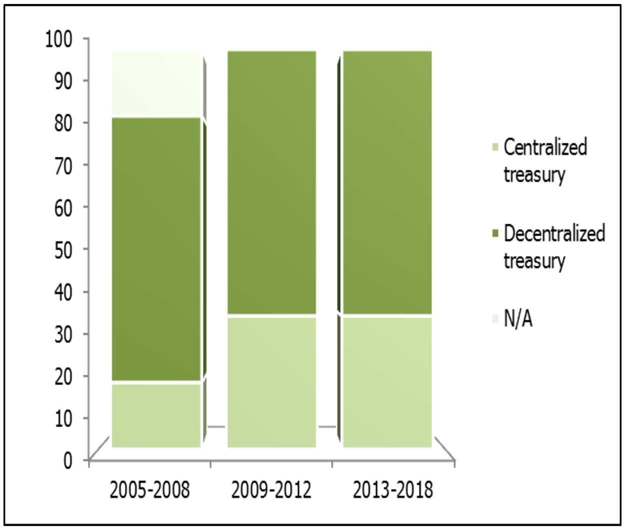
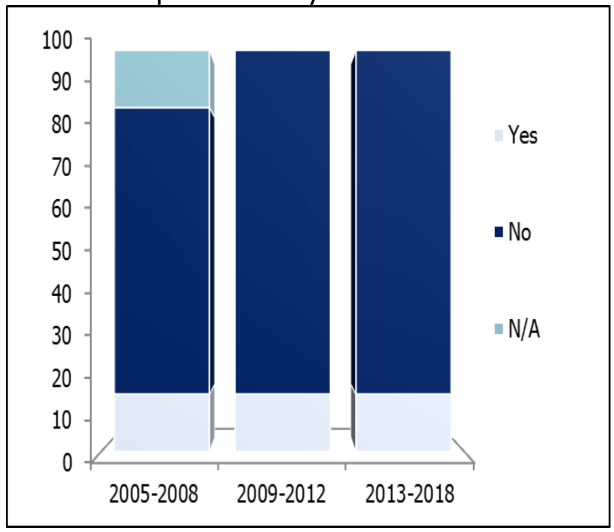


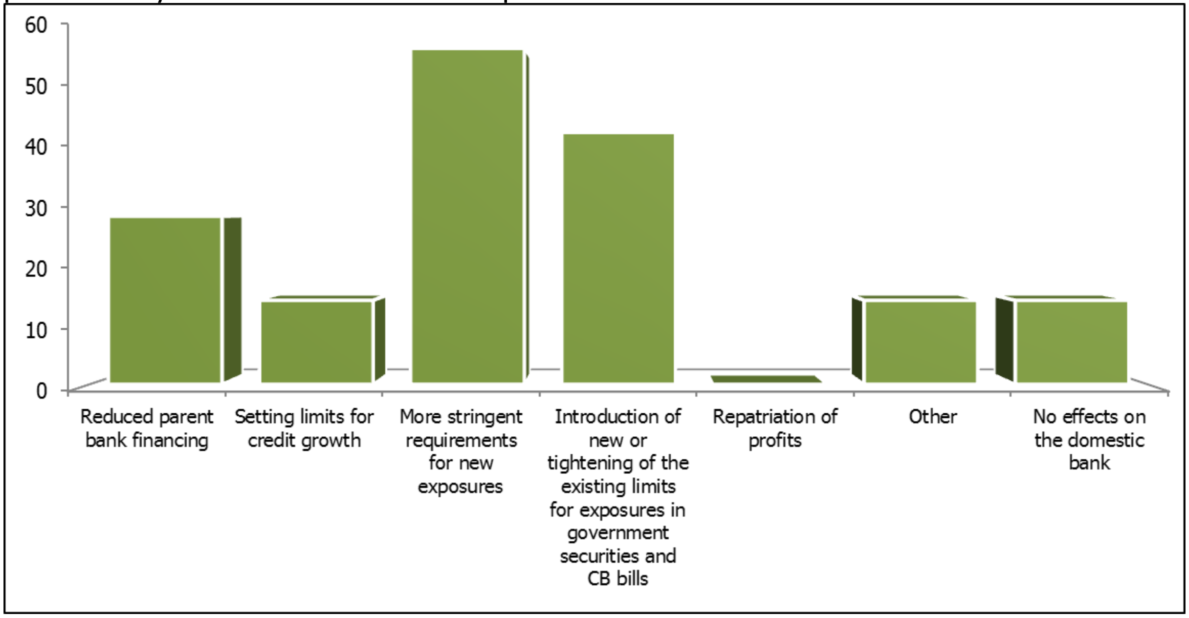
Chart 8 The domestic bank has approved a loan to the parent entity



Source: NBRNM, based on the responses submitted by the surveyed banks.

However, the results of the Survey suggest certain indirect effects of the crisis on the domestic banks' operations that were mainly realized through the process of adjustment of the foreign parent entity to the post-crisis financial regulation (Basel 3 and EU CRD IV/CRR) and to the requirements of the supervisor of the parent entity. According to most of the banks, the tightened post-crisis regulation was mainly reflected by tightened criteria for approving new exposures (57%) and establishing or tightening the limits for exposures in securities issued by the government and by the National Bank (43%). Part of the banks (29%) experienced a reduction in the volume of funding by the parent entity, while only one bank also faced credit growth limits. Such results confirm the theses on the “deleveraging” elements present in domestic banks under the influence of parent entities, which was nevertheless of limited character, allowing a solid growth of the credit activity in the post-crisis period.

Chart 9 Effects of the adjustment of the foreign parent entity to the post-crisis financial regulation (Basel 3 and EU CRD IV/CRR) and of the requirements of the supervisor of the parent entity on the domestic bank's operations



Source: NBRNM, based on the responses submitted by the surveyed banks.

According to the domestic banks' perceptions, despite the need for adjustment to the post-crisis financial regulation, one cannot determine additional factors that caused deleveraging of parent entities (86% of the banks), while 57% of the banks assess that the parent entity made certain changes to the funding model after the global crisis, including increased reliance on funding through deposits from the non-banking sector, as a more stable source of financing. All surveyed banks agree that the parent entity fundamentals (such as solvency, liquidity, asset quality, leverage level, profitability, etc.) do not affect the domestic bank's operations, which can again be explained by the high independence of subsidiaries from parent entities and their good reputation on the domestic market.

Chart 10 Other reasons for deleveraging of the foreign parent entity (except the post-crisis regulation)

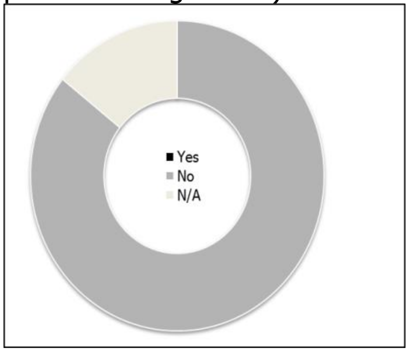


Chart 11 Parent entity fundamentals affect the domestic bank

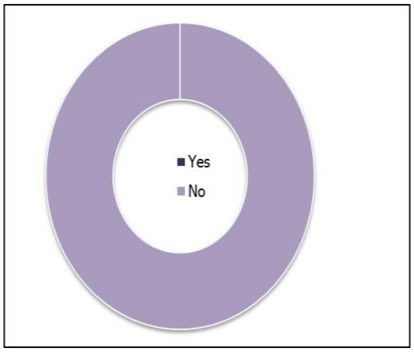


Chart 12 In the period after the global economic crisis, the parent entity made changes to the funding model

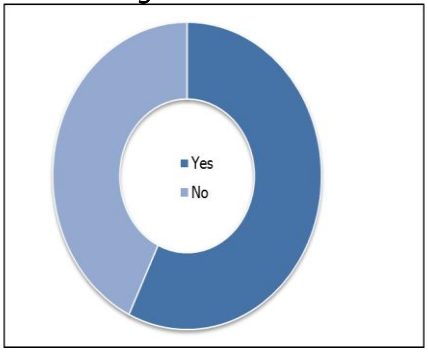
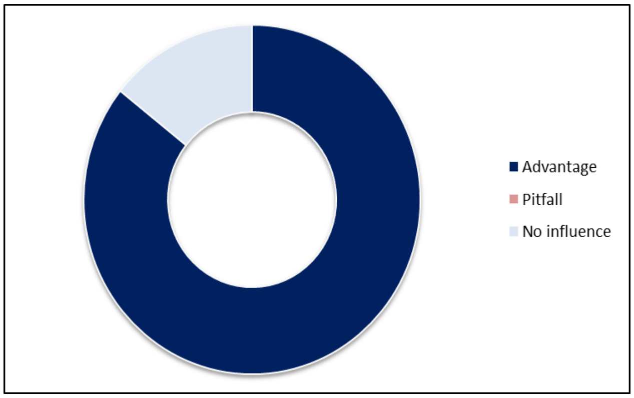
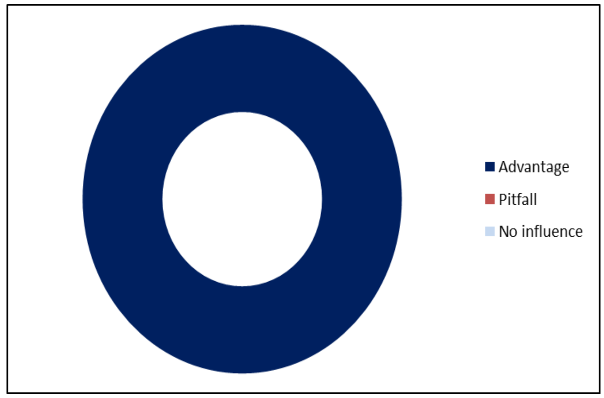


Chart 13 The status of a subsidiary of a foreign parent entity is assessed as an advantage or pitfall to more easily bridge shocks on:
the international market the domestic market



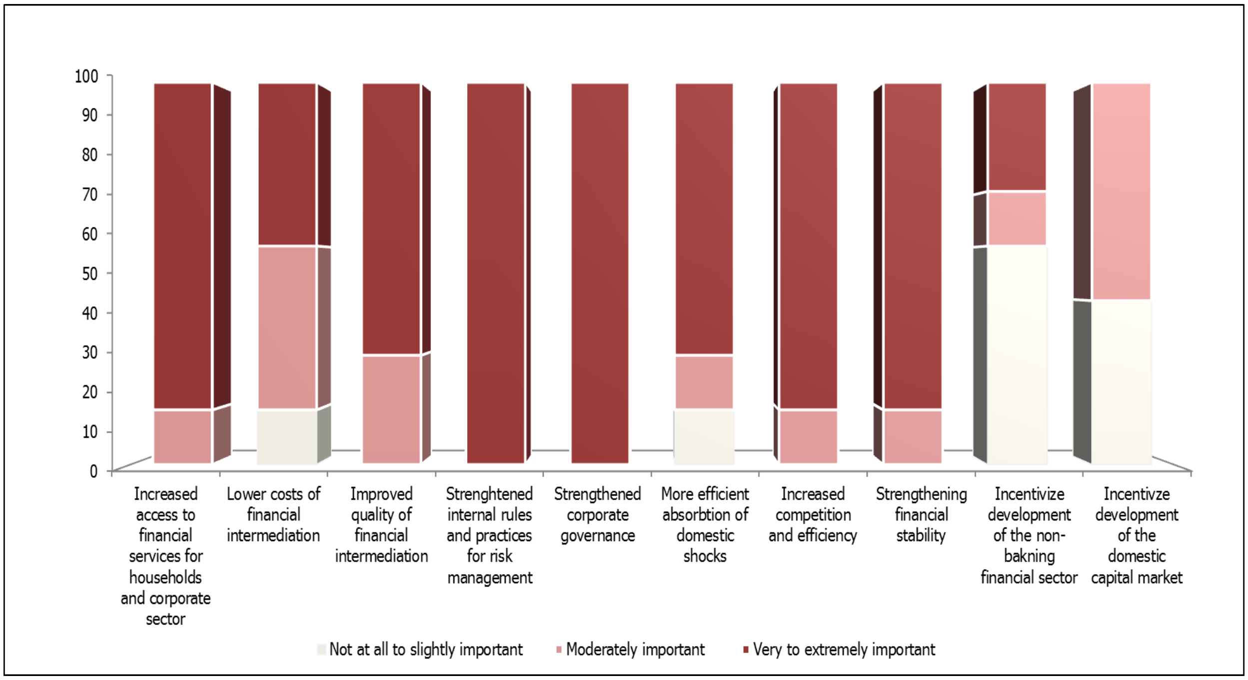


Source: NBRNM, based on the responses submitted by the surveyed banks.

Within the Survey, the banks were asked to assess whether the fact that they are a subsidiary of a foreign parent entity is an advantage or pitfall to more easily bridge shocks that originate from the international and domestic environment. **All banks assess that the affiliation to a foreign parent entity increases the resilience to the two types of shocks**, with the exception of one bank that has assessed that the fact that it is a subsidiary of a foreign parent entity has no influence on the ability to deal with the shocks from the international market. Banks mainly associate the advantage for easier overcoming of the shocks with the support in the financing by the parent entity which is assessed as a reliable source of financial funds in the event of illiquidity or liquidity problems on the domestic market. As an additional advantage, the banks indicate the continued support by the parent entities in the domestic bank's operations, including the capital position, as well as the support in strengthening the internal capacities of the bank in all areas of the operations by transferring experiences and knowledge and applying best practices.

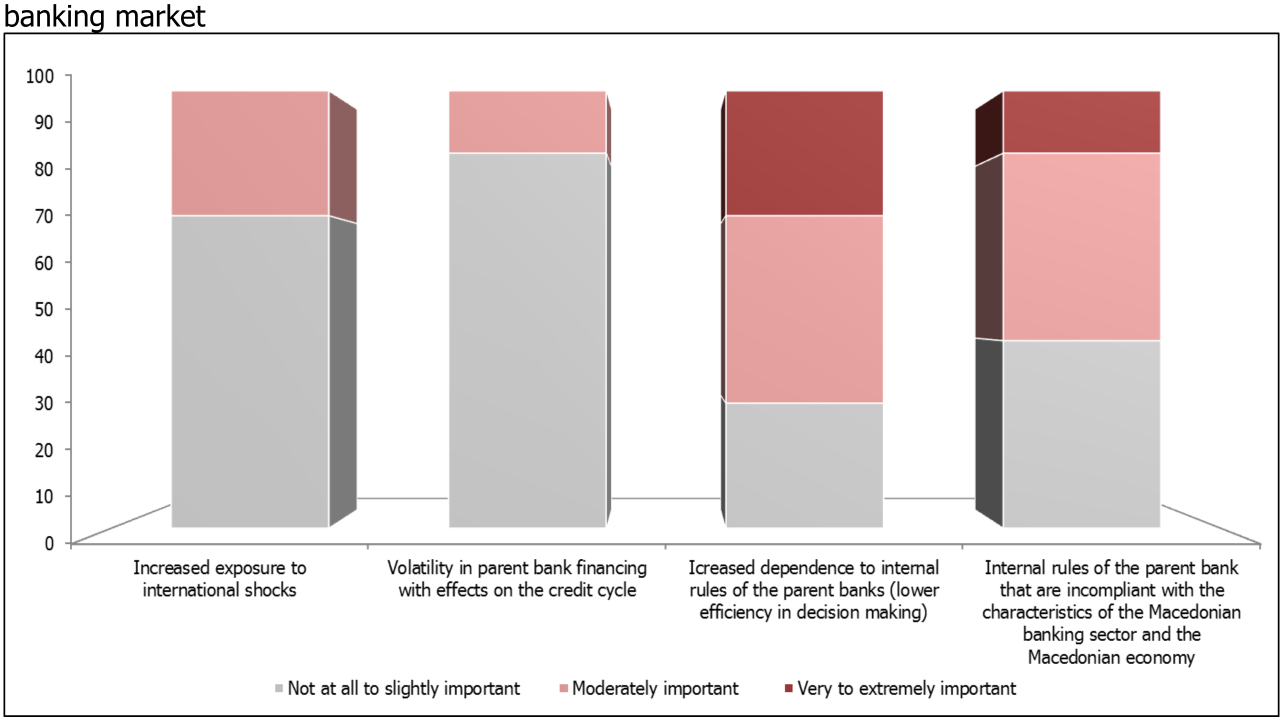
According to the domestic banks' estimations, the entry of foreign banking groups into the domestic banking market provides much more benefits than shortcomings and costs for the domestic economy. Thus, all banks consider that the strengthened corporate governance and the strengthened internal risk management rules and practices are "very to extremely important" advantages from the entry of foreign banks. A large majority of the banks (86%) estimate that the entry of foreign capital has positive effects for increased access to financial services for the households and for the corporate sector, increased competitiveness and efficiency and strengthening of the financial stability. According to 71% of the banks, the entry of foreign capital has also contributed to enhancing the quality of financial intermediation and to building capacities for more efficient absorption of domestic shocks. According to the banks, the smallest influence was registered in the area of encouraging the development of the non-bank financial sector and the domestic capital market. Thus, 57% of the banks assess that there are not at all to slightly important benefits from the entry of foreign banks for the development of the non-banking financial sector, while identical 57% assessed a moderately significant contribution to encouraging the development of the domestic capital market.

Chart 14 Major benefits from the entry of foreign banking groups into the domestic banking market



Source: NBRNM, based on the responses submitted by the surveyed banks.

Chart 15 Basic shortcomings/costs from the entry of foreign banking groups into the domestic banking market



Source: NBRNM, based on the responses submitted by the surveyed banks.

The adverse effects related to the presence of foreign banks are mainly associated with the increased dependence in the operations on the internal rules of the parent entity (reduced efficiency in the decision-making), for which however there are different perceptions by individual bank. Thus, 43% of the banks assessed that this segment has a moderate influence on their operations, while the remaining 57% are equally distributed between the responses "very to extremely important influence" and "not at all to slightly important influence". Part of the banks (43%) also point to a moderate influence from the incompliance of the internal rules of the parent entity with the characteristics of the Macedonian banking system and the Macedonian economy, while identical 43% assess that this factor has no influence or has a very small influence on the operations. The majority of banks do not see risks associated with the increased exposure to shocks from the international environment (71%) and volatility of sources of financing from the parent entity with effects on the credit cycle (86%).

Overall, the results of the Survey indicate positive benefits from the entry of foreign banking groups for the Macedonian economy, contributing to the development and improvement of the internal capacities of domestic banks and to the maintenance of the financial stability. The foreign parent entities, with their reputation and long-standing tradition in the activity, have contributed to the improvement of the domestic banks' operations, with the greatest benefits in the area of corporate governance and risk management. There is a significant contribution in the area of the promotion of financial inclusion and the quality of financial intermediation with the households and the corporate sector. The Survey suggests a sustainable position of foreign subsidiaries in the domestic market, which implies full legal and high financial independence from parent entities, which, together with prudential domestic regulations, was an important factor for the resilience of the domestic banking sector to the global crisis.