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What Has Been the Impact of Foreign Banks in Croatia?

Tomislav Galac
Evan Kraft

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Tomislav Galac and Evan Kraft

Project Team:
Hrvoje Dolenec, Mladen Duliba, Michael Faulend, Tomislav Galac,
Evan Kraft, Vedran Šošić, and Mladen-Mirko Tepuš

What Has Been the Impact of Foreign Banks in Croatia?

Summary

This article examines the impact foreign banks have had on the Croatian market by interviewing bankers from both foreign and domestic banks. Since entry was slow and foreign banks were cautious in their approach to the Croatian market through late 1999, foreign banks' impact has not been dramatic. Competition has been increased mildly, but foreign banks have introduced few new products and services. Foreign banks have cheaper funding sources, possess approximately equal knowledge of the local market, and employ better cadre than local banks, according to our interviews. Analysis of the structure of foreign banks' clients on both sides of the balance sheet suggests that foreign banks raise deposits from both domestic and foreign clients, but lend somewhat more to domestic clients. Furthermore, as major players on the interbank markets, the foreign banks have channeled funds to domestic banks during the hard times of the 1998-99 banking crisis. Finally, the arrival of the foreign banks represents substantial foreign direct investment in and of itself. Thus, the overall impact of foreign banks appears to have been positive in the period studied.

JEL: F23; G21; P34

Key words: foreign banks; Croatia; foreign direct investment; banking

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What Has Been the Impact of Foreign Banks in Croatia?

1. Introduction

The entry of foreign banks into the Croatian banking market has been the subject of considerable public interest and occasional controversy. With this in mind, the Financial Markets and Institutions Analysis Division of the Research Department of the Croatian National Bank devoted part of its recent survey to questions relating to the impact of foreign banks.[1]

The proponents of allowing foreign banks to enter the domestic market generally point to a number of economic benefits: transfer of know-how, especially knowledge of bank management, risk management, and information systems; increased competition, which leads to the provision of new financial services and to decreased prices for existing financial services; and increased resources that can stimulate economic growth.

The critics of foreign investment argue that foreign banks may gain undue influence over the domestic economy, that they may have different priorities and agendas than domestic banks or the domestic public, that foreign entry will hurt domestic banks, and that foreign banks should not enjoy the protection extended by the government to local banks, especially those deemed "too big to fail."

In this paper, we will attempt to shed light on the relevance of these arguments to Croatia using the answers from our interviews with Croatian banks. However, it must be said at the outset that the evidence is somewhat limited. The foreign banks that have operated in Croatia, at least until recently, have been relatively cautious and have operated at relatively small scale. Furthermore, the sale of four large banks recently in rehabilitation to foreign banks during 1999 and early 2000, along with several other foreign acquisitions, indicates that foreign ownership will be much more widespread in the coming years than it has been up to now.

All this means that the evidence we have gathered, and the conclusions we will draw, relate to a period of limited foreign entry, a period that has now finished. We will try to draw some conclusions about the future from our findings, but such conclusions must necessarily be tentative.

1.1 The arguments for and against entry of foreign banks

Bonin et al (1998) provide a clear exposition of the main expected benefits from the entry of foreign banks.

1 The other part of the survey, which deals with the effects of the recent banking crisis and with banks' lending policies, is covered in a separate report. (Croatian National Bank, (2000), *The Lending Policies of Croatian Banks*, Surveys S-3, December)

They include:

Product and service innovation. The argument here is that foreign banks already offer a wider variety of products and services in their home markets, and will find it relatively easy to introduce such new products to the local market. Also, local banks may be too preoccupied with solving inherited problems such as bad assets in their portfolios, inappropriate organizational structures and outdated information systems, to develop new products.

Economies of scale and scope. Two arguments can be made here: first, that foreign banks can provide the technology needed by large local banks to take advantage of economies of scale, but will only do so if they acquire majority ownership in such banks. And second, that foreign banks can help encourage the consolidation of the banking system by participating in mergers and acquisitions with smaller local banks. Also, foreign banks take advantage of economies of scope through their knowledge of other financial activities such as insurance, portfolio management and brokerage services.

Environment of competition. The argument here is simple: foreign banks represent potent competitors to large local banks. However it should be noted here that some research has indicated that foreign banks often concentrate on specific market niches, and do not always compete in the broadest market sectors. (Buch 1997, Sagari 1992).

Develop financial markets. Foreign banks may help deepen the interbank market, and may attract business from customers that would otherwise have gone to foreign banks in foreign countries.

Spillover effects of good banking practices. This refers to the transfer of know-how. It can happen in many ways, for example when employees of the foreign banks take jobs at local banks, or simply through imitation.

Attract foreign direct investment. The presence of foreign banks may convince foreign non-financial firms to invest, both because of the "vote of approval" it offers and because foreign companies may want to use the services of the foreign banks.

Finally, Bonin et al stress that entry of foreign banks is a form of foreign direct investment and, as such, adds to the resources available to the domestic economy.

The main arguments against foreign direct investment in banking are the following:

Fear of foreign control. Undoubtedly, control over the allocation of credit implies substantial economic power in any economy. Some people are uncomfortable with the idea of foreigners having such control.

Banking as an infant industry. Some analysts advocate giving banks in less developed banking markets an initial period of protection, so that they can grow. This argument is a form of the general infant industry argument.

Banks are special. Banks are subject to numerous special protections from government, due to their central role in the economy. A good example of this is the fact that a major bank liability, deposits of individuals and of certain categories of business, is subject to government insurance. Some commentators believe that it is improper for foreign banks to enjoy such protection.

Foreign banks have different objectives. It is possible that foreign banks may be overly interested in promoting exports from their home country, or in supporting projects undertaken by home country firms. Some have expressed concern that foreigners will gather deposits in the host country and make loans in the home country.

Regulatory differences. Under European Union law, when a foreign bank opens a representative office or branch, the representative office or branch is supervised by home country supervisors. Thus, the host country supervisors lose regulatory control. If the home country has weak bank supervision, this may lead to unsound banks operating in the host country.

The main test of these arguments is empirical, and will emerge through the findings presented below. However, it must be mentioned that there are some logical problems with some of the arguments against foreign bank entry. First, the idea of protecting banks like other infant industries ignores the high costs that such protection would have on the rest of the economy. Is it sensible to subject the economy to high interest rates and even high costs of resolving bank failures with the aim of eventually achieving local ownership? The usual protection of infant industry harms domestic consumers in order to benefit domestic producers, but an infant industry approach in banking actually harms all users of the banking system, households and non-financial businesses, in favor of the domestic banking industry alone.

A more plausible version of the infant industry argument is to advocate the formation of strong domestic banks or bank groups through mergers, perhaps with the assistance of government, in place of privatization to foreign strategic investors. Stiblar (1999) elaborates such a strategy for Slovenia. Still, it is not clear whether such a strategy would work in an open, competitive environment, given the many advantages foreign banks enjoy in technology, financial power and know-how. As we will see below, such efforts were abandoned in Poland.

Another very mild version of the infant industry argument is Buch's (1997) comment that it can be harmful to open up the banking market in transition countries to unlimited foreign competition if the bad debts inherited from the previous system and the early days of transition have not been cleaned-up. Specifically, Buch calls for recapitalization of domestic banks before opening up to foreigners. But after that, she says, foreign entry should be unrestricted.

The argument that foreign banks have different objectives than local banks also is somewhat suspect. All banks have the objective of making profits. While some banks may be comfortable working with home country clients they know, it is to be expected that they will seek to identify host country clients with whom they can work to mutual advantage.

Also, the regulatory differences argument is not likely to be relevant, for Croatia has the right to refuse to allow foreign branches from countries with unsound supervision to be started. It would only waive the right to supervise branches by bilateral agreement, or upon entry to the EU. Presumably, Croatia would not be endangered by such a situation.

These comments suggest that the arguments against foreign bank investment are not terribly strong a priori. But we do not wish to rest here. Instead, we will proceed to empirical evidence.

1.2 Experience from other transition economies

Two of the most advanced transition countries, Hungary and Poland, have allowed extensive foreign entry into their banking markets. Thus, it seems appropriate to examine their experiences. The table below shows the importance of foreign banks in each country:

Table 1: Foreign ownership in Hungary and Poland

	Hungary	Poland
Total number of banks	43	80
Foreign majority owned banks	30	34
% of total banking capital held by foreign banks	61	52

Source: Storf (2000). Data for Hungary September 1999, for Poland mid-1999.

Although foreign banks first entered Hungary in the 1970's, with considerable liberalization of the market coming in 1987, the bulk of foreign entry occurred with four big privatization deals in 1995 and 1996. These deals were spurred on by the fact that, even though large amounts of public money had been spent to rehabilitate Hungarian banks, their position remained problematic. The Hungarian government decided to seek strategic partners for the largest banks. These partners were reputable foreign banks.

In the ensuing years, the average capital adequacy ratio of the banking system has risen from 8% to 14%. The Hungarian Banking Association comments that "The privatization process has brought about a number of benefits. Many of the new foreign owners are prepared for significant capital increases. The appearance and expansion of prestigious foreign banks has created a healthy competition, triggering the spread of highly developed financial information technology systems and above all a sophisticated financial culture." (cited in Storf, p. 12)

Buch (1997) provides evidence that foreign banks in Hungary had higher ratios of loans to total assets, lower rates of bad loans, and better profitability in the period through 1995, thus contributing to improved quality and quantity of financial services.

While the foreign banks started to operate in particular market niches in Hungary, they have now expanded to most major areas of the banking business. Citibank, for example, starting with retail services for high net worth individuals, a fairly limited market segment. But now, it and other foreign banks have moved much more extensively into both the retail and corporate markets.

One result of foreign entry in Hungary has been extremely low interest rate spreads. The difference between lending and deposit rates has been in the area of 3 to 4 percentage points, similar to Western European levels. By contrast, in Croatia the spread has remained in the area of 10 percentage points.

Poland's bank privatization was more spread out over time, occurring between 1994 and 1999.[2] In addition, Poland experimented with the formation of large domestic bank groups to compete with foreign banks.(Bonin and Leven, 1996) However, this experiment was eventually abandoned. As of mid-1999, the Polish banking system was much healthier than in the past—instead of 20 to 30% bad loans, as in the early 1990's, the system had just 4.6%.

Other signs of growing health in the banking system in Poland include the increase in banking capital from USD 1590 million in 1993 to 7070 million in mid-1999, a substantial growth in banking services, including corporate account officers, capital market transactions, credit cards and many others, and introduction of new technology such as electronic banking.

Finally, there is evidence that domestic Polish banks have greatly strengthened themselves and are much better placed to meet the competitive challenges of greater integration with the EU. Some domestic Polish banks have proved strong bidders for banks auctioned by the Polish government. While the challenges ahead are daunting, Polish banks may have a better chance of survival precisely because they faced strong competition early on.

Extensive foreign ownership now exists in the Czech Republic and Estonia, among other transition countries. Indeed, of the five transition countries likely to enter the European Union first, only Slovenia does not have a major share of foreign banks in their banking sector.

With this as background, we now turn to the Croatian experience, starting with a description of our sample.

1.3 The sample and response strength

There were fifty-three banks operating in Croatia when our survey took place. Table 2 shows some basic characteristics of the banking system.

Forty-seven of the fifty-three banks operating at the time of our survey participated in it. The only banks excluded from the survey were three banks for which bankruptcy procedures had been proposed, one bank that declined to meet with our research team, and two banks facing imminent merger into their "mother" bank. In short, we came very close to interviewing the whole population of commercial banks in Croatia.

As Table 2 shows, foreign bank entry has been relatively slow and cautious. Only one foreign bank entered the market before "Operation Storm" and the Dayton Accords in 1995. Foreign banks' share in total banking assets remained quite modest through late 1999, when a large bank in rehabilitation was sold to a foreign bank. It is clear that Croatia was considered a relatively risky market, both due to political-military risk and due to economic instability in 1998 and 1999.

There were thirteen banks in Croatia in majority-foreign ownership at the end of 1999. Six of these were daughters of foreign banks, incorporated as self-standing banks in Croatia. One was a branch of a foreign bank.

2 For early assessment of bank privatization in Poland, see Abarbanell and Bonin (1997) and Bonin et al (1998).

Table 2: Basic characteristics of the Croatian banking system

	1993	1994	1995	1996	1997	1998	1999
Total number of banks[a] (end year)	43	50	54	58	61	60	53
Number of banks with foreign ownership exceeding 50% (end year)	na	na	1	4	7	10	13
Total assets of banks (end year, million HRK)	53,164	60,175	69,268	73,807	94,125	104,318	93,820
Total assets of banks with foreign ownership exceeding 50% (end year, million HRK)		57	115	664	2,788	6,885	37,732

[a] Commercial and savings banks excluding savings cooperatives.

Table 3: Strength of response of the domestic banks

Response strength (12 questions)	Number of banks	% Number/Possible	Assets managed (000 HRK)	% Assets/Possible
Attainable maximum	40		84,210,144	
Observed maxima	40	100.0%	84,210,144	100.0%
Observed minima	35	87.5%	56,480,547	67.1%
Weighted averages	39.1	97.75%	77,549,606	92.09%

Table 4: Strength of response of the foreign banks

Response strength (47 questions)	Number of banks	% Number/Possible	Assets managed (000 HRK)	% Assets/Possible
Attainable maximum	7		7,783,890	
Observed maxima	15	214.3%	18,782,974	241.3%
Observed minima	1	14.3%	651,640	8.4%
Weighted averages	6.1	87.14%	6,906,135	88.72%

Through the end of 1997, these were the only foreign banks in Croatia. In the last two years, however, six other banks have come under majority foreign ownership through the acquisition of controlling equity stakes in the banks. For three of these banks, foreign acquisition has been so recent that we were unable to meaningfully discuss with the banks their experience as foreign banks. Of the other three majority foreign-owned banks, one is facing the opening of bankruptcy procedures, and was not interviewed. This was the only foreign bank not interviewed.

The other two banks acquired by foreigners are run wholly by local Croatian managers, who were not able to shed much light on the thinking of their foreign owners. We have included the replies of these majority foreign-owned banks under the foreign category only in certain instances where they are clearly relevant. Otherwise, we have treated these banks as domestic, even though we feel that such local banks acquired by foreigners are a very important category and will become even more important in the coming years.

The 40 domestic banks (including the two majority foreign-owned but self-identified domestic banks) were asked about their experiences and perceptions of how the banking system has changed during the last several years due to the entry of foreign banks on the market. The strength of response varied slightly from question to question, with all forty domestic banks (the whole population) answering most questions. This gives us confidence in the validity of the answers.

At the same time, response strength for the seven foreign banks was also very high. While some specific questions applied only to a limited number of foreign banks, most questions were answered by almost all the banks. This response strength also inspires confidence in the validity of our results.

2. Competitive Advantages and Disadvantages of Foreign Banks

In our survey, we had a rare opportunity to obtain both the domestic banks' perceptions of the foreign banks' competitive advantages and disadvantages and the corre-

Table 5: Perceived cost of funds of the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Less expensive	33	65,432,823	82.5%	77.7%
No opinion/knowledge	5	2,673,054	12.5%	3.2%
Not less expensive	1	15,696,141	2.5%	18.6%
Total	39	83,802,018	97.5%	99.5%
Possible	40	84,210,144		

Table 6: Cost of funds of the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Less expensive	5	6,963,106	71.4%	89.5%
Not less expensive	2	820,784	28.6%	10.5%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 7: Borrowing from the foreign "mother"

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Borrowing possible	5	4,519,917	71.4%	58.1%
Total	5	4,519,917	71.4%	58.1%
Possible	7	7,783,890		

Table 8: Domestic vs. foreign banks' savings deposit rates – 1999 averages

Category	Weighted avg. dep. int. rate	Number of banks	Assets managed (000 HRK)	% Number/Total	% Assets/Total
Foreign	2.97	7	7,783,890	14.89%	8.42%
Domestic	3.24	40	84,678,819	85.11%	91.58%
Total	3.22	47	92,462,709	100.00%	100.00%

Note: Weights are end-of year assets, not deposits; current and gyro rates not included.
Source: CNB, Statistics Department

sponding foreign banks' self-perceptions. It turns out that, while these coincide on many important aspects of banking business, sometimes they do not match exactly, as we show next.

2.1 Cost of funds

It is widely believed that the foreign banks operating in Croatia have less expensive funding sources than the domestic banks. Our survey confirms that this opinion is shared by an overwhelming majority of domestic banks. Remarkably, only one domestic bank disagrees, while only five have no opinion. The most unusual remark made regarding the funding sources was that "the foreign banks have less expensive sources since the disappearance of the gyro account money". Its author was alluding to the very poor liquidity of corporate clients during the economic crisis of the last year and a half. Two banks stated foreign banks have less expensive sources because they rely heavily on their own capital, i.e. they have a higher capital to deposits ratio.

We also asked the seven foreign banks whether they had less expensive funds than their domestic competitors. While five confirmed this perception, two banks disagreed. The latter cite the country-specific risk-premium they pay when borrowing in international markets as the reason that they face the same funding costs as Croatian banks. Moreover, one bank from the five that do believe that foreign banks have lower funding costs also cites the same reason for its funds not being as inexpensive as they could be. The reason that they are still less expensive than the domestic bank's funds is the reputation of this bank in the international markets.

Another reason why foreign banks have less expensive funding sources may be that virtually all of them are allowed to borrow from their foreign "mothers" (i.e. their founders with the same name). We presumed that the only foreign branch in Croatia was allowed to do this, but we also found that at least five out of six foreign "daughters" can borrow from their "mothers", as well (one "daughter" did not answer the question).

Finally, we observed that the seven foreign banks said nothing about the cost of deposits they attract in Croatia. Using CNB interest rate statistics, we can get a sense of how foreign banks' interest rates compare to domestic banks' interest rates. The table bellow suggests that the foreign banks incur lower costs on the savings collected in Croatia than their domestic competitors.[3]

In conclusion, we have every reason to believe that the Croatia's foreign banks have less expensive funding sources than the domestic banks. On the other hand, it appears that these funds are not as inexpensive as those of the mother-bank, or the daughters/branches in some other countries. This is caused by Croatia's relatively poor country investment rating, rather than bank-specific causes.

2.2 Loan interest rates

One of the justifications of financial market opening and liberalization in Croatia has been that foreign banks' entry will fuel lending competition, and consequently bring Croatia's high lending rates down. However, expert circles have noted that the foreign banks that have entered the Croatian market so far have quickly adapted to the country's high lending rates. A majority of the domestic banks state that competition from foreign banks has not forced them to reducing their loan rates, while less than half of that number feel that it has.

There is much more to be discerned from the banks' comments on this subject. As many as seven of the eleven banks that agree with the thesis that competition from foreign banks has forced loan rates down believe that this is a "recent development", "only a slight reduction was necessary", or "they could not be sure whether it was just

3 We have some reservations about these data, however. The CNB has developed a standard methodology for reporting interest rates, but this methodology is not yet in place. Until it is, there is some danger that interest rates are being misstated.

Table 9: Perceived loan rate competition by the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Had not affected loan rates	27	49,880,373	67.5%	59.2%
Forced loan rates down	11	33,542,319	27.5%	39.8%
No opinion/knowledge	2	787,452	5.0%	0.9%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

Table 10: Domestic vs. foreign loan rates – 1999 averages

Category	Weighted avg. loan rate	Number of banks	Assets managed (000 HRK)	% Number/Total	% Assets/Total
Foreign banks	10.90	7	7,783,890	14.89%	8.42%
Domestic banks	14.69	40	84,678,819	85.11%	91.58%
Total	14.13	47	92,462,709	100.00%	100.00%

Note: Weights are end-of year assets, not loans; non-loan placements included.
Source: CNB, Statistics Department

the foreign banks competition, or some other influence". Also seven banks that feel competition from foreign banks' has had no effect on their own loan rates claim that foreign banks have raised their rates instead.

Examining CNB loan rate statistics, we found no support for such beliefs. Some possible causes for this discrepancy are 1) that the foreign banks loan portfolios include a significant proportion of certain low-interest loans unobserved by the domestic banks, and 2) that the foreign banks calculate interest differently. Some domestic banks also suggested that the foreign banks compensate for their lower nominal loan rates by a much wider variety of loan fees. Unfortunately, we have no means to verify this claim at this time.

Considering these ambiguities, we are reluctant to draw any definite conclusions about foreign banks' lending interest rates and their impact on domestic banks' rates. We can only conclude that they are no higher than the domestic banks' interest rates on particular types of loans, and that their weighted average rates are significantly lower than those of domestic banks.

2.3 Employee quality

It seems to be a widespread popular impression that foreign banks attract better workforce, by offering higher wages or better working conditions. We find that over half of the domestic banks feel that this is not just a myth, while about one fifth feel that it is. The most prominent factors are thought to be higher salaries, other benefits, international reputation, and a current fad for working at a foreign bank.

Related to this issue, we asked the domestic banks whether they suffered employee loss to the foreign banks. With little over half of the banks claiming no losses, and little under a half acknowledging such losses, we could not establish a clear pattern. However, those that acknowledge employee loss account for over 80% of the interviewed population's total assets. Thus, it seems reasonable to conclude that larger banks have served as recruiting grounds for the foreign banks' workforce, definitely not a desirable trend.

According to our findings, the domestic banks show a full range of experiences with this phenomenon. While some have lost only a few employees, others have lost many. Also, some banks' losses have been limited to lower level staff, while others have lost their top managers. Finally, some banks have experienced an inflow of workforce from the foreign banks that often compensated for the outflow to the foreign banks.

In conclusion, the domestic banks' perceptions are verified on their foreign competitors' side. The foreign banks are by and large convinced that they really do have a better workforce than the domestic banks. Thus, we may conclude that, in general, the foreign banks in Croatia attract a better workforce.

2.4 Banking product innovation

Besides bringing down high interest rates, foreign entry was expected to bring new banking products (or services) to the market. These products could subsequently be

Table 11: Perceived foreign banks' employee quality

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Better	23	34,873,558	57.5%	41.4%
Not better	8	20,075,430	20.0%	23.8%
No opinion/knowledge	4	1,531,559	10.0%	1.8%
Total	35	56,480,547	87.5%	67.1%
Possible	40	84,210,144		

Table 12: Employee outflow to the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Experienced no outflow	22	13,795,821	55.0%	16.4%
Experienced outflow	17	69,818,983	42.5%	82.9%
No opinion/knowledge	1	595,340	2.5%	0.7%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

Table 13: Quality of the foreign banks' employees

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Better employees	6	7,433,793	85.7%	95.5%
No opinion/knowledge	1	350,097	14.3%	4.5%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

adopted by domestic banks, thus enriching the variety of products available in Croatia. Unfortunately, the vast majority of domestic banks say they have not adopted such products, while only a few claim that they have.

It may not be clear from the very construction of this question whether domestic banks are saying that the foreign banks introduced nothing, or that what had been introduced is not worth adopting. However, from our interviews, it seems that the foreign banks are only credited with the introduction of leasing. The vast majority of domestic banks have not yet started offering leasing to their clients, because they feel that in Croatia the tax system is not conducive to leasing. (See CNB, December (2000), "The Lending Policies of Croatian Banks", Surveys S-3, December).

Table 14: Adoption of new products introduced by the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Adopted none	36	81,435,025	90.0%	96.7%
Adopted some	4	2,775,119	10.0%	3.3%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

Table 15: New products introduced by the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Nothing	2	1,672,933	28.6%	21.5%
SWAPs	1	133,842	14.3%	1.7%
Futures	1	133,842	14.3%	1.7%
Real-time forex trading	1	133,842	14.3%	1.7%
Callable deposits	1	2,242,455	14.3%	28.8%
Callable revolving credits	1	470,687	14.3%	6.0%
Modified existing products	1	2,962,430	14.3%	38.1%
Total	8	7,750,031	114.3%	99.6%
Possible	7	7,783,890		

Table 16: New products to be introduced by the foreign banks

Which new products are you planning to introduce to the Croatian market?				
Short answer	**Number of banks**	**Assets managed (000 HRK)**	**% Number/Possible**	**% Assets/Possible**
Forfaiting	2	1,672,933	28.6%	21.5%
Structured trade finance	1	2,962,430	14.3%	38.1%
Business equipment leasing	1	350,097	14.3%	4.5%
Cash & asset management	1	1,322,836	14.3%	17.0%
Factoring	1	1,322,836	14.3%	17.0%
Total	6	7,631,132	85.7%	98.0%
Possible	7	7,783,890		

Table 17: New products that could not be introduced due to laws and regulations

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Forfaiting	4	5,106,050	57.1%	65.6%
Forward exchange rates	1	301,543	14.3%	3.9%
Structured trade finance	1	2,962,430	14.3%	38.1%
Uniform savings-book for Italy, Austria, Croatia	1	2,242,455	14.3%	28.8%
Business equipment leasing	1	350,097	14.3%	4.5%
Total	8	10,962,575	114.3%	140.8%

Another interesting comment made by several banks is that, while the foreign banks are not ahead in new product introduction, the flattering title of the leader in this area could easily be awarded to the largest domestic bank. This perhaps can be explained by the fact that there is the most room for product innovation in the area of retail banking, which is still heavily dominated by the domestic banks. Foreign banks have just begun entering this field.

We asked the foreign banks a series of questions dealing with their role in introducing new banking products to the Croatian market. While two medium-sized banks stated they had not introduced anything new to the market, one small bank (in Croatia but not at all small overall) introduced as many as three new products: SWAPs, futures, and real-time foreign exchange trading. Another medium sized bank introduced callable revolving credit that can be cancelled by either the creditor or the user. One large bank introduced callable time deposits paying interest rates slightly lower than a 3-month time-deposit, and requiring a 15-day withdrawal notice. One large bank stated that it had only offered modifications of already existing products. The fact that the major three banks that offered no new products manage almost 60% of the total of foreign banks' assets may explain why the domestic banks feel that the foreign banks have not offered new products.

Considering the short time that some of the foreign banks have been in Croatia, we inquired about any new products or services they are planning to offer in the future. Forfaiting was the highest-ranked on this list, with one bank planning to introduce it as a part of a wider array of products jointly named "structured trade finance". Other items on the list include business equipment leasing, and cash and asset management. One bank plans to offer factoring, which is definitely not a new product.

Finally, we wanted to know whether there have been any products that the foreign banks had planned to introduce to the market, but were unable to offer because of existing Croatian laws and regulations. By far the highest ranked on this wish-list is forfaiting, which would be introduced by as many as five foreign banks (by one bank within a "structured trade finance" package). The other currently illegal products on the wish-list include forward exchange contracts, and uniform savings-books for Austria, Italy, and Croatia, while business equipment leasing, although legal, is difficult under current legal provisions.

In conclusion, we can establish that the foreign banks have not stood out as leaders in banking product innovation. It is likely that their role in this area would have been more important had it not been for some restrictive (foreign exchange) regulations. Their clear leadership is evident only in leasing, and probably only because the domestic banks saw no interest in it, within the current legal framework, and specifically with the current tax laws.

2.5 Client knowledge

It should be noted that in sections 2.1-2.4 we established three competitive advantages of the foreign banks: lower funding costs, lower nominal credit rates, better employee quality. One may reasonably conjecture that client knowledge would be the foreign banks' disadvantage. So, we asked the domestic banks to judge whether the foreign banks were as well informed about Croatian loan-seekers as domestic banks are. Surprisingly, over half of the domestic banks believe that the foreign banks are at least equally well informed, while about a third believe that they are not as well informed. Two banks even think that foreign banks may be better informed because of their more systematic market research. About one third of the banks that believe that foreign banks are equally well informed believe that the main reason for this is that their employees come from basically the same pool of domestic banking specialists.

We were also interested in the self-perceived client knowledge of the foreign banks. Only one bank feels that

Table 18: Perceived foreign banks' client knowledge

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
At least as domestic banks' knowledge	23	35,816,556	57.5%	42.5%
Worse than domestic banks' knowledge	14	46,148,147	35.0%	54.8%
No opinion/knowledge	3	2,245,441	7.5%	2.7%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

Table 19: The foreign banks' self-perceived client knowledge

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
At least as domestic banks' knowledge	6	7,433,793	85.7%	95.5%
Worse than domestic banks' knowledge	1	350,097	14.3%	4.5%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 20: Perceived foreign banks' advertising success

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Successful	24	26,157,351	60.0%	31.1%
No opinion/knowledge	9	6,903,836	22.5%	8.2%
Unsuccessful	7	51,148,957	17.5%	60.7%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

Table 21: The foreign banks' self-perceived advertising success

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Successful	4	4,337,521	57.1%	55.7%
No opinion/knowledge	2	3,096,272	28.6%	39.8%
Very successful	1	350,097	14.3%	4.5%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

its client knowledge is inferior to its domestic competitors. As many as four banks explicitly attributed their equal client knowledge to the fact that their workforce in this segment of operations is entirely or mostly domestic. One bank admitted to having inferior client knowledge in the past, but not at present. Thus, the domestic and the foreign banks agree that the foreign banks are equally well-informed about Croatian loan seekers.

2.6 Advertising

Over the years, many foreign banks have engaged in heavy advertising to attract new clients. Again, one has reason to believe that foreign banks' relatively weaker market knowledge presents a disadvantage when it comes to advertising efforts. Thus, we asked the domestic banks to judge the success of foreign banks' advertising campaigns. Three fifths of them think that these campaigns have been successful, while less than one fifth believe the opposite. It is significant that as many as five banks explicitly mention that the "foreign name" alone plays a key role in attracting clients. Some of them assert that only some (or especially some) foreign banks have had successful advertising campaigns, usually singling out those foreign banks most involved in retail.

In reality, all but one of the seven foreign banks have engaged in advertising at some point to attract domestic clients. Four banks feel that their advertising campaigns in Croatia have been successful, while one even considers them very successful. Two banks have no opinion on the actual success of their advertising efforts, one because it does not advertise. In spite of their relatively homogeneous feelings about the success of their advertising in Croatia, foreign banks' perceptions of their own advertising styles are quite different. One considers itself to be unaggressive, another uses the "word of mouth" only, while a third launches a loud advertising campaign with every new product. Thus, we may conclude that, in general, foreign banks' advertising has been successful in Croatia, despite (or because) of different marketing approaches. In addition, the domestic banks clearly recognize various degrees of advertising success of their foreign competitors.

2.7 Internal communications

Besides not knowing the market well, one would expect that not knowing the language or the culture in the new country of business is also a competitive disadvantage of the foreign banks. Namely, all the foreign banks in Croatia have been founded by German, Italian, or French speaking mother-banks. Also, though they employ mostly domestic workers, some of them have a very high proportion of foreign managers, as we shall see in Section 5.2. What we found is that none of the banks complained about persistent communication problems.

The most interesting finding in this area of our research is that the official language in use between domestic and foreign managers in Croatia's foreign banks is overwhelmingly English. This is despite the fact that none of the founders' home countries are English-speaking countries! One foreign bank uses Croatian as the official language. One bank mentioned that they use the mother-bank's native language in communication with the mother-bank only. Thus, considering the widespread use of English in finance in general, and in Croatia in particular, we have no reason to suspect that foreign banks in Croatia suffer from problems in internal communication.

2.8 General competition level

To cap-off the discussion of the competitive advantages and disadvantages of the foreign banks, we asked the domestic banks whether they perceived the foreign banks as serious competition (threat) to their businesses in general. As many as 70% of the number of the domestic banks answered in the negative. However, almost half of those that answered negatively believe either that "foreign banks will represent a threat in the future", "foreign banks might present a threat in the future", or "foreign banks already do represent a threat, but not to their bank". Thus, based on our findings, as many as 40% of the

Table 22: Communication problems due to cultural differences

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Never	3	2,677,840	42.9%	34.4%
Sometimes	2	820,784	28.6%	10.5%
Total	5	3,498,624	71.4%	44.9%
Possible	7	7,783,890		

Table 23: The official language in the daughter bank

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
English	6	7,482,347	85.7%	96.1%
Croatian	1	301,543	14.3%	3.9%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 24: The foreign banks as a threat to the domestic banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
No	28	71,081,965	70.0%	84.4%
Yes	12	13,128,179	30.0%	15.6%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

total number of the domestic banks consider the current lack of threat a more permanent condition, which is a surprisingly large number.

3. Domestic Banks in Banking System Consolidation

The next group of questions for the domestic banks dealt with their future business prospects as independent enterprises. We tied this to the subject of a silent but clearly evident consolidation process in the Croatian banking system. There are many foreign banks, not presently active in Croatia, willing to enter the market through mergers and partial or full acquisitions of domestic banks. The table below appears to suggest an upward trend of domestic bank acquisitions by foreign banks, though more detailed and longer time series data would be required to draw stronger conclusions. However, our finding is strengthened by the fact that the sales to foreigners in the first quarter of 2000 and those planned for the remainder of the year are not recorded in the table. Additionally, including the assets of failed (domestic) banks in the 1998 total would strengthen the apparent trend even further, since very few of them were counted in the 1999 total.

3.1 Mid-term survival

There were sixty banks operating in Croatia at the beginning of 1998. Two years later, there are fifty-three banks, but two of them are in a state-run rehabilitation process, and four are facing bankruptcy. Thus, there are forty-seven banks pursuing a "normal" course of business. At the time of writing, this number seems poised for a further reduction, not due to failures, but rather to acquisitions and mergers. It has been announced that at least four banks will be fused into their (domestic) mother banks, and at least three banks to be merged by a new

Table 25: Croatia's banks ownership structure

	1999		1998	
Majority-ownership	Number of banks	Assets = December 31, 1999 (000 HRK)	Number of banks	Assets = December 31, 1999 (000 HRK)
Foreign	13	14.9%	10	10.3%
Domestic	39	85.0%	42	89.6%
50-50	1	0.1%	1	0.1%
Total	53	100.0%	53	100.0%

Source: CNB, Banking Supervision Department owner, which should bring down the number to forty-one, at most. In such a tumultuous environment, where it seems that the most difficult thing for a bank to do is to stay independent, we asked the domestic banks about their mid-term prospects as independents.

We find that almost one third of the domestic banks believe that they cannot survive the next five years as independent enterprises. Several banks believe that "perhaps" they could, contingent upon economic recovery. Finally, among those that believe in their survival, two banks state that bare "survival" is all they can do as independents (without growth and/or development), and three banks expect difficulties along the road. Thus only about 30% of the domestic banks feel strongly about their mid-term prospects as independents.

3.2 Domestic vs. foreign "strategic" partner

To tie this issue in with the foreign supported consolidation, we asked the domestic banks whether they would

Table 26: Perceived mid-term independent survival prospects

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Good	17	34,160,555	42.5%	40.6%
Bad	12	18,934,711	30.0%	22.5%
Irrelevant	5	25,890,529	12.5%	30.7%
Moderate	4	4,476,649	10.0%	5.3%
No opinion/knowledge	1	516,008	2.5%	0.6%
Total	39	83,978,452	97.5%	99.7%
Possible	40	84,210,144		

Table 27: Foreign vs. domestic "strategic partner" preference

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Irrelevant	25	71,040,963	62.5%	84.4%
Foreign	8	7,534,219	20.0%	8.9%
Domestic	6	5,039,622	15.0%	6.0%
No opinion/knowledge	1	595,340	2.5%	0.7%
Total	40	84,210,144	100.0%	100.0%
Possible	40	84,210,144		

Table 28: Probable reaction to a hostile minority-stake bid by a foreigner

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Positive	11	4,516,440	27.5%	5.4%
Irrelevant	11	34,209,128	27.5%	40.6%
Neutral/depends	10	6,039,095	25.0%	7.2%
Negative	5	13,119,100	12.5%	15.6%
No opinion/knowledge	1	547,861	2.5%	0.7%
Total	38	58,431,624	95.0%	69.4%
Possible	40	84,210,144		

Table 29: Probable reaction to a hostile majority-stake bid by a foreigner

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Positive	12	5,369,172	30.0%	6.4%
Irrelevant	11	34,993,482	27.5%	41.6%
Neutral/depends	8	4,132,621	20.0%	4.9%
Negative	4	13,071,354	10.0%	15.5%
No opinion/knowledge	3	864,995	7.5%	1.0%
Total	38	58,431,624	95.0%	69.4%
Possible	40	84,210,144		

prefer a domestic to a foreign partner, if they decided to merge or sell a sizeable share of their ownership. The answers suggest that whether a potential partner is domestic or foreign is of secondary importance. A similar number of banks would prefer a foreign partner as a domestic partner. However, well over half of the domestic banks stated that either 1) they do not expect to merge or sell ownership shares, 2) they are already negotiating with potential partners, or 3) they find this characteristic in a potential partner insignificant. Within the latter group, several banks require just a "quality" partner, not a foreign or a domestic partner. Half of those preferring a foreign partner cite the "foreign name" (or reputation or image) as the main reason for their preference.

3.3 Unsolicited (hostile) acquisitions

We also wanted to assess the probable reactions of domestic banks to hypothetical "unsolicited minority/majority stake offers by reputable foreign banks". Our intention here was to predict reactions to possible (and even probable) hostile bids, even though these have been mysteriously absent in the consolidation process until now. When it comes to a minority-stake offer, we found that only a small number of banks would react negatively, with about equal numbers of those welcoming such offers as having neutral attitude towards them.

When it comes to a majority stake offer the results are similar, with almost a third of all banks reacting positively, one fifth neutrally, and a few banks negatively. In both the minority-stake and the majority-stake cases, as many as eleven out of forty banks stated that this (hypothetical) offer would be irrelevant at this time. The most common reasons are some specific circumstances such as bank's strategy, public ownership structure, that they have just been bought (three banks), or that they are currently negotiating an acquisition.

4. Reasons for Coming to and Staying in Croatia

One of the goals of our survey was to find out what brought the foreign banks to Croatia, and more importantly, what keeps them here. The questions were based on those used by Konopielko (1999) in his survey of foreign bank entry into transition markets. The answers to these questions confirm much of our own prior informal knowledge about the aspects of the Croatian market attractive to foreign banks, and to foreign capital in general.

4.1 Reasons for coming to Croatia

We presented the foreign banks with several possible general reasons for entering the Croatian market: following existing (home country) clients, searching for new clients, financing the international trade, competition in the home country. The last two reasons are judged less important than the first two. Two other general motivations are mentioned, one by each bank: expansion strategy, and paving the way for home country clients.

We also inquired about specific features of the Croatian market that made it attractive to foreign banks. These features can be seen as more specific reasons for entering the Croatian market than the ones just presented. Considering some foreign banks' comments implying that Croatia is at present in an acute state of "general exhaustion of households and enterprises", they may also be viewed as specific reasons for staying in Croatia, while awaiting and supporting economic recovery. The three most frequently mentioned attractive features of the Croatian market are, not surprisingly, 1) potential in tourism, 2) proximity (both geographical and in mentality), and 3) high interest spreads. One other interesting fea-

Table 30: General reasons for entering the Croatian market

Reason given	Importance level	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Following existing clients	most important	4	5,809,414	57.1%	74.6%
	very important	3	1,974,476	42.9%	25.4%
Total		7	7,783,890	100.0%	100.0%
Search for new clients	most important	2	4,285,266	28.6%	55.1%
	important	2	2,543,998	28.6%	32.7%
	very important	2	820,784	28.6%	10.5%
Total		6	7,650,048	85.7%	98.3%
Financing international trade	very important	2	2,592,552	28.6%	33.3%
	most important	1	133,842	14.3%	1.7%
Total		3	2,726,394	42.9%	35.0%
Competition at home	important	1	1,322,836	14.3%	17.0%
Total		1	1,322,836	14.3%	17.0%
Other reasons	most important	2	651,640	28.6%	8.4%
Total		2	651,640	28.6%	8.4%
Possible		7	7,783,890		

Table 31: Attractive specifics of the Croatian market

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Tourism	2	2,543,998	28.6%	32.7%
Proximity	2	3,263,973	28.6%	41.9%
High spreads	2	1,456,678	28.6%	18.7%
Stable industry branches	1	470,687	14.3%	6.0%
Nothing	1	350,097	14.3%	4.5%
Expansion opportunity	1	1,322,836	14.3%	17.0%
Existing clients	1	1,322,836	14.3%	17.0%
Agriculture	1	2,242,455	14.3%	28.8%
Possible	7	7,783,890		

ture noted is potential in agriculture. Only one bank sees no attractive specifics of the Croatian market. Multiple answers were allowed.

4.2 Reasons for staying in Croatia

4.2.1 Doing business with home country clients in Croatia

One of the reasons for coming to Croatia most definitely has been following home country clients' businesses to Croatia. As we see in the Table 32 this is still one of the most important aspects of foreign banks' operations in Croatia.

Moreover, most banks expect this type of business to increase in the future. In their comments, the foreign banks suggested that "there were indications" of an increase since the January elections, and that they expected a substantial increase in both greenfield investments and direct firm acquisitions.

4.2.2 Foreign exchange trading

We asked the foreign banks how important foreign exchange trading is for their operations in Croatia. The Table 34 shows that the importance level of this type of business for six out of the seven foreign banks is evenly distributed from "important" to "most important".

Not surprisingly, the same six banks are not ecstatic about the prospects of Croatia adopting the Euro as its official currency. They believe that the resulting loss of trading profits will not be compensated for by probable greater liquidity and elimination of exchange rate risk. On the other hand, the only bank not appearing in the table above feels that adopting the Euro would make the Croatian market substantially more attractive.

Finally, we corroborate the above findings with official CNB data on foreign exchange trading volumes. As these data suggest, foreign banks share in foreign exchange trading volume is several times greater than their share in total banking assets. Thus, we may conclude that this business activity is very important to foreign banks in Croatia.

Table 32: Doing business with home country clients in Croatia

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Most important	4	3,917,056	57.1%	50.3%
Important	2	3,565,291	28.6%	45.8%
Unimportant	1	301,543	14.3%	3.9%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 33: Future of doing business with home country clients in Croatia

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Will increase	4	5,106,050	57.1%	65.6%
Won't increase	2	2,543,998	28.6%	32.7%
Total	6	7,650,048	85.7%	98.3%
Possible	7	7,783,890		

Table 34: Foreign exchange trading in Croatia

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Important	2	2,543,998	28.6%	32.7%
Very important	2	4,285,266	28.6%	55.1%
Most important	2	483,939	28.6%	6.2%
Total	6	7,313,203	85.7%	94.0%
Possible	7	7,783,890		

Table 35: Croatian market with Euro in place of Kuna

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Not significantly more attractive	6	7,313,203	85.7%	94.0%
Significantly more attractive	1	470,687	14.3%	6.0%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 36: Foreign exchange trading in Croatia in 1999

Category	Purchases	Sales	Number of banks	Assets managed (000 HRK)	% Number/Total	% Assets/Total
Foreign banks	20%	23%	7	7,783,890	14.89%	8.42%
Domestic banks	80%	77%	40	84,678,819	85.11%	91.58%
Total	100%	100%	47	92,462,709	100.00%	100.00%

4.2.3 Export-import financing

For as many as five foreign banks, one of the most important activities in Croatia is export-import financing. More specifically, two banks explicitly said that they finance only Croatian producers-exporters, and not traders-importers, which definitely is a desirable development. Since in the present state of the economy our exports can only increase, we included this type of business among the main reasons for the foreign banks to stay in Croatia.

4.2.4 Other

Besides the activities in subsections 4.2.1 through 4.2.3, there were no others that a larger number of the foreign banks felt strongly about. Among the more prominent activities that foreign banks had mixed feelings about are leasing and retail banking. Most of them found securities trading and non-financial activities relatively unimportant.

However, we have strong indications that besides foreign exchange trading, interbank lending also plays an ex-

Table 37: Financing exports and imports in Croatia

Short answer	Number of banks	Assets managed (000 HRK)	% Number/ Possible	% Assets/ Possible
Very important	4	2,228,908	57.1%	28.6%
Most important	1	2,962,430	14.3%	38.1%
Total	5	5,191,338	71.4%	66.7%
Possible	7	7,783,890		

Table 38: Interbank money market participation by the foreign banks in 1999

Category	MM – placed	%Total	MM – received	%Total	Assets	%Total
Foreign banks	196,958,870	35.8%	24,187,996	3.7%	7,783,890	8.5%
Domestic banks	353,841,874	64.2%	625,060,942	96.3%	84,210,144	91.5%
Total	550,800,744	100.0%	649,248,939	100.0%	91,994,034	100.0%

Source: CNB, Statistics Department

Table 39: Expansion to Croatia within the foreign banks' regional strategy

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Fits very well	4	5,856,525	57.1%	75.2%
Fits well	2	1,793,523	28.6%	23.0%
Does not fit	1	133,842	14.3%	1.7%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

tremely important (profitable) role in foreign banks' activity in Croatia. It seems that foreign banks have managed to make considerable profit in the recent banking crisis, precisely because of the liquidity problems of all but the best domestic banks. Only this can explain their disproportionately large participation on the lending side and disproportionately small participation on the borrowing side of the interbank money market. In the Table 38, we find foreign banks' share in interbank credits placed to be several times their share in total banking assets, and their share in total banking assets to be twice as large as their share in interbank credits received.

Finally, the most important, albeit very general, reason for foreign banks to stay in Croatia is precisely the most important reason for coming here in the first place: expansion to Croatia fits well within their regional strategies. Significantly, most banks included Croatia in the expansion round to the CEE countries including Slovenia, the Czech Republic, Slovakia, Poland, and Hungary, while one bank added Russia, Ukraine and Bulgaria to this group. Moreover, two banks stated explicitly that they are not in a hurry to expand further to the South-East (Bosnia, Montenegro, Macedonia).

Only one of the seven banks stated that the expansion to Croatia does not fit its expansion plans any more. This bank has recently sold its business in Croatia to another foreign bank.

5. Strategy in the Croatian Market

For a successful foreign bank, there are many ways to come to Croatia, and many more ways to remain here. Until quite recently, most foreign banks have entered the Croatian market by founding their daughters here. Consequently, they started building their Croatian businesses virtually from scratch. Such beginnings required many adjustments and innovations to the founding mothers' policies, procedures, and systems, to adapt to domestic laws, regulations, and banking practice. They also required formulation of the relationships between the mothers and their Croatian daughters. Finally, they required learning the domestic corporate culture, the domestic culture in general, the market and the clients, and incorporating all this knowledge in marketing efforts aimed at "stealing" some clients from the domestic banks. In this section we discuss these aspects of foreign banks' entry to Croatia.

5.1 Organizational structure and relationship with the foreign founder

Recently, there have been a large number of foreign banks entering Croatia by purchasing domestic banks. However, the seven banks in our focus here all entered the market by founding "daughters" or branches. Though one may think that the choice of strategy for entering new markets should be based on economic factors, five of our seven banks stated that founding a "daughter" (or a branch) when entering a new market is their standard practice. We may find it indicative though that the largest banks cited reasons such as caution and compromise as their reasons. In their elaboration they admitted that they had feared small domestic banks out of lack of knowledge about the Croatian banking system, while they were still too weak to buy large banks.

It is interesting to notice that only one of the seven banks in question founded a branch in Croatia, while all others formed daughters. We were unable to find any deeper reasons for this difference in approaches. Both groups of banks cited "standard practice" as the sole reason for choosing a daughter over a branch, and vice versa.

Naturally, pledging their capital is not the only way the "mothers" get involved in their daughter's operations. Six banks stated that their mothers are represented in the Managing Boards of the daughters.[4] Unfortunately, only two banks were specific about the proportion of this representation (33% in one, and 100% in another case). Also six banks stated that their mothers are represented in the Supervisory Boards of the daughters. More importantly, three banks stated that the mother has 100% control over the SB, while the other three were not specific on this question.

Another interesting characteristic of Croatia's foreign banks is that all seven of them carry the mother's name(s) in their name, usually in the form "Mother's name – Croatia d.d." or the like. This perhaps is the most important reason why all seven banks can borrow funds from their mothers, and count on financial and other help in times of crisis. One bank specifically stated that the mother would most certainly help the troubled daughter primarily to protect the mother's (international) reputation. Of course, in the case of our single branch, the mother is legally obliged to provide financial assistance.

Considering that the foreign mothers not only invested capital in their Croatian daughters, but also

4 Interestingly, in five of the six domestic banks acquired by foreign banks in the last two years, the managing board consists exclusively of Croatians.

Table 40: Reasons for founding a daughter or a branch in Croatia

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Standard practice	5	2,579,005	71.4%	33.1%
Compromise solution	1	2,242,455	14.3%	28.8%
Out of caution	1	2,962,430	14.3%	38.1%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 41: "Mother's" assistance to a troubled "daughter"

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Every form of assistance	4	3,747,912	57.1%	48.1%
Financial assistance	3	4,035,978	42.9%	51.9%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 42: "Mother's" participation in credit approval

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Largest credits only	4	4,889,795	57.1%	62.8%
Not only largest credits	1	301,543	14.3%	3.9%
Total	5	5,191,338	71.4%	66.7%
Possible	7	7,783,890		

pledged that they would support them in their activities here if need be, we wanted to get a sense of how much the "mothers" got involved in the every day operations of their Croatian "daughters". To this end, we asked the foreign banks whether they needed approval from the mother to grant any but the largest loans in Croatia.

As we see in the Table 42, most foreign daughters in Croatia are independent in their daily lending business. Even the single bank in which the mother participates in regular credit approval stated that in reality small and medium credits are granted independently of the mother, large loans jointly, and the largest ones exclusively by the mother. On the other side, one of the banks stated that the daughter is independent even in approving the largest credits. For most ban ks however, the mother usually has the exclusive decision about the largest credits.

5.2 Foreign managers

We were also interested in some specific features of the foreign banks' foreign managers. First, we found out that between 1/3 and 1/1 of the higher level managers in the foreign banks are foreign, with the majority of the banks keeping this ratio between 1/3 and 1/2.

Second, we inquired about foreign bank managers' experience working in other transition countries. While four banks employ managers with such experience, three do not. When asked, three of the former four banks confirmed that they found this experience a welcome asset in doing business in Croatia.

5.3 Clients

As far as strategy in the Croatian market is concerned, probably the most interesting and the most important issue is client targeting. Our survey shows that there are two to five main client types sought by the foreign banks. The most sought after are large "top" domestic companies and small to medium domestic companies (mostly exporters). Following them are foreigners and foreign investors, high-income individuals (lawyers, doctors, dentists, etc.), and international corporations. Multiple choices were allowed.

Another point of interest was the proportion of foreign clients in total deposits and in the total credits. As we can see, on the deposit side foreign banks have a much larger proportion of foreigners (20-75%), than on the credits side (0-67%). This speaks of a desirable net-effect of foreign financing through Croatia's foreign banks and dispels the myth that domestic savings in Croatia's foreign banks are transferred to and invested abroad.

5.4 Strategic decision-making

We were interested in how the mothers influenced the making of key strategic decisions in Croatia's foreign banks. As the following three tables show, there is less homogeneity in strategic decision-making than in other aspects of foreign banks Croatian operations analyzed up to this point. Depending on the decision to be made, the main role is played by either the "mother", or the Managing Board, or the shareholders' assembly and the Supervisory Board.

Table 43: High-level foreign managers in the foreign banks

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
1/2	3	906,072	42.9%	11.6%
1/3	2	4,285,266	28.6%	55.1%
1/1	1	350,097	14.3%	4.5%
2/3	1	2,242,455	14.3%	28.8%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 44: Foreign managers transition country experience

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
None	3	3,397,815	42.9%	43.7%
All	2	1,672,933	28.6%	21.5%
Some	2	2,713,142	28.6%	34.9%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 45: The foreign banks' key clients in Croatia

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Top large companies	3	4,419,108	42.9%	56.8%
Small and/or medium companies (exporters)	3	3,014,685	42.9%	38.7%
Foreigners/foreign investors	2	3,565,291	28.6%	45.8%
High-income individuals	2	3,565,291	28.6%	45.8%
International corporations	2	3,096,272	28.6%	39.8%
Households	1	301,543	14.3%	3.9%
Large exporters	1	350,097	14.3%	4.5%
Sole proprietors	1	470,687	14.3%	6.0%
Possible	7	7,783,890		

Table 46: Foreign clients on the deposit side

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
20%	2	1,624,379	28.6%	20.9%
40%	1	350,097	14.3%	4.5%
75%	1	133,842	14.3%	1.7%
Total	4	2,108,318	57.1%	27.1%
Possible	7	7,783,890		

Table 47: Foreign clients on the credit side

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
0%	2	435,385	28.6%	5.6%
15%	1	2,242,455	14.3%	28.8%
20%	1	470,687	14.3%	6.0%
30%	1	2,962,430	14.3%	38.1%
50%	1	1,322,836	14.3%	17.0%
67%	1	350,097	14.3%	4.5%
Total	7	7,783,890	100.0%	100.0%

Table 48: Capital changes decisionmakers

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
"Mother"	3	3,566,959	42.9%	45.8%
Shareholders' assembly	3	2,894,095	42.9%	37.2%
SB	1	1,322,836	14.3%	17.0%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 49: Policies and procedures decisionmakers

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
MB	4	6,998,408	57.1%	89.9%
"Mother"	1	133,842	14.3%	1.7%
Daughter's MB + mother's MB	1	350,097	14.3%	4.5%
MB and SB	1	301,543	14.3%	3.9%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 50: Dividends decisionmakers

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Shareholders' assembly	2	2,592,552	28.6%	33.3%
SB	2	4,285,266	28.6%	55.1%
"Mother"	1	470,687	14.3%	6.0%
MB and SB	1	301,543	14.3%	3.9%
Irrelevant	1	133,842	14.3%	1.7%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 51: Information systems

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
New system	3	5,506,428	42.9%	70.7%
"Mother's" system	2	604,529	28.6%	7.8%
Small adjustments to "mother's system"	2	1,672,933	28.6%	21.5%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 52: Credit policies

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
Small to medium changes to "mother's" policies	3	1,974,476	42.9%	25.4%
New policies	3	5,675,572	42.9%	72.9%
"Mother's" policies	1	133,842	14.3%	1.7%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

Table 53: Personnel policies

Short answer	Number of banks	Assets managed (000 HRK)	% Number/Possible	% Assets/Possible
New policies	4	4,889,795	57.1%	62.8%
Small to medium changes to "mother's" policies	3	2,894,095	42.9%	37.2%
Total	7	7,783,890	100.0%	100.0%
Possible	7	7,783,890		

In all but one of the seven foreign banks, any changes to capital are decided upon by either the "mother" or the shareholders assembly.

In four out of seven banks the policies and the procedures are the responsibility of the Managing Board.

Interestingly, two banks explicitly stated that they had not distributed dividends in the past, and one of them said that it is not clear whose decision it should be. The decision on dividends is the responsibility of the shareholders' assembly in just as many and as large banks as it is the responsibility of the Supervisory Board.

5.5 Operations adjustments

We assumed that the foreign daughters had to adapt their mothers' systems, policies and procedures to the specifics of the Croatian market, its laws and its regulations. So, we specifically asked them about the extent of those adjustments, referring to the information system, the credit policies, and the personnel policies.

We have been unable to find out why an approximately equal number of daughters started out with a new information system, as opposed to making only smaller changes or simply adopting the mother's information system. Curiously, one bank stated that all its mother's (foreign) daughters use the same system – a system different from the mother's system.

Just as many banks started with a complete new set of credit policies, as with slightly or moderately changed mothers' policies. Only one very small bank stated that its mother's policies needed no changes to be applied in Croatia. Basically, those banks that created completely new credit policies stated that they only adopted the core principles from their mothers' policies.

Finally, we found that the mothers' personnel policies had to be changed even more drastically than credit policies before being implemented in Croatia. As many as four out of the seven foreign banks started out with brand new personnel policies, while no bank stated that it adopted the mother's policies without any adjustments.

6. Conclusions and Directions for Further Research

As a way of summarizing our findings, we will now review the claims for and against foreign ownership from Section 2 above against the evidence from the interviews. We begin with the advantages.

Product and service innovation, economies of scale and scope. This is one of our most interesting findings. In Croatia, it has not been the foreign banks that have been the main introducers of new products. On the contrary, the two largest domestic banks have had the scale of operation, both in their retail and corporate divisions, to justify introducing new products. Although the largest bank has had an easier time thanks to a much smaller legacy of past problems, the second largest bank has also started to function as a product and service innovator. It is important to note that such know-how can be readily purchased via consultants and international suppliers (e.g. for ATM hardware). Thus, a domestic bank that has the resources and the desire to innovate can do so.

Foreign banks have offered some new products such as leasing, and plan more, such as forfaiting. They, perhaps even more than other banks, seem limited by restricting foreign exchange laws and regulations. Judging by the plans for new products and services banks were willing to share with us, we can expect that foreign banks will be more active in product and service innovation in the near future.

Large domestic banks have been able to incorporate new banking technology (improved information systems, ATMs, PC banking). Unlike in Hungary, where foreign banks came with ready-made information systems, in Croatia many foreign banks report having to make substantial modifications to their IT. This may be the result of certain idiosyncrasies of the Croatian situation, such as the lack of credit registers, the importance of the ZAP both in making payments and in monitoring clients, and the overall low level of information on clients. These peculiarities of the Croatian market have probably partially protected Croatian banks from foreign competition.

However, it will be interesting to see whether the much larger scale of some of the foreign banks that have recently entered the Croatian market will give them significant advantages. One foreign bank talks about using a standard risk management system throughout all of Central and Eastern Europe, and such approaches, if successful, might give larger players scale advantages.

Similar things can be said about economies of scope. So far, the two largest domestic banks have handled the only IPOs and initial placements of corporate bonds in Croatia. It remains to be seen whether foreign banks will have advantages in scope economies.

Environment of competition. It is clear that the arrival of the foreign banks has intensified competition somewhat, but not to a great extent. Foreign banks have been willing to free ride on high interest spreads, thus earning substantial profits in some cases. Also, many of the foreign banks have sought out niche markets such as high net worth individuals and blue-chip firms, rather than seeking to compete in broad wholesale or retail markets.

Most market players expect competition to increase substantially in the coming period. This seems especially likely in view of the fact that foreign banks have spent relatively large amounts of money to purchase domestic banks with substantial banking networks. Based on this fact, the comments made by the bankers we interviewed, and statements in the press, it seems likely that these banks will seek to be major players in broad commercial and retail banking markets.

Development of financial markets. Here, a substantial effect can be seen in the foreign banks' major role on the interbank market. Without their participation, liquidity would be substantially more difficult for domestic banks to obtain. Also, foreign banks' sophistication in foreign exchange trading has clearly had an important impact on that market.

Spillover effects of good banking practice. This cannot be assessed from our data.

Attraction of foreign direct investment. Foreign banks are eager to work with home country firms in Croatia. This certainly stimulates trade. However, we did not hear many stories about how foreign banks directly encouraged FDI decisions. In the recent period, the political changes in Croatia probably were the major factor changing the FDI climate, not the presence of foreign banks.

However, it should be noted that the inflow of funds resulting directly from the arrival of the foreign banks has been extremely significant. Even before the major privatizations of late 1999 and early 2000, banking was one of Croatia's leading sectors for FDI inflow. With the privatizations of the four banks finishing rehabilitation, banking privatization has become the main form of FDI inflow along with telecommunications. This injection is of enormous importance to the investment-starved Croatian economy.

Let us now look at the negative factors:

Fear of foreign control. As with many of the benefits of privatization, this will only materialize – if it does at all – after the current privatizations are finished. So far, even banks in 100% foreign ownership remain Croatian run. While each bank has its own business strategy, we had no reason to believe that these foreign banks were operating in any way that would harm the Croatian economy.

Protect infant industry. Given the limited impact foreign banks have had so far, it is hard to argue that they have undermined the infant Croatian banking industry. There is some limited evidence that Croatian banks have lost personnel to foreign banks, and at times these lost personnel have been important managers. But other Croatian banks report gaining personnel from the foreign banks, so the net effect does not seem great.

Banks are special. So far, only one foreign bank has failed, and this is a small bank whose foreign ownership comes from a less developed market than Croatia's (Bosnia-Herzegovina). In any case, the extension of deposit insurance to this bank would really benefit Croatian depositors, not the foreign owners of the bank.

The issue becomes somewhat more interesting in relation to banks that have been rehabilitated. The Croatian government will continue to service substantial amounts of rehabilitation bonds to the foreign owners of these banks. However, it should be remembered that without these bonds, the net worth of these banks would have been lower (negative, in fact), so that the banks could not have been sold without the bonds. Given that shares were sold substantially above book value for these banks, it seems that the government has gotten the best deal possible under the circumstances.

Foreign banks are special. Here, we would stress that foreign banks place more of their assets with Croatian entities than they obtain funds from Croatian depositors. In other words, foreign banks are not taking Croatia's money and sending it somewhere else. Instead, they are bringing money to the Croatian economy, a very important and beneficial fact.

Regulatory differences. This is simply not an issue at this time. Croatia supervises all banks, even bank branches, as though they were domestic branches.

To summarize, foreign entry into the Croatian market has been relatively slow and cautious until this year. Foreign banks have come in pursuit of regional strategies, to do business with home country clients and to seek new clients. They appear to possess competitive advantages in cheaper funding sources, lower loan interest rates, superior personnel, and successful advertising approaches (name recognition). Their entry has mainly been beneficial, bringing significant funds into Croatia and mildly stimulating competition and new product and service development. Negative effects on domestic banks seem to have been fairly mild (loss of personnel). However, we will have to wait a bit to see whether larger benefits will flow from the currently much higher level of foreign participation in the market.

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