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SELECTED PROCESSES INFLUENCING CONTEMPORARY BANKING SYSTEMS

WYBRANE PROCESY WPŁYWAJĄCE NA WSPÓŁCZESNE SYSTEMY BANKOWE

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Summary: The aim of the paper is to present synthetically some of the processes, which influence the shape of the contemporary systems. There are characterized in details three of them: internationalization, privatization and demutualization. The author focuses on potential advantages and disadvantages of those three processes, in the context of their influence on financial stability.

Keywords: Financialization, privatization, internationalization, financial systems, demutualization.

Streszczenie: Celem artykułu jest syntetyczna charakterystyka wybranych procesów wpływających na kształt i funkcjonowanie współczesnych systemów bankowych. W szczególności scharakteryzowano trzy spośród z nich: internacjonalizację, prywatyzację i demutualizację. Skupiono się przy tym na potencjalnych wadach i zaletach tych procesów, w kontekście ich wpływu na stabilność finansową.

Słowa kluczowe: finansyzacja, prywatyzacja, internacjonalizacja, systemy finansowe, demutualizacja.

1. Introduction

The last 50 years have brought along rapid changes in the conditions of functioning of banking systems. They were connected, among others, with such factors as globalization and internationalization of the financial markets and institutions, liberalization and deregulation, disintermediation, technological progress or, last but not least, financialization. Those processes have influenced processes of creation and regulation of money, the very functioning of financial intermediaries (as well as changes of those institutions themselves), as well as the processes of savings and

investments. They contributed also to changes in ownership and structure of the domestic financial systems and economies.

Origins of those phenomena were diverse. Some of them resulted from intrinsic market processes, while the others constituted the aftermath of specific decisions and actions made by politicians, policymakers and supervisors. The mentioned processes had, however, some similar patterns and consequences. Among them, one may list decreasing role of the government, growing linkages between domestic economies and their financial markets (connected with greater risk and scale of so-called contagion effects), slackening supervision of the latter ones and, finally, emancipation of financial markets and institutions.[1] Moreover, their influence was not only strictly economic, but had also clear social and cultural dimensions [Kose et al 2006; Kowalski 2013; Scholte 2006].

The aim of the paper is to present synthetically some of the mentioned processes. They are characterized by: internationalization, privatization and de-mutualization. The author focuses on potential advantages and disadvantages of those three processes, in the context of their influence on financial stability.

2. Definition, features and consequences of banks' internationalization

Internationalization of financial systems is already established and well known phenomenon. It had started already in the 19th century, accelerating significantly during 1960s. The group of financial institutions that was the main object of internationalization were banks, but also involved in it were other types of financial intermediaries, mainly insurance companies.

Thus, giving its precise and clear-cut definition is not a simple task. According to Solarz and Wyczański [1997], internationalization of banking systems may be understood in two ways: as a process of expanding activities by a domestic bank through expansion on foreign markets or as a process of entering foreign investors into domestic banks. The authors add simultaneously that under such circumstances foreign banks are treated as an institutional form of transmitting worldwide tendencies into the domestic banking sector. Bearing in mind that definition, the degree of banking system internationalization might be measured here by the share of foreign shareholders and creditors in liabilities of the consolidated domestic banking system.

Internationalization of financial systems has two dimensions: internal and external. The former can be measured by number of branches and subsidiaries which foreign institutions open in a given country and/or value of their assets

[1] What is interesting, those processes intensified after 1978, i.e. after formal abandonment of gold convertibility – the last officially existing relic of commodity money. Since then, money has had entirely fiduciary character [Marszałek 2014].

compared to total assets of the consolidated domestic financial system. By analogy, with reference to banks, as the measures of the latter are considered the number of branches and subsidiaries opened by domestic institutions abroad and value of their assets also compared to total assets of the consolidated banking balance sheet [European Central Bank 1999; Solarz, Wyczański 1997].

Internationalization, intertwined strictly with globalization processes has contributed to profound changes in banking systems of individual countries, especially developing ones [Frąckowiak, Szambelańczyk 2000]. Large financial institutions took advantage of problems with insufficient level of national capital in those countries, taking active part in privatization processes in the Central and Eastern European countries. Banking institutions which took part in the process transformed into large multinational banks, conducting their businesses globally. It concerned also insurance companies. Moreover, both types of financial intermediaries often, in a way, melted together, creating large financial holdings, offering broad variety of financial services [Janc 2004].

Generally, within the economic mainstream internationalization is perceived as a positive phenomenon. It is argued that the process increases competition [Padoa--Schioppa 2001]. It occurs due to two reasons. First, internationalization causes the increase in the number of financial institutions which seek clients' favors. Second, the very market on which banks may run their operations becomes larger. Additionally, international scope of banks' activity enforces improvements in safety net and supervisory frameworks. Moreover, through its interdependencies with deregulation, internationalization contributes in a way to international cooperation between supervisors from individual countries. That cooperation, in turn, is conducive to consistency of regulatory frameworks worldwide [Frąckowiak, Szambelańczyk 2000; Heffernan 2005; Krugman, Obstfeld 2007].

Considering benefits (advantages) of internationalization one may take into account gains acquired by banking institutions and the banking system as a whole, their clients, as well as economies of individual countries. Those benefits may be short-term or more profound, expressing in permanent changes of a domestic banking (and financial) system. All identified advantages of internationalization are synthetically described in Table 1.

Thus, internationalization appears to be quite positive. There is also, however, the other side of the coin. Some negative consequences of internationalization are also indicated. There are two mains strains of the critique. The first one is connected with a kind of asymmetry and – in many cases – harmful influence of internationalization on the economy of developing countries. The second, more intensified and visible in the last years, line of argument against internationalization considers the phenomenon as one of financial crises triggers (see Table 2).

Table 1. Advantages of internationalization

Item	Developed countries	Developing countries
Banks	– high profitability of foreign activity – greater competitive power on the foreign markets, providing more flexibility – mobilizing more funds from depositors – support for enterprises from home country – risk diversification	– transfer of capital, technology and management expertise – support of large international institution as the main investor – more efficient corporate governance
Banking system	– additional source of profits	– overcoming of problems connected with lack of domestic capital – possibility to recapitalize local banks – factor driving modernization and increasing competition in the whole sector – better solution than cross-border lending (international banks with a local presence on the ground are more stable providers of credit) cross-border component of bank lending
Customers		– broader and more diverse offer – spread of financial innovation – lower local banks' profit margins – enforcing more efficiency of local banks that translates into lower-cost of financial services
Economy		– integration with global economy

Source: author's work.

Table 2. Disadvantages of internationalization

Item	Developed countries	Developing countries
1	2	3
Banks		– too intense competition – multinational banks edge out local banks by luring their best (lowest-risk) clients away; this forces local banks to provide services to higher-risk clients, which makes them less profitable, less efficient and less competitive
Banking systems	– proliferation and transmission of financial innovations and highly risk-prone operators – strong and robust negative effect of geographical distance on lending stability; distant borrowers more difficult to screen and monitor in general and their creditworthiness particularly difficult to assess	– higher idiosyncratic risk due to maturity and currency mismatches – foreign banks may boost capital outflows – proliferation and transmission of complex financial innovations and highly risk-prone operators – strong and robust negative effect of geographical distance on lending stability; distant borrowers more difficult to screen and monitor in general, and their creditworthiness particularly difficult to assess

1	2	3
	– risk (political, operational, etc.) of operating abroad	
Customers		– foreign banks usually use wider-net interest-rate spreads than local ones do and behave like “rentier” capitalists – lending supply in emerging markets affected through a contraction in cross-border lending by foreign banks; a contraction in local lending by foreign banks’ affiliates; and a contraction in lending by domestic banks due to a funding shock to their balance-sheet
Economy	– susceptibility to financial crises – contagion effects	– susceptibility to financial crises – contagion effects – problems of local banks caused by problems of their foreign partners – credit crunch

Source: author’s work.

Pro-crisis influence of internationalization is in the literature discussed mainly with reference to the crises in Latin and South America countries in the 1990s and 2000s and the subprime crisis of 2007 in the US and being aftermath of it the Global Financial Crisis. Because of poor risk and liquidity management, the banks are supposed to play a central role in the 2008–2009 financial crisis and following it contagion processes.

In details, one may argue that multinational banks (and other financial institutions) contributed to emergence, proliferation and transmission of financial innovations and highly risk prone operators. All activities of those institutions connected with spreading and distributing products of financial engineering on individual domestic markets (often offered to agents with lack of sufficient knowledge) contributed to greater risk (political, operational, etc.) in the individual markets as well as to great instability of the overall financial system [Buch, Neugebauer, Schröder 2013; Palley 2012].

3. Demutualization

Demutualization, in principle, is a phenomenon that occurred after the Second World War and intensified during the last few decades. The process is variously defined (see e.g. [Chaddad, Cook 2004; Elliot 2002]). Generally, one may say that demutualization is the process of converting (financial) institutions from non-profit, member-owned organizations to for-profit, shareholder-owned corporate entities, or, to put it in another way, the process by which mutual organization or co-operative changes legal form to a joint stock company.

Among organizations involved one may point mainly at stock exchanges (for instance Stockholm Stock Exchange in 1993, Amsterdam Stock Exchange in 1997 and the London Stock Exchange in 2000), insurance companies, construction societies and – especially often discussed in the literature, cooperative banks. What is characteristic, the global financial crisis created new interest in demutualization in the new light. In some country like UK the failures of demutualized societies (e.g. Northern Rock and Bradford & Bingley), led consumers to transfer their business back to the mutual holding societies, like for example cooperative banks.[2]

There are, however, many reasons of demutualization process of the last decades. They can be divided into five groups. The first one is organizational isomorphism. According to this approach conversion in investor-oriented enterprises would be the final stage of a non-congruent isomorphic trend aimed to get legitimacy from society, from market or from financial institutions (see e.g. [Bager 1994; Hawley 1968; Mayers, Smith 1986]).

The second group consists of cultural reasons. As J. Birchall [1998] stresses, the same cultural environment that supported privatization from the 1980s onwards created a sympathetic attitude to the process of demutualization.

The third group of reasons that stood behind demutualization processes is connected with expropriation by managers [Mayers, Smith 1986], whereas the fourth – with political reasons. Namely, the fall of the socialist system in Europe entailed a wide-spread demutualization, just because people perceived cooperatives as part of socialism and wanted to do away with it. In post-communist countries people in many countries thought demutualization as positive and being in public interest in order to liquidate possible pockets of socialist resistance [Wegren 2009; Amelina 2002].

The fifth and last cause of demutualization sometimes is considered inefficiency or lack of growth perspectives. The starting point of this approach is the conviction that for some reasons (vaguely defined property rights, financial constraints, limited horizon of cooperative members) cooperative structure limits or even inhibits growth. Such point of view is somehow connected with the idea of market effectiveness and evolution of market structures toward creation of large financial holdings, being superior institutions, dominating less developed financial intermediaries.

Demutualization in emerging markets differs in certain respects from the process observed in more developed markets. Particularly, one may notice that demutualization in emerging markets was often centrally planned by the government and regulator, as opposed to being driven by the financial intermediaries and exchanges themselves. In general, regulators in emerging market have made substantial progress in strengthening practices and improvements to infrastructure in their capital markets by following this route. It is important that regulators and

[2] It was for instance the case of Poland, where cooperative banks strengthened their position in the financial system during the crisis and were generally perceived as more stable and predictable than big commercial banks [Janc, Jurek, Marszałek 2013].

market participants continue to work together to create policies and market conditions that are conducive to such changes and are in the overall best interest of the market.

The advantages and disadvantages of demutualization are synthetically presented in Table 3.

Table 3. Advantages and disadvantages from demutualization

Advantages	Disadvantages
– more flexible decision making – removed conflicts of interest between owners and managers – greater ability to acquire funds – a wider range of investment products and sources of revenue	– lack of close identity between the organization and the direct users – detrimental to clients – abandoning initial mission – demutualized organization usually preoccupied with profits (short term perspective, weak regulation) – it weakens local communities

Source: author's work.

From the table it follows that the process may limit access to funds and financial services to some groups of clients, especially those with rather small financial potential and capacities. Such clients, being traditionally clients of mutual associations and not interest in sophisticated services and products, might be – due to changing character of their financial partners – in a way excluded from financial market or so to speak, condemned to relationship with big financial companies. Simultaneously, demutualization of stock exchange may contribute to short termism in decisions and inappropriate selection of activities. It leads also to increasing scale of speculative behaviors. On the other hand, there are also mentioned in the literature benefits of the process, connected mainly with greater elasticity and better perspectives of acquiring funds.

4. Privatization

Privatization, among all discussed phenomena, is probably the most controversial one, in a sense that it is strictly connected with opinions and views on scope and appropriateness of state intervention into market mechanism. Thus, one may observe strong ideological blend here, being one of the most important (and controversial) factors in deciding about scale and forms of regulations. By no means, the problem is the subject of one of the oldest discussions within the field of economics and politics.

Privatization, also with reference to banking institutions, became extremely important within few last decades, with growing importance of liberalization processes and free market attitudes in the major economies worldwide. It was also visible in Europe, where privatization of the financial sector commenced in the early

1980s and intensified in the 1990s. Apart from changes in countries of Western Europe, important factor contributing to the growing scale of privatization was also economic and political transformation in the post-communist countries and some other emerging markets as well), where privatization of the economy constituted crucial part of the economic reforms, being perceived as one of the most important factors of fast economic changes and restoring market mechanisms.

Privatization of the financial sectors was driven by the same factors and incentives, as privatization of other domains of economy. Among them, one may point especially at: theoretical reasons, connected among others with works of A.A Alchian and H. Demsetz [1972, 1973]; ideological reasons, related mainly to the growing influence of the – already mentioned – neoliberal approach to economic theory and economic policy; systemic reasons, linked with the previous ones and connected with attempts to strengthen market mechanisms and to create more favorable conditions for free competition[3] and, finally "socio-political" reasons, i.e. those resulting from the pressure of various interest groups (progress of privatization treated as the result of activity of some groups, to which privatization was an opportunity to gain benefits associated with the acquisition of existing public property).

All those factor are displayed on the both microeconomic and macroeconomic levels. At the first one, the reasons for privatization were mainly related to the intention of removing barriers to development and increasing the efficiency of financial institutions. On the other side, at the macroeconomic level, the reasons for particular decisions to privatize the public sector were related primarily to the expected benefits for the government budget, which were a consequence of decreased spending on subsidizing (recapitalizing) the public sector, and – in short run – of raising government revenues from privatization [Dymarski, Brzica, Sawyer 2009; Kieżun 2010].

S. Kikeri and J. Nellis [2002] identify the following five main effects of privatization: financial and operational performance at the enterprise level, the fiscal and macroeconomic effects of privatization, broader welfare and economic consequences of privatization, impacts on employment and a broader labor market and, finally, the effects of privatization on income and wealth distribution. It is characteristic that there is wide discussion whether those effect have beneficial impact on the economy or are they rather harmful. Precise assessment is hard, as many factors are matter of interpretation. Nevertheless, advantages and disadvantages of privatization, formulated in the literature are synthetically described in Table 4.

[3] According to economists rather skeptical to free market mechanisms, those reasons, in general, arose from the desire to transform the existing socio-economic systems (previously dominant welfare state and social market economy in Western European countries, as well as the socialist economic system in Central and Eastern European countries) into a generally uniform European system of a liberal, free-market economy – see e.g. [Dymarski, Brzica, Sawyer 2009; Hein 2012; Palley 2012].

Table 4. Advantages and disadvantages of privatization

Advantages	Disadvantages
– greater efficiency, profitability and output – improved incentives – improved competition – free market appraisal – revenues for the state – in emerging market countries – way of overcoming problems with lack of capital	– problems with accountability – focus on profit maximization – lack of transparency – increased risk – limited lending to some groups of clients – conducive to creation large financial holdings

Source: author's work.

With reference to financial systems of the CEEs privatization was perceived as rather positive. What is characteristic, it was strictly connected with internationalization and active participation of the foreign capital in changes of ownership. In the initial period of transition, these countries lacked domestic investors with sufficient capital to participate in bank privatizations. Moreover the privatization strategies focused on a search for strategic investors in order to protect financial system stability and increase the quality of corporate governance [National Bank of Poland 2003]. Such action, initially beneficial, with time turned to be somehow short-sighted, as large foreign financial institutions dominated financial system in Poland, being part of contagion tendencies and generating some forms of credit rationing, especially with reference to small and medium enterprises and also, to some extent, with reference to households. Similar problem was observed also in other CEEs.

5. Conclusions

Balance of discussed issues remains at least ambiguous. Results of discussed process in terms of profitability, efficiency and capitalization of banking institutions are not clear cut. By no means, all three discussed processes may bring some benefits to the economies of individual countries and the whole global economy. Moreover, some of their outcomes are visible more clearly just on the supranational level. As follows from Tables 2–4, there are advantages and disadvantages of the phenomena under discussion.

Generally, it can be stated that all considered processes were conducive to growing divergence of interests of banks' customers, managers and shareholders. They supported also attitudes of managers towards focus on profits, with little attention paid to social aims. Common feature of decisions made in large multinational financial holdings was their short term horizon. Moreover, the institutions invested rather in financial instruments and products (very often complicated and artificial). As it was mentioned, such attitude was one of the causes of the global financial crisis and problems of many financial intermediaries, leading in turn to turmoil in the real sectors of individual economies.

This, together with the loss of identity by demutualized and private associations and companies, limited supply of funds addressed to small and medium enterprises, interfering with processes of sustainable growth and generating growing inequalities in particular economies. More severe has become also the problem of financial exclusion, especially in less developed countries, where, by nature, problem was already serious.

More clear question are strict interdependencies between the processes. Due to internationalization, foreign banks could take active part in the privatization processes (especially in the financial sectors of the CEEs). Private owners were also more eager than national ones to demutualize associations which were under theory control or were influenced by them due to personal or capital links. At the same time, large international financial institutions have become so big and influential that they have been able to overcome actions of the governments of individual countries or even enforce some actions, beneficial from theoretical point of view.

Thus, all such factors generated problems with supervision on financial institutions, increased uncertainty and level of moral hazard in the global economy and on the individual domestic markets. By no means, it was conducive to spreading financialization processes, with all their negative consequences. Also conducting economic policy (especially monetary policy) became harder, due to ineffectiveness of many instruments, aimed at influencing private institutions (especially banks). The latter institutions have nowadays own sources of funds and liquidity, and are to a large degree independent of monetary authorities. The activity of those institutions is also harder to supervise and regulate under current institutional conditions.

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