Risk Taking by Banks in Transition Countries

Banks in transition countries have learned how to manage their risks by now

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At the start of the 21st century banks in transition countries look very much like banks elsewhere. They are by no means problem-free but they are struggling with the same issues as banks in other emerging market countries.

What is the current risk behavior of banks in transition countries and how is it affected by the environment? As known, the institutional environment differs considerably among these countries. The new EU members have been obliged to establish creditor rights and ensure proper law enforcement, while many of the other countries have not been exposed to the same external pressures for reform, and their institutions offer, on average, less protection for lenders.

Using information from the EBRD's 2005 BEPS survey of bank managers in 20 transition countries and balance sheet and income data prepared by BankScope, we examine the relationship between the quality of institutional environment and risking-taking by banks. As there is no ideal single measure of risk, we relate various measures of bank risk — solvency, liquidity, default probability and credit risk among others — to the size, location, ownership, institutional settings and management characteristics of banks.

No Excessive Risk Takers

We find that there are some noticeable differences in balance sheet characteristics among bank ownership groups and across regions. State-owned banks have more capital, larger loan loss reserves and more short term loans than the others. Domestic banks make less use of contingent liabilities and are less liquid, while foreign banks maintain less equity than the others. EU banks have smaller solvency ratios and loan loss reserves but they maintain more liquid assets. Finally, there is clearly an inverse relationship between the solvency ratio and bank size or market share. Also, very large banks and those with shares over 10% make fewer short term loans than others.

The estimated default probability is lower among EU banks, foreign banks and large banks (both in terms of size and share). Nevertheless, these differences are not large. The credit risk measure varies somewhat with bank size and is higher for small banks, since these banks generally provide a larger fraction of lending for small and medium-sized companies. Government-owned, small banks, and banks in South Eastern Europe have a considerably higher capital to risk adjusted asset ratio than their competitors, which might well reflect a desire to signal their creditworthiness.

Under bad institutional settings, banks lend less to households and small firms

Our findings suggest that banking markets are relatively homogenous and no clear groups of banks with excessive risk taking can be identified.

No Link between the Level of Risk and the Environment

If size, location and ownership do not matter that much, could a bank's taste for risk depend instead on its perceptions of the banking environment?

Interestingly, we find no clear pattern between estimated default probability and the institutional environment. When bankers have better perceptions of the quality of law and when the laws are objectively better, the default probability is higher. This suggests that bankers are willing to take on risky lending when the legal environment for dealing with bad loans is better. However, better perceptions of the courts and better law enforcement are associated with lower default probabilities.

Overall, evidence for a relationship between banks' risk and their institutional environment is not very strong, yet there is one exception. Banks that have access to a credit registry clearly show a lower probability of default. Overall, this does not mean that the institutional setting is unrelated to banking risk. One reason for our finding could be the specific nature of banking risk. Bank lending involves uncertainty and an efficiently functioning bank needs to take on risks. Under bad institutional settings, banks are less active lenders and mostly lend to borrowers about whom they can easily obtain information, such as large enterprises and the government. Such lending is, however, less risky than lending to more opaque borrowers, like households and SMEs. This could explain why we do not find a clear pattern between a solid institutional environment and banks' probability of default.

Nevertheless, all our indicators, no matter whether they are based on subjective surveys or bankers' own perceptions, show that banks operating in a poor environment tend to keep a higher capital risk adjusted assets and solvency ratio, thus adapting to their environment by adjusting their capital. Furthermore, banks that take on more risk also actively manage that risk by creating a risk management department or obtaining credit histories from their borrowers. Such banks also tend to hold more capital. This implies that banks are aware about the level of risk they take on.

Thus, we conclude that banks in transition countries have learned how to manage their risks by now and basically operate and mange risk as banks in other developed markets.

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