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for Reconstruction and Development

The Way Forward: **Preconditions for Financial Sector Sustainability in Emerging Europe**

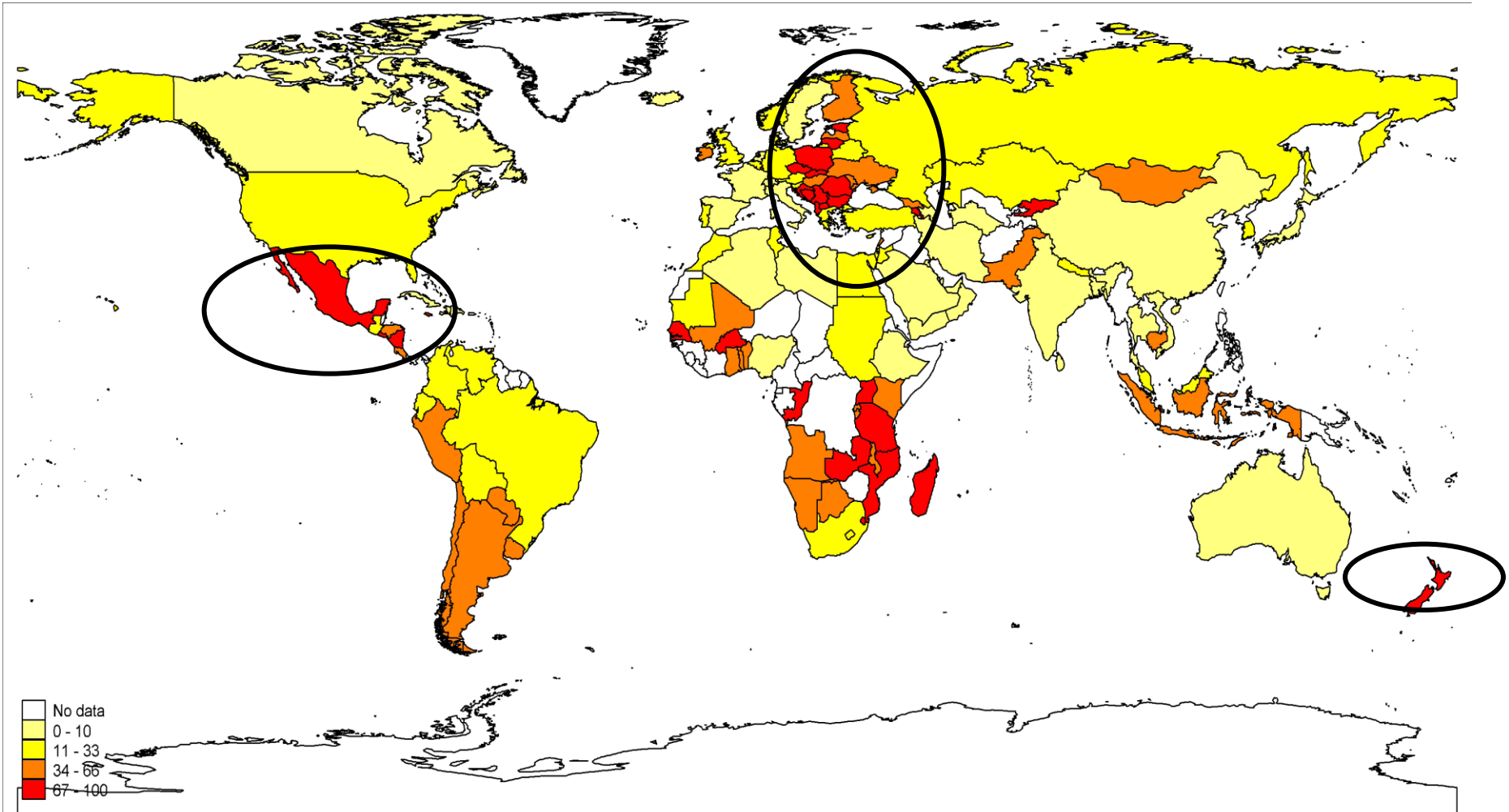
Piroska M. Nagy
EBRD

JVI 20th Anniversary Conference
Vienna, July 12 2012

The overall setting : cross-border bank ownership with systemic impact in host countries is rare ...

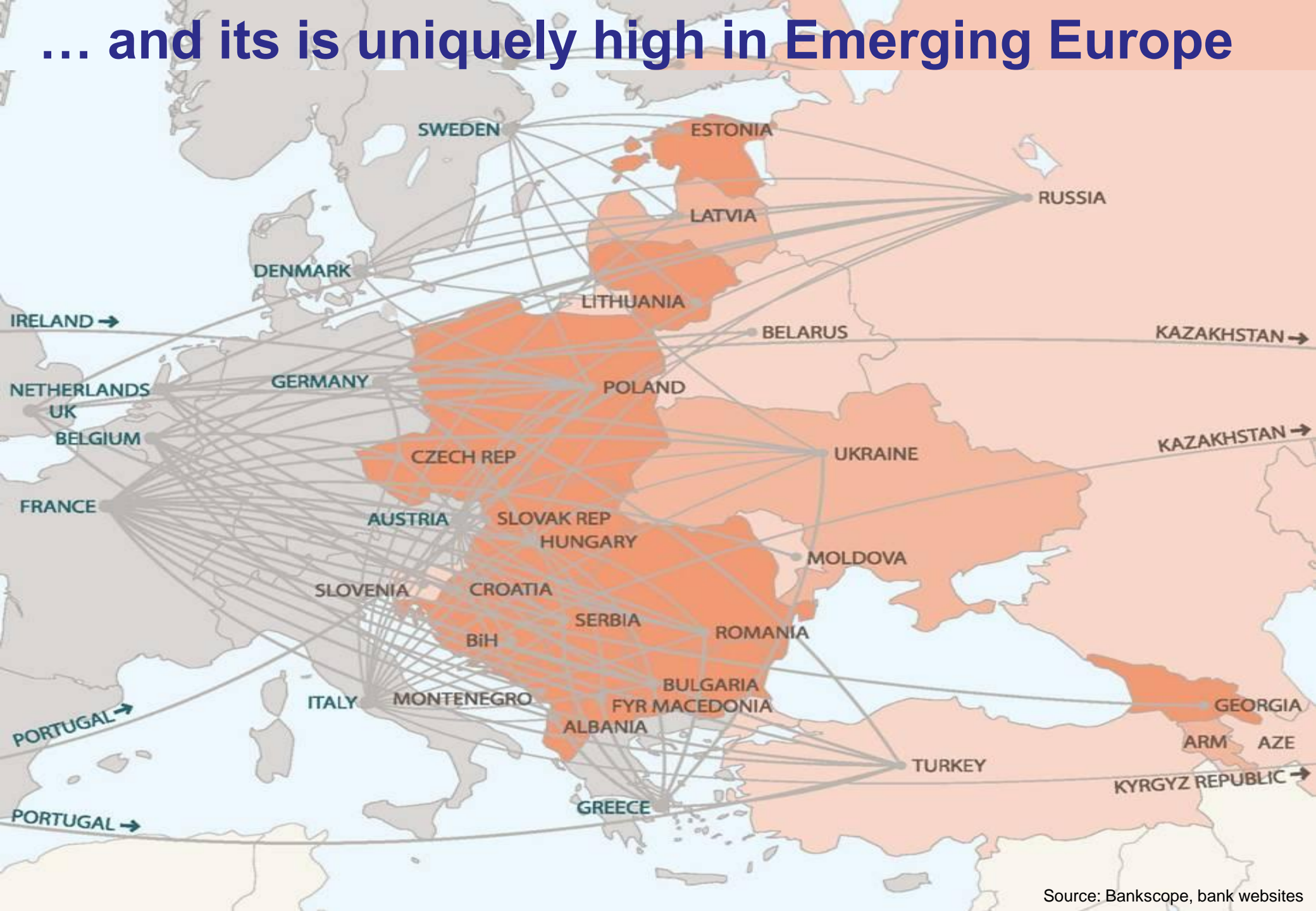


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Source: Claessens and Van Horen (2012) and EBRD

... and its is uniquely high in Emerging Europe



How vulnerable are financial sectors in EE?



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- **Rapid financial sector deepening in support of growth and convergence before the crisis, but significant vulnerabilities**
 - Two-way transmissions; funding model; excessive leveraging in some sectors and countries
- **Impressive banking sector resilience during crisis**
 - Huge shocks
 - Mature and coordinated policy actions under Vienna 1.0
 - ✓ Active parent bank support via PSI
 - ✓ Unique IFI coordination and support
 - No foreign bank subsidiary failed – no host country fiscal costs from foreign-bank related stress

How to reduce vulnerabilities?



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- **More diversity in ownership**
 - Concentration and exposure risk on both home and host country sides countries
 - Political economy disadvantage (overtaxing those who don't vote)
 - Foster some local banking and perhaps new owners (equity funds etc)
- **More balanced funding model**
 - Lower L/D and increase local sources of funding
- **More local currency funding**
- **Developing local capital markets**
- **Managing change under Vienna 2.0**
 - Deleveraging
 - Managing supervisory bias/conflict

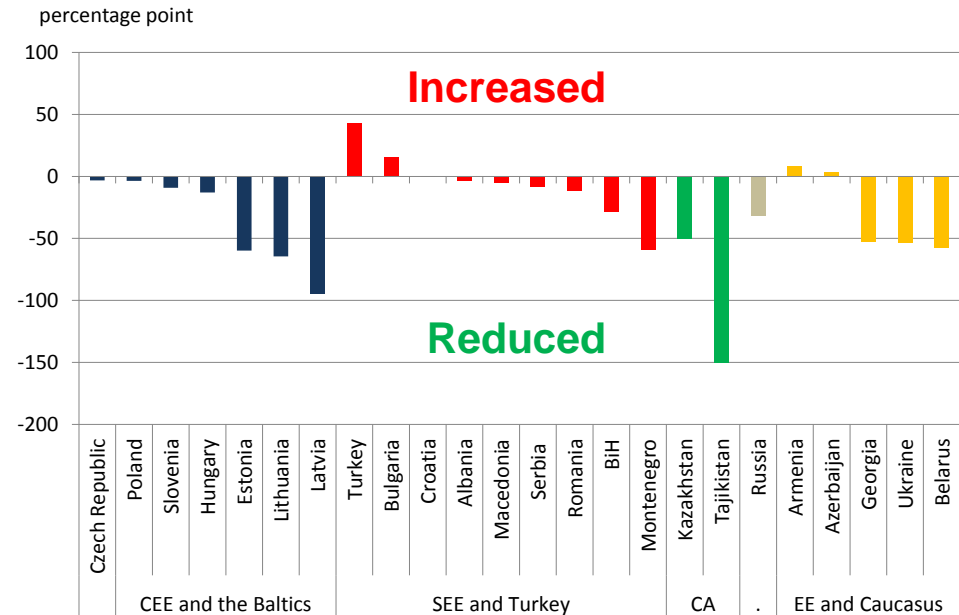
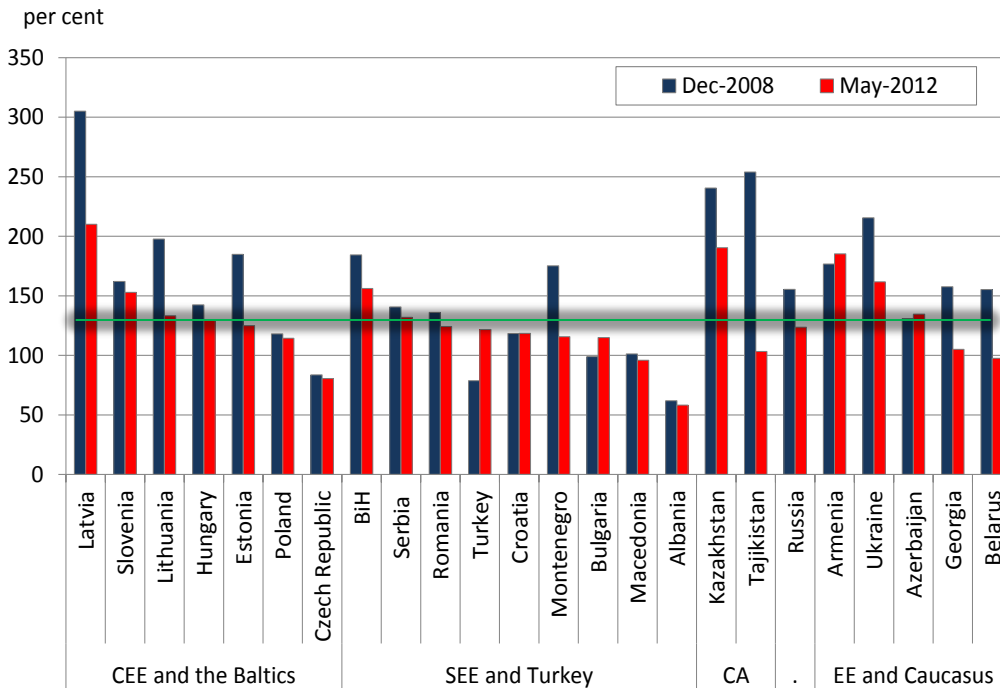
How much progress thus far?

Loan/Deposit ratios improving



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L/D Level and change December 2008 – May 2012



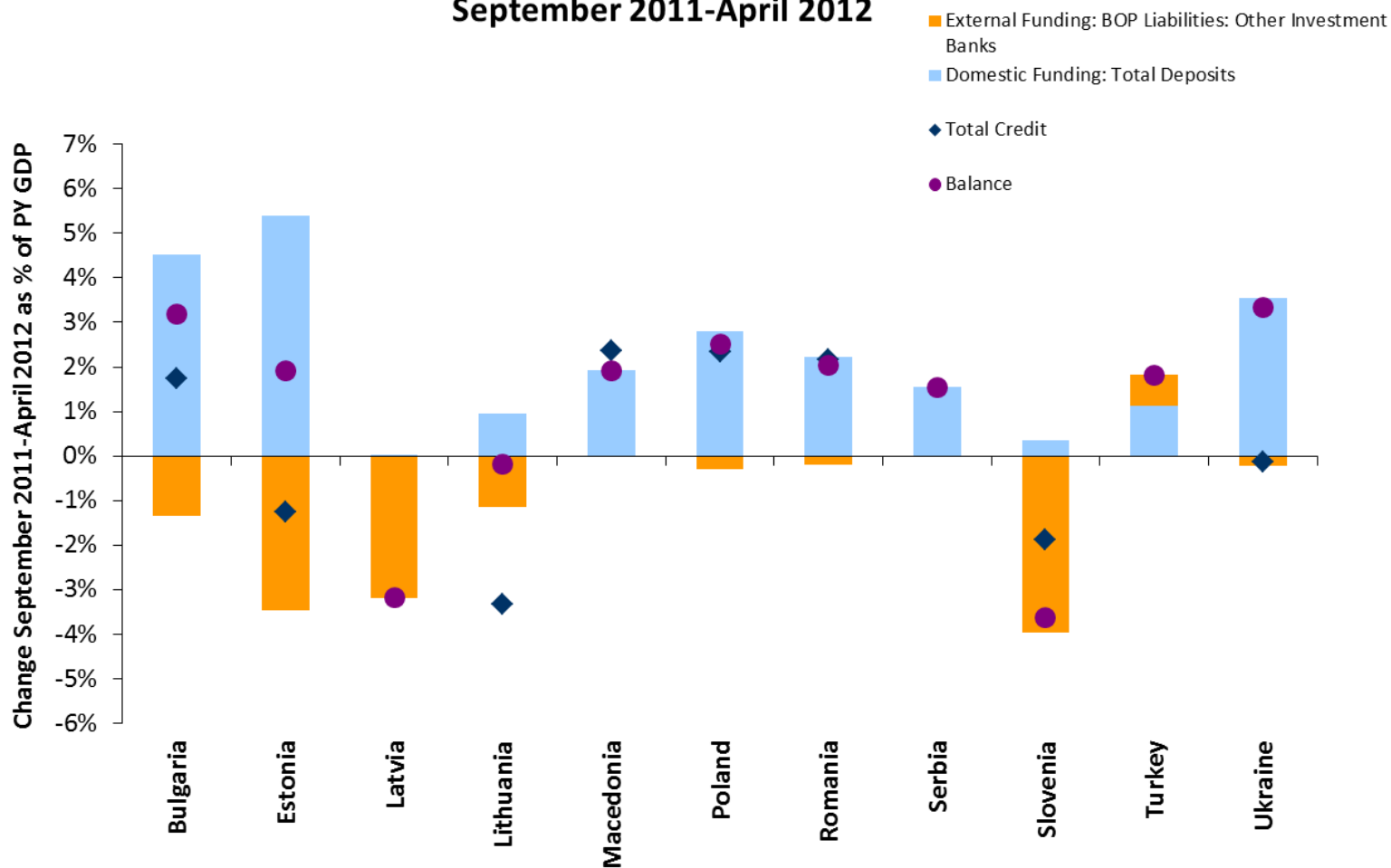
Source: CEIC

Partially replacing parent funding with domestic deposits



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Change in Banks' Funding Sources:
September 2011-April 2012

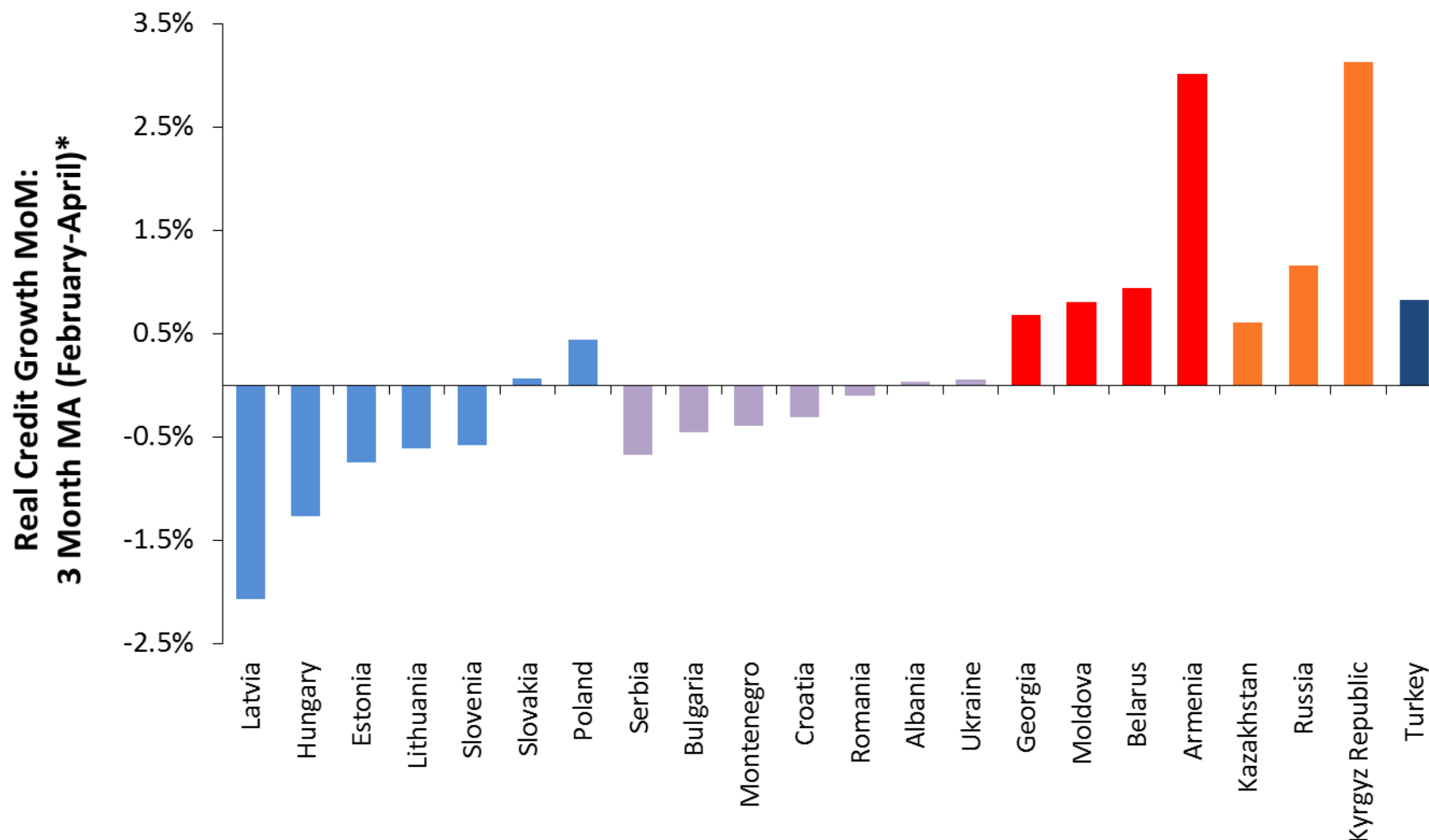


Source: National Sources via CEIC data service

... but still shrinking credit in the countries most integrated with the Eurozone



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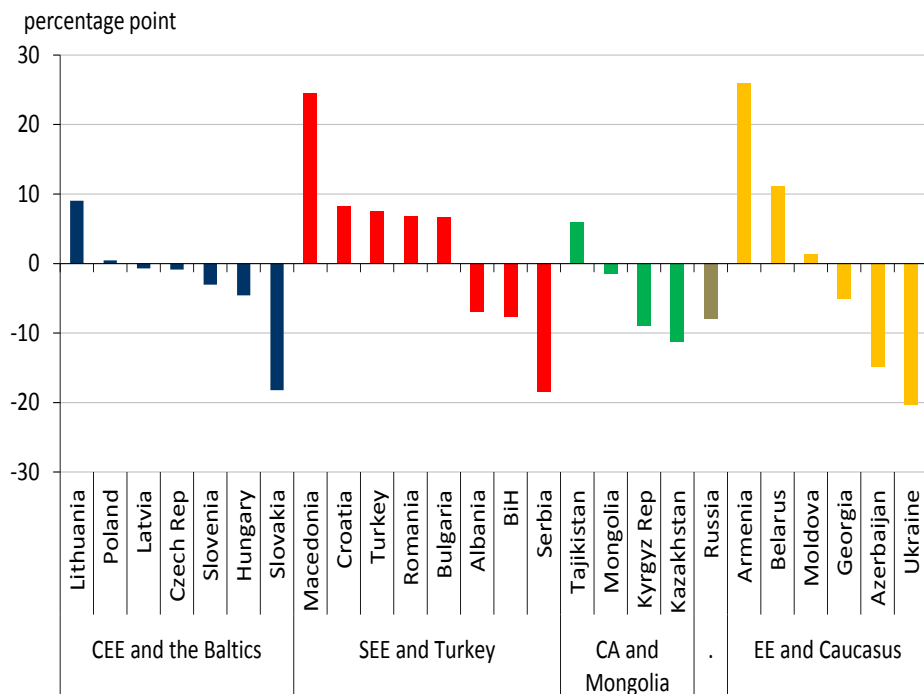


* For Croatia, Montenegro, Armenia, Georgia, and Russia chart shows average from January to March

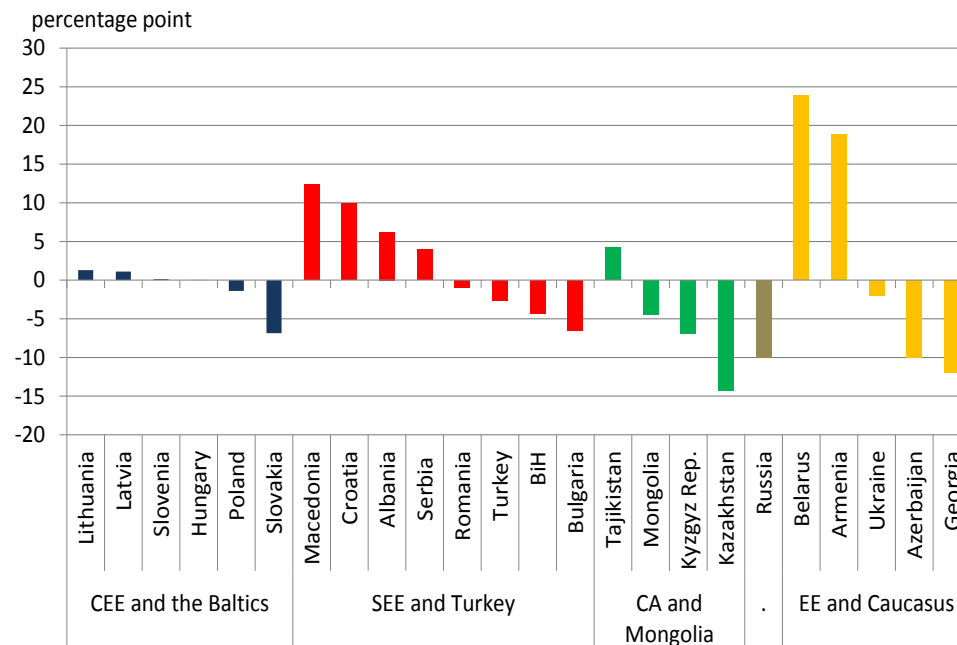
Source: National Sources via CEIC data service

... and progress is mixed on reducing financial dollarisation

Change in share of FX loans in total



Change in FX deposit share



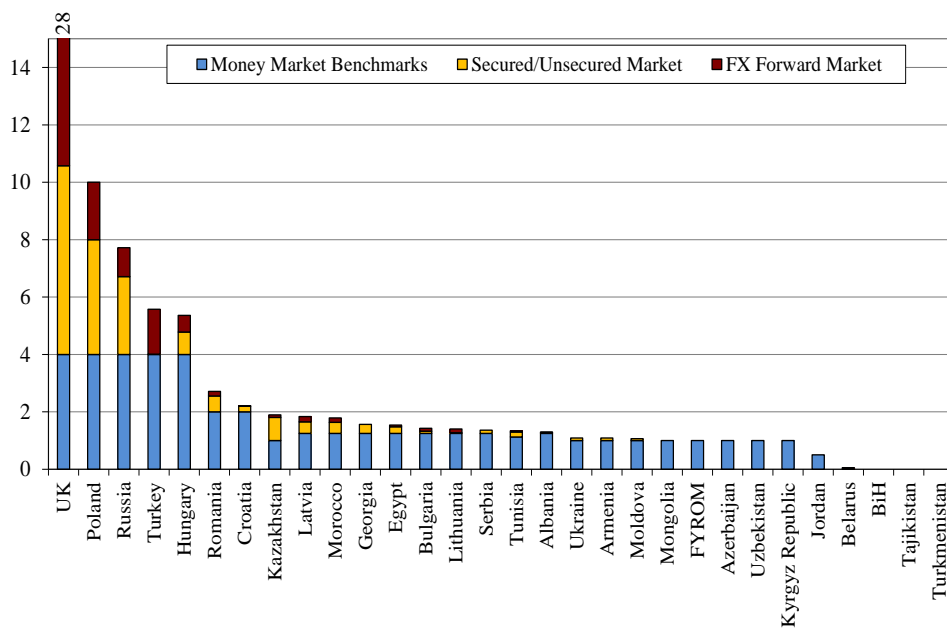
Source: CEIC, CBBH, CBR, IMF, NBC, NBH, NBS

... and local capital markets are still very underdeveloped

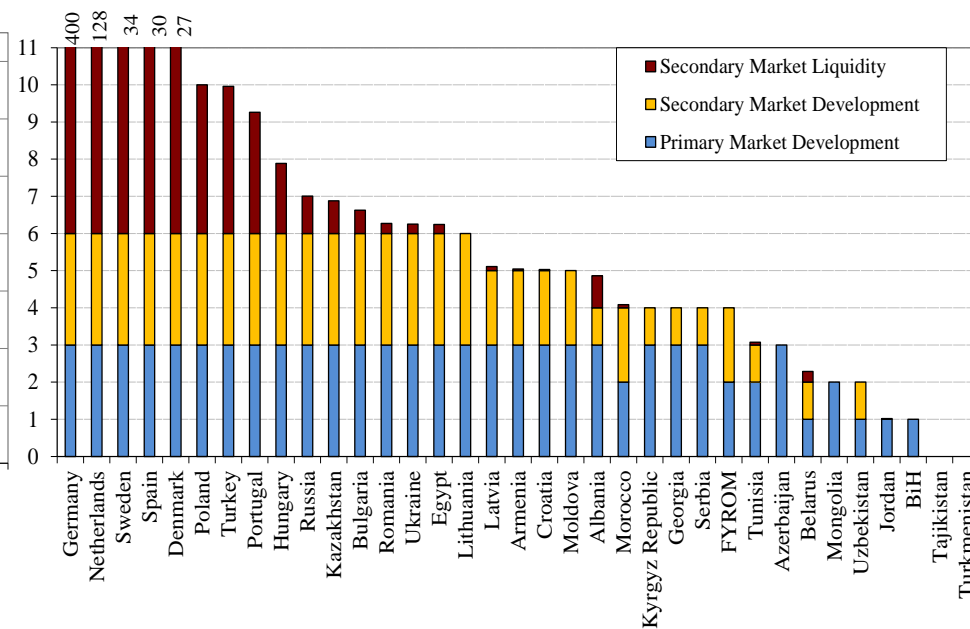


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EBRD money market development index



EBRD government bond market development index



Source: EBRD

Problem: negative spillovers and systemic risks from:

Nationally focused actions by supervisors, and
Uncoordinated private sector de-leveraging.

Objectives:

Much like in 2009

Preserving the single market for capital – no home bias

Facilitating a *gradual* adjustment to a new business model

Instruments:

Home-host coordination (supervision, bank resolutions, supporting EU institutions)

IFI operational coordination

Coordination across bank groups

(but no 100% exposure commitments)

New



VI 2.0: redefines systemic risks of bank groups to include host country concerns



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- **Objectives**

- Manage euro-zone crisis induced deleveraging to minimize systemic risks in the CEE-SEE region
- Involve host country authorities in bank group decisions with cross-border impact

- **How to do it?**

- Complement evolving EU level arrangements with practical sub-regional ones for emerging Europe, where host country's systemic banks are foreign owned
- Precedent: the Nordic-Baltic MoU that complements EU-wide rules
- Adhere to Principles adopted in Brussels March 2012
- Support and strengthen new EU institutions

... but in the challenging context of rapid financial market fragmentation in Europe ...

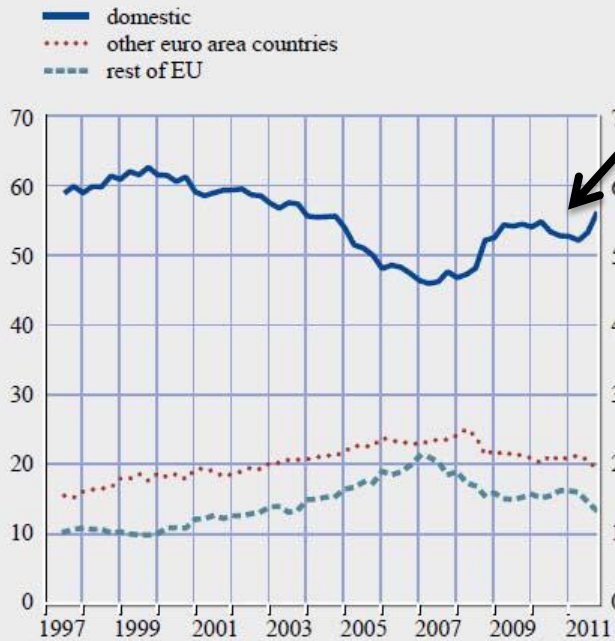


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Share of domestic lending
declined from 61% in 1999 to 46%
by 2007 to increase again

Chart 25 MFI loans to MFIs; outstanding amounts by residency of the counterparty

(share of total lending excluding the Eurosystem; percentages)

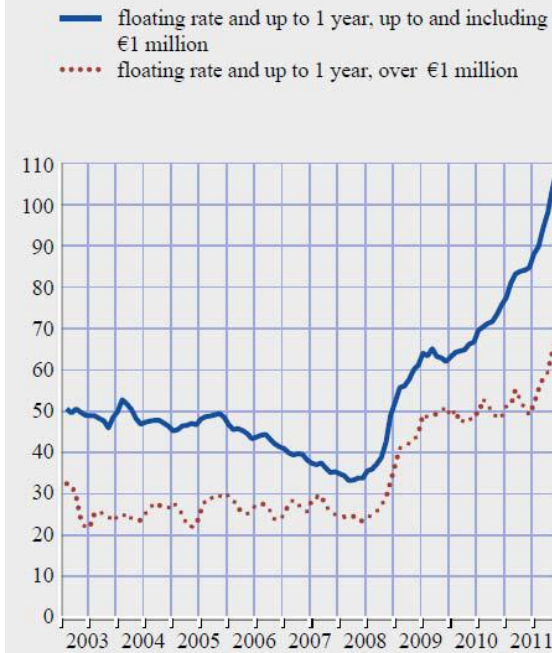


Source: ECB.

Strong market fragmentation in the corporate retail market :short-term loan price dispersion increased during the crisis

Chart 27 Cross-country standard deviation of MFI interest rates on new loans to non-financial corporations

(unweighted; basis points)



Source: ECB.

Is the Banking Union the answer?



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- We certainly hope so
- Whatever supra-national construct, systemic concerns in host countries must be taken into account
 - Need for 'first loss' functions at national level to avoid moral hazard
 - Systemic risks to be redefined according to Vienna 2 principles
- Transition period to a banking union will likely be long. Until then coordination of national interest remains key
- Banking union is planned only for EZ, whereas cross border banks reach well beyond EZ and even EU borders
- There thus seem to be a need for Vienna 2.0 type coordination.