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Foreword

This is the first issue of a new publication "*Central, Eastern and Southeastern Europe—Regional Economic Issues.*" This new series, produced by the IMF's European Department, contains analytical, one-off pieces on issues of interest to the CESEE region. We hope this new series will enrich the economic debate within this important region, and prove useful for policy makers, academics, and the broader public alike.

This issue takes up the topic of "Financing Future Growth: The Evolving Role of Banking Systems in CESEE." It discusses the important role that foreign banks, mainly from Western Europe, have played in the banking systems of CESEE, both in terms of ownership and funding, and raises the question to what extent banking in CESEE will change as a result of the global economic and financial crisis. This paper was prepared for a joint IMF/Czech National Bank Conference on the same topic, which took place on April 26th in Prague.

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FINANCING FUTURE GROWTH: THE EVOLVING ROLE OF BANKING SYSTEMS IN CESEE

April 22, 2013

EXECUTIVE SUMMARY

1. Foreign banks, mainly from Western Europe, play an important role in the banking systems of CESEE, both in terms of ownership and funding. High foreign ownership is largely a legacy of economic transition, when banks were privatized to strategic foreign investors to quickly introduce modern banking practices and secure financial stability. Reliance on foreign funding emerged during the region's credit boom in the mid-2000s, when foreign banks embraced a "centralized" bank funding model and supplied their CESEE subsidiaries with ample parent bank financing.

2. Benefits and pitfalls from the prevalence of foreign banks were very evident in CESEE over the past decade. The incidence of banking crises fell sharply, banking practices improved, foreign banks helped absorb local shocks, and access to credit rose dramatically. However, the region's economies became closely exposed to the large swings in funding from foreign banks. During 2003–08 most CESEE countries experienced a foreign-funded credit boom that led to very high domestic demand and GDP growth. In the wake of the Lehman Brothers' collapse in September 2008, earlier inflows of bank funding reversed and the overheated economies in the region plunged into deep recessions. About a third of the boom-time inflows from banks unwound during 2008–12, reflecting the strains on foreign banks, as well as flagging credit demand during CESEE's economic downturn.

3. The region's recent experience raises the question what banking in CESEE should and will look like in the future. Overall, strong foreign ownership seems to have served the region rather well and the associated key benefits are likely to persist. Ownership per se seems to have contributed only moderately to the cyclicality of lending. In contrast, heavy reliance on foreign funding exhibited important drawbacks. In good times it facilitated unsustainable credit booms, which were difficult to control for policy makers. In times of tight global liquidity, it exacerbated the retraction of credit supply, again with little scope for domestic policy makers to counteract. There is no evidence that greater access to foreign funding improved the economic growth performance in CESEE over the cycle.

4. Since late 2008 foreign banks have been rebalancing their funding toward domestic sources. This reflects banks' frustration with "centralized" funding models since the 2008/09 crisis. Further impetus came from the global regulatory reform agenda, aimed at strengthening consolidated bank balance sheets and improving the resolvability of large cross-border banking groups, as well as new guidance from western regulators against high loan-to-deposit ratios in subsidiaries. A shift toward more "decentralized" funding model in CESEE is hence well underway. The transition toward more decentralized funding is appropriate, but the process should not go too far or too fast. The presence

of foreign banks in CESEE has been beneficial, but better management of their funding models would help ensure that they continue to support growth. Rolling back excessive reliance on foreign funding should lead to better banking in CESEE over time, but rapid withdrawal of still large foreign funding could severely crimp credit and economic prospects. Also, some scope for intra-group funding should be retained, so that resources can be channeled to the genuinely most productive uses and financial stability is bolstered at the group level.

5. Policy makers can facilitate an orderly evolution of banks' funding models in CESEE. Pushing ahead with establishing the envisaged integrated European financial architecture would remove many of the drawbacks of "centralized" banking, thereby diminishing the need for a large change in the composition of funding. Improving home-host cooperation more generally to better manage cross-border banking, including through more coordinated use of macroprudential policies, would do so too. Policy makers should also eschew ring-fencing capital or liquidity, outside impending bank failures or situations where domestic financial stability is jeopardized. And to mitigate the economic fallout from foreign funding reductions that may nevertheless accompany the transition to more "decentralized" funding, policy makers in CESEE should accelerate efforts to remove other obstacles to credit growth, for example by tackling still very high non-performing loans that make banks reluctant to extend new loans, and facilitating local capital market development to open up alternative ways to finance investment.

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CONTENTS

I. CONTEXT

1. The particularly strong role of foreign banks in CESEE sets its banking systems apart from those in most other regions. Foreign banks have brought many benefits, not least the expanded availability of finance to support economic growth and convergence of income levels. But the global financial crisis and its aftermath have also made plain important risks and volatilities. As a result, the region's banking systems are now undergoing important changes. Are these changes for the better? What banking paradigm would serve the region best by promoting steady growth and continued convergence? And what can policy makers do to steer developments?

2. Foreign banks play an important role in the banking systems of CESEE, both in terms of ownership and funding (Figure 1 and Technical Note I).[1] Bank assets owned by foreign banks exceed 50 percent of GDP in virtually all countries. This translates into dominant market shares, in some places as high as 90 percent. Cross-border funding is typically also very high, surpassing 20 percent of GDP in most countries and reaching about 60 percent in some cases.[2] Cross-border funding goes in roughly equal parts to banks and nonbanks. Funding to banks predominantly takes the form of parent bank funding to subsidiaries in CESEE. Foreign ownership and foreign funding do not necessarily go hand-in-hand, and indeed several countries have high foreign ownership but limited foreign funding.

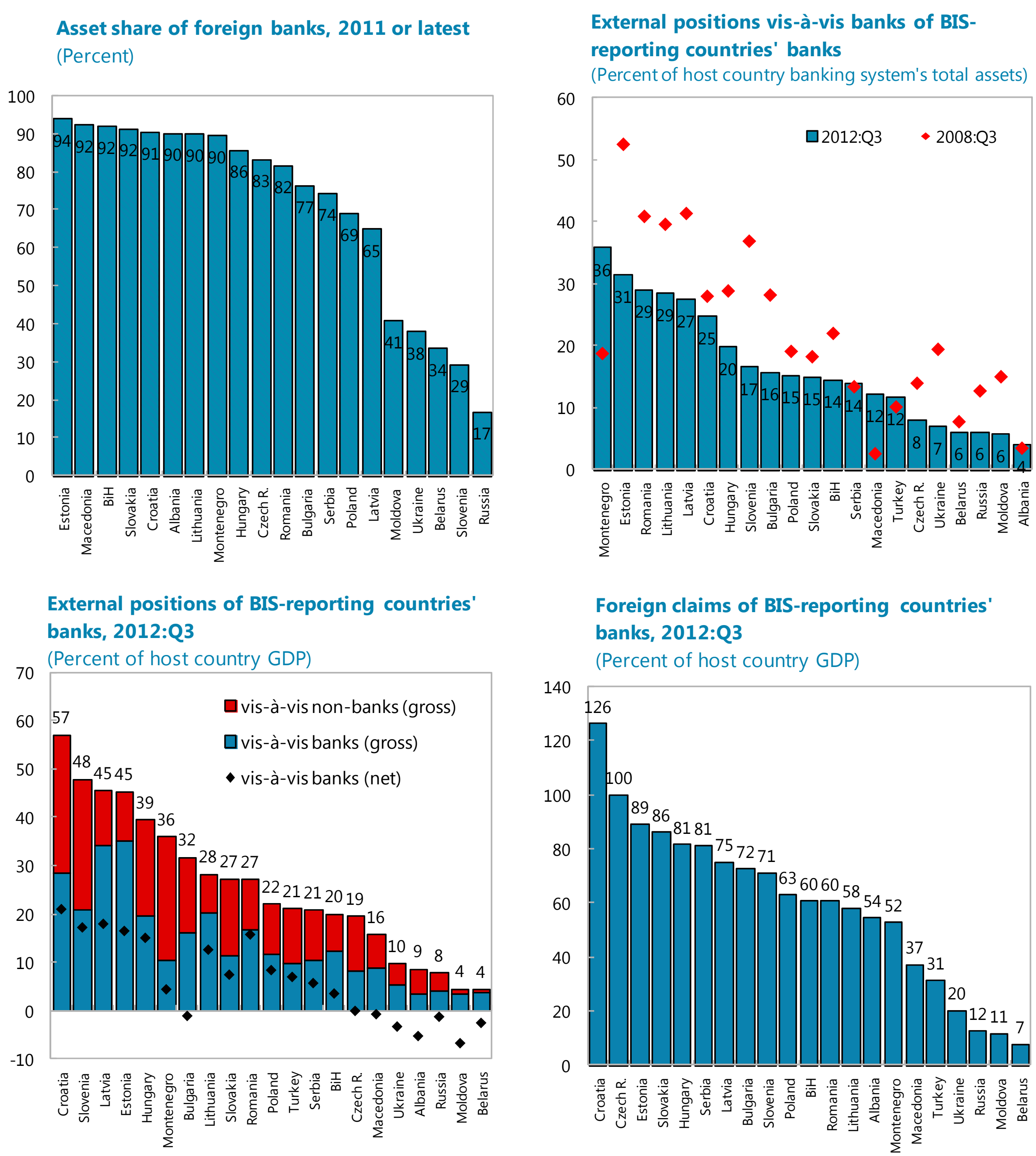
3. High foreign ownership reflects the decision of most CESEE countries to privatize their banks to strategic foreign investors during the economic transition of the 1990s. Bank reform was a daunting task for transition economies, which had inherited "monobank" systems from the central planning era that fulfilled none of the typical banking functions of western banking systems. The rapid establishment of state-owned banks and new domestic private banks led to pervasive poor lending practices and hampered macroeconomic stabilization, and a string of banking crises followed. This changed when banks were privatized to foreign strategic investors, who mostly came from nearby Western Europe (Bonin et al., 2008). Western banks also imported their better bank governance, more modern banking practices, and superior supervision by their home authorities. Banking groups from Western Europe continue to be the major players in the region. While their subsidiaries are often systemic in the host countries, they typically constitute only a small part of their own banking group.

4. High foreign funding emerged in the mid-2000s when foreign banks freely provided financing to CESEE—notably through their own subsidiaries—amid ample global liquidity and rapid

[1] Western European banks operate in CESEE primarily through their local subsidiaries, as well as cross-border lending to non-financial enterprises. Branches of Western European banks play only a minor role in CESEE and are therefore not discussed in this paper. The pros and cons of subsidiaries versus branches are analyzed in Fietcher et al. (2011).

[2] Based on the BIS International Banking Statistics. For a discussion and interpretation of these statistics, see Box 1.

Figure 1. CESEE: Foreign Ownership and Foreign Funding of the Banking System



Sources: BIS, International Banking Statistics (Tables 6 and 9); EBRD Banking Survey; IMF, World Economic Outlook database; and IMF staff calculations.

economic growth in the region. Foreign banks embraced a "centralized" bank funding model, whereby funding and liquidity management decisions are centralized and parent banks shift funds to where they are deemed most needed, with intra-group pricing of liquidity not necessarily fully reflecting credit and (indirect) foreign-currency risk (IMF, 2011). In contrast, foreign banks in other regions, such as in Latin America, followed a "decentralized" funding model—an approach characterized by a high degree of financial self-sufficiency of subsidiaries.

5. Section II takes a closer look how the benefits and pitfalls of foreign banking played out in the rapid expansion of foreign bank funding to CESEE and its subsequent reversal. It analyzes to what extent the evolution of foreign bank funding was driven merely by credit demand in CESEE and to what extent it was an autonomous force that drove developments in the region. It asks whether the "centralized" bank funding model followed by the foreign banks operating in the region exacerbated boom-bust cycles. Section III looks at the factors shaping the evolving new banking paradigm of the region. Apart from the boom-bust experience, important drivers are global market developments, the global regulatory reform agenda, the emerging European banking union, and prospects for bank profitability in CESEE. Section IV discusses policy implications in light of recent trends in CESEE's banking systems.

II. THE BOOM-BUST OF FOREIGN BANK FLOWS INTO CESEE

6. Foreign bank ownership and funding from abroad have both benefits and pitfalls, many of which played out in CESEE over the past decade. An extensive literature on the topic, reviewed in Technical Note II, identifies a number of clear advantages associated with the presence of foreign banks from advanced economies: better financial know-how, technology, access to international networks, and higher governance standards, which improve the efficiency and quality of financial intermediation in host countries and reduce the incidence of banking crises. Although there are concerns in the literature that foreign banks might engage in "cherry picking" and thereby worsen access to credit, the evidence for CESEE points to the opposite—a vast improvement of access to credit in the wake of opening up to foreign banks.

7. Cross border banking can bring risk diversification gains for both cross-border banking groups and host countries. For banks, having well diversified operations spread across several countries can reduce their overall risk profile. For host countries, the presence of foreign banks can help mitigate the impact of domestic shocks on host country economies. However, the presence of foreign banks increases the exposure to foreign shocks and foreign-owned banks are more difficult to supervise and to resolve. Because of their greater access to foreign currency funding, they are also more likely to lend in foreign currency, which increases foreign currency risk and complicates macroeconomic management.

8. The potential benefits from improved access to credit can easily be undone by the emergence of credit boom-bust cycles. Better access to credit opens the door to extended credit

booms, especially in times of abundant global liquidity that cross-border banks can easily direct to host countries. These credit booms tend to become self-reinforcing, through their impact on asset prices and income growth, turn excessive, and eventually end in inevitable bust.

A. The Boom Years: 2003–08

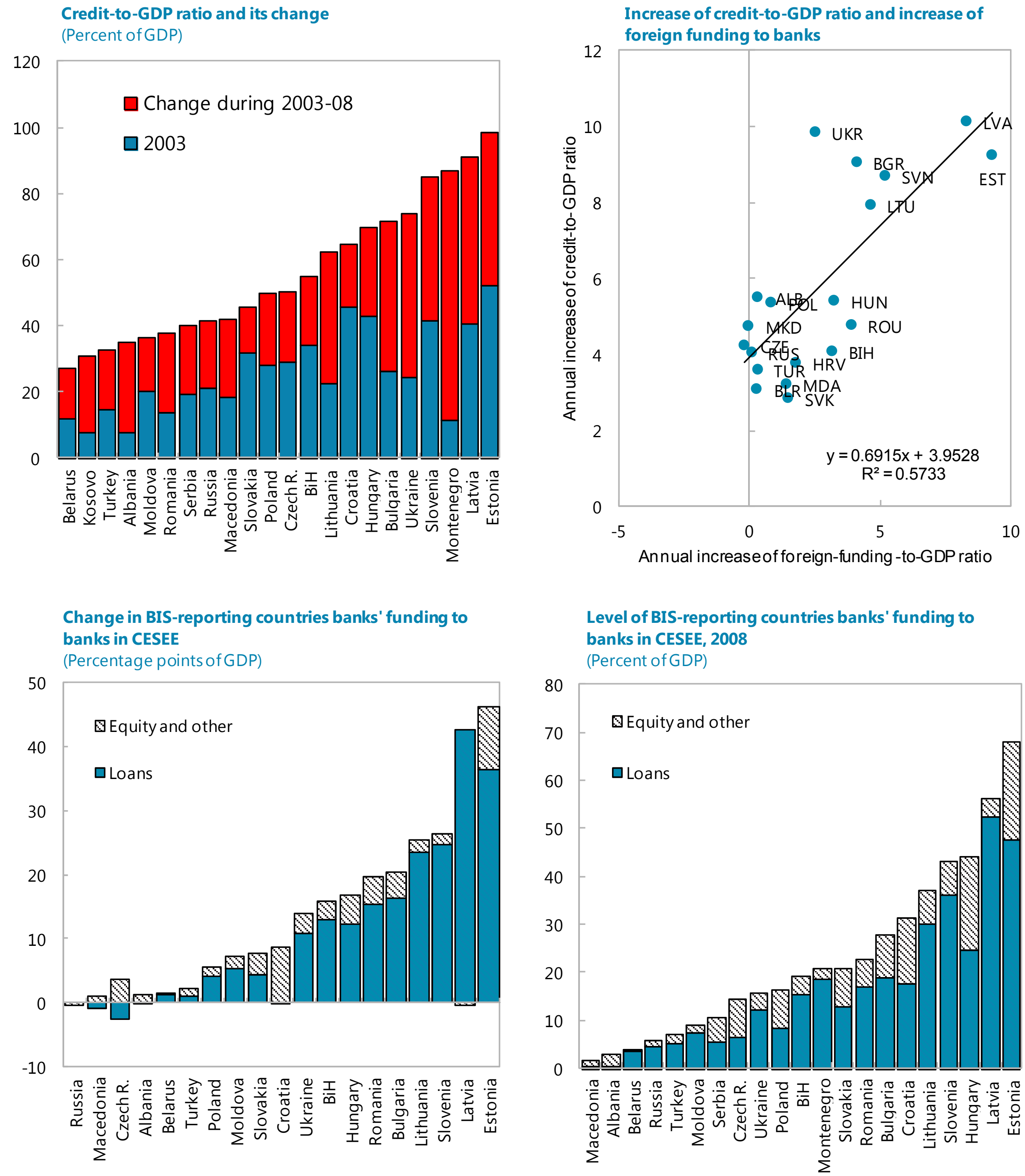
9. Once established in CESEE, Western European banks expanded quickly in their new markets through further acquisitions and organic growth. With few exceptions, foreign banks in CESEE are headquartered in Western Europe, reflecting geographic proximity, deepening economic integration, cultural closeness, and actual or prospective common EU membership. Both push and pull factors accounted for their rapid expansion in CESEE. Western European banking groups faced largely saturated home markets and ready access to increasingly bountiful global liquidity. The CESEE market seemed to offer attractive conditions, including EU membership, rapidly improving institutions, income convergence, and an initially small banking sector.

10. The involvement of western banks in CESEE was initially confined to equity investment in their local subsidiaries, but over time western banks provided more and more financing. Total funds provided to the region grew from around US$200 billion in 2002 to some US$1 trillion in 2008 or 25 percent of regional GDP. About half comprised funding for banks (in particularly their CESEE subsidiaries), mostly in the forms of loans. The other half of the financing took the form of cross-border loans to non-banks. During 2003–08, most CESEE countries experienced a credit boom (Figure 2, top left). During this period foreign banks competed for market share and optimistic borrowers with little initial debt were eager to take out loans for consumption and investment alike. The process reinforced itself as economic growth picked up and asset prices started to rise steeply. There were few limits to financing because of abundant global liquidity and tight financial integration of CESEE with the West, not least through the presence of cross-border banks. Credit grew most rapidly in the Baltic countries, Bulgaria, Montenegro, and Ukraine. The boom in private sector credit was fueled and financed by a surge in funding from BIS-reporting banks to banks in CESEE (Figure 2, top right). The larger the increase in the private sector credit to GDP ratio, the larger the increase in funding from foreign banks to banks in CESEE. Much of the new funding was in the form of loans (Figure 2, bottom left).

11. The increase in funding from BIS-reporting banks to banks in CESEE showed only a weak association with the share of assets of foreign banks in the banking sector (Figure 3). For example, the banking sectors in both Estonia and the Czech Republic are almost entirely foreign controlled, but foreign (gross) funding to Estonian banks increased by 46 percentage points of GDP while the increase was essentially 0 in the Czech Republic. This does not mean that foreign ownership has no implications for foreign funding—rather foreign ownership creates the potential for large foreign financing that is exploited or may lay dormant, depending on host country circumstances.

12. Foreign banks' also increased direct cross-border funding of the non-bank sector (Figure 4). In most countries, the increase in bank funding was higher than the increase in lending to nonbanks,

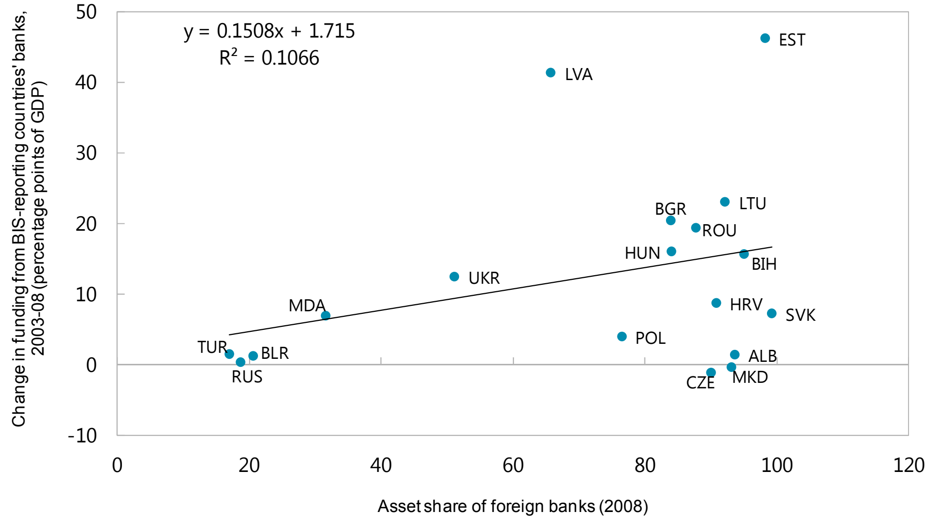
Figure 2. CESEE: Credit Growth and Funding from BIS-Reporting Countries' Banks to Banks in CESEE, 2003-08



Sources: BIS, International Banking Statistics; and IMF, World Economic Outlook database.

with the exception of Bulgaria and Croatia. These countries tried to cool the credit boom through macroprudential measures applicable to the banks established in their jurisdictions. However, these were circumvented by cross border banking groups, which booked loans at the parent level or channeled loans through leasing companies.

Figure 3. CESEE: Asset Share of Foreign Banks in 2008 and Increase in Funding of BIS-Reporting Countries' Banks to CESEE Banks during 2003-08



Sources: BIS, International Banking Statistics; EBRD; IMF, World Economic Outlook database; and IMF staff calculations.

13. The increase in funding boosted GDP growth, but the credit boom also led to serious imbalances and vulnerabilities. CESEE economies started to overheat, with asset prices entering an unsustainable path and large current account deficits emerging as the flipside of the CESEE's ample recourse to foreign financing.[3] By 2007/08, 10 out of 22 countries in the region had a current account deficit of 10 percent of GDP or more (Figure 5, top panel).[4] In the banking sector itself, loan-to-deposit ratios escalated (Figure 5, bottom panel). That said, the level of credit penetration in CESEE economies in 2008 did not appear excessive, despite the rapid expansion of credit during the boom years. Credit-to-GDP ratios ranged from 27 percent of GDP in Belarus to 99 percent of GDP in Estonia and averaged 56 percent of GDP, compared to 140 percent of GDP in the euro area (Figure 6, top left). This suggests that it was primarily rapid credit *growth* rather than the level of indebtedness per se that was problematic.

14. The credit boom was also associated with a surge in foreign currency loans in most countries (Figure 6). The surge reflected both demand and supply factors:

- On the demand side, foreign currency borrowing was boosted by interest rate differentials. Foreign currency loans were cheaper—particularly when the exchange rate risk was ignored.[5]

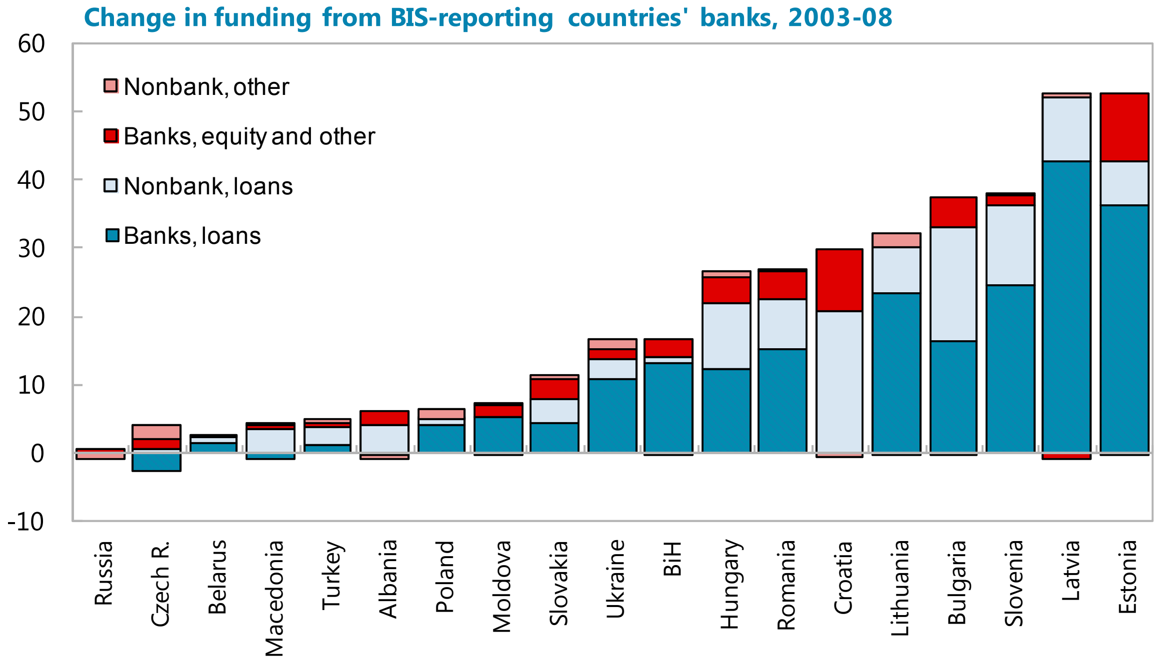
[3] Individual country experiences differed substantially. For a country-by-country account of the boom-bust cycle see Bakker and Klingen (2012).

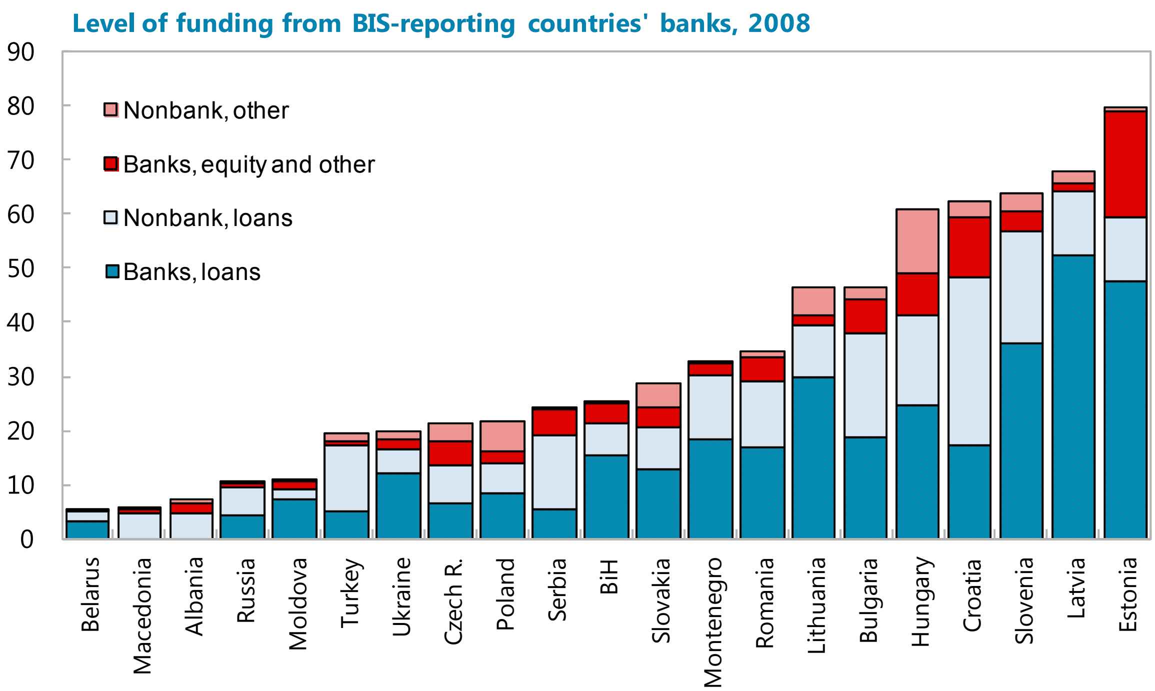
[4] Bakker and Klingen (2012) argue that to a large extent the high current account deficits were the result of the large capital inflows, rather than the other way around. Indeed, when capital inflows dropped after Lehman, the current account deficits declined very rapidly.

[5] Notable exceptions were the Czech Republic and Slovak Republic, where foreign currency loans remained very limited.

Figure 4. CESEE: Funding from BIS-Reporting Countries' Banks to Banks and Nonbanks in CESEE during Boom Years

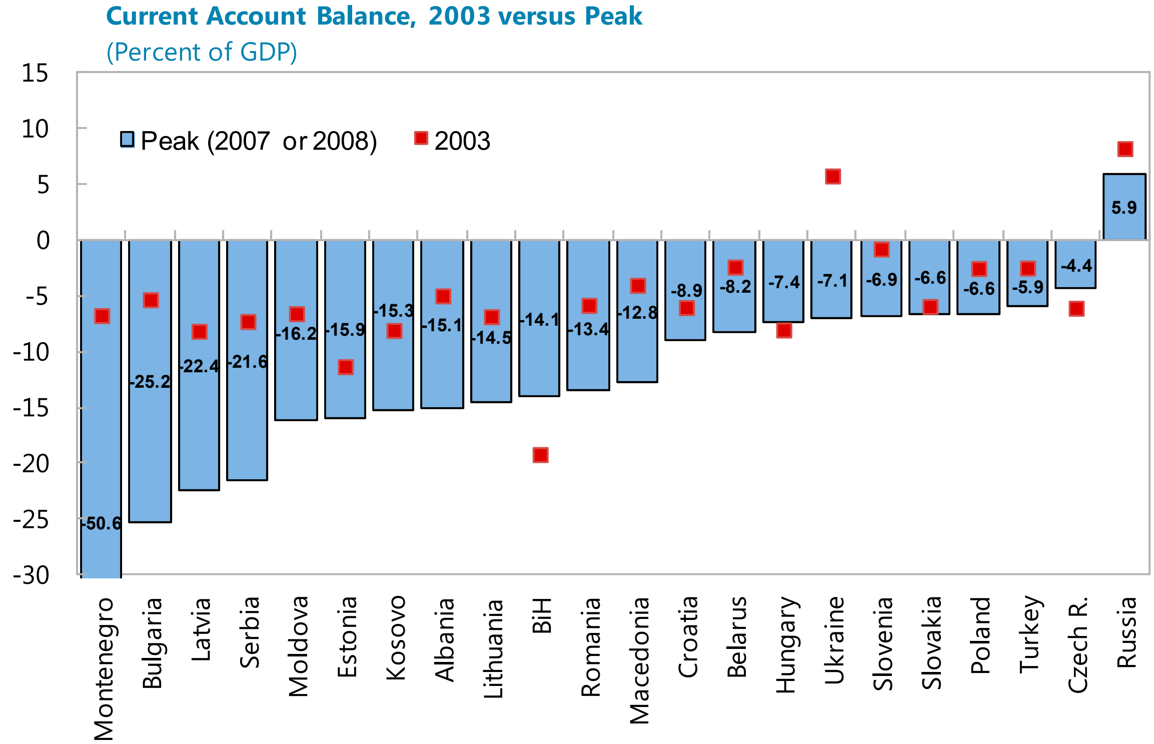
(Percent of GDP)

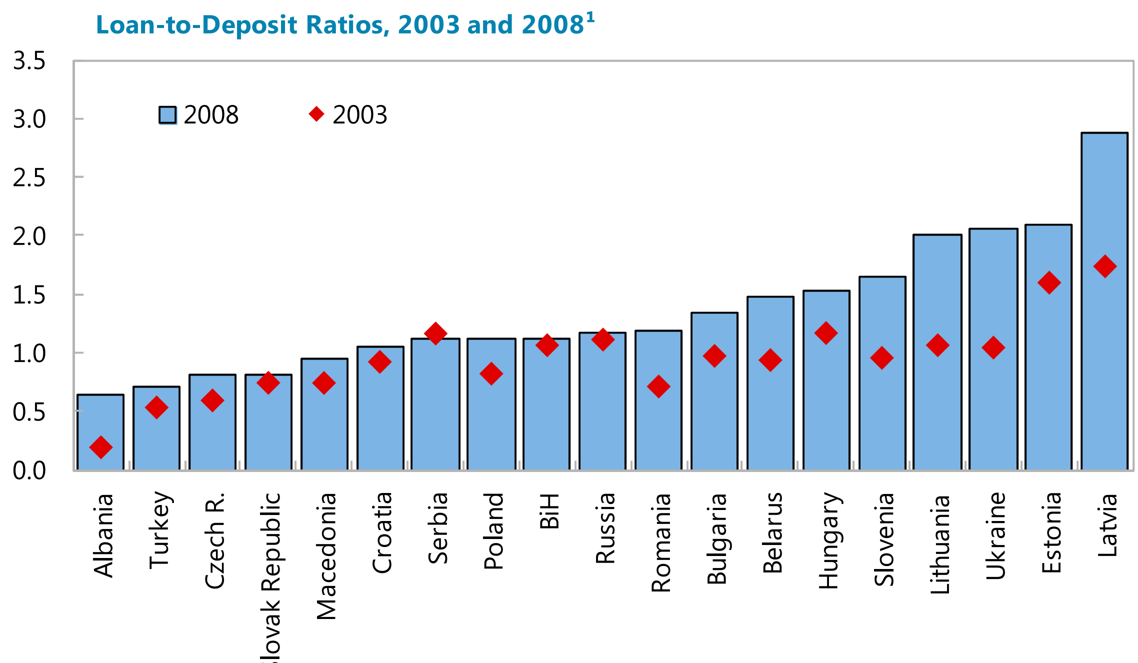




Source: BIS, International Banking Statistics.

Figure 5. CESEE: The Building Up of Imbalances

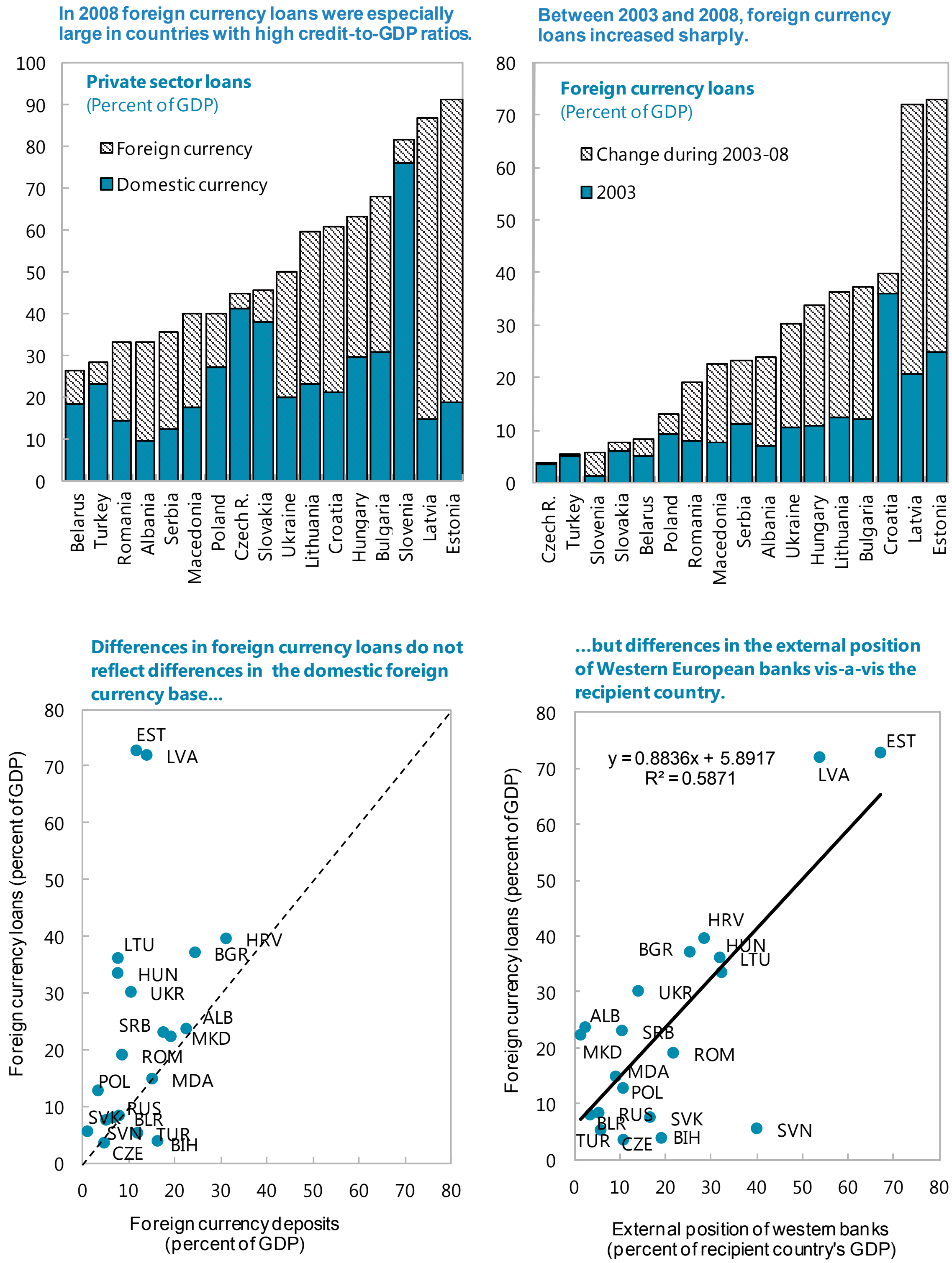




[1]Slovak Republic, 2006 instead of 2003.

Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Figure 6. CESEE: The Boom in Foreign Currency Loans, 2003-08



Sources: IMF, International Financial Statistics; and IMF staff calculations.

Foreign currency loans were not confined to euro-loans; in some countries, loans were also denominated in currencies with even lower interest rates, such as the yen and the Swiss franc.

- On the supply side, the funding structure provided incentives for foreign currency lending as local subsidiaries obtained funding from their parent bank in euro, they on-lent in euro rather than in local currency to close their open currency position.[6] If demand for foreign currency loans exceeded the supply of foreign currency funding, then banks would convert domestic currency deposits into foreign currency funding using swaps.[7]

15. Many CESEE countries became concerned about foreign funding risks during the boom years and some, but not all, deployed a range of macro-prudential policy measures. Vandenbussche, Vogel, and Detragiache (2012) document the breadth of instruments used in the region, and their use across 16 countries. Countries such as Bulgaria, Croatia, and Serbia implemented a number of countercyclical measures targeting capital, liquidity, and borrower eligibility criteria but these measures were not always effective in taming the credit boom because of circumvention. Other countries, including Latvia and Lithuania, were more reluctant to step in despite witnessing some of the largest booms in the region, in part because of policy-makers' concern about circumvention and the risk of transformation of subsidiaries into branches (under the EU' s single passport policy) if the regulatory gap between home and host countries grew too wide.

Macro policies made a difference.

16. Countries with floating exchange rates had an easier time dealing with large capital inflows than countries with fixed or heavily managed exchange rates (Bakker and Gulde, 2010). Countries with fixed exchange rates cannot let the nominal exchange rate appreciate in the face of capital inflows, and are therefore less able to "insulate" domestic liquidity from capital inflows. Currency boards have even fewer instruments. A comparison among the new EU member states suggests that exchange rate appreciation indeed made a difference. Most of the countries with floating exchange rates (the Czech Republic, Poland, Romania, and the Slovak Republic) tightened monetary conditions by letting the nominal exchange rate appreciate. This helped keep inflation low and real interest rates high. By 2008, where the nominal exchange rate had appreciated, the credit boom was less pronounced, inflation lower, and current account deficits lower. The acceleration of wages and prices was also much smaller.

17. Monetary policy credibility made a difference as well in containing the share of foreign currency loans. Across the group of five EU and EU-candidate inflation-targeters in the region, higher policy rates were associated with a higher share of foreign currency loans (Technical Note

[6] That funding structure, rather than ownership, is key for the currency denomination of loans is illustrated by the example of the Czech Republic, which has a largely foreign owned banking system, but very few foreign currency loans.

[7] See Box 11 in October 2010 Regional Economic Outlook for Europe.

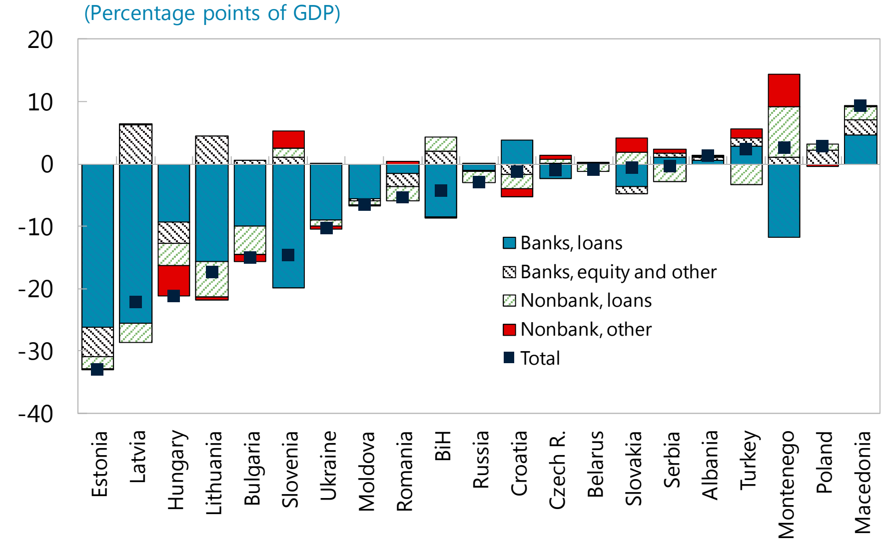
III).[8] While there are multiple demand and supply factors that explain the currency composition of credit and each of them is likely to have played a role in favoring the growth of foreign currency loans in the region over time, it is striking to see that among this group of five countries, the level of the monetary policy interest rate is very strongly associated with the share of foreign currency loans. Except for the Czech Republic, interest rates on domestic currency loans are generally higher than on FX loans, due to lower monetary policy credibility and/or higher inflation volatility in the domestic economy. Indeed, in many countries in CESEE, foreign currency loans were perceived as cheaper during the boom years, as borrowers typically did not factor the risks of foreign currency appreciation into borrowing costs. This was especially the case for mortgages: mortgages in euros and Swiss francs carried a much lower interest rate—and longer maturity—than those denominated in local currency.

B. The Reversal of Bank Flows: 2008–12

18. Between 2008 and 2012, much of the earlier bank inflows reversed (Figure 7). Most of the outflows were the result of a reduction in loans to banks. The larger the bank inflows in the pre-crisis boom years, the larger the outflows in the aftermath of the crisis (Figure 11, top left). On average for the region, over half of the increase in the foreign funding to GDP ratio during the 2003–08 unwound during 2008–12.

19. The reversal of bank flows coincided with deep recessions, and countries with the largest outflows suffered the most (Figure 8, top right). This correlation does not say anything about causation, but causality likely ran both ways. Initially, the sudden stop in bank inflows caused a deep recession as domestic demand collapsed for lack of new funding and countries with the previously largest inflows were affected most. As countries went into recession, credit demand crumbled, causing subsidiaries to use surplus funds to repay parent bank loans, although in the

Figure 7. CESEE: Change in External Position of BIS-Reporting Countries' Banks, 2008:Q4-2012:Q3
(Percentage points of GDP)



Sources: BIS, International Banking Statistics (Table 6); and IMF, World Economic Outlook database.

[8] A similar argument can be found in Dell'Ariccia, Laeven and Marquez (2011), who show that when domestic interest rates are high, it may be optimal for individual firms to borrow in foreign currency—even though that increases systemic risk.

intermediate aftermath of the crisis, some parent banks *increased* the liquidity provided to some of their subsidiaries.

20. The boom-bust in bank flows thus contributed to high macro-economic volatility. The influx of large bank flows was associated with rapid growth, overheating economies and increasing imbalances, while the reversal of the flows was associated with deep recessions.[9] The higher volatility was not compensated by higher average GDP growth: countries with larger inflows during the boom years did not have higher average GDP growth over the combined boom-bust period (Figure 8, bottom right).

21. The reversal in bank funding came in two waves (Figures 9 and 10).[10] The first wave followed the collapse of Lehman Brothers in September 2008 and ended in mid-2010. As bank funding markets froze globally, funding from Western European parent banks for their CESEE subsidiaries also dried up. External bank funding dropped by 19 percent between 2008:Q3 and 2010:Q2, corresponding to US$176 billion or 3.8 percent of the region's GDP.

22. Funding reductions remained orderly thanks to a comprehensive policy response. CESEE's loss of foreign bank funding in the first wave was no doubt very substantial but it was spread out over almost two years, which was instrumental in averting a regional financial meltdown. The relatively contained reduction of foreign bank funding in the initial phase of the crisis was no coincidence but the result of multiple policy interventions.

23. In the aftermath of the collapse of Lehman Brothers, there was a concern in some quarters that banks would "cut and run" from their engagement in the east in an uncoordinated rush to the exit.[11] This could have wrecked havoc in CESEE economies, thereby validating each bank's exit decision in a self-fulfilling prophecy. Recognizing this risk of coordination failure, the international community made large-scale financing available, mainly through the IMF and the EU. In addition, the so-called "Vienna Initiative" brought the key cross-border banks, home and host country authorities, and International Financial Institutions together to secure a collaborative outcome (Box 2). Banks pledged to remain committed to the region and in the case of five countries with IMF-supported programs their CEOs pledged in commitment letters to maintain exposure.[12] The higher resilience of banking flows to CESEE relative to Latin America and East Asia during the height of the crisis likely also reflects high foreign ownership in CESEE banking systems (Vogel and Winkler, 2012). At the country level, national authorities implemented extensive economic adjustment to

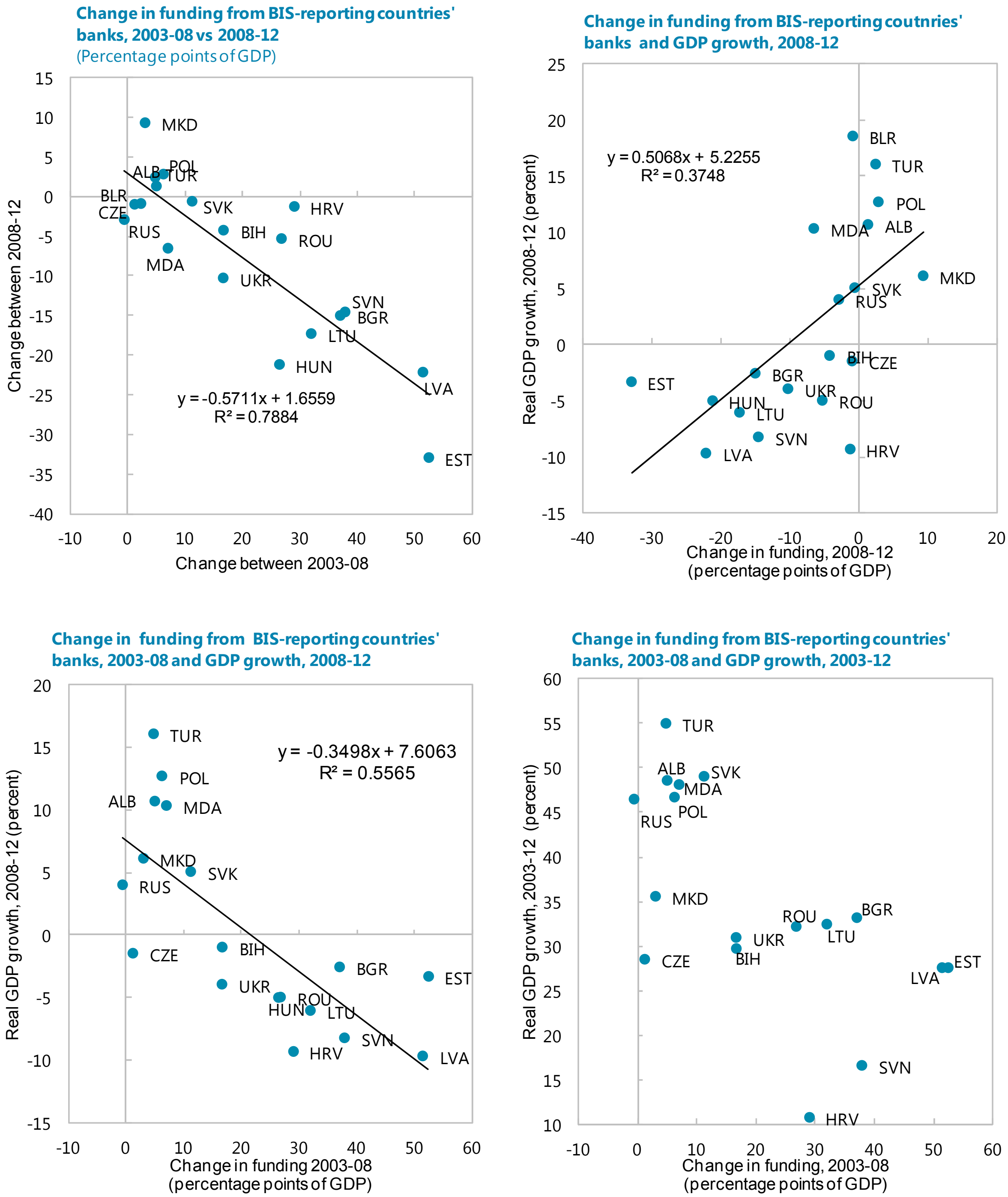
[9] The finding that countries with lower imbalances during the pre-crisis boom years experienced smaller downturns is also confirmed by other research. For example, IMF (2010) shows that emerging market countries that had improved policy fundamentals and reduced vulnerabilities in the pre-crisis period reaped the benefits of this good management during the crisis.

[10] See Quarterly Deleveraging Monitors (www. vienna-initiative.com).

[11] Please refer to the quotes given in Bakker and Klingen (2012), Chapter V, pages 75–76.

[12] Bosnia and Herzegovina, Hungary, Latvia, Romania, Serbia. The programs with Latvia, Hungary, and Romania were jointly supported by the IMF and the EU.

Figure 8. CESEE: Debt-Funding from BIS-Reporting Countries' Banks and GDP Growth

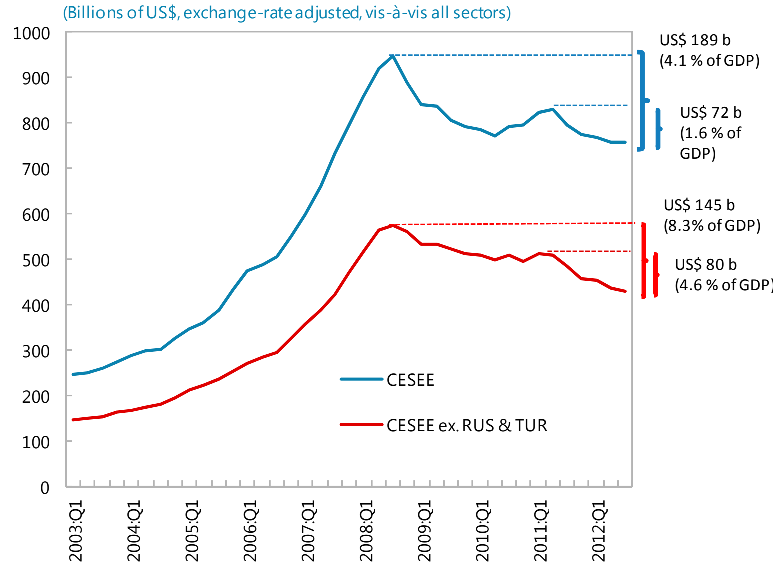


Sources: BIS, International Banking Statistics (Table 6); and IMF, World Economic Outlook database.
Note: Debt-funding includes "Loans" (Table 7 in BIS, International Banking Statistics).

contain the deterioration of public finances, improve external competitiveness, and stabilize financial sectors.

Figure 9. CESEE: External Position of BIS-Reporting Countries' Banks vis-à-vis CESEE, 2003:Q1-2012:Q3

(Billions of US$, exchange-rate adjusted, vis-à-vis all sectors)



Source: BIS, International Banking Statistics (Table 6).

24. While a financial meltdown was averted, most CESEE countries still suffered very deep recessions. Thanks in part to the rather gradual reduction of western bank financing, provision of official financing, and measures at the country level, banking crises occurred only in Latvia and Ukraine.[13] The fixed exchange rate regimes in the region endured (with the exception of Ukraine), and the initial depreciation in countries that did not peg largely unwound soon after the crisis peak. Nonetheless, deep recessions could not be avoided as the vulnerabilities built-up during the boom years had to be corrected. The sudden stop in credit pulled the rug from under growth that had been driven by domestic demand. In many countries the tradable-goods sector had shrunk or become uncompetitive, putting it in a poor position to take over as a new engine of growth. Public finances turned out to be much weaker than headline deficits had suggested during the boom years, forcing many countries into pro-cyclical fiscal adjustment. Banks' asset quality started to deteriorate rapidly as borrowers struggled to repay their loans in the downturn. Loans denominated in Swiss francs became particularly hard to service as safe-haven effects pushed up its value. CESEE's GDP contracted by 6 percent in 2009, more than any other region.

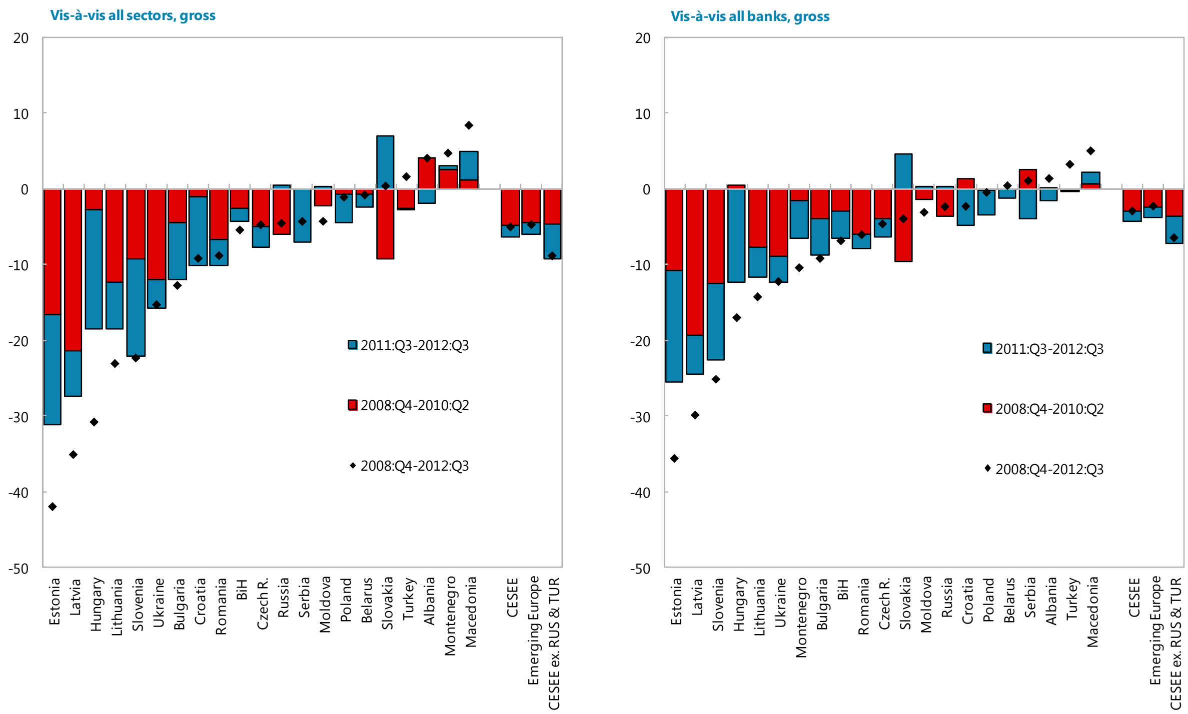
25. The second wave of funding reductions started in mid-2011 when western European banks came under renewed pressure. During mid-2010 and mid-2011 western bank funding for CESEE had inched up as the region climbed out of its recession and the euro area crisis remained contained to three small peripheral countries. This changed when the euro area crisis escalated to engulf the larger European economies, and banks came under pressure, even in the "core" countries. Pressures were compounded by regulatory tightening under Basel III and EBA recommendations, which were necessary to get to a stronger and more resilient banking system over time but carry the risk that banks choose to reduce lending rather than raise capital (Box 2).[14] In the second half of 2011, EBA had issued a recommendation for substantial capital raising for 37 banks by mid-2012. More

[13] Laeven and Valencia (2012) classify Hungary and Slovenia as borderline cases.

[14] For the drivers of bank deleveraging see IMF's Global Financial Stability Report of April 2012, pages 25–42. In principle there is no trade-off between bank capitalization and banks' credit provision (Admati and Hellwig, 2013) but

(continued)

Figure 10. CESEE: Change in External Positions of BIS-Reporting Countries' Banks vis-à-vis CESEE countries, 2008:Q4-2012:Q3
(Percent of GDP)



Sources: BIS, International Banking Statistics; IMF, World Economic Outlook database; and IMF staff calculations.

stringent requirements under Basel III are to be phased in over many years, but market pressures prompted banks to try complying with future requirements ahead of schedule. Western banks reduced their funding for CESEE excluding Russia and Turkey between 2011:Q2 and 2012:Q3by 16 percent (US$80 billion, 4.6 percent of GDP).

26. The second wave of funding reductions hit some countries particularly hard. Estonia, Hungary, and Slovenia, saw funding reduction of over 10 percent of GDP, while Macedonia, Russia, and the Slovak Republic registered small increases. This diversity likely reflects country idiosyncrasies, to which banks might have become more sensitive in the post-crisis period. Concerned about the rapid pace of bank funding reductions from CESEE in the second half of 2011 and to enhance cooperation between home and host country authorities, the international community revived the Vienna Initiative under Vienna 2 in January 2012 (Box 2).

27. The second wave of funding reductions coincided with a renewed growth slowdown. With the European and global outlook deteriorating and some rebound from the 2009 recession having run its course in several countries, economic growth in CESEE declined again. The softening economy became clearly visible in the GDP figures for early 2012, though much less so in the second half of 2011. Credit growth in the region as whole ground to a halt (Figure 11).

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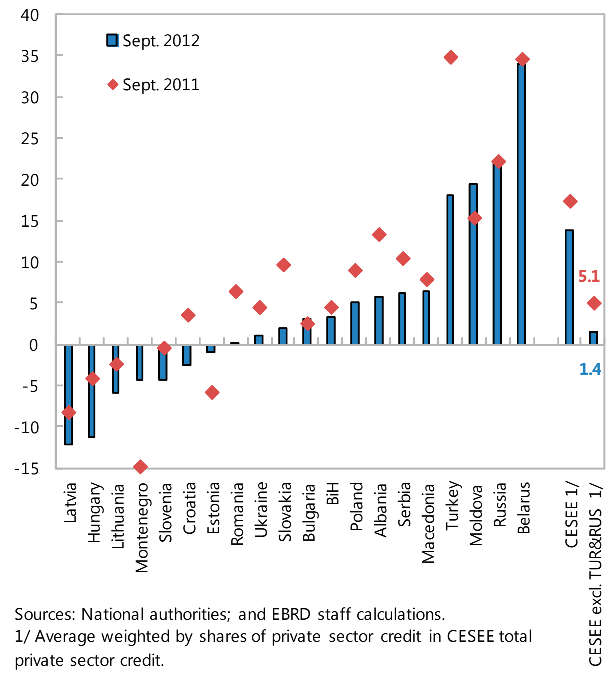
in practice incentives in the financial sector might be so that banks choose to reduce the supply of credit when capital requirements are hiked, especially in adverse market conditions that make it unfavorable to raise capital.

28. Since the 2008/09 crisis, there have not been big changes in the high degree of foreign ownership of banks in CESEE. A few sales of CESEE subsidiaries by weak parent banks took place but buyers tended to be foreigners as well. For example, the Polish subsidiary of Anglo Irish Bank (Ireland) was sold to Santander (Spain), the large Polish branch of EFG Eurobank (Greece) was sold to Raiffeisen (Austria), and the Turkish subsidiary of Dexia (Belgium) and several CESEE subsidiaries of Volksbank (Austria) were sold to Sberbank (Russia). Unicredit (Italy) is centralizing its (small) Baltic operations in Latvia, closing branches in Lithuania and Estonia. Nonetheless, western parents seem to continue to regard most CESEE countries as part of their "core markets" and there have been no major exits to date.[15]

Figure 11. CESEE: Growth of Credit to Households and Enterprises

(Percent, year-on-year, nominal, exchange-rate adjusted)



Sources: National authorities; and EBRD staff calculations.
1/ Average weighted by shares of private sector credit in CESEE total private sector credit.

C. Were Funding Developments Demand or Supply Driven?

29. CESEE's banking paradigm, and changes to it, affect the economy to the extent that it is an autonomous driver of funding for credit. But was this the case in the past? In principle, there are two competing explanations: funding flows could passively accommodate changes in credit demand, or funding flows could be an active driver of credit developments from the supply side.

30. It is likely that the first deleveraging wave that followed the default of Lehman Brothers was triggered by a reduction in credit supply, but as the economies fell into deep recessions, weak credit demand played an increasingly important role.

- After the default of Lehman Brothers, advanced countries' banks, which were confronted with liquidity and capital shortages, came under severe liquidity pressure and saw themselves forced to stop new lending or even deleverage. In a change of strategy, they advised their subsidiaries that new credit would henceforth need to be financed from an increase in local deposits rather than additional parent bank funding.[16]

[15] In Ukraine, however, Commerzbank (Germany) and SEB (Sweden) sold their subsidiaries to domestic investors, and Erste Bank (Austria) it about to do the same; Societé Générale sold its retail portfolio to Alfa-Bank in 2012, while Swedbank decided to close down its 10 regional branches in 2012. In Russia, several Western European banks (including Barclays, BNP Paribas, HSBC, KBC, Santander, and WestLB) with relatively small operations exited or retreated from the retail market in 2010–12.

[16] This did not apply to the CESEE region only. As discussed in BIS (2010), a key development in the global banking industry in response to the crisis has been the intention to increase reliance on retail funding.

- By early 2009, when the region was in deep recession, credit demand had dropped sharply as well. Indeed, the funding reductions coincided with a dramatic turnaround in the saving-investment balance of the nonfinancial private sector—a stark contrast with the deterioration during the boom years (Figure 12).

31. Similarly, the second deleveraging wave may also have been *triggered* by supply factors, with weak credit *demand* playing an increasingly important role thereafter. Funding withdrawals from CESEE started in mid-2011 (Figure 13), at a time when GDP growth in CESEE was still robust (Figure 14). This timing of the two key drivers of credit supply and credit demand suggests that the initial impulse for the downturn of credit growth came from supply side factors. Avdjiev et al. (2012) formalize this reasoning and conclude that the second wave of funding reduction of western banks for CESEE was driven by supply side factors. The observation that credit growth was particularly weak in banks with initially high loan-to-deposit ratios and that credit supply conditions tightened from mid-2011—at a time when credit demand conditions as assessed in senior loan officer surveys were improving—further corroborates the importance of supply side factors (Vienna Initiative, 2012).

32. To further investigate the role of demand versus supply factors in the slowdown of credit growth and the effects of foreign ownership on the credit cycle, bank-level data from the BankScope database were analyzed (Technical Note IV).[17] Annual data for the 2001–11 period were used, linking each individual bank's credit growth to macroeconomic conditions in the host country, the bank's own fundamentals, and the parent bank's fundamentals if applicable.

33. The analysis shows that *before the crisis* (in the period up to and including 2007) credit growth of individual banks depended very significantly on GDP growth, suggesting that credit *demand* played a key role.[18] A one percentage point rise in real GDP growth led to some 1½ to 2 percentage points increase in banks' annual credit growth. The role of the demand side is also evident in the large differences in credit growth of subsidiaries of the same parent banks across different countries. For example, during the boom years, credit growth by Raiffeisen subsidiaries ranged from 28 percent in Hungary to 58 percent in Bulgaria (Figure 16).

34. In the 2008–11 period, the relevance of GDP growth for credit growth diminished, while the relevance of supply factors such as bank solvency, asset quality, and the loan-to-deposit ratio increased, and banks in the sample with poorer asset quality, lower equity-to-net-loans ratios, or higher loan-to-deposit ratios extended less credit than banks with stronger fundamentals.

[17] Two features of the dataset constructed for this study allow it to provide deeper insight into the role of foreign ownership. First, the dataset tracks the ownership of individual banks over time. This is different from most other studies based on BanksScope data, where a bank's ownership is often defined only based on its most recent status. Second, based on the historical ownership information of each individual bank, the dataset matches foreign subsidiaries with their parent banks. The additional information on parent banks enables the study to not only look at the difference between domestic and foreign banks, but also to explore the variations among foreign banks and examine the impact of parent banks' financial conditions on subsidiaries' credit growth.

[18] From the perspective of an individual bank, GDP growth is an exogenous variable, and does not depend on its own credit growth.

Figure 12. Selected CESEE Countries: Nonfinancial Private Sector Saving-Investment Balance

Source: Haver Analytics.
1/ 2010 versus 2008 for Bulgaria, Slovakia and Latvia.

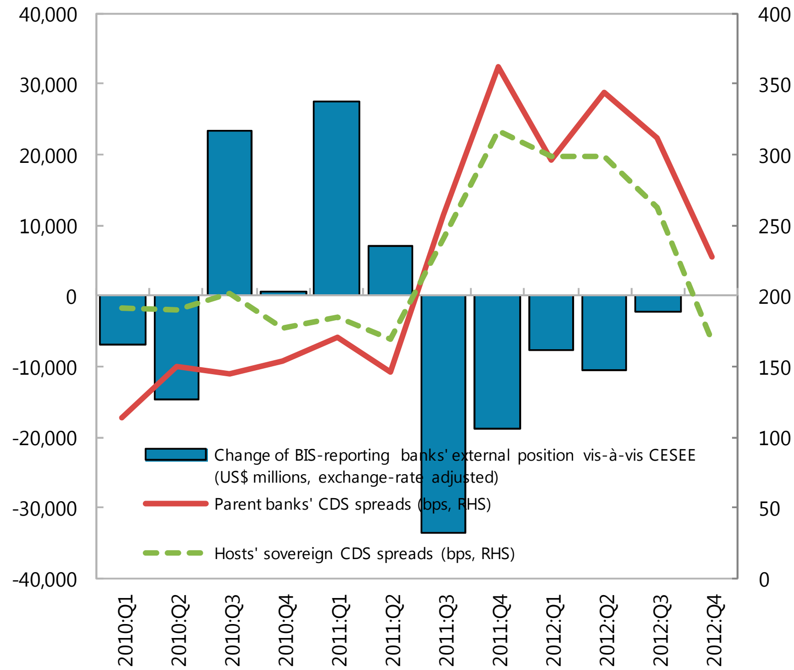
35. Analysis of individual years in the post 2007 period further confirms the increasing importance of supply factors. Figure 15 shows that the worsening of macroeconomic conditions played a particularly large role in 2009, accounting for over 60 percent of the credit slump. In 2010 and 2011, however, it was banks' own fundamentals and their more conservative response to fundamentals that put most drag on credit growth.

D. Did Foreign Banks Behave Differently?

36. If lending decisions of foreign banks differ fundamentally from those of domestic ones, their evolving role in CESEE can be expected to have important economic effects. What is the record of the recent past in CESEE?

37. The analysis shows that foreign banks are behaviorally different from domestic banks, and that parent bank characteristics matter. First, while domestic banks grow faster when they are more profitable, this is not true for foreign banks, perhaps because they do not depend as much on retained earnings to build capital and grow. Second, foreign banks have behaved differently since the onset of the crisis as they have become much more sensitive to their solvency and to the quality of their loan portfolios. Third, three key parent bank characteristics matter: solvency (proxied by the equity to total assets ratio), the loan-to-deposit ratio, and the home country sovereign CDS spread (a proxy for bank funding costs, as well as governments' ability to support banks). This implies that shocks to the parent's solvency and access to funding and funding costs are transmitted to the subsidiary. Regarding parent bank solvency, the estimates suggest that the impact of shocks to parent solvency had about the same impact as that of shocks to the local affiliate's solvency before the crisis. Thus, from the perspective of the host country, it is best to have parents with a relatively low-risk profile, a

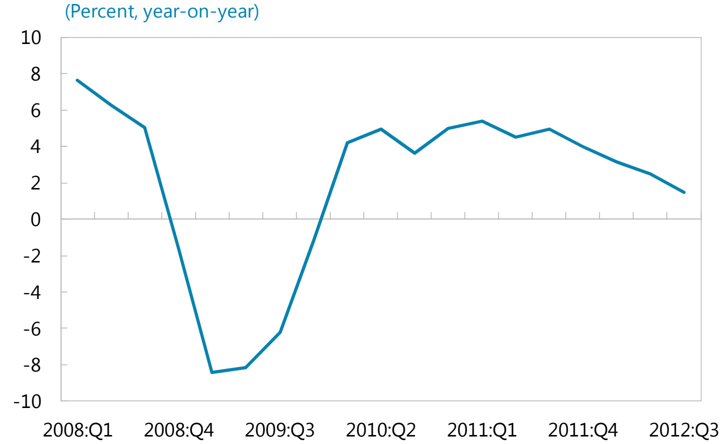
Figure 13. CESEE: Funding by Western Banks and Their Funding Costs, 2010:Q1-2012:Q3



Sources: BIS, International Banking Statistics; Bloomberg; and IMF staff calculations.

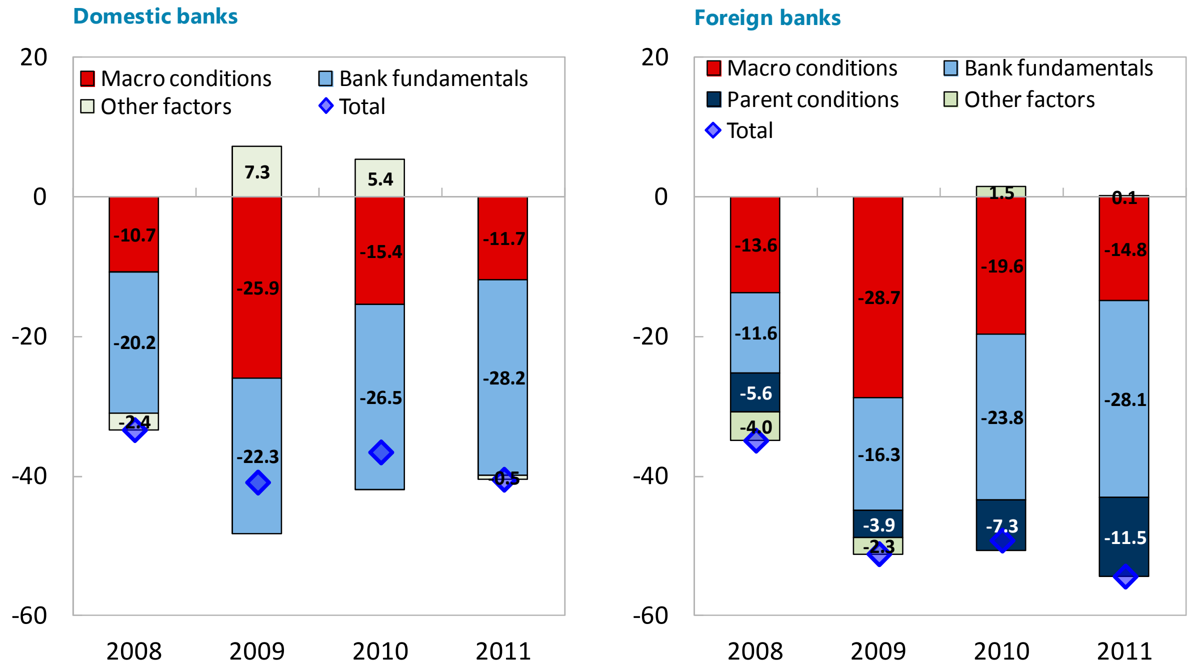
Figure 14. CESEE: Real GDP Growth

(Percent, year-on-year)



Sources: Haver Analytics; and IMF staff calculations.

Figure 15. Decomposition of Credit Growth Slowdown in 2008-11
(Relative to 2001-07 average, percentage points)

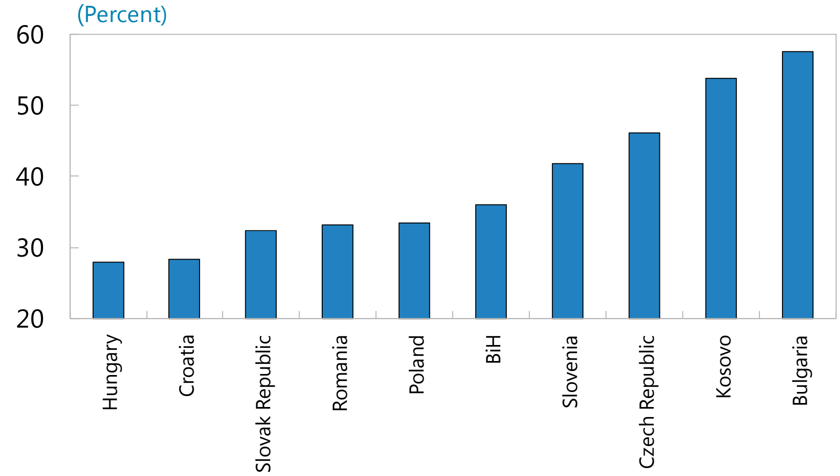


Note: The results of the underlying regression are reported in column (5) of Table 9 in Technical Note IV.

well-balanced funding strategy at the group level, and a strong sovereign as they are less likely to be sources of financial instability.

38. Credit growth of foreign banks exceeded that of domestic banks before the 2008/09 crisis but slowed down more thereafter, reflecting above all the tightening in parent banks' funding conditions. In the pre-crisis period, the annual credit growth of foreign banks was some 6 percentage points higher but from 2009 onward this margin disappeared (Figure 17). Figure 18 decomposes the difference in the credit slowdown between foreign and domestic banks in 2008–11. It shows that the tightening in parent banks' funding conditions explained most of the difference. Changes in other parent bank fundamentals, as well as the macroeconomic conditions and banks' own financial fundamentals, accounted for only a small share.

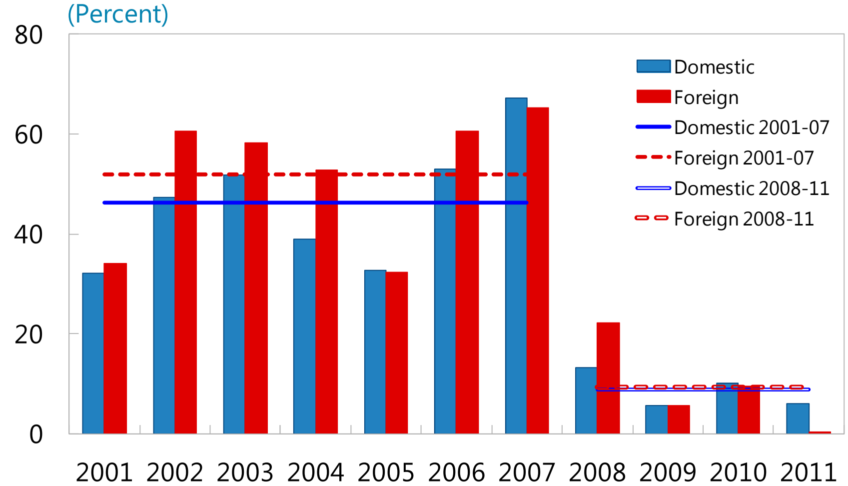
Figure 16. Credit Growth by Subsidiaires of Raiffeisen, 2005-07 [1]
(Percent)



Sources: BankScope; and IMF staff calculations.
[1] Credit is measured in US dollars, and reported are simple averages over time and across subsidiaries in the same country.

39. Foreign ownership *per se*, after controlling all other factors, seems associated with higher credit growth throughout and cyclicality similar to that of domestic banks. Foreign ownership has boosted the subsidiaries' annual credit growth by 10 to 12 percentage points during the pre-crisis period, and by 7–9½ percentage points since 2008. This small reduction of the credit growth margin of foreign banks over domestic banks suggests that foreign ownership per-se has contributed only very moderately to the procyclicality of credit growth.

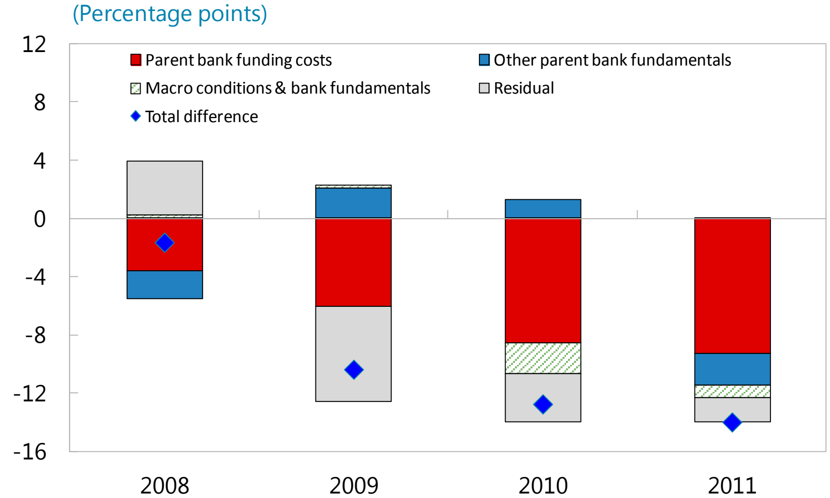
Figure 17. CESEE: Average Annual Credit Growth by Banks, 2001-11[1]
(Percent)



Sources: BankScope; and IMF staff calculations.
[1]Unweighted average, excluding Russia. Credit is measured in US dollars.

40. In contrast to foreign ownership, banks' funding structure had a large bearing on cyclicality. The funding leverage ratio did not seem to carry much weight in banks' lending decisions before the crisis, but it has become a major concern since 2008. The decomposition exercises show that, for both foreign and domestic banks, this factor alone can account for over 20 percent of the total credit growth slowdown since 2008. With the funding leverage ratio likely closely associated with foreign funding in the case of foreign banks, the analysis is indicative of foreign funding being a key source of cyclicality.

Figure 18. Why Foreign Banks Credit Growth Slowed Down More than that of Domestic Banks during 2008-11
(Percentage points)



Sources: BankScope; and IMF staff estimates.

III. STRUCTURAL FACTORS SHAPING BANKS' NEW FUNDING MODELS

41. The future of banking in CESEE is likely to be shaped by the experience of the 2008/09 global financial crisis, as well as the boom-bust cycle in the region and its legacies. The crisis and its aftermath served as an eye opener both for the vulnerability of some advanced economies banks' funding structure and for the true risks and opportunities associated with banking in CESEE. It also left lasting marks on banks' balance sheets that will affect their behavior going forward. Moreover, the global financial crisis has led to questions about how to better regulate banks, and an overhaul of regulation is well underway at the global, the EU, and national levels. Most of these developments will have a restricting effect on funding provided by foreign banks to their CESEE subsidiaries. The effect on foreign bank ownership in CESEE is less clear. As discussed above, sizable funding reductions have already been occurring while foreign bank ownership has remained rather stable.

A. Lessons Learned from the Boom-Bust Cycle in CESEE

42. Under the centralized banking model used by most Western European banks active in CESEE, boom-bust cycles may become more severe.

- During good times, the credit supply curve in host countries is very elastic, as parent banks shift funds to where credit growth is rapid, and profits are high. This means that credit growth can become much higher than in an economy where credit growth has to be funded from local deposit growth alone. Moreover, the pricing of such funding may also be lower than what could have been possible domestically or in international markets and may not fully capture risks.[19]
- When parent banks are hit by shocks and the supply of foreign funding dries up, the end of the credit boom may trigger a sharp downturn in the host countries. As credit demand declines, lending rates may not fall (which would mitigate the downturn), but instead funds may be repatriated to the parent bank.

43. This lesson echoes one of the conclusions of IMF (2011) which found that if parent-sourced funding is inappropriately priced, the gains brought by advanced economies' banks to emerging markets may get eroded, leading to adverse macro-financial loops. Advanced economies' banks may have lacked the incentives to internalize the macroeconomic risks caused by excessive lending growth, while simultaneously acting as conduits for shocks through the funding link to their subsidiaries.

[19] The Liikanen Report (2012) emphasizes excessive risk-taking fuelled by intra-group subsidies as a key factor that undermined the resilience of a number of European banks during the crisis (page 89).

44. The experience in CESEE underscores these drawbacks of the centralized funding model. Providing large-scale funding to a country or region can set off a self-reinforcing cycle of rising domestic demand, quickly improving incomes, lofty asset prices, high profitability of lending, and yet more lending. But as the experience in much of CESEE shows these dynamics can get out of hand leading to a hard landing when the self-reinforcing cycle goes into reverse.

45. As a result, the banking paradigm in CESEE is now shifting from centralized toward more decentralized funding. The main takeaway from the boom-bust experience for banks seems to have been the inferiority of the fully centralized approach of international banking. Parent banks have also seen how host and home-country regulators added constraints on their intra-group liquidity management in crisis times. Thus, the more decentralized approach is now taking hold, with subsidiaries much more self-reliant in terms of funding.[20] To what extent the new approach applies only to new lending, which henceforth needs to be funded through local deposit growth, or to the existing stock of loans, so that loans are allowed to run off unless sufficient domestic financing can be mobilized, is not entirely clear.

46. Home supervisors also seem in favor of the shift toward decentralized banking. The crisis showed that obtaining liquidity through the parent and distributing it throughout the rest of the banking group can expose the parent institution to significant funding risk. It represents a large contingent liability for home countries, especially in the absence of burden-sharing arrangements with host countries. The most visible reaction in this regard has been that of the Austrian authorities, who have decided to start monitoring a variant of the loan-to-deposit ratio (the "loan-to-local-stable-funding ratio") for their large banks' subsidiaries and have asked these banks to develop living wills one year ahead of the EBA-imposed deadline so as to improve resolvability, which is less complicated under decentralized banking.

B. New Global Market and Regulatory Forces on Parent Banks

47. Parent banks' strategy in the region will be circumscribed by tighter constraints on funding at the *group level*. The global financial crisis forced national authorities in many countries to provide liquidity and funding support to their banking systems. BIS (2010) discusses five key developments in the global banking industry in response to the crisis: (i) the intention to increase reliance on retail funding; (ii) the overhaul of internal transfer pricing; (iii) the increased centralization of the monitoring of liquidity risks and funding conditions; (iv) the strengthening of risk management and stress tests; and (v) the centralization of the management of collateral and of contingent liabilities. International banks surveyed in BIS (2010) indicated that the trend toward decentralized funding was likely to be driven by their greater emphasis on retail funding within their existing model, rather than by a generalized adoption of the "pure" decentralized funding model.

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[20] For example Unicredit's Head of CEE & Poland Strategic Planning Mucci says "The new environment has put more focus on domestic funding sources and as part of this shift banks have paid greater attention to rebalancing their loan-to-deposit ratios" (Mucci et al., 2013). Erste Bank's strategy for retail banking in the Eastern part of the EU is to "focus on local currency mortgage and consumer loans funded by local deposits" and to offer "FX loans only where funded by local FX deposits" (2011 Annual Report, page 11).

48. The tighter funding envelope at the group level is bound to weigh on the willingness of European cross-border banks to provide wholesale funding, which will of course affect CESEE significantly. Le Leslé (2012) shows that as of end-June 2012 Western European banks still compared unfavorably to international peers according to various funding metrics. She documents how their operating environment has become tougher in recent years because of the downgrading of some European sovereign's creditworthiness, reduced ability of sovereigns to financially support banks, restricted funding market access, and persistent investor concerns. Long-term investors, such as insurance companies, are also likely to adjust the composition of their portfolios in response to the upcoming Solvency II requirements, which increase the attractiveness of covered bonds but reduce that of term unsecured debt.

49. Funding pressures on parent banks are further compounded by the trend toward increased subordination of senior and unsecured debt and more involvement of debt holders in burden sharing, as discussed in Le Leslé (2012). Subordination becomes more pronounced with rising asset encumbrance (associated with extensive central bank financing, covered bond issuance, and higher haircuts) and the global trend toward depositor preference (over unsecured creditors) in bank resolution. Investors in bank debt are increasingly being asked to share in the burden to resolve or recapitalize troubled banks: (i) once implemented, Basel III will require that regulatory capital instruments are fully written down or converted into equity at the "point of non-viability"; (ii) recent cases of debt restructuring associated with official sector recapitalization have involved subordinated debt; and (iii) Europe's evolving new bank resolution and recovery regime foresees the bail in of bank debt holders. As a result, the cost of unsecured debt funding is likely to remain permanently higher, again negatively affecting cross-border banking groups' incentives to make funding available to CESEE.

50. While the implementation of Basel III's solvency and liquidity ratio is unlikely to affect the CESEE region directly, it may do so through their effect on parent banks.[21] On a solo basis, the capital ratios of CESEE banks tend to be high relative to the new standard and very limited reliance on hybrid capital instruments means that the quality of capital should not be much of an issue. However, some Western European banks still need to reduce leverage (IMF, 2013) and some parent banks are being pressed by their supervisors to further increase their risk-bearing capacity (OeNB, 2012, page 9). Current liquidity ratios of CESEE banks also look comfortable, although it remains to be seen how parent bank deposits and credit lines will be treated under the evolving EU liquidity regulation. The adoption of the net stable funding ratio (currently under review) makes customer domestic deposits more attractive and could affect CESEE banks having a relatively high loan-to-deposit ratio and/or having a parent with a stable funding deficiency. In any event, the Basel III liquidity coverage ratio will be phased in only from 2015 to reach full effectiveness in 2019, and the net stable funding ratio will only be implemented in 2018, which leaves sufficient time for

[21] See Impavido et al. (forthcoming) for a discussion of the indirect impacts of the global regulatory agenda on CESEE banks.

smooth adjustment, although tensions between home and host supervisors cannot be ruled out (Box 3).

C. Banking Union

51. The envisaged establishment of a European banking union will also be an important force shaping the makeup of banking in CESEE—by addressing some of the shortcomings of cross-border banking it will work against the fragmentation of financial markets along national lines.

52. In response to the euro area crisis a European banking union is being established. The pernicious crisis in the euro area that started with sovereign funding problems in Greece in the spring of 2010 revealed flaws in the design of the Economic and Monetary Union (EMU). The adverse feedback loops between problems in public finances and in bank balance sheets that disrupt the monetary transmission mechanism in EMU are now being addressed, including by establishing a banking union in the euro area—first by centralizing supervision in the ECB through the Single Supervisory Mechanism (SSM), and then with a single resolution mechanism with industry funding. National deposit insurance schemes are to be harmonized. It is envisaged that EU-countries outside the euro area can "opt into" the SSM by entering into close cooperation agreements with the ECB.

53. A full banking union—comprising a single supervisory mechanism, single resolution, and common safety nets with effective backstops—would bring positive spillovers to CESEE and enhance the functioning of the EU single market for financial services. Most CESEE countries are outside the euro area. Yet the establishment of a full banking union could have indirect benefits for CESEE to the extent that it helps overcome the euro area crisis, enhances financial stability, and removes financial market fragmentation in the EU as a whole (Goyal et al., 2013). Allowing direct bank recapitalization with resources of the European Stability Mechanism (ESM) would provide an early backstop that could weaken the link between sovereigns and banks. A key risk is that of incomplete or stalled implementation of the Banking Union, which would impede its effectiveness. Other risks in the transition relate to the ability to build adequate capacity at the ECB and establish incentive-compatible relationships between the ECB and national regulators.

54. For EU participants of the SSM, moving supervision of significant banks to the ECB could also provide benefits. It would likely improve supervisory quality and harmonize practices, reduce compliance costs for cross-border banks, limit the scope for regulatory arbitrage, and improve the congruence between the market for financial services and the underlying prudential framework. Long standing problems with the coordination between home and host supervisors would be addressed by centralizing supervision in the ECB, although the operational challenges for the ECB should not be underestimated. The SSM would help remove national bias in supervision. As such it would also help mitigate ring-fencing and reduce regulatory forbearance.

55. However, it is future EU institutional arrangements regarding bank resolution that are likely to exert the most powerful force on the shape of CESEE banking systems. In the absence of an

integrated European resolution authority or ex ante burden sharing arrangements with host countries, home countries could end up carry alone very significant contingent liabilities related to their large international banks' activities abroad. At the same time, host country authorities might worry that home authorities might abandon subsidiaries in the event of a crisis, thereby dumping the cost of financial-sector cleanup on them. Harmonizing recovery and resolution and aligning with international best practices, especially in the case of cross-border institutions, is an essential first step. For members of the banking union, a single resolution authority and common safety nets with backstops in a European banking union would further facilitate least cost resolution and burden sharing. It would shift recovery and resolution costs to the supranational level—the same level where banking supervision is exercised. This would remove the root cause of the lack of cooperation between home and host supervisors that besets international under current arrangements—thereby lessening the case for decentralized banking.

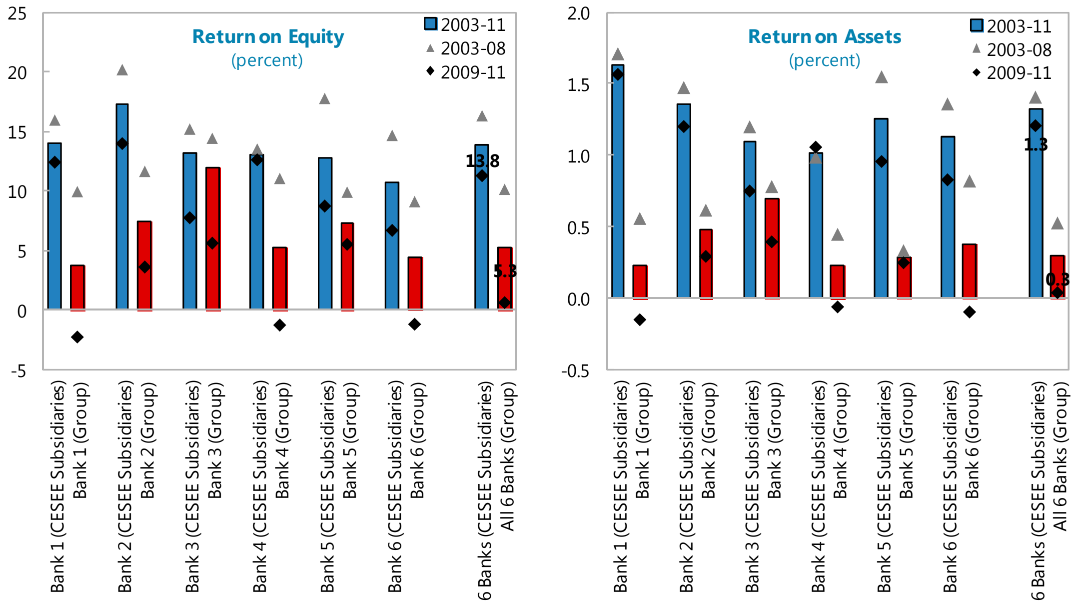
D. Attractiveness of the CESEE Banking Markets

56. To what extent foreign banks will remain committed to the region in the long run will ultimately depend on the profitability of their operations there. Looking back, the boom years were obviously more lucrative than the subsequent crisis period. Moreover, the crisis of 2008/09 has left banks' balance sheets saddled with high non-performing loans (NPLs). Many of the hastily granted loans of the boom years have turned sour, pushing the average NPL ratios in the CESEE region from a pre-crisis low of 3 percent to 12 percent at end-2012. Some countries have seen ratios of over 20 percent and NPLs seem not to have peaked everywhere in CESEE yet. These high NPLs are likely to weigh on credit supply going forward (Vienna Initiative, 2012; Klein, 2013; and IMF, 2013). Moreover, the associated provisioning has adversely affected profits. This has dented the long-term profitability of western banks' engagement in CESEE making them more cautious to deploy capital in the region.

57. Overall, however, profitability of CESEE subsidiaries still augurs well for the long-term engagement of the western banks in the region. For the five largest banking groups active in the region, CESEE subsidiaries were still substantially more profitable than the operations at the group level over the entire period: during 2003–11 returns on equity were 13.8 percent against 5.3 percent and returns on assets came to 1.3 percent compared to 0.3 percent (Figure 19). Although the management consultancy McKinsey points out that such profitability levels of the CESEE subsidiaries are rather mediocre compared to long-term industry standards, it appears to still make good business sense for these cross-border banks to operate in CESEE rather than confining themselves to their other activities. Moreover, the same study points out that there is much room for the foreign banks to make their CESEE operations more profitable. This includes: (i) reshaping their portfolios to reap economies of scale; (ii) building stronger regional hubs in charge of operations and risk management in several countries;[22] (iii) developing a differentiated approach to priority segments,

[22] As discussed in BIS (2010), international banks are likely to combine the adoption of a more decentralized, less wholesale-oriented approach to funding and greater centralization of liquidity risk monitoring and risk management.

Figure 19. Profitability of Western Banks' Operations in CESEE and at a Group Level, 2003-11[1]



Sources: BankScope; and IMF staff estimates.
[1] Largest 6 foreign banks operating in CESEE and their weighted average.

and (iv) innovating to deliver products better tailored to country characteristics (McKinsey & Company, 2011). In any case, the continued process of integration of real economies (through international, trade and FDI) in the context of the EU single market will continue to be a very strong factor for the attractiveness of CESEE markets for many Western European internationally-active banks.

IV. POLICY IMPLICATIONS

58. Widespread foreign ownership has brought clear benefits to CESEE. Foreign banks were key to introducing modern banking practices to the region, improving governance in the sector, and access to credit. Foreign ownership has undoubtedly helped improve domestic financial stability–the sharp reduction in banking crises since the entry of foreign banks is striking—and support overall economic growth and income convergence

59. An important lesson from the global financial crisis, however, is that better management of banks' funding model would help ensure that banking systems continue to support overall economic growth and stability. While foreign ownership does not in itself make banking systems more or less pro-cyclical, foreign ownership can open the door to potentially large cross-border funding flows, depending on the funding strategy of the parent bank and the macro-economic situation in the home and host countries. Too much reliance on foreign funding increases pro-cyclicality, without boosting average GDP growth over the longer term. During good times, inflows of foreign funding fuel and finance credit booms, while during bad times, the repayment of external funding contributes to tight credit conditions.

60. The transition toward more decentralized funding appears appropriate, and should reduce boom-bust risks. However, rapid withdrawal of still large foreign funding could severely crimp credit and economic prospects. It is hard to quantify what exactly would constitute an excessive pace of foreign funding reductions from CESEE, but the level seen in the second half of 2011 was probably as much as the region could tolerate without setting off disorderly dynamics. Also, some scope for intra-group funding should be retained, so that resources can be channeled to the genuinely most productive uses and financial stability is bolstered at the group level.

61. Policy makers can help ensure a smooth evolution of CESEE banks' funding models. Pushing ahead with establishing the envisaged integrated European financial architecture would remove many of the drawbacks of "centralized" banking, thereby diminishing the need for large and rapid changes in CESEE bank's funding structures. Improving home-host cooperation more generally to better manage cross-border banking, include through more coordinated use of macro and microprudential policies, would do so too. Policy makers should also eschew ring-fencing capital or liquidity, outside impending bank failures or situations where domestic financial stability is jeopardized. That, in turn, would limit banks' incentive to move excessively decentralized funding models.

62. The entry of foreign banks from other home countries could also help offset any scaling back of foreign funding available to the established subsidiaries of western European banks. This would also make for a better risk diversification for host countries as shocks in individual home countries would be less important for any host country. However, the overall benefit would depend on the strength of the newly entering banking groups and the quality of cooperation with the new home supervisors.

63. Removing other obstacles to credit growth will facilitate the transition to more balanced foreign funding. Even a well-paced and well-calibrated transition to more "decentralized" banking will involve headwinds from foreign funding reductions on credit growth. Tackling the high non-performing loans that make banks in CESEE reluctant to extend new loans could provide an important offsetting effect on credit growth. A pro-active and cooperative approach to NPL resolution, prioritizing voluntary private sector arrangements, and removal of legal obstacles that currently hinder swift NPL resolution would help. In addition, developing local capital markets could help create a source of stable, long-term domestic funding for banks.[23] Policies can help by providing an enabling environment, such as development of extended yield curves and easing restrictions on investment policies of institutional investors. Euro area accession would provide impetus for institution investors in Western Europe to enter CESEE capital markets.

64. While it may not seem likely at the time, policy makers should also be prepared to deal with renewed capital inflows, as the convergence potential of many CESEE countries is still significant. Macroeconomic and macroprudential policies that strongly lean against the wind during good times

[23] See Impavido, et al. (forthcoming) for a discussion of possible policy options in this area and IMF (2013) for a diagnostic framework for local currency bond markets.

can help prevent the buildup of external imbalances and excessive reliance on capital inflows, and build buffers that can be used during bad times. While potential circumvention of macroprudential measures through cross-border lending remains an issue, the reciprocity agreement on countercyclical capital surcharges embedded in Basel III, the availability of the ESRB as a potential arbitrator, and a strong role for the ECB under the SSM for banking union participants are likely to help in the period ahead. Further gains in macroeconomic policy credibility can also lower domestic currency interest rates and therefore limit the attractiveness of foreign currency funding and lending.

Box 1. The BIS Banking Statistics

The BIS publishes two sets of statistics on international banking activity: the ***locational*** statistics and the ***consolidated*** statistics.

- The locational statistics show the external positions of reporting banks. In essence, they measure cross-border funding. They capture gross outstanding claims of banking offices located in the BIS-reporting countries, including positions between related offices. The locational statistics are compiled using principles that are consistent with balance of payments statistics.

- The consolidated statistics show the worldwide consolidated claims (also known as foreign claims) of banks headquartered in the BIS-reporting countries. In essence, they measure what a bank owns. They include claims of their own foreign affiliates but exclude positions between related offices.

The locational and consolidated statistics differ in their treatment of banks' foreign affiliates. The consolidated statistics include all assets of banks' foreign affiliates, whereas the locational statistics only include the cross-border claims on their foreign affiliates. As an example, suppose that an affiliate bank has only US$100 in loans on the asset side, which is funded by US$80 in local deposits and US$20 in a loan from the parent. The consolidated claims in this case are US$100, while the external position is US$20.

External positions are broken down into external positions on the banking sector and on nonbanks. The external position on the banking sector includes the external position vis-à-vis both affiliated banks, and vis-à-vis non-related banks. Consolidated claims are broken down into international claims and local claims of foreign affiliates in local currency. International claims in turn are split further into cross-border claims, and local claims of foreign affiliates in foreign currency, although the BIS does not publish this breakdown.

		Local subsidiary	
Local currency loans	60	Local currency deposits	60
Foreign currency loans	30	Foreign currency deposit:	10
		Loan from parent bank	20
		Nonrelated bank	
		Loan from foreign bank	5
		Nonrelated nonfinancial sector firm	
		Loan from foreign bank	10

Consolidated claims	**105**
International claims	**45**
Cross border claims	15
Banks	5
Nonbanks	10
Local claims of foreign affiliates in foreign currency	30
Local claims of local affiliates in local currency	**60**
External position	**35**
Vis-à-vis banks	25
Vis-à-vis nonbanks	10

An example may help to understand both sets of statistics. Suppose a BIS-reporting bank headquartered in France has lent US$5 to a nonrelated bank in Germany, US$10 to a nonrelated nonbank firm in Belgium, and owns a subsidiary in Romania that has extended loans of US$60 in local currency and US$30 in foreign currency. The local subsidiary's assets are funded through US$60 in local currency deposits, US$10 in foreign currency deposits and US$20 through a loan from the French parent (table). In this case, consolidated claims will be US$105, and the external position US$35.

At the end of 2012:Q3, consolidated claims of BIS reporting banks vis-à-vis CESEE countries amounted to US$1,574 billion, compared with an external position of US$756 billion (table).

Consolidated Claims and External Position of BIS Countries' Reporting Banks vis-à-vis CESEE, 2012:Q3

(Billions of US dollars)

Consolidated claims (foreign claims)	**1573.5**
International claims	**862.5**
Banks	157.7
Non financial private sector	541.2
Public sector	156.0
Local claims of local affiliates in local currency	**711**
External position	**756**
Vis-à-vis banks	387
Vis-à-vis nonbanks	369

Box 2. The Vienna Initiative and the Vienna 2 Initiative

The Vienna Initiative was formally inaugurated in January 2009 as part of the response to the crisis of 2008/09 in CESEE. In a novel private-public sector platform it brought together the main stakeholders: the key western parent bank groups; home and host-country authorities (financial supervisors, finance ministries, and central banks); and multilateral organizations (IMF, EBRD, the European Commission, the EIB, and the World Bank).

The idea was to secure a superior coordinated outcome rather than risk a rush to the exit by the western banks that would have hurt everybody, including the banks themselves. Western banks had invested some US$1 trillion in CESEE and a sudden withdrawal would have had severe consequences for host country economies, their financial stability, their exchange rates, and the franchise value of western banks' CESEE subsidiaries themselves. On the other hand, if banks stayed put, IFIs provided loans, and home countries supported their banks, the economic fallout from the global financial crisis would be much smaller and the franchise value of banking in CESEE largely preserved.

All stakeholders made critical commitments to bring about this cooperative outcome. Parent banks pledged to maintain their exposure to CESEE and recapitalize their local subsidiaries as needed. This was backed up by public commitment letters from banks' CEOs in the case of five countries with IMF-supported programs (Bosnia-Herzegovina, Hungary, Latvia, Romania, and Serbia), monitoring of agreed quantitative targets by central banks, and follow-up in the context of IMF program review missions as needed. The IMF and the EU provided large-scale financial support in the context of programs. Other international financial institutions made direct financial assistance to banks available under the so-called Joint IFI Initiative. Home-country authorities agreed that any public support for parent banks would not discriminate between the groups' domestic and foreign operations—later reaffirmed by EU leaders in their emergency summit in March 2009. Host-country authorities committed likewise not to discriminate between domestic and foreign banks, in addition to implementing adjustment programs as agreed.

The Vienna Initiative was successful: all parties largely kept their commitments and the feared regional financial meltdown was averted. Broader policy discussions, for which the Vienna Initiative also provided a platform, strengthened collaboration and fostered mutual understanding. With the expiration of the IMF-supported programs, banks' exposure maintenance commitments also lapsed.

In January 2012, the Vienna Initiative was revived as the "Vienna 2 Initiative." The concrete triggers were large funding reductions of western banks in the second half of 2011 and emerging gaps in the supervisory area. Since then the Vienna 2 Initiative monitors closely the evolution of western banks' funding for CESEE and publishes its assessment in "Quarterly Deleveraging Reports," with a view to guarding against any disorderly deleveraging that might emerge. In the supervisory and resolution areas it has flagged concrete issues that should be addressed to reduce overlaps and gaps in the context of cross-border banking with CESEE. It also tries to foster mutual trust and understanding between home and host country authorities by encouraging and assisting in arranging "Host Country Cross Border Forums," which have so far taken place in Albania, Croatia, and Serbia.

Since the launch of the Vienna 2 Initiative, reductions of foreign bank financing for CESEE have declined considerably. The recent push within the EU to harmonize and centralize the treatment of banks holds the promise of overcoming long-standing coordination problems for member states that host subsidiaries of western banks.

Box 3. The Evolving Global Regulatory Agenda and Its Impact on CESEE

Since the 2008/09 global financial and economic crisis, banking regulatory reform has been high on the international agenda. The Basel 2.5 and Basel III packages were issued respectively in 2009 and 2010 to: (i) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; (ii) improve risk management and governance; and (iii) strengthen banks' transparency and disclosure.

The new global regulatory framework for banks will contribute to increased financial stability. As a result, some institutions may become smaller with higher risk activity (investment banking and trading) either being transferred to nonbank institutions, or shrinking in size while remaining within the banking sector. If activities do move out of the banking sector, this will require greater attention to regulation and supervision standards in the nonbank sector to ensure that risks are properly addressed. If risks remain within the banking sector, the effects of increased concentration or entrenchment of too-important-to-fail will need to be considered. There is also potential for a greater concentration in some nontraditional business lines (for example, fixed income, commodities, and currencies) in banks where increased costs can be offset by economies of scale.

The reforms are unlikely to have much *direct* impact on banks in CESEE, as banks in the region are already highly capitalized. Banks in CESEE countries generally maintain capital levels in excess of internationally agreed regulatory minimums because of the higher degree of macroeconomic volatility and overall risk in these jurisdictions and, in some cases, because of higher minimum ratios required by local regulators. However, CESEE countries are likely to be *indirectly* affected by the impact of the reforms on the Western European banks active in CESEE:

- The new capital rules may exacerbate the balance sheet rebalancing of some internationally active banks. The need for internationally active banks to raise new high quality capital or to reduce risk weighted assets may prompt them to reduce exposures to CESEE countries in excess of what would be considered "healthy" deleveraging.

- The cost of finance in the region could increase due to inherent inconsistencies in the treatment of sovereign exposures at the solo and consolidated levels. Host supervisors typically apply low risk-weighting for exposures to the host sovereign. However, under the forthcoming set of EU regulations, higher risk weights on these exposures could result in a higher cost of finance in the host jurisdiction.

- Retrenchment in specialty finance would be particularly harmful to the growth outlook of the region. Some of the sectors most exposed to the retrenchment process are specialty finance lines, particularly infrastructure finance and trade finance. Infrastructure finance is characterized by long maturities, heavy use of syndication, and dependence on long-term dollar funding that make it particularly exposed to deleveraging.

Inherent tensions in the application of the liquidity framework at the consolidated and solo levels may expose subsidiaries to excessive liquidity risk. For example, there is an inherent tension between the home and host supervisors in the definition of liquid assets: the host supervisor may be interested in ring fencing liquidity, even if this may result in inefficient trapped pools of liquidity and higher funding costs, while home supervisors may be interested in ensuring mobility in case of stress.

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