



The European Bank Coordination ("Vienna") Initiative

**Report by the Public-Private Sector Working Group on
Local Currency and Capital Market Development¹**

Approved by the EBCI Full Forum Meeting

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¹ The members of the Working Group included the representatives of several home supervisors/central banks (Austria and Italy); host supervisors/central banks (Hungary, Romania and Serbia), parent banks operating in emerging Europe (EFG, Erste, Intesa, KBC, Piraeus Bank, Raiffeisen International, Societe Generale and Unicredit), as well as the IMF, the European Commission, the World Bank and the EBRD (lead of the Working Group). The ECB attended as an observer.

Executive Summary of the Working Group's Report ²

Preamble

This document summarises the report of the conclusions and recommendations of the Working Group on Local Currency and Capital Market Development that was established in the context of the European Bank Coordination 'Vienna' Initiative. The Executive Summary and its recommendations are, as any EBCI-VI product, voluntary, nonbinding and public. The recommendations are intended to inform market participants, policy makers and the general public about agreed approaches and best practices. They in no way should restrict future policy options, including regulatory decisions.

Introduction

Foreign currency lending is prevalent in Emerging Europe. On the positive side, lending growth, to a large extent in foreign currency and externally financed, has contributed to convergence in CEE over the last decades. However, this also took place in the context of large capital inflows which contributed to overheating, sizable macro imbalances and a proliferation of investment flows especially directed at the nontradables sector. The global financial crisis has highlighted the systemic risks associated with large stocks of foreign currency loans to borrowers without matching foreign currency income (hereafter called "unhedged borrowers"). Concerned about such borrowers' ability to repay foreign currency loans under significantly worsening economic conditions, central banks found themselves dealing with constraints in the setting of policies including exchange rate adjustments. At the same time, local capital markets have been underdeveloped and could not provide adequate sources of local currency funding. Lowering macroeconomic vulnerabilities associated with foreign currency lending to unhedged borrowers will therefore need to be a key element of sustainable post-crisis growth.

To be successful, any attempt to reduce vulnerabilities associated with foreign currency lending to unhedged borrowers requires a country-by-country approach that needs to be coordinated among home and host country authorities of foreign parent banks, as well as both parent and local banks. This coordination complements ongoing efforts in home (e.g. Austria) and host (e.g. Hungary and Serbia) countries and the Local Currency and Local Capital Markets Initiative launched by EBRD at its Annual Meetings in May 2010. The European Bank Coordination "Vienna" Initiative is a ready platform for such coordination.

The Public-Private Sector Working Group on Local Currency Development was set up at the Athens Meeting of the EBCI Full Forum on March 18-19, 2010. At its first meeting in May 2010, the Working Group established a number of subgroups: one to look at general principles to support local currency lending and capital market development; and three country-specific sub-groups, covering Hungary, Romania and Serbia. The country authorities

² The full report is available for the members of the Full Forum.

of each of the three countries organised meetings to identify country-specific measures that could support a move away from foreign currency lending to unhedged borrowers and develop local money and capital markets.

Main Findings

The reasons for foreign currency lending are many and complex, and, similarities notwithstanding, can significantly differ across countries. The following factors have played an important role: lack of credibility of macroeconomic policies, weak institutions, insufficient domestic savings, lower cost of foreign than domestic funding of banking systems, implicit guarantees associated with expectations of euro adoption, not fully effective regulation, and lack of local currency market infrastructure and in particular the lack of long-term local currency funding of banking systems.

The dearth of local currency lending cannot be viewed in isolation from local currency savings as a source of local currency funding. Development of local currency capital markets can in principle provide savings vehicles and the stable sources of funding that are needed to sustain local currency lending.

Policy initiatives to reduce foreign currency lending to unhedged borrowers include regulatory and supervisory measures as well as measures to develop local currency funding markets. Over time, appropriate macroprudential policies and a reduced flow in foreign currency lending can gradually help reduce the stock of foreign currency loans, which remains a concern in some countries. Success will be predicated on building credibility of macroeconomic policies. While there are some cross-cutting themes, many measures will need to be tailored to country-specific circumstances.

Recommendations

1. The causes for foreign exchange lending can differ country-by-country, therefore, the existence of commonalities notwithstanding, approaches to address this issue should also be country specific.
2. Foreign currency lending to unhedged borrowers can become a source of systemic risk. (Foreign currency lending to borrowers with adequate foreign currency income can be appropriate.)
3. Policy efforts to shift towards local currency lending require close coordination among home and host country authorities to prevent regulatory spillovers and circumvention through cross-border lending.
4. There are three interrelated preconditions for successfully shifting toward local currency lending and out of foreign currency lending: strengthening macroeconomic stability and acceptance of the local currency; increasing availability of local currency savings; and developing funding markets in local currency, particularly at longer maturities.
5. In recognition of the competition for market share in the strongly contested financial markets of Eastern Europe, coordinated actions by the competent national authorities, with

due notification to the EBA, may be required to ensure that risky lending practices in foreign currency are curbed throughout the financial system.

6. Any possible actions by the competent national authorities, with due notification to the EBA, should ensure a level playing field across all financial sector entities that lend to unhedged borrowers, for example, banks and non-banks, or foreign-owned and domestically-owned banks, or sources of cross-border loans and domestic loans.

7. Measures should be appropriately considered so as not to introduce distortions on price or volume of lending decisions. Administrative measures such as bans on FX lending may prove counterproductive if alternative market-based approaches to funding instruments in local currency are not available. The result can be a freeze in lending and the market altogether.

8. The Working Group welcomes the practice of discontinuing foreign currency lending to unhedged borrowers in non-euro foreign currencies (especially in Swiss franc and Japanese yen), adopted by banks in a number of countries. Similarly, unsecured foreign exchange lending to unhedged individuals for consumption purposes (i.e. short-term) should be discouraged and limited to those individuals with highest creditworthiness.

9. The competent national authorities should address the higher risk inherent in foreign currency loans to unhedged borrowers compared to local currency loans. For instance, the competent national authorities, in the context of the supervisory review process (Pillar II), may require banks to hold additional capital for exposures arising from foreign currency lending to borrowers without foreign currency income and/or require banks to set more conservative loan-to-value or debt-service-to-income ratios in case of foreign currency lending. This could help the competent national authorities secure an appropriate capitalisation of the concerned banks and/or that creditworthiness standards remain sufficient to ensure loan repayment capacity even in the event of a significant depreciation of the local currency. In this respect, the EBA may develop guidelines or principles that would allow for more consistency of the supervisory approaches across the EU.

10. The competent national authorities should satisfy themselves that banks have adequate liquidity buffers and appropriate access to liquidity (including FX swap markets) to guarantee the stability of their funding for foreign currency loans.

11. To enhance consumer protection, there needs to be mandatory disclosure in an accessible format of the risks of borrowing in foreign exchange (and of risks in other borrowing instruments too), as well as of reference rates.

12. The competent national authorities should take steps to build local currency savings both in the form of long-term deposits and capital market investments. If the fiscal position permits, local currency deposits can be encouraged with carefully crafted tax incentives, as many advanced countries do for long-term or pension savings. In countries with heavily dollarised or euroised financial sectors, local currency savings in general could be encouraged. Local currency capital markets can be developed by:

- (i) Shifting sovereign debt management toward local currency within an appropriate macroeconomic framework, building up a full yield curve and helping develop a secondary market for bonds as a reference for the loan market;

- (ii) Improving the legal-regulatory framework for capital market operations by removing any existing obstacles;
- (iii) Increasing the availability of domestic savings and encouraging lending in local currency through appropriate regulatory policies; and
- (iv) Creating incentives and supporting institution building for the development of new markets:
 - a standardised foreign currency swap market to begin to appropriately price the foreign currency risk inherent in foreign currency loans to borrowers without foreign currency income;
 - a standardised mortgage bond market in local currency to develop longterm funding sources and thus enabling the banking sector to provide long-term loans including at fixed interest rates;
 - a covered bond market against local currency public sector assets and mortgages to develop a benchmark yield curve for local currency instruments.

13. The competent national authorities could consider developing a regional bond market if individual countries are considered too small to develop capital markets. The Asian Bond Market is an example of what can be done. Further integration into the Euronext and OMX market platforms could be considered.

Who should do what?

Many stakeholders are in the process of implementing these recommendations. The below summarises the ongoing agenda and division of labour.

The *authorities* can:

- Ensure macroeconomic stability and a low inflation environment;
- Address the higher risks from foreign currency exposures to borrowers without foreign currency income, e.g. by requiring additional capital in the context of the supervisory review process (Pillar II), to set more conservative loan-to-value or debt-service-to-income ratios, better information provision on the risks of foreign currency lending, and enhanced consumer protection;
- Shift sovereign debt management toward local currency within the context of an appropriate macroeconomic framework, with a view to establish a long-term benchmark yield curve, and amend legislation to facilitate financial market development in local currency.

Banks can:

- Strengthen risk management procedures to take into account the higher credit risk of unhedged borrowers in foreign currency;
- Discontinue the riskiest forms of foreign currency lending to unhedged borrowers (such as Swiss franc, yen and short-term consumer lending);
- Parent banks can review exposure limits of local subsidiaries to other local banks in order to further develop local money (including foreign currency swap) markets and proactively participate in local currency funding markets.

IFIs can, in close coordination with each other, support:

- Governments to pursue macroeconomic and regulatory policies that are conducive to the use of local currency (low and stable inflation, sound macroeconomic policies);
- The development of local capital markets according to their remit and expertise. This includes, for investing IFIs, helping develop local currency longer-term funding instruments and markets, the investor base (pension and insurance funds) and lending in local currency as established above. Lending by asset class could be closely coordinated so as not to undermine ongoing efforts for local currency use;
- Provision of long-term funding in local currency, including at fixed rates to the extent possible;
- Global regulatory reform with a view to develop and implement macroprudential best practices.

Next Steps

The Working Group proposes:

- a conference to be organised in one of the participant countries where the Executive Summary will be presented to the broader public;
- the implementation of the recommendations, to be monitored by the EBCI according to its mandate.