Conference Report - SUERF and MNB Conference

The Future of Banking in CESEE after the Financial Crisis

By Ernest Gnan, SUERF Secretary General

The President of SUERF, **Catherine Lubochinsky**, warmly thanked the Hungarian Central Bank for its hospitality. Governor **András Simor** welcomed the conference participants and expressed his satisfaction with the smooth cooperation with SUERF. In his keynote address, "*Micro to Macro: New Focus in Financial Stability*", the Governor mentioned that countries - especially in CESEE - which grew fast in the run up to the crisis relied heavily on external funding. But they also suffered more in the recession. Foreign exchange lending played an important role in all this. Foreign banks have been very loyal. They maintained their exposure in the CESEE region. The Vienna initiative played a key role in this context.

Which lessons should one draw from the crisis?

1. Strong reliance on external funding makes countries vulnerable. A sound fiscal policy and a low inflation commitment are now required to lower risk premiums. A stronger focus on domestic financial markets and domestic saving is needed. Domestic capital markets need to be developed. This will contribute to stability in the future.

2. Macroprudential supervision needs to be enhanced. Supervision should look at cyclicality, interdependence, and the link with macroeconomic developments. Central banks should play a much more important role in this field: they already have experience with the lender of last resort function, they follow financial markets very closely, and price and financial stability are closely related.

3. There is a need to foster prudent lending at the micro level. Foreign currency lending is curtailed in many countries. But prudent lending practices should go far beyond this. Many countries got into trouble not because of too lax fiscal policies but because of excessive private sector indebtedness. Supervision needs to take a much more active role to prevent this. The Basel proposals currently on the table would penalize interbank funding, which is crucial for many CESEE financial systems. Inter-group funding is stable and should therefore not be penalized.

The Governor's main message was that after the crisis, the focus should be on achieving sustainable convergence with disciplined fiscal policy, higher household savings and an improved macroprudential framework.

Session 1, chaired by **Ernest Gnan**, Secretary General of SUERF, drew a picture of the post-crisis macroeconomic environment for banking in CESEE.

Iryna Ivaschenko, International Monetary Fund, presented a study on "Capital Flows and Financial Fragilities in Emerging Europe" prepared in the context of the May 2010 IMF Regional Economic Outlook. Emerging Europe benefited from much larger capital inflows prior to the crisis than Latin America or Asia but built up fragilities. Subsequently, the region experienced a much deeper recession than other emerging economies. Naturally, this observation conceals large variations within the region. This experience prompts the questions of how to ensure a healthy level of foreign investment into emerging Europe for the future, while preventing excessive capital inflows and improving the stability of an increasingly internationally integrated financial sector. Empirical estimates show that different types

of capital inflows are influenced by different factors. Structural factors and the outlook for potential growth determine FDI inflows. Cross-border loans are primarily influenced by macroeconomic policies. Portfolio debt reacts to fiscal policies and capital controls, and portfolio equity flows are mostly influenced by growth prospects. In CESEE countries, inflows sometimes exceeded the healthy levels required by convergence, e.g. reflecting non-sustainable asset and credit booms. Higher risk-taking by the financial sector amplified the effect of macroeconomic policies on capital inflows. The resulting build up of financial fragilities was often associated with fixed or heavily managed exchange rate regimes. Foreign currency loans were both caused by demand and supply side factors and constitute an important source of financial fragility. Macroprudential policies temporarily slowed inflows into banks and altered the composition of inflows, with capital controls proving partly successful in reducing portfolio debt inflows. Policy recommendations for countries already seeing a resumption of inflows include exchange rate flexibility (where possible), tight fiscal policies (particularly under pegs), use of prudential tools (e.g. capital requirements on foreign borrowing) to curb excessive risk-taking by banks, and temporary capital controls. Countries not yet seeing a resumption of inflows may wish to reorient their growth strategy towards the tradable sector and to improve intersectoral labour mobility, lower skill mismatches and address infrastructure bottlenecks.

Markus Eller, Oesterreichische Nationalbank, investigated the question "What has driven private sector credit developments in CESEE? Long-run relationships and short-run dynamics". The background paper explores demand versus supply factors, the existence of structural changes over time, the speed of adjustment of credit to macroeconomic fundamentals, and sectoral differences. The paper shows a strong positive long-run impact of economic activity and a largely negative impact of inflation on the level of credit. Supply factors explain much of the variation in credit growth but their impact differs across sub-periods. Periods of bank restructuring or crises trigger also adjustment in credit. While before the crisis, country-specific developments were important, the recent crisis had a considerable cross-regional impact. Macroprudential analysis should also analyse bank-related credit supply factors. If credit does not adjust by itself to levels in line with economic fundamentals, regulation might need to step in to make up for the absence of market self-correction.

Reiner Martin, European Central Bank, gave a presentation on "Euro Area enlargement – the ECB convergence report May 2010". Countries with hard pegs experienced much sharper recessions in the crisis than countries with floating exchange rates. Also, before the crisis inflation in countries with a peg soared to much higher levels than in floating exchange rate countries. At the same time, current accounts in hard peg countries experienced much larger deficits before the crisis and a much sharper correction during the crisis than floating exchange-rate countries. General government balances were broadly balanced in hard peggers before the crisis, but turned sharply negative during the crisis. They consistently exhibited sizable deficits already before the crisis in countries with floating exchange rates, with some further deterioration in the crisis. The enlargement process stipulated by the EU Treaty means that in practice the time for a non-ERM II EU country to enter the euro area is three years. The crisis implies that very few countries currently comply with the fiscal deficit and government bond yield criteria, while the debt criterion is satisfied by all CESEE countries. Only three countries currently satisfy the inflation criterion and also only three countries are currently members of the ERM II. Legal convergence has gained increasing attention over recent years. As at 1 January 2011, Estonia will join the euro area as its 17th member. Given the absence of a well-developed market for long-term debt securities denominated in Estonian kroon, a broad-based

analysis of financial markets was conducted to evaluate compliance with the interest rate convergence criterion. The presentation concluded with a number of economic policy recommendations for Estonia relating to fiscal, wage and structural policies as well as measures to prevent credit booms in the future.

The session was concluded by **Debora Revoltella,** UniCredit Group, evaluating "The prospect for the banking market in CESEE after the crisis". While overall, banks in CESEE withstood the crisis well, 2010 may turn out more difficult than 2009, given necessary credit write-offs. Economic convergence will continue but the pre-crisis dependence on external financing needs to give way to stronger reliance on domestic savings. This implies lower growth prospects than before the crisis (albeit still much higher than in Western Europe). This will also dampen growth and profit prospects for banking business in CESEE. Risk premia are coming down but remain above pre-crisis levels. Adjustment in retail banking lags behind the one on corporate business. Profit prospects are in principle good, but adverse scenarios need to be taken into account, with increased long-run volatility of profits in several countries. Capital buffers are high for the banking systems as a whole, but Basel III may still require adjustments. A revival of economic activity in the region given high country risk and the need for tight fiscal policies should focus on three pillars: 1) full use of EU funds (this can contribute 0.8-2.0 percentage points to annual growth rates); 2) improvements in competitiveness to compensate for other long-term challenges such as ageing; 3) appropriate regulatory measures.

The 2010 SUERF Annual Lecture was given by **Manfred Schepers**, Vice President, Finance, EBRD, on "The role of domestic financial markets in an integrated Europe". Financial markets are currently undergoing fundamental change, which is driven by international regulatory reform as well as national initiatives, and the need for fiscal consolidation as well as current account adjustments. Banks need to revamp their business strategies, product mix, funding methods and risk management. Financial integration has brought great benefits to CESEE. Domestic financial systems are in turn an important stepping stone for reaping the full benefit from an integrated EU financial market. Cross-border banking groups have introduced effective banking practices into CESEE countries. The resulting access to finance has allowed growth and catching up. This has now been

challenged by the financial crisis. Financial integration provided a false sense of security and prompted countries and agents to take excessive risks. Reliance on external funding has exacerbated foreign exchange credit expansion prior to the crisis. Unregulated foreign exchange borrowing is a source of risk which needs to be addressed. More balanced and reliable funding practices need to be developed. At the same time, cross-border lending within banking groups was a source of resilience in the crisis. Banks also recapitalised their subsidiaries appropriately.

The development of local capital markets has lagged behind the development of cross-border banking, particularly for corporate financing. Access to euro area markets and the prospect of euro area participation reduced the incentive to develop domestic markets. Lack of domestic saving also contributed. Bond markets in many CESEE countries are dominated by government issues. Other countries have relied on foreign financing in euro. The development of functioning domestic corporate bond and covered bond markets is desirable. Demand will need to be created domestically through competitive terms and conditions and efficient market infrastructure. Otherwise the dominance of bank financing will be self-perpetuating. There are important obstacles to be overcome: For longer maturity bond markets to develop, transparent secondary market pricing as well as swap markets and recognized benchmark rates need to be established. Efficient clearing and settlement infrastructures need to be installed.

It is in the hands of national authorities to establish the necessary conditions for well-functioning domestic capital markets. The prospect for euro participation should not distract from this need. Even eventual euro area participation will not make national bond markets

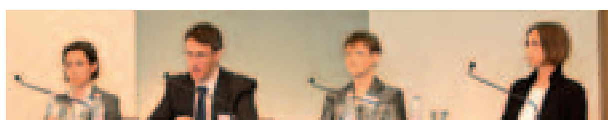
redundant, given existing home bias. Domestic financing is a useful complement for integrated euro area capital markets for smaller companies with a mostly domestic investor base and may turn out more resilient in crisis periods.

Session 2, chaired by **János Müller**, Hungarian Banking Association, was devoted to post-crisis banking models. The chairman started by referrinf to the well-known banker's statement, "When the music plays, we must all dance!" He added that recently the music had sounded more like heavy metal than the Wiener Waltz.

Gergely Tardos, OTP Bank, spoke on "Banking models in CESEE from a domestically-owned bank's perspective". Before the crisis, banks' aggressively expansionary business strategies were characterised by rapid credit deepening, cross-border financing, an emphasis on foreign currency lending, an increasing role of mortgage loans, and substantial maturity mismatches (mortgage versus short-term financing through deposits, parent bank financing, bonds and fx swaps). Several aspects of this strategy were not sustainable, and the crisis triggered a sudden stop or even reversal. The roots of foreign exchange lending lie in fixed or quasi-fixed exchange rate regimes, imprudent fiscal policies raising risk premia on domestic currency loans, and underdeveloped or non-existent local currency covered bond markets. Euroisation can be sustainable in converging economies if the domestic currency experiences sustained real appreciation. However, it reduces the scope for national monetary policy action. Also, real convergence can be suddenly reversed in a crisis or stopped by imprudent fiscal policy. Therefore, if foreign currency lending were to be continued, it would need to be accompanied by prudent fiscal policy and stricter banking regulation (debt to income ratio, loan to value ratio, capital adequacy). The introduction of Basel III (capital adequacy, leverage ratio, liquidity coverage ratio, net stable funding ratio, counter-cyclical provisioning or capital rules) will likely cut back banks' loan generation capacity. As regards growth prospects in CESEE, much of the current account adjustments have been achieved, debt levels are mostly (except for Hungary) still comparatively low, and the overheating of domestic demand has gone. After the crisis, catching up will again result in higher growth (albeit slower than before the crisis) than in Western Europe, and also banking penetration will catch up. But growth patterns will differ across countries, economic structure will be important. Banking markets will also grow more slowly and will be less driven by credit. Cross-border strategies will be negligible, there will be a revival of local currency loans. Mortgages will be important, financed by pension savings.

Jiři Škorvaga, Ceska sporitelna a.s., addressed "Changes in the CESEE Retail Banking Arena". Business before the crisis was characterised by high growth, low cross-selling, low average income per client, a dominance of interest income, low accumulation of wealth, low cost per employee, high variable pay, various types of branch formats and growth. In the changes ahead there will be winners and losers, depending on their differing business models, which may quickly need to be adjusted to changing circumstances. The new environment is characterised by new regulation, new governments, low growth, and more consumer protection. Also customers will change: less wealthy customers were hit more badly, there is less appetite for credit, safer products are preferred as pensions are an important issue, the new, internet-driven customers are less loyal and more sensitive to pricing. Customers will remain to be different, some being profitable, others not. The most profitable customers are either very wealthy or rather poor (the latter due to their need for credit). Competition will rise. Both universal and specialised banks can be successful. International groups with a consequent regional strategy will be better positioned. Customer value has to be weighed against immediate profit. M&As are not the answer, alliances look more promising. A very high degree of customer satisfaction will be crucial to increase customer loyalty. Product policy will be influenced by lower information asymmetries, fees and spreads will be under pressure, deposits and lending will remain crucial for profitability, and substitutes (life insurance, pension schemes and investment funds) are a solution only in the log run. Regarding distribution policy, cross selling requires commitment and client loyalty, with trust having been dented by the crisis. Efficiency (standardisation, centralisation, automation) needs to be traded off against flexibility and agility. Mobile phone payments are an important future product area.

Cornelius Walter, McKinsey & Company Inc., Budapest, presented his ideas on "CEE banking models in the new normal". Due to the crisis the global banking revenue pool lost USD 350 billion (11%), mostly from increasing risk cost. Eastern Europe was hit particularly hard. Despite dark clouds, there is a high-growth scenario conceivable with slower volume growth but a moderation of risk costs. However, also several adverse scenarios are conceivable, stemming from a) too light regulation, b) fragmented markets and tough regulation, c) another severe crisis, with governments no longer being able to save the financial system a second time. The current stars are located in Asia, but Eastern Europe should continue to be an attractive market. For Eastern Europe there are a number of both positive (above-average future growth after the crisis, continued potential for increasing bank penetration, global banks' involvement in CESEE banking systems) and negative (CDS spread volatility and sensitivity, slow down in volume growth, reduced profit margins, high risk charges, capital constraints) risk factors. In the "new normal", the gap between the best and worst performers will be wider. Those who do not adjust quickly enough will vanish. Successful Eastern European players pursued either a leverage or a clear niche strategy in the past, the problematic middle players had a hard time; this trend will strengthen considerably. Key success factors will thus include an aggressive portfolio strategy, conscious risk selection and risk mastering, lean operations, secure funding, systematic preparation for downside scenarios and the ability to react quickly to changing circumstances if necessary, and appropriate regulatory management.



Session 3, chaired by **Péter Tabák**, Hungarian Central Bank, addressed issues in supervision. **Malgorzata Iwanicz-Drozdowska**, Warsaw School of Economics, opened the sessions by presenting her views on "Deposit insurance systems – lessons from the crisis for CESEE banking systems". Deposit insurance systems are a crucial element of financial safety nets but need to be designed properly to avoid moral hazard and problems in crises. The empirical evidence on the possible links between the existence of deposit insurance coverage and bank failures is mixed; some more recent studies suggest a u-shaped relationship: optimal deposit insurance coverage should be less than full. Indeed, this was the case in most EU and non-EU CESEE countries prior to the crisis. Coverage varied widely across EU countries, though. After the Lehman collapse and Icelandic crisis EU governments increased guarantees to mostly EUR 50,000 or 100,000 and cancelled co-insurance by depositors, with some countries introducing blanket state guarantees, i.e. de facto state financing. It is difficult to measure and compare the ex ante strength of deposit insurance schemes, given incomplete data. High concentration in the banking sector raises the required level of deposit insurance. In CESEE countries, branches of foreign banks are according to the EU Directive covered by the home country deposit insurance scheme. As the case of Iceland shows, the home country rule may in practice have its limits, if the home country is not able to honour the resulting liabilities. Deposit insurance is of limited relevance if a bank is in any case too big too fail (provided the home country has a sound fiscal position ensuring the rescuing of the bank in case of problems). The author concluded with a number of suggestions for changes in deposit insurance schemes, such as abolition of blanket guarantees and the re-introduction of co-insurance by depositors, access for host countries to supervisory reports on hosted banks, and the collection and publication of data on eligible and covered deposits in all EU countries.

Zsuzsanna Kardosné Vadászi, Hungarian Financial Supervisory Authority, talked on "New regulatory and supervisory challenges after the financial crisis". Current work on an overhaul of financial system regulation and supervision builds upon the G20 principles and actions from November 2008 and the De Larosière report from February 2009. Steps undertaken or under way relate to deposit insurance, credit rating agencies, Solvency II, an amendment to CRD II and III, a new supervisory architecture, the registration of alternative investment fund managers, amendments to the Prospectus Directive and procedures for improved cross border crisis management. Future steps include a more conceptual change in deposit guarantee schemes, investor compensation schemes, CRD IV, the Market Abuse Directive, MiFID and Derivatives, UCITS depositories, implementation of the measures for Solvency II, rules for crisis management and resolution, corporate governance, and amendments to the Capital Requirements Directive (CRD IV). The European supervisory architecture will be thoroughly reformed, including as new bodies the European Systemic

Risk Council (ESRC), the European System of Financial Supervision (ESFS), comprising the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). There will be new cooperation agreements, while existing competences of national supervisory authorities remain. A number of challenges in regulation remain: the ambitious regulatory reform (over 30 initiatives) requires speedy conclusion by Spring 2011. Impact assessments and a careful assessment of regulatory risks, including risks on growth, need to be prepared. Transitional arrangements need to be devised, the effectiveness will also depend on future financial innovation. Consistency between the EU and international regulatory frameworks can be a challenge, too. While EU rules are binding, many international initiatives are not. There is a risk for the EU of running ahead with no way back. The scope of regulation might differ. A tension between principle-based versus rule-based regulation approaches remains. Challenges in supervision include inter alia tensions between global financial services provision and national supervision, the relation between macro and microprudential supervision, and the convergence of supervisory practices.

Petra Kalfmann, ITCB Consulting, spoke on "Changes in Risk Management Practices after the Crisis – the Hungarian Perspective", based on a questionnaire among practitioners in seven large Hungarian banks covering 60% of total assets. Most banks have a risk strategy approved by the Board, and in the majority of banks the crisis has triggered considerable changes. The role of the risk management organisation has increased. Risk awareness by top management has increased since 2008. An evaluation of operative risk management processes showed that institutions commonly reported tightening of risk management processes across all business areas (retail, SME, large corporate, project finance, work-out). In the retail business, the most important tightening happened in judgement criteria, required coverage and the work-out process. Behavioural scorecards, covering customers' past behaviour, gain in importance. Thus, risk appetite decreased, and the significant tightening is likely not to be temporary. For corporate clients tightening occurred mainly in judgement criteria, work-out process, monitoring process and limit setting. For SMEs the loan origination process as well as monitoring and work-out will be tightened. Top managers receive comprehensive risk reports on the aggregate risk indices, capital intensiveness and portfolio quality on a monthly basis, reflecting considerably increased risk awareness with top management. Currently common risk measurement tools, such as probability of default, are mostly regarded as mature, robust and reliable. The majority of banks use stress tests to evaluate potential impacts of extreme situations on risk levels. Banks are very much aware of reputational risks and put a lot of emphasis in customer relationship management and regular measurement of its quality. Risk aspects were incorporated into incentive systems in all banks. Remaining challenges include IT support for risk management systems and the permanent sustainability of a risk-conscious corporate culture as well as the concept of responsible banking.

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As Manfred Schepers put it: "The shape of the financial industry, its resilience and capacity to allocate and provide capital efficiently, will be crucial for CEE's continued convergence process. So [this] gathering of financial market practitioners, regulators and academic experts under the SUERF umbrella [proved to be] particularly timely." As usual, the presentation and papers given at the conference can be found at SUERF's website and most of the papers will be published shortly in a SUERF Study.

New *SUERF Studies*

2010/2 The Quest for Stability: the Macro View, edited by Morten Balling, Jan Marc Berk and Marc-Olivier Strauss-Kahn, Vienna/Brussels, May 2010, ISBN 978-3-902109-52-1

2010/3 The Quest for Stability: the view of financial institutions, edited by Morten Balling, Jan Marc Berk and Marc-Olivier Strauss-Kahn, Vienna/Brussels, July 2011, ISBN 978-3-902109-53-8