Banking in
Central and Eastern Europe and Turkey
Challenges and Opportunities
Banking in Central and Eastern Europe and Turkey

Challenges and Opportunities

January 2013
Lead authors
Christoph Klingen, Deputy Chief of the Emerging Economies Unit, European Dep., IMF
Fabio Mucci, Head of CEE & Poland Strategic Planning, UniCredit (until October 2012)
İzlem Erdem, Manager of the Economic Research Division, Isbank
Gunter Deuber, Head of CEE Research, Raiffeisen Bank
Stefan Kavan, Financial Stability Analyst, Oesterreichische Nationalbank
Märten Ross, Adviser, Monetary and Research Department, Bank of Finland

Editors*
Atanas Kolev, Economist, European Investment Bank
Sanne Zwart, Economist, European Investment Bank

The articles in this document were discussed at a roundtable event hosted by the EIB’s Economics Department in Luxembourg on January 30th, 2013.

About the Economics Department of the EIB
The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 25 economists and assistants, is headed by Debora Revoltella, Director of Economics.

Disclaimer
The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB.

* Secretarial and editorial support was provided by Samira Benkhedimallah and Anna Schumacher.
PREFACE

The last decade has been quite eventful for the banking sector in emerging Europe. In Central and Eastern Europe, loan growth has been extraordinarily high at the beginning of the century, fuelled by easy access to international funding, in the context of huge opportunities for local market development. This period ended with the outbreak of the global financial crisis. The recent low lending volumes reflect subdued demand, but to a certain extent also increased lending standards of banks. Among the new EU member states, Poland has been an exception as it continued to perform relatively well during the crisis. Turkey has had an altogether very different decade. After its 2000-2001 crisis, the cleaned-up banking system was well-prepared to endure the financial stress and could continue to support the recent impressive growth. These differences highlight the difficulty of generalizing when discussing the banking sector in this region. Nevertheless, many countries face similar issues, such as: local banking systems being largely dependent on funding from Western parent banks which themselves face increased capital needs as well as funding pressures and regulation aimed at increasing financial stability, which might have unwanted side effects on lending activities.

Within the context of the “Vienna Initiative”, the new Joint International Financial Institution Action Plan is a direct response to the continuing impact of Eurozone problems on the economies of emerging Europe. The EIB Group, the World Bank Group and the European Bank for Reconstruction and Development together committed EUR 30bn in the period 2013-2014 to rekindle growth in the region by supporting private and public sector initiatives, including infrastructure, corporate investment and the financial sector. The EIB Group will provide at least EUR 20bn, mainly in the form of long term loans to the private and public sector, addressing priority areas such as SMEs, renewable energy and energy efficiency, innovation and convergence.

This study was prepared for the EIB’s roundtable discussion on Banking in Central and Eastern Europe and Turkey. It was put together by the EIB’s Economics Department to support the Bank’s new initiatives in the regional banking sector and to contribute to a better understanding of the recent market developments in the sector. The study was a collaborative effort with contributions from key regional players, namely IFIs, regulators and some of the leading banks. It provides an informative overview of recent developments and the challenges and opportunities ahead.

Werner Hoyer
President of the European Investment Bank
CONTENTS

Introduction .............................................................................................................................. 5
  ATANAS KOLEV AND SANNE ZWART

Perspectives on Growth Prospects for Central, Eastern and Southeastern Europe ... 13
  CHRISTOPH KLINGEN

Banking Sector Trends in CEE and Turkey ................................................................. 27
  FABIO MUCCI, DMITRY GOVOV AND ANNA KOLESNICHENKO

Developments in the Turkish Banking Sector after the 2000-2001 and 2009 Crises..37
  İZLEM ERDEM

Foreign-owned Banks in CEE/CIS ................................................................................. 47
  GUNTER DEUBER AND GLEB SHPILEVOY

Regulatory Actions and International Banking in CEE/CIS: Topical Evidence .......... 61
  STEFAN KAVAN (ALSO EDITOR OF THE ARTICLE), MARTIN BODENWINKLER, GERNOT EBNER, ELEONORA ENDLICH, MAXIMILIAN FANDL, ULRICH GUNTER, DAVID LIEBEG, MARKUS SCHWAIGER, EVA UBL AND TINA WITTENBERGER

Regulatory Experience in the Baltics ........................................................................... 73
  MÄRTEN ROSS

The EIB in Central and Eastern Europe and Turkey...................................................... 83
Introduction

ATANAS KOLEV AND SANNE ZWART

Following a period of economic transition and restructuring, the last decade was a period of rapid economic growth combined with financial-sector expansion and deepening for the countries in Central and Eastern Europe and Turkey. The exceptional growth performance of many of these countries relied largely on external financing both in the form of direct investment and loans. The substantial benefits to people and economies in the region were accompanied however by a build-up of macroeconomic imbalances – a bloated non-traded sector, high asset prices, a high share of non-performing loans and a significant debt overhang in some sectors. These imbalances came to the fore with the advent of the financial crisis in 2007 and the ensuing deep economic recession. Countries with worse imbalances went through deeper recessions and faced more severe problems in their banking-sectors. The short recovery after the recession in 2009 faltered with the intensification of the sovereign debt crisis in the euro area at the end of 2011. Economic growth in the region can be much higher due to its advantageous location, human capital and institutional setup. In order to exploit these strengths however, many countries will have to reinvent their growth models after the bounty years of cheap and abundant foreign financing have passed. A return to higher economic growth will also benefit banking and financial sectors across the region and that in turn should feedback positively to economic growth.

Central and Eastern Europe (CEE) and Turkey are a unique group of emerging economies – they are close geographically, have a similar institutional setup as rich Western European countries and many are members of the EU. With the exception of Turkey, these countries moved from a centrally-planned to a market economy in the beginning of the 1990s. This transition made obsolete enormous stocks of human capital, while at the same time creating the need for new skills and knowledge. It brought along large-scale industrial restructuring and the introduction of many institutions that did not exist or were dysfunctional in the decades of centrally-planned economy.

The financial systems and corresponding legal frameworks were among the most profoundly changed sectors of the CEE economies. As a result, in the initial years of transition, banking in these countries relied on relatively low expertise and made up a tiny share of economic activity. At the same time, the on-going industrial restructuring and the need to replace the obsolete capital stock created large demand for finance and banking services. This discrepancy between supply and demand, coupled with still weak and inexperienced institutions created tensions that culminated in banking and financial crises during the 1990s in several CEE countries.

1 Economics Department, European Investment Bank. The views expressed in this article are those of the authors and do not necessarily reflect the position of the European Investment Bank.
By the end of the 1990s it was clear that most CEE countries had good prospects of EU membership and would benefit greatly from the accompanying political stability, economic growth and income convergence. Governments in those countries were typically committed to providing a business-friendly economic environment. This bright outlook and the initial hardships in the CEE banking sectors represented a unique business opportunity for big western banks, seeking to expand their activities.

In the ten years to 2008, big western banks took strong positions in CEE countries. Their presence brought to the region the much needed expertise, modern business practices and fresh capital. Western banks helped improve access to credit, introduced very important banking products that were largely absent in these economies until early 2000, like mortgages. They also brought along state-of-the-art risk management practices, good marketing and a customer-oriented service culture. Figure 1 illustrates the overwhelming presence of foreign banks in CEE countries, where they manage between 65 and nearly 100 per cent of bank assets. Turkey is the outlier in this group having only 15 per cent of its bank assets owned by foreign banks.

Figure 1: Share of foreign-bank assets in total bank assets in 2008

![](chart.png)

Source: Claessens and van Horen (2012)

The majority of CEE countries are catching up with the rich Western economies with which they have similar institutional setups. Convergence of CEE countries and Turkey to income levels in Western Europe is associated with substantial investments that in most countries exceed available domestic savings. Figure 2 plots the average difference between gross investment and savings (in per cent of GDP) over the period 1995-2012. According to it, all CEE economies, as well as Turkey, needed foreign financing to cover the gap between their domestic saving and investment rates. This financing came both in the form of FDI and bank loans from western banks to their subsidiaries.

---

2 Based on individual bank data, shares seem not to have changed substantially apart from Turkey (see the chapter on Turkey in this publication).

Expectations for rapid income growth in CEE countries and Turkey in the beginning of the last decade directed more and more cheap foreign financing to less and less productive uses in the region. Domestic demand was propped up, as well as asset prices, especially of real estate. As a result, private debts kept on piling up until 2007 and these economies built substantial imbalances that threatened to throw them in serious trouble should foreign banks decide to withdraw from the region.

Local subsidiaries of western banks contributed to the making of this credit-boom-gone-bust in most of CEE countries.\(^5\) They have fuelled credit growth, which in some countries reached spectacular rates, by borrowing cheap funds from their western owners. Figure 3 illustrates this by plotting the change in the ratio of private credit to GDP between 2000 and 2008.

Growing private sector indebtedness was aggravated in several countries, most notably Hungary, by a high share of loans in foreign currencies (mostly in Swiss francs) to households

---

\(^4\) Data on Serbia (RS) covers only the period between 2010 and 2012.

\(^5\) Some countries, like Czech Republic and Slovakia, managed to avoid this boom-bust cycle altogether.
and small businesses that did not have a natural hedge against movements in exchange rates.

**Bank supervisors in CEE countries have made serious efforts to contain excessive credit growth and especially risky practices like loans that pass foreign-exchange risk to unhedged customers.** By 2005, regulators in several CEE countries, particularly those with fixed exchange rate regimes, put in place macroprudential measures to control the growth of bank lending to the private sector and to stem the extension of loans that bear foreign exchange risk for unhedged borrowers. These measures included higher reserves requirements, higher capital requirements and, in the case of Bulgaria, specific credit ceilings. Success of these interventions was if anything mixed. Western banks began extending direct cross-border loans to prime customers, thereby circumventing subsidiaries and local regulations. Other lending was directed to leasing companies and other non-bank financial institutions undermining prudential policies and leaving domestic banks with poorer quality borrowers. While coordination between home and host supervisors improved relative to the period before 2007, there remained considerable room for further improvements.

**Excessive credit growth largely financed from abroad made CEE economies particularly vulnerable to a sudden stop of these transfers.** Such a stop became quite likely with the advent of the financial crisis at the end of 2007 and the subsequent deep economic recession in 2008-2009. In order to stave off such developments, several international financial institutions (IFIs), including the EIB, have initiated the creation of the European Bank Coordination Initiative (the Vienna Initiative). Set up in January 2009, the Vienna Initiative brought together the public and private sector to ensure a framework for coordinating crisis management and resolution of problems that emerged during that time. The main goal of this initiative was to ensure that foreign banks remain committed to the region and preserve capital and funding for the local banking sector. Key participants, in addition to major IFIs, are home and host country regulatory and fiscal authorities, as well as the large cross-border banking groups with stakes in the region.

**Within the Vienna Initiative, the Joint IFI Action Plan (JAP) is one of several important achievements.** The Vienna Initiative ensured that large cross-border banking groups committed to preserve funding and keep adequate capital in their subsidiaries in Emerging Europe. This commitment was complemented with EC/IMF programs in the countries that were worst-hit by the financial crisis and the ensuing recession. The EIB, the World Bank Group and the EBRD also made a substantial commitment agreeing to provide EUR 24.5bn for the period 2009-2010 for crisis-related support for the financial sector in Emerging Europe. By the end of the planned period the initial commitment was largely exceeded as actual support reached EUR 33bn. Around that time economic prospects of the countries in the region started to improve with the respective positive implications for their domestic banking sectors.

---

6 Bulgaria, Estonia, Latvia, Lithuania, and Bosnia and Herzegovina are the countries in the region with fixed exchange-rate regimes.
The relative calm came to an end again at the end of 2011 as euro area sovereign debt problems escalated and brought the euro area to the brink of a new recession. A fresh wave of tensions on European financial markets prompted banking authorities in some countries that are home to banks with important presence in the CEE countries to force banks to implement new prudential standards in anticipation of Basel III and rebuild their capital base. Consequently, concerns about new financing from western banks to their subsidiaries reappeared. These developments triggered a revival of the European Bank Coordination Initiative that brought Vienna 2.0 into life. The aim of Vienna 2.0 is to revitalise growth in the region and to ensure that the process of withdrawals of funds from subsidiaries of western banks in CEE countries is managed to minimise systemic risk. Within Vienna 2.0, IFIs agreed a new JAP that targets not only banks, but all economic activity with a focus to ease constraints on economic growth.

More importantly, western banks have changed their paradigm of doing business in the region. Due to current and planned regulatory changes, western banks are moving towards a more sustainable business model whereby new lending by subsidiaries is increasingly financed by domestic funds.

A new survey of banks, administered by the EIB, sheds more light on this paradigm shift and on the current situation of banking markets in CEE countries. This bank lending survey aims to cover all cross-border banking groups active in the CEE region, both at the parent-bank level and at the subsidiary level. In its first administration during October 2012, the survey was conducted with 8 cross-border groups and 42 subsidiaries in the region, which corresponds to a coverage of some 40 per cent of the region’s banking assets.

Preliminary analysis reveals that western banks remain committed to the region but they have become more selective in their strategies at the country level in particular with a view to rebalancing toward a more self-sustained local banking model. This seems to imply a larger adjustment for those countries where market and local funding opportunities are relatively weak and reliance on parent-bank funding is currently relatively high at the group level. As tighter regulation enters into force, all of them have engaged, and expect to continue to engage, in various strategic operations to increase capitalization. At the same time, they are deleveraging at the group level.

Banks report that both subdued credit demand and domestic and international supply-side factors are responsible for the current sluggish credit growth. On the demand side, the list of negative factors is long: low consumer confidence, unfavourable housing price prospects, subdued M&A activities and weak fixed investment dynamics. Progress with debt restructuring was reported as the only positive demand-side development over the last six months. As to the international determinants of credit supply, the global market outlook, group funding conditions, group capital constraints and group-level non-performing loans were all quoted as having had a clear negative influence on local credit standards over the

---

past six months. Concerning the local determinants of credit supply, the local market outlook, local regulation, compliance with often high local capital requirements and non-performing loans at the subsidiary level were the key constraining factors over the last six months. Local bank funding on the other hand was increasingly seen as improving, thereby making a contribution toward less tight supply conditions. Indeed, as the shift toward more self-sustained local banking model proceeds, improved access to local funding, be it retail deposits or capital markets, becomes pivotal for restarting credit growth.

Going forward, banks expect a pickup of credit demand, continued tight international supply conditions and somewhat easier domestic supply conditions. On the demand side, expectations are improving and progressively more subsidiaries expect some rebound in demand for credit across different products and maturities over the next six months. Credit supply is expected to continue to be a constraint, but these expectations vary significantly across banks. International factors will continue to contribute to tighter credit standards, whereas domestic funding is expected to contribute positively. Supply-side constraints could thus become selectively more binding, depending on whether improvements in local conditions provide enough room to accommodate the prospective pickup of credit demand.

Summing up, results from this new survey of banks in the CEE region suggest that the current stagnation in the banking sector in the region stems from both demand and supply factors. Furthermore, both domestic and international supply factors constrain credit growth. These supply constraints can stem economic growth if they do not ease in parallel with likely growing demand in the future. Addressing these constraints, both on national and international level, thus becomes an important policy issue.

While geographically close, Turkey’s experience during the 2000s was very different from that of the CEE countries. During November 2000 and again in February 2001 it faced a full-blown systemic banking crisis. The following clean-up of the banking system and the reforms implemented, however, led to a much more sound financial system. For example, FX lending was curtailed, capital positions strengthened and the latest risk-management procedures were implemented. Banks were thus in a good position to support the economic growth. Stimulated further by the liberalization of several parts of the economy, which took place in the context of the EU accession negotiations, the economy continued to expand rapidly until the outbreak of the global financial crisis. While GDP contracted by almost 5 per cent during 2009, the banking system was much less affected due to the previous reforms and limited direct exposure to foreign risky assets. Banks were thus in a good position to stimulate economic activity when demand picked up and the extraordinary growth of the Turkish economy in 2010 and 2011, about 9 per cent in both years, was fuelled by a rapid rise in credit volume. Although lending growth has normalized since, Turkey, and hence its banks, remain dependent on capital inflows as a result of the very low domestic savings rate. To quickly react to the sometimes quickly changing international circumstances, i.e. periods of flight-to-quality alternating with stretches of ample global liquidity, the Turkish Central Bank has introduced a novel monetary policy framework. Its unorthodoxy, however, raises several questions about the ultimate policy aims while it is debated whether benefits outweigh the costs. Nonetheless, thanks to its high growth potential, Turkey is an attractive region for
foreign banks, as can be seen from their growing presence, while at the same time Turkish banks start to look across the borders themselves.

**Outline of the publication**

This publication discusses the challenges and opportunities for the banking sectors in CEE countries and Turkey that arose after the financial crisis in 2007 and the on-going tensions on European sovereign debt markets. Its aim is to take stock of the views of commercial banks, the regulators and IFIs and to provide a starting point for the Roundtable Discussion organized by the EIB on this topic, as well as a useful reference text on banking in the region.

The contribution of Christoph Klingen, Deputy Chief of the Emerging Economies Unit of the European Department of the IMF, to this publication, offers a detailed analysis of the current macroeconomic and financial situation and the legacy from the boom-bust cycle between 2003 and 2007. His analysis concludes that sources of future growth should be very different from the recent past since domestic demand growth driven by foreign credit would neither be possible nor desirable. The countries in the region should build on their current strong links with western production systems and revisit their reform agendas.

The views of the private sector about banking trends, strategy and business outlook in the region are contained in three contributions. Fabio Mucci and his co-authors from UniCredit, present an analysis of credit markets in the region that disentangles supply and demand factors. One of the key findings is that, as of present day, lending activity in most countries of the region is still low and this is most likely attributable to demand factors. In their view, current post-crisis environment has changed banks’ funding strategies focusing them more on domestic funding sources, which may slow down growth of banking assets relative to pre-crisis levels. Nevertheless, the authors believe that the region still presents a good opportunity for business.

Although the banking sector in Turkey sailed unscathed through the global financial crisis, it faces challenges of its own, according to Izlem Erdem, from Economic Research at Isbank. A combination of reforms implemented after the 2000-2001 crisis and political stability obtained after 2002 has shielded Turkish banks from the worst effects of the global financial crisis. Nevertheless, the Turkish banking sector has recently experienced a rapid rise in credit volume that led to large capital inflows. These partly reflect the interest of foreign business in the Turkish economy and particularly the interest of foreign banks, who take an increasingly large share of the banking business.

Gunter Deuber, who is heading CEE research in Raiffeisen Bank International, and his co-author Gleb Shpilevoy argue that business models of western banks operating in Central and Eastern Europe and countries of the Commonwealth of Independent States are robust in general, but may need to be adjusted to the post-crisis environment. Moreover, this adjustment should be customized for each country of operation, rather than relying on general region-wide strategies. Key challenges for these banks are local competitors in some CIS markets, lack of coordination among regulators in the region and unnecessarily strict host-country regulations.
The views of regulators are presented in the contributions by Stefan Kavan and his co-authors from the banking supervision unit of the Austrian Central Bank and by Märten Ross from the Finnish Central Bank. Kavan et al. focus on Central and Southeastern Europe and the Commonwealth of Independent States. They stress the importance of reshaping the banking sector business model so that it has more balanced external positions and a more sustainable credit growth rate. Regulators should pay special attention to phenomena that are typical for countries where subsidiaries of foreign banks hold large shares of the banking market, such as foreign-currency lending to unhedged borrowers. Special attention should be put into fostering more balanced and locally sourced refinancing markets.

Märten Ross, stresses the importance of cross-border coordination of banking supervision in an environment with high capital mobility. Without such coordination host-country supervisors may have very limited ability to effectively implement macroprudential measures. He nevertheless admits that such coordination is difficult to achieve even in a homogenous area such as the one comprising the Baltic and the Nordic countries. For the moment, the best possible outcome of cross-border coordination is extensive information exchange and some contingency planning.
Perspectives on Growth Prospects for Central, Eastern and Southeastern Europe

CHRISTOPH KLINGEN1, 2

Executive Summary

• The countries of Central, Eastern and Southeastern Europe (CESEE) have made great strides in adjusting their economies following the crisis of 2008/2009. Large external imbalances have been corrected, deteriorating public finances have been turned around and respectable growth was achieved in 2010 and 2011. As a result, CESEE has held up well against the challenges posed by the euro area crisis. Nonetheless, the crisis has left unpleasant legacies, including high non-performing loans on banks’ books, deleted fiscal buffers and still too high unemployment.

• CESEE’s short-term outlook is difficult, reflecting an unsupportive external environment, as well as some homemade factors. Even with the euro area crisis abating since last summer, the growth outlook remains dismal for this part of Europe. A general sense of high uncertainty and bank deleveraging dampen global economic prospects. These factors will be a drag on growth in CESEE given its close economic and financial ties with the particularly weak economies of Western Europe. On the home front, sizable numbers of over-indebted households and firms along with limited room to loosen macroeconomic policies compound the problem.

• Longer-term, the sources of growth in CESEE will have to be very different from those of the recent past. There is no going back to the foreign-credit-and-domestic-demand driven growth of the 2003-2008 period. While the growth rates of that period will be difficult to match in future, CESEE has the potential to achieve strong and durable growth. This requires dealing with the crisis legacies, building on CESEE’s many strengths and tackling the unfinished transition agenda. Some countries already have made much headway along many of these dimensions and the rest of the region should take note.

1. The 2008/2009 crisis, adjustment and legacies

Central, Eastern and Southeastern Europe3 has come a long way since the crisis of 2008/2009. The economies of CESEE suffered a larger setback than any other region of the

1 Emerging Economies Unit, European Department, IMF.

The views expressed herein are those of the authors and should not be attributed to the IMF, its Executive Board, or its management.

2 Editorial close: December 2012. Data and projections as per the IMF’s October 2012 World Economic Outlook. For the IMF’s current economic projections the reader is kindly referred to the latest edition of the World Economic Outlook or World Economic Outlook Update available at www.imf.org.

3 CESEE refers to ten EU member states (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia), eight (potential) candidate EU countries (Albania, Bosnia and
world when the global financial crisis put an abrupt end to unsustainable domestic booms. Large-scale international support and strong policy responses at home prevented the worst. After a deep recession in 2009, CESEE returned to respectable growth in 2010 and 2011, albeit with significant differences across individual countries. Overall, the region has held up reasonably well when the euro area crisis unfolded from the spring of 2010. This owes to the progress made in rectifying much of the vulnerabilities that had previously plagued the region. That said, there are still weaknesses in the CESEE’s resilience to shocks and securing durable and strong growth over the medium term remains a challenge.

**CESEE’s recent economic history is a tale of boom and bust.** Between 2003 and 2008 the region enjoyed very fast growth as high expectations from the integration with Western Europe and readily available credit buoyed domestic demand. Much of the rapidly expanding credit was provided by the local subsidiaries of western banking groups, which could easily tap into the abundant global liquidity of the time and funnel funds eastward. Strong domestic demand not only pushed up GDP growth but also gave rise to large current account deficits, rapid debt accumulation, general overheating, sharp asset price appreciation and oversized nontradable sectors. While a few countries, such as the Czech Republic and the Slovak Republic managed to largely avoid excess, and Russia’s boom was primarily driven by soaring prices for its energy exports, CESEE generally followed more and more an unsustainable growth path dependent on continued foreign financing intermediated by cross-border banking groups. This vulnerability came to haunt the region when global liquidity dried up in the global financial crisis and fresh financing for the region was no longer forthcoming. Domestic demand collapsed as credit booms ended and confidence sagged. The simultaneous freezing of global trade combined to a near perfect storm for the region. A deep recession became unavoidable and complete financial meltdown a real possibility.

**The bust did not turn into financial meltdown though.** At the peak of the global financial crisis in late 2008 and early 2009, there were significant concerns that capital flight and loss of confidence would destabilize CESEE’s financial systems and exchange rates. Banking systems relied heavily on foreign funding and depositors were nervous. Many countries had fixed exchange rates and limited international reserves. Large-scale depreciation would have been problematic even in countries with floating exchange rate regimes as it would have likely rendered widespread foreign currency loans nonperforming. In the event, financial meltdown was avoided as countries moved quickly to stabilize their financial sectors, the international community provided large-scale financial support in the context of IMF-supported arrangements and western banks remained committed to the region, including through the coordination efforts under the “Vienna Initiative.” Only Latvia and Ukraine suffered systemic banking crises, which were related to troubles in domestically-owned banks. None of the fixed exchange rate regimes collapsed—although Belarus, Russia, and Ukraine chose to devalue and make their systems more flexible—and much of the initially large depreciations of flexible exchange rates soon reversed.

Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, Serbia and Turkey) and four CIS states (Belarus, Moldova, Russia and Ukraine).
After a difficult 2009, CESEE’s growth returned to around 4½ per cent in 2010 and 2011. In a difficult global environment and as the excesses of the boom period unwound, CESEE went through a deep recession in 2009 with real GDP contracting by 5.9 per cent. As global and country-level stabilization measures started to take hold, most countries recorded growth in 2010 again for a regional average of 4.4 per cent. In 2011, all economies except for Croatia had returned to growth again and CESEE expanded by 4.7 per cent. Individual country experiences were of course far from uniform: Poland for example managed to contain the pre-crisis boom and deployed countercyclical policies in the downturn so that a recession was avoided in 2009 and solid growth resumed early; the Baltic counties on the other hand had among the largest pre-crisis excesses and adjusted forcefully early on when the crisis hit, leading to an extremely deep recession in 2009 but a strong rebound thereafter; and the countries in Southeastern Europe generally suffered recessions close to the regional average but are struggling to return to stronger growth thereafter.

Where does the boom-bust cycle leave CESEE and what are the legacies? The region has made great strides in reducing key vulnerabilities that came to haunt it in 2008/2009, but others persist and some new ones have emerged. Output suffered a large setback in the crisis, from which several countries still need to fully recover.

- A key achievement has been the swift correction of the large current account deficits in almost all countries. Domestic overheating and excessive credit growth are likewise generally no longer an issue. Pre-crisis current account deficits of 15-30 per cent of GDP in the Baltic countries and Bulgaria have given way to broadly balanced external accounts. In Turkey, very strong growth in 2010 and 2011 deteriorated the current account substantially, but an orderly correction is already underway. Current account deficits remain elevated in a number of Balkan countries, despite substantial improvement from pre-crisis peaks. Overall this means that the region is no longer dependent on large continuous inflows of external financing.

Figure 1: Current account deficits in per cent of GDP

Source: IMF WEO (October 2012)

---

4 CESEE* refers to CESEE excluding Russia and Turkey.
• However, a sizeable portion of the outstanding stock of private sector credit in CESEE is still funded by foreign banks, as local subsidiaries continue to rely on substantial parent bank funding and CESEE’s nonfinancial sector has significant cross-border loans outstanding to western banks. Funding from foreign banks currently corresponds to 24 per cent of CESEE’s private credit and cross-border loans, or 17 per cent of CESEE’s GDP, compared to 34 and 24 per cent, respectively, in mid-2008. For individual countries these ratios can be much higher. Hence, CESEE remains exposed to an abrupt reduction of foreign bank funding.

Figure 2: External positions of BIS reporting banks vis-à-vis all sectors in per cent of GDP (left) and external loans of BIS reporting banks vis-à-vis all sectors in per cent of private credit and external loans vis-à-vis non-banks (right)

Source: Bank for International Settlements

• Another vulnerability that persists is the high prevalence of foreign currency lending. In half the countries of the region the share of foreign-currency lending exceeds 50 per cent. This reflects the need of banks to close their open currency positions by matching foreign-currency denominated parent-bank funding, as well as a still eurorized local deposit base in some countries in Southeastern Europe, with foreign-currency lending. It also reflects customers’ desire to benefit from the lower interest rates of foreign-currency loans. In Hungary for example, foreign currency lending even exceeds banks’ funding in foreign currency, prompting them to close their long foreign-currency position in the swap market. The share of foreign currency lending has not come down from pre-crisis times—more often it rose due to valuation effects. Any large-scale depreciation of CESEE’s currencies would still significantly increase the debt burden of households and firms, thereby crimping demand and straining the financial sector through a likely increase of nonperforming loans.
Public finances in many countries need further repair. The boom had flattered headline fiscal deficits and underlying weaknesses came to the fore when it ended. In addition, some countries engaged in fiscal stimulus to soften the downturn in the crisis years. As a result, public debt is now much higher than before the crisis and deficits remain elevated in several countries, despite often large fiscal consolidation efforts. Debt is projected to exceed 50 per cent of GDP in Albania, Croatia, Montenegro, Poland, Serbia, Slovenia and Hungary in 2012 and deficits are set to exceed 3 per cent of GDP in the Albanian, Croatia, the Czech Republic, Lithuania, Montenegro, Poland, Serbia, the Slovak Republic, Slovenia and Ukraine. Gross financing needs are correspondingly high in several countries—a vulnerability if there is a renewed sharp increase of global risk aversion.

A new vulnerability is sharply higher non-performing loan ratios on banks’ books. Those had been low during the boom years but when the crisis unfolded many of the hastily extended loans turned sour. Non-performing loan ratios climbed into the 20-per-cent range in several countries and have yet to peak in a number of countries. While generally adequate provisioning and relatively high bank capitalization provide considerable buffers, they are an impediment to economic recovery and a

---

5 Includes foreign-currency indexed loans.
considerable strain on the financial sector, especially if growth remains weak or economies slip back into recession.

Figure 5: Non-performing loans in per cent of total loans

Source: Country authorities, IMF country desks and IMF Statistics Department

- The boom-bust cycle and the subsequent recovery have left GDP lower and unemployment higher than pre-crisis levels in several countries. The crisis setback was particularly large for domestic demand, as support from brisk credit growth evaporated, while exports have more than fully recovered. However, pre-crisis peaks are likely to be inappropriate benchmarks, especially in countries where the boom-bust cycle was most pronounced. Compared to, say, 2005 output has still grown at an annual average rate of 3½ per cent and unemployment is now slightly lower for the region as a whole.

Figure 6: Unemployment rate (left) and real GDP (right; index: 2005=100)

Source: IMF WEO (October 2012)

2. The impact of the euro area crisis on CESEE

CESEE held up well in the face of the euro area crisis until mid-2011. When the euro area crisis unfolded from the spring of 2010, CESEE seemed surprisingly sheltered from the turmoil. As several countries in Western Europe had to fall back on financial support from the EU and the IMF and others came under considerable market pressure, financial markets’

---

Data are not fully comparable across countries due to differences in national classification practices. Latest observation in 2012 is between June and October 2012, depending on the country.
performance in CESEE was relatively favourable. Between early 2010 and mid-2011 CDS spreads for sovereigns in the euro area periphery rose continuously, but those for CESEE sovereigns remained firmly on a downward trend. CESEE’s exports performed well despite the euro area being their main destination. And credit growth, while low or even negative in a number of countries, started to pick up moderately, as foreign banks increased the funding provided to the region somewhat between mid-2010 and mid-2011.

**Figure 7: 5-year average sovereign CDS spreads in basis points**

![Graph showing 5-year average sovereign CDS spreads in basis points](source: Datastream and IMF staff calculations)

**However, CESEE caught a whiff on contagion in the second half of 2011.** Western banks came under intense pressure as the euro area crisis deepened and regulators called for higher capitalization under Basel III and in the wake of stress tests by the European Banking Authority. Concerns that this could set off a renewed crisis in CESEE came to the fore again. CDS spreads re-coupled and rose steeply in Western Europe and CESEE. Confidence took a hit. Exchange rates and reserve positions came under pressure and several sovereigns were shut out of international funding markets. Western banks resumed withdrawing funding from CESEE. For CESEE excluding Russia and Turkey as a whole, banks used funding gains from the growth of domestic deposits in their entirety to repay foreign banks. Credit growth in the region essentially ground to a halt.
Financial markets calmed from end-2011 onward, but negative spillovers from the euro area recession are being felt in CESEE. From late-2011 a number of policy steps calmed markets. This most notably includes the ECB’s three-year Long-term Refinancing Operations, the ECB’s announcement of potentially unlimited purchases of sovereign bonds under Outright Monetary Transactions, recapitalization of Spanish banks with EFSF funds, and the establishment of the European Stability Mechanism. Further supported by a new round of quantitative easing in the United States, CDS spreads declined to the levels of early 2011 and sovereigns regained market access. With this, risks of a spillover of the crisis to CESEE have receded. However, funding withdrawals of western banks from CESEE continued, albeit at a more moderate pace. With the euro area falling into recession in the second quarter of 2012, CESEE exports decelerated. This has begun to take a toll on CESEE growth.

3. Short-term outlook

The global economic outlook is soft. While the global economic recovery continues, it suffered a setback in 2012 and is expected to pick up only moderately in 2013. Still weak financial systems, fiscal consolidation in the advanced economies, which seemed to have affected growth more than expected, and policy tightening in emerging Asia and Latin America are one important set of reasons. The other is a general feeling of uncertainty, spawned in particular by the difficulties in resolving the euro area crisis and concerns about the course of fiscal policy in the United States. The IMF’s October 2012 edition of the World Economic Outlook (WEO) sees global growth declining from 3.8 per cent in 2011 to 3.3 per cent in 2012 before picking up to 3.6 per cent in 2013. The modest reacceleration of activity reflects the assumption that policy actions in the euro area and the United States will reduce uncertainty, as well as continued monetary accommodation and gradually easier financial conditions. Developments since the publication of the October 2012 WEO suggest that the global recovery might well gather steam later than anticipated, which would imply lower-than-projected growth in 2013.

---

7 Exchange rate adjusted. The formal exit of Parex and Krijbanka from the Latvian banking system gave rise to a negative statistical effect to credit and deposit growth of about 5 and 1 per cent of GDP, respectively.
Growth is set to slow to a subdued pace in CESEE. The October 2012 WEO projects growth to decline from 4.7 per cent in 2011 to 2.6 and 3.0 per cent in 2012 and 2013, respectively. The slowdown generally applies to both domestic demand and exports, although Russia’s commodity exports should remain relatively strong and trade diversification into the Middle East and North Africa, along with special factors, should continue to support Turkey’s exports.

Strong economic and financial linkages with the weak economies of Western Europe explain a good part of the low growth in CESEE. The euro area is set to go through a mild recession in 2012 and performance in 2013 is unlikely to be much better. With almost half of Emerging Europe’s exports destined for advanced Europe and foreign banks, most of them headquartered in Western Europe, accounting for around two thirds of CESEE’s banking system, CESEE is subject to powerful spillovers from advanced Europe.

- Western banks have resumed withdrawing funding from CESEE. This lowers credit growth and domestic demand in the region, everything else equal, although credit demand is also weak in many countries. Two important factors drive funding withdrawals: pressures on the cross-border banks at the group level and the strategic objective to rebalance the funding of subsidiaries toward local sources. While pressures on the cross-border banking groups have eased in 2012, the rebalancing of subsidiaries’ funding sources is likely to continue to be a drag on credit growth going forward.

- The weak economy in advanced Europe makes for low export demand for CESEE’s goods and services. Its export markets are projected to grow by a modest 3 and 4 per cent in 2012 and 2013, compared to expansions of 11 and 7 per cent in 2010 and 2011. Weak export growth is bound to dampen GDP growth, especially in the more open economies and those that are tightly integrated into the pan-European supply chain.

Several home-made factors also weigh on growth. Macroeconomic policies have been tight. On the fiscal front, many countries stepped up fiscal consolidation beginning in 2011 as they moved ahead with the necessary repair of public finances from the aftermath of the crisis. The picture of monetary policy is more mixed, but monetary tightening is still working its way through the three largest economies. Poland, Russia, and Turkey have been mostly in tightening mode over the last 18-months, more recent loosening steps notwithstanding.

Beyond the macroeconomic policy setting, structural factors will also weigh on the growth outlook. The indebtedness of households and firms rose sharply during the boom period. While economy-wide debt levels are hardly alarming by international standards, the high incidence of non-performing loans nonetheless suggests that quite a number of individual households and firms have taken on more debt than they can shoulder. As they repair their balance sheets—and banks remain reluctant to lend in the face of the poor quality of their existing loan portfolio—domestic demand is bound to remain subdued. Current debt levels and the clouded outlook are key factors that keep credit growth down.
Interregional growth differentials in 2012 and 2013 are likely to mirror the familiar pattern of the recent past. Several of the 22 countries that make up CESEE are estimated to have been in recession in 2012 and in all likelihood not all of them will have climbed out of it in 2013. The Baltic economies still have a lot of momentum and are expected to grow above average in 2012-2013. Russia will likely also do relatively well on the back of still favourable commodity prices. Southeastern Europe is once again likely to have the lowest growth prints, reflecting their still unfinished transition agenda and relatively strong linkages with the weaker economies of Greece and Italy.

It is uncertain when exactly the recovery will reaccelerate. The WEO projections are predicated on the external environment for CESEE improving in 2013. Global financial sentiment has indeed improved and emerging market economies now face favourable financing conditions on capital markets. Internal drags on growth should also dissipate over time. However, it is less certain when these forces will lead to a pickup of growth and how deep it is going to trough before that. Incoming data and partially updated projections since the October 2012 WEO suggest that growth could be somewhat weaker than expected in 2012-2013. For now the pace of economic activity in most countries is still on a downward trend, with quarterly year-on-year GDP growth in the third quarter mostly lower than in the second and the first.

4. Longer-term challenges

CESEE’s future sources of growth will be very different from those of the recent past. It is neither likely nor desirable that strong foreign-credit-and-domestic-demand-driven growth will make a comeback in the region anytime soon. Cross-border banking flows are in retreat, or at least not in any sort of stronger expansion mode, for the foreseeable future. Moreover, this kind of growth had big drawbacks for CESEE. It proved ultimately unsustainable, involved extremely large output volatility, led to an excessive allocation of resources to the nontradable sector, and left private and public balance sheets stretched. CESEE’s future growth paradigm will and should be different. It needs to seek balance between the development of the tradable and nontradable sectors. It needs to strive for robust growth—

---

8 Third quarter data not yet available for Belarus and Albania.
certainly strong, though likely lower than the 6¾ per cent achieved in the boom period of 2003-2008—and above all durable.

**Policies for a successful new growth paradigm fall into three broad categories:** addressing the legacies of the boom-bust cycle, building on CESEE’s strengths and tackling old challenges obscured by the boom but now coming to the fore again.

**Key crisis legacies include:**

- ** Dependence on foreign funding of outstanding credit.** Plans of foreign banks to rebalance the funding of their CESEE subsidiaries toward domestic sources could entail a significant drag on credit growth in countries where reliance on parent bank funding is currently high. A two-pronged approach would help CESEE countries address this challenge: minimizing funding withdrawals, or at least spreading them out over time, by fostering home-host supervisory cooperation and creating conditions in host countries that make a good business case for foreign banks to remain highly engaged, and reducing the economic fallout from any remaining funding withdrawals. The latter could involve steps to better develop local capital markets as an alternative funding source for local banks and the non-financial sector alike.

- **High non-performing loans.** If unaddressed, the poor quality of banks’ loan portfolios in many CESEE countries could likewise become a drag on credit growth, inhibit economic activity of over-indebted firms and households, and trap resources in unproductive uses. This risk makes speedy non-performing loan resolution a policy priority. Numerous tax and regulatory obstacles currently stand in the way. Legal and judicial reform would be equally important, along with a concerted effort to go ahead with loan restructuring rather than holding out for an elusive recovery of loan quality and collateral values in the distant future.

- **Bloated nontradable sectors and idle resources.** The boom period had lured too many resources into the nontradable sector in most CESEE countries. They are now either stuck there or, more likely, have been idled when the boom turned to bust. The challenge is now to redeploy them to the tradable sector. Several countries in CESEE have been quite successful in growing the export-to-GDP ratio since the 2008/2009 crisis—not only because world trade has recovered but because they managed to expand their exports faster than their export markets grew. Countries that still have sizable current account deficits but have so far not made much progress in improving the share of exports in their economies should take note.
Deteriorated public finances. Where fiscal deficits and public debt are still high in the wake of the boom-bust cycle it remains important to persevere with the repair of public finances. Otherwise countries risk higher funding costs or even a disruptive loss of market access for the sovereign, banks and the larger economy, especially if global financial sentiment takes a renewed turn for the worse. Most countries have made substantial progress in bringing down their deficits since the crisis—the Baltic authorities were particularly determined. In contrast, in Serbia and Croatia deficits are currently large and exceed those recorded in 2009.

In securing robust growth for the future, CESEE can build on its many strengths. One important asset is the economic integration with Western Europe, which is closest for the current EU members and has been a key driver of income convergence in the past. In particular, integration into the cross-border supply chain with Germany brought many benefits, including an indirect link to markets around the world via CESEE inputs imbedded in German exports. While diversification of economic linkages with other regions of the world is certainly beneficial, further integration with Western Europe would continue to pay growth dividends, even if its economies are currently weakened. Many countries in CESEE have several of the attributes that are usually found to foster growth, such as low income taxes and flexibility. These deserve to be preserved and emulated by those countries of the region that are currently lagging. For example, labour markets in some CESEE countries are much more flexible than those in Western Europe: unlike in many Western European countries, the rise in unemployment in the Baltic countries triggered strong wage adjustment, especially in hard hit sectors, thereby helping improve competitiveness, shift resources to more promising sectors, and ultimately put unemployment on a downward path again.

That said, the end of the boom-bust cycle also casts a spotlight on the incomplete transition agenda in many parts of CESEE. As the dust settles on the boom-bust cycle, it

---

9 Contributions from exports competitiveness gains are due to export growth over and above trading partner import growth. Contributions from other factors are the residual and comprise terms-of-trade effects, cross effects, etc.
becomes clear that many old problems that the boom years had obscured are still present. For example, the strengthening of institutions and privatization have further to go, there still are infrastructure bottlenecks, and labour participation rates remain low in many countries. With the growth conditions of 2003-2008 not returning, all these deep-seated issues need to be tackled to secure a robust and steady increase of living standards in the region.

**Figure 11: Labour force participation rates (left) and Transition Indicators (right) in 2010**

![Image of Figure 11](image)

*Source: World Bank World Development Indicators and EBRD Transition Indicators*

### Selected References


---

10 **EA** = euro area. **MIC** = middle income countries. Transition indicators are on a scale from 1 to 4.3. 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialized market economy; simple average of sectoral scores.
Banking Sector Trends in CEE and Turkey

FABIO MUCCI, DMITRY GOUROV AND ANNA KOLESNICHENKO

Executive Summary

• Before the crisis, banking business in CEE and Turkey was based on rapid lending growth, to a large extent externally financed. In late 2008, the crisis hit hard the region and in 2012 a full recovery in lending activity is still lagging behind in most of SEE countries and the Baltics, while it regained quickly ground in fast recovering economies (such as Turkey and Poland). Overall, retail lending proved to be more stable showing positive growth even in 2009. The corporate segment instead, contracted initially, but then showed a strong rebound in 2010 and 2011.

• According to our estimates, in most of the CEE countries probabilities of creditless recoveries higher than the sample average are largely attributable to demand side factors. At the same time, contributions on the supply side, although remaining quite low in most of the cases, become crucial in countries that have been hit by large banking shocks or experienced a significant deleveraging process.

• The new environment has put more focus on domestic funding sources and as part of this shift banks have paid greater attention on rebalancing their loan-to-deposits ratio. The unbalanced funding position of several CEE countries coupled with the generalized tightening of liquidity conditions, however, contributed to the rising fears that capital needs and funding pressures faced by Western European banks may heighten pressure to deleverage in the CEE region. Differentiation across the region and uncertainty in terms of bank flows continue to persist and improvements in weaker economies should materialize only gradually as the euro area recovers.

1. Funding and liquidity support remains crucial

CEE and Turkey (“the region”) did not emerge from the crisis unscathed with full recovery in lending activity still lagging behind in some countries. Before the crisis, the regional banking business was based on rapid lending growth, to a large extent externally financed. Leveraging on abundant international liquidity and low cost of country risk, local banks were able to support growth by financing domestic lending via international capital inflows, in the context of low domestic saving rates. Both retail and FX lending boomed, supported by an

1 Fabio Mucci: CEE & Poland Strategic Planning, UniCredit (until October 2012); Dmitry Gourov and Anna Kolesnichenko: CEE Strategic Analysis, Bank Austria.
The views expressed in this article are those of the authors and do not necessarily reflect those of UniCredit Group.

2 The article covers the period up to the third quarter of 2012.

3 In this article, CEE refers to the Baltics, Central Europe (CE) and Southeastern Europe (SEE), where CE comprises Czech Republic, Hungary, Poland, Slovakia and Slovenia and SEE comprises Bosnia and Herzegovina, Bulgaria, Croatia, Romania and Serbia.
artificially low cost of risk. In late 2008, the crisis hit hard the CEE economies and Turkey and the region’s banking sector was severely affected. The economic crisis first took the form of a liquidity crunch, followed by rapidly multiplying credit quality problems, accompanied by a credit crunch that was both demand and supply driven.

The recovery has been credit-less in the most problematic countries in the aftermath of the crisis, while lending activity regained quickly ground in fast recovering economies such as Turkey and Poland. Weak demand was at the forefront of credit crunch in a number of countries with banks generally being characterized by an excess of liquidity. Retail lending proved to be more stable during the crisis, showing positive growth even in 2009. The corporate segment contracted initially, but then showed a strong rebound, growing by 12 per cent (at constant FX rates) in 2010.

### Table 1: Banking in CEE - Key indicators by country

<table>
<thead>
<tr>
<th></th>
<th>Loans (%) of GDP</th>
<th>Deposits (%) of GDP</th>
<th>Loans / Deposits (%)</th>
<th>Top 5 banks (%) of total assets</th>
<th>Mortgage (%) of GDP</th>
<th>FX loans (%) of total loans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2007</strong></td>
<td><strong>2012</strong></td>
<td><strong>2007</strong></td>
<td><strong>2012</strong></td>
<td><strong>2011</strong></td>
<td><strong>2011</strong></td>
<td><strong>2011</strong></td>
</tr>
<tr>
<td><strong>Baltics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>94</td>
<td>81</td>
<td>48</td>
<td>57</td>
<td>196</td>
<td>142</td>
</tr>
<tr>
<td>Latvia</td>
<td>88</td>
<td>76</td>
<td>37</td>
<td>44</td>
<td>239</td>
<td>174</td>
</tr>
<tr>
<td>Lithuania</td>
<td>61</td>
<td>57</td>
<td>38</td>
<td>43</td>
<td>162</td>
<td>132</td>
</tr>
<tr>
<td><strong>CE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>46</td>
<td>57</td>
<td>65</td>
<td>81</td>
<td>71</td>
<td>70</td>
</tr>
<tr>
<td>Hungary</td>
<td>62</td>
<td>57</td>
<td>47</td>
<td>48</td>
<td>132</td>
<td>118</td>
</tr>
<tr>
<td>Poland</td>
<td>40</td>
<td>56</td>
<td>42</td>
<td>53</td>
<td>95</td>
<td>105</td>
</tr>
<tr>
<td>Slovakia</td>
<td>45</td>
<td>50</td>
<td>57</td>
<td>55</td>
<td>78</td>
<td>90</td>
</tr>
<tr>
<td>Slovenia</td>
<td>77</td>
<td>90</td>
<td>58</td>
<td>63</td>
<td>134</td>
<td>142</td>
</tr>
<tr>
<td><strong>SEE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>55</td>
<td>62</td>
<td>55</td>
<td>51</td>
<td>99</td>
<td>121</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>62</td>
<td>71</td>
<td>61</td>
<td>69</td>
<td>101</td>
<td>102</td>
</tr>
<tr>
<td>Croatia</td>
<td>68</td>
<td>84</td>
<td>61</td>
<td>66</td>
<td>112</td>
<td>127</td>
</tr>
<tr>
<td>Romania</td>
<td>36</td>
<td>40</td>
<td>33</td>
<td>33</td>
<td>111</td>
<td>121</td>
</tr>
<tr>
<td>Serbia</td>
<td>37</td>
<td>69</td>
<td>37</td>
<td>45</td>
<td>100</td>
<td>157</td>
</tr>
<tr>
<td><strong>Turkey</strong></td>
<td>32</td>
<td>51</td>
<td>40</td>
<td>49</td>
<td>80</td>
<td>104</td>
</tr>
</tbody>
</table>

**Source:** UniCredit CEE Strategic Analysis based on national Central Banks

During 2011, lending activity continued expanding in the CEE region, but with growth gradually dissipating in the second half of the year on the back of continuing turmoil in the financial markets and a rapidly deteriorating funding environment. Growth was spurred by the corporate segment which profited from the cyclical recovery in the economy posted in 2010 and the beginning of 2011, while retail lending turned more subdued, despite the observed improvement in household financial conditions and stronger consumer confidence. Within retail, the dynamic of loans for house purchase was however more stable as it was

---

4 Figures for 2012 refer to end of September.
supported by longer maturities, on-going renegotiation activities and a lower level of saturation compared to the more developed segment of consumer financing.

The weakening growth momentum over the first nine months of 2012 contributed to further delay a full recovery in lending activity. Overall, CEE and Turkey remained a region of two halves, with major cross-country differences related to lending-markets developments still persisting. Turkey has outperformed substantially the rest of the region in the first nine months with lending growth standing at 12 per cent year-to-date. In the majority of Balkan countries, recovery in lending (particularly in retail) was delayed by high unemployment and the impact of inflation on households’ real disposable income. The Baltics continued to experience further deleveraging. Credit stock has also contracted in Hungary, hampered by local regulation and the persistence of challenging macroeconomic conditions.

Figure 1: Lending growth (ytd September 2012)\(^5\)

FX-denominated loans, which proved to be one of the key drivers of fast lending expansion before the crisis, registered a strong slowdown in their dynamic over the last couple of years. This was partly due to more stringent regulation and even a ban on this type of business in some countries. While the bulk of these loans remain mainly denominated in Euro in SEE countries and the Baltics, in the case of Hungary and to some extent Poland, a larger relevance of Swiss Franc loans is observed. Although the negative macroeconomic implications of widespread FX lending to unhedged borrowers are clear and banks have taken a pro-active approach to sort them out, it is equally true that given the lack of long-term domestic funding, a full ban on the business (particularly for countries converging toward the Euro) could prove to be detrimental for the region.

2. A creditless recovery?

Demand-side factors play a prominent role in explaining the on-going creditless recovery in the more problematic countries of the region. Even after the CEE region re-emerged from the most severe recession in the last decades, the growing output over the last couple of years was not accompanied by a recovery in lending activity in several countries. This is

---

\(^5\) Left panel unadjusted for FX movements; right panel adjusted for FX movements.
not surprising. Financial downturns tend to last longer than economic recessions. In particular, episodes of credit crunches and equity price busts generally last twice as long as recessions; house price busts last more than three times as long. When it comes to recessions associated with credit crunches, the real economy typically recovers while credit is still contracting. New credit may thus not be a necessary condition for output to recover.

As confirmed by the literature, creditless recoveries are not at all a rare event. According to the findings of a recent ECB paper 7 based on a sample of low and middle income economies, one out of four recoveries in output occurs without a pick-up in lending activity. Evidence also suggests that creditless recoveries are typically preceded by large declines in economic activity and financial stress, in particular if private sector indebtedness is high and the country is reliant on foreign capital inflows.

In such a context, questions currently debated in CEE focus on how far lending could fall and to what extent this could further hold back economic growth. Indeed, with growing evidence pointing to a decoupling between credit growth and the economic cycle, it becomes necessary to focus increasingly on the characteristics and the determinants of this phenomenon, in order to fully understand why some countries are (or could be) affected by a creditless recovery.

To shed light on this apparent paradox, we use a panel probit model to investigate the impact of several explanatory variables on the probability of a recovery phase to occur without a pick-up in bank lending. Our results show that recoveries without credit tend to be anticipated by large declines in economic activity and by events that are likely to disrupt credit supply.

The weak credit growth observed particularly in the Baltics appears to be the result of both weak demand and supply constraints. On the demand side, the bounce-back effect undoubtedly plays an important role: the capacity under-utilization originated during the crisis in many firms made possible an output recovery without any need for new

---

6 EU members of CEE, Croatia and Turkey.
investments, thus keeping credit demand at low levels. On the supply side, some deleveraging is still taking place notwithstanding the recovery phase, with particularly intensive reductions in exposure of BIS-reporting banks toward the Baltics. Indeed, stress conditions on banks’ balance sheets strongly increase their need for liquidity and additional capital, thus affecting the probability of a country experiencing a recovery in the context of subdued lending activity.

According to our estimates, in most of the countries included in our sample, probabilities of creditless recoveries higher than the sample average are largely attributable to demand side factors. Indeed, demand factors make the probability of creditless recoveries higher by about 56 percentage points (pps) in Latvia, 41 pps in Estonia, 27 pps in Lithuania, 9 pps in Slovenia and 8 pps in Hungary. At the same time, contributions on the supply side, although remaining quite low in most of the CEE economies, become crucial in countries that have been hit by large banking shocks and/or experienced a significant deleveraging process: supply side factors increase the probability of a creditless recovery by about 28 pps in Latvia and 15 pps in Slovenia.

---

8 Unadjusted for FX movements.
9 Relative contributions to differences in the probability of credit(less) recoveries with respect to the CEE average. Sub-regional averages are weighted by nominal GDP of each country.
Although new bank credit may not be a necessary condition for output to restart growth, our analysis on creditless recoveries is not without consequences on the macroeconomic side. First of all, creditless recoveries tend to be more protracted, taking longer for output to return to its long-term trend. Based on our sample, average GDP growth during episodes of creditless recoveries stands at 5.0 per cent per year, compared to roughly 6.6 per cent in episodes of recoveries accompanied by credit expansion. Second, in cases where sluggishness in new bank lending is predominately due to tighter credit conditions rather than demand factors, the economy is also likely to experience a prolonged decrease in credit-dependent investments with negative consequences for long-term growth. In practice, a prolonged period of stress in credit conditions can lead households to delay or even cancel their expenditure decisions and firms to simply demand short-term financing for working capital, while obtaining long-term financing for physical capital is likely to remain more difficult. Finally, the lack of credit may also favour sectors that are not the most productive, but are simply less dependent on external sources of financing, resulting in a suboptimal composition of output growth.

3. Increased focus on domestic funding sources

Lending growth is increasingly tied to the one in deposits, particularly in more unbalanced economies of the region. As pre-crisis loan-to-deposits mismatches in the region proved unsustainable (particularly in SEE and the Baltics), banks started an intense competition to attract customer funds by offering higher interest rates. 2010 has witnessed substantial deposits growth at 12.8 per cent in the region, which almost fully covered funding needs for the year.

Substantially tightened liquidity makes banks willing to participate in the competition for deposits. At the beginning of 2011, following the restoration of better liquidity conditions and increasing evidence that competition for deposits was starting to be detrimental to banks’ profitability, the focus on deposits became less acute with some re-leveraging taking place. However, later on in 2011, tightening of liquidity came as a result of weaker funding inflows from abroad, compounded in some cases by restrictive central bank policies in an attempt to stem weakening of local currencies. As a result, the fight for deposits again
became the name of the game. In the first nine months of 2012 banks fully funded lending growth by deposits.

**Figure 6: Lending growth and funding availability**

The fact that Western European banks have a significant share of banking assets in the region has exacerbated fears about liquidity and possible spill-overs from the euro area crisis in late 2011 and early 2012. After many years of rapid growth, the external position of the BIS-reporting banks reached roughly USD 732bn on the eve of the Lehman Brothers collapse in September 2008 and dropped by 22 per cent in the following two years. The commitment undertaken by Western European banks under the Vienna Initiative has been crucial in order to contain funding withdrawals from the region. From mid-2010 banks’ external position vis-à-vis the region started to edge up again to recover and stabilize around the level of USD 634bn one year later.

**Figure 7: External positions of BIS reporting banks vis-à-vis all sectors (in USD bn)**

The intensification of funding strains across Europe, regulatory and market pressures to boost the level of capitalisation as well as subdued demand for credit have prompted banks to resume the withdrawal of funding from the region. Between mid and end 2011, cross-border deleveraging has been significant in a number of countries, most notably Bulgaria, Croatia, Hungary and Romania. On the other hand, Turkey continued to enjoy

---

10 Year-on-year, unadjusted for FX-movements.
foreign inflows into its banking sector. The ECB’s LTROs brought relief against the elevated stresses of the last quarter of 2011 and signs of levelling off in the process of deleveraging have increased in early 2012. However, differentiation across the region in terms of bank flows continues to persist. Turkey is outperforming, while Hungary, where policy uncertainty remains rife, and the Balkans, with weaker growth performance and higher exposure to Greece, continue to see outflows. The cost and availability of funds remains an issue to be carefully watched, with uncertainty of bank flows likely to persist and improvements in weaker economies to materialize only gradually as the euro area recovers.

**The overall environment has paid more attention on domestic funding sources and as part of this shift there has been a greater focus on the loan-to-deposits ratio.** From this perspective, a better use of domestic resources is being made. In terms of funding strategies, the issue is similar and given the wide differences in the loan-to-deposits ratios, banks face very different local funding conditions. Regulatory restrictions do complicate matters for cross border banks, given that upstream lending limits in many countries cause difficulties in the free flow of liquidity and cash pooling. These constraints, in the context of shallow capital markets and low availability of long-term local currency funding, could clearly constrain lending activity to the region in the mid-to-long term, especially so given that the problems with accessing domestic funding are mainly related to the short-term nature of banks’ deposits. In such a context, the development of local currency long-term funding remains crucial in order to foster lending in the region. On balance, the wholesale markets in most countries of the region are limited in their depth and are in most cases insufficient to cover the funding needs arising from banks’ commercial gap.

**4. Good capital position, but low revenues and high non-performing loan ratios**

Subdued lending activity and more expensive funding, together with tighter regulatory requirements, have eaten into banking sector revenue generation capacity. The most pronounced revenue decline between 2008 and 2012 has been observed in the SEE region, with poor net interest income performance in Romania, Bulgaria and Slovenia, on the back of a weak lending activity. In Hungary, weak economic growth and the introduction of a bank tax have severely affected both interest and non-interest income of banks, with the system as a whole going into loss in 2012. After a stronger 2011, revenues have been more subdued in 2012 in CE and the Baltics and contracted further in SEE on weaker growth and funding pressures. Turkey, however, performed much better in 2012 since the central bank relaxed monetary policy as the economy started to show signs of slowdown.
Figure 8: Revenues (left) and provisions (right) as a percentage of average loans + deposits

Source: National Central Banks

On the positive side, credit quality has generally stabilised and provisioning has substantially reduced in 2012 compared to the 2010-2011 period. The average impaired loans ratio for the region increased only marginally in 2011 (from 8.5 per cent in December 2010 to 8.7 per cent in December 2011) and remained stable in the first half of 2012. It then started to rise again in the third quarter. In a number of countries impaired loans ratios had peaked or stabilised by mid-2011. However, in the majority of SEE countries (Bulgaria, Croatia, Romania, and Serbia) as well as in Hungary and Slovenia, the non-performing loan ratio was still growing in 2011-2012 as economic recovery lags behind the rest of the region. In turn, non-performing loan levels of 15 to 20 per cent are a drag on economic growth.

Table 2: Impaired loans ratio (% of gross loans)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Baltic countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>4.4%</td>
<td>4.0%</td>
<td>4.9%</td>
<td></td>
<td></td>
<td>4.5%</td>
</tr>
<tr>
<td>Latvia</td>
<td>5.3%</td>
<td>5.3%</td>
<td>5.4%</td>
<td></td>
<td></td>
<td>5.3%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>5.1%</td>
<td>5.0%</td>
<td>5.4%</td>
<td></td>
<td></td>
<td>5.2%</td>
</tr>
<tr>
<td>CEE countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>4.4%</td>
<td>4.3%</td>
<td>4.3%</td>
<td></td>
<td></td>
<td>4.3%</td>
</tr>
<tr>
<td>Hungary</td>
<td>6.5%</td>
<td>6.6%</td>
<td>5.1%</td>
<td></td>
<td></td>
<td>5.1%</td>
</tr>
<tr>
<td>Poland</td>
<td>6.5%</td>
<td>6.5%</td>
<td>6.5%</td>
<td></td>
<td></td>
<td>6.6%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>5.5%</td>
<td>5.5%</td>
<td>5.4%</td>
<td></td>
<td></td>
<td>5.4%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>5.2%</td>
<td>5.2%</td>
<td>5.1%</td>
<td></td>
<td></td>
<td>5.2%</td>
</tr>
<tr>
<td>SEE countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>5.5%</td>
<td>5.5%</td>
<td>5.5%</td>
<td></td>
<td></td>
<td>5.5%</td>
</tr>
<tr>
<td>Croatia</td>
<td>5.6%</td>
<td>5.6%</td>
<td>5.6%</td>
<td></td>
<td></td>
<td>5.6%</td>
</tr>
<tr>
<td>Romania</td>
<td>5.6%</td>
<td>5.6%</td>
<td>5.6%</td>
<td></td>
<td></td>
<td>5.6%</td>
</tr>
<tr>
<td>Serbia</td>
<td>5.6%</td>
<td>5.6%</td>
<td>5.6%</td>
<td></td>
<td></td>
<td>5.6%</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.5%</td>
<td>5.5%</td>
<td>5.5%</td>
<td></td>
<td></td>
<td>5.5%</td>
</tr>
</tbody>
</table>

Source: National Central Banks

11 Including only retail and corporate.
12 No data available for Bosnia and Herzegovia.
Improvements in asset quality were reflected in a further contraction in the cost of risk, which proved to be supportive of banks’ profitability in 2011 and 2012. Exceptions are Hungary, Serbia\(^\text{13}\) and Slovenia, where the cost of risk grew in 2011. In the first half of 2012, the cost of risk continued to be on a downward trend, even as credit quality stopped improving in some countries.

The overall profitability contracted for banks in the CEE region. The return-on-equity declined from an average of 16 per cent in 2007-2008 to roughly 10 per cent in the 2010-2011 period, again in the context of large cross-country differentiation. SEE countries emerge on average with a much lower profitability, having a return-on-equity below 3 per cent. The banking sector in Romania reported a loss both in 2010 and 2011.

The good news is that the reasonably good capital position could help CEE banks to withstand euro area woes. As of the first six months of 2012, banks’ capital adequacy ratios in the region were substantially higher compared to the minimum required by the local regulator. However, still high levels of non-performing loans in some countries, although manageable, could represent a potential source of risk, with actions targeted to a proactive resolution remaining crucial.

\[\text{Figure 9: Return-on-Equity}\]

\[\text{Figure 10: Capital adequacy ratio}\]

\(^{13}\) In Serbia, there was a one-off due to a bankruptcy of the state-run Agrobanka (ranking 13\(^\text{th}\) by assets).
Developments in the Turkish Banking Sector after the 2000-2001 and 2009 Crises

İZLEM ERDEM\textsuperscript{1}

Executive Summary

• Reforms implemented after the 2000-2001 crisis and the political stability obtained after 2002 limited the fall-out of the global financial crisis. The strengthened banking regulation and supervision, together with conservative banking practices, led to better asset quality, much smaller FX positions and higher capital levels. As a result, the Turkish banking sector could contribute to the robust recovery by rapidly increasing lending volumes.

• Although the Turkish banking sector weathered the global crisis well, new macroeconomic and financial risks have emerged recently. Along with some other emerging market countries, Turkey experienced a rapid rise in credit volume, accommodated by ample global liquidity that led to large capital inflows. The authorities, being aware of the financial stability risks, have responded with novel policy tools that have been successful in shielding the domestic economy from large external shocks.

• Foreign banks’ share in total banking sector assets has increased steadily during recent years and now stands at 40 per cent. New players are expected to enter the market in the years ahead, attracted by high returns on capital and good growth prospects as Turkey has significant untapped banking potential. For the same reasons, while Turkish banks are increasingly looking across borders, their main priority is still their home market.

1. Restoring confidence in the banking sector was key during the 2000-2001 crisis in Turkey

At the beginning of this century, Turkey experienced a severe financial crisis as a result of high fiscal imbalances, macroeconomic instability originating from persistently high and volatile inflation and increased concerns about the financing of the current account deficit. These macroeconomic problems, coupled with structural problems in the banking sector, intensified during November 2000 and February 2001 and turned into a systemic banking crisis.

The Banking Sector Restructuring Program was put into place in May 2001. The aim of the Program was the restructuring of public banks, the resolution of banks taken over by the

\textsuperscript{1} Economic Research Division, Isbank.

The views, opinions and analyses expressed do not represent the official standing of Türkiye İş Bankası A.Ş. and are personal views and opinions of the author.
Saving Deposits Insurance Fund of Turkey, the rehabilitation of the private banking system, the strengthening supervision framework and the increase of competition and efficiency in the sector. More specifically:

- Within the context of the program, the capital structure of public banks was strengthened. Public banks were restructured based on their operational scale, professional staff was added to their managements and the number of branches and employees was reduced to levels more in line with actual activities.
- Banks taken over by the Saving Deposits Insurance Fund were resolved by mergers, sales or direct liquidation in a short period of time. At the end of this process, out of 79 banks operating in the system at the end of 2000, 22 banks were transferred to the Saving Deposits Insurance Fund. The cost of restructuring these banks and public banks was USD 54bn, which was almost a quarter of Turkey’s GDP at that time.
- In order to make the private banks sound in structure, FX positions were closed significantly. With the help of the capitalization program, necessary measures were taken concerning the banks having capital inadequacy, and the balance sheets of banks were made more transparent.

In other words, the aim of the program was simply to rebuild the reputation the sector critically needed at that time.

Reforms implemented after the 2000-2001 crisis and the political stability obtained after 2002 have facilitated a significant improvement in Turkey’s fundamental indicators. These reforms, which were also carried out with the start of EU accession negotiations in 2004, are focused primarily on the liberalization of the Turkish economy, increasing the weight of the private sector, improving the strength of the financial sector and setting the social security system on sound foundations. The degree to which such reforms have been successful may be seen in Turkey’s current solid macroeconomic fundamentals and fiscal indicators. In the period between 2002 and 2011, Turkey’s public sector debt-to-GDP ratio receded from 74 per cent to 39 per cent and has been below the Maastricht criterion since 2004. This has helped the Turkish economy to become resilient at a time when many mature economies are facing debt crises. As of 2011, the gross domestic product of Turkey reached USD 774bn, from USD 230bn in 2002. During the same period, per-capita income climbed from USD 3,500 to USD 10,500.

Reforms to overcome the fragilities in the Turkish banking sector enabled the sector to become the engine of economic growth during the last decade. The number of branches and employees, which had decreased significantly after the crisis, started to increase steadily. In line with banks returning to their intermediation activity, loans have increased significantly further fuelling growth. There was a steep decline in non-performing loans as a share of total loans, which shows the improved asset quality and banks advanced scoring and risk management techniques. While assets were growing rapidly, banks’ capital also showed constant growth and the sector’s profitability has increased.

Another factor contributing to the healthy growth of the sector was the expansion of the supervisory role of the Banking Regulation and Supervision Agency (BRSA). The Agency’s
regulatory process was made more participative and transparent and its supervisory process was improved with on-site audit.

Turkey’s experience showed the importance of restoring confidence in the banking sector to overcome the economic crisis. Coordination and timeliness in decision making are critical for rebuilding banks’ reputation. Also, the 2000-2001 crisis Turkey experienced pointed out the importance of monitoring the banking sector with early warning systems and implementing proactive resolving strategies before the banks become more problematic. This is more cost-efficient and more effective than waiting until a bank faces severe problems as delays tend to increase the losses of problematic banks and, moreover, problems are likely to spill over to other banks.

2. Reforms triggered by previous crises limited the fall-out of the global financial crisis on the Turkish banking sector

Thanks to effective regulation and supervision together with the policy coordination among authorities, the Turkish banking sector experienced a healthy growth until the eruption of the global financial crisis. The crisis has been a very tough test for the Turkish banking sector and for the authorities as it remained to be seen whether strengthened banking regulation and supervision and the conservative banking practices prevailing since the 2000-2001 crisis could protect the Turkish banking sector from the global financial downturn. The subsequent developments have proven that the Turkish banking sector has passed the test successfully.

The soundness of the banking sector thanks to the reforms achieved following the 2000-2001 crisis and the absence of any direct exposure of Turkish banks to the global mortgage markets, limited the negative repercussions of the global crisis on the Turkish financial system. The success was achieved not only by a prudent crisis management, but also by the strong capital and asset quality of Turkish banks. Cautious approach and good risk management of banks, as well as effective audit and supervision helped the banking sector combat the crisis as well.

The improved health of the Turkish banking sector can be clearly seen from the FX positions relative to equity capital. In 2000, the on-balance sheet FX position of the Turkish banking sector had reached nearly twice the size of its equity capital as banks’ equity capital had been eroded to a great extent. But in the current global crisis period, the Turkish banking sector continued to perform well with a strong equity capital of USD 77bn. The net FX position of the banking sector was only 0.4 per cent of its equity capital in 2011. As a result, the 23 per cent depreciation of the Turkish Lira against the US Dollar had no significant negative impact on the sector’s balance sheet.

The strengthened asset quality of the Turkish banking sector has also contributed to the robust recovery in the domestic market after the 2008 crisis through healthy and sustainable loan growth. The loan–to-GDP ratio, which was 14 per cent at the end of 2002, increased to almost 53 per cent at the end of 2011. At the end of 2009, the non-performing loan (NPL) ratio in the sector increased to only 5.3 per cent from 3.7 per cent at the end of 2008. After having reached this level, the NPL ratio continued to improve gradually in line
with the economic recovery and at the end of 2011 it was as low as 2.7 per cent. Today it stays around this level.

In the Turkish banking system, the capital adequacy ratio is above the legal limit of 8 per cent. After the 2000-2001 crisis, the capital adequacy ratio has increased well above the legal requirement and even above the target ratio of 12 per cent set in 2006 by the BRSA. During the global financial crisis, it was higher than in many other emerging markets and developed countries. At the end of 2011, the capital adequacy ratio was 16.6 per cent.

There could be several motivations behind keeping a capital buffer in excess of that required by the regulations. The general view is to protect banks against negative shocks with a cushion. In the Turkish banking system, the sound financial position of Turkish banks protects them from asset quality deterioration and puts them under less pressure in their lending activities due to the capital buffer. Regarding international capital adequacy standards, Turkey is still in the process of implementing Basel II regulations, while draft regulations are being prepared by BRSA to comply with the new Basel III standards.

Unlike many other countries, Turkey has not found it necessary to raise its bank deposit guarantee levels despite the global crisis. Among the OECD countries, only the Turkish government did not transfer any public funds into the banking system under the global financial crisis.

In addition to the resilience of the banking sector, authorities were also quick to react. For example, the Central Bank of Turkey made extraordinary monetary easing during the crisis, and although no direct public financial support was provided, amendments were made to regulations aiming at preserving banks’ earnings and capital adequacy while maintaining credit growth at the same time.

3. The rapidly changing banking sector together with external developments creates new challenges for regulators

Mirroring the rapid growth of the economy since 2002 is the return of Turkish banks to their intermediation activity. The share of loans in total assets has increased significantly which further fuelled economic growth. On the other hand, due to the lower public sector borrowing requirement as a result of the government’s dedication to fiscal discipline and banks’ focus on providing loans, the share of securities declined.

<table>
<thead>
<tr>
<th>Table 1: Distribution of assets in the Turkish banking sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Loans</td>
</tr>
<tr>
<td>Securities</td>
</tr>
<tr>
<td>Cash + Central Bank + Banks</td>
</tr>
<tr>
<td>Other Assets</td>
</tr>
</tbody>
</table>

Source: BRSA Monthly Bulletin

Although deposits remain the main funding source of the Turkish banking sector, banks also started to issue bonds as an alternative source of funding. Securities issued increased from TRY 18.5bn at the end of 2011 to TRY 33.5bn in September 2012. In addition,
depending on the global risk perception, banks continue to raise money from abroad. Wholesale funding such as bond issues help the banks to increase the maturity of liabilities. The banking sector intends to utilize alternative funding instruments in order to diversify liabilities. However, this strategy is used opportunistically depending on the prevailing rates for other funding sources.

### Table 2: Distribution of liabilities in the Turkish banking sector

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>64.9%</td>
<td>57.1%</td>
</tr>
<tr>
<td>Banks</td>
<td>10.3%</td>
<td>13.8%</td>
</tr>
<tr>
<td>Money Market</td>
<td>6.1%</td>
<td>9.1%</td>
</tr>
<tr>
<td>Securities Issued</td>
<td>0.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>18.3%</td>
<td>18.5%</td>
</tr>
</tbody>
</table>

*Source: BRSA Monthly Bulletin*

Moreover, thanks to the rapid recovery in the economy and the resilience of the banking sector, foreign investors’ interest towards Turkish banks also intensified. In terms of total assets, the share of foreign banks increased from 6.4 per cent at the end of 2005 to 16.4 per cent at the end of 2011. The start of EU accession negotiations in 2004 also supported this process.

Although the Turkish banking sector weathered the global crisis well, new macro-financial risks have recently emerged. Along with some other emerging market countries, Turkey experienced a rapid rise in credit volume, accommodated by ample global liquidity that led to large capital inflows and strong domestic demand contributing to a sharp widening in the current account deficit.

The authorities, being aware of the financial stability risks, have responded proactively. The BRSA took several steps including increased risk weights for some of the consumer loans, increased general provisioning requirements for banks with high levels of consumer loans or non-performing consumer loans and limits to payments that are made below the total debt level of the period for credit card payment. These measures contributed to keeping credit growth at sustainable levels and thus improving the resilience of the banking sector.

In mid-November 2010, the Central Bank added financial stability in its policy framework together with price stability. It started differentiating and increasing Turkish Lira and FX reserve requirements in several steps to lengthen maturities and increase the cost of funding. The Central Bank widened its interest rate corridor, reduced the policy rate and increased the Lira’s volatility in order to discourage very short-term capital inflows. As main instruments, the Central Bank currently uses reserve requirement ratios and reserve option coefficients in terms of credit policy, weekly repo rate in terms of interest rate policy and the interest rate corridor, open market operations, the effective funding rate and reserve option coefficients in terms of liquidity policy (see Box 1).

Partly because of the above measures taken by the authorities and partly because of the slowdown in the economy, credit growth in the Turkish banking sector started to decelerate in mid-2011. Annual credit growth declined from around 40 per cent in 2010 to
30 per cent in 2011 and is expected to be around 15 per cent in 2012, which contributed significantly to maintaining price stability and financial stability in the current unstable global economic environment.

**Box 1: Monetary policy tools used to ensure financial stability**

**Policy rate and interest rate corridor.** In the post-crisis period, capital inflows towards Turkey surged as a result of the low level of interest rates in the global economy and quantitative easing implemented by major central banks. Strong macroeconomic fundamentals in Turkey also supported this process. In this environment, the Turkish Lira appreciated and credit growth accelerated. All these factors resulted in a worsening of the current account deficit which reached 10 per cent in 2011. In the last quarter of 2010, the Central Bank introduced the widened interest rate corridor, the gap between the O/N lending rate and O/N borrowing rate. As the average funding cost lies within the corridor, the Central Bank can fine-tune it on a daily basis. Due to the increased flexibility, the Central Bank can quickly adjust the average funding cost to the volatility in the global and domestic markets. If the risk appetite in global markets is high and capital inflows are strong, the Central Bank tends to use a wider interest rate corridor in order to increase the interest rate volatility and slow down the capital inflows. On the other hand, if the risk perception increases, the Central Bank narrows the interest rate corridor.

**Reserve requirement ratios.** In order to ensure financial stability along with price stability, the Central Bank actively changes reserve requirement ratios. According to the Central Bank, short-term interest rates could not be used to achieve both price stability and financial stability as in an environment of massive capital inflows, raising the policy rate to curb the rapid credit growth would result in increasing capital inflows due to the higher returns. This would in turn lead to overvaluation of the local currency and further deteriorate the current account balance. Therefore, the Central Bank prefers to increase the reserve requirements of banks to control the credit growth. The average reserve requirement for Turkish Lira-denominated liabilities was raised from 5.5 per cent at the end of 2010 to as high as 13.5 per cent in 2011. The Central Bank also differentiated the reserve requirement ratios according to maturities.

**Reserve option mechanism.** This mechanism allows the Central Bank to limit the impact of excessive capital inflows on financial stability. It is a facility enabling banks to hold a certain percentage of their Turkish Lira-denominated required reserves in FX and gold. Coefficients determining the FX or gold equivalent to be maintained per unit Turkish Lira-denominated required reserves are defined as Reserve Option Coefficients. Crucially, banks are free to choose the share of required reserves held in FX or gold. When capital inflows towards Turkey are high, banks would use this facility as the cost of FX funding is lower. As part of the FX inflow will be withdrawn from the market, appreciation pressure on the Turkish Lira will be mitigated. This mechanism is thus expected to act as an automatic stabilizer in the FX market without the need of an intervention by the Central Bank and to complement the reserve requirement ratio in limiting credit expansion driven by a surge of capital inflows.

Turkey’s experiences during the 2000-2001 crisis and the global financial and economic crisis show the importance of timely and coordinated responses to emerging risks. Turkey’s new macroprudential policy framework has been successful in limiting the negative effects of short-term capital inflows, thereby shielding the domestic economy from large external shocks. The improved financial stability was one of the reasons for Fitch to recently upgrade Turkey to investment grade.
4. Outlook and Risks

The Turkish banking sector has remained resilient throughout the latest financial crisis due to a robust capital structure, reliance on conventional banking activities, a healthy loan portfolio and a low-leverage structure. In this respect, the sound capital base of the Turkish banking sector has been a significant advantage. The capital adequacy ratio of the Turkish banking sector calculated according to the Basel II standards is 16.5% as of September 2012, significantly higher than the target ratio of 12 per cent and the legal limit of 8 per cent. In order to implement Basel II into Turkish Law, the BRSA issued a new regulation on measurement and assessment of capital adequacy of Turkish Banks, which was put into effect on July 1, 2012. Due to the amendments to the regulation in the form of “national discretions”, the impact of the new regulation has been very limited.

Table 3: Key figures of the Turkish banking sector

<table>
<thead>
<tr>
<th>Overview</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of banks</td>
<td>50</td>
<td>49</td>
<td>49</td>
<td>49</td>
<td>48</td>
<td>48</td>
</tr>
<tr>
<td>Number of branches</td>
<td>8,071</td>
<td>9,250</td>
<td>9,526</td>
<td>10,000</td>
<td>10,440</td>
<td>10,813</td>
</tr>
<tr>
<td>Number of employees</td>
<td>167,212</td>
<td>182,100</td>
<td>183,614</td>
<td>190,586</td>
<td>194,617</td>
<td>198,542</td>
</tr>
<tr>
<td>Stocks and flows (in USD bn)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>500.8</td>
<td>482.2</td>
<td>560.1</td>
<td>656.5</td>
<td>648.1</td>
<td>735.4</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>65.3</td>
<td>56.9</td>
<td>74.4</td>
<td>87.7</td>
<td>76.9</td>
<td>94.5</td>
</tr>
<tr>
<td>Deposits</td>
<td>307.2</td>
<td>299.2</td>
<td>345.6</td>
<td>402.4</td>
<td>370.3</td>
<td>414.7</td>
</tr>
<tr>
<td>Loans</td>
<td>246.1</td>
<td>242.2</td>
<td>263.7</td>
<td>343.1</td>
<td>363.5</td>
<td>424.8</td>
</tr>
<tr>
<td>Securities</td>
<td>141.7</td>
<td>127.4</td>
<td>176.5</td>
<td>187.7</td>
<td>151.7</td>
<td>156.1</td>
</tr>
<tr>
<td>Net profits</td>
<td>-0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Ratios (in %)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NPL / Total loans</td>
<td>3.5</td>
<td>3.7</td>
<td>5.3</td>
<td>3.7</td>
<td>2.7</td>
<td>3.0</td>
</tr>
<tr>
<td>Capital adequacy ratio</td>
<td>18.9</td>
<td>18.0</td>
<td>20.6</td>
<td>19.0</td>
<td>16.6</td>
<td>16.5</td>
</tr>
<tr>
<td>Assets / GDP</td>
<td>69.0</td>
<td>77.1</td>
<td>87.6</td>
<td>91.6</td>
<td>94.0</td>
<td>93.6</td>
</tr>
<tr>
<td>Loans / GDP</td>
<td>33.9</td>
<td>38.7</td>
<td>41.2</td>
<td>47.9</td>
<td>52.7</td>
<td>54.0</td>
</tr>
<tr>
<td>Housing loans / GDP</td>
<td>3.6</td>
<td>3.7</td>
<td>4.4</td>
<td>5.4</td>
<td>5.6</td>
<td>5.7</td>
</tr>
<tr>
<td>Housing loans / Total loans</td>
<td>10.5</td>
<td>9.6</td>
<td>10.7</td>
<td>11.2</td>
<td>10.7</td>
<td>10.6</td>
</tr>
<tr>
<td>Foreign banks’ share in total assets</td>
<td>14.0</td>
<td>17.0</td>
<td>15.8</td>
<td>16.6</td>
<td>16.4</td>
<td>16.7</td>
</tr>
</tbody>
</table>

Source: BRSA

Work has been started by the BRSA on Basel III as Turkey being a G20 and Basel Committee member, is keen on complying with the new regulations. The Turkish banking sector not only has a relatively high capital ratio, its capital structure is also rather strong: within own funds the share of subordinated debt and hybrid instruments is low (the share of supplementary capital was only 10 per cent at the end of 2011), while there are high levels of paid-in capital, profit reserves and undistributed profits reflecting the BRSA’s decision to limit banks’ dividend payments. As those are the main components in the Basel III definition of common equity, the Turkish banking sector is expected to benefit from its strong capital base and CAR ratios after the implementation of Basel III. Also, it is expected that the liquidity ratios of Basel III will not have a significant effect on the credit growth and

---

2 “Foreign banks” refers to those banks of which the share of foreign capital in total assets exceeds 50 per cent.
profitability of the sector and leverage will not be a constraint for Turkish banks as they are currently operating with relatively comfortable ratios.

When compared to EU, the shares of loans, household indebtedness and deposits to GDP point at a huge potential for the Turkish banking sector. It is anticipated that the banking sector indicators of Turkey will converge to EU averages taking into consideration the ongoing financial distress and slowdown in the EU banking sector. At the end of 2011, the loan-to-GDP ratio was 194 per cent, the deposits-to-GDP ratio was 176 per cent and the total assets-to-GDP ratio was 367 per cent in the EU27. For Turkey, loans and deposits will probably reach 65-70 per cent of GDP and banking sector total assets will exceed 100 per cent of GDP in the medium term. Demographic features of Turkey also indicate a high growth potential of the banking sector. The number of households whose annual income is between USD 25,000 and USD 50,000 is expected to reach 4 million in the medium term, a sharp increase from the 1.5 million in 2005. In parallel, it is expected that the penetration ratio will increase and branch networks will continue to widen until the 2020’s, while improvements in branch and personnel efficiency will also continue.

In the Turkish banking sector, as the savings are still very low by international standards, the high level of competitiveness still continues on the deposit side. Since 2011, increased competition on the deposit side was the result of liquidity management strategies rather than the wish to increase market share. Precisely the banks with rather limited access to non-deposit funds offered aggressive rates for deposits. While in the short run the high current account deficit, 10 per cent of GDP in 2011, was addressed by limiting the credit volume via macro-prudential, fiscal and monetary policy measures, in the long run increasing domestic savings is critical for sustainable growth in Turkey.

With an on-going structural problem of insufficient domestic savings in Turkey, high dependence on foreign funding may be regarded as a main vulnerability not only for the Turkish economy but for the banking sector as well. However, the sensitivity of the Turkish banking sector to the volatility in capital inflows towards Turkey is much less compared to the past due to a number of reasons. First, the Turkish banking sector accumulated significant capital buffers after the 2000-2001 crisis and developed extensive risk management systems thanks to the prudent regulation and supervision. Second, banks are now fully guarded against a possible depreciation of the Turkish Lira in case of a sudden stop in capital inflows due to the fact that the banking sector is currently long in FX. In fact, banks are subject to very strict regulations in terms of open FX positions. This creates a very effective cushion against volatility of the Turkish Lira. Third, although the share of deposits in total liabilities is declining, deposits still have a high share and the majority of these deposits are domestic limiting the banking sector’s reliance on foreign funding. Fourth, as explained above, the Central Bank has developed several tools against a possible change in direction of capital inflows. In addition, both the Central Bank and the BRSA highlight the importance of countercyclical policies more frequently and design their policies accordingly.

In terms of asset quality, at the peak of the crisis during the last quarter of 2009, the NPL ratio in the Turkish banking sector increased to only 5.4 per cent. After having reached this level, the NPL ratio continued to improve gradually in line with the economic recovery and at
the end of 2011 it stood as low as 2.7 per cent. This performance is not only due to the rise in credit volume but also due to the improved collection from NPLs and advanced scoring and risk management techniques implemented by the banking sector. On the other hand, as a result of the slowdown in domestic demand during 2012, the NPL ratio increased somewhat to 3.0 per cent as of September 2012. Even if the previous high credit growth will lead to a further increase in NPLs, the losses will not materially affect banks’ balance sheets.

In Turkey, banks usually have the opportunity to sell some part of their NPL portfolio at a reasonable price to lower the NPL ratio and improve their balance sheet outlook. However, the collection rates are quite high which makes it more profitable to keep the portfolio instead of selling it. In fact, although there was a steep increase in the NPL ratio in 2009, the high volume of collections created net negative NPL formation in the following years, which contributed to the increase in the banking sector’s net profits.

Low interest rates, high competition and pressure on the net interest margin are likely to continue defining the Turkish banking sector in the near future. Therefore, the importance of creating stable sources of non-interest income has become a key factor to sustain the high return on equity and assets of the Turkish banking sector. In addition, sustaining profitability necessitates also the continuation of attentive cost-control policies and improved branch and employee productivity.

<table>
<thead>
<tr>
<th>Table 4: Profitability of the Turkish banking sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
</tr>
<tr>
<td>Net Income / Average Assets (%)</td>
</tr>
<tr>
<td>Net Income / Average Shareholder’s Equity (%)</td>
</tr>
<tr>
<td>Net Profit (TRY bn)</td>
</tr>
</tbody>
</table>

Source: BRSA Monthly Bulletin

Low interest rates and the degree of competition in the sector could trigger a wave of consolidation in the sector in the medium term. While still at relatively high levels compared to developed markets, the decreasing interest margins will be a catalyst for consolidation. Especially small- and medium-sized banks need scale in order to keep their profitability. Also, consolidation will enable these banks to control their costs more effectively.

Foreign banks’ interest in the Turkish banking sector gained pace in the second half of 2000s such that today the share of foreign capital stands at around 40 per cent when the foreign share in banking stocks listed at the ISE is also taken into account. Although the profitability in the Turkish banking sector is declining, Turkey still continues to offer high returns on capital and a significant growth opportunity.

Although a few foreign banks which invested in the Turkish banking sector sold their stakes recently, this is mainly due to their capital adequacy and liquidity problems in their home countries and does not show a decline in investors’ interest in the sector. For example recently, the Turkish banking authority gave a license for the establishment of a new bank for the first time in the last 12 years and this bank is a foreign-owned bank. Besides, the largest bank of Russia has recently invested in the sector. Leading banks from
the Middle East and the Far East are reportedly looking for investment opportunities in Turkey. Their interest is not only in terms of buying stakes from current players but also through acquiring licenses to establish new financial institutions. Although there is no cap set by the authorities regarding the share of foreign banks, the BRSA has been following a cautious and selective approach regarding the provision of new licenses.

**While foreign banks’ interest in Turkey continues, Turkish banks are also increasing their investments abroad.** The near and Middle East, the Turkic Republics, Russia and the Balkans are among the favourite destinations. The main strategy of the Turkish banks has been to “follow the customers” since they first started to expand their business in the region. The idea is to be involved in all the main markets for Turkish businessmen and entrepreneurs. In addition, Turkish banks have recently tended to expand their operations by providing services to local retail businesses and local households as well. The know-how of the Turkish banking sector that is acquired over the years is useful not just in the domestic market or in Turkey-related businesses but also in realizing the potential of foreign markets. However, it is important to note that for all Turkish banks the main priority is to expand in their core market, as Turkey still offers high growth potential with relatively high profitability.

**There is every reason to believe that its strong balance sheet structure, experienced staff, technological infrastructure, reputation, trustworthiness and innovative attitudes will continue to make the banking sector a cornerstone of Turkey’s development over the next decade as well.** When compared with EU figures pertaining to total assets, total credits, household indebtedness and total deposits as shares of GDP, there appears to be a significant untapped banking sector potential in Turkey. In the longer term, we can expect to see a much higher degree of banking sector penetration thanks to the sector’s own dynamics as capital markets deepen and the informal economy comes under greater control.

**References**


Central Bank of the Republic of Turkey, “Inflation Report 2012-IV”.


Foreign-owned Banks in CEE/CIS

GUNTER DEUBER AND GLEB SHPILEVOY

Executive Summary

- Business models of major, highly diversified western banks operating in Central and Eastern Europe, Russia and other countries of the Commonwealth of Independent States are robust and largely depend on traditional lending. Current loan-to-deposit ratios at leading western banks operating in this region are sound and major. Western banks are well placed to increase deposits in line with expected loan growth in the near future.

- Big-name western banks are a dominant force in Central and Eastern Europe. New entrants are unlikely to pose a threat to their defensive strategies in the challenging markets. For example, Sberbank Europe (former Volksbank International) operates 250 branches in Central and Eastern Europe, while the average big-name western bank has some 2000 branches. However, with the latter competing in markets both inside and outside the EU in the region they are exposed to greater regulatory pressure than some local players. On the key Russian market, core franchises of leading foreign banks may be hard put to defend market share.

- Uncoordinated, self-insuring national regulation and soaring regulatory costs are downsides in Central and Eastern Europe, a region where banking integration in practice has gone further than in the rest of Europe. EU regulatory policies need to be formulated with an eye on their potential spill-over effects. Otherwise, foreign banks may also face populist demands for a “domestication” of banking in their core markets in the region. Moreover, for most major foreign banks operating in Central and Eastern Europe and the Commonwealth of Independent States, all their local franchises, especially given the weight of the Russian market, are of importance to achieve a solid profit and risk diversification.

1. Western Banks presence in the region and recent market trends

Compared to the balance sheets of Western Banks (WBs), banking sectors in CEE/CIS² are relatively small. Total CEE banking assets amount to EUR 2,068bn in 2011. Top-three European banks such as Deutsche Bank, HSBC and BNP Paribas have balance sheets of roughly the same size. As Russia already represents some 50 per cent of the CEE/CIS market,

1 Gunter Deuber: CEE Research, Raiffeisen Bank International AG; Gleb Shpilevoy: Credit Research CIS Financials, Raiffeisen Bank International AG.

The views expressed in this article are based on projects and research work at Raiffeisen Bank International. However, the article presents the personal opinions of the authors and does not necessarily reflect the views of Raiffeisen Bank International or its staff.

2 In this article, CEE refers to Central Europe (CE) and Southeastern Europe (SEE), where CE comprises Czech Republic, Hungary, Poland, Slovakia and Slovenia and SEE comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania and Serbia. CIS refers to Russia, Ukraine and Belarus.
the CEE banking sector is much smaller in size with banking assets of some EUR 711bn in CE and EUR 231bn in SEE.

As a result, CEE/CIS assets of leading Western banks like Raiffeisen Bank International (RBI) and Erste Bank (Erste), and those of global European banks with a significant regional presence, such as UniCredit, Société Générale (SocGen), Intesa, KBC, Commerzbank (Coba) and Santander, or regional banks like OTP, are also small. The total CEE/CIS assets of the top seven regional WBs (Erste, Intesa, KBC, OTP, RBI, SocGen and UniCredit) amount to EUR 490bn in 2011 – more or less the equivalent of a single European bank in the top 30–40. The CEE/CIS assets of WBs like UniCredit, SocGen, Intesa or Coba, make up “just” 4 to 20 per cent of their total assets.

Even the balance sheets of major international Russian banks such as Sberbank and VTB are small, with total assets of EUR 260bn and EUR 163bn respectively (end 2011). With average annual lending growth of 30 per cent, Russia’s banking market has seen the strongest expansion in recent years – it accounted for 20 per cent of CEE/CIS assets ten years ago compared to 50 per cent in 2011. In contrast, CE’s share in CEE/CIS banking assets decreased from 64 to 34 per cent during the same period. As a result, any regional analysis of banking in Eastern Europe has to deal with Russia as the key market for WBs operating in the region.

**Table 1: Assets and branches of banks active in the region**

<table>
<thead>
<tr>
<th></th>
<th>CEE/CIS assets (EUR bn)</th>
<th>Regional asset allocation (% total, 2011)</th>
<th>CEE/CIS branches</th>
<th>Regional branch allocation (2011)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Erste</td>
<td>33 84</td>
<td>65  32  3</td>
<td>1313 2149 2140</td>
<td>2009 131</td>
</tr>
<tr>
<td>Intesa</td>
<td>17 41</td>
<td>57  37  6</td>
<td>549 1585 1446</td>
<td>1029 417</td>
</tr>
<tr>
<td>KBC</td>
<td>32 55</td>
<td>61 22 17</td>
<td>792 1364 875</td>
<td>812 63</td>
</tr>
<tr>
<td>OTP</td>
<td>18 36</td>
<td></td>
<td>935 1496 1424</td>
<td>1124 300</td>
</tr>
<tr>
<td>RBI</td>
<td>31 85</td>
<td>49 28 23</td>
<td>2281 3017 3238</td>
<td>2037 1201</td>
</tr>
<tr>
<td>SocGen</td>
<td>21 74</td>
<td>48 28 24</td>
<td>887 2722 2663</td>
<td>1953 710</td>
</tr>
<tr>
<td>UniCredit</td>
<td>63 116</td>
<td>50 29 21</td>
<td>2280 3031 2861</td>
<td>2266 595</td>
</tr>
<tr>
<td>Total</td>
<td>215 491</td>
<td></td>
<td>9037 15364 14647</td>
<td>8964 3417</td>
</tr>
<tr>
<td>Sberbank</td>
<td>73 260</td>
<td>2 2 96</td>
<td>19734</td>
<td>250 19484</td>
</tr>
<tr>
<td>VTB</td>
<td>31 163</td>
<td></td>
<td>983</td>
<td>983</td>
</tr>
</tbody>
</table>

**Source:** Company data, Raiffeisen RESEARCH.

The CEE banking market is characterised by a strong presence of WBs, with foreign ownership at 70 to 90 per cent of banking assets, while in the CIS countries, ownership ratios of WBs are much lower. From 2000 until 2008/2009 WBs increased their CEE/CIS loan books and asset base by 10 to 30 per cent per year in Euro terms. This was considerably faster than loan growth in their domestic markets as Western European banks with little or no CEE/CIS exposure recorded an average annual loan-book growth of 5 to 15 per cent in the same period. The total CEE/CIS assets of the top seven regional WBs increased from EUR 215bn in 2005 to EUR 490bn in 2011.

---

3 HVB+UniCredit in 2004 and 2005.
With business models geared towards traditional lending and a strategy based on the assumption of a structural catch-up in the labour-intensive loan business, the number of branches operated by leading WBs in CEE/CIS soared from 9,000 to 15,000 between 2004 and 2009. Currently, the “average leading Western CEE/CIS” bank has some 2,300 branches spread across 12 CEE/CIS markets. In total, the top WBs have some 250,000 employees in the CEE/CIS markets.

After a decade of strong growth, WBs saw their regional CEE/CIS loan books stagnate or shrink in 2008/2009. The branch expansion also went into reverse. At the end of 2011, leading WBs were operating some 14,700 branches in CEE/CIS, which is 5 per cent down on peak levels. In 2010, 2011 and the first half of 2012, loan growth stabilised at major WBs. However, growth drivers have changed. Pre-crisis, WBs with a strong presence in SEE and CIS performed best. Currently, WBs geared towards Russia and CE enjoy a solid performance.

2. Western Banks operating in CEE/CIS compared to their European peers

WBs running a traditional universal bank model in the CEE/CIS region differ greatly from the largest European universal/investment banks with little or no CEE/CIS exposure in terms of balance sheet structures and revenues. WBs present in CEE/CIS are in general less active on the capital markets than major European investment/universal banks, SocGen being the exception. As a result, trading income is less important than for the average major European universal/investment bank. Trading accounts for 2 to 8 per cent of the total income at leading WBs with a presence in CEE/CIS (1 to 5 per cent when excluding SocGen), while net interest income (NII) makes up some 60 per cent of total revenue (65 per cent when excluding SocGen). In CEE/CIS subsidiaries of WBs, NII usually represents around 70 to 80 per cent of revenue. On the other hand, European universal/investment banks with little or no CEE/CIS exposure had an average revenue share of 15 per cent from trading and 46 per cent from NII during the last cycle. Among top European investment banks, the figures were 18 per cent and 40 per cent, respectively.

Market and investor pressures and especially regulatory pressures that directly or indirectly affect retail, corporate and investment banking have had a different effect on the capital leverage ratios. In 2008 top European investment/universal banks with little or no CEE/CIS exposure had a higher capital leverage ratio (risk-weighted assets to capital) than WBs with a CEE/CIS presence, namely 16.6 and 14.7 respectively (14.2 when excluding SocGen). However, in 2012 massive adjustments via asset sales took place at European investment/universal banks. Their capital leverage ratio is now 10.2, which is below the 10.8 of WBs present in CEE/CIS (10.9 when excluding SocGen). This trend reflects the intense regulatory strain on international investment/universal banks and global systemically important financial institutions (SIFIs). Moreover, it is easier to deleverage in the capital markets/trading business than in the client-driven lending business. In addition, the current low-interest-rate environment, both globally and in many CEE/CIS markets, limits profit

4 Our sample of major European investment/universal banks includes Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, Royal Bank of Scotland and UBS.

5 Although leading European investments/universal banks are targeting a broad mix of assets for disposal, the largest single categories are in trading assets and structured finance.
potential in traditional banking for WBs with a CEE/CIS presence. Among WBs present in CEE/CIS, only UniCredit and SocGen – both global SIFIs – now have capital leverage ratios more or less on par with those of major European investment/universal banks.

Table 2: Western Banks operating in CEE/CIS and their European peers

<table>
<thead>
<tr>
<th></th>
<th>Top Western Banks present in CEE/CIS</th>
<th>European universal/investment banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trading revenue adj.</td>
<td>9.6</td>
<td>27.3</td>
</tr>
<tr>
<td>Net interest revenue</td>
<td>54.3</td>
<td>63.6</td>
</tr>
<tr>
<td>Net interest revenue adj.</td>
<td>46.8</td>
<td>39.7</td>
</tr>
<tr>
<td>Cost-income-ratio</td>
<td>60.6</td>
<td>55.4</td>
</tr>
<tr>
<td>Capital leverage</td>
<td>14.7</td>
<td>14.2</td>
</tr>
<tr>
<td>Non-performing loans</td>
<td>5.0</td>
<td>8.7</td>
</tr>
<tr>
<td>Loan-to-deposit ratio</td>
<td>1.17</td>
<td>1.08</td>
</tr>
<tr>
<td>Tier-1 capital ratio</td>
<td>8.00</td>
<td>10.3</td>
</tr>
<tr>
<td>of which core Tier-1</td>
<td>7.2</td>
<td>8.7</td>
</tr>
</tbody>
</table>

Source: Company data, rating agencies and Raiffeisen RESEARCH.

Brisk lending activity in the late boom phase drove loan-to-deposit (L/D) ratios above 100 per cent in all CEE/CIS regions and at all major WBs present in CEE/CIS. This was quite a change after the early boom years (2000–2006) when there had been a significant deposit overhang in CEE/CIS. While L/D ratios of above 100 per cent are a rather novel feature for the region and WBs with a presence in CEE/CIS, L/D ratios of major West European banks in the 1995–2011 period averaged 111 per cent, and have been well above 100 per cent in each year except 1999. Moreover, well-diversified WBs present in CEE/CIS never went over the top in terms of L/D ratios at a group level, unlike some competitors, which ran ratios well above 150%.

At present, loan growth in CEE/CIS takes place in “self-funding” banking sectors with L/D ratios in or below a comfort zone of 90 to 110 per cent. All major WBs with a CEE/CIS presence managed to bring down L/D ratios due to solid deposit collection. At 105 per cent, the L/D ratios of these banks do not look excessive at the moment and are below the 114 per cent L/D ratio of other major European banks. However, it has to be acknowledged that the rebalancing of funding profiles at WBs operating in CEE/CIS was achieved in times of fairly low loan extension and GDP growth well below potential in most cases, but relatively high deposit growth. It remains to be seen to what extent deposit collection will be sufficient to finance a future expansion in all individual CEE/CIS banking markets.

Country risk mitigation by cross-border banking, some legacy problems in Hungary and SEE are noteworthy. In 2008/2009, large CEE/CIS exposures of WBs were considered a tail risk to asset quality and bank stability. However, the deterioration in CEE/CIS exposures in terms of

---

6 Trading and net interest revenues in per cent of total revenues, non-performing loans in per cent of total loans, loan-to-deposit ratio in per cent, capital ratios in per cent; the included Western Banks present in CEE/CIS are Erste, Intesa, OTP, RBI, SocGen and UniCredit.

7 Large losses due to materialisation of tail risks are excluded.
Banking in Central and Eastern Europe and Turkey – Challenges and Opportunities

Asset quality and profitability at leading WBs turned out not to be as bad as expected. This is especially clear in comparison with other major European banks. Non-performing loans (NPLs) at major European banks have nearly doubled from an average of 3.3 per cent in 2008 to some 6.2 per cent in 2012. At first sight, NPLs at leading WBs present in CEE/CIS have risen more strongly from 5 per cent in 2008 to some 12 per cent in 2012. However, much of this rise can be attributed to the very high NPLs at OTP, which took a strong hit from adverse home market conditions and currently has an NPL ratio of 23 per cent. When excluding OTP, NPLs at leading WBs in CEE/CIS increased to a level of 10 per cent in 2012, which is also more or less “just” a doubling like at other major European banks.

CEE/CIS banks are to a certain extent used to current NPL levels. NPLs in CEE stood at 8 to 12 per cent ten years ago, and had peaked well above that level. In contrast, for major European banks their current NPL level is new territory as NPLs have ranged from 2 to 4 per cent in the 1995–2007 period. Moreover, aggregate asset quality at CEE/CIS banks stabilized somewhat in 2011 and the first half of 2012, driven by the Russian, Polish, Czech and Slovak markets. Well diversified WBs benefited from the sketched asset quality trends, as opposed to those with a focus on markets like Hungary, Slovenia and several SEE countries, where NPLs continued to rise in 2012 and reached 15 to 30 per cent in some cases.

Core Tier-1 capital ratios of major European investment/universal banks are now higher than those of WBs with a presence in CEE/CIS. Major European banks with little or no CEE/CIS exposure had an average core Tier-1 capital ratio of around 10.6 per cent in 2012, up from 6.6 per cent in 2006. Leading WBs present in CEE/CIS also increased their average core Tier-1 ratio, albeit to a lesser extent: from 7.2 per cent in 2008 to 10.3 per cent 2012 (numbers do not change when SocGen is excluded). Austria’s RBI and Erste, which are both examples of WBs with a strong historical focus on retail and corporate lending, have below-average core Tier-1 ratios of 7 to 8.5 per cent when government participation capital is excluded. Other leading WBs with a presence in CEE/CIS have ratios closer to that of major European banks.

Profitability indicators like the Return on Assets (RoA) for the euro area banking sectors remained low or turned negative in 2008 and 2011, while average banking sector profitability in the CEE/CIS markets remained fairly sound in recent years, even during the
challenging years 2008 and 2011. In 2010/2011, major CEE/CIS franchises of WBs also posted solid results. In terms of profitability, Bank Pekao (UniCredit), Česká Spořitelna (Erste) and ČSOB (KBC) were among the top 25 foreign-owned subsidiaries of the global top 1,000 banks in 2011. In terms of banking markets, Russia and Poland were among the top ten countries worldwide in terms of return on capital in 2011, ranking fifth and sixth respectively. All in all, the through-the-cycle performance of well-diversified WBs active in CEE/CIS exceeded expectations in 2008/2009, and this gradually comes to the attention of external observers (rating agencies, IMF, investors). However, in Hungary and a lot of SEE banking sectors the situation remains challenging (anaemic lending, poor asset quality, RoE below government bond yield). This is mainly due to brisk pre-crisis expansion, which pushed credit-to-GDP ratios to high levels in relation to economic fundamentals and income levels in some SEE markets.

3. Relative strengths and weaknesses of leading WBs in CEE/CIS

At WBs present in CEE/CIS, country-specific downsides are at least partly offset by more resilient markets, diversified networks, presence in Russia and Poland and/or increased capitalisation. The profiles below show the respective weaknesses and strengths of WBs with at least 1000 branches and operations in at least five countries.

**Erste:**
- Operating in 7 CEE/CIS markets with 2,100 branches (below WB average), strong focus on selected CEE markets, very strong market position in selected CEE markets
- NPLs at 8.9 per cent (2011), expected to peak at around 9.5 per cent in 2012/2013; third quarter of 2012: first reduction in NPL volumes since 2007 due to NPL sales
- Risk provisioning at 63 per cent of NPLs; high credit risk concentration in Hungary and Romania (loss-making operations in Hungary throughout 2011 and the first half of 2012, in Romania since the second quarter of 2011); sound Austrian home market, but CEE/CIS operations, except for Czech Republic, too small to compensate for negative effects in Hungary and Romania; profits in CEE driven by Czech Republic and to a lesser extent Slovakia (NPLs: CZ: 5.5 per cent; SK: 7.5 per cent; RO: 27.5 per cent and HU: 25.3 per cent)
- Relatively weak capitalisation (2011 Tier 1 capital ratio: 10 per cent; 2011 core Tier 1 capital ratio: 7.8 per cent, slight improvements expected in 2012, to 11 per cent and 8.5 per cent, respectively)
- Not present in Poland, Russia (largest, attractive CEE markets), possible divestment in Ukraine

**Intesa:**
- Represented in 10 CEE/CIS markets with 1,400 outlets (below WB average)
- NPLs at 11 per cent in 2011, which may increase to around 12 per cent in 2012
- Solid position on domestic market, strong capitalisation (2011 Tier 1 capital ratio: 11 per cent; 2011 core Tier 1 capital ratio: 10.1 per cent), no further improvements required/expected in 2012
- Management committed to maintain/grow selected CEE/CIS exposure despite limited scale compared (6-7 per cent of group exposure) to UniCredit, RBI and Erste
OTP:
- Represented in 9 CEE markets with 1,400 outlets (below WB average)
- Challenging conditions in home market; domestic Hungarian operations accounted for 68 per cent of 2011 profit, share of largest foreign contributor, Russia, was 25 per cent
- Relatively high NPLs in Russia and Bulgaria (14.8 per cent and 18 per cent, respectively) compared with peers – in the case of Russia this is driven by a strong focus on consumer lending
- High overall NPLs, at around 24 per cent (2012), but solid NPL coverage of around 73 per cent
- High capitalisation (2011 Tier 1 capital ratio: 13.3 per cent; 2011 core Tier 1 capital ratio: 11.9 per cent; uptick in core Tier 1 ratio to 13 per cent expected in 2012); high capitalisation required due to perceived risk profile as a bank with a CEE home country
- Management looking to compensate for weak Hungarian lending by accelerating growth in high-margin consumer/POS lending in Russia (where OTP currently has a return-on-equity of 30 per cent) and Ukraine; however, competitive environment in Russia in consumer/POS lending can create significant challenges for OTP

Raiffeisen Bank International:
- Represented in 15 CEE/CIS markets with 3,200 branches (above WB bank average)
- Strong presence in Russia (third-largest foreign-owned bank), Russian profit contribution usually on par with other CEE sub-regions (i.e. CE and SEE)
- NPLs at 9.3 per cent (2011), expected to peak above 10 per cent in 2012/2013; very low NPLs in Austria and some CEE markets (e.g. SK: 5.2 per cent; RU: 5.8 per cent; CZ: 6.6 per cent); double-digit NPLs in Hungary (27.7 per cent), Ukraine (37.5 per cent) and several SEE markets
- Still solid risk provisioning at 66–67 per cent of NPLs, but coverage ratio decreased from around 75 per cent some 2-3 years ago; limited need for deleveraging, but some capital-intensive assets have been disposed of and Slovenian business has been restructured
- Overall lending volumes outside Austria more or less flat since four years and year-to-date loan growth mainly driven by Polbank acquisition; adjusted for consolidated negative loan growth in the first half of 2012, which limited profit growth
- Relatively weak capitalisation (2011 Tier 1 capital ratio: 10 per cent; 2011 core Tier 1 capital ratio: 6.4 per cent; improvement expected in 2012 to 11 per cent and 7.1 per cent, respectively); rating agencies consider capital buffer too low in relation to perceived risks, moderate wholesale funding reliance
- Highly diversified CEE franchise (35 per cent of exposure in non-investment grade countries); M&A in Poland (Polbank acquisition from Greece’s Eurobank) to reduce dependence on Russia
SOCIÉTÉ GÉNÉRALE:
- Represented in 14 CEE/CIS markets with 2,700 outlets (above WB average)
- Greater deleveraging needs than some CEE peers at group level, relatively high reliance on (short-term) wholesale funding at group level
- International retail business underperformed for some time, due in part to one-off charges at the Russian operation (including goodwill impairment on Rosbank), strong earnings capability in Czech Republic; NPLs at 6.5 per cent (2011), expected to pass 7 per cent in 2012, relatively cautious approach to foreign-currency denominated loans in CEE as compared to Austrian and Italian peers
- Strong capitalisation (2011 Tier 1 capital ratio: 11 per cent; 2011 core Tier 1 capital ratio: 9.3 per cent; further improvement expected in 2012 to 12 per cent and 10.5 per cent, respectively)
- Largest foreign player in Russia, combined loan book (Rosbank, Rusfinance, Deltacredit) 1.5 times larger than that of UniCredit, restructuring of the Russian operations on-going, some progress recently (net profit in the third quarter of 2012 after several quarters of net losses); ambitions to grow corporate lending in Russia, targeting synergies between Rosbank and SocGen’s global corporate and investment banking; SocGen to sell Belrosbank (from Rosbank) to Alfa Bank Belarus as Rosbank will focus on Russian market going forward

UNICREDIT:
- Represented in 16 CEE/CIS markets with about 2,800 branches (above WB average)
- Need for deleveraging less urgent, but Italian business has undergone substantial restructuring; NPLs at 12.9 per cent (2011), which may increase to around 14 to 15 per cent in 2012/2013 as conditions on the home market deteriorate, NPLs at 10.1 per cent at UniCredit Bank Austria with NPL coverage of 52 per cent; certain reliance on wholesale funding at UniCredit Bank Austria
- CEE business performing relatively well; substantial improvement in capitalisation (2011 Tier 1 capital ratio: 9 per cent; 2011 core Tier 1 capital ratio: 8.4 per cent; improvement expected in 2012 to 11 per cent and 10.3 per cent, respectively); diversified CEE/CIS franchise (30 per cent of exposure attributable to non-investment grade countries)
- Second-largest foreign bank in Russia; significant upside due to large presence in Turkey
Table 3: Strengths and weaknesses of Western Banks present in the region

<table>
<thead>
<tr>
<th>Bank/International</th>
<th>More resilient countries where the bank has a strong position:</th>
<th>More vulnerable countries where the bank has a strong position:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Erste Bank</td>
<td>Czech Republic, Slovakia; very strong market position in selected CEE markets, which leads to very solid cost-income ratios around 40% in some markets</td>
<td>Hungary, Romania, Serbia, Ukraine; no presence in Poland and Russia; diversification of CEE network not comparable to leading WBs</td>
</tr>
<tr>
<td>Intesa</td>
<td>Russia, Slovakia</td>
<td>Hungary, Ukraine, Romania; diversification of CEE network not comparable to that of leading WBs</td>
</tr>
<tr>
<td>OTP</td>
<td>High capitalisation, Russia</td>
<td>Hungary, Ukraine, Bulgaria; diversification of CEE network not comparable to that of leading WBs</td>
</tr>
<tr>
<td>Raiffeisen Bank International</td>
<td>Russia, Czech Republic, Slovakia, Poland; M&amp;A activity in Poland; highly diversified CEE/CIS network</td>
<td>Hungary, Croatia, Ukraine</td>
</tr>
<tr>
<td>Société Générale</td>
<td>Strong position in Czech Republic; highly diversified CEE network</td>
<td>On-going restructuring of Russian unit; Romania</td>
</tr>
<tr>
<td>UniCredit</td>
<td>Russia, Czech Republic, Poland; largest foreign bank in Russia and Poland; highly diversified CEE/CIS network</td>
<td>Croatia, Ukraine, Kazakhstan</td>
</tr>
</tbody>
</table>

Source: Company data, rating agencies, press coverage and Raiffeisen RESEARCH

4. Current and future challenges for WBs operating in CEE/CIS

Like their West European peers, some major WBs with a presence in CEE/CIS were hit by sovereign and/or bank rating downgrades in 2011 and/or 2012, which sometimes concerned the entire banking system. Parental downgrades by two to three notches since 2011 also affected the ratings of their CEE/CIS subsidiaries. In some cases CDS spreads of WBs with a CEE/CIS presence are more driven by sovereign risks in their home country rather than individual credit profiles. This can be seen in the “risk shift” between WBs from Austria and Italy in recent years. Some major WBs with a CEE/CIS presence are also suffering from asset quality problems on their home market or sizeable holdings of peripheral Eurozone sovereign debt, leading in some cases to a higher domestic cost of risk than in CEE/CIS markets in 2011/2012.9 This is especially true for Italian and Greek lenders, Hungary’s OTP and to some extent French banks, among which SocGen is a key regional player.

No indiscriminate deleveraging has taken place at WBs active in CEE/CIS. Like other European banks, major WBs with a CEE/CIS presence are currently focusing on boosting efficiency and reining in costs. Moreover, major Western CEE/CIS lenders are refining their business strategies. However, compared to the significant cuts European banks implemented in Developed Markets, modest deleveraging took place in CEE/CIS. This can be attributed to the behaviour of large WBs with a CEE/CIS presence based in Austria, Italy and

8 UniCredit presence in Turkey (10 to 13 per cent of total loans in the CEE portfolio) also represents a significant strength.

9 All major WBs present in CEE/CIS have local subsidiaries with better individual ratings than the parent, for example UniCredit and Pekao in Poland, Erste and Česká Spořitelna in Czech Republic, SocGen and Komerční Banka in Czech Republic and RBI and Tatra Banka in Slovakia.
France. All of the major banks (Erste, RBI, SocGen, UniCredit and Intesa) increased their CEE/CIS loan books in 2010/2011 on a cumulative basis. As a consequence, in Austria, France and Italy cross-border banking claims on CEE/CIS also remained flat or increased slightly, while banks based in these countries cut back other international activities by 30 to 40 per cent. Overall, cross-border CEE/CIS exposures of European banks are 4 to 5 per cent below their 2008 levels, while European banks reduced global exposures by around 35 per cent. The sketched trends in cross-border banking flows do not exclude substantial selective cuts made by Austrian and Italian banks in, for example, Hungary or Slovenia. However, the fact that WBs did not cut exposures in the CEE/CIS markets has not brought them some of the possible benefits of a stronger RWA ratio, such as a better capitalisation or lower leverage.

**WBs with a significant CEE/CIS presence and deep regional ownership links have bucked the trend towards cross-border deleveraging in Europe, because they still see a substantial growth and earnings potential in a lot of countries in the region.** The crucial question going forward will be their ability to fund and grow their business, i.e. to translate financial stability to credit expansion/growth. Moreover, the creditworthiness of some WBs with a CEE/CIS presence has deteriorated due to home country sovereign rating downgrades. It remains to be seen whether this will be reflected in a permanent increase in refinancing costs. According to long-term time series there is a clear link between unsecured bank bond issuance costs and the sovereign creditworthiness and this link holds especially at the lower end of the rating scale. At least in price-sensitive areas of business, like corporate finance, increased refinancing costs could translate into disadvantages for some WBs.

**Adverse effects of regulatory pressures on the lending volume of WBs active in CEE/CIS should not be underestimated.** Some global Western CEE/CIS banks, for example UniCredit and SocGen, will be affected by the regulatory treatment of global SIFIs. Others, such as RBI and Erste, will be impacted by local SIFI regulation, such as the “Austrian Finish” which also calls for higher capital ratios, as well as market pressure to increase capitalisation. Due to underdeveloped capital markets, the trend towards disintermediation in CEE is likely to be less pronounced than in Western Europe, but the risk of credit supply shortages for SMEs is all the greater. Moreover, lack of long-term refinancing opportunities combined with current regulatory pressures may lead to a shortening of loan maturities in CEE. Here, IFIs will continue to have a role in supporting leading CEE/CIS banks. Banks’ CEE/CIS subsidiaries could also be hit by stricter national banking regulation. All of the above trends could promote disintermediation in CEE, even though corporate lending in the region is still at low levels. The attraction of capital market financing is already growing in CEE – but this only has a bearing on top corporates and not on SME clients. In Western Europe, we expect some policy initiatives to support the SME sector due to its high dependency on bank lending and very negative trends in SME lending in the euro area and especially in its peripheral countries. It remains to be seen to what extent such initiatives can be implemented by the CEE/CIS countries on their own.

**Increasing country differentiation at WBs is the “name of the game”.** Going forward, WBs in the CEE/CIS region are likely to pursue highly differentiated country strategies, designed to refocus on the “right markets” or “better-quality regions”. They will probably select markets where they will invest and others where they will remain on hold or divest. KBC may
sell its operations in Russia (ZAO Absolut Bank), Slovenia (NLB stake) and Serbia. RBI is currently adjusting its presence in Slovenia significantly. Erste will offload its Ukrainian operation to locally-owned PJSC Fidobank in the course of 2013, Coba has already sold its Ukrainian subsidiary (Bank Forum) and SocGen sold Belrosbank (Belarus) to Alfa Bank. For WBs with a presence in CEE/CIS, an ability to grow the deposit base and remain profitable in every country under current funding conditions will be much more important than before the crisis. A footprint in retail banking, a highly regarded brand and an extensive branch network will be key to grow the deposit base. Refocused country strategies are also a likely trend, as the gains from RWA optimisation or optimised data reporting at WBs active in CEE/CIS have largely been exhausted. Such measures partly explain reasonable loan growth at leading WBs despite RWA reduction. Nevertheless, highly differentiated country strategies along national lines, which potentially favour some selective CEE/CIS markets vis-à-vis other markets, sit somewhat oddly with current efforts in Western Europe to achieve increased banking integration which in practice is to some extent already a reality in CEE.

**While there are still tendencies towards nationally oriented regulation in CEE, for example regarding refinancing, banking sector integration requires cost-effective supervisory structures for multinational banking groups.** Cyclically insensitive and uncoordinated national policies or resolution planning and soaring regulatory costs are the main downsides in the CEE banking sector. Complete separation of the parent WBs from their CEE/CIS subsidiaries is not a realistic option. Moreover, regulatory policies adopted at the European level, like the exercise of the European Banking Authority, need to take account of potential collateral damage to the CEE banking sector. For example, the Single Supervisory Mechanism (SSM) is still far from inclusive for non-EMU members from the CEE. Meanwhile, banks in CEE/CIS with West European parents are being buffeted by reputational problems that provide ammunition for calls to “domesticate” the banking systems. The Western European debate about separating bank activities, namely to separate fairly vaguely defined investment banking activities from deposit taking, may also have an impact on banking in the CEE region. In case of a separation, there can be some downside effects as major WBs with a presence in CEE/CIS markets are more or less traditional universal banks, with all advantages this business model offers in terms of diversification effects and more stable return profiles compared to specialised banks/banking systems. Given the smallness of the CEE banking sectors and limited international attention, WBs with a CEE/CIS presence and local regulators may need allies, such as the EBRD and the IMF, to prevent negative regulatory spill-overs. It need hardly be added that stabilisation of the euro and the euro area will be crucial to the prospects of WBs with a CEE/CIS presence. Only a sustained period of calm and recovery on European financial markets would permit capital increases at affordable cost.
Box 1: Greek-owned banks in SEE

Banks with Greek-capital are major regional players in SEE and are in the same league as their Austrian and Italian counterparts in Albania, Bulgaria, Macedonia, Montenegro, Romania and Serbia. Most Greek banks that have a presence in SEE operate in four or five countries via 400 to 600 branches. In all, Greek lenders account for 30 to 35% of total cross-border claims in a small group of SEE countries (but not in Croatia, which is dominated by the Austrian and Italian banks). In some SEE markets, Greek-owned banks’ have market shares of some 20 to 25 per cent. Although the SEE banking markets themselves remain challenging in terms of profitability and asset quality, NPLs of the Greek parent banks in their home market have topped those of some of their foreign operations in 2012: NPLs are in the range of 10 to 20 per cent in SEE markets, compared to some 16–17 per cent in Greece.

In view of the adverse home market conditions they face, the continuing presence of Greek lenders’ and only gently declining market shares in SEE (at least up to now) may surprise some observers. Greek-owned banks active in SEE have shrunk their balance sheets by only about 10 per cent since 2008. This has led to a modest fall in their average market share of five percentage points from the peak reached in 2008 to some 20 per cent in 2012. Up to a certain extent, the declining market shares of Greek-owned banks in SEE could be also interpreted as a market-based process of “flight to quality/safety”. The Greek banks’ defensive stance in SEE should also be seen in the light of high L/D ratios: 150 to 200 per cent for all foreign operations in 2010/2011 and even higher in some countries. The better than expected performance of Greek-owned lenders in the region is due to the fact that they are largely operated as subsidiaries, resulting in a degree of independence from their parent companies – a feature that SEE regulators have lately sought to reinforce. Nevertheless, conditions on both home and SEE host markets are likely to prevent the Greek banks’ earnings situation from normalising before 2013 at the earliest. Those that have not pulled out will most likely attempt to stay on in SEE in order to generate much-needed profits. Moreover, successful mergers between Greek banks themselves (like NBG and EFG) could partially strengthen their market position in some SEE countries. However, recent sales of foreign-owned Greek parent banks also caused a reduction of the Greek presence in the SEE banking sectors that might be reflected in their future market share and cross-border exposure data (e.g. Crédit Agricole separated SEE activities from Emporiki before its sale). M&A activity involving Greek-owned SEE banks and third parties is unlikely before the overall earnings situation in SEE rights itself, although it cannot entirely be ruled out.

5. Consolidation and the growing importance of Russian banks in CEE

There are few competitors to challenge the leading regional WBs in CEE. At the top end of the market, major WBs with a significant CEE/CIS presence face little competition in CEE. Poland is a possible exception as there are also many other WBs present. In CE, the top five or six regional WBs have a 30 per cent market share; when Poland and Slovenia are excluded, their share is even 50 per cent. In SEE, the top five WBs also have a 50 per cent market share, the top three (UniCredit, RBI and Erste) have a combined share of 34 per cent and there is no locally owned bank among the top five. Due to large market shares, defensive strategies by WBs could possibly have a major impact on the SEE banking sectors and economies. In CE, there are some local competitors such as OTP or PKO. The latter is among the top five CE banks and, like OTP, may seek opportunities beyond its home market. The current regulatory and market pressures on WBs may also benefit smaller locally owned competitors. However, in most of the CEE countries, domestic banks are too small in terms
of balance sheets, international presence and branch coverage to make major market
inroads in the medium term, and it would take time, or M&A activity, to roll out significant
branch networks.

**M&A activity in the next one to three years cannot be excluded, but no large deals
involving major players are expected due to defensive RWA stances.** The major WBs’
constantly need to work on their capital adequacy. This may prevent them from seizing
growth opportunities, which would make room for other players – notably Russian lenders.
Even if this happens, however, it is questionable whether newcomers will make up for the
shortage of credit from WBs in CEE.

**Russian banks – a dominating force in the home market – are increasing their footprint in
CEE and globally.** The Russian banking market, dominated by local champions (see Box 2), is
currently growing much faster than the rest of CEE and the other CIS countries. Although
962 banks have banking licences in Russia, the sector remains very concentrated. The 50
largest banks have a combined market share of 70 per cent in lending. If Vnesheconombank
(a development bank) is counted, the five largest banks are all state owned. The loan book
of the market leader, Sberbank, is 12 times the size of that of the largest privately owned
bank, Alfa. In contrast to most other CEE/CIS markets, Russia’s banking sector has recently
recorded strong growth. Lending was up 28 per cent in 2011 and almost 15 per cent in the
first nine months of 2012, while annual inflation stood at 6 per cent. Unsecured retail
lending has been rising rapidly by 40 to 50 per cent per year. Such high growth is unlikely to
persist as banks have been pumping up balance sheets beyond the ability to source funding
and generate capital. A combination of margin pressure, weaker demand and regulatory
tightening has already slowed corporate lending. It remains to be seen whether recently
introduced regulatory measures to discourage banks from aggressive (retail) lending will be
effective.

**Most large Russian banks remain CIS-centred and Sberbank is the only player with
international ambitions.** Russia’s two largest state-owned banks, Sberbank and VTB, are the
biggest lenders in CEE/CIS, with a combined market share of 20 per cent. This equals the
combined market share of the five to six leading WBs in the CEE/CIS region. However, both
Russian lenders hold the lion’s share of their assets in their home market, while their
international footprint is CIS centred. The banks’ strategies outside CIS diverge. Sberbank
gained access to the Turkish market and several CEE markets outside of CIS through the
acquisitions of Turkey’s Denizbank and Vienna-based Volksbank International (VBI, now
Sberbank Europe). While Denizbank has a high-profile franchise in Turkey, former VBI is a
small CEE player and it will take time to increase the footprint. Around 97 per cent of
Sberbank’s 19,700 branches are located in Russia and 99 per cent in CIS countries. Sberbank
Europe has around 250 branches in seven CEE countries.

**Sberbank’s limited presence in CEE will not be easily scaled up.** By way of comparison,
leading WBs are operating via 10,000 branches in CEE. Moreover, Sberbank’s management
stated that the lender will be pausing for breath after recent acquisitions, which was also
reflected in the declared non-interest in buying additional CEE exposure from Austrian Hypo-
Alpe Adria. It will first focus on integrating existing assets. However, opportunistic M&A
activity outside the CIS region cannot be ruled out and Sberbank makes no secret of its interest in the Polish market. Though, there is good reason to suppose that it is serious about the consolidation strategy as capital adequacy has declined as a result of acquisitions and strong organic growth.

**Despite its international ambitions in investment banking VTB is unlikely to pursue major acquisitions in CEE in corporate or retail banking for some time to come.** The bank needs to tackle its low capital adequacy, which stems from two large acquisitions in Russia (Bank of Moscow and Transcreditbank) and large losses in equity trading.

**Looking at other larger locally-owned players, there are few candidates for expansion into CEE.** Gazprombank has used most of its recent capital increase to grow its loan portfolio. Russian Agricultural Bank has a semi-development bank mandate with a focus on agroindustry, which makes CEE expansion an unlikely scenario. The same applies to Vnesheconombank. Nomos will have its hands full with its merger with Otkrytiye. Besides the need to rebuild its capital adequacy, Promsvyazbank has no track record of growing by acquisition, even on its home market. Alfa, the biggest Russian privately-owned bank, is a “dark horse”, since its shareholders will cash in on one large investment soon and may start looking for capital allocation opportunities. However, it is not clear at this stage whether any of this money will be invested in the bank, and if so, whether it will be used for acquisitions in Western Europe or CEE. Other Russian banks, outside the top ten, are too small to have an impact in CEE.

---

**Box 2: The Russian banking market**

*Foreign ownership in Russia is low and WBs (dominating in CEE) are defensively positioned.* In the Russian market, subsidiaries of foreign players command a market share of 17 per cent in terms of total assets in 2011 – one of the lowest readings in CEE/CIS. Nevertheless, the reported statistics overstate the level of foreign ownership because the Central Bank of Russia (CBR) treats banks controlled by non-resident entities as foreign-owned even if those entities have Russian owners. For example, Alfa Bank and Promsvyazbank are most probably regarded as foreign players. Based on a sample of the 50 largest banks, “true” foreign-owned lenders hold a total market share of 6.6 per cent as of the third quarter of 2012. Their market share had declined in the current cycle and was 4.1 percentage points below their peak in 2008. However, the 2008 data should be treated with caution as some of the pre-crisis growth was by acquisition and the acquirees were growing rapidly prior to the change of control.

*The loss of market share by leading WBs reflects a number of factors.* Firstly, the Russian banking market is expanding strongly and WBs may be unwilling to follow suit as there are signs of overheating in consumer lending. Secondly, some local players are growing at an unsustainable pace and are likely to reach their limits in terms of capital adequacy and funding. Last but not least, WBs are under intense pressure from stricter regulatory capital requirements and some of them face harsh home market conditions. This puts them at a competitive disadvantage vis-à-vis locally-owned peers. Nonetheless, the three largest foreign-owned WBs (SocGen, UniCredit and Raiffeisen) are still firmly anchored in the Russian top ten. The gap between the tenth-largest player and those ranked 11–20 remains sizeable. However, rapid growth of mid-sized players and ongoing consolidation, for example the mooted merger of Nomos Bank and Otkritiye, could make it hard for WBs in Russia to maintain their market share and remain attractive financial service providers for international and local clients.
Regulatory Actions and International Banking in CEE/CIS: Topical Evidence

Stefan Kavan (also editor of the article), Martin Bodenwinkler, Gernot Ebner, Eleonora Endlich, Maximilian Fandl, Ulrich Gunter, David Liebeg, Markus Schwaiger, Eva Ubl and Tina Wittenberger

Executive Summary

• This short article focuses on regulatory actions affecting international banks active in Central and Eastern Europe and the Commonwealth of Independent States. In this respect, topical evidence is provided covering the time period from the beginning of 2009 to the first half of 2012. The first issue concerns foreign currency lending, a widespread phenomenon in the region and an example for overly risky lending practices before the crisis. Having issued repeated warnings beforehand, regulators stepped up their efforts to restrict foreign currency lending before and especially during the crisis, when exchange rate volatility increased and credit risk started materialising in several countries.

• New requirements to strengthen capitalisation levels and foster local funding and liquidity levels have been put in place. In both cases, regulatory actions relate to lessons learned from the crisis. First, banks require higher capital buffers of better quality in order to be able to absorb the risks they take and to shield tax payers from losses in the private sector. Second, a more balanced and locally sourced refinancing structure of banks gives better incentives for sustainable credit growth rates and reduces the risk of volatile macroeconomic boom-bust cycles negatively affecting the banking sector.

• The region needs to adjust its macroeconomic as well as its banking sector business model to a “New Normal” of more balanced external positions and a more sustainable credit growth rate. In this gradual process, close coordination between all public and private actors responsible for maintaining financial stability is of the utmost importance, given the high degree of interconnectedness in the European banking system.

1. Introduction

The global financial crisis did not immediately affect the economies of Central and Eastern Europe and the Commonwealth of Independent States (CEE/CIS), but after the collapse of Lehman Brothers in September 2008, the region’s real economy and its banks were affected by the ensuing downturn in Western Europe. Since banks in CEE/CIS were little...
exposed to toxic assets emanating from sub-prime borrowers in the United States and wholesale funding played an insignificant role in their direct refinancing, their traditional business models only felt the impact when the decoupling of emerging and developed economies proved a myth and the real economy in many countries started contracting in 2009, due to strong trade interlinkages with Western Europe and depreciation pressures on local currencies.

Loans became non-performing, which in turn put the profitability and the capitalisation of banks under pressure. The stability of bank refinancing also gained attention, given the reliance of many CEE/CIS subsidiaries on their parent bank’s funding that helped to finance the pre-crisis credit boom in the absence of a sufficient deposit base and underdeveloped local currency capital markets.

This short article focusses on regulatory activities in reaction to these developments in host as well as in some home countries. Rather than enumerating an extensive list of regulatory actions, it tries to provide topical evidence covering the time period from the beginning of 2009 to the first half of 2012 focussing on those aspects most relevant for international banking groups active in CEE/CIS. The emphasis is placed on measures dealing with credit risks (especially in connection with foreign currency lending), the strengthening of capitalisation levels, as well as the fostering of local funding and liquidity levels. The article also deals with concerns of disorderly deleveraging and cross-border coordination efforts to avoid it.

2. Credit risk – restricting foreign currency lending in CEE/CIS

In many CEE/CIS countries, credit growth reached unsustainable levels in the pre-crisis years and several local supervisors took proactive steps to avoid excessive developments, such as increasing minimum reserve requirements. These macroprudential activities notwithstanding, some of the riskiest forms of lending, including asset-based, consumer lending and/or foreign currency lending (FCL) have been important drivers of pre-crisis credit growth.

The risks of FCL were largely known even before exchange rate risks materialised in the downturn, and some CEE/CIS currencies devalued strongly against their counterparts, such as the Euro, Swiss Franc and US Dollar. The Polish Financial Supervision Authority (PFSA) enacted FCL-specific recommendations as early as 2006, while Hungarian authorities’ resolve to restrict this risky form of lending was strengthened in the face of a depreciating Forint and the country’s heavy stock of FCL. Meanwhile, Austrian (home) supervisors, which had long warned of the inherent risks of FCL at home and abroad, issued guiding principles for the subsidiaries of the major Austrian banking groups active in CEE/CIS. The following subsections takes up these three countries’ regulatory actions regarding FCL.

2.a. Polish measures

The PFSA addressed the rapid growth of FX-housing loans in Poland early on and with several regulatory measures of increasing intensity. Already in 2006, Recommendation S required banks to ensure that borrowers with unhedged exposures in foreign currencies
have to be especially creditworthy: Banks granting FCLs to unhedged borrowers should assess their creditworthiness under the assumption that the foreign interest rate is at least equal to the domestic rate and the value of the loan is 20 per cent higher than the contractual one. Furthermore, the FX-exposures must be stress-tested on a regular basis (at least once a year). In 2008, Recommendation S II re-confirmed Recommendation S and improved customers’ options, as it allowed for directly repaying their FCL in foreign currency.

In 2010 under Recommendation T, stress-testing of a borrowers’ creditworthiness was accentuated even further. Banks should calculate the maximum ratio of borrowers’ debt-payment to income by taking into account a 400 basis points increase of interest rates and a 30 per cent domestic currency depreciation. Also, the PFSA implemented regulations regarding maximum indebtedness in terms of debt-to-income.

Finally, in 2011, Recommendation S** obliged banks to follow the guidelines set by Recommendation T in assessing the credit risk in case of all retail exposures financing real estate. In case of FX-exposures, the debt-repayment burden cannot exceed 42 per cent of a borrowers’ average net income.

2.b. Hungarian Measures

Against the background of a comparatively large stock of FX lending in general and Swiss Francs lending in particular, the Hungarian government took unilateral actions (by a number of legal initiatives transferring FX risk to banks), that were heavily criticised by the local banking industry as well as international banking groups active in Hungary. In December 2011, the Hungarian government and the Hungarian Banking Association concluded an agreement with the aim to cope with the high level of FX-mortgage indebtedness of private households. Thereby, the “early repayment scheme” gave clients with performing loans the possibility to repay their outstanding FCLs all at once at fixed preferential exchange rates below market rates. The scheme was scheduled from October 2011 until February 2012. Hungarian households repaid around 24 per cent of their total foreign currency mortgages’ outstanding market value. Hence, the Hungarian banking system registered a loss of 370bn HUF, part of which is, however, deductible from the bank levy in 2011 and 2012. Since the repaid loans were performing, banks also suffered from a reduction in future interest income and from a reduced average asset quality in the remaining portfolio.

Another FCL-measure (the “exchange rate protection scheme”) addresses clients with performing loans. Borrowers may apply for participation in the program until end-2012. Clients opting for this scheme are allowed to repay part of their principal instalments at fixed preferential FX rates. The difference between the fixed preferential and the market exchange rates will be accumulated on a Forint-denominated account, which is to be paid

---

3 In addition to the measures presented in more detail, the Hungarian authorities also applied macroprudential tools in the area of loan-to-value and debt servicing burden limitations.
4 Namely CHF 1 = HUF 180, EUR 1 = HUF 250 and JPY 1 = HUF 2.5.
5 See footnote 4.
back by the debtors after 60 months (repayments starting from July 2017 at the latest). The
interest payment due for the values between the exchange rate ranges shall be equally
borne by the government and the banks. In the event of exchange rate levels exceeding
certain levels\(^6\), exchange rate risks are entirely borne by the Hungarian State. According
to the Hungarian Financial Supervisory Authority (HFSA), the potentially impacted loan
portfolio amounts to a maximum of around HUF 3.3tr.

Furthermore, debtors that are delinquent for more than 90 days (the non-performance has
to be determined as of 30 September 2011) and fulfilling certain criteria, have the possibility
to convert their outstanding debt into a Forint-denominated loan. Subsequently 25 per cent
of the debt shall be cancelled by the banks. The Hungarian National Bank’s (MNB) data
indicate that a loan portfolio of approximately 375bn HUF is potentially affected by this
measure. Losses due to the aforementioned debt cancellation for banks are, according to
MNB, assumed to be relatively constrained because of existing write-offs of the concerned
non-performing mortgage loans. Parts of the losses arising for banks due to this measure are
deductible from the bank levy.

2.c. AUSTRIAN GUIDING PRINCIPLES

In early 2010, the Austrian Financial Market Authority and the Oesterreichische
Nationalbank issued Guiding principles on foreign currency lending in CEE/CIS that have
since then been applicable to the CEE/CIS subsidiaries of the major Austrian banking
groups active in the region. The target of this supervisory initiative is to reduce the high
volume and share of foreign currency loans in CEE/CIS in order to diminish the vulnerability
of the regional banking system. The initiative, which was established in close cooperation
with the affected banks, addresses the riskiest forms of FCL in CEE/CIS by curbing the flow of
new FCL in exotic currencies to unhedged borrowers of the private household and small and
medium enterprise (SME) sector, as well as exposed forms of consumer lending.

Banks committed themselves not to grant new loans in currencies other than the domestic
currency or the Euro (and/or US Dollars in the CIS region) to private households and SMEs in
CEE/CIS. Compared to Euro-denominated loans, foreign-currency lending in e.g. Swiss Francs
exposes banks to additional risks, since access to liquidity may prove more difficult,
especially in times of crisis, and exchange rate volatility is clearly higher. Moreover, a couple
of CEE countries have the perspective of joining the EMU and/or have their currencies
pegged to the Euro. In addition, banks will not introduce foreign-currency bullet loans in
combination with repayment vehicles to the CEE/CIS region in the future. With respect to
foreign-currency consumer loans, new loans in Euro (and/or US Dollars in the CIS region)
should only be granted to private households with the best creditworthiness. Continuous
affordability of the foreign-currency loan and the prevention of adverse selection must be
assured through the rigid application of country-specific criteria set by banks’ internal risk
management systems by considering measures such as loan-to-value, loan-to-income, or
payment-to-income ratios.

\(^6\) Namely CHF 1 = HUF 270, EUR 1 = HUF 340 and JPY 1 = HUF 3.3.
Clients with a natural hedge (foreign-currency income of sufficient size to service the loan), large non-financial corporations, trade finance for SMEs, as well as restructured, rolled-over or prolonged loans (new business is defined in the strict sense of the term) remain explicitly excluded from the scope of this initiative.

In a follow-up for products for which an immediate switch to local currency lending is either not viable (due to a lack of local market liquidity/hedging instruments) or would cause a severe competitive disadvantage for the banks concerned (in particular mortgage loans for private households in Euro or the remaining part of loans to SMEs), a coordinated regulatory approach will be warranted – either on a multilateral or country-by-country basis – in order to preserve a level playing field and prevent the further build-up of FX-induced credit risk.

3. Capitalisation – strengthening the risk bearing capacity

As initially mentioned, credit risk started materialising in 2009 and doubts about the risk-adequate level of capitalisation of banks came to the fore. Some regulators had already taken steps to tighten banks’ risk bearing capacity before 2009 (e.g. in Bulgaria and Croatia), while others – such as in Austria and Slovakia – raised the minimum quantitative and qualitative capital requirements during the crisis in order to ensure market confidence in their banking systems and reduce the likelihood of further state aid affecting sovereign debt levels and the tax payers.

3.a. COUNTRIES TIGHTENING CAPITAL REQUIREMENTS ALREADY BEFORE THE CRISIS

Before the global economic and financial crisis hit the CEE/CIS region, several countries – in particular in Southeastern Europe, in the Commonwealth of Independent States, as well as Bulgaria and Romania – already had capital requirements in place that exceed those required under the Capital Requirements Directive (CRD).

CEE/CIS countries that imposed tighter capital requirements on their banks prior to the crisis were in a position to relax them to some extent during the downturn. Bulgaria, for instance, with a minimum capital adequacy ratio (CAR) of 12 per cent and higher risk weights than required under the CRD, adjusted risk weights down, while maintaining the 12 per cent minimum ratio. In addition, Bulgarian supervisors sought to get the commitment by foreign parent banks to confirm their support in case of capital needs at their Bulgarian subsidiaries. At the same time, Bulgaria restricted the distribution of dividends starting in 2008.

Croatia also demanded a higher minimum CAR, namely 10 per cent, until 2008 and higher risk weights for FCLs to unhedged borrowers increased capital buffers even further. Thus, the move to CRD/Basel II would have represented a significant lowering of the required capital levels and in response, the Croatian National Bank raised the minimum CAR to 12 per cent in 2008.

The regulations concerning the minimum CAR for banks in CEE/CIS are currently very heterogeneous and the respective fragmentation of the region is highlighted in Figure 1 below.
3.b. **AUSTRIAN SUPERVISORY GUIDANCE**

The Austrian supervisors require from the largest internationally active Austrian parent institutions\(^7\) the full implementation of the quantitative and qualitative Basel III rules in respect of Common Equity Tier 1 (CET1). This implies a minimum requirement of 4.5 per cent CET1 and a capital conservation buffer of 2.5 per cent CET1 at consolidated level from 1 January 2013 without making use of any related transitional provisions - with the exception that private and state participation capital subscribed under the bank support package (which is fully loss absorbing) will be fully included in the capital base.\(^8\) As of 2012, the supervisory guidance regarding banks’ capital levels will be integrated in the capital adequacy and joint risk assessment process under Pillar II.

Furthermore, the Austrian supervisors will apply an additional capital surcharge to these banking groups at consolidated level of up to 3 percentage points of CET1 from 1 January 2016, following the international Globally Systemically Important Banks regime, taking into account specificities of the Austrian banks’ risk profile.

3.c. **SUSTAINABILITY MEASURES IN SLOVAKIA**

In January 2012, the Financial Market Supervision Unit of Národná Banka Slovenska (NBS) issued a recommendation in order to support the stability of the Slovak banking sector and calls for banks to maintain a Core Tier 1 capital ratio of at least 9 per cent to increase the risk bearing capacity of banks. Banks whose capital falls short of ensuring such a buffer should limit their distribution of profits and banks are also expected to take into consideration potential future adverse effects of a slowdown in economic growth and other risks to their profitability in their dividend policies. Furthermore, the NBS included a “no

---

\(^7\) Currently, the Austrian supervisors consider Erste Group Bank, Raiffeisen Zentralbank and Unicredit Bank Austria as large internationally active Austrian banks with respect to this supervisory guidance, given their size, systemic relevance and complex business models with numerous subsidiaries.

\(^8\) The treatment of participation capital subscribed by the state and by private investors under the Austrian banking support package will be fully in line with the final Capital Requirements Regulation grandfathering/phasing-out provisions.
deleveraging clause” in its recommendation: Any bank that needs to strengthen its capitalisation to reach the recommended level should do so by retaining earnings and/or increasing its equity capital, while avoiding the tightening of lending conditions or reducing their lending activity.

4. Funding – fostering the stability and availability of local funding

The current global financial crisis not only emphasised the risks of wholesale funding being a very volatile refinancing source for banks in times of stress, but also enhanced the status of non-bank deposits as a source of stable funding. Efforts undertaken by banks and regulators to rebalance the banks’ business and growth models should help foster the sustainability of future credit growth and also reduce macroeconomic imbalances and excessive dependences on international capital flows. The following subsection portrays regulatory actions taken by Austrian and Slovak authorities exemplifying these trends, Hungarian measures to strengthen liquidity levels and tackle maturity mismatches in FX-positions, as well as exposure limitations in force in the Czech Republic meant to strengthen the availability of liquidity in the domestic banking sector and limit large exposures.

It is well worth noting that supervisory measures relating to the funding situation of banks can sometimes be controversial and therefore require very detailed impact analyses, given that the need to improve the reliance on stable funding sources to foster financial stability in a banking system may well be interpreted as attempts of ring fencing, since (at extremis) they may render centralised cross-border liquidity management in large banking groups – such as those active in CEE/CIS – more difficult. Also, aspects relating to the deepening of financial integration in the European Single Market have to be taken into account.

4.a. Austrian Supervisory Guidance

Austrian supervisors observed that subsidiaries which exhibited high Loan-to-Local Stable Funding Ratios (LLSFRs) in boom times were more vulnerable to credit risks (and write-offs) during the crisis. In order to strengthen the stability of the local funding base at banking subsidiaries and to improve the quality and sustainability of future credit growth, the Austrian supervisors therefore aim at improving the balance of the refinancing structure of banking subsidiaries by using the LLSFR as a monitoring tool and early warning indicator for non-sustainable lending growth (danger of boom-bust-cycles). According to historical evidence, the LLSFR monitoring would also send anticyclical signals: warning about excessive credit growth in boom periods, while not requiring deleveraging in times of crisis.

According to the Austrian supervisors’ analysis, banking subsidiaries that entered the recent financial crisis with high LLSFRs in the stock, i.e. above 110 per cent, were significantly more likely to exhibit higher loan loss provisioning rates than other banking subsidiaries that had a

---

9 The exact definition of the LLSFR and its components in the stock is: volume of loans to non-banks after provisioning divided by the local stable funding (i.e. deposits from non-banks + supranational funding + capital from third parties + the total outstanding volume of debt securities with original maturities of one year or more issued by the subsidiary to investors outside their consolidated group). The flow ratio is defined using the year-on-year changes in the stock of these components, i.e. flow-LLSFR = (stock of loan portfolio(t) − stock of loan portfolio(t-1))/(stock local stable funding(t) − stock local stable funding(t-1)).
more conservative and balanced growth model. These results were broadly supported by a recent IMF paper,\(^{10}\) which concludes that “evidence for [CEE/CIS] banks suggests that the LLSFR is an appropriate tool to monitor the possible build-up of credit risk besides its more obvious role as an indicator of liquidity risk.”

Their experience led the Austrian supervisors to the prudential conclusion that a business model where a subsidiary’s stock-LLSFR is above 110 per cent and its flow-LLSFR is equally unsustainable – thus worsening the subsidiary’s situation further – runs a high risk of not being sustainable and contributes to potential vulnerabilities in crisis situations. Consequently, the Austrian sustainability package published in March 2012 contains a clear advice for internationally active large Austrian parent institutions to ensure a balanced refinancing structure in the net new lending business at their banking subsidiaries and a monitoring framework to detect developments in their LLSFRs. In order to coordinate all regulatory efforts and avoid unintended consequences, the results of this monitoring are to be openly discussed with the competent host and home supervisors in the framework of supervisory college cooperation with a view to agreeing whether constraining supervisory measures are necessary. Furthermore, parent institutions are expected to risk-adequately price intragroup liquidity transfers to their subsidiaries, as detailed in the relevant Committee of European Banking Supervisors/European Banking Authority guidelines.\(^{11}\)

### 4.b. Sustainability Measures in Slovakia

The recommendation issued by the NBS at the beginning of 2012 to support the stability of the Slovak banking sector also contains a provision related to banks’ funding. Banks are required to strengthen their stable funding\(^{12}\) by keeping a loans-to-stable funds ratio of not more than 110 per cent (stock). Any bank exceeding this ratio will be expected to submit to the NBS a plan for complying with it. Regarding their refinancing position, banks are also asked to increase their stock of long-term (agreed maturity over one year) and stable deposits (according to the banks’ observations). As with the capital provision, banks should not restrict their lending activities to customers when seeking to meet this recommendation. The NBS also gave notice that it will for the time being pay particular attention to whether banks, when conducting new transactions (including intra-group transactions), are taking due consideration of the risks they undertake and the impact of such transactions on their overall liquidity.

### 4.c. Hungarian Measures

In 2012, liquidity regulations for credit institutions were implemented in Hungary in order to strengthen the liquidity position of the banking sector and to tackle the maturity mismatch of FX-positions of credit institutions that evolved before the crisis. The MNB and the HFSA established three minimum requirements for financial institutions after an intensive consultation process with stakeholders:

\(^{10}\) Vandenbussche, J., “Funding of Austrian Banks’ CESEE Subsidiaries and Associated Risks”, IMF Selected Issues Paper, July 2012.

\(^{11}\) In particular “Guidelines on liquidity cost benefit allocation (2010)”.

\(^{12}\) Stable funds are defined as the sum of deposits received from customers and issued debt securities.
• Short-term liquidity: In January 2012, the balance-sheet and deposit coverage ratios became effective, which respectively state that credit institutions shall hold liquidity reserves for the following 30 days that should cover 10 per cent of the balance sheet total or 20 per cent of the retail and corporate deposits.

• Long-term liquidity: In July 2012, the foreign exchange funding adequacy ratio became effective, which should be at least 65 per cent and is defined as the quotient of stable foreign exchange funds (after haircuts) plus the stock of net foreign exchange swaps with a maturity over one year, divided by the weighted foreign currency denominated assets outstanding with a maturity over one year.

According to MNB, the majority of the banks meet these regulatory requirements.

4.d. INTRA-GROUP EXPOSURE LIMITS IN THE CZECH REPUBLIC

In July 2012, the Czech National Bank (CNB) tightened limits on related-party exposures in order to address the issue of foreign parent banks potentially requiring funding support from their well-funded Czech subsidiaries. Under the previous regulation, banks were allowed to take a 75 per cent haircut on their net related-party exposures (i.e. after collateral), which then had to be lower than the regulatory hurdle on maximum single-client exposures (25 per cent of regulatory capital). The CNB changed this haircut to 50 per cent, which at the maximum would double the amount of parent group exposure that banks have to take into account in the comparison against the regulatory hurdle.

5. The importance of close coordination in adjusting to a “New Normal”

The CEE/CIS region has been severely affected by the recent crisis and its macroeconomic as well as banking sector business model had to adjust to a “New Normal” of more balanced external positions and a more sustainable growth rate. While the boom years were followed by a sharp bust experience in several countries, it is important that necessary adjustments take place in an orderly manner. In this context, it is crucial to find the right balance between avoiding moral hazard, i.e. giving banks the right incentives by allowing those that mispriced risks to adjust their lending capacity downward in those areas where lending was/is given at rates below the cost of capital, while at the same time fostering coordination between market participants to avoid disorderly deleveraging in CEE/CIS.

While distinguishing between necessary deleveraging and excessive credit supply withdrawals can be a formidable task, given that supply and demand factors are difficult to disentangle, no system-wide credit crunch was recorded in CEE/CIS following the European Banking Authority recapitalisation exercise or local regulatory changes. Nevertheless, the situation in certain markets remains challenging, as banks flexibly differentiate their lending behaviour depending on the country-specific economic and regulatory environment.

In this respect, the European Bank Coordination Initiative, in short “Vienna Initiative”, was brought into life at the beginning of 2009 at the height of the financial crisis to tackle the risk of uncoordinated actions by private sector stakeholders, foremost banks, in the emerging Europe region. The Vienna Initiative provides a coordination framework which brought together international financial institutions (International Monetary Fund, the EBRD, European Investment Bank and the World Bank), European institutions (European Commission and the European Central Bank as observer), home and host country regulatory and fiscal authorities, as well as the largest banking groups operating in the region.

In the beginning of 2009 the risk was imminent that – as a response to the crisis – cross-border banking groups would try to limit losses by being the first mover out of the region and by that trigger systemic bank crises not only in individual countries, but in the region as a whole. The Vienna Initiative succeeded in preventing such behaviour, which was seen in many previous banking crises in emerging markets. It did so by ensuring that parent banking groups publicly committed to maintain their exposures and recapitalise their subsidiaries (if needed), by ensuring that national support packages for cross-border banking groups benefitted also their subsidiaries in emerging Europe, by agreeing on basic crisis management and crisis resolution principles in the region, and by strengthening cross-border regulatory cooperation and information sharing. International financial institutions (IFIs) contributed by providing support of banking systems and lending to the real economy in the region under the “Joint IFI Action Plan” in the amount of EUR 33bn by the end of 2010. These measures helped fostering coordination between the official sector, regional authorities and IFIs and set the stage for further efforts in this field. In this respect the Vienna Initiative has worked on issuing recommendations on the development of local currency and capital markets, on the role banks can play in helping with the absorption of EU structural funds, on dealing with non-performing loans, and on implementing the Basel III framework in the region. More recently, the Vienna Initiative has issued “Basic Principles for Home-Host Authority Coordination under Vienna 2.0” that are designed to enhance cooperation and coordination among the various stakeholders in the region.

6. Concluding remarks

Many of the developments in CEE/CIS before the crisis proved to have been unsustainable and required regulatory actions in home and host countries. Excessive loan growth not only fuelled macro-economic imbalances, but also weakened the systemic financial stability of several countries. While regulators already tried to act against emerging imbalances in several instances, they felt compelled to act more decisively and put their banking systems on a stronger footing against the background of the economic downturn in 2009. Although some international banks required state aid and had to reduce their exposure to CEE/CIS, for the majority of banks, the transition to the “New Normal” requires the adoption of a more balanced and sustainable business model.

In order for international banks to return to a more sustainable growth path in CEE/CIS, capital and liquidity levels need to be strengthened and the riskiest forms of lending avoided. This rebalancing also requires enhanced cross-border coordination, which will take place in a highly dynamic regulatory environment. Banks and their regulators face the
difficult task to take decisive steps towards the described “New Normal”, while the macroeconomic situation remains challenging. It not only involves a re-balancing, away from overly risky activities, such as foreign currency or purely asset-based lending, and towards a business model that supports the real economy with risk-adequately priced banking products, but also a stronger reliance on local sources of funding. In this process, which will run in parallel to the introduction of Basel III and a European Banking Union, avoiding the dangers of excessive deleveraging, which could hurt the catching-up of the CEE/CIS region, will be important and clearly remains on the regulatory agenda for the foreseeable future.
Executive Summary

• After regaining independence, the build-up of banking regulatory and supervisory environment in the Baltics was greatly helped by international regulatory initiatives. On the other hand, specific domestic circumstances (including other policy decisions such as a currency board-based monetary policy) influenced its specific design and early banking crises generally supported a regulatory approach tougher than international minimum standards.

• Over the turn of the century, the regulatory environment was notably more influenced by the emergence of increasing cross-border banking activities with its specific demands that were not at the time well recognized by the global and European-wide regulatory initiatives. As a result of the excessive lending-boom in the mid-2000s, the regulations were further tightened to counteract related risks. While country-by-country based tightening definitely helped to smoothen the cycle, undoing the credit growth fully during these years would have been neither possible nor sensible. The Baltic experience however shows that macroprudential regulation under the cross-border banking and high capital mobility requires very intensive cross-country cooperation to be effective.

• While the increasing risks of cross-border links were acknowledged, more practical coordination of regulations in the region remained limited. In particular when stricter rules were introduced only in a single country, the equal treatment of branches and subsidiaries remained problematic. Cross-border coordination of authorities remained therefore primarily concentrated around extensive information exchange as well as some contingency planning.

1. Introduction

Banking sectors in the Baltic countries started to develop from scratch in the early 1990s. The first decade was dominated by the build-up of both private and public sector institutions in a more or less traditional single-country paradigm and tried to compromise underlying international regulatory trends and ad hoc country-specific needs. The intensified integration with the Nordic banking groups after the 1997-1998 Asian-Russian crisis created however a new supervisory environment and required the formulation of suitable approach for a more multi-country cross-border context.

1 Monetary and Research Department, Bank of Finland. The author thanks Jaak Törs (Eesti Pank), Zoja Razmusa (Latvijas Banka), Dace Antuza and Ludmila Vojevoda (Finanšu un kapitāla tirgus komisija) for valuable comments and discussion. The views expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.
Efforts to contain the risks related to the credit and asset price boom of the mid-2000s, that developed hand in hand with EU accession and global financial over-deepening, added to the puzzle as domestic and international agendas tended to conflict occasionally with each other. In some cases, macroprudential domestic regulation had to be reversed to align with international agreements even if the former tended to predict forthcoming changes in the regulatory approaches during the following global crisis. Recent fundamental changes in supervisory and regulatory strategies in Europe, including the decision to move towards a single supervisory authority, at least in the euro area, will obviously take the Nordic-Baltic country context into a totally new playground.

2. International and regional context during the first decade after independence

The way how the banking system was built up in the Baltic countries during their economic transformation was in many respects the reflection of underlying liberalization and restructuring processes of international and regional financial markets. In the broader context, the European financial system had by the early 1990s got rid of most of its capital controls. That in turn mirrored an increased level of capital movements. To reflect these trends, the process of introducing common international Basel banking regulations was started in the late 1980s. The aim was to foster the level playing field and to try to improve banking sector soundness under a more globally integrated regime.

At that time, the Nordic banking sector was the prime example of these developments. Influenced, among other things, by the liberalization in the 1980s and fuelled by the fast increase in cross-border financial flows (see Figure 1 for the example of Finland), all countries developed to varying degrees sizable imbalances in their financial systems. This was reflected in a large increase in lending and asset prices and the eventual correction had detrimental consequences for macroeconomic stability as well as for the banking sector. The result was notable banking crisis (Honkapohja, 2009).

Figure 1: Finnish banks’ foreign funding (in per cent of GDP)

The policy reaction was to radically clean up the banks from problem assets and then to restructure them. This included in some cases bank resolution and also government intervention into the banks’ ownership. The situation had stabilized by around the mid-
1990s. In parallel, countries started to implement vigorously just agreed international rules on banking regulation and capital requirements were aligned with the proposals of the Basel process. As after several mergers and acquisitions a new banking structure emerged, banks started to take steps to build up also cross-border Nordic banking links. This process was most prominently mirrored in the formation of Nordea in 1997-2000. The Swedish bank Nordbanken merged with the biggest Finnish banking group Merita, Norwegian banking group Kreditkassen and Danish Unibank and formed one of the biggest banking groups at the time in the region.

At the same time the creation of a commercially oriented financial services sector was still in its embryonic phase in 1991 when Baltic countries regained independence, even if some early elements of it were already introduced under the Soviet system. Creating the banking sector was therefore one of the basic tasks in the transition process of the 1990s. Furthermore, also a wide range of other institutions that have a fundamental effect on the financial sector, like introducing private ownership, creating new accounting standards and implementing such elementary parts of the functioning market economy as bankruptcy procedures were only emerging at that time.

In these circumstances the Basel regulatory framework that had just been introduced in Europe provided natural benchmark for all Baltic countries. Almost naturally, its basic elements (including risk weighted capital adequacy requirement, large exposure limits, initial minimum capital requirement etc.) were copied into the domestic legislation even though these countries were still not members of the EU nor did their banks practice large international transactions. Besides, the implemented regulations obviously reflected a fair amount of situation specific innovations, high reserve requirements for banks (up to 10 per cent of deposits) being one such specific feature on the liquidity side. While there was no formal coordination among the three countries, bilateral contacts tended to support some convergence in approaches.

In spite of these regulatory and supervisory efforts, the first decade after independence was accompanied by several waves of bank collapses that were in many cases dealt with through outright bank closures and losses to creditors. However, as the level of financial deepening was still relatively small, the bank closures had less pronounced effects on the economy. Furthermore, as these problems reflected partly other policy choices, like strict currency-board based monetary arrangements without unlimited liquidity support to the banks, they should be partly interpreted as a result of the overall stability and rule-based oriented general approach. Partly for this reason many weak spots of banks were not fully covered by taxpayer resources at the time. An illustration of this is deposit insurance, which was introduced only in 1998 in Estonia and Latvia and even later in Lithuania.

However, for the supervisory environment these crises induced further gradual tightening of regulatory requirements that showed up most clearly in higher minimum capital requirements in all countries (at 10 per cent). However, the directions differed somewhat on liquidity regulations. In Estonia, the liquidity requirements in the form of required reserves at the central bank, which stood at a level of 10 per cent since 1992, were tightened to 13 per cent in 1997. Also their calculation base was broadened to reflect international
wholesale borrowing. It was induced also by a strict interpretation of the currency board-based monetary arrangement that essentially ruled out discretionary central bank liquidity support against domestic collateral. At later stages half of the requirement was allowed to be kept in AAA-rated and liquid foreign assets. This implied that banks had to keep well over 10 per cent of their balance sheet in cash. Not surprisingly, with such a requirement the other and more specific supervisory liquidity requirements lost their formal role. Contrary to Estonia, Latvia and Lithuania continued to stress the importance of regulatory liquidity ratios, for example Latvian banks were required to keep liquid assets at the level of at least 30 per cent of liabilities with residual maturity shorter than 30 days. At the same time, liquidity requirements in a sense of central bank reserve requirements were viewed in this context less important and were lowered notably both in Latvia and in Lithuania.

Importantly, just before the so called Asian crisis of 1997, more notable transactions by Nordic banking groups were carried out in the region. While acquisitions of minority shareholdings in some of the bigger Baltic banks did not yet break the ground fundamentally, they were important building blocks of the full market integration during the following years. Based on these acquisitions, two major Swedish banking groups, SEB and FöreningsSparbanken (later Swedbank) changed the market structure fundamentally by acquiring the majority shareholdings of the biggest Baltic banking institutions during the so called 1998 Russian financial crisis. Swedbank became a majority shareholder of Estonian-based Hansapank that by that time had built up notable positions in all Baltic countries. Similarly, SEB acquired majority shareholdings in Eesti Ühispank, Latvijas Unibanka and Vilniaus Banka that were all among the top three institutions in their respective markets. The single most important banking institution without foreign ownership in the region remained Latvian Parex Banka.

As a result, the early 2000s were influenced by relative calm in the banking sector. Baltic regulators were relieved by stabilizing the banking sector after the Russian crisis via entry of strong foreign owners. At the same time the issue of cross-border supervision and regulation was not yet a very pressing topic for home supervisors, as the risks from these positions remained subdued on a consolidated level. Primary focus of the Nordic regulators at the time was to implement changes in the global and EU regulatory environment as a number of initiatives were launched after the so called Lamfalussy and Brouwer reports. The most pressing specific subject in the field of cross-border banking in the Nordics was at the time to arrange relevant procedures and institutions for the first genuine Nordic banking group – Nordea. For a while Nordea even planned to change their incorporation to become a full EU company, which would have generated further problems of a supervisory and regulatory nature. Also, dealing with other on-going internal consolidation issues like the planned but later recalled merger between SEB and Swedbank continued to be on top of the agenda.

For the Baltic countries, however, preparation for joining the EU in 2004 implied in parallel full harmonization of existing regulations of the EU directives. In most cases this implied only technical changes or the introduction of regulatory rules that were not previously deemed necessary due to the actual market situation. However, in some cases this harmonization led to de facto loosening of previously stricter national rules.
From a global perspective, new financial stability assessment procedures introduced as a separate surveillance mechanism in the IMF added further impetus to streamline rules and procedures with the global agreements and principles. Partly influenced by that, regular stress testing was introduced into the supervisory procedures. As a curiosity one should recall that high importance was at the time given also to temporary high-fly risks like the Y2K problem during the turnover of the millennium. More seriously, after the 2001 terror attacks in New York and prior to the EU accession the importance of improving effectiveness of anti-money laundering regulation was also reflected in supervisory activities, particularly in Latvia.

3. EU accession and the roller-coaster of imbalances

During the early 2000s, the macro-prudential concerns remained mostly at the background. Concerns about accelerating credit growth led to some moral suasion, soft law initiatives in Estonia during 2002-2003 and to small deductions in the favourable tax treatment of borrowing (see Sutt, Korju and Siibak, 2011).

However, the relative calm started to change more profoundly around the time Baltic countries joined the EU in mid-2004. Primary reasons for the changed environment were lower perceived political risks, deepening labour market integration and related heightened income expectations. In the banking sector this showed up in increasing lending activity to finance a construction boom and in rising asset prices. Baltic banking activities became increasingly financed through wholesale market borrowing of primarily Nordic mother banks that by international comparisons were themselves already relatively highly exposed to this type of financing.

In parallel, internal integration of Nordic-Baltic banking groups was enhanced by full acquisition of daughter banks in 2004 and 2005 as Baltic countries had previously been explicitly defined as their home markets. That led to de facto centralization of a number of activities, including treasury operations. While in most cases the legal structure remained the same and did not intrude into the home-host division of formal supervisory responsibilities, the difference between the truly independent institutions and highly integrated branch offices became more blurred and was reflected also in a supervisory prioritization of activities.

By mid-2005 speeding up of lending activities, signs of asset price increases and further widening of external imbalances started to seriously worry the authorities. While moral suasion remained constantly part of the toolkit and was exercised actively in the following years as well (for example regarding loan-to-value issues, principles of risk assessment and client relations), the feeling was increasingly that the efficacy of it started to decline on a single country level. As the economic expansion continued and risks, referred to already as early as 2002-2003 for example in Estonia, had not materialized, the credibility of “warnings” and soft law tended to decline. Furthermore, as banking groups were increasingly directed from the overseas headquarters the moral suasion at the local level had even less effect on the strategic decisions.
During 2005-2007 there was a step-by-step regulatory tightening in all Baltic countries regarding that part of regulation that remained outside the European joint effort and these moves included basically all “usual suspects”. On capital, Latvia applied an increased 100 per cent risk-weight for commercial mortgages and established a minimum loan-to-value ratio of 70 per cent to qualify for the preferential 50 per cent risk-weight for residential mortgages. Estonia increased the risk-weight of all mortgage loans from 50 per cent to 100 per cent. A similar move, although targeting only part of the loan book of individuals, was introduced in Lithuania. On liquidity, Estonia raised reserve requirements to 15 per cent with almost full coverage of non-equity liabilities. Both Lithuania and Latvia kept their supervisory liquidity requirements at the same high level before. Latvia also doubled banks’ reserve requirements from 4 per cent to 8 per cent and widened its calculation base to include long-term liabilities and borrowing from foreign credit institutions. On loan-to-value ratios, Latvia introduced an explicit 90 per cent upper limit and a 10 per cent down-payment requirement. Lithuania introduced on a regulatory level the loan-to-value guidance of 70 per cent. However, as long as the expected growth in asset prices remained in excess of 20 per cent or more a year, its direct effect was unavoidably limited. In addition, regulatory limits to dividend payments were introduced and either the taxation of real estate transactions and income were toughened or income tax credits related to borrowing constrained further in all countries, most aggressively probably in Latvia under the so-called 2007 Anti-Inflation Plan. However, the expectation that widely differing regulatory environments in an integrated banking market would just induce a switching of assets within the banking groups and be without any real influence on risk taking, played also an important role during these years and limited further unilateral tightening of regulations.

Even if the build-up of imbalances had very similar roots and only limited variances in timing, there was no explicit coordination between the Baltic countries during the pre-crisis period. Some important differences in market structure might explain a part of it. As the Estonian market comprised almost exclusively subsidiaries and branches of Nordic cross-border institutions, in Latvia and Lithuania a notable minority role was still played by domestically owned banks. This could, for example, explain why equal treatment considerations induced Latvian authorities to lower capital requirements back to an 8 per cent minimum level in 2004.

As cross-border exposures and external imbalances built up, however, also home country attention, mainly in Sweden as the prime base for Baltic expansion, was gearing up. This was increasingly reflected in, for example, relevant stability reports and by 2007 also in a joint supervisory Memoranda of Understanding. During 2007, joint crisis management exercises were carried out and also moral suasion on the group level was intensified.

However, it should be stressed that even during 2006-2007 the Baltic exposure of Swedish banks remained relatively limited and it remained only one issue of concern in the field of cross-border activities. For example, the share of Baltic lending in the Swedbank Group peaked at 17 per cent in 2008 (see Figure 2). At the time, Danske Bank’s acquisition of Sampo Pankki in Finland (in 2006), SEB’s activities in Germany, Swedbank’s expansion to the Russian and Ukrainian market and the Icelandic bank expansion in all Nordic countries were examples of important issues on the Nordic supervisory agenda. From a risk perspective,
also the high exposure of the banking sector to international wholesale financing was increasingly on the radar screen, although before late-2007 the related risks were difficult to grasp.

Figure 2: Swedbank Group’s balance sheet and the importance of Baltic lending (in SEK bn)

While emerging integration of cross-border banking activities and related risks increasingly concerned the authorities on both sides of the Baltic Sea, the international background for the policy design was mostly determined by the implementation of Basel II capital regulations and the introduction of new IFRS accounting standards in Europe. In the Nordic-Baltic case this included widespread cross-border coordination issues as both banks’ headquarters and subsidiaries had to apply for specific supervisory treatment in the new risk assessment procedures. Increasing attention in the EU was given to improve the functioning of the single market that at the time had more to do with the harmonization of rules rather than specific cross-border stability issues. Despite the introduction of the Memoranda of Understanding between the EU member states’ authorities, the influence of cross-border stability issues remained rather limited almost until 2012, when the concept of banking union emerged in a totally new context.

Therefore, while domestic stability considerations had high importance in setting banking regulations, broader processes had their influence on the actions. In some cases, such as higher capital requirements for mortgage lending and higher capital adequacy requirements introduced to counter emerging overheating, new EU level regulations actually meant procyclical loosening of requirements as domestic regulations had to be scaled down at least after the transition period. Applying common EU regulations and preserving equal treatment was therefore not a particularly good environment to introduce or fine-tune country-specific actions addressing macroprudential concerns.

Considering this, it is not surprising that while the increasing risks of cross-border links were acknowledged, more practical coordination of regulations remained limited. In particular when stricter rules were introduced only in a single country, the equal treatment of branches and subsidiaries remained problematic. As an example, the Estonian initiative to coordinate its introduction of stricter risk weights on the mortgage loans at the regional level failed as apparently it intruded with the basic broader process of harmonization of regulations (Sutt et al, 2011). Ironically, market-specific capital requirements appeared only
few years later into the global agreements. Cross-border coordination of authorities remained therefore primarily concentrated around extensive information exchange as well as some contingency planning.

4. From rebalancing to European debt crisis

Unwinding of the Baltic credit growth and asset prices started step-by-step during the first half of 2007 and became more intense during the eruption of the global financial crisis (see Ross, 2012). The country pattern of adjustment followed broadly the same order as the initial upswing. The real estate markets and credit growth slowed first in Estonia, then with some time lag in Latvia and at last by mid-2008 the mood turned also in Lithuania. The situation worsened strongly during the post-Lehman period, when the internal adjustment process was further shocked by a collapse in external demand as global trade faced the abrupt squeeze and refinancing concerns erupted also on the Nordic banks’ group level.

This change was reflected also in regulation and supervision as the expansion concerns started to abate or disappeared altogether. Attention of regulatory and moral suasion issues was therefore turned from countercyclical capital buffering and lending procedures issues to preserving liquidity, further deepening and clarifying cross-border cooperation and dealing with specific crisis management issues, like the takeover and restructuring of Parex Banka in Latvia. Therefore, essentially no changes were introduced after that into the capital adequacy regulations, except of course for the on-going Basel II implementation, or lending procedures. Further attention was however turned to preserving banking sector liquidity that was reflected for example in swap agreements between Eesti Pank and Sveriges Riksbank in 2009.

In the European context the crisis aggravation was reflected in an overnight change in the deposit guarantee schemes and temporary government support arrangements. Also in the Nordic countries legislation was quickly changed to broaden the deposit insurance and introduce liquidity and capital support schemes. Obviously, similar changes were introduced also in the legislation in the Baltics, although in the Estonian and Lithuanian cases they were not needed during this episode (European Commission, 2011).

At the same time cross-border cooperation was intensified further, for example through supervisory colleges or cross-border stability groups (see also the Cooperation Agreement (2010)). By late 2009, it became more or less clear that the major cross-border Nordic banking groups, except for the Icelandic banks, managed to preserve their capitalization without direct government support as losses remained subdued in Nordic markets and sufficiently contained in the Baltics and were in some cases even below expectations. Only the Swedish and Danish government liquidity guarantee schemes were temporarily needed in order to cover the large exposure to the wholesale funding markets. Therefore, the crisis did not reach the levels where cross-border crisis management in the Nordics could have been tested in the most stressed circumstances.
References


Eesti Pank, various Annual Reports.

Eesti Finantsinspektsioon (Estonian Financial Supervisory Authority), various Annual Reports from 2005-2008.


Sveriges Riksbank, various Financial Stability Reports from 2005-2010.
The EIB in Central and Eastern Europe and Turkey

The European Investment Bank

The EIB is the European Union’s bank. As the largest multilateral borrower and lender, it provides finance and expertise for sound and sustainable investment projects, mostly in the EU. It is owned by the 27 Member States and the projects it supports contribute to furthering EU policy objectives. The over 2000 staff members can build on more than 50 years of experience in project financing. It is headquartered in Luxembourg and has a network of local and regional offices in Europe and beyond.

In 2012, the EIB provided over EUR 50bn of loans for projects in the European Union and beyond. The EIB’s main lending priorities are:

- Supporting jobs and growth. The Europe 2020 Strategy aims to achieve smart, sustainable and inclusive growth. For the Bank, this means investing in knowledge and innovation, supporting a “greener” and more resource-efficient economy and contributing to economic, social and regional cohesion. Small and medium-sized enterprises (SMEs), the backbone of Europe’s economy, are also a specific target of EIB financing.

- Climate action. Some 30 per cent of the Bank’s yearly financing goes to investments that mitigate greenhouse gas emissions and improve adaptation to climate change impacts. These are mainly in the energy, transport, water, wastewater, solid waste, forestry and research, development and innovation sectors. Climate action considerations are also increasingly taken into account in all of its lending activities.

The EUR 10bn capital increase approved at the end of 2012 will allow the EIB to play an even stronger role in supporting the EU recovery. The additional lending will target four priority sectors and be dedicated to supporting innovation and skills, SMEs, clean energy and modern infrastructure in the EU. The capital increase will allow the EIB to provide up to EUR 60bn, over a 3 year period, in additional lending to the EUR 50bn regular annual activity.

Under its external mandates, the EIB helps to implement the financial pillar of the EU’s foreign policy. It is active mainly in the pre-accession countries, as well as in the neighbouring countries to the South and East. The Bank also operates in the African, Caribbean and Pacific countries and Asia and Latin America. Its financing activities are aimed at supporting local private sector development, improving social and economic infrastructure and climate change mitigation and adaptation.

The EIB offers a wide range of financial products at favourable interest rates. For certain investments, the EIB is ready to accept more credit risk if this increases value added in support of EU policies. The Bank also offers technical assistance to support project preparation and implementation, particularly in countries that recently joined the European Union or countries outside the EU.

Borrowers are public sector bodies and private enterprises. Projects with a cost of over EUR 25mn are financed with direct loans. Small and medium-scale ventures and smaller
infrastructure projects are financed through credit lines in cooperation with national and regional intermediary banks (intermediated loans). In general, the EIB does not lend more than 50 per cent of the funds required for implementing a project. The EIB approval of a loan often works as a catalyst, drawing in other financing to complete the investment plan. The EIB works closely with other international financing institutions, the European Commission and commercial banks.

In addition, the European Investment Fund (EIF), of which the EIB is the majority shareholder, also promotes the implementation of EU policies, notably in the field of entrepreneurship, technology, innovation, growth, employment and regional development. The EIF’s core activities include equity/mezzanine instruments, guarantees, microfinance and securitisation.

**EIB – Strong engagement in Central and Eastern Europe and Turkey**

The EIB has been active in Central and Eastern Europe (CEE) and Turkey since 1964, when it financed the first Turkish project. In 1977, the EIB carried out its first operations in the former Yugoslavia, and in the aftermath of the political events of 1989 its activities significantly increased across the region as a whole. The first lending operations in Poland and Hungary were approved in 1990. A year later, the EIB participated in the creation of the EBRD, the European Bank for Reconstruction and Development, in which it still holds a stake.

The 10 CEE countries that have joined the EU since 2004 automatically became shareholders in the EIB, with representation in its governing bodies. Croatia will join the EU in 2013.

The overall focus of EIB operations in the region is to support full convergence of those economies to EU living standards, both in the CEE countries that are already part of the EU member states and in the pre-accession countries.

**Breakdown of signed finance contracts by country (2004-2012)**

<table>
<thead>
<tr>
<th>Member States</th>
<th>Enlargement countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>Albania</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Bosnia and Herzegovina</td>
</tr>
<tr>
<td>Estonia</td>
<td>Croatia</td>
</tr>
<tr>
<td>Hungary</td>
<td>FYR</td>
</tr>
<tr>
<td>Latvia</td>
<td>Macedonia, FYR</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Montenegro</td>
</tr>
<tr>
<td>Poland</td>
<td>Serbia</td>
</tr>
<tr>
<td>Romania</td>
<td>Turkey</td>
</tr>
<tr>
<td>Slovakia</td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td></td>
</tr>
</tbody>
</table>

The EIB plays a crucial role in supporting economic development, by addressing bottlenecks in infrastructure, which typically entails large projects that require long-term financing. Supported range from local and domestic infrastructure aimed at filling gaps, to trans-European transport and energy corridors that contribute to the full integration of the region into the Western European networks. While not exclusively, those projects often benefit from EU structural and cohesion funds financing. Structural Programme Loans (SPLs) are an
important component of EIB business. Since 2007 the Bank has approved 27 SPLs, representing an amount of just above EUR 18bn. These are co-financed operations leveraging EC grants. The EIB has greatly increased its portfolio during the 2007-2013 programming period in this area, blending EC grants with its own resources or providing technical assistance in order to leverage the impact of its financing. Moreover, having in mind the crucial role of EU funds for the region and the deficiencies in the institutional capacity for attracting those funds in some of the countries, the EIB has a strong commitment to provide advisory and technical assistance services. Joint Assistance to Support Projects in European Regions (JASPERS) provides technical expertise for any stage of the project cycle, covering technical, economic and financial aspects. The total investment cost of the more than 550 projects supported so far exceeds EUR 60bn. The Joint European Resources for Micro to Medium Enterprises (JEREMIE) and Joint European Support for Sustainable Investment in City Areas (JESSICA) are examples of how the EIB helps countries to absorb the available funds.

In the private sector, to support growth and consequently economic and social convergence of the region, the EIB is providing financing to both SMEs and larger companies. Funding specifically targeted at SMEs is made available at favourable conditions through local banks, under the condition that they provide additional funding to a matching portfolio of SMEs. In the current context, the EIB supports a rebalancing of the local banks funding model, providing long term funding resources to the sector.

The EIB is also active in direct corporate lending, for new investment projects. Competitiveness of the region is further supported through the financing of innovation and Research and Development (R&D). This is achieved via direct lending to companies, intermediated lending via banks or risk sharing mechanisms, or financing of public sector innovation.

Finally, a sizeable share of EIB financing is made available for projects supporting Climate Action mitigation and adaptation.
The Joint IFI Action Plans support the region during the financial crisis

After robust growth during the early 2000s CEE countries were hit strongly by the financial crisis. A virtual standstill of global credit markets and capital flows coincided with a sudden contraction in international and internal demand, leading to a strong correction of output. In the context of the European Bank Coordination Initiative (the Vienna Initiative) of which the EIB was one of the founders, three International Financial Institutions (IFIs) – the EIB Group, the World Bank Group (more specifically, IBRD, IFC, MIGA) and the EBRD – decided at the height of the global financial crisis in February 2009 to deliver a coordinated and targeted financial assistance to CEE. Through a Joint IFI Action Plan the institutions committed to deliver assistance of up to EUR 24.5bn in 2009-2010 to support banking sector stability. By the end of 2010, when the Joint IFI Action Plan reached its closure, the three IFIs had made available EUR 33.2bn in financial assistance, well in excess of their initial commitments.

The Joint IFI Action Plan, the banks’ commitment to the region and the EC/IMF programs were crucial to avert a systemic banking crisis in the region which could have caused severe damage to the real economy. Subsequently, economic activity picked up and the countries returned to strong growth rates. By playing a key role in restoring confidence in the region’s financial systems, the Joint IFI Action Plan demonstrated the important counter-cyclical role played by the IFIs during the financial crisis.

However, with the sovereign debt crisis in the euro area, countries in CEE have come under renewed pressure. Financial sector instability and rising risk premiums on the back of an uncertain outlook on sovereign debt are limiting private sector access to credit. Since mid-2011 cumulative funding withdrawal reached 4 per cent of GDP, with several countries hit significantly harder.

In response to the renewed pressure the EIB, the World Bank and the EBRD agreed in November last year on a New Joint Action Plan to support growth and employment in the region. The initiative includes more than EUR 30bn of joint financing for the period 2013 to 2014. Unlike the previous action plan, which focused on banks only, the new initiative concerns the entire activity spectrum of contributing IFIs in the region, as this time the focus is to restart growth in CEE countries. The IFI’s commitment is strong, as demonstrated by the fact that during the two months following the New Joint Action Plan’s announcement, the EIB has already approved loans for some EUR 3.5bn.

<table>
<thead>
<tr>
<th>Commitments and delivery under the Joint IFI Action Plan in EUR bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitments</td>
</tr>
<tr>
<td>EIB Group</td>
</tr>
<tr>
<td>World Bank Group</td>
</tr>
<tr>
<td>EBRD</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>
The European Investment Bank (EIB) is the European Union's financing institution

Under its external mandates, the EIB helps to implement the financial pillar of the EU's foreign policy. It is active mainly in the pre-accession countries of South-East Europe, as well as in the neighbouring countries to the South and East. The Bank also operates in the African, Caribbean and Pacific countries and Asia and Latin America. Its financing activities are aimed at supporting local private sector development, improving social and economic infrastructure and climate change mitigation and adaptation.

Contacts

Economics Department
(+352) 43 79 - 86147
(+352) 43 79 - 67799

European Investment Bank
98-100, boulevard Konrad Adenauer
L-2950 Luxembourg
(+352) 43 79 - 1
(+352) 43 77 04
www.eib.org