EBCI | Vienna Initiative

CESEE DELEVERAGING AND CREDIT MONITOR[1]

October 31, 2013

Funding of western banks for Central, Eastern, and South Eastern Europe (CESEE) excluding Russia and Turkey continued to decline for the eighth consecutive quarter in 2013:Q2, but only moderately so. It has so far proved resilient to the financial market turmoil in the wake of the prospective roll-back of unconventional monetary policy in the US, although this could change as implementation draws closer. Europe's forthcoming bank asset quality review and stress tests enter additional uncertainties. Private sector credit growth remained weak in CESEE, with the exception of the CIS countries and Turkey. Supply-side and demand-side factors are both responsible, but the former could become more binding as credit demand seems to be recovering faster than lending conditions, according to the latest edition of the Vienna Initiative's bank lending survey. High non-performing loans (NPLs) and regulatory uncertainty appear principal constraining factors on the supply side. Even if they are addressed, the more fundamental challenge remains to fund a meaningful credit recovery in the region with banks now committed to a funding strategy based much more on local sources and given shallow local capital markets. Western banks remain committed to the CESEE region according to the survey but are becoming more selective, which could create important challenges in markets seen as lacking potential.

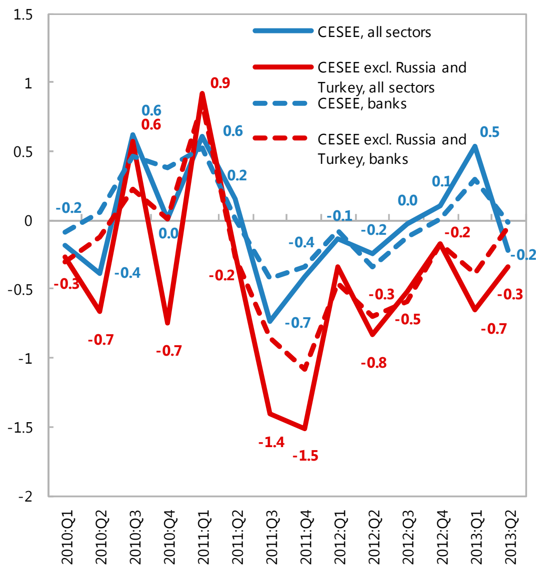
Developments in cross-border bank funding for CESEE

Funding reductions of western banks for CESEE continued in 2013:Q2 at a moderate pace (Figure 1). BIS-reporting banks reduced their external position vis-à-vis the region as a whole by 0.2 percent of GDP and by 0.3 percent of GDP vis-à-vis CESEE excluding Russia and Turkey. In this quarter, it was mainly direct cross-border lending to companies and governments that declined, while the funding for CESEE banks held roughly steady. Although funding reductions were smaller than in previous quarters, CESEE excluding Russia and Turkey has now experienced eight consecutive quarters of funding losses in the "second wave" of funding

[1] Prepared by the staff of the international financial institutions participating in the Vienna Initiative's Steering Committee. Reflects comments on earlier versions received from the Steering Committee at its meeting on October 11, 2013 in Washington DC and from the Full Forum at its meeting on October 21-22, 2013 in Brussels. Previous editions of this quarterly monitor are available at http://vienna-initiative.com.

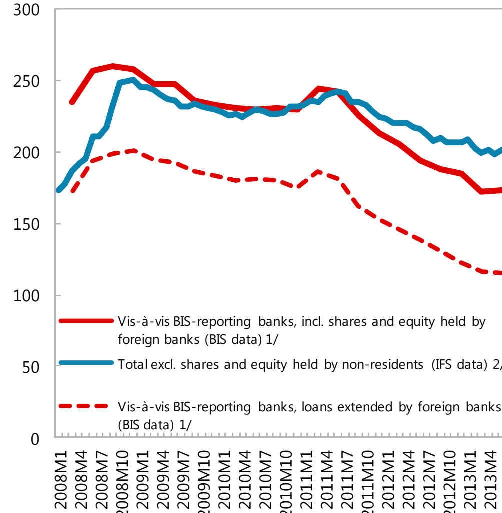
reductions that started from mid-2011. Data from the IMF's International Financial Statistics broadly mirror these trends of the BIS's International Banking Statistics (Figure 2).[2]

Figure 1. CESEE: Change of External Positions of BIS-reporting Banks, 2010:Q1-2013:Q2
(Percent of GDP)



Sources: BIS, Locational Banking Statistics: and IMF staff calculations.

Figure 2. Emerging Europe excl. Russia and Turkey: External Liabilities of Banks, 2008:M1-2013:M6
(Billions of US$)

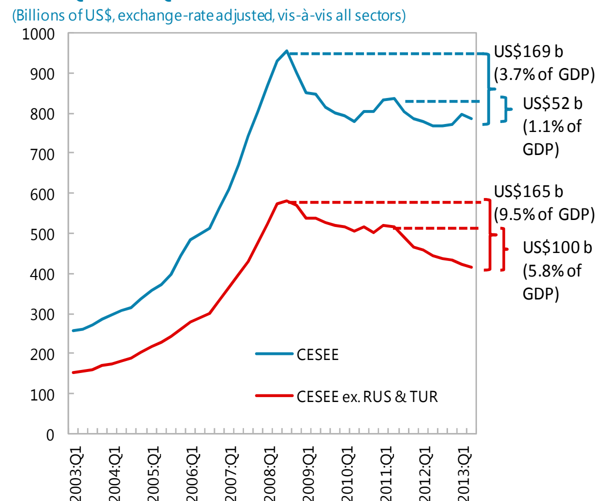


1/ BIS-reporting banks' claims on banks in emerging Europe (exchange-rate adjusted).
2/ Other depository institutions' liabilities to non-residents (exchange-rate adjusted).

Sources: BIS, Locational Statistics; IMF, International Financial Statistics (IFS); and IMF staff calculations.

Cumulative funding reductions have been sizable in the second wave of funding reductions, especially for some countries. Since mid-2011 funding of western banks for CESEE excluding Russia and Turkey fell by some 6 percent of GDP, more than during the height of the financial global financial crisis in late 2008 and 2009 (Figure 3). Funding losses over the last 12 months amounted to a more modest 1.7 percent of GDP, but some countries were much more affected than others (Figure 4). Funding from western banks declined by over 5 percent of GDP in the case of Hungary, Latvia, and Slovenia. In contrast, funding for Macedonia, Montenegro, and Slovakia rose.

Figure 3. CESEE: External Position of BIS-reporting Banks, 2003:Q1-2013:Q2
(Billions of US$, exchange-rate adjusted, vis-à-vis all sectors)

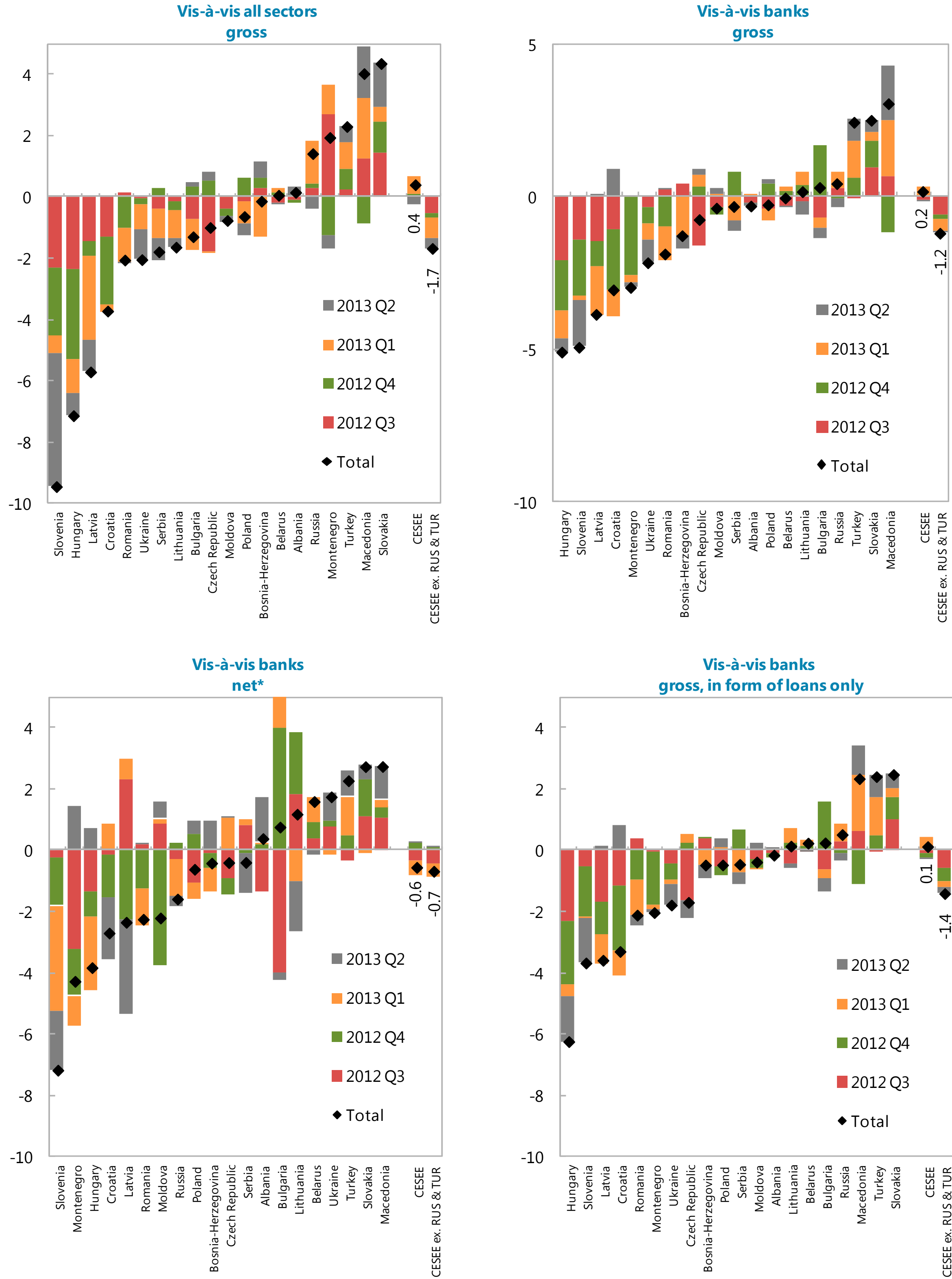


Source: BIS, Locational Banking Statistics.

[2] BIS data on western banks' external position vis-à-vis CESEE banks and IFS data on CESEE banks' external liabilities both capture western banks' loans to and deposits with CESEE banks. They therefore track each other closely. However, there is no exact match as IFS data (but not BIS data) include foreign funding from non-banks and BIS data (but not IFS data) include equity financing of CESEE banks by western banks. Moreover, data are collected from different sources so that statistical discrepancies are to be expected.

Figure 4. CESEE: External Positions of BIS-reporting Banks, 2012:Q2 - 2013:Q2

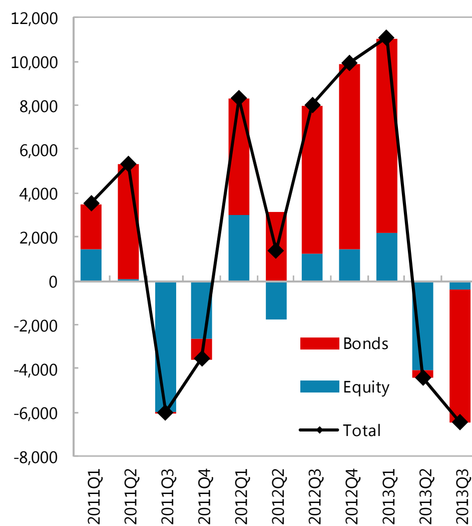
(Change, Percent of GDP)



Sources: BIS, Locational Banking Statistics; and IMF staff calculations.
* Includes changes of positions by CESEE central banks with BIS-reporting banks.

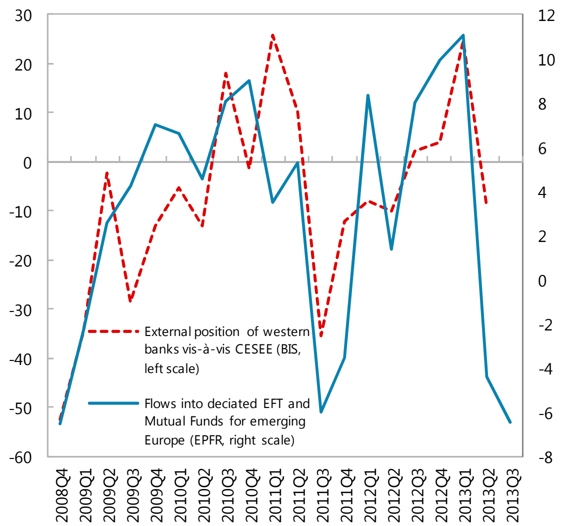
For the time being, western banks' funding for emerging Europe seems little affected by the recent tightening of financial conditions for emerging market economies, but there are downside risks going forward. The Fed's announcement of May 22, 2013 that it might soon start tapering its program of quantitative monetary easing was followed by a bout of global financial market volatility and many emerging market economies came under pressure as capital inflows declined or reversed. Countries with previously large inflows and high vulnerabilities, such as wide current account deficits, were most affected, including in emerging Europe.[3] However, even though portfolio flows and bank financing flows to emerging Europe tend to correlate rather strongly—both are driven by investor sentiment toward the region—funding reductions by western banks have so far remained modest despite a large adverse swing in bond and equity flows (Figures 5 and 6). While it cannot be ruled out that the effect on bank funding will still show up with a lag in the third-quarter data given that the Fed announcement came only relatively late in the second quarter, the more likely scenario is that bank funding for CESEE would be materially affected only if western banking groups' own financing conditions tightened significantly. In this context, any impact from tapering of quantitative monetary easing in the run-up to its actual implementation needs to be carefully monitored.[4] Equally important are possible repercussions from the forthcoming asset quality review of euro area banks and subsequent stress tests. The results and uncertainty about the likely findings could impact the funding costs of cross-border banking groups, with spillovers to their ability and willingness to provide funding for their affiliates in CESEE.

Figure 5. Emerging Europe: Flows into Dedicated ETFs and Mutual Funds, 2011:Q1 - 2013:Q3
(US$ millions)



Source: EPFR, equity and bond country flows.

Figure 6. Emerging Europe: Bank and Portfolio Flows, 2008:Q4 - 2013:Q2
(US$ billions)



Sources: BIS, Locational Banking Statistics; EPFR, equity and bond country flows; and IMF staff calculations.

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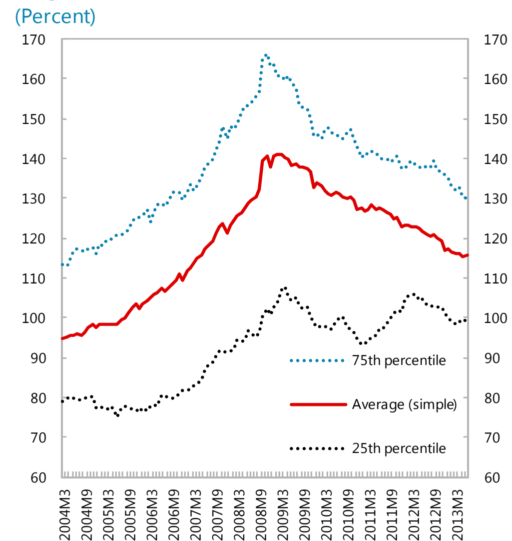
[3] See chapter I in: IMF (2013), Faster, Higher, Stronger—Raising the Growth Potential of CESEE, *Regional Economic Issues*, October.

[4] For an in-depth analysis of the likely effects from tapering unconventional monetary policy in the US see chapter 1 in IMF (2013), Transition Challenges to Stability, *Global Financial Stability Report*, October.

The medium-term is likely to bring a further trend reduction of western banks' funding for CESEE. During the boom years of 2003–08, CESEE banks built up heavy reliance on funding from their western parents—a pattern that cross-border banking groups are no longer comfortable with. As they rebalance toward a new paradigm that emphasizes local funding sources and reduce loan-to-deposit ratios in CESEE subsidiaries, funding for the banks in the region is inevitably scarce.[5] A good part of this rebalancing has already taken place—the average loan-to-deposit ratio is down to 115 percent from a pre-crisis peak of 135 percent—but funds extended by western banks to CESEE still stand at a very sizable US$416 billion (24 percent of GDP), down 28 percent from the pre-crisis peak (Figure 7 and Figure 3, above). This suggests that the process of rebalancing is not yet complete and that further funding reductions by western banks from the region are in the offing.

Figure 7. CESEE: Domestic Loan to Domestic Deposit Ratio, 2004:M3 - 2013:M6*

(Percent)



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

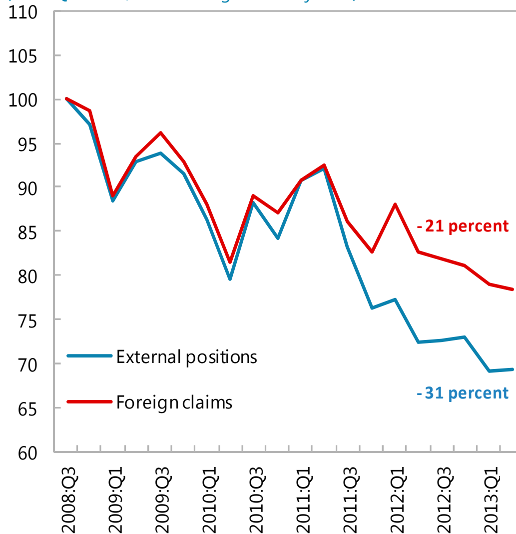
* Excludes loans and deposits from other financial institutions. Derived from Standardized Reporting Forms. May differ from "headline" ratios reported by national authorities. In the case of Russia, derived from IFS as ratio of claims on the private and nonfinancial public sectors to all deposits.

Domestic deposit growth has cushioned but not fully offset the decline of foreign bank funding. An expanding domestic deposit base allowed foreign banks to contain the contraction of their operations in CESEE excluding Russia and Turkey despite the loss of foreign bank funding. Accordingly, the decline of foreign bank exposures to the region (as measured by the "foreign claims" in the BIS Consolidated Banking Statistics) has been smaller than foreign banks' funding reductions (as measured by "external positions" in the BIS Locational Banking Statistics)—21 percent against 31percent since the 2008/09 crisis (Figure 8). However, while positive, trend domestic deposit growth has not picked up, abstracting from the gyrations during the height of the crisis, and is currently actually lower than in the pre-crisis years. Hence, the reduction of foreign bank financing has fed through into reduced overall financing (Figure 9).

[5] The changing CESEE banking paradigm is discussed in more detail in IMF (2013), Financing Future Growth: The Evolving Role of Banking Systems in CESEE, *Regional Economic Issues*, April.

Figure 8. CESEE excluding Russia and Turkey: External Positions and Foreign Claims, 2008:Q3 - 2013:Q2

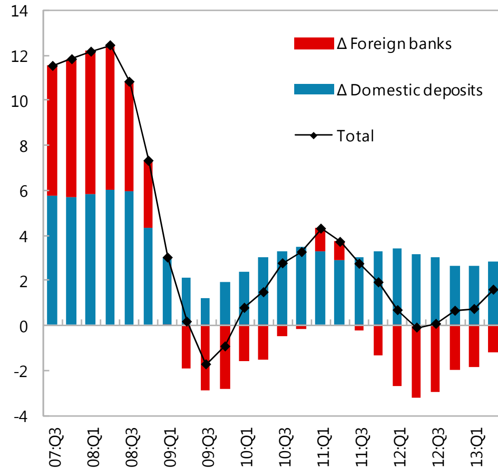
(2008:Q3 = 100, not exchange-rate adjusted)



Source: BIS, Locational and Consolidated Banking Statistics.

Figure 9. CESEE excl. Russia and Turkey: Evolution of Main Bank Funding Sources, 2007:Q3-2013:Q2*

(Percent of GDP, 4-quarter moving average, exchange-rate adjusted)



* Excludes Montenegro and Kosovo because of data unavailability.

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

The funding base for CESEE banks might remain weak even when foreign funding reductions have eventually subsided. Once cross-border banks have brought down loan-to-deposit ratios and parent bank funding to levels they feel comfortable with in the next few years, rebalancing will cease being a drag on overall funding of CESEE banks and domestic deposits will become the predominant driver of funding availability. Domestic deposits can be expected to continue to grow, but overall funding availability is set to remain much tighter than in the pre-crisis years, implying lower credit growth, less investment, and lower growth potential. Developing supplementary funding sources for investment and ensuring efficient allocation of credit will therefore be important priorities.[6]

Credit developments

Private sector credit growth has remained very weak in CESEE excluding Russia and Turkey. In nominal and exchange-rate adjusted terms, credit is currently expanding at a rate of only 1.2 percent, marginally less than a year ago and implying shrinkage in real terms (Figure 10). Several countries are still experiencing an outright contraction of nominal credit. The weakness of lending pervades both lending to households and lending to corporates and is slightly more pronounced in the corporate segment (Figure 11).

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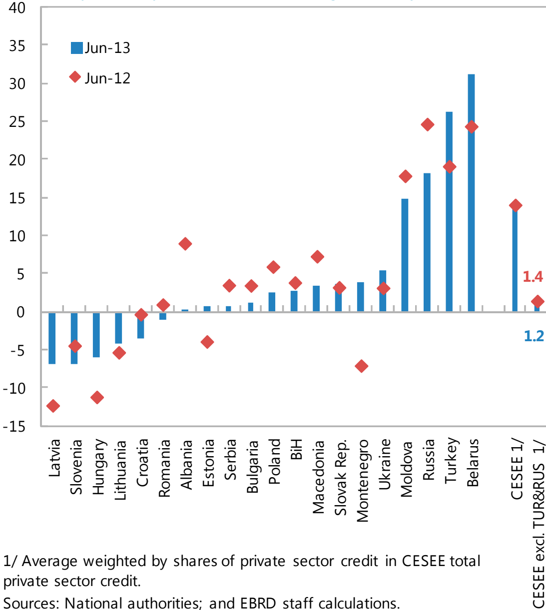
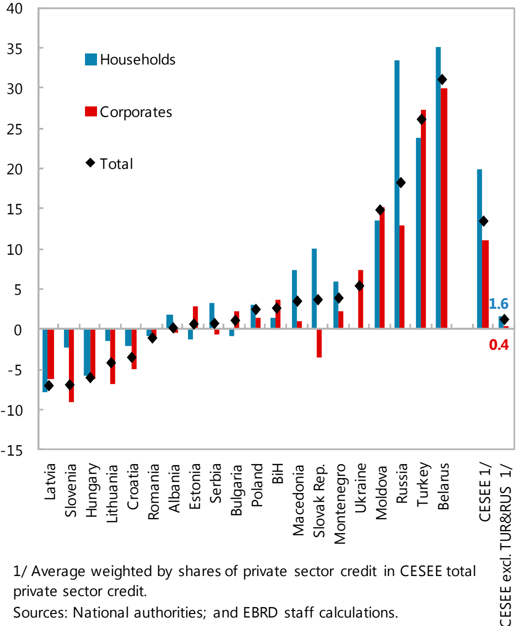
[6] Domestic deposits currently expand at about 3 percent of GDP per year. This is sufficient for keeping deposits constant as a share of GDP at nominal GDP growth of 6 percent, but not more (assuming a deposit-to-GDP ratio of 50 percent). The implications of reduced financing availability for investment and the region's growth potential are discussed in more detail in IMF (2013), Faster, Higher, Stronger—Raising the Growth Potential of CESEE, *Regional Economic Issues*, October.

Figure 10. CESEE: Growth of Credit to the Private Sector
(Percent, year-on-year, nominal, exchange-rate adjusted)



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

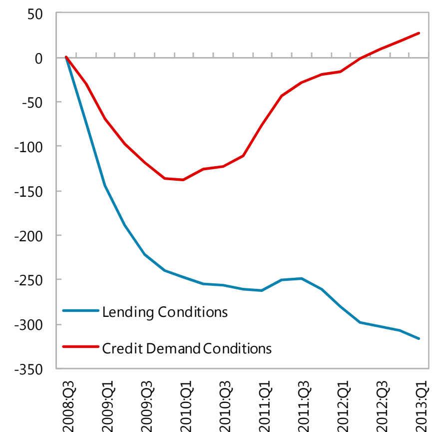
Figure 11. CESEE: Growth of Credit to Households and Corporations
(Percent, year-on-year, nominal, exchange-rate adjusted)



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

Weak credit growth reflects a plunge in supply and demand of loans following the 2008/09 crisis. As the economic outlook took a dramatic turn for the worse, customers became much more reluctant to take out loans and banks much more cautious in extending them. The ensuing steep rise in NPLs attests to many over-extended borrowers, although CESEE countries are typically not considered as suffering from a generalized debt overhang.[7] Cross-border banking groups operating in CESEE came under market pressure themselves and their fundamentals deteriorated, prompting them to reduce credit supply, tighten credit conditions, and embark on a rebalancing of funding sources for their CESEE operations from parent-bank funding to local sources. Empirical studies confirm the important role of macroeconomic factors in the downturn of credit growth and show that factors on the supply side, such as bank fundamentals and funding costs, have a significant effect on credit growth.[8] Bank lending surveys by central

Figure 12. CESEE: Cumulative Change of Lending and Demand Conditions*
(Cumulative "net percentage" from 2008:Q3 in Bank Lending Surveys. Increase indicates an easing of banks' lending conditions and an increase of demand for banks loans.)



* Simple average for Albania, Latvia, Lithuania, Hungary, Poland, and Romania.
Sources: National Central Banks; and IMF staff calculations.

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[7] See for example chapter 3 in: Mitra, P., M. Selowsky, and J. Zalduendo (2010), *Turmoil at Twenty—Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union* (Washington DC: The World Bank).

[8] See chapters II-C and II-D in: IMF (2013), Financing Future Growth: The Evolving Role of Banking Systems in CESEE, *Regional Economic Issues*, April; and Avdjiev, S., Z. Kuti, and E. Takata (2012), The euro area crisis and cross-border lending to emerging markets, *BIS Quarterly Review*, December.

banks—available for six countries in the region—point to lending conditions having tightened substantially in successive rounds and a sizeable drop of credit demand in the post-crisis years (Figure 12). Lending conditions started easing during mid-2010 to mid-2011, but tightening resumed with the second wave of funding reductions thereafter.

More recently, the pace of tightening has been slowing while credit demand has started to pick up. In order to devise policies that help support a recovery of actual credit growth it will be important to identify in more detail which underlying factors hold back demand and supply and how binding they are. The Vienna Initiative's CESEE Bank Lending Survey, conducted by the EIB, focuses on the cross-border banks operating in CESEE and tries to shed light on these aspects.

The Vienna Initiative's CESEE Bank Lending Survey

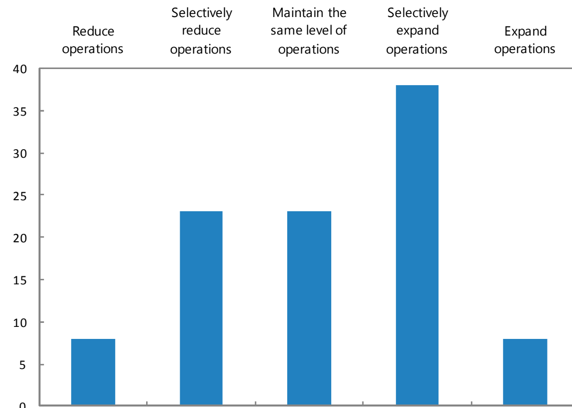
The third run of the survey took place during September 2013 and targeted pertinent cross-border banks at the group and subsidiary levels, while also making an effort to include locally-controlled banks of sizable market share on a stand-alone basis. In all, it covered 14 cross-border banking groups and 73 subsidiaries and locally-controlled banks, corresponding to over 50 percent of banking system assets on average. Questions related to group and subsidiary level strategies, intra-group linkages, and demand and supply developments, along with the factors driving them. The survey has backward and forward looking components.

Banks are continuing with their group-wide restructuring process. Cross-border banking groups active in CESEE have engaged and expect to continue to engage in various forms of strategic restructuring with a view to improving their overall capitalization and strengthening their core activities. While past efforts focused on raising capital on the market, future efforts are expected to emphasize the sales of assets and affiliates. Some 40 percent of banking groups report that group-wide deleveraging remains on the agenda, although this is considerably less than the 70 percent that said so in the previous run of the survey. Concerns about group-level funding constraints are easing, reflecting better funding from retail and corporate deposits along with improvements of conditions on interbank markets, which allowed banks to reduce recourse to central bank financing.

Cross-border banks remain generally committed to CESEE, but report that their regional strategy has become more selective. Operations in CESEE continue to be a key component of their global strategy for most banking groups active in the region. For slightly more than 50 percent of them, CESEE operations deliver higher profitability in terms of return on assets than their overall group operations. However, opportunities are seen to vary significantly within the region, prompting banks to become more discriminating across countries and to potentially reposition in some markets. Some 30 percent of respondents envisage reducing or selectively reducing their operations in CESEE, against roughly 45 percent that report a likely expansion or selective expansion of CESEE operations in the future (Figure 13). This is a more differentiated

picture than in the previous run of the survey where the vast majority wanted to maintain operations at current levels, 7 percent intended to reduce or selectively reduce and 36 percent planned to expand or selectively expand. About 30 percent of subsidiaries are considered as weakly positioned for a proper exploitation of local market opportunities or as located in markets with low potential. Opportunistic M&A activities, assets swaps, and market consolidation are hence likely to pick up going forward. At the same time, countries where foreign-owned subsidiaries are currently important but that are no longer perceived as an attractive business proposition could face challenges.

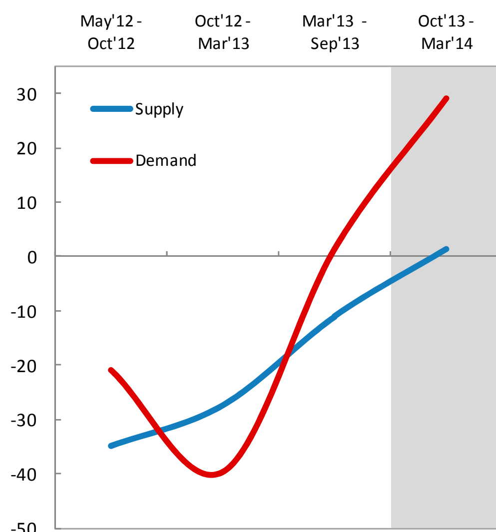
Figure 13. Group-level Longer-term Strategies
Looking at operations via subsidiaries in CESEE, the group intends to…



Source: Vienna Initiative, CESEE Bank Lending Survey.

Constraints on both credit demand and supply seem to be easing, with the process somewhat more advanced on the demand side (Figure 14). By a narrow balance, CESEE subsidiaries report for the first time an increase of demand for loans and credit lines, mostly related to debt restructurings and working capital needs. On the credit supply side, the balance is still tilted toward tightening but less strongly so that in the past. Indeed, the picture differs between lending to households and corporate clients. For the former the balance has already swung into easing territory, driven by developments in the consumer credit segment, while the latter still face a tightening of supply conditions on balance, especially in lending to small and medium size enterprises (SMEs). Over the next six months these trends are expected to continue, according to the survey: a larger number of respondents expect an increase of credit demand and fewer respondents expect a tightening of credit conditions, thereby moving the balance of opinion for the supply side to neutral for the first time. Expectations of improving credit demand rest on higher consumer confidence and larger non-housing related outlays by households, in addition to continued positive contributions from debt restructurings and working capital needs. Respondents foresee a less pronounced pickup of credit demand in the corporate segment. Differentiation of the supply side conditions is expected to continue, with households facing easier lending terms than the corporate segment, where the balance remains slightly tilted to the tightening side in the next six months.

Figure 14. Demand and Supply Conditions, Past Developments and Outlook
(Net percentages: negative supply-side values indicate a tightening of credit standards and positive demand-side values indicate an increase of demand)



Source: Vienna Initiative, CESEE Bank Lending Survey.

Supply conditions are driven by factors related to the domestic market in which the respective CESEE subsidiaries operate in, as well as international factors affecting the cross-border banking group to which they belong (Figure 15):

- **High NPLs constraining.** High levels of NPLs at the subsidiary and the group level are the factor most prominently reported as weighing on credit supply. With about half of all respondents expecting NPL ratios to rise further, the predominant view is that their negative effect on lending conditions will persist.

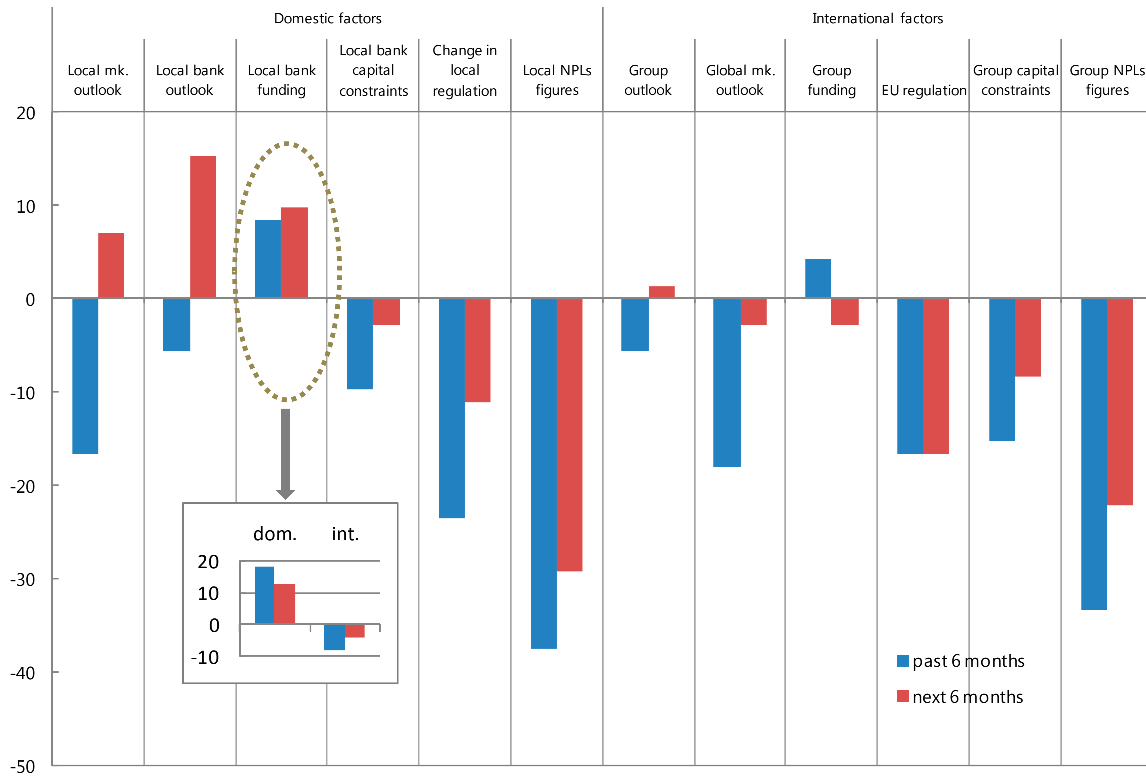
- **Regulatory changes constraining.** CESEE subsidiaries report by a wide margin that regulatory changes in their respective local markets and at the EU level contribute to tight lending conditions. Going forward, the negative role of local regulatory changes is expected to decline, perhaps because local regulation is stabilizing after a period of adjustment in the wake of the 2008/09 crisis. In contrast, changing EU regulation is widely expected to remain as constraining a factor as in the past, probably reflecting the ongoing overhaul of the financial architecture of the EU and the euro area.

- **Funding availability not a widespread independent pressure point.** Subsidiaries' access to international funding is predominantly reported as a constraining factor, with tight parent bank funding ameliorated to some extent by funding provided by International Financial Institutions. However, a reported improvement of local funding availability from retail and corporate deposits means that overall funding is not reported as a widespread constraining factor for lending. Apparently, an overall cautious post-crisis approach to lending means that funding availability is not much of a direct limiting factor in an environment where credit demand is also subdued. However, this could change as other constraining factors ease and credit demand recovers. Another complication is that much of the now locally sourced funding is at short tenors and therefore not well suited to support long-term lending.

- **Local economic and banking outlooks expected to help ease lending conditions.** For the first time, the view predominates amongst CESEE subsidiaries that the local economic outlook will help make credit conditions easier in the period ahead. Likewise, the outlook for local banking profitability is expected to turn from a factor having predominantly weighed on lending conditions in the past to one that will mostly contribute to easier conditions. Previous runs of the surveys had also reported such expectations of a turnaround in the outlook for local banks that, however, failed to materialize.

Figure 15. Domestic and International Factors Affecting the Supply of Credit

(Net percentage; negative values indicate tightening of credit conditions)



Source: Vienna Initiative, CESEE Bank Lending Survey.

Conclusions and the way forward

The moderation of funding reductions by western banks from CESEE is a welcome development but uncertainties lying ahead call for continued vigilances. Concerns about large funding withdrawals at the inception of the second wave of funding reductions in mid-2011 had been a key impetus to revive the Vienna Initiative with a view to keeping any deleveraging gradual and orderly. The subsequent decline of funding reductions has therefore been a welcome development, although individual countries experienced substantial outflows over time. However, a potentially difficult terrain may still lie ahead. The prospective roll-back of unconventional monetary policy, the forthcoming bank asset quality review and stress tests in Europe, and other uncertainties could yet lead to a reacceleration of bank funding reductions vis-à-vis CESEE. Monitoring, preparedness, and coordination therefore remain important—the Vienna Initiative will continue to provide a platform for the key stakeholders.

The persistent lack of credit growth in CESEE excluding Russia and Turkey remains a concern that needs addressing in a multipronged approach. While both demand-side and supply-side factors have played a role thus far, going forward supply-side constraints will likely be more binding and therefore particularly important to tackle. High NPLs and changes in bank regulation seem to be the most predominant constraining factors on the supply side. It is

important that NPL resolution is accelerated by removing tax, regulatory, and judicial obstacles, and through a concerted effort to break the cycle of high NPLs, low credit growth, and subdued economic activity. Improved collateral execution, judicial and legal processes, and out-of-court procedures will not only help NPL resolution but also put in place a framework that can support a higher level of credit in the economy. Regarding regulatory reforms, the Vienna Initiative will continue to draw attention to the implications for CESEE countries, whether inside or outside the EU, as the new financial architecture for the euro area and the EU takes shape. Beyond these immediate constraining factors on credit supply, the more fundamental question is how a meaningful recovery of credit growth in CESEE would be funded with banks committed to a funding strategy based on local sources and local capital markets still shallow. While local capital market development remains a medium-term objective, the Vienna Initiative will look into the merits of credit enhancements to improve the allocation of credit to potentially underserved segments, such as SMEs, and by enhancing the volume of credit by helping mobilize additional funding.

With the more selective post-crisis approach of western banks to the region possibly giving rise to challenges for individual countries, it will be important to avoid hasty and uncoordinated moves. As banks draw lessons from the boom-bust cycle in much of CESEE and adjust to the new global banking environment, their approach to the region is becoming increasingly selective. Strategic disengagement from countries with insufficient potential and critical mass or which no longer fit into the group-wide strategy cannot be ruled out. Considering that host country operations might be small from a bank-group perspective yet systemic for the host country banking system, transitional challenges loom large. They need to be carefully managed through close coordination among bank groups, their subsidiaries, as well as home and host regulators, and by allowing generous time lines.