Cross-border banking in the balance

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Future of cross-border banks uncertain

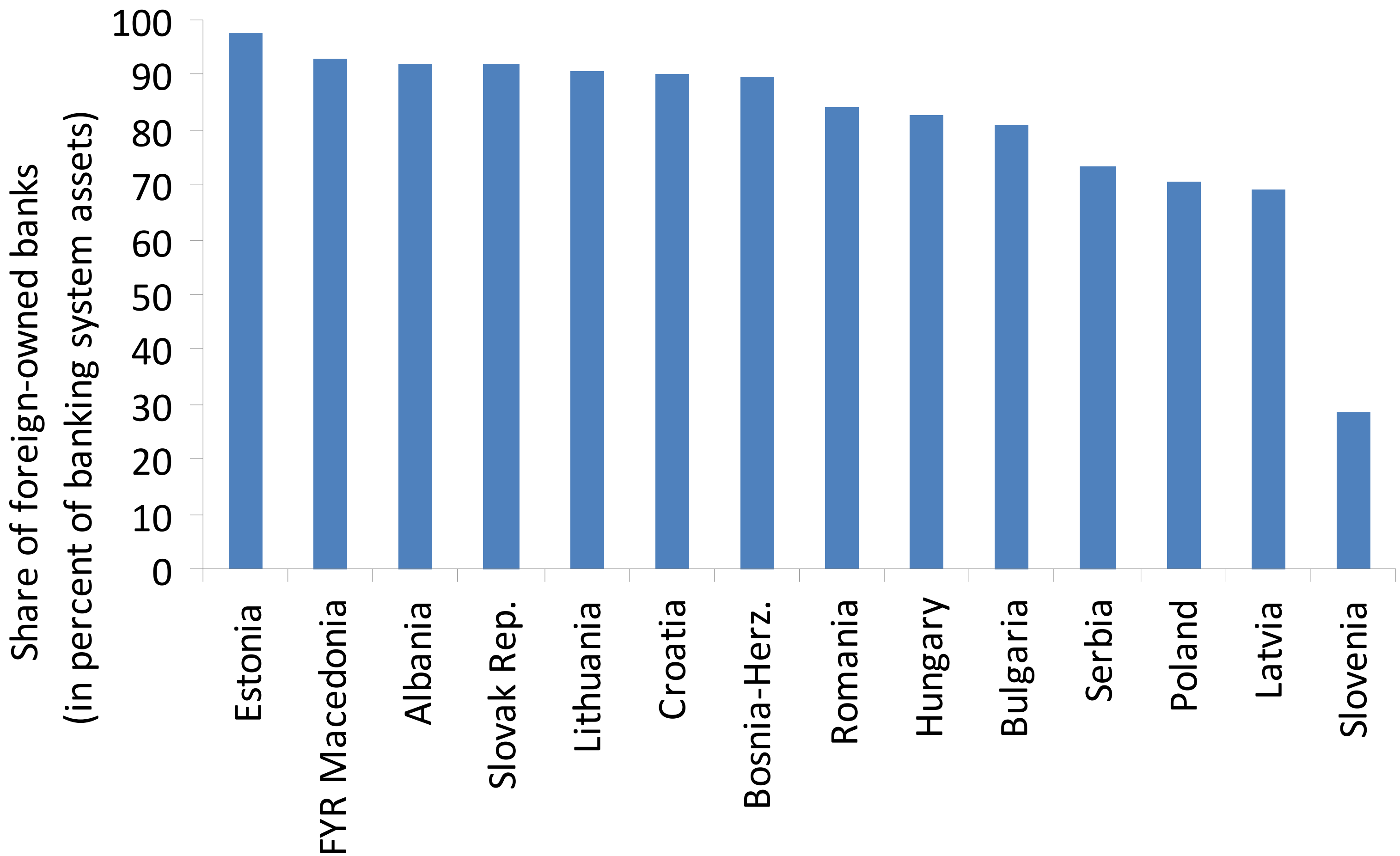
- Home countries: weak parents and sovereigns, and exposures unacceptable to taxpayers
- Host countries: unacceptable exposure in crisis
- Global agenda biased against emerging markets: capital, liquidity, cross-border resolution etc.
- **If cross-border banking has a future, it must be in the Eurozone**
- **To have a future, it must survive current crisis**
- **Vienna 2.0 needed**

Banks brought growth and stability

Unique among emerging markets (EBRD TR 2009)

- Positive impact due to high penetration and sound institutions
- Liquidity outflows more modest
- Commitments to subsidiaries *buffered* EU shock

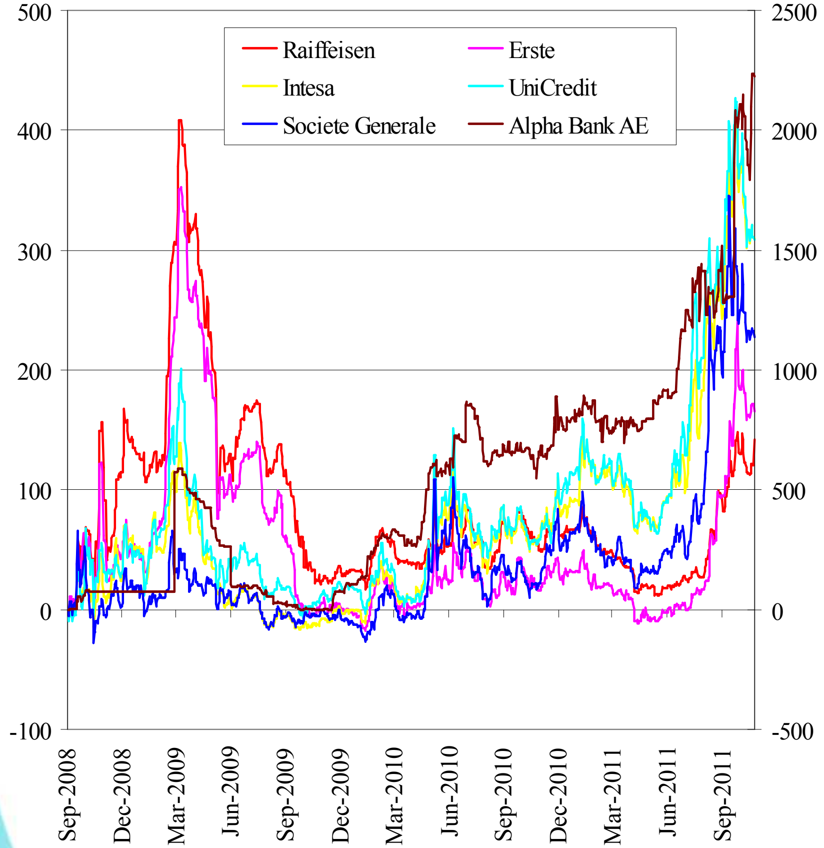
Banking systems dependent on EZ banks



Banks' funding more difficult than in 2008

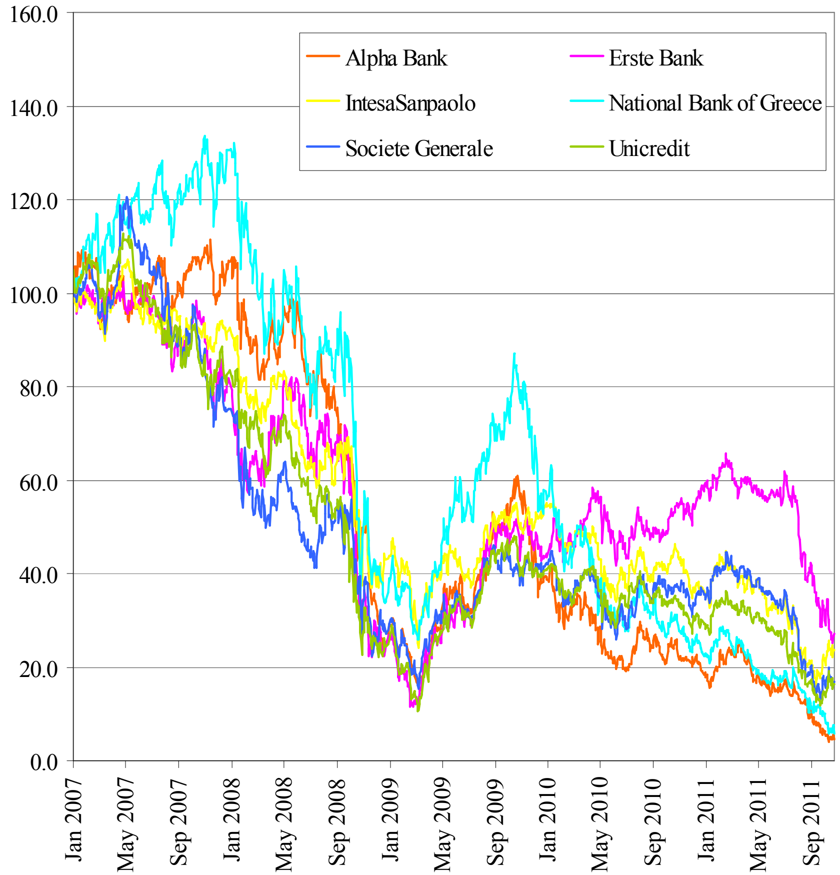
CDS spreads of some parent banks

(change in bps from 01/09/2008)



Share prices of some parent banks

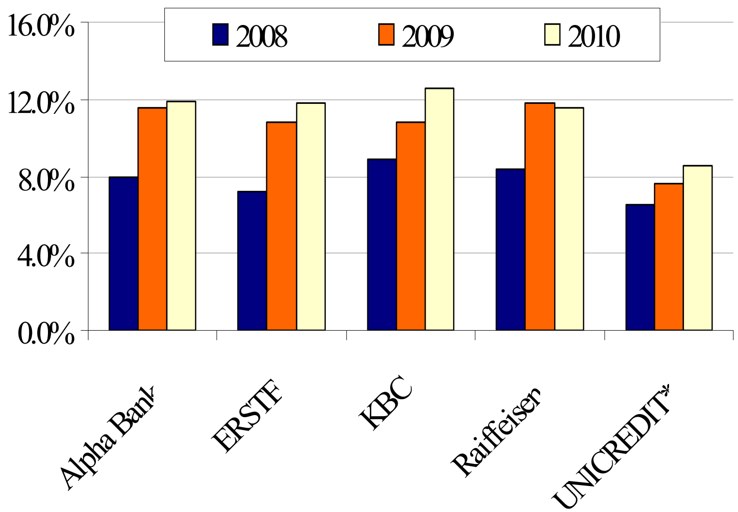
(1 January 2007 = 100)



Source: Bloomberg

…and parent bank capital still inadequate

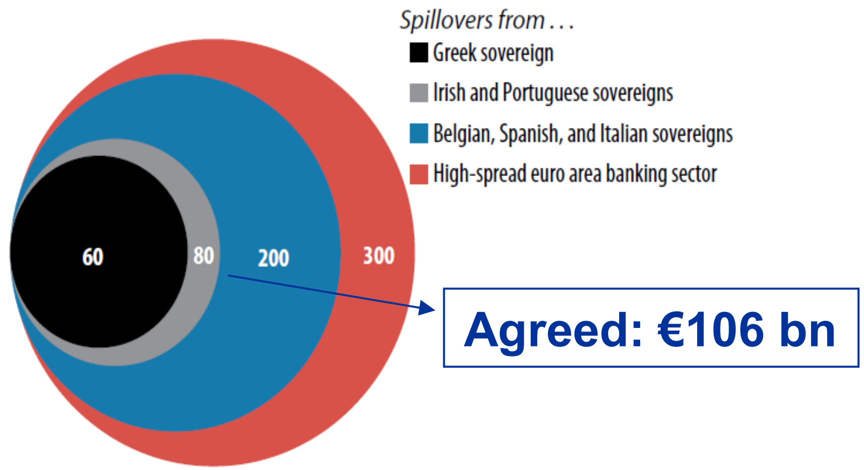
Tier 1 Capital Adequacy Ratio at group level



**Core Tier 1, 2009: before capital strenghtening*

Source: Banks' annual reports

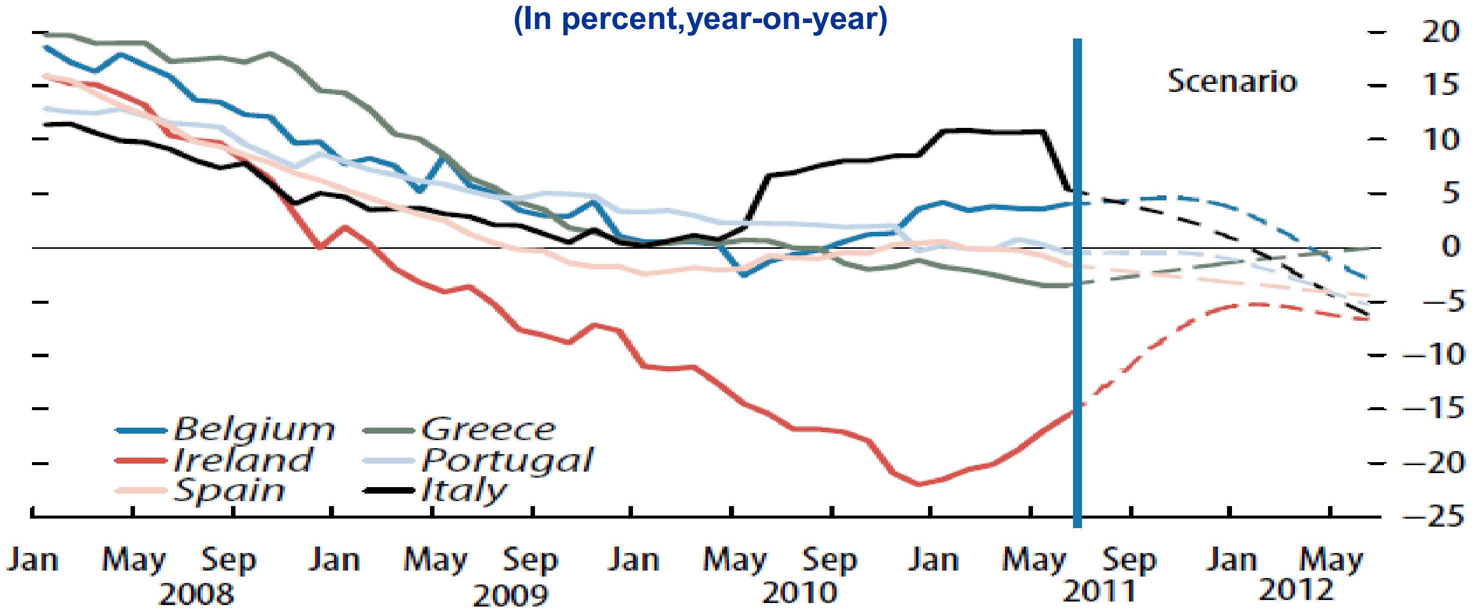
Spillover from euro sovereigns to the EU banking system



Source: IMF staff estimates.
Note: The size of the circles is proportional to the size of the spillover. Includes banking systems in 20 European Union countries. The high-spread euro area countries are Belgium, Greece, Ireland, Italy, Portugal, and Spain. Figures are rounded to the nearest 10 billion euros.

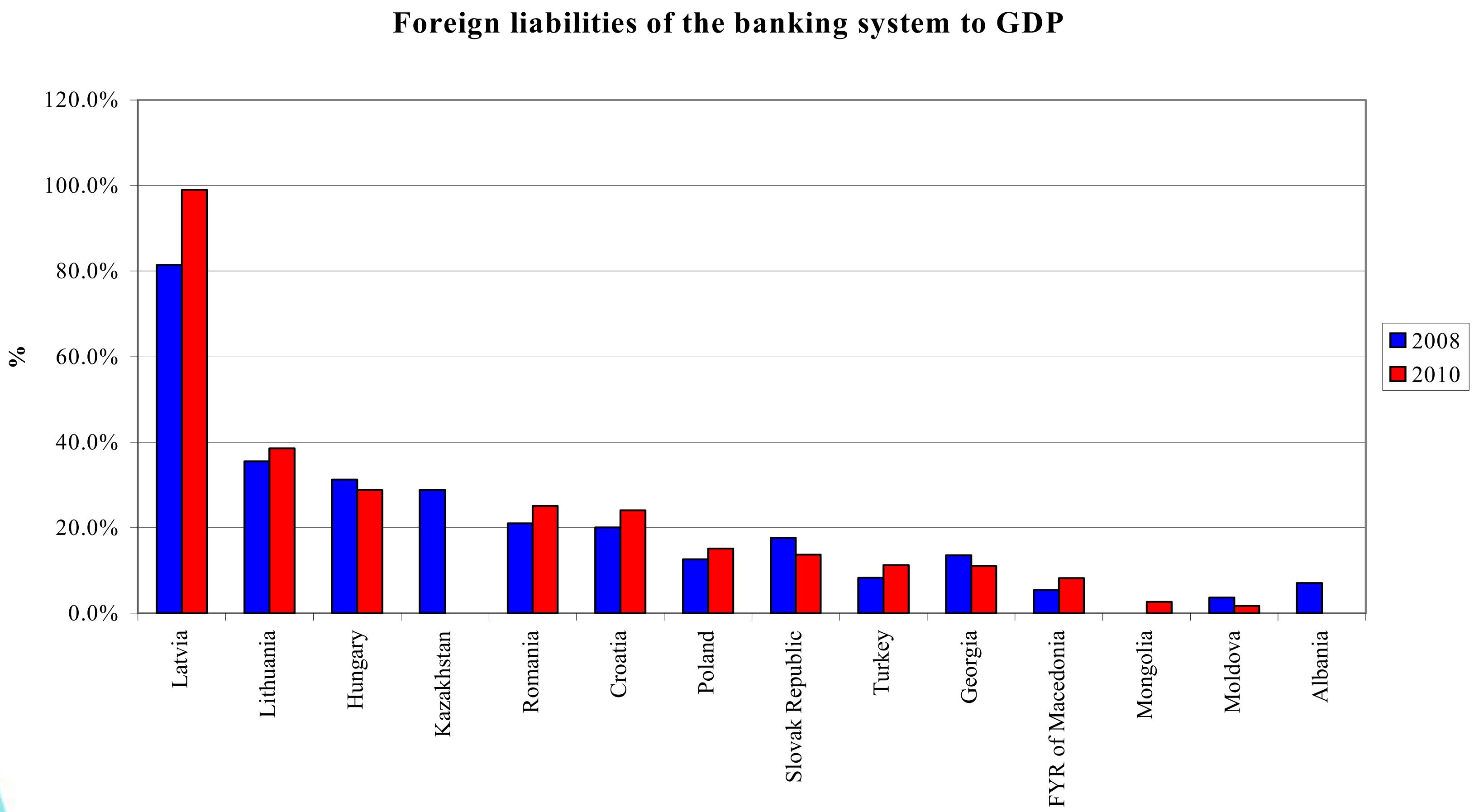
Deleveraging everywhere

Change in credit to the nonfinancial private sector



Sources: Haver Analytics; Bloomberg L.P.; and IMF staff estimates.
Note: The dotted lines are estimates based on the assumption that banks are unable to obtain funding in markets.

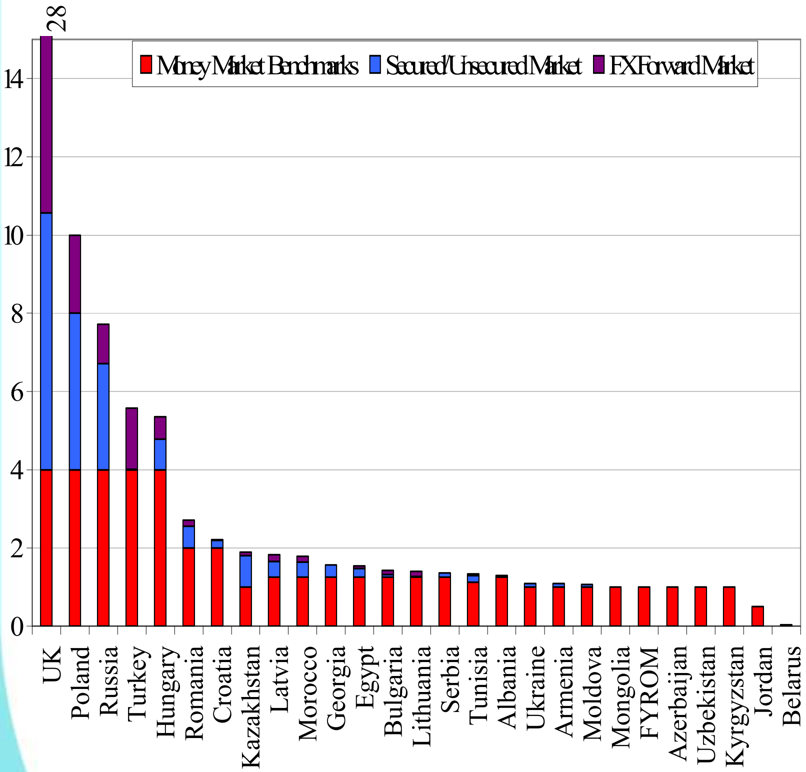
Subsidiaries still rely on parent funding

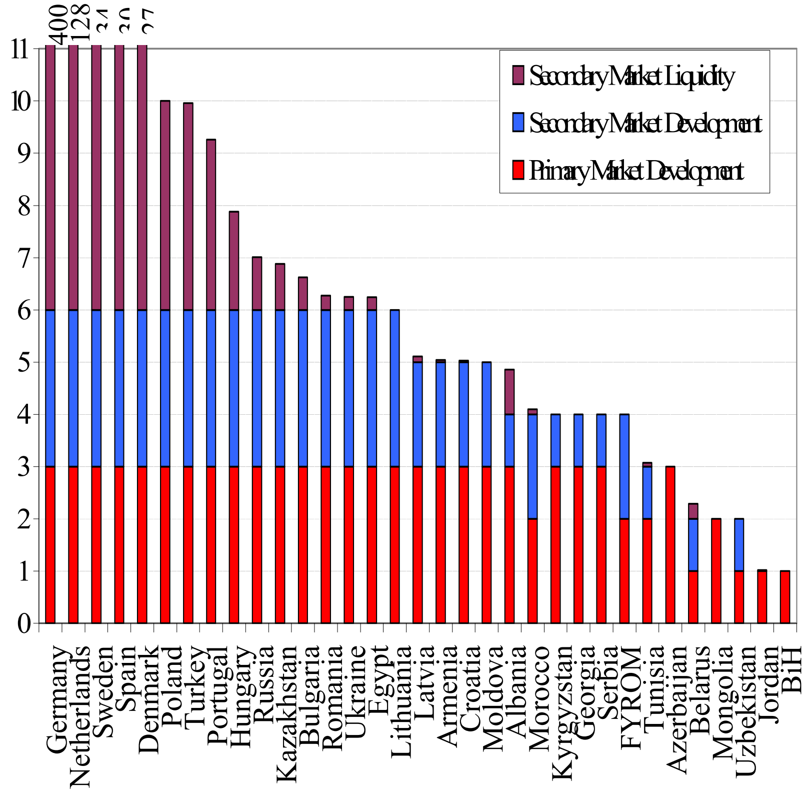


Source: WEO

Local funding alternatives limited

EBRD government bond and money market development index



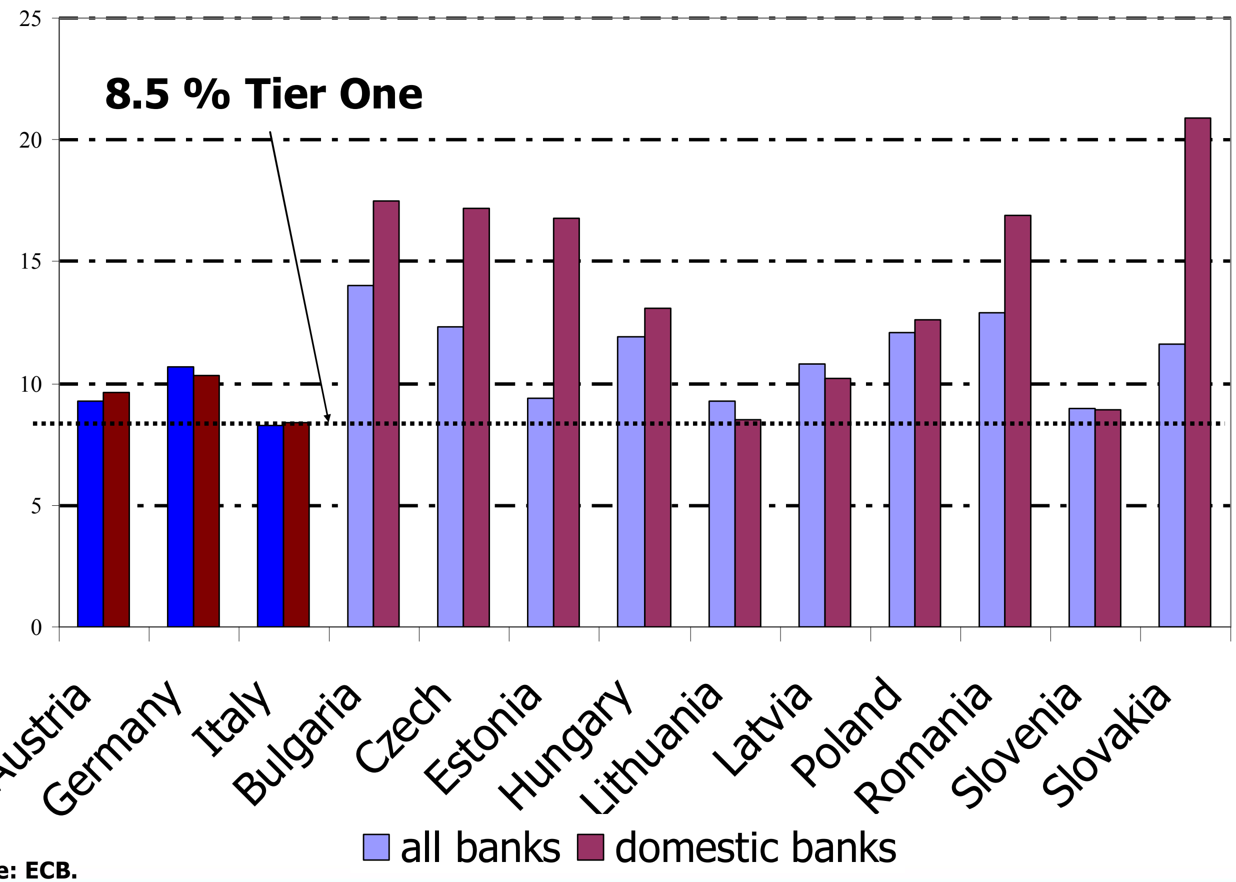


Source: EBRD

G-20/Basel III package implementation

- Motivated by and designed for advanced markets
- Emerging markets (specifically EU-10): illiquid local debt markets, short maturities, and parent funding
- Better quality capital and higher coverage, though generally not as big a concern as in EU-15; group-wide consolidation of minority stakes?
- Short term and long term maturity matching sensible – lengthy phase-in period needed in EU-10
- Limiting large swings in credit provision needed, though counter-cycle capital buffer falls not sufficient.
- EU: financial transactions tax and crisis resolution

Capital adequacy not the issue



Source: ECB.

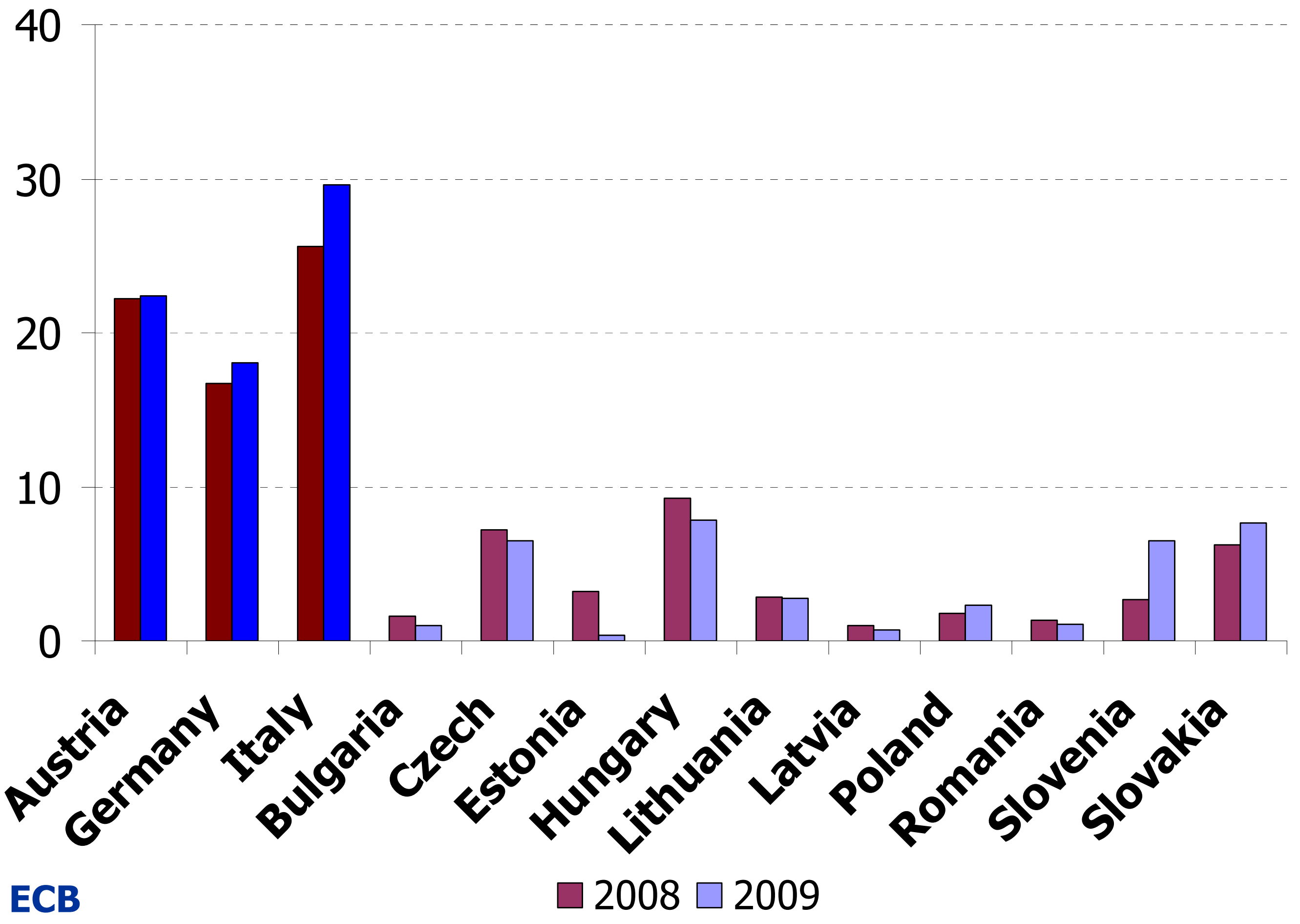
Quality of capital not an issue in CEE?

- Consolidated capital at group level does not reflect minority participations in subsidiaries that may not be transferred for loss absorption elsewhere
- History of partial privatisations and acquisitions left large number of minority bank stakes

→ Distribution and 'fungibility' of capital within bank groups and across integrated EU financial market but fragmented regulatory space

→ Discourage acquisition with significant minority stakes, also negative for equity market liquidity and local ownership support

But liquidity requirements demanding

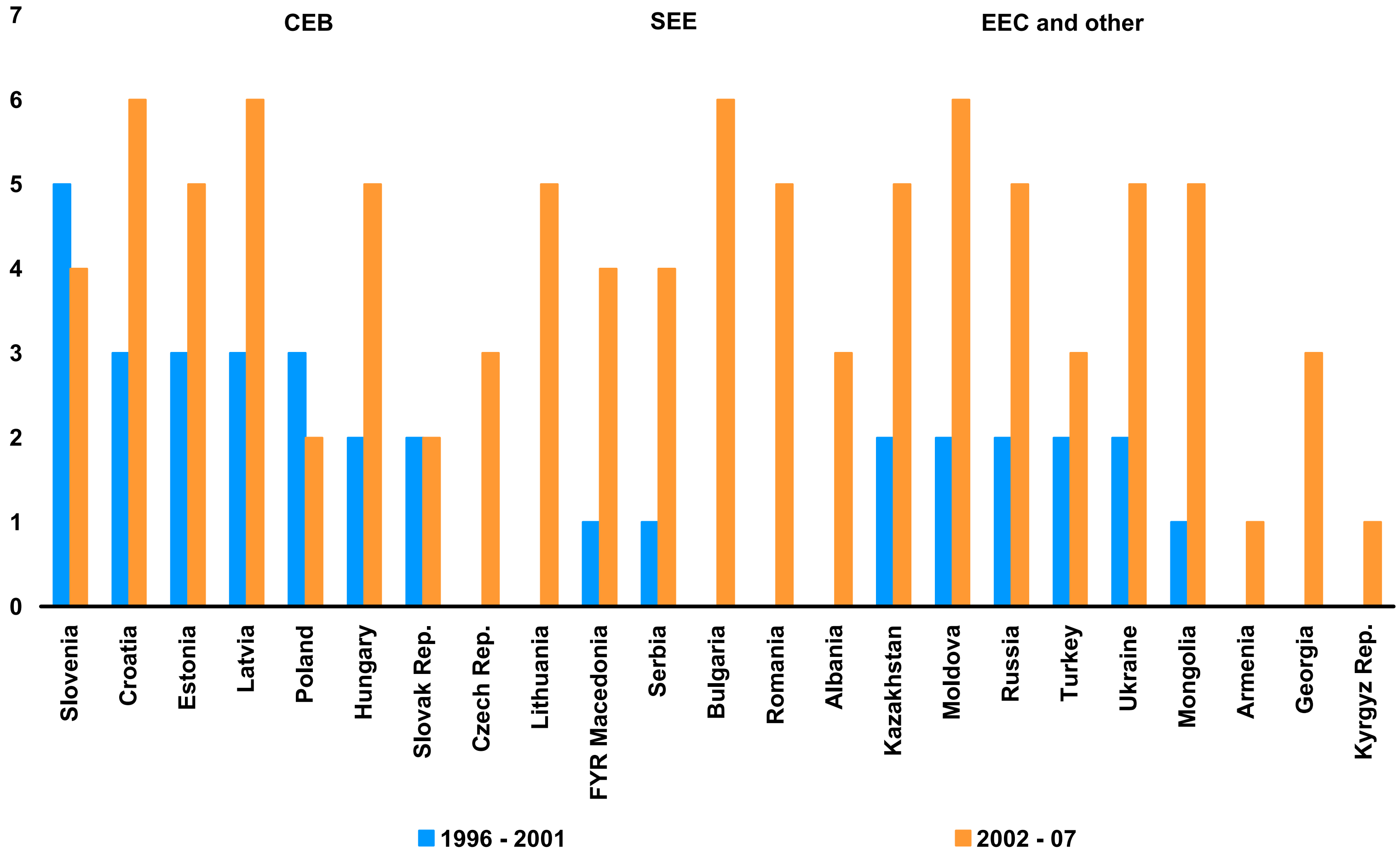


Source: ECB

Liquidity ratios ARE a concern

- **Short term liquidity coverage (LCR)** already in effect, though ‘liquid assets’ now more restrictive
  - ‘marketability’ not be based on central bank refinancing options
- **NSFR** key concern: few term deposits and debt securities small share of overall liabilities, and at short maturities (3m-1y),
  - Further unwinding of banks’ long term assets, in particular in nascent corporate bond market, and corporate credit

Credit booms highly correlated



Counter-cyclical capital complicated

- Deviation from trend credit/GDP path not good guide. EU-10 short – and often poor – data availability
- Emerging economies more prone to sharp credit cycles – enforcing lending standards more important
- Cross-selling (from home and other CEE countries) undermines effectiveness of national requirements
- Capital charges blunt: more tools likely to be required (already in effect); branches remain unregulated
- ESRB-coordination needed: on type of instruments, and on scale and mutual recognition of capital buffers

Host country initiatives in EU-10 region

Pre-crisis

- Limited effectiveness of national measures, given open capital account and avoidance (e.g, lending from parent)

Immediately prior to and during the 2008-09 crisis

- Deposit insurance stepped up
- National and cross-border swap arrangements
- Standards on lending practices
- Greater disclosure

2010-11

- Bank taxes (Hungary…), clearing up stock of FX loans

Fledgling EU Institutional framework

- Advances: ESRB + EBA
  - ESRB – tentative start, but still early days – unclear what clout
  - EBA – immediate impact, but castrated
- Still missing cross-border crisis and resolution
- Wave of host country regulation and supervision
- Home country moves: Dodd-Frank and Vickers

EU-10 subsidiaries in deleveraging

- EU leaders mandate temporarily higher capital ratios, European Banking Authority (EBA) estimate of EUR 106 bn capital gap: conservative sovereign valuations
- EBA seeks coordination process, with EU leaders ruling out "excessive deleveraging" and calling for balance between all member states.
- Bank lending conditions within eurozone, and major host countries remain restrictive
- Major European Banks announce asset disposals, and 'running down' of operations in certain countries.

Recapitalisation poses immediate threat

- Private measures: how to meet capital requirements – asset sales vs. capital raising
- Public measures: home bias against foreign subs
- Competition authorities: compensatory measures

→ **All these may lead to asset sales, reinforcing ongoing deleveraging**

How resilient are banking systems?

- Better macroeconomic and external fundamentals
- Bank balance sheets strengthened (capitalisation, loan-to-deposit ratios), though balance sheet pressures still a concern (NPLs, FX stocks)
- Proven crisis management record of supervisors (e.g. national lines)
- Host country regulatory risk slightly higher
- Parent funding at risk + local funding underdeveloped

Cross-border banking in CEE

- Shock may turn out to be more severe + exposed
- Parent bank and sovereign fragility greater
- Little room for countercyclical fiscal policies
- Regulatory wave poorly timed and designed
- Highly exposed to Eurozone troubles
- No tested European cross border crisis mechanism

Need a Vienna 2.0

Vienna 2.0

- Home-host coordination
- Public-private sector coordination
- International financial institutions (investing IFIs + IMF)
- Regulators + supervisors **+ finance ministries**
- **ESRB + EBA**
- **Purpose:** to **enforce "Vienna Principles"** as defined in European Council and ECOFIN decisions