EBCI | Vienna Initiative

Vienna Initiative 2 Full Forum

Luxembourg, March 6, 2017

Report on the Proceedings

The Ninth Full Forum of the Vienna Initiative took place at the Headquarters of the European Investment Bank (EIB) in Luxembourg under the chairmanship of **Boris Vujčić**, Governor of the National Bank of Croatia.

The meeting was opened by EIB President **Werner Hoyer**. President Hoyer recalled the important contribution the Vienna Initiative, in both its first and second variants, had made to helping the Central, Eastern and South-Eastern European (CESEE) region overcome the financial crisis, and that the EIB had been firmly committed to its work. The Vienna Initiative constitutes a good platform for discussions between banks and their regulators and between home and host country regulators. The current priorities of the Vienna Initiative included both legacy issues from the crisis – deleveraging, non-performing loans (NPLs), banking fragmentation – as well as supporting the region's adaptation to a new growth model. President Hoyer reconfirmed the EIB Group strong commitment to the Vienna Initiative process. Through the Investment Plan for Europe, the EIB is helping to support investment in the region, both directly and by mobilizing private capital. A further challenge is to strengthen both the European Union, and to help neighbouring countries, especially in the West Balkans, to become more resilient, and this is a task for which the Vienna Initiative is well positioned.

The Chairman of the Vienna Initiative, **Boris Vujčić**, welcomed participants to the meeting and commented that the level of attendance indicated the continuing importance of the Initiative. The main objectives of Vienna Initiative 2 were to prevent disorderly bank deleveraging, allow national authorities to react effectively in case of a crisis, and to reduce regulatory risk by enhancing home-host country authorities' coordination. While parent groups had continued to reduce funding to subsidiaries in an effort to lower loan-to-deposit (LTD) ratios, and had become more discriminating in their strategies, capital exposure had been maintained, and increased domestic funding had generally matched the withdrawal of intra-group funding. The NPL monitor published under the NPL initiative

showed that the sale of assets was leading to an improvement in asset quality in almost all countries in the region. There were still impediments to tackle, particularly tax treatment and insolvency regulation and implementation. And even after NPLs had been taken off bank balance sheets, they still needed to be resolved.

The chairman outlined the five main current and future work streams of the Vienna Initiative:

- The Future of Funding in the CESEE Region: What are the optimal forms of cross-border funding, and how will the imminent tightening of ECB monetary policy affect it? There would probably be a role for the Initiative in mitigating subsequent outflows, and it would be important to continue to monitoring flows.

- European Banking Union: The Vienna Initiative provides a valuable forum for sharing views on how proposals on capital, liquidity, recovery, and resolution affect banking in the region. It can promote the voice of the non-euro zone, non-EU members on these matters.

- Supporting Investment in CESEE: The Initiative can both analyse investment flows and assess the effectiveness of policy measures to promote investment. This includes the usefulness of instruments provided by the IFIs, and action to promote the investment of private capital. The work on credit guarantee schemes, for example, has helped lenders compensate for the lack of equity or collateral in the region.

- Capital Markets Union: Proposals at the EU level will affect the CESEE subsidiaries of EU banks, and the countries of the region will need to revise their own regulatory frameworks if they are to benefit from the union. The proposed CMU working group will allow some of these issues to be addressed.

- The NPL Initiative: The work will be continued with further country assessments, legal technical assistance, capacity-building efforts, and fostering the market for assets.

Session 1: Stock-taking of the Economic Situation of the CESEE Region

The first session was chaired by **Vazil Hudák**, Vice-President, EIB.

Bas Bakker of the International Monetary Fund (IMF) presented the macroeconomic background. Global growth since the global financial crisis has hovered around 3 to 3½ percent, well below pre-crisis levels, and outside China and India, growth is only around 2 percent. Most of the CESEE region was recovering well, with unemployment in EU new member states now approaching pre-crisis levels, but the CIS area, in particular Ukraine, was only now coming out of recession. US dollar interest rates had risen sharply

since the US election and the dollar had risen against most of the currencies in the region. Key risks ahead included US protectionism that could spark a trade war, and faster US monetary tightening than expected. In addition, inflation was picking up, and several important elections ahead in the EU raised political risk. Finally, the slowing of convergence and the aging of the population, leading to an annual decline of 1 percent in the labour force, were among the longer-term challenges for the region.

Turning to the monitoring of cross-border banking flows in the region, **Bas Bakker** noted that bank external claims on the CESEE region in aggregate, and excluding Russia and Turkey, had stabilized over the three quarters ending in September 2016, as LTD ratios had been brought down in most countries to much safer levels. Bank funding was now rising by about 3 percent annually, with domestic deposit growth more than compensating for small outflows of external funding. This had allowed the growth of credit to the private sector to pick up in most countries since late 2014.

Luca Gattini, EIB, presented the results of the latest *Bank Lending Survey*. The cross-border banks surveyed continued to express their commitment to the region, although their approach was a selective one. Operations in the CESEE region remained generally among the most profitable in these groups. But banks increasingly differentiated between markets in terms of their potential and the strength of their position in those markets. While the banking groups reported continued reduction in exposure to the region, the number indicating a reduction since mid-2015 was much smaller than before. Demand constraints on credit activity continued to loosen, while constraints on supply had not changed much on aggregate. These supply constraints were primarily international in nature, stemming from capital, regulation and NPL stocks at the group level, rather than domestic. And indeed, most banks had seen a fall in local NPLs over the six months to September 2016, and half expected further such reductions over the next six months.

The latest developments on NPLs were presented by **Bojan Marković** of the European Bank for Reconstruction and Development (EBRD). In the twelve months since June 2015, the volume of NPLs in the region had fallen by €4.3 billion (7.5 percent) to €53 billion, largely through sales. This has brought the average level of NPLs down by 0.8 percent to 7.2 percent of all loans, while the NPL coverage ratio has remained stable at 61 percent. The market for NPLs is deepening, with €7.3 billion in sales in the 18 months to end 2016, with Croatia, Hungary and Romania accounting for 80 percent of transactions in the second half of 2016, and additional transactions in Bulgaria and Croatia have already been done in 2017.

The session chairman, **Vazil Hudák**, pointed out that according to the EIB investment survey, entrepreneurs attributed their unwillingness to increase capital expenditures in the region to gaps in financing, high levels of uncertainty, insufficient support for innovation, and regulations. He asked the commercial bank groups present what they saw as the key risks in the current environment? What was restraining lending? What were the banks' strategies?

Speaking for **Société Générale**, **Olivier de Boysson** said he shared the previous analysis of the growing dynamism in the region and reduced systemic risks. His group had not changed its basic strategy, but had become more discriminating among markets. SocGen had sold Splitska Banka in Croatia since SocGen's presence in Croatia was not large enough to cover the rising costs of doing business there, including the cost of regulatory compliance, and it was unwilling to compromise standards. SocGen was open to competitors that were consolidating, but was itself also a potential consolidator in some markets. It was happy with its presence in Romania, Bulgaria, Serbia and the Czech Republic, with Komerční banka in the last mentioned being the most profitable subsidiary in the group. There was an issue of reducing the costs of large networks, *e.g.*, data centre management, how such networks could be consolidated, against demands that they be kept local. Finally, he took issue with the finding of the BLS that the main factor holding back credit was on the supply side: in SocGen's view, it was more an issue of the lack of good credit demand.

Chris Muyldermans noted that **KBC** followed the bancassurance model and had now repaid the state aid needed during the crisis. It was strengthening its presence in the region, and wanted to extend the integration of banking and insurance. For example, it had recently improved its position in Bulgaria by buying the local units of the National Bank of Greece. KBC was in the region to stay. As to constraints on credit expansion, it was not that there was a shortfall in funding, but the absence of quality demand.

Efthymios Zois of **Eurobank** recalled that, as part of the approval of the 2014 recapitalization, Eurobank committed to reducing its non-core (non-Greek) exposure by 2018. This requires it to selectively reduce its footprint in the region. Eurobank remains committed to the region, albeit with a more focused approach. This notwithstanding, Bulgaria is a key market, with Eurobank-owned Postbank being the only Greek bank operating in the country, following the acquisition of Alpha Bank branch and sale of UBB to KBC.. The Bulgarian market is key due to the large number of Greek companies operating in the country and proximity to Greece. In order to meet its commitments, Eurobank has already sold its Ukrainian unit. Romania is the market with the largest potential: Eurobank needs to capture a larger market share there, and has launched an official process for attracting a strategic partner in order to fully capture the market dynamics .

Luca Leoncini Bartoli, described **Intesa Sanpaolo** as a stable investor in the region, with EUR40 billion of assets in some 10 CESEE countries. Serbia, Slovakia and Croatia are core countries of operations, accounting for market shares of 15 to 20 percent. Intesa Sanpaolo made extensive use of IFI credit facilities, both for access to cash and guarantees. Among the regulatory issues to flag was that of the capital requirements for large exposures. There can be different requirements for EU and non-EU states, and this can affect the bank's liquidity, as it affects access to the repo market. Unburdening national barriers to data processing was important, as data localization requirements were expensive: regulation on this matter should be at the whole-group level. Finally, the public authorities, the IFIs, and the local financial intermediaries needed to work together to improve capital markets, as part of the Capital Market Union initiative. He cited his bank's work in connection with creating a kuna mortgage market in Croatia.

Christine Würfel of **Raiffeisen Bank International (RBI)** said the region still offered interesting perspectives on growth and interest rates. Actually, the main strategic driver for banking groups were the regulatory and supervisory requirements which were challenging, as the CESEE environment in which the bank was operating included both members and non-members of the euro zone and of the European Union. RBI had done its "homework" in this respect, had put capital ratios on to a solid basis, and was focusing on costs and on streamlining its organizational structure. The bank was engaged in dialogue with different European and national authorities, but also faced incompatible national initiatives. A harmonized view among national authorities was key, especially due to the plurality of authorities: ECB, home/host authorities, national resolution authorities and the Single Resolution Board etc. The Vienna Initiative provided one of the rare forum for a comprehensive dialogue among all stakeholders which should be fostered by common feasible approaches.

Costanza Buffalini of **Unicredit** said her bank had been subject to more regulatory pressure since the financial crisis, and had adopted a more prudent approach to risk. But the CESEE region remained very attractive, with low credit penetration levels, profitability double that in Western Europe, and a young customer base. It would continue to be a key market for Unicredit, with a widespread presence in 11 countries and a capillary network of more than 1,800 branches. Unicredit's market share had risen over the last two years, and the region accounted for 20 percent of the group's revenues. It planned further consolidation of its leading market positions through innovation and digitalization. It planned to strengthen its data analytics to allow it to cross-sell more products, and CESEE would be used as a testing ground for this. Gross NPLs were expected to decline from 10 to 8 percent over the next two years. Comments on regulatory constraints would be presented in the next session.

Session 2: Current Issues in Bank Regulation

This session was chaired by **Pierre Heilbronn**, Vice President, EBRD. He noted that European economic growth was picking up, with leading indicators strengthening and an upturn in inflation. While profits of some banks were beating expectations, at the same time they continue to face challenging conditions as a legacy of the past crisis. Regulators have been trying to make a safer system through CRR/CRDIV, and this had resulted in revised capital buffers and better liquidity, but may have also led to some unintended consequences. Recently, regulations in the United States may now be loosened, and there was a question of how Europe should respond to this. Finally he asked how regulation was affecting bank operations in CESEE. In this context, Vice President Heilbronn stressed the importance of continuing work on resolution of large NPLs in the region, following the achievements of the Vienna Initiative's NPL Initiative so far, and reconfirmed EBRD's strong commitment to the Vienna Initiative.

Ádám Farkas of the **European Banking Authority (EBA)** made a presentation on how developments in EU banking regulation might affect banks in CESEE and cross-border banking. The main points were:

- **Recovery Planning:** The EBA has been monitoring the recovery plans of bank groups and found a number of shortcomings. Insufficient attention is often paid to subsidiaries, even they are systemic banks in host jurisdictions. Host supervisors often lacked understanding how the new framework operated and how a group recovery plan was meant to be constructed. The EBA had observed a lack of consistency in the level of analysis performed in preparation of these plans, with authorities having different views on the concept of material deficiency, and inconsistent approaches to the calibration of recovery capital requirements (and subsequently resolution requirements) at the group and subsidiary levels. The EBA was recommending which should be the relevant entities, and updating the single supervisory handbook (SSH). It also had power to mediate, if a group recovery plan could not be agreed.

- **Leverage ratio:** The EBA considered that a 3 percent ratio provided a suitable backstop supplementing the capital requirements, and the potential shortfall for EU banks would be very small. The impact on cross-border banking activity is not likely to be material. The EU proposal for CRR2 incorporates proposed changes to the Basel standards, but the final Basel III package is yet to be agreed, and could involve changes in definitions and a surcharge for Globally Systemic Important Insurers (G-SIIs).

- Liquidity Coverage Ratio (LCR): Liquidity is managed centrally in many cross-border groups, but the LCR may not recognize true intragroup liquidity flows, and thus some banks may not be able to meet the LCR on a solo basis. While the central management of liquidity is a good thing, the allocation within the group may not be optimal from the host regulator's point of view. In the EU legislative framework, there is a wide range of measures that could be applied which would cater to needs of host authorities, and the EBA has mandate to specify these further.

- Net Stable Funding Ratio (NSFR): As with the LCR, some banks may not be able to meet the NSFR on a solo-basis. Some preferential treatment options have therefore been developed to reflect the way cross-border groups are funded and how groups are able to support subsidiaries with provision of stable funding. Unlike the case of the LCR, EBA has no mandate to specify these requirements further.

- Resolution framework: The relevant directive provides for joint planning on resolution plans at the group level, resolvability assessments and minimum requirements for own funds and eligible liabilities (MREL), including binding and non-binding mediation. Resolution action for groups should also involve joint decisions, but there is no binding mediation. Work is underway on redrafting total

> loss absorption capacity (TLAC) guidelines, and the EBA considers that fully collateralized guarantees could be accepted for TLAC under strict conditions.

Dimitar Bogov, Governor of the **National Bank of the Republic of Macedonia**, presented a note on the impact of CRR/CRDIV on EU subsidiaries in non-EU countries. Article 114 of the CRR required parent banks to apply a 100 percent risk weight on exposures of their subsidiaries to non-EU sovereigns and central banks when presenting consolidated group accounts. This superseded the previous regulations which allowed lower risk weights by agreement with individual home country supervisors. The new regulation had led to a reduction in the exposures of the subsidiaries of EU banks to government securities or central bank bills in Macedonia, as well as deleveraging in Macedonia, Montenegro, Serbia and Bosnia and Herzegovina since 2014, as the parents imposed exposure limits on their subsidiaries. This has led to constraints on running both monetary policy (as central bank bills are the main monetary policy instrument) and fiscal policy (as governments are pushed to raise funding abroad). It can also put pressure on the exchange rate as domestic savings are more likely to flow abroad, since deposits in parent (or other foreign) banks are the main substitute for safe liquid host country assets. There has thus been additional deleveraging pressure and parent decisions to disinvest, all of which may affect banking system stability. Governor Bogov suggested that a solution may lie in: accelerating the assessment of the equivalence of regulatory and supervisory regimes in non-EU CESEE countries with the EU regime; the inclusion of these countries in the decision-making processes (supervisory colleges) for the EU subsidiaries active on their markets; and for the EU authorities to assess the impact of their measures on the financial systems and monetary policies of the affected non-EU countries.

Costanza Bufalini and **Alberto Orsi** of Unicredit presented a joint paper from the commercial banking groups on the banks' adjustment towards an increasingly complex regulatory environment. They asked what were the main regulatory impediments for cross-border banking, and concluded that an appropriate trade-off has not been struck between the benefits and costs of regulation. The banks were willing to cooperate in finding suitable solutions. Their concerns related both to EU measures impairing the free flow of capital and liquidity within cross-border groups, and national measures affecting the banking systems of CESEE countries.

While Basel requirements for capital and liquidity only applied at the consolidated group level, the EU requirements on cross-border banks applied both at the consolidated and solo levels. The EU requirements thus apply to relations between entities of the same group. A system of waivers has been introduced which applies mainly to waivers in the same member state, but it is the intention to introduce in CRR2 a package of waivers for cross-border exposures within banking groups. The EU acknowledges that absent such waivers, the efficient management of own funds and liquidity may be impaired, and recognizes that the Single Supervisory Mechanism (SSM) has reinforced group supervision. While the proposed waivers are improvements, they remain discretionary and rely on collateralization to an undesirable degree. No changes are proposed for the cross-border treatment of risk weights, the LCR, or the large exposures rule, but some allowance is made for cross-border flows in the NSFR. The new rules are likely to continue to block the

efficient allocation of capital and liquidity within groups, with damaging effects on credit to households and SMEs, and risks to group financial stability. The banks propose bolder changes that would treat the EU, or, failing that, the euro zone, as a single jurisdiction.

Turning to national measures that have been detrimental to banking in the CESEE region, the commercial bank group presentation drew attention to the misuse of the consumer protection rationale in some countries and the inconsistent application of EU regulations. Individual national initiatives have had a significant impact on banks' ability to support the local economy and have created concerns on the reliability of national legal environments. Specific actions that were mentioned included: legislation converting Swiss franc loans in Hungary, Romania, Croatia and Poland, the mortgage directive in Romania, and bank levies in Hungary and Poland. Among other concerns were the retroactive application of legislation, the lack of proportionality, the lack of consultation including with the ECB, the lack of protection of vulnerable borrowers, and the endangering of EU single market principles. These were having negative effects on banks' profitability as well as damaging the countries' attractiveness to investors. The banks suggested that policies that are jointly discussed were more likely to achieve a wider range of objectives, and expressed their willingness for further dialogue.

In the subsequent discussion, Barnabás Dezséri of the **Hungarian Ministry of National Economy** took issue with the commercial bank statement as it related to Hungary, which he found one-sided on the issue of the conversion of Swiss franc loans. No reference was made to the profitability of bank operations in Hungary. The NPL stock had shrunk, and the government was committed to supporting initiatives to resolve the problem and prevent a new build-up, and had indeed been commended for its work by the IMF and the ECB.

Mario Nava (DG FISMA) thought the industry presentation showed the wisdom of the approach taken by EU President Juncker in his most recent report (http://europa.eu/rapid/press-release_IP-17-385_en.htm). Was there a common economic area or not? Whichever decision is taken, it will have consequences for banks. He recalled that the Basel Committee did not recognize the euro zone as a single area for some purposes.

Aristotelis Spiriotis (Bank of Greece) found the analysis of Governor Bogov on the impact of CRR/CRD IV on EU subsidiaries in non-EU countries to be interesting. But he did not see what the solution might be. **Governor Bogov** said that if the non-EU jurisdiction was assessed to have supervisory equivalence, then EU rules should apply. **Bojan Marković** suggested that this matter might be taken up in the Banking Union work stream. A workshop on the matter might explore what willingness there was to take the matter further.

Sharon Finn of the **European Central Bank (ECB)** made a presentation on the development of ECB Guidance to banks on NPLs. Within the euro area, NPL ratios (to equity and loan loss reserves and to total loans) for significant banking groups had deteriorated markedly in the countries most affected by the financial crisis. The ECB had established an NPL Task Force to develop and implement a consistent supervisory approach to the

significant institutions with high NPLs that it supervises. Draft guidance was issued for public consultation in September 2016, and final guidance will be published in Spring 2017. Under the guidance, Joint Supervisory Teams will work with affected banks on their strategies for dealing with NPLs, governance of NPLs and related operations, and policies for forbearance, recognition, write off and use of collateral. Solving the NPL problem will need the engagement of other stakeholders to remove the structural obstacles that impede banks from resolving their NPLs.

Mario Nava (EC DG FISMA) reported on the work of the EU Financial Services Committee Subgroup on NPLs. The group had been set up in July 2016 to assess asset quality developments and relevant legal frameworks in member states and to identify options for addressing the NPL overhang. Its final draft report is expected to be presented to the informal April 2017 ECOFIN. Stock-taking work had been completed, including the microeconomic, macroeconomic and financial impact of NPLs, the cross-border implications had been reviewed and current policies analyzed. The policy lessons were that the problem called for a comprehensive approach at the national and European level, and it would take time to achieve sustainable results. Among the elements should be the promotion of liquid secondary markets and the restructuring of banking sectors. These would be tackled in future meetings of the Subgroup.

Paweł Gąsiorowski of the National Bank of Poland reported on the work of the Expert Group on NPLs of the **European Systemic Risk Board** (ESRB). The group was established to look at the macroprudential dimensions of NPLs. It produced an interim report in November 2016 and is expected to present its final report in June 2107. The group had been looking at the systemic consequences of high NPL stocks. These included their impact on bank profitability, the resultant increase in bank funding costs, the higher burden they placed on bank capital, and the higher lending rates that they caused. Impediments to market solutions included the underdeveloped state of distressed asset markets, the gap between offer and demand prices, the tax and legal incentives to keep NPLs on bank books, and obstacles to the efficient management of distressed assets by purchasers. Possible structural solutions discussed included better information, harmonized regulation of NPL servicing activities, improvements in collateral enforcement and debt collection, and tax changes. Possible solutions to market impediments included securitization on or off balance sheet, asset management companies (AMCs) and a platform for direct NPL sales.

Ádám Farkas of the **EBA** noted that there was a market failure impairing banks' ability to remove non-performing assets from their balance sheets. The EBA was exploring the possibility of setting up an AMC at the European level with a role for support with public sector money. The operations of such an AMC would have to be consistent with EU State Aid rules and the Bank Recovery and Resolution Directive (BRRD). Stress tests might identify capital shortfalls in banks giving the total envelope for potential state aid for each bank. The real economic value of assets (as opposed to current market values) could be determined using State Aid policy methodology. An AMC would be established with public funds and crowding in private capital, and this would acquire some of the bank NPLs at real economic value, with bank equity taking the remaining loss from book value. The AMC would have three years to dispose of assets at real economic value. **Mario Nava (DG FISMA)**

noted that, provided BRRD and State Aid conditions are met, banks might conceivably be provided with aid in the form of a precautionary recapitalisation to finance an impaired asset measure.

Olivier de Boysson (SocGen) found the suggestion in the EBA presentation that an AMC could be useful in price discovery to be an interesting one. But he was not clear on how real economic value would be determined. **Ádám Farkas** responded that DG COMP used the concept of real economic value in applying the policy on state aid. Some assets for sale are priced well below this level at the moment, since there are only very few specialized players in the market. **Mario Nava (DG FISMA)** clarified that the real economic value was defined as the value that would prevail in the absence of a market failure.

Bojan Marković (EBRD) updated the Forum on developments in the Vienna Initiative NPL Initiative. The transparency of national restructuring frameworks had been improved by the work on out of court resolution, impediments to asset sales, and insolvency, and up-to-date and authoritative assessments were available for several countries on the NPL Initiative recently launched website (http://npl.vienna-initiative.com/). Two regional conferences, two regional training sessions on NPL restructuring, and various local workshops had served to enhance capacity and foster policy dialogue. The new website and the regular publication of the NPL monitor by the Vienna Initiative had helped to raise understanding of the issues. Over the period ahead, the work of the initiative might be replicated in other countries, *e.g.*, Cyprus and Greece, working groups might also be established in Croatia and Montenegro, and Ukraine might become involved. Legal technical assistance will be provided for drafting bankruptcy legislation and developing out-of-court resolution mechanisms and further training of stakeholders (judges, insolvency office holders and bankers) will be provided.

Mario Guadamillas (World Bank) gave a presentation which stressed that NPL resolution needs a holistic approach, and only the coordinated work of private and public sector stakeholders could bring meaningful NPL reduction. Banks have the primary responsibility in NPL resolution at the individual level and should ensure time-bound and efficient NPL workouts. However, public sector authorities should set comprehensive and clear frameworks for NPL reduction thus removing impediments to financial stability and economic growth. The Financial Sector Advisory Center (FinSAC), based in Vienna and funded by the Austrian government, works exclusively for the region and has several programmes designed to address NPL resolution. The World Bank group has been engaged in developing and implementing debt resolution programmes in Albania, Bosnia and Herzegovina, and Serbia, assessed NPLs in Kosovo, worked on improvement of the resolution framework in Ukraine, has delivered a handbook on NPL resolution in Slovenia, a study on relevant tax considerations in Croatia, and an insolvency ROSC in Bulgaria.

Kudret Akgün (International Finance Corporation, IFC) drew attention to the IFC's Debt and Asset Recovery Program (DARP), which focuses on the acquisition and resolution of NPLs and distressed assets, refinancing and roll-over risk of viable emerging markets entities, and restructuring of small and medium-sized companies. In the CESEE region, the IFC's commitments are approximately US$650 million. There have been DARP

interventions in Romania, Bulgaria, Croatia, Serbia and Russia. In 2016, DARP participated in the largest secured corporate transaction and the largest retail sale to date in the Balkans. DARP plans to continue building its network with local partners in the region to build the capacity to play an active role to develop a dynamic distressed asset market.

Session 3: Investment in the CESEE Region, and Financial Instruments to Support it

This session was chaired by **Debora Revoltella, EIB**.

Áron Gereben, **EIB**, gave a presentation on Investment in CESEE – Macroeconomic Perspective and Results from the EIB Investment Survey (EIBIS). The EIB EIBIS survey interviews some 12,500 corporates about their investment activity. It shows significant investment gaps in the CESEE region. Although investment in CESEE has exceeded average EU levels, it has mostly been below the levels required for economic convergence. Public investment - supported by EU funds - has been well above the EU average, while private investment is at EU levels. However, slow capital accumulation has contributed to low potential growth, particularly in the Baltics, Hungary, Slovakia and Slovenia. Investment in innovation has been much lower than elsewhere in the EU. The financial crisis brought about a reversal of FDI and bank-based inflows, but firms in CESEE are now expecting to investment more than they did last year, with some 20 percent believing they invested too little in the past. However, more firms, especially SMEs, believe they are credit-constrained, and this is particularly the case in Bulgaria, Croatia, Hungary.
The implications for policy were that there were still significant gaps in the stock of capital in the CESEE. The pre-crisis model of financing capital accumulation - based on FDI inflows and funds channelled through cross-border banking - was not operating as it did earlier. A shortage of skilled labour force is increasingly becoming a constraint in the region. A complementary growth strategy could be to switch to more reliance on both internal savings and on investment in skills and innovation. Strengthened investment in digital infrastructure, R&D, education, and healthcare could underpin this approach. EU structural funds were a key source of funding for investment and they should be used efficiently. But capital market development is crucial to channel the savings and to diversify the funding of investment by decreasing the reliance on banks. The IFIs can help by continuing to support infrastructure development and by supporting innovation, business development, and the preservation of human capital.

Oliver Fürst (RBI) and **Kiril Velitchkov (KBC)** presented the results of commercial bank brainstorming on the financial instruments to support growth and investment in the CESEE region. They expressed great appreciation for the work of the IFIs in developing banking markets in the region, and noted that there had been a strong positive impact on SMEs, with reduced interest rates and collateral requirements. It has also benefitted the banks, which are better able to manage risk transfers, recover claims and optimize capital.

The new securitization framework under development in the EU should provide high quality securitization (simple, transparent, standardized (STS)) with preferential capital and liquidity requirements starting in 2018. However, as now formulated, the framework

will be of limited relevance to banks in the CESEE region, as the focus is on true sales and synthetic structures can only be used in SME pools in which IFIs would have to participate. According to past experience, pools in certain jurisdictions are typically not big enough to support adequately-sized transactions, therefore mixed portfolios have to be selected (the limit of 70 % for SME is consequently too high). In addition, the new Article 270(e) of the CRR raises multiple concerns: (i) the mandatory inclusion of IFIs will further increase the counterparty limits vis-à-vis IFIs; (ii) a bias against (private) institutional investors is observed; and (iii) there are concerns that the IFIs will have the capacity to support all transactions. The banks therefore propose the inclusion of fully collateralized (cash, government) guarantees in the new CRR Article 270(e).

Additional business might be generated by reducing the complexity and number of instruments available, and by standardizing definitions (*e.g.*, of SME) and conditions. Banks would like to be involved in the design of instruments, not just their implementation. They would like to see more instruments targeting mid-caps, in addition to SMEs, and clearer information on how to combine various financial instruments with EU grant programmes. Capital relief, including RWA relief, has become as important to banks as risk transfer. Guarantee caps should cover both expected and unexpected losses, not just realized losses, if they are to provide significant risk transfer. There should be more uniformity in the regulatory capital relief for guarantees by different national authorities, and IFI support would be crucial under the new securitization framework to reach this harmonized treatment. Banks appreciate the higher flexibility provided by the IFIs (*e.g.*, for acceptance of working capital under InnovFin; and the extension of guarantee programmes (COSME, Horizon2020) to new countries). Funding instruments are equally important and, if applied the right way, could even serve as a catalyst for the development of local capital markets. Integrated product offerings (covering, for example, funding and technical advice) are very useful. The adjustment of fees in legacy transactions in light of the changed interest rate environment would be appreciated.

Lucyna Stańczak-Wuczyńska (EBRD) described the EBRD's business priorities as access to finance for SMEs, local currency and capital market development, and supporting the resilience of the financial sector. In the CESEE region, SME finance had been provided in 2015/6 under several programmes – the Green Economy Finance Facility (9 projects for EUR 265 million); the Trade Facilitation Programme Facility (15 projects for EUR445 million); and SME lending and risk-sharing (22 projects for EUR 320 million). Capital market development had been promoted by equity investment in banks (15 projects for EUR 560 million in 2015/6); equity investment in stocks exchanges (2 projects over 2014/6); covered bonds and senior unsecured (6 projects for EUR 155 million over 2016/7); and SME securitizations (4 projects for EUR 130 million over 2014/6). Support of financial stability was indicated by projects to fund deposit insurance schemes (6 projects for EUR 700 million), NPL resolution work, and cross-currency swaps. In addition to its investments, EBRD is actively focusing on the policy dialogue and the advisory services in (i) improving SME access to finance, (ii) greening initiatives, and (iii) inclusion. In terms of capital market development EBRD is supporting a number of initiatives including (i) review of covered bond and securitization legislations in the region (ii) supporting SME's access to local stock exchanges via listing support programs or SME investment vehicles,

(iii) setting up integrated platforms such as SEE link in Western Balkans or building the crowdfunding platforms (Croatia).

Kudret Akgün (IFC) reported that since the crisis the share of IFC investments going to financial institutions had risen from 40 percent to 65 percent. It had found a lack of bankable projects in the market above the SME segment. Its forward-looking approach was to support the creation of new markets, such as those in local currency instruments, supply chain finance, secured finance, financing NPL projects and trade finance.

Luca Lazzaroli (EIB Group) drew attention to the successful SME initiatives (Horizon and COSME) which used the EIB/EIF balance sheets to cover first losses. Structured funds have been applied to early stage equity opportunities, and now reflows under these instruments could be converted into later stage equity.

Session 4: Financial Market Fragmentation and Capital Market Union (CMU)

This session was chaired by **Mario Nava, EU Commission, DG FISMA**.

Filip Keereman (DG FISMA) proposed the establishment of a Working Group on Capital Market Union under the auspices of the Vienna Initiative. He recalled that non-financial corporates in the CESEE region were primarily financed by bank loans or own equity. Both debt market and stock market capitalization were around a third of levels prevailing elsewhere in the EU. Only a small share of IPOs in the EU was from CESEE, and the financial assets of pension funds and insurance companies were relatively small. Local SMEs were neglected by capital markets for a variety of reasons. Private equity and venture capital were of minor importance compared with the rest of the EU. This meant that CESEE capital markets had a high catch-up potential.

The CMU Action Plan of the Commission aimed to remove barriers to cross-border capital raising and investments, increase market-based finance from various sources and build a stronger equity culture; and stimulate long-term finance for investments in infrastructure and SMEs. The proposed Working Group would mobilise the Vienna Initiative network to identify challenges and opportunities for capital market development at the national and regional level. The terms of reference would provide for the working group to consist of relevant experts and up to two representatives per participant. Up to three meetings would be held, the first in Brussels on 4th of April, 2017, and a report would be prepared by the end of 2017 for endorsement by the next Full Forum.

Paul McGhee or the **Association for Financial Markets in Europe (AFME)** spoke on the benefits of capital markets to high potential EU economies. AFME represented leading participants in Europe's wholesale capital markets. Its new report analysed the depth of capital markets relative to GDP across 23 different metrics for 11 EU member states in the CESEE region. These were about a third the size of capital markets in the rest of the EU, and outside the Visegrad 4, had contracted since the crisis. The key issue was to increase the supply of long-term capital. He noted that, except in Poland and Hungary, private pension

assets had increased, but were still below 10 percent of GDP. Initiatives were under way for EU11 covering pools of capital, new products, SME programmes, tax and insolvency reform, and investor education, but there was room to increase their momentum.

James Hinton of the European Commission **Structural Reform Support Service (SRSS)** explained that its role was to supply expertise to member states for reforms that they wished to do at national level (via technical cooperation or policy dialogue). The SRSS budget in 2017 is nearly EUR 25 million, and assistance is to be requested by member states. The three main topics that it covers in the financial sector are the CMU, NPLs, and financial stability. It plans to provide capital markets diagnostics to interested member states and is very supportive of the proposed Working Group on CMU. The SRSS takes a horizontal approach to NPLs, for example, but also tackles the legal-judicial and other angles.

Session 5: Next Steps

This session was chaired by **Mark Allen (EIB)** and mainly covered developments in the Ukrainian financial system.

Dmytro Sologub, Deputy Governor of the **National Bank of Ukraine,** provided an update of financial developments. Following a combination of war, accumulated macroeconomic imbalances and lax regulatory practices, Ukraine launched a comprehensive reform of its banking sector. The clean-up phase has been completed, with 87 insolvent banks closed, gradual recapitalizations based on asset quality reviews (AQR) and stress tests, disclosure of ownership and the start of the unwinding of related party transactions. The structure of the banking system has changed, with some foreign banks leaving the market, while the remainder increased their market share. This reflected a flight to quality, and the main losers have been local banks involved in illegal activity. The direct cost of the banking crisis in the last three years including private costs has been 26 percent of GDP, of which the direct fiscal cost is 13 percent of GDP.

Ukraine is now in the reloading phase. A major systemic bank (Privatbank), with 18 percent of all bank assets, had been nationalized. The state-owned bank share had thus risen to 52 percent of the total, although plans are to gradually wind this down. In the immediate future, priority was given to improving the governance and management of state-owned banks (currently 4) in line with the strategy for state-owned banks developed as part of the IMF programme.

Strict stress testing showed that NPLs had reached 53 percent of the assets of the top 20 banks, but most of this has been provisioned. Resolution of the NPL situation is now a priority. NPL resolution will be facilitated by the removal of judicial obstacles, and the development of a Kyiv approach to out-of-court restructuring. The intermediation capacity of the economy has declined and household have considerably deleveraged. Corporate deleveraging is happening more slowly, and leverage in terms of loans to GDP is still excessive.

Jerôme Vacher (IMF) presented a complementary perspective on the reform of Ukraine's financial sector. Since 2014, Ukraine had dealt with the impact of enormous economic shocks, cleaned up most of the banking sector, resolving half of all bank assets, revamped the central bank and laid the basis for a rehabilitated financial sector and growth. With the support of the IMF, bank recapitalization plans had been reviewed and implemented, related-party exposures unwound, banking supervision and corporate governance enhanced, a strategy to tackle state-owned banks adopted, the deposit guarantee fund given greater power to recover asset values, and the framework for NPL resolution strengthened. Financial sector policies will continue to be an important pillar of the IMF-supported program.

At the end of the Forum, the chairman, **Boris Vujčić**, said that the Vienna Initiative would continue to publish the three monitoring reports (the deleveraging and credit monitor, the bank lending survey, and the NPL monitor). Technical assistance on NPL issues would continue to be provided where it was needed, including possibly in Cyprus and Greece, which had approached the EBRD. The Working Group on Capital Markets Union would be set up under the leadership of the European Commission, and would aim at producing its report by the end of the year. Another Working Group could also be established on the financial instruments that might support investment in the region, and other IFIs and the commercial bank groups had expressed their interest in participating. Terms of reference will be drafted by the EIB, with support from other members, and these could be adopted at the next meeting of the Steering Committee to be held during the Spring Meetings in Washington, D.C. (April 21-23, 2017). The EC will also envisage a way to put forwards the concerns in terms of CRD IV implementation discussed in session 2. An action plan will be presented at the next steering.

Finally, the chairman indicated that next Full Forum would be hosted by EBRD and held in London in March 2018.