EBCI | Vienna Initiative

CESEE DELEVERAGING MONITOR[1]

April 30, 2013

The second wave of funding reductions by western banks vis-à-vis Central, Eastern, and South Eastern Europe (CESEE) that started in mid-2011 is petering out. Depending on which data are emphasized, there was either a slight increase or slight decrease of funding in 2012:Q4. This likely reflects a rough balance between two countervailing forces: renewed capital inflows into emerging markets amid ample global liquidity and receding risk aversion; and the trend for banks to rebalance the funding of their CESEE subsidiaries toward local sources. However, funding reductions have not stopped everywhere—Hungary and Slovenia for instance continue to face challenges—and private sector credit remains generally anemic in CESEE excluding Russia and Turkey. A new run of the EIB's bank lending survey suggests that weak credit reflects both restrictive demand and supply factors. Amongst the latter, banks emphasize high non-performing loans (NPLs) more prominently than funding constraints. Nonetheless, the survey confirms that the trend to lower loan-to-deposit ratios at the group level and to rebalance CESEE subsidiaries' funding sources continues. And, while cross-border banking groups remain generally committed to the region, they now are clearly more discriminating between countries. Headwinds for credit growth, as well as a pickup in M&A activity and banking sector consolidation, seem in the pipeline. Risks of deleveraging becoming disorderly have receded.

Recent developments

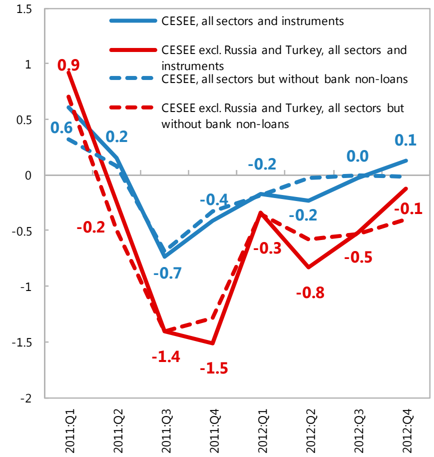
The external position of BIS-reporting banks vis-à-vis CESEE increased slightly in the fourth quarter of 2012, ending a six-quarter string of reductions. The rise of 0.1 percent of GDP comes after a flat external position in the third quarter and quarterly reductions ranging from 0.2 to 0.7 percent of GDP during 2011:Q3-2012:Q2 (Figure 1). With Russia and Turkey recording sizable inflows, the rest of the region continued to see a slight reduction of the external position. However, even this 0.1 percent of GDP reduction was significantly smaller than any of those experienced in previous quarters.

Technical issues likely flatter the evolution of external positions somewhat. External positions as compiled in the BIS International Banking Statistics comprise funding provided to CESEE in the form of loans and non-loans. In the case of funding provided to CESEE banks, the

[1] Prepared by the staff of the international financial institutions participating in the Vienna Initiative's Steering Committee. Reflects comments on an earlier version received from the Steering Committee at its meeting on April 19, 2013 in Washington DC. Previous editions of the quarterly deleveraging monitor are available at http://vienna-initiative.com.

latter constitutes mainly equity positions that are valued at market prices. Valuation changes can hence exacerbate the decline of external positions in downturns when banks' stock prices slump. Conversely, when financial sentiment improves and banks' stock prices rise, as recently, external positions paint an overly positive picture of the funding made available to CESEE. One way to eliminate such valuation effects is to exclude non-loans to CESEE banks from external positions (the dashed lines in Figure 1). This adjustment makes little difference to the overall funding reduction since mid-2011, but the path of this aggregate is smoother and continues to show funding reductions in 2012:Q4 for CESEE excluding Russia and Turkey. But they remain small and seem on a declining trend.

Figure 1. CESEE: Change of External Positions of BIS-reporting Banks, 2011:Q1-2012:Q4
(Percent of 2012 GDP)



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

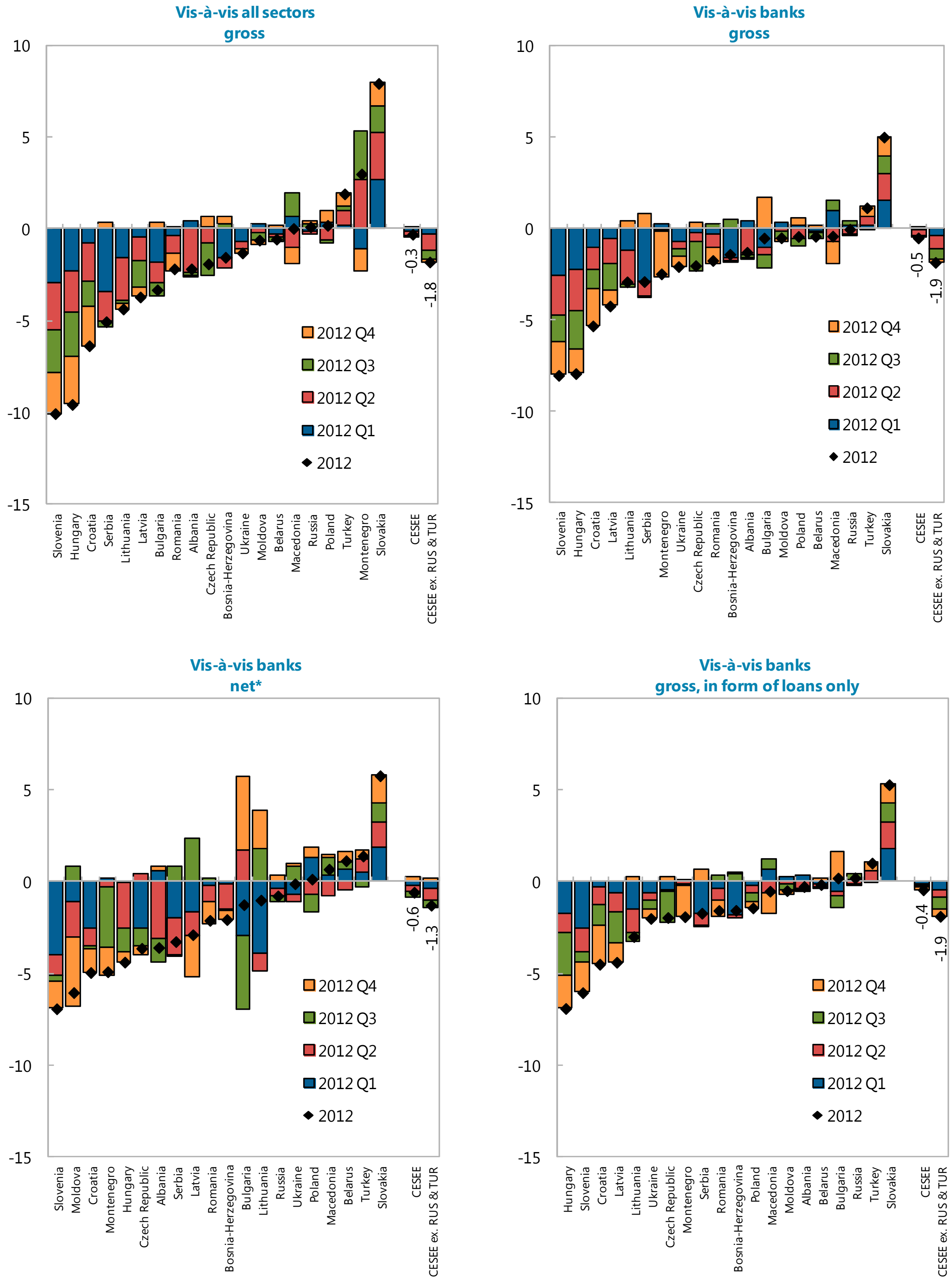
Funding reductions by western banks continued to differ strongly across CESEE countries and are still an issue in some countries (Figure 2). Overall, CESEE excluding Russia and Turkey lost funding equivalent to 1.8 percent of GDP in 2012. However, Hungary and Slovenia were much more strongly affected, with losses of around 10 percent of GDP. For them there was also little sign of funding reductions becoming smaller, reflecting the idiosyncrasies of their economic circumstances. Croatia also suffered sizable losses, although they might appear unduly large in the BIS statistics.[2] On the other hand, Turkey and Slovakia benefitted from increasing external positions throughout last year. Bosnia and Herzegovina, Bulgaria, the Czech Republic, and Serbia saw a turnaround of foreign bank funding from outflows to inflows in the fourth quarter of 2012. The overall picture of funding reduction developments is consistent across different aggregates of the BIS International Banking Statistics, although the absolute magnitudes of reductions are somewhat smaller when net positions or positions excluding bank equity are considered (the bottom panels of Figure 2).

The IMF's *International Financial Statistics* (IFS) confirm the improvement in foreign bank funding for CESEE banks. Foreign liabilities of banks in emerging Europe as reported in IFS should be the broad mirror image of the external position of BIS-reporting banks vis-à-vis banks in emerging Europe. Indeed, IFS and BIS data generally track each other fairly closely (Figure 3). Russia and Turkey have been an exception for many quarters already, with IFS data indicating less funding reductions than BIS data. This pattern is also visible on a smaller scale for the rest of the region. One possible explanation for the discrepancy is that banks in emerging Europe partly compensate the loss of funding from western banks by tapping other foreign funding sources, such as international capital markets. This would slow the decline of foreign liabilities in IFS but not in the BIS International Banking Statistics. In any event, foreign liabilities of CESEE banks no longer show a decline. For the region excluding Russia and Turkey, the decline from mid-2011 has given way to a flattening out and a slight uptick more recently. IFS data are available through January 2013 and suggest that the improvement of late 2012 continued into this year.

[2] In a recent operation, foreign banks moved non-performing loans and their financing from subsidiaries in Croatia to the parent bank level. In the BIS International Banking Statistics such an operation would technically show up as a reduction of the external position vis-à-vis Croatia.

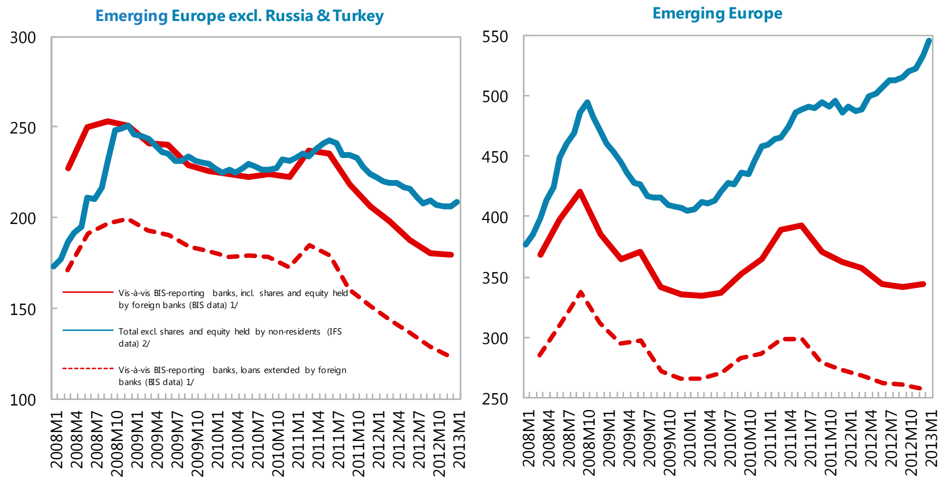
Figure 2. CESEE: External Positions of BIS-reporting Banks, 2012:Q1 - 2012:Q4

(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.

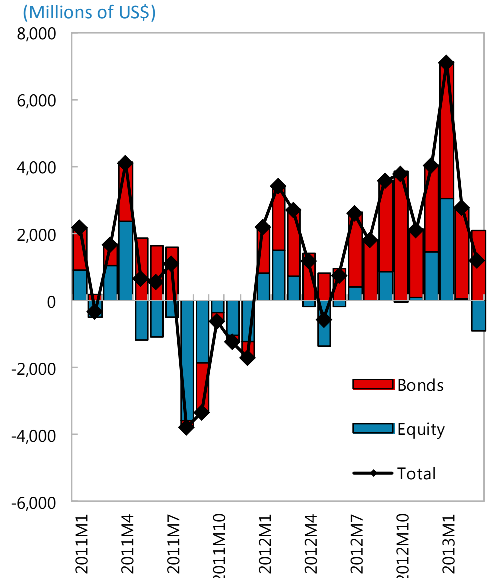
Figure 3. External Liabilities of Banks, 2008:M1-2013:M11
(Billions of US$)



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.

Buoyant financial sentiment toward emerging markets will likely continue to support western bank funding for CESEE going forward. CESEE financial markets benefit from improved sentiment toward emerging markets in general. Inflows into exchange-traded and mutual funds dedicated to CESEE were very strong toward end-2012 and remained high in the first quarter of this year (Figure 4). Bank funding and portfolio inflows do not always move in tandem, but bank flows tend to be stronger at times when portfolio flows are plentiful, everything else equal. It is hence unlikely that significant foreign bank funding reductions from CESEE could have resumed in 2013:Q1. In addition, portfolio inflows have the potential to substitute for foreign bank funding to some extent. They make it easier for large corporates and governments to raise funds in capital markets and reduce their bank funding commensurately, thereby making room for lending to SMEs and households. According to balance-of-payments data, net portfolio inflows into CESEE were small in 2011—just 1 percent of GDP owing to outflows in the second half of the year. In 2012 they recovered to 2¼ percent of GDP.

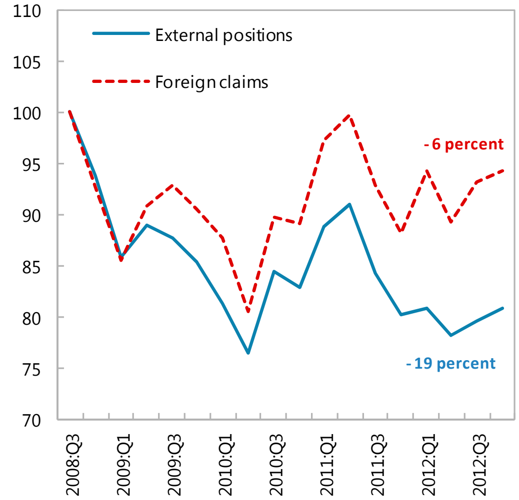
Figure 4. Emerging Europe: Flows into Dedicated ETFs and Mutual Funds, Jan. 2011 - Mar. 2013
(Millions of US$)



Source: EPFR, equity and bond country flows.

The only marginal increase of external positions of western banks despite buoyant financial market sentiment speaks to strong countervailing forces. Western banks remain under various market and regulatory pressures and uncertainties that militate against balance sheet expansion at the group level. This is also being felt in CESEE—funding for the subsidiaries there is accordingly on the tighter side and there is little appetite for rapid expansion of subsidiaries' balance sheets. A factor specific to CESEE is the legacy of the 2003-08 lending boom that left loan-to-deposit ratios high and the quality of banks' loan portfolios low. While significant adjustment has already been worked through, the process is not yet complete. To rebalance the funding of CESEE subsidiaries from parent bank sources to local sources and bring down loan-to-deposit ratios, banks have in the past effectively used the proceeds from domestic deposit growth to repay parent bank loans. As a result, western banks' exposure to CESEE (as measured by "foreign claims" in the BIS Consolidated Banking Statistics) have declined much less than funding (as measured by "external positions" in the BIS Locational Banking Statistics): 6 percent against 19 percent, in non-exchange rate adjusted terms (Figure 5). Another factor for the weak dynamics in foreign bank funding is the renewed softening of the real economies across Europe in 2012 and the associated dampening of credit demand, which reduces the need for bank funding, including from foreign banks.

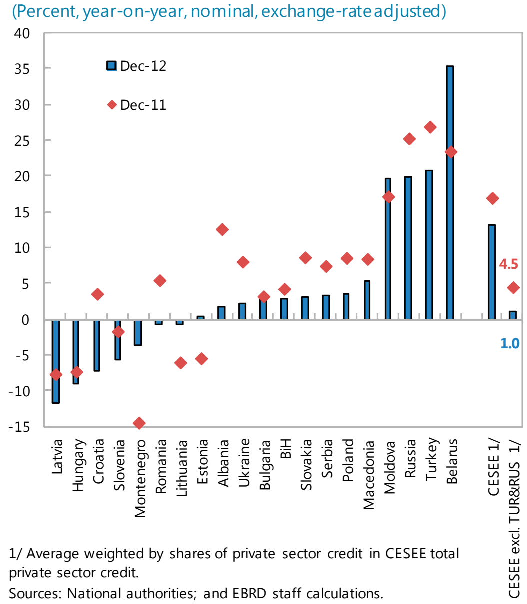
Figure 5. CESEE: External Positions and Foreign Claims, 2008:Q3 - 2012:Q4
(2008:Q3 = 100, not exchange-rate adjusted)



Source: BIS, Locational and Consolidated Banking Statistics.

The combination of weak credit demand and constraints on financing has left private sector credit growth low (Figure 6). In exchange-rate adjusted terms, private sector credit grew by just one percent nominally in CESEE excluding Russia and Turkey. This is considerably weaker than a year earlier. While the example of the Baltic countries shows that strong economic growth without credit growth is possible, there are doubts whether this can be sustained over the medium term and whether this experience is easily applicable elsewhere. Hence, even though the risk of disorderly deleveraging from CESEE appears to have been averted, the task to put in place credit conditions that can underpin a strong recovery and convergence with the west remains.

Figure 6. CESEE: Growth of Credit to Households and Enterprises
(Percent, year-on-year, nominal, exchange-rate adjusted)

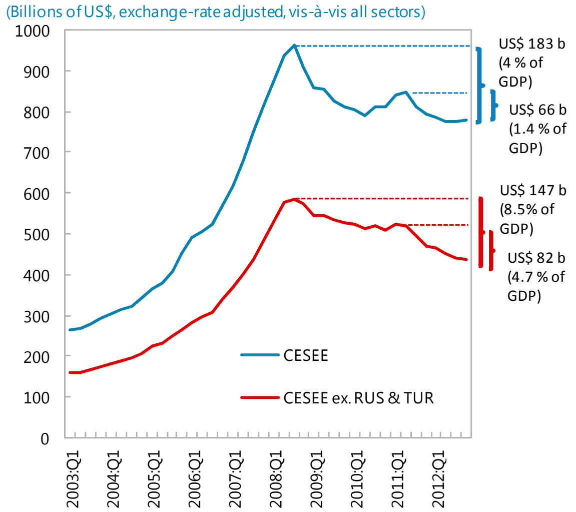


1/ Average weighted by shares of private sector credit in CESEE total private sector credit.
Sources: National authorities; and EBRD staff calculations.

Since the onset of the 2008/09 crisis, western banks' funding reductions have been substantial but by no means have they unwound all of the boom-time increase, raising the question how much more may still be in the pipeline. Since 2008:Q3 the external position of BIS-reporting banks has declined by some 20 percent for the CESEE region as a whole and by about 25 percent for CESEE excluding Russia and Turkey (Figure 7). This compares to 13 percent for all countries over the same period. In the euro area reduction of cross-border funding was arguably even larger than in CESEE excluding Russia and Turkey—at 15 percent it was smaller as a percent change but substantially larger as a share of GDP with 22 percent of GDP against the 8½ percent of GDP sustained in CESEE excluding Russia and Turkey. That said, in the euro area banks could partly offset funding losses through recourse to ECB funding, an option not available to CESEE banks. In any event, the outstanding stock of foreign bank funding for CESEE remains substantial and much higher than at the outset of the boom period in 2003. The correction of often very high loan-to-deposit ratios on the eve of the 2008/09 crisis has unwound by about half (Figure 8, panel 1). For the region on average, the ratio now stands at around 120 percent, compared to roughly 140 percent at the peak of the boom and just under 100 percent at the outset of the boom period. Cross-country differences remain substantial though (Figure 8, panel 2). The correction in loan-to-deposit ratios is larger than the one in foreign bank funding because of substantial domestic deposit growth, which helps bring down the former but does not affect the latter. With this substantial correction already done, the region is now less vulnerable. However, given the high degree of uncertainty about what level of foreign funding and loan-to-deposit ratios the cross-border banks active in the region will feel comfortable with in the medium-term, further substantial adjustment cannot be ruled out and calls for continued vigilance.

Figure 7. CESEE: External Position of BIS-reporting Banks, 2003:Q1-2012:Q4

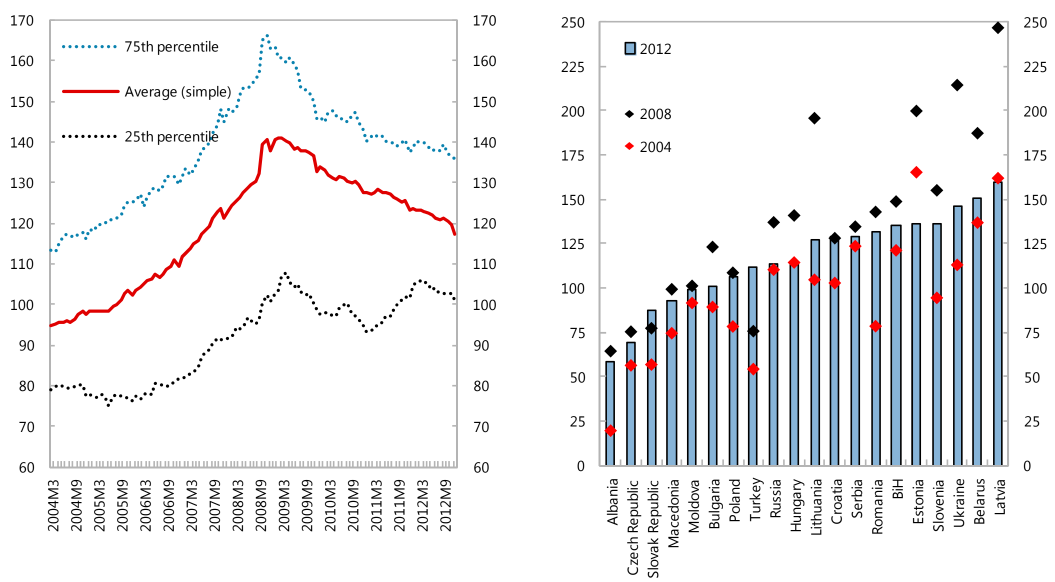
(Billions of US$, exchange-rate adjusted, vis-à-vis all sectors)



Source: BIS, Locational Banking Statistics.

Figure 8. CESEE: Domestic Loan to Domestic Deposit Ratio, 2004:M4 - 2012:M12*

(Percent)



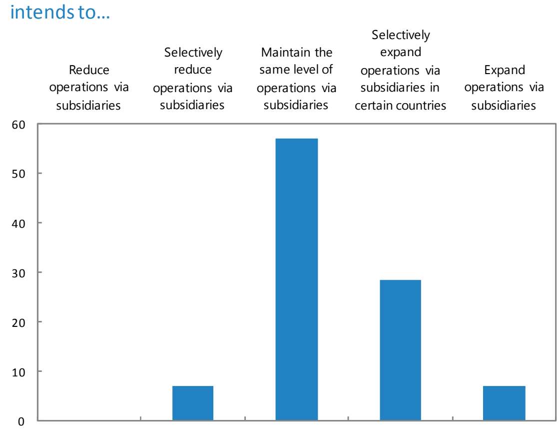
Sources: IMF, Monetary and Financial Statistics; IMF, International Financial Statistics; and IMF staff calculations.
* Excludes loans and deposits from other financial institutions. Derived from Standardized Reporting Forms. May differ from "headline" ratios reported by national authorities. In the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

The EIB's CESEE Bank Lending Survey: second run

To shed more light on the outlook for credit growth in CESEE and the different factors driving it, the EIB runs a survey of banks active in the region for the Vienna Initiative. The survey specifically targets the cross-border banking groups at both the parent and at the subsidiary level. An effort is made to also include locally-controlled banks on a stand-alone basis when they have sizable market share. In this second run during March-April 2013, the survey covered 14 cross-border banking groups and 73 subsidiaries and locally-controlled banks, corresponding to over 50 percent of the relevant banking systems by assets. Questions focus on parents' and subsidiaries' own strategies, as well as intra-group linkages. The survey has backward and forward looking components. As such, it is well placed to help disentangle the relevance of the different domestic and international factors influencing credit growth from the supply and demand sides. It also gives a first-hand glimpse into what may lie in store for credit growth in CESEE in the period ahead.

As their restructuring process continues at the group level, the cross-border banks remain generally committed to CESEE, but reiterate that they have become more selective in their regional strategies and more discriminating among countries since the 2008/09 crisis (Figure 9). As a result of the global financial crisis, cross-border banking groups active in CESEE have engaged and expect to continue to engage in various strategic operations with the aim of improving their overall capitalization. Raising capital on the market and selling assets are among the most frequently mentioned options. At the same time they are deleveraging at the global level, with more than 70 percent of the sample signaling a decrease in the loan-to-deposit ratio over the next six months, despite a reported improvement in access to funding in global markets. All groups profess to the key role of CESEE in their overall business. While the profitability of the CESEE business operations has deteriorated somewhat in the past six months, it is expected to recover according to the survey responses. As had already transpired in the previous run of the survey (undertaken in October 2012), cross-border banking groups have become much more selective in terms of their geographical presence: a full 30 percent of subsidiaries are considered to be too weakly positioned for a proper exploitation of local market opportunities or to operate in markets with now insufficient appeal. Nevertheless, currently only seven percent see a selective reduction of their operations as a way out of this situation. Still, opportunistic M&A activities, assets swaps, and market consolidation can be expected going forward.

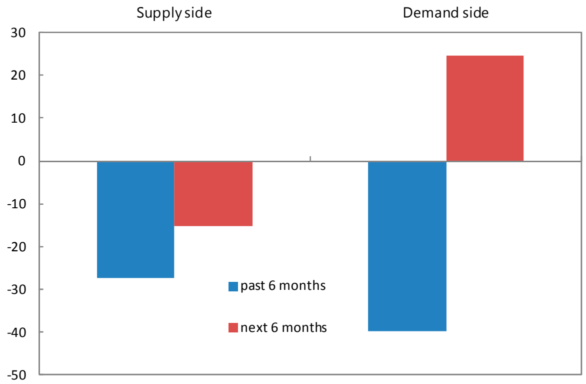
Figure 9. Group-level Longer-term Strategies
Looking at operations via subsidiaries in CESEE, the group intends to…



Source: EIB, CESEE Bank Lending Survey.

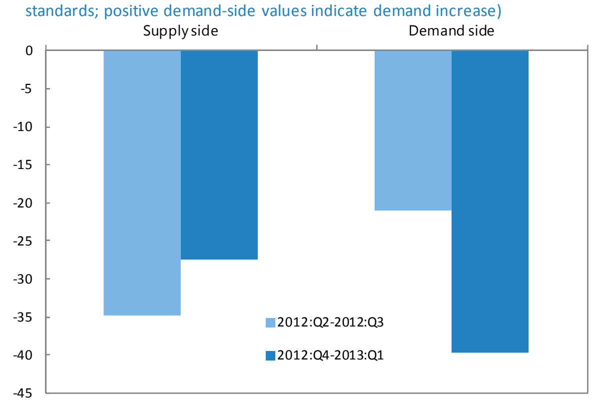
CESEE subsidiaries report that both demand and supply factors are behind sluggish credit growth, and emphasize the detrimental role played by the NPL stock. CESEE subsidiaries have generally continued to experience soft credit demand and tight credit supply conditions (Figures 10 and 11). On the demand side, consumer confidence, housing market prospects, M&A activities, fixed investments dynamics, and housing-related expenditure were the main negatives in the past six months, swamping the positive effects from debt restructuring, inventories, and working capital. Credit supply is still reported as contributing negatively, although there was a mild easing compared to the results of the previous run of the survey. Both international and domestic factors contribute to tight supply. The global market outlook, group funding conditions, group capital constraints, and group-wide NPL levels are all mentioned as having had a clear negative effect on credit conditions over the past six months. On top of those, local market outlook, local regulation, local bank capital constraints, and NPLs at the subsidiary level were the key constraining factors domestically. Notably, access to funding for subsidiaries had apparently only a mildly negative impact on credit supply—and less so than in the previous run of the survey. As opposed to foreign funding, and overall funding, domestic funding was even described as having had a mild easing effect on credit supply. Taken together, these responses sit well with the notion that banking groups use local deposit growth in CESEE to compensate for declining parent bank funding as they rebalance subsidiaries' funding sources and remain generally cautious with new lending in the wake of the 2008/09 crisis.

Figure 10a. Developments of Credit Conditions - comparing past developments and expectations
(Net percentage; negative supply-side values indicate tightening credit standards; positive demand-side values indicate demand increase)



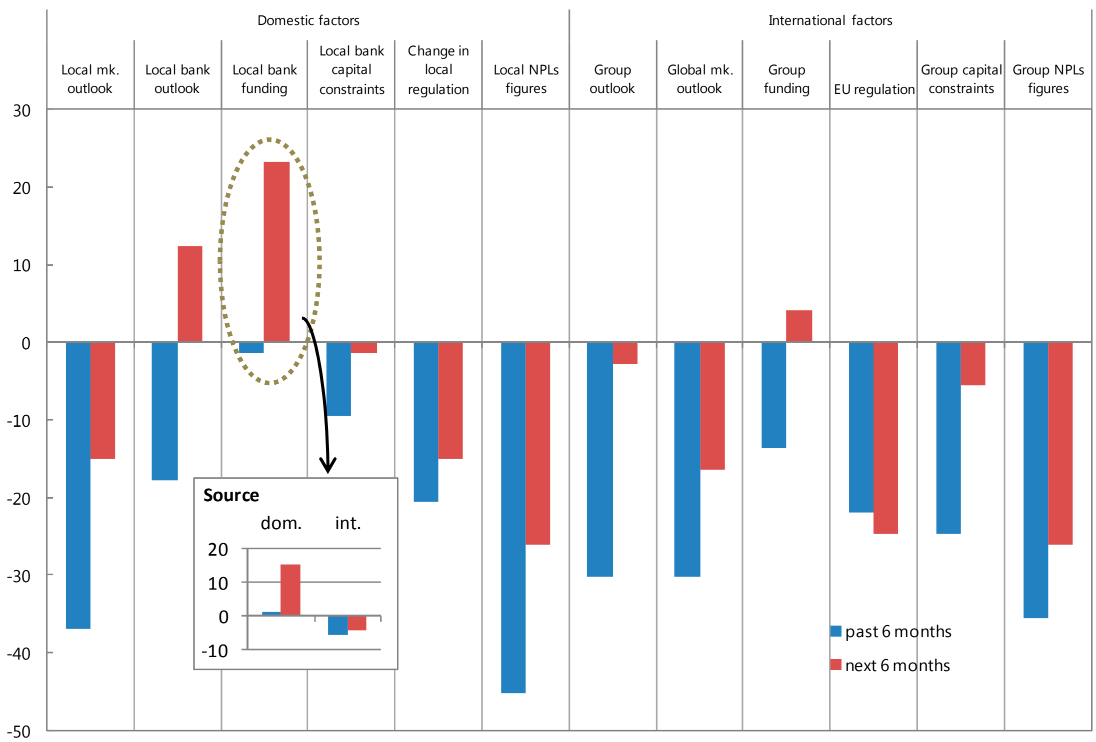
Source: EIB, CESEE Bank Lending Survey.

Figure 10b. Developments of Credit Conditions - comparing reported developments over time
(Net percentage; negative supply-side values indicate tightening credit standards; positive demand-side values indicate demand increase)



Source: EIB, CESEE Bank Lending Survey.

Figure 12. Domestic and International Factors Affecting the Supply of Credit
(Net percentage; negative values indicate tightening of credit conditions)

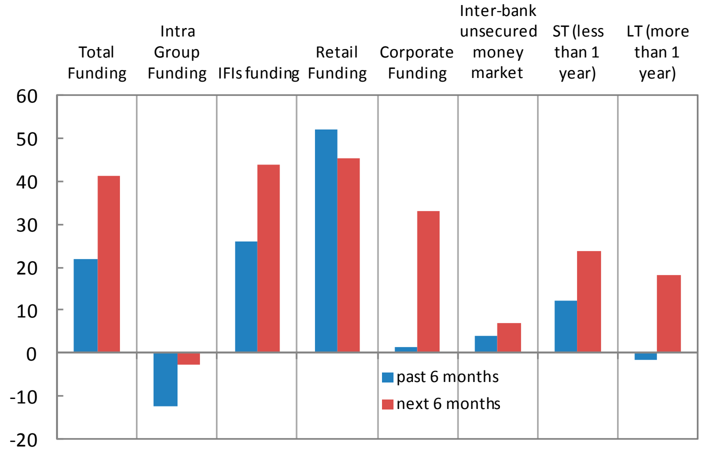


Source: EIB, CESEE Bank Lending Survey.

Going forward, banks expect a pickup of credit demand, but still tight domestic and international supply conditions (Figure 12). On the demand side, subsidiaries generally expect some rebound in demand for credit across different products and maturities over the next six months. However, it should be noted that similarly positive expectations regarding demand conditions expressed in the previous run of the survey did not materialize, perhaps because of disappointment with the speed of economic recovery in the euro area. The supply conditions are still expected to weigh on credit growth in the next six months, albeit less so than in the past six months. Amongst the negative supply-side factors, NPLs at both the group and subsidiary levels remain the most pertinent constraining factors, followed by EU regulation. CESEE subsidiaries expect funding constraints to relax further in absolute terms, reflecting good access to domestic and IFIs funding and less restrictive conditions for intra-group funding.

Figure 12. Access to Funding by CESEE Subsidiaries

(Net percentage; positive values indicate improvement)



Source: EIB, CESEE Bank Lending Survey.

Overall the survey points to two important challenges for the future: dealing with high NPLs and dealing with a new funding paradigm for CESEE subsidiaries. The first argues for swift NPL resolution, certainly by removing undue obstacles that still beset the frameworks in many countries of the region but also by a more concerted effort to get it done.[3] Meeting the second challenge requires being judicious in the transition to less parent bank and more local funding and ultimately opening up supplementary channels for financing productive investment to support CESEE convergence with living standards in the most advanced economies of Europe.[4]

[3] The report of a Vienna Initiative working group on the topic provides detailed analysis and recommendations (http://vienna-initiative.com/wp-content/uploads/2012/08/Working-Group-on-NPLs-in-Central-Eastern-and-Southeastern-Europe.pdf). Multiple efforts by the IFIs to support CESEE country authorities in resolving NPLs are underway.

[4] A recent Regional Economic Issues report by the IMF's European Department discusses options for financing CESEE's future growth as its banking systems evolve (http://www.imf.org/external/pubs/ft/reo/2013/eur/eng/ereo0413.htm).