# Deleveraging Outlook and Structural Change in Banking Systems

## Emerging Europe (EE) and Central Asia (CA)


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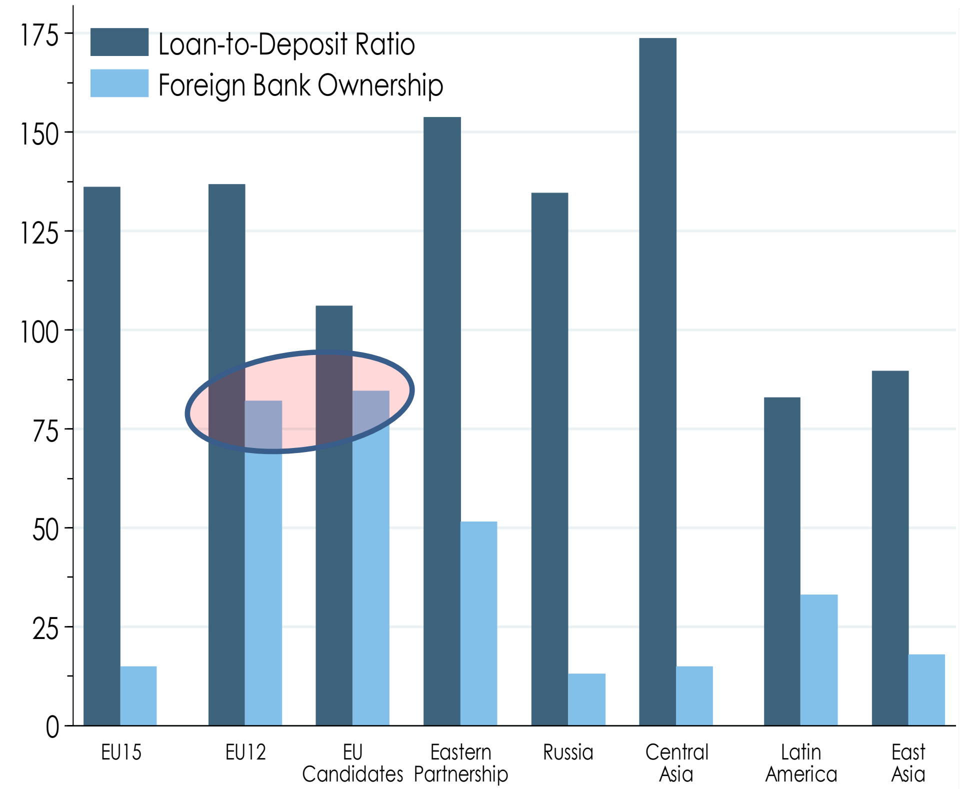
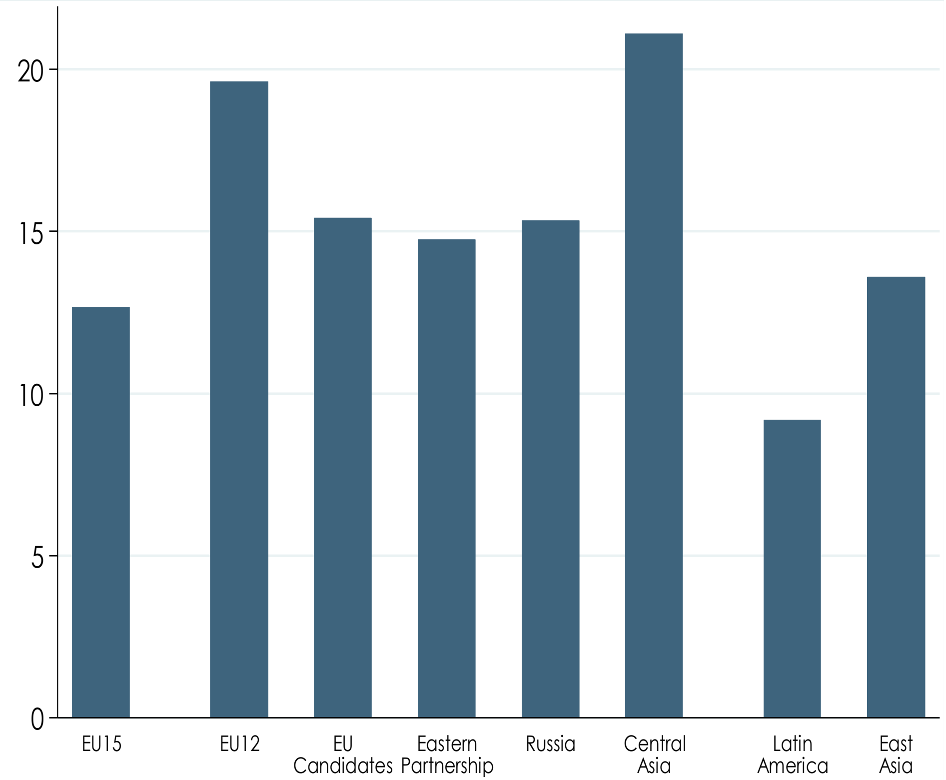
# Pre-Crisis Banking Sector Characteristics

- The pre-crisis banking model relied on:
  - a large foreign bank presence (EU12 and EU candidate) and
  - a high dependence on foreign funding (both in EE and CA)
- LAC relied on a more domestically funded model even in countries with large foreign ownership in the banking system
- EE and CA were an important source of profits for parent banks

**Loan-to-deposit ratios and foreign bank ownership as a percent of banking system assets (2008, %, median)**

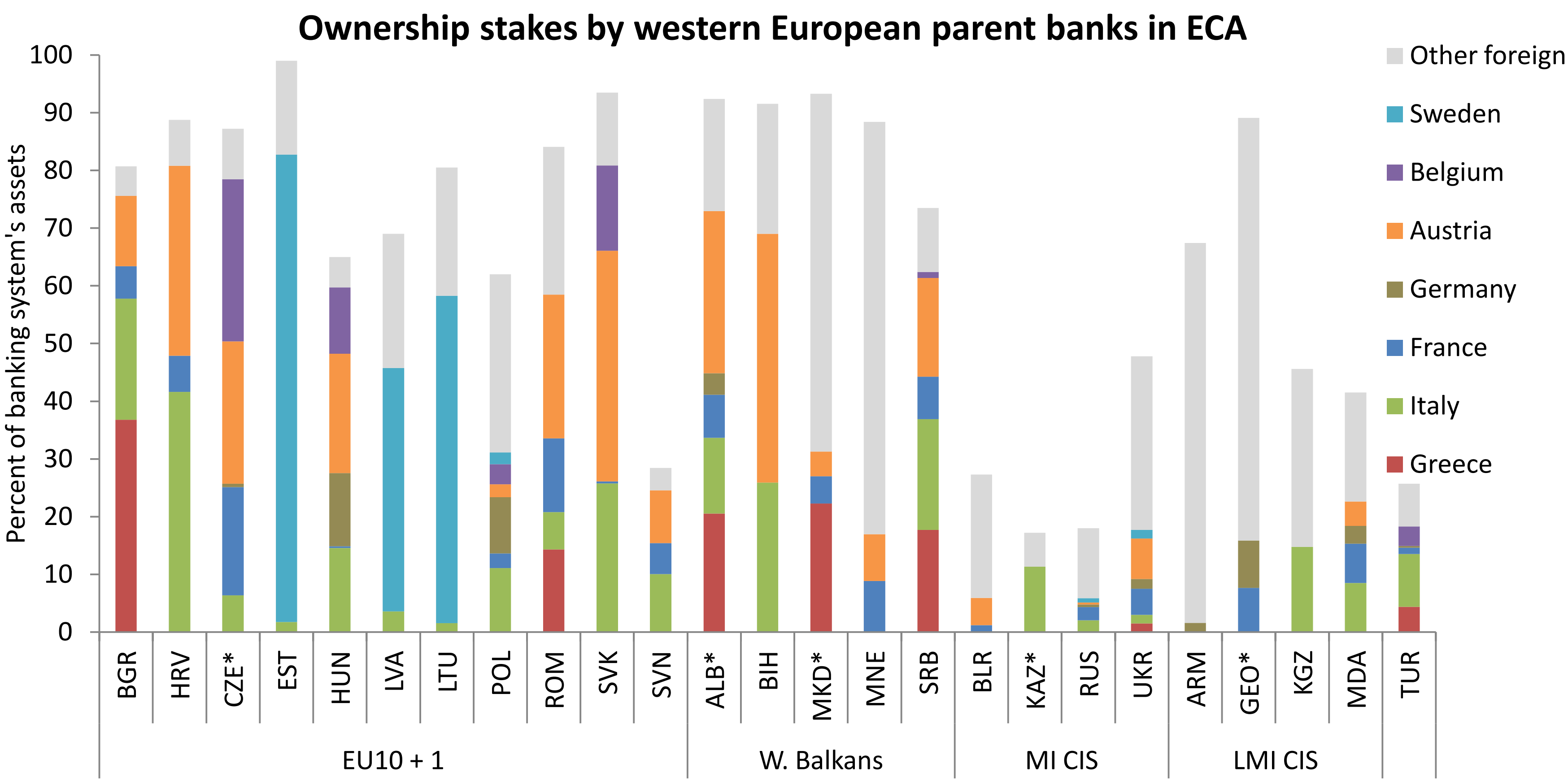



**Return on equity (2008, %, median)**



# Foreign Bank Ownership

- Italian and Austrian banks are important throughout the region
- Swedish banks are important in the Baltic countries
- Greek banks are important in the Balkan countries



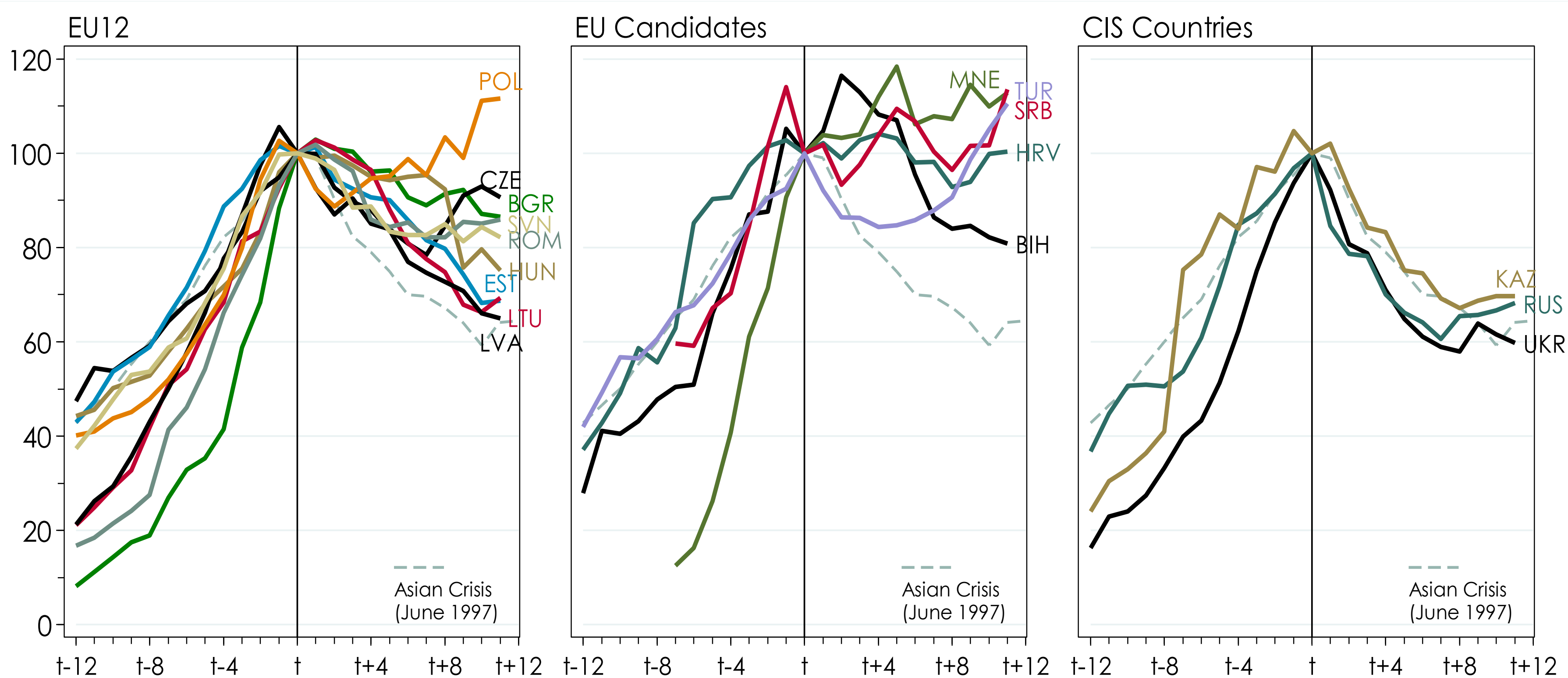

Sources: Bankscope, Bankers Almanac, Central Banks, Banks' Annual Reports, European Bank for Restructuring and Development, the World Bank.
Note: Data only include banks with at least 50% ownership in the respective subsidiaries
*"Other foreign" for these countries was calculated with 2009 data on asset share of foreign-owned banks.

# So Far An Orderly Deleveraging in EE—less so in CA

- Foreign ownership is a source of funding stability
  - wholesale funding de-linked from ownership—volatile and rapidly declining, as was the case during the East Asia crisis (UKR)
  - funding linked to ownership structures—a more gradual reversal compared to the experience of East Asia in late 1990s and Central Asia in late 2000s

**External Position of BIS reporting banks on Emerging Europe and Central Asia countries**

(t=100 in September 2008; quarterly data until June 2011) 1/




Note: For East Asian countries (dashed line; five countries: Indonesia, Korea, Malaysia, Philippines, and Thailand) t=100 is June 1997. Index constructed based on exchange rate adjusted changes. BIS locational statistics; assets as described in Table 6A.

# Western Europe’s Economic Problems are Creating Deleveraging Pressures in Banks


**Sources of banking sector strains are:**

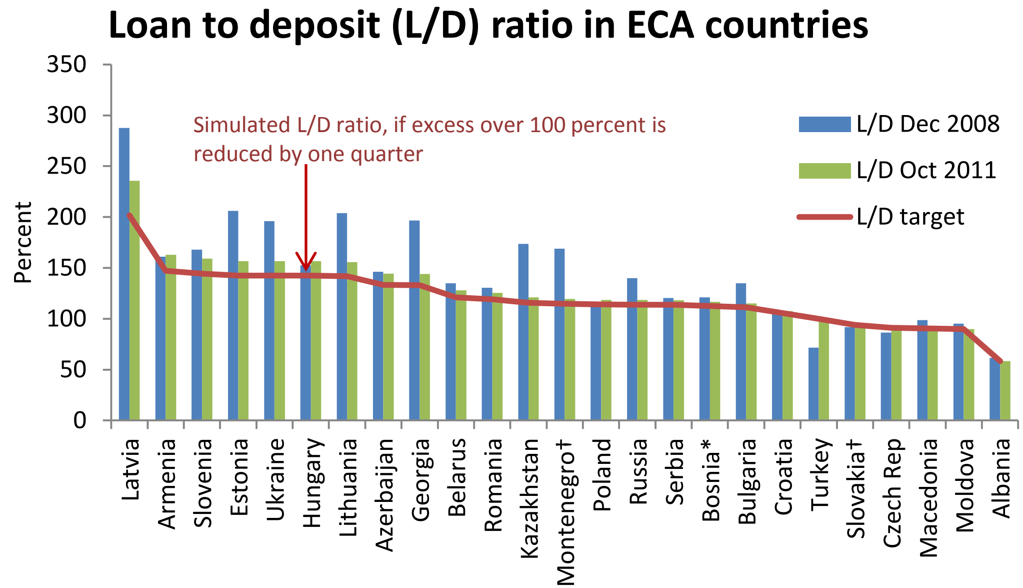
- **Markets pressures:** Investor concerns of European bank soundness have
  - Increased funding costs for European banks
  - closed term funding markets for banks
  - made issuance of fresh capital less attractive as bank equity valuations have declined sharply during 2011
- **Regulatory pressures:** EBA and national authorities’ announced increases in capital requirements could add to deleveraging pressures in emerging Europe given market conditions and uncertainties in Europe

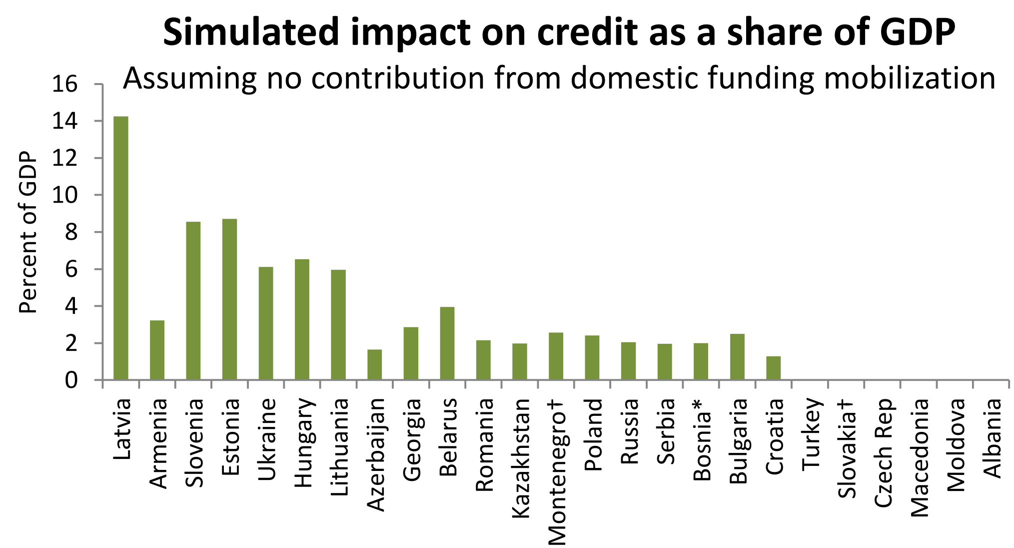
# Spillovers from Western Europe to Europe and Central Asia (ECA)—Numerous Channels

- **Bank solvency:** If parent banks are materially weakened it would affect (directly) ECA banks
- **Bank liquidity:**
  - **Parent funding:** may be under pressure for a sustained period as parent banks are facing their own funding problems
  - **Wholesale funding:** Relying on wholesale funding is increasingly perceived as risky and supply is likely to be less abundant in the future
- **Cross border lending:** ECA enterprises borrowing directly from Western Europe may experience difficulties in rolling over such funds
- **Depositor confidence:** subsidiaries may experience (indirectly) loss of confidence and thus deposit withdrawals by residents and non-residents
- **Firesale of assets:** in exceptional cases, such as nationalized parent banks or unprofitable subsidiaries, parent banks may  divest EE and CA presence
- **Weak economic activity**: lower domestic and global economic activity will raise NPLs and negatively impact trade and SME financing
- **Currency movements**: capital outflows and declining exports could trigger depreciations, which would increase credit risk in foreign currency loans

# Trend towards Deposit Funding may Persist as a Structural Change with material impact on some EE Countries

- A simulated reduction in L/D ratios by ¼ of the difference to 100% leads to a decline in credit-to-GDP of about 2-5% of GDP in several, but not all, EE countries
- The bank business model of externally funded credit growth has been changing since 2008…
- …towards a more domestic deposit funding, and this is likely to continue as (i) parents banks price subsidiary funding risk higher, and (ii) home supervisors see parent funding as riskier than in the pre-crisis
- The adjustment must be gradual to avoid disruptive impacts on financial sectors and economic growth




Source: IFS. Notes: *As of September 2011, †As of August 2011.

# Conclusions

- Spillover channels, as noted in slide 6, are numerous
- Fostering an orderly deleveraging process is a policy priority
  - EE and CA subsidiaries remain core strategic and profitable assets in the long-run if Europe's uncertainties are addressed
  - home and host authorities of large internationally active banks should coordinate on measures to foster an orderly deleveraging
    - For example, Eurozone banks seeking to sell or withdraw funds from branches/subsidiaries abroad should communicate with both home and host regulators regarding their plans
  - supervisors could play an important role by encouraging parent banks to (i) raise in capital levels (not ratios) and (ii) maintain credit lines
- Over the coming months close home-host coordination is imperative
- Authorities should monitor the functioning of key markets (e.g., FX swap markets, term-funding wholesale markets)
- Successful entry of new banks depends heavily on the expertise of new banks to manage the unique risks that characterize emerging markets