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ECFIN Economic Brief

Potential risks for home and host countries stemming from activities of multinational banks in the CEE10 region

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Summary

Ongoing financial market turbulences within the euro area are likely to have a negative impact on the CEE10 region(*) as a whole, which should, nevertheless, vary considerably across countries. Likely spill-overs into the real economy will affect the entire CEE10 region, as it was the case in 2008-09. However, the impact on banking sector performance should again vary markedly. Countries with banking sectors which largely rely on the domestic funding base (low loan-to-deposit ratios) and also have relatively sound loan portfolios (i.e. low NPL ratios) should be hit less severely. Meanwhile, parent banks exposed to the most overleveraged banking sectors with poor (and sometime still deteriorating) asset quality appear to face the highest risks. Banks operating in the three euro-area CEE countries (i.e. Slovenia, Slovakia and Estonia) can directly rely on the Eurosystem refinancing operations, which should largely facilitate their funding situation and costs. Given the risk of negative cross-border feedback loops, the further strengthening of cooperation among home and host country banking sector supervisors appears warranted.

(*) Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

Introduction

The intensification of the financial market crisis in the euro area negatively affected market sentiment in the CEE10 region in recent months. As a result, concerns have emerged, as was the case during the 2008-09 global financial crisis that the exposure to the CEE10 region may be in itself a source of substantial risks, in particular for the home countries of the parent banks operating in this region. At the same time, there is a fear that the deleveraging process in the core euro-area banking sector will negatively impact credit supply and thus overall economic developments in the CEE10 countries. This would in turn also have a negative impact on the asset quality and consequently on profitability of parent banks operating in this region. This paper, therefore, aims at analysing whether the exposure to the CEE10 is a risk for parent banks. Simultaneously, risks for the CEE10 countries implied by the strong presence of foreign-owned banks, as well as possible feedback loops, are discussed.

The paper is structured in the following way. First, the impact of the 2008-09 global financial crisis on the CEE10 countries is summarised. Second, the current situation in local financial markets and in the banking sector is analysed. Third, potential risks faced by the CEE10 as well as by home countries of the parent banks operating in the region are discussed. Some conclusions are drawn in the last section.

1. Impact of the 2008-09 global financial crisis on the CEE10 countries

Balance of payments (BoP)

As far as the aggregated CEE10 balance of payments is concerned, the current account balance was the main negative driver of international reserve evolution throughout the period 2008-10. By contrast, partly due to the official international financial assistance to some countries, "other investment" flows (notably loans) accounted for most of the increase in CEE10 international reserves. In addition, capital accounts and direct investment flows remained positive during the entire period. The sum of portfolio flows throughout 2008-10 was also positive, but there were net portfolio investment outflows in H2-2008. The cumulative contribution of financial derivatives was marginally negative.

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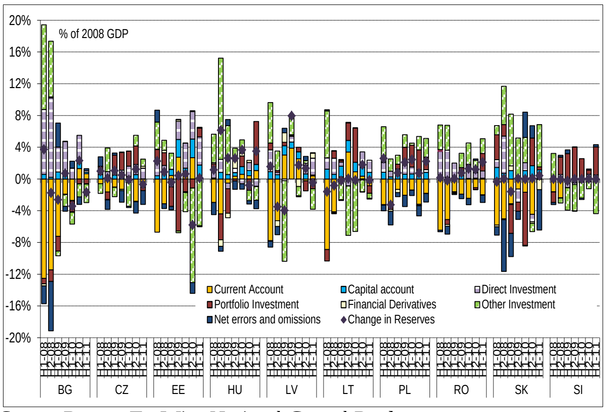
However, in the CEE10 countries experiencing substantial foreign funding outflows, current account deficits decreased substantially or turned into surpluses during the crisis period. A reversal of foreign funding inflows induced a contraction in domestic demand and thus led to a turnaround in current account balances from deficits to surpluses in the Baltics in H1-2009, in Hungary in H2-2009 and in Bulgaria in H2-2010. Although still in deficit, the current account balance also narrowed substantially in Romania and to a lesser extent in Slovenia. In contrast, the Czech Republic, Poland and Slovakia recorded rather persistent current account deficits during most of the crisis period. The composition of net foreign financing outflows differed somewhat across the CEE10 countries. Portfolio investment was the main driver of financial outflows from Hungary and Slovakia, other investment accounted for most of the outflows from Latvia and Lithuania, whereas both portfolio and other investment outflows were relatively substantial in Bulgaria and Estonia. Financial derivatives also played a significantly negative role at the peak of the financial crisis in Latvia, Hungary and to a lesser degree in Poland. Finally, other investment inflows into Romania remained positive only due to substantial official international BoP assistance.

Graph 1: Composition of BoP flows between H1-2008 and H1-2011

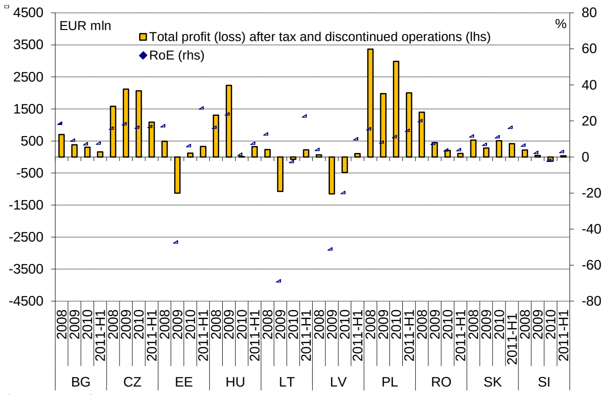


Source: Reuters EcoWin, National Central Banks

Banking sector profitability

Even when the crisis period 2008-2010 is considered, the overall results of the CEE10 banking sector appear better than in the rest of the EU (EU17). The (weighted) average RoE in the CEE10 banking sector dropped from some 14% in 2008 to around 5% in 2009, before recovering again to almost 7% in 2010 (and then to above 10% in H1-2011). It has thus continued to over-perform compared to the rest of the EU, where the (weighted) RoE reached just around 1% in 2009 and 4% in 2010 (5% in H1-2011), after bottoming out at some -2% in 2008. As a result, cumulative after-tax profits of the CEE10 banking sector amounted to almost EUR 20bn in 2008-10 and thus reached roughly 30% of the EU17 banking sector profits (some EUR 66bn) despite CEE10 GDP representing just some 8% of the EU17 GDP in 2010. There were, however, important cross-country differences within the region. After-tax profits remained positive in all CEE10 countries apart from the Baltics, where cumulative 2008-10 losses amounted to about EUR 1.5bn in Latvia, EUR 1bn in Lithuania and EUR 0.5bn in Estonia, reflecting large recessions resulting from preceding excessive credit expansion. Although these losses are substantial when compared to the local banking sectors' equity (RoE of around -50% in Estonia and Latvia and -70% in Lithuania in 2009), these magnitudes appear manageable in terms of their impact on the consolidated capital position of banking groups active in the region.

Graph 2: Banking sector profitability from 2008 until H1-2011

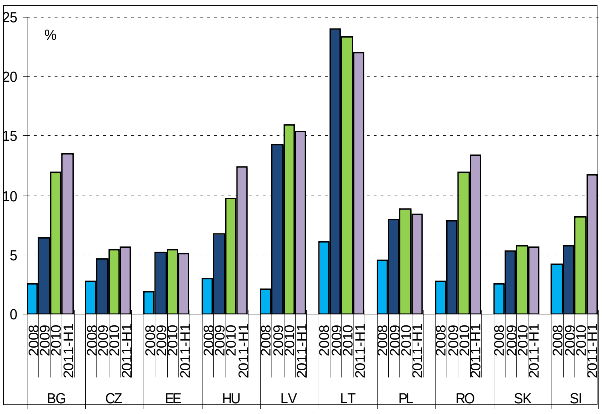


Source: ECB

Quality of bank portfolio and credit developments

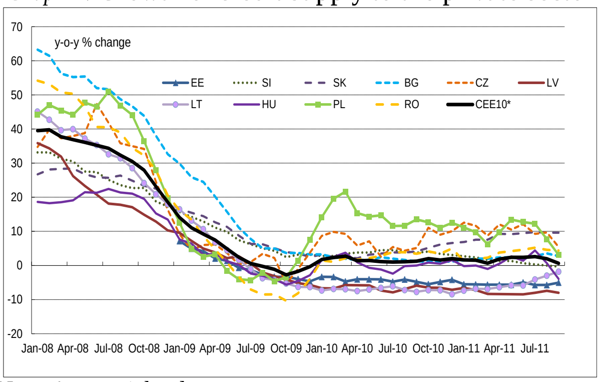
Against the backdrop of the rapid expansion in lending to the private sector in the pre-crisis period, asset quality has deteriorated in all CEE10 banking sectors, albeit at different speed. Non-performing loans have increased more significantly in Bulgaria, Hungary, Latvia, Lithuania and Romania between 2008 and 2010 and at a slower pace in the other CEE10 countries. The deterioration in asset quality seems to have peaked in Estonia, Latvia, Lithuania, Poland and Slovakia, but not yet in the rest of the CEE10 region. Given the slowing pace of economic recovery and very modest or even negative credit growth rates in most countries, non-performing loans may prove to be sticky going forward and thus continue to put a strain on solvency ratios.

Graph 3: Share of non-performing loans in total loans



Source: IMF

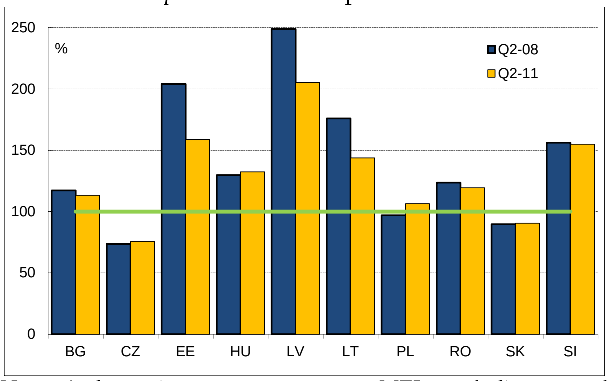
Graph 4: Growth of credit supply to the private sector



Note: * un-weighted average
Source: ECB and own calculations

Despite a significant narrowing of the gap in recent years, the stock of loans to the non-financial private sector is still not fully covered by its deposit base in most of the CEE10 banking sectors. Negative credit growth and higher saving rates led to a substantial decline in loan-to-deposit ratios (LTDs) in the Baltic countries between Q2-2008 and Q2-2011. Nevertheless, in Q2-2011 the LTD still exceeded 200% in Latvia and was close to 150% in Estonia, Lithuania and Slovenia (where only a slight downward adjustment materialised in recent years). LTDs also decreased somewhat in Bulgaria and Romania to below 115% and 120% respectively. On the other hand, bank loans are more than fully covered by deposits in the Czech Republic, Slovakia and to an almost full extent also in Poland, where LTDs have increased somewhat in recent years. The excess of lending over deposits in the CEE10 region is largely funded by the parent banks, which are mainly based in the euro area and are currently faced with the challenge of ensuring sufficient capital buffers under the recapitalisation plan agreed by the European Council in October 2011.

Graph 5: Loan-to-deposit ratios*



Note: * domestic counterpart – non-MFIs excluding central government sector
Source: ECB and own calculations

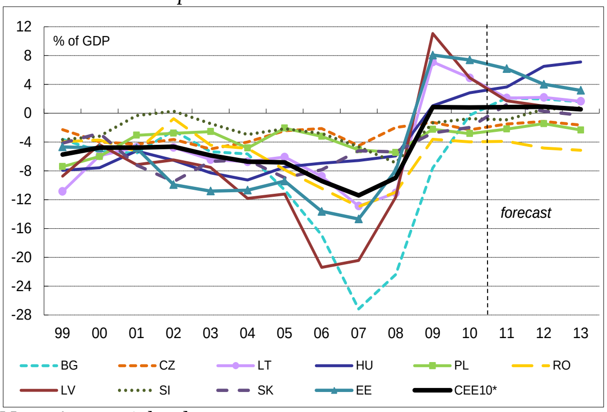
The expansion in foreign currency-denominated credit to the private sector spiked in the pre-crisis period, but slowed significantly during the global downturn. The FX share in total lending in the CEE10 countries has broadly stabilised in 2010-11 amid generally weak credit activity across the region. Contrary to the pre-crisis developments, commercial banks have largely stopped channelling foreign capital inflows to most of the non-euro-area CEE10 economies – though a major deleveraging from the region was prevented by the exposure commitments under the European Bank Coordination "Vienna" Initiative (EBCI). Nonetheless, there was a significant differentiation in terms of FX lending across the region. Some countries (such as Romania and Lithuania) saw further expansion in FX lending during the crisis (though rather 'domestic' FX liquidity was used for credit expansion), whereas other countries (i.e. Poland, Hungary) implemented strict prudential rules to curb FX lending. Some countries (e.g. the Czech Republic) did not need foreign capital inflows to boost bank lending due to a large domestic deposit base, as reflected in relatively low LTD ratios.

2. Current position of the CEE10 countries in terms of dependence on foreign funding, local financial market situation and soundness indicators of the banking sector

Balance of payments position

Given the correction of external imbalances during the period 2008-09 in the most vulnerable CEE10 countries, the impact of a sudden stop in foreign capital inflows on economic activity in the region should now be smaller. According to our Autumn 2011 forecast, the (un-weighted) average annual external balance of the CEE10 is expected to remain in small surplus over the whole forecast horizon with only the Czech Republic, Poland and Romania recording persistent external deficits. Albeit reduced, there still remains a considerable variation among the CEE10 countries, with Hungary forecasted to record an external surplus of some 7% of GDP in 2013 amid continued rapid parent bank deleveraging. Nevertheless, economic activity in the region (and investment levels in particular) seems currently less dependent on foreign funding inflows than in mid-2008.

Graph 6: Net external balance

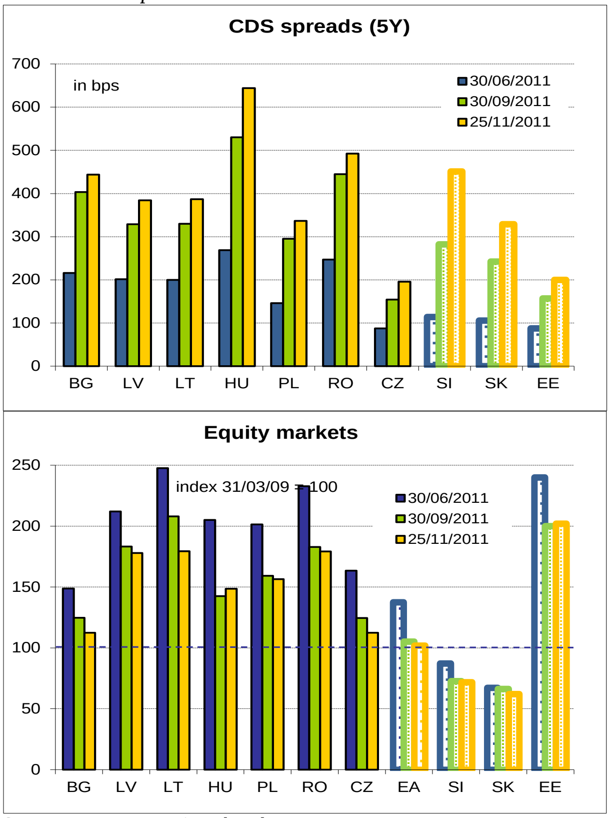


Note: * un-weighted average
Source: Commission services Autumn 2011 forecast

Financial market situation

The global financial market turbulences are weighing heavily on CEE10 region – including those in the euro area. Nonetheless, the markets continue to differentiate among the NMS with respect to macro and financial resilience, penalising rather the countries suffering from major imbalances or policy weaknesses. In particular, Hungary and Slovenia, where adoption of necessary economic policy reforms appears most uncertain, saw a steep rise in credit default swap spreads and in long-term interest rates on sovereign debt this autumn. The CEE10 floating currencies lost much ground against the euro since summer 2011, particularly the Hungarian forint and the Polish zloty. Regional equity markets sharply dropped in line with their EU-15 peers in the second half of 2011 amid fears of an abrupt deleveraging in the region, though they remain above the levels seen at the market trough in March 2009.

Graph 7: Financial market indicators

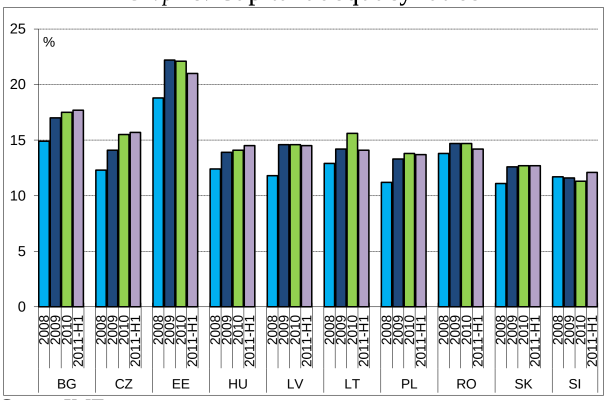


Source: Reuters EcoWin, Bloomberg

Banking sector capitalisation

In spite of the sizeable deterioration in asset quality, the banks operating in the CEE10 region have maintained reassuring capital buffers. The capitalisation of banking sectors has improved in all CEE10 countries since 2008. The capital adequacy ratios of the CEE10 banking sectors ranged between 12% and 21% in the first half of 2011, with Estonia registering the highest solvency ratio and Slovenia the lowest. As the large majority of the banks operating in the CEE region are foreign-owned, they have benefited from the capital support provided by their parent banks throughout the downturn period. Given the high percentage of Tier 1 capital in the overall solvency ratios of the CEE10 banking sectors, banks appear to still retain some loss absorbing capacities to face further pressures on asset quality. This is especially the case in the Czech Republic, Estonia and Slovakia, which have experienced a more moderate increase in impaired assets since 2008.

Graph 8: Capital adequacy ratios

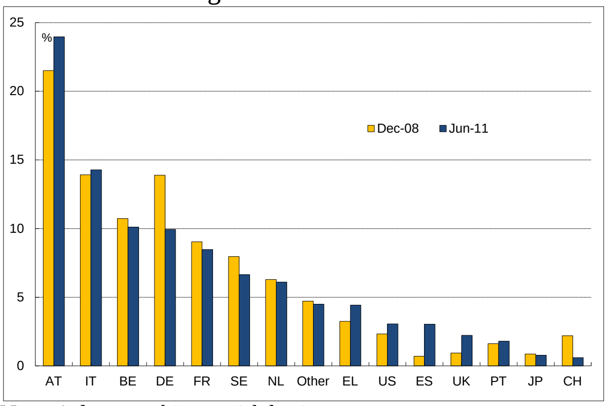


Source: IMF

Relative exposure of home countries

Consolidated foreign claims of BIS reporting banks on the CEE-10 countries decreased between Q2-2008 and Q4-2010, but went up in the first half of 2011. Within the euro area, banking sectors in Austria, Italy, Belgium, Germany and France have the largest exposures to the CEE10 region. The BIS data show a different behaviour of the banking groups from these countries towards the CEE10 region since end-2008. Whereas Austrian and Italian banks have increased their exposure to the region (i.e. both in absolute and relative terms) having fulfilled their commitments in the framework of the European Bank Co-ordination "Vienna" Initiative, Belgian, German and French banks have reduced their exposure to these countries. Swedish banking groups, which are important players in the banking sectors of the Baltic countries, have reduced their presence in these countries since 2008. Greek banks, which have also participated in the EBCI, have increased their exposure to the CEE10 in the period under consideration.

Graph 9: Consolidated claims of BIS reporting banks as % of all foreign banks' claims on the CEE10*

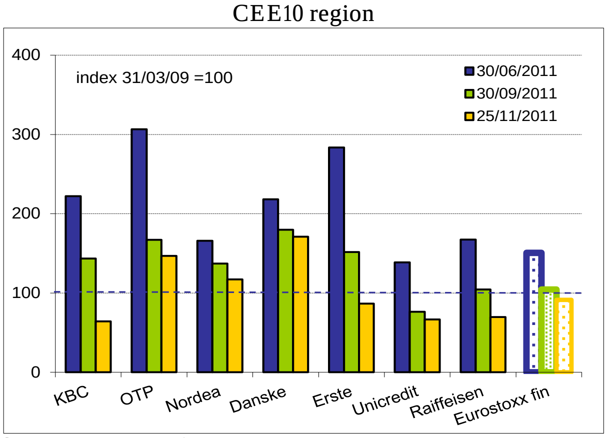


Note: * data on ultimate risk basis
Source: BIS

Stock market performance of multinational banks operating in the CEE10 region

Share prices of multinational banks with high exposure to the CEE10 region have significantly underperformed Eurostoxx financials since the beginning of the second quarter 2011. The exceptions to this general pattern were Nordea and Danske, whose stock prices declined more moderately and broadly in line with the EU financials. By contrast, the shares of Erste Bank and OTP were particularly hit. The risk assessment of banks with large CEE10 exposures deteriorated significantly amid worsened sentiment towards the CEE10 region. CDS spreads increases were particularly steep for Unicredit, KBC and Erste in the second half of 2011 although these increases also reflect developments in home country sovereign CDS spreads. At the same time, the increases for the two Nordic banks were more muted.

Graph 10: Share prices of major banks operating in the CEE10 region

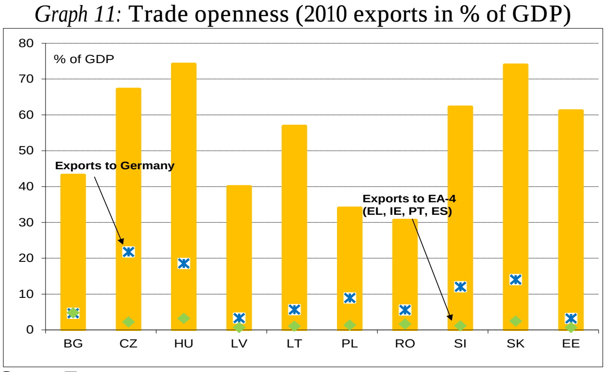


Source: Reuters EcoWin

3. Potential risks faced by the CEE10 as well as by home countries of the parent banks operating in the region

A key contagion channel between the euro-area and the CEE10 region is likely to be through trade linkages. All CEE10 countries, except for Poland, can be considered as small and highly open economies. Therefore, the expected deterioration in their export market performance will negatively affect domestic economic activity and ultimately also credit quality. However, a significant part of the CEE10 exports is directed towards the 'core' euro area economies (including Germany, that has been rather resilient so far), whereas the share of euro-area periphery in CEE10 exports is rather limited (with the exception of Bulgaria). As a result, the negative impact on the economic activity and thus banking sector's performance should be cushioned somewhat in the short-run. A potential further deterioration in their operating environment would likely be more challenging for the banking sectors where capital buffers are relatively thin and/or the share of non-performing loans is already elevated.[1] Consequently, the performance of parent banks exposed to these markets should (at least on a consolidated basis) also be the most affected. Nevertheless, the medium-term growth prospects and the apparent strong pricing power of banks still make the CEE10 region an attractive investment destination in principle.

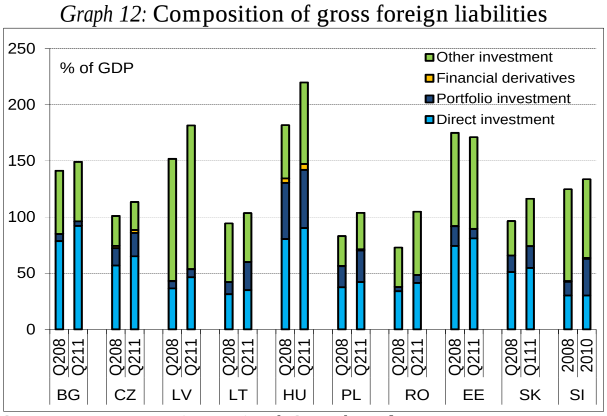
Graph 11: Trade openness (2010 exports in % of GDP)



Source: Eurostat

Another important contagion channel could be through foreign funding linkages. As discussed above, the CEE10 economies, in particular those with the weakest fundamentals have already significantly decreased their dependence on foreign funding flows compared to their external position in 2008. Nevertheless, given large stocks of foreign liabilities (which have increased further compared to 2008), the region still faces substantial foreign-debt-roll-over risks. Moreover, beyond the pure roll-over risks,[2] the absorption of excess liquidity by parent banks (in order to optimize their risk-weighted assets as fast as possible to improve their capital adequacy positions or to just increase liquidity ratios) could induce a credit crunch, exacerbating economic downturn and thus hurting profits and portfolio quality of local banking sectors. This would in turn also have negative feedback loops on the performance of parent banks. It is therefore likely that parent banks and home country supervisors will take into account these effects when deciding on cross-border liquidity allocation. As a result, the risk of a severe credit crunch seems larger in the case of those CEE10 countries where the availability of domestic funding is more constrained, that is, in banking sectors with higher loan-to-deposit ratios.

Graph 12: Composition of gross foreign liabilities



Source: Reuters EcoWin, National Central Banks

[1] It should, however, be noted that in some countries there is a large variance around sectoral averages. As a result, some likely smaller banks in other countries may also already have very thin buffers.

[2] In view of the still positive medium-term prospects, it is unlikely that parent banks would (if avoidable) let their subsidiaries default on their foreign liabilities, thus inducing bankruptcy and/or risk a take-over by local supervisory authorities.

Conclusion

Current financial market turbulences within the euro area are likely to have a negative impact on the CEE10 region as a whole, which should, nevertheless, vary considerably across countries. Financial market indicators both in the euro area and in the CEE10 countries already signal substantial amount of stress. Likely spill-overs into the real economy will affect the entire CEE10 region, as it was the case in 2008-09. However, the impact on banking sector performance should again vary considerably. It seems reasonable to assume that countries with banking sectors which largely rely on the domestic funding base (i.e. low loan-to-deposit ratios) and also have relatively sound loan portfolios (low NPL ratios) should be hit less severely, due to their potential to remain profitable even in the short-run while also offering a positive medium-term growth outlook. At the same time, parent banks exposed to the most overleveraged banking sectors with poor (and sometime still deteriorating) asset quality appear to face the highest risks. Finally, banks operating in the three euro-area CEE countries (i.e. Slovenia, Slovakia and Estonia) can directly participate in Eurosystem refinancing operations, which should largely facilitate their funding situation and costs.

Given the risk of negative cross-border feedback loops, further strengthening of cooperation among home and host countries' supervisors appears warranted. Beyond the universal need to avoid conflicting interests and regulatory arbitrage, the specific situation of most CEE10 banking sectors, where the supply of credit is largely dependent on parent bank funding, must be taken into account. Furthermore, host country supervisors should step up information flows to home countries (through supervisory colleges and joint on-site inspections) on potential risks as well as opportunities faced by the parent banks operating in the CEE10 region.

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