Throughout the expanded European Union, regional banks are growing anxious as economic woes threaten to stall credit and change the lay of the once-thriving banking sector

Alarm Bells in Central and Eastern Europe

ECONOMICS

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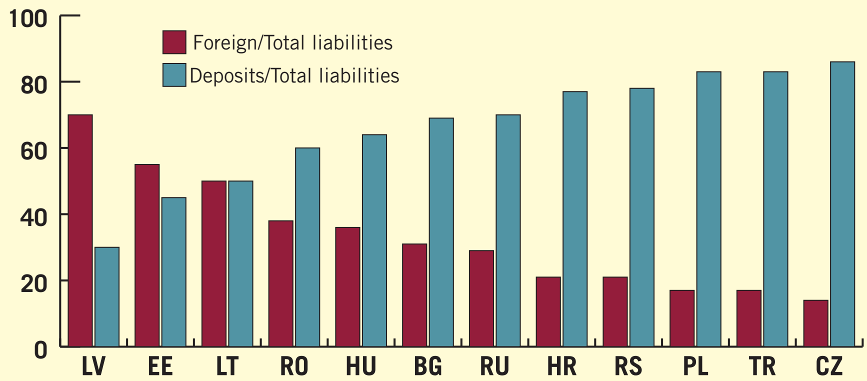
Bank credit expanded very rapidly in most central and eastern European countries in the past few years. As internationally active banks funded the bulk of this expansion, the onset of the crisis in major financial centres has raised concerns about a possible sudden stop of cross-border banking flows and the resulting credit crunch in CEE. In assessing these risks it is useful to look at key developments that have led to the build-up of vulnerabilities; some factors providing insulation to CEE banks; and how the authorities in both eastern and western Europe have so far responded to the crisis. As will become clear, tight prudential regulations and banking supervision may have been a factor of resilience for a number of banking systems in the region.

Sources of bank funding

As a percentage of total liabilities



Total liabilities include total deposits, domestic market, funding, foreign liabilities and other liabilities. Date are mostly for end-August
Sources: IMF, International Financial Statistics; author'scalculations.

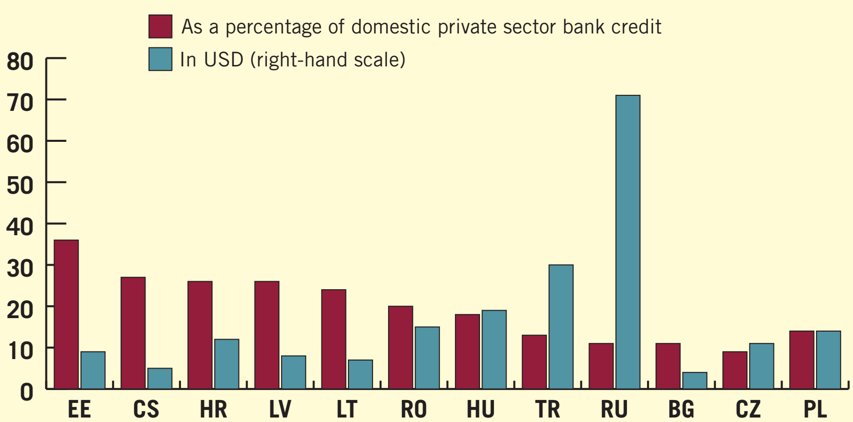
Vulnerabilities

Reliance of banks in CEE on cross-border bank flows as a source of funding, and the practice of extending foreign currency loans to retail customers, are two most obvious sources of vulnerability for banking systems in CEE.

For a number of years, banks in CEE could count on fairly easy access to low-cost funding from their parent institutions or from international wholesale markets. However, severe liquidity shortages in interbank markets and problems in major international banks since August 2007 have led many parent banks to reconsider further expansion of intra-bank credit. Although data available through the second quarter of 2008 do not yet point to a major retrenchment of foreign funding, those countries where banks rely more heavily on cross-border loans than on domestic deposits – including the Baltic states, Hungary and Romania (Graph 1) – have been clearly at greater risk.

CEE banks' exposure to exchange rate risk is another potential vulnerability at the current juncture. Reflecting sustained capital

Foreign currency loans by CEE banks



Consolidated cross-border claims of BIS reporting banks vis-à-vis banks in CEE, in all currencies, and local claims in non-local currencies, June 2008.
Sources: BIS, consolidated banking statistics; IMF, International Financial Statistics.

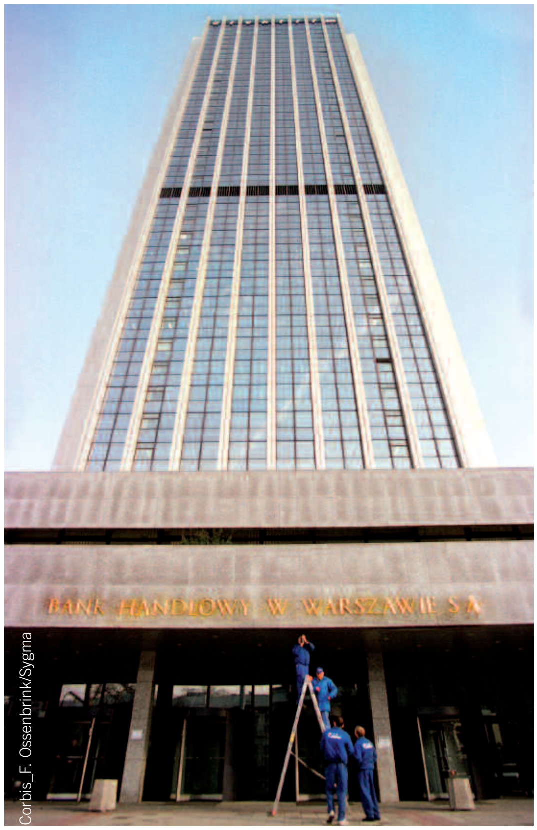
inflows over the past few years, many households and small and medium-sized enterprises in CEE have taken foreign currency loans offered by local banks to finance their housing, consumption and investment. These retail bank customers are typically not hedged against exchange rate risks, thus exposing banks indirectly to currency depreciation through the credit risk channel. Cross-border claims (which are largely on-lent) vis-à-vis banks in CEE, together with local claims in foreign currencies, represented on average 20% of domestic private sector bank credit in CEE (a total of $204 billion) at the end of June 2008 (Graph 2).

Policymakers in CEE have been aware of these vulnerabilities for some time but have considered them to a large extent beyond their control. In particular, the surge in capital inflows has resulted from a combination of cyclical, structural and policy factors that included low real interest rates and high growth of the global economy; rapid financial sector development and growing economic and financial integration with the EU; and greater macroeconomic and financial stability in CEE. At a more micro level, foreign-owned banks had an incentive to provide foreign currency loans because the parent bank, or its supervisor, wanted to limit the size of the exchange rate risk the banks bore directly, and partly because exposure of any larger western European bank to the relatively small CEE economies represents a small share of their overall exposure.

Easy availability of foreign bank credit has in turn acted as a disincentive for diversification of domestic funding sources. Despite some efforts to develop domestic money and bond markets following the banking crises of the 1990s, banks in CEE generally raise negligible funds in domestic wholesale markets.

Resilience a key

Many CEE countries have nonetheless managed to insulate their banking systems to a certain degree through structural reforms implemented since the late 1990s. These reforms have involved bank recapitalisations, the closure or consolidation of the weakest players and, as already noted, opening-up to foreign financial institutions.



Citibank is interested in purchasing Poland's Handlowy Bank.

Large foreign exchange reserves have also been source of resilience. Owing to sizeable reserves cushions, the authorities in a number of CEE countries, including Hungary, Poland, Russia, Turkey and south-eastern Europe, have been in a position to provide liquidity to the markets at critical times, thus slowing the spread of the crisis.

A factor of resilience in countries such as Croatia, the Czech Republic, Poland, Serbia and Turkey has been that domestic deposits still fund a large share of bank credit (Graph 1). For the region as a whole, the ratio of total private sector loans to deposits averaged around 1.1 (excluding the Baltics).

Of particular interest from a regulatory perspective is that these ratios have in some cases been a result of regulatory limits on bank borrowing abroad. In south-eastern Europe in particular, central banks have actively used reserve requirements to tighten or loosen commercial banks' foreign currency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and domestic liquidity. Although at times heavily criticised by the industry and some international institutions as market-unfriendly, these measures have proved extremely useful, not only in restraining domestic credit expansion when local markets were flush with liquidity, but also in overcoming severe foreign exchange liquidity shortages in recent months.

A number of specific prudential and supervisory measures have in addition helped improve banks' capacity to evaluate credit risk. Central banks in Bulgaria, Croatia and Poland, among others, have implemented closer monitoring and enforcement of provisioning and loan evaluation needs. These measures have been aimed at ensuring that banks hold sufficient regulatory capital consistent with the underlying risks (including indirect credit risk from foreign currency lending to unhedged borrowers). Adequate provisioning for expected losses has perhaps also contributed to more accurate – ie, lower – projections of rates of return on equity by parent banks, discouraging overambitious credit expansion plans.

Some supervisory authorities (including in Estonia, Poland and Serbia) have improved the quality of creditor information in response to signs of an unsustainable build-up in credit risk. Specific measures have included requiring corporate borrowers to provide accurate financial reports; extending the credit registry to cover households as well as corporations; and tightening various limits on debt-to-income and/or debt service-to-income ratios for households, eg by requiring banks to use household debt and income data that are more reliable (eg based on personal income tax returns). Better data on borrowers' and guarantors' debt, debt repayment and income may have facilitated a more realistic assessment of credit risk.

The Hungarian Central Bank in Budapest, above, and the stock market tower in Budapest, right.

Finally integrated supervision of banks and non-bank financial institution within the central bank has proved to be an advantage in containing the spread of the credit boom and managing the crisis. The fact that policymakers in CEE have not made major policy mistakes so far may have additionally reassured some long-term investors and prevented a more widespread pull-out from the region. One case in point is the decision not to use capital controls. Non-EU countries in the region have maintained that such measures would be a significant step back in their liberalisation process and EU aspirations, and would be

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anyway largely circumvented. These fears have been partly justified by the experience of Thailand, where the authorities, in March 2008, felt compelled to lift the capital controls they had introduced a year and a half before.

Concerns about state intervention in Western Europe

Although foreign bank ownership has so far been a source of stability for banking systems in central and eastern Europe, large rescue packages announced for the financial sector in western Europe have raised some concerns in the banking industry and among policymakers in CEE.

One concern is that governments in central and eastern Europe simply do have as deep pockets as the governments of large western European countries to rescue their banks, should this become necessary at some point. Credit risk premia for CEE debtors would increase and currencies weaken even if CEE governments attempted to support domestic banks on a much smaller case than, for instance, has been the case in the United Kingdom.

Another concern – shared by some parent banks from smaller western European countries – is that across-the board rescues of some large but poorly managed institutions from western Europe might create unfair competition for the smaller and better managed banks with operations in CEE. For instance, a large bank rescued by the state could start competing aggressively for the profitable market in CEE with smaller domestic and foreign-owned banks in CEE that did not receive guarantees or other forms of state support.

Possible restrictions on cross-border lending found in some rescue packages are a related source of concern. Governments in some countries announced that banks receiving state support could use all or part of the money only to fund SMEs and housing at home instead of expanding their more profitable operations in central and south-eastern Europe. Such "home bias" in credit allocation could not only come at the expense of customers in CEE countries, but could also backfire, to the extent that credit in home countries ends up with customers who are not entirely creditworthy.

It remains to be seen, however, whether unwinding of the credit boom in central and eastern Europe will remain a story without a sad ending.

(The views in this article represent those of the author alone and do not necessarily represent those of BIS.)