Receding tide or gathering tsunami?

Cross-border lending in Emerging Europe

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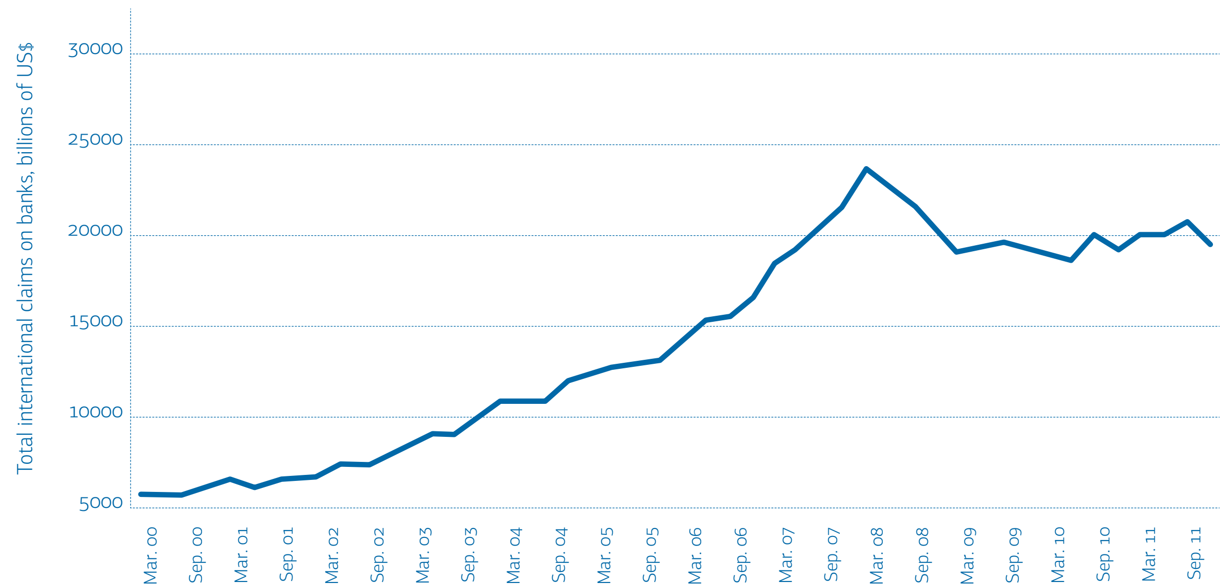
I. Introduction: are we post- or pre-crisis?

Over the past 10 years, the liberalization of financial sectors in both emerging and developed economies has led to a corresponding increase in cross-border lending to heights never before seen in the world economy (Figure 1).[1] From 2000 to June 2008, total international claims on banks increased by 225%, a percentage that contracted as a result of the global financial crisis but still remains (as of December 2011) at a level 181% higher than it was in December 2000. Moreover, as Table 1 shows, cross-border lending grew across all emerging markets. This was a particularly important source of capital for firms in countries from Central, Eastern, and Southern Europe (CESE) that were acceding to the EU or in talks to accede.[2] After the worst of the global crisis had passed, this trend apparently returned, with cross-border lending rebounding in 2010 and in the beginning of 2011. Indeed, in CESE countries, cross-border claims increased by 15% to $923b from June 2010 to June 2011. Their reliance on cross-border lending has been a key driver for growth.[3] So this rebound has helped the economies of the CESE region recover from the deep GDP contraction experienced during the crisis (Figure 2).

However, this rebound in cross-border lending has been threatened of late by market turmoil and, perhaps more seriously, regulatory plans emanating from Western Europe. Proposed (and in some cases, recently enacted) regulatory moves in the EU cut the CESE region off from bank lending. In November

Figure 1 – Total international claims on banks, by quarter, 2000-2011



Source: BIS Data

1 Cross-border lending is defined by the Bank for International Settlements (BIS) as "lending to entities located in a country other than the country of residence of the reporting banking office (on a balance of payments basis)." See, "Highlights of the BIS International Statistics," BIS, March 2011, available on-line at: http://www.bis.org/publ/qtrpdf/r_qt1103b.pdf.

2 Indeed, much of the spike in lending over the 2005-08 period reflected the accession to the EU of Poland, Hungary, Slovenia, Czech Republic, Slovakia, Estonia, Latvia, and Lithuania in 2004 and Romania and Bulgaria in 2007.

3 See Friedrich, C., I. Schnabel and J. Zettelmeyer (2011) 'Financial Integration and Growth – Is Emerging Europe Different?' mimeo available on-line at: http://www.financial.economics.uni-mainz.de/Dateien/Friedrich_Schnabel_Zettelmeyer.pdf.

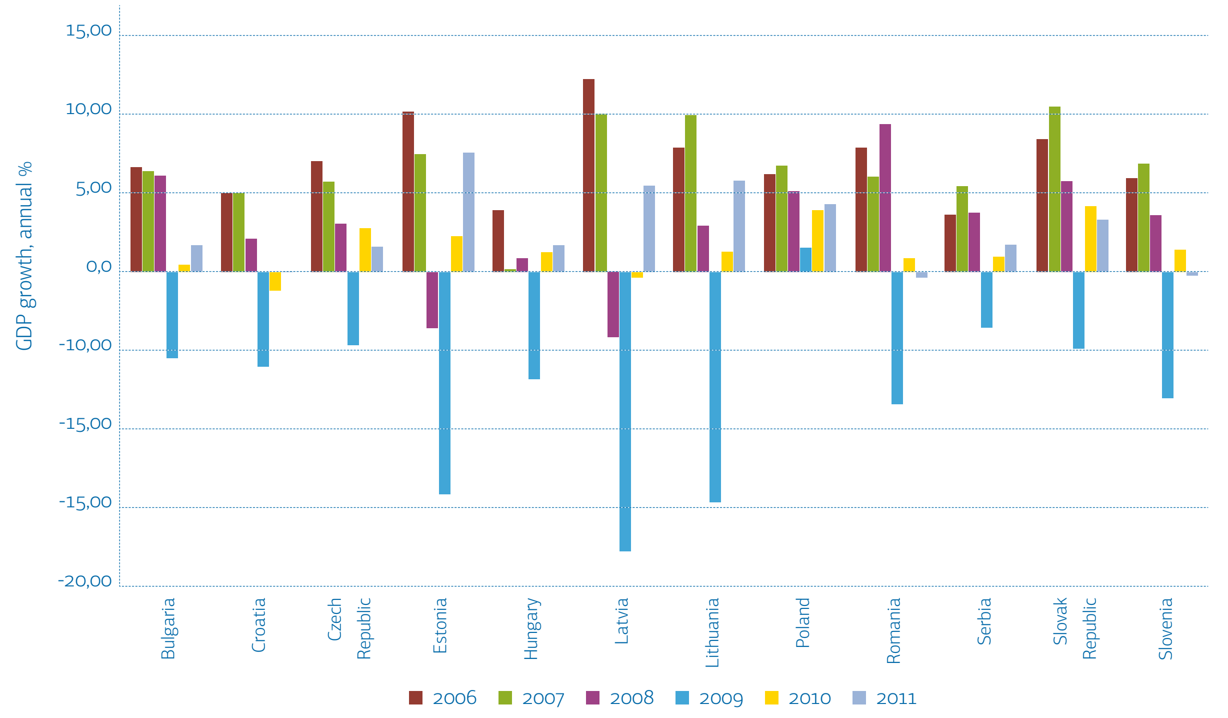
2011, the Austrian National Bank (OeNB) explicitly directed banks to reduce exposure to Central Europe, and Basel III capital requirements were brought forward to 2013. Other directives targeted subsidiaries in CESE that are "particularly exposed" to ensure that their loan-to-deposit ratio does not exceed 110%.[4]

Recent moves by countries such as Austria typify a go-it-alone approach

In tandem with the Eurozone troubles, this directive has affected lending in the region. Recent data from the Bank for International Settlements (BIS) notes that during "the fourth quarter of 2011, BIS reporting banks recorded their largest decline in aggregate cross-border claims since the drop in the fourth quarter of 2008… cross-border lending to non-banks decreased; but the decline of claims on banks was sharper – and the largest in almost three years."[5]

After a brief rebound in the first quarter of 2012, the picture in the second quarter was even bleaker, as banks suffered their second largest contraction since early 2009. Cross-border claims dropped $575b (or 1.9%).[6] Indeed, recent pullbacks in lending have mostly affected Hungary (which saw a drop of $6.9b, approximately 10% of its cross-border assets) and Poland (a decline of $5.1b, or 4.0% of its cross-border assets), with the reductions coming from the largest banks in Austria (as well as France and the Netherlands).[7]

Figure 2 – GDP growth in CESE economies, 2006-2011



Source: World Development Indicators

4 "Austria pushes ahead with Basel III," Centralbanking.com Newsdesk, November 22, 2011, available on-line at: http://www.centralbanking.com/central-banking/news/2126969/austria-pushes-ahead-basel-iii.

5 "International Banking and Financial Market Developments," BIS Quarterly Review, June 2012, available on-line at: http://www.bis.org/publ/qtrpdf/r_qt1206.pdf.

6 "International Banking and Financial Market Developments," BIS Quarterly Review, December 2012, available on-line at: http://www.bis.org/publ/qtrpdf/r_qt1212.pdf.

Over the past 10 years, the liberalization of financial sectors in both emerging and developed economies has led to a corresponding increase in cross-border lending to heights never before seen in the world economy

The regulatory initiatives typified by the OeNB's new requirements are all the more startling as they contradict the sort of collective actions that were the hallmark of the response to the global financial crisis. While there have also been calls for "Vienna 2.0", a reconstitution of the European Bank Coordination Initiative (ECBI) convened in 2009 to coordinate crisis management and crisis resolution of financial sector issues in the region, recent moves by countries such as Austria typify a go-it-alone approach that can only work to the detriment of the CESE region.[8] Further regulatory moves in this direction could severely reduce the stock and flows of capital in CESE countries. This could lead to slow growth, particularly in countries that have a small local deposit base and rely on international banks for risk mitigation.

The purpose of this report is to explore the ramifications of recent regulatory proposals for businesses and banks in the "new Europe" and elsewhere, mooted as part of the response to the Eurozone crisis. . Is there another round of credit tightening in store for CESE countries? Is the latest contraction of lending an aberration or a trend? How will current regulatory proposals related to cross-border lending affect the business of banking?

7 'International Banking and Financial Market Developments', BIS Quarterly Review, June 2012.

8 "Vienna Initiative – Moving to a New Phase," European Bank for Reconstruction and Development (EBRD), available on-line at: http://www.ebrd.com/downloads/research/factsheets/viennainitiative.pdf.

Table 1 – Cross-border lending by geographic region

	Amounts outstanding End-period, US$ billions		Percentage changes Period average	
	External positions	Cross-border loans	External positions	Cross-border loans
Vis-à-vis all 3 Emerging Market regions	...	...	**8,8**	**6,7**
1990–1994	525	573	7,1	...
1995–1999	646	536	6,1	–2,1
2000–2004	809	607	3,5	1,6
2005–2008	1 695	1 291	25,3	24,7
2009	1 645	1 206	–17,4	–16,5
Vis-à-vis emerging Asia	...	...	**9,8**	**3,8**
1990–1994	273	340	15,4	...
1995–1999	303	266	6,7	–6,8
2000–2004	381	305	3,6	2
2005–2008	679	519	22,4	20,4
2009	656	477	–25,1	–26,9
Vis-à-vis Latin America	...	...	**3,6**	**2,8**
1990–1994	209	188	1,8	...
1995–1999	249	195	4,3	1,6
2000–2004	210	149	–2,8	–4,7
2005–2008	349	257	15,7	15,5
2009	345	234	–13,4	–10,3
Vis-à-vis CESE	...	...	**15,9**	**21,5**
1990–1994	43	44	–0,4	...
1995–1999	94	75	13,8	16,1
2000–2004	217	153	16,8	14,2
2005–2008	666	516	38,6	40,4
2009	644	494	–10,2	–6,8

Source: Sabine Herrmann and Dubravko Mihaljek, "The Determinants Of Cross-Border Bank Flows To Emerging Markets: New Empirical Evidence On The Spread Of Financial Crises," BIS Working Paper No. 315 (July 2010).

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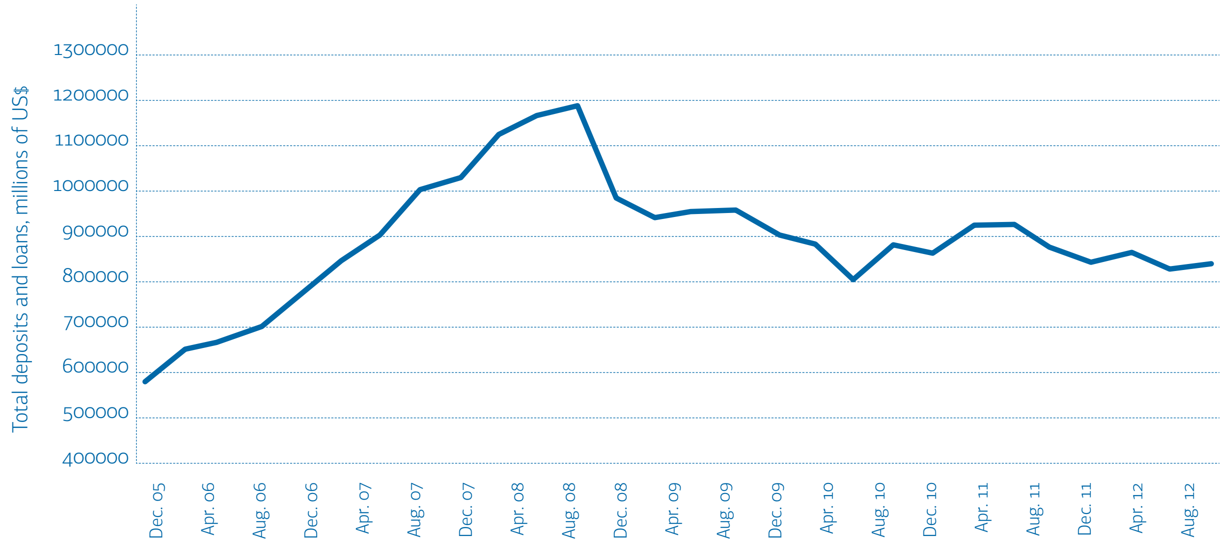
II.
From global crisis to Eurozone crisis: what's next?

While the CESE region as a whole depended on the developed banking systems of Western Europe for financing transition (see Appendix), over the period of the global financial crisis from 2008-2011, credit in the CESE region, as elsewhere, began a hasty retreat. By June 2010, it had bottomed out at the level of March 2007 (Figure 3). This headline number masks differences amongst countries, however, as some CESE countries weathered the global financial crisis excellently. For example, Poland is held up as an exemplar of prudential lending, and relies less on international banks than other countries. Moreover, "decreases in cross-border loans to central and eastern Europe [were] more limited compared to Asia and Latin America… in large measure because of the higher degree of financial and monetary integration in Europe."[9]

Econometric evidence from the European Commission has shown that the high level of foreign bank share in CESE actually mitigated "the sudden stop in cross-border flows" that came about after September 2008. This result did not hold for other developing regions in the world.[10]

Another key reason for the relatively shallower decline in the CESE region was institutional integration within Europe, which allowed for a sober and coordinated response to the crisis. The prime example of this response was the "Vienna Initiative", a program put in place in 2009 by and with the acquiescence of the IMF, the European Central Bank (ECB), the European Bank for Reconstruction and Development (EBRD), various national regulators and, most importantly, banks with branches in the CESE region.

Figure 3 – External loans and deposits of banks in emerging Europe, December 2005-December 2012



Source: BIS Statistics (Table 7a). Emerging Europe includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey, and Ukraine.

9 Sabine Herrmann and Dubravko Mihaljek, 'The Determinants Of Cross-Border Bank Flows To Emerging Markets: New Empirical Evidence On The Spread Of Financial Crises', BIS Working Paper No. 315 (July 2010).

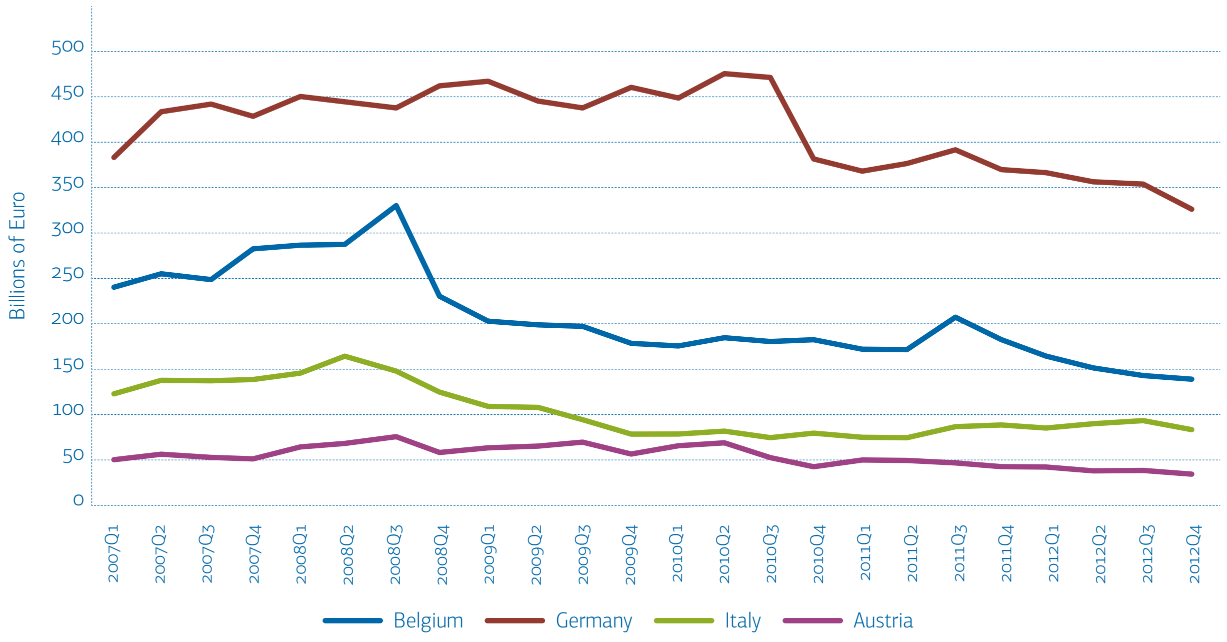
10 Ursula Vogel and Adalbert Winkler, "Cross-Border Flows and Foreign Banks in the Global Financial Crisis – Has Eastern Europe Been Different?" in European Commission Directorate-General for Economic and Financial Affairs Occasional Paper No. 75, "Capital Flows to Converging European Economies – From Boom to Drought and Beyond?," October 1, 2010, available on-line at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp75_en.pdf.

As part of the Vienna Initiative, banks headquartered in Western Europe agreed to remain in the CESE countries, and to recapitalize their subsidiaries and branches in the region via funding from the IMF and the EU.[11] According to the EBRD, the Initiative "informed as well as supported policy decisions in both home and host countries," allowing for banking sector support to be used across borders in CESE subsidiaries of bank groups. This also allowed "monetary policy tools in host countries such as reserve requirements [to be] loosened to address weak demand, with the assurances that additional liquidity will not be used for capital flight."[12] While such an initiative would never have been sustainable (or agreed to) if the fundamentals had not been sound, the actions of the group helped to calm volatility and rein in some of the animal spirits that might have left the region otherwise.

Regulatory moves afoot

If the global financial crisis did not harm lending in the CESE countries because of high levels of integration and coordination within Europe, current turmoil in the Eurozone might have a greater impact due precisely to that integration, combined with a lack of coordination. The ongoing Eurozone crisis – an increasingly fluid situation with no clear resolution in sight – has shown once again the sensitivity of cross-border lending to broader macroeconomic trends. While cross-border lending is no different than other financial intermediation practices that banks perform, it has some added risks from the bankers' point of view. In particular, political and regulatory risk stands out as perhaps one of the most difficult risks to manage. Different governing rules (especially regarding the financial sector), different reporting requirements, and a different political environment can trip up even the most prudent banks. It is much easier for banks to lend in countries with similar regulatory and political climates. But political changes (such as a switch from a conservative to a socialist government) can still have dramatic consequences.

Figure 4 – Cross-border loans from Austria, Germany, Italy and Belgium, Q1 2007-Q4 2012



Source: European Central Bank

11 'EBRD warns of Capital Outflow from Eastern Europe', EurActiv, January 17, 2012, available on-line at: http://www.euractiv.com/euro-finance/ebrd-warns-capital-outflow-easte-news-510192.

12 'Vienna Initiative – Moving to a New Phase', European Bank for Reconstruction and Development (EBRD), available on-line at: http://www.ebrd.com/downloads/research/factsheets/viennainitiative.pdf.

Over the period of the global financial crisis from 2008-2011, credit in the CESE region, as elsewhere, began a hasty retreat

The added risk of cross-border lending has been in the sights of international financial regulators in Europe, who are determined to focus on lessening "systemic risk" in the wake of the global financial crisis and the current euro crisis. "Banks headquartered in the euro area [are] facing pressures to reduce their leverage,"[13] with several hasty measures put in place to lessen risk in one or more countries already having an impact on cross-border lending in CESE countries. Indeed, policy responses by governments in both the Eurozone and the CESE countries might be exacerbating the current situation more than actual liquidity issues.[14] The two largest proposals on the table involve an increase in capital adequacy ratios and, in Austria, an increase in local funding (with Austrian regulators also having required all large international banks to submit recovery and resolution plans by the end of 2012).

Increased capital adequacy ratios in Western Europe

Perhaps the largest regulatory challenge comes from the European Banking Authority (EBA), the EU's regulatory body for the financial sector. It implemented a directive at the end of June 2012 requiring banks in the Eurozone to raise their capital adequacy ratios to 9% from previous levels of 7%. Concurrently, as noted above, the OeNB also jumped into the regulatory pool with its directive to bring forward Basel III requirements on Common Equity Tier 1 (CET1) as of the beginning of 2013, with no transition period. Known as the "Austrian Finish", the regulators at OeNB have also decreed that "international Austrian banking groups will be subject to an additional capital surcharge of up to 3 percentage points of CET1 (depending on the perceived riskiness of banks' business models from a regulator's point of view) from January 1, 2016."[15]

These requirements could not come at a worse time for the CESE countries. Given the short time frame that was allowed for compliance with the EBA directive, the only way for many banks to reach this level was to deleverage assets, leading to even further reductions of credit in CESE subsidiaries. (Figure 4 shows the drop in cross-border lending of the biggest four countries in CESE through Q4 2012.)[16] Thus, even safe havens, such as Poland, will be affected over the coming months, as will banks that have only limited exposure to the sovereign debt that is causing so many headaches in the Eurozone. As Herbert Stepic, RBI Chief Executive, has noted: "Despite rather limited risk, we still have to raise capital adequacy... and it all comes at a time and with a speed that will distract management attention away from building business and assisting economies to grow after the last crisis in 2009."[17]

13 International Banking and Financial Market Developments', BIS Quarterly Review, June 2012.

14 See especially Manfred Wimmer, Erste Bank's Chief Financial Officer, quoted by Philip Alexander in "Too Soon to Say Goodnight Vienna," The Banker, February 1, 2012.

15 'CEE Banking Sector Report', Raiffeisen Research, June 2012, available on-line at: http://www.rbinternational.com/eBusiness/services/resources/media/677226413664515143-677226413664515144_1026067974202-823135594832814856-1-10-EN.pdf.

16 A capital adequacy ratio is defined as the ratio of a bank's equity capital to its risk-weighted assets. Thus, the ratio can be improved either by increasing equity or removing risk-weighted assets (loans). In the short-term, it is much easier to remove loans than it is to raise equity capital, making this directive a further threat to credit in CESE.

17 Quoted by Philip Alexander in "Too Soon to Say Goodnight Vienna," The Banker, February 1, 2012.

This move is compounding a liquidity crunch that has already accelerated due to turmoil from Greece, with the largest effects found in the countries with the largest exposure to Vienna or Paris (instead of Athens). By the fourth quarter of 2011, banks headquartered in developed European economies reduced their entire set of cross-border assets by $466b (or a reduction of 2.3%), while those specifically in the Eurozone reduced their international assets by $584b (a reduction of 4.7%).[18] These repercussions have been felt most strongly in the CESE countries, which saw a fourth consecutive quarter of credit contraction in the second quarter of 2012, with claims dropping by $11b (or approximately 1.5%).

This move is compounding a liquidity crunch that has already accelerated due to turmoil from Greece, with the largest effects found in the countries with the largest exposure to Vienna or Paris (instead of Athens)

This pullback in liquidity, which is mostly unrelated to the fundamentals in CESE, is also leading to poor performance on banking "stress tests". However, once again, this is not uniform across the CESE region. For example, researchers at the Czech National Bank (CNB) performed a highly advanced test on 23 banks in the country and found that "most Czech banks have a sufficient liquidity buffer to be able to withstand a potential liquidity stress on their balance sheets" similar to that caused by the global financial crisis.[19] Conversely, Hungary's national bank, MNB, admitted in late 2011: "The capital buffers of several banks are close to running out."[20] This was despite two of its largest banks, OTP and FHB Mortgage Bank, being found to be strong by the Committee of European Banking Supervisors' (CEBS) stress tests at the end of 2010, and OTP being confirmed as sound at the end of 2011.[21]

Rising non-performing loan (NPL) burdens in Hungary continue to plague the system. An estimated 18% of loans were NPLs at the end of Q2 2012, up from some 16% in the first quarter (with corporate NPLs still on the rise, increasing 3% from Q1 to Q2 2012).[22] As Figure 5 shows, other potential trouble spots include Ukraine, Slovenia and Lithuania, where undercapitalization threatens the banks that have the highest amount of NPLs. However, the countries with the biggest exposure to Western European banks, such as the Czech Republic, Slovakia, Croatia, and Serbia, all have incredibly low capital shortfalls. Therefore, they will be harmed by the declining availability of capital, especially when increasing capital adequacy ratios appear to be targeted at insulating risk from the already-risky countries, such as Hungary.

18 International Banking and Financial Market Developments', BIS Quarterly Review, June 2012, available on-line at: http://www.bis.org/publ/qtrpdf/r_qt1206.pdf.

19 Zlatuše Komárková, Adam Geršl, and Luboš Komárek, 'Models for Stress Testing Czech Banks´ Liquidity Risk', Czech National Bank Working Paper No. 11 (November 2011), available on-line at: http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/research/research_publications/cnb_wp/download/cnbwp_2011_11.pdf.

20 MNB Governor Marton Nagy, quoted in "Hungary Banks Need Capital Under Stress Test," Reuters Online, November 2, 2011, available at: http://uk.reuters.com/article/2011/11/02/hungary-banks-idUKL5E7M21FE20111102.

21 'Press Release on the Results of the EU Wide Bank Stress Test', Hungarian Financial Supervisory Authority press release, July 23, 2010, available on-line at: http://www.pszaf.hu/en/topmenu/press/pszafen_pressreleases/stress_test.html. FHB Mortgage Bank was not included in the CEBS round of stress tests conducted in 2011.

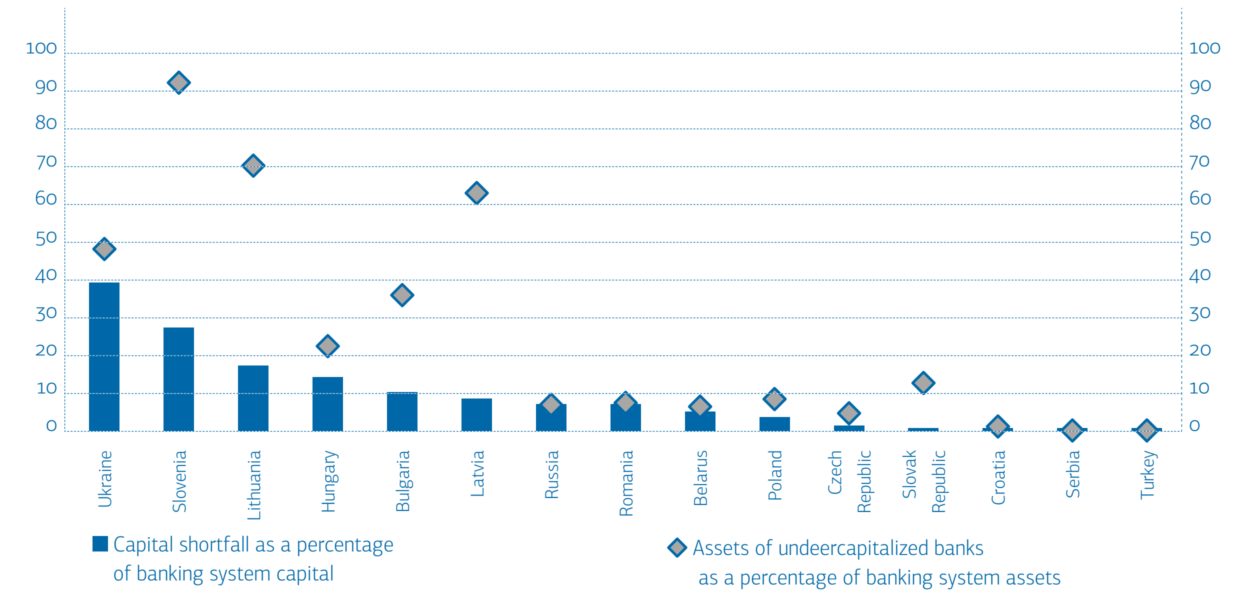
22 'CEE Banking Sector Update', Raiffeisen Research, Issue 3/2012 (December 19, 2012), available on-line at: http://www.rzb.at/eBusiness/services/resources/media/831197035645054749-826100030434411352_826101618230137223_826102026788901786-845106675835384990-1-1-NA.pdf.

Climbing loan ratios in Austria

On top of this capital adequacy requirement, the OeNB has also instituted a recommendation for banks to exhibit a Loan to local stable funding ratio (LLSFR) of below 110% in all new business, monitored jointly by Austrian and subsidiary country regulators. Local "stable" funding is defined as customer deposits, local capital markets issuances in excess of one year, and funding from supranational organizations where the other organization takes the counterparty risk.[23] While major Austrian banks have noted that the Austrian Finish requirements are less onerous than the EBA capital adequacy requirements, the increase in capital requirements and the emphasis on stable local funding could also slow credit growth throughout the CESE. Most bank funding in the CESE countries is already dominated by currency deposits and loans, with long-term debt holdings relatively rare. According to the OeNB, "sporadically available data (e.g., for Croatia, Hungary and Romania) suggests that financing from parent banks accounts for around 50% to 70% of the banking sector's external liabilities."[24]

The threat of cross-border lending being directed away from "new Europe" because of lack of "local stable funding" is also galling in the CESE countries because, as noted, they are not a monolithic bloc. As Figure 6 shows, the CESE region is by no means uniform in terms of its

Figure 5 – Banks with a capital adequacy ratio of less than 8% after write-off of impaired loans



Source: European Banking Coordination "Vienna" Initiative Working Group on NPLs in Central, Eastern and Southeastern Europe Report, March 2012.

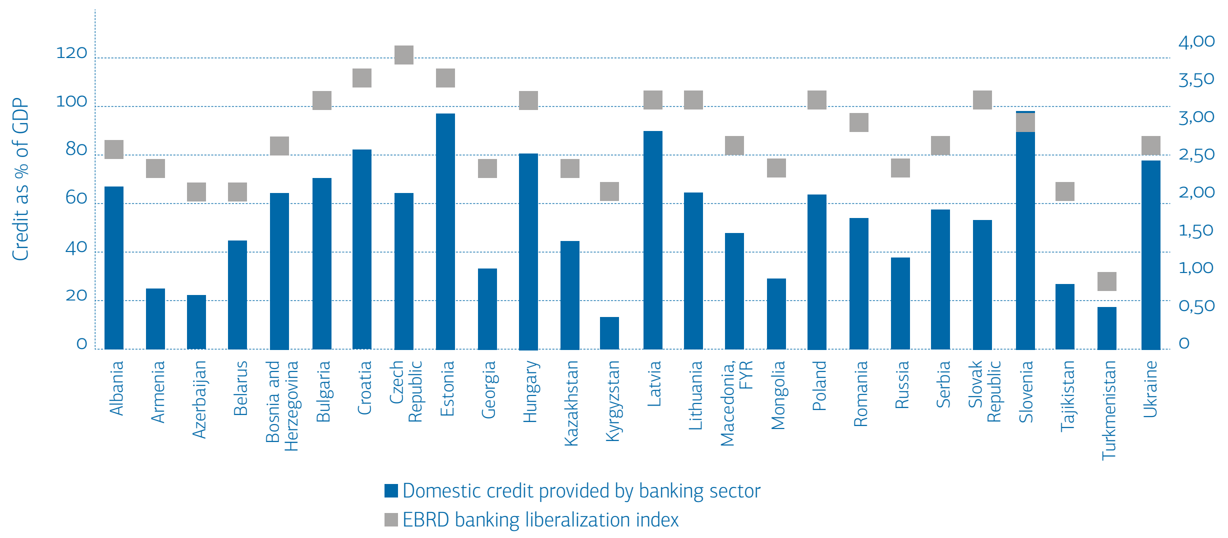
23 "Capital Planning in a Volatile Regulatory Environment," presentation by Erste Bank CFO Manfred Wimmer to Erste Bank Capital Markets Day, December 9, 2011, Available on-line at: http://www.slideshare.net/Erste_Group/erste-group-cmd11-capital-planning-in-a-volatile-regulatory-environment. As Raiffeisen Research note, "The LLSFR should not be interpreted as a very strict limit; instead, it should function more as a reasonable early warning indicator."

24 Zoltan Walko, "The Refinancing Structure of Banks in Selected CESEE Countries," Financial Stability Report, No. 16, Austrian National Bank, 2008, available on-line at: http://www.oenb.at/en/img/fsr_16_special_topics_01_tcm16-95420.pdf.

financial development or progress in the liberalization of its banking sector. This situation is mirrored in foreign banking activity across countries (Figure 7). As Raiffeisen Bank Research has noted, "the region contains some high growth markets like Russia and Poland and rather stable growth markets like Slovakia or the Czech Republic [where] non-performing loans are stabilizing or declining… on the other hand, credit growth remains subdued and non-performing loans are still on the rise in some banking sectors, such as those in Hungary, Romania, Bulgaria or Croatia."[25] This divergence can be seen in an examination of NPLs in CESE region banks. As Figure 8 shows, here again there has been a wide range of country performances in terms of NPLs, with countries such as Slovenia and the Czech Republic with low stocks of NPLs even at their peak, and countries such as Lithuania and Montenegro in a danger zone of nearly a quarter of their loans non-performing over the previous two years. (As noted above, Hungary's NPLs have continued to climb since 2011, currently at a level of 18% of all loans.) This differentiation amongst countries means that blanket regulations such as the LLSFR directive can do more harm than good for both Austrian banks and the countries in the CESE region.

> The threat of cross-border lending being directed away from "new Europe" because of lack of "local stable funding" is also galling in the CESE countries because, as noted, they are not a monolithic bloc

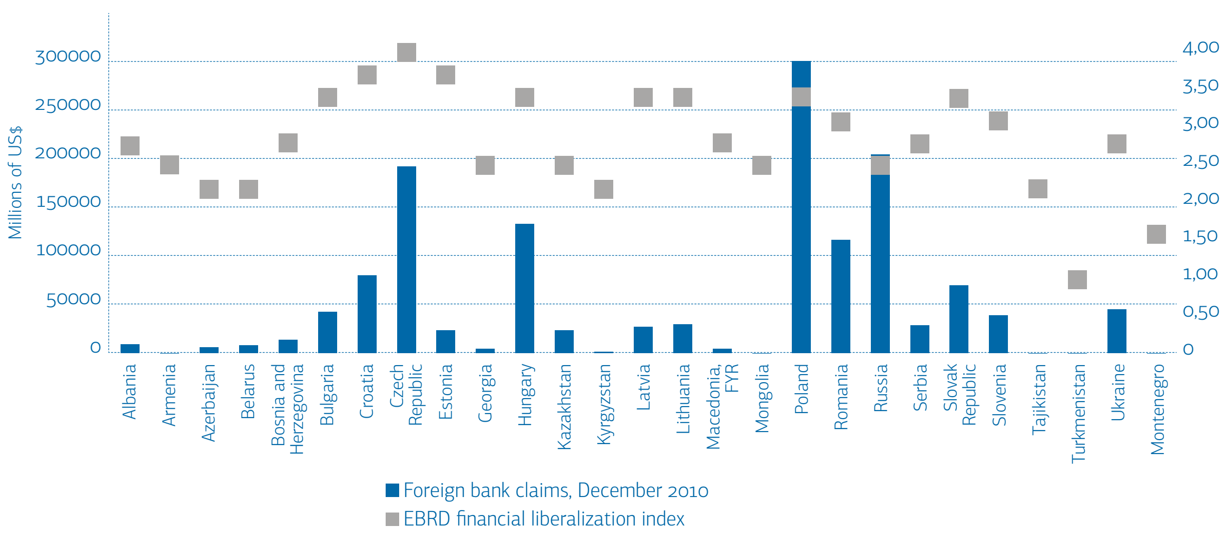
Figure 6 – Domestic credit from the banking sector v. financial liberalization, 2010



Source: World Bank Development Indicators (WDI) and EBRD Transition Indicators. Slovakia data is from 2008 and the Kyrgyz Republic and Tajikistan's data is from 2007, the latest years available in WDI.

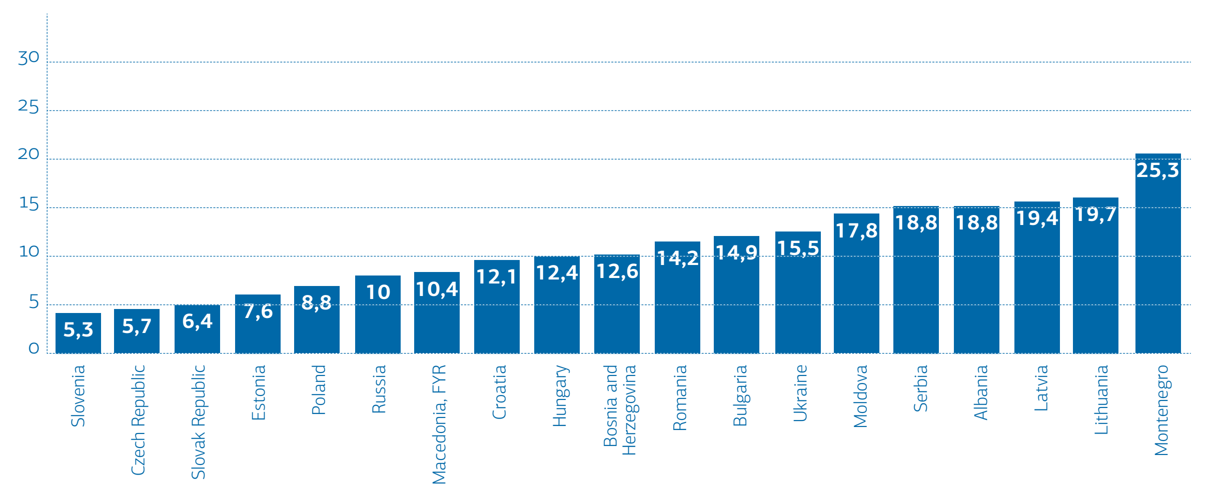
25 'CEE Banking Sector Update', Raiffeisen Research, February 6, 2012, available on-line at: http://www.rzb.at/eBusiness/services/resources/media/677043205476211500-677043205476211501_1025308884300_1025311539513_1025311893931-797114950454572559-1-9-DE.pdf.

Figure 7 – Foreign bank claims, in millions of US$ v. financial sector liberalization, 2010



Source: Bank for International Settlements (BIS) and EBRD Transition Indicators.

Figure 8 – Peak non-performing loans as a percentage of all loans from 2009-2011



Source: European Banking Coordination "Vienna" Initiative Working Group on NPLs in Central, Eastern and Southeastern Europe Report, March 2012.

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III. Conclusion: the future for cross-border lending in CESE

The Eurozone's current troubles could spell difficulty in the short-run for credit in the CESE countries. Nevertheless, in reality, it is not the short-term difficulties of Greece and Spain that will impact upon cross-border lending in CESE the most, but the long-term political maneuvers surrounding both the euro and, more importantly, banking regulation, that will determine the framework for credit extensions. Several key lessons have emerged from this brief examination of recent regulations regarding cross-border lending:

Recent moves toward greater prudential regulation have not helped stabilize the CESE region. Coupled with uncertainty about regulatory moves in the future, many banks are pulling back on all kinds of risk and cross-border lending holds more risks than safe instruments denominated in home currency and servicing a small, familiar market

Market risks are being accelerated in the CESE region, not mitigated

Recent moves toward greater prudential regulation have not helped stabilize the CESE region. Coupled with uncertainty about regulatory moves in the future, many banks are pulling back on all kinds of risk and, as noted above, cross-border lending holds more risks than safe instruments denominated in home currency and servicing a small, familiar market. However, this market-driven risk allocation has been unduly accelerated by the regulatory moves described above. Austria's pre-emptive directives to bring up Basel III regulations and its explicit instructions to banks to reduce risk to CESE, coupled with the move from EBA to shore up home country banks through increased capital adequacy, are symptomatic of the regulators' view toward this risk in an era of volatility. This less-than-nuanced view sees nearly all financial activities in the CESE region as risky, despite the reality that the region is composed of many different countries with different economic trends, risk profiles, and states of health in the financial sector.

Successful models from the past are being discarded in favor of a go-it-alone approach

Perhaps worse still, the regulations that are coming through in Western Europe are increasingly uncoordinated with supra-national (i.e., EU and Basel) conventions, and they are all attempting to act on similar types of risks through broad instruments. While there have already been calls for a "Vienna 2.0" – to succeed the Vienna Initiative that came to an end in April 2011 – to coordinate crisis management and crisis resolution of financial sector issues in the region, there has been little success in this direction. Despite national policymakers and banks returning to Vienna in January 2012 to attempt to thrash out another collective response to troubles,[26] as The Banker correctly notes, "the challenge may be more profound this time. The funding and capital threats to parent banks are becoming severe."[27] This re-

26 'Vienna Initiative – Moving to a New Phase', European Bank for Reconstruction and Development (EBRD), available on-line at: http://www.ebrd.com/downloads/research/factsheets/viennainitiative.pdf.

27 Philip Alexander, 'Too Soon to Say Goodnight Vienna', The Banker, February 1, 2012, available on-line at: http://www.thebanker.com/World/Central-Eastern-Europe/Too-soon-to-say-goodnight-Vienna.

ality means less appetite for collective action that could save foreign countries while the domestic financial sector continues to flounder. Indeed, the crisis this time around in the CESE countries might be the exact opposite of before. The demand for lending could remain constant in many growing CESE countries, but European banks might not be able to meet this demand due to regulatory changes. Thus, the lack of coordination from regulators on these and similar issues is threatening to do to the region's banks what the global financial crisis could not do: dry up lending and leave the region starved of credit.

> The lack of coordination from regulators on these and similar issues is threatening to do to the region's banks what the global financial crisis could not do: dry up lending and leave the region starved of credit

Nuanced approaches work better than blunt instruments

While the lack of coordination is problematic from the banks' point of view, the real issue at stake is that recent regulatory moves are, in and of themselves, blanket restrictions rather than nuanced moves based on the actual differing risk profiles in the region. If one looks at the CESE region as a whole – as financial sector regulators in Brussels and Vienna appear to be doing – the underlying macroeconomic fundamentals are mostly sound, as is the state of the banking industry. As Raiffeisen Research put it in its latest survey of the region, the banking sector is "much better than expected", notwithstanding difficulties in Hungary due to policy moves and in south-east Europe due to exposure to Greece.[28] Indeed, even as threatened as specific local banks are in some countries (as shown in Figure 3), the Western European banks involved in the CESE region remain strong overall. Both Erste Bank and Raiffeisen passed the CEBS stress tests at end-2011, and the international organizations of the Vienna Initiative have noted that "the capitalization of the large western banking groups which dominate many banking systems in CESEE countries would generally not be greatly affected by the NPL write-off in the host-country subsidiaries."[29]

Country-specific risk is not systemic risk

As this overview has shown, the countries in the CESE region are not at all similar in their exposures and risk profiles. Countries such as Poland and the Czech Republic remain high-growth opportunities and countries such as Hungary are relatively more risky. (In Hungary, a bank tax on financial services "windfalls" was proposed to help reduce the country's sizable budget deficit and continue the Hungarian government's access to EU development funds. Such moves strengthen the argument for the sort of risk profiling that many banks operating in the CESE region already practice, based on conditions on the ground rather than possible issues that could come from the home country.[30]

Nevertheless, "systemic" risk mitigation moves, such as increased capital adequacy, ignore this differentiation and can instead harm the risk-worthy CESE countries as they continue along the path of transition. Indeed, one of the main contributions that foreign bank ownership has made to the development of the CESE countries is precisely the fact that it has enabled financial intermediation in countries that have a small deposit base. These new regulations could price smaller countries out of the market, with too little a base to support any lending operations and other avenues precluded by banks' capital adequacy requirements. The sum total effect could be to restrain all risk appetites, even those that have benefited banks and CESE countries thus far.

28 CEE Banking Sector Report, Raiffeisen Research, June 2012.

29 European Banking Coordination Vienna Initiative Working Group on NPLs in Central, Eastern and Southeastern Europe Report, March 2012.

30 Gergely Szakacs and Marton Dunai, 'Hungary Plans New Tax on Banks, Sees Aid Talks Soon', Reuters Newswire, May 9, 2012, available on-line at: http://www.reuters.com/article/2012/05/09/hungary-taxes-idUSL5E8G989Y20120509.

> Recent regulatory moves are, in and of themselves, blanket restrictions rather than nuanced moves based on the actual differing risk profiles in the region

Fight protection with liberalization

Finally, the only way for the CESE countries to lessen the impact of these regulations in Western Europe is to stick to the course and continue the policy that made them attractive to foreign banks in the first place: financial liberalization, which deepens their own capital markets and provides competition for foreign banks. By allowing the market for capital (still strong in most CESE countries) to determine winners and losers, the moves of regulatory agencies in the West will have the impact of hurting their own banks rather than the financial sectors of the East.

Thus, in the short-term, EBA and OeNB regulations could not come at a worse time for CESE countries, with the prospect of continued deleveraging resulting in larger firms relying on internal financing and smaller firms having to make do without. The medium-term will see risk differentiation within the major Austrian, Italian, Nordic and Belgian banks re-assert itself and appropriately price the lending risk in various countries (albeit with a smaller pool of capital to spread around). In the longer-term, these same banks could find that they no longer have a natural market in the CESE countries. Indeed, it is quite possible to see financial services substitution in countries such as Poland and Slovakia (and of course, Russia) where it has been shown that home-grown banking can survive and even flourish. If Europe continues to issue edicts to guard against most forms of risk, regulations might just force a reallocation of risk appetite from Austrian and Italian banks to Polish and Russian ones.

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APPENDIX: Recent trends in cross-border lending in Emerging Europe

"Systemic" risk mitigation moves, such as increased capital adequacy, ignore this differentiation and can instead harm the risk-worthy CESE countries as they continue along the path of transition

As Figure 1 and Table 1 showed, cross-border lending has increased substantially around the world since the fall of communism from 1989-91. Some of the largest flows have gone to the very same post-communist countries in Central, Eastern and Southern Europe (CESE). The freeing of long-repressed financial systems and the entry of foreign banks tapped a latent but increasing demand for financial intermediation as the various countries of the former communist bloc moved towards a market economy. Indeed, as financial liberalization increased and opportunities were created by accession to the European Union, so did the amount of credit available and the share of foreign banks in the economy (Figures 2 and 4).[31] By 2010, with over 20 years of transition for some countries, liberalization in the financial sector had led to similar levels of credit as would be expected in developed countries, with developed country banks chasing the higher returns available in the CESE region and its relative stability, compared to other regions (such as Latin America). As noted earlier, this structure of banking and reliance on cross-border lending in the CESE countries led to impressive growth.

Much differentiation exists across countries in the region in financial sector activity. And there have been different economic outcomes. Countries such as the so-called "Visegrad Four" (Poland, Hungary, Slovakia and the Czech Republic) entered the EU in its first wave of post-communist accession in 2004, and had the earliest contact with Western European banks and non-bank financial institutions (and also had, not incidentally, the lowest risk premiums). Buoyed by proximity to the EU (and Germany and Austria in particular), the Central European countries pursued some of the most rapid liberalization of the banking sectors, welcoming both cross-border capital movements and foreign banks into their markets. By contrast, countries further away from Brussels, such as the former Soviet republics, saw limited liberalization and correspondingly limited lending (apart from countries that had abundant natural resources, such as Kazakhstan and Azerbaijan, which remain closed politically but financially more developed).

Apart from a few isolationist stalwarts in the CIS (such as Turkmenistan and, to a lesser extent, Uzbekistan) which have maintained high barriers to entry in their financial sectors, foreign banks have made inroads into all transition countries, and cross-border lending has increased as a result. Exposure to Western European banks is different across the CESE region: in the Central European countries (the Visegrad Four plus Slovenia), foreign banks currently hold an average of 75% of all banking assets. However, this is differentiated by country, with Poland and Slovenia having much more flair for banking (66% and 37%, respectively, of all assets in 2010) while the Czech Republic, Hungary and Slovakia have nearly 90% of their assets dominated by foreign banks and cross-border lending.[32] In Southern Europe (including Bulgaria, Romania, Croatia, Serbia and the Western Balkan countries), foreign ownership is even more prevalent. This is, perhaps, explained by the small size of the markets, with 80-95% of banking assets in these countries held by foreign banks.[33] Only in the CIS countries is this

31 Excellent work on the determinants of investment in the CESE countries has been done by Dubravko Mihaljek. See especially his piece, "The Financial Stability Implications of Increased Capital Flows for Emerging Market Economies," BIS Papers, No. 44, December 2008, available on-line at: http://www.treasury.nl/files/2009/02/treasury_1155.pdf#page=19.

trend broken, with a mere 18% of Russian bank assets held by foreigners.

Moreover, with the CESE at a relatively less mature phase of development than its Asian or Western European brethren, the demand for capital for expansion and creation of new businesses remained high among the region's more-developed countries. This was again due to the unleashed market forces that had been repressed for so long. With firms having less ability to utilize internal financing, bank lending had to remain a driver for business growth.

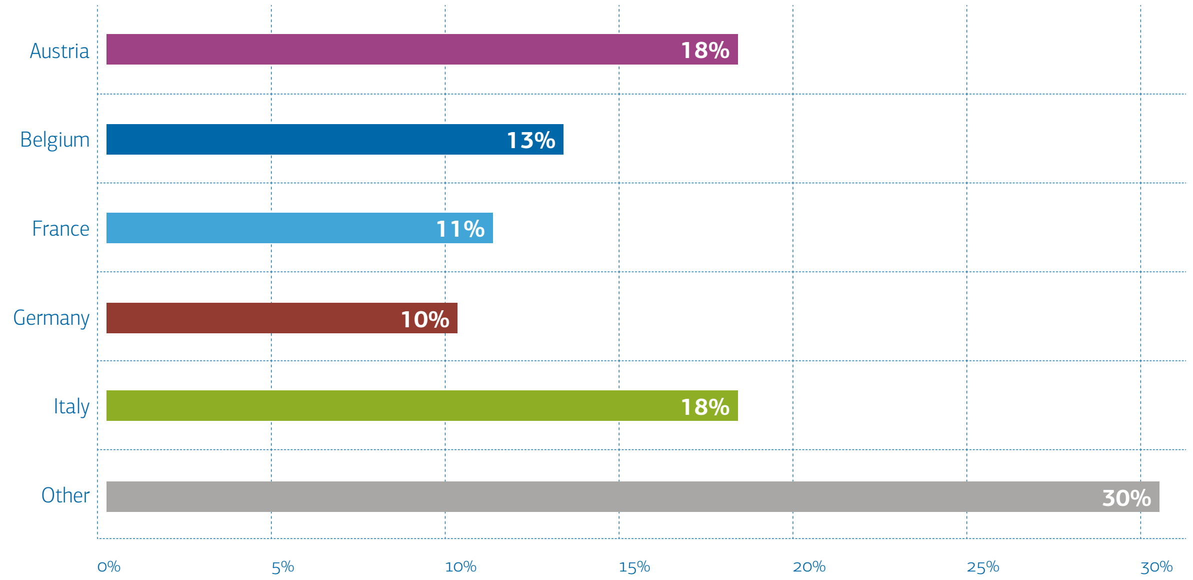
The charge into the formerly communist countries of the CESE has been led, and continues to be dominated, by Austrian banks, with Italian and Belgian banks (Figure 9) also playing a large part. Raiffeisen Bank International (RBI) and Erste Bank (both Austrian) and UniCredit (Italian) headed the list of largest foreign banks in the region by assets. Perhaps not coincidentally, these three banks were among the first foreign banks to enter the CESE. UniCredit acquired its base in CESE through purchasing Germany's HypoVereinsBank, which in turn owned the market leader Bank Austria Creditanstalt.[34]

The preferred method of entry for these and other large banks has been "indirect" lending (that is, lending directed through equity provided to subsidiaries of Western European banks). Such lending has far outstripped "direct" cross-border lending (i.e., loans from headquarter banks to residents or companies in the CESE region). However, in recent years, direct lending has been on the increase. For example, in 2009 Austrian banks had exposures of €79b in indirect loans and €41b in direct loans.[35] Moreover, indirect lending has proceeded through two separate avenues: first, greenfield investment, where a bank such as UniCredit opened a subsidiary in a transition country that was tied to the parent bank in Germany; and second, through acquisition of existing assets via privatization. The route chosen (greenfield versus acquisitions), at least at the outset of transition, was dependent upon the route of financial liberalization (e.g., privatization) that was pursued in the early years of the move from plan to market. But as EU integration processes continued and privatized assets became more scarce, greenfield investment in new subsidiaries became the norm.[36]

By allowing the market for capital (still strong in most CESE countries) to determine winners and losers, the moves of regulatory agencies in the West will have the impact of hurting their own banks rather than the financial sectors of the East

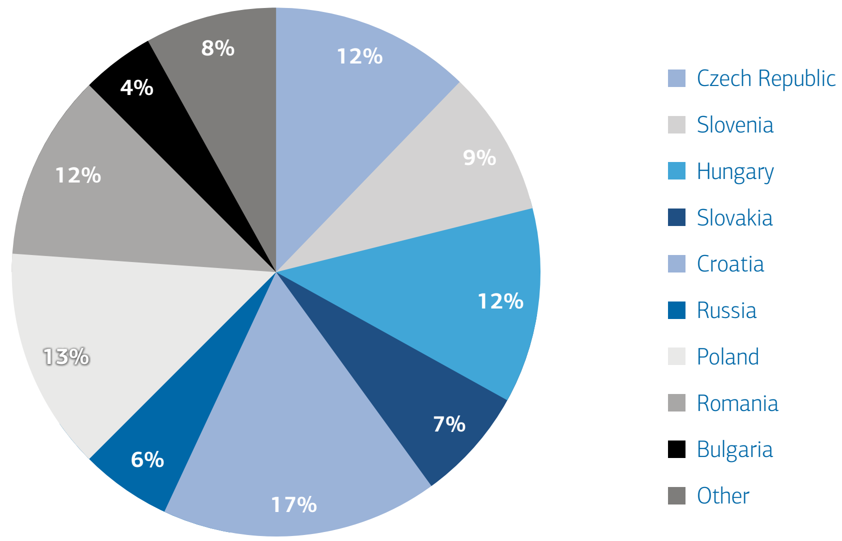
Much of this is likely because cross-border lending is, as noted earlier, primarily driven through subsidiaries. So long as the parent

Figure 9 – Financial sector FDI to Central and Eastern Europe, percentage of total, 1990-2003



Source: Data from Committee on the Global Financial System, BIS, "Foreign Direct Investment in the Financial Sector of Emerging Market Economies," March 2004, available on-line at: http://www.bis.org/publ/cgfs22.pdf.

Figure 10 – Austrian cross-border lending by country, end-2008



Source: Compiled from Austrian National Bank data (OeNB). "Other" includes Albania, Bosnia, Latvia, and Serbia and Montenegro in the CEE region and Belarus and Ukraine in the CIS.

32 Data on bank ownership taken from Raiffeisen Research, "CEE Banking Sector Report," October 2011, available on-line at: http://www.rbinternational.com/eBusiness/services/resources/media/677012584775275435-677012584775275436_677251119927032833-772104317120223179-1-9-DE.pdf.

33 Ibid.

34 'Banks in Central Europe: A Three-Horse Race', the Economist, May 19, 2011, available on-line at: http://www.economist.com/node/18713588.

35 Johannes Pann, Reinhardt Seliger, and Julia Übeleis, 'Foreign Currency Lending in Central, Eastern and Southeastern Europe: the Case of Austrian Banks', Financial Stability Report No. 20, Austrian National Bank, December 2010, available on-line at: http://www.oenb.at/de/img/fmsb_20_schwerpunkt01_tcm14-214500.pdf.

36 Kou Takata, 'Evolution of Banking Sector Structures within Central-Eastern Europe Countries during Transition', Interfaces for Advanced Economic Analysis, Kyoto University, Discussion Paper No. 065 (March 2005), available on-line at: http://www.kier.kyoto-u.ac.jp/coe21/dp/61-70/21COE-DP065.pdf.

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banks' host country credit was strong, cross-border lending could continue. In the words of the EBRD, "international bank lending through a local network of branches and subsidiaries is much more stable than direct cross-border lending, and… foreign bank subsidiaries reduce their lending less during a financial crisis than domestic bank lending."[37]

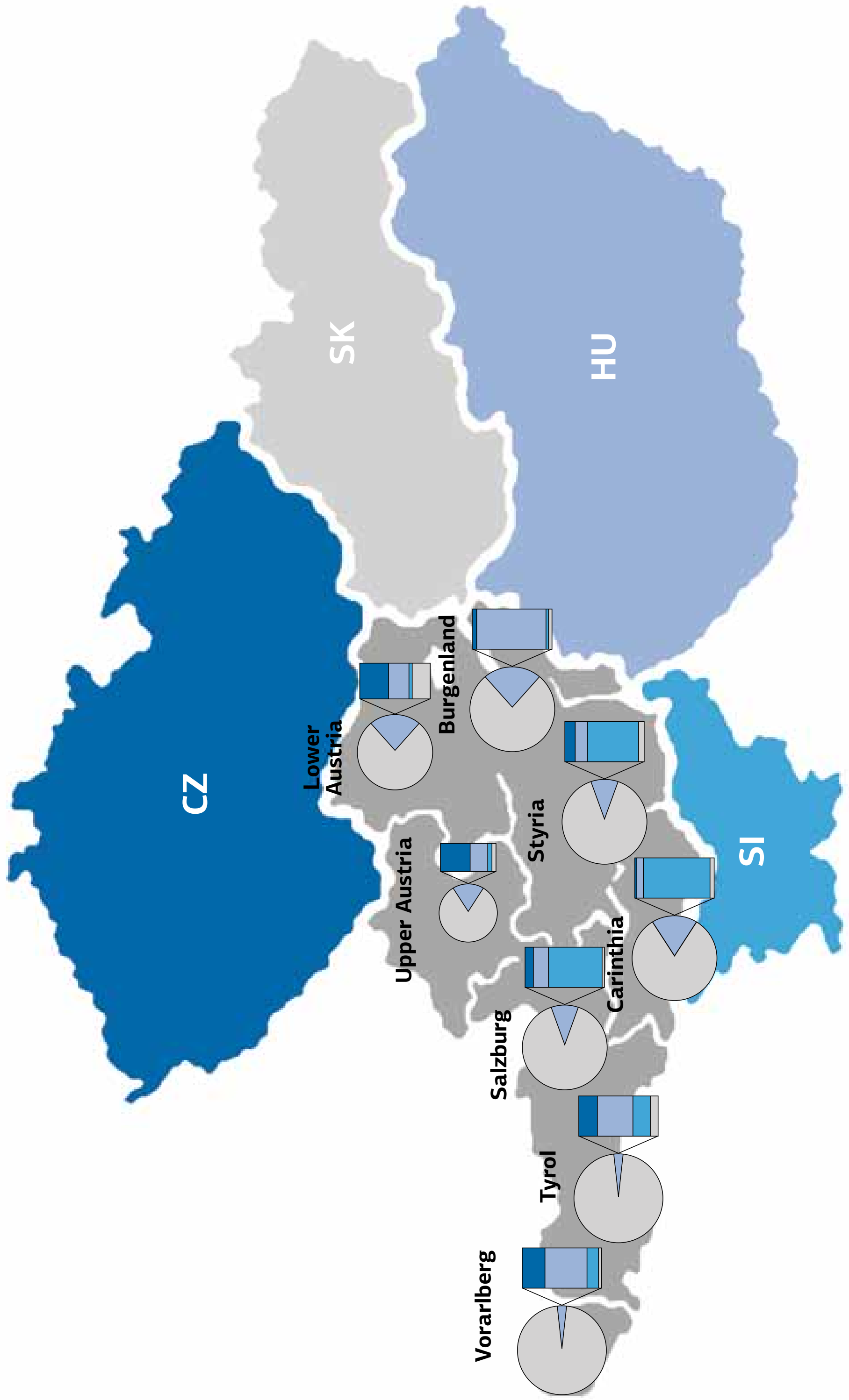
Beyond the big three banks noted above that are diversified throughout the region, smaller (Western) European banks typically lacked the access to subsidiaries or capital to purchase assets, and thus had to rely on direct lending for their expansion.[38] This reliance on direct lending has also led to specific geographic patterns in lending, creating relative "spheres of influence" based on geographical proximity to various countries. Indeed, the pattern of lending in the CESE region has closely corresponded to the international trade "gravity model", where closer (and larger) countries are more likely to receive more services and funding than ones further away or smaller. This can be seen in the lending of Austrian banks by the end of 2008 (Figure 10). The largest recipients of cross-border lending were: the biggest economy in the region (Poland); a historically-close neighbor (Croatia); a country that was once joined with Austria in empire (Hungary); and neighboring Slavic countries (the Czech Republic and Slovakia, with the relatively larger economy of the Czechs receiving proportionately more lending). Figure 11, reproduced from a study by researchers at the Austrian National Bank (OeNB) makes the neighborhood effect even clearer, showing that cross-border lending by banks, by region of Austria, overwhelmingly goes to the closest border.[39]

37 Erik Berglöf, Yevgeniya Korniyenko, Alexander Plekhanov, and Jeromin Zettelmeyer, 'Understanding the Crisis in Emerging Europe', EBRD Working Paper No. 109 (November 2009), available on-line at: http://www.ebrd.com/downloads/research/economics/workingpapers/wp0109.pdf.

38 Claus Puhr, Markus S. Schwaiger, and Michael Sigmund, 'Direct Cross-Border Lending by Austrian Banks to Eastern Europe', Financial Stability Report No. 17, Austrian National Bank, June 2009, available on-line at: http://www.oenb.at/en/img/fsr_17_special_topics04_tcm16-140534.pdf.

39 Ibid.

Figure 11 – The neighborhood effect in lending from Austrian regions, by country



Source: Claus Puhr, Markus S. Schwaiger, and Michael Sigmund, "Direct Cross-Border Lending by Austrian Banks to Eastern Europe." Graphic provided by and reproduced with their permission.

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