Governance of Cross-Border Banking in Crisis and Beyond – The Emerging European Experience

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Financial integration in Emerging Europe - a systemic problem in search of a systemic approach

Source: Bankscope, bank websites
Key messages

- Crisis unveiled weaknesses in framework for crisis management and regulation/supervision
- Vienna Initiative – a public-private sector initiative for coordination that seems to work
- Need new framework to mitigate impact of move towards host country regulation/supervision and increased fiscal buffers and reserves
- Vienna Initiative help reduce vulnerabilities and regulatory weakness and manage future crises
Crisis threat to financial integration

- “Rush for the exit” by banks
  - Accelerated deleveraging

- Financial protectionism
  - Restrictions on home country bank support programs
  - “Ring-fencing” or discrimination by host authorities

- “Beggar-thy-neighbour” policies
  - Increased capital requirements, deposit insurance…

=> need for coordination, but institutional vacuum at European level
Vienna Initiative – some landmarks

- Nov-Dec 2008: Among banks + IFIs + warnings
- Jan 2009: Home-host authorities + IFIs meet in Vienna
- March 2009: Home-host authorities, IFIs and banks all meet – IFI investment package + bank commitments
- March 2009: IMF/EU program for Romania with exposure commitments by banks and regulatory forbearance – emulated in all subsequent programs
- Sept 2009, March 2010: all stakeholders, including 17 banks, meet in Brussels and Athens; from exposure commitments to measures to reduce FX mismatches
Vienna Initiative design: collective action and commitment

- Filled institutional vacuum at European level + included supervisors and non-EU members
- Platform for collective action and building of trust
  - Policy coordination and mutual commitments
  - Ex post burden sharing: home-host + private banks
- Incentivise bank groups to stay engaged
  - Part of IMF/EC programs + coordinated IFI investments
  - Regulatory forbearance (mainly capital requirements)
  - “Naming and shaming” of CEOs increased signal credibility
Vienna Initiative results: No rush for the exit

- No restrictions on home country bank support packages + very little host protectionism + effective ex post burden sharing
- Public parent bank commitments in IMF/EU programs respected – maintained exposures and no foreign subsidiary failed
- Helped stabilise individual countries (Romania, Serbia etc.) and built market confidence
- Lowest outflows - despite largest output shock
Lessons: successful coordinated approach - Vienna Initiative

EUR Money Market Spread and CDS Developments

- The demise of Lehman Brothers
- Start of “Vienna Initiative” and intensification of support for CESEE by IFIs
- Joint announcement of measures designed to address pressures in short-term funding markets by BoE, FED, ECB, SNB and BoC
- Coordinated action of ECB, FED and SNB
- ECB injects 95bn EUR overnight to improve liquidity
- Eurostat refuses budget statistics of Greece

Source: Datastream; * … weighted by AT banks' country risk exposure as of 2009Q3.
Emerging Europe least affected region in terms of capital outflows in the crisis

Percentage changes in external assets of BIS-reporting banks

-3.4  
-11.1  
-4.4  
-7.8  
-11.9  

Emerging Europe  Russia  Ukraine  Cent Asia  Caucasus  Latin America  Emerging Asia
...even though Emerging Europe suffered the largest output decline in the crisis.

<table>
<thead>
<tr>
<th>Region</th>
<th>Avg 2003-2008</th>
<th>2009*</th>
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<tbody>
<tr>
<td>Transition Region</td>
<td>-6.2</td>
<td>-6.2</td>
</tr>
<tr>
<td>Advanced Economies</td>
<td>-3.4</td>
<td>-2.0</td>
</tr>
<tr>
<td>Latin America</td>
<td>-2.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Developing Asia /1</td>
<td>5.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Emerging Asia /2</td>
<td>8.2</td>
<td>5.0</td>
</tr>
</tbody>
</table>
Austrian banks reduced absolute exposures, but less than in developed countries

Volume of foreign assets owned by Austrian banking groups (incl. assets owned by subsidiaries)

USD mil

- Advanced economies
- Emerging Europe
- Other emerging economies
- Others

2002 2003 2004 2005 2006 2007 2008 2009 Latest data 2009Q3

Source: BIS consolidated statistics, table 9B; BIS defines emerging Europe as including the following countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, FYR, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey, Ukraine
Vienna Initiative: why more successful than previous attempts to involve private sector?

- Initial conditions different
  - Deeper financial (and political) integration;
  - Banks more committed through subsidiaries.

- Massive and coordinated macroeconomic and micro (IFI) financing incentives

- Measures voluntary and public → public and peer pressure, name-and-shame devices

- Longer in duration and more formalised
Crisis unveiled broader issues of cross-border banking

- Home country regulation/supervision didn’t work and politically unsustainable
- Existing supranational arrangements little or no impact
- Massive “too complex to fail” problem
- Banks with branches (rather than subsidiaries) more prone to run for the exit?
- Costly fiscal and international reserve buffers judged to be necessary - and often insufficient
The Baltic Debacle
– a case study

- Dramatic financial integration generated strong growth
- Fragmented regulatory and supervisory framework + failure of regional coordination
- Rapid credit expansion + asset bubble + massive FX exposures => countries + entire Nordic region at risk
- Nordics: Massive support to banks + swap line from the ECB + 1.8 bn euros to Latvian EU/IMF program
- Baltics: GDP drop close to one-fifth in 2009 – still in recession and all under very harsh austerity programs

Source: Bankscope, bank websites
International regulatory agenda: Likely responses

- Subsidiarisation of cross-border banks
- Home country fiscal capacity to limit bank size
- Post-crisis clean-up procedures “living will”
- Systemic risk tax (how capture cross-border?)
- Better cross-border coordination – progress in Europe, but yet to be tested
- Build fiscal and international reserve buffers
- “HOST COUNTRY RULE” to dominate
Issues with “host country rule”

- Host countries limited capacity (Citigroup in Moldova) and often politically less stable
- Forces substantial increases in capital buffers and changes in business models of banks
- Comes with subsidiarization and increased complexity – more friction and moral hazard
- Overall fragmentation of financial system and possibly a reversal in financial development
Issues of “home country rule”

- Incentives misaligned – home authorities do not internalise impact on host countries
- Regulatory capture by large bank groups
- Politically unacceptable to host countries (post-crisis)

=> Need cross-border arrangements with host country legitimacy – some hope in European framework, but untested
Vienna Initiative – part of framework for cross-border coordination

- Regional approach – flexible to reflect actual financing patterns, but still lacks formalization of burden sharing
- Complement regulation/supervision by home and host authorities – compensate for host weaknesses and limit jurisdiction shopping
- Involves the private sector – international banks
- Offers role to the IFIs in global financial architecture
- Resolve issues of ex post (and ex ante?) burden sharing and address vulnerabilities (e.g., FX exposures) + coordination in next crisis…
Conclusions

- Crisis unveiled weaknesses in framework for regulation/supervision and crisis management
- “Host country rule” and reserve build-up the short-term result, but need to find other solutions in the longer term
- Emerging EU arrangements go some way towards such a balanced approach, but still untested
- Vienna Initiative – a public-private sector initiative for coordination that seemed to work in the crisis
- VI could offer platform to reduce vulnerabilities and regulatory weaknesses and manage future crises…
European bank exposure to Eurozone periphery
- a systemic problem in search of a systemic approach
USD 100 bln
Thank you