

## **Banking in the SEEs: Crisis effects, outlook and risks**

Dear governors, distinguished guests, ladies & gentlemen:

It is my great pleasure to be here today and say a few words about the banking developments in the South Eastern European Economies, the effects of the crisis and the way I see the financial sector evolving in the years to come.

In the last six months, thanks to the drastic intervention of governments, central banks and international organizations, we have managed to escape a major collapse of the global financial system. This narrow escape is evident in the financial press, which has switched the topic of discussion – as the weekly magazine The Economist puts it - *from the future of capitalism to the future of capital requirements*. The interbank market is almost back to normal, the bond market is revived, M&A activity is up, and the international stock markets have already discounted the recovery of the global economy and future new profit opportunities.

I will begin by briefly reviewing the market views on the crisis, then discuss the structure of banking in the SEE countries and the problems that constrain new lending to households and corporations. I will finish with an assessment of the future evolution of the banking industry in our region and the globe.

### **1. Is the crisis over?**

In our region, risk premia have declined a lot, especially since February-March, when the IMF was allocated a lot of funds by the G-20, about \$1 trillion to spend on problematic economies. Yet in some countries these risk premia are still above the levels they reached

prior to the Lehman collapse in September 2008. Markets think that the crisis is not fully over.

In my view, SEE sovereign spreads still have room to decline towards a lower equilibrium level. However, this equilibrium, will remain higher in the future than it would have been had the crisis not occurred. In other words, I expect the crisis to leave its lasting mark on the risk premia of the SEEs as well as the advanced economies.

## **2. Banking in the SEEs: The strong points**

Turning now to banking in the region, there are items that make us happy and items that we continue to worry about. A big plus in the SEEs is the stable nature of their banking systems, and their strong capital cushion. But let me give you some more concrete numbers.

In the past four-five years, a large wave of capital inflows has taken place to the region of emerging Europe. As a consequence, the banking sector in the countries of SEE - with the exception of Turkey - is mostly foreign owned. And unlike the Baltic region, this inflow of bank capital came from a variety of countries. Moreover, simple ratios of bank capital to total assets for the SEE banking systems are a lot higher than the corresponding ratios in Western Europe.

The major foreign players are the 4 Greek banking groups (NBG, Alpha, Eurobank, Piraeus) plus 7 additional banks, 2 Italian (Unicredit and Intesa San Paolo), 3 Austrian (Erste, Reiffeisen, Hypo Alpe Adria), one French (Societe Generale) and one Hungarian bank (OTP). Their asset exposures to SEEs vary from 31% for Hypo Alpe Adria to 1.7% for Societe Generale. These banks have high capital adequacy ratios.

Banks that operate in the SEE region were particularly strong during the crisis. From June 2007 to early October 2009, banks in all of Europe suffered capital losses equal to \$467 bn. These losses came from a variety of sources, loan charge-offs and provisions (20%), non-mortgage asset backed securities (13%), monoline insurers (10%), CDOs (8%), subprime RMBSs (8%), and other. Yet only a very tiny component – originating from loan provisions - is due to losses occurred in the SEE region. Also very few banks involved in the SEE region occurred large losses. From the previous 11 key player-banks in the SEE region, only Societe Generale had global write-down of \$12.6 bn and ranks 13<sup>th</sup> among the 59 European banks with losses. Unicredit occurred a \$6.5 bn loss and ranks 22<sup>nd</sup>. Nevertheless, both banks have small asset exposure to the SEE region.

### **3. The constraints on new lending**

In the past, the SEE countries relied heavily on the financial sector to promote growth. In 2007, their economies were overheating and credit growth was running at high rates. Yet, unlike the Baltic States, the region did not become as vulnerable to the credit expansion. The international financial crisis caught the credit expansion in the beginnings of a bubble and, hence, saved the SEE region from re-living the Baltic experience. Thus, by the end of 2008, total credit to GDP had not reached the levels observed in the Baltic States.

The recession has caused the credit expansion to stall. However, it should not be expected that the financial sector will pull the countries out of the recession. Prior experience in the more developed western world shows that credit expansion lags the economic expansion. During a recession, it is the economy that drives credit, not the other way around.

There are two major problems that constrain credit expansion. The first is liquidity. With the exception of Albania and Turkey, loans exceed deposits in the SEE countries. New liquidity is hard to come from abroad nowadays. Thus loan expansion requires domestic policy action, like reducing reserve requirements, utilizing the ample assistance of the IMF, capital increases in state-owned banks, increasing the minimum insurance on bank deposits, etc. Indeed, the SEE authorities took many of those measures in order to release new credit to households and enterprises.

The second constraint to loan expansion is the fear of borrower default. The experience with the business cycle in the West shows that NPLS rise as the recession progresses and peak after the end of the recession. NPLs are thus expected to reach very high levels in 2010. An additional cause for concern is the behavior of the local exchange rates, as large devaluations increase the burden of households and companies that have borrowed in FX.

#### **4. What is the future of banking?**

The future of banking in the SEEs will not only follow the future of the local economies but also the future of the global financial system. I will, therefore, make some remarks on the latter.

From the time of the Great Depression, the global financial system has increased in relative size and power. This is evident in the graph of employment as a percentage of total employment which doubled, and would be even more evident in value added terms, which quadrupled. However, today everyone asks whether or not the next few years mark the beginning of shrinkage in the importance of the global financial sector.

We are facing a new world order ahead. Global economic growth will slow down, political power will shift towards Asia and the G-20, and the regulatory authorities will have the upper hand with the Financial Stability Board and the IMF running the show. The G-20 regulatory decisions will affect banks. Wall Street will counter attack with plenty of money and political influence.

The task for regulators is to increase global financial stability without hurting the good side of the banking business, which promotes healthy lending, conducts the maturity transformation needed by both depositors and borrowers and promotes the larger intermediation role. If onerous restrictions were to be imposed on banking, then a new wave of deregulation would be unfolding, which would appear optimal in the future as the memory of today's near-collapse fades.

In the process of re-regulating the global financial system, regulators ought to observe two main principles.

(1) Cross-country **level – playing field** among financial institutions.

This seems to be understood by the G-20, as they promote identical accounting standards and common restrictions on liquidity and leverage. Unilateral restrictive decisions by individual country regulators, which may appear to be working in the short-run, will hurt their banking system in the long-run as financial capital is highly mobile.

(2) **Capital is costly**. This is perhaps less appreciated by the floating initial rough proposals on countercyclical capital buffers or the need for quality capital, i.e. a larger stock component in capital adequacy rules. Yet there are some smart proposals also floating around by academics, which take care of the countercyclical buffer property without imposing too much unwarranted cost on banking.

## **5. Conclusion**

This severe crisis has wakened us all up to the dangers of an unregulated financial system that is vulnerable to extreme behavior. The lesson is to build a new system whose structure of incentives thwarts this behavior. We are optimistic that we will succeed in the same manner we succeeded in averting a global depression.

Our region was lucky not to host banks involved in toxic assets or the pursuit of extraordinary profit at any risk. Yet, we were not spared by the consequences of the crisis, as we all operate in a globalized environment. Liquidity and NPLs are major concerns for banks that prohibit them from aggressively supplying new loans. The past business cycle experience shows that the recovery in lending will follow the recovery of the economies, as risks decline and loan demand by healthy borrowers returns.

As we look ahead to the future, we can only predict rising living standards and healthy banking systems in the SEEEs that would further support growth. The SEE countries share a common anchor in their domestic political and policy decisions. This anchor is the process leading to EU or EMU entrance, which forces the economically rational decisions on politicians and the public.