Strengthening crisis resilience within CESEE's open financial systems

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20 October 2016

Key points

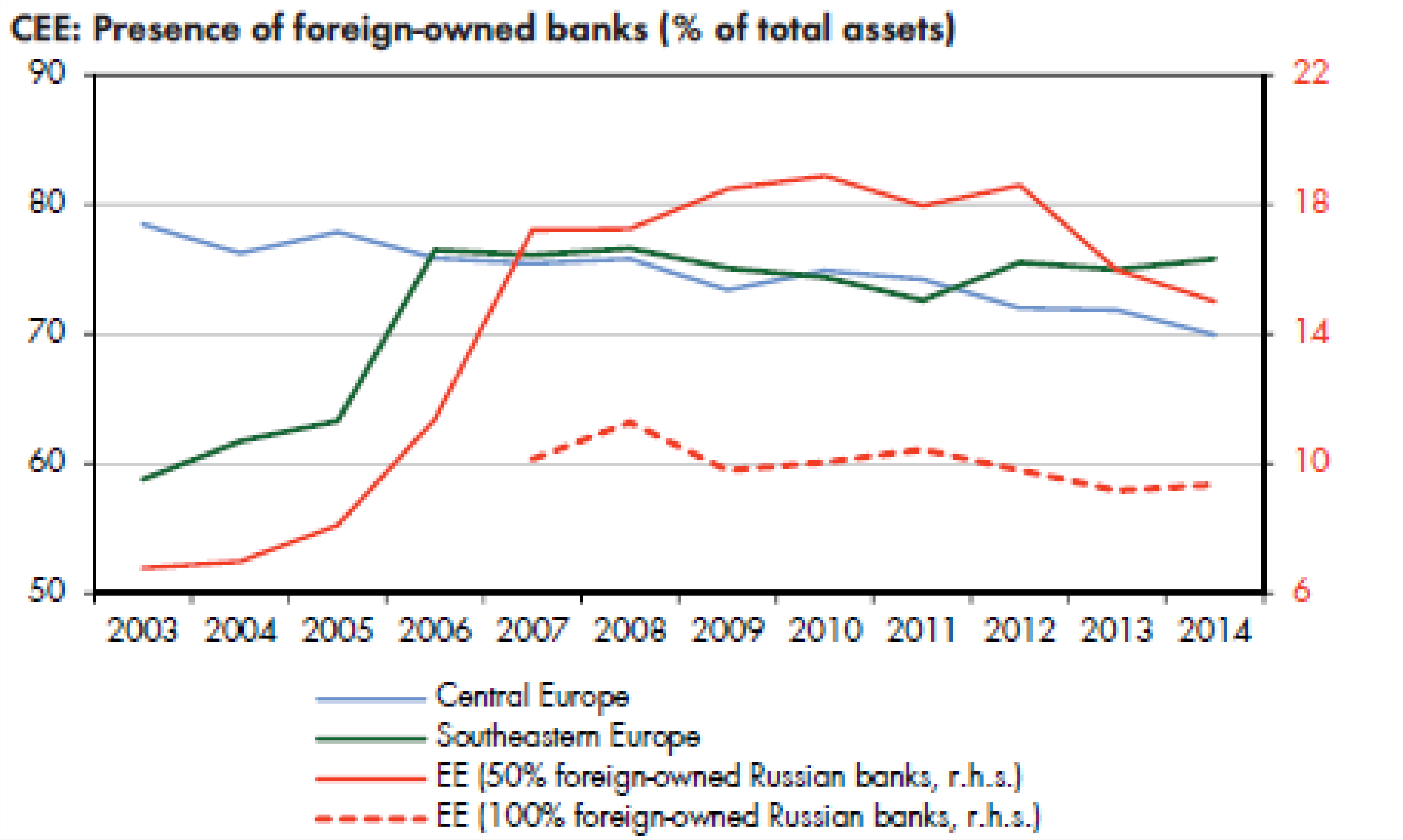
I. Even after the recent episode of financial deleveraging, the CESEE remains one of the most open financial systems - this has been good for growth and financial stability, and will remain so.

II. Banking fragility in the euro-area remains a risk for CESEE, mitigated by the progress in establishing the EU Banking Union.

III. Divisions between the EU's Banking Union 'ins' and 'outs' need to be managed.

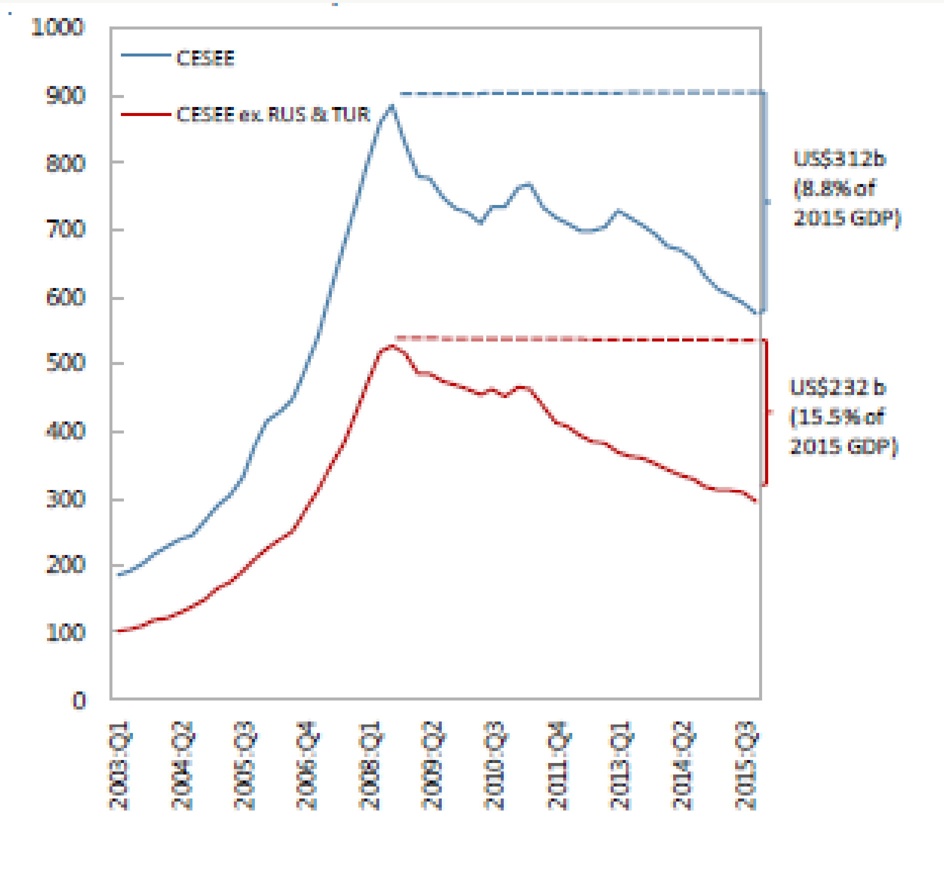
IV. NPL resolution and vulnerabilities from private debt now move centre-stage in bank supervision.

I. CESEE remains the most financially open emerging markets region



Source: Raiffeisen Research.

Deleveraging in response to euro-area crisis, and other regulatory factors



Benefits of foreign ownership as yet unaffected by deleveraging dynamic:

- Substitution of cross-border funding through relatively strong deposit inflows – this is positive in reducing cross-border shock transmission.
- Reduction in cross-border exposures by all EA banks. It has been more muted in the CESEE.
- Home country re-regulation: part prudential, part ring-fencing.
- Host developments: re-emergence of state banks (Hungary), local consolidation (Poland), and debt restructuring (e.g. Slovenia).
- Adjustment in business models towards 'multinational banking' (IMF, 2015).

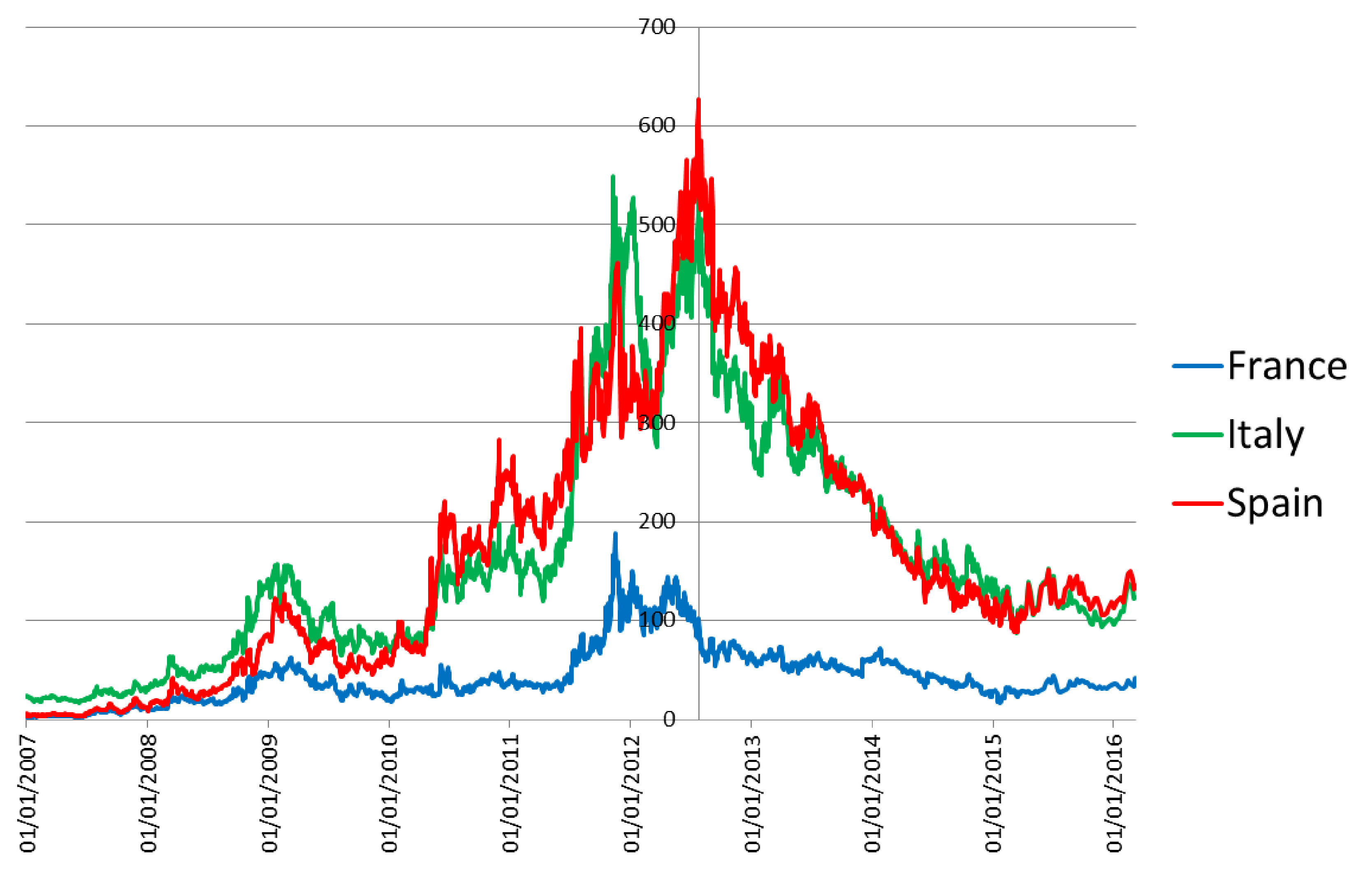
II. Progress with the EU Banking Union

- Pre-crisis regime in euro area
  - Single market, single currency, EU regime on competition policy and state aid
  - National banking supervision & crisis management
  - “Banking nationalism” → declining supervisory quality, in-built moral hazard
- “Bank-sovereign vicious circle”
- Decision point in June 2012
  - Contagion Spain, Italy → euro area breakup risk
  - Fiscal union? Discussed late 2011, no consensus
  - Summit on 28-29 June 2012 decides on supervision within ECB + potential ESM recapitalisatoin
  - subsequent ECB ‘Outright monetary transaction’

The EU Banking Union

- Single Supervisory Mechanism (SSM) since Nov. 2014
  - Following the ‘Comprehensive Assessment’ of 130 banks
- Single Resolution Mechanism (SRM) since 2015
  - Single Resolution Board (SRB)
  - Single Resolution Fund (SRF): “national compartments” starting 01/2016, gradual mutualization to 2024
- European Deposit Insurance Scheme (EDIS)
  - Legislative proposal 11/2015

The mid-2012 turning point: 'positive contagion'



10-year sovereign bond spread over Germany. Source: Bloomberg

SSM activity so far

- Comprehensive Assessment 10/2014
  - 130 banks, accounting for almost 90 per cent of assets; Asset Quality Review (AQR) & Stress Test
  - 25 fails as of end-2013 (35 with fully-loaded CRR)
  - 9 more banks tested 11/2015 (e.g. Novo Banco)
- Supervisory Review & Evaluation Process (SREP)
  - First SREP decisions 02/2015 based on C.A.
  - Second round 11/2015
- 2016 Stress Tests
  - Fewer banks than 2014, no hard pass-fail
- Decisions on executives, change of control

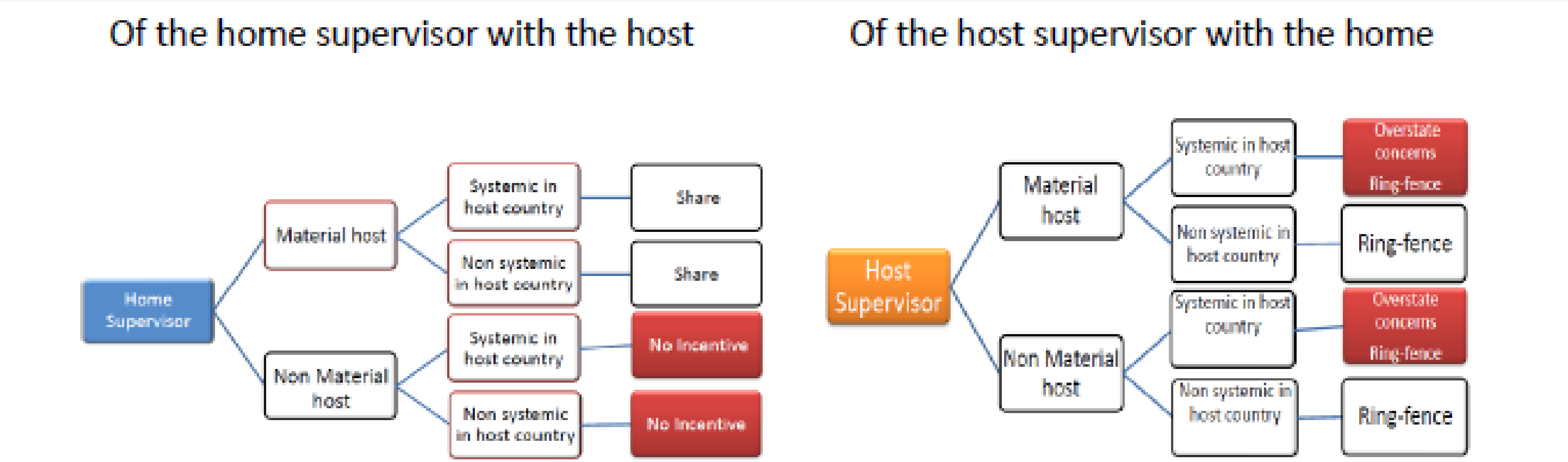
current reform discussions

- SSM agenda
  - Reduce “Options & National Discretions”
  - Gradual phasing-out of geographical ring-fencing
  - NPL resolution/balance sheet repair
  - Banking sector consolidation / restructuring
- Strengthening Banking Union
  - Deposit insurance
  - Reduction of sovereign-debt home bias
  - Resolution plans, TLAC / MREL calibration
  - Resolution Fund capacity

III. Banking Union 'ins' and 'outs'

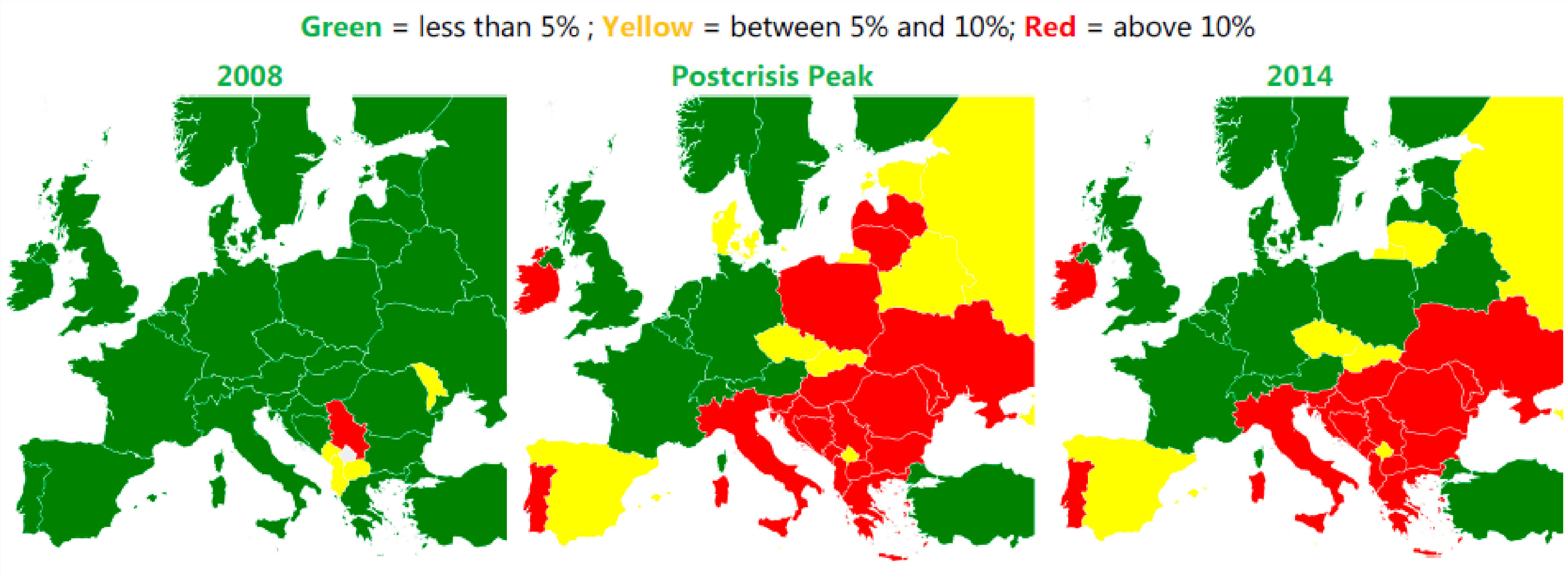
- EBA's Single Rule Book is an EU standard
- SSM already home supervisor for key bank subsidiaries.
- But supervisory practice could reassure investors.
- Banking union could prepare path into the euro area , without necessarily initiating that process.
- Despite early enthusiasm there have been no opt-ins :
  - Huettl and Schoenmaker: 'Should the 'outs' join the European Banking Union?, Bruegel Policy Contribution, Feb. 2016.
  - Lehmann and Nyberg: Europe's banking union in the global financial system: constructing open and inclusive institutions, EBRD Working Paper no. 175.
  - Berglof, de Haas, Zettelmeyer: Banking Union: the view from emerging Europe, VOX 2012.

Information sharing in cross-border supervision



Source: D'Hulster (2011).

IV. NPLs and private debt

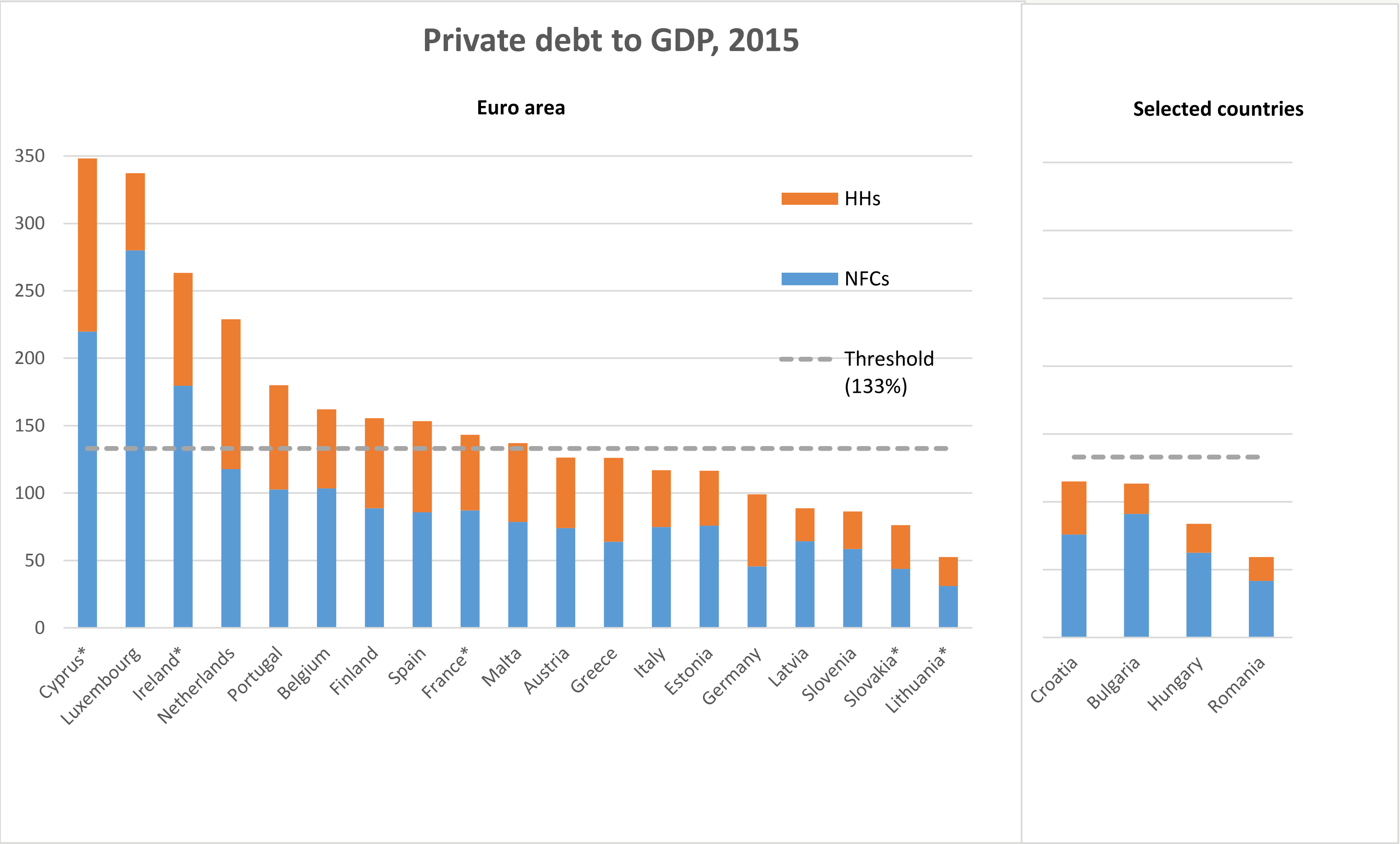


IMF (2015): A strategy for resolving Europe's problem loans.

Progress on NPLs in EBA and SSM

- 2013 EBA technical standard on NPEs and forbearance: a new and consistent standard
- … formed the basis of the 2014 national AQRs, and ECB's comprehensive assessment, and now for regular reporting, e.g. in the *Risk Dashboard*, and EBA summary report of June 2016
- September 2016: ECB draft guidelines on banks' management of NPLs, and assessment of national frameworks:
  - Targets for NPL reductions
  - Transparent benchmark on internal governance
  - Account to supervisors on NPL strategies, reductions in distressed portfolios, and operational capacity

But bank supervision cannot tackle private debt deleveraging

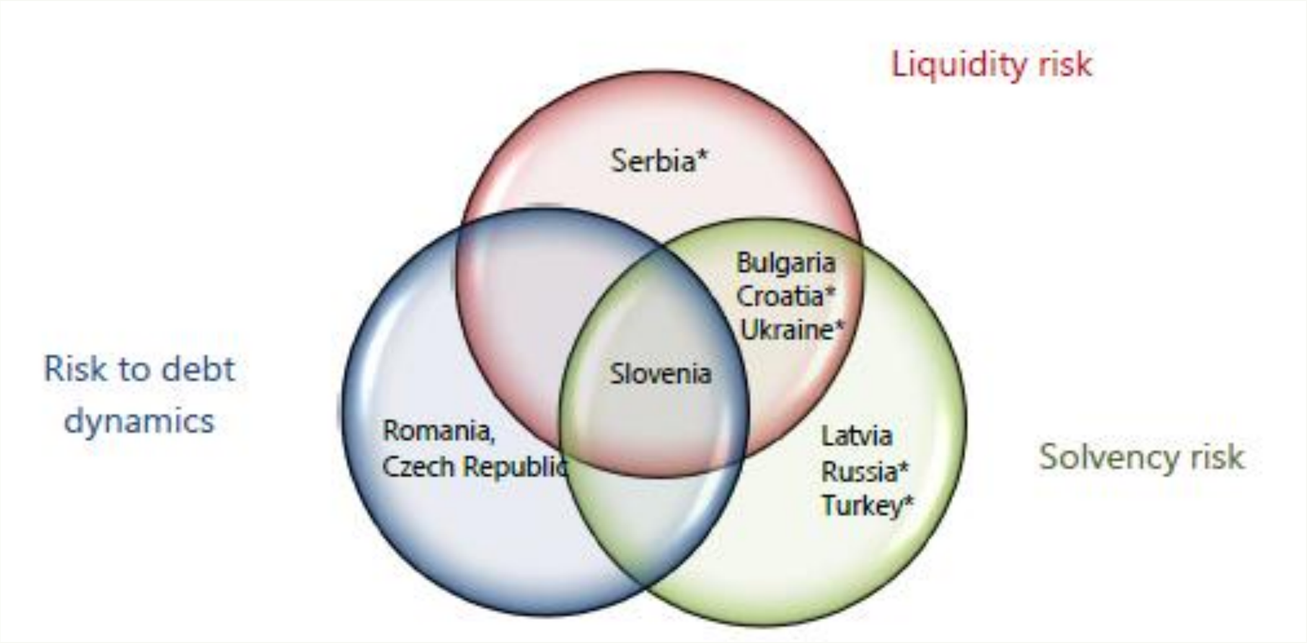


Sustainability and debt distress

Debt sustainability:

- “net worth remains on a non-decreasing path” (Arrow et al. in JEP 2014, vo. 18, and Quarterly Report on the Euro Area, 2014, no. 3).
- Two thirds of boom-period increase (IMF, 2013)

Dimensions of debt distress:



Source: IMF Regional Economic Issues, May 2015.

The distribution of debt needs to inform deleveraging policy

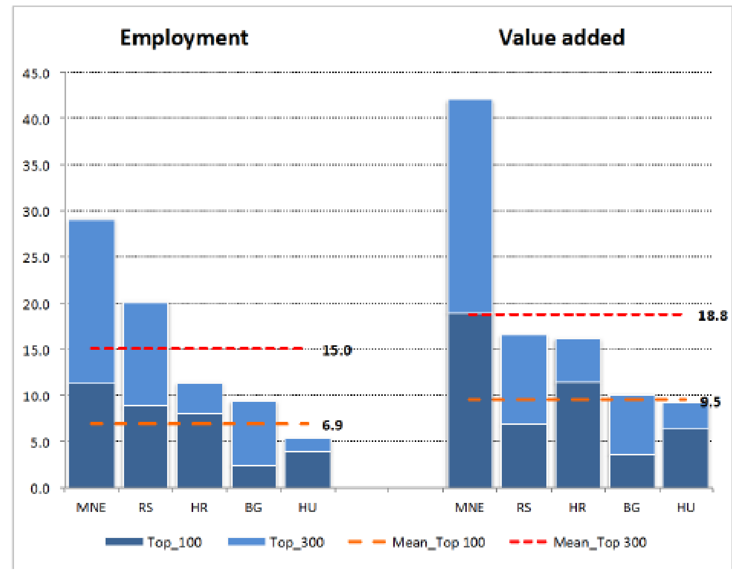
"All estimates of deleveraging needs are based on aggregate measures of debt at the level of the sector. […] low aggregate indebtedness may still conceal deleveraging risks if debt is concentrated among households with low value assets and incomes under stress" (Pontuch in Quarterly Report on the Euro Area, 2014, no. 3)

Direct importance of debt concentration

Share in total employment & value added (%)

Top-300 debtors account for:

- ≈ 50 – 70 % overall debt overhang
- ≈ 15 % overall employment
- ≈ 19 % value added,



J. Damijan (2016): Corporate NPL portfolios in CESEE countries: impact of corporate leverage and debt spillovers on firm performance, EBRD Working Paper no. 191.

The agenda for NPL resolution and debt deleveraging:

Priorities for banks:

- Commitment by parent reflected in KPIs within subsidiaries
- Uniform capacity/mobility of workout teams
- Parent involvement in large exposures
- Participation in collective resolution frameworks/INSOL
- Consistent strategy for portfolio sales

… for host country supervisors:

- Implementation of EBA standards, and gradual introduction of SSM guidelines within subsidiaries
- Coordination with home supervisors, also on operational aspects

… and for governments:

- Support capacity building in judiciary and insolvency professions
- Certainty in regulation of loan servicing and restructuring investors

Thank you.

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