GLOBAL FINANCIAL CRISIS AND BANKING SECTORS OF FOUR CENTRAL AND EAST EUROPEAN STATES AND THREE BALTIC STATES

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Abstract

The paper first explores why the crisis extent varied among the four Central and East European States and three Baltic States by distinguishing major differences in the pre-crisis bank lending practices. Based on the analysis of bank performance indicators and the author's interviews with representatives of major banks active in the region, the important role of foreign banks in mitigating the risks of financial contagion is outlined. We inspect the concrete experience of financial supervision authorities in the Baltic States to show why the host country supervisors could not curb excessive lending by large Scandinavian banks. The paper also addresses the issues in the financial crisis prevention and management which will improve based on the new EU regulatory and supervisory framework for credit institutions.

Keywords: Global Financial Crisis, Baltic States, EU Regulatory, Banking Sectors

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1. Introduction

The 2008-09 financial crisis in the EU affected the new EU member states in Central and Eastern Europe. The banking sectors of these states have been experiencing a large-scale financial crisis for the first time since they became predominantly foreign-owned. However, it is important to distinguish among these states according to the extent to which they have been affected by the financial crisis. As Figure 1 shows, Baltic States and Hungary were the worst affected economies.

In this paper we will specify those features of the pre-crisis developments in the banking sector that explain why certain countries were more affected than others by the 2008-09 financial crisis in the EU. We will focus on four Central and East European States (CEES) and three Baltic States. Next we address the issue of financial stability and demonstrate how the foreign banks in this region react to the worsening economic situation. Then we outline policy responses to the crisis, namely the financial supervision and regulation. Finally, we discuss the implications which can be drawn from the crisis.

Figure 1. Real GDP growth rate (as % change on previous year)

	2005	2006	2007	2008	2009	2010	2011
Estonia	9.4	10.6	6.9	-5.1	-13.9	3.1	4.9
Latvia	10.6	12.2	10.0	-4.2	-18.0	-0.3	3.3
Lithuania	7.8	7.8	9.8	2.9	-14.7	1.3	5.0
Poland	3.6	6.2	6.8	5.1	1.7	3.8	4.0
Czech Rep.	6.3	6.8	6.1	2.5	-4.1	2.3	2.0

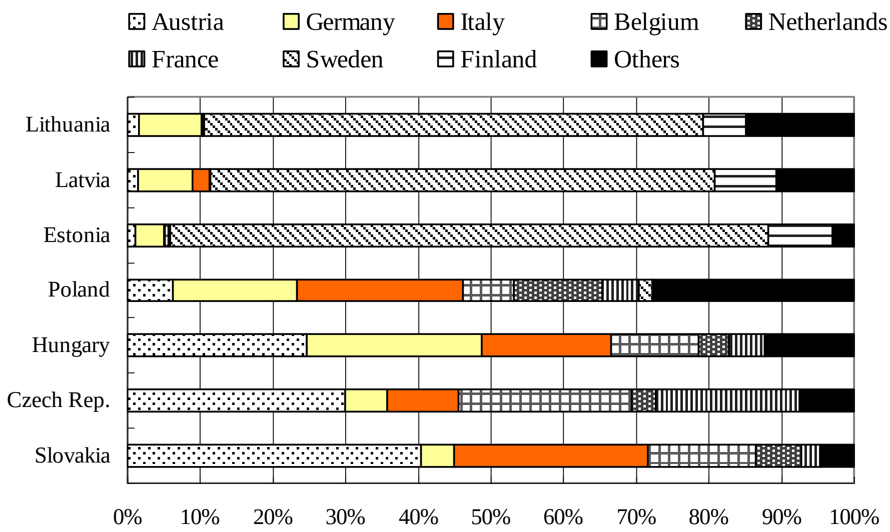
Slovakia	6.7	8.5	10.5	5.8	-4.8	4.0	3.5
Hungary	3.2	3.6	0.8	0.8	-6.7	1.2	2.7
Slovenia	4.5	5.9	6.9	3.7	-8.1	1.2	1.9
Cyprus	3.9	4.1	5.1	3.6	-1.7	1.0	1.5
Malta	4.2	1.9	4.6	5.4	-3.3	3.2	2.0
Romania	4.2	7.9	6.3	7.3	-7.1	-1.3	1.5
Bulgaria	6.4	6.5	6.4	6.2	-5.5	0.2	2.8

Source: Eurostat.

2. Pre-crisis Developments in Bank Credit to Private Sector

Following the liberalization of financial sectors during the EU accession process, banks from EU member states of Western and Northern Europe participated in the bank privatization of CEES and Baltic States. As a result, the banking sectors of these states have a high degree of foreign ownership[1]. However, while the claims on Baltic States are highly concentrated in Sweden, CEES have a more diversified structure of main lenders (Figure 2).

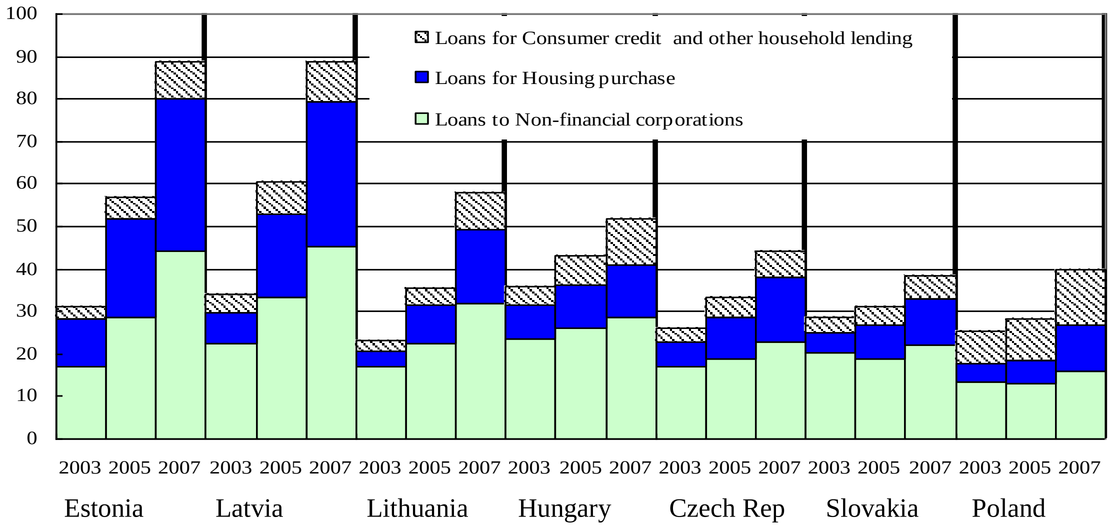
Figure 2. Consolidated Foreign Claims on individual states by nationality of reporting banks (immediate borrower basis) as of end-March 2007



Source: BIS, *Consolidated Bank Statistics*

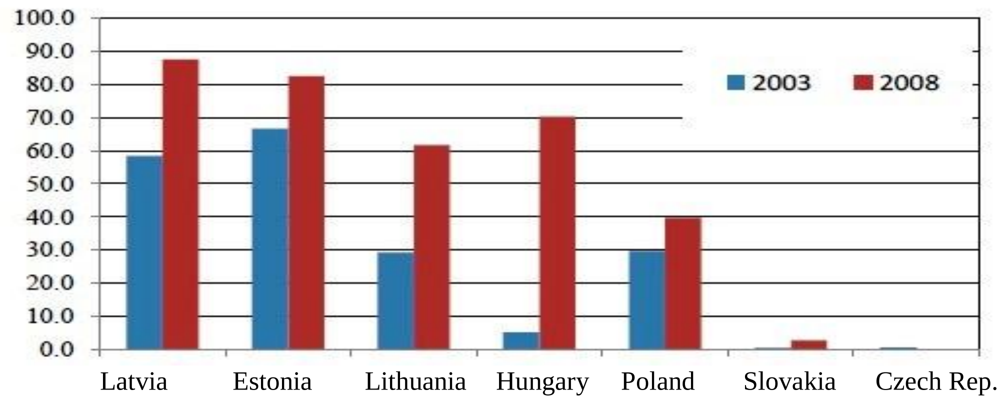
A very dynamic credit growth distinguished Baltic States from CEES since 2002[2]. In terms of loan structure, Baltic States showed two distinctive features. Firstly, household loans for housing purchases expanded very rapidly in Estonia and Latvia, followed by Lithuania, while all loan types increased on a much smaller scale in CEES (Figure 3)[3]. Secondly, foreign currency loans represented a much larger share of loans (especially household loans) in the Baltics than in CEES (except for Hungary) between 2003 and 2008 (Figure 4)[4]. In the states with a high share of foreign currency loans (Baltic States and Hungary) foreign currency loans expanded more rapidly than foreign currency deposits, which clearly indicates an increasing currency mismatch[5].

Figure 3. Structure of Bank Loans to the Private Sector (as % of GDP)



Source: ECB, *EU Banking Structures, Years 2005 and 2008*.

Figure 4. Foreign currency denominated loans (as % of household loans)



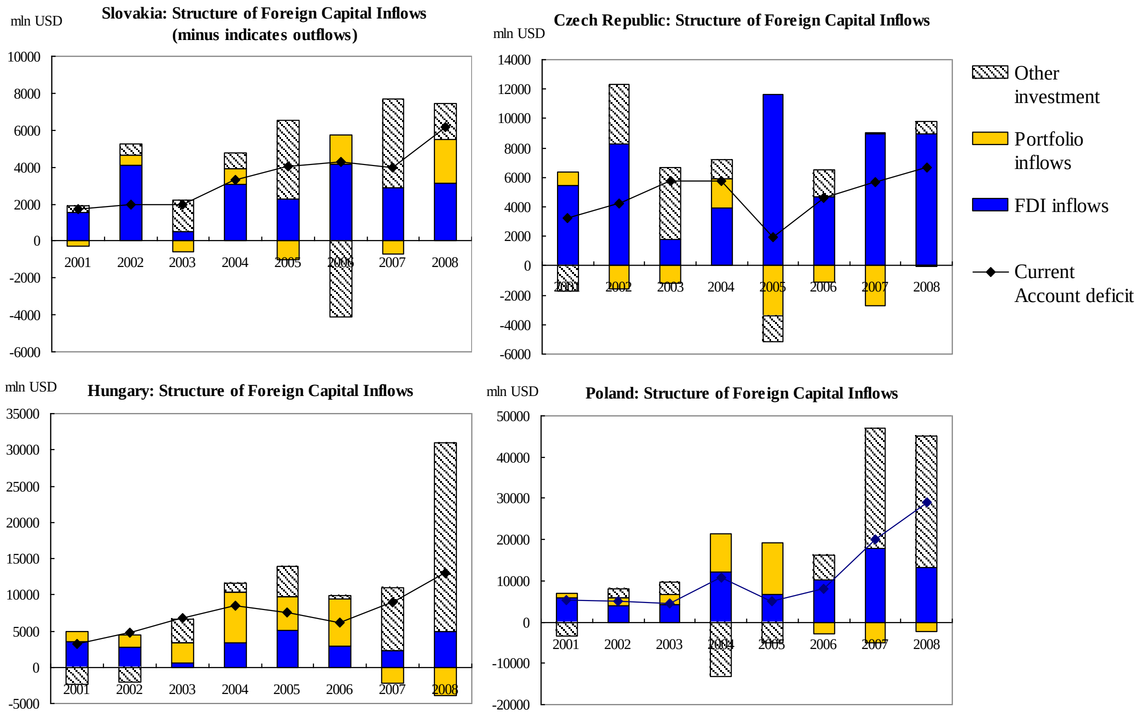
Source: Magyar Nemzeti Bank (2009), *Report on Financial Stability*, Statistical data, April. .

3. Reasons for Different Pre-crisis Credit Developments

Regarding the foreign currency loans, it has to be noted that while most foreign currency loans in the Baltic States were Euro denominated, Swiss Franc-based loans were dominant in Hungary[6]. Such a difference in foreign currency composition reflects different motives behind demand for foreign currency loans in these states. Lower interest rates of foreign currency loans were the main motivating factor in Hungary, whereas the Baltic States have had the tradition of foreign currency borrowing since the 1990s due to their fixed exchange rate regimes leading to a low perception of exchange rate risk[7].

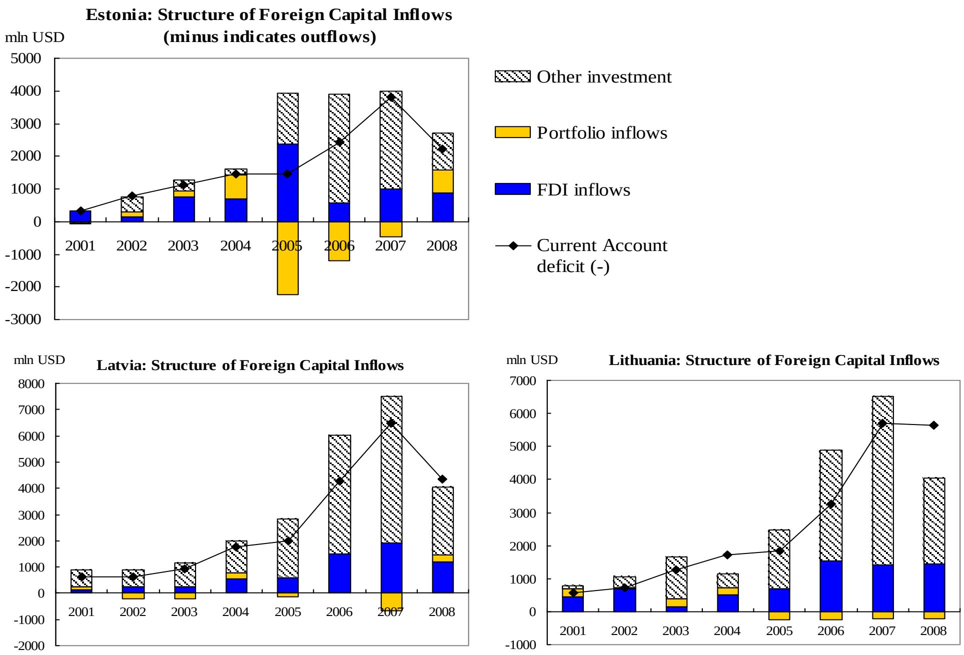
Next, when we compare developments in Balance of Payment of these states, there are the following differences in the structure of foreign capital inflows that financed current account deficits of these states. FDI (Foreign Direct Investment) dominated capital inflows in CEES except for Hungary that relied mostly on portfolio investment between 2003 and 2006 (Figure 5), while other investments (investment which consists mainly of intra-group bank loans) dominated Baltic foreign capital inflows and clearly exceeded FDI after 2005 (Figure 6). As evident from this data, credit expansion which Baltic States experienced prior to 2007 was mainly due to a large capital supply from foreign parent banks (shown by increased other investment) to their Baltic subsidiaries. This was demonstrated by high loan to deposit ratios in the Baltics (and Hungary), compared to the three CEES[8].

Figure 5. Structure of Foreign Capital Inflows in CEES (minus indicates outflows)



Source: IMF, *International Financial Statistics* and National Central Banks.

Figure 6. Structure of Foreign Capital Inflows in Baltic States (minus indicates outflows)



Source: IMF, *International Financial Statistics* and National Central Banks.

We can therefore conclude that high loan to deposit ratios in the Baltics and Hungary mean that when funding the credit supply, instead of reliance on local deposits only, banks in these countries relied on borrowing from foreign parent banks,. On the other hand, foreign banks in the 3 CEES relied on local deposits.

4. Financial Crisis and Banking Sectors of CEES and Baltic States

Let us now examine to what extent the financial crisis affected banking sectors of CEES and Baltic States. After 2007 Baltic States and Hungary experienced a much larger decrease in loan-to-deposit ratios than the three CEES due to restricted lending[9]. This mainly reflects the fact that the financial crisis made it more difficult for foreign banks active in the region to find market funding. Swedish banks in particular are highly dependent on market funding and were thus affected by increased funding costs[10].

Overall, loan quality in the whole of Eastern Europe deteriorated. Latvia and Lithuania have been experiencing the deepest recession among the seven states compared in this paper and therefore had much higher non-performing loan ratios than all CEES and Estonia in 2009[11]. As Figure 7 shows, the pre-crisis significant increase in bank assets of Baltic subsidiaries has generally been followed by their decrease in 2009, whereas in most CEES subsidiaries the bank assets increased in the 2008-09 period. Another contrasting difference between CEES and Baltic States can be observed in banks' profitability, as shown by Return on Equity (ROE). Since 2008, only in the case of Baltic subsidiaries did the ROE decrease and eventually turn negative. Swedish banks' subsidiaries in Baltic States thus experienced increased credit losses throughout 2009 and the market associated the two Swedish banks most exposed to the Baltics (Swedbank and SEB) with higher risks than other banks.

Figure 7. Selected Bank Performance Indicators

	Size of Assets (USD mln)				ROE (%)				NPL (%)			
Bank	03	06	08	09	05	06	08	09	05	06	08	09
Swedbank Estonia	8,080	25,536	35,122	31,567	28.2	28.9	24.5	-115	0.4	0.4	-	14.0
Swedbank Latvia	3,787*	7,171	11,103	9,534	33.9	34.7	17.5	-65.8	0.3	0.2	-	22.8
SEB Lithuania	3,105	8,045	12,048	12,454	18.2	30.7	19.9	-96.3	1.2	-	4.6	16.6
CSOB (Czech R.)	23,641	36,516	36,513	46,765	38.9	33.7	37**	51.9	1.7	1.7	1.7**	3.2
MKB (Hun)	5,979	7,733*	15,355	16,519	20.4	13.0**	5.0	45.9	3.8	3.2**	-	6.3
Pekao (Poland)	16,845	23,262	44,547	47,428	31.4	34.8	39.7	20.6	16.2	11.4	-	6.8
Tatra Bank (Slov.)	4,153	5,770*	14,864	12,988	26.8	34.3**	36.3	21.0	-	1.1**	1.4	3.8

Source: *The Banker*, various issues.

However, the risk of financial contagion in both CEES and Baltics has been mitigated by several factors. Firstly, foreign banks have regionally diversified operations and their exposure to these states remains very small from the bank group perspective, which limits the risk of negative spillover from subsidiaries to the parent. Secondly, loan portfolios in CEES and Baltics remain generally more stable compared to other East European subsidiaries. Thirdly, foreign banks have maintained their commitment to the region by taking measures to absorb current and future loan losses (often with the support of governments in their home countries). For instance, Loan Guarantee Fund of Swedish government enables banks to issue debt with government acting as a guarantor. Fourthly, major banks officially stated their commitment to support their bank subsidiaries and it is evident that banks also employ non-traditional methods to deal with worsened financial situations of their clients[12].[1]

[1] Data for 2005. **Data for 2007.
***CSOB is owned by Belgian KBC Group; MKB is owned by German Bayerische Landesbank; Bank Pekao is owned by Italian UniCredit; Tatra Banka is owned by Austrian Raiffeisen International.

5. Issues of Financial Supervision and Regulation

Let us inspect the main problems which the financial supervision authorities experienced in Baltic States and the recent improvements in the crisis prevention and management. It is important to point that in the context of the EU, subsidiaries of foreign banks are supervised by authorities of the host country, while foreign bank branches are supervised by their home country authorities.

It has been indicated that local supervisory authorities were not able to curb the excessive lending and risk-taking by Scandinavian banks in the Baltics[13]. Firstly, local authorities in Baltic States lacked sufficient instruments for restricting excessive lending (measures such as moral suasion, information exchange with home country authorities failed to be effective). Secondly, there are indications that host-country authorities tended to be reluctant in implementing stricter measures towards foreign banks (one of the reason being the perception that the home-country supervisory authorities have more experience and know-how in supervision)[14]. Thirdly, the local real estate market has been transformed very quickly, which made it easier for market players to avoid certain regulations (for instance, regulation by loan-to-value ratio was difficult to implement in newly developed areas which differed from standard buildings projects that the regulation covered)[15]. Fourthly, regulation of cross-border banking groups remained a complex issue (for instance, six Scandinavian cross-border banking groups had to respond to rules of seven supervisory authorities and eight central banks)[16].

These issues could be addressed by a more effective regulations coordinated at the EU level. A high-level group chaired by Jacques de Larosiere was mandated by the European Commission to recommend changes in the European financial supervision system. Based on the group's recommendations published in February 2009, a reform of the financial regulation and supervision in the EU started since 2009 and it was agreed that the new EU supervisory framework should include both microprudential and macroprudential supervision. Therefore, ESRB (European Systemic Risk Board) will identify macro-financial risks and will be in the position to recommend appropriate action to curb excessive credit growth. Concerning the need of a coherent framework for crisis management and resolution, the above-mentioned group's final report in Recommendation 13 emphasized measures needed to set up a new EU framework for crisis management in the banking sector and these measures have been consulted by the European Commission. Since the EU lacked a coherent framework for crisis management and resolution (for example, the issue of burden sharing in case of cross-border bank failures remains largely unresolved), the increase of bank deposit guarantees at the EU level for stabilization of each country's domestic bank system has been an important step forward (Estonia and Latvia raised their bank deposit guarantees to 50,000 Euro and Lithuania to 100,000 Euro).

In each Baltic State reporting and information exchange on the cross-border base and risk management measures were strengthened[17]. Furthermore, concrete plans for financial crisis prevention and management which have recently been adopted in Baltic States (such as in Lithuania in November 2008) aim to strengthen the cooperation between the bank supervisory authorities and other institutions in the financial market (such as Central Bank, Ministry of Finance etc.). Cooperation and information exchange has been strengthened between Baltic supervisory authorities and their counterparts in Scandinavian States (Baltic-Nordic Memorandum of Understanding issued in August 2010 is one of concrete examples of such cooperation)[18].

6. Conclusions

What implications can be thus drawn from the crisis? This paper outlined the developments in the banking sectors of four Central and Eastern European countries and three Baltic States and showed that these states' divergent economic developments prior to 2007 can explain why the global financial crisis affected them to a different extent. Previous research showed that the CEES and Baltic States' banking sectors have become dominated by foreign banks in the context of an integrated EU financial market and that the presence of foreign banks brought many benefits. However, this paper illustrated an example in Baltic States of how over-dependence on easily accessible capital from foreign parent banks (demonstrated by increased other investment) can fuel credit booms. There is still a lack of research on the stability of the foreign-bank dominated systems of new EU members during a large-scale financial crisis. In this regard, this paper showed several mitigating factors within the EU framework concerning financial stability. We showed that foreign banks involved in the Baltic States have been able to cope with economic downturn in these countries. However, the case of Baltic States also illustrated the need for reform of the EU financial regulation and supervision and active efforts in this direction have been pointed out. The future research needs to focus on the impact of the continuing European debt crisis on parent banks (such as Italian and Austrian banks) and their subsidiaries in Central and Eastern Europe.[2]

1. In 2007, foreign bank assets as percentage of total bank assets represented between 97-99% in Czech Republic, Estonia and Slovakia, around 85% in Lithuania and Hungary, 76% in Poland and 67% in Latvia (BSCEE Review 2007 and RZB Group (2008), CEE Banking Sector Report).
2. European Commission (2008).
3. Since in Lithuania corporate loans expanded more rapidly than the household loans, its lending structure slightly differed from the other two Baltic States and resembled that of Hungary.
4. In December 2006, the share of foreign currency loans for all sectors was approximately 80% in Estonia and Latvia, around 50% in Lithuania and Hungary, around 25% in Poland, around 20% in Slovakia and approximately 10% in the Czech Republic (European Commission (2008)).
5. Rosenberg, Ch. B. and Tirpak, M. (2008), p.5.
6. Enoch, Ch. and Otker-Robe, I. eds., (2007) and MNB (2009), p.26.
7. Estonia and Lithuania operate currency boards with Euro as foreign anchor currency. Baltic States planned an early Euro adoption (2007-08) when they became EU members in 2004. All three states joined ERM II with a restricted fluctuation band. Hungary operated the crawling peg until 2008 when it replaced it with a flexible exchange rate.
8. Loan-to-deposit ratio of Baltic States was over 140% in 2007, that of Hungary was 128%, while in the three CEEC the ratio ranged between 72% and 91% (ECB (2008b), p.41).
9. MNB (2009), p.28.
10. Half of Swedish banks' funding consists of market funding and during the financial crisis Swedish banks faced most difficulties mainly in renewing the foreign market funding (e.g. issuing debt abroad) Riksbank (2009), Financial Stability Report 1/2009, pp. 92-93.
11. IMF (2009), p.27. However, it needs to be pointed out that in the context of Eastern Europe, loan quality in Ukraine and Romania deteriorated to a larger extent than in Latvia and Lithuania.
12. For instance, management from the Head Office of SEB and Swedbank visited the governments and Central Banks of Baltic States and officially stated their commitment towards their Baltic subsidiaries (author's interview with a Lithuanian subsidiary of a Swedish bank, Vilnius, 17 September 2010). Since January 2010, Nordea Bank made an agreement with Riga Property Management regarding re-assessment and support towards the bank clients who became unable to pay their rents (The Banker, March 2010).
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18. Author's interview at Estonian Ministry of Finance, (Tallinn, 13 September 2010).

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