EU banking reform and financial stability in South East Europe

September 2013
EU banking reform and financial stability in South East Europe

This report draws on discussions at the workshop on “EU banking reform and financial stability in South East Europe”, which was held in Oxford on 16th May, 2013, in cooperation with the Political Economy of Financial Markets programme. The participants included academics and officials from Bosnia and Herzegovina, the United Kingdom, the EBRD, the ECB, and the region of South East Europe. The report represents SEESOX’s interpretation of discussions at the workshop and does not purport to reflect the views of any of the participants.

Preamble

Discussions during the first session of the workshop drew on the findings of two experienced professionals in the financial sector who addressed the case for “rebooting EMU” in light of the capital flow experience in the Euro area and emerging Europe. Delegates heard that European monetary union resulted in an explosion of cross-border intra-union debt creating capital flows, as the disappearance of currency risk made high yielding bonds and other bond or money-like securities issued by agents within the Eurozone too attractive to resist for investors. By issuing such securities, countries on the periphery of the Eurozone could easily finance government borrowing and/or capital outflows, such as foreign direct investment. Countries in emerging Europe outside the Eurozone, but in its neighbourhood, also received debt creating inflows, but on a smaller scale and mainly in the form of cross-border bank finance rather than securities. Capital inflows, moreover, were much more balanced in nature, with a high proportion being in the form of foreign direct investment (FDI). Quite a lot of this FDI, however, had gone into the non-traded goods sector. Some FDI outflow from the Eurozone periphery to Southeast Europe was to be expected, as the periphery had already achieved a degree of convergence with the advanced economies in the EU, and were from a technological point of view (and financial point of view) able to export this expertise to developing Europe. The problem was the degree of leverage involved was too great. When confidence evaporated in 2008, a colossal financial crisis was the inevitable outcome.

While Emerging Europe outside the Eurozone also suffered from the increase in risk aversion in 2008, as
foreign banks stopped lending and foreign direct investment halted, the effect was more “real” than financial. The so-called “Vienna Initiative” succeeded in persuading the key parent banks from actually withdrawing finance and capital and thus averting what could have been a fatal financial squeeze. The result was therefore a sudden stop, rather than reversal, of capital flows. The same thing occurred with foreign direct investment, which (by its nature) cannot be reversed easily anyway. However, the close linkage between foreign financing and domestic activity meant that even a stop (as opposed to reversal) could still plunge the real economies into severe recession. This, in turn, impacted on fiscal accounts which in some cases proved hard to finance and led to governments seeking assistance from the IMF.

Faced with this analysis of events, the discussion turned to remedies. How could the Eurozone be redesigned and rebooted so as to avoid a similar outcome in the future? Unlike a collection of nation states unconnected by monetary union, the Eurozone had no internal buffers, for example, foreign exchange reserves, to handle cross border capital flight. There was only the ECB and the newly formed ESM to backstop the system. This immediately raises questions about the role of the ECB, as well as about its independence. A central bank’s proper role might be to ensure adequate liquidity, but surely not to ensure system solvency? With its target responsibilities growing—
inflation control, bubble avoidance and financial stability—there was clearly a need for additional instruments. Macro-prudential tools (yet to be fully defined) were called for, but would they be enough? And where does responsibility for solvency lie? Who should make up the losses that the ECB might suffer when buying bonds of potentially insolvent nations? Can a bank resolution process shift the whole burden of solvency adjustment onto private creditors and depositors, à-la-Cyprus? And what are the consequences of doing this for financial stability? It might strengthen against moral hazard, but also increase the likelihood of financial panic.

After a break, the discussion resumed, following a comprehensive tour d’horizon of the issues provided by a senior representative of the ECB, with a special focus on the implications of the proposed EU “banking union” for Southeast Europe. Delegates benefited from a clear and detailed explanation of the evolving blueprints for the Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and the Harmonised Deposit Guarantee Scheme (DGS), including how these arrangements were supposed to interact with each other. There remained many unresolved issues concerning these arrangements, not least of which being the question of a fiscal backstop for the SRM, how this would be provided, and whether it would require an EU treaty change. It was argued that the implications of EU banking union (which in practical terms
would mean Eurozone banking union with the option of opt-ins for non-
Eurozone EU members) should be broadly positive for non-EU countries in Southeast Europe. Such countries should benefit from enhanced and more consistent supervision of parent banks based in the EU, while coordination among EU banks with stakes in Southeast Europe should also be easier and national ring-fencing avoided in crisis situations. Nevertheless, concerns were expressed about the lack of representation of supervisors in Southeast Europe in the SSM.

Financial stability from the perspective of South East European countries

The afternoon session invited delegates from the region of Southeast Europe to share their experiences of recent economic developments and financial reform initiatives. Bosnia and Herzegovina (BiH) was reported as still facing weak domestic demand, high unemployment, a deteriorating fiscal balance, and slow political reforms. Deleveraging of foreign banking groups—upon which BiH depended for finance—had shifted the burden on funding onto local deposits which were not adequately suited for longer term financing and insufficient in quantity. Local capital markets are underdeveloped. Nonperforming loans had been rising but the pace of increase has reduced and it is expected that they will hold at present levels. In Albania, the capital market comprised mainly short term government debt securities, with little secondary market volume. Financing was heavily dependent on bank deposits. About half of the asset side of the country’s 16 banks were devoted to loans, and a sizeable share was invested overseas. As elsewhere, nonperforming loans have been on the rise. The Bank of Albania has used and will continue to use macro-prudential regulation to manage systemic risk, credit risk and liquidity risk. Further work was expected toward the design of a more comprehensive macro-prudential policy framework. Banks in Serbia also featured a high proportion of nonperforming loans on their balance sheets, but they were otherwise liquid and well capitalized. The main challenge to financial stability derived from the high degree of euroization of the financial system. While banks’ domestic foreign exchange (forex) liabilities were hedged against domestic loans similarly denominated, household forex borrowers were not hedged, and thereby represented a potential credit risk for banking system. The National Bank of Serbia was trying to promote the development of a market for dinar securities and the development of forex hedging instruments, along with macro-prudential measures, while also promoting dinar savings. The results of such efforts, however, had so far proved very modest. Euroization was also a problem in Croatia, and limited the country’s policy options regarding the exchange rate. The EU accession process, on the other hand, has been
a positive boost to confidence, and hopefully will help breathe life into the very low rate of growth in the economy. Nonperforming loans (mainly corporate) had been on the rise too. In Montenegro, nonperforming loans had risen to especially high levels, and were deemed a major risk to financial stability. Reflecting this, the World Bank had convened a working group to develop a new framework for their clearance and resolution, with banks and regulators. Perhaps because Macedonia did not enjoy such a strong boom prior to the crisis, it did not suffer quite so much as other countries when the crisis struck. Nonperforming loans, at around 11 percent, were of concern, but nevertheless manageable. The country also stood out as being one of the few where euroization had gone in reverse—in 2012, for the first time in many years, dinar deposits exceeded forex deposits. In Greece, next door, nonperforming loans were at record highs of 25 percent—which is perhaps not surprising given the extraordinary severity of the recession. There was, however, hope for their clearance in the possible development of a secondary market, with strong interest from foreign funds to take them over (at a discount) and restructure. By contrast, nonperforming loans in Turkey, which had hitherto escaped the global crisis, were a mere 3 percent. Indeed, the problems in Turkey were altogether very different from elsewhere in the region. Policymakers were more worried about excess domestic demand than by recession.

Summing up

The two co-chairs of the workshop, for BiH and for the European Studies Centre (SEESOX and PEFM), summed up.

From the vantage point of BiH, the external risks to Southeast Europe were seen as continuing to revolve around the ongoing global economic crisis, especially the slowdown of economic activity in the EU, which remains the region’s most important trading partner. The dire situation of the Eurozone periphery remains a compelling object lesson—particularly regarding debt—on what Southeast Europe should aim to avoid. Policymakers in the region needed to pay particular attention to: (i) further spillovers from the crisis due to the heavy presence of foreign banking groups; (ii) possible transmission of the crisis to other segments of the financial sector – leasing companies, capital markets and insurance companies; (iii) the effectiveness of cross border cooperation in banking supervision; and (iv) corporate management in banks, with special emphasis in improving relationship with customers.

The following workshop takeaways were identified:

- The EU banking outlook is crucial for financial stability in Southeast Europe, and the prospects for EU banking union, in particular, are
complex and shifting. Key surplus countries (Germany) are seeking to create political space for essential institution building in the EU, and there is, despite the odds, a strong likelihood that a SRM (in some shape or form) would be put in place eventually to complement the SSM.

- Inflows to the Eurozone periphery had increased debt but not greatly benefited debt-servicing capacity. This suggested the possibility of a protracted debt work-out in the Eurozone, limiting any growth in exposure to emerging Europe over the medium term. Inflows to SEE had featured a higher share of equity, but had still favoured the non-traded goods sector. Both these findings suggested the need for a change in the composition and financing of growth in Southeast Europe over the medium term.

- There was a need for ongoing structural reforms to improve the business environment in Southeast Europe, going beyond a simple increase in 'flexibility'. The pattern of trade and investment integration needed to favour exports and FDI, including with partners outside the EU. The business model of banks must shift more towards corporations and local currency operations.

- The mechanisms for dealing with nonperforming loans were becoming a shared “good practice” area, though the legal or tax framework in some cases needed reform; factoring, secondary loan sales, assignment, and out of court settlement processes were among the key initiatives being taken.

- Other more immediate tasks for the region included (i) assessing whether credit stagnation reflected demand or supply; (ii) ensuring that deleveraging took place at an acceptable pace; (iii) containing the influence of the public finances on financial stability; (iv) in floating rate cases managing the impact of depreciation on prices and balance sheets.

- On macro-prudential policy in the future, EU members in Southeast Europe faced a choice of less autonomy if they joined the SSM, but the benefits of dealing with the ECB as a single actor for home bank supervision – which presented a tantalising trade-off.

- All in all, the financial stability toolkit in the region was evolving satisfactorily, including through this kind of experience-sharing; but successful strategies would depend crucially on a resumption of economic growth in the region.
EU banking reform and financial stability in South East Europe

Oxford, 16 May, 2013

PROGRAMME

9:30 – 10:00 Welcome and opening remarks by Kemal Kozarić and Othon Anastasakis

Morning session: Financial trends in South East Europe (SEE) and reform of the EU banking sector

10:00 – 11:30 Capital flows to SEE in a European perspective
Presentation: Gillian Edgeworth (Unicredit and PEFM) and Gene Frieda (Moore Capital and PEFM)
Chair: Ernadina Bajrović (Central Bank of Bosnia and Herzegovina)

12:00 – 13:15 Systemic risks in SEE and possible effects of the EU banking sector reforms
Presentation: Mauro Grande (ECB)
Chair: Max Watson, SEESOX and PEFM

Afternoon session: Financial stability from the perspective of SEE countries

14:30 – 16:00 Roundtable discussion of regional financial stability experts
Expert contributions will focus in particular on:
• Non-performing loan resolution
• Deleveraging of foreign banking groups
• Country-specific systemic risks
Chair: Ernadina Bajrović (CBBH)

Closing panel: Financial stability in SEE and the EU banking reforms

16:30 – 17:30 Panel: Kemal Kozarić, Mauro Grande, Max Watson
PARTICIPANTS

Cihan Aktaş (Deputy Executive Director, Central Bank of the Republic of Turkey)
Othon Anastasakis (Director of SEESOX; Director of the European Studies Centre; Fellow, St Antony's College, Oxford)
Sasho Arsov (Member of the Council of the National Bank of the Republic of Macedonia)
Ernadina Bajrovic (Vice Governor, Central Bank of Bosnia and Herzegovina)
Zlatko Bars (Director, Banking Agency of the Federation of Bosnia and Herzegovina)
Adam Bennett (Associate of SEESOX; Senior Member, St Antony's College, Oxford)
Denys Bennett (Trustee, Financial Market Policies Foundation)
Nigel Davies (Managing Director, Wyn River Ltd)
Gillian Edgeworth (Head of EEMEA Economics, Unicredito)
Gene Frieda (Senior Global Strategist, Moore Capital)
Mauro Grande (Advisor to the Economic Board, European Central Bank)
Irem Gucceri (Lecturer in Economics, St Catherine's College, Oxford)
Jelena Ivanovic (Junior Analyst, National Bank of Serbia)
Maja Ivanovic (Senior Examiner, Supervision Department, Central Bank of Montenegro)
Russell Kincaid (former Department Director, International Monetary Fund)
Dejan Kovacevic (Head, Monitoring/Analysis Dept., Central Bank of Bosnia and Herzegovina)
Kemal Kozarić (Governor of the Central Bank of Bosnia and Herzegovina)
Eleni Dendrinou-Louri (Deputy Governor, Bank of Greece)
David Madden (former Political Advisor to the EU Peacekeeping Force, Bosnia and Herzegovina; Senior Member, St Antony's College, Oxford)
Sead Manov (Director of Deposit Insurance Agency, Sarajevo Branch Office)
Kalypso Nicolaïdis (Professor of International Relations; Fellow, St Antony's College, Oxford)
Ademir Osmanovic (Financial Stability Senior Specialist, Central Bank of Bosnia and Herzegovina)
Rahul Prabhakar (D.Phil. student, St Johns College; Global Economic Governance Programme)
Vesna Papic (Head of Financial Stability Department, Central Bank of Bosnia and Herzegovina)
Perica Rajcevic (Director of Deposit Insurance Agency, Banja Luka Branch Office)
Tomislav Rđzak (Director of Financial Stability Department, National Bank of Croatia)
Almir Salihovic (Head of the Governor's Office, Central Bank of Bosnia and Herzegovina)
Peter Sanfey (Deputy Director, Office of Chief Economist, EBRD; Associate of SEESOX; Senior Member, St Antony's College, Oxford)
Enisa Serdarevic (Senior Protocol Officer, Central Bank of Bosnia and Herzegovina)
Klodion Shehu (Head of Financial Stability Department, Bank of Albania)
Altin Tanku (Head of Research Department, Bank of Albania)
Nedzad Tuce (Deputy Director, Banking Agency of the Federation of Bosnia and Herzegovina)
Max Watson (Coordinator, Political Economy at SEESOX; Director of Political Economy of Financial Markets Programme, St Antony's College, Oxford)
South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at St Antony’s College, Oxford. It focuses on the interdisciplinary study of the Balkans, Greece, Turkey and Cyprus. Drawing on the academic excellence of the University and an international network of associates, it conducts policy relevant research on the multifaceted transformations of the region in the 21st century. It follows closely conflict and post-conflict situations and analyses the historical and intellectual influences which have shaped perceptions and actions in the region. In Oxford’s best tradition, the SEESOX team is committed to understanding the present through the *longue durée* and reflecting on the future through high quality scholarship.

SEESOX has the following objectives:

- To support high-quality teaching and research on South East Europe;
- To organise conferences, workshops and research seminars;
- To promote the multi-disciplinary study of the region within the University of Oxford (e.g. politics, international relations, anthropology, sociology, economics) working in collaboration with other Centres and Programmes within the University, including student societies;
- To spearhead intellectual exchanges and debate on these issues among networks of individuals and institutions beyond Oxford;
- To foster cooperation between the academic and the policy making communities.