Ten years of the Vienna Initiative

2009-2019

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Introduction

Managing a supra-national public-private platform still based on sovereign interests

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Governor of the Croatian National Bank
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The Vienna Initiative is a unique project, a platform that consists of representatives of international financial institutions, national and supranational regulators and industry representatives who meet regularly to exchange views on financial trends in a group of European countries. It has been an interesting and successful experiment. None of the participating institutions has a formal obligation to attend and there is no money on the table, yet all old stakeholders, and some new ones, ten years after the crisis that created the Vienna Initiative, are still happy to go on. People vote with their feet, it is often said, and in this sense the support provided by various stakeholders suggests that they have recognized the Vienna Initiative as a purposeful platform for coordination and information exchange. In particular, the strong involvement of Western European banks confirms that they have a long-term commitment to the Central, Eastern and Southeastern Europe (CESEE) region, despite the controlled deleveraging that took place in the aftermath of the global financial crisis.

The historical role of the Vienna Initiative

The desire to protect CESEE countries from disorderly deleveraging was the original motive for establishing the Vienna Initiative. The region was in a vulnerable position at the onset of the global financial crisis. Following several years of credit-driven economic expansion, many of these countries suffered from severe internal and external imbalances. Part of the blame for the unsustainable expansion of CESEE countries rests with Western European banks. Specifically, banks from advanced EU Member States borrowed at low rates in European money markets and channelled these funds to their subsidiaries in CESEE. In addition, they fought aggressively for market share by lowering lending standards. Such a combination resulted in excessive credit growth. Demand-side factors also contributed to the credit expansion, as the propensity to borrow in CESEE was high due to relatively low interest rates and overly optimistic expectations regarding the convergence potential of these countries.

The outbreak of the financial crisis in late 2008 and the consequent global recession hit the CESEE region very hard. External demand weakened considerably, while domestic demand collapsed due to a significant drop in confidence and a sharp slowdown in credit growth. The need to eliminate excessive imbalances further contributed to the contraction of domestic demand in some CESEE countries, as they were no longer able to finance these imbalances by borrowing extensively from abroad. Due to weak fundamentals, almost none of the countries concerned had sufficient space to engage in fiscal loosening that could have helped mitigate the recession. On the contrary, most of them were forced to tighten fiscal policy in the midst of the crisis in order to preserve debt sustainability and restore investor confidence.

An additional problem for CESEE countries was that, in the context of lower capital inflows and diminishing investor confidence, their national currencies faced depreciation pressures. While in advanced countries depreciation of the currency in times of recession is typically considered beneficial because it can stimulate recovery by increasing net exports, in emerging market (EM) countries currency depreciation often only makes things worse. The reason is that economic agents in emerging market countries, including the CESEE region, are typically heavily indebted in foreign currencies. If, for some reason, the value of domestic currency were to decline substantially, these debts would become more expensive to service. A sharp drop in disposable income caused by increased debt repayment costs would far outweigh the gains resulting from improved price competitiveness, thus exacerbating the economic downturn.

Therefore, CESEE countries were confronted with numerous challenges both domestically and externally. In such a difficult environment, the decision of foreign banking groups to maintain their presence in the region had a great positive impact. On the one hand, it enabled private and public sector entities to retain access to financing at the peak of the crisis, when the availability of external sources was limited. On the other hand, the foreign banks' decision to maintain their investments in CESEE reduced the likelihood of detrimental currency and debt crises. Had large banking groups had not made that decision, the withdrawal of foreign currency liquidity from CESEE would have been so large that central banks would have likely failed to defend national currencies from severe devaluations. In such a scenario, not only would the private sector borrowers have struggled to service their foreign currency indexed loans, but also public debt sustainability would have come into question.

The success of the Vienna Initiative illustrates how an ambitious coordinated effort can lead to a positive outcome with substantial benefits for all parties involved. Of course, the question remains what would have happened if it were not for the Vienna Initiative, but that we shall never find out. Although from the perspective of individual banks it seemed reasonable to exit overheated markets in CESEE, a simultaneous withdrawal of many banks would have imposed such a heavy toll on the CESEE economies that the banks' investments in the region would quickly lose value. Due to the size of cross-border operations, for some banking groups large credit losses in the region could have jeopardized the solvency of the parent institution. In such a context, it was in foreign banks' best interest to keep supporting these economies. There was a case for coordination.

Several other successful international initiatives took place during the recent global financial crisis with a view to containing the impact of the crisis and making the financial system and the economy more resilient. Probably the most important of these was the coordinated monetary policy loosening by major central banks. The large monetary stimulus was key to alleviating the liquidity crisis, which threatened to trigger further failures of systemically important institutions and lead the entire global economy into a depression. Furthermore, it is worth mentioning the swap arrangements among the major central banks and a number of key EM central banks, coordinated efforts of advanced countries to boost the lending capacity of the International Monetary Fund (IMF), implementation of the common EU framework for banking system support, and the ambitious overhaul of global prudential standards through the work of the Financial Stability Board (FSB) and the Basel Committee.

There is a broad consensus among policymakers and academics that the global crisis would have been much more severe if such measures had not been taken. This view is based on a simple comparison between the recent global crisis and the Great Depression of 1929-33, when international cooperation was virtually non-existent. While both crisis episodes were characterized by systemic bank failures, stock market crashes and deep economic downturns, total output loss was considerably larger during the Great Depression. The literature suggests that the Great Depression was extremely severe because the largest countries relied excessively on inward-oriented policies to protect their economies, instead of working together through mutually beneficial policy co-ordination. The situation worsened when some major central banks adopted a harmful monetary tightening in a failed attempt to preserve the gold standard. The resulting substantial reduction in the money supply led to the collapse of a large number of banks, which in turn amplified the credit crunch and the economic downturn.

The Great Depression was a major failure of international policy coordination and macroeconomic management and therefore an important lesson for the future. The vigorous response of the leading central bankers, the IMF, the World Bank and other policymakers after the outbreak of the recent global financial crisis was motivated by the desire to avoid another economic catastrophe similar to the Great Depression. Against such a background, the launch of the Vienna Initiative in 2009 and the concerted efforts of participating institutions can be viewed as a reflection of a more responsive international financial architecture, where major actors – if confronted with serious challenges – are willing to cooperate with each other to reduce overall costs. Maintaining financial support to CESEE was clearly a positive-sum game, as foreign banks not only helped CESEE countries to weather the crisis but were also protecting their own investments in these countries from severe losses. The decision of foreign banks to maintain their exposure to the CESEE region was also important in order to facilitate the implementation of macroeconomic adjustment programme supported by the IMF. Namely, at the height of the global financial crisis, the IMF provided financial support to some of the CESEE countries experiencing severe balance of payments problems. Had foreign banks decided to withdraw funds from the region, this would have led to a depletion of foreign currency liquidity that these countries obtained through financial arrangements with the IMF, thus reducing the likelihood of success of adjustment programme.

While foreign banking groups still dominate the banking systems in CESEE, their business models have changed considerably since the crisis. Despite the fact that borrowing conditions in European markets are extremely favourable, which Western European banks could use to support their operations in CESEE, hardly any carry trade occurs. In fact, in the last few years foreign-owned banks have been funded almost exclusively by retail deposits. This is partly related to regulatory interventions, such as the Austrian regulator's decision of March 2012 to monitor closely the loan-to-local stable funding ratios of internationally active Austrian banks. In addition, stronger reliance on retail deposits reflects the fact that the available local supply of deposits was more than sufficient to maintain the desired volume of lending. As the entire region experienced a prolonged economic slump after the outbreak of the global crisis, banks' asset quality deteriorated, which in turn prompted them to cut back on new lending. In addition to supply-side factors, a weakening credit demand also contributed to the sharp slowdown in lending. Although more recently credit activity has accelerated somewhat, subsidiaries of foreign banks have no reason to import additional funds from abroad, since banks still operate in an environment of abundant excess liquidity and loan-to-deposit ratios of around unity.

The switch to local funding sources is encouraged by both home and host country regulators. Having in mind the detrimental impact of the global crisis on countries that previously experienced a foreign-funded credit boom, regulators are now well aware of the importance of prudent funding and lending practices. Prior to the crisis, excessive reliance on capital inflows as an engine of credit growth was not just a feature of CESEE countries. It was also a major source of vulnerability for some advanced countries. For instance, the subprime crisis in the US was the consequence of a protracted housing market boom, which was partly generated by large European banks that were heavily involved in the securitization business in the US. Likewise, the sovereign debt crisis in the euro area, at least in some of the affected countries, emerged as an indirect result of local banks' excessive short-term borrowing in European financial markets.

The dire consequences of excessive cross-border banking – what some economists call the "banking glut" – triggered several waves of regulatory reforms. The most important of them was the adoption of a set of new global prudential standards – Basel III. The enhanced regulatory framework introduced by Basel III provides an expanded toolkit that can be used to prevent an excessive accumulation of both refinancing and credit risks in banks' balance sheets. The database on macro-prudential measures collected by the European Systemic Risk Board reveals that national regulators in the EU are very active in applying these measures, although the degree of regulators' responsiveness varies somewhat between member states.

Current and future tasks

In view of the stricter regulatory framework and notable changes in the foreign banks' business models, it does not seem likely that CESEE countries will soon encounter challenges similar to those that led to the establishment of the original Vienna Initiative. However, this does certainly not mean that the platform has lost its purpose. Over time, the Vienna Initiative has evolved from a temporary crisis-mitigation platform to a permanent forum for discussions, where competent policymakers and industry representatives share views on specific issues from different perspectives. Monitoring reports that are regularly published under the Vienna Initiative – the *Deleveraging and Credit Monitor*, the *NPL Monitor* and the *Bank Lending Survey* – are valuable because they provide an analytical basis for discussions. These reports and discussions have allowed participants to gain valuable insight into cross-border funding flows, bank lending and asset quality developments. They also enable central banks of host countries to understand better the funding and lending strategies of foreign banking groups, which in turn allows them to make well-informed monetary and macroprudential policy decisions.

There are many specific areas where cooperation between the industry and the public sector within the framework of the Vienna Initiative can produce visible gains. In that regard, a good example is the nonperforming loan (NPL) Initiative. This project aims to identify the main obstacles for the disposal of non-performing loans and promote best practices in debt restructuring, in order to facilitate the NPL resolution process in the participating countries. The ultimate objective of the NPL Initiative – a reduction of the persistently high stock of bad loans – would be beneficial for both participating countries and banks, as it would potentially release banks' capital and thus enhance their capacity to extend loans to the real economy. Specifically, while liquidity is currently not a concern in CESEE, some banking groups are still capital-constrained, and therefore a reduction in NPLs would be likely to increase their lending potential.

Another important strand of work relates to financial instruments of international financial institutions (IFIs). The basic motivation for launching a discussion on IFIs' instruments under the Vienna Initiative stemmed from the need for a more effective blending of public sector resources with the funds provided by commercial banks. Tailoring the IFIs' products to the investment needs of CESEE countries was recognized as crucial as it may lead to higher take-up rates and thus stimulate the still subdued investment activity in the region. Namely, in the aftermath of the global financial crisis, investment activity in CESEE countries has remained well below levels observed in the pre-crisis period, undermining their catching-up potential. However, when comparing investment levels, it should be borne in mind that a significant portion of total investment in the pre-crisis period was financed by foreign savings and allocated to sectors with lower productivity, such as housing construction. What CESEE countries need today is a higher level of domestically funded productive investment, preferably investment in innovation and human capital.

Fostering productive investment should include, among other measures, improving access to finance for innovative start-ups. This will require an adequate response from both international financial institution (IFIs) and commercial banks. These small businesses are often not bankable in a traditional sense, because their main assets are the knowledge and skills of their employees, rather than physical assets that are easier to pledge as collateral. Developing the appropriate products to suit their borrowing needs is key to keeping up with global trends and reducing the likelihood that small to medium-sized enterprises (SMEs) migrate from traditional banking to less regulated shadow banks. Failure for secure necessary resources to this sector would produce adverse long-term effects, as it could hinder innovation and productivity growth. Given the collateral constraints and higher risks associated with lending to small innovative firms, credit guarantees and other instruments provided by IFIs could play a vital role in stimulating bank lending to these firms. Cooperation between IFIs and banks under the Vienna Initiative is beneficial in this respect, as it may shorten the time needed to set up public-private arrangements that are most effective in promoting investment in CESEE.

The Vienna Initiative has served also as a forum for discussions on various regulatory issues. Given that the financial markets in the region are generally underdeveloped, it is quite difficult for CESEE countries to comply with some of the requirements originally designed to tackle risks in more sophisticated financial markets. Challenges associated with the introduction of minimum requirement of own funds and eligible liabilities (MREL) rules are one of the most debated topics. The provisions on MREL require banks to maintain a sufficient level of junior liabilities, which could be bailed in if the bank experiences solvency problems. This poses a particular problem when a multiple-point-of-entry approach is applied, where, in view of the shallowness of financial markets in CESEE, it is highly uncertain whether banks will succeed in finding sufficient demand for such debt instruments, and at what price would that be feasible. Moreover, in the context of already high excess liquidity, it is unclear what banks would do with additional liquidity obtained by issuing bail-in-able liabilities. The meetings of the Vienna Initiative have also been a convenient place for participating non-EU countries to express concerns about some of the adverse effects of EU banking regulation on their financial systems.

Finally, should Europe face another financial crisis, the Vienna Initiative could take its primary role and protect CESEE from a potentially harmful abrupt capital flight. While from the current perspective it seems unlikely that the CESEE countries will be hit by a large crisis anytime soon, it is certain that a new crisis will emerge at some point in the future. This is yet another reason for the Vienna Initiative to continue operating despite the fact that foreign banks' deleveraging no longer represents an imminent threat to financial stability. The presence of a permanent crisis-mitigation platform for the CESEE region is justified both because the CESEE region is the place where most cross-border banking takes place and because many of these countries still suffer from structural vulnerabilities – such as large currency mismatches in the non-financial sector – which makes them highly sensitive to capital flow shocks.

The region would be more resilient to such shocks if there were a network of foreign exchange swap agreements between national central banks and the European Central Bank (ECB) in place, which would allow CESEE countries' central banks to borrow euros from the ECB in the event of foreign currency shortages. The mere existence of swap lines could help dispel investors' fears and thus contain depreciation pressures in times of crisis. Swap arrangements proved to be very effective globally in late 2008 and in 2009, with the US Federal Reserve playing a leading role by providing both advanced and emerging market countries with much needed dollar liquidity. In the absence of such swap agreements in Europe, close cooperation between national regulators and West European banks within the framework of the Vienna Initiative is important in minimizing the risk of self-fulfilling runs on currencies.

Concluding remarks

In view of the important historical role of the Vienna Initiative, as well as its current and future relevance, it has been both an honour and a pleasure to serve as a chair of the Steering Committee. Taking part in the work of the platform has been useful to me personally, given the unique cross-dimensional perspective that the Vienna Initiative's work and discussions provide to participating stakeholders, while performing duties has not been a difficult task, given the ambitious involvement of all participating institutions. Despite the informal nature of the body, all work, including the work done by designated working groups, is carried out very professionally, and with a clear intention to provide value added. Involvement of IFIs and industry representatives has been particularly valuable, as they are able to provide market intelligence that is usually not available to other stakeholders. In future I also look forward to the further involvement of new European institutions such as the Single Supervisory Mechanism (SSM), European Banking Authority (EBA) and EU Single Resolution Board (SRB) that were not originally part of the Vienna Initiative, as they were created after the crisis, but which now create new supervisory and regulatory environments and are therefore a key part of the future work of the Initiative. In a way, the CESEE region is to some extent what many envisaged the integrated banking market of the EU would one day look like – a common banking market with much a smaller role for national champions and with greatly reduced home country bias. In a way, and in a contemporary language, also a sandbox for the rest of the EU.

PART I

Historical perspectives

CHAPTER 1

Ten years of the Vienna Initiative: a chronology

Mark Allen

EBRD, IMF and CASE Research

Introduction

The Vienna Initiative[1] was launched in early 2009 to help the countries of Central and Eastern Europe overcome the impact of the global financial crisis on their economies. It was designed as a cooperative approach to ensure that the cross-border banks, which owned the major part of the banking system of most of the countries in the region, did not exacerbate the crisis by withdrawing funding and capital from their subsidiaries. The adjustment programmes implemented by several countries facing difficulties in the region, supported by the Vienna Initiative process, allowed them to overcome their problems and reduce their vulnerabilities over the next couple of years.

But in 2011, the global financial crisis took another turn, with sovereigns in the euro area and their banks coming under pressure. The measures taken by the euro area countries to provide support to sovereigns and strengthen their banking systems ran the risk of creating negative spill-overs to the functioning of the banks' subsidiaries in Central and Eastern Europe. The Vienna Initiative was relaunched at the start of 2012, and rechristened Vienna Initiative 2.0, with a new focus on managing the tensions that might follow from new supervisory

1 Membership of the Vienna Initiative is in principle open to all host countries among the new EU member states (NMS) and EU candidates in the West Balkans, as well as EU countries which were the home authorities for cross-border banks operating in the CESEE region. A number of the NMS (Bulgaria, Czech Republic, Estonia, Lithuania, Slovakia, Slovenia) either did not participate in any of the Vienna Initiative's activities, or only did so occasionally. Other countries might be admitted as appropriate. In 2012, Ukraine was admitted as a member, as discussed below. Cyprus, which had become involved in the work of the NPL Initiative, joined the Vienna Initiative in 2017.

actions applied to the banks by their home supervisors, or other pressures on cross-border banks. The transposition of international financial standards into European law, and the creation of the European Banking Union, has affected cross-border banking and the functioning of the financial systems of the region, which the Vienna Initiative has tried to mitigate.

The Origins of the Vienna Initiative

The expansion of cross-border banking into Central and Eastern Europe was an important driver of the transition process. The region had been underbanked and provided a profitable market for expansion for several West European banking groups in the late 1990s and early 2000s. In turn, this allowed the rapid penetration of modern and what appeared at the time to be relatively well-supervised banking into the region, with considerable benefit to business and consumers. The cross-border banking links created a channel for capital to flow into the region, providing abundant finance particularly during the years of the Great Moderation at the start of the new millennium. This financing channel was supported by the narrative of the convergence process within the European Union, which many of the countries joined in the enlargements of 2004 and 2007, and to which many of the remaining countries aspired. The larger financing flows were also supported by a general view that new financial technology allowed credit risks to be better handled than in the past.

At the same time, however, the flow of capital through the cross-border banking system and the increase in financial leverage created vulnerabilities. The banking systems in the region were dependent on parent banks and international financial markets for funding, with the value of loans being considerably higher than the stock of local deposits. This left the system vulnerable to a shock to the funding model. External funding also provided funds mainly in foreign currencies, in part as the result of the thinness of local currency financial markets. But this also gave the banks an incentive to denominate their lending in foreign currency, which satisfied a strong demand for foreign exchange finance by local borrowers, particularly in the mortgage market, on account of the lower interest rate costs such borrowing entailed. The abundance of financing promoted asset price booms.

Impact of the global financial crisis on CESEE and the Vienna Initiative Response

When the global financial crisis began, international funding markets began to dry up, and this affected European banks disproportionately. The vulnerabilities of some of the Central and Eastern European countries became obvious. With the parent banks scrambling for funding, their generous provision of finance to subsidiaries in the region came into question. And for the countries involved, an interruption of cross-border bank funding was experienced as a sudden stop in the capital inflows that had financed very large current account deficits. The depreciation of exchange rates, or pressure for such depreciation, worsened the financial position of those companies and individuals with debt denominated in foreign currencies. This in turn led to payments difficulties and to a growing non-performing loan (NPL) problem. The rollover needs in 2009, particularly of the private sector, were substantial. There was a risk that the rise in NPLs would require a considerable injection of capital into the region's banks.

The chairmen of the main banks involved in cross-border lending to the CESEE region (Erste, Intesa San Paolo, KBC, Raiffeisen, Société Générale and Unicredit) expressed their concern over the financial situation in emerging Europe in a letter to the European Commission and G20 Chair on 27 November 2008. They called for the measures to increase the provision of liquidity in these countries and strengthen deposit insurance to be supplemented with action to revive the real economy, including more IFI funding and various forms of regulatory accommodation.

The first CESEE countries that were hit by the crisis were Ukraine, Hungary and Latvia. Internationally supported adjustment programmes, with assistance from the IMF, the World Bank Group and (in the case of the EU members) the EU, were agreed in October, November and December 2008, respectively. In December 2008, the Austrian Ministry of Finance agreed with a proposal of the EBRD to organize an urgent meeting with the home and host supervisory and fiscal authorities of the large EU-based bank groups operating in emerging Europe, together with the IFIs, namely the EIB, the EBRD and the IMF. This meeting and informal seminar took place in Vienna on 23 January 2009, with some seven host and six home countries represented.[2] The establishment of a "Vienna Club" as a collective action platform was proposed, but the name actually assigned was "Vienna Initiative" to reflect the nonbinding nature of the movement.[3] This was intended as a way to deal with the collective action problem among the banks, to send a signal to the markets and to allow the IFIs to complement each other's work. It was agreed that the IMF would draw up a proposal for burden-sharing rules between home and host authorities. Such a proposal was presented and broadly approved at a follow-up meeting of the group at the Joint Vienna Institute on 17 March 2009. The Vienna Initiative was formally named the European Bank Coordination (Vienna) Initiative.

2 See Nitsche, 2010.
3 Pres_Vienna_HH.pdf.

The Initiative was complemented by the announcement on 17 February 2009 by the EBRD, the EIB and the World Bank Group of a Joint IFI Action Plan to channel €24.5 billion into the region over the next two years, including for the purpose of supporting parent banks in maintaining their exposures.[4] This responded to the November 2008 call by banking group chairmen. Between March and June 2009, the EIB, the European Bank for Reconstruction and Development (EBRD) and the World Bank/International Finance Corporation (IFC) met jointly with each of the seventeen cross-border banking groups to assess what assistance they might need under this exercise.[5] By the end of September 2009, some €16.3 billion of IFI support had been disbursed in the form of senior loans, tier 1 and 2 capital, trade finance, facilities for small business loans and syndicated loans.[6]

The spread of the crisis was marked by further programmes with Serbia (January 2009), Romania (May 2009), and Bosnia-Herzegovina (July 2009). These programmes provided for financing to cushion the fiscal adjustment path, action to repair the banking system and deal with non-performing loans (NPLs) and somewhat formal arrangements with individual banks to maintain exposures as part of an international support package with the approval of their home authorities and to recapitalize subsidiaries should stress tests performed by the host authorities require it. These agreements to maintain exposure and capitalization were the central feature of the original Vienna Initiative.

From the time of the Latin American debt crisis of the 1980s, if not before, action to encourage creditors to maintain exposure and not to succumb to the temptation of withdrawing financing precipitately from a debtor country in distress had been a feature of the international handling of debt crises. In the Latin American crisis case, where the main form of distressed debt was syndicated bank lending to sovereigns, bank steering committees were established to provide a forum to negotiate with the debtor and to communicate with the IFIs, and also to resolve the collective action problem by restraining those banks that might have preferred to dump their claims. Similarly, in the Asian crisis, where most of the debt was in the form of bonds or credit to non-sovereign entities, adjustment programmes provided for the close monitoring of daily developments in exposures by individual creditors, and moral suasion was applied to prevent any exit of capital from disrupting the economic

4 Actual lending under the JIFIAP by end-2010 was €33 billion.

5 List of banks participating: Alphabank, DnB NORD, Erste Group Bank AG, BayernLB, Piraeus Bank, Eurobank EFG, Hypo Alpe-Adria, Intesa Sanpaolo, KBC Group, National Bank of Greece, NLB Group, Nordea Bank, RZB Group/Raiffeisen, Société Générale, Swedbank, Unicredit and Volksbank International.

6 De Haas, R., Y. Korniyenko, A. Pivovarsky, and T. Tsankova, 2015. Taming the herd? Foreign banks, the Vienna Initiative and crisis transmission", *Journal of Financial Intermediation*, 24(3), 325-355.

adjustment. Those earlier experiences guided policy makers in setting up the Vienna Initiative, a similar arrangement for these CESEE countries where the funding of international bank subsidiaries was the main channel of capital market pressure.

The international banks with subsidiaries in the region faced different sources of pressure. They were finding it increasingly difficult to fund their balance sheets. They also knew that in the wake of the Asian crisis of 1996-98, European policymakers had been particularly insistent on private sector involvement (PSI) as a central part of the support for a country facing capital account pressures. This had been interpreted to mean that the official sector would not provide massive financial resources to a country if a large part went simply to repay private sector creditors. And the banks were aware that there was a collective action problem: if one creditor withdrew funds, stealing a march on its competitors, this would precipitate a deepening of the crisis and the destruction of the value of their investments. In this environment, the banks were highly responsive to the project embodied in the Vienna Initiative.

The precise arrangements for maintaining exposure differed from case to case.[7] The arrangements for Latvia were fairly informal: the main banks involved were Nordic banks, and the Swedish Riksbank was instrumental in ensuring that the parent banks' own adjustment strategies did not put undue pressure on Latvia. No formal agreement was reached in the case of Ukraine, given problems with the implementation of the IMF programme. In other cases – Bosnia-Herzegovina, Hungary, Romania and Serbia – there were formal agreements between individual banks and the central banks of the host countries on maintaining a level of exposure to their subsidiary and its capitalization. The approval of IFI lending was linked to the signing and implementation of these agreements.[8] The adjustment programmes all involved banks taking actions to deal with weaknesses revealed by stress tests. In some cases where the parent bank had received state aid in response to the crisis, efforts had to be made to ensure that the remedial actions required by the European Commission's DG COMP did not undermine these agreements. Throughout this period, there was concern that other countries in the region would require financial support from the IFIs, and that similar arrangements might have to be put in place. But, as it was, the combined action of the countries' adjustment programmes, the IFI and EU support, the Vienna Initiative and the Joint IFI Action Plan limited the spread of problems beyond the countries listed.

7 See De Haas *et al., ibid*. p. 332.

8 In March 2009, the EU leaders summit agreed that national bank support packages should not require constraining banks' CESEE operations. De Haas *et al., ibid*.

The main cross-border banking groups agreed in each case to maintain the level of overall exposure to their subsidiary, taking into account the availability of adequate lending opportunities and sound risk management practices. In addition, they committed to maintain their subsidiaries' good financial standing through periods of market turbulence and economic slowdown. The banks would have preferred a "regional approach", allowing them to shift both capital and exposure between countries, in conformity with normal banking practice and the EU's principles of free movement of capital, but this was not possible. It would have made monitoring in the national context next to impossible and ran the risk of spreading contagion to non-programme countries in the region. There were continued calls for flexibility, especially as the recession in the adjusting countries was reducing the amount of profitable lending opportunities, and earlier over-lending had ultimately to be corrected. It proved possible to accommodate some of these calls during the reviews of the commitments in individual country cases. Another call was for public guarantees to be given to bank lending, but this was generally resisted as it was contrary to the principles of PSI.

There was a conflict between the desire of the banking groups to be able to use resources in their networks to the benefit of the bank as a whole, and the desire of the host authorities to ringfence and protect their domestic financial systems by preventing outflows of capital or liquidity. This was a matter of trust, not only between the host authorities and the banking groups, but between host and home supervisors, with the stakes of potential national financial crisis and bank group failure being very high for all participants. The commitments to maintain exposure and replenish capital levels for the programme countries were embedded in the international support packages for these countries, implicitly giving primacy to rebuilding financial stability at the national level. The Vienna Initiative forum, however, provided a useful complement by opening up the channels for communication and discussion that could mitigate tensions that might arise and identify solutions to emerging problems.

Effectiveness of the Vienna Initiative response

When the success of the initiative was reviewed at the first Full Forum meeting of the Initiative in Brussels in September 2009, it was found that reductions in exposure has been contained.[9] Bank exposures to their subsidiaries had

9 The meeting was chaired by the European Commission's DG ECFIN, and gathered about 90 participants from (i) 15 European banking groups active in the countries receiving EU/IMF balance-of-payments assistance (Hungary, Latvia, Romania, Bosnia-Herzegovina, Serbia); (ii) representatives from central banks and finance ministries of the host countries (iii) home country supervisors (Belgium, France, Germany, Italy, Greece, Sweden, Austria); and (iv) representatives from the European Commission (DG ECFIN and DG COMP), IMF, EBRD, EIB and the World Bank Group, the ECB and CEBS (the predecessor of the EBA).

fallen somewhat in Latvia and Hungary, but had been broadly maintained in Romania and Serbia, and had actually risen in the case of Bosnia-Herzegovina. Commitments lapsed with the expiry of the officially supported adjustment programmes, by which time the country situations had stabilized and pressure to withdraw funding had abated. The assistance given to banking groups under the Joint IFI Action Plan often contained provisos requiring their continued engagement, and this certainly encouraged the rollover of exposures. On the other hand, the change in the strategies of some banking groups which sought to withdraw from some or all countries in the CESEE region complicated matters. In one case this resulted from the application of competition rules by the European Commission's DG COMP on account of the state aid the group had received.

Stable financial conditions were broadly restored by the third quarter of 2009. This was the result of the adjustment programmes in many CESEE countries, the success of the exposure agreements under the Vienna Initiative and the financing for banks mobilized in the Joint IFI Action plan. After sharp recessions in 2009, growth in most of the CESEE region resumed in 2010 and 2011.

The Vienna Initiative in its first incarnation helped stabilize the financial situation of CESEE countries, restore market confidence and build trust between home and host regulators, the banks and the IFIs.[10] It was an *ad hoc* vehicle, filling a gap in the arrangements developed and envisaged earlier by the European Union, which had focused on problems in individual banks rather than systemic problems. However, it created mechanisms that were complementary to EU mechanisms rather than competitive with them. The temptation to apply national ring-fencing during the crisis was high, for both home and host regulators, concerned about contagion and leakage of financial support or bank profits across borders. But the Vienna Initiative created a framework in which these issues could be discussed, and pragmatic solutions reached, at least during the period of the adjustment programmes. In particular, the principle was established that the conditions of national support packages should not discriminate between local and foreign banks. The Vienna Initiative received most support from those home supervisors whose banking systems were most exposed to the region – Austria, Italy and Greece. Elsewhere in Europe, cross-border banking issues were treated in a less cooperative manner.

10 Wolfgang Nitsche, "The Vienna Initiative/European Bank Coordination Initiative: Assessment and Outlook", BMF Working Paper 4/2010.

Taking stock and drawing lessons from the crisis response

The key players – the host countries and supervisors, the cross-border banks and their home supervisors, the EBRD, the EIB Group, the World Bank Group, the IMF and the European Commission – recognized that the Vienna Initiative had created a useful forum for discussing current and emerging problems and identifying cooperative solutions to cross-border banking issues in the CESEE region. At a meeting of the IFIs and the European Commission in Vienna on 20 January, 2010, it was proposed to focus attention on using the Vienna Initiative framework to tackle the vulnerabilities revealed by the crisis and the crisis legacy. A second Full Forum of the Vienna Initiative was held in Athens on 17-18 March 2010.[11] To tackle the continuing vulnerabilities of the region, two working groups involving a range of public and private sector participants were set up, one on local currency and capital market development and one on the absorption of EU structural funds. This shift of the Vienna Initiative work in the direction of crisis prevention was accompanied by a rebranding of the initiative as "Vienna Plus."[12]

The **Working Group on Local Currency and Capital Market Development**, chaired by the EBRD, reported in November 2010. As foreign currency lending financed with cross-border flows had created serious vulnerabilities in the countries of the region, the report recognized the need to move to a funding strategy relying on domestic savings, particularly in domestic currencies. The report recommended that regulators tighten prudential requirements on foreign currency lending and issue sovereign debt in local currency, that banks discontinue the riskiest forms of foreign exchange lending and shift the funding of their subsidiaries towards local currency markets, while IFIs promote macroeconomic policies conducive to local currency market development, support the development of a local institutional investor base, raise funding themselves in local currencies, and provide such funding to investors in the region.[13]

The **Working Group on Absorption of EU Structural Funds**, chaired by the European Commission, noted the low level of absorption in the countries of the region, in particular Romania and Bulgaria, and made several recommendations by which the involvement of commercial banking groups could facilitate the use

11 The meeting was chaired by Deputy Governor Ioannis Papadakis of the Bank of Greece, and attended by some 20 cross-border bank groups; those listed earlier, together with ING Bank, OTP Bank, Piraeus Bank, and SEB, as well as the Czech and Polish authorities.

12 See EBRD note of May 2011 "Vienna Initiative – moving to a new phase".

13 These conclusions fed into the ESRB Recommendations on Lending in Foreign Currencies, 21 September 2011. For subsequent Vienna Initiative work on developing local capital markets, see the discussion below of the Working Group on Capital Markets.

of EU Structural Funds. This would both speed recovery from the crisis and strengthen the asset side of banks' balance sheets. Although not directly linked to the recommendations of the Working Group, utilization rates of EU structural funds in the region subsequently improved markedly. (The activity of this Working Group is discussed below in the chapter on supervisory and regulatory changes by Keereman *et al.*)

At the third Full Forum meeting of the Vienna Initiative held in Brussels on 17-18 March 2011, participants adopted these two reports, and considered the future of the Initiative. They agree that the Vienna Initiative framework should be preserved as such given remaining risks in the region, but that its main focus should be issues of crisis prevention that benefitted from its unique, flexible private-public sector composition, based on the model of the first two working groups. The structure and governance of the Initiative should also be formalized. Two new working groups were set up, one on the implications of the new Basel III regulations for emerging Europe; and the other on dealing with nonperforming assets.

The euro area crisis

In mid 2010, the global financial crisis spread to Greece, where the spreads on sovereign paper began to rise sharply. Pressures were also felt in other euro area countries, in particular, Spain, Portugal and Ireland. The increasing riskiness of sovereigns spread to West European banks, as major holders of claims on these sovereigns, and in turn worsened the creditworthiness of sovereigns who were the ultimate source of backing for their banks. Funding pressures began to rise in mid 2010 and market turmoil continued to increase during 2011. Banks operating in CESEE faced difficulties raising finance, and European national regulators and shareholders also pressed the parent banks to take additional action to clean their balance sheets, increase capital levels and reduce reliance on volatile funding.

By the last quarter of 2011, euro area banks were seeking to improve their capital ratios and under severe pressure to deleverage. Fears rose that funding for subsidiaries in CESEE would be withdrawn or the subsidiaries themselves sold, and that this could exacerbate a credit crunch in the region, pushing some countries into recession. The situation of Greek banks with their subsidiaries throughout the Balkans was of particular concern, as the parent balance sheets were suffering from the crisis in the domestic economy. The home bias of regulators and of fiscal authorities made it likely that the interests of host countries would not receive sufficient weight as the problems of euro area banking groups were addressed.

On 27 October, the European Council adopted a measure to raise the core tier 1 capital requirement temporarily to 9% by 30 June 2012 for all euro area banks. The Chief Economist of the EBRD suggested to the press at the start of November that a new Vienna Initiative, Vienna Initiative 2.0, might be called for as a cooperative venture to shield the CESEE region from external risks and deleveraging.

The increasing concerns about the stability of the euro area and of soundness of banks led the Austrian authorities on 21 November 2011 to introduce stricter requirements on the capitalization and cross-border activities of their banks. The three biggest Austrian banks, all of which were active in CESEE, were required to increase their core tier 1 capital to 7% of risk-weighted assets by January 2013 with an additional 3% buffer by January 2016, considerably in advance of the date provided in European regulations implementing Basel III. Local subsidiaries with more than 2.5% of the Austrian bank's external assets, mainly in the CESEE region, would have to limit the growth in new lending to 110% of new deposits. Other subsidiaries would have to produce a plan to reduce their loan to deposit ratio to 110%. And on 25 November, the Swedish authorities announced that the largest Swedish banks would have to meet a capital target of 10% by January 2013 and 12% by January 2105.

The Austrian measures were introduced without consultation with regulators in those countries that would be affected by the new restrictions on lending. Subsequently, the Austrian authorities held a series of meetings to explain their actions to the European Commission, to the supervisors in affected host countries, both inside and outside the European commission, and to the IMF and EBRD. The Austrian actions showed that there were very real dangers of the spill-over of supervisory action in home countries to host countries where relatively small subsidiaries might be systemic. The fear that Austrian actions might be emulated by others, lead to an accelerated deleveraging of banks in the region and hamper growth prospects brought about a revitalization of the Vienna Initiative.

Relaunching of Vienna Initiative 2.0

On 16 January 2012, the official sector participants of the Vienna Initiative – home and host authorities, IFIs (EBRD, EIB, IMF and the World Bank), the European Commission, along with the ECB, EBA and ESRB as observers – met in Vienna to relaunch the Initiative. Recognizing that many banks did need to reduce their leverage, the meeting looked for ways to improve the coordination of national policies to avoid excessive and disorderly deleveraging and other adverse cross-border effects in the CESEE region, including credit crunches in host countries.

The meeting agreed that home country authorities should take into account the cross-border effects on EU and non-EU countries when formulating measures and coordinate them with host authorities. Recapitalization plans of international banks should be scrutinized by the supervisory colleges under the EBA for their systemic impact on host economies. Host authorities should further the development of local sources of bank funding to the extent possible. Information sharing between home and host authorities should be stepped up to avoid unnecessary ring-fencing of liquidity. Finally, in the event of sales of systemically important subsidiaries, home and host authorities should share information and take each other's concerns into account. It was agreed that the official sector participants in the Vienna Initiative would elaborate these principles and ensure their implementation. The banking groups, whose cooperation was vital, were debriefed at a meeting the following day.

Following the January 2012 Vienna meeting, a process of consultation with stakeholders was launched. Five host countries (Bulgaria, Croatia, Czech Republic, Hungary, Poland) and five home countries (Austria, Belgium, France, Italy, Sweden) were visited by an EBRD-IMF team. The team also visited the European Commission, the EBA and the Bank for International Settlements (BIS)/Financial Standards Board (FSB), as well as bank groups in home and host countries. The consultations showed that the problem of negative spill-overs from supervisory actions continued. Cross-border banking groups were revising their business models in the light of market and balance sheet pressures, and the resulting deleveraging and changed models were having an impact on activities in the region. The question was raised of how the IFIs could give more support to the banks' adjustment of their business models.

Basic principles of Home-Host Authority Coordination

The first order of business of Vienna Initiative 2.0 was to flesh out the principles which should be expected to govern the cooperation between home and host authorities in the circumstances of CESEE.

The principles laid out by the CEBS (Committee of European Banking Supervisors, later European Banking Authority, EBA) were primarily designed for cases where the major part of a country's banking system consisted of local banks subject to the local supervisor, and where cross-border establishment was a minor feature.[14] Each jurisdiction's supervisory authority was responsible for

14 Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability of 1 June 2008.

financial stability within its borders. Branches located abroad were the supervisory responsibility of the home supervisor, while subsidiaries came under the host supervisor. This failed to address the close relationship between parents and subsidiaries within banking groups, and the spill-overs of home and host regulator decisions on to each other's financial markets. The tendency to reach for national solutions by ring-fencing had been evident in the response of supervisors to the difficulties in the Franco-Belgian Dexia bank in 2008-9.

After consultation with participants of the Vienna Initiative, Basic Principles for Home-Host Authority Coordination under Vienna 2.0 were adopted by the Fourth Full Forum held in Brussels on 12 March 2012.[15]

Basic principles for Home-Host Authority Coordination under Vienna 2.0
As parts of the European banking sector undergo a process of deleveraging, it is important to recall that stability of the financial sector and orderly credit conditions in CESEE are in the shared interest of the private sector and home and host country authorities. The following interconnected principles are designed to enhance cooperation and coordination among the various stakeholders so as to help ensure mutually beneficial outcomes even in times of global financial stress and a shifting financial-sector landscape.
1) Principle of free allocation of liquidity and capital consistent with safeguarding financial stability. The commitment to free movement of bank liquidity and capital in accordance with the Treaty for EU members is reaffirmed. In this context, ex-ante coordination of financial stability measures among home and host authorities is essential, especially in conditions of financial market stress.
2) Principle of matching the supervisory framework with the cross-border integration of financial markets: Arrangements for cross-border supervision need to be made compatible with the integrated financial markets across Europe. Mechanisms should be adopted to involve jurisdictions outside the EU where European banking groups are active.
3) Principle of fiscal authority cooperation: Supervisory coordination must be accompanied by coordination among the fiscal authorities, particularly with regards to crisis management and resolution issues.
4) Principle of considering spill-overs from national actions. Supervisors, central banks, and fiscal authorities must take account of the implications of their actions for other national jurisdictions and for the European financial system as a whole.
5) Principle of the central role of European institutions: The European Commission should play its role in promoting an EU single and stable market in financial services. The European Supervisory Authorities should play a central role in supervisory cooperation and mediate among country authorities. The European Systemic Risk Board should play a key role in macroprudential oversight.
6) Principle of private sector engagement. Banking groups active in the region should cooperate actively with national authorities in efforts to promote financial stability, orderly credit conditions and sustainable cross-border banking.
7) Principle of IFIs involvement. International organizations, internalizing the impact of cross-border spill-overs, should promote adjustment to more robust financial systems. They can assist the implementation of these principles through their surveillance, mediation, timely data collection, and financial support functions.
8) Principle of focus on implementation. Participants are committed to the structured implementation of these principles. A Steering Committee will report on the proposed approach to operationalize these principles.

15 See Press Release for 13 March 2012 and http://vienna-initiative.com/wp-content/uploads/2012/08/Principles-for-Home-Host-Authority-Coordination.pdf

Following the adoption of the principles, the participants at the March 2012 Full Forum gave their attention to concrete actions that might be possible. Among the areas to be covered were the functioning of supervisory colleges, cooperation on resolution issues, the establishment of host-country cross-border stability groups and how international institutions might best support this process. A proposal to set up four implementation groups covering these areas was rejected. In particular, a danger was seen that the work on supervisory and resolution colleges would duplicate or conflict with work being done by European Union institutions, work which would lead to the road map for a Banking Union later in the year. The principles were therefore followed up in a more *ad hoc* fashion, as discussed below.

The March 2012 Fourth Full Forum also adopted the reports of the working groups on Basel III implementation and on Non-Performing Loans (NPLs). The report of the **Working Group on Basel III Implementation in Emerging Europe**, coordinated by the World Bank and EBRD, was motivated by the concern that transposition of Basel III rules into the EU's Capital Requirements Directive (CRD IV) might have unintended consequences for financial market development and cross-border relationships in CESEE. The report made a number of recommendations concerning capital definitions, liquidity requirements, the coordination of macroprudential instruments and home-host supervisory collaboration. It pointed out that future regulation and calibration should better take account of the emerging market perspective and market development needs.

The **Working Group on Non-Performing Loans (NPLs) in CESEE**, coordinated by the IMF and World Bank, was established in light of concerns that the 2008-9 crisis legacy of a high level of NPLs throughout the region would be a major obstacle to recovery and sustained growth. The working group drew on surveys conducted by the EIB/EBRD and the ECB. It concluded that the resolution of the problem by individual bank action was proceeding slowly. A more comprehensive and concerted approach was needed, with distinct roles for the various stakeholders: the relevant country authorities should press ahead with removing burdensome regulatory, tax and legal impediments to NPL resolution identified in the report; regulators should tighten supervision to eliminate incentives to let NPLs linger; banks should step up their collective effort to speed up NPL resolution; and avenues for out-of-court debt restructuring and corporate rehabilitation negotiations between debtors and creditors should be explored.

Formalization of the Vienna Initiative

It was also decided to make the Vienna Initiative structure more formal, with a Chair, a Steering Committee and a Mission Statement or terms of reference. The latter was adopted at a meeting in Warsaw on 18 July 2012, which clarified that the objective of the Vienna Initiative 2.0 was to help:

1. Avoid disorderly deleveraging, which could jeopardize financial stability in host countries and ultimately hurt home and host country economies alike;
2. Ensure that potential cross-border financial stability issues are resolved;
3. Achieve policy actions, notably in the supervisory area, that are taken in the best joint interest of home and host countries.[16]

While the Vienna Initiative 1.0 was focused on West European banking groups' maintaining exposure to their CESEE affiliates and their providing capital and liquidity as needed, the Vienna Initiative 2.0 was, despite private sector participation, mainly geared towards encouraging authorities to cooperate in order to avoid disorderly deleveraging.

The organizational aspects of the Initiative were clarified in a note adopted following a meeting in Prague in June 2012. This specified that the participants in the Initiative take part in accordance with their respective legal framework and policies. This allowed them to participate in whichever aspects of the work they wished, without necessarily committing their institutions to endorsing the recommendations. The Full Forum, consisting of all participants, sets the priorities for the Initiative by consensus, approves the work programme and adopts reports and recommendations. Between the meetings of the Full Forum, a Steering Committee conducts the work of the Initiative and the chairman of the Steering Committee coordinates all public statements. Operational support for the Vienna Initiative's work is provided principally by the EBRD, and a website, www.vienna-initiative.com, was set up.

The Steering Committee of the Vienna Initiative consisted of representatives of the four IFIs (the EIB, the EBRD, the World Bank and the IMF), the European Commission and the European Council's Economic and Finance Committee (EFC), and, on a rotational basis, one home and one host supervisor (initially Italy and Romania). Marek Belka, Governor of the National Bank of Poland, agreed to serve as chairman of the Initiative for five years.[17] In January 2013, a position on

16 http://vienna-initiative.com/vienna-initiative-part-2/mission-statement/
17 Boris Vujčić, Governor of the Croatian National Bank, replaced Marek Belka as chairman in November 2016.

the Steering Committee was created for Albania, as representative of non-EU host countries. From July 2013, a representative of a cross-border banking group was also appointed to the Steering Committee.

Monitoring developments

With a focus on orderly deleveraging in the CESEE region, the Steering Committee created and published a *Deleveraging Monitor* showing and analysing trends in the region. It was largely prepared by the IMF staff and based upon BIS international banking statistics and information collected by the IMF on balance of payments developments. This publication was initially prepared with a quarterly frequency, and the first issue was in July 2012. From November 2012, the report included more timely and forward-looking information gathered by the EIB in a quarterly, and later semi-annual, survey of both parent banks and their subsidiaries in the CESEE region. The detailed results of this survey were also published by the EIB in a separate publication, *CESEE Bank Lending Survey*, starting in December 2013. The *Deleveraging Monitor* gradually expanded its coverage of credit developments in the region, and how successful banks were in replacing external funding, primarily from parent banks, by domestic deposit funding. It was renamed *Deleveraging and Credit Monitor* in October 2013 and the frequency was changed to semi-annual starting in December 2016. From the middle of 2016, these publications were joined by a semi-annual *NPL Monitor* for the CESEE prepared by the EBRD.

Host-Country Cross-Border Banking Forums (HCCBs)

The Vienna Initiative had shown itself to be a useful forum to bring together the banking groups and authorities involved in cross-border banking for the CESEE region, to generate solutions to broad problems and to discuss issues that arose in the process. However, while there were similarities in the problems that countries faced, there were also many specific country-by-country issues, and the constellation of actors was different in each. One of the ideas that was generated during the planning for Vienna 2.0 was to establish individual country forums that could help generate trust and resolve issues that arose from cross-border banking. The model here was in part the Nordic-Baltic Cross-Border Stability Group, established in August 2010.

The HCCBFs were designed as a framework to allow host country authorities to interact with the banks that are systemic in their local banking systems, the banks' parents and the parent's home regulators. IFIs and European bodies might participate as observers. While in most countries outside the CESEE region banks respond to local conditions and supervisors have the undisputed ability to influence their activities, in CESEE banks may respond instead to the conditions of the parent banks or the concerns of the parents' supervisors. In a low-key informal setting, and with all parties in the same room, issues could be thrashed out properly and the root cause of problems identified. The HCCBF was designed to be a discussion forum only, and not a framework for obtaining commitments, as the country meetings in the original Vienna Initiative had been. The aim would be to build trust and understanding and promote a sound and responsive banking system.

A pilot HCCBF was convened by the Croatian National Bank in October 2012, attended by the systemically important banks in Croatia, their parents and Austrian and Italian regulators, and was considered to be a success. Subsequently, HCCBF meetings were held in Albania, Bosnia-Herzegovina, Serbia and Slovenia; in some cases several such meetings were held. A similar format, the Ukraine Financial Forum was used several times by Ukraine, to bring together its cross-border banks and their supervisors. However, the idea petered out. There were possibly unrealistic expectations of what could be achieved, and what might have been a long-term programme to build up trust was displaced by more urgent immediate matters.

Expanding on the Basic Principles for the Supervision of Cross-Border Banks

Rather than establish a formal group to expand on the Basic Principles in the area of supervisory practices, an *ad hoc* approach was taken. A note containing **observations on supervisory practices** was prepared by Lars Nyberg, former Deputy Governor of the Swedish Riksbank, and some colleagues, with support from the EBA, based on the experience of the IFIs and host countries, and after informal consultations with EU institutions. A draft was discussed at a workshop in London of Vienna Initiative participants on 12 September 2012 and the final version issued on 18 October 2012.

The document pointed out that recent experience showed that home and host supervisors can differ in their assessment of the systemic risk of financial institutions, not least because subsidiaries may account only for a minor part of a banking group yet be systemic in host countries. These concerns can be even more pronounced in countries outside the EU where EU-based banks have systemic operations. Practices in this area were improving as the EBA gained experience in implementing its mandate. Some of the issues were related to the work under way on the EU's Bank Recovery and Resolution Directive (BRRD), as well as proposals for a Banking Union.

The document contains some 22 observations concerning supervisory gaps, as seen primarily from the point of view of host country authorities, together with some proposals. The proposals focused on the following.[18]

1. Addressing potential conflicts of interest to ensure that supervisory colleges take a wider European perspective.
2. Ensuring that the EBA guidelines are observed and implemented in practice.
3. Fostering more open and active discussions in supervisory colleges.
4. Strengthening the position of the EBA as an "honest broker" in mediation and involving fiscal authorities when fiscal issues are relevant.
5. Bringing the relevant non-EU countries into the supervisory cooperation framework.
6. Highlighting the need to ensure appropriate conditions for the non-euro area countries to participate in the banking union ("opting in").
7. Bringing the macroprudential perspective into the discussion of cross border supervision, including in supervisory colleges.

These proposals were submitted to the EBA, the ECB and the European Commission as an input into the design of Europe-wide supervisory arrangements.

The Fifth Full Forum meeting, which took place in Brussels on 9 November 2012, discussed the large agenda of regulatory developments under way at the European Union level. These included the CRD IV, deposit guarantee schemes, the recovery and resolution framework and the new proposals for a Banking Union. A draft note of observations on resolution practices and the implications of the Banking Union for CESEE were presented. Work on the development of local capital markets to improve local bank funding, on the resolution of NPLs, and possibly on bank taxes was proposed.

Second Joint IFI Action Plan

The day before the Full Forum, the presidents of the European Investment Bank Group (EIB), the World Bank Group (WBG), and the EBRD announced a new Joint IFI Action Plan (JIFIAP) for Growth in Central and Eastern Europe. This was spurred by evidence that the effect of the euro area crisis on demand for CESEE exports, and the cross-border deleveraging under way, were already having a negative effect on the region. The three institutions committed themselves to providing at least €30 billion of new resources to the region over 2013-14

18 See Press Release.

to rekindle growth by supporting private and public sector initiatives, including infrastructure, corporate investment and the financial sector.

The JIFIAP was developed in the context of the Vienna Initiative, and based on the 2009-10 Joint IFI Action Plan. Financing under the second JIFIAP was envisaged to support economic restructuring, consolidation and diversification, as well as enhancing long-term competitiveness through increased availability of long-term credit and equity, mobilizing export trade finance and supporting policy reform. This broad range of activity contrasted with the bank-focused operations of the first JIFIAP. Nevertheless, a major objective was to help ensure that the region's banking system remained in a condition to extend credit, especially to SMEs and mid-caps, and this was achieved by providing a large volume of reliable funding and actions to help cross-border banking groups use their capital more efficiently.

The EIB committed a minimum of €20 billion, mainly in the form of long-term loans to the private and public sector, addressing priority areas such as SMEs, renewable energy and energy efficiency, innovation and convergence. The EIB was also the main provider of first loss guarantees and private equity and venture capital to the region, as well as making particular efforts to support the mobilization of EU grants. The World Bank commitment was for about €6.5 billion, the IBRD and International Development Association (IDA) providing policy-based lending and technical assistance; the International Finance Corporation (IFC) supporting the private sector through its investments and advisory services; and Multilateral Investment Guarantee Agency (MIGA) providing political risk insurance to support investments across all sectors. EBRD investments were projected at €4 billion in loans, equity and trade financing to facilitate regional integration and export-led growth. In the event, these commitments were exceeded, with delivery by December 2014 reaching €28.3 billion for the EIB, €7.4 billion for the WBG, and €7.0 billion for the EBRD, a total of €42.7 billion.[19]

Observations on resolution

After the Observations on Supervisory Practices, another strand of the Basic Principles for Home-Host Authority Coordination that needed elaboration was that of cooperation on resolution issues. Again, the approach taken was for Lars Nyberg to consult and prepare a note on the topic. A preliminary draft was discussed

19 See Final Report on the Joint IFI Action Plan for Growth in Central and South Eastern Europe.

at the London workshop on 12 September 2012, and subsequent draft at the Full Forum on 9 November 2012 in Brussels.

The discussion of the resolution of cross-border banks took place against the background of the European Commission's proposal for BRRD of 6 June 2012, and the proposals for a Banking Union, involving a single resolution authority. The note pointed out that the approach of creating resolution colleges to handle cross-border issues was promising but untested, with cross-border use of resolution funds being problematic. The EU should give legal backing to the principle that if host countries were expected to participate in resolution procedures, then they needed to be fully involved in the normal non-crisis work of supervisory colleges. But the subsidiaries and branches of cross-border banks in host countries were often too small to be of concern to home regulators.

For supervisory and resolution colleges to work properly, the note stated, there must be an adequate two-way exchange of information and participation in college discussion. Host authorities should also be involved in the preparation of group Recovery and Resolution Plans ("living wills"). While the EBA rules provide for much of this as far as hosts that are EU members are concerned, the rules need to be properly enforced and participation of non-EU host countries ensured. Memoranda of understanding could help regulate these issues.

The incentives facing home and host countries on resolution issues were not aligned. The proposed BRRD shifted more power to home authorities, while host country authorities were still to be responsible for financial stability in their domestic economies. Host countries must have a clear say in matters affecting their domestic financial stability. If the role of the EBA as a binding mediator was to be generally respected, the interest of host countries, whether in the euro area or not, must be properly recognized in the EBA mandate and voting structure. Ring-fencing of resources was a critical issue, and the Commission proposal provided a basis for discussing the matter. But it was unclear whether the proposals for intra-group support would work as intended, especially as the imbalance between decision power and responsibility for local financial stability still exists. A "comply or explain" procedure might help protect the interests of host countries.

Burden-sharing issues might ultimately be resolved for countries in the Banking Union but were much more problematic for non-members of the euro area, both within and especially outside the EU. Finally, the issue of bail-in-able bonds in countries with weak capital markets could be very difficult.

These observations and proposals were submitted to the European Banking Authority, the European Central Bank, the European Systemic Risk Board and the European Commission in January 2013.

Since 2013, the work of the Vienna Initiative has had three main strands. The first has been the monitoring of developments in the region, as a form of early warning of larger developments that might have negative spill-overs for the stability of local banking systems and the strength of local economies. The second has been to examine the consequences of regulatory and supervisory proposals and actions that have an impact on CESEE, particularly those countries outside the European Union, and to try to resolve difficulties that emerge. Thirdly, the Vienna Initiative has sought to foster renewed growth in the CESEE region, by removing obstacles to bank credit activity and examining how IFI finance might facilitate this. The last two areas are the focus of much of the rest of this chapter.

The impact of regulatory and supervisory change on CESEE

In January 2013, a **Working Group on the European Banking Union and Emerging Europe**, led by the IMF and the EBRD, was established to look at the impact of the proposed Banking Union on host countries and the banks operating there. The work focused on the impact on EU members and non-members in the CESEE region that were not part of the euro area, but where banking groups headquartered in the euro area were active. This work took place while intensive preparations for the Banking Union were underway in the EU, including the proposals for the BRRD and the single rate mechanism (SRM), and allowed a more precise formulation of some of the concerns of countries in the region. At the time of the discussions, the prospect of non-euro area countries becoming members of the Banking Union and the conditions for this were under close scrutiny.[20] The Working Group drew upon the Vienna Initiative's earlier Observations on Supervision and on Resolution, and an April 2013 report on the Single Supervisory Mechanism.

The report of the Working Group, issued in April 2013, distinguished between the concerns of three groups of countries in the region.[21] Those subject to the Single Supervisory Mechanism (the euro area members) faced a situation where supervision was now supranational, but bank resolution and deposit guarantees remained national, creating a mismatch between decision-making power and fiscal

20 In the event, no non-members of the euro area applied to join the Banking Union until Bulgaria requested this in 2018 in the context of its application to adopt the euro.

21 The report of the Working Group provided input into the work of the European Union on the design of the Banking Union, and several of its recommendations were subsequently incorporated in the final documents.

responsibilities. Countries which were considering opting in to the Banking Union would find it easier to do so if they could benefit from the availability of ECB liquidity facilities in times of crisis. Finally, those countries that remained outside the Banking Union would benefit from the establishment of permanent cooperation mechanisms with the ECB, including through supervisory colleges and agreements between the EBA and non-EU members.

This latter point received particular attention at a Full Forum session devoted to the concerns of South Eastern Europe (SEE), the West Balkans, where the countries were candidates or potential candidates for EU membership but not yet eligible to belong to EU institutions. It was pointed out that some of these countries could not participate in supervisory colleges because they did not comply with supervisory and confidentiality standards. To gauge compliance the EBA needed to perform an assessment, and there was a backlog of these. Given the importance of these issues to the countries in question, it was proposed that the assessments be accelerated and a procedure for doing this be elaborated. Similarly, there would be a need for formal lines of contact between the SRM/SRB and the countries of SEE.

The increased importance of the West Balkan countries of SEE in the work of the Vienna Initiative was reflected in the appointment of a representative of these countries to the Steering Committee. The first representative, the Governor of the Bank of Albania, served to raise awareness of these issues by hosting a Technical Meeting in Tirana on 3 October 2013[22] to promote cooperation between these countries.

He pointed out that the worsening of the euro area crisis had rapidly affected the region through lower risk tolerance of lenders and an interruption of lending by the subsidiaries of European banking groups. This reduction occurred even when subsidiaries were mainly financed through domestic deposits. The requirements of the EBA for additional capital at the group level prompted banks to “save” regulatory capital by reducing lending rather than by raising more capital. One unfortunate example of this had occurred when Raiffeisen’s Albanian subsidiary had reduced its holdings of Albanian government paper by selling the equivalent of 3% of Albania’s GDP of such holdings on the market in a very short period of time in order to help raise the group’s capitalization level. The Governor pointed

22 BIS central bankers’ speeches, Ardian Fullani: Overview of Albania’s recent economic and financial market developments, 3 October 2013. The steering committee position was later filled by the Governor of the National Bank of the Republic of Macedonia.

out that the Vienna Initiative had been relaunched to protect economies from disorderly deleveraging and called for effective measures to restore healthy lending in the economies of SEE. A permanent working relationship between the countries of the region and the ECB as the new regulator of most parent banking groups should be established. In addition, barriers to the exchange of supervisory information should be eliminated and non-EU members should participate fully in relevant supervisory colleges.

These issues were taken up at a session of the October 2013 Sixth Full Forum in Brussels. Subsequent regional cooperation meetings were held in Banja Luka in September 2014 and Podgorica in November 2014.

Cooperation with EU and euro area regulators

As the European Union was developing the legal texts for the SRM and the BRRD, the Vienna Initiative working group on Banking Union submitted observations on the EU proposals at the end of 2013. These dealt in particular with how to protect the interests of countries outside the Banking Union, especially those outside the EU, and where the subsidiaries of cross-border banks based in the Banking Union were of local systemic importance. Among the matters raised were the need for credible fiscal backstops in such jurisdictions, local recovery plans to supplement group recovery plans, and the avoidance by the SRM of action which might trigger instability elsewhere. While recognizing that these are all difficult and sensitive issues, the solutions proposed concentrated on greater participation of non-EU authorities in the resolution process and SRM, in crisis management groups, supervisory and resolution colleges, the importance of early engagement in advance of a crisis, and the establishment of effective mediation procedures.

The Vienna Initiative has been particularly well placed to tackle issues arising from the Banking Union facing non-EU countries in the West Balkans. The centralization of supervision with the SSM at the ECB and creation of the Single Resolution Board create a large single euro area authority supervising most of the banks engaged in cross-border banking in CESEE. The European Union's own regulations in this area, administered by the European Banking Authority (EBA) and the European Commission seek to ensure that EU member countries outside the euro area are not discriminated against in this regulation. However, this principle does not extend to third countries, such as those in the West Balkans, or to countries such as Belarus, Moldova and Ukraine in the EU's Eastern Neighbourhood.

The first task was to ensure that these countries could **participate in supervisory colleges** for the cross-border banks. This was particularly important for the countries in question, since a bank subsidiary could be systemically important in the host's banking system while only constituting a relatively insignificant part of the banking group's overall operations. Participation in the supervisory colleges was governed by regulations issued by the EBA[23] and required that the confidentiality standards of the host supervisor reached the standards required by the European Union.

During 2015, the Vienna Initiative negotiated an umbrella agreement, a Memorandum of Cooperation, with the EBA covering a number of West Balkan countries. The Memorandum was a non-binding agreement establishing a framework of cooperation and information exchange designed to strengthen banking regulation and supervision of banks operating in the EU and the West Balkan countries. Within this framework, the EBA would update the partner authorities on the relevant developments of the single rule book and of progress in convergence of supervisory practices, thus facilitating their participation in the colleges of supervisors.[24] The EBA also opened its regular training activities to the partners, while the signatory authorities agreed to provide the EBA with regular and *ad hoc* information for risk analysis purposes on relevant developments in their banking systems. At the same time the signatory authorities aimed to bring their own regulatory and supervisory standards and institutional arrangements into line with those in the EU, according to a timetable appropriate to the conditions in individual countries.

After some months of discussion, and a review of the countries' supervisory systems, this Memorandum was signed on 23 October 2015 under the auspices of the Vienna Initiative by the EBA and the supervisory authorities of the Federation of Bosnia and Herzegovina and the Republika Srpska (two entities constituting the Republic of Bosnia-Herzegovina), Macedonia, Montenegro, Serbia and Albania. The Memorandum is supplemented with agreements with each of the individual signatories, after a finding that their confidentiality regimes could be deemed equivalent to that of the EU.[25]

The creation of the Banking Union and the transfer of **supervisory and resolution authority** to the ECB (SSM and SRM) made it desirable to supplement the agreement

23 Article 116(6) of the CRD IV, Directive 2013/36/EU.
24 See EBA press release of 23 October 2015.
25 The Central Bank of Kosovo signed the Memorandum in March 2017, and the National Bank of Moldova in February 2019.

with the EBA with memoranda of understanding with the ECB itself. Discussions were held subsequently with the ECB by representatives of the Vienna Initiative regarding an umbrella agreement with the West Balkan countries, but the ECB preferred the route of taking over the individual memoranda that host supervisors had signed with the SSM's predecessors. Nevertheless, the discussion helped to raise the priority given by the SSM to supervisory spill-overs to and from the West Balkans.

Discussions with the ECB also provided an opportunity to raise matters connected with the **subsidiaries of Greek banks**, where the parents came under severe pressure in the first half of 2015 and had to receive considerable support. Restructuring plans were agreed by DG COMP with four major Greek banking groups, and most of these plans involved a focusing of the groups' operations, usually including the disposal of some subsidiaries abroad. The distress in the Greek banking system also caused a weakening of confidence in some of the subsidiaries in the Balkans, although most deposit flight remained in the local banking system and the local central banks could provide the needed liquidity support. While ensuring the stability of Greek subsidiaries in the European Union (primarily Bulgaria, Romania, Cyprus, the UK and Germany) was at the centre of the EBA's attention, the position of subsidiaries outside the EU was more problematic.

The Governor of the National Bank of Macedonia wrote to the chairman of the Vienna Initiative at the end of July 2015. On behalf of Macedonia, Serbia and Albania, he requested that the Vienna Initiative facilitate a unified regional response in arranging a financial backstop facility with the ECB, which would enable the three central banks access to ECB's refinancing operations, should the situation worsen with respect to subsidiaries. He also requested help in ensuring that host supervisors could actively participate in decision-making that might affect the operation of Greek subsidiaries, or at least participate through a regular exchange of relevant information. Subsequently, the chairman of the Steering Committee engaged in discussions with the senior ECB officials on these issues. Nevertheless, it proved hard for host supervisors to obtain information about the restructuring plans of parents agreed with the European Commission (DG COMP) even when they involved divestment of relevant subsidiaries.[26]

Another area in which the Vienna Initiative has sought to ameliorate the regulatory spill-over of new European banking regulations relates to the

26 In November 2015, the EBRD announced an investment of €250 million to support the recapitalization of Greece's four systemic banks (Alpha Bank, Eurobank, National Bank of Greece and Piraeus Bank).

application of Article 114 of CRD IV.[27] This provision required banking groups to apply a 100% risk weight on exposures of their subsidiaries to non-EU sovereigns and central banks when presenting consolidated group accounts. This was a change from the previous zero risk weight regime, which made it very expensive for subsidiaries in certain countries to engage in normal operations in government debt or central bank paper, hampering monetary and fiscal policy and fostering capital outflows. The resolution of the issue identified by Vienna Initiative participants required the affected countries to take steps to allow a positive assessment by the European Commission of the equivalence of their regulatory and supervisory regimes with that of the EU, and for the acceleration of such assessments by the Commission.

The Vienna Initiative served two important functions when it helped the countries of South Eastern Europe, and especially the non-EU candidate countries in the West Balkans, adjust to the European Banking Union. One was to raise the profile of these countries and the priority which European institutions give them in their work. In setting up the new European supervisory and regulatory structures, it has been necessary to reach equivalency and cooperation agreements with supervisors in many other locations. In this process, the more important of the world's financial markets have inevitably taken precedence, since this is where the bulk of the EU's cross-border banking business takes place and is most crucial to the largest European financial institutions. The Vienna Initiative has helped to redress the balance as far as the smaller markets of the West Balkans are concerned, since while operations there are relatively insignificant for Europe's banking system as a whole, the spill-overs from the European Union can be destabilizing for the local markets and can stymie development and growth. The other function was to provide a forum where the countries of the region can discuss common issues and exchange experience, additional and complementary to the events that are organized by the EBA and the ECB.

In implementing the Basel III requirements for total loss-absorbing capacity (TLAC), the European authorities established targets for each bank of a MREL to act as an additional loss absorber in the face of stress. This requirement has created some difficulties for cross-border banks in the CESEE region. It is even more difficult to issue such liabilities in countries with small and shallow capital markets, such as those in the region, than it is in Western Europe, and this will tend to raise the banks' funding costs. This is a complicated issue, with BRRD

27 See the contribution by Angelovska *et al.* in this volume.

provisions not yet transposed uniformly into national legislation. Banks have sought solutions, including the suggestion that IFI funding be ruled MREL-eligible or that IFIs assist them by making markets for MREL. At the same time, host regulators face the problem that if MREL requirements are met by their banks raising more capital, their profitability will suffer, and this may affect their ability to provide credit. Since 2018, the Vienna Initiative has provided a venue for the discussion of how these issues might be resolved.

Reviving Credit in the CESEE region

Another principal focus of the Vienna Initiative 2.0 has been to revive the growth of credit in the CESEE region, which had been largely flat over the period 2009-13. The participating banks considered the main obstacle impeding new credit to be the regulatory uncertainty that increased risks to their operations. This uncertainty related in part to the new initiatives at the EU level, but also to the degree of ring-fencing that home and host supervisors might require to limit the domestic costs of financial instability. The authorities tended to view the problem in terms of weak credit demand, the high NPL level and inadequate action by banks to clean their balance sheets of non-performing assets. There was potential for IFIs or local credit enhancements to help overcome the perceived riskiness of SME lending in these countries.

Credit Guarantees

The need to remove obstacles to the extension of bank credit in support of growth led to two lines of activity, the first work on tackling NPLs and the second the use of guarantee schemes to support small and medium-sized enterprise's (SME's) access to finance. When expressing their priorities in July 2013, the banking groups considered that credit guarantees and other risk-sharing mechanisms were key instruments to support lending to SMEs and SME access to capital markets. A **Working Group on SME Guarantee Schemes** was proposed in October 2013 to assess existing national credit guarantee schemes in this area, to review the relevant EU instruments in this area and to come up with concrete proposals for more effective credit enhancement schemes. This was established at the November 2013 Full Forum.

The Working Group was jointly chaired by the EIB, the World Bank and the National Bank of Poland. It surveyed national credit guarantee agencies, banks and regulators concerning the adequacy of existing facilities. In its report, finalized in November 2014, it concluded that there was a strong demand for SME credit guarantees in the CESEE region, and they could be an effective way to improve

SME access to finance. Public funding was under stress, but EU and IFI funding could play a key role at this time. There was scope for credit guarantee schemes to improve the clarity of their objectives and the evaluation of their operations. Improved procedures could alleviate the need of borrowers for collateral and avoid too narrow a definition of eligible clients. A more uniform treatment by national authorities of the credit risk mitigation and associated capital relief would promote the use of these instruments and a more coherent approach by regulatory and supervisory authorities would be helpful.

Following the discussion of the report at the November 2014 Full Forum, the members of the working group instituted a programme of outreach to endure that the messages reached both national credit guarantee schemes and banks. A guideline was issued by the EBA to clarify conditions under which regulatory capital relief could be provided in the presence of guarantees. A joint EIB-EIF-EBA seminar was held in London in May 2016 on synthetic securitization and financial guarantees following up the Vienna Initiative working group. It brought together regulators, banks and IFIs to discuss the regulatory and supervisory treatment of such production, including in the funding and risk transfer areas, as a step towards a more consistent approach by regulators to such instruments, allowing guarantee programmes to be more effective and banks to have more confidence in their use. The report and recommendations of the Working Group were also important inputs into subsequent discussions on the role of guarantees in SME finance throughout the European Union.

NPL Initiative

The NPL Initiative, a regional project, was launched at the November 2014 Full Forum. (See the contribution by Marković, Cloutier and Jerić, below.) Resolving the high stock of NPLs was seen one of the elements needed to create the conditions for balanced credit recovery, the others being credit enhancements schemes (to address high risk perceptions) and local currency capital market development. The report of the Working Group on NPLs issued in March 2012 had identified the obstacles to reducing the large stock of such assets in the region, as well as making recommendations on how banks and countries might tackle the problem. Nevertheless, the problem remained severe in many countries, and remained at the forefront of attention in Vienna Initiative meetings.

Even before the issue of the Working Group's 2012 report, implementation workshops were being held around the region and NPL workout programmes established in several countries. The World Bank provided assistance on NPL issues through its Financial Sector Advisory Center (FinSAC) in Vienna (funded by the Austrian government) to Albania, Montenegro, Kosovo and Serbia; the IMF worked with Bosnia-Herzegovina and Serbia on the subject as part of adjustment programmes. Bank regulation and tax and collateral legislation were amended in several countries. The parent banks resident in Vienna were working on common principles for out-of-court action. And there was investor activity, purchasing portfolios of non-performing assets in Croatia, Hungary, Montenegro, Romania and Slovenia. The October 2013 Full Forum welcomed the publication of the new harmonized definitions of NPLs and regulatory forbearance by the European Banking Authority (EBA). Nevertheless, NPL levels throughout the region were still high and rising.

The NPL Initiative brought much of this work together in a regional project with country-specific action plans. At the regional level, the focus was placed on knowledge-sharing, policy support and monitoring. At the country level, domestic forums (including HCBBFs) focused on removing the obstacles specific to each market and building capacity to resolve NPLs. Corporate restructuring has been promoted where needed, potential investors brought in and support sought from the European authorities. The IFIs have provided both advice and investment, while the banking groups, led by Raiffeisen, helped finance the coordination. Full-time staff were hired by the EBRD, but the initiative drew on the work of the IMF, the World Bank, the EIB and the European Commission. A website (http://npl.vienna-initiative.com/) was set up, with the aim of promoting the transparency of restructuring frameworks and disseminating information on best practices.

Successive issues of the *NPL Monitor* show the progress made in removing impediments to reducing the stock of NPLs. These include changes in laws and regulations, including on provisioning, and tax provisions governing asset sales, as well as training of bank officials and the promotion of local loan servicing capacity. The NPL Initiative has promoted markets in non-performing assets, and out of court resolution frameworks. The NPL Initiative has held a series of national and regional workshops. There has been a marked reduction in the level of NPLs in the region and a growing market in distressed assets. The work of the NPL Initiative has informed the guidance produced by the ECB, the ESRB and the European Commission concerning the NPL problem in Europe as a whole. The work of the NPL Initiative has extended to Cyprus and Greece, and Cyprus requested to join the Vienna Initiative primarily in light of its interest in this work.

Local Capital Market Development

The parent-to-subsidiary funding model which fuelled cross-border banking in CESEE created several vulnerabilities, from both the mismatch of the funding and the local currency and the dependency of the subsidiary on the financial market access of the parent. The earliest work of the Vienna Initiative looked into how alternative funding models could be promoted, among them the development of local capital markets.[28] Recognizing that this was a difficult endeavour in small countries without a tradition of financial depth and stability, the IFIs sought to address this issue.

The EBRD launched its Local Currency and Capital Market Development Initiative in 2010 to reduce reliance on foreign currency lending and borrowing. This involved EBRD lending and borrowing in local currency, investing in local currency and developing a long-term institutional investor base. Complementing this was a programme of policy dialogue, technical assistance and advisory work. The IFC similarly had a programme for local capital market development and the issue of local currency bonds, and the EIB issues in local currencies. And the World Bank and IMF have been assisting the development of local government bond markets.[29]

During the years since the crisis, banks in the CESEE region have been remarkably successful in replacing parent funding with local deposits, a process that is documented in the *Deleveraging and Credit Monitor*. However, deposit-based bank financing has limits in these countries, and regulators have also pressed for more stable funding arrangements, so the banks have been eager for IFI help in supporting longer-term funding instruments in local currencies. Promoting this development of local currency capital markets has been the subject of much discussion at successive Vienna Initiative meetings.

The European Commission adopted in September 2015 an action plan on building a Capital Markets Union (CMU) with the aim of establishing the "building blocks" of an integrated EU capital market by 2019. The aim was to create more opportunities for investors, connect financing to the real economy, foster a stronger and more resilient financial system, deepen financial integration and increase competition. Since a CMU could have a major impact on financing investment and sustaining growth in CESEE countries, this was seen as an area where the Vienna Initiative

28 See the above discussion of the Working Group on Local Currency and Capital Market Development of 2009.

29 A discussion of IFI operations to strengthen local currency capital markets in the CESEE region can be found in the *First Report on the Joint IFI Action Plan for Growth in Central and South Eastern Europe*, pp. 12-13.

had a role to play. At the November 2015 Full Forum in Warsaw, the meeting encouraged CESEE authorities to identify areas where EU technical assistance could help them implement CMU-related measures of relevance to their countries.

A **Working Group on Capital Markets Union**, chaired by the European Commission, was set up at the March 2017 Full Forum in Luxembourg. Its objective was to provide an overview of challenges faced by capital markets in the CESEE region, and to identify measures needed to enhance local capital markets which might be implemented at national, cross-border and European level. To this end, the working group carried out a twelve-country survey among its members of the challenges they were facing and the solutions they were considering. The survey respondents were all EU member states, with the exception of Macedonia.

The report made recommendations at the national, regional and EU level. At the national level, the report called for national capital market strategies, support for listing by SMEs and encouraging the privatization of state-owned enterprises through capital market floatation. Regional recommendations were aimed at increasing cross-border cooperation by facilitating foreign listings, creating cross-border links between local market infrastructures, cooperation between stock exchanges and their merging and harmonized regulations. At the EU level, the report recommended providing relief for disproportionate regulations such as excessive penalties for small companies, the possibility of bank investment in MREL issued by subsidiaries in some circumstances and further harmonizing regulations in some areas, such as fintech. Financial support from IFIs could both help overcome market failures and increase the funding pool for investments. The report was primarily focused on EU member states in the CESEE region. (See also the discussion in the chapter below on supervision and regulation by Keereman *et al.*)

The Working Group report was presented to the March 2018 Full Forum in London, where it was endorsed and transmitted to the European authorities. The Commission followed it up with a Communication on EU support for local capital markets. This emphasized the importance of the development of smaller financial centres as a way to realize the CMU, rather than relying excessively on the expansion of established financial centres.

Investment in CESEE

At the March 2017 Full Forum there was a discussion of the investment needs of the countries in the CESEE region. The EIB's Investment Survey had found that investment levels in EU member states in the CESEE region, while somewhat higher than in the rest of the EU, were below the levels needed to sustain convergence. The funding channels of foreign direct investment (FDI) and cross-border bank flows were not working as before, and more firms in the region considered themselves credit-constrained. EU funds had been important in sustaining investment levels, but could be used more effectively, especially by levering investment through credit enhancements and other mechanisms. The banking groups supported this analysis and suggested they might have a role to play in improving the design of IFI instruments. In this connection, they were now as interested in forms of funding that would give them capital relief as in simple risk transfer. There were unnecessary differences in how different national authorities treated regulatory capital relief.

The subject thus defined became matter of finding solutions that served the interests of the banking groups, the EU, the IFIs and the banks' home and host regulators, and the Vienna Initiative provided a suitable platform for elaborating these. A **Working Group on IFI Financial Products Supporting Investment in CESEE**, chaired by the EIB, was set up at the April 2017 Steering Committee meeting. Its objectives were to identify the market gaps and priority policy areas where IFIs could best support investment, support the development of instruments best meeting the investment needs of the CESEE region and assess the local investor base and how to improve cooperation amongst IFIs, thus helping to shape the new IFI products.

The working group reported in early 2019 and concluded *inter alia* that IFIs could play a catalytic role as the region developed a new growth model based on productivity growth through human capital development and home-grown innovation. More accessible information on IFI activity and product mix would make for better investor take up. The bank capital relief that IFI products for SMEs and mid-caps provided was at least as important as the funding itself, and the IFIs should also broaden their local currency offerings. Complying with MREL was challenging for banks in the region and the Vienna Initiative should devote more attention to the issue. IFIs should adapt their product offers to the characteristics of the region, with smaller ticket sizes and more flexibility in loan structures, among other things. Grants combined with financial instruments had a high potential in the region as their socio-economic impact could be large.

The discussion of new growth model for the CESEE region, which lay behind the establishment of the Working Group on IFI Financial Instruments for Investment, also led to a recognition of the need to ensure that investment in the CESEE region was more focused on intangibles and sustaining innovation.

A further **Working Group on Financing for Innovation**, proposed by the EIB and cochaired by the EBRD, was set up at the March 2018 Full Forum. The terms of reference provided that the Working Group would: review and identify gaps in existing policies targeting innovation and entrepreneurship; investigate the role of banks and other providers of financing in the different stages and forms of innovation; help develop tools for banks to assess innovative firms and select appropriate financing vehicles; and assess how to facilitate cooperation between IFIs, banks and alternative providers of financing for innovation, such as venture capital and private equity firms.

Concluding Remarks

Cross-border bank supervision issues are among the most complicated in the whole regulatory area, and international rule-making has not resolved many of the most serious issues. The failure of a bank or banks in one jurisdiction can have spill-over effects threatening the financial stability of another. While cooperation between supervisors can ameliorate the situation, each has responsibility for financial stability in his or her own country, where the taxpayer will hold each to account for any bailout or compensation that has to be paid in the event of failure. The issues are not resolved at the global level, particularly in the event of the failure of a cross-border bank or banks. For most countries, however, the bulk of the domestic banking system consists of home country banks, and inward and outward cross-border spill-overs are likely to be relatively small and contained. But when banking systems are interlinked, these effects are likely to be large. For the euro area, when a crisis hit the banking system, the response was to centralize supervision and resolution create a Banking Union, so that problems of supervisory cooperation could be eliminated. Even implementing that solution has been to climb a political mountain.

But the problems are much larger for the countries of the CESEE region, where often virtually their entire banking system is externally owned. Not only that, but, given their small domestic financial markets, a subsidiary which is a small part of the parent bank and an afterthought in a recovery or resolution plan can be systemically vital to the host country. The challenges of supervisory and regulatory cooperation in the CESEE region are of a different order from elsewhere. Changing ownership in the banking system would bring another group of problems to countries that need a well-managed and properly functioning banking system to underpin their growth. The Vienna Initiative is needed to help the countries of this region to engage in a responsive dialogue with the home supervisors and regulators of their banks.

In its first phase, Vienna Initiative 1.0, it was a spectacular success, helping to stabilize the financial markets of the region and limit contagion, while allowing the banks to repair their balance sheets and remain engaged with the countries. Vienna Initiative 2.0 was also launched at a time of crisis, with banks facing huge deleveraging pressures and home regulators on the verge of taking actions to ring-fence their markets. Deleveraging occurred for some years, but at a pace that could be contained. The monitoring under the Vienna Initiative put in place an early warning system so that action could be taken, or discussions held, when anything untoward occurred. The region's banking systems have weathered reduced parent funding and the disengagement from the region of several banks. The Vienna Initiative has been a forum for identifying new ways of helping the cross-border banks continue to supply the region with the credit it needs. And, most importantly, it has helped the smaller countries, particularly those in the West Balkans, to raise issues when regulatory reform had or threatened to have serious spill-overs on their banking systems. The Vienna Initiative is a framework for ensuring the financial stability of the countries of the region, and it has been quite successful in doing so.

The weaknesses of the Vienna Initiative 2.0 are a mirror image of its strengths. It is not a decision-making forum, and the desire of various participants to obtain commitments in that forum have been unsuccessful. Banking groups would have liked to see the Initiative take a firmer view on bank taxes in various countries, as well as measures that put the financial burden of resolving foreign exchange mortgages onto the banks. They would also have liked more binding agreements to limit ring-fencing of capital and liquidity. CESEE countries would have liked to have stronger commitments from banks to provide the credit and financing needed to support the domestic economy. They would also have liked stronger commitments from home supervisors to involve them in decisions and home country authorities to provide them with resources *in extremis*.

On the other hand, if the various participants were bound to implement decisions, they would have institutional difficulties in engaging in the forum. The terms of reference are explicit that participant takes part in activities under the Initiative in accordance with its respective legal framework and policies. Each institution has its own governance structure, be it an intergovernmental board, domestic legislation and charter or shareholders. If decisions taken in the Vienna Initiative context bound these bodies, there would have to be formal decisions taken. And for many of the participants, the issues that the Vienna Initiative deals with, while important for a part of their activity, may have relatively minor significance in the context of all their activities. Discussions would therefore be stymied from the difficulty of mobilizing enough management and board attention to the subject.

The Vienna Initiative is more than a "talking shop", and has been able to mobilize its members to take actions needed to promote the financial stability of the region. It has had some singular successes, and some of its work, for example, on resolving NPLs and the use of credit enhancements, has been broken the ground for EU-wide initiatives. But cross-border banking is a difficult area where regulators struggle and, as Andrea Enria notes in a recent paper on financial fragmentation in Europe,[30] in time of crisis foreign business is still the first to be curtailed and supervisors and states still reach at once for measures to defend the national interest. But he cites the Vienna Initiative as a notable exception, "a cooperation framework involving relevant central banks and supervisory authorities, large banking groups with systemic presence in several Central, Eastern and South-Eastern European countries committed to maintaining cross-border activity and keeping their subsidiaries well capitalised, hence decreasing the need of ring-fencing responses from host authorities."

Annex: Ukraine and the Vienna Initiative[31]

Ukraine was exceptionally hard hit by the global financial crisis, with GDP falling 14.9 percent in 2009. An adjustment programme was agreed with the IMF in October 2008, and Ukraine participated in some of the initial discussions concerning the Vienna Initiative.[32] Country meetings were held with the Ukrainian government and its foreign-owned banks in January and February 2009, but these did not result in letters committing the banks to maintain their exposure.[33] This was in part due to the depth of the adjustment problems facing Ukraine and its banking system, and in part because the ownership structure differed from that of the other Vienna Initiative countries, in that, while a large share of Ukraine's banking system was foreign-owned, Russian banks owned a larger share than did EU banks.

Ukraine maintained its interest in the Vienna Initiative, even though it was not a potential candidate country for European Union membership. In June 2012, the Governor of the National Bank of Ukraine, Serhiy Arbuzov, wrote to the chairman,

30 Andrea Enria, Chairperson of the European Banking Authority (EBA), *"Fragmentation in banking markets: crisis legacy and the challenge of Brexit"*, Speech at the BCBS-FSI High Level Meeting for Europe on Banking Supervision, 17 September 2018.

31 See also the discussion in the chapter in this volume on supervision and regulation by Keereman *et al.*

32 See Nitsche, Wolfgang. 2010. The Vienna Initiative/European Bank Coordinational Initiative: Assessment and Outlook. *Austrian Federal Ministry of Finance Working Paper Series* 2010 (4).

33 De Haas *et al., ibid.*, p.331.

Marek Belka, asking to participate more fully in the work of the Vienna Initiative. The Steering Committee considered Ukraine's involvement desirable, as it was an important host of European banks. Ukraine participated in the November 2012 Full Forum, and the Vienna Initiative facilitated cooperation between the NBU and the EBA concerning participation in supervisory colleges.

Following the events in Ukraine in early 2014, there was an intensification of work with the Vienna Initiative. The steering committee meeting with selected banks in Warsaw in May 2014 discussed the consequences for cross-border banks of the annexation of Crimea and subsequent measures by the Ukrainian authorities. The possibility of support to Ukraine under arrangements similar to those of the original Vienna Initiative was discussed. In the event, Ukraine was more interested in the Host Country Cross-Border Banking Forums as a venue for productive discussions between public and private sector participants, primarily cross-border banks and regulators.

A first Ukraine Financial Forum was organized in Kyiv on 5 July 2014, bringing together cross-border banks active in Ukraine, their supervisors, the IFIs and European Commission, together with the Ukrainian authorities. The participants discussed the implications for the banking system of Ukraine's IMF-supported adjustment programme, in particular, bank restructuring, recapitalization and resolution, as well as NPLs and changes in bank supervision.

A second such forum was held in Brussels on 14 November 2014, the day following the Vienna Initiative Full Forum. Discussions focused on the implications for Ukraine's banking sector of exchange rate movements, asset quality, NPLs, capitalization levels and the constraints on new lending, as well as the disruption to banks' business from the situation in Eastern Ukraine and Crimea.

A third Ukraine Financial Forum under the auspices of the Vienna Initiative took place in Kiev on 15 March 2016 and took stock of reforms in Ukraine's banking sector. Participants discussed the high level of NPLs, a proposed national action plan for NPL resolution to be developed as part of the Vienna Initiative's NPL Initiative, actions needed to revive bank lending and the structure of Ukraine's banking system and its regulatory framework.

Ukraine has also been active in the NPL Initiative, with conferences on NPL issues in March and April 2018 organized by the World Bank and the EBRD, respectively.

Meetings in the Vienna Initiative Framework[34]

Date	Forum	Place	Results/Subjects Considered
2009			
23 Jan	Vienna informal seminar	Vienna	"Vienna club" to be established
27 Feb	Launch of Joint IFI Action Plan		
17 Mar	Meeting of official sector participants	Vienna	Broad home-host burden-sharing rules agreed
26 Mar	Meeting on Romania	Vienna	Agreement to support subsidiaries
27 Mar	Meeting on Serbia	Vienna	Agreement to work towards supporting subsidiaries
25 Apr	Meeting of official sector participants	Washington	Stock-taking
15 May	JIFIAP meeting	London	Stock-taking
19 May	Coordination meeting on Hungary	Brussels	Commitments to support subsidiaries
20 May	Coordination meeting on Romania	Brussels	Commitments to support subsidiaries
22 Jun	Meeting on Bosnia-Herzegovina	Vienna	Agreement to support subsidiaries
22 Jul	Meeting on Romania		Reaffirmation of support
11 Sep	Meeting on Latvia	Stockholm	Commitment letter signed
24 Sep	First Full Forum	Brussels	Stock-taking. Possible relaxation on deleveraging
19 Nov	Meeting on Romania	Brussels	
20 Nov	Meeting on Hungary	Brussels	
2010			
18 Jan	Official sector meeting	Vienna	
26 Feb	Meetings on Serbia and Bosnia-Herzegovina	Vienna	Relaxation of exposure commitments for Serbia
17 Mar	Second Full Forum meeting	Athens	Discussion of use of VI framework beyond crisis management. Working Groups on local currency market and EU fund absorption set up.
22 Jul	Meeting on Romania		
23 Jul	Meeting on Hungary		
2011			
16 Mar	Meeting on Romania	Brussels	Stock-taking
18 Mar	Third Full Forum	Brussels	Vienna Initiative to shift focus to crisis prevention. Reports on local currency market and EU fund absorption adopted. Working Groups on Basel III and non-performing assets set up.

34 Partial list

Date	Forum	Place	Results/Subjects Considered
2012			
16 Jan	Special Official side meeting	Vienna	Relaunch of Vienna Initiative 2.0
17 Jan	Debriefing for banks	Vienna	
12 Mar	Official Side Meeting	Brussels	Understanding the new co-ordination framework (EC, EBA, ESRB, FSB); Principles and Responsibilities
13 Mar	Fourth Full Forum	Brussels	Reports of Working Groups on Basel III and NPLs; Monitoring of economic situation; Coordination principles for Vienna 2.0
20 Apr	Steering Committee	Washington	Monitoring, Governance structure; Recommendations for implementing Vienna 2.0 principles
18 May	Informal meeting with banks	London	Report on activities post-March
13 Jun	Informal Steering Committee	EBRD London	Mission statement, Workstreams on supervisory colleges and resolution framework, Selection of Chairman, Ukraine
26 Jun	Informal Steering Committee	Prague	Mission statement, Workstreams, HCCBF, Deleveraging report
18 Jul	Steering Committee	Warsaw	Adoption of Vienna Initiative 2.0 mission statement. Discussion of deleveraging, supervisory colleges, resolution, HCCBFs, SEE/Greek banks
12 Sep	Workshop on Bank Supervision and Resolution	London	
8 Nov	Steering Committee	Brussels	Next steps: enhancing bank participation
9 Nov	Fifth Full Forum	Brussels	Monitoring; EU Regulations; IFI lending; Progress under VI; Resolution and Banking Union
2013			
14 Jan	Steering Committee with Banks	Vienna	DCM; BLS; NPL Working Group on BU; LCM dev; Addition of non-EU country to Steering Committee
19 Apr	Steering Committee	Washington	Note from Working Group on BU and EE
17 Jul	Steering Committee	Luxembourg	SRM including SEE; NPLs and credit guarantees to help SMEs;
3 Oct	Technical Meeting for Regional Cooperation	Tirana	Impact of Banking Union on SEE
11 Oct	Steering Committee	Washington	Funding WE banks; Report on SEE issues; note on success indicators
21 Oct	Sixth Full Forum	Brussels	Monitoring deleveraging and credit growth; NPLs; SRM; call for special SRM and EBA arrangements

Date	Forum	Place	Results/Subjects Considered
2014			
13 Jan	Steering Committee	Vienna	Five Priorities established for 2014; Progress reports
11 Apr	Steering Committee	Washington	Update on Working Groups
15 May	Steering Committee with banks	Warsaw	Banking Union, Ukraine, NPLs
5 Jun	First Ukraine Financial Forum	Kiev	
23 Sep	Debt Restructuring and NPL Resolution	Vienna	NPL Initiative Regional Conference
10 Oct	Steering Committee	Washington	Monitoring; AQR and ECB measures on parent banks; Working Groups on Credit Enhancements, NPLs, BU, Ukraine and Bulgaria, Strategic Directions
13 Nov	Seventh Full Forum	Brussels	Monitoring, Banking Union, Working Group on Credit Enhancement, NPLs
14 Nov	Second Ukraine Financial Forum	Brussels	
2015			
19 Jan	Steering Committee	Vienna	
17 Apr	Steering Committee	Washington	Monitoring, Progress report on NPL work, Banking Union Working Group, Work Programme
14 May	Meeting with banks	Tbilisi	
26 Jun	NPL Resolution in Emerging Europe	Vienna	NPL Initiative Regional Conference
26 Jun	Steering Committee	Vienna	Monitoring, Impact of QE on region, NPL Workshop, Update on Working Groups on BU and Credit enhancements
23 Oct	Memorandum of Cooperation Signing	EBA London	EBA and Vienna Initiative
27 Oct	Macroprudential Workshop	Vienna	OeNB and NBP
17 Nov	Workshop on Bank Ownership Changes	Warsaw	
18 Nov	Eighth Full Forum	Warsaw	
2016			
20 Jan	Steering Committee	Vienna	Greek banks, Work programme implementation
15 Mar	Third Ukraine Financial Forum	Kiev	
15 Apr	Steering Committee	Washington	Monitoring, NPL work, Working Groups on Banking Union and Guarantees, Organizational matters

Date	Forum	Place	Results/Subjects Considered
2017			
6 Mar	Ninth Full Forum	Luxembourg	Monitoring, Bank regulation, Investment in CESEE, CMU, Ukraine
27 Apr	Steering Committee	Washington	Monitoring; West Balkans, Working Group IFI Instruments, CRD IV
14 Oct	Steering Committee	Washington	Monitoring, West Balkan Banking systems, Working Group on IFI instruments, CRD Art.114
11 Dec	Workshop on CRD114 impact on non-EU WB	London	
2018			
12 Mar	Tenth Full Forum	London	Monitoring, Working Groups on CMU and IFI instruments, NPL Initiative, Financing Innovation, MREL and Regulatory Issues
21 Apr	Steering Committee	Washington	Monitoring, Working Groups on IFI Instruments, Innovation, CMU
26 Apr	Workshop on Financial Restructuring and NPLs	Kiev	NPL Initiative Regional Conference
8 Oct	Workshop on MREL	Vienna	
13 Oct	Steering Committee	Bali	Monitoring, Working Groups on IFI Instruments, and Innovation, MREL

CHAPTER 2

Reflections on multi-country and multi-player issues

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EBRD, IMF, EBRD and Bruegel

Abstract

The segment of the global financial crisis and later the euro area crisis that triggered the Vienna Initiative differed from other crisis situations and experiences. The multitude of countries and players involved made it more difficult to recognise and understand the problem at an early stage and mitigate free rider concerns. At least four distinct sets of players had to coordinate within and among themselves – governments, international institutions, banks and central banks/ supervisors – each with its own and sometimes conflicting interests. In particular, the authorities of home and host countries of the banks operating in the region had to deal with inherent conflicts of interest. A major difference to previous attempts of cross-country coordination in crisis situations was the presence of European institutions. While these institutions enhanced the potential for effective enforcement, there was no clear role for them in financial supervision and no common bank resolution mechanism existed. Some issues to be dealt with arose within the euro area, within the EU and other parties outside. This added complexity. This chapter examines whether the institutional reforms in the aftermath of the crisis have made future crisis resolutions easier, and whether there are also broader lessons to be learned from the Vienna Initiative outside Europe.

Introduction

The genesis of the global financial crisis (GFC) has been widely discussed and analysed. Europe had to deal with the fallout from the GFC in a number of distinct phases and events. Best remembered will be the euro area crisis, which we can approximately date from the end of 2009 to 2012/3. The earlier phase of the crisis in

Central Eastern European (CEE) countries from 2008 onwards is less well anchored in public memory, as the Vienna Initiative largely dissipated and mitigated the crisis.

By now the impact of the Initiative has been well documented, and some of the lessons have already been integrated into regulatory and supervisory frameworks for cross-country coordination.[1] This paper recapitulates some of the initial coordination issues and looks at the lessons learned, drawing policy conclusions for the future. In particular, we are interested in how the insights from the Vienna Initiative can help strengthen the Global Financial Safety Net and facilitate cross-border banking in Europe and elsewhere.

The timeline and the participation of different actors during the first phase of the Vienna Initiative have well been documented on the Vienna Initiative's website.[2] The timeline illustrates the pressure building in the banking sector throughout the autumn of 2008. Despite a strong global response and rapid (national) interventions in Europe, liquidity in CEE economies started drying up. Ukraine and Hungary were the first to face serious balance of payments crises requiring International Monetary Fund (IMF) (Ukraine) and IMF/EU (Hungary) programmes. Several other countries were in the pipeline for similar interventions.

Lending had increased dramatically in the CEE economies in the period leading up to the global financial crisis, partly in anticipation of, and then as a result, of EU membership. However, once the crisis hit, the institutions of these countries had weaker credibility as they had only been EU members for a few years. The perceived riskiness of exposure was reflected in the equity prices of the parent banks and ultimately in the sovereign spreads of their home countries. As banks had been encouraged to hold domestic paper, this was the beginning of the infamous "doom loop", which later became the core of the euro area crisis.

A number of other interdependencies played out and amplified the potential fallout in the early stages of the crisis. Changes in the supply and maturity structure of bank funding increased the liquidity needs of parent banks and put pressure on them to withdraw liquidity from CEE subsidiaries. Possible credit contraction in CEE countries risked leading to further economic downswings, forcing parent banks to write off losses in subsidiaries. In turn, this would see home country governments

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1 Haas *et al.* (2012) document that the Vienna Initiative prevented fire sales and slowed down leveraging with no negative spill-overs for countries that decided not to join. The Vienna Initiative today is part of the European regional financing arrangement (RFA) safety net.

2 See http://vienna-initiative.com/wp-content/uploads/2012/08/Timeline2.pdf

having to prop up these banks, given the resulting liquidity and capital needs. The market perceptions of increasing country risk of home countries put additional pressures on them to raise regulatory requirements.

Cooperation in crisis: The G20 response

Many, but by no means all, actors understood early on that combatting a cross-border crisis requires cross-border solutions, which in turn necessitate cross-border cooperation. The more actors there are, the stronger the need for a coordinating entity. Preferably this entity should have been designated in advance – once the crisis has broken out, agreeing on a coordinator is more difficult.

The post-Lehman response to the drying up of global liquidity was coordinated swiftly and efficiently by major central banks, particularly through the swap lines provided by the US Federal Reserve. A limited number of actors, one single set of policy instruments and concerns about an imminent meltdown helped make this coordination effective.

The global fiscal response was coordinated by the reactivated G20, culminating in the London Summit in April 2009. The "finest hour" of the G20 worked reasonably well. It built on an existing institutional structure, a joint analysis of the problem and exceptionally strong leadership by the heads of government of the UK and the US, who clearly appreciated the dangers of the situation.[3]

Recognising and acknowledging the global dimension of the crisis and its gravity was not too difficult for policymakers as the Lehman event and the post-Lehman situation were adequately dramatic. Analysis by the international institutions was concise and clear and helped to push policymakers in the right direction.

The number of actors was large, but comparatively limited in the sense that addressees were essentially central banks and finance ministers. Convocation and coordination rested clearly with the G20 presidency, underpinned by the clear lead of the IMF in providing the drafts of the economic rationale and blueprints. The

3 "We face the greatest challenge to the world economy in modern times; a crisis which has deepened since we last met, which affects the lives of women, men, and children in every country, and which all countries must join together to resolve. A global crisis requires a global solution." The Leaders went on to "pledge to do whatever is necessary to: restore confidence, growth, and jobs; repair the financial system to restore lending; strengthen financial regulation to rebuild trust; fund and reform our international financial institutions to overcome this crisis and prevent future ones; promote global trade and investment and reject protectionism, to underpin prosperity; and build an inclusive, green, and sustainable recovery. By acting together to fulfil these pledges we will bring the world economy out of recession and prevent a crisis like this from recurring in the future." G20 London Summit - Leaders' Statement, 2 April 2009.

world was less multipolar than it is today. Even so, herding more than 20 sovereigns, with diverse interests and many with strong internal divisions, towards a single set of policy actions was a major achievement.

Participants understood that commitments rested on voluntary action, some of which would have to come from the jointly owned institutions and some from national action. In the absence of legally binding powers or judicial recourse, moral suasion and peer pressure were the main means of enforcing commitments.

Yet the G20 process left a gaping void. To be efficient it focused on the "globally systemically important" economies, but abstracted from possible spill-overs and developments in countries of regional systemic importance. Global and regional processes and arrangements were not linked up. In particular, Austria and Sweden, whose banks owned much of the banking sectors in Emerging Europe, were not part of the G20 process.

The set-up leading to the Vienna Initiative

The quick and effective global response at the G20 level clearly helped stabilize banking sectors around the world, and in this sense it was also helpful for the financial systems in Central and Eastern Europe. At the same time, the limited fiscal resources available to governments in these countries and the pressures from policymakers in the home countries of the banks active in the region initially triggered outflows and, more importantly, made liquidity provision by parent banks more difficult.

The potential macroeconomic consequences of the GFC were severe. While there was no sudden stop as in previous emerging market crises, CEE experienced a gradual withdrawal of credit as international banks started to cut back exposure in these markets.[4] These pressures were fuelled by severe funding mismatches of banks, many of which had relied on wholesale or parent funding. The drying up of liquidity – in particular in foreign exchange – forced instant problem recognition in the CEE.

However, coordination in Europe faced some specific challenges. On the eve of the GFC the EU lacked clear regulatory, supervisory and resolution mechanisms for its large cross-border banks. The fundamental mismatch between the supranational

4 Analogous retrenchment was occurring outside Europe, notably as European banks downsized their Asian exposures. However, European banks had a much smaller footprint in those markets.

cross-border nature of banks and their essentially national regulatory/supervisory and resolution mechanisms was laid bare when the GFC hit in autumn 2008. For "core" Europe (EU-15), this mismatch was addressed only when the euro area crisis erupted in autumn 2011, leading to the creation of the European Banking Union with a single supervisory system and nascent supranational backstop mechanisms, the beginning of what is today the European Stability Mechanism.

For Emerging Europe, this mismatch had to be addressed much earlier, in late 2008, simply because the region's banking sector consisted of virtually only cross-border banks: most banks in the CEE countries were owned by advanced core EU-15-based parent banks. The Vienna Initiative was brought to life in late 2008 in the debilitating absence of European institutions and coordination structures to deal with cross-border financial stability issues in Emerging Europe.

Cross-border impacts underestimated

Despite these clearly visible signs, politicians and policymakers in Europe were slow in realizing the cross-border dimensions. One of the more striking illustrations was the extension of significantly higher, sometimes unlimited deposit insurance. When, to give an example, Slovenian officials complained to Austrian colleagues that the increase in Austrian deposit insurance had led to significant capital outflows, the Austrians in turn complained that they themselves had experienced outflows after the German government had declared the "absolute security" of deposits. The Germans extended the chain, justifying their action as a reaction to the Irish blanket guarantee on deposits. The governments in CEE, on the other hand, could not credibly respond, as the amounts involved were very large compared to their reserves. In the end, uncoordinated national actions led to deposit volatility and a beggar-thy-neighbour attitude.

There were several scenarios with considerable potential spill-overs. Bombastic statements made by several leading politicians in Western Europe, saying that no taxpayer money should be used to save banks in Central and Eastern Europe, added to the risks.[5] Had these threats been carried out, affected countries would have prevented subsidiaries from transferring money to headquarters. If one country had done so, all countries would eventually have been forced to do the same.[6]

5 The Swedish prime minister Fredrik Reinfelt famously promised that "not a single krona" should go to the Swedish bank subsidiaries in the Baltic states.

6 This scenario was effectively avoided thanks to the EU heads of state meeting of 1 March 2009, where it was deemed against the EU treaties to prevent capital from flowing from one EU Member State to another. There was nevertheless some ring-fencing in many Central and Eastern European countries, but it never led to major disruptions.

In the private sector the challenge was that while it was in the interest of a single bank to withdraw as quickly as possible, the banks as a collective would prefer to draw down on their exposures more gradually to preserve asset values. There was also a lack of communication between parent banks and host governments, and as a result little appreciation for the system effects in host countries of decisions taken at the headquarters of these banks.

Macrofinancial linkages ("doom loop") unknown, real sector thinking prevailing

These uncoordinated actions were all the more problematic as the majority of actors in Europe were still stuck in thinking in terms of the real economy suffering a supply shock. They had not yet internalised the role that the financial sector had come to play over the previous two decades, and still regarded the transmission of shocks as something that occurred through the trade account. The "doom loop" between banks and sovereigns, and between sovereigns and banks, was not really visible yet and certainly had not been factored into policy making in most countries. The cross-border dimension through the capital account was poorly recognized. The probability of contagion was seen as small, each crisis being regarded as an individual country crisis with little cross-correlation.[7]

While CEE supervisors were getting concerned about the risks from poor supervisory dialogue among home and host country authorities, they lacked both the authority and the capacity to act. For example, the Croatian central bank, on behalf of most CEE central banks and supervisory authorities, wrote a letter to the European Commission in 2004 on this problem. Shortly before the crisis the EU had managed, under Slovenian presidency in the first half of 2008, to negotiate a Memorandum of Understanding between finance ministers, central banks and supervisors on modalities of cooperation in the case of a crisis.[8] The final document had some 120 signatories but was of very limited help as the crisis struck. Too many actors jealously guarding national information, no formal coordinating and command structure and above all no final clarity on where losses would ultimately

7 In the early years of the new millennium Klaus Regling, then Director General of the Economics and Financial Directorate at the European Commission had travelled Europe together with the late Max Watson. They had discussed these issues with regulators, central bankers and supervisors, highlighting the risks inherent in financial markets as closely linked as those in Europe. His clear sighted analysis and concerns went unheeded, to the detriment of the European economy.

8 https://www.ecb.europa.eu/pub/pdf/other/mou-financialstability2008en.pdf

impact. Needless to say, the cooperation regime envisaged in the Memorandum of Understanding never played a role in the ensuing crisis.[9]

Personalities do play a role in historic developments, even though their contributions can be exaggerated at times. The genesis of the Vienna Initiative was, however, clearly influenced by the fact that many leading actors in Brussels (and some of the capitals) had still not internalised the enlargement of the EU. Their world view and understanding of economic policies was still resolutely EU-15 centric, apart from severely underestimating the real effects of financial sector events. This led to the view that the financing issues of Western European banks could be alleviated by a retrenchment of operations in CEE. That this would exacerbate a regional real shock to the economies and would add to financial instability instead of resolving it was not clear to all policymakers. These attitudes hampered and delayed the involvement of some Member States, and above all that of the European Commission.

No clear lead institution, especially as European Commission reticent and ECB not too supportive

Lack of a clear lead added to the potential convening and coordination issues that such an initiative faced. The Commission is one of the very few institutions with the institutional structure and reputation that would have been unequivocally respected, and whose call would have been headed by all concerned. Given the reticence of the Commission, the European Central Bank (ECB) at the outset felt obliged to play a low-key role, perhaps out of institutional solidarity but also because it was also just learning on the job in many respects. In particular, it did not provide real currency swap arrangements to CEE countries such as Poland and Hungary in 2009 (unlike the US Fed, which had done so for Mexico, for example).[10]

It was symptomatic that the intervention from the Commission in the first informal Vienna meeting was about the asymmetry in the government support provided by the EU-15 and the support offered in the countries in Central and Eastern Europe.

9 It is worth mentioning the agreement signed by the authorities in the Nordic and Baltic region post GFC. This Nordic-Baltic Memorandum of Understanding of the Nordic-Baltic Stability Group was first signed in 2010. The document is not legally binding, but it goes quite far in spelling out the obligations of the authorities which have signed up, particularly when it comes to how to share the burden in a financial crisis in the region. While the Nordic-Baltic Memorandum has never been tested, it served as an important benchmark as the Vienna Initiative was revised in late 2011 to respond to the deleveraging pressures on the banks in non-EU SEE countries.

10 We should clarify that the ECB did provide swaps to these countries but only against euro-denominated assets. These naturally did nothing to help with currency mismatches but curiously eased market concerns that did not recognise this difference. (Half of the ECB swaps for Hungary were reported to have been converted against local currency collateral in autumn 2009.) The ECB did provide real currency swap for Sweden (a non-euro-area member), which in turn passed on these swaps to Baltic countries where Swedish banks operated. More importantly, ECB liquidity support to parent banks did trickle down to subsidiaries thus indirectly helping CEE countries.

At the time EU institutions also lacked both a mandate in financial supervision and a dedicated framework for dealing with bank restructurings.[11]

An important issue was also that not all countries affected were EU members, first and foremost Ukraine.[12] These countries benefitted from the home country guarantees provided to parent banks, and from the decision to prevent national authorities from impeding banks from supporting their subsidiaries abroad, but they were also exposed to the same pressures as the Central European EU members.[13] *A fortiori* most countries concerned, at least as far as the host countries were concerned, were not members of the euro area – an issue which has become more important with the formation of the Banking Union and strengthening of the mechanisms for financial supervision and the financial safety net.

Results in IMF and EBRD taking the institutional lead

Given this situation at the European level, the regional knowledge and policy capacities of the IMF and EBRD made them acceptable as the lead institutions at the start, as the Commission was unwilling to take on that role. The IMF had deeper knowledge and experience from previous financial crises around the world and naturally had well-established contacts with regulatory and supervisory authorities in the concerned countries, while the EBRD had a deeper understanding of the situation in the individual banks active in the region and a freer role in communicating with the private sector. Both institutions took on expanded responsibilities. The IMF had to take on an initial lead role in the EU. The EBRD had to move into policy issues to help steer policy and private sector thinking towards a coordinated approach. As the mandate and set of tools of the Commission increased it took on a more equal or even lead role, including a larger share in financing.

It was less clear who should be convening and coordinating the participating countries and other actors. The issue was definitely not one for the EU presidency, which at the turn of the year had passed from France to the Czech Republic. Neither

11 Throughout the crisis the European Commission dealt with bank restructurings through competition policy, initially even without distinguishing them from non-financial corporations.

12 Ukraine was invited to participate in the Vienna coordination exercise (in fact the first preparatory "Vienna" coordination meeting took place in Kiev in December 2008), and it was initially represented by a Deputy Governor of the National Bank of Ukraine. After Maidan in 2014, the EBRD and the IMF also initiated a special forum to manage deleveraging in the foreign banks, including the Russian banks, represented in the country. Ukraine then also participated in a Full Forum in Brussels later the same year.

13 An unintended consequence of the determination that home country authorities could not prevent parent banks from providing liquidity to their subsidiaries was that subsidiaries in countries outside the EU could also be supported – once the capital had left the home country it could be redirected to a country outside the EU.

was there an established group or setting such as the G20 which had clear rules on which country would organize meetings at which point in time.

In this chaotic setting the Austrian Ministry of Finance took on the organisation and convened the first meetings in January–March 2009 in Vienna, closely working with the EBRD and the IMF. Austria invited the key home and host country authorities of parent banks, international financial institutions and the European Commission; the ECB and the Committee of European Banking Supervisors (CEBS), the nascent European Banking Authority (EBA), participated as observer. The first meeting adopted the name "Vienna Initiative".[14] The EBRD hosted the Vienna Initiative Secretariat from the outset.[15]

Both home and host countries of banks active in CEE participated from the very beginning. However, the level of engagement differed. Germany only sent rather low level and mostly no representation. The Nordic home countries participated, but they largely viewed their problem as confined to the Nordic-Baltic region. Even getting the host countries to participate was by no means as easy as one might expect. One central bank from outside the EU claimed that it could not afford the price of a plane ticket to Vienna (the Austrian taxpayer happily obliged). There was definitely a concern in some quarters, particularly in Bulgaria and the Czech Republic, which had until then weathered the crisis better than some of the other CEE countries, that there would be a stigma associated with the initiative that could lead to further outflows.

Participants came mainly from ministries of finance and the central bank, plus at times also supervisors – finance ministry participation was viewed as critical as burden-sharing was an important part of the discussions. Within the European Union there is a well-established network of senior officials of finance ministries and central banks who meet at least once a month in the Economic and Financial Committee (EFC). Central bankers and supervisors have their additional separate institutional cooperation. This well-structured and regular cooperation has been further deepened over the last decade.

14 Initially, we thought of calling it "Vienna Club", modelled on the Paris Club and the London Club, which manage official and private sector debt restructuring, respectively, but we settled on "Vienna Initiative" to reflect the voluntary, cooperative, multi-player and continuous characters of the endeavour. Later, as the Initiative had made good progress and the European Commission assumed a lead role for EU-wide policies and coordination, it was agreed that the European Commission and the IMF would jointly lead the effort, which was given the rather anodyne name of the "European Bank Coordination Initiative", which never really took hold, participants and markets preferring to use the original Vienna Initiative name.

15 Pistor (2012) calls the EBRD an "anchor tenant" of the Initiative – a non-dominant flexible player that can credibly create motivation for important others to engage.

The institutions directly affected, the banks themselves, did not participate directly in the meetings of officials at the outset, but their joint letter in late November 2008 to EC President Barroso and G20 french presidency (finance ministers and central banks), copied to the heads of the EBRD, EIB and the IFC, helped nudge policy thinking towards a more supranational crisis response. Bank views were initially taken on board through separate meetings, the results of which were channelled into the meetings of officials. Over time these separate meetings become more formalised and larger joint meetings were organised back-to-back, though they became rather large, with more than 100 people around the table during Annual Forum discussions.

The separate meetings of the public sector were also important as confidentiality was critical to the discussions, particularly within the public sector. An important contribution to these meetings later came from the Bank for International Settlements (BIS) which produces very important data on changes in bank exposures over time. The lag between collection of these data and eventual publication was, in the early years of the crisis, more than nine months. Thanks to the willingness of BIS to share these data in preliminary form with the public sector participants, the lag could be reduced to four months.

In parallel, investing IFI members of the Vienna Initiative – the EBRD, the EIB (with the largest balance sheet), the World Bank Group including the International Finance Corporation (IFC) and the small but proactive Multilateral Investment Guarantee Agency (MIGA) – developed a large joint financial package called the Joint IFI Action Plan (JIFIAP). This was launched in late February 2009, and ultimately provided €33 billion (US$40 billion) to banks to support their commitments under the Vienna Initiative. Along with the large IMF and EU balance of payments support, the sizeable JIFIAP helped market confidence and financing to the real economy in a high-risk environment.

The delivery on the Vienna commitments was thus simultaneously supported by the IFIs and the EU for those at risk: host countries and commercial banks. The Vienna Initiative was about both coordination and funding.

Incentives and commitments under Vienna

The Vienna Initiative is a special form of what is called a private sector involvement (PSI) exercise, in which the IMF had extensive experience during the Asian crisis and in Latin America over the decades. At the core, PSI commitments imply a burden-sharing in the case of financial crises and minimise the amount of public money used to bail out the private sector. The IMF stressed the importance of PSI early on, and precursors of the later Vienna Initiative commitment letters were signed as part of the programme in Hungary in autumn 2008.

But the Vienna PSI mechanism differed in important aspects, which may inform future crisis management. It was a regional, multi-country, public-private sector commitment device to address a well-defined common objective. Private banks' commitments were contingent upon policy delivery by host countries and backed by IFI and home country support; host country policy delivery was backed by IFI and Commission support and private bank commitments; and the IFIs shared the crisis-related high risks of their transactions through each others' participation. For the first time IFIs acted not as individual (and sometimes excessively competing) institutions but as a joined-up system.

The enforcement mechanism of the Vienna commitment letters were "light touch": these were not legally binding and there were no "sanctions" for defectors.[16] Yet the coordination was not a simple "mediation" between home and host countries, or banks and IFIs (Pistor 2012): the Vienna Initiative created ground rules for an informal governance framework that required a degree of transparency and extensive collaboration among the stakeholders to effectively stabilize the financial system. These ground rules were simple but powerful: open discussion among all relevant stakeholders; publicity about commitments made; and trust and authority bestowed to the IFIs and eventually the Commission.

The basic principles for crisis management and quid-pro-quos were explicitly agreed upon during a series of meetings of the official sectors and IFIs in January-March 2009. The development of these "Vienna principles" was led by the IMF. Host country authorities were responsible for appropriate macroeconomic policies and liquidity support in local currency irrespective of bank ownership nationality, as well as for funding their deposit insurance schemes. Parent bank groups and the home country authorities behind them were responsible for providing funding in foreign exchange and recapitalising subsidiaries. IFIs were responsible for providing as much support as possible within their remit and coordinating their assistance closely.

16 The first fully-fledged parent bank commitment letters were signed in Vienna by parent banks active in Romania and Serbia in late March 2009; others (including for Hungary) followed quickly. Subsequent country review meetings to assess the delivery of bank commitments were linked to IMF-EU programme reviews.

Impact

The GFC-related crisis management phase of the Vienna Initiative was concluded by early 2010, but participants, and most importantly the Commission, opted to continue. The Initiative has since evolved with conscious modifications in response to evolving financial sector risks. During the "Vienna Plus" phase, joint public-private working groups were set up to address these risks: foreign exchange lending; rising non-performing loans; impediments to access EU funds; and so on. Each working group was led by one of the IFIs or the Commission.

The euro area crisis reactivated the original crisis-management mode ("Vienna 2.0") in 2011. And as Southern European countries have been moving closer to EU membership, the geographic focus of the Initiative has shifted to that region, supporting them to build linkages with the European Banking Authority, which has become an important player in the subsequent Vienna Initiative phases, and the ECB, which has also worked closely with the Initiative and backed important Vienna Initiative issues such as foreign exchange lending risks and addressing the rising problem of non-performing loans (NPLs).

The Vienna Initiative's governance structure also evolved, with the formal establishment of a Steering Committee in 2009 and later the arrival of its inaugural chairman, the President of the National Bank of Poland, Marek Belka, in mid-2012, as the fallout from euro area crisis intensified. This enabled more structured work and gave a stronger role to the host countries in the process.

In sum, the meetings of the Vienna Initiative in the first few years had a very diverse make up, with numerous institutions, agencies and actors participating, most of them contributing actively in discussions, problem definition and problem solving. Given the gravity of the situation, the lack of formal structure, rules and precedent proved not to have been a major obstacle, and the related flexibility proved beneficial when quick actions were needed in often rapidly changing environments. This was to a certain degree due to the good will and strong incentives of many of the people and institutions involved, but also to a measure of good luck.

Implications

Problem recognition was delayed, despite the GFC having shown the magnitude and rapidity of financial contagion issues. There were no established structures or rules that actors could rely upon. There was thus no algorithm for defining a lead institution or a coordinator, for the provision of analysis, or for the development of policy options and their implementation.

Yet more than at the G20 level there was a clear "do ut des", and the spill-overs from the failure to coordinate were more immediate and much larger due to the geographic proximity and advanced integration of the financial sectors in the countries most affected. In this context a number of key institutions internalised these spill-overs, including the IMF, with existing and prospective programmes in several of the countries, the EBRD, with investments in more than 200 banks in the region, and the private banks which had many subsidiaries in several countries, in some cases numbered in the double digits.

What do we learn for the future?

Next time will be different, because of the measures taken since the crisis and because the source of the crisis is likely to be different. The regulatory and supervisory framework put in place through the Banking Union and other supportive structures is something of which those present at the creation of the Vienna Initiative could only have dreamed. Yet, history tells us that the triggering factor in a particular crisis is different from that in the preceding one. Next time one may occur in regions of the world where institutional setups are different and where financial integration has taken on other forms. Nevertheless, we may try to draw some conclusions from the genesis of the Vienna Initiative.

Despite current attempts by major actors to roll back financial integration and multilateral cooperation, cross-border issues will not go away. Financial sector interlinkages will remain strong in one form or another. The current tide of retrenching cross-border banking is likely to recede, and other channels for cross-border flows, possibly more volatile, will grow stronger – the economic logic for these flows is, if anything, likely to strengthen. Even though the reforms of the last decade have made the financial sector more resilient, spill-overs between the financial sector and the real economy will also be important in future crises.

The overall risk level in the part of the European financial system addressed by the Vienna Initiative has undoubtedly decreased – in part as a result of the improved regulatory and supervisory framework and in part because of actions taken by the individual banks operating in the region. More local savings have been mobilized and cross-border flows have been cut back to safer levels, but the net effect is most likely that financial access and opportunities for risk diversification have both become more limited in most countries in Central and Eastern Europe. The impact would have been even greater had it not been for the expansive monetary policy pursued by the ECB, which provided ample liquidity that trickled down even to non-members of the euro area through cross-border banking. When the policy stance shifts, pressures on these financial systems are likely to increase substantially.

There are also remaining coordination challenges not fully addressed by the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism. Even in their full-blown form they would mainly address the problem of coordination within the public sectors – across and between levels of regulation and supervision – but these measures will not really deal with the coordination within the private sector and between the parent banks and host-country regulators and supervisors.

In order to mobilise the true potential of the European financial system inside the EU and adjacent regions and increase its resilience we need to find ways of further strengthening the institutional framework. We suggest the following lessons from the Vienna Initiative.

Effective macrofinancial surveillance is key to crisis prevention. This will entail a larger role and deeper interaction between national and regional macroeconomic analysis and interlinkages with financial sector risks. Surveillance efforts by countries, the Commission, the IMF and others need to be part of a comprehensive framework for stress testing financial systems and linkages, with close cooperation among players (see also below) a key to success.

Close cooperation in times of need has to build on close cooperation in good times. This was instrumental in swiftly knowing who could contribute what in crisis times. Thanks to established track records, trust already exists. Building up cooperation structures is much more difficult once a crisis has hit. Cooperation in peacetime should also involve preparation for cooperation in war. Stress-testing existing structures and running through scenarios to determine what burden-sharing might look like are good ways to anticipate issues and address them preventively.

Clear structures with clear responsibilities are important, and they need to rest on voluntarily accepted principles. Such formats existed to some extent at the G20 level, but were largely absent in Europe before the Vienna Initiative – there was precious little in the global agreements that could have helped coordination within Europe. Global and regional structures must be made more compatible with a complete coverage of regions and sectors by institutions and procedures that can swing into action if a crisis occurs. Current discussions on stitching together the Global Financial Safety Net need to go further.

Designation of leadership is essential as agents have overlapping responsibilities and interests. In the case of the EBRD, the IMF and, slightly later, the World Bank, IFC and some others, this was fairly easily solved, as complementarity was high and interests aligned, but with other actors this could have become a tedious process. Within the EU we can be certain that nowadays the lead institutions would be clearly defined. They would happily acknowledge their responsibility, and their role would be accepted by all. This division of labour has evolved throughout the euro area crisis and thanks to the joint work on European Financial Stability Facility/European Stability Mechanism programmes over the years. The question, of course, remains of how to ensure such clear attributions of responsibility outside the EU. For future crises that straddle the EU and its neighbours, we will need to think of the role of the IMF in Europe, with a sharing of responsibilities as well as of financial burden. We may also want to reflect on whether the ESM should have a role outside the euro area, or even outside the EU.

A continuous structured dialogue is needed at different levels to ensure that these issues are present in the minds of decision makers and translated into action. At the European level it would also be good to have regular meetings, building on concrete policy projects, in good times. But these reflections are needed at the level of sub-regions and individual countries as well.

A more balanced engagement of home and host country supervisors is needed. There was an important home country bias in the regulatory and supervisory framework at the time of the Vienna Initiative. Home country authorities as the "lead regulator and supervisor" were supposed to be responsible. These arrangements obviously failed. The creation of the Single Supervisory Mechanism was meant to address these shortcomings, but some of the bias still persists as host country perspectives are not always properly reflected in the analysis and actual decisions. The Vienna Initiative tried to compensate for this bias rooted in underlying power structures and often weaker institutional capacity of host countries by creating the so-called host country financial stability fora to strengthen the host country perspective.[17] Such conversations can also be part of the pre-accession process for candidate countries, but would require a separate format for those countries where accession

17 These meetings involve representatives from both home and host country regulators and supervisors, as well as representatives from finance ministries and private sector banks present at the table along with the ECB and the international financial institutions. They have become an increasingly important means to ensure that systemic issues in individual host countries were taken into account in the decisions taken by regulators and supervisors as well as bank headquarters in home countries. This approach, along with several other features of the Vienna Initiative, are now "integrated features of the European financial architecture", as the then Commissioner for Financial Affairs, Michel Barnier, expressed it in 2014.

is not foreseen, at least for now. The split mandate between the SSM and national authorities is here a complicating factor as both EU-level and national institutions need to be sensitized to the host-country perspective.

Deeper cooperation, information sharing and strengthening of supervisory colleges are also needed, particularly when non-EU members are involved. Transparency about financial sector issues and the health of national systems is well established within the EU, but more needs to be done in and with some of the countries outside the EU. This has been a focus of the Vienna Initiative in recent years. Other regions are institutionally and constitutionally less closely linked and intertwined than Europe. Without institutions and legal frameworks, let alone supervisory cross-border institutions, preparations must take account of these facts. The mutual reticence even of EU supervisors before the crisis is a good indicator of some of the issues that need to be addressed. Setting up regular exchanges of information on the financial sector, ensuring that all relevant actors are institutionally acquainted with each other and providing and setting up at least a framework for increased transparency seem to be realistic ambitions.

IFIs should be working as a system. It was under the Vienna Initiative and the Joint IFI Action Plan that IFIs started to work as a system and not as separate and sometimes excessively competing entities. Policy options including conditionality were shared among IFIs and joint missions were conducted to maximize the impact of individual IFI funding. Joint coordinated actions also meant effective risk-sharing, with IFIs taking comfort for their individual balance sheets from each other's crisis-related engagements. More needs to be done in this area, as the recent G20 Eminent Persons Group report (2018) highlights, but the seeds of close IFI collaboration in Europe were sown under the Vienna Initiative.

Strategic engagement of the private sector is needed in policy coordination and implementation. When the global financial crisis hit, banks were among the first to alert policymakers of cross-border dimensions; in subsequent years the Vienna platform has benefitted from the insights and knowledge of banks, and their commitments served as leverage vis-à-vis other Vienna participants, most importantly host countries to deliver appropriate policies under IMF/EU programmes. The process naturally must be carefully managed to avoid regulatory capture while maximizing private sector buy-in.

"Soft power" and publicity should be used with publicly made commitments and continuous monitoring. Bank commitments in the form of joint public letters were not legally binding – but they were made public and closely followed by the media. Publishing monitoring reports such as the *Deleveraging and Credit Monitor*, the *Banking Survey*, the *Reports of the Joint IFI Action Plan* and related investor calls also helped credibly inform markets at crucial times.

Regional and sub-regional arrangements should be linked to the global safety net. An important issue is also the link between regional arrangements and the global safety net. There is a clear interest in having a central institution, the IMF, engaged in these issues in all regions, as the dimensions of cross-border issues may not be only regional but also spread beyond. Regular dialogue between participants in these different regional set-ups should be encouraged, and efforts should be made to ensure the interoperability of structures and procedures. It would probably be helpful if the global institutions and those at regional level could draw on each other's procedures. For example, qualification for liquidity support from the IMF could also trigger complementary support from regional frameworks. Information exchange should also protect the integrity of the views expressed by different stakeholders to ensure that different perspectives are taken into account in decision making.

These proposals still do not provide final solutions to the problems in terms of analysis and problem recognition. Challenges will continue to evolve with the structures of our economies. Within Europe, membership in the Monetary Union may over time impact the policy-making capabilities of national actors, which may be a risk at some stage in the future. What appear to be missing are regional and global policy shops where best practices in analysis in policy are shared. The IMF has such a role for mainly junior policymakers, but there appears to be a need in all regions for all levels of policymakers and politicians to engage in a more professional debate.

Concluding remarks

Regional and global financial stability is a global public good. Its provision cannot be left to market forces alone, or to the workings of a benevolent hegemon. This needs to be recognized in good times. Globally and regionally we can build on existing structures and institutions.

In the end, the Vienna Initiative has been a success thanks to the good will and strong incentives of many of the persons and institutions involved, the gravity of the situation that was recognized at an early stage by some and a fortunate alignment of the stars. Whether the same coordination would be achievable with the current nationalistic tendencies is not clear. Yet, preparing structures for even deeper cooperation than we see at present would be a benefit for the future.

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CHAPTER 3

A perspective from the World Bank Group

by World Bank and IFC staff*

Abstract

After more than ten years from the start of the 2008 financial crisis, it is very timely to remember how critical things were at the time and how close we were to a full meltdown of the financial systems of several countries globally and in the Central, Eastern and Southeastern Europe (CESEE) region.[1] It is significant that, for a change, the financial crisis did not start at the periphery of the international financial system in an emerging economy, but originated in the largest economy, hub to the most important international banks and largest capital market. The crisis spread from the financial centre, impacting most countries in the world. This note focuses on one of the regional responses (the Vienna Initiative) to contain the crisis and avoid a much deeper contraction of financial intermediation, with the possible failure of domestic systemically important financial institutions (D-SIFIs), combined with a possible balance of payments crisis and steeper credit and economic contraction.

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1 Central, Eastern and Southeastern Europe includes Albania, Bosnia-Herzegovina, Bulgaria, the Czech Republic, Croatia, Estonia, the Republic of North Macedonia, Hungary, Kosovo, Latvia, Lithuania, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia, all members of the European Union, candidate or potential candidate countries.

The Origins of the Vienna Initiative: Urgent Need for Collective Action

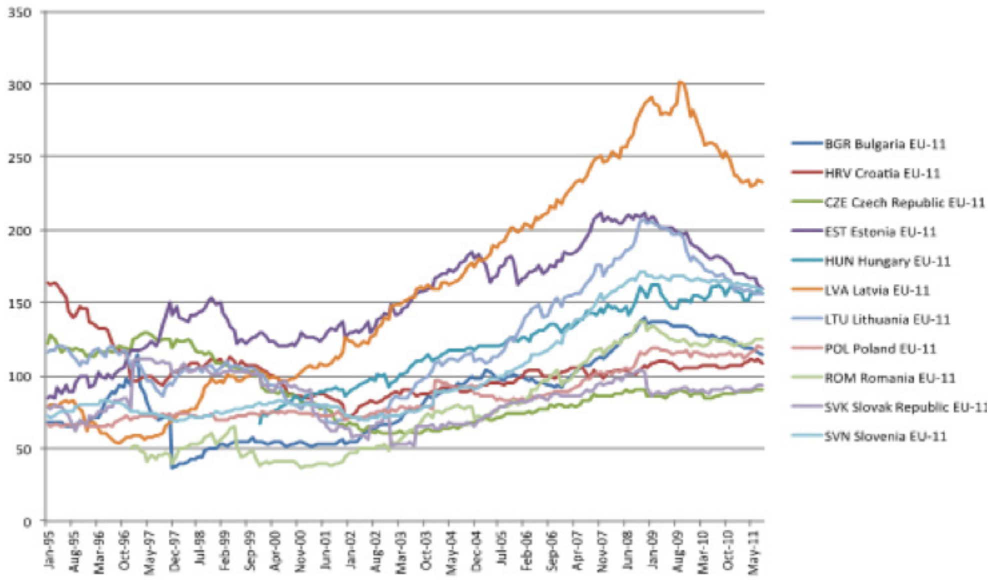
Build-up of risks prior to the crisis

After the fall of the Berlin Wall and the adoption of a market economy model, new EU Member States in Central Europe and countries in the Western Balkans experienced a rapid privatization of their financial systems and the entry of regional international banking groups to the local markets through the purchase of local banks, either establishing subsidiaries or opening branches. The rapid expansion of cross-border banking coupled with a lack of sufficient domestic financial savings led to a banking model with the following characteristics.

1. High dependence of subsidiaries and branches of foreign banks on financing from the parent banks, resulting in a rapid credit growth, mostly foreign financed (mainly from Austrian and Italian banks), with extremely high loan-to-deposit ratios (LTD) – as shown in Figure 1. Broadly speaking, LTD ratios of around 3, like the one reached by Latvia in mid-2009, mean that only one-third of the bank loans were funded with domestic deposits, while two-thirds were funded with possibly more volatile and expensive sources (e.g., wholesale funds, parent bank financing, syndications or issuance of Euro-bonds); and
2. Built-in currency mismatches, as lending was largely provided in foreign currency mostly to unhedged domestic borrowers and often with large duration gaps (as many of the long-term housing loans were financed in foreign exchange with shorter-term financing).

Banking systems in many CESEE countries went through major credit booms in the pre-crisis period, when financing from parent banks was ample. Consequently, countries in the region experienced rapid increases in household and corporate indebtedness and booming asset and real estate prices. When the inflows of financing dried up, banks in those countries faced rising levels of non performing loans (NPLs) while remaining highly dependent on parent banks providing liquidity and funding in an environment of shallow or inexistent local funding markets and over-indebted borrowers with poor information but presumably with high debt-to-income (DTI) and debt-service-to-income (DSTI) ratios. Aspirations to reach EU standards of living had been running ahead of citizens' capacity to service debts, particularly as domestic currencies depreciated against the various foreign currencies (euro, Swiss franc, and Japanese yen) in which many mortgages were denominated, with the misleading incentive of low interest rates but large ignored foreign exchange risks that ended up materializing during the crisis.

Figure 1.
Loan-to-deposit ratio, in percent



Source: World Bank Global Financial Development database.

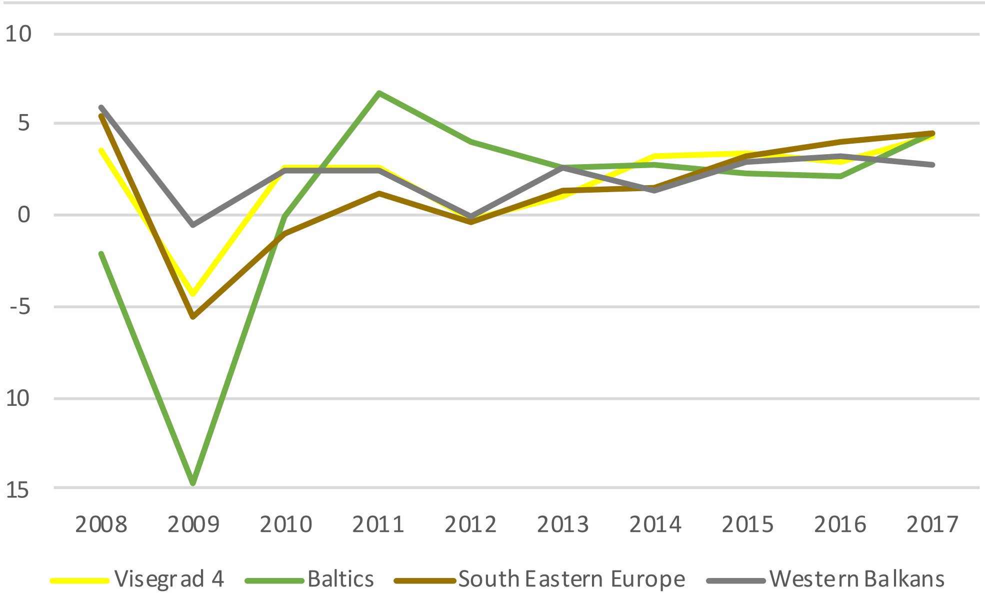
The presence of foreign-owned banks with a systemic footprint in host countries in CESEE, combined with highly dollarized economies, significantly restrained the authorities' policy options when market conditions took a drastic turn for the worse in 2008, with liquidity crunches followed by eventual insolvency – as NPLs skyrocketed and bank losses increased. In the immediate aftermath of the Lehman Brothers failure, external financial markets largely closed for banks (euro bonds, wholesale funding and syndications), creating a major problem for banks to meet their refinancing needs, with firms and individuals in those countries increasingly defaulting on their obligations. Even some of the strongest institutions and systemically or regionally important banks were faced with liquidity stresses until the European Central Bank (ECB) and the US Fed intervened massively to provide liquidity (to "do whatever it takes" to save the euro system) and provide dollar financing, respectively.

In the CESEE region, this situation was aggravated by the significant currency and maturity mismatches in the banks' balance sheets, with several countries facing serious housing crises and political pressure to convert foreign-exchange-denominated loans at favourable exchange rates, passing enormous losses to the foreign banks and their subsidiaries.

While a regional systemic financial crisis was avoided, real gross domestic product (GDP) growth fell sharply in most countries and a "V-shaped" deep recession was unavoidable during the years 2008-10 (see Figure 2). The economic contraction was more severe in the Baltic countries, which had the highest LTD ratios and were more dependent on external financing, which closed completely at the time, resulting in a sudden stop of credit, extremely high NPLs, high unemployment and overall economic distress. Things were made more difficult with the onset of the Greek sovereign crisis and the risk of contagion through the Greek banks being present in several countries in the CESEE region.

Figure 2.

Real GDP growth, in percent



Source: *WB staff calculations based on October 2018 IMF WEO database.*

Note: *Visegrád 4 are Hungary, Poland, Slovakia, Czech Republic. Baltics are Estonia, Latvia, Lithuania. South Eastern Europe includes Bulgaria, Croatia, Romania. Western Balkans includes Albania, Bosnia-Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia.*

The need for collective action

A collective action problem occurs when all stakeholders would be better off cooperating but fail to do so because of conflicting interests, the presence of "free riders" and the inability to exclude them. At the time of the crisis there was a big risk of a diverging scenario, with host authorities trying individually to "ring-fence assets" of subsidiaries/branches at the national level, while home authorities were trying to contain parent banks' losses – independently of the effects on host financial systems – repatriate profits and bring more capital to the centre (under pressure from the home regulators to raise more capital). This was a very dangerous situation, which could have had a high probability of triggering disorderly deleveraging processes as a result of uncooperative actions, amplifying stress on banking sectors in CESEE host countries.

On the contrary, an effective response to the collective action problem could restore market confidence benefiting all stakeholders. However, it was not easy to achieve this level of cooperation given the need for: i) avoiding a "rush to the exit" (i.e., exiting a jurisdiction under threat); ii) providing sizeable countercyclical funding; iii) adopting sounder domestic macroeconomic policies and resisting populist policies to benefit national debtors at the expense of foreign banks; and iv) strengthening domestic regulatory and supervisory frameworks and capacity.

The biggest concern at that stage was the sustainability of the proposed collective solution. It was critical to avoid a short-term approach, in which major foreign banks could have just exited the host markets, after the provision of countercyclical funding by IFIs, essentially converting the IFIs into lenders funding capital flight from a particular borrowing jurisdiction.

The critical role of IFIs

IFIs were seen as "honest brokers", able to use their reputation, convening power and lending to bring all stakeholders to the table (home and host regulatory authorities and governments, the European Commission (EC), foreign banks and their subsidiaries, IFIs and international private lenders) to implement a collective solution. IFIs were able to play a neutral and constructive role (as non-interested parties) and, at the same time, collectively provide sizeable countercyclical funding. Also, the decisive action of those IFIs leading the effort was critical in overcoming initial doubts and distrust, restoring confidence and facilitating the participation of all critical stakeholders in maintaining their exposures at national levels and launching the Vienna Initiative.

The IFIs' strong commitment to support the region materialized in the sizeable and complementary funding programmes that were delivered to the CESEE countries. Under the Vienna Initiative, IFIs launched the Joint IFI Action Plan (JIFIAP, discussed further below) in February 2009, with two main objectives in mind: i) to support local banking systems, prevent their failure and/or exit from new EU member countries and the countries in the Balkans; and ii) to prevent or mitigate an even more serious credit crunch with a devastating negative impact on the real economy of these countries. A pragmatic division of labour was for the International Monetary Fund (IMF), International Bank for Reconstruction and Development (BRD) (policy dialogue through Development Policy Loans) and EC be involved in the macroeconomic policy dialogue, while the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) would focus on assisting the private financial system stakeholders. The Vienna Initiative had built-in flexibility with joint assessments of the economic conditions and financial strength of regional banks, but with each participating institution using its own methods and internal guidelines in its lending decisions. The approach was initially more about "learning by doing", as there was no *ex ante* blueprint to guide the process.

Private banks' engagement was critical to providing a sustainable solution. In January 2009, the representatives of the IFC, EIB, EBRD and EC held a meeting in Paris, where the need to meet with major European banks was voiced. In particular, it was important to understand private banks' perspective on expected regional development in 2009-10, the financial needs of their subsidiaries in the region and to identify a proper strategy for IFIs financing support to the region. For that reason, in the three months following the launching of the JIFIAP, a series of meetings took place with the largest banking groups operating in the CESEE region (controlling 60 percent of bank assets in the region). The meetings with the private banks were attended by the IFC representatives, who also acted on behalf of MIGA. In March 2009, the first set of parent banks signed commitment letters to maintain their presence and recapitalize their subsidiaries based on the stress test results in Romania and Serbia. Subsequently, such commitment letters were signed for Hungary, Bosnia-Herzegovina and Latvia. The first Full Forum meeting in September 2009 of the EC, IMF, EBRD, EIB, WBG and ECB with 17 systemically important EU-based parent banks of subsidiary banks in CESEE and their home and host country supervisors, fiscal authorities and central banks was a reflection that collective action solutions could be achieved. A combined effort to coordinate appropriate host government policies, major international support and parent bank engagement helped stabilize the economies in the region. Bank groups benefited from a stabilizing macroeconomic environment and access to the funding under the *Joint IFI Action Plan* launched by the EBRD, EIB and the World Bank Group (WBG).

As mentioned earlier, the JIFIAP was launched on 27 February 2009 to support the banking sectors in the CESEE region and to facilitate lending to businesses hit by the global economic crisis. The drafting of the Plan was done in close cooperation with the European Commission, key European institutions and the IMF. The initial commitment under the JIFIAP of up to €24.5 billion was exceeded by a significant margin. Upon its completion at end-2010, more than €33 billion had been made available by IFIs in crisis-related support for the financial sectors and for replenishing the foreign exchange reserves of countries in the region, of which €28.6 billion were in the form of signed loans. The contributions provided by each IFI were as follows: EBRD €8.1 billion, EIB €15.5 billion and WBG €9.6 billion – out of which the IBRD delivered €5.2 billion, €2.4 billion the IFC and €2.6 billion MIGA.

Sluggish economic recovery in many CESEE countries and their trading partners in the post-crisis period, as well as intensified cross-border bank deleveraging pressures on the backdrop of the European sovereign debt crisis, prompted the need for further reassurance of commitment by the IFIs to the CESEE region. In 2012, there had been a significant slowdown in economic activities in all CESEE countries, with real GDP growth in 8 out of 16 countries falling negative or trembling below 1 percent (Figure 3). Weak external environment, countries' internal vulnerabilities, high volumes of non-performing assets in the banking sector and stricter regulatory requirements introduced as part of the establishment of the European Banking Union fueled the fears of prolonged instability in the region.

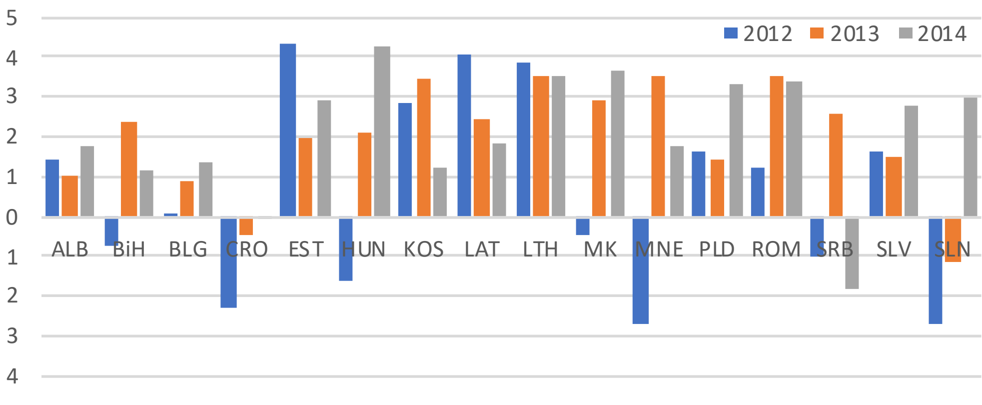
In November 2012, the WBG, EBRD and EIB launched the *Joint IFI Action Plan for Growth* in the CESEE region under Vienna Initiative 2.0. The *Joint IFI Action Plan for Growth* was a second phase of the IFI commitment to provide financing to the CESEE region that aimed to restore growth in the crisis-hit region by supporting private and public sectors initiatives, including those in infrastructure, corporate investment, and the financial sector. Under the *Joint IFI Action Plan for Growth*, the three IFIs committed to provide up to €30 billion in new funding to CESEE over the following two years. At the end of 2014, the IFIs delivered €42.7 billion, which is significantly higher than was initially planned, of which about €7 billion was delivered by EBRD, €28.3 billion by the EIB Group and €7.4 billion by the WBG, including €4.9 billion by IBRD, €1.4 billion by IFC and €1.1 billion by MIGA.

The coordinated and cooperative approach applied by the IFIs proved to be effective in preventing a full-scale crisis in CESEE and in maintaining confidence in the financial systems in the region in the post-crisis period. The IFIs played a significant role in bringing to the table all key players from the EU authorities, home and host governments, major banking groups, the IMF and other donors to work out the details of a comprehensive, collaborative and effective solution for supporting the

CESEE countries in the time of distress. Moreover, the contributions of the WBG, together with the EBRD and the EIB, in the form of coordinated financial assistance to CESEE helped prevent cross-border bank deleveraging, maintain confidence in the financial systems and support the recovery in the region.

Figure 3.

Real GDP growth by country, in percent



Source: IMF WEO database, October 2018.

At the inter-institutional level, as the *Joint IFI Action Plan* concluded: "*... it leaves a legacy of much stronger cooperation between the IFIs than ever before, which will continue in post-crisis Central, Eastern, and Southeastern Europe and which is also ready to be deployed again and elsewhere as needed*".[2] Such cooperation extended beyond the completion of the JIFIAP, with the sixth "Full Forum" of the Vienna Initiative meeting in Brussels on 21-22 October 2013. That meeting assessed recent trends in deleveraging, credit provision and NPLs in the banking sectors of CESEE. It discussed the impact of the recently proposed Single Resolution Mechanism for a European banking union on CESEE. A special session highlighted the particular challenges faced by the non-EU countries of South Eastern Europe (SEE). The Full Forum stressed the urgent need to tackle persistently high NPLs in several countries in the region – thereby also improving frameworks for new lending. For credit to recover, a concerted effort by regulators and banks may be needed to provide the incentives and momentum to break the cycle of low growth and high NPLs. The Forum welcomed the publication of the new harmonized definitions of NPLs and regulatory forbearance by the European Banking Authority (EBA).

2 EBRD, EIB and WBG "Final Report on the Joint IFI Action Plan", March 2011.

Implementation of the Vienna Initiative: WBG contribution

The WBG delivered over €17 billion under the two phases of the JIFIAP in the course of 2009-14. Most of the delivered financing has been in the form of signed IBRD loans. Given the specific nature of the institutions that constitute the WB Group, the IBRD's contributions were mainly policy-based lending and technical assistance on deepening reforms to promote competitiveness, strengthening and diversifying financial sectors, improving energy efficiency and supporting social sector reforms.

Table 1.

Commitments and Delivery of the WBG under JIFIAP and JIGIAP for Growth in billions of euros

Date	JIFIAP (2009-2010)		JIFIAP for Growth (2013-2014)	
	Committed	Delivered	Committed	Delivered
WBG	**7.5**	**9.6**	**6.0**	**7.4**
IBRD	3.5	5.2 /1	4.0	4.9
MIGA	2.0	2.0	1.3	1.4
IFC	2.0	2.4	0.7	1.1

Source: *JIFIAP reports.*
/1 *Including a €1 billion loan to Hungary that was later cancelled at the request of the government.*

The IFC focused on recapitalizing banks, increasing access to trade finance, supporting infrastructure investment and funding for microfinance. It also provided significant value through advisory support to local banks, for example through an advisory seminar in Kiev with the representatives of Ukrainian banks on risk management and on how to manage NPLs. MIGA's guarantees helped support the recapitalization of banks by providing political risk insurance that covered the cross-border capital injections made by foreign parent banks.

A unique way of cooperation within the WBG in the framework of the Vienna Initiative has been beneficial. Joint activities conducted by IFC and MIGA led to a creation of a joint unit of the IFC and MIGA that specializes in cross-selling MIGA insurance products to IFC clients across all industries and globally. Moreover, IFC and MIGA have jointly developed new products, including MIGA's bestselling "Capital Optimization Product", which creates synthetic capital for international banks having subsidiaries in sub-investment-grade emerging markets.

The representatives of IBRD, MIGA and IFC have been actively participating in the Vienna Initiative 2.0 Full Forum, Steering Committee and brainstorming meetings and contributing to the technical discussions on deleveraging, cross-border supervision, NPL resolution, bank resolution, and the impact of the proposed European Banking Union on the CESEE countries.

In accordance with commitments made under the JIFIAPs, the World Bank Group greatly increased its financial support to overcome the consequences of the global 2008 financial crisis in the CESEE region. The key outcomes of the WBG activities in the CESEE region can be summarized as follows:

a) Prevention of a systemic regional crisis by quickly providing liquidity (followed by capital increases from parent banks) and helping restore market confidence via the countercyclical role played by the IFIs' lending, unique in its scale, under the JIFIAP. Countries in Central and Eastern Europe showed earlier signs of recovery from the global crisis than other regions.
b) Parent banks continued to support their cross-border subsidiaries, branches.
c) Most viable local banks managed to stay in business.
d) Banking systems in CESEE have been recapitalized, and bank lending is exhibiting positive dynamics in most CESEE countries, thereby contributing to economic recovery in host countries. However, continued instability in Europe poses challenges to sustainability, given the strong presence of major European banks in the region.

The multilateral approach to mitigate global crisis effects resulted in effective cooperative arrangements to deal with issues beyond the immediate financial crisis response. The WBG president at the time, Robert B. Zoellick, emphasized the importance of multilateralism as a response to the crisis in several of his speeches in 2009 (e.g., "Seizing opportunity from crisis: making multilateralism work", 31 March 2009; and "The World Bank Group beyond the crisis", 6 October 2009).

The activities under the Vienna Initiative and cooperative approach by IFIs, public and private entities inspired the creation of a dedicated World Bank unit based in Vienna, the Financial Sector Advisory Center (FinSAC) to go beyond the short-term crisis response and to provide long-term support for strengthening prudential regulatory and supervisory frameworks in CESEE. FinSAC was established in 2011 with funding provided by the Austrian Federal Ministry of Finance to support client countries in building more resilient and more stable financial sectors. Thematically, FinSAC's work is centred around three pillars: macroprudential supervision and crisis management; microprudential supervision and NPL resolution; and bank recovery. Geographically, FinSAC covers EU candidate and potential candidate countries (Albania, Bosnia-Herzegovina, Kosovo, Former Yugoslavia Republic of Macedonia, Montenegro and Serbia); select EU member states (Bulgaria, Croatia, Poland and Romania); and EU neighbourhood countries (Belarus, Moldova, Ukraine, Armenia, Azerbaijan and Georgia).

Bilateral technical assistance (TA) constitutes the backbone of FinSAC's work programme. FinSAC engages with countries through demand-driven, bilateral TA projects, the organization of knowledge events and analytical work. In practice, it concludes an average of 10-12 TA projects per year, organizes one international conference and one workshop and produces at least one analytical piece. Demand from central banks, banking regulators and resolution authorities has been robust, as illustrated by high client satisfaction scores and the fact that client countries usually solicit follow-up support upon conclusion of projects. A distinguishing feature of FinSAC is the availability of in-house technical experts that are taking the lead in the delivery of FinSAC's work programme, enabling FinSAC to deliver, with its own resources, a core curriculum of financial-stability-related topics.

FinSAC has been playing an important role in building and maintaining deep and continuous engagement with eligible countries on stability-related topics, which, more than a decade after the crisis, have remained a high-priority policy area. To date, it has delivered around seventy technical assistance assignments in sixteen ECA countries, organized ten regional conferences and published nearly ten research and policy papers/briefs. FinSAC has helped ensure the implementation of wide-reaching reforms in crisis-affected client countries that would probably have taken much longer to achieve without this support.

FinSAC has established itself as a knowledge hub on financial-stability-related topics for the CESEE region, and it has emerged as a trusted provider for TA to eligible client countries. Much of client-country demand, particularly from the Western Balkan countries, is motivated by the EU accession process, which requires alignment with the corpus of prudential regulation (i.e., the Capital Requirements Directive IV and the Capital Requirements Regulation) as well as the Banking Recovery and Resolution Directive (BRRD – see Box 1). At the same time, it is a priority for FinSAC to ensure that more generic supervisory and regulatory topics receive sufficient attention, particularly in countries further east that are still grappling with a challenging financial stability outlook (see box 2).

Box 1.
Helping Albania operationalize its new recovery and resolution regime

FinSAC supported the Bank of Albania and other relevant authorities in developing a new legal framework for implementing the BRRD. The technical assistance involved analysing the existing framework and its compliance with international and EU principles and good practice, providing advice during drafting and adopting of a revised legislation as well as during drafting of secondary legislation, preparing methodological documents and providing training to the supervisors and staff from the Resolution Department.

After the new Bank Resolution Law was adopted by the Albanian parliament in December 2016, FinSAC helped the Bank of Albania operationalize the newly created recovery and resolution framework and advance the assessment of banks' recovery plans.

Recovery plans

FinSAC supported the Bank of Albania in communicating new supervisory requirements to the banking industry and provided sample calculations and templates (adapting European Banking Authority (EBA) and EU Single Resolution Board (SRB) information templates to the local framework) to assist in completing recovery plans by local banks. FinSAC conducted a two-day workshop for supervisors on the assessment methodology, using the recovery plans submitted by large Albanian banks. Based on that workshop, the methodology has been adjusted and is now fully implemented for the current and future assessment of recovery plans.

Supervisory capacity building

FinSAC organized a workshop to discuss proposals for integration of supervisory work for recovery planning into other supervisory tasks. The workshop participants have also discussed common features and different approaches in individual supervisory tasks, as well as ways of optimizing and leveraging efforts and ensuring their compliance with international best practices. Based on those discussions, the Bank of Albania has been working on improving internal cooperation between its departments. De Nederlandsche Bank has also been involved to develop information exchange rules between different units within the Bank of Albania.

Creation of a resolution unit

FinSAC has been supporting the Bank of Albania in creating a resolution unit that will be responsible for developing effective resolution planning, including the use of appropriate resolution tools. FinSAC supported the newly created unit in developing a resolution manual, detailing the practical aspects of resolution planning, including the resolvability assessment and the definition of MREL, considering the Bank of Albania's role as a host country. FinSAC provided an opportunity for a staff member of the new resolution unit to spend three weeks with the staff of the EU SRB. This provided a great opportunity for Bank of Albania staff to obtain insights of work at the SRB, as well as practical learning experience of all aspects of resolution planning within the euro area.

Development of legislation

FinSAC has been working closely with various departments within the Bank of Albania to promote coordination and to ensure consistency of resolution legislation with the legislation on banking supervision – e.g., that early intervention measures in the Resolution Law are in compliance with the existing supervisory measures in the Banking Law. FinSAC has also provided advice on drafting the required by-laws.

Source: FinSAC 2017 Annual Report.

Box 2.
Supporting Ukraine in tackling NPLs

Ukraine has one the highest NPL ratios in the world, with NPLs representing more than 58 percent of gross loans as of end-2018. Contributory factors include: the consequences of the global financial crisis and subsequent economic recession; currency devaluation that eroded unhedged borrowers' debt-servicing capacity; the collapse of economic activity in parts of the country; and sharp negative adjustment in real estate prices. A significant portion of the stock of bad loans is concentrated within the corporate sector – the top-20 groups of borrowers account for 49 percent of corporate banking loans.

The World Bank and other international financial institutions (including the International Monetary Fund and the European Bank of Reconstruction and

Development) are providing financial and technical assistance to help address the problem. FinSAC, together with the World Bank local office, conducted a comprehensive assessment of the NPL resolution framework in Ukraine, identifying priority areas for action and thus streamlining the workload of national authorities and external advisers. The methodology used was based on a gap analysis with euro area peers.

A FinSAC seminar in Kyiv in March considered the study findings and took a holistic look at NPLs and the establishment of an effective resolution framework. The complexities of NPL resolution, involving a range of different stakeholders, make such a holistic approach essential to achieving any meaningful decrease in rates. The National Bank of Ukraine responded quickly, enlisting FinSAC assistance in three areas identified as requiring substantial further work: i) collateral valuation identified as problematic in the NPL assessment; ii) NPL write-offs; and iii) NPL governance/workout.

i) FinSAC assessed collateral valuation practices in the EU and shared the findings together with advice on possible improvements for implementation in Ukraine. These included: a) regulations on collateral valuation rules for the banks (e.g., valuation methods used, frequency, minimum requirements for appraisers); b) the construction of a database of real estate appraisals for assets used as collaterals; and c) the establishment of regulation (directly or indirectly) for appraisers that deliver services in the financial industry. Based on this, the Risk Management Department of the National Bank of Ukraine initiated construction of a database for collateral values used in the financial sector.

ii) FinSAC provided a written summary of NPL write-off practices implemented in other countries, including European countries. The document advised implementing a similar mandatory NPL write-off regulation in Ukraine based on quantitative and qualitative parameters.

iii) FinSAC developed a set of Guidelines for Effective Management and Workout of NPLs. This aimed to assist in efforts to issue a binding regulation for banks regarding the functioning of NPL resolution units in banks. The final guidelines reflect extensive discussions with the National Bank and other banks, and World Bank internal review. They cover the main aspects of the workout cycle (i.e., early warning system, identification of NPLs, organization of workout units in the banks, segmentation and best practice for organizing workouts, including workout strategies) and include specific examples of how restructuring could be tackled in Ukraine.

The National Bank of Ukraine also sought FinSAC's advice on their draft regulations on risk management and connected borrowers in the context of NPL resolution. The team delivered written comments to the National Bank experts, which were incorporated in the draft regulations.

FinSAC's assistance in close collaboration with other international financial institutions will continue into 2018.

Source: FinSAC 2017 Annual Report.

The World Bank Group contributions to Vienna Initiatives 1.0 and 2.0 were built on close cooperation with other development partners. During Vienna Initiative 1.0, the World Bank Group provided funding support to the governments (IBRD) and private sector (IFC, MIGA), engaged in policy dialogue with the client countries, and provided technical assistance on a number of pressing issues. The World Bank Group has extended funding support and technical advice to the CESEE region during Vienna Initiative 2.0 in cooperation with the Austrian government.

Future of the Vienna Initiative: Role of the WBG

The Vienna Initiative is a forum for the exchange of views and for coordination/joint action on financial sector development by IFIs, central banks from host and home countries and commercial banks' representatives. While Vienna Initiative 1.0 was focused on western banking groups maintaining exposure to their CESEE affiliates and providing capital and liquidity, as needed, Vienna Initiative 2.0 is mainly geared towards authorities, encouraging them to cooperate. Beyond an active contribution to the preservation of financial stability in participating countries, it provides an important forum for the exchange of experience and discussions around appropriate actions with a goal of financial sector development. (Importantly, there is still no alternative forum where major stakeholders (IFIs, central banks, commercial banks, representatives and risk investors) meet and discuss financial and real sector volatility and opportunities to strengthen the financial sector.) It also serves well as a prevention mechanism through practical monitoring of the deleveraging process and by setting up temporary structures where private and public-sector decision makers meet to exchange experience and discuss appropriate actions. The latter concerns the establishments of different working groups on strategic issues, where World Bank Group actively participates and contributes.

Looking back at years of continuous fruitful collaboration under the Vienna Initiative, the World Bank Group stays committed to working together on future financial sector reform challenges. The World Bank Group will continue to support the client countries in conducting diagnostic activities to ensure resilient financial sectors, and implementing reforms to strengthen financial systems by streamlining supervisory and regulatory frameworks in line with best international practices and developing tailored approaches to dealing with NPLs. The World Bank Group is committed to staying an active member and prominent contributor to the Vienna Initiative agenda. In additional to the ongoing work streams, there are newly evolving potential areas from that countries could benefit from, such as: i) diversification of financial systems; ii) development finance; iii) advances in technologies for providing financial services; iv) innovation and increased productivity; v) development of green finance; and vi) mitigation of risks created by sovereign-bank nexus

Policymakers and regulators in the CESEE region increasingly recognize the importance of furthering **diversification of financial systems**. Diversification of financial markets in the region is key when it comes to the provision of term financing aimed at fostering investments and ultimately economic growth. In that context, the availability of a wider range of financing instruments will be able to benefit the varying needs of households and enterprises. Beyond traditional lending channels, there is an increasing range of financing options for different needs of firms over their life cycle: (i) asset-based finance (asset-based lending, export – buyers and suppliers – credit and insurance, factoring, purchase order finance, warehouse receipts, leasing), (ii) alternative debt (corporate bonds, securitized debt, covered bonds, private placements, crowdfunding (debt)), (iii) hybrid instruments (subordinated loans/bonds, mezzanine finance), and (iv) equity instruments (private equity, venture capital, business angels, specialized platforms for public listing of SMEs, crowdfunding (equity)). Not only the awareness, but also availability of these type of finance is limited in CESEE.

Development finance could also play a more important role in supporting access to finance and economic growth by better leveraging available funding resources, especially in light of the availability of EU structural funds and IFI support in CESEE. Essentially, development banks serve as a vehicle for mobilizing and channeling medium- and long-term capital into the economy and addressing market failures in the financing of priority sectors. Through this, they can facilitate the growth and competitiveness of companies and ultimately the economy under the strategic direction of the government. Even though EU integration has circumscribed the ability of governments to directly support national economic interests, governments have adapted development banks to indirectly implement national economic policy via market-based mechanisms.

Advances in technology are enabling financial services to reach greater numbers of low-income individuals and small firms at lower cost and risk. Recent FinTech developments point to a fundamental re-imagining of the processes and business models of the financial services industry. In this process of heightened disruption, a clear insight emerges – banks and fintech players are naturally interdependent. Fintech players have built a bouquet of innovative products and services on the strong backbone of the banking and payments infrastructure in the country. Banks, on the other hand, have relied on innovative solutions developed by fintech players to better address the needs of their existing customer base. Finally, at the center of the policy debate is the question how this new area of finance should be regulated and supervised.

CESEE countries will benefit from a new and more balanced growth and financing model with a stronger focus on **innovation and increased productivity**. There are still significant gaps in the region's framework conditions, demand, and supply sides of the innovation ecosystem. The Innovation Finance working group concludes that risk capital for the region's companies' growth stages is a particular constraint. IFIs can play a key role in a coordinated effort of all market participants to support the growth of innovative firms.

Mobilizing the required funding for financing sustainable and green economic growth, a great proportion of which is expected to come from the private sector, calls for re-shaping key parts of the financial system and identifying and setting new international standards for investment. To attract capital, growing environmental concerns and action on climate change need to be combined with sustainable economic returns. Governments around the world are taking steps to encourage the **development of green finance** with a view toward mobilizing the needed resources to support economic transformation and maintain competitiveness. While green finance is an emerging segment of financial markets, a range of financial instruments such as green loans, green bonds, green funds and green index products has been developing rapidly. Beyond perhaps energy efficiency and renewable energy financing, the supply in CESEE remains weak.

The **sovereign-bank nexus** reflects the interconnectedness between the health of the sovereign and the banking system, whereby stress in one sector may create and amplify stress in the other. There are two direct channels (bank's direct exposures to the sovereign and the "presumption" of government support to failing banks) and two indirect channels (fiscal and bank interactions with the real sector). The Basel III capital and liquidity accords, the G20 "too big to fail" reforms, the Financial Stability Board's Key Attributes for effective resolution frameworks for financial institutions- and the Basel Committee's review of the regulatory treatment of sovereign exposures all offer relevant measures, but also pose implementation challenges in light of institutional capacity constraints and the level of economic and financial market development in CESEE. Finally, improving transparency and data quality of bank-sovereign linkages and contingent liabilities is critical for surveillance and prudential purposes.

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CHAPTER 4

The European Investment Bank and the Vienna Initiative

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Introduction

The European Investment Bank (EIB) is the bank of the European Union, owned by the EU Member States. The EIB provides finance and expertise for sound and sustainable investment projects worldwide. The EIB's particular strategic positioning – its cross-border operational perimeter – has allowed it to steer policy actions developed either elsewhere (e.g. European Commission) or in conjunction with other IFIs. For instance, the capability to finance projects with both parent and subsidiary banks has allowed the EIB to operationalize efficiently the policy needed to generate a cross-border anchor in times of crisis in the Central, Eastern and Southeastern Europe (CESEE) region during the first Joint IFI Action Plan. Moreover, the EIB has played a key role in the Vienna Initiative, supporting large-scale and operational financial support and providing the largest part of the international financial institutions' (IFIs') financial involvement.

The EIB was a co-founder of the Vienna Initiative and has been an active participant since the beginning. Beyond the crucial co-ordination work aimed at avoiding the withdrawal of the international banking groups from the region, the EIB's support in the form of funding helped to maintain a flow of credit into these economies in times when private sources of external funding had been suddenly severed. The EIB

1 The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB or its shareholders.

has also contributed to the analytical and policy agenda of the Vienna Initiative, being a distinguished thought leader in the CESEE region. The EIB has developed a unique *Bank Lending Survey* for the CESEE region, serving as a public good for monitoring and assessing credit developments in the region. Moreover, the EIB has been proactively engaged in work streams that have had direct strategic and operational impact through its leading role in various working groups of the Vienna Initiative.

Investment support during the crisis

The EIB, together with the World Bank Group (WBG) and the European Bank for Reconstruction and Development (EBRD), launched two Joint IFI Action Plans (JIFIAPs) in 2009 and in 2013 respectively. The first JIFIAP committed €24.5 billion of resources between 2009 and 2010 to the CESEE region. Roughly 45 per cent of the total commitment came from the EIB, 25% from the EBRD and 30% from the WBG.

During the first JIFIAP, EIB lending fulfilled the dual function of supporting both final beneficiaries – small to medium-sized enterprises (SMEs) or small infrastructure projects – and the region's banks, including the majority of large Western European banking groups' subsidiaries in the region.[2] The European Investment Fund (EIF), the subsidiary of EIB focusing on venture capital and guarantees for SMEs, made a wide range of financial products available to intermediaries, from equity and equity-like investments to funding products, in order to address both capital and liquidity issues, always with the objective of stimulating SME financing. One channel of this EIF assistance was the JEREMIE initiative, where the establishment of five Holding Funds in the area started to successfully address the specific regional requirements, often with the development of tailor-made financial instruments. As a result, a number of funded risk-sharing agreements were put in place, combining an upfront funding of a new SME loan portfolio and a risk-sharing of losses on a loan-by-loan basis.

Although absorption by banking groups varied by country and by customer type under this first JIFIAP, banks drew available resources, which rapidly reached final beneficiaries, implying a doubling of pre-crisis absorption rates in some of the most affected countries, and effectively complementing the reduced lending from local banks as a result of the crisis. This result is considered a notable success, as EIB

2 Final Report on the Joint IFI Action Plan, March 2011.

resources made up for the crisis-induced decline in the availability of traditional funding sources for local banks.

The second JIFIAP, launched in 2013, was more focused on supporting growth, including convergence of new EU Member States and of the candidate countries in the region.[3] It sought to ensure that the supply of funding for economic activity was maintained, and to finance investment needed to overcome obstacles to the longer-run growth. The second JIFIAP entailed a total commitment to the region of €30 billion. Roughly 66% of the total commitment came from the EIB, 14% from the EBRD and 20% from the WBG. In total, the second JIFIAP over-delivered, reaching €42.7 billion by December 2014. Assistance from the IFIs was in the order of 1½ percent of the region's GDP each year and supported around 6 percent of the region's investment.

The largest share of the EIB's operations during the period of the second JIFIAP, 2013-14, 39.4 percent, went to the region's infrastructure, including strengthening its links with trans-European transport networks. Almost as much, 32.6 percent of the value of operations, went to finance SMEs and mid-caps, including EIF operations to provide equity and guarantees. Some 15.6% went to energy and the environment, with the remaining 12.4 percent going for RDI (research, development and innovation), manufacturing, health, training and education. These operations were supported by the EIB's capital increase approved in early 2013, as well as the availability of EU funding for the EIF, with assistance for countries in the West Balkans provided under the EU's external mandate using EU budget guarantees.

Given the deleveraging pressures facing the supply of funds to the region's banks, a major objective of the second JIFIAP was to help ensure that the region's banking system remained in a condition to extend credit, especially to SMEs and mid-caps. This was achieved through the supply to local banks of a large volume of reliable funding to finance such lending, and also by actions to strengthen the local banking systems and help cross-border bank groups use their capital more efficiently. To this end, the EIB signed a series of credit lines with banks in almost all countries of the region.

Another objective was to help countries use available EU funds for investment and growth, and to replenish the pipeline of project funding at a time when most

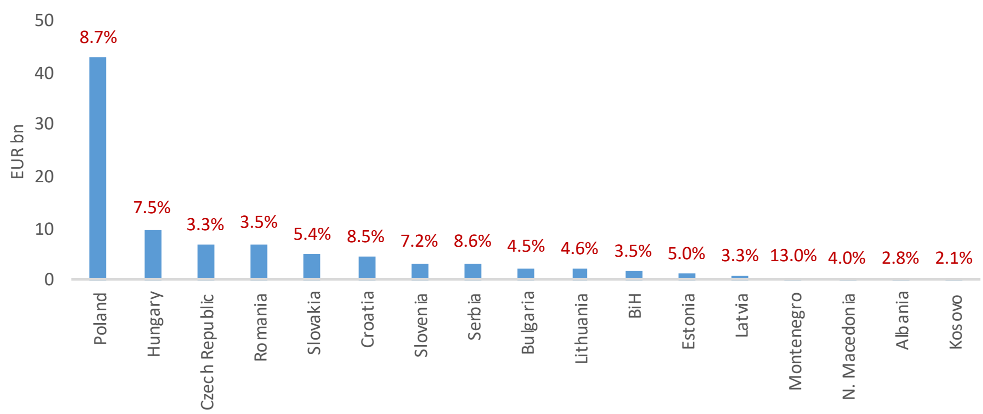
3 Final Report on the Joint IFI Action Plan for Growth in Central and South Eastern Europe, April 2015.

governments in the region were not in a position to expand their investment expenditures substantially. Stepping up the absorption of EU funds, to the benefit of both the recipient countries and their banking systems, had been the objective of an early Vienna Initiative working group. The main thrust of the working group's conclusions was the need to strengthen national procedures for project selection. This complemented the work of the IFIs to improve project preparation, particularly through the EU's Joint Assistance to Support Projects in European Regions programme, managed by the EIB. Another innovation in this respect was EIB lending to co-finance EU funds during 2014-20, and loans were agreed with the majority of new Member States for this purpose.

Besides improving access to finance via the banking sector, the EIF also focused on the development of the equity ecosystem in the region, with increasing use in the region of its risk-sharing instrument, designed to promote innovation in SMEs and mid-caps. These operations have been useful in helping banks conserve capital, in that the guarantor takes all or part of the credit risk. The EIB was centrally involved in the Vienna Initiative's Working Group on Credit Guarantee Schemes, which examined the availability and regulatory treatment of such schemes in the CESEE region. At the end of 2018, EIB's total lending in the CESEE region amounted to €92.5 billion.

Figure 1.

The EIB's total exposures in CESEE by country, end-2018 (billions of euros, and percent of GDP as data labels)



JIFIAP assistance effectively focused on the needs of the region. Infrastructure lending has improved the interconnection of transport, energy and communication systems. It has helped establish more reliable energy supplies, improve energy efficiency and increase the supply of renewables, thus contributing to containing climate change. Lending has facilitated the more rapid and effective use of EU structural funds. JIFIAP assistance helped the banking system strengthen its capital position and maintain lending to the region's economies. The programmes of the IFIs have helped meet the deficit of equity and risk finance in the region and have promoted the development of capital markets. And operations have served to raise productivity and increase the export orientation of countries, creating the basis for more productive employment. The JIFIAP has shown that the IFIs are among the most reliable partners of the region, capable of responding to its specific needs and providing an important element of stability. The EIB Group gradually adjusted its product portfolio to the changing demands of the CESEE market. At the early stage of the crisis, when funding had dried up, Multiple Beneficiary Intermediated Loans supported lending to SMEs and mid-caps of the region by alleviating the commercial banks' shortage of liquidity and allowing them to keep on with their corporate lending activity. Later, when capital rather than liquidity became the bottleneck for lending due to crisis-related losses and tighter regulatory requirements, capital relief products such as credit guarantees were offered to support lending to SMEs and innovative firms.

Sustaining growth and convergence in the CESEE region has required a strengthening of investment activity, since the per capita capital stock is less than half that in the rest of the European Union. This was the objective of the 2015-17 Investment Plan for Europe (the Juncker Plan), to whose implementation the EIB was central. The plan depended on attracting substantial private capital to co-finance projects, using the endowment of the European Fund for Structural Investments (EFSI) as the bearer of first loss. This use of EU funds as guarantees rather than as grants was pioneered in the EIF's operations in the CESEE region. The EIB's leading participation in the Vienna Initiative working group on IFI financial products supporting investment in CESEE has been important in realizing the Juncker Plan's objectives in the region.

Contribution to the analytical and policy work

One of the key features of the Vienna Initiative is the pooling of institutional resources for joint understanding of the economic challenges in the region. In this context, the EIB has been contributing actively in the regular monitoring activity of the Vienna Initiative. Launched in 2012, the semi-annual EIB CESEE Bank Lending Survey (BLS) is a unique information source that assesses both credit demand and supply conditions in the region, and also the strategic view of the large international banking groups towards the CESEE banking market. The BLS captures banks' views in a cross-border perspective, thus analysing conjectural development from both the home and host banking sectors. It contributes to the monitoring of cross-border banking activities and deleveraging in CESEE, to a better understanding of the determinants/constraints influencing credit growth in CESEE and to gaining some forward-looking insights into cross-border banks' strategies and market expectations regarding local financial conditions.

The BLS key findings feed into the *Vienna Initiative Credit and Deleveraging Monitor* coordinated by the IMF. Moreover, the BLS results are initially presented and endorsed by the Vienna Initiative Steering Committee. The BLS has become an internationally recognized tool to grasp credit conditions and fundamental drivers in the region. Specifically, the BLS investigates international banks' strategies, restructuring plans, access to funding and deleveraging at the global and group levels. It also examines the main determinants of local banking conditions. Attention is given to credit standards and credit terms and conditions, as well as to the various domestic and international factors that may be responsible for changes to them. Demand for loans is also explored in great detail, including the elements that may affect loan demand. Credit quality and the funding conditions for banks in CESEE are also monitored.

When it comes to the policy agenda of the Vienna Initiative, the EIB has been proactively engaging in those work streams that have direct strategic and operational impact. Two working groups have been established under the EIB's chairmanship: one focusing on credit guarantee schemes, and one assessing the product palette of IFIs operating in the region.

The credit guarantee working group was launched in October 2013. The aim was to explore the possible role of credit guarantee schemes in alleviating the low supply of credit in CESEE. The work was based on two unique sets of surveys. As part of the policy conclusions, the group called for a uniform treatment of the regulatory capital relief for credit guarantees as a key step that may facilitate the more widespread use of such instruments.

The working group looking at the product palette of IFIs was established in 2017. The main objectives of the work were to identify the market gaps and priority policy areas for IFI products, to support the development of instruments to meet the investment needs of the region and to contribute to the debate on shaping the next generation of IFI products. The key policy conclusions highlighted the importance of capital relief products, the potential role of IFIs in helping the banks through the challenges of the MREL regulation, the need for well-targeted support to venture capital and the need for better data and coordination of IFI activity.

In addition, the EIB has launched an initiative and is currently co-chairing a working group on financing innovation with EBRD. Established in in 2018, its objectives include the mapping of innovation performance and ecosystems in CESEE, the analysis of bank and non-bank financing options for innovative companies, the identification of gaps in framework conditions and financing and formulating policy recommendations, including for the role of IFIs.

Next steps

The example of the Vienna Initiative shows how important coordination is when it comes to financial integration. Home bias is very strong when it comes to banking. Mutual trust and strong incentives are needed to prevent suboptimal outcomes. Regular and open discussion between host and home country stakeholders (parent banks, central banks, regulators) has therefore proven to be crucial for cross-border banking to be successful.

The Vienna Initiative is widely considered an excellent example of policy coordination among international institutions, both private and public. The EIB remains committed to the Vienna Initiative model, and actively supports its future, for instance, by contributing to the financing of the newly established permanent Vienna Initiative secretariat.

The strength of the Vienna Initiative has always been the presence of the large commercial banks that are active in the region. Banks are at the core of the Vienna Initiative work, and the agenda has to remain bank-focused. However, banking is changing, and banks are opening up towards new areas that are particularly important for the growth of the CESEE region. In this environment, the role of the Vienna Initiative is no longer crisis management; rather, establishing the link between the financial sector and the areas that are crucial for the region's economic development, such as financing innovation, the transition towards a green economy, digitalisation, etc., are of the essence. The Vienna Initiative is the ideal forum for finding pragmatic solutions to these issues, and the EIB stands committed to playing a key role in this process.

CHAPTER 5

The Vienna Initiative: how it all started

Herbert Stepic[1]

In early spring 2008, the head of the research division at Raiffeisen Zentralbank Österreich AG (RZB, the predecessor of Raiffeisen Bank International (RBI)) informed the management board about his expectations and forecasts concerning problems in the US real estate sector. He described them as serious, without of course being able to quantify their effects on Europe or the European financial system. Information received from our New York office painted an even worse picture. Consequently, we started to take preparatory measures in the group's head office in Vienna.

By October 2008, it was evident that the seriousness of the problem had turned out to be well beyond our expectations, not to mention our fears. And while I could well imagine possible future measures by Western European central banks to help the region's financial industry to overcome possible liquidity shortages, I could not imagine how this could be done for Central and Eastern Europe (CEE). Unlike in Western Europe and other countries with well-developed financial markets, the liquidity supply in CEE was primarily provided by foreign, i.e., Western European, banks. (These banks' market share in Central Europe and Southeastern Europe exceeded 80% at the time, and capital markets barely existed.) As the banking market in CEE was expected to double in size every five years, any disruption to lending activities would have seriously endangered the region's transformation process.

1 Dr. Herbert Stepic, born 31.12.1946, CEO of RBI from 2010 to 2013. From 1995, Deputy Chairman of the Managing Board of RZB and from 2001 to 2010, CEO of Raiffeisen International Bank-Holding AG.

The two most important groups needing credit, namely small and medium-sized companies and households, would have suffered particularly badly if the liquidity supply were to come to a sudden stop. A complete breakdown of CEE financial markets was also a possible scenario....

At about the same time, several initiatives and actions were developed in Western Europe. An "Overall European Framework for Action" was set up, initially at the ECOFIN Council in Brussels on 4 November 2008 and then at an extraordinary European Council on 7 November. We knew that the European Commission would propose raising the capital base of the European Investment Bank (EIB) by doubling the current ceiling for euro-denominated bonds. As a matter of fact, such fresh money would only be relevant for troubled EU Member States. The Commission clearly saw the need for strong support of the financial system from both the European Central Bank (ECB) and local central banks.

The financial crisis had by then begun to affect the new EU Member States from CEE. In order to meet this threat, the EU considered providing substantial medium-term financial assistance together with the International Monetary Fund (IMF). However, such funds would generally be lent directly to the countries involved (e.g., to offset financial deficits or to meet financial stability parameters) without any specific allocation to individual banks. This would also mean that the Western banks primarily active in CEE, which carried out the lion's share of liquidity transformation at a time when capital markets were essentially non-existent in the region, would run the risk of being excluded from any sort of stabilisation measures from Brussels or Western supranational institutions.

In September 2008, I therefore started to liaise with my executive colleagues at the largest Western banks in CEE to convince them of the need for concerted action focusing on three "targets":

- Brussels decision makers and the ECB;
- supranational institutions such as the European Bank for Reconstruction and Development (EBRD) and the EIB;
- Central European finance ministers and central bank governors.

The goals were: to convince Western banks not to reduce refinancing lines for their subsidiaries in CEE (initially, this was the wish of the Austrian National Bank, among others); the Brussels authorities to stand by with liquidity lines through their institutions; and CEE central bank governors and finance ministers to support the money market needs of those of their local institutions not owned by foreign investors.

Under the title “CEE Concerted Action”, representatives of EIB, EBRD, Erste, UniCredit and Intesa met at RBI on 6 November 2008 in order to align and coordinate actions in Brussels and CEE capitals. Considering major government interventions (such as liquidity enhancement profiles in Western Europe and CEE, government guarantees and deposit schemes) as well as the interventions of international and European authorities (such as the declaration of a concerted European action plan on 12 October or the EU’s International Financial Architecture on 28 October), a concrete master plan was prepared, discussed, adapted and finally agreed upon.

Each bank or financial institution, including the subsidiaries of Western banks in CEE, undertook certain tasks within a specified time frame, such as organising meetings with CEE governors and finance ministers. The lobbying activities were shared between the Western bank executives, depending on their individual personal contacts. In a letter dated 1 December 2008 and signed by Andreas Treichl, Corrado Passera, André Bergen, Frédéric Oudéa, Alessandro Profumo and me, we officially presented our request for “Stability for the Financial Sector in EU Member States and Candidate Countries” to Christine Lagarde, Manuel Barroso, Joaquin Almunia and EU Commissioner Charlie McCreevy.

In a follow-up meeting at RBI on 17 December, there was a detailed discussion and summing up of all interventions so far by all members of the group. In the meantime, I had entrusted six senior RBI staff members with the coordination of the action plan in both Eastern and Western Europe. While overall feedback was positive – after all, we did make substantial progress – there were severe problems with the ECB’s rule at the time that local currency bonds were not eligible as collateral or for repo transactions. We thought that the IMF could be supportive in this matter. Time was of the essence, so we decided to differentiate CEE countries by their macroeconomic status as “fragile” (double-digit current account deficit and inflation, real estate bubble), “intermediate” (high inflation and current account deficit) or “somewhat stable”.

Some countries, such as Hungary and Serbia (National Bank Governor Radovan Jelašić was extremely supportive) had already responded with concrete measures; Bulgaria and Poland were about to prepare special packages to stabilise lending. The alignment with the Czech Republic was especially important due to their upcoming EU Presidency.

We also agreed to offer to selected countries a reduction of lending against a gradual reduction of reserve requirements. Several other proposals for requests to the central banks of the individual banks' home countries were agreed, such as their accepting local currency collateral or providing local currency/euro swap facilities and repo transactions. The EBRD offered to provide a coordinated response to the needs of all banks in the region, bank by bank and product by product, to be proposed to international financial institutions (IFIs), who then could approach the ECB and International Finance Corporation (IFC), thus offering coordinated support. Discussions took place between banks on the one side and the EBRD, the EIB and the IFC on the other to open credit lines for the then 37 banks active in the region to the sum of approximately €5 billion. In the meantime, we actively communicated with the media. There were several interviews with the *Financial Times* and other leading newspapers to raise awareness of our initiative.

One should not forget that, by the end of January 2009, money markets in Western Europe had started to dry up. Banks became terrified because they did not know whether, and to what extent, their counterparties might have toxic assets on their books. This led to a drastic reduction of credit lines/short-term money market lines even between parties with a long historical track record. The worst period was between January and March 2009, a time when our action plan, now branded the "Vienna Initiative", had successfully alerted major decision makers in both Eastern and Western Europe of the need to counteract the effects of the fall of Lehman Brothers with a concerted action safeguarding their financial industries and, in some cases, even their countries.

On 23 January 2009, the group – which by this time had been joined by Swedbank, Eurobank EFG and Skandinaviska Enskilda Banken – addressed a further letter to the ECB, calling on it specifically to support the stability of new EU Member and Candidate Countries with concrete measures.

When we started the Initiative, we had yet to learn that no official platform existed where regulators of Western and Eastern European countries could informally exchange their views, let alone talk about coordinating or jointly designing important measures. The "Vienna Initiative" has existed ever since to serve exactly this purpose, as a platform where regulators meet with their peers and representatives of IFIs, as well as with the active cross-border banks, to coordinate activities in the region for the benefit of the financial industry and national economies.

PART II

The effectiveness of the Vienna Initiative during the 2009-11 crisis

CHAPTER 6

If you really want to find a solution: a personal story of the Vienna Initiative from a Hungarian eyewitness[1]

Julia Király[2]

The post-Lehman liquidity crisis hit some Central and Eastern European (CEE) countries brutally hard, especially Hungary, Romania, Serbia, Ukraine and Latvia. These countries had to turn to the IMF and the EU for standby credit. Hungary was the first, after its financial markets stopped functioning on 9 October 2008. The government lost access to international markets, and the banking sector could not refinance itself in Swiss francs (a major currency used in foreign exchange lending to households at the time) due to the dried-up swap markets. In October, parent banks provided the necessary liquidity for their subsidiaries; however, as the crisis worsened, their own governments put them under pressure to keep funds (liquidity) at home. As the same few parent banks owned most of the local banks (their subsidiaries) across Central Europe, the story was much the same in all the other CEE countries, and soon, the whole region – irrespective of EU membership – was considered the most vulnerable part of the emerging market world.

And, then a new international initiative of public-private cooperation was born, the first of this type: the Vienna Initiative. As an eyewitness, in my personal reminiscences I would like to share my impressions of the long process, which finally resulted in genuinely broad cooperation among the public and private institutions of different nations.

1 The paper is an except from the author's book: Király Júlia: A tornádó oldalszele. Személyes válságtörténet. Park Könyvkiadó, 2019. (Király, J. (2019) The side-wind of the tornado. Personal crisis history. Park Publishing Company).

2 Professor of the International Business School Budapest and external researcher of the Economic Research Institute of the Hungarian Academy of Sciences. During the crisis (2007-2013), deputy governor of the MNB, the Central Bank of Hungary.

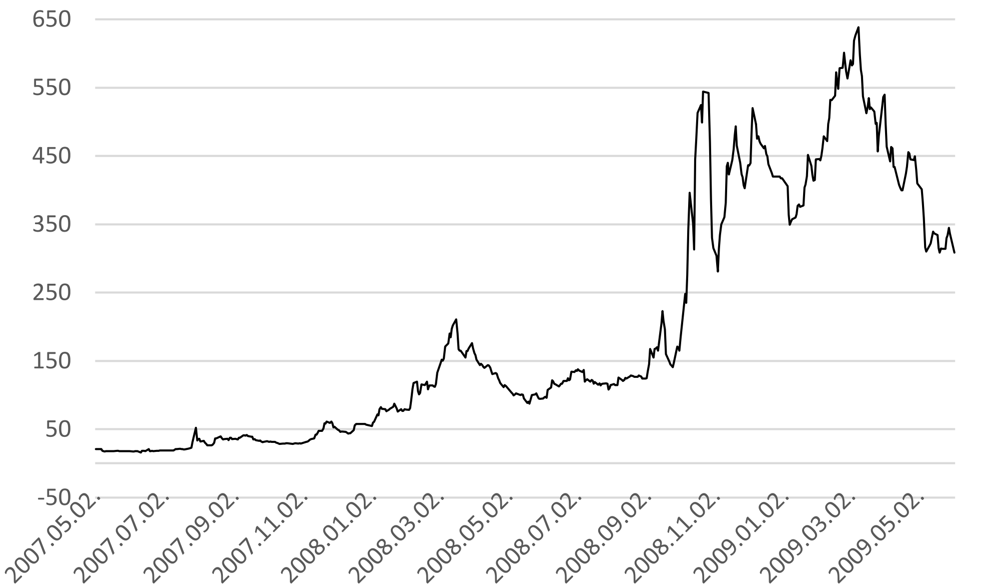
The Global Financial Crisis and Hungary

The first memo summarising the main features of the subprime crisis was prepared by the staff of the MNB (Central Bank of Hungary) in the summer of 2007. However, it had a rather optimistic conclusion: "*In spite of the increase of credit risk premium the developments on the American mortgage market will probably exert only a marginal impact on risk appetite until they affect other markets or household consumption as well, of which there is no indication as yet.*"[3] The general feeling was that this turbulence would exert only a marginal impact, and most central banks hoped for a soft landing. This was particularly true of the emerging markets. As Guillermo Ortiz, governor of Bank of Mexico said in an oft-cited quote: "*This time we did not cause it [the crisis].*" (Blinder 2013: 171). In 2007, decoupling theories popular at the time advocated that on this occasion the crisis stemmed from the most developed financial markets, so emerging markets would be less contaminated, and would suffer less. Dooley and Hutchison (2009) analysed 16 emerging markets including Hungary with event-driven econometrics, and found that the emerging markets were indeed enjoying a certain heyday up until the Lehman crisis. Most of currencies appreciated against the dollar, these countries had avoided bank crises, since their banks (even most of the parent banks of local subsidiaries) had not accumulated significant stocks of toxic assets. However, CDS spreads started slowly crawling upwards, reflecting deterioration in investor sentiment deteriorated, and leading to risks being re-priced (Figure 1).

We at the central bank did *not* assume that the turmoil would not affect Hungarian markets in some way, since increases of the cost of foreign funds and the shortening of maturities appeared as immediate signals of the coming turbulent times. My department, the Financial Stability team, was in particular worried about accelerating FX lending in the country. In our Financial Stability Report and various conference papers, we tried to send messages to the banking sector that it would be better to slow down. At that time, unfortunately, we could not do anything more than exercise moral suasion, since the regulation was in the hands of the Ministry of Finance, while supervision was within the competence of the independent Financial Supervisory Authority. Moreover, parent banks were supervised by their own ("home") authorities according to the then prevailing rules and, despite many memoranda of understanding, cooperation between "home" and "host" authorities was scant. We were more or less impotent.

3 Minutes of the Monetary Council Meeting on 23 July 2007, page 4.

Figure 1.
Five-year CDS spread of Hungary (2007-09)



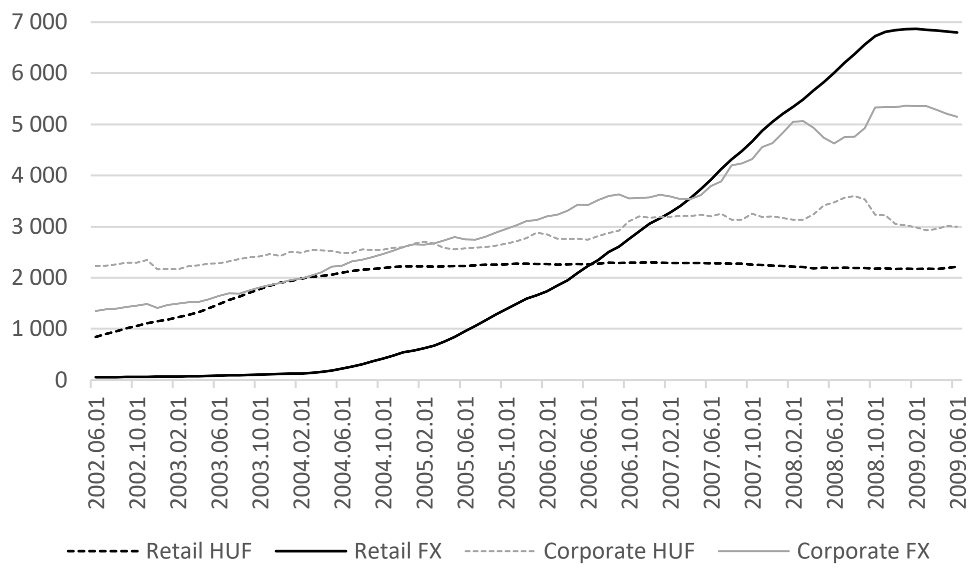
Source: MNB Inflation Report November 2007 and August 2009.

Unfortunately, the warnings did not decelerate the Hungarian FX lending boom. In recent years several papers have analyzed various aspects of FX lending (Brzoza-Brzezina 2010, Király 2018, Király-Simonovits 2016, Király-Banai 2014, Rosenberg-Tirpák 2008). Now, I would focus on the credit supply, in particular, on the role of the banking sector. As Professor Lámfalussy kept saying: "*There is no irresponsible borrower without an irresponsible lender.*"

By the 2000s everywhere in the CEE region, the lion's share of the banking system had been acquired by foreign strategic owners, mainly Austrian, Italian, Belgian and French banks as a result of the massive bank privatisation. These banks dominated not only the Hungarian but the whole Central European banking market as well. Swedish banks were active in the Baltic countries, and Greek banks in the Balkans. Due to the high entry costs to the retail market, foreign-owned subsidiaries initially focused on the corporate segment. Most of the subsidiaries had not inherited low-quality corporate portfolios from the pre-transition period and had experience in the field of commercial banking, and could thus offer more favourable conditions overall to customers than their domestic competitors.

In the late 1990s in Hungary the profitability of the corporate segment began to shrink due to fierce competition, so banks turned towards the retail segment providing unsecured consumer loans and car loans though their leasing companies.[4] EU accession, and disappearing capital controls offered excellent opportunity for foreign-owned banks to considerably increase their retail market share. In 2004, after the necessary abolition of an ultra-generous government subsidy on mortgage loans, mortgage interest rates jumped to 12-14% from the subsidised 4-6%, and demand started to promptly fall. The foreign-owned subsidiaries through their parent banks had easy access to the international wholesale market, and thanks to the plentiful liquidity prevailing at that time, the foreign exchange (FX) funding costs were 4-6% lower than the actual Hungarian forint (Ft HUF) funding cost. The inflation differential, with Hungary's CPI rising faster than in home, predominantly eurozone member countries, also played some role. Subsidiaries relying on cheap FX funds could offer much cheaper FX-denominated mortgage loans than expensive Ft HUF loans. Banks omitted to price in the foreign exchange risk of the mainly unhedged borrowers. As happened earlier in the corporate sector, the same pattern was replicated in the retail sector, especially in the mortgage loan market (Figure 2).

Figure 2.
The FX denominated lending boom



Source: MNB macroprudential indicators.

Not much later the local banks entered the FX denominated mortgage market, too. The fast-evolving lending boom had all the characteristics of subprime lending. Households with weak scoring could not afford expensive Ft HUF loans, but had

4 Due to Hungarian tax regulations it was much cheaper to provide auto loans in the form of financial leasing.

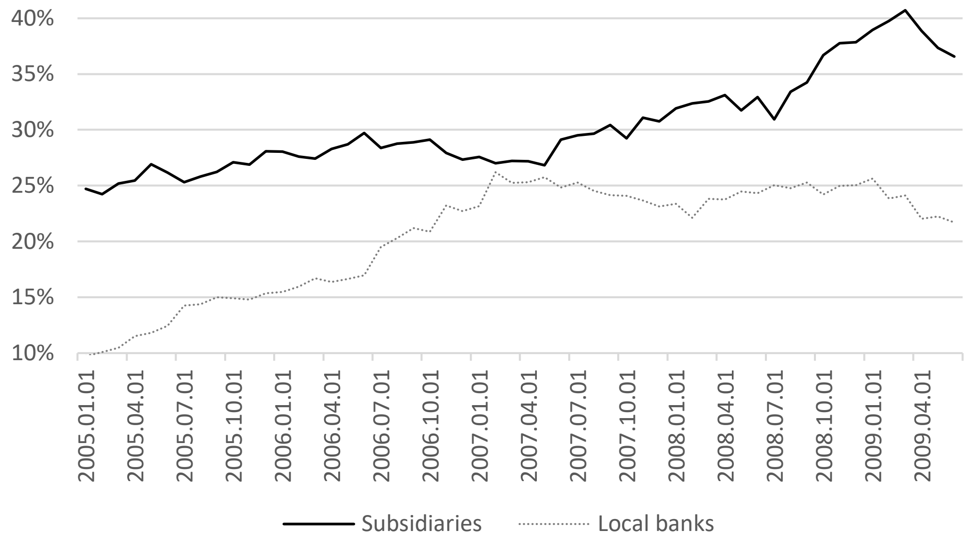
access to cheap FX loans. Others borrowed more than they could have borrowed in Ft HUF, and were able to buy larger, more expensive houses. Between 2004 and 2008 LTVs (loan-to-value ratios) and DSRs (debt-service ratios) of loans significantly increased, home equity loans[5] had a larger and larger market share and teaser rate loans and NINJA (no income no job no asset) loans were no longer an exception. The lending bubble with fierce competition exploded the profitability of banks, and the average return on equity in the sector exceeded 20%. The smaller part of the profit was repatriated by foreign parent banks, while the greater part – 60-70% – was reinvested. This not only increased the capital adequacy of subsidiaries, but made possible their future growth, as well.

On the dark side of the credit boom, significant imbalances accumulated not only in the household sector, which became chronically over-indebted in foreign currency against which they had no hedging, but in the banking sector, too. On the one hand, the growth of loans exceeded that of deposits, with the loan-to-deposit ratio of banks accelerating to peak at 180% at the end of 2008. On the other hand, since the lending boom was financed from the international market, between 2005 and October 2008 the share of foreign funds increased from 20% to 35% at subsidiaries, and from 10% to 25% in local banks without a foreign owner (Figure 3). Foreign bank subsidiaries were in a better position than locals, as they could rely on their parent banks: 60-70% of foreign funds were provided by the foreign owners.

After the outbreak of the US subprime crisis, access to wholesale market funds became more difficult, and the cost of funds increased. It became difficult to get access to unsecured interbank loans, while normally, FX swaps were available. In the case of local banks, almost 100% of foreign funding consisted of continuously shortening FX swaps (Figure 4).

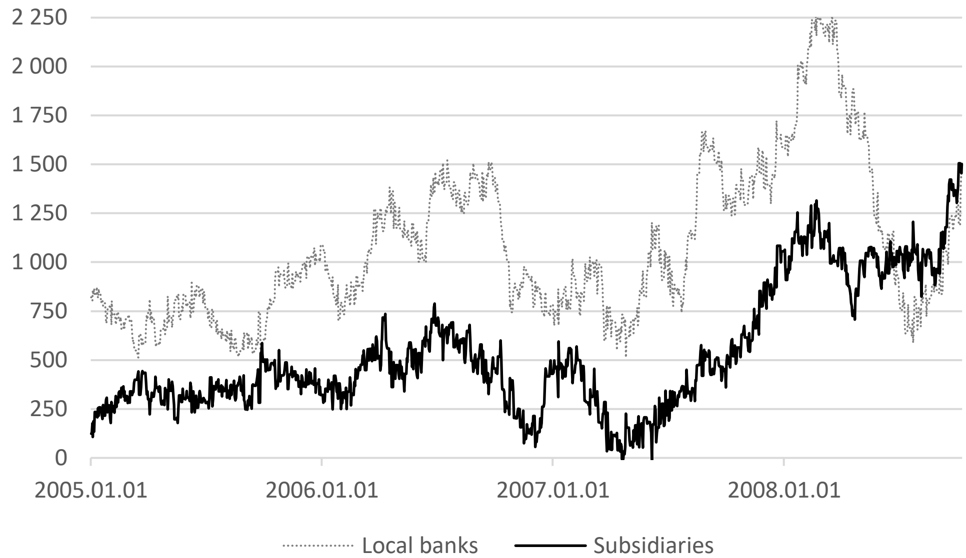
5 In the special Hungarian terminology: "free utilisation loans".

Figure 3.
Share of foreign funding in banks' liabilities



Source: *Banai et al (2010).*

Figure 4.
Total amount of FX swaps in the banking sector (billion Ft HUF)



Source: *Banai et al (2010).*

The imbalances generated by the FX lending bubble threatened the financial stability of the country; however, the voice of our Financial Stability department was too weak and largely unheard. It was believed inconceivable that any of the liquid money markets, and in particular the super-liquid FX swap market, could dry up.[6] Consequently, neither MNB staff, nor the Monetary Council (MC) saw the possibility of contagion from the US-based subprime crisis to the boom in FX lending in the CEE countries. Nobody could imagine an FX liquidity crisis.

The first direct contagion effect of the subprime crisis reached the Hungarian money markets in March 2008. Liquidity seemed to disappear from the government bond market, bid-ask spreads increased, and other liquidity indicators deteriorated. Intervention by the Government Debt Management Agency (ÁKK) and a rapid hike of the base rate by 50 basis points by the MC calmed the markets, and during the summer the decoupling sentiment returned.

On 15 September 2008, Lehman Brothers famously collapsed. During the following days, nothing special happened on the emerging markets. What's more, the evaluation of the CEE region actually *improved*, and the Czech koruna and Polish zloty appreciated. During the Lehman week most analysts stuck to the decoupling scenario between advanced country crisis and emerging market invulnerability.

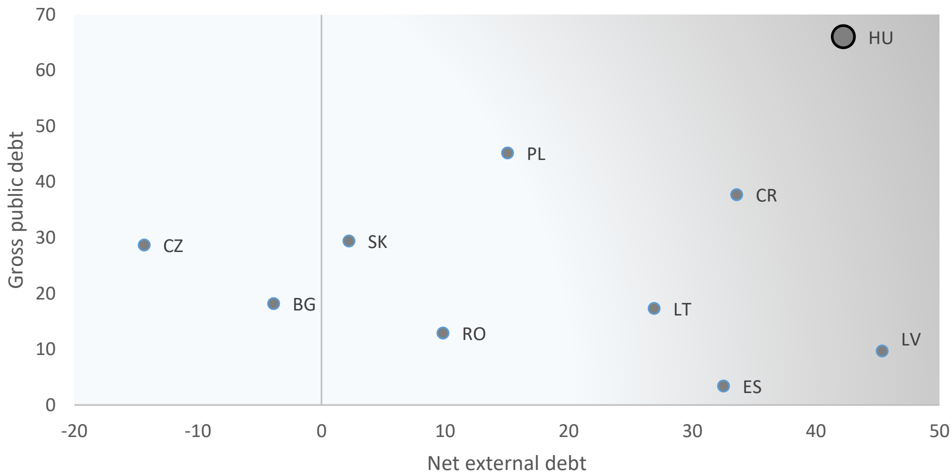
On 29 September the US Congress rejected the US$700 billion Troubled Asset Relief Program (TARP). Although five days later the bill was passed in the end, it was too late, as the Lehman tsunami swept over the world's financial markets. Within two weeks of Congress's refusal, credit default swap (CDS) spreads and interest rates rocketed, while stock prices plunged, not only on the US markets or other developed country markets, but this time also on the emerging markets. There was no more "decoupling". Financial markets dried up, including the super-liquid money markets. On the very same day, (29 September) at the rate-setting session of the MC, members expressed mild concern only by observing: "*Although Hungary was no longer among the most vulnerable countries, forint investments were not the safest assets for investors and, therefore, a potential worsening of financial disruptions might have a more pronounced effect on the prices of forint assets compared with other countries of the region.*"[7] Nevertheless, the MC saw no reason for any kind of monetary intervention. Some domestic banks reported serious friction on

6 In Hungary the daily turnover of the FX swap market was about Ft HUF 750 billion (€3 billion) while that of the FX spot market totalled Ft HUF 250 billion (€1 billion).
7 Minutes of the MC meeting on 29 September 2008.

the FX swap market, and yet the big picture sketched by the central bank was rather optimistic. We had realised that the problems in the fiscal and financial sectors reinforced each other after Lehman, but we were convinced that, due to the recent fiscal consolidation, Hungary was far from being the most vulnerable country in the region. We were wrong: the flow was improving, but the stock was still high. Hungary had the highest gross public and net external debt in the region (Figure 5).

Figure 5.

Gross public and net external debt as a percentage of GDP (December 2007)



Source: MNB Financial Stability Report April 2009.

In October, the tsunami hit Europe: in the first week of the month, share prices of the big European banks plunged, and their CDS spreads almost exceeded those of the big American banks.

On 8 October we published the MNB's *Financial Stability Report*, asserting that the Hungarian banking sector was strong, its capital base and profitability solid and the Ft HUF and FX liquidity of the banks adequate, and arguing that, although the funding conditions had deteriorated, foreign owners would mitigate this negative effect.

On 8 October, the Hungarian money markets were still functioning smoothly. But as we know from Winnie-the-Pooh: "They're funny things, Accidents. You never have them till you're having them."[8]

8 Milne, A.A.: The House at Pooh Corner. Chapter IV. In Which it is Shown That Tiggers Don't Climb Trees; https://www.e-reading.club/chapter.php/71303/6/Milne_-_The_house_at_Pooh_Corner.html

On the next day, 9 October, the Hungarian money markets all of a sudden dried up entirely:

- market makers and price quotations disappeared from the government bond market, the regular T-bill auction of the ÁKK failed;
- trade on the Budapest Stock Exchange had to be suspended due to harsh price drops, and the share price of OTP Bank, by far the biggest Hungarian commercial bank, collapsed;
- the Ft HUF came under strong depreciation pressure;
- the FX swap market froze, banks faced a liquidity crisis, there was no FX liquidity provider, and Hungarian banks could not roll over expiring swaps which funded their FX-denominated loans.

This was really the sinister *sudden stop*, when funding just disappears from the system. Headlines of foreign newspapers suggested that Hungary would be "the second Iceland", and journalists and analysts all envisioned the mother of all crises: a bank-exchange rate-balance of payment – and fiscal – crisis.

The crisis team of the central bank was immediately set up, and in subsequent weeks we spent more time within our fortress-like headquarters building, than outside.[9] Our duty was to overcome the liquidity crisis as soon as possible. Workshops, brainstorming, hundreds of e-mails, thousands of different meetings and negotiations – and of course a lot of coffee – filled our days. I am sure 2008-09 was a golden time for coffee producers.

First, Hungary immediately turned to the International Monetary Fund (IMF) and applied for a standby loan. The country's good policy package was supported by what was a truly large – "oversised" – combined IMF standby and EU balance of payments loan of €20 billion. This helped calm the markets, restore confidence and avert a deep overall crisis.

Second, parent banks behaved in a responsible way, and by the end of the year increased funding in their subsidiaries by more than 20%, providing fresh liquidity and substituting the maturing wholesale funds. The MNB provided the rest of the required FX swaps backed by the IMF-EU loan. Parent banks (which themselves got refinancing from the European Central Bank (ECB)) and the MNB were

9 We remembered that at the beginning of the 20th century the bank management lived together with their family in the building...

together able to revitalise Hungarian FX money markets and provide the banks with sufficient FX liquidity.

Third, we made an agreement with primary dealers and long-term investors to revitalise the government securities market, as soon as possible. We intervened on the secondary market and provided extra Ft HUF liquidity for other actors, asking them to do the same. And they did!

Fourth, we increased the base rate by a massive 300 basis points to stop harsh speculation against the Hungarian forint.

By the end of October, the acute liquidity crisis was over. Even *The Economist* admitted: "*The Hungarian central bank is impressively well-run.*"[10]

The Lehman tsunami hit the country with full force but, with the help of the IMF and the EU, the responsible behaviour of foreign parent banks and the rapid crisis management of the MNB, Hungary was prevented from becoming "the second Iceland".

The East European panic and the birth of the Vienna Initiative

The October 2008 liquidity crisis did not mean the end of the crisis. The stability of the banking sector was fragile, and a sudden stop and credit crunch were real threats. Over-indebted households and corporates were expected to deleverage, which was bound to deepen the approaching recession. The 2009 recession was on our heels. In the US, UK, Ireland, Spain, Germany, Belgium, Italy and several other developed countries, the financial storm hit the banking sector severely, with more than 40 banks bailed out using state aid. Europe spent a cumulative 13% of its GDP on bailout programmes (CEPS 2010). First the credit flow slowed down, and then it practically stopped. The consequences nicely illustrated the old textbook thesis: "When the banks stop – the economy dies". The slowdown of individual economies contributed to the abrupt 11% fall in world trade. The contagion reached almost every economy. In the US, GDP fell by 2.4%, in the eurozone by 4.1%, in the UK by 4.9%, and so on. Even in China and India the previous double-digit growth decelerated to single digit. Black humour dominated the Internet; I received this e-mail more than ten times:

10 "Who's next" – *The Economist*, 23 October 2008. http://www.economist.com/node/12465279

Subject: Notice from God. "Due to the current financial crisis facing the world, the light at the end of the tunnel will be switched off to save on electricity costs until further notice. Sincerely, God".

The first reaction of politicians was to save their own economy, and their own local banking system. Although, in their speeches after Lehman, they stressed the importance of international cooperation, the reality was just the opposite.

The lack of international collaboration had a particularly negative effect on the CEE region as well as the Balkans. The special crisis history of the region is usually left out even from the best crisis narratives (an excellent counterexample being Tooze 2018). In the pre-crisis years, the region attracted a lot of fresh capital, much more than any other developing region of the world. These years were characterised not only by green-field investments and reinvestment but by a seemingly unconstrained global liquidity that fuelled the credit boom. In 2008, the total debt of these countries exceeded that of Latin America – no small feat as many of the countries were known for having "debt overhangs". After the subprime crisis, however, the flow of capital slowed down, and after Lehman it was reversed. Due to increased risk aversion, capital fled these countries, similarly to what happened in 1997 during the Asian Financial Crisis. The recession proved to be much deeper in the CEE region than elsewhere, and in several countries (the Baltic countries, Slovakia) the earlier double-digit growth turned into a double-digit fall in GDP.

Governments of EU Member States which bailed out their banks often asked them informally (but sometimes even publicly) to focus more on domestic lending, instead of funding their Central European subsidiaries. Uncertainty arose as to whether multinational banks would keep funding East European customers through their local subsidiaries. This increased the threat of an uncoordinated rush on banks in the region. "*Although most banks confirmed their commitment during the early stage of the crisis, there was no formal policy framework or coordination mechanism in place to ensure these commitments were credible. The fear was that while it would be in the collective interest of banks to roll over debt, the absence of a coordination mechanism could lead individual banks to withdraw, ultimately causing a 'run' on the region. The absence of agreements on how to share the burden of a defaulting subsidiary between the fiscal authorities in the home and host countries further exacerbated the risk of such a run. The accompanying decline or reversal in financial flows would not only have had dire consequences for local firms and households but also have led to large exchange-rate fluctuations and balance of payments problems.*" (De Haas *et al.* 2012).

Irrespective of whether or not a CEE country happened to be a member of the EU (or in some cases of the Eurozone), the global sentiment did not distinguish between them. The countries were uniformly considered as belonging to a crisis-hit region, which was left out from the umbrella of the Union. Several politicians (then European Commission President José Manuel Barroso among them) *opposed* setting up a crisis management fund for the CEE region.

The ECB refused to provide a swap line for the crisis-hit countries. On 10 October, after the collapse of its money markets, the MNB applied for a EUR/Ft HUF swap line but was refused. Instead, the ECB offered a repo line, which meant that the MNB had access to euro liquidity at the expense of diminishing its international reserves. It was never clear why the ECB refused formal FX swap lines to CEE countries in the first place.[11] The ECB agreed confidentially to provide forint swaps (and zloty swaps to Poland), but only in September 2009 when the acute crisis was over… . It was a steep learning curve… . What is more, the ECB, while it significantly enlarged its list of acceptable collateral, refused to accept the government bonds of the region's non-Eurozone members, discriminating against all the countries of the region.

Despite EU loans provided to some of the countries, "*… certain actions, or failures to act, on the part of EU institutions and governments, have amplified the effects of the crisis on CEE countries. The European Central Bank has given little direct support to non-euro-area countries, and the EU has done little for EU neighborhood countries. Meanwhile, euro-area membership has shielded from the crisis some countries with worse fundamentals than certain CEE countries*" (Darvas 2009).

The first cross-border initiative was taken by the parent banks. Austrian, Italian, French, Flemish, German, Greek and other international banks, having several subsidiaries in the "dangerous" region, had all been caught in a vice from which it was very difficult to escape. At the end of November six of them – Raiffeisen International, Erste Group, Intesa SP, Société Générale, KBC Group and

11 "In private conversations, ECB officials mentioned operational risk as a key hurdle, which was in fact a politically correct way of saying that they were uncomfortable with accepting forint or zloty on their balance sheets. Although, in a currency swap, the main risk that the counterparty takes on is that of currency convertibility, which in the case of all EU countries was virtually nil since the EU treaty prevents capital controls and limits convertibility risk (Art 64 TFEU). There was also an issue of consistency since the ECB provided formal FX swap lines to two other EU countries: Denmark (an ERM2 country) and Sweden (a non-ERM2 country) but refused to do so with Latvia (an ERM2 country as well) and other non-ERM2 CEE countries. The policy justification for those choices was and remains murky and is based on the untold willingness to give enough euro liquidity to the Swedish Riksbank which could eventually swap it back to the Bank of Latvia, or to Swedish commercial banks invested in Latvia without the ECB taking direct exposure to the Bank of Latvia." https://ftalphaville.ft.com/2010/03/30/191041/behind-closed-doors-at-the-ecb/

UniCredit – sent a letter to EC President Barroso and G20 Chair Christine Lagarde, with copies to the presidents of the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB), expressing financial stability concerns in emerging Europe and urging actions by host governments. However, the joint efforts were not so easy to coordinate, and they only focused on what the host country authorities should do, while neglecting what their own home authorities (and themselves) could offer.

The EIB and the International Finance Corporation (IFC), supported by the EBRD, put together (and launched at the end of February 2009) what had become a "Joint IFI Action Plan" of these institutions along with the World Bank for a total of €25 billion. But this needed a policy framework. Erik Berglöf, the chief economist of the EBRD, with the Director for Policy, Piroska Nagy-Mohácsi, took on their shoulders the first round of discussion. I have known Piroska for a long time: back in Budapest we struggled together at university for the rights of students and for a better quality of education, which was not always welcome by the party bureaucrats in old socialist times. During these actions I learned that Piroska could always achieve what she considered to be important; however, in December 2008, when she contacted me for the first time to show the draft letter of the foreign banks and describing a policy action plan of public and private partners, I was quite sceptical. By then I had learned from the crisis: "forget international cooperation, you can rely only on yourself!" I tried to dissuade her, describing all the difficulties she would meet, but of course, Piroska was not a person who would give up on a dream so easily. In December 2008, she met with Thomas Wieser, who was at that time Director General for Economic Policy and Financial Markets at the Ministry of Finance of Austria and Vice-President of the EU's Economic and Financial Committee (EFC).[12] Together they drew up a plan to first mobilise the official sector – home and host country authorities, international financial institutions particularly the IMF – to establish the "rules of engagement" (who does what in crisis management) and in the second phase engaging the parent banks as well. Thomas travelled to key countries, and Erik and Piroska, together with EBRD banker colleagues, travelled around the region, met with authorities, parent banks, central banks, etc., and tried to convince people about the imminent need for cooperation. Theoretically, everybody agreed – but practically, there was little common ground. What made the difference was the serious support of Wieser. He convened the first meeting of the future Vienna Initiative in Vienna on 23 January 2009.

12 From March 2009 he became president of the EFC, and from October 2011 the full-time president of the European Working Group (EWG).

Representatives of the countries and banks of the region, as well as of the IFIs (international financial institutions: EBRD, IMF, WB, EIB, IFC) were seated at a big round table in the Ministry of Finance, where the lessons of the crisis were reconsidered in order to set up a reliable action plan. Erik Berglöf suggested calling it the "Vienna Club"; this was then modified to "Vienna Initiative" to reflect the voluntary nature of participation. The MNB[13] summarised the Hungarian evidence, from fiscal alcoholism (Kopits 2008) to the FX-denominated credit bubble, stressing the problem of the lack of a local currency capital market. Since foreign banks provided most of the FX liquidity, sudden stop and credit crunch was still a threat. In this respect, our presentation highlighted that the region could be negatively affected by host country problems; that financial stability should be a joint responsibility; that continued support from parent banks is essential; and that a level playing field in liquidity provision in and outside the Eurozone is a prerequisite for further cooperation. Our presentation was in line with the others.

In February the CEE panic was boosted by a fatal misunderstanding. Some analysts misinterpreted cross-border data published by the Bank for International Settlements (BIS) and broadly exaggerated the exposure of Austria or Italy to the region, forecasting total collapse both for home and host countries. The conclusion of the analysts was unanimous: these contagious countries should be isolated from the West. By the time the misunderstanding had been clarified,[14] facts and fictions had been separated and bad data had been improved, investors were fleeing from this most vulnerable part of the world. All the currencies of the region weakened, and CDS spreads broadly increased. In February the panic intensified: in Hungary for example, the Ft HUF/EUR rate surpassed the 300 limit, considered at that time a "psychological barrier". The MNB was trapped in the usual crisis dilemma of central bankers: the high interest rate should have been reduced because of the deepening recession, but a lower interest rate further weakened the Ft HUF and threatened the balance sheets and debt service of FX-indebted households and corporates. In February we stopped the rate-cutting cycle. The October crisis team was reconvened, and we spent days and nights in the MNB, with workshops, meetings and brainstorming following each other endlessly. Coffee machines functioned at full capacity.

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13 On behalf of the MNB Péter Tabák, head of the Financial Stability Department, took part in this first meeting. In 2010 Péter joined the EBRD. Not a simple coincidence, as during these meetings he proved his analytical and personal abilities.

14 The major distinction that needs to be made regarding the US$1.7 trillion figure is the fact that it includes both money borrowed from abroad, as well as loans provided (and funded) by local subsidiaries of foreign banks on local markets." https://www.erstegroup.com/content/dam/at/eh/www_erstegroup_com/en/Presse/pressemeldungen/2009/pi20090309-en.pdf

Fortunately, the Vienna Initiative team was more active than ever. At the second Vienna meeting in March, the main principles of burden-sharing were outlined, and from the end of March a lot of bilateral and multilateral meetings were organised among parent banks, national authorities and IFIs. Parent bank commitment letters were signed and published. I remember well the heated debates during these meetings and at the Full Forum of the Vienna Initiative in London, during the EBRD Annual Meeting in May 2009. By that time, the broad outline of the agreements seemed to be more and more acceptable to all partners.

The first Full Forum meeting for Hungary was held on 19-20 May, not in Vienna, but in Brussels; however, the Vienna name remained and, thanks again to the skillful management of Thomas Wieser and his team, was never changed, despite suggestions to that effect from the IMF and the EU. Hungary was a special case because, unlike the other countries where the IMF (and EU) support was negotiated in parallel with Vienna Initiative commitments (e.g., Romania or Serbia), it already had a working IMF-EU arrangement. IFI had the feeling they had already provided the necessary support through the €20 billion IMF-EU loan package, and pressed the parent banks not to withdraw their funds from a well performing programme country. The parent banks, for their part, stressed that they had done their best during the liquidity crisis by increasing their exposure to the country, but now, during a harsh recession, asked why they should keep redundant funds here. As the head of the Hungarian delegation I emphasised on the threatening credit crunch, explaining that the rapidly shrinking credit flow according to our empirical analysis was the consequence both of declining credit demand due to deleveraging, and of the lack of credit supply due to shrinking banking funds. Finally, at the end of a tedious two-day discussion a joint statement consisting of eight bullet points was accepted. I will never forget the last two hours, when Piroska read, sentence by sentence, the suggested text, and here and there we stopped for 15-20 minutes to change and re-change some words or expressions. All the major European home banks – Bayerische Landesbank, Erste Group, Intesa SP, KBC Group, Raiffeisen International and UniCredit – signed the statement, declaring "*We entered the Hungarian market as strategic investors and key contributors to its transition toward an open, market-based economy, based on our assessment of and continued confidence in the country's long-term growth prospects. We have made substantial investments in Hungary over a number of years, and we remain committed to doing business in the country. We are aware that it is in our collective interest and in the interest of Hungary* *for all of us to reconfirm, in a coordinated way, our commitment to maintain our overall exposure to Hungary.*"[15] We had taken a big step forward.

The "only" open question left for further discussion was the adequate level of required and sustainable exposure: "*Mechanisms to specify this effort will be developed in due course, taking into account availability of adequate lending opportunities or alternative investment instruments in Hungary within boundaries defined by sound risk, capital and liquidity management practices.*"[16] My staff ran several analyses and stress tests concerning the future liquidity and solvency of the Hungarian subsidiaries in order to determine the required level of exposure. We concluded that the absolute minimum would be around 94-96 % of the pre-crisis level.

Meanwhile, the parent banks summarised their standpoint in a joint letter sent to the IMF and European Commission asserting "*By fixing the exposure, without taking into account the local credit demand as well as the existence of adequate alternative investment opportunities for liquidity locally, we as parent companies are concerned that we would under those circumstances, not be able to fulfil our holding responsibility to efficiently distribute liquidity and equity within our respective banking groups. In times of economic downturn and inefficient use of capital and liquidity impairs the steering functions of our bank holding companies and could also, in the worst case, destabilise bank holding companies themselves and possibly negatively impact banking subsidiaries in the region.*"[17]

The dark day (19 November 2009), when the last moves of the Hungarian coordination game were played out in the huge ground floor meeting room of the Charlemagne EU building, things did not seem very promising. Two weeks earlier, all the participating parties had received the suggested text, to have enough time to polish it. There were not too many points to be challenged, except for a tiny little detail: "*Our group is committed to maintain its overall net exposure to Hungary, as defined in the attachment, at least at* ***[90 or 95 – to be discussed]*** *% of its level as of end-September 2008*". Our mandate was clear: since we had acknowledged the parent banks' sacrifice with the reference date (the end of September 2008 instead of the end of December), we should achieve the 95 %, or even more, if possible. Sitting around the table, all of us were searching for supporting arguments in the opening remarks of Sean Berrigan (Acting Director EC/ECFIN) and James Morsink (Head of the IMF Hungarian Mission), and then in the consecutive

15 http://www.imf.org/en/News/Articles/2015/09/28/04/51/cm052009 points 4 and 5.
16 http://www.imf.org/en/News/Articles/2015/09/28/04/51/cm052009 point 5.
17 Letter of Erste Bank Group AG, Intesa Sanpaolo SPA, KBC Group, Raiffeisen International Group AG and UniCredit Group to Dominique Strauss-Kahn (Managing Director IMF) and Joaquin Almunia (European Commissioner for Economic and Monetary Affairs) of June 2009.

presentations of Iryna Ivaschenko (IMF Resident Representative to Hungary), Barbara Kauffmann (Head of Unit EC/ECFIN), Filip Keereman, (Head of Unit EC/ECFIN), Peter Lohmus, (Adviser EC/ECFIN), Olivier Frécaut (Senior Financial Sector Expert, IMF/MCM) and others. All had become old friends by that time, so the atmosphere of the discussion was really friendly. However, the standpoints of the opposing parties, i.e., of the parent banks and the Hungarian authorities, had not changed. We targeted 97%, but banks did not want to go over 92-93%. It seemed that, despite all the common efforts, we would not be able to agree on that tiny detail. The finalisation of the text was again the task of Piroska, and she very wisely announced an extra coffee break before starting this last stage. The representatives of banks were good old friends as well, so, during the break we had our coffee together and continued our debate in a more relaxed way. Just 10 minutes before the end of the break, we had finally achieved the best compromise possible: banks accepted holding 95% of exposure, including not only the funds and capital provided to banks but also the Hungarian treasury bonds they held in their portfolios.[18] Everybody was a winner: we proved that international multilateral cooperation is a possible way to beat the crisis.

Ten years after

The Vienna Initiative had a positive effect not only on the stability of the banking system, but on the assessment of the country, and the region as a whole. The message was unanimous: none of the countries of the region would be left without protection, and international cooperation would extend to all the crisis-hit countries. The East European panic slowly faded away.

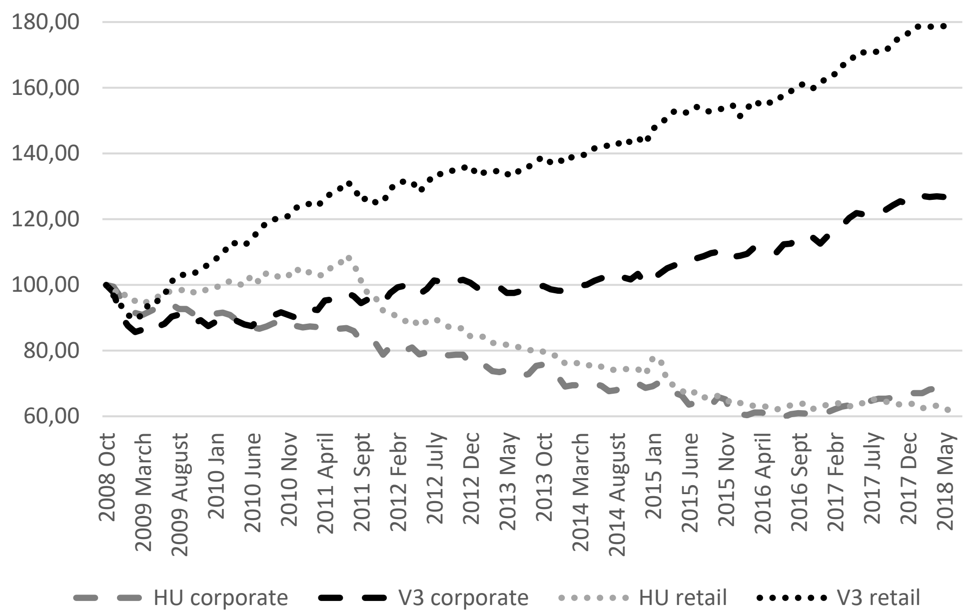
The Hungarian Vienna Initiative (VI) 1.0 program ended earlier than expected. The Fidesz government coming to power in 2010 made a sharp U-turn. "*Despite the colourful variations, until 2010 the countries [of the region] all moved in the same general direction: progress towards a market economy based on the dominance of the rule of law and of private ownership. Hungary was the first member of this group of 15 countries which has performed a sharp U-turn and set off resolutely in the opposite direction*" (Kornai 2015). The government blamed the banks for the crisis, and put the burden on their shoulders: not only was a new, irrationally high special tax levied on banks in 2011, but banks suffered huge losses, while wealthy borrowers were allowed to reimburse their FX-denominated loans at a preferential exchange rate, much below

18 I have received very positive feedback about my strong position and sometimes emotional defence of my country's interests, from both IFIs and banks. After my resignation from the MNB, the KBC Group invited me to join them as an independent director. Marco Voljč, head of International Markets at that time, highlighted my behaviour during the VI as one of the most important arguments during the nomination process. Seven years later, in 2016, Sean Berrigan nominated me as the SP member of the Hellenic Financial Stability Fund (HFSF), remembering our joint struggle at the VI. So, I consider myself personally a great winner of the VI.

the actual market rate. Since, in 2010 the government broke the loan agreement with the IMF and the EU, the VI programme agreement was formally exited. The paralysed banks slowly started to withdraw their funds from Hungary, but the outflow speeded up only in 2012 when the Eurozone crisis hit. On the other hand, banks increased the capital base of their subsidiaries, stood by them and did not let them go bankrupt. The result of the new government policy was nevertheless catastrophic: the credit flow in the country slowed down, and its recovery was the worst in the region (Figure 6).

Figure 6.

Credit flow in Hungary and in the Visegrád countries (2008-18)



Source: *MNB Growth Report 2018 (Figure 4.2.) https://www.mnb.hu/kiadvanyok/jelentesek/novekedesi-jelentes/2018-11-08-novekedesi-jelentes-2018-november*

Notes: *The Report has not been published in English*

The Vienna Initiative 1.0 was then followed by VI plus, VI 2.0 and so on, but this is already another story.

The "Vienna Initiative" has become the international trademark of cross-border public–private cooperation: when German chancellor Angela Merkel and French president Nicolas Sarkozy worked on the Greek crisis, they agreed the best would have been a kind of "Vienna Initiative Agreement." [19]

19 http://www.france24.com/en/20110617-imf-france-germany-sarkozy-and-merkel-call-for-rapid-solution-to-greek-crisis

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CHAPTER 7

Lessons from the global financial crisis in the context of the Vienna Initiative

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Abstract

Following the collapse of Lehman Brothers, Central, Eastern and Southeastern Europe experienced a deep recession, yet avoided a financial meltdown. This was helped by: (i) swift and decisive policy responses by countries; (ii) large, front-loaded financial assistance packages from the IMF/EU; and (iii) continued commitment to the region by multinational banks, facilitated by the Vienna Initiative.

Context

Since the onset of transition in the early 1990s, Central, Eastern and Southeastern Europe (CESEE) has made impressive progress.[1] Following an initial sharp decline in output as the region transformed from centrally planned to market principles, it grew faster than most emerging market regions and by the end of the decade GDP exceeded its pre-transition levels. Until early 2000s, growth was driven largely by exports, reflecting its integration into Western European regional value chains. Between 2003 and 2008, however, the region experienced a credit-driven domestic demand boom, fueled by large capital inflows from Western European banks.[2]

1 For a careful historical overview of the crisis – its origins, triggers, policy responses, and the subsequent recovery — readers should refer to *How Emerging Europe Came Through the 2008/09 Crisis—An Account by the Staff of the IMF's European Department*, edited by Bas B. Bakker and Christoph Klingen. Washington, DC: International Monetary Fund, 2012.

2 An IMF study on linkages between eastern and Western Europe showed that financing provided by Western European banks added 2 percentage points to the region's annual domestic demand growth, or 1.5 percentage points to GDP growth during 2003-8. International Monetary Fund, 2011. *Regional Economic Outlook: Europe*. Washington, DC, October.

With low margins in Western Europe, large European banks focused on higher rates of returns in CESEE and extended funding of about US$560 billion. Western banks brought the much-needed know-how, technology and better governance. However, large volumes of lending were channelled into consumption and non-tradeable sectors, resulting in excessive current account deficits, high external debt and homegrown asset price bubbles.

The global financial crisis hit the CESEE region exceptionally hard. The prosperous pre-crisis years had left most of the region dependent on foreign-financed credit growth, making it vulnerable to sudden stops in capital inflows. In the aftermath of the Lehman Brothers' bankruptcy in September 2008, capital inflows into the region plummeted, global trade collapsed, credit growth suddenly stopped and domestic demand plunged. Capital flows from Western European banks to the region dried up sharply and local banks came under acute funding pressures. This "perfect storm" resulted in a sharp economic contraction, with GDP growth declining, on average, by about 6% in 2009.

While the CESEE experienced a deep recession, the region avoided a contagious financial meltdown. Without doubt, the swift and decisive domestic policy responses played the main role in staving off even deeper recessions. Policymakers were prepared to do whatever it took to preserve their long-standing fixed exchange rate regimes and avoid painful currency crises. Monetary, fiscal and financial policy responses were nimble and astute. However, the domestic policy efforts would have been considerably less successful had it not been for large-scale financial assistance packages from the IMF/EU, support from the World Bank, EBRD and EIB as well as multinational commercial banks' commitment to the region, facilitated by the Vienna Initiative.

Solving collective action problems

The Vienna Initiative's purpose was to prevent a panic-driven *en masse* exit of Western banks from CESEE. In the midst of the global financial crisis, liquidity and solvency conditions deteriorated rapidly, prompting Western banks to repair their balance sheets and retrench to their home markets. A large-scale deleveraging of CESEE exposures would have caused havoc in the region. This meant that, individually, the obvious strategy for any parent bank would have been to reduce its CESEE exposure as quickly as possible, to benefit from the first-mover advantage and minimise losses. However, if all banks had applied such a strategy, this would have caused severe financial stress in host countries, which, in turn, would have inflicted further damage to bank balance sheets.

The Vienna Initiative provided a platform that helped solve collective action problems. It facilitated cooperation between Western banks with large CESEE exposures, their home- and host-country supervisors and multilateral organisations. This helped to avoid an uncoordinated pullout of Western banks from the CESEE region. In the context of the Initiative, 17 Western European banks signed voluntary country-specific commitment letters pledging to maintain their net exposure to their subsidiaries. These banks accounted for almost 90% of foreign banks' total assets in the five signature countries, with their total market share ranging from a third of total banking sector assets in Hungary to two-thirds in Romania. No parent bank allowed any of its CESEE subsidiaries to fail, and additional liquidity and capital were provided as needed.

Five CESEE countries with IMF/EU-supported programmes benefited from international coordination in the context of the Vienna Initiative: Bosnia-Herzegovina, Hungary, Latvia, Romania and Serbia.[3] The Western banks present in these countries reiterated their commitment to their subsidiaries following each programme review for the duration of the IMF/EU-supported programmes. And while Western banks' overall exposure to the region did decline, subsidiaries of parent banks that signed commitment letters proved to be more stable sources of credit than subsidiaries of banks that did not sign such letters in the same country, with credit growth about 10 percentage points higher.[4] To some extent, this resulted in the five CESEE programme countries experiencing less private sector deleveraging than the five advanced European economies most affected by the crisis. At the same time, banking sectors in these five CESEE programme countries required less government support than their peers in advanced Europe.

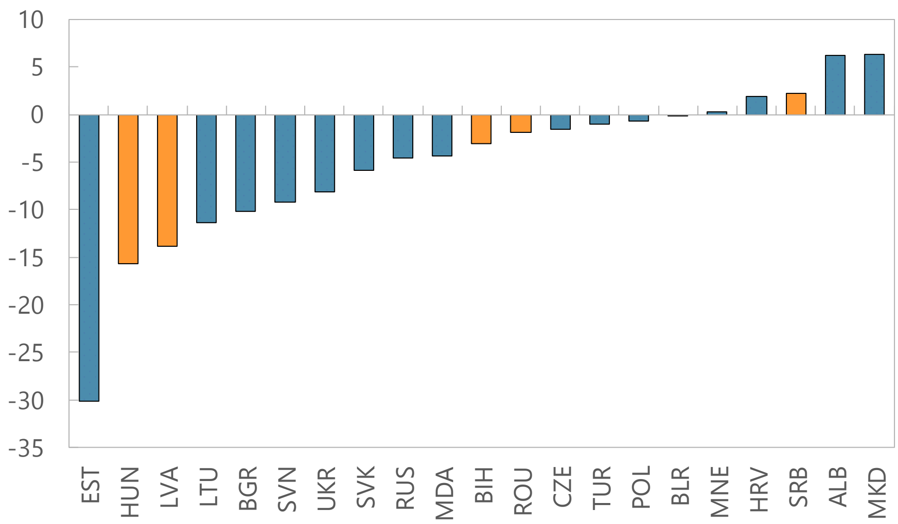
3 In the cases of Bosnia-Herzegovina, Romania, and Serbia, these commitments were an integral part of the negotiations of the IMF/EU stabilisation programmes. However, in the cases of Hungary and Latvia, banks' commitment letters were finalised only after the programmes had been put in place.

4 De Haas, R., Y. Korniyenko, A. Pivovarsky, and T. Tsankova, 2015. Taming the herd? Foreign banks, the Vienna Initiative and crisis transmission, *Journal of Financial Intermediation*, 24(3), 325-355.

Figure 1.

CESEE: Change in External Positions of BIS-reporting Banks, 2008Q3-2011Q4

(in percent of GDP, exchange-rate adjusted, vis-à-vis all sectors)

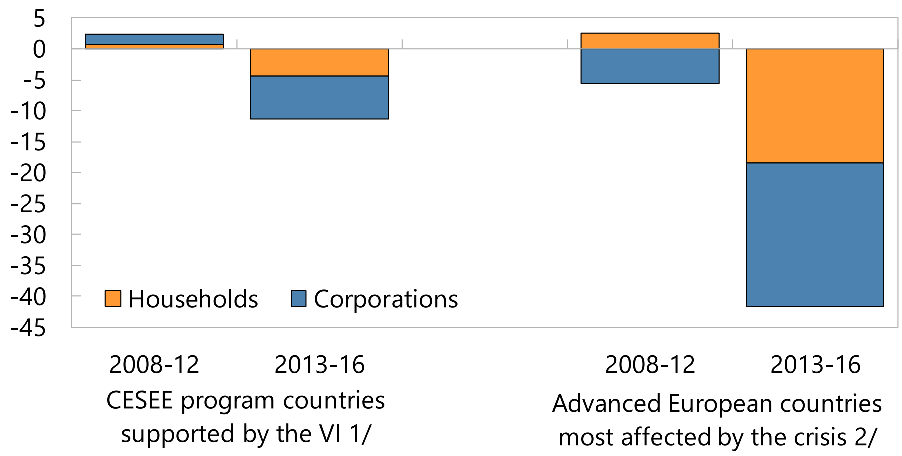


Sources: BIS; and IMF's World Economic Outlook and staff calculations.

Figure 2.

Private Non-financial Sector Deleveraging

(In percent of GDP; PPP-GDP weighted)



Sources: IMF's World Economic Outlook; Monetary and Financial Statistics; and staff calculations.

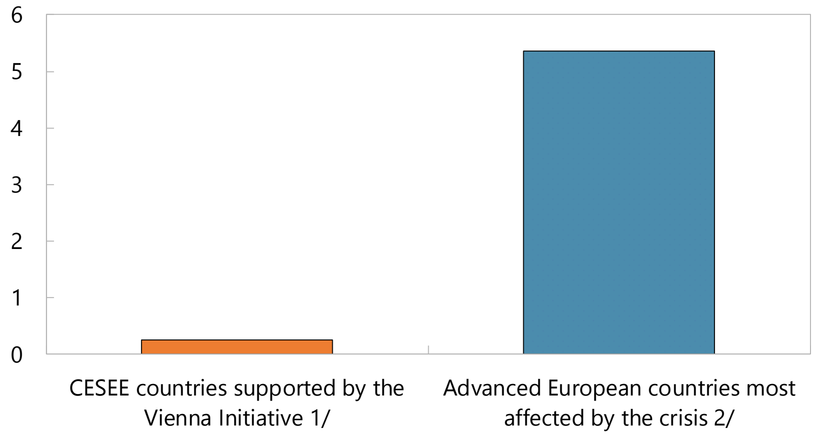
1/ Bosnia-Herzegovina, Hungary, Latvia, Romania and Serbia.

2/ Greece, Iceland, Ireland, Portugal and Spain.

Figure 3.

Government Support of Financial Institutions, 2009-12

(In percent of GDP; PPP-GDP weighted)



Sources: Eurostat.
1/ Hungary, Latvia and Romania only.
2/ Greece, Iceland, Ireland, Portugal and Spain.

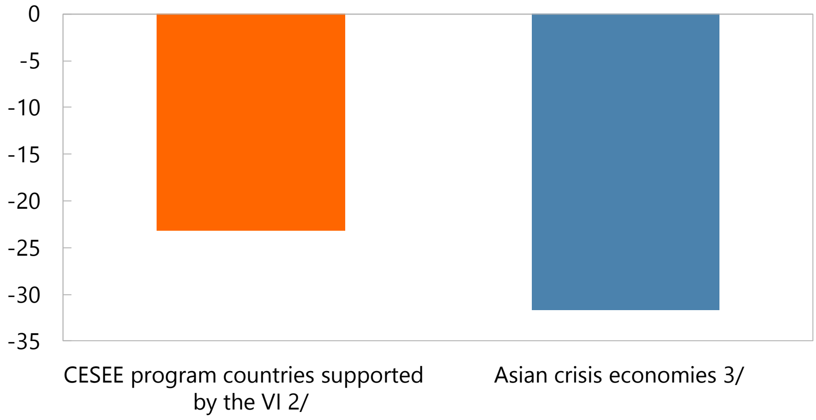
The economic outcomes of the five countries with the IMF/EU-supported programmes were remarkable. On average, the five CESEE programme countries experienced milder recessions than the emerging Asian countries affected by the Asian crisis in the late 1990s, even though their required current account adjustment was larger. Under the programmes, current account deficits declined from 11% of GDP to 2.5% of GDP – an adjustment of 8.5 percentage points. This reflected a continued growth of exports, as the countries improved their competitiveness, and a significant compression of imports, the growth of which declined to about 3% post-crisis from over 15% before the crisis. A similarly favourable comparison can be drawn vis-à-vis other emerging markets that required IMF financial support in 2008-10.[5] These countries achieved a significantly smaller current account adjustment than the five CESEE countries, and it was much more attributable to import compression.

5 This group includes other emerging markets that required the Fund support as capital flows dried up at the start of the crisis: Armenia (2009), Belarus (2009), Georgia (2008), Kosovo (2010), Mongolia (2009), Sri Lanka (2009) and Ukraine (2008 and 2010). Similar grouping was used in IMF, 2015, *Crisis Programme Review*.

Figure 4.

Real GDP Growth Relative to Trend

(Percent difference of real GDP in year t+5; PPP GDP weighted) 1/

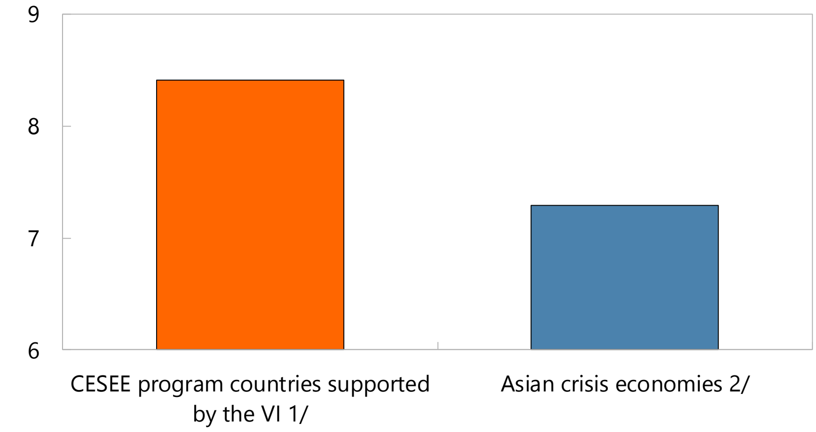


Sources: IMF's World Economic Outlook and staff calculations.
1/ Trend GDP is calculated over 10 years, starting 2 years before the crisis.
2/ Includes Bosnia-Herzegovina, Hungary, Latvia, Romania and Serbia; t=2009.
3/ Include Indonesia, Korea, Malaysia and Thailand; t=1998.

Figure 5.

Change in Current Account Balance

(In percent of GDP, difference between 3-year post- and pre-crisis averages; PPP-GDP weighted)



Sources: IMF's World Economic Outlook and staff calculations.
1/ Bosnia-Herzegovina, Hungary, Latvia, Romania and Serbia.
2/ Indonesia, Korea, Malaysia, and Thailand.

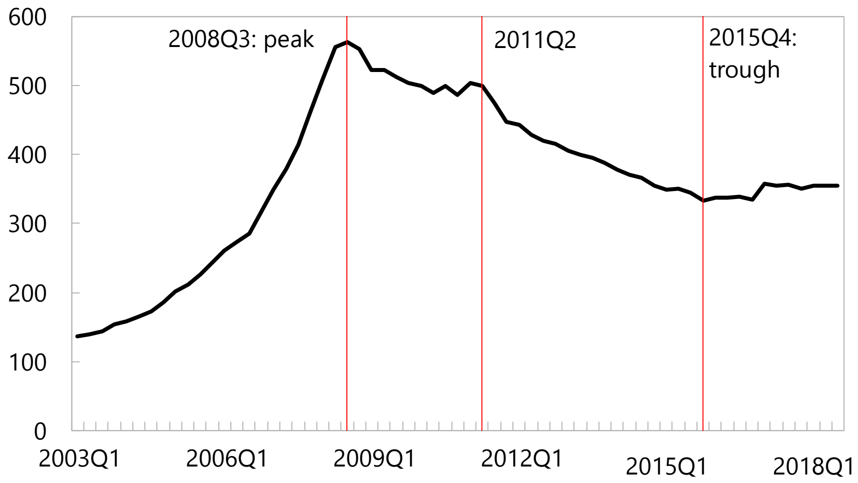
Western bank deleveraging in CESEE after the crisis

The deleveraging of Western banks vis-à-vis CESEE resumed in the second half of 2011, as the eurozone sovereign debt crisis worsened. The combination of intensifying funding strains in the markets, regulatory and market pressures to improve capitalisation and weak credit demand prompted Western banking groups to resume the withdrawal of funding from CESEE. Between June 2011 and December 2015, BIS-reporting banks reduced their external positions by US$165 billion, or 6% of the region's GDP (CESEE excluding Russia and Turkey)—almost 2.5 times more than in the three years after the crisis. In addition, strategies of some cross-border banks devised at the group level paid insufficient attention to the implications for host countries, unduly straining some local market segments. In some countries, concerns about domestic policies and economic vulnerabilities compounded the outflows. While deleveraging has broadly stabilised since 2016, foreign bank funding remains significantly below pre-crisis levels in most CESEE countries.[6] The Initiative remained engaged in the region in its updated 2.0 reincarnation.

Figure 6.

CESEE excl. Russia and Turkey: Change in External Positions of BIS-reporting Banks, 2003Q1–2018Q3

(Billions of US$, exchange-rate adjusted, vis-à-vis all sectors)



Sources: BIS, Locational and Consolidated Banking Statistics.

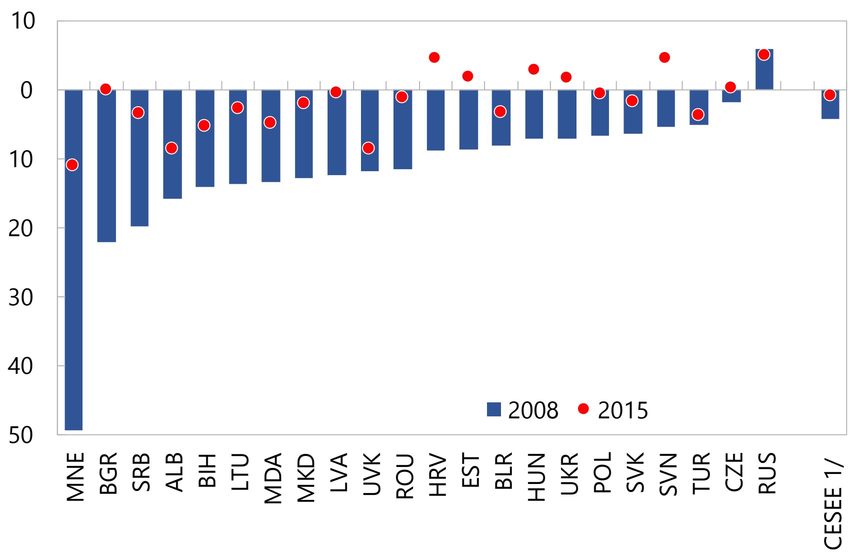
6 *CESEE Deleveraging and Credit Monitors*, various editions.

The deleveraging of Western banks in CESEE proceeded on the back of significant current account adjustments in these countries. Following the global financial crisis, current accounts in the region improved significantly, on average, by about 5% of GDP, from a deficit of around 5% of GDP in 2008 to close to balance in 2015. This turnaround reflected that national savings replaced foreign savings and investment took a hit in the crisis. The size of the improvement varied appreciably across countries, ranging from about 2 percentage points of GDP in the Czech Republic to around 10 percentage points in the Baltics, and over 20 percentage points in Bulgaria.

Figure 7.

CESEE: Balance of Current Account, 2008 versus 2015

(Percent of GDP)



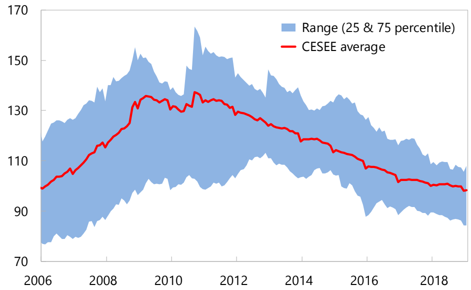
Sources: IMF, World Economic Outlook; and IMF staff calculations.
1/ Excluding Russia.

With the rise in domestic savings came faster deposit growth, which partially cushioned the decline of foreign funding. During the boom years of 2003-8, CESEE banks relied heavily on funding from their Western parents. After the global financial crisis banking groups emphasised developing local funding sources and lowered their loan-to-deposit ratios in CESEE subsidiaries. A good part of this rebalancing had occurred by 2015, with the average loan-to-deposit ratio declining to around 110% from a pre-crisis peak of 135% (left chart in Figure 8). An expanding domestic deposit base allowed foreign banks to contain the contraction of their operations in CESEE. Accordingly, during 2008-15, the decline of foreign bank exposures to the region (measured by the "foreign claims" in the BIS Consolidated

Banking Statistics) was smaller than foreign banks' funding reductions (measured by "external positions" in the BIS Locational Banking Statistics)—about 20% compared to about 40% (right chart in Figure 8).

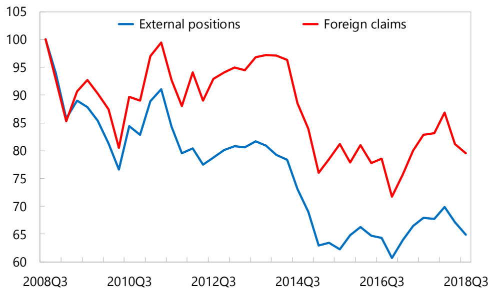
Figure 8.

CESEE: Domestic Loan to Domestic Deposit Ratios
(Percent; Jan. 2006 - Jan. 2019)



Sources: IMF, International Finance WorldStatistics; and IMF staff calculations.

CESEE: External Positions and Foreign Claims
(Index, 2008Q3 =100)



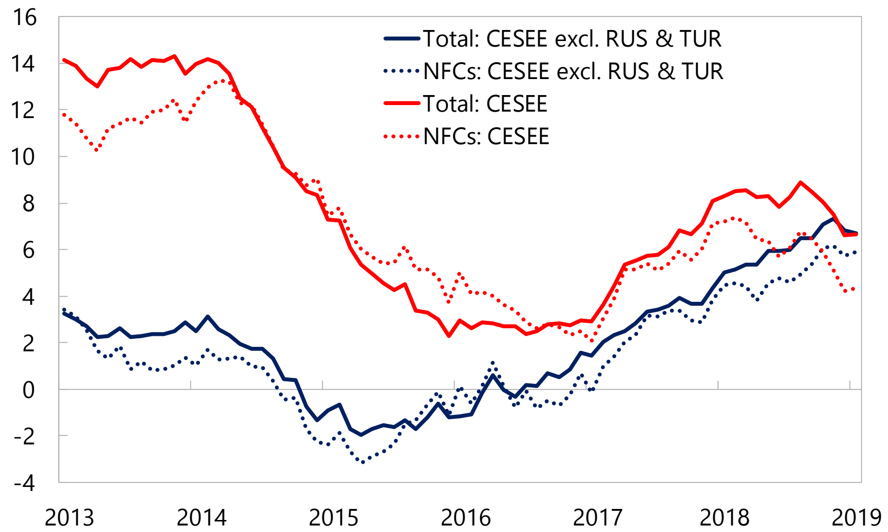
Sources: BIS; Haver Analytics; IMF, Economic Outlook*; and IMF staff calculations.*

Private sector credit growth in CESEE (excluding Russia and Turkey) remained very weak in the aftermath of the global and euro area crises and turned positive only in early 2017. In nominal and exchange-rate adjusted terms, credit growth declined dramatically after the global financial crisis from over 20% to low single digits during 2010-14 and turned negative in 2015-16. Credit growth has been recovering gradually since mid-2016.

Figure 9.

CESEE: Credit to Private Sector

(Year-over-year percent change, exchange-rate adjusted, PPP GDP-weighted)



Sources: EBRD; Haver Analytics; and IMF staff calculations.

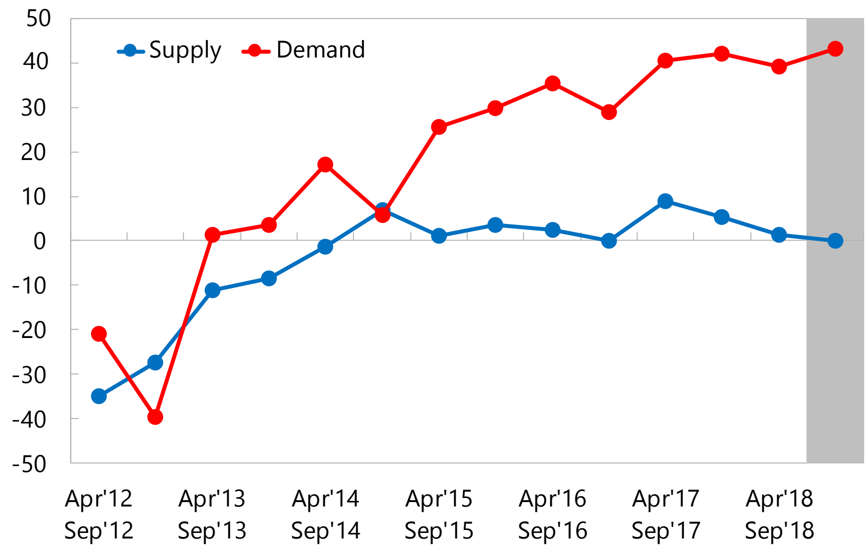
Weak credit growth reflected a plunge in both supply of and demand for loans in the aftermath of the global financial crisis. As the economic outlook deteriorated, customers became much more reluctant to take out loans and banks much more cautious in extending them. Nonperforming loans (NPLs) increased steeply, although CESEE countries typically did not experienced a generalised debt overhang. As cross-border banking groups operating in CESEE came under market pressure and their fundamentals deteriorated, they reduced credit supply, tightened credit conditions and embarked on the rebalancing of funding sources toward local deposits.

Empirical studies confirm the important role of macroeconomic factors in the downturn of credit growth. They show that factors on the supply side, such as bank fundamentals and funding costs, significantly slowed credit growth. Bank lending surveys by central banks showed a substantial tightening of bank lending conditions and a sizeable drop of credit demand in the post-crisis years. Lending conditions started easing during mid-2010 to mid-2011, but tightening resumed following the euro area crisis. Credit conditions eased again starting in early 2015, as the recovery of economic activity broadened and strengthened across Europe.

Figure 10.

Credit Conditions: Supply and Demand, April 2012-March 2019

(Net percentages; positive figures indicate increasing demand/easing credit standards)



Sources: EIB, CESEE Bank Lending Survey.

Lessons for the future

New multilateralism: participation in the Vienna Initiative resulted in more ownership by the five programme countries and provided greater incentives to cooperate. This fits well with the call of the IMF's Managing Director for the "new multilateralism", whereby governments and the private sector work together to tackle the key challenges of the 21st century. The Vienna Initiative could be a part of this "new multilateralism" by keeping the firefighter framework ready as we prepare for the next crisis, which probably lurks somewhere over the horizon. If the next crisis once again impairs banks, we now have more limited room for policy manoeuvre, more limitations to bailouts and the new systems for bail-ins are not yet fully funded and remain untested. As a result, there may be a need for greater reliance on multilateral responses—including the Vienna Initiative—and on the global financial safety net.

The role of the Vienna Initiative beyond crisis times should focus on financial surveillance and strengthening cooperation mechanisms.[7] Fostering a regular policy dialogue between home and host regulators and bank supervisors, parent banks and multilateral institutions is critical for upholding Vienna Initiative's readiness to be an effective part of a broader policy response to the next crisis. In the interim, more

7 The semi-annual *CESEE Deleveraging and Credit Monitor*, to which the Fund contributes, is a key part of the Vienna Initiative's financial surveillance.

needs to be done to manage the strategic pull back of selected Western banks from the region and support European financial integration. The Initiative should also help EU policymakers and bank supervisors understand the spill-overs from the changing EU regulatory landscape to CESEE, particularly the non-EU countries, as well as prepare their CESEE counterparts for the new regulations. Finally, the Initiative should continue to provide smaller non-EU host countries in the Western Balkans with a forum to discuss common issues and the opportunity to be heard.

CHAPTER 8

FX-denominated loans in Central, Eastern and Southeastern Europe: a risky but often unavoidable step in the transition

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Launched at the height of the financial crisis in January 2009, the Vienna Initiative aimed at preventing a "run to the exit" of the EU parent banks operating in Central, Eastern and Southeastern Europe, in the various countries severely hit by the crisis and benefiting from multilateral financial assistance. At that time, a withdrawal strategy by the EU parent banks would have led to capital outflows and to full-blown balance of payments crises. While most EU parent banks rapidly reaffirmed their long-term commitment to the region, the issues at stake were aggravated by the relatively high degree of euroisation of the banking sectors, which were thus very exposed to currency depreciation against the euro. Beyond stabilising the balance of payments, one unofficial objective of the international financial assistance was therefore to avoid sharp depreciation of domestic currencies. In some countries, such as Hungary, the use of the Swiss franc introduced an additional dimension to the nature of the risks.

With the benefit of hindsight, this contribution reviews the dilemma for EU parent banks regarding their role in the euroisation process of several markets in the region prior to 2008, and how the Vienna Initiative was decisive in navigating through the resulting challenges.

The lessons of dollarisation

If the circulation of several currencies within a territory is an old phenomenon, illustrated by the history of metallism, a process of dollarisation or euroisation has usually been the consequence of an acute crisis of confidence in the domestic currency. The alternative for the monetary authorities is then either to impose exchange controls and financial repression, or to tolerate a variable degree of dollarisation or euroisation. The outcome is rarely a policy choice and more often imposed by the political circumstances of the moment. The economic literature, referring mostly to dollarisation, is rather laconic as to the practical consequences. Dollarisation allows for the expansion of the financial sector but can only be described as a second-best solution. It implies a lasting loss of monetary policy autonomy. A greater exchange rate risk is embedded in the domestic economy and there is an increased responsibility for fiscal policy.

The process of dollarisation is most often measured by the share of US dollar loans and deposits in the banking sector, due to the lack of a more refined measure (for instance, regarding its use for payments or by industries). Its dangerousness is difficult to assess precisely, because it depends on all the factors that can increase the embedded exchange rate risk in the economy: the overall balance of funding and net external position of the country, the position of the various agents, the external environment and the factors determining confidence. The lessons of the past are not easy to generalise: some countries have been able to navigate smoothly for long periods with a degree of dollarisation above 50 percent (such as Peru) or even with full unilateral dollarisation (such as Panama, Ecuador). Others (such as Brazil, Russia) have managed to keep dollarisation below 30 percent despite acute crises of confidence in the domestic currency. The Argentine experience of the 1990s began with the recognition of the benefits of "bi-monetarism" before ending up in disaster. Through this diversity, one general lesson can nevertheless be learned: a high degree of dollarisation is more sustainable for small open economies with strong banking systems, moderate external debt and close economic links to the United States, the reverse characteristics being each of them sources of fragility. For the countries aiming at regaining monetary policy autonomy, the process is always very lengthy, as monetary and supervisory authorities have to deliver a comprehensive monetary stabilisation, rebuilding confidence in the value of the local currency.

The challenge of rebuilding capitalism without capital

After the initial shock of the transition, GDP growth in CEE was mainly driven by a catch-up process with "old" Europe stimulated by rising commercial and financial integration with the EU. The situation of the new or aspiring EU members was for this reason quite specific. Their development pattern was often associated with high growth and high imbalances such as rapid credit expansion and significant current account deficits. The imbalances partly stemmed from the initial choice of rapidly ensuring full convertibility of the currencies (a requirement of EU adhesion) in order to attract foreign direct investment (FDI), thus disconnecting investments from domestic savings and leading to current account deficits. It was ingrained in the need to rebuild capitalism, with a low initial stock of domestic capital at the early stage of the transition. This historical juncture, rebuilding capitalism without capital, had many consequences.

A regional euroisation trend driven by the catch-up process…

Kick-started in the 1990 by the restructuring and privatisation of the banking sectors, credit expansion started from a low base, with loans to households (consumer and mortgage loans) often growing more rapidly than loans to the corporate sector. Foreign currency lending expanded, including for households. The rationale to take out debt in foreign currencies was strong, as agents anticipated the appreciation of their local currencies in real terms against the euro, as well as rising incomes in the local currency. As an anecdote reflecting this mood, high-ranking officials in the region often privately highlighted that they were personally indebted in euros, confident that they would be winners over the long term. The euroisation process was further fostered by the desire to save in euros and by the lower interest rates for borrowers in euros. The perception that exchange rates should on average continue to appreciate in real terms in the long term was supported by the Balassa-Samuelson effect linked to the catch-up process: high productivity gains associated with FDI were expected in the tradeable sector.

Table 1.

Loans in foreign currency (percent of total loans)

	1998	2000	2002	2004	2006	2008
Slovenia		77	84	90	90	
Estonia	76	79	83	80	78	86
Latvia		51	53	66	70	85
Lithuania	56	58	49	59	53	65
Hungary	55	49	37	40	43	61
Poland	21	21	27	25	27	34
Czech Rep.	20	16	15	11	10	9
Romania		45	50	58	49	58
Bulgaria	39	36	42	48		57
Croatia*			91	86	88	77
Serbia*					85	71

** FX and FX-indexed loans*

In 2008, rapid credit growth had been registered for several years. Since 2003, credit to the private sector had grown annually in real terms by around 5% in Poland and Slovakia, 10 percent in the Czech Republic, about 15% in Hungary and Slovenia and between 30 and 50 percent in the Baltics and the Balkans. In some countries, the bulk of domestic credit was denominated in or indexed to foreign currencies (see Table 1, sourced from central banks). The share of loans in foreign currencies did increase through the region, except in the Czech Republic, which managed to avoid the trend, thanks to early monetary stabilisation and a well-calibrated subsidy program for domestic savings in local currency. At the other end of the spectrum, former Yugoslavian countries were already deeply euroised after the crises and wars of the 1990, with few benchmarks in local currencies. These foreign currency loans were predominantly in euros, but Swiss francs and Japanese yen were also popular in Hungary and Poland.

...and by powerful microeconomic forces

Large sectors of the domestic economies were more significantly euroised. This was notably the case for the real estate sector, both commercial and residential, where contracts, transaction prices, rents and values for collateral were most often calculated and settled in euros. The action of large foreign investors whose business models were connected to the more mature markets of the euro area had the effect of pushing the trend further. This was true also in the automobile sector, with input costs incorporating imported spare parts, and in the distribution sector, with contracts for imported brands and shopping centre rents denominated in euros. Large European players were at the time powerfully reshaping these sectors and had the ability to impose price targets in euros on their local subcontractors, with an objective to control costs and reduce the exchange risk. Many tariffs for utilities were also *de facto* linked to costs in euros. Only the more local activities and the public sector escaped this trend.

This tended to create an illusion of deeper "de facto" euroisation of the economy that also responded to the psychological needs of hoarding. But real revenues in euros were of course only coming from exports and expatriate transfers that represented a significantly lower share of the economy. This illusion was undoubtedly a risk factor in the event of a deep crisis. Other types of income, including wages, while sometimes denominated in euros, did not have the same quality. In the event of a balance of payment crisis, they could fall sharply versus the euro. While informal revenue was often cited as a factor of the resilience of the economies, this type of income was clearly not always available to repay debts in euros.

The dilemma faced by commercial banks

As previously examined, the euroisation process in the region was shaped by powerful micro- and macroeconomic forces. Domestic banks were of course key players in this process. As credit demand in foreign currency exceeded deposit accumulation, they started to rely increasingly on external funding in euros, sometimes provided by EU parent banks, thus building negative external positions. EU parent banks could also book some loan portfolios at their head office, pushing the trend further. It was a way to respond rapidly to the new market opportunities.

While the financial deepening process was occurring at high speed, in some countries it was nurturing a worrying combination of features such as a widening current account deficit, a negative net external position of the domestic banking sector and a rising share of foreign currency denominated loans. Some countries displayed all these features (the Baltics, countries in South Eastern Europe), others only some of them. Various academic papers started to underline these concerns,[1] raising the question of the resilience of banking sectors to the risk of an exchange rate shock or a prolonged economic downturn. Central banks in the region had already started to enact a panel of measures to try to slow the pace of foreign currency lending, mainly through increases in reserve requirements, tighter loan classifications and higher risk weights for these types of lending, albeit with very limited results. It was very much like trying to lean against a dominant wind. They were also wary of introducing too many competitiveness handicaps versus non-resident financial players who were not subject to the same restrictions.

For commercial banks riding the optimistic wave, the financial deepening was rational. The client base was expanding from a low level and included selectively the most solvent borrowers in the countries. A degree of comfort was also provided by specific regional factors seen as mitigating the risks.

Specific factors were seen as mitigating the risks

For most countries, the prospect of joining the euro area sooner or later mitigated the perceived currency risks by providing a credible exit strategy out of the danger zone. Euro adoption was not an option but was compulsory for new and aspiring EU members. In Slovenia, once the country entered Exchange Rate Mechanism II,

1 "Too much of a good thing?", IMF Working paper May 2005; "The foreign currency gamble", S&P, August 2006; "What do the sources of fund tell us of credit growth in Central and Eastern Europe ", EU occasional paper November 2006 ; "Credit expansion in Emerging Europe, a cause for concern ?", World Bank , January 2007.

foreign currency lending increased rapidly as the corporate sector seized the opportunity to finance acquisitions abroad. Entering the euro area as of January 2007 led to the conversion of local currency in euros, which eliminated the risks associated with the currency mismatches. In 2008, the prospect of euro adoption by 2010 for Baltic countries, and early in the next decade for many other countries, was estimated to be quite likely.

Specific microeconomic features were also expected to mitigate the risks. Banks in the region were overwhelmingly foreign-owned, by a supposedly strong pair of hands, and thus enjoying strong financial backing from their Western parent institutions. Strong capital ratios provided a cushion that seemed to make a homegrown systemic crisis unlikely. The traditional channels of contagion (asset bubbles, short-term liabilities, high public external borrowing requirements) were not spotted through the region, and strong parent banks were expected to play a stabilising role in the event of a crisis of confidence.

Past banking crises in emerging markets had often been preceded by rapid growth of credit in the context of semi-fixed exchange rate regimes. The question remained whether excessive imbalances could derail the process of joining the euro area and hurt the banking sectors in countries where it was a more distant prospect. The view at that time was that this risk could be assessed through a stress test scenario that would entail significantly weaker growth and a 20-30% currency depreciation in real terms for a period of up to two years, somewhat like what Poland had been through at the beginning of the decade, which had dented bank's profits for two years but had not been long lasting. A more severe stress was considered extreme, requiring a mechanism of contagion, deep doubts on the long-term catch-up process or wide-ranging euro-scepticism.

Indeed, the impression prevailed that new and aspiring EU members were going through an exceptional historical period. Even sceptical observers were not ready to question the long-term catch-up perspective. Only the speed of catch up seemed questionable, not its direction, nor its duration (likely to continue for 10 to 15 years), nor the continuation of the microeconomic transformation allowed by the accession process to the EU.

To the test of the great financial crisis

With the benefit of hindsight, we have learned that some of these assumptions were far less robust than we believed. Some were even destroyed by the great financial crisis.

- EU parent banks were significantly weakened by the global financial crisis and the subsequent euro area crisis. Some of them, not only limited to Greek and Irish banks, could no longer be considered as "strong pair of hands". For a period, the exposure of EU parent banks to the region was seen more as a liability than an asset.

- The catch-up process came to a sudden halt for several years, except in Poland. It restarted regionally at a much lower speed only after 2013. In parallel, the crisis of the euro area periphery also showed that, for older EU members, the productivity catch-up had not been steady but had stalled at a fraction of the productivity of the core euro area.

- While Slovakia joined the euro area in 2009 and the exit strategy eventually worked for the Baltic states in the following years, the agenda of euro adoption was postponed for other countries, sometimes without new dates, with a growing mood of euro-scepticism. The EU enlargement process was also more or less stopped after the joining of Croatia.

In the years before the crisis, the real-term appreciation of currencies versus the euro, pushed by the foreign capital inflows, had been more rapid than suggested by the Balassa-Samuelson effect linked to the catch-up process. Productivity gains in the real world had been slower than credit and currency markets had been anticipating. When capital inflows stopped in 2009, a rebalancing was needed, and some currencies appeared to be overvalued while the prospects of joining the euro area were delayed. In this new context, the need to reduce the foreign exchange risk embedded in the economies came to the fore.

The response of the Vienna Initiative

While previously the sole concern of some central banks in the region, the need to reduce the foreign exchange risk embedded in the economies became more widely shared by the other institutions. The Vienna forum played a decisive role in that matter. As macroeconomic forces were no longer pushing for further euroisation, the action of regional central banks started to bite much more powerfully. Time was needed for an orderly rebalancing, and the Vienna Initiative was crucial in providing this time. The process of de-euroisation required attracting savings in local currency. Beyond the action of regional central banks, this was made progressively possible by the successful external rebalancing of the economies and the macroeconomic and currency stabilisation that followed. The spreads between the instruments labelled in local currency versus the euro started to collapse, diminishing greatly any previous incentive to support a foreign exchange risk. Euroisation in the region diminished progressively as shown by Table 2.

Table 2.

Loans in foreign currency (percent of total loans)

	2008	2010	2012	2014	2016	2018
Slovenia						
Estonia	86	89				
Latvia	85	89	87			
Lithuania	65	75	73	73		
Hungary	61	62	55	51	22	21
Poland	34	33	32	29	27	21
Czech Rep.	9	8	8	10	11	13
Romania	58	63	62	55	43	34
Bulgaria	61	64	64	57	45	40
Croatia*	77	73	75	74	66	60
Serbia*	71	69	72	69	69	67

** FX and FX-indexed loans*

Some issues were more confrontational. Swiss franc loans were rightly spotted as very risky, as was illustrated in 2015 when the Swiss unpegged the franc from the euro. Hungary implemented forced conversion of these loans in to local currency and was later followed by Croatia, while Poland and Romania contemplated schemes that were not eventually enforced. Hungary, followed later by Poland and other countries, started to tax more foreign capital and to question its role in their economies. While these debates have left some scars, it is also clear that no major player has chosen to exit the region for this reason.

The Vienna Initiative is a case study of successful cooperative behaviour, being built on a strong basis. The fact that the same commercial banks were both large domestic players and the main external creditors did crucially help in that regard. Market funding was not prevalent in most cases, and the relatively low level of public debt ratios in the region was a strength. A systemic banking crisis in the region was thus avoided, to the benefit of all players. The orderly rebalancing of banks' business models reduced the levels of risk and facilitated the de-euroisation process where it was necessary. The region now appears to be on a much more solid footing to weather future crises.

CHAPTER 9

The Vienna Initiative: from short-term impact to long-term solutions

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Introduction

The start, in 1989, of emerging Europe's transition from communism to capitalism opened the region to the large-scale entry of foreign banks. Eastern Europe quickly became one of the financially most integrated parts of the world as foreign direct investment (FDI) fostered strong links between Western European parent banks and Eastern European subsidiaries and branches. The empirical evidence that emerged over the next two decades shows that – at least until the outbreak of the global financial crisis – the large-scale entry of foreign banks was, by and large, a force for good. Local investment was boosted by firms' improved access to foreign savings; foreign financial institutions stimulated banking-sector competition (Havrylchyk and Jurzyk, 2011); and – relying on their strong parents – foreign bank subsidiaries also contributed to stability during episodes of *local* financial turmoil (De Haas and Van Lelyveld, 2006; 2010; 2014).

The global financial crisis put this model of intense cross-border banking to the test. The crisis was unique in that it originated in the *home* markets of the banking groups operating in emerging Europe. Although few of these large banks had direct U.S. sub-prime exposures, many of them were affected by the sharp reduction in interbank liquidity as of the second half of 2007. Banks started to deleverage both at home and abroad, a process that accelerated after the collapse of Lehman Brothers in September 2008 (De Haas and Van Horen, 2013). It became increasingly uncertain whether multinational banks, now battered by problems elsewhere, would keep funding Eastern European customers through their local subsidiaries.

In response to these mounting pressures, Western governments supported various banks with guarantees, capital and liquidity towards the end of 2008. This alleviated concerns about a credit crunch “at home” but did not mitigate worries about a retrenchment of banks from emerging Europe. On the contrary, concerns were raised that government support came with strings attached. Anecdotal evidence suggests that many banks were indeed asked to focus on domestic lending.

Tightening funding constraints and biased government interventions raised concerns about the possibility of an uncoordinated rush of banks out of emerging Europe. Although many banks confirmed their commitment to the region during the early stage of the crisis, there was no formal policy framework or coordination mechanism in place to ensure these commitments were credible. The concern was that this lack of coordination could lead individual banks to withdraw, thus causing a “run” on the region, even though it would be in their collective interest to roll over debt. The absence of agreements on how to share the burden of a defaulting subsidiary between the fiscal authorities in the home and host countries further exacerbated the risk of such a run. The accompanying reversal in financial flows could not only have had dire consequences for local firms and households but also have led to disruptive exchange-rate fluctuations and balance of payments problems.

In response to this emerging institutional vacuum, the Vienna Initiative (VI) was born. At its most basic level, the objective of the VI was to avoid collective action problems (Pistor, 2012) and to guarantee macroeconomic stability in emerging Europe. In February 2009, the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and the World Bank Group launched within the context of the VI *a Joint IFI Action Plan in support of banking systems and lending to the real economy in Central and Eastern Europe*. The goal was to mobilise resources from these institutions to avert a banking crisis and support bank lending in the region. This support was integrated with IMF and European Union macro-financial support programmes to Bosnia-Herzegovina, Hungary, Latvia, Serbia and Romania. In return for financial support under the *Joint IFI Action Plan* and countries’ commitment to keep support programmes on track, several multinational banks signed country-specific commitment letters in which they pledged to maintain exposures and to continue to provide credit to firms and households in that country. Parent banks confirmed that they would keep subsidiaries adequately capitalised and provide them with enough liquidity. The VI thus developed into a public-private partnership that combined macro financial support by the IMF and the EU (a “bailout”) with funding by development institutions and a coordinated ‘bail in’ of private lenders.

The other chapters in this volume describe the genesis and politics of the VI in considerably more detail. The goal of this chapter is to summarise some empirical evidence on its effectiveness. Did the VI really succeed in stabilising cross-border flows? Of course, over the past decade it has become clear that the complete and uncoordinated withdrawal of banks from emerging Europe did not materialise. Divestitures of foreign subsidiaries have been limited and, in many cases, involved sales from one foreign bank to another (De Haas and Van Horen, 2016). Crisis-affected parent banks typically also consolidated their foreign operations by selling smaller and more distant acquisitions (Claessens and Van Horen, 2015). In short, as most multinational banking groups continued to see emerging Europe as a strategic growth market, they decided to stay put. And in that broad sense, the VI can be considered a success.

Yet, it is of interest to delve a bit deeper into the data to uncover the mechanisms through which the VI managed to stabilise cross-border banking and, later on, to somewhat decelerate the reduction in funding from Western parent banks to their Eastern subsidiaries. To this end, this chapter, which draws heavily on De Haas, Korniyenko, Pivovarsky and Tsankova (2015), aims to answer three questions. First, were there observable differences in the lending behaviour of banks that were part of the VI versus those that were not, keeping all else equal? Second, for those multinational banks that *were* part of the VI, did their lending differ in countries where they signed commitment letters as compared with countries where they did not sign such letters? And third, did signing commitment letters lead to negative spill-overs to other countries (as many feared at the time)? We finish this chapter on a forward-looking note as we assess how increasing the availability of local-currency funding may help to stabilise bank lending in emerging Europe going forward.

The impact of the Vienna Initiative

The Vienna Initiative in a nutshell

As part of the VI, a total of 17 parent banks pledged, via so-called 'commitment letters', to maintain their exposures and to recapitalise subsidiaries for the duration of the IMF/EU programmes in five countries – Bosnia-Herzegovina, Hungary, Latvia, Romania and Serbia.[1] On average the banks that signed up had a joint

1 Commitment letters were signed for Romania and Serbia in March 2009, Hungary in May 2009, Bosnia-Herzegovina in June 2009 and Latvia in September 2009. Belarus and the Ukraine had IMF programmes but no commitment letters were signed.

market share in the host country of about 63%. Importantly, the banks that signed differed by country, as did the exact nature of the commitments. In the case of Latvia, the assumption was that foreign banks would roll over at least 80% of their lending to the country, the majority of which was to their own subsidiaries. In the case of Hungary, banks promised to ensure a "prudent capitalisation of their subsidiaries" and to maintain at least 95% of their September 2008 exposure. In Romania, the pledges were most concrete, as banks promised to "increase the minimum capital adequacy ratio for each subsidiary from 8 to 10%" and to fully maintain their March 2009 exposure for the time of the IMF programme. In Bosnia-Herzegovina and in Serbia too, banks committed to roll over 100% of their exposure (as of December 2008) and to recapitalise subsidiaries if and when needed. Some of these commitments were reaffirmed in 2009.[2] As the crisis subsided, pressure to maintain cross-border exposures was reduced, and some rollover commitments were lowered by early 2010.

Importantly, concerns were expressed at the time that the focus of the commitment letters on five specific countries could tempt multinational banks to support their subsidiaries in these countries by withdrawing funds from countries without exposure commitments, such as Poland or the Czech Republic. Such negative spill-overs could have contributed to the further cross-border transmission of the crisis. These concerns were only partially alleviated by a number of so-called 'horizontal meetings' with multinational banks and the relevant national and international authorities that were held in September 2009 and March 2010. The focus of these meetings was on lending to the whole region rather than the five countries with an IMF/EU programme and explicit exposure commitments.

Data

To assess the impact of the VI, the analysis in this chapter draws on detailed balance-sheet and income statement data for over 350 banks in emerging Europe during 1999-2011.[3] This time window includes the global financial crisis as well as the (partially overlapping) euro area crisis of 2009-11. The source is Bureau van Dijk's BankScope database and all data are denominated in US dollars to ensure comparability across banks. These data are combined with macroeconomic information from the IMF International Financial Statistics. In addition, hand-

2 In Romania, parent banks ultimately did not maintain full exposures. Except for three banking groups, parent bank financing declined before the commitments were reaffirmed (see IMF, *Romania: Letter of Intent and Technical Memorandum of Understanding*, February 2010).

3 The country sample includes Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovak Republic and Slovenia.

collected information on crisis-related government support to banks in both home and host countries is used. This includes support in the form of capital injections, bank-specific guarantees and asset sales to the government.

The main variable of interest is annual gross nominal credit growth. We define gross nominal credit as net loans plus loan loss reserves. Thus, our dependent variable reflects changes in banks' output of new loans, but not loan loss provisions and write-offs. If certain banks provisioned more during the crisis than others, this should therefore not bias our dependent variable. A quick eyeballing of these data reveals that, before the outbreak of the crisis (1999-2007) both domestic and foreign banks grew rapidly at an average pace of just over 40% per year. Credit growth was even somewhat higher among foreign banks, especially among subsidiaries whose parent banks would sign VI commitment letters in 2009. Foreign-bank subsidiaries typically had easier access to foreign wholesale funding – either from international capital markets or from their parent banks – and were less constrained by the availability of local funding.

Bank lending started to slow markedly towards the end of 2008, and this was true for both domestic and foreign banks. Interestingly, relative to banks that would not end up in the VI, VI banks reduced their lending significantly more in 2008. However, in 2009 – once the VI had come into force – the two groups of foreign banks displayed a similar nominal growth rate of about 1%. In the same year, foreign subsidiaries in the less-affected countries outside of the VI still grew on average by 10%. While credit growth decelerated substantially during the period 2008-09, persistent negative growth only started occurring in 2010-11 when the euro area crisis intensified.

Importantly, in each of the five VI countries there were two groups of foreign-bank subsidiaries: those with parent banks that signed a VI commitment letter in that country and those with parents that did not. For instance, in Hungary UniCredit and Raiffeisen Bank signed commitment letters whereas Commerzbank and Deutsche Bank did not. There was also variation among foreign-bank subsidiaries regarding whether their parent banks received government support or not. For instance, Commerzbank received capital support from the German government whereas Deutsche Bank did not. Moreover, parent banks signed commitment letters in some countries but not in others. Erste Bank signed a letter in Hungary but not in Serbia. Similarly, NLB Bank committed to rollovers in Bosnia & Herzegovina but not in Serbia. These are the exactly the sources of within-country and within-bank variation that are exploited in the remainder of this chapter.

Empirical analysis

This section briefly discusses the mechanics of the analysis of the VI impact. The interested reader is referred to the more technical discussion in De Haas *et al.* (2015) for more details. The analysis will consist of three main parts.

First, the chapter discusses panel-data regressions for the period 1999-2011 to analyse whether foreign-bank subsidiaries continued to be relatively stable lenders, as they had been during earlier *local* crises, or whether they were fickler during the global financial crisis. These panel data are also used to zoom in on the sub-sample of foreign banks and to differentiate these by VI participation status. Here we differentiate between countries that were and were not one of the five VI countries and, second, whether a parent bank of subsidiary *i* in country *j* signed one or more VI commitment letters (in country *j* or elsewhere). Because VI participation was not randomly allocated over the banking population, it is important to control for other bank characteristics. The analysis therefore consistently controls for a battery of other bank characteristics such as their profitability, size, loan-to-deposit ratio, solvency, liquidity and loan quality.

Second, we collapse our panel data to estimate so-called difference-in-differences regressions to detect the effect of foreign ownership and participation in the Vienna Initiative on average credit growth. Here the variable of interest is a bank's average credit growth during the three-year crisis period (2009-11) relative to a pre-crisis window of equivalent length (2005-07).

Third, we run a set of cross-sectional regressions where the dependent variable is either bank-specific credit growth in 2009; average credit growth in 2009-11; or a variable that is '1' in case of non-negative credit growth in 2009 and zero otherwise. Here the sample is limited to the five countries that participated in the VI and the focus is on foreign-bank subsidiaries only. Since each of these countries contains several subsidiaries, we can include country fixed effects to control for credit demand at the country level. Country fixed effects allow us to compare, within the same country, how lending by banks that signed a commitment letter differed from banks that did not sign a letter. To the extent that we adequately control for confounding factors, we expect that banks that signed a letter in a country, were relatively stable credit sources compared to other foreign banks.

Main findings on the effectiveness of the Vienna Initiative

This section briefly summarises the main findings of the analysis. First, the patterns in the data clearly confirm that foreign banks reduced credit growth significantly more than private domestic banks during the whole crisis period. For instance, compared to average annual pre-crisis growth of 41.0%, private domestic banks in 2010 reduced credit growth by 21.1 percentage points (to an average of 19.9%) whereas foreign banks shrank lending by an additional 14.7 percentage points (to 5.2%) during that year. This holds when controlling for a battery of other (lagged) bank characteristics. In line with expectations, these controls show that large banks, banks with an already high loan-to-deposit ratio, and banks with high loan loss reserves (*i.e.*, worse loan quality) grew slower on average. More liquid and profitable banks were able to continue to expand credit more quickly. There is also weaker evidence that state banks reduced credit growth less in 2009. This may reflect that in some countries governments used state-owned banks to smooth aggregate lending when privately owned banks started to deleverage. None of these results is particularly surprising and they are in line with a broad literature on the role of foreign-bank ownership during crises.

Second, we can now start our investigation of the impact of the Vienna Initiative on bank lending. We use the same panel data structure as before but limit ourselves to foreign banks. We run separate analyses for a sample consisting of all of emerging Europe, the non-VI countries, and the five VI countries. We focus on the growth of gross credit as well as the VI impact on banks' asset growth. We consider both because when banks signed VI letters, they committed themselves to roll over their total *exposure* in a country, not just their outstanding loan portfolio. The data show that overall – when compared to pre-crisis rates of expansion – the reduction in foreign-bank lending during 2008-11 was not different in VI and non-VI countries. However, that asset growth was reduced significantly more by banks in those countries that would need to be supported by the IMF and EU. We find that in the year *before* the VI was put in place, there were no significant differences in credit growth adjustments between subsidiaries of parent banks that would become part of the VI and subsidiaries of parent banks that would stay out of the VI. However, once the VI was in place in 2009, we start to observe differences between these two groups of foreign-bank subsidiaries. On average, subsidiaries of VI parent banks now grow about 15 percentage points faster compared to subsidiaries of non-participant banks.

Interestingly, this positive relationship between VI status and credit growth during 2009-11 appears to extend to non-VI countries. That is, we find that participation in the VI did not lead to negative spill-over effects. VI banks did not support their lending in VI countries – as per the signed commitment letters – by reducing their lending elsewhere in emerging Europe. If anything, there are *positive* externalities involved as subsidiaries of VI parent banks also grew faster in non-VI countries, *i.e.*, in those countries where their parent banks faced no commitment to maintain exposures. Similar results emerge for asset growth.

One can also focus on VI countries only, and that allows for a comparison of three distinct types of foreign banks in these countries. As a benchmark group we consider the subsidiaries of parent banks that were nowhere involved in the VI. We compare this group to two types of VI subsidiaries: those for whom the parent bank signed a letter in the country of the subsidiary itself and those with a parent bank that signed a letter in *another* country.

This analysis shows that there was a positive VI impact in 2009 of local signings on credit and asset growth of about 10.1 and 15.0 percentage points, respectively, when compared to non-VI banks. We do not, however, find evidence of additional positive effects of VI parents that signed elsewhere. For example, Raiffeisen Bank signed commitment letters in Bosnia-Herzegovina, Hungary, Romania and Serbia, but did not commit in Latvia. Our results suggest that participation by Raiffeisen in the VI stabilised lending by its subsidiaries in those countries where it signed (such as Hungary and Romania) but not in those VI countries where it did not sign (Latvia). Importantly, spill-over effects to 'third' countries – such as Raiffeisen Poland – were positive in nature. We can also confirm these results for asset growth. This suggests that the VI – and especially the Joint IFI Action Plan that focused on bank lending to firms and households –did not push banks to continue lending while shortening their local balance sheets in other ways.

In a next step, we can estimate a so-called difference-in-differences regression framework. In these regressions the dependent variable is average annual credit growth during 2005-07 (pre-treatment) or 2009-11 (treatment).[4] This analysis confirms that while both domestic and foreign banks substantially reduced credit growth during the crisis, the average annual adjustment was almost 10 percentage points stronger for foreign banks. This effect is driven by the VI countries. When we focus on foreign banks only, the data show that in these five countries, subsidiaries of VI parent banks were relatively stable lenders. This effect is driven – in line with our earlier results – by those subsidiaries for which a letter was signed. Lastly, the data again return no evidence for spill-over effects to non-VI countries.

4 We thus leave out the early-crisis year 2008 when Lehman Brothers had not yet collapsed and the VI was not yet in place. This allows for a clean comparison between the most severe part of the crisis and the pre-crisis period. Including 2008 – and separately interacting it with the treatment variable – yields very similar (and slightly more significant) results for the 2009-11 treatment effect.

That is, any cross-country spill-overs that may have occurred were positive rather than negative.

In a third and final step, we move the analysis to a pure cross-sectional approach in which we focus exclusively on foreign-bank subsidiaries in VI countries. In this case, we compare, within the same host country, subsidiaries of banks that signed a commitment letter in that country versus those that did not. The results indicate that within VI countries, signing a commitment letter had a positive incremental effect on bank-level growth. The magnitude of this effect is 23.7 and 21.0% for credit and asset growth, respectively. Relative to subsidiaries of non-VI parent banks the effect is also positive but less pronounced: around 9% for both credit and asset growth.

We then test whether the VI impact persisted in 2010 and 2011. In both cases we indeed find a positive average impact during the years 2009-11. When we next estimate a model to predict the likelihood that a subsidiary fully rolled over its 2008 exposure in 2009 (implying a credit growth rate of at least zero per cent) we find that this probability is 42.2 per cent higher for subsidiaries for which the parent bank had signed a commitment letter as compared to subsidiaries of non-participating parents. Importantly, the analysis does not point towards a separate, general impact of government support – in the form of capital injections, bank-specific guarantees, or asset sales – on either credit or asset growth.

We end the analysis with a concise counterfactual exercise to assess what aggregate credit growth would have been if – in the five VI countries – the foreign-bank subsidiaries that signed commitment letters had not signed. Such a counterfactual calculation is a useful back-of-the-envelope assessment of the overall magnitude of the VI impact. An important assumption is that the VI did not impact the credit growth of other types of banks (domestic banks and foreign banks outside the VI) so that one can keep their growth rates constant. This back-of-the-envelope calculation shows that, in the absence of the VI, credit growth of these subsidiaries would on average have been lower by between 7 and 12 percentage points. Since these VI banks were relatively large players in their respective host countries, their lower credit growth would have translated into substantial *aggregate* impacts. Instead of an aggregate nominal credit growth rate of 7% in 2009, lending would have grown by only 2% or even shrunk by 1%. It goes without saying that such a severe credit crunch would have entailed a substantially more negative impact on firms and households too.

Moving forward: rebalancing bank funding across emerging Europe

In the wake of the global financial crisis, a substantial academic literature has pointed out that banks that, pre-crisis, were heavily dependent on wholesale (as opposed to deposit) funding were extra vulnerable to funding shocks and, as a result, had to reduce their domestic and cross-border lending more when the crisis hit (De Haas and Van Lelyveld, 2014). Ongena, Peydró, and Van Horen (2012) focus specifically on emerging Europe and find that not only foreign but also domestic banks that borrowed in the international wholesale markets had to cut back lending more during the crisis.

Indeed, the average bank in emerging Europe had substantially increased its reliance on non-deposit funding in the run up to the crisis. Banks' loan-to-deposit ratios, an often-used proxy for banks' dependence on wholesale funding, increased from on average 0.80 in 2005 to 1.16 in 2008 (EBRD, 2015; De Haas and Van Horen, 2018). Much of this wholesale funding was denominated in (or swapped into) a foreign currency, typically the euro. In the wake of the crisis, these loan-to-deposit ratios have declined for three main reasons. First, various European banks, especially those that relied heavily on short-term wholesale funding, had to reduce new lending and dispose of non-core assets. Second, partly due to regulatory pressure, some banks made substantial efforts to increase their deposit base. Third, weaker demand for loans due to recessions in many European countries contributed to the downwards trend in loan-to-deposit ratios as well.

Recognising the role of excessive wholesale, short-term and foreign exchange (FX) denominated funding as a source of bank-lending instability, the VI has started to focus on addressing this root cause of financial instability in emerging Europe. After all, the strong reliance of parent banks on foreign currency funding had also been a key driving force of the widespread household lending in foreign currencies, mainly in euros but in some countries (Hungary, Poland) also in Swiss francs. Such foreign currency lending was historically widespread in former Yugoslav countries, due to the history of hyperinflation in the 1990 and early 2000 but became prevalent in Central Eastern Europe countries throughout the 2000 as well. Various factors contributed to this expansion of FX lending. In addition to parents 'pushing' cheap euro funding to their subsidiaries, these factors included: the large interest differential between local and foreign currencies (especially the Swiss franc); the experience of Austrian parent banks with Swiss franc mortgage lending; relative exchange rate stability; and a climate of persistent strong economic growth. Moreover, central banks' toolkit to contain the proliferation of foreign currency lending and its negative effects was limited, while political pressures to keep up FX lending in many countries were strong.

When the global financial crisis hit, the large-scale foreign currency lending to (often unhedged borrowers), combined with the substantial depreciation of local currencies (and, especially, the strong appreciation of the Swiss franc), made it difficult or impossible for many borrowers to keep servicing their debt. This led to a surge in defaults and a rapid accumulation on non performing loans.

In order to address these issues, a public-private sector working group involving international (financial) institutions (EBRD, European Commission, IMF, World Bank and the ECB as observer), home and host authorities, as well as parent and subsidiary banks, was set up within the Vienna Initiative in March 2010. The EBRD also launched the Local Currency and Capital Markets (LC2) Initiative in May 2010, including a specialised unit to coordinate and spearhead work on financial market development within the EBRD. Both the WG and the LC2 Initiative applied a holistic approach in order to tackle the root causes of foreign currency use. The focus was and continues to be on:

- building stable and sustainable macroeconomic policy frameworks;
- improving the legal and regulatory environment to support capital market activity;
- developing financial market infrastructure including clearing and settlement;
- developing an institutional investor base; and
- promoting a more efficient transaction environment and expanding product range.

The activities under the Initiative have been wide-ranging, including the following.

- Country legal and financial market assessments on the key needs to support local currency use and financial market development, including in the area of macroeconomic policy, financial sector regulation, market structure, market infrastructure and the legal and regulatory framework. The assessments were made by EBRD, usually in cooperation with IMF and World Bank experts.
- Policy dialogue supporting local currency use and capital market development.
- Technical assistance focusing on supporting financial market development.
- Funding and lending activities such as local currency bond issuances in several currencies and countries (for example, Armenia, Georgia, Poland, Russia,

Serbia) as well as local currency lending/financing (SME Local Currency Lending Programme, supporting bond issuance by a Kyrgyz financial institution, mortgage bond programmes in several countries) by EBRD.

The VI public-private sector working group also published several key recommendations aimed at addressing the root causes of foreign currency lending as well as the underdevelopment of capital markets:

- the need for a country-specific approach to tackle foreign exchange lending;
- improving coordination of policies among home and host authorities in order to avoid unwanted effects from regulatory actions;
- addressing higher risks of foreign currency lending through supervisory measures (e.g., higher risk weights and appropriate liquidity requirements, stricter lending standards, enhanced consumer protection measures);
- a stronger focus on developing financial markets (e.g. foreign currency swap, mortgage and covered bond markets).

Importantly, the local currency – lending related – activities under the Vienna Initiative gave impetus to home and host regulators to restrict foreign currency (especially non-euro) lending and led to the issuance of recommendations on lending in foreign currencies by the European Systemic Board in September 2011.

In a similar vein, a Vienna Initiative Capital Markets Union working group was established with the following aims: to remove barriers to cross-border capital raising and investments; to increase capital market-based finance; to build a stronger equity culture; and to stimulate long-term finance for investments in infrastructure and SMEs. The establishment of this working group reflects the fact that emerging European companies remain primarily financed by bank loans and still relatively rarely access the debt or stock markets for financing. Additionally, the financial assets under management by institutional investors in the region are small, as are the local private equity and venture capital markets. The Capital Markets Union working group published its report and associated policy recommendations in March 2018, which resulted in the implementation by EBRD of the proposed policy actions in selected countries. These initiatives include the development of national capital market development strategies, increasing the number of institutional investors, strengthening capital market infrastructures and extending the locally available product range.

Conclusions

The strong and manifold linkages that developed between Western banking groups and their emerging European subsidiaries have not been accompanied by equally intense supervisory cooperation and integration. When the parent banks of these subsidiaries were being increasingly affected by the global crisis, this void had to be filled by an *ad hoc* coordination mechanism: the Vienna Initiative. The evidence that we present in this chapter suggests that, by and large, the VI has been successful. In particular, subsidiaries of parent banks that signed commitment letters were significantly more stable sources of credit than subsidiaries of banks that did not sign such letters *in the same country*. Moreover, there is no evidence that VI banks withdrew from non-VI countries in order to maintain exposures to countries where they signed commitment letters. If anything, VI participation had positive rather than negative spill-over effects. The implications of these findings go beyond emerging Europe and the latest financial crisis. They reinforce recent evidence to suggest that IMF support and public bail-outs may be successful, especially when private sector resources are effectively crowded in (Papi, Presbitero, and Zazzaro, 2015). In the case of the Vienna Initiative, such a coordinated (but non-coercive) bail-in of private lenders helped countries not only to close external funding gaps but also to soften and delay the inevitable deleveraging process.

A more sustainable solution to the current governance void in emerging Europe may, of course, lie in better coordination and cooperation between home and host country supervisors. This is necessary not only to prevent spill-overs of financial shocks, but also because the alternative – forcing highly integrated pan-European banking groups to hold more capital and liquidity in each individual subsidiary – could be costly. Effectively cutting up multinational banks into strings of independent banks ('ring-fencing') would be a second-best option that reflects the inability of national supervisors to reach a satisfactory level of cross-border cooperation and burden-sharing. It bears repeating that the growth losses due to increased fragmentation of European banking markets are likely to be substantial (Schnabel and Seckinger, 2015). Further cross-border bank deleveraging risks undoing the very tangible benefits that banking integration has had in terms of speeding up the economic convergence of Europe's eastern with its western half (Friedrich, Schnabel, and Zettelmeyer, 2013).

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PART III

Vienna Initiative 2.0: post-crisis stresses on cross-border banking

CHAPTER 10

Supervisory and regulatory changes since the crisis and the Vienna Initiative

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Abstract

Since the global financial crisis, the regulatory and supervisory landscape has evolved significantly, and the Vienna Initiative adapted accordingly by focusing on a number of issues of particular relevance for Central, Eastern and Southeastern Europe (CESEE) countries. This type of activity is not new. Even during Vienna 1.0, when the focus was on crisis management, the Initiative had already broadened its scope, assessed the absorption of EU funds in the region and explored ways to involve commercial banks in this process. Against the background of the emerging Banking Union, the Vienna Initiative became a platform for formulating and sharing with key EU decision makers observations on supervision and resolution from the perspective of host countries, while taking account of the specific situation of the banks operating in the region. These discussions led to the signature of a Memorandum of Understanding between the European Banking Authority (EBA) and the Southeastern European (SEE) countries. The Vienna Initiative supported the comprehensive banking sector reform programme launched in Ukraine in 2014. Furthermore, attention was drawn to the implications of the non-zero risk weighting of government bonds issued in foreign currencies from January 2018. The CMU Working Group explored options for improving the access to finance, in particular to local capital markets, of smaller companies in CESEE. A related discussion took place on how banks in the region could fulfil their minimum requirement of own funds and eligible liabilities (MREL) targets, given the small size of their capital markets.

1 The views expressed in this publication are the sole responsibility of the authors and do not necessarily reflect the views of the European Commission. Comments by Sebastijan Hrovatin, Kai Fahnenbruck, Massimo Zaffiro, Marie Donnay and Audrius Pranckevičius are gratefully acknowledged.

Introduction

In January 2012, the Vienna Initiative was re-launched as a coordination platform for home-host banking issues in emerging Europe (European Commission, 2017). According to its mission statement,[2] the objectives of the Vienna Initiative 2.0 were to help avoid disorderly deleveraging, ensure that potential cross-border financial stability issues are resolved and achieve policy actions, notably in the supervisory area, taken in the best joint interest of home and host countries. Subsequently, the Vienna Initiative has provided advice on all key regulatory and supervisory developments in the EU. However, Vienna Initiative 1.0 has already dealt with some projects of this kind.

Regulatory and supervisory issues tackled under Vienna Initiative 1.0

Report of the Working Group on absorption of EU funds

In order to facilitate compliance with the exposure commitments made by the euro area parent banks operating in the Central, Eastern and Southeastern Europe (CESEE) region during the first phase of the Vienna Initiative, the Full Forum in Athens on 19 March 2010 decided to set up a working group mandated to focus on enhancing the role of commercial banks in the process of EU fund absorption. EU structural funds, the second most important budgetary instrument of the EU, were underutilised in many new EU Member States, even while lending activity was sluggish during the financial and economic crisis. The working group, coordinated by the European Commission, noted that commercial banks could potentially play a significant role in the selection, implementation and financing of projects consistent with present EU regulations on structural funds in order to improve the absorption of EU funds in the CESEE region. Private financial actors can contribute to leveraging EU funds through their knowledge of local corporate sectors and their on-going search for innovative entrepreneurial concepts. The involvement of commercial banks may alleviate constraints regarding the co-financing of EU funds, which the official sector has experienced, particularly in times of economic downturn and budgetary consolidation.

Between August and December 2010, the working group studied the options available to foster the involvement of banks in the absorption of EU funds, based on the experiences of several EU Member States (Greece, Hungary, Italy, Latvia and Romania). The working group concluded its research with a report endorsed by the Full Forum meeting

2 Available at www.vienna-initiative.com

organised in Brussels on 16-17 March 2011.[3] The report on the role of the commercial banks in the absorption of EU funds included key conclusions and recommendations of the working group for a closer involvement of banks in EU fund absorption, in particular in Bulgaria and Romania, within the EU regulatory framework. At the time when the report was finalised, the involvement of commercial banks as intermediary bodies in the process of EU absorption was an option in the medium term rather than the short run. The services that banks could provide included administrative functions (e.g., receiving applications and examining viability of projects), the associated financing relationships as projects progress and certain monitoring functions on behalf of the Managing Authorities for EU funds.

Report of the Working Group on developing local currency markets

As the global financial crisis highlighted some of the risks associated with foreign currency lending to borrowers without foreign currency income ("unhedged borrowers"), the Full Forum of the Vienna Initiative in Athens on 19 March 2010 decided to set up a working group focusing on developing local currency markets in the CESEE region. Foreign currency lending was one of salient features of the majority of CESEE economies, particularly before the onset of the global financial crisis in 2008. Whereas foreign currency lending contributed to the convergence in the CESEE region in recent decades, it also took place in the context of the pre-crisis large capital inflows, which contributed to overheating and the build-up of sizeable macroeconomic imbalances, and underdeveloped capital markets.

The working group on local currency and capital market development concluded its work with a report endorsed by the Full Forum meeting in Brussels on 16-17 March 2011.[4] The report found that the increase in foreign currency lending in the CESEE region was supported *inter alia* by the lack of credibility of macroeconomic policies, weak institutions, insufficient domestic savings, lower cost of foreign versus domestic funding of banking systems, etc. Policy initiatives to reduce foreign currency lending to unhedged borrowers included regulatory and supervisory measures as well as measures to develop local currency markets. In this respect, the report included several recommendations addressed to national authorities, commercial banks and international financial institutions (IFIs). Over time, appropriate macroprudential policies and a lower flow in foreign currency lending can also gradually help reduce the stock of foreign currency loans.

3 http://ec.europa.eu/economy_finance/articles/financial_operations/2011-04-11-role_commercial_banks_in_absorption_eu_funds_en.htm

4 http://vienna-initiative.com/wp-content/uploads/2012/08/Working-Group-on-Local-Currency-and-Capital-Market-Development4.pdf

Assisting the creation of the Banking Union: the perspective of countries in Central, Eastern and Southeastern Europe

Observations on bank supervision and resolution

One of the first areas of interest of the Vienna Initiative 2.0 was the implications of the emerging Banking Union for the countries in CESEE. In the first stage, the Steering Committee of the Vienna Initiative discussed cross-border supervision and resolution in Europe and shared its observations with the key EU institutions. Thereafter, it decided to establish a dedicated working group on the Banking Union with a broader participation, which prepared reports on two pillars of the Banking Union: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), as they were shaping up.

In September 2012, the Vienna Initiative organised a High-Level Workshop in London on the observations on home-host supervisory practices and the observations on bank recovery and resolution. Discussions focused on the new EU proposals for establishing the Banking Union, in particular the SSM[5], just proposed by the Commission at the time of the Workshop and for the framework for bank recovery and resolution[6] proposed by the European Commission in June that year.

Work on the observations advanced after the Workshop, involving frequent exchanges between the international financial institutions, national authorities and private banks. The observations on enhancements in cross-border supervision were ready by October 2012[7]. Their aim was to provide input for the design of the supervisory framework in the EU and to communicate the key systemic concerns of host countries. The observations reflected the Steering Committee's views on cooperation between national home and host authorities during the crisis. Marek Belka, the chairman of the Steering Committee, sent the observations to the main EU authorities: the European Commission, the European Central Bank (ECB) and the EBA. The European Commission, as a member of the Steering Committee, inserted a disclaimer regarding these observations in which it noted that it might have different views on some of the issues addressed in the document.

5 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No. 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No. 1024/2013.

6 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms … .

7 http://vienna-initiative.com/wp-content/uploads/2012/08/Supervisory-Practices-Oct-18-FINAL_sent2.pdf

In his reply to Marek Belka's letter, Olli Rehn, vice-president of the European Commission and Commissioner for Economic and Financial Affairs, emphasised his appreciation for the contribution of the Vienna Initiative 2.0 to the debate underpinning the reform of the European banking sector. In his view, the observations put forward a number of valid remarks on the functioning of the supervisory colleges and the implications of the Banking Union on the countries in CESEE outside the euro area. In his keynote speech at the Vienna Initiative Full Forum in Brussels on 9 November 2012, Olli Rehn said: *"We are turning the lessons we have learnt from the crisis into practical solutions. The necessary measures, in the area of bank recovery and crisis management and the Banking Union, impact the relations between home and host country authorities. This is where the Vienna Initiative provides support – by offering a coordination platform and strengthening the voice of host countries."*

The second set of observations – on cross-border bank resolution – was submitted to the EU institutions in January 2013[8]. These observations focused on critical aspects of home-host cooperation, which were of particular importance for the CESEE countries. Some specific features made the cross-border resolution process particularly challenging in this region. These included the systemic importance of subsidiaries (or branches) of euro area parent banks for host countries, and the fact that those subsidiaries in many cases relied on the parent bank not only for funding support but also for all major strategic and financial decisions. Based on the principle that actions taken by authorities in one country should not lead to financial instability in another country, the note raised several points on involving host countries in the decision-making process concerning recovery plans and resolution procedures, participation in resolution colleges and the mediating role of EBA, as well as burden-sharing and bail-in arrangements. The observations on cross-border resolution were shared with the European Commission, ECB, EBA and the European Systemic Risk Board (ESRB).

Working Group on the Banking Union

In the context of the EU moving further towards a full Banking Union, the Steering Committee meeting in Vienna in January 2013 decided to set up a public-private working group (WG) on the impact of the proposal for a European Banking Union on the countries of emerging Europe. Lars Nyberg, adviser at EBRD and former vice-governor of the Central Bank of Sweden, collected views and recommendations from the WG members, moderated the discussions and drafted the reports. The

8 http://vienna-initiative.com/wp-content/uploads/2013/01/Resolution-note-01-09-2013-to-Gov-Belka.pdf

WG analysed more closely the impact of the Banking Union on host countries, covering specific issues that affected emerging EU countries inside and outside of the euro area, as well as non-EU countries. The European Commission and the European Investment Bank (EIB), while being members of the Vienna Initiative, did not participate in this working group. Therefore, the WG reports included a disclaimer stating that these institutions might have different views on the issues addressed therein.

In April 2013, Marek Belka, chair of the Steering Committee, submitted the report on the evolving Banking Union to the leaders of European institutions. The document[9] focused on the project's impact on host countries in emerging Europe, analyzing in particular the possible sequencing issues and the opt-in conditions, i.e., conditions for countries outside the euro area that want to become members of the Banking Union. It stressed that a geographically inclusive and fully fledged Banking Union, with appropriate conditions for participation, was in the interest of all cross-border banking stakeholders in Europe's deeply integrated financial markets.

In July 2013, the European Commission adopted the proposals to establish the SRM, a second pillar of the Banking Union. The SRM was subsequently enacted through a Regulation[10] and an Intergovernmental Agreement (IGA).[11] At its July meeting in Luxembourg, the Steering Committee discussed the proposed EU resolution framework and decided that it would further assess its potential implications for emerging European countries. The EU proposal also featured on the agenda of the Full Forum in Brussels in October 2013. The Forum called for strong incentives for opt-in to ensure as inclusive a membership as possible and to develop an effective interface with host countries outside the Banking Union, including non-EU members.

The Working Group on the Banking Union concluded its activity by delivering its report on the new European bank resolution framework[12] in November 2013. The report included considerations on the Bank Recovery and Resolution Directive (BRRD) and the SRM, separately for non-opt in and non-EU countries, SSM

9 http://vienna-initiative.com/wp-content/uploads/2013/05/VI2-BU-WG-April-2013_final.pdf
10 Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund.
11 The Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund. The details of some aspects of the functioning of the SRF, including the transfer and mutualisation of funds from national authorities to the centralised fund, was split off from the Regulation into the IGA due to concerns, especially by Germany, that they were incompatible with current EU treaties.
12 http://vienna-initiative.com/wp-content/uploads/2013/11/VI-BU-WG-Report-on-BRRD-and-SRM.pdf

countries and opt-ins. It emphasised the need for developing clearer conditions for the use of the bail-in tool by national authorities, for having credible fiscal backstops (including for opt-in countries) and for preparing local recovery plans for cross-border banking groups. The report also raised some questions concerning the operational capacity of the Single Resolution Board, particularly in the areas of transparency, independence, voting powers and decision-making in urgent cases. It recommended concluding agreements between SRM and non-SRM countries to ensure early participation of non-SRM national authorities in resolution procedures. Finally, it called for the completion of all three pillars of the Banking Union, namely supervision, resolution and deposit insurance.

Discussions on resolution strategies and Minimum Requirement for own funds and Eligible Liabilities (MREL)

The experience during the financial turmoil in 2007-8, when bailout packages were designed by the governments in the home countries of parent banks, led to nervousness by national authorities in CESEE, as public aid was limited to banks subject to a country's own jurisdiction, including foreign branches but not subsidiaries. It illustrated the national character of governance structures, while financial contagion has become transnational (Pistor, 2012). As a reaction, host country supervisors ring-fenced activities of banks operating on their territory by imposing increased reserve requirements or limiting liquidity by the Central Bank. This was not an optimal policy response, either for the home country or for the host country, and the Vienna Initiative, with its unique composition of stakeholders, attempted to remedy the situation.

The main concern expressed by host countries was the insufficient involvement of host supervisors and fiscal authorities in the decision-making process regarding bank resolution, where decisions rested mainly with the home countries, following the principle of consolidated supervision. This was legally very clear in the case of branches, of which some are of systemic relevance in CESEE, but it applied also to subsidiaries. Related was the debate on whether the resolution strategy should adopt a Single Point of Entry (SPE), generally the preferred approach at EU level, or Multiple Points of Entry (MPE). The latter strategy is favoured by the Austrian banks with international activities and their home supervisor, which argue that the subsidiaries' activities in Central and Eastern Europe are decentralised and easily separable.

A call was made to strengthen the role of host country supervisors in the supervisory and resolution colleges and ensure a timely exchange of information, as well as early involvement in drawing up recovery and resolution plans. Attention should be paid to the appropriate intra-group support in crisis situations. Host countries also feared an unfair burden-sharing of fiscal costs, when they were not adequately represented in resolution decisions. Finally, in order to minimise the use of taxpayers' money, the new framework included a bail-in tool. A plea was made to take into account the simple funding structure of local banks heavily relying on deposits and the thin domestic capital markets, which need to be developed further to allow for the issuance of bail-inable instruments.

Through amendments to the Capital Requirements Directive and Regulation framework, the BRRD and Single Resolution Mechanism Regulation, these concerns were reflected in the political agreement reached on 4 December 2018[13] between the European Parliament and Council of the European Union in an effort to balance the interests of home and host countries. Following the agreement reached in mid-February 2019 regarding risk reduction measures in the banking sector, all the amendments to the above-mentioned directive and regulations were scheduled to be voted on by the European Parliament before the European elections in May 2019.

In order to avoid the down-streaming of losses towards the subsidiary, intra-group liabilities are excluded from the bail-in of the parent bank. Also, the use of internal MREL waivers and its replacement by collateralised guarantees is limited to the same country, while in a cross-border context prepositioning of MREL is the norm. All in all, host countries have an important say in the joint determination of MREL, as the so-called "rule of the sum", or the coherence check between the sum of internal MREL and the total consolidated external MREL at group level, was deleted. Furthermore, the introduction of a "safe harbour" clause will provide host authorities with the possibility of topping up the internal MREL calibration outside of the mediation powers of EBA.

Facilitating home-host cooperation with non-EU countries

Memorandum of Understanding between the European Banking Authority and supervisors in South-Eastern Europe

After the launch of the Banking Union in the EU, the Vienna Initiative advocated common concerns and coordinated actions of non-EU countries in the Western Balkans, leading to the signing of a Memorandum of Understanding between those countries and EBA in October 2015.

13 http://europa.eu/rapid/press-release_IP-18-6659_en.htm

The Vienna Initiative Full Forum in Brussels in October 2013 included a session dedicated to SEE as a region significantly affected by the EU financial sector reform. However, this region still remained mostly outside the reach of the EU's supervisory coordination mechanisms. The Full Forum welcomed EBA's decision to re-engage with non-EU countries for supervisory confidentiality assessments. Given the euro area banks' systemic importance in these countries, it also called for a special regional arrangement of non-EU members on the path towards EU membership with the SSM and EBA.

The operational launch of the SSM on 4 November 2014 was a milestone for moving towards an effective cross-border supervisory framework in the EU. The Vienna Initiative Full Forum in Brussels on 13 November 2014 discussed the collaboration between the SSM and SEE countries. The Forum acknowledged the EBA's work to enhance the information sharing between the SSM and non-EU member SEE countries and proposed a possible Memorandum of Understanding (MoU) on cooperation between the SSM and SEE countries for the consideration of the European authorities, including the EBA and the ECB.

On 23 October 2015, the EBA and representatives of the supervisory authorities of Albania, the Federation of Bosnia and Herzegovina, Republika Srpska, North Macedonia, Montenegro and Serbia signed a Memorandum on Cooperation (MoC) at the EBA premises in London. The involved parties negotiated the MoC for almost two years with the mediation of the EBRD under the auspices of the Vienna Initiative.

The MoC constitutes a major achievement for home-host banking relations between the EU and its neighbouring countries. It was the first MoC signed by the EBA, setting out a framework for cooperation and information exchange, covering *inter alia* the EU single rulebook, financial stability issues and equivalence assessments. In addition, EBA committed itself to facilitating the participation of the signatory authorities in the relevant colleges of supervisors and to opening its regular training activities to the staff of the signatory authorities. The MoC was open to adherence by other countries if the EBA completed an assessment of their confidentiality regimes with a positive result.

Ukraine Financial Forum

In 2014-16, Vienna Initiative 2.0 assisted the reforms of the banking sector in Ukraine through the multilateral Ukraine Financial Forum, which included local bank subsidiaries, authorities and international institutions. The forum was based on the model of host-country cross-border banking fora, organised previously in Hungary, Croatia, Serbia, Albania, Montenegro and Slovenia. On 15 May 2014, the Vienna Initiative Steering Committee met in Warsaw in the margins of the EBRD annual meeting, chaired by Marek Belka. The Steering Committee proposed to organise a Vienna Initiative forum in Kiev, co-organised by the IMF, EBRD and the National Bank of Ukraine, in order to build additional confidence in the IMF programme. The National Bank of Ukraine supported this initiative.

The first Ukraine Financial Forum, organised under the aegis of the Vienna Initiative, took place in Kiev on 5 June 2014, benefiting from a high level of participation from both the international and the Ukrainian sides. National Bank of Ukraine Governor Kubiv and Deputy Minister of Finance Lisovenko presented a comprehensive strategy and declared a strong commitment to reform the Ukrainian banking sector. International and EU institutions offered unprecedented levels of financial and technical assistance. Domestic banks and Ukrainian subsidiaries of European banks, however, raised questions on multiple risks to the success of the reform agenda, pointing to endemic corruption, banking sector fragmentation and the shortage of creditworthy borrowers. The National Bank of Ukraine highlighted the important role the international financial institutions and Western banks could play in the Ukrainian financial sector in terms of promoting reforms, supporting financial stability, instilling best practices in corporate governance and bringing know-how.

The second Ukraine Financial Forum was organised adjacent to the Full Forum in Brussels in November 2014. The commercial banks appreciated the authorities' continued commitment to the banking sector reform. Discussions focused on the key challenges facing the banking sector, including the implications of volatile foreign exchange rates and of the deteriorated quality of banking assets and capital adequacy ratios, as well as the disruption to banks' business resulting from the war in Eastern Ukraine and the occupation of Crimea. Johannes Hahn, EU Commissioner for European Neighbourhood Policy and Enlargement Negotiations, said: *"Today's Financial Forum on Ukraine provided an excellent opportunity for a frank and productive discussion among policy makers, supervisors, commercial banks and international financial institutions... . Events like this one make a valuable contribution to identifying the key actions and reforms needed to address these challenges, and ways to support them through enhanced cooperation with the EU and international financial institutions."*

The third – and last – Ukraine Financial Forum met in Kiev on Wednesday, 15 March 2016, to take stock of the key reforms in the banking sector. In her opening speech, Valeria Gontareva, Governor of National Bank of Ukraine, highlighted that a stronger financial sector had emerged in the wake of restructuring and reforms. Jan Tombinski, Ambassador of the EU delegation to Ukraine, said: *"The European Union hopes that the comprehensive programme of financial sector reform until 2020 outlined by the National Bank of Ukraine with other Ukrainian authorities will continue on track in 2016... . The Vienna Initiative is a perfect platform for discussing and addressing numerous challenges such as the high NPL [nonperforming loan] level, related party lending and banking sector effectiveness."* Participants welcomed the opportunity to engage in a constructive dialogue and noted the importance of regular consultations between authorities, regulators, banks and international financial institutions to ensure effective design and implementation of reform measures.

Implications of the non-zero risk weighting of government bonds issued in foreign currencies

Another issue where the Vienna Initiative was very active on the regulatory front was with respect to Article 114 of the Capital Requirements Regulation setting the risk weights for exposures to central banks and central governments. Exposures to central banks and to sovereign debt in the EU benefit from a zero risk weight, but, from January 2018, only when denominated in domestic currency or when the credit rating is sufficiently good (*e.g.*, credit quality step 1). This regime is also applicable to third countries for which the regulatory and supervisory frameworks are considered equivalent to those in the EU.

This regime impacts, in particular, the Western Balkans, which includes some candidate countries (Albania, North Macedonia, Montenegro and Serbia) with a systemic presence of subsidiaries of EU banks and whose governments and central banks issue regularly in euros. These countries have raised a number of concerns in this context. They highlighted that a non-zero risk weighting on their sovereign or central bank exposure might reduce the profitability of these banks. It also constrains fiscal policy, as the reduced appetite of local banks may prompt governments to tap foreign investors, with an increased reliance on inherently more volatile cross-border flows as a consequence. Monetary policy may be hampered, as an increased reserve requirement subject to a non-zero risk weight to mop up liquidity could be counteracted by banks selling bonds, which would offset the desired objective of tightening monetary policy. The exchange rate could also come under pressure as banks sell government bonds in local currency.

Aware of these concerns and of the political angle in view of the EU candidate status, the European Commission and the EBA continue to monitor the regulatory and supervisory developments in these countries, particularly in the light of potential future equivalence determinations.

Improving access to finance: development of local capital markets

Since 2015, the Capital Markets Union (CMU) has been one of the EU's priority initiatives in the area of financial services, aiming to mobilise capital in Europe and channel it to companies and infrastructure projects. The Vienna Initiative CMU Working Group established in 2017 explored how local capital markets and smaller companies' access to finance could be fostered in CESEE.

Following the adoption of the CMU Action Plan in September 2015 (European Commission, 2015), the Vienna Initiative Full Forum in Warsaw in November 2015 encouraged CESEE authorities to identify areas where technical assistance from the European Commission could support the implementation of the CMU priorities. The Vienna Initiative has been a good platform for an exchange of views in this area, as the EU Member States from CESEE have been among the main potential beneficiaries. Economic analysis showed that countries from CESEE lagged behind their EU peers in terms of capital markets development, leading to reduced options for financing business start-ups and expansion. Consequently, companies in those countries relied heavily on bank financing and were reluctant to use equity, bonds or risk capital instruments.

Following a proposal from the European Commission, the Vienna Initiative Full Forum in Luxembourg on 6 March 2017 decided to set up a Working Group on Capital Markets Union. The objective of the Working Group was to provide an overview of the challenges faced by capital markets in CESEE and to identify the measures necessary to enhance local capital markets that could be implemented at national, regional (cross-border) and European level. To this end, the Working Group carried out a country survey among its members. The Working Group included about forty representatives of both public and private institutions from CESEE countries as well as international institutions (*i.e.*, EIB, EBRD and the World Bank Group). The European Commission coordinated the work, chaired the meetings and provided the secretariat of the Working Group. Three full-day meetings of the Working Group took place in Brussels on 4 April, 30 June and 3 October 2017.

The report of the Working Group[14], endorsed by the Full Forum in London on 12 March 2018, listed policy actions aimed at the development of local capital markets. The proposed measures were of both legislative and non-legislative nature. They included new initiatives and work already underway. Initiatives at national level were considered crucial for capital market development. These included the development of capital market strategies, modernisation of the business environment, using public financial support for capital markets, *e.g.* listing of SMEs, privatisation of state-owned companies through the stock exchange, facilitating conditions for institutional investors, enhancing capital market supervision and increasing financial literacy. Further measures could be taken at the regional level to strengthen cross-border cooperation. This included facilitating foreign listing and market access, promoting cooperation between stock exchanges and the creation of cross-border links between local market infrastructures (central securities depositories, central counterparties) and harmonising legislation at regional level.

At the EU level, issues revolved around better regulation and a greater use of the available financing instruments. Further work was warranted on the observance of the proportionality principle in EU law (*i.e.*, by review of selected capital market directives), on the better implementation of EU law (*e.g.*, by technical support) and further harmonisation of legislation at EU level (*e.g.*, in the area of crowd-funding or fintech). The deployment of financial support instruments (*e.g.*,. by the European Structural Investment Funds, EIB, EBRD or the World Bank Group) would help to overcome market failures and increase the funding pool for investments.

Concluding remarks

In the last ten years, the Vienna Initiative has played a role in the stabilisation of the financial sectors in CESEE by balancing the interests of the banking sector and those of home and host supervisors. In the post-crisis era of regulatory and supervisory reforms in the EU, it has amplified the voice of the host countries on the European scene. The Vienna Initiative has contributed to the discussions surrounding the historical process of creating a Banking Union and Capital Markets Union in the EU. At the same time, it has continuously observed the concerns of non-EU countries in the region, leading to some tangible achievements such as the 2015 Memorandum of Cooperation with EBA.

14 http://vienna-initiative.com/wp-content/uploads/2018/03/VI-CMU-Working-Group-Final-Report-March-2018.pdf

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CHAPTER 11

Cross-border banking in Central, Eastern and Southeastern Europe through the lens of the EIB's Bank Lending Survey

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Abstract

We revisit cross-border banking in Central, Eastern and Southeastern Europe (CESEE) from a historical perspective. Using information from the European Investment Bank (EIB) *CESEE Bank Lending Survey* (BLS), combining its results with other data sources, we demonstrate how the model of cross-border banking changed in the region after the global financial crisis. We argue that cross-border funding flows declined significantly, whilst equity exposures remained as important as before. On the one hand, international banking groups are maintaining their commitment to the region; on the other, the decline of external funding has led to a lending strategy based on domestic funding. This strategy appears to result in more cautious – less dynamic, but also safer – credit developments in the region.

Introduction

There is a broad consensus that the economic benefits of "balanced" cross-border banking outweigh the potential costs. Cross-border banking can stabilise output through risk diversification and reduce the likelihood of bank failures and credit crunches for the same reason. It can also lead to stronger competition, faster technology transfer and more rapid spread of best banking practices, thus further enhancing financial stability. Foreign capital, however, comes at a cost. Foreign funds are likely to be more mobile than domestic ones. They can also expose the domestic economy to foreign shocks. Yet, unless it generates undue concentration, cross-border banking is

1 The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB or its shareholders.

thought to bring an overall net increase in welfare (Allen *et al.*, 2015). Strengthening cross-border banking to reap these benefits is high on the EU political agenda: these economic benefits are a key argument supporting the Banking Union.

CESEE has often been regarded as the "poster child" of cross-border banking. The last twenty years have seen an impressive development of the banking market in the CESEE region. Starting from the mid-1990s, a process of deep transformation allowed banks to become real intermediaries of resources, with access to finance substantially increased in both the retail and the corporate sectors. A privatisation process allowed several international players to enter the region and to engage in regional growth strategies. These large players became market leaders in almost all countries in the region, carrying fresh capital and new banking practices. Large market potential and banks' access to funding from parents fuelled strong credit growth before 2008/9. Domestic regional demand accelerated, with both consumption and investment growing fast.

The 2008/9 crisis changed the picture. External demand collapsed and the correction of capital inflows was rather sharp, leading to negative economic growth all over the region. Concerns about potential spill-overs, via the parent/subsidiary channel, from the international financial crisis to the region increased. In this environment the Vienna Initiative has functioned as an anchor, strengthening confidence in financial markets and preserving banking activities. The European Commission and the International Monetary Fund (IMF) provided financial support to countries in need, while the European Investment Bank (EIB), European Bank for Reconstruction and Development (EBRD) and the World Bank guaranteed enhanced support to productive investment, including liquidity lines for small to medium-sized enterprise (SME) financing. At the same time, international banks active in the region committed themselves to continuing to support their subsidiaries, providing capital and funding. Ultimately, international financial institutions engaged in a *Joint Action Plan*. The initiative strategically contributed to preserving financial stability in the overall CESEE region. Indeed, tail risks disappeared, and fully fledged bank runs were avoided.

The recovery from the crisis was long and painful in many countries in the region. In general, the higher the pre-crisis imbalances, the longer economic activity took to recover. Potential growth in the region has been reassessed and linked more closely to the underlying country fundamentals – i.e., productivity and export performance capacity, while nonperforming loans (NPLs) have been weighing on banks' portfolios. At the same time, the post-crisis domestic environment, the emerging changes in the regulatory environment and a reassessment of local market opportunities have been leading to a rethinking of the operational strategies for the cross-border banks active in the CESEE region.

All in all, foreign-owned banks fostered convergence and economic growth in CESEE: they contributed to raising living standards, supported increasing investment levels – yet also possibly generated imbalances and contagion.[2] Today, the share of foreign ownership of banks in CESEE is high compared with other regions, and many subsidiary banks are also systemically important at a local level (host country).

Nevertheless, the global financial crisis brought some important lessons and changes in the nature of cross-border banking flows. First, it showed that shocks can propagate from home to host countries, possibly threatening host countries' financial stability. Second, the experience of the crisis triggered a re-evaluation of the strategies of international banks towards the region. Some financial institutions left the region altogether, while those who stayed changed their strategies. Third, credit flows in the CESEE region in the aftermath of the crisis stalled for an extended period between 2011 and 2015. While positive credit developments resumed subsequently, lending growth has remained at a lower level than ten years before. This may represent an impediment to medium-term economic performance. Therefore, understanding the determinants of credit growth and fundamental credit market conditions is key for effective policy actions.

Against this backdrop, we revisit the state of cross-border banking in CESEE ten years after the crisis. We attempt to identify how the nature of cross-border banking has been changing, and whether these changes had an impact on aggregate credit developments (and if so, how). First, we sketch the key developments in cross-border lending. Then we describe international banks' attitudes and positioning in the CESEE region using the EIB *CESEE Bank Lending Survey*.[3] Next we deal with credit development and the fundamental factors behind it before offering our conclusions.

2 The transmission channels between parent and subsidiary banks have been extensively investigated in several studies focusing on different geographical areas, including CESEE. The effect of parent conditions on the lending performance of subsidiaries has been thoroughly analysed. For example, the existence of internal capital markets within international banking groups (Houston and James, 1998; De Haas and Van Lelyveld, 2010; Jeon et al., 2013) was found to be a fundamental vehicle spurring growth throughout a network of subsidiaries, as well as possibly transmitting financial weaknesses. Other studies have connected lending performance to parent banks' balance sheet positions. (e.g. Cull and Martinez Peria, 2013; Dinger, 2009; De Haas and Van Lelyveld, 2006; Jeon *et al.*, 2013; Gattini and Zagorisiou, 2016; Temesvary and Banai, 2017).

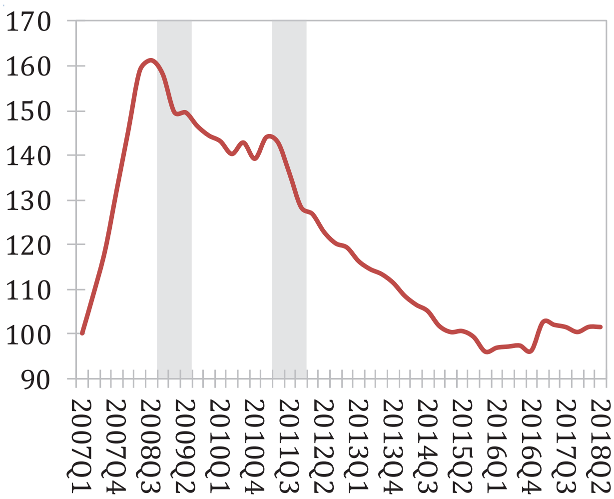
3 In October 2012, under the umbrella of the revived Vienna Initiative 2.0, the EIB designed, and now manages, the *Bank Lending Survey* (BLS) for the CESEE region, to disentangle demand and supply factors as well as the underlying domestic and international components affecting lending activity in the region. Taking into account the unique nature of the regional banking sector, with a large proportion of banks being foreign-owned, the survey investigates both the strategies of international banks active in CESEE and the market conditions and market expectations as perceived by the local subsidiaries/local banks. To that end, the survey covers the major international banks operating in CESEE and their subsidiaries in the region. At the same time, to gain a full understanding of local market conditions, an effort has been made to also include in the survey the relevant domestic players in a specific local market. For more details on the survey and data please refer to the following link: http://www.eib.org/en/about/economic-research/surveys.htm

Bank *capital* remained largely cross-border, bank *funding* less so

When looking at total cross-border banking exposures vis-à-vis CESEE, there has been at a steady decline since 2009. The external position of Bank for International Settlements (BIS)-reporting banks is currently down at levels comparable to early 2007. Figure 1 documents the boom in cross-border lending in the run-up to the 2008/9 financial crisis, and the subsequent decline in external positions.[4] It also shows two major events that triggered significant contractions in the external exposure: they are highlighted with grey bars. First, the global financial crisis of 2008/9 contributed to a reduction in cross-border exposures. Second, the regional eurozone sovereign debt crisis, which reached its peak in mid-2011, also had a detrimental effect on cross-border banking exposures. It had a first-round effect, generating an immediate reduction in exposures. Then, as the eurozone national banking models came under further stress, cross-border banks entered into a rebalancing strategy whereby direct funding support to their subsidiaries has been gradually reduced over time.

Figure 1.

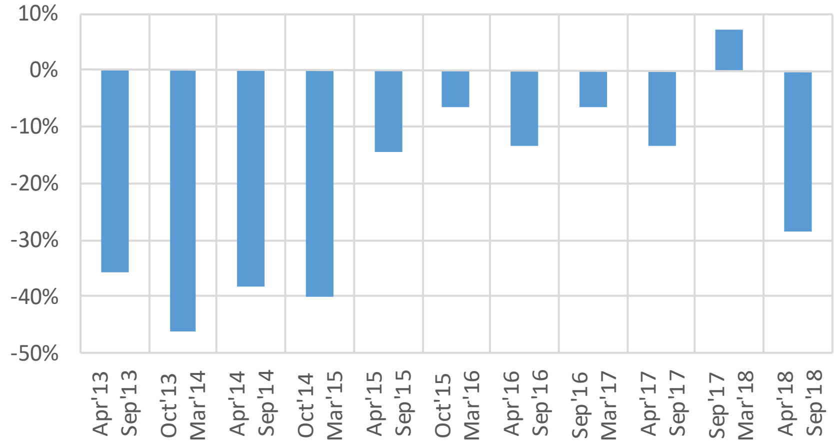
External positions of BIS reporting banks vis-à-vis CESEE countries – index 100=2007Q1



Source: *Authors calculation based on BIS data.*
Note: *Index 100=2007Q1 based on billions of US$, exchange-rate adjusted, vis-à-vis all sectors; grey bars correspond to the global financial crisis and the Eurozone sovereign debt crisis.*

4 The figure is based on cross-border claims of BIS-reporting banks on counterparties listed in the CESEE region. The series have been normalised to equal 100 in 2007 Q1.

Figure 2.
Groups' total exposure to CESEE (net percentages)

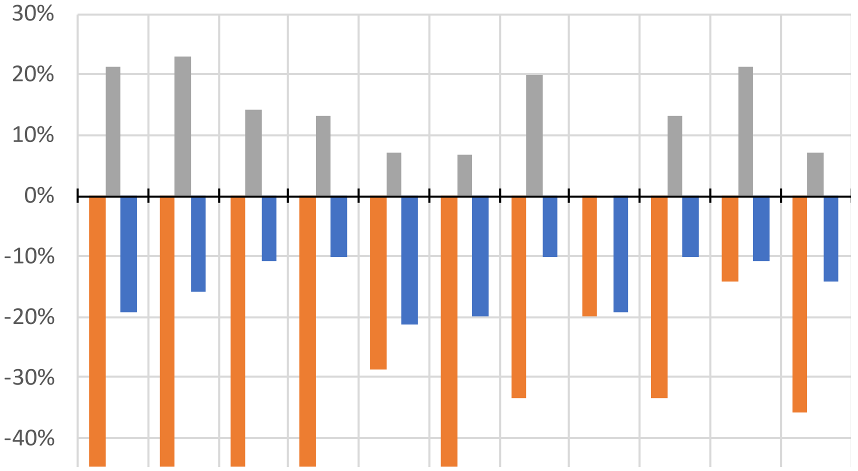


Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *Cross-border operations involving CESEE countries – Net percentages: positive (negative) figures refer to increasing (decreasing) exposure. Question from the survey: Group's exposure to CESEE: Concerning cross-border operations to CESEE countries, your group did/intends to increase/decrease/maintain the exposure compared to the previous six months.*

The aggregate net balance of self-reported exposures in the BLS is consistent with the BIS data. International banks reported on average that they had been decreasing their exposure to the CESEE region in the past few years, including over the second half of 2018 (Figure 2). The last observation shows a significant turnaround compared to the positive outcome recorded for the first time in early 2018. Interestingly, the trend of total exposure to the CESEE region has plunged into negative territory because the number of banks declaring an increase in exposure was significantly lower than in the second half of 2017. This rather substantial reversal squares with the significantly higher volatility recorded in global financial markets, and especially emerging market economies.

Nevertheless, the reduction in exposures is specific to debt funding. While many banking groups operating in the CESEE region have reduced their regional exposure over the past six years, most of the enduring negative contributions to the CESEE exposures stemmed from reduced *intra-group funding* to subsidiaries. International banking groups reducing their intra-group funding exposures have significantly outnumbered banking groups expanding their intra-group funding to CESEE subsidiaries (Figure 3).

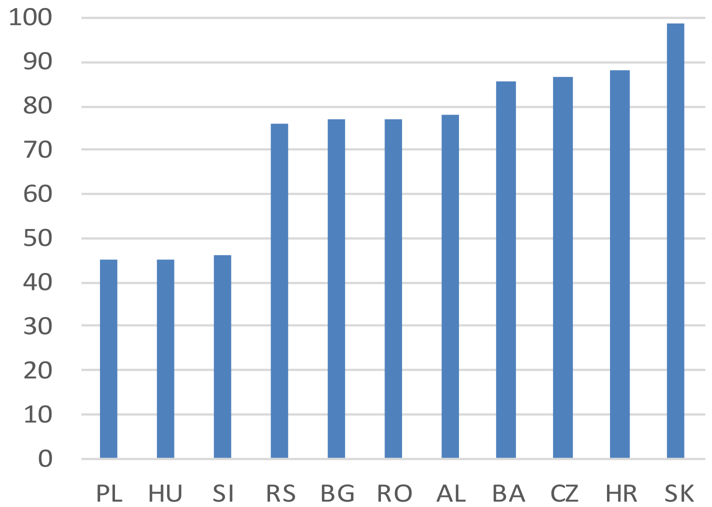
Figure 3.
International banking groups' exposure to CESEE by type (net percentages)



Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*

Note: *Cross-border operations involving CESEE countries – Net percentages: positive (negative) figures refer to increasing (decreasing) exposure in the specific category. "Other" refers to an average of direct cross border lending to domestic clients and funding to banks not part of the group. Question from the survey: Group's exposure to CESEE: Concerning cross-border operations to CESEE countries, your group did/intends to increase/decrease/maintain the intra-group/capital/other) exposure compared to the previous six months.*

Figure 4.
Share of foreign ownership in the banking system (per cent)



Source: *Raiffeisenbank International.*

Note: *Data refer to 2017 and represent foreign-owned assets as a share of total assets.*

At the same time, most parent banks reported consistently that they have maintained their capital exposure to their subsidiaries. Data from the BLS confirms that, on average, international banks contributed positively to their capital position in the CESEE – in stark contrast to the dynamics of intra-group funding.

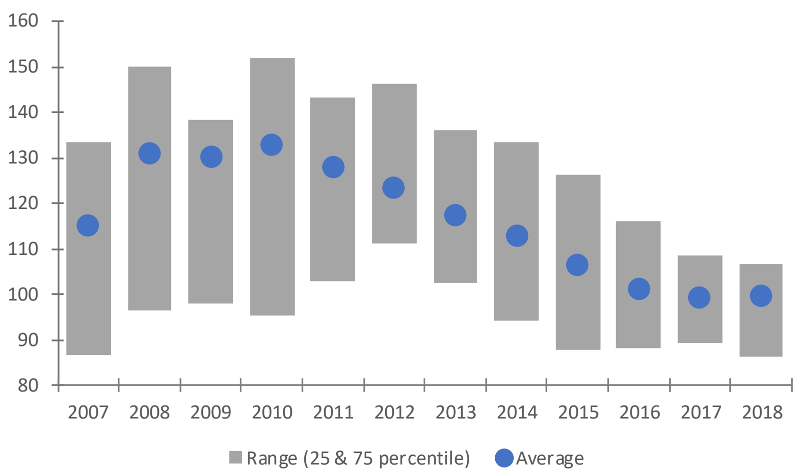
The stability of equity-type banking flows is also reflected in the stable share of foreign bank ownership in the region, which remains exceptionally high by global standards (Figure 4). While there have been some exits from the region, and minor declines in the share of foreign ownership in certain countries, the overall picture has not changed: international banks continue to play a pivotal, determining role in the financial landscape of CESEE.

It appears that cross-border banking is still alive, but the model has changed somewhat. The strategic commitment of international banks to the region does not seem to be at stake. Yet, a progressive reduction of parent/subsidiary funding has been taking place.

The emerging focus on self-sustainability as a fundamental driver of global banks' strategic decisions reflects their experience of the crisis. Cross-border lending flows intermediated by the banking system may indeed have contributed to some extent to pre-crisis imbalances and, as a consequence, to the amplitude of the boom-bust cycles in credit and growth. International banks operating in CESEE have adapted to this lesson by calling on their subsidiaries to implement a more self-sustained financing model, with lending financed mostly via domestic funding – e.g., deposits.

Figure 5.

Loan-to-Deposits ratio – (domestic loan to domestic deposit ratio)



Source: *Authors' calculation based on National authorities; BIS; ECB; EBRD; and IMF, Monetary and Financial Statistics.*

Note: *Average values represent the (unweighted) mean across countries in the region.*

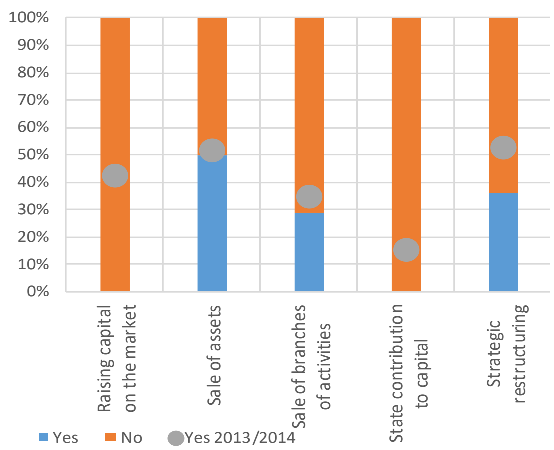
This strategy can be observed in the development of loan-to-deposit ratios (LTDs), which went through a significant rebalancing in recent years. The average regional LTD was relatively high between 2007 and 2014, averaging above 110%, albeit improving over time. By 2016 the average LTD was already close to 100% (Figure 5). The LTD improved further between 2017 and 2018, ultimately stabilising at around 100%. This means that some of the past vulnerabilities have been addressed, and the banking sector in the region is currently in a better shape to sustain present and future growth, being currently more reliant on domestic sources of funding. These developments go hand-in-hand with the strategy of most international groups operating in the region: a gradual reduction in intra-group funding to their subsidiaries in favour of a rebalanced organic growth strategy strongly focused on domestic funding sources.

We can conclude that, despite the decline in total bank exposure, cross-border banking is alive and well in CESEE. While adapting their funding strategies to the key lessons from the crisis, foreign-owned banks continue to play a key role in the financial system of the region, and they remain committed to doing so. In the following section we look at this commitment more closely.

International banks maintained their commitment to the CESEE region

Figure 6.

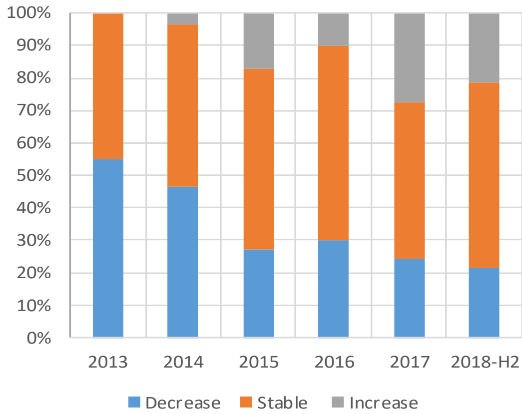
International banking groups' strategic operations to increase capital ratio exposure to CESEE by type (net percentages)



Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *"Yes 2013/2014" refers to the average percentage positive responses for 2013 and 2014. Question from the survey: Has your group conducted strategic operations to increase the capital ratio and/or will conduct strategic operations? If yes, which type?*

Figure 7.

Expected change in the loan-to-deposit ratio over the next 6 months



Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *Question from the survey: Deleveraging – over the next six months, do you expect the loan-to-deposit ratio of your group to increase/decrease/remain stable.*

The commitment of international banking groups to the CESEE region can be assessed through various questions from the CESEE BLS. These are answered at the parent level, and cover various areas within the banking group's strategic operations, such as deleveraging in general, capital increases and decreases and funding positions, as well as the banking group's view about the region's market, its attractiveness, profitability and riskiness relative to the group's overall operations, etc.

About 30% of the banking groups operating in CESEE still continued their restructuring activities at a global level in 2018. This value is nevertheless below the 2013-14 average. Capital increases have been achieved exclusively via sales of assets and branches. The relevance of these types of activities remained largely the same between 2013 and 2018 (Figure 6).

Around 50% of the banking groups signal intentions to continue to conduct sales of assets. This is a broad concept that can includes sales of loan portfolios, security holding, physical assets, etc. These strategic trades cannot be seen as ad hoc adjustments to balance sheets; rather they should be interpreted as a structural feature of doing business for some international groups.

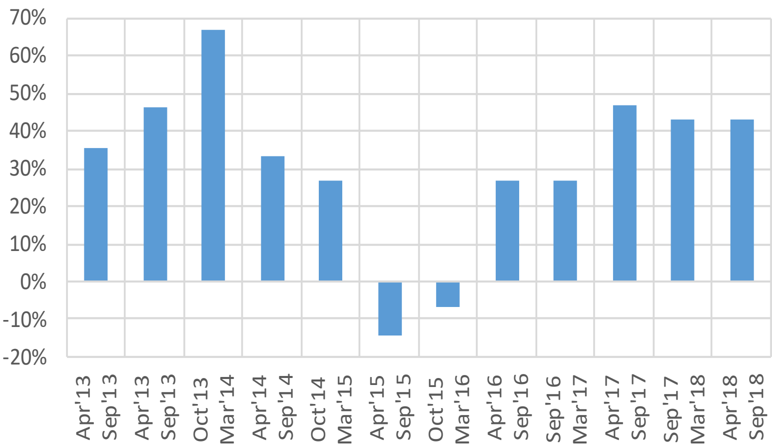
A smaller number of international groups signal sales of branches of activities. This is probably part of on-going structural adjustments to the business strategy of international banking groups, as well as a response to regulatory and recapitalisation requirements in some cases.[5]

No public contribution to bank capital has been reported recently or is expected in the near future. However, the state had been an active source of capital increases in some cases between 2014 and 2015. In 2013 and 2014, banks had also been raising capital on the market, but this source has not been used recently according to the latest rounds of the survey.

The survey also indicates that the deleveraging has ended. Only about 20% of banking groups – less than in 2013-14 – have continued to decrease their LTD, whilst an equal number of banking groups have been re-leveraging. Deleveraging at the group level (Figure 7) has slowed significantly compared to 2013 and 2014, and compared to the already improved conditions in 2015 and 2016. Overall, the even distribution between increases and decreases in groups' LTDs shows that the earlier trend of unequivocal deleveraging has stopped, and banks are considering new funding strategies for the coming years.

Figure 8.

Access to funding



Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *Net percentages; positive values indicate increased access to funding; Question from the survey: in terms of funding: has access to funding of your subsidiary/branch/local bank changed over the past six months? Possible answers: increased/decreased/unchanged.*

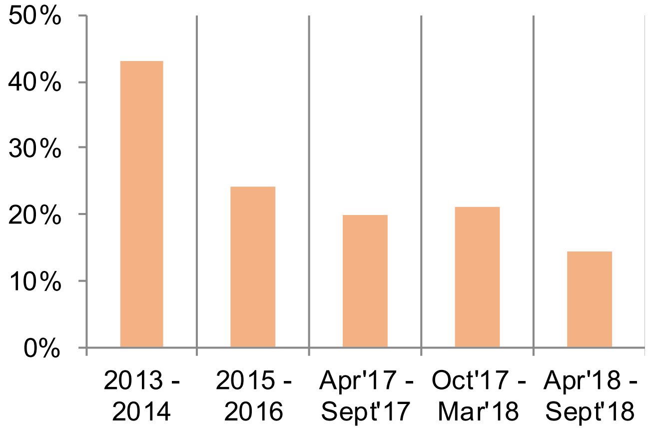
5 For example, some banks headquartered in Greece had mandated provisions to sell part of their non-domestic assets under the recapitalisation plans executed within the framework of the third macroeconomic adjustment programme.

Funding conditions at the group level have broadly eased in past years and have continued to ease over the past six months (Figure 8). Corporate and retail deposits made a significant positive contribution to total access to funding. The global access to funding of the banking groups continued to ease in the recent past. Following a contraction during 2015, access to funding resumed an easing trend in the first half of 2016 and accelerated further in 2017. The contraction in access to funding in 2015 was a temporary event, which coincided with the long-tail effects generated by the Greek crisis of spring/summer 2015. The 2018 developments can be described as broadly in line with 2017 outcomes. The developments detected in aggregate access to funding reflect prolonged improvements in retail and corporate funding, and positive contributions from wholesale debt issuance. Notably, the interbank market continued to play a positive role, and banking groups have continued to rely less and less on central bank liquidity. This is a further positive signal of a more stable and self-supporting funding environment.

The majority of banking groups are planning to maintain or selectively expand their CESEE operations. This commitment is supported by the profitability of CESEE operations: the overall return on assets on operations in the region is reported to be higher than that of the overall group. While this is true for the majority of the banks present, some 20% of banking groups report a combination of diminishing regional returns and intentions to reduce operations. Overall, the assessment of market prospects shows a continued stabilisation in the region, with diversified potential and profitability across countries (Figure 9). Cross-border banking groups signal an intention to expand operations selectively in the region (Figure 10). Nevertheless, they continue to discriminate in terms of countries of operation as they reassess their country-by-country strategies. Around 35% of the groups have a medium- to long-term strategy of selective expansion of operations, whilst about 45% of groups intend to maintain the same level of operations in the region. Around 20% of banking groups – predominantly, but not exclusively those based in Greece – indicated that they may reduce operations in the long term.

Figure 9.

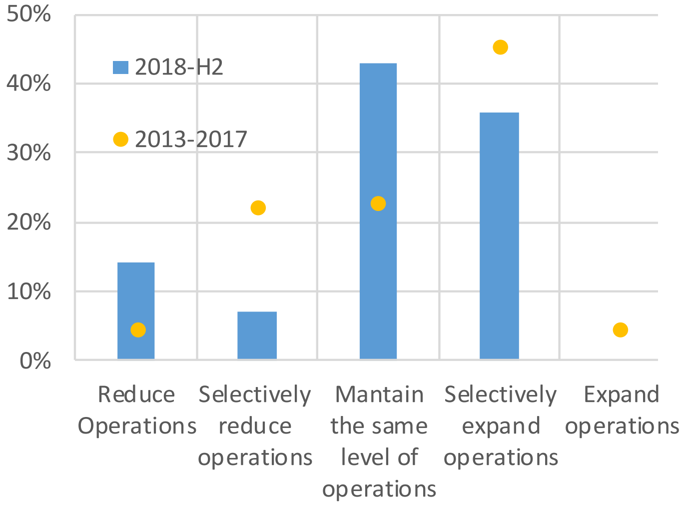
ROA of your CESEE operations - percent of responses with ROA lower than overall group ROA



Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *Question from the survey: profitability of the strategy in the CESEE region: is ROA of your CESEE operations higher/lower/equal to that for the overall group?*

Figure 10.

Groups' intentions on aggregate operations in CESEE



Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *Question from the survey: longer-term strategic approach (beyond 12 months): looking at operations via subsidiaries in CESEE, your group intends to...*

Credit to the private sector: lower but safer

Overall credit growth in the CESEE region has been positive since late 2016, after a period of heightened volatility characterised by fluctuations. In the post-crisis period credit demand contracted significantly, and supply conditions tightened in parallel. Demand for credit first started to accelerate in late 2014 in some countries. This positive trend solidified further in 2015-16. Heightened demand was the main precursor of credit growth. Figure 11 depicts demand and supply drivers underpinning regional credit developments in CESEE, using measures derived from the BLS. According to these, demand conditions became self-sustained in 2017 and 2018, thus leading credit growth to accelerate further.

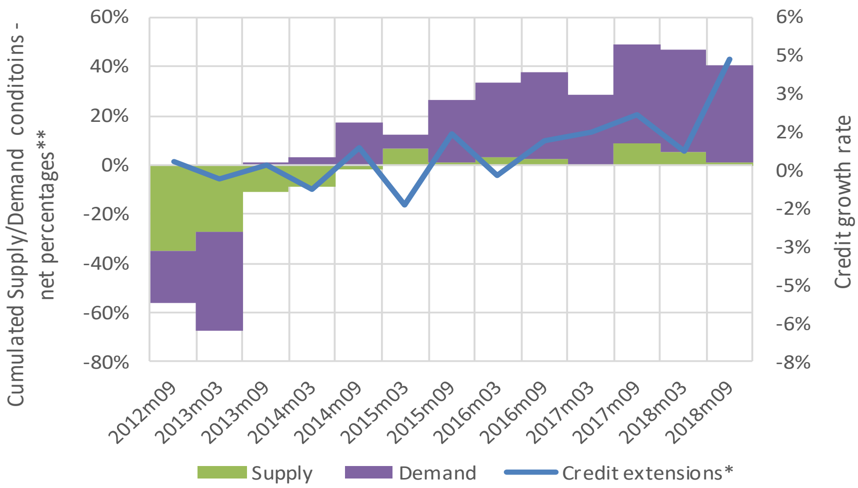
Demand for loans and credit lines continued to increase robustly (Figure 11). The latest results from the BLS mark the eleventh consecutive half-year of increased aggregate demand for credit. The positive and increasing demand is now present in all client segments, product types and maturities, but somewhat less so for foreign currency loans. This is a very different situation from 2013, when demand for loans was decreasing across the board, except for a mild positive development on short-term maturities. Towards the end of 2014, demand started to turn around in some segments, notably in local currency from SMEs and for consumer credit. Ultimately, demand for foreign-currency-denominated loans turned positive in 2017, when all other components of demand were already largely in positive territory.

Supply conditions eased only marginally in past years. Supply conditions eased slightly in 2015 and 2016 (Figure 11). A mild easing was also recorded in the second half of 2017 and early 2018. Across the client spectrum, credit standards eased on SME lending and consumer credit, whilst they continued to tighten on mortgages. Supply conditions eased on short-term loans, and only slightly on long-term loans, primarily those in local currency. The general terms and conditions of loan supply to the corporate segment loosened recently, with easier collateral requirements, longer maturities and markedly larger average sizes.

However, improvements in supply have been lagging behind the increase in demand. The increasing optimism on the demand side was still met with cautious improvements in supply-side conditions, leaving a noticeable perceived gap between demand and supply, given the strong economic growth recorded recently in CESEE.

Figure 11.

Demand and supply forces underpinning regional credit developments



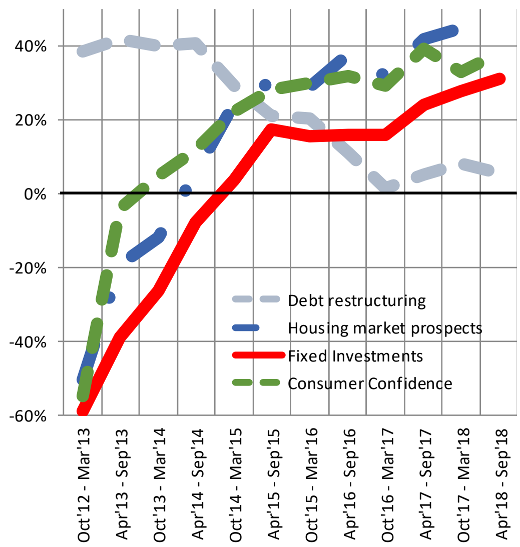
Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey and WIIW data for credit extensions.*

Note: ** Credit growth is computed using a semi-annual window, and the reference period is the previous six months to match it with the survey releases and survey information set and the perimeter reflects the BLS country coverage; **net percentages: positive values indicate increased (easing) demand (supply); the credit aggregate is constructed based on growth rates aggregated via country-specific GDP weights and the country perimeter reflects the BLS country coverage. Questions from the survey: Credit Supply: bank's (local subsidiary's) credit standards applied when assessing credit applications (eased, unchanged, tightened); Credit Demand: demand for loans or credit lines to enterprises and households (increased, stable, decreased). Net percentages; positive figures refer to increasing (easing) demand (supply).*

Almost all the individual factors behind credit demand show significant improvements. Unlike 2013-14, all factors influencing demand made a positive contribution (Figure 12). Working capital accounted for a large share of the demand stemming from enterprises. Contributions to demand from investment exerted a significant positive impact, scoring increasingly higher over time. This indicates a stronger economic cycle and an improved macroeconomic and financial environment more conducive to investment. Corporate and debt restructuring, as well as mergers and acquisitions, have been less and less important factors behind demand, and all currently stand near zero. This also indicates a shift of demand from less to more productive sources. Housing- and non-housing-related consumption also continued to make robust and positive contributions to demand, and consumer confidence continues to exert a positive effect.

Figure 12.

Factors contributing to demand conditions – net percentages

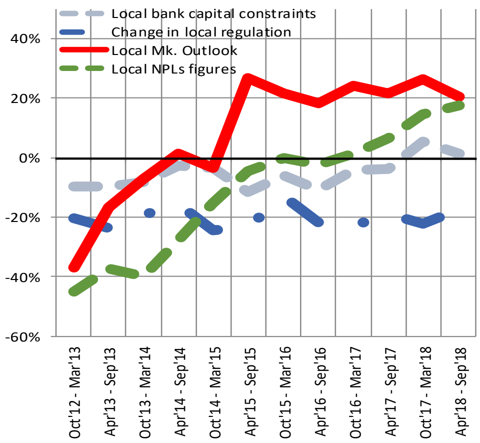


Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*
Note: *Net percentages; positive values indicate a positive contribution to demand; Question from the survey: Factors affecting clients' demand for loan applications – how have they changed over the past six months? (options: contributed to lower/unchanged/higher demand).*

The number of domestic and international factors limiting supply has decreased substantially over time (Figures 13 and 14). Until end-2014, essentially all factors had constrained supply conditions. In 2015, some elements started to be supportive. Lately only few components are still considered a binding constraint to supply. Specifically, EU regulation, group capital constraints, group outlook and group NPL figures were the core international factors constraining supply until end-2015. Group capital position and EU regulation shifted from a constraining position to a rather neutral contribution from early 2016 onwards. Generally, group outlook played a supportive role, whilst group NPLs are still perceived today as a constraining factor.

Figure 13.

Domestic factors contributing to supply conditions – net percentages

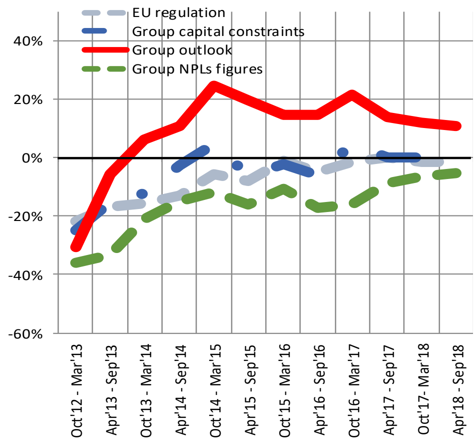


Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*

Note: *Net percentages; positive values indicate a positive contribution to an easing of supply/credit standards; Question from the survey: Factors affecting your bank's credit standards (credit supply). Have the following domestic and international factors contributed to tighten (ease) your credit standards over the past six months? Options: tightening/easing/ neutral contribution to supply conditions.*

Figure 14.

International factors contributing to supply conditions – net percentages



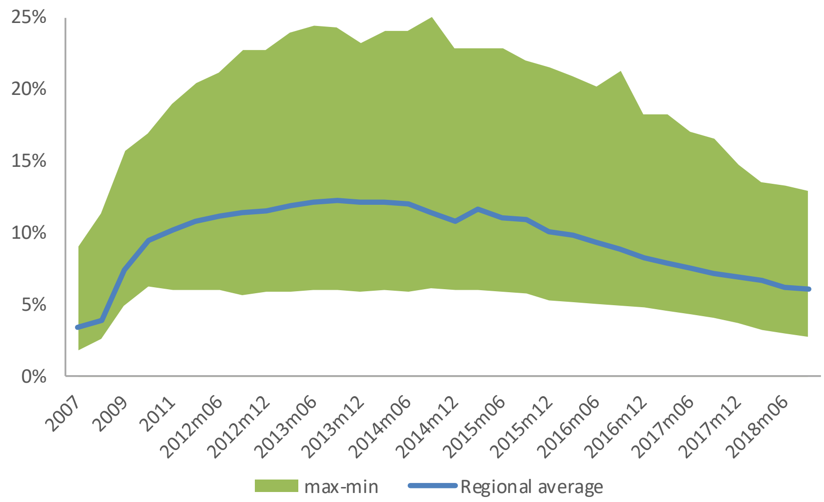
Source: *Authors' calculation based on EIB – CESEE Bank Lending Survey.*

Note: *See Note to Figure 13.*

On the domestic side, local market outlook was the first factor to contribute to an easing of supply during the second half of 2015. By mid-2017, domestic NPLs had also ceased to be a constraining factor. In 2018, local capital became more of a neutral contributor rather than a tightening factor. Finally, changes in local regulation are still perceived as a limiting element to an easing of supply.

It appears that the more cautious strategy of the banks has contributed to the improvement in the quality of credit portfolios. Originally, the crisis led to a marked deterioration in the ratio of NPLs. However, 2015 was a turning point, and NPLs at an aggregate level have been improving ever since (Figure 15). By mid-2018, regional aggregate NPL ratios had normalised substantially and reached levels that are broadly in line with the pre-crisis ones. The commercial banks' efforts to eliminate the NPL legacy of the crisis was supported by a substantial set of reforms by domestic regulators. These measures helped to incentivise the banks to clean these legacy assets, which had been acting as a drag on new lending, from their balance sheets. The Vienna Initiative played an active role in the coordination and implementation of this reform agenda in the region (see EBCI, 2018).

Figure 15.
NPL ratio in CESEE

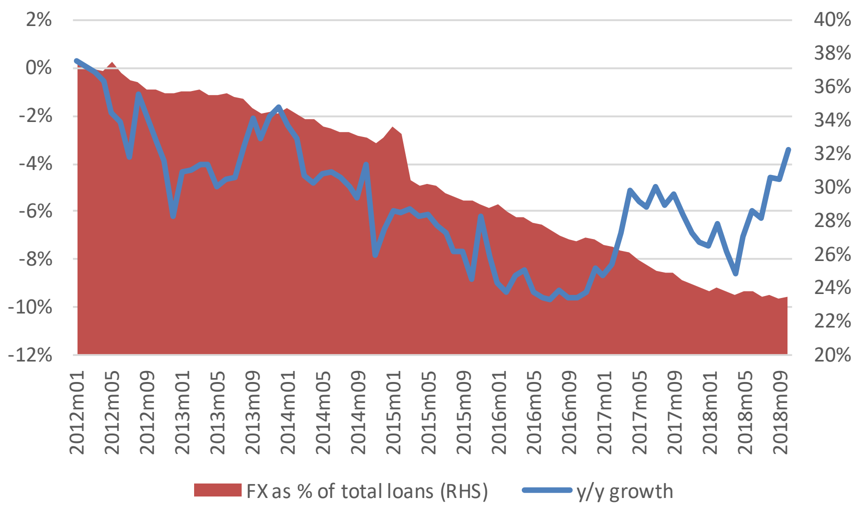


Source: *Authors' calculation based on WIIW and national central banks.*
Note: *Regional average computed using EUR based GDP weights (average 2012-2018) and based on Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia and Slovenia.*

Safer bank lending practices are also reflected in the declining role of loans denominated foreign currency (Figure 16). These loans represented a significant vulnerability in some countries of the region during the crisis. The role of such loans has been diminishing at a steady pace, again as a result of the banks' own strategy, relying chiefly on domestic funding, combined with decisive regulatory disincentives in many of the countries that were heavily affected by the issue during the crisis. As a result, the role of foreign-exchange-denominated loans has been typically restricted to those segments of the corporate sector that obtain revenues in foreign currencies and therefore have a natural hedge against the exchange rate risk.

Figure 16.

Foreign currency loans to non-financial private sector in CESEE (percent of total and year on year growth)



Source: *Authors' calculation based on WIIW and National Central Banks.*
Note: *Regional average for shares and growth rates computed using EUR based GDP weights (average 2012-2018) and based on Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia and Slovenia.*

All in all, the experience so far suggests that the post-crisis model of cross-border banking leads to lower, but possibly safer, credit growth in CESEE. On the one hand, credit dynamics finally turned into positive territory after a long period of contraction after the crisis. On the other hand, the positive growth of credit is not comparable with the seemingly excessive dynamics that characterised the period leading up to 2008. The fact that credit growth is driven by demand factors rather than by the ease of supply factors suggests that credit dynamics are not procyclical but, on the contrary, are more likely to be in line with the underlying economic developments. Although good portfolio quality during a cyclical upswing provides limited information about resilience during a crisis, the continuous improvement in NPLs indicates that the portfolios are relatively safe, and that the banks in CESEE could overcome the legacy of the crisis. Furthermore, the significantly lower prevalence of foreign-exchange-denominated loans also indicate a more cautious and prudent lending strategy by the international banking groups present in the region.

Conclusions

In this chapter we looked at the status of cross-border banking in CESEE in the post-crisis period. Our analysis points to cross-border banking being as important in the region as it was before. However, the way international banking groups operate has changed substantially, and the banks' approach to the region has incorporated some lessons from the crisis and the post-crisis period.

Substantial foreign inflows into bank equity has remained an important feature of the CESEE region, and the level of foreign bank ownership is still particularly high. International banking groups reinforced their commitment to the region and look at their local operations as strategic assets that bring profitability and risk reduction through diversification.

Nevertheless, when it comes to debt-type foreign inflows, the region experienced significant outflows. International banks implement a more self-sustained financing model for their subsidiaries in the region, with lending financed mostly by domestic funding – e.g., deposits. This is reflected in the substantial reduction in LTD.

Reliance on domestic funding allows for less, but safer credit in the region. Total credit growth in the region has been positive again since 2016. This credit growth is driven primarily by demand, with the supply-side developments lagging. This cautious approach of banks is reflected in the fact that, so far, credit growth has been accompanied by a parallel decline in the share of NPLs. Dependence on domestic deposits for lending may also limit the procyclicality of credit dynamics, and could help to avoid overheating and bubbles while tying credit flows more closely to potential growth. The presence of additional safeguards and a more cautious approach are also reflected in the very limited role of foreign-currency lending in recent credit growth.

Is there a role for more cross-border banking in CESEE? In principle, stronger cross-border capital flows could foster more rapid convergence of the CESEE economies and would also strengthen international risk sharing. However, the crisis showed that cross-border capital flows can have a detrimental impact, especially if the institutional framework is not prepared. If the countries of CESEE have the ambition to reap the benefits of even higher levels of cross-border capital flows, the preconditions and safeguards need to be laid down. This is particularly true when it comes to the regulation of the financial sector: large international capital flows should come hand-in-hand with a high level of coordination of banking regulation, supervision and resolution policies – just as envisaged by the ambitious Banking Union project of the EU. While the seeds of CESEE-level coordination are present, for instance, within the Vienna Initiative, a much stronger regulatory integration is needed for the region to successfully handle the challenges stemming from large-volume cross-border capital flows intermediated through international banking groups.

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CHAPTER 12

The Non-Performing Loans Initiative: progress since its launch in 2014

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Executive Summary

In the aftermath of the global financial crisis of 2008-9, the Central, Eastern and Southeastern Europe (CESEE,[1] or the region) rapidly became burdened with the accumulation of Nonperforming loans (NPLs) in the banking systems. This threatened financial stability nationally, but also introduced contagion between countries, particularly where larger banking groups had a presence across the region. Gaps between countries in tackling their growing NPL problems also became apparent.

The Vienna Initiative[2] has long recognised NPLs as a key impediment for a revival in credit markets, and created the NPL Initiative workstream in 2014 to build greater transparency of the NPL resolution framework, support country reforms in the area and improve restructuring environments. The work has been focused on five "Partner Countries" (Albania, Croatia, Hungary, Montenegro and Serbia), whilst many other CESEE countries also benefited from the Initiative, as did Cyprus and Greece[3]. A broad range of technical assistance has been provided to the region under the framework to solve the most pressing impediments to NPL resolution and to support the development of sound markets.

1 CESEE countries refers to Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovak Republic, and Slovenia.

2 The "Vienna Initiative" is a framework for safeguarding the financial stability of emerging Europe. It brings together all the relevant public and private sector stakeholders of EU-based cross-border banks active in emerging Europe, which own much of the banking sectors in that region.

3 Cyprus and Greece are not formally included within CESEE region definition of this paper.

While challenges remain, the CESEE NPL situation has improved considerably since the launch of the NPL Initiative. The gross NPL ratio in the region more than halved from its peak of 9.8% in 2014 Q1 to 4.0% in 2018 Q3. In Partner Countries, the improvement was particularly striking, with the ratio falling from 17.4% to 6.2% in the same period. NPL volumes in CESEE also decreased to €38.0 billion in 2018 Q3 from €68.1 billion in 2013 Q3. Moreover, in the period 2015 H1 to 2018 H1 an estimated €13.7 billion[4] of market NPL sales were realised in CESEE, with over 20 companies now providing NPL management and/or recovery services across the region. These developments are at least partly a direct result of the efforts provided by multiple institutions and stakeholders through the NPL Initiative.

Background of the NPL Initiative

The extent of the NPL challenge in the CESEE region at its peak

The very high credit growth in the CESEE during the period 2003-8 led to an unsustainable boom which ended abruptly with the global financial crisis of 2008/9.[5] This resulted in economic downturns and even recessions in many jurisdictions across CESEE. The banking systems ultimately suffered, leading to the rapid accumulation of NPLs in the following years[6].

The volume of NPLs[7] in the CESEE peaked at €68.1 billion in Q3 2013.[8,9] The significant undercapitalisation of the banking system accentuated the challenge, contributing to further credit contraction in the economies, and itself accentuating the problem. NPL ratios[10] continued to rise to reach 9.8%in CESEE in 2014 Q1.[11] These levels were unsustainable for local economies and the broader financial stability of the region.

4 This transaction value is sourced from public sources only, but it is expected that a number of confidential transactions have also been realised across the region.
5 European Banking Coordination "Vienna Initiative": Working Group on NPLs in CESEE, March 2012.
6 For more details see "Non-Performing Loans in CESEE: Determinants and Impact on Macroeconomic Performance" (March 2013), by Klein, Nir (IMF Working Paper), https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Non-Performing-Loans-in-CESEE-Determinants-and-Impact-on-Macroeconomic-Performance-40413
7 Unless stated otherwise, NPL refers to Gross NPL throughout the publication.
8 Unless stated otherwise, all data are sourced from the IMF Financial Soundness Indicators (IMF FSI), available at http://data.imf.org/regular.aspx?key=61404590, accessed on 1 March 2019. For individual country definitions and to allow more precise comparisons, it is advised to consult the IMF FSI metadata. In addition, data on Montenegro and Serbia are obtained from respective central banks, as they are not available in the IMF FSI database.
9 All data were sourced in local currency and converted to US dollar and then Euro, using IMF exchange rates available at the following link: National Currency per US Dollar, end of period http://data.imf.org/regular.aspx?key=61545862.
10 The NPL ratio is calculated by taking the NPL volume as the numerator, and the total gross value of the loan portfolio (including gross NPLs, i.e. before the deduction of specific loan-loss provisions) as the denominator.
11 Weighted average.

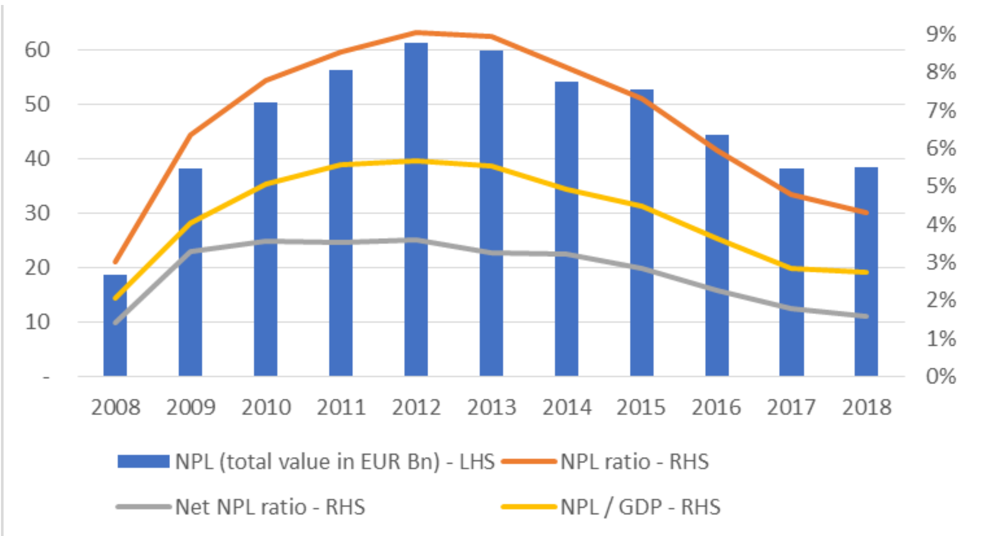
As a large portion of the distressed assets were on the balance sheets of subsidiaries of the cross-border banks that dominated the region's banking sectors, there was a growing risk that bank failures would have systemic consequences with contagion between jurisdictions, even beyond the CESEE region.

Structural changes were required to resolve NPLs, as most CESEE countries did have not have adequate market infrastructures and the institutional prerequisites to support efficient and effective debt restructuring, enforcement or liquidation in the non-financial corporate sector. Common categories of market impediments included the inadequacy of the legal framework and infrastructures, weaknesses in banking supervision, opacity (or absence) of information and counter-effective tax regimes. In addition, the regional market for loan sales remained under-developed, with banks having limited external options to deleverage their NPL risks. However, banks were also ill-equipped to manage such loans internally, with insufficient skills and resources to deal with the mounting problem. This combination of factors led to amplification of the NPL problem and value erosion in the banks' distressed loan books.

Rapid measures were therefore required to improve the situation and avoid a downward spiral in the banking systems, both on a regional and country-specific level.

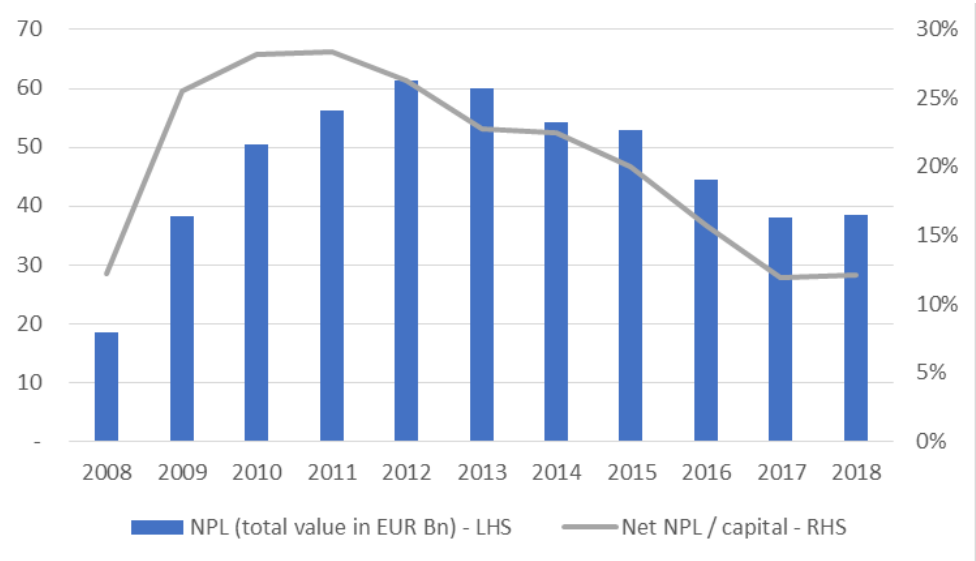
Figure 1.

Evolution of gross NPL volumes (€ billion) and NPL/GDP, gross NPL, and net NPL ratios in CESEE, 2008-2018



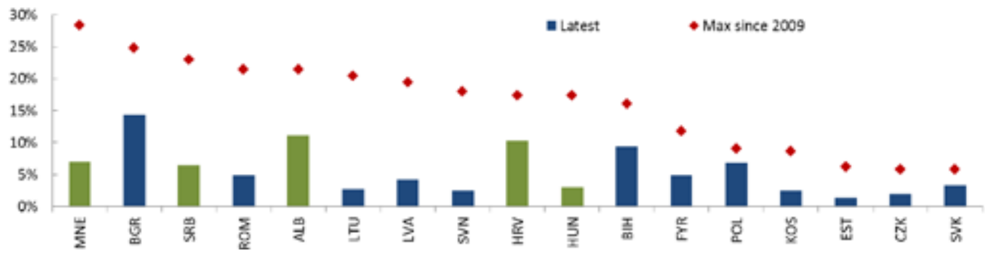
Source: NPL Monitor and associated EBRD database.a

Figure 2.
Evolution of gross NPL volumes (€ billion) and net NPL/capital ratio in CESEE 2008-2018



Source: NPL Monitor and associated EBRD database.

Figure 3.
Latest NPL ratios available across CESEE (blue) with five Partner Countries in green (Albania, Croatia, Hungary, Montenegro, and Serbia



Source: NPL Monitor and associated EBRD database.

The roots of the NPL problem

CESEE region

The reasons for the rise of NPLs varied between countries, depending on the specific local circumstances. There were, however, some region-wide commonalities to the initial rapid rise in NPLs. Most notably, a considerable portion of increases in NPLs were triggered by currency depreciation, as many household and corporate loans were denominated in foreign currencies (such as US dollars, euros or Swiss francs) while borrowers' incomes were in local currencies, leading to the inability to meet their loan obligations.

As confirmed empirically[12], there is a robust relation between high NPLs and weaker credit and GDP growth, with two-way causality. High NPLs can depress credit activity, growth and ultimately job creation, which in turn perpetuates private-sector debt difficulties and leads to further increases in NPLs, potentially leading to a downward spiral. This was the situation of many CESEE countries, posing considerable systemic risks for the region. Some regulators were initially reluctant to allow banks to write off unrecoverable NPLs, fearing that this would further weaken banks' capital and lead to broader strains in the financial system. This contributed to the accumulation of the NPL stock in the banks of these jurisdictions.

The five Partner Countries of the NPL Initiative

While there were many region-wide commonalities, there were also a variety of specific issues leading to the accumulation of NPLs across countries. For example, the five countries which collaborated closely with the Vienna Initiative institutions under the NPL Initiative workstream (the "Partner Countries"), all presented some specificities at the root of their NPL growth and/or in the challenges they faced in reducing them.

- **Hungary** was principally impacted by the significant exchange rate depreciation that increased the debt service burden of FX loans (52% Hungarian forint (HUF) depreciation against the US dollar in the period 2008 H1 to 2012 H1) in combination with the weak labour market.[13] While the core of the NPLs came from the household segment, there were also a considerable number of corporate NPLs linked to project financing in the real estate market (accentuated by declining real estate collateral values). Furthermore, a decreased level of demand (due to increasing unemployment) forced corporations to reduce production/product prices and lower rental fees, which served as the primary sources of instalment payments. Moreover, many real estate related projects were not finished or could not be sold post completion, pushing debtors into nonperforming status.

12 For the overview of the literature see Balgova *et al.*, 'The economic impact of reducing non-performing loans", EBRD Working Papers Series (2016) and Navaretti *et al.* (eds.) "European Economy: Banks, Regulation, and the Real Sector – Non-Performing Loans" (2017).

13 For more details, see: "Analysis of Corporate Restructuring and Insolvency in Hungary" (February 2015), published by EBRD, EY and White & Case.

- **Albania** was also particularly impacted by foreign currency loans, principally in the corporate segment. Over-lending and financing of speculative assets in combination with a large number of moral hazard cases were some of the key drivers of unsustainable NPL volumes. The situation resulted in two large corporate bankruptcies in 2016 (an oil refinery and a commodity exporter).

- **Croatia** had become heavily exposed by the unsustainable credit boom of 2001-8. Given a relatively stable exchange rate between Croatian kuna (HRK) and the euro, in 2013 the proportion of nonperforming housing loans indexed to the Swiss franc was about two and a half times greater than those that were euro-indexed. The corporate NPL ratio reached nearly double the size of the household NPL ratio, with the construction and commerce sectors contributing the most to the NPL problem.[14] In addition, the country suffered the administration procedure of the largest Croatian conglomerate, Agrokor Group,[15] in 2017.

- **Serbia**, as with Croatia, experienced an increase in its corporate debt burden to almost three times the size of its household NPLs.[16] The majority of corporate debt was accumulated either by large conglomerates (holdings) originating from earlier privatisations of state-owned enterprises or by businesses that developed organically from small family companies, whose growth was accompanied by increased indebtedness. In addition, the 50 most indebted companies held between 50% and 60% of total corporate excessive debt.[17]

- **Montenegro** was mostly challenged by its corporate indebtedness. The economic downturn decreased corporate profits and made many companies run losses, which impaired their ability to pay the monthly instalments. Furthermore, the decrease in corporate liabilities to domestic banks was largely offset by rising indebtedness to non-residents, which can be partly explained through the transfer of NPLs from bank balance sheets to asset management companies belonging to parent banks.[18]

14 For more details see 'Financial Stability No 11' (July 2013), published by Croatian Central Banks (HNB) https://www.hnb.hr/documents/20182/122362/e-fs-11-2013.pdf/c3976160-548d-4e41-a0f1-1fc18006800b

15 For more details look at 'Financial Stability No 19' (May 2018), published by Croatian Central Banks (HNB) https://www.hnb.hr/documents/20182/2502358/e-fs-19-2018.pdf/96fd21fc-d4af-4f45-9588-c3eae0e3d6c6

16 For original data look at: http://nbs.rs/internet/cirilica/90/ioi_arhiva.html

17 For more details look at 'Corporate NPL portfolios in CESEE countries: impact of corporate leverage and debt spillovers on firm performance' (August 2016), published by Damijan, Joze. P. (EBRD Working Paper) http://npl.vienna-initiative.com/wp-content/uploads/sites/2/2016/09/NPL-impact-of-corporate-leverage-and-debt-spillovers-on-firm-performance.pdf

18 For more details, see IMF Country Report No.16/79 (March 2016) http://www.imf.org/external/pubs/ft/scr/2016/cr1679.pdf

Regional technical assistance through the NPL Initiative

The significant stock of NPLs in the region was considered a systemic challenge, as it imposed significant pressure on financial stability, banks' profitability and the overall economy. A key issue in tackling the NPLs was a "collective action" problem, in which individual payoffs to NPL resolution were limited in the absence of a system-wide coordinated approach. Such coordination support and technical assistance were necessary in CESEE, both at the individual jurisdiction level and for the region as a whole.

The Vienna Initiative, launched in 2009, has long recognised NPLs as a key impediment for a revival in credit markets. The European Banking Coordination "Vienna Initiative" report published in March 2012 highlighted[19] the key issues in the CESEE and the need for more robust actions from IFIs to support and help accelerating NPL resolution in the region. In order to tackle the issue, the NPL Initiative was born in 2014 as a dedicated workstream, building upon the successful private-public sector coordination platform of the Vienna Initiative.

The NPL Initiative is a broad International Financial Institutions' (IFIs) NPL project. It draws on the work within the International Monetary Fund (IMF), the World Bank Group, the European Investment Bank (EIB) and the European Commission (EC) and is managed by a small group of experts within the European Bank for Reconstruction and Development (EBRD). Each of these IFIs supports individual countries' efforts in their particular area of expertise, fully coordinating their help and initiatives for maximum impact.

While most CESEE countries have benefited from the Initiative, the work has been focused on the five Partner Countries which have a more formal collaboration agreement, namely Albania, Croatia, Hungary, Montenegro and Serbia. Numerous activities have been implemented since the start of the NPL initiative (see Section 2) and important progress has been made in the region in reducing the lagging stock of NPLs and preventing new accumulation (see section 3).

Key objectives and achievements of the NPL Initiative

The NPL Initiative aims to increase the speed and effectiveness of NPL resolution and support the development of sound NPL transaction (sales) markets in the region. It provides a structured framework in which IFIs and National Competent

19 For more details look at 'European Banking Coordination Vienna Initiative' (March 2012) https://www.imf.org/external/region/eur/pdf/2012/030112.pdf

Authorities (NCAs) ¬– in consultation with banks, investors and industry experts – can work together to define and implement solutions to individual countries' NPL challenges.

The NPL Initiative has three overlapping objectives:

1) enhancing the transparency of restructuring frameworks
2) capacity building through technical assistance
3) knowledge sharing

The extent to which these objectives have been reached through the IFIs' commitment to tackling NPLs is best illustrated by three recent and tangible achievements.

- **Creation of the NPL Initiative website** (npl.vienna-initiative.com) by the EBRD. In line with the objectives of enhancing transparency of restructuring frameworks and disseminating knowledge, the website has become an industry reference as a "one-stop shop" for intelligence and information on the best ways to resolve NPLs.

- **Publication of a semi-annual NPL Monitor** (six editions published since May 2016). The publication adds value to the existing NPL analyses by tracking distressed debt transactions and national reform measures. Each publication is authored by EBRD NPL specialists in consultation with other IFIs and national partners.

- **Capacity building**, which includes among other things technical assistance coordinated between the principal international organisations and EU bodies. Training in modern restructuring principles has also been provided in various jurisdictions to build local skills. Such capacity building has been provided through organising conferences, workshops and training. For example, the EBRD has led (i) three regional conferences on NPLs (Vienna in June 2015 and September 2014, and Kiev in April 2018), (ii) four regional trainings on NPL restructuring (Vienna in November 2015 and October 2016, and Athens in November 2017 and May 2018) and (iii) various local workshops (Budapest in October 2016, Zagreb in November 2016, Nicosia in May 2017, Sofia in September 2017 and Skopje in October 2018).

In addition to work performed in the partner countries of the NPL Initiative, further technical assistance has been provided to other countries on an *ad hoc* basis. Overall, the EBRD has provided technical assistance on NPLs to eleven countries since the start of the NPL Initiative in 2015, and other IFIs have reached out to even more countries.

In addition, in November 2017 the EBRD launched an investment framework to mobilise up to €1.5 billion to help further reduce the high levels of NPLs in its countries of operation. Under this framework, the EBRD can commit to minority investments up to a total of €300 million, which is to be complemented by external financing of up to €1.2 billion from approved commercial partners. This comes in addition to the International Finance Corporation's (IFC's) distressed asset programme, which has a more global reach.

Cross-institutional cooperation and coordination

Regulators, IFIs and the banking industry worked together to assess, define and implement solutions to the reduction of the high stock of NPLs in the CESEE. While no "one-size-fits-all" model can be applied, a broad consensus exists in terms of prerequisites for supporting efficient and effective NPL resolution. But specific frameworks and remediating measures must be tailored on a country-specific basis to ensure that the right solutions are identified and that the solutions are adapted to the local specificities and needs. The broader IFI work on NPLs was therefore complemented by specific in-country dialogues and technical assessment by the IFI members of the NPL Initiative for the Partner Countries. This resulted in the development, together with the NCAs, of series of country-specific activities. For example, the EBRD sponsored in-depth impediment assessments in countries such as Hungary and Serbia to support the development of multi-year action plans. The World Bank led on a similar work in Albania.

In addition to the IFIs' work, a broad range of initiatives have also been adopted in the European Union, as it also faced (and still faces) important challenges with an accumulation of NPLs in the banks of its member countries. As part of the NPL Initiative, the EBRD was a permanent contributor to the European Systemic Risk Board (ESRB) expert group on NPLs, whose report contributed to the development of the European Action Plan on NPLs. In July 2017, the European Council adopted a detailed "Action Plan on Reducing NPLs in Europe", which calls upon various EU regulators to take appropriate measures to address the challenges of high NPLs in Europe. This led to a broad range of European regulations both to tackle the stock of NPLs and to prevent the creation and accumulation of new NPLs, further contributing to NPL resolution in both the EU and arguably non-EU CESEE countries.

Building on international best practices

The work performed under the NPL Initiative has leveraged international best practices, including through the impediment assessments performed by the IMF and the World Bank, as well as the broad range of NPL-related regulatory measures implemented in the EU in recent years.

For example, in September 2015 the IMF published a study on the "Strategy for Resolving Europe's Problem Loans", which analysed structural obstacles that discourage European banks from addressing their problem loans. It offers actionable policy recommendations across three key areas: (1) enhancing prudential oversight, (2) reforming debt enforcement regimes and insolvency frameworks and (3) developing distressed debt markets. This has been the cornerstone of the NPL Initiative approach.

The World Bank Group also publishes, on an annual basis, its *Global Doing Business Report*[20], which assesses objective measures of business regulation and their enforcement across 190 countries and cities. The reports identify, amongst other things, impediments in the legal and judicial systems. In the context of NPLs, the World Bank Group reports pay particular attention to the strength of credit reporting systems and the effectiveness of collateral and bankruptcy laws in facilitating lending, as well as time, cost and outcome of insolvency proceedings involving domestic legal entities and broader quality and efficiency of the court system.

The Bank for International Settlements (BIS) published a policy paper on the resolution of nonperforming loans[21] in October 2017, which analyses a broad range of countries that suffered financial crises (including those from Asia, the Nordic region and the United States) to provide practical insights into the feasibility and success factors behind different NPL resolution strategies. The BIS also analyses how country-specific characteristics can affect the applicability and effective of measures.

20 The most recent reports and relevant methodology available at http://www.doingbusiness.org/en/doingbusiness.

21 BIS, Financial Stability Institute Insights, Resolution of non-performing loans – policy options, October 2017, https://www.bis.org/fsi/publ/insights3.pdf

In addition, European Union regulators have developed and implemented a broad range of initiatives in recent years to increase the speed and effectiveness of NPL resolution. In July 2017 the Council of the EU announced an action plan to reduce NPLs[22], which was further enhanced in October 2017 by the EC's "communication on completing the Banking Union". As background to the Council of the EU's action plan and subsequent regulatory initiatives, the reader may refer to the European Commission's reflection paper of the European Council's *NPL Action Plan*,[23] the findings of the subgroup on NPLs of the European Council's Financial Services Committee (FSC),[24] the report of the ESRB Expert Group on NPLs[25] and the ECB second stocktake on the range of practices relating to NPL workout in all 19 Single Supervisory Mechanism countries.[26] All of the aforementioned studies have shaped the assistance provided to Partner Countries by the NPL Initiative.

The NPL Initiative as a catalyst to reforms

The structural approach of the NPL Initiative to identifying impediments to NPL resolution has its roots in the IMF report *Strategy for Resolving Europe's Problem Loans*.[27] The IMF classifies the most important impediments for tackling NPLs into five broad categories: informational obstacles, inadequate supervisory framework, inadequate legal framework, a lack of a distressed debt market and tax regime implications. Deficiencies in the legal framework and underdeveloped NPL markets tend to be the major obstacles; nevertheless, all types of obstacles are interconnected and their effects compound.

22 Council of the EU, Council conclusions on Action plan to tackle non-performing loans in Europe, July 2017, https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/

23 EU Commission, Reflection Paper on the Deepening of the Economic and Monetary Union, May 2017, https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf

24 Council of the EU, Report of the FSC Subgroup on Non-Performing Loans, May 2017, http://data.consilium.europa.eu/doc/document/ST-9854-2017-INIT/en/pdf

25 ESRB Expert Group on NPLs, Resolving Non-Performing Loans in Europe, July 2017, http://npl.vienna-initiative.com/wp-content/uploads/sites/2/2017/07/ESRB-Report-on-NPLs.pdf

26 ECB, second stocktake of national supervisory practices and legal frameworks related to NPLs, June 2017 (https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.stock_taking2017.en.pdf

27 For more details look at "A Strategy for Resolving Europe's Problem Loans" (Main Discussion Note and Technical Background) (September 2015) https://www.imf.org/external/pubs/ft/sdn/2015/sdn1519.pdf

Table 1.
Key impediment categories identified by the IMF for NPL resolution

IMF Category	Description
Legal framework	Inadequate bankruptcy laws, particularly for household insolvencies, lack of legal enforcement mechanisms and inadequate (or absence of) out-of-court debt restructuring (OOCR) procedures, and institutional deficiencies (such as prolonged enforcement procedures and lack of transparency or training of the judiciary).
Supervision	Inadequate supervisory efforts in enforcing bank provisioning and timely resolution of NPLs.
Information	Lack of transparency in public registers and asymmetry of information.
NPL market	The market largely non-existent without any interest from investors and servicing capabilities (see below), in addition to limited domestic know-how capabilities (both from the private and public stakeholders).
Tax regime	Primarily disincentivising tax rules for NPL resolutions.

Source: NPL Monitor and associated EBRD database.

The IFIs under the NPL initiative have taken a similar approach, in collaboration with the NCAs, to identify the impediments to NPL resolution and sales specific to each of the Partner Countries. Action plans were developed with the local authorities (formally or informally), involving the local banking industry and other relevant stakeholders (such as banking associations) to ensure the completeness and relevance of the impediments identified and to develop policy measures and other initiatives which are fit for purpose.

Progress with reforms undertaken in the Partner Countries since the start of the NPL Initiative

A broad range of reforms have been implemented for tackling the main categories of impediments to NPL resolution in the Partner Countries since the start of the NPL Initiative. We have observed particular progress in improving the legal framework of most individual countries, with the implementation of multiple creditors' out-of-court restructuring (OOCR) frameworks, progress with insolvency/bankruptcy laws and enforcement mechanisms, strengthening of the judicial frameworks (including the training of judges) and information transparency and availability (although important work in this regard remains to be done).

Below is a summary of the main reforms implemented in Partner Countries since the launching of the NPL Initiative.

Table 2.
Albania

Category	Main reforms undertaken since the start of the NPL Initiative
Legal framework	• 2013: Guidelines on OOCR for individuals were issued by the Bank of Albania to guide banks with OOCR in view of accelerating the reduction of NPLs. • 2014: Guidelines on loan restructuring for individuals and guidelines for the preparation of real estate appraisals. • 2015: The new legislation on obligatory write-offs for lost loans older than three years. • 2016: Bankruptcy Law approved by Parliament, incorporating best international practices and simplifying existing procedures. • 2016: Amendment to the Civil Code approved, aimed at harmonising the Civil Code with the Law on Bankruptcy regarding the ranking of preferred creditors in bankruptcy proceedings. • 2016: Amendment to the Civil Procedure Code with the main objective of increasing the efficiency of litigation and foreclosure procedures. • 2016: Amendment to Private Bailiffs Law and Law on Judicial Bailiff Service approved, with the aims of increasing the efficiency of foreclosure procedures and debt collection and improving the structure of fees for Bailiff Services (i.e., base tariff plus success fee). • 2018: Two additional decisions by the Council of Ministers to strengthen the Bankruptcy law from 2016; (1) the formation of the National Bankruptcy Agency – the competent state authority entrusted with the supervision, training, and licensing of insolvency administrators, and (2) the promulgation of the Insolvency Administrator Code of Ethics.
Information	• 2016: The Bank of Albania's credit register was upgraded to include loans undergoing court proceedings, restructured loans, and loans sold to third parties. • 2018: The Albanian Association of Banks (AAB) has undertaken the initiative of establishing a new comprehensive Credit Bureau. In October 2018, the EBRD engaged an international expert and local legal firm to prepare a roadmap on the legal and operational framework necessary to set up the Bureau.

Source: NPL Monitor and associated EBRD database.

Table 3.
Croatia

Category	Main reforms undertaken since the start of the NPL Initiative
Legal framework	• 2015: The Ministry of Justice (MoJ) introduced non-binding "Guidelines on Corporate Debt Restructuring by Means of Out-of-Court Agreement" which aim at the timely resolution of insolvency-related disputes. • 2015: New Bankruptcy Law aimed at shortening long bankruptcy procedures and strengthening creditors' control over the process. The new legislation enforces these procedures within eight days if a company's bank accounts are blocked for more than 120 days. • 2016: Consumer Bankruptcy Act introduced the legal concept of consumer bankruptcy into the legal system for the first time. • 2017: The MoJ launched a process to eliminate inconsistencies or unclear provisions from the new Bankruptcy Act.
Tax regime	• 2017: New tax reform which includes changes to a set of several tax regulations, including the efforts to help banks reduce their NPLs. In addition, there was a one-off measure, valid for 2017 only, which allowed banks to treat provisions related to NPLs as tax-deductible expenses.

Source: NPL Monitor and associated EBRD database.

Table 4.
Hungary

Category	Main reforms undertaken since the start of the NPL Initiative
Legal framework	• 2015: Amendment to the Personal Bankruptcy Act aimed at simplifying the existing framework and creating an efficient personal bankruptcy system to provide a relief to qualifying debtors. The new Personal Insolvency Law is mainly intended for NPLs in the housing sector. • 2017: Law on enforcement procedure was introduced with the intention of increasing the minimum sale price of a residential property in the enforcement procedure from 70 percent to 100 percent of the market value. • 2017: The Hungarian National Bank (MNB) recommendation sets out best practice guidelines on OOCR and consensual settlement of NPLs in the corporate sector. Although the recommendation is non-binding, it adds power of persuasion and constitutes an important tool for NPL resolution. • 2017: The MNB introduced an additional capital buffer for banks with large portfolios of commercial real estate (CRE) NPLs. As part of its annual review, the MNB Financial Stability Board decided to maintain the countercyclical capital buffer rate applicable from 1 January 2018 at zero percent, with a view to supporting lending. The capital buffer rates, ranging from 0.125 percent to 2 percent, will gradually increase until 2020.
Legal framework	• 2018: The MoJ organised the first meeting of the cross-stakeholder working group, which has been set up to overhaul Hungary's 1991 Bankruptcy Law. The objectives of the new legislation include a controlled reorganisation of the working group, viable enterprises and fast liquidation of non-viable businesses, greater protection of creditors' interests in insolvency, and improving the efficiency of court-led insolvency processes. The timetable for the proposed reform is fairly tight, as the law is set for adoption by the Parliament in Q4 2019.
Other	• 2015: The Electronic Sales System (EÉR) was created as an online platform for selling the assets of debtors in liquidation.

Source: NPL Monitor and associated EBRD database.

Table 5.
Montenegro

Category	Main reforms undertaken since the start of the NPL Initiative
Legal framework	• 2015: Although the application of the Law on Voluntary Financial Restructuring was initially envisioned for only two years (May 2015-2017), the law has been extended to May 2019, with a broader coverage of assets under restructuring. • 2017: To address remaining supervisory shortcomings, and in particular extend the Central Bank of Montenegro's (CBCG) supervisory remit to factoring, leasing, and credit and guarantee operations, six new laws and related directives were introduced: (i) Central Bank Act; (ii) Law on Financial Institutions to expedite the resolution of NPLs offloaded from banks' balance sheets into factoring companies; (iii) Law on Voluntary Financial Restructuring; (iv) Deposit Insurance Law; (v) Banking Law; and (vi) Law on Recovery and Resolution of Banks, the latter two being related to Montenegro's alignment with EU regulation. • 2018: The CBCG adopted a set of by-laws which further regulate the operation of non-banking financial institutions, following the adoption of the all-encompassing Law covering factoring, leasing, micro-crediting and credit guarantee operations.
Information	• 2018: The Council of the CBCG adopted a new Decision on the Credit Registry (opened in January 2019) with the aim of further improving the Credit Registry by providing enhanced individual and aggregated data from the Credit Registry. In accordance to the new non-banking FI legislation, data from the leasing, factoring and receivable repurchase companies will be included in the Credit Registry.

Source: NPL Monitor and associated EBRD database.

Table 6.
Serbia

Category	Main reforms undertaken since the start of the NPL Initiative
Legal framework	• 2015: Amendments to the Law on Agency for Bankruptcy Administrators have strengthened the Agency's authority over all bankruptcy procedures and administration for the state-owned company bankruptcy cases. • 2015: Supervisory Guidance for Loan Loss Provisioning (LLP) • 2015: Amendments to the Mortgage Act. One of the most prominent changes was the possibility of any creditor regardless of the ranking of its claim to initiate the foreclosure procedure. • 2016: Law on Real Estate Appraisers was adopted with the aim of regulating the profession of real estate appraisers and is intended to help ensure that collateral valuations are sufficiently conservative, and thus contribute to adequate provisioning. • 2017: Bankruptcy Law amendments aimed at improving in-court debt resolution and mortgage framework and enhancing the insolvency regulatory framework. • 2017: The National Bank of Serbia (NBS) adopted a number of regulations to support the implementation of IFRS9, including in the fields of accounting and financial reporting and with strengthening its own analytical and supervisory capacity. A particularly effective measure was the introduction of mandatory write-off of fully provisioned NPLs. • 2017: The NBS published an official interpretation of the banking secrecy rules with the aim of enabling comprehensive due diligence for NPL sales. • 2017: Amendments to the Corporate Income Tax Law and the Personal Income Tax Law introducing tax incentives for financial institutions (i.e., recognition of banks' corporate loan write-offs as expenditures for tax purposes) and individuals (i.e., banks' obligation to pay on a withholding basis the personal income tax for debt write-offs to private individuals). • 2018: Amendments to the Civil Procedure Law grant an unconditional right to the new creditor (acquirer of an NPL) to take over an ongoing dispute without additional consent from the counterparty. • 2018: The Government adopted an NPL Resolution Program that represents a natural continuation of the efforts and activities undertaken under the NPL Resolution Strategy. The Program focuses primarily on prevention of new NPL accumulation and on secondary market development.
Other	• 2018: The Deposit Insurance Agency (DIA) announced its first auction for the sale of the NPL portfolio of €240 million. This is the first auction in the process of the planned resolution of the DIA NPL portfolio of circa €1 billion. • 2018: Serbia introduced an E-Cadaster. The Law on the Registration Procedure with the Cadaster of Real Estate and Utilities simplifies the registration procedure and is expected to increase the efficiency of the Cadaster.

Source: NPL Monitor and associated EBRD database.

Progress with developing a sound NPL market in the CESEE

Despite the initial challenges in developing a sound NPL market in the region, NPL transactions in CESEE have grown considerably in the last few years, attracted a broad range of international investors and demonstrated an appetite for NPL transactions and their dynamism. This can be largely attributed to the reforms implemented in many of these countries, reducing disincentives to NPL purchasing and providing further comfort to buyers of distressed debt that the local laws and regulations allow them to adequately manage the NPLs and recover their investments. In addition, better requirements for banks to provision their NPLs more accurately had the effect of encouraging banks to sell their NPLs to the market, providing sufficiently sizeable portfolios to attract international investors. While the CESEE NPL market remains small, fragmented and imperfect, it functions well overall.

Results to date and next steps

Steady decrease of the NPLs stock in the CESEE region

Since the start of the NPL initiative, the gross and net NPL ratios for CESEE decreased from 9.8% and 3.5%, respectively, in 2014 to 4.0% and 1.5% in 2018 Q3. Furthermore, NPL volumes shrank from €68.1 billion in 2013 Q3 to €38.0 billion as of 30 September 2018.

Such significant progress in the reduction of NPL volumes was the result of a broad range of factors. Nonetheless, the identification of national impediments, the development of country-specific NPL action plans and the implementation of concrete reforms supported by the NPL Initiative were important contributors to the speed and extent of the improvements in some countries in the region. Improvement to national legal, judicial and tax systems, combined with more transparent and accessible information, provided not only banks with more options (and incentives) to cope with their distressed borrowers, but also further comfort to foreign investors to acquire NPL portfolios and develop local servicing capabilities. The IFIs, under the NPL Initiative, worked closely with the NCAs and the banking sectors of the five Partner Countries to support the implementation of such measures.

In terms of results observed since the start of the NPL Initiative in 2014, the five Partner Countries significantly outperformed the average CESEE region in NPL reduction. The NPL ratios in Serbia, Hungary, and Albania saw double-digit percentage point reductions between 2014 Q1 and 2018 Q3 (15.9, 13.7 and 11.1 percentage points, respectively). The reduction in Montenegro (9.9%)

and Croatia (5.7%) was above the CESEE average of 5.5%. Similarly, with the exception of Albania, NPL coverage ratios have increased by more than the average in the CESEE region.

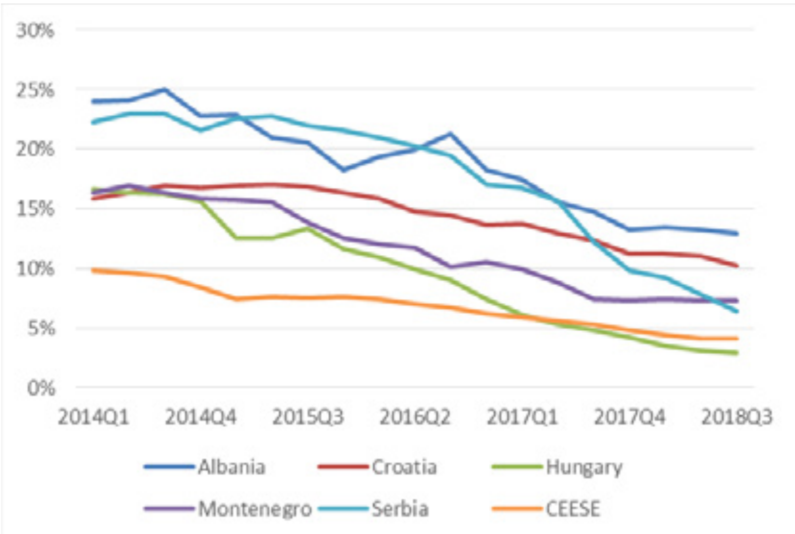
Table 7.

Evolution of NPL ratio, coverage ratio, and NPL volume (percent, € billion), Q1 2014 versus Q3 2018[28]

	NPL volume (€ bn)		NPL ratio (%)		NPL coverage ratio	
Country	Q3 - 2018	Variation(%)	Q3 - 2018	Δ(pp)	Q3 - 2018	Δ(pp)
Albania (AL)	0.6	▼ -37.8	12.9	▼ -11.1	65.4	▲ 0.9
Croatia (HR)	3.5	▼ -41.1	10.2	▼ -5.7	69.4	▲ 22.4
Hungary (HU)	1.5	▼ -82.4	2.9	▼ -13.7	70.3	▲ 15.7
Montenegro (ME)	0.2	▼ -49.2	7.0	▼ -9.9	67.6	▲ 22.2
Serbia (RS)	1.2	▼ -65.8	6.4	▼ -15.9	61.3	▲ 9.9
5 Partner Countries	7.0	▼ -63.9	6.2	▼ -11.2	67.9	▲ 15.9
CESEE	38.0	▼ -40.8	4.0	▼ -5.5	61.9	▲ 3.0

Figure 5.

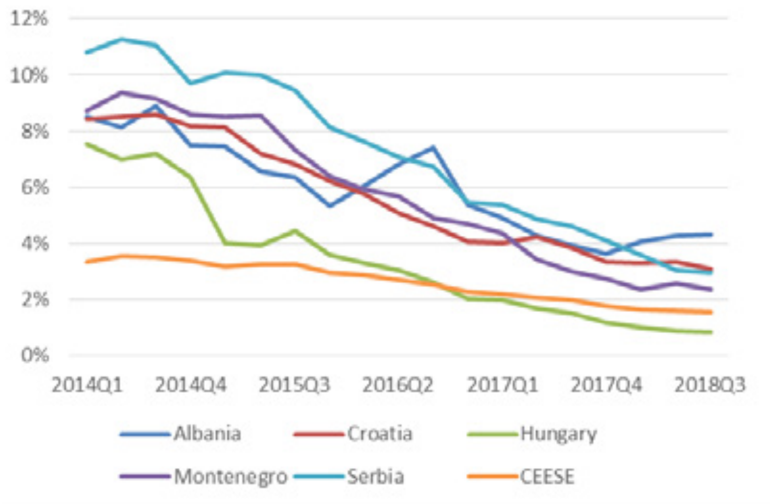
Evolution Gross NPL ratio in CESEE 1Q 2014 – 3Q 2018



28 CESEE and 5 Partner Countries averages are based on Q3 2018 IMF FSI values for all countries, except Montenegro and Serbia (obtained from central banks directly), although the latest available figures for Montenegro, Slovenia and Lithuania are as of Q2 2018.

Figure 6.

Evolution of Net NPL ratio in CESEE 1Q 2014 – 3Q 2018



NPL sales to the secondary market as part of the medium-term solution

Since 2015 H1, the NPL transactions in the CESEE region have amounted to €13.7 billion. Although Albania and Montenegro are yet to develop an NPL market, Croatia and Hungary (and to some extent Serbia) have recorded a large number of significant transactions. As shown in Figure 8, Croatia had at least to €2.27 billion of NPL sales between 2015 H1 and 2018 H1, while Hungary and Serbia saw €1.63 billion and €500 million of NPL transactions, respectively.

The CESEE region's distressed debt market has mostly consisted of outright sales to non-bank participants, but also included some joint ventures between banks, specialist firms and investors. While some countries (Slovenia, Latvia and Hungary) have established public asset management companies (AMCs) as part of a comprehensive strategy to address banking system problems, the transfer of NPLs by banks to private or public AMCs has been used less frequently than anticipated and has yielded mixed results.

Figure 7.
Evolution of NPL transaction volumes in CESEE (€ billion) 1H2015 – 1H2018

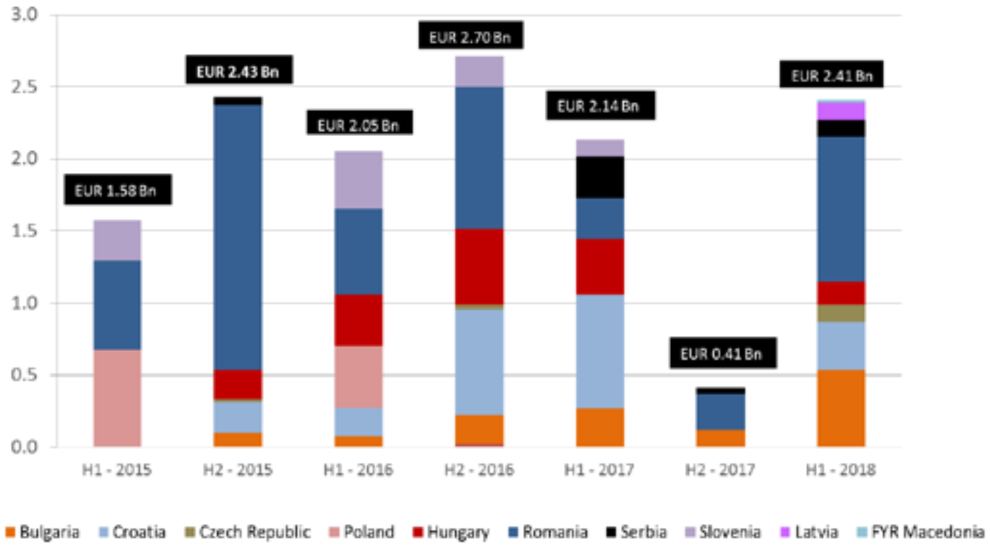
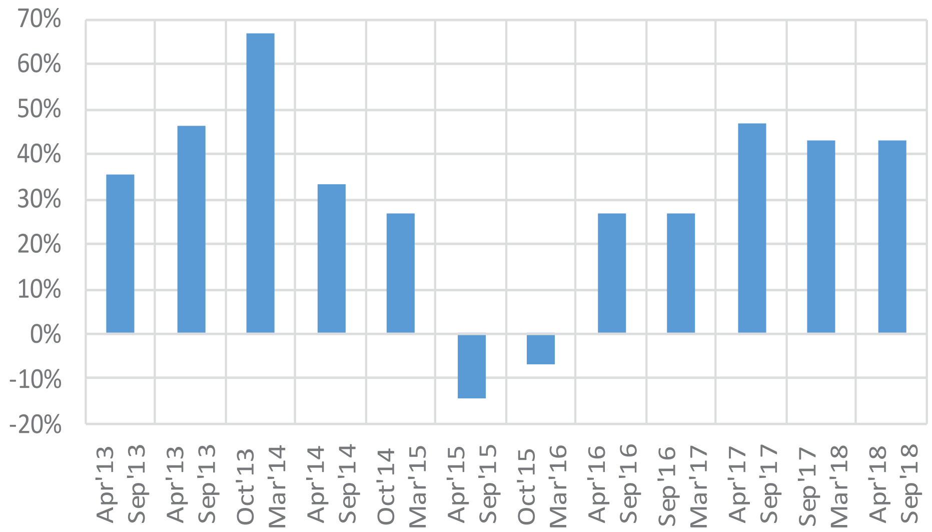


Figure 8.
Evolution of NPL deal volume in CESEE with the key focus on Partner Countries (€ billion, cumulative amounts) 1H2015 – 1H2018



The growth of NPL servicers in the region

Alongside numerous NPL sales realised in recent years, we observed considerable increases in servicing capabilities in the region. While cross-border servicing remains challenging, the number of multi-asset firms operating in the region increased. As banks outsourced collection to local agencies, and foreign investors acquired NPL portfolios needing servicing, the servicing capacity grew steadily.

Specialised servicing is particularly important for resolving the corporate NPL segment, as it involves the complex and lengthy process of corporate restructurings and wind-downs. The limited skills available in most CESEE economies meant that larger investors had to invest in their own servicing capabilities (including by importing skills and know-how) when buying large NPL portfolios. This also contributed to the rise in the number of servicers.

There are now more than 20 servicers and collection agencies operating in at least one of the CESEE countries, and some have cross-border activities. The expertise also varies across retail, small to medium-sized enterprise, corporate and residential asset classes. However, the extent of capabilities, service offerings and asset classes covered differs between countries, and some servicers only manage their own assets.

From firefighting to embedding NPL solutions

Important reforms have been implemented in the region to improve the resolution of NPLs, and the conditions for a sound secondary NPL market (although still not perfect) contributed greatly to the ability of banks to deleverage a large part of their stocks. As of early 2019, the work is still not completed. Recent progress has in large part been driven by firefighting needs to tackle the NPL stock, but more needs to be done to embed changes within the banks themselves for sustainable long-term NPL prevention and management.

Large stocks of NPLs still remains in many countries in the region, and fundamental structural challenges still exist within a number of banks, particularly the smaller local banks that have not felt the same pressures to change as have their peers, the subsidiaries of European or international groups. Local restructuring skills remain limited, poor and incomplete data still characterise many banks and inadequacies in credit underwriting practices and NPL management can be observed across the region.

CESEE countries can further build on the best international practices to prevent new flows of NPLs and ensure that any stock will not reach the same unsustainable levels in the future. For example, the broad range of measures implemented in the European Union (EU) for the management of NPLs and for improving overall credit-risk management in EU banks can also be used in non-EU CESEE countries, tailoring the best practices to local particularities and needs.

The next phase of the NPL Initiative is to improve the region's banking systems, coordinate the joint IFI support and work closely together with NCAs in promoting and supporting further implementation of best practices in the areas of credit underwriting and NPL management within the banks under their supervision.

PART IV

The future of cross-border banking

CHAPTER 13

Ten years of the Vienna Initiative: the future from a banking group's perspective

Christine Würfel and Barbara Atroszczak (with contributions by Martin Lee-Warner and Daniela Tsoneva)

Raiffeisen Bank International AG (March 2019)

Austrian contribution to containing the Global Financial Crisis in CESEE

It all started in Vienna... with a phone call

It was mid-November 2008 when the Raiffeisen Bank CEO initiated telephone discussions with the respective CEOs of Erste Group Bank AG and Bank Austria (UniCredit Group) to propose a collective representation of leading European banks operating throughout Central and Eastern Europe (CEE) to implement appropriate measures to increase the resilience of the respective financial systems. This followed on from critical issues highlighted at the October 2008 International Monetary Fund/ World Bank meetings in Washington, DC, and indeed from the European Commission's subsequent focus on stability of the overall financial sector throughout the EU New Member States (NMS). Time was of the essence, and within two weeks a meeting had been called at Raiffeisen's Vienna Head Office, attended by six leading European banks with CEE exposure, together with "informal attendance" by the European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB). As a result of this well-addressed initiative, a letter to the European Commission was duly drafted and the text agreed by these banks. Together with proposed measures to enhance the soundness and stability of the banking systems in CEE countries, it was delivered on 1 December 2008. The "kick-off" letter and proposed measures are set out below.[1]

1 See Annex 2: Exhibit 1.

Over the ensuing weeks, with a fast unfolding credit crisis, it was clear that market and funding liquidity was rapidly drying up in the CEE region. There was an acute awareness amongst all potential stakeholders that there must be a cohesive approach, and not just one driven by these leading Western European banks. Stable credit was critically needed for the various NMS economies, and in this regard it was deemed necessary that these banks express their concerns to all relevant national authorities and to those international financial institution (IFI) that were demonstrating their own support for such initiatives. Several CEE central banks (CBs) were attempting to restore confidence through a range of measures, but isolated measures at a national level were clearly not sufficient. At a time when neither a Single Supervisory Mechanism nor a Banking Union existed in Europe, key actions needed to be taken in a coordinated way at an international level. By the end of January 2009, nine of the leading European banks operating in the CEE region jointly signed a comprehensive letter to Jean-Claude Trichet, ECB Chair, which was also duly copied to the respective CB Governors of those countries where the banks were headquartered (six EU countries) – and indeed this letter was subsequently made available to the CB Governors of the NMS. At this point the Central Banks were becoming increasingly uniform in their response.

This letter dated 23 January 2009, and proposals therein – set out below[2] – prompted swift actions by, *inter alia*, the EBRD, EIB, EU Commission, International Monetary Fund and World Bank, and within a few weeks Vienna Initiative 1.0 was formulated. The EBRD speedily proffered an effective secretariat, and this evolved into a very meaningful framework focusing on and addressing the pertinent key issues throughout the CESEE region.

Measured against the original objectives, Vienna Initiative 1.0 was successful. Since 2007/8, cross-border banking exposures had been modestly declining vis-à-vis the core CESEE countries where major European cross-border banks were operating. Moreover, larger parts of this moderate contraction had not been driven by region-specific developments *per se* but by several international trends with an impact on the CEE region (e.g., changes in regulatory ratios, international banks revisiting their cross-border business strategies). Furthermore, no substantive banking sector rescue packages had been needed in the CESEE region.

2 See Annex 2: Exhibit 2.

Future topics driving the financial services industry in CESEE and the need for action

But the story doesn't end there: leveraging the existing format of a private-public sector platform, the Initiative was reformulated as Vienna Initiative 2.0, so it could continue making the financial sector in emerging Europe more resilient in the longer term.

One of the Initiative's goals arose from a lesson learned from the eurozone crisis, which highlighted the risk of disorderly deleveraging of western parent banks *vis-à-vis* their affiliates in Central, Eastern and Southeastern Europe (CESEE) and of difficulties in cooperation between home and host country authorities. Additionally, along with three EU-driven programmes – the Banking Union,[3] the Capital Markets Union[4] and the Digital Single Market[5] – that form an umbrella for long-term policy development of the financial sector in Europe, further strengthening the conditions for stable and well-functioning cross-border banking has been a major driver of the Working Groups of Vienna Initiative 2.0.

Fostering Capital Markets in CEE

Capital markets need clear and reliable rules to ensure the trust of market participants. This prerequisite is even more important for smaller and less-developed markets lacking local institutional investors and which are thus dependent on cross-border investments. Therefore, CEE countries, to which these circumstances apply, must take care to provide such a stable environment. The Vienna Initiative has, since its beginning, continuously been directed at these features and has asked local governments and supervisors to enable an appropriate, reliable framework to develop their capital markets for a more diversified financed economy. The envisaged merits of the Capital Markets Union heavily depend on stable and trustworthy (common European) rules and harmonised supervisory practices throughout the Union.

The new rules on bank recovery and resolution[6] require every bank to provide sufficient bail-in-able capital to be prepared for stress situations. Additionally, the

3 European Commission, Banking Union, European Commission, Banking Union, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union_en
4 European Commission, Capital Markets Union, https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union_en
5 European Commission, Digital Single Market Strategy, https://ec.europa.eu/digital-single-market/en/news/digital-single-market-strategy-europe-com2015-192-final
6 European Commission, Review of the bank recovery and resolution directive, https://ec.europa.eu/info/law/bank-recovery-and-resolution-directive-2014-59-eu/upcoming_en

provisions limit considerably the distribution of such instruments (e.g., bail-in-able bonds) to retail investors. These provisions are suitable for markets facing a strong demand by institutional investors but challenging for smaller markets lacking that kind of investor and at the same time not being members of the eurozone (having their own local currencies). Several CEE countries belong to such markets and are now confronted with the dilemma of ensuring their banks have sufficient bail-in-able capital, while lacking the appropriate demand of local institutional investors to invest in them. The Vienna Initiative has repeatedly pointed out this problem and promoted the need for a doorkeeper or gatekeeper role of IFIs to engage more heavily in these kinds of instruments in these markets to make them more attractive for cross-border investing institutional investors.

Sustainable Finance – what is needed from a bank's perspective

Since March 2018, when the EU Commission published an action plan on "sustainable growth",[7] the trend has become a key future topic driving the financial industry (including banks, asset managers, insurance companies and pension funds). One of the reasons why this proposed legislative initiative will heavily impact market players is the planned use of the capabilities of the financial sector to fill the gap of around €180 billion p.a. in investments in sustainable projects. Consequently, these provisions should contribute to enabling the EU to reach the goals of the 2015 Paris Agreement on climate.[8]

While the application of the proposed action plan might offer interesting additional business and the possibility to develop reliable strategic positioning in the market, there is still the need for further clarification on the side of the regulators. A clear first step is the development of the agreed international taxonomy, which will define what is considered a "sustainable economic activity". This can be further used as a basis for all other legislative proposals in this context. Additional disclosure rules should avoid any unnecessary administrative burdens, and the new provisions should allow for sufficient time to adapt respective business models and internal processes accordingly. A further key point, which must be kept in mind in this respect, is the avoidance of a gold-plated mechanism. In particular, legally harmonised certainty should be created for feed-in-tariffs and Green Certificates for renewable energy.

7 European Commission, Sustainable Finance, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

8 United Nations Climate Change, The Paris Agreement, https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

Aside from the need for further legal clarifications, a well-considered incentive system is needed for financial market participants. Similar to the success story of the SME supporting factor, which allows banks to reduce capital requirements for credit risk on exposures to small and medium-sized firms, a "green supporting factor" with regards to capital relief for sustainable finance would leverage bank lending in this area and support sustainable growth. And, to be very clear, it is not about unjustifiably minimising risks. It is in the interest of the bank to make correct risk provisions in any case. But, in our opinion, such a "green supporting factor" clearly leads to a prioritisation and preference of a bank to finance more sustainable activities rather than to support non-sustainable businesses. Therefore, the new mandate of the European Banking Authority (EBA) to assess whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives is really justified (Art. 501 Capital Requirements Regulation new). But the long timeframe – six years – of its assessment might be a difficulty given the urgency of the topic.

Additionally, risk-sharing-products from IFIs which act as market makers for sustainable/green loans are another very effective instrument, especially in those countries where such instruments are in short supply.

In the context of the Vienna Initiative, this important topic of sustainable finance should also be highlighted in its future work in CESEE by setting up structures where private and public decision makers meet to exchange experience and discuss appropriate actions for the economies of the region.

New ways of financing innovation

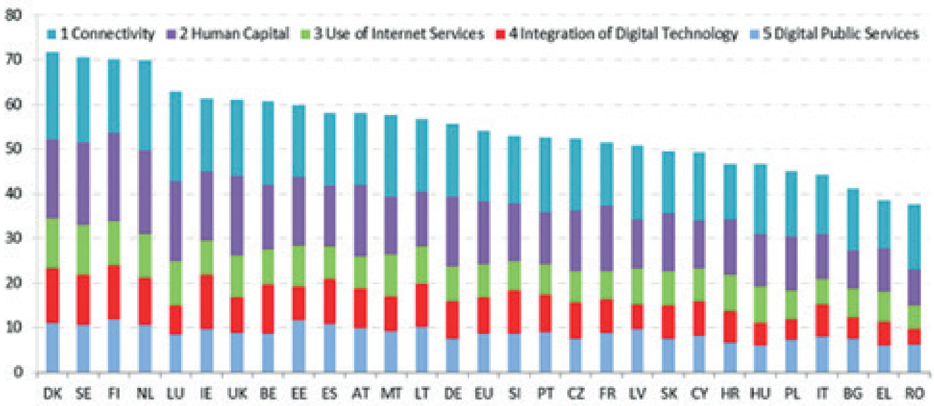
History has shown that successive waves of technological change have transformed human societies and economies, with long-term benefits for both economic growth and quality of life. The current digital revolution has the power to do so again.[9] Therefore, investments in innovation have nowadays become more crucial than ever before, especially for the financial sector, which has been the largest user of digital technologies. On top of that, relevant indicators of Europe's digital performance (e.g., Digital Economy and Society Index, Innovation Scorecard or Europe's Digital Progress Report), which track the evolution of EU Member States, show a clear gap between CESEE and Western economies. As clearly seen in the chart below,

9 European Commission, Mid-Term Review on the implementation of the Digital Single Market Strategy, Brussels, 10.5.2017.

the former, with some remarkable exceptions, still lag behind in their digital and innovation competitiveness.[10]

Figure 1.

Digital Economy and Society Index (DESI) 2018 ranking



Source: European Commission.

Beyond debt - expanding different forms of financing

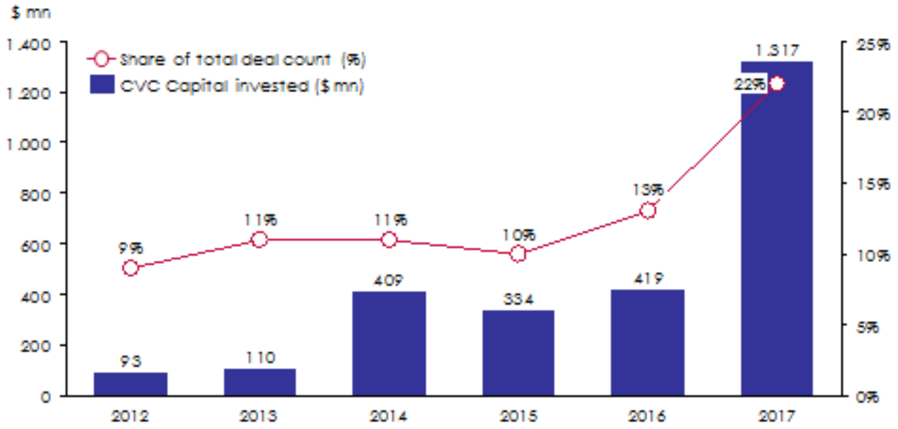
While reviewing their business models, banks, which represent a major driver in the digital transformation of the economy and society, are increasingly considering different forms of financing for innovation. The banks active in CESEE try to position themselves in a niche role, filling the gap left by the relative scarcity of venture capital or private equity funds in that region. While the suitability and even the role of banks in debt/equity funding is still under discussion, their participation in the broader ecosystem of start-up or fintech companies, for example, is inevitable.

This participation is not only at the behest of the regulator, but since banks are at the forefront of new technologies and new markets, they have a wider insight and early access to a broad array of innovations and new business fields. Subsequently, by acquiring venture management skills and by launching corporate venture capital (CVC) focused on direct investments in later-stage fintechs, banks foster knowledge and innovation transfer on the market. Their engagement with the innovation ecosystem is mainly driven by their desire to stimulate innovation within their own core operations, gain early insights into new technologies and develop VC and venture management networks. Large banking groups are

10 European Commission, Digital Economy and Society Index Report, 2018.

developing in-house units which can invest directly in innovative companies. These tend to focus on fintech and/or other technology companies of strategic value to the bank's operations. Examples of the latter include companies with products and services that improve or complement banks' existing operating systems, processes and capabilities, e.g., cybersecurity, big data analysis, cloud computing and biometrics. As seen in the figure below, European corporate VC investments in fintechs picked up considerably in 2017, and the trend is growing.[11]

Figure 2.



Source: KPMG International (2017).

This new approach, together with other well-known forms of financing all stages of a firm's life cycle (e.g., direct bank loans), is a major topic on the Agenda of the Working Group on Financing for Innovation. The Vienna Initiative aims to play an active role in helping cooperating banks and FinTechs expand into this dynamic region, thus closing the gap between CESEE and western economies.

Tightening post-crisis regulation vs. innovation

All in all, there is still a big question mark over the future involvement of the banks in supporting fintech and other technology-intensive SMEs via CVC. The reason is the capital treatment of bank CVCs, which is similar to the treatment of VC exposure. Taking the Raiffeisen example, since Elevator Ventures CVC is a 100% subsidiary of Raiffeisen Bank International (RBI), its current regulatory framework is given by Basel III (implemented in the EU via the Capital Requirements Regulation). Thus, Elevator Ventures has to meet the capital requirements according to the Capital Requirements Regulation, which

11 KPMG, The Pulse of FinTech 2018.

will depend on the investments carried out by the company and on the amount of the investment. Currently, this would result in a risk weight of up to 250% of book value – this can increase up to 400% with full implementation of Basel IV rules. This rule appears very strict, and a lower capital consumption (i.e., lower risk weights) for such investments would foster or at least incentivise banks to make such investments. Under Basel III, exposures to VC funds, whether through the look-through or fallback approach, carry between 250 and 1250% implications for capital.[12] Furthermore, CVC investments also require specialist skills and operational agility, which are difficult and costly for banks to attract and build upon.

Funding is not enough

Apart from money, banks' CVCs offer participating fintechs significant operational support by portfolio companies, including advice and services in business development, corporate development, hiring, fund-raising and internationalisation. Very often former fintech founders and financial services experts will act as consultants and mentors to founders and help them achieve scale.

Taking again the example of Elevator Ventures, experience from both rounds of the virtual accelerator programme "Elevator Lab" has shown that cooperation between the start-ups and RBI benefits both sides. Within a few months, pilot projects were developed with the five participating start-ups, which are now in their extended testing or implementation phases. RBI regards the start-ups as equal partners and deliberately forgoes equity participation during this phase. In addition, the RBI can offer fintech founders access to its innovative network in fourteen markets in CEE and its 16.6 million customers.

Closing the gap in the CESEE

Coming back to the level of digital maturity in Europe that was discussed before from the financing perspective, CEE banking markets are still characterised by a moderate degree of financial intermediation. In some SEE banking markets, the ratio of assets to GDP stands at only around 40-50%, while in more developed CE countries this is 139% (and in the euro area about 235%). And a similar picture emerges regarding the use of digital channels to make payments. In some SEE banking markets only 20-30% of the population have made digital payments,

12 Bank of International Settlements, Basel Committee on Banking Supervision: High-level summary of Basel III reforms, https://www.bis.org/bcbs/publ/d424_hlsummary.pdf

while in more developed CE countries this is 70-80% (in the euro area levels are 90% or more). It is precisely these that need to be increased.

Empirical studies show a very clear connection between the degree of market penetration in conventional banking (account management, debit card ownership, credit card ownership, savings products) and market penetration via digital channels (in most cases, an account and/or credit card is the basic prerequisite for digital participation). Moreover, increasing digital development in less mature CEE banking markets also brings interesting opportunities in terms of institutional development (e.g., digital banking may help to increase financial inclusion or may help to increase the degree of formality in the economy, i.e., it may help to combat corruption). However, some selected banking markets in Central Europe (such as Slovakia, the Czech Republic and Poland) and Eastern Europe (Russia) are also among the most innovative European banking markets in the field of digital banking. In this respect, knowledge gained in these leading markets and proven digital products, distribution ideas or digital features can then be transferred to less developed markets in CEE.

In this respect, the basic idea of extending the product life cycle through international expansion continues to exist in this region, even in the digital age. The large cross-border CEE banks will increasingly have to become internal learning platforms and, of course, the exchange will no longer only take place from West to East, but also from East to West, especially since customers expect smart solutions from cross-border banks in CEE with regard to cross-border instant payments or even a uniform and customer-friendly market presence in many countries. Such technical cross-border integration across many markets with varying degrees of maturity may well entail increased risks of cybercrime. Therefore, cross-border banks operating in CEE will have to invest a lot in the technological area going forward, going well beyond front-end solutions.

A coordinated approach on the Highway towards Big Data

The Digital Single Market (DSM) strategy for Europe mentioned in the opening section of this chapter and that has been driving policy initiatives since 2015, aims inter alia at unifying Europe's rules on data from many different perspectives. One of them is data protection, which has been achieved by the implementation of the General Data Protection Regulation (GDPR). Another one is ensuring the cyber resilience of the financial sector. Finding the right policy mix between these two that would neither hinder innovation nor cause administrative burdens has been one of the main challenges for regulators after the crisis. The harmonised incident reporting framework, which is currently lacking common taxonomy across regulations, jurisdictions and sectors, should ease the understanding of multi-country and multi-sector cyberattacks and eventually lead to efficient responses.

The financial sector is increasingly dependent on digital technology and is most subject to high-profile cyberattack. Therefore, cybersecurity has moved from being a technical issue to a political and boardroom issue.[13] Especially with the increasing trend of outsourcing of data to the "cloud" (meaning nothing more than that geographical location no longer plays a role in data storage), implementing the same highest standards for data security across the whole of Europe plays a crucial role in cyber resilience. Here again, the Vienna Initiative is welcome to take over the coordinator role leveraging on its existing platform and committed stakeholders.

The need for harmonization of data-reporting rules and templates is apparent. Taking as an example the new requirements that are needed for resolution purposes, as well as their higher complexity due to an increase in granularity, e.g., AnaCredit, the technical and personnel burden on banks to deal with additional information demand from the regulators is set to increase in the near future. (For example, in 2018 RBI submitted no less than 1,200 regulatory reports.)

Lessons learned from the "Vienna Initiative" and future challenges for cross-border banking in CESEE

The public-private coordination partnership was always helpful for dialogue on financial services in the region – being at the table on a par with all financial stakeholders constitutes quite a unique model. The biggest value of this dialogue is the holistic discussion and connection of topics in the forum where all stakeholders, IFIs, public sector and private banks are debating with each other. Combining the topics of the different workshops and making the ideas operational would underline the success of the Vienna Initiative. In times of agile and innovative workarounds, it should also be possible for such a diversified group of stakeholders to develop practical and tangible success stories.

Therefore, a lot of potential lies with the Vienna Initiative, which is more needed than ever in the context of nationalistic developments towards the unifying idea of a harmonised Europe – especially in the financial services sector. The more

13 Cybersecurity in Finance. Getting the policy mix right! Report of a CEPS-ECRI Task Force, June 2018.

strongly the cross-border banking business develops in CEE, the more successful the fundamental rights of the European Union, especially the freedom of movement of capital – a prominent pillar of the European internal market which supports financial stability – can be defended. Cross-border capital and liquidity flows can strengthen resilience by reducing fragmentation. They are necessary for the efficient allocation of resources across the EU economy and will facilitate private risk-sharing. During the financial crisis, cross-border banking business and banks' commitment to the region explicitly helped support CEE economies and fostered investors' trust in the region. This thesis is prominently demonstrated by the achievements of Vienna Initiative 1.0. For this reason, enabling and supporting a strong cross-border financial services sector should also be one of the important future goals of the Vienna Initiative.

"Do more of the same", as a closing remark for the Vienna Initiative at a time of even stronger isolationist politics in Europe seems to be the right takeaway for the future. A further harmonisation of what has already been achieved and thought through on the European level by joining forces, experiences and ideas from East to West and West to East is the key to a better future. The same counts for stepping in when cross-border banking has to rethink its business model, not (fortunately) because of the crisis facing it but driven by the sustainable, digital and agile world around it. For everyone who contributed to the Initiative, the past 10 years have proved that you cannot achieve anything on your own in life, and this will remain true in the future.

Annex 1: Abbreviations

CB	Central Bank
CEE	Central and Eastern Europe
CESEE	Central, Eastern and South-eastern Europe
CVC	Corporate Venture Capital
CRR	Capital Requirements Regulation
DESI	Digital Economy and Society Index
DSM	Digital Single Market
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
GDPR	General Data Protection Regulation
GFC	Global Financial Crisis
GSF	Green Supporting Factor
IFI	International Financial Institution
IMF	International Monetary Fund
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NMS	New Member States
NPL	Non-performing Loans
RBI	Raiffeisen Bank International AG
RWA	Risk-weighted asset
SEE	South East Europe
SME	Small and Medium Size Enterprises
VC	Venture Capital

Annex 2: Exhibits

Exhibit 1
"Stability for the Financial Sector in EU New Member States and Candidate Countries"

Letter from Andreas Treichl (Chairman and CEO, Erste Group Bank AG), Corrado Passera (Managing Director and CEO, Intesa Sanpaolo SpA), Andre Bergen (Chief Executive Officer, KBC), Herbert Stepic (Chairman of the Board of Management, Raiffeisen International Bank Holding AG), Frederic Oeda (Chief Executive Officer, Societé Générale), Alessandro Profumo (Chief Executive Officer, UniCredit SpA)

1 December 2008

Christine Lagarde
Ministre de l'Economie, de l'Industrie et de l'Emploi
Rue de Bercy 139 - Télédoc 336
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Joaquin Almunia
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European Commission
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Charlie McCreevy
European Commissioner for Internal Market and Services
European Commission
Rue de la Loi 200
B-1049 Brussels
Belgium

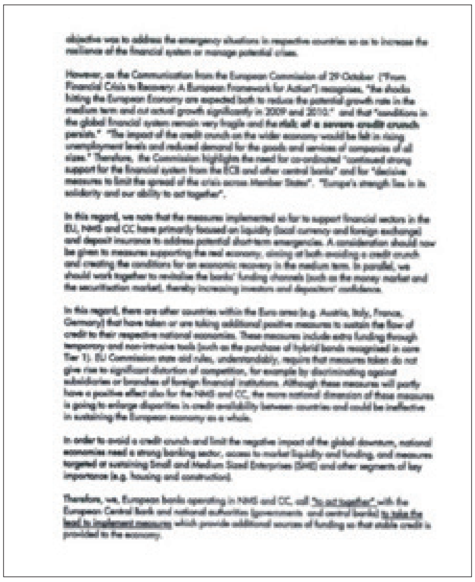
1st December 2008

Dear Madam,
Dear Sirs,

Re. Stability for the Financial Sector in EU New Member States and Candidate Countries

Last October, the EU Council and the European Commission (EC) agreed upon a series of immediate measures aimed at protecting citizens' savings as well as enhancing the soundness of the banking system in order to pursue the stability of the financial system.

In the Central East European area, the Candidate (and potential candidate) countries (CC) have implemented a number of initiatives, some being similar to those carried out by New Member States (NMS). These measures include the raising of the minimum coverage of deposit guarantees, new central bank lending facilities and lower reserve requirements. The common



objective was to address the emergency situations in respective countries so as to increase the resilience of the financial system or manage potential crises.

However, as the Communication from the European Commission of 29 October ("From Financial Crisis to Recovery: A European Framework for Action") recognises, "the shocks hitting the European Economy are expected both to reduce the potential growth rate in the medium term and cut actual growth significantly in 2009 and 2010," and that "conditions in the global financial system remain very fragile and the risk of a severe credit crunch persists." "The impact of the credit crunch on the wider economy would be felt in rising unemployment levels and reduced demand for the goods and services of companies of all sizes." Therefore, the Commission highlights the need for co-ordinated "continued strong support for the financial system from the ECB and other central banks" and for "decisive measures to limit the spread of the crisis across Member States". "Europe's strength lies in its solidarity and our ability to act together".

In this regard, we note that the measures implemented so far to support financial sectors in the EU, NMS and CC have primarily focused on liquidity (local currency and foreign exchange) and deposit insurance to address potential short-term emergencies. A consideration should now be given to measures supporting the real economy, aiming at both avoiding a credit crunch and creating the conditions for an economic recovery in the medium term. In parallel, we should work together to revitalise the banks' funding channels (such as the money market and the securitisation market), thereby increasing investors and depositors' confidence.

In this regard, there are other countries within the Euro area (e.g. Austria, Italy, France, Germany) that have taken or are taking additional positive measures to sustain the flow of credit to their respective national economies. These measures include extra funding through temporary and non-intrusive tools (such as the purchase of hybrid bonds recognised in core Tier 1). EU Commission state aid rules, understandably, require that measures taken do not give rise to significant distortion of competition, for example by discriminating against subsidiaries or branches of foreign financial institutions. Although these measures will partly have a positive effect also for the NMS and CC, the more national dimension of these measures is going to enlarge disparities in credit availability between countries and could be ineffective in sustaining the European economy as a whole.

In order to avoid a credit crunch and limit the negative impact of the global downturn, national economies need a strong banking sector, access to market liquidity and funding, and measures targeted at sustaining Small and Medium Sized Enterprises (SME) and other segments of key importance (e.g. housing and construction).

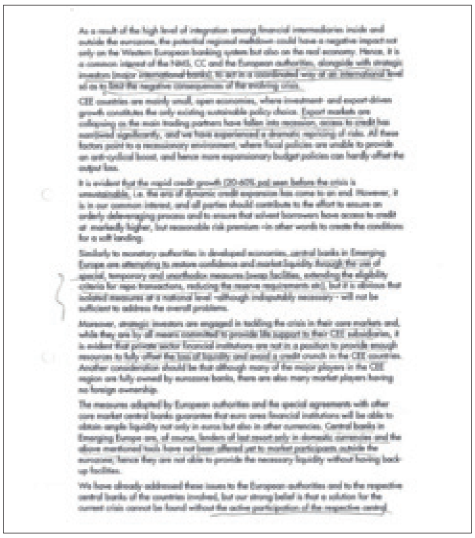
Therefore, we, European banks operating in NMS and CC, call "to act together" with the European Central Bank and national authorities (governments and central banks) to take the lead to implement measures which provide additional sources of funding so that stable credit is provided to the economy.

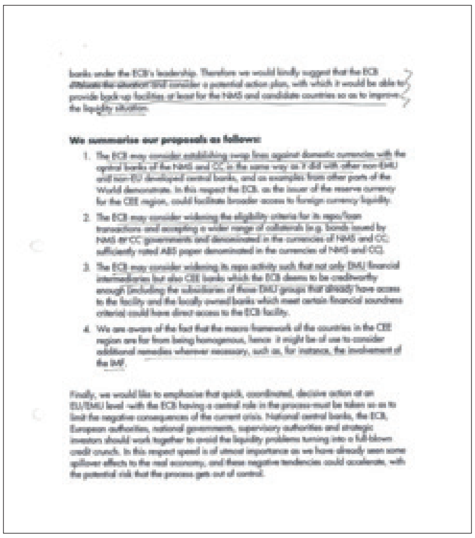
Yours faithfully,

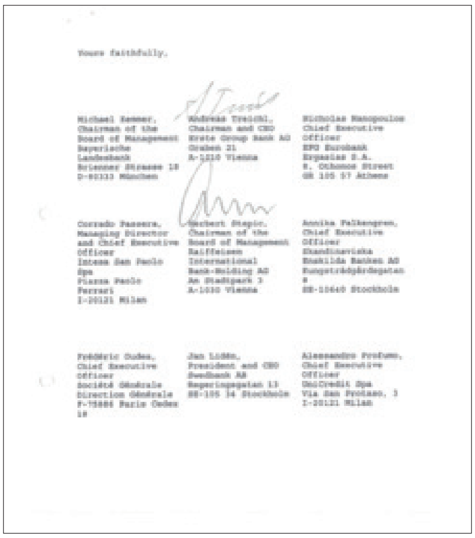
Exhibit 2
"Proposal of potential measures by the ECB to support the stability of the EU New Member States (NWS) and Candidate Countries (CC)"

Letter from Michael Kemmer (Chairman of the Board of Management, Bayerische Landesbank), Andreas Treichl (Chairman and CEO, Erste Group Bank AG), Nicholas Nanopoulos (Chief Executive Officer, EFG Eurobank Ergasias SA), Corrado Passera (Managing Director and CEO, Intesa Sanpaolo Spa), Herbert Stepic (Chairman of the Board of Management, Raiffeisen International Bank Holding AG), Annika Falkengren (Chief Executive Officer, Skandinaviska Enskilda Banken AG), Frederic Oudea (Chief Executive Officer, Societé Générale), Jan Liden (President and CEO, Swedbank AB), Alessandro Profumo (Chief Executive Officer, UniCredit SpA),

23 January 2009







CHAPTER 14

Cross-border banking in North Macedonia: a country perspective

Anita Angelovska Bezhoska, Ana Mitreska, Frosina Celeska and Ljupka Georgievska

National Bank of the Republic of North Macedonia

Abstract

Extensive foreign presence has been a common feature of the banking systems across countries in the Central, Eastern and Southeastern Europe (CESEE) region, including North Macedonia. This chapter will shed some light on the main benefits of the presence of foreign banks, such as easier access to finance, the introduction of modern banking practices and corporate governance and overall risk diversification. But it will also discuss the risks involved in cross-border banking, which came to the fore with the global financial crisis, when foreign financing retreated and banks' activities were scaled down. The note frames the experience in Macedonia, as a country where foreign funding is limited and banks are involved in more conventional banking, all of which shielded it from the crisis and moderated the amplitude of the credit cycle. This chapter will discuss the main challenges for effective cross-border banking, related to the need for a more balanced approach to the financing of banks and the avoidance of excessive cross-border exposures, the need for more effective cross-border cooperation arrangements, with a focus on the coordination between home and host regulators, as well the impact that post-crisis regulatory changes may have on the region, with a particular emphasis on those that may have unintended adverse effects.

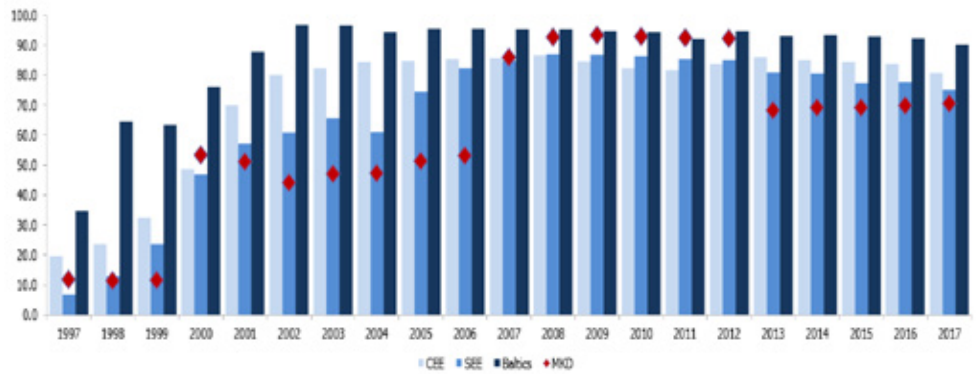
The role of foreign banks

The role played by foreign banks in the CESEE region since the onset of the transition has been immense. The transformation of the banking systems in CESEE countries brought in foreign banks as strategic investors, thus raising the extent of foreign ownership, which became dominant in most of the countries in the region.

This expansion of foreign ownership has facilitated the provision of financing by increasing access to foreign savings while domestic savings were low, especially during the early years of transition. Banks in foreign ownership have also probably played a role in channelling savings hidden under mattresses into official financial channels, thus supporting increased financial intermediation. Equally importantly, such banks introduced modern banking practices, improved corporate governance, diversified financial services and products to the benefit of consumers and corporate clients and increased access to the financial system, thus contributing to greater financial inclusion. In fact, the benefits of the presence of foreign banks in the region, as assessed by the International Monetary Fund (IMF 2013a,b), were visible in the sharp drop in the incidence of banking crises,[1] improved banking practices, greater capacity for absorbing local shocks and improved access to finance. An important benefit of cross-border banking relates to risk diversification, both for the foreign banking groups and for host countries' banking systems. For the first group, the allocation of their activities across different countries can markedly reduce their risk profile. For the second group, the risk exposure to local shocks could be significantly reduced when foreign groups are present.

Figure 1.

Foreign presence in the banking systems (Assets share of foreign banks, in %)



Source: *IMF (2013a,b) Financing Future Growth: The Evolving Role of the Banking Systems in CESEE: Technical note; BSCEE Reviews and central banks' website.*

1 According to IMF research (IMF 2013a,b), the incidence of banking crises in CESEE countries (Albania, Belarus, Bosnia-Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, North Macedonia, Poland, Romania, Russia, Slovakia, Slovenia, Turkey and Ukraine) dropped significantly during the 2000s, registering only six systemic crises (five of which were related to the global crisis) as compared to the 1990s, when almost all CESEE countries experienced some form of banking crisis. The entrance of strategic foreign investors that operationally restructured domestic banks is considered a critical contributor to the stability of the banking sectors, along with the process of macroeconomic stabilisation in the region and tightened entry conditions and supervision of banks.

From the beginning of transition until the global financial crisis, the amount of assets of foreign banks as a share of the total assets of the banking systems in the CESEE region has seen a significant increase. This is observed across all CESEE economies, with the highest share reached in the Baltic States at more than 90% of the total assets just before the global crisis. In Central Europe (CEE) and Southeastern Europe (SEE) it amounted to about 85% in 2007.

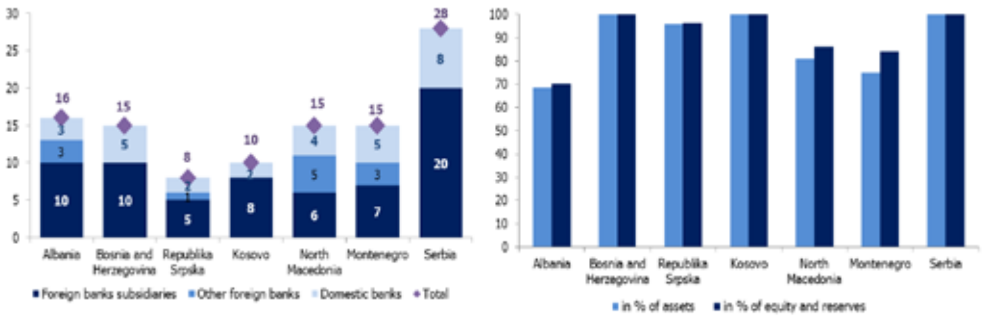
In line with the pattern in other countries of the region, foreign banks entered North Macedonia as well, mainly through the acquisition of already established banks, and in most cases through banks headquartered in the EU. The predominance of the latter, in North Macedonia as in other countries, presumably reflected geographic proximity, trade linkages and the EU integration process as an economic and political anchor. Both pull and push factors played significant roles. "Push" factors included saturated domestic markets in Western Europe, the need for cross-border expansion and the search for higher earnings. The initially small local banking systems, the EU perspective and the real and institutional convergence of the countries in the region were important "pull" factors for the entrance of foreign capital in the banking system.

Although foreign investors were present in the Macedonian banking system from the early 1990s, the major breakthrough started in 2000. The process of acquisition of domestic banks by foreign investors had mostly ended by the time of the outbreak of the global crisis in 2008, with no major acquisition or green-field investment occurring afterwards. The number of foreign-owned banks increased gradually, currently (2019) standing at eleven out of fifteen banks in the system. An important feature of the foreign banks is the presence of subsidiaries of foreign banks (foreign subsidiaries), of which there are six,[2] and which have a large share in the capital and the assets of the overall banking system. In fact, compared to some other Western Balkan (WB) countries, the number of subsidiaries as a share of the total number of foreign banks is smaller (55%, compared to 90% in WB), but their share of total assets and capital is rather comparable, at around 90% of total assets and capital of foreign-owned banks. The prevalence of subsidiaries, as well as the fact that in most of the banks standalone strategic investors entered the system, ensured a strategic approach would be taken, focusing on modernising systems, improving overall corporate governance and increasing market share on a sustainable basis.

2 The remaining five foreign-owned banks are controlled by non-banking financial institutions or other qualified investors under the Banking Law.

Figure 2.

Banking system structure (number of banks) **and foreign subsidiaries as a share of total assets and total equity and reserves of foreign banks**

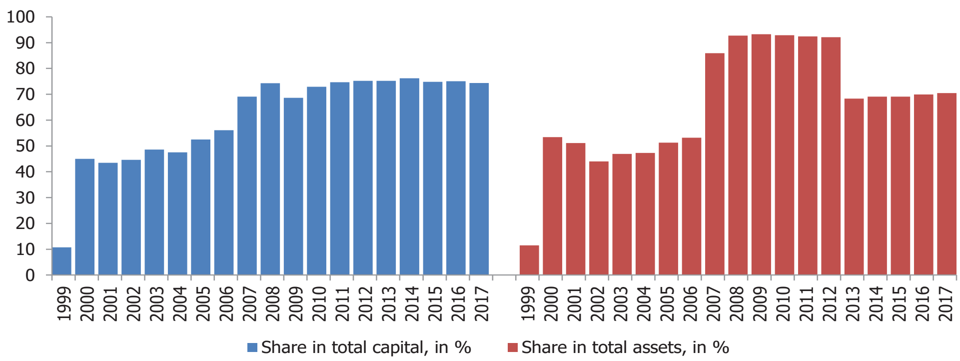


Source: National supervisory authorities in the Western Balkan countries.
Note: Data refer to September 2018.

Although the number of foreign banks in the Macedonian banking system rose gradually, the size of the entrant banks varied significantly, preventing a smooth rise in foreign banks' share of the total capital and total assets of the system. Over the 1999–2017 period, there are two points in the timeline where more pronounced shifts were observed. The first one pertains to 2000, when two major banks, NBG (Athens) and NLB (Ljubljana), entered the market, leading to marked increase of the share of foreign banks in total capital and total assets, from around 11%, to around half of the capital and the assets of the banking system. The change in 2007 was also visible, when another international banking group entered the market, Societé Générale (Paris).[3]

Figure 3.

Foreign banks' presence in North Macedonia



Source: NBRNM.

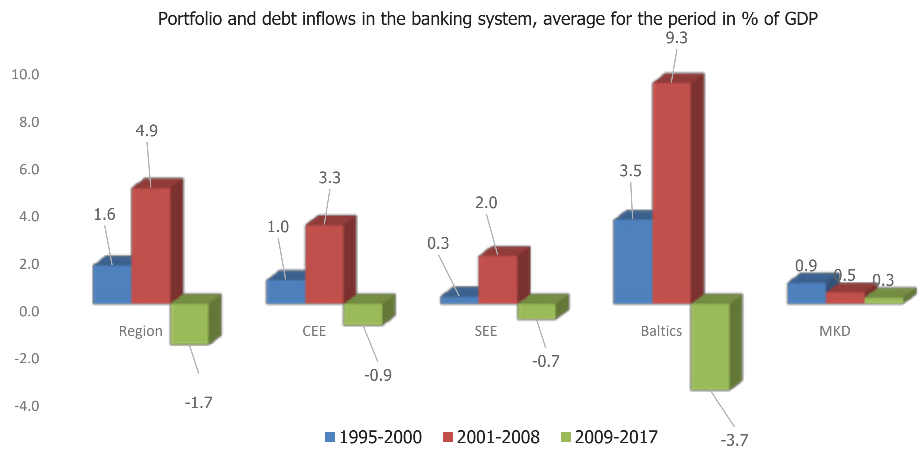
3 The foreign assets share of the total assets declined sharply in 2013 to 68%, reflecting the reduced share of a foreign strategic investor in one bank. This does not change the overall picture of international banking group dominance in North Macedonia.

One of the important benefits that foreign banking presence brought was enhanced access to cross–border financing, as an additional source for boosting bank resources. Hence, after the initial entry through equity, additional funding was provided subsequently across almost all countries in CESEE as debt financing. The inflows significantly accelerated in the period prior to the crisis (2000-8), in particular in the Baltics, where annual inflows reached on average around 9% of gross domestic product (GDP). The inflows into the banking systems of the CEE and SEE countries also accelerated, but at a more moderate pace in comparison with the Baltics (3.3% and 2% of GDP, respectively). Different patterns across countries reflect country-specific factors, and the data on external financial flows in the banking system show different patterns among country groups.

In this context, the Macedonian case fits into the pattern of most of the CEE and SEE economies, with limited cross–border linkages and negligible dependence on parent-bank funding. Despite the rising foreign presence in the banking system, foreign funding was not important for the domestic banking system. Sufficient local funding, together with the rather conservative business models of the banks, as well as prudential regulation, probably contributed to this. Although some cyclical upturn was visible in the external debt position of domestic banks prior to the crisis, it was rather modest, and reached its peak in 2010. It subsequently adjusted in a slow and orderly manner, without indications of abrupt capital flight, reflecting the overall slowdown in the growth of credit, while available local funding remained strong. More or less the same inferences can be drawn by observing only the interconnectedness with parent banks. Funding from this source remained rather low, currently standing at around 3% of total assets.

Figure 4.

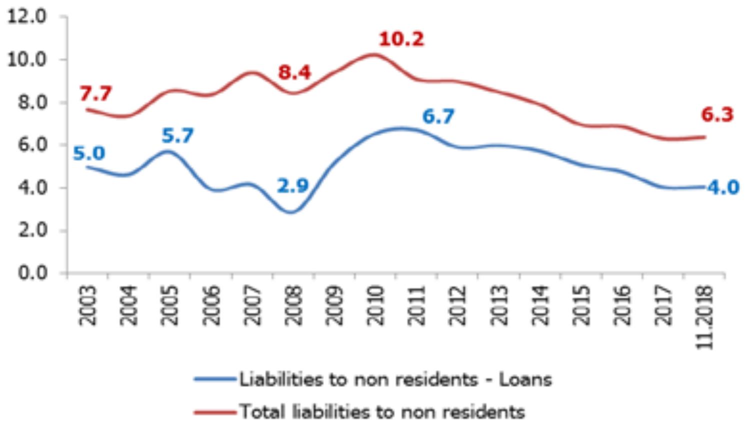
International liabilities of the banking system by debt instrument



Source: IMF Balance of payments statistics.

Figure 5.

North Macedonia – Banking sector liabilities to non-residents (as % of total assets)

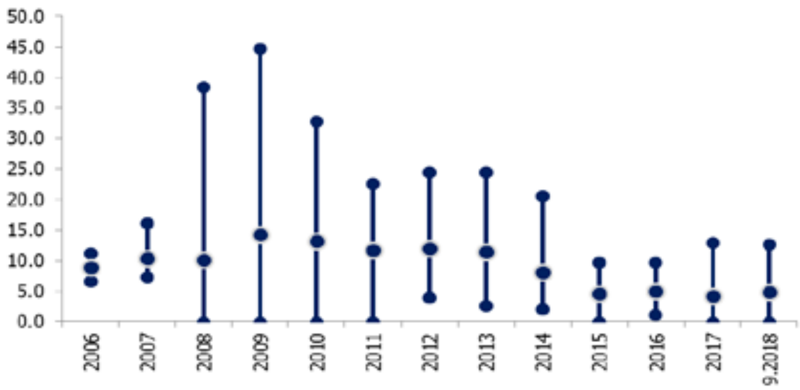


Source: *NBRNM.*

Chart 6.

North Macedonia – Subsidiaries liabilities to parent banks

(as % of total assets, maximum, average and minimum %)

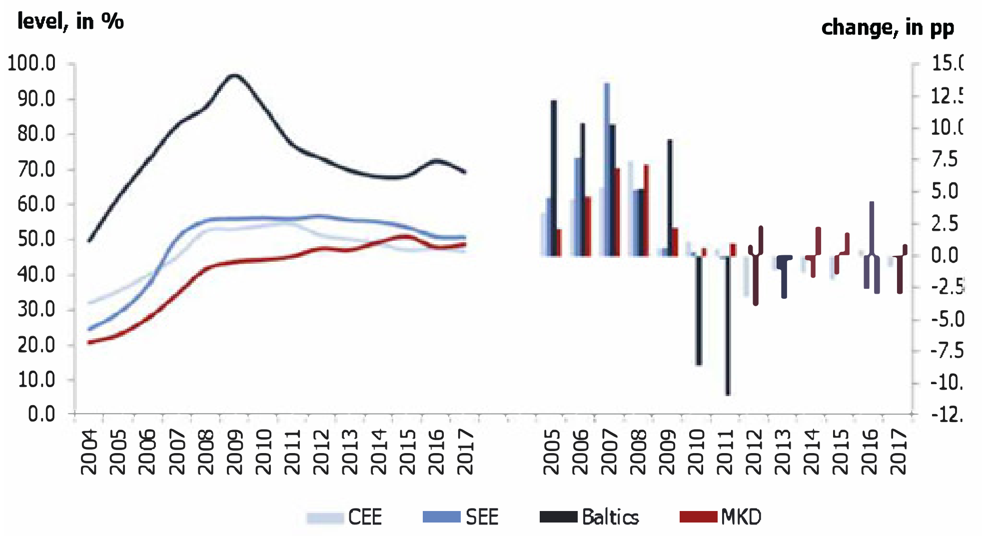


Source: *NBRNM.*

The rather low dependence of the Macedonian banking system on cross-border financing proved to be one of the important buffers that helped the banking system and the economy in general to weather the crisis well. The whole cycle was moderate, with no "sudden stop" episodes, thus preventing a boom-bust episode in the economy. Bank-level data show some differences across banks, with some banks relying more on parent funding than others. The share of parent-bank financing ranges from almost no financing at all at some banks to more than one-third of total assets at others, reaching a peak of 45% at one bank in 2009. For the post-crisis period (2013-18) the maximum level of parent funding averaged 15% of total assets, while the minimum stood at 1%. This may reflect differences in banks' business models with respect to financing, as well as parent banks' commitment to supporting the funding needs of their subsidiaries during the early years of acquisition in order to gain market share. Stronger parent funding is more common for smaller banks, which perhaps face a greater need for additional funding to boost their growth.

The rising foreign presence, in ownership or funding or both, contributed to faster financial deepening. As the post-transition restructuring was reaching its final stages, the environment was becoming conducive for an expansion of the credit market. The credit-to-GDP ratio started to increase across the board, with notable acceleration in the 2003-8 period, before the outbreak of the global crisis. It was a period of abundant global liquidity; foreign banks were competing for market share, the initial debt level was rather low and the propensity for taking on debt was high. The confluence of all these forces enabled strong credit flows, which underpinned overall growth. As growth increased, a self-reinforcing mechanism started to work, boosting assets prices and provoking additional capital inflows.

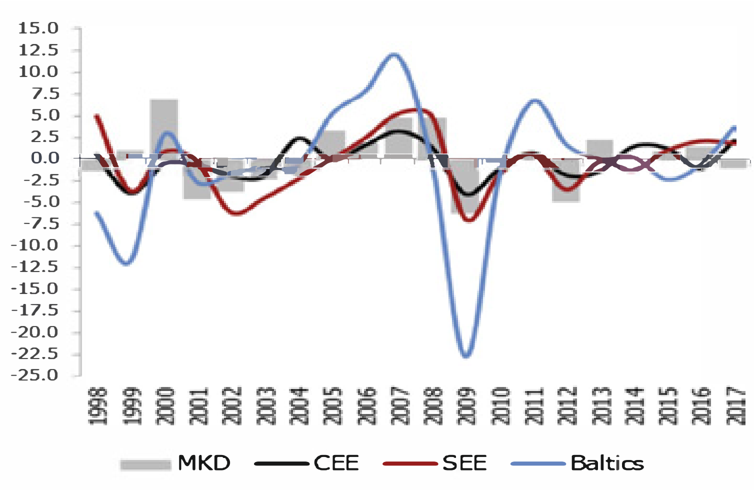
Figure 7.
Credit to GDP



Source: *Central banks' websites and IMF WEO database.*
Note: *Gaps are calculated as actual minus HP filter of GDP growth rates.*

Figure 8.

GDP gap, in percentage points



Source: Central banks' websites and IMF WEO database.
Note: Gaps are calculated as actual minus HP filter of GDP growth rates.

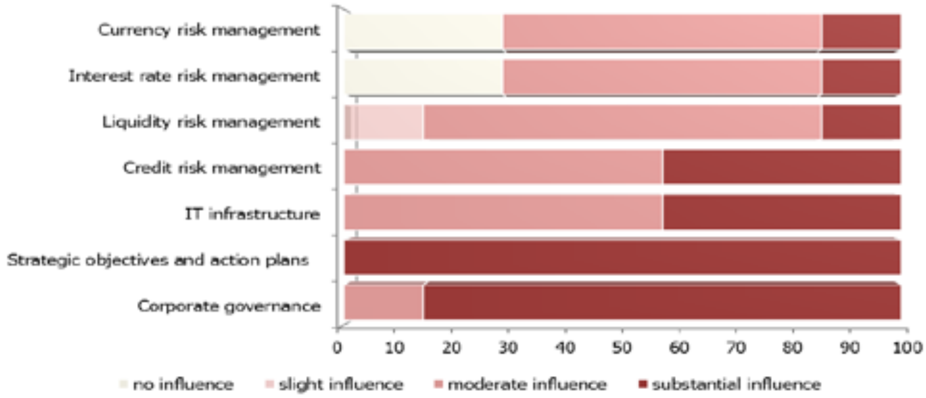
Compared to some other countries in the regional context, the financial deepening in North Macedonia occurred somewhat later, and did not coincide with the exact timing of foreign entry into the banking system. Given country-specific circumstances related to political uncertainty, and also the time needed to restore the confidence in the banking system, the more intensive process of financial convergence occurred as the global financial crisis was breaking. Credit-to-GDP was hovering below 20% of GDP until 2004, when it started to grow rapidly, and by the end of 2008 it rose to about 42% of GDP. Although at the time it was assessed mostly as a catching-up process in a rather conducive domestic and international environment, preventive measures were taken on the macroprudential front to avert potential risks. These measures – the low dependence on cross-border funding and the strong prudential regulation – prevented a credit boom prior to the crisis, as well as a subsequent credit bust in the period following the crisis. In fact, North Macedonia is one of the rare countries in which only moderate credit growth was observed. Since the beginning of the crisis until now, credit has continued to grow at a rather steady rate, reaching around 50% of GDP at end-2018.

Aside from the increased access to additional financing, the presence of foreign banks in the region also brought non-financial benefits, equally important to a stronger banking system and the provision of credit finance to the economy.

A recent survey[4] conducted by the National Bank of the Republic of North Macedonia (NBRNM) among foreign subsidiaries in the country acknowledged the important role of the parent in shaping strategies and policies of the domestic subsidiaries and transferring managerial and operational practices from the home to the host country. Yet the influence is stronger in some areas than in others. The leading area where all of the surveyed banks report substantial influence by the parent is the definition of strategic objectives and action plans for their fulfilment, suggesting a strong parent-subsidiary relationship.

Figure 9.

Parent banks' influence on domestic banks



Source: NBRNM survey on the effects from foreign banks entrance into the domestic banking sector, January 2019.

The second area is the corporate governance arrangements, which are perceived by 86% of the respondent banks to be substantially influenced by the parent. These results are generally comparable with the European Bank for Reconstruction and Development's "Banking Environment and Performance Survey II" (EBRD 2011), which reveals corporate governance as important business area influenced by parent banks according to 100% of banks surveyed in SEE, CEE and the Baltics. Given the importance of corporate governance for the overall organisational infrastructure of a bank, and hence for the achievement of its goals, the involvement of a well-established parent bank with a long tradition in the industry is highly beneficial for

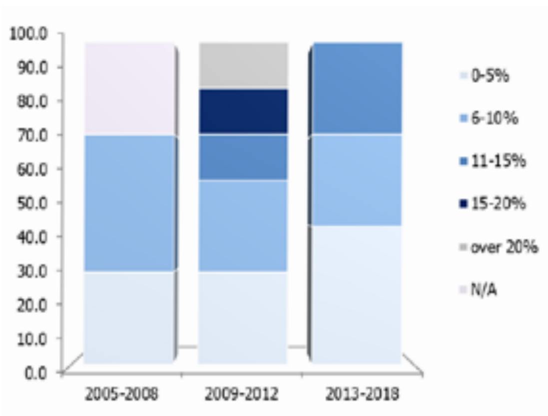
4 The NBRNM conducted a survey of foreign bank subsidiaries in North Macedonia in order to get banks' views on the effects of foreign bank entry into the domestic banking sector. The survey was conducted in January 2019 and included six foreign bank subsidiaries in the country and one bank belonging to an international financial holding company. The survey consisted of 15 questions. The results presented in this chapter are in aggregated graphical form, showing the share of surveyed banks in percent. Charts showing the results of all of the questions from the survey can be found in Appendix II. The NBRNM wishes to thank the banks for their contribution and their participation in the survey.

the overall capacity building and performance of the domestic banks. In addition, areas that 80-100% of the banks in the SEE region pinpointed as impacted domains were credit risk portfolio management, credit risk assessment and IT systems. The NBRNM survey shows a similar stance by banks in North Macedonia, though with a lesser weight being put on these domains. The majority of the banks (57%) perceive a moderate influence of their parents with respect to risk-management policies (for liquidity-risk management, 71% of banks) and IT infrastructure, while only 29% cited no influence at all in the areas of interest rate and currency risk management.

Another important inference from the NBRNM survey is the relatively high financial independence of domestic subsidiaries from their parents, which is in accordance with their business models. The majority of banks report parent funding makes up less than 10% of total sources of financing, with certain fluctuations in the period during and after the crisis. Only 33% of Macedonian banks report the existence of a centralised liquidity model, which is another argument in support of subsidiaries' independence in managing liquidity and funding. Moreover, only 43% of banks use parent funding for liquidity purposes, such as smoothing unexpected shocks to the deposit base, while the majority predominant share channel it to meet credit growth targets or to take advantage of new opportunities.

Figure 10.

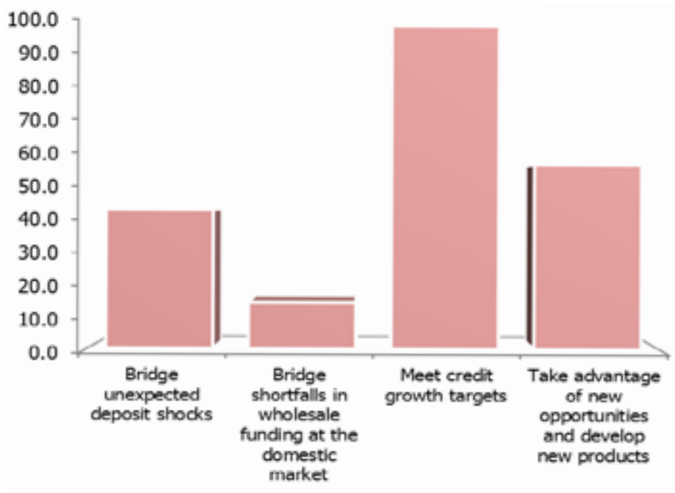
Average parent funding share of total sources of financing (excluding equity and reserves)



Source: *NBRNM survey on the effects from foreign banks entrance into the domestic banking sector, January 2019.*

Figure 11.

Main reasons for parent funding



Source: NBRNM survey on the effects from foreign banks entrance into the domestic banking sector, January 2019.

The majority of the banks agree that being a subsidiary of an international banking group strengthens their resilience to domestic and international shocks due to the parental support in funding that can be easily accessed in case of liquidity shortages. In the banks' view, the entry of foreign banks has brought many benefits that considerably outweigh the costs (Figures 13 and 14 in Appendix II). All of the banks report improved corporate governance and risk management as "very to extremely important" benefits associated with foreign bank parents. A large majority (86%) report "very to extremely important" spillover effects in increasing access to finance, improving competition and efficiency of the banking system and strengthening financial stability in the country. At the same time, 71% of surveyed banks link the entry of foreign banks to the improved quality of financial intermediation and the building of shock absorption capacities. In terms of costs, 43% of banks report moderate adverse effects from internal rules of the parent that are non-compliant with the characteristics of the Macedonian banking sector and economy, with increased dependence on group policies weighing on efficiency in decision-making.

Changed landscape after the global crisis?

Cross-border banking has certainly brought many benefits for CESEE countries, but growing financial linkages also entail risks, as a large foreign presence might propagate foreign shocks and amplify cycles. These costs partly materialised with the emergence of the global crisis, particularly in countries where foreign ownership was allied with substantial foreign funding. The structure of cross-border banking played a role in the transmission of shocks. Although the foreign bank presence in the region is predominantly in the form of subsidiaries, the prevailing dominance of EU-headquartered banks with systemic importance at local level has accentuated concentration risks arising from concentrated foreign exposure to a single geographic area, i.e., the EU.

With the occurrence of the crisis, overall capital flows, including those in the banking system of the CESEE region, slowed down or even reversed, thus depressing the activity of domestic banks. In those countries where foreign funding prior to the crisis was buoyant and financing constraints were limited, the credit cycle was considerably amplified. While before the crisis this model enabled strong support to the overall leverage of the economies, with the outbreak of the crisis it led to a "hard landing". The larger the inflows, the larger the reversal, and the more severe the financial and economic downturn. This pattern was visible in the Baltic States, in particular – a region where, prior to the crisis, foreign debt flows into the banking system in certain years reached almost 20% of GDP. The subsequent adjustment was severe, with foreign funding outflows over the three-year period 2009-11 totalling 22% of GDP. On the other hand, the overall pre/post crisis financial cycle, in terms of both external indebtedness of the banking system and credit growth in CEE and SEE countries, including North Macedonia, as discussed above, was more moderate, though country differences are visible.

Figure 12.

Customer deposits, percentage share of total liabilities, in 2008

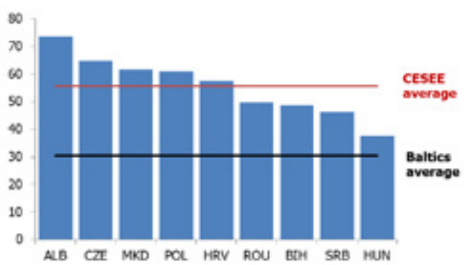
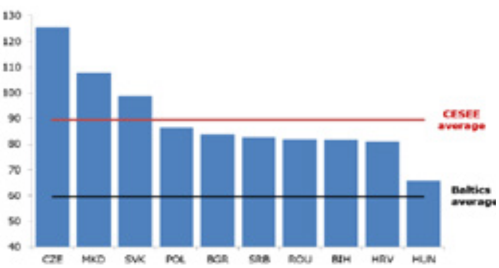


Figure 13.

Deposit-to-credit ratio in 2008



Source: IMF FSI database and central banks websites.

The traditional banking model and the dominance of local funding, similar to some other CEE and SEE countries, were important factors shielding the Macedonian banking system from the crisis. Macedonian banks recorded a deposit-to-credit ratio of 108% prior to the crisis, the second highest among observed CESEE countries after the Czech Republic. Even in the pre-crisis period, CESEE banks, including

Macedonian banks, predominantly employed retail-based funding from customers' deposits at home, which proved to be a more stable source of funding during stress periods (IMF, 2015). The share of residents' deposits in CESEE banks amounted nearly 60% of their total liabilities on average in the years prior to the crisis. The deposit-to-credit ratio was at a comfortable level of 90% in 2008 as compared to 60% in the Baltics.

The pre-crisis fundamentals of Macedonian banks were sufficiently strong to act as a buffer against potential disruptions, and remained well in place post-crisis. The liquidity ratio of the system was in line with the CESEE average at 32% for 2006-8.[5] Banks maintained sound capital buffers slightly above the CESEE average at 17.2%[6], and the adequate solvency ratio was maintained after the crisis. Profitability moved in line with the business cycle and declined moderately in the wake of the crisis, but remained positive. Post-crisis recovery was generally faster than the CESEE average, with return on equity and return on assets approaching their pre-crisis levels in recent years. Foreign and domestic banks showed similar trends in terms of their profitability during and after the crisis, although foreign bank subsidiaries seem to perform much better in the post-crisis period. Outliers are "other" foreign banks, whose profitability indicators were improving up to 2015 and started to deteriorate afterwards, mostly due to their lower market shares and limited ability to improve their efficiency. The poor quality of bank assets was a major drag on credit growth in the CESEE post-crisis. Yet this was not the case for North Macedonia. The nonperforming loan (NPL) ratio stabilised reasonably soon, to about 10% in 2012, below the SEE average. Underpinned by the NBRNM's 2015 measures for mandatory write-offs of NPLs which have been fully provisioned for more than two years, the NPL ratio was brought down to 5.2% in 2018, which is even below the pre-crisis level.

5 Data refer to liquidity ratio at system level.
6 Data refer to the capital adequacy ratio at system level.

Figure 14.
Capital adequacy ratio

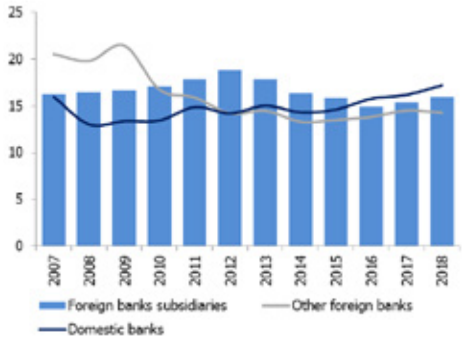


Figure 15.
Liquidity ratio

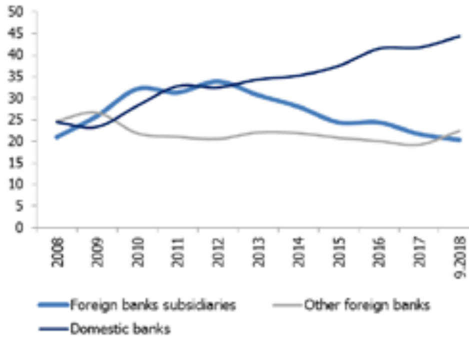


Figure 16.
Profitability

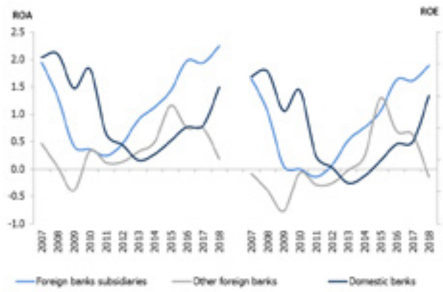
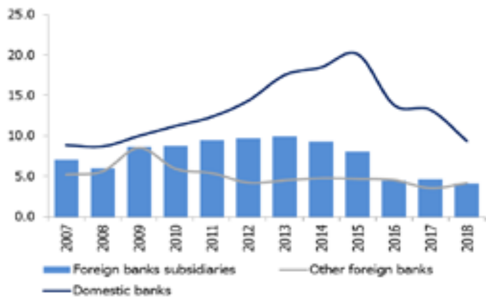


Figure 17.
NPL ratio



Source: *NBRNM.*
Note: *Figures refer to Macedonian banking sector.*

With the system in sound shape, the National Bank took a pre-emptive stance and undertook a number of measures to further support banking system resilience and strengthen financial stability in the country. In late 2008, well before the introduction of Basel III liquidity requirements, stricter liquidity buffers were introduced, calling on banks to maintain a certain minimum level of liquid assets for covering the liabilities falling due in the following 30 and 180 days. The NBRNM used a combination of monetary, supervisory and macroprudential measures to contain risks from rapid credit growth in the years before the crisis, including prevention of induced credit risk related to foreign exchange lending and credit controls on households' lending.[7] These measures helped to reduce the vulnerability of the banking sector and enhance its resilience to shocks.

7 For more details on the macroprudential policies of the NBRNM in the period before and during the global crisis, see Celeska, Gligorova and Krstevska "Macroprudential Regulation of Credit Booms and Busts: The Experience of the National Bank of the Republic of Macedonia", World Bank Policy Research Working Paper 5770.

Despite the low dependence on foreign financing, rather conservative business models and prudent regulation, threats of parent banks' deleveraging could not be ignored in Macedonia, or in other CESEE countries. Though funding risk was not a particular issue, the possible sale of the subsidiaries or divestment by large international banking groups remained open. With the escalation of the European sovereign debt crisis around mid-2011, European banks came under renewed pressures leading to a second wave of deleveraging. Several cases at that time of forced divestment, two of which related to international groups present in Macedonia, brought to the fore the possibility of foreign banks' exit, which could arise regardless of the underlying profitability of the bank subsidiaries in question or their dependence or lack of dependence on parent funding. The most rigorous deleveraging occurred during the European debt crisis, reinforced by stricter financial regulation under Basel III and EU legislation.

Figure 18.
Liabilities to EU parent banks, as a percentage of total liabilities

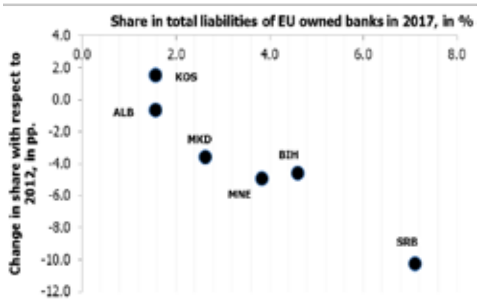
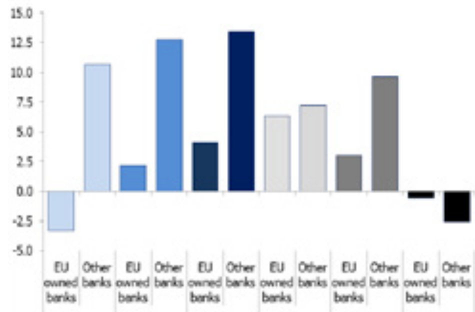


Figure 19.
Credit to non-financial sector, year-on-year, in %, 2013-17 average

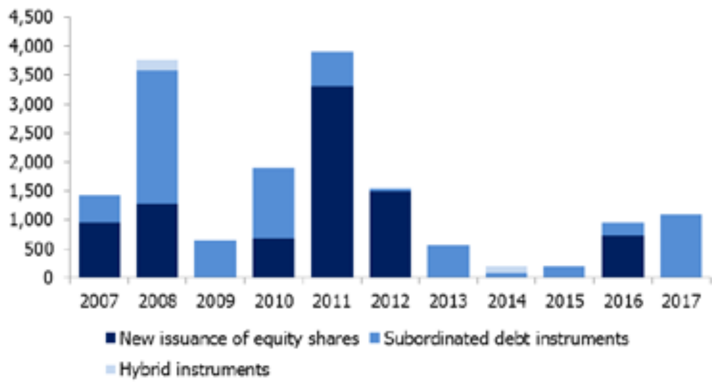


Source: Central banks' websites.

Some parent banks of key subsidiaries in North Macedonia experienced losses during the financial crisis that were so significant as to qualify for state aid within restructuring plans agreed with the European Commission. Restructuring plans, inter alia, envisaged substantial cost-cutting, including sizeable scaling back of banks' activities abroad. This threatened to destabilise Macedonian subsidiaries through the confidence and reputation channel. The 2015 financial turbulence in Greece triggered some deposit withdrawals, but their impact was moderate and short-lived. Banks effectively managed the liquidity pressures that accompanied the measures taken, and more stringent surveillance by the NBRNM has swiftly restored trust and normalised the situation. More precisely, in mid-2015 the NBRNM adopted capital flow measures against Greece that were time-bound (valid for a maximum of 6 months), forward-looking and targeted towards capital transactions. The aim was to prevent possible contagion from the Greek crisis that could undermine the stability of the Macedonian banking sector or potentially cause balance of payments distress, given the sizeable presence of Greek banks and businesses in North Macedonia. Macedonian subsidiaries suffered some consequences from the stresses on parent banks via pressures to consolidate capital at parent level and group-level restrictions on credit growth. Still, this was of rather limited extent. This can also be observed implicitly from Figure 19, where North Macedonia stands as an outlier, with no large discrepancies in post-crisis growth between EU-owned banks and the rest of the system. Parent banks stayed broadly committed to the Macedonian market and continued to maintain their operations in the country.

Figure 20.

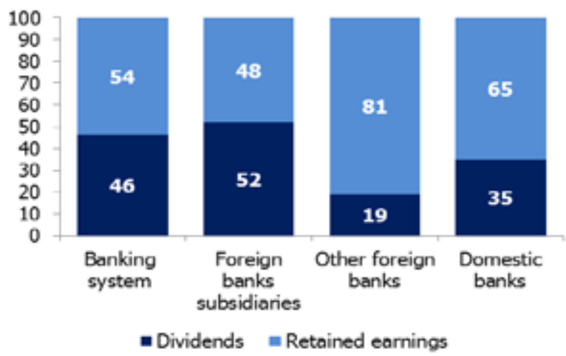
North Macedonia – Capital allocations, system-level (flows, in MKD million)



Source: NBRNM.

Figure 21.

North Macedonia – Profits distribution, share in profit after tax, at group level in % (2013-17 average)

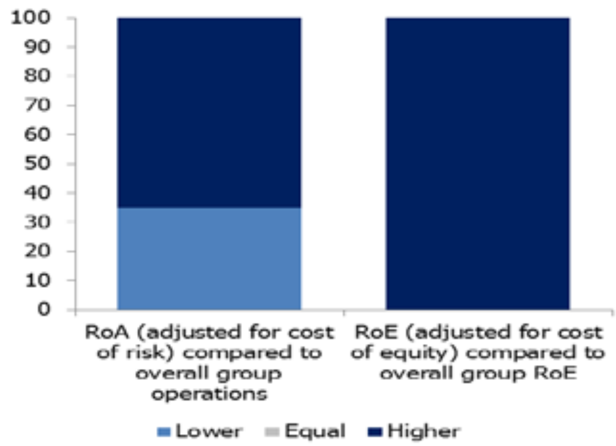


Source: NBRNM.

The latest EIB CESEE Lending Survey shows all the surveyed parent banks reported a higher return on equity of their Macedonian subsidiaries compared to the overall group level, while a large majority also reported a higher return on assets. Foreign banks' subsidiaries captured around 77% of the profits earned at the system level in 2013-17. Profits earned in this period were almost equally distributed between dividends and retained earnings, which subsidiaries largely used to support investments in future growth. Subsidiaries' growth prospects were further enhanced by the capital support that parent banks provided during and after the crisis, mainly through the issuance of subordinated debt. Some of the banks have strengthened their capital positions using new issuance of equity, although, on average, the post-crisis period was marked by lower levels of new issuance of equity or subordinated and hybrid instruments (with most of the increases in banks' own funds coming from retained earnings and issuance of subordinated debt). This is attributable to some extent to the already sound capital positions of Macedonian subsidiaries that, along with their solid profitability, continued to sustain their ability to grow without any additional capital injections. In addition, if needed, these banks have easier access to tier 1 and tier 2 instruments from their parent.

Figure 22.

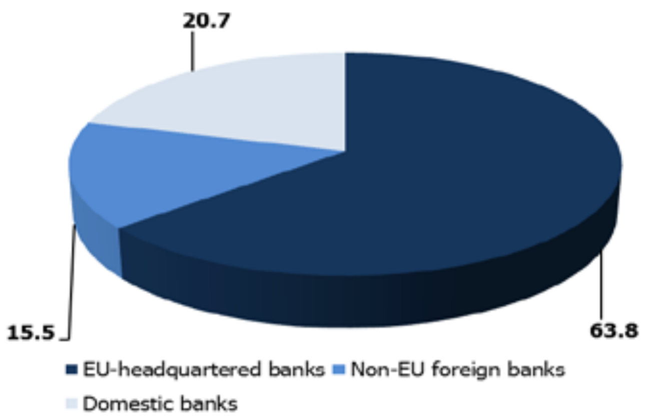
Parents bank assessment for Macedonian subsidiaries (% of surveyed banks)



Source: EIB CESEE Lending Surve, H2 2018.

Although the banking system came through the crisis quite well and the overall behaviour of foreign banks in Macedonia did not cause disruption, the crisis has slowed the process of entry of new foreign capital in North Macedonia and the region as a whole. Faced with severe impairments on their balance sheets as legacy of the crisis, international banks have put their expansion plans on hold and even reduced some of their activities abroad. In the Western Balkans region, the non-EU foreign groups have filled the gap left by EU banks, entering the market through a number of mergers and acquisitions. This has resulted in an increased share of assets owned by non-EU foreign banks. In North Macedonia there was only one exit of an EU bank headquartered in Greece, which has sold its Macedonian subsidiary, belonging to the group of small banks, to an investor from Switzerland. Despite the post-crisis restructuring, EU banks still remain dominant foreign investors in the region and have retained their systemic importance for the host jurisdictions.

Figure 23.
Distribution of banking sector assets in Western Balkans



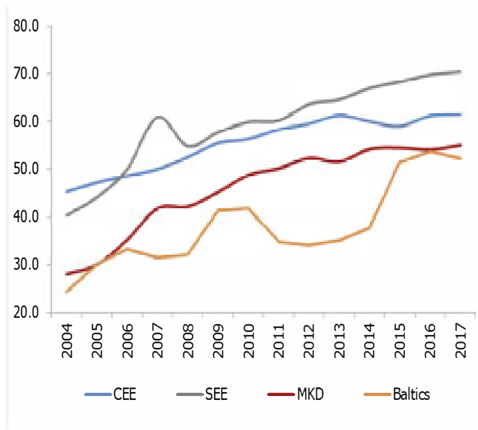
Source: National supervisory authorities in the Western Balkan countries.
Note: Data refer to September 2018.

Looking ahead, foreign banks can be expected to continue to play an important role in the further development of CESEE financial systems. Despite the progress achieved in convergence towards advanced economies, the convergence gap for many countries in the region remains wide, underlining the need to step up structural reforms in different segments of their economies. These efforts need to be underpinned by adequate funding sources and an efficient and developed financial infrastructure. Having proper access to domestic and external finance is a main precondition for unleashing the growth potential and achieving faster income convergence.

It seems that countries in the region cannot count on sizeable capital inflows, including inflows through the banking system, as in the period preceding the crisis, which clearly underlines the need for more focus on domestic resources.

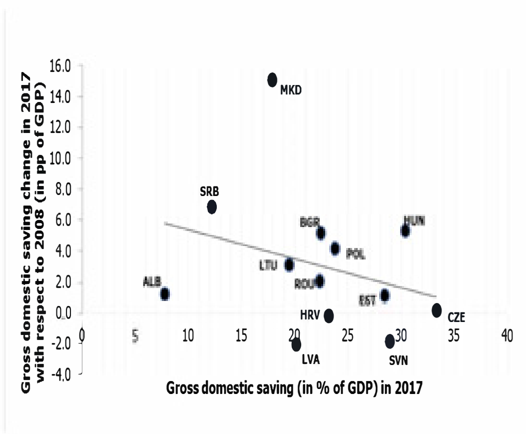
A new financing model for economic growth will most probably be more balanced between external and domestic sources. Many of the countries were able to offset the drag in foreign funding via deposit growth. Resident deposits in SEE increased by nearly 7 percentage points of GDP during the acute phase of EU bank deleveraging (2011-14) and continued to grow afterwards, providing the banks with sufficient funding to extend new lending. The deposit-to-credit ratio broadly improved across the region to about 120% on average in 2017.

Figure 24.
Residents' deposits to GDP, in %



Source: Central banks websites and IMF WEO database.

Figure 25.
Gross domestic saving



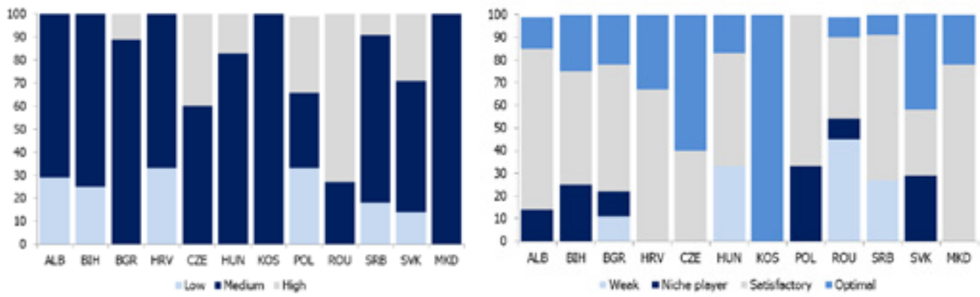
Source: Eurostat and NBRNM calculations.

Nevertheless, many CESEE countries suffer from low levels of domestic saving, suggesting that deposit funding on its own may not be sufficient to support stronger financial deepening in the period ahead. This holds in particular for the SEE region where domestic saving rate ranks from 7.8% of GDP in Albania to 23.3% of GDP in Serbia. In 2017, North Macedonia had saving rate of about 17% of GDP, comparable to the regional average but lower than in CEE countries (28% of GDP). These rates of savings are not adequate to support investments that have plunged in the post-crisis period and, despite some recovery in the recent period, remain low, even below some traditional benchmarks for faster convergence. Thus, attracting fresh capital from abroad remains an important complement to low domestic savings.

However, foreign banking groups see limited prospects in the region. The EIB CESEE Lending Survey shows that banking groups essentially assess market potential in the CESEE region as medium and their market positioning as satisfactory, but with differences across countries. In Croatia, for instance, assessments are dispersed between medium and low potential, likewise in Poland, and in Albania and Bosnia-Herzegovina to some extent. In North Macedonia and Kosovo, all of the surveyed banks report medium market potential. In terms of long-term strategies, the majority of banks intend to maintain the same level of operations or selectively expand activities in the region.

Figure 26.
Parent banks' assessment for CESEE

Market potential **Market positioning**



Source: EIB CESEE Lending Survey.

Slower growth prospects as compared to the pre-crisis period are an important factor behind foreign investors' hesitance following the crisis. Some countries face additional constraints related to their overbanked systems. According to IMF (2017) analysis, all of the Western Balkans countries have fragmented banking systems in terms of the number of banks per capita that may be discouraging new entrants by deterring competition and hampering efficiency. The problem of overbanking is particularly pronounced in Bosnia-Herzegovina and Montenegro, but Albania, North Macedonia and Serbia are not exempt. In such an environment, encouraging consolidation through bank mergers and acquisitions may contribute considerably to improving the structure and efficiency of the banking sector and attract new investors from abroad.

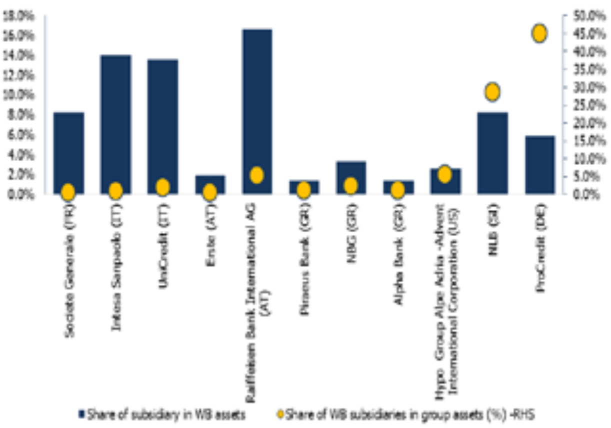
In this process, policymakers should not forget the lesson from the latest crisis, which provided evidence that the benefits of foreign banking presence can be maximised, and costs can be minimised, when moderate, but not excessive, levels of cross-border finance are in place. In essence, one of the main challenges ahead is related to the need in some countries for transiting from a centralised funding model to a more balanced approach to funding sources. This approach could enhance the resilience of domestic subsidiaries to any shock which the parent bank might be faced with. Of course, the impact of a shock might not be related solely to the funding model. The characteristics of parent banks, in terms of their solvency, liquidity and funding costs, are highly important as well. Any major shock to parent bank solvency and its access to funding and funding costs easily translates to the subsidiary. IMF (2013) explored this issue in an attempt to disentangle the main causes for the different post-crisis credit growth patterns (2008-11) between domestic and foreign-owned banks in CESEE countries. The main determinant of the difference in growth of credit detected was parent bank funding costs, which deteriorated markedly after the crisis. This again confirms the previous point, that high exposure to cross-border funding could severely amplify any foreign shock that might occur. Thus, less centralised funding could provide for buffers and room for manoeuvre and prevent severe vulnerabilities.

Challenges for host supervisors

Apart from the inferences listed in the previous section, the substantial presence of foreign banking groups on the domestic market inevitably draws attention to the importance of cross-border cooperation arrangements as a tool for ensuring efficient information exchange and smooth data flows. The recent history and the lessons learnt stress the necessity for strong home-host supervisory cooperation and involvement of all concerned parties when major decisions are made, which is an important precondition for effective supervision. This matter is even more relevant given the fact that foreign banks in North Macedonia, as well as in the region, are large and systemically important for the host countries, while on the group level they are less important. Apart from two EU subsidiaries, all other subsidiaries have insignificant shares in the total assets of their groups while being extremely important for the region's banking systems.

Figure 27.

Share of foreign banks' subsidiaries in total WB assets and in total group assets[8]

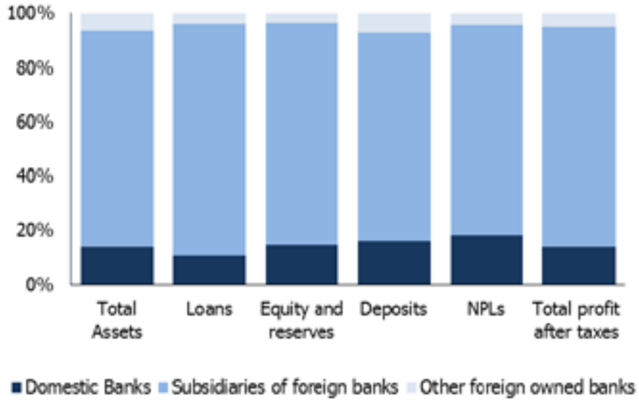


Source: Bankscope and NBRNM calculations.

8 It should be highlighted that there were certain divestment activities in the region after September 2018, which might change the data presented in these charts.

Figure 28.

Structure of the systemically important banks



Source: National supervisory authorities in the Western Balkan countries.

The importance of the foreign banks is even more pronounced in the structure of the systemically important banks,[9] accounting for more than 87% of their total assets. The numbers highlight the importance of a sound platform for cooperation between the regulators, especially during the aftermath of the global financial crisis, when parts of the European banking sector underwent a process of deleveraging and even divestment from the CESEE countries, including the Western Balkan countries.

Although the restructuring of global activities in 2018 was less intense than in past periods,[10] there are still examples of group-level strategies tilted towards a reduction in operations. Around 80% of the EU banking groups have a long-term strategy of maintaining the same level of operations or selectively increasing their operations in certain countries. Still, the percentage of EU banking groups which plan to reduce their operations in the CESEE countries has substantially increased in the last two years and, more importantly, this percentage remained quite steady during this two-year period (around 13%, compared to just around 1% in 2013-15). Having in mind the impact that the withdrawal of the EU banks from the region might have on the local banking systems, strong cooperation between the home and host supervisors is of utmost importance to ensure mutually beneficial outcomes. The European Central Bank, the European Banking Authority, the

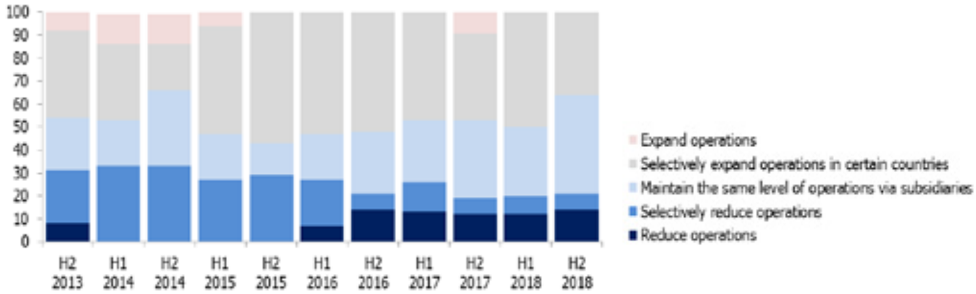
9 As determined by the national authorities of the Western Balkan countries in accordance with their local methodologies, which follow Basel III principles and recommendations.

10 According to the latest CESEE Deleveraging and Credit Monitor from November 2018, there are few signs of deleveraging of western banks in the region in the first half of 2018.

Single Resolution Board, as well as the national supervisory authorities acting as home supervisor of the banks in the region, remain major counterparties of the host supervisors from the region. The share of EU banking groups ranges from 48.2% in North Macedonia to 81.6% in Bosnia-Herzegovina. On average, local supervisors in the Western Balkan countries are the home supervisor for only 28% of total bank assets, while the ECB and other EU national supervisors are "responsible", as home supervisors, for more than 63% of banks' assets, loans and equity.

Figure 29.

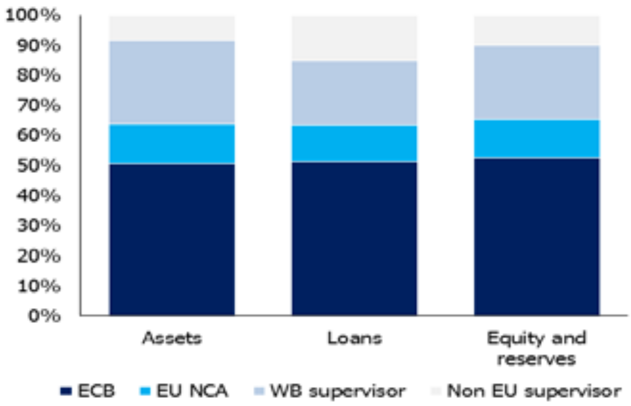
CESEE: Group-level 12-month strategies



Source: EIB-CESEE Bank Lending Surveys.

Figure 30.

Home supervisor of banks in the Western Balkan countries



Source: National supervisory authorities in the Western Balkan countries.

During the past few years, through joint activities and under the auspices of the Vienna Initiative, the Western Balkan countries have managed to intensify their cooperation with the relevant EU bodies. In October 2015, six supervisory authorities from this region[11] signed a Memorandum of Cooperation with the EBA,[12] as a platform for a harmonised approach to solving any future challenges. By the end of 2018, the NBRNM, as a banking supervisor in North Macedonia, had signed a Memorandum of Understanding (MoU) with the European Central Bank,[13] which has enabled the NBRNM to continue its participation in the established supervisory colleges for two eurozone banks present on the Macedonian banking market. Even though the NBRNM can participate in the supervisory colleges only as an observer, the colleges provide a valuable insight into the groups' operations and major risk exposures.

However, there is a room for further improvement. First, the NBRNM does not participate in the supervisory colleges of all EU banks present on the domestic market. Second, experience shows that information from home authorities (including the Single Supervisory Mechanism) has sometimes been difficult to obtain, especially regarding issues such as capital planning and recovery plans. In addition, there has been limited interaction with the home supervisor concerning measures undertaken or actions required that focus on achieving the stability and orderly operation of the EU banks (such as the restructuring plans agreed with the EU Commission), which can have adverse impacts on the host country's banking system and financial stability. Usually, the home authorities undertake these measures without fully considering the spillover effects of their actions on other banking systems.

When accounting for the influence that the presence of EU banks has on the host countries, special attention should be paid to the "pressure" to achieve greater compliance with EU standards and requirements in the regulatory and supervisory area. Harmonisation with EU standards reduces the regulatory and supervisory burden on the local subsidiaries, as both the parent bank and the subsidiary are required to comply with only one common regulatory framework. In addition, it provides further enhancement of host supervisory practices, which enhances banks' ability to tackle potential shocks and ultimately leads to more stable and sound banking and financial systems. However, though harmonisation strengthens the soundness of the system and puts banks in a position to compete with their peers on the EU market, if not tailored to the specifics of the host countries, it may distort their business models and their ability to grow.

11 Supervisory authorities from Albania, Federation of Bosnia-Herzegovina, North Macedonia, Montenegro, Republika Srpska and Serbia.
12 Later on, the Bank of Kosovo and Bank of Moldova also joined the MoC with the EBA.
13 All other supervisory authorities in the region have also signed similar MoUs with the ECB on a bilateral basis.

Two particular issues arise in this context – the impact of the differential treatment of home and host government securities in the risk-weighting of assets by parent banks and the implementation of the Bank Recovery and Resolution Directive (BRRD)[14] and related minimum requirement for own funds and eligible liabilities (MREL).

According to the Capital Requirements Regulation (CRR),[15] EU banks can apply lower risk weights on exposures to central governments and central banks of third countries only if the EU Commission adopts a decision determining that these third countries apply supervisory and regulatory arrangements at least equivalent to those applied in the EU. This provision requires full implementation of all requirements prescribed in the CRR. Without the decision of the EU Commission, the risk weights for this type of exposure are assigned in accordance with the third country's sovereign rating, i.e., in most cases, the EU parent banks (on a consolidated basis) are required to apply 100% risk weights to host government and central bank exposures of their CESEE subsidiaries. The effects of this provision are two-fold. First, third countries with a large presence of EU banks are forced to harmonise in full their banking regulation and supervisory practice with the EU, without leaving any room for adjustments or gradual implementation that might be needed because of the features of the third country's banking system. Lack of full implementation of EU standards does not mean that certain risks are not covered with the appropriate level of capital. As an example, the existing Macedonian capital adequacy regulation does not encompass the securitisation framework, as banking and capital markets lack such sophisticated financial instruments, but the risks arising from investing and trading in these instruments are appropriately captured with the capital requirements for credit and market risk. Thus, the lack of full harmonisation should not necessarily mean non-equivalence with the EU standards.

Second, in order to comply with already stringent capital rules, the CRR provision places additional pressure on the EU parent banks to reduce their investments in central bank and government securities of the host countries, by limiting the maximum amount of sovereign exposure of their subsidiaries. According to the National Bank's survey, 42.9% of the surveyed banks cited the introduction of new or tightening of the existing limits for exposures in government securities and central bank bills as an instrument employed by their parents to adjust to post-crisis

14 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

15 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

regulation (Basel II and/or EU regulation). The imposed internal limits may pose limitations for policy making in the host country, reducing the effectiveness of monetary policy, as well as fiscal policy, given that government securities are an important source of government financing, with domestic banks holding around one-third of total issued amount of government securities.

Similar challenges arise for the countries in the region from their effort to adopt the recovery and resolution framework established under the BRRD. Most of the banks in the region have traditional and conservative business models. Deposits, covering on average 70% of the banking sector assets, are the predominant form of bank finance. Banks operate with a liquidity surplus, which results in underdeveloped markets for senior unsecured debt. In compliance with their conservative model, banks are focused on lending to domestic retail and corporate clients, with only limited cross-border exposures, and this contributes to their stability. Loans to nonfinancial entities represent more than 50% of the banks' assets in the region, while the loans-to-deposit ratio is more than 80%. All banking systems are highly capitalised, with equity and reserves of more than 14% of the total assets.

If we consider the case of North Macedonia, banks operate with high Common Equity Tier 1 (CET1) ratio of 14.9% on average, where the CET1 instruments represent more than 91% of the banks' own funds. The total Pillar 1 and Pillar 2 capital requirements for Macedonian banks range from 9.6% to 17.5%. Starting from March 2017, banks are required to implement the capital conservation buffer (2.5%), while the banks identified as systematically important are required to implement additional capital buffers. Thus, the total amount of capital requirements (Pillar 1, Pillar 2 and capital buffers) for the banks in the country ranges from 13.1% to 20.0%, which is an indicator of their relatively high loss-absorbency capacity.

This indicates that, while bigger EU banks rely more on the financing from the wholesale market,[16] banks in North Macedonia (as well as in the region as a whole) hardly issue any senior unsecured bonds, while the level of long-term deposits of large corporate clients is marginal. The lack of a developed market for senior unsecured debt implies it would require a long time to build an investor base. Even if banks try to comply and decide to issue such debt, they would

16 According to the latest EBA Report on funding plans from September 2018 (https://eba.europa.eu/documents/10180/2357155/EBA+Report+on+Funding+Plans.pdf), 159 reporting banks from all EU jurisdictions forecast a broad-based growth in the volumes of subordinated debt in the following three years, which suggests that banks plan to focus on bail-in-able instruments to comply with their total loss-absorbing capacity/MREL requirements and are preparing for the transition from central bank funding to market-based funding.

be challenged not only by the pricing (investors will demand high returns to account for the risk they might never get their initial investment back) but also by the availability of investors willing to assess and accept the risks associated with these instruments.

The compliance with MREL requirements, applied in a prudent way by the resolution authorities in these countries, might have unintended consequences. Namely, the BRRD requires banks to have enough liabilities eligible for bail-in, i.e., bank creditors will be written down or converted into shareholders, meaning that banks will be rescued internally without public money. Additional debt issued by the banks in order to comply with MREL requirements will result in an increase or restructuring of their balance sheets. Complying with the requirements by raising most of the funding in foreign currencies will bring unnecessary foreign exchange risk onto their balance sheets. This will have an adverse effect on countries' de-euroisation initiatives, one of the pillars for managing systemic risks. Given the characteristics of these instruments, price of funding will increase, and it would be practically impossible for banks to continue with their conservative investment policies. They might be forced to invest in riskier assets or cross–border markets, which would increase the riskiness of the whole banking sector. Such a shift in investment policy does not correspond with the traditional focus of these banks on the local market and their low risk appetite, which has so far contributed to their overall stability. Therefore, having in mind the structure, size and sources of funding of these banks, provision of loss-absorbing capacity by the parent might be the only available form of MREL at this stage of development of capital markets – in the form of either capital or bail-in-able debt.

Conclusion

The foreign presence in the banking systems of the countries in the CESEE region brought many benefits, increasing access to cross–border financing and providing for more efficient and competitive banks. Nevertheless, rising financial linkages also entail certain risks, as they allow for stronger propagation of external shocks and amplification of cycles. In some countries in the region, part of these risks materialised with the outbreak of the global financial crisis, when a sudden stop of cross-border financing occurred and parent banks faced deleveraging pressures which were transmitted to the host countries. Observing our country experience, one could conclude that North Macedonia fits into the pattern of countries with strong foreign ownership of the banking system but rather low dependence on parent banks and overall cross-border financing, given the sufficiency of local funding. The foreign presence strongly influenced the strategic profile of domestic subsidiaries and their corporate governance, as well the overall infrastructure and risk management practices. The low dependence on external financing, rather conservative business models, prudent regulation and the strong pre-crisis fundamentals of the banking system allowed us to withstand the global shock with no severe consequences. However, although no funding risk was present, some pressures, mainly in the form of risks of possible divestment of the large European banks, were felt and called for vigilance. This, together with the major regulatory overhaul at the global and European level, called for a thorough examination of their potential impact on the domestic banking system.

Guided by the experience from the last crisis, a few lessons can be learned for the future. First, inevitably, additional cross-border financing will be needed to support convergence in some of the countries in the region, including North Macedonia. Some of this finance will probably be channelled through the banking system, and in this context the consensus of having "balanced" cross-border banking should be respected, so as to maximise benefits and minimise costs. Second, the larger the presence of foreign international banking groups in smaller countries, the higher the probability that some of the group-level decisions might have an adverse impact on domestic subsidiaries. Recent history shows the necessity for strong home-host cooperation and involvement of all stakeholders when major decisions are made, so as to preclude possible negative consequences. Third, harmonising regulatory and supervisory standards is crucial, as it strengthens the soundness of the system and puts banks in a position to compete with their peers on the EU market, for instance. However, if some aspects of the regulatory framework do not fit with the specifics of the host countries, banks' business models may be distorted and their ability to grow compromised.

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Appendix I: Foreign presence in the banking systems in the region (Assets share of foreign banks, in percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
CEE average	**19.6**	**23.6**	**32.4**	**48.8**	**70.1**	**80.0**	**82.5**	**84.5**	**84.8**	**85.3**	**85.9**	**86.6**	**84.7**	**82.3**	**81.7**	**83.7**	**85.9**	**85.1**	**84.4**	**83.7**	**80.8**
Czech Republic	23.3	26.4	38.4	65.4	89.1	85.8	86.3	84.9	84.4	84.7	84.8	84.7	84.0	83.5	83.4	95.4	95.7	92.6	93.5	93.1	92.1
Poland	16.1	32.7	49.3	72.6	72.2	70.7	71.5	71.3	74.3	74.2	75.5	76.5	72.3	70.5	69.2	63.6	63.2	61.5	61.5	56.6	45.5
Slovakia	19.3	23.7	24.1	42.7	78.3	84.1	96.3	96.7	97.3	97.0	99.0	99.2	91.6	91.8	91.5	98.8	98.8	98.7	98.8	98.8	98.9
SEE average	**7.0**	**13.0**	**23.7**	**46.9**	**57.2**	**61.0**	**65.6**	**61.0**	**74.4**	**82.4**	**84.8**	**87.1**	**86.9**	**86.3**	**85.4**	**85.1**	**81.1**	**80.6**	**77.5**	**77.7**	**75.2**
Bosnia and Herzegovina	4.2	1.9	3.8	21.6	65.3	76.7	79.7	80.9	90.9	94.0	93.8	95.0	94.5	94.5	92.1	91.0	91.0	90.6	68.9	70.8	69.4
Burlgaria	15.5	32.5	42.8	75.3	72.7	75.2	82.7	81.6	74.5	80.1	82.3	83.9	84.0	80.7	76.5	73.6	69.8	76.3	76.4	76.5	76.5
Croatia	3.0	6.6	40.0	84.1	89.3	90.2	91.0	91.3	91.3	90.8	90.4	90.6	90.9	90.3	90.6	89.8	89.8	90.3	90.4	89.8	90.3
North Macedonia	11.8	11.4	11.5	53.4	51.1	44.0	46.9	47.3	51.3	53.2	85.9	92.7	93.3	92.9	92.4	92.1	68.3	69.1	69.1	69.9	70.5
Montenegro								31.0	87.7	91.9	78.7	84.6	87.1	88.4	89.7	90.0	90.0	79.5	77.6	75.5	73.0
Romania	6.8	25.2	43.6	46.7	51.4	52.9	54.8	57.5	59.2	87.9	87.3	87.7	84.3	84.1	81.8	89.8	90.0	89.9	90.4	91.3	77.0
Serbia	0.6	0.5	0.4	0.5	13.2	27.0	38.4	37.7	66.0	78.7	75.5	75.3	74.3	73.5	74.5	69.6	68.7	68.5	69.7	69.9	69.7
Baltics average	**34.7**	**64.5**	**63.5**	**76.1**	**87.9**	**96.8**	**96.6**	**94.4**	**95.6**	**95.5**	**95.3**	**95.2**	**94.9**	**94.4**	**92.1**	**94.9**	**93.2**	**93.4**	**93.0**	**92.3**	**90.3**
Estonia	28.8	90.2	89.8	97.4	97.6	97.5	97.5	98	99.4	99.1	98.8	98.2	98.3	97.9	94	95.8	94.8	94.7	94.1	92.7	89
Lithuania	40.5	38.8	37.1	54.7	78.2	96.1	95.6	90.8	91.7	91.8	91.7	92.1	91.5	90.8	90.1	93.9	91.6	92	91.8	91.9	91.7

Source: *IMF (2013) Financing Future Growth: The Evolving Role of the Banking Systems in CESEE: Technical note; BSCEE Reviews and central banks websites.*

Appendix II: Results from the NBRNM survey on effects from foreign banks entrance into the domestic banking sector

Figure 1.

Parent bank influence on domestic bank

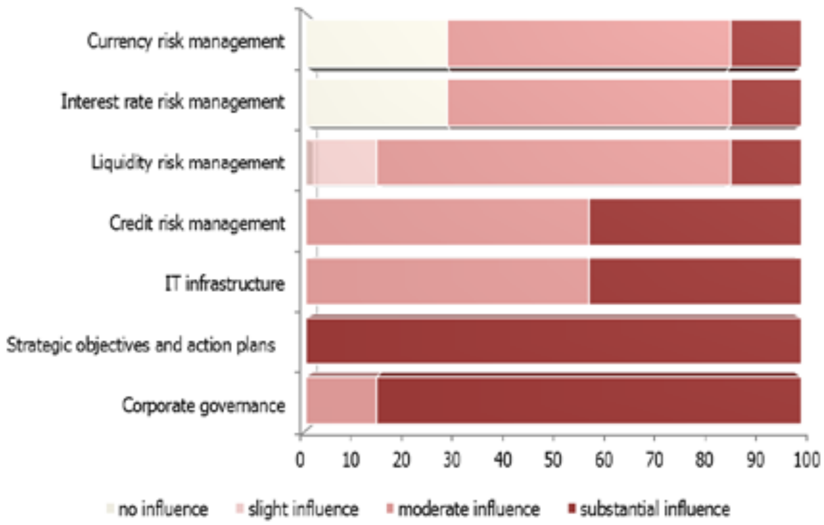


Figure 2.

Types of parent bank funding

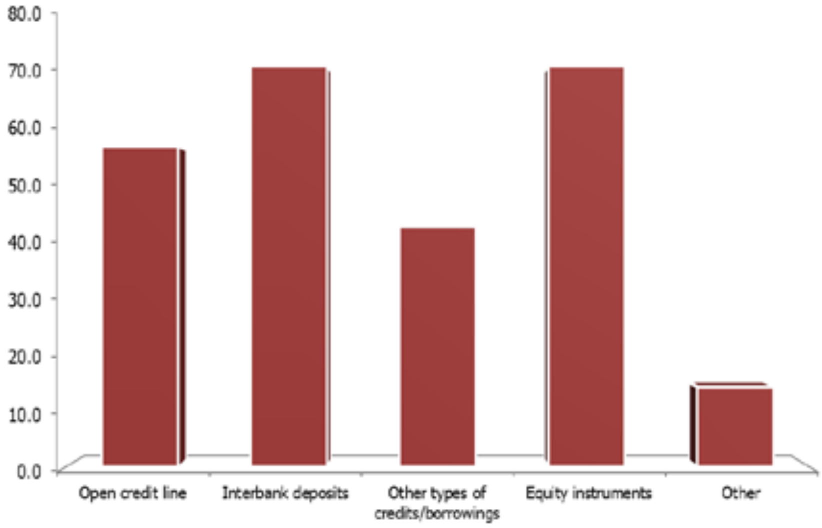


Figure 3.

Average share of parent bank funding in total sources of financing (excluding equity and reserves)

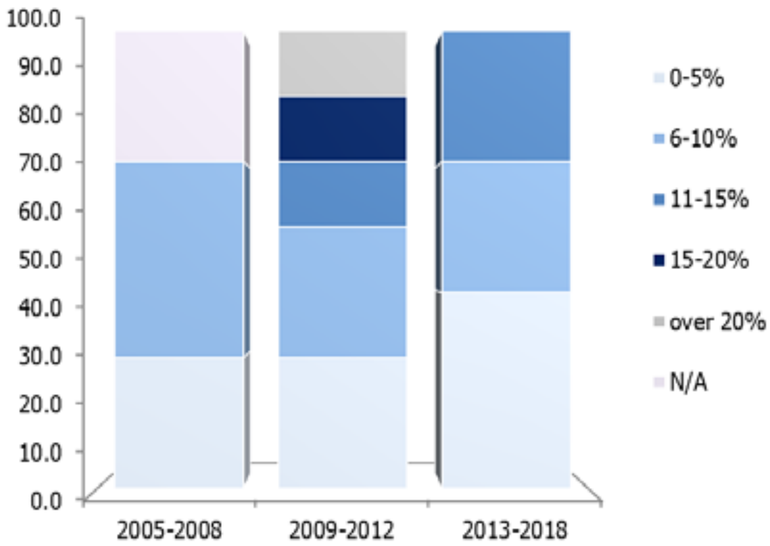


Figure 4.

Main reasons for parent bank funding

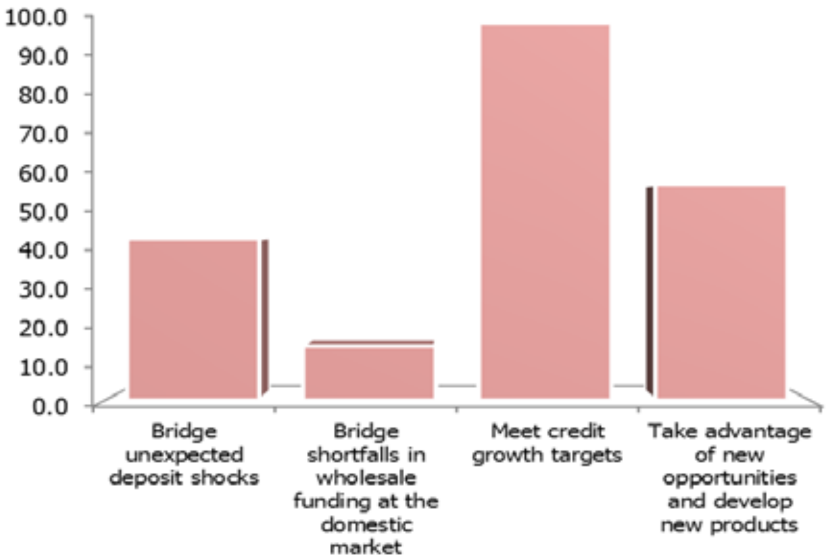


Figure 5.

Parent bank funding is a cheaper source of financing (compared to retail and wholesale financing on domestic market)

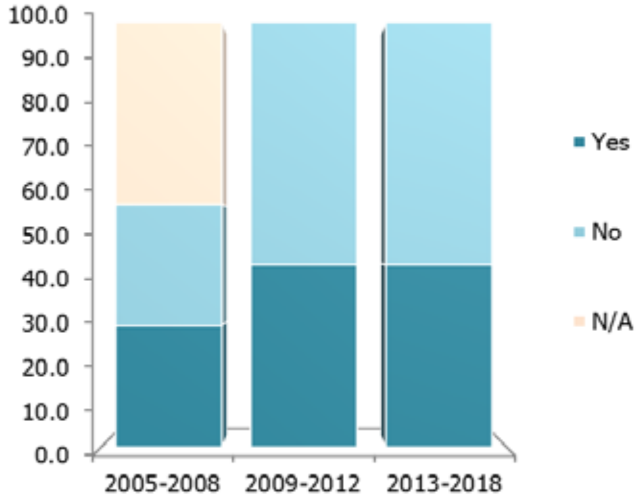


Figure 6.

Parent bank treasury desk

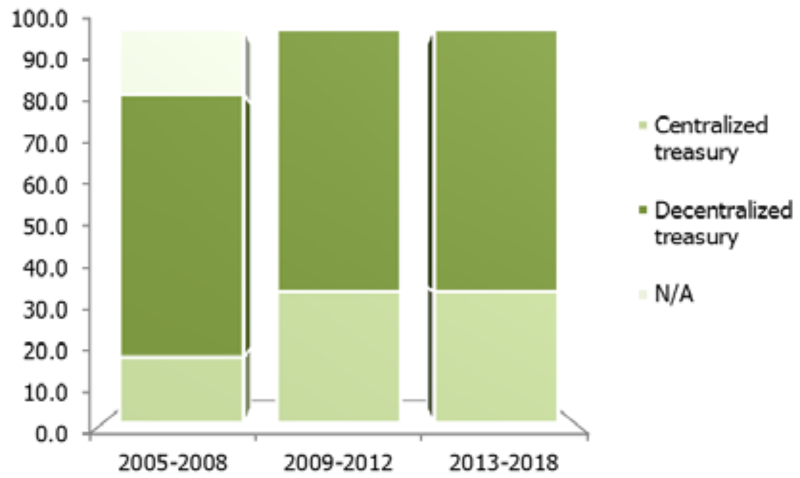


Figure 7.
Parent bank made changes in the financing model following the crisis

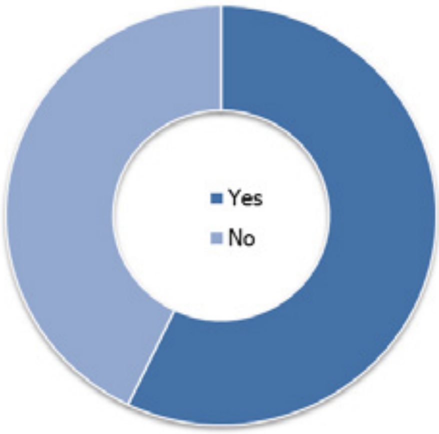


Figure 8.
Domestic bank approved credit to parent bank

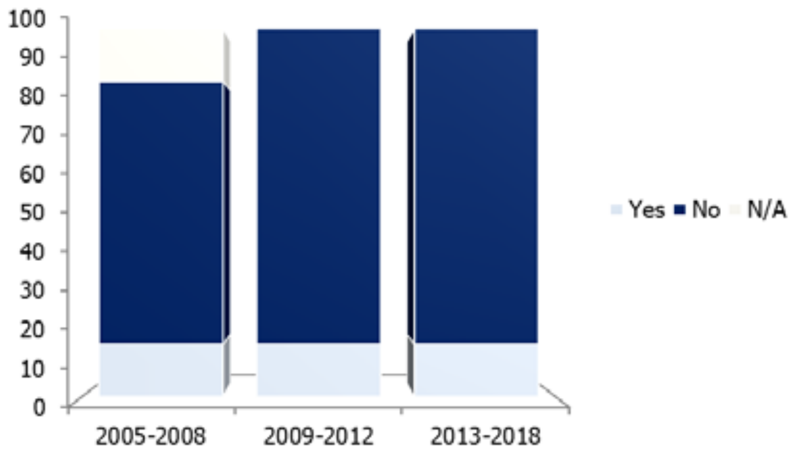


Figure 9.

Parent bank adjustment to post-crisis regulation (Basel III and EU regulation), effects on domestic banks

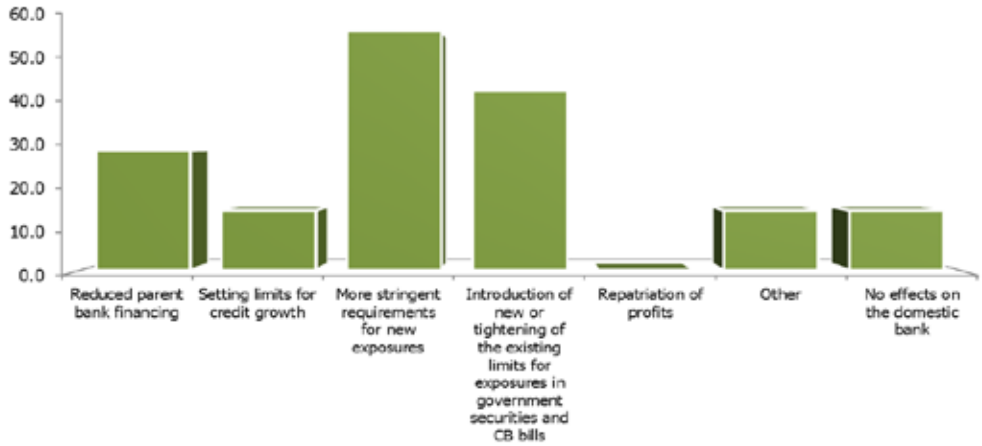


Figure 10.

Other reasons for parent bank deleveraging besides post-crisis regulation

Figure 11.

Parent bank fundamentals affect domestic bank

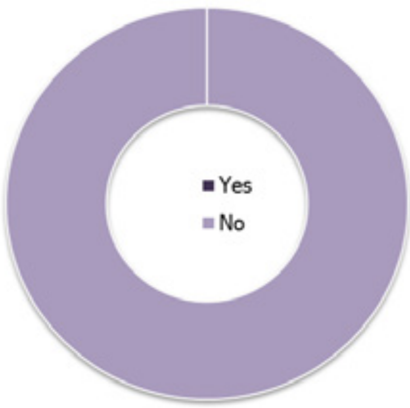


Figure 12.

Being a subsidiary of an international banking group, domestic bank sees as advantage or pitfall to more easily bridge:

international shocks **domestic shocks**

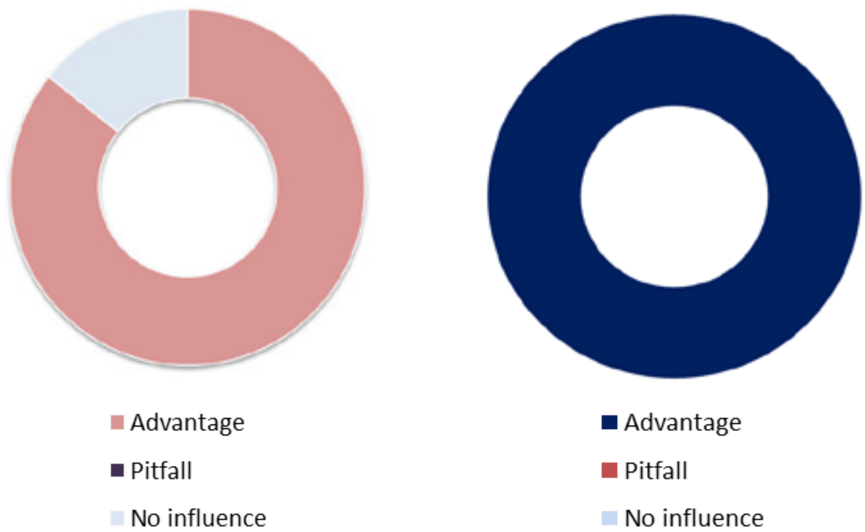


Figure 13.

Main benefits from the entrance of the foreign banking groups into the domestic banking sector

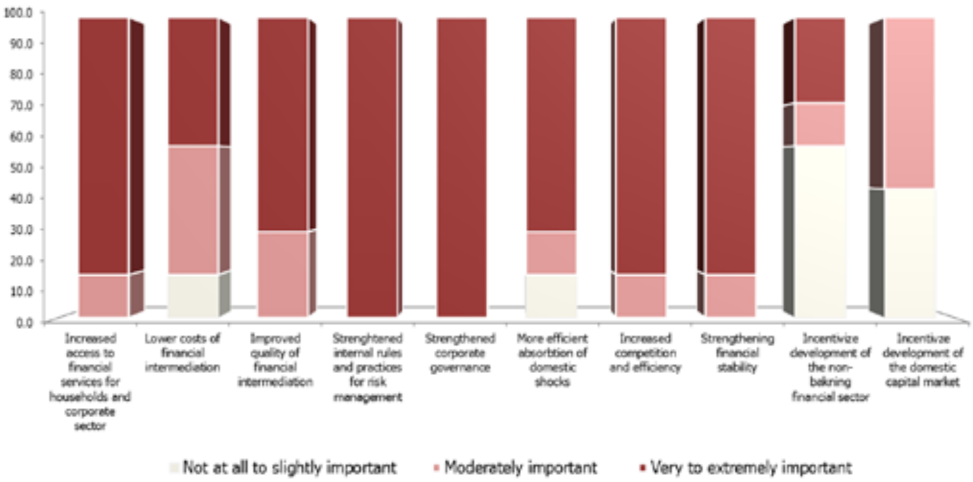
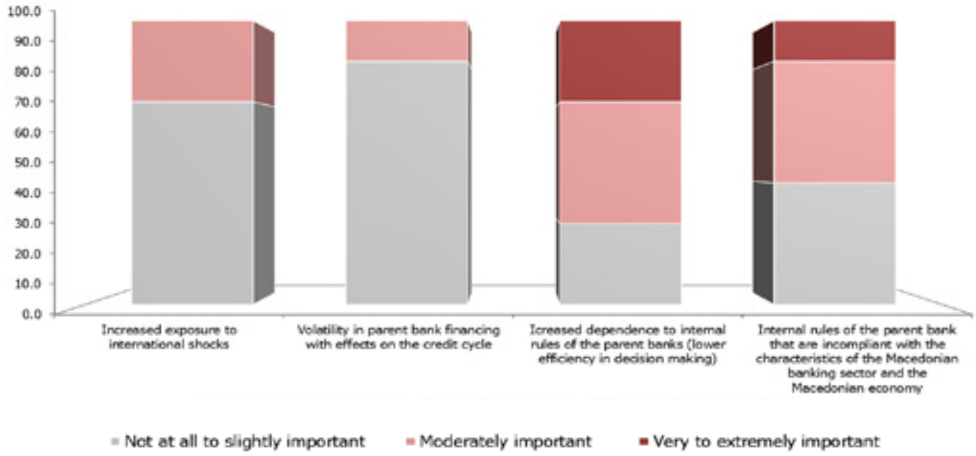


Figure 14.
Main pitfalls/costs from the entrance of the foreign banking groups into the domestic banking sector



Source: *NBRNM survey on the effects from foreign banks entrance into the domestic banking sector, January 2019.*

Note: *The Figures show the share of surveyed banks in percent.*

CHAPTER 15

Reforming the banking sector in Albania in the light of the Vienna Initiative

Gent Sejko

(Governor, Bank of Albania)

Abstract

This chapter reviews the main developments in the Albanian banking sector during the boom-and-bust cycle of the past 15 years and shares the experience of how local authorities led the banking sector through necessary reforms to overcome the crisis and post-crisis challenges and to adapt to the new financial environment. While going through the timeline of these events, we pay special attention to the important coordinating role played by the European Bank Coordination "Vienna" Initiative (1.0 and 2.0) in dealing with the deleveraging by EU banks in the Central, Eastern and Southeastern Europe (CESEE) region, and the resolution of high nonperforming loan (NPL) levels. While it can be intuitively seen that, in the case of Albania, Vienna 1.0 had some indirect positive spill-over effects on the lending behaviour of local EU subsidiaries during the crisis, the effect of Vienna 2.0 was much more direct. The platform played an important guiding role in helping local authorities to address the issue of NPL resolution and undertake the necessary reforms. It is still contributing today through information and experience sharing, as well as coordinating the interests of the public and private stakeholders, while adopting a new growth model for the financial industry focused on innovation and productivity.

Introduction

The liberalisation of the financial system in Eastern European countries as part of their transition process from communism to capitalism in the early 1990s attracted the large-scale entry of foreign banks into the region. These newly liberalised markets with high growth potential became the hosts of affiliates of multinational

Western European banks looking for profitable opportunities in the region. Their presence increased significantly during the 2000s and was shown to be beneficial for the economic and financial development of Eastern European countries, since they provided abundant funding and increased efficiency, and brought useful know-how to the new markets. It is widely acknowledged that the entry of foreign banks in the CESEE region contributed to mitigating the effects of local crises and increasing financial stability in local markets (De Haas et al. 2015).

Once the global financial crisis broke out and started to spread towards Europe, the model of intense cross-border banking was put to the test, and the once beneficial economic and financial interconnectedness among Eastern and Western European countries became a source of panic and uncertainty in the crisis situation. Despite being little exposed to US sub-prime problems, multinational EU banks operating in Eastern Europe became seriously affected by the growing financial market distress after the collapse of Lehman Brothers in September 2008, suffering a sharp reduction in interbank liquidity. Banks therefore started to deleverage both at home and abroad, increasing concerns about whether they would continue to fund their local subsidiaries in emerging Europe. This risk was considered to be high because of the significant asymmetry in the relative importance of cross-border exposure between banks' home and host countries, which became very evident at the time of the crisis. The funding received by foreign banks (usually in the form of parent funding of subsidiaries, direct lending or banks' holding of securities) was very important for the Eastern European countries, while for the originating banks such exposures were minimal. A massive and uncoordinated reversal of financial flows would have endangered macrofinancial stability throughout the region, since it would have not only had negative consequences on local firms and households, but also exposed these countries to disruptive exchange rate fluctuations and major balance of payment problems. Moreover, the absence of agreement between the fiscal authorities in the home and host countries on how to share the burden of a defaulting subsidiary increased the risk of a run on funds from the region.

This situation highlighted the absence of a coordination mechanism to ensure banks' commitment to the region. The European Bank Coordination "Vienna" Initiative, launched in January 2009, came as the response to the institutional vacuum. Gathering relevant authorities (such as central banks and ministries of finance) from host and home countries, representatives of multinational EU banks and international financial institutions (IFIs), this platform aimed to introduce a coordinating framework between the public and private sectors, in order to mitigate possible adverse collective action of banks and to guarantee macrofinancial stability in emerging Europe.

A month later, the heads of European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and the World Bank Group (WBG) launched a Joint IFI Action Plan, offering at least €24.5 billion to support banking systems and lending to the real economy in Central and Eastern Europe. This support was integrated with International Monetary Fund (IMF) and European Union macrofinancial support programmes to five countries: Bosnia-Herzegovina, Hungary, Latvia, Serbia and Romania. In return, the parent banks of the largest foreign-owned EU banks operating in these countries signed bilateral and country-specific commitment letters in which they pledged to maintain their exposure to these countries and provide capital for their subsidiaries as needed. At the same time, host country authorities had to commit themselves to continuing the efforts of macroeconomic stabilisation, while home country authorities had to support the operations of their cross-border banks. This way, the Vienna Initiative developed into a public-private partnership that combined macrofinancial support by the IMF and EU with funding by development institutions and the coordinated "bail-in" of private lenders (De Haas et al., 2012).

The sovereign debt crisis in the euro area and a general economic slowdown provoked a second wave of EU bank deleveraging from emerging Europe during summer 2011. The need was felt once more to step up the coordination between banks and their home and host country authorities. In this context, in January 2012 the Vienna Initiative was relaunched as Vienna Initiative 2.0. According to its mission statement, the objectives of Vienna Initiative 2.0 were: (i) to help avoid disorderly deleveraging, which could jeopardise financial stability in host and home countries, (ii) to ensure that potential cross-border financial stability issues are resolved and (iii) achieve policy actions, notably in the supervisory area, that are taken in the best joint interest of home and host countries. Unlike Vienna 1.0, the new platform had a more formal institutional structure. A Steering Committee was formed, including the EBRD, EIB, IMF, WBG and the European Commission, as well as representatives of home and host country authorities and commercial banks (European Commission, 2017) . From the outset, Vienna 2.0 expanded the scope of its involvement beyond the monitoring of credit and deleveraging trends between the Western parent banks and their Eastern subsidiaries. During this second phase, the initiative advocated interests and coordinated actions of non-EU countries in the Western Balkans. As the crisis left most countries in the region with a large stock of NPLs, impeding banks' ability to lend and economic recovery more generally, in September 2014 the Vienna Initiative launched a regional action plan to coordinate national approaches for addressing the NPL problem. Hungary, Croatia, Serbia, Albania and Montenegro participated in this initiative, later joined by North Macedonia.

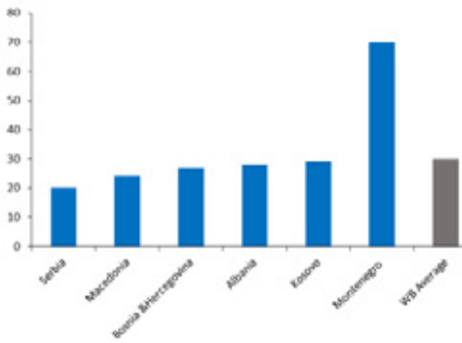
This chapter shares the Albanian experience in dealing with the issue of EU bank deleveraging and the high NPL legacy as the two major spill-over effects of the crisis. After going through the timeline of the crisis and post-crisis developments and challenges in the Albanian banking sector and the needed reforms undertaken by the country's authorities to address them, we also analyse the role and contribution of the Vienna Initiative in this process. While during the crisis and post-crisis period, the Vienna Initiative helped local authorities in the region to mitigate the effects of the crisis and cope with the remaining challenges (such as NPL resolution), nowadays this platform is being transformed into a knowledge and experience-sharing forum. Faced with the reality of EU banks consolidating at parent level and the risk of insufficient local funding resources, the new approach of the Vienna framework is guiding the region towards a new growth model while focusing on boosting innovation and productivity in the financial industry.

Weathering the effects of global financial crisis in Albania and the role of Vienna Initiative

Most of the challenges faced today by the banking sectors in Albania and other Western Balkans countries are a legacy of the boom and bust cycle of the past 15 years. Similar to that in most Eastern European countries, the banking sector in Albania went through a gradual privatisation process after the 1990s, which was completed in 2004 with the selling of the largest state-owned bank to Raiffeisen Bank, Austria. The liberalisation of the banking sector allowed some major international banking groups to enter the market. They were mostly branches or subsidiaries of multinational European banking groups and were able to provide adequate funding and know-how. Their importance increased substantially after 2004-5 (see Figure 1) expanding credit to the private sector and improving the overall efficiency, performance and profitability of the banking sector.

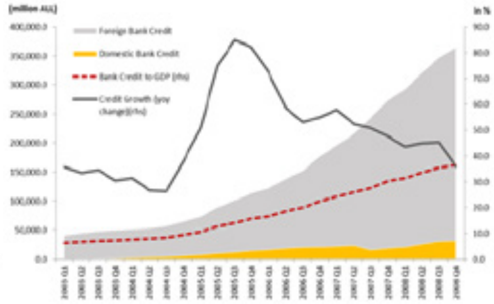
Average annual credit growth during the pre-crisis years was 40% (the highest rates recorded between 2004-8 reaching 57% on average), reflecting both demand and supply factors, but also owing to a very low starting base. This expansion of funding led to a jump in credit penetration, and the ratio of credit to GDP increased by some 30 percentage points between 2001 and the end of 2008. Albania stood somewhat in the middle of its regional neighbours, where the credit-to-GDP jump ranged from 20 percentage points in Serbia to 70 percentage points in Montenegro (see Figure 2). The credit boom contributed to rapid economic growth, but also led to rising imbalances and increasing risks to financial stability.

Figure 1.
Private credit-to-GDP in Western Balkans prior to the crisis



Source: IMF.

Figure 2.
Credit growth and credit-to-GDP ratio development in Albania during 2003-8



Source: Bank of Albania.

At the onset of the global financial crisis (2007/8), Albania and other Western Balkan countries seemed unaffected by it, mostly due to their very small exposure to the US sub-prime issue and low financial integration, and therefore their banking sector assets kept expanding.[1] In addition, lending was mostly domestically financed as, in contrast to some regional neighbours, the banks' reliance on parent funding had traditionally been low. By this time (2008 Q1), foreign banks almost totally dominated the financial sector in Albania, owning about 94% of total sector assets and providing 92% of total credit. About 73% of the total credit portfolio was denominated in foreign currency (mostly euro), and banks' loan portfolios were mostly dominated by corporate lending (65% of the total portfolio).

However, as the global crisis escalated and tightened financial constraints on most multinational EU banks, Western Balkan countries also experienced a reversal in external funding, though less severely than the rest of the CESEE region (such as Romania, Bulgaria and Latvia), mostly due to less leveraged banking sectors. As most EU countries entered a period of economic stagnation, various negative spill-over effects were transmitted to the region through financial and trade channels, unwinding the structural vulnerabilities and macroeconomic imbalances accumulated during the pre-crisis boom years.

1 During 2008, the Albanian banking sector increased its assets by 12.3% compared to the previous year, reaching about 86% of the country's GDP

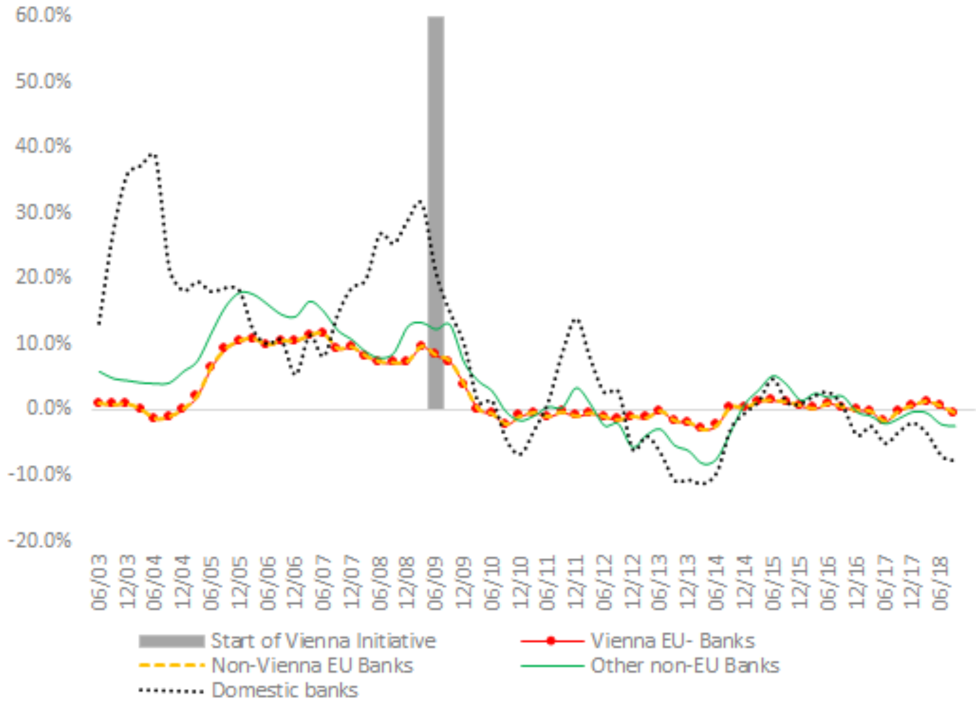
In case of Albania, the first spill-over effects of the global crisis were felt by the end of 2008, initially in the form of a deterioration in the balance of payments, mainly reflecting a decrease in exports and remittances from emigrants living in EU countries. On the other hand, increasing concerns regarding the escalation of the crisis heightened Albanian depositors' sensitiveness, leading to a withdrawal of deposits by the end of the year. The good capitalisation state of the banks (overall system capital adequacy ratio about 17%) and the swift actions taken by the Bank of Albania, such as liquidity injections through open market operations and amendments to the Law on Deposit Insurance, increasing the insurance premium and deposit compensation level, helped to some extent to overcome the liquidity stress. Nevertheless, the unstable performance of deposits and the ongoing deleveraging trend of EU parent banks affected the banking sector's lending activity. The combined effect of these developments was transmitted to the real-estate sector, harming the financial situation of corporates and households, which later translated into a deterioration in bank asset quality.

Credit growth in Albania therefore started to slow down from the high rates of the boom years, a result of both demand and supply factors. The shrinking of activity was more pronounced in the case of foreign banks, especially EU banks, compared to domestic banks or other foreign non-EU banks. Initially, Albania was not directly involved in the Vienna Initiative, since it did not face a major funding risk and banking activity was mostly domestically funded and less dependent on external funds. However, the country was host to six subsidiaries of EU banks that had become part of the Initiative and had committed themselves to maintaining their exposures to the CESEE region: Raiffeisen Bank, Intesa Sanpaolo, National Bank of Greece, Alpha Bank, Piraeus Bank and Société Générale. By the end of 2008, these banks owned, in total, 72% of the banking sector's assets, while their credit portfolio share accounted for 71% of the total lending portfolio of the system. Overall, they constituted a large share of the Albanian banking sector, making the country particularly dependent on their credit behaviour. Nevertheless, at the consolidated level, these subsidiaries had very small shares on their parents' balance sheets (usually not more than 2%), increasing the particular risk of a potential withdrawal of funds in case of consolidation actions at parent level.

In fact, these banks were the first to reduce their lending activity in Albania (from the end of 2008-9), compared with other foreign (EU and non-EU banks) and domestic banks, and were probably affected by the risk-averse behaviour towards the CESEE region of their parent banks under the growing pressure by EU authorities to consolidate their balance sheets in the light of the funding constraints in financial markets. To maintain the new capital levels set by European Central Bank (ECB) regulations, EU parent banks (large banking groups) also asked their local subsidiaries in Albania to reduce such activities as investment in government securities or low risk-weighted credit as part of the deleveraging process. As a result, the market share of these banks in terms of total assets diminished by 4-5% annually, falling to only 65% of banking system assets.

As the crisis fully hit the country (and the whole Western Balkan region) and bank deleveraging activity intensified during 2009-10, this trend was more contained in the case of EU banks following the commitments of their parent banks under the Vienna Initiative, compared with the other ownership groups operating in Albania (Figure 3). Faced with liquidity constraints due to low deposit growth in the country and the lack of access to alternative funding sources, domestically owned banks experienced the sharpest decrease in their lending activity.

Figure 3.
Annual change of the share of total loans/total assets (in percentage points)



Source: Bank of Albania.

Considering the complexity of the situation, it is difficult to isolate the effect of the Vienna Initiative in the lending behaviour of the "Vienna" banks in Albania from other effects, such as of Bank of Albania policy actions or banks' managerial decisions to cope with the crisis. Nevertheless, looking at the lending behaviour of banks in Figure 3, it can easily be seen that, while both foreign and domestic banks sharply curbed credit growth during the crisis, the banks whose parents took part in the Initiative remained relatively stable lenders, maintaining their leading position in the market. On the other hand, despite initial concerns that the focus of the commitment letters signed with five specific countries could tempt the committed multinational banks to support their subsidiaries in these countries by withdrawing funds from countries without exposure commitments, such as Albania, such negative spill-overs did not materialise. Several so-called "horizontal meetings" between multinational banks and relevant national and international authorities, coordinated under the Vienna Initiative between September 2009 and March 2010, helped to address such potential shifting of funds. Therefore, it can be intuitively seen that, in the case of Albania, this coordinating framework had some indirect positive spill-over effect on the lending behaviour of local subsidiaries of the "Vienna" parents, and that without such an effect the fall in credit growth in the country might have been much sharper.

The relaunch of the Vienna Initiative (known as "Vienna 2.0") in January 2012, to address the risk of a second wave of deleveraging of the EU parent banks in CESEE countries, expanded its coordination focus from preserving the presence of Western banking groups in CESEE region by providing capital and liquidity to their local affiliates as needed (the main focus of Vienna 1.0) to encouraging the authorities to cooperate in overcoming the situation. The mission statement clearly defined the objectives of Vienna 2.0 as being to help avoid disorderly deleveraging, ensure that cross-border financial stability issues were resolved and achieve policy actions, specifically in the supervision area. The renewed platform also established a more formal institutional structure and extended its geographical coverage to include other CESEE countries with a substantial Western bank presence. Non-EU countries could join the Steering Committee and participate in the dialogue between the relevant stakeholders. The Bank of Albania joined the Steering Committee in April 2013.

Since its launch, Vienna 2.0 has held several general policy and country-specific meetings and events in pursuit of its aims. The platform put effort into coordinating the discussion on issues arising from the crisis and also coordinated solutions, thus avoiding a unilateral crisis response. Several useful analytical tools (such as the CESEE *Deleveraging and Credit Monitor and Bank Lending Survey*) were also developed under Vienna 2.0 to provide strict monitoring of credit and deleveraging trends as well as assessments of future trends between Western parent banks and their Eastern subsidiaries. Such information has been useful in providing a wider picture of the situation, and domestic authorities, such as the Bank of Albania, include them in their own assessments of the banking sector and regional comparisons.

NPL resolution and the role of Vienna 2.0

In the years following the crisis, the Albanian economy entered a spiral of decreasing lending activity and stagnating economic growth. EU banking groups also kept deleveraging and gradually shrinking their activity due to their balance sheet consolidation under more conservative capital requirements from the EBA and as part of their overall exit strategies. Despite individual heterogeneities, similar developments characterised the whole Western Balkan region. Notwithstanding cross-country specifics, the negative feedback loop between low and decreasing credit growth and weak economic growth materialised in a sharp deterioration of banks' asset quality during 2009-14. Peak NPL ratios were the highest (above 20%) in Albania, Montenegro and Serbia. In some cases, increases in the volume of NPLs were reinforced by currency depreciation, as many household and corporate loans were denominated in foreign currency (mostly in euros for Albania) while borrowers' incomes were in local currencies. In the case of Albania, the NPL problem mostly affected the corporate sector; however, the rapid rise of consumer and housing loans in the run-up to the crisis increased the share of household NPLs in the total portfolio of problematic assets. Despite banks' increasing efforts to reduce NPLs by setting up dedicated internal units to deal with this matter, the result was minimal.

The growing volume of NPLs on banks' balance sheets in most Western Balkan countries created uncertainty and became a drag on credit growth due to their adverse effects on funding costs and profitability. This situation raised concerns not only from the financial stability point of view, but also from the perspective of monetary policy and ultimately economic growth. Various factors beyond the banking sector, such as legal and regulatory framework issues regarding collateral execution, hampered the process of NPL resolution. Less expensive ways to achieve debt settlements, such as out-of-court restructurings, were little used in the region. Despite various actions from domestic authorities to address this issue, NPL ratios remained at high levels until 2014. In the case of Albania, between 2011 and 2013 two working groups were established under the lead of the Bank of Albania and with the participation of other relevant authorities (such as the Ministry of Finance and Ministry of Justice), which aimed to address different problems related to NPL clean-up. The Bank of Albania introduced a package of countercyclical measures aiming to encourage lending in the domestic economy while discouraging banking sector investment in foreign assets.[2]

Nevertheless, considering that the presence of many structural obstacles that impeded NPL resolution in the region hampered the banks' ability to lend, there was an urgent need for concrete action. This required designing coordinated and comprehensive strategies needing effective collaboration between relevant authorities and private stakeholders. As a result, in September 2014, the Vienna Initiative launched a regional action plan to address the NPL problem under the framework of Vienna 2.0, and drawing on the output of the previously established Working Group on Non-performing Loans. Albania participated in this initiative, alongside Hungary, Croatia, Serbia, Montenegro and, later, North Macedonia. Since the clean-up of NPLs was a multi-dimensional problem, it required multi-pronged strategies tailored to country-specific conditions. Therefore, under the coordination and following the recommendations of the platform, the authorities in the participating countries increased their efforts in designing comprehensive and effective measures to alleviate the sizeable burden of NPLs on banks' portfolios. In this regard, the Albanian authorities launched a comprehensive national strategy in November 2015, with the aim of integrating and advancing the work on various reforms of supervision, enforcement, debt restructuring and insolvency.[3]

In brief, the whole package of policy actions and measures carried out by the Albanian authorities to address the two main post-crisis challenges – the high NPL levels and weak credit growth – resulted in a series of important amendments and reforms in relevant areas, including the following.

Amendments in the legal framework affecting NPLs, including amendments to the Civil Procedure Code to simplify and shorten collateral enforcement procedures, revision of the Bankruptcy Law to incorporate the best international practices, simplify the existing framework and protect economic and governance rights of secured and unsecured creditors, amendments to the Private Bailiffs Law and the Law on the Juridical Bailiff Service, in order to increase the efficiency of the foreclosure procedures and debt collection, amendment to the Law on registration of immovable properties, etc.

2 To stimulate domestic lending, lower capital requirements were applied to banks that increased their domestic lending by 4-10% on annual basis (this measure was abolished in 2016). On the other hand, higher capital requirements were applied to banks increasing their level of non-resident investment in foreign currency (this measure was abolished in 2018).

3 A timeline of these measures is shown in Annex 1.

Amendments to the existing NPL resolution framework, targeting three areas: (i) clean-up of banks' balance sheets through the compulsory write-off of all loans classified as "lost" for more than three years in a row; (ii) regulatory amendments to encourage bank policies on loan restructuring; (iii) guidelines by the Bank of Albania for commercial banks regarding out-of-court (debt) restructuring (OOCR) for corporates and households, in order to facilitate and accelerate NPL clean-up.

Regulatory changes introduced by the Bank of Albania regarding the management of banks' large exposures, management of credit risk from banks and branches of foreign banks, defining loan restructuring conditions, etc.

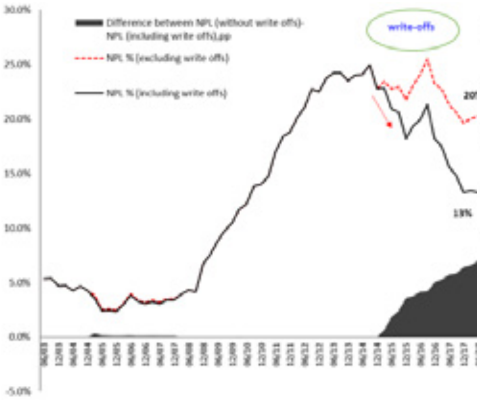
Amendments to the tax law, with the aim of removing some of the legal and technical issues impeding loan write-offs, especially regarding the classification of write-offs as a deductible item from banks' net income.

Other important actions included guidelines published by the Bank of Albania regarding real estate appraisals, OOCR for corporates and households, upgrade of the Credit Registry and the establishment of a credit bureau commissioned by the EBRD, etc.

While the aggregate results and effects of such structural reforms are difficult to quantify, and many of their effects will only manifest in the future, the enforced write-offs had a direct and immediate impact in lowering the overall NPL level in the Albanian banking sector. The Bank of Albania has estimated that, without these measures, the actual NPL level would have remained above 20% (see Figure 5).

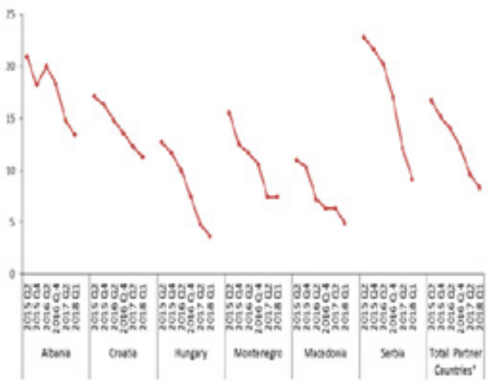
Judging from the developments in NPL ratios in the Vienna Initiative NPL partner countries (see Figure 5), as well as other NPL indicators shown and analysed in the *NLP Monitor*, one can conclude that the platform has been generally successful in guiding and coordinating the efforts in addressing the NPL issue. Despite country-specific factors, all partner countries managed to achieve a sustainable and consistent clean-up of banks' balance sheets, as well as important reforms in various areas contributing to the high levels of NPLs. Nevertheless, most of the reforms are still under way and their results are only expected to be seen in the medium and long term. On the other hand, important challenges (legal, regulatory, tax, structural, etc.) preventing banks from resolving their NPLs and from attracting secondary market investors still remain to be tackled, highlighting the need for a continuous collaboration and knowledge-sharing about NPL solutions.

Figure 4.
Developments in the NPL ratio and write-offs (in %)



Source: Bank of Albania.

Figure 5.
NPL developments in Initiative Partner Countries (2015-18)



Source: NPL Monitor for CESEE region 2016 H1, H2; 2017, H1, H2; 2018, H1, H2.

Post-crisis trends and challenges for the Albanian banking sector: adapting to the "new banking reality"

The Albanian banking sector successfully managed the crisis and post-crisis periods. Despite large NPL write-offs (up to 6% of GDP) and significant decreases in bank profitability, banks remained liquid and well capitalised, and thus no outside intervention was needed. Since the onset of the crisis, the Bank of Albania has worked intensively towards adapting the existing regulatory and supervisory framework with the aim of increasing banking sector resilience to external and internal shocks and to encourage the banking industry to adopt a more balanced and self-funded model in the medium and long term. Although foreign subsidiaries operating in Albania have traditionally been less dependent on parent funding than some regional neighbours, policy measures and regulatory changes have aimed at minimising the banking sector's reliance on foreign funding and at developing a banking model more based on deposits and domestic funding. It is important that the banking sector utilise existing opportunities and keeps carrying out its financial intermediation role and fostering economic growth at home, within the parameters of safe banking activity and in line with the requirements of the regulatory and supervisory framework.

As the economy gradually recovered from the crisis, domestic credit demand somehow bounced back.[4] Bank profitability has improved in recent years, mainly

4 Based on the results of the Bank of Albania Lending Survey conducted during 2018.

due to lower loss-loan provisions associated with NPLs, while capitalisation and liquidity buffers are well above regulatory minima. Nevertheless, credit growth has remained weak, lagging behind regional neighbours.[5] On the other hand, the low loan-to-deposit ratio (about 50%), by far the lowest in the region, suggests low funding risk but also less access to finance.

Some key post-crisis developments are judged to be a drag on credit growth, affecting the future prospects of the banking sector and the country's economic recovery in general. They relate mainly to supply factors, such as *asset quality* and the need to reinforce banks' balance sheets, as well as *indirect credit risk*. Despite the sizable reduction of non-performing loans on banks' balance sheets, the aggregate NPL ratio still remains above pre-crisis levels and the highest in the region. Moreover, the effects of the measures taken by Albanian authorities to facilitate collateral enforcement (described in the previous section) have not yet fully materialised, and various non–bank structural factors (of a regulatory/legal nature, etc.) continue to constrain the clearing up of bank balance sheets, putting pressure on their ability to lend.

The high share of foreign currency loans in banks' lending portfolios, and especially loans to unhedged foreign currency borrowers (as a legacy of the boom years), constitutes a tail risk to banking sector stability, since it exposes the system to adverse exchange rate movements. Addressing this issue has been a crucial part of post-crisis policies. The Bank of Albania has worked on various measures to encourage lending in domestic currency and reduce the high level of euroisation in the country.[6] Banks for their part have been following more prudent lending strategies to minimise the exchange rate risk and indirect credit risk from unhedged borrowers. This has resulted in a gradual rebalancing of banks' foreign currency loans from the high levels of the pre-crisis period (Figure 6).

Similar to that of other Western Balkan countries, the Albanian banking sector has also undergone some important structural changes in recent years. The gradual deleveraging, and the ongoing process of EU banks selling, merging and acquiring, has resulted in a continuous shrinking of their market share against other foreign-owned banks and domestic banks (Figure 7). This has particularly been the case of the Greek banks that faced stress in the past and had to consolidate capital at parent

5 By 2018 Q3, the stock of bank credit to private sector had decreased at an annual rate of 0.7%.
6 During 2018, Bank of Albania designed a comprehensive de-euroisation strategy, including the country's public and private stakeholders (Ministry of Finance, Financial Supervisory Authority, banks and non-bank financial institutions), to promote the use of the national currency in financial sector activity and the economy in general.

level as part of their bailout restructuring plans. They were the first to significantly downsize their activity in Albania and the Western Balkan region in general, and some of them have already been sold or are in the process of being sold. Despite the deleveraging trend from EU parent banks seeming to have come to an end in the region, they still see limited prospects, and many of them are following global trends towards self-funded subsidiaries (IMF, 2017).

Figure 6.
Currency-based loan structure of the Albanian banking sector

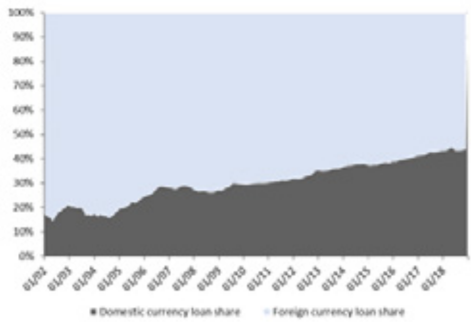
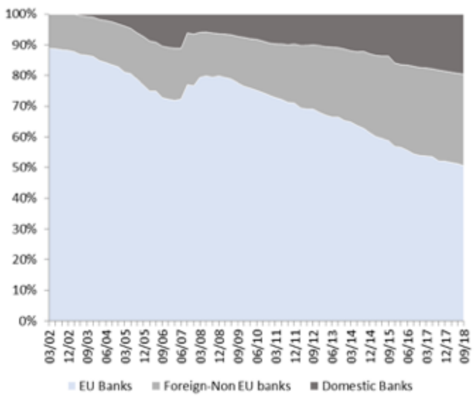


Figure 7.
Changes in the structure of Albanian banking sector assets



Source: Bank of Albania.

The approach of the Bank of Albania is to lead the banking sector towards a gradual consolidation, through encouraging the takeover of existing banks by banks already operating in the country, while preserving the credit growth and safeguarding financial stability. Such consolidation has reduced the number of banks from 16 at the beginning of 2018 to 14, which is still considered to be high in the light of the size of the market, but is also expected to strengthen the balance sheets of the remaining players.

Given the deleveraging trend and lower activity of EU banks, funding risk might become a challenge in the long run. Despite the abundance of local funding resources up to now, these might become insufficient in the future once credit demand picks up. The potential for domestic deposits to fully offset the reduction in foreign funding remains a common challenge for most Western Balkan countries. Moreover, the possibility of a return to more EU parent funding is low, as these parents see limited prospects in the whole region and are gradually implementing exit strategies, while pressures from EU regulatory authorities to reinforce balance sheets at the parent level remain high. Looking towards the medium term, the design of effective policy measures to diversify bank funding through the development of domestic capital markets, as well as expanding domestic savings, might meet this challenge.

Despite their shrinking activity, the subsidiaries of the EU banking groups are still important systemic players in the financial systems of Albania (accounting for over 50% of total banking sector assets) and other Western Balkan countries. Therefore, the authorities in the region have been closely monitoring the banks and communicating with parent banks to maintain an adequate funding base and avoid potentially disruptive episodes. In this context, the Vienna Initiative plays a crucial role, encouraging and coordinating the dialogue between parties, especially after the establishment in 2015 of the two pillars of European Banking Union, the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM), which were expected to bring significant changes to the domestic supervisory framework in host countries of EU banks' affiliates. This is because a significant part of total bank assets in the region are assessed on a consolidated basis under ECB supervision. Although the establishment of the SSM and SRM was considered beneficial to host countries, since it increased financial stability and reinforced home-host supervisory coordination, some concerns were raised, mainly relating to the significant asymmetry in the importance of the EU banks' subsidiaries to the host countries compared to their small size as part of their parent banking groups. It was therefore in the interest of both domestic and foreign supervisory authorities to develop effective cooperation mechanisms, exchanging information and knowledge to facilitate the banking industry's adaptation to a new reality while safeguarding financial stability in the region. The Vienna Initiative played an important role in this matter by advocating countries' interests and coordinating the collaboration between the European Banking Authority (EBA) and six Southeastern Europe countries,[7] including Albania, leading to the signing of a Memorandum of Cooperation in October 2015.

This agreement established a framework for cross-border cooperation and information exchange between the EBA and the participating countries' supervisory authorities. It has helped by setting up a dedicated forum with the aim of strengthening banking regulation and supervision in the signatory countries, as well as aligning their regulatory and supervisory standards and institutional arrangements towards those of the EU. So far, it has facilitated information sharing

7 The Signatory Supervisory Authorities were the Bank of Albania, the Banking Agency of the Federation of Bosnia and Herzegovina, the Banking Agency of the Republika Srpska, the National Bank of the Republic of Macedonia, the Central Bank of Montenegro and the National Bank of Serbia.

by both parties on the main developments and changes in supervisory practices and college activities, as well as on the main risks and vulnerabilities affecting the domestic banking sector in the participating counties. As Marek Belka commented in the Vienna Initiative Steering Committee, this Memorandum "is one of the visible effects of the works of Vienna Initiative and may serve as a model for future coordination".

While expanding and reinforcing its coordination focus, the Vienna Initiative has gradually grown into a wide, high-level network and a virtual thinktank that, time after time, brings together public and private stakeholders who share a common interest in financial stability and developmental issues in the region. Both the risk of insufficient funding sources and reduced competitiveness and productivity in the banking sector due to EU bank consolidation at parent level are becoming serious growth challenges in Eastern European countries. The new approach of the platform therefore aims to guide the region towards a new and more balanced growth and financing model, with a stronger focus on increased productivity and innovation in the banking industry. Its presence and continuous collaboration with the domestic public and private stakeholders will thus be crucial in helping the adoption of the latest technologies that are new to local markets and in coping with the challenges related to them.

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Annex 1

Timeline of reforms and measures implemented in Albania to address the NPL issue.

Publishing/Approval Date	Type of Measure	Explanation of the measure
2013	Out-of-Court Debt Restructuring (OOCR):	Guidelines on "corporate OOCR" and "OOCR for individuals" were issued by the Bank of Albania in 2013 to guide banks with OOCR aim of accelerating the reduction of NPLs. In 2016, in further consultation with banks, the Bank of Albania unified and revised the guidelines and prepared the final draft of the new Framework for OOCR.
October 2013	Improved collateral execution	Changes in the law in progress. Amendments to the Civil Procedure Code became effective in October 2013 to help simplify and shorten the collateral enforcement procedures.
January 2014	Published guidelines	The Bank of Albania published (1) the guidelines on loan restructuring for individuals and (2) guidelines for the preparation of real estate appraisals used for the purpose of obtaining a loan from financial institutions.
April 2014	Amendment to the tax law	Albania, Letter of intent, Memorandum of economic and financial policies and technical memorandum of understanding, 27 January 2015. In effect since April 2014 and with the aim of removing some of the legal and technical issues impeding loan write-offs.
July 2015	Management of Large Exposures	A regulation was issued by the Bank of Albania in July 2015 to enhance the responsibility of Board of Directors and setting out rules and criteria for calculating, supervising and reporting a bank's large exposures to a person/client or group of persons/clients connected between them or with the bank.
Early 2015	Write off	Bank of Albania regulation came into force in early 2015 to mandate the write-offs of loans that have spent more than 3 years in the lost category.
November 2015	NPL Working Group and action plan	A comprehensive strategy to address the NPL issues was developed and published. It integrates and sequences reforms in the areas of supervision, enforcement, debt restructuring and insolvency. The plan is monitored and revised periodically.

Publishing/Approval Date	Type of Measure	Explanation of the measure
February 2016	New Law and amendments to the Law on registration of immovable properties	Approved by the Parliament in February 2016. The law and amendments improve the registration process for incomplete real estate developments, strengthening creditors' security over such collaterals and regulating conflicts following an enforcement procedure. Transfer of development rights to the bank are facilitated, thus allowing emancipation from the insolvent developer.
April 2016	Upgrade of Credit Register and establishment of a credit bureau	In April 2016, the Bank of Albania's credit register was upgraded to include loans undergoing court proceedings, restructured loans and loans sold to third parties. The EBRD commissioned a study on the feasibility of a Consumer Credit Bureau in Albania. In 2017, the Albanian Association of Banks undertook the initiative of establishing a new comprehensive Credit Bureau.
26 October 2016	Bankruptcy law	Prepared by the Albanian government in collaboration with International Finance Corporation (World Bank Group) and approved by the Parliament on 26 October 2016. The law incorporates the best international practices, simplifies the existing framework, allows for expedited approval of reorganisation plans and protects economic and governance rights of secured and unsecured creditors (incl. the ranking of preferred creditors in bankruptcy proceedings).
October 2016	Amendment to Private Bailiffs Law and Law on Juridical Bailiff Service	Approved in October 2016. Aims to increase the efficiency of foreclosure procedures and debt collection and improve the structure of fees for Bailiff Services (i.e., base tariff plus success fee).
October 2016	Amendment to the Law on Securing Charges	Approved by the Parliament in October 2016. The amendment reinstated definitions for "intangible property", "instrument", "securities" and "accounts" that were removed from the Law in 2013 (causing insecurity for legal professionals, banks and businesses).
November 2016	Amendment to the Civil Code	Approved in November 2016. Aims to harmonise the Civil Code with the new Law on Bankruptcy with regard to the ranking of preferred creditors in bankruptcy proceedings.

Publishing/Approval Date	Type of Measure	Explanation of the measure
November 2016	Amendment to the Civil Procedure Code	Approved in November 2016. Aims to harmonise the Civil Code with the new Law on Bankruptcy with regard to the ranking of preferred creditors in bankruptcy proceedings.
June 2018	Financial health assessment of top Albanian corporates	The International Finance Corporation and Financial Sector Advisory Center sponsored a study conducted by Deloitte of the financial health of top Albanian corporates. The report analyses different financial ratios across industries, covering the period from 2014 to 2016.

CHAPTER 16

European cross-border banking after the crisis

Michael Teig and Erik F. Nielsen

UniCredit Group

Why more consolidation is needed, particularly cross-border mergers

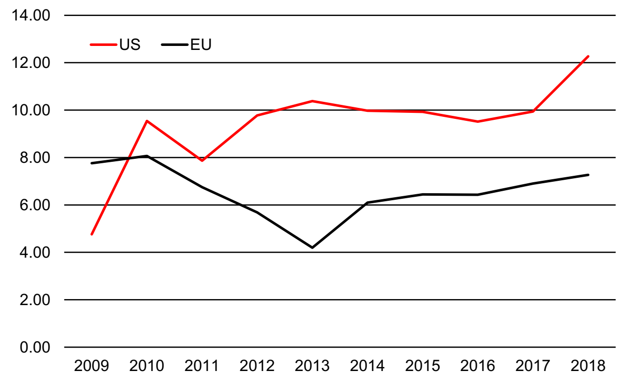
Persistently low profitability of EU banks

The European banking landscape recovered from the global financial crisis with banks well under way in their reform process, including dealing with legacy issues such as nonperforming loans (NPLs), and better capitalised. They have also made significant progress towards resolving litigation issues. The average profitability of European Union (EU) banks remains low, however, particularly compared to the large US banks. For financial year 2018, the largest 15 eurozone banks reported, on average, a return on equity of only 7.3%, compared with 12.3% for the largest 15 US banks. Higher profitability is one explanation for the higher stock market valuation of US banks, which have a price-to-book value of above one, while the stocks of EU banks are still trading at a significant discount to their book value.

US banks are more profitable than EU banks, leading to a higher equity valuation

Figure 1.

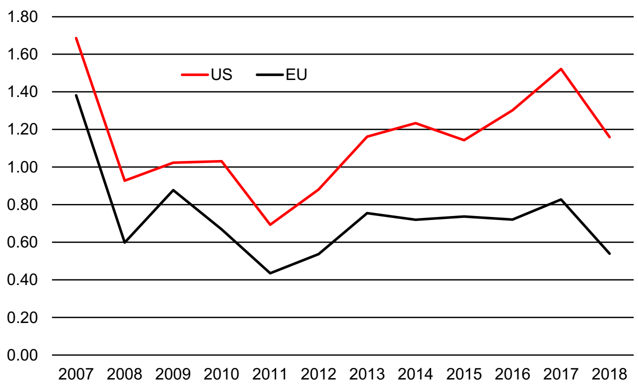
Return on equity of the top 15 EU and US banks



Source: Bloomberg, UniCredit Research

Figure 2.

Price-to-book value of the top 15 EU and US banks



Source: Bloomberg, UniCredit Research.

Drivers of the low profitability of EU banks

The underlying drivers of this difference in profitability are manifold, including both cyclical and structural ones. The low interest rate environment and low margins are cyclical factors. Structural components include increasing competition (e.g., in the form of new players or challenges to market position from other banks), higher regulatory costs, changing customer behaviour, digitalisation and an increasing share of capital market borrowing by corporate customers taking the place of traditional bank loans. US banks' better performance has also been boosted by the stronger GDP growth in the US than in Europe, the difference in monetary policy cycles (leading to different interest rate levels) and the increasingly dominant role of US banks in investment banking.

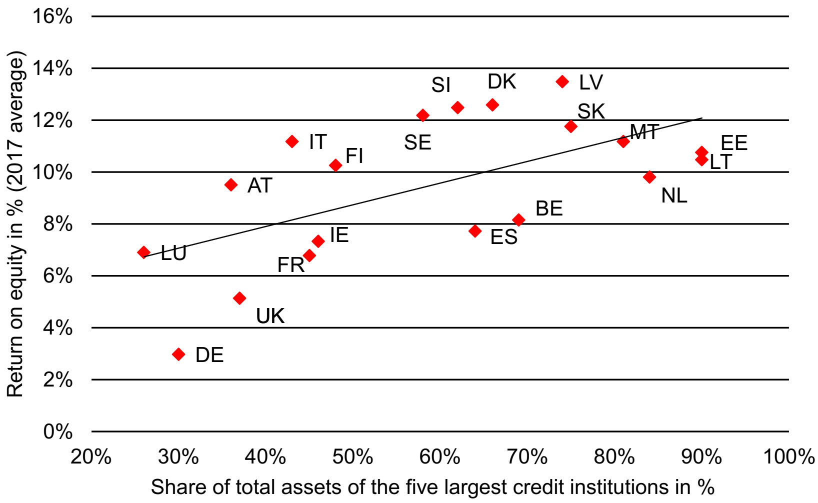
Furthermore, one important structural component of EU banks' inadequate profitability is linked to the fact that the European banking landscape remains fragmented and overbanked. The average share of assets of the EU's five largest banks at a national level is 48%, varying from 30% in Germany to 97% in Greece, according to 2017 European Central Bank (ECB) data, the latest available. This level of concentration in the financial sector in Europe is well below that of other highly industrialised economies.

There is clear empirical evidence that concentration of banking is positively correlated with profitability. In general, fewer banks might not necessarily lead to less competition, as domestic banks might face more competition from foreign players in a functioning single market. However, larger banks can provide banking services at lower costs, as they bring to bear economies of scale for expenses related to regulation and digitalisation.

Concentration matters, but focus on domestic mergers

Figure 3.

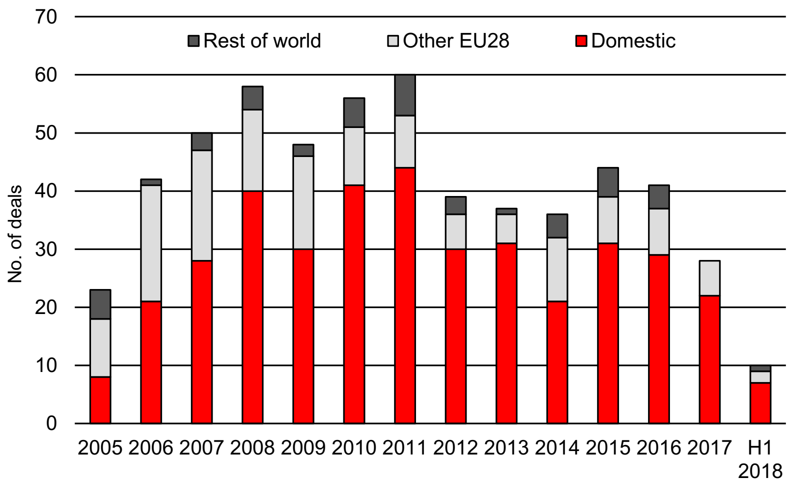
Link between concentration and profitability



Source: *European Banking Authority, Eurostat, S&P Global Market Intelligence, UniCredit Research.*

Figure 4.

The most recent European bank mergers are domestic



Source: *European Banking Authority, Eurostat, S&P Global Market Intelligence, UniCredit Research.*

Cross-border mergers and financial stability

Cross-border banking increases the geographical diversification of a bank's loan book and deposit base, thereby increasing its ability to absorb country-specific economic shocks. In the case of banks located in Central and Eastern Europe (CEE) countries, for instance, the dominance of foreign ownership has proven to be supportive for financial stability. Foreign banks initially brought extensive bank management expertise to less mature markets. This helped banks in CEE countries to catch up with Western European countries. As illustrated in the left-hand graph below, the outflow of funds from banks in core eurozone countries (Austria, Belgium, Finland, France, Germany and the Netherlands) during the sovereign debt crisis was more limited in CEE than it was in Europe's periphery, including Greece, Ireland, Italy, Portugal and Spain. Foreign banks had a strategic interest in remaining invested in foreign banking markets.

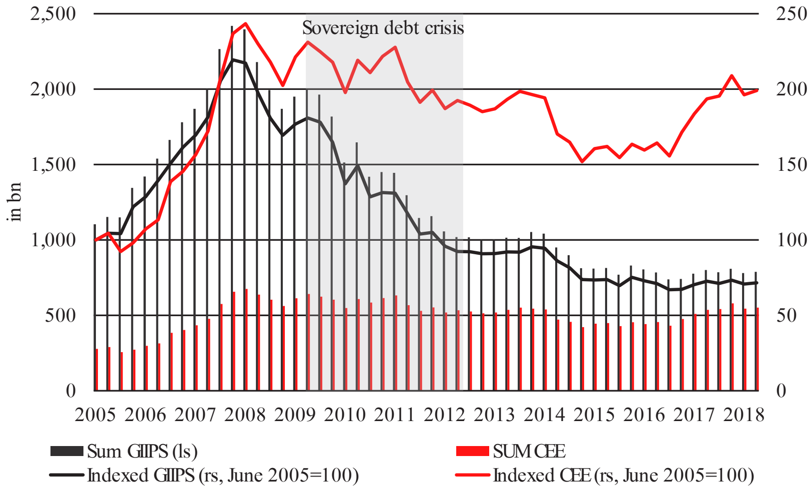
The biggest contribution of foreign banks to CEE was an inflow of cheap capital that allowed growth to pick up and asset prices to rise in CEE. The fastest catch-up to EU per capita GDP levels happened at a time when markets were liberalised, progress in reforms was fast before EU accession and banks expanded quickly in the region. Fund outflows were limited right after the crisis by the first Vienna Agreement, helping to smooth the recession in CEE. While negotiations were tense, foreign banks followed the International Monetary Fund's call and kept most of their exposure to CEE markets intact. Only when the ECB loosened the conditions in the second Vienna Agreement, did eurozone banks start to reduce exposure to CEE at a faster pace (see the fall for 2014-15 in the chart). By then, the recession was over, savings rates were high and private sector deleveraging was proceeding at a fast pace throughout CEE (allowing eurozone banks to cancel some of the funding lines granted to CEE daughters without affecting business).

Moreover, regarding cross-border banking, the accompanying increases in efficiency would lead to higher profitability, which acts as a first line of defence against potential shocks, and would support organic capital growth capacity.

An additional benefit of cross-border mergers is that they reduce the so-called doom loop between banks and sovereigns. There is a large home bias in sovereign-debt holdings (see right-hand chart below). If two banks were to merge across borders, the share of a single country's sovereign exposure relative to its equity would almost certainly decline.

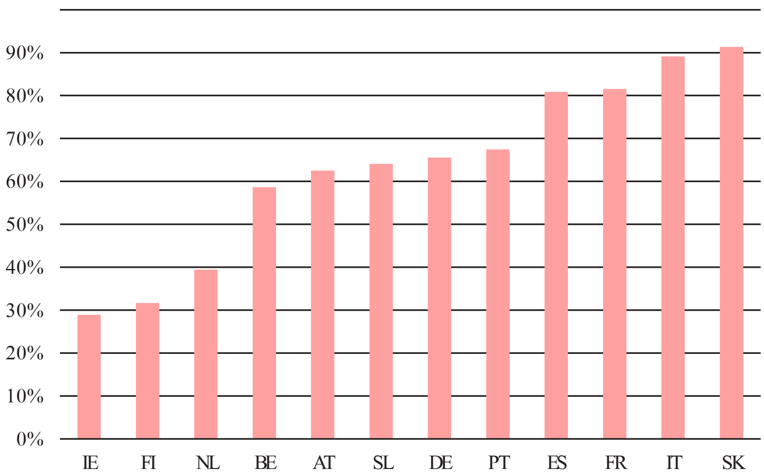
Core eurozone banks' exposures to Greece, Italy, Ireland, Portugal, and Spain (GIIPS) and CEE countries and home bias in sovereign holdings

Figure 5.
Development of exposure of core eurozone banks to GIIPS and CEE countries



Source: BIS, ECB, UniCredit Research.

Figure 6.
Home bias: banks' holdings of domestic general government debt to total general government debt (data as of January 2019)



Source: BIS, ECB, UniCredit Research.

The various forms of cross-border banking

Cross-border banking can take different forms, from cooperation in certain areas up to cross-border mergers and acquisitions (M&A), but to harvest the full benefits in terms of profitability and risk reduction, full mergers would need to be pursued.

Bank cooperation: Examples of cooperation include the joint back-office and IT systems of UBS and Credit Suisse, which includes shared operations in the areas of compliance, settlements and trade processing and the sharing of databases and servers. Another example is Nordic KYC Utility, a joint venture by the five largest Nordic banks to develop a shared know-your-customer (KYC) infrastructure. Both projects are in the early evaluation stage and the latter might face headwinds from recent anti-money-laundering issues, but these examples demonstrate that cooperation among banks can take various forms.

Bank M&A: The frequency and size of bank-related M&A deals declined after the financial crisis, when banks faced litigation, weak profitability in a low-interest-rate environment, deteriorating asset quality and new regulatory requirements. These factors distracted EU banks from exploring consolidation opportunities. Amid this overall decline in bank M&A deals, the share of domestic mergers increased while the proportion of cross-border mergers decreased. The share of domestic M&A deals among European banks increased from 50% before 2009 to 73% after 2009.

Strategic options to increase consolidation in the European banking sector will increasingly be evaluated

European banks have made good progress with regard to internal restructuring and to reducing stocks of NPLs, although cost levels remain elevated in many banks, particularly in Germany. The healthier banks' focus is now, therefore, increasingly shifting towards exploring strategic options for the future to secure adequate profitability and risk management, including non-organic growth opportunities. More consolidation in Europe is therefore both likely and desirable over the next few years. In the following, we evaluate the main obstacles to an increase in cross-border banking in the EU.

Existing obstacles to cross-border banking

In general, cross-border bank mergers within the EU have been hampered by the lack of a fully fledged European banking union, which would provide not only common regulation, resolution and supervision but also a European deposit-insurance scheme (EDIS), accompanied by a common and coordinated decision-making processes among the different competent authorities. Amid the lack of a truly common banking union, eurozone banks have broadly been separated into two categories.

Banks headquartered in the EU core countries have benefited in general from fewer legacy issues and a more stable macroeconomic environment. This has kept credit losses low and afforded banks low risk premiums on home sovereign bonds, which, in general, has translated into low wholesale-market refinancing costs. Therefore, these banks have faced little pressure to reform and adjust their operations or their cost-to-income ratios. As a result, their profitability has remained poor, and their price-to-book ratio well below par, leaving them very little currency with which to acquire banks in other countries.

Meanwhile, banks in the EU periphery have made generally impressive progress in adjusting costs and dealing with legacy NPL issues, but being located in countries with higher sovereign spreads compared to the core euro area has taken its toll. Hence, banks located in the EU periphery have faced considerably higher wholesale funding costs and somewhat more political risk compared to banks in the EU core. Concerns related to these issues are reflected in these banks' stock market valuations, which have also left them little currency with which to acquire banks in other countries.

On top of this, there is a risk that political pressure, sometimes exercised via direct shareholding and sometimes indirectly, is used to prevent potential cross-border mergers. Governments do not seem open to give up whatever national control they perceive they have over their banks in favour of creating larger European players. In addition, in core EU countries, resistance to cross-border bank mergers on the part of politicians and national regulators may also reflect worries that "their" banks could increase exposure to peripheral countries.

In more detail, the low proportion of cross-border mergers among banks in Europe can be explained by several factors: (1) supervisory barriers, including national favouritism on the part of regulators with regard to establishing capital, liquidity and resolution requirements; (2) ownership structure (less than 50% of European banks have a dispersed ownership structure); (3) variation in NPL levels and political risks; (4) a wide variation in legal frameworks in Europe (e.g., differences in insolvency procedures, labour laws, tax laws); (5) the third pillar of an EU banking union – an EDIS – has yet to be established.

Regulatory and supervisory barriers

Unfortunately, in spite of the impressive progress on a banking union, there are still supervisory hurdles to cross-border mergers. For a long time, the avoidance of "too big to fail" was a regulatory mantra. Since then, European regulators have seemingly become more open to forming larger banking groups, including those formed as a result of cross-border mergers. This change in sentiment has been driven by a greater appreciation of the fact that strong profitability represents a first line of defence against shocks to the banking sector.

At the level of the national regulators, there is, however, still a substantial degree of national discretion with regard to establishing liquidity requirements. The Capital Requirements Regulation (CRR) allows liquidity waivers to be granted to facilitate compliance with the liquidity requirements of the liquidity coverage ratio and the net stable funding ratio. However, several EU countries apply national exposure limits on intra-group exposure and these limits prevent these waivers from being used. This is not a surprise, as the responsibility to supervise banking has been centralised at the ECB (at least for the EU's larger banks). Nevertheless, the authority to regulate national deposit-insurance schemes still remains with individual Member States. The CRR does not envisage capital waivers.

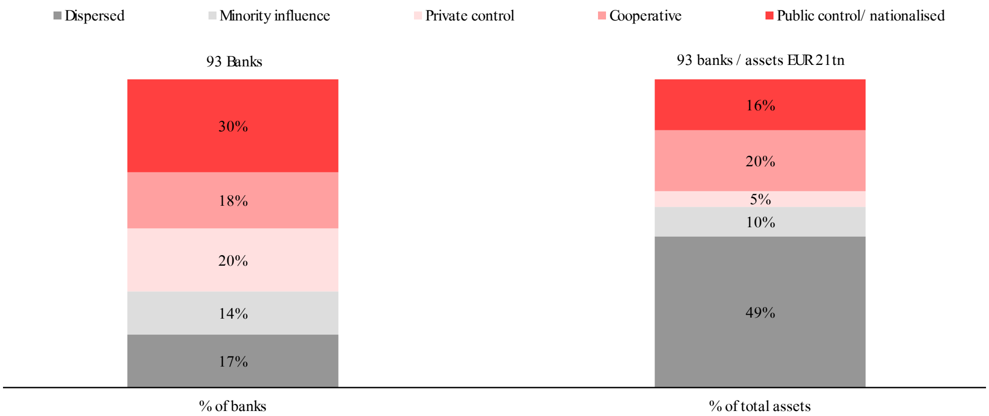
The national ring-fencing of capital and liquidity is one key obstacle to more cross-border concentration. National regulators play an important role in regulating non-ECB-supervised banks. However, banks under ECB supervision should not be subject to additional restrictions on the part of national regulators regarding liquidity in a functioning single market. The free movement of capital should also be allowed for banks under ECB supervision, as long as the bank fulfils its capital requirements at an aggregated level. Addressing this remaining national prerogative would improve the fungibility of capital and liquidity within single pan-European banking groups.

Regarding the global regulatory landscape, the framework regulating global systemically important banks (G-SIBs) assigns a higher systemic risk score to those banks that form larger cross-border entities. This also reduces incentives for cross-border transactions and geographical diversification.

The ownership structure of banks

The ownership structure of European banks plays an important role as well. Less than 50% (weighted by total assets) of ECB-supervised European banks have a dispersed ownership structure. Several EU countries boast a mix of public-sector banks, cooperative banks and private banks. Mergers among these banks are unlikely due to variations in their history and backgrounds, and for political reasons. Mergers are impeded by such an ownership structure. Also, a considerable 7% of banks (weighted by total assets) still remain nationalised following the financial market crisis and its aftermath. This is particularly surprising in an era where the political mantra is one of protecting taxpayers from risk in the financial system. Actual ownership surely exposes taxpayers to a considerably larger extent than any other relationship.

Figure 7.
Less than 50% of EU G-SIBs have a dispersed ownership structure



Source: Company data, ECB, Bloomberg, UniCredit Research.

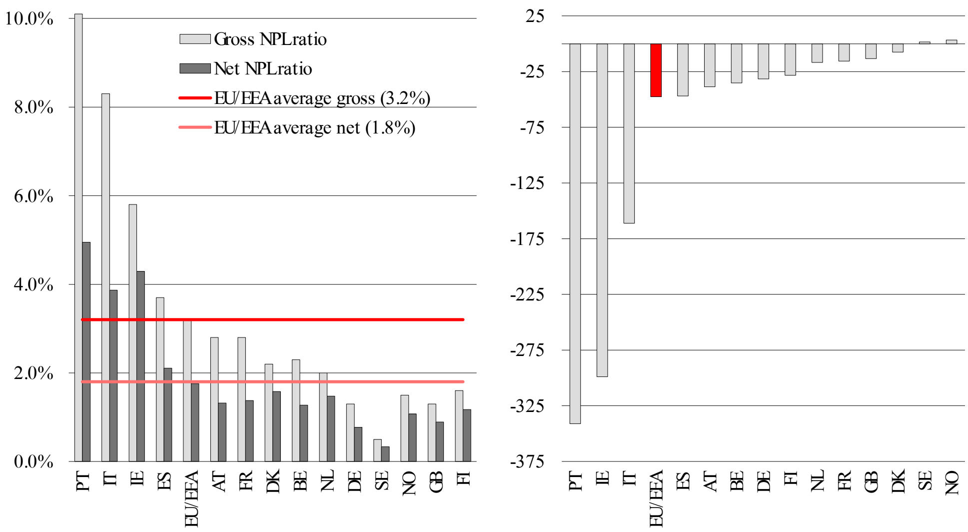
Heterogeneous levels of NPLs

The risks on the balance sheets of European banks are still heterogeneous for various reasons. Ireland and Spain, for instance, suffered from a real-estate bubble, which created large stocks of nonperforming housing loans after these bubbles burst. With the macroeconomic recovery, housing prices recovered in both states. This enabled banks to reduce outstanding NPLs quickly, either via an improvement in the market prices of underlying assets (which facilitated the sale of NPLs) or as the result of an increase in the proportion of NPLs that were able to be re-categorised as performing loans. The situation is different in Italy. Some 80% of Italy's NPLs are corporate loans, which are partly related to the structural decline of the manufacturing sector in Italy. This makes the NPL-workout process in Italy more complex and time consuming. The fact that Italy did not seek recourse under any of the European Stability Mechanism's support programmes (as Ireland and Spain did) in order to support the banking sector and offload NPLs into national NPL asset vehicles has further slowed down the clean-up process.

Figure 8.
2018 Q4 NPL levels among European banking markets

Gross and net NPL ratios among European banks

Year-on-year change in net NPL ratios in basis points



Source: European Banking Authority, UniCredit Research

Variations in NPL stocks across the EU represent one obstacle facing cross-border mergers. The reasons for this are twofold. First, variations in NPL levels have led to discounted stock market valuations. This has made shareholders resistant to agreeing to a deal at current valuation levels. Second, if a bank with a low number of NPLs were to merge with a bank with a higher number of NPLs, national regulators might be concerned by the risks that would end up being their responsibility.

The rapid decline in NPLs in all European countries is clearly positive and means that this obstacle is likely to recede in the coming years.

Political factors

While rarely visible, political factors play an important role in cross-border merger considerations. First, a merger can only be successful if the combined entity can cut costs, including a reduction in the combined workforce. Political support for a cross-border merger plays an important role in determining whether planned cost reductions succeed. Second, politicians determine national politics and, to some extent, European politics and therefore represent an important driver of economic growth, investment and fiscal positions, all of which are important to bank performance. Stable and reform-friendly governments therefore reduce the political-risk premium for cross-border mergers, making the outcomes of takeovers more predictable. Third, political willingness to support larger European institutions will have to replace thinking that has traditionally been limited by national barriers and that protects national players from forming larger entities with EU-wide competitors. Third, several national measures in recent years have had a negative impact on the functioning of the banking system and were not justified, including the taxation of bank assets and the forced conversion of foreign-currency-denominated loans. The unpredictability of the national regulatory environment lowers a country's attractiveness for cross-border banks.

Variation in the legal frameworks in Europe

The legal landscape within Europe differs from country to country with regard to the legal areas that are important to banks, such as labour law, tax law and insolvency procedures. The harmonisation of laws in these areas is, however, more of a long-term project, and it is uncertain whether there will be much more harmonisation in these areas. First, it seems that the EU currently has other priorities. Second, further harmonisation in these areas is a politically sensitive topic – one that requires strong commitment on the part of all stakeholders. Differences in national legal frameworks, however, partly explain why there have been more domestic mergers recently.

The EU's lack of an EDIS

The Single Supervisory Mechanism (SSM), the first pillar of an EU banking union, took effect in November 2014, and the Single Resolution Mechanism (SRM), the second pillar of an EU banking union, entered into force in January 2015. European banks are also subject to a single European rulebook. However, the third pillar of an EU banking union, an EDIS, has still not been implemented. The EDIS comprises a discussed scheme to protect retail deposits in the EU banking union. It was proposed by the European Commission in November 2015 but has not yet received political approval due to differing views on the progress on risk reduction in the European banking sector. Establishing an EDIS would strengthen deposit-insurance coverage and improve the confidence of depositors into Europe's banking system by establishing a European, rather than a national, recourse if a lender were to fail. If an EDIS were to be implemented, the reliability of retail deposits would improve, and the risk of deposit-based refinancing would decline. This would make the projections with regard to cross-border mergers more predictable.

Conclusions

More cross-border consolidation of European banking will both increase banks' profitability and reduce risk in the banking system. In order to promote such consolidation, politicians, regulators and banks should take steps to proactively address the obstacles summarised above.

Politicians and regulators have recently become more open towards mergers and have openly addressed the topic. Yet, politicians could do more, for example, to reduce government stakes in rescued banks and in making progress towards establishing a system of further risk sharing in Europe (EDIS). Politicians could also foster the establishment of a level playing field by smoothly re-privatising nationalised lenders and by working towards more harmonisation with regard to taxation and insolvency proceedings.

Regulators at the European level worked very efficiently and established a remarkable process to set up a working European SSM in a short time frame. For banks directly supervised by the ECB, the role of national regulators should be limited, however, and there should be no national restrictions on liquidity and capital if a banking group fulfils all such requirements at the group level, which is monitored by the ECB's SSM. More harmonisation would support the reduction of obstacles, with the requisite prudential safeguards in place to address the potential concerns of national regulators. International regulators, mainly the Bank for International Settlements, should reconsider their G-SIB scoring models and examine whether or not these hinder cross-border concentration. One should acknowledge, though, that changes have been implemented at the EU level in the recent banking package, although the revised methodology would not allow a bank to be disqualified as a G-SIB but could lead to a lower final G-SIB score.

Meanwhile, banks should continue to improve efficiency and to address NPLs and other legacy issues proactively. This would bolster the ongoing balance sheet de-risking trend among European banks and would help dispel the concerns of regulators and politicians with regard to the formation of larger banks. Moreover, digitalisation has changed customer behaviour. This presents a challenge – but also an opportunity – for banks. If banks use these opportunities and become geared more towards digitalisation, mergers will be easier to implement than they would be if they involve more costly, less agile and branch-focused business models.

If properly managed and supervised, larger banks would be more resilient to macroeconomic shocks. An improvement in geographical diversification would mitigate national economic shocks, and improved profitability would serve as a first line of defence (as a shock absorber) and would support organic capital growth.

Only sufficiently profitable banks will be able to attract, over the medium term, sufficient own-equity investors willing to put their money into bank equity and thereby willing to show their preference for banking over other sectors. All stakeholders therefore have an interest in making the European banking sector more efficient and in working towards reducing the obstacles it faces.

PART V

Conclusions on the achievement of the Vienna Initiative

CHAPTER 17

Success and failure of the Vienna Initiative mechanism and similar arrangements

Filip Keereman, Daniel Kosicki and Corina Weidinger Sosdean

European Commission[1]

Abstract

As a flanking measure to the financial assistance programmes for some countries in Central, Eastern and Southeastern Europe, the Vienna Initiative helped to avert contagion to neighbouring countries via the EU parent banks with cross-border activities and operations in the region. This success is based on a mixture of: (i) a cooperative approach, involving the private sector and concretised in a series of bilateral country-specific meetings and "Full Forums"; (ii) bilateral or general commitment letters by EU parent banks; (iii) involvement of European institutions (European Commission, European Central Bank – as observer) as well as international financial institutions (International Monetary Fund, European Bank for Reconstruction and Development, European Investment Bank and World Bank Group) and finally (iv) the institutional/governance setting of a banking group creating a strong link between parent banks and their subsidiaries. These aspects are highlighted and compared with the Nordic model of supervisory cooperation, which served as a source of inspiration for the Vienna Initiative. During the Greek crisis, an attempt was made to set up a similar arrangement, and it will be explained why this did not work at that time.

1 The views expressed in this publication are the sole responsibility of the authors and do not necessarily reflect the views of the European Commission. Statistical assistance from Rajko Vodovnik for charts and tables is gratefully acknowledged.

Introduction

When the financial crisis broke out in late 2008 in Central, Eastern and Southeastern Europe (CESEE), a specific feature of the banking sector in that region was its high dependence on foreign banking groups, in particular from the European Union (EU). It was feared that financial turmoil in one country could spill over to another via these interbank links. There was a conflict between the individual interest of the bank and financial stability for the system at large if all banks were to behave in the same way. Downscaling financial activity could affect both home countries, where the parent banks are located, and host countries, where their subsidiaries or branches are operating. Mistrust and the first mover advantage had to be overcome. This is a typical collective action problem, where the individual and common benefits are not aligned. A solution to the conflict may be sought in a multilateral setting, but success is not guaranteed. A solution, however, is facilitated when some conditions are fulfilled and incentives provided. The Vienna Initiative provided a framework which helped to bridge initially divergent interests.

First, we explain one of the key factors for success, namely arriving at a common understanding of the issues at stake. Second, we discuss the joint declarations and concrete actions specified in bilateral commitment letters, in order to go beyond good intentions. Third, we present the equally important financial support provided by the International Monetary Fund (IMF), the EU and the international financial institutions to the crisis-hit countries. Fourth, we highlight the strong intra-bank cross-border relations between parent and subsidiaries. What the Vienna Initiative achieved in its second phase, namely a controlled deleveraging, is put into perspective, by comparing it with similar arrangements elsewhere. Finally, we draw some conclusions.

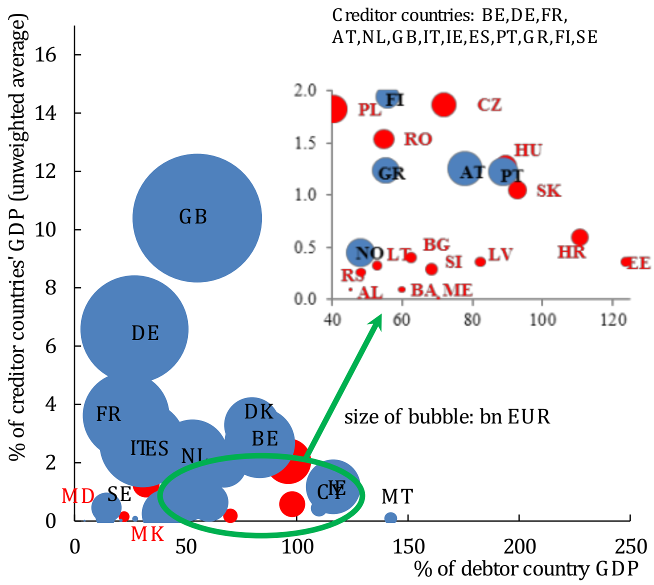
Mutual understanding of the issues at stake and the cooperative approach

One of the salient features of the exposure of the EU banking groups to the CESEE region is its asymmetry, depending on whether the analysis focuses on the home or host country of these banking groups. Before the outbreak of the financial crisis, the claims of the EU parent banks represented a 60-120% share of the GDP of the host countries in CESEE (Figure 1), while they accounted for less than 2% of GDP of the home countries of the respective banking groups. As a result, the exposure of the EU parent banks has been very important for host countries in CESEE, but negligible for the home countries of these banking groups. Due to high importance of the exposure of the EU banking groups for the host countries in the CESEE region, a "run to the exit" of the EU parent banks operating in the countries in

CESEE benefitting from multilateral financial assistance had to be prevented. Sudden capital outflows because of the uncoordinated withdrawal strategies by the EU parent banks would have led to a full-blown balance-of-payments crisis with severe consequences for these countries. The retrenchment of the EU parent banks would have also put at risk the macroeconomic and fiscal stabilisation programmes supported by the EU, the IMF and other international financial institutions (IFIs). In this respect, the Vienna Initiative played a key role in ensuring that the EU parent banks remained committed to the CESEE region.

Figure 1.

Importance of international exposure in some EU Member States and its neighbours, December 2008



Source: Bank for International Settlements.

The interaction between the public sector (EU institutions, IFIs, national central banks, home and host county supervisors, ministries of finance) and the EU parent banks operating in the CESEE region followed a cooperative approach, which entailed a series of multilateral/horizontal (Full Forum) meetings and specific meetings (bilateral country meetings). The Full Forum meetings (Table 1), which were organised at least once a year and benefitted from a large participation of both the official and private sector: i) assessed the outcome of the commitments of the EU parent towards the countries in the CESEE region; ii) discussed relevant supervisory and regulatory development at national and EU level; iii) endorsed the work of the various working groups set up by the Vienna Initiative; and iv) provided guidance on the strategic orientation of the Initiative and its future work streams. The main issues discussed and the decisions taken during each Full Forum meeting were made public through press releases published after the conclusion of the respective meetings.

Table 1.

Overview of country-specific exposure commitments and bilateral country meetings

Kick-off meetings (press release)		**Joint declaration**		**Bilateral letters (not public)**			
	Number of banks	**Date**	**Place**	**Date**	**Place**	**Reference date for exposure**	**roll-over rate**
Hungary	6	20.5.2009	Brussels	19.11.2009	Brussels	Sep-08	95%
Latvia	4	14.9.209	Stockholm	no (but vaguer letters of comfort were signed)			
Romania	9	26.3.2009	Vienna	19.5.2009	Brussels	Mar-09	100%
Bosnia Herzegovina	6	22.6.2009	Vienna	na		Dec-08	100%
Serbia	10	27.3.2009	Vienna	na		Dec-08	100%
Follow-up meetings (press release)	**Number of banks**	**Date**	**Place**	**Main results**			**roll-over rate**
Romania	9	18.11.2009	Brussels	No change in commitments			100%
Bosnia Herzegovina	6	26.2.2010	Vienna	No change in commitments			100%
Serbia	10	26.2.2010	Vienna	Change in exposure commitment from 1.4.2010 (reference date unchanged)			80%
Hungary*	6	22.07.2010	Brussels	No change in commitments			95%
Romania	9	22.07.2010	Brussels	Change in exposure commitment from 1.10.2010 (reference date unchanged)			95%
Romania	9	16.3.2011	Brussels	In line with precautionary programme, looser exposure commitment			none

Source: *European Commission.*
Notes: **The Hungarian programme and also the exposure ended in November 2010.*

The bilateral country meetings organised during the first phase of the Vienna Initiative provided a platform for assessing the fulfilment of exposure commitments by the EU parent banks towards Hungary, Romania, Latvia, Serbia and Bosnia-Herzegovina (Table 1). These meetings enabled discussion on the measure taken or envisaged by the national authorities to facilitate the maintenance of exposure commitments by commercial banks. All relevant public sector representatives, IFIs and EU parent banks of systemic relevance for the individual countries participated in these meetings. Before the bilateral country meetings, informal discussions between the IFIs and international banks took place.

Joint declarations and bilateral commitment letters

The EU parent banks operating in the countries receiving financial assistance agreed through joint declarations as well as general or bilateral commitments to maintain their exposure to these five countries and provide capital support to their affiliates, as needed. For Latvia, the EU parent banks did not sign bilateral commitment letters, but only a general commitment to maintain exposure to the country and promote financial stability in the Baltic region. In the absence of bilateral commitment letters, there were no specific reporting requirements for the participating banks regarding the maintenance of their exposure to Latvia. The Central Bank of Latvia monitored data on the net external liabilities of the Latvian subsidiaries to the parent banks[2] that signed the general commitment to maintain exposure to Latvia.

The EU parent banks signed bilateral commitment letters[3] to maintain their exposure to Hungary, Romania, Serbia and Bosnia-Herzegovina as compared to a country-specific reference date.[4] The bilateral commitment letters included an exposure roll-over rate of 100% as compared to the reference date for Romania, Serbia and Bosnia-Herzegovina, and, of 95% for Hungary. The participating banks provided data on the fulfilment of their exposure commitments on a regular basis, closely monitored by the home country banking supervisors. The assessment of the maintenance of exposure commitments and the measures adopted by the home country authorities to facilitate the fulfilment of these exposure commitments took place in the framework of country-specific meetings, at least once a year (Table 1), and the Full Forum meetings of the Vienna Initiative 1.0. These Full Forum meetings were organised once a year, mainly in Brussels (European Commission, 2017).

According to the bilateral letters signed by the EU parent banks, the exposure and capital commitments were supposed to cease at the end of the economic adjustment programmes for the assisted countries. In the case of Hungary, parent banks had to abide by the exposure and capital commitments only until the end of the balance of payments programme in November 2010. As regards Romania, it benefited from a first balance-of-payments programme (which ended in May 2011), followed by two precautionary programmes (2011-13 and 2013-15) with precautionary/contingent financial support. In the absence of exposure commitments under the second and

2 The four banks were Bank DnB NORD A/S, Nordea Bank Finland Plc, Swedbank AB and Skandinaviska Enskilda Banken AB.
3 The EU parent banks, which signed bilateral commitment letters were: Erste Bank Group, Raiffeisen International, Volksbank, Hypo Alpe Adria, Unicredit, Intesa Sanpaolo, Société Générale, KBC Group, Bayerische Landesbank, NLB, Alpha Bank, National Bank of Greece, EFG Eurobank and Piraeus Bank.
4 In the bilateral commitment letters, the exposure of EU parent banks was defined as: (i) the outstanding balances on all loans and other debt instruments owed by entities in these countries minus balances owed by the parent to financial institutions in these countries; (ii) the parent's deposits with financial institutions in these countries, less deposits of financial institutions with the parent; and (iii) all forms of capital by the parent to the subsidiary, including subordinated debt and hybrid instruments.

third programmes, EU parent banks committed themselves to maintaining their well-capitalised subsidiaries operating in Romania (i.e., solvency levels above 10%).

The involvement of official bodies

In order to alleviate the impact of the financial and economic crisis and coordinate the crisis response, in February 2009 three IFIs (European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), the World Bank Group) launched a *Joint IFI Action Plan* to support the economies in CESEE (Table 2). The main objectives of this Plan were to avert a system crisis, support banking sector stability and lending to the real economy in the crisis hit countries in CESEE. The EBRD, EIB and the World Bank Group (International Bank for Reconstruction and Development (IBRD), Multilateral Investment Guarantee Agency (MIGA), International Finance Corporation (IFC)) agreed a financing plan of up to €24.5 billion for the period 2009 10. The IFIs committed themselves to deploy rapid assistance in a coordinated manner, according to the policy and products of each of the involved institutions. The IFIs involved in the *Joint IFI Action Plan* were also significantly involved in the work of the Vienna Initiative. Overall, the IFIs exceeded their initial financing targets, as a response to a larger-than-expected impact of the financial crisis in the countries of the region. The total amount mobilised under the *Joint IFI Action Plan* reached roughly €33 billion at the end of 2010.

Table 2.

Joint Action Plan of the International Financial Institutions: commitment and delivery

EUR billion	Commitments 2009 - 2010	Available end-2010
Total	**24.5**	**33.2**
EBRD	6.0	8.1
EIB	11.0	15.5
World Bank Group	7.5	9.6
IBRD	3.5	5.2
MIGA	2.0	2.0
IFC	2.0	2.4

Source: *EBRD, EIB, World Bank Group.*
Notes: *The available funds from IBRD as of December 2018 include a €1 billion loan to Hungary which was later cancelled at the request of the government.*

The resources made available through the *Joint IFI Action Plan* complemented the multilateral assistance programmes granted by the IMF and the EU to EU and non-EU countries in the CESEE region most impacted by the crisis, namely to Hungary, Latvia, Romania and Serbia, as well as Bosnia-Herzegovina (Table 3). While the IMF granted financial assistance through Stand-By Arrangements (SBAs), the EU granted financial support to the Member States outside the euro area in the framework of balance-of-payments (BOP) programmes. BOP assistance took the form of medium-term loans that were conditional on the implementation of policies designed to address underlying economic problems. For non-EU countries, the EU granted macrofinancial assistance, which is a form of financial aid extended by the EU to partner countries (including candidate countries) experiencing a BOP crisis. It was only available to countries benefiting from a disbursing IMF programme. The total disbursing support committed by the IMF, the EU and the World Bank to Hungary, Latvia, Romania, Serbia as well as Bosnia-Herzegovina at the onset of the financial crisis amounted to €52.4 billion.[5]

Table 3.
Multilateral assistance granted by the EU, IMF and World Bank

	Hungary	**Latvia**	**Romania**	**Bosnia Herzegovina**	**Serbia**
EUR billion	Nov-08	Dec-08	May-09	Jul-09	Jan-09
Total	**20.0**	**7.5**	**20.0**	**1.4**	**3.5**
% of 2009 GDP	21.7	40.5	17.1	11.6	11.3
EU	6.5	3.1	5.0	0.1	0.2
IMF	12.5	1.7	13.0	1.1	2.9
World Bank	1.0	0.4	2.0	0.2	0.3

Source: *EU, IMF, World Bank.*
Notes: *The table does not include contingent programmes beyond 2011. For Latvia: including bilateral resources (€1.9 billion) committed by Sweden, Denmark, Finland, Norway and Estonia.*

The link between parent and subsidiary

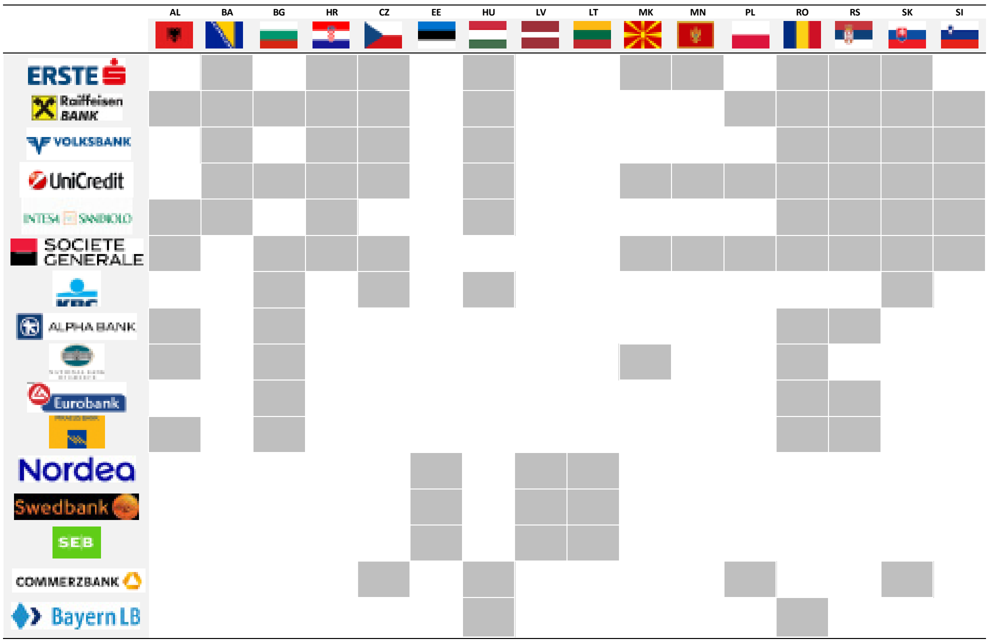
With a saturated home market, major Western banks have seized the opportunity to expand in CESEE since the early 1990s, when these countries opened their borders after the collapse of the Soviet Union (Figure 2). This took the form of both greenfield investment and acquisition of domestic banks. New financial services and payment techniques were introduced, and credit grew rapidly to finance the development of the economy. This led to a sharp increase in banks' balances sheets,

5 Since some of the recipient countries did not draw the entire financial assistance granted by the EU and the IFIs, the total disbursements to these five countries amounted to €40.6 billion.

and in several countries the market share of the foreign banks reached more than 80%, including in some Baltic countries, Slovakia, Czech Republic, and Romania. While the environment has been more volatile than that of the home markets, the contribution of these catching-up economies to overall group profits has been significant. In addition, the investment in buildings for local headquarters and branches, and in the transfer of know-how and staff means there is a strong footprint which foreign banks are unlikely to give up easily. Against this background, a sustained commitment of the Western banks to the region is understandable.

Figure 2.

Presence of major international banks in Central and Eastern Europe (as of 2011)



Source: S&P Global.

Impact of the vienna initiative in the light of similar arrangements

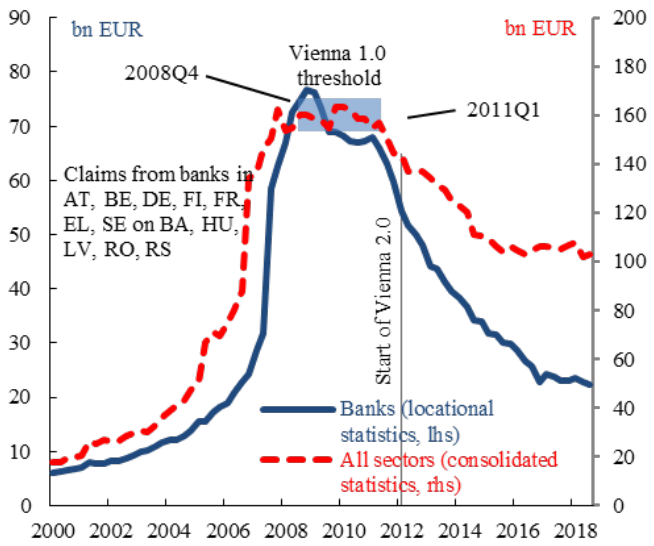
Based on mutual understanding and on the tight links between the involved stakeholders, the concerted action under the Vienna Initiative helped to stabilise the economies of Central and Eastern Europe. As illustrated by similar arrangements, a positive outcome could not be taken for granted, since such an outcome depended on the presence of some enabling conditions. Nordic-Baltic cooperation, on which the Vienna Initiative was modelled, was successful in avoiding financial stress in that region because of the strong involvement of authorities. However, private sector support during the Greek crisis in 2010 failed in the absence of important foreign bank subsidiaries in Greece and the complexity of the economic adjustment programme for Greece. Furthermore, Private Sector Involvement in debt restructuring, entailing a haircut on Greek government debt, did not help.

Vienna Initiative: temporary stabilisation of exposure paves the way for orderly deleveraging

Based on exposure data submitted by the banks to the host country supervisors, the highest exposure rollover rate compared to the reference data was in Hungary (i.e., 125%, data as of March 2011) and the lowest in Latvia (88%). Despite sizeable differences concerning the fulfilment of the bilateral or general exposure commitments, parent banks broadly maintained their overall exposure to these countries in 2009-10 (Figure 3) and provided the necessary funding to their subsidiaries throughout the multilateral assistance programmes.

Figure 3.

Vienna Initiative 1.0: maintaining exposure towards subsidiaries and the economy



Source: Bank for International Settlements.

The orderly deleveraging of the EU parent banks in CESEE and the reduction in intra-group liquidity transfers offered breathing space for mobilising local savings and replacing the reduced funding of subsidiaries from their parent banks (Figure 4). Furthermore, it contributed to maintaining overall exposure levels to the economies, which declined less than the subsidiaries (compare claims on banks and on all sectors in Figure 3).[6] Nevertheless, overall (not only in the countries covered by the Vienna Initiative) cross-border flows declined in absolute amounts and as a percentage of both creditor countries and recipient countries (Figure 5), but from 2015 the situation reversed, without, however, fully regaining the lost ground.

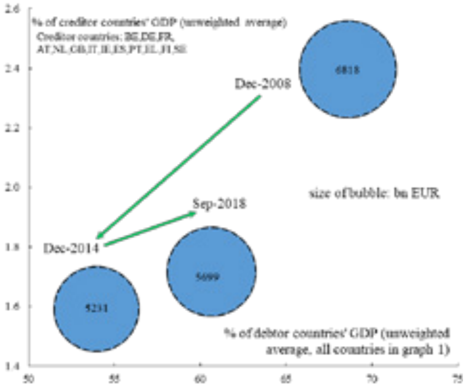
Figure 4.

Domestic funding replacing parent bank funding in some CESEE countries

Source: European Central Bank, International Monetary Fund.

Figure 5.

Exposure in some EU Member States towards their neighbours through the crisis



Source: Bank for International Settlements

As a public-private cooperative action platform, the Vienna Initiative 1.0 has proved to be a useful crisis management tool (De Haas et al., 2015) due to its unique composition of European Commission, IFIs, home and host banking sector supervisors as well as national authorities (i.e., ministries of finance) and commercial banks. In its first phase, the Initiative built relationships that have provided a good basis to address macrofinancial stability challenges in the new EU Member States and Western Balkan countries receiving multilateral financial assistance.

6 Supervisory guidance adopted by home country supervisors has also contributed to improvements in the funding model of subsidiaries in CESEE. For instance, in March 2012 the Austrian supervisors introduced supervisory guidance on strengthening the sustainability of the business models of internationally active banks. The subsidiaries of those banks with a loan-to-local-stable funding ratios (LLSFR) in excess of 110% were subject to enhanced monitoring. The LLSFR is the ratio of total loans to non-banks (net of provisions) to the sum of deposits from non-banks, funding from IFIs, capital from third parties and securities with original maturities of at least one year issued to investors outside the bank group.

The Nordic-Baltic cooperation agreement

Table 4.
Nordic-Baltic cooperation compared to the Vienna Initiative

Legal status	**Semi-formal** Agreement on Financial Stability (2010)	**Informal** Vienna Initiative 2 Mission Statement (2012)
Governance	**Centralised** Nordic-Baltic Stability Group, chaired by one country on rotating basis	**Multilateral** Ad-hoc cooperation under Vienna Initiative 1 Chairman and Steering Committee under Vienna Initiative 2
Outreach	**Regional** Nordic and Baltic countries	**Regional** Central, Eastern and South-Eastern Europe
Membership	**Closed** Limited to 8 countries signing the Agreement	**Open** All countries of the region invited
Participants	**Public sector** Ministries of finance, central banks, financial supervisors	**Public and private sector** Ministries of finance, central banks, financial supervisors, commercial banking groups
Objectives	**Financial stability** Development of a cross-border crisis management and resolution framework	**Financial stability and development** Preventing unorderly cross-border deleveraging and coordinating various home-host banking issues
Duration	**Undetermined** MoU on resolution updated in 2016 MoU on financial stability updated in 2018	**Undetermined** 2009-2012: Vienna Initiative 1 Since 2012: Vienna Initiative 2

Source: European Commission.

Compared to CESEE, financial integration in the Nordic-Baltic region has been more advanced. Six financial groups[7] dominated the markets of Denmark, Sweden, Norway, Finland, Estonia, Latvia and Lithuania. On the one hand, these banks' foreign exposure to the countries in the region played a major role in their balance sheets. On the other hand, they had the status of systemic institutions in all the domestic markets. Hence, there were strong advantages from establishing a coordinated pan-Nordic financial stability and resolution framework and burden-sharing arrangement.

The work on the Nordic-Baltic cross-border crisis management and resolution framework was based on a Memorandum of Understanding (MoU; Agreement on Financial Stability) signed between the ministries of finance, supervisors and central banks on 17 August 2010.[8] The implementation of the Agreement was entrusted to the Nordic-Baltic Stability Group, composed of representatives from all signing parties. Several working groups proceeded with practical aspects of implementation of the MoU. For example, there was a separate subgroup on *ex ante* burden sharing

7 Nordea, SEB, Swedbank, Svenska Handelsbanken (Sweden), Danske Bank (Denmark) and DNB (Norway).
8 Involving authorities of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden.

arrangements for the Nordea group only. The Nordic-Baltic Macroprudential Forum was also established.

Both the Nordic home supervisors and the banks proved their commitment to preserving financial stability in the region during the financial crisis in 2008-9. The parent banks continued to provide liquidity to their Baltic affiliates throughout the recession that impacted the economies of Estonia, Latvia and Lithuania. Cultural factors and the encouragement from the home supervisors seem to have played a key role. Sometimes, the concept of "extended home market" (Hansson, 2013) was used to describe the level of integration achieved in the region in spite of different monetary regimes, ownership structures and financial deepening. In the early years of the Vienna Initiative, the Nordic-Baltic cooperation in the area of supervision and crisis management constituted an example and an inspiration, notwithstanding the ultimate differences between the arrangements (Table 4).

The failed attempt at private sector support during the Greek crisis

Figure 6.

Private sector support during the Greek crisis

Source: Bank for International Settlements.

Inspired by the Vienna Initiative, a private sector support arrangement was attempted for Greece in 2010, when an international rescue package was arranged for the country. The French Banking Association and the German financial sector committed themselves to this arrangement (Box 1), but after a promising start it was not possible to reach a coordinated approach across the EU. Compared to the

Vienna Initiative, overall EU parent banks had fewer subsidiaries in Greece and relatively more exposure to the troubled Greek sovereign. Against that background, which eventually lead to private sector involvement with a deep haircut on government bonds, it appeared difficult for banks to honour their commitments of keeping exposure and remaining engaged in the country. At the end of 2012, the French banks Crédit Agricole and Société Générale sold at a large loss their Greek subsidiaries Emporiki and Geniki to Alpha Bank and Piraeus. Subsequently, foreign exposure almost completely dried up in Greece (Figure 6).

Box 1.

Commitments by French banks and the German financial sector towards Greece in 2010

Greece: Large French banks maintain their exposures, 5 May 2010

http://www.fbf.fr/fr/espace-presse/communiques/grece---les-grandes-banques-francaises-maintiennent-leurs-engagements

(Translated from French) Meeting at the beginning of the afternoon in Bercy, the main French banks confirmed to Christine Lagarde, the Minister for the Economy, Industry and Employment, that they would maintain their exposures to Greece for the entire duration of the assistance programme, in the context of the discussions with the European Commission, the European Central Bank and the International Monetary Fund.

The major French banks welcome the agreement at the European level on the support programme for economic and financial stability of Greece, thereby helping to maintain their exposures.

Germany's Financial Sector Joins Bailout of Greece, 7 May 2010

http://www.spiegel.de/international/germany/cash-from-the-banks-germany-s-financial-sector-joins-bailout-of-greece-a-693654.html

Leading lenders Deutsche Bank and Commerzbank AG teamed up for the coordinated credit line, alongside DZ Bank AG, HVB Group, Allianz and Munich Re.

> A statement distributed by the Finance Ministry said banks and insurers will provide €4.8 billion… in financing to replace Greek Government bonds by purchasing new bonds or providing other forms of financing. In addition, they will replace expiring credit lines worth €3.3 billion, thus buying Greece some much needed time.

Concluding remarks

In its first phase, the Vienna Initiative achieved a relative success by roughly maintaining the exposure of the involved banks to Hungary, Romania, Latvia, Serbia and Bosnia-Herzegovina at the agreed levels during 2009-10. However, when the commitments expired from 2011 onwards against the background of the euro area debt crisis, the claims of the EU parent banks on these countries declined in the context of an orderly deleveraging. This did not constitute a development specific to the region, but was part of a global trend according to which international banks retrenched to their domestic markets. Nevertheless, the Vienna Initiative allowed the recipient countries to buy some time and in order for the deleveraging to be orderly.

Key factors for success appeared to have been the cooperative approach between public and private stakeholders facilitated by the presence of international institutions organising a discussion platform. It allowed participants to reach a common understanding in the interests of all to engage in some collective action. Banks would keep their exposure, and international institutions offer financial support, while authorities would ensure economic stability and the reform process. Nordic-Baltic cooperation was equally successful, resting on similar principles, including strong cross-border interconnectedness of banks. The importance of this factor and the stable policy environment is illustrated in the attempt to set up private sector support for Greece in 2010. It failed because of the absence of a systemic presence of international banks in the country, facilitating a retreat, and because public finances were out of control, leading to a haircut of the banks' government bond portfolio in 2011-12.

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CHAPTER 18

Financing sustainable growth in a small economy with large cross-border financial links: the role of the Vienna Initiative

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The quest for the sustainability of growth

Emerging markets economies require a long-lasting and stable economic growth to converge and achieve the level of wealth of the advanced countries. Between 1995 and 2007 the Central, Eastern and Southeastern Europe (CESEE) countries grew faster than almost all other emerging markets regions;[2] see Figure 1. This favourable trend was dramatically broken in the majority of CESEE countries by the outbreak of the financial crisis in 2007/8. The long-term sustainability of the business model, and thus the growth path in some of those economies, was called into question.

Sustainable growth requires long-term investment in the assets that expand the productive capacity of an economy.[3] Thus, the contribution of components of the GDP: consumption and investment (both public and private), as well as net exports, should be properly balanced in time. Until 2003 growth in the region was driven mainly by exports. Thereafter the growth structure changed, and domestic demand became the main engine of growth.[4] The structure of

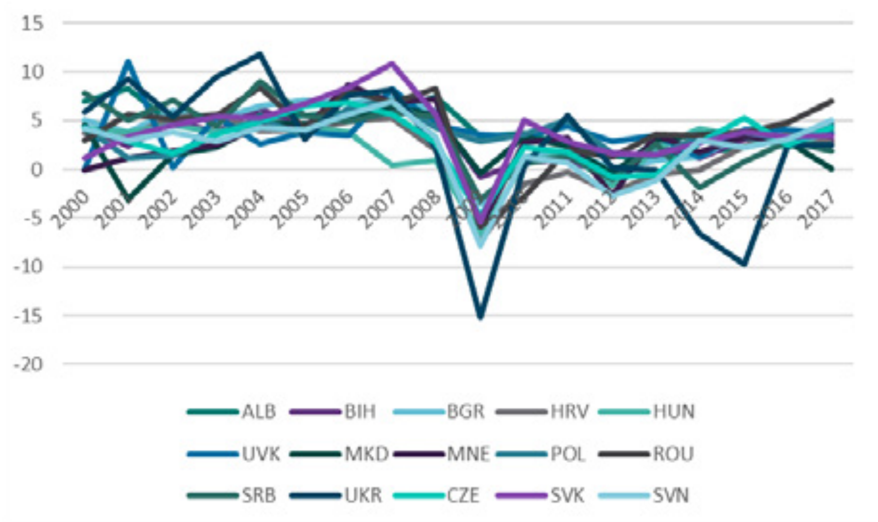
1 The views expressed in this chapter are those of the authors and do not necessarily represent the views of the Narodowy Bank Polski. The authors would like to thank Ms. Milena Kabza and Mr. Paweł Smaga for research assistance.

2 Bakker, B. and Ch. Klingen, eds., How Emerging Europe Came through the 2008/09 Crisis. *An Account by the Staff of the IMF's European Department*, International Monetary Fund, 2012.

3 Group of Thirty, *Long-term Finance and Economic Growth*, Working Group on Long-Term Finance, Washington, D.C., 2013.

4 Bakker and Klingen, *op. cit*.

Figure 1.
Real GDP growth in CESEE countries



Source: *International Monetary Fund, World Economic Outlook Database, October 2018.*

growth determines its stability. On the one hand, high consumption stabilises growth during the downturns (see the example of Poland in 2007/8). On the other hand, a high share of consumption in relation to investments ultimately hinders an increase in potential output. Insufficient investment decreases the international competitiveness of the economy, which is particularly important for open economies with significant economic links to their neighbours from the European Union (EU).

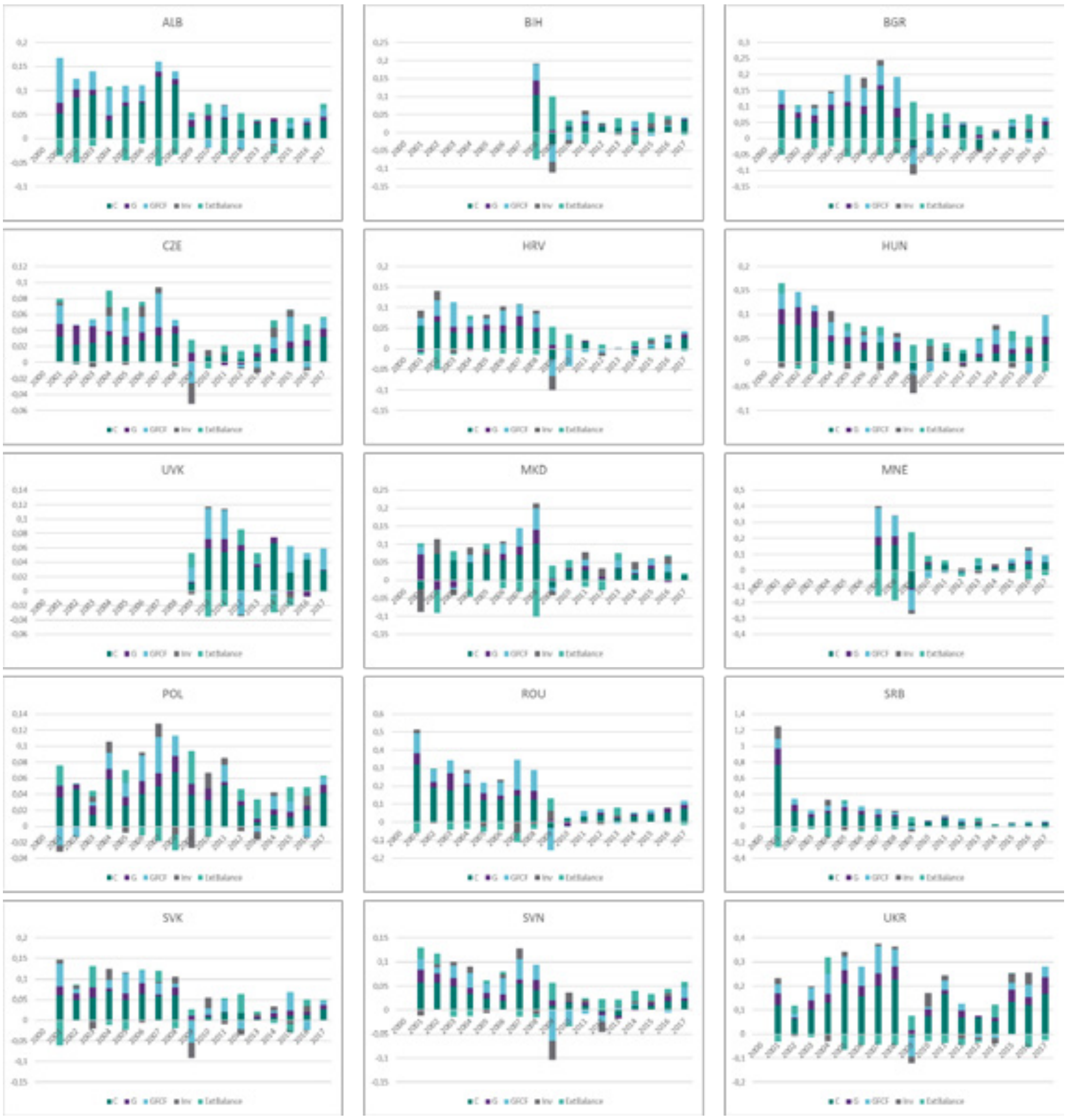
The factors contributing to GDP growth varied between CESEE countries; see Figure 2. While in some countries, such as the Czech Republic and Croatia, the contribution of investment was strong and stable until the outbreak of the global financial crisis, some other countries, such as Albania, Poland, Romania and Ukraine, featured a strong consumption contribution.

Another view on growth sustainability takes into account experience deriving from the global financial crisis. Pre-crisis growth in CESEE was characterised by strong domestic demand which inflated the non-tradeable sector,[5] while the contribution from net exports was weak. One of the explanations for this phenomenon was a higher trade deficit caused by the increase in domestic demand. Therefore, until 2010, most of the CESEE countries recorded persistent current

5 Bakker and Klingen, *op. cit.*

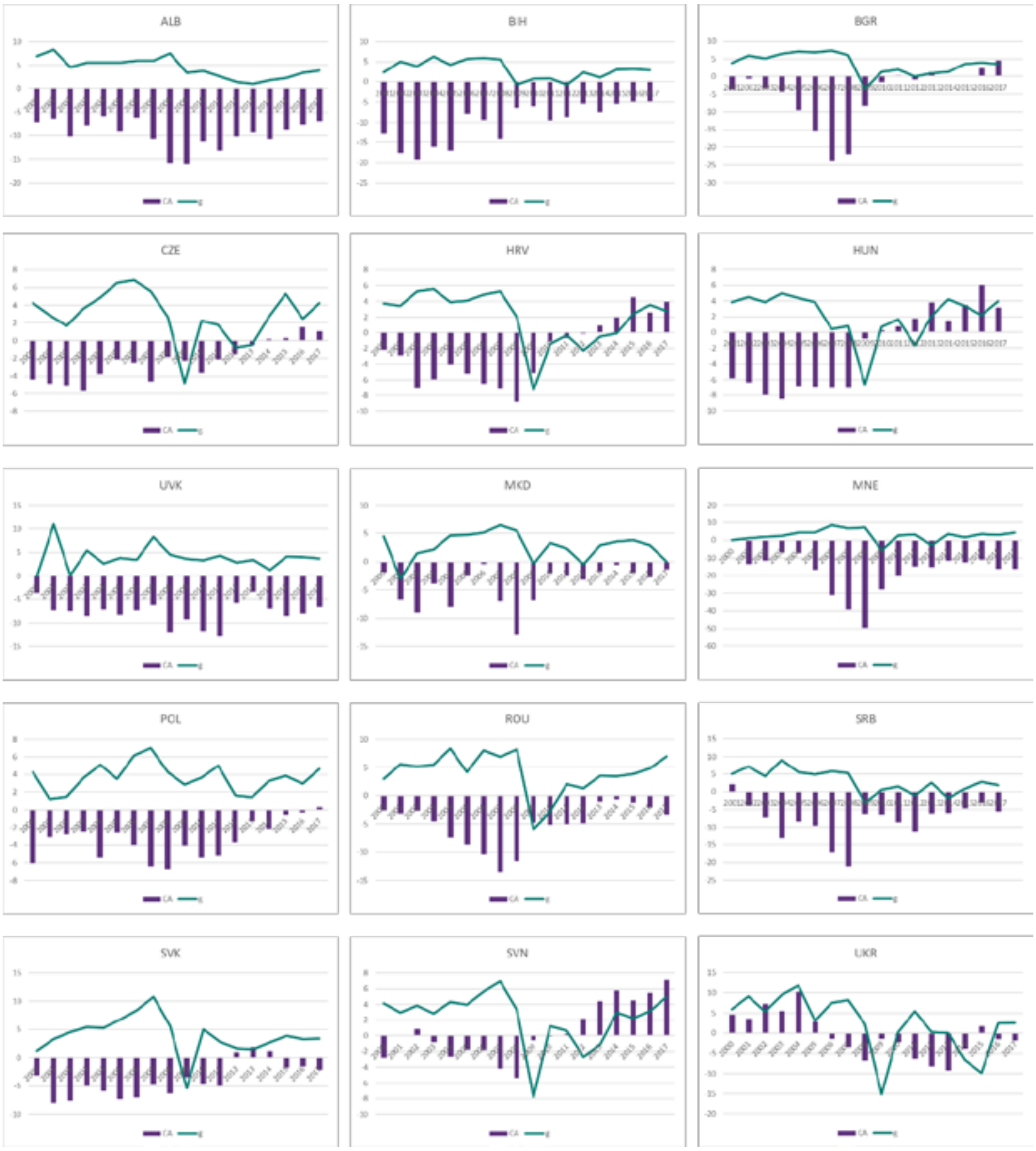
Figure 2.

Contribution of consumption, government spending, gross fixed capital formation and net exports to GDP growth



Source: Authors' own computations, International Monetary Fund, World Economic Outlook Database, October 2018.

Figure 3.
GDP growth and current account balance



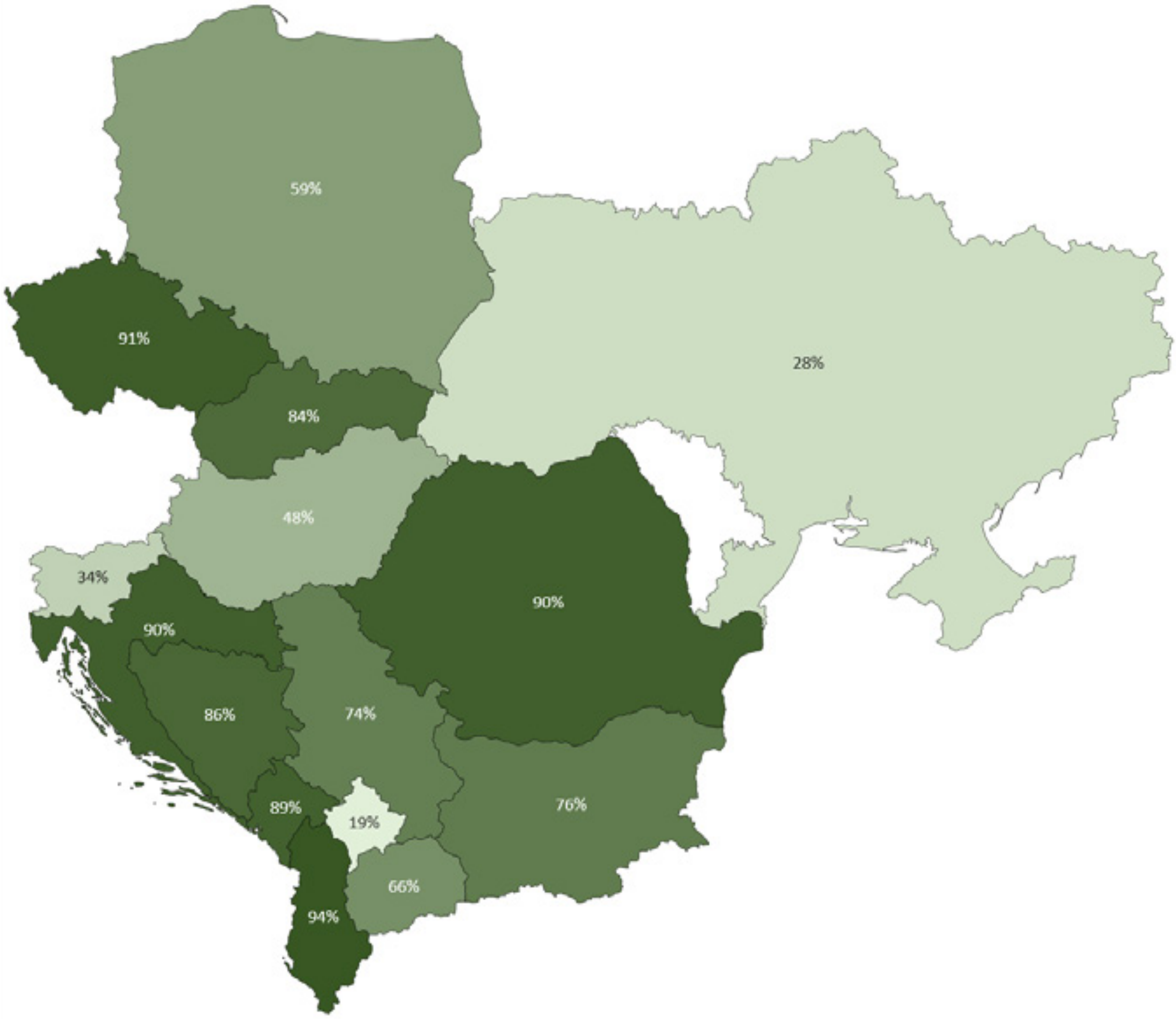
Source: International Monetary Fund, World Economic Outlook Database, October 2018.

account deficits; see Figure 3. The external imbalance contributed to the build-up of external debt and made these economies vulnerable to external shocks related to the financing of the balance of payments. The concurrent real exchange appreciation of national currencies also eroded international competitiveness. Such a growth model required continuous external financing and this – as the experience of the global financial crisis showed – was not sustainable. Therefore, the sustainable growth model – particularly in smaller economies – should rely more on a tradeable sector.[6] However, too much reliance on external demand exposes economies to shifts in global trade trends. This might be particularly important in the near future if the global trade tensions intensify and have adverse effects on the economic standing of key importers. Additionally, sustainable growth requires the availability of a skilled labour force, increases in human and real capital, as well as labour and capital productivity and the presence of domestic firms on international markets.[7]

The current account deficits – a mirror image of insufficient domestic savings – indicated that the CESEEs, in order to expand, had to rely on external financing. Capital flows in Europe (not only CESEE) as a share of GDP were the largest in history.[8] The flow of external financing occurred in the form of foreign direct investment (FDI), including to the banking sector. The gradual liberalisation of capital flows and the gradual opening of privatisation opportunities attracted foreign investors to purchase local/domestic banks. As a result, the region is characterised by a high share of foreign banks as holders of banking systems' assets; see Figure 4. The access to new markets as well as a cheap skilled workforce attracted FDI to the corporate sector as well. The FDI brought in not only capital but also new technologies and modern management culture and practices. The foreign financing in CESEE took also the form of the purchase of sovereign debt. Nevertheless, the most important flow occurred through the direct financing of banks and the corporate sector from foreign banks (see Figure 5), as well as through intercompany loans. Another important source of external financing for the new Member States of the EU was the cohesion and structural funds.

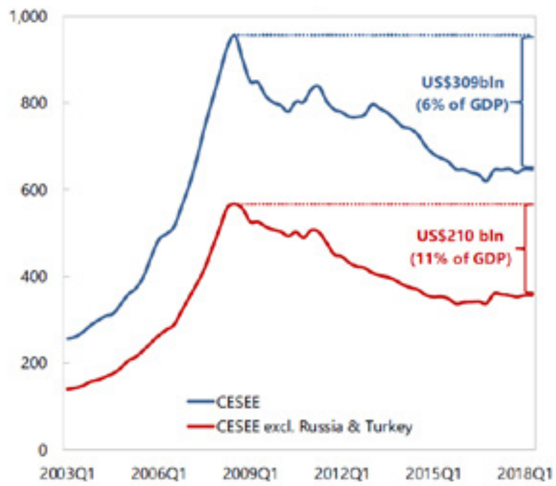
6 Bakker and Klingen, *op. cit*.
7 Błędowski, K., *Kiedy Polska przystąpi do Pierwszego Świata?*, Dziennik Gazeta Prawna, 28 January 2019.
8 Gill, I. S. et al., *Golden Growth: Restoring the Lustre of the European Economic Model*, International Bank for Reconstruction and Development, 2012.

Figure 4.
Share of foreign banks in banking systems' assets in 2014



Source: *Helgi Library, European Central Bank and national central bank data.*
Note: *For ALB, BIH, MKD, MNE data for 2013.*

Figure 5.
External positions of BIS-reporting banks, 2003 Q1-2018 Q2



Source: *CESEE Deleveraging and Credit Monitor November 20, 2018.*
Note: *USD billion, exchange-rate adjusted, vis-à-vis all sectors.*

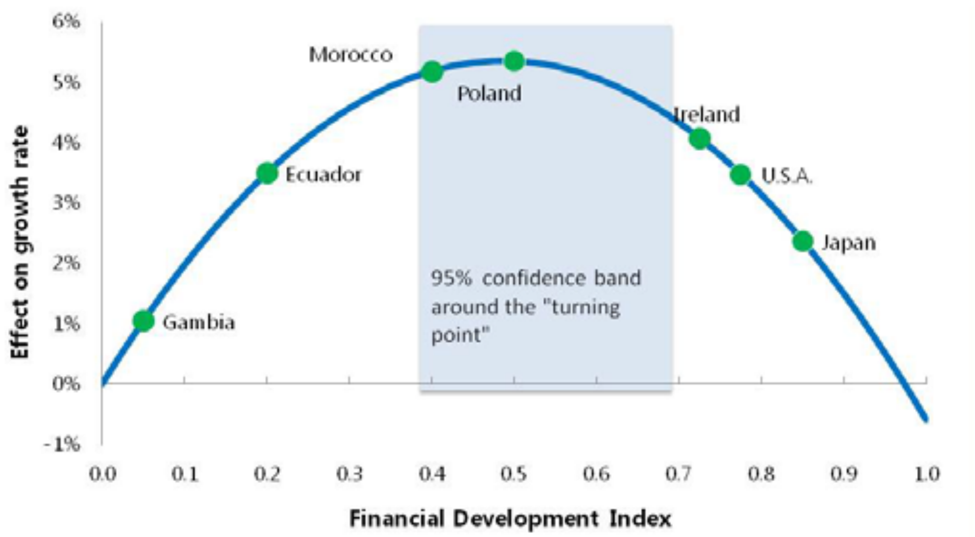
A stable financial system supports the sustainability of growth.[9] A stable financial system promotes the effective and efficient allocation of resources mobilised by savers and required by investors. It also supports appropriate pricing and allocation of financial risk in the economy. By lowering transaction prices and information asymmetry, the development of the financial systems improves the range of possibilities for corporations to finance investments and for households to smooth consumption. This contributes to better shock absorption in the economy and better allocation of capital and risk, which, as a result, has a positive impact on long-term growth. The impact of the financial system on growth depends on the size of the sector, the pace of growth of the sector, the structure of the sector and the degree to which financial resources are used to increase the productive capacity and efficiency of the economy, rather than for speculative purposes.[10]

The experience of the global financial crisis demonstrates that an excessively large financial sector increases systemic risk and negatively impacts the economic

9 Moshirian, F., The global financial crisis and the evolution of markets, institutions and regulation, *Journal of Banking and Finance* 2011, 35(3); Szczepańska, O., *Stabilność finansowa jako cel banku centralnego*, Scholar, Warszawa, 2008; Levine, R., Finance and Growth: Theory and Evidence, NBER Working Paper No. 10766, NBER 2004.
10 See, e.g., Rioja, F., and N. Valev, Does one size fit all? A reexamination of the finance and growth relationship, *Journal of Development Economics*, 74, 2004; Cecchetti, S. G., and E. Kharroubi, Reassessing the Impact of Finance on Growth, BIS Working Papers No 381, BIS 2012; Arcand, J. L. et al., Too Much Finance?, IMF Working Paper WP/12/161, IMF, 2012.

performance of the real sector.[11] On the other hand, a system that is too small does not foster economic growth because it does not provide sufficient resources for the economy. However, if financial development[12] is too large, the positive effects on economic growth decline, while economic and financial volatility rises; see Figure 6. A large financial system increases the frequency of booms and busts, after which the economy is left with lower real GDP growth. It also leads to a decrease in efficiency of investment, as it does not allocate financial resources to the most productive activities. Moreover, too much finance diverts talent and human capital away from productive sectors and towards the financial sector.

Figure 6.
Financial development effect on growth



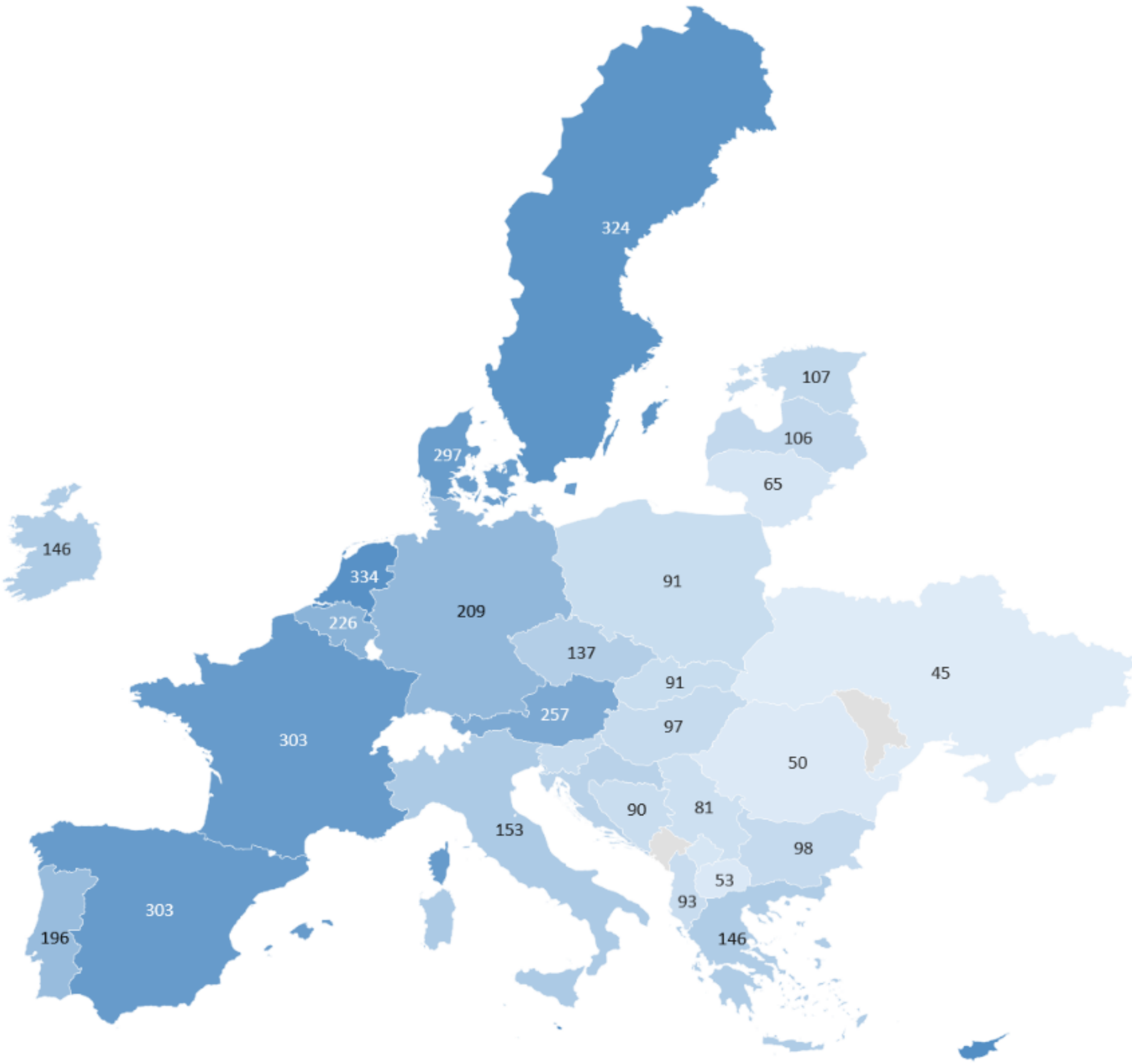
Source: *Sahay R. et al., Rethinking Financial Deepening: Stability and Growth in Emerging Markets, International Monetary Fund, SDN/15/08, 2015.*

The size of the financial system in the CEESEs is not excessive and the credit is mainly provided by the banks; see Figure 7. Thus, there is still possibly scope for a growth-enhancing increase in the size of the system. A key question remains, however: what is the optimal structure of the financial sector that would best serve to support growth?

11 Sahay R., M. Čihák, P. N'Diaye, A. Barajas, R. Bi, D. Ayala, Y. Gao, A. Kyobe, L. Nguyen, Ch. Saborowski, K. Svirydzenka, S. Reza Yousefi, *Rethinking Financial Deepening: Stability and Growth in Emerging Markets*, International Monetary Fund, SDN/15/08, 2015.

12 Financial development can be measured, e.g., as in Sahay *et al*. 2015, as an index capturing depth, access to and efficiency of financial institutions and markets.

Figure 7.
Banks' assets as a percentage of GDP, end of 2017



Source: European Central Bank, Raiffeisen Bank International.

It is not only the size of the financial sector that matters, but also the speed of growth of the financial system – too rapid growth may lead to greater bank fragility and a higher risk of systemic banking crises.[13] This is because dynamically growing financial

13 Barajas A., Th. Beck, E. Dabla-Norris, S. Reza Yousefi, Too Cold, Too Hot, Or Just Right? Assessing Financial Sector Development Across the Globe, International Monetary Fund, WP/13/81, 2013.

institutions take on too much risk and leverage and may not have sufficient capacity to properly assess and withstand the risks related to newly obtained exposures. This was particularly visible in the CESEE region before the crisis. The economic catch-up process led to rapid credit growth, and in some countries the speed of credit growth exceeded what could be justified by appropriate financial deepening and jeopardised macroeconomic stability. Rapid credit growth fuelled consumption and led to rises in house prices. Interestingly, in CESEE, the magnitude of the credit boom was linked to the size of the capital inflow from western banks.[14]

The quest for stable financing of growth

Stable financing of growth requires fulfilling at least the following four criteria.

1. **Ensuring the stability of the financial system.** The financial system contributes to growth if it is properly supervised from both the micro- and macroprudential perspectives. In CESEE, where the foreign presence in the banking sector is dominant, this requires good cooperation between the home and host authorities. This is because the home authorities indirectly (in case of subsidiaries) or directly (in case of branches) influence the behaviour of banks. Good supervisory cooperation is particularly crucial when credit growth is externally funded, as was the case for CESEE, and when the host supervisors have to rely on the monitoring of risk profiles by the banks' home supervisors. Foreign-owned banks can also switch from domestic to cross-border lending. Such a supervisory structure creates misaligned incentives: it creates supervisory gaps and has been associated with a level of mistrust that impedes effective cooperation.[15] The home country supervisors may tend to focus on ensuring stability of their domestic banking system rather than that of the host country. This is particularly important if the host and home countries are not members of the EU, where mediation mechanisms for arbitrating between home and host supervisors exist. Moreover, even within the EU, a mechanism for sharing the cost of liquidity support between the European Central Bank (ECB) and non-euro-area central banks does not exist, nor there a mechanism to share the costs of bank recapitalisation between the member states.

2. **Ensuring the quality of banks' assets.** The legacy of crisis left some CESEE countries with a high level of nonperforming loans (NPLs). The dynamic credit growth during 2003-8, followed by the global financial crisis, led to an increase in NPLs in some CESEE countries to a level which constrained the recovery of credit provision, and

14 Bakker, and Klingen, *op. cit*.
15 Gill, I. S. et al., *op. cit*.

thus the economic recovery. The high level of NPLs impacted banks' profitability and funding costs: banks with higher NPLs were less profitable and thus had less capacity to generate capital. They were also less active in credit provision. High NPLs were also a reflection of a high indebtedness of the corporate sector and/or households. Such high indebtedness has a negative impact on investment and consumption.

3. **Ensuring stable financing through the banking system.** The financial systems in CEESE are dominated by banks, and the flow of external financing to the CESEE region was channelled through the banking sector, mostly foreign-owned, rather than through capital markets. The reliance of the corporate sector on bank lending, rather than on the market funding, could be – to a large extent – explained by history and the fact that most of enterprises in the CESEE region are small or medium-sized. These companies rely more on relationship banking and leasing.[16] Banks are also natural credit providers for households. The reliance on banks exposes small to medium-sized enterprises (SMEs) to variability in access to finance, as lending to SMEs in particular becomes more expensive during crises.[17]

4. **Ensuring stable financing for innovative businesses.** Banks – due to their obligation to return deposits to their clients – are more inclined to finance businesses generating stable cash flows with contained risks. However, such businesses might not be the most innovative and may not improve the competitive edge of the country in the long run. Moreover, bank financing might not be available for start-ups, which typically have a short credit history. Therefore, for growth to be sustainable, provision of non-bank financing is needed as well. For example, the development of stock markets is positive for industries that are at the frontier of growth – innovative, high-tech and patent-intensive industries – as well as for growth in total factor productivity.[18] Such business projects are better financed by market-based financiers – venture capital and private equity firms. An efficient financial system thus requires complementary components – both an effective and resilient banking sector and market-based financing to allocate savings in line with the risk profiles of investors. Moreover, the structure of banks' loan portfolios in some CESEE countries, e.g., Poland and Slovakia, may not support sustainable growth, since the portfolios are dominated by household loans, while only loans for enterprises are positively correlated with GDP growth; see Figure 8.

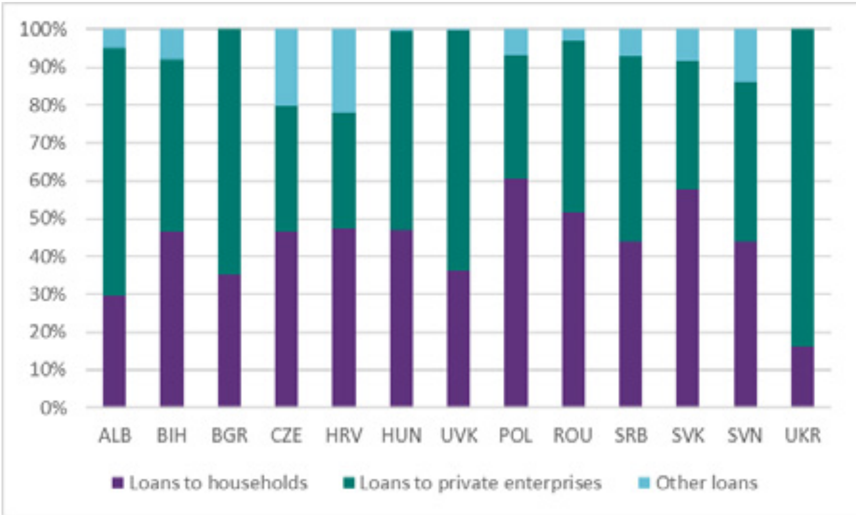
16 European Commission, *Survey on the access to finance of enterprises* (SAFE), November 2018.

17 Holton, S., and F. McCann, Sources of the Small Firm Financing Premium: Evidence from Euro Area Banks, Working Paper Series, No 2092, ECB, 2017.

18 Kremer M., and A. Popov, *Financial development, financial structure and growth: evidence from Europe*, in Financial Integration in Europe, European Central Bank, 2018.

Figure 8.

Loan portfolio structure, end of 2017



Source: Raiffeisen Bank International.

The role of Vienna Initiative in supporting sustainable growth

Vienna Initiative helps in ensuring financial stability in the region by focusing on resolving potential cross-border financial stability issues and underscoring the need for supervisory policies to be taken in the best joint interest of home and host countries. This is achieved through the continuous dialogue within the Vienna Initiative meetings and working groups, which is also focused on macroprudential issues. One of the key objectives in this dialogue is ensuring the involvement of non-EU countries in the region, which do not participate in EU cooperation frameworks.

One of the key work streams of the Vienna Initiative is that focused on reducing NPLs in CESEE. This has been achieved by identifying obstacles in the legal, judicial, tax and regulatory areas to addressing the NPL problem.[19] The Vienna Initiative also developed a plan for addressing the level of NPLs in countries where it was particularly high. The key deliverables included preparation of specific country assessments, provision of technical support related to NPLs (regarding, for example, restructuring frameworks and principles) and organising industry workshops, as well as fostering NPL markets. The Vienna Initiative also regularly monitors NPLs in the CESEE.

19 See Working Group on NPLs in Central, Eastern and Southeastern Europe, Report, March 2012.

The Vienna Initiative helped ensure that CESEE economies maintained access to foreign financing. During the first phase of the crisis, for the countries that benefited from International Monetary Fund (IMF)/EU-supported programmes, the Vienna Initiative coordinated actions of the West European parent bank groups and home and host-country financial authorities,[20] as well as the international financial institutions[21] and the European Commission. These actions secured commitments from parent banks to maintain their exposure to CESEE and recapitalise their local subsidiaries as needed, as well as IFIs' assistance towards the banking sector, which supplemented the financing provided under IMF/EU-supported programmes. The public support for parent banks was provided by home-country authorities in a way that did not discriminate between the groups' domestic and foreign operations. Also, the host country authorities committed not to discriminate between domestic and foreign banks.[22] Subsequently, under Vienna Initiative 2.0, the monitoring of credit and deleveraging activity helped ensure that foreign banks continued their engagement in the region.

The Vienna Initiative has also focused on access to finance by providing a comprehensive assessment of credit guarantee schemes available to reduce credit risk of SMEs in the region and by helping ensure finance for innovation and investment. This second goal is promoted through work on capital market development in the CESEE region, which has led to the identification of challenges and obstacles to capital market development in several CESEE countries and proposals for solutions to address them, as well as policies that might be pursued to help capital markets in the CESEE region catch up with those in the rest of Europe.[23] The Vienna Initiative also focused on supporting the development of IFI instruments to meet the investment needs of the CESEE region.

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The experience of the Vienna Initiative countries shows that maintaining a stable flow of financing in small open economies dominated by foreign banks requires good cross-border cooperation between the financial market authorities and banks. It also requires further deepening of financial intermediation, mostly through the development of market channels.

20 i.e., supervisors, finance ministries and central banks.
21 International Monetary Fund, European Bank for Reconstruction and Development, European Investment Bank, World Bank Group (World Bank, International Finance Corporation and Multilateral Investment Guarantee Agency).
22 Bakker and Klingen, *op. cit*.
23 See, e.g., Report by the Working Group on Capital Markets Union http://vienna-initiative.com/wp-content/uploads/2018/03/VI-CMU-Working-Group-Final-Report-March-2018.pdf

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CHAPTER 19

Forward-looking implications of the Vienna Initiative: why did Western banks enter the Central, Eastern and Southeastern Europe region, what went wrong and what did we learn?

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The banking sectors in Central Europe (CE) and South Eastern Europe (SEE) offered ample growth opportunities in the early 2000s. Following hefty restructuring and/or crises in the 1990s, bank balance sheets had been largely cleaned up, providing attractive entry points for long-term-oriented private sector equity investors. Moreover, macroeconomic stability had returned to the Central, Eastern and Southeastern Europe (CESEE) region. From a macrofinancial point of view, financial intermediation levels appeared to be very low, offering a lot of catching-up potential vis-à-vis financial intermediation levels in West European banking sectors. Therefore, European banks made a big push into the ostensibly underpenetrated CESEE region. Bank privatisation deals in CESEE were marked by robust interest for strategic equity investments by West European lenders.[1] It is interesting to note that West European lenders chasing growth opportunities in the region and CESEE host countries were largely concentrated in a very few West European home countries, a fact that contributed to a certain degree of risk concentration. Austrian-, Italian- and French-owned international banks dominated in CESEE, while German banks also played a certain role in the beginning of the regional "CEE banking sector boom".[2]

1 For a full account of the process through which Western banks acquired high levels of CESEE banking assets, see Rachel A. Epstein, *In Pursuit of Liberalism: International Institutions in Postcommunist Europe* (Johns Hopkins University Press, 2008).

2 The large and concentrated ownership of Nordic banks in the Baltic region is not explicitly addressed here, but similar conclusions to those drawn here for the CESEE region in this paper seem plausible in that region as well.

On the back of strong investment activity of Western lenders, foreign ownership in the CESEE banking sectors increased to very high levels by international and European standards. West European banks operating on the CESEE markets developed into large and complex cross-border banking groups. At peak levels, foreign-owned banks accumulated a market share of 75% of total assets in CE and some 85% in SEE. Therefore, banking sectors in CE and SEE turned into very internationally integrated European banking sectors when it came to cross-border financial flows, backed by deep equity links. At that time, West European banks operating in the CESEE region also met a by and large integration- and globalisation-friendly mood on the ground. The strategic push of Western banks into the CESEE region and first successes during the market-conquering phase supported aggressive mergers and acquisitions and organic growth strategies. From 2000 until 2008/9, the total assets of the seven largest cross-border banks in the CEE region grew from some €70 billion to around €490 billion. The speed of asset expansion sketched previously entailed annual balance sheet growth rates in excess of 20% year-on-year. On a macro level, the CESEE loan-to-GDP ratio increased from some 20% to close to 50%. The average regional ratio masks the fact that loan-to-GDP ratios surpassed sustainable levels in several CESEE banking markets.

The brisk expansion and decisive financial deepening sketched previously are clear indications that the CESEE region was characterised by a procyclical, credit-driven overheating. The market entry of foreign European Union (EU) banks helped to boost the availability of domestic credit in less developed, smaller banking sectors in CESEE. Foreign-owned local banks were able to raise local deposits relatively cheaply, to borrow from their parent banks or on international markets supported by the reputation of their parent banks. Therefore, the market entry of West European banks that were previously locked into stagnant home markets (with low interest rate margins) and that started to become international banks in the CESEE region only in the late 1990s supported a strong regional credit expansion. Moreover, because of their initial under-penetration and the relatively small nominal size of the CESEE economies and banking sectors, CEESE operations were relatively small compared to the domestic operations of West European banks, making a rapid expansion easy to finance. In addition, the focus was on expansion and not on optimising governance and (risk) management. Some of the Western lenders that made a push into the CESEE region were also not very experienced in doing banking business in emerging markets. Hence, long-term risks may have been partially underestimated during good times and in certain CESEE economies. Widespread lending in foreign currencies in the region was based on the optimistic assumption that several CESEE countries would join the euro area quickly. Hard currency pegs or soft *de facto* pegs and the underlying exchange rate stability also fuelled widespread and risky lending in foreign currencies. Due to the extrapolation of strong capital inflows, a lot of free-floating CEE currencies were expected to appreciate vis-à-vis major foreign currencies from a medium- to long-term perspective. The strong expansion in CESEE also exposed Western banks to relatively unstable/illiquid local funding markets; this held especially true in crisis times.[3]

All in all, aggressive and parallel lending policies of a few large private sector players contributed to the need for coordinated crisis management at a later stage. Nevertheless, the strong presence of foreign banks cannot be seen as the only driver of the rapid credit growth in CESEE. Overly optimistic long-term growth expectations in a lot of banking sectors in the whole of Europe (including the Central European economy of Slovenia that never opened up its banking sector to foreign investment like other CESEE economies) in combination with a favourable global and European economic and financial market backdrop were additional drivers of the rapid credit growth in CESEE. High growth expectations were partially fuelled by overly optimistic assumptions, i.e., the vision that banking sectors in CESEE could easily catch-up with (inflated) euro area financial intermediation levels within a limited period of time (e.g., ten years or so). Therefore, one could say that a flawed model of thinking as well as an overexpansion in euro area banking (that developed into a sort of flawed benchmark) also promoted aggressive growth strategies at West European cross-border banks operating in CESEE.

There had been warnings with regard to the rapid credit growth in certain CESEE countries. External observers, such as EU institutions, the European Central Bank (ECB) and the International Monetary Fund (IMF), had been very critical of the rapid credit growth in CESEE (especially in the years 2004-8). During the boom, Western cross-border banks were mostly caught up in their “growth momentum” and mostly downplayed such fundamental concerns. There were even some indications that cross-border Western banks had invested a certain amount of expertise into circumventing locally set regulatory growth brakes. However, there was also local complacency in the CESEE host countries. In some cases, the growth-supportive brisk banking sector expansion was also welcomed by local political elites who profited indirectly or even directly from this state of affairs because of the ways in which strong credit-driven economic growth supported their electoral prospects. Moreover, local economic and political elites also participated in some less sound

3 For a detailed analysis of the regional (pre- and post-crisis) credit cycle see also Gunter Deuber, 2011. Post-crisis Banking Sector Outlook in CEE, *Osteuropa-Wirtschaft*, 56(3-4).

business practices (such as the widespread extension of foreign currency loans in certain CE/SEE countries).

At peak levels in 2008/9, the leading Western banks in the region were operating in 9-12 markets on average and had an average total CEE balance sheet size of some €80 100 billion. For comparison: the average size of the CESEE host economies ranged from some €35 billion to €55 billion (depending on the method of measurement). Therefore, Western banks operating in the region were in many cases considered as "too large to fail" by markets. Moreover, international investors were also concerned about the very high degree of home market concentration (particularly in the case of Austria). The combination of a rapid expansion and a sizeable and complex cross-border footprint of Western private sector banks operating in CESEE was a key factor in the need for coordinated private-public sector and cross-border crisis-management within the Vienna Initiative (VI) framework at a later stage.

With the benefit of hindsight, it seems clear what went wrong in CESEE banking. However, from a forward-looking perspective, procyclical developments in the banking and financial sector, such as those that played out in CESEE, certainly cannot be reliably prevented or contained in advance, given a long history of economic and financial crises. Therefore, it makes sense to have a closer look at the question of why the much-needed cross-border private-public sector crisis management in the context of the VI was so successful.

Vienna Initiative: A lot of praise for its positive outcome, although some false interpretations still persist; some more critical takes emerged as well

The VI framework emerged as an *ad hoc* and flexible response to a systemic regional financial stability problem within a very specific setting of elevated equity-based cross-border financial sector integration. Measured by its original objectives, the VI achieved its goals. A regional systemic banking sector crisis was avoided and a supportive spirit for cross-border crisis management was established. All relevant studies suggest that a swift, decisive and damaging deleveraging did not take place, contradicting earlier expectations of a devastating "cut and run" episode. This holds true for the countries explicitly covered within the VI framework, as well as for the broader CESEE region. Therefore, the VI can be seen as a success story.[4]

4 See also Bakker, Bas, and Christoph Klingen (eds.), How Emerging Europe Came through the 2008/09 Crisis: An Account by the Staff of the IMF's European Department, Washington, DC, 2012.

In order to draw forward-looking implications from the VI with an eye towards replicating its stabilising effects in future crises, it is important to carefully specify the sources of the VI's success. And here we depart, to a certain extent, from the conventional interpretation of why and how the VI prevented a rapid, precipitous and damaging deleveraging from CESEE. We argue that, while the VI certainly contributed to public-private coordination and provided reassuring market signals, the VI's success was nevertheless primarily derivative of the largest Western and multinational banking groups' business strategies and interests as equity investors in the region, rather than a consequence of independent public sector power.

Much of the literature analysing the VI argues that international organisations, including the European Bank for Reconstruction and Development (EBRD), the World Bank Group and the IMF, independently compelled Western banks to maintain their exposures to CESEE through a voluntary bank rollover agreement. A recent quotation from Robert Zoellick, former World Bank Group president and former US trade representative, is illustrative. Referring to the VI, he argues that these organisations "persuaded Western European commercial banks to keep capital in eastern European subsidiaries, avoiding a countercyclical contraction."[5] An auxiliary argument is that Western banks invested in CESEE faced a collective action problem as the US and then the global financial crisis unfolded. Given traditional market investor incentives to flee a failing market or asset first rather than last, this reasoning suggests that Western banks had every reason to cut their exposures to their CESEE markets – and to cut them first, in order to avail themselves of relatively stronger asset and currency values. From this point of view, Western banking exposures appeared potentially volatile indeed, with severe contagion among investors probable. Many observers have therefore concluded that it was international institutional pressure on private sector banks that helped resolve the apparent collective action problem by compelling the largest banks to stay – with commitment letters by banks, IMF stabilisation and open communication among stakeholders.[6]

We find several evidentiary problems with this dominant narrative, however. Moreover, the differences between the conventional wisdom and our own findings are significant enough that the implications for future crisis management would

5 Robert Zoellick, Whoever runs the World Bank needs an emerging markets plan, *Financial Times*, 5 February 2019.
6 See, for example, Katherine Pistor, Governing interdependent financial systems: lessons from the Vienna Initiative." *Journal of Globalization and Development*, 2(2), Article 4 (2011); and the IMF, *Regional Economic Outlook: Europe: Building Confidence*, Washington, D.C. (2010), p. 63.

vary. To reiterate, correct specification of what worked in the VI is essential to sound policy going forward.

Our counter-interpretation revolves around which actors initiated the VI, the timing and scope of the commitment letters signed by banks, banks' long-term business strategies and their own funding difficulties during the crisis.[7] Starting with the critical actors, it was six of the largest Western banks operating in CESEE in autumn 2008 who came together to author a collective letter to the European Commission, Christine Lagarde as Chair of the G20 and others pointing out that the national approach to bank and funding sustainability that was being pursued at the time would disproportionately harm Eastern Europe and violate the spirit and undermine the functioning of the European Union's single market. According to the CEO signatories to the letter:

> The more national dimension of these measures is going to enlarge disparities in credit availability between countries and could be ineffective in sustaining the European economy as a whole.[8]

The coordinated call to action by private sector banks directed at key international organisations does not depict a collective problem in which banks were on a hair-trigger, ready to leave the region. If the collective action problem has been misconstrued, then the coordinated action by banks leaves open the question of what role the international institutions did play.

Our second evidentiary concern stems from the substance of the VI itself. We think that if the international institutions in question created an independent effect, in part through the formulation of bank exposure commitment letters, it is likely that there would have had to have been more than five such letters. In addition, for those exposure commitments to have traction, we argue that they would have had to be agreed to before the crisis had abated. As it was, bank exposure commitment letters were signed for only Latvia, Romania, Hungary, Bosnia and Serbia, whereas the absence of "cutting and running" extended across the EU's New Member States (NMS) and EU Candidate Countries (CCs) in CESEE (i.e., formal exposure commitments only covered 25 30% of all regional banking sector exposures

7 For a fuller account of these arguments and events, see also Rachel A. Epstein, *Banking on Markets: The Transformation of Bank-State Ties in Europe and Beyond* (Oxford University Press, 2017).

8 The letter was also addressed to Joaquin Almunia, EU Commissioner for Economic and Monetary Affairs, and Charlie McCreevy, EU Commissioner for Internal Market and Services. The EBRD and the EIB were both copied on the letter. The letter is available at https://www.ebrd.com/downloads/research/economics/events/Banks_letter.pdf. Accessed 10 March 2019.

at leading Western banks operating in the region). And in Hungary, Latvia and Serbia, IMF stabilisation programmes pre-dated bank exposure commitment letters by between three and eleven months. This timing suggests that the commitment letters – the voluntary bank rollover agreements – had little to do in securing banks' continued exposures compared to other factors.

This brings us to our third and final set of arguments about the ways in which the VI process assisted in the crisis, mindful of the primacy of the business strategies of the multinational banking groups themselves and their long-term interests in the region. Knowing that it was the banks that alerted national and supranational authorities to the dangers of a national approach, and knowing also that these banks were coming from relatively small home markets and/or markets that were completely saturated with low margins, we posit that the last thing these financial institutions wanted to do was to "cut and run" from CESEE and to reinvest their equity funding in their home markets. Indeed, they had spent the previous one to two decades investing overwhelmingly in host-monitored subsidiaries and building mass-market share. And many parent banks had lent large volumes to their subsidiaries – making potential losses under conditions of market flight very large. Unwinding their access to 100 million new and underbanked consumers was never a viable option. In addition, the Western banks operating in the region had increasingly localised their management within their CESEE network (i.e., top management positions were filled with local personalities with a high degree of local embedding). In this respect, rapid and reckless deleveraging was practically impossible from a governance perspective. Moreover, some of the local management teams had very specific crisis management experience, which West European bank managers lacked in this form.

Western banks did have a series of problems, however, including waning confidence in their commitment to their CESEE operations, ring-fencing by national authorities in both Eastern and Western Europe, declining economic outlooks everywhere and creditor doubts about these banks' future prospects. Media reports forecasting doom for Eastern Europe, and by extension the euro area, did not help matters. So, if multinational banking groups really did not want to cut and run and did not face a collective action problem per se, what role did international institutions play, and was the VI truly critical to forestalling a worse set of outcomes?

Our answer is that international institutions played an important role in mitigating the crisis, but it was not the role so often imputed. That is, it was not so much a question of solving a collective action problem or persuading banks to stay, as Zoellick puts it. It was rather the EBRD, the European Commission and international and public actors joining the multinational banking groups in, firstly, developing a coordinated response that militated *against* a purely national approach and, secondly, signalling to market actors that the CESEE region was not going to fall off an economic cliff. International institutions fulfilled the critical signalling function, therefore, of communicating broadly multinational banking groups' intention and capacity to stay – a message that the banks themselves had had difficulty in transmitting effectively and credibly in times of a global credit crunch.

Emphasising the primacy of West European banks' interests in CESEE, and their long time horizons as strategic equity investors there, is important for understanding the difference in apparent success between the VI and other voluntary bank rollover agreements – many of which had historically failed.[9] It means also that we need to be clear-eyed about the limits of the independent effects that public actors can have on private ones. And it points again to the necessity of shared public and private objectives – in this case stabilising funding to CESEE for the betterment of economies there and across the EU – in effective crisis management.

Despite its success, the VI was not seen positively by all external and local observers. For example, the private sector definitely played a major role in fuelling imbalances that required coordinated public-private sector crisis management within the VI framework at a later stage. Given the overexpansion in CESEE banking sectors pre-crisis, it can be questioned why a resulting over-indebtedness and/or liquidity crisis must be mitigated by coordinated public-private sector crisis management (including the use of public funds). This holds especially true as private sector banks were also calling actively for the introduction of a format like the VI when the banking sector situation became shakier in CESEE in late 2008 and early 2009. A prominent group of regional economists asked whether the VI was more of a "clean-wash mechanism".[10] Some observers even labelled the VI as "regulatory capture" and/or "policy confusion".[11] However, experience inside the euro area (and beyond) has shown that it is beneficial for an economy and its partners if a hefty and swift cross-border banking sector deleveraging can be avoided. Some more critical

9 Nouriel Roubini and Brad Setser, *Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies* (Washington, D.C., Institute for International Economics, 2004).

10 De Haas, R., Y. Korniyenko, A. Pivovarsky, and T. Tsankova, 2015. Taming the herd? Foreign banks, the Vienna Initiative and crisis transmission, *Journal of Financial Intermediation*, 24(3), 325-355.

11 See Bankwatch MAIL, Issue 52, May 2012, p. 3.

observers have also interpreted crisis management within the VI framework as a "bail-out" exercise for the private sector. In this context it has to be stressed that the VI offered "no blanket bailouts". The VI was only helpful to put a floor under the funding costs of Western banks operating in CESEE and the asset prices of their foreign direct investment participations in CESEE, so that they in turn could support or recapitalise local subsidiaries if necessary.

Furthermore, the VI framework provided some plannability for Western CESEE banks. The resulting stabilisation of cross-border and foreign-bank exposures towards CESEE should be seen as a direct means to support the local banking sectors and economies, given the deep integration of the subsidiaries of Western banks into the local real economy. By and large the CESEE exposure of leading Western banks is about conventional banking sector business with the local real economy. Most importantly, all major Western banks operating in CESEE were very confident about the long-term business prospects in the region for the decades to come. Therefore, for the private sector the VI was also an important "signalling device" to the outside world and more short-term oriented financial market investors (focused on current imbalances in the real economy and banking sector). Therefore, the VI framework also helped to preserve the by and large sound business models of large cross-border banking groups, with a focus on conventional banking business.[12]

Vienna Initiative: Lessons learned and implications for the rest of Europe

Although the VI can be considered a success story according to its original purpose, a rather critical view of foreign bank ownership and the potential risks involved in this form of cross-border equity integration have emerged in recent years. This holds especially true in the case of Hungary and Poland, but such motives are also of relevance in countries such as Romania or the Czech Republic (e.g., with regard to sectoral taxes, limitations to dividend outflows).[13] Therefore, it seems appropriate that the merits of the VI process are actively promoted (as it happens with this edited volume). In an optimal scenario, lessons learned from the VI framework may even support certain changes to banking market conditions and institutions at the broader European level. As shown in this chapter, we identify some important

12 See Deuber, G., and G. Shpilevoy, Foreign-Owned Banks in CEE/CIS, in Banking in Central and Eastern Europe and Turkey, Challenges and Opportunities, European Investment Bank, 2013.

13 See 'Re-Polonisation' puts banks under government scrutiny, *Reuters Business News*, 26 September 2016; Poland seeks to boost state control of economy, EU Observer, 24 February 2016; Hungary deepens control of banking sector, *Financial Times*, 9 February 2015; Czech politicians take aim at banks, Politico, 17 March 2017; Romania's 'Greed Tax' Reminds Banks of Eastern Europe's Risks, Bloomberg, 19 December 2018.

lessons learned from an institutional and broader European perspective. This holds especially true considering limited progress when it comes to the still incomplete "Banking Union" (BU) within the euro area (BU refers here to centralised oversight and potential resolution at the ECB within the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM)).

Experience within the VI framework has shown that even if actors had divergent approaches with regard to banking sector stability in the run-up to the crisis, nearly all the relevant private and public sector parties converged rather quickly in crisis times (in 2008/9). Prior to 2008/9, some Western banks and Western bank managers were significantly less concerned about regional credit overexpansion than competent local authorities (e.g., central banks). Therefore, it seems more important that all relevant actors can be gathered and coordinated rather quickly, while they need not necessarily have shared a certain mind-set pre-crisis. Moreover, active private-public sector coordination may help to come quickly to a proper market and banking sector risk assessment. In CESEE, private-public sector coordination helped in this regard, resulting in an efficient risk assessment.

Initially, it seemed that some public sector actors were less concerned than private sector agents about the financial instability risks in CESEE. This holds true in Western Europe and in several CESEE countries. A quick risk assessment as well as the following swift response had been crucial for anchoring market expectations and prices. Hence, a negative feedback loop between falling regional asset prices and further negative market expectations was avoided. Moreover, private-public sector coordination helped to increase the leverage of international financial institutions (IFIs) with regard to programme implementation in countries under explicit VI plus IFI coverage. In other words, a higher stabilisation performance can be achieved through cooperation between the public and private sectors, and less public money and risk taking may be necessary than in a purely public-sector-supported stabilisation programme. Therefore, the public sector has an interest in such coordination as well. The limited use of public and pre-defined funding resources could be of special interest for the set-up within the euro area/BU, where a joint and sizeable backstop (e.g., a European Deposit Insurance Scheme) seems to be a very distant option.

Western cross-border banks operating in CESEE were considered to be relatively large compared to their home country GDP, the GDP of host countries, as well as to the overall regional GDP. Therefore, the absorption of exposure to the CESEE region by a few complex cross-border West European banks definitely contributed to a certain risk concentration (i.e., it contributed to common borrower and debtor problems). This might be judged as negative from a regulatory point of view. However, counterintuitively, exactly this risk concentration also supported effective cross-border crisis management. Firstly, the complexity and risk concentration increased the incentives to engage in joint private and public sector cross-border crisis management. It is interesting to note that the cross-border dimension of crisis management also shielded West European banks operating in CESEE – which considered themselves as truly pan-European actors – from too much pressure from their home regulator (a very a common phenomenon in banking and financial crises).

Secondly, crisis management could be delivered via the coordination of a very limited number of actors. Therefore, a coordinated crisis response transpired within a rather short period of time, something that happens rarely in European policymaking. Hence, experience within the VI framework definitely supports the rationale for more banking sector consolidation in Europe. This holds true on a national level and when it comes to cross-border integration in particular. Too many banks are still operating inside the European Monetary Union (EMU)/EU and in some member countries. Nevertheless, a lot of observers are still more focussed on "too big to fail" or "too complex to fail" considerations when it comes to banking sector integration in Europe. It is exactly the success of the VI that shows cross-border banking sector integration does not necessarily lead to a higher degree of financial instability. Hence, a certain market concentration might even be tolerable from a financial stability point of view. A much needed banking sector consolidation in the whole of Europe may also lead to a similar concentration in terms of home countries and actors, as in case of the CESEE region (i.e., that a pan-European banking sector consolidation could be driven by, say, 5-8 banks with a sustainable business model out of 2-4 countries).

The character of integration and the resulting long-term private sector interests matter. The experience of the VI has shown that the degree of international equity capital integration in the banking sector is an important factor in generating positive cross-border effects for financial stability. Notably, with the exception of CESEE, the degree of equity-based cross-border banking integration inside the euro area and EU was, and still is, fairly modest. Among West European euro area members, and most especially in the four largest euro area states (Germany, France, Italy and Spain), "national banking champions" still dominate and levels of foreign ownership in banking sectors are very low. To the extent there was financial integration within the euro area before the US financial crisis, it was debt-based – and a decade later, this is still mostly the case. However, an effective European BU that limits both country-specific as well as systemic risks will require tangible cross-border expansion of healthy banks. Recent financial fragmentation and crisis events inside the euro area have shown that incentives for banks in crisis times differ considerably in an environment of equity- or debt-based cross-border banking integration. Equity-based integration offers more incentives and possibilities to maintain cross-border stability in crisis times. In contrast, debt-based integration increases the risk of damaging “cut and run” behaviour.

The arguments above were very clearly confirmed in the global financial crisis, as well as during the euro area debt and currency crisis that followed. In the course of the euro area debt and banking crisis, cross-border bank financing within the euro area and vis-à-vis certain countries was massively and quickly reduced (in the range of 60-70%). This deleveraging mainly took place vis-à-vis banks from the so-called euro area periphery (and the ECB was forced into large-scale substitution of this financing). This was mainly due to the fact that these interdependencies were generally not backed by a cross-border equity capital injection, so that banks from country A (such as Germany and Austria) had only lent money or granted loans to other "third-party" banks from country B (e.g., Italy, Spain) at short notice.[14] In particular, we would point out that, while West European multinational banking groups had little to no desire to abandon their CESEE markets, funding in Western Europe – where foreign bank ownership levels were low – experienced a devastating home bias in lending. In other words, where financial integration had been achieved through cross-border borrowing (as in Western Europe), funding was much more volatile and prone to retreat than where foreign bank ownership levels were high (as in CESEE). The home bias in lending that afflicted Western Europe had far-reaching consequences. The aggressive retreat of funding behind national borders in the euro area meant that the ECB could not implement its monetary policy effectively; bank-state doom loops were exacerbated as funding costs for crisis-hit governments rose; and economic downturns were compounded by capital scarcity, particularly on Europe’s periphery.

Historically, it seems states have been more likely to accept high volumes of cross-border capital flows than to accept high levels of foreign bank ownership. For the purposes of achieving financial stability, however, it could well be that their priorities should be reversed. This is because equity-based integration introduced a much higher

14 See, for example, ECB, 2012. *Financial Integration in Europe*, Report, April, European Central Bank, Frankfurt am Main; available at http://www.ecb.europa.eu.

level of "financial resilience" – which is exactly what we witnessed in Eastern Europe during the crisis. Precisely because of foreign bank ownership, there was foreign direct investment, because Western banks had invested in subsidiaries and because those subsidiaries were also beholden to host governments, much of the capital and liquidity that had been extended in CESEE could not easily be reversed – quite apart from the lack of desire among banks to forsake market share, as we have already argued.

Given these developments, and the admittedly novel scope and character of foreign bank investment in CESEE, we take one of the central lessons of the VI to be the value of transnational bank ownership in the euro area more broadly – keeping in mind that we believe the VI's salutary effects were strongly driven by a comity of public and private sector interests, rather than by international institutional power alone. The EU in general may be over-banked, a number of weak institutions have long been protected by national authorities and cross-border bank flows went into retreat during the crisis. To remedy these vulnerabilities, building banking markets in Western Europe that more closely resemble those in Eastern Europe – where financial resilience was high and banking markets are competitive because of openness to foreign investment – could well bring greater stability to the euro area. There are definitely critics of such an approach. In particular, policymakers and analysts alike have wondered whether or not banks would continue to come under pressure from governments to privilege home markets over foreign ones during a crisis.[15] The supranationalisation of bank oversight in the ECB through the SSM goes a long way in establishing the authority to prevent that – at least in the euro area. How the ECB will ultimately exercise that authority is still unknown.

Our larger point is that the recent years of clean-up and increasing resilience in the macroeconomic stability inside the euro area and its individual banking sectors should be seized on to boost and deepen the cross-border equity integration in the financial sector. The deep level of banking sector integration in CESEE was also achieved following hefty adjustments in the 1990s, increasing the attractiveness for market entries and cross-border equity integration in a subsequent recovery and growth phase.

Speaking of a return to expansion and growth in European banking, the experience in the CESEE region (or some euro area periphery countries) has shown that it might

15 See for example Robert Wade, "The Aftermath of the Asian Financial Crisis: From 'Liberalize the Market' to 'Standardize the Market' and Create a 'Level Playing Field'." In B. Muchhala (ed.) *Ten Years After: Revisiting the Asian Financial Crisis*, pp. 73-94/ Washington, D.C., Woodrow Wilson Center for Scholars (2007).

be hard for regulators to stop a self-fulfilling credit boom, one that might finally lead to a bust. Crisis management mechanisms are therefore at least as important as preventive measures. That said, the BU framework (SRM, Single Resolution Board (SRB)) will not shield the euro area and/or the EU from all banking sector instability going forward. However, accurate and somewhat more centralised information about interlinkages (due to more centralised banking sector oversight at the ECB and European Systemic Risk Board (ESRB)) may facilitate crisis management – if needed. Hence, coordinated cross-border crisis management inside the euro area/EU, as in the context of the VI seen back in 2008/9 and involving the private plus public sectors, seems to be a more realistic option nowadays. Moreover, the success of the VI has shown that crisis management is possibly most effective when a limited number of relevant people that share a common vision know and trust each other and can be brought together quickly. Therefore, it is positive news that the foundation for such structures and networks has been partially established within the euro area architecture in recent years. With the ECB as the central institution for banking sector oversight for the largest (cross-border) institutions, the ESRB framework euro area/EU institutions and competent national authorities can act quickly. Moreover, close contacts between supranational regulators and the largest European banks have also intensified.

Experience with the VI framework has also demonstrated that large-scale and complex banking sector risks in an integrated financial market cannot be insured at the national level and by the public sector only. Therefore, a certain formalisation of similar cross-border and private-public sector crisis management structures in line with the VI framework at the European level could also be helpful. As part of an imaginary "Paris" Initiative or "Frankfurt" Initiative (due to the headquarters of the European Banking Authority in Paris or ECB in Frankfurt), major euro area/EU banks or other creditors could be offered credible and coordinated stand-still agreements (e.g., for cross-border banking exposures or sovereign bond holdings) in exchange for temporary ECB/Outright Monetary Transactions support. Finally, a robust European Stability Mechanism (ESM)-sponsored stabilisation and reform package – a structure similar to the VI 1.0 format would be productive. In order to increase the reach of such a would-be "Paris" or "Frankfurt" Initiative or agreement, it would be helpful to boost the reach of the BU beyond the euro area.

It is positive news that the BU's design foresees flexible forms of "opt-in" and "close cooperation" when it comes to European/EU countries that have not yet joined the euro area. However, the "opt-in" option has not been used up to now, as the incentives for non-euro countries to join are weak. This may change if a somewhat more formalised but flexible cross-border private and public sector crisis management architecture could be established at the European level, reaching beyond the euro area/BU. Moreover, establishing some sort of crisis management beyond the euro area may contribute to more enlightened decisions about the benefits of joining the euro area on a national level. Due to the lack of support measures beyond the euro area, entering the currency union could still be considered an "easy" option to boost the resilience of an economy with substantial ties to the euro area banking sector.

That said, an envisaged entry into the euro area could be even more attractive for EU countries with a lower degree of financial sector stability or credibility than for countries with a high degree of resilience and credibility. Therefore, the decision to join the euro area could be possibly also driven by factors other than the readiness to succeed economically within the single currency area. Hence, with more effective and flexible crisis management tools, the euro area could be confronted less often with "unqualified" applications. Moreover, a repetition of stabilisation exercises, as within the VI format at the EU or European level with ESM participation – if needed – could support the ESM going forward. The ESM may gain in profile as an institution with its own policy identity and agenda. However, such a crisis management architecture would certainly require some institutional change. For instance, the ESM mandate should be enlarged, reaching beyond the euro area. When it comes to financial stability operations, the ESM should be in a position to get involved in all EU countries, possibly even in non-EU countries with close economic and financial sector linkages to the euro area/EU and euro area/EU banks.[16]

As sketched previously, somewhat more "formalised" cross-border private-public sector banking crisis management architecture could be helpful and preferable compared to *ad hoc* solutions. However, too much formalisation of a "Paris/ Frankfurt Initiative" does not seem possible either. Firstly, a framework like the VI has to keep a certain degree of flexibility. Moreover, the VI process has shown that established national and/or supranational public sector actors and institutions could be more critical to the establishment of a new formal institutional set-up. Nevertheless, a definition of certain pre-conditions for public-private sector coordination and crisis framework could make sense (e.g., with regards to Private

16 For ideas on the institutional architecture of the euro area and EU institutions, see G. Deuber, 2018. EMU/EU Economic Integration – "Soft Deepening" looked-for as "Quantum Leap" not feasible for longer, in: G. Sander and G. Deuber (eds.), EU und EWU vor neuen Herausforderungen im Nachgang der Staatsschuldenkrise, Verlag Dr. Kovač, Hamburg.

Sector Involvement (PSI), minimum criteria such as keeping banking sector or market instrument exposures constant in exchange for IFI support, maintenance of capitalisation levels in bank subsidiaries). Moreover, it has to be clear that such a format would be about limiting tail risks with a substantial cross-border dimension. Effective crisis management between the private and public sector (as in the VI framework) is not about complete risk insurance or an equalisation of financing or banking sector conditions across Europe. Neither should short- to medium-term oriented crisis management (with a focus on the next 12-36 months) limit any longer-term structural adjustments (as we have seen in CESEE, including some VI countries), which may last for some 5-10 years. In this context it seems that longer-lasting and orderly adjustments in the CESEE banking sectors, following a procyclical overleveraging pre-crisis, are partially overshadowing the fact that the VI (including the engagement of private sector banks) helped to avoid a rapid, steep and dangerous deleveraging as well as possible balance of payments and/or financial market crises in the first place.

Longer-term structural adjustments in some CESEE banking sectors with high foreign/Western banking sector ownership have definitely contributed to local scepticism about economic integration and/or foreign investment, most notably in banking. Prominent examples include Hungary, Poland and Romania (and to a certain extent the Czech Republic), where re-nationalisation or domestication for formerly foreign-owned banks and/or "envy" (in terms of profitability) have become established in recent years in relation to the banking sector. Here, political discourse often overlooks the fact that cross-border equity integration implies profit and risk sharing across economic and financial cycles. In this respect, cross-border equity integration means that in "good" times, for example, cross-border dividend payments from host to home countries will also take place. But lessons from the VI and financial market integration will be obscured by lingering nationalist sentiments, not just in CESEE. In Western Europe, too, there have been demonstrated political tendencies (quite questionable) to preserve or even expand upon the "national champions" approach to banking. For example, the debate in Germany regarding the possible Deutsche/Commerzbank merger (an idea that has now been abandoned) was very much centred on how to maintain politically susceptible commercial bank behemoths. Meanwhile, cross-border bank mergers, even if they would better support the euro, are not necessarily valued in such political circles. Against the background of the multifaceted experiences in the context of the VI and with cross-border equity capital integration in the banking sector in CESEE, these nationalist attitudes and policies run counter to some of the most important empirical findings of the crisis.

Conclusion

The Vienna Initiative has shown that effective public and private sector crisis management could become a key feature of integrated European banking and financial markets. This holds especially true as large-scale banking sector risks cannot be insured at the national level and only by the public sector. The evolving structures of the "Banking Union" offer increased opportunities to engage in effective private-public cross-border crisis management in times of instability. Such crisis management structures may also help to formulate a proper risk assessment in challenging times and should be seen as an effective way to secure private-public sector coordination and burden-sharing. Effective private-public sector coordination may also help to deploy less public sector funding for the same "amount of financial stability". A limited formalisation of relevant crisis mechanisms, or a repeat of the VI structures within a "Paris" Initiative or "Frankfurt" Initiative – if needed – would definitely help to further boost banking sector integration in Europe – and to avoid backlashes in crisis times. Here, market structures still do not match recent institutional progress within the BU. Furthermore, BU institutions will undergo further change. The financial stability mandate of BU/EU institutions should be much broader than just for the euro area. For such a mandate, a somewhat formalised but still flexible private and public sector crisis management framework would definitely be supportive.

In this brief chapter not only have we stressed the extent to which market structures, especially in Western Europe, have not kept pace with the needs of euro area governance, but we also note that key actors – national governments especially – are not embracing the main findings from the VI episode and its implications for euro area management. And in Eastern Europe it appears that some of the key lessons have even been unlearned. In particular, our past research shows that: cross-border equity investment in banking was a stabilising factor in the financial crisis; cross-border debt flows were by contrast highly destabilising; forging ahead with more transnational bank ownership in the EU would support the euro as well as the ECB's new bank oversight and governance institutions; and cross-border bank mergers would also ease the coming political struggle over pan-European and mutualised deposit insurance. It is true that our recommendations violate past practice with respect to traditional government ties to banks (especially in Western Europe). But it is also true that, in light of the common currency and single market, now is the time to embrace further change rather than the nationalist mobilisation that threatens to stymie the European integration project.

All in all, the experience of the VI has shown that effective banking sector crisis management requires a certain alignment of interest between the public and private sectors. Such an alignment could be supported by deep equity-based banking sector integration that transcends national thinking in the banking sphere. In the case of (Western) Europe there seems to be a lot of room for further equity-based cross-border banking sector integration, driven by larger European banks with a sustainable business model. However, such an integrated market may bring a degree of individual or systemic risk concentration (e.g., in terms of regional exposures at certain banks and/or of home country concentration, or that cross-border banks from 2-3 European countries may dominate the overall banking sector in Europe much more than now). However, the VI framework has shown that such risk concentration does not necessarily increase financial instability risks if and when effective crisis management is able to meet the long-term interests of all relevant actors in the public and private sector.

Annexes

Conference on the tenth anniversary of the Vienna Initiative: a summary

Held in the Austrian National Bank, Vienna, 27 March 2019

The conference was under the chairmanship of **Boris Vujčić**, Governor of the Croatian National Bank and Chairman of the Vienna Initiative. The two opening addresses were given by the hosts, Harald Waiglein, Director General of the Austrian Federal Ministry of Finance, and Ewald Nowotny, Governor of the Austrian National Bank.

Director **Harald Waiglein**, standing in for Minister Hartwig Löger, recalled the tension in the Austrian Federal Ministry of Finance ten years previously. Austria had a caretaker government at the time of the collapse of Lehman Brothers. At that point, the spread on Austrian bonds began to widen, and those in the Ministry started to get worried. In those circumstances, the staffs of international financial institutions (IFIs) started to coordinate their efforts to support the countries of Central, Eastern and Southeastern Europe (CESEE), and the Ministry encouraged Austrian banks active in the region to engage with the IFIs in support of these countries. The *IFI Joint Action Plan* for the region was hatched as a leg of the Vienna Initiative. Ten years later, one question is whether the Vienna Initiative could be replicated today, should it be necessary. Director Waiglein was inclined to doubt it, as it seemed unlikely today that private banks could be persuaded to extend their exposure in the international interest.

Governor **Ewald Nowotny** was somewhat more sanguine. The Vienna Initiative had been a model of how to deal with the Prisoner's Dilemma. If each of the banks involved had followed its first instinct and reduced its exposure, the system of cross-border banking in the CESEE region would have collapsed. Over time, the participants faced coordination fatigue. But the lessons of the Vienna Initiative remain very important. While cross-border banking in Europe continues to have problems, the efficiency gains are large. If these gains are to be realised over the long run, there must be cooperation on regulation, taxation and other issues, which are being tackled in the Vienna Initiative. It is good that the chair of the Initiative, Boris Vujčić, is someone able to deliver this message effectively.

The keynote address was given by **Thomas Wieser**, former president of the EU's Economic and Financial Committee and of the Eurogroup Working Group, and with the Austrian Federal Ministry of Finance at the time of the Vienna Initiative.

The crisis that led to the Vienna Initiative and the Initiative itself taught us many lessons. The first might be that our economic systems, national and international, move from one disequilibrium to another. Our intellectual and institutional frameworks therefore need to be flexible and adaptable, and we should be prepared to scrutinise ourselves. Looking back ten years, we should pay tribute to the work of Klaus Regling and the late Max Watson, who saw how things were developing more clearly than most. They criss-crossed the continent warning about the emerging bank-sovereign "doom loop" and being told that there was no correlation in country risk, and that European banks' capital buffers against such a circumstance were just fine. If Max were still alive, he would be calling today for the building of buffers. The second lesson is that strong systems need to be put in place during the good times.

But when the crisis strikes, there needs to be a clear lead institution and a clear attribution of responsibilities, as well as a broad understanding of how risks and losses are to be allocated. Europe has since created a multitude of bodies to handle these things, but the goal is not yet in sight. A remarkable aspect of 2009 is that the stars were aligned and there was excellent cooperation between the myriad actors. But, the third lesson – this only happened because the conditions for nurturing such cooperative attitudes had been created.

Cross-border banking involves risk taking, rather as trapeze artists do. But the banking safety net is not under the trapeze. For banks and countries, it makes a big difference whether or not the country is in the European monetary union. The local safety net of the monetary union, the European Stability Mechanism, is not well aligned with the global safety net, nor does the European Stability Mechanism provide comfort for European countries outside the European Union. Greater integration increases the risks of contagion and correlation. The fourth lesson is that this integration makes a structured dialogue based on mutual trust essential – indeed, the closer the integration, the greater the need for regular surveillance.

The temptation to stick one's head in the sand is not helpful – the fifth lesson is that closing borders does not work. If we build barriers around Europe, around individual countries and then around institutions, we will return to the Stone Age of European integration. A corollary to this is the sixth lesson – we encountered a significant lack of understanding of CESEE in Brussels ten years ago. We are a European Union of 28 (or 27) countries, no longer a grouping of West Europeans. But by the same token, many on the Eastern side of the continent do not understand the EU. And, finally, a seventh lesson – politicians want to wish away losses, shifting them to other balance sheets, but losses always remain as losses. There needs to be honesty on this.

But looking back ten years, what is most cherished is the friendship and enthusiastic cooperation of those most involved, and their sense of a shared destiny. This was a time when people believed in cooperative, multilateral solutions to problems. While we can hope, it is not obvious that this optimism and this belief still reign today.

The first session of the conference covered *lessons from the crisis in the context of the Vienna Initiative* and was chaired by Boris Vujčić

Julia Király recalled that the first time she visited Vienna in the capacity of Deputy Governor of the National Bank of Hungary in charge of financial stability was in October 2007. Together with Boris Vujčić of the Croatian National Bank and Christian Popa of the National Bank of Romania, she had met with Thomas Wieser to discuss the credit bubble in CESEE. At the time they were all confident that they could cope with such a small bubble – maybe the Baltics had more of a problem. But the first lesson in her view was that when you see a bubble, be careful. Subsequently, Andreas Treichl, CEO of Erste Group, visited Budapest, and the officials of the National Bank asked him to stop foreign exchange lending in Hungary. But there was no response to this request, until a sudden stop of capital hit the CESEE region in October 2008, right after the Lehman crisis.

At the start of the crisis, it was believed that there was an umbrella over the eurozone countries, but as Zsolt Davas pointed out, the actions of the European Central Bank (ECB) exacerbated the effect of the crisis on the CESEE region. It didn't feel as if European institutions were offering much help. The CEOs of major parent banks wrote to the European institutions about the urgent need for action to preserve stability. Piroska Nagy-Mohácsi and Erik Berglöf of the European Bank for Reconstruction and Development (EBRD) ran around Europe trying to get something done. They proposed a public-private partnership to deal with the situation where no one cared about their neighbour and, as Thomas Wieser noted in January 2009, everyone was focused on preserving their own country.

It was not an easy time to get action – nothing was easy and there was the prospect of a big recession. Everyone was facing their own local problems. The CESEE region was seen as source of contagion. Thus, on 3 March 2009, US President Obama called for "a common set of principles [concerning] banking, so that problems that exist in emerging markets like Hungary or the Ukraine don't have these enormous ripple effects that wash back onto our shores". And yet cooperation was mobilised through the organisation of the Vienna Initiative.

Jörg Decressin, Deputy Director of the International Monetary Fund (IMF) European Department, noted that the CESEE region in 2009-10 managed a greater and less costly adjustment in external imbalances than did many other parts of the world. The Vienna Initiative probably contributed to this outcome. Before the crisis, the rate of CESEE *per capita* income convergence was similar to that of Korea, and banks helped finance this growth but also the resulting imbalances. The real GDP contraction in 2009 was 6% – a very deep recession but without contagious financial meltdown. Governments in the region avoided large devaluations, and in this they were supported both with IFI and EU financial packages and by the commitment by banks to the region.

The policy aim was to avoid a panicked withdrawal of foreign funding. Seventeen banks were involved, and no subsidiaries failed. Parent banks provided additional capital and liquidity. Five CESEE countries were supported by the IMF, and banks renewed their commitments within IMF-supported programmes. A study by Ralph de Haas has shown that parent banks which signed commitment letters behaved better than those which did not. The recessions experienced by the countries were smaller than during the Asian crisis, and adjustment was as large. The Vienna Initiative meant there was more commitment and more buy-in.

Looking ahead, the Vienna Initiative should focus on financial surveillance. A regular dialogue in anticipation of crises is a necessary coordination device. And it can also be a forum for sensitising EU regulators to the region. Finally, the withdrawal of some banks from the Western Balkans now underway is a matter of concern.

Helmut Ettl, Executive Director of the Austrian Financial Market Authority (FMA), recalled that 2006-7 was a bonanza for Austrian banking groups operating in the CESEE region. They had up to 40% market share and were willing to pay high prices to take over local banks. This was considered a major success story for Austrian banks. The main area of business was lending to households and companies, and the parents provided the funding in the form of cheap liquidity and capital transfers. A side effect of the funding model was extensive foreign exchange lending.

Once the crisis was underway in 2009, Paul Krugman famously described Austria as the advanced country at most risk. The IMF and others shared this view, and they were probably not completely wrong. A crisis was emerging in the real economies of the region, and if there had been payments difficulties, it would have had implications for Austrian banks at home. The Vienna Initiative was intended to avoid uncoordinated reactions, and to ensure that bank support packages also helped their subsidiaries abroad. In this regard, the Austrian government stabilisation package of November-December 2008 included €2 billion to help Austrian banking groups, and this was not restricted to domestic use. It was not easy for Austrian politicians to explain to the public, but those then in charge had the courage to do so.

So how should we judge the Vienna Initiative? It was developed and implemented at the right time and by the right people. But this should not be taken for granted – we tend to think that what happened had to happen. But in 2009 things were not so clear. Economic understanding and political expertise were in short supply, and who was to be trusted in such a strained environment? Trust has to be built in good times, so you can employ it when you need it. Austria had the luck to have Thomas Wieser. Was the environment favourable to cooperative approaches, despite some theories of economic competition? In fact, it was not an anonymous market, but a limited number of people and players. The public institutions were willing to avoid ring-fencing, as supervisors agreed that it would make no sense. The organisation under an international and EU umbrella and close monitoring by a respected third party both played their part. And one important precondition was that the assets of Austrian banks were not reduced. We can now see with hindsight that the portfolio of subsidiaries consistently produced profits, except in 2016 when nonperforming loans (NPLs) were shed from balance sheets. And with the hindsight of ten years, we can see that the Vienna Initiative was a success.

Andreas Treichl, CEO of Erste Group, saw at the conference a number of people who had been very helpful in 2008-9 and with whom he had been able to talk through the issues. The Vienna Initiative had worked extremely well as it was a cooperative venture between politicians, regulators and bankers willing to work together without any preconditions. All were fighting against those who thought that the CESEE was disaster zone – foremost among them, Paul Krugman.

In 2008 Erste Group saw the crisis approaching. The thing that got Erste into trouble was the price of its most recent acquisitions. As Treichl explained: we were worried that everything we had built up over the previous eight years would be destroyed. We had tried to recreate what had been founded two hundred years previously with the establishment of Moravian and Bohemian savings banks in 1825. We were trying to recreate this structure and had Asian and UAE investors willing to give us the capital we needed. The Austrian Government was supportive. We had a Chancellor and Minister of finance with three-digit IQs, advised by brilliant people with three-digit IQs. Some colleagues were against our use of foreign capital. We did it. It was not pleasant, but it helped. And we thought we were safe.

When the real crisis broke out, our share price started to fall dramatically. The value of the bank, worth €14 billion in 2007, collapsed to €1 billion. We were really furious at President Obama when he talked disparagingly about the CESEE region. We got calls from investors saying there would be no more capital. That phase didn't last long, but it was a very frightening experience. We learned the lesson that intragroup funding is basically contingent capital. The loan-to-deposit ratio in Hungary was 300, but now it is 60.

The Vienna Initiative was more than a success. No country in the region required any support to its banking system – the whole region was kept clean of government support, a huge success. It is a wonderful story to tell regulators in Brussels. A case of professional people getting together to solve a problem and having the guts to do it. The ECB should ask itself whether they would be allowed to do this again. Would such an approach get the approval of the EC and the ECB in 2019? Are we in an environment that is so heavily regulated that this Initiative would now be impossible?

Piroska Nagy-Mohácsi, London School of Economics (originally with the EBRD), spoke of the personal bonds created during the first phase of the Initiative. She drew attention to the subsequent developments of Vienna Initiative Plus and Vienna Initiative 2.0. After victory had been declared in the crisis management phase in 2010, the Vienna Initiative platform was used for financial discussions. Various pressing issues such as NPL reduction, foreign exchange lending and the utilisation of EU structural funds were examined. Then the eurozone shock occurred and Vienna 2.0 was established with the strong support of the Commission. Now it was time for Vienna 3.0 to cover the issues that Jörg Decressin had mentioned.

In looking at the experience of the Vienna Initiative, three points emerge. The first is the importance of any supranational coordination being rooted in strong national interests. The post-war system is now being challenged. The Vienna Initiative Plus approach showed that any supranational coordination has to be anchored in national sovereign self-interest. Voters are nation-based. The luck of the Vienna Initiative was that Thomas Wieser was able to link up sovereign interests. He showed that it was not just Austria, but France, Italy and others who would benefit, plus, on the host-country side, as Julia Király has mentioned, Hungary, Serbia and others. And European structures also benefitted from this. Vienna Initiative Plus complemented what could be done at the EU level, and so Mario Nava and Sean Berrigan urged us to continue with the Vienna Initiative. The emergence of clubs inside the EU may be a way forward and help to reduce the democratic deficit.

A second point is how to involve the private sector, a signal strength of the Vienna Initiative, which itself was prompted by the famous letter from bank CEOs. Schemes for private sector involvement had been in existence for some time. But in the Vienna Initiative, it was not private sector involvement, but private sector *engagement*. It was not simply something called for, to be followed by the application of moral suasion, but the banks had an input. This was both a very important element and a major strength. The banks' commitment was part of the overall support package, and conditional on appropriate adjustment in the host countries. Post review meetings were held with the banks, and it was clear that if the country programme went off track, commitments could be abandoned. This was never a matter of regulatory capture, and EU institutions did a great job.

The third point is the importance of the IFI community. Of course, the central banks and ministries of finances of home and host countries and EU institutions were centrally involved. But, fundamentally, it was the technical convening power of the IFIs that gave impetus to the process. This was the first time the IFIs worked together as a system, as indeed they should. The importance of this collaboration is a major lesson from the Vienna Initiative. The result was that, in addition to the macroeconomic IFI programmes that were put in place, micro-oriented IFIs also played a complementary role. This was not a matter of one or two institutions leading, but true cooperation. Looking at this from an academic perspective, the Vienna Initiative was a form of "democratic experimentalism" with transnational institutions.

In the subsequent discussion, **Helmut Ettl** noted that Vienna 1.0 was about stabilisation, but the Austrian authorities urgently needed to strengthen their banking groups. The Austrian stabilisation package launched in 2012 was controversial, since it not only asked a lot of the banks but had an effect on host countries. The system up till then had given false comfort to the host countries, and that needed to change. The Vienna Initiative did a good job in handling this matter. **Andreas Treichl** thought that the Vienna Initiative would be required in the future, but will have to involve a different set of players. The European banking system now provides about 80% of the economy's financing, a figure which reaches 92% in CESEE. By contrast, banking only constitutes 25% of the US financial system. The emerging European regulatory system does not allow for banks to finance 92% of the economy, and much of this financing will have to be replaced by capital markets. But in that case, a different set of people will have to sit around the Vienna Initiative table. **Piroska Nagy-Mohácsi** considered that the challenges ahead related to such matters as restructuring the financial sector and digitalisation. Finally, **Julia Király** concluded that there were dark sides to globalisation and freedom of cross-border capital movement, and among the lessons was that intragroup capital becomes contingent capital. But the most remarkable aspect of the Vienna Initiative was that no bank was bailed out in CESEE as a result of the crisis, and the recovery of the CESEE region had been stronger than that following other crises.

The second session of the conference dealt with the future of cross-border banking and was chaired by Andreas Ittner, Vice-Governor of the Austrian National Bank

Dinosaurs, Ittner remarked, were huge animals whose extinction was due to a change in environment and a lack of adaptability. Such a fate should not be that of the Vienna Initiative. The regulatory environment was changing rapidly with the establishment of the Single Supervisory Mechanism, memoranda of understanding, deposit insurance, etc., but equally important was the evolution of the banks themselves. Cross-border banking, despite all its problems, is an important driver of financial integration. Even if Europe will have to rely more on capital markets, the financial system will not work without banks. The business model of banks has been changing rapidly, and new competitors, such as Fintech have emerged. With protectionism increasing at global levels, strengthened multilateral coordination is becoming more important than ever, but we must strive to make it relevant to the emerging environment.

Sabine Lautenschläger, until recently the head of the Single Supervisory Mechanism (SSM), called for more discussion of cross-border banking. It was clear that if it is done correctly, it provides for a diversification of risks and thus more financial stability. Clearly, cooperation among supervisors was critical, but one of the lessons of the crisis was that even if there was excellent informal cooperation before the crisis, it all became much more difficult when the crisis started. Lautenschläger recalls: in 2008, when the crisis struck, half my contacts seemed dead – or were just not answering the phone. Everyone was scrambling for information on their own or on other banks. Markets and banks turned out to be much more interconnected than we had expected. In the aftermath of the crisis, there was much discussion of information exchange, and global and European standards were raised substantially. A structural framework was put in place on what to exchange, how to do on-site inspections, SREP ratios, etc.

But it is vital that this not stop now. The key to the process is trust and constant cooperation and making friends. It is important to get to know one's counterparts in other authorities. To know how and whether to rely on another authority's supervision. This is easier in theory than in practice. When a host supervisor requests an exchange of information, you have to explain what information you collect, what rules you apply and why the request is wanted. The Vienna Initiative is a very good example of cooperation in time of crisis.

It shows how important it is to create structures for a deeper dialogue between supervisors. At the start of the SSM, things were quite difficult, since there were no memoranda of understanding, just an inherited network of 104 old memoranda. Since then our appreciation of the issues has increased enormously, as the SSM is both home supervisor in some cases and host supervisor in others. It would be good if some of the matters which do not work well in cross-border banking, such as "fit and proper", capital waivers, large exposure waivers and liquidity waivers, could be left as national options at the discretion of Member States.

Filip Keereman, Head of Unit, DG FISMA European Commission, spoke on how to prevent crises in cross-border banking. The banking system was strongly interconnected, but this was more a problem for the host country than the home country. As a result, tackling the problem of contagion required action at the central level while paying attention to the impact on individual countries and at the regional level. Since the crisis, the examination of policies during the European semester under the Macroeconomic Imbalances Procedure paid increasing attention to financial variables. Critical thresholds had been established for several variables, including the real house price index, the total balance sheet, private sector credit flows and private debt. There was now an examination on an annual cycle, with the Commission producing recommendations.

The Vienna Initiative had been a temporary success, in that it allowed time for an orderly deleveraging and the building up of local deposits. But it did not work in the Greek context, which provides some sort of counterfactual case. One difference was the absence of a strong international banking footprint in Greece. The support required from the private sector became a haircut on its exposure and this led to contagion to Cyprus. Another reason for the differential success was that there was a better understanding in the CESEE region concerning policy needs than there was in Greece.

Anita Angelovska-Bezhoska, Governor of the National Bank of North Macedonia, agreed that cross-border banking had played an immense role in her country, with exposure reaching 69% of GDP at some point. It had brought large benefits and increasing access to finance and had been among the main drivers of convergence. Surveys by the ECB have shown the advantages of cross-border banking, including the introduction of financial know-how into the region. And, in coping with the crisis, the Vienna Initiative played a critical role.

In the future, the region is going to have to rely more on domestic resources. A significant share of banks are planning to reduce their operations in the region, and interest in it is declining. There is still a lot to be done to increase cooperation. Much progress has been made – local deposits are rising throughout the region and the ratio of credit to deposits is falling rapidly. But the economies suffer from low savings levels, and so cannot rely on this for convergence in future. If investment levels are to rise, the cash that is currently outside official channels needs to be mobilised.

Erik Berglöf, London School of Economics (previously Chief Economist, EBRD), recalled that, when the crisis struck CESEE, the EBRD had a strong incentive to engage, as it had relations with 200 banks in the region. The challenge was to find a way to work together to get the region through the crisis, and here personal relations were critical. Most of those in the room would not be friends had it not been for the global financial crisis. For himself, the crisis had completely changed his life. The lesson was that these personal relationships needed to be built up in peacetime, and this was especially important when the whole structure of international cooperation was under threat.

We are seeing a retrenchment of cross-border banking across the globe. This is partly about risk aversion, but it is also about capital flows from rich to poor countries. There clearly were too many risks in cross-border banking, especially in Europe, but he wondered whether we had gone too far in our response.

There seemed to be three trends concerning this cross-border banking. Firstly, there was retrenchment, with a lowering of risk levels and disintermediation. Corporate bonds were becoming more important in international financial flows, but this meant that the risk had been shifted to a less regulated part of the system. Secondly, concentration had increased and there were now fewer banks involved in cross-border banking. This might be a good thing, but it also brought heightened vulnerabilities. Finally, the political atmosphere had worsened. Populism in finance may have started in Hungary, but there were signs elsewhere – and globally. Institutions were trapped as sitting ducks for political movements. This also was a worrying development.

These three factors could come together, possibly in the event of a downturn. To find the right balance, we need to be aware of the value of these capital flows. It is essential to create an environment that provides a stable basis for such flows. Progress in creating the Banking Union in the EU is encouraging, but the problem of how to create the right structures elsewhere to deal with the volatility of capital flows has not yet been resolved.

Aurelio Maccario, head of regulatory affairs at the Unicredit Group, said that memories of the Vienna Initiative came to him each year when looking at the scenarios that the bank prepared for the SSM. The lessons of the Vienna Initiative had been well explained by Governor Nowotny and Thomas Wieser. In times of crisis, things depended on the individuals involved – everyone needed to be seated round the table. The European cycle was getting worse, and thus good times needed to be used to strengthen cooperation. The European Capital Market Union had to be created from scratch and would not work if other capital markets were copied blindly. Post-crisis, the traditional commercial banking model still prevails. In developing capital markets, it was most important to look at the buy side – pension funds, insurance, etc., – and to recognise European specificities. Finally, on the Banking Union, Maccario said that the Vienna Initiative was the first attempt to bring all relevant parties around the table. It showed that with a bit of planning and strategic direction, things can be done even before the Banking Union is fully developed. Group recovery plans can now be prepared for all supervisors, as opposed to the situation before.

In the subsequent discussion, **Chris Muyldermans** of KBC noted that the panels seemed to see cross-border banking primarily as a matter of capital flows. She thought that the full range of cross-border activities needed to be considered so that, for example, a customer could use a single account in his or her transactions across the continent. **Jörg Decressin** wondered whether it would be possible to do something like the Vienna Initiative in the event of a new crisis. **Piroska Nagy-Mohácsi** explored the question of whether the Vienna Initiative could work in other circumstances. In the case of Ukraine, an attempt to use Vienna Initiative mechanisms foundered because, in the absence of a strong host country adjustment programme, it was impossible to get bank commitment. And in the case of Greece, the approach was not that of the Vienna Initiative – there was no collective treatment of the banks; nor was peer pressure applied. In response, **Andreas Ittner** pointed out that facing a sudden stop of capital flows was a situation in which countries had limited options. They could nationalise the banks, but this would not have helped with the funding problem. The case of Greece was different, in that funding help was expected from the eurozone. As for the question as to whether this could happen again, it was doubtful that the supervisor would be able to let banks keep lending to a country where government policy was unclear.

Sabine Lautenschläger referred to some principles that a supervisor should follow. The first was that a supervisor should not tell a bank what sort of business it should or should not undertake. But a second principle was that a supervisor should not be blind to the emergence of risk. The eurozone was now in a better place in regard to the legal environment, but there was a fear that the procyclical behaviour of supervisors and the banks could make things worse. It was important to focus not only on the crisis but on whether enough risk-mitigants – counter-cyclical buffers – were in place before the crisis. Now was the time to be bold, so that the supervisor can say it comfortable with the available buffers. If a risk-mitigating structure, such as Vienna Initiative, exists, then the supervisor can take it into account. But supervisors do not want to be told to be as lax as possible during a crisis.

Erik Berglöf agreed that cross-border banking was a relatively stable and safe way of transferring capital between countries. But it had also made other important contributions to the prosperity of the CESEE region, even if it allowed risks to build up. But there was little prospect of this happening in the rest of the world because of the new constraints that were being placed on commercial banks. In emerging Europe we have a chance to do better than elsewhere, as we have an anchor to support cross-border banking.

Aurelio Maccario agreed that, thanks to the single market, there was no problem in servicing corporates cross border. But, with the movement to a Capital Markets Union, and facing a lot of new regulations, it was becoming harder to lend to many new clients, as the banks did not want to build up more NPLs. Since the bulk of companies were small to medium-sized enterprises, the conditions needed to be created to provide more equity finance for such companies. The new capital requirements will typically penalise European banking, and it was to be hoped that this matter would be on the new European Parliament's agenda.

At the end of the session **Andreas Ittner** summarised that cross-border banking was urgently needed within the SSM, and that trust between stakeholders should be built up during peacetime.

The third session of the conference, under the chairmanship of Boris Vujčić, covered the future role of the Vienna Initiative in preserving financial stability and promoting growth.

The chairman pointed out that the structures of cross-border banking in the region had changed, and that would matter in a future crisis. The loan-to-deposit ratio was now below unity, so that would be less of a factor, but there was still the matter of MREL. And the Capital Market Union would also affect the structure of the financial system.

Cyril Muller, Vice President, Europe and Central Asia of the World Bank, argued that it was important to understand why the Vienna Initiative worked. The key was collective action to address challenges and problems by stakeholders who trusted each other. Personal relationships mattered, as well as the ability to leverage the power of international institutions for a greater purpose. But how is such credibility to be built? Ten years ago, he was an observer of the process, then President of the World Bank Group Robert Zoellick placed huge emphasis on private banks being around the table. It was also vital that the interventions of the multilateral development banks be credible and in sufficient amounts, and in the end, commitments under the *Joint IFI Action Plan* were exceeded significantly. One indicator of the success of the Vienna Initiative is the fate of countries where such a mechanism was not in place, such as Ukraine and Turkey.

The next crisis is unlikely to come from the banking sector, since there is no longer such excessive leverage. However, there is stronger dependence between the financial and fiscal sectors. Central banks did a good job in the crisis, but the performance of the fiscal authorities is less clear. And the financial sector is evolving, with fintech a particular growth area. But it is striking how surveys of companies in the tech sector never mention access to finance and credit. And then there is the question of ownership of private and privatised banks, since some of the potential owners have doubtful track records.

Pierre Heilbronn, Vice President, EBRD, remarked that trust and friendship had been an important part of the Vienna Initiative, which in turn had contributed to orderly and gradual deleveraging. As for the challenges ahead, the macroeconomic picture had changed, and the growth model needed to be reinvented. European countries had not converged in the last ten years and growth had slowed down. There is a debate about why productivity has slowed down and whether financial integration contributed to this outcome. For the future, innovation needed to be put at the centre of attention. It was not just a matter of money, but policy and investment needed to be applied to the issue.

The Vienna Initiative continues to play a very important part in bringing the region's NPLs down rapidly. Other areas where it has a role are in promoting the transparency of shareholding in the region's financial institutions, and sustainable finance, which is also vital to bringing the region onto the path for sustainable growth. The EBRD takes climate change into account in its dealings with each country and with partner banks. The Vienna Initiative has also had a role in supporting European financial integration, going well beyond the banking sector. It should continue to bring together European and domestic stakeholders, both in EU Member States and in Candidate Countries.

Vazil Hudák, Vice President, EIB, recalled that it was important to celebrate the successes of joint action in today's Europe. Crises, in his view, were good for Europe, since it was in response to these that forward-looking plans were drawn up. Both the European Energy Union and the European Banking Union had been accelerated by crises. Looking to the future, the banking system was there to collect deposits and to lend. But convergence in Europe has slowed down and a new model for economic growth was needed. He agreed with **Pierre Heilbronn** that innovation from the region was central. Europe still faced an investment gap of €400 billion a year, despite the Juncker Plan. Research and development (R&D) expenditure was only about 2% of GDP, well behind China and the US. Clearly the small share of capital markets in finance was one problem here, and there needed to be more support for scale-ups. Local banks are well capitalised and have large domestic deposits, but do not engage in enough cross-border projects. Investment platforms for cross-border projects should be created involving close partnership with banks and governments.

Johann Strobl, CEO, Raiffeisen Bank International, pointed out how the situation of the banking sector had changed substantially since 2007-8. The loan-to-deposit ratios in the region had fallen sharply and banks' capital positions were now much stronger. The banking part of the financial system is now very safe and well-positioned to cope with potential problems, especially from the political sphere. Therefore, as for the potential roles for the Vienna Initiative, he highlighted the importance of a common EU approach towards tackling political instability and unilateralism in some countries of the region, and actively asked for the governments and local ministries to the Vienna Initiative to be invited to foster the understanding and insight of the topics of this private-public platform. A constructive dialogue with all relevant stakeholders and trustworthy impact assessments would be of great value in the period ahead. All kinds of national measures affecting the financial stability in the region should be subject to this treatment. From a cross-border perspective, the Vienna Initiative should continue coordination between policymakers and bankers to address the resolution of bad debt, regulatory reform and the availability of funding for innovation. Strobl mentioned Raiffeisen's Elevator Lab, which is looking for innovative fintech solutions and showcases best practices of the fintech collaboration model in CESEE.

In the subsequent discussion, **Piroska Nagy-Mohácsi** raised the issue of a new growth model. The previous model had been driven by the availability of cheap labour in the region, and now the challenge was to switch to a knowledge-based agenda. **Vazil Hudák** remarked that banks were still constrained in providing support for small to medium-sized enterprises. They now had plenty of liquidity, but needed capital saving finance.

Mattia Romani, Managing Director for Economics, Policy and Governance at the EBRD, wondered whether the Vienna Initiative was still a relevant mechanism in a world where multilateralism was under threat. **Cyril Muller** pointed out that, before the financial crisis, the main criticism by some countries of IFIs' activities was that they had too much financing and should get into riskier lending. But when the crisis hit, these players wanted the IFIs to make a "big announcement", but did not want to put their own money into it. He wondered if the global system was now prepared to put in the money if a similar situation arose. The new phase of the Vienna Initiative focused on the nexus between banks, supervisors and the IFIs. But this level of activity was not in the public consciousness, and the political context was much more complicated than before. There had to be a better dialogue involving broader groups of stakeholders. Collective action with governments was much more difficult when those governments were changing more frequently. **Pierre Heilbronn** also referred to the relationship between the political landscape and what the EBRD was trying to do at the local political level. The Bank was intensely involved, since among its aims were democracy and more open democratic governance, matters that were in the hands of many actors.

Boris Vujčić asked how participants saw the banks' involvement in the new model. Would the operations be more decentralised or would the Banking Union bring back centralisation? **Johann Strobl** responded that Raiffeisen had always been decentralised. It had adjusted its model, if not quickly enough. Before 2007, the lack of local funds was countered with a central supply, which had led to over-indebtedness in some countries and sectors. Now the region is growing twice as fast as the core eurozone, and Raiffeisen could bring in capital as needed. The real need was for investment in infrastructure and R&D. The potential was certainly there – technical capacity existed in the region, and local people were brilliant. With money and local government cooperation, a lot could be done.

Closing the conference, the chairman, **Boris Vujčić** drew the lesson that the Vienna Initiative should continue to do the relatively small initiatives required by cross-border banking in the region and stand ready for a larger crisis. The Vienna Initiative and its effectiveness were an example for other regions, maybe the eurozone itself. Work should continue on shareholder transparency, and there would be a discussion of work on anti-money laundering and combating the financing of terrorism. Trust is built by sitting round a table and working together. It was the cooperation, not finding the right people, that mattered. The working groups on sustainable finance and green finance were building consensus among the participants, the banks, their supervisors and the international institutions. The longer-term view was more in the hands of the various institutions. On the matter of finance for innovation, both the banks and the institutions had a problem, in that it was hard to provide the finance at the appropriate stage in the process. And so, the working group included private equity and venture capital firms with the aim of creating a product of interest to everyone. There was also the matter of a new growth model and how to accelerate convergence. It was encouraging that **Johann Strobl**, speaking for one of the major banks, did not see this as too much of a problem. The chairman also paid tribute to the work done on monitoring and reducing NPLs, and the way that regulators and banks had been brought together to improve communications in the area.

Winding up the conference, the chairman thanked the Austrian National Bank and its staff, particularly **Alexandra Schober-Rhomberg**, for the excellent organisation.

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