SOME ASPECTS REGARDING THE RECOVERY OF THE EUROPEAN BANKING SYSTEMS AFTER THE FINANCIAL CRISIS

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Abstract

From the beginning of the crisis in 2007 the financial markets in Europe have lost approximately one half of their value and those in the emerging countries declined by at least three quarters. Also in the banking sector of the Western Europe and US a large portion of the equity portfolio that they've own are drastically reduced forcing many large banks to go insolvent or to request government aid. Governments, both in the US and in the EU have attempted to aid the banking system by recapitalizing the banks in trouble but these efforts proved badly designed and implemented.

Currently financial markets in the Western Europe have stabilized but the signs of recovery are still weak especially for Central an East Europe countries, the so called "Emerging Europe". Their banking systems are heavily depended on their western counterparts and they are still struggling to find their balance.

Keywords: Banking Systems, Financial Crisis, Developments, Central and Eastern Europe

JEL Classification: E30, G15, G21

Introduction

The banks in the EU zone have taken more leverage that their US counterpart and therefore are more exposed to the effects of the current financial crisis. They had almost doubled the leverage ratios in comparison to their American counterparts. To compensate for these exposures they bought credit default swaps especially from AIG the most important American insurer which was save in last moment by the US authorities from bankruptcy using the taxpayers money. If the Americans didn't saved AIG the position of most European banks would be even riskier in the present.

Particularities of the EU Zone banking systems that make them more vulnerable to crisis

At the current discussion time, banking systems, in a global perspective, remain largely dysfunctional and the local credit markets dropped to historical lows in EU

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and also in the US. The loses from the toxic asset are reaching to about 4 trillion dollars, mainly in the Western Europe countries (2 trillions dollars), US (1,8 trillions dollars) and 150 billions dollars in the emerging economies.

Some $3 trillion of the total losses resulted from assets originated in the US, while the other quarter originated in Europe. US bank loan losses total $1.1 trillion, of which half have already been written down, while euro zone and UK bank loan losses will be over $900 billion. Of the $4.6 trillion of foreign bank loans to emerging economies, euro zone banks account for 73.4 per cent while US banks account for only 0.3 per cent; UK banks also have exposure. Thus, European banks are being more affected by a global slowdown. By March 2009, EU governments had provided $380 billion for bank recapitalizations and guaranteed $3.17 trillion of bank loans.

One of the characteristics that put European banks at risk in the current economic environment is that they are very large when comparing to the GDP of their home countries. So, in the case that one of these large banks fails, the government can guarantee, in one way or another, the depositors funds only in short amounts. This, in turn, encouragers owners of large capital in emerging market and small economies to transfer their funds to more solid economies, looking for cover against default risks. One especially eloquent case is that of Iceland where the banking system had assets ten times larger that the country's GDP. Another more recent case is that of Greece who currently suffer a confidence crisis from the international financial community and especially from the large wealth owners. Almost all local billionaires had redrawn their funds from the local banks into foreign accounts.

In the EU there is also another big problem that currently affects even the stability of the EURO: in US the Federal Reserve can act as the lender of last resort if the US government is unable to obtain the needed funds through taxes or borrowing. But euro zone governments have no lender of last resort to monetize their debts. The European Central Bank is not authorized to do this. The European situation has been described quite accurately as one where "the banks are too big to fail but too large to save".

Currently there is a large uncertainty about the degree and especially the value of the toxic assets that European banks hold. Their value cannot be determined and in the last instance the European governments will have to intervene in one of the following ways:

- Nationalize their problem banks
- Bail them out
- Purchase their toxic assets at a premium

All these methods pose serious threat to the specific government finances and, more importantly, none of these approaches was, since now, especially effective.

This type of bailout have already taken place in several European economies like Belgium, Greece, Germany, Iceland, Ireland, Netherlands and the UK and western banks still need to raise between 160 and 300 billion dollars in new capital. Ireland is a special case, being the first and only European country that set up a "bad bank" after the Swedish model from the 1990's crisis. Germany tried first to discern between illiquid and insolvent banks and after that only guaranteed for the last ones.

Europe financial sector based on national regulations and institutional structure is not fit to deal with the current financial crisis. Although US had implement a system of insuring bank deposits after the Great Depression, EU doesn't currently have such a scheme to protect bank customers. After the crisis manifested in the EURO Zone the national government acted largely uncoordinated and, on some occasions, even against each other , trying to extend guarantees to bank deposits. One example is the UK, where banking supervision was so separated from the central bank's lender of last resort facility that the latter had no idea in its dealings with Northern Rock whether it was insolvent or just illiquid.

Another characteristic of the European banking system that jeopardized his reactions to the current crisis was that, although the banking activity is regional or global, the majority of the regulation is national. So cross border entities in the banking market had not a clear idea on how to treat financial loses and further more, if an intervention is needed to help the bank there is not a clear arrangement on which government will provide it and if it is provided to a subsidiary of the bank, an unsolved obligation of the parent bank not to withdraw the funds, draining the local bank, still remains. This is the case of the National Bank of Romania intervention to aid some local branches of foreign banks which, immediately after that transferred the fund to their parent entity, making NBR intervention futile and useless. Also parent country governments did not want the assistance they were providing to their domestic institutions to be transferred to subsidiaries abroad and one such example was the warning of the Greek government to the local banks with international or regional operations not to transfer funds provided by them in January 2009 in a $37 billion support package to foreign subsidiaries abroad.

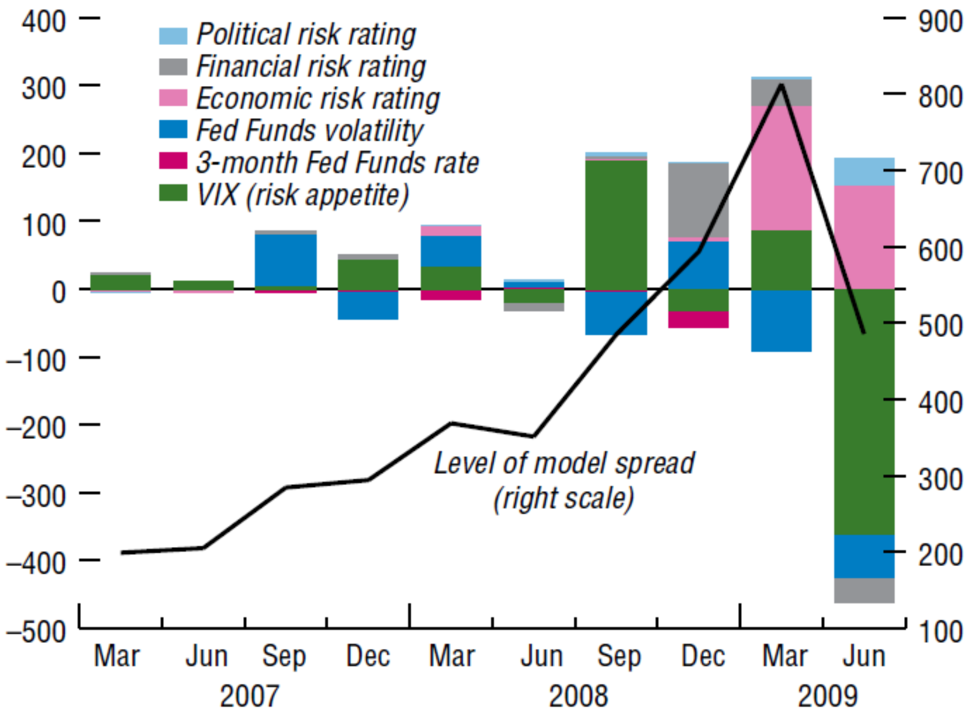
"Emerging Europe"-the same goals in dealing with the crisis but different paths

The economies of "Emerging Europe" (mainly CEE states) pass trough extreme difficulties in 2009, being directly affected by the developments in their Western counterparts. Some of them managed to better cope with the crisis and implemented measures aimed to retain capital, control exchange rate extreme fluctuations and eliminate default risk. Most of them have managed to strengthen their position and defer short term risks, that being seen also in the evolution of the credit default swap (CDS) spreads which tend to rearrange to levels prior to the start of the crisis in 2007 (Figure 1).

Although the risks of default in macroeconomic collapse have passed there are still some sectorial vulnerabilities that can jeopardize economies in "Emerging Europe" such as: current account balance levels, needs of refinancing the external debt for 2010, net external position vis-à-vis BIS-reporting banks, average real credit growth, loan/deposit ratio or Forex share of total loans. (Table 1)

Figure 1. Contributions to Changes in Emerging Market Sovereign External Spreads

(In basis points)



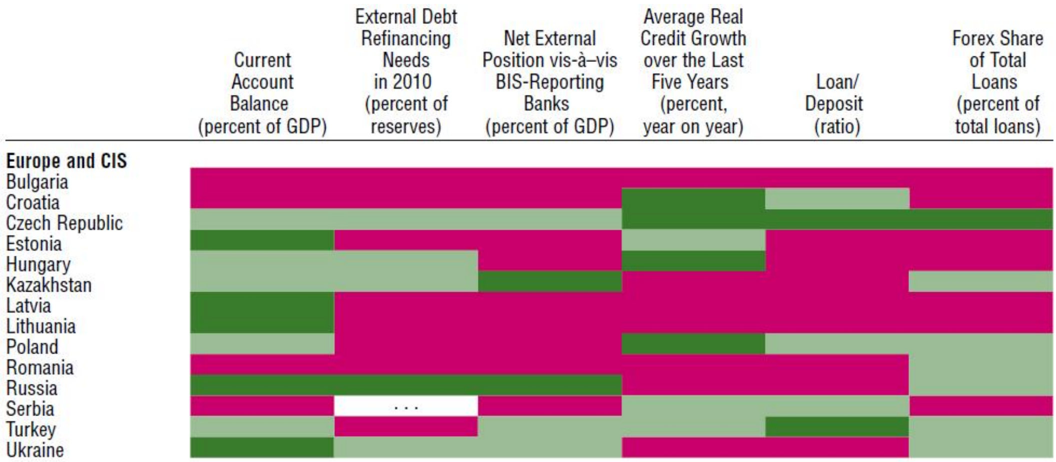
Source: IMF, Global Financial Stability Report October 2009

External financing risks to Central an East European (CEE) banking systems have now subsided and the main focus for the medium-term outlook has shifted toward domestic variables. While it is likely that the downward trend in asset growth will reverse in the beginning of this year, the recovery process will be fragile and the pace of expansion will not return to pre-crisis levels. Ultimately, fundamental demand conditions across (CEE) might not be favorable to a rapid expansion of loans. Moreover, persisting risks from widespread deleveraging in Western Europe, presented above, capital market volatility and asset quality deterioration will contain growth in banking sectors across Emerging Europe. The deteriorating trend in CEE's banking sector asset growth is expected to reverse in the beginning of 2010, in congruence with an acceleration of a regional macroeconomic recovery. In addition, the variations between divergent economies are pronounced and the pace of asset expansion will not recover to pre-crisis levels.

The growth potential for 2010 in the banking sector of Central and Eastern Europe will be affected by some factors, such as:

- The lack of demand on domestic markets will not permit a rapid recovery for the loan activity
- Prolonged and sustained deleveraging in Western Europe capital markets
- An ongoing asset quality deterioration who has never stopped especially for the high risk markets: Baltic States, Greece, Hungary, etc.
- The increasing level of reglementation which followed the crisis and also the growing fiscal burden from the governments facing default risk from lack of adequate tax incomes.
- The investment banking sector will also be affected by large volatility in capital markets who still did not regained a clear upward trend after the events following the beginning of the current crisis.

Table 1. Heat Map of Macro and Financial Indicators in Emerging Europe Market Countries



Source: IMF, Global Financial Stability Report October 2009

Due to the particularities of the banking systems in Central and Eastern European (CEE) that have most part of their assets allocated to domestic credit, the main focus that will drive the growth in 2010 will be the local demand for new loans. But this demand has also economic and mainly fiscal implications that currently are not very good for these countries. So a slow recovery is also expected for the baking systems in the region.

Currently a fundamental increase in demand determined by productive investments from the private sector is less likely given the fact that the private sector is still hurt from recent developments and under a heavy fiscal burden from local governments. On the other side, that of household credit demand, the current growth in GDP will eventually affect the employment levels and their incomes but not in a fast way, more probably with a significant "lag" that will further contain growth in the credit market to low levels. The mortgage and personal low, real engines for growth in the retail credit market before the crisis will tend to remain well bellow the 2007 levels.

One of the main aspects that affect credit demand is the willingness of the banking system to lend. From this point of view there are not many reasons to encourage banks to increase lending at this moment. Economies and also banking systems in Eastern Europe are umbilical depended on the large commercial banks based in Western Europe or U.S. But this entities already face many difficulties on home markets an currently there are not willing to extend credit in the Eastern Europe markets and it is also unlikely that Western European banks, will be in a position to re-leverage and re-establish the investment positions they had in Central and Eastern Europe pre-recession.

This reluctance to extend credit in from western banks reflects not only their deteriorating conditions on their main markets but also an above the limit deterioration of their assets on the emerging markets especially due to the real estate crisis. These deteriorations will also reflect in their balance sheets also in 2010 by the loss provisions they took in 2008 and 2009, regardless of the relative stabilization of the real estate market. This is especially the case in higher-risk places including the Baltic States, Russia, Ukraine, Hungary and Bulgaria, where the economies are undergoing structural contractions over a multi-year time horizon.

Also rates of nonperforming loans (NPL) skyrocketed from the 2008 levels in most Central and Eastern Europe states (Figure 1.), especially Rusia, Ukraine and the Baltic States. Even in relatively better economically positioned Central and Eastern European countries, such as Poland, Hungary, Czech Republic Turkey, NPL rates raised further to new multi-year highs.

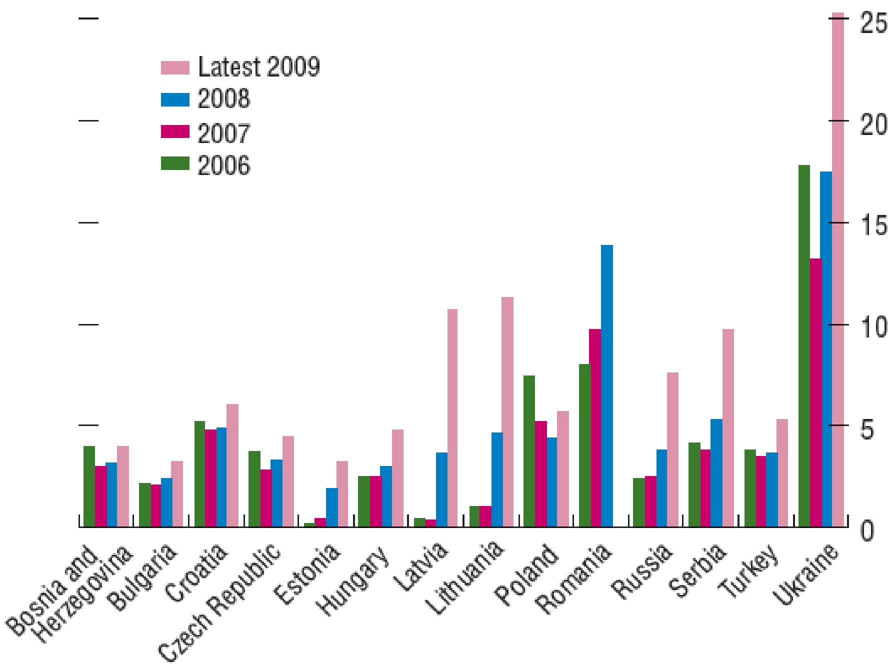
Corporate loan quality has been deteriorating more rapidly than household credit quality, reflecting the higher leverage and the worsening business climate, and overall loan quality is likely to deteriorate further in the next 12 to 18 months.

Nonperforming loan ratios are forecast to peak up to twice the current levels, according to various central bank projections. While the current level of provisions is generally sufficient to cover loan losses at this time, the additional provisioning required going forward will limit banks' capital positions and their ability to issue new loans. While we can expect asset quality deterioration to hit its trough in 2010, it will take several years for NPL rates to unwind back to pre-crisis lows. The resulting shift higher in loan loss provisions will accentuate limitations on capital allocations to new loan growth throughout banking sectors in the region.

This will result in a broader asset allocation shift towards government treasuries and away from private sector credit, which will further limit asset growth potential over the medium term. Already, Central and Eastern European bank asset holdings are shifting to more conservative securities, which have been facilitated by a marked surge in state borrowing requirements alongside broader fiscal stimulus programmes. With those stimulus measures unlikely to be wound down until 2011, the increase in the supply of treasury bonds will at least in part have a crowding-out effect on the private sector. The sustained capital market volatility over the medium term can also encourage the shift to government securities. The combination of ongoing macroeconomic uncertainty, unprecedented monetary easing and weak demand conditions will mean that profitability on the investment banking side will similarly be volatile, affecting headline performance.

Figure 2: Emerging Europe: Nonperforming Loan Ratios

(In percent)



Source: IMF, Global Financial Stability Report October 2009

Policies in the region should be aimed at managing an orderly adjustment of bank, corporate, and household balance sheets. This will prevent a resumption of the adverse feedback between financial conditions and the real economy and limit the risk of contagion among vulnerable countries. Decisive measures are required to deal with nonperforming assets and troubled banks, including removal of problem assets from bank balance sheets, bank resolution, and recapitalization. This will limit the scope for further banking sector deterioration and prevent the possibility that weak banking systems will impede the recovery from the current recession. Further, while governments should continue to support viable corporate facing rollover difficulties, there may be a need for encouraging further debt restructurings to share the burden of losses with international creditors.

While the broad trend across the region will be for the recovery in 2010 to be only mild, there will remain wide variations in the growth potential and stability of banking sectors throughout the region. Relative performance of the varying sectors will continue to be closely linked to the degree of leverage the outlook for domestic demand and the degree and nature of the exposure to other eastern and western European banks.

Taking those factors into consideration, we hold to our core views that banking systems in Poland, Turkey, the Czech Republic and Slovakia will be in a better position to take advantage of the regional macroeconomic recovery. In turn, those sectors in the Baltic states, Bulgaria, Hungary, Ukraine and Kazakhstan will likely underperform on a relative basis.

Romania - on the road to recovery

Although Romania's banking sector has so far avoided any major systemic ructions, it is expected that asset quality deteriorate in 2010 as the number of non-performing loans (NPLs) heads higher. Last year political crisis resulted in market sentiment taking a turn for the worse, which sended borrowing costs higher and upset financial stability at a time when the banking sector remained vulnerable to financial market volatility.

Romania's banking sector continues to muddle through the global downturn, with immediate systemic risks largely diffused as a result of improving global liquidity and risk appetite, plus unprecedented stimulus programmes across the world. Falling external borrowing costs have bolstered the banking sector's debt repayment capacity, while improving risk sentiment has prevented massive decapitalisation of the industry. In addition, the implicit and explicit support of Western parent banks to their subsidiaries in Central and Eastern Europe (CEE) has further shored up the outlook for Romania's banking sector.

Banking sector leverage remains around 11:1 (10:1 is considered appropriate for a mature banking sector) and the loan-to-deposit ratio (indicative of pressures on external financing) stood at 77% in October 2009, suggesting a fairly limited degree of external borrowing (Figure 4 and 5 and Table 2).

This is certainly reflected in the National Bank of Romania (NBR)'s gross external debt data, with the banking sector's foreign debt standing at around 20% of GDP, fairly modest compared to elsewhere in the region. The limited deleveraging requirement and apparent lack of systemic crisis risks can keep the banking industry on an even footing in 2010, which in turn can help support the broader economic recovery over the medium term. That said, it is expected to see some asset quality deterioration as weak corporate profitability and high unemployment drive nonperforming loans higher.

A further rebalancing of the industry's asset profile is expected, with banks absorbing more government bonds on the back of a weaker outlook for private sector loan demand, plus a higher return on treasuries as the government seeks additional financing to cover its bloated fiscal deficit. Signs of this have already begun to emerge, with the banking sector's bond holdings nearly quadrupling in October 2009 compared to same month in 2008.

Table 2. Comparison of key banking indicators

	Loan deposit ratio %	**Loan/ Asset ratio %**	**Loan/ GDP ratio %**
UK	97	58,1	304,1
Slovenia	96	80	120
Latvia	201	61,1	94,4
Greece	85	47,6	85,4
Ukraine	201	84,9	81,5
Croatia	115	69,2	80
Bulgaria	125	73,1	72,6
Hungary	125	50,5	67,1
Kazakhstan	203	75,9	60,5
Bosnia	116	71,4	59,5
Czech Republic	82	49,5	58
Poland	111	62,1	53,9
US	80	55,7	53,1
Romania	**77**	**63,5**	**51,9**
Slovacia	81	45,4	50,4
Rusia	129	63,8	43,6
Turkey	62	40	27,9

Figure 4. Loan/assets ratio's for emerging European economies and UK

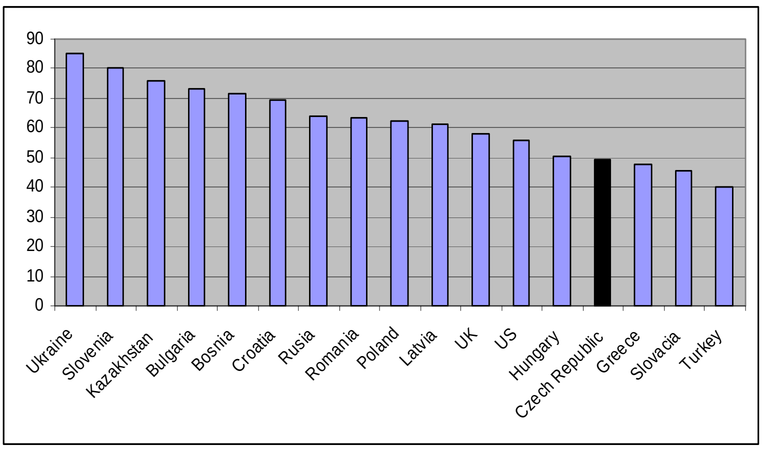
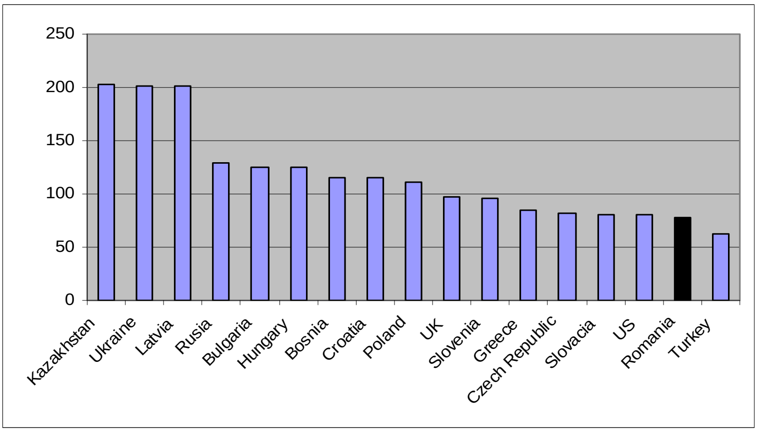


Figure 5. Loan/deposit ratio's for emerging European economies and UK



Source: Central banks statistical bulletins

In the current economic conditions a SWOT analysis for the Romanian commercial banking system would look like this:

Strengths

- The high grow rates of the Romanian banking system in previous years, partially because of the low usage of banking service by the population.
- The macroeconomic indicators look better than other countries in the region (Bulgaria, Hungary, etc.)
- Romanian banking system is dominated by some major foreign banks who can support their subsidiaries in case of failure, saving also the whole system (Societe Generale, Erste Bank, ING Bank, Unicredit, etc.)
- The National Bank monitoring of the Romanian banking system is highly effective and the monetary policies are well targeted and implemented.

Weaknesses

- The global economic condition will further affect the profit margin and operations of banks on the local market
- A high number of Greek banks are currently holding important assets in the ro,anian banking system, inducing a negative effect from their home country (Piraeus, Alpha Bank, Emporiki, Bancpost)

Opportunities

- The current economic conditions offer great opportunity for concetrations in the banking secotr
- Also these developments induce a good setting for foreign banks who are not yet present to enter the Romanian market

Threats

- One of the main threats is the contagion effect form other countries in the region who suffer from the economic crisis effects, especially Greece.

- The weak recovery for Romanian economy can bring further challenges to the banking sector although we can witness a "back-fire" effect due to the high cost of capital induced by the interest rates that the local banks are charging for new loans.

Conclusions

In conclusion, the banking sectors of the European emerging markets are heavily dependent on external capital markets and when world capital markets froze in 2008, were unable even to roll over existing funds. As their domestic economies began to decline, they also had increasing numbers of non-performing loans which could reach up to 25 per cent of assets. The new member states of the EU and countries south-east Europe benefited to some degree from the fact that their external borrowing was by local subsidiaries from parent banks in Western Europe which were somewhat accommodating but in the end they should correct their internal economic imbalances which weight heavily on their banking systems recovery prospects.

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