



FitchRatings

Financial Stability in Emerging Europe

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Presentation at Chatham House
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Presentation Outline

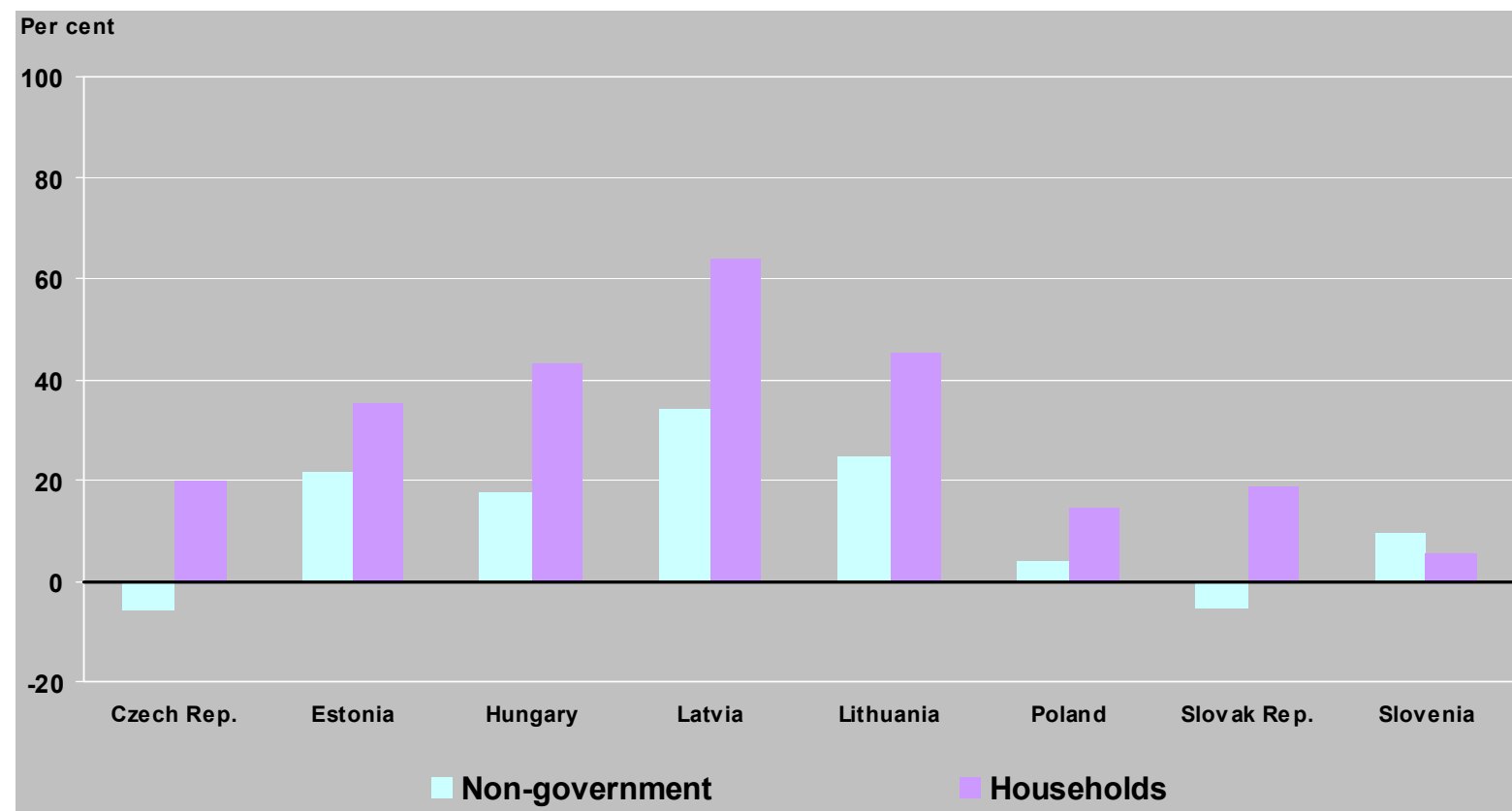
- > Financial stability in emerging Europe
 - > Region emerging from a series of bank crises and rapid structural transformation
 - > Rapid credit growth – “good” or “bad” type?
- > New methodology developed at Fitch and its results for emerging Europe
- > How worried should we be? Policy implications

Rapid Credit Growth – Basic facts 2004-1999

- > **Rapid growth in private sector credit in virtually all transition countries:**
 - > Fastest on average in last 5 yrs: CIS-3 and Baltics, from very low levels
 - > Deepest financial intermediation: NMS and Croatia, with domestic credit at around 54% of GDP at end 2004
- > **Fastest growing asset class:** credit to households, especially high growth in SEE and CIS, accounting for about 1/3 of total private sector credit at end-2004
- > **Maturities have lengthened, particularly in NMS**
- > **Currency composition**
 - > NMS: about 1/3 of private sector credit, except Baltics where it is dominant
 - > SEE and CIS: about 1/2 of private sector credit
- > **Financing of credit growth**
 - > Domestic deposit increase: significant except in Visegrad countries
 - > External liability: very significant in Baltics, Slovenia, candidate countries

Rapid real growth in credit to non-government sector and to households, CEE

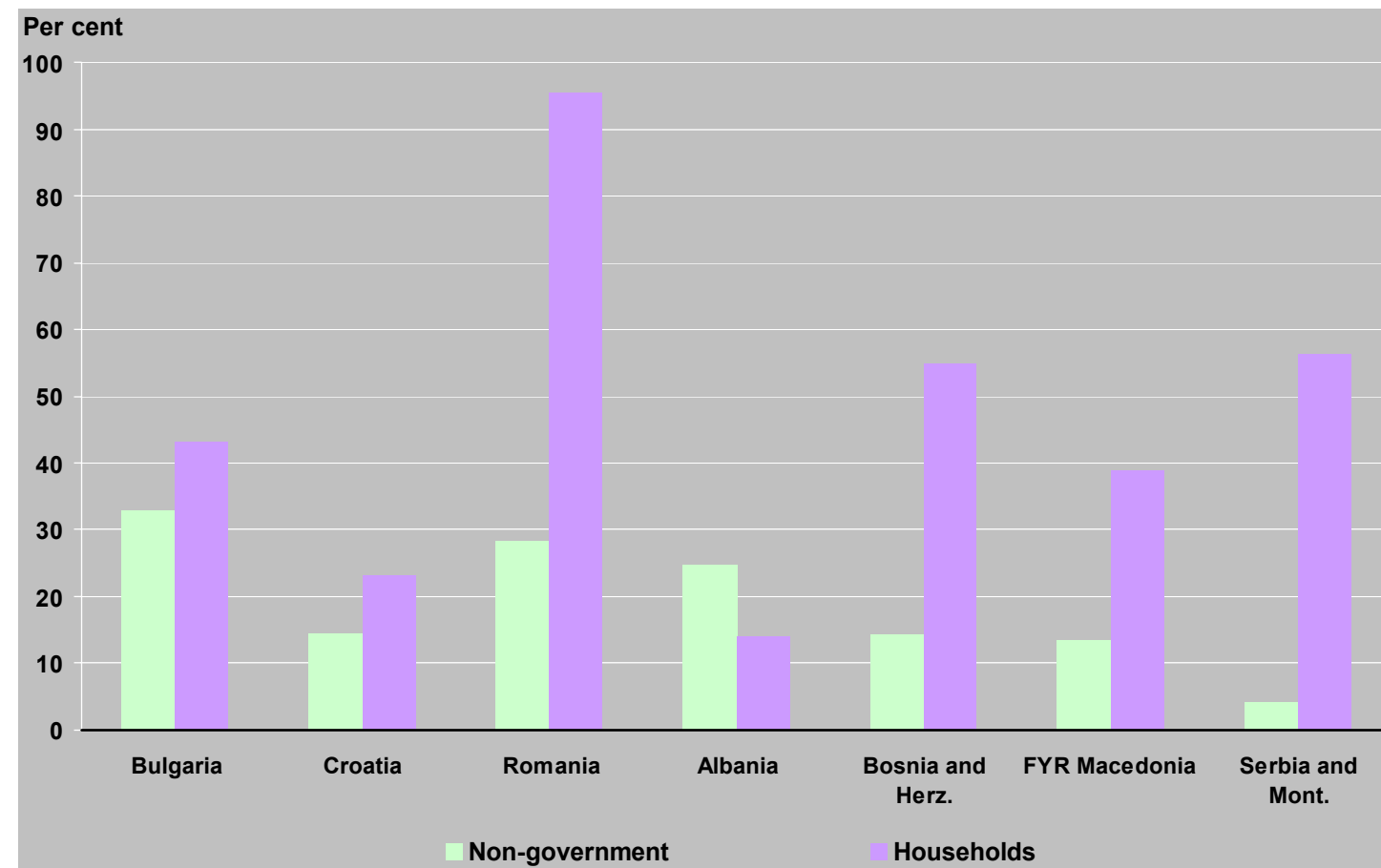
(Annual average, 1999-2004)



Source: EBRD

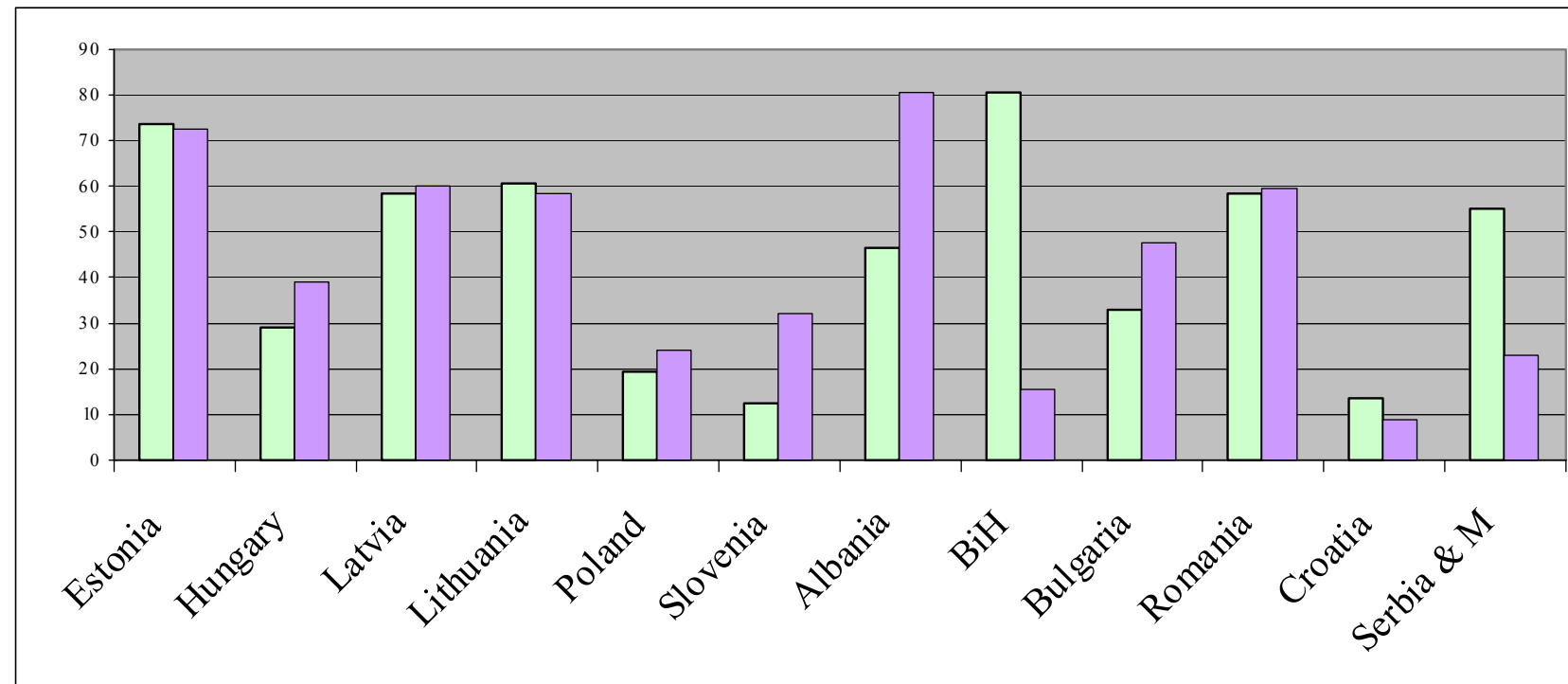
Real growth in credit to non-government sector & households, SEE

(Annual average, 1999-2004)



Forex borrowing is high in quite a few countries

Credit in forex/total credit (%) in 1999 and 2004



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- > Against the backdrop of fast financial deepening and also some cyclical factors (excess global liquidity & TOT gains), have systemic risks in the banking sectors of emerging Europe increased?
 - > **A new methodology to assess systemic risks** in the banking system, developed in Fitch.
 - > **Reason for it:** present methodology focuses on *either* on the macro causes of a crisis (exchange rate overshooting, asset bubble, interest rate shocks, reversal of capital inflows, etc), *or* on micro level bank weakness (capital adequacy, liquidity, weak governance/fraud etc). Yet the two approaches should be *combined* because strong banking systems can better withstand macro shocks than weak ones. Also, more attention must be paid to systemic factors
 - > **Objective:** monitoring tool of developing stress in the banking system

New methodology of identifying banking sector systemic risk

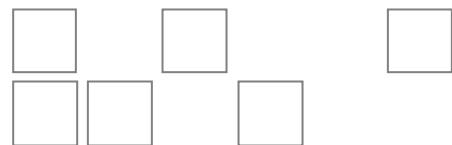
- > The new methodology thus brings together Fitch's detailed knowledge of banks and banking systems with recent "early warning" research
- > Focuses on three complementary aspects of systemic risk;
 1. **System Average Individual Rating (SAIR)** – a measure of a banking system's stand alone financial strength
 2. **Systemic Risk Analysis of banking systems (SRA)** – identifies specific systemic risks implicated in previous banking crises
 3. **Macro-prudential Indicators (MPI)** – based on the "early warning" literature, is a systematic analysis of key economic indicators which together have been shown to have had reasonable success anticipating banking crises



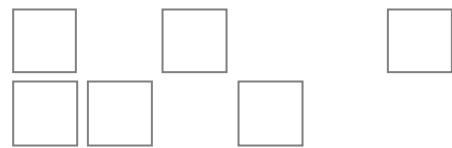
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System Average Individual Rating (SAIR)

- > Measures banking system stand-alone strength, based on Fitch's Individual bank ratings, which assess the risk of a bank failing
- > A simple asset-weighted average of Individual ratings for a critical mass of the banking system
- > Includes all rated banks and significant unrated banks, in total covering at least two-thirds of banking system assets and usually more
- > For unrated banks an internal assessment of the Individual rating is used
- > SAIR = the average risk of a systemically important bank failing

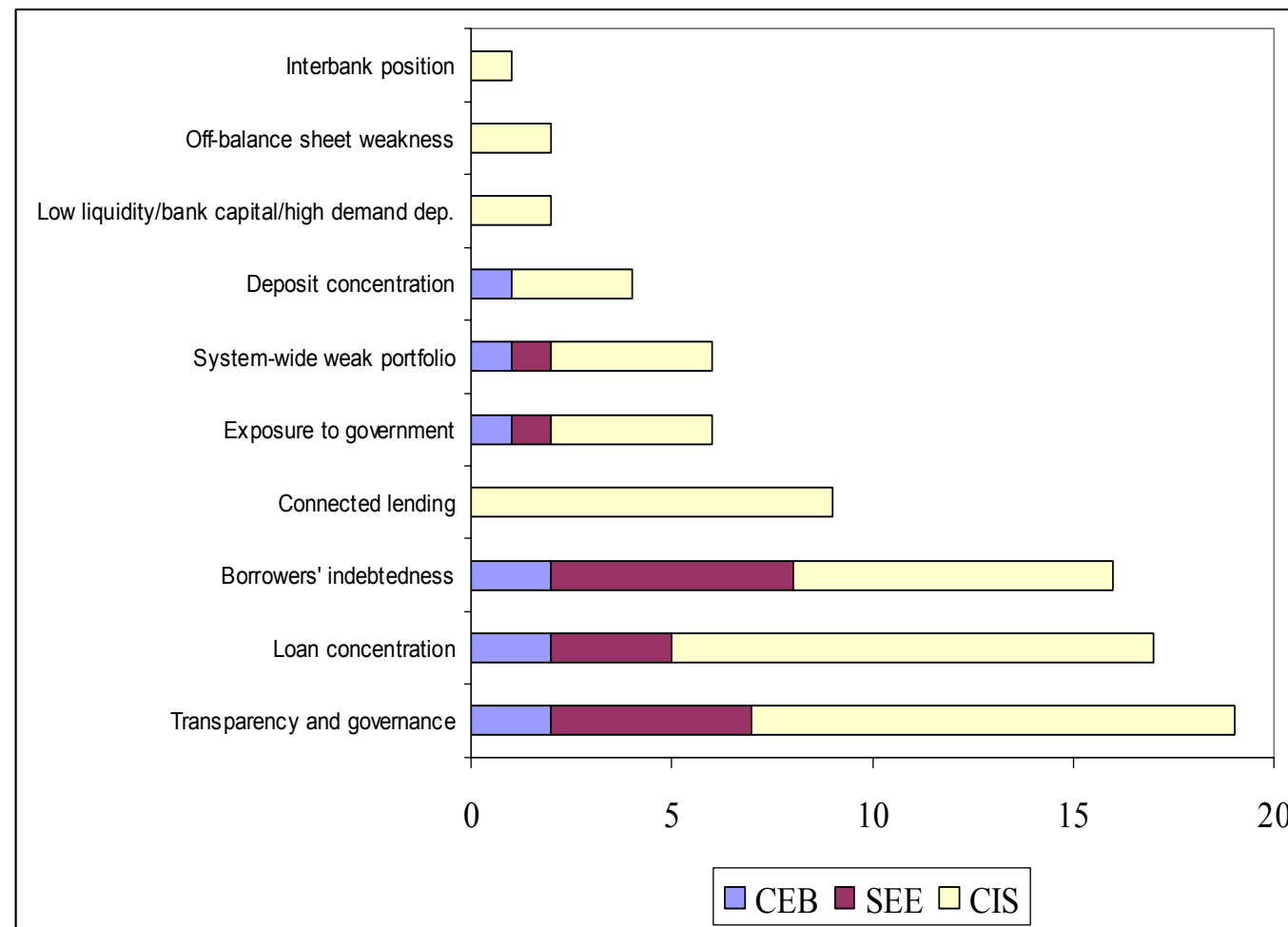
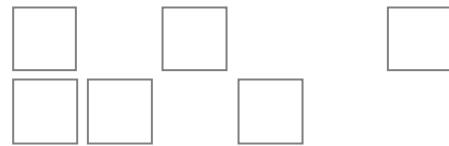


Systemic Risk Analysis (SRA)



- > Failure of one bank will not always trigger a system-wide crisis
- > The SRA focuses on weaknesses present in most banks in a system rather than in individual banks
- > Causes of recent systemic crises are grouped under 9 broad headings:
 - > Inter-bank exposure
 - > Borrower indebtedness
 - > Foreign currency borrowing without FC resources
 - > Exposure to the sovereign
 - > Other common lending concentrations
 - > Common deposit concentrations
 - > Combination of low bank liquidity, low capital ratios and high share of demand deposits
 - > Quality of regulatory systems and data transparency
 - > Other systemic weaknesses

Systemic risk factors by region

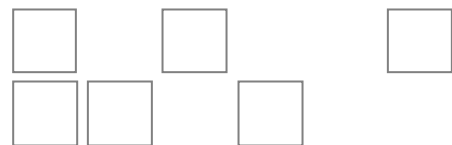


Source: EBRD, Transition Report 2005

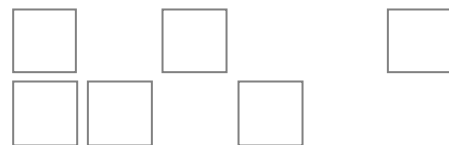


Aggregate Banking System Indicator (BSI)

- > The SRA takes the form of a questionnaire, with overall risk determined by the degree of concern over each risk category
- > More work needed to improve measurement and consistency across regions
- > Results of the SAIR and SRA are highly correlated
- > So the overall banking system indicator (BSI) currently relies mainly on the SAIR. The SRA is used as an internal reality check
- > The BSI indicates overall system “quality” ranging from Very High (A), High (B), Adequate (C), Low (D) to Very Low (E)

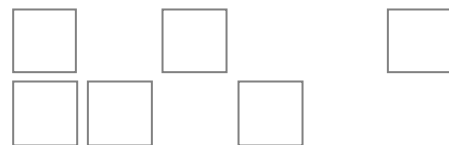


Macro- Prudential Indicator (MPI)



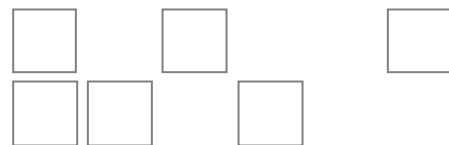
- > Based on the “early warning” literature, particularly that of Borio and Lowe (BIS, 2002)
- > Critical indicators are;
 - > private sector credit as % of GDP,
 - > real asset price appreciation – equity, property or both
 - > real exchange rate appreciation
- > B&L looked at 34 countries between 1960-1999 and estimated threshold values for these indicators that optimised their model’s success rate
- > Fitch has extended the sample to over 80 countries, including many more emerging markets
- > Most recent crisis predicted was that of Dom.Rep. (2003)

Macro- Prudential Indicator (MPI) – continued



- > Fitch calculates that about 70% of banking crises since the 1980s were preceded by over-lending
- > But fewer emerging market bank crises, especially in Latin America, were of this type. Thus, extending the sample to include more emerging markets reduces the model's overall success rate
- > Data deficiencies also greater in emerging markets: series more volatile and subject to breaks, especially in Eastern Europe, and sometimes not available
- > Fitch found it "optimal" to raise the credit:GDP threshold from 4% to 5% above trend but left other thresholds unchanged
- > Preliminary work done with property prices and this will be extended
- > Countries are graded 1 to 3 according to the degree of potential stress: Low, Moderate, High

Interplay of BSI and MPI



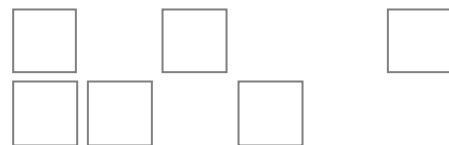
- > Overall systemic risk increases as either intrinsic banking system risk (BSI) or potential macro-prudential stress (MPI) increases
- > Macro-prudential stress is of greater concern in weaker banking systems, less able to absorb further weakening in their balance sheets
- > Thus, A and B-rated banking systems can absorb quite a high level of macro-prudential stress before overall risk increases
- > By contrast, even a moderate degree of macro-prudential stress raises overall risk for a D or E-rated banking system
- > All E-rated banking systems are deemed very high risk

Bank Systemic Risk Matrix

Banking System Indicator	Macro-prudential Indicator		
	1	2	3
A	Luxembourg, USA	Australia, Netherlands, UK	
B	Belgium, Canada, Chile, Denmark, France, Sweden, Switzerland	Estonia , Finland, Greece, Ireland, Italy, Portugal, Spain	South Africa
C	Austria, Czech R. , Germany, Korea, Malta , Mexico, Slovenia	Iceland	
D	Brazil, Cyprus , India, Japan, Kazakhstan , Poland , Romania , Slovakia , Turkey, Ukraine	Bulgaria , Croatia , Latvia , Lithuania , Russia	Hungary <i>Fitch downgrade Dec 6 2005</i>
E	Argentina, Azerbaijan, China, Egypt	Dominican Republic, Iran	

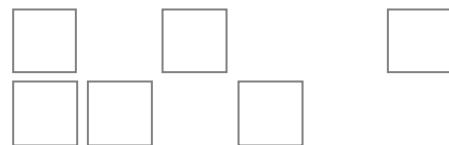
Results for CEE

- > **B2, Estonia:** One of only 5 emerging markets with a BSI of B (high quality), on a par with most developed country systems. Moderate macro-prudential risk.
- > **C1, Czech, Malta, Slovenia:** Among 10 emerging markets with “adequate” banking systems and low macro-prudential risk
- > **D1, Cyprus, Poland, Romania, Slovakia, Ukraine:** Weak systems but with low macro-prudential risk
- > **D2, Bulgaria, Croatia, Latvia, Lithuania:** Weak systems with moderate macro-prudential risk
- > **D3, Hungary:** Weak system with high risk of macro-prudential stress



Results for SEE (EBRD only)

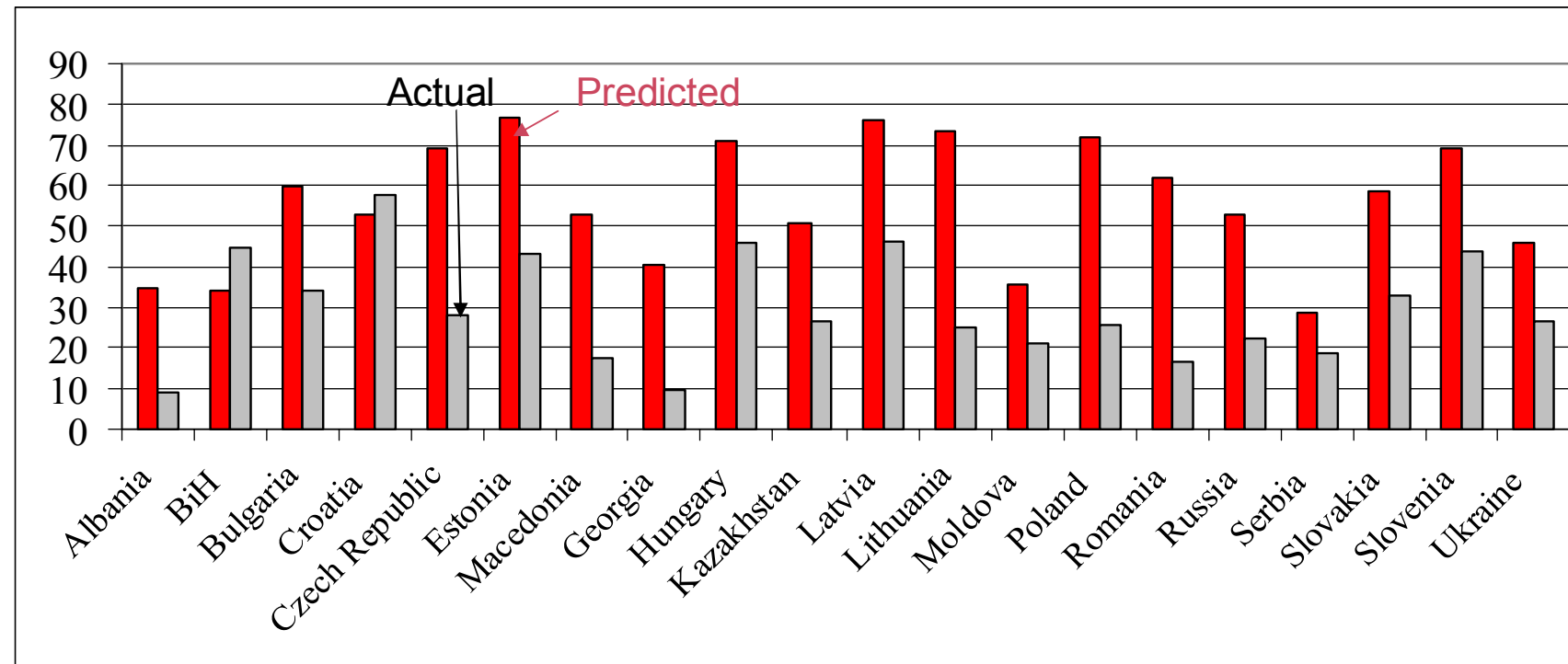
- > **D1, FYR Macedonia**
Weak systems but with low macro-prudential risk
- > **D/E2, Albania, Bosnia-Herzegovina**
Weak systems but with moderate macro-prudential risk
- > **E2, Serbia:**
Very weak systems with moderate macro-prudential risk



How worried should we be?
Policy considerations

This is financial deepening

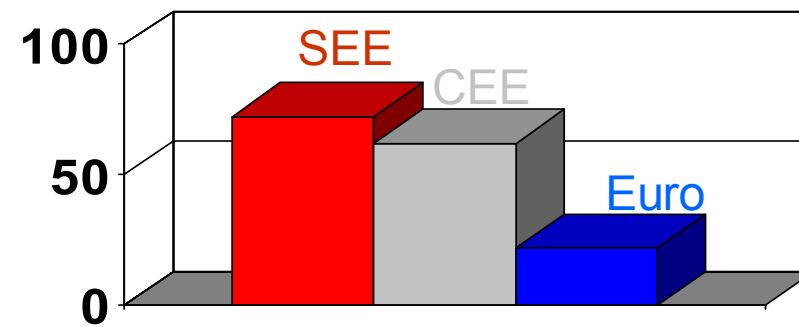
Non-government credit/GDP in %, 2004



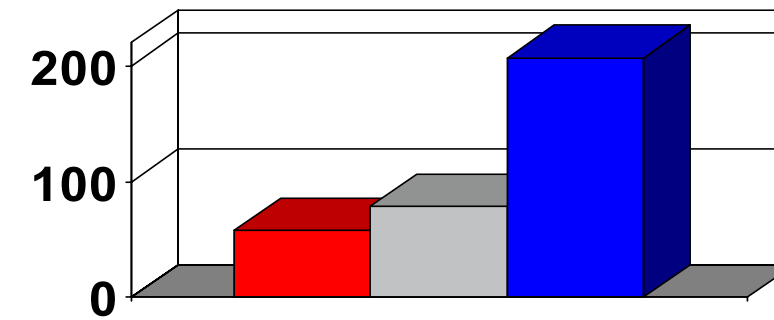
Source: EBRD, updating and extending the model by Cottarelli et al

Financial system are still underdeveloped

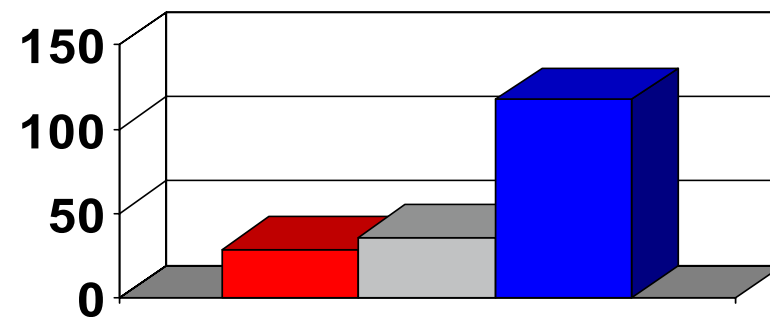
*Share of foreign banks
(% of total)*



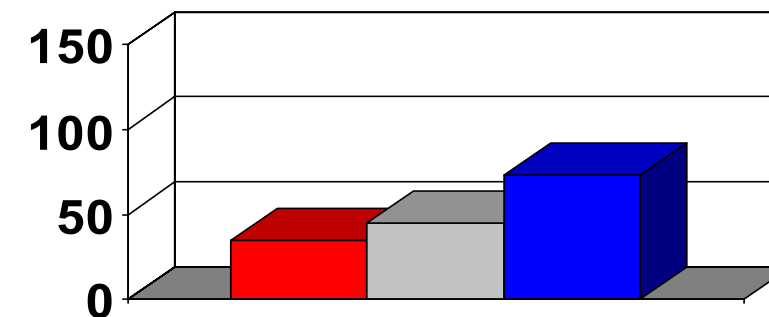
*Total bank assets
(% of GDP)*



*Total loans
(% of GDP)*

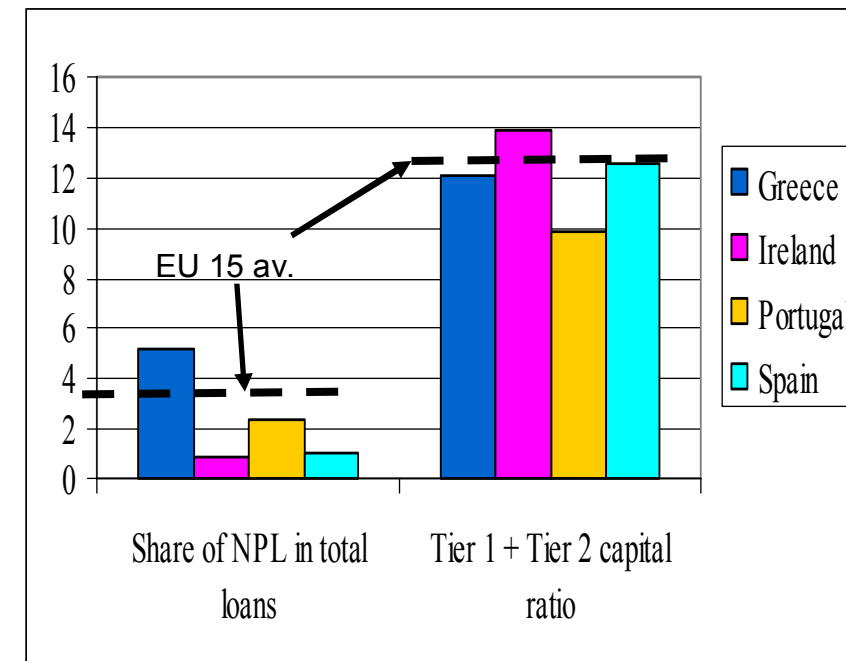


*Total deposits
(% of GDP)*



We seen an even faster financial deepening before without crash

- > Greece, Ireland, Portugal and Spain in the run-up to the euro have seen even faster financial deepening from higher initial levels
- > It has not resulted in a weakening of the banking system
- > However, the rapid balance sheet expansion of both the private sector and the government may have contributed to a prolonged lower-than-potential growth in Portugal





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But even when moving to new equilibrium, rapid credit growth must be carefully managed

Policy implications (1)

- > Countries with stronger banking systems, high foreign ownership, and EU-aligned banking supervision: overt banking crisis may not be likely but prolonged underperformance of growth is very possible: → “risks to growth” (Max Watson)
 - > Macro management/fiscal policy should be key. However, making fiscal space for private sector growth may not be likely in key Visegrad countries
 - > Specific prudential instruments (LTV limits, marginal reserve requirements, dynamic provisioning)
 - > An issue: Basel II’s home-host issue raises systemic questions.

Policy implications (2)

- > Countries with weak systems and weak supervision are more prone to have a “classical” overt banking crisis
 - > Improve banking supervision & prudential regulation. High capital requirements are needed because Basel I is quite meaningless. Shift to the simple Basel II methods (“Standardized Approach”) may make sense in emerging market economies contrary to what the IMF/World Bank says
 - > Transparency, governance → legal system
 - > Market development (credit bureaus)
 - > Crisis mitigation: cost of crisis may be limited (low monetization) and reserves in many countries are high.



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