

Financial Institutions Markets and Regulation Thorough Central Eastern European eyes

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Selected topics through CEE eyes

FX lending: a special original sin

- (Market failure) Bad incentives – bubble
- (Market failure) A special interbank market – the swap market

Financial globalization: home and host

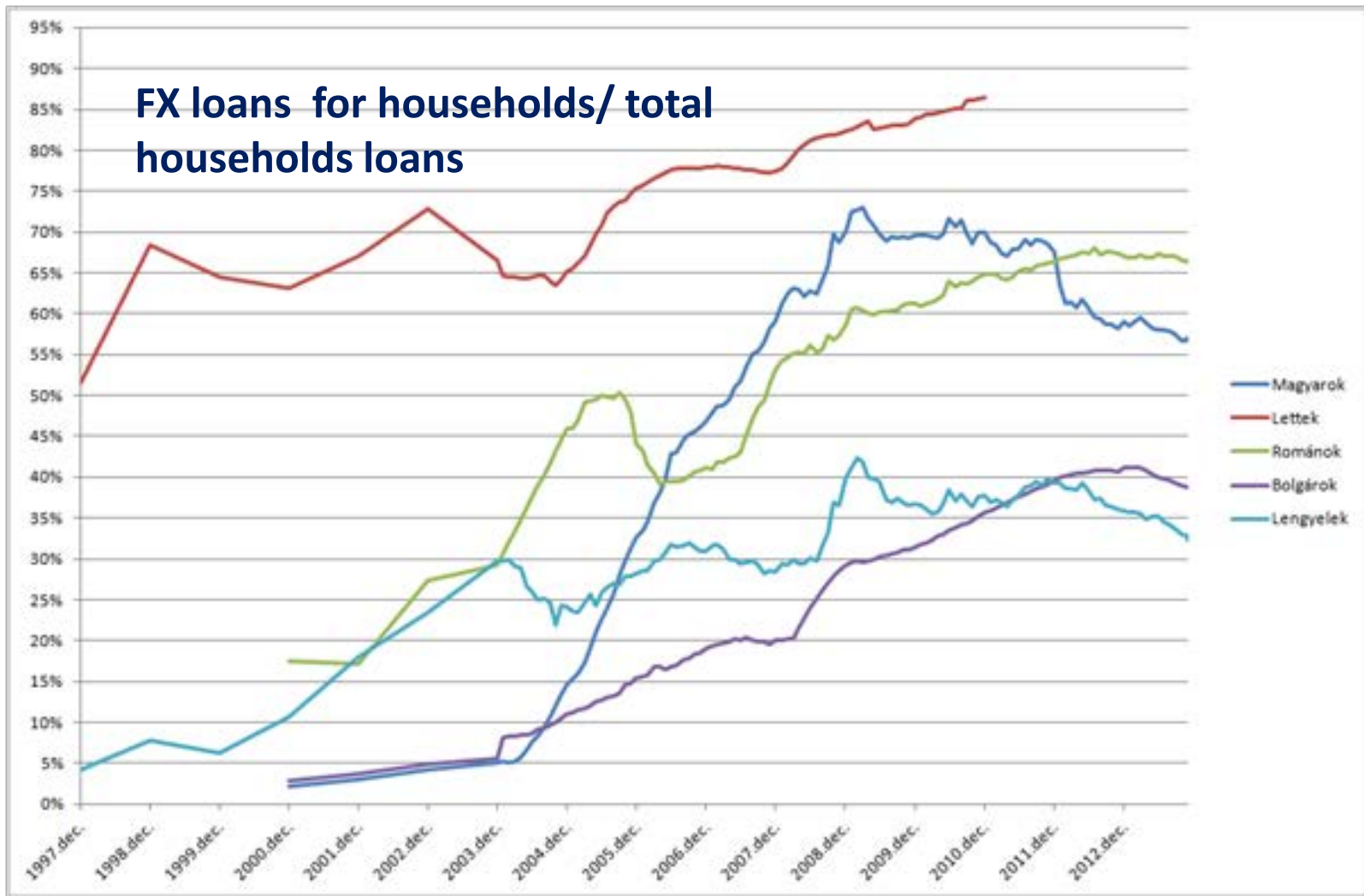
- Reverse contagion
- Regulatory race to the bottom
- Bankunion

Some special issues – from the point of view of a commercial banker

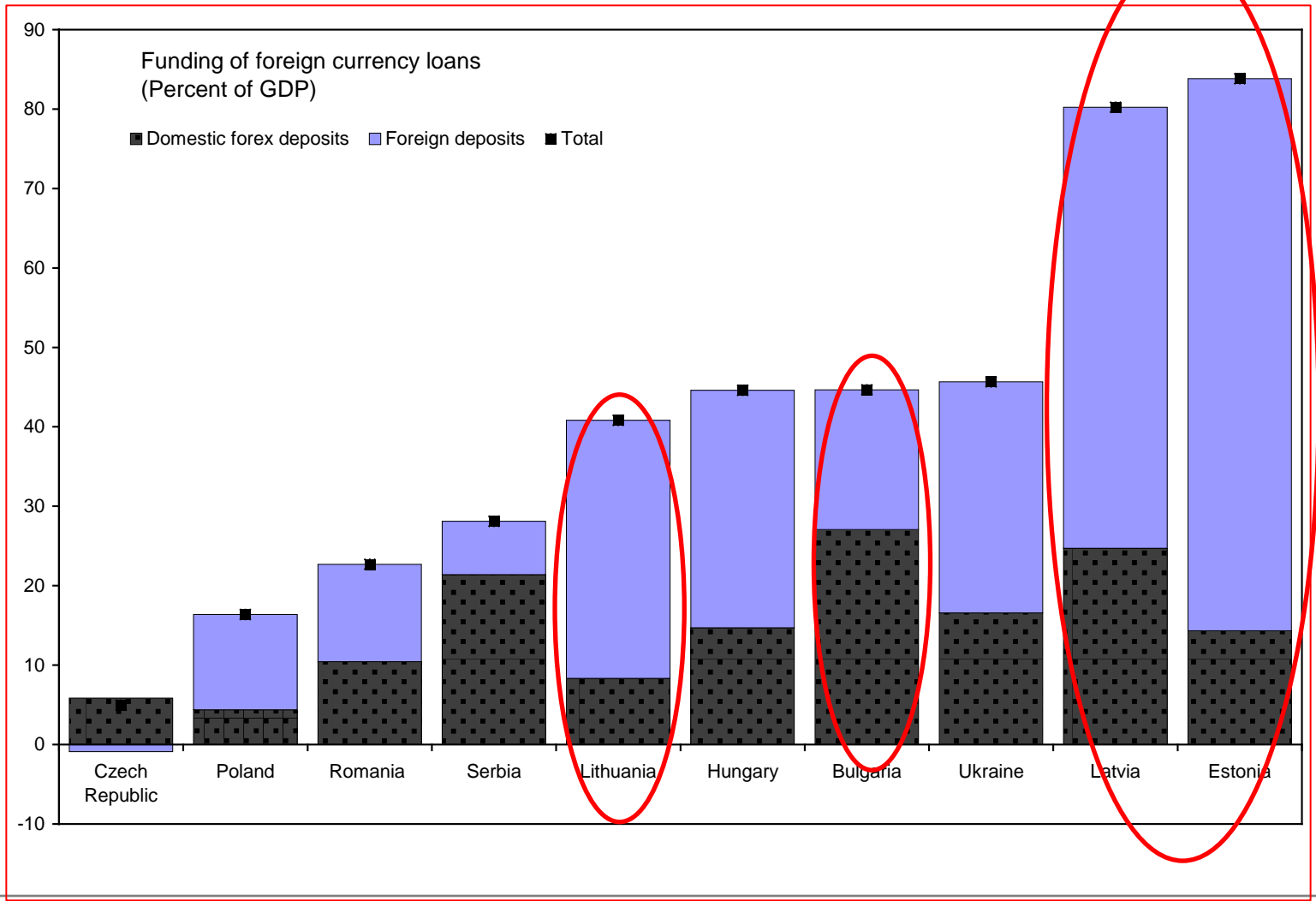
I. FX LENDING

Banai-Kiraly 2014, Banai-Kiraly-Varhegyi 2009,

FX denominated retail lending boom in the CEE countries 1997-2013



FX deposits only partly fund FX loans



FX lending to unhedged individuals (and SMEs) – a special form of the original sin

Original sin: „If a country could not persuade its own citizens to lend in local currency at long maturities, it could not convince foreigners to do the same” = **MACRO IMBALANCE**

- Lack of long term local currency denominated funds – cheap foreign funds (typical for the pre crisis period) **PROBLEM OF THE LOCAL ECONOMY (can not be cured by regulation – good economic policy!)**
- Financial globalization – free flow of capital (in Europe: financial integration due to European Union, lack of any capital constraints) **PROBLEM OF FINANCIAL GLOBALIZATION (Cure: capital control?)**
- Wide network of foreign owned banks with cheap parent funds **PROBLEM OF FINANCIAL GLOBALIZATION (See later)**

SIDE EFFECT: overindebtedness due to FX lending (special bubble)

Case 1: the borrower is „buying” installment – i.e. borrows more than planned (individual indebtedness will be higher than planned)

Case 2: due to loosening credit requirements even those will have access to credit, who would never be let under normal circumstances (the number of debtors increase)

Case 3: the probability of default increases due to predator loans (high LTV, high PTI, NINJA loans, 30-35 year maturity)

**= MACRO IMBALANCE DUE TO BAD INCENTIVES (can be corrected?)
How effective are macroprudential measures? Do banks circumvent the regulation?)**

Regulatory responses

Macroeconomic reforms!

Capital control (ban of FX loans) – not a possible solution within the EU

Developing the long term LC market (easing mortgage bond market entry)

Optimizing FX lending regulation: capital (2nd pillar) & liquidity (FX-NSFR; mortgage lending regulation)

Optimizing FX lending consumer protection (LTV and PTI control)

A special approach (Mero-Piroska 2015) „locally initiated macroprudential tools were often used to satisfy local policy makers’ own agendas: financial nationalism in Hungary and protectionism in Slovakia.”

A special interbank market: the swap market

Funding the FX loans in the banking sector:

- Deposits (on B/S) – safe solution (?) – maturity mismatch ? (cure: long LC funding requirement?, FX based LCCR?)
- Swap (off B/S) – „toxic funding”! Dried up market segment! (topology (*Banai et al 2014*), interconnectedness – contagion)

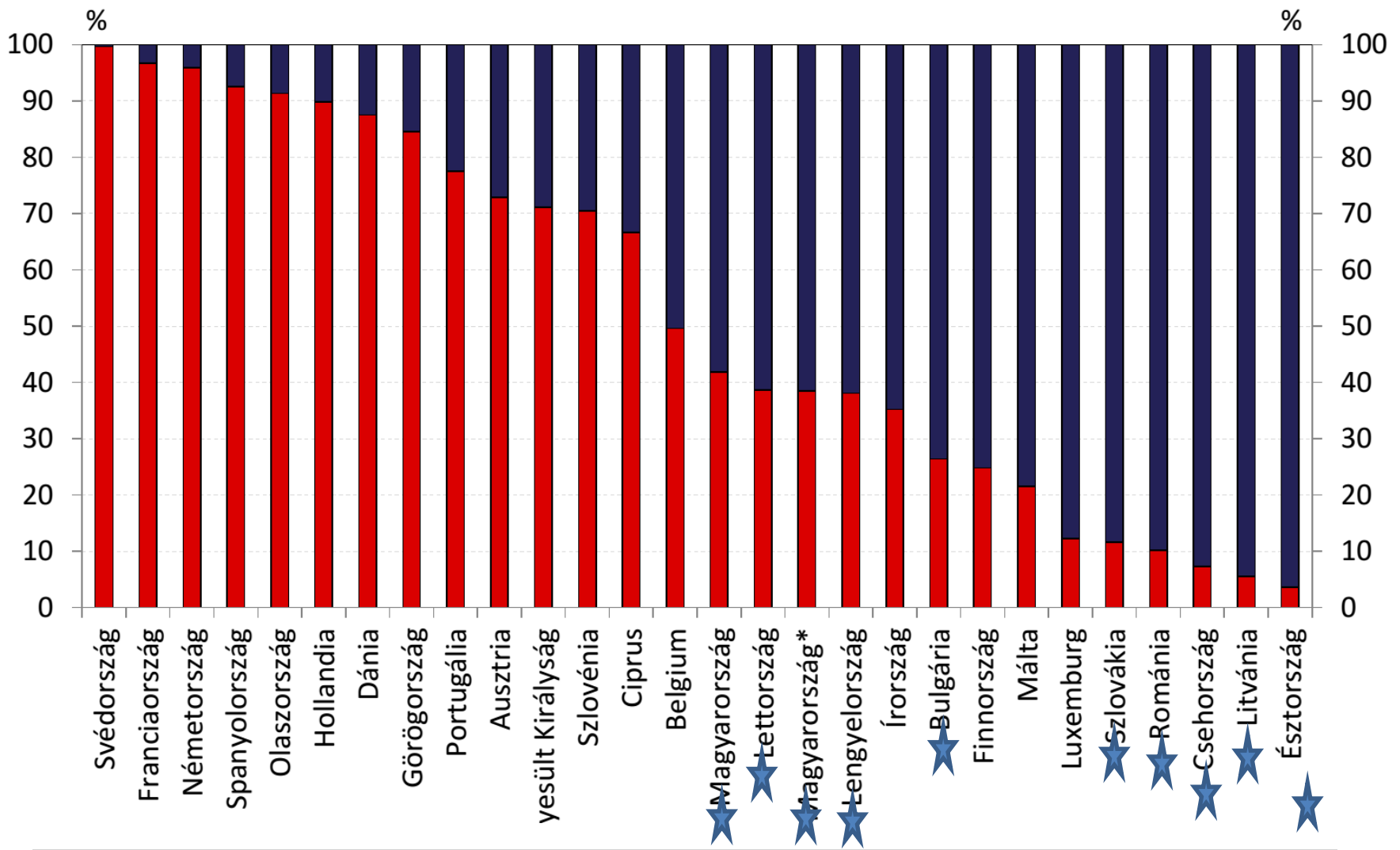
Immediate responses in Hungary to liquidity crisis – October 2008

- **(Local currency:** new tender facilities (2W, 6M), cutting the reserve rate, expansion of the range of collateral)
- **Foreign currency:** HUF/EUR swap tenders (O/N, 1W, 3M, 6M); EUR/CHF swap tenders (Home-host cooperation? and the ECB?)

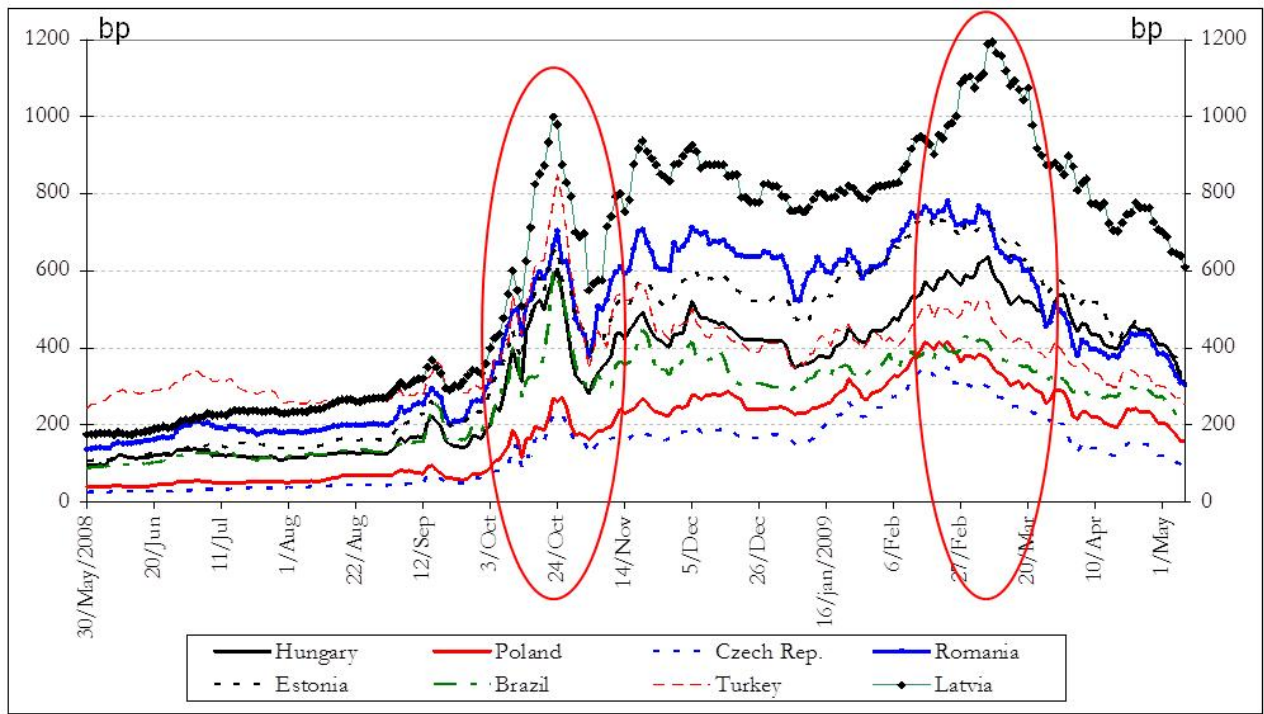
II. Home and host

Banai-Kiraly-Varhegyi 2009; Csajbók-Király 2012

Foreign ownership in the EU banking sector



Home-host market failure: reverse contagion



5 year CDS spreads

Before the crisis: loose credit control, cheap funding, over-equilibrium credit growth

High exposure of Euro zone to CEE countries: fear of sudden stop

High level of FX loans: fear of sudden stop

Solution: VIENNA INITIATIVE (EBRD, IMF, WB, IFC, local authorities and the private sector)

Home-host market failure: „Regulatory race to the bottom”

Raab is a river between Austria and Hungary

There are leather-work plants in Austria along the Raab

Strictly regulated against pollution

How did the foam emerge on the Hungarian side? Regulatory race especially dangerous to the more vulnerable country



Banking Union: Home and Host

Bankunion = union for the eurozone

To enter or not to enter ?

Intragroup liquidity management: „free to chose ?”

Intragroup capital management: European level resolution ?

FX lending: a special original sin

Financial globalization: home and host banking

Some special issues – from the point of view of a commercial banker

- Paradigm shift (and the „regulatory risk“)
- Over-capitalization
- Banking and insurance (activity restrictions)
- Be simple – be effective (find the good incentive system)
- Let the market go!
- „Regulatory risk“: permanent change („dynamic regulation“); human burden;

Additional references

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Csajbók, A., Király J: “Cross-border coordination of macroprudential policies” in Claessens, Stijn – Evanoff, D. – Kaufman, G – Kodres, L (ed) Macroprudential regulatory policies. World Scientific Publishing CO 2012 pp 65-89

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