Wide Angle Shot: European/CEE banks facing complex transition challenges

November 30, 2022 6:35 CET

European banks, also those active in Central and Eastern Europe (CEE), are currently facing multiple transition challenges. We shed some light on the aspects of geographical re-allocation, changing funding conditions (incl. the regional MREL challenge in CE/SEE) as well as the all-encompassing ESG transformation.

European/CEE banks in transition: Where do you do business, how do you refinance it, and what do you do about ESG?

European banks, including the major Western European and pan-European banks with large CEE business, are currently facing several simultaneous, complex strategic (transition) challenges in order to ensure a sustainable and future-oriented orientation of their business models in many dimensions (e.g. geographically, in refinancing and in the area of the ESG turn). In the following, we would like to focus here on three aspects in particular.

- First, **European banks** are particularly exposed in the region of **Eastern Europe** and **Russia**. There has been and continues to be some adjustment here, both currently and in recent years. This realignment mostly benefited countries that are positioned at the Western side of the new "iron curtain". However, in our opinion, the experiences in the Russian and Eastern European business also hold some important learning effects in times of increasing influences of geopolitics and geoeconomics on banking business. Ultimately, we also see an increasing influence of holistic ESG approaches (ESG country ratings and ESG risk considerations) on **geographical alignment decisions**.
- Secondly, the **funding environment** for European and CEE banks is currently changing drastically. The times of excess liquidity in terms of cheap deposits, on the capital market and favourable central bank and capital market refinancing conditions are over. Moreover, MREL instruments out of CE/SEE are harder to place and at the same time pressure on the deposit side should continue to increase.
- Last but not least, the issue of **ESG** is increasingly preoccupying the **asset** and **liability** side of (European) banks. We think that central banks and regulators could use some incentive elements in the current challenging environment to strengthen the European banking sector in the long term. The leitmotif could be "more incentives than punishment (or just stress testing)", while a further and more holistic "greening" of monetary policy/central banking looks like a smart option.

European CEE banks: Portfolio rebalancing started well-ahead of Ukraine war

Up **until 2013/2014**, there was a **tendency** in the **CEE banking business** towards **riskier** and/or **more "exotic" markets** or **country exposures**. Or to put it more concretely, one could observe a kind of political-economic "convergence bet" at work here. Since 2004, the balance sheet share of the Southeastern European (SEE) region within the overall portfolio

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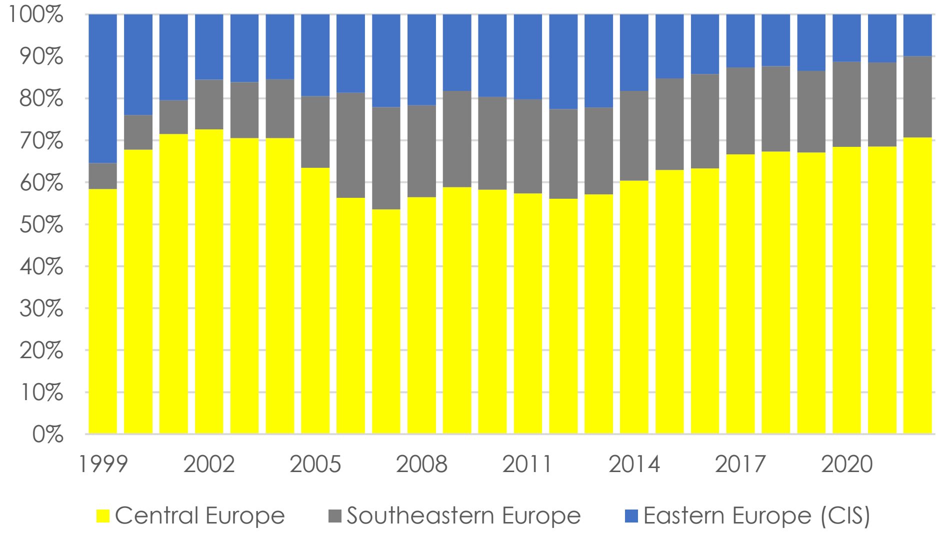
of Western CEE banks has risen sharply, followed by the share of the Eastern European (EE) business and especially Russia since 2009/2010. The latter aspect can be partly also attributed to **balance sheet adjustments** in the **European banking business** following the Global Financial Crisis and euro area crisis. Moreover, for a longer period of time profitability ratios of the Russian banking sector were well above the respective readings in CE/SEE. However, **since 2013/2014**, a **strong refocusing** of **Western CEE banks** on the region **Central Europe (CE)** can be observed. The region's share within the CEE exposures of Western banks has since then risen from a low of 56% (2012) to currently almost 70% (2022).

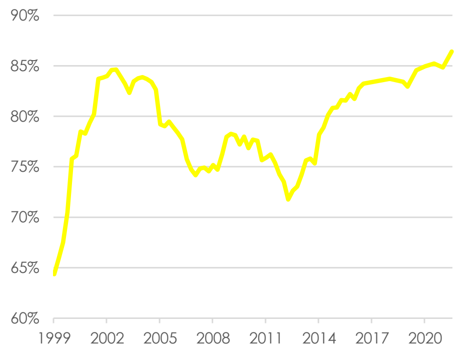
Regional breakdown CEE exposures Western banks
% of total



CE: PL, HU, CZ, SK, SI; SEE: RO, HR, BG, RS, AL, BA; EE: RU, UA, BY
Source: BIS, company data, RBI/Raiffeisen Research

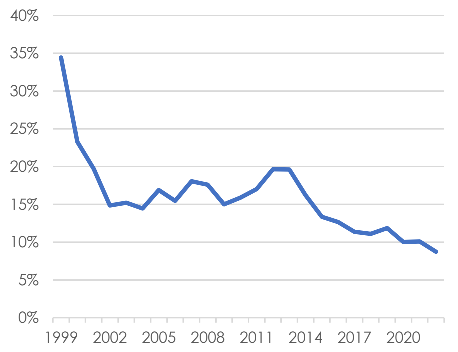
The secular "revival" of CE operations is all the more remarkable, as Western CEE banks tend to remain cautious with regard to Polish business, and the latter is still below historical highs. In line with the **re-focusing** on the **CE region**, the **share of** the **(current) EU markets** in **regional portfolios** of **Western CEE banks** has risen sharply again in recent years (currently **86%**, 2013 "only" 71%, 2003: 84%). The "return" to EU and Western CEE markets reflects a complex interplay of various factors over time. First, simple "convergence bets" have not materialized on many levels. The adoption of the euro by CE/SEE markets has progressed more slowly than expected at the beginning of the 2000s or has been put on the back burner in some cases. Moreover, through-the-cycle profitability in more risky/exotic markets had been possibly less favourable than assumed (or economic/political convergence had been less succesfull than hoped for). Secondly, political and geopolitical risks have long been a relevant factor in CEE business. This applies to the issue of Russia/Ukraine and also the Western Balkans. The ongoing war in Ukraine has once again accelerated the outlined trends as the relative share of Russian business in the regional footprint of Western CEE banks has currently reached an absolute low of just under 7-8%. Overall, it is evident that Western banks have not acted in a completely "geopolitical" or "geo-economic" naïve manner with regard to their regional CEE business strategies, as indicated by regional balance sheet adjustments following the Crimea annexation. From 2013/2014 onwards major Western banks adjusted their regional asset allocation in a way that any material geopolitical escalation in the Eastern Europan region (Russia, Ukraine, Belarus) would not endanger the very existence of regional CEE business strategies.

Share EU markets (% of total)*
Exposures Western CEE banks



* current EU members: PL, HU, CZ, SK, SI, RO, BG, HR
Source: BIS, company data, RBI/Raiffeisen Research

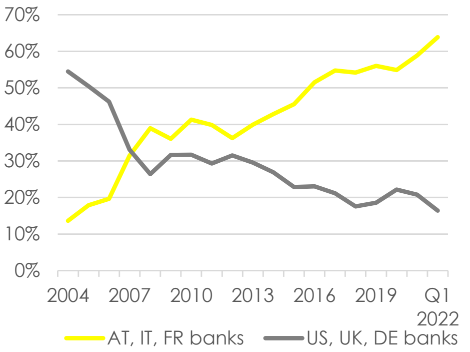
Share Russia (% of total)
Exposures Western CEE banks



Source: BIS, company data, RBI/Raiffeisen Research

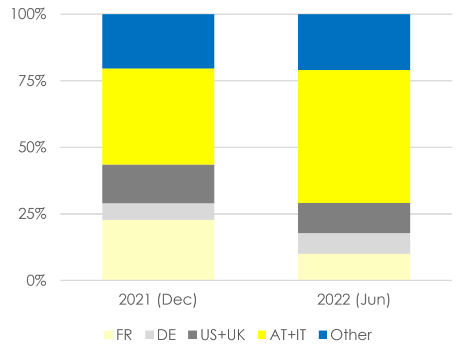
However, it should also be noted that **European** or **EU banks** have been **particularly exposed** to **Russian business** for years. Some European banking sectors (among them France, Italy and Austria) have even made significant (market share) gains here in some cases. In the short term, these trends could intensify. In the future, EU banks should keep a closer eye on developments in "banking against geopolitical actors" such as the USA and UK. However, it should also be noted that EU banks are currently less exposed to China than credit institutions from the USA or UK. As we will show later on, further differentiated country or geographic strategies of international banks should continue to emerge, driven by country-specific risk factors related to relevant ESG classifications or ESG country ratings. Moreover, recent developments in the international banking business in Russia show how complex it is to scale back exposure once a geopolitical confrontation is well underway. (Gunter Deuber)

Share Russian exposures (%)
Western CEE banks



Source: BIS, RBI/Raiffeisen Research

Share Russian exposures (%)
Western CEE banks



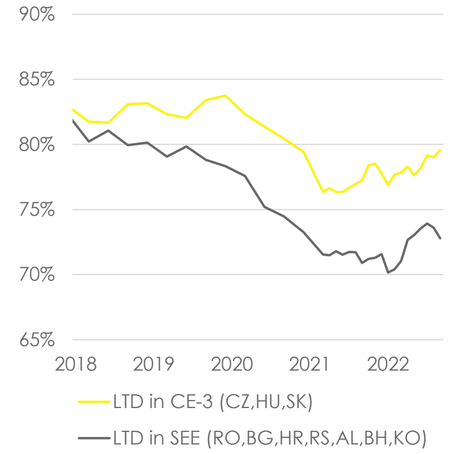
Source: BIS, RBI/Raiffeisen Research

Funding: Deposit pricing catches up while MREL cost bites

The **funding model** at **CE/SEE banks** has long seemed set in stone featuring strong domination of a **conservative customer deposit base**. This even went to extremes in the **COVID-19 crisis years** when the banks found themselves confronted with a secular **over-liquidity problem** amid soaring saving rates and declining loan-to-deposit ratios. The funding base rich of low-cost and sticky current accounts helped limit the banks' lending margin compression in the time of monetary easing back then. Meanwhile, with the turn of the cycle toward aggressive monetary tightening in the course of this year (average monetary policy rates in CE/SEE being currently at 9%+, higher than prior to the Global Financial Crisis and in times of the CE/SEE "bonanza boom"), high inertia in deposit pricing fostered prompt a recovery of the Net-Interest-Margin (NIM). Having said that, the **funding situation** is **becoming less favourable** as compared to recent years. **Deteriorating real incomes** make households tap into their coffers while the high-rate environment and challenging capital markets funding environment spurs **bank competition** for **new deposits**.

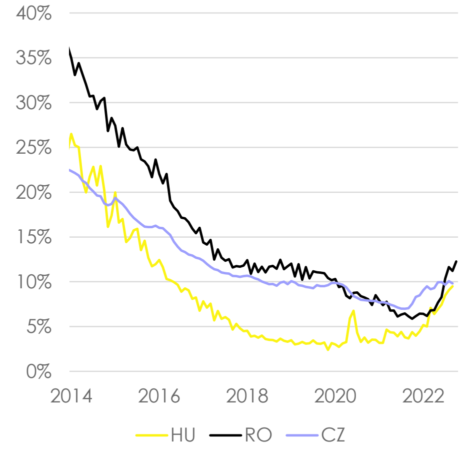
It is probably not yet a wide transformation but the **customers' shift** toward **higher-yielding term deposits** has been clearly afoot, even though low-cost sight deposits remain to be the core product. Looking for instance at Czechia, Hungary and Romania, in terms of new business volumes time deposits have supplanted around 5-7% of current/overnight accounts in the household segment since the beginning of 2022. At first blush, this shows only marginal change in composition, however its **impact** on the **blended cost of deposit funding** is actually nontrivial when one considers the large difference in the applied interest rates. Thus, while the market rates on overnight accounts in the given countries have barely bottomed out from virtual zero, the cost of new <1y term deposits in local currency has exceeded mid-single digits. Notably, the latter represents the most expensive bucket in the term structure reflective of the inverted (government) benchmark yield curves in the markets.

Loan-to-deposit ratio*
data till Q3 2022, weighted average



** loans and deposits of non-financial corporates (NFC) and households (HH)*
Source: ECB, National banks, RBI/Raiffeisen Research

Share of LCY HH term deposits
% total LCY HH new business deposits



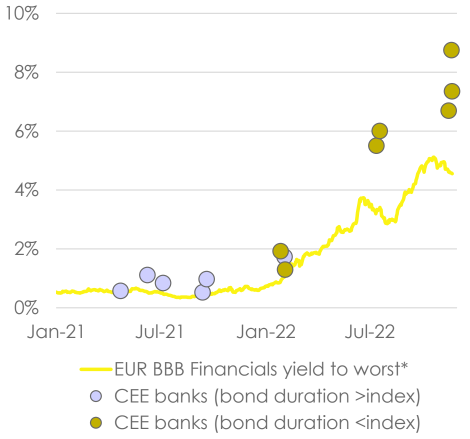
LCY - Local currency; HH - Households
Source: National banks, RBI/Raiffeisen Research

Together with certain catch-up in deposit prices, **CEE banks' funding profile** is now also challenged by **required MREL debt issuance**. Here, in contrast to Western markets the **eastern part** of the **EU proved slower** to **implement** the **bail-in regulation** on both the **national** and **single-bank level**.

As a result, the lenders are now running into a pitfall of generally **uneasy borrowing conditions** on **international** and **local capital markets** coupled with the **short time** before the **final legally-binding MREL targets** (1 January 2024). In principle, the banks have some leeway in terms of the local debt markets capacity and support from multilateral creditors (EBRD et al.). Indeed, **MREL issuance** in **local currency** is actively used, for example, by Czech and Romanian systemic banks, where they can also often secure a relative price advantage (compared to issuance on international markets). Having said that, there is still little alternative to the Eurobond market when seeking to borrow larger size. **International investors**, however, **turned much less receptive** to **CEE risk** this year. Therefore, even the established subsidiaries of European MPE [Multiple Point of Entry resolution strategy] banks and entrenched local players have to pay considerable premium currently to get their MREL debut issuance deals done. So, it is not uncommon to see on the screen **high single-digit issue yields** for **CEE banking senior Eurobonds** even at short maturities of 2-3y.

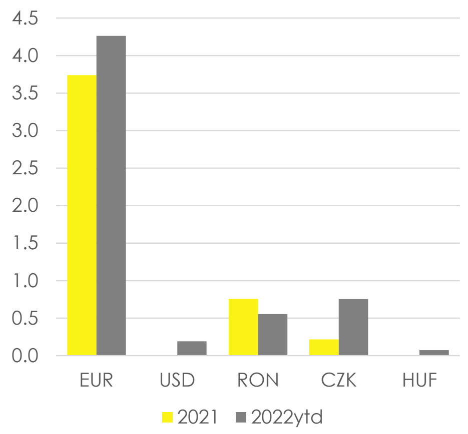
Altogether, we estimate there is still **~EUR 8 bn of external MREL funding missing** in the **CEE** remit, where the banks have to take it on the chin and **absorb** the **additional cost of borrowing** through their P&L. This leads us to expect moderation in the expanding NIM trend for core CE/SEE markets. At the same time, any easing of geopolitical risks should help improve the borrowing conditions. Additionally, there is also room to increase transparency of MREL requirements by single CEE banks which should be welcomed by investors. (Ruslan Gadeev)

CEE banks MREL issue yield
Issues ≥EUR 100 mn & ≥BBB



** ICE BofAML BBB Euro Financial index*
Source: Refinitiv, RBI/Raiffeisen Research

CEE banks MREL issuance*
In EUR bn equivalent

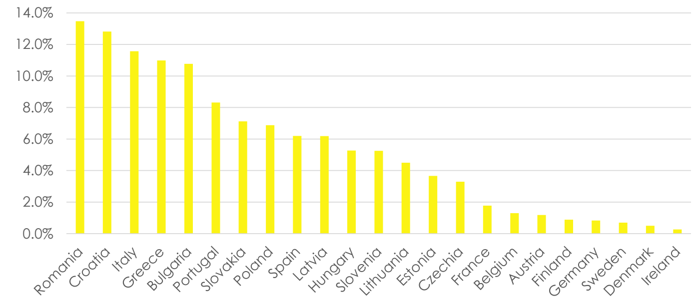


** External MREL issues only*
Source: Refinitiv, RBI/Raiffeisen Research

ESG & EU/ECB: Looking for a carrot-and-stick balance

It clearly seems to be the **political will** of **EU** and **ECB** to take the **leading role worldwide** in the area of **sustainability**, especially on **financial markets** and when it comes to Green Finance/ESG finance. For instance, EU is actively pushing for transparent Green Bond standards. After finalization of the E-pillar of the EU taxonomy the S and G pillars shall be worked out or ECB will actively take Green Finance considerations into account in its Corporate Bond buying/reinvestments. When it comes to the general direction, we are in complete agreement with EU and ECB. However, we would recommend to **pay attention** to **methods** used to guide the long-term ESG transition and in particular to the fact that the **European financial sector does not end up** at a **global competitive disadvantage**, but can benefit from the ESG transition. What is true for Europe as a whole is even more true for the **CE/SEE region**, where **ESG finance** still **remains** fairly **underdeveloped**. Definitely nowhere else in Europe can one properly invested euro bring about more CO_2 savings — so from a sustainable point of view it is always efficient and purposeful to strengthen and support the CE/SEE region as well as the financial intermediaries in this region. This is certainly happening in part through the NGEU instrument, in which CE/SEE is one of the biggest beneficiaries.

RRF NGEU in % GDP (loans + grants)



Source: Bruegel, Fitch, RBI/Raiffeisen Research

In our opinion, these absolutely positive approaches at the EU policy level are less actively supported when it come to banking sector oversight/regulation. At the moment, ECB is trying to push sustainability agendas largely through the risk perspective, by means of **stress tests** and **potential penalties** (higher capital requirements). Here it is important to emphasise that in the stress-testing regime, the incentives tend to be designed in such a way that a bank definitely will not want to end up at the bottom, but a place in the middle of the field is also OK; competition for best solutions is not promoted by stress tests (in contrast to capital relief). In this context it is worth mentioning that China, for example, is taking a different approach and incentivizes granting of "sustainable" loans via the People's Bank of China. (see also our current Green Deal). A step-by-step plan also makes sense to us, as it seems almost impossible to address all issues at the same time. For this reason, it would make sense to us, for example, to focus on the topics of CO2, water and energy efficiency as well as circular economy in a first step when it come to financial sector KPIs. As these variables seem to us to be more measurable and successes can be achieved in a timely manner.

How to support the Green Finance and ESG-alignment of the banking sector

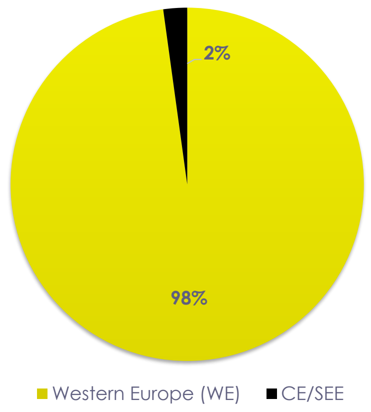
For the financial sector and its customers (companies) in particular, concrete incentive systems of the regulator seem more important to us than "standalone" stress tests. For example, the following proposals could promote and speed up a sustainable transformation in banking and finance:

- **A green TLTRO from the ECB with attractive conditions linked to further new lending that meets "green" TLTRO criteria**. The option of introducing a green TLTRO seems possibly even more relevant than some 6-12 months ago given the substantive change of short-term and long-term banking sector refinancing conditions on the back of the front-loaded ECB tightening and overall capital markets volatility. A green TLTRO could secure more generous financing conditions (in time of more restrictive overall bank lending conditions) for private sector projects that support the Green Transition. From our view a green TLTRO could be well-designed to avoid "carry trades" or investments in Green sovereign bonds (which will most likely meet solid demand).
- **Lower risk weights for sustainable loans and project finance.** Within the context of the debate over a Green Supporting Factor (GSP) or Brown Penalty (BP), we would clearly opt for the GSP approach. Our take is mainly supported by the fact that currently banks are possibly having much more "brown" or high-carbon assets than green assets on their balance sheet. Therefore, the short-term disruptive impact of a GSP would be possibly lower, while the long-term benefit is possibly higher and more sustainable (compared to a one-off adjustment in case of a BP). However, we are fully aware of the fact that a GSP will be possibly harder to define and implement compared to an BP. Nevertheless, we think that the effort will be worth an investment.
- **Capital ratio requirement reduction (e.g. within the P2R) in case of a very significant reduction of the CO2 footprint of the loan portfolio.** We would see such a focussed and measurable initiative as reasonable given the fact that the carbon footprint is a key variable in the fight against climate change, while banks are well advances in measuring their CO2 footprint. The ECB focus on this variable in its corporate bond buying/re-investment strategy would also speak in favor of such a focussed approach. That said, it can be argued that ambitious approaches at the individual bank level minimise long-term institution-specific transition (credit) risks.
- **A European model/standard for transition bonds (loans) in order not to exclude "weaker" market participants seems much needed** (e.g. Canada plans transition bonds). Currently, we see the EU being focussed on the Green Bond market. However, we would see the development of EU market standards for transition bonds/financing as equally important given diverging profiles of EU countries when it comes to the ESG transition. Such financing would also enable firms that would not qualify for Green Bonds/financing to tap the ESG finance market.

- **Guarantees for sustainable projects that involve higher risk costs or implementation risks**. Such guarantees could be especially helpful for projects that involve higher commercial and/or country risks. In this context it is worth noting that the ESG-transition in global finance and banking is currently mainly a story of Developed Markets and/or more mature Emerging Markets. Therefore, less mature markets and countries could clearly benefit from such instruments (especially if they are reaching out of LCY financing in Emerging Market currencies). In this context it is important to stress, that investments into Green/ESG transition outside of the EU would possibly have greater (global) benefits compared to a euro area/EU focussed ESG finance agenda.

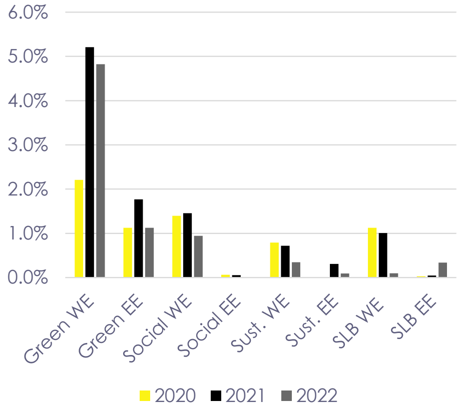
Overall, we see a particular need for action and development in the area of capital market financing of the sustainable transition in CE/SEE (being mindful of the fairly good starting position of a lot of countries within holistic ESG country rating approaches). Currently, only **2%** of **European ESG debt captial market issuance** is coming out of the **CE/SEE region** (having a GDP share of around 10%+ within the EU GDP). Moreover, in the last three years, we have not seen any material catch-up movement from the region; on the contrary, 2022 represented a step backwards. In addition to the topic of **transition bonds**, the topic of **sustainability-linked bonds** seems to us to be particular importance for the CE/SEE region. This form of financing allows companies to invest money more flexibly in their sustainable development, backed by ambitious KPIs. We believe that such instruments can contribute at least as much to sustainable change as, for example, the classic Green bonds; currently in the focus of EU regulatory initiatives. (Jörg Bayer, Gunter Deuber)

Share ESG bonds CE/SEE
% European market



Source: Refinitiv, RBI/Raiffeisen Research

Share ESG bonds
region/category, % of total issuance



Source: Refinitiv, RBI/Raiffeisen Research

Note: This publication was prepared to back-up our presence at the Conference on European Economic Integration (CEEI) 2022 organized by the Austrian National Bank November 2022 within the Panel "Banks in transition: need for rescoping toward sustainable markets and products?"

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Producer of this publication Raiffeisen Bank International AGAm Stadtpark 9, A-1030 Vienna

Creation time of this publication: 30/11/2022 6:35 A.M. (CET) ;

First Dissemination of this publication: 30/11/2022 6:35 A.M. (CET)