

Eighth KfW International Financial Sector Symposium

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Session 3: Crisis Resilience of Financial Institutions and its Management

Summary prepared by Rainer Hartel

Session 3 was composed of the following experts:

Keynote Speaker

Sylvia Wisniwski European Fund for South East Europe, Chief Operating Officer

Panellists:

Joost Zuidberg The Currency Exchange Fund (TCX), Managing Director

James N. Mwangi Equity Bank Kenya, Chief Executive Officer

Carlos Martabit Banco Estado Chile, Chief Financial Officer

Holger Rothenbusch Deutsche Investitions- und Entwicklungsgesellschaft (DEG),
Senior Vice President

Helen Alexander Pro-Credit Holding, Managing Director

Moderation:

Ruurd Brouwer FMO, Director Financial Institutions

Keynote: Lessons from the Crisis Response of Financial Institutions in South East Europe (Sylvia Wisniwski)

Overview. Eastern Europe's financial markets have been particularly hard hit by the ongoing crisis. This keynote discusses how individual financial institutions (FIs) in South East Europe have weathered the crisis since the onset in October 2008. The presentation is organized by the core management functions and the relevance as crisis symptoms occurred and affected FIs (i) liquidity crunch, the key issue at the onset of the crisis; (ii) managing asset quality and provisioning, which continues to be the predominant topic at the moment; (iii) asset-liability management including maturity and currency mismatch and repricing risk with both having impacts on liquidity and asset quality and (iv) profitability, which reflects the combination of the three areas.

Its vicinity to the European Union (EU) and prospects EU membership the Euro became the primary currency in the region, which posed challenges to national regulators and FIs. FIs' business operates within a level playing field determined by national regulation and EU financial market conditions. Some regulators responded to the crisis by drastic tightening of regulation which affected FIs' business. Macro issues were discussed in detail in Session 4.

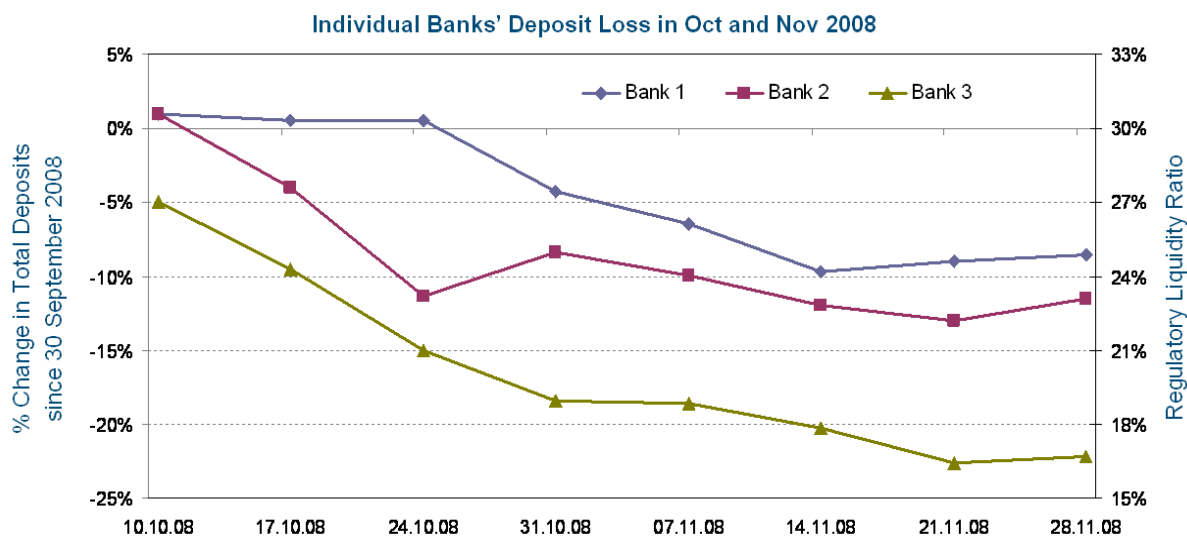
The keynote speech is based on the FI crisis experience and response of the European Fund for South East Europe which has 56 FI clients in nine countries. Of these nearly half are commercial banks and the remainder banks and non-banks operating in microfinance. For a summary of EFSE's operations see www.efse.lu.

Liquidity management issues

Deposit withdrawal- maintaining and restoring client confidence. On 15 September 2008 the demise of Lehman in the US triggered the collapse of financial markets in the US and Western Europe. Southeast Europe was immediately affected and depositors massively withdrew deposits. Graph 1 illustrates the withdrawal of deposits in three Montenegrin banks. While the overall trend shows a significant withdrawal from mid October to mid November 2008 it appears that banks 1 and 2 managed this challenge better than bank 3. Within 3 weeks bank 3 lost almost 20% of its deposits.

The weaker performance of bank 3 lies in its business model, structure of deposits and profile of depositors. Also as a late comer in the market it faced a limited choice of customers.

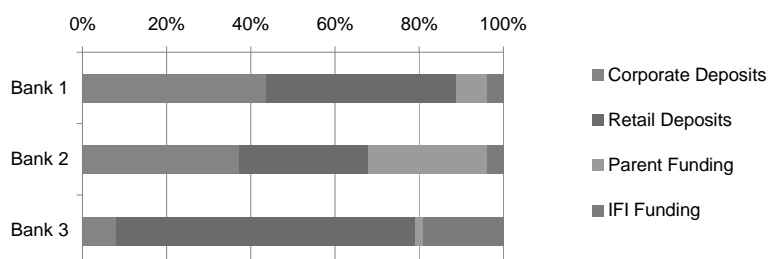
Graph 1. Montenegrin Banks' Response to the Bank Run (October/ November 2008)



Source: EFSE Participating Lending Institutions

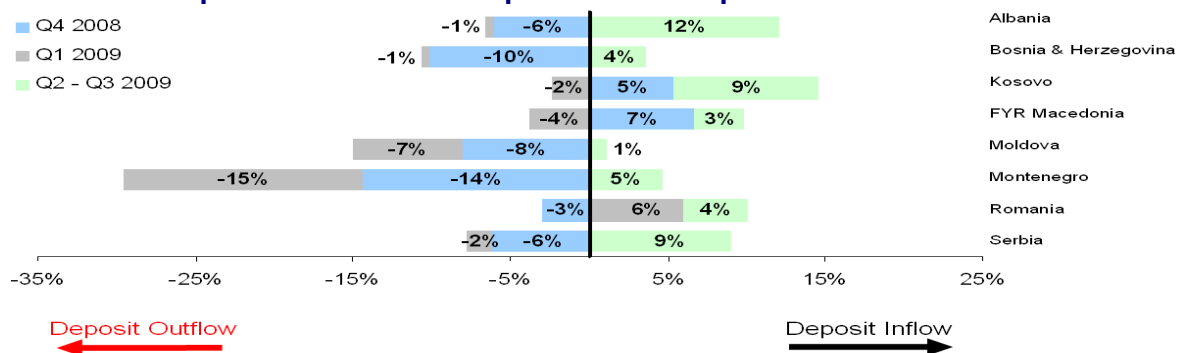
Graph 2 shows that bank 3 relies to 90% on retail deposits, while other banks relied more on stable corporate deposits, who use the bank relationship for other services. Most bank 3 retail depositors are interest sensitive clients who move their relationship quickly unlike stable multiple service clients. While all three banks had a policy of paying out deposits immediately on demand, bank 3 failed to engage in a dialogue with their depositors to generate the necessary confidence. This added to the negative effect of deposit withdrawal.

Graph 2. Montenegrin Banks' Composition of Deposits in percent of Total Liabilities)



Deposit flows over 12 months – country perspective. From the 4th quarter 2008 through the 1st quarter 2009 customers massively withdrew bank deposits. Since the 2nd quarter 2009 the situation stabilized and deposits flew back into the system. Within 12 months BIH, Montenegro, and Moldova had not recovered deposits to pre-crisis levels while in Albania Kosovo, Macedonia Romania and Serbia deposits exceeded pre-crisis levels (Graph3).

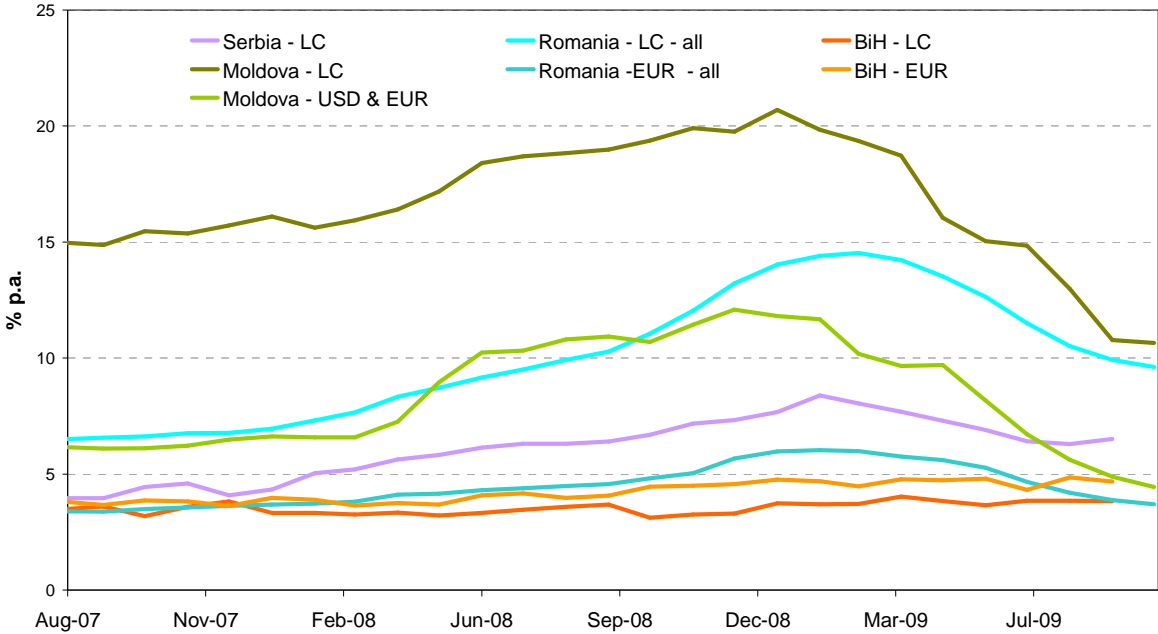
Graph 3. South East Europe – Flow of Deposits 4Q 2008 – 3Q 2009



Source: EFSE

What triggered the reflow of deposits? Deposit interest rates have risen prior to the Lehman collapse, peaked from late November 2008 to mid-January 2009, and subsequently dropped, well before deposits flew back in the system (Graph4). This implies that interest rates were not essential for depositors and rather reflect the shattered market confidence.

Graph 4. South East Europe –Local and Hard Currency Deposit Rates 2008 –2009

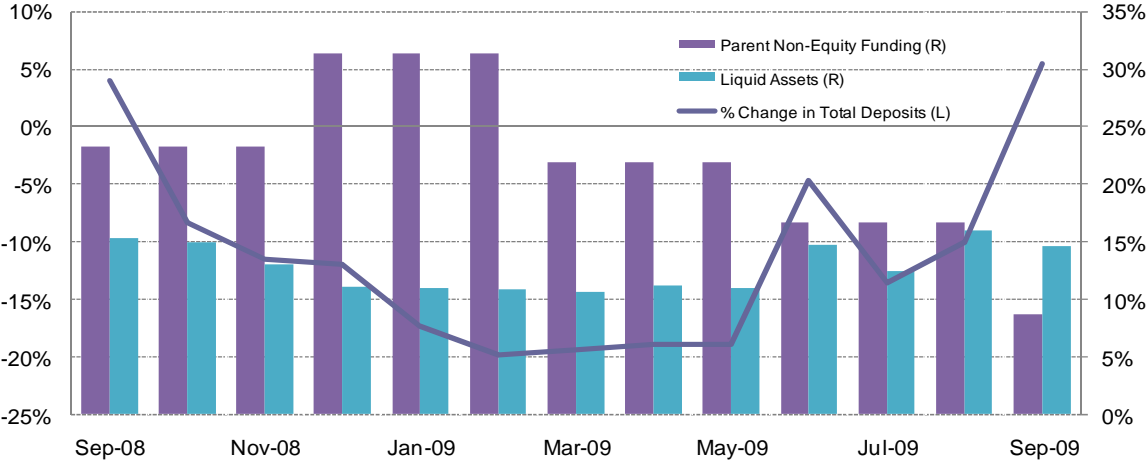


Source: EFSE

Take-Away 1 – Deposit structure and active management are critical to minimize adverse liquidity impact. Corporate and multiservice clients are more stable. Public trust is the key driver for deposit recovery.

Parent funding is an important source for liquidity. For example Bank 2 in Montenegro shows that additional parent funding in the 4th Q 2008 and 1st Q 2009 were critical, when massive outflows of deposits took place. When liquidity stabilized, deposits increased again. Effectively the foreign parent, backed by liquidity support of the European Central Bank (ECB) transferred this support of lender of last resort to bank 2.

Graph 5. Montenegro Bank 2 Parent Funding and Deposits during Crisis
Bank 2 - Deposit base, liquidity and parent funding, 09/08 - 09/09



Source: EFSE

Foreign parent banks manage liquidity within a limit system between their subsidiaries as well as providing core liquidity from the parent itself. This helped when some regulators

temporarily blocked the transfer of liquidity from one country to another. Recourse to both sources and backing through the ECB were critical for the banking system in Eastern Europe.

Take-Away 2 – Liquidity was substantially enhanced during the period of deposit withdrawal through foreign parents. Parent funding acted as pre-lender of last resort by group liquidity management and provision of parent core liquidity.

Contrary to banks active liquidity management, Microfinance Institutions (MFI) focused on aggressive growth strategies neglecting adequate liquidity management. MFIs exclusively relied on few sources of funds and ignored deposits as a stable source. Liquidity contingency plans did not exist at the MFI or the network levels. For example bank 3 in Montenegro is part of a microfinance network, which was unable to support it.

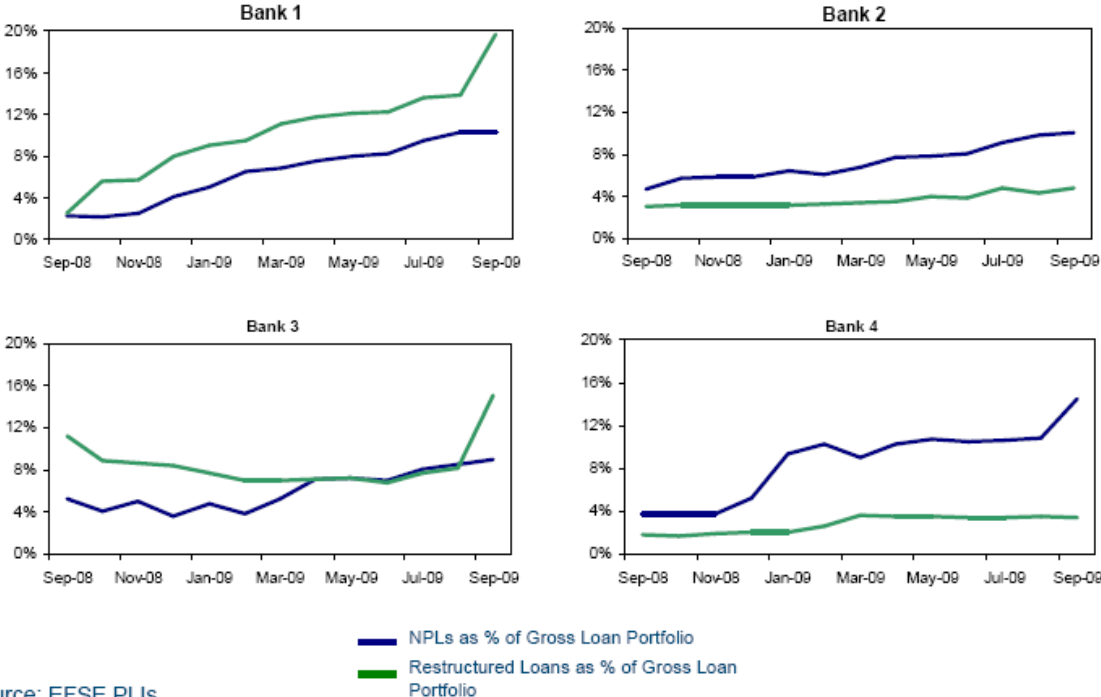
Despite these challenges no MFI in Southeast Europe defaulted because of liquidity issues. MFIs were lucky to have sufficient liquidity for future business growth that could be used as a buffer when sources – primarily from local commercial banks- were withdrawn.

Take-Away 3 – MFIs were lucky and lacked proper liquidity management benefiting from securing funding for business growth in advance and some private and IFI support on a case by case basis.

Asset Quality Management & Provisioning Policies

Asset quality is currently a key concern. Four banks in Moldova illustrate different asset management strategies. Bank 1 has substantially restructured its loan portfolio early on including asset classification prior to becoming overdue and proactive rescheduling with the client. Bank 3 and 4 undertook only limited restructuring and Bank 2 did not even show the true NPL picture (Graph6).

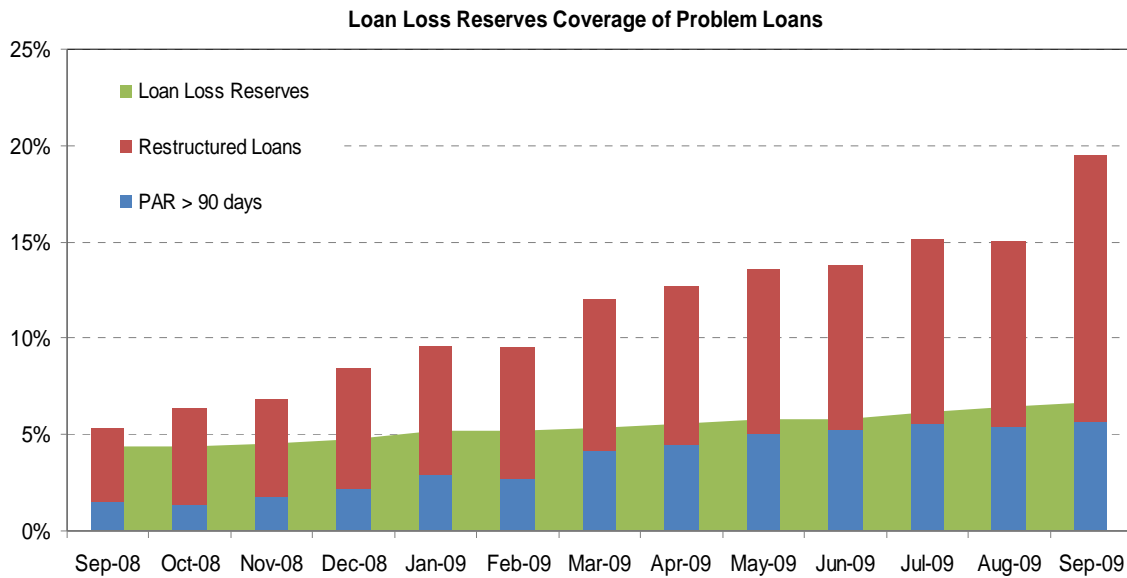
Graph 6. Moldova – Asset quality management by four banks



Source: EFSE PLIs

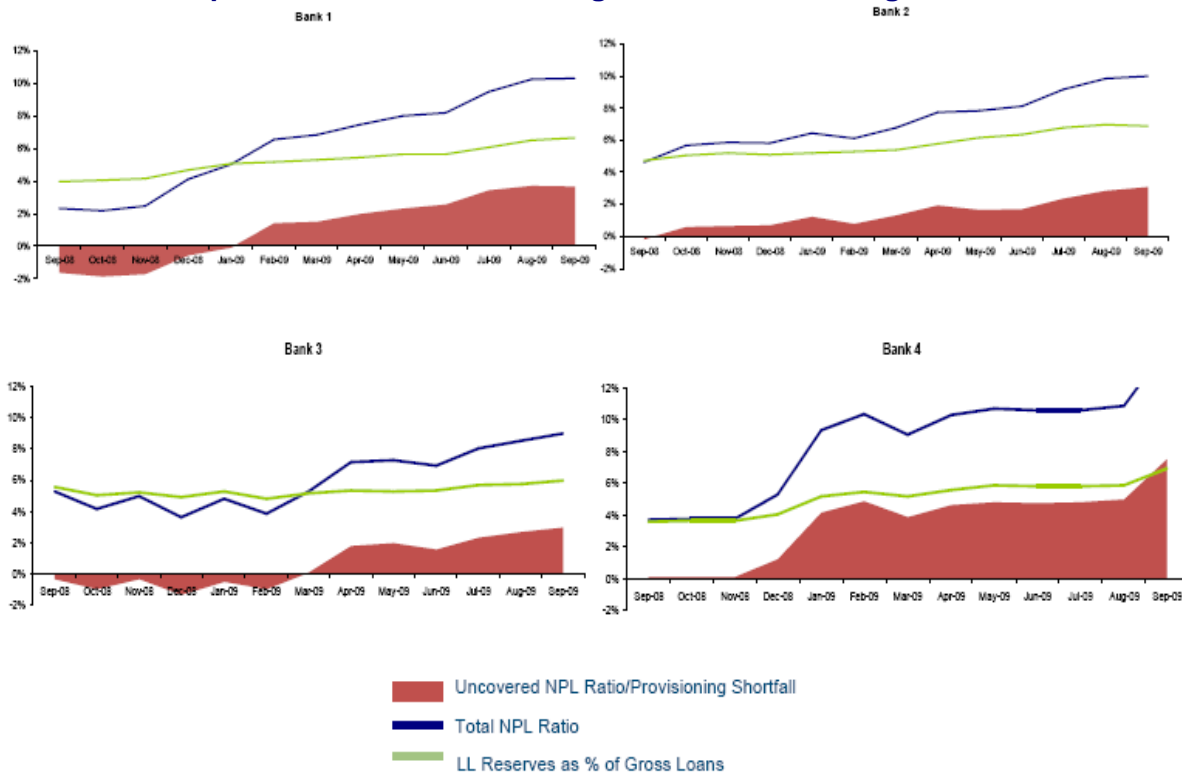
The Moldovan financial sector shows a sharply rising trend of Portfolio at Risk (PAR) and restructured loans over 12 months from September 2008 -2009, while loan loss reserves remained roughly the same. Initially provisions covered PAR and restructured loans while meanwhile PAR are barely covered. It shows that FI solvency has been adversely affected.

Graph 7. Moldova – Asset quality and provisioning during the crisis



Despite that overall negative trend on provisioning there has been a diverse picture for the four banks (Graph 8). Bank 1 and Bank 2 had initially loan loss reserves which were quickly eaten up during the crisis, while Bank 4 was never adequately provisioned and shows increasing provisioning shortfalls. If proper asset classification was applied and managed in this bank the shortfall would be much larger. The provisioning policy reflects that all the 4 banks manage provisioning as a left-over when their profitability requirements and pay out to shareholders have been met.

Graph 8. Moldova –Provisioning of four banks during the crisis



Take-Away 4 – Bank managers were experienced in loan restructuring however internal rating and scoring proved unreliable. Adequate provisioning was undermined by excessive dividends to private shareholders undermining FI solvency in Moldova.

Asset Liability Management

Currency Mismatch. While banks may reduce currency mismatch in the presentation of their balance sheets by passing currency risk through to the client borrower this policy translates into higher credit default risk in the case of a devaluation unless the bank client has adequate cash flow income in that currency.

Technically Foreign exchange management including limit systems and value at risk calculation may be in place. However often hard facts about the true exposure are not systematically required and collected by central banks leaving high uncertainty as to the quality of information.

Take-Away 5 – Formally closing open foreign exchange positions does not reflect cost of large FX-induced credit risk at the client level. There are very limited foreign exchange swaps for short maturities available. Foreign exchange denominated lending disguises the massive underlying credit risk in the case of devaluation.

Repricing Risk. Banks undertake basic interest rate risk mitigation, trying to match the different repricing buckets on the liability and the asset side because there is no derivative market available. So far they have done well with sensitivity testing normally assuming changes of plus and minus 2% to understand the impact on economic capital. Historically this worked well. However during this crisis the 2% band may be too narrow.

MFIs do not seem to undertake interest rate risk mitigation. There seems to be denial of the problem because of the high turnover of the portfolio on a quarterly basis, which allows repricing. However this does not reflect interest rate risk associated with long term funding.

Profitability. Refinancing cost might have a very significant impact on overall profitability. For example FIs in BiH showed increasing risk margins since the onset of the crisis. However, nominal funding costs matter for bank profitability. In the case of BIH nominal costs declined. Since 2009 the drop of the Euribor rate was more than compensating the increase of the risk margins. So overall the profitability benefited from declining refinancing costs.

Other important factors hurt profitability during the crisis such as the low portion of income earning assets, high cost of liquidity, low lending activity. Raising loan interest rates was not successful. Reducing operational costs is risky because a stress situation binds staff resources. The other cost reduction may come from low provisioning and as presented in Moldova these are cost incurred and realization delayed

Take-Away 6 –Profitability. High liquidity cost, low lending activity and limited fee business hurt profitability, while the level of refinancing costs had less impact on profitability. Main short-term measures to address insufficient profitability are lower provisioning levels and operational costs.

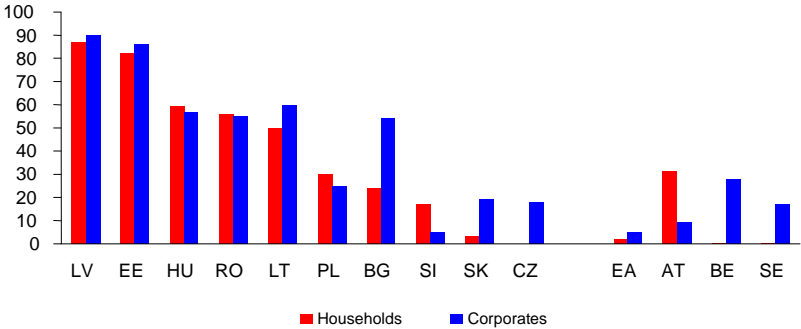
Limitations of financing domestic currency assets through hard currency liabilities. (Joost Zuidberg)

Currency losses were major at the onset of the crisis demonstrating the high risk of currency asset liability mismatch for financial systems, institutions and their clients. Graph 9 illustrates this case in Eastern Europe where high systemic foreign currency exposure of households and corporate borrowers in Latvia, Estonia, Hungary, Romania, Lithuania, and Bulgaria, was not backed by income cash flow in a matching currency. This foreign currency mismatch increased vulnerability of the local financial market. The mismatch also severely limits local central banks' ability to address economic shocks through devaluation which would trigger insolvency of foreign currency borrowing individuals, companies and banks.

If local domestic markets unable to fund the local long term investment needs, accessing international financial markets may be a solution. Graph 10 shows that a FI or an international investor with a diversified currency risk exposure spread over 20 currencies (red line) is much better able to balance even large devaluation as in the case of Indonesia. Individuals or institutions being exposed to single foreign currencies are far more exposed as

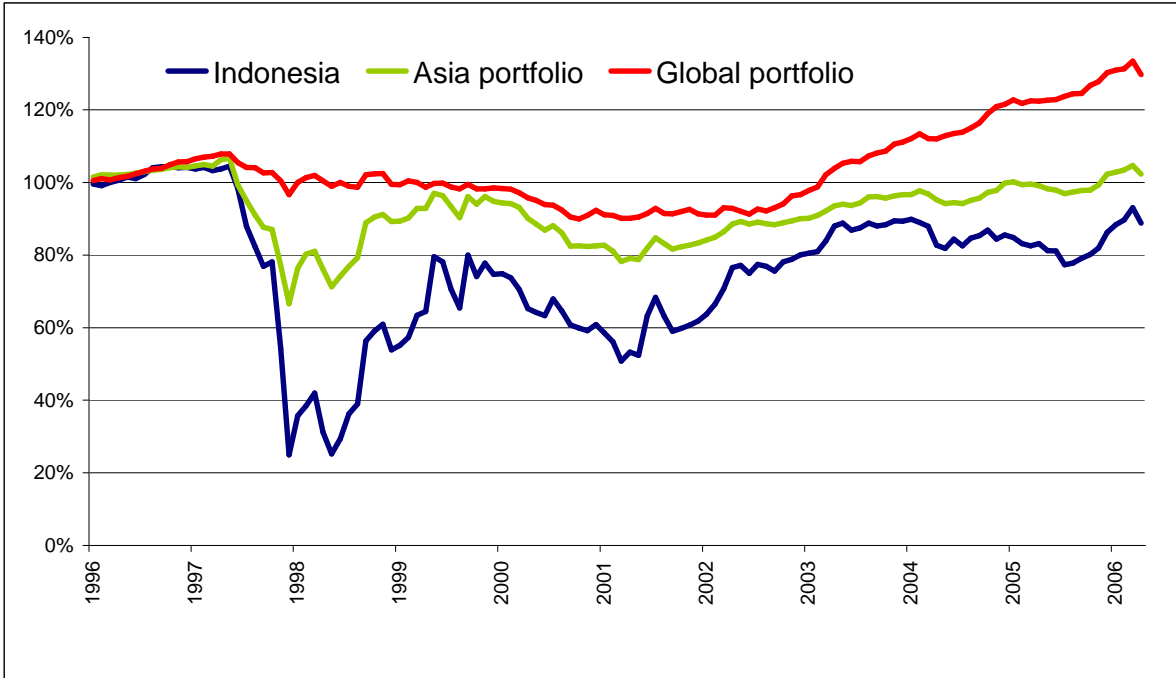
presented in the case of Indonesia (blue line). Obviously individuals should not bear the foreign exchange risk.

Graph 9. Foreign currency loans in % of total loans in European countries (2008)



Source: BIS, ECB, national central banks
 Note: EA = euro area. SI - data February 2008

Graph 10. Cumulative returns on investment for single versus multiple foreign currency exposures in the case of Indonesia and Asia (1996-2007)



Equity Bank’s experience in weathering the crisis in Kenya (James Mwangi)

Kenya was less affected by the first round effect of the financial crisis but rather from its second round effect on the real sector. This crisis immediately followed a severe political crisis in Kenya. In addition Kenya’s farmers suffered from continued severe drought, causing a significant drop in farming output and with it a lack of sufficient food for 30% of the population. Increasing food prices fueled inflation up to nearly 20%. Since early 2007 the economic conditions in Kenya are extremely challenging.

Equity Bank is home to 56% of bank accounts and 45% of deposits in Kenya. It is the 4th largest listed company. It has witnessed rapid growth exceeding 100% annual asset growth since 1997. Despite the unfavorable economic environment Equity bank continued to grow during the crisis at a similar pace presenting high profitability. The price of the shares kept at the pre-2007 levels unlike other companies in Kenya, who's shares tumbled.

Equity Bank's has a long term vision and prudence has supported its crisis resilience. During the boom, it diversified its funding, which at that time depended on short-term savings to raising long-term shareholder funds and subordinated debt up to 40% of total funds. These long term resources helped it to escape the liquidity crunch in the context of the crisis.

Equity Bank strongly emphasized the need to cultivate clients' loyalty through good customer relationship. This proved critical to master the economic crisis. Equity Bank used a conservative approach towards matching currency exposures and thus avoided a disastrous impact of devaluation. From its origins as a microfinance bank it has diversified by opening to SME clients followed by diversification across all the sectors in the economy and thus reducing the relative exposure to individual regions or sectors.

The Chilean experience in weathering the crisis – prudent macroeconomic management during the pre-crisis period and appropriate stimulus instruments (Carlos Martabit)

Central Bank accumulated 25% of GDP in reserves due to high copper prices, and government created sovereign funds to manage reserves. This provided comfortable fiscal space.

Thanks to prudent financial regulations the Chilean financial sector has low exposures on derivatives and structured instruments. Some investments into US FIs caused minor losses. The international banks' liquidity crunch overseas transmitted to their local subsidiaries in Chile, particularly in foreign currency. Uncertainty created high demand for liquidity and increased aversion to risk. FIs raised their requirements for credits causing a credit crunch.

The Central Bank provided liquidity to the financial sector and massively reduced the monetary policy rate from 8.25% to 0.5%. The Government provided a US\$ 700 million stimulus package for public investments and guarantees for small companies. Additional measures included transitory elimination of tax on loans (US\$ 650 million equivalent), capitalization of US\$ 500 million for Banco Estado, subsidies and grants to support employment and training, as well as low income families.

Banco Estado played a social and anti-cyclical role during the crisis. I accommodated the credit flow in the financial system, when the private banks were reluctant, undertook portfolio restructuring, facilitated trade, and promoted the use of guarantees for loans to SMEs.

The Bank weathered the crisis through close monitoring of markets who indicated problems since early 2007. Uncertainty at international banking meetings prompted more conservative lending policies and adopted a policy to reduce net FX position to near zero, and hedging the "real" position with simple derivatives such as forwards and swaps. A high proportion of liquid investments and appropriate proportion of long term lending helped to avoid liquidity stress. **A strong state owned bank proved useful to weather the crisis.**

Investor perspective from emerging markets outside the Eastern European crisis epicentre (Holger Rothenbusch)

In the developing regions of Asia, Africa, Latin America the crisis has not unfolded nearly as severe as in Eastern Europe. There were no toxic assets and there was no significant liquidity crunch. There have been some measures to adapt cash flows and loan maturity, trimming costs, improving efficiency and reducing balance sheet exposure.

The complete stop lending and retrenching of their activities very quickly lead to undermine access to finance for micro and smaller and middle size enterprises. These target clients had limited access before the crisis and this has become worse with the crisis. With the crisis banks are focusing more on the bigger companies and some select areas of retail.

The crisis has highlighted that high business growth is associated with high risk and does require extraordinary good management, systems and structures. In the majority of cases, where we have seen extraordinary growth we have seen extraordinary problems. Fast growth requires new staff and their quick integration and training.

Poor lending practice is a key issue. For example in Nigeria a number of banks have been running enormous books on margin lending in the stock market. When the market collapsed NPL ratios surged as high as 40%.

The dominating presence of foreign banks is a double edged sword. On the positive side foreign banks may introduce international standards and help improve professionalism. On the negative side liquidity of these banks can be quickly removed and contribute to drying up of markets as seen in Latin America, where the US parent banks were in deep trouble. While foreign banks did not close their subsidiaries they reduced their balance sheets very dramatically. In a market where the top five banks are foreign owned and controlling more than 70% of the banking sector assets and are using the same approach there is an immediate systemic issue. The credit crunch in those local markets was caused by foreign bank presence and behavior as a consequence of decisions made without regard of the needs in the local market.

Institutionalizing good corporate governance is a challenging process. While organizations and processes may be appropriate in form we have found, mainly in Eastern Europe and in central Asia that the appropriate culture and people are not place. An appropriate risk, reward culture can be eroded by people taking excessive risk and they are not being made accountable for inappropriate risk taking.

ProCredit Crisis Perspective from 23 developing markets (Helen Alexander)

ProCredit Holding (PCH) operates in 22 developing countries which have all been exposed to the crisis to varying degrees. Its business focus on the asset side is enterprise lending catering about one million clients ranging from micro to a few medium sized enterprises. At the liability side PCH has two million depositor customers.

In the onset of the financial crisis liquidity and equity disappeared overnight. This was only a short term problem in late 2008 since most of PCH business is funded from deposits and retail savings, which proved very stable in the end. Currently excess liquidity is a problem since deposits have returned while credit demand remains low.

A big challenge is managing credit risk exposure, currency volatility, and related client over indebtedness. Prior to the crisis there was simply too much money in many markets, particularly at low end where consumer finance was strong. Most difficulties are in markets like Bosnia, and Ukraine, which are poorly regulated and were very liquid with massive foreign investment and little responsibility to customers. Other markets are much better developed and regulated such as Bolivia, Serbia, and Kosovo.

During 2009 PCH focused on stabilizing its loan portfolio at zero growth. Portfolio quality has significantly declined compared to the historical 10 year average with a portfolio at risk over 30 day of well under 0.5 % and now at 3.5%. PCH has restructured about 7% of its loans. Despite this difficult environment PCH did not make any losses largely because of regional diversification. For example Kosovo operations supported Ukraine.

The biggest challenge is to train the ever increasing staff which expanded sevenfold to 21000 within only five years. This requires an enormous effort of training and recruiting staff. Associated with this challenge is training to know clients well, understand clients' ability to manage their business when his sales decline substantially. Credit scoring, collateral, credit

guarantees can not substitute well trained staff. Above all the crisis highlighted the importance of the organization to manage a large number of staff people with a commitment to clients.

The support and patience of shareholders both public and private proved essential during the crisis. This includes an understanding that high growth and return cannot continue and that large resources are required to manage the risks.

Discussion

Do we need a strong state owned bank? The success story of Banco Estado de Chile described above triggered a controversial debate on the merits and pitfalls of having at least one strong government FI in a financial system. It is recognized that country specific parameters such as the independence of a bank from politics which seems to be the case in Chile are essential.

A large country in South Asia went for a different route privatizing about 80% of its banking system within less than 10 years. This approach reflected the previous heavy influence of Government in the appointment of Management and imposing credit directed towards a political patronage and undermining sound risk underwriting. NPLs went up to extremely high levels and clearly called for severing the link between politics and the financial sector. Today, the same banks which were causing losses and were fed by the Government budget are making profits, giving taxes and the residual value of the government owned shares has multiplied. The NPL ratio has come down from 25% to 7%, and NPL net of provisioning is at 3%. Privatization proved to be a great success, while the only large public bank remaining is again being abused to a large scale by the Government for political patronage.

The debate then shifted to discuss an appropriate framework of discipline for a professionally managed public bank that may be desirable while keeping incentive problems and political influence in check: This involves addressing the following key issues.

Development finance institutions (DFIs) have a countercyclical role. However in reality the DFI grows in good times competing with the market (no countercyclical role) while it grows in bad times countercyclical to fill the market gap. Appropriate policies and controls need to be in place to ensure the countercyclical role and low business levels during boom periods.

DFIs operate as extra-budgetary entities and bypass the budgetary control of parliament and do not have an exit strategy. Mechanisms need to be in place to limit contingent liabilities for taxpayers and manage the risk properly independent from politics.

Is there a way to prevent crises to happen? Are the banks actually prepared to cope with another crisis? A number of lessons have been learned from this crisis but each crisis is different. Institutions know now how to respond to the crisis and may be better prepared. But if the crisis is completely different, again FI might be vulnerable.

Going back to what you really know, going back to the familiar client base with because much of the growth that we have seen had to do with going out unsystematically and working in markets just for market share but not knowing the clients. In that sense many banks have learned to concentrate on what you know and where you are good at.

Another lesson is to look at underlying business assumptions more carefully.

The crisis is not over. Do we have sufficient skilled staff to address the tremendous challenge of bad debt resolution and loan workout? ProCredit experienced crises in 23 countries simultaneously and most staff had no crisis experience. Massive retraining in a short time was required to understand what it means to restructure a loan and stay in close contact with the client. A massive commitment to training is necessary.

People are very important and constitute a serious limitation to business expansion. It is important to create a strong centre of expertise that provides the relevant instruments to be

used. It is a pool of experienced people, representing approaches from different organizations to be used across the organization.

With the absence of a default history of new FIs how are risk management systems properly calibrated? The best way possible is to set up credit scoring or rating models. What is missing is a periodical review of the basic assumptions and the parameters on which these scoring models are based. Until today some models are being used without fundamental review of their validity. This is the main issue.

Conclusion. Key conclusions from the crisis are that (i) quality management, (ii) foreign exchange risk management, (iii) credit scoring, and (iv) stress tests at the FI level failed. The crisis brings out the biggest problems in any FI. What have we learned about a crisis? We cannot prevent the next crisis. However it is essential to be alert that any type of crisis that can happen at any moment.

The focus is to keep the house in order, adopt basic rules of risk management. Most of all, focus on people inside the FI, train them, and make sure that they believe in the values of the organization. And stay in contact with clients, to make sure that they are loyal to the FI. There is hope as long we stay focused on each other.