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How banks responded to the global financial crisis – international experience*

A legion of analyses have addressed the development, reasons and implications of the global financial crisis. Public interest has been particularly heightened toward central banks' policies aimed at alleviating the unfavourable effects of the crisis and also toward various forms and tools of government involvement. Drawing from international experience, this essay analyses the responses given by banks, especially commercial banks, to the crisis. The essay has a future-oriented approach, trying to reach conclusions for the future from historic trends and the challenges presented by the current environment wherever possible.

MAIN CHARACTERISTICS OF THE CRISIS, CHALLENGES BANKS WERE FACING

The price bubble that had ballooned in the U.S. subprime mortgage market eventually burst, causing a severe crisis in mortgage lending in the United States, which cascaded into global markets. The price bubble had swollen as a result of a process that had spanned years, including a global abundance of liquidity, investors' deep hunger for risks and increasing propensity to take risks, as well as processes on financial markets, and overly optimistic expectations of future prices in equity markets. The combination of all these factors led to the *crisis that started in July–August 2007*, which first affected U.S. banks that had considerable mortgage portfolios and mortgage-backed securities, named structured financial instruments. According to an IMF report,[1] structured lending designs had been growing exponentially until the crisis, their combined issue price had increased from USD 500 billion in 2000 to USD 2,600 billion. Of them, CDOs (Collateralised Debt Obligation) accounted for USD 1,200 billion and MBSs (Mortgage-based Securities) totalled an even USD 1,000 billion. A fast-paced fall in real estate prices caused a heavy depreciation in these asset-backed financial innovation products, and financing leveraged designs, based on loans, have become increasingly hard and costly as a consequence of a deepening financial crisis.

This phase of the crisis was characterised by major American and European banks heading toward bankruptcy or going under entirely.

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Bankruptcies in the banking sector undermined the stability of the entire global financial system, triggering direct government intervention, primarily in various forms of providing distressed banks with capital. The consolidation of financial institutions – the strengthening of their capital positions – has been supplemented with liquidity bolstering measures (concerted reduction of prime rates, easing the conditions of obtaining funds from central banks, etc.). The crisis identified weak spots of the system and gradually spilled over to other areas of the financial market and other countries, making an increasing impact in production as well.

The banking sector of most countries have been affected most severely by the *second phase* of the global financial crisis which started with Lehman Brothers, one of the largest investment banks in the world, going bankrupt in September 2008. As a consequence, confidence in the banking sector has dropped to an all-time low, on the back of which the abundance of liquidity has swung to the other extreme as the liquidity of interbank financial market has shrunk dramatically on global level, actually drying up in October 2008, while interbank interest rates surged and have permanently stayed at a high level.

As the crisis deepened, confidence in the entire system of financial intermediation suffered a very severe blow. In particular, players in the stock market and financial innovations they employed, fuelled by obvious losses that various investment funds, structured products and stock markets themselves incurred. Financial intermediation where banks are also involved has also suffered from the crisis, partly because, in spite of deteriorating returns, banks themselves preferred using instruments that later proved toxic, and on the other hand a general downsizing of leveraged positions led to severe liquidity problems, culminating in a credit squeeze and, ultimately, in a credit crunch as lending was all but crippled. Panic-stricken capital extraction by investors, as they swiftly ditched risky instruments, has affected Central and Eastern European converging countries severely, particularly Hungary. A staff note[2] made by the IMF for the Ministers and Central Bank Governors of the G-20 in London in March 2009 underlined *loss of confidence* as a key component to the current crisis, and restoration of confidence as the precondition to recovery. It requires the establishment of a global financial system that operates transparently and upon a new basis to be governed by a new international regulatory cooperation. *The Economist* was even more to the point when it said in an article: *"confidence in future values is everything for a financial product: if confidence is lost, the market collapses."*[3]

Provisioning requirements regarding risky instruments as well as a growing bulk of impairments made it unavoidable for banks to strengthen their capital positions, but they did not have sufficient funds to do it. In addition to ad hoc bailout packages devised for financial institutions, government efforts in the USA were mostly aimed at managing risks in the financial system that had caused lending markets to freeze.[4] Government action first took the form of capital injections, liquidity provided by the central bank, and guarantees on accounts receivables, and subsequently designs were devised for bad loans to be purchased or guaranteed by the government.

The gravity of the crisis is well reflected by the fact that practice has defied the axiom-like canon '*too big or too interconnected to fail*'. Following Lehman Brothers' bankruptcy, Merrill Lynch and Bear Stearns have been acquisitioned, but Washington Mutual also fell victim to the carnage. All-American mortgage institutes Fannie Mae and Freddie Mac were rescued by a life-line thrown by government, but insurance giant AIG[5] also had to be saved by a USD 85 billion loan from the FED. It was not before long that the crisis spilled over to Europe. In Germany, Sachsen LB and subsequently Hypo Real Estate had to be bought out by the government; and the UK government first had to provide Norther Rock and subsequently Bradford & Bingley with liquidity and later nationalise them. The same occurred with the Dutch government and Fortis Bank. But major players like Citi, Merryl Lynch, and UBS also had to swallow huge write-offs. In respect of the measures implemented in European countries, *The Economist said 'the continent nearly became a laboratory of bailouts'*.[6]

The crisis that crippled global financial markets and institutions of the intermediation system soon began to affect real economy. Financing problems of enterprises deepened, and the downturn of production degraded outlooks for economic growth, and all this led to a tumble in growth and public expenditures became harder to finance. In the critical situation that developed in the autumn of 2008, the risk of a liquidity crisis in the global market of government securities represented the biggest threat. Estimates made at that time indicated that the public finance system of the USA alone would have to borrow USD 1,750 billion in that budget year. The loan demand of EU member states with regard to financing budget deficits and bank bailout packages was estimated at an even USD 1,000 billion.[7] On global scale, the volume of government securities issue is projected at USD 3,000 billion, three times as high than in 2008. In the Economic and Monetary Union 16 sovereign issuers with different credit ratings are competing. The realities of the liquidity crisis were driven home as a massive quantity of Irish government securities were sold by foreign investors. Nearly 90 per cent of Irish government securities were held by foreigners. They pulled out their capital from the country to meet payment obligations in their home countries.

Tension in financial markets had abated by January 2009, and further consolidation has occurred since, but is doesn't mean the end of the crisis by any means. The situation continues to be quite uncertain in spite of an obvious improvement. Although recovery from the global recession has started, also reflected in increasingly favourable growth figures in a succession of prognoses, the durability of the process is still an issue. The IMF's latest report on global economic outlooks, for the first time in 60 years, expects global economy to shrink 1.1 per cent on average in 2009, which will switch to a 3.1-percent increase in 2010. Developed countries are to expect above-average economic downturn of 3.4 per cent in 2009, including the USA with 2.7 per cent, Euroland with 4.2 per cent, and Japan with 5.4 per cent. In 2010 the USA and Japan are looking to a growth of approximately 1.5 per cent and 1.7 per cent, respectively, but contrary to earlier expectations a 0.3-percent GDP growth is expected in eurozone as well. Emerging markets and developed countries are projected to expand by 1.7 per cent collectively, and a 5.1-percent dynamism is forecast for next year. This is a promising sign, but still falls short of the 6.0 per cent growth registered by the group of countries in 2008.[8]

Banks have had to face *different sources of losses* in various phases of the crisis. The *first stage* of the crisis was characterised by *write-offs for assets* that had depreciated. Their magnitude was unknown, bad debts were falling out of closets on after another, thus the process could not have been forecast. Due to the complexity of structured products, it was hard to estimate at what extent securitised banking assets were compromised. Due to lack of information on subprime and even lower-rated debtors, it was hard to give even an educated guess on the ratio of debts going bad in this scope, and, consequently, the extent at which loan portfolios were deteriorating. To make matters worse, banks valuated illiquid assets at prices that reflected a severe scarcity of buyers in addition to the quality of the assets in question. According to the October 2009 report of the International Monetary Fund,[9] the total of potential write-offs in banks' financial assets (loans and securities) is estimated at USD 2.8 trillion globally.

Additional impairment shocks cannot be ruled out, either, but potential or actual losses that banks are facing in the *current second phase of the global financial crisis* are much more calculable, because they are related to the *deterioration of loan portfolios.* Correlations between recession and the development of loan portfolio quality are well-known, as there are historic data to the connection between the two. With the rise of unemployment, a particularly substantial plunge is to be expected in credit card and mortgage business, but the situation will not be any better in respect of auto loans or leasing finance, either.

MAIN FEATURES OF BANKS' RESPONSES TO THE CRISIS

It turned out that scores of leading international banks of the world needed to be given capital injections in order to ensure prudent operation, and their operation also needed to undergo radical changes. It is best to start the analysis of what responses banks gave to the crisis from the fact, however, that the future of most financial institutions in developed market economies looks secure, because their governments will not let them go under lest they disrupt financial stability. Nevertheless, banks given government bailout money in the restructuring process and also financial supervisory authorities will have to answer the question in the future whether in what time horizon and under what conditions the government should terminate its ownership positions. The government's appearance in financial intermediation raises competition concerns and pricing problems[10] in the longer term due to its newly acquired ownership position in banks, therefore market logic would dictate that the government should withdraw from financial markets as soon as possible after the crisis has gone. Obviously, this could only be done gradually, otherwise another steep plunge may be triggered. The analysis of this problem would, however, rupture the quantity confines of this essay.

The general terms and conditions of banking loans have changed radically, the market, basically driven by demand earlier, have developed a shortage in supply due to the crisis and a consequent increase of risks, which means today *supply is the bottleneck in lending.* Due to an increase in provisioning to offset huge write-offs incurred in financial innovations in stock markets ("toxic instruments") and lending losses (bad mortgages, deteriorating loan portfolios, etc) and the deterioration in the quality of banks' outstanding assets, financial institutions have trimmed down their loan offers, downscaled their business activities, or in other words reduced their total assets. As a consequence, bargaining power of banks in pricing has increased considerably.

Of course, *general demand for loans has also diminished* due to the crisis, particularly in the scope of US households, but at a lesser extent than the supply. Due to their financial problems, households no longer focus as much on borrowing than on reducing their debts, repaying their loans, but at least lowering their debt burden (interest plus repayment). First and foremost, this statement applies to the first stage of the global crisis even though in the current phase of the financial and economic crisis the core problem in the corporate sector continues to be a poor demand for loans, particularly in Western Europe, which indicates a higher level of prudence in the corporate sector than in the banking market. For corporations do no start investments in a recession environment or one susceptible of recession right away when they see falling interest rates, or at least they do when they expect the interest rates of variable-rate loans to stay low or remain on a downward path in the longer run. In order to slow the drop of economic performance and bolster growth, various designs devised by the EBRD and the European Central Bank aim to give corporate lending a boost. However, there are lots of companies, particularly in the sector of small and medium enterprises, that need loans to survive, yet they are not given any.

In the past decade when capital was cheap, banks' business strategies focused on the *asset side of their balance sheets.* Financial innovations (securitisation, structured loans, etc.) also affected assets, securing high yields in the long run while risks are spread across global financial markets by said innovations. International ratings agencies were "partners in crime", because then methodologies had not been ready to assess actual risks inherent in structured investments and loan designs or their interaction and consequences. Excellent grades were given to products and designs of financial innovation despite the fact that, due to a high multiple leverage, financial risk management faces a more complex task in detecting and managing the actual extent of risks than in other more traditional business areas. Credit ratings agencies had had no experience in reliable risk assessment of those special designs, particularly not in estimating the impacts they would make in unfavourable economic environment and stress situations. In the scope of structured investments they could not properly gauge the interaction between risks in various tranches, and therefore assumed there was a low level of correlation between excellent-grade senior tranches and riskier ones. Ratings outfits were focusing on credit contracts basically, even though securities are subject to liquidity and market risks, and investors were prone to neglect or at least underestimate this latter. Discussing the responsibility of ratings agencies also goes past the limits of this analysis.

Since the outbreak of the global financial crisis, a shift in banks' focus to the liabilities side has been increasingly evident as the size and quality of capital to provide protection against impairments and also the maturity of liabilities have become more important.[11] *Capital requirements of banks* have been on the rise not only because of changes in legislation but also because of the requirement to have enough coverage for occasional losses. Due to a current and relative scarcity of capital as well as its higher price, total assets are hard to increase, and banks have even been trying to reduce them. Additionally, innovative designs (securitisation) that put loan risks off balance sheet, virtually improving banks' compliance with capital requirements, can no longer be used. This is evidenced by banks' having relinquished this practice that was widespread earlier. Additionally, capital at banks' disposal must be utilised more efficiently than before. Some activities have a high capital demand with low return, but gearing is also lower due to deleveraging, and risks are higher and capital costs are up. The capital requirements of Basel II. and additional tightening of regulations launched on the back of the crisis have left banks with smaller and smaller space for manoeuvring. The regulations about new capital requirements, formulated by the Basel Committee, have been implemented as directives in the European Union legislation as well.[12] Compared to previous rules, this is much more comprehensive and flexible, and links capital needs much tighter with risks potentially arising with banks, particularly risks related to loans, markets, and operation. The latter is also managed in Hungarian legislation separately.[13]

Amid the global financial and economic crisis, a different light has been shed on the *liq-*

uidity of assets. At times when markets are less liquid, assets are held in balance sheets longer. This increases risk for bank and ties up capital which could be utilised more efficiently elsewhere, urging financial institutions to focus on *less capital intensive business areas.* For instance, Credit Suisse wants to keep up its activity in the American market of mortgage-backed securities, a deep and liquid market, but plans to withdraw from the European market of the same securities, where banks are compelled to hold onto these assets longer. Banks are striving to reduce the risks they can take, which also means they are *downscaling own-equity deals,* relying on customers at a greater extent.

There is a growing interest on the part of banks for *activities that do not tie up considerable capital* or come with great risks, such as investment banking consulting, depository services, asset management (in this latter case banks risk other people's money). Demand for advisory services is expected to be fuelled in the longer run by the fact that a lots of companies need capital influx or have to restructure their debt portfolios because of the crisis.

Banks are now devoting greater attention to assets that provide *coverage* for additional loans. Accordingly, they split their activities into two. The first group consists of businesses that *require collateral* also accepted by central banks (high-quality mortgages, for instance) or inherently provide adequate security (certain blue chips, for example). The other group contains activities that *do not require coverage,* therefore allow financing without collateral.

Banks aim to reduce their exposure to wholesale banking finance, relying at a greater extent on deposits rather than on securing funding through interbank markets and equity market instruments. A sectorwide endeavour of *decreasing loan/deposit ratios* is seen in an attempt at providing larger coverage for disbursed loans by collecting more deposits. A long-brewing structural change played a prominent role in the current severe financial crisis, which meant the significance of long-term deposits delivered by the customer base had decreased in banks' liquidity in comparison to investor-provided funds. Banks were at *foreigners' beck and call* at an increasing extent.[14] Loans combined with financial innovation products were implemented by many banks in the past decade with the intention of securitising their accounts receivables and selling them to investors *(originate-to-distribute model).* Consequently, a simple loan took the form of a bond, then, rebundled as a structured product in an investment fund, it was sold to another investor. From this point, the dynamics of lending depended not on predictable depositors but much more on the willingness of investors to buy securities, which is much harder to forecast. On the back of the crisis, deposits have become appreciated higher in securing funding, and experience indicates that banks with extensive branch networks have been much more successful in attracting and collecting deposits than banks that focused on other sales channels (the Internet, etc.). Nevertheless, relying too much on deposits has its own *risks* and dangers, if not necessarily comparable to those of lending. Deposits are easy to withdraw, and government guarantees designed to protect depositors do not prevent depositors at all from discriminating one financial institution from another.

As one of the impacts of the crisis, a peculiar phenomenon has emerged, namely *supermarkets are trying to enter the retail banking market,* thus banks have to face new market players beside their old and traditional competitors. Supermarkets have low customer acquisition costs, because throngs of shoppers visit their points of sale. Supermarkets' good reputation has not been jaded in the crisis, which could ensure them a significant edge against banking brands that have been messed up in the crisis. TESCO is the most serious pioneer in this kind of diversification.[15]

Changes in consumer behaviour, especially an *increase in the savings portfolio of households,* created subsequent opportunities for retail banks. In the USA, banks with retail businesses are considering offering households structured savings products that allow stock investment while providing protection for the invested capital. Also in the United States, demand for savings designs denominated in foreign currencies is on the rise.

An interesting change, banks earlier were afraid of corporate customers going bankrupt, but *now banks' corporate customers want to take out insurance in case the bank folds.* In fact, corporations now demand banks to issue official statements about what will happen to services provided by them in case they go bankrupt. Similarly, guarantees for access to services provided by banks at the agreed prices are demanded in case a bank would merge with or into another financial intermediary.

As for the future, various types of banks have different options. Outlooks are gloomier for minor banks that fall outside the scope of government involvement (deposit insurance, central banks' *lender of last resort* protection, bank bailout packages) or have less diversified loan portfolios. The weight of these non-guaranteed financial institutions increased at a fast pace in the US financial system until they represented a systemic risk,[16] because they had not had the safety net until 2008 that had worked for other banks. But the position of US regional banks and Spanish savings banks are still very unstable, because they incurred huge impairments in their commercial real estate portfolios. On the back of the crisis, the number of banks in the United States is expected to drop to 2,000 from current 8,000.[17] IMF experts say the outbreak of the current crisis was also caused by the fact that in the scope of financial intermediation prudential requirements did not apply to non-banking market players (investment banks, hedge funds, mortgage bond issuers, venture funds, etc.) at all or with less stringency than to banks. The importance of this matter is well-reflected by the fact that the assets held by such bank-like institutions at the end of 2007 in the United States were estimated at an even USD 10,000 billion,[18] virtually identical to the total assets held by the regulated banking sector. Commercial banks themselves benefited from the unregulated nature of this *shadow banking system* by circumnavigating capital adequacy requirements through its players or by transferring risks to them.

Due to low interest rates, the *yield curve has become steeper,* which means the spread between short- and long-term interest rates has increased. This also affected *interest margins,* the gap between deposit and lending rates. At times when prime rates are close to zero, banks are supposed to lower their lending rates, while they are unable to reduce their deposit rates due to a race in securing funding. These factors cause interest margins to contract. Banks' manoeuvring space gets very limited when low rates persist.[19] Banks are interested not in high rates but high margins – the gap between deposit costs and lending rates – which they can achieve also with generally lower deposit and lending rates, reflecting a lower risk level, and with a diminishing level of mandatory provisions.

Banks secure their income and earnings not by the interest margin alone, but by *various fees* and commissions. A significant risk, the banking sector is being subjected to an increasing level of political pressure as their reputation deteriorates and the general public gets irate by high banking profits and outstanding remuneration of bank bosses, they sooner or later fall under scrutiny whether the fees and commissions charged by them for various services are fair or not. Demands for fairer, in other words cheaper, fees and commissions affect banks' fee income adversely.

BANKS' RESPONSES IN SPECIFIC REGIONS AND COUNTRIES

Banks' responses to the crisis show different specifics in various regions and countries. In the *United States*, the decisive majority of banks used the funds (USD 700 billion) provided by the government-financed TARP (Troubled Asset Relief Program) to disburse new loans. A smaller percentage of banks used the government funds to acquire competitors.[20] But their buy-up actions are frowned upon by US authorities.

The magnitude of bank relief packages implemented by some *EMU countries* amounted to approximately 22 per cent of their combined GDP[21] with Germany and France being close to that level with their individual ratio close to 20 per cent. In proportion, the Netherlands spent exactly twice as much on bank bailout as the European Union, but Austria's 30-percent support in terms of GDP is also way above the average, indicating a much higher risk exposure for he banks of these countries.

The *Canadian banking sector* sports many features that call for a little more detailed analysis. The largest banks of Canada posted profits for the three months preceding 31 January 2009, exactly at the time when market conditions were worst across the globe.[22] Canadian banks pursue much more conservative business strategies, their risk propensity is considerably lower than those of US banks. Consequently, "toxic" products – designs financed with very high leverage,[23] using external funds – were basically absent in the portfolios of Canadian banks. It was also due to the fact that one of the largest Canadian banks had withdrawn from the market of structured products and others had followed the example, and also that the Canadian central bank had limited the contribution of equity businesses to profit in a range between 20 and 30 per cent.

The structure of the Canadian banking sector is an oligopoly with the involvement of five dominating banks. On the one hand, it limits price competition. Independent brokers intermediated only one-third of all mortgages in Canada, a sharp contrast to 70 per cent in the USA. On the other, it makes it easier for banks to back out when things start turning too risky.

Since banks in Canada with dominant market positions are too large to go under, the banking supervisory authority is much more stringent, too, which is also apparent in the regulator defining the maximum leverage ratio. Also, a standardised system for commercial and investment banks is applied. Less austere and much more fragmented systems in other countries facilitated an explosive increase of banks' total assets. According to a survey,[24] Canadian banks use a much lower leverage ratio than international competitors. They have a 78-percent loan/deposit ratio, while the corresponding indicator is 83 per cent in the USA and 96 per cent in the United Kingdom. The most significant financial difference between the USA and Canada lies in the way how mortgage lending is regulated. In the USA, the interest on mortgages are tax deductible, stimulating borrowing at a considerable extent. In Canada, the interest may not be deducted from the tax. (However, it's not justified to overrate the significance of it. In this context, the system employed in the United States is identical to the Canadian, yet the mortgage market is in dire straits).

If the loan amount should exceed 80 per cent of the value of the real estate that serves as collateral, borrowers in Canada are obligated to take out an insurance with state-owned Canada

Mortgage and Housing Corporation (CMHC). Banks also insure the rest of their portfolio with CMHC. As a result, strict standards are applied for mortgages guaranteed by CMHC. Unlike in the USA, these factors do not make banks interested in securitising mortgages.

As the economic situation deteriorated, the operating conditions of lots of banks became harsher in many *emerging countries,* especially in Asia. At the same time, few of them have had to terminate no or just a few leveraged positions, because they either had a low volume of those assets or had not invested in those instrument at all. Therefore, regulatory changes are not necessary at such an extent in other markets that have been hit by the crisis harder. Asian banks have contained their exposure to cross-border equity flows. Consequently, structural changes are necessary only in a comparatively narrow scope.

The situation is much more contradictory in *Central and Easter Europe.*[25] This region is characterised on the one hand by the fact that a large percentage of the banking sector is owned by foreign entities, mostly Western European financial institutions. Total assets of domestic commercial banks in Hungary, owned by foreign parent banks amounted to 93.1 per cent of GDP in 2007. The only higher ratio were registered in Croatia (157.2 per cent), Estonia (142.2. per cent), and Lithuania.[26] On the other hand, due to a large number of factors, forex loans (mostly denominated in the euro and the Swiss franc) spread fast both in the corporate and retail sector (but with the exception of the Czech Republic). The forex debt portfolio of households is exposed to unhedged foreign exchange risks. Thirdly, in lack of sufficient domestic savings, Hungarian banks under foreign ownership were given short-term forex funding by their parent banks, which they then disbursed as long-term loans, however (for instance, in the from of home loans with real estate acting as collateral).

Earlier, in a favourable economic landscape the EU was supportive of Western European banks' expansion in the newly accessed member states, because recipient countries were given access to more sophisticated financial facilities and a higher level of financial security that way. That Central and Eastern European countries had been included in a close circle of developed EU economies by the EU enlargement and financial and economic integration had supported the market belief that they had a bigger chance of being given support in case of a crisis. Due to this assumption, their CDS spreads were lower than without it. Markets had priced the government securities of these countries 50 to 100 basis points lower than justified by economic fundamentals,[27] which meant they could pay less for external funds despite their vulnerability. Initially, it seemed these countries would be spared the crisis that developed in the United States in 2007, because they had practically no exposure to "toxic assets", but capital influx to the region dropped as the crisis deepened, which made it harder for the sector to maintain the dynamics of loan financing, which had relied less on domestic savings and deposits than on foreign funds. At the same time, the exports opportunities of these countries deteriorated, particularly in their position as auto industry suppliers.

According to Basel-based Bank of International Settlements (BIS), banks registered in the members states of the Economic and Monetary Union (particularly in Austria, Italy, and Belgium) and in Sweden have a combined loans exposure of nearly USD 1,500 billion in Central and Eastern Europe (total foreign bank loans in the region amount to USD 1,656 billion). The exposure of Austrian banks in Central and Eastern Europe reaches 70 per cent of Austria's GDP and 26 per cent of the total asset of the banking sector. Austrian banks had EUR 187 billion exposure in Eastern Europe at the end of the first quarter of 2009. The

Austrian government has given leading Austrian banks (Erste, Raiffeisen, Bawag PSK, Volksbank, Hypo Alpen-Adria) capital injections amounting to EUR 6.4 billion in total.[28] A tacit agreement said an occasional crisis should not impact recipient countries more adversely than the parent country would be affected. As a result of their expansion in the region, banks registered in EMU countries had been reaping huge profits in recent years the majority of which they had relocated back home.[29]

The global financial crisis has questioned the operation of the above business model. On the one hand, Western European parent banks were facing liquidity problems after Lehman-Brothers had gone bankrupt in September 2008, on the back of which they could not finance their Central and Eastern European interests like before.[30] On the other hand, a liquidity and forex crisis descended on Central and Eastern European countries – particularly affecting Hungary as she had accumulated a considerable bulk of external debt in international comparison – manifesting as depreciation of their currencies. Some of these countries, including Hungary, could only contain the liquidity and forex crisis with support from the loan package provided by international organisations (IMF, World Bank, European Union).

International examples of crisis management show that governments tried to mitigate the impacts of the crisis by deploying monetary and fiscal tools simultaneously. Bailout packages explicitly focused to rescue banks, counterbalance the economic downturn, consolidate companies, maintain employment, and rescue industries and corporations of strategic importance that had been affected by the crisis. Since these interventions lacked international alignment, national protectionism gained growing importance on the back of the crisis, and government put pressure on market players to spend the crisis management funds they were given on retaining domestic jobs.

Financial protectionism has an even more severe consequence, when banks rescued by their governments start preferring – partly upon political pressure – the interests of their home country's taxpayers in lending and reduce their international loan disbursement, including finances, forex funds to be more exact, that they provided for their foreign affiliates, including those in Central and Eastern Europe. Consequently, maintaining their business activity is very closely related for affiliated banks operating in the region to what results they can produce in deposit collection. In the scope, an intensifying price competition has been apparent in recent months among banks operating in Hungary.[31] It cannot be documented in detail, but it may not be a too far-fetched assumption to say parent banks do no want to increase their exposure in Central and Eastern Europe, lest they end up having to inject capital in their affiliates. Their stand-by approach indicates their prudential considerations are much stronger than their earnings expectations, which could be one of the reasons for the fact that lending activities of commercial banks has diminished at a dramatic extent.

The downturn in the business activity of parent banks in the CEE region is attributed to the write-offs they incurred on toxic assets and to fears of deteriorating loan portfolios. One of its manifestations is a reduced demand even for the refinance designs offered by Magyar Fejlesztési Bank [Hungarian Development Bank]. It has to be noted, however, that the players in the demand side, companies in the sector of small and medium enterprises, contain rather few really marketable and therefore creditworthy players. Nevertheless, the financial protectionism mentioned above was in total contradiction to the European Union directive that parent banks are responsible for the operation of their foreign affiliates.

However, Western European banks involved are not interested in giving up their hard-earned market positions in the region because of the crisis and abandon their affiliates in Central and Eastern Europe. It is a much graver argument than the moral reasoning mentioned earlier – 'You made a mint at times of boom, now you are expected to stay on board in crisis' – especially when the costs and toil of re-entering a market is considered to take perhaps years after the crisis has gone. Nine banks holding interest in newly accessed EU countries started lobbying early 2009, aiming to persuade the European Union and the European Central Bank to extend the anti-crisis measures outside the boundaries of the economic and Monetary Union and even the European Union (particularly to Ukraine and certain former countries of Yugoslavia).

At the moment, in addition to the Baltic States, foreign-owned banks of Romania, Serbia, and Hungary have been assured that their Western European parent banks will meet their obligations. MKB [Hungarian Foreign Trade Bank] has been given a capital injection by its Bavarian parent bank, itself having been rescued by the German government; and Raiffeisen Bank has been cemented by EUR 20 million of loan capital. CIB Bank received a HUF 42 billion bailout package from its parent banks. Nevertheless, foreign banks apparently are not considering increasing their exposure in Central and Eastern Europe.

SUMMARY, CONCLUSIONS

Even though the turbulence experienced in international financial and equity markets in the autumn of 2008 has abated considerably by now, the situation remains quite uncertain. While additional write-offs cannot be ruled out, what banks could be facing in the future is impairments occurring from the deterioration of loan portfolios, driven by the crisis in real economy.

Contrary to the era of cheap money when the asset side of the balance sheet was in focus, banks are now concentrating on the liabilities side as a response to the crisis, in other words the size and quality and/or the maturity of assets have become increasingly important. In order to meet strict capital requirements implemented by regulators, banks deploy tools on the asset side (selling assets, reducing lending activity, terminating open positions) and the liabilities side alike (capital increase, lower dividend, subordinated loans).[32]

The drive to increase total assets stemmed from the pre-crisis banking model *(originate to distribute)*. Now quality aspects have become important, for instance as efficient and profitable utilisation of capital as possible, risk reduction by self-financed transactions, improvement of asset liquidity, specialisation in less capital-intensive activities, boosting the ratio of unhedged deals, or to provide quality collateral for transactions that require coverage. In line with the Basel II agreement, capital requirements are expected to be tightened, and, consequently, much greater attention will be given to the enhancement of applied risk assessment methods, as well as connections and interaction between global and local financial regulation. Governments should terminate ownership positions they acquired in the course of risk management as soon as they can, because their permanent presence in financial intermediation could trigger competition distorting impacts.

One of the top priority components in banking strategies is the reduction of loan/deposit ratio by encouraging deposits, but it has its inherent risk, too, because deposits are easy to withdraw.

Consolidation and development options are limited for banks that have not received rescue capital from their governments or hold less diversified loan portfolios.

Due to tight interest margins, resilience of low interest rates affect the banking sector adversely. For political goals, a heavy pressure is expected on banks that have been bailed out by the government to lower their various fees and commissions.

As for country-specific features, the majority of US banks are using the capital received from the federal government to expand their lending activities. Due to their peculiar characteristics that are not present elsewhere, the Canadian banking sector has not suffered from the global financial crisis. In the scope of emerging markets, Asian banks have not been affected by the global financial crisis other than the impacts of the recession. In Central and Eastern Europe, the crisis has questioned the sustainability of the pre-crisis lending model. Following a long-winded hesitation, the Western European parent banks of foreign-owned local affiliates confirmed their ability to ensure liquidity for their CEE interests. However, it is barely enough to keep lending level, let alone ensure growth.

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