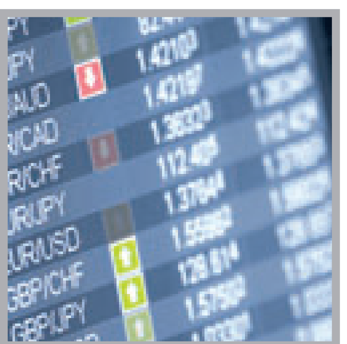
CEE Banking Outlook



January 2011

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Executive Summary

In the aftermath of the global crisis the economic recovery in Central and Eastern Europe (CEE) is consolidating. After expected growth of 3.6% yoy in 2010, we forecast an acceleration to 3.8% yoy in 2011. The growth outlook varies, with Central Europe, Turkey and the CIS back on track, while South Eastern Europe is still addressing some necessary restructuring issues. While risks remain, the long-term potential needs to be reassessed, and the CEE region reaffirms itself as an attractive market.

The crisis did not affect CEE's long-term potential related to the "convergence story". The regional growth model, based on capital inflows, growing competitiveness and improving standards of living remains intact. In the longer term, however, potential growth will remain below pre-crisis levels and risks persist.

A rebalancing of the macroeconomic model implies a changing banking model. Pre-crisis CEE banking was based on rapid lending growth, to a large extent externally financed. Leveraging on abundant international liquidity and low cost of country risk, local banks were able to support growth by financing domestic lending via international capital inflows in the context of low domestic saving rates. Both retail and FX lending boomed. The economic crisis was reflected first in a liquidity crunch, followed by rapidly multiplying credit quality problems, accompanied by a credit crunch. At that stage, the support of local banks' parent companies was essential to avoiding a full fledged crisis. In line with economic recovery, the second half of 2010 witnessed some stabilisation in the dynamic of problematic assets. However, moderately lower provisioning requirements were offset by lower revenues generation capacity. Full recovery from the demand side is essential before seeing an acceleration in lending activity and banking business in general. We expect gradual strengthening in banks' revenues generation capacity in 2011, throughout the region.

On a medium to long-term perspective, banking in CEE remains an opportunity, but the banking model has to change. Given both the higher cost of funding and cost of country risk, there is a need for stronger focus on domestic funding, although access to external funding remains a competitive advantage. The penetration gap, which was the driver for retail lending growth in the past, is still in place on the mortgage side, while it remains less evident for consumer credit. On the corporate side, competition remains fierce, providing opportunities for those players who have enough risk appetite to diversify into new segments (small and medium companies as well as innovative businesses). Overall, in a less dynamically growing sector, efficiency and innovation emerge as crucial drivers for success.

The tougher post-crisis banking environment in CEE may drive further changes. While international investors who have been active in the region in the last decade are reaffirming their strong committment to CEE, the search for optimal positioning could result in M&A activities or asset swaps, while newcomers in specific markets and/or at the regional level are already indicating their interest. In this context, for international players active in the region, the ability to leverage on a solid funding base and capital position, good access to international markets in addition to favourable positioning, will increasingly become key success factors. As we stated last year, risk appetite is also crucial, making the difference between winners and losers.

Challenges ahead for the region's banking industry include growing national and international regulatory pressures. The fear is that regulation might end up penalising the cross-border banking model, which has been the basis of economic and financial convergence in CEE.

CEE Banking Outlook

Banking in CEE: the new growth model

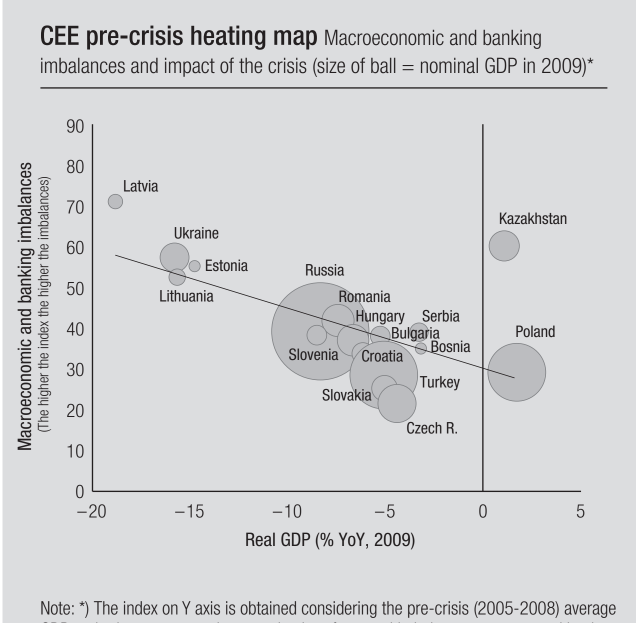
The economic framework

The crisis hit hard in Central and Eastern Europe, but did not change the long-term potential related to the “convergence story”. The regional macroeconomic growth model, based on capital inflows, growing competitiveness and improving standards of living remains intact. However, in the longer term, potential growth will remain below pre-crisis levels, as all the convergence drivers will be less influential than in the past. The outlook remains more robust than in Western Europe, as the region as a whole still has some catch-up potential to exploit mainly through further productivity gains. We forecast long-term average growth slightly above 4.0 % yoy for the region.

CEE hard hit by the crisis

At the end of 2008 and beginning of 2009 freezing global credit markets and capital flows were associated with a sudden contraction in international and internal demand, leading to a strong correction in output. The downturn saw the Baltic States and Ukraine contract 16 % yoy and 15 % yoy, respectively and others shrink in the high single-digit area, with only Poland persistently recording some positive growth. The crisis hit harder those countries that had to correct a macroeconomic overheating and stronger external imbalances, as the needed correction added to the direct trade shock. Furthermore, policy reactions varied based on the macroeconomic stance of individual countries. All of this underscored that CEE is not a homogeneous region.

CEE pre-crisis heating map Macroeconomic and banking imbalances and impact of the crisis (size of ball = nominal GDP in 2009)*

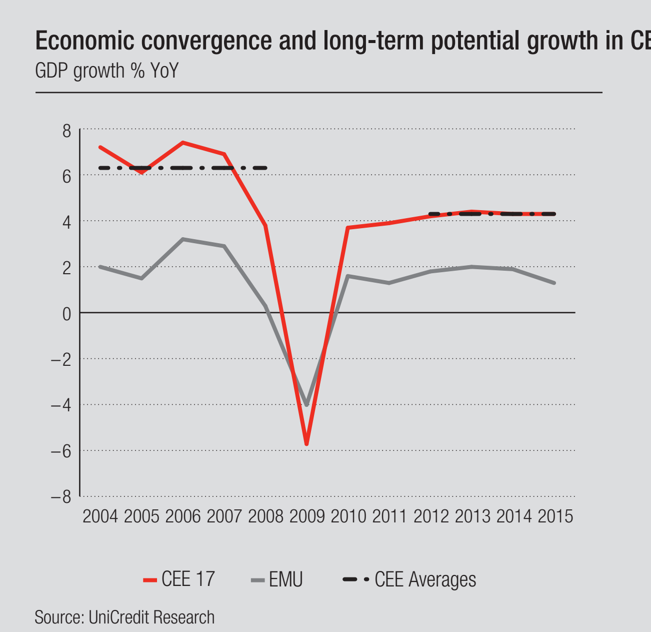


Note: *) The index on Y axis is obtained considering the pre-crisis (2005-2008) average GDP and private consumption growth, size of external imbalances as measured by the CA deficit, lending growth and banking sector funding gap. A higher level of the index is associated with stronger imbalances and economic overheating
Source: UniCredit CEE Strategic Analysis

International commitment has been quick and effective as concerns CEE. The Group of 20 summit in London in April 2009 ensured the International Monetary Fund had enough funds to provide assistance to countries with financing difficulties. The IMF at the same time adopted a more flexible approach and reacted in strong coordination with the EU and other IFIs. The role of international banks active in the region has been crucial as well – as part of the “Vienna Initiative” they committed to keep capital and funding to their subsidiaries constant throughout the crisis.

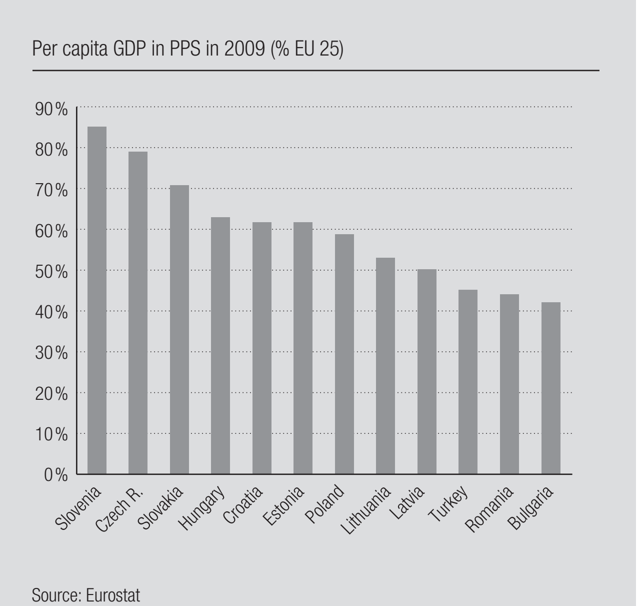
Economic convergence and long-term potential growth in CEE

GDP growth % YoY



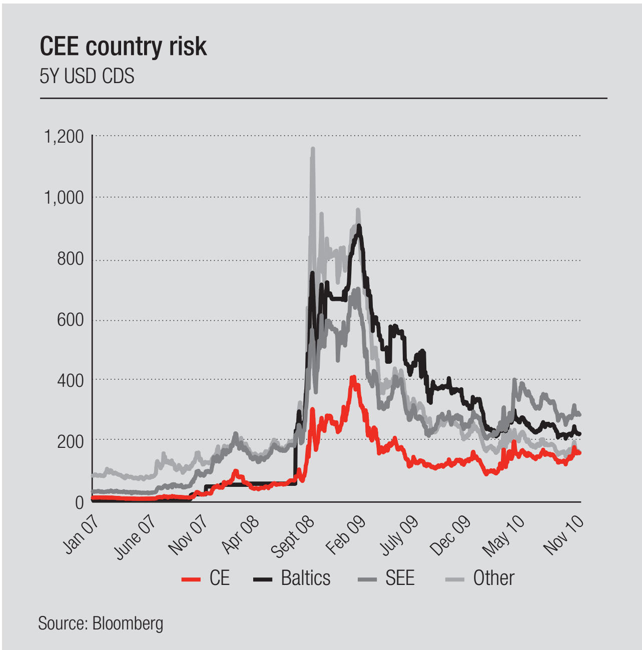
Source: UniCredit Research

Per capita GDP in PPS in 2009 (% EU 25)



Source: Eurostat

Global recovery had a strong start in 2010, including upside surprises in the CEE region. However, new headwinds emerged in April – May 2010, with the Greek debt crisis. The crisis has confirmed that the phase of cheap funding is over and the cost of country risk is expected to remain volatile and above pre-crisis levels in the medium to long term as well. This is bad news for converging economies, even if CEE countries generally have a better fiscal stance than some of the Euro area periphery. The Greek debt crisis (and the Irish crisis later on) also revealed that the euro area is not homogeneous in terms of risk, as reflected in the visible increase in the volatility of sovereign CDS spreads across the board. This confirms that the 'euro bonus' is now substantially lower than in the past. The performance of Estonia's CDS spread following the official announcement of euro adoption points in this direction (CDS spreads down by 95 bp from beginning of 2010 up to end of July – still at 120 ytd, well above the 38 bps ytd level for Germany).



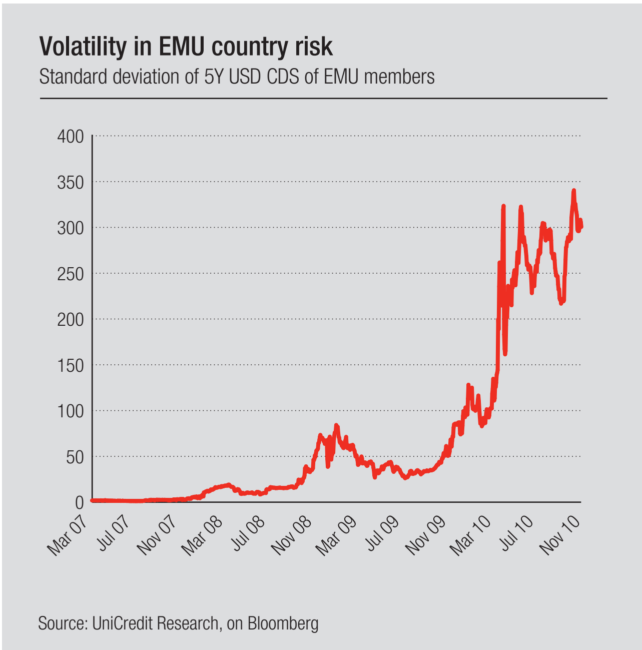
Source: Bloomberg

Recovery underway but not homogeneous among countries and segments

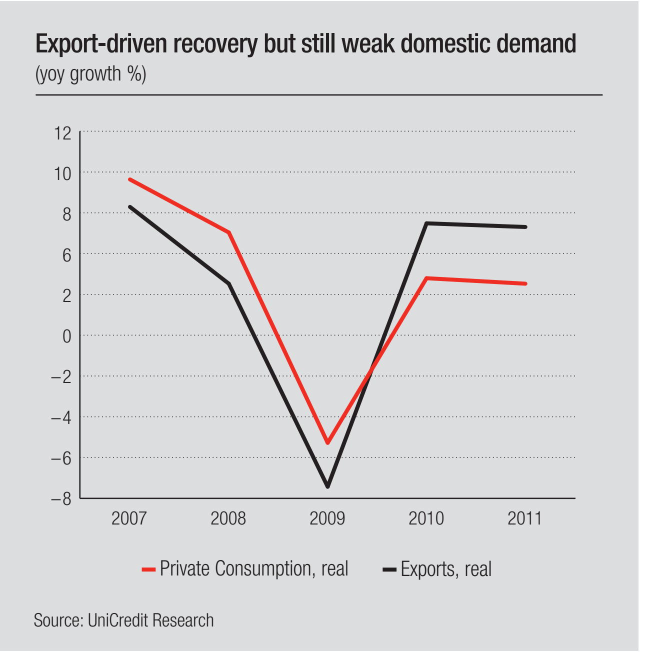
After expected 3.6 % yoy growth in 2010, we forecast GDP growth to accelerate to some 3.8 % yoy in 2011. The patterns of recovery, however, vary among countries and segments.

Recovery to date has been driven by industry and inventories supported by a rebound in export demand. Those countries showing the strongest trade openness and tighter links with Germany were those which restarted first. South Eastern European countries which have stronger ties with the periphery of Europe and are still rebalancing have delayed the recovery. The positive contribution of domestic demand to growth has been less relevant in a first phase, with some strength detected only in Russia, Turkey and Poland. Consumption remained constrained throughout the region by high unemployment, low wages growth and debt overhang. Investment activity has been gradually restarting, with some infrastructure projects going on despite strong fiscal control.

2011 will see some consolidation in the recovery path supported by a stable export dynamic and a pickup in consumption in most CEE economies. We forecast average growth of 3.4 % yoy in Central Europe in 2011, led by Poland. SEE will also see some acceleration to around 2.0 % (from an estimated – 1.2 % in 2010) with persisting weaknesses in domestic demand to continue dampening growth. The Baltic countries are likely to finally return to some positive growth, with fiscal policy remaining a key challenge in Latvia and Lithuania. Growth momentum is expected to slow in both Turkey and Kazakhstan but should remain relatively strong



Source: UniCredit Research, on Bloomberg



Source: UniCredit Research

supported by solid domestic demand and commodity prices, respectively. In Ukraine, the economy enters 2011 on a solid footing with preparation for EURO 2012 and recovery in consumer spending to support further acceleration of GDP growth to 5.0 % from an estimated 4.0 % recorded last year.

CEE macroeconomic forecasts

	GDP real yoy % growth		Inflation, avg	
	2010	2011	2010	2011
Poland	3.8	4.4	2.6	3.5
Turkey	7.4	4.1	8.6	5.8
Russia	3.4	4.3	6.8	9.1
Croatia	–1.5	1.6	1.0	2.3
Bulgaria	0.1	2.8	2.4	3.2
Czech Rep.	2.3	1.8	1.4	2.1
Hungary	1.2	2.5	4.9	4.4
Romania	–2.5	1.7	6.1	6.1
Slovakia	3.9	3.1	1.0	4.1
Bosnia	0.5	1.8	2.1	2.1
Serbia	1.8	2.7	6.3	9.4
Slovenia	1.2	2.5	1.9	2.4
Ukraine	4.0	5.0	9.4	11.0
Kazakhstan	6.0	5.3	7.1	7.2
Estonia	2.4	3.9	2.2	2.4
Latvia	–0.9	3.9	–1.4	1.4
Lithuania	0.9	3.7	1.0	1.9
CEE-17	**3.6**	**3.8**	**5.9**	**6.7**

Source: UniCredit Research

Long-term potential intact, even if long-term growth will remain below pre-crisis level

Looking ahead, we do believe the ‘old’ growth model remains viable but CEE countries should pursue it with more cautiousness, emphasising the development of domestic markets, sound regulation and diversification. Before the crisis, growth in the region benefited from a process of ‘catching-up’ based on a high degree of trade liberalisation, capital movements, financial integration and membership in the EU or prospects of either accession or a strong association with the EU. Capital inflows were however fuelling growth in the context of high and cheap international liquidity and low perception of country risk. The process was accompanied by the ‘build-up’ of large external imbalances, with strong consumption and investment growth financed from abroad. Moreover, the huge capital inflows recorded in the decade before the crisis largely targeted non-tradable sectors such as real estate, construction and financial intermediation, thereby contributing much less to the build-up of a competitive and sufficiently sized manufacturing sector.

Once the crisis has passed, most such trends will remain in place, but the changing global framework will imply a higher cost of international liquidity and risk, meaning a more balanced ‘integration model’. Overall, long-term growth potential will be lower than prior to the downturn, as all drivers of convergence remain, but are less strong than in the past. A combination of both changed external conditions (e.g. uncertain world outlook and growing competition from Asia, higher global risk, more difficult EU/EMU entry) as well as internal behavioural responses to the crisis (e.g. higher than pre-crisis cost of country risk, constraints on fiscal spending and further household de-leveraging) will shape the region’s growth pattern. Long-term growth potential will most probably remain lower than pre-crisis, even if the outlook remains more robust than in Western Europe, as the region as a whole still has some catch-up potential to exploit, mainly through further productivity gains.

Banking Framework

Banking in CEE

Key indicators by country (2010E)

	Loans / GDP	Deposits / GDP	Loans / Deposits ratio	5Y CDS (YTD avg)*	Loans (% yoy)	Deposits (% yoy)
Central Europe						
Poland	53.1	51.0	104	131	7.9	9.4
Hungary	68.1	49.7	137	281	3.6	–1.6
Czech R.	55.3	75.1	74	89	3.2	2.0
Slovakia	50.6	57.4	88	79	4.9	2.9
Slovenia	92.5	63.8	145	–	4.1	–0.1
Baltics						
Estonia	102.1	60.6	169	–	–4.0	2.1
Latvia	101.6	51.3	198	365	–6.0	9.5
Lithuania	67.2	44.7	150	262	–3.0	6.5
SEE						
Bulgaria	73.7	62.6	118	258	1.1	6.5
Romania	43.7	35.4	123	298	3.8	1.3
Croatia	80.5	65.0	124	244	5.8	5.2
Serbia	58.9	41.7	141	348	27.5	14.5
Bosnia-H	59.3	52.6	113	–	3.7	6.5
Other						
Turkey	41.7	50.9	82	168	24.3	16.0
Ukraine	65.7	36.4	180	641	1.8	21.9
Russia	37.6	38.4	98	163	10.3	16.4
Kazakhstan	47.0	38.3	123	192	8.0	28.2

Note: *) Last data as of Dec 16th
Source: UniCredit CEE Strategic Analysis

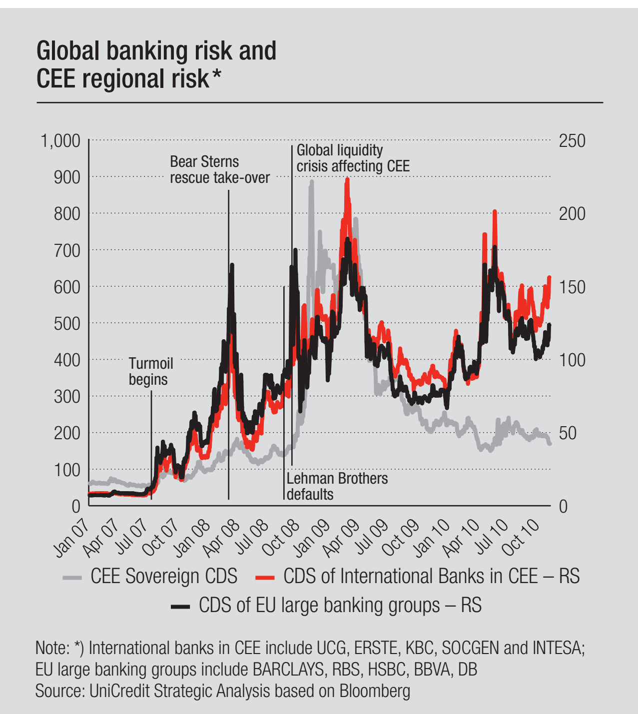
The impact of the crisis on CEE banking

Before the crisis, CEE banking was based on rapid lending growth, to a large extent externally financed. Leveraging on abundant international liquidity and low cost of country risk, local banks were able to support growth by financing domestic lending via international capital inflows, in the context of low domestic saving rates. Both retail and FX lending boomed, supported by an artificially low cost of risk.

The region's banking sectors did not emerge from the crisis unscathed. The economic crisis first took the form of a liquidity crunch, followed by rapidly multiplying credit quality problems, accompanied by a credit crunch, that was both demand and supply driven.

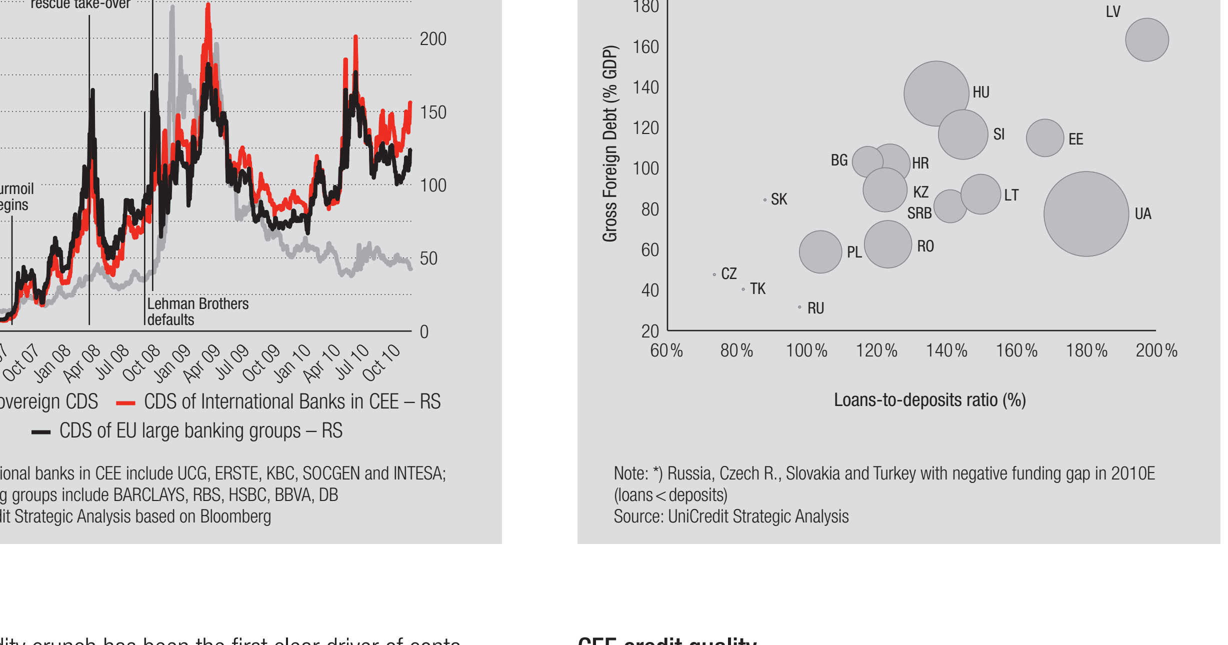
In the final quarter of 2008 the international liquidity crunch spread and the cost of funding for the domestic banking sector started to peak. On the one hand, liquidity risk for the banking industry globally peaked, on the other, the cost of country risk, with particular relevance to CEE was spiking. Full-fledged bank runs were avoided and none of the countries experienced a sharp reversal in external financing, mostly thanks to the strong support provided by international players active in the region. The international liquidity crunch and the increase in the cost of country risk and funding for the domestic banking system have been the drivers of structural change, but with long-term implications. The loans-to-deposits ratio has become a relevant constraint for banks. Particularly in those banking sectors which were characterised by strong imbalances, with ratios well above 100 %, banks have started aggressive deposits collection campaigns in order to deleverage.

Global banking risk and CEE regional risk*



Note: *) International banks in CEE include UCG, ERSTE, KBC, SOCGEN and INTESA; EU large banking groups include BARCLAYS, RBS, HSBC, BBVA, DB
Source: UniCredit Strategic Analysis based on Bloomberg

Country external debt and banks' external funding need, 2010 (size of ball = loans – deposits in € terms)*



Note: *) Russia, Czech R., Slovakia and Turkey with negative funding gap in 2010E (loans < deposits)
Source: UniCredit Strategic Analysis

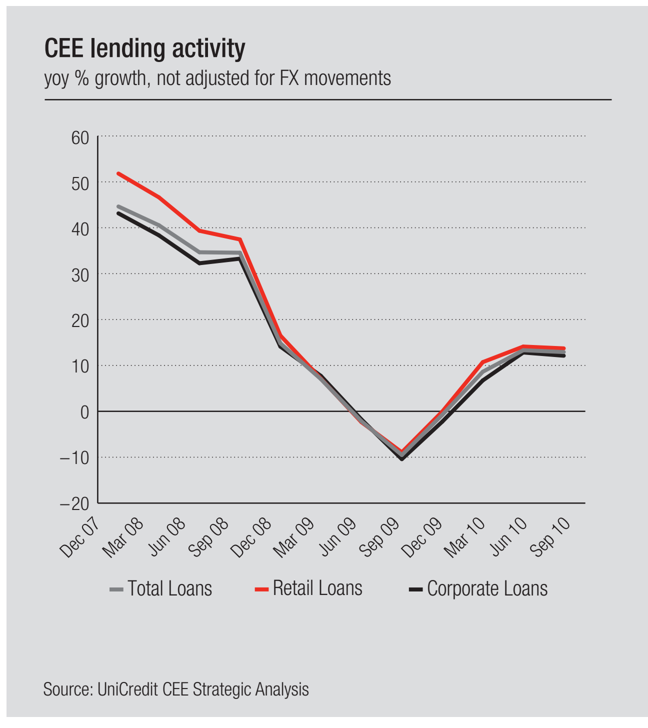
While the liquidity crunch has been the first clear driver of contagion, the full impact of the crisis on CEE banking materialised only in 2009, with mounting credit quality problems. Economic deceleration had an immediate effect on corporate sector credit quality, triggering a process of renegotiation and restructuring of loans. On the retail side, deteriorating labour market conditions and adverse FX developments, in the context of strong investment in the Euro and CHF by individuals, was reflected in credit quality concerns. Given rapidly rising unemployment, banks were also starting soft collection and re-negotiation programmes in retail. According to available estimates, at the end of 2009 the share of restructured loans was still low amounting, for example, to roughly 4.0 % in countries such as Romania and 0.5 % in the Czech Republic. Restructuring activities were more intensive in badly affected economies such as Latvia and Ukraine accounting for roughly 25 % and 38 % of the loan portfolio, respectively in 2009.

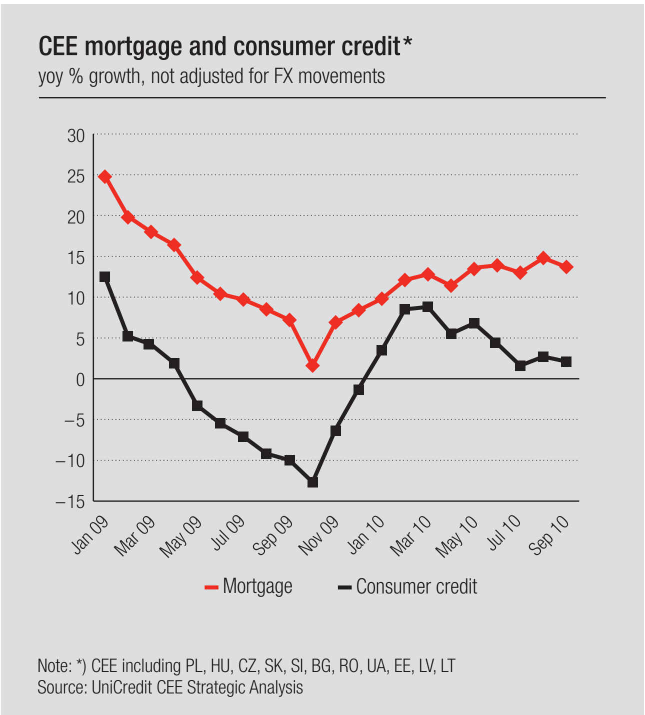
The share of non-performing loans in total gross loans almost doubled compared to the end of 2008 in Central Europe and in South Eastern Europe. A somewhat worse performance was recorded in Romania, due to the correction in the real estate market and a young indebtedness culture, untested before the crisis. NPLs increased more than four times in the Baltic states, given the low starting level and the large adjustment in economic activity subsequent to the bursting real estate bubble. The collapse of the real estate market and the failure of two of the leading banks, BTA and Alliance in early 2009, are behind a peak in distressed assets in Kazakhstan of over 30 %, with even higher ratios recorded in Ukraine, following its currency devaluation.

CEE credit quality
Impaired loans ratio in percentage of gross loans

	2008	2009	3Q 2010	3Q 2010 vs 2008	Expected peak
Central Europe					
Poland	4.3	7.9	8.8	2.0	4Q 10
Hungary	4.5	8.5	11.6	2.6	1H 11
Czech R.	3.2	5.2	6.1	1.9	4Q 10
Slovakia	3.2	5.5	6.4	2.0	3Q 10
Slovenia	2.8	5.5	–	–	4Q 10
Baltics					
Estonia	2.9	6.5	7.1	2.5	3Q 10
Latvia [1]	3.6	16.4	19.0	5.3	2011
Lithuania	4.6	19.3	–	–	4Q 09
SEE					
Bulgaria	3.2	6.2	10.6	2.8	2011
Romania	6.3	14.7	20.2	2.8	4Q 10
Croatia	4.9	7.8	10.2	1.9	4Q 10
Serbia	11.3	15.7	17.8	1.6	4Q 10
Other					
Turkey	3.5	5.2	4.2	1.2	4Q 09
Ukraine	17	30	–	–	1H 11
Russia	12.7	18.7	19.4	1.5	3Q 10
Kazakhstan [2]	10.8	28.7	33.6	3.0	2011

Note: 1) Latvia as of Jun 2010 / 2) in % of assets
Source: UniCredit CEE Strategic Analysis

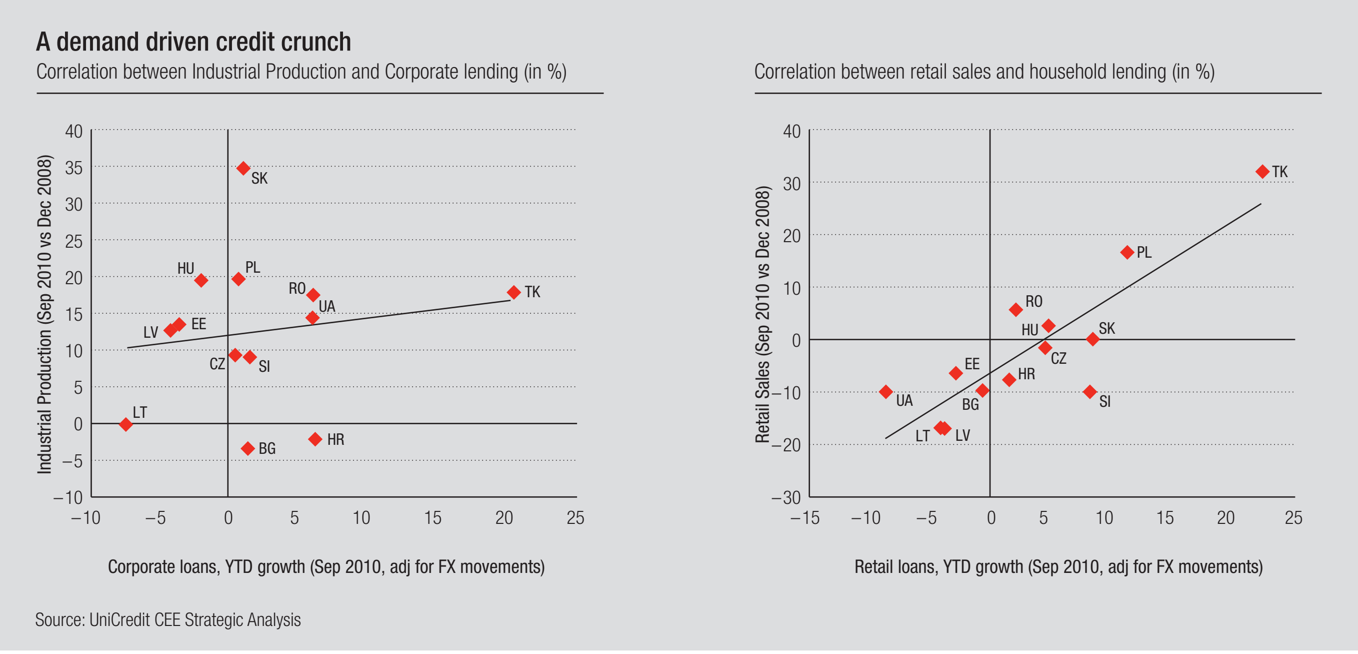




The initial deterioration in liquidity conditions, the economic downturn resulting in a lack of business demand and increasing risk aversion backed by mounting credit quality problems played a prominent role in explaining lending weakness between 2008 and 2009. As a result, expansion of banking sector loans decelerated sharply from 14 % yoy in 2008 to –0.2 % yoy in 2009. The households segment has been at the forefront of the contraction, mainly due to a slowdown in demand for loans to finance consumption, while mortgages remained more stable, benefiting from longer maturities and ongoing renegotiation activities. Borrowing activity in the corporate sector has also been affected due to the decrease in investment activity and export flows, with more open economies such as Central European countries and the Baltic States having experienced the largest contraction.

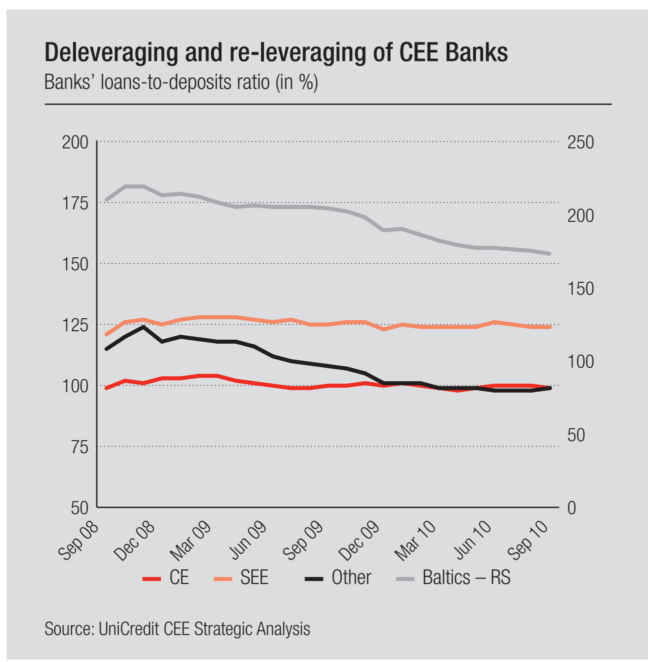
As the 18-month storm subsided, banks in Central Eastern Europe entered calmer waters in 2010, albeit with a variety of tricky channels still left to navigate. Turkey has been the first country to show a convergence in credit quality, with the peak recorded in 2009. The second half of the year also revealed some stabilisation in the dynamic of problematic assets in other countries, reinforcing signs that the peak in terms of non-performing loans might be reached between the end of 2010 and the beginning of 2011 (with probably a one half-year / year lag for Kazakhstan and Latvia relative to the rest of the region).

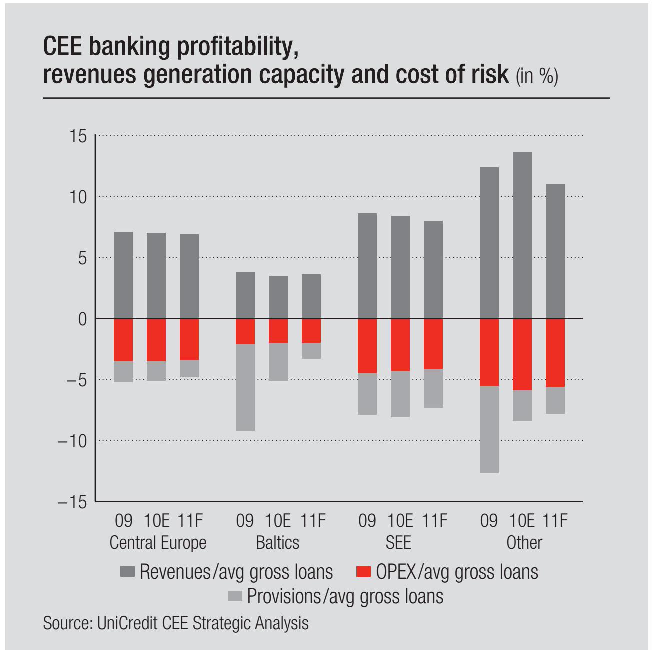
The recovery has been generally credit-less so far and lending growth is also expected to recover slowly in 2011. Average regional lending growth has been hovering at an estimated 11 % (not adjusted for FX movements) in 2010. Weak demand remains behind the ongoing credit crunch in a number of CEE countries with banks generally being characterised by an excess of liquidity. This is clearly proved by the strong positive correlation between revival of demand and lending growth, shown for both the corporate and the retail segment. All over the region, corporate lending has been rebounding first, with annual growth in 2010 expected to have reached an estimated 12 % by year-end. Loans to the household sector began to reaccelerate only recently, in real terms supported by some revival in demand for lending for consumption purposes, but the overall dynamic is still lagging the corporate.



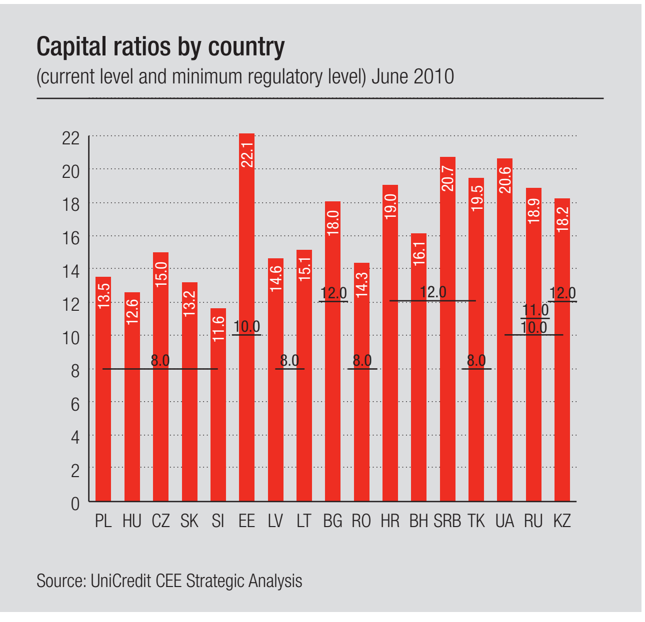
Banks' deleveraging has been achieved through a combination of actions. While a more balanced loans to deposits ratio was a must at the peak of the crisis, banks started to realise that a country's saving attitude can not be changed in the short run and fierce competition for funding was becoming inefficient and detrimental to profitability. The solid growth recorded in bank deposits during 2009 (+ 10.4 % yoy) came to a halt toward the end of the year and beginning of 2010, as some of the banks began to abandon extraordinary deposit collection campaigns that had been put in place. Generally, the loans-to-deposits ratio at the regional level is expected to start to gradually increase. However, in those countries which had the strongest gap in terms of domestic funding, as in the case of the Baltic states, deleveraging might last for some time.

Overall, 2010 has turned out to be as equally challenging as 2009 in terms of banking profitability, as lower provisioning requirements are matched to a lower revenues generation capacity, due to delays in economic recovery, still high cost of funding and sluggish loan demand (mostly concentrated in low risk-low margin business). Recovery will strengthen in 2011, although trends substantially vary among countries.





In Central Europe and in South Eastern Europe, the banking sectors weathered the crisis without major issues in terms of capital. Capital standards were generally above minimum requirements prior to the crisis and banks were maintaining a comfortable capital buffer. Throughout the crisis, stress tests have revealed a fairly stable situation, with retained earnings (often strongly suggested instead of dividend payments by local regulators) contributing to increases in capital ratios in both 2009 and 2010. Only in a few cases have additional capital injections or the reduction in risk weighted assets been systematically applied. A more active approach has been necessary in the former CIS countries, but resolution has been fast with state capital injections worth more than EUR 3.2 bn in Ukraine, EUR 36 bn in Russia and EUR 1.8 bn in Kazakhstan.



Capital ratios by country
(current level and minimum regulatory level) June 2010

Source: UniCredit CEE Strategic Analysis

A changing banking model, but still a promising region

Looking ahead, the potential of the CEE banking business continues to present itself as an opportunity. However, a return to business requires time and a rebalancing of the banking model. In the short term, recovery in lending activity is expected to remain tepid and patchy, with consumer demand expected to continue to lag the corporate sector. In line with a lower long-term growth outlook for the local economies, in the longer term volumes growth is forecast to rebound but at a more moderate pace compared to the pre-crisis period, with the credit dynamic generally more tied to that of deposits and with the cost of country risk higher than in the past.

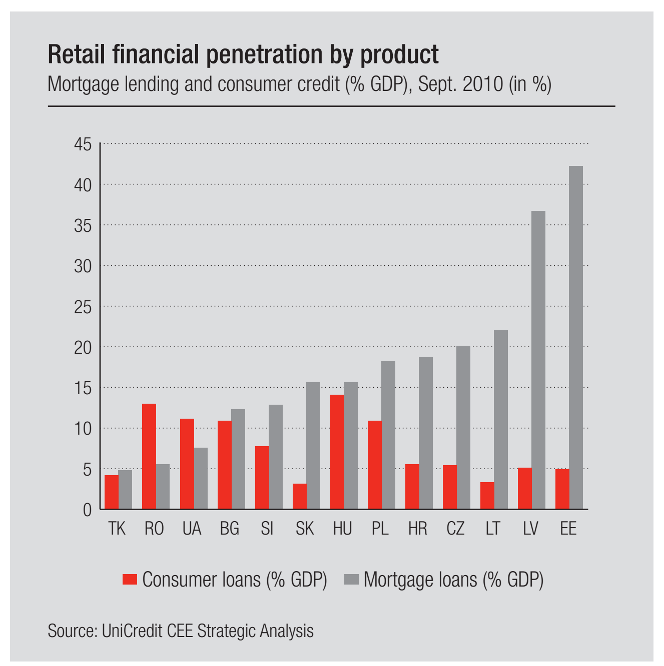
Before the crisis, banks focused on the advantages of cheap external funding to finance domestic lending growth, particularly in the retail and FX businesses. Going forward, a rebalancing of the growth model will require a stronger focus on domestic funding and highly value-added sectors and less focus on the retail and FX businesses, with lending activities in general less emphasized than in the past. At the same time, access to external funding will continue to represent a key competitive advantage as the CEE banking sector is expected to remain dependent on financing from abroad for the foreseeable future.

In terms of business potential, there is still a clear financial penetration gap in the mortgage segment, while it is less evident for consumer credit. Mortgage financing penetration relative to GDP is expected to have approached the level of 8 % in 2010. This compares with a ratio of 40 % in the Euro area and indicates that market potential still exists, particularly when taking into account that CEE still has some gap in the supply of residential real estate. Mortgage financing also proved to be relatively resilient during the crisis, with growth remaining in positive territory in most of the region. Such a positive dynamic covers however both some structurally stable physiological demand and the effects of

Retail financial penetration gap vs EMU
Retail lending (% GDP), 2009

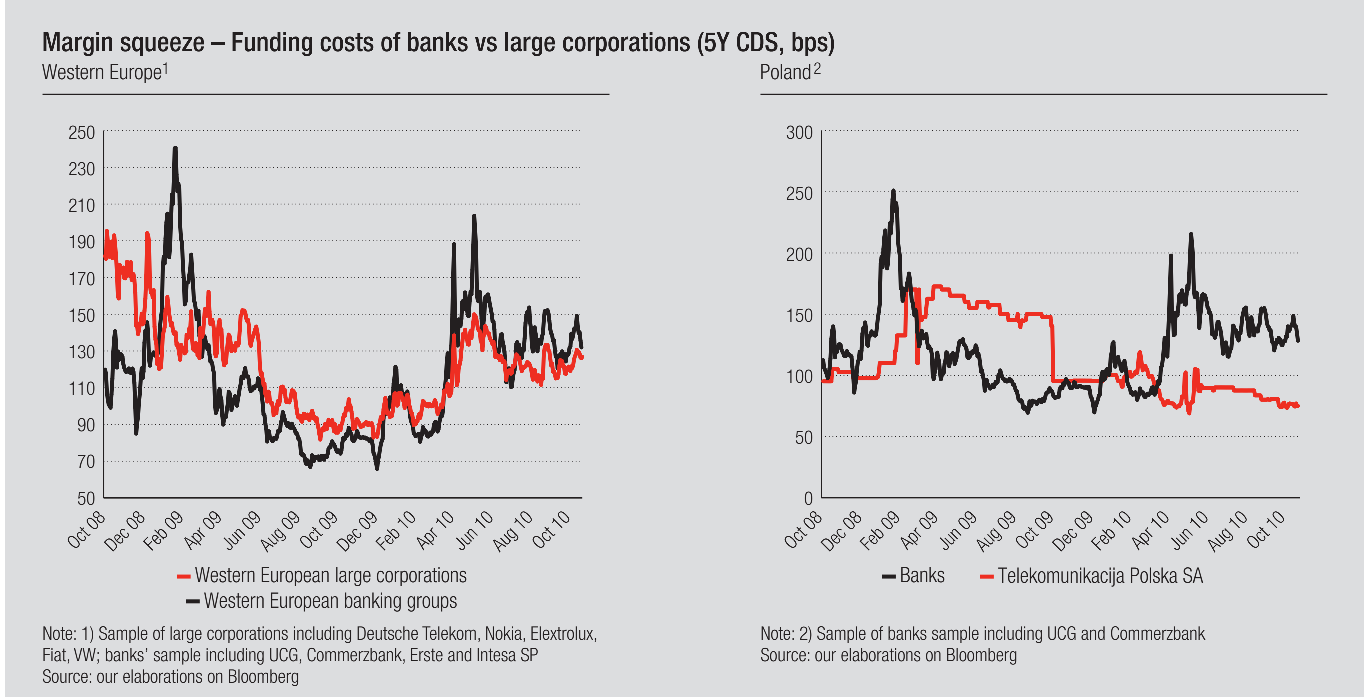
EMU	EE	LV	HR	PL	LT	HU	BG	CZ	BH	UA	SI	SK	RO	SRB	KZ	TK	RU
55	54	47	37	33	31	31	28	27	26	26	24	21	20	14	14	13	10

Source: UniCredit CEE Strategic Analysis



Retail financial penetration by product
Mortgage lending and consumer credit (% GDP), Sept. 2010 (in %)

Source: UniCredit CEE Strategic Analysis



Margin squeeze – Funding costs of banks vs large corporations (5Y CDS, bps)

Note: 1) Sample of large corporations including Deutsche Telekom, Nokia, Elextrolux, Fiat, VW; banks' sample including UCG, Commerzbank, Erste and Intesa SP
Source: our elaborations on Bloomberg

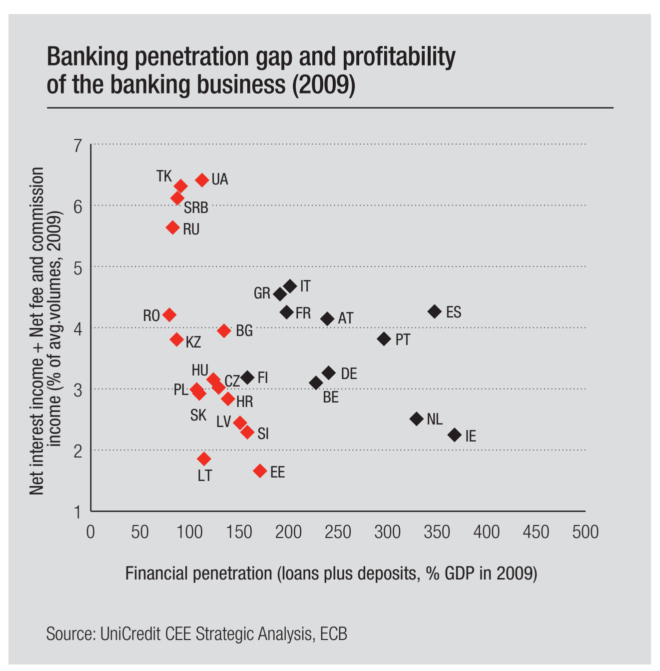
Note: 2) Sample of banks sample including UCG and Commerzbank
Source: our elaborations on Bloomberg

renegotiation programs implemented by the banks (with grace periods during the crisis, lengthening of loan maturities etc). In the case of consumer credit lending the penetration gap is less evident, with a 9 % ratio in CEE on average (ranging from 6 % in Russia and 20 % in Croatia), versus 7 % in more developed western markets. The consumer credit market was booming pre-crisis, particularly in Romania and Bulgaria, most probably overshooting some kind of equilibrium level, based on low perceived cost of risk, low cost of funding and strong demand.

Going forward we can expect convergence to continue, but somewhat less dynamic growth on the retail lending side than before the crisis. Acceleration of retail lending activities will remain moderate, as the recovery pattern continues to be characterised by high unemployment and moderate salary growth. The crisis has shown that the cost of risk particularly on the retail side was underestimated, while regulatory pressure to switch to domestic currency lending given the lack of or more expensive long term domestic currency funding for the banks should lead to some tightening on the supply side. Countries differ however – those with a more mature market are already returning to a relatively normal convergence path (i.e. Czech Republic, Poland or Slovakia). Countries whose pre-crisis growth was accelerated, indicating a possible overshooting of the convergence trend, might need more time (i.e. Bulgaria and Romania).

The potential related to a penetration gap is also evident on the corporate side, with loans to the corporate sector at 28 % of GDP in CEE as compared to 52 % in the Eurozone. However, as economic recovery is restarting, it is clear that some transformation in the corporate business might occur in the medium term, including: (1) a more globalised approach for large / global companies (including more sophisticated products and services) as their incentives for global management of their financial positions increase; (2) some renewed interest in SME financing and service, as well as in diversification of business toward new sectors in line with the economic transformation needed in some of the countries away from non-tradable sectors. In general, as recovery strengthens, the winning players will be those banks which demonstrate some higher risk appetite in the short to medium term.

In the current phase, competition for the best clients is extremely high and margins are rapidly being squeezed. One extreme situation to note is the relationship between the cost of funding of international banks and international companies. A very simple indicator combining the CDS associated with external funding of the international banks



Banking penetration gap and profitability of the banking business (2009)

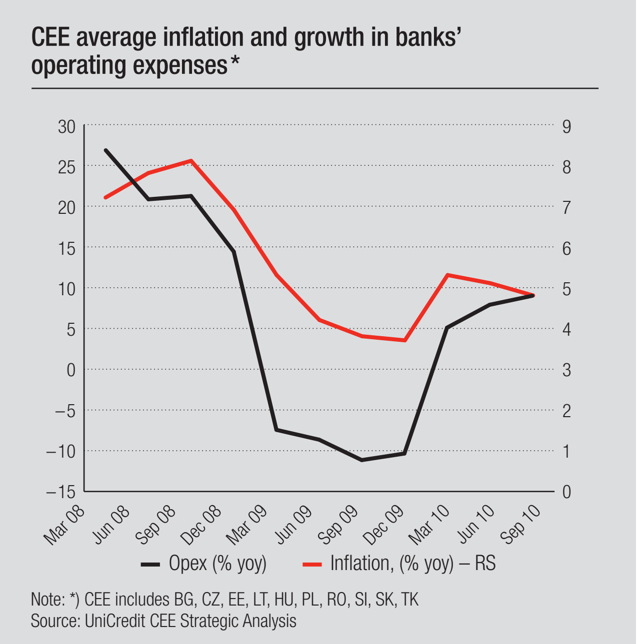
Source: UniCredit CEE Strategic Analysis, ECB

active in the CEE region and the CDS associated with a number of leading international companies active in the CEE region shows only minor differences and in recent months even some lower cost of funding associated with the large international companies. Under such conditions, the role of the local banks as financial intermediaries for the largest global companies active in the region is being eliminated, calling for the above-mentioned diversification of business focus.

In an environment of lower volumes growth and competitive pressures, banks will be confronted with lower profitability relative to the pre-crisis level, but overall the CEE banking sector is expected to remain attractive. CEE countries differ when benchmarking average business profitability versus more advanced European financial markets. By considering net interest income and net fees and commission relative to total volumes, as a measure of stable profitability (as the trading income component is excluded) it is immediate to distinguish among countries like Turkey, Ukraine, Russia and Serbia, where stable profitability of the business is much higher than in more advanced European markets and countries such as the Baltics or Slovenia, where average profitability of the existing business has already converged with that of more mature markets. All the CEE countries however feature quite a significant financial penetration gap, which highlights opportunities for banking business growth.

Normalisation in credit quality problems will somewhat ease pressures on banks' profitability, with cost of risk at the regional level expected to gradually decelerate although remaining above the pre-crisis level. As previously mentioned, we expect the peak in NPLs to be reached by the end of 2010/first quarter of 2011, depending on the different countries, with cost of risk having already peaked in 2009. Still, particularly in retail, we expect the pre-crisis cost of risk to have been underestimated, due to the market's very rapid growth, which did not allow time for NPLs to materialise. Emerging from the crisis, we thus expect cost of risk to definitely converge from its current level back to values above the pre-crisis one.

Cost control will be a focus for the medium term in the context of a dynamic business environment, characterised by some lower profitability than in the past. During the crisis, banks in CEE strongly focused on cost control measures. Costs have substantially undershot inflation, as banks were putting investment strategies on hold, while also leveraging on higher flexibility and substantial room for enhancing efficiency. While efficiency remains an important driver for future profitability in a lower margin environment, it is clear that those players who want to experience the region's upside, need to restart some investment activities as soon as market conditions allow.

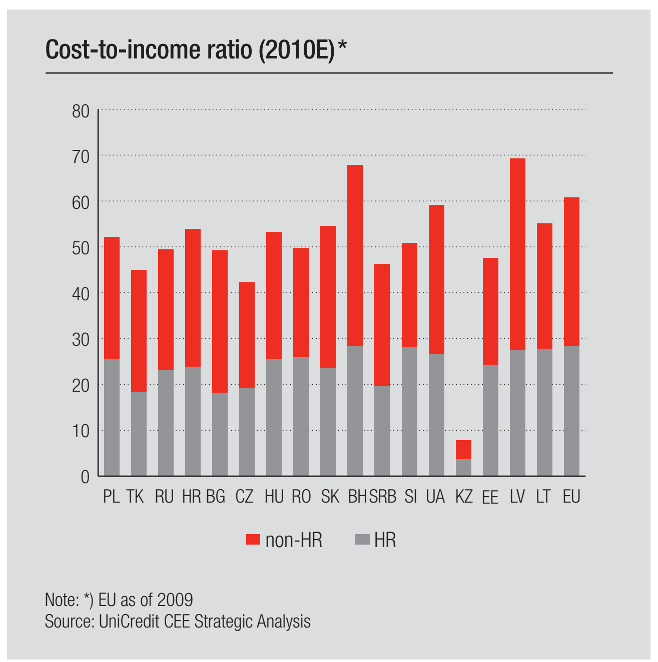


Note: *) CEE includes BG, CZ, EE, LT, HU, PL, RO, SI, SK, TK
Source: UniCredit CEE Strategic Analysis

CEE cost of risk by regions* (in % of gross loans)

8
7
6
5
4
3
2
1
0
2007 2008 2009 2010 2011 2012 2013 2014 2015
SEE Baltics Central Europe Other

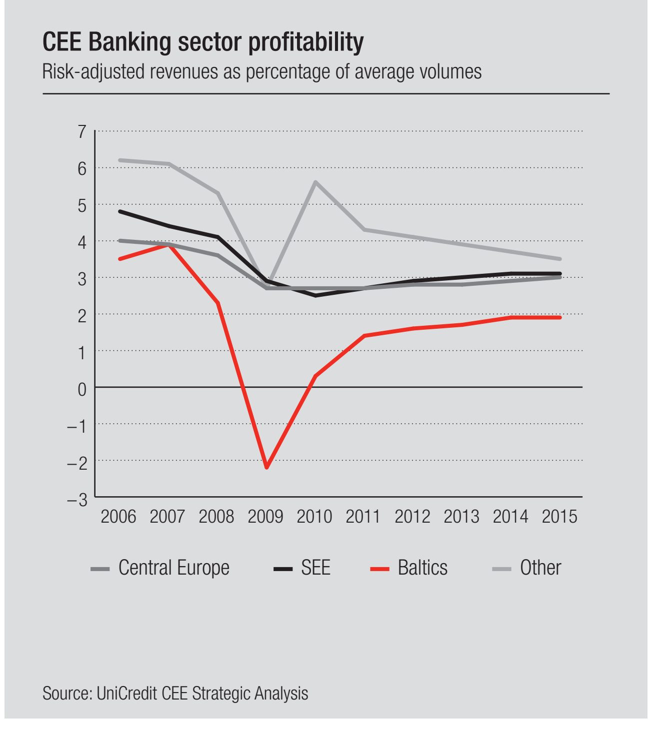
Note: *) Central Europe incl. PL, SK, SI, HU, CZ; SEE incl. HR, BG, RO, SRB, BiH; Other incl. KZ, RU, TK, UA
Source: UniCredit CEE Strategic Analysis



Note: *) EU as of 2009
Source: UniCredit CEE Strategic Analysis

Overall, post-crisis we expect a recovery in the CEE banking industry's profitability. The still converging but less dynamic growth model will imply some lower revenues generation capacity, matched to strong pressures for efficiency and converging cost of risk. In addition, tighter regulation and more stringent capital requirements will result in a level of profitability still above that of more mature markets but below pre-crisis levels. All this will occur, however, in the context of decreasing risk.

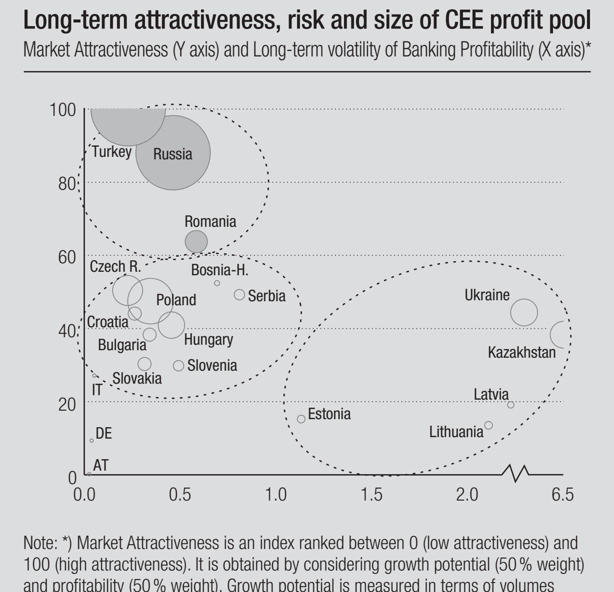
The region's future development presents a quite diversified scenario. The market attractiveness / risk mix clearly remains in favour of Russia, Turkey and Romania. Other Central and Southern European countries have favourable conditions and a low risk profile. The crisis had the strongest impact on Ukraine, Kazakhstan and the Baltic countries, with a clear need to rebalance their growth models.



CEE Banking sector profitability

Risk-adjusted revenues as percentage of average volumes

Source: UniCredit CEE Strategic Analysis



Long-term attractiveness, risk and size of CEE profit pool

Market Attractiveness (Y axis) and Long-term volatility of Banking Profitability (X axis)*

Note: *) Market Attractiveness is an index ranked between 0 (low attractiveness) and 100 (high attractiveness). It is obtained by considering growth potential (50 % weight) and profitability (50 % weight). Growth potential is measured in terms of volumes growth, while profitability in terms of ROA. Long Term Volatility of Banking Sector Profitability means the standard deviation of banking system ROA. Size of ball equals to banking profits in 2015

Source: UniCredit CEE Strategic Analysis

Changing competitive environment – winners and losers

Along with changes in the global banking competitive landscape, the post-crisis banking environment in CEE might drive further changes. While the current top international players in the region are expected to largely maintain their position due to the long-term nature of their presence, the search for optimal positioning at single country level might lead to M&A activities or asset swaps, while newcomers in specific markets and/or at the regional level are already exhibiting an interest.

The table below shows an update of the ranking of international players active in CEE, based on H1 2010 figures. UniCredit's leading position in CEE is reconfirmed. With EUR 124 bn in assets invested in 19 countries, the Group remains committed to the region, which accounts for more than 23% of Group revenues. As a truly European bank, UniCredit benefits from its global diversification, which implies adequate funding and a solid capital base, in addition to expertise and best practice sharing opportunities. In the region, UniCredit profits from a widespread and diversified network, with some of its local subsidiaries leading market players and others with the ambition to achieve an optimal scale to compete.

The second regional player in terms of size is Erste, which characterises itself as a strong retail bank, well positioned in some of the most stable and sound markets of the region (No. 2 in the Czech Republic, and No. 1 in Slovakia) and with Romania as the area for regional growth (No.1). CEE accounts for 38% of Group revenues, meaning that the Group is largely a CEE story with not much global diversification. However, thanks to the retail nature of its network (mostly made up of the former local savings banks) the Group enjoys a low funding gap. During the crisis, Erste took advantage of the Austrian government support programme and recently announced that it will be compliant with the Basel III requirement by 2019, without any need to raise equity over the next years in order to repay the participation capital to the Austrian government.

Previously the second largest regional player in terms of size, Raiffeisen lost its position following the strong deleveraging carried out in 2009. In 2010 the Group's governance structure underwent a significant transformation, with Raiffeisen International (the financial sub-holding for CEE) fully incorporated in the RZB to exploit synergies and furnish better access to capital and funding. In terms of country positioning, RZB is primarily a corporate bank, with a widespread network in 19 countries. Only in Bosnia, is one of the RZB subsidiaries a market leader, while in the rest of the region Group subsidiaries tend to be medium-sized players with a strong corporate focus.

Directly hit at the global level by the crisis, KBC had to agree with the European Commission to a divestment programme involving some of its activities in CEE, in order to be able to repay the capital that it borrowed from the state. The CEE network of KBC, nonetheless, has remained the growth engine of the large bank-assurance Group, while the bank-assurance model has not been questioned. As a large player in the Czech Republic and Hungary, a medium-sized one in Slovakia and a small player in Poland, Bulgaria, Russia and Serbia, as part of the restructuring plan, KBC announced its intention to focus on its key markets and to exit non-core regions. The Group has announced its intention to sell its participations in Russia and Serbia after 2011, as well as non-core businesses such as consumer finance in Poland. Since several years, given an uneasy management of a minority shareholding in the Slovenian NLB, the Group is confirming its interest in disposing of this participation.

Ranking of international players in CEE

Data as of 1H 2010	Total Assets (EUR bn)	Net Profit (EUR mn)	CEE, % share in Group Revenues	CEE L/D ratio [1], %	Funding Gap (when L>D) in % Group assets	Group Core Tier 1 ratio, %	CEE leverage ratio (x times)	Assets in highly attractive countries [2]
UniCredit	124	700	23	107	1.1	8.4	8.0	28
Erste	83	466	38	90	3.5	8.6	12.5	20
Raiffeisen	78	212	79	121	7.3	8.5	10.5	24
KBC [3]	66	316	36	78	0.9	9.7	12.1	5
Société Générale	66 [4]	–	16 [5]	95 [4]	0.4 [5]	8.5	10.6 [5]	41 [4]
Intesa San paolo	41	167	12	112	0.8	7.7	9.4	7
OTP	36	257	100	115	7.9	11.4	7.7	10

Note:1) calculated on net loans, apart from Raiffeisen; 2) percentage on total assets controlled in the CEE region; 3) In this table, CEE for KBC excludes Russia, Serbia and Slovenia;
4) apart from subsidiaries in Czech Rep., Romania, Serbia, Bulgaria and Albania, data as of FY09; 5) data as of FY09;
Source: UniCredit CEE Strategic Analysis

Societe Generale (SocGen) is emerging as one of the well positioned players in the region, with a high share of assets in the most attractive countries. The capital increase of EUR 4.8 bn at the end of 2009, allowed the Group to buy back (and then cancel) the preference shares previously issued by the state, leaving SocGen with a good capitalisation level, while the Group is well diversified globally and can leverage on international sharing of expertise. SocGen has announced an ambitious strategic plan for 2015, aiming to become a leading player in Russia (among the top 3), consolidating its position in Czech Republic and Romania and accelerating growth in areas with potential for higher banking penetration (which also includes North and SubSaharian Africa), and eventually making new acquisitions as well.

The sixth largest regional player is Intesa San Paolo, which is present in 11 countries in the region, with a major presence in Slovakia, Croatia and Serbia, a medium player in Bosnia and Hungary and a small one in Slovenia, Ukraine, Russia and Romania. Like UniCredit, Intesa San Paolo did not apply for state support and now, after the capital increase carried out at the end of 2009, is ready to consider new entry opportunities / further growth options in CEE (Russia, Turkey, Poland) or in North Africa countries.

OTP is the only regional player in our list originating from the region. It is the dominant bank in Hungary, with a cross-CEE strategy, which includes a presence in Bulgaria (No. 2) and smaller subsidiaries in Serbia, Slovakia, Russia, Romania, Croatia and Ukraine. OTP in Hungary is a retail bank with a strong retail culture. Its growth strategy in the rest of CEE has been based on Group key competences, thus with a strong emphasis on retail lending growth (both mortgage and consumer credit). The Group can profit from a still relatively good level of capitalisation, but compared to other regional players it can not leverage on global diversification.

For all these consolidated regional players, the CEE strategy remains the option for long-term growth. In general, the possibility to leverage on a solid funding base and capital position, good access to international markets, in addition to being well positioned, will increasingly become key competitive factors. Furthermore, as we stated last year, risk appetite is also crucial, making the difference between winners and losers. While some reshaping of current positioning might occur, we do not expect any large-scale divestment from these players. Most probably strategies at single country level will focus on reaching an optimal size versus market ambition. This might imply some acquisitions, assets disposals or asset swaps, but also, more simply, some redefinition of Group ambitions in a single market (i.e. focus on some market sub-segments only).

In line with stabilising market conditions and multiples, M&A activity has restarted in the region, with some significant new entries. Banco Santander, the Spanish Bank with a leading presence in South America, acquired BZ-WBK (the fifth largest bank in Poland) from Allied Irish Bank. Another Spanish Bank, BBVA bought 24.9 % of Garanti Bank (the third largest bank in Turkey), and reached an agreement with the other shareholder Dogus, which gives it joint control and equal votes. Also Russian banks, which were already gradually pursuing cross-regional expansion strategies, might reinforce their approach, also taking advantage of the restructuring plans in Ukraine and in the former CIS countries.

By contrast, following the crisis some of the Greek banks which were quite aggressively targeting growth in South Eastern Europe are somewhat reshaping their strategies. Prior to the crisis growth ambitions prompted them to raise cheap capital and funding in the Eurozone in order to finance aggressive market share growth on the lending side in the region. The CEE crisis first and the Greek debt crisis later revealed the weakeness of their model – while CEE remains an area for growth, those banking players are now focusing much more on deposit collection and more balanced growth in all their subsidiaries. Bayerische Landesbank / Hypo Alpe Adria is another bank that is clearly retreating after the crisis. Hit by the crisis, the recapitalisation of BayernLB by the Free State of Bavaria, and the takeover of Hypo Alpe by the Austrian government led to a breaking up of the Group, with potential room now for disposal of assets both in Hypo Alpe and BayernLB subsidiaries in CEE, such as MKB (one of the large Hungarian banks) or other banks in the SEE countries.

At the single country level, Russia, Turkey and Poland remain the most attractive countries for new M&A activities in the near future, based on an optimal risk / return balance and forthcoming opportunities. In Russia the government has recently announced plans for the future privatisation of minority stakes in the large state-owned banks: 7.58 % in Sberbank, 35 % in VTB and 25 % in RosAgroBank. However, the privatisation will not substantially change the ownership structure of those banks, as the state will keep 50 % + 1 share control in the first two and 75 % in the third and disposed shares will most probably only increase the free float. However, some of the small and medium-sized banks might also become available in the market. In Poland some foreign players may be selling their Polish assets due to changes in their strategic focus. A similar situation also exists in Turkey, where the National Bank of Greece is going to reduce its participation (from 95 % to 75 %) in Finansbank, and where a privatisation plan of the state banks is going to be in place in the medium term.

Table of international players, Sept. 2010

	# 1	# 2	# 3	# 4	# 5	# 6	# 7	# 8	# 9	# 10
Poland	PKO BP State	Pekao UCG	BRE Commerzbank	ING BSK ING	BZ WBK Santander	BGK State	Millenium BancoComPort	Kredyt Bank KBC	Citibank Citi	Getin Noble Local private
Czech R.[1]	CSOB KBC	Ceska Sporitelna Erste	Komercni Banka SocGen	UniCredit UCG	Raiffeisen RZB	GE Money GE Capital	ING Bank ING	Citibank Citi	Commerzbank Commerzbank	Volksbank Volksbank Intl
Slovakia	Slov Sporitelna Erste	VUB IntesaSP	Tatra RZB	CSOB KBC	UniCredit UCG	Dexia Dexia	Postova banka local private	Prva Stavebna Bausparkassen	Volksbank Volksbank Intl	OTP OTP
Hungary	OTP International Capital	K&H KBC	Erste Erste	MKB BayernLB/Foreign State	CIB IntesaSP	Raiffeisen RZB	UniCredit UCG	FHB No majority	Budapest Bank GE Capital	BNP Paribas BNP Paribas
Slovenia	NLB State/KBC	Nova Maribor State	Abanka Vipa Local private	SID banka d.d. State	UniCredit UCG	SKB SocGen	Banka Celje NLB 41%	Banka Koper IntesaSP	Hypo Alpe Hypo G./For.State	Gorenjska Local private
Croatia	Zagrebacka Banka UCG	Privredna Banka IntesaSP	Erste Erste	Raiffeisen RZB	Hypo Alpe Hypo G./For.State	SocGen SocGen	Hrvatska Postanska State	OTP OTP	Volksbank Volksbank Intl	Medimurska B. Privredna/Intesa SP
Bulgaria	UniCredit UCG	DSK OTP	United Bulgarian NB of Greece	Raiffeisen RZB	Eurobank EFG Eurobank EFG	FirstInvestBank Private	Piraeus Piraeus	SG Expressbank SocGen	Corporate Comm. Local private	Alpha Bank Alpha Group
Romania	Banca Comerciala Erste	Pentru Dezvoltare SocGen	Alpha Bank Alpha Group	Banca Transilvania Local private	UniCredit UCG	Volksbank Volksbank Intl	Raiffeisen RZB	CEC State	Banc Post Eurobank EFG	ING ING
Bosnia-H.[2]	UniCredit UCG	Raiffeisen RZB	Hypo Alpe Mostar Hypo G./For.State	Hypo Alpe BL Hypo G./For.State	Intesa SP IntesaSP	NLB Razvojna NLB/KBC	NLB Tuzlanska NLB/KBC	Nova Banka BL foreign private	Volksbank Volksbank Intl	Sparkasse Bank S. Stmk. Sparkasse
Serbia	Banca Intesa IntesaSP	Komercijalna State	Raiffeisen RZB	UniCredit UCG	Hypo Alpe Hypo G./For.State	Eurobank EFG Eurobank EFG	AIK ATEbank Greece	SocGen SocGen	Vojvodjanska NB of Greece	Alpha Bank Alpha Group
Turkey	Ziraat State	Is Bankasi Is Bank fund	Garanti BBVA	Akbank Citi	Yapi Kredi UCG	Vakifbank State	Halk Bank State	Finansbank NB of Greece	Denizbank Dexia	ING ING
Ukraine	PrivatBank Local private	Ukreximbank State	Oschadbank State	Raiffeisen RZB	UniCredit UCG	Ukrsibbank BNP Paribas	VTB bank VTB Group	Prominvest Vnesheconom	Alfa Alfa Group	OTP OTP
Russia	Sberbank State	VTB State	Gazprombank Gazprom/State	Rosselkhozbank State	Bank of Moscow Moscow City	VTB 24 State	Alfa-bank Alfa Group	Societe Gen Group SocGen	UniCredit UCG	Raiffeisen RZB
Kazakhstan	Kazkommerts Local private	Halyk Bank Local private	BTA Bank State	Center Credit Kookmin B. Korea	ATF Bank UCG	Alliance Bank State	Eurasian Bank Local private	Kaspi Bank Caspian Group	Nurbank Local private	Sberbank Sberbank/Foreign S.
Estonia[1]	Swedbank Swedbank	SEB SEB	Nordea Nordea	Danske Bank Danske Group	Eesti Krediidipank Bank of Moscow	DnB Nord DnB Nord	UniCredit UCG	BIGPANK Local private	Handelsbanken Handelsbanken	Tallinna Aripank Local private
Latvia[1]	Swedbank Swedbank	SEB SEB	Parex (Citadele) State/EBRD	Nordea Nordea	DnB Nord DnB Nord	Aizkraukles Local private	Rietumu Private	Mortgage Bank State	UniCredit UCG	Latvijas Krajbanka Snoras
Lithuania[1]	SEB SEB	Swedbank Swedbank	DnB Nord DnB Nord	Nordea Nordea	Snoras Local private	Danske Bank Danske Bank	Ukio Local private	Siauliu EBRD/private	Parex (Citadele) Parex/For. State	UniCredit UCG

Large international groups · State, state controlled and state related · Regional foreign players · xxxxxx Other international players · Potential entry opportunities

Note: 1) Data as of YE 2009; 2) Data as of 2Q 2010
Source: UniCredit CEE Strategic Analysis

Regulatory framework

The tightening of the regulatory framework poses a challenge for banks and might actually constrain their capacity to support economic growth. The most important items under discussion, with implications for CEE, include the introduction of levies on banks / extraordinary taxes on banks, regulation for FX lending and Basel III.

Levy or tax on banks

The implementation of a bank levy or a tax for financial institutions is currently being discussed, both at the global European level and at the single country level. So far no coordination or agreement has been reached, as the features of the levy / tax and the planned use of proceedings differ radically among countries.

Generally, a levy or a tax on banks might be justified when:
- The proceedings are used by the authorities to recover part of the resources allocated to support the financial sector during the crisis
- The proceedings are used to build a stability fund for preventing a future crisis

The justification is less clear when proceedings are used for government budget financing, when no government bailout programme has been put in place.

So far the German cabinet agreed to adopt a bank levy on 25 August 2010, used to constitute a stability fund. The UK also imposed a levy on banks, but largely for budget financing, to recover the costs of the banking sector bailout. The Hungarian government voted on 22 July to introduce a bank levy valid for 2010–2011 and possible extension to 2012, used for current budget financing. Sweden has had in place a levy-backed bailout fund since 2009. A levy on banks has been approved by the Austrian Parliament in December 2010, for an amount of some € 500 mn, or 0,2 % of GDP, for the next 3 years, with proceeding to be used for budget financing. Political debate on the opportunity of charging such a levy has been opened in Poland and Romania, while motions have been rejected for the time being in both Croatia and Slovakia.

Tax on banks

Country	Normal level of taxation for banks (% of profits)	Special Tax on Banks (or bank levy)
Bosnia	Bih 10 % / RS 10 %	No
Bulgaria	10 %	No
Croatia	20 %	Government proposal so far abandoned
Czech R.	19 %	No
Estonia	21 %	No
Hungary	19 % + 49 % [1]	■ HUF 120 bn or € 430 mn borne by the banks in 2010, 2011 and 2012 (HUF 60 bn) [2] ■ 0.4 % of nominal GDP in 2010 ■ The tax is used for current budget financing ■ Tax is 0.53 % of 2009 “modified balance sheet amount, with deductions”, for banks above 50 bn forints (0.15 % if below) ■ A 30 % special tax on net profits is also levied, but this amount is deducted from the tax on assets (allowing different accounting treatment)
Kazakhstan	20 %	No
Latvia	15 %	No
Lithuania	15 %	No
Poland	19 %	Government discussion on the possible introduction of a tax on bank
Romania	16 %	■ Government proposed to analyse introduction of a new tax on banks, for budget financing, but so far the decision has been to wait for an EU common approach ■ State Fund for covering potential losses of bank bankruptcies. ■ cost: up to 0.1 % per annum on (total assets – liabilities covered by deposit insurance + contingent liabilities + commitments). The suggested rate for 2011 is 0.05 % ■ the Fund will be created within the framework of the deposit insurance agency
Russia	20 %	No – Putin formally announced he is not considering the implementation of a tax on banks
Serbia	10 %	Rumours on the possible introduction of extra tax on EUR denominated banking assets
Slovakia	19 %	No – waiting for EU common solution (a motion led by opposition for 2011 has failed to pass)
Slovenia	20 %	Discussion of a possible tax on banks, with exemption for those with a high share on new loans
Turkey	20 %	From 2010 new additional charge on branches according to geographical location
Ukraine	25 %	No

Note: 1) estimated impact of special bank tax 49 % of PbT in 2009, 52 % in 2010; 2) In 2012 the tax burden is expected to be halved
Source: UniCredit CEE Strategic Analysis

The EU Commission is trying to align the matter among countries, but so far countries seem to be keen in keeping independence in the fiscal decision making process. In the current context, a number of issues are relevant:

- The lack of coordination at the EU level generates risks of duplications for cross-border banks, which might end up paying both at the holding and at the subsidiary level
- In case of implementation of a EU compliant levy on banks, measures already implemented by single countries should converge toward the EU agreed solution to avoid duplications
- Lastly, in the event of a considerably high amount of the tax, the risk is that of putting a further constraint on the recovery, hindering the capabilities of the banking sector to sustain growth – something extremely risky in this phase of credit-less recovery

FX lending for unhedged retail clients

Following the crisis, there has been a strong push for further regulation of FX lending for unhedged retail clients. FX lending was one of the drivers of strong economic growth in the region before the crisis. In the context of a lack of domestic long-term funding sources for the local banks and high domestic interest rates, by leveraging on cheap international funding in FX (also due to the artificially low cost of country risk), the local banking system has been providing a strong stimulus for domestic growth.

FX lending became a source of instability however, by fuelling both unsustainable growth and a consumption boom. At the microeconomic level, it created a potential FX risk for unhedged retail clients, which was actually comparable to the interest rate risk they would have faced in the case of local currency lending. During the crisis, at the macroeconomic level the widespread presence of FX lending was particularly concentrated around unhedged retail clients, which seriously constrained the local central banks' monetary policy options.

Discussion of the best policy option for tackling the issue still continues. Although the negative macroeconomic implications of widespread FX lending to unhedged borrowers are clear, it is equally true that given the lack of long-term domestic funding, it would be detrimental for the region to impose a full ban on the business. Indeed, in the absence of local currency funding, the local banking sector would be unable to extend long-term lending without opening FX positions in their own balance sheets. Developing long-term local currency capital markets is thus a necessary pre-condition for local currency lending, with the important drawback that the experience of other emerging markets shows that this process might take decades and might not be worth tackling in those countries which are rapidly converging toward the Euro. Given these reasons, there is no unique strategy in terms of policy options.

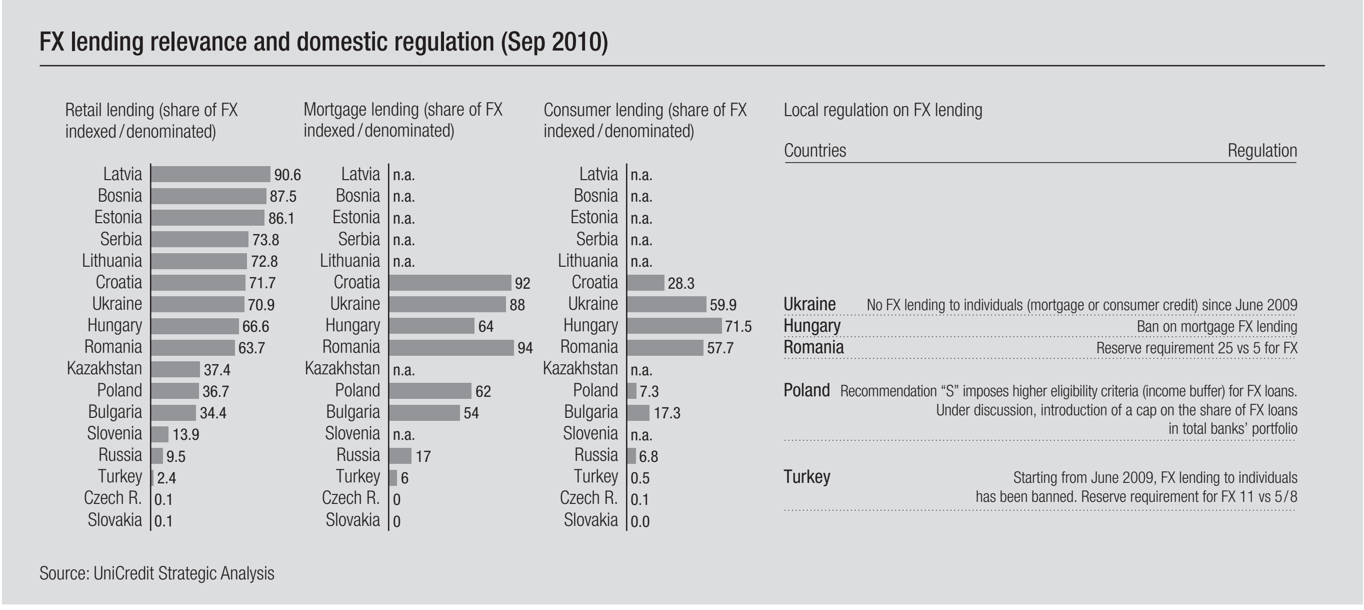
So far Hungary, Ukraine and Turkey have introduced measures to completely ban FX lending to individuals, while Poland is discussing the implementation of a cap on the share of FX loans in a bank's credit portfolio. Some of the countries (including Hungary and Romania), already had in place different regulatory requirements concerning LTV and LTI for FX and LC lending to unhedged retail clients.

Taking into account the need to develop the domestic currency market first, as a precondition for stimulating domestic currency lending, some countries, also through the coordination of the "Vienna initiative", point to the development of constructive solutions based on own market specificities. The tables below and on the next page show the key figures related to FX retail lending in the region, including availability of long-term funding in local currency and of a reference interest rate curve, a precondition for the development of long-term local currency lending and proposed regulations.

CEE Money Markets*

	3M	6M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Poland	3.7	3.9	4.1	4.8	5.1	5.3	5.4	5.4	5.5	5.5	5.5	5.5	6.1	6.2	
Hungary	5.6	5.7	5.9	6.6	6.7	6.8	6.9	7.0	7.1	7.1	7.1	7.1	6.9	6.6	
Czech R.	0.9	1.2	1.4	1.9	2.1	2.3	2.4	2.6	2.7	2.8	2.9	3.0	3.3	3.3	3.2
Lithuania	1.0	1.8	1.7	3.7	5.3										
Latvia	0.8	1.3	2.1												
Estonia	0.8	1.0	1.3												
Romania	6.4	7.0	7.1	7.3	7.4	7.3	7.3	7.2	7.2						
Bulgaria	2.1														
Croatia	2.0	3.0	3.7	5.0	5.6	5.8	6.1	6.3	6.4	6.5	6.5	6.7			
Bosnia H.															
Serbia															
Turkey	5.6	5.8	6.5	7.0	7.4	7.6	7.8	7.9	8.0	8.2	8.2	8.3			
Ukraine															
Russia	4.1	4.4	4.7	5.5	6.0	6.3	6.6	6.8	7.0	7.2	7.3	7.4	7.9	8.3	

Note: *) Maturities above 1Y are interest rates or cross currency swaps unless otherwise stated
Source: UniCredit Research



Source: UniCredit Strategic Analysis

Basel III implications for CEE countries

In December, the Basel Committee on Banking Supervision (BCBS) published its final set of rules on bank capital adequacy and liquidity as agreed by the Governors and Heads of Supervision and endorsed by the G20 Leaders at the November summit in Seoul.

Global regulatory challenges also have an impact on CEE, with Basel III discussions overlapping with the implementation of Basel II. The table below shows the list of countries where Basel II was already implemented.

In terms of timing the next issue is still related to Basel II and concerns the need to comply in 2011 with regulations related to the coverage of trading book and counterparty risk. However, initial estimates show that on an aggregate level CEE banking sector will face no major challenges to satisfying those requirements as local banks are mostly commercial banks in relatively traditional businesses.

Basel II implementation within CEE countries

	Minimum CAR requirement	Reporting standard	Comments
Bulgaria	12.0%	Basel II	All banks adopt the standardized approach; few banks moved to IRB
Czech R.	8.0% (informally required target 10%)	Basel II	3 banks out of top 5 players have already moved to IRB approach (some of them only partially – for specific segments retail/corporate)
Hungary	8.0%	Basel II	Most of top players already moved to the advanced IRB approach
Slovenia	8.0%	Basel II	Most of the banks going for standardized approach
Poland	8.0%	Basel II	None of the banks uses advanced IRB approach
Romania	8.0% (informally required target 10%)	Basel II	Some of the top players moved to IRB approach
Slovakia	8.0%	Basel II	–
Croatia	12.0%	–	–
Serbia	12.0%	–	Only some foreign banks implemented standardized approach
Russia	10% (for banks with capital less than RUB 180 mn, the MCR is 11%, while for banks with capital more that RUB 180 mn, it is 10% – BoR directive N 110-И 16.01.2004)	–	Only some foreign banks implemented the standardized approach
Turkey	8.0% (formally but 12% in practice – below 12% Turkish banks can not open new branches)	–	Once implemented, banks will probably move to the standardized approach

Source: UniCredit CEE Strategic Analysis

Then Basel III challenge follows.
Overall, the new Basel III rules cover the following key topics:

1. **Quality of capital** – stricter definition for Common Equity Tier 1 and regulatory adjustments applied to Core Tier 1. The Basel Committee has adopted a stance that the predominant form of Tier 1 capital must be represented by common shares and retained earnings that can fully absorb losses. Innovative hybrid capital instruments, currently limited to 15 % of Tier 1, will be phased out. In addition, Tier 2 capital will be harmonised and the so-called Tier 3 capital instruments eliminated. The new rules also imply further adjustments as concerns the treatment of deferred tax assets. In particular, in the final formulation the threshold for minorities' excess capital has been lowered from 8 % to 7 % of risk weighted assets. For deferred tax assets that rely on future profitability of the bank, the portion linked to tax losses carried forward will be deducted directly from Common Equity Tier 1 capital, while the remaining part will be deducted only for the portion exceeding the 10 % of Common Equity Tier 1 capital.

2. **Higher capital requirements and buffers** - minimum capital ratios increase with progressive introduction from 1/1/2013 to 1/1/2015: by 2015, banks will be required to meet the following new minimum requirements in relation to risk weighted assets: 4.5 % Common Equity Tier 1; 6.0 % Tier 1 capital and 8.0 % total capital. The Committee is also introducing a framework to promote the conservation of capital and the build-up of appropriate buffers. The capital conservation buffer, to be added on top of the conservation buffer, equals 2.5 % of Common Equity Tier 1 with progressive introduction starting from 1/1/2016 and year end 2018 becoming fully effective on 1/1/2019. Basel III also introduces a countercyclical buffer aimed at protecting the banking sector from periods of excess aggregate credit growth. Each Basel Committee member jurisdiction then identifies an authority with the responsibility to make decisions on the size of the countercyclical capital buffer (varying between 0 % and 2.5 %) to be applied on top of the conservation buffer.

3. **introduction of leverage ratio** – designed to prevent excessive balance sheet size/growth. Compared to the amendments made in July 2010, the formulation of the leverage ratio was mostly unchanged in the final version of the text released in December. A minimum leverage of 3 % based on the ratio between Tier 1 capital and on-off balance sheet items has been suggested. The Basel Committee on Banking Supervision (BCBS) will use the transition period to assess whether its proposed design and calibration is appropriate over a full credit cycle and for different types of business models. Based on the results of a parallel run period, any adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

4. **New liquidity standards** – the BCBS further strengthened its liquidity framework by developing two minimum standards for funding liquidity. These standards have been developed to achieve two separate but complementary objectives:

   - The first objective is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month. The BCBS developed the Liquidity Coverage Ratio (LCR) to achieve this objective. The metric has been defined as the ratio between the stock of eligible assets (those which can be converted easily into cash with only minimal loss in value) and outflows (net of inflows) than can be expected during a period of financial stress. In its final formulation the LCR has seen some softening in many of the outflow assumptions while tightening the inflow assumptions and placing a cap on their value.

   - The second objective is to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. The Net Stable Funding Ratio (NSFR) has been defined under the hypothesis of a one-year stress scenario in order to assess the "real" amount of stable funding available and required. The metric is designed as the ratio between available stable funding (incl. capital, liabilities with more than one year and stable retail/SME deposits) and required stable funding (defined as the value of on- and off- balance sheet items multiplied by a conversion factor assigned to each asset depending on its risk profile. After an observation period beginning in 2011 the LCR, including any revisions, will be introduced on 1 January 2015. The NSFR, including any revisions, will move to a minimum standard by 1 January 2018.

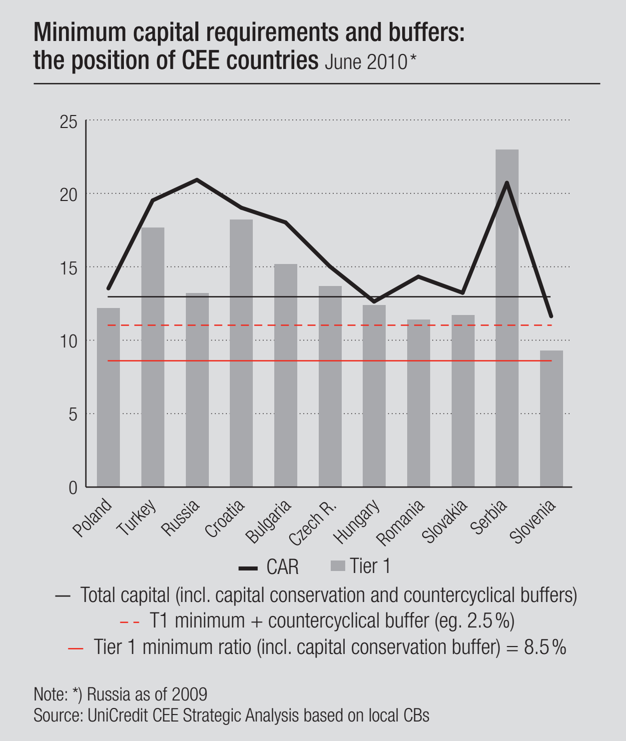
To evaluate the potential impact of the new Basel III framework we have run initial estimates focusing on data for the entire banking system and, where necessary, refining estimates by using individual banks data for a few of the country top players. Due to the complexity of the exercise and generally low level of data disclosure, assumptions have been made and proxies have been used. The analysis has been restricted to those countries which have already implemented or are close to implementing Basel II. Russia has been excluded as it has already postponed Basel II implementation. However, analysts' estimations made on top players (Sberbank, VTB) tend to suggest that the impact on Russian banks is potentially higher than in other CEE countries*. It should be noted that even in those countries which will not immediately implement Basel III, the targets set will become an important benchmark. International banks active in the region will have to accomplish globally and this will influence their own subsidiaries. Analysts will start considering the Basel III scenario as a benchmark for all banks globally, meaning that even if not formally binding, those targets will at least become informal constraints for the largest players.

On the whole, we expect the direct impact of Basel III on CEE to be clearly perceivable while still not being a "game changer". CEE banks benefit from a stable oriented retail deposit base, low reliance on wholesale funding (except for some CIS banks and intra-group funding) and low complexity of the asset structure.

*) Deutsche Bank (2010) 'EMEA banks – assessing the Basel III impact'

CEE banking systems have relatively high capital ratios and unused capital, as well as a large proportion of high quality capital (low incidence of Tier 2 capital and high quality of Tier 1). However, all this presents a picture based on current levels and calculation of risk weighted assets. Substantial changes in that aspect may alter the situation.

Minimum capital requirements and buffers: the position of CEE countries June 2010*



Note: *) Russia as of 2009
Source: UniCredit CEE Strategic Analysis based on local CBs

As concerns points 1 and 2 (quality and level of capital) we do not expect the impact to be dramatic, maintaining the assumption that Tier 1 capital coincides with Common Equity Tier 1 capital and not taking into account the potential impact related to RWA calculation changes. The relevance of preferred shares and in particular of hybrid instruments is limited in CEE, remaining in the range of 2 – 5 % of Tier 1 capital in most of the countries under review. There may be some impact from adjustments related to minorities, but not much from deferred tax. Apart from specific cases, generally, minority interests account for no more than 1 – 3 % of shareholders' equity and in some cases even less (i.e. Slovakia). Among the CEE countries under review, Slovenia emerges as among the most affected by the introduction of Basel III given its relatively weaker capital base compared to the rest of the region. Moreover, it cannot be ruled out that on an individual basis, there might be banks not fulfilling the new minimum requirement although this is more likely for total capital including the capital conservation and cyclical buffer rather than for Common Equity Tier 1 and Tier 1 capital.

In line with evidence for most of the countries around the world, point 3 (leverage) is also most probably not binding. In evaluating the positioning of the different banking systems, we relied on the assumption that the capital measure coincides with the new definition of Tier 1 capital as the impact of the underlying amendments to the capital definition is assumed to be generally limited. For off-balance sheet items (OBS), we used a 100 % credit conversion factor applied to the total amount of OBS. According to our estimates, Bulgaria and Croatia emerge with the highest leverage ratio driven by comparatively lower exposure to non-cash loans, while the Czech Republic produces the lowest ratio driven by the banks' assets size and the relevance of off-balance sheet exposure. Despite these cross-country differences, in all countries the average leverage ratio remains at comfortable levels above the benchmark.

We expect a stronger impact from point 4, as far as concerns the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). However, our exercise entails a number of assumptions as most of the Central banks and individual banks do not yet report sufficient data. Moreover, all results rely on the assumption that parent banks will not experience any problem in guaranteeing stability of refinancing to their local subsidiaries. This means that local banking systems will strongly depend on international banks active in the region for their capacity to adhere to these requirements. Any limitations or disadvantage for the parent banks regarding the treatment of their funding to the local subsidiaries should thus be carefully evaluated.

Concerning the first standard for the short-term liquidity requirement (LCR), we relied on the conservative assumption that all potential sources of inflows over a 30-day period are rolled over. Our estimates confirm that a few countries, namely Bulgaria, Romania, Serbia, and Slovakia, should be significantly impacted in case of serious financial distress due to the relatively shorter-term liability base particularly in the case of Romania. The impact looks milder concerning the standard for longer-term structural liquidity mismatches (NSFS) supported also by the generally high capital base. In the calculation, we assumed that all short-term retail and small business deposits are of a less stable nature. Even in this case a few countries could be more affected, namely Bulgaria, Romania and Hungary due to their relatively shorter term loan maturity structure, low availability of long-term funding and particularly in the case of Bulgaria lower exposure to government securities. These arguments partially hold also for Slovakia, where the slightly below benchmark net stable funding ratio also reflects some higher relevance of off-balance sheet commitments and lower long-term parent banks' refinancing.

Still, the CEE region might end up being indirectly affected by Basel III implementation, should international players active in the region end up being constrained in their global growth strategies. Shortfall or too binding constraints in terms of capital and funding affecting those international players, as well as limitations to their optimal intra-group allocation of capital and funding, due to strict national boundaries, might end up penalizing the cross-border banking model, which has been the basis of economic and financial convergence in CEE.

Central Europe

Overall in good shape but regulatory risks exist, especially in Hungary

The crisis has been felt in Central Europe (CE), but without long lasting consequences. The region is in good shape, with a favourable economic environment and a sound financial sector. Central Europe's GDP growth rebound in 2010 (+3.0% yoy from –1.9% in 2009) has been supported by reviving export demand, mostly German. A further acceleration is foreseen for 2011 (+3.4%), with domestic demand increasingly replacing export in supporting economic dynamics. Low capacity utilisation and good liquidity in the corporate sector will stimulate new investment activity, while private consumption remains modest, at least at the beginning of the year, impacted by strong fiscal correction plans (in place in all the CE countries in order to narrow the budget deficit) and somewhat higher inflation (on the back of food, alcoholic beverages and energy price increases).

Poland is the best performing economy, on the back of the EU co-financed infrastructural projects related to the Football European Championship in 2012. Hungary continues to show some vulnerability, due mainly to high public debt and still relevant external financing needs (both public and private). Czech Republic and Slovakia will record a slight deceleration in their growth pattern in 2011, as the effect of a stronger fiscal correction plan will dampen the ongoing recovery in domestic demand, while in Slovenia the expected positive contribution from gross fixed capital formation (for the first time since 2008) will support economic recovery.

The development of banking volumes will be positively affected by improving economic conditions. Lending activity is expected to grow by 11.2% yoy in 2011 (up from 6.3% in 2010). Corporate lending will accelerate in view of new investment plans, while retail lending will more or less maintain the same pace as in 2010 in the context of still high unemployment and low wage growth.

Liquidity is generally not an issue for banks in Central Europe, with the ratio of loans to deposit below or close to 100%. Hungary and Slovenia represent an exception, with the domestic banking industry dependent on external funding. We expect deposit growth to remain a crucial element in banks' strategies and we forecast an increase of 10.6% yoy. Corporate deposits should be supported by higher corporate sector liquidity – somewhat less so in Slovakia,

Central Europe

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.1	6.1	3.9	–1.9	3.0	3.4	3.7
CPI, avg	2.2	3.5	5.0	2.7	2.5	3.3	3.3
Loans (yoy % growth)	22.9	29.0	17.4	4.1	6.3	11.2	9.1
Loans (% GDP)	43.1	48.7	50.1	58.6	57.2	58.9	59.2
Mortgage loans (yoy % growth)	40.7	42.7	31.7	10.5	14.7	14.3	8.8
Mortgage loans (% GDP)	9.3	11.7	13.5	16.7	17.6	18.7	18.7
Loans denominated/indexed in FX (% Total loans)	28.9	23.9	29.2	27.3	–	–	–
Deposits (yoy % growth)	14.8	17.8	8.0	6.8	6.1	10.6	8.5
Deposits (% GDP)	49.9	51.5	48.7	58.5	56.9	58.3	58.3
Loan-to-deposits ratio	86.3	94.5	102.7	100.2	100.4	101.0	101.6
External Liabilities (in % total liabilities)	14.1	16.7	21.3	17.4	–	–	–
Cost-to-Income ratio (%)	56.7	54.6	54.9	49.6	49.9	49.1	48.0
Revenues/Average Volumes (%)	3.8	3.7	3.9	3.5	3.4	3.3	3.3
Return on assets (%)	1.6	1.6	1.4	1.0	1.0	1.1	1.2
Impaired loans ratio (in % gross loans)	4.9	3.9	3.9	6.6	8.5	7.7	6.9
Cost of risk (in % ∅ gross loans)	48 bp	50 bp	98 bp	172 bp	164 bp	145 bp	124 bp

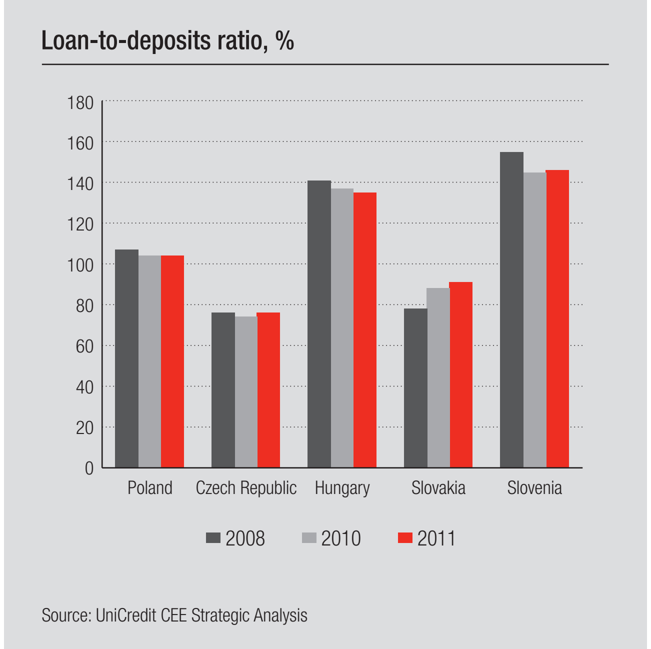
Source: UniCredit CEE Strategic Analysis

where EMU membership has prompted multinational companies operating in the country to keep their own funds in the countries of origin. Retail deposits will be backed by some improvement in households' saving attitude, although mutual funds and other savings assets may also remain attractive, especially in Hungary, Slovakia and Slovenia.

Improved volumes dynamics will have a positive impact on banking sector net revenues development, despite tighter interest margins. Focus on costs remains crucial, as well as management of the cost of risk and efforts in terms of re-collection and provision reversals. Non-performing loans are generally expected to peak at the end of 2010 (or the beginning of 2011 in the Czech Republic, Slovakia and Hungary), while the cost of risk, after peaking in 2009 (for Slovenia in 2010), will decline in 2011. Overall we expect profitability levels, in terms of return on assets to range between 0.5 % in Slovenia and 1.5 % in Poland in the forthcoming years.

Regulatory risk is however relevant in Hungary and has triggered a strong reaction by foreign investors, with some considering scaling back their growth plans in the country. The Special Bank Tax (SBT) of HUF 120 bn imposed in 2010 and 2011 is likely to remain in place – albeit at a lower amount – in 2012 as well. Furthermore, proposed regulation affecting the banking sector includes a full ban on new FX lending to unhedged borrowers and the creation of a government-run agency to collect and manage bad assets related to mortgage loans to individuals. In Poland, some discussion on possible limitations on FX lending as well as on the bank levy is still ongoing.

Capital level are comfortably high throughout the region. Slovenia shows some vulnerability under these conditions, as the EU stress test in July highlighted some need for recapitalisation for NLB, the country's major bank, which at the end of 2010 announced the need to dispose of some assets / subsidiaries in order to raise capital.



South Eastern Europe

2011 still challenging for banks as fundamentals remain weak

Despite signs of marginal recovery since the start of 2010, the overall macro environment in South Eastern Europe remains fragile on the back of structural vulnerabilities which continue to act as a drag on growth for the economy and banking business. In line with the rest of the region, SEE economies reached their trough during Q4 2009, but yearly growth stayed in negative territory for most of 2010 with Serbia the only exception. The situation looks particularly challenging in the case of Romania where following the austerity package approved last summer, domestic demand has remained depressed with no major improvement in sight as the private consumption dynamic is still conditioned by tense labour market conditions and a high debt burden.

The economic outlook in SEE generally remains quite uncertain with growth expected to have re-accelerated since Q4 2010 and projected to firm to around 2 % yoy in 2011 from an estimated –1.2 % yoy in 2010. Domestic demand looks set to remain weak in most of the countries with investment spending in particular acting as a constraint. In Bulgaria and Romania, the situation of the household sector remains more critical as painful adjustment of jobs in the non-tradable sector does not seem to be over and looking ahead, will continue to weigh negatively on employment and income. In Serbia, there is evidence of somewhat stronger domestic demand; however, the spectre of widening external imbalances and their implications for the sustainability of stronger growth and the domestic currency represent the major risk in that country.

The recovery has been credit-less for most of 2010 with lack of demand and deterioration in credit quality behind the sluggish dynamic in lending activity. Exceptions are Serbia and Croatia (where some lending activity continued, backed by government support for infrastructure projects, resulting in an estimated increase of 28 % yoy and 6 % yoy, respectively last year) and Romania (which experienced a modest 4 % growth mainly driven by the corporate segment). Growth is estimated to have remained more moderate in Bosnia and Bulgaria as retail lending was hampered by low consumption demand and corporate by weak investment spending. With economic recovery regaining some strength starting from Q4 2010, loan growth in SEE is projected to gradually re-accelerate to record a 7.0 % yoy increase compared to an estimated 3.9 % yoy

SEE

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.7	6.2	5.9	–5.8	–1.2	2.0	3.1
CPI, avg	6.7	5.0	8.6	4.6	4.4	5.1	3.8
Loans (yoy % growth)	36.4	37.8	21.3	2.0	3.9	7.0	10.5
Loans (% GDP)	39.6	45.2	48.9	55.5	56.8	58.2	58.8
Mortgage loans (yoy % growth)	49.1	41.9	28.2	2.6	7.5	10.7	13.3
Mortgage loans (% GDP)	6.1	7.1	8.2	9.4	10.0	10.5	10.8
Loans denominated / indexed in FX (% Total loans)	57.5	56.7	61.1	64.0	–	–	–
Deposits (yoy % growth)	31.4	27.5	5.3	3.2	2.7	6.2	9.9
Deposits (% GDP)	39.8	42.0	39.5	45.4	45.9	46.7	46.9
Loan-to-deposits ratio	99.4	107.4	123.7	122.3	123.7	124.6	125.3
External Liabilities (in % total liabilities)	22.6	23.2	26.0	24.1	–	–	–
Cost-to-Income ratio (%)	56.6	54.6	53.7	52.0	50.7	50.8	50.0
Revenues / Average Volumes (%)	5.0	4.8	5.1	4.7	4.6	4.3	4.2
Return on assets (%)	1.5	1.5	1.7	0.7	0.4	0.7	0.9
Impaired loans ratio (in % gross loans)	3.1	3.4	5.2	10.2	15.5	14.4	12.1
Cost of risk (in % ∅ gross loans)	187 bp	203 bp	239 bp	341 bp	384 bp	322 bp	274 bp

Source: UniCredit CEE Strategic Analysis

in 2010. Corporate loans are anticipated to remain the main driver with retail lending lagging although on a gradual upward trend supported by growth consolidation in mortgages. In Bulgaria, growth will remain more balanced with retail lending expected to marginally exceed that of corporate this year. Still, the key challenge in the recovery phase would be for lending activities to change target sectors, from the traditional non-tradable engines of growth (real estate, trade, construction), toward tradable / competitiveness enhancing sectors.

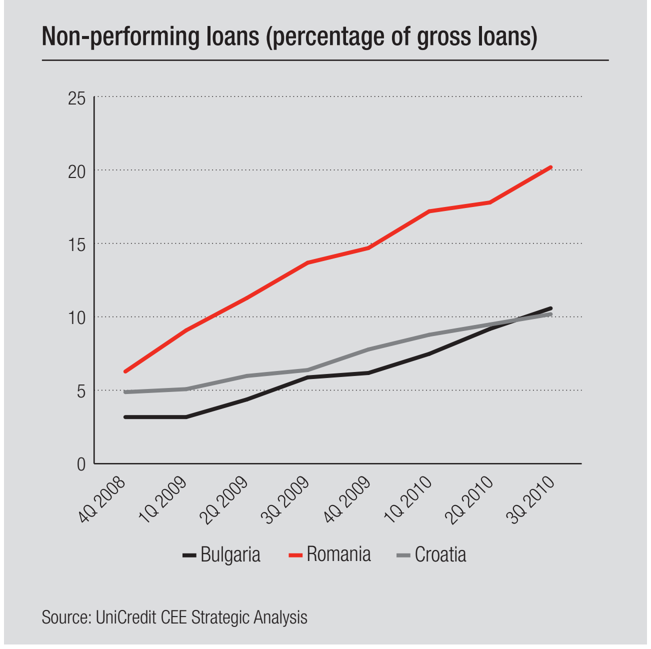
Banks' deleveraging has been generally achieved and 2010 has marked some gradual increase in the loan-to-deposits ratio in most countries mainly on the back of a decelerating dynamic in deposits. After having moved into the spotlight at the peak of the crisis, deposits growth started to lose some strength during last year as banks realised fierce competition for funding was turning inefficient and eroding profitability. Growth in retail deposits remained solid in Bulgaria supported by still relatively attractive returns and a gradual improvement in sentiment indicators during the year ending up with an estimated 10 % yoy increase in 2010. The return of confidence also provided a basis for moderate growth in Bosnia. In Croatia, better than expected household deposits' growth during 2010 could be exposed to the risk of slower growth in 2011 as capital market returns are expected to rise in response to expectations that the country will complete EU accession talks in H1 2011. The dynamic in corporate deposits remained under pressure in the region (with the exception of Serbia and Bosnia) during last year as a result of companies' liquidity problems, resulting in estimated average negative growth of – 0.8 % yoy in 2010. Gradual re-acceleration of economic growth and increased availability of credit will provide ground for a more solid dynamic in corporate deposits this year with projected growth of 4.2 % yoy. Overall, growth in deposits is forecast to gain strength in 2011 posting an increase of 6 % yoy from an estimated 2.7 % yoy recorded in 2010.

Generally, the loans-to-deposits ratio is expected to stay on a moderate upward trend at the regional level, with Bosnia and Bulgaria delaying the re-leveraging process.

Banking sector profitability in this region remains exposed to downside risks given the generally weak economic environment. All banking sectors are, however, expected to post aggregate profits in 2011. Despite tightening banking margins, re-acceleration in bank revenues in the context of a strong focus on costs will be the key driver of the improved outlook. Pressures on margins remain particularly strong in Croatia as an EU accession related factor. In Romania, some uncertainty remains in connection with a new levy for the stability fund which could negatively influence profitability of a banking sector which today is still in the red.

Banks will benefit from an envisaged gradual stabilisation in provisioning activity. Credit quality problems and the resulting increase in provisions has been the main challenge for banks in both 2009 and 2010. Signs of levelling off in NPL dynamics have gradually emerged during last year and we expect NPL peak levels to be reached during the first half of 2011 with Romania and particularly Bulgaria likely to lag behind due to the delayed economic recovery. Possible strengthening of the CHF might represent an issue to monitor as a risk factor for the loan portfolio quality particularly in Serbia and Croatia (due to larger relevance of CHF denominated / indexed loans in the total loan book).

Overall, banking sectors in South East Europe remain capitalised and stable, not least because of continued support from parent banks. Romania probably emerges as one of the most exposed to potential erosion in the capital ratio when taking into account the uncovered part of distressed assets.



Other CEE Countries (CIS and Turkey)

Turkish banking business to benefit from solid macro outlook, while structural changes and banks' balance sheets clean-up still affecting developments in CIS

The crisis environment proved to be a particular test for the banking system in the CIS region, while banks in Turkey reacted surprisingly well.

As an effect of the global crisis, the Russian banking sector experienced a liquidity and credit quality shock in late 2008 and 2009, accompanied by a complete credit crunch, with lending activities contracting in nominal terms. The Russian banking system was also quite quick in the recovery phase, however, as macroeconomic activity restarted from 1Q 2010. In the middle of the crisis, the reaction of the Russian authorities (central bank and government) was essential to restoring public confidence. Capital injections, liquidity provision as well as quite aggressive expansionary policies helped to create the premise for broader stabilisation in banking activities. As growth restarted, it has been a credit-less recovery at first, with low demand and early redemptions by Russian companies. The anaemic recovery in lending activity was accompanied by dynamic growth in deposits, particularly in the retail segment, resulting in a significant rebalancing of the funding gap. In the recovery phase, the state banks have played a strong role in setting the new competitive framework. Well capitalised and provisioned, they emerged from the crisis with a strengthened market dominance. They are now employing aggressive strategies, particularly targeting the large corporate business and key sectors of the economy. Going forward, the consolidation in economic growth this year to around 4.3 % – from an estimated 3.4 % in 2010 – will be a key driver for a broadly-based recovery in the demand for credit, with loan growth expected in the range of 15 % yoy slightly above the one in bank deposits (at 14 % yoy). Non-performing loans are still a source of concern for Russian banks, particularly on the retail side, but the peak is expected to have been reached at 18.5 % in 2010, while profitability is gradually returning to comfortable levels. Resolution of capitalisation problems has been also fast, with the central bank now aiming at a further tightening of capital requirements in order to comply with the Basel regulation during 2011.

Kazakhstan and Ukraine are the two countries in the region which experienced a full-fledged banking but not economic crisis. There are signs of recovery following an acceleration in 2010 economic growth, but the situation remains fragile. The situation in the Kazakh banking system remains difficult, despite successful restructuring of BTA's and Alliance's foreign debt. However, driven by increased demand in the corporate segment, overall lending activity gradually started recovering toward the end of last year ending up with growth of 8.0 %. The low quality of the loan portfolio and some uncertainty about future regulation (regarding capital adequacy and consumer protection) contributed to keeping banks risk-averse particularly in the first part of last year. Banks were rather using liquidity to repay foreign debt or state liquidity support and to purchase (rather low-yielding) securities. The expected solid dynamic in GDP

CIS and Turkey

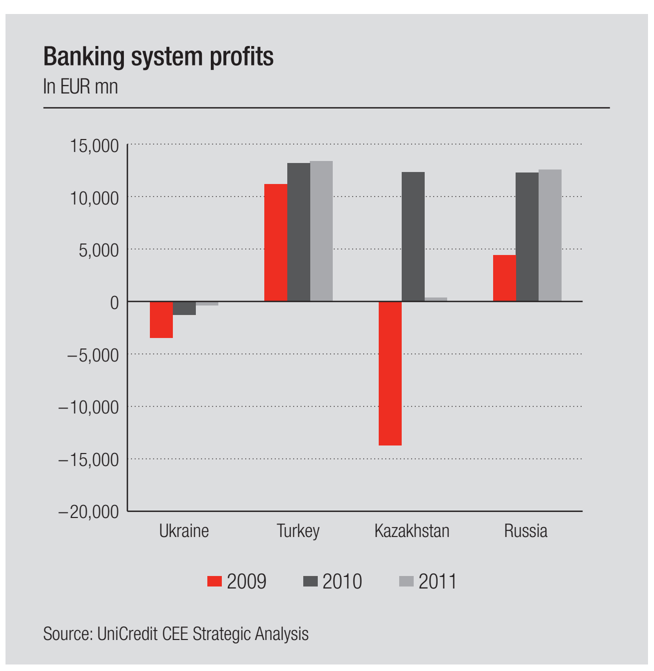
	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	7.6	7.1	3.7	–6.9	4.7	4.3	4.5
CPI, avg	9.6	9.3	14.0	10.1	7.5	8.1	7.5
Loans (yoy % growth)	38.8	44.6	10.6	–2.3	17.3	17.2	15.7
Loans (% GDP)	30.4	37.4	35.7	43.3	39.5	41.6	45.1
Mortgage loans (yoy % growth)	94.8	77.4	17.0	4.5	18.3	19.6	17.3
Mortgage loans (% GDP)	1.9	2.9	3.0	3.8	3.5	3.8	4.2
Loans denominated / indexed in FX (% Total loans)	30.0	28.2	31.5	29.8	–	–	–
Deposits (yoy % growth)	23.6	31.2	1.1	14.4	21.2	16.1	13.8
Deposits (% GDP)	31.0	34.6	30.2	43.0	40.5	42.3	45.0
Loan-to-deposits ratio	98.0	107.9	118.0	100.8	97.5	98.4	100.1
External Liabilities (in % total liabilities)	18.7	19.1	18.2	13.9	–	–	–
Cost-to-Income ratio (%)	48.7	48.3	49.3	44.1	43.6	50.9	50.3
Revenues / Average Volumes (%)	6.3	6.1	7.0	6.3	6.2	5.1	4.7
Return on assets (%)	2.6	2.6	1.9	–0.1	2.6	1.6	1.6
Impaired loans ratio (in % gross loans)	7.3	7.3	10.7	16.8	17.9	16.1	14.4
Cost of risk (in % ∅ gross loans)	195 bp	179 bp	346 bp	716 bp	245 bp	222 bp	189 bp

Source: UniCredit CEE Strategic Analysis

and improvement in domestic demand will drive some moderate acceleration in lending growth during 2011 to around 8.4 % yoy, below the 16 % projected in deposits, driving further rebalancing of the funding gap to around 115 % (from an estimated 123 % in 2010). However, the challenge for the banking industry is to refocus operations, toward competitive and productive sectors. So far, the only ongoing operations seem to be related to export financing, energy industries, as well as some business of multinationals. Credit quality remains the key constraint for Kazakh banks. The share of distressed assets has inched constantly upward through the year to reach the estimated level of almost 34 % in 2010 with the peak probably delayed to the second half of 2011. Profitability of the banking sector has benefited from the debt forgiveness to BTA and Alliance in 2010, but we expect only a moderately positive figure for 2011. However, for the first time since May 2009, the banking system's capital turned positive in August last year thanks to the completion of BTA's foreign debt restructuring. The authorities also seem now more willing to address the bad debt problem in a centralized way. Government induced / supported debt equity swaps for highly indebted corporations might be one of the variants.

In Ukraine, an estimated 4 % GDP growth in 2010, following the steep fall in 2009, is providing ground for some recovery in banking activities, although Ukrainian banks are still facing the consequences of the crisis, with large portfolios of non-performing assets to be managed. The crisis brought a complete collapse of economic activities, with a substantial change in the drivers of growth, away from non-tradable sectors. In addition to a considerable devaluation of the local currency in late 2009, a combination of a deep liquidity crunch, credit crunch and credit quality stock problem has materialised. Debt restructuring activities have become a key focus for most of the banks, both on the retail and corporate side. The credit crunch was particularly evident in the retail segment, following the ban introduced on FX since June 2009 (also extended from October to corporates without FX arrears) with contraction estimated to have reached –11 % yoy in 2010 compared to a marginally positive dynamic in total loans of 1.8 % yoy. A big surprise during 2010 was instead the very robust growth in deposits. After the panic of late 2008-early 2009, driven by currency devaluation, last year saw a massive return of deposits into the system against the background of the stable currency, with growth estimated to have reached around 22 % yoy. As a result, the loans-to-deposits ratio has been constantly edging downward although remaining well above 100 % at an estimated 180 % at the end of 2010. The upbeat outlook for economic growth in 2011 and infrastructure investments in preparation for Euro 2012 will be supportive for some recovery in lending activity, mainly in the corporate segment, although banks seem to continue to follow very prudent strategies and to be involved mostly in project based financing. Further rebalancing of the loans to deposits ratio is expected, while management of the stock of non-performing assets will require time. With moderate profitability and still concern over the cost of risk, cost-cutting strategies remain key. We however continue to forecast a moderate loss also in 2011 for the system, which will return to profitability in 2012. Following the large wave of recapitalisation which took place in 2008 – 2009, in the amount of EUR 5.2 bn, capital adequacy for the overall banking sector stood however at 20.2 % in September 2010 vs. the minimum requirement of 10 %. In 1H 2010, EUR 1.3 bn was further injected into the system with a total of EUR 2.8 bn estimated for FY 2010 and additional EUR 1 bn in 2011.

The case of Turkey is completely the opposite. Turkey's banking sector has reacted surprisingly well to the crisis as the local banks, with considerable experience from past periods of strong volatility, had very balanced positions pre-crisis in terms of funding, capital and exposure to different kinds of risks. Starting from 2009, broad disinflation has created a significant opportunity for an acceleration of retail lending through unsecured credit and mortgages, as well as SME lending, as affordability constraints lessen pent-up demand materialised and growth gradually rebounded. Thus, while all over the region a credit crunch has been the reality, in Turkey retail lending is expected to have recorded a significant rebound in 2010, increasing by 26 % yoy. A similar strong dynamic was also recorded in the corporate segment with total lending expected to have increased by 24 % yoy. Although some loss in momentum is likely during 2011, lending growth is projected to remain strong. Retail loans continue to be the main growth driver and the share of retail loans in the total is likely to increase in the long term. Deposits growth remained robust throughout the crisis and is expected to consolidate this year, with the loan-to-deposits ratio expected to further increase although remaining below 100 % in the medium to long term as well. The strong recovery in economic conditions and rebuilding of household / corporate balance sheets, were behind the observed reduction in the NPL ratio during 2010 following the peak reached in November 2009. Also in terms of profitability, the Turkish banking sector remains an exception. Banks are estimated to have recorded even higher profits in 2010 than in 2009, supported by a strong effort to control costs, a decline in provisions and gains from NPL collections.



Source: UniCredit CEE Strategic Analysis

Baltics

Stabilisation in banking achieved but challenges remain

After the sharp GDP contraction experienced during 2009, growth has returned to positive territory first and with more intensity in Estonia and Lithuania and also in Latvia later in 2010, with GDP estimated to have reached close to a 1 % yoy increase last year. However, a persistently high degree of uncertainty related to the global outlook and a still distressed corporate and particularly households sector could threaten the expected consolidation in economic recovery. The stability of the Baltic countries will also be influenced by trends in the cost of refinancing, particularly following the renewed pressures arising from concerns over debt sustainability of the euro periphery, with the cost of country risk expected to remain above the pre-crisis level in the medium-term as well. Estonia's Euro adoption certainly acts as an amplifier for the improvement in investor confidence and could support a faster recovery in the inflows of foreign direct investments, thus contributing to the envisaged acceleration in economic growth. The region also benefits from consolidation of the recovery in its main trading partners, i.e. Russia and Scandinavia, and an improved liquidity position of parent banks (particularly of Nordic banks which dominate the local banking sector).

After the severe credit crunch which occurred during 2009, credit demand remained depressed during last year with growth in total lending estimated to have reached some –4.4 % yoy on average in the region with more visible drops being recorded in Latvia and Lithuania. The situation looks more favourable in the case of Estonia where the first signs of re-acceleration in lending already were evident starting from 2H 2010, driven by the corporate segment. Downside risk for growth remains connected to the implication of the debt restructuring law (allowing courts to reduce all debtors' liabilities that exceed the market value of the collateral) endorsed last year by the parliament and expected to come into force this April. Generally, the still tense labour market conditions characterised by a high level of unemployment and anemic recovery in income growth will continue to dampen growth in domestic consumption, causing a delayed recovery in household demand for credit, while corporate demand will benefit from recovery in export-oriented sectors. Overall, growth in lending is expected to regain some strength from the second half of this year resulting in an overall average increase of 3.7 % yoy. The deposits dynamic remains weak but is showing slightly positive growth, with the corporate segment

Baltics

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	9.7	8.9	–1.0	–15.7	0.7	3.8	3.8
CPI, avg	4.7	7.3	12.3	3.2	0.6	1.9	2.3
Loans (yoy % growth)	45.9	36.7	13.4	–7.1	–4.4	3.7	4.5
Loans (% GDP)	69.6	77.8	80.6	90.3	86.0	84.9	83.9
Mortgage loans (yoy % growth)	70.8	44.2	12.6	–2.4	–	–	–
Mortgage loans (% GDP)	22.4	26.4	27.2	32.1	–	–	–
Loans denominated / indexed in FX (% Total loans)	69.2	73.6	78.8	83.8	–	–	–
Deposits (yoy % growth)	30.2	18.6	3.8	4.7	6.1	4.6	4.7
Deposits (% GDP)	41.2	39.9	37.9	47.8	50.5	50.3	49.8
Loan-to-deposits ratio	169.1	194.8	212.8	188.8	170.2	168.7	168.3
External Liabilities (in % total liabilities)	46.8	51.3	52.8	48.1	–	–	–
Cost-to-Income ratio (%)	47.3	41.5	47.9	54.6	58.3	54.3	52.5
Revenues / Average Volumes (%)	3.1	3.6	2.9	2.6	2.3	2.2	2.3
Return on assets (%)	1.6	2.0	0.8	–3.9	–1.1	0.2	0.4
Impaired loans ratio (in % gross loans)	0.8	0.8	3.8	14.6	17.1	17.2	15.7
Cost of risk (in % ∅ gross loans)	20 bp	23 bp	113 bp	712 bp	310 bp	133 bp	119 bp

Source: UniCredit CEE Strategic Analysis

recovering faster than retail. The non-residents' deposit base remains more volatile and vulnerable despite the visible improvement recorded in its dynamic during 2010 – a feature that is most significant in Latvia, where non-resident deposits accounted for around 35% of total deposits at the end of last year. Deleveraging is still ongoing and it will take some time before there is any observable reversal in the trend. In that context, the role of parent banks' support and dependency upon foreign refinancing will remain crucial to a full resumption of growth.

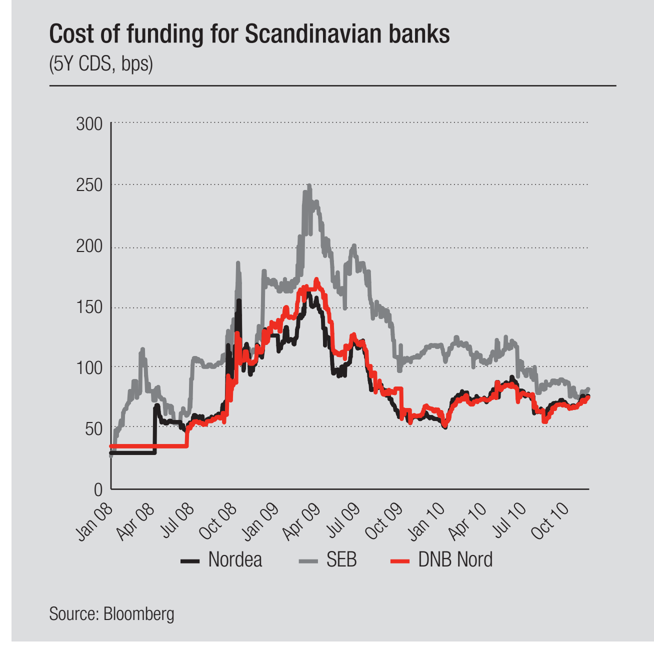
The skyrocketing increase in the level of provisions on the back of rapid deterioration in the quality of loan books has been mainly responsible for the aggregate loss reported by Baltic banks during 2009. There has been some gradual stabilisation in 2010 in the cost of risk, which is estimated to have fallen to around 310 bp from around 712 bp in the previous year, although staying well above pre-crisis levels. Generally, the growth rate of problematic loans has considerably slowed in recent months but the peak in credit quality problems probably will be delayed to around mid/end 2011 in both Estonia and Latvia, while in Lithuania it looks already over supported by lower exposure to the hard hit construction sector. Credit risk deterioration took place in the context of low interest income deriving from unfavourable economic conditions, with a price war adding to the pressures and proving quite costly for banks.

Going forward, the acceleration in economic recovery is expected to facilitate some mild revival in demand for services, which will increase fee and commission income. At the same time, pressure on margins is expected to continue, particularly in Estonia on the back of euro introduction, resulting in some further marginal decline in interest income relative to average volumes. Costs will remain a focus with all major banks still keeping network expansion plans on hold and growth in operating expenses projected to remain in line with average inflation.

In spite of the challenging economic situation and large losses reported, the aggregate capital adequacy of banking groups remained high (well above the minimum requirement) as also confirmed last year by the CEBS' stress test results. Banks in Latvia increased their capital by around LATS 800 mn (EUR 1.1 bn) in 2009 and a further LATS 250 mn (EUR 357 mn) are expected to have been injected by the end of last year. Similar actions were also taken in both Estonia and Lithuania to cover losses from the crisis, with banks opting to refrain from paying dividends in order to further strengthen their level of capitalisation.

The challenge ahead for the economy and the banking sector in the Baltics, however, remains the success of a quick transformation – away from an Irish growth model.

Cost of funding for Scandinavian banks
(5Y CDS, bps)



Source: Bloomberg

Annex – Country data

Central Europe

Czech Republic

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.8	6.1	2.5	–4.1	2.3	1.8	3.3
CPI, avg	2.5	2.8	6.3	1.0	1.4	2.1	2.4
Loans (yoy % growth)	17.4	24.5	15.3	1.5	3.2	8.3	9.3
Loans (% GDP)	42.0	47.7	52.7	54.4	55.3	57.8	59.8
Mortgage loans (yoy % growth)	32.6	37.6	20.1	11.5	6.5	9.6	12.3
Mortgage loans (% GDP)	11.5	14.5	16.7	18.9	19.8	21.0	22.3
Loans denominated / indexed in FX (% Total loans)	10.4	9.1	9.5	8.8	–	–	–
Deposits (yoy % growth)	8.8	15.2	8.5	5.4	2.0	4.5	6.5
Deposits (% GDP)	63.8	67.0	69.7	74.7	75.1	75.7	76.3
Loan-to-deposits ratio	65.8	71.1	75.6	72.8	73.6	76.3	78.3
External Liabilities (in % total liabilities)	7.8	9.4	10.5	8.3	–	–	–
Cost-to-Income ratio (%)	54.7	50.3	49.7	40.3	42.2	43.5	43.5
Revenues / Average Volumes (%)	3.4	3.3	3.1	3.6	3.4	3.3	3.2
Return on assets (%)	1.5	1.6	1.3	1.7	1.6	1.5	1.5
Impaired loans ratio (in % gross loans)	3.7	2.8	3.3	5.4	6.9	6.8	5.9
Cost of risk (in % ∅ gross loans)	31 bp	50 bp	86 bp	152 bp	127 bp	116 bp	105 bp

Hungary

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	4.0	1.0	0.6	–6.3	1.2	2.5	3.4
CPI, avg	3.9	8.0	6.1	4.2	4.9	4.4	3.4
Loans (yoy % growth)	18.8	13.5	18.5	–3.5	3.6	3.5	5.8
Loans (% GDP)	57.6	61.3	68.7	68.1	68.1	66.7	66.9
Mortgage loans (yoy % growth)	19.4	17.2	25.5	2.3	6.6	1.2	3.1
Mortgage loans (% GDP)	11.8	13.0	15.4	16.2	16.6	15.9	15.6
Loans denominated / indexed in FX (% Total loans)	47.4	56.4	64.6	63.3	–	–	–
Deposits (yoy % growth)	13.8	9.3	10.8	4.6	–1.6	5.4	6.1
Deposits (% GDP)	45.3	46.4	48.7	52.3	49.7	49.6	49.8
Loan-to-deposits ratio	127.2	132.0	141.1	130.2	137.1	134.6	134.2
External Liabilities (in % total liabilities)	25.8	27.5	32.9	29.7	–	–	–
Cost-to-Income ratio (%)	52.6	54.1	61.0	45.5	53.1	52.0	48.5
Revenues / Average Volumes (%)	4.1	4.0	3.4	4.1	3.4	3.5	3.7
Return on assets (%)	1.6	1.4	0.8	0.8	0.3	0.5	0.9
Impaired loans ratio (in % gross loans)	3.6	3.7	4.5	8.5	11.5	9.9	8.0
Cost of risk (in % ∅ gross loans)	61 bp	73 bp	85 bp	237 bp	216 bp	187 bp	148 bp

Poland

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.2	6.8	5.1	1.7	3.8	4.4	3.9
CPI, avg	1.0	2.5	4.2	3.5	2.6	3.5	3.7
Loans (yoy % growth)	22.4	29.4	36.7	8.7	7.9	8.1	7.8
Loans (% GDP)	34.2	39.9	50.4	51.9	53.1	53.2	53.6
Mortgage loans (yoy % growth)	55.0	49.9	64.4	11.5	18.9	11.4	11.5
Mortgage loans (% GDP)	7.4	10.0	15.2	16.1	18.1	18.7	19.5
Loans denominated / indexed in FX (% Total loans)	26.0	23.4	32.5	30.4	–	–	–
Deposits (yoy % growth)	14.0	14.4	20.5	10.1	9.4	8.8	8.2
Deposits (% GDP)	41.0	42.3	47.1	49.1	51.0	51.4	52.0
Loan-to-deposits ratio	83.4	94.4	107.1	105.7	104.2	103.5	103.2
External Liabilities (in % total liabilities)	8.7	12.2	19.3	16.9	–	–	–
Cost-to-Income ratio (%)	59.2	56.6	55.1	54.7	51.9	50.2	49.0
Revenues / Average Volumes (%)	4.5	4.4	4.0	3.7	3.6	3.5	3.5
Return on assets (%)	1.8	2.0	1.5	1.0	1.1	1.3	1.4
Impaired loans ratio (in % gross loans)	6.8	4.9	4.2	7.0	8.9	8.0	7.3
Cost of risk (in % ∅ gross loans)	48 bp	41 bp	96 bp	179 bp	165 bp	147 bp	130 bp

Slovakia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	8.5	10.5	5.8	–4.8	3.9	3.1	4.5
CPI, avg	4.5	2.8	4.6	1.6	1.0	4.1	3.7
Loans (yoy % growth)	20.0	23.9	15.3	0.6	4.9	7.6	8.2
Loans (% GDP)	40.3	44.6	47.3	50.6	50.6	51.0	51.2
Mortgage loans (yoy % growth)	30.8	30.0	25.9	10.8	16.0	14.8	13.8
Mortgage loans (% GDP)	9.2	10.7	12.4	14.6	16.2	17.4	18.4
Loans denominated / indexed in FX (% Total loans)	1.2	1.3	1.2	1.0	–	–	–
Deposits (yoy % growth)	12.2	13.7	15.4	–8.9	2.9	4.3	6.2
Deposits (% GDP)	56.0	57.0	60.4	58.5	57.4	56.1	55.3
Loan-to-deposits ratio	71.9	78.4	78.3	86.4	88.1	90.9	92.6
External Liabilities (in % total liabilities)	5.3	4.9	6.1	4.0	–	–	–
Cost-to-Income ratio (%)	56.0	56.3	53.3	56.3	54.4	53.8	53.6
Revenues / Average Volumes (%)	3.4	3.2	3.2	3.0	2.9	2.9	2.9
Return on assets (%)	1.5	1.2	1.0	0.7	0.8	0.9	0.9
Impaired loans ratio (in % gross loans)	3.3	2.5	3.2	5.5	6.5	6.2	6.0
Cost of risk (in % ∅ gross loans)	43 bp	27 bp	111 bp	128 bp	109 bp	101 bp	93 bp

Slovenia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	5.9	6.9	3.7	–8.1	1.2	2.5	2.8
CPI, avg	2.5	3.6	5.7	0.9	1.9	2.4	2.9
Loans (yoy % growth)	25.2	32.3	18.1	2.8	4.1	6.3	6.8
Loans (% GDP)	65.0	77.3	84.6	91.7	92.5	93.8	94.8
Mortgage loans (yoy % growth)	43.0	36.4	27.2	9.0	10.5	–	–
Mortgage loans (% GDP)	6.3	7.7	9.1	10.5	11.2	–	–
Loans denominated / indexed in FX (% Total loans)	63.1	7.2	7.5	5.8	–	–	–
Deposits (yoy % growth)	9.5	8.4	7.5	14.4	–0.1	5.5	6.1
Deposits (% GDP)	56.3	54.8	54.5	65.8	63.8	64.1	64.4
Loan-to-deposits ratio	115.6	141.1	155.0	139.3	145.1	146.3	147.3
External Liabilities (in % total liabilities)	31.7	37.3	36.5	31.2	–	–	–
Cost-to-Income ratio (%)	58.1	53.0	57.6	53.7	50.7	50.1	49.9
Revenues / Average Volumes (%)	3.2	3.1	2.6	2.5	2.6	2.5	2.4
Return on assets (%)	1.1	1.2	0.7	0.3	0.2	0.3	0.5
Impaired loans ratio (in % gross loans)	4.1	3.2	2.8	4.8	6.0	5.8	5.4
Cost of risk (in % ∅ gross loans)	68 bp	68 bp	83 bp	155 bp	178 bp	164 bp	135 bp

Baltics

Estonia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	10.0	7.2	–3.6	–14.1	2.4	3.9	4.0
CPI, avg	4.4	6.6	10.4	–0.1	2.2	2.4	2.5
Loans (yoy % growth)	41.6	33.3	7.9	–4.8	–4.0	3.5	4.6
Loans (% GDP)	83.5	94.2	98.8	110.2	102.1	100.4	99.4
Mortgage loans (yoy % growth)	63.4	31.5	10.4	–1.6	–	–	–
Mortgage loans (% GDP)	32.3	36.0	38.6	44.5	–	–	–
Loans denominated/indexed in FX (% Total loans)	78.1	79.2	85.2	87.3	–	–	–
Deposits (yoy % growth)	28.0	13.8	6.0	5.9	2.1	4.5	5.0
Deposits (% GDP)	50.0	48.1	49.6	61.5	60.6	60.1	59.8
Loan-to-deposits ratio	167.1	195.7	199.3	179.3	168.6	166.9	166.3
External Liabilities (in % total liabilities)	47.4	52.9	54.1	52.2	–	–	–
Cost-to-Income ratio (%)	44.4	33.9	42.8	51.7	47.5	48.9	48.0
Revenues/Average Volumes (%)	2.6	3.5	2.8	2.1	2.3	2.1	2.1
Return on assets (%)	1.6	2.4	1.2	–2.8	0.3	0.6	0.7
Impaired loans ratio (in % gross loans)	0.3	0.7	2.9	6.5	8.0	7.8	7.5
Cost of risk (in % ∅ gross loans)	15 bp	28 bp	84 bp	527 bp	144 bp	86 bp	79 bp

Latvia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	12.2	10.0	–4.6	–18.0	–0.9	3.9	4.0
CPI, avg	6.5	10.1	15.5	3.6	–1.4	1.4	2.2
Loans (yoy % growth)	57.3	34.0	12.4	–7.3	–6.0	4.0	4.7
Loans (% GDP)	86.9	88.5	91.1	104.5	101.6	100.8	99.8
Mortgage loans (yoy % growth)	86.4	44.5	7.3	–4.5	–	–	–
Mortgage loans (% GDP)	28.9	31.7	31.2	36.9	–	–	–
Loans denominated/indexed in FX (% Total loans)	76.9	86.3	88.4	92.1	–	–	–
Deposits (yoy % growth)	43.1	17.2	8.7	–0.9	9.5	4.0	5.0
Deposits (% GDP)	41.6	37.1	36.9	45.3	51.3	50.9	50.5
Loan-to-deposits ratio	208.7	238.6	246.6	230.7	198.0	198.0	197.5
External Liabilities (in % total liabilities)	54.7	59.2	57.5	52.5	–	–	–
Cost-to-Income ratio (%)	47.6	45.5	51.7	57.2	69.1	58.3	54.6
Revenues/Average Volumes (%)	4.2	4.5	4.1	3.4	2.6	2.6	2.7
Return on assets (%)	1.9	2.0	0.4	–4.1	–2.7	0.0	0.2
Impaired loans ratio (in % gross loans)	1.0	0.7	3.6	16.4	22.5	23.5	21.0
Cost of risk (in % ∅ gross loans)	18 bp	25 bp	225 bp	821 bp	528 bp	172 bp	164 bp

Lithuania

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	7.8	8.9	2.8	–15.0	0.9	3.7	3.6
CPI, avg	3.7	5.7	11.0	4.5	1.0	1.9	2.2
Loans (yoy % growth)	38.1	42.9	19.1	–8.8	–3.0	3.5	4.3
Loans (% GDP)	50.5	60.8	64.0	70.2	67.2	66.1	65.2
Mortgage loans (yoy % growth)	60.2	61.8	24.9	24.3	–	–	–
Mortgage loans (% GDP)	12.5	17.1	18.8	22.5	–	–	–
Loans denominated/indexed in FX (% Total loans)	52.1	54.8	64.0	72.4	–	–	–
Deposits (yoy % growth)	23.2	23.4	–1.3	8.2	6.5	5.1	4.4
Deposits (% GDP)	36.1	37.5	32.7	42.6	44.7	44.7	44.1
Loan-to-deposits ratio	139.9	162.2	195.7	164.9	150.2	147.9	147.7
External Liabilities (in % total liabilities)	35.9	39.7	45.9	39.8	–	–	–
Cost-to-Income ratio (%)	49.3	43.2	45.8	53.1	54.9	54.0	53.4
Revenues/Average Volumes (%)	2.4	2.7	2.0	2.1	2.0	2.0	2.0
Return on assets (%)	1.3	1.7	1.1	–4.5	–0.5	0.1	0.4
Impaired loans ratio (in % gross loans)	1.0	1.0	4.6	19.3	19.0	18.5	17.0
Cost of risk (in % ∅ gross loans)	28 bp	17 bp	20 bp	746 bp	219 bp	133 bp	105 bp

South-Eastern Europe

Bulgaria

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.5	6.4	6.2	–4.9	0.1	2.8	3.5
CPI, avg	7.3	8.4	12.4	2.8	2.4	3.2	3.3
Loans (yoy % growth)	24.3	63.6	32.9	3.9	1.1	4.1	6.4
Loans (% GDP)	43.8	61.6	71.1	74.7	73.7	72.4	72.1
Mortgage loans (yoy % growth)	81.9	71.8	38.6	3.1	3.1	8.9	10.8
Mortgage loans (% GDP)	7.1	10.5	12.6	13.2	13.2	13.6	14.1
Loans denominated/indexed in FX (% Total loans)	45.0	50.0	56.7	58.2	–	–	–
Deposits (yoy % growth)	33.8	35.0	8.8	3.3	6.5	6.6	7.6
Deposits (% GDP)	52.6	61.1	57.7	60.3	62.6	63.0	63.5
Loan-to-deposits ratio	83.2	100.8	123.2	123.9	117.7	114.9	113.7
External Liabilities (in % total liabilities)	15.2	19.8	25.7	23.1	–	–	–
Cost-to-Income ratio (%)	54.9	47.4	50.0	50.3	49.1	48.5	48.0
Revenues/Average Volumes (%)	4.7	4.2	4.2	4.1	4.0	3.9	3.8
Return on assets (%)	2.2	2.1	2.2	1.2	0.9	1.0	1.3
Impaired loans ratio (in % gross loans)	3.0	2.5	3.2	6.2	12.5	14.0	12.9
Cost of risk (in % ∅ gross loans)	56 bp	120 bp	75 bp	205 bp	257 bp	241 bp	195 bp

Bosnia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.7	6.8	5.4	–2.9	0.5	1.8	2.5
CPI, avg	6.1	1.5	7.4	–0.4	2.1	2.1	2.6
Loans (yoy % growth)	23.2	28.4	22.1	–3.1	3.7	5.4	7.2
Loans (% GDP)	48.5	54.7	58.9	58.7	59.3	60.2	61.4
Mortgage loans (yoy % growth)	–	–	–	–	–	–	–
Mortgage loans (% GDP)	–	–	–	–	–	–	–
Loans denominated/indexed in FX (% Total loans)	76.4	77.2	74.4	73.9	–	–	–
Deposits (yoy % growth)	27.9	37.5	–1.4	2.1	6.5	6.0	6.2
Deposits (% GDP)	45.9	55.5	48.2	50.7	52.6	53.7	54.2
Loan-to-deposits ratio	105.6	98.7	122.1	115.8	112.8	112.2	113.3
External Liabilities (in % total liabilities)	27.4	26.4	30.0	27.8	–	–	–
Cost-to-Income ratio (%)	63.7	62.3	69.9	67.6	67.7	65.3	64.1
Revenues/Average Volumes (%)	5.0	4.6	4.4	4.4	4.1	4.1	4.1
Return on assets (%)	0.8	0.8	0.5	0.1	–0.5	0.0	0.6
Impaired loans ratio (in % gross loans)	3.3	2.5	2.6	5.3	5.8	4.9	3.8
Cost of risk (in % ∅ gross loans)	246 bp	237 bp	181 bp	239 bp	327 bp	277 bp	202 bp

Croatia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	4.7	5.5	2.4	−5.8	−1.5	1.6	2.0
CPI, avg	3.2	2.9	6.1	2.4	1.0	2.3	2.8
Loans (yoy % growth)	22.5	13.4	14.6	2.2	5.8	5.6	6.6
Loans (% GDP)	66.3	68.5	72.1	75.7	80.5	81.8	83.2
Mortgage loans (yoy % growth)	33.3	22.9	15.7	1.3	4.4	4.1	6.1
Mortgage loans (% GDP)	14.3	16.0	17.0	17.7	18.6	18.6	18.8
Loans denominated/indexed in FX (% Total loans)	71.8	62.3	65.8	72.5	–	–	–
Deposits (yoy % growth)	16.7	16.5	6.3	−0.1	5.2	4.0	5.2
Deposits (% GDP)	57.8	61.3	59.8	61.4	65.0	65.0	65.3
Loan-to-deposits ratio	114.7	111.7	120.4	123.2	123.9	125.8	127.5
External Liabilities (in % total liabilities)	25.4	19.4	20.8	21.6	–	–	–
Cost-to-Income ratio (%)	59.4	56.0	56.1	52.6	53.9	53.8	53.6
Revenues/Average Volumes (%)	3.4	3.4	3.5	3.6	3.3	3.3	3.2
Return on assets (%)	1.4	1.5	1.6	1.2	0.9	0.9	1.0
Impaired loans ratio (in % gross loans)	3.2	3.1	3.3	5.3	10.0	9.5	8.5
Cost of risk (in % ∅ gross loans)	39 bp	48 bp	48 bp	139 bp	157 bp	144 bp	128 bp

Romania

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	7.9	6.2	7.1	−7.1	−2.5	1.7	3.4
CPI, avg	6.6	4.8	7.9	5.6	6.1	6.1	3.7
Loans (yoy % growth)	54.7	60.8	34.6	3.4	3.8	7.0	10.5
Loans (% GDP)	27.4	36.8	40.5	43.0	43.7	43.8	44.8
Mortgage loans (yoy % growth)	55.9	71.8	57.2	9.1	18.8	16.8	17.8
Mortgage loans (% GDP)	2.4	3.5	4.5	5.0	5.9	6.4	7.0
Loans denominated/indexed in FX (% Total loans)	46.3	53.0	56.0	56.9	–	–	–
Deposits (yoy % growth)	28.1	33.9	18.7	8.3	1.3	5.0	10.5
Deposits (% GDP)	29.5	33.0	32.1	35.7	35.4	34.8	35.6
Loan-to-deposits ratio	92.7	111.3	126.2	120.5	123.4	125.9	125.8
External Liabilities (in % total liabilities)	22.5	28.2	30.6	26.2	–	–	–
Cost-to-Income ratio (%)	62.8	59.7	51.5	52.6	49.6	51.0	50.2
Revenues/Average Volumes (%)	4.9	4.6	5.3	4.8	4.9	4.7	4.5
Return on assets (%)	1.5	1.2	1.6	0.3	−0.1	0.3	0.7
Impaired loans ratio (in % gross loans)	2.7	3.9	6.3	14.8	21.0	18.1	14.0
Cost of risk (in % ∅ gross loans)	123 bp	180 bp	231 bp	366 bp	465 bp	370 bp	304 bp

Serbia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	5.2	6.9	5.5	−3.1	1.8	2.7	3.5
CPI, avg	12.7	6.5	11.7	8.4	6.3	9.4	6.7
Loans (yoy % growth)	15.0	36.4	34.8	24.8	27.5	15.3	7.9
Loans (% GDP)	31.2	36.3	41.4	50.0	58.9	60.6	59.4
Mortgage loans (yoy % growth)	–	–	–	–	–	–	–
Mortgage loans (% GDP)	–	–	–	–	–	–	–
Loans denominated/indexed in FX (% Total loans)	–	–	68.3	67.9	–	–	–
Deposits (yoy % growth)	40.6	46.3	7.7	23.1	14.5	14.2	5.1
Deposits (% GDP)	29.1	36.3	33.1	39.4	41.7	42.5	40.5
Loan-to-deposits ratio	107.2	99.9	125.1	126.9	141.4	142.7	146.5
External Liabilities (in % total liabilities)	24.2	17.9	18.2	21.4	–	–	–
Cost-to-Income ratio (%)	43.5	46.7	55.9	47.1	46.1	44.6	42.9
Revenues/Average Volumes (%)	12.5	9.3	7.7	7.9	6.8	6.3	6.4
Return on assets (%)	1.3	1.4	1.8	0.9	1.0	1.1	1.2
Impaired loans ratio (in % gross loans)	4.1	3.8	11.3	15.7	20.0	18.5	16.2
Cost of risk (in % ∅ gross loans)	1081 bp	844 bp	1059 bp	1114 bp	859 bp	715 bp	643 bp

Other CEE countries (CIS and Turkey)

Kazakhstan

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	10.7	8.9	3.3	1.2	6.0	5.3	5.5
CPI, avg	8.6	10.8	17.2	7.3	7.1	7.2	7.1
Loans (yoy % growth)	85.6	50.5	5.5	5.3	8.0	8.4	11.3
Loans (% GDP)	49.6	59.8	50.6	53.4	47.0	44.6	43.8
Mortgage loans (yoy % growth)	–	–	–	–	–	–	–
Mortgage loans (% GDP)	–	–	–	–	–	–	–
Loans denominated/indexed in FX (% Total loans)	48.4	42.7	44.2	48.4	–	–	–
Deposits (yoy % growth)	87.1	24.9	19.9	26.9	28.2	15.6	14.7
Deposits (% GDP)	30.0	30.0	28.8	36.6	38.3	38.8	39.2
Loan-to-deposits ratio	165.5	199.4	175.6	145.7	122.7	115.1	111.6
External Liabilities (in % total liabilities)	46.0	46.0	37.1	28.9	–	–	–
Cost-to-Income ratio (%)	31.4	29.5	29.0	57.9	7.7	30.6	27.7
Revenues/Average Volumes (%)	5.2	6.3	6.3	2.4	13.3	2.9	3.1
Return on assets (%)	1.5	2.2	0.3	–19.4	15.0	0.4	1.0
Impaired loans ratio (in % gross loans)	2.6	6.6	10.8	28.7	33.5	34.0	33.5
Cost of risk (in % ∅ gross loans)	402 bp	389 bp	674 bp	3592 bp	–446 bp	314 bp	250 bp

Russia

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	8.2	8.5	5.2	–7.9	3.4	4.3	4.1
CPI, avg	9.7	9.0	14.1	11.7	6.8	9.1	7.5
Loans (yoy % growth)	46.5	51.9	34.3	–2.6	10.3	14.7	15.8
Loans (% GDP)	29.6	36.6	39.2	40.5	37.6	39.1	41.9
Mortgage loans (yoy % growth)	182.4	113.8	58.2	0.1	4.1	10.5	15.1
Mortgage loans (% GDP)	1.4	2.5	3.1	3.3	2.9	2.9	3.1
Loans denominated/indexed in FX (% Total loans)	24.5	22.7	24.7	23.7	–	–	–
Deposits (yoy % growth)	41.4	41.5	20.2	20.6	16.4	13.7	13.9
Deposits (% GDP)	27.8	31.9	30.6	39.2	38.4	39.6	41.7
Loan-to-deposits ratio	106.7	114.6	128.0	103.4	97.9	98.8	100.4
External Liabilities (in % total liabilities)	19.5	20.4	17.9	13.4	–	–	–
Cost-to-Income ratio (%)	47.7	48.5	49.5	42.1	49.2	53.7	54.3
Revenues/Average Volumes (%)	6.1	5.6	5.9	6.4	5.5	4.9	4.6
Return on assets (%)	2.6	2.5	1.5	0.7	1.5	1.4	1.3
Impaired loans ratio (in % gross loans)	10.0	9.5	12.7	18.7	20.0	18.5	17.3
Cost of risk (in % ∅ gross loans)	188 bp	159 bp	318 bp	600 bp	291 bp	219 bp	197 bp

Turkey

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	6.9	4.7	0.7	–4.7	7.4	4.1	5.1
CPI, avg	9.6	8.8	10.5	6.3	8.6	5.8	6.9
Loans (yoy % growth)	40.4	26.4	29.6	6.0	24.3	23.2	23.6
Loans (% GDP)	28.3	32.2	37.1	39.1	41.7	46.7	51.3
Mortgage loans (yoy % growth)	79.3	39.1	21.5	13.7	29.4	27.9	23.8
Mortgage loans (% GDP)	3.0	3.8	4.1	4.6	5.1	5.9	6.6
Loans denominated / indexed in FX (% Total loans)	31.5	30.1	34.8	32.1	–	–	–
Deposits (yoy % growth)	22.1	14.6	26.9	13.0	16.0	17.1	18.4
Deposits (% GDP)	39.1	40.3	45.4	51.1	50.9	54.1	57.0
Loan-to-deposits ratio	72.4	79.9	81.6	76.5	82.0	86.3	90.0
External Liabilities (in % total liabilities)	12.0	10.2	11.7	9.7	–	–	–
Cost-to-Income ratio (%)	50.8	49.2	52.3	42.9	44.9	46.3	44.7
Revenues / Average Volumes (%)	6.7	6.8	5.9	7.0	5.8	5.2	4.8
Return on assets (%)	2.9	3.1	2.2	3.0	2.8	2.4	2.4
Impaired loans ratio (in % gross loans)	3.6	3.5	3.5	5.2	4.3	4.1	3.9
Cost of risk (in % ∅ gross loans)	148 bp	144 bp	198 bp	277 bp	162 bp	145 bp	142 bp

Ukraine

	2006	2007	2008	2009	2010	2011	2012
Real GDP (yoy % growth)	7.1	7.6	2.1	–15.1	4.0	5.0	5.0
CPI, avg	9.1	12.8	25.2	16.0	9.4	11.0	10.4
Loans (yoy % growth)	71.0	74.1	72.0	–1.5	1.8	6.7	9.8
Loans (% GDP)	45.6	59.9	77.2	79.1	65.7	59.0	53.9
Mortgage loans (yoy % growth)	195.9	127.2	92.2	10.2	–	–	–
Mortgage loans (% GDP)	3.8	6.5	9.4	10.8	–	–	–
Loans denominated / indexed in FX (% Total loans)	49.5	49.9	59.1	50.8	–	–	–
Deposits (yoy % growth)	38.0	52.7	26.7	–6.9	21.9	14.4	15.0
Deposits (% GDP)	34.6	39.8	37.8	36.6	36.4	35.1	33.5
Loan-to-deposits ratio	131.9	150.4	204.0	215.9	180.3	168.2	160.6
External Liabilities (in % total liabilities)	18.3	23.3	29.2	23.4	–	–	–
Cost-to-Income ratio (%)	57.9	57.7	50.1	61.1	59.0	61.2	59.3
Revenues / Average Volumes (%)	5.6	5.4	6.4	6.2	5.6	5.2	5.2
Return on assets (%)	1.7	1.5	1.1	–4.5	–1.5	–0.4	0.6
Impaired loans ratio (in % gross loans)	5.8	5.7	17.0	30.0	40.0	34.0	25.0
Cost of risk (in % ∅ gross loans)	236 bp	216 bp	416 bp	887 bp	546 bp	378 bp	281 bp

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