UniCredit CEE Strategic Analysis

CEE Banking Outlook

January 2012

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CEE Banking Outlook

Banking in CEE: the new 'normal'

Executive Summary

CEE remains a key "engine of growth" for UniCredit Group, which is underlined by our strong commitment to the region. Our approach considers, however, that in a high-growth area such as Central and Eastern Europe the banking business has profoundly changed and any strategy needs to be reassessed in light of the major transformations we face. Overall, we maintain a positive view of the region's performance in the coming years. Western European banks' deleveraging represents a clear downside risk with some countries more exposed than others, but according to our baseline scenario, this remains a manageable drag.

Economic growth will likely be structurally lower and growth differentials within the region much wider than in the past. CEE should remain a region of two halves with larger economies (e.g. Turkey, Russia and Poland) likely to keep growing almost at full steam whereas others (especially in SEE) may suffer from their structural weaknesses and high correlation with the performance of peripheral Europe. Overall, the long-term outlook for regional convergence remains intact but CEE countries should pursue it through broader economic diversification and an increasing role for tradable sectors. Bank lending will play a crucial role and should support this switch.

We still see potential for the CEE banking sector to generate above-EU average growth in banking volumes and profitability, as the penetration gap still exists, although there remain large divergences among segments and countries. Mortgages and corporates remain the most attractive segments, while country-wise we expect Russia and Turkey to contribute the most in terms of lending growth. These remain large markets which are still relatively underpenetrated. Overall, lending activity should converge toward a lower growth rate path compared to the pre-crisis period, but remain in the low double-digits. Under the new 'normal' a more balanced funding structure should also prevail, particularly in countries featuring high funding gaps. Bank margins also should progressively shrink in the wake of much harsher competition for deposits. The top line will thus need to be supported by stronger fee generation (to make the overall relationship with the customer more profitable) and the dynamic in gross operating profit will have to be underpinned by much stricter cost control than in the past.

Asset quality will be the other strategic focus of international and local players who aim to maintain a sound level of profitability. The typical emerging market strategy of banks pursuing strong volumes growth to generate flooding revenues (and at the same time accepting a rising cost of risk) will no longer be viable in the context of slower volumes growth, scarce liquidity (accompanied by a strong regulatory push in favor of funding in local currency) and stricter regulation. In such an environment, a solid funding base and strong capital position will remain key competitive advantages.

We hope you enjoy reading this publication and find it useful.

Yours sincerely,

Gianni Franco Papa
Head of CEE Division and UniCredit Bank Austria Deputy CEO

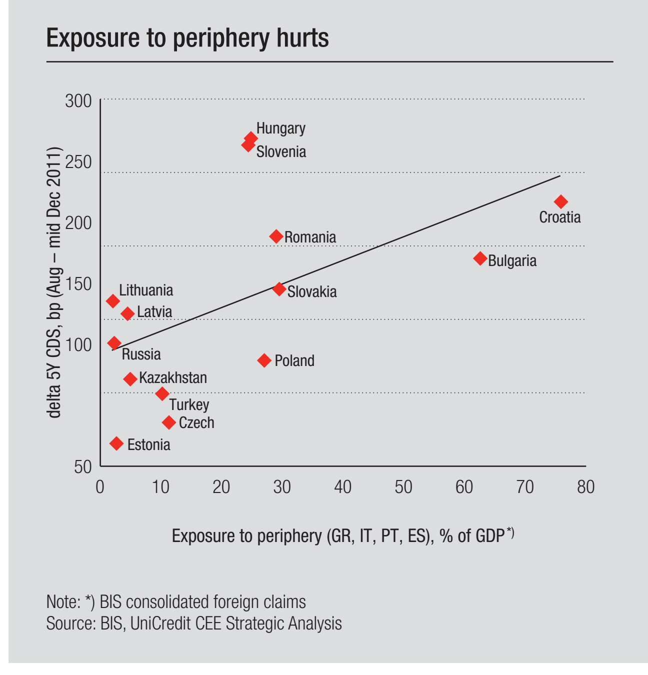
Economic Framework

CEE: a region of two halves

European jitters are dampening near term growth prospects for CEE countries. The region remains to some extent linked to the EMU export cycle, given its importance as an intermediate goods producer in the supply chain. As in 2008, countries more exposed to trade (Czech, Hungary and Slovakia) are also likely to be those more affected by external shocks. The slowdown of the export cycle in 2H 2011 underscores the more challenging external environment, with the boost from trade during 2H 2009–1H 2011 slowly dissipating. If maintained, this slowdown represents a risk factor, especially given the concentration of some industries (e.g. automotive) more exposed to fluctuations in external demand, with slower exports having the potential to act as a drag on domestic demand through higher unemployment and lower investment (both of which have still not fully recovered to pre-crisis levels in the CEE region).

The positive news is that compared with 2008, CEE is not in the eye of the storm, with end of year data continuing to show gains. Looking at industrial production data in November, we see a slowdown in comparison to 1H 2011, but no collapse. Some economies have come to a standstill – Turkey (–2.8 %), Bulgaria (–0.4 %), Russia (+0.1 %) mom seasonally adjusted, while others continued to post decent gains – Kazakhstan (+1.2 %), Poland (+1.6 %), Czech (+2.7 %) and Hungary (+4.2 %) mom seasonally adjusted. We are seeing a similar message from the PMI numbers, where the index has moved below 50 in Czech and Poland but continued to be in expansionary territory in Russia and Turkey, although there has been some disconnectedness between PMI and the real economy in recent months. Looking at retail sales, we are also seeing some differentiation with mom gains seen in Romania (2 %), Poland (4.1 %) and Kazakhstan (4 %) in October/November and a halt in Bulgaria (–0.8 %), Hungary (0 %) and Russia (–0.3 %) mom. We reckon that

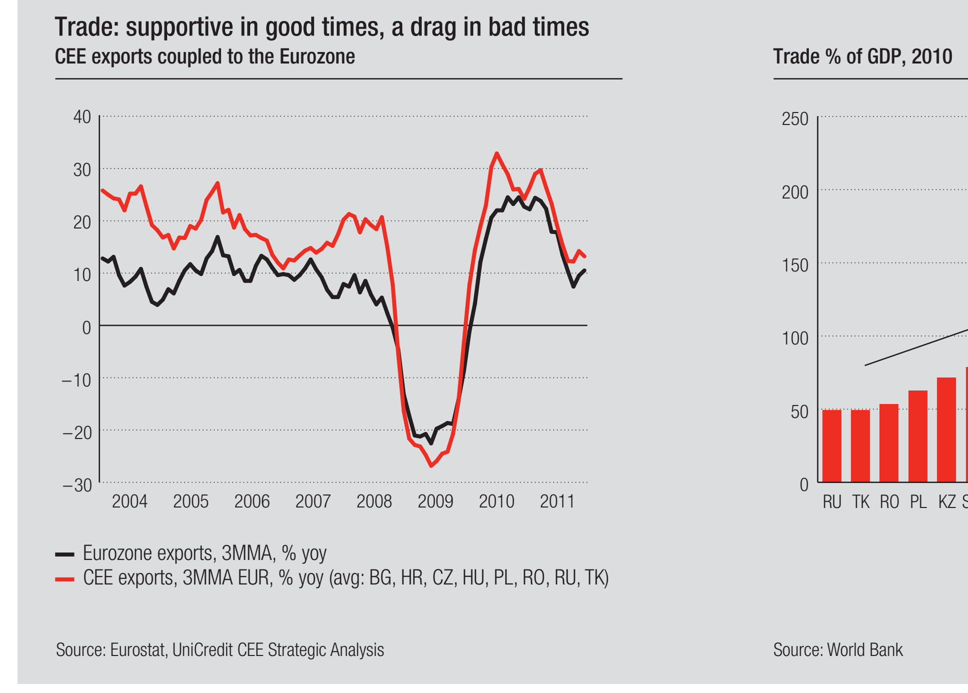
Exposure to periphery hurts



Note: *) BIS consolidated foreign claims
Source: BIS, UniCredit CEE Strategic Analysis

Trade: supportive in good times, a drag in bad times
CEE exports coupled to the Eurozone

Trade % of GDP, 2010



Source: Eurostat, UniCredit CEE Strategic Analysis

Source: World Bank

it is inevitable that some pass-through effect from a risk off environment will continue to weigh on economic performance in the months ahead. But we still see CEE well placed to withstand pressures, as premia widening in the CEE has been concentrated on a number of countries, in particular in Ukraine (a change of +388 bp in 2H 2011), Slovenia (+287 bp), Croatia (+272 bp), Slovakia (+195 bp) and Hungary (+356 bp), which stands in contrast to a stronger widening in Western Europe (Greece is up by 1,872 bp, Portugal by 357 bp and Italy 324 bp).

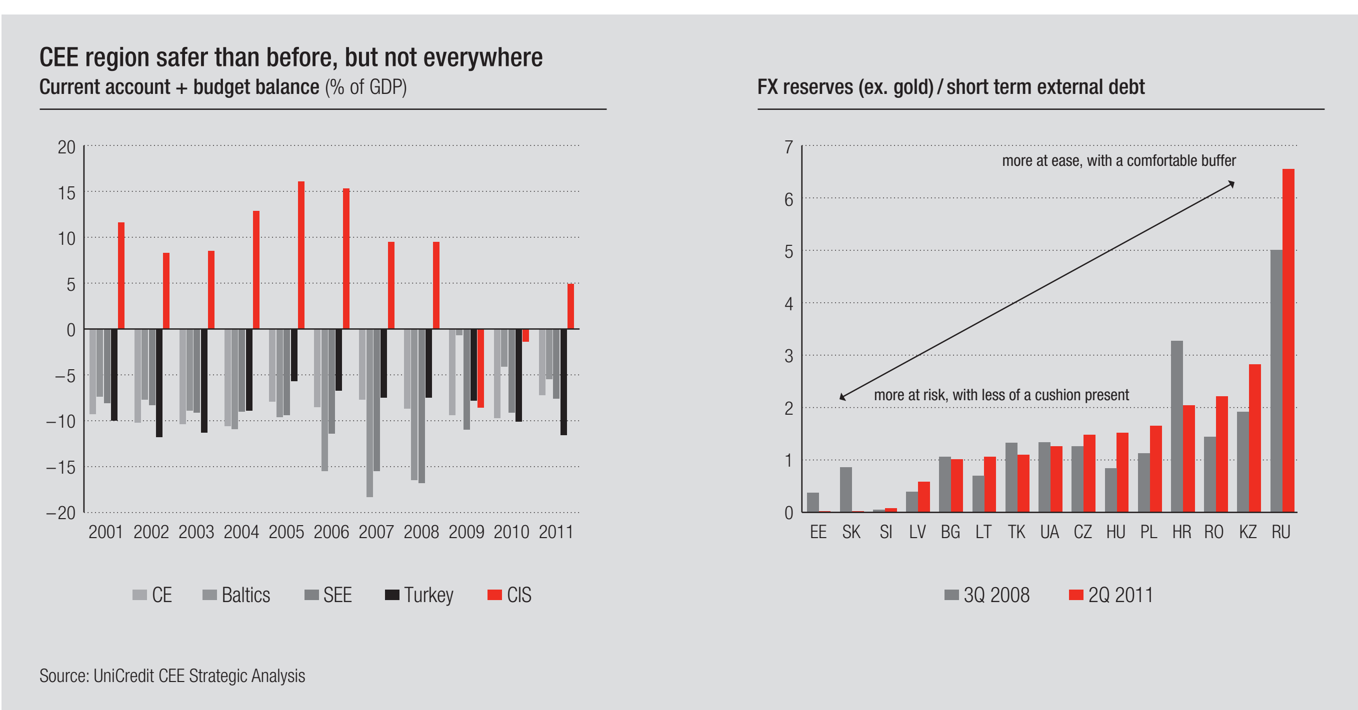
The ongoing deceleration in the global outlook should however continue to weigh on growth prospects for the region. Under these challenging and uncertain conditions, we see countries that are able to stimulate and maintain domestic demand as having the greatest potential to fare more smoothly than others in the coming quarters. From this perspective we single out the bigger economies in the region – Poland, Russia and Turkey, as being best placed on this metric, with policy makers having a greater degree of freedom to use fiscal stimulus and looser monetary conditions. However, a potential challenge from this perspective in 2012 is represented by the willingness of Western European banks to support the CEE region, as their need to replenish capital could act as a drag on lending activity and force some deleveraging. The process is likely to be non-uniform with the more leveraged economies being at greater risk from a reduction in funding availability.

During previous episodes of similar financial market volatility we saw a greater differentiation of growth performance in the region, something that we also anticipate in 2012. We see Hungary, Croatia and Romania, as well as Slovakia and Slovenia as being more exposed to downside economic risks, with a greater degree of moderation in headline figures also likely to be maintained in 2012.

On the other hand, Poland, Russia, Kazakhstan and Turkey ought to show a better performance. Balancing out these two forces, our forecast is one of a soft landing in 2012 with real GDP growth in the CEE region coming down to around 3 % yoy from above 4 % yoy estimated for 2011. In terms of sub-regions, some differentiation in performance should persist, with growth in SEE economies expected to remain lackluster in 2012 compared to Central Europe and particularly CIS countries.

Under such circumstances it is important to look at what is different now compared to September 2008. Private sectors in the region have undergone significant adjustment and are now running much smaller financial deficits, as proxied by private sector investment-savings gaps. This on balance decreases their funding needs from abroad, and increases resistance to any external shocks. Accordingly we have seen the largest post-2008 adjustment take place in the Baltics and SEE economies, and then a more moderate one in Central Europe (CE). Kazakhstan and Russia have continued to run a surplus, while Ukraine has decreased its shortfall and is now more on a par with the Central European economies. On the contrary the Turkish economy has continued to witness further deterioration from 2008 onward, with similar trends being observed also in the Czech Republic (on the back of a higher CA and budget deficit) – making them more prone to adverse shocks as a sudden adjustment in the availability of financing for the gap would force a greater adjustment in domestic demand.

Looking at a different metric (FX reserves relative to short-term debt) we have seen an improvement post-2008 in many of the CEE economies (Russia, Kazakhstan, Romania, Poland and Hungary all stand out as being more able to withstand shocks now than they were back in 2008). This gives the local policy makers a greater



Source: UniCredit CEE Strategic Analysis

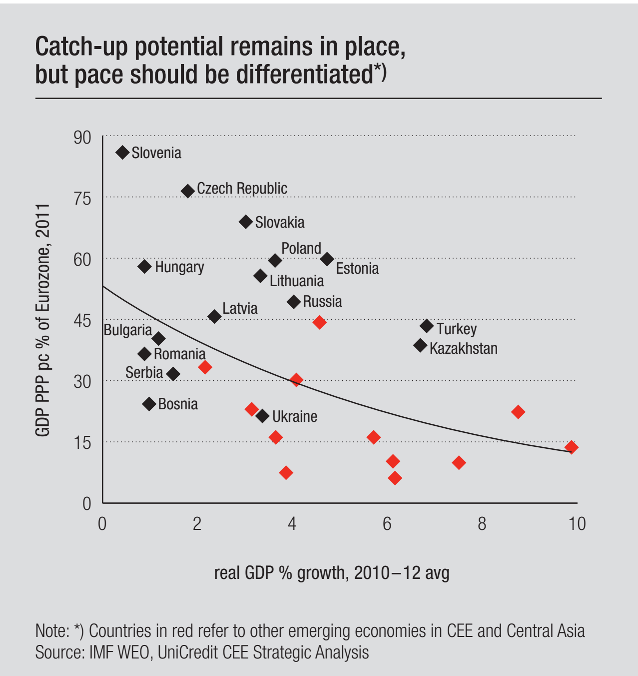
ability to plug financing shortfalls. It is noteworthy that this process has not been uniform and some countries (particularly Croatia and Turkey, and to a lesser degree Bulgaria and Ukraine) are now worse off than they were back in 2008.

Convergence, but not at breakneck speed and driven by tradable sectors

Despite the challenging times ahead, there are strong reasons to continue to believe in the CEE region. The geographical proximity to the Eurozone has made it a destination for many western companies over the past decade, with net FDI stocks standing close to 50 % of GDP on average for the region. A number of countries have particularly benefitted in terms of FDI inflows: Bulgaria (97 % of GDP), Czech (60 %), Hungary, Slovakia and Estonia (each 55 %), while others still have to catch up. Many firms have come to CEE for the long term and ought to continue to invest, given the benign labor cost environment (labor remains much cheaper when compared to that of Germany, although this is partly reflected by the productivity gap).

Over the medium term we should still see decent catch-up potential, underpinned by improving productivity and convergence of income levels, something that is echoed by our long-term GDP growth forecasts averaging above 4 % for the CEE region. We expect convergence prospects to remain broadly intact, although in the context of persisting cross-country differentiation. Part of this is related to the already wide differences in income levels present in the region, where Slovenia ranks as the richest member with 86 % of Eurozone GDP per capita, while Ukraine ranks last with a mere 21 %. Countries further away from income levels in the Eurozone are expected to witness faster GDP growth rates, while those that are closer will need to do more work, focusing on productivity and investment gains.

The long-term vision for regional convergence thus remains in place but CEE countries should pursue it through broader diversification of the economy and the increasing role of tradable sectors. Bank lending will play a crucial role and should support this switch. From this perspective we see a number of sectors as having the potential to outperform in the coming years (when compared to the pre-crisis performance), singling out agriculture, textiles, chemicals and utilities. On the other hand sectors that grew too fast pre-2008 should witness more moderate growth rates: real estate, banking, construction among others.

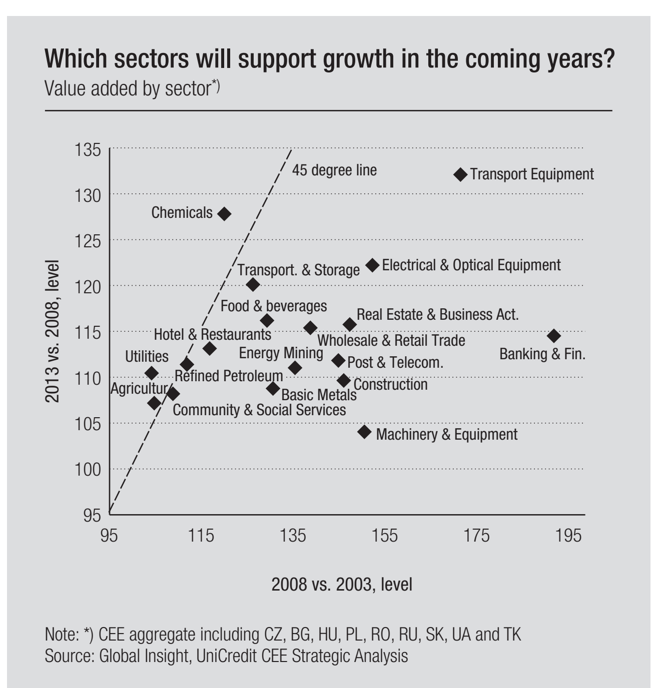


CEE is still attractive in terms of labour cost

Hourly labour costs, % of German costs (2009)

BG RO LT LV PL HU EE SK HR CZ SI

Source: Eurostat



Banking Framework

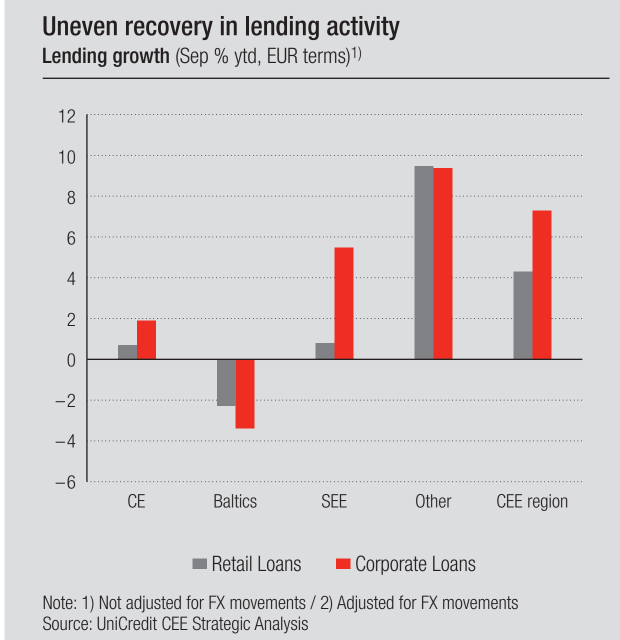
Funding and liquidity support remain crucial variables to monitor

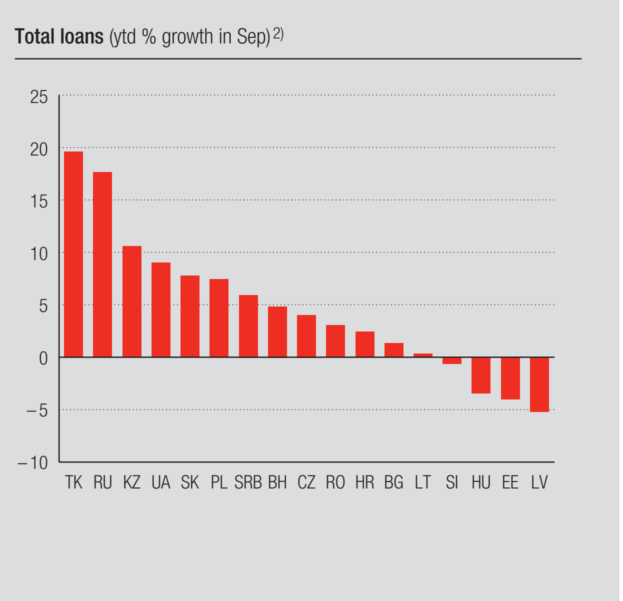
Lending activity continued to expand in the CEE region during 2011, although at a slower pace than in 2010 and with growth slowly dissipating in 2H on the back of continued turmoil in the financial markets and a rapidly deteriorating funding environment. Lending growth was driven by the corporate segment which profited from the cyclical recovery in the economy posted in 2010 and 1H 2011, while retail lending remained more subdued (when adjusting for the impact of FX movements) despite the observed improvement in household financial conditions and stronger consumer confidence. Within retail, the dynamic of loans for a house purchase was however more stable, supported by longer maturities and ongoing renegotiation activities.

Overall, CEE remained a region of two halves, with important cross-country differences related to lending markets developments still persisting. Russia and Turkey have outperformed substantially the rest of the region in 2011 with growth estimated to have reached 21 % and 31 %, respectively. The Balkan countries represent a clear exception as recovery in lending (particularly in retail) was delayed by high unemployment and the impact of inflation on the dynamic of real households' disposable income, while the Baltics continued to experience further deleveraging. Credit growth also remained subdued in Slovenia and Hungary, hampered by weak economic conditions and in the latter by regulation as well.

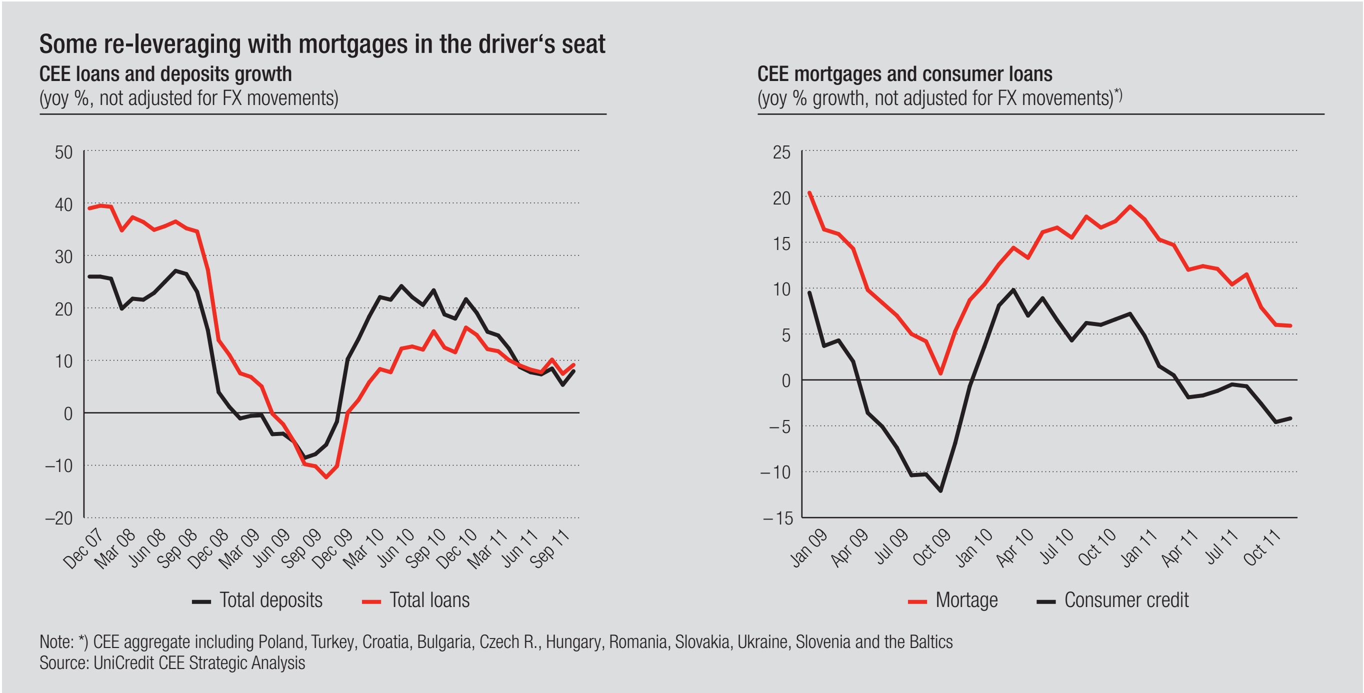
As pre-crisis loan-to-deposits mismatches in CEE proved unsustainable, banks started an intense competition to attract customer funds by offering higher interest rates. 2010 has thus witnessed quite impressive deposits growth, in the range of 21 % on average for the CEE region, with particularly strong dynamics in CIS countries and Turkey. This resulted in a substantial contraction in the average funding gap for the region, with the loan-to-deposits ratio trending south to reach 102 % in 2010 compared to 105 % observed in the previous year. At the beginning of 2011, following the restoration of better liquidity conditions and increasing evidence that competition for deposits was starting to be detrimental to banks' profitability, the focus on deposits became less acute with some re-leveraging taking place. In 2H 2011, however, banks reversed course, as liquidity substantially tightened on the back of the Euro-area debt crisis and the fight for deposits again became the name of the game.

Uneven recovery in lending activity





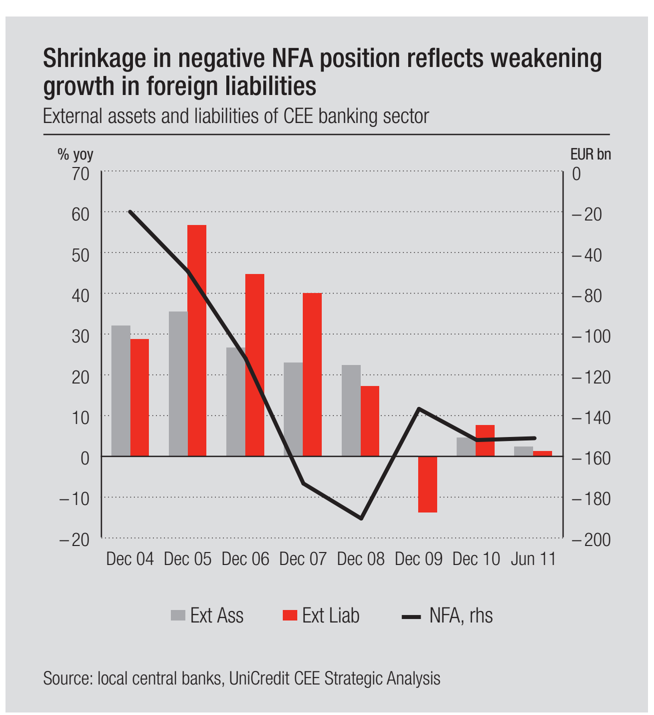
Note: 1) Not adjusted for FX movements / 2) Adjusted for FX movements
Source: UniCredit CEE Strategic Analysis



To some extent, tightening of liquidity came as a result of weaker funding inflows from abroad, compounded in some cases by restrictive central banks' policies in an attempt to stem local currencies weakening.

During the pre-crisis years, the net foreign assets (NFA) position of CEE banks moved substantially into negative territory. In 2009 NFA experienced a sharp correction as external funding dried up but again in 2010 returned to negative territory. However, this trend almost stopped in 2011 as tensions on European markets made it difficult for CEE banks to attract additional funding. During 2011, some CEE countries have seen growth in foreign assets of their banking sectors although, on a net basis, most of them remained recipients of funding. The only exceptions were Russia, Czech Republic and Kazakhstan. Russian banks have seen a sharp reversal last year from negative to positive NFA's position, which mainly reflects growing foreign assets. Kazakhstan has also switched from a negative to a slightly positive NFA, while Czech banks continued to be a net asset provider (maintaining the position held since many years). At the other extreme were Poland and Turkey, which saw their NFA position moving south during 2011 as a result of strong inflows in foreign refinancing. The majority of other countries had shrinking negative NFA positions.

In a few cases, local authorities even expressed concern that foreign banks may start to fund themselves by using their subsidiaries' liquidity as the funding cost for European banks surges. In the case of Russia, major banks with foreign capital increased their loans to non-residents by EUR 8 bn between January–October last year, but almost half of this increase took place in August–October. In other countries of the region banks have been substantially reducing their foreign liabilities, as their external debt repayment far outpaced their new external borrowing. Summing together bank and non-bank corporate borrowing offshore in Poland between July and September, net repayments stood at EUR 4.8 bn compared with an inflow exceeding EUR 1 bn over the same period last year. Hungary saw a repayment of foreign capital of EUR 1.7 bn over 3Q 2011, up from EUR 0.9 bn for the same period in the previous year. Ukraine saw rollover ratios on external bank debt collapse to almost zero in September, translating into a ytd outflow of USD 2.9 bn (of which USD 1.1 bn in September alone).



Despite the observed deterioration in funding conditions and pressures on the revenue side banking sector performance improved on a range of parameters. In particular, credit quality has generally stabilised on the back of recovery in lending and the improvement in macroeconomic conditions. The average impaired loans ratio for the region has not increased since year-end 2010, drifting to an estimated 14 % at the end of 2011. In the majority of CEE countries impaired loans ratios have peaked or stabilized by mid-2011. Aggregate numbers however conceal a rather heterogeneous picture. Clear exceptions are represented by Hungary, Croatia, Romania and Bulgaria where non-performing loans were still growing in 2011 as economic recovery lagged behind the rest of the region. Despite some signs of gradual stabilization, distressed assets also remained at a high level in countries such as Ukraine and Kazakhstan. In the latter, problematic loans have not yet peaked, particularly if loans "restructured" by simply extending maturities are taken into account.

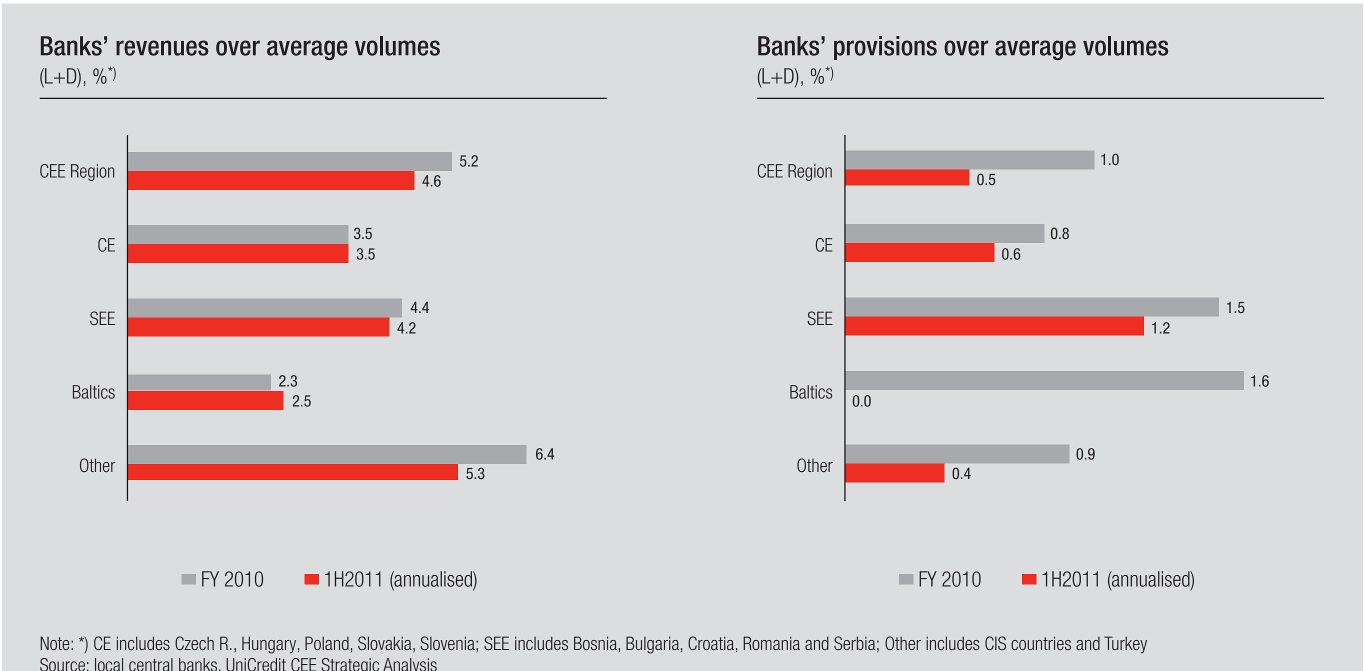
Improvements in asset quality were clearly reflected in a further contraction in the cost of risk, which proved to be supportive for banks' profitability both in 2010 and 1H 2011. Provisioning levels declined in all countries except Kazakhstan, with the strongest drop being recorded in the Baltics, Russia, Bosnia, Hungary and Ukraine. As a result, the share of provisions over average banking volumes halved in 2011 compared to 2010. Cost containment measures have also contributed to the bottom line.

By contrast, revenue generation capacity has somewhat weakened in 2011. The subdued lending growth combined with tighter regulatory requirements and increasing pressure on banks' margins were the main drags on the industry's revenue stream. The most pronounced decline was recorded in the 'other' cluster of countries, mainly due to falling net interest income in Turkey on the back of restrictive central bank policies and poor performance of non-interest income in Kazakhstan. Revenues have also been contracting in Hungary and Romania due to weak lending activity and a poor non-interest income performance (particularly in the case of Romania). All remaining countries saw growing revenues relative to 2010, with a strong rebound in the Baltics and in Ukraine driven by a significant recovery in the interest income component. On a net basis, profitability in 1H 2011 remained broadly in line with 2010 levels. The weaker performance in Kazakhstan, Russia and Turkey was partially offset by an acceleration in the rest of the

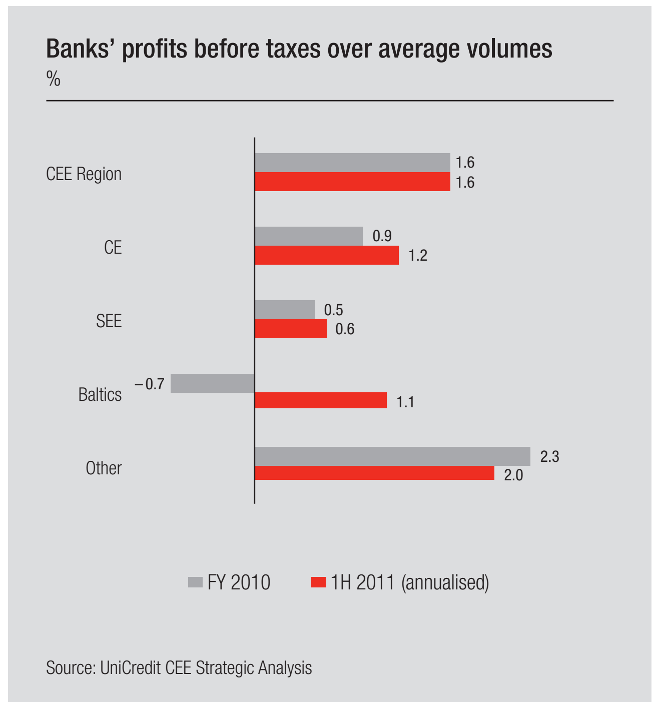
Impaired loans ratio (% of gross loans)

	Dec 10	Jun 11	Sep 11	Peak level between 2007 and 2011
Poland [1]	8.8	8.4	8.4	8.8
Ukraine [2]	11.2	10.9	10.1	11.6
Hungary	12.5	13.7	14.2	14.2
Czech R.	6.5	6.6	6.5	6.7
Croatia	11.2	11.9	12.2	12.2
Romania [3]	20.5	21.6	22.6	22.6
Bulgaria	11.9	13.5	14.5	14.5
Russia	18.8	19.3	17.8	19.4
Slovakia	6.0	5.8	5.9	6.4
Turkey	3.6	2.9	2.7	5.2
Kazakhstan [4]	32.3	32.0	33.5	33.6
Estonia	6.4	5.9	5.9	7.2
Latvia	19.0	18.4	18.0	19.4
Lithuania	19.7	18.4	17.8	19.7

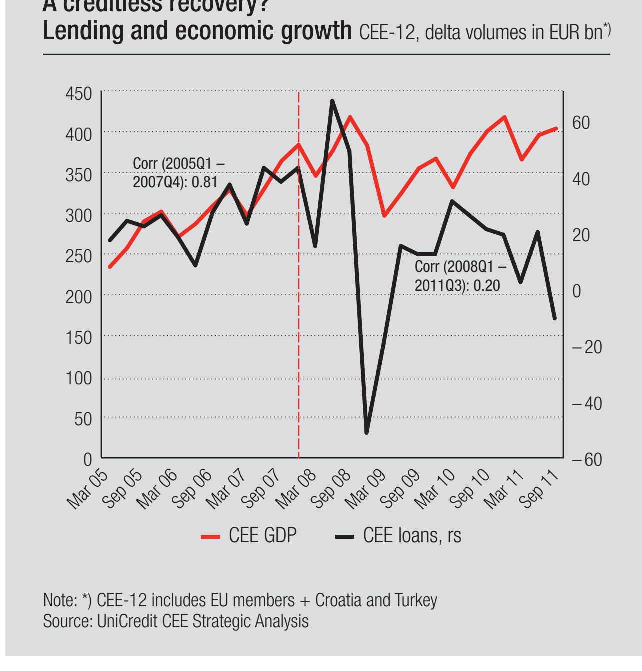
Note: 1) Including only retail and corporate; 2) Based on data officially reported by NBU; other estimates point to an impaired loans ratio of 40 % at the end of last year; 3) Doubtful and loss loans over non-governmental credit; 4) Non-performing assets
Source: local central banks, UniCredit CEE Strategic Analysis



Note: *) CE includes Czech R., Hungary, Poland, Slovakia, Slovenia; SEE includes Bosnia, Bulgaria, Croatia, Romania and Serbia; Other includes CIS countries and Turkey
Source: local central banks, UniCredit CEE Strategic Analysis



Source: UniCredit CEE Strategic Analysis



Note: *) CEE-12 includes EU members + Croatia and Turkey
Source: UniCredit CEE Strategic Analysis

CEE region. In particular, the Baltics have recorded a strong turnaround, boosted by both a recovery in revenues and a reduction in provisioning levels.

Creditless recoveries: how important is bank lending?

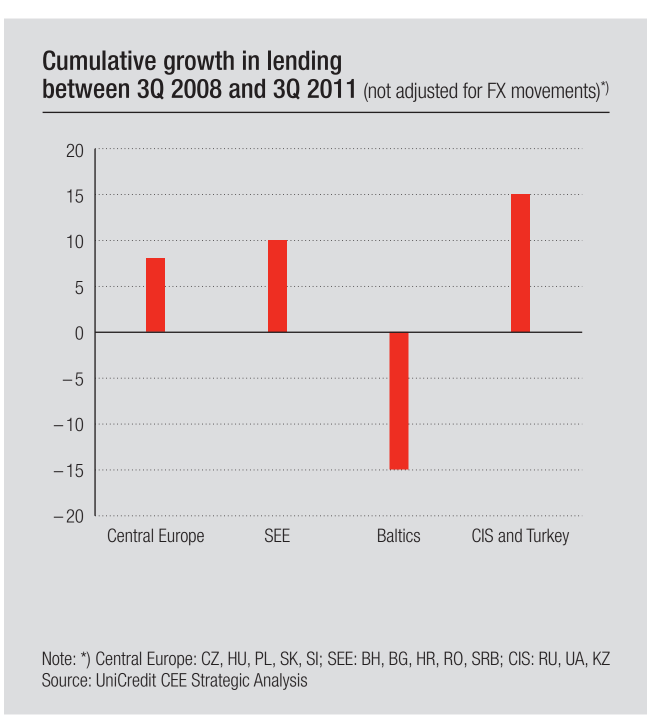
Even after the CEE region re-emerged from the most severe recession in the last decades, we have noticed (particularly in some countries) that growing output over the last couple of years was not accompanied by a recovery in lending activity. This is not surprising. Financial downturns tend to last longer than economic recessions. In particular, episodes of credit crunches and equity price busts generally last twice as long as recessions; house price busts last more than three times as long. When it comes to recessions associated with credit crunches, the real economy typically recovers while credit is still contracting. New credit may thus not be a necessary condition for output to recover.

As confirmed by the literature, creditless recoveries are not a rare event. According to the findings of a recent ECB paper*) based on a sample of low and middle income economies, one out of four recoveries in output occurs without a pick-up in lending activity. Evidence also suggests that creditless recoveries are typically preceded by large declines in economic activity and financial stress, particularly if private sector indebtedness is high and the country is reliant on foreign capital inflows.

In such a context, questions currently debated in CEE focus on how far lending could fall short and to what extent this could further hold back economic growth. Indeed, with growing evidence pointing to a decoupling between credit growth and the economic cycle, it becomes necessary to focus increasingly on the characteristics and the determinants of this phenomenon.

To shed light on this apparent paradox, we implemented a panel probit model to investigate the impact of several explanatory variables on the probability of a recovery phase to occur without a pick-up in bank lending: our results show that recoveries without

Note: *) M. Bijsterbosch, T. Dahlhaus, 'Determinants of credit-less recoveries', ECB Working Paper No. 1358



Note: *) Central Europe: CZ, HU, PL, SK, SI; SEE: BH, BG, HR, RO, SRB; CIS: RU, UA, KZ
Source: UniCredit CEE Strategic Analysis

credit tend to be anticipated by large declines in economic activity and by events that are likely to disrupt credit supply.

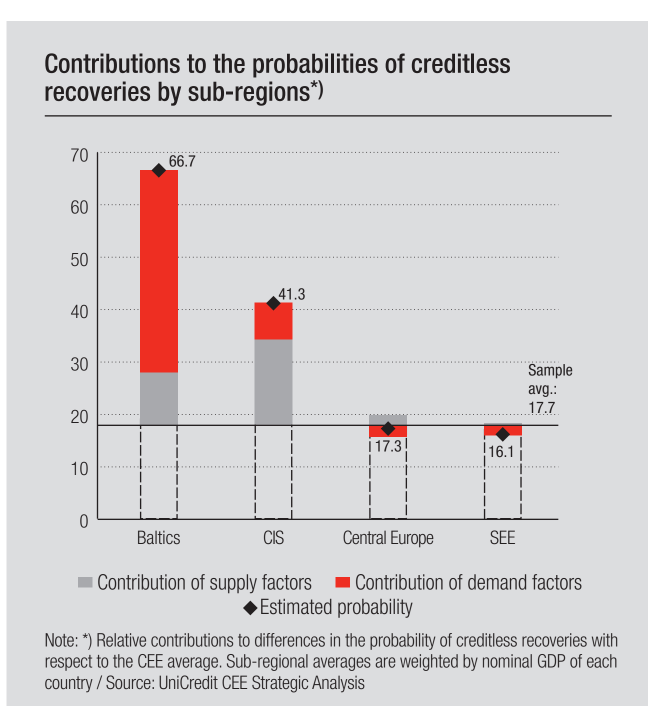
The weak credit growth observed particularly in the Baltics appears to be the result of both low demand and supply constraints. On the demand side, the bounce-back effect undoubtedly plays an important role: the sizable capacity underutilization originating during the crisis in many firms made it possible for output to recover without any need for new investments, thus keeping credit demand at low levels. On the supply side, some deleveraging is still taking place notwithstanding the recovery phase, with particularly intensive reductions in exposure of BIS-reporting banks toward CIS countries and the Baltics. Indeed, stress conditions on banks' balance sheets strongly increase their need for liquidity and additional capital, thus affecting the probability of a country experiencing a recovery in the context of subdued lending activity.

According to our estimates, contributions of demand factors remain higher than those on the supply side, in all countries where the probabilities of creditless recoveries are the highest, i.e. Ukraine and the Baltics. At the same time, the role of supply side factors, although remaining quite low in most of the CEE economies, becomes crucial in countries that have been hit by large banking shocks and/or experienced a significant deleveraging process (increasing the probability of a creditless recovery by about 28pps in Latvia and Ukraine and 15pps in Kazakhstan and Slovenia).

Our forecasts reveal that probabilities of creditless recoveries during the coming years remain largely heterogeneous across countries, with extremely high rates in Latvia and Ukraine and relatively low rates in Poland, Serbia and Bosnia. Interestingly, results obtained in our analysis are fully in line with projections on lending growth in the CEE region for the 2010–2012 period, which corresponds to three years after most of the economies have reached the trough of the downturn. In this time interval, countries where real growth of loans (deflated by price increases) is expected to remain negative or close to zero, are only the Baltics, Ukraine, Hungary and Slovenia, together with Romania which is instead better positioned in our ranking.

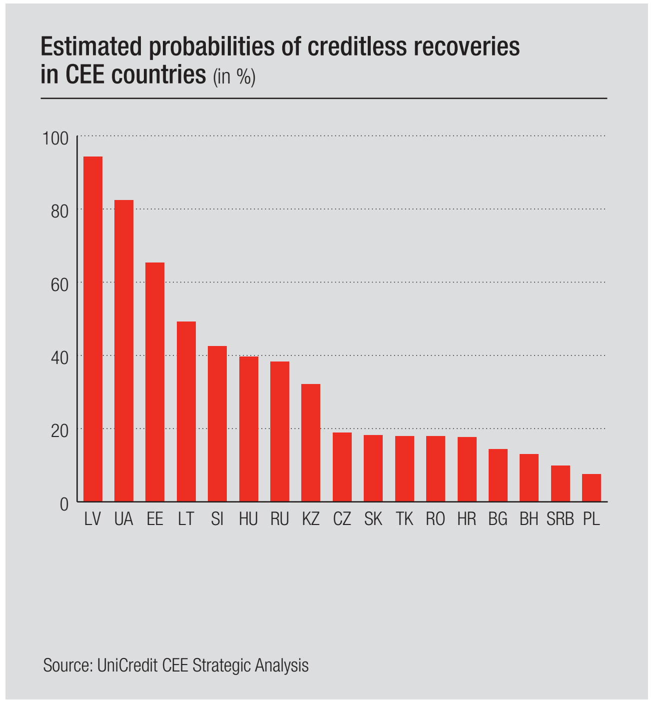
Although new bank credit may not be a necessary condition for output to restart, our analysis on creditless recoveries is not without consequences on the macroeconomic side. Firstly, creditless recoveries tend to be more protracted, taking longer for output to return to its long-term trend. Based on our sample, average GDP growth during episodes of creditless recoveries stands at 5.0% per year (both in the whole sample and in the emerging markets sub-sample), compared to roughly 6.6% in episodes of recoveries accompanied by credit expansion (7.1% in emerging markets). Secondly, in cases where sluggishness in new bank lending is predominately due to tighter credit conditions rather than demand factors, the economy is also likely to experience a prolonged decrease in credit dependent investments with negative consequences for long-term growth. In practice, a prolonged period of stress in credit conditions can lead households to delay or even cancel their expenditure decisions and firms to simply demand short-term financing for working capital, while obtaining long-term financing for physical capital is likely to remain more difficult. Finally, the lack of credit may also favor sectors that are not the most productive, but are simply less dependent on external sources of financing, resulting in a suboptimal composition of output growth.

Contributions to the probabilities of creditless recoveries by sub-regions*)



Note: *) Relative contributions to differences in the probability of creditless recoveries with respect to the CEE average. Sub-regional averages are weighted by nominal GDP of each country / Source: UniCredit CEE Strategic Analysis

Estimated probabilities of creditless recoveries in CEE countries (in %)

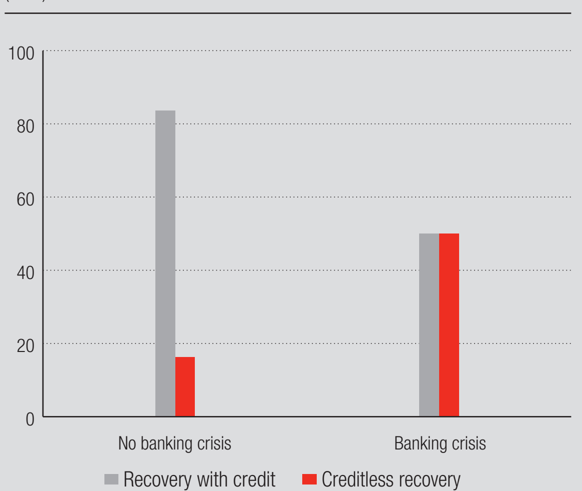


Source: UniCredit CEE Strategic Analysis

BOX 1 – Creditless recovery: empirical analysis

A common empirical finding in the emerging market literature is that creditless recoveries are not rare phenomena.[1] After sudden stops in capital flows and banking crises, output can in fact recover with no accompanying revival in bank lending. In order to test this conclusion, we built a database consisting of an unbalanced panel (183 countries including both developed and emerging economies in a time interval which ranges from 1963 to 2010) with data obtained from various sources such as the International Financial Statistics and the World Economic Outlook (IMF), the World Development Indicators (World Bank) and other banking statistics from the BIS. We then examined real GDP and real private credit and followed the approach of some previous works in the literature, in order to identify output recoveries and to distinguish "normal" from "creditless" recoveries. In particular, recovery periods are identified with the first three years following the trough of an economic downturn, with troughs corresponding to years when cyclical GDP[2] is more than one standard deviation below zero. Moreover, recoveries are identified as "creditless" when the level of real credit is higher in the trough year than in the third year of the recovery period. Our results show that creditless recoveries represent 19 % of all the recoveries and this percentage increases up to 50 % if a systemic banking crisis occurred in the two years prior to or coinciding with the year of the downturn.

Relative frequency of creditless recoveries
(in %)



Source: UniCredit CEE Strategic Analysis

This simple frequency analysis seems to confirm the stylized facts from the literature. Then, using a probit model and adopting several suggestions from the literature, we tested the predictive power of several macro and banking indicators and their contribution to the probability of a creditless recovery to occur. According to our analysis, the following explanatory variables resulted to have a significative impact on the probability of a recovery to be creditless:

- **Output gap at the trough of the crisis:** it is the cyclical GDP divided by the trend component. Strongly negative values generally indicate a wider underutilization of productive capacity created during the crisis episode, which is supposed to help facilitate the occurence of a creditless recovery. Indeed, the higher the unused idle capacity at the trough of the crisis, the higher the probability that firms resume production simply through the absorption of unused capacity without investing in new gross fixed capital and consequently without borrowing money from banks. According to our estimates, experiencing a (negative) output gap which is higher by 1 percentage point increases by almost 5 percentage points the probability of a creditless recovery. As a high correlation exists between this variable and the Banking Crises dummy, we also introduced "output gap at the peak" as an instrumental variable for "output gap at the trough", in order to obtain a consistent estimation of the coefficient.

1) In Calvo, G.A., Izquierdo, A. and Talvi E. (2006), "Sudden stops and Phoenix miracles in emerging markets", American Economic Review, Papers and Proceeding, Vol. 96, no. 2 one can find a first documentation of such recoveries, for which the term "Phoenix Miracle" is coined, since output "rises from its ashes" (without aid from credit), as it happens from the mythologic creature.
2) Cyclical GDP is obtained as the difference between the logarithm of real GDP and a trend component computed by using the Hodrick-Prescott filter.

- **Investment growth at the beginning of the recovery phase:** this explanatory variable is complementary to the first one. As investment is assumed to be a credit-intensive activity, weak investment growth during the recovery phase can explain the lack of new credit following a recession. Lower investment growth by 1 percentage point in the recovery phase results on average in a frequency of creditless recoveries which is higher by about 0.5 percentage points.

- **Banking crisis (dummy):** we use the banking crisis dummies from Laeven and Valencia (2010) and match them to our data set in order to test the hypothesis that creditless recoveries are a reaction to frictions in the supply of bank lending. According to the authors' definition, a banking crisis is considered to be systemic if two conditions are met: (a) significant signs of financial distress in the banking system (as indicated by significant bank runs, losses in the banking system and bank liquidations); (b) significant banking policy intervention measures in response to significant losses in the banking system (where the magnitude of policy interventions is based on several indicators such as the size of liquidity support, bank restructuring costs, bank nationalizations, guarantees put in place, asset purchases, deposit freezes and bank holidays). Calvo et al. (2006) argue that an impaired financial intermediation preventing firms from obtaining funding for new investment is the main explanation for the lack of credit growth during these recoveries.

  Actually, in our estimates the occurrence of a banking crisis increases the probability of the following recovery to be creditless by about 25pps.

- **Growth in foreign exposure toward domestic banks:** the availability of (external) funding is an important determinant for reducing the probability of a recovery to be creditless. According to data on cross-border exposure of BIS-reporting banks, a higher cumulative growth in foreign exposure by 10 percent in the three years starting from the trough of the crisis decreases the frequency of creditless recoveries by more than 0.6 pps.

To summarize, a recovery can occur without a pick-up in lending because new bank lending is not available or simply because it is not needed. Our results clearly show that both demand factors (output gap and investment recovery) and supply factors (banking disruptions and deleveraging) can play a decisive role in a creditless recovery. An additional investigation at the micro level would also allow one to analyze further potential determinants of creditless recoveries such as: (a) the substitution between bank credit and other sources of financing such as trade credit, retained earnings or bond and equity markets; (b) the reallocation of resources from more to less credit-intensive sectors. When these circumstances occur, output can still increase without an accompanying credit expansion, thus explaining the occurrence of a creditless recovery.

Marginal effects after probit regression
Dependent variable: probability of a recovery to be creditless

Variables	Marginal effect: dy/dx	Std. Err	z	P>|z|	[95% Conf. Interval]		Average value in the sample
Output gap at the trough of the crisis	−4.972	1.896	−2.62	0.009	−8.687	−1.257	−0.040
Investment growth at the beginning of the recovery phase	−0.592	0.165	−3.59	0.000	−0.916	−0.269	0.093
Banking crisis (dummy) *)	0.244	0.104	2.36	0.019	0.041	0.447	0.135
Growth in foreign exposure to domestic banks	−0.064	0.028	−2.25	0.025	−0.119	−0.008	0.477

*) dy/dx is for discrete change of dummy variable from 0 to 1
Source: UniCredit CEE Strategic Analysis

A more balanced funding structure should prevail with EMU bank deleveraging a manageable drag

Over the medium to long term we believe there is still potential for the CEE banking sector to generate above-EU average growth in banking volumes and profitability, as the penetration gap still exists, although there remain large divergences among segments and countries. At the end of 2011, total loans in the CEE region should have approached EUR 1.5trn (up by roughly 9 % yoy), with corporate loans accounting for the lion's share (57 %), followed by retail (37 %). Penetration of lending activity still remains below Western European standards (loans to GDP stood at an estimated 49 % in 2011 for CEE vs. 120 % in the Euro area), with the largest gaps particularly evident in Russia, Kazakhstan, Romania and Turkey. The overall picture also remains non-uniform among subsectors: market potential still exists when looking at the penetration of mortgage financing relative to GDP (8 % vs. 40 % in the Eurozone) also taking into account that CEE has some gap in the supply of residential real estate. This is hardly the case for consumer lending with a 10 % ratio in CEE on average versus 7 % in more developed western European markets.

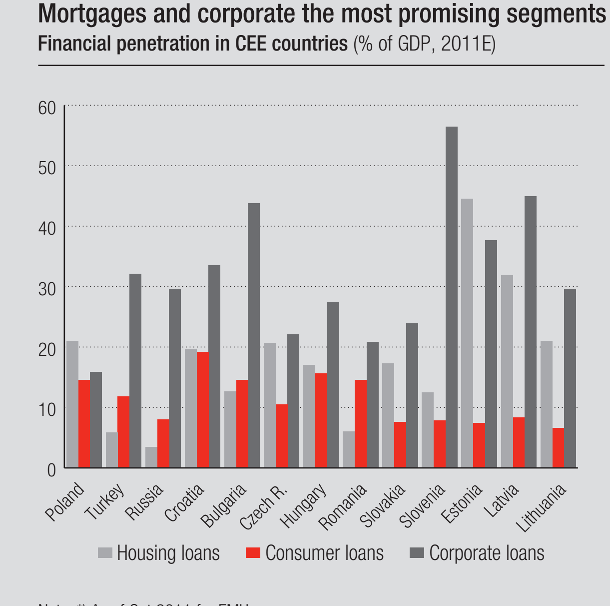
In light of the pressures parent banks are currently facing to strengthen their capital adequacy, it is clear that future developments in mortgage financing are likely to depend significantly on the availability of long-term funding in local currency. Unfortunately, this is still an issue in many countries in the region due to shallow capital markets and could result in some potential constraints regarding the pace of growth in the mortgage segment going forward.

Corporates also remain an attractive segment with penetration of an estimated 28 % in 2011 (vs. 50 % in the Eurozone). Of course, there remain stark differences in the level of penetration within CEE, with an overleveraged sector in countries such as Slovenia and Bulgaria indicating less rosy prospects for corporate lending compared to other countries in the region. The gradual shift in the region's growth model – with more focus on productive investments (especially in tradable sectors) and less emphasis on consumption – should also prove supportive for this segment's prospects. But there are challenges here as well, as the most attractive clients – large companies with a good risk profile – switch away from bank financing. These are multinationals and large industrial and energy companies for which it is now more cost efficient to access capital markets directly, as their cost of funding is sometimes lower than financing conditions applied by banks.

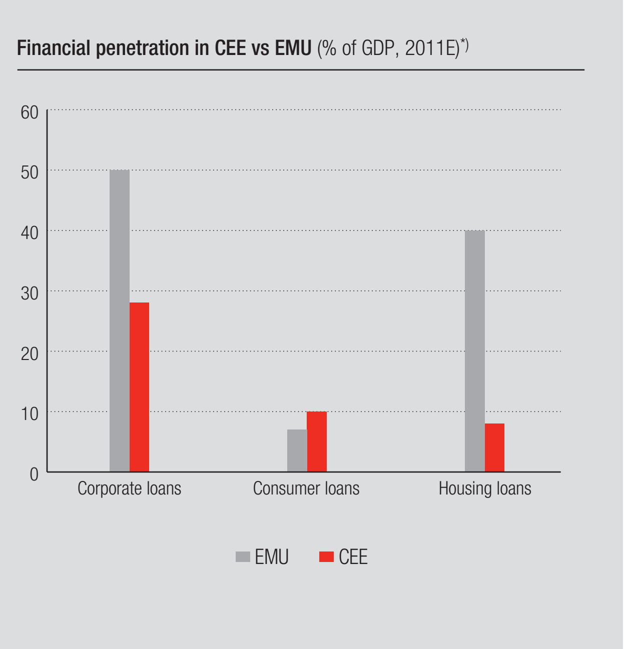
Country-wise, we expect Russia and Turkey to contribute the most in terms of lending growth over the 2011–2015 period with growth expected in the range of 13 % and 18 % on average, respectively. These remain large markets which are still relatively underpenetrated. Overall, given that tight funding conditions are likely to persist in the near future, lending growth in CEE is likely to be determined not only by the catch-up potential, but also by availability of funding. A full-scale credit crunch was generally averted in the 2008–2009 crisis thanks to a large extent to the Vienna initiative and EU/IMF support provided to the most affected countries. However, the liquidity draught that began in 2H 2011 could have much stronger negative consequences on lending activity in CEE, as European banks, which are dominant players in the region, are now facing tougher conditions due to market-wide strains and pressure from financial regulators in some Western European countries. EMU bank deleveraging represents a clear downside risk with some countries more at risk than others; but according to our baseline scenario, this is a manageable drag.

Mortgages and corporate the most promising segments

Financial penetration in CEE countries (% of GDP, 2011E)



Financial penetration in CEE vs EMU (% of GDP, 2011E)*)



Note: *) As of Oct 2011 for EMU
Source: local central banks, ECB, UniCredit CEE Strategic Analysis

Overall, lending activity should converge toward a lower growth rate path compared to the pre-crisis period, but remain in the low double-digits.

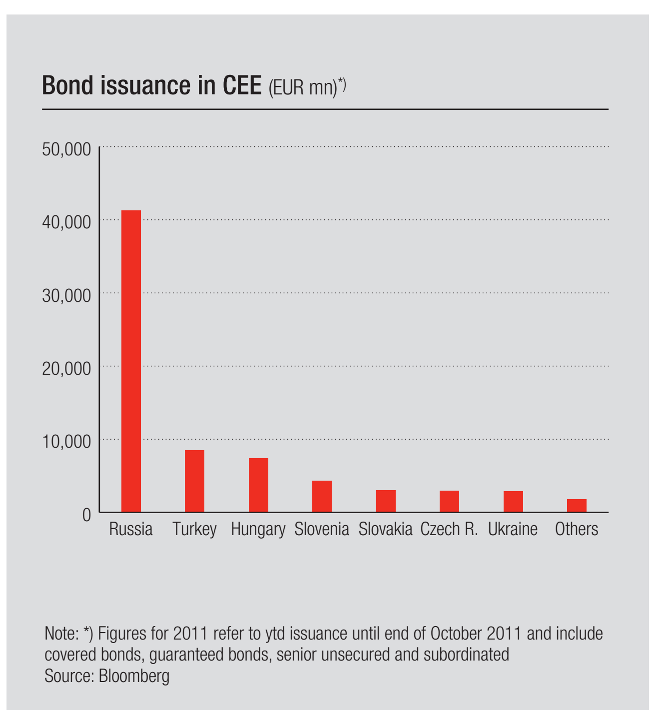
Under the new 'normal' a more balanced funding structure should generally prevail, particularly in countries featuring high funding gaps with loan growth more closely tied to that in deposits than it was in the past. We expect banking systems with higher dependency from abroad to be more affected by the ongoing deterioration in growth prospects and tightening in funding costs. According to this metric, countries in South-Eastern Europe and the Baltic region look more vulnerable, being characterized by a loans-to-deposits ratio well above the other CEE countries. However, it is important to stress that in all cases, there are historical structural reasons behind the high L/D ratio (above all explained by the domestic saving gap and lack of an inherited stock of financial wealth). Convergence toward a much healthier funding structure is highly desirable, but should be gradual and proceed in an orderly manner in order to avoid major disruptive consequences for local economies and potential repercussions for banks' financial stability (connected to a higher level of insolvencies).

In such an environment, we foresee deposits and other local funding as likely increasing their significance in banks' total liabilities with a further contraction in the share of external liabilities, particularly in countries featuring above average loans-to-deposits ratios (i.e. the Baltics, Ukraine, Slovenia and Serbia). However, given the short-term nature of deposits, the development of local currency long-term funding remains crucial in order to foster lending activity in the region. With this in mind, local authorities have launched a number of initiatives, although further steps are still needed. The Hungarian central bank has introduced a support program under which it has been purchasing local currency mortgage bonds both on the primary and the secondary markets, but the success of the initiative has been negatively impacted more recently by a frozen mortgage market. In Romania, few international banks with operations in the country have issued RON-denominated bonds on European financial markets and IFIs have plans to issue domestic bonds in the near future, although the overall size of those issued domestically remains limited. Indeed, over 2008–2011 the bulk of bond issues, amounting to EUR 72 bn, still relates to the Russian market. Given the uncertain and challenging market conditions likely to persist at least in the short term, it can be expected that apart from supranational funding, additional local funding opportunities are likely to remain concentrated in large markets such as Russia, Turkey and the Czech Republic through issuance of covered bonds and syndicated loans.

The reasonably good capital position could help CEE banks to withstand Eurozone woes. As of June 2011, banks' capital adequacy ratios in the region were substantially higher compared to the minimum required by the local regulators. However, still high NPL levels represent a potential source of risk. At the regional level, we see the impaired loans ratio falling from 2012, but only gradually and with the trend mixed across countries. Indeed, the adverse trend in credit quality deterioration has not yet come to an end in the case of Bulgaria, Croatia and Kazakhstan and in our baseline scenario we reckon with non-performing loans reaching their peak in these countries either during 2012 or in early 2013. In some cases, the less favourable macroeconomic environment in 2012 is likely to halt the process of loan quality improvement (e.g. Poland and Turkey).

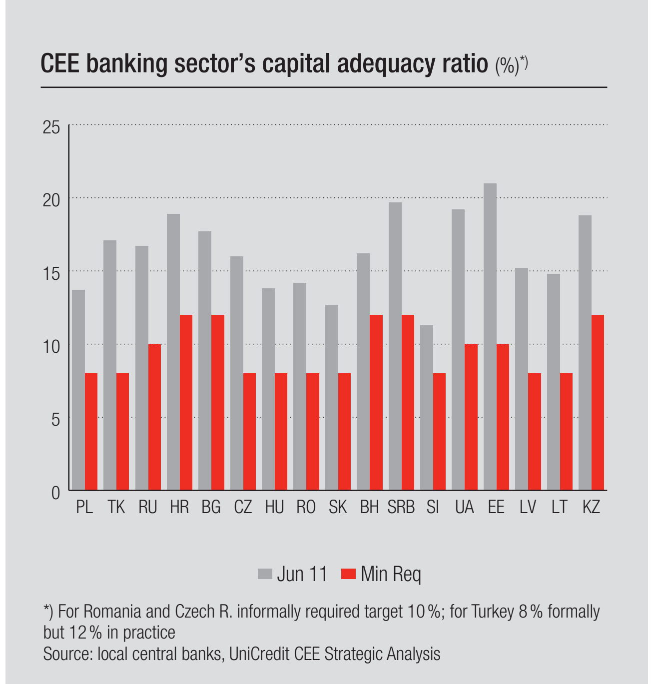
Empirical studies show that recoveries tend to be slow and creditless after banking crises characterized by impaired financial

Bond issuance in CEE (EUR mn)*)



Note: *) Figures for 2011 refer to ytd issuance until end of October 2011 and include covered bonds, guaranteed bonds, senior unsecured and subordinated
Source: Bloomberg

CEE banking sector's capital adequacy ratio (%)*)

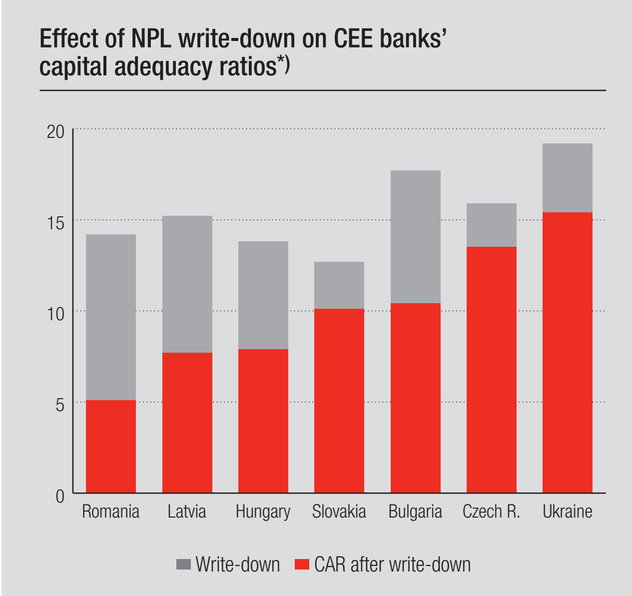


*) For Romania and Czech R. informally required target 10%; for Turkey 8% formally but 12% in practice
Source: local central banks, UniCredit CEE Strategic Analysis

intermediation. A faster resolution of NPLs could be desirable, but it can prove harmful to a banking system's stability. Based on our simulation on a sample of CEE countries, an abrupt write-down might cause large capital shortages as in the case of Hungarian, Latvian and Romanian banks, with CAR falling below the minimum required.

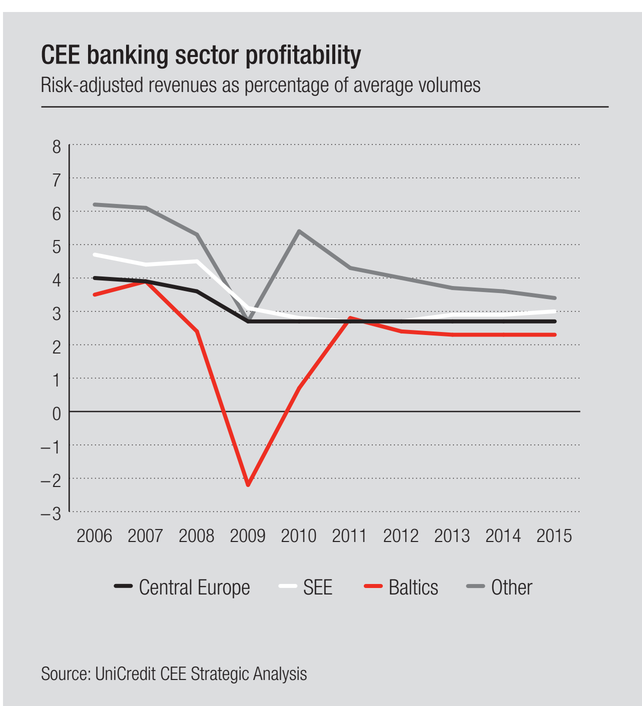
The weight of problematic loans, higher regulatory requirements combined with increasing competition and tight funding conditions may constrain the CEE banking revenue stream in the years ahead.

Effect of NPL write-down on CEE banks' capital adequacy ratios*)



Note: *) For Ukraine, simulation based on official NPL statistics; using unofficial estimates on the NPL ratio, the impact would be more severe with CAR turning negative
Source: local central banks, UniCredit CEE Strategic Analysis

CEE banking sector profitability
Risk-adjusted revenues as percentage of average volumes



Source: UniCredit CEE Strategic Analysis

Banks are thus likely to be confronted with lower profitability relative to the pre-crisis level, but overall the CEE banking sector is expected to remain attractive with risk adjusted revenues as a share of average volumes likely to stay well above Western European levels. Further normalization in credit quality should also continue to ease pressures on banks' profitability, with cost of risk at the regional level expected to gradually decelerate although remaining above 100 bps through the cycle. Cost control should remain a focus for the medium term in the context of a dynamic business environment, characterized by lower profitability than in the past. Overall, we expect 2012 to be another challenging year with profitability turning somewhat weaker than last year and with gradual recovery expected in the following years. In terms of the region's future developments, countries such as Turkey and Russia are better positioned in terms of a market attractiveness / risk mix and should remain key contributors to the regional banking system profit pool, accounting for roughly 66 % of total profit before taxes over the 2012 – 2015 period.

EMU bank deleveraging impact on CEE is a manageable drag

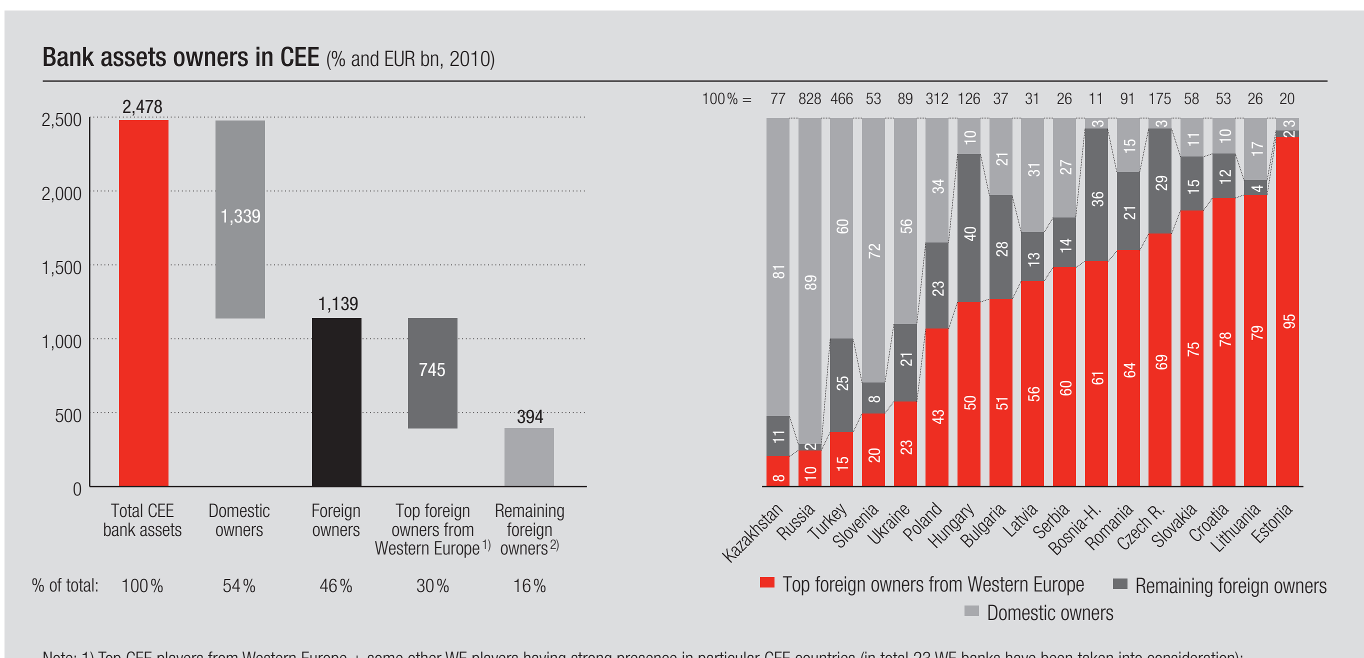
The severity of the current crisis in the Euro area contributed to the rising fear that capital needs and funding pressures faced by Western European banks may heighten pressure to deleverage in Central and Eastern Europe.

Western European (WE) financial institutions are important owners of banks in CEE. Out of EUR 2.5 trn of bank assets in the region 46 %, is controlled by foreign owners. Top foreign owners from Western Europe[3] control 30 % of the region's assets. These aggregated figures hide significant differences among CEE countries, the new EU members (EU-10) and remaining countries from the region (CEE-7[4]). While top foreign owners from Western Europe account for a mere 16 % of assets in the CEE-7, they control 54 % of assets in the EU-10. This differentiation is due to the fact that banking sectors in the CEE-7 are to a larger extent dominated by domestic players, including some large state-owned banks.

Multiple capital linkages between CEE and Western European banks have made the region exposed to knock-on effects from the current crisis in the Euro area. For many years some banking sectors in CEE have been relying strongly on foreign funding (mainly parent funding) and foreign liabilities currently account for a significant part of their assets.

In our opinion the short-term risk for CEE stemming from Western European banks' response to the EBA capital requirement remains limited. This expectation is based on the information from particular banks on how they plan to achieve a 9 % CT1 ratio by the end of June 2012. The most preferred options are: earnings retention, rights issues and conversion of bonds. In our view this reduces the

3) This group includes top CEE players from Western European banks plus some other Western European banks with a strong presence in particular CEE countries (e.g. some Scandinavian banks which control the majority of banking sectors in Baltic states). In total 23 Western European banks have been taken into consideration.
4) Bosnia, Croatia, Kazakhstan, Russia, Serbia, Turkey and Ukraine



Note: 1) Top CEE players from Western Europe + some other WE players having strong presence in particular CEE countries (in total 23 WE banks have been taken into consideration); 2) Remaining WE players (with a negligible share in CEE) + other foreign players (e.g. from US)
Source: UniCredit CEE Strategic Analysis & Pekao Research based on local central banks

risk of a widespread short-term deleveraging in the CEE region, although some impact may be visible in countries with a meaningful presence of Greek owners (particularly Serbia, Romania and Bulgaria). In the mid-term we do not rule out that a less favourable macroeconomic environment and persistent regulatory pressure may force some Western European banks to implement more rebalanced (toward self-funding) business models in their CEE subsidiaries.

The scale of exposure of a particular CEE country to the potential mid-term parent funding withdrawal is a function of: 1) current dependence on external funding (foreign liabilities as a share of total bank assets) and 2) shareholder structure of a particular CEE country's banking sector assets – some Western European banks will likely face a greater challenge to adjust to the new regulatory / macro environment (we named this factor as "propensity to deleverage"). When calculating the propensity to deleverage we assigned ranks of risk to major foreign owners of banks in CEE depending on their potential deleveraging need (in relation to the current assets) due to potential capital shortage[5]. In a second step we considered their CEE subsidiaries' reliance on external funding[6]. Finally we have computed aggregated scores of risk for each CEE country.

In general country scores of risk remain rather low. This means that the overall impact of potential Western European banks deleveraging on the CEE region ought to remain limited. The group of the most exposed countries includes Bulgaria, Croatia, Romania and Serbia.

This is related to the fact that their banking systems are highly penetrated by foreign players, who in the past heavily funded their local subsidiaries and are currently exposed to heightened pressures. On the other side of the scale there is a group of countries (e.g. Russia, Turkey) that does not face a risk of deleveraging related to parent banks problems[7].

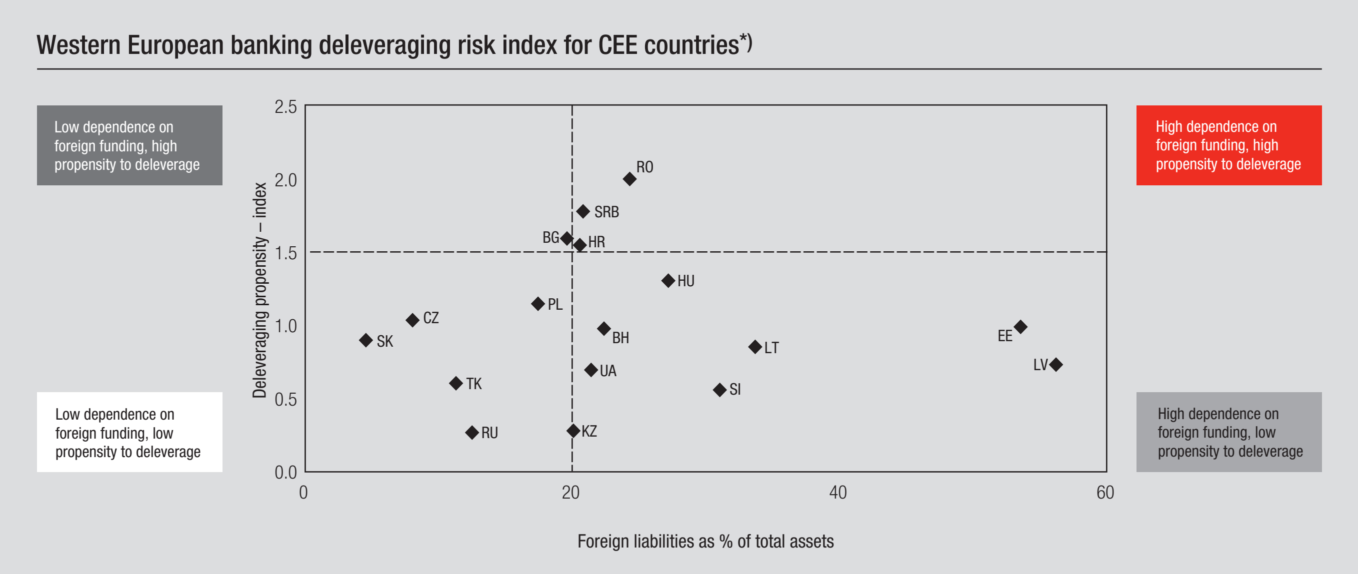
We have calculated the potential impact of Western European banks deleveraging in CEE countries on the average growth in loans for the 2011 – 2015 period. The deleveraging scenario was built against our baseline scenario for the region. For the countries with "moderate" exposure to deleveraging it was assumed that 30% of foreign funding might be withdrawn until 2015. For the countries with "low" exposure it was assumed that 15% of foreign funding might be withdrawn until 2015. For the remaining countries no foreign funding withdrawal has been assumed. Looking at the impact of mid-term Western European bank deleveraging, we can observe that:

- Not surprisingly, the impact on lending activity would be visible in countries most exposed to deleveraging – i.e. Bulgaria, Croatia, Romania and Serbia.
- In Czech Republic, Hungary and Poland the scale of the potential impact on the loan market would remain limited and to a large extent could (especially in the case of Czech Republic and Poland) be offset by mitigating efforts such as more aggressive deposits collection or reduction in foreign assets.

5) The analysis is based on the EBA's data for particular banks' exposure to an adverse macroeconomic scenario (based on July's stress test). We also took into consideration capital raising initiatives, which have been announced recently by some banks.
6) In our approach self-funding (e.g. through local deposits) of a particular subsidiary eliminates risks arising from the general need of the parent bank to deleverage.

7) It is worth noting that although countries such as Turkey and Russia (also Kazakhstan and Ukraine) are not exposed to the risk of parent banks' problems, they may experience pressure on their external funding in the event of global risk aversion (similar to what took place during the post-Lehman collapse)

Western European banking deleveraging risk index for CEE countries*)



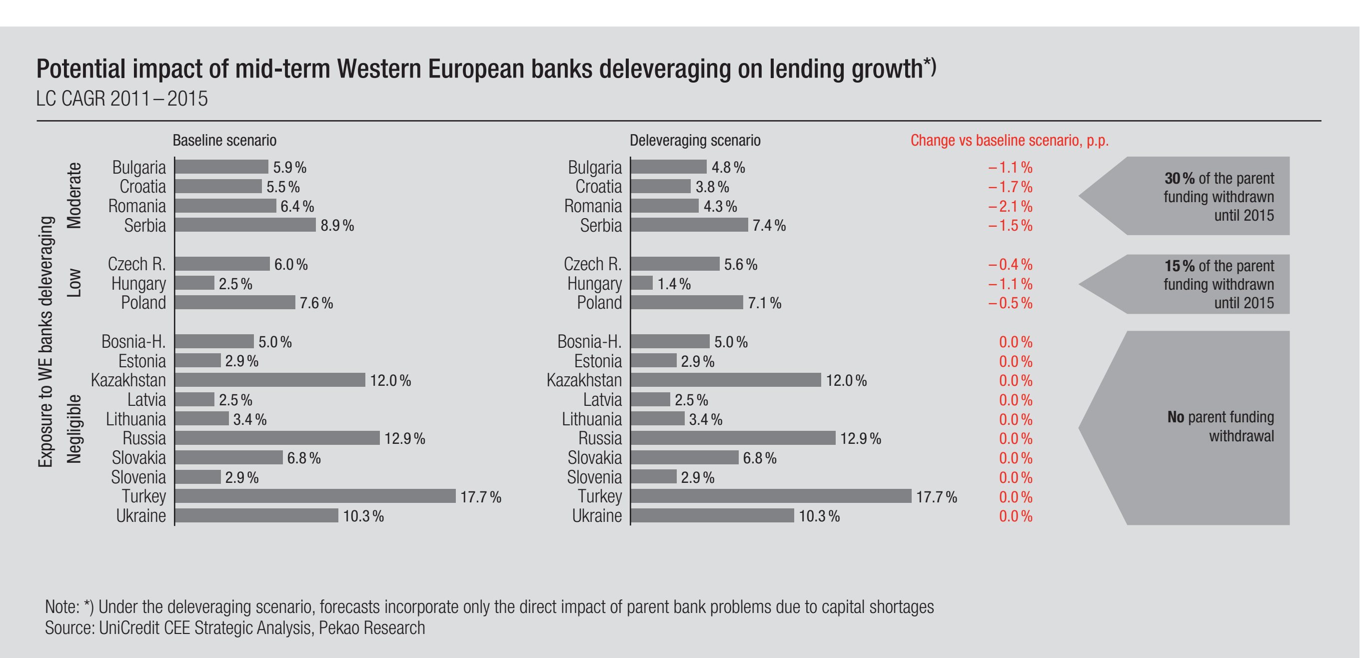
Note: *) The index is a weighted (with a share in a country's total bank assets) average of bank owners' ranks. The ranks vary from 0 (no risk) to 5 (high risk). 0 = domestic owners; 1 = non-WE foreign owners and WE owners with small (<5 %) potential need to deleverage or CEE subsidiary fully self-funded; 2 = WE owners with potential need to deleverage by 5–10 %; 3 = WE owners with potential need to deleverage by 10–15 %; 4 = WE owners with potential need to deleverage by 15–20 %; 5 = WE owners with potential need to deleverage by more than 20 %
Source: UniCredit CEE Strategic Analysis, Pekao Research, EBA

- In the remaining CEE countries, the direct impact on the loan market stemming from parent bank problems (due to capital shortages) would be negligible. Other economic reasons could also play a role particularly in countries featuring high funding gaps (i.e. Baltics and Slovenia) but these have been to some extent incorporated in our baseline scenario.

It is also worth mentioning that potential parent banks deleveraging (and withdrawing resources from CEE) may also have some indirect implications for the region. The most important one would be the impact on the FX market (depreciation pressure on local currencies). This risk would be especially important in the case of an abrupt and large-scale withdrawal, a scenario to which we currently assign a very low probability of occurring.

Potential impact of mid-term Western European banks deleveraging on lending growth*)

LC CAGR 2011–2015



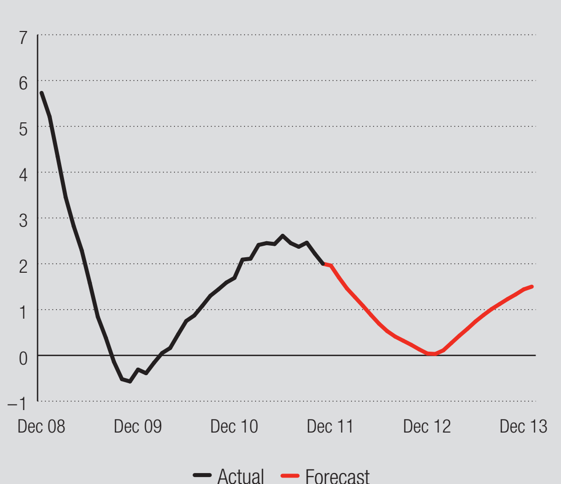
Note: *) Under the deleveraging scenario, forecasts incorporate only the direct impact of parent bank problems due to capital shortages
Source: UniCredit CEE Strategic Analysis, Pekao Research

BOX 2 – Outlook for Western European banking: cyclical slowdown exposed to downside risks

In the Eurozone, 2011 closes out with most survey indicators signalling a high probability of a mild GDP contraction at year end. However, hard data continue to come in somewhat firmer, confirming a trend that has been in place for the last few months. This leaves us comfortable with our long-held view that the Eurozone economy is going through a "soft patch", but not falling off a cliff. We forecast a 0.2 % qoq GDP drop in 4Q11, the quarter that will probably see the largest impact on business and consumer sentiment from the market turmoil that started last summer. However, we remain more optimistic than consensus and think that the Euro area will be able to avoid a recession, although we are aware that this call relies heavily on the assumption that sovereign tensions will abate over the course of this year.

In yearly average terms, following 1.6 % expansion in 2011, we forecast GDP growth of 0.6 % in 2012 and 1.6 % in 2013. These aggregate numbers reveal a heterogeneous picture: among the largest economies, next year Germany is expected to outperform (+1.2 %), while Italy should likely lag behind (–0.3 %), due to the mix of fiscal austerity and tight financial conditions. As per the impact of this cyclical correction on banking aggregates, the scenario is supportive of flattish growth in 2012 for the Eurozone as a whole, followed by a gradual acceleration toward the 1.5 – 2.0 % range in 2013.

Banks' lending activity to the private sector*) in EMU
(% yoy)



Note: *) Including household and non-financial corporations sector
Source: UniCredit on ECB data

These forecasts result mainly from the interaction of the following items:

- The varying impact of the economic slowdown on specific lending aggregates. Given structural lags between economic activity and the credit cycle, we expect to observe the trough in lending growth around year-end 2012. However, considering banks' funding pressures and stricter capital requirements we factor in a slightly faster transmission mechanism, which should lead to the most rapid deceleration in loan growth being observed in the first half of 2012.
- A gradual normalization of wholesale debt markets from the current stressed status. Hard constraints to loan expansion based on deposit growth are however applied in countries with higher funding gaps.
- The assumption of medium-term loan expansion settling at around 2 – 2.5 %, around 1 – 1.5 % lower than expected nominal GDP growth. This growth rate, substantially lower than pre-crisis levels, reflects private sector deleveraging and / or ongoing banking disintermediation processes in some Eurozone countries.

What the forecast does not assume is a straightforward deleveraging of banks' balance sheets over the short term. Unfortunately, the case for such deleveraging cannot be ruled out. Indeed, a harsher than foreseen deterioration of the economic environment, coupled with extended challenging market conditions and mounting regulatory pressures could eventually end up in much weaker lending activity in Europe.

Markets' (and in some circumstances regulators') calls for an earlier adoption of Basel III capital regulatory requirements imply, already on their own, a threat to loan expansion as they limit the ability of the banks to orchestrate a balanced response over a reasonably long time horizon. The limited operational leeway resulting from the ambition to become Basel III compliant by 2013 has been further strained by market dislocations as they have impaired banks' ability to access wholesale debt and inter-bank markets and made prospects of issuing fresh capital more challenging.

The recent 9 % core tier 1 capital requirement announced by the European Banking Authority to deal with potential haircuts on sovereign debt and, above all, the tight deadline set to be compliant may exacerbate the problem, resulting in many European banks being left with limited available options beyond shrinking their asset base. This possibility is made even more concrete by the fact that internal capital generation

is likely to be hampered over the period by the downward pressure that the upcoming economic slowdown is expected to put on earnings generation. Furthermore, as opposed to Basel III requirements (targeting a level playing field), the latest EBA stress has a strong home bias, as banks domiciled in countries under market stress are those required to adjust their capital ratios by a greater extent. This could prove to be an ultra pro-cyclical measure that risks further endangering growth prospects in countries under greater economic stress.

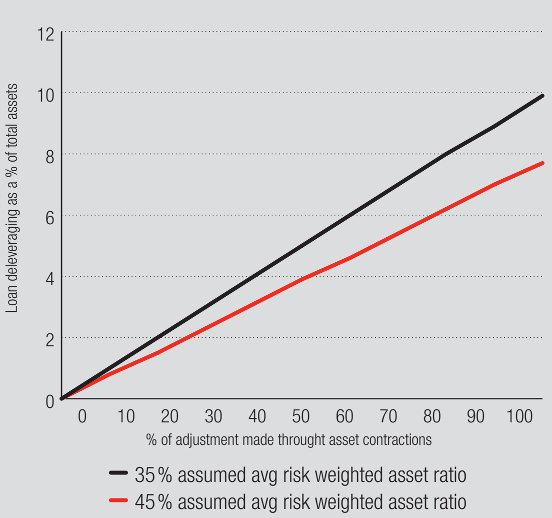
Finally, deleveraging pressures may mount also on the demand side as the re-pricing of bank's liabilities due to the intensification of the European debt crisis may affect loan pricing and hence, negatively affect demand and / or push borrowers to look for alternative funding solutions outside the banking sector. In fact, on top of likely tighter lending conditions, structurally higher interest rates could make marginal investments in fixed capital formation non-economic and lead to a substantial drop in investments and, as a result, demand for long-term loans. Furthermore, limitations in terms of access to long-term funding for prolonged periods could change the loan product offer (potentially triggering a bias toward shorter-term maturities).

The ultimate risk is that a vicious loop between lending and economic growth may be created. From this perspective it is necessary to deploy all available levers to try and normalize wholesale debt markets and, more in general, ensure that liquidity conditions in the European banking sector remain at an adequate level. From this perspective recent measures implemented by the ECB and national authorities to provide exceptional liquidity support are a move in the right direction.

The other open point is related to the potential deleveraging effects connected to stricter regulatory requirements and in particular recent EBA targets.

To have a grasp of how far a deleveraging process in the EMU could go we can use a simplistic approach based on the latest EUR 115 bn total capital shortfall identified in the latest EBA stress test on European banks' holdings of sovereign bonds. Depending on the assumption made about the percentage of the total adjustment through asset contraction and on the deleveraging strategy used (in terms of assets being targeted and, hence, weighted average risk weight of the loan book being phased out), full compliance with the EBA requirements could result in a reduction of up to 8 – 10 % of the Eurozone's banking assets.

Simulation of asset reductions due to European banks' capital shortfall under different scenarios



Source: UniCredit, ECB, EBA

Of course the effect is likely to be lower as only a portion of this adjustment is likely to take place through asset shrinkage. Furthermore, the ultimate impact on lending also will depend on the assets being targeted for reduction. If we were to assume a 50 % asset adjustment factor and a (unlikely) proportional application of this adjustment through banks' assets we would end up with a 5 % decline in the stock of loans to the private sector. Based on the Eurozone's average loan duration distribution, this would imply that around 35 % of the loans falling due over the next year are not renewed.

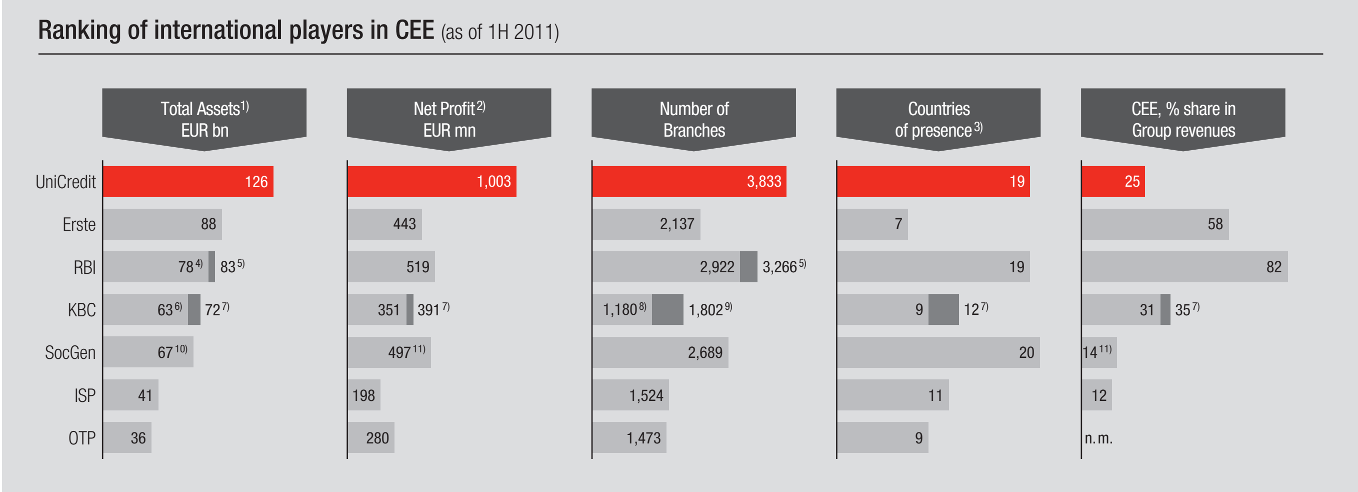
Competitive Environment – greater emphasis on diversification

In light of the recent developments in the global economy and European banking sector, the significance of the CEE region to the growth and profitability of international players has become even more evident. The region strongly contributed to the revenue steam of international banking groups in 2011 and is set to remain a key driver for their growth, as its performance should continue to surpass that of their home markets.

While diversification in the geographical footprint remains a key pillar in the strategy of international players, some re-shaping of the business strategy with a clearer focus on specific markets became visible throughout last year. Recent events have clearly contributed to accelerating the number of divestments of operations in the region by subscale players facing difficulties in their home markets. The sale by Allied Irish, the troubled Irish lender, of its Polish unit BZ WBK to Banco Santander is one of these; Portugal's Millenium BCP is seeking to offload its subsidiary in Poland, Bank Millenium, and KBC is selling Kredyt Bank, also in Poland.

Indeed, Poland, Turkey and Russia emerge with outstanding potential for the majority of players. At the same time the subdued economic recovery and the changing regulatory landscape have limited the magnitude of players' investment and expansion plans elsewhere, thereby leading to a greater emphasis on cost efficiency. A solid funding base and strong capital position remain key competitive advantages and – as the ongoing Euro debt crisis has severely restricted Euro area banks' access to unsecured funding sources – the availability of local funding sources is expected to gain even more importance in the future.

The updated ranking of international players active in CEE shows that as of 1H 2011, UniCredit maintained its leading position in the region and outperformed its main international peers in terms of size and profitability. Its presence in 19 countries, which in total contributed 25 % to the Group's revenues, underscores UniCredit's ongoing commitment to the region as well as CEE's relevance in the Group's diversified and balanced business model. Ranking within the top 5 of 11 countries, UniCredit enjoys sound positioning in the region's most attractive markets such as Poland, Russia and Turkey. In the coming years, the Group's leadership in CEE is to be maintained through a focused approach aimed at pursuing profitable growth opportunities in the region on a more selective basis than in the past. Through a number of strategic initiatives aimed at an intensified optimization of investments, the value of CEE operations



1) 100 % of total assets for controlled companies (stake > 50 %) and pro rata for non-controlled companies (stake < 50 %), except for OTP; 2) After tax before minority interest. Consolidated net profit for the CEE Region, except for Erste and SocGen (aggregated net profit); 3) Including direct and indirect presence in the 25 CEE countries, excluding representative offices; 4) Results of RBI exclude group corporate, markets and corporate center segments; 5) Including pro-forma Polbank; 6) Underlying figures adjusted by subsidiaries earmarked for divestment (RU, SRB and SI); 7) Including RU, SRB, SI; 8) As of YE 2010; 9) Branches as of YE 2010 including RU, SRB, SI; 10) Data for Albania, Croatia, Macedonia, Moldova and Montenegro are as of 2010; 11) Figures for Croatia, Albania, Moldova and Macedonia not available
Source: UniCredit CEE Strategic Analysis

should be further maximized. The Group has also announced a plan to raise EUR 7.5 bn in new common equity, with pre-emptive rights to current shareholders. The capital strengthening measures will allow UniCredit to achieve a Common Equity Tier 1 (CET1) ratio, under the full impact of Basel 3 regulations above 9 % as early as in 2012, well above regulatory requirements and ahead of the official deadline, and above 10 % in 2015.

Emerging as the second largest player in the region in terms of allocated assets, Erste Group operates through the smallest network, being present in only seven countries. With 58 % of revenues stemming from the region and more than 90 % of them concentrated in only four countries (Romania, Czech Republic, Slovakia and Hungary) the Group has a rather small degree of geographical diversification relative to its peers. Erste enjoys superior positions in the majority of countries (top 3 except for Serbia and Ukraine); however, the results differ among the countries with respect to profitability – while more mature markets record strong profits, the challenging economic environment and the changes in the regulatory framework in other markets have forced the Group to take extraordinary measures (i. e. additional risk provisions and write-down of goodwill), leading to a negative result in those regions in 3Q 2011. Within the scope of the restructuring and realignment of its Hungarian operations, Erste announced the integration of subsidiaries into the bank, downsizing the branch network by 43 branches and reduction of staff by 400 – 450 employees. This has been followed recently by a revision of the CEE strategy and business model. Regional large-scale investments are no longer seen as a growth strategy, while a scaling down of operations / exposure in Ukraine is already planned. Moreover, unlike initially planned, due to uncertainties in the global economic outlook and the lack of any resolution of global sovereign debt issues, the Group might postpone the early repayment of the governmental participation capital by at least one year.

With the second largest regional network in terms of country presence and number of branches, Raiffeisen confirmed its position as one of the leading international players in CEE. Since the merger between the customer business segments of Raiffeisen Zentralbank and Raiffeisen International in October 2010, aimed at strengthening the Group's position in CEE and gaining better access to capital and funding, CEE has been managed by the newly established sub-holding Raiffeisen Bank International. Raiffeisen continued its non-organic expansion in CEE during last year. Following the approval of the European Commission in June 2011, Raiffeisen's Polish subsidiary may acquire a majority stake in Polbank EFG, thus creating a new mid-sized bank in the Polish market ranking no. 6 by total assets. However, Raiffeisen's recent strategy has ruled out any further plan of non-organic growth as long as the Group keeps the state aid on its books. Holding a leading position only in Bosnia and Herzegovina, Raiffeisen subsidiaries are characterised as mid-sized players with a strong corporate focus. In 1H 2011 CEE accounted for 82 % of total revenues and approximately 77 % of profits, indicating that the Group's bottom line is very much connected to the region's performance. In response to the unprecedented government intervention in the Hungarian banking market, Raiffeisen, similar to Erste, decided to write down the goodwill, create extra provisions and undergo the necessary capital increase. For the years ahead RBI is putting emphasis on boosting investment banking products, advancing affluent business and enhancing cross-selling. Through its direct banking subsidiary ZUNO Bank AG, the Group launched new online and mobile banking services in Czech Republic and Slovakia focusing on deposit collection and providing attractive saving and term deposits accounts. As a response to the deteriorating operating environment in Hungary, Raiffeisen decided to close 7 % of its branch network and lay off employees to a similar extent, while looking for further cost rationalisation in the country.

Among the largest international players, KBC agreed with the European Commission on a restructuring plan in order to be able to repay the state capital. KBC now aims to capture sustainable organic growth potential in CEE with a more focused range of activities and markets as well as a reduced risk profile and also plans to divest or run down activities with a low strategic fit. Out of 12 CEE countries with a direct and indirect presence, four have been earmarked for divestment (Russia, Serbia, Slovenia and Poland). According to its medium-term strategy, KBC is committed to four core markets (Czech Republic, Slovakia, Hungary and Bulgaria) where it already has a strong franchise or intends to continue building a presence. The bank ranks no.2 in Czech Republic, no. 3 in Hungary and has a considerable presence in Slovakia: both in Slovakia and Czech Republic, the Group enjoys superior overall profitability and a sound loan portfolio. In the first six months of 2011, CEE contributed 31 % of Group revenues and 29 % of profits. Also taking into consideration the subsidiaries earmarked for divestment, the region accounts for 35 % and 32 % of total revenues and profits, respectively.

Intesa Sanpaolo emerges with the smallest exposure (6 % of total assets) to CEE among the top regional players. Present in 11 CEE countries, Intesa can leverage on superior positions in Serbia (no. 1), Slovakia (no. 2) and Croatia (no. 2), while being somewhat of a mid-sized player in Bosnia (no. 5) and Hungary (no. 5). In 1H 2011, 12 % of the Group's revenues stemmed from CEE and the region's contribution to net profit reached some 14 %. In CEE, ISP is characterized by an overall good revenue generation capacity; nonetheless the strong provisioning effort coupled with lower cost efficiency in some of the countries drag on Intesa's profitability in the region. Following the EUR 5 bn capital increase in June 2011, the Group expects organic growth in countries where it already has a presence, as well as in new highly attractive markets (e. g. Poland, Czech Republic and Turkey). Corporate & Investment Banking will be at the backbone of its strategy with plans to consolidate its international presence by significantly strengthening existing foreign branches and selectively opening new ones. Furthermore, the penetration of international top corporates and financial institutions will be increased as well, as more emphasis should be put on supporting the internationalisation of Italian companies. Within the Group's foreign branches and regional subsidiaries, Intesa plans to create Public Finance desks.

With one of the largest networks and broadest country presence in CEE and outside of the region, Société Générale can rely on a very well diversified geographical footprint. Although the Group is present in 20 regional markets, in terms of profit generation its network is highly concentrated – with 85 % of 2010 results originating in Czech Republic and Romania. Other than these countries, Société Générale holds strong positions only in some of the Balkan countries (Macedonia, Montenegro and Moldova) while operating through a mid-sized or small franchise in the rest of the region. In 2010 the Group's exposure to CEE in terms of assets amounted to only 6 % – as the smallest among the top players – while 23 % of Group profits were connected to the regional network. One of the key pillars in the Group's five-year strategic plan is the international network which clearly includes the CEE region. Société Générale has set ambitious targets in Russia, where the bank strives to become the market leader in the retail segment, leveraging on its universal bank (Rosbank and BSGV merged in Jun 2011), the consumer credit subsidiary (Rusfinance) and the housing loans specialist (Delta Credit). Other than Russia, the focus is on the Czech Republic, where intra-Group synergies and cross-selling will be actively developed. Moreover, the opening of more than 700 branches in countries with lower banking penetration has been announced.

OTP Group – the seventh largest player in CEE by total assets – is the only one with a regional origin. Based on its historically dominant position in Hungary, the bank started its regional expansion in 2002. Today OTP operates in nine countries, where – in addition to Hungary – it plays a decisive role in Bulgaria and Montenegro, while subsidiaries in Croatia, Romania, Russia, Serbia, Slovakia and Ukraine are relatively small-sized players. With a strong retail culture in Hungary, the bank is trying to implement best practice in the region and to ensure funding from its core market. Overall, the Group demonstrates a remarkable revenue generation capacity but generally lower cost efficiency (except for Hungary). High revenues are usually offset by the high cost of risk due to lower credit quality – especially in Serbia, Montenegro and Ukraine. Non-organic options are still on OTP's agenda, primarily focusing on markets where the bank has a lower market share (e.g. Slovakia, Croatia, Serbia and Romania). Recently, management showed an interest in expanding the Group to Kazakhstan and Turkmenistan – under acceptable market conditions. Regarding its business strategy, the spotlight is on consumer lending in Russia and Ukraine, while OTP's newly established Hungarian division for real estate, SMEs and agriculture aims to channel EU funds to these sectors. The Group is traditionally characterized by a high level of capitalization with the core Tier1 ratio standing at 12.7 % in 3Q 2011.

Among the regional players, it is also important to mention Sberbank – the dominant player in the Russian banking market currently undergoing a transformation from a large domestic financial institution to an international banking group active in a wide range of CEE countries. Sberbank, a state-owned Russian bank ranking no. 1 by total assets and controlling about half of the retail deposits in the local banking market, has announced that it will boost its international presence in order to diversify its sources of revenues. The bank is aiming to significantly boost profitability generated outside Russia, with 5 to 7 percent of total revenues expected to stem from foreign operations by 2014 (currently the share amounts to around 2 % with an international presence only in Belarus, Kazakhstan and Ukraine). At the time of writing, the Group is in the final stage of acquiring a 100 % stake in the Austrian Volksbank International, which it plans to use as a springboard for expanding into the rest of the CEE region, including Turkey. VBI was put up for sale after its financial situation in CEE worsened in 2010 due to the Romanian provisions and the write-down of the Ukrainian business, while the majority stakeholder Volksbank is in need of funds to repay the EUR 1 bn in Austrian state aid in order to avoid possible nationalization. Through this brownfield investment, Sberbank will gain a foothold in seven new CEE banking markets and strengthen its position in Ukraine. Upon the closing of the transaction, the Russian group will rank among the top ten banks in Bosnia, Croatia, Czech Republic and Slovakia, while being among the top 15 in Hungary, Serbia and Slovenia.

Baltics

Stabilization ongoing but some risks remain on the horizon

Marco Frigerio

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	–1.2	–15.5	1.1	6.5	2.6
CPI (% avg)	11.7	1.6	2.0	4.5	2.8
Banking volumes					
Deposits (% yoy)	3.8	4.7	8.0	0.2	2.0
Lending (% yoy)	13.4	–7.1	–6.2	–3.8	0.4
Loan-to-deposits ratio (%)	212.8	188.8	163.9	157.4	155.0
Mortgages (% of GDP)	27.2	32.0	30.9	27.9	26.5
FX lending (% of total lending)	–	–	–	–	–
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability [1]					
Revenues / Average Volumes (Loans+Deposits), %	3.32	2.52	2.28	2.93 [2]	2.63
Net Operating Profit (% of GDP)	0.95	–5.06	–0.91	1.78 [2]	1.06
Cost / Income (%)	47.9	54.6	60.3	47.8 [2]	54.9
ROA (%)	0.87	–3.79	–0.71	1.53 [2]	0.98
ROE (%)	11.06	–46.83	–8.14	15.37 [2]	8.93
Capital, liquidity and funding					
CAR (%)	13.4	15.8	16.4	17.2	17.5
Net foreign assets (% of GDP)	–40.0	–36.9	–28.8	–19.1	–17.9
Bank bonds outstanding, (% of GDP)	1.5	1.5	1.1	1.1	1.2
Asset quality					
Impaired Loans (in % of gross loans)	3.7	14.6	15.6	14.3	13.5
Cost of Risk (bp)	133	712	246	16	46
Banking sector structural indicators					
Foreign ownership (% of total assets) [3]	82.6	82.6	80.9	80.6	–
Top 5 players (% in total assets)	79.7	82.2	74.9	75.1	–

Note: 1) Forecasts do not include the potential impact of recent bank failures in Lithuania and Latvia; 2) 2011 figures are affected by a large increase in non-interest income, resulting from changes in the legal structure of Swedbank AS (Estonia) starting from 3Q 2011; 3) For Estonia and Lithuania, foreign banks' market share is computed considering the top 10 banks in the two countries.
Source: local central banks, FKTK, UniCredit CEE Strategic Analysis

Macro Environment

Macroeconomic and banking stabilization is taking place in the Baltic region and it is supposed to continue in the forthcoming years although in the context of persisting vulnerabilities (as proven by the financial scandals that have recently involved Snoras Bank in Lithuania and its Latvian subsidiary).

Baltic economies experienced a strong rebound last year with GDP expected to have grown by an estimated 6.5%, following only modest recovery recorded in 2010. The economic outlook for the years ahead remains supported in the three countries by a gradual resumption in domestic demand, while inflationary pressures should remain moderate as shocks in global prices dissipate. Exposure to trade shocks remains relatively high and could affect negatively the Baltic region in 2012 in light of the current global outlook. However, the three countries have carried out significant structural reforms and are likely to enjoy a higher pace of growth in the long term.

Banking Environment

Banking systems in the Baltics have provided visible signs of stabilization, but dependency on parent banks' support still remains a source of vulnerability. Recent events have also cast doubts on the solidity of some individual players. In mid-November the Lithuanian government took over and later decided to nationalize Snoras Bank after an inspection by the central bank revealed that the lender had solvency issues and that assets in the amount of LTL 3.4 bn

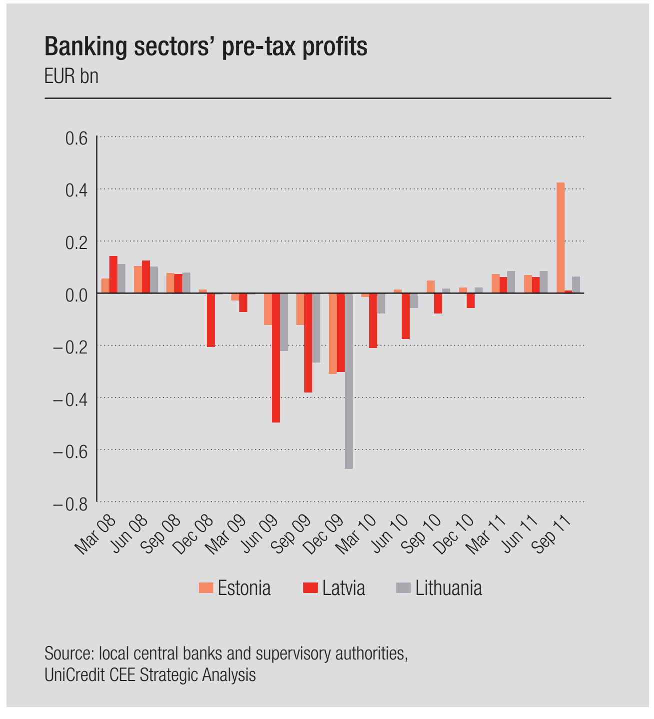
(EUR 985 mn) were missing in the bank. According to the national authorities, Snoras ignored instructions to reduce operational risks, avoided providing information needed for supervisory purposes and may have given false information to regulators. At the beginning of December, the Lithuanian government already approved a six-year loan of LTL 3.3 bn to the insurance fund to repay the insured deposits held in Snoras. The Latvian Krajbanka is also missing LVL 100 mn (EUR 142 mn), and national authorities suspended its operations.

The dynamic in deposits is showing weaknesses especially in Latvia and Lithuania. Growth in deposits is estimated to have remained close to zero in 2011, with a negative trend in all the relevant segments apart from retail (+3.4 % yoy). The non-residents' deposit base is also experiencing a negative performance in Lithuania and Latvia, while remaining positive in Estonia, supported by the recent adoption of the Euro. The positive macro prospects should support some gradual re-acceleration in total deposits from an average +2.0 % yoy expected in 2012 to some 6 % by 2015.

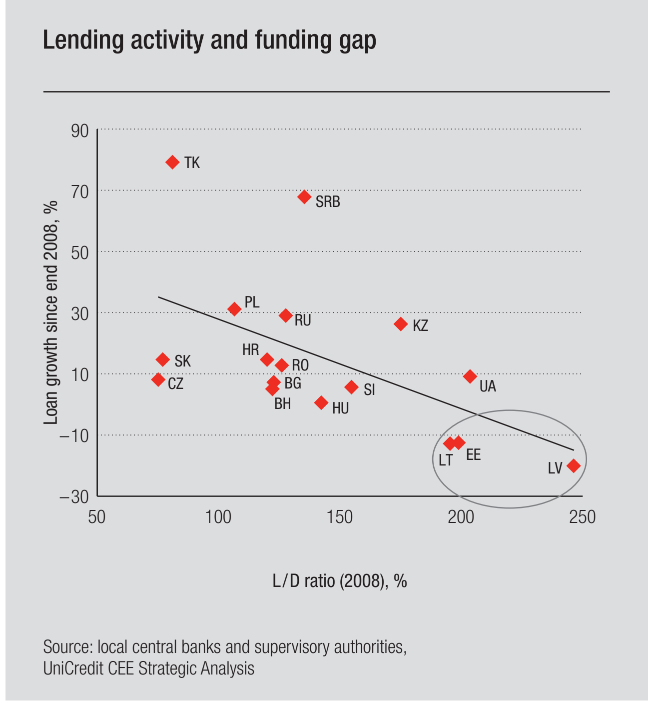
Bank lending has yet to recover, experiencing the third consecutive year of negative growth, with the most discernible drops recorded in Latvia and Estonia (–6.8 % yoy and –5.1 % yoy, respectively). The ongoing deleveraging process started from 2009 and it is not expected to halt in the mid term, as high uncertainty in the general environment and a further slowdown in refinancing from abroad should continue to take the lead. As a consequence of feeble deposit growth and banks' deleveraging, growth in banks' lending is expected to remain extremely weak in the mid term (CAGR 2011–15 equal to 3.0 %), with moderate positive growth expected in 2012 (+0.4 % yoy).

Notwithstanding the difficulties mentioned above and potential repercussions of new financial scandals in Lithuania and Latvia, banks' profits in the two countries are estimated to have returned to positive territory for FY2011, mainly thanks to a higher revenue generation capacity and a significative reduction in loan loss provisions. After having reached the trough in 2010, the ratio of banks' revenues to average volumes is actually recovering, although it is likely to remain quite weak in the short term compared to its historical average. Operating costs are expected to stay in line with average inflation in the forthcoming years. Although NPLs still remain high compared to pre-crisis levels (particularly in some sectors), credit quality issues are gradually stabilizing on the back of the improved economic environment. The improving quality of the loan book is also reflected in a substantial reduction in the cost of risk, which even turned negative in Estonia and Lithuania in the first three quarters of 2011 as some banks started releasing provisions built up in 2009 and 2010. Overall, banking systems in the Baltics should return to an average ROA of 0.9–1.0 % in the 2012–15 period from –1.0 % recorded for the period 2009–2011.

Despite the ongoing stabilization, some potential areas of risks remain on the horizon. Among these, the rising cost of funding for banks represents a key issue to monitor particularly in the context of still high dependency on external refinancing. Restoring confidence in the local banking sector is also of utmost importance as revealed by government moves to seize some lenders in Lithuania and Latvia and troubling episodes of a bank run. However, we expect risks from the recent financial scandals to remain limited, with minimal consequences in terms of overall banking sector financial stability.



Source: local central banks and supervisory authorities, UniCredit CEE Strategic Analysis



Source: local central banks and supervisory authorities, UniCredit CEE Strategic Analysis

Bosnia and Herzegovina

Entering a period of more balanced growth

Goran Saravanja

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	5.4	−2.9	0.7	1.8	0.5
CPI (% avg)	7.4	−0.4	2.2	3.7	2.8
Central Bank reference rate (% eop)	–	–	–	–	–
Banking volumes					
Deposits (% yoy)	−1.4	1.3	3.7	0.7	2.0
Lending (% yoy)	22.1	−3.2	3.5	5.6	2.0
Loans-to-deposits ratio (%)	122.1	116.8	116.6	122.3	122.3
Mortgages (% of GDP)	–	–	–	–	–
FX lending (% of total lending)	9.9	9.9	7.7	10.1	10.0
of which CHF (if relevant), % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	4.6	4.4	4.5	4.6	4.6
Net Operating Profit (% of GDP)	0.4	0.1	−0.4	0.3	0.3
Cost / Income (%)	69.9	66.6	65.1	62.4	62.4
ROA (%)	0.5	0.1	−0.5	0.4	0.4
ROE (%)	3.6	1.0	−2.9	2.1	2.2
Capital, liquidity and funding					
CAR (%)	16.3	16.1	16.2	16.0	16.1
Net foreign assets (% of GDP)	5.9	5.8	4.6	6.0	5.9
Bank bonds outstanding, (% of GDP)	–	–	–	–	–
Asset quality					
Impaired Loans (in % of gross loans) *)	3.1	5.9	11.4	13.3	14.0
Cost of Risk (bp)	181	248	365	267	258
Banking sector structural indicators					
Foreign ownership (% of total assets)	95.0	94.6	92.8	92.5	92.0
Top 5 players (% in total assets)	74.9	74.5	71.3	71.2	71.0

Note: *) from 2012 consistency in application of accounting and financial reporting standards will provide the quality impaired loans data at a system wide level, impaired loans reported are using this methodology
Source: Central Bank of Bosnia Herzegovina, Entity Banking Regulatory Agencies, UniCredit CEE Strategic Analysis – Zagrebačka Banka Research

Macro environment

Real GDP growth is expected to come in at 1.8 % yoy in 2011, largely thanks to the positive developments of exports and its beneficial effects on industrial production. Despite the solid export growth recorded in 2011, the worsening external environment is having an impact and we accordingly revise our 2012 GDP forecast from 1.5 % to 0.5 % in 2012. The data released in 2011 confirms our average growth forecast in consumer prices of 3.7 % yoy for the full year, with the pace of growth in inflation set to slow in 2012, mostly as a result of a high base value and absence of a significant annual growth in oil and food prices. The fiscal deficit should widen in 2012 and we expect the formation of a national level government in 2012 to enable a re-engagement with international financial institutions, which would provide a much needed boost in sentiment toward Bosnia Herzegovina. In the medium term, we still see good catch-up potential to the rest of the region, with growth expected to remain above 3 % in 2013 – 2015, although with downside risks stemming from to the uncertain economic outlook of the Eurozone.

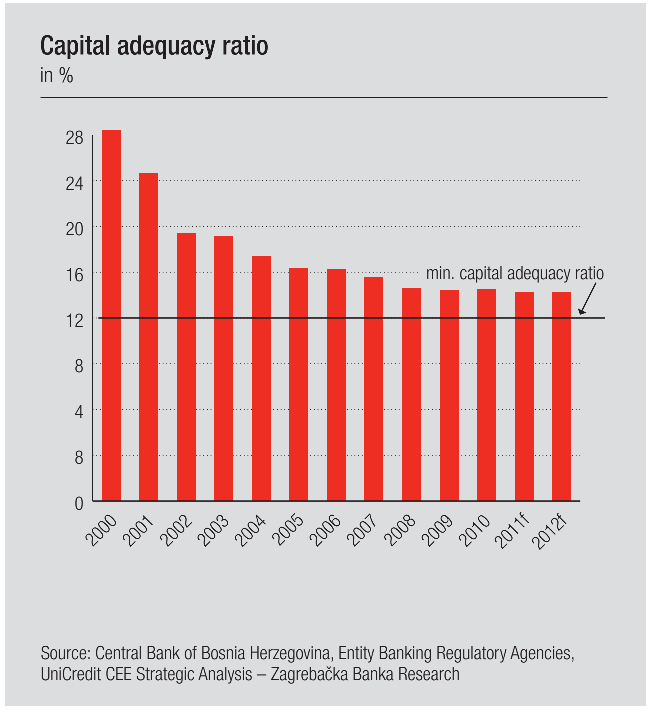
Developments on the domestic financial markets have been clearly marked by the inaugural issue of T-bills by entity governments in Bosnia and Herzegovina. Both the Federation and Republika Srpska governments began issuing T-bills and T-bonds

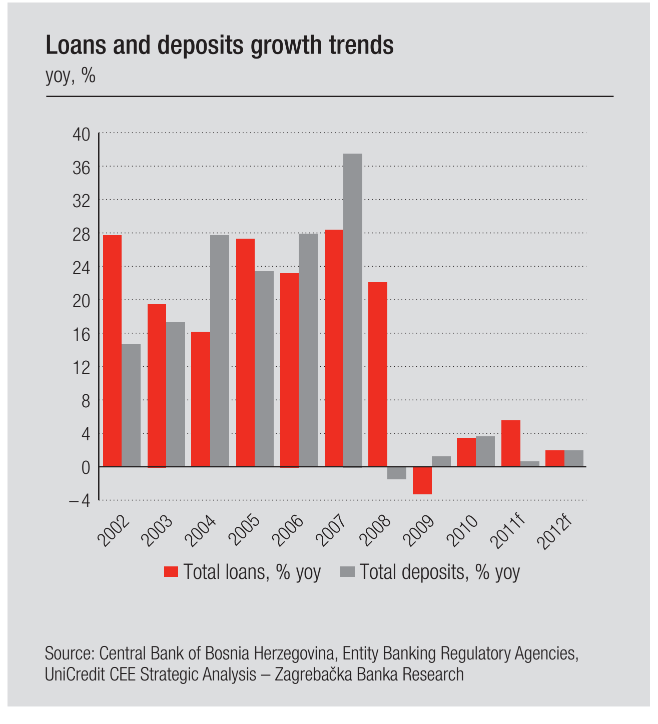
in 2011 as the IMF program was effectively suspended. In 4Q 2011 yields have risen, and we expect this to continue given expectations toward the accelerated issuance of T-bills and T-bonds in 2012 coupled with the sovereign downgrade by S&P at the end of November. Key reasons for the rating agency's move were the political disagreements and their impact on the stalled EU accession process, as well as the adoption of the state budget for 2011 and 2012 – although the state budget is only 9 % of total spending. Pressure on the sovereign rating by Moody's should considerably grow if there is no progress in domestic political relations in the first months of 2012. However, once the national level government is formed, it will also likely show interest in financing its activities locally, especially given the need to repay previously disbursed funds to the IMF at the end of 3Q – 4Q 2012.

Banking environment

The nature of monetary policy in Bosnia Herzegovina is characterized by a strict Currency Board policy maintained over the last 13 years, which has successfully overcome external financial shocks. A stable currency regime with a fixed relation to the euro underpins the stability of the banking sector, especially in the context of adverse balance sheet effects of exchange-rate volatility on euro- and Swiss franc-linked loans in some other countries in Central and Eastern Europe. Furthermore, the financial system in Bosnia Herzegovina is clearly bank-based: official statistics indicate that the share of bank assets was over 80 % of overall financial sector assets. Trends recorded during last year indicate that the share of bank assets in the financial sector has increased partly as a result of falling assets of microcredit institutions, while the net asset value of investment funds continues to be constrained by a shallow domestic capital market and unfavorable external environment developments.

Given the tighter external financing conditions stemming from the ongoing Eurozone crisis, a stronger focus on domestic sources of financing in the mid-term is expected. We expect to see more balanced growth between loans and deposits, something that is mimicked by the loan-deposit ratio staying flat at 122 %. The change in banking sector orientation toward a relatively limited domestic deposit market could in our view lead to declining interest margins for banks as deposit rates rise on the back of increased competition for customers. In this respect, growth of household deposits should experience a stronger dynamic with CAGR 2012 – 15 expected at ~6 % – however, below pre-crisis levels given the relatively high unemployment rate and minimal wage growth. On the other hand, corporate deposits depend on numerous elements such as relations with the IMF (disbursements result in government payments to suppliers, which influence corporate deposit dynamics) or fund inflows from abroad. Another important influence is the effect of domestic bonds and treasury bills whose issuance could see corporate deposits being shifted into new issues. On the other hand, the issuance of government bonds should boost infrastructure investment and reduce late payments to the corporate sector, thereby strengthening the deposit base. In terms of loan dynamics, we see an opposite situation from deposits, where a greater increase in the corporate segment





compared to households is expected. However, we only expect to see modest headline loan growth, especially in the near term, on the back of both demand and supply factors.

The stability of the banking sector remains at respectable levels: a relatively tight regulatory framework prescribes a minimum 12 % CAR, with the capital adequacy ratio standing slightly above 15 % in 2011 (this is, however, lower than what we saw at the end of 2010 – a direct consequence of the growth in risk weighted assets). We expect the capital adequacy ratio to improve, considering the recent relaxation of capital management frameworks, particularly the valorization of banking exposures to the national and entity governments (risk weight of 0 % instead of 100 %; T-bills and bonds 0 % instead of 20 % – these conditions have been in force since October 1, 2011).

NPL dynamics are subject to certain methodological inconsistencies, derived from a different application of the international accounting and financial reporting standards in the Federation and RS (IAS 39). This has led to relatively slower growth of non-performing loans in 2011. From 2012 the application of these standards will be consistent in both entities, providing more certainty in the quality and timeliness of NPL data at system level. Our expectations are tilted toward an improvement in the NPL ratio on the back of these changes, with a fall from 13.3 % in 2011 to 7.7 % in 2012 (and a further decline in the medium term to below 4 %).

During 2011 banking developments had been marked by a slight improvement of the overall environment, especially as a result of stronger management of credit risks in commercial banks. These processes have resulted in reducing the cost of risk and combined with revenue growth of claims from previous periods (one-off effect produced by local accounting standards in the Federation), led to a significant recovery of banking sector profitability in 2011 in comparison to the previous year. Overall, the outlook for the banking industry in 2012 remains challenging. Nevertheless, maintaining the current level of asset quality accompanied by moderate growth in lending activities and the preservation of the interest margin should result in some modest growth in banks' profitability. On balance we expect profitability to remain decent in the coming years, with the net operating profit remaining broadly flat at + 1.5 % of GDP. We do see further measures in terms of cost management in the banking system, with the cost / income ratio expected to further improve from 62 % seen in 2011 to 59 % in 2015. However, the effect of the Eurozone sovereign debt crisis is set to affect the availability and cost of foreign funds, but on the other hand interest rates on loans to domestic institutional sectors should also be exposed to upward pressure.

Bulgaria

Slowing growth will put credit quality to the test

Kristofor Pavlov and Elena Kostadinova

	2008	2009	2010	2011E	2012F
Macro/Monetary					
real GDP (% yoy)	6.2	−5.5	0.2	2.0	1.5
CPI (% avg)	12.4	2.8	2.4	4.2	1.6
Central Bank reference rate (% eop)	4.07	0.23	0.20	0.25	0.38
Banking volumes					
Deposits (% yoy)	8.8	3.3	8.5	11.7	8.4
Lending (% yoy)	32.9	3.9	1.7	1.7	3.1
Loan-to-deposits ratio (%)	123.2	123.9	116.2	105.8	100.5
Mortgages (% of GDP)	12.6	13.2	13.3	12.7	12.6
FX lending (% of total lending) *)	57.0	58.8	61.4	64.0	65.5
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues/Average Volumes (Loans+Deposits), %	4.5	4.2	4.2	4.0	3.8
Net Operating Profit (% of GDP)	2.2	1.3	1.0	0.8	0.7
Cost/Income (%)	50.0	50.3	48.8	50.2	50.1
ROA (%)	2.2	1.2	0.9	0.8	0.7
ROE (%)	19.3	9.1	6.8	5.7	4.9
Capital, liquidity and funding					
CAR (%)	14.9	17.0	17.5	17.8	18.5
Net foreign assets (% of GDP)	−15.7	−13.4	−9.7	−4.4	−1.4
Bank bonds outstanding, (% of GDP)	–	–	–	–	–
Asset quality					
Impaired Loans (in % of gross loans)	3.2	6.1	11.9	15.3	17.4
Cost of Risk (bp)	75	205	257	260	269
Banking sector structural indicators					
Foreign ownership (% of total assets)	83.9	84.0	80.7	77.2	75.2
Top 5 players (% in total assets)	57.1	58.0	54.5	51.7	49.8

Note: *) Including loans to non-residents
Source: Bulgarian National Bank, National Statistical Institute, UniCredit CEE Strategic Analysis, UniCredit Bulbank Economic Research

Macroeconomic environment

In 2011 the Bulgarian economy has weathered relatively well the challenges stemming from the Eurozone sovereign crisis. Rapid adjustment has put an end to most of the boom-related imbalances. The current account is now running a small surplus while core inflation remains subdued. GDP recovery is under way but progressing at a slow pace. Overall, the fundamental problem undermining Bulgaria's recovery is the lack of demand on the part of both businesses and households. This mainly reflects the persistently weak housing and labor market revival in addition to corporate sector deleveraging. Given the currency board arrangement, the policy response has so far been focused on preserving a tight counter-cyclical fiscal policy and pressing ahead with growth-enhancing structural reforms. But this, in our view, is unlikely to prove enough to compensate for the slack from the anticipated slump in exports and, as a consequence, we expect real GDP growth in 2012 to slow down to 1.5% from 2% in 2011.

Banking environment

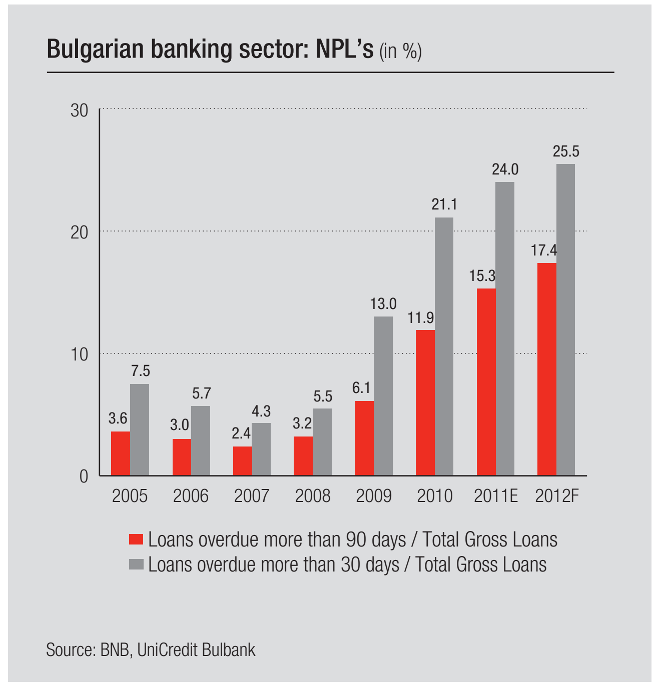
Solid precautionary savings and improved stimulus for savings – real interest rates have remained in positive territory – played a key role in explaining the double-digit rise in customer deposit volumes in 2011. Initially, the process was entirely driven by the retail segment; however, the pace of corporate deposits expansion also

gained momentum in mid-2011 as escalation in the Euro sovereign debt crisis prompted local companies to start building liquid reserves to meet more comfortably their elevated external funding needs. Weak competitive pressures from alternative savings products and improving fiscal position were also among the relevant drivers behind the impressive increase in deposits in 2011. Looking ahead to 2012, the ongoing stabilization of employment (if uninterrupted by slowing exports) should provide some stimulus to households' spending, causing cash hoarding to wane and retail deposit growth to lose some momentum. Given the significant scale of the remaining deleveraging challenge that the corporate sector still faces, corporate deposit growth is also likely to decelerate in 2012.

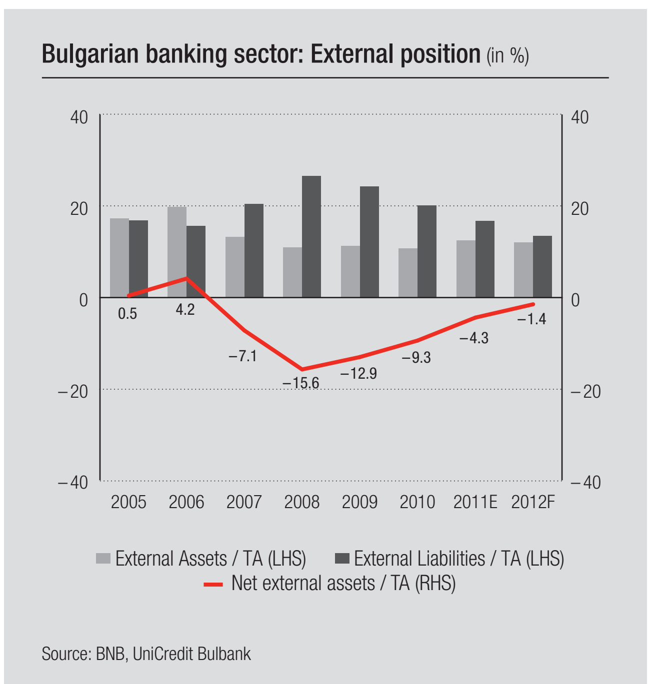
As a result of diminishing demand for new loans and some tightening in credit standards, Bulgaria's credit to households and non-financial corporations increased only modestly in 2011. Moreover, some banks chose to reduce their "non-core" assets, either through disposal or by running off maturing assets, contributing additionally to the weak lending activity in 2011. The bigger picture though, is that after having bottomed out in 2010, credit growth is slowly getting back to normal. As more sectors of the economy see deleveraging pressure slowly coming to an end, we expect corporate lending growth to gain additional momentum in the years to come.

With deposit growth far exceeding that of credit, at the end of 2011 banks were able to reduce their reliance on external borrowing close to the level seen back in early 2006, thereby becoming less exposed to a possible credit crunch induced by ongoing constraints in the Eurozone's funding markets. This aggregate picture, however, masks considerable divergences among individual banks. Thus, while most of the banks have broadly balanced their external positions (with net external assets being either close to zero or even positive), there are a limited number of local players that still have a relatively long way to go in terms of bringing their external borrowing down to more sustainable levels.

The adverse trend in credit quality deterioration has not yet come to an end. Our baseline scenario envisages non-performing loans reaching their peak (in between 17.5 % and 19 % of total gross loans) between the end of 2012 and the beginning of 2013. Asset quality remains vulnerable to the weak protection of creditor rights as well as the non-negligible concentration of corporate loans in the real estate and construction sectors, which are among the sectors that have been particularly hit by the downturn in the real economy. In 2012, banks should also see the quality of their loans tested by slowing economic growth in the Eurozone, which is the final output destination for most of the exporting companies in Bulgaria. Other sources of vulnerability



Source: BNB, UniCredit Bulbank



Source: BNB, UniCredit Bulbank

include still declining housing prices and ongoing deleveraging in the corporate sector as many firms are still under pressure to cut back their external liabilities. On the other hand, however, there are several stabilizing factors. Real income growth has remained in positive territory, while the balance sheets of both the households and particularly the public sector remain very solid. Most banks continue to maintain decent profit margins, which help them to further boost their loss absorption capacity (the share of loans denominated in currencies other than EUR and BGN accounts for less than 4 % of total loan portfolio). In addition, the capital adequacy was 15.6 % of risk-weighted assets for tier one capital and at 17.8 % for total capital ratio in September, while BNB had BGN 4.2 bn in extra reserves (in addition to those required to keep the currency peg) which, if needed, could be used for acting as a lender of last resort. However, we should not completely rule out that some less solid players may ultimately need capital support in the foreseeable future, because while on a consolidated level Bulgarian banks are better capitalized than many of their peers in CEE, there is little clarity as to how capital is distributed among individual banks.

Headline profitability remained weak in 2011, with ROE expected to have remained somewhat below the cost of equity. The aggregate pre-tax profit of the system is seen at around BGN 600 mn at the end of 2011. This mainly reflects one-off factors such as higher losses related to valuation adjustments and provision charges on impaired loans. To a lesser extent, the weaker profitability was also attributable to the higher funding cost as external-borrowing conditions deteriorated in the course of the year, while administrative costs increased broadly in line with the average inflation. Looking ahead, we expect a broadly unchanged profitability picture in both 2012 and 2013, as the operating environment should remain challenging with prospects for improvement related to 2014 and particularly 2015.

Croatia

Banks remain a pillar of stability in a challenging economic environment

Goran Saravanja

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	2.2	–6.0	–1.2	0.0	–0.5
CPI (% avg)	6.1	2.4	1.1	2.4	2.9
Central Bank reference rate (% eop)	–	–	–	–	–
Banking volumes					
Deposits (% yoy)	6.3	–0.1	5.4	1.0	3.1
Lending (% yoy)	14.6	2.2	8.1	5.4	3.1
Loan-to-deposits ratio (%)	120.4	123.2	126.4	131.9	131.9
Mortgages (% of GDP)	16.1	16.7	18.3	18.6	18.5
FX lending (% of total lending)	64.4	71.3	71.9	72.5	73.0
of which CHF, % of FX lending	24.3	18.2	17.2	15.5	14.0
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	3.6	3.6	3.5	3.4	3.4
Net Operating Profit (% of GDP)	1.7	1.3	1.4	1.2	1.2
Cost / Income (%)	56.1	52.7	51.4	50.9	50.9
ROA (%)	1.6	1.1	1.2	1.0	1.1
ROE (%)	9.5	6.4	6.3	5.6	5.7
Capital, liquidity and funding					
CAR (%)	15.2	16.4	18.8	19.0	18.5
Net foreign assets (% of GDP)	7.3	9.2	10.4	10.8	10.0
Bank bonds outstanding, (% of GDP)	1.1	0.2	0.2	0.2	0.2
Asset quality					
Impaired Loans (in % of gross loans)	4.9	7.8	11.2	12.0	11.5
Cost of Risk (bp)	48	141	137	150	143
Banking sector structural indicators					
Foreign ownership (% of total assets)	90.6	90.9	90.3	88.9	90.0
Top 5 players (% in total assets)	72.3	75.4	75.3	75.9	77.0

Source: Croatian National Bank (CNB), UniCredit CEE Strategic Analysis – Zagrebačka Banka Research

Macro Environment

Heading into 2012 we expect the economy to contract slightly (–0.5 %). We estimate that in 2011 the economy recorded zero growth. The main reason behind this forecast is our expectation that the new government will tighten fiscal policy in 2012. In addition, especially in 1H 2012 we expect a less supportive external environment given the ongoing Eurozone crisis. Finally, although we expect Croatia to boast a balanced external position in 2012, the country's high debt service obligations will continue to exert depreciation pressures on the currency. Therefore we see no scope for a loosening of monetary policy even as fiscal policy becomes more restrictive.

Croatia signed the EU accession treaty on December 9, 2011 with a view to becoming a full member on July 1, 2013, once the ratification process is complete. This is positive both in terms of investor sentiment and structural funds.

A key issue for Croatia is maintaining its investment grade credit rating, which is currently at the lowest notch, with two of three major agencies maintaining a negative outlook. A combination of a credible plan to achieve a primary fiscal surplus over the life of the government's 4-year mandate, an acceleration of structural reforms to boost sustainable growth and more openness toward private sector investment are needed to achieve this outcome.

Such measures would allay any concerns investors may have about the pace at which the new administration would implement their economic plan.

Banking Environment

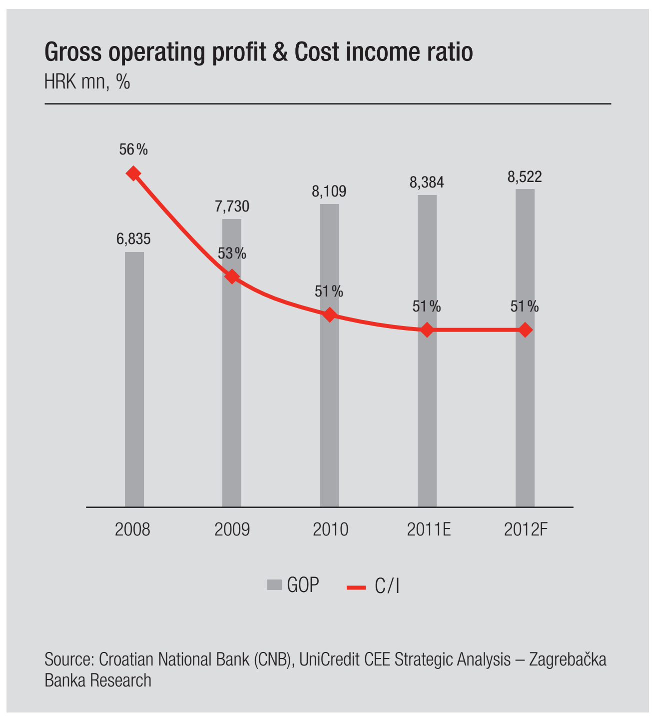
Given the impaired macroeconomic environment, the banking sector in 2012 should face a challenging time. We continue to expect minimal volume growth both for loans and deposits. In 2011 total deposits are expected to increase by 1 % yoy with household savings expanding by 3.0 % yoy while corporate deposits should remain under pressure – we expect them to contract 2.5 % yoy in 2011. In terms of loan volumes corporate loan growth will again outstrip households in 2012 – families continue to deleverage given the high unemployment and the minimal real wage growth, while corporate loan growth rose an estimated 6.5 % yoy in 2011 and we expect growth of 3.0 % yoy in 2012. The main risk to this forecast is the consolidated general government borrowing requirement in 2012, which we estimate at EUR 3 bn, that may crowd out private sector access to loans.

During 2H 2011 interest rate margins have come under pressure as the positive effect of last year's deposit rate reductions has dissipated. Amid the tighter external funding conditions, the focus of the domestic banking sector will shift toward accumulating deposits. Evidently, this has the potential to squeeze margins, especially in an environment where increasing lending rates further is unlikely to be feasible as it would further constrain the already poor demand for loans and risk exacerbating credit quality. The bottom line is that the deterioration in interest margins seen in 2H 2011 is likely to continue also next year.

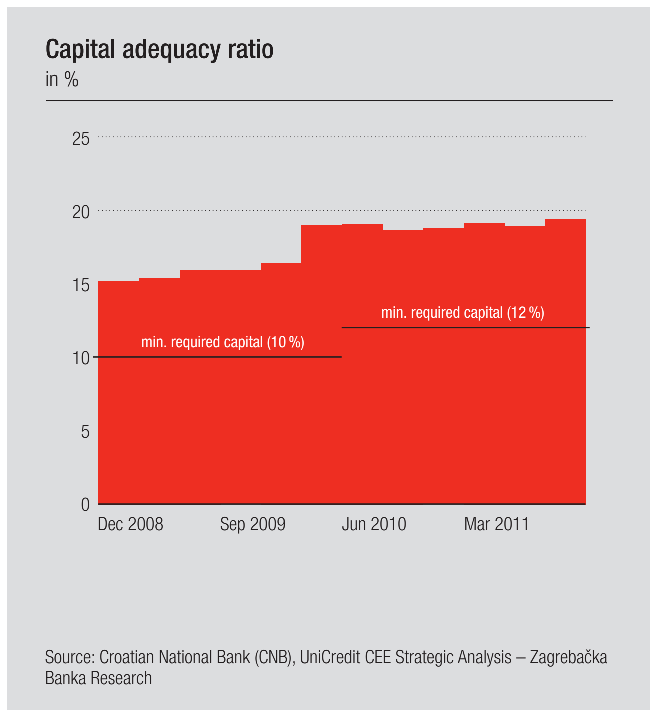
After posting a growth of over EUR 1 bn from the end of 2010 to May 2011, the aggregated balance sheet of the banking sector has only risen by half as much until the end of October (latest available data at the time of writing). Given the persisting funding constraints for European banks and our expectation that EU economic conditions in 1H 2012 will remain poor, we see only minimal growth in banking sector assets in 2012 of 1.8 % compared to 3.5 % in 2011.

In terms of funding sources, it is evident that external liabilities have fallen from a peak of HRK 91.9 bn at the end of May 2011 to HRK 85 bn at the end of October. While no breakdown between long-term and short-term is provided, looking at the foreign debt data, banking sector short-term indebtedness fell by EUR 500 mn in the three months to August 2011 to EUR 2.7 bn (latest data point). Over the same period, long-term external debt fell EUR 700 mn – nonetheless, the stock of long-term external banking sector debt at the end of August at EUR 8.1 bn was EUR 400 mn higher than at the end of 2010.

Domestic sources of funding essentially mean deposits, with the stock of outstanding debt securities issued standing at only HRK 2 bn at the end of October 2011. In 2012 we expect net external financing to remain positive in Croatia on the back of parent group support, but at a lower level compared to previous years.



Source: Croatian National Bank (CNB), UniCredit CEE Strategic Analysis – Zagrebačka Banka Research



Source: Croatian National Bank (CNB), UniCredit CEE Strategic Analysis – Zagrebačka Banka Research

Should the local authorities enact the necessary legislative amendments, the issuance of covered bonds on the local market could become an additional source of funding – however, this is not something we expect to characterize the banking sector in 2012.

Given the recessionary environment prevailing for a large part of last three years, it is no surprise that credit quality has deteriorated. We expect 2012 to mark the peak in non-performing loans at 13 % and for the cost of risk to peak then as well. Mortgage loans remain the best performing in terms of credit quality with NPLs at 5 % at the end of 3Q11. For loans to households in total the NPL ratio was 8.5 % at the end of 3Q11, while for enterprises the ratio was just below 20 %.

The focus of the banking sector in recent years on cost control has been one key contributing factor toward ensuring the achievement of gross operating profit growth throughout the post-2008 period. The contribution of higher net interest margins in 1H11 underpins the 3.4 % growth expected to have been recorded in operating profit, while in 2012 we expect a slower rate of growth of 1.6 % in line with tighter funding conditions and slower volume growth. 2011 should also have seen headline profitability falling by 7.5 % compared to 2010, mainly as a result of increased loan loss provisioning. However in 2012, headline profitability should record a growth of 3.6 % supported by lowering cost of risk in the context of a gradual stabilization in credit quality.

The Croatian banking sector remains highly capitalized with a capital adequacy ratio of 19.4 % at the end of September 2011. The minimum capital adequacy ratio prescribed by the regulator is 12 %. 2012 will again be characterized by high capital adequacy.

In terms of regulatory changes the sector will continue to gradually implement Basel III requirements. Given that 80 % of the money supply in Croatia is in foreign exchange and deposits of the banking sector are at similar levels, it is not feasible to expect restrictions on FX-linked lending. At the same time, the new government has not indicated any desire to levy banking sector taxes.

The Croatian banking sector remains profitable despite rising loan loss provisions, pressures on interest margins and low volume growth thanks to disciplined cost control. In the medium term reductions in loan loss provisions as the economy recovers should be supportive for improvement in banks' profitability. Nonetheless, a return to the levels of profitability seen in the pre-global financial crisis days is unlikely.

Czech Republic

Economic fundamentals to weigh but euro debt crisis less so

Pavel Sobisek and Patrik Rozumbersky

	2008	2009	2010	2011E	2012F
Macro/Monetary					
real GDP (% yoy)	3.1	–4.7	2.7	1.8	0.9
CPI (% avg)	6.3	1.0	1.5	1.9	3.1
Central Bank reference rate (% eop)	2.25	1.00	0.75	0.75	1.00
Banking volumes					
Deposits (% yoy)	8.5	5.4	2.4	2.9	1.4
Lending (% yoy)	15.3	1.5	2.8	5.0	4.7
Loan-to-deposits ratio (%)	75.6	72.8	73.0	74.5	76.9
Mortgages (% of GDP)	16.0	18.3	19.3	20.1	20.6
FX lending (% of total lending)	9.5	8.8	8.3	8.5	8.1
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues/Average Volumes (Loans+Deposits) %	3.2	3.7	3.3	3.3	3.2
Net Operating Profit (% of GDP)	1.4	1.9	1.7	1.7	1.6
Cost/Income (%)	49.8	40.3	44.1	45.7	47.2
ROA (%)	1.3	1.7	1.5	1.4	1.4
ROE (%)	13.7	15.7	13.5	12.3	11.7
Capital, liquidity and funding					
CAR %	12.3	14.1	15.5	16.0	16.2
Net foreign assets (% of GDP)	6.6	6.2	5.7	4.9	4.7
Bank bonds outstanding, (% of GDP)	7.0	7.9	7.8	8.1	8.3
Asset quality					
Impaired Loans (in % of gross loans)	3.3	5.4	6.5	6.5	6.7
Cost of Risk (bp)	86	152	111	111	96
Banking sector structural indicators					
Foreign ownership (% of total assets)	97.1	97.3	96.9	97.0	97.0
Top 5 players (% in total assets)	62.1	62.4	62.5	62.0	62.0

Source: CNB, UniCredit CEE Strategic Analysis, UniCredit Bank Czech Republic Economic Research

Macro Environment

GDP may have fallen into a quarterly contraction in 4Q 2011 on the back of faltering manufacturing (until recently the only engine of growth). The gloomy short-term outlook for the Czech economy is a function of depressed external demand while the domestic supply side factors (financial conditions, macro stability, policies) remain rather healthy. The economy thus looks prepared to react swiftly once demand returns. Our baseline scenario envisages a mild and brief recession. A rebound by mid-2012 would still allow for full-year GDP growth of 0.9%, in line with our expectations. Healthy supply side factors also make the 2013 outlook much more promising than 2012.

Banking Environment

Hand in hand with overall economic activity, the total lending dynamic continued to strengthen in the first months of 2011 but has run out of steam since 2Q. This was mainly a reflection of the trend in the corporate rather than in the retail segment, as the latter has long remained on an easing path. In addition to a more adverse business environment, one special factor has also taken the lead in corporate loan growth recently i.e. the photovoltaic boom in 2H 2010 and related investment loans whose volume was estimated at tens of CZK billions. A decline in the retail lending dynamic observed for many years has slowed substantially over recent months. Within retail lending products, however,

diverging trends are looming between consumer and housing products. Whereas the portfolio of consumer credits has even started to contract recently, the growth rate for the housing loans portfolio has likely bottomed out. The recovery of the mortgage market, in part encouraged by the planned VAT rate hike in January 2012, is also reflected in new production statistics. The volume of newly granted mortgages should have hit roughly CZK 115 bn in 2011. Such a sum would lag behind the pre-crisis 2008 volume by only CZK 5 bn.

In 2012 we expect a deceleration in corporate lending to offset the moderate revival in retail lending, so that total loans growth is seen down 0.3 p.p. from the 5 % yoy expected to have been recorded in 2011. On the one hand the corporate segment should feel the pinch of economic stress; on the other hand the ongoing pick-up in mortgage loans should be strong enough to boost the household credit dynamic. This should likely not be the case during the first months of 2012 due to the VAT-induced surge in late 2011. However, assuming that mortgage interest rates will stay near their record-low levels and the cost of construction works is impacted by another round of the lower VAT rate hike from 2013, there is a solid chance for housing lending to regain momentum in late 2012.

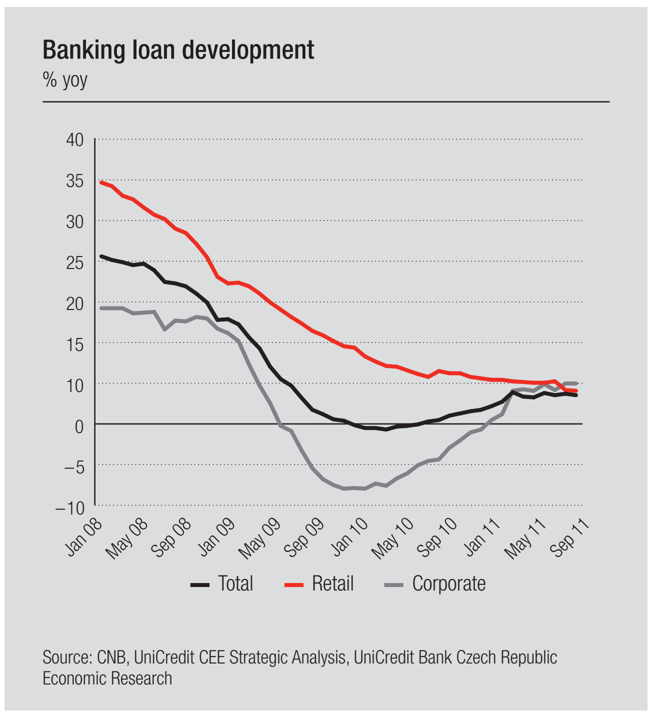
Total deposit growth has lagged well behind the lending dynamic, even though the most recent development pointed to some acceleration. This has been primarily driven by the financial and non-financial corporations segments, while household deposits have suffered from a substantial drop sparked by a shifting of money to the new government bonds tailored to retail investors. Until 3Q 2011, however, retail deposit growth maintained a solid momentum, benefiting from the outflows from equities and money-market funds. Going forward, we expect subdued growth for both retail and corporate deposits through 2012, with the weak income situation, unattractive interest rates and potential further retail bond issues being the major obstacles to expansion.

With the CNB holding its benchmark 2-week repo rate at a record-low level and longer-term interest rates declining for most of the past year, the downward trend has continued for the average lending rate. In the retail sector, this tendency was underscored by fierce competition in the mortgage segment. On the deposit side, however, the average rate has remained more or less flat since the start of 2011, with that in the corporate segment even showing a moderate increase. As a result, the total spread which had been on the rise since 2007 turned sharply downward last year. Provided that the CNB tightens monetary conditions at the earliest in late 2012, the trends seen until recently are unlikely to change dramatically in the foreseeable future. Pressure on margins is likely to persist also due to new market players offering extra yields for their deposit products in order to boost their funding base.

Concerning the balance sheet structure, banks continue to benefit from the conservative preferences of households that favor bank deposits over alternative forms of savings. This ensures a significant excess of client deposits over loans, with the loan-to-deposit ratio expected to have reached 75 % at the end of last year.

Banking loan development

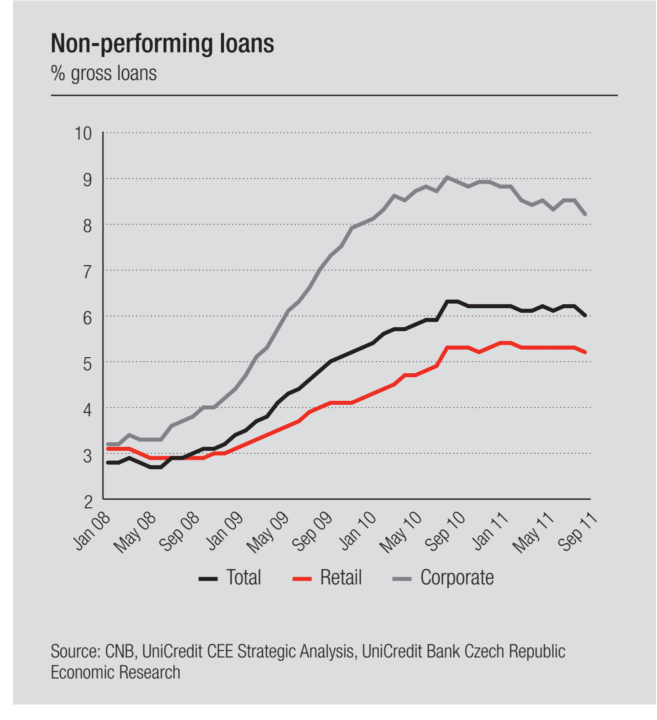
% yoy



Source: CNB, UniCredit CEE Strategic Analysis, UniCredit Bank Czech Republic Economic Research

Non-performing loans

% gross loans



Source: CNB, UniCredit CEE Strategic Analysis, UniCredit Bank Czech Republic Economic Research

In addition to deposits from resident clients (which account for about 62 % of total liabilities), the funding from local sources includes bonds (7 %) and interbank loans (5 %), while external liabilities are roughly 10 % of the total. Therefore, banks do not depend on funding from abroad and maintain a positive net external position. Even though the ratio of net foreign assets to GDP has long been on the decline, no dramatic deterioration is expected in the next years.

The rise in the volume of impaired loans eased substantially in 2011. More importantly, the NPLs ratio has stabilized at around 6.5 % since 2H 2010, suggesting that the problem of credit quality is no longer escalating. However, deterioration in the macro environment could again change the situation. In line with our GDP scenario, which assumes a relatively marked slowdown but not recession in the Czech economy in 2012, we expect only a moderate increase of the NPLs ratio toward year end.

The banking sector pre-tax profit is expected to have contracted for the second consecutive year in 2011. The negative reading stemmed primarily from impairments on Greek bonds booked in the amount of roughly CZK 8.7 bn during 2Q – 3Q. On a positive note, however, loan-loss provisions have posted a significant drop and the revenue side of the P&L statement has shown an improvement in the operating profit. In 2012, we expect total profit growth to return to positive territory with additional impairments on periphery bonds unlikely to be charged. Nevertheless, benign volume growth and tightening interest rate spreads curbing growth of net interest income combined with deteriorated credit quality and elevated growth of operating costs will not allow for a substantial pickup in the banks' profitability.

The results of the latest CNB stress test have confirmed the overall stability of the banking sector even in the case of highly adverse shocks. These include the impact of a potential escalation of the euro area debt crisis, which translates into a deep recession in the Czech economy. Under the stress scenario, cost of risk was assumed to surge to 270 bps in 2012 (from 110 bps estimated for 2011) and devaluation of all claims toward five indebted Eurozone countries*) brought to zero. Even though this assumption of a 100 % haircut is extremely stressed, the total exposure of the Czech banking sector to these countries (CZK 24.4 bn in 3Q 2011, or 0.6 % of total banking sector assets) is not significant enough to cause any major consequences for banking sector stability. Despite the relatively high credit and market losses in the stress scenario, the aggregate capital adequacy ratio should stay above 11 %. This is mainly thanks to prudent risk management conducted by local banks resulting in a sufficiently high capital buffer (CAR stood at 15.7 % in 3Q 2011).

*) Exposures to the governments and private sector institutions of Greece, Ireland, Italy, Portugal and Spain

Hungary

Banking processes mainly shaped by the regulatory environment

Ágnes Halász

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	0.8	–6.7	1.2	1.5	0.0
CPI (% avg)	6.1	4.2	4.9	3.9	4.9
Central Bank reference rate (% eop)	10.00	6.25	5.75	7.00	7.00
Banking volumes					
Deposits (% yoy)	9.5	5.8	–1.3	3.0	3.2
Lending (% yoy)	18.5	–3.5	4.1	0.4	0.3
Loan-to-deposits ratio (%)	142.9	130.3	137.4	133.9	130.2
Mortgages (% of GDP)	15.4	16.2	17.1	16.9	15.6
FX lending (% of total lending)	64.6	63.3	63.0	62.1	58.3
of which CHF, % of FX lending	68.4	61.8	62.6	60.1	56.2
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	3.6	4.1	3.3	3.3	3.3
Net Operating Profit (% of GDP)	1.00	1.03	0.26	0.25	0.58
Cost / Income (%)	61.0	45.3	57.3	53.3	52.7
ROA (%)	0.8	0.8	0.2	0.2	0.5
ROE (%)	10.6	9.5	2.5	2.5	5.9
Capital, liquidity and funding					
CAR (%)	11.2	13.1	13.0	12.0	12.5
Net foreign assets (% of GDP)	–27.9	–25.7	–22.9	–21.7	–20.6
Bank bonds outstanding, (% of GDP)	5.3	7.3	8.0	9.1	10.2
Asset quality					
Impaired Loans (in % of gross loans)	4.5	8.5	12.5	14.5	14.5
Cost of Risk (bp)	86	245	208	227	178
Banking sector structural indicators					
Foreign ownership (% of total assets)	86.4	86.0	86.4	88.4	88.9
Top 5 players (% in total assets)	62.0	61.3	59.8	67.1	68.2

Source: NBH, HFSA, UniCredit Bank Hungary

Macro Environment

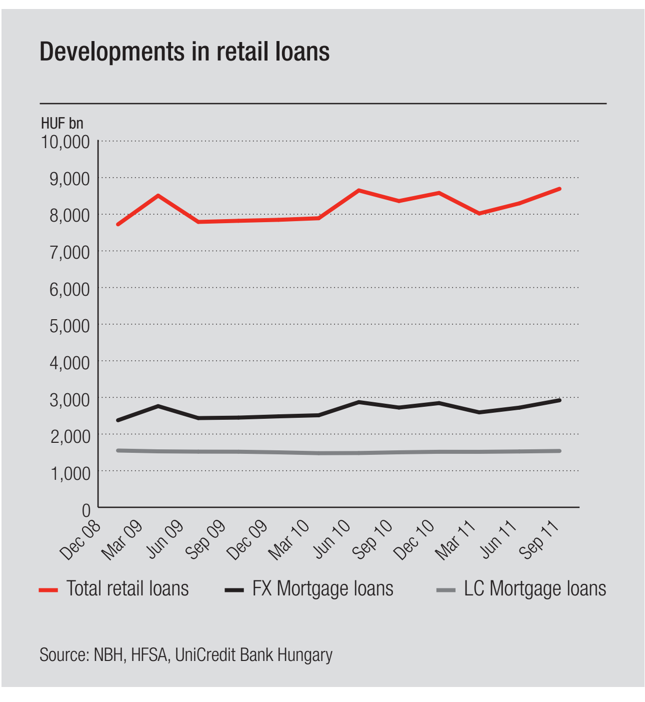
Due to its deep economic and financial integration, Hungary is highly exposed to the current global economic backdrop. Weakness in the US and Eurozone economies and the appreciation of the Swiss franc since mid-summer resulted in a massive depreciation of the Hungarian forint. As FX exposure of Hungarian households is extremely high, the strong CHF has triggered a significant deterioration in households' income position, thus negatively affecting private consumption and investment. Moreover, unpredictable regulatory environment and fiscal policy have resulted in a loss of credibility with financial markets. Along with lagging external demand, these factors may result in a sluggish and creditless recovery for Hungary in the next years. Nevertheless, the potential renewal of IMF co-operation on a safety net, the government's commitment to the deficit target and the decreasing external exposure enable the country to maintain a decent level of refinancing despite recent downgrades of Hungarian sovereign ratings to junk status.

Banking Environment

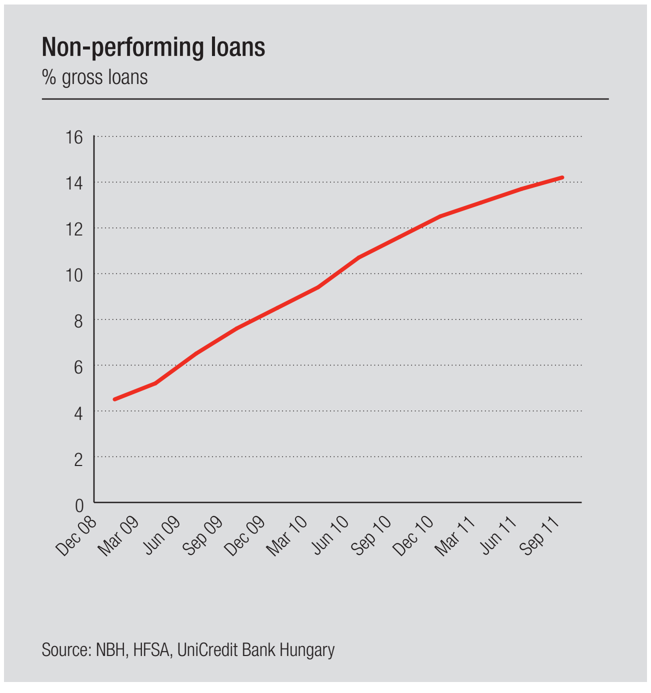
Changes in the regulatory environment have been the main factor shaping banking activity in Hungary over the last couple of years. In addition to a punitive bank tax introduced in 2010, the Hungarian government has undertaken a number of legislative steps to alleviate households' solvency problems, which impose a substantial

burden upon the banks. The first important administrative measure was the "Home Protection Plan" in May 2011. The act included (among other things) an exchange rate cap that allows borrowers to temporarily opt to fix the exchange rates of their FX loans, the establishment of the National Asset Management Agency and a gradual lifting of the moratorium on evictions and foreclosures. Effects of the package however remained rather moderate. At the end of September, this step was followed by new legislation introducing the possibility of early final repayment of FX mortgage loans at preferential exchange rates. This legislation affects the Hungarian FX loan market, which has a value of over EUR 18 bn, with an immediate loss of at least 15 % for EUR loans and at least 25 % for CHF loans on each repayment. A number of banks have already announced significant losses in 3Q 2011 due to the higher loss provision connected to the scheme and further substantial loss provisions are estimated to have been made by the end of 2011. In December, the government and the Banking Association reached a further agreement on how to solve the problem of FX mortgage debtors. Based on this agreement, 30 % of banks' losses arising from early final repayments at preferential exchange rates could be deducted from the special bank tax. In the case of DPD90+ debtors' banks convert the FX-mortgage loan to a HUF mortgage loan and cancel 25 % of such clients' debts by May 15, 2012. Of the cancelled claims, 30 % can be deducted from the special tax due in 2012. There are preferential rates at which duly performing FX mortgage debtors can choose to repay their debt (HUF / EUR 250, HUF / CHF 180 and HUF / JPY 2). When exchange rates exceed the cap, the surplus is being booked in a buffer account and deferred until 2016. Interest accruing in respect of the amounts booked on the buffer account is borne by the Hungarian government and the banks on a 50:50 basis, unless the FX exchange rate exceeds certain pre-defined levels, in which case the (additional) interest accruing on the buffer account is borne by the Hungarian government only. The government committed to maintain the basis and the rate of the bank tax unchanged in 2012, while the rate will be decreased by 50 % in 2013. In 2014 the bank levy will be not higher than the bank tax as defined by the legal framework of the EU, or the average of the bases and the rates of bank taxes in effect in Member States.

Despite a frozen lending market, effects of exchange rate revaluations on outstanding loan volumes have been visible, as 65 % of retail and 47 % of corporate loans are denominated in foreign currency. Considering that the Hungarian Forint depreciated against both the EUR and CHF by 10 – 11 % on average in 3Q 2011, gross loans increased nominally to around the previous year's level in Sep. Adjusting for FX effects, however, a declining trend was visible. Demand and supply factors both play a role in the sluggish lending activity, which should remain moderate during this year as well. In the retail segment, the unfavorable and uncertain income position continues to have a negative effect on households' consumption. On the other hand, supply side constraints (exacerbated by the bank levy and the impact of the early repayment law) resulted in tighter credit market conditions. The declining trend of deposits volumes reversed in 3Q supported by real interest payments from pension funds and the exchange of FX deposits into HUF (due to a depreciating forint and higher forint interest rates). Going forward we expect deposits growth to remain moderate but above that in lending, resulting in further reduction in the loan-to-deposits ratio to around 128 % by 2013.



Source: NBH, HFSA, UniCredit Bank Hungary



Source: NBH, HFSA, UniCredit Bank Hungary

The rise in non-performing loans (NPLs) also continued in 2011, albeit at a slower pace. In the corporate sector, the ratio of loans overdue more than 90 days increased to 16 % in 3Q 2011. As a result of deteriorating profitability caused by the challenging economic environment and a decrease in demand, restructured loans gradually turned to non-performing. The weak economic prospects also put pressure on the financial position of performing enterprises. In the retail segment a more moderate deterioration of portfolio quality was reflected in an NPL ratio of up to 13 % in 3Q. Going forward, some further deterioration cannot be ruled out although the overall NPL ratio should stabilize around the level estimated for 2011.

The number of banks recording losses has been declining throughout the first half of 2011. However, provisioning in connection with the early repayment program in the second half of 2011 is estimated to have eroded profitability further. The relatively favorable result thus remains dependent on market players' ability to compensate for worsening external conditions with rationalization measures and boosting efficiency where possible. This is very observable in the disciplined and stable cost performance expected to persist during 2012. Profit before tax in the Hungarian banking sector reached HUF 87 bn in the third quarter of 2011 and is estimated to have fallen to some HUF 70 bn by the end of the year, although with a large degree of uncertainty connected to the full impact of the FX law. In addition to the flat dynamic in banking volumes and strict focus on cost containment measures, this year's profit performance is likely to continue to be shaped to a large extent by loan loss provisioning and the uncertain regulatory outlook.

Kazakhstan

Deposits funding credit growth, NPLs resolution at early stages

Hans Holzhacker

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	3.3	1.2	7.3	6.8	6.0
CPI (% avg)	17.2	7.3	7.1	8.5	6.6
Central Bank reference rate (% eop)	10.50	7.00	7.00	7.50	7.50
Banking volumes					
Deposits (% yoy)	19.9	26.9	17.1	18.7	13.7
Lending (% yoy)	5.5	5.3	9.0	11.1	8.5
Loan-to-deposits ratio (%)	175.6	145.7	135.6	127.0	121.2
Mortgages (% of GDP)	4.1	4.3	3.1	2.7	2.6
FX lending (% of total lending)	44.2	48.4	42.3	37.0	36.0
of which CHF (if relevant), % of FX lending					
Profitability					
Revenues / Average Volumes (Loans+Deposits)	6.6	2.6	−3.4 [1]	2.4	2.4
Net Operating Profit (% of GDP)	0.2	−17.8	−3.5 [1]	−0.2	0.0
Cost / Income (%)	29.0	57.9	– [3]	59.1	54.1
ROA (%)	0.3	−19.4	−5.4 [1]	−0.4	0.1
ROE (%)	2.6	– [4]	−61.2 [1]	−4.3	0.6
Capital, liquidity and funding					
CAR % (local accounting standard – k2)	12.4	−11.6	17.9	17.7	–
Net foreign assets (% of GDP)	−10.0	−3.6	2.0	3.6	4.6
Bank bonds outstanding, (% of GDP)	1.4	2.5	7.2	5.8	–
Asset quality					
Non-Performing Assets (%)	10.8	28.7	32.3	34.0	34.5
Cost of Risk (bp) [2]	166	713	245	276	43
Banking sector structural indicators					
Foreign ownership (% of total assets)	13.1	16.8	17.5	22.0	–
Top 5 players (% in total assets)	74.8	73.9	71.8	62.0	–

Note: 1) Net of USD 15bn in foreign debt forgiveness; 2) Based on new provisions – if taking into account also releasing of provisions: 2008 (6.7%), 2009 (35.9%), 2010 (0.6%), 2011 (2.4%), 2012 (1.9%); 3) In 2010 income was negative, net of debt restructuring; 4) In 2009 the equity of the banking system was negative
Source: NBRK, UniCredit Research

Macro Environment

In 2011, real GDP growth is expected to have remained strong at about 7 % yoy. We believe that the current investment fatigue in oil and gas is linked to the specific stage of oil fields development and disputes over re-distribution in ownership of major projects. Should that remain transitory, we would expect to see economic growth remaining robust also in the long term. We forecast that in 2012 real GDP growth should hold up at 6.0 % despite somewhat lower export growth as terms of trade stay relatively favorable and allow for further increases in income and consumption. A moderately lower current account surplus in 2012 vs. 2011, a continuation of high portfolio outflows together with weaker RUB prospects are set to undermine the appreciation pressures seen up to mid-2011. On the back of this we see the KZT broadly unchanged vs. the USD despite strong fundamentals.

Growth in the broad money supply was little changed in 2011 vs. 2010 and growth in M1 has slowed. The money supply is thus contributing only moderately to inflationary pressures, with global food and energy prices having a larger impact. At the same time liquidity has not been scarce in Kazakhstan, as witnessed by the significant increases in banks' reserve holdings with the central bank. The NBRK is unlikely to take either tightening measures or measures in support of liquidity any time soon. Inflation eased to

7.8 % by November 2011, which is within the central bank's implicit target of 6 %–8 %. We expect a further decline to as low as 6 % in early 2012 due to a base effect, followed by a return to marginally above 7.2 % by Dec 2012 as easing food price pressures will be outweighed by faster tariff hikes.

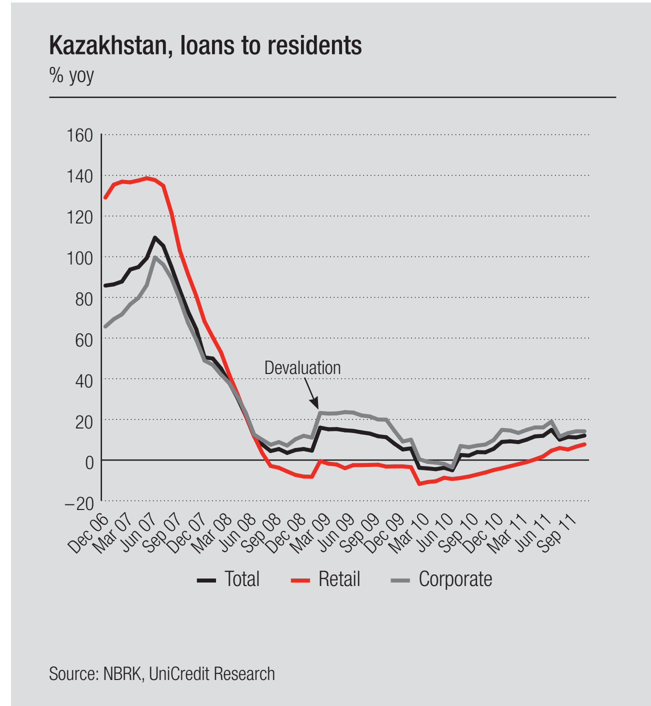
Banking Environment

Banking continues to be the weak spot in Kazakhstan's growth story. NPLs have remained high. They have not yet peaked, particularly if loans "restructured" by simply extending maturities are taken into account. However, trust in the Kazakhstani banking system has remained intact: customer deposits were 12.7 % higher in October 2011 than the previous year, deposits by residents by 14.0 % (corporate deposits were up 6.4 % yoy, retail deposits 28.2 % yoy). Loans to customers increased 12.7 % in the 12 months to October 2011, loans to residents 12.1 % (corporate 14.2 % yoy, retail 7.8 % yoy). About 3 pp of this was due to accounting (mostly writing back of loans by BTA), but there has actually been some credit growth in 2011, although with much of the increase in lending concentrated among a few banks with rather aggressive lending policies. Outstanding loans increased in all sectors with the exception of trade, where some deleveraging is still going on, particularly among SMEs.

We expect only moderate loan growth of 8.5 % in 2012, only marginally higher than inflation, and some 12 % in 2013, as banks continue to focus on work-outs and companies remain rather cautious about increasing their debt burden. Loan demand should come from manufacturing (particularly metals, food, chemicals), large government-sponsored infrastructure projects, but also from some recovery in the housing market which began in late 2010. We expect deposits to grow broadly in line with income (nominal GDP) at about 13–14 % in 2012/2013. Wholesale funding should continue to contract until 2012, due to ongoing net repayments of foreign debt, but again play a somewhat bigger role from 2013 onwards.

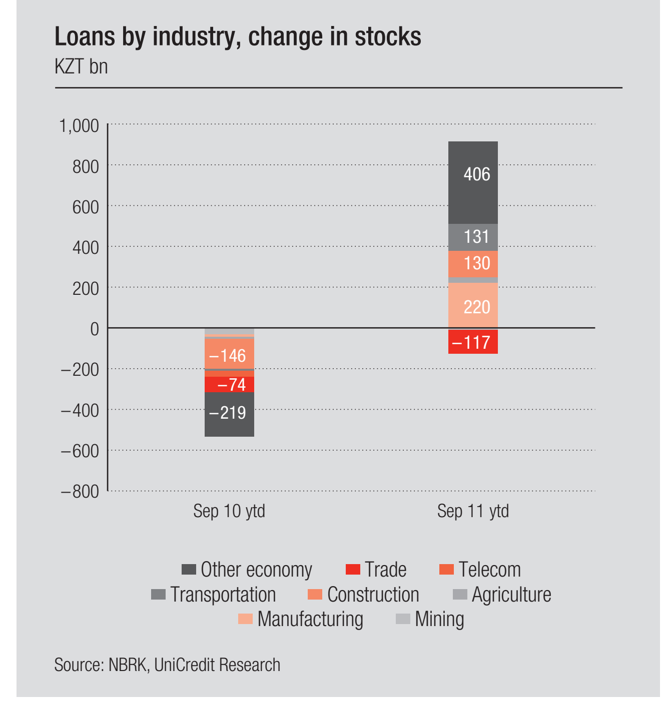
We foresee interest rate spreads narrowing slightly over the coming years due to increased competition in the banking system, offset however by a shift to higher yielding non-loan assets and fees and commissions for services. Operating expenses should increase slightly below inflation as staff cuts will not be fully offset by increases in real wages to hire qualified personnel and as economizing on outlays of office space etc. is not fully countered by higher costs for IT and other directly product-related spending. Although we do not expect a significant reduction in the NPL ratio in Kazakhstan any time soon, we also do not envisage a further substantial increase. New provisions will at least in part be offset by write backs of provisions thanks to the ongoing work-out process, leaving net provisions well below the levels of new provisioning. We therefore expect the banking system to return to (very moderate) profitability in 2012.

Kazakhstan, loans to residents
% yoy



Source: NBRK, UniCredit Research

Loans by industry, change in stocks
KZT bn



Source: NBRK, UniCredit Research

Capital adequacy remained at the comfortable level of 17.7 % on average for the banking sector in Oct 2011 (according to local accounting standards), although for individual banks the level might be lower. Problems for some banks might be aggravated when Basle III is applied as of 1.1.2013 (as planned by the authorities). However, we do not believe that problems of individual banks will drag the banking system as a whole into a crisis, not least because of ample fiscal reserves, which in the worst case will allow the state to step in. BTA will hold a shareholders meeting in late January at which a second restructuring of foreign debt shall be discussed. In our forecasts we assume that solutions will be found which do not severely affect the banking system's aggregate figures. However, drastic measures such as the transfer of non-performing loans to a non-banking institution, large write-offs because of liquidation and similar options would of course have a significant impact on our forecasts.

Downside risks for the banking system's performance include a severe fall in commodity prices, which would sharply narrow the funding base, as large oil and metals companies would be forced to withdraw their deposits. We see the probability of such a scenario, however, as very low. Foreign funding, by contrast, has lost much of its significance, as by October 2011 according to the NBRK, banks had reduced their reliance on foreign debt to 20 % of total liabilities, from a pre-crisis peak of over 50 % (or to USD 18.6 bn in 2011 from USD 45.9 bn at end-2007, according to foreign debt statistics).

Important regulatory changes are expected to shape banking activity going forward. The Ministry of Finance drafted a new law separating rehabilitation and bankruptcy processes and introducing creditor councils. Amendments to the tax law have been adopted, which should ease the write off of bad loans. Moreover, plans have progressed to set up a centralized, central bank-owned, independently managed Distressed Asset Fund (DFA), to be financed in three tranches by pension funds, the banks and the central bank itself. The DFA will not purchase loans related to real estate, i. e. the larger part of problematic loans. For dealing with real estate, banks are expected to set up several types of SPVs. These can manage assets in a way banks are not allowed to under a banking license. The SPVs have to be consolidated into the banks' balance sheets and offer therefore only limited relief to the P&L. Authorities plan to apply Basel III from January 1, 2013 onwards. The net effect is not yet completely clear: while some capital requirements might become tighter than is currently the case, some types of provisioning requirements might be less stringent than under the current rules and there are plans to ease rules, which relate to foreign funding of capital. All of these measures still need to be put into practice. The road to improvement in the banking system's health will probably remain lengthy and bumpy, given the magnitude of the accumulated problems. However, Kazakhstan's overall macro stability provides support and we are convinced that the banking system will gradually return to a sounder situation.

Poland

Well prepared for a global slowdown

Andrzej Halesiak

	2008	2009	2010	2011E	2012F
Macro/Monetary					
real GDP (% yoy)	5.1	1.6	3.8	4.0	3.1
CPI (% avg)	4.2	3.5	2.6	4.2	2.9
Central Bank reference rate (% eop)	5.0	3.5	3.5	4.5	3.75
Banking volumes					
Deposits (% yoy)	20.5	10.1	9.7	8.9	7.8
Lending (% yoy)	36.5	10.0	9.8	12.2	5.9
Loan-to-deposits ratio (%)	108.1	107.9	108.1	111.4	109.5
Mortgages (% of GDP)	15.2	16.1	19.0	21.1	21.6
FX lending (% of total lending)	31.4	29.2	29.7	30.7	30.1
of which CHF, % of FX lending	63.8	63.9	63.5	60.4	60.5
Banking sector profitability					
Revenues/Average Volumes (Loans+Deposits), %	4.4	3.8	3.7	3.6	3.4
Net Operating Profit (% of GDP) [1]	1.3	0.8	1.0	1.2	1.2
Cost/Income (%)	55.1	54.4	52.5	50.8	50.5
ROA (%)	1.5	0.9	1.2	1.4	1.3
ROE (%)	14.3	6.8	8.6	10.4	9.8
Capital, liquidity and funding					
CAR (%)	11.2	13.3	13.8	13.6	13.9
Net foreign assets (% of GDP)	–10.2	–10.7	–11.7	–12.4	–11.4
Bank bonds outstanding, (% of GDP)	1.3	1.8	2.1	3.0	3.5
Asset quality					
Impaired Loans (in % of gross loans)	4.2	7.0	7.8	7.5	7.7
Cost of Risk (bp)	95	189	148	111	111
Banking sector structural indicators					
Foreign ownership (% of total assets)	72.3	68.1	66.2	n.a.	n.a.
Top 5 players (% in total assets)	44.6	44.2	43.9	45.5 [2]	n.a.

Notes: 1) Profit before taxes; 2) As of September 2011
Source: Pekao Research, NBP, UniCredit Research, UniCredit CEE Strategic Analysis

Macro environment

The 2012 macroeconomic environment is expected to be less favorable, with our forecast showing GDP growth slowing to 3.1 % yoy from the 4 % expected to have been recorded in 2011. The main factor behind the slowdown should be a smaller contribution of investment, which we see peaking in 1H 2012 (in preparation for the European football championship), and then declining in 2H 2012 as public expenditures on infrastructure level off. Corporate investment should be able to offset some of the decline, but the uncertainty related to the Eurozone debt crisis might limit capital outlays. A weaker pace of growth in the Eurozone is set to reduce external demand, but an even stronger decline in imports on the back of internal substitution stimulated by the weaker zloty should render the contribution of net exports to GDP growth positive. With regard to foreign trade it is worth noting that compared to other CEE economies Poland is less dependent on external demand (accounting for 40 % of GDP) and exports are mainly directed toward Germany, which will likely avoid recession in 2012. Over the medium term we continue to see solid potential for growth in Poland given the flexibility of the economy (large domestic market helps to absorb external shock) and credible policy. Recent government actions aimed at keeping the fiscal deficit/debt under control should help to rebalance growth to more sustainable trajectory over the medium term.

Slower growth in 2012 is expected to create stronger headwinds for the labor market. We have seen employment in the enterprise sector improving recently, but would be cautious about any significant improvement in the unemployment rate from here on. At 3% growth, the labor market is not able to absorb the inflow of young people entering the labor pool. A fairly weak labor market in our view should lower demand pressure and coupled with a statistical base effect, help bring inflation closer to the central bank target (2.5%) in 2012. This would create space for monetary policy easing. We expect the NBP reference rate to be reduced by 75 bp over the course of the year, translating into a slightly smaller interest margin for the banks and putting some pressure on overall banking sector profitability. Our reasoning is that banks will favor keeping interest rates on deposits high, amid the uncertain funding outlook.

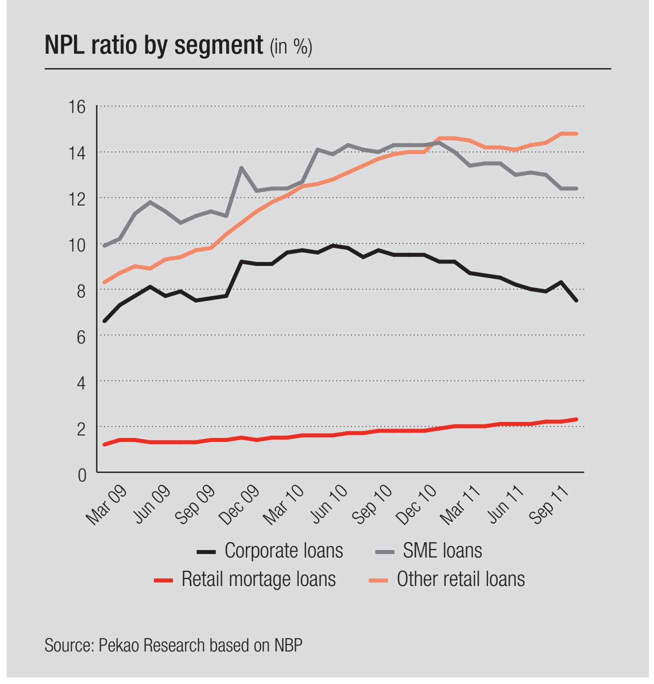
Banking environment

The Polish banking sector, dominated by Western European capital, is potentially threatened by some parent banks' deleveraging. Still a number of factors play into a more favorable story, given that: i) a significant (1/3) part of banking assets belongs to domestic owners; ii) foreign capital is highly diversified – investors stem from as many as 18 countries and no country accounts for more than 12.5% of total assets; iii) reliance on parent funding is limited (net foreign liabilities account for 12% of assets). So far the problems of parent banks have not had significant implications for the Polish banking system. What we have been witnessing instead is a change of ownership, with AIB selling BZ WBK to Santander, and EFG Eurobank intending to sell its controlling stake in Polbank to Raiffeisen.

In order to reduce their dependence on parent funding (and thus support the deleveraging process) some banks may focus on deposit collection in 2012. On the back of this, we expect deposit growth in 2012 to be higher than that of loans (7.8% yoy vs. 5.9% yoy), which should also help to maintain a healthy L/D ratio of below 110 (also beyond 2012). The larger slowdown in loan volumes is chiefly a function of a less favourable macro environment (which should dampen demand for credit from enterprises) and slower growth of household incomes. We expect the biggest slowdown to be visible in the corporate segment (from 12.5% [1] in 2011 to around 4% in 2012) and mortgage loans (from 18.9% [2] in 2011 to 9.1% in 2012). The mortgage market should tend in the direction of smaller volumes of new loans and smaller average size, given the declining prices of dwellings and reduced subsidies for housing loans. In the case of loans for consumption financing we do not expect significant changes in 2012, with the growth rate remaining subdued (3.9% vs. 2.6% in 2011) on the back of high saturation. The flipside of the overall slowdown is that growth in corporate deposits ought to remain in line with that seen in 2011, as the financial results of Polish companies remain solid and their propensity to invest declines.

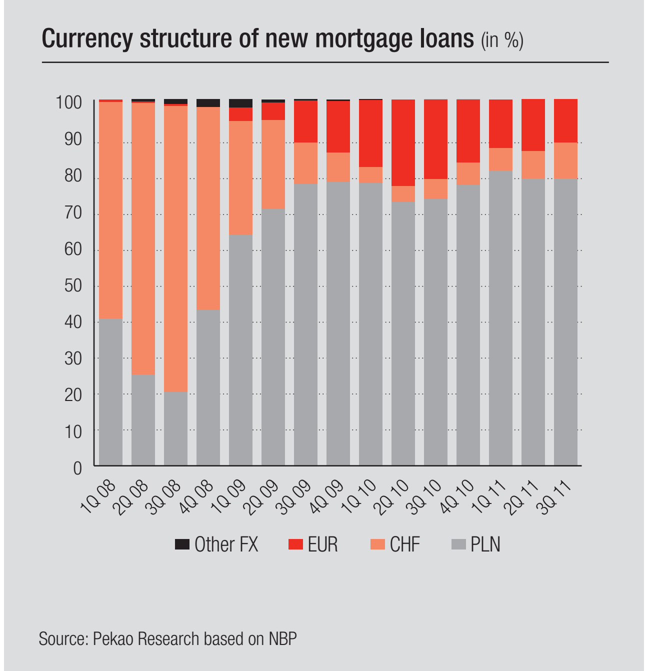
1) 2011 growth rate is distorted by the weakening of the zloty, which increases the zloty value of FX loans (these account for 26% of the total corporate loan portfolio). Adjusted for this effect corporate loan growth was equal to around 10%.
2) As in the case of corporate loans changes in mortgage loans are also distorted by FX movements (FX loans account for ca. 60% of that portfolio). Adjusted for the FX effect mortgage loan growth in 2011 was equal to 14.5%.

NPL ratio by segment (in %)



Source: Pekao Research based on NBP

Currency structure of new mortgage loans (in %)



Source: Pekao Research based on NBP

We also expect that a less favorable macroeconomic environment will likely halt the process of loan quality improvement. During 2011 the non-performing loans ratio fell by 0.6 % (to 7.4 % in October). We expect that at the end of 2012 the NPLs ratio should reach 7.7 %. Something that may also constrain its improvement is the FX loan portfolio structure (~40 % of retail loans, most of which are CHF mortgages), which is highly dependent on developments in the global FX markets. Further measures by the Swiss National Bank to weaken the franc against the euro would support the stabilization of households' balance sheets in Poland.

The Polish banking sector remains stable and attractive, with gross profits forecast in excess of 1 % of GDP forecast for the coming years. Following the robust results seen in 2011, we expect to see some moderation in the banks' P&L in 2012 on the back of higher cost of risk, even as operating results remain decent. ROE should remain close to double digits and the cost/income ratio ought to continue to decline as banks keep tight control of their outlays. Another factor that makes Polish banks attractive is their overall high capitalization. At the end of 3Q 2011 the capital adequacy ratio (CAR) stood at 13.2 %, with the vast majority of capital in the form of the highest quality core tier 1 capital. Stress tests conducted by the Polish Financial Supervision Authority (KNF) in 2011 showed that even in the adverse macroeconomic environment all large banks operating in Poland would not only meet the 5 % core tier 1 requirement, but also the 9 % requirement. Polish banks do not have any exposure to Greek sovereign debt or any meaningful exposure to other Eurozone sovereigns. Nevertheless, the regulator is putting pressure on bank owners to retain a significant part of their 2011 earnings, something that is expected to further support the CAR during 2012.

Another topic worth highlighting is the further potential for additional regulatory tightening. The KNF continues its policy of issuing recommendations aimed at reducing bank exposure to market and credit risk. The regulator was among the pioneers in the CEE region in introducing regulations limiting customers' access to FX loans. An important step in this direction was recommendation S (from 2006), which imposed the requirement of an additional income buffer for those borrowing in FX. Thanks to this prudent policy, the quality of the FX mortgage portfolio is now better than the one in zloty. Most recent regulatory changes are aimed at further displacing FX loans from the retail segment (e. g. starting from 2012 a risk weight for FX mortgage exposures is being raised from 75 % to 100 %). An important change in 2012 is also an amendment to the Tax Ordinance Act, which eliminates a loophole in the law creating space for tax avoidance (capital gains tax on interest from deposits). The existence of this loophole has contributed to the significant reduction of the average retail deposit maturity, which should now be reversed. On the other hand, banks are likely to be forced to increase interest on deposits to avoid an outflow toward alternative forms of savings. At the time of writing, we are also seeing further developments on the earlier proposed special tax on banks, with the Ministry of Finance having presented a bill amending the law on the Bank Guarantee Fund and proposing the subsequent creation of a new stability fund. The fund is to be financed from the contributions of banks in the form of a "prudence fee". The fee is designed to be of anti-cyclical nature, and will hence be introduced in 2013 at the earliest. According to the draft, a sum of the prudential fee and the general yearly contribution to the Guarantee Fund cannot exceed 0.3 % of the base (the latter is 12.5 times the capital requirement). Given that the yearly contribution is now 0.099 %, the ceiling for the "prudential fee" according to our estimates would be 0.201 %.

Romania

Navigating troubled waters

Dan Bucsa

	2008	2009	2010	2011E	2012F
Macro/Monetary					
real GDP (% yoy)	7.1	–7.1	–1.3	2.6	1.4
CPI (% avg)	7.9	5.6	6.1	5.9	3.8
Central Bank reference rate (% eop)	10.25	8.00	6.25	6.00	5.50
Banking Volumes					
Deposits (% yoy)	18.6	8.3	4.9	4.9	6.2
Lending (% yoy)	34.6	3.4	4.4	6.3	3.4
Loans-to-deposits ratio (%)	126.3	120.5	119.9	121.5	118.3
Mortgages (% of GDP)	4.4	5.0	5.7	6.0	6.0
FX lending (% of total lending)	57.8	60.1	63.0	63.7	63.5
of which CHF, % of FX lending	–	–	–	12.1 [1]	–
Banking sector profitability					
Revenues/Average Volumes (Loans+Deposits) %	6.0	5.0	4.5	4.2	4.1
Net Operating Profit [2] (% of GDP)	1.0	0.3	–0.1	–0.1	0.1
Cost/Income (%)	51.5	52.6	55.7	56.7	57.3
ROA (%)	1.6	0.3	–0.2	–0.2	0.1
ROE (%)	14.9	2.8	–1.3	–1.4	0.7
Capital, liquidity and funding					
CAR (%)	13.8	14.7	15.0	13.4	12.6
Net foreign assets (% of GDP) [3]	–18.9	–16.7	–17.6	–17.1	–15.5
Bank bonds outstanding, (% of GDP)	0.2	0.2	0.4	0.3	0.3
Asset quality					
Impaired Loans (in % of gross loans) [4]	6.3	14.8	20.5	20.8	18.1
Cost of Risk (bp)	231	366	396	367	302
Banking sector structural indicators					
Foreign ownership (% of total assets)	88.2	85.3	85.1	84.6	85
Top 5 players (% in total assets)	54.3	54.5	52.7	52.9	53

Notes: 1) As of June 2011; 2) Profit before taxes; 3) Figures refer to banking sector; 4) Doubtful and loss loans over non-governmental credit
Source: UniCredit Tiriac Research, NBR, UniCredit Research, UniCredit CEE Strategic Analysis

Macro environment

Until 2009 Romania's economy grew, spurred by consumption and investment but in 2009 and 2010 domestic demand corrected sharply. The return to growth in 2011 relied on industrial production and exports, lower labour costs and RON depreciation which increased external competitiveness. Bumper crops and a positive comparison with austerity-stricken 2H 2010 spurred domestic demand in 2H 2011, accelerating GDP growth to around 2.6 % in 2011. The positive base effect is set to support GDP growth in 1H 2012 as well.

The gradual return to potential growth is slowed down by weak foreign demand and by low fund inflows, problems that could persist over the next years. Foreign direct investment decreased 42.7 % yoy to EUR 1.3 bn in 10M 2011, while the foreign liabilities of the banking system fell by EUR 0.5 bn (2.1 %) in 10M 2011. Portfolio investment is the main type of foreign funding (EUR 2.7 bn in 10M 2011), benefitting from high RON yields, but has been affected since July by contagion fears from Eurozone's debt problems. FDI flows could be hit in 2012 by risk aversion and by an uncertain post-electoral landscape. Foreign investment is likely to remain

subdued over the next years, with European funds and portfolio investment as the dominant forms of financial inflows, provided that absorption picks up for the former and that risk appetite and RON yields do not fall significantly, thereby affecting the latter.

The budget deficit is expected to shrink to 2.5 % of GDP in 2012 and 2013, after having contracted by an estimated 4.4 % of GDP in 2011. This fiscal adjustment is necessary because the MinFin is relying heavily on local financial institutions to finance public spending and Romanian banks could reduce their exposure to ROGBs in 2012. Funding a part of the public debt abroad has been problematic in 2011 because of rising yields in the Eurozone and falling investor appetite for CEE assets. We expect the financing of budget needs to include a mixture of foreign borrowing and money from International Financial Institutions (IFIs)*) in 2012. In a risk-averse environment, Romania's public debt could remain below 40 % of GDP over the medium term.

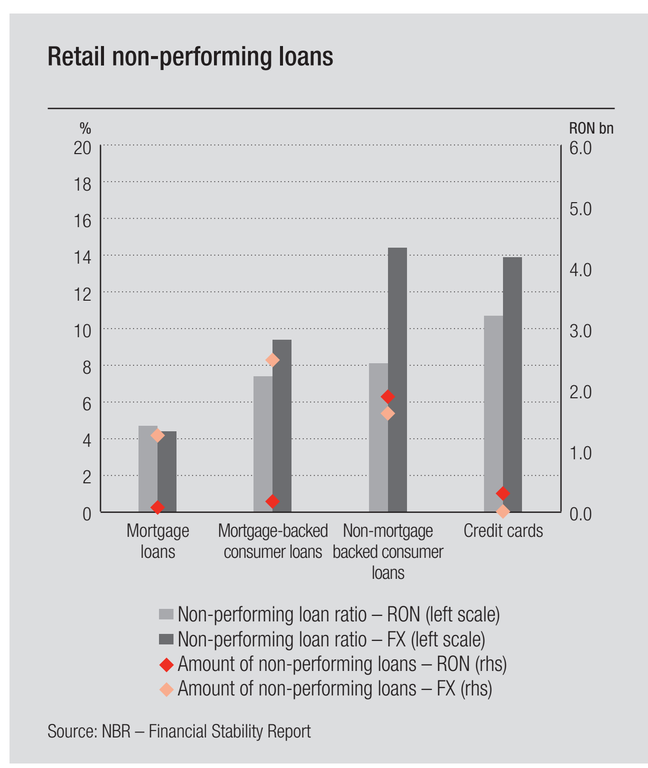
Banking environment

A challenging macroeconomic environment is clearly affecting the whole Romanian banking system. The impaired loans ratio accounted for 23 % of total loans at the end of October 2011, growing since July 2011 on the back of a negative balance sheet and wealth effect generated by RON depreciation. According to the NBR, consumer lending (among types of loans), FX loans (among types of currency) and SMEs (among types of customers) generated the highest NPL ratios at the end of 1H 2011. The quality of the portfolio is expected to improve once the current financial turmoil unwinds, supporting further decline in the cost of risk from the roughly 370 bps estimated to have been recorded last year.

With external funding sharply curtailed, we expect lending to be completely financed by local deposit gathering, bringing the loan-to-deposits ratio down to 113 % by 2015 from 122 % expected in 2011. Banks should vie for private sector funds by ensuring positive real returns. Supplementary funding could be obtained through loans from IFIs and bond issuance (at higher costs than lines from parent banks), but local diversification through other types of liabilities should remain limited by low appetite for non-deposit forms of investment. Since 2010, new loans have been extended mainly to companies and mortgage buyers, while consumer lending has stalled. We expect the gap to widen in 2012 because consumer lending will be hit by poor demand and new regulation that limits loan maturity to a maximum of five years, while curbing FX lending through higher debt service-to-income ratios and greater down payments. A substitution of FX consumer loans with RON lending should be limited by scarcer and more expensive RON funding. The expected result is likely to be almost flat household lending in 2012 and an average growth rate of 6 % until 2015. Corporate loans are expected to grow 6.5 % yoy in 2012 and above 8 % on average until 2015.

*) In the 2012 budget law, the government states that it intends to tap into World Bank funds. We believe that the government could borrow from the EUR 5 bn of the current IMF stand-by agreement if foreign funds prove to be expensive in 1H 2012.

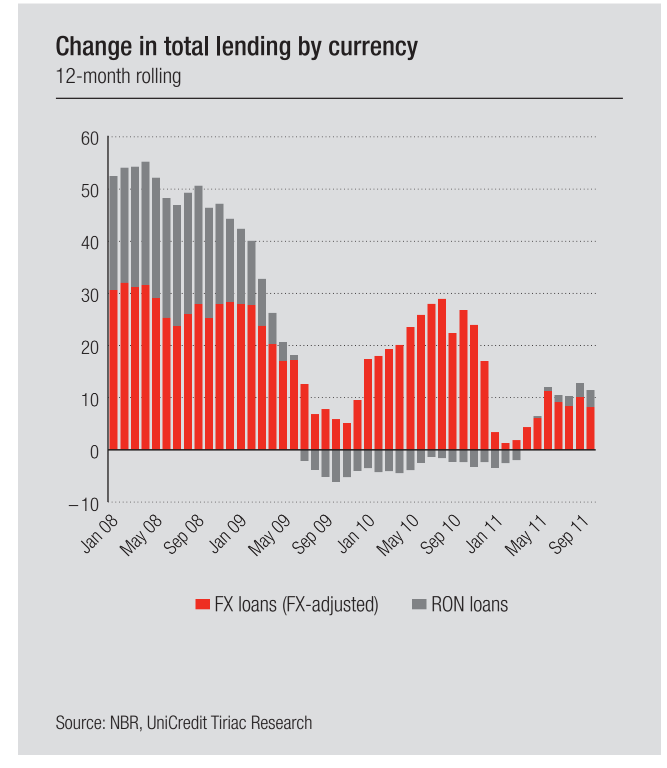
Retail non-performing loans



Source: NBR – Financial Stability Report

Change in total lending by currency

12-month rolling



Source: NBR, UniCredit Tiriac Research

In the absence of strong loan demand from households, banks have focused on lending to companies since 2010, the result being an unsustainable fall in margins given the current rise in risk and liquidity premiums for both FX and RON loans. Even if the monetary policy rate is likely to be cut to 5.5% by mid-2012, RON yields are unlikely to have a parallel decline, especially if the MinFin starts competing with banks for private sector money. The pressure could be partly alleviated if the NBR cuts the sizeable minimum reserve requirements (currently standing at 15% for RON and 20% for FX liabilities with maturities up to two years, adding roughly 1pp to the funding cost).

Falling margins and increasing NPLs have sent the Romanian banking sector into the red in 3Q 2011. The system could swing back to profit in 2012 if the market can absorb higher margins for new lending and if the cost of risk decreases. The move to IFRS from Romanian Accounting Standards (RAS) in January 2012 could have positive effects on provisioning, since RAS are more restrictive than international standards.

The Romanian banking system had a solvency ratio of 13.4% at the end of 3Q 2011, several banks announcing new capital increases in late 2011 and early 2012. We expect capital adequacy ratios to remain well above EBA and Basel thresholds over the medium term.

The major downside risks to the baseline scenario come from slower economic growth in the short run and the availability and price of liquidity over the forecast horizon. The first factor could affect both deposits gathering and demand for new loans, although further corrections of the current account deficit should boost the former. The availability and price of liquidity should remain an issue as long as a considerable loosening of monetary conditions is not plausible. The NBR has already stepped up its money market operations to boost RON liquidity and could extend the array of operations in 2012 (LTROs might be an option in order to contain RON interest rates). If the European banking sector accelerates the deleveraging process in order to comply with tighter capital rules, it is unlikely that the Romanian banking sector will not be affected. However, the perceived risks for the banking system in general and those coming from the large exposure to the Greek and Austrian banking sectors in particular seem overestimated. According to the NBR, financing lines from parent banks have an average maturity of more than one year and the NBR's reserves (EUR 31.7 bn in November 2011) cover 134.3% of the banking system's foreign liabilities. Central bank officials declared that direct financing from Greek banks to local subsidiaries amounted to approximately EUR 4 bn mid-2011, less than one-third of the total assets of those subsidiaries. Those lines could be easily replaced (in the unlikely scenario of massive deleveraging) from NBR reserves. Moreover, the three main domestic banks have already met the limit imposed by the Austrian National Bank.

Russia

Ready for challenging times

Nikolay Akimov and Artem Arkhipov

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	5.2	−7.8	4.0	4.2	3.9
CPI (% avg)	14.1	11.7	6.9	8.6	6.2
Central Bank reference rate (% eop)	8.5	6.0	5.0	5.25	5.5
Banking volumes					
Deposits (% yoy)	20.2	20.6	23.6	17.7	12.0
Lending (% yoy)	34.3	−2.2	11.0	20.6	12.5
Loan-to-deposits ratio (%)	128.0	103.8	93.3	95.5	95.9
Mortgages (% of GDP)	3.2	3.4	3.3	3.3	3.3
FX lending (% of total lending)	–	–	–	–	–
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	6.6	6.7	5.5	5.0	4.5
Net Operating Profit (% of GDP)	1.0	0.5	1.3	1.5	1.3
Cost / Income (%)	49.5	42.1	56.8	56.5	58.2
ROA (%)	1.5	0.7	1.7	1.9	1.7
ROE (%)	10.9	4.3	12.2	15.0	13.8
Capital, liquidity and funding					
CAR (%)	16.8	20.9	18.1	15.0	11.7
Net foreign assets (% of GDP)	−1.3	1.9	1.1	1.8	2.1
Bank bonds outstanding, (% of GDP)	2.8	3.0	3.0	2.9	2.9
Asset quality					
Impaired Loans (in % of gross loans)	12.7	18.7	18.8	18.5	17.3
Cost of Risk (bp)	318	599	140	62	66
Banking sector structural indicators					
Foreign ownership (% of total assets)	18.7	18.3	18.0	17.4	16.6
Top 5 players (% in total assets)	46.0	47.6	47.3	49.5	53.0

Source: CBR, UniCredit Research, UniCredit CEE Strategic Analysis

Macro Environment

Over the next several months the most important theme for the Russian economy is the agenda after parliamentary and presidential elections. Although the winners in both cases seem to be quite predictable, efforts of the authorities to ensure both economic stability and political and social consensus are solid. Indeed, the current economic situation in Russia supports this objective, as all of the key macroeconomic indicators look rosy. Firstly, inflation (as measured by CPI) has decelerated to less than the CBR's target (11 months YTD in 2011 stood at 5.6 %). Such low levels seem to be sustainable in the short term due to non-growing food prices, a non-expansionary monetary policy and a delay in tariffs increase until Jul 2012. Secondly, economic activity in Russia's real sector is improving: the Nov reading of the manufacturing PMI demonstrated a solid optimism at 52.6, as did the services PMI (54.8). Driven by manufacturing and agriculture, GDP accelerated to 4.8 % yoy in 3Q 2011. Risks for the economy (e.g. a sharp decline in oil prices) have not materialized, or their impact has so far been minor.

At the same time, the mid-term risks are increasing. For example, new questions as to budget stability have arisen, which implies a challenge for the financial system's liquidity (i.e. the government may be unable to deposit as much with banks as it did in 2011). Moreover, additional government bond placements may diminish

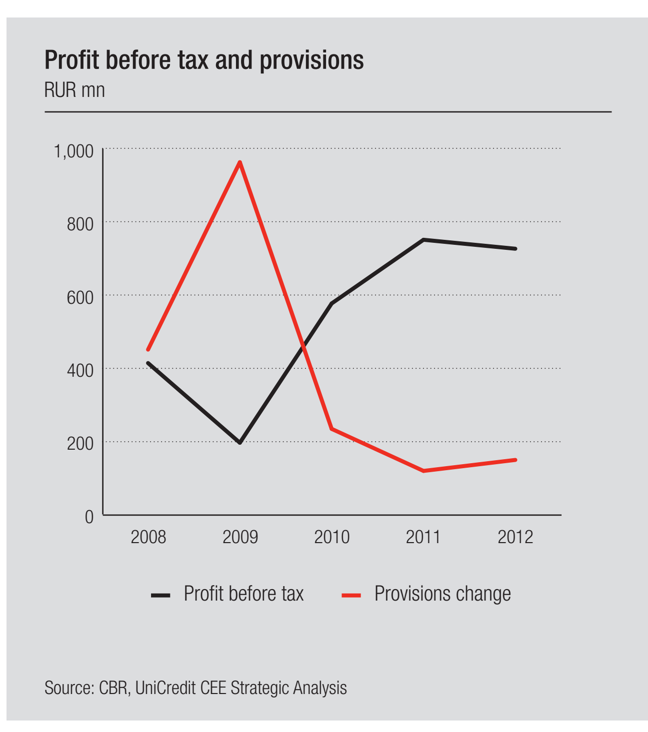
the appetite for other instruments and lending. Persisting problems in the Eurozone and other regions have led to an appreciation of the USD, in turn creating the risk of lower oil prices. Coupled with high capital outflows from Russia (amounting to some EUR 60 bn in 2011), exchange rate risks also have become increasingly important. It should be stressed that the Central Bank of Russia (CBR) is very pro-active and significantly widens refinancing options for banks as soon as risks for the sector are recognized. The CBR also demonstrates positive shifts in terms of the flexibility of its forex operations, hence we think that the ruble volatility is likely to remain higher, but speculative attacks are unlikely. However, this implies higher money-market rates, thereby suggesting an increase in other rates. Economic growth is likely to slow down due to a lack of investment in 2010–2011, implying an increase in credit risks this year.

Banking System

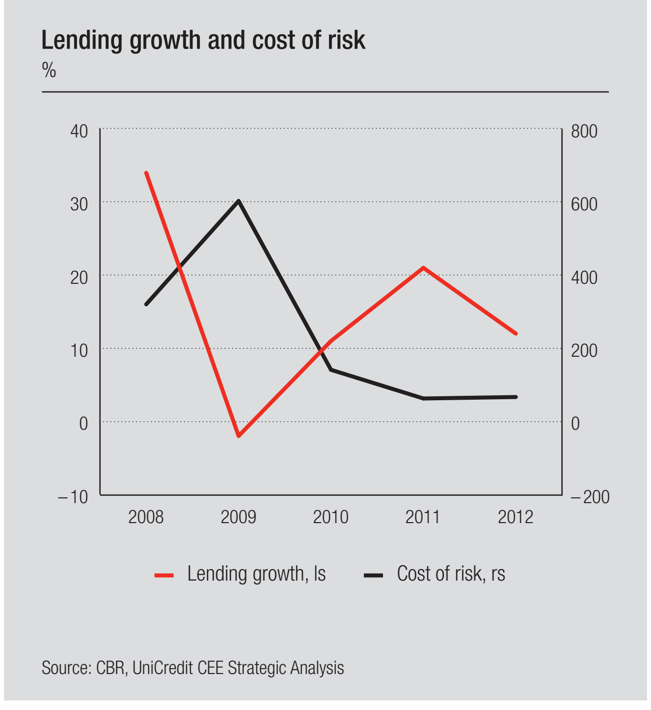
The Russian banking system in general posted a solid performance in 2011 despite the volatility on global markets, with the overall performance much better than the one recorded in 2010. Growing private consumption and household disposable income should have fueled 2011 retail lending growth to an estimated 26 % yoy, while the recovering industrial sector has driven corporate lending, which increased at an estimated 19 % yoy. On the other hand, corporate clients were still somewhat skeptical about taking on excessive debt and tried to maximize the utilization of available funds, which caused a deceleration in corporate deposits volume growth to an estimated 8 % yoy in 2011. Retail deposits growth should have also substantially decelerated compared to 2010 to an estimated 12 % yoy mostly due to growing consumption on the back of improved consumer confidence. Global instability will most likely affect future lending activity. We expect lending growth to have peaked in 2011, followed by a gradual deceleration throughout 2012–2015 to around 13 % annually. On the deposits side a similar trend is expected although it might be skewed to the upside by massive government injections of liquidity (in the form of deposits) in the event of any crisis.

Banks' effort to improve the quality of their loan portfolio through restructuring measures proved to be quite successful. As a result, the NPL ratio has declined from the peak of 20 % in Aug 2010 to roughly 18 % as of the end of Oct 2011. However, in the case of a worsening economic environment a reoccurrence of credit quality problems cannot be ruled out.

In terms of liquidity, the first part of last year was quite favorable for the banking system. Lending interest rates continued to decrease even beyond pre-crisis levels, driven by growing competition. As a result, the interest margin was squeezed considerably, putting pressure on interest income. But the deepening European sovereign debt crisis together with forthcoming elections and overall market restlessness intensified capital flight and provoked some dry-up in liquidity with consequent interest rate increases in 2H 2011. The government and the central bank promptly provided extra liquidity to the market, thus calming it for a while, and promised further injections if needed. Liquidity has also been affected by rather weak corporate and retail deposits growth in 2011.



Source: CBR, UniCredit CEE Strategic Analysis



Source: CBR, UniCredit CEE Strategic Analysis

Similar to the rest of the countries in the region, Russia's banking system profitability suffered from the crisis. After recording the highest ROE and ROA in 2007, profitability declined until 2010 when the trend reversed upward. Pre-tax profit in 2011 is estimated to have been the best ever owing to a decrease in provisioning, rapid lending growth and stabilization of the non-interest income flow. In 2012, on the other hand, we expect profitability to stagnate, mostly due to global uncertainty with possible liquidity shortages, a resultant margin squeeze and depletion of reserves accumulated during the crisis. In general, we expect the nominal level of pre-tax profits to flatten in 2012–2015.

Capital adequacy was not an issue in 2011, staying well above the minimum requirement, although it might become an issue in 2012 as the central bank has tightened the nominal capital requirement starting from Jan 1, 2012 and should implement a new RWA calculation methodology from Jul 1st, directly influencing the CAR's calculation. The first measure should primarily affect small and partially medium banks, prompting them to increase capital, look for M&A options or shut down business completely, while the new RWA calculation may affect the entire Russian banking system, as even the largest banks will have to increase capital.

Ongoing consolidation of the Russian banking system was accelerating not only due to the crisis, but was also facilitated by the state's policies. Unequal government support during the 2008 crisis provided state-owned banks with a noncompetitive advantage, leading to a rapid expansion of their market share. Furthermore, ongoing regulatory pressures are likely to make life even more difficult for private banks by further worsening the already-distorted competitive environment. Tighter capital requirements may have a positive medium-term effect on the banking system's stability, but have adverse long-term consequences such as limited availability of banking services, higher prices for customers and slower economic development.

Serbia

Good liquidity and capital buffers should protect banks against the challenging macroeconomic environment

Anna Kolesnichenko

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	3.8	–3.5	1.8	1.7	1.0
CPI (% avg)	11.7	8.4	6.3	11.2	5.4
Central Bank reference rate (% eop)	17.8	9.5	11.5	9.5	9.0
Banking volumes					
Deposits (% yoy)	7.7	23.1	15.1	3.8	6.7
Lending (% yoy)	34.8	24.8	30.9	3.8	5.5
Loan-to-deposits ratio (%) *)	125.1	126.9	144.3	144.3	142.8
Mortgages (% of GDP)	6.0	6.9	8.6	–	–
FX lending (% of total lending)	76.9	75.6	69.2	–	–
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	8.0	6.6	5.6	5.1	5.0
Net Operating Profit (% of GDP)	1.3	0.7	0.9	0.8	0.8
Cost / Income (%)	59.0	62.6	63.5	63.5	63.8
ROA (%)	1.9	0.9	1.0	1.0	1.0
ROE (%)	7.1	3.5	4.0	3.7	3.6
Capital, liquidity and funding					
CAR (%)	21.9	21.4	19.9	–	–
Net foreign assets (% of GDP)	–8.6	–12.4	–13.1	–10.5	–9.9
Bank bonds outstanding, (% of GDP)	–	–	–	–	–
Asset quality					
Impaired Loans (in % of gross loans)	11.3	15.7	16.9	19.0	17.8
Cost of Risk (bp)	266	285	201	175	169
Banking sector structural indicators					
Foreign ownership (% of total assets)	75.3	74.3	74.0	–	–
Top 5 players (% in total assets)	46.2	46.0	45.0	–	–

Note: *) L / D ratio excluding loans and deposits to / from non-residents
Sources: NBS, UniCredit Research, UniCredit CEE Strategic Analysis

Macro environment

Economic growth in Serbia slowed in the second half of 2011 due to moderating industrial production and weakening exports. Domestic demand was also shrinking, as household consumption and government spending contracted; however, fixed investments were still resilient (helped by strong FDI inflows). We expect GDP growth to slow further to 1 % in 2012 as demand from main export markets (the EU) falls and domestic consumption stagnates as household real income remains weak, while government consumption is constrained. Moreover, fixed investment had already begun to slow at the end of 2011 and risks here are on the downside. In particular, the delay in the EU accession process may slow investment activity.

Monetary policy has been accomodative since June as a slowdown in inflation and currency appreciation allowed the central bank to focus on weakening economic growth, delivering a cumulative 2.75 pp rate cut between June and year end. In 2012 we expect headline inflation to bottom out near 3 % yoy in March / April but thereafter to accelerate after the elections, due to a likely rise in administered prices, with year-end inflation coming in at 7.0 % yoy. As a result, we expect the central bank to maintain an expansionary stance in the first half of the year (with policy rates bottoming out below 8 %), but with possible rate hikes down the road, with a net 75 bps drop in the policy rate to 9 % by the end of the year. We expect the EUR / RSD to remain

broadly stable in 2012 on account of the new IMF program and despite the loose monetary policy and, on balance, riskier outlook for financing.

Banking environment

The slowdown in growth in 2011 has translated into a much weaker banking sector performance. From 25–30 % annual growth over 2009–2010, lending expansion dwindled to 3.5 % ytd as of October. However, a big part of the buoyant lending in 2009–2010 is explained by massive government subsidies for loans. In 2011 the picture has changed dramatically, as the government had to cut spending as part of its commitments under the IMF program. The cut in subsidies on the back of weak economic growth and depressed household real income resulted in very subdued lending growth. Between January–October 2011, retail lending grew 3 % ytd and corporate by only 2 % ytd. Tighter external liquidity has also been a limiting factor: between January–October 2011, banks' external liabilities contracted by 14.7 %. As a result, in 2H 2011 banks were relying almost exclusively on deposits, which grew 3.9 % in the first nine months of the year. FX deposits growth was especially strong, but a large part of it is attributable to a one-off transaction [1]. Retail FX deposits remain the major funding source, accounting for 56 % of total deposits and 27 % of total funding as of September 2011. We expect weak lending dynamics in 2012 as well on the back of continuing economic stagnation and tight external liquidity. Credit growth should subsequently reaccelerate in 2013–2015, as the economy revives (assuming no recession in the EU). In these years we forecast that loans will grow at roughly the same rate as deposits, keeping the loan-to-deposits ratio fairly constant.

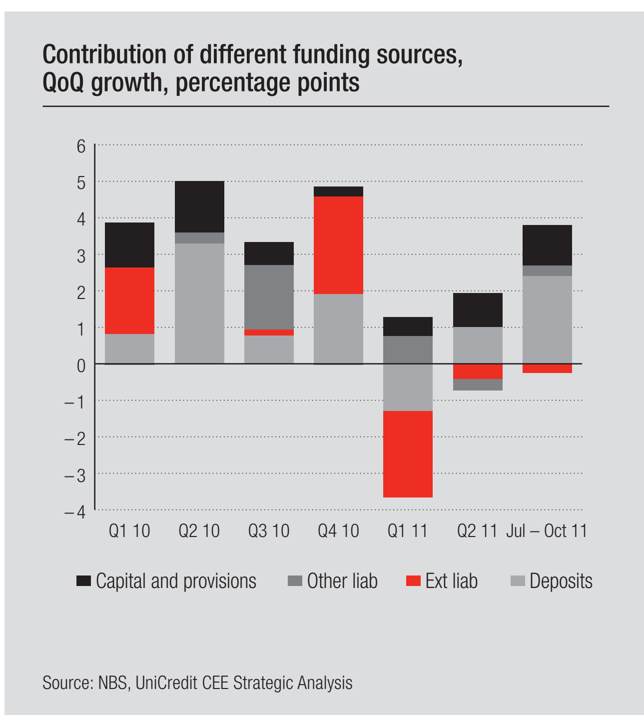
The large share of FX deposits and loans represents a major financial stability risk for Serbia and also limits the effectiveness of monetary transmission. The government and the central bank have come up with a range of initiatives to stimulate local currency lending and funding. With this in mind, the central bank introduced differentiated reserve requirements that favor local currency loans and deposits; it also decreased loan-to-value ratios for FX-linked mortgages. Moreover, government subsidies in 2009–2010 were provided only for local currency loans. [2] So far, the effect of these measures has been rather moderate, with the share of dinar lending rising by 1.1pp yoy in September 2011 to reach 30.2 % of the total. Ultimately, the success of "dinarisation" will depend on the ability of policy makers to foster trust of economic agents in the stability of the local currency.

Non-performing loans have still been rising in 2011, although not posing a major threat to the banking system's stability as coverage stands at comfortable levels (127 % as of June 2011). The largest share of NPLs (67 %) is in the corporate sector, and the NPL ratio here is by far higher than in retail (23.7 % vs. 9.2 % in June 2011). We expect only a moderate reduction in the NPL ratio

1) These were receipts from the sale of the "Delta Maxi Group" enterprise, which were used to settle the debts of this enterprise and were deposited in short-term corporate accounts.

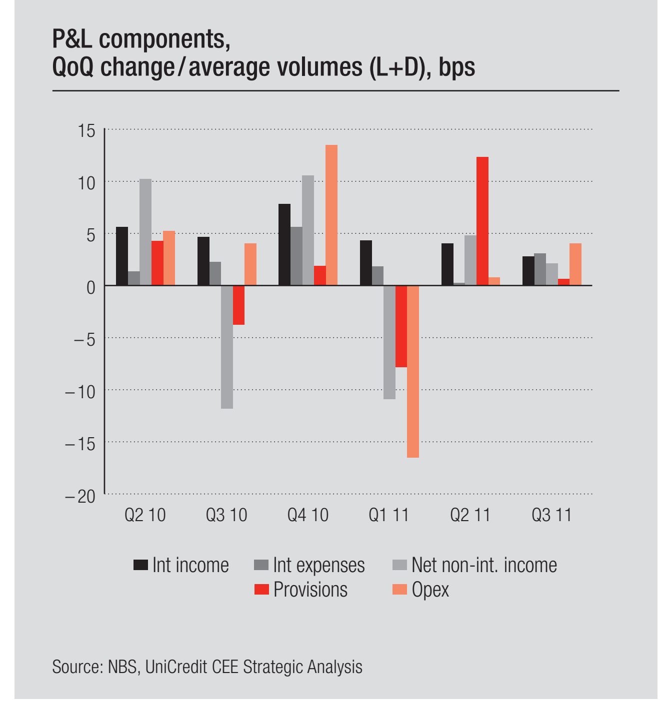
2) There were many other measures, like development of hedging instruments, differentiated taxation on interest from deposits (10% tax on interest from FX deposits and no tax in case of dinar deposits).

Contribution of different funding sources, QoQ growth, percentage points



Source: NBS, UniCredit CEE Strategic Analysis

P&L components, QoQ change/average volumes (L+D), bps



Source: NBS, UniCredit CEE Strategic Analysis

in 2012 due to continued weakness of the economy, and then a faster reduction in subsequent years. Although we expect some nominal growth in provisions in 2012, the cost of risk will continue falling (having peaked at 2.9 % in 2009).

Despite weak lending, net interest revenues of the banking sector improved due to slower growth in interest expenses as central bank financing became cheaper. Dinar deposit rates also eased, but on a much smaller scale, while dinar lending rates grew (in part due to the termination of disbursement of new subsidised loans that involved lower lending rates by banks). The effect of rising margins on dinar business, however, was counterbalanced by falling margins on the FX portion, as banks raised FX deposit rates on the back of tighter EUR liquidity. We expect tight FX margins in 2012 as well, with dinar margins also possibly falling on weak demand for loans, which would dampen profitability. Cost containment has been supportive for the bottom line in 2011, with both personnel and administrative expenses growing much less than inflation. With weak income in 2012, we expect banks to continue pursuing tight cost policies.

On the positive side, the Serbian banking system has accumulated substantial liquidity and capital buffers. As of June 2011, the capital adequacy ratio stood at 19.7 %, much higher than the required 12 %. However, at the end of 2011 CAR may decrease somewhat, as Basel II comes into force, with some banks facing the need to increase capital. Banks also hold an exceptionally high stock of liquid assets, with the liquidity ratio [3] consistently staying around 2. Part of the liquidity is in the form of high reserve requirements (as of mid-Dec 2011 banks held an equivalent of EUR 1.9 bn in mandatory reserves with the NBS, which is about 7 % of total assets). Banks also have substantial holdings of government T-bills (RSD 148 bn at the end of June) and central bank repo-securities (RSD 100 bn at the end of Oct, i.e. more than double over January – October 2011, increasing by RSD 53 bn, or EUR 520 mn). Unfortunately, despite the abundant level of liquidity, local currency lending remains still weak partly because of the high interest rates on dinar-denominated loans. This means that in the near future, credit availability in Serbia should, to a large extent be determined by the availability of FX funding, while further dinarisation efforts are crucial in order to achieve a gradual switch to local funding.

3) This is a ratio of short-term assets (up to 1 month + 90% RSD T-bills with min maturity of 3 months) to short-term liabilities (up to 1 month) and part of sight deposits.

Slovakia

Deposits and lending continue to grow, bank levy to cut profit

Vladimir Zlacky and Korsnak Lubomir

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	5.9	–4.9	4.2	2.9	1.9
CPI (% avg)	4.6	1.6	1.0	3.9	2.5
Central Bank reference rate (% eop)	2.5	1.0	1.0	1.0	1.0
Banking volumes					
Deposits (% yoy)	15.4	–8.9	5.5	4.2	3.3
Lending (% yoy)	15.3	0.6	5.2	7.6	5.0
Loan-to-deposits ratio (%)	78.3	86.4	86.2	89.0	90.4
Mortgages (% of GDP)	12.4	14.7	16.1	17.4	18.2
FX lending (% of total lending)	21.9	1.8	1.5	1.5	1.6
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	3.4	2.9	3.1	3.2	3.1
Net Operating Profit (% of GDP)	1.0	0.5	1.0	1.3	1.0
Cost / Income (%)	53.3	56.5	51.0	48.4	53.6
ROA (%)	1.0	0.6	1.1	1.5	1.1
ROE (%)	10.9	5.2	9.5	12.0	8.8
Capital, liquidity and funding					
CAR (%)	11.1	12.6	12.7	12.9	13.1
Net foreign assets (% of GDP)	–1.9	2.7	1.7	0.6	0.6
Bank bonds outstanding, (% of GDP)	5.3	5.6	5.2	5.3	5.4
Asset quality					
Impaired Loans (in % of gross loans)	3.2	5.5	6.0	5.7	5.7
Cost of Risk (bp)	111	134	85	50	64
Banking sector structural indicators					
Foreign ownership (% of total assets)	97.0	95.2	94.4	89.0	88.0
Top 5 players (% in total assets)	71.6	72.2	72.5	72.5	72.5

Source: NBS, Statistical Office SR, UniCredit Bank Slovakia

Macro Environment

After a post-crisis rebound in 2010 – 2011, a cyclical slowdown in economic activity is expected in 2012. Economic growth should be 1.9 % as the downturn in the Eurozone, where about half of Slovak exports (mainly manufacturing goods) are directed, will take its toll. At the same time, uncertainty in the run-up to March general elections could imply that investment remains subdued as investors wait to see which political constellation attains power. On a more positive note, there should be substantial disinflation in 2012 (vs. 2011) which will lead to some moderate increase in real wages. Headline inflation should decline to 2.5 % and real wages post a 0.8 % gain in 2012. Consequently, we expect that household consumption will stage some moderate recovery after three years of stagnation / decline, boosting overall growth. Unemployment should be broadly stagnant in 2012 averaging 13.4 % as losses in the first half of the year should be recouped later in the year as we see some recovery in 2H12 both in the Eurozone and Slovakia.

Medium term, we expect the economy to return to a path of economic growth of above 4 %. This is however based on the assumption that the government's fiscal consolidation program continues and no major retrenchment on structural reforms takes place after the March elections. Slovakia's economy needs further

structural reforms – business environment, pension system, judicial reforms, education and science – as part of a complex program for building a knowledge-based economy in order to tap into the opportunities offered by a highly integrated global economy.

Banking Environment

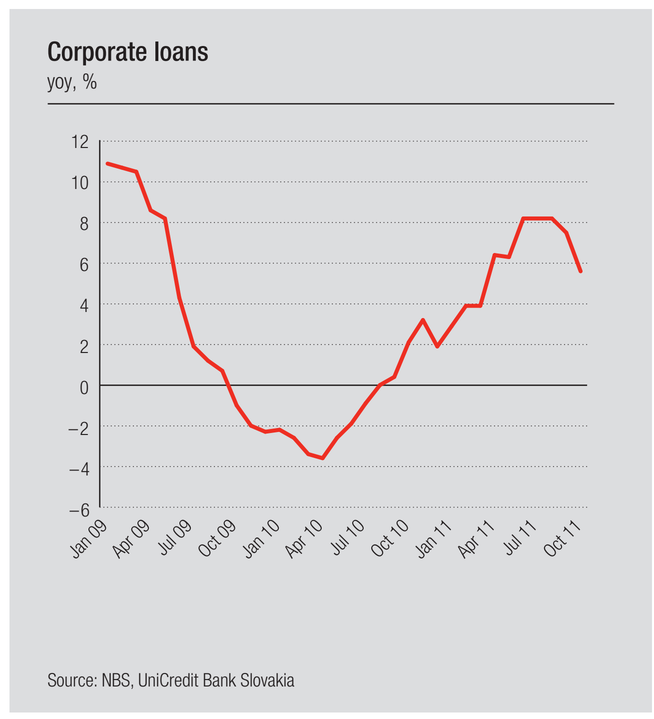
The banking sector started 2011 in a good condition, benefiting from a strong economic rebound. Investment activity has been gradually recovering, with a positive impact on corporate loans (8.2 % yoy as of 1H11, driven mainly by the energy sector). However, increasing uncertainty coming from financial markets will probably lead in several cases to a postponement or reconsideration of investment plans, having a negative impact on corporate loans in the upcoming period. We could see the first signs of freezing in 3Q11. The euro debt crisis could have an impact on demand for corporate loans as well as lead to some tightening of credit standards in upcoming months. The growth dynamic is expected to slow down, with some recovery only in 2H12, hand in hand with stabilization in financial markets. A prolonging of the debt crisis, however, could postpone a rebound to 2013–2014.

Increasing revenues of local companies supported the growth of corporate deposits in 1H11; however, about 60 % of corporate deposits are still sight deposits. A weaker industrial performance in 3Q11 was thus immediately reflected in corporate deposits. The expected economic slowdown should prevent a recovery in corporate deposits. Furthermore, additional risk for corporate deposits comes from a new bank levy, which could intensify the outflow of deposits (mainly of multinationals) abroad due to lower competitiveness of local interest rates.

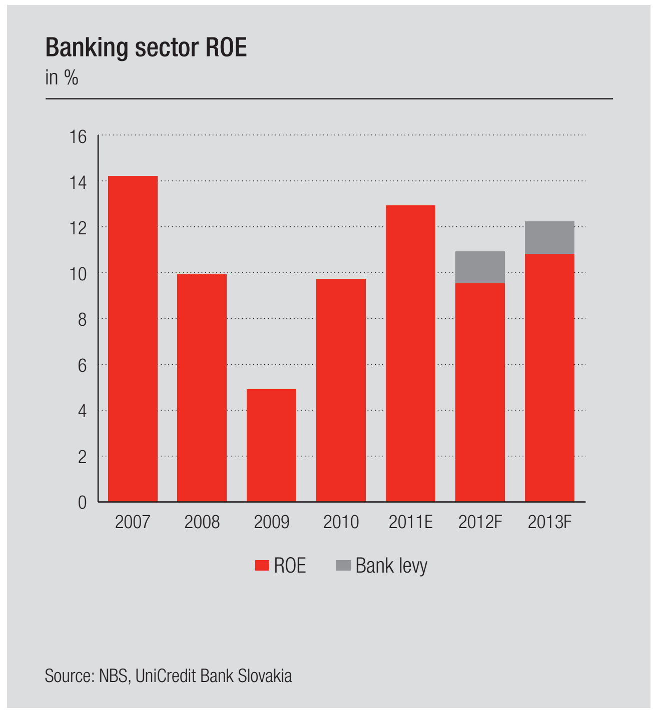
Household loans are still driven mainly by loans for housing purposes. The increasing competition on the market pushed down prices of mortgages in 2H10 and 1H11. Together with a stabilization of real estate prices the demand for mortgages increased and approached record pre-crises levels. However, the market has nearly frozen again in 2H11, affected by increasing uncertainty and deteriorating household sentiment. Furthermore, we cannot exclude the possibility that any prolonged turmoil on the financial markets could again lead to a tightening of credit standards (LTV, risk premium etc.). Mortgage growth is thus expected to slow, with a possible rebound only from 2H12.

In another retail segment, continually weak consumer confidence prevented a significant rebound in consumer finance. We can observe mainly decreasing demand for short-term financing. Attractiveness of overdrafts and credit cards – often already pre-approved – could potentially increase again in line with a worsening of the labor market similar to 2008–2009.

Despite the strong economic rebound in 2010–2011, household consumption remained subdued. The government austerity package and accelerating inflation practically extinguished consumer confidence. The saving rate remained relatively high. Furthermore, households turned out to be more conservative again as a result of financial market turmoil. We have observed a significant outflow



Source: NBS, UniCredit Bank Slovakia



Source: NBS, UniCredit Bank Slovakia

of financial assets from open-end funds toward bank term deposits since June 2011. The bank deposits of households accelerated the growth dynamic to over 7 % yoy. Despite the expected weakening of economic growth, the gross earnings of households should continuously grow in the coming period. Retail deposits thus should continue to post relatively strong growth of close to 5 % yoy in 2012.

The banking sector remains characterized by a stable funding position with the L / D ratio significantly below 100 (moving in a range of 85 – 90 % in 1H11). Despite some marginal increase mainly on the back of stronger retail-driven lending growth, the L / D ratio should remain below 100 in the upcoming years. All top three players (together with some smaller retail banks) are enjoying an L / D ratio of below 100. On the other hand, some mid-sized and small players offset the lack of primary liquidity by using funding from parent banks.

FX lending is scarce. The share of FX loans in total loans was moving in the range of 1.3 % – 1.5 % in the first nine months of 2011, or between 2.0 and 2.5 % in the corporate segment and 0.1 % in retail. Most FX loans were provided in USD (44 %), CZK (37 %) and CHF (10 %).

The NPLs ratio of the banking sector remains contained, reaching its peak in October 2010 at the level of 6.4 %. The ratio has been continually decreasing since then, reaching 5.8 % in 1H11, with corporates and retail accounting for 6.7 % and 4.6 %, respectively. Because of weaker economic growth and increasing risk coming from financial markets we expect that there could be a pause in the decline of the NPLs ratio in the next months, while we cannot exclude a temporary slight increase in 1H12.

Nevertheless, the banking sector's CoR should broadly remain at current levels.

The lending markup is expected to remain stable, while growth of net interest revenues for the banking sector should be driven almost exclusively by increasing volumes. Growing business volumes should have a positive impact on net income from F&C. Furthermore, the banks could try to offset the new bank levy by further increasing bank fees. At the same time we also expect increasing pressure on cost optimization. Despite this, operating costs should grow slightly above inflation, driven by staff costs, as staff reductions should be compensated for by real wage growth. All together, the banking sector's ROE should thus remain above 10 % in the coming years.

The banking sector is well capitalized, with a capital adequacy of 12.75 % as of 1H11. Furthermore, almost 90 % of regulatory capital is tier 1 capital, suggesting no need for an extraordinary capital increase. The exposure of the banking sector against PIIGS debt is relatively low (2 % of total assets), concentrated mainly in one domestically-owned bank, which has already secured capital for potential write-downs.

Regulatory developments represent a clear issue to monitor. A new bank levy will be introduced in 2012, calculated as banking sector liabilities less equity and insured deposits (retail deposits) and was set at the level of 0.4 %. It will decrease the ROE of the banking sector by 1 – 1.5 pp. The level of the bank levy rate could be reconsidered (increased) after the election, as the main opposition party (and most likely winner of the March 2012 elections) suggested setting the bank levy at higher level of presumably 0.7 %.

Slovenia

Focus on asset reductions

Marco Frigerio

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	3.6	−8.0	1.4	0.5	−0.6
CPI (% avg)	5.7	0.9	1.8	2.0	2.4
Central Bank reference rate (% eop)	2.5	1.0	1.0	1.0	1.0
Banking volumes					
Deposits (% yoy)	7.5	14.4	−0.5	4.1	2.8
Lending (% yoy)	18.1	2.8	3.3	−0.8	1.5
Loan-to-deposits ratio (%)	155.0	139.3	144.6	137.8	136.1
Mortgages (% of GDP)	9.1	11.1	13.7	14.4	14.8
FX lending (% of total lending)	7.5	5.8	5.4	4.5	4.2
of which CHF, % of FX lending	88.1	85.4	90.2	89.6	–
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits), %	2.77	2.63	2.62	2.49	2.47
Net Operating Profit (% of GDP)	0.90	0.46	−0.14	−0.05	0.10
Cost / Income (%)	57.6	53.7	51.8	52.8	53.5
ROA (%)	0.73	0.31	−0.09	−0.03	0.07
ROE (%)	8.61	3.77	−1.12	−0.38	0.80
Capital, liquidity and funding					
CAR (%)	11.7	11.6	11.2	11.9	12.3
Net foreign assets (% of GDP)	−23.1	−19.7	−24.4	−17.9	−17.6
Bank bonds outstanding, (% of GDP)	3.5	4.3	5.0	4.1	4.2
Asset quality					
Impaired Loans (in % of gross loans)	2.8	4.9	8.0	9.8	8.5
Cost of Risk (bp)	83	155	230	206	187
Banking sector structural indicators					
Foreign ownership (% of total assets)	31.2	30.3	28.7	28.2	–
Top 5 players (% in total assets)	59.4	59.4	59.8	60.3	–

Source: BSI, UniCredit Research, UniCredit CEE Strategic Analysis

Macro Environment

During the global financial crisis Slovenia experienced one of the sharpest GDP declines in the Eurozone and on a five-year horizon its growth is expected to remain among the lowest in CEE. The economy has been slowly recovering between 2H 2010 and 1H 2011 supported by external demand, but growth suddenly turned negative in 3Q 2011 on the back of the deteriorating global environment. With investment activity remaining chronically weak in the mid-term, mainly due to a persistent deleveraging process, and consumption expected to remain low because of high unemployment and fiscal retrenchment, real GDP is expected to grow by only 0.5 % yoy in 2011 and to decrease by 0.6 % in 2012. In the 2013 – 2015 period growth should remain well below 2 % yoy, with inflation stabilizing at around 2.5 – 2.6 % yoy, following the + 2 % yoy estimated in 2011.

The weaker performance of the economy relative to the rest of the region can be explained, at least in part, by several structural weaknesses which still prevent the country from embarking on a more solid recovery. Some major macroeconomic imbalances are being observed in the primary budget deficit and a vulnerable financial position against the rest of the world, while some political uncertainty is delaying the adoption of reforms. Furthermore, taking in account the deepening Euro area crisis and the relatively large exposure of Slovenia's exports to Western Europe, downside risks for growth in 2012 are skewed on the upside, with stagnation likely to turn stronger than anticipated.

Banking Environment

Slovenian domestic problems, such as the relatively high debt-to-equity ratio of the corporate sector, as well as the impact of deteriorating conditions in the Eurozone regarding banks' access to foreign sources of funding, are expected to shape banking sector developments for some years. In such a context, we reckon the loans-to-deposits ratio to maintain a gradual downward trend to reach a level

of 126 bps in 2015, starting from 145 bps at the end of 2010. As a result of the fragile economic background and the ongoing deleveraging process, lending growth turned negative during 2011 and in the short term it will struggle to return to its pre-crisis levels. The decrease in lending activity is mainly due to a deceleration in corporate lending (–1.1 % yoy estimated last year) while retail lending remained on a positive path, thanks to positive developments in the mortgage segment, which still holds some potential for higher penetration.

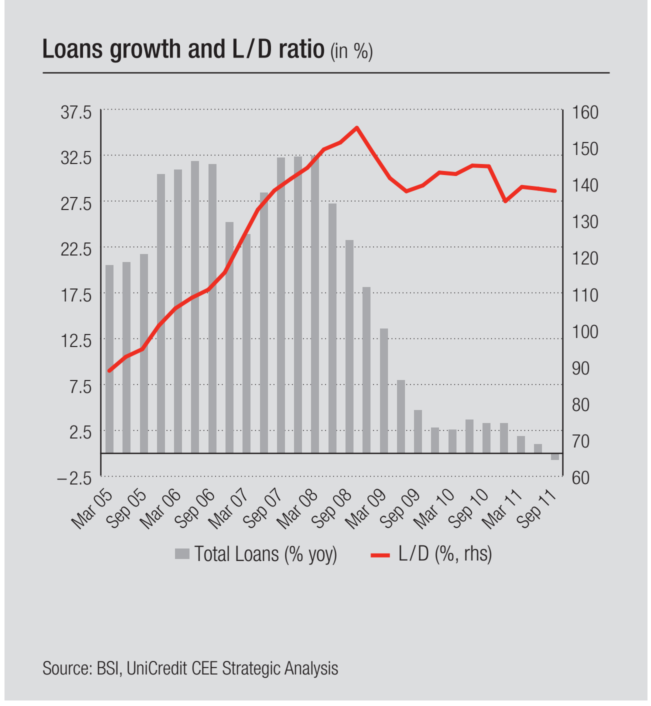
Following a negative performance in 2010, deposits growth is gradually returning to a positive path, mainly supported by the strong contribution from the government segment. In the forthcoming years we expect deposits gathering will be very much in focus in the context of tight external refinancing conditions. Total deposits growth in 2012 should amount to some 2.8 % yoy compared to a weaker 1.5 % increase in gross loans, with a similar gap to be broadly confirmed at least in the next years. We think the most likely scenario is an orderly deleveraging with the need of some banks to replenish capital. Indeed, Slovenia still shows some vulnerability related to banks' capital position, as the capital adequacy ratio (CAR) in the banking sector remains among the lowest in CEE, while the 2011 EU-wide stress test specifically confirmed a need for recapitalization for the largest bank in the country.

Following the sovereign debt crisis, spreads on Slovenian government bonds have been on the rise and banks' funding is becoming increasingly expensive. Within this framework, Slovenian banks are trying to progressively restructure their sources of funding. The proportion of household and government deposits is steadily increasing, while a significative drop is taking place in external liabilities (–11 % yoy estimated in 2011) and debt securities (–16 % yoy). The reliance on ECB liquidity has also increased to a year high (EUR 835 mn) at the end of October 2011, exceeding by about EUR 233 mn the figure registered at the end of 2010. However, given that household and government deposits and ECB liquidity only partially compensated for the reduction in remaining liabilities, banks' total assets have been contracting in the first ten months of 2011.

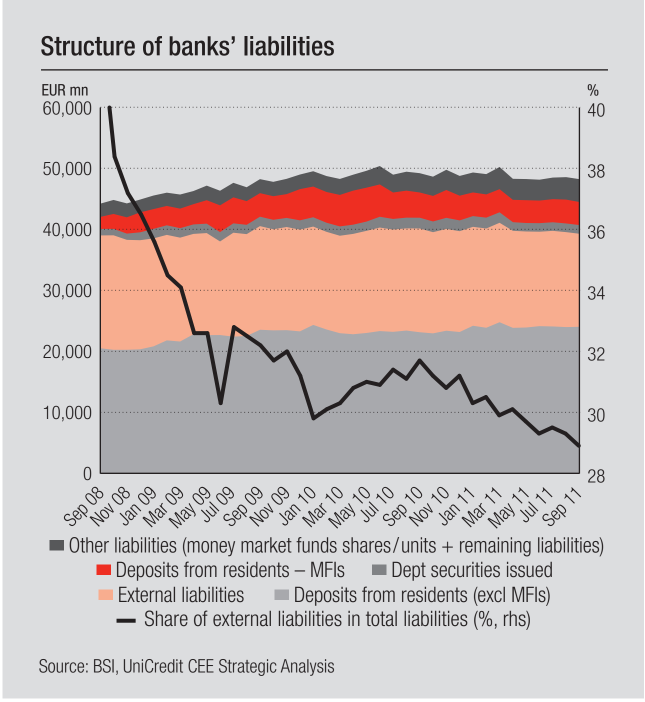
Given the stagnant dynamics in volumes, the revenue generation capacity of the banking system remained subdued and no major improvements are expected to materialize in the short term. Net revenues should turn positive starting from 2012 but their growth is likely to remain below 3 % per annum until 2015. Focus on costs remains central. In the next few years we expect growth in staff expenses to remain moderate and steadily below inflation. In late summer 2011, the government also introduced a bank levy to be applied starting from this year. Slovenian banks will have to pay a 0.1 % tax on their balance sheet size unless they manage to increase their corporate loans in the amount equal to 5 % of their total assets in the previous year*).

Despite some stabilization, credit quality still remains an issue particularly for sectors hit hard by the crisis. As a consequence, loan loss provisions should moderate only slowly going forward, continuing to act as a major drag on industry's profitability. Overall, we estimate banks' profits to have remained negative in 2011 (EUR –17 mn), while in 2012 their gains should marginally re-accelerate to reach EUR 37 mn, provided that impairments and provisioning costs undergo a sufficient reduction from current levels. In terms of return on assets, profitability levels should remain below 0.2 % in the next couple of years, confirming the difficulties in restoring pre-crisis results.

*) A bank may also reduce its tax obligation (up to the amount of the tax obligation) by 0.167 % of total loans granted to non-financial entities and sole proprietors. Total exemption is granted where a bank's loans to non-financial companies and sole proprietors are less than 20% of banks' total assets. This is aimed to protect the purely retail banks from such levy.



Source: BSI, UniCredit CEE Strategic Analysis



Source: BSI, UniCredit CEE Strategic Analysis

Turkey

Still resilient despite increasing challenges

Aslı Angınbaş and Oğuzhan Vural

	2008	2009	2010	2011E	2012F
Macro / Monetary					
real GDP (% yoy)	0.7	–4.8	9.0	7.9	3.6
CPI (% avg)	10.5	6.3	8.6	6.5	9.4
Central Bank reference rate (% eop)	15.00	6.50	6.50	5.75	5.75
Banking volumes					
Deposits (% yoy)	28.0	12.0	19.7	15.9	15.2
Lending (% yoy)	28.7	5.4	35.8	30.6	16.5
L/D ratio (%)	80.3	75.6	85.8	96.7	97.8
Mortgages (% of GDP)	4.1	4.6	5.4	5.7	5.9
FX lending (% of total lending)	34.8	32.1	32.1	33.6	32.0
of which CHF (if relevant), % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues / Average Volumes (Loans+Deposits) %	6.6	7.3	6.1	5.0	4.5
Net Operating Profit (% of GDP)	1.7	2.5	2.4	1.8	1.4
Cost / Income (%)	52.3	42.9	45.8	50.1	51.5
ROA (%)	2.2	3.0	2.7	1.9	1.5
ROE (%)	16.5	19.7	17.8	14.1	11.1
Capital, liquidity and funding					
CAR (%)*)	18.8	19.3	17.7	15.0	13.2
Net foreign assets (% of GDP)	–	–	–	–	–
Bank bonds outstanding, (% of GDP)	–	–	0.3	1.5	1.9
Asset quality					
Impaired Loans (in % of gross loans)	3.6	5.3	3.6	2.7	3.0
Cost of Risk (bp)	198	280	140	125	150
Banking sector structural indicators					
Foreign ownership (% of total assets)	37.4	39.5	40.2	41.6	–
Top 5 players (% in total assets)	62.3	62.9	62.7	61.4	–

Note *): Excluding investment banks
Source: Central Bank of the Republic of Turkey, Banking and Regulation Supervision Agency, UniCredit CEE Strategic Analysis, Yapı Kredi Research

Macro environment

In 1H 2011 strong domestic demand growth in Turkey continued, with increasing private consumption and investment triggering 10 % yoy GDP growth in 1H 2011. A potential risk of economic overheating induced the CBRT to adopt an unorthodox monetary policy intended to slow both domestic demand and the widening of the current account deficit. The obvious consequences for the economy became evident starting from 3Q11 with growth estimated to have slowed to 5.8 % in 2H 2011, reaching less than 8 % growth for the full year. The positive impact of the CBRT's policies should be even more evident in 2012 as the decline in private sector investment expenditures is likely to result in a more balanced GDP growth of 3.6 % yoy. With this soft landing of the economy and the policy mix encouraging savings vs. consumption, the current account deficit is estimated to gradually decline to $ 62.5 bn or 7.8 % of GDP by year-end 2012.

Inflation, which increased sharply in recent months on the back of exchange rate movements, hikes in administered prices as well as the base effects in unprocessed food prices, is expected to hover at high levels for the next couple of months before converging to 6 – 6.5 % by the end of 2012. The CBRT is expected to continue its flexible monetary policy and effective liquidity management using instruments such as an interest rate corridor, repo auctions and reserve requirement adjustments, while the policy rate should remain stable in 2012.

Banking environment

2011 was marked by regulatory headwinds for the Turkish banking sector. During 1H 2011, the CBRT undertook multiple measures to slow robust lending growth and to curb the widening current account deficit (i.e. by a significant hike in reserve requirement rates, cancellation of interest payments to banks on reserve requirements, a cap on loan growth of 25 % and an increase in general provisioning on consumer loans). The targeted deceleration began in July 2011. Total lending growth is expected to have reached ~30 % yoy (or 25 % when adjusted for the exchange rate, in line with the CBRT's lending growth guidance) in 2011. Deposit growth, although remaining weak in the second half of 2011, is seen to have picked up around year end to reach 16 % yoy resulting in a loan-to-deposits ratio stable at 97 %.

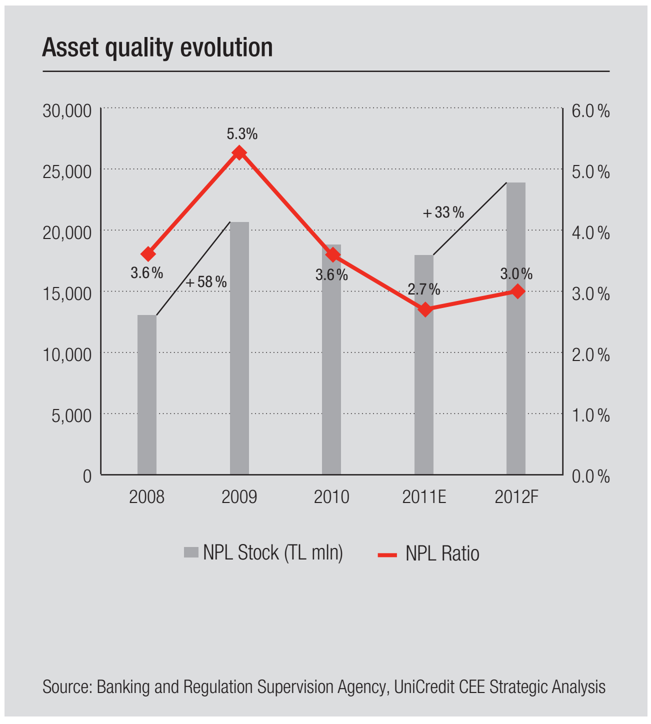
The slowing pace of growth in lending activity and CBRT's liquidity management constitute the pillars of the banking outlook for 2012. Based on November 2011 average loan growth (below 15 %), lending in 2012 is expected to expand by 17 % yoy with SME, consumer and project finance loans likely to be the key drivers as the banks should continue growing selectively to optimize the loan mix. Worth mentioning is also the fact that the CBRT repeatedly stressed its intention to keep the focus on credit growth also in 2012.

We see moderate lending growth in 2012 to be funded mostly through deposits, increasing by 15 % yoy, as the use of repo funding (already on a declining path at the end of 2011) is likely to remain low due to the persistently high cost of funding. Furthermore, banks are likely to continue tapping the market for TL bond issues as they should remain advantageous in 2012. Meanwhile, the Eurobond market, currently on hold, is expected to recover with an easing global environment and Turkish banks ready to issue whenever the market is available.

Another important issue should be a potential re-occurrence of credit quality problems. The NPL ratio should reach 3.0 % in 2012, after having declined to an estimated 2.7 % in 2011 from 3.6 % at year-end 2010, with non-performing loans expected to grow by 30 % yoy. However, it should be kept in mind that even during the recession in the post crisis period in 2009, NPL growth amounted to ~60 % yoy.

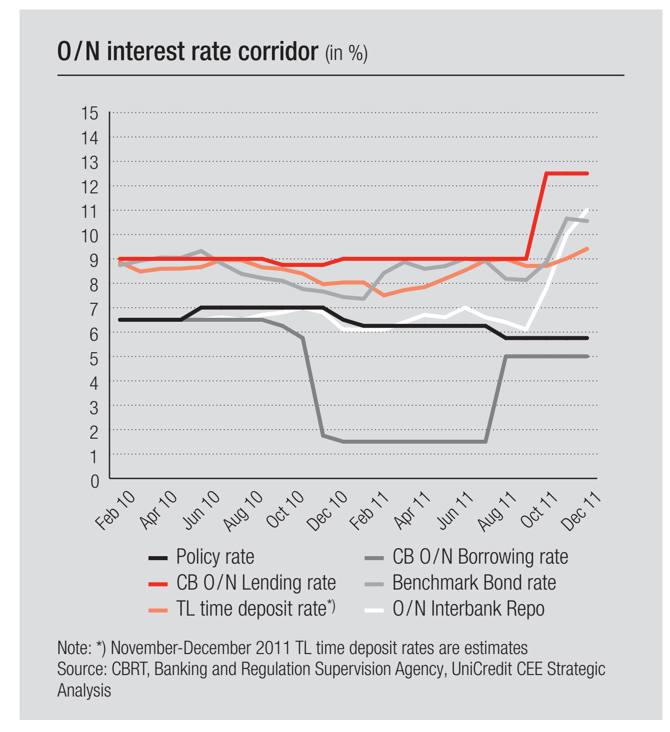
The change in capital adequacy reporting to Basel II standards in July 2012 is estimated to curb the capital adequacy ratio of the Turkish banking sector by ~100–150 bps to ~13–13.5 % at year end 2012, still well-above the 12 % minimum requirement.
The profitability of Turkish banks is expected to decline in 2012, impacted by the ongoing tightening policy, persisting pressure on margins, fees-related regulatory changes, worsening of credit quality as well as elevated costs due to high yearly average inflation. Nonetheless, in the following years, a gradual improvement in profitability is forecast, due to an expected recovery in the momentum of economic growth, flagging regulatory pressure, healthier competition and efficiency improvement.

Asset quality evolution



Source: Banking and Regulation Supervision Agency, UniCredit CEE Strategic Analysis

O/N interest rate corridor (in %)



Note: *) November-December 2011 TL time deposit rates are estimates
Source: CBRT, Banking and Regulation Supervision Agency, UniCredit CEE Strategic Analysis

Ukraine

Funding and credit quality problems still constraining lending activity

Anna Kolesnichenko

	2008	2009	2010	2011E	2012F
Macro/Monetary					
real GDP (% yoy)	2.1	–14.8	4.2	4.0	2.0
CPI (% avg)	25.2	16.0	9.4	8.0	6.6
Central Bank reference rate (% eop)	12.0	10.3	7.8	7.8	7.8
Banking volumes					
Deposits (% yoy)	26.7	–6.9	24.4	15.5	13.1
Lending (% yoy)	72.0	–1.5	1.3	10.2	7.7
Loan-to-deposits ratio (%)	204.0	215.9	175.9	167.8	159.8
Mortgages (% of GDP)	15.1	14.5	10.1		
FX lending (% of total lending)	58.7	50.5	45.7	41.7	38.8
of which CHF, % of FX lending	–	–	–	–	–
Banking sector profitability					
Revenues/Average Volumes (Loans+Deposits), %	7.5	5.8	5.9	5.9	5.6
Net Operating Profit (% of GDP)	1.1	–4.3	–1.2	–0.5	0.2
Cost/Income (%)	51.4	58.9	60.0	60.7	60.9
ROA (%)	1.4	–4.3	–1.4	–0.6	0.3
ROE (%)	11.2	–33.4	–10.4	–4.1	1.9
Capital, liquidity and funding					
CAR (%)	14.0	18.1	20.8		
Net foreign assets (% of GDP)	–23.8	–16.3	–9.7	–7.0	–4.5
Bank bonds outstanding, (% of GDP)	0.8	0.5	0.3	0.5	0.7
Asset quality					
Impaired Loans (in % of gross loans)	17.0	30.0	40.0	37.0	33.0
Cost of Risk (bp)	385	887	539	441	319
Banking sector structural indicators					
Foreign ownership (% of total assets)	–	–	45.3	44.1	–
Top 5 players (% in total assets)	33.3	34.8	36.8	37.4	–

Source: NBU, UniCredit Research, UniCredit CEE Strategic Analysis

Macro environment

The Ukrainian economy has remained on a recovery track in 2011, increasingly driven by internal demand as the external backdrop has weakened. Private consumption was the primary growth driver on the back of strong real wage growth (8% ytd as of the end of September), but fixed investment has also rebounded in part thanks to the preparations for the Euro-2012 football championship. The expected softening of global growth in 2012 should strongly affect the economy, as it is highly dependent on commodities exports. Indeed, the Ukrainian economy has probably one of the highest "betas" in the CEE region, as its dependence on commodities and its fragile external balances make it vulnerable to any swings in the global economic outlook and market sentiment. Unfortunately, the country has not exploited the 2008–2009 crisis to restructure and streamline its economy which remains highly energy inefficient and skewed toward low value added goods. Therefore, the outlook for Ukraine over the next several years will to a large extent depend on the dynamics of commodity prices. Assuming that the 2012 slowdown remains contained, the Ukrainian economy should gain growth momentum over 2013–2015, but lacking any meaningful progress with structural reform, growth is likely to remain contained. Private consumption and investment should counterbalance weak exports in 2012; however, their further strengthening will depend a lot on the availability of credit.

In the near term, the major risk is external financing, especially for the public sector. In 2012 the government faces significant volumes of amortisations on its external debt. With strained budget finances and weak foreign capital inflows the ability of the government to refinance or repay the debt may come into question.

Banking environment

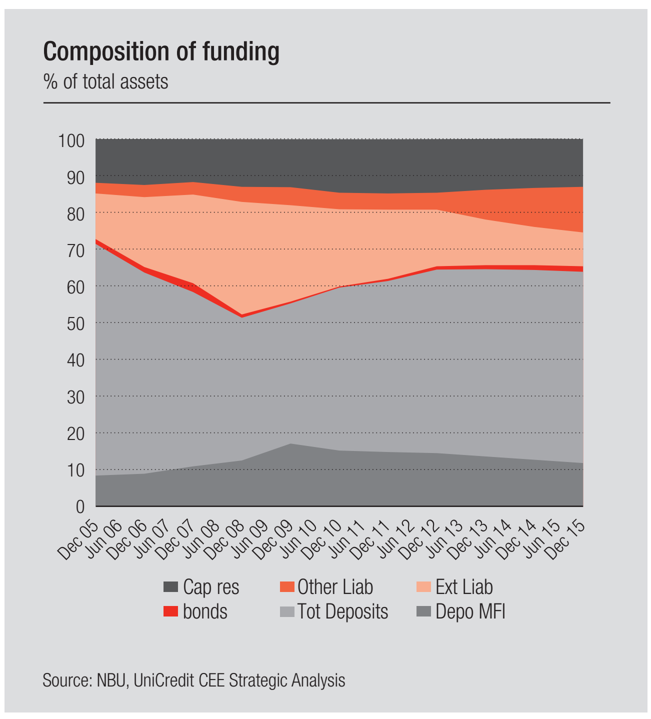
The Ukrainian banking sector performance in 2011 was still weak, but better than in 2010: lending recovery started to gain momentum, the NPL ratio has stabilised and profitability improved substantially, although the system is expected to have remained in loss. Corporate lending has continued to drive the credit recovery, supported by favourable export conditions in 1H 2011 and to some extent by construction projects in the context of preparation for the Euro-2012 football championship. A notable feature of last year was a recovery in local currency retail lending, predominantly in consumer and automotive loans, as economic stabilization and strong growth in real wages supported consumption. At the same time, FX lending stagnated, causing the overall contraction of retail credit. For 2012 we expect a slowdown in credit growth, as Ukrainian corporates should be negatively affected by diminishing external demand and Euro-2012 preparations conclude in 1H2012. A ban on FX loans and the still weak condition of household balance sheets should weigh on real estate lending [1] in 2012 and subsequent years. Therefore, corporate lending, consumer and car loans will be the main drivers of credit growth in 2012 and the next several years. In the longer term, however, real estate loans have the greatest potential, as penetration in this segment is quite low compared to other CEE countries (7.5 % vs. 17.8 % simple average for the CEE region as of year-end 2010). Development of this segment, however, should depend a lot on the availability of local long-term funding, which is currently not available.

1) As of October 2011, 84 % of real estate loans were in FX, predominantly USD-denominated.

Unlike in pre-crisis years, supply constraints might play a more prominent role in credit provision in the next years. This is especially relevant for Ukraine, as it has one of the largest structural funding gaps in the region with loans-to-deposits (L/D) ratio expected to have reached 168 % at the end of last year. The L/D ratio has already declined substantially from its peak of 216 % in 2009, and we expect it to fall further to about 148 % by 2015. Deposits should remain the main source of funding, while the significance of external funding will diminish. From 63 % in 2005, the share of customer deposits in funding has declined to 38 % at the end of 2009; we expect it to recover to about 50 % in the next several years. By contrast, external funding expanded strongly before 2009, but since then this trend has reversed, with external liabilities declining by EUR 10.7 bn as of Oct 2011 from their maximum of EUR 28 bn in September 2008. Tight liquidity conditions on the European markets in 2H 2011 made it even harder for Ukrainian banks to attract external funding. We expect them to continue reducing their external exposure in 2012.

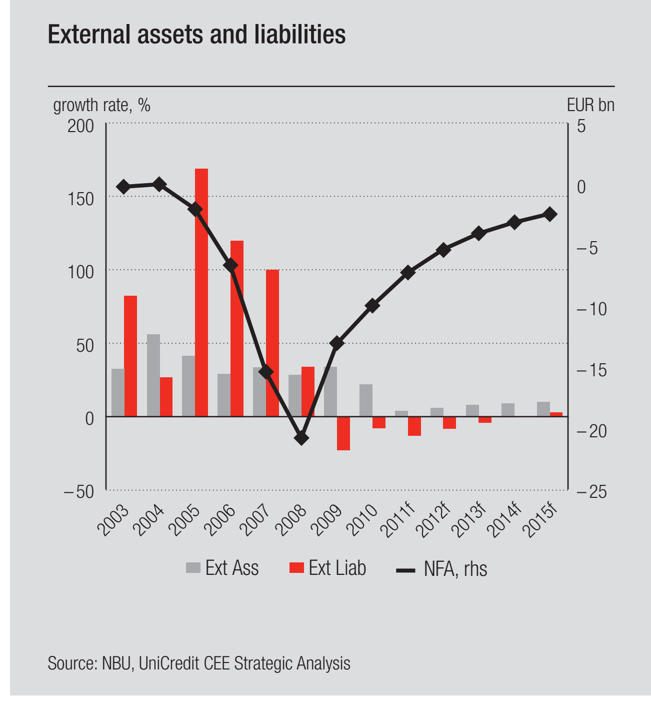
While a narrowing of the external funding gap by the banking sector is desirable for Ukraine, it risks stifling the credit supply if other sources of funding are not employed. Overall, the outlook remains mixed. On the one hand, deposits growth has been quite healthy in

Composition of funding
% of total assets



Source: NBU, UniCredit CEE Strategic Analysis

External assets and liabilities



Source: NBU, UniCredit CEE Strategic Analysis

1H 2011 on the back of a stable economy and improving households' confidence. However, escalation of the Eurozone debt crisis and rising fears of hryvnia devaluation led to a massive outflow of deposits in September. The central bank managed to contain the crisis by imposing diverse restrictions on FX exchange and limiting UAH liquidity on the market. The situation has subsequently stabilized but at the expense of tight liquidity. In view of an expected poor BoP performance in 2012, the hryvnia is likely to remain weak, implying a prolonged tight monetary policy, which runs the risk of reducing the credit supply. Banks have already responded by hiking deposit rates – from an average 6.7 % in July to 13.1 % in November. This translated into a respective hike of lending rates in hryvnia – from an average 14 % in July to 19 % in November. If such high rates persist, the most likely outcome will be much weaker demand for credit.

Banking sector performance and the ability to extend credit are still constrained by large portfolios of non-performing loans. We estimate that the NPL ratio should have stabilised by the end of 2011. The official NPL ratio has fallen 2 % since October 2010, when it reached the maximum of 12 %. Although our estimate of the volume of NPLs differs [2] (37 % as of June 2011), we believe that the peak has indeed been reached, and the ratio should marginally decline going forward. This should be supported, in particular, by the resolution of NPLs, a process that already started in 2011 but progressed slowly due to a discouraging legislative environment. We expect NPL resolution to gradually accelerate in 2012, in particular thanks to regulations approved in autumn 2011 (the tax administration allowed banks to put NPL write-offs to expenses).

The banking system still came in at a loss in 2011, but the size of the loss halved relative to 2010 mainly thanks to a fall in provisions and also due to stronger income generation on the back of a gradual recovery in lending activity. From the peak of 8.9 % in 2009, CoR fell to 4.4 % in 3Q 2011, and we expect it to decline to 3.2 % in 2012 and then gradually to 2.2 % in 2015. We expect the banking system to return to profitability in 2012. Stabilization of loan quality and a reduction in the cost of risk should remain the main drivers of the improved performance. Revenues growth is forecast to be weak in 2012, but then to gradually recover over 2013 – 2015 on growing lending volumes. We also expect non-interest income to support banks' revenue generation capacity: banks have already started searching for non-interest income opportunities, such as raising fees for servicing accounts, and this trend is likely to continue.

2) Our definition includes substandard, doubtful, and loss loans, while the NBU definition includes only loss loans (overdue more than 90 days) and loans on which enforcement / foreclosure action was initiated.

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