

BANKING IN CEE

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Executive Summary



- **Macroeconomic and Global Banking Sector factors the main causes of contagion**
 - countries most affected are those more dependent on trade, with strong dependency from capital inflows and with a more unbalanced banking sector
 - presence of international banks in the region should be considered a stabilizing factor
- **World economic growth is recovering and this boosts prospects in CEE** - 2010 will show a positive regional growth, though this will remain below potential and subject to risks. Strong regional differentiation is confirmed
- **Markets are out of a “liquidity-crisis mood” – credit quality and risk appetite today’s key constraints for CEE banking**
- **Medium term: “CEE convergence story” holds, but the banking model has to be rebalanced**
- **Policy actions needed:**
 - ✓ **Macro:** EU Funds absorption crucial, clear EU neighboring policy, mechanisms to avoid contagion, clear roles for Euro adoption
 - ✓ **Banking:** Avoid the risk of over-regulations, Capital regulation and capital efficient allocation, FX lending

AGENDA



1. The CEE banking sector and the crisis

2. Banking through the crisis

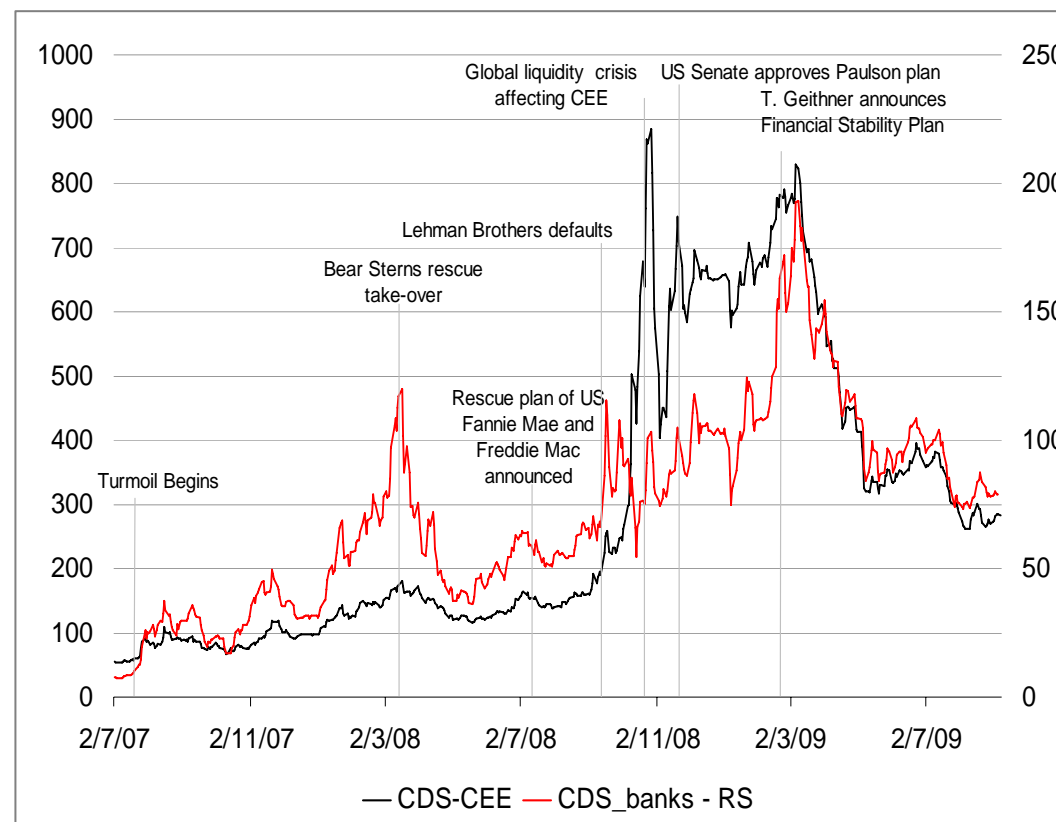
3. Policy actions needed

The international crisis transmission to CEE banks: 2 key contagion channels at work



- Through **macroeconomic factors**:
 - Lower international demand
 - Dependency on external funding
 - Generalized crisis of confidence on the region
- Through the **international banking sector crisis of confidence**:
 - “Imported” confidence crisis – run for deposits
 - Sustainability of external funding for CEE banks
 - Credit quality and capital constraints

Evolution of sovereign CDS spread compared to average of CEE major players¹



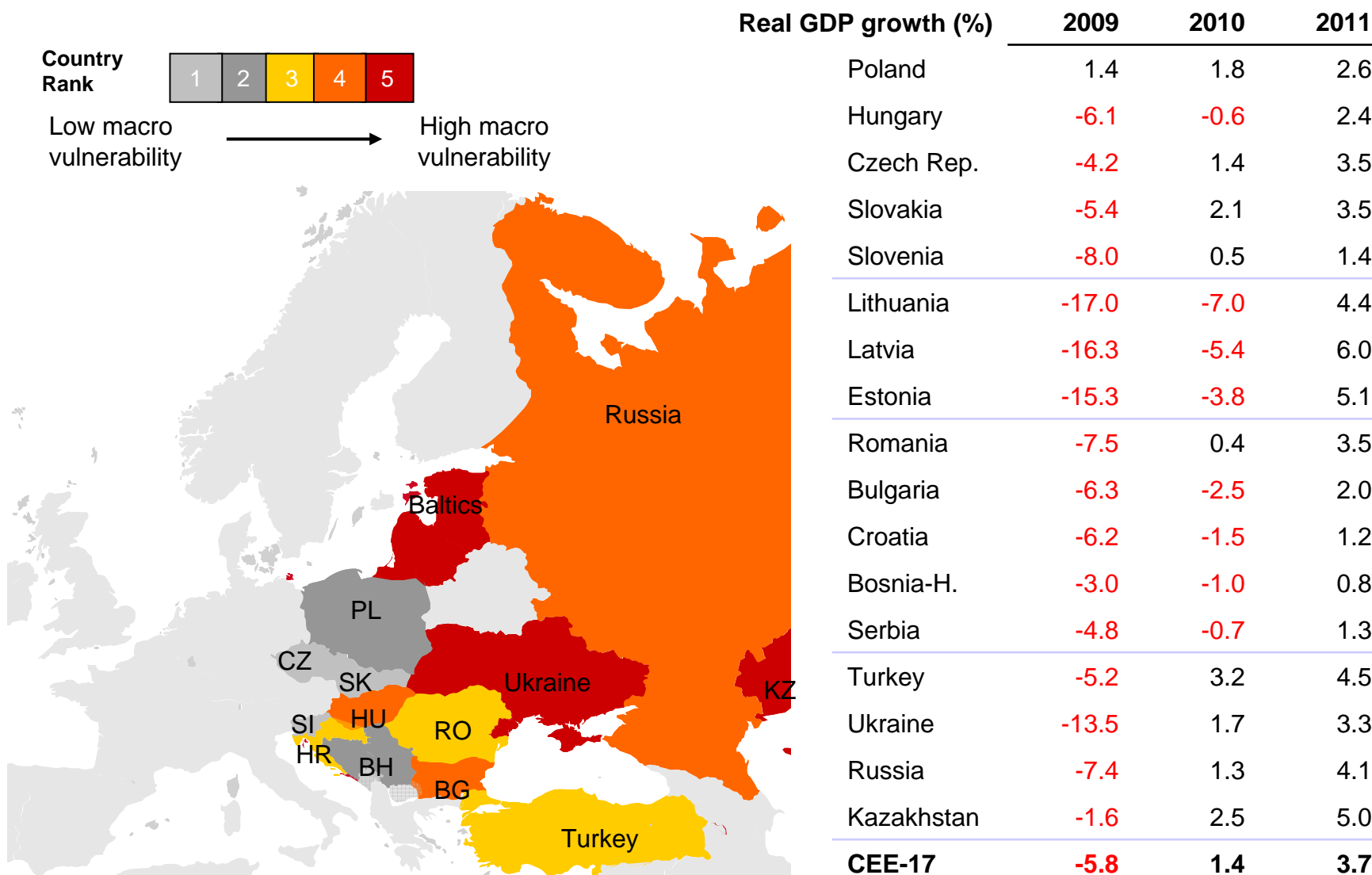
Note: (1) Average 5Y CDS spread for banks including UniCredit Group, Société Générale, Intesa, Erste and Commerzbank
 Source: UniCredit Group CEE Strategic Analysis based on Bloomberg

International commitment toward the CEE region has been crucial for managing the crisis



- **Participating capital and support packages in Western EU countries**
- **Support packages implemented by the IMF and EU in a range of CEE countries helped to deflate the partly exaggerated market concern**
 - IMF - USD 60 bn in Serbia, Bosnia, Hungary, Latvia, Ukraine and Romania under the stand-by agreement program + 20.5 bn Euro in Poland with new short-term credit line
 - EU Balance of Payment assistance - EUR 6.5 bn for Hungary, EUR 3.1 bn for Latvia and EUR 5 bn for Romania
 - EBRD, EIB and World Bank - 16.3 bn Euro by end Sept 2009
 - Single countries extended extra support, as in the case of the Nordic countries
- **The commitment to the region of strategic investors in the banking sector has also been key**
 - The IMF has been securing international banks' firm commitment to single markets (as part of the IMF support packages to the countries) by getting them to sign a bilateral agreement with the local central banks to maintain their exposure and eventually recapitalize their subsidiaries over the next years if required
- **Human factor – more used to crisis**

Signs of recovery: still 2010 implies growth below potential and countries confirm to be very different



Note: (1) CEE-17: Poland, Hungary, Czech R., Slovakia, Slovenia, Lithuania, Latvia, Estonia, Romania, Bulgaria, Croatia, Bosnia-H, Serbia, Turkey, Ukraine, Russia and Kazakhstan
Source: UniCredit Group CEE Strategic Analysis, CEE Research

Out of a “liquidity crisis mood”, credit quality the main risk and restarting lending the challenge



Out from a “liquidity crisis” mood

- Interbank markets working both domestically and at the international level
- Deleveraging process started and already being reverted
- International banks active in the region providing funding to their subsidiaries
- **Availability and cost of external funding remains a key competitive advantage for banks in the region**

Credit crunch clear

- Negative growth in lending on a YTD basis June vs December in all countries, provides clear sign of a credit crunch
- Only exceptions Poland (where the economy continued to grow) and Serbia and Croatia, where government lending or government guaranteed lending have played a role
- **Risk of second round effects from credit crunch to credit quality**

Credit quality today challenge

- Credit quality is the main constraint for lending, other than low demand
- **NPLs to peak in 2010, while cost of risk already high**

Revenues generation and Loss Absorption Capacity

- Low banking business combine with high cost of risk, meaning a risk in terms of loss absorption capacity

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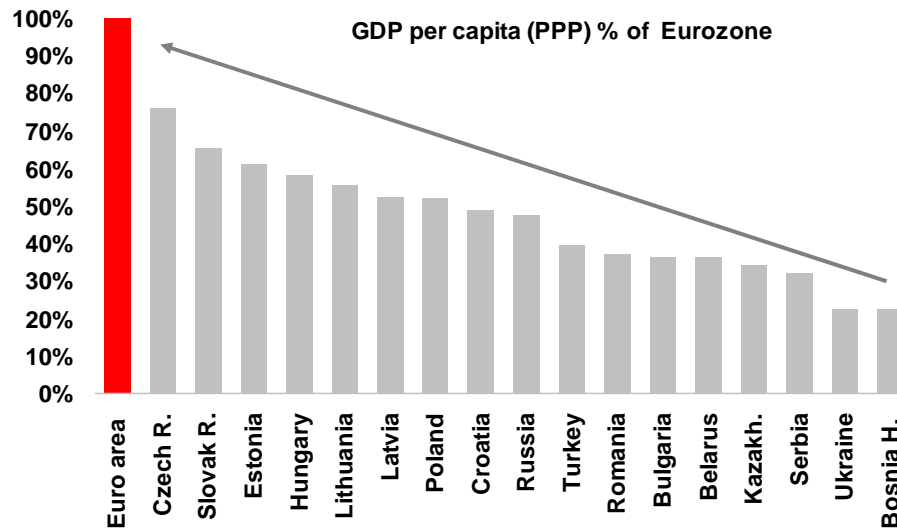


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The long term potential of the CEE region is intact

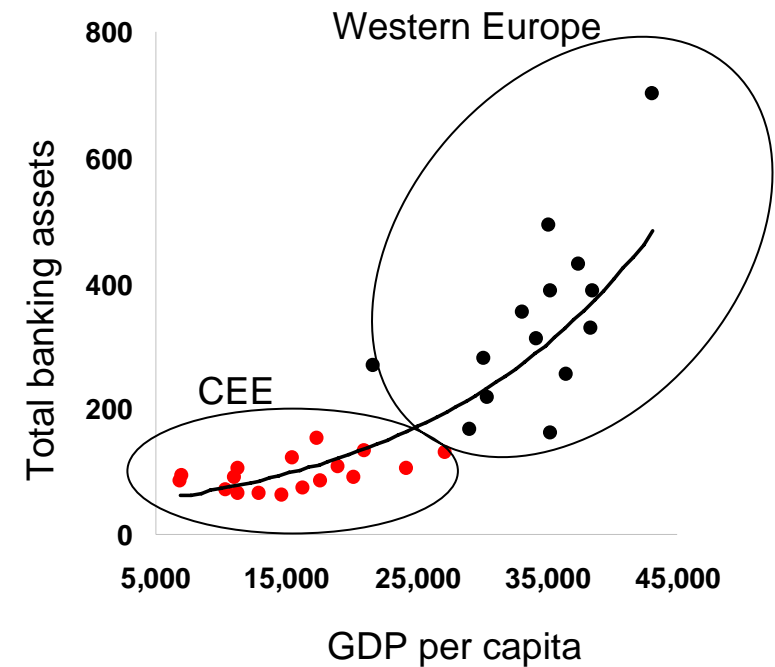


Real income convergence in CEE ⁽¹⁾



Financial deepening process

(% of GDP and PPS in dollar terms)



The story of economic and income convergence towards the standards of Western countries, as well as the potential related to the banking sector penetration gap, continue to hold

(1) CEE incl. new EU member states, Croatia and Turkey; calculation based on GDP per capita expressed in dollar terms
Source: UniCredit Group CEE Strategic Analysis, IMF, ECB

CEE banking - the medium-term scenario implies new constraints and new competitive advantages



OPPORTUNITIES

- Long term growth potential unchanged
- Weaker competitive pressures in terms of market shares than in the past, with some players constrained in their strategies

THREATS

- State Influence to increase
- New Entrants might consider the market, taking advantage of lower prices and un-tapped long-term potential

STRENGTHS

- Strong network / presence in the market
- Diversification
- Access to capital and funding
- Long term commitment
- Adequate risk appetite

WEAKNESSES

- Credit quality problems eroding profitability
- Too strict risk control
- Funding constraints

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Policy actions – Macroeconomic point of view



- **Eligible countries need to focus on EU Funds absorption.** Maximum absorption should be guaranteed and means should be allocated for co-financing
- **Infrastructural projects** which can be activated (taking into account the fiscal constraint) **should be directed towards competitiveness enhancing initiatives** (energy efficiency, legal and regulatory streamline, other competitiveness related measures, IT, etc)
- **Strong focus on neighboring policy of the EU,** to grant economic and political support for the non EU member countries. Essential condition to grant stability around the EU, given the strong social cost and possible political stability problems related to the crisis
- **Design measures/mechanisms to avoid contagion** – i.e. emergency instruments from the ECB for swap operations in specific countries, strong wording / signalling effect from the ECB to avoid contagion in case of events in one country
- **Clear rules for Euro adoption**

Policy actions - Banking



- **Avoid the risk of over-regulations**
- **FX lending** – Different proposals:
 - **EU proposed directive** - proposes higher capital absorption for those loans in FX towards unhedged retail clients. Only for new business and will be applied to those loans with a loan-to-value (LTV) above 50%
 - **Hungarian authorities** – upfront regulation, limiting the LTV for mortgage loans to un-hedged clients to 75 % in the case of LC loans, 55 % in case of Euro loans and 35 % in case of other currencies
 - **Banks proposal**: constraints on income of the borrower, rather than on the LTV
 - Consider that **all measure affect the new business and not the stock** of existing business. Most of the countries might have adopted the Euro and that before they will have meaningful effect
- **Capital** – new capital standards are now required by the market. But as capital is a limited resources, it is important that once adequate capital is granted at the Group level, allowing for adequate buffers, **capital is than redistributed among countries in an efficient way**. If every country is asking for increases in the minimum capital and country specific buffers, international Groups might turn out to be inefficient in their allocation of capital, not allowing proper remuneration of investment and further constraining lending growth