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The Banking Sector in Central Europe
Performance Overview

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Foreword

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For most Central European countries, the last decade of the 20th Century was when the commercial banking systems of most CE countries had just started to develop. After the Communist era, banks were short of capital and therefore needed to be commercialised and privatised. The fact that this was taking place at the same time in most countries has led to significant similarities between most of the region's banking markets. The level of assets to GDP is small compared to Western European countries, but this is quickly growing despite the legacy of the crisis. On the other hand, the operations of CE banks are in many areas more advanced than those in their parent organisations, because they managed to skip some stages of banking evolution to move directly to the newest solutions.

Almost five years after the global turmoil of the financial crisis and the worst global economic downturn of recent times, banks in the region are striving for success in a continually changing industry. The global banking sector has faced a series of problems since 2008 that have decimated the overall net profit of the sector to just 10% of its previous level. Central European banks faced the same difficulties of falling profitability, but the nature of the process differed from country to country.

Among the many factors contributing to the current state of affairs, one of the most important is the resilience of each market to economic slowdown, which highlights some differences between CE countries. The Polish, Czech and Slovak banking sectors managed to get through the crisis much more easily than those in the region's southern countries, where sector-wide ROE is well below 10% and in some cases even negative. The key factors that have pushed national banking systems towards negative profitability are the new regulations and severe taxes introduced in Hungary and some other countries. The high concentration of the banking sector, where the top 10 banks hold more than 70% of the sector's assets, is making cost effectiveness easier to achieve in countries like Croatia and Slovakia. Differences in the rates of unemployment growth are also causing variations in the level of credit risk and its impact on banks' results.

While taking into account their disparities and similarities, the different banking sectors across the region face the same challenges and continue to offer considerable opportunities, which require careful analysis and prioritisation to leverage. Part of the challenge for the banks will be how to continue finding suitable business models that fit current circumstances on both a regional and a national level. Whether they are looking to recover, restructure, comply, recapitalise or simply to grow, banks in the CE region need to generate success on multiple fronts.

The Banking Sector in Central Europe - Performance Overview analyses the banking sectors in Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Serbia, Slovakia and Romania. It focuses on the financial results of each sector and aims to describe the individual factors impacting the profitability of each country's banking industry.

The report seeks to identify the key individual revenue drivers and particular elements that influence the level of costs that banks must contend with. It also addresses the question of how heavily those provisions created to de-risk loans with a high probability of default are impacting upon each respective sector's net profits. We also look at the impact of the new banking taxes and other regulations that have been introduced in some countries.

Understanding the drivers of banks' financial results is the key to making the right decisions in a constantly changing market environment. We hope our study and the insights from local markets will help banking executives better understand our region better and make better choices in terms of strategic directions.

Key insights

Bulgaria

- Recent years have confirmed the stress caused when assets go sour, which have clearly undercut profitability. Over last four years, net profits declined at a CAGR of 25%.
- Asset quality deteriorated massively from 2009 to 2011, with the ratio of overdue loans over 90 days increasing to 19.7% from the 11.5% recorded just two years earlier.
- Weak productivity is highlighted by metrics such as assets or net revenues per employee, which respectively stand at EUR 1.1M and EUR 59.0K; this is to some extent offset by clearly lower per capita personnel costs, which average EUR 11.0K.

Croatia

- The sector's net profit showed some positive momentum to total EUR 0.5B in 2011. It still remained at a level below the peak of EUR 0.6B recorded in 2008.
- Overall decrease in profitability clearly highlights the detrimental impact of the increasing cost of risk, which expanded at an annual rate of 44%. The negative impact of this was only partially offset by better cost-to-income ratio, which improved by 3% annually.
- A conservative approach to liquidity management is evident from a closer look at the loan-to-deposit ratio, which has tended to remain a notch below 100% over the last couple of years. Such a balanced proportion of loans and deposits shows a responsible approach to financing and emphasises the self-funding ability of Croatian banks.
- The top 10 banks combined command as much as 92% of the sector's assets, the highest concentration among the CE countries we have analysed.

The Czech Republic

- Outstanding efficiency coupled with a cautious approach to risk assessment has resulted in strong profitability in recent years. ROA and ROE ratios in 2011 amounted to 1.19% and 14.7% respectively – levels that many countries in the region would aspire to.
- Operational efficiency is the strongest aspect of banks operating in the Czech market. Cost-to-income for the sector stood at an excellent 45.0% in 2011, among the best recorded in the CE region.
- The loan-to-deposit ratio in the Czech Republic ratio stood at 96.4% in 2011, having oscillated around 92% over the last 10 years. The way in which this ratio has evolved shows how lending activity is closely matched to the expansion of the deposit base.
- Asset quality has remained relatively stable in recent years, with only limited deterioration. The ratio of loans overdue by more than 90 days to the total loanbook value has stabilised, totaling 7.1% in 2011.

Hungary

- The previous four years paint a bleak picture, with net profit declining with each consecutive year and into loss in 2011, when the net loss amounted to just EUR -0.3B. Consequently, profitability ratios are in the red – the ROA and ROE of the banking sector in 2011 amounted to -0.21% and -2.5% respectively.
- The asset quality of Hungary's banks showed severe deterioration between 2009 and 2011. The ratio of loans overdue by 90 days+ increased to 14.9% in 2011, showing a sharp rise on the 7.7% recorded just two years earlier.
- Regulatory changes were the chief cause of the tectonic shifts that have taken place in the Hungarian banking sector. A banking levy was introduced in 2010 and is based on the adjusted assets of a financial institution. Further steps taken by the lawmakers have also had painful consequences for the sector. The Hungarian government introduced the possibility of early repayment for FX-denominated mortgages at stipulated favourable FX rates. On top of such regulatory burdens comes the transaction tax, coming into effect from 2013, the tax will be imposed on cash transactions.

Poland

- ROA and ROE stood at 1.21% and 12.2% respectively. A comparison with other CE countries shows Polish banks in a good light, placed among a small group of countries with a double-digit return on equity.
- Some compression of margins is evident - revenues per retail costomer declined rapidly, by -11% on an annual basis, which was only partially offset by increasing numbers of branches and customers.
- The market dominance of the top 10 players in Poland is some way below the average observed for the region, which gives space for consolidation .
- Poland is the biggest banking sector in CE with assets of EUR 314.0B.
- Poland is the fastest growing banking sector in CE with assets that increased by almost 12% in 2011.

Romania

- Over the last four years, net profit has declined at a massive CAGR of 59%. Net profit was barely existent in 2011, and net income amounted to just EUR 4.5B, far below the peak of EUR 5.1B recorded in 2008.
- The cost of risk in 2011 remained at an eye-watering 3.1%, the highest in the region.
- The Romanian loan to deposit ratio, which in 2011 stood at 125%, is among the highest in the region.
- Romanian market has its very strong reliance on FX lending, which amounts to a high 63.7% of the total loanbook. This dependence is visible in both main customer segments – FX-denominated credit stands respectively at 61% and 66% of corporate and retail lending.

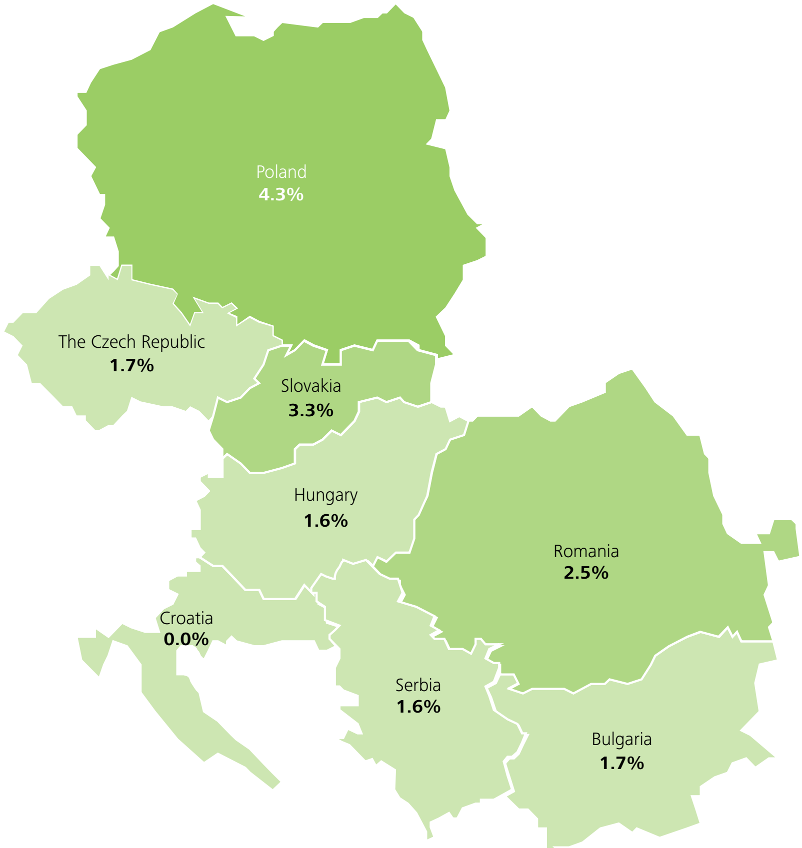
Serbia

- Net profit in 2011 amounted to just EUR 12M, scarcely managing to stay out of the red.
- The cost of risk amounted to 2.8% in 2011, up from 2.3% the previous year, placing Serbia among those countries with the highest levels of provisions in the CE region.
- Recent developments affecting the loan-to-deposit ratio, which has stayed around the 100% mark over the last couple of years, point to the Serbian banks' cautious approach to liquidity management.
- Among positives is the quite significant share of the equity account, which amounted to 21% in 2011, a larger contribution than is usual.

Slovakia

- The ROA and ROE ratios of the Slovak banks stood at 1.14% and 15.0% respectively in 2011, an excellent outcome by any measure. Comparison with other CE countries shows the sector's underlying strength, among the region's front-runners.
- The banking tax rate was initially based on a flat rate of 0.1% when it went live in early 2012. After five months the government reconsidered its position and increased the rate to 0.4% (valid from 2013 onwards), which raises estimates of the tax's revenues from EUR 50M to EUR 200M.
- The share of non-performing loans stood at a mere 4.0% in 2011, growing only slightly from the 3.5% recorded in 2009. As a result, Slovakia has the lowest share of overdue loans of any CE country.
- Operational efficiency remains the strongest feature of Slovakia's banks. The cost-to-income ratio for the sector stood at a cutting-edge 48.8% in 2011, putting Slovak banks right at the forefront for the region.

Figure R1: 2011/2010 GDP growth in Central Europe



Central Europe

Eight core CE markets examined. Although the term "Central Europe" conveniently embraces several countries in one phrase, it would be misleading to think that geographical proximity always predicates similarities in terms of banking activity in different states. Instead, the countries across the region comprise a remarkable patchwork of financial sectors at different stages of development, with varying levels of sophistication and multiple approaches to the challenges posed by the financial and economic crisis.

In this report, Deloitte analyses eight leading banking markets from Central Europe including:

- the biggest economies in the region – Poland, the Czech Republic, Slovakia and Hungary

- the largest Balkan countries – Bulgaria, Croatia, Romania and Serbia

Multi-dimensional approach. The analysis includes an in-depth look at these markets via several different sets of lenses. We take a view that is both broad and deep, striving to drill down into several key issues. So the report investigates the current structure and potential for future consolidation activity in each national market. The presence of the state is also taken into the equation, as well as exploring asset and liabilities structures. The funding base of each country, which is currently the key element of future growth, is scrutinised. And we probe profitability trends on several levels of the P&L statement including: (i) the capacity to generate revenue; (ii) cost adjustments and operational efficiency; and (iii) trends in asset quality and the cost of risk. This results in a multi-dimensional picture for all the analysed countries.

Similar, but not homogeneous. Naturally, many parallels could be drawn among countries and their respective banking systems. This is understandable, especially as the forces shaping the developments of private banks are closely related to culminate in: (i) a prominent presence of foreign investors; (ii) market consolidation ahead of levels seen in Western Europe; and (iii) rapid growth experienced during the run-up to the financial crisis. Nevertheless, there are also notable discrepancies in the evolution of CE's banking sectors such as: (i) the varying size and sophistication of financial intermediation; (ii) different approaches to foreign wholesale funding, ranging from outright dependence to a complete ability to self-fund; and (iii) FX lending levels that range from virtually non-existent to dominating the loanbook.

Slow economic growth is affecting financial institutions' results

The differences between the region's individual banks have increased since 2008, although the overall trends they face are expected to be similar for all. Yet there are major differences in both the magnitude and timing of events, which are easily visible when comparing the development of local economies. While Poland survived the crisis with a substantial growth in GDP (averaging 3.3% between 2009 and 2011) other countries have faced either a significant decline in their growth rate (Slovakia recorded – 0.9% over the same period) or even recession (such as in Bulgaria, Croatia, the Czech Republic, Hungary, Romania and Serbia). This contrast may be reflected in banks' future revenues.

The assets of the financial sector in Central Europe have risen each year by an average of 8.0% to reach around EUR 893.4B.

Figure R2: Return on equity in analysed CE countries

In 2011 the volume of write-offs and other impairment costs equalled 24.4% of the revenues generated by the banking industry, as compared to 12.2% in 2008.

The banking sector is growing but its profitability is suffering

The position of Central Europe's financial institutions is relatively good. Since year after the economic meltdown, the assets of the financial sector have risen each year by an average of 8.0% to reach around EUR 893.4B. Interestingly, the value of these aggregated assets of Central Europe's financial institutions is comparable with that of Denmark (at EUR 919.7), and is smaller than those in most western countries. The growth rate in the region amounted to 5.8% in 2011 and was largely accounted for by the largest economies in the region – Poland and the Czech Republic.

The overall business activity of the region's financial institutions is still increasing. While the banks have reacted to the worsening economic situation with a more risk-aware approach, through cost optimisation and (when possible) by deleveraging assets, their revenues have continued to rise. However, their profitability is ~40% lower than in 2008. The reason for such a significant decline is explained by the very high level of impairment costs (the gap between an asset's value on the balance sheet and its recoverable amount). In 2011 the volume of write-offs and other impairment costs equalled 24.4% of the revenues generated by the banking industry, as compared to 12.2% in 2008. Had impairment costs remained at the 2008 level, banks' ROE would now stand at 12.7% - 51.9% higher than today.

High cost of risk decreasing bank's appetite for new loans

The level of non-performing loans (NPL) has grown dramatically since 2008, but is now expected to stabilise. While the situation in countries like Poland, the Czech Republic and Slovakia is relatively good with NPL levels below 7.3% and decreasing, it is a growing issue in the rest of the region, at its highest in Serbia at 19.0%.

What's more, many banks in Central Europe have modified their loan policies to non-financial customers and are not willing to increase their loan commitments as fast as before the crisis. Nevertheless, the volume of loans in 2011 compared to 2010 has grown by 9.4%, but this has been inflated by the 16.2% growth in the region's largest market – Poland. High growth has also taken place in Hungary (15.2%) and Slovakia (8.7%).

The liquidity issue

Another problem that the banks are facing is a lack of liquidity. Before 2008, the interbank market was very active and banks were lending money with great confidence. The situation has changed since then, and many smaller banks have serious problems in finding sources of liquidity other than deposits.

Capital requirements

In most European countries, banks are facing serious problems in meeting their capital requirements. Pressure from the European banking system and the parent companies of the region's banks is making funding both increasingly expensive and limited. As a result, banks are being forced to seek capital on the open market.

The Capital Adequacy Ratio (CAR) is particularly high among Central Europe's banks, most notably in Croatia and Serbia where it has reached over 19.0%. The region's lowest CAR level (13.1%) is in Poland. Nonetheless, many banks in the region were unable to meet the requirements of Basel III by the end of 2011. Forthcoming regulation may require the banks to take action in order to increase their Capital Adequacy levels. Higher minimum capital requirements are scheduled to begin being phased in at the beginning of 2013 and to be fully implemented by 2015.

Figure R3: Impact of loan-to-deposit ratios on market development

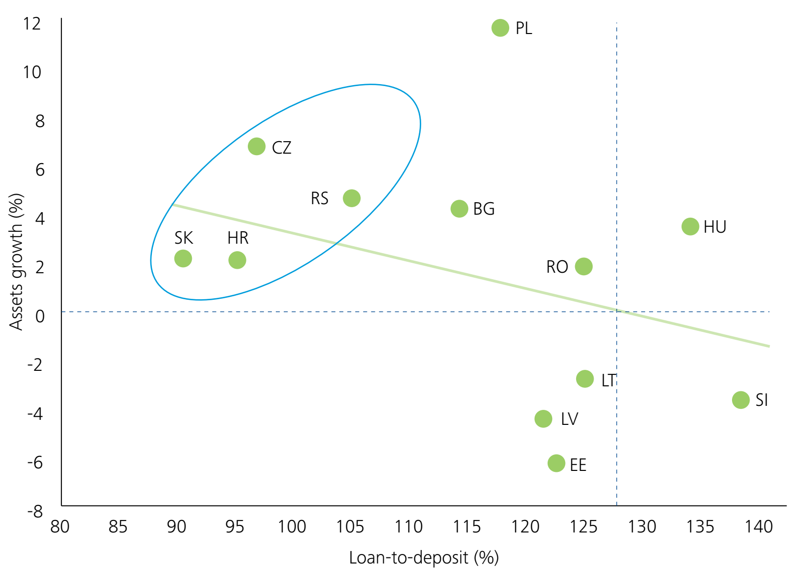
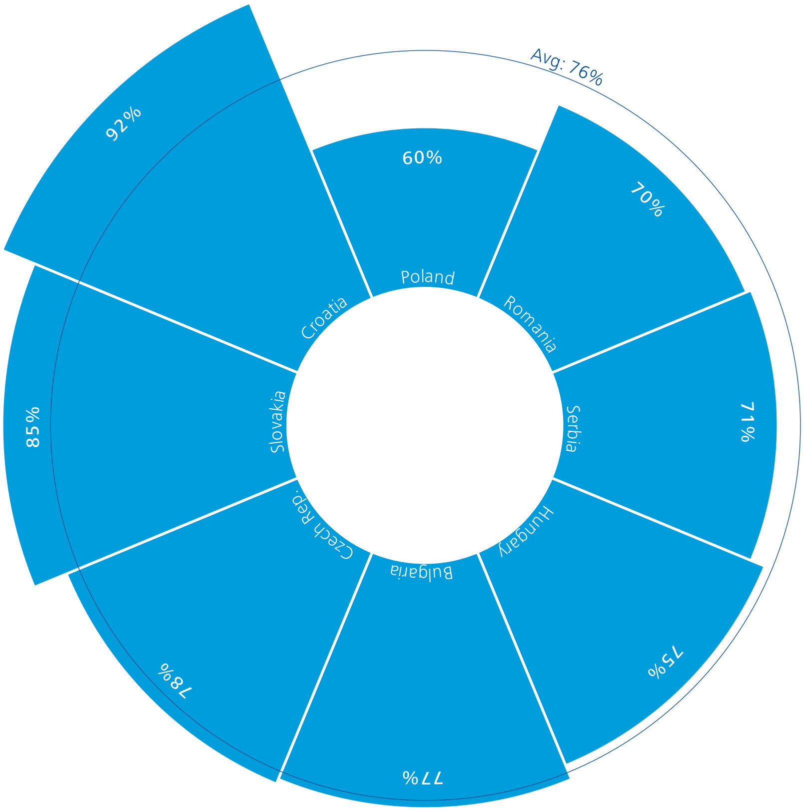


Figure R4: Concentration of the assets of the top 10 banks



Further market consolidation is expected

Taking all the above into account, the overall market situation is difficult. This is reflected in the market capitalisation of numerous banks, which is lower than their book value; this means that their expected return on equity is lower than the expected rate of return. From an investor's point of view, of course, such a situation might look like a cause of temptation, but despite this the region's M&A activity is not particularly strong, suggesting that the level of uncertainty is too great.

Most CE banking markets are relatively concentrated. Particularly in Croatia, Slovakia and the Czech Republic, where the asset share of top the 10 banks stands at 92%, 85% and 78% respectively, competition between the largest players is making it difficult for other banks to compete with those that can leverage their scale.

Several M&A transactions have taken place over the last year, besides those mergers on the international stage that have had an impact on operations in Central European countries, such as the acquisition of the international operations of Volksbank (Austria) by Sberbank (Russia) and the merger between EFG Group (Greece) and Alpha Bank (Greece).

Poland has proved to be particularly attractive market thanks to its relatively strong economic performance and large internal market. Some two thirds of the banking assets in the country belong to foreign-owned banking groups, which have needed financial aid following the crisis and have been forced to dispose of foreign assets including well-performing Polish banks. Add to this the fact that Poland was already considered as an investment opportunity before the fall of Lehman Brothers, so further consolidation is expected. During 2011/2012, two significant M&A transactions took place. After acquiring BZ WBK (Poland's fifth largest bank by assets), Santander Group has also purchased Kredyt Bank and is currently merging these two institutions. The second deal is the purchase of Polbank from EFG by Raiffeisen Bank. These transactions are proving the need for scale in the Polish domestic market, and following the mergers, both banks will strengthen their position in the country's top ten.

In other Central-European countries, meanwhile, a lack of any large scale foreign interest has meant that banking transactions have mainly involved the divestment or winding up of smaller subsidiaries by larger Western-European banking groups.

Yet it is expected that M&A activity will increase in years to come. Firstly, international players will continue to leave due to their strategic refocus and the limited opportunities for them to gain the scale needed to fulfil their potential in the region. Secondly, there are still too many universal banks in most CE countries. This will result in further sector consolidation as the leading players strengthen their positions. Thirdly, we expect a heavy wave of asset deleveraging by the larger players, involving NPL and non-core loan portfolios, which might take place as a direct sale, albeit one with a complex structure.

Business model optimisation

Recession in the financial markets has forced banks to seek savings opportunities in all areas of their operations. As a result, banks are increasingly recognising the lower costs involved in leveraging existing customers rather than attracting new ones, largely through increasing their satisfaction with products and services. As a result, customer loyalty levels are increasing.

At the same time banks, are investing in new technologies, upgrading existing core systems and hiring teams of young professionals to create products to attract a younger, more sophisticated customer group that understands and uses mobile technology, even though they are not generating high revenues.

This makes the current situation even more interesting – while the banks are cutting costs, they are also simultaneously reaching for two very different groups of customers.

Competition through innovation

In recent years, some fascinating product innovations have been introduced and popularised. Interestingly, at a time when innovation may dictate whether or not banks will survive, only a few of these were actually introduced by financial institutions. This is because not just non-banking but even non-financial companies are becoming increasingly active within the financial services market, forcing incumbents to revise their business models to become more flexible, either by increasing the level of innovation within the organisation or by cooperating with third parties in virtually every area. Since the banking ratio (the proportion of the population using banking services) in some of the region's countries still shows scope for improvement, this is creating an opportunity for financial institutions both to attract new customers and to improve customer satisfaction.

M&A activity will increase in years to come.

Regardless of industry, innovation requires a top-down approach. Company leaders need to provide a roadmap for employees and encourage out-of-the-box thinking that drives ideas in terms both of new products and areas for improvement within the organisation's business processes. Not only does this approach improve efficiency, it also motivates teams and has a direct positive impact on the quality of services.

Even in the highly regulated banking sector, it is possible to work with companies from numerous other industries to address various areas of the business. Global concepts and ideas such as Groupon Now, Foursquare, Square, Cardlytics and MoneyAisle show the kinds of opportunity that are still available.

Moreover, innovation should include banks' core systems. Many of these are still not meeting the needs of a changing market and are restricting the potential development of new opportunities. Investments in this area will generate long-term benefits, including an enhanced ability to assess customer needs and expectations so enabling banks to tailor products more precisely.

Customer-centricity

In order to win new customers and retain existing ones, banks need to understand and address the changing needs and expectations of their customers. A wider range of products, high-quality innovative services and transparency together provide a strong basis for competitive advantage, a foundation stone of customer satisfaction and, in the long term, a powerful driver of loyalty.

A recent report, "Setting a new course: The customer experience challenge facing Central Europe's retail banks", which was published by Deloitte based on a survey carried out by TNS Global in Poland, the Czech Republic, Slovakia, Hungary and Romania, helps to pin-point this key issue.

It represents a significant move away from the business model of the past, in which revenues were derived through transaction fees and banks were largely content to see customers "churn" from one provider to the next. Today, therefore, banks are making investments in quality to improve customer loyalty at the same time as reducing risk through more robust approaches to credit-process design and operational excellence.

In this process, the experience of other European banks can prove to be particularly beneficial. Regional financial institutions understand and benchmark the business cases of other institutions and can avoid the problems encountered by pioneers.

What next?

The banking market is becoming more and more challenging, and banks must take a series of key actions to build sustainable competitive advantage.

The traditional sources of income for banks are becoming much more restricted than before the crisis:

- The availability of mortgages is limited due to problems with long-term financing
- Consumer finance and SME lending are weak, due to the high risks involved that result from slow economic growth and growing unemployment
- Revenues from deposits have significantly decreased as a result of the high cost of liquidity and intense competition for deposits in those markets with high loan-to-deposit ratios
- Transactional fees are gradually decreasing as customers make the shift towards electronic banking, where services are much less costly

As a result, banks are seeking other sources of income and trying to increase their cross-sell ratios as a means of improving the falling revenues they make from each individual customer.

In most countries in the region, the penetration of banking services is very high, leaving limited room for further organic growth. The banks therefore have to concentrate on improving service quality in order to secure the loyalty of existing customers. The best way to do this is to understand customer needs and, most important, the possible future changes that will take place. Deep understanding of customer needs and addressing them in the right way makes customers willing to pay more for their banking services, because they appreciate the value they deliver.

It is expected that the next generations of customers will be tech-savvy; the banks will have to meet their needs in order to build the customer base of the future, while retaining those "traditional" customers who still generate a significant share of their profits.

Growing competition from non-financial companies is another issue. If they take no action, the banks may become mere cash and liquidity providers while other areas will be served by external companies.

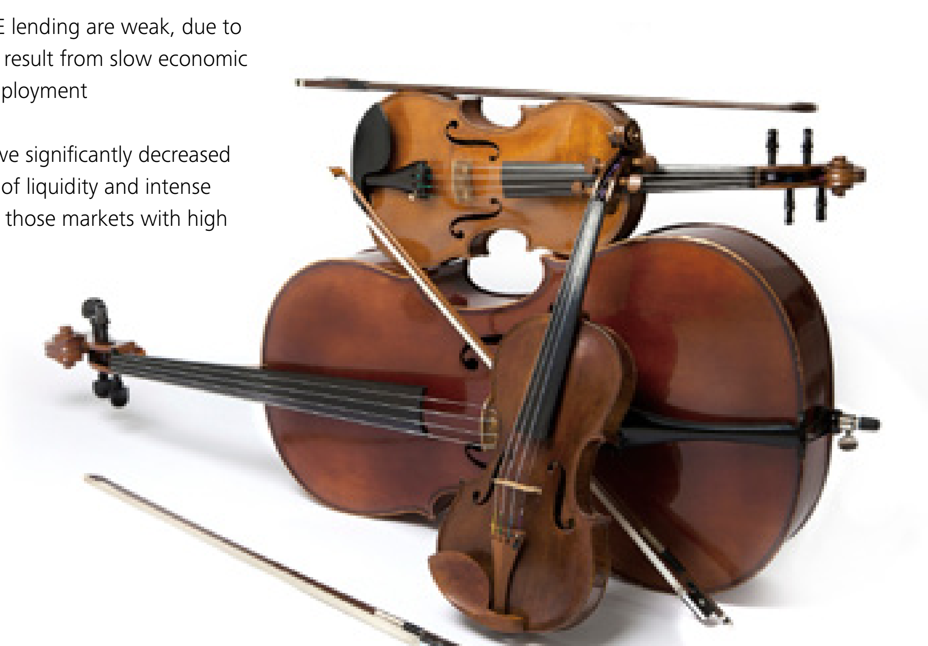
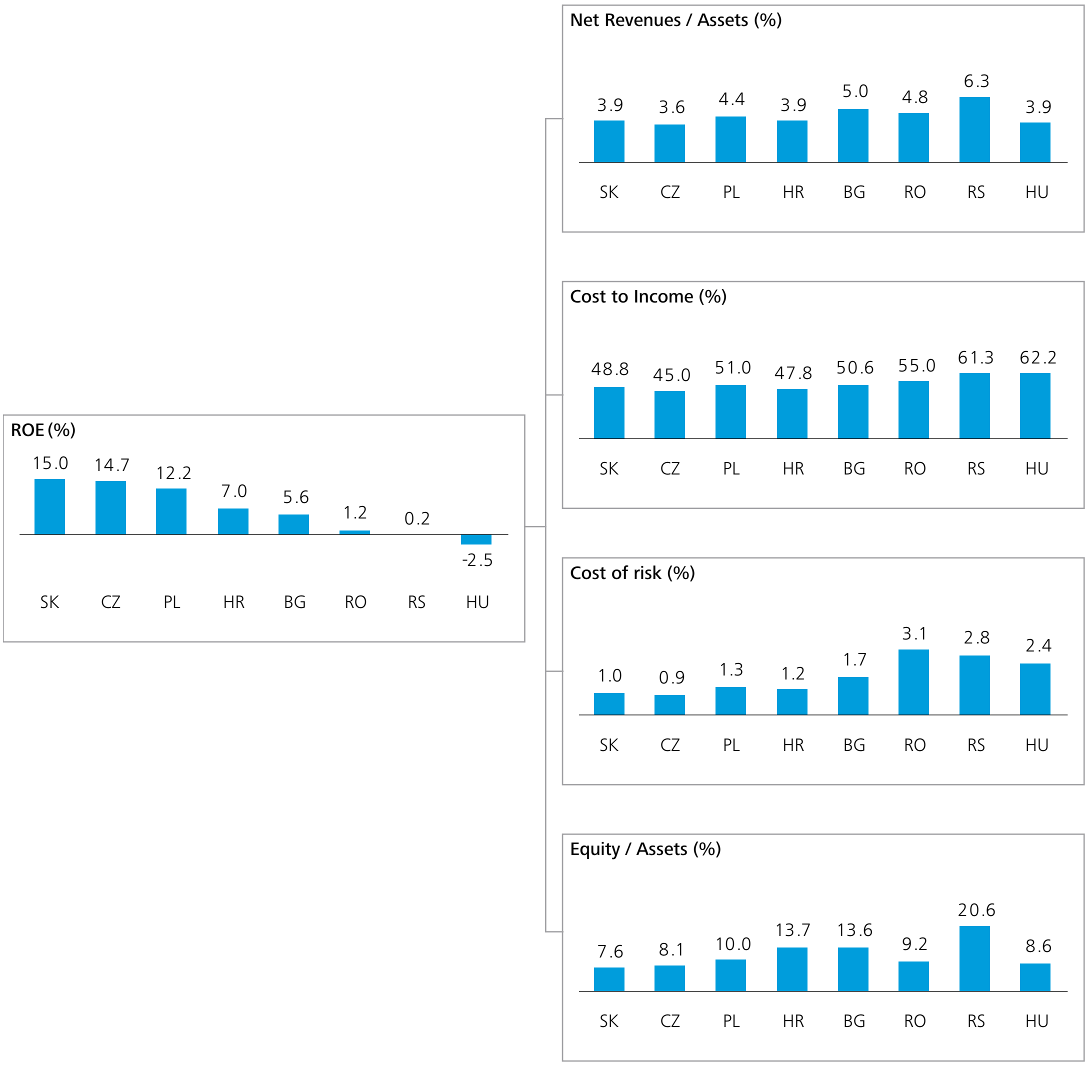


Figure R5: ROE drivers for the CE region (2011)



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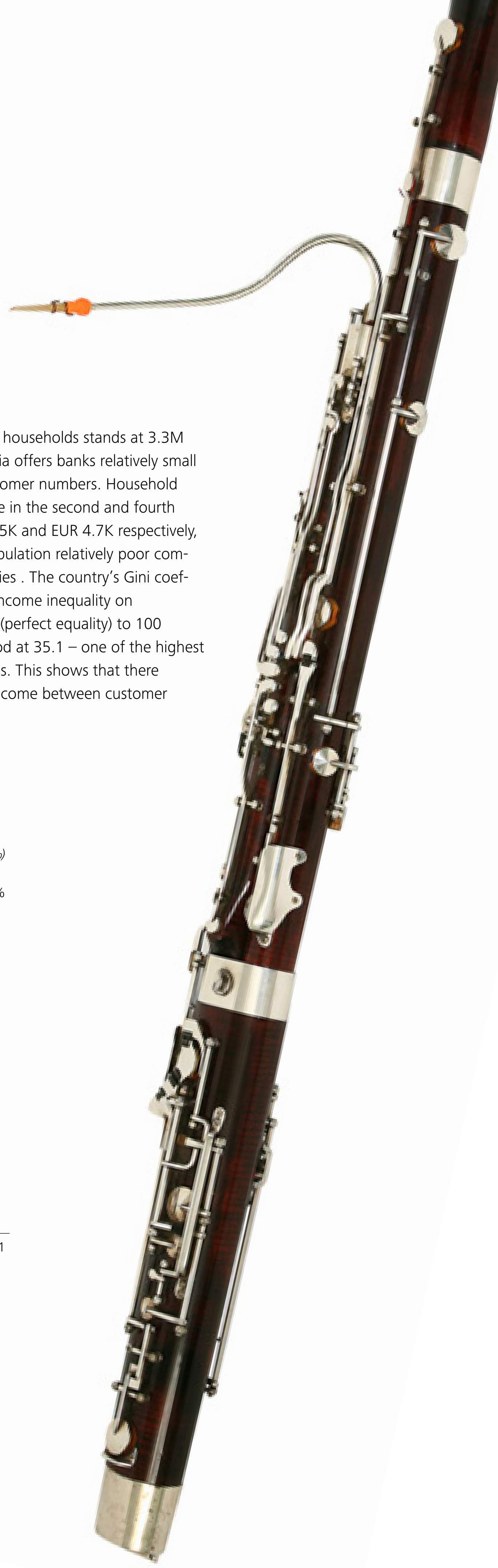
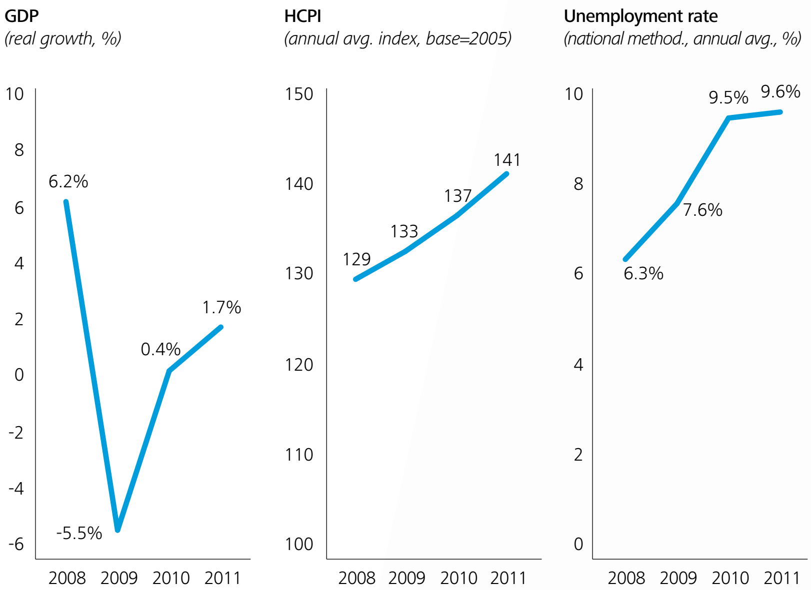


Economic outlook

The recent performance of the Bulgarian economy shows that its “growth engine” is firing on just one cylinder. After two difficult years when GDP shrank (-5.5% in 2009) or stagnated (growing by just 0.4% in 2010) the economy showed some signs of recovery in 2011 (with a GDP growth of 1.7%). Unfortunately this growth didn’t manage to save the country from increasing unemployment, which grew to 9.6% in 2011. Export remains the main driver that is helping the economy to move forward. Internal demand, meanwhile, is fragile, with households and businesses alike holding back on consumption. This is one of the main reasons for the sluggishness of the economy, while the export-led recovery is confined only to selected sectors.

The number of Bulgarian households stands at 3.3M which means that Bulgaria offers banks relatively small potential in terms of customer numbers. Household monthly income for those in the second and fourth quintiles averages EUR 2.5K and EUR 4.7K respectively, making the Bulgarian population relatively poor compared to other CE countries . The country’s Gini coefficient, which measures income inequality on a percentile scale from 0 (perfect equality) to 100 (maximal inequality), stood at 35.1 – one of the highest levels among CE countries. This shows that there are large differences in income between customer segments.

Figure BG1: Macroeconomic indicators



Introduction

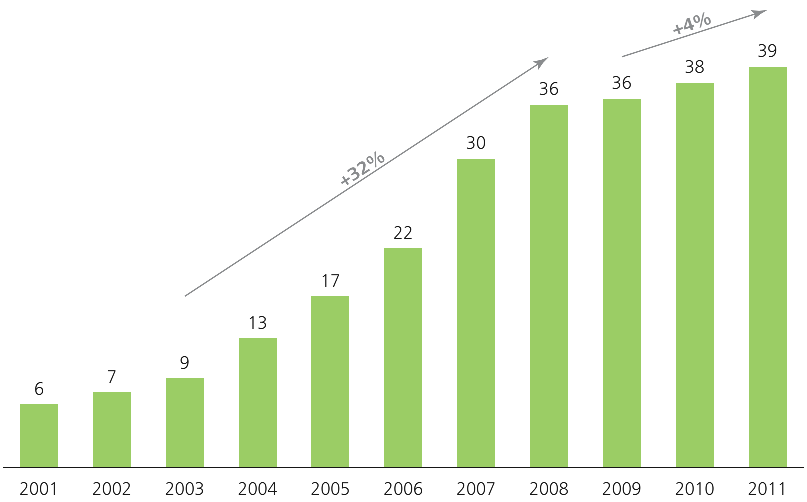
Testing times. These are lean years for Bulgaria-based banks. Saddled with deteriorating asset quality and plagued by high impairment charges, the sector additionally faces depressed demand for loans. On top of all that comes the country's proximity to the eurozone, in the midst of its biggest ever crisis. This is exerting a sizable drag upon Bulgaria, not only in its economic sphere but also in its banking sector as foreign owners are forced to curtail the scale of their operations in the country. This is particularly painful for a country where the scale of banking activity is sizable. After all, the Bulgarian banking assets stood at an impressive 102% of gross domestic product in 2011, which puts the country among the most advanced in the region. This is, however, a legacy of the rapid expansion that was seen in the years preceding the financial crisis, delivering a strong compound annual growth rate (CAGR) of 32% from 2003 to 2008. Subsequent headwinds have sharply reduced the pace of growth, yet it has continued in positive territory with a CAGR of 4% during the three years to the end of 2011.

Profitability

Pressure from deteriorating asset quality. Recent years have confirmed the stress caused when assets go sour, which have clearly undercut profitability. Over last four years, net profits declined at a CAGR of 25%. In 2011, net profits totaled EUR 0.3B, substantially below the peak of EUR 0.7B recorded in 2008. Consequently, profitability ratios have been under pressure during recent years, and are showing deepening deterioration – the ROA and ROE delivered by the Bulgarian banking system in 2011 amounted to just 0.76% and 5.6%, respectively.

The cost of risk is high among the factors that have impacted banks' profitability over recent years. It increased sharply (with a CAGR of 54% in 2008 to 2011). Revenue relative to assets showed a gradual deterioration (a CAGR of 3%) over the same period. New cost efficiencies provided no relief, resulting in a flat cost-to-income ratio. It is also notable that equity grew in strength as it grew in proportion to loans.

Figure BG2: Assets of Bulgarian banks (EUR bn)



Bulgarian banking assets stood at an impressive 102% of GDP in 2011.

Figure BG3: ROE drivers (2011)

1. Return on end period equity
2. Including depreciation

Banking sector results

Top line

Staying stable. Top line results have remained constant over the last couple of years, with total income standing firm at EUR 2.0B. The same could be stated regarding the structure of banking income throughout the period. Net interest income remains the chief source of revenue and its share of total income grew marginally to 74% in 2011. This is not a positive trend. In times when the demand for and supply of new loans are small, an increasing share of interest income shows that there are problems with fee-based business. Fees constitute the second most important source of income, with a 19-21% share of total income over the period, and represent the largest potential for growth. Fees and commissions generate 24-26% of total revenues in the most profitable markets in the region (Poland and the Czech Republic). As one might expect, financial operations remain the most volatile component, with their share fluctuating in the range of 4% – 9%. In our view, revenues are the most important factor in improving the cost-to-income ratio for the sector.

Figure BG4: Income structure (EUR bn)

Cost side

Limited recent growth. Operating expenses have shown limited growth over recent years, with a CAGR of just 1.8%. The way in which banks' operational costs are structured reveals that administrative expenses constitute the bulk of their total costs (52%); due to this sheer size, they stand out as one of the main cost drivers over recent years (and are continuing to grow with a CAGR of 2%). This small increase was realised despite a slight decrease in the number of branches in Bulgaria, which decreased by 50 outlets between 2009 and 2011. Physical presence is a strong feature of the banks operating in Bulgaria. This is evident not only in terms of the number of bank branches per 100K inhabitants (which exceeds 40, putting Bulgaria ahead of any other country in the region) but also in terms of its ATM statistics. The number of ATMs per 100K paints a similar picture with only Estonia matching Bulgaria's penetration – both countries boast the region's most developed networks. Such a footprint allows Bulgarian banks to be close to the customer, enabling good access to banking services.

Staff costs are the second most significant factor, responsible for 37% of operational expenses; they are also showing the lowest growth rate (CAGR of 0.8%), however, which underlines how the number of employees in the banking sector is decreasing. The 33,667 full-time employees (FTE) recorded in 2011 were down from close to 35,000 in 2008, which is offsetting the low level of wage-inflation. It appears that the sector is shedding lower value-added jobs as the cost per employee is actually increasing. Depreciation and amortisation remain the least important cost categories, representing just 12% of total expenses in 2011. This category is, however, simultaneously exhibiting the highest pace of growth (with CAGR standing at 4.7% over the four-year period ending in 2011).

Operational efficiency – limited deterioration. Overall, the banking sector's balance in terms of cost-efficiency remains slightly negative, with a recent slight decline in the cost-to-income ratio, to 50.6% in 2011. However, this decline is by a mere two percentage points, so there is a need to maintain a sense of perspective. Strengthening revenues could help the sector to improve its performance ratios.

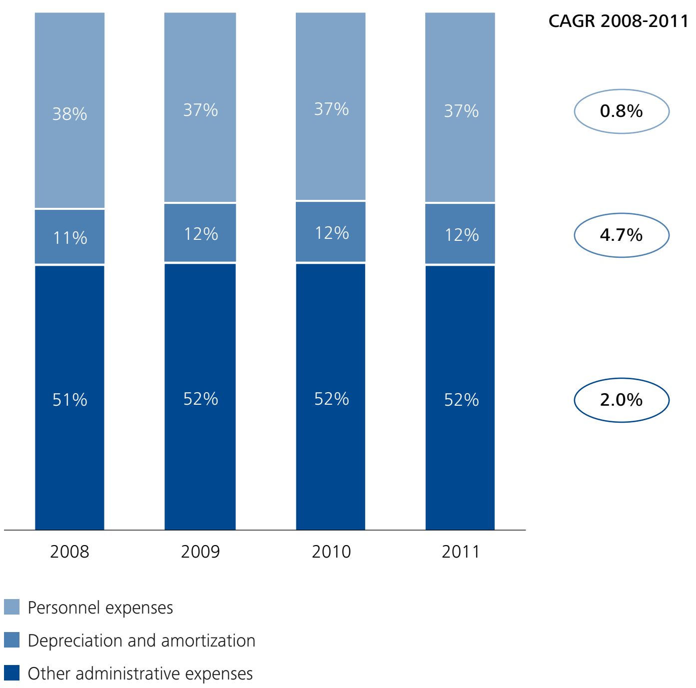
Performance per employee is behind the rest of the Central Europe. A comparison between the banking sector in Bulgaria with those of other CE countries reveals a lower business volume per employee. Weak productivity is highlighted by metrics such as assets or net revenues per employee, which respectively stand at EUR 1.116M and EUR 59K; this is to some extent offset by clearly lower per capita personnel costs, which average EUR 11K.

On an individual basis, the gains to be had through a larger scale of operations appear to be substantial. UniCredit and DSK, the country's two biggest players, both exhibit fundamentally better efficiency as measured by their cost-to-income ratios. The fact that bank performance deteriorates with declining size is also evident among the country's other universal banks.

Concentration

Market structure reflects the region. If one were to seek a typical market structure that prevails in the CE region, Bulgaria would come close to being a model market. With the top-10 banks holding 77% of the banking assets, the structure is very close to the average for the region. This also reflects another general feature of the countries that form the CE block – market consolidation has gone further than in the more developed countries. This, in our view, should not put the brakes on further mergers and acquisitions, especially among those smaller players seeking to exploit economies of scale. A bank-by-bank analysis shows two clear leaders - Unicredit and DSK – respectively holding 15.5% and 11.1% of the market. These players dominate the banking landscape in all major categories (loans, deposits, assets and equity). Although the next four banks in the top 10 list (UBB Raiffeisen FIB and Pastbank, First Investment, Postbank EFG) each command a market share that is under the 10% threshold, they are all firmly established with a market share of over 7%. The remainder of the market is fragmented, divided between a group of smaller players each with little market strength.

Figure BG5: Structure of operational costs



Operating expences since 2008 have been increasing annualy by only 1.8%.

Leading role of private capital. Private investors have a significant presence in the market, with the top 10 largest banks belonging to private capital groups. The majority of market players are either owned by a foreign strategic investor (Unicredit, OTP, National Bank of Greece and Raiffeisen for example), or are a part of a local capital group. It is typical of many CE countries that their banking sectors are dominated by banks with headquarters in Italy, Austria and France. In Bulgaria, three top 10 banks have Greek owners and one Hungarian. Both these countries are facing serious problems in their local markets, which might impact on Bulgarian operations or trigger a series of M&A transactions.

Asset quality

Loan quality crumbles. Asset quality deteriorated massively from 2009 to 2011, with the ratio of overdue loans over 90 days increasing to 19.7% from the 11.5% recorded just two years earlier. This triggered the growth of impairment charges, which with the cost of risk standing at 1.7% remain among the highest in the region. Nevertheless, the resulting increase in provisions was not as sharp as in the case of non-performing loans. Consequently the coverage ratio remains relatively low, particularly when compared to other CE countries. In Bulgaria, provisions for loans overdue for 90+ days constitute 44.4% of the stock, the second lowest in the region.

The ratio of overdue loans over 90 days increasing to 19.7% from the 11.5% recorded in 2008.

Impairment charges – the biggest drag on profitability. The deteriorating macro-economic backdrop, coupled with slower growth of the loanbook, have both contributed to a jump in provisions. You can see the sheer scale of this growth if you look back over a few years: loan-loss provisions totaled EUR -0.7B in 2011, more than three times the total for 2008. The cost of risk remains at significantly higher levels than during the pre-crisis period. The FX structure of a loan portfolio has an important impact on the level of provisions, where not only credit risk but FX risk as well is reflected .

FX loans are ubiquitous. The share of loans in the aggregated balance sheet of banks is stable, oscillating around the 80% mark. Bulgaria is in a group of countries that are characterised by the high significance of their FX lending (at 63.7% of total loans). This is predominantly a corporate phenomenon, in which as much as 75% of loans are granted in foreign currencies. The domestic currency prevails in the retail sector, although a still sizable 40% of lending is denominated in foreign currencies.

Figure BG6: Net profit and impairment costs (EUR bn)

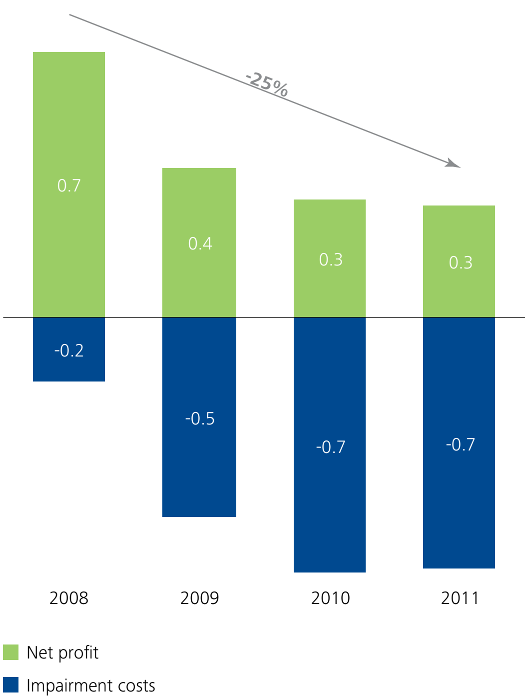
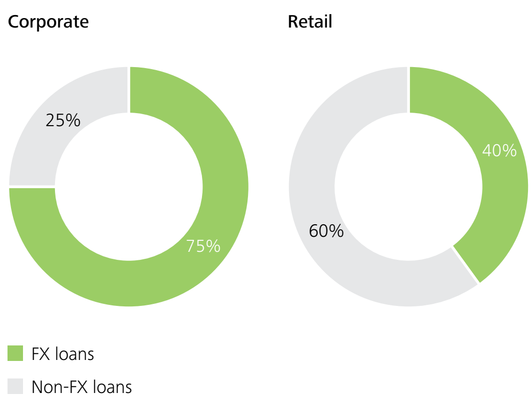


Figure BG7: Share of FX loans by segment (%)



Liquidity

A move towards deposits. Deposits are the primary source of liquidity for Bulgarian banks, representing 69% of liabilities in 2011. The significance of deposits has increased over recent years, with their effect on the expense of interbank lending increasing by 9 percentage points since 2008. This is not surprising, considering the fickleness of the wholesale markets during this period, and the drain on liquidity as parent companies needed to prop up their balance sheets. In that light, the stability of the deposits base has assumed major importance. This trend is also in line with the "flight-to-quality" move we have observed across the region. Naturally, such a strategy has its cost – the rapid withdrawal of interbank funding forced banks to raise the rates they offered depositors, which resulted in a significantly higher cost of deposits. This continues to be a key challenge as it is seriously impacting banks' profitability.

Slimming down. The rebalancing on the liquidity side is also clearly reflected in the development of banks' loan-to-deposit ratios. Prior to 2007, the sector was awash with liquidity and parent companies that were more than willing to provide credit. This resulted in loanbooks growing faster than deposits. The financial crisis then accelerated this trend, and the ratio peaked in 2008 at 133%. This situation was not sustainable in the long term, and recent years clearly show that banks' dependence on non-deposit funding is decreasing – the ratio has drifted down steadily, showing a CAGR of -8% from 2009 to 2011.

The effects of rebalancing become visible.
This rebalancing has made Bulgaria stand out from others when comparing the asset growth rates of its banking sector (positive single-digit annual growth in 2011) with its loan-to-deposit ratio (improving to 114% in 2011). This underlines the sector's limited but positive growth prospects for the near-future.

Figure BG8: Asset structure (EUR bn)

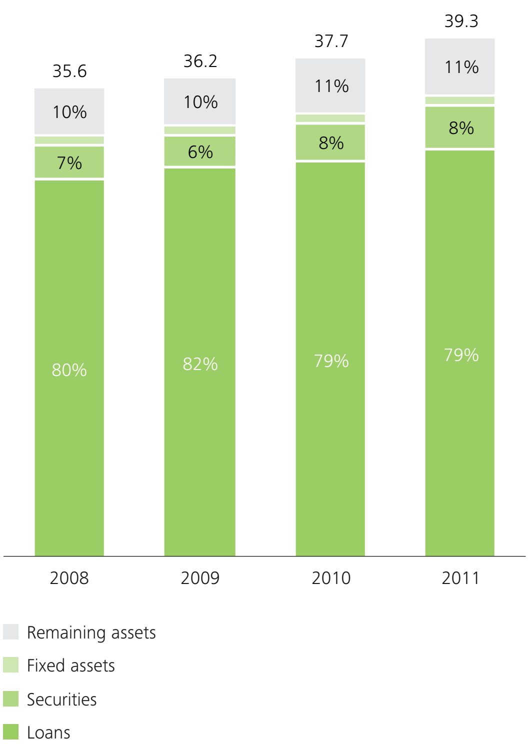


Figure BG9: Liabilities structure (EUR bn)

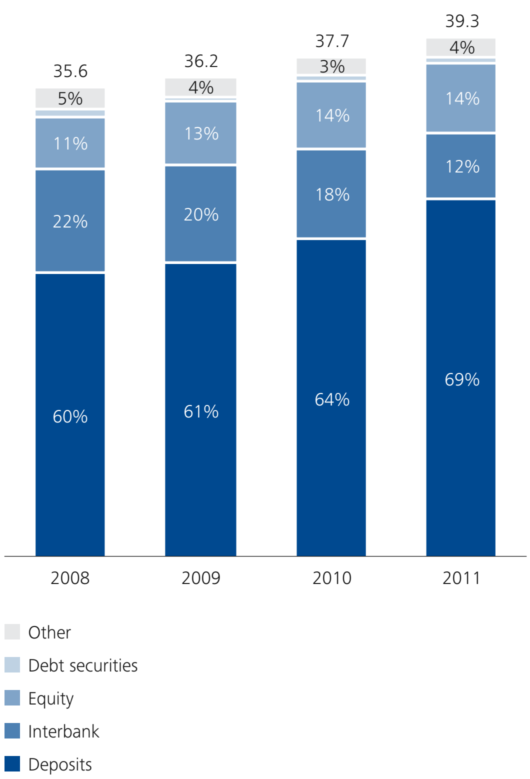


Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets / FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
Unicredit	6.1	4.0	3.7	115.8	15.5%	1.9%	11.3%	38.7%	107.1%	218	87	1 623	Unicredit
DSK	4.4	3.4	3.3	43.6	11.1%	1.0%	6.5%	34.8%	104.0%	386	74	977	OTP
UBB	3.4	2.5	2.2	6.1	8.7%	0.2%	1.1%	44.0%	112.3%	265	71	1 201	National Bank of Greece
Raiffeisen	3.3	2.4	2.3	26.1	8.4%	0.8%	5.4%	50.5%	103.4%	185	54	949	Raiffeisen
First Investment	3.1	2.1	2.8	18.7	7.9%	0.6%	7.7%	66.7%	75.5%	161	46	1 099	First Investment
Postbank	3.1	2.1	2.5	7.7	7.8%	0.3%	1.9%	54.0%	83.6%	200	53	1 022	EFG
Corporate commercial	2.1	1.3	1.7	31.2	5.3%	1.5%	15.9%	35.5%	77.7%	26	126	4 298	Bromac
Expressbank	1.7	1.3	1.0	24.2	4.3%	1.4%	11.1%	54.5%	124.4%	145	52	1 061	Societe Generale
Piraeus	1.6	1.4	0.7	27.1	4.2%	1.6%	8.6%	40.5%	210.4%	100	101	1 837	Piraeus
CCB	1.5	0.7	1.3	6.9	3.9%	0.4%	4.0%	77.0%	56.3%	242	28	696	CCB
Market	**39.3**	**30.9**	**27.1**	**299.7**	**100.0%**	**0.8%**	**5.6%**	**50.6%**	**113.8%**	**6 030**	**59**	**1 166**	

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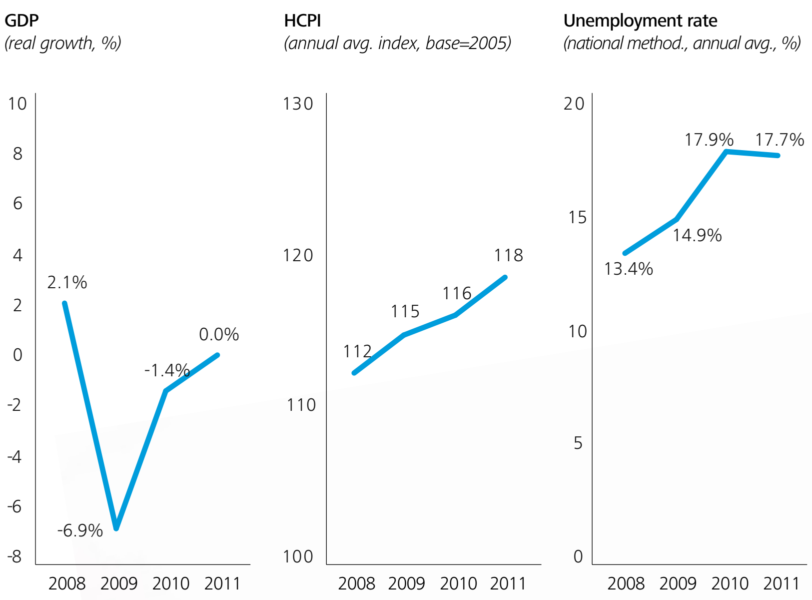
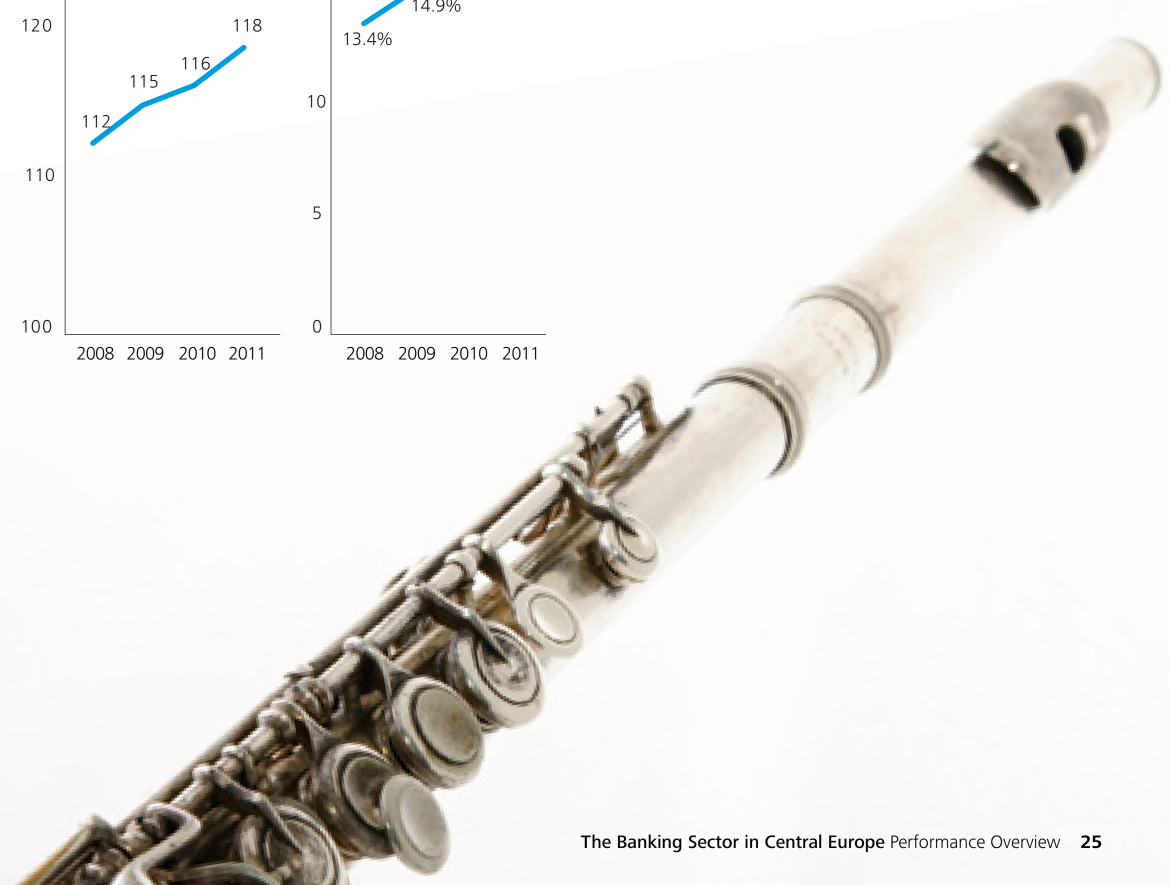
Market Outlook

The years following the global financial crisis have proved to be a challenging period for Croatia, as macroeconomic recovery – although eagerly awaited – never truly materialised. The country's economy contracted for two consecutive years, before stagnating in 2011. Two years of negative GDP growth (-6.9% in 2009 and -1.4% in 2010) caused a rate of unemployment that has consistently grown, from 13.4% in 2008 to 17.7% in 2011. To a great extent, the macro environment remains hostage to such structural impediments as significant external indebtedness and the considerable reliance of the banking sector on FX funding, which have caused the economy to stall. This challenging environment continues to cast a shadow over the Croatian banking sector.

The total number of households in Croatia stood at 1.493M in 2011, meaning it is small in terms of its banking services market potential. Those customers in the second and fourth quintiles respectively had average incomes of EUR 4.8K and EUR 8.5K making Croatia a relatively wealthy country within a CE context. The Croatian Gini coefficient stood at 31, placing it among those CE countries with the highest coefficient which means that there are significant inequalities in the income of the Croatian population; this requires banks to offer tailored propositions to the different groups of customers.

Figure HR1: Macroeconomic indicators

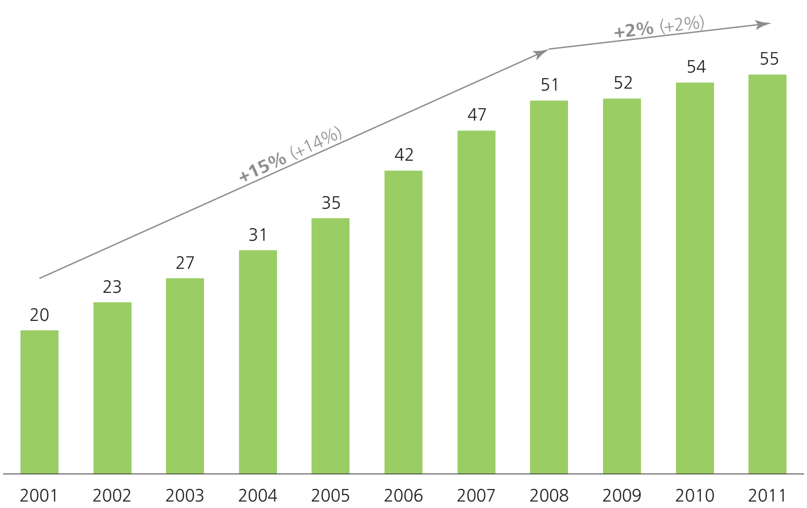




Introduction

Trying times. Recent years have brought a series of demanding tests for Croatian banks. First, in the post-crisis world, the stuttering economic engine dented the sector's growth rates. Just looking back a little illustrates this point: for several years before the crisis struck the worldwide financial sector and economy, the growth rate of the banking sector in Croatia continued at a robust pace (with a CAGR of 15% in the years 2001 – 2008). In the years following 2008, this upward evolution of the sector stalled – assets have only managed to edge up by a mere 2% per annum. This disparity in the pace of growth is striking, emphasising the impact of subdued demand and diminished access to external financing. Despite this slower growth, the size of the banking sector, measured by the relative value of its assets to gross domestic product, stood at a substantial 122% in 2011. This puts the country's banks among the most advanced in the region.
A second check is to look at the quality of banking assets. The loanbook has deteriorated considerably, driving impairment charges up. Although these developments have had an impact on banks' results, overall the sector has managed to pass the tests facing it in fairly decent shape.

Figure HR2: Assets of Croatian banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Profitability – steady recovery. Although recent years have shown the negative impact of deteriorating assets on banks' profitability, some subsequent turnaround is also visible. Profitability plummeted in 2009, but the following year showed that the sector was able to adjust to a much more demanding environment and push net profit marginally upwards. Upward movement was again confirmed in 2011, with both the ROA and ROE of the banking system increasing once again, by 0.96% and 7.0% respectively. Although, the sector's net profit showed some positive momentum to total EUR 0.5B in 2011, it still remained at a level below the peak of EUR 0.6B recorded in 2008.

This decrease in profitability clearly highlights the detrimental impact of the increasing cost of risk, which expanded at an annual rate of 44% between 2008 and 2011. The negative impact of this was only partially offset by a better cost-to-income ratio, which improved by 3% annually, and some minor improvement in revenue margins. The proportion of equity to loans remained flat through the period.

Banking sector results

Top line – on the growth path. Croatian banks' top line has grown continuously in recent years, with total income increasing to EUR 2.2B in 2011. The annual growth rate averaged 3% between 2008 and 2011. In 2009, net interest income (NII) came under pressure, but the stronger contribution of financial operations offset this decline. Non-core income stabilised in subsequent years, while NII and fees combined continued to climb. Overall, recent years have displayed a pattern of balanced and uninterrupted top line growth for the Croatian banking sector.

NII and fees at the forefront. A closer look at the structure of the income generated by Croatian banks reveals the key role of NII, which has been increasing over recent years, with a contribution to total income that fluctuated between 62% and 72% over the period from 2008 to 2011. Fees are second in importance, accounting for around 20% of total income. Financial operations show significant volatility, but usually contribute up to a 10% share of the total in all but the most extraordinary years. Overall, the top line remains driven by NII and fees on the back of growing business volumes. This highlights healthy patterns of expansion for the sector.

Figure HR3: ROE drivers (2011)

1. Return on end period equity
2. Including depreciation

Cost side remains flat. Operational costs have remained flat over recent years – a decent performance, especially given that the ability to grow revenues was unhindered by strict controls over costs but also in the light of a gradual growth in the number of branches.

Good coverage. The branch network is well-developed in Croatia. The number of bank branches per 100K inhabitants is over 30 (the regional average), placing it in the group of countries with the densest networks (alongside Latvia, Poland and Romania). The availability of ATMs is even higher. The country has an unparalleled network in the CE region (more than 100 ATMs per 100K citizens). Such a footprint allows Croatia's banks to maintain strong customer proximity, providing good access to banking services.

Operational efficiency – better with every year. The efficiency of the sector improved every consecutive year from 2008 to 2011. The cost-to-income ratio was driven down to 47.8% in 2011 from the 52.4% recorded in 2008. This is a good result, emphasising good cost control and the successful restoration of revenues, which have resulted in healthy performance gains.

Figure HR4: Income structure (EUR bn)

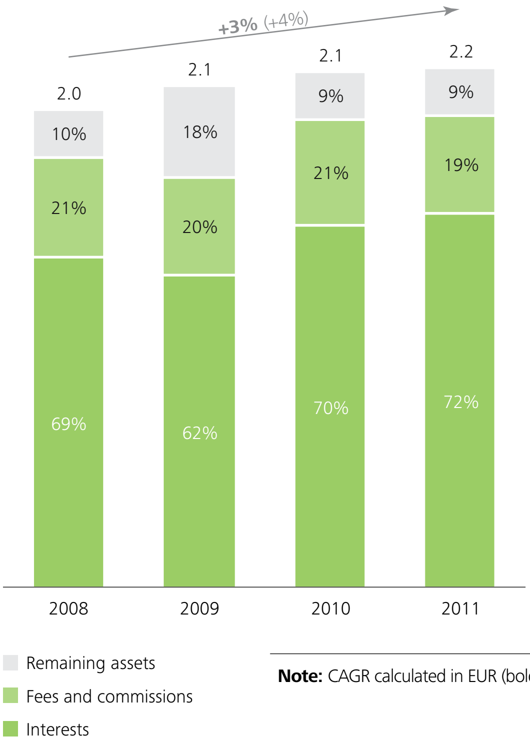
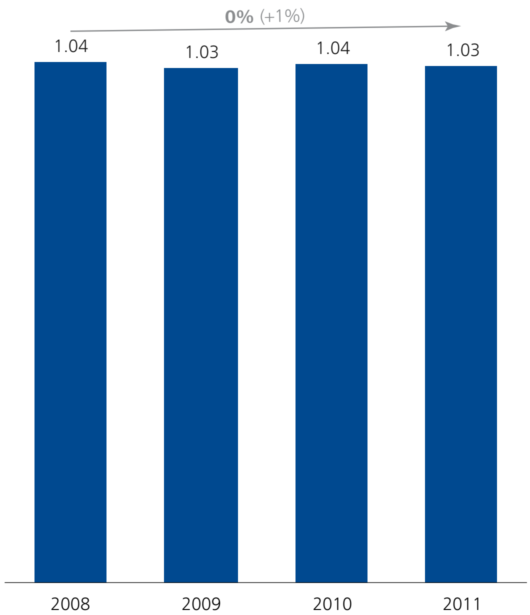


Figure HR5: Operational costs of banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

The cost-to-income ratio was driven down to 47.8% in 2011 from the 52.4% recorded in 2008.

Concentration

Strong dominance of the big players. In terms of market structure, the Croatian banking sector is exceptional thanks to the particularly strong grip exerted by the biggest financial institutions. The top 10 banks combined command as much as 92% of the sector's assets, the highest concentration among the CE countries we have analysed. This also reflects a general feature of the countries that form the CE block – sector consolidation is significantly more pronounced than in more developed countries. In the case of Croatia, such strong market dominance by the biggest players effectively negates organic growth opportunities for new players. This means that mergers and acquisitions comprise the primary tool for increasing market share and efficiency.

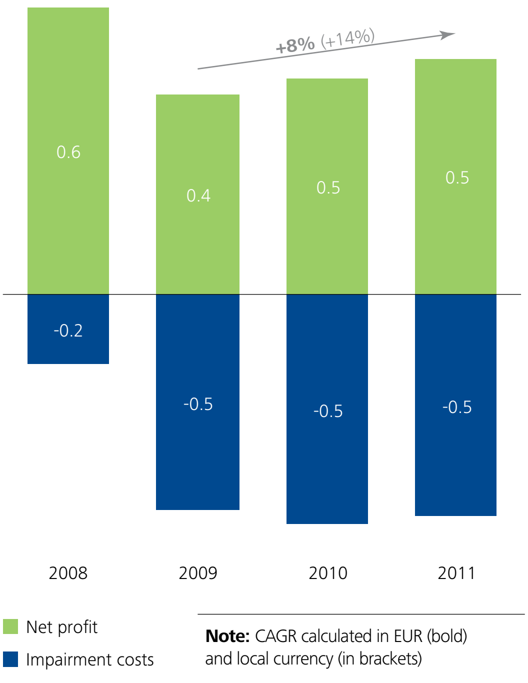
On a bank-by-bank basis, one cannot ignore Zagrebacka Bank – the local giant, which holds a 25.5% share of the market and dominates the banking landscape in every category. Although second-placed Privredna boasts a respectable 16.6% of the banking pie, making it a natural challenger, the gap to the leader is unbridgeable through organic growth alone. The combined market share of these two titans adds up to 42%, severely inhibiting the expansion of the competitors. While the two banks that are next in line - Erste and Hypo Alpe Adria - each have a market share of over 10%.

Little state control. All but one of the top 10 largest banks in Croatia are privately owned. The majority of players are owned by foreign strategic investors (including Unicredit, Intesa Sanpaolo and Erste). Just one of the top ten is partially state owned (Hrvatska Postanska), occupying seventh position.

The advantages of size are clearly visible in Croatia. Zagrebacka Banka and Privredna can each boast market-leading efficiency levels as measured by their cost-to-income ratios. The trend that sees performance deteriorate with falling size is clear-cut in the case of the country's other universal banks.

Impairment charges – the main damper of profitability. The combination of a worsening macroeconomic backdrop and decelerating loanbook growth has contributed to a jump in impairment charges. The cost of risk amounted to 1.2% in 2011, making Croatia around average for a CE country. The deterioration on this front is highly evident, especially when you take 2008 as a base year. Loan-loss provisions totaled EUR -0.5B in 2011, more than double the low level recorded in 2008. Higher impairment charges have been a persistent characteristic of recent years.

Figure HR6: Net profit and impairment costs (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

The cost of risk amounted to 1.2% in 2011, making Croatia around average for a CE country.

Funding

Reliance on deposits continues. Croatian banks rely predominantly on deposits for their funding, with a share that in 2011 was similar to that of loans in the structure of balance sheet. Dependence on deposits has increased slightly over recent years, but the build-up has been gradual. This is not surprising, as in the post-crisis world banks have tended to reconsider less stable sources of financing. Consequently, dependence on interbank or wholesale funding – which showed a disturbing predisposition to dry up suddenly in the event of stress – was reconsidered and not enlarged. This also explains the stable structure of banks' liabilities over recent years. Moreover, in the case of the Croatian banking sector, the impact of other financing sources such as interbank borrowing was in any event relatively limited. A positive feature is the larger than usual share of equity held across the sector's consolidated balance street, which highlights the above average capitalisation of Croatia's banks.

A perfect balance. A conservative approach to liquidity management is evident from a closer look at the loan-to-deposit ratio, which has tended to remain a notch below 100% over the last couple of years. Such a balanced proportion of loans and deposits shows a responsible approach to financing and emphasises the self-funding ability of Croatian banks. Although the ratio showed a sharp upward trend in the years before the financial crisis, when it expanded from 61.2% in 2001 to 97.2% in 2008, it has remained close to this level ever since. Admittedly, its recent level (95.5% in 2011) implies that the loanbook must grow at a pace close to that of deposits, unless banks are to increase their reliance on external and wholesale funding.
The latter seems rather unlikely, considering the tremors from the eurozone crisis being felt by banks operating in Western Europe (and particularly in Southern European countries), which often are investors in Croatian banks. Consequently, we believe that a lack of dependency on parent companies for funding should be maintained.

Figure HR7: Asset structure (EUR bn)

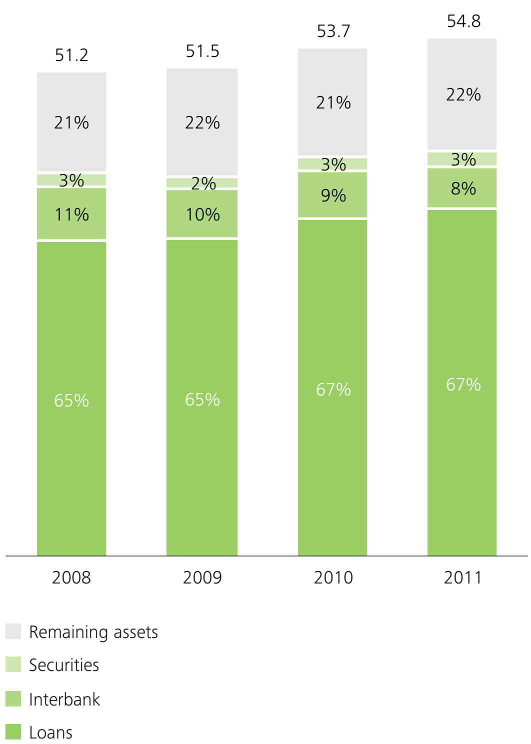
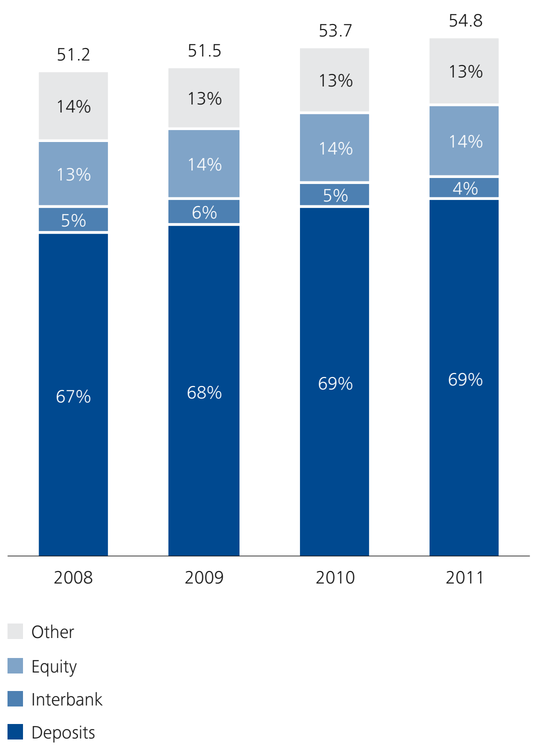


Figure HR8: Liabilities structure (EUR bn)



Room available for further growth. The diagram comparing recent asset growth rates with the loan-to-deposit ratio puts Croatia in the top-left sector, which indicates a good starting position for future growth. This is a positive indication, as growth rates exhibited in the recent past are in line with a healthy funding structure, so confirming the long-term sustainability of this prevailing trend. It is well worth pointing out that this is a special feature of the Croatian banking sector, as only a handful of markets can claim such favourable prospects.

Loanbook

Edging up. The share of loans on the aggregated balance sheet of banks has been showing steady growth, and in 2011 stood at 67%. This does not appear particularly excessive, and there is further room to increase the contribution of the loanbook to total assets, particularly as there has been no significant pressure on the funding side. The role of interbank lending, meanwhile, is diminishing.

Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets / FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
Zagrebacka Banka	14.0	9.4	10.1	176.9	25.5%	1.3%	8.5%	40.4%	92.7%	90	122	3 084	Unicredit
Privredna	9.1	5.9	5.9	152.7	16.6%	1.7%	10.1%	45.0%	100.0%	217	126	2 705	Intesa Sanpaolo
Erste	7.7	5.3	4.3	87.5	14.0%	1.1%	10.2%	37.5%	124.0%	130	151	3 832	Erste
Hypo Alpe Adria	5.5	4.0	2.2	5.7	10.0%	0.1%	0.8%	58.6%	177.8%	72	99	3 157	HAA
Raiffeisen	5.2	3.4	3.1	44.0	9.4%	0.9%	5.8%	53.1%	109.7%	81	109	2 482	Raiffeisen
Splitska Banka	3.6	2.5	1.9	18.6	6.6%	0.5%	4.0%	57.6%	129.2%	120	103	2 283	Societe Generale
Hrvatska Postanska	2.2	1.3	1.7	11.8	4.0%	0.5%	7.0%	70.1%	75.8%	49	89	2 065	State-owned
OTP	1.7	1.2	1.4	13.4	3.1%	0.8%	7.2%	50.6%	83.9%	99	93	1 692	OTP
Volksbank	1.0	0.7	0.5	0.1	1.8%	0.0%	0.1%	64.2%	142.9%	31	83	2 229	VB
Medimurska	0.4	0.2	0.3	4.4	0.7%	1.1%	8.8%	60.5%	57.9%	16	73	1 669	Intesa Sanpaolo
Market	54.8	36.1	37.8	525.5	100.0%	1.0%	7.0%	47.8%	95.5%	1 280	99	2 505	

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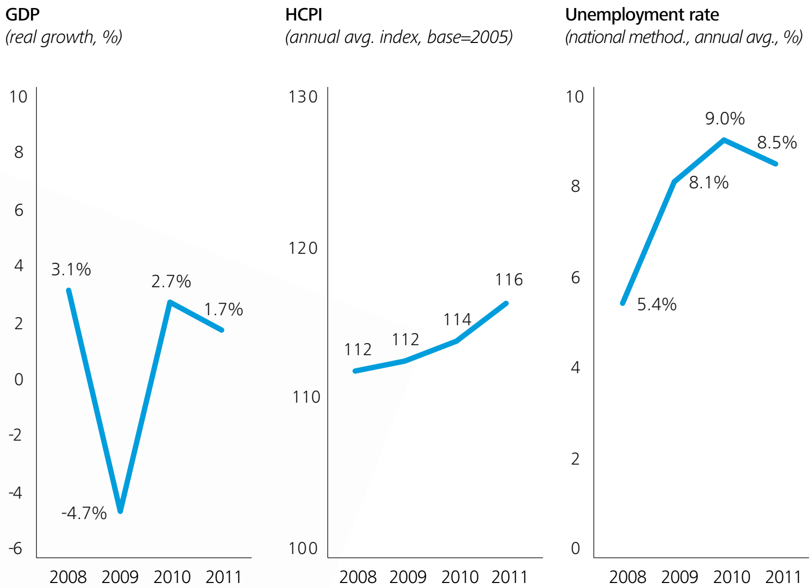
Market outlook

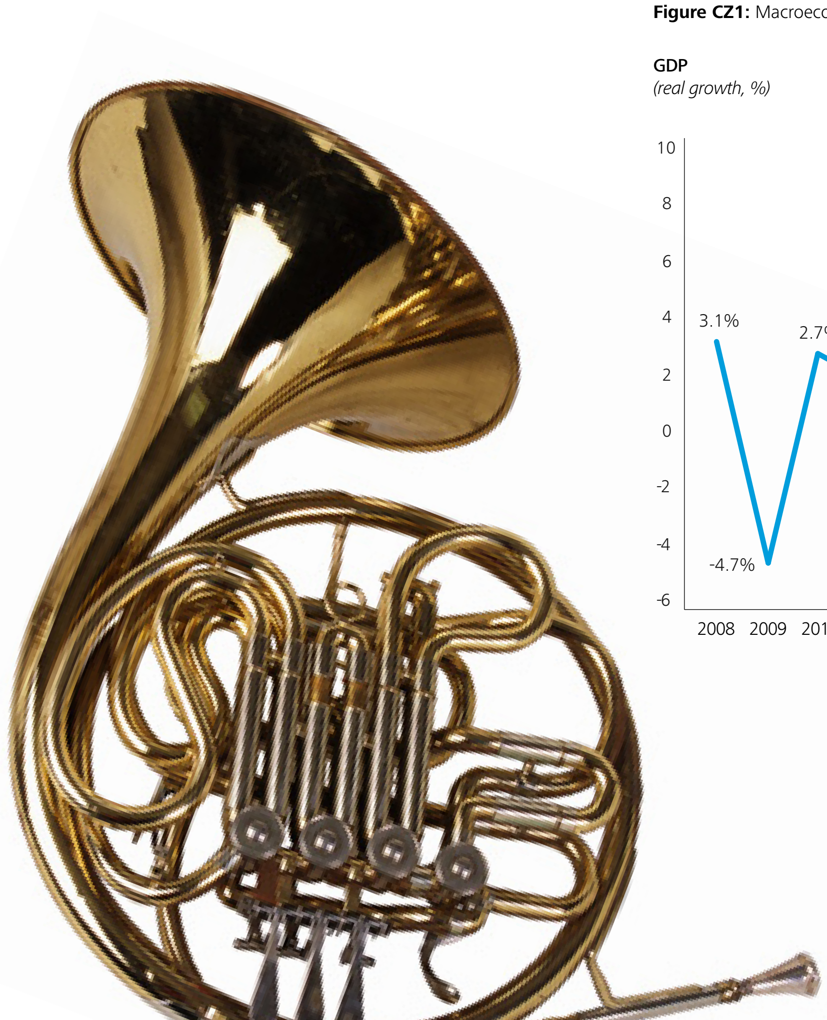
Although the impact of the financial crisis was painful and the Czech economy stumbled into recession in 2009 with GDP decreasing by 4.7%, the recovery that followed appeared to be rapid. The next two years brought decent growth rates of 2.7% in 2010 and 1.7% in 2011, thanks to rebounding exports and manufacturing levels. Private consumption and investment remained subdued through the period, however, due to a relatively low unemployment rate which slightly increased from 5.4% in 2008 to 8.5% in 2011. The Czech growth rate then decelerated in late 2011 on the back of lower public demand resulting from the austerity measures undertaken by the government.

The population of the Czech Republic contains around 8.7M potential banking customers aged 18 and above (from a total population of 10.5M). Based on Deloitte's research, 75% of this market, 6.5M people, actively uses banking services, making Czech market saturation one of the highest in the CE region.

There are 5.3M households in the Czech Republic. In 2011, those in the second and fourth quintiles had incomes of EUR 6.5K and EUR 9.9K respectively. This shows that the population of banking customers in the Czech Republic is small, but that they are the wealthiest in the CE region. The Czech Gini coefficient amounted to 24.9, placing it among the region's lowest. This means that there are small inequalities in income within the Czech population, so banks do not need to differentiate the banking propositions they offer different groups of customers.

Figure CZ1: Macroeconomic indicators

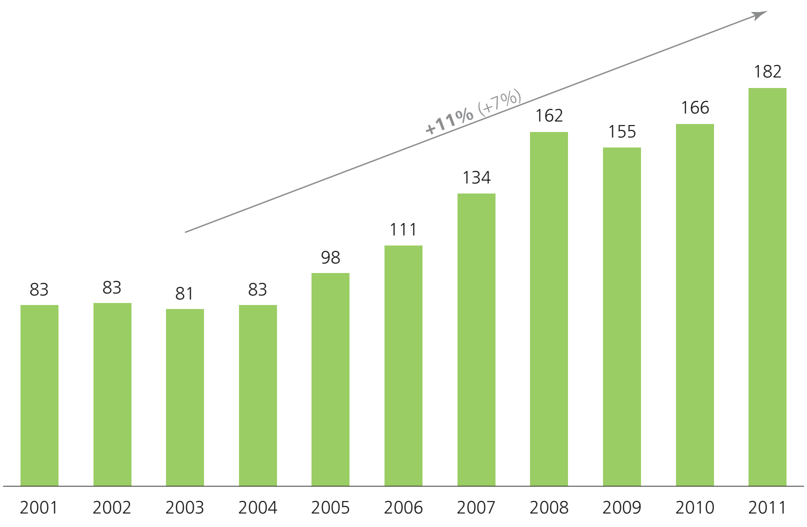




Introduction

An attractive market. The Czech Republic may easily be seen as "the sweetest spot" in the CE region's banking sector, as its market has a number of appealing elements. First, productivity and efficiency remain very good. Second, bank's asset quality continues to be firm. Third, strong foundations provide enviable opportunities for profitability. Fourth, the last eight years brought rapid expansion, with CAGR for the sector's assets achieving a robust 11%. Although the post-crisis world has witnessed slowing growth rates, this is also to a large extent one result of the Czech market being among the most mature and advanced in the region. At 117% of GDP, the country's penetration of banking assets illustrates that point well and confirms that the Czech Republic has one of CE's most developed banking systems.

Figure CZ2: Assets of Czech banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

The Czech banking sector has the highest ROE in the region.

Profitability – a robust performance. Outstanding efficiency coupled with a cautious approach to risk assessment has resulted in strong profitability in recent years. ROA and ROE ratios in 2011 amounted to 1.19% and 14.7% respectively – levels that many countries in the region would aspire to. A comparison with other CE countries shows the undisputed strength of Czech banks, which are clear leaders in terms of profitability. The strength of the Czech banking sector was confirmed during the recent financial crisis, when no Czech banks needed a bail-out. On the contrary, the profits of the Czech banking sector were used to strengthen the capital base of ailing Western parent companies.

An analysis of this profitability reveals an improving operating side. The sector showed a slightly improving revenue to assets ratio (with a CAGR of 2% in the 2008 – 2011 period) on both the retail and corporate sides. Cost-to-income ratios also improved during the period, showing improving operational leverage. Two counter-balancing factors were also at play. First, the cost of risk was on the rise throughout the period (CAGR of 15%). And second, the banking sector's keenness to retain equity saw its scale increase in relation to the loanbook.

Banking sector results

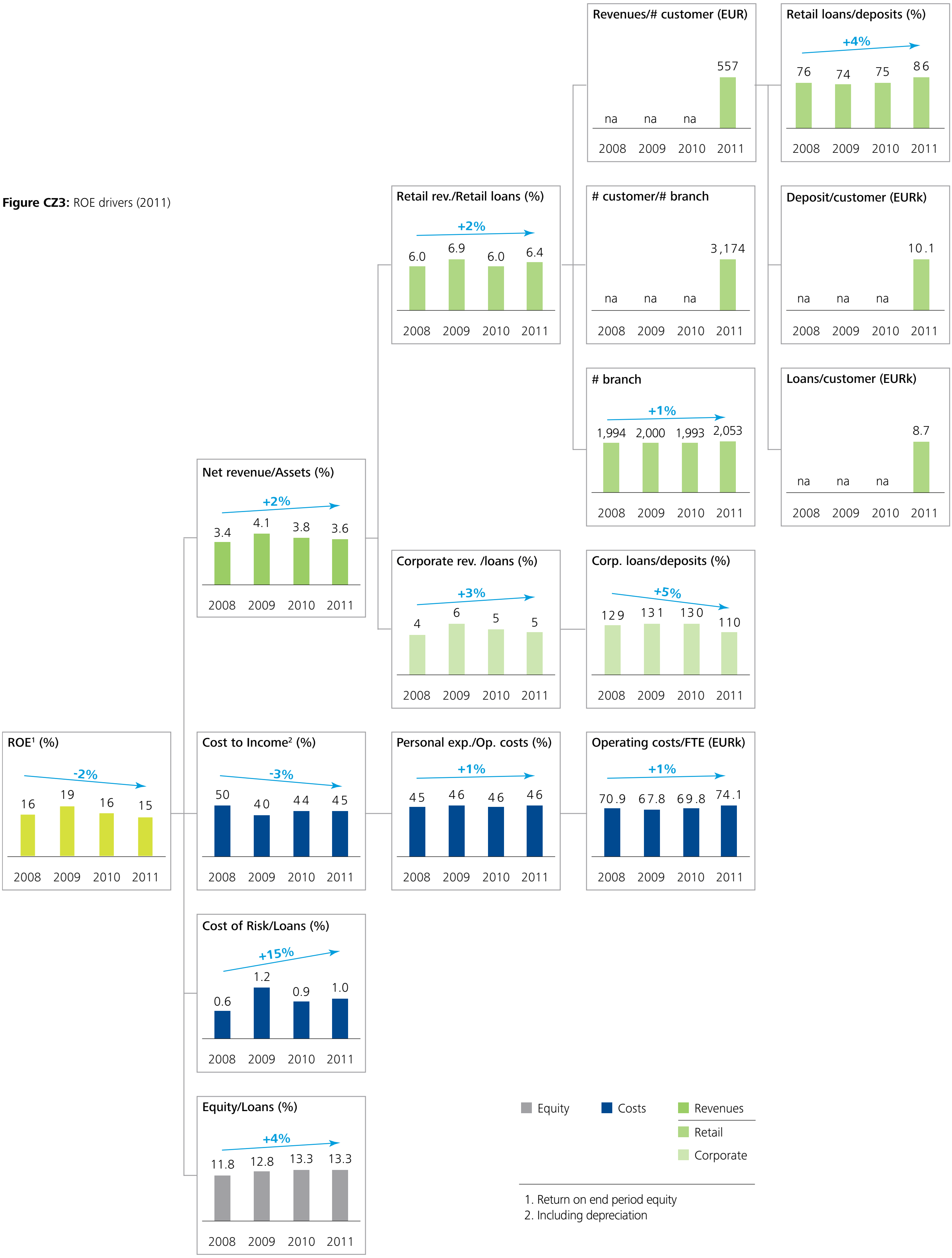
Top line

Growth trajectory confirmed. While recent years have been variable for the top line at Czech banks, the overall direction has proved to be positive. Total income amounted to EUR 5.5B in 2008. Both net interest income and fees remained stable, while the results generated by financial operations have soared, driving total income for the sector up to EUR 6.4B in 2009. The next two years showed stable top line expansion driven by further sound growth in core income; there was a small hiatus in 2010, however, when the contribution of financial operations showed a clear weakening year-on-year. Overall, however, recent years highlight the healthy income growth achieved by the Czech banking sector on the back of steady expansion in net interest income and fees. Consequently, the sector's total income in 2011 grew to EUR 6.6B.

Income structure

Financial income – the main source of volatility. The income structure of the Czech banking sector has been relatively stable in the recent past. Unsurprisingly, net interest income is the key source income, with

Figure CZ3: ROE drivers (2011)

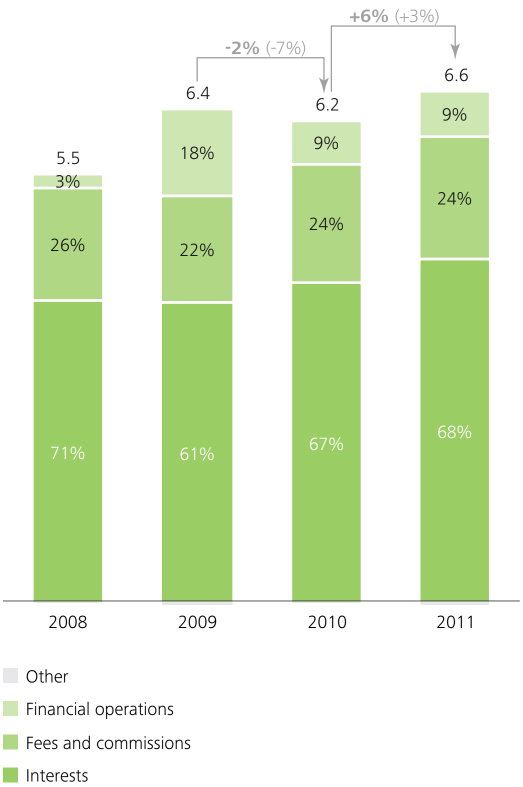


1. Return on end period equity
2. Including depreciation

a contribution to the total oscillating around 70%. Fluctuations in the share of net interest income within total income are mainly the result of variations in financial income. The level of net interest income, meanwhile, has maintained a stable upward trend over recent years. In 2008, the share of net interest income within total income stood at 71%; this abruptly declined to 61% the following year (a consequence of strong financial income), later recovering to within a range of 67-68%.

Fees rank second in importance with a 22-26% contribution to the top line. This evolution is also to a great extent a consequence of the volatility seen in banks' non-core income. Financial operations, by definition and also judging by recent history, remain the most unstable element of top line income. Recent years confirm this, with the share of financial income in total income varying significantly from year to year (between 3% and 18%).

Figure CZ4: Income structure (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Operational costs

On the rise. Although operating expenses fell sharply in 2009 to enable major improvements in operating efficiency, this trend was later reversed. In 2010, total costs expanded by 7% to EUR 2.74B, a level close to that of 2008. This increase negated the majority of the savings realised in the past. Further growth of 8% was seen in 2011, when the total reached EUR 2.97B. The cost side split shows that the relative contributions of personnel and administrative expenses were similar (at 46% and 44% respectively) in 2011. Recent years (2008 – 2011) have shown strong increases in HR costs (with a CAGR of 3.2%). In 2009 there were massive lay-offs in the banking sector, but the number of people working in the sector was soon increasing again, however, and in 2011 the number of banking employees was almost 1K higher than in 2008. This could be attributed both to headcount growth, which started again after an initial fall in 2009 and increasing average salaries. More modest but nonetheless significant growth (with a CAGR of 2.4%) was also seen in non-HR spending, a result of some minor growth in the number of branches.

In the middle. The density of the branch footprint in the Czech Republic is not exceptional. The country is mid-table the branch-density spectrum, alongside the likes of Lithuania and Slovakia, with between 20 and 30 branches per 100K citizens. An even weaker position is revealed by ATM statistics, which place the country in the bottom cluster of CE countries, alongside Lithuania and Serbia with less than 50 ATMs per 100K. Fortunately, this no longer seems to be a drawback as the internet is changing the way banking services are accessed.

The Czech market is showing a rise in technological sophistication. With 42% of customers accessing banking services via the internet, the country finds itself among the region's most tech-savvy alongside Poland. Moreover, 23% of Czech customers are using both physical and virtual channels. This shows that the online offering is indispensable for the majority of customers. Naturally, there is a group of ardent supporters of branch banking (34% of customers), but this group is the smallest among the countries we analysed.

Depreciation and amortisation, which account for nearly 10% of the cost base, comprise the only category where cost savings have been permanent (with a CAGR of -1.9%). Nevertheless, the reductions achieved in this area were far too small to offset the increases seen in other areas of cost.

In terms of business volumes per employee, the Czech market again stands out. In 2011, the average asset value per employee stood at EUR 4.55M; this is double the average for the CE region and tops the scale. It also translates into a strong value for net revenue per employee, which again is the best in the region. Good revenue generation comes at a price, however – the cost of the average employee is also well above that of other CE countries.

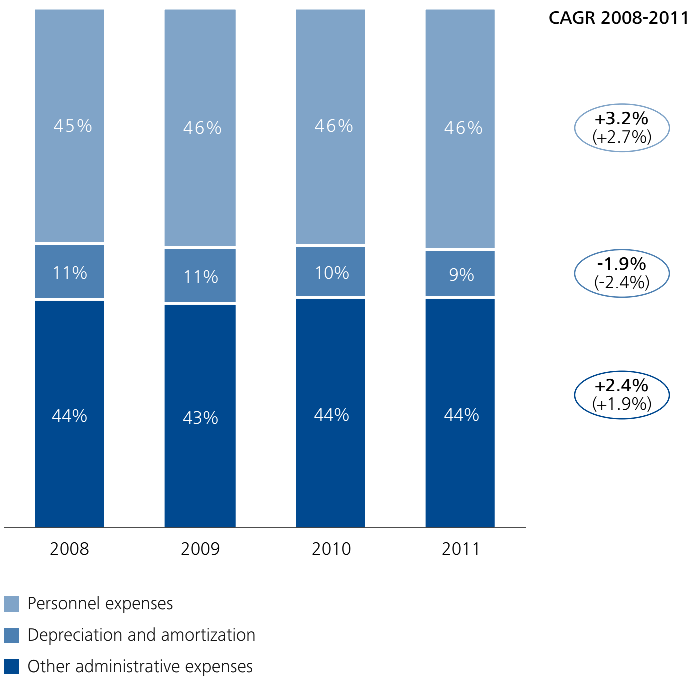
Operational efficiency – best in class. Operational efficiency is the strongest aspect of banks operating in the Czech market. Cost-to-income for the sector stood at excellent 45.0% in 2011, among the best recorded in the CE region. Interestingly, however, this is not the strongest showing in recent years, as it stood at its record low of 40.3% in 2009. Nevertheless, the record-breaking 2009 was a consequence of two favourable developments – a particularly strong income side, helped by robust financial income and vigorous cost-cutting. Circumstances proved to be less favourable in subsequent years, when the ratio deteriorated to remain within the range of 44%-45%.

A more detailed look reveals how scale delivers gains. Comparing Czech banks on an individual basis shows how the three largest players achieve a cost-to-income ratio and revenue pool that are clearly ahead of the country's other banks.

Market structure - concentration

A big boys' game. The combined market share of the 10 largest Czech banks totals 77.8%, making the market's concentration level slightly above average for the region. This is further emphasised when you consider the leading three, which between them command over 50% of the sector. The big trio - CSOB, Ceska Sporitelna and Komercni Banka – can each boast a market share well in excess of 10%. Those that follow must make do with much smaller pieces of the cake, all well below 10%. The most significant players in the banking sector are well-established and successfully maintain a stable market share. New entrants have only been able to reach a niche audience, and do not represent any real threat to the business of the market-leaders. On the other hand, new market entrants are disturbing the market by providing deposit interest rates which incumbent banks cannot match. And their aggressive marketing means they are not only "stealing" deposits from the larger players (even though the impact is not significant as yet) but they are also causing customers to question the high fees and low deposit interest of the established banks. The overall structure of the Czech banking sector is stable, however, although consolidation remains an option for growth, especially among smaller players.

Figure CZ5: Structure of operational costs



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

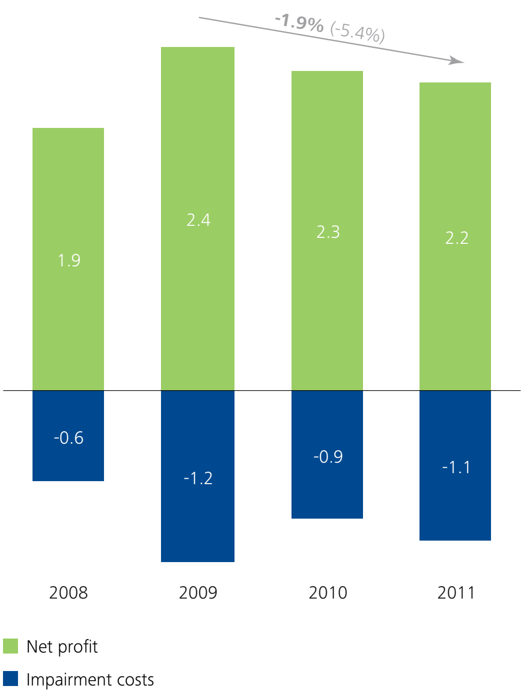
State presence

A private club. The hand of the state is not visible in the banking sector, as all the major players are privately owned by foreign financial groups (among these strategic investors are such renowned names as KBC, Erste and Société Générale). Private ownership, which enforces good oversight and quality management coupled with the large operational scale of such major players, supports excellent profitability.

Asset quality

Holding up well. Asset quality has remained relatively firm in recent years, with only limited deterioration. The ratio of loans overdue by more than 90 days to the total loanbook value has stabilised, totaling 7.1% in 2011. Earlier growth, driven by the growing number of personal bankruptcies and company insolvencies, continued until mid-2011. Stabilisation is now enabling relatively low impairment charges, which in 2011 stood at EUR 1.1B (translating into a cost of risk of 0.9%). Asset quality also remains resilient when considered in a regional context, with the ratio of non-productive loans among the three lowest reported. At the same time, however, coverage ratio remains disappointingly at the lowest level among the CE countries we analysed.

Figure CZ6: Net profit and impairment costs (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Impairment charges.

Impairment charges under control. While recent years have confirmed that there is pressure on asset quality, any deterioration has turned out to be relatively weak and easily manageable. And although impairment charges have remained consistently higher than the EUR -0.6B posted in 2008, the increase is limited. Prudent risk management, coupled with macroeconomic recovery, has allowed Czech banks to keep the cost of risk low. This is emphasised by a comparison with the other markets in the region – the ratio of impairment charges to average book value is among the lowest in the CE region.
The only discernible weakness lies in the country's poor coverage ratio, which stood at 37.9% in 2011 – the lowest level of all CE countries.

Funding

Deposits prevail. The funding of Czech banks is based on deposits. Their contribution amounted to over 63% in 2011, and has been quite stable over recent years with only minor fluctuations. Interbank and wholesale funding come second and third in terms of significance, respectively contributing 19% and 8% to the sector's total liabilities. Similarly, both categories have remained fairly constant over the years.

Loan-to-deposit ratio

An excellent balance. The Czech sector's solid funding structure is well illustrated by its first-rate proportion of loans to deposits. The loanbook is fully funded via existing deposits, underscoring the sustainability of the sector's lending activities and its ability to operate on a stand-alone basis. This lack of external financing needs may also prove to be increasingly important in the context of the rising risk of a liquidity crunch among Western banks due to problems in the eurozone. Western financial groups are often also the owners of CE financial institutions, making them the financial supporters of their banking subsidiaries operating in the region. Fortunately, the loan-to-deposit ratio in the Czech Republic ratio stood at 96.4% in 2011, having oscillated around 92% over the last 10 years. The way in which this ratio has evolved shows how lending activity is closely matched to the expansion of

Figure CZ7: Asset structure (EUR bn)

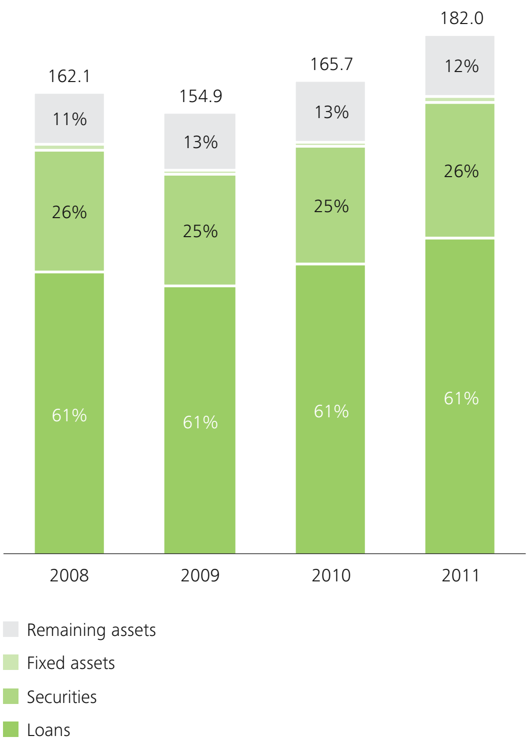
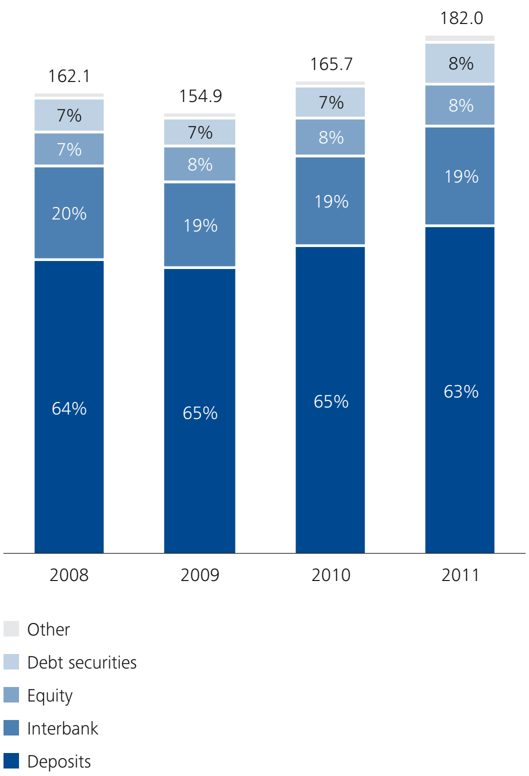


Figure CZ8: Liabilities structure (EUR bn)



the deposit base, which reaffirms the stability and robustness of Czech banks' credit activities.

Untapped growth potential. The chart that tracks asset growth rates against the loan-to-deposit ratio places the Czech Republic in the top-left quadrant – an attractive position for future growth opportunities. This spot conveys two essential messages: above average growth rates in the recent past; and a healthy funding structure. Both signs are positive and leave the door wide open for further lending expansion for the Czech banking market. This is a distinguishing feature, as only a few national markets may claim such favourable prospects.

Loanbook

Stable and with prospects. The share of the loanbook in the consolidated balance sheet of Czech banks amounts to 61% and has remained very stable over recent years. Admittedly, this is not particularly high, leaving ample scope for an expansion of lending activities. The share of FX loans in the sector's loanbook is also negligible, which means increased stability.

The total loan volume of the Czech banking industry has followed a similar path to deposits, with only minor growth in 2009 (EUR 94B) following a significant expansion in lending the previous year. Although the banks' own balance sheets then suffered due to the increasing share of non-performing loans (NPL), banks managed to maintain their lending activities. In 2010, in fact, total net loans increased by 8% (EUR 102B) and by a further 9% in 2011 (EUR 111B).

The loan-to-deposit ratio in the Czech Republic ratio stood at 96.4% in 2011.

Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets / FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
CSOB	33.6	10.6	20.2	432.7	18.4%	1.3%	23.1%	45.6%	52.6%	252	142	4 321	KBC
Ceska Sporitelna	31.9	18.0	21.3	611.1	17.5%	1.9%	19.9%	42.4%	84.4%	654	155	2 991	Erste
Komercni Banka	26.9	15.2	19.1	323.3	14.8%	1.2%	11.0%	42.7%	79.3%	397	146	3 438	Societe Generale
Unicredit	11.7	7.4	7.3	46.6	6.5%	0.4%	3.5%	63.4%	101.7%	93	145	5 931	Unicredit
Raiffeisen	8.3	6.4	5.9	90.3	4.5%	1.1%	13.7%	53.7%	110.2%	127	143	2 827	Raiffeisen
HB	7.4	6.6	0.0	107.0	4.0%	1.5%	10.8%	15.5%	-	27	437	16 806	CSOB
CMSS	6.9	6.3	6.4	84.3	3.8%	1.2%	20.7%	31.8%	98.3%	-	275	11 336	CSOB
GE Money	5.7	3.9	4.4	158.6	3.1%	2.8%	13.1%	43.1%	89.6%	253	147	1 644	GE Capital
ING	5.0	0.8	3.6	36.2	2.7%	0.7%	94.2%	47.6%	22.7%	10	299	17 042	ING
SSCS	4.3	1.7	4.0	41.8	2.3%	1.0%	20.1%	22.9%	42.5%	30	384	21 381	Ceska Sporitelna
Market	**182.0**	**111.2**	**115.4**	**2172.7**	**100.0%**	**1.2%**	**14.7%**	**45.0%**	**96.4%**	**2 053**	**165**	**4 549**	

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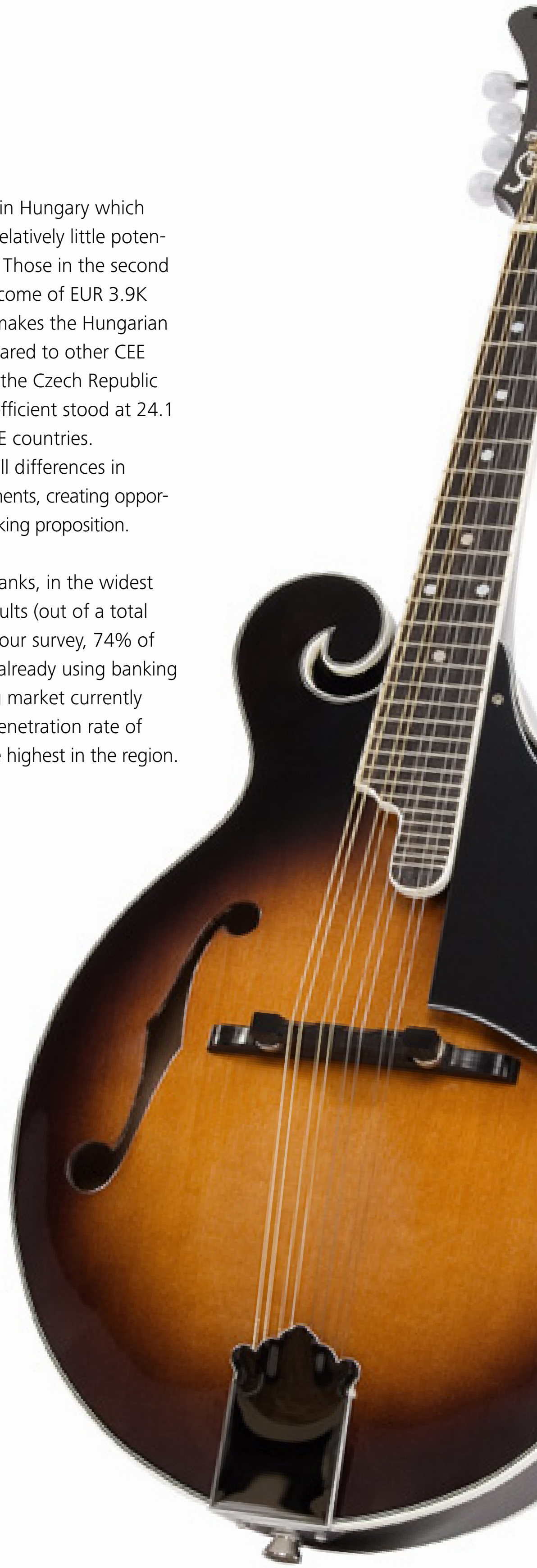


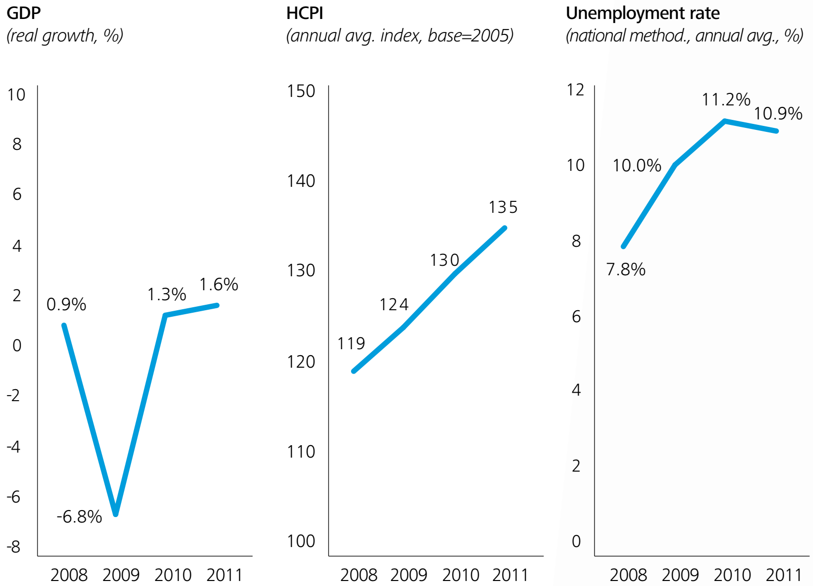
Economic outlook.

Caught off-guard. As the global financial crisis approached, Hungary had already experienced a serious budget deficit and was witnessing a slowdown in the economy. When the crisis hit the country, and all European governments tried to stimulate their economies, the Hungarian government was forced to ask for an IMF loan of EUR 20 bn and to implement austerity measures to avoid bankruptcy. Although economic growth resumed after the severe contraction of 2009, this remained subdued. Hungarian GDP grew by 1.3% in 2010 and by 1.6% in 2011, helping to drive the unemployment rate down slightly, from 11.2% in 2010 to 10.9% in 2011. The need to balance the budget forced the government to implement some non-standard and often controversial policies, including the introduction of a new banking tax. Additionally, the massive depreciation of the Hungarian forint added to the gloom affecting households and their ability to service their mortgages, the majority of which were denominated in foreign currencies.

There are 4.35 million households in Hungary which means that Hungary offers banks relatively little potential in terms of customer numbers. Those in the second and fourth quintiles had a 2011 income of EUR 3.9K and EUR 6.0K respectively, which makes the Hungarian population relatively well off compared to other CEE countries but less so than those in the Czech Republic and Poland. The country's Gini coefficient stood at 24.1 in 2010, the lowest level among CE countries. This means there are relatively small differences in the income between customer segments, creating opportunities for a quite standardised banking proposition.

The target market for Hungarian banks, in the widest possible sense, comprises 8.0M adults (out of a total population of 10M). According to our survey, 74% of those eligible to be customers are already using banking services, meaning that the banking market currently consists of 5.9M customers. The penetration rate of the Hungarian market is among the highest in the region.

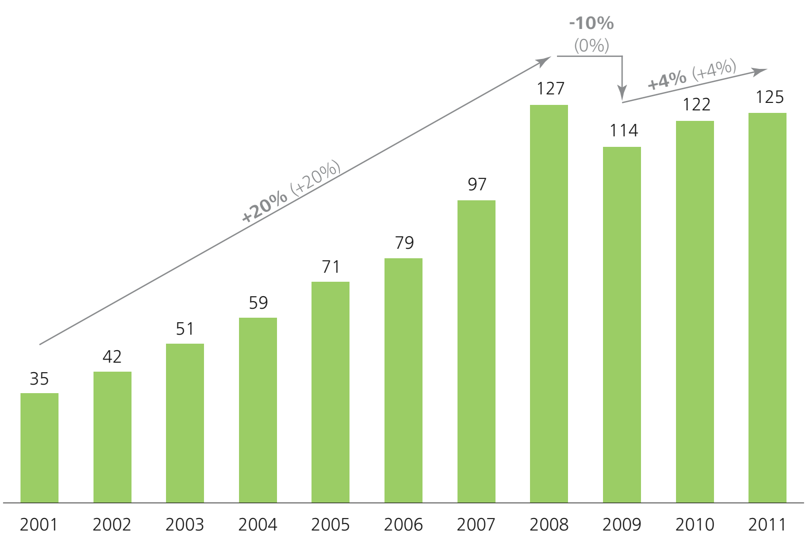
Figure HU1: Macroeconomic indicators



Introduction

A vicious circle. It seems that everything that could go wrong has gone wrong for Hungarian banks. The sector has needed to grapple with a harsh period of economic gloom, resulting in the diminished capacity of borrowers to repay and therefore spiraling bad loans. Such an environment alone could be described as challenging. However, this is not the sole area of challenge in the sector. A second battleground is on the funding side. A strong reliance on the interbank and wholesale markets has made the sector particularly vulnerable to disruption. Lastly, punitive measures undertaken by the state, banking levy legislation in particular, have added another layer of concern. The factors involved are evident in the sector's financial results, which in 2011 remained in the red. Given such a hostile environment, the banks are still in survival mode and growth prospects for the sector are remote. Still, the size of the Hungarian banking sector is significant when compared to peer-group countries, with the assets of the Hungarian banking sector amounting to a sizable 124% of GDP. This, however, is a legacy of much happier years before the crisis, which now seem like a dim and distant past.

Figure HU2: Assets of Hungarian banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

ROE of Hungarian banking sector amounted to -2.5%.

Profitability

In the red - impairment charges the chief burden. Recent years have clearly emphasised the strain felt as a result of the rapidly deteriorating quality of assets. This remains principally in the shape of a burden on profitability. The previous four years paint a bleak picture, with net profit declining with each consecutive year and swinging back into loss in 2011, when the net loss amounted to just EUR -0.3B. Consequently, profitability ratios are in the red – the ROA and ROE of the banking sector in 2011 amounted to -0.21% and -2.5% respectively.

A detailed analysis of the profitability situation identifies the spiraling cost of risk as the major cause of plummeting profitability. The cost of risk grew by a worryingly high annual rate of 50% in the 2008-2011 period. Neither the revenue side, which expanded at an annual rate of 1.4%, nor the cost-to-income ratio, which remained stable, were able to offset its crippling effect. As a result, ROE plunged into negative territory in 2011.

Banking sector results

Top line – other losses impact growth. The top line of Hungarian banks has been volatile during recent years. After strong growth in 2009, other losses appeared in 2010 which resulted in total income decreasing to EUR 4.5B. The situation improved in 2011, with total income climbing to EUR 4.8B, but even this was still below the excellent results of 2009. The most volatile items are other income (which is also the chief source of income compression), and to a lesser degree financial operations. Net interest income (NII) and fee income are both pillars of stability. Net interest income has managed to grow in most recent years, whereas some pressure has been felt on fees. This is not a positive trend; at a time when the demand for and supply of new loans are small, an increasing share of interest income shows that there are problems with banks' fee-based business. Overall, although we have seen some pressure on the top line, the trend towards growth prevails.

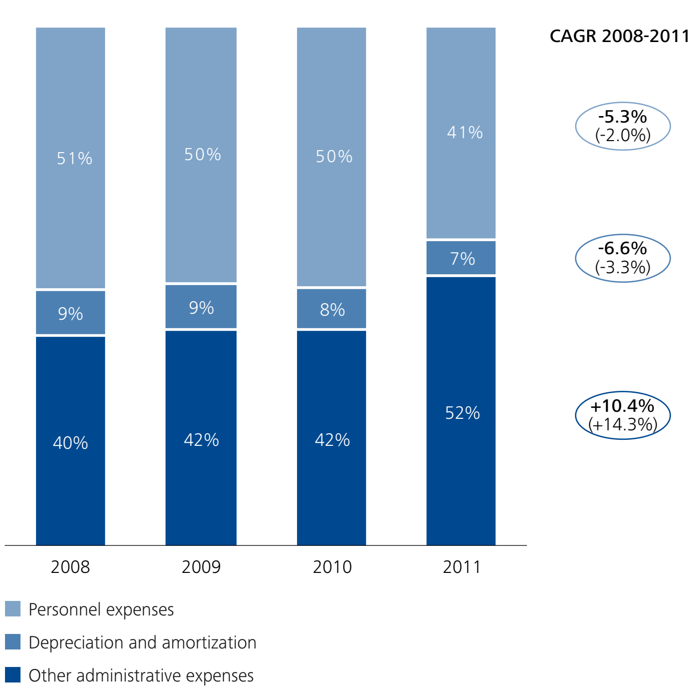
NII and fees in the forefront. Net interest income remains the chief source of income and its significance has grown in recent years. It grew from 60% of total income in 2009 to 77% in 2011 (with a peak of 84% in 2010). Fees contribute steadily to the top line, and remain the second most important source of income, with a 20% share of the total. This area offers banks

Figure HU3: ROE drivers (2011)

1. Return on end period equity
2. Including depreciation

Figure HU4: Income structure (EUR bn)

Figure HU5: Structure of operational costs



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

4000 people lost their jobs in Hungarian banking sector since 2008.

the largest potential for growth. In the most profitable markets in the region (Poland and the Czech Republic) fees and commissions generate 22-26% of total revenues. Financial operations and other income sources tend to fluctuate strongly.

Cost side – other cost increases absorb savings realised by personnel costs. After the strong decline of operational costs that was seen in 2009, growth has resumed with operational costs increasing by a sizable annual 12% since then. In 2011, total costs amounted to EUR 3B. Recent years have shown a striking discrepancy between the rapid growth of other administrative expenses (with a CAGR of 10.4%) and a major decrease in personnel costs (CAGR of 5.3%). This has resulted in the rapidly increasing share of other administrative expenses, up from 40% in 2008 to 52% in 2011. Simultaneously, personnel costs have shown the opposite trend – their contribution to the total decreasing by 10 percentage points to 41% in 2011. A major reason for this has been the consistently decreasing number of employees in the Hungarian banking sector, which has seen a decline of close to 4K people (nearly 10%) since 2008.

The contribution of depreciation and amortisation to total costs is less than 10%. Savings made in the cost of personnel have predominantly been achieved by reductions in headcount (CAGR of 3.5%) and branch closures. Although wages tended to fluctuate in the intervening period, the 2011 level was somewhat below that of 2009. Similarly, depreciation and amortisation decreased by 6.6% on an annual basis in 2008-2011.

Branch density

Light physical presence. Cost-cutting exercises were also visible in the area of branches. Between 2008 and 2011, the number of branches in Hungary decreased by

86, close to 5% of the country's entire retail banking network. Partly as a result, the density of the Hungarian branch network remains below the levels seen in other CE countries. Hungary and Serbia are the only countries where there are fewer than 20 branches per 100K inhabitants. ATM statistics for Hungary are somewhat more favourable, with between 50 and 70 devices per 100K inhabitants. This is in the middle of the pack, alongside Poland, Romania and Slovakia. Overall, the branch and ATM networks seem to be less numerous than in the remaining CE countries.

It is clear that customers of Hungarian banks appreciate branches – over 75% see the branch as a primary channel. Although Internet acceptance is not the lowest in the region, it is still a relatively uncommon way to do banking – just 7% use only online banking. The remaining 16% see Internet and branch-based banking as complementary offerings. Interestingly, this rather flies in the face of data on bank branch development, which is not particularly intense in Hungary when compared to other countries in the region.

Operational efficiency – back to square one. Overall, cost efficiency has turned full circle as those gains made in 2009 have been rapidly lost. The current cost-to-income level stands at 62.2%, which is very close to the 2008 level. The coincidence of a strong income side with much leaner operating costs in 2009 allowed the ratio to improve to an excellent 47.0%. It seems that this was a one-off, however, as the ratio deteriorated over the next two years.

Comparing the productivity of the banks operating in Hungary with that of other CE countries highlights above average per capita productivity. Higher than average productivity is indicated by such metrics as assets or net revenues per employee, which both are above average for the region at EUR 3.16M and EUR 122K respectively. Strong revenue generation comes at a price however, as the average cost per employee is also well ahead of the group.

Concentration

The top 10 share is typical of CE, but OTP is clearly the leader. The high concentration of the banking sector among a few large players should result in the benefits of scale and be reflected in the sector's cost-to-income ratio. With the largest 10 banking groups enjoying 75.1% of the sector's total assets, the structure of the Hungarian banking market is around average for the whole CE region. This does not dampen prospects for further M&A activity in the future, as significant differences exist in terms of size between individual players. OTP remains the undisputed leader, since on a consolidated basis its market share is close to 25% (on an individual basis, OTP and OTP Mortgage hold 19.5% and 4.8% respectively). This matches the combined market share of the next three players (Erste, K&H and MKB). Only OTP has a market share above 10%, and it clearly dwarfs all other players in each major category (loans, deposits, assets and equity). Five players (numbers two to six) each have a share above the 5% level.

Private ownership (and a trace of state presence). Although there is some state presence among the 10 top Hungarian banks, its significance is limited. The Treasury is still a shareholder in MFB – the nineth largest bank with 4.0% market share. The other largest banking institutions are privately owned, often part of an international capital group (such as Erste, KBC and Intesa Sanpaolo). This ensures sufficient competition, given the market structure and presence of well-established western players.

Asset quality

Loanbook stress-tested. The asset quality of Hungary's banks showed severe deterioration between 2009 and 2011. The ratio of loans overdue by 90 days+ increased to 14.9% in 2011, showing a sharp rise on the 7.7% recorded just two years earlier. This is the second worst result in the group of CE countries we analysed. It forced banks to create a higher level of provisions, reflecting borrowers' curtailed ability to repay their loans. High impairment charges set in recent years have helped to improve the coverage ratio, which stood at 54.3% in 2011 – the average level for the CE group.

The ratio of loans overdue by 90 days+ increased to 14.9% in 2011.

Impairment charges – escalating. A deteriorating macroeconomic backdrop and slower loanbook growth have resulted in a swift escalation of provisions. The cost of risk in 2011 remained at a poor 2.4% following deterioration from the previous year. This is also confirmed in the relationship between impairment charges and assets – at 1.8%, this remains one of the highest in the CE region. The contrast is striking when you compare the EUR -2.2B of provision booked in 2011 with the mere EUR -0.6B reported in 2008. This is also the single most important category from a profitability point of view.

Figure HU6: Net profit and impairment costs (EUR bn)

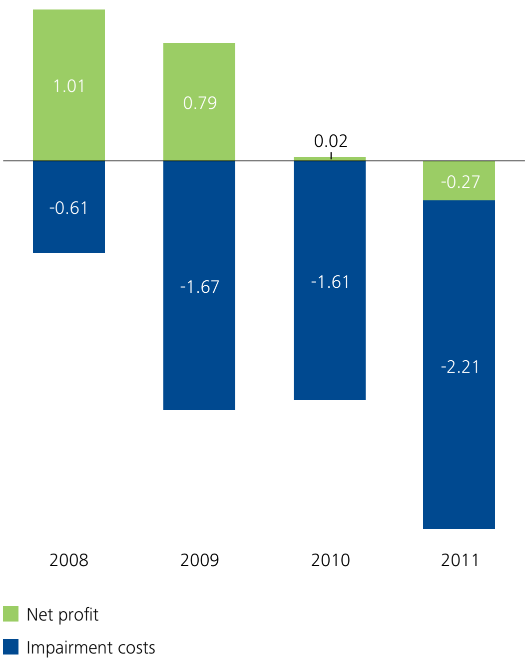
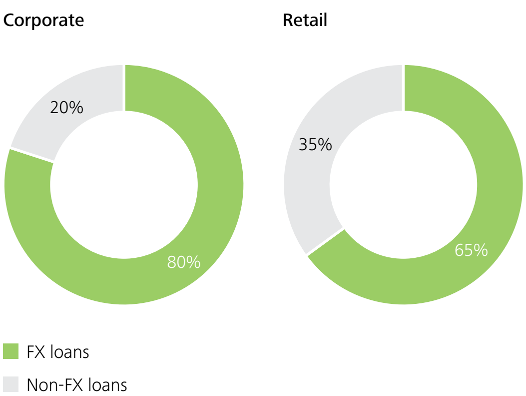


Figure HU7: Share of FX loans by segment (%)



Funding

Wholesale funding plugs the gap. With significant demand for FX lending, banks operating in Hungary are being forced to seek funding sources other than deposits. This is emphasised by the sector having one of the lowest share of deposits in its liabilities structure. Although the contribution of deposit funding increased to 46% in 2011, it is still at an unusually low level compared to other CE countries. Consequently, attracting additional deposits from the non-financial sector is a major concern, particularly given the international backdrop. In the CE region, there is a general push for improved liquidity and stability. Customer deposits have these virtues, which is why they remain high on the banks' priority list. Simultaneously, household savings have been under pressure due to the harsh macroeconomic environment, making deposit-taking difficult. Such circumstances mean that the issue of overreliance on foreign funding remains unresolved. The lower than average contribution of deposits to their liability structures is forcing Hungarian banks to rely more than they would wish on wholesale borrowing. Interbank borrowing oscillates around 29% of the sector's liabilities, with debt placements adding another 10%. Both these items highlight Hungarian banks' reliance on external funding.

External funding still indispensable. The loan to deposit ratio, which in 2011 stood at 134.3%, is the highest among the countries we analysed. Strong demand for FX borrowing and double-digit loanbook growth have both resulted in a soaring loan to deposit ratio. This initially peaked in 2007, improving temporarily in 2008 and 2009 before starting to deteriorate thereafter. Current levels still highlight the need for further rebalancing in the sector.

Funding handicap. The graph illustrating asset growth rates and the proportion of loans to deposits puts Hungary far over the right side of chart, which suggests a likely reduction in assets going forward. Such a situation is an outcome of a strong reliance on external and wholesale funding, which suggest low sustainability and the need for readjustment in the future. The recent low growth rate seems to confirm this condition. The rebalancing could be twofold – on the asset side, it would translate into a shrinking loanbook, while on the liabilities side it would encompass a faster growth rate for customer deposits. Given the poor outlook for savings, the former seems more probable, although one cannot exclude a combination these adjustments taking place. Hungary is in a worse position than the other countries in the region that we analysed.

Loanbook

FX loans prevalent. The share of loans within the aggregated balance sheet of the Hungarian banking sector amounted to 57% in 2011, having oscillated between 48% and 52% in the previous three years. Hungary is among the countries that have a widespread presence of FX loans (66.5% of the total book) with only Serbia showing a higher share. Although such reliance is more pronounced in the corporate segment, where FX-denominated credit amounts to 80% and dwarfs the local currency, the picture is not much prettier in the retail segment, where as much as 65% of lending is granted in FX currencies. Such dependence on foreign lending adds to the riskiness of the portfolio, as FX fluctuations impact upon borrowers' ability to service debt.

Regulatory environment

The ground is shifting. Regulatory changes were the main cause of the tectonic shifts that have taken place in the Hungarian banking sector. Not only was Hungary a pioneer of a banking levy, but it has also witnessed a plethora of further legislative changes. These include the ability of FX mortgage borrowers to prepay loans at favourable rate and the recently introduced transaction tax, which all profoundly impact the way banks do business. Unfortunately, the new legal arrangements introduced since 2010 are typical of an increasingly hostile regulatory environment.

Step one – banking levy. A banking tax was introduced in 2010 and is based on the adjusted assets of a financial institution. The levy has subsequently raised around EUR 0.5B annually. To put things in perspective, the consolidated net profit of the banking sector was close to EUR 0.8B in 2009. A year later, the bottom line

Figure HU8: Asset structure (EUR bn)

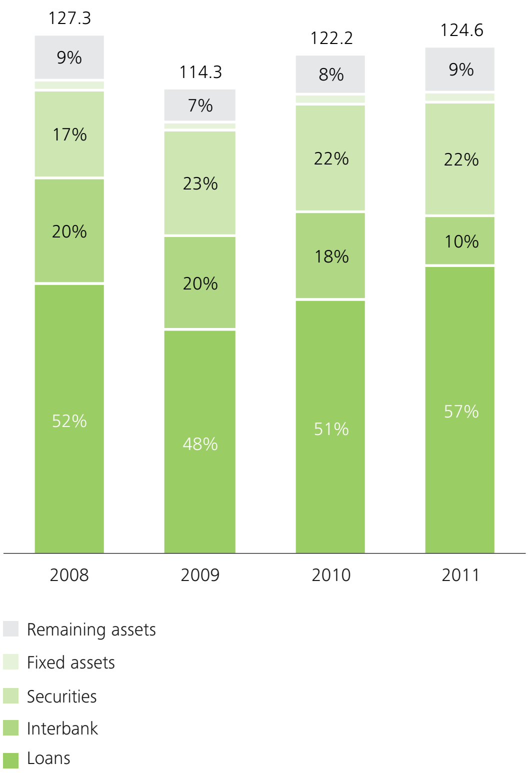
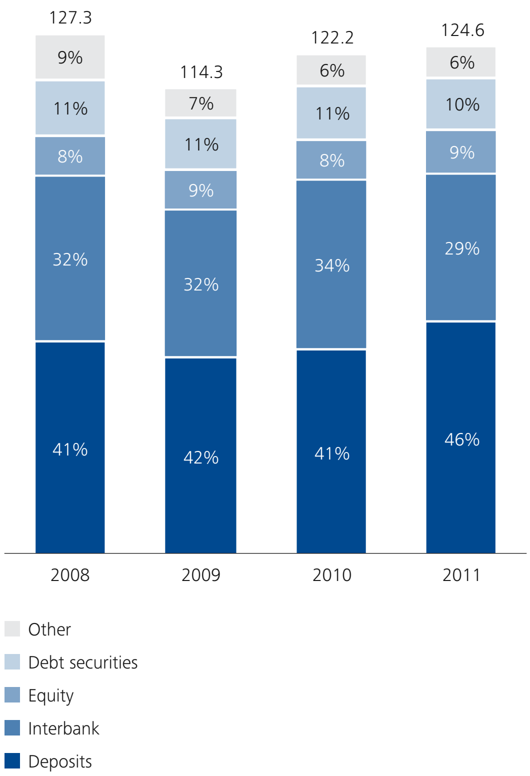


Figure HU9: Liabilities structure (EUR bn)



The loan-to-deposit ratio which stood at 134% is the highest in the region.

plummeted to EUR 0.02B, a decrease of almost 97%. Then in 2011 the banking sector had to face losses of EUR 0.3B. Despite earlier assurances that the levy would be only a transient burden on the sector, it has instead turned out to be a permanent measure that will stay firmly in force into 2013 and beyond.

The next move - mortgage borrowers' pre-payment. Further steps taken by the lawmakers have also had painful consequence for the sector. In order to alleviate the problems of indebted individuals, the Hungarian government introduced in October 2011 the possibility of early repayment for FX-denominated (mainly CHF) mortgages at stipulated favourable FX rates. The option was open for five months until February 2012, during which time almost 170K FX mortgage loans were repaid, slashing the number of outstanding FX mortgages by a massive 23%. The impact of this scheme on banks' P&L was ruinous for the sector, with the net impact exceeding EUR 0.9B in losses that ate harshly into profitability. Another blow for the sector stemming from this early repayment programme was the loss of its best retail mortgage customers, together with a stable and sustainable income stream.

The march continues – transaction tax. On top of such regulatory burdens comes the transaction tax, coming into effect from 2013. The tax will be imposed on cash transactions. The state plans in its budget for 2013 to raise around EUR 0.8B in tax revenues from the tolls. Since banks are not willing to incur further losses, the burden of the transaction tax will at least partially shift to customers, possibly resulting in downward pressure on corporate profitability and a contraction of individuals' disposable income. Additionally, it is likely that transaction volumes will drop in response to the higher cost of each operation.

Is it really worth it? Although the introduction of the banking levy raises tax revenues in a swift and efficient manner (admittedly, no small feat in a world of persistent budget deficits) there are nonetheless several severe drawbacks to such an arrangement. Firstly, lower net earnings translate directly into lower potential growth rates for banks as they accumulate equity at a lower rate. In the extreme scenario of losses brought about by regulation, which became reality in Hungary, vanishing equity may force deleveraging with all the negative repercussions that involves.

Secondly, such a situation can result in a diminished capacity to lend, leading to outcomes including loan rationing, the exclusion of certain groups of customers and the discouragement of financial intermediation. Third, an impaired ability to generate profit reduces banks' ability to bolster their capital adequacy ratios, which is a vital factor for weaker or ailing banks. The consequence is that lower capital buffers will undermine the overall stability of the banking sector.

Fourth, inferior profitability reduces the keenness of investors to supply capital, with all the negative consequences that involves for the future development of the sector. And lastly, although taxing banks may be a sensible way to discourage further growth in those Western countries where the sector expanded too far, this is not the case for CE economies. This long list of potential adverse side effects shows what a risky gamble governments take when they sweat tax revenues from beleaguered banks.

Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets / FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
OTP	24.3	10.3	12.2	396.4	19.5%	1.6%	10.0%	47.1%	84.8%	377	162	2 867	OTP
Erste	11.6	8.3	4.3	-534.8	9.3%	-4.6%	-84.0%	42.1%	192.2%	142	159	3 643	Erste
K&H	10.4	5.2	6.2	15.9	8.3%	0.2%	2.50%	58.4%	84.4%	236	117	3 248	KBC
MKB	9.7	6.4	4.6	-398.6	7.7%	-4.1%	-142.3%	126.2%	137.8%	88	67	4 354	Bay. Land. Bank
CIB	9.0	6.8	4.9	-133.5	7.3%	-1.5%	-15.3%	46.9%	139.3%	120	146	3 068	Intesa Sanpaolo
Raiffeisen	8.2	5.5	5.1	-318.1	6.6%	-3.9%	-55.2%	77.7%	106.4%	132	146	2 655	Raiffeisen
Unicredit	6.1	4.1	3.8	52	4.9%	0.9%	7.8%	47.2%	108.5%	132	160	3 090	Unicredit
OTP Mortgage	5.9	5.3	0.0	-106.4	4.8%	-1.8%	-34.5%	9.8%	-	380	6 967	156 309	OTP
MFB	5.0	1.4	0.2	-105.1	4.0%	-2.1%	-12.4%	75.8%	737.4%	101	90	4 311	State-owned
Budapest Bank	3.4	2.3	2.6	32.7	2.7%	1.0%	7.2%	48.2%	87.5%	102	104	1 170	GE Capital
Market	**124.6**	**70.9**	**52.8**	**-265.7**	**100.0%**	**-0.2%**	**-2.5%**	**62.2%**	**134.3%**		**122**	**3 157**	

Consolidated data for Budapest Bank,CIB Bank, Erste Bank, Raiffeisen, Unicredit

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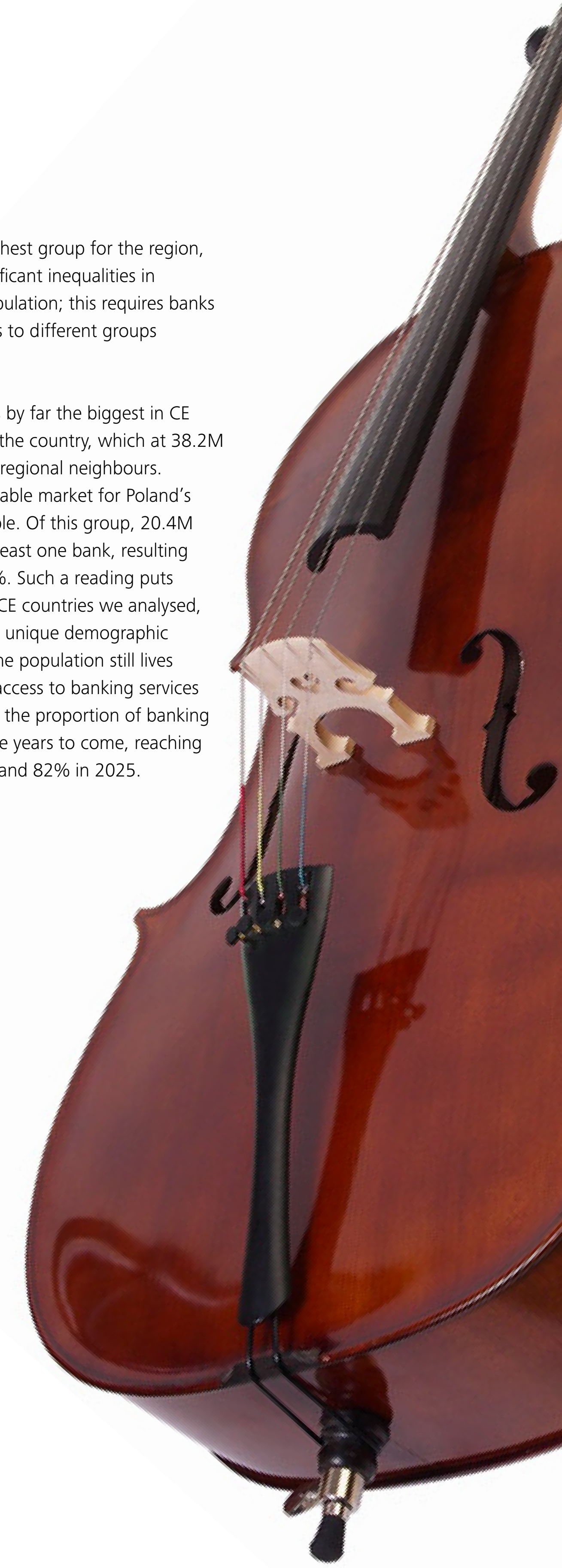


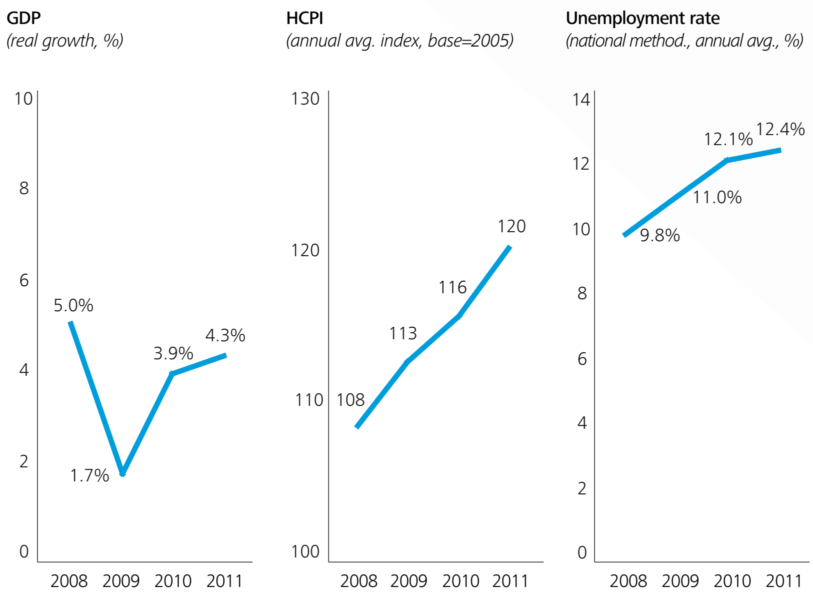
Economic outlook

Resilient performance. Despite the waves made by global financial turmoil and the subsequent crisis in public finances, the Polish economy has survived relatively unscathed, with a positive growth rate recorded every year since 2008. The country's above average reliance on internal consumption, coupled with its relatively accommodating fiscal policy and the country-wide programme of infrastructure investments connected with Euro championship have all helped to offset the negative effects of weaker external demand. This has resulted in a relatively benign environment for the Polish banking sector.

The number of households in Poland totaled 14.9M in 2011. This makes Poland one of the largest CE countries in terms both of market potential and opportunities to achieve valuable economies of scale. Those in the second and fourth quintiles had incomes of EUR 3.0K and EUR 6.8K respectively, indicating that Poland has a relatively wealthy population compared to other CE countries. Its Gini coefficient stands at over 30. This places Poland in the highest group for the region, meaning that there are significant inequalities in the income of the Polish population; this requires banks to offer tailored propositions to different groups of customers.

The Polish banking market is by far the biggest in CE thanks to the population of the country, which at 38.2M is significantly more than its regional neighbours. As a result, the total addressable market for Poland's banks stands at 30.5M people. Of this group, 20.4M are already customers of at least one bank, resulting in a penetration ratio of 67%. Such a reading puts Poland in the middle of the CE countries we analysed, and reflects the effects of its unique demographic structure whereby 38% of the population still lives in rural areas, so restricting access to banking services and their benefits. However, the proportion of banking customers will increase in the years to come, reaching 73% in 2015, 78% in 2020 and 82% in 2025.

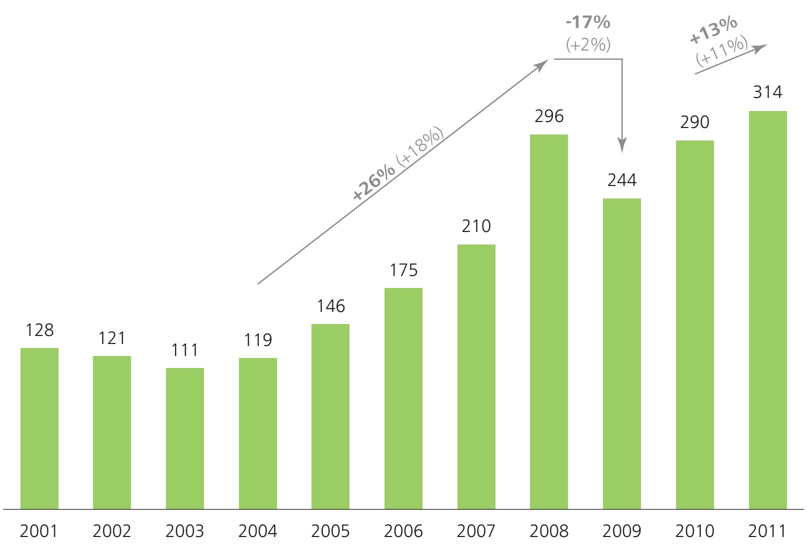
Figure PL1: Macroeconomic indicators



Introduction

Due to the size of its population, Poland is in the league of its own within CE. To a large extent, this is also the secret of its success. In recent years, domestic demand has cushioned the impact of lower exports, while a large internal Polish market also offers its banks plenty of scope for growth. This is well reflected by the economy's performance of recent years, when the country's single most important distinguishing feature has been its growth rate. While in most other CE countries, 2009 and often 2010 were years when GDP decreased, the Polish economy managed to grow in both years, by 1.7% in 2009 and 3.9% in 2010. In 2011, the Polish economy continued this trend with a GDP growth rate of 4.3%. Although growth slowed after the financial crisis struck, the Polish banking sector still continued to achieve double-digit growth, a pace noticeably ahead of all other EU countries (between 2009 and 2011, Poland's CAGR stood at 13%). In terms of the penetration of its banking assets, Poland fares fairly typically, with banking assets amounting to 85% of GDP, close to the CE average.

Figure PL2: Assets of Polish banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Revenue by customer in retail banking has decreased by 11% since 2008.

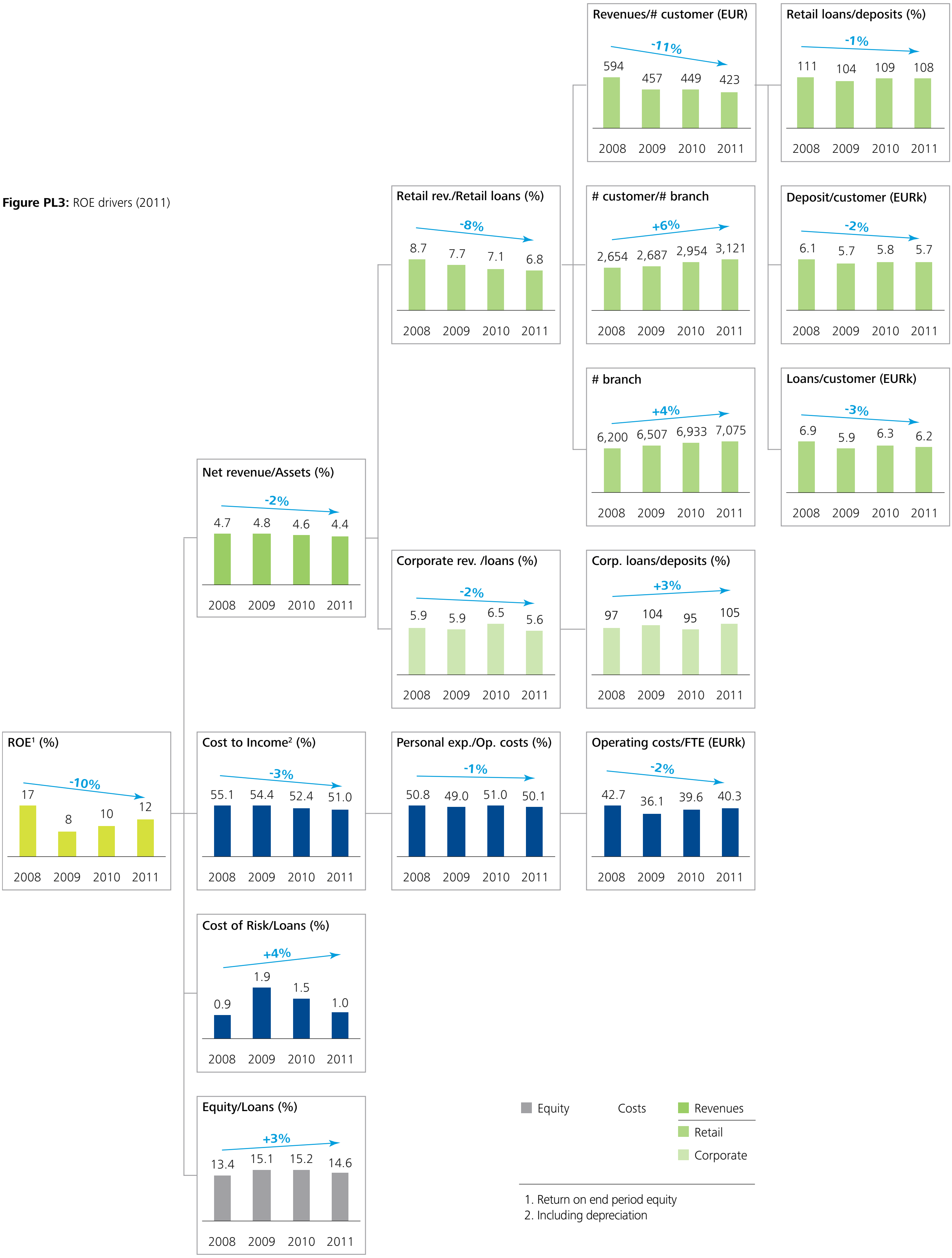
Profitability – in good company. Rising charges coupled with pressure on the income side were the most important factors behind the deteriorating profitability of Poland's banks, which saw both ROA and ROE plummet in 2009. Recovering net interest income (NII), coupled with a moderating cost of risk, brought some improvement in the following years – in 2011, for example, ROA and ROE stood at 1.21% and 12.2% respectively. A comparison with other CE countries shows Polish banks in a good light, placed among a small group of countries with a double-digit return on equity. What's more, there is also a positive trend in profitability, as ROE strengthened in 2011 over the previous year. This was driven by improving efficiency (a better cost-to-income ratio) and a slight deterioration in the cost of risk.

Looking individually at the drivers of ROE demonstrates that margins were generally squeezed by the fierce competition in the years from 2008 to 2011. Net revenue on assets declined over this period to 4.4%, with the main pressure seen in the retail segment (down by 90 basis points) while corporate business remained stable. Some compression of margins is evident - revenues per retail customer declined rapidly, by -11% on an annual basis, which was only partially offset by increasing numbers of branches and customers.
ROE is helped by the tighter cost control visible in falling operating costs per employee. The cost of risk was volatile during this period, peaking in 2009, since when it has moderated.

Banking sector results

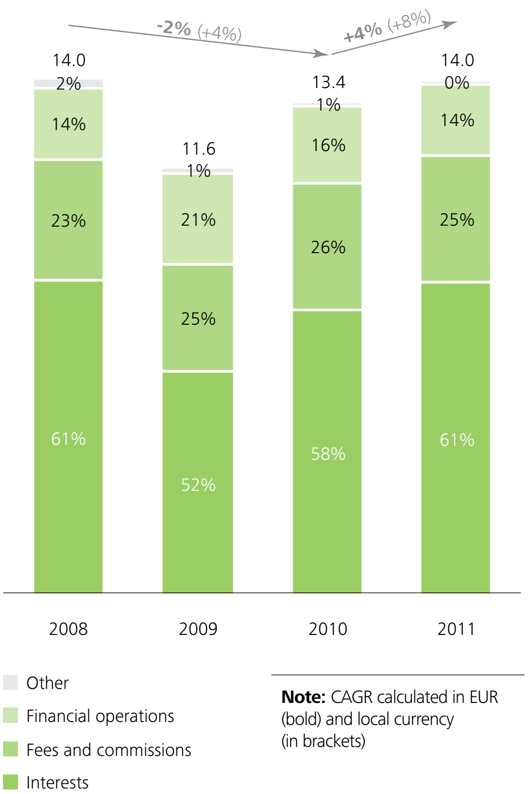
Top line – a complete rebound. Total income for the Polish banking sector amounted to EUR 14B in 2008. The next year saw a visible decline to EUR 11.6B, predominantly due to depressed net interest income. This was one result of a fight for liquidity among banks caused by volatility in the money and FX markets which prompted banks to turn to deposits. This came at significant cost, however. The negative effect was additionally compounded by falling market rates, which put a damper on asset profitability. The stabilising situation in 2010 brought about a visible top line recovery to EUR 13.4B, predominantly thanks to improving net interest income. This positive trend continued the following year, when total sector income completed a full circle again to reach EUR 14B – the same excellent level recorded in 2008.

Figure PL3: ROE drivers (2011)



1. Return on end period equity
2. Including depreciation

Figure PL4: Income structure (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

NII volatile in recent years. The structure of income in the Polish banking sector has changed considerably in the recent past. Although net interest income remains by far the biggest contributor to the top line, its wild fluctuations were also the primary reason for top line volatility. In 2008, NII's share of total income stood at 61%, sharply falling to 52% a year later due to increasing competition for retail deposits and falling market rates. Falling stress levels and calming financial markets enabled the following year's recovery. The share of net interest income increased to 58% in 2010 and 61% in 2011. Fees are the second most important source of income with a stable 23-26% share of banks' total income. With NII expected to decrease in the next few years, banks are trying to increase their fee business in order to avoid a possible decrease in total revenues. Financial operations, by their nature, remain the most volatile component of banking income, and recent years have been no exception with the share of total income varying between 14% and 21%.

Cost side – tangible improvement. Operating expenses have shown a considerable decline from the high levels reached in 2008. From 2008 to 2010, banks were able to trim their costs by an excellent 9% in total, mostly as a result of positive FX trends, although costs have been significantly reduced in the local currency as well. The structure of their operational costs reveals that personnel expenses constitute the most important item (with a 50% share). The banks exercise strict cost control in this area (driving a CAGR of -3% from 2008 to 2011), enabled by falling headcount (with a CAGR of -0.9% in the period). Other administrative expenses constitute the second major category, with a share of total costs that oscillates around 40%. This is an area where cost controls have proved more difficult to implement (CAGR in the period amounted to 3%), in a large part due to additional regulatory burdens (such as higher contributions to the deposit insurance fund) and the rising number of branches. Poland is the only country in the region where the number of branches significantly increased during the crisis period.

Good coverage. The Polish branch network remains among the most developed in the CE region. Poland is a member of a prominent group of countries (along with Bulgaria, Romania and Latvia) where the number of bank branches per 100K inhabitants is over 30. Interestingly, ATM statistics are not so favourable and the country is only average for the region. This is because Poland has been the region's leader in offering customers free cash withdrawals. This undermined the profitability of banks' individual ATM networks, meaning that independent ATM providers have been the sole recent drivers of growth.

Internet banking on the rise. It seems that internet banking has taken Poland by storm. Statistics show that Poles are early adopters – as many as 48% of customers do their banking online. This is the highest share among the group of five CE countries that were analysed in Deloitte's Customer Experience survey. It also shows the future direction of the market and the rising prevalence of internet banking. Interestingly, there is relatively strong polarisation – only 14% of customers appreciate both branch and online banking. The remaining 38% want to use the branch as their main channel for banking services, where they should be well looked after as branch network development in Poland remains above average.

Depreciation and amortisation remain the least important item in the cost structure (with a meagre contribution of 9% over the period), although they have simultaneously exhibited the highest rate of growth (with CAGR standing at 3.5% over the four-year period ending in 2011).

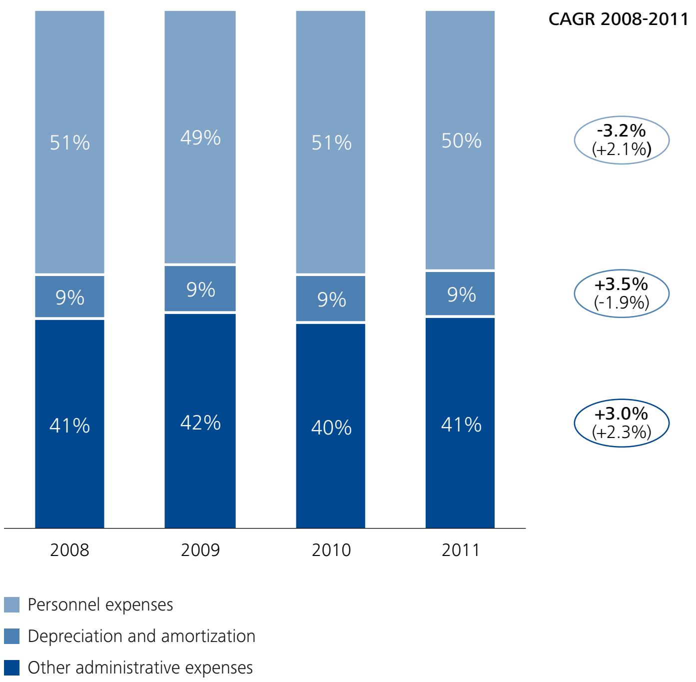
Operational efficiency – major improvements. Operational efficiency, measured by the cost-to-income ratio, has shown steady improvement in the recent past and improved to 51.0% in 2011. The fact that this ratio declined in every consecutive year underlines not only stringent cost controls but also a rebounding top line. Over the 2008 – 2011 period, the change in the cost-to-income ratio amounted to an impressive four percentage points.

The value of assets per employee stands at EUR 1.8M, which is below average for a CE country. This translates also into a below average revenue per employee. On the other hand, personnel costs per employee are in line with the CE average, highlighting the above average density of the branch network.

Concentration

Below average for CE region. In Poland, the low concentration of the market is driving a high cost-to-income ratio compared to the scale of Polish banking sector. The market dominance of the top 10 players in Poland is some way below the average observed for the region. Combined, the top 10 banks hold 60% of the sector's assets, which is markedly less than the 76% average for the region and close to that of more developed countries, where the concentration tends to be significantly less than CE levels. On the other hand, given the planned merger of BZ WBK and Kredyt Bank and the recent tie-up between Raiffeisen and Polbank, the grip of the largest players is certainly set to strengthen. Further consolidation remains an attractive option for expansion, especially as organic growth rates are on a downward trend which might be accelerated by the looming cyclical slowdown. Currently, the only barriers to this taking place on a large scale appear to be uncertainty in the markets and the need for those banks with the capacity to participate in the process of consolidation to focus instead on priorities arising from the crisis in public finances. On the one hand, consolidation may be highly attractive to banks seeking to improve their financial efficiency, thanks to

Figure PL5: Structure of operational costs



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Cost-to-income ratio improved to 51.0% in 2011.

the enormous economies of scale involved. On the other, however, the continuing concentration of the banking market could lead to a pricing environment in which smaller competitors would struggle, especially if we see a handful of dominant players emerge in 2015-2020.

A state-owned market leader. There is a visible state presence in the Polish banking sector, as the Treasury remains the chief shareholder at PKO BP – the country's largest bank, with a 14.5% market share. Nevertheless, all the remaining top-league players are privately owned and, in the majority of cases, are part of one or other of the major international capital groups (Unicredit, Commerzbank, ING and Santander, to name a few). This results in high levels of competition given market fragmentation and the expertise of western players.

Asset quality

Cyclical deterioration. Asset quality remained relatively stable between 2009 and 2011. The ratio of loans overdue by 90+ days to the total loanbook improved marginally in 2011 to 6.0%. This triggered a decline in impairment charges, which in 2011 stood at EUR 2.1B, 30% less than the peak recorded in 2009. Nevertheless, despite falling provisions, coverage ratio improved noticeably over the same period by an excellent 31% to stand at 53% in 2011. Asset quality remains resilient, especially when considered in a regional context, as the Polish banking sector has the second-lowest share of loans overdue by more than 90 days. Coverage ratio remained close to the levels seen in peer countries.

Impairment charges – pressure on profitability. Recent years have shown increasing pressure on asset quality, resulting in a higher level of impairment charges. This was particularly acute in 2009, when provisions doubled year-on-year to total EUR -3B. Since then the situation has improved, showing a decline in charges even though their level still remains higher than in the pre-crisis years.

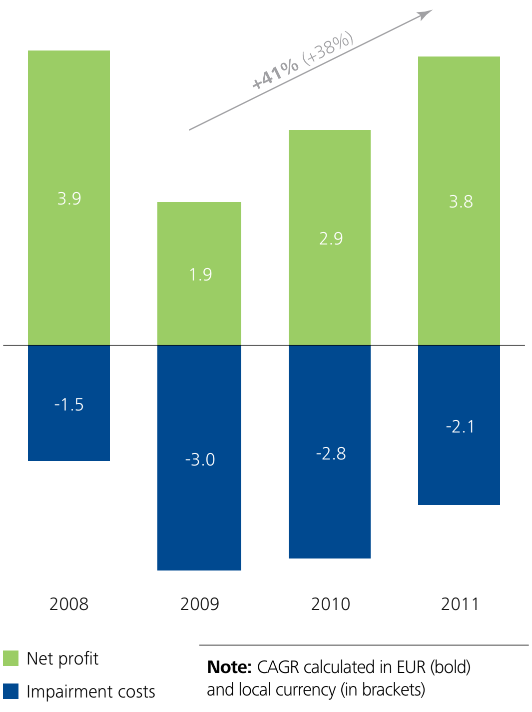
Funding

A trend towards deposits. Deposit-taking remains the chief source of funding for Polish banks, constituting as much as 70% of their total liabilities in 2011. The turbulence of 2008 led to the return of deposits as banks' primary source of stable funding. Wobbling financial and FX markets forced them to address their deposit-gathering policies; this was so successful that a year later, the share of deposits within total funding had increased by a massive 16 percentage points. Another offshoot of this changing approach, and to some extent a derivative of the drying wholesale markets, was the diminished significance of interbank funding (down to 15% of liabilities in 2011 from 23% at the peak).

Stabilising for sustainability. The loan-to-deposit ratio of Polish banks saw its most rapid expansion between 2005 and 2008, coinciding with a boom in FX mortgage lending. In this era of abundant liquidity, parent companies were keen to provide financing for their foreign subsidiaries. This stance was reassessed during and after the financial crisis, and recent years have seen loan-to-deposit ratio growth rate moderate with much slower

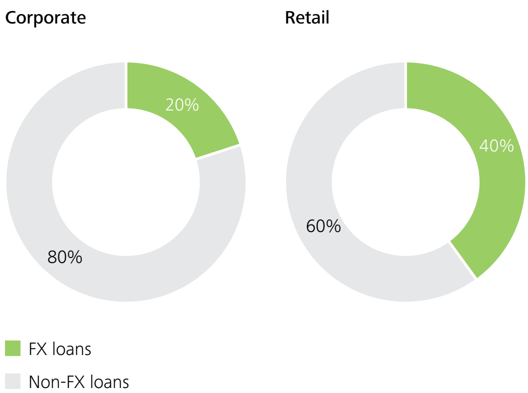
Impairment costs are decreasing since 2009.

Figure PL6: Net profit and impairment costs (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Figure PL7: Share of FX loans by segment (%)



growth– (up to 118.5% in 2011 from 109.4% in 2008). This is a result of steady double-digit loanbook growth over the period, coupled with the stable inflow of external financing. The country's healthy macroeconomic performance and a continuing firm demand for mortgages in Poland allowed Polish banking subsidiaries to receive continuous inflows of parent company funding. Nevertheless, tighter regulations governing FX retail lending will reverse the trend of increasing reliance on foreign funds. While this is likely to result in decelerating loanbook growth rates, it should also help to drive further improvements in the loan-to-deposit ratio.

Moderate outlook. The map contrasting asset growth and the loan-to-deposit ratio places Poland above the centre, emphasising its rapid growth rate in 2011, but also highlighting the steady rise in its loan-to-deposit ratio. Nevertheless, such a starting point suggests that the Polish banking sector's prospects are set to reduce over the near term and that its growth will decelerate to move towards the average for the CE region.

Loanbook

On the growth path. The share of loans in the aggregated balance sheet of banks shows a clear upward trend, reaching 72% in 2011, up from a mere 57% in 2008. This expansion underlines the continuous double-digit growth of the loanbook over recent years. Simultaneously, it is also a welcome development from the margin point of view, due to the increasing contribution of higher-yielding assets.

Diminishing FX book significance. The Polish market is also distinguished by the moderate share of FX lending as a proportion of total loans – in 2011, total foreign-denominated loans amounted to 32.3% of the loan stock. FX lending is concentrated in the retail segment (predominantly in CHF and EUR mortgages), where it represents a significant 40% of the loanbook. Given the authorities' persistence in limiting the availability of FX loans to retail borrowers, whose income is in the domestic currency, the share of FX mortgages in banks' retail portfolios is certain to decline in upcoming years. Corporate FX lending accounts for a much lower 20% of the loan stock.

Figure PL8: Asset structure (EUR bn)

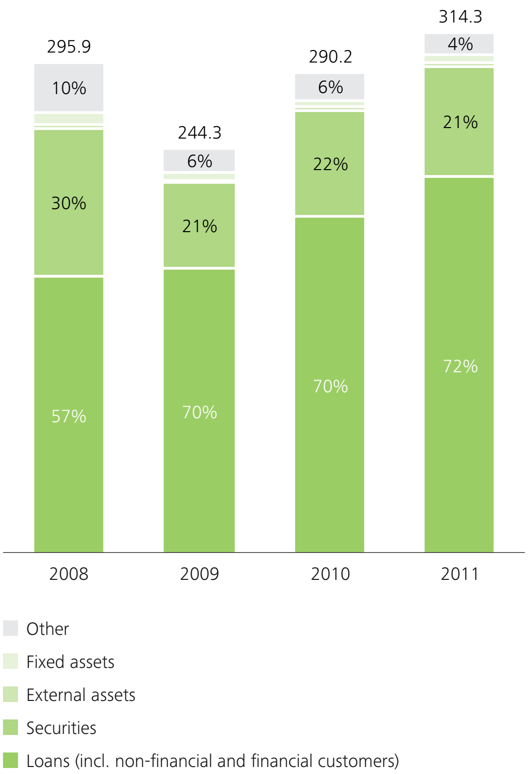


Figure PL9: Liabilities structure (EUR bn)

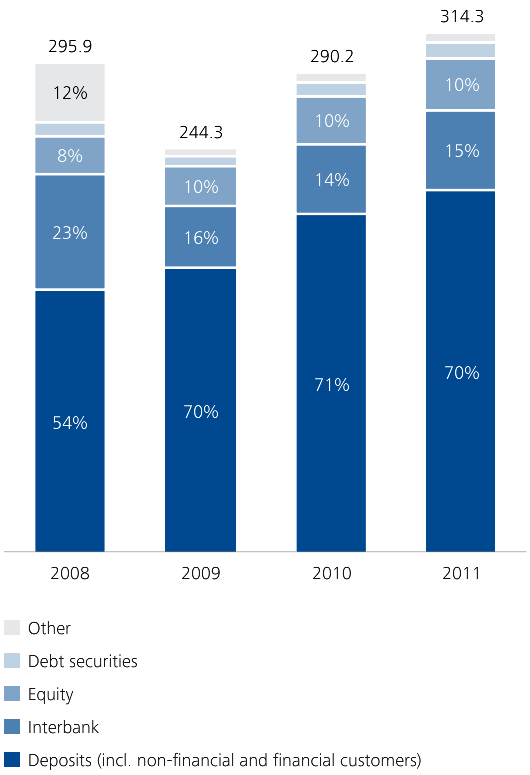


Table: Top 10 banks' financial results (2011)

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	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
PKO BP	45.7	34.0	36.4	959.5	14.5%	2.1%	17.3%	37.6%	93.4%	1 198	101	1 765	State-owned
Bank Pekao	34.6	22.4	26.2	685.9	11.0%	2.0%	13.6%	46.1%	85.3%	1 002	99	1 928	Unicredit
BRE	22.8	15.0	13.1	258.7	7.3%	1.1%	14.0%	45.1%	114.2%	288	155	4 819	Commerz-bank
ING	16.9	10.3	12.9	219.3	5.4%	1.3%	14.5%	55.4%	79.7%	439	86	2 058	ING
BZ WBK	14.3	9.1	11.4	281.1	4.6%	2.0%	17.0%	49.2%	79.6%	526	97	1 643	Santander
Getin Noble	12.9	10.2	11.3	135.2	4.1%	1.0%	14.2%	27.5%	90.4%	n/a	156	3 235	Getin Holding
Millennium	12.0	9.7	9.1	100.8	3.8%	0.8%	9.7%	61.1%	106.1%	447	71	2 046	BCP
Kredyt Bank	10.1	7.3	6.8	75.3	3.2%	0.7%	10.2%	61.5%	107.5%	373	78	2 068	Santander
Citi	10.1	3.4	5.9	175.0	3.2%	1.7%	11.3%	58.5%	58.2%	147	115	2 016	Citi
BPH	8.8	6.8	3.3	50.0	2.8%	0.6%	5.9%	66.3%	202.8%	429	76	1 422	GE Capital
Market	**314.2**	**214.9**	**181.4**	**3809.9**	**100.0%**	**1.2%**	**12.2%**	**51.0%**	**118.5%**	**7 075**	**79**	**1 779**	

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Economic outlook

In 2009 and 2010 years, the Romanian economy underwent a painful readjustment due to a sharp correction in domestic demand. Romania's GDP decreased by 7.1% in 2009 and in 2010 by 1.3%. Although recovery flickered the following year, this was export-driven leaving other sectors of the economy still under stress. As a result, the pace of growth stayed below its potential and was unevenly distributed between sectors. The resulting economic woes can also be felt on a wider scale as the same pattern of under-performance may also be observed among neighbouring countries. An interesting point comes from an analysis of unemployment. Despite a decrease of GDP in 2010, the unemployment rate decreased from 7.8% in 2009 to 7.0% in 2010 and 5.1% in 2011.

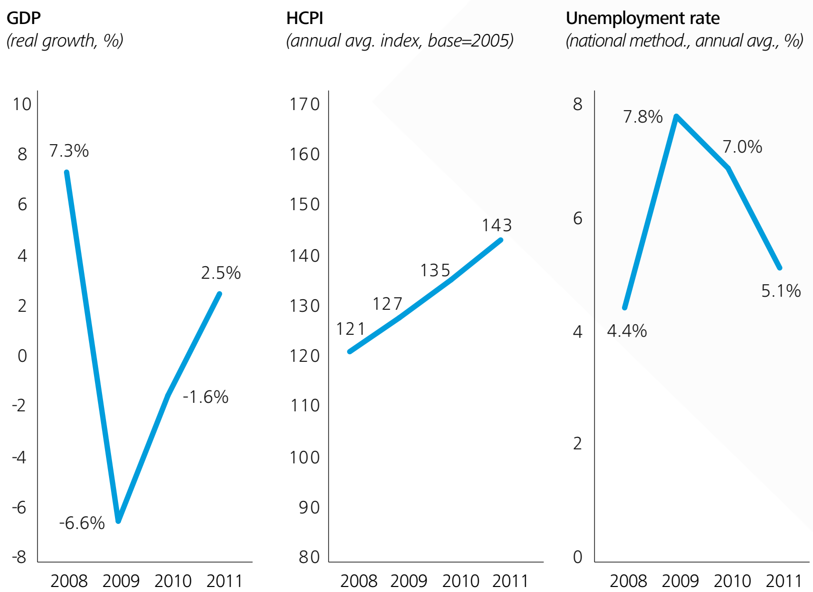
The statistics for Romania put the number of households at 8.5M, making the Romanian market quite large compared to other CE countries, with the potential to achieve attractive economies of scale. Customers in the second and fourth quintiles had monthly incomes of EUR 1.7K and EUR 3.3K respectively, meaning the Romanian population is relatively poor compared to other CE countries The Gini coefficient stood at 33.3, the highest level among CE countries. This shows that there are large differences in income between customer segments, meaning that banks need to tailor their approach to the differing needs of different customer groups.

A closer look at the profitability of banks operating in Romania illustrates the impact of the soaring cost of risk, which jumped to 3.1% in 2011 and showed an annual growth rate of 26% from 2008 to 2011. This is the main reason behind the negative profitability of 2011. Other elements of the equation showed much greater stability – yields on assets expanded slightly, while the cost-to-income ratio remained flat.

The Romanian population totals 21.4M, one of the largest in the region. This group includes non-adults, however, meaning that banks' total addressable market is 17.3M - but the penetration of banking services is very low and stands at just 40%.

Two key issues affect banking penetration in Romania. The first is connected with the geographical distribution of the population, given that 44% of people live in non-urban areas. Second, the relative lateness of Romania's economic transformation and access to the EU mean that the Romanian banking sector is at an earlier stage of development than most CE countries

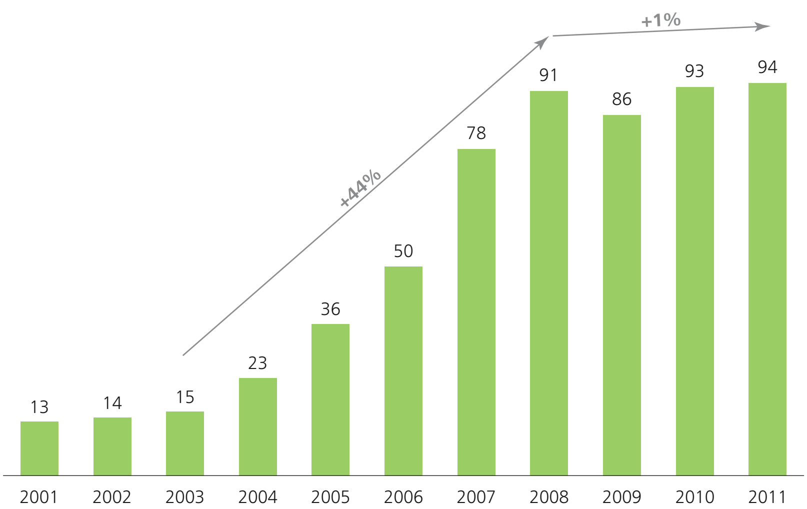
Figure RO1: Macroeconomic indicators



Introduction

That sinking feeling. The post-crisis years have been particularly tough for Romanian banks, chiefly caused by the rapid growth of bad loans. This, in turn, has resulted in spiraling impairment charges, which have depressed profitability. Although severe austerity measures taken by the banks have delivered some significant cost savings, this factor alone has not counterbalanced the damage caused by deteriorating asset quality. Nevertheless, they are limiting the growth prospects of a banking sector that is still relatively small, with assets amounting to a mere 69% of GDP. A similar conclusion could be drawn from comparing the penetration rates of CE countries, when Romania is in last place. This is despite the rapid growth took of the pre-crisis years (with a strong CAGR of 44% between 2003 and 2008). Nevertheless, this was insufficient to build operations of the scale necessary to support and drive efficiency. The subsequent downturn reduced the pace of growth to a crawl – annual growth over the four-year period ending in 2011 was just 1%.

Figure RO2: Assets of Romanian banks (EUR bn)



Over the last four years, net profit has declined at a massive CAGR of 59%.

Profitability – impairment charges the main barrier. Recent years have clearly emphasised the strain caused by deteriorating assets, which is the principal barrier to profitability. Over the last four years, net profit has declined at a massive CAGR of 59%. Net profit was barely existent in 2011, and net income amounted to just EUR 4.5B, far below the peak of EUR 5.1B recorded in 2008. Consequently, profitability ratios are very weak and continuing to deteriorate – in 2011, the ROA and ROE of the Romanian banking sector amounted to just 0.11% and 1.2% respectively.

Banking sector results

Top line – pressure intensifies. The top line has remained under severe pressure over the last couple of years. Total income decreased by 4.3% annually, falling to EUR 4.5B in 2011. Plummeting financial operations are the chief cause of revenue decreases, although this negative trend is additionally exacerbated by declining fees. Fortunately, net interest income (NII) has been resilient, helping to counter some of this decline. Overall, there is pronounced pressure on the top line, with total income declining in each consecutive year. Falling revenues are the primary cause of the deteriorating cost-to-income ratio.

Financial income dwindles. Net interest income remains the chief source of revenue and has gained in significance. Its share of total income has expanded from 55% in 2009 to 72% in 2011. Fees constitute the second most important source of income, with a 19-24% share of total income. Financial operations have consistently lost importance over recent years, down to 13% from a peak of 24%.

Cost side – major savings achieved. A strong decline in operational costs demonstrates the sheer amount of effort that Romanian banks have put into this area. Costs, which in 2008 stood at EUR 2.7B, decreased to EUR 2.5B in 2011, showing an annual decline of 3.1%. The majority of these savings were made in 2009; however, subsequent years have also shown a small decline in total costs, driven by cuts in HR and other areas. There were also widespread branch closures, with the network decreasing massively to just 6.0K in 2011 from 7.3K in 2008. The depreciation and amortisation area is the only exception when it comes to cost savings, having grown annually by 10% during the period.

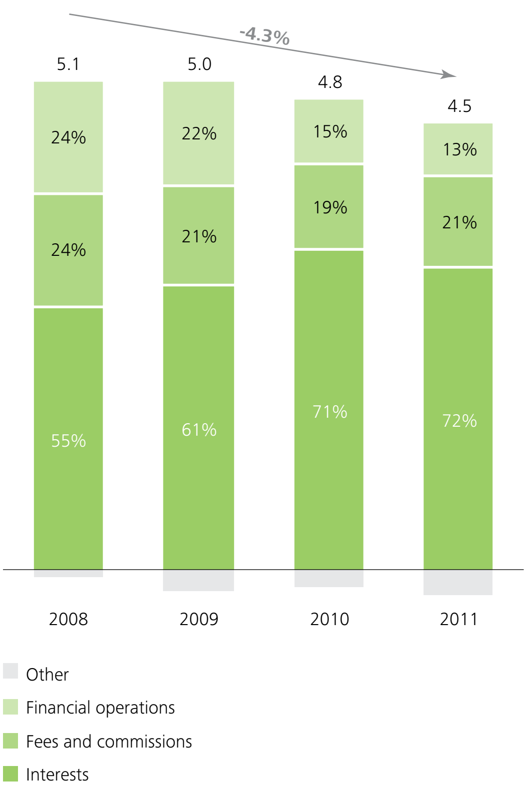
Figure RO3: ROE drivers (2011)

1. Return on end period equity
2. Including depreciation

Above average density. Despite a decrease in terms of number of branches, the banking network in Romania remains quite well-developed compared to other countries in the region. Romania is among a group of countries (including Bulgaria, Latvia and Poland) where the number of bank branches per 100K inhabitants is between 30 and 40. This is mostly caused by the demographic profile of Romania, which necessitates building branches close to many people living in non-urban areas. ATM statistics are somewhat less advantageous, although the country is in the middle of the CE pack. Overall, Romanian customers enjoy relatively good proximity to banking services, which is partially the result of the country's lower-than-average market consolidation.

For 93% of Romanian customers, branches are still a major channel for building the banking relationship, although they also use the Internet or a mix of branch-based and Internet services. This accounts for the high emphasis customers place on all aspects of direct interaction with their bank at branch level, and the low impact on satisfaction that stems from Internet, mobile and call centre services. Despite a significant overall reduction in branch numbers in 2010-11, the top three Romanian banks by number of customers opened new branches in 2011, highlighting direct interaction as the primary channel for the customer relationship. 68% of customers who use Internet banking services, either exclusively or in parallel with the branches, are aged between 15 and 35, sending a clear signal that once a new technology-literate younger generation enters the potential pool of banking customers, on-line services will become increasingly important in terms both of usage frequency and quality expectations.

Figure RO4: Income structure (EUR bn)



A closer look at operational cost structures shows that the primary cost category is personnel, contributing a hefty 49% of the total. General and administrative expenses come second, with a 40% share of total expenses in 2011. The remaining 11% of the cost base is attributable to depreciation and amortisation. Recent years (2008 – 2011) showed a similar share of HR expenses within the total.

Operational efficiency – recent decline. At best, the overall balance in terms of cost efficiency remains mixed. Despite improvements resulting from the overhaul of the cost side, the sector's weak top line has not allowed improvements in efficiency. After some initial gains, falling revenues in 2011 have pushed the cost to income ratio up to 55.0%.

Comparing Romania's banking sector to other CE countries reveals a smaller overall scale of business. Mediocre productivity is highlighted by such metrics as assets or net revenues per employee, which at EUR 1.4M and EUR 68K per employee respectively are both below average for the region. Personnel costs per head are close to average for the region, highlighting the sector's weak productivity despite the decreasing headcount and wage deflation.

A look at the individual players indicates the substantial gains that arise from economies of scale. BCR and BRD, by far the two biggest players, both demonstrate superior efficiency as measured by their cost-to-income ratio. Additionally, there is a clear tendency for economies of scale to disappear with reducing size, as smaller players have a substantially smaller revenue pool to exploit.

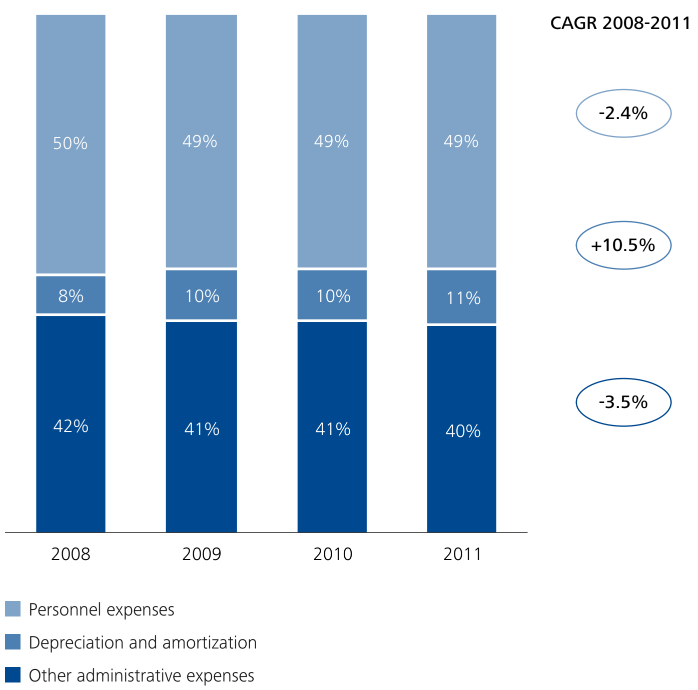
Concentration

Market concentration slightly below average. A high concentration of the leading banking players might cause economies of scale to impact operational effectiveness ratios. With the 10 largest banking groups controlling 70% of banking assets, the market is marginally below average for the region in terms of concentration. Such a level is still ahead of those seen in Western countries. The region as a whole is distinguished by the greater dominance of the largest players when compared to more developed markets. Nevertheless, in our view, the current situation should not hamper further M&A activity, especially among smaller players seeking to gain greater efficiency on the back of better economies of scale. The two largest banks - BCR and BRD - command 18.6% and 12.3% respectively in market share and clearly dominate the Romanian banking landscape in every major category (loans, deposits, assets and equity). The next four banks in terms of size (BT, CEC, RZB and Unicredit) each have a market share in the range of 5% to 6.5%, giving them a solid foothold in the market. Remaining market share is quite fragmented among minor players.

Primary private ownership, but the state is also represented. There is some state presence among the biggest Romanian banks as the Treasury owns CEC, the fourth largest bank with a market share of 6.3%. Nevertheless, all the remaining top-league players are privately owned, in most cases being part of an international capital group (such as Erste, Société Générale and Unicredit). This ensures an adequate level of competition given the country's market fragmentation and the expertise of western players.

Despite improvements on the costs, cost-to-income increased in 2011 to 55%.

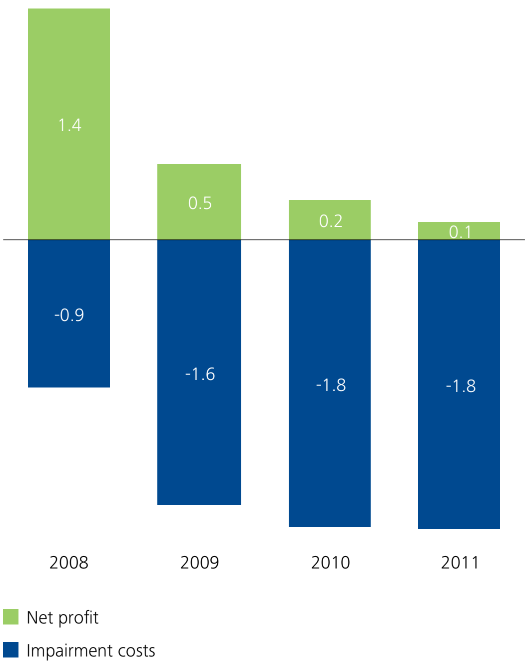
Figure RO5: Structure of operational costs



Asset quality

Troubled assets on the rise. The quality of loans showed a rapid deterioration from 2009 to 2011. The ratio of loans overdue for more than 90 days increased to 11.4% in 2011, a sharp rise on the 5.8% recorded only two years earlier. Although impairment charges have not changed significantly in recent years, they have nevertheless stabilised at a consistently high level. In Romania, provisions for loans overdue for 90+ days constitute 59.9% of the stock. Compared to other CE countries, such a level seems quite comfortable for Romanian banks - the ratio stands out as the second highest in the region.

Figure RO6: Net profit and impairment costs (EUR bn)



High cost of risk decreased net profit of Romanian banking sector.

Impairment charges – the main barrier to profitability. A deteriorating macroeconomic backdrop and slower growth in the loanbook have brought about a jump in provisions. The cost of risk in 2011 remained at an eye-watering 3.1%, the highest in the region. This is also confirmed by looking at the proportion of impairment charges to assets – at 1.9%, again the highest among CE countries. The flip side is that despite a major increase in non-performing loans, these high impairment charges have helped to keep the coverage ratio at a good level. The sheer scale of this growth is highlighted when comparing the 2011 provision level with what has gone before; loan-loss provisions totaled EUR -1.8 in 2011, more than two times the level of 2008.

Funding

The funding gap. Romanian banks have historically been among the least dependent in the region on deposit funding, illustrated by the low share of their liabilities that is represented by deposit funding (a little over 50%). This is noticeably less than the CE average. This is particularly concerning, as since the Lehman collapse, liquidity and stability have been the watchwords for every bank from the smallest local player to the largest global financial institution. Customer deposits score high on both scales, being one of the most solid and reliable sources of funds. Although there is a slight upward trend in the share of deposits in overall funding in Romania, it is barely discernible as household savings remain under pressure to make taking deposits quite difficult. Such circumstances leave the issue of overreliance on foreign funding still unresolved.

External funding still indispensable. The Romanian loan to deposit ratio, which in 2011 stood at 125%, is among the highest in the region. Such an elevated level is the legacy of the rapid growth seen from 2005 to 2008. Before 2007, the sector was abundant with liquidity and parent companies pumped in funding without limits. Such a favourable situation allowed the loanbook to grow at a faster rate than deposits. Consequently, the ratio rocketed ahead in the run-up to the financial crisis. The financial turbulence then felt in 2008 accelerated this tendency further, pushing the loan-to-deposit ratio to its peak of 136% that year. It subsequently declined slightly, stabilising at around 125%. Current levels still suggest a lingering need for further rebalancing in the sector.

Adjustment inadequate so far. The graph setting asset growth rates alongside the loan-to-deposit ratio puts Romania on the right side of the chart, suggesting poor prospects for future growth. Such a position stems from a combination of the relatively limited growth experienced in the recent past and low reliance on self-funding, which seem together to confirm low sustainability going forward. Such a blend indicates that the need for funding side adjustment may cause growth to be slower or even static in the short-term future. Compared to other countries in the region, however, Romania is still in a better position than Hungary or the Baltic states.

Loanbook

FX loans widespread. The share of loans in the consolidated balance sheet of the sector remained at 75% in 2011, having fluctuated between 73% and 84% over the previous couple of years. This relatively high contribution of loans to the asset-mix supports profitability. What distinguishes the Romanian market is its very strong reliance on FX lending, which amounts to a high 63.7% of the total loanbook. This dependence is visible in both main customer segments – FX-denominated credit stands respectively at 61% and 66% of corporate and retail lending. Given the volatility of FX rates, combined with the impact of rising unemployment, this might contribute to further market turbulence in the near future. Demand for the euro might also negatively influence the RON's stability.

Figure RO7: Asset structure (EUR bn)

Figure RO8: Liabilities structure (EUR bn)

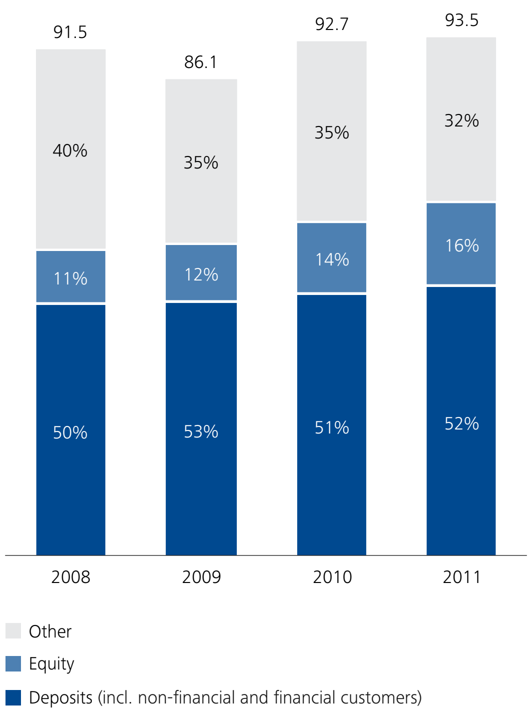


Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets / FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
BCR	17.4	11.1	9.2	57.8	18.6%	0.3%	3.1%	46.5%	120.7%	152	128	2 156	Erste
BRD	11.5	7.4	7.2	110.7	12.3%	1.0%	8.0%	44.1%	103.6%	221	89	1 395	Societe Generale
Banca Transilvania	6.1	3.3	4.8	53.9	6.5%	0.9%	9.9%	45.9%	69.2%	130	49	897	EBRD
CEC	5.9	2.4	4.2	27.4	6.3%	0.5%	6.0%	62.2%	58.5%	282	36	894	State-owned
Raiffeisen	5.7	3.5	4.0	100.9	6.1%	1.8%	15.8%	62.5%	86.6%	128	71	879	Raiffeisen
Unicredit	5.4	3.4	2.7	37.6	5.8%	0.7%	6.4%	49.8%	125.6%	58	96	1 808	Unicredit
Volksbank	4.4	2.6	0.5	-95.2	4.7%	-2.2%	-19.8%	51.2%	517.0%	31	89	3 015	Volksbank
Alpha Bank	4.0	3.0	1.2	6.8	4.3%	0.2%	1.8%	51.4%	249.8%	38	73	1 672	Alpha Bank
Bancpost	3.0	1.8	1.9	-28.9	3.2%	-1.0%	-7.8%	85.7%	95.1%	63	47	900	EFG
Piraeus	2.3	1.3	1.3	15.8	2.4%	0.7%	4.8%	42.9%	103.3%	44	119	1 210	Piraeus
Market	**93.5**	**51.8**	**41.3**	**100.0**	**100.0%**	**0.1%**	**1.2%**	**55.0%**	**125.4%**	**1 426**	**68**	**1 422**	

Consolidated data for Raiffeisen Bank; Data for Piraeus bank as of 31/12/2010

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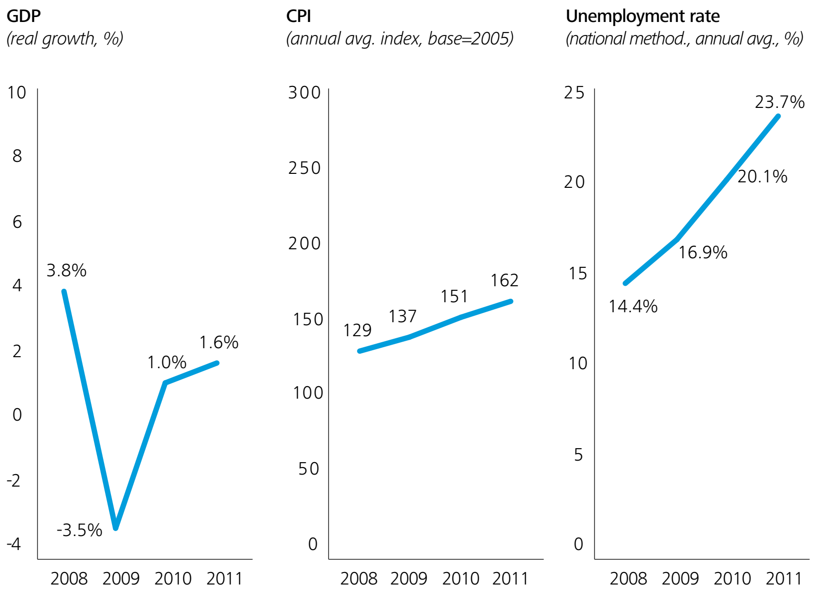
Market outlook

2009 was a tough year for Serbia, when the economy went sharply into reverse. Fortunately, subsequent years brought recovery as buoyant exports helped to lift the economy, encouraging enterprises and spurring on investments to further boost the pace of growth. In 2009 the country's GDP decreased by 3.5%, before managing to slowly grow again over the following two years by 1.0% and 1.6% respectively. This positive process has not reached the country's households, however. The downturn hit the labour market hard; this failed to recover, resulting in a job-less recovery.

The unemployment rate, which stood at 14.4% in 2008, increased to 23.7% in 2011. Persistently high unemployment has dampened domestic consumption, resulting in below par economic growth rates as an export-led economic revival only benefits a limited number of sectors and is heavily dependent on the regional economic situation.

The number of households in Serbia in 2011 totaled 2.5M, making this a small market even when compared to many CE countries.

Figure RS1: Macroeconomic indicators

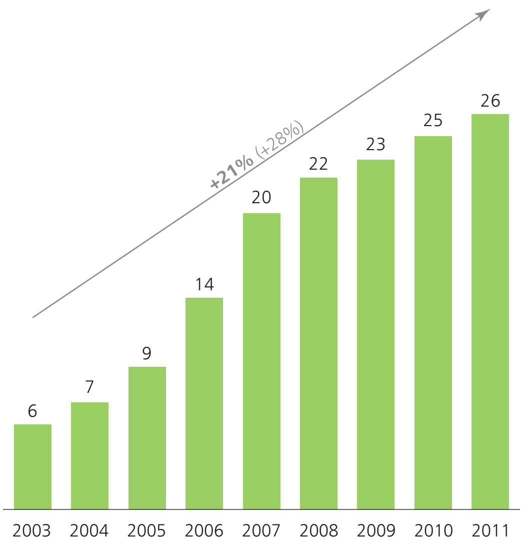


Introduction

Under pressure. Recent years have proved to be an exercise in crisis management for Serbian banks. Asset quality has been under assault due to a deteriorating macroeconomic situation, which has hit banks via rising impairment charges. Although adjustments have been apparent as the banks trimmed headcount and closed some branches, this has proved not to be enough as profits have plummeted due to higher impairment costs.

However, although profitability is reduced for the time being, the long-term picture looks more positive. The capitalisation of the sector is more than adequate, while the growth rate of the market is another cause for optimism. Contrary to the experience of most CE countries, where growth rates decelerated after the crisis, the pace of growth in Serbia continues to be brisk. Over the eight years up to 2011, the assets of the banking sector expanded at an annual rate of 21%. To some extent this is a result of the sector's still relatively small size, especially when you take the regional perspective into account. The assets of the Serbian banking sector total around 83% of GDP, placing the country among the less developed in the region and suggesting that its long-term prospects are good.

Figure RS2: Assets of Serbian banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Profitability – barely in the black. Recent years have been demanding for Serbian banks as the negative impact of depreciating assets have hit profitability. While there was a clear deterioration in the sector's ability to generate net profit in the years immediately following 2008, banks still managed to deliver low, single-digit profitability. The final blow from rising provisions came in 2011, which wrecked the profitability of the banking sector. As a result, ROA and ROE both fell in 2011, to 0.05% and 0.2% respectively. Net profit in 2011 amounted to just EUR 12M, scarcely managing to stay out of the red.

A comprehensive profitability analysis illustrates two negative trends. First, the cost of risk has risen sharply, especially in 2011. Second, revenue relative to assets contracted throughout the period at an annual rate of 8%. The cost-to-income ratio remained stable at the same time, causing profitability to fall.

Banking sector results

Top line – arresting the downward trend. Although their top line was under visible pressure for three years, Serbia's banks managed to reverse this downward trend in 2011. In 2008, total income amounted to EUR 1.8B and decreased to EUR 1.6B a year later, followed by further declines the following year. While the chief driver of decline was the weaker contribution of financial operations, net interest income (NII) and fees also contracted but to a lesser degree. The first signs of revival came in 2011, when 6% annual growth was recorded mainly on the back of growth in NII and a revival in fees. Overall, after a period of sluggish top line, 2011 staged a long-awaited recovery.

NII and fees at the forefront. Closer scrutiny of the total income generated by Serbian banks reveals the leading role of NII, whose contribution has grown over recent years, fluctuating between 66% and 71% between 2008 and 2011. Fees are second in importance, amounting to 21% throughout this period. The significance of financial operations has diminished, from a peak of 13% to a mere 5% share of total income in 2011. Overall, the top line of the Serbian banking sector has recovered and remains driven by net interest income and fees on the back of growing assets.

Figure RS3: ROE drivers (2011)

Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Cost side – limited improvement. Operational costs have decreased in recent years, most strongly in 2009. Costs fell further the following year, albeit to a much lesser degree. Between 2008 and 2010, operating costs decreased each year by 4%, predominantly enabled by employment cuts. Then some limited growth was seen in 2011 (2%) resulting in costs increasing to EUR 1.0B. Headcount fell to 29.2K in 2011 from 32.2K in 2008. A similar trend was seen in terms of branches, with numbers shrinking by 328 between 2008 and 2011.

Weak coverage. The Serbian branch network is under-developed, but with these necessary cost-cutting exercises underway, it is hard to predict that it is going to improve. There are fewer than 20 bank branches per 100K inhabitants, below average and, together with Hungary, placing Serbia among those countries with the least developed branch presence. Serbia also has one of the lowest ATM penetration rates in the CE region (fewer than 50 ATMs per 100K citizens).

Operational efficiency – limited deterioration. The efficiency of the banking sector has decreased in recent years. The cost-income ratio deteriorated from 60.3% to 63.4% between 2008 and 2010, the result of sluggish income levels. The recovery seen in 2011 has helped to improve the ratio, which fell back to 61.3%. Such developments underline the challenging banking environment, which is limiting the sector's ability to grow its top line.

A comparative analysis of the sector with those in other CE countries reveals its inferior productivity. This is the picture painted by looking at assets and net revenues per employee, which at EUR 889K and EUR 56K respectively are both clearly below average for the region. The gap between Serbia's personnel costs per head (EUR 14K) and the regional average (EUR 20K), meanwhile, is smaller than the equivalent gap in revenues. This highlights weak Serbian productivity, even despite the sector's decreasing number of employees.

Figure RS4: Income structure (EUR bn)

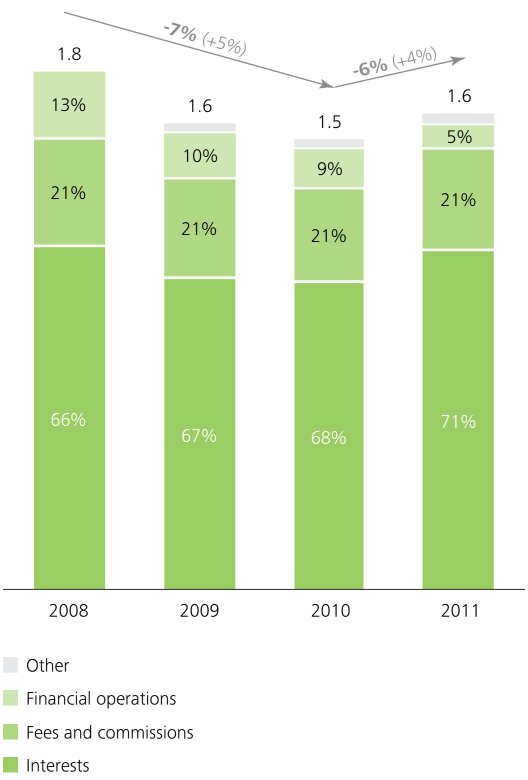
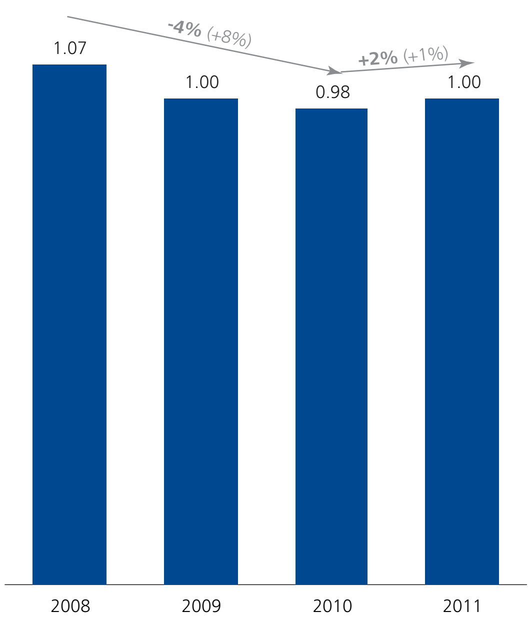


Figure RS5: Operational costs of banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Bank-by-bank analysis shows the substantial benefits that arise from a larger scale of operations. Banca Intesa, the Serbian market leader, also easily takes the top spot on the charts for cost-to-income ratio and revenue pool. The clearly weaker performance of other players emphasises the effects of economies of scale.

Concentration

Below average consolidation. One of the major reasons for Serbia's high cost-to-income ratio is the low concentration of the banking sector. Less dominance is concentrated among the largest players in the Serbian banking sector than in most CE countries. The top10 banks' share of the sector's assets amounts to 71%, the third-lowest concentration level among the countries we analysed. It is a shared feature of CE countries that their largest banks share a higher proportion of the market than do the leaders in Western Europe. This strong market presence of the biggest players limits organic growth opportunities for smaller and new players, making mergers and acquisitions the primary route to gaining market share. Banca Intesa has a market-leading 14.8% share of the Serbian sectors' assets. At number two, Komercijalna Bank has 10.4% of the banking pie. The remaining players have market shares of well below 10%. The three next in line, Unicredit, Raiffeisen and Société Générale, all have market shares of above 7%, and the shares held by the next in line rapidly fall away.

Significant presence of state-owned entities. Although most owners of Serbia's 10 largest banks are private, the state presence is significant nevertheless with three banks being state-run. Komercijalna Banka is the second largest bank of all, a state-owned player with assets accounting for 10.4% of the sector. The others that are partially owned by the state are in eighth and ninth positions (AIK and Vojvodanska). Most privately owned banks are inside international groups (including the likes of Intesa Sanpaolo, Unicredit and Raiffeisen).

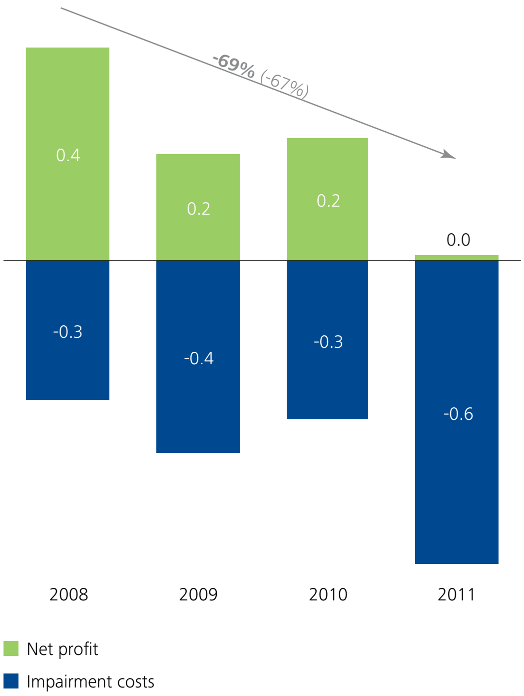
Impairment charges mounting. A weak macroeconomic backdrop and slower loanbook growth have resulted in a strong increase in loan-loss provisions. This was particularly pronounced in 2011. The cost of risk amounted to 2.8% in 2011, up from 2.3% the previous year, placing Serbia among those countries with the highest levels of provisions in the CE region.

Deterioration is particularly evident when you take 2008 as a base year: loan-loss provisions totaled EUR -0.6B in 2011, more than twice the 2008 level.

Funding

Closely matched. Deposits are the cornerstone of Serbian banks' funding strategies, contributing 58% of liabilities – a slightly lower level than loans. This reliance on deposits has remained largely unchanged over recent years. Interestingly, the significance of interbank lending has been rising, up from 11% of total liabilities in 2008 to 15% in 2011. Among other positives is the quite significant share of the equity account,

Figure RS6: Net profit and impairment costs (EUR bn)



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The cost of risk amounted to 2.8% in 2011, up from 2.3% the previous year, placing Serbia among those countries with the highest levels of provisions in the CE region.

which amounted to 21% in 2011, a larger contribution than is usual. This demonstrates the above-average capitalisation of Serbian banks.

A good balance. Recent developments affecting the loan-to-deposit ratio, which has stayed around the 100% mark over the last couple of years, point to the Serbian banks' cautious approach to liquidity management. Such a balanced proportion of loans and deposits shows a conservative approach to funding and emphasises their ability to fund themselves. Although, the ratio has shown some movement in recent years (between 92.2% and 108.4%), overall it has remained in the vicinity of 100%. Admittedly, its current level (104.3% in 2011) hints that the loanbook may start to expand at a rate close to that of deposits unless the banks increase their reliance on external and wholesale funding. This may prove to be difficult considering the impact of the eurozone crisis on banks operating in Western Europe (and in particularly Southern European countries), which have been eager investors in Serbian banks. Consequently, we think that the self-funding capacity of Serbian banks will determine their growth rates going forward.

Room for further growth. The diagram comparing recent asset growth rates with the loan-to-deposit ratio puts Serbia in the top-left sector, which indicates a good starting position for future growth. Such a position is the result of a combination of healthy recent growth rates and the availability of adequate funding that confirms the potential for sustainable progress. Only a select group of CE markets are in such a strong position.

Loanbook

On the rise. The Serbian loanbook has grown in recent years at a healthy 6% annually, in line with growing assets. This is confirmed by the share of loans on the sector's consolidated balance sheet, which despite its recent tendency to fluctuate over recent years stood at 60% in both 2011 and 2008. This leaves scope for further increases, which could improve asset profitability. Interbank lending holds the second most important position in the asset structure of Serbia's banks, with up to a 20% share of assets.

Figure RS7: Asset structure (EUR bn)

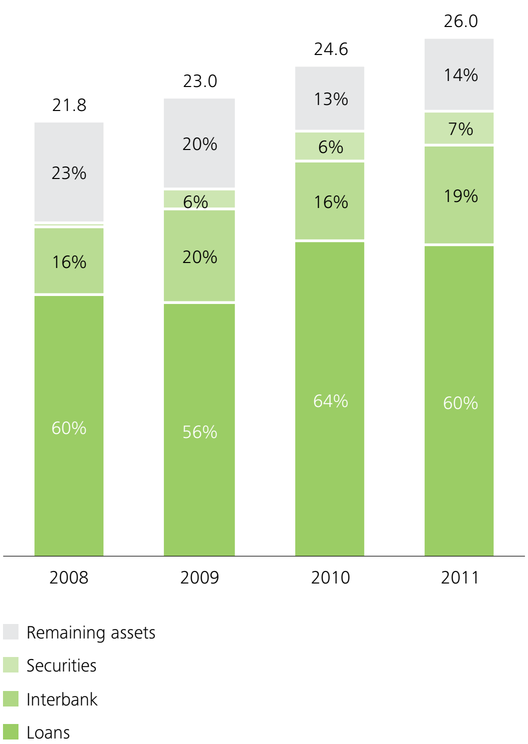

Figure RS8: Liabilities structure (EUR bn)

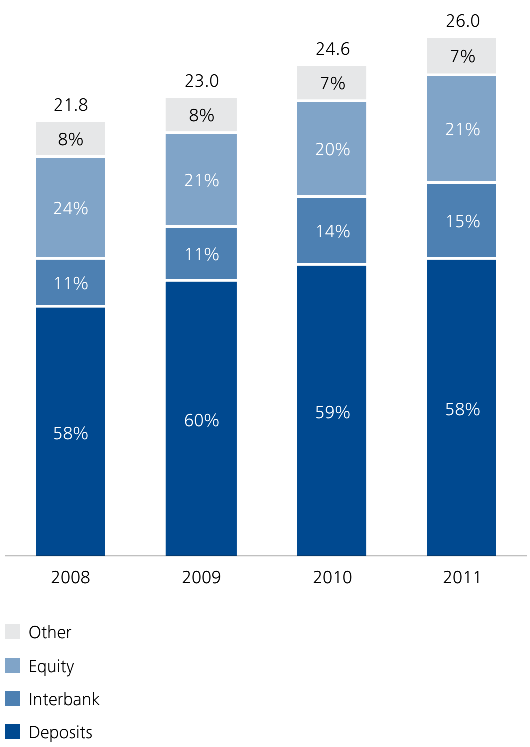

Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets/ FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
Banca Intesa	3.8	2.4	2.3	94.1	14.8%	2.4%	11.9%	43.2%	105.9%	208	81	1 196	Intesa Sanpaolo
Komercijalna	2.7	1.5	2.0	34.5	10.4%	1.3%	7.9%	63.0%	75.5%	217	46	894	State-owned
Unicredit	1.9	1.3	0.8	44.6	7.5%	2.3%	10.7%	33.8%	167.2%	75	115	1 994	Unicredit
Raiffeisen	1.9	1.0	1.0	52.1	7.3%	2.7%	9.6%	51.6%	97.4%	83	87	1 130	Raiffeisen
Societe Generale	1.9	1.2	1.0	13.5	7.1%	0.7%	4.1%	59.2%	124.4%	102	65	1 395	Societe Generale
Eurobank	1.6	1.0	0.8	28.4	6.1%	1.8%	6.6%	51.1%	114.9%	126	65	984	EFG
Hypo Alpe Adria	1.4	1.0	0.7	12.6	5.5%	0.9%	3.9%	47.0%	145.5%	n/a	106	1 701	HAA
AIK	1.4	0.7	0.9	32.5	5.4%	2.3%	7.1%	29.4%	74.3%	n/a	164	2 798	Piraeus
Vojvodanska	0.9	0.5	0.6	-13.7	3.5%	-1.5%	-7.0%	117.2%	79.2%	66	30	510	National Bank of Greece
Alpha Bank	0.8	0.5	0.6	-20.7	3.2%	-2.5%	-20.6%	129.6%	85.6%	n/a	24	570	Alpha Bank
Market	26	15.6	15	12.3	100.0%	0.0%	0.2%	61.3%	104.3%	2 383	56	889	

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Slovakia

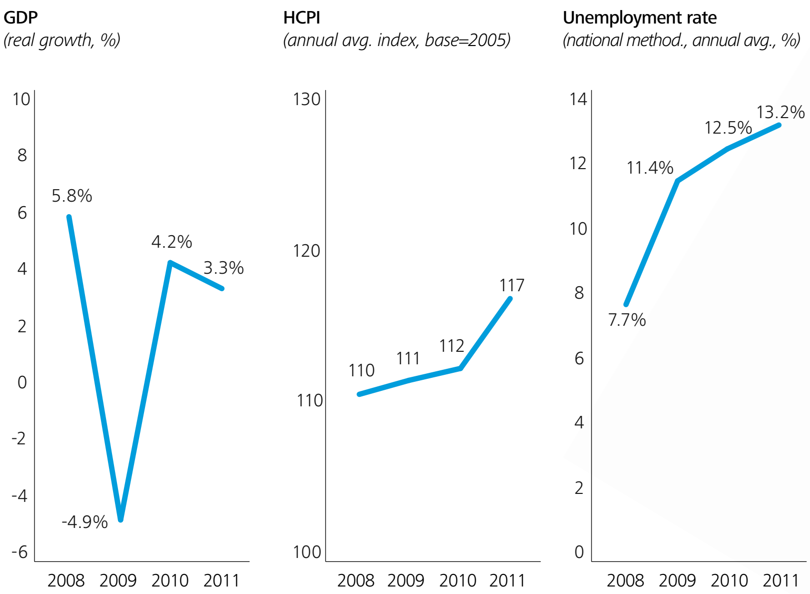
Economic outlook

Although the financial crisis hit Slovakia hard, the subsequent recovery proved to be swift and robust. The economy returned firmly to a growth path thanks to a rebound in foreign demand. In 2009, Slovak GDP decreased by 4.9% but it managed to quickly return to growth (by 4.2% in 2010). Growing exports were also a factor that contributed to a revival in private investment levels. But although the Slovak growth rate remains brisk, a more broad-based recovery has not yet materialised. This is a common theme in the CE region, with household consumption remaining low due to persistently high unemployment. The Slovak rate of unemployment has grown throughout the whole period following 2008, reaching 13% in 2011.

Although Slovakian banks theoretically have a total addressable market of 4.4M people (out of a population of 5.4M), just 66% presently has a banking relationship. The number of actual customers therefore stands at 2.9M.

There were 2.9M households in Slovakia in 2011, which means that Slovakia offers banks relatively little potential in terms of number of customers. Households in the second and fourth quintiles had monthly incomes of EUR 5.5K and EUR 8.8K respectively, making the Slovakian population relatively well off compared to other CEE countries. The Gini coefficient stood at 25.9, which puts it among the lowest for the region. This means there are relatively small differences in income between customer segments, creating opportunities for a quite standardised banking proposition.

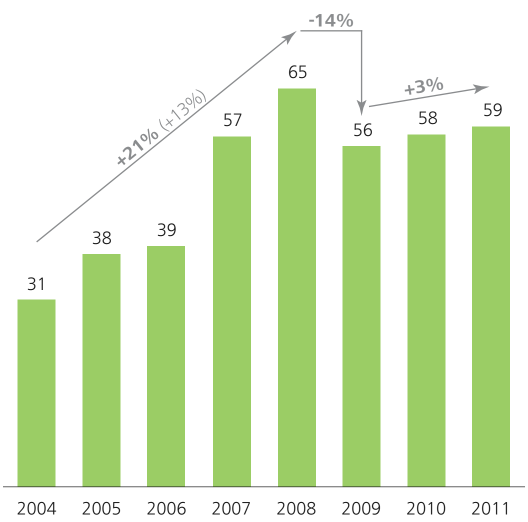
Figure SK1: Macroeconomic indicators



Introduction

"Old-school" banking continues to pay off.
Banks in Slovakia tend to do business the old-fashioned way. Their approach to lending remains unadventurous – growth rates in the past were brisk (with a CAGR of 21% in the run-up to the financial crisis), but still well below the breakneck pace experienced by some of the countries in the region. This is clearly reflected in the scale of banking intermediation, which, at 85% of GDP in 2011, puts the sector among the least well developed in the CE region. The Slovak attitude towards risk remains conservative, with the low popularity of FX lending being a good case in point. Lastly, the liability management strategy used by Slovak banks is cautious, with self-funding as its centre-piece. As it turns out, this simple recipe works surprisingly well, as the banking sector's profitability in Slovakia is among the strongest in the region.

Figure SK2: Assets of Slovakian banks (EUR bn)



Note: CAGR calculated in EUR (bold) and local currency (in brackets)

Slovakia has one of the highest profitability in the region.

Profitability – strong performance. Solid efficiency coupled with careful risk assessment and management all add up to strong profitability. The ROA and ROE ratios of the Slovak banks stood at 1.14% and 15.0% respectively in 2011, an excellent outcome by any measure. Comparison with other CE countries shows the sector's underlying strength, among the region's front-runners.

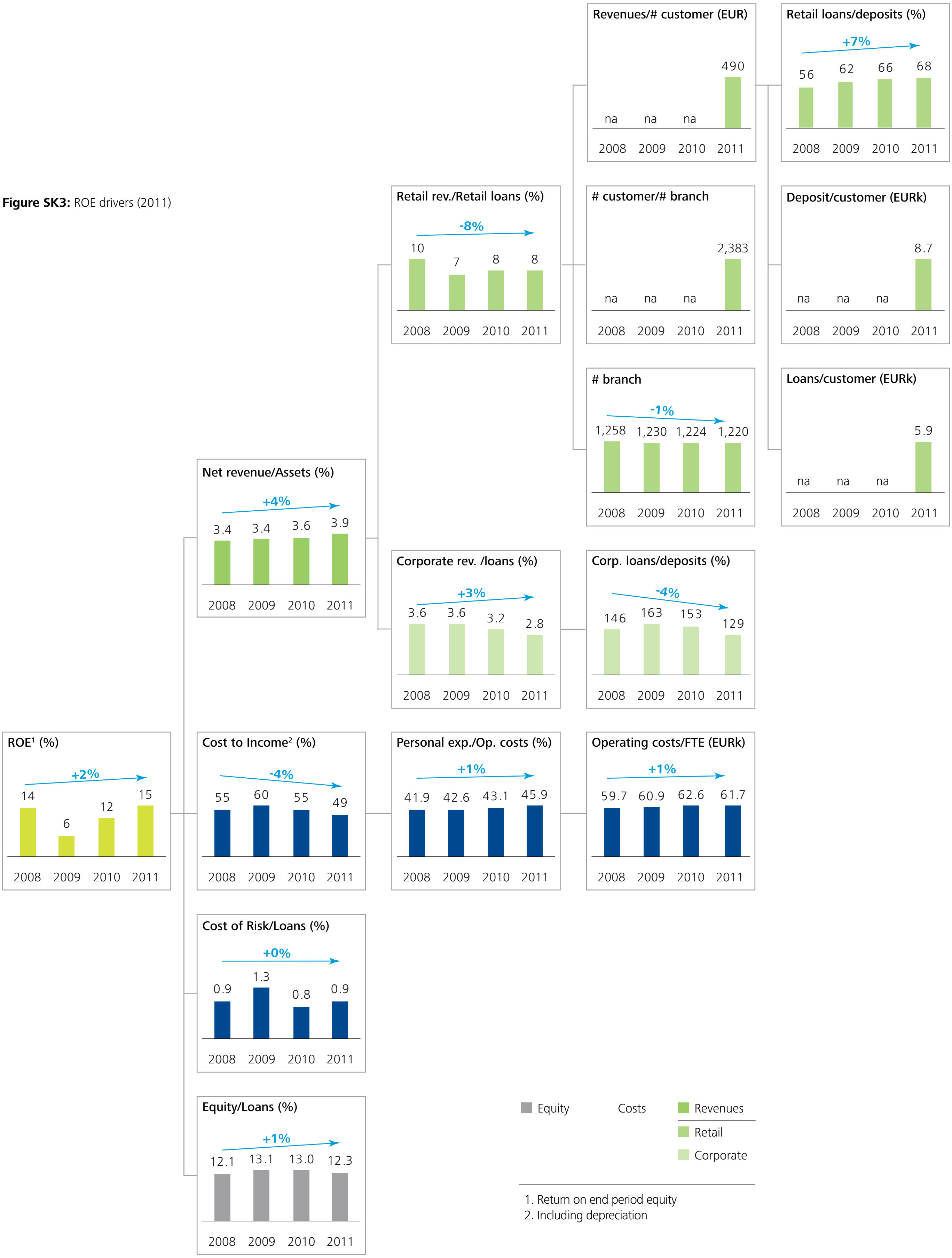
Looking at the individual drivers of ROE reveals a slight growth trend for banks' revenue margins – net revenue in relation to assets grew by an annual rate of 4.5% from 2008 to 2011. Such a positive trend is possible thanks to the firm profitability of the retail book, which showed an upward trajectory after a weak 2009, which offset some pressure coming from corporate customers. In terms of the cost-to-income and cost risk ratios alike, an improving situation over the period has favourably affected ROE.

Banking sector results

Top line – on the upward path once more. After the slump in total income that was seen in 2009, subsequent years have shown a positive trend that has enabled the top line to be gradually rebuilt. The total income of the Slovak banking sector amounted to EUR 2.2B in 2008. The next year, while its main income sources – net interest income (NII) and fees combined – remained stable, results from financial operations plummeted. This resulted in total income shrinking to EUR 1.9B. The next two years showed top-line expansion, helped by sound growth in NII and fees, with a limited contribution from financial operations. Recent years display a picture of balanced growth – total income in 2011 amounted to EUR 2.3B, exceeding the previous peak achieved in 2008.

The major role of NII and fees. The top-line composition of the Slovak banking sector has remained relatively stable in recent years. Unsurprisingly, NII is the most important constituent, with a contribution oscillating around the 80% mark. The high share of interest income is a result of a low loan to deposit ratio. In many countries where deposit wars are fought to finance assets, there is negligible room for banks to make a margin from their deposit products. In Slovakia the aspect of interest income that comes from the liabilities side is relatively high. Fees are next in terms of importance at around 20% of total income. Financial operations are the most volatile factor, but most often (barring windfall years) have a negligible impact on total

Figure SK3: ROE drivers (2011)



1. Return on end period equity
2. Including depreciation

income (around just 1%). Overall, therefore, the top line is driven by growth in NII and fees, which demonstrates a healthy pattern of expansion.

Costs – on the wane. During recent years, operating expenses have shown a consistent downward trend, enabling tangible efficiency gains. In 2008, the sector's cost base stood at EUR 1.23B; this was the starting point for a significant 7% decline in costs the following year. Cost deflation, albeit at a much lower level of 1%, was persistent over next two years, resulting in expenses falling to EUR 1.12 billion in 2011.

The cost side split shows that the relative contributions of personnel and administrative costs are quite close together at 46% and 42% respectively.

The remaining 12% of the cost base is attributable to depreciation and amortisation. Recent years (2008 -2011) have shown no growth in the costs of employment. This stability was achieved on the back of

Figure SK4: Income structure (EUR bn)

headcount cuts (2,400 employees have lost their jobs), although these savings have been offset by salary increases. Significant savings were made in remaining cost categories, however. Cuts in the "other administrative expenses" category have been considerable (with a CAGR of -4.9%), and even deeper cuts were achieved in depreciation and amortisation (with a CAGR of -6.2%). Branch closures were an option of last resort, and the number of operating branches has remained relatively stable (1,258 branches in 2008 and 1,220 in 2011). Such developments point to how stringent cost-control measures can translate into heightened efficiency.

Midway. The Slovak branch footprint is modest, with 20 – 30 branches per 100K citizens – this places Slovakia in the middle of the CE branch-density spectrum. A similar position is revealed by ATM statistics, which again place the country in the mid-range of the scale (50 to 70 ATMs per 100K inhabitants).

Halfway. Correspondingly, Slovakia seems to be positioned halfway between those countries where a traditional approach prevails and those where there is a greater acceptance of technology in banking. Indisputably, the majority sees branches as an indispensable way of using banking services. Nevertheless, a respectable 17% of people are happy to use online channels alone. The growing popularity of the online offering is further augmented by the share of customers who use both channels. At 23%, this forms the second largest group of users – those who embrace the benefits of branch and online banking alike.

Operational efficiency – best in class. Operational efficiency remains the strongest feature of Slovakia's banks. The cost-to-income ratio for the sector stood at a cutting-edge 48.8% in 2011, putting Slovak banks right at the forefront for the region. The sector's efficiency gains have been particularly evident over the last two years, thanks to recovering income and persistent cost trimming. In 2009, the sector's cost-to-income ratio stood at 59.6%, driven predominantly by a sharp reduction in income as financial results simply evaporated. Subsequent improvements over the next two years, by way of contrast, saw growth of more than 10% annualy, an outstanding achievement. An analysis of the stand-alone performance of Slovak banks reveals the importance of scale, as all the largest players deliver the best performance right across the board.

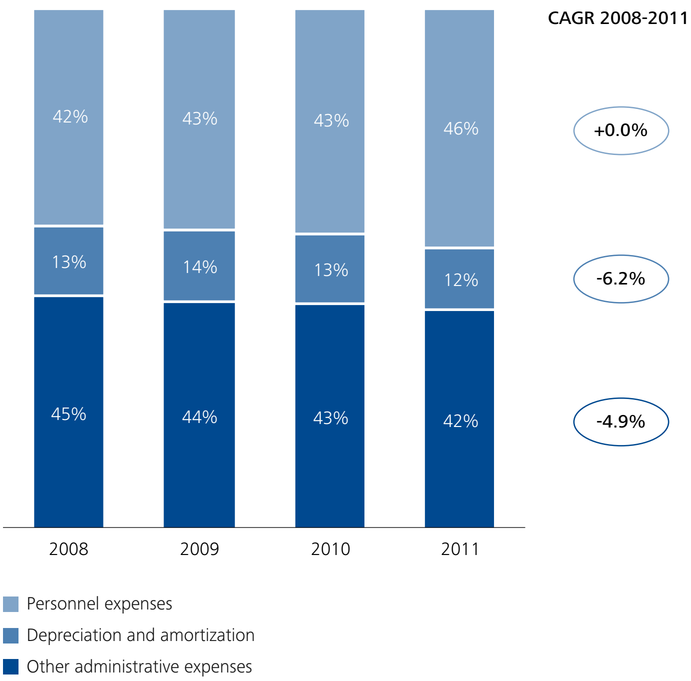
In terms of business volumes per employee, Slovak banks are ahead of the curve. The average asset value per employee was EUR 3.2M in 2011, which is not only visibly better than average, but also the second best result in the CE region. This also translates into strong net revenues per employee, which likewise is the second best in the region. Costs per employee are also higher than average, making the sector's costs the third highest in the region.

Concentration

The big three dominate. The high concentration of banking services has an important positive effect on the cost-efficiency of the Slovak banking sector, despite its small market potential in terms of customer numbers. The aggregate market share of the 10 largest Slovak banks totals a sizeable 85.2%, indicating how the largest banks dominate the financial landscape. This is the second highest concentration level among CE countries. The dominance of the leading players is particularly evident when you consider the combined market force of the three largest banks, which easily exceeds 50%. These three giants – Slovenska Sporitelna, VUB and Tatra Bank – enjoy a market share of well over 15% each. The next three are medium-sized banks, each with a share of between 5% and 9% (CSOB, Unicredit and Postova Banka). The remaining market share is fragmented and divided between a group of minor players, each with a stake of well below 5%.

Such a market structure strongly favours the largest banks, allowing them to leverage a strong strategic advantage. Consequently, market consolidation would probably be considered as a serious option for those smaller organisations, especially as their growth options are limited. Such a trend is already visible, as the Slovak banking sector is currently undergoing a process of further consolidation. A number of banks saw a change of ownership in 2011 and the preceding years. It is expected that this process will continue in the near future as a result of the problems being faced by Western European banks, which are seeking to sell their assets in many non-core markets, both to improve their capital base and repay loans granted by their governments. As well as the established players, two new and fast-growing "e-banks" are seeking either to gain new, young customers or to acquire customers from the competition.

Figure SK5: Structure of operational costs



48.8% cost-to-income ratio in relatively small country like Slovakia is impressive.

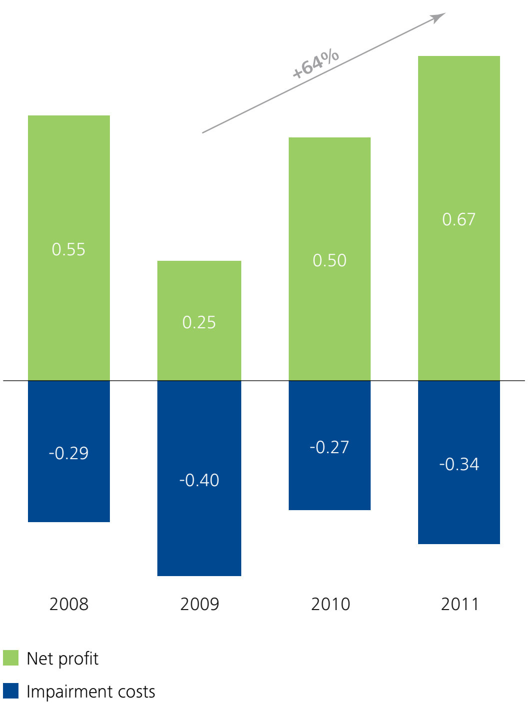
Private ownership prevails. Any state ownership in the sector is minor and not visible among the top players. Most are either owned by a foreign strategic investor (Erste, Intesa Sanpaolo, Raiffeisen) or are part of a local capital group. The size and scale of operations alongside good management practices coupled with firm oversight are among the pillars that enable excellent profitability.

Asset quality

The clear leader in terms of asset quality. Although the post-crisis world has caused asset quality to deteriorate somewhat, the decline has been less pronounced in Slovakia than in other CE countries. The share of non-performing loans stood at a mere 4.0% in 2011, growing only slightly from the 3.5% recorded in 2009. As a result, Slovakia has the lowest share of overdue loans of any CE country. Similarly, the country's coverage ratio is also the highest among its peers. This is no small feat considering the sobre realities of the post-crisis world, and illustrates the sound fundamentals of the sector.

Impairment charges – sound risk control. Recent years confirmed pressure on asset quality, yet its scope has turned to be limited. This limited impact on asset quality has allowed Slovak banks to keep impairment charges stable (in the range of EUR 0.3B to 0.4B) over the period from 2009 to 2011. Prudent risk management coupled with the country's macroeconomic recovery allowed banks to keep the cost of risk low (in the range of 0.8% - 1.3%). This is emphasised when compared to the other markets in the region, which shows that the ratio of impairment charges to the average book value is the lowest in the CE region. The strong coverage ratio, which stood at 81% in 2011 (the highest level among CE countries) confirms the resilient quality of the Slovak banking sector's assets.

Figure SK6: Net profit and impairment costs (EUR bn)



Funding

Deposit taking at the forefront. An examination of Slovak banks' liabilities structure shows that deposits are the dominant item in their consolidated balance sheet, standing at 68% in 2011 following a gradual increase in importance over recent years. While deposits are the main pillar of funding, support also comes from interbank and wholesale activities, each amounting to 7% or 8% of the total. Similarly, both categories have stabilised over recent years.

Funding structure – a cause of satisfaction. The sector's overridingly conservative approach to funding can be deduced from its loan-to-deposit ratio of 90.7%. Such a well-balanced proportion of loans to deposits conveys the strong self-funding ability of Slovak banks. Their lack of dependency on parent companies ensures that they will be able to expand their lending activities even if external funding were to run dry. This is a key advantage due the rising probability of a looming liquidity crunch among Western banks in the event of deepening eurozone problems, particularly as some banks have already been forced to withdraw from deeper involvement in the other countries in the CE region. The loan-to-deposit ratio in Slovakia has risen slowly over recent years, and its current level provides ample scope to increase further. Such an evolution of this ratio would increase the proportion of high-yielding assets in the mix, which in turn should translate into better asset profitability.

Latent growth potential. The map charting asset growth rates alongside the loan-to-deposit ratio places Slovakia in the top-left quadrant – the best place to be for growth prospects. Such a position paints an encouraging picture, as the positive growth rates of the recent past coincide with a healthy funding structure to

Figure SK7: Asset structure (EUR bn)

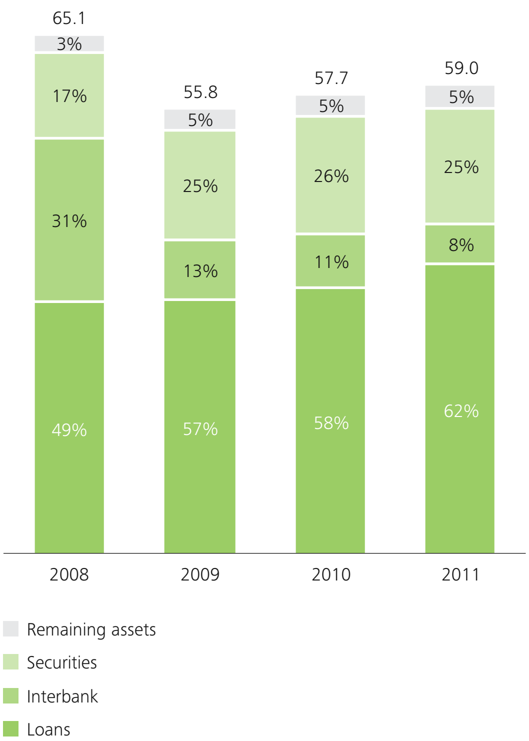
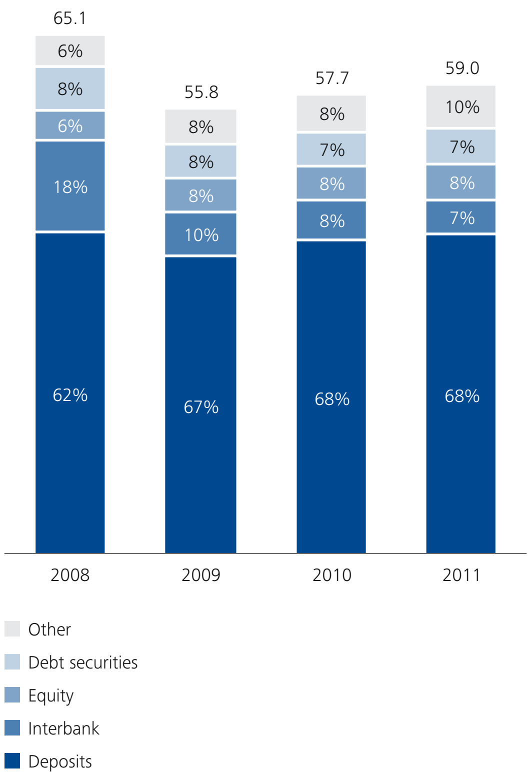


Figure SK8: Liabilities structure (EUR bn)



confirm the ongoing sustainability of the trend towards growth. It is well worth pointing out that this is a distinguishing feature, as only a handful of markets can enjoy such favourable prospects.

Loanbook

Stable and with prospects. Loans amount to over 60% of total assets in the consolidated balance sheet of Slovak banks. While the loanbook share has expanded over recent years, the current level still does not strike one as particularly high and leaves sufficient room for further expansion. The share of FX loans in the sector's loanbook is negligible, which means good stability. Another distinguishing feature is the relatively high share of interbank loans in the asset structure.

Regulatory environment

Banking tax arrives. Since 2012, Slovakia has also been one of the countries where the government collects tax revenues from the banking sector via a new levy on its indigenous banks and the branches of foreign organisations operating there. This was created to establish a fund, which may be used to address potential problems affecting the banking sector.

The more you have, the more you want. Although the tax rate was initially based on a flat rate of 0.1% when it went live in early 2012, after five months the government reconsidered its position and increased the rate to 0.4% (valid from 2013 onwards), which raises estimates of the tax's revenues from EUR 50M to EUR 200M. The 2011 consolidated profit of the Slovak banking sector amounted to EUR 674M; the tax burden therefore amounts to 7% (in 2012) or 30% (from 2013) of the bottom line.

Is it really worth it?

Although the introduction of the banking levy raises tax revenues in a swift and efficient manner (admittedly, no small feat in a world of persistent budget deficits) there are nonetheless several severe drawbacks to such an arrangement. Firstly, lower net earnings translate directly into lower potential growth rates for banks as they accumulate equity at a lower rate. In the extreme scenario of losses brought about by regulation, vanishing equity may force deleveraging with all the negative repercussions that involves.

Secondly, such a situation can result in a diminished capacity to lend, leading to outcomes including loan rationing, the exclusion of certain groups of customers and the discouragement of financial intermediation.

Third, an impaired ability to generate profit reduces banks' ability to improve their capital adequacy ratios, which is a vital factor for weaker or ailing banks. The consequence is that lower capital buffers will undermine the overall stability of the banking sector.

Fourth, inferior profitability reduces the willingness of investors to supply capital, with all the negative consequences that involves for the future development of the sector. And lastly, although taxing banks may be a sensible way to discourage further growth in those Western countries where the sector expanded too far, this is not the case for CE economies. This long list of potential adverse side effects shows what a risky gamble governments take when they sweat tax revenues from beleaguered banks.

Table: Top 10 banks' financial results (2011)

Name	Assets	Loans	Deposits	Net Profit	Market Share	ROA	ROE	C/I	LTD	# of branches	Income / FTE	Assets / FTE	Capital Group
	EURbn	*EURbn*	*EURbn*	*EURm*	*%*	*%*	*%*	*%*	*%*	*#*	*EURk*	*EURk*	
Slovenska Sporitelna	11.3	6.7	8.0	164.9	19.2%	1.5%	16.4%	43.0%	83.7%	292	141	2 891	Erste
VUB	10.8	6.9	7.5	157.7	18.3%	1.5%	14.7%	43.0%	92.3%	250	114	2 659	Intesa Sanpaolo
Tatra Banka	9.2	6.4	6.9	139.1	15.5%	1.5%	13.2%	54.1%	91.7%	151	118	2 611	Raiffeisen
CSOB	5.2	3.4	3.4	74.2	8.7%	1.4%	11.8%	55.7%	99.0%	137	112	2 522	KBC
Unicredit	3.9	3.0	2.4	31.8	6.5%	0.8%	7.4%	58.9%	123.6%	75	103	3 233	Unicredit
Postova Banka	3.0	1.3	2.4	1.3	5.2%	0.0%	0.5%	32.6%	53.5%	40	198	3 671	Istrokapital
PSS	2.2	1.8	1.9	28.8	3.8%	1.3%	11.5%	44.9%	93.0%	7	231	5 334	Erste
Prima Banka	1.9	1.2	1.6	-11.7	3.2%	-0.6%	-13.5%	99.9%	78.9%	49	94	3 378	Penta Group
Volksbank	1.6	1.1	1.2	-4.6	2.7%	-0.3%	-3.6%	73.2%	98.1%	41	91	2 764	Volksbank
OTP	1.2	0.9	0.9	1.1	2.1%	0.1%	1.1%	73.7%	95.1%	69	83	2 036	OTP
Market	**59.0**	**36.4**	**40.1**	**674.2**	**100.0%**	**1.1%**	**15.0%**	**48.8%**	**90.7%**	**1 220**	**126**	**3 240**	

Consolidated data for Tatra Banka

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The new regulatory realities, the demanding economic environment and the growing needs of customers are changing the landscape of the financial institutions sector in a dramatic way. Outlining the real sources of competitive advantage in these rapidly changing times is of upmost importance.

How are strategies and business models changing? How to address regulatory requirements? What are the challenges facing retail banking? In which direction is corporate banking heading? What is the future of insurance business? Where to look for new sources of revenue? How to invest in new technologies wisely? How to finance the activities of financial institutions in Central Europe?

The financial sector, more than ever, needs insights, reliable recommendations, independent opinion and drawing future directions, but most importantly high quality industry data.

Assumptions

In response to the growing information needs, Deloitte Central Europe has established the Deloitte Center for Financial Services as an independent research unit, a specialised center for knowledge, the aim of which is to analyse the financial sector, and publish reports and opinions on the financial institutions sector in Central Europe.

The main areas dealt with by the Center's experts are industry trends, strategies, creating competitive advantages, the impact of regulation on banks, the use of modern technologies and the analysis of customer needs and expectations. An important element of the Center's work is to collect and present examples of innovative and practical solutions for growth in rapidly changing times. The Center will maintain databases about the market, products, customers, institutions and their financial operational benchmarks, regulations and customers.

It is also equipped with tools, methodologies and competencies to run consumer research projects, develop market sizing models for different products and customer segments, build simulations and forecasts, and run benchmarking of individual institutions against peers.

The Center's research approach is industry focused, collaborative, and aims to bring a financial services integrated view. Through research, executive dialogue, and industry benchmarking, the Center originates and incubates leading practices surrounding core financial challenges.

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