Deloitte.

CE Banking Outlook
North-South Divide on the Road to Recovery

September 2014

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Contents

Foreword

The economy is supportive to the CE banking sector despite the crisis in Ukraine but the starting point and the outlook are quite different in the north and the south. This year marks an important turning point for both and we expect the focus of M&A to gradually shift from the north to the south.

Economic growth in Central Europe (CE) has picked up this year, outpacing the euro area as it transitions from recession to recovery. Domestic demand has picked up in much of the region, whilst euro area growth has been supporting exports. The escalation of the crisis in Ukraine (and Russian sanctions) has weighed on the still fragile European recovery in recent months. At this point, however, expectations are for growth in both CE and the euro area to remain on an upward path in 2014-16. Based on EIU forecasts, growth in CE should rise from 1.1% in 2013 to 2.3% in 2014 and 2.9-3.6% in 2015-16.

Six years after the financial crisis, there is a clear divide in the CE banking sector between north (Poland, Czech, Slovakia) and south (Hungary, Romania, Bulgaria, Croatia, Slovenia). The division starts with asset quality, affecting loan growth as well as risk costs, and hence ROE. NPL ratios peaked much earlier in the north and have been in decline. NPL ratios in the south are much higher and were still rising last year. Healthier demand has kept loan growth positive in the north and it picked up last year. At the same time, loans declined on most southern markets and growth, where visible, was poor. Risk costs in the north are already at near normal levels, whereas in the south remain very elevated and volatile.

This results in very different profitability levels, with an aggregate ROE of +10.8% in the north last year contrasting against -8.4% in the south.

This year marks a turning point for both the north and south. In the north, accelerating loan growth should support revenues and enable the banking sector to defend its double digit ROE (expected to stabilize in 2014-16), under pressure in recent years from lower margins and the build-up of capital. In the south, risk costs are reaching peak levels, either last year
or this year, on the back of accelerated balance sheet cleaning and event-driven losses (e.g. AQR in Slovenia last year, FX debt relief in Hungary this year). This sets the stage for a steep decline of risk costs in 2015-16, as loan quality should also improve on the back of economic recovery. Deleveraging pressures in the south should also ease gradually with loans bottoming out this year or next and returning to positive growth. We expect ROE to return to positive levels of 3-4% in southern markets by 2015-16.

As consolidation in the sector continues, the focus of M&A is likely to shift from the north (Poland) towards the south. That 4 out of the 5 largest CE transactions over the past two years have been in Poland can be attributed to the health of the market, reflected in demand and attractive pricing. As asset quality stabilizes and profitability is restored in the south, these markets should attract more interest from buyers going forward. There is a pipeline of planned disposals, among the top 10 banks, in Slovenia (NKBM, Abanka Vipa) and Croatia (Hypo Alpe-Adria-Bank) over the next two years.

Furthermore, our research shows the importance of critical mass to achieving sound profitability in CE, hence WE banks active in the region should be open to further consolidation, either seeking to grow by acquisition or to exit areas where profitability has been persistently low.

This report seeks to identify key drivers of banking sector profitability and balance sheet growth over the next three years. It also examines the competitive positioning of the largest players in the region and the strategic directions banks are taking in each CE market. We hope the study will help banking executives better understand the challenges and opportunities facing the region.

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Executive summary

An economic recovery is underway, despite recent developments in Ukraine. GDP growth in CE is expected to pick up from 1.1% in 2013 to 2.3% in 2014 and 2.9-3.6% in 2015-16. Risks, from the fragile euro area recovery and the conflict in Ukraine, have partly materialized and resulted in downward revisions but expectations remain for the region to stay on a positive trajectory.

European banks are expected to shift in the direction of growth, after years of deleveraging. Credit risk remains a concern but a successful AQR can restore confidence. A large share of CE bank assets is held by subsidiaries of WE banks. CE markets best positioned to benefit will have adequate local funding, asset quality on the mend, and sufficient returns on capital, characteristics that are best reflected in the north (PL, CZ, SK).

A turnaround in CE banking sector profitability, following a decline in ROE from 6.2% in 2012 to 3.7% in 2013, is expected to rebound to 4.8% in 2014 and 8.1-8.6% in 2015-16. This reflects a relatively stable outlook in the north (PL, CZ, SK) and a recovery, following event--driven losses and balance sheet cleaning, in the south (HU, BG, RO, HR, SI).

A stable ROE outlook in the north, as erosion in the Czech Republic (from 13.7% in 2013 to 12.2% in 2016) is offset by improvement in Poland (from 10.1% to 10.9%) and Slovakia (from 7.9% to 8.6%). Revenues are the key driver, as risk costs are already low, with relatively little room for improvement as the economy picks up.

An ROE turnaround in the south is expected from -8.4% in 2013 to 4.0% in 2016. A series of event driven losses (AQR in Slovenia last year, FX debt relief in Hungary and the bank run on CCB in Bulgaria this year) as well as accelerated balance sheet cleaning in Croatia and Romania have depressed earnings but set a foundation for the recovery ahead.

Asset quality is better in the north but risk costs are falling in the south. NPL ratios are much lower and trending down in the north but will peak only this year or next in many southern markets. However, elevated risk costs are expected to decline much more steeply in the south (from 4.0% in 2013 to 1.7% in 2016) than in the north (from 0.9% to 0.8%).

Loan growth is picking up in the north. Whilst demand is the main driver, supply is encouraged by relatively strong capital formation (profitability) and good asset quality.
The highest loan growth in CE is expected in Slovakia (2013-16 CAGR of 7.8%), where mortgages are expected to maintain a double-digit pace (12%), whilst the fastest acceleration this year is seen in Poland (3.2% in 2013 and 5.5% in 2014).

Deleveraging is easing in the south. Loan growth is still negative in most southern markets but should reach a turning point, as the economic recovery becomes more entrenched. A slowdown in Bulgaria has already turned around, whilst loans are seen bottoming out in Hungary and Romania this year and in Slovenia and Croatia next year.

Cost/income trends favor the north. With loan growth lifting revenues, cost/income ratios should fall in northern markets, led by Poland (from 52.8% in 2013 to 49.9% in 2016).
Weaker revenues will see many southern markets struggle to maintain cost/income ratios, though a revenue rebound and deeper cost cutting should make Slovenia an exception (66.1% to 51.3%).

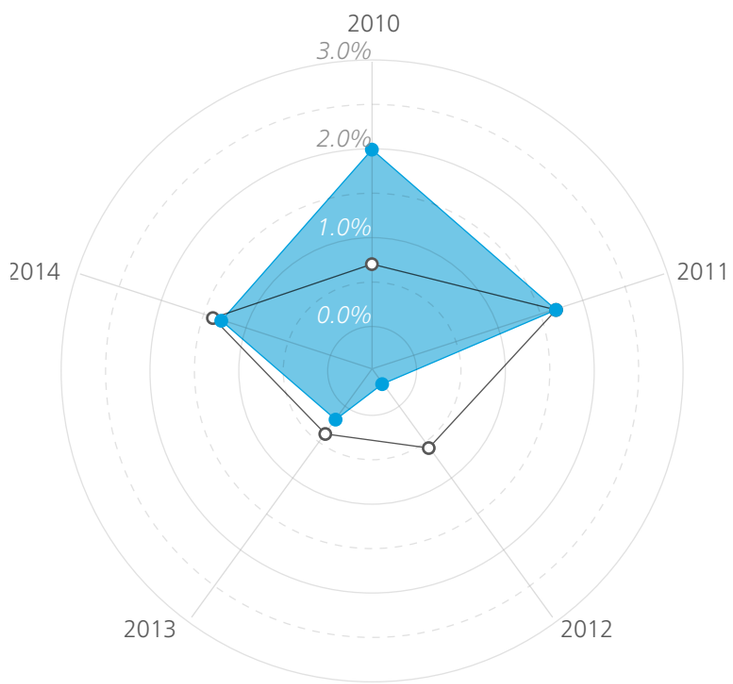
Consolidation in the south should benefit from economic recovery. The largest M&A transactions in CE in the past 2 years have been in Poland thanks to the health of the market, supporting demand and attractive pricing. In the coming years, markets in the south should see stabilizing asset quality and recovering profitability, whilst a pipeline of planned disposals waits.

Banks in the south are expected to focus on maximizing their bottom-line recovery, prioritizing management of non-performing assets, via collection, restructuring/workouts and sales. The relatively weak outlook for revenue growth in the south will necessitate a greater emphasis on cost cutting by optimizing distribution, operations, and exiting non-core businesses.

As market volumes pick up, banks in the north are expected to focus on customer growth, smaller players on customer acquisition and incumbents on retention.
Effective strategies will address changing customer channel behavior, utilizing analytics and new mobile technology.
In a lower margin environment, cross-selling will also be key to growing customer profitability.

Banking outlook in Central Europe

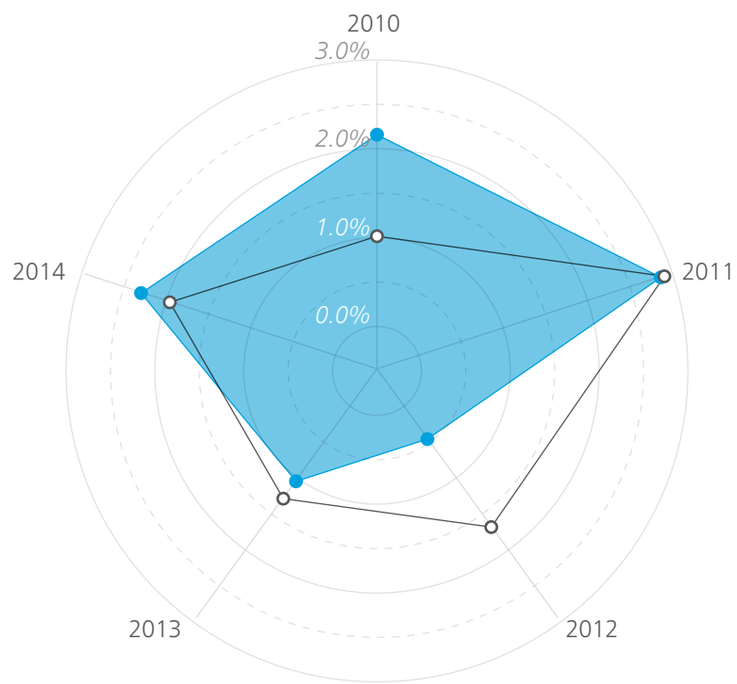
Chart 1: GDP expectations and actual for EU28



Actual (latest EIU forecast for 2014)
Forecast (based on Autumn EC forecast of previous year)

Source: Eurostat, European Commission, EIU

Chart 2: GDP expectations and actual for CE (8 countries)



Actual (latest EIU forecast for 2014)
Forecast (based on Autumn EC forecast of previous year)

Source: Eurostat, European Commission, EIU

CE accelerating as the Europe transitions from recession to recovery

With Europe transitioning from recession to a tepid recovery, economic growth in CE should accelerate. GDP growth in the EU28 is forecast, by the EIU, to rise from 0.2% in 2013 to 1.3% in 2014 and 1.6-1.8% in 2015-16, whilst growth in CE is seen ca. 1-2 p.p. above WE rising from 1.1% in 2013 to 2.3% in 2014 and 2.9-3.6% in 2015-16. Growth in Europe is uneven and has faltered in recent months, due to the deadlock over Ukraine with Russia.

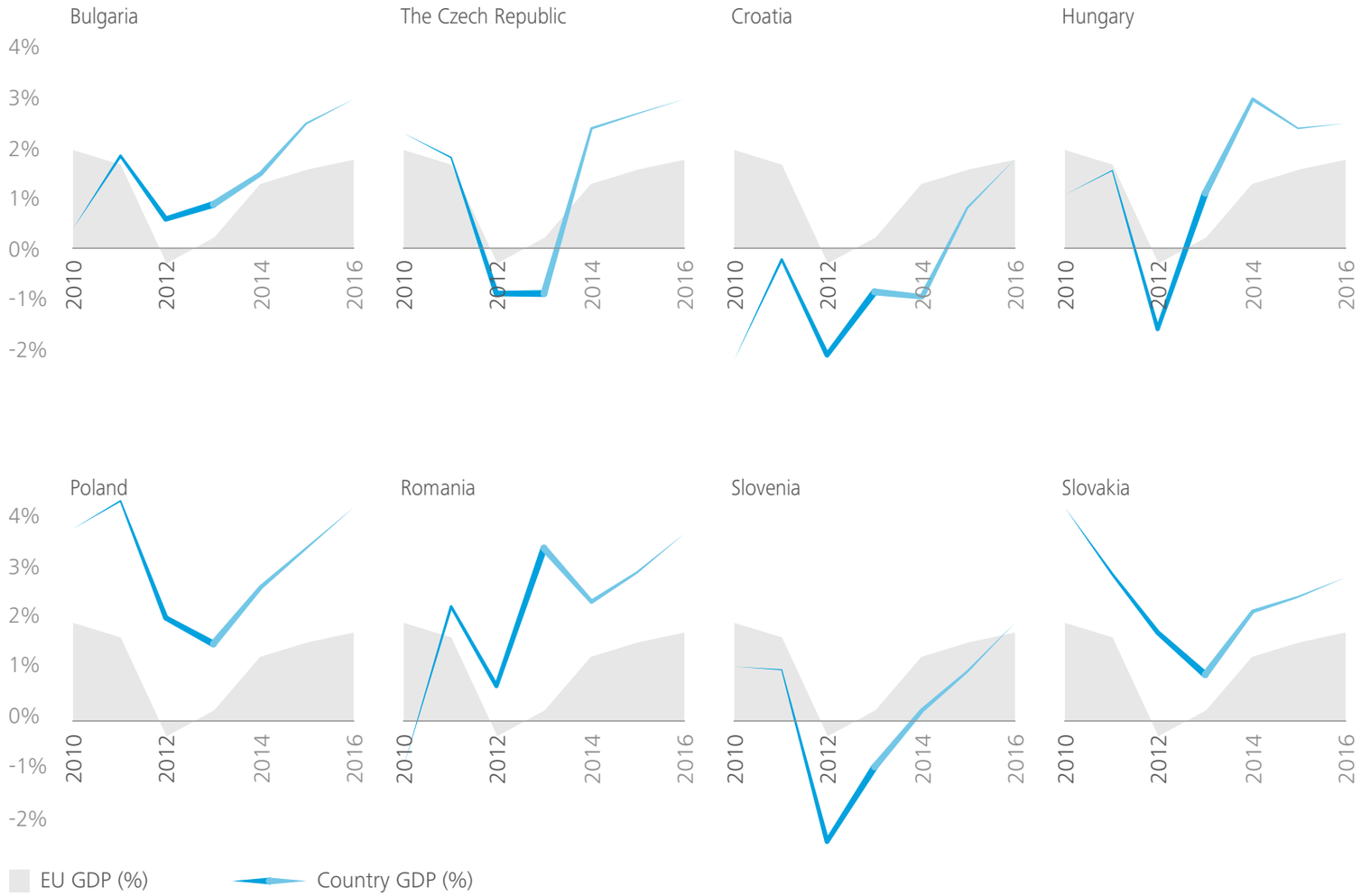
There are negative factors in geopolitical risk, fragile economic sentiment, unutilized capacity, and high unemployment. However, domestic demand will benefit from accommodative ECB monetary policy, house prices are showing signs of stabilization, and exports are supported by global growth.

Even after the most recent downward revisions, taking into account developments so far in Ukraine, the euro area is still forecast, by the EIU, to accelerate growth (after a decline of -0.3% in 2013) from 0.8% in 2014 to 1.2-1.7% in 2015-16, keeping a positive trajectory that will be important for CE exports (with the euro area accounts for over 50%) and business confidence.

Bank balance sheets in Europe have strengthened

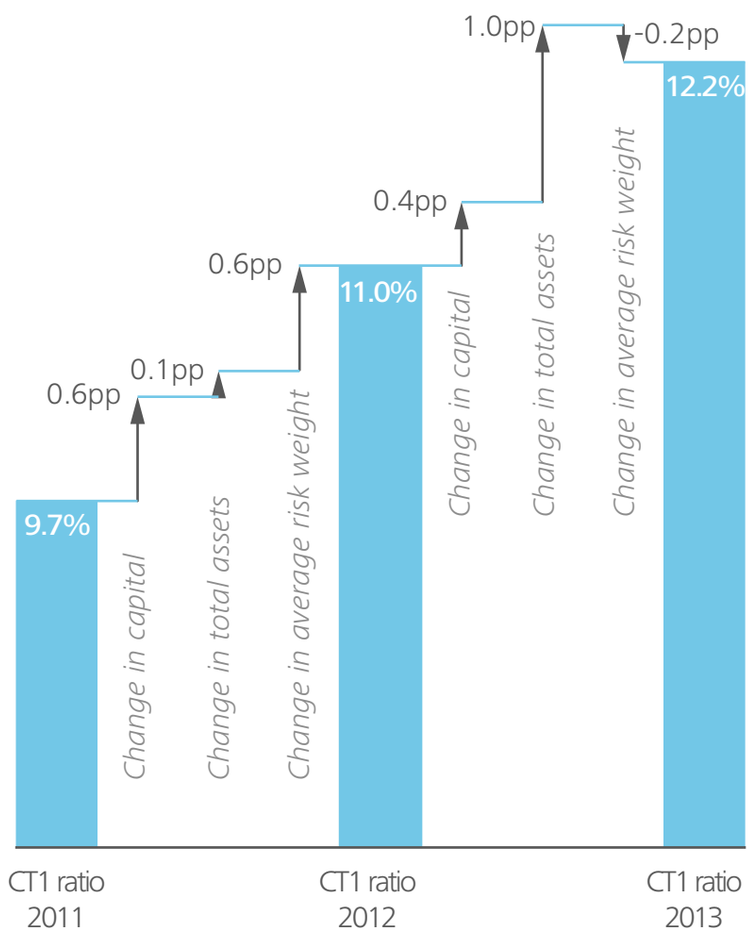
The creditless recovery so far in the Euro area has been partly a function of weak demand but also reflects a strengthening of bank balance sheets. Euro area private sector loan growth was down 1.7% y/y in June 2014, following a decline of 2.3% y/y in 2013. Banks have been deleveraging to help meet rising capital requirements under BIS III. On aggregate, the two equally

Chart 3: Real GDP Growth



Source: Eurostat, European Commission, EIU

Chart 4: Tier I ratio decomposition



Note: The aggregate core Tier 1 ratio is based on publicly available data for a sample of 69 SBGs.
Source: ECB, SNL Financial

important drivers of increased tier 1 ratios for euro area significant banking groups (SBGs), from 9.7% in 2011 to 12.2% in 2013, have been asset reductions (+1.1 p.p.) and increased capital (+1.0 p.p.). According to the ECB, euro area SBGs have reduced their consolidated balance sheets by 20% from peak levels. A further strengthening of balance sheets has been seen in front of the ECB's comprehensive assessment and stress tests this year.

A successful AQR can restore confidence…

The ECB's asset quality review (AQR), by ensuring a level playing field, should help address market concerns over credit risk. Rising provisioning levels, which have weighed on bank earnings over past year, have been in part related to preparations for the assessment. According to the EBA's risk dashboard (covering 55 EU banks), whilst the weighted-average impaired loan ratio increased from 6.5% to 6.8% in 2013, specific provision coverage increased from 41.8% to 45.9%. At the same time, however, the banks in the lowest quartile of coverage made the least improvement.

The dispersion widened between the 25th percentile (rising from 34.9% to 35.6%) and the median (41.7% to 46.1%). By using common definitions for non-performing asset classification and debt forbearance, there should be greater visibility of the adequacy of banks' provision coverage.

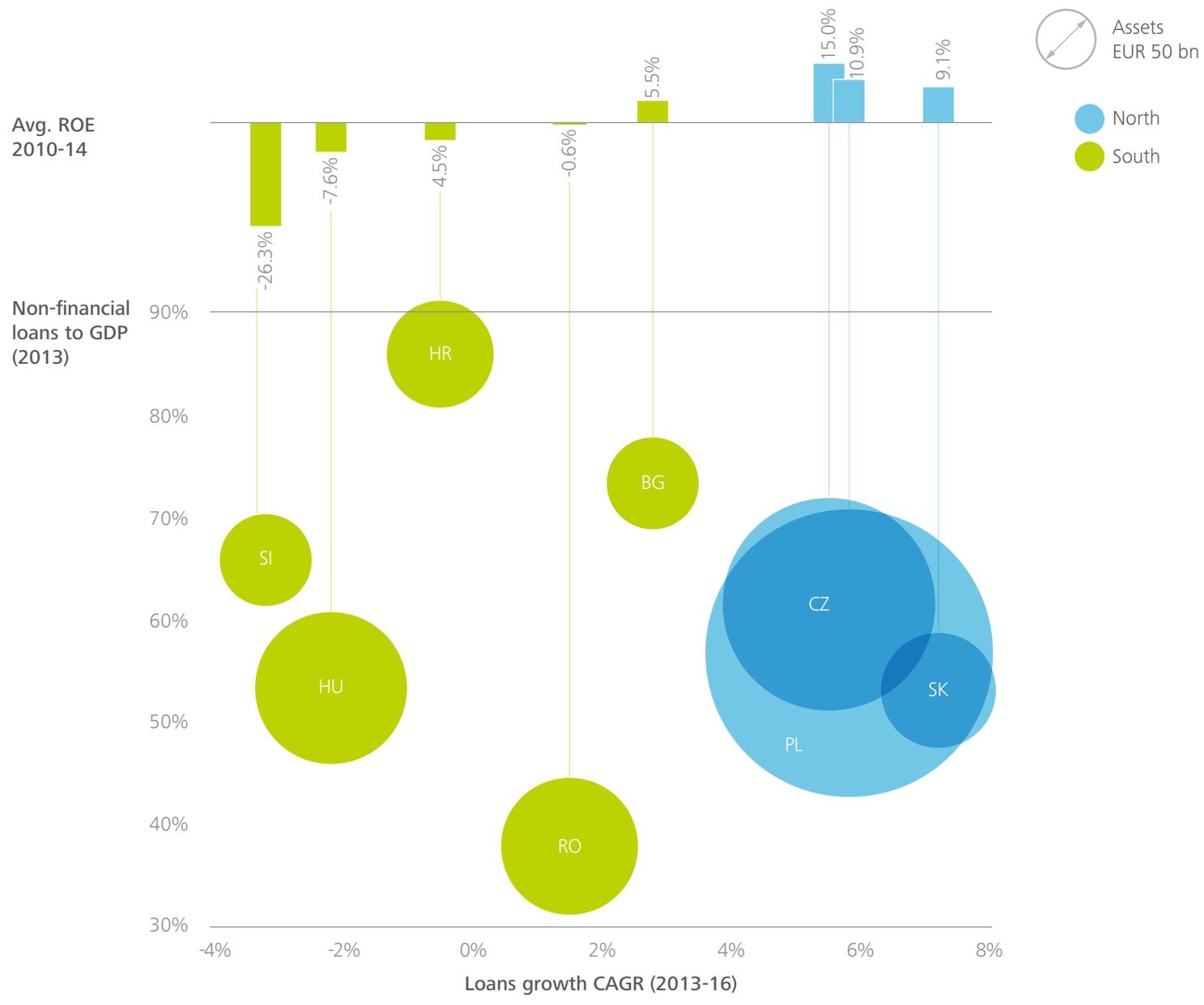
The impact will depend on implementation and the results but a successful AQR can restore confidence in banks' capital strength.

…beyond which a shift in focus towards growth will benefit CE

If the focus of European banks gradually shifts towards growth in the coming years as we expect, higher potential CE markets should benefit. A large share of CE banking sector assets are held by subsidiaries of WE banks (e.g. 7 of the top 10 Polish banks, 5 of the top 10 Hungarian banks, etc.). Convergence (the income gap) supports ongoing expectations for above average economic growth in CE and demand will benefit in the long-term from the relatively low penetration levels of financial products. However, CE suffered a slowdown and the performance of individual markets continues to vary greatly.

The markets best positioned to deliver growth in the next few years will have adequate levels of local deposit funding, asset quality that is on the mend, and offer returns on capital sufficient to attract investment, characteristics that are best reflected in the north.

Chart 5: Loans to GDP in 2013 and Loans growth CAGR (2013-2016)



Source: Eurostat, National Bank of Poland, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank, Deloitte forecasts

A turnaround in CE banking sector profitability

The decline of CE banking sector profitability in recent years was accompanied by a widening north-south divide. The gap is however expected to gradually narrow as the sector recovers over the next few years. While the ROE in CE declined once again from 6.2% in 2012 to 3.7% in 2013, the minor erosion in the more profitable north from 12.4% to 10.8% contrasted with a sharp decline in the south from -3.5% to -8.4%. The key factors contributing to the gap in profitability have been asset quality, with net provisioning peaking much earlier in the north than in the south, and event-driven losses in individual markets (e.g. Slovenia's AQR in 2013, Hungary's FX mortgage refunds in 2014). Our expectation for an improvement of ROE in CE to 4.8% in 2014 and 8.1-8.6% in 2015-16 reflects a relatively stable outlook in the north and a recovery, after balance sheet cleaning, in the south to -5.7% in 2014 and 3.2-4.0% in 2015-16.

ROE recovery expected in the south

Balance sheet cleaning in the south is setting the stage for an earnings recovery in 2014-16, expected to be led this year by Slovenia and Croatia, and followed next year by Hungary, Romania, and Bulgaria. Slovenia's AQR led to a huge EUR 3.6bn loss (-97% ROE) and recapitalization last year but a decline in net provisioning should enable it to approach breakeven this year and lift ROE to 1.3-3.7% in 2015-16. In Croatia, accelerated provisioning (on tightened central bank regulations) drove down earnings by 73% last year (ROE 1.3%) but improved coverage and slowing NPL formation is expected to help lift ROE back to 2.5% in 2014 and 2.9-3.7% in 2015-16.

The recommendation of Romania's central bank to raise provisions and accelerate write-offs is expected to see ROE drop to -1.6% this year before receding risk costs enable a recovery to 2.7-3.9% in 2015-16. Bulgaria, which has reported the highest profitability among southern markets in recent years, faces a setback this year due to losses at CCB (where a loan quality review still underway) but receding risk costs are expected to increase ROE to 6.8-7.1% in 2015-16. Hungary should rebound after a huge one-off loss this year (ROE -23%), due to the cost of FX debt relief (HUF 600-900bn, -20-30% of equity), though ongoing industry taxes are expected to limit ROE to 2.3-2.8% in 2015-16.

Stable ROE outlook in the north

Profitability in the north is expected to remain relatively stable, with erosion in the most profitable market (the Czech Republic) offset by improvement in Poland and to a lesser extent Slovakia. The revenue outlook is a key driver, as risk costs are already low in these countries and therefore have only moderate room for improvement due to the economic pick-up. In the Czech Republic, margin pressure from competition and low interest rates is expected to continue drive a decline in ROE from 13.7% in 2013 to 12.9% in 2014 and to 12.5-12.2% in 2015-16. In Poland, revenue growth is benefiting from a margin recovery this year and an acceleration of lending, which should see its ROE level out at 10.2% in 2014 and rise to 10.5-10.9% in 2015-16. Loan growth is also expected to contribute to a moderate ROE improvement in Slovakia

Table 1. Return on average equity (%)

	2010	2011	2012	2013	2014	2015	2016
North	12.3	13.6	12.4	10.8	10.7	10.8	11.0
Poland	10.4	12.7	11.2	10.1	10.2	10.5	10.9
Czech	16.8	15.1	16.3	13.7	12.9	12.5	12.2
Slovakia	9.6	11.9	7.7	7.9	8.3	8.5	8.6
South	2.9	-1.6	-3.5	-8.4	-5.7	3.2	4.0
Hungary	0.3	-10.4	-6.1	1.1	-22.6	2.3	2.8
Romania	3.1	1.1	-6.4	0.8	-1.6	2.7	3.9
Bulgaria	6.3	5.7	5.3	5.3	5.0	6.8	7.1
Croatia	7.0	7.0	4.9	1.3	2.5	2.9	3.7
Slovenia	-2.3	-10.9	-19.6	-96.9	-1.6	1.3	3.7

Source: Eurostat, National Bank of Poland, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank, Deloitte forecasts

from 7.9% in 2013 to 8.3% in 2014 and 8.5-8.6% in 2015-16. A large part of the profitability gap between Slovakia and its northern peers is explained by its bank levy (lowering ROE by around 2 p.p.). Although this is set to be cut in half next year, the P&L impact is expected to be offset by a new contribution to the European bank resolution fund.

NPL ratios peaked much earlier in north…

NPL ratios have been trending lower in the north and already low risk costs are expected to benefit only very moderately from economic recovery. The best asset quality in CE is in the Czech Republic and Slovakia where the NPL ratios, 5.5% and 5.4% respectively in 2013, have been gradually trending lower since 2010 and are forecast to reach 4.7% in 2016. Poland's NPL ratio, falling since 2012, is higher than its northern peers, 8.5% in 2013, but is expected to decline more quickly over the next few years to 7.2% in 2016, supported by its active debt purchase market (broadening to include mortgages). Differences in risk costs (net provisioning / average gross loans) among northern markets can be explained at least in part by loan book structure and are expected to persist. Slovakia's very low risk costs, 0.6% in 2013, reflect a high proportion of mortgages (40% of loans to the non-financial sector) and lower non-mortgage retail loans (14%). Poland's somewhat higher risk costs, 0.9% in 2013, reflect a higher level of non-mortgage retail lending (24%). The Czech Republic falls in between.

...and are peaking only now in the south…

NPL ratios will peak only this year or next in many southern markets. NPL ratios are expected to decline this year in Slovenia, Hungary, and Romania, whilst peaks are seen this year for Bulgaria and next year for Croatia. Banks in Romania are accelerating write-offs of older NPLs, following a central bank recommendation, and are seen reducing CE's highest NPL ratio from 21.9% in 2013 to 18% this year and further to 16% in 2016. In Hungary, where costly FX debt relief will benefit the retail segment, the NPL ratio is expected to fall from 16.0% in 2013 to 14.4% in 2016 (a more significant decline is possible depending on implementation of a National Asset Management Company). In Slovenia, large transfers to the Bad Asset Management Company (BAMC) cut the NPL ratio from 19.9% to 14.9% last December and a further decline is seen to 14.5% in 2014 and 13.2% in 2016. In Bulgaria, CCB (under special supervision) is seen contributing to increase in the NPL ratio from 17.0% in 2013 to 18.7% this year, before it falls back to 17.0% in 2016. Given its relatively weak economic outlook, in Croatia, the NPL ratio is expected to continue to rise, from 16.1% in 2013, towards a peak of 19.4% in 2015, before moderating to 18.8% in 2016.

…but elevated risk costs in the south should fall steeply

Elevated risk costs in southern markets are expected to decline steeply on the back of economic recovery and prerequisite balance sheet cleaning. Our forecast is for risk costs in the south to ease from 4.0% in 2013 to 3.8% in 2014 but then fall more sharply to 1.9-1.7% in 2015-16. The expected step down in risk costs next year results from

Table 2. Cost of risk (%)

	2010	2011	2012	2013	2014	2015	2016
North	1.4	1.1	1.0	0.9	0.9	0.8	0.8
Poland	1.5	1.1	1.1	0.9	0.9	0.9	0.8
Czech	0.9	1.0	0.6	0.8	0.7	0.7	0.7
Slovakia	0.9	1.0	0.5	0.6	0.6	0.6	0.5
South	2.6	3.2	2.7	4.0	3.8	1.9	1.7
Hungary	2.4	4.1	1.1	1.8	6.6	1.4	1.4
Romania	3.7	3.4	4.7	4.0	4.1	2.8	2.4
Bulgaria	2.5	2.4	2.2	1.9	2.3	1.7	1.6
Croatia	1.4	1.3	1.3	2.1	1.9	1.8	1.5
Slovenia	2.6	3.8	5.3	14.4	2.9	2.4	2.1

Source: Eurostat, National Bank of Poland, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank, Deloitte forecasts

Table 3. Loan growth (%)

	2010	2011	2012	2013	2014	2015	2016
North	8.4	12.6	2.2	4.3	5.5	6.9	7.7
Poland	10.5	16.2	1.9	3.2	5.5	7.0	7.6
Czech	4.3	6.4	2.6	6.7	5.1	6.4	7.3
Slovakia	6.6	8.7	2.7	5.7	6.8	7.6	8.9
South	4.0	2.3	-5.0	-4.7	-2.6	1.1	2.7
Hungary	3.1	0.6	-14.2	-5.2	-6.7	0.4	1.8
Romania	5.6	3.5	1.5	-2.3	-0.2	2.3	4.3
Bulgaria	1.2	4.0	3.0	0.9	2.1	3.4	4.5
Croatia	5.8	6.2	-3.7	1.4	-1.3	-0.3	1.7
Slovenia	2.7	-2.4	-5.9	-21.1	-6.7	-1.4	0.1

Source: Eurostat, National Bank of Poland, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank, Deloitte forecasts

a series of event-driven spikes in provisioning. Risk costs are expected to decline this year, steeply in Slovenia (after last year's AQR) and moderately in Croatia (after last year's change in loan classification rules). At the same time, however, there will be a jump in risk costs this year in Hungary (due to FX debt relief) and in Bulgaria (due to the loan quality review at CCB), whilst Romania also faces another difficult year (due to accelerated write-offs). Risk costs on southern markets are expected to normalize more gradually beyond 2015.

Loan growth is picking up in north…

Loan growth is picking up this year across the board in northern markets. Whilst demand is the main driver, supply is encouraged by relatively strong capital formation (profitability) and asset quality. The highest loan growth in CE is expected in Slovakia, whilst the fastest acceleration this year is seen in Poland. In Slovakia, loan growth is expected to rise from 5.7% y/y in 2013 to 6.8% y/y in 2014 and reach a 3Y (2013-16) CAGR of 7.8%. Mortgages in Slovakia are seen maintaining their current double-digit pace (3Y CAGR 12%), whilst a turnaround in investment should help relatively sluggish corporate loans return to positive growth this year. Czech loan growth is expected at 5.1% y/y in 2014 and a 3Y CAGR of 6.2%, also led by mortgages (3Y CAGR of 7.3%) but at a more moderate pace. Loan growth in Poland is expected to rise from 3.2% y/y in 2013 to 5.5% y/y in 2014 and reach a 3Y CAGR of 6.7%. Initially led by a relatively quick recovery in consumer (6.5% y/y) and corporate loans (6.3% y/y). Mortgages (5.1% y/y in 2014 and 3Y CAGR of 7.4%) are expected to make a stronger contribution to Poland's growth over the medium

term. Loans/deposits ratios, in Poland (112% in 2013), as well as Slovakia (95%) and the Czech Republic (75%), are expected to trend gradually higher.

…but deleveraging easing in south

Following years of deleveraging, loan growth is still negative in most southern markets but should reach a turning point, as the economic recovery becomes more entrenched. Loans are seen bottoming out in Hungary and Romania this year and in Slovenia and Croatia next year, whilst Bulgaria has maintained positive growth. In Hungary, FX debt relief (deducted from loan principal) is expected to contribute to a steep loan decline of -6.7% y/y this year but thereafter, the retail segment should lead a return to positive growth of 0.4-1.8% in 2015-16. In Romania, accelerated write--offs are expected to contribute to further loan decline of -0.2% y/y this year but growth should pick up to a 3Y CAGR of 2.1% led by mortgages (3Y CAGR of 7.6%). The steepest decline in CE is taking place in Slovenia (managed via transfers to the BAMC), mainly related to the corporate sector, with loans down -21% y/y in 2013 and an expected 3Y CAGR of -2.7%. The near-term outlook for Croatia is stagnation, with loans declines gradually easing, -1.3% y/y in 2014 and -0.3% y/y in 2015, in front of a gradual turnaround in 2016. Bulgaria's loan growth, after reaching a low point (+0.9% y/y) in 2013, is expected to gradually pick up to a 3Y CAGR of 3.3%. Loans/deposits ratios in southern markets (above 100% in 2013, with the exception of Bulgaria 91%) are expected to continue to trend lower across the board.

Falling cost/income in the north…

With loan growth supporting revenues and cost containment, we expect falling cost/income ratios and a growing pre-provision operating profit in northern markets in 2014-16. Poland should deliver the strongest growth of pre-provision operating profit (3Y CAGR of 5.5%), after seeing a recovery this year of both its margin (adjustment of funding costs) and net fee income (base effect, after negative impact last year from changing recognition of bancassurance). Despite headwinds (e.g. margin pressure from lower interest rates and lower interchange fees), we see relatively strong revenue growth (3Y CAGR of 3.4%) for Poland and a decline of cost/income from 52.8% in 2013 to 49.9% in 2016.

In Slovakia, we expect a pre-provision operating profit 3Y CAGR of 4.0% and a decline in cost/income from 56.0% in 2013 to 54.0% in 2016. Slovakia should benefit from the strongest loan growth in CE and a 50% reduction of its bank levy next year but faces a partial offsets from margin pressure (rollovers and refinancing to lower interest rates) and new contributions to the banking resolution fund. In the Czech Republic, we expect a pre-provision operating profit 3Y CAGR of 2.1%, with cost/income declining from 43.0% in 2013 to 41.7% in 2016. The Czech Republic has a relatively weak revenue outlook, due to continuing margin erosion (low interest rates and competition) and a trend of declining fee income but should maintain a track record of tight cost containment.

..but outlook for cost/income mixed in south

Most southern markets will struggle to keep cost/income ratios on a downward path but deeper cost cutting in Slovenia should make it the exception. The cost/income ratio in Slovenia is expected to improve from 66.1% in 2013 to 53.9% in 2014, mainly on the back of recovery in the margin and other non-interest income, and remain on a downward path to 51.3% in 2016, despite revenue stagnation, due to significant cost cutting (3Y CAGR of -3.5%).
In Bulgaria, we also expect a fall in the cost/income ratio from 53.5% in 2013 to 50.5% in 2014, on the back of a higher margin (reduced competition for deposits). However, due to a lack of revenue growth for Bulgaria in 2015-16, we expect the cost/income will rise back to 51.6% in 2016.

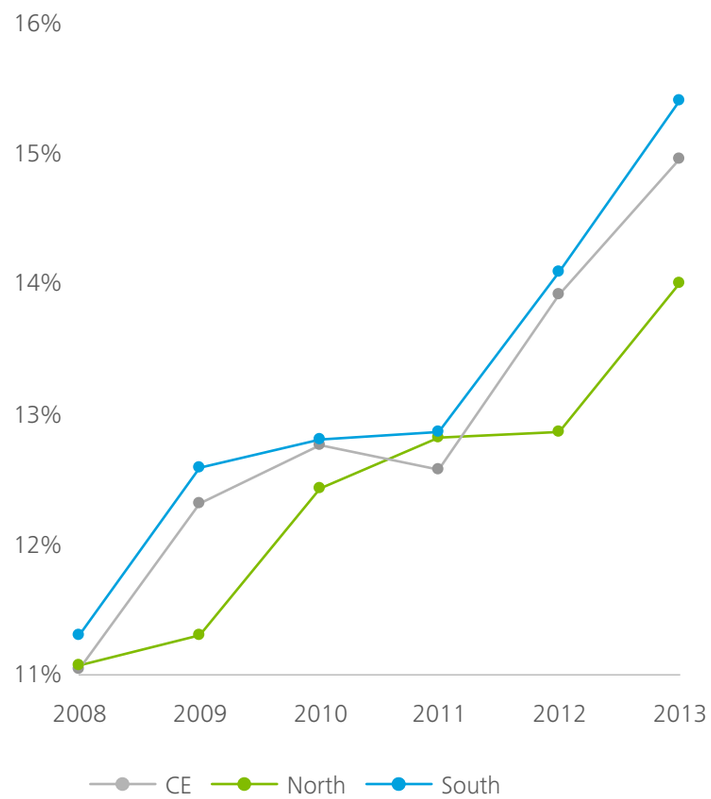
Hungary is expected to follow a similar trend with the cost/income ratio falling from 69.2% in 2013 to 66.4% in 2014 before rising back to 69.1% in 2016. Revenues are benefiting from higher fee income this year, following last year's introduction and ratcheting up of the financial transaction tax, but will suffer next year as FX debt relief hits net interest income.
In Croatia, we expect a flat development of the cost/income ratio from 52.2% in 2013 to 52.0% in 2016, with little growth seen in either revenues or costs. In Romania, the outlook is relatively poor, with the cost/income expected to rise from 55.7% in 2013 to 59.9% in 2016. Whilst Romanian banks are expected to cut costs (3Y CAGR of -0.5%), the sector faces margin erosion from lower interest rates and lower securities income once interest rates level out.

Table 4. Cost to income (%)

	2010	2011	2012	2013	2014	2015	2016
North	50.2	48.9	49.7	50.3	49.6	48.9	48.1
Poland	52.4	50.7	50.9	52.8	51.9	51.0	49.9
Czech	44.0	45.0	43.9	43.0	42.3	42.0	41.7
Slovakia	54.6	49.6	61.0	56.0	54.7	54.2	54.0
South	52.9	52.8	60.3	59.3	57.5	59.2	59.0
Hungary	58.6	53.8	79.7	69.2	66.4	70.0	69.1
Romania	51.4	55.0	58.9	55.7	57.2	59.4	59.9
Bulgaria	48.8	50.0	52.0	53.5	50.5	51.7	51.6
Croatia	48.3	47.9	51.7	52.2	51.8	51.8	52.0
Slovenia	52.2	53.7	47.4	66.1	53.9	53.3	51.3

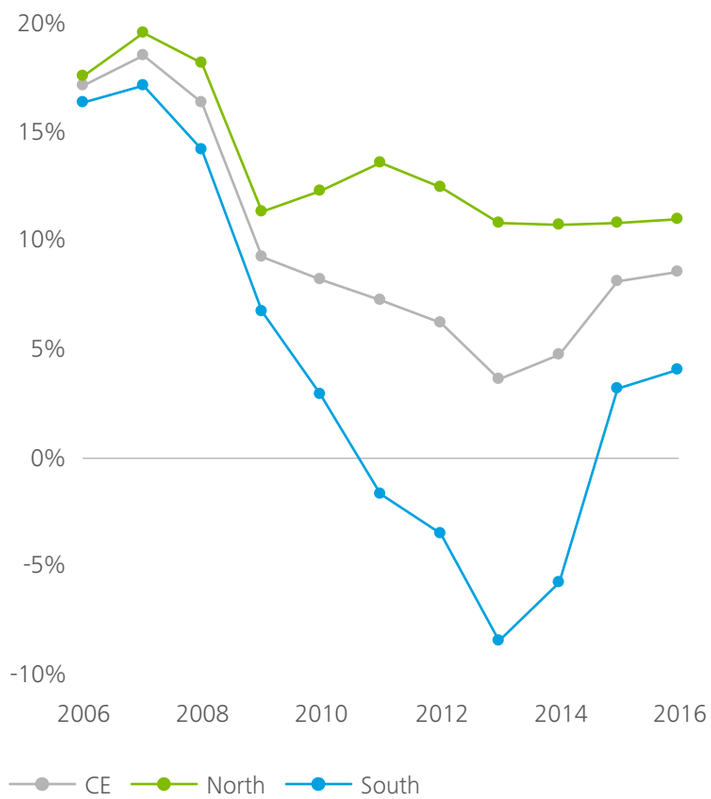
Source: Eurostat, National Bank of Poland, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank, Deloitte forecasts

Chart 6: Tier I ratio



Source: IMF

Chart 7: Pre-crisis ROE levels (2006-16)



Note: 2006 figures do not include Romania
Source: Eurostat, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank, Deloitte forecasts

"New normal" ROE below pre-crisis level

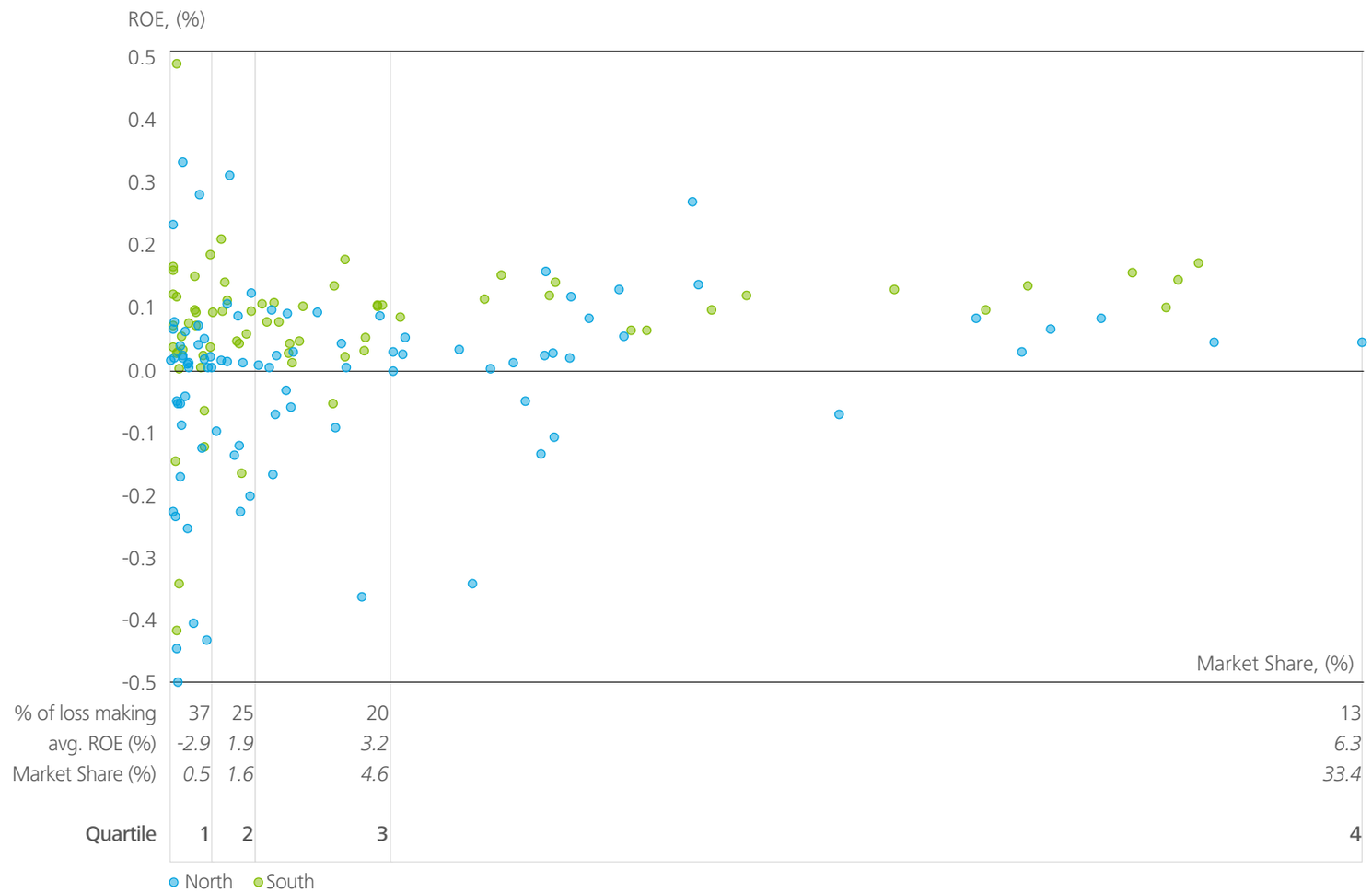
CE banking sector profitability is not expected to have fully recovered by 2016 (with an expected ROE of 8.6%) but the "new normal" level towards which it is moving will be much lower than pre-crisis levels. Banking sector profitability in CE will face ongoing burdens from higher capital requirements, tightened regulation, and, in some countries, industry taxes. Whilst southern markets (4.0%) will still be recovering, our 2016 ROE expectation for northern markets (11.0%) should reasonably approximate a normal level. These levels compare to a sector average ROE in CE in 2006-08 of 17.3% (18.4% in northern markets and 15.9% in southern markets). Reflecting higher expectations from markets and regulators, the sector tier 1 ratio in CE has increased from 11% in 2008 to 15% in 2013. Banks in Hungary and Slovakia are burdened

by significant industry taxes (reducing ROE last year by an estimated -3 p.p. and -2 p.p. respectively). Whilst Slovakia's levy will gradually fall over time, the first reduction next year will be largely offset by payments to the European bank resolution fund, to which Slovenian banks must also contribute. On the other hand banks face tightened consumer protection legislation, impacting fees that can be earned for different products and services (e.g. insurance, card payments, loan applications, loan servicing, early repayments, cash withdrawals).

Sector profit distribution is uneven

The distribution of banking sector net profit is uneven and in a highly competitive market scale matters. The largest players in a given market typically achieve better-than-average ROE, which leaves smaller players in a more challenging position.

Chart 8: Distribution of profits (2013)



Note: Analysis does not include Slovenia
Source: Bankscope, National Bank of Poland, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank, ECB, Bank of Slovenia, Croatian National Bank

Our examination of banks in CE (161 banks covered by Bankscope, excluding Slovenia) points to a relationship between market share in assets and profitability. In the first quartile (market share < 0.5%), 37% of banks are loss-making and 83% have a below-sector ROE (7.7% in 2013, excluding Slovenia). In the fourth quartile (market share > 4.6%), only 12.5% of banks were loss-making and more than half (52%) of banks made an above-sector ROE. Whilst economic recovery should help lift ROEs in the sector across the board in 2014-16, smaller players will likely remain at a disadvantage, with many facing the question of whether to get much bigger or to exit. This situation should help drive consolidation.

Consolidation to continue

Many WE banks active in the CE region have subsidiaries in multiple countries but few are achieving required rates of return in all of them. Examining the subsidiaries of the top 11 regional players in CE, 73% have a below average ROE and 37% a market share less than 5%. With pressure to lift profitability and capital ratios, WE banks have been re-defining the perimeter of their core business and identifying focus markets. Many of the largest transactions in CE (AIB's sale of Bank Zachodni WBK to Santander in 2012, the merger of Kredyt Bank with Bank Zachodni WBK to facilitate KBC's exit in 2013, BLB's sale of MKB in 2014) have occurred out of necessity to repay (or as a condition of having received) state aid. However, this trend was also reflected in 2013 in Nordea's sale of its Polish operations to PKO Bank Polski and in Rabobank's

sale of BGŻ to BNP Paribas. That 4 out of the 5 largest CE transactions over the past two years have been in Poland may be attributed to the health of the market (reflected in demand and attractive pricing).

M&A should pick up in the south

As the economic recovery helps stabilize asset quality and restore profitability in the south, more significant transactions on these markets may be expected going forward. Privatizations are planned in Slovenia, with NKBM slated for this year and Abanka Vipa for 2015. In Croatia, Hypo Alpe-Adria-Bank is being prepared for sale by mid-2015, and the state may sell Hrvatska poštanska banka. In Hungary, the FX debt relief that is driving huge losses in the banking sector this year should also reduce credit and regulatory risk, which have been key barriers to transactions.

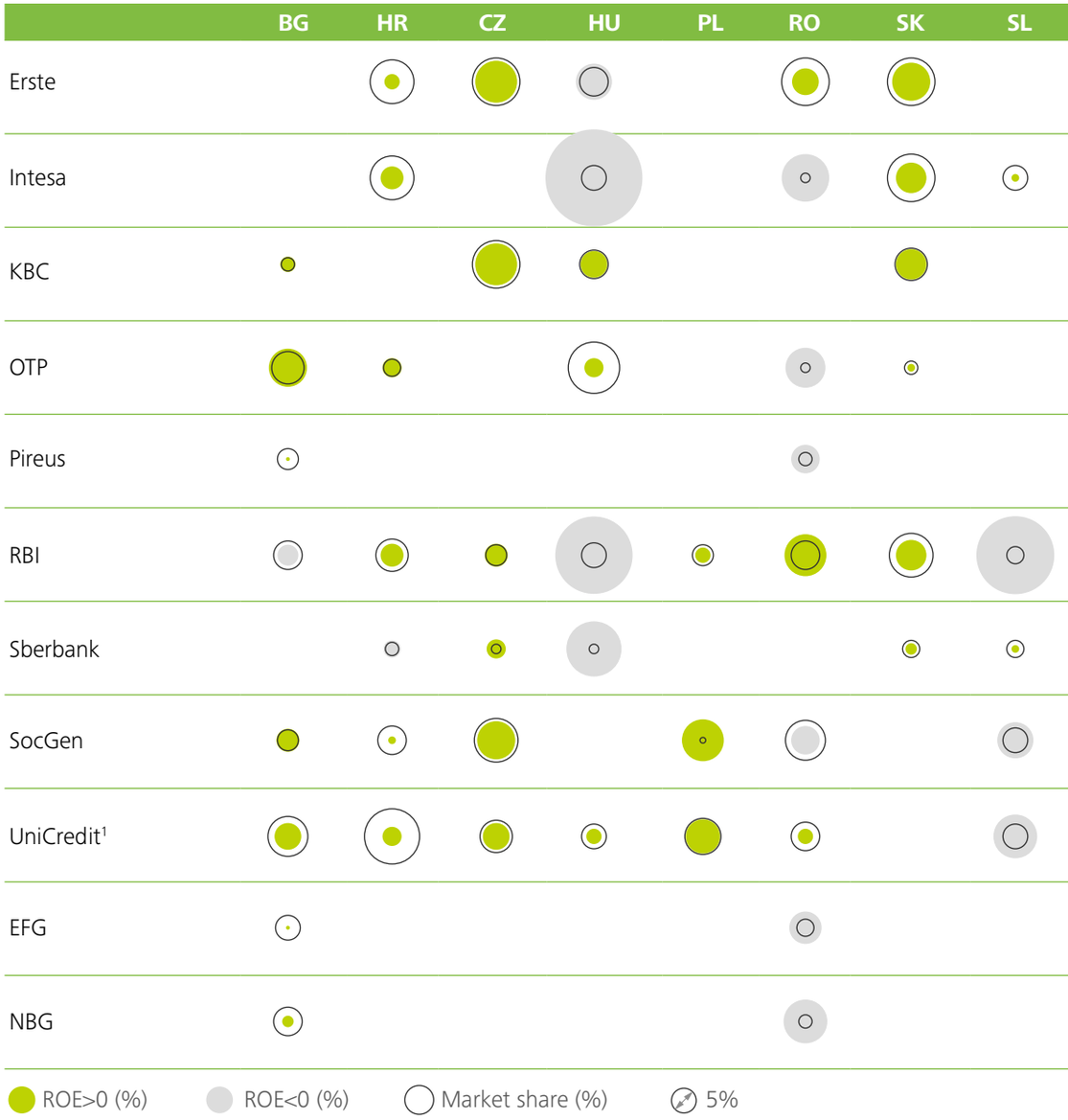
Given the industry taxes in Hungary that will keep profitability persistently low, more foreign banks may exit. In Romania and Bulgaria, one or more Greek-owned banks are likely to be sold as their parents re-focus operations on core markets.

Table 5. Selected transactions in the last 2 years

Date	Country	Target	Buyer	Seller	Total assets (EUR bn)	Deal value (EUR m)	Book value multiple
2012	Poland	Kredyt Bank	Bank Zachodni WBK	KBC Groep	10.1	1 061	1.4
2013	Poland	Bank BGŻ	BNP Paribas	Rabobank	8.8	919	1.1
2013	Poland	Nordea Bank Polska	PKO Bank Polski	Nordea AB	8.1	629	1.1
2014	Hungary	MKB bank	Hungarian government	BayernLB	6.6	55[1]	0.1
2013	Poland	Santander Consumer Bank	Bank Zachodni WBK	Santander Consumer Finance	3.5	514	1.7
2014	Romania	Banca Millennium	OTP Bank Romania	Banco Comercial Português	0.6	39	0.5
2013	Bulgaria	MKB Unionbank	Bulgarian First Investment Bank	MKB Bank	0.8	-	-
2014	Croatia	Banco Popolare	OTP Banka Hrvatska	Banco Popolare Societa Cooperativa	0.3	19	0.4

1. In exchange BayernLB agreed to waive claims of EUR 270 m
Source: mergermarket.com, Banks' press realeses

Chart 9: Regional players (2013)



		BG	HR	CZ	HU	PL	RO	SK	SL
Erste	ROE (%)		3	16	-13		8	15	
	Market share (%)		15	19	7		18	20	
Intesa	ROE (%)		6		-75		-20	10	1
	Market share (%)		16		6		1	19	6
KBC	ROE (%)	3		18	8			10	
	Market share (%)	3		20	8			9	
OTP	ROE (%)	14	4		4		-13	1	
	Market share (%)	10	3		21		1	2	
Pireus	ROE (%)						-7		
	Market share (%)	4					3		
RBI	ROE (%)	-5	5	5	-34	3	16	9	-48
	Market share (%)	7	8	4	6	4	7	16	3
Sberbank	ROE (%)		-3	4	-27			2	1
	Market share (%)		2	1	2			3	4
SocGen	ROE (%)	5	1	13		17	-7		-11
	Market share (%)	4	7	17		1	13		6
UniCredit[1]	ROE (%)	8	4	7	3	12	3		-16
	Market share (%)	15	26	9	6	11	8		6
EFG	ROE (%)	0					-9		
	Market share (%)	7					3		
NBG	ROE (%)	2					-15		
	Market share (%)	8					2		

ROE>0 (%) ROE<0 (%) Market share (%) 5%

1. UniCredit Bank Slovakia was absorbed by Czech unit in 2012 and seperate financial statments not available

Source: Bankscope, Banks' financial statement, Polish Financial Supervision Authority, Czech National Bank, National Bank of Slovakia, Hungarian Financial Supervisory Authority, Bulgarian National Bank,ECB , Bank of Slovenia, Croatian National Bank

Strategic directions

Examining the strategic priorities of banks in CE over the next 3 years, there are differences that emerge on a north-south divide. To maximize their bottom-line recovery, banks in the south will need to prioritize the management of non-performing assets, via collection, restructuring/workouts and sales. The relatively weak outlook for revenue growth in the south will also necessitate a greater emphasis on cost cutting, by continued optimization of distribution networks, streamlining processes, and exiting non-core businesses. Due to the faster pick up in volumes in the north, banks in these markets will place a greater focus on customer growth, smaller players on acquisition and incumbents on retention. Product pricing and features will remain important but effective strategies will address changing customer channel behavior, utilizing analytics and new mobile technology.
For banks in north and south, cross-selling will be the key to growing customer profitability in a lower margin environment, emphasizing the importance of being a 'main bank' for customers.

Key risks

The forecasts in this note are subject to a number of economic risk factors. Among the key factors are geopolitical risk, macroeconomic conditions, currency and interest rate risks, competition, and business risks. Chief among the geopolitical risk factors is the risk of a deepening conflict in Ukraine, which might lead to more crippling economic sanctions between Europe and Russia and could undermine growth. The economic recovery in Europe has faltered in recent months, prompting the ECB to respond by further easing monetary policy. Our forecasts are based on EIU's current economic forecasts for a recovery in the euro area but there remains a risk of another recession, which could impact CE exports and business sentiment. Our interest rate forecasts are based on currently low forward rates, implied by yield curves. Margins in CE tend to be positively correlated with interest rates and could benefit higher rates.

Bulgaria
Key Insights

Economic growth is picking up (to an expected 1.5% in 2014) but prospects are below average for CE. Political uncertainty and the June bank run on the country's fourth largest bank (CCB) have weighed on confidence but a turnaround of domestic demand is underway.

CCB is undergoing a loan quality review under special supervision but the extent of its losses (BGN 259m as of July) is not yet known. Even if the burden turns out to be substantial it should be manageable for Bulgaria, given its strong fiscal position.

Demand is the limiting factor for loan growth and should pick up. The banking sector is well funded, with the gross loans/deposits ratio down to 91% at year-end 2013.

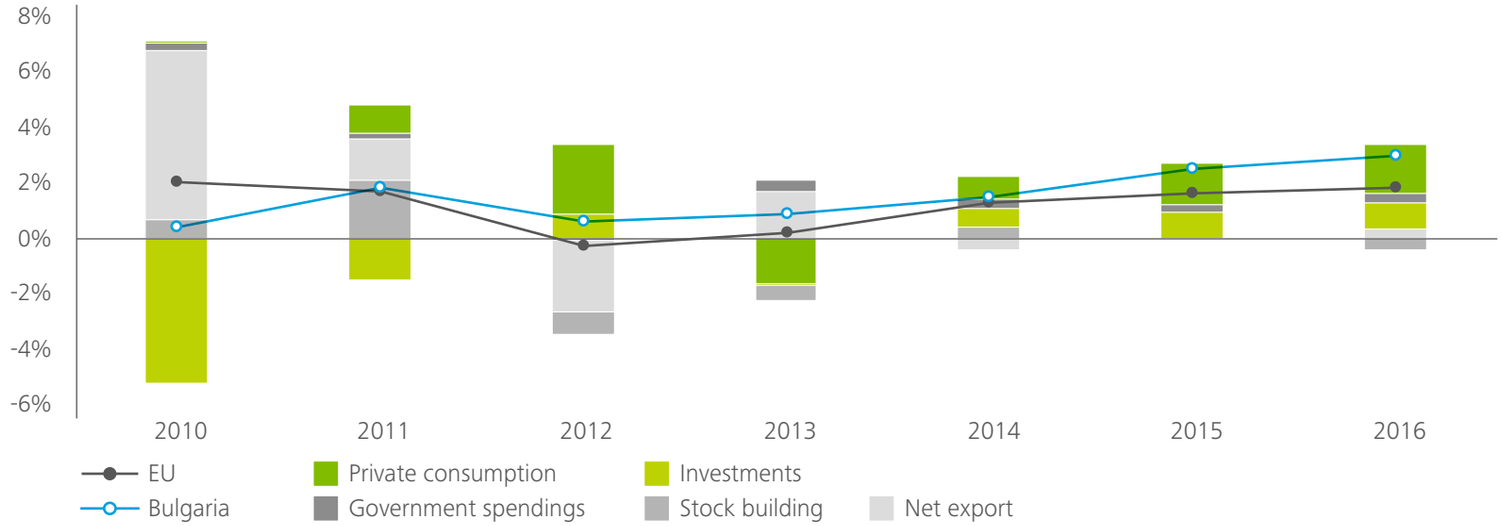
NPL ratio (17.0% in 2013) should peak this year. A review of banks' asset quality (including CCB) is expected to result in higher NPL recognition this year but a gradual improvement is expected in 2015-16 as the economy strengthens.

ROE (5.3% in 2012-13) has been above that of southern CE peers in recent years. The impact of CCB on the 2014 bottom line is uncertain but the remainder of the sector should benefit from a more stable margin (on easing competition for deposits) and receding risk costs.

Bulgaria
Economy

Bulgaria's economy is picking up with a turnaround of private consumption this year

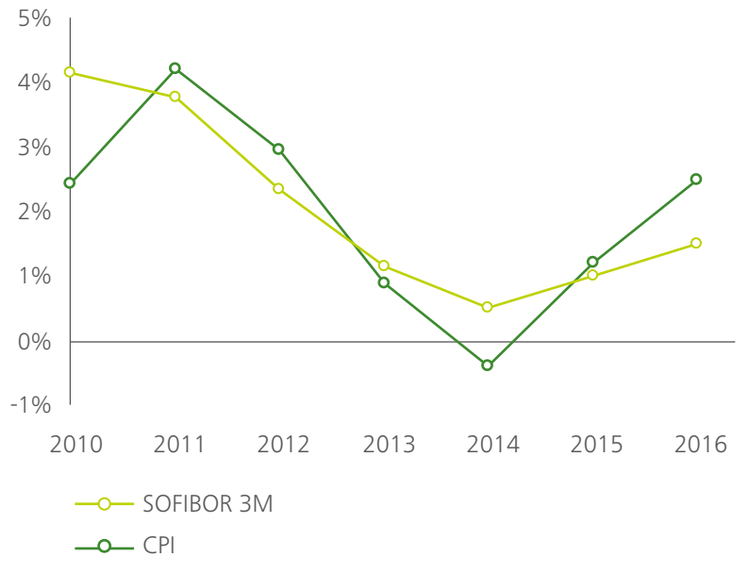
Chart BG1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)



Source: Economist Intelligence Unit

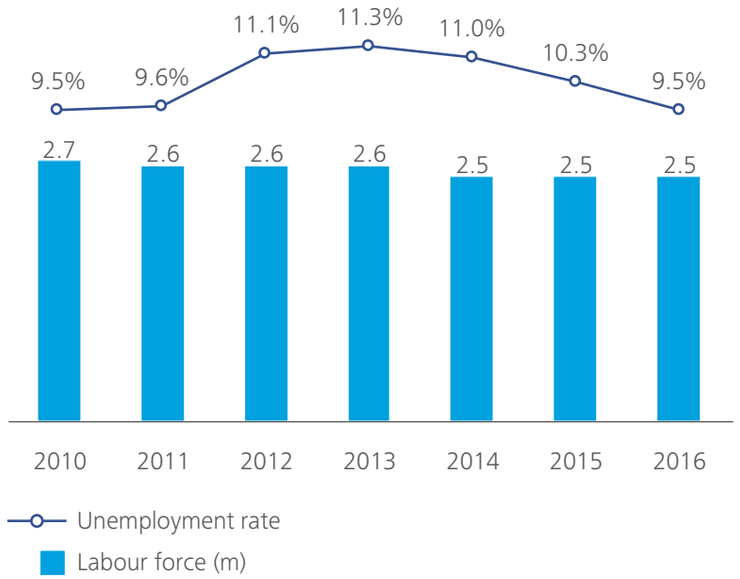
Bulgaria's economy is gradually picking up, after a slowdown in 2012-13, although growth prospects are below average for CE. Consumer and business confidence were improving in H1 2014, before suffering a setback in recent months after the bank run on the country's fourth largest bank Corporate Commercial Bank (CCB, now under special supervision). Political uncertainty has also been high, with the last government stepping down early and elections now set for October. Solid economic fundamentals underpin stability, however, including the long-standing currency board (peg to EUR), fiscal conservatism, and low public debt (18.6% of GDP in 2013, the second lowest in the EU).

Chart BG2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart BG3: Labour market



Source: Economist Intelligence Unit

Years of strong deposit growth (2010-13 CAGR of 10%) have greatly improved the local funding of the banking sector and falling interest rates have made credit more affordable. A turnaround of private consumption is expected this year, with the labor market on an improving trend, and investment growth supported by accelerated absorption of EU funds.

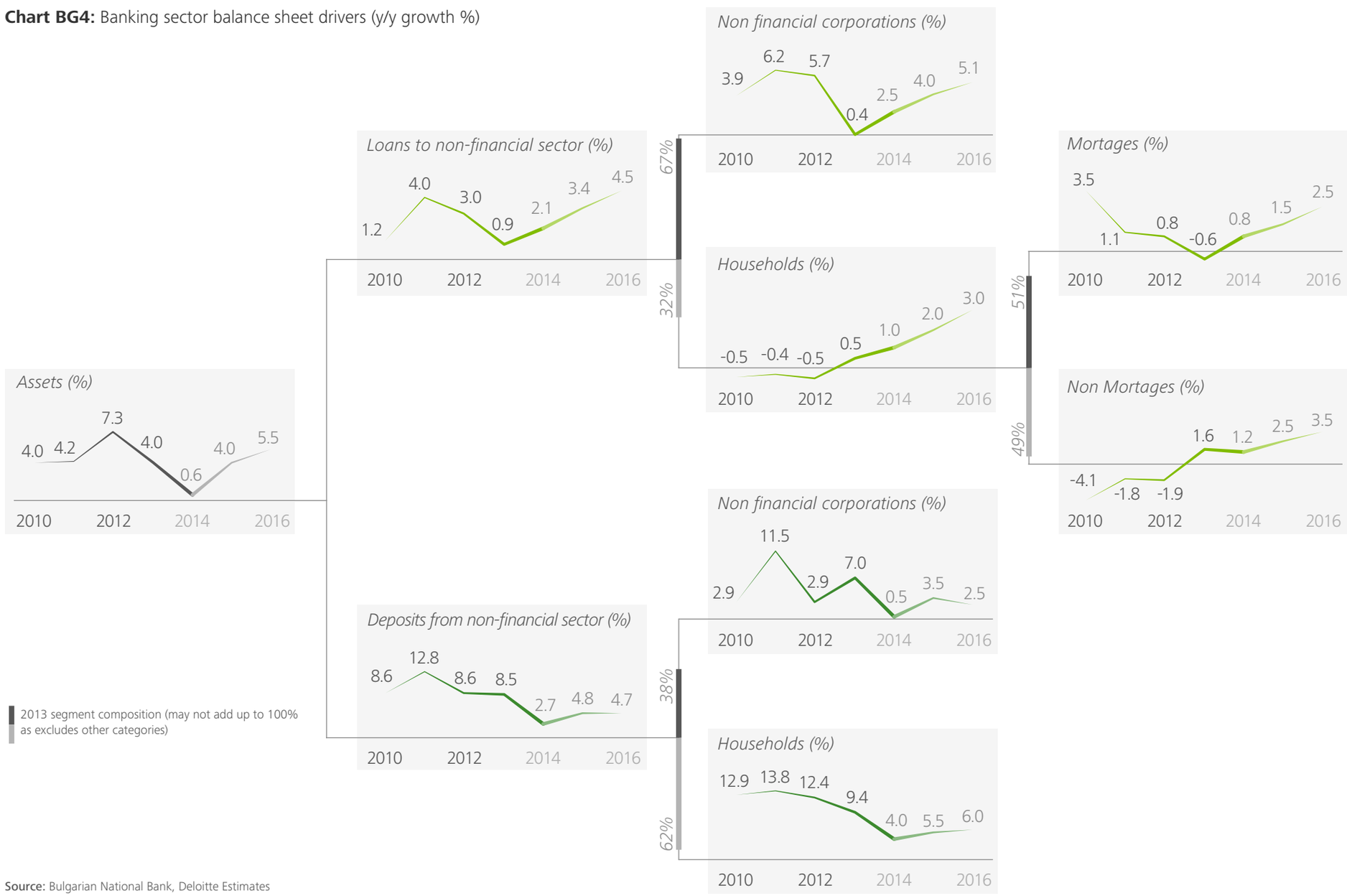
Bulgaria
Balance sheet

A gradual recovery in lending is expected with corporate loans outpacing household loans

A gradual recovery in lending is expected, as the economic recovery gains pace, although the situation at CCB is expected to depress growth somewhat this year. Higher business confidence and growing investment should support rising corporate loan growth to 4% in 2015 and 5% in 2016. Retail loan growth has been stagnant but an improving labor market and falling rates should lead to stronger demand. With consumer loans outpacing mortgages, we expect a gradual improvement in retail loan growth to 3% in 2016.

Demand is the limiting factor for loan growth. The healthy banks in the sector are well capitalized with a tier 1 CAR of 16% (at year-end 2013). Deposit growth, both in the households and corporate segment, has been robust (8.5% y/y in 2013) and we expect growth of 2-3% this year, despite CCB, and 4-5% in 2015-16. The sector's gross loans/deposits declined to 91% at year-end 2013 and is expected to continue to move lower over the next few years.

Chart BG4: Banking sector balance sheet drivers (y/y growth %)



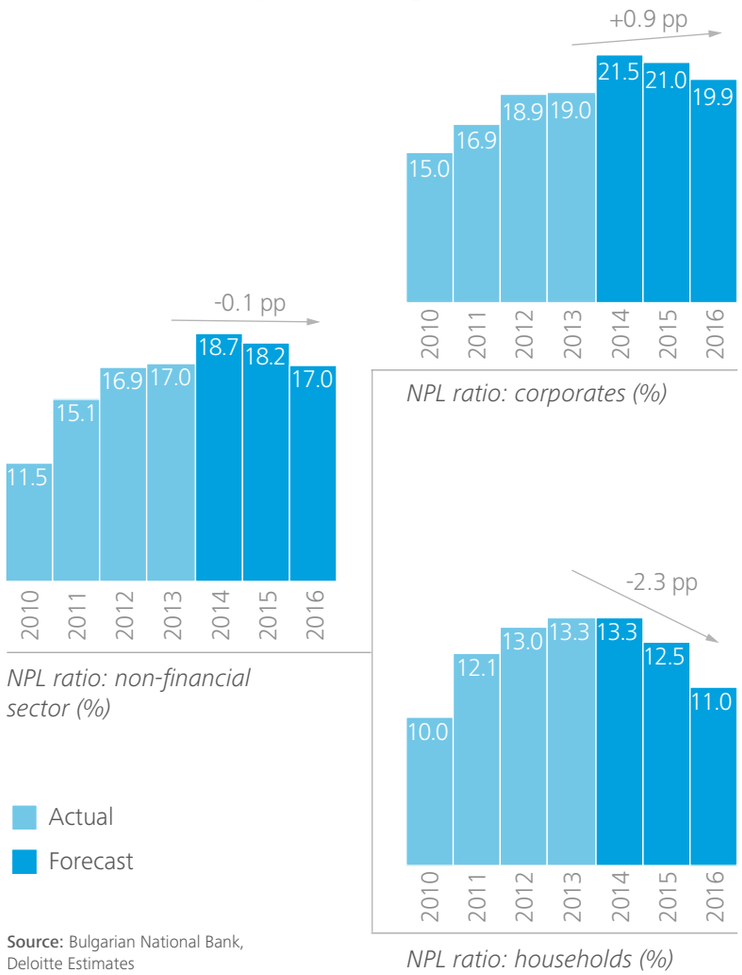
Source: Bulgarian National Bank, Deloitte Estimates

Bulgaria
Asset quality

NPL ratio likely to rise this year, due mainly to CCB and corporate segment

The sector NPL ratio was up last year, from 16.9% to 17.0%, and should rise again this year before the pick-up in the economy drives a gradual improvement in 2015-16.
The NPL ratio last year increased from 18.9% to 19.0% in the corporate segment and from 16.2% to 17.1% in housing loans, whilst it declined from 9.7% to 9.4% in consumer loans. We expect the corporate NPL ratio to rise above 21% this year, due largely to CCB (a pure corporate lender with 12% market share), whilst the outlook for the retail segment is relatively stable. A review of banks' asset quality (either as subsidiaries of their European parents or under the supervision of the central bank) may also result in increased NPL recognition this year. Provision coverage increased from 48% to 51% last year and is expected to rise further, in part driven by the asset quality review.

Chart BG5: Asset quality of the banking sector



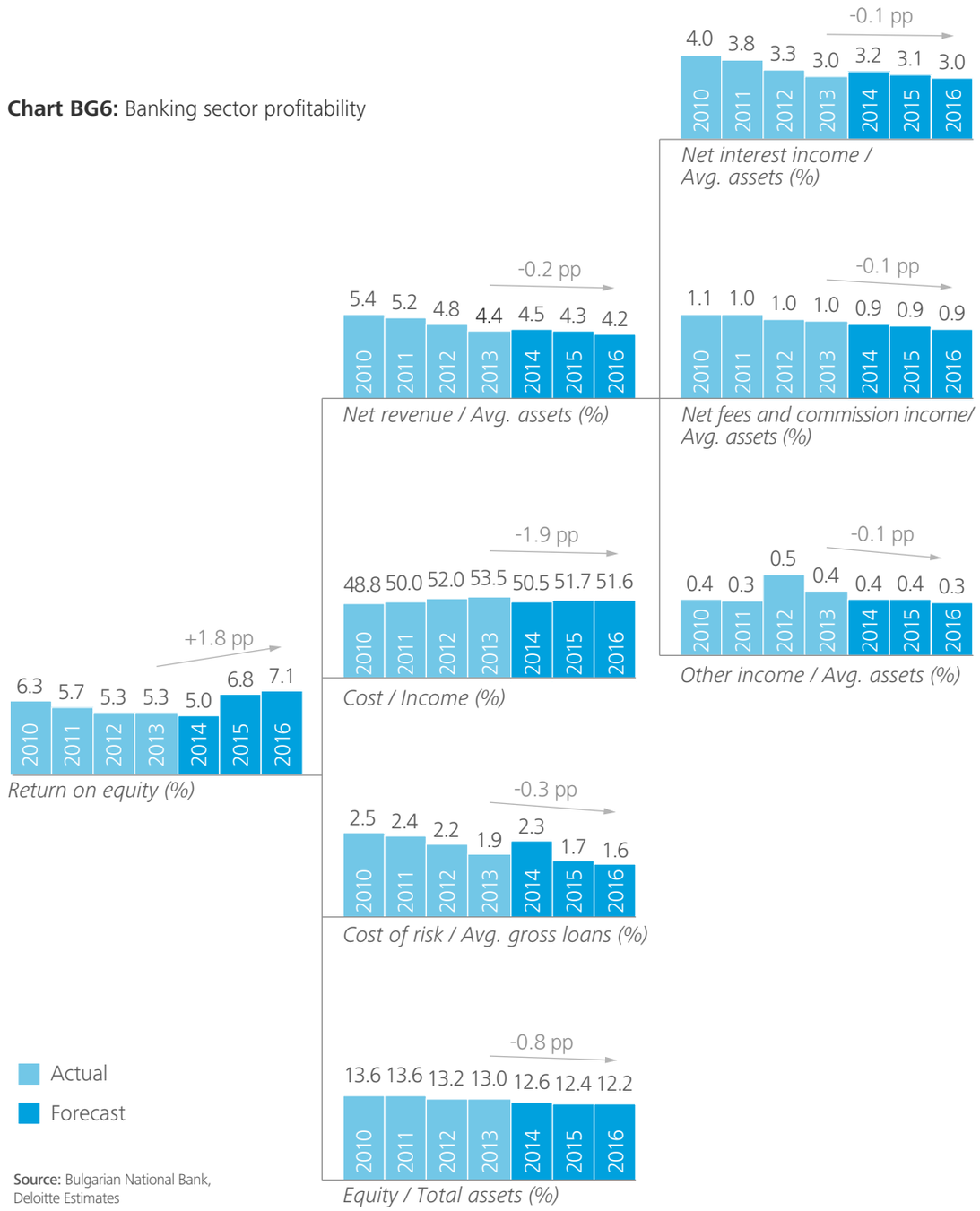
Source: Bulgarian National Bank, Deloitte Estimates

Bulgaria
Profitability

The banking sector ROE (5.3% in 2012-13), above that of southern CE peers in recent years, faces a setback due to losses at CCB in 2014 but an underlying trend of improvement should be visible in 2015-16. CCB, under special supervision, has reported a year-to-date loss of BGN 259m as of July but the extent of its losses will only be known after the ongoing review of its loan quality. The remaining banks in the sector should improve profitability, supported by a decline in the cost of risk, as the improving economy benefits the financial standing of the corporate sector and falling unemployment benefits households. The downward trend in the margin has reversed this year, as competition for deposits has eased, and the removal of CCB, which offered relatively high rates, will reinforce this. However, renewed margin pressure is expected in 2015-16, due to competition on the lending side and growth of mortgage refinancing. Net fee income is expected to decline this year, under pressure from competition and regulation (e.g. the ban of certain lending fees) but should stabilize next year on growing transaction volumes. Cost growth will be contained but, with a lack of revenue growth in 2015-16, we expect no significant progress beyond this year of the cost/income ratio.

The key driver of improving profitability in 2015-16 will be a decline in the cost of risk

Chart BG6: Banking sector profitability



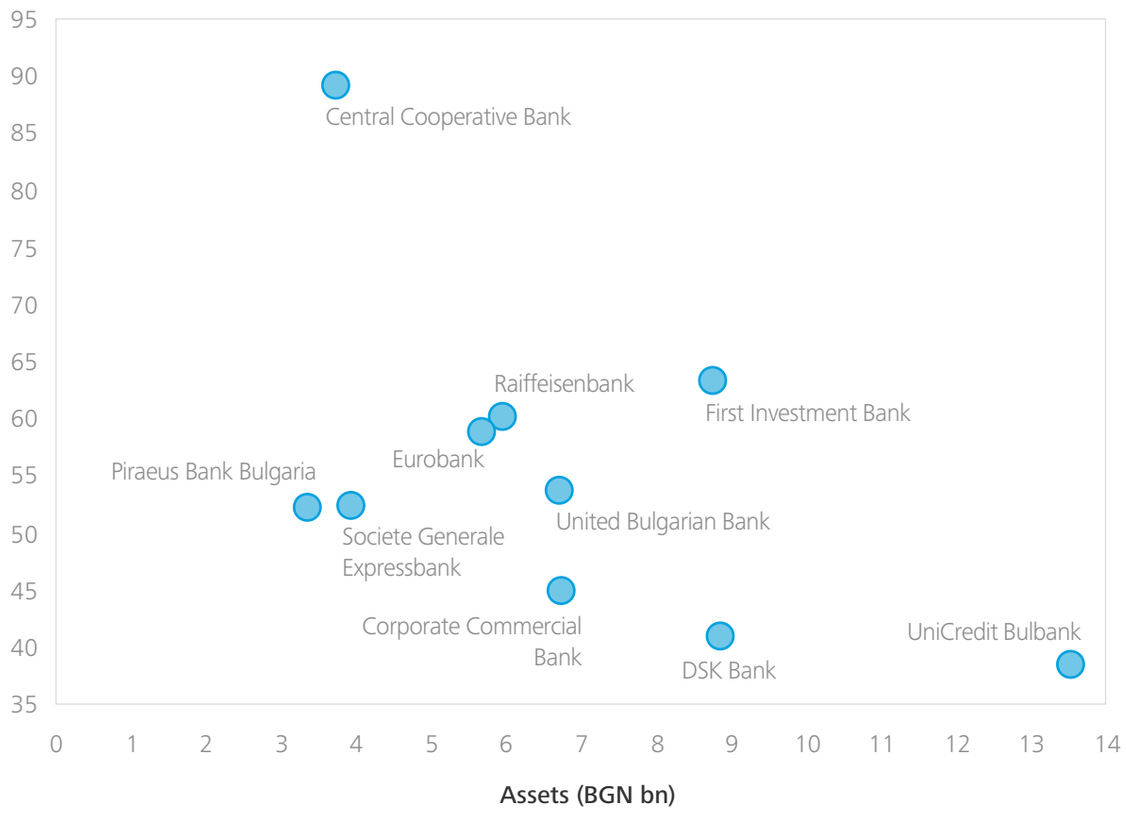
Source: Bulgarian National Bank, Deloitte Estimates

Bulgaria
Top 10 Banks

The fastest growing lenders have been locally-owned: CCB (#4), followed by FIB (#3)

In recent years, locally-owned banks have been gaining market share at the expense of foreign-owned banks, notably the Greek-owned banks but most of the others as well. The fastest growing lenders in the top 10 last year were CCB (#4), followed by FIB (#3). Given the situation at CCB, the growth of the other local owned banks is likely to be more restrained. FIB received liquidity support from the central bank, which should be repaid by the end of the year. At the same time, the largest foreign-owned banks will likely benefit from a flight to quality. Corporate leader UniCredit Bulbank (#1) has better retained market share in loans in recent years but retail leader DSK (#2) has made better progress in bringing down loans/deposits and restoring ROE (on lower risk costs). The largest Greek-owned bank, UBB (#5), after making substantial progress in lowering loans/deposits below 100% and repaying parent funding, is better positioned for growth. Raiffeisen has been losing market share overall but a shift in focus has seen it gaining in retail loans. The fastest growing foreign-owned bank in the top 10, SG-owned Expressbank (#8), has winning market share in retail loans as well as deposits.

Chart BG7: C/I ratio versus assets, 2013

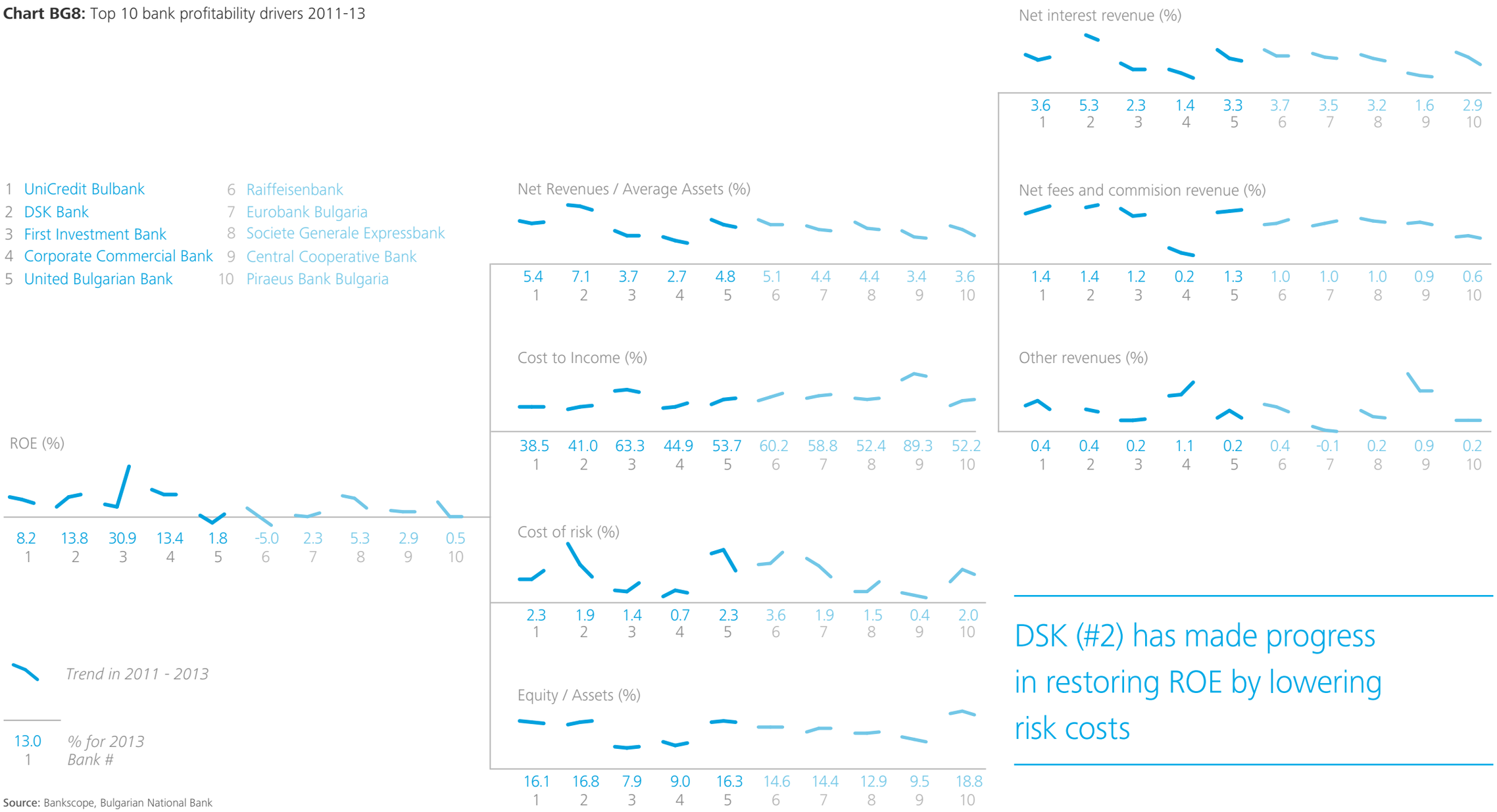


Source: Bankscope

Typical effect of scale observable among top 10 banks

Chart BG8: Top 10 bank profitability drivers 2011-13

1 UniCredit Bulbank
2 DSK Bank
3 First Investment Bank
4 Corporate Commercial Bank
5 United Bulgarian Bank
6 Raiffeisenbank
7 Eurobank Bulgaria
8 Societe Generale Expressbank
9 Central Cooperative Bank
10 Piraeus Bank Bulgaria



Source: Bankscope, Bulgarian National Bank

DSK (#2) has made progress in restoring ROE by lowering risk costs

Chart BG9: Top ten banks market share development

	Loans MS 2013 change	Loans (BGN bn)	Deposits (BGN bn)	Deposits MS 2013 change	Assets MS 2013 change
UniCredit Bulbank	16.2% +0.3pp		12.7	13.8% -0.4pp	14.8% -0.5pp
DSK Bank	12.2% -0.6pp		8.9	11.2% -0.3pp	10.4% -0.2pp
First Investment Bank	8.9% +0.7pp		7.4	10.3% -0.2pp	8.7% +0.3pp
Corporate Commercial Bank	8.1% +1.6pp		6.7	9.3% +0.9pp	7.9% +1.0pp
United Bulgarian Bank	8.6% -0.5pp		6.7	8.3% +0.1pp	7.8% +0.1pp
Raiffeisenbank	8.1% -0.6pp		6.0	6.6% -0.9pp	7.0% -0.5pp
Eurobank Bulgaria	7.4% -0.3pp		5.7	7.3% -0.5pp	6.6% -0.2pp
Societe Generale Expressbank	5.0% +0.1pp		3.7	4.2% +0.3pp	4.3% -0.1pp
Central Cooperative Bank	2.9% +0.2pp		3.7	5.2% +0.3pp	4.4% +0.3pp
Piraeus Bank Bulgaria	4.3% -0.5pp		3.4	2.9% +0.4pp	3.9% +0.2pp
Total Market (BGN bn)	57.376[1]			62.870[2]	85.747

Retail
Corporate and others
Total volume/ breakdown not available
Assets (BGN bn)

1. Loans to non-financial sector 2. Deposits from non-financial sector
Source: Bulgarian National Bank

Bulgaria
Strategic Directions

Consolidation is likely to emerge as a key strategic issue in the next few years, as one or more Greek-owned banks are likely to be sold as their parents re-focus operations on core markets. This will be an opportunity for smaller foreign-owned banks in the sector to achieve better scale and synergies. Whilst price competition for deposits should ease, intensifying competition is expected in lending, particularly in mortgage refinancing after prepayment penalties (beyond the first year) were banned in July. This will offer a customer acquisition opportunity to players looking to grow in retail and increase the importance of retention at incumbent DSK. With limited overall demand for new credit and pressure on fee income, increasing cross-sell and penetration of non--credit products to grow customer wallet--share will be important. Given the still weak asset quality and large NPL stockpile in the sector, attention should also be given to more effective management of credit risk, including the workout, restructuring, and third-party sales of non-performing assets.

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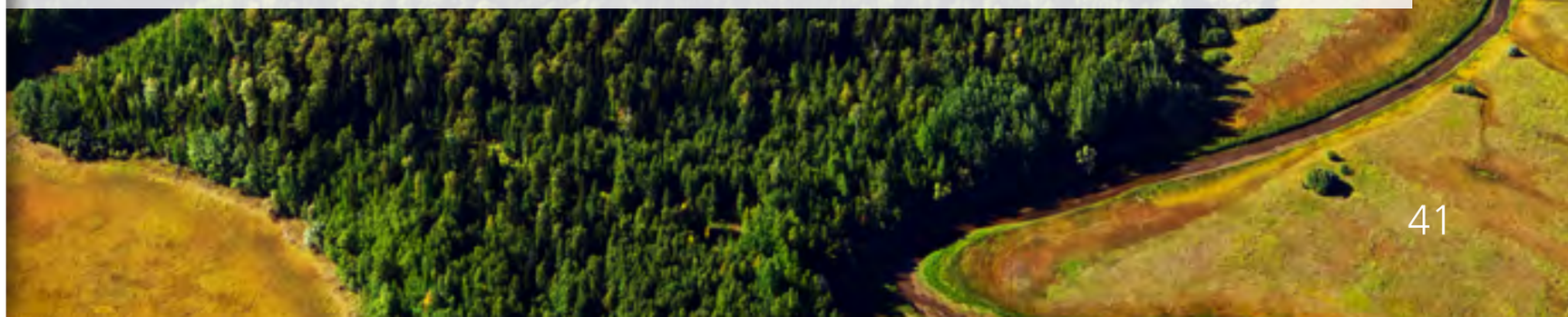
Croatia
Key Insights

Still weathering a 5-year long recession, Croatia should return to growth next year but its economic outlook is the weakest in CE.

Loans remain in decline but, with gradual economic recovery, a turning point is expected for the corporate sector in 2015 and households in 2016.

A rising NPL ratio (16.1% in 2013) is expected this year and next but net provisioning requirements should be past the peak following balance sheet cleaning last year.

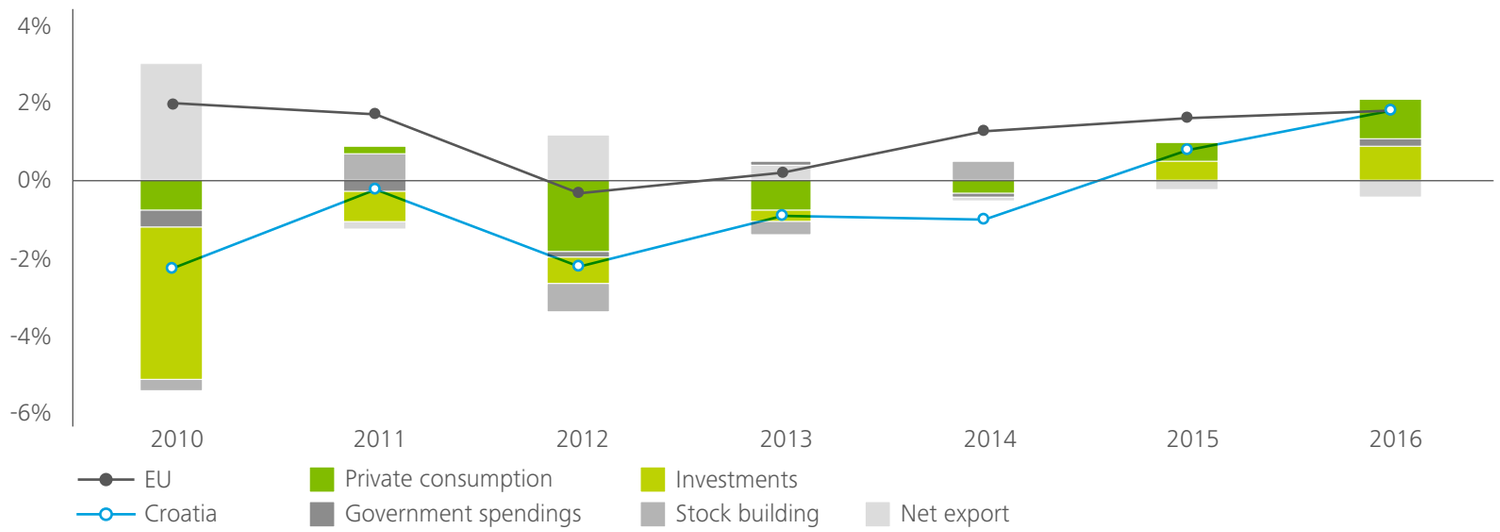
Profitability has passed a low point and should recover gradually from this year. The top 4 banks, with c. 2/3 of sector assets, earned c. 90% of sector profit in 2013.



Croatia
Economy

Croatia is still weathering a 5-year long recession but should begin a gradual recovery next year

Chart HR1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)

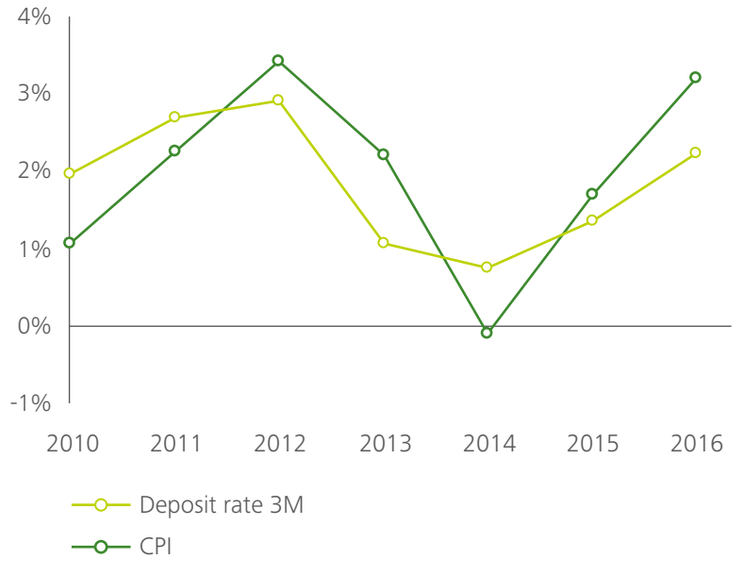


Source: Economist Intelligence Unit

The economic outlook for Croatia is the weakest in CE. The country is still weathering a 5-year long recession and is expected to shrink by 1.0% in 2014 but should begin a gradual recovery with growth of 0.8% next year.

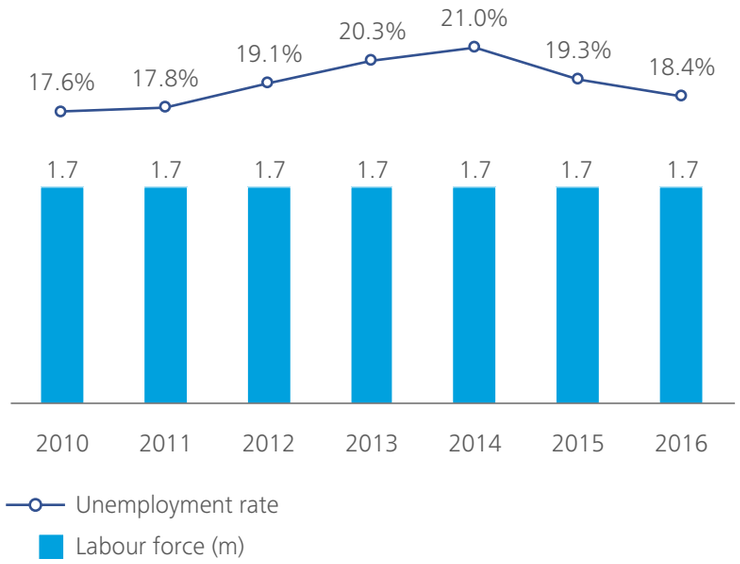
The outlook for domestic demand is negative this year and sluggish next year, with a deteriorating labor market weighing on the confidence of households and fiscal consolidation necessary to reduce the government deficit.

Chart HR2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart HR3: Labour market



Source: Economist Intelligence Unit

Unemployment (20.3% on average in 2013) is the highest in CE and is expected to rise again this year. Monetary policy must prioritize exchange rate stability to avoid a revaluation of euro-indexed debt.

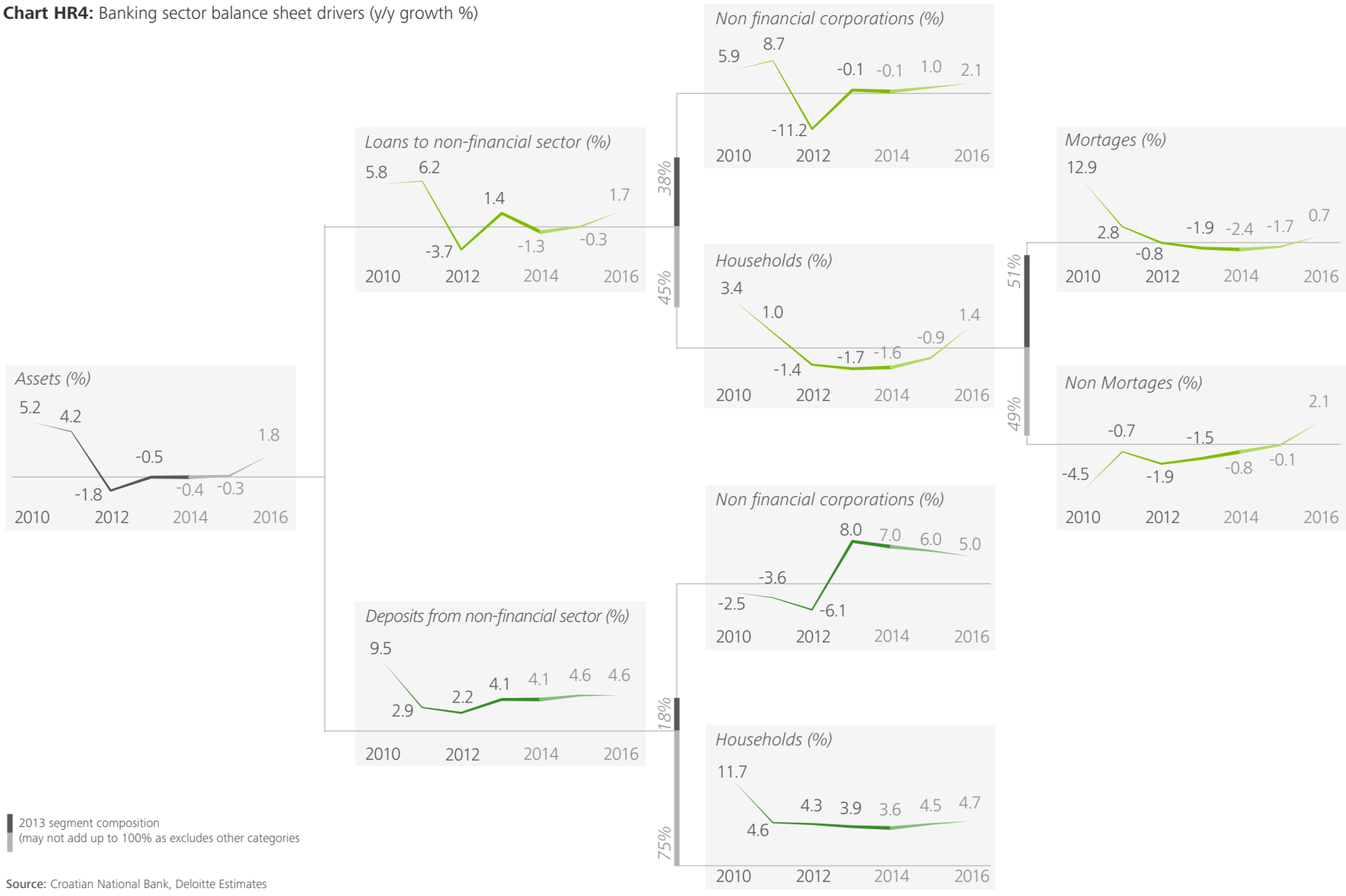
However, net exports should be supported by recovery in Europe helping external demand. Croatia should also benefit from absorption of EU funds.

Croatia
Balance sheet

Loans are on a downward trend expected to reach a turning point in 2016

Deleveraging is expected to continue in the near term, with total loans expected to decline this year (-1.3% y/y) and next (-0.3% y/y). The loans-to-deposits ratio is on a downward trend from 126% in 2011 to 116% in 2013 and should continue to move lower. This reflects mainly a lack of loan demand of sufficient quality. With a strong capital position (tier 1 ratio of 19.9%), banks are prepared to increase lending. Lending to the corporate sector has been stagnant over the past year (-0.1% y/y in 2013) but should pick up along with the economy in 2015, helped by investment in infrastructure by public enterprises. Lending to households has been shrinking (-1.7% y/y in 2013), both housing and consumer loans, and is only expected to reach a turning point in 2016.

Chart HR4: Banking sector balance sheet drivers (y/y growth %)



2013 segment composition
(may not add up to 100% as excludes other categories

Source: Croatian National Bank, Deloitte Estimates

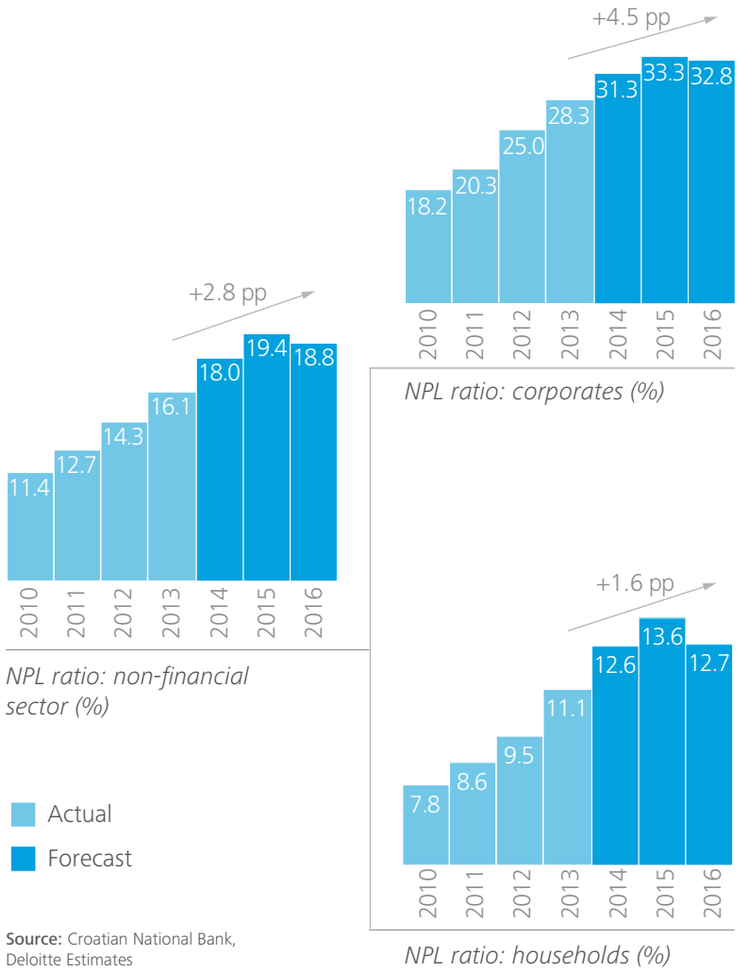
Croatia
Asset quality

NPL ratio rising but should reach a peak in 2015

The NPL ratio of the banking sector is rising and is not expected to peak until next year. The main driver is the corporate sector, where the NPL ratio has risen from 25.0% to 28.3% in 2013, and the construction sector has been particularly hard hit. However, the NPL ratio in the retail segment is also on an upward trend, rising from 9.5% to 11.1% last year.

The NPL ratio of home loans, which are predominantly FX-linked (33% CHF, 59% EUR, and 1% other foreign currencies), grew from 6.2% to 8.1% last year. Disposals should continue but have so far had a limited impact on the NPL ratio (cumulatively c. 2p.p.). The modest improvement we expect for the economy should lead to a gradual slowdown in NPL formation but the tide will not turn in the absence of loan growth.

Chart HR5: Asset quality of the banking sector



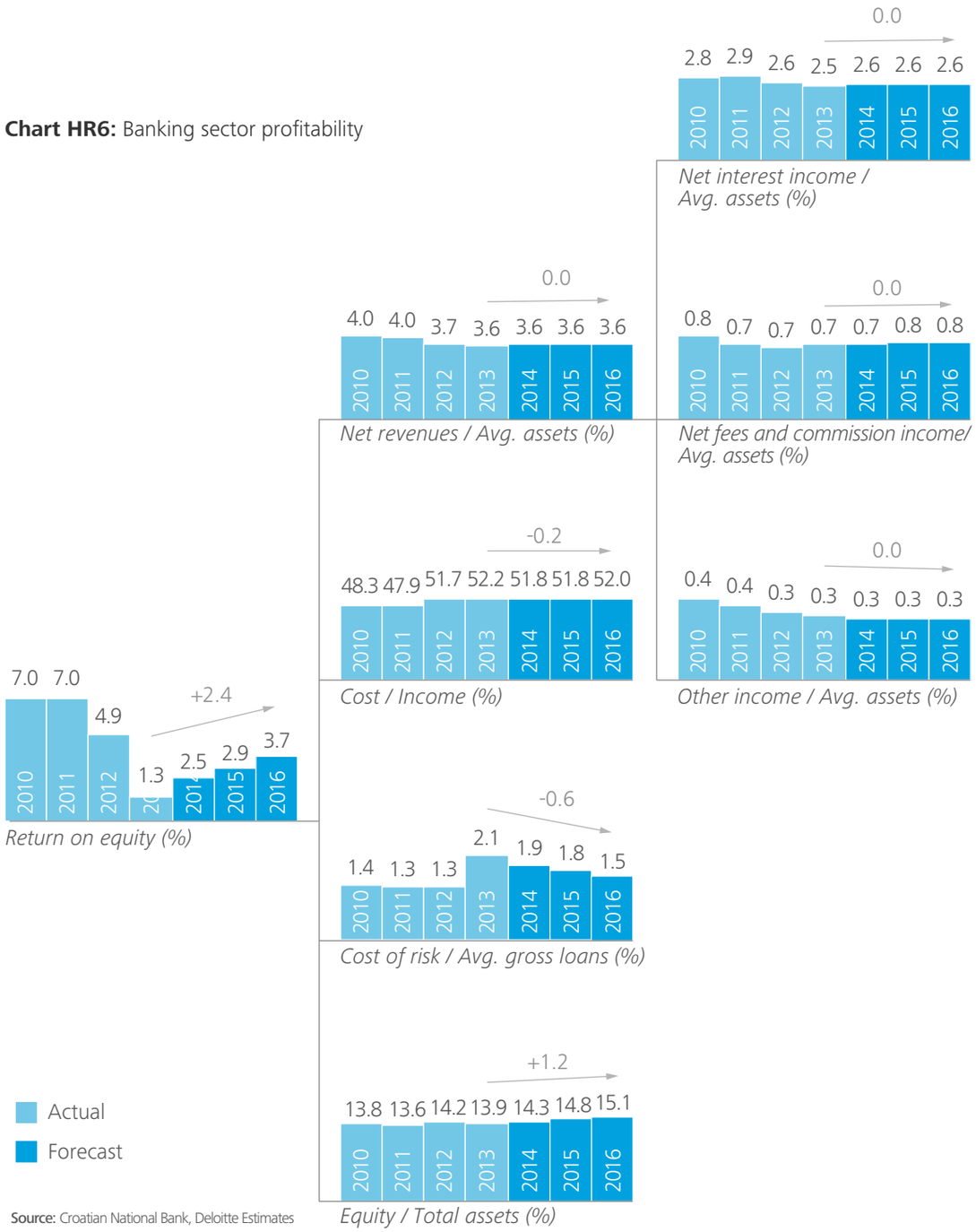
Source: Croatian National Bank, Deloitte Estimates

Croatia
Profitability

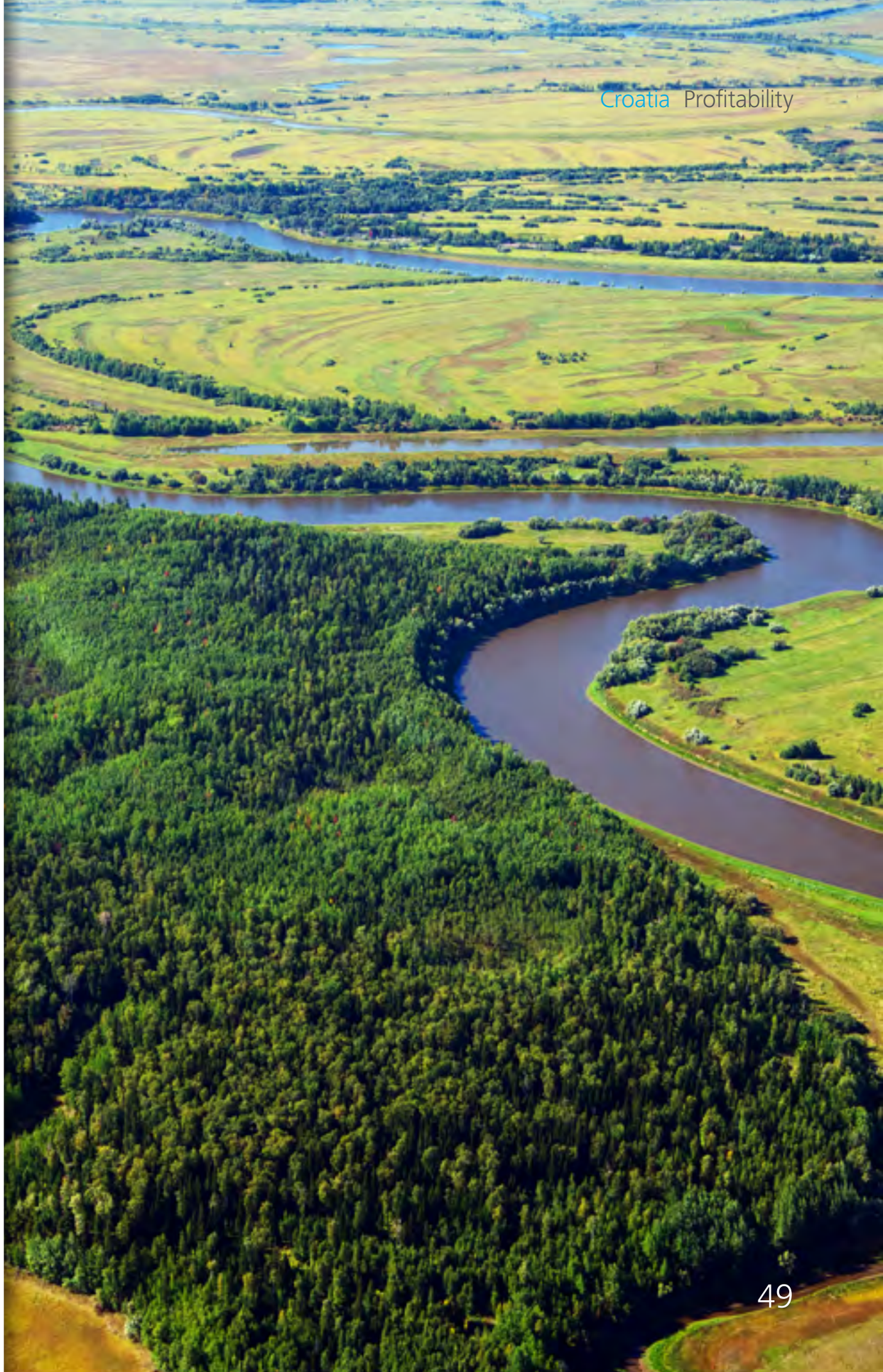
Profitability in 2013 was influenced by a balance sheeet clean-up but the worst should be over

Despite the prolonged recession, Croatia's banking sector has remained in the black and the worst should now be over from the standpoint of profitability. ROE reached a low point last year, falling to 1.3%, from 4.9% in 2012, as a central bank decision on loan classification prompted a balance sheet clean-up (and a net loss in 4Q 13). Provision coverage of NPLs should continue to rise, in part due to central bank rules, but we expect slowing NPL formation will allow risk costs to gradually recede. Revenues declined last year but a stabilization of the net interest margin, underpinned by the re-pricing of deposits, should ease pressure on operating profitability going forward. Growth of fee income has been positive but it is hindered by slow volumes and regulatory impediments. A further reduction of costs is expected in the near-term and the rising trend in cost-to-income should reverse and flatten out.

Chart HR6: Banking sector profitability

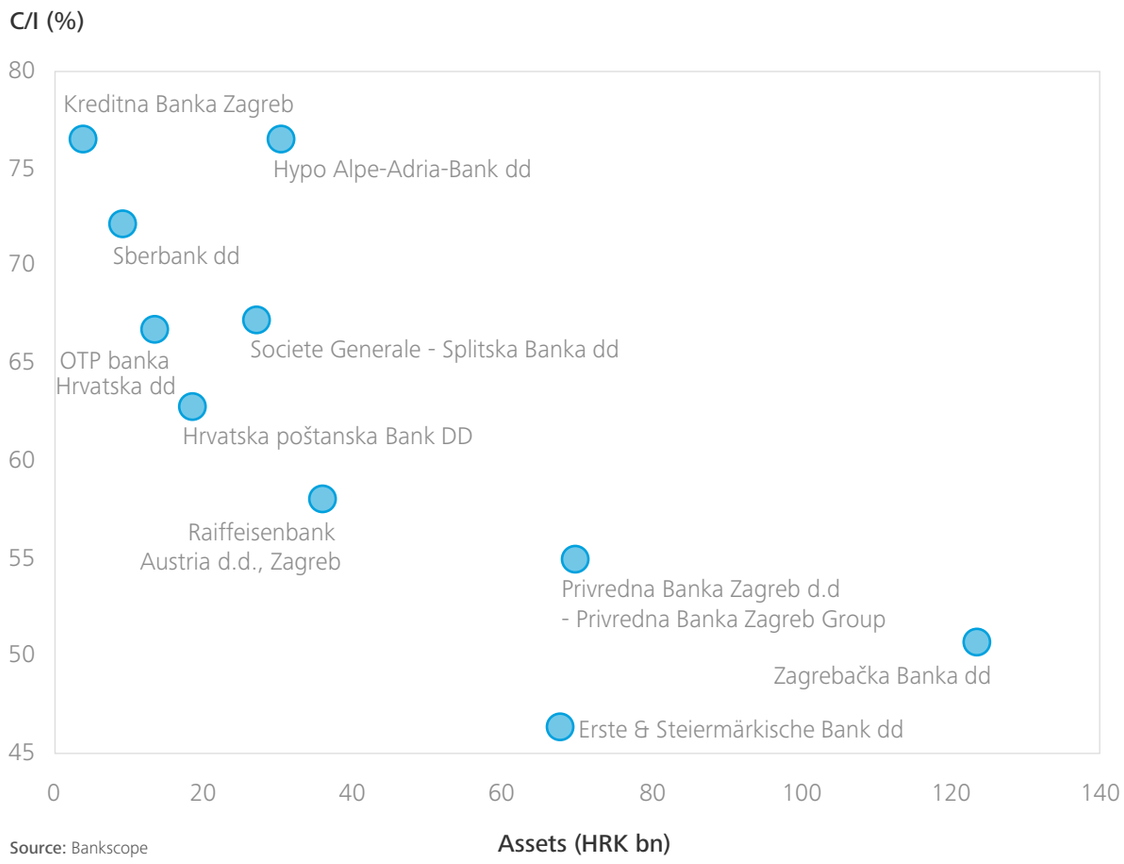


Source: Croatian National Bank, Deloitte Estimates



Croatia
Top 10 Banks

Chart HR7: C/I ratio versus assets, 2013

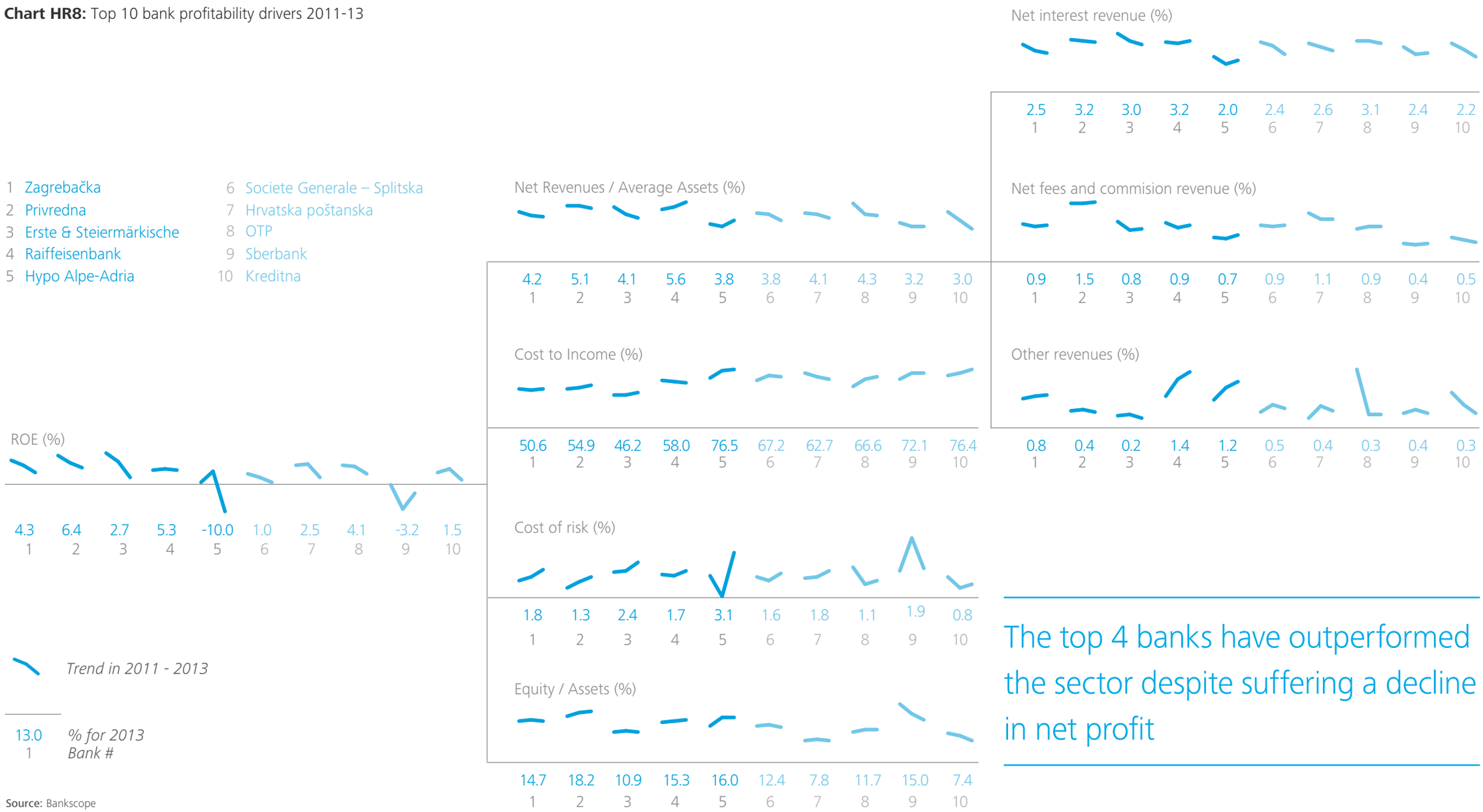


Source: Bankscope

Scale effect sustains market leaders cost superiority

Net profit in the banking sector declined by 73% to HRK 748m in 2013, with profitability in the sector suffering across the board. Nearly half of the total banks in Croatia were loss-making in 2013, though this was also true in 2012. The single biggest factor was the swing from net profit to a loss at #5 Hypo Alpe-Adria-Bank (HRK -530m), cleaning its balance sheet in preparation for its planned privatization (by mid-2015). The top 4 banks outperformed the sector, suffering a 35% y/y decline in aggregate net profit but still managing to keep an average ROE of 4.8% in 2013. Zagrebačka (#1) and Erste (#3) outpaced the sector in lending last year but suffered greater profit erosion from provisioning than Privredna (#2) and Raiffeisen (#4), which allowed their loans to decline in 2012-13. The main market share gainers in the top 10 have been mid-tier players, Sberbank (#9), HPB (#7), and OTP (#8).

Chart HR8: Top 10 bank profitability drivers 2011-13



Source: Bankscope

The top 4 banks have outperformed the sector despite suffering a decline in net profit

Chart HR9: Top ten banks market share development

	Loans MS 2013 change	Loans (HRK bn)	Deposits (HRK bn)	Deposits MS 2013 change	Assets MS 2013 change
Zagrebačka	27.5% +0.8pp		107	25.8% -0.3pp	26.3% +0.8pp
Privredna	17.2% -0.8pp		66	19.2% -1.0pp	16.2% -0.6pp
Erste & Steiermärkische	16.0% +0.6pp		60	14.1% +0.5pp	14.8% +0.5pp
Raiffeisenbank	8.6% -0.3pp		33	9.0% -0.8pp	8.1% -0.6pp
Hypo Alpe-Adria	8.1% -1.0pp		30	7.1% -0.8pp	7.4% -1.1pp
Societe Generale-Splitska	6.8% +0.1pp		27	7.3% +0.5pp	6.7% +0.3pp
Hrvatska poštanska	4.6% +0.4pp		18	5.8% +0.3pp	4.5% +0.3pp
OTP	3.5% +0.2pp		14	4.5% -0.1pp	3.4% +0.1pp
Sberbank	2.5% +0.3pp		9	2.2% +0.1pp	2.3% +0.3pp
Kreditna	0.6% 0.0pp		4	1.4% +0.3pp	1.0% +0.2pp
Total Market (HRK bn)	281.462[1]			242.152[2]	405.679

Retail
Corporate and others
Total volume/ breakdown not available
Assets (HRK bn)

1. Loans to non-financial sector 2. Deposits from non-financial sector
Source: Croatian National Bank, Bankscope

Croatia
Strategic Directions

Against the backdrop of a weak economy, deteriorating asset quality, and absent revenue growth, banks face the challenge of maximizing their bottom-line recovery.
A key focus will be reducing credit risk costs and the management of non-performing assets. Pre-bankruptcy settlement procedures can be used to accelerate the restructuring of corporate debt. Collections processes are growing in importance for the retail segment and third-party debt sales should expand further. Tight control of operating costs will also remain a priority. Moderate employment reduction is likely to continue, as banks improve processes, IT, and network. Larger scale restructuring may be prompted if an eventual disposal (e.g. Hypo Alpe-Adria-Bank, Hrvatska poštanska banka) results in consolidation. On the revenue side, larger banks are expected to be focused on customer retention and activation, with the aim of growing fee income by cross-selling.

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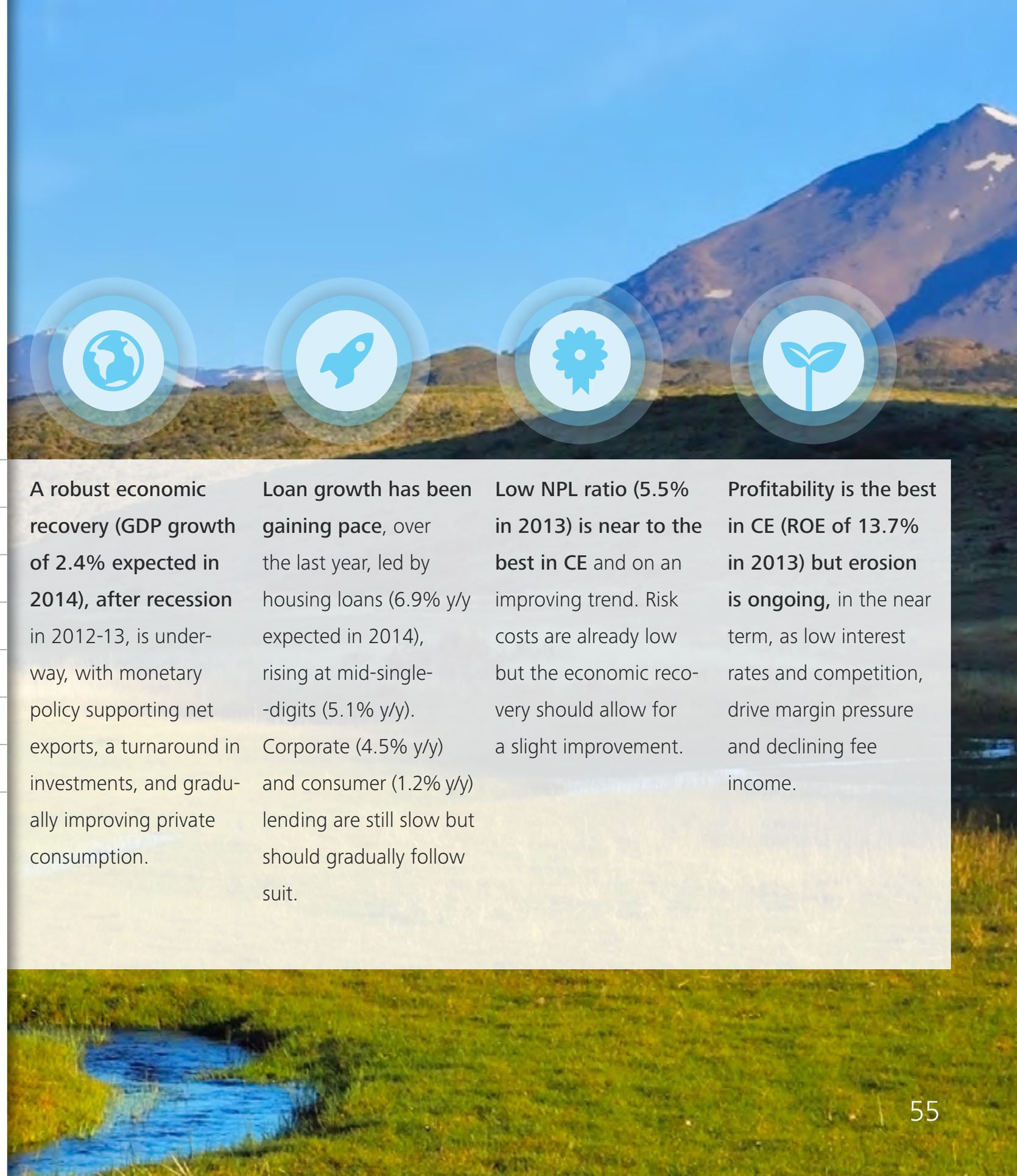
The Czech Republic
Key Insights



A robust economic recovery (GDP growth of 2.4% expected in 2014), after recession in 2012-13, is underway, with monetary policy supporting net exports, a turnaround in investments, and gradually improving private consumption.

Loan growth has been gaining pace, over the last year, led by housing loans (6.9% y/y expected in 2014), rising at mid-single-digits (5.1% y/y). Corporate (4.5% y/y) and consumer (1.2% y/y) lending are still slow but should gradually follow suit.

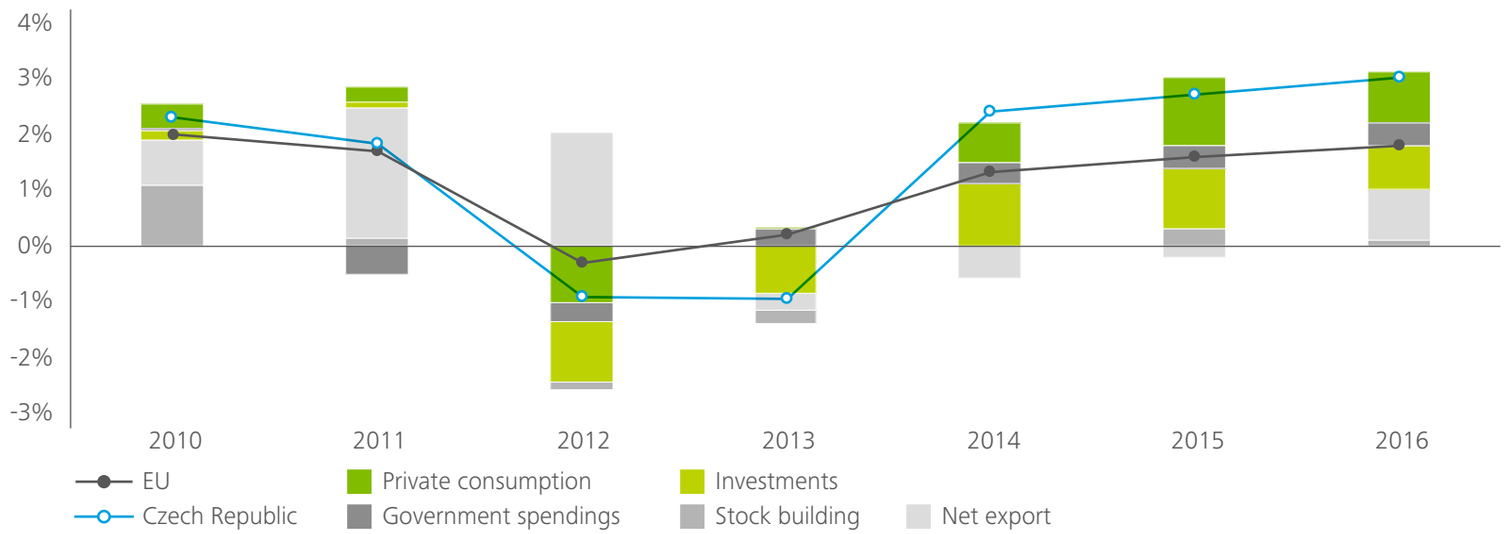
Low NPL ratio (5.5% in 2013) is near to the best in CE and on an improving trend. Risk costs are already low but the economic recovery should allow for a slight improvement.

Profitability is the best in CE (ROE of 13.7% in 2013) but erosion is ongoing, in the near term, as low interest rates and competition, drive margin pressure and declining fee income.

The Czech Republic
Economy

A robust economic recovery is underway with contribution from investments and improving private consumption

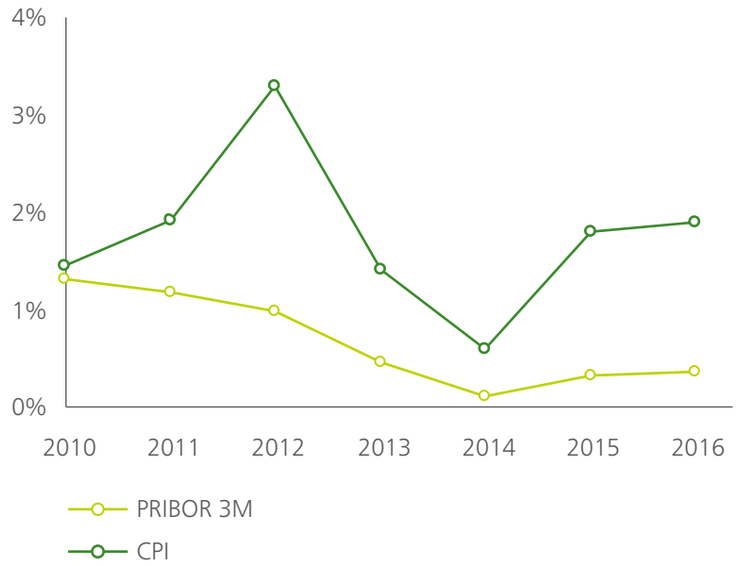
Chart CZ1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)



Source: Economist Intelligence Unit

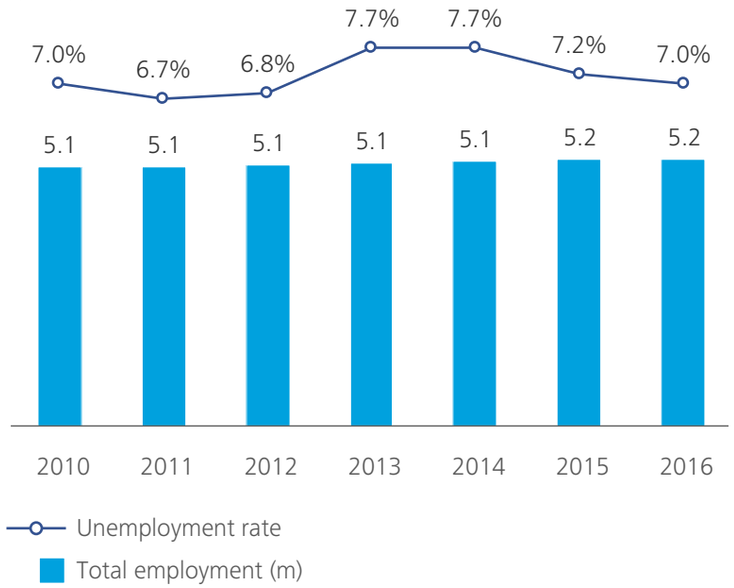
Emerging from a recession (GDP growth declined -0.9% both in 2012-13), the Czech economy is expected to make a robust recovery. to make a robust recovery. Monetary policy is supportive of net exports. With the key interest rate already technical zero since 2012, the CNB weakened the currency last year (-5.9% m/m in November) with a commitment to maintain a rate CZK 27 to the euro until at least the end of 2015. Given the export orientation of the economy, this helps position the Czech Republic as a key beneficiary in CE of growing external demand. Improved business confidence should support a swing in investment this year back to positive growth.

Chart CZ2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart CZ3: Labour market



Source: Economist Intelligence Unit

Private consumption, which has stagnated in recent years, is expected to improve moderately supported by improving labor market conditions and real wage growth.

Unemployment (7.7% on average in 2013), already at one of the lowest levels in CE, should fall moderately.

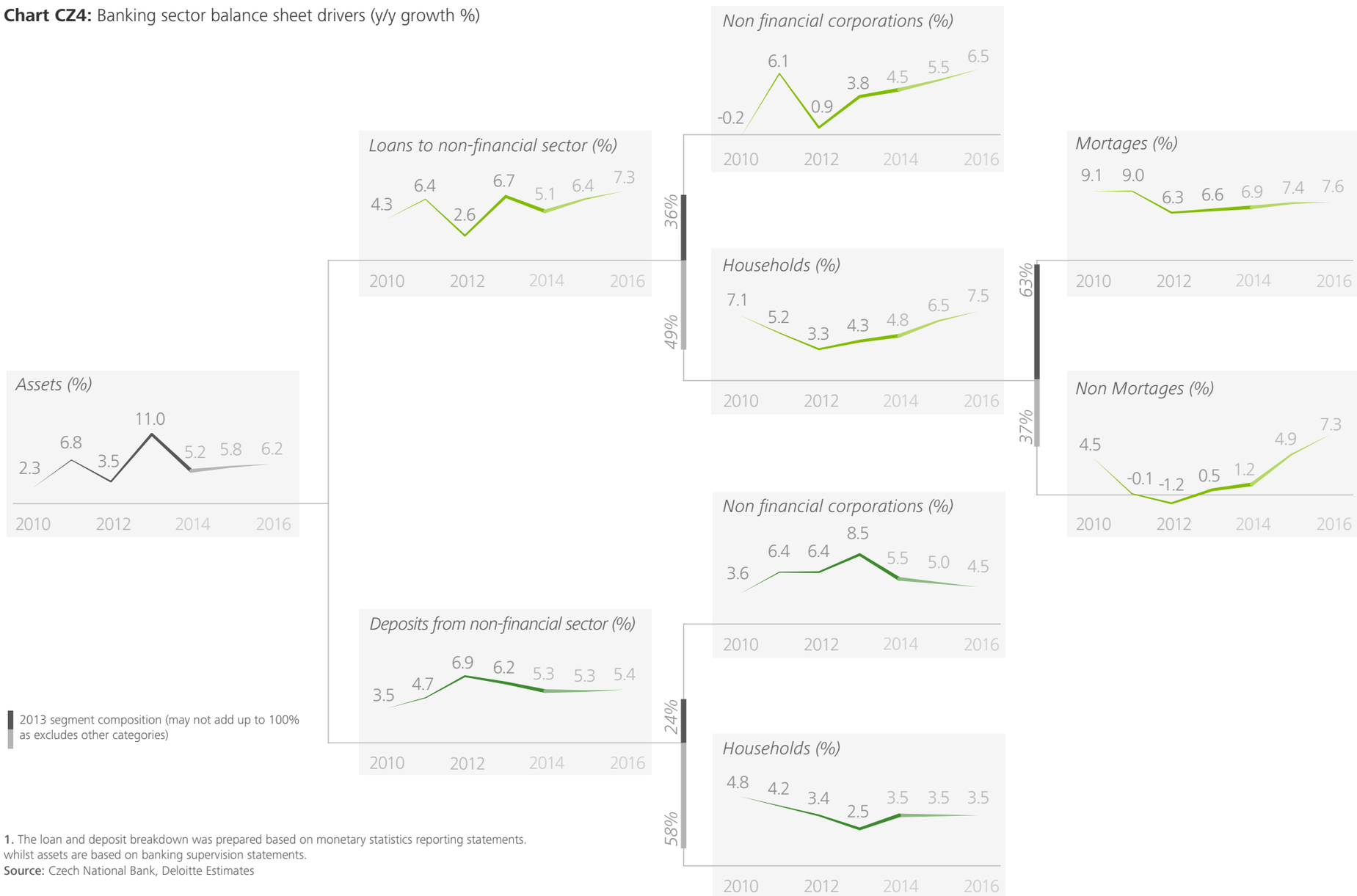
The Czech Republic
Balance sheet

Corporate and consumer lending are still slow but should gradually recover

Loan growth has been gaining pace since 2H 13, led by the retail segment. A decline in mortgage interest rates to record lows (3.2% in 2Q 14) has supported demand for housing loans, which are rising at 6-7% p.a. in 2013-14 and slowly building momentum. Affordability is favorable from a historic perspective and residential housing prices have started to slowly rise. Consumer lending has remained weak (0.5-1.2% in 2013-14) but should eventually accelerate along with household spending. Corporate lending (4-5% p.a. in 2013-14) is expected to rise, with growth in investment, but this should be gradual as companies utilize available cash reserves. Loan growth is mainly a function of demand and not availability.

The banking sector is well capitalized, with a tier 1 CAR of 16.9%, and has the lowest loans/deposits ratio (75% in 2013) in CE.

Chart CZ4: Banking sector balance sheet drivers (y/y growth %)



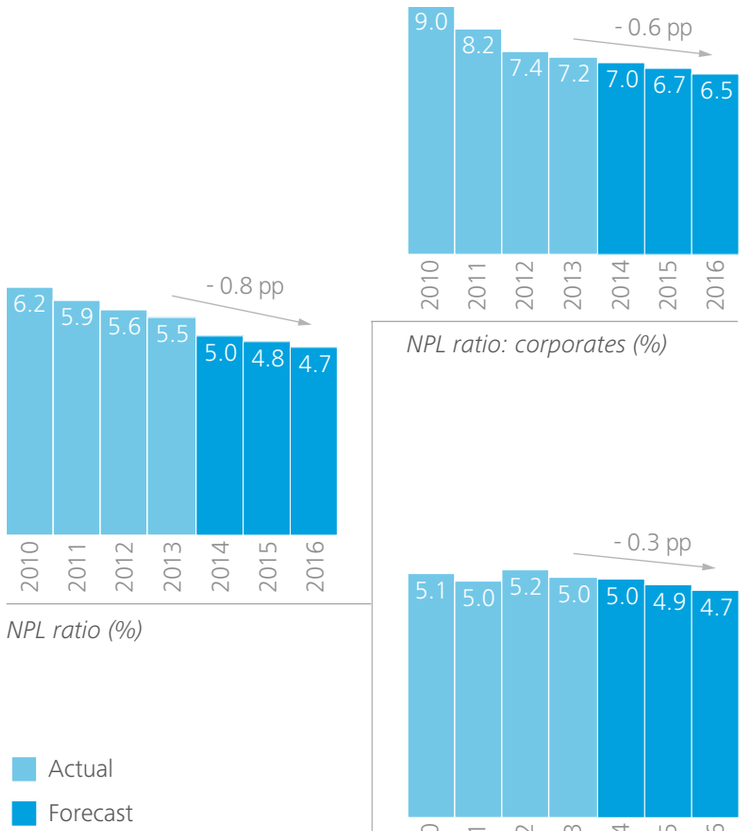
1. The loan and deposit breakdown was prepared based on monetary statistics reporting statements. whilst assets are based on banking supervision statements.
Source: Czech National Bank, Deloitte Estimates

The Czech Republic
Asset quality

NPL ratio to further decline with support from economic recovery and active debt purchase market

With the NPL ratio falling from 5.6% to 5.5% last year, asset quality is near the best in CE; only Slovakia has a lower NPL ratio. There was improvement last year both in retail (from 5.2% to 5.0%) and in corporate (from 7.4% to 7.2%) and a further decline is expected, with the economic recovery benefiting the financial standing of companies and the labor market. The trend is supported by an active debt purchase market for retail (mainly consumer) NPLs at relatively high prices. Provision coverage has been trending higher from 49.5% to 51.8% in 2013, as NPLs have migrated towards riskier categories and this trend is expected to continue in the near term.

Chart CZ5: Asset quality of the banking sector[1]



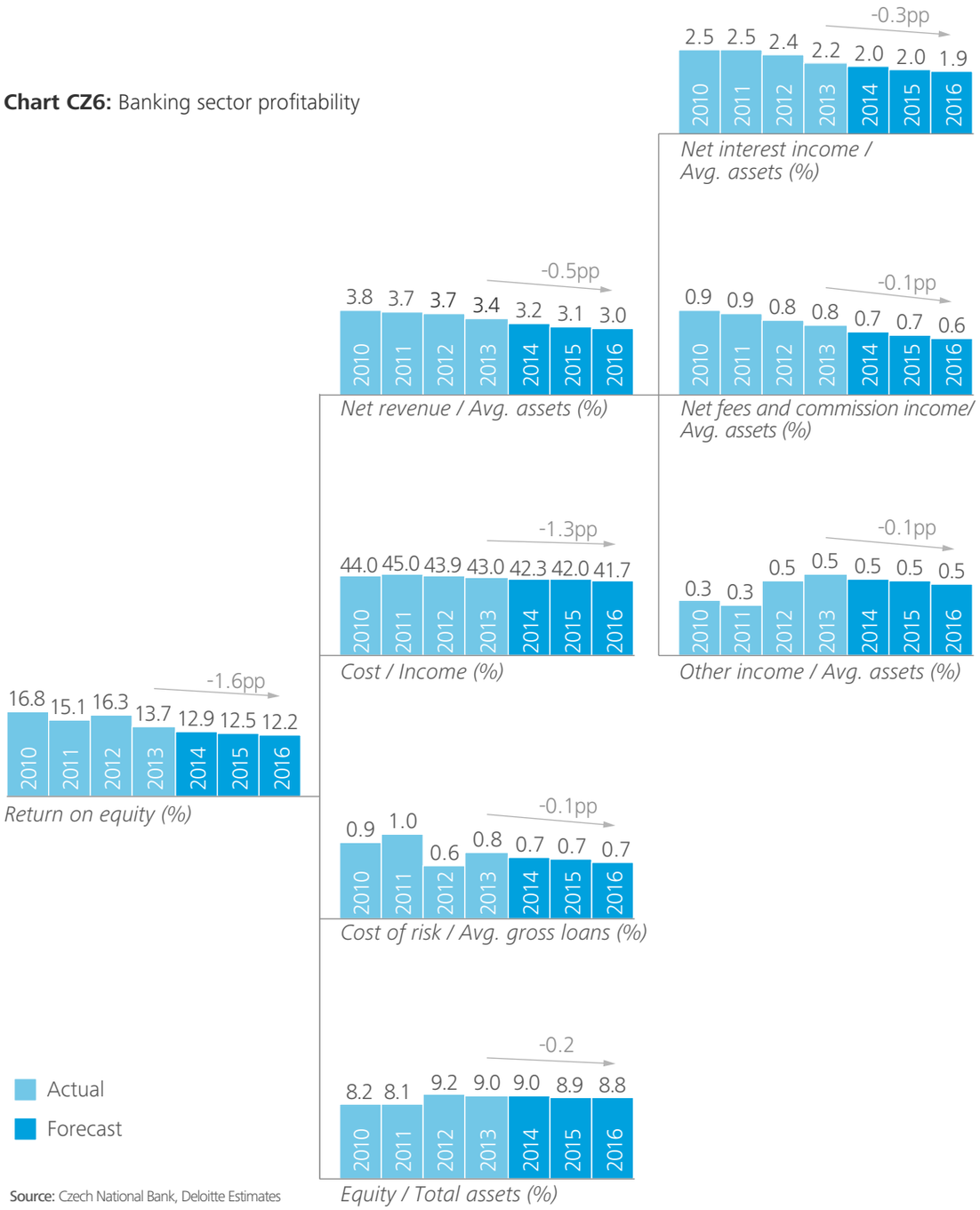
1. NPL includes only residents
Source: Czech National Bank, Deloitte Estimates

The Czech Republic
Profitability

ROE erosion is ongoing, driven by low interest rates, margin pressure and declining fee income

The banking sector has the highest ROE in CE but it faces ongoing erosion. A fall in net profit of 5% in 2013 contributed to a drop in ROE from 16.3% to 13.7% and the outlook is for continued ROE decline. Margin pressure, due to low interest rates and competition, has been and will continue to be a negative factor. Stronger loan volumes improve the outlook for net interest income, which fell 2% y/y last year, but we expect only moderate positive growth. Net fee income has also been shrinking in recent years, and this trend is expected to continue in the near term, affected by a shift to electronic payments and servicing. Banks reduced costs last year (-1.5% y/y), in response to weak revenues, and will continue to seek to the preserve cost/income ratio (43% in 2013). Net provisioning is already low, with payment discipline made easier by falling rates. However, economic recovery should still lead to some decline in defaults and allow for a slight improvement in risk costs.

Chart CZ6: Banking sector profitability



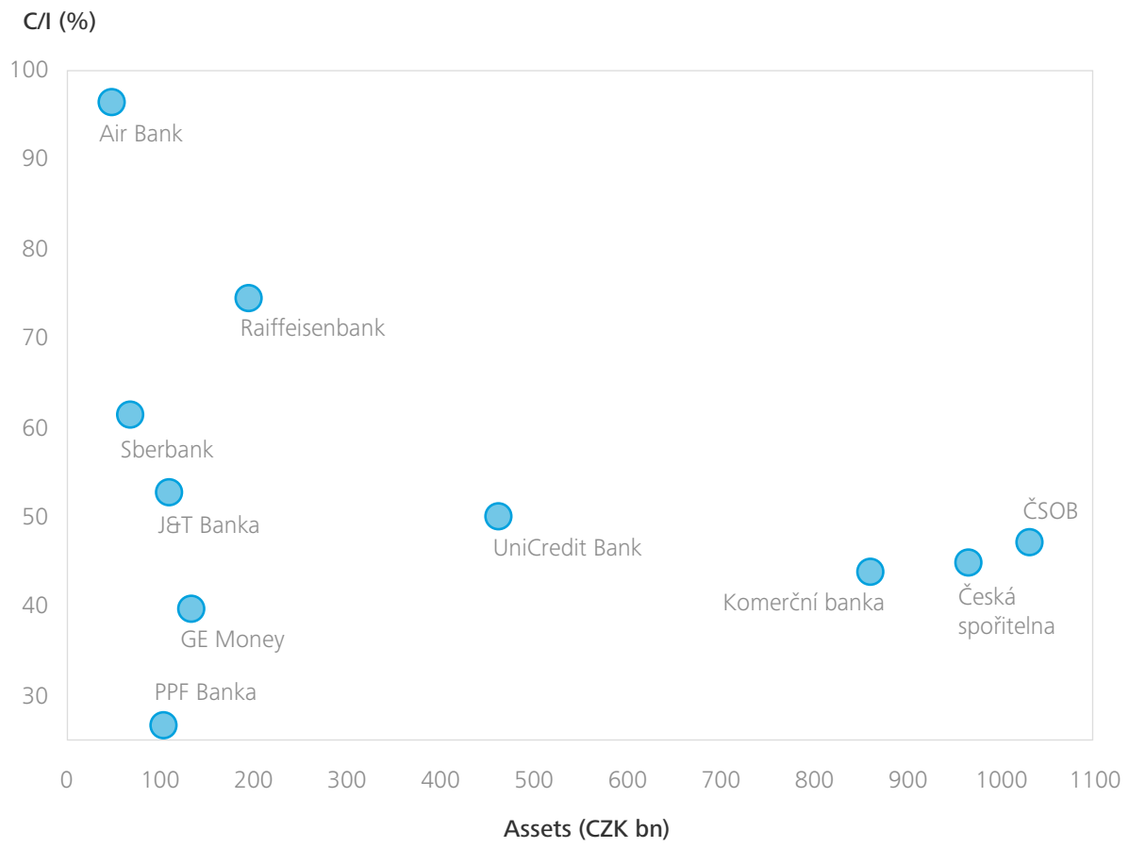
Source: Czech National Bank, Deloitte Estimates

The Czech Republic
Top 10 Banks

Three top banks have similar position on typical effect of scale curve

The average ROE of the 3 largest banks in the Czech Republic, 15.6% in 2013, is double that of the middle-tier, while the smallest banks (assets < CZK 50bn) in the sector remained on aggregate loss-making last year. The top 3 banking groups have assets, equating to 56% of the sector, but net profit equating to nearly 70%. The top tier has stood its ground in overall market share, performing well in mortgages and corporate lending but losing some ground in retail deposits, particularly Česká spořitelna. Smaller banks are taking advantage of the excess liquidity in the sector, capturing market share in deposits by offering above--average interest rates. Air Bank (launched in 2011), which has increased its deposit base 43% y/y (bringing market share to 1.3% in 2013) and is breaking into the middle tier, has said that it now plans to breakeven in 2014 (a year earlier than previously planned).

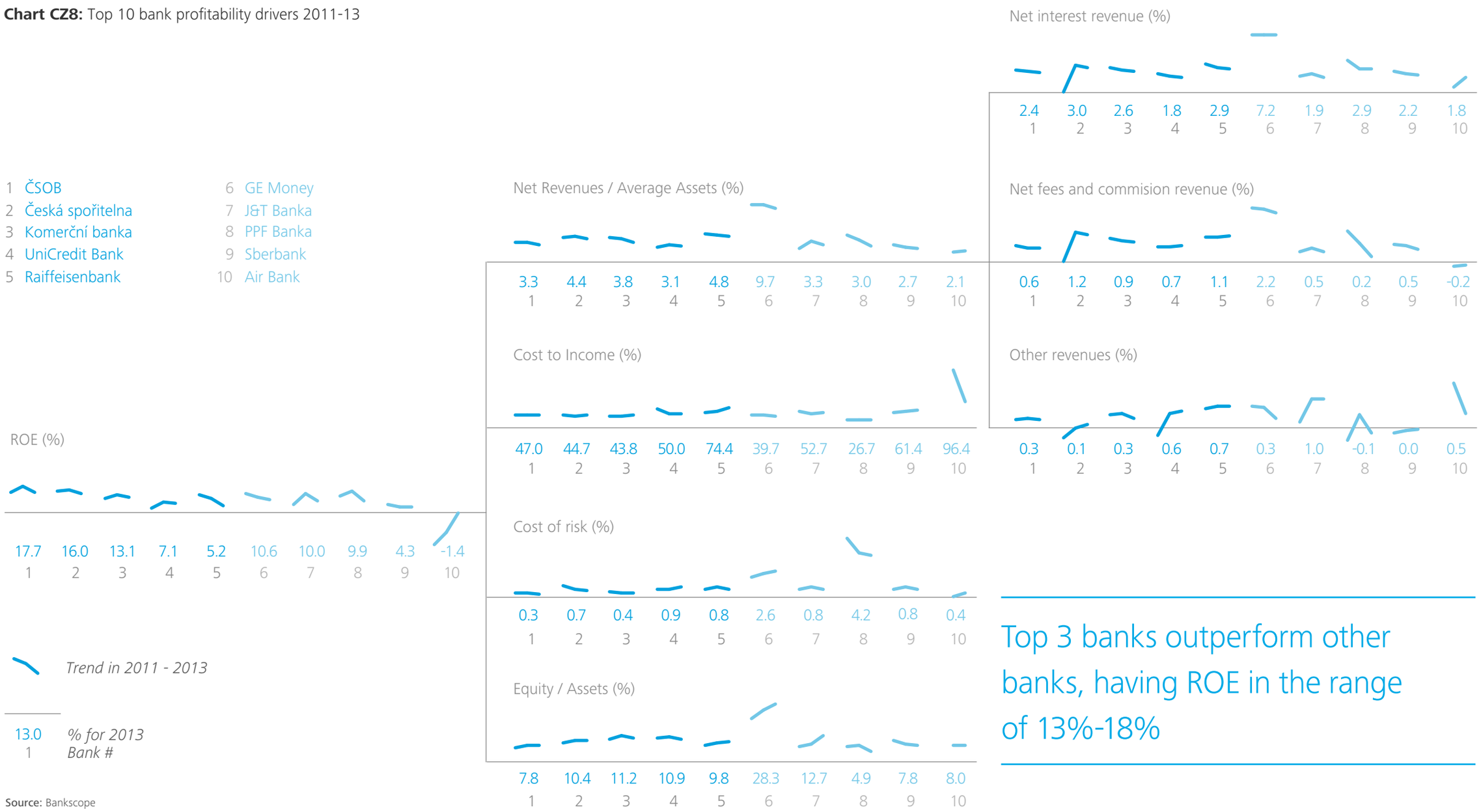
Chart CZ7: C/I ratio versus assets, 2013



Source: Bankscope

Chart CZ8: Top 10 bank profitability drivers 2011-13

1 ČSOB
2 Česká spořitelna
3 Komerční banka
4 UniCredit Bank
5 Raiffeisenbank
6 GE Money
7 J&T Banka
8 PPF Banka
9 Sberbank
10 Air Bank



Top 3 banks outperform other banks, having ROE in the range of 13%-18%

Source: Bankscope

Chart CZ9: Top ten banks market share development

	Loans MS 2013 change	Loans (CZK bn)	Deposits (CZK bn)	Deposits MS 2013 change	Assets MS 2013 change
ČSOB	20.7% -0.1pp		1 035	21.2% +0.8pp	20.1% -0.1pp
Česká spořitelna	20.2% -0.5pp		969	20.8% -1.1pp	18.8% -1.0pp
Komerční banka	19.5% -0.3pp		864	18.7% +0.4pp	16.8% -0.2pp
UniCredit Bank[1,2]	11.9% n.a.		465	8.8% n.a.	9.0% n.a.
Raiffeisenbank	6.2% -0.2pp		197	4.4% -0.2pp	3.8% -0.4pp
GE Money	4.5% -0.4pp		135	2.8% -0.3pp	2.6% -0.3pp
J&T Banka	2.1% +0.3pp		110	2.6% +0.5pp	2.1% +0.2pp
PPF Banka	1.3% +0.2pp		105	2.2% +0.5pp	2.0% +0.4pp
Sberbank[2]	2.1% +0.1pp		70	1.4% +0.1pp	1.4% 0.0pp
Air Bank[2]	0.9% +0.4pp		50	1.3% +0.3pp	1.0% +0.2pp
Total Market (CZK bn)	2 514.322			3 340.068	5 142.861

Retail
Corporate and others
Total volume/ breakdown not available
Assets (CZK bn)

1. Absorbed Unicredit Bank Slovakia in 2013 2. Unconsolidated statements
Source: Bankscope, Czech National Bank

The Czech Republic
Strategic Directions

In the highly competitive Czech market, banks are paying increased attention to customer experience and loyalty, aiming to provide a better aligned omni-channel service. Investment in multichannel platforms and advanced CRM solutions are inevitable, as customer journeys and interaction includes, on top of traditional branches, an ever widening range of digital touch points. Analytics will assume a stronger role in all segments, to identify and target customer needs with better focused and personalised offers; banks will have to start tapping into pools of so far unused but valuable unstructured data in order to utilise the full breadth of information they keep on their customers. As market consolidation is not very likely, organic growth and focus on existing customer portfolios will continue to dominate.

Due to erosion of profitability, we can also expect a trend of broadening of traditional core banking services by new cross-sell revenue products like e.g. energy or telco services, supported by new client reward programs and PFM solutions. Cross-industry alliances will likely be formed or potential within financial groups tapped. Banks will need to consider providing higher added value advisory and focus on innovation to ensure further revenue growth as traditional, especially retail banking services, are becoming a commodity with little room for any differentiation.

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Hungary
Key Insights

A creditless economic recovery is underway in Hungary. Loans have been shrinking (-6.7% y/y expected in 2014), in both the retail and corporate segments but should bottom out this year.

NPL ratio (16.0% in 2013) should improve gradually The corporate NPL ratio has fallen from a mid-year peak in 2013 and debt relief should benefit FX mortgages, the key trouble spot in the retail segment.

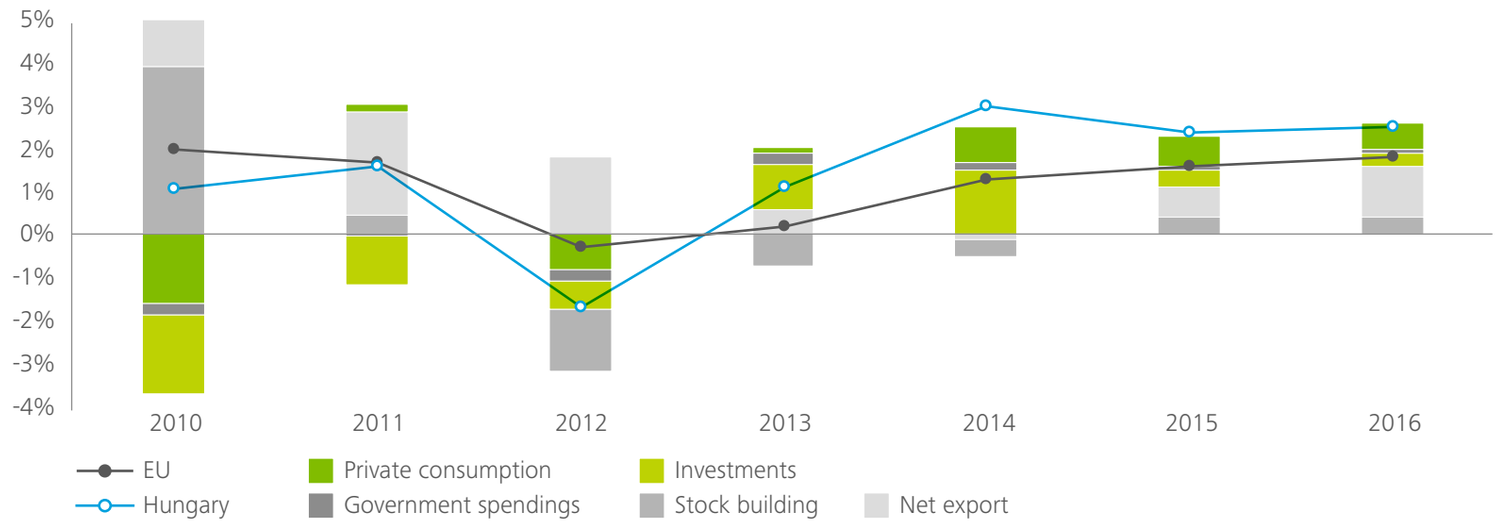
FX debt relief will plunge the banking sector into a deep loss (of more than HUF 600 bn) this year, with losses on refunds of FX margin and unilateral interest rate changes estimated by the MNB at HUF 700-900bn.

ROE will remain poor (expected at 2-3%) in 2015-16, burdened by industry taxes, with pressure on revenues from low interest rates, shrinking volumes, and regulation, offsetting falling risk costs.

Hungary
Economy

Hungary's economy has accelerated but it may lose some of its momentum in 2015-16

Chart HU1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)

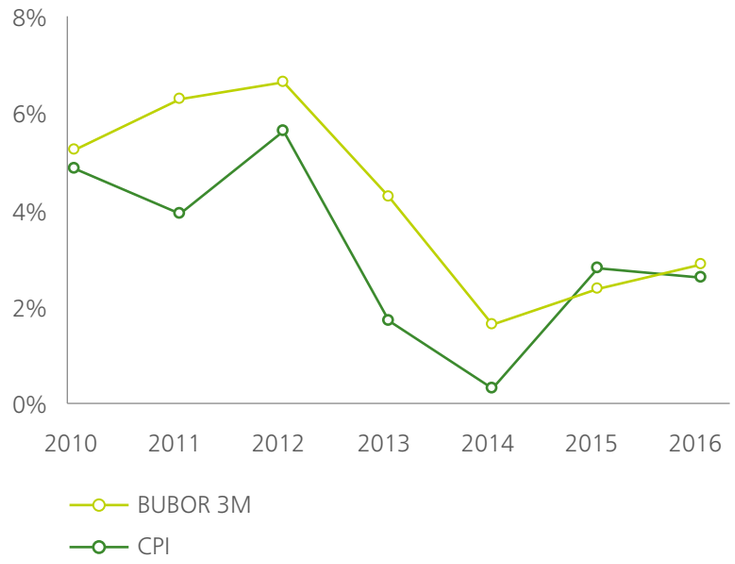


Source: Economist Intelligence Unit

Hungary's economy has accelerated this year but it may lose some of its momentum in 2015-16. Hungary's creditless economic recovery over the past year has been fueled largely by public spending and investment accelerated in front of the April elections.

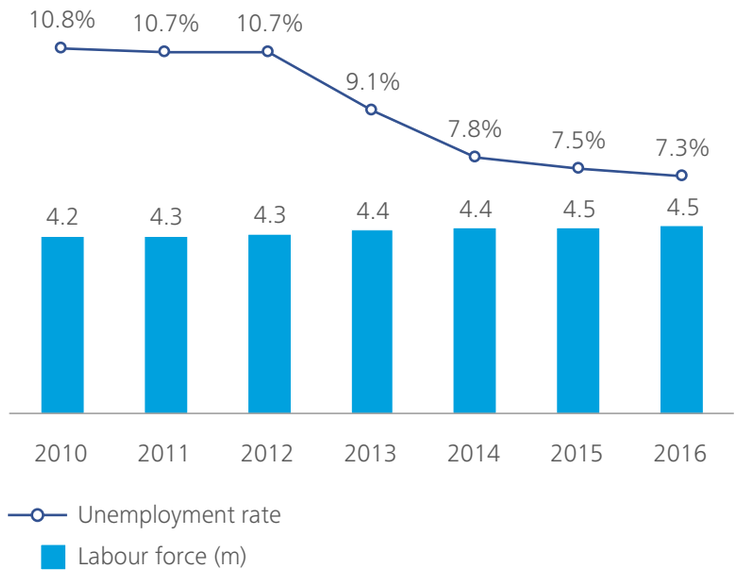
Unemployment has declined more than in any other CE country over the past 12 months (from 10.4% to 8.1% in June 2014) but public work schemes have been a major factor. Private sector investment has been supported partially by the Funding for Growth Scheme (FGS). The contribution of government programs to growth should fade in the coming year.

Chart HU2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart HU3: Labour market



Source: Economist Intelligence Unit

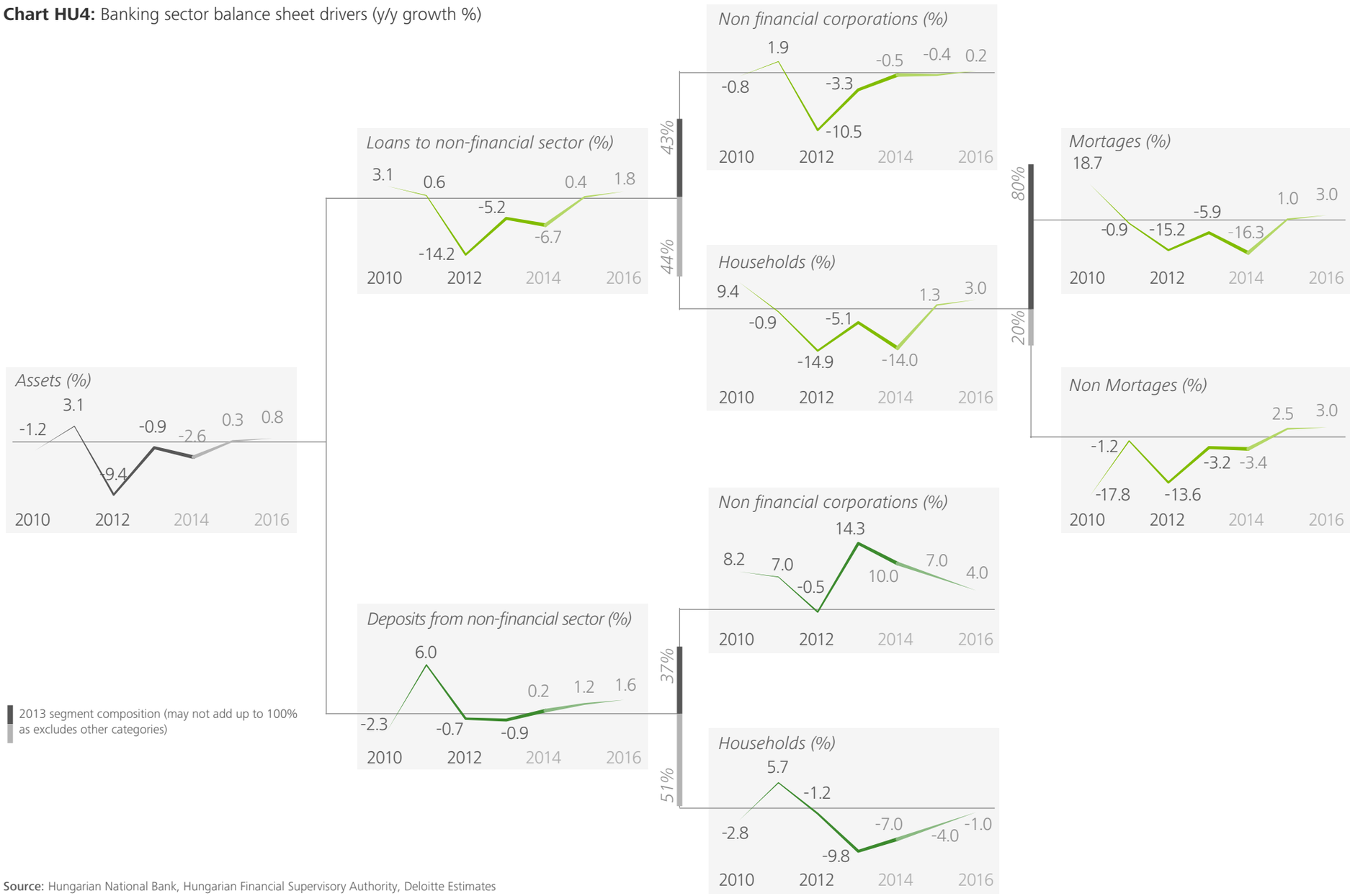
Growth next year should rely more on private consumption, which has been rising gradually, supported by the labor market improvement and growing disposable income. Households will also benefit in the coming months from substantial FX debt relief and face lower payments going forward that will reduce the need for further deleveraging.

Hungary
Balance sheet

Loans should bottom out this year, with the retail segment to lead a gradual turnaround in 2015-16

Loans are in decline, in both the retail and corporate segments, but should bottom out this year. Retail loans, after falling by 5% y/y in 2013, are expected to shrink by a further 3-4% y/y this year on an underlying basis but the drop including FX debt relief may reach 13-15%. After this refund, growth in purchasing power and improved confidence should trigger a return to positive retail loan growth in 2015-16. Corporate loans, down 3% y/y in 2013, have been propped up by the FGS, providing low-interest credit primarily to SMEs. With the impact of the FGS (stage II ends in December) already in the base, a slight decline to flat development is expected in corporate lending in 2014-16. Appetite to grow corporate lending will be negatively impacted by losses suffered as a result of FX debt relief, which could amount to a third of tier 1 capital. The sector's tier 1 CAR was 14.7% of RWA at year-end 2013 but recapitalizations are likely to occur at some banks (e.g. CIB, Erste). Only minimal growth of deposits is expected, as households will continue to shift towards alternative investments (e.g. mutual funds, retail government bonds) in the low-interest-rate environment.

Chart HU4: Banking sector balance sheet drivers (y/y growth %)



Source: Hungarian National Bank, Hungarian Financial Supervisory Authority, Deloitte Estimates

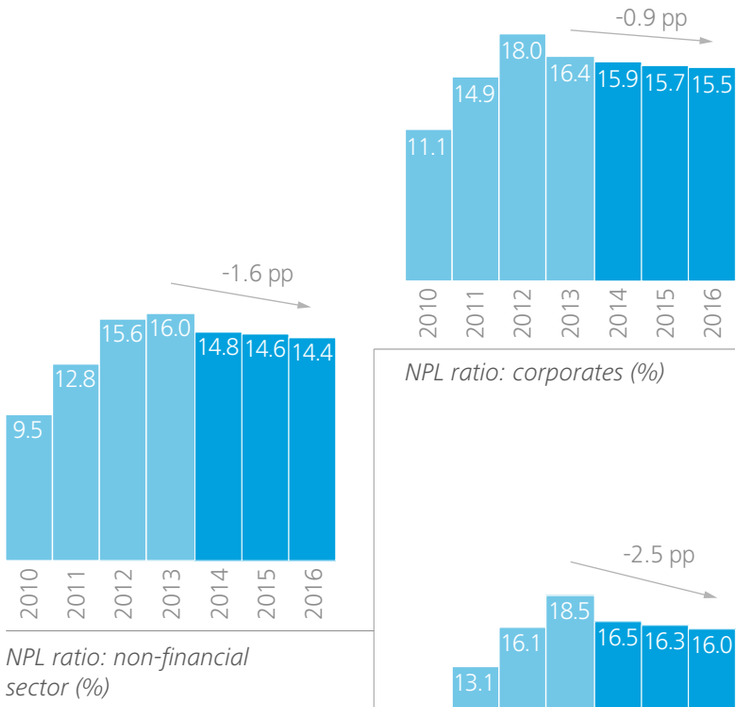
Hungary
Asset quality

Asset quality in Hungary should recover gradually after benefiting from FX mortgage relief this year

Credit risk in Hungary remains high but the NPL ratio (>90 days) should improve gradually. The corporate NPL ratio has fell back from 18.0% to 16.4% in 2013, due mainly to a record level of portfolio cleaning. The improving economy should bring a further more gradual improvement, although project loans (mainly commercial real estate), accounting for 40% of corporate NPLs, will remain a key risk. We expect the corporate NPL ratio to decline to 15.5% in 2016 (a new state-owned Asset Management Company if implemented could contribute to a more significant decline).

The retail NPL ratio has continued to rise, from 16.1% to 18.5% in 2013, driven mainly by FX mortgages and home equity loans, but should peak this year. The level of FX debt relief will be very significant on average (15-20%), which suggests a significant proportion of NPLs may be cured, potentially more than offsetting the base effect. Moreover, the improvement in the labor market and swing in the stock effect, as retail loans start growing again, should put the retail NPL ratio on a gradual downward path next year towards 16.0% in 2016.

Chart HU5: Asset quality of the banking sector



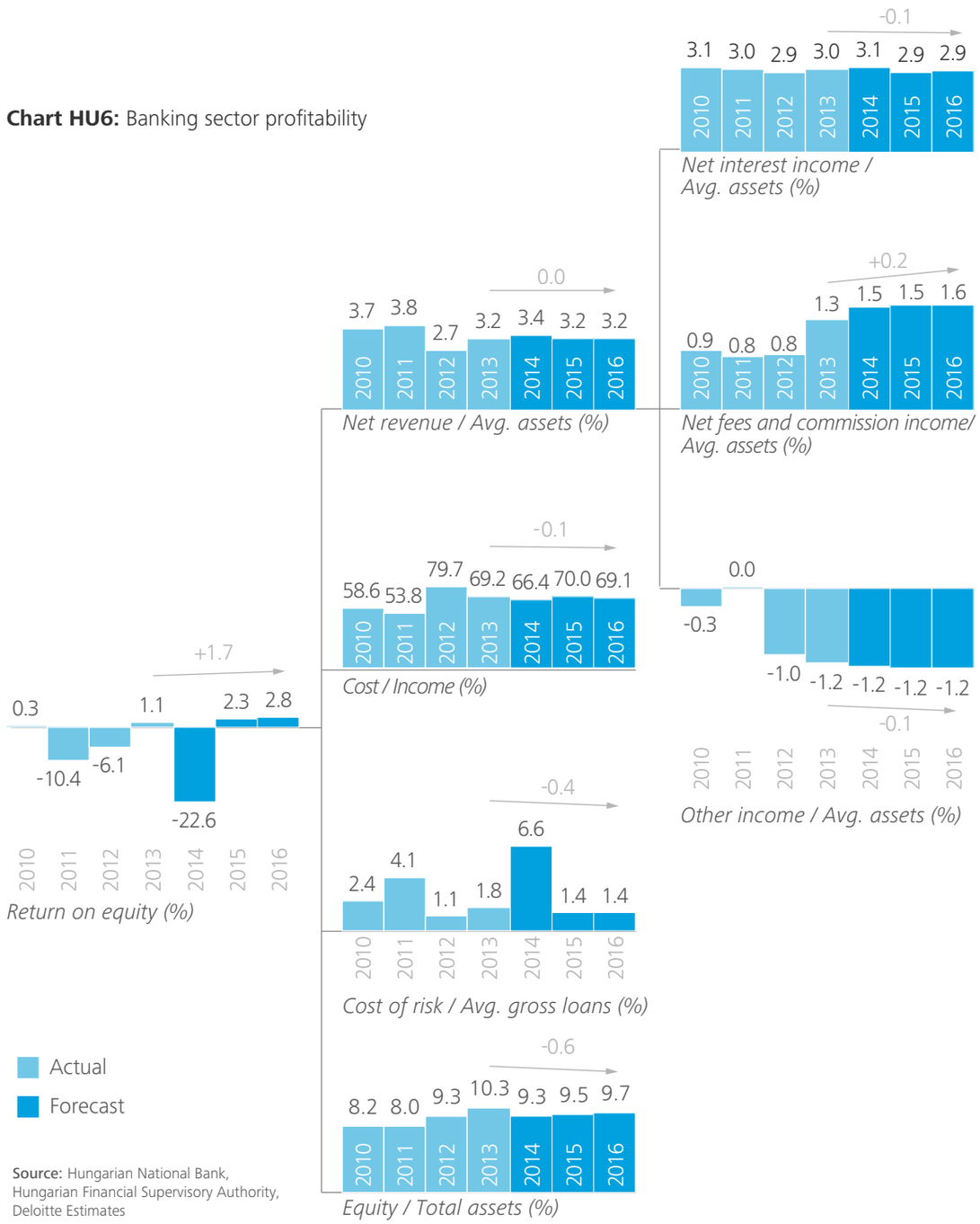
Source: Hungarian National Bank, Hungarian Financial Supervisory Authority, Deloitte Estimates

Hungary
Profitability

FX mortgage relief will drive a huge loss in 2014 but underlying profitability is also very weak

The banking sector faces a huge loss this year, due to the costs of FX mortgage relief, and profitability will remain under pressure in 2015-16. Losses this year on refunds to customers of FX margin and unilateral interest rate changes have been estimated by the MNB at HUF 700-900bn. Next year, the government plans legislation on the conversion of FX loans to HUF, which presents a risk of further losses (not included in our forecast) if this occurs at a below-market exchange rate. The underlying profitability of the sector is very low. A one-off item (the relief of external liabilities by a parent bank amounting to HUF 120bn) accounted for a majority of the sector's HUF 155bn pre-tax profit in 2013, without which pre-tax ROE was just 1-2%. The sector will continue to face a heavy burden from the banking levy (HUF 128bn) and the financial transaction tax (FTT, c. HUF 200bn in 2013). Net fee income has risen quickly over the past year, as banks re-priced to offset the impact FTT, but this effect will dissipate. FX debt relief will benefit risk costs in 2015-16 but this will be more than offset by the negative impact on net interest income. Banks have been cutting costs but, with less room now after many years of scaling back, we do not expect this to be a significant driver of the bottom line going forward without consolidation.

Chart HU6: Banking sector profitability



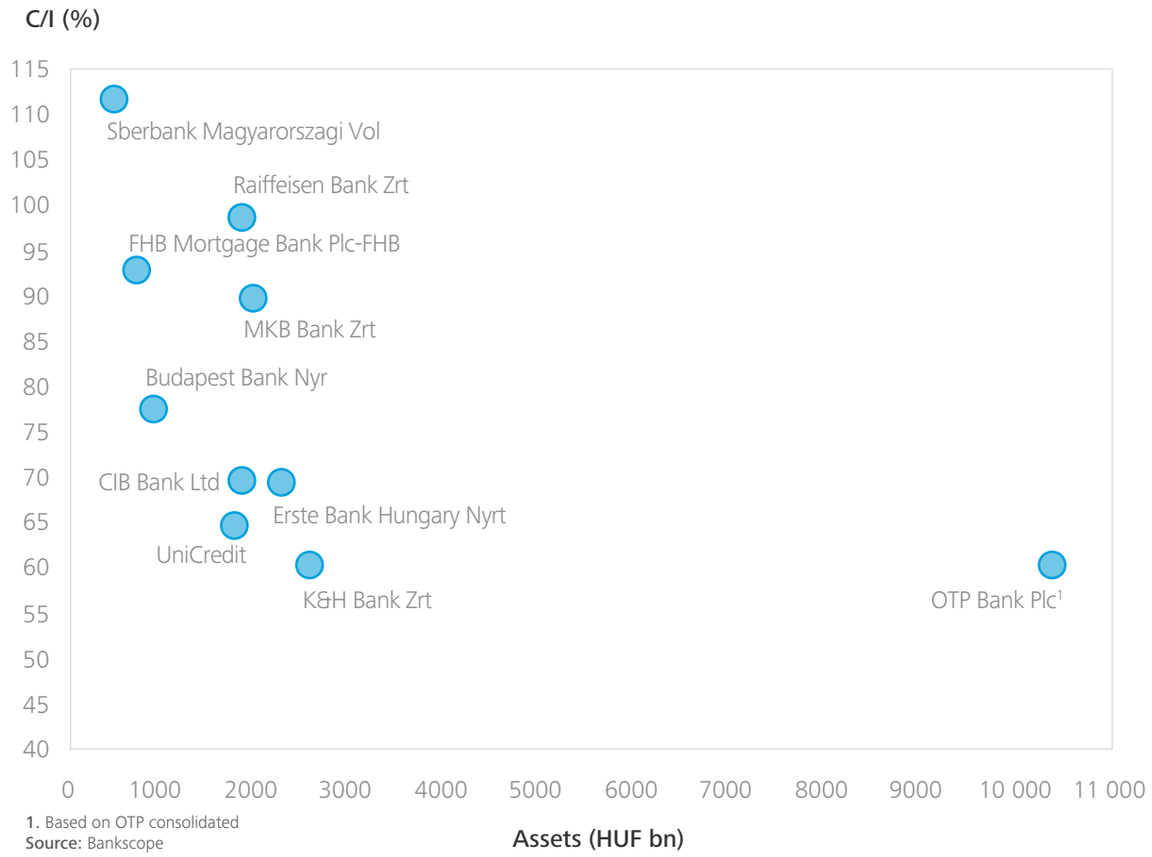
Source: Hungarian National Bank, Hungarian Financial Supervisory Authority, Deloitte Estimates

Hungary
Top 10 Banks

Cost to income is increased by the burden of industry taxes

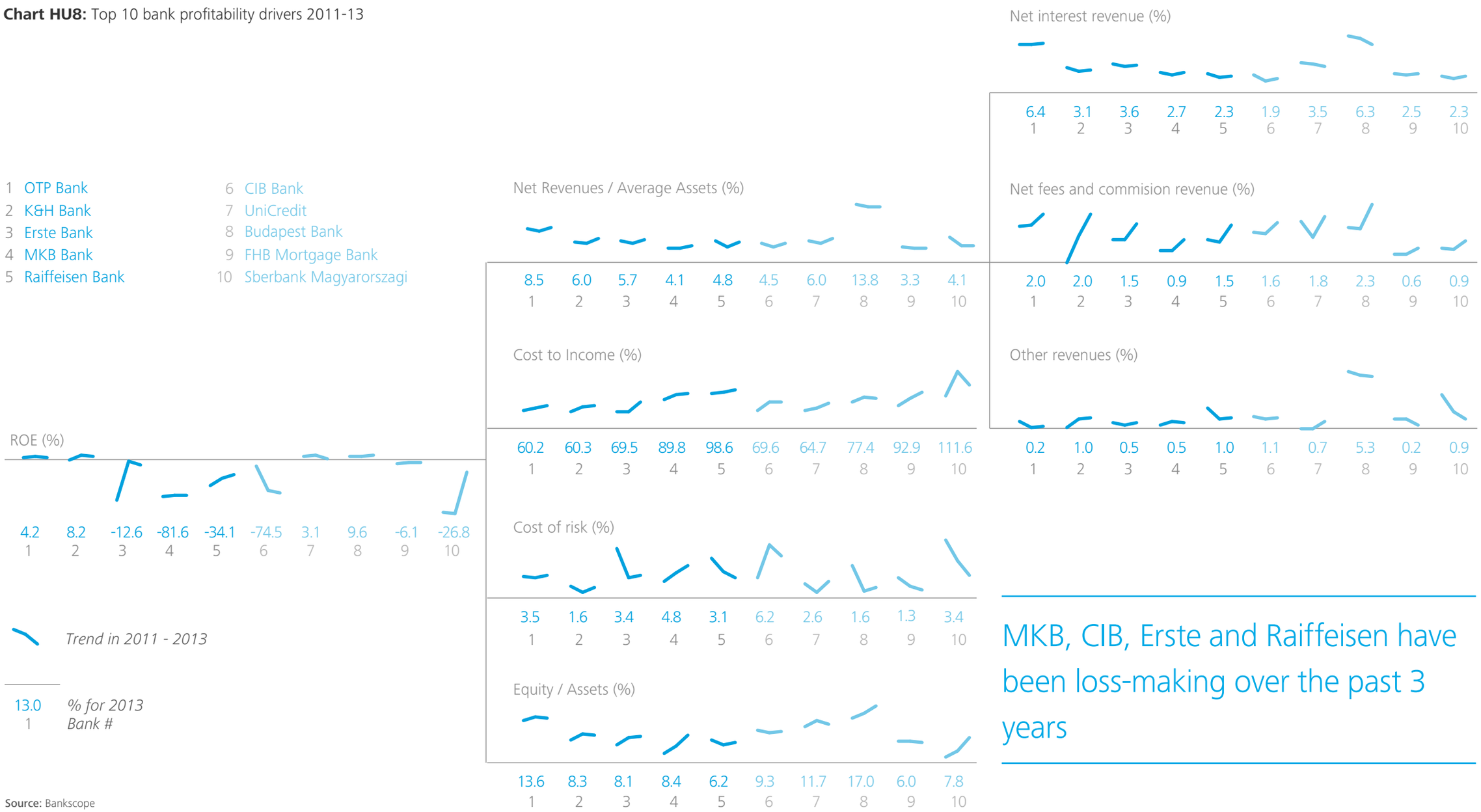
There is a large gap in the sector between those banks that have remained consistently profitable (OTP, K&H, Budapest Bank, UniCredit) and those that have been consistently loss-making (MKB, CIB, Erste, Raiffeisen) over the past 4 years. The loss-making banks, in general, have either been over-exposed to project finance and commercial real estate or were aggressive lenders during Hungary's FX mortgage boom. Tasked with bringing down relatively high loans/deposits ratios, these banks have been ceding market share in lending. Although the sector has been shrinking overall, many of the most profitable banks in the sector have been selectively gaining market share in lending. OTP Bank has increased market share in both corporate and consumer loans, though it has faced erosion of its leading position in mortgages. Both UniCredit and Budapest Bank have increased market share in mortgages, with the latter also gaining in SME loans.

Chart HU7: C/I ratio versus assets, 2013



1. Based on OTP consolidated
Source: Bankscope

Chart HU8: Top 10 bank profitability drivers 2011-13



MKB, CIB, Erste and Raiffeisen have been loss-making over the past 3 years

Source: Bankscope

Chart HU9: Top ten banks market share development

	Loans MS 2013 change	Loans (HUF bn)	Deposits (HUF bn)	Deposits MS 2013 change	Assets MS 2013 change
OTP Bank[1]	17.0% -0.1pp		6 455	25.8% +1.0pp	20.7% +0.9pp
K&H Bank	7.2% +0.1pp		2 562	11.2% +1.1pp	8.2% +0.4pp
Erste Bank	9.1% -0.8pp		2 267	8.2% -1.1pp	7.3% -1.6pp
MKB Bank	8.5% -1.6pp		1 962	7.9% -1.5pp	6.3% -1.9pp
Raiffeisen Bank	8.4% +0.3pp		1 851	8.3% -1.5pp	5.9% -0.7pp
CIB Bank	9.0% -0.7pp		1 849	7.8% -1.0pp	5.9% -0.8pp
UniCredit	5.7% +0.1pp		1 770	7.2% +0.2pp	5.7% +0.4pp
Budapest Bank	3.2% +0.1pp		905	4.3% -0.5pp	2.9% 0.0pp
FHB Mortgage Bank	2.8% -0.1pp		738	1.5% +0.5pp	2.4% 0.0pp
Sberbank Magyarorszagi	1.7% +0.1pp		489	1.9% 0.0pp	1.6% -0.2pp
Total Market (HUF bn)	17 865			14 865	31 156

Retail
Corporate and others
Total volume/ breakdown not available
Assets (HUF bn)

1. Based on OTP Core
Source: Bankscope, banks' annual reports

Hungary
Strategic Directions

Industry consolidation is set to become a key strategic issue in Hungary. Although the operating environment should gradually improve, beyond this year, the profitability of many banks will remain very poor under the burden of industry taxes. Following FX debt relief and the planned conversion, the banking sector will face a reduced level of credit and regulatory risk, which has been a key barrier to transactions. In July, BLB announced the sale of MKB to the state, in order to prevent further losses to the parent company and to meet its EC commitments. Other foreign parents may follow suit, as they look for cost saving opportunities and refocus on more profitable core businesses. Opportunistic buyers, apart from the state, could include OTP, K&H, or Sberbank. Another priority for banks is the management of non-performing assets, including workout and debt restructuring as well as third party sales. Cross-selling will increase in importance for established players seeking to take best advantage of the gradual pickup in the retail segment.

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Poland
Key Insights

Strongest economic outlook in CE (expected GDP growth of 2.7% in 2014 and 3.5% in 2015), and a top performer in the EU, Poland is benefiting from strengthening domestic demand, with rising private consumption and investment.

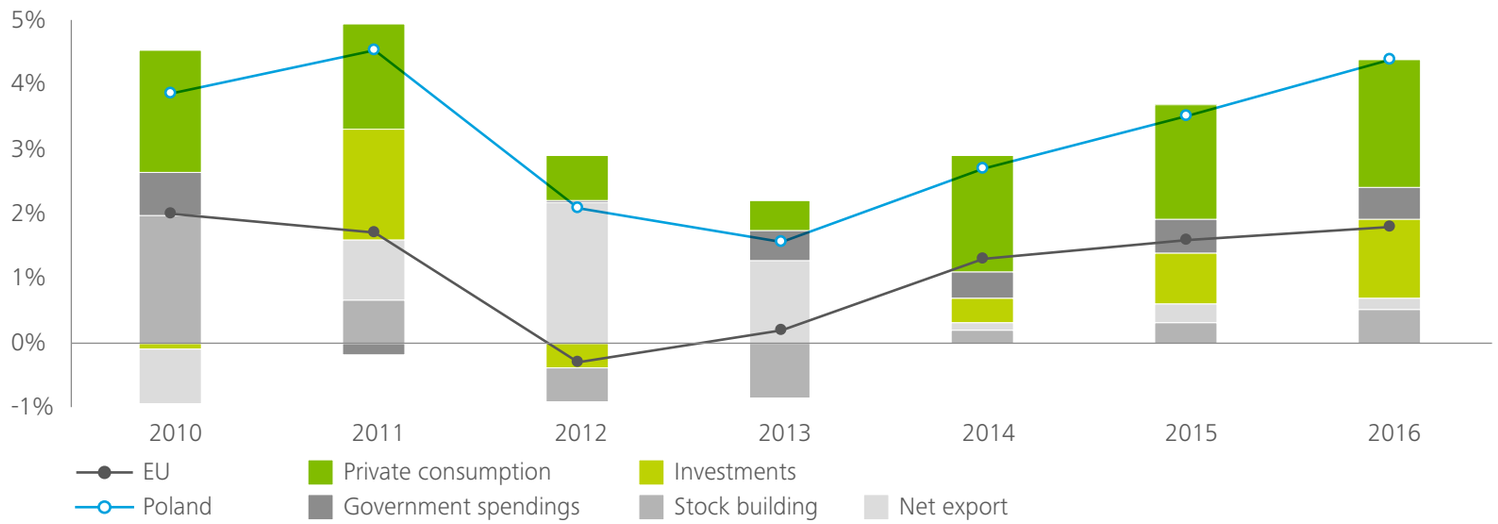
Loan growth is accelerating, led by an increase in corporate borrowing (6.3% y/y expected in 2014) to support investments and a strong pick-up in consumer loans (6.5% y/y). Mortgage loan growth should follow.

NPL ratio (8.5% in 2013) is above northern CE peers but is improving, on the back of a stronger economy and with support from an active debt purchase market. Risk costs should fall moderately.

ROE (10.1% in 2013) is among the best in CE and is levelling out after years of erosion. Accelerating loan volumes are expected to drive the fastest net interest income growth in the region.

Poland
Economy

Chart PL1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)

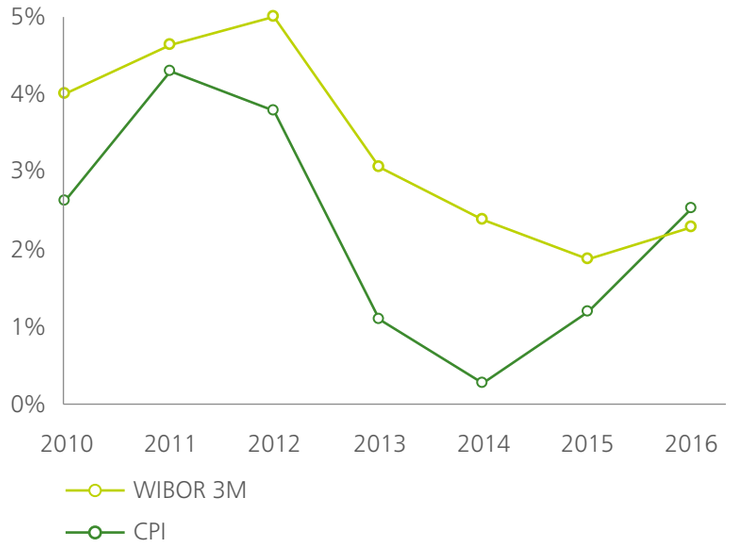


Source: Economist Intelligence Unit

Poland's strong economic outlook is supported by private consumption and investment

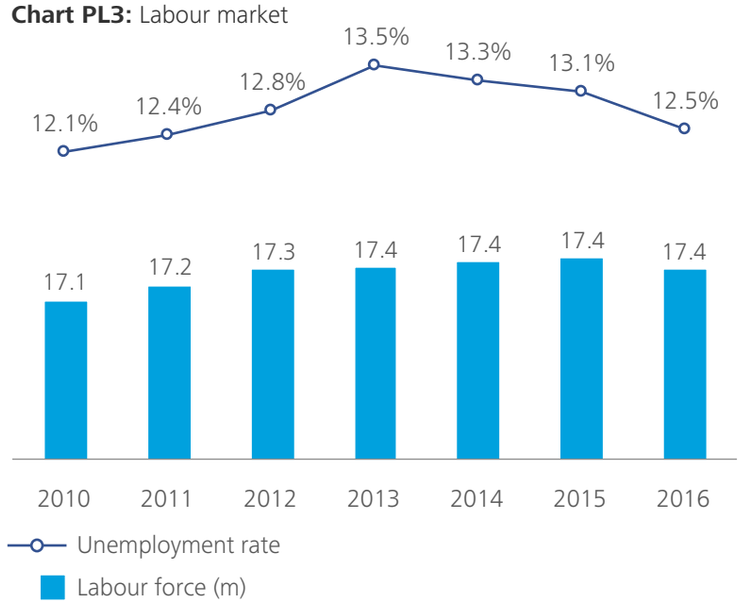
Poland's economic outlook is the strongest in CE, supported by an acceleration of domestic demand. The contribution of net exports to GDP growth is expected to fade on rising imports. Corporate investment is accelerating, reflecting improving business confidence.

Chart PL2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart PL3: Labour market



Source: Economist Intelligence Unit, Central statistical office of Poland

An improving labor market, with unemployment falling and rising wage growth, together with increasing consumer confidence is contributing to growth of private consumption, whilst property prices are levelling out.

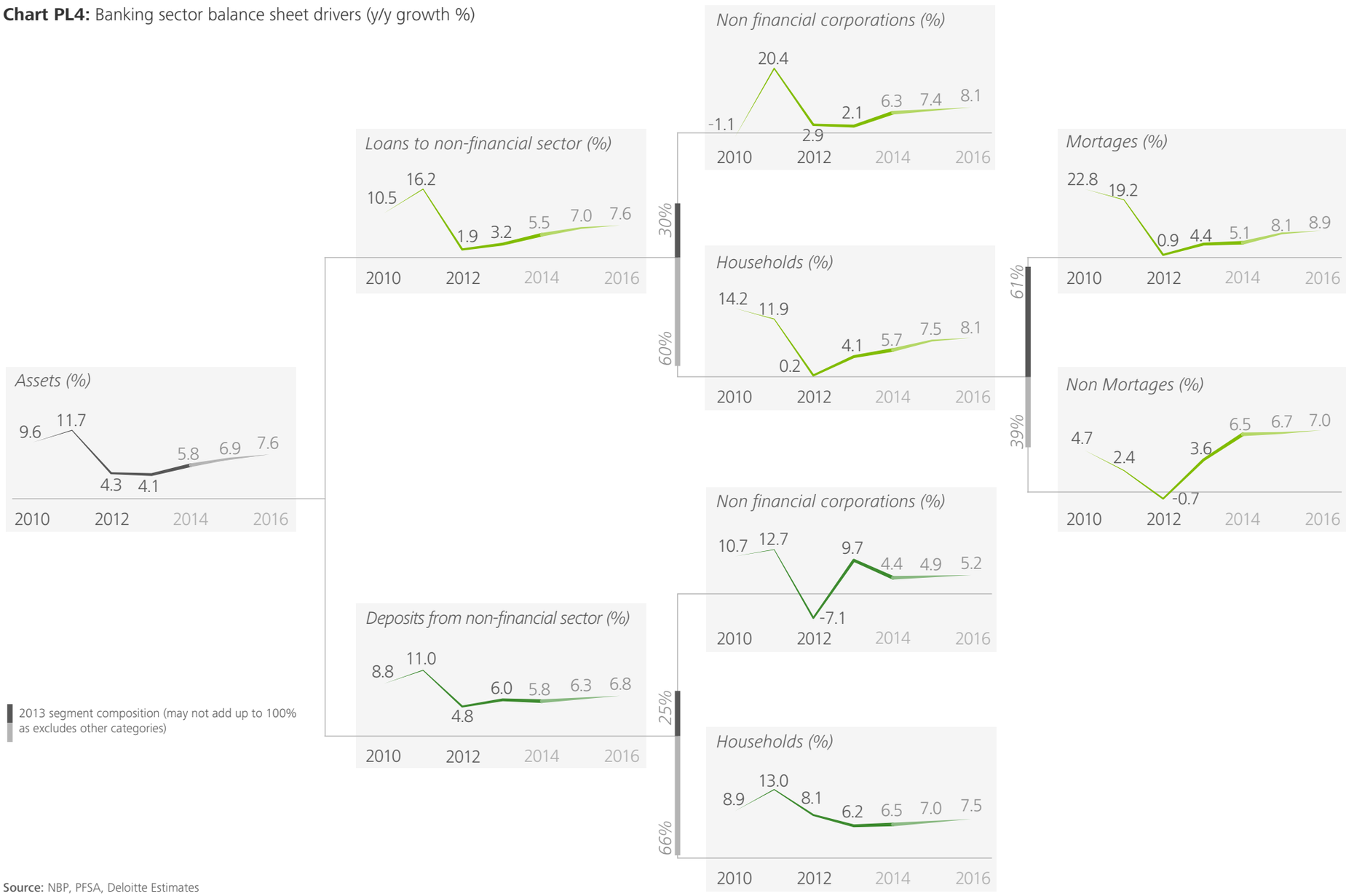
Record low interest rates are encouraging private sector borrowing and, with inflation running at very low levels, money markets are now pricing in another cut by the central bank this year.

Poland
Balance sheet

Loan growth is accelerating, led by corporate borrowing and consumer loans

Loan growth is accelerating. Corporate loan growth is picking up, from 2.1% y/y in 2013, and is expected to reach 6.3% y/y this year, and continue to build momentum on the back of investment, with capacity utilization at a relatively high level (77% in 2Q 14). At the same time, the de minimis portfolio guarantee facility is supporting working capital loans for SMEs. Consumer loans, after a decline of more than 2 years, have been accelerating since mid-2013 and are expected to reach 6.5% y/y this year. Demand is encouraged by low interest rates, whilst the regulator has eased credit criteria. Mortgage loan growth should pick up gradually, supported by the affordability of credit and stabilizing property prices, but will be diminished by rising principal repayments as the portfolio matures. As corporates utilize cash reserves, deposit growth in the segment is expected to ease, from 10% y/y in 2013 to 4-5% in 2014-16, which should return overall loans/deposits to a slight rising trend over the next few years.
The sector is well capitalized, with a tier 1 ratio of 14.2% at year-end 2013.

Chart PL4: Banking sector balance sheet drivers (y/y growth %)



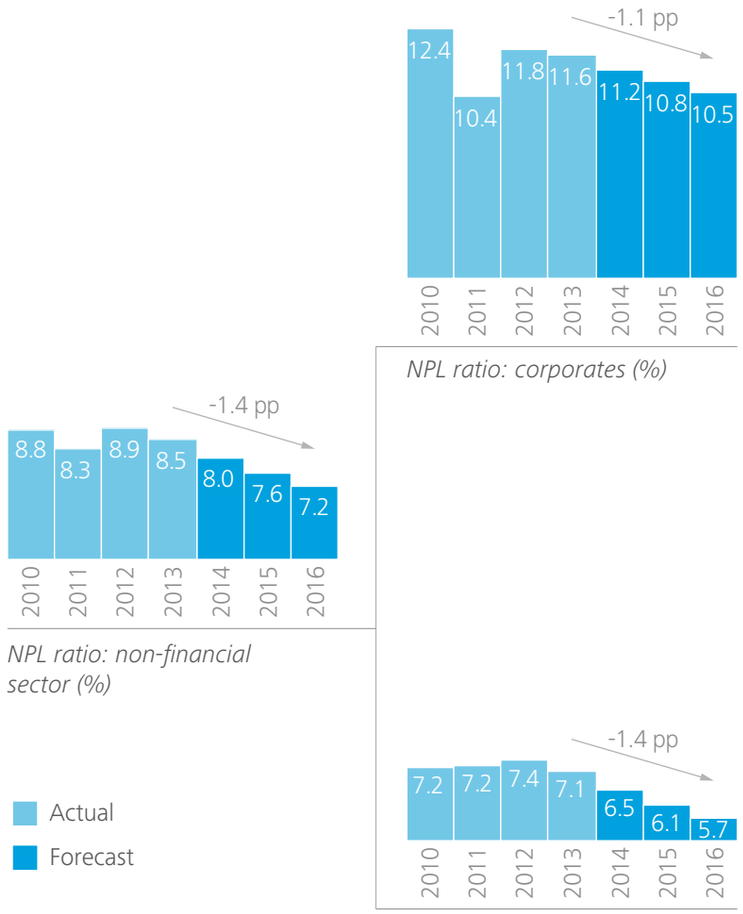
Source: NBP, PFSA, Deloitte Estimates

Poland
Asset quality

NPL ratio is improving on the back of a stronger economy and with support from the debt purchase market

The banking sector's NPL ratio (8.5% in 2013) is above that of northern CE peers but should decline more quickly over the next few years, supported by loan portfolio growth and an active debt purchase market. The corporate NPL ratio fell from 11.8% to 11.6% in 2013 but the decline has accelerated this year, helped by the improving financial standing of companies. The retail NPL ratio fell from 7.4% to 7.1% in 2013, as a function of the mortgage NPL ratio, rising from 2.8% to 3.1%, and the consumer NPL ratio, falling from 14.4% to 13.1%. A continued decline of the consumer NPL ratio will be supported by the propensity of banks to sell older unsecured loans and the improving labor market, although bank credit standards are easing. The mortgage NPL ratio has been rising, as the portfolio matures but should be near a turning point. The debt purchase market for mortgage NPLs is nascent but a record transaction this year points to growing activity. Although about half of mortgages are denominated in FX (primarily CHF), the weaker PLN (since origination) has had only a moderate impact on loan quality, as servicing capacity benefits from low CHF interest rates and rising household income.

Chart PL5: Asset quality of the banking sector



Source: NBP, PFSA, Deloitte Estimates

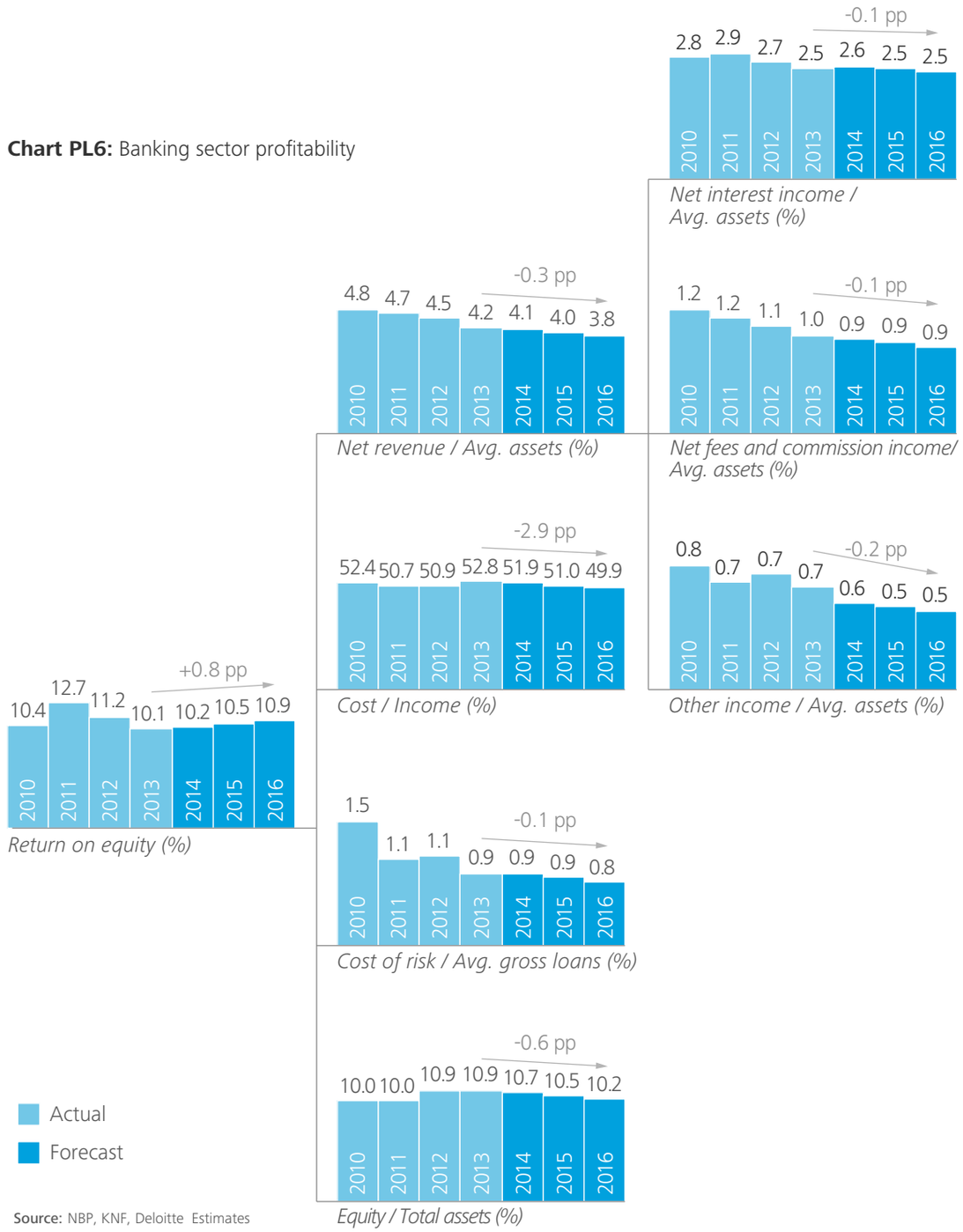
Poland
Profitability

ROE improvement beyond 2014 helped by volume-driven revenue growth

The ROE of the banking sector, one of best in CE (second only to the Czech Republic) at 10% in 2013, has suffered erosion in recent years but should level out in 2014 and rise gradually in 2015-16. Near-term headwinds include a decline in securities income (after large bond market gains last year) and a negative impact on net fee income from cards due to a cut in interchange fees. The margin, which managed a partial recovery in H1 2014, will also be negatively affected if, as we expect, the central bank cuts interest rates later this year. Competition for deposits is also expected to heat up, with asset growth accelerating.

However, with rising loan volumes, net interest income growth (3Y CAGR 5.4%) is expected to be the strongest in CE in 2014-16. This should put the cost/income ratio on a downward trend, even allowing for a moderate pick up in costs. Risk costs are above northern CE peers and, due to the relatively favorable trend in asset quality, should fall moderately. In sum, we expect 5% earnings growth this year but 7-9% growth in 2015-16. A potential increase in BGF contributions next year, to support plans for bailouts in the credit union segment, however, does pose some risk to the otherwise favorable outlook.

Chart PL6: Banking sector profitability

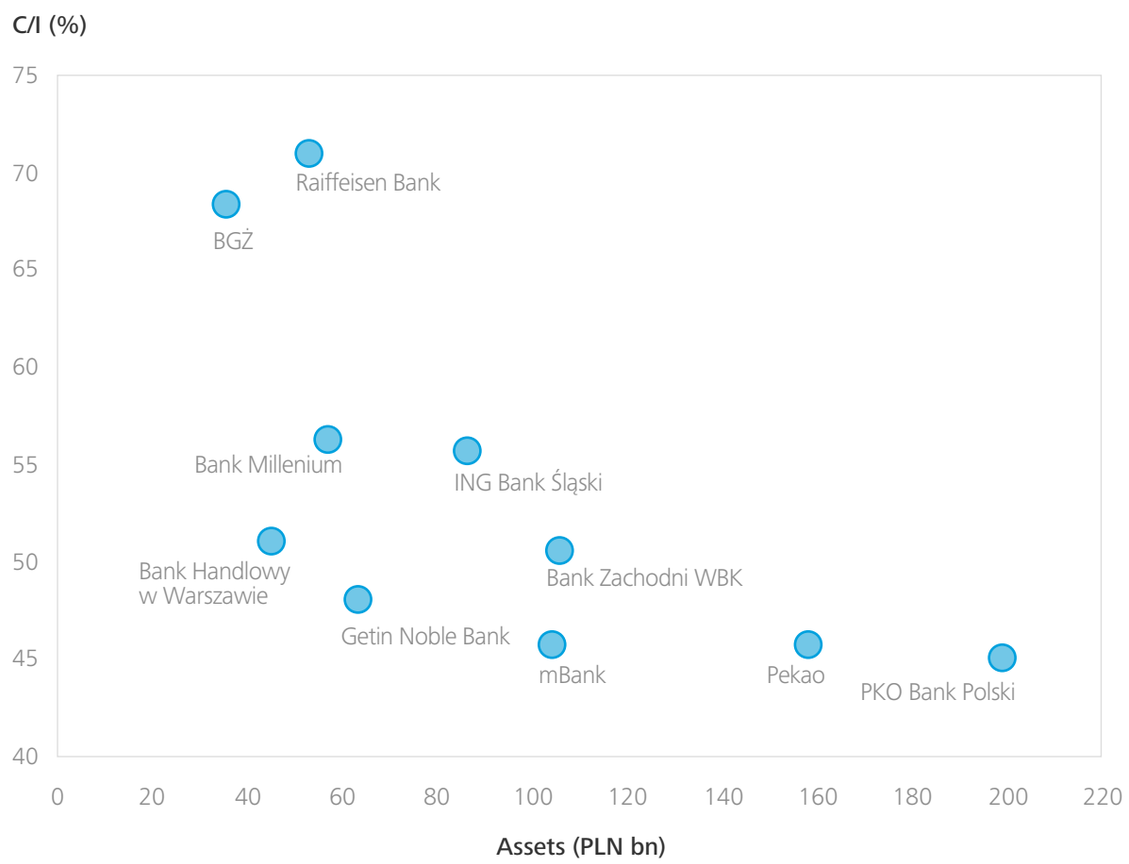


Source: NBP, KNF, Deloitte Estimates

Poland
Top 10 Banks

Recent consolidation has driven significant market share gains for some of Poland's top 10 banks. PKO Bank Polski (#1) is merging with Nordea's Polish operations, Bank Zachodni WBK (#3) has merged with Kredyt Bank and is acquiring a 60% of Santander Consumer Bank, and Raiffeisen Bank (#8) has merged with Polbank. The key natural overall winner of market share in both the retail and corporate segment has been ING Bank Śląski (#5). Bank Pekao (#2) also registered gains in corporate and retail lending but suffered erosion of its share in retail deposits. mBank (#4) lost ground in retail volumes last year, ceding market share in loans and deposits, as it prioritized margin and fee income, but was still one of the sector leaders in customer acquisition. A similar trade-off was made by Getin Noble Bank (#6), which has prioritized a reduction of funding costs and growth of current account volumes.

Chart PL7: C/I ratio versus assets, 2013

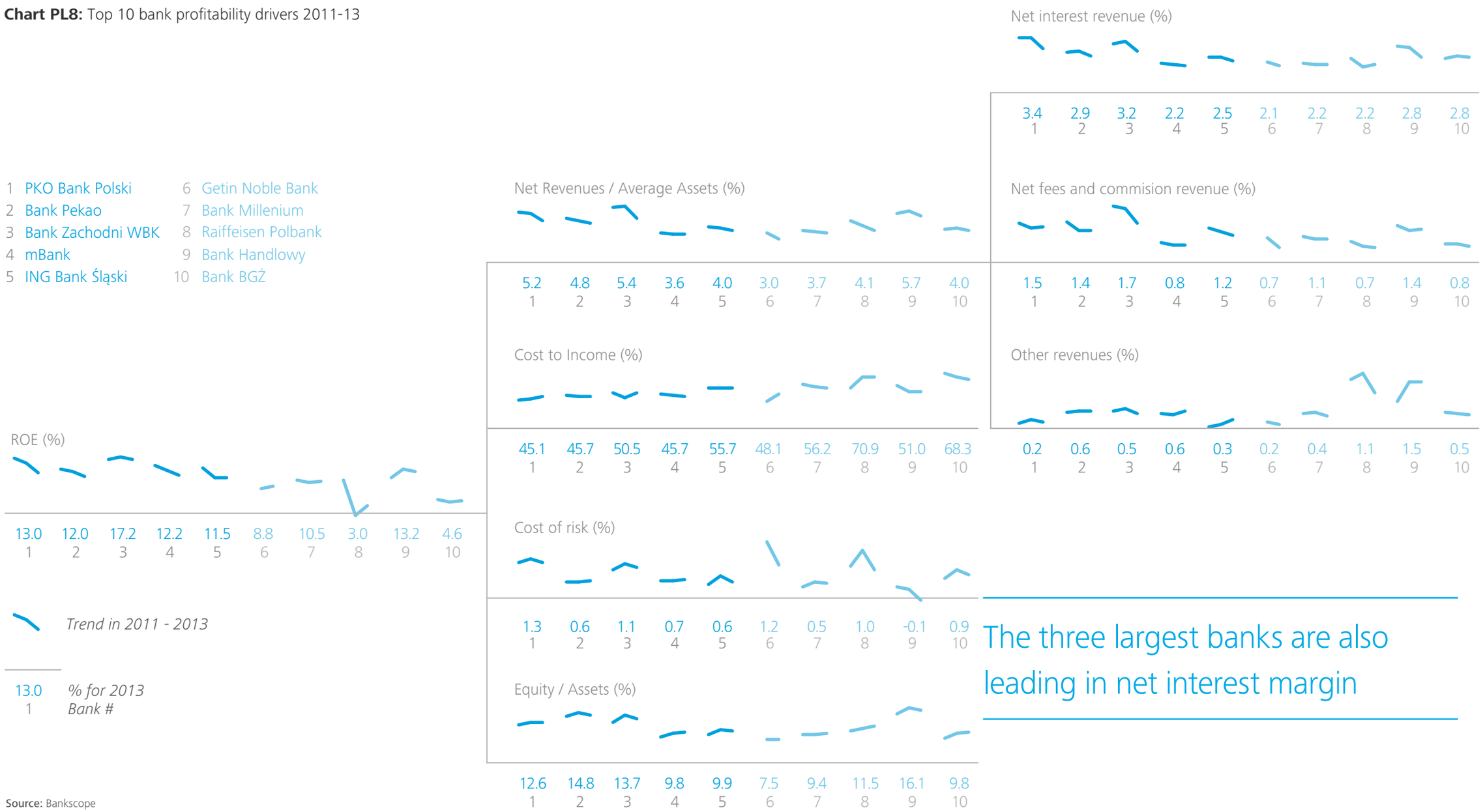


Source: Bankscope

Scale effect in terms of C/I ratio is clearly visible in Poland

Chart PL8: Top 10 bank profitability drivers 2011-13

1 PKO Bank Polski
2 Bank Pekao
3 Bank Zachodni WBK
4 mBank
5 ING Bank Śląski
6 Getin Noble Bank
7 Bank Millenium
8 Raiffeisen Polbank
9 Bank Handlowy
10 Bank BGŻ



The three largest banks are also leading in net interest margin

Source: Bankscope

Chart PL9: Top ten banks market share development

	Loans MS 2013 change	Loans (PLN bn)	Deposits (PLN bn)	Deposits MS 2013 change	Assets MS 2013 change
PKO Bank Polski	16.6% -0.1pp		199	18.1% -0.5pp	14.2% -0.1pp
Bank Pekao	11.4% +0.4pp		159	14.0% +0.9pp	11.3% +0.1pp
Bank Zachodni WBK	7.7% +3.1pp		106	9.4% +3.5pp	7.5% +3.1pp
mBank	7.6% -0.1pp		104	6.9% -0.3pp	7.4% -0.1pp
ING Bank Śląski	5.4% +0.5pp		87	8.0% +0.7pp	6.2% +0.4pp
Getin Noble Bank	5.6% +0.3pp		64	6.2% -0.2pp	4.5% +0.2pp
Bank Millenium	4.6% 0.0pp		57	5.5% +0.2pp	4.1% +0.1pp
Raiffeisen Polbank	4.0% -0.3pp		53	3.6% -0.5pp	3.8% -0.3pp
Bank Handlowy	1.7% -0.2pp		45	3.1% +0.1pp	3.2% 0.0pp
Bank BGŻ	3.0% -0.1pp		36	3.2% -0.2pp	2.5% -0.2pp
Total Market (PLN bn)	931.048			830.753	1 405.722

Retail
Corporate and others
Total volume/ breakdown not available
Assets (PLN bn)

Source: Bankscope, PFSA

Poland
Strategic Directions

Further consolidation is likely but targets will probably be limited to smaller banks, with the PFSA signaling it will oppose further concentration among the top players. This underlines the importance of organic growth and as volumes pick up, Polish banks are increasing emphasis on growing customers in retail and SME. Product pricing and features remain important but effective customer acquisition strategies will address changing customer behavior, utilizing analytics and new technology, and optimize channel mix. Innovation in distribution will continue to see new corporate partnerships formed (e.g. mBank and Orange, Alior Bank and T-mobile) as banks seek access to a wider customer base. Cross-selling will be the key to growing customer profitability in a lower margin environment, emphasizing the importance of being a 'main bank' for customers. As competition intensifies, ensuring the profitability of client relationships in the corporate segment will be a challenge, calling for well-defined segmentation, sales effectiveness, and adaptable coverage models that allow appropriate levels of cost-to-serve.

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Romania
Key Insights

Economic growth above average for CE should be driven by rising domestic demand, with consumption aided by rising household income and investment boosted by EU fund absorption.

Declining loans should reach a turning point next year, as the economic recovery becomes more entrenched. Mortgages (+9% y/y in constant FX in 2013), fuelled by the Prima Casa program, should maintain steady growth.

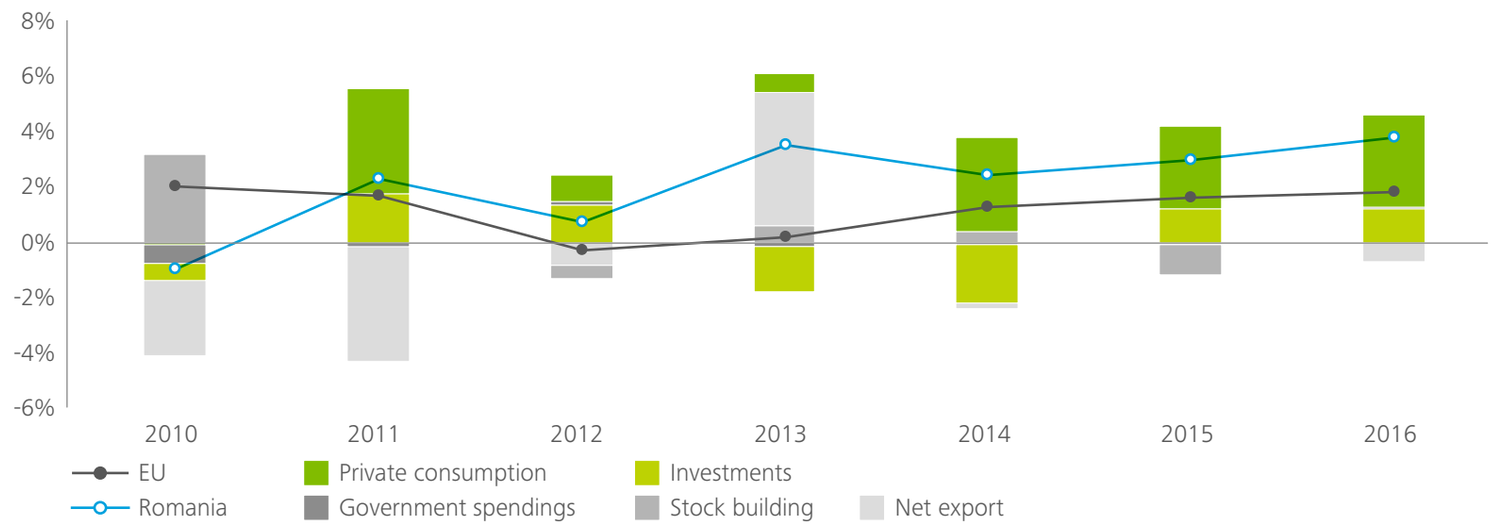
Highest NPL ratio in CE (21.9% in 2013) should decline this year, with the formation of new NPLs slowing and the supervisor recommending that banks accelerate write-offs of older NPLs.

A return to a net loss is expected this year (ROE -2%), as revenues decline and net provisioning remains elevated, but ROE should rise in 2015-16, as risk costs recede and the margin stabilizes.

Romania
Economy

Romania's economic growth, driven by rising domestic demand, is expected to remain above average for CE

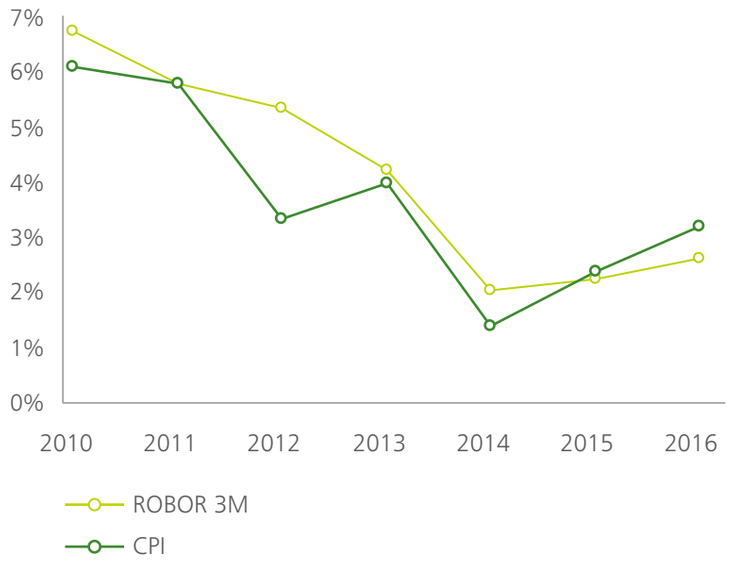
Chart RO1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)



Source: Economist Intelligence Unit

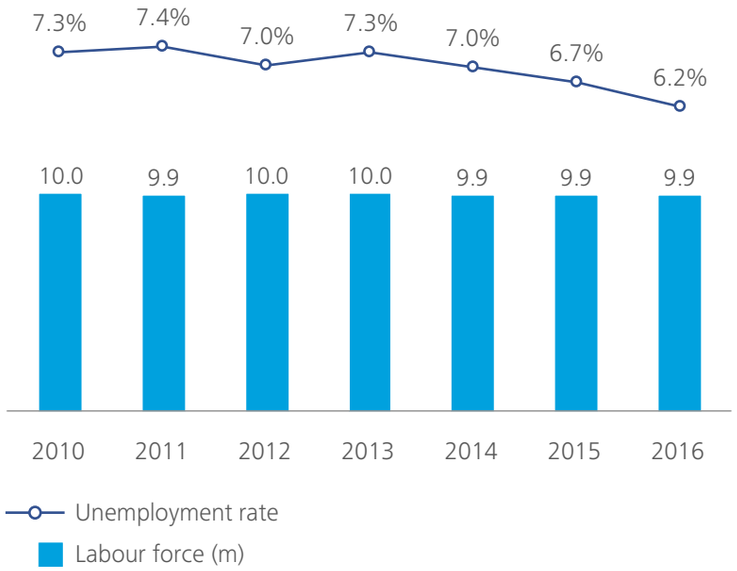
Romania's economic growth is expected to remain above average for CE in the next few years, with a transition from net exports towards domestic demand as the main driver. GDP growth, after reaching 3.5% in 2013 on the back of a bumper harvest and a jump in automotive industry exports, should moderate this year to 2.4%.

Chart RO2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart RO3: Labour market



Source: Economist Intelligence Unit

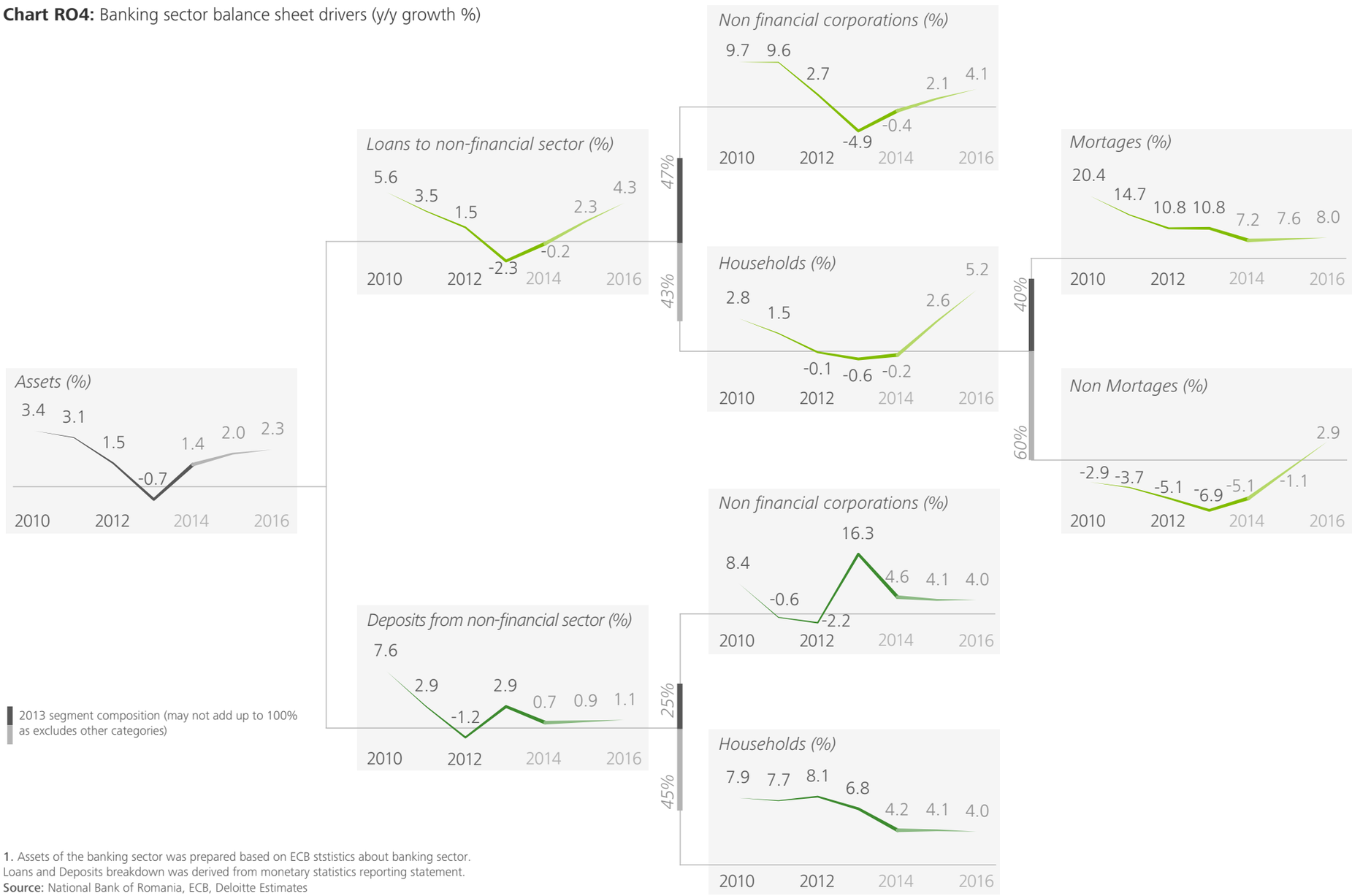
Export growth has slowed in 2Q 14. However, improving consumer confidence, wage growth (including a substantial increase in the minimum wage), and growing employment is contributing to a slow rising of private consumption. Housing prices are down year-on-year but the market is showing signs of levelling out, with lower interest rates and improved affordability supporting demand. Investment growth was negative last year and is taking longer to recover but a turnaround is expected, with support from infrastructure projects and better absorption of EU funds.

Romania
Balance sheet

Declining loans should reach a turning point as the economic recovery becomes more entrenched

Loans have been in decline but a gradual recovery is expected, as the economic recovery becomes more entrenched. Corporate loans have been falling (-5% y/y in 2013), amidst tightened lending standards, and face a headwind from accelerating write--offs. However, improving economic sentiment should drive demand and limit the drop to around 1% this year, before leading to growth of 2-4% in 2015-16. The deleveraging of households via consumer loans (-7% y/y in 2013) is ongoing. Whilst a gradual turnaround should occur, as household spending picks up, we expect a return to positive growth (+3% y/y) only in 2016. Fuelled by government guarantee program Prima Casa, mortgages continue to grow (+11% y/y in 2013, +9% y/y in constant FX). Mortgages are predominantly denominated in FX (92% at year-end 2013, mainly EUR) but, with Prima Casa only available in RON from August 2013 and a narrowing interest rate differential, a shift towards local currency is underway.
We expect steady mortgage growth of 7-8% over the next few years. Retail deposit growth has been robust (+7% y/y in 2013) and is expected to slow to 4% p.a. over the next few years, as lower interest rates encourage alternative investments. Nonetheless, the sector's gross loans/deposits (110% in 2013) should remain on a downward trend until 2016.

Chart RO4: Banking sector balance sheet drivers (y/y growth %)



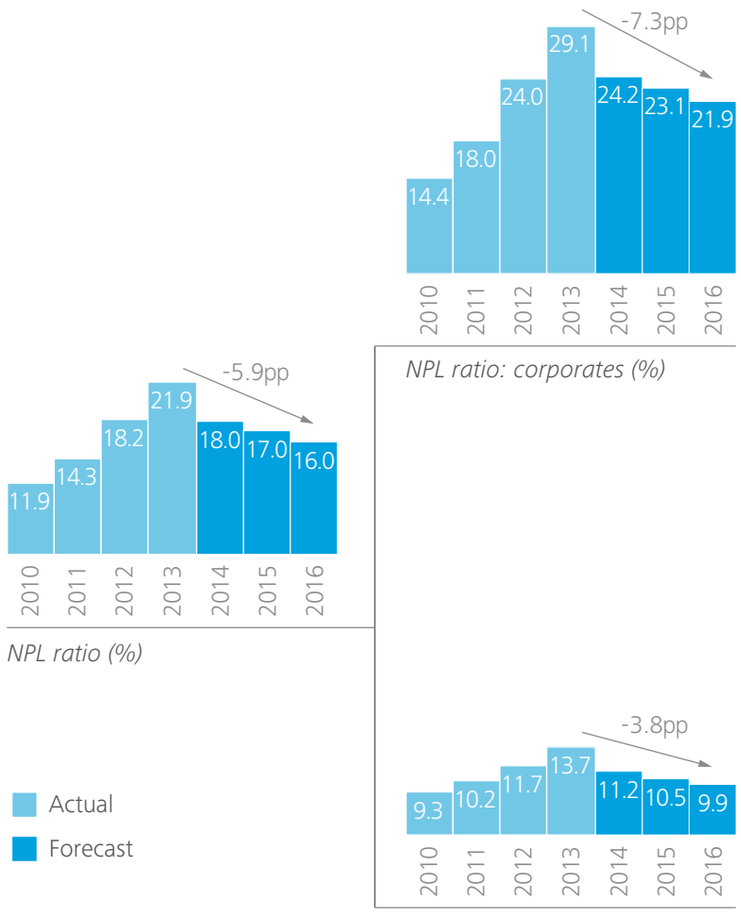
1. Assets of the banking sector was prepared based on ECB ststistics about banking sector. Loans and Deposits breakdown was derived from monetary statistics reporting statement.
Source: National Bank of Romania, ECB, Deloitte Estimates

Romania
Asset quality

Record high NPL ratio is expected to decline in line with regulators recommendation to write-off older NPLs

The sector NPL ratio is the highest in CE but should decline by year-end, with the central bank recommending that banks write-off a large proportion of older NPLs, where there is no history of recovery, making the provisions where necessary to do so. This would mainly impact the SME segment, where the NPL ratio has reached c. 30%, whilst an active debt purchase market has helped keep NPL ratio in consumer loans below 14% and mortgages peaked last year at 6%. Growth of the NPL ratio has decelerated in recent quarters, rising by 3.9 p.p. in 2012 and 3.7 p.p. in 2013 but by just 0.7 p.p. from 21.6% in 3Q 13 to 22.3% in 1Q 14. The central bank has estimated that write-offs could potentially reduce the NPL ratio by 8-9 p.p. this year, although the decision to do so belongs to banks. We expect a more moderate improvement but, even so, accelerating the write-off process will drive higher net provisioning at some banks. Sector provision coverage (IFRS) was 68% at the end of last year, up from 54.2% in 1Q 12.

Chart RO5: Asset quality of the banking sector



Source: National Bank of Romania, Deloitte Estimates

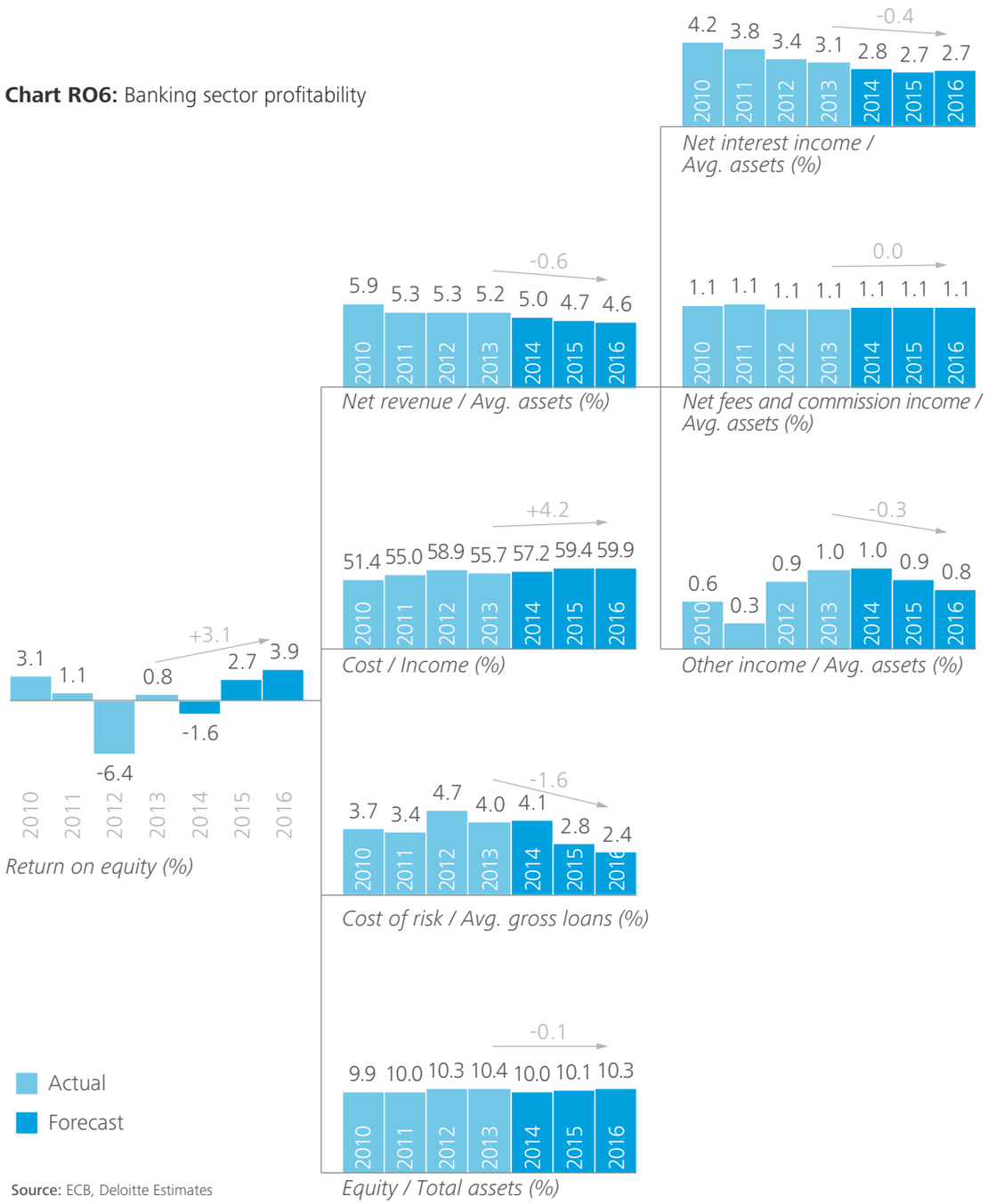
Romania
Profitability

Profitability of the banking sector should improve in 2015-16 as net provisioning declines

The banking sector is expected to return to a net loss this year (ROE -2%), as revenues continue to decline and net provisioning remains elevated, but profitability should improve in 2015-16. The sector's slight profit last year (ROE <1%) was due to a one-off tax gain, whilst there was a loss on a pre-tax level. After peaking in 2012, net provisioning (-17% y/y in 2013) should continue to trend lower, as NPL formation slows, but postponed this year by accelerated write-offs. The clean-up should enable a steeper decline of net provisioning in 2015-16. Net interest income (-6% y/y in 2013) is expected to suffer a further decline this year (-10% y/y) but pressure should ease next year (-3% y/y), before reaching a turning point (+4% y/y) in 2016.

The margin has been under pressure from falling interest rates and deteriorating asset quality but should stabilize during next year, whilst loans should also return to positive growth. Net fee income (+1% y/y) should maintain growth in low single digits (+1-3% p.a.), picking up along with volumes, with cross-selling and investment products to help offset competitive pressure. As falling interest rates level out, securities gains should ease in 2015-16. Weaker revenues are expected to lead to an increase in the cost/income ratio over the next few years. Operating costs (-6% y/y in 2013) are expected to be cut again this year (-2-3% y/y) before levelling out next year, and rising with inflation in 2016.

Chart RO6: Banking sector profitability



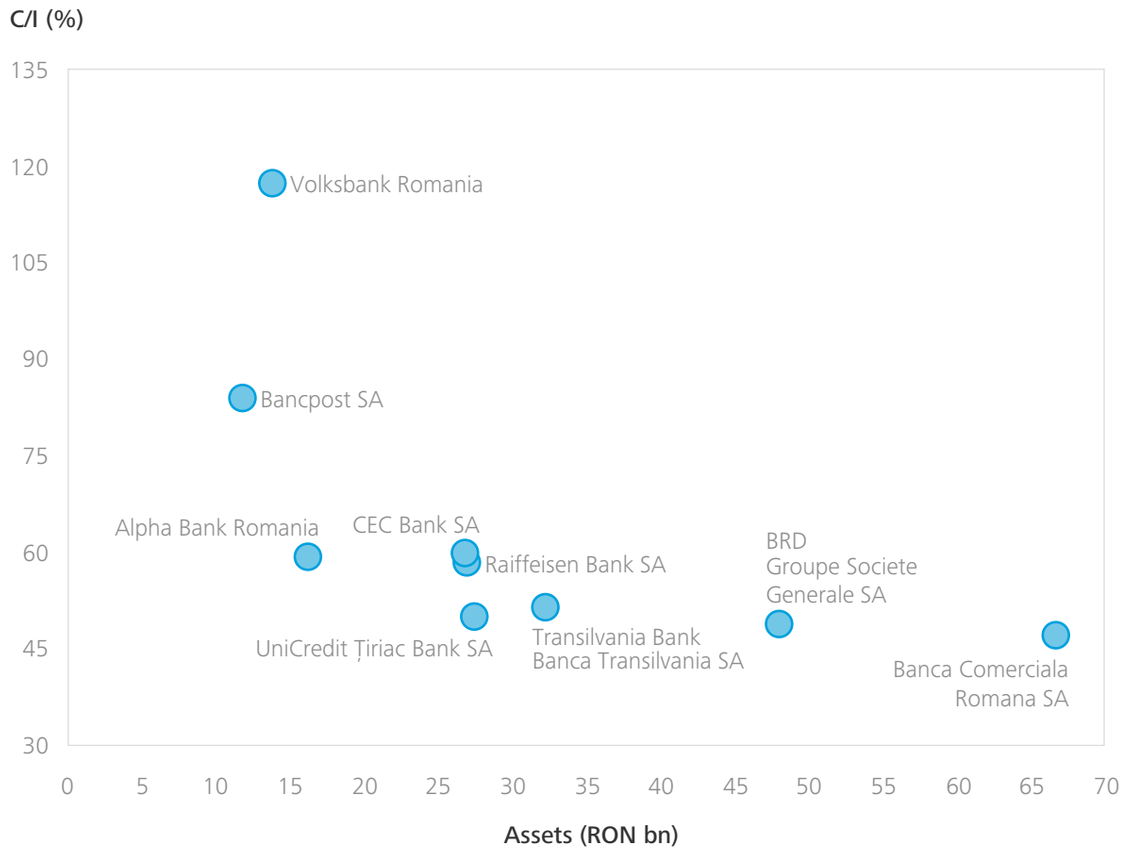
Source: ECB, Deloitte Estimates

Romania
Top 10 Banks

Mounting NPL ratios and the need to raise provision coverage has driven losses at Romania's largest banks in recent years.

In recent years, Romania's largest banks, BCR (#1) and BRD-GSG (#2), have both suffered large losses, due to mounting NPL ratios and the need to raise provision coverage, thus also directly impacting market share in loans, despite the good performance of both banks in new production, especially in retail. BCR has also seen a significant correction of its deposit market share, whilst significant gains in deposits at BRD-GSG have lowered its loans/deposits below 100%. The best performing banks belong to the middle tier, with BT (#3), Raiffeisen (#5) and ING Romania (#7) all managing a double-digit ROE, whilst achieving market share gains. While these banks have higher cost/income ratios than the top tier, risk management has been the differentiating factor behind the profitability gap, with NPL ratios and net provisioning requirements kept at below-average levels. UniCredit Țiriac (#4) and CEC (#6) have also remained profitable, with low single-digit ROEs, and have been gaining market share but the AQR may prove important as these banks have above-average NPL ratios and lower-than-average provision coverage. Loss-making Greek-owned banks Alpha Bank (#8) and Bancpost (#10), as well as Volksbank (#9), have been losing market share in loans but gaining in deposits in order to improve their local funding.

Chart RO7: C/I ratio versus assets, 2013



Source: Bankscope

Major banks in Romania achieved typical effect of scale

Chart RO8: Top 10 bank profitability drivers 2011-13

1 BCR
2 BRD-GSG
3 Transilvania Bank
4 UniCredit Țiriac
5 Raiffeisen
6 CEC Bank
7 ING Bank
8 Alpha Bank
9 Volksbank
10 Bancpost

ROE (%)

1	2	3	4	5	6	7	8	9	10
8.4	-6.9	13.6	2.7	16.3	2.1	n.a.	2.2	-37.9	-9.0

Trend in 2011-2013

13.0 *% for 2013*
1 *Bank #*

Net Revenues / Average Assets (%)

1	2	3	4	5	6	7	8	9	10
5.9	6.0	5.9	5.3	8.2	4.3	n.a.	4.0	2.6	4.9

Cost to Income (%)

1	2	3	4	5	6	7	8	9	10
47.0	48.8	51.3	49.9	58.5	59.8	n.a.	59.3	117.3	83.9

Cost of risk (%)

1	2	3	4	5	6	7	8	9	10
4.0	5.8	2.2	4.0	2.2	3.3	n.a.	1.8	3.3	3.1

Equity / Assets (%)

1	2	3	4	5	6	7	8	9	10
11.1	11.2	10.0	10.3	11.4	7.7	n.a.	10.2	9.2	12.3

Net interest revenue (%)

1	2	3	4	5	6	7	8	9	10
4.0	3.6	3.3	2.7	4.4	3.2	n.a.	3.2	2.1	2.6

Net fees and commision revenue (%)

1	2	3	4	5	6	7	8	9	10
1.1	1.6	1.2	1.1	2.4	0.5	n.a.	0.4	0.2	1.0

Other revenues (%)

1	2	3	4	5	6	7	8	9	10
0.8	0.9	1.4	1.5	1.4	0.6	n.a.	0.4	0.4	1.3

The best performing banks belong to the middle tier (#3, #5), managing a double-digit ROE

Source: Bankscope

Chart RO9: Top ten banks market share development

	Loans MS 2013 change	Loans (RON bn)	Deposits (RON bn)	Deposits MS 2013 change	Assets MS 2013 change
BCR	20.7% -2.2pp		67	18.2% -2.0pp	18.3% -1.7pp
BRD-GSG	15.2% -0.4pp		48	17.6% +0.6pp	13.2% -0.2pp
Transilvania Bank	8.6% +1.0pp		32	12.5% +0.2pp	8.8% +0.7pp
UniCredit Țiriac	7.8% +0.4pp		27	7.4% 0.0pp	7.5% +0.7pp
Raiffeisen	7.4% +0.6pp		27	9.6% +0.5pp	7.4% +0.8pp
CEC Bank	5.6% +0.3pp		27	10.5% 0.0pp	7.4% +0.1pp
ING Bank	n.a.			n.a.	n.a.
Alpha Bank	5.8% +0.2pp		16	3.1% +0.1pp	4.4% -0.1pp
Volksbank	5.0% -0.3pp		14	2.2% +0.6pp	3.8% -0.7pp
Bancpost	3.1% -0.2pp		12	4.1% -0.1pp	3.3% -0.1pp
Totl Market (RON bn)	226 204[1]			205 453[2]	364 819

Retail
Corporate and others
Total volume/ breakdown not available
Assets (RON bn)

1. Excluding external assets 2. Excluding external liabilities
Source: Bankscope and Banks financial statement

Romania
Strategic Directions

The most important challenge for the sector over the next few years is to more effectively manage non-performing assets, via restructuring/workouts and sales. The debt purchase market is already very active for consumer loans but should be developed for the corporate and for secured retail NPLs. As lending picks up (outside Prima Casa), improved risk management and analytics should be implemented to ensure customer profitability via segmentation and differentiated pricing. Banks will also seek to develop their product mix to offer more sophisticated value-added services to SMEs (eg. treasury and cash management) and relationship based products to retail customers (eg. credit cards, asset management).

A priority for banks will be building relationships with customers, via increased transparency and individualized service, to improve customer retention/acquisition. Penetration of internet banking is still very low but, as it increases, banks will need to rethink branch strategies. Consolidation in the sector is ongoing with smaller players exiting and will be viewed as an opportunity for mid-sized banks to obtain customers. Larger transactions should also emerge, as Volksbank is being prepared for sale and one or more of the Greek-owned banks could also be sold, as their parents re-focus operations on core markets.

Contacts

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Slovakia
Key Insights

Pulling out of an economic slump, Slovakia is benefiting from a turnaround in domestic demand. Improving confidence is lifting private consumption and investment should follow.

Loan growth is the strongest in CE (6.8% y/y expected in 2014), led by the retail segment (10.6% y/y) and double-digit growth in housing loans (12.3% y/y). A turnaround in corporate loans should contribute to acceleration this year.

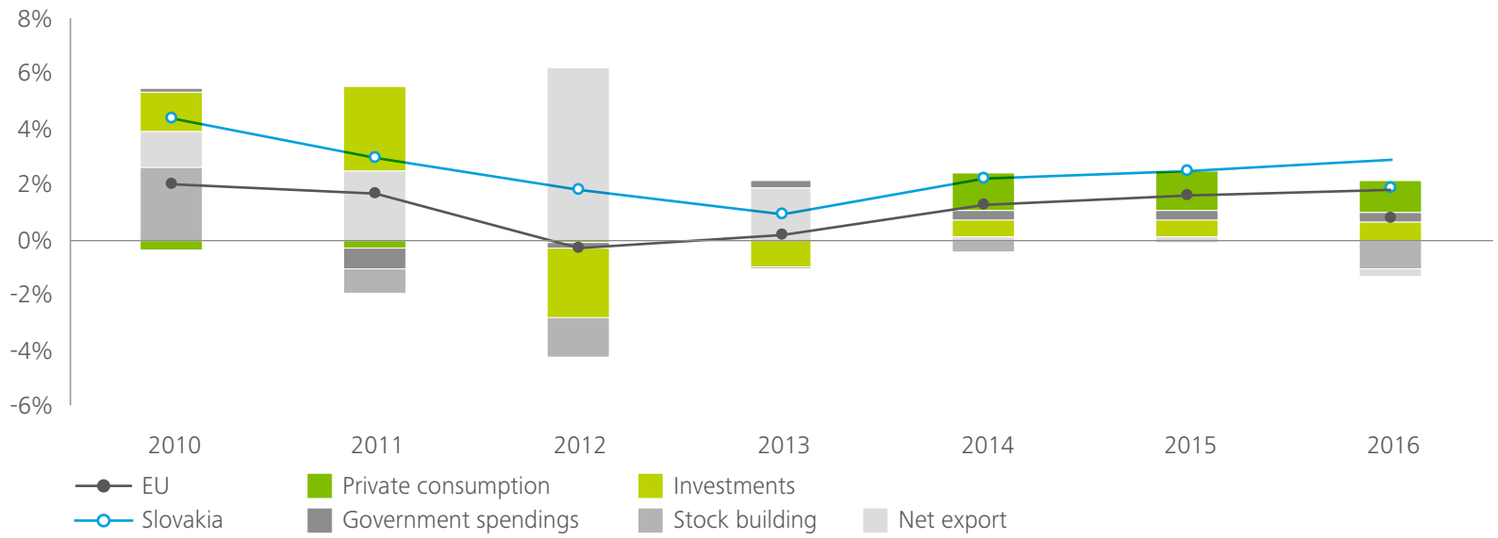
Lowest NPL ratio in CE (5.4% in 2013) should fall further, with a stronger economy to support asset quality. However, already low risk costs have limited room to further improve.

Profitability (ROE of 7.9% in 2013) is expected to improve only slightly, despite strong volume growth, as banks will contend with margin pressure, driven by intense competition and low interest rates.

Slovakia
Economy

Slovakia is pulling out of an economic slump, benefiting from private consumption and increased investment

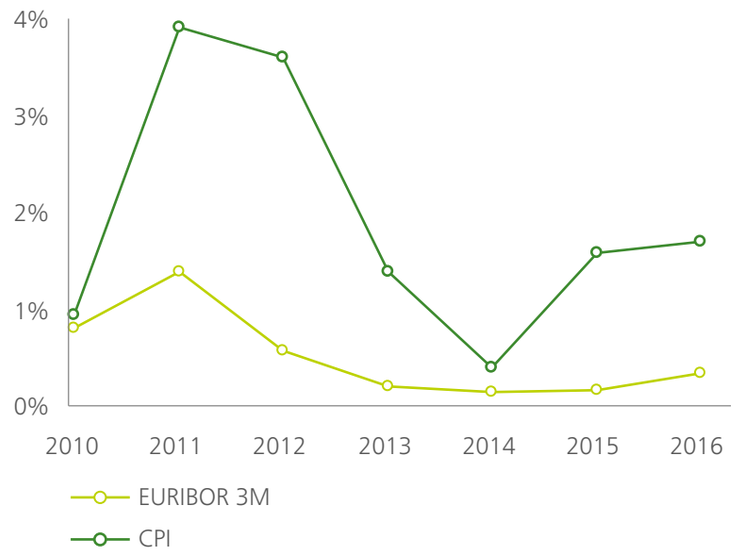
Chart SK1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)



Source: Economist Intelligence Unit

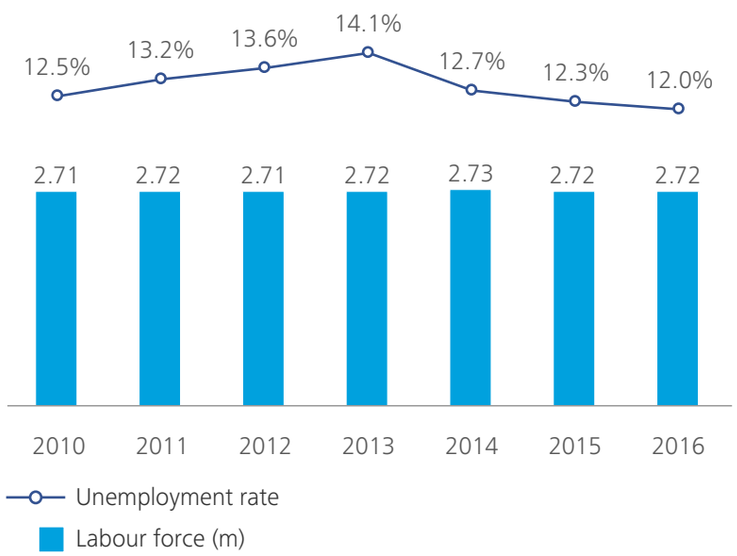
Following a slowdown in 2013, Slovakia's economy has picked up with an outlook for solid above average growth this year (2.2%) and next (2.5%). Growth of domestic demand (2.2% expected in 2014) is a key driver. Household confidence has improved, and after 4 consecutive years of decline, private consumption has turned positive this year.

Chart SK2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart SK3: Labour market



Source: Economist Intelligence Unit

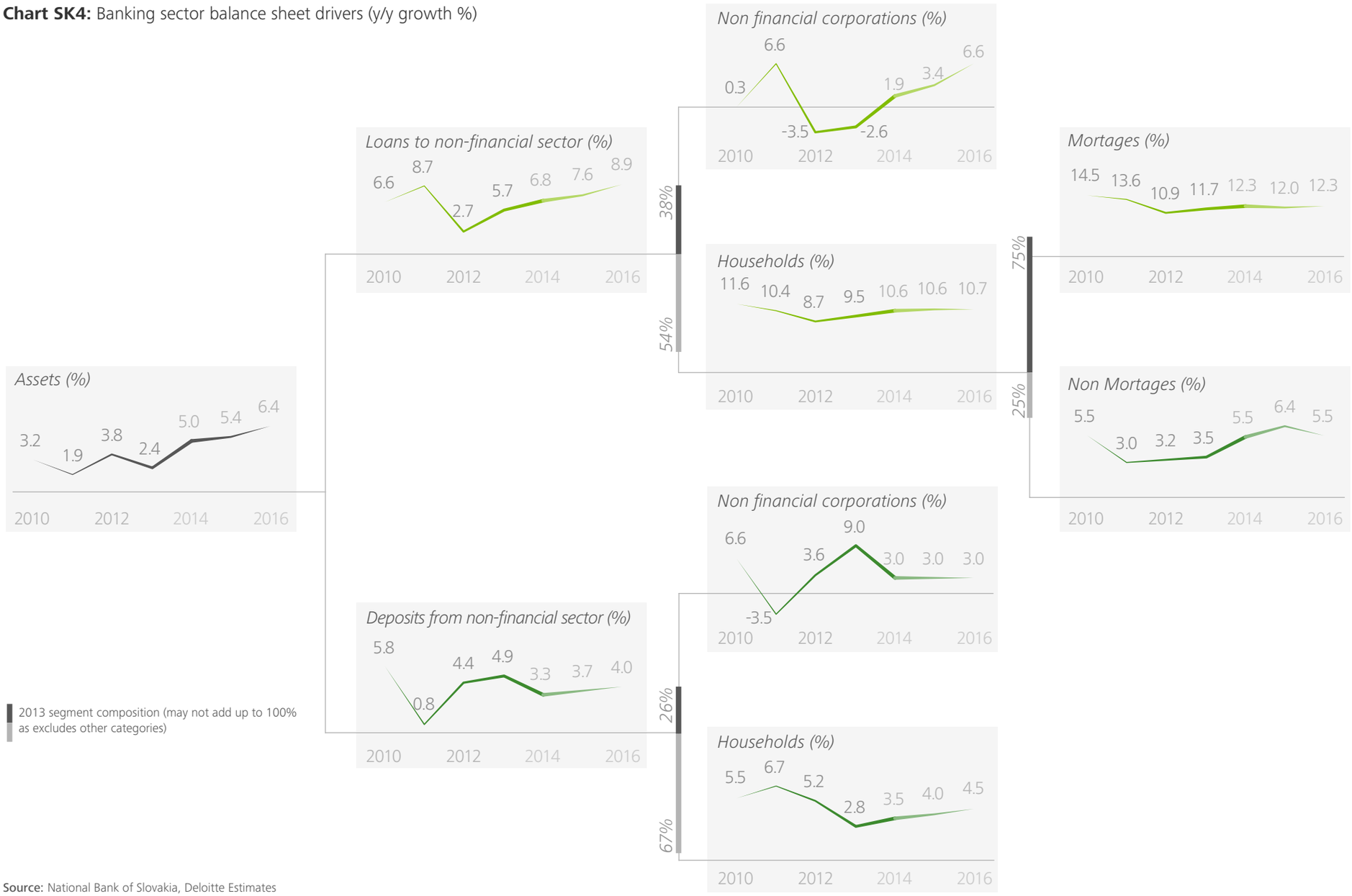
Unemployment in Slovakia is structurally high (second only to Croatia in CE) but the labor market is showing signs of improvement and employment should grow this year. Investments should also turn positive this year, although only moderate growth is anticipated due to underutilized capacity. Net exports should be supported by a pick--up in external demand.

Slovakia
Balance sheet

Loan growth is led by double-digit growth in housing loans

Loan growth in Slovakia is the strongest in CE. Retail loans have been the main driver, up nearly 10% y/y in 2013, and should gain pace. Housing loans should maintain double-digit growth over the next few years (at c. 12% p.a.), supported by low rates and affordability of real estate. Demand for other retail loans should rise, as household spending picks up. Corporate loans are expected to return to positive growth this year and accelerate along with the economy. The banking sector is well funded, with a tier 1 CAR of 16.0%, although gross loans/deposits is expected to rise above 100% in the next few years. We expect an improvement in household income but, with a rise in spending and low interest rates encouraging alternative investments, we expect only a slight increase in deposit growth.

Chart SK4: Banking sector balance sheet drivers (y/y growth %)



Source: National Bank of Slovakia, Deloitte Estimates

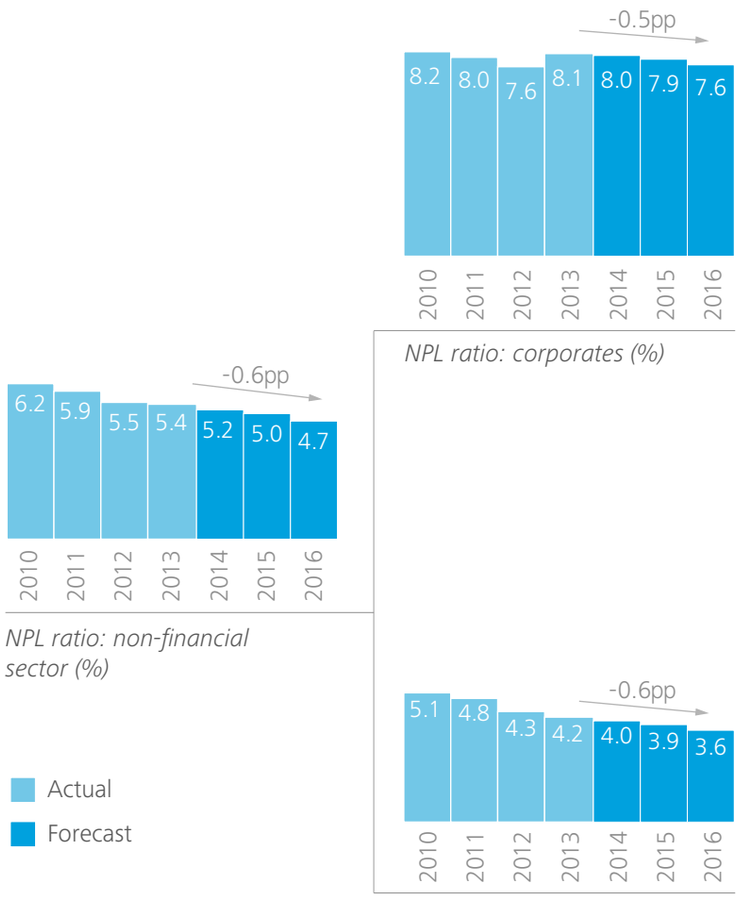
Slovakia
Asset quality

Already low NPL ratio should benefit from economic recovery

The NPL ratio, at 5.4% last year, is the lowest in CE and we expect a further decline. The drop in the retail NPL ratio from 4.3% to 4.2% last year was mainly due to the denominator (i.e. strong retail loan growth). Going forward, we expect a positive impact also from falling unemployment. The corporate NPL ratio increased last year, from 7.6% to 8.1%, due mainly to commercial real estate and construction.

Whilst there was no change in trend in 1Q 14, we expect an eventual decline in the corporate NPL ratio to begin this year, as the domestic economy strengthens. Overall NPL write-offs and sales have had a lower impact in 2012-13 on NPL volumes than loan repayments and recoveries. With provision coverage well above average, 75% at the end of 2013, we anticipate a gradual moderation as the outlook improves.

Chart SK5: Asset quality of the banking sector



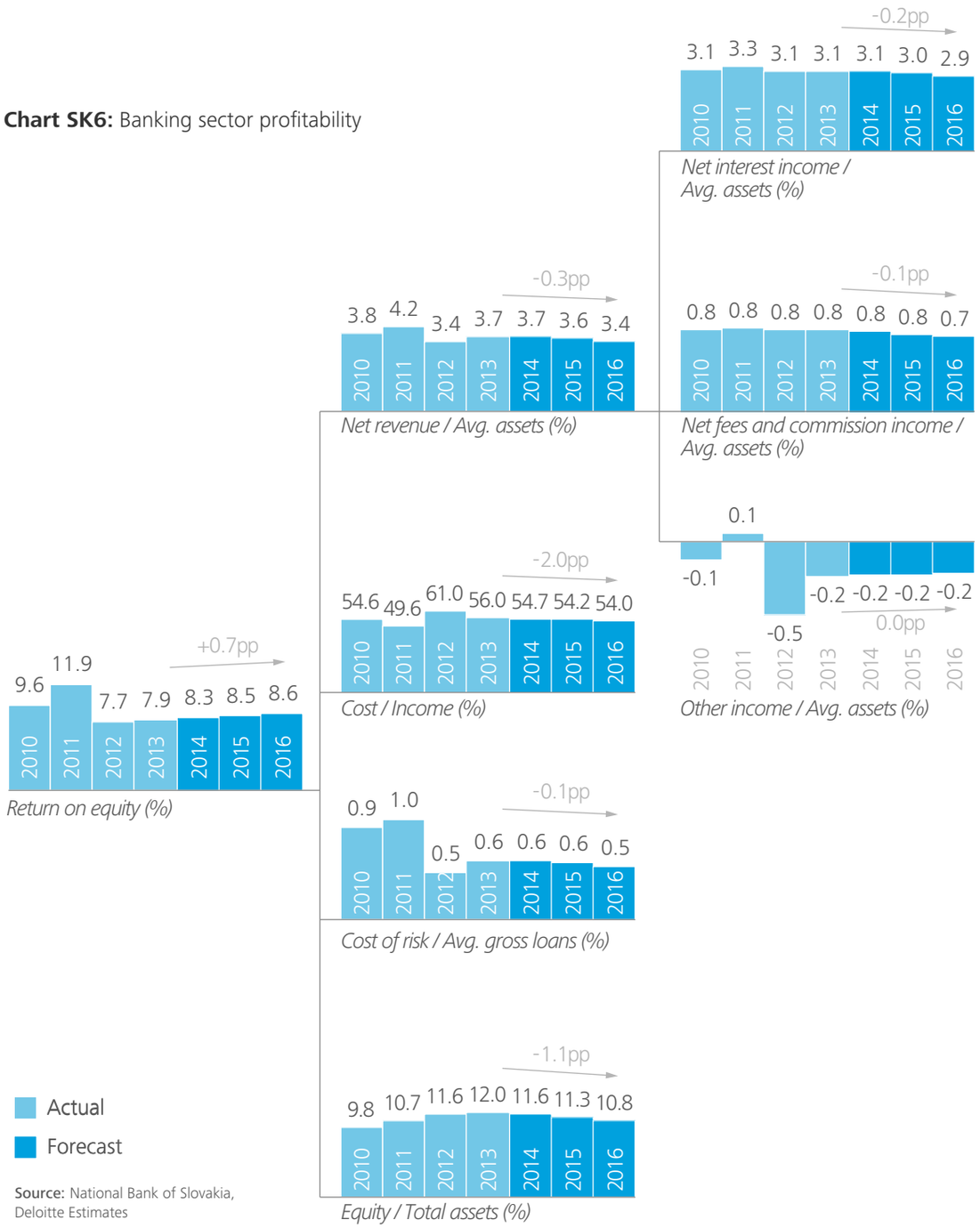
Source: National Bank of Slovakia, Deloitte Estimates

Slovakia
Profitability

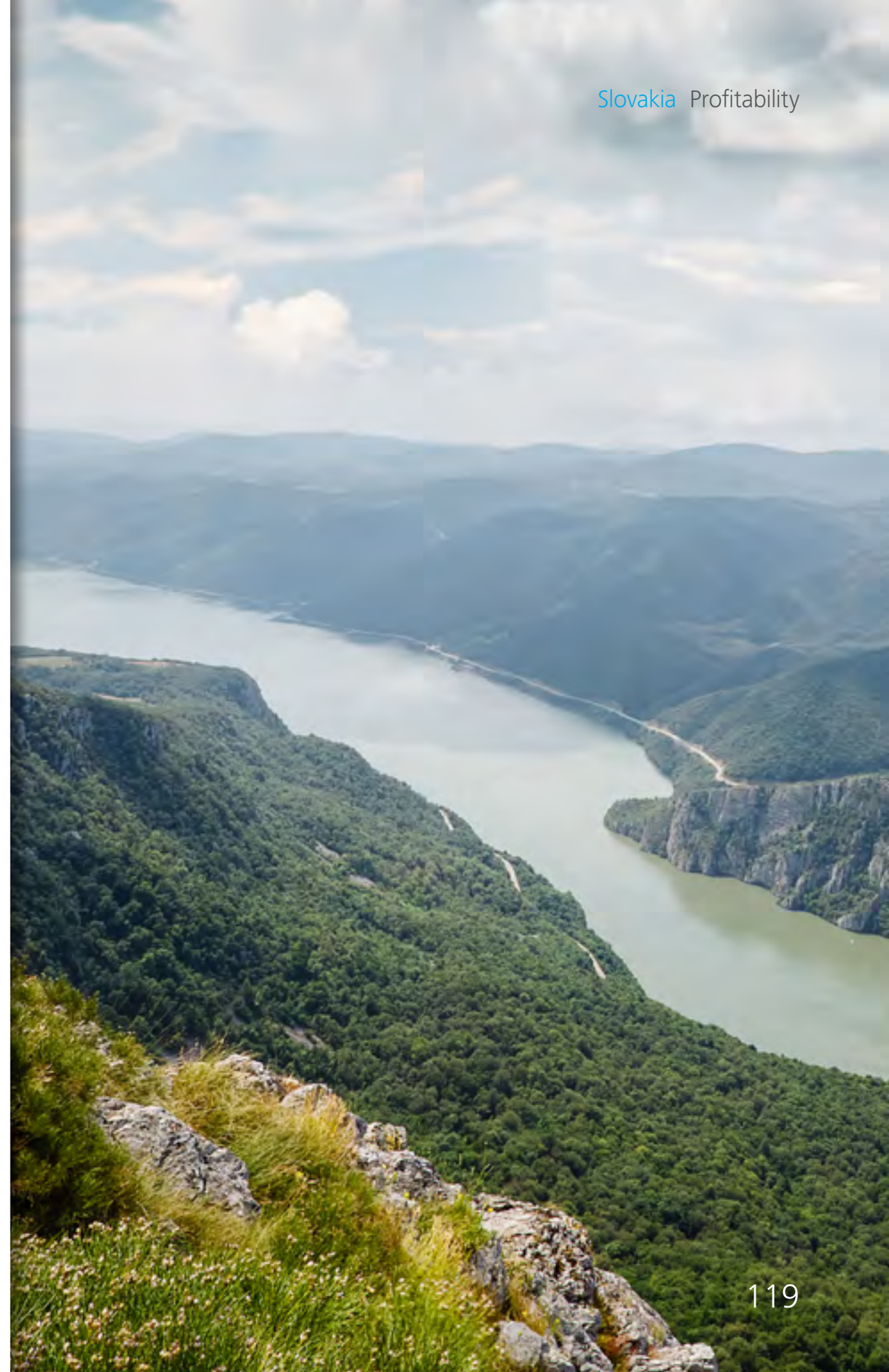
Banks will contend with margin pressure, driven by intense competition and low interest rates

The ROE of the banking sector, 8% in 2013, is below that of its northern CE peers and we expect only slight improvement. The key reason is Slovakia's bank levy, which lowers ROE by about 2 percentage points. This levy should fall from 0.4% to 0.2% of liabilities next year (after accumulating > EUR 500m) but the P&L impact is expected to be offset by a new contribution to the European bank resolution fund. Despite strong lending, the revenue outlook is for low single-digit growth. In an environment of lower interest rates, there is margin pressure from the re-pricing of loans (typically fixed for 1-5 years) and securities. Over the last year, refinancing has accounted for over a third of new retail lending. Net fee income should rise on volumes and cross-selling but is negatively affected this year by the cancellation of loan account fees (in June 2013). Cost containment will therefore remain an imperative. Although the improving economy will support loan quality, there is little room for risk costs to decline from the current level.

Chart SK6: Banking sector profitability



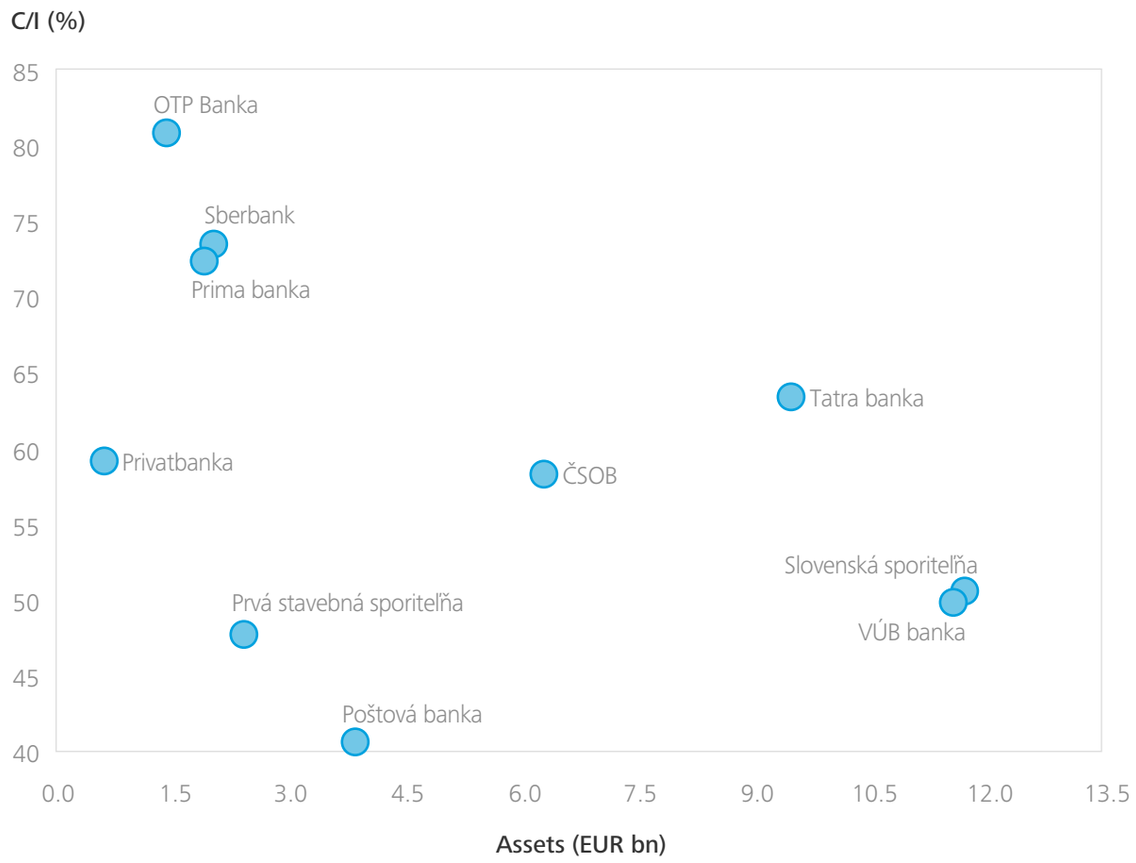
Source: National Bank of Slovakia, Deloitte Estimates



Slovakia
Top 10 Banks

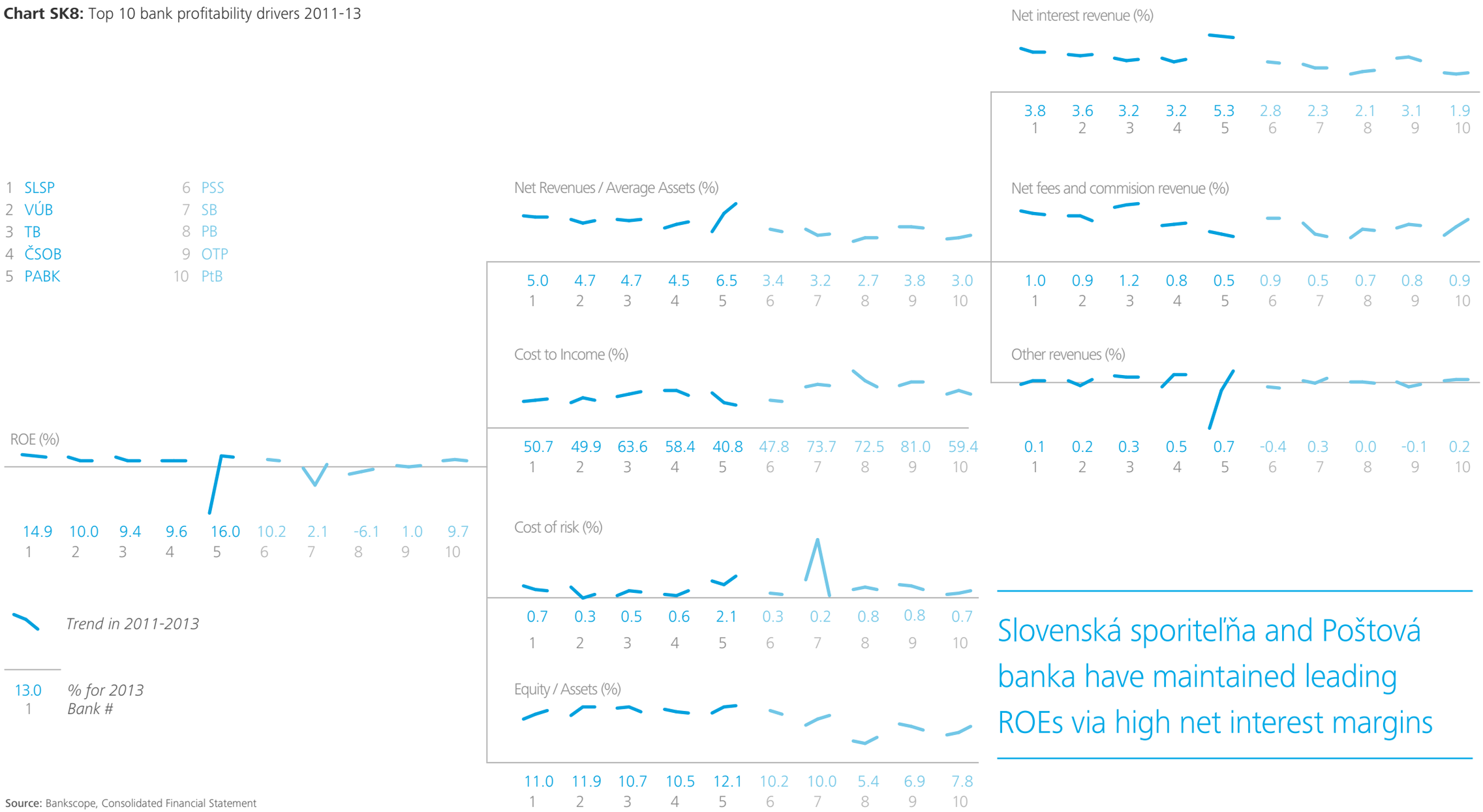
Among the top 4 banks, retail-oriented Slovenská sporiteľňa has achieved the fastest growth in loans, supported by its leading share in mortgages, and deposits over the past 2 years. The bank's ROE remains above average (14.9% in 2013) but, with a margin that has suffered more than peers, on the back of falling market interest rates, it has been running to stand still from the standpoint of revenue. In contrast, the remainder of the top tier (VÚB, Tatra banka, and ČSOB), which have lagged the sector in loan growth, managed to increase margins last year. The largest market share gains in loans and deposits have come at smaller banks, namely Poštová banka, OTP Banka, and Sberbank. Leveraging its extensive network, #5 Poštová banka has continued to aggressively gather deposits, at above average cost, despite its low loans/deposits ratio, maintaining its leading margin and ROE via relatively high yield lending. Whilst growth has focused on consumer loans at OTP Banka and mortgages at Sberbank, the lack of scale and high cost/income at both banks has limited ROE to low single digits.

Chart SK7: C/I ratio versus assets, 2013



Source: Bankscope

Chart SK8: Top 10 bank profitability drivers 2011-13



Source: Bankscope, Consolidated Financial Statement

Slovenská sporiteľňa and Poštová banka have maintained leading ROEs via high net interest margins

Chart SK9: Top ten banks market share development

	Loans MS 2013 change	Loans (EUR bn)	Deposits (EUR bn)	Deposits MS 2013 change	Assets MS 2013 change
Slovenská sporiteľňa	19.2% 0.0pp		11.7	20.5% +0.7pp	19.7% -0.6pp
VÚB banka	18.9% -1.0pp		11.2	17.7% -0.3pp	18.8% +0.1pp
Tatra Banka	16.7% -0.4pp		9.5	15.8% -0.4pp	16.0% +0.3pp
ČSOB	9.2% -0.4pp		5.6	9.1% -0.1pp	9.4% +0.1pp
Poštová banka	5.0% +0.2pp		3.8	7.4% +0.7pp	6.5% +0.6pp
Prvá stavebná sporiteľňa	5.1% -0.1pp		2.4	4.8% +0.1pp	4.1% +0.1pp
Sberbank	3.9% +0.3pp		2.0	3.6% +0.3pp	3.4% +0.4pp
Prima banka	3.4% -0.1pp		1.9	3.4% 0.0pp	3.2% -0.2pp
OTP	2.8% -0.2pp		1.4	2.5% +0.1pp	2.4% +0.2pp
Privatbanka	0.5% 0.0pp		0.6	0.9% -0.2pp	1.0% -0.1pp
Total Market (EUR bn)	39.325			44.302	59.313

Retail
Corporate and others
Total volume/ breakdown not available
Assets (EUR bn)

Source: Bankscope, National Bank of Slovakia, Banks' financial statements

Slovakia
Strategic Directions

In an environment of low interest rates, robust retail loan growth and intense competition, banks face the challenge of maximizing market share while preserving profitability against margin pressure. Larger banks will prioritize customer retention, prepared to invest by cutting prices to preserve long-term relationships. Customer activation will play a key role in determining customer profitability and banks better able to use customer analytics to cross-sell more effectively will have an advantage. Small and mid-sized banks will focus on new customer acquisition, seeking to take advantage of the trend in the sector towards refinancing and debt consolidation, with competitive pricing and risk appetite the key levers. Cost containment will continue to be important for the sector overall and smaller banks will need to address their lack of scale but consolidation will likely play a role only in the medium term.

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Slovenia
Key Insights

Recovering gradually from a recession, Slovenia is benefiting from EU funded projects and net exports. However, near-term GDP growth prospects are below average for CE.

Deleveraging is ongoing, with a decline in both corporate (-12.5% y/y expected in 2014) and retail loans (-2.1% y/y), but the pace should slow. We expect stabilization in 2016 to be led by a gradual turnaround in retail lending.

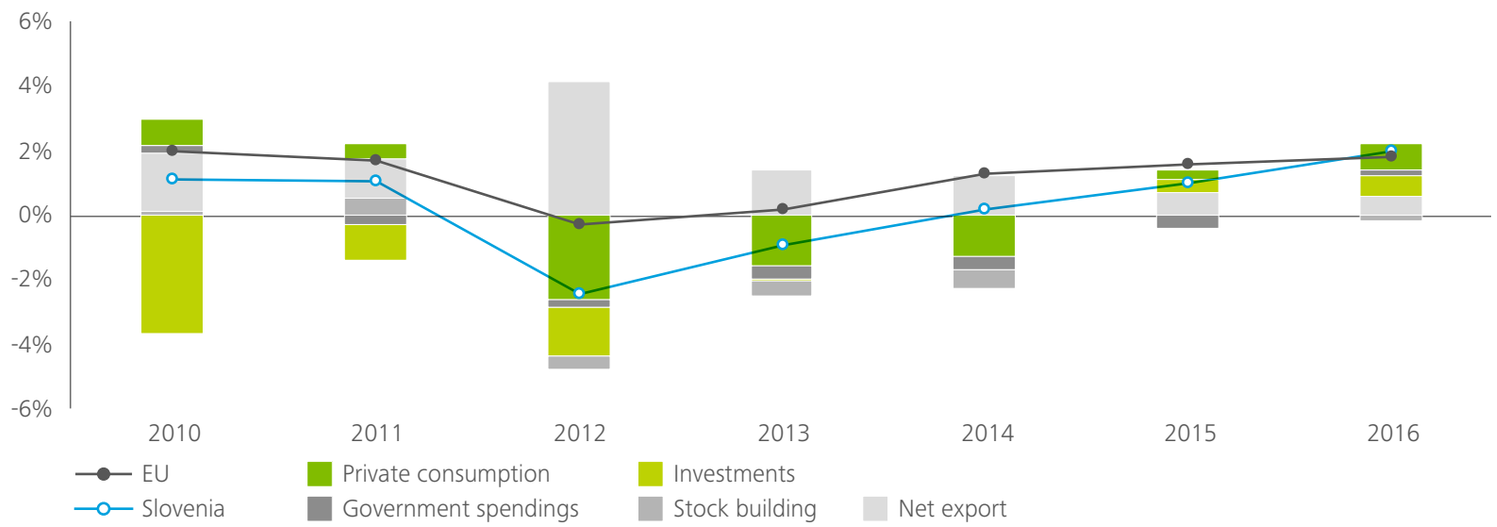
Transfers to the BAMC should drive a further reduction in the NPL ratio this year. A decline next year will rely on slowing defaults and progress in the workout/write-off of corporate debt.

After a huge loss in 2013, a balance sheet clean-up and recapitalization has positioned the banking sector for recovery. Returning to profit this year will be a struggle but ROE should grow to 1.3-3.7% in 2015-16.

Slovenia
Economy

Slovenia is recovering from a recession with help from exports but growth prospects are below the EU average

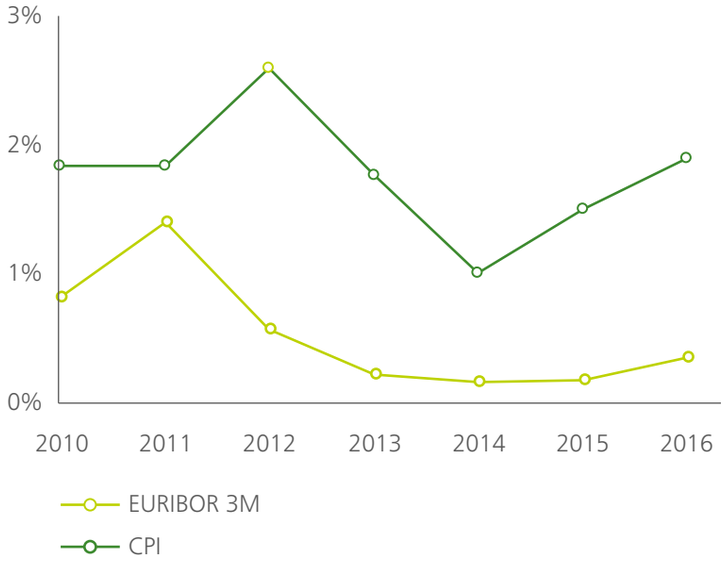
Chart SI1: Real GDP growth (y/y%) vs. Real GDP drivers (change as a % of real GDP)



Source: Economist Intelligence Unit

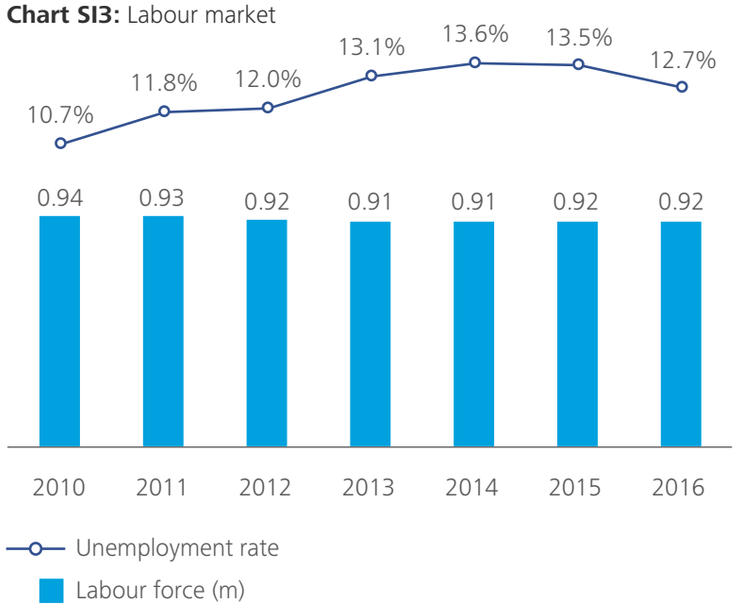
The near-term GDP growth prospects of Slovenia (0.2% expected in 2014 and 1.0% in 2015) are below average for CE but the economy is recovering gradually after a recession (-2.4% in 2012 and -0.9% in 2013). Growth is supported by a positive contribution from net exports and government investment through EU-funded projects. Restructuring in the corporate sector continues to be a source of uncertainty but household confidence is returning.

Chart SI2: Interbank interest rate and CPI



Source: Economist Intelligence Unit, Reuters

Chart SI3: Labour market



Source: Economist Intelligence Unit

The labor market is stabilizing, with wages rising gradually and unemployment (expected to peak this year at 13.6%) nearing a turning point. After years of decline, private consumption is expected to fall again this year but should rise next year. Headwinds from deleveraging in the household and corporate sector are gradually subsiding.

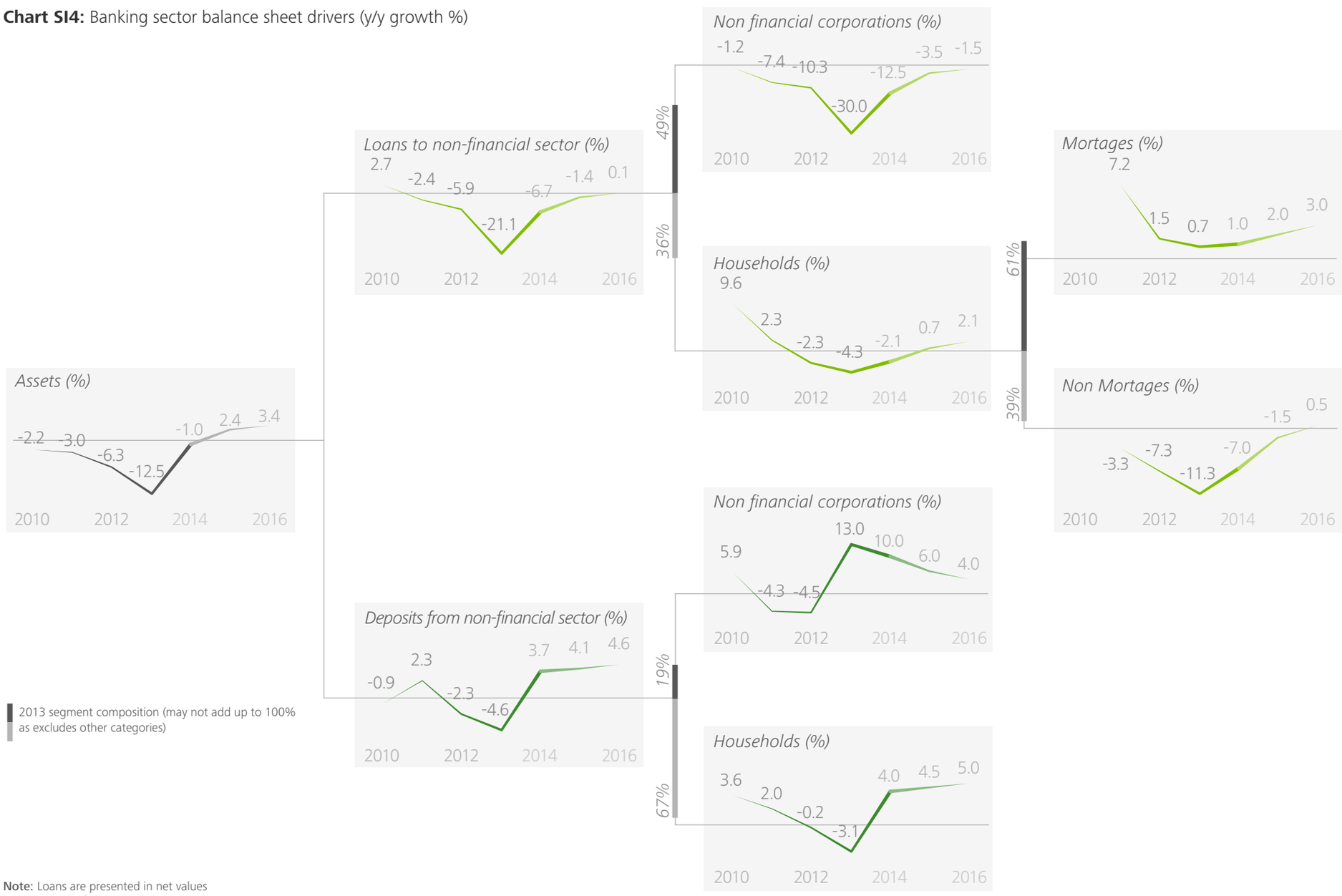
Slovenia
Balance sheet

Deleveraging is ongoing with loans expected to decline in 2014-15

Loans are expected to continue to decline this year and next but the sector balance sheet has been strengthened and economic recovery should bring stabilization in 2016. The steepest correction has been in corporate loans, which fell by 30% y/y in 2013, including transfers to the BAMC. We expect a further declines of 12-13% y/y this year (7-8%, excluding transfers to the BAMC), 3-4% in 2015, and 1-2% in 2016. This trend reflects a lack of quality demand, a higher proportion of corporate borrowing abroad, and supply constraints as the largest banks cut exposure. The decline in retail loans, -4% y/y in 2013, has been comparatively moderate and we expect a gradual turnaround in 2015-16. Mortgage loans, up 1% y/y in 2013, are expected to pick up moderately, and the contraction in consumer loans, down 11% y/y in 2013, should bottom out next year. Tier 1 CAR was increased by 3.8 p.p. to 13.3% in 4Q 13 and further recapitalizations will lift it again this year.

Household deposits suffered an outflow last year (-3% y/y) on bailout concerns but have since recovered and should grow at a steady pace, keeping the loans/deposits (108% in 2013) ratio on a downward trend.

Chart SI4: Banking sector balance sheet drivers (y/y growth %)



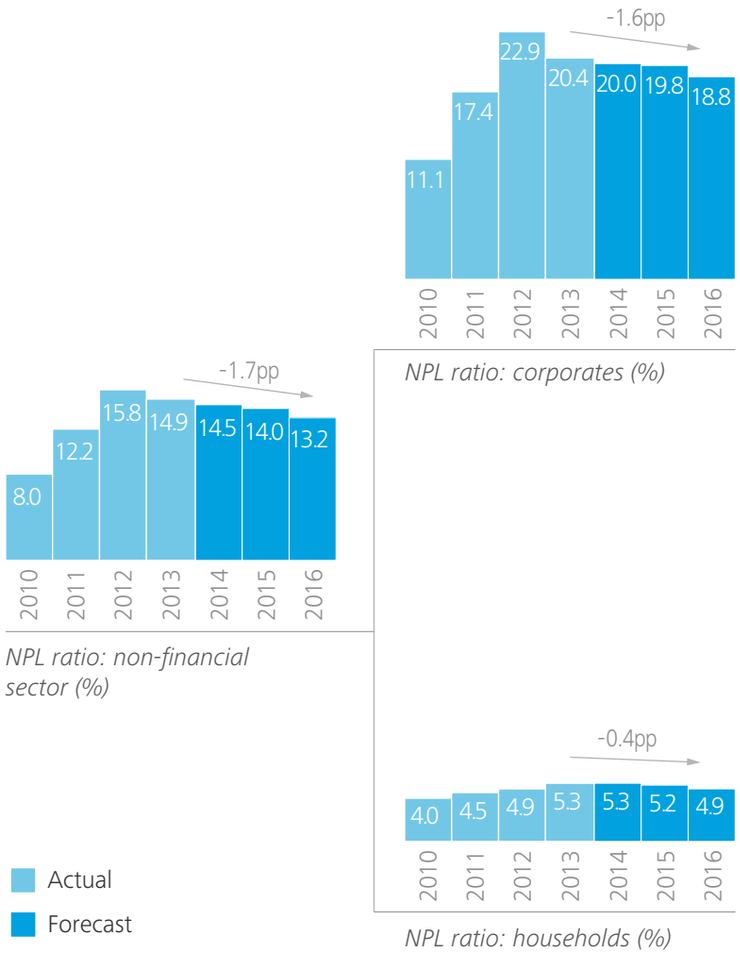
Note: Loans are presented in net values
Source: Bank of Slovenia, Deloitte Estimates

Slovenia
Asset quality

Asset transfers have driven a decline of the NPL ratio

The NPL ratio of the banking sector declined from 15.8% to 14.9% last year, after falling from a November peak of 19.9% on the back of a EUR 3.26bn asset transfer to the BAMC. The unaffected retail segment, where the NPL ratio rose from 4.9% to 5.3% last year, has been relatively healthy and should remain so. The impact was mainly on the troubled corporate sector, where the NPL ratio peaked at 28% in November before a reduction to 20.4% at year-end. The upward trend in the corporate NPL ratio has since resumed, reaching 23.1% in April, but a further asset transfer of c. EUR 1bn to the BAMC should see this decline back to around 20% by year-end. A further decline of the corporate NPL ratio is expected next year, aided by fewer defaults, as the economy recovers, and more efficient processing of non-performing assets, leading to debt restructuring and/or write-offs. This will be aided by the sector's strengthened provision coverage (up 13 p.p. to 57% in 2013).

Chart SI5: Asset quality of the banking sector



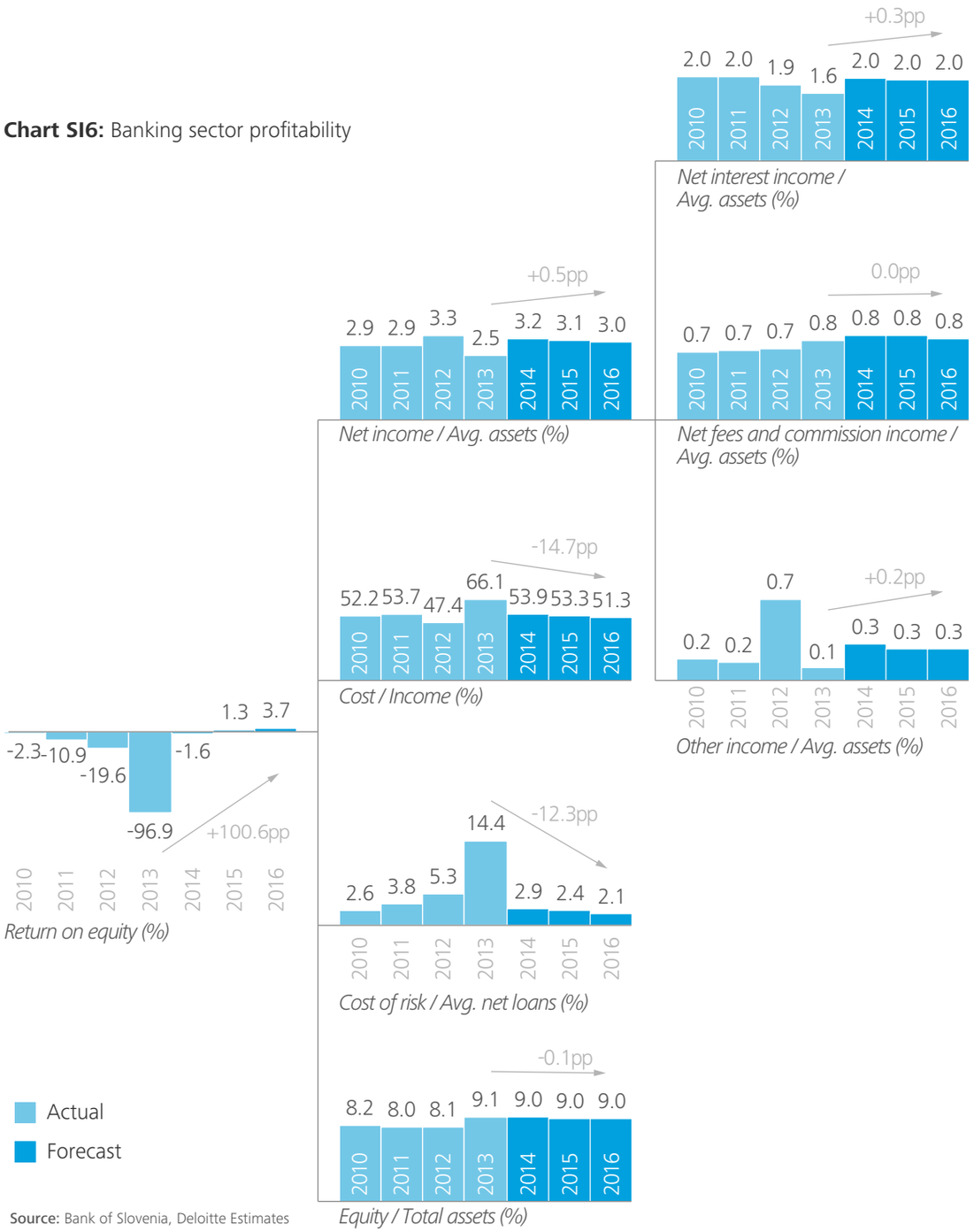
Source: Bank of Slovenia, Deloitte Estimates

Slovenia
Profitability

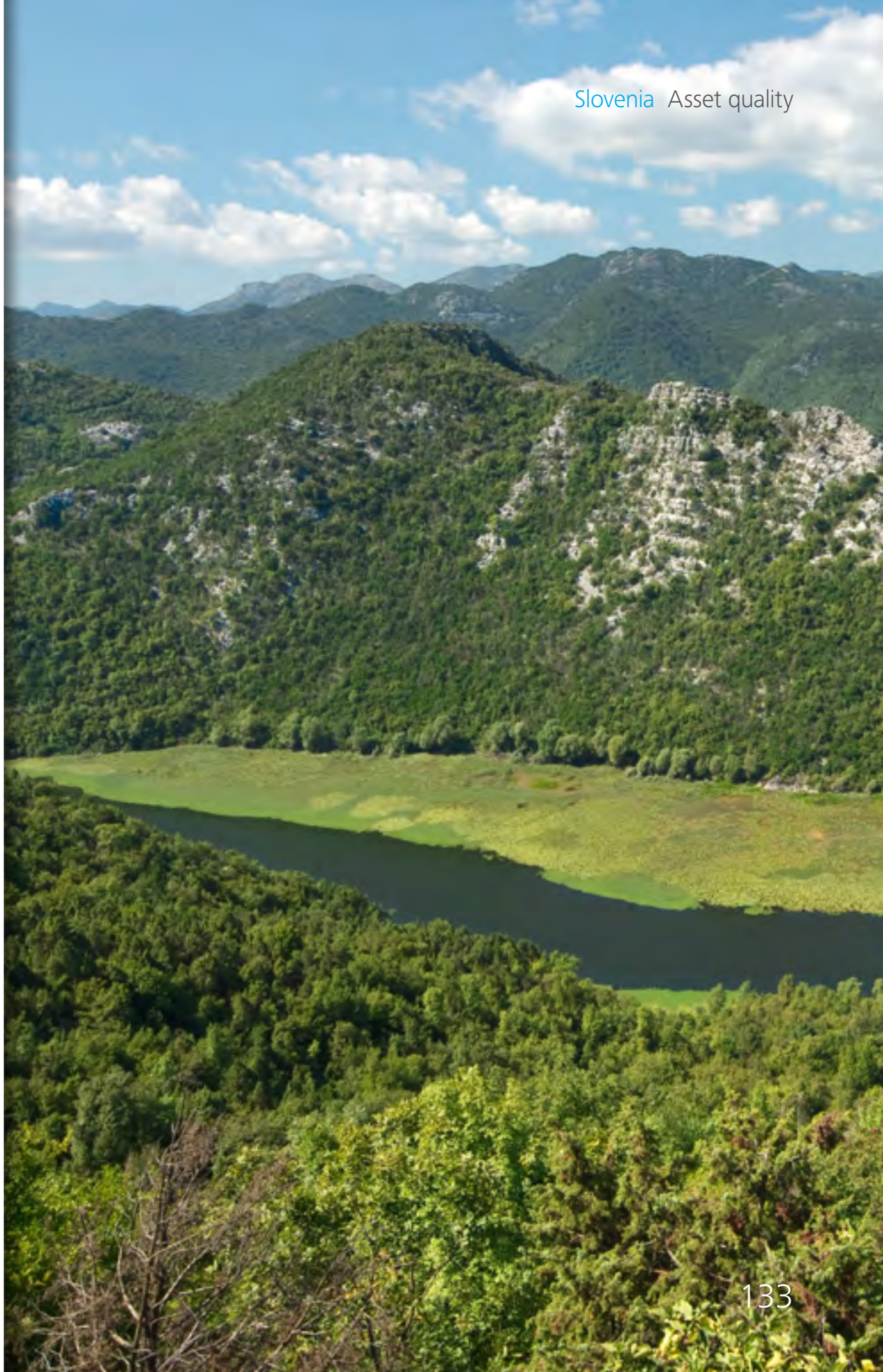
After a huge loss in 2013 resulting from balance sheet cleaning, a return to profit is expected in 2015-16

The banking sector plunged to a huge loss (EUR -3.6bn, equating to 97% of beginning of year equity) in 2013, on sharply higher loan loss provisioning, but a balance sheet clean-up and recapitalization has positioned it for recovery. The margin has widened, as a result of easing competition for deposits and the asset transfer to the BAMC, and net interest income is rising strongly this year. Fee income has been resilient. Revenue growth is expected to subside next year, as the margin levels out, but cost reduction programs should keep the cost/income ratio on a downward trend from 54% in 2014 towards 51% in 2016. The sector's bottom line will hinge on net provisioning requirements, which may be volatile in the near--term but should decline substantially over the next few years. Corporate credit risk remains high but should improve gradually. Even though it was profitable in the first quarter, the banking sector may struggle to remain in the black in 2014. However, it should deliver a positive and growing ROE to 1.3 - 3.7% in 2015-16.

Chart SI6: Banking sector profitability



Source: Bank of Slovenia, Deloitte Estimates

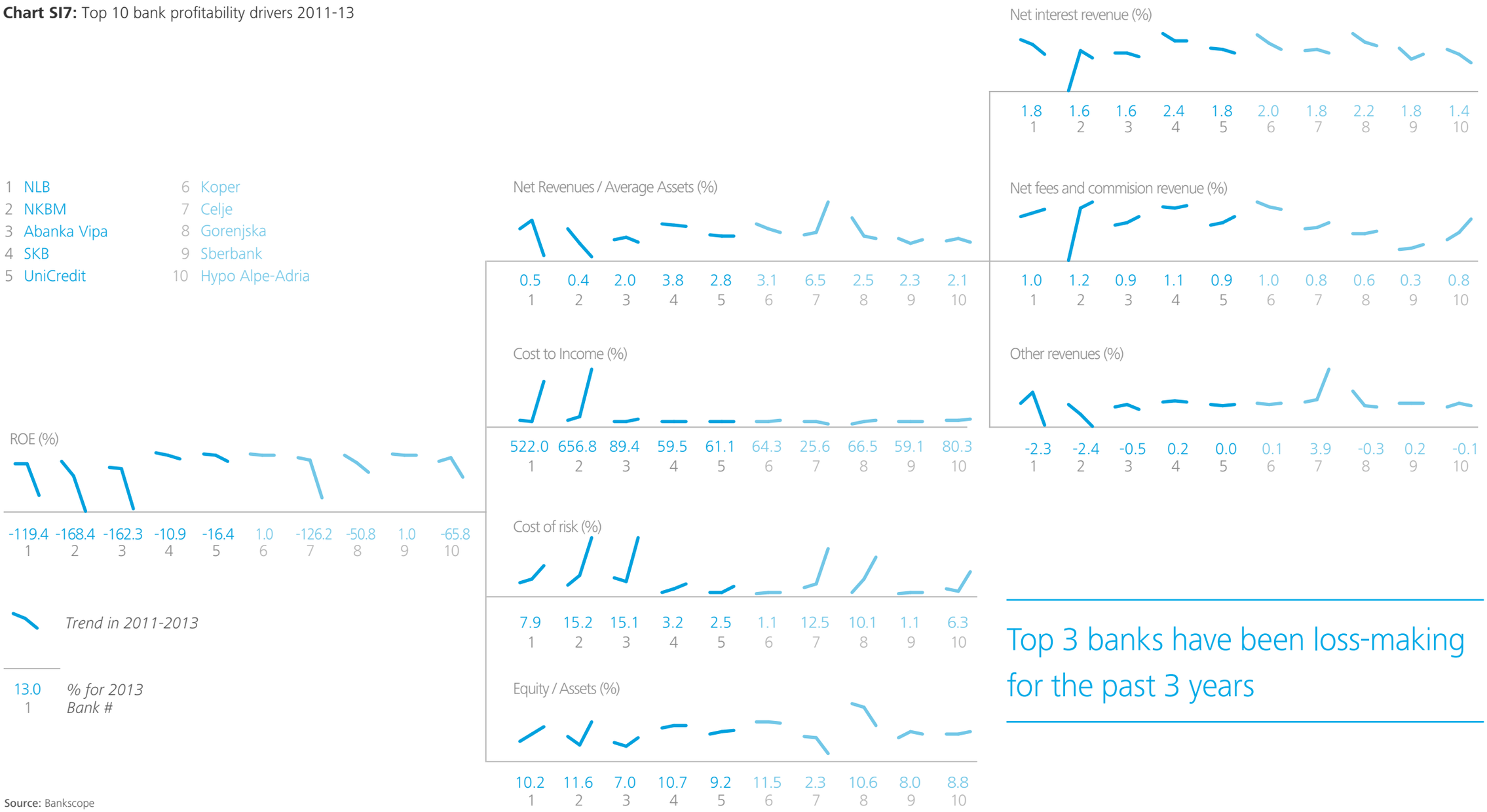


Slovenia
Top 10 Banks

The largest loan book contractions were at NLB (#1) and NKBM (#2) which transferred assets to the BAMC

Slovenia's top 3 banks have been loss--making for the past 3 years and suffered the biggest losses in proportion to assets in 2013. The largest loan book contractions were also at NLB (#1) and NKBM (#2), which transferred assets to the BAMC, and Abanka Vipa (#3) will follow suit this year along with Banka Celje (#7). Although these state-controlled banks have been strengthened by aid, they have submitted restructuring plans to the EC, committing (through 2017) to shrink their balance sheets, restrict lending, and reduce costs, in order to improve long-term viability. This offers a potential advantage to foreign-owned banks but only Sberbank (#10) appears set on capturing significant market share. The profitability of foreign banks has also suffered and most have little risk appetite as they bring down still very high loans/deposits ratios. Privatizations are planned with NKBM slated for 2014 and Abanka Vipa for 2015, which will change the competitive landscape, as new owners will not be tied by the banks' EC commitments.

Chart SI7: Top 10 bank profitability drivers 2011-13



Top 3 banks have been loss-making for the past 3 years

Source: Bankscope

Chart SI8: Top ten banks market share development

	Loans MS 2013 change	Loans (EUR bn)	Deposits (EUR bn)	Deposits MS 2013 change	Assets MS 2013 change
NLB	22.3% -3.4pp		9.5	19.1% -0.6pp	23.6% -1.3pp
NKBM	9.7% -1.7pp		4.8	10.2% -0.3pp	11.9% +0.4pp
Abanka Vipa	8.7% +0.5pp		3.0	6.2% +0.1pp	7.6% -0.3pp
SKB	7.8% +0.9pp		2.5	5.7% +1.2pp	6.3% +0.4pp
UniCredit	7.0% +0.4pp		2.5	4.2% +0.7pp	6.2% +0.1pp
Koper	6.5% +0.7pp		2.3	5.5% +1.2pp	5.8% +0.6pp
Celje	5.4% +0.5pp		1.8	4.2% +0.1pp	4.5% -0.4pp
Gorenjska	4.1% +0.4pp		1.6	3.5% +0.2pp	3.9% 0.0pp
Sberbank	4.0% +1.2pp		1.5	2.5% +0.8pp	3.7% +0.8pp
Hypo Alpe-Adria	4.4% -0.4pp		1.4	2.5% +0.3pp	3.6% -0.5pp
Total Market (EUR bn)	29.199			30.279	40.344

Retail
Corporate and others
Total volume/ breakdown not available
Assets (EUR bn)

Note: Loans marekt share calculated based on net values. NLB, UniCredit, Hypo alpe-Adria, Sberbank and Gorenjska Banka unconsolidated annual reports.
Source: Bankscope

Slovenia
Strategic Directions

The underlying deterioration of asset quality and huge NPL stockpile in the corporate sector makes improving the effectiveness of workout and debt restructuring processes of key importance in this segment. As the largest banks in the sector shrink their balance sheets, the main area of decline is expected to be in the corporate sector. Banks will focus on preserving market share in retail and SMEs, making customer retention in these segments a priority. At the same time, banks should support net fee income by growing customer activity and increasing cross-selling. After years of cutting costs, banks face the challenge of managing further reductions to meet efficiency targets over the next few years, by optimizing distribution networks, streamlining processes, and exiting non-core businesses. Consolidation within the sector offers potential efficiency gains through cost synergies, but targets will be more attractive once credit risks in the sector subside.

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Definitions

Loans to non-financial sector	**Bulgaria** Includes: central government corporate and retail	**The Czech Republic** Includes: loans to non-financial corporations, household, non-profit institutions serving households, general government, loans to non-residents	**Croatia** Includes: loans to government units, non-financial corporations, non-profit institutions, households, non-residents	**Hungary** Includes: non-financial enterprise, including associated companies, household, non-profit institutions serving households, central and local governments and foreigners
	Poland Includes: households, non - financial corporations, non--profit institutions, government institutions, local governments, SSFs	**Slovakia** Includes: retail loans, corporates, general government and nonresidents	**Romania** Includes: Household, Non-financial corporations, general government, external assets	**Slovenia** Includes goverment, households, non--financial corporations and foreigners

Definitions

Deposits from non-financial sector

Bulgaria

Includes: institutions other than credit institutions and individuals and households

Croatia

Includes: government units, non--financial corporations, non--profit institutions, households, non-residents

The Czech Republic

Includes: loans to non-financial corporations, household, non-profit institutions serving households, general government, loans to non-residents

Hungary

Includes: non-financial enterprise, associated companies, household, other domestic customers and foreigners

Poland

Includes: households, non - financial corporations, non--profit institutions, government institutions, local governments, SSFs

Romania

Includes: non-financial corporations, households, central government, external liabilities

Slovakia

Includes: retail loans, corporates, general government and nonresidents

Slovenia

Includes goverment units, households, non-financial corporations and foreigners

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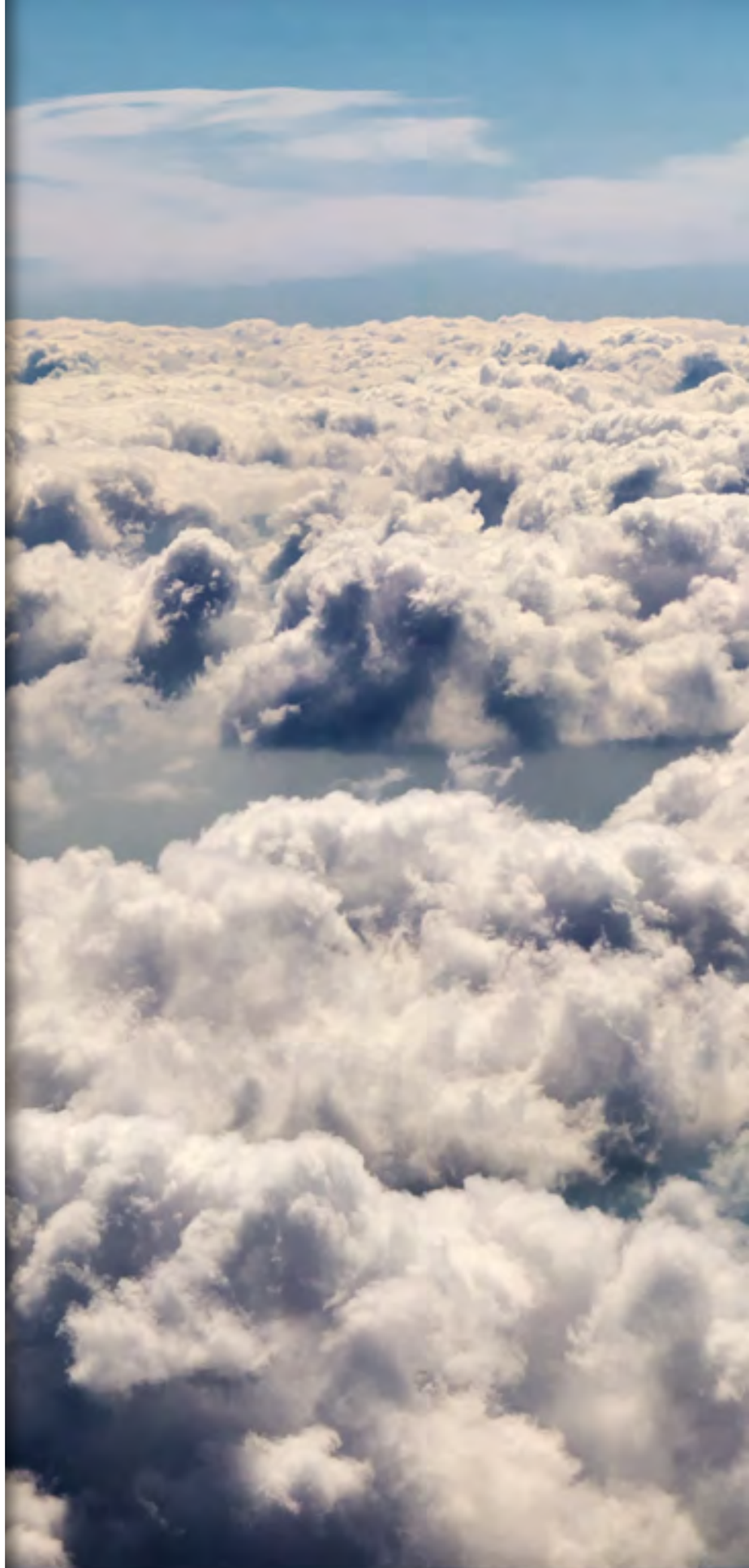

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