Banks' challenges in CEE

Radovan Jelasity

CEO and Chairperson, Erste Bank Hungary

Helsinki, November 27, 2012

ERSTE BANK
Nálunk Ön az első.

To be a banker today in the CEE is a challenging exercise!

- Circumstances under which banking is carried out is getting more complicated day by day, and it is far from being the end
- Supervisory challenge has been continuously increasing in the CEE region
- Recent experiences in CEE are forcing banks the reassess their strategy going forward
- Fundamentals are more important than ever; punishments for not prudent macroeconomic policies are quite high
- Differences among the CEE countries (even among the ones in the EU) are larger than ever; experiences from Hungary should be closely monitored

Both local, regional and international conditions got more challenging

Banking in the CEE is facing a new era – adjustment is still ahead of us

Macroeconomics

- Macroeconomic uncertainties
- Substantial deleveraging
- Different fundamentals
- Substantial reduction of loan growth outlook and the impact on GDP

Political

a) Regular oral attacks (banker bashing)

b) Concrete measures
  - Banking tax
  - FTT
  - Early repayment and other measures
  - Increased state involvement

c) Usage of additional power levers (competition authority, government audit …)

Banks

Public

- Anti-banking attitude
- Reduced confidence
- Different experience (FX lending)
- Active usage of additional legal levers

Investors

- Low risk appetite
- Expectation of additional measures
- Dropping profitability
- Facing new medium term reality

Banks need to deal with the past as well

- Substantial increase of NPLs
- Increased funding costs
- Dealing with maturity mismatch and FX portfolio
- Substantial additional HR related costs (risk, workout, internal audit, supervision …)

  ⇨ Deteriorating profitability

- Lack of capital (RWA considerations) looking both backward and forward (treatment of sovereign exposures)

- Divergent economic policies (open and hidden) among the countries - “me first” syndrome

… and should not forget about the regulators either (1/2)

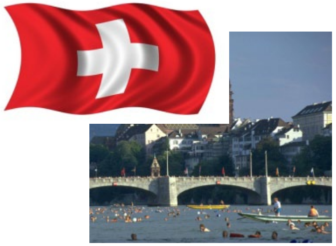
European Banking Authority (EBA)

= **core capital level of 9%**

→ Banks are being forced to make short term decisions
→ Will trigger higher cost of capital and consequently to asset repricing
→ Additional to Basel III and in some respect speeding up the implementation of Basel III requirements

Austrian National Bank & Financial Market Authority (OeNB/FMA)

= Full implementation of Basel III requirements
= Additional capital buffer of up to 3%
= „*Sustainable business model*" in view of CESEE exposures
= Ratio of new loans to local refinancing < 110%



Basel Committee on Banking Supervision (BCBS)

= **Common Equity Tier 1 of 7% (= Basel III)**

→ The impact in Europe (in particular CEE) will be bigger than in other regions (e.g. US)
→ Product costs are expected to change under Basel III
→ Credit rationing & increased borrowing costs in Europe specially hit SMEs, the backbone of the EU economy

… and should not forget about the regulators either 2/2)

European Commission

= **Capital Requirement Directive IV (CRD IV) / Capital Requirement Regulations (CRR)**

→ transposes the internationally agreed Basel III standards to the European banking specifics
→ same concern as in the case of Basel III that it might disadvantage the SME

Hungarian Financial Supervisory Authority (HFSA) and Hungarian National Bank (HNB)

→ Issuance of additional local regulations
→ Establishment of new consumer protection related measures
→ No final opinion regarding European Banking Union

European Central Bank (ECB)

→ Which (new) responsibilities and starting when?
→ How much new resources will be needed?

Cumulative effects of regulatory initiatives – twister for bankers!

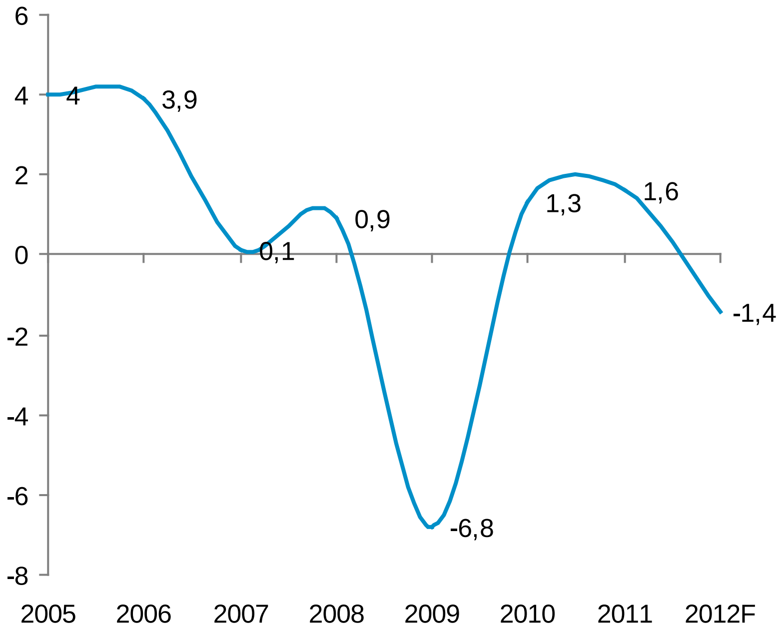
© Morgan Stanley Research

Nálunk Ön az első.

Hungary: bust without a boom!

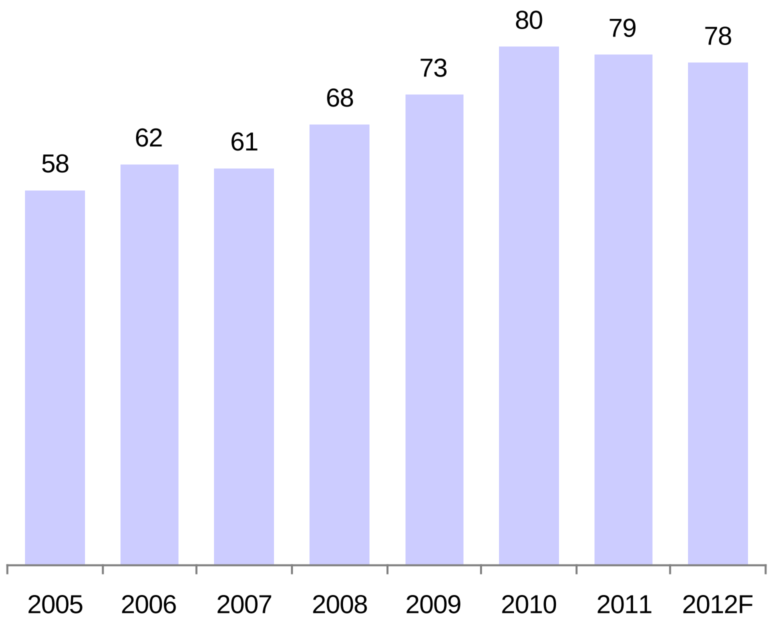
Limited GDP growth in the past few years…

GDP growth (%)



…while public debt increased significantly

Debt to GDP (%)

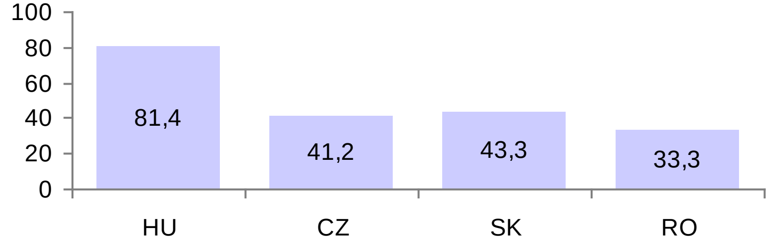


Source: Central Statistical Office, Hungarian Debt Management Agency, Erste analysis

Hungary cold serve as a good example of a disbalanced country

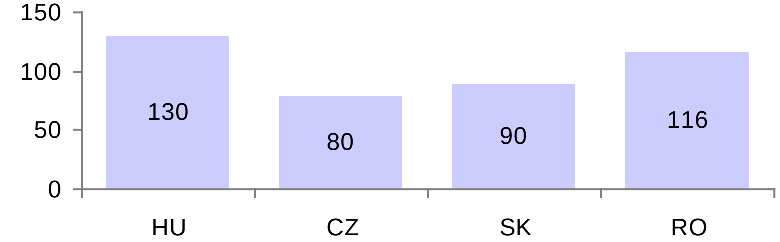
Hungary with highest indebtedness among peers

Public debt/GDP (2011, %)



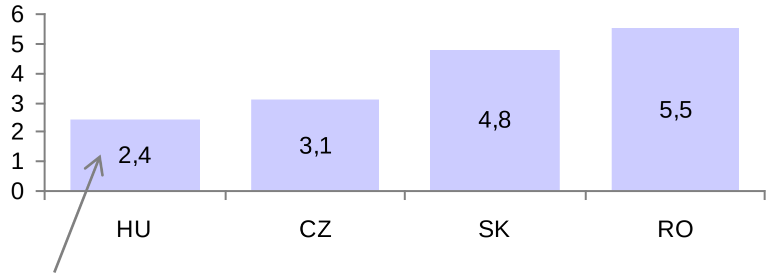
Despite improving trends, L/D ratio still highest in region

L/D ratio of banking sector (2011, %)



Budget deficit slightly below 3%, but mostly due to one-offs

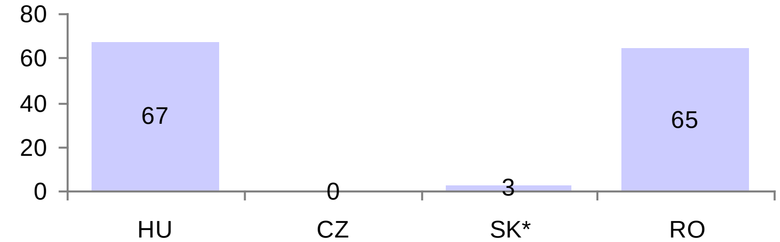
Budget deficit/GDP (2011, %)



w/o pension money takeover (number according to EconMinistry)

High share of FX-denominated loans in retail

FX retail loans as % of total (2010)



* 2008 data

Source: Erste Group Research Database, FX lending in Hungary (Nyeste-Árokszállási, 2012, in: Negyedszázados a Magyar Bankszektor, Hungarian Banking Association, volume of studies)

Several measures were taken in the Hungarian banking sector

Measures[1]	Direct effects	Indirect effects
Banking tax	▪ EUR 650mn yearly levy (0.5% of 2009 balance sheet)	▪ Adverse macroeconomic effects, substantial reduction of lending ▪ Reduction of banks' profitability ▪ Erosion of investor confidence
Early repayment	▪ EUR 1bn loss up front ▪ Close to equal additional loss of future interest income	▪ Decrease of portfolio quality ▪ FX mortgage portfolio reduction ▪ Loss of future interest revenue ▪ Branch closure and employee reduction
Financial transaction tax	▪ EUR 700mn[2]	▪ Increase of service fees ▪ Change of banking habits ▪ Transfer of corporate deposits to other countries

1. Without previous agreement with the banks 2. Expected gov't income from banking sector, to be transferred on to clients

Recent lessons from the CEE region

- Several countries are entering unchartered waters as we are facing the period of uncertainty – *we need fast, common and decisive decisions*!
- Too fast (forced) deleveraging carries a substantial price; full final effects are still to be seen – *experience sharing is more important than ever*!
- Counter cyclical supervision only magnifies “booms and busts” cycles – *we need to intensify talks between supervisors and banks*!
- Bad economic decisions can be priced in, but uncertainty cannot – *more than ever banks need predictability and certainty*!
- Current circumstances are forcing banks to re-evaluate their business strategy (e.g. giving up business areas incl. entire banking market) - *banks’ model in the CEE needs a major revision*!