Banking in the SEEEs:
Crisis effects, outlook and risks

Dear governors, distinguished guests, ladies & gentlemen:

It is my great pleasure to be here today and say a few words about the banking developments in the South Eastern European Economies, the effects of the crisis and the way I see the financial sector evolving in the years to come.

In the last six months, thanks to the drastic intervention of governments, central banks and international organizations, we have managed to escape a major collapse of the global financial system. This narrow escape is evident in the financial press, which has switched the topic of discussion – as the weekly magazine The Economist puts it - *from the future of capitalism to the future of capital requirements*. The interbank market is almost back to normal, the bond market is revived, M&A activity is up, and the international stock markets have already discounted the recovery of the global economy and future new profit opportunities.

I will begin by briefly reviewing the market views on the crisis, then discuss the structure of banking in the SEE countries and the problems that constrain new lending to households and corporations. I will finish with an assessment of the future evolution of the banking industry in our region and the globe.

1. Is the crisis over?

In our region, risk premia have declined a lot, especially since February-March, when the IMF was allocated a lot of funds by the G-20, about $1 trillion to spend on problematic economies. Yet in some countries these risk premia are still above the levels they reached prior to the Lehman collapse in September 2008. Markets think that the crisis is not fully over.

In my view, SEE sovereign spreads still have room to decline towards a lower equilibrium level. However, this equilibrium, will remain higher in the future than it would have been had the crisis not occurred. In other words, I expect the crisis to leave its lasting mark on the risk premia of the SEEEs as well as the advanced economies.

2. Banking in the SEEEs: The strong points

Turning now to banking in the region, there are items that make us happy and items that we continue to worry about. A big plus in the SEEEs is the stable nature of their banking systems, and their strong capital cushion. But let me give you some more concrete numbers.

In the past four-five years, a large wave of capital inflows has taken place to the region of emerging Europe. As a consequence, the banking sector in the countries of SEE - with the exception of Turkey - is mostly foreign owned. And unlike the Baltic region, this inflow of bank capital came from a variety of countries. Moreover, simple ratios of bank capital to total assets for the SEE banking systems are a lot higher than the corresponding ratios in Western Europe.

The major foreign players are the 4 Greek banking groups (NBG, Alpha, Eurobank, Piraeus) plus 7 additional banks, 2 Italian (Unicredit and Intesa San Paolo), 3 Austrian (Erste, Reiffeisen, Hypo Alpe Adria), one French (Societe Generale) and one Hungarian bank (OTP). Their asset exposures to SEEEs vary from 31% for Hypo Alpe Adria to 1.7% for Societe Generale. These banks have high capital adequacy ratios.

Banks that operate in the SEE region were particularly strong during the crisis. From June 2007 to early October 2009, banks in all of Europe suffered capital losses equal to $467 bn. These losses came from a variety of sources, loan charge-offs and provisions (20%), non-mortgage asset backed securities (13%), monoline insurers (10%), CDOs (8%), subprime RMBSs (8%), and other. Yet only a very tiny component – originating from loan provisions - is due to losses occurred in the SEE region. Also very few banks involved in the SEE region occurred large losses. From the previous 11 key player-banks in the SEE region, only Societe Generale had global write-down of $12.6 bn and ranks 13th among the 59 European banks with losses. Unicredit occurred a $6.5 bn loss and ranks 22nd. Nevertheless, both banks have small asset exposure to the SEE region.

3. The constraints on new lending

In the past, the SEE countries relied heavily on the financial sector to promote growth. In 2007, their economies were overheating and credit growth was running at high rates. Yet, unlike the Baltic States, the region did not become as vulnerable to the credit expansion. The international financial crisis caught the credit expansion in the beginnings of a bubble and, hence, saved the SEE region from re-living the Baltic experience. Thus, by the end of 2008, total credit to GDP had not reached the levels observed in the Baltic States.

The recession has caused the credit expansion to stall. However, it should not be expected that the financial sector will pull the countries out of the recession. Prior experience in the more developed western world shows that credit expansion lags the economic expansion. During a recession, it is the economy that drives credit, not the other way around.

There are two major problems that constrain credit expansion. The first is liquidity. With the exception of Albania and Turkey, loans exceed deposits in the SEE countries. New liquidity is hard to come from abroad nowadays. Thus loan expansion requires domestic policy action, like reducing reserve requirements, utilizing the ample assistance of the IMF, capital increases in state-owned banks, increasing the minimum insurance on bank deposits, etc. Indeed, the SEE authorities took many of those measures in order to release new credit to households and enterprises.

The second constraint to loan expansion is the fear of borrower default. The experience with the business cycle in the West shows that NPLS rise as the recession progresses and peak after the end of the recession. NPLs are thus expected to reach very high levels in 2010. An addistional cause for concern is the behavior of the local exchange rates, as large devaluations increase the burden of households and companies that have borrowed in FX.

4. What is the future of banking?

The future of banking in the SEEEs will not only follow the future of the local economies but also the future of the global financial system. I will, therefore, make some remarks on the latter.

From the time of the Great Depression, the global financial system has increased in relative size and power. This is evident in the graph of employment as a percentage of total employment which doubled, and would be even more evident in value added terms, which quadrupled. However, today everyone asks whether or not the next few years mark the beginning of shrinkage in the importance of the global financial sector.

We are facing a new world order ahead. Global economic growth will slow down, political power will shift towards Asia and the G-20, and the regulatory authorities will have the upper hand with the Financial Stability Board and the IMF running the show. The G-20 regulatory decisions will affect banks. Wall Street will counter attack with plenty of money and political influence.

The task for regulators is to increase global financial stability without hurting the good side of the banking business, which promotes healthy lending, conducts the maturity transformation needed by both depositors and borrowers and promotes the larger intermediation role. If onerous restrictions were to be imposed on banking, then a new wave of deregulation would be unfolding, which would appear optimal in the future as the memory of today's near-collapse fades.

In the process of re-regulating the global financial system, regulators ought to observe two main principles.

(1) Cross-country **level – playing field** among financial institutions. This seems to be understood by the G-20, as they promote identical accounting standards and common restrictions on liquidity and leverage. Unilateral restrictive decisions by individual country regulators, which may appear to be working in the short-run, will hurt their banking system in the long-run as financial capital is highly mobile.

(2) **Capital is costly**. This is perhaps less appreciated by the floating initial rough proposals on countercyclical capital buffers or the need for quality capital, i.e. a larger stock component in capital adequacy rules. Yet there are some smart proposals also floating around by academics, which take care of the countercyclical buffer property without imposing too much unwarranted cost on banking.

5. Conclusion

This severe crisis has wakened us all up to the dangers of an unregulated financial system that is vulnerable to extreme behavior. The lesson is to build a new system whose structure of incentives thwarts this behavior. We are optimistic that we will succeed in the same manner we succeeded in averting a global depression.

Our region was lucky not to host banks involved in toxic assets or the pursuit of extraordinary profit at any risk. Yet, we were not spared by the consequences of the crisis, as we all operate in a globalized environment. Liquidity and NPLs are major concerns for banks that prohibit them from aggressively supplying new loans. The past business cycle experience shows that the recovery in lending will follow the recovery of the economies, as risks decline and loan demand by healthy borrowers returns.

As we look ahead to the future, we can only predict rising living standards and healthy banking systems in the SEEEs that would further support growth. The SEE countries share a common anchor in their domestic political and policy decisions. This anchor is the process leading to EU or EMU entrance, which forces the economically rational decisions on politicians and the public.

"BANKING in the SEEEs: CRISIS EFFECTS, OUTLOOK & RISKS"

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BoG – Oxford Un. Conference on:
"Challenges and Prospects of South East European Economies
in the wake of the financial crisis"

Athens, October 16, 2009

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BANKING in the SEEEs:
CRISIS EFFECTS, OUTLOOK & RISKS

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I.

IS THE CRISIS OVER?

"From the future of capitalism
to the future of capital requirements"

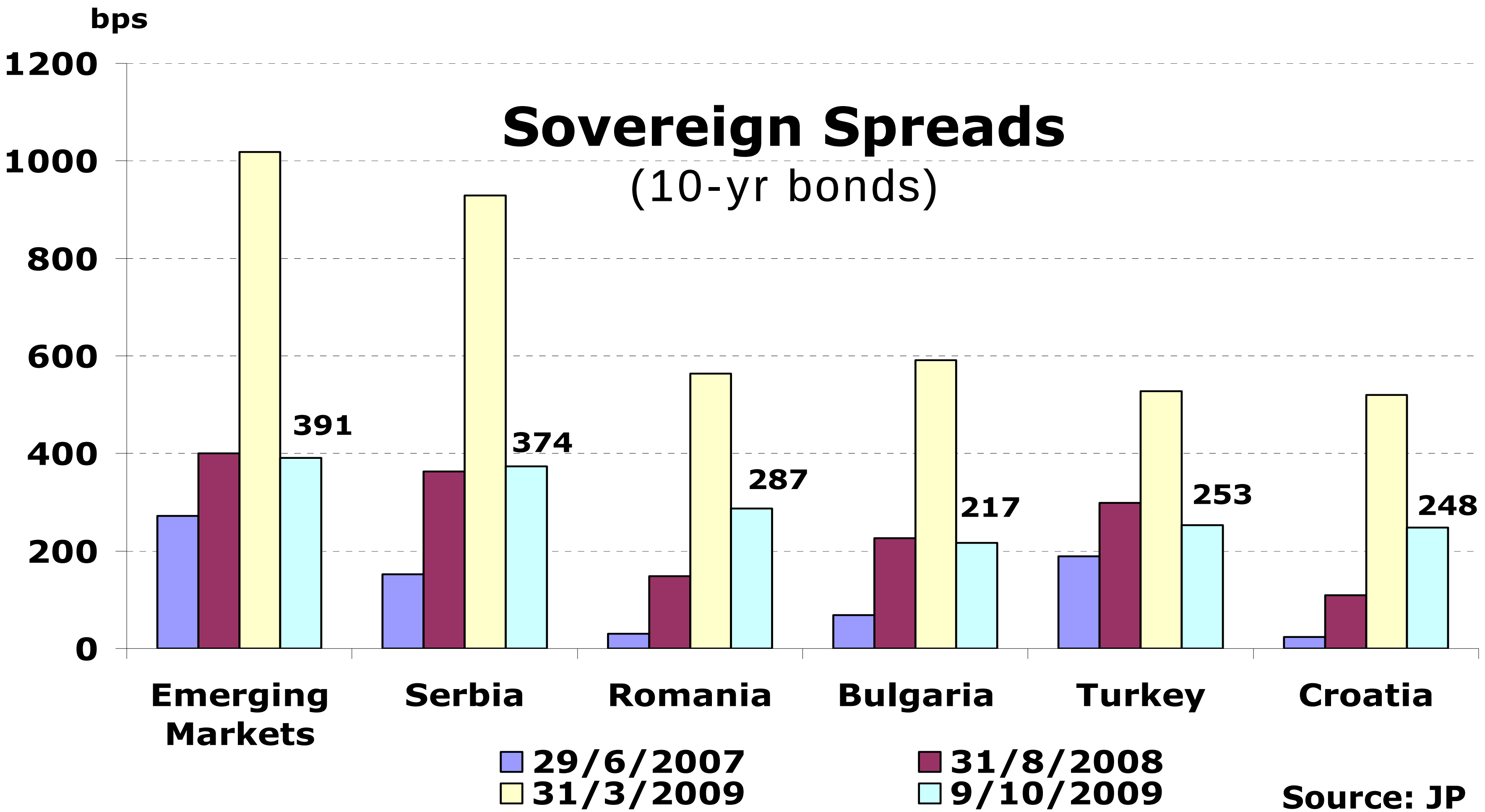
What a difference 6 months have made in our discussions!

The Economist, October 3-10, 2009

I. Financial market fears ease, yet concerns remain for the SEE region

Eurobank EFG

- ✓ **Potential IMF funding leads sovereign spreads to decline at almost pre-Lehman levels**



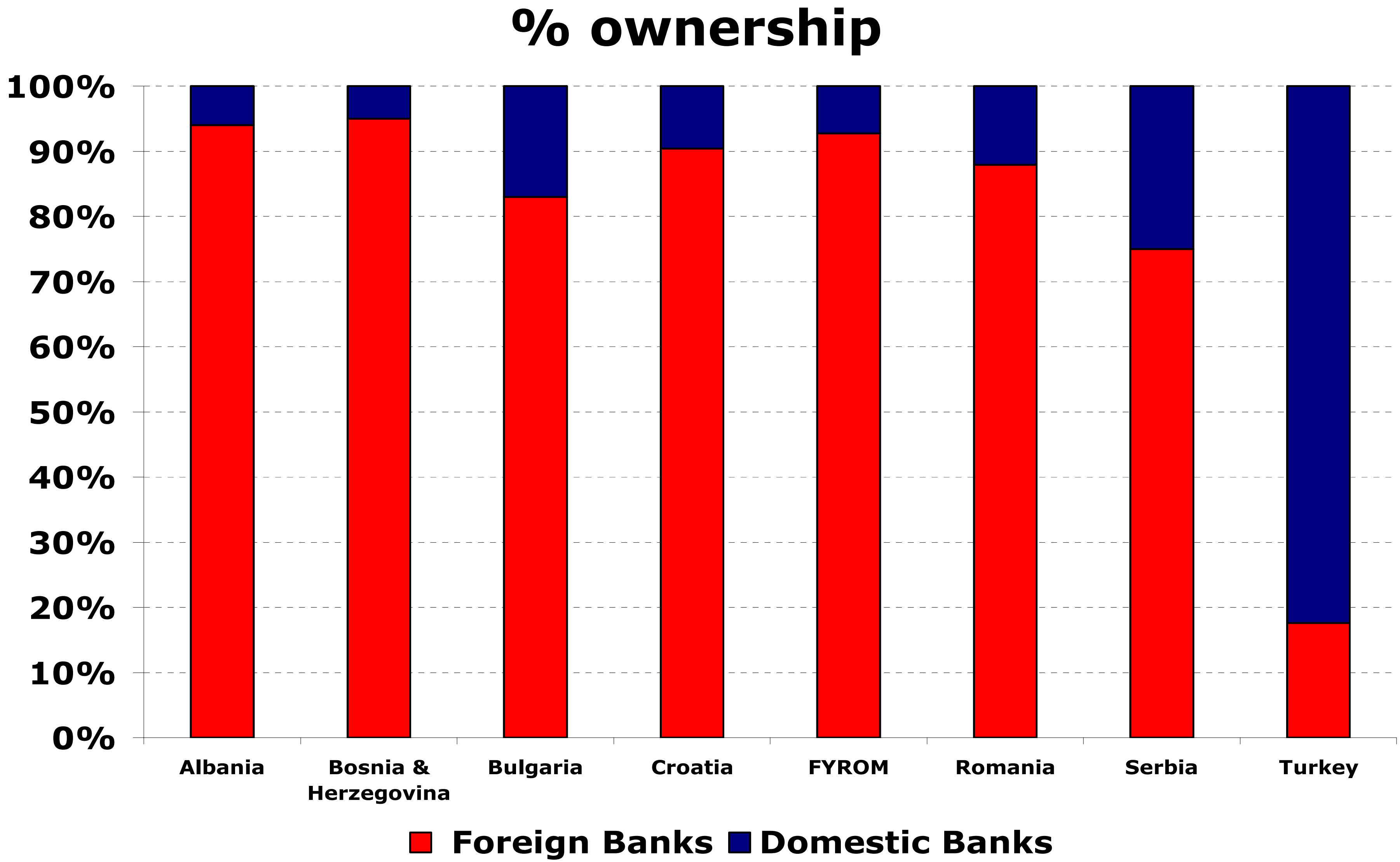
Source: JP Morgan EMBIG

II.

BANKING
in the SEEEs

The strong points

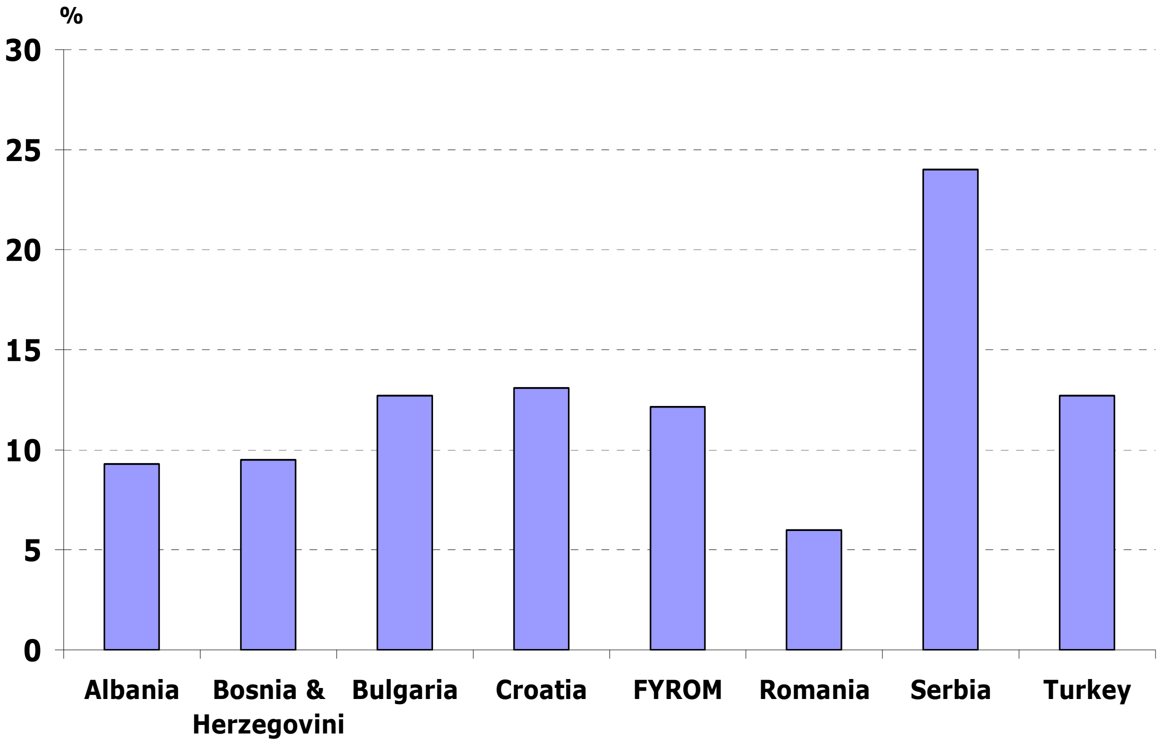
II. Large foreign ownership of banking sector



II. Adequate capitalization

Eurobank EFG

Bank Capital to Assets ratio
(Q2 2009)



***FYROM, Romania and Serbia as of Q1 2009**

Capital / Assets		
Austria	**6.3**	Q1 09
Belgium	**3.4**	Q1 09
Ireland	**5.1**	Q1 09
Germany	**4.5**	2008
Portugal	**6.1**	2008
Norway	**4.2**	2008
Sweden	**4.7**	2008
UK	**4.4**	2008
Greece	**4.5**	2008
Spain	**6.4**	2008

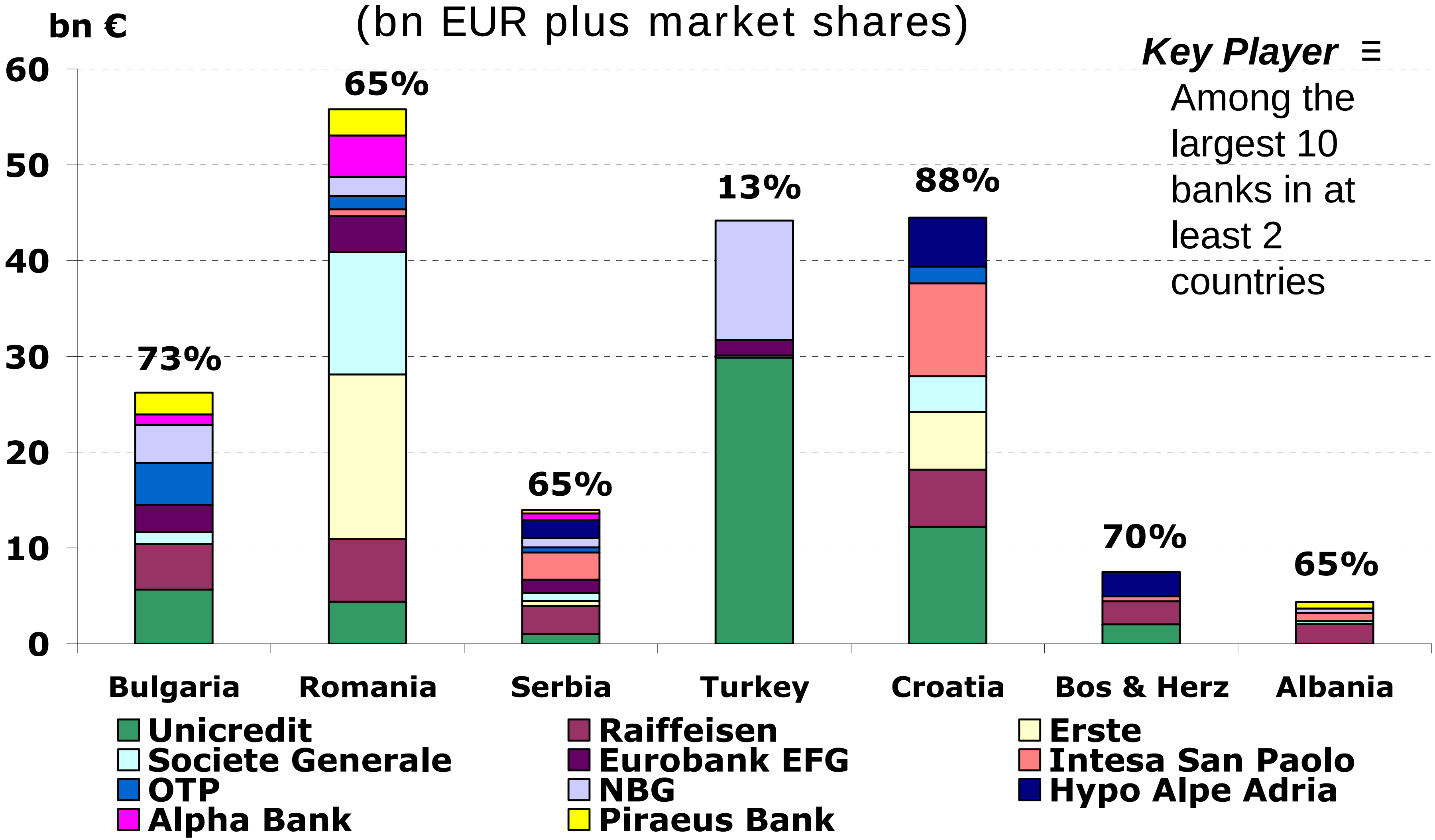
Source: Central Banks, Eurobank Research

✓ **Capital to assets ratio relatively stronger in SEE**

II. Key "systemic"players

Eurobank EFG

Assets of key players in SEE countries



Key Player ≡
Among the largest 10 banks in at least 2 countries

II. Exposure of key players

Eurobank EFG

Financial Institutions in SEE & Turkey (2008)						
	Group Assets (bn EUR)	SEE Assets (bn EUR)	SEE Share (% Total Assets)	Group Capital Adequacy Ratio*	SEE Loans (bn EUR)	SEE Deposits (bn EUR)
Societe Generale	€ 1130.0	€ 19.4	1.7	11.6	€ 12.5	€ 10.1
Unicredit	1045.6	55.1	5.3	11.4	34.9	34.6
Intesa San Paolo	636.1	14.6	2.3	10.2	9.4	9.1
Erste	201.4	23.7	11.8	10.1	15.7	10.7
NBG	101.8	19.9	19.5	10.3	15.3	11.0
Raiffeisen	85.4	21.8	25.5	9.7	14.2	12.3
Eurobank EFG	82.2	9.6	11.6	10.4	6.0	5.9
Alpha Bank	65.3	6.1	9.3	10.1	6.5	2.8
Piraeus Bank	55.0	6.1	11.1	9.9	4.4	2.1
OTP	37.7	9.3	24.6	15.3	6.4	6.2
Hypo Alpe Adria	32.8	10.1	30.7	11.9	5.5	3.7

* Does not include preferred shares

Source: National Authorities, Raiffeisen Bank, Eurobank Research

II. European banks: Write-downs and capital increases

June 2007 – September 2009

Eurobank EFG

	Banks	Loss	Capital Raised	Present in N.E.
1	UBS	$52.8	$ 39.8	
2	HSBC Holdings	50.1	28.4	
3	HBOS	28.8	25.1	
4	RBS	28.3	54.4	✓
5	Barclays	23.1	30.1	
6	Bayerische	19.7	21.8	
7	Credit Suisse	19.4	12.8	
8	Deutsche Bank	19.3	10.9	✓
9	ING Group	18.3	21.2	✓
10	BNP Paribas	17.6	7.5	✓
11	IKB Deutsche	15.1	12.5	
12	KBC Groep	12.9	8.1	✓
13	Soc Gen	12.6	16.1	✓
14	Banco Santander	11.4	28.2	
15	Fortis	9.7	23.6	
16	Credit Agricole	9.4	13.1	✓

	Banks	Loss	Capital Raised	Present in N.E.
17	Natixis	$ 9.2	$ 8.4	
18	DZ Bank	7.9	0.0	
19	Anglo Irish	7.7	0.1	
20	Hypo Real Estate	7.3	0.1	
21	Dexia	6.9	9.4	✓
22	Unicredit	6.5	9.2	✓
23	Commerzbank	6.4	26.8	✓
24	Dresdner Bank	5.3	0.0	
25	Landesbank Baden Wurttemberg	4.8	0.0	
26	HSH Nordbank	4.3	1.9	
27	WestLB	4.1	7.4	
28	Rabobank	3.6	1.5	
29	Lloyds Banking Group	3.6	14.2	
30	Northern Rock	3.3	5.5	
31	Bank of Ireland	3.0	5.2	

II. European banks: Write-downs and capital increases

Eurobank EFG

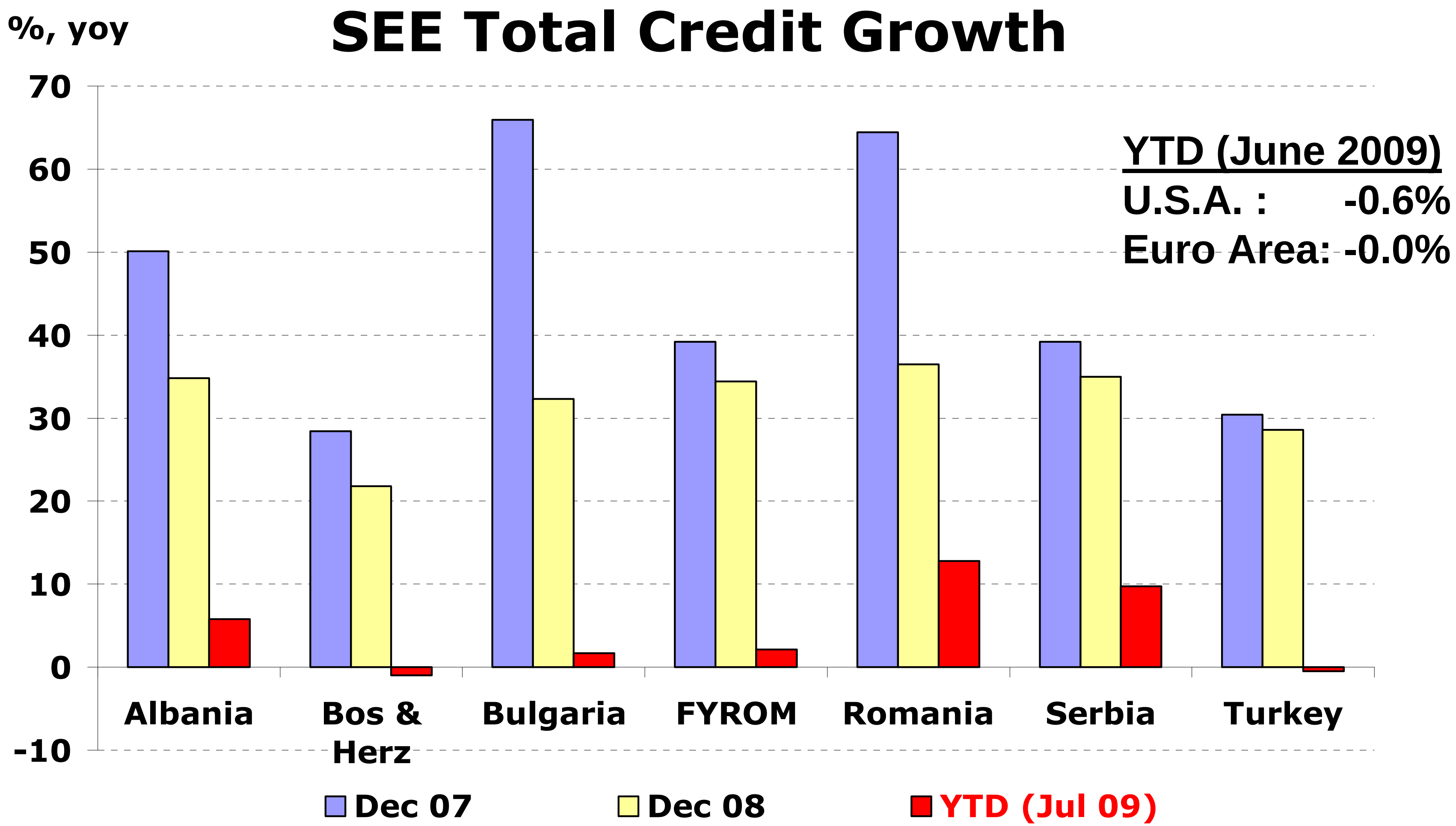
	Banks	Loss	Capital Raised	Present in N.E.
32	Allied Irish Banks	$ 2.7	$ 5.2	
33	Intesa Sanpaolo	2.7	3.7	✓
34	Landesbank Sachsen	2.6	0.0	
35	Alliance & Leicester	2.6	0.0	
36	Deutsche Postbank	2.5	1.5	
37	Banco Bilbao Vizcaya Argentaria	2.5	0.0	
38	Banco Popolare	2.4	0.0	
39	ABN AMRO Holding	2.3	0.0	✓
40	Bradford & Bingley	2.0	3.0	
41	DNB NOR ASA	1.8	0.0	
42	Banco Popular Esp	1.8	1.8	
43	Groupe Caisse d'Epargue	1.2	5.3	
44	EFG Eurobank	1.1	0.0	✓
45	Landesbank Hessen-Thueringen	0.8	0.0	
46	HVB Group	0.7	0.0	

	Banks	Loss	Capital Raised	Present in N.E.
47	Standard Chartered	$ 0.6	$ 0.0	
48	Norddeutsche Landesbank	0.6	0.0	
49	Danske Bank	0.6	0.0	✓
50	Piraeus Bank	0.5	0.0	✓
51	Roskilde Bank	0.5	0.7	
52	Alpha Bank	0.5	0.0	✓
53	Landesbank Berlin	0.5	0.0	
54	NIBC Bank	0.5	0.0	
55	SEB	0.5	0.0	
56	Kommunalkredit Austria	0.1	0.0	
57	Aareal Bank AG	0.1	0.0	
58	Kaupthing Bank	0.1	0.0	
59	Erste Group	0.0	0.6	✓
	Total	**467**	**465**	

III.

The Constraints on New Lending

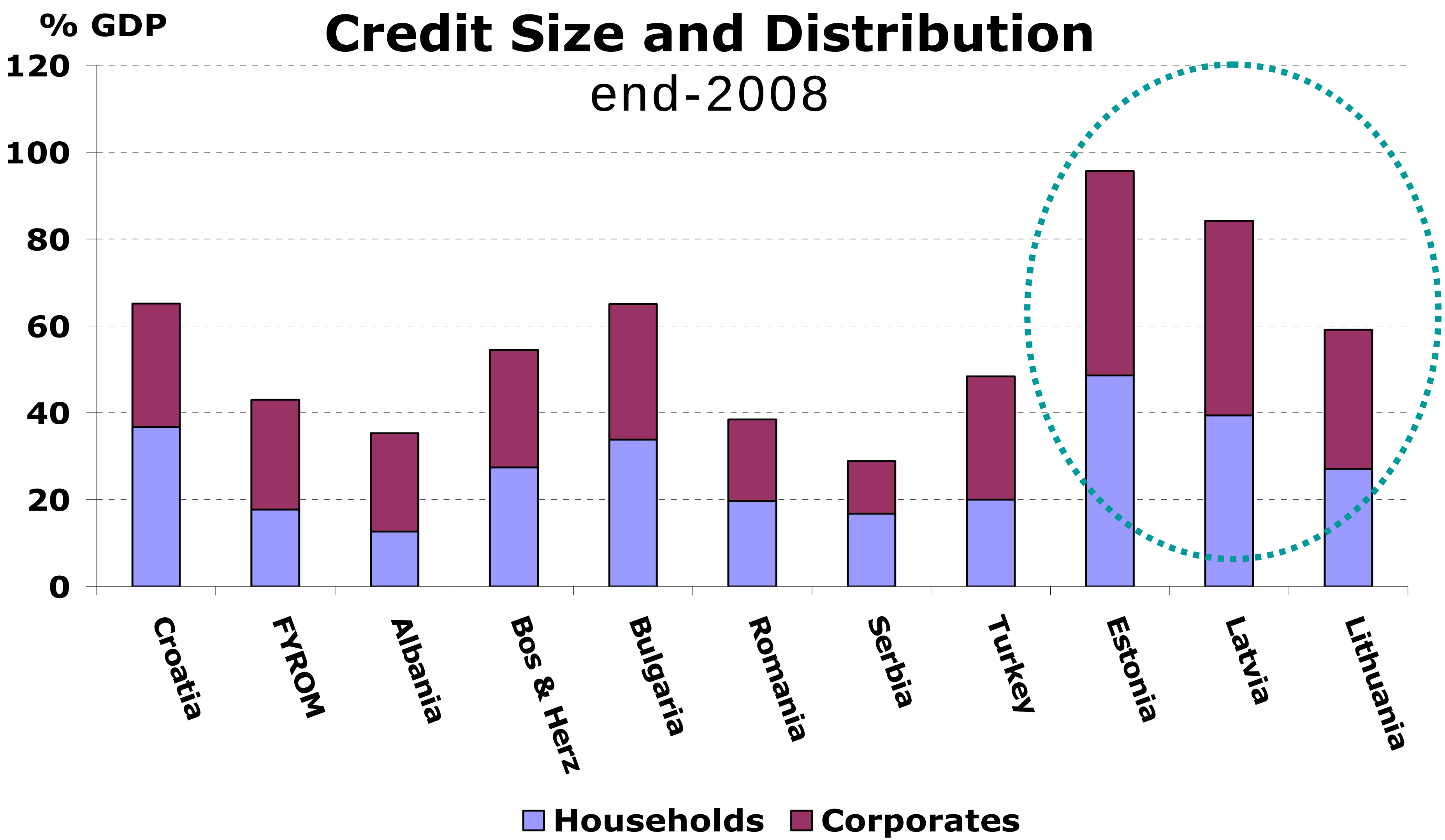
III. From huge credit growth rates to zero or negative expansion



Source: Central Banks, Eurobank Research

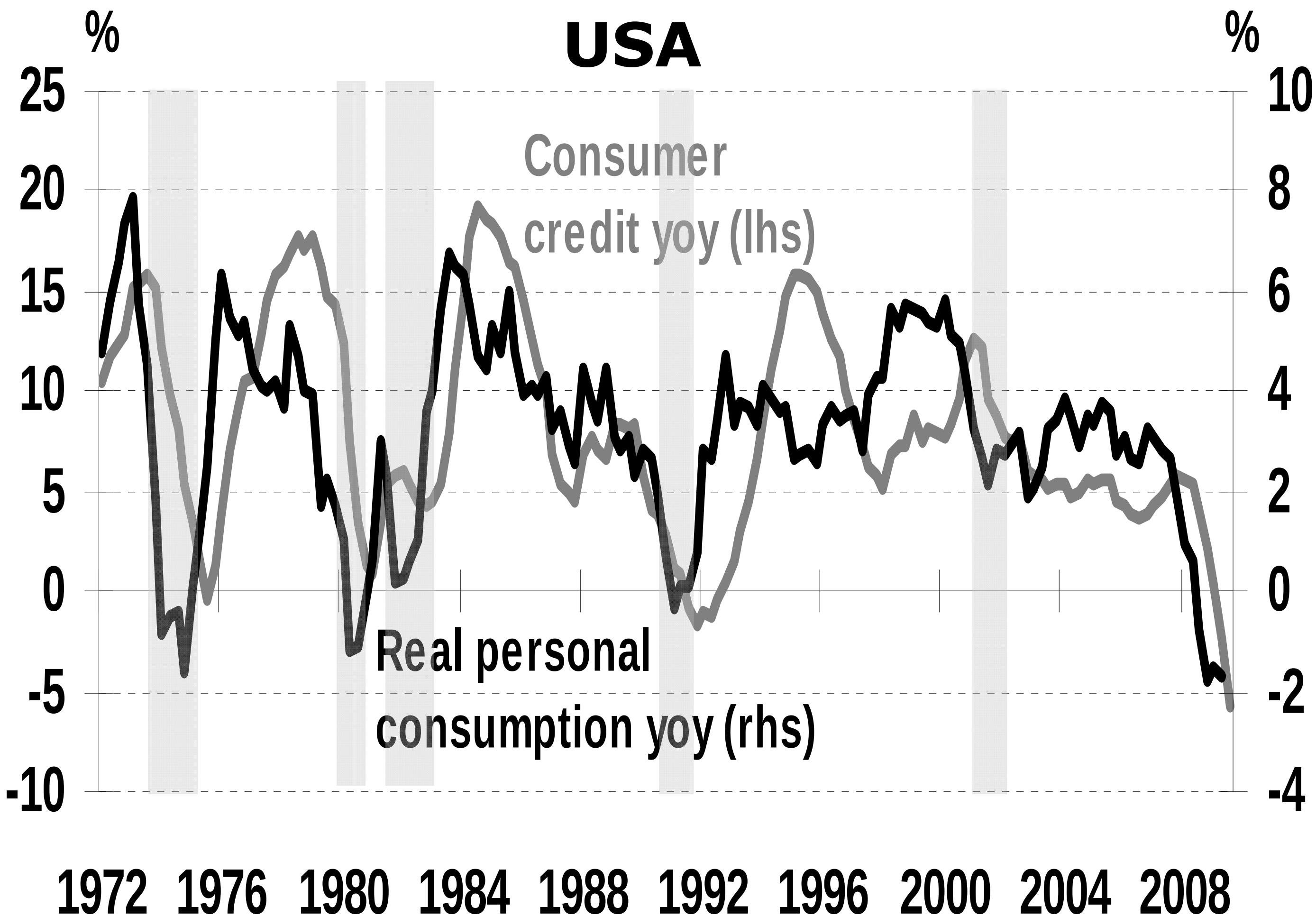
✓ The drop in SEE credit growth is more visible in 2009

III. Compared to the Baltics, credit did not reach unprecedented levels



Source: Central Banks, Eurobank Research

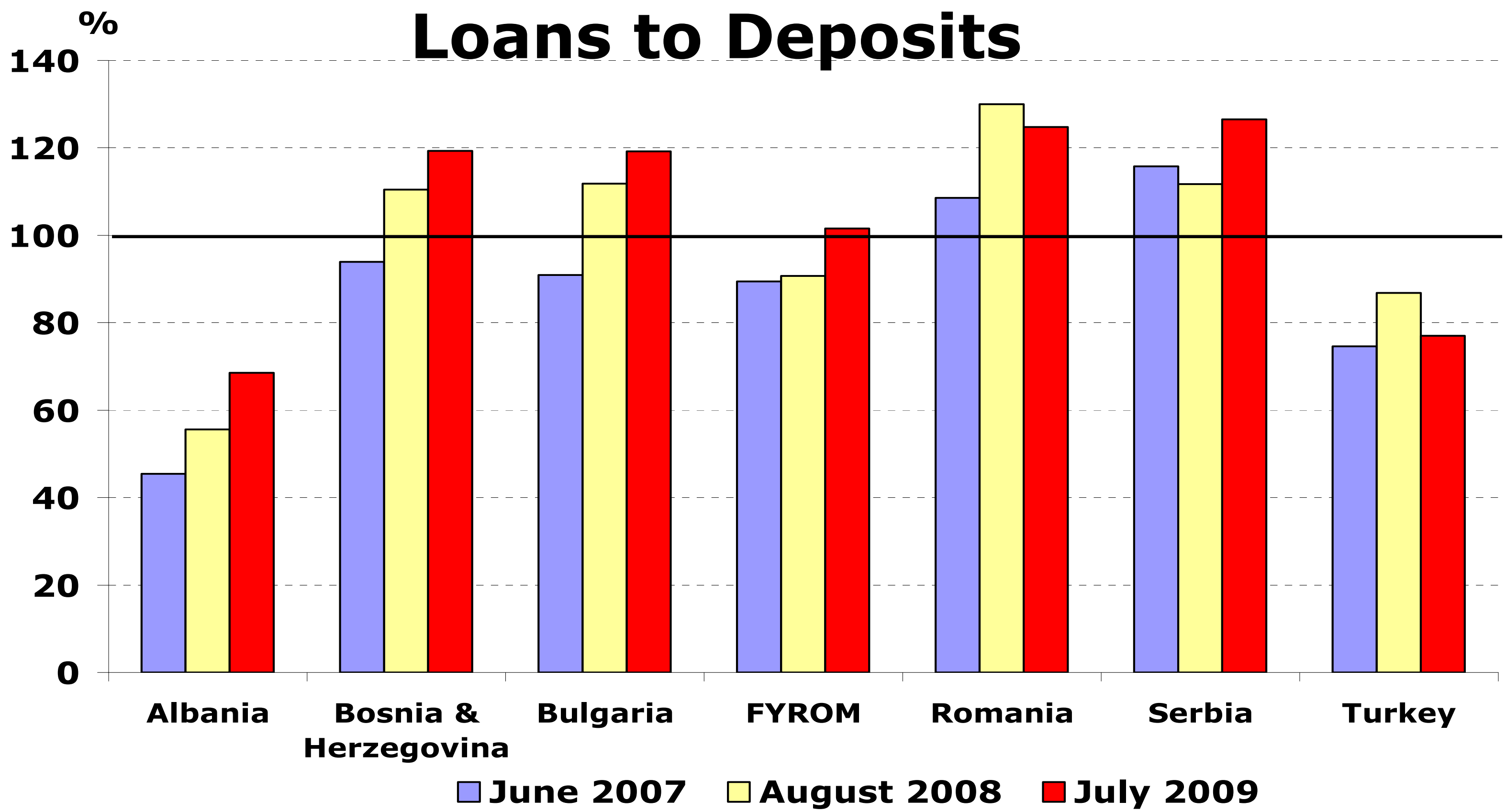
III. Credit expansion follows a recovery ⇨ SEEEs cannot rely on banks to push them out of the recession



Source: Federal Reserve, Eurobank EFG

- ✓ In 9 out of 10 previous US post-war recessions, real personal consumption has rebounded **3 quarters earlier** than consumer credit growth
- ✓ SEEs should therefore hope that good credit flows into their economies, **not any credit**

III. Liquidity is the first major constraint to credit expansion



<u>**Baltic States at July 2009**</u>

Latvia	**105.0**
Lithuania	**183.3**
Estonia	**167.9**

- ✓ **Domestic deposits unable to support a large expansion in credit growth**
- ✓ **Difficult to bring liquidity from abroad**

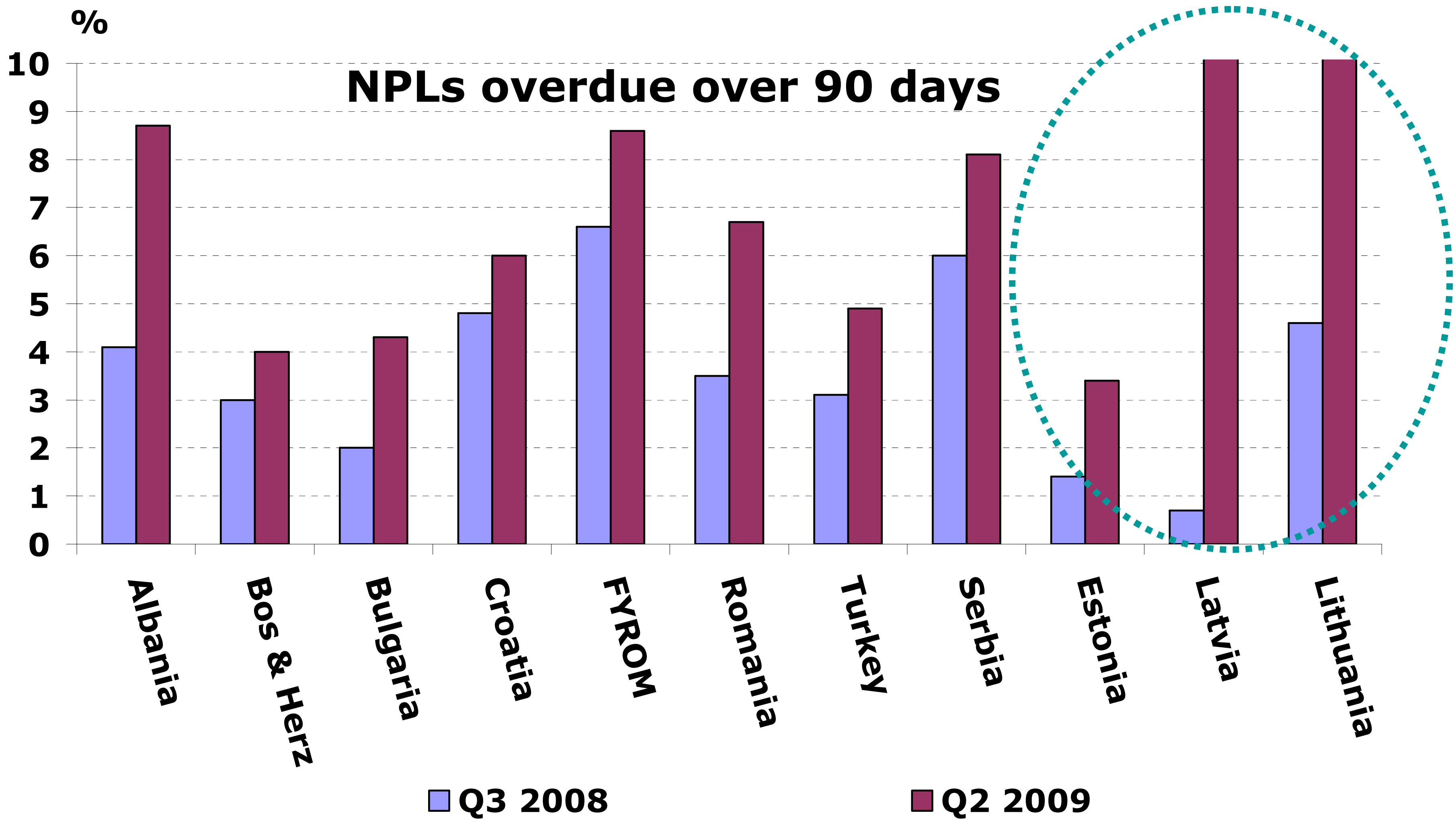
Source: Central Banks, Eurobank Research

III. Government & Central Bank initiatives to strengthen lending

	Albania	Bosnia	Bulgaria	Romania	Serbia	Turkey
Deposits Guarantees	✓	✓	✓	✓	✓	✓
Minimum Reserve Requirements		✓	✓	✓	✓	✓
IMF Support		✓		✓	✓	
Special Lending Support	✓		✓	✓	✓	
Monetary policy easing	✓			✓	✓	✓
Other measures (tax, regulatory etc)	✓			✓	✓	✓

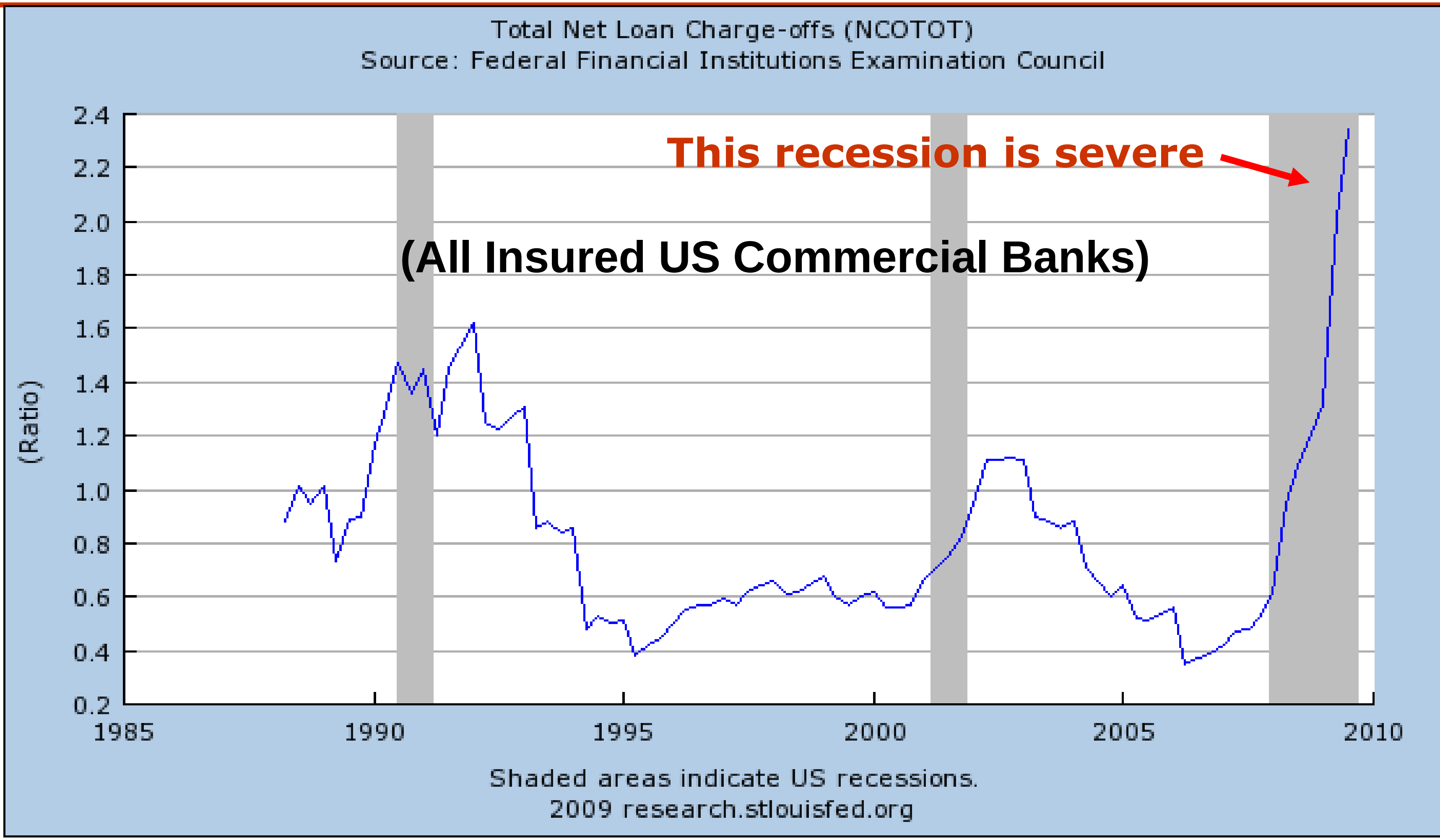
III. NPLs is the second major concern

✓ **Not as high as in the Baltic region**



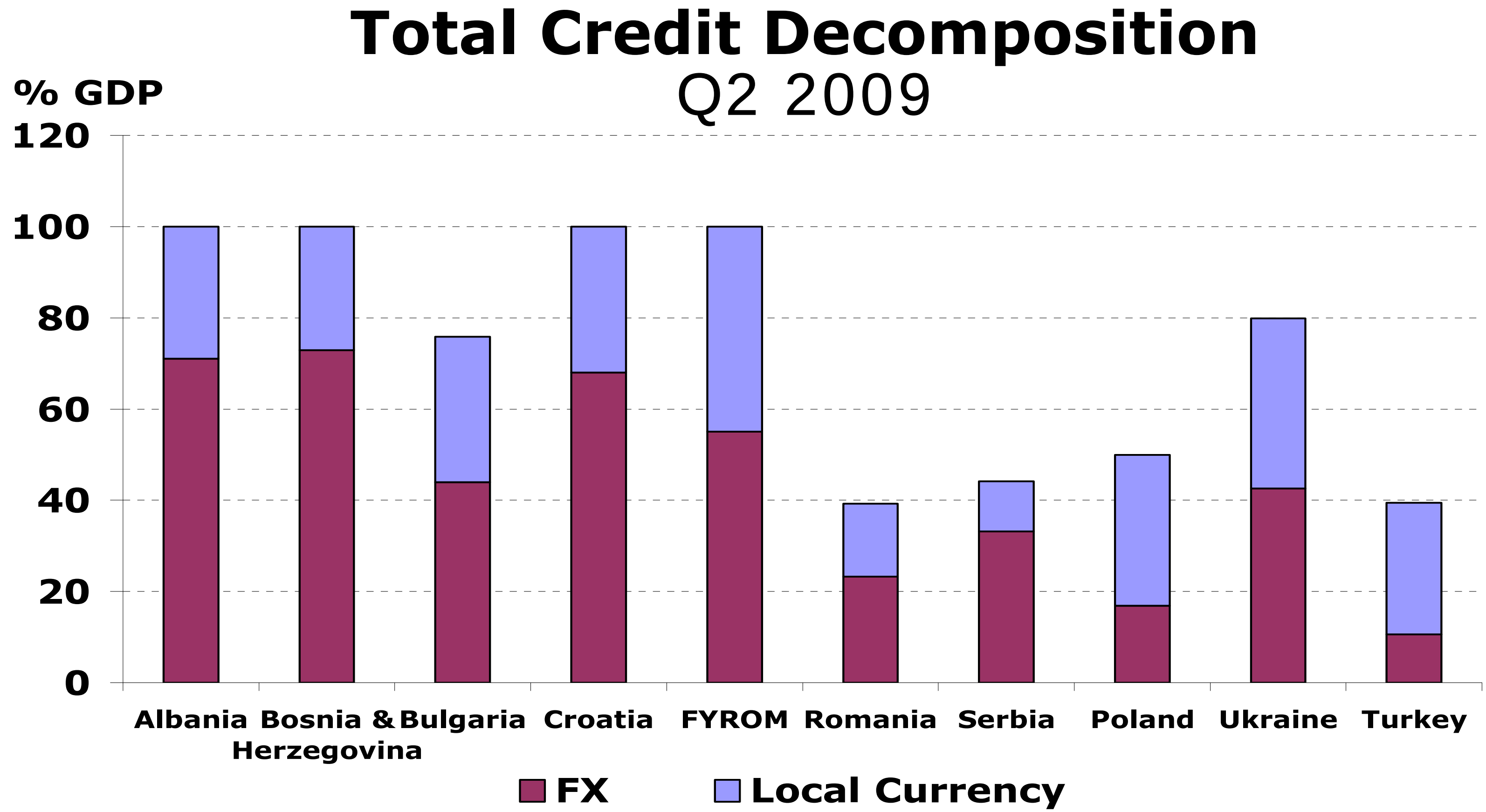
*Serbia as of Q1 2009, Lithuania Q4 2009

III. Evidence from US points to a cyclical increase in NPLs



Note: Loan losses divided by total loans (annualized quarterly data for all US banks). Charge-offs are measured on a net basis, i.e. loan losses minus recoveries on loans preciously charged off.

III. Large FX exposure increases vulnerability to NPLs



*** Albania, Croatia as of Q1 2009**

- ✓ **Currency board would be attacked in Baltic States first, before migrating to Bulgaria**

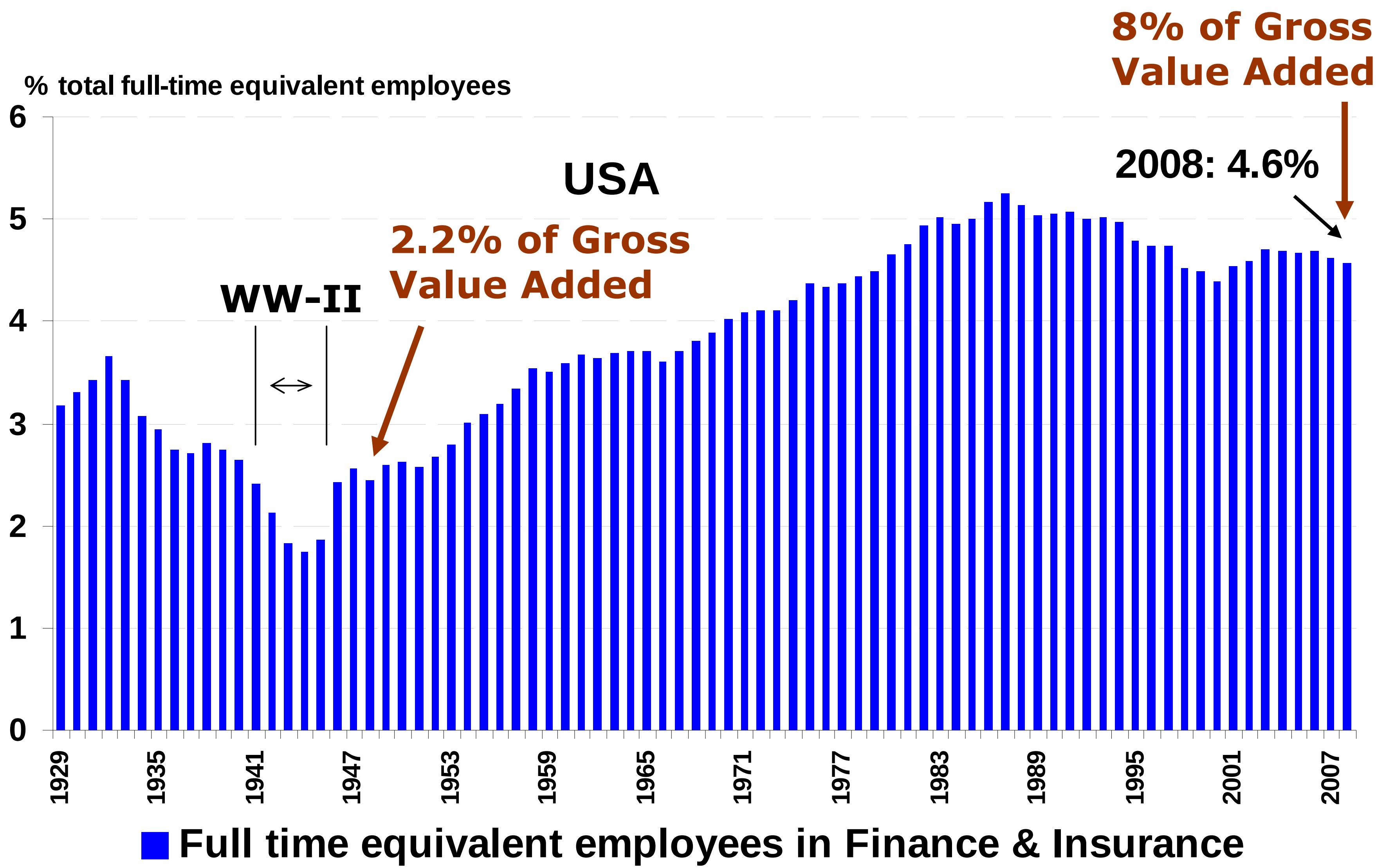
IV.

What is the Future of Banking?

SEE Banking will depend on:

1) Regional economic growth
2) Evolution of global banking system

IV. Will the expanding financial industry suffer?



Source: Bureau of Economic Analysis

IV. A different world ahead

- ✓ Economics: Slower global growth
- ✓ Politics: Economic & political power → Asia and G-20
- ✓ Global Regulation:
    - The Financial Stability Board gains power
    - A stronger IMF, better able to fight crises
    - Stricter regulation, easier implementation in Europe than in the US

- ✓ **G-20 decisions will affect banks**

❖ Yet Wall Street continues to hold considerable **political power <u>against future regulatory restrictions</u>**

IV. We need smart regulatory protection

- ✓ Aim should be to avoid the excesses of the financial sector without imposing too much cost
- ✓ Restrictions should be uniform across the globe and respect the **level-playing field**
- ✓ **Onerous restrictions may cause a new wave of future de-regulatory fervor**
- ✓ Some smart proposals by academics that bear a minimum cost

V. Conclusions

- ✓ The SEE region is bound to grow at high rates as the EU and EMU play important anchoring roles to political and policy decisions
- ✓ Banking will subsequently benefit from future local economic growth and contribute to that growth as well
- ✓ SEE banking did not participate in the excesses of international banking that led to the current crisis
- ✓ An expansion of bank lending will follow the exit from the current SEE recession
- ✓ The global financial system requires smart regulation which minimizes excess behavior without imposing too much cost
- ✓ The global financial system requires and a level-playing field

THANK YOU FOR YOUR ATTENTION!!

My thanks to the Research Department of Eurobank EFG for able research assistance and support

For more info, please consult the Eurobank website:

http://www.eurobank.gr/research

New Europe:	**A quarterly analysis of the countries of New Europe.**
Economy & Markets:	**A monthly publication on issues from the Greek and World economy.**
Global Economic & Market Outlook:	**A quarterly in-depth analysis of major market and economic trends across the globe with our detailed forecasts.**