



2010: Deleveraging is the name of the game

December 17, 2009

Key views

- **Funding structure starts to adjust in 2010.** Alongside the gradual withdrawal of monetary stimulus in Western Europe, long-term external wholesale or intragroup funding will become much more costly. Anticipating this development Eastern European banks will intensify their efforts to bring down their loan-to-deposit ratios via sluggish loan growth, strong competition for (retail) deposits and some selling of distressed assets.
- **NPL management crucial for future profitability.** Peak NPL levels will in most countries be reached in 2010. The level of recovery rates and impact on profitability will depend on the quality of legal systems and the availability of tested NPL collection procedures.
- **Tougher regulatory standards.** We expect national regulators to implement tougher standards regarding indebtedness, FCY liquidity or FX lending (e.g. via loan-to-value or payment-to-income ratios differentiating between FCY and LCY lending).
- **Competitive landscape not to change dramatically.** After this year's increase in state influence in the CIS we do not expect any substantial shifts in market shares in 2010. Only some foreign players with a low market share in Eastern Europe might consider exiting the market.

Sluggish growth recovery

With EMU and the US having exited recession in the second quarter, more and more signs of economic recovery are emerging in Eastern Europe as well. With the exception of the Baltics and Bulgaria we expect all economies to show positive growth rates next year, albeit below potential (see chart). While net exports are expected to contribute positively to growth, investment and consumption will remain dampened by high unemployment and sluggish credit growth (see chart). Overall, we forecast annual real credit growth in the single digits in 2010.

Funding structure starting to change

As foreign parent banks only slightly reduced their exposure to their Eastern European subsidiaries during the crisis, no substantial external deleveraging has happened in the Eastern European banking sectors so far. With the exception of Kazakhstan (where the state replaced some external funding due to low foreign ownership) banks' external liability-to-asset ratios have remained largely unchanged compared to one year ago (see chart on next page). This high dependence on external funding is mirrored in the high loan-to-deposit ratios. Except in the Czech Republic and Poland loan-to-deposit ratios remain well above the 100% level (see chart). They have even increased in Latvia and Ukraine, where deposits have fallen in the light of the crisis. But alongside the gradual withdrawal of

Sticky loan-to-deposit ratios

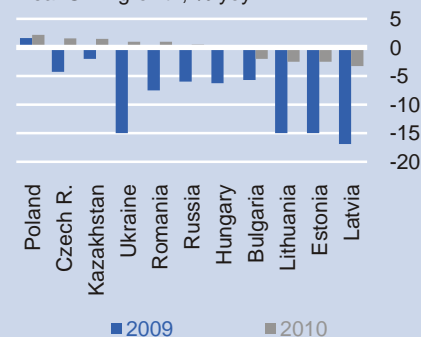
Loan to deposit ratio, %



Sources: National central banks, DB Research

Weak growth prospects

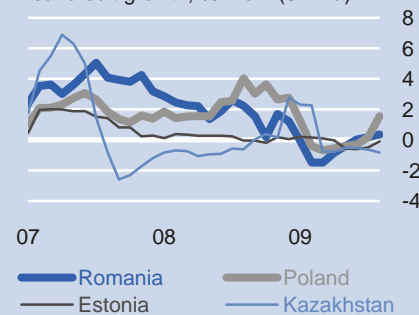
Real GDP growth, % yoy



Source: DB Research

Credit growth to pick up only slowly

Real credit growth, % mom (3mma)

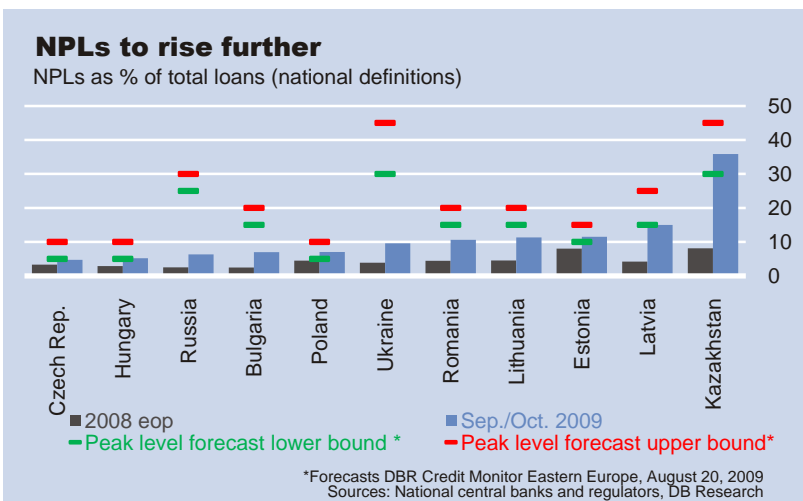
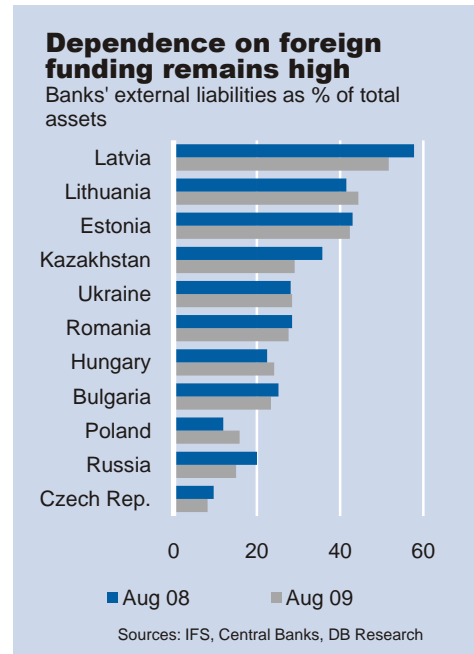


Sources: National central banks, IFS, DB Research

monetary stimulus in Western Europe and the US, long-term external wholesale funding or intragroup funding will become much more expensive. So why has this new environment not led to a more substantial adjustment or restructuring on either the asset or the liability side so far? First, given the favourable liquidity situation, credit has continued to grow in several countries. Second, banks have been unwilling and unable (the latter due to the large presence of “covenant-light” deals during the times of the credit boom) to sell or restructure parts for their loan portfolio. But in our view a more meaningful adjustment of funding structures has only been postponed so far and will seriously start now. Banks will intensify their efforts to bring their loan-to-deposit ratios closer to the 100% level (EMU average is around 120%) via sluggish loan growth, some selling or restructuring of distressed assets and strong competition for (retail) deposits. Overall, the process of diversifying the banks’ funding base will take time and go on for several years.

NPL management crucial for future profitability

As highlighted in our previous Credit Monitor, we expect asset quality to continue to deteriorate. Peak NPL levels will mostly be reached in 2010 (see ranges depicted by the green and red bars in the chart below). The discrepancy between actual and forecast NPL ratios in Russia and Ukraine is driven by the fact that bad loans are rolled over or restructured in order to avoid provisioning and to postpone their reflection on the balance sheet (“evergreening”). According to Fitch, “true” NPL ratios (including restructured loans) are currently standing at 17% in Russia and 33% in Ukraine. The ability of banks to enforce collateral (e.g. in the mortgage lending segment) as well as the possibility to carry out sustainable corporate debt restructurings will be crucial for future profitability. We expect recovery rates to be highest in those countries with the most advanced legal systems and tested NPL collection procedures (e.g. Czech Rep. or Poland).



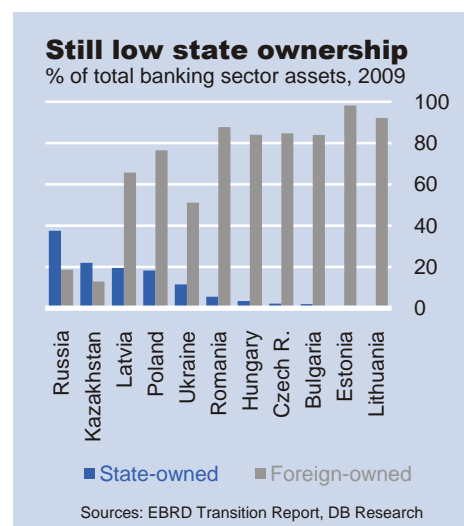
Tougher regulatory environment

We expect national and international regulators to implement tougher standards regarding lending (i.e. limits on indebtedness), FCY liquidity or FX lending. The EU is currently proposing higher capital requirements for FX loans. In Hungary, limits regarding loan-to-value or payment-to-income ratios are expected to be implemented in the mortgage lending segment.

Other countries might follow, as the prospect of euro entry is still some way off and thus systemic risks associated with FCY lending will remain. However, especially for mortgage loans the lack of long-term funding in local currency is one obstacle that needs to be addressed.

No dramatic change in competitive landscape

This year the banking sector's competitive landscape has changed mainly in the CIS, where state influence has increased in light of the financial crisis. For 2010, however, we do not foresee any substantial shift in market shares. Big Western parent banks are expected to keep their Eastern Europe exposure which, even in a tougher regional environment, is set to remain an important source of profitability for those banks. Still, funding for new loans will be reduced significantly. Only some niche players (either foreign or local) might consider exiting the market and in turn some new market entries are possible. Overall, a strong local funding base will be key to a strong market position.



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