



SECTOR COMMENTARY

## Central and Eastern Europe versus Eurozone Banks: Challenges and Opportunities

**Contacts:**

Carola Saldias  
Senior Director  
+39 02 7274 6011  
[carola.saldias@dagongeuropa.com](mailto:carola.saldias@dagongeuropa.com)

Evgeni Petkov, CFA  
Associate Director  
+49 69 7805 9056  
[evgeni.petkov@dagongeuropa.com](mailto:evgeni.petkov@dagongeuropa.com)

### Highlights

**Higher lending growth in CEE countries:** While banks in some Eurozone<sup>1</sup> countries are still suffering from the effects of the recession in 2011-2012, the stronger economic recovery in CEE<sup>2</sup> countries has enabled their banks to expand lending volumes and grow their balance sheets sustainably.

**Overall improvement of unemployment rates:** In terms of unemployment, the environment for banks in the Eurozone and CEE is mostly favourable. Differences in unemployment rates are still very high (e.g. Spain with 17.1% for 2017 compared to 2.8% for Czech Republic), however, the positive trend, supported in some cases by legal reforms, is shared across all Europe. We expect that unemployment rates will decrease further, contributing to provide a stable economic environment for banks to apply a more active lending strategy.

**NPL reduction as a common challenge:** Based on the latest available data from the Q4 2017 EBA Risk Dashboard, the weighted average NPL ratio for the EU is 4.0% with coverage at 44.5%. Therefore, banks in countries like Romania, Hungary, Bulgaria, Italy and Portugal have further pressure to improve asset quality through more aggressive strategies including larger write-offs and NPL sales. In terms of coverage, the dispersion is less evident with the lowest among the selected CEE countries for Bulgaria with 54.5% and for Eurozone countries Germany with 39.3%.

**Better profitability in CEE countries:** Profitability based on bank's return on assets shows a wide dispersion across Eurozone and CEE countries. For Eurozone banks with operations mainly in Europe the low interest environment has hurt overall profitability. In CEE countries, banks benefit from growing markets and a different competitive landscape, leading to significantly higher return on assets than banks in the Eurozone.

**Capitalisation is improving consistently:** Banks across Europe are responding to the pressure from regulators and market participants to strengthen capitalisation levels in order to anticipate regulatory changes and Basel III implementation. Banks in CEE countries show a significantly better CET1 ratio on average compared to Eurozone countries. We believe that banks in CEE are building up capital to face higher lending growth, supported also by the positive results and higher return on equity compared to Eurozone banks.

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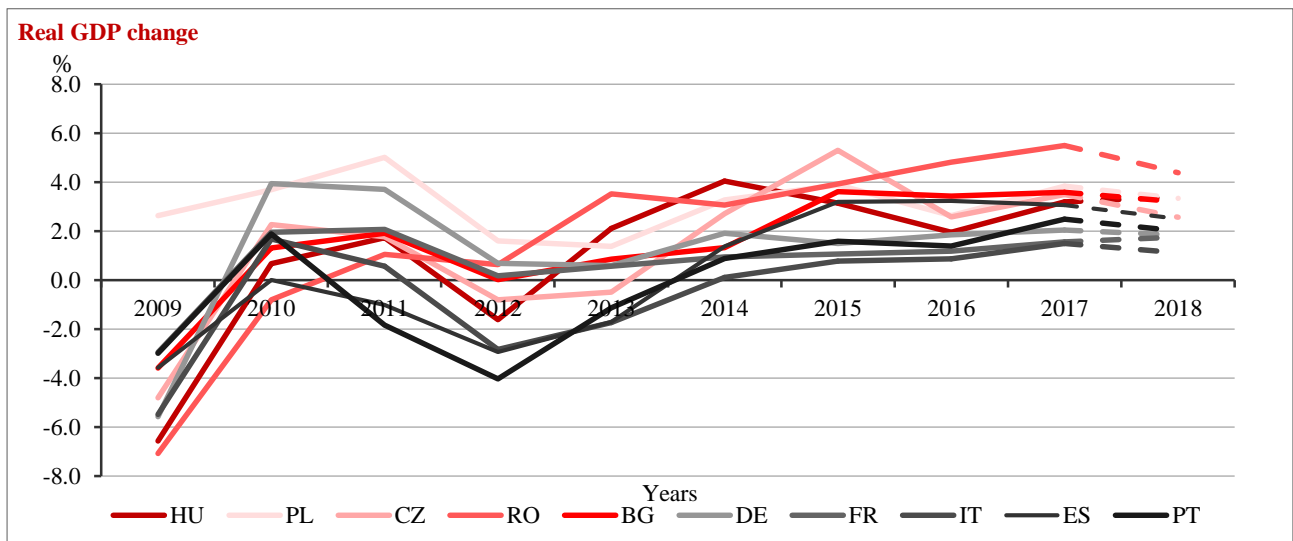
<sup>1</sup> Eurozone countries included in this commentary: Germany (DE), France (FR), Italy (IT), Spain (ES), Portugal (PT).

<sup>2</sup> CEE countries included in this commentary: Hungary (HU), Poland (PL), Czech Republic (CZ), Romania (RO), Bulgaria (BG).

**1. Lending growth: supported by stronger GDP growth in CEE countries**

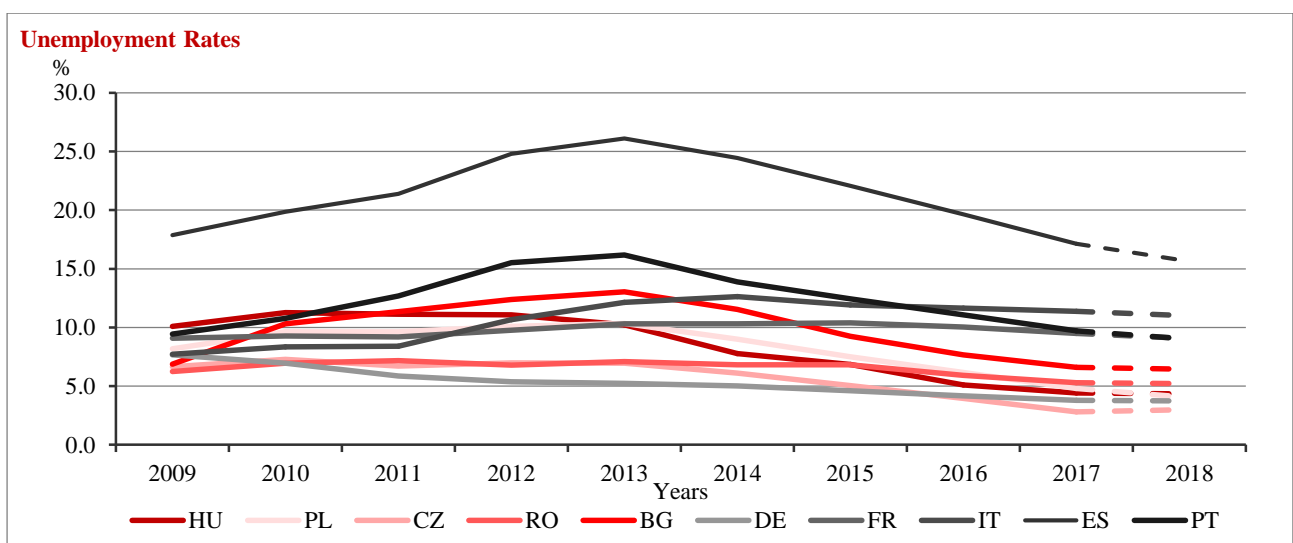
After the crisis of 2011, the Eurozone was affected by negative real GDP growth in most of the countries, showing signs of recovery only since 2014. The same effect was faced by most of CEE countries, although to a lower extent. The recovery however, came faster in CEE. The higher economic growth is providing a positive economic momentum for banks in CEE, enabling them to expand their balance sheets.

On the contrary, for Eurozone banks, growth opportunities are less evident. Banks in Germany, France and Portugal among others are still facing a de-leveraging process, with banks reducing large exposures to favor retail loans (mostly mortgages). In addition, the majority of Eurozone banks have been very cautious with their risk-taking and lending growth strategies. We observe different behavior in banks from CEE, which have shown rapid growth in lending, not only from retail but also from their SMEs and corporate portfolios.



Source: IMF

In terms of unemployment, the trend for banks in the Eurozone and CEE is mostly favourable. Differences in unemployment rates are still very high (e.g. Spain with 17.1% for 2017 compared to 2.8% for Czech Republic), however the positive evolution of employment levels, supported in some cases by legal reforms, is shared across all Europe. We expect that unemployment rates will decrease further, contributing to provide a stable economic environment for banks to move towards a more active lending strategy.



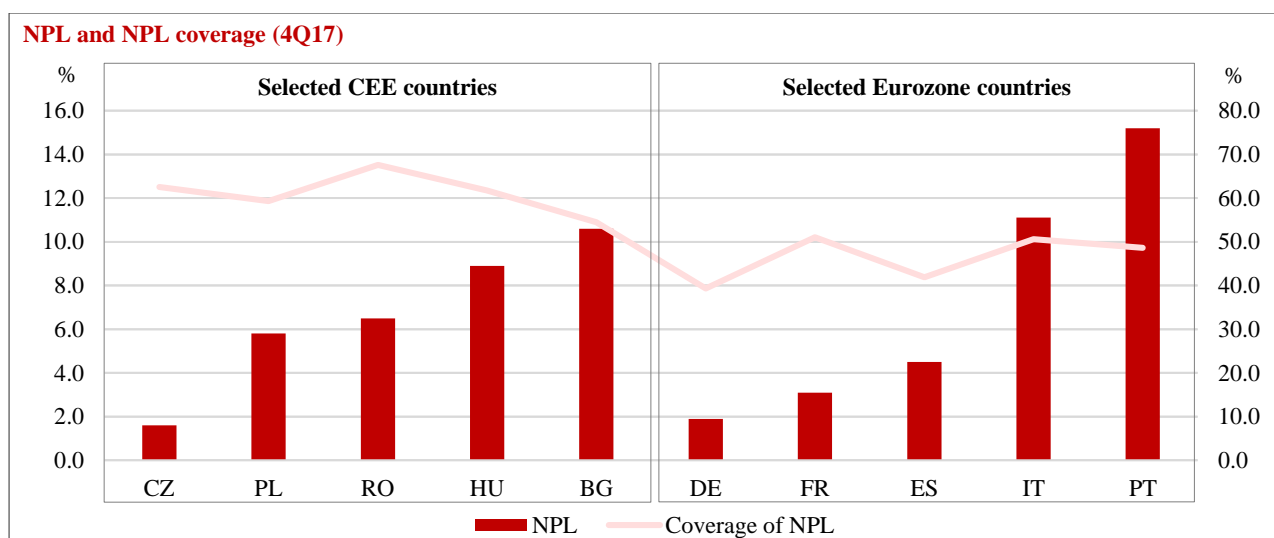
Source: IMF

**2. Asset quality: NPL reduction as a common challenge**

Assets quality has been the main concern for regulators across Europe. The significant increase in NPL after the crisis of 2011 for European banks has been managed differently across countries, with cases in which the national regulators intervened at early stage (e.g. Spain and Ireland through the creation of special vehicles owing NPL) and others acting through stricter regulations.

The different initiatives implemented by regulators and the strategies followed by banks across Europe led to a high dispersion of NPL across countries: on one side Czech Republic and Germany with NPL levels at 1.6% and 1.9% for 4Q17 respectively, and on the other side Italy and Portugal with 11.1% and 15.2%, respectively. We consider NPL ratios of above 8.0% as very weak and we expect banks with higher NPL to implement more proactive strategies to reduce them in the medium-term.

As a common goal, banks with NPL levels higher than the EU average (using as a reference the NPL ratio and coverage level published on a quarterly basis on the EBA Risk Dashboard) are actively engaging in strategies to improve their asset quality. This is partially a result of the ‘Guidance to banks on non-performing loans’ published by the ECB with the objective of providing a basic framework to banks to actively reduce NPL. While the guidance is non-binding, banks should explain and substantiate any deviations from it upon supervisory request.



Source: Q4 2017 EBA Risk Dashboard. Note: Left hand side y-axis refers to NPL in %; Right hand side y-axis refers to coverage in %.

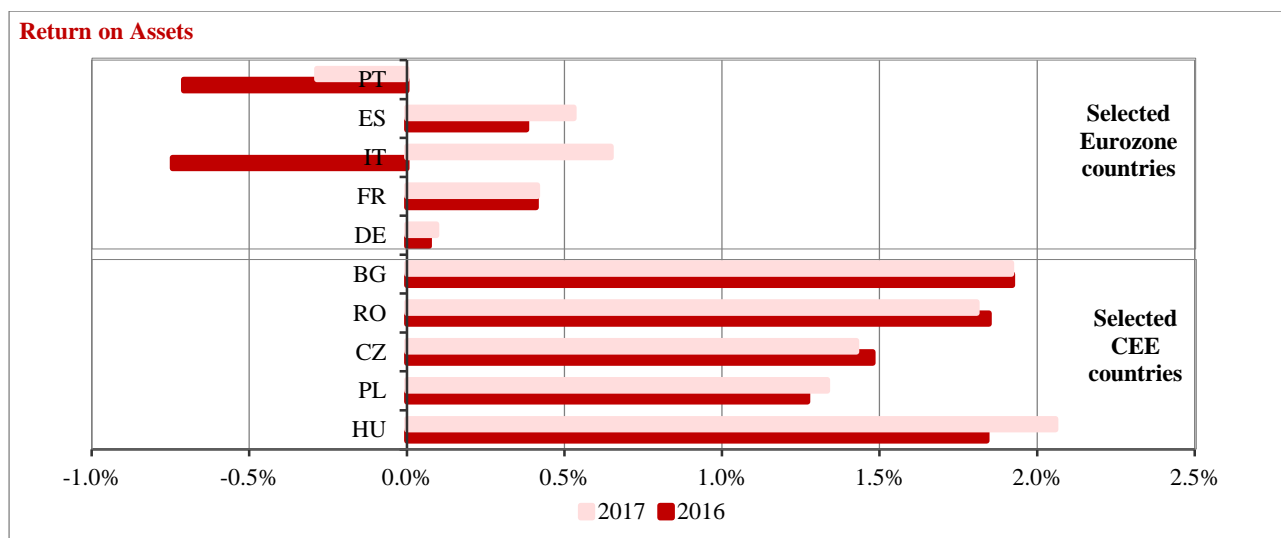
Based on the latest available data from the Q4 2017 EBA Risk Dashboard, the weighted average NPL ratio for the EU is 4.0% with coverage at 44.5%. Therefore, banks in countries like Romania, Hungary, Bulgaria, Italy and Portugal have further pressure to improve asset quality through more aggressive strategies that can include larger write-offs and NPL sales. In terms of coverage, the dispersion is less evident with the lowest coverage ratio in CEE countries for Bulgaria with 54.5% and for Eurozone countries Germany with 39.3%. We view coverage ratios of below 40.0% as weak, however, the differences in historical recovery rates between the countries should be considered to counter-balance at a certain level the difference in coverage.

Furthermore, the latest initiative published by the ECB in October 2017 as a consultation paper, sets minimum levels of prudential provisioning for exposures classified as NPL. The guidance requires that banks should provision new unsecured NPL in full within a period of two years of them being classified as such and secured NPL exposures within a period of seven years. This would help to encourage banks to reduce their NPL exposures faster than in the past, otherwise provisions can raise significantly and increase the opportunity cost of keeping the exposures on the balance sheet.

### 3. Profitability: market structure enables higher profitability of CEE banks

Profitability based on bank’s return on assets shows a wide dispersion across Eurozone and CEE countries. For Eurozone banks with operations mainly in Europe (mostly Italian and Portuguese banks) the low interest environment has hurt their interest income both on the loan and the investment portfolios. In the case of banks in CEE, profitability has improved in 2017, based on the relatively better lending growth and reduced cost of risk, and also due to the opportunity to invest their securities portfolios mostly in non- Euro sovereign bonds.

In addition, CEE countries still have lower banking penetration. This represents an opportunity for banks in CEE to continue developing the housing market through national currency mortgages (moving away from foreign currency products as had been the case in the past), expanding their SME exposures and therefore increasing profitability through higher loan volumes.



Source: Q4 2017 EBA Risk Dashboard.

Profitability levels also reflect in our opinion the ‘maturity stage’ of the banking sectors. While we see that for CEE countries banking is still growing in all segments, for the Eurozone we see an already established banking sector with fierce competition in pricing at the level of corporate and SMEs lending.

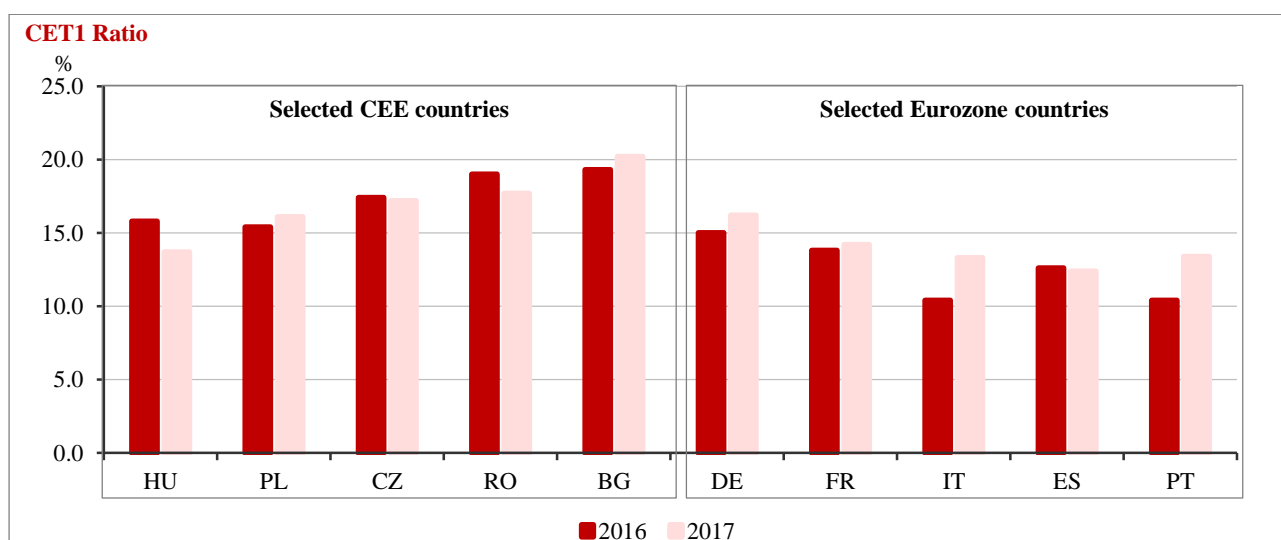
In terms of operational costs, we see also differences between CEE and the Eurozone. Banks in the Eurozone have some levels of excess capacity, therefore profitability is also affected by large operational structures that do not allow to manage costs efficiently (e.g. Germany with a cost to income ratio at 79.9% for 4Q17). In the case of CEE countries, we see banks with cost to income ratios on average better than the euro weighted average (63.4% for 4Q17) and in some cases significantly lower (Bulgaria with a cost to income ratio at 38.0% for 4Q17).

#### 4. Capitalisation: strengthening of CET1 to anticipate regulatory requirements

Banks across Europe are responding to the pressure from regulators and market participants to strengthen capitalisation levels in order to anticipate regulatory changes and Basel III implementation in full. For banks in the Eurozone, the strengthening of total capital is larger in 2017, based on IPOs and AT1 issuances and, at a lower extent, reductions of RWAs.

Banks in CEE countries show a significantly better CET1 ratio on average compared to Eurozone countries. With the lowest CET1 ratio is Hungary with 13.7%<sup>3</sup>, compared to 12.4% for Spain. We observe that banks in CEE are building up capital to anticipate the lending growth, supported by the positive results and higher return on equity compared to the banks in the Eurozone.

For the case of banks in the Eurozone, we expect that total capital will continue increasing, at a pace that will depend mostly on the individual strategies of the banks to anticipate the regulatory requirements related to MREL. As highlighted by the ECB in the latest Financial Stability Report, banks in the euro area could have potentially large MREL shortfalls based on the MREL requirement less the already issued eligible debt, which means that we should expect larger issuances in the next years in order to reduce the estimated shortfall.



Source: Q4 2017 EBA Risk Dashboard.

<sup>3</sup> It should be noted that these ratios are based on EBA data, which considers only the top 3 banks in Hungary. The CET1 ratio reported by the Central Bank of Hungary is significantly higher.

**Annex: Financial highlights of selected banks from CEE countries with data available as of YE17**

	Country	Total Assets EUR Bn	Tier 1 Capital Ratio (%)	RoAA (%)	Dagong Global Ratings LTCR (1)
PKO Bank Polski	Poland	71.1	16.5%	1.1%	NR
Česká spořitelna (part of Erste Group)	Czech Republic	52.0	18.1%	1.2%	NR
Československá obchodní banka (part of KBC Group)	Czech Republic	51.5	17.2%	2.3%	NR
Bank Polska Kasa Opieki	Poland	44.4	16.1%	1.4%	NR
OTP Bank	Hungary	42.5	12.7%	2.3%	BBB+/Stable
Komerční banka (part of Societe Generale)	Czech Republic	39.3	18.0%	1.5%	NR
Bank Zachodni (part of Grupo Santander)	Poland	36.5	15.3%	1.7%	NR
Banca Comercială Română (part of Erste Group)	Romania	15.2	17.4%	1.0%	NR
Banca Transilvania	Romania	12.8	20.2%	2.3%	NR
BRD Groupe Sociétés Générales (part of Societe Generale)	Romania	11.8	20.1%	2.7%	NR

(1) LTCR: Long-Term Credit Rating.

Sources: S&P Global Market Intelligence, Dagong.

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