Central and Eastern Europe – The Growth Market for Austrian Banks

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Although the Central and Eastern European banking market (excluding Russia) is relatively small with total assets of some EUR 350 billion (by comparison, total assets of banks operating in Austria were some EUR 605 billion at the end of 2003), it is nevertheless a growth market. In addition to higher economic growth, the low degree of bank intermediation (about a third of its Western European equivalent) suggests strong growth potential for banks in Central and Eastern Europe (CEE) in the coming years.

Above-average growth potential, higher interest margins than in Western Europe and restructuring potential have led Western European banks to invest heavily in the CEE banking sector. Approximately 70% of the CEE banking market is currently controlled by Western European banking groups. Austrian banks were among the first to invest in Central and Eastern European countries and are now some of the best-known Western European banks in the region (market share in the region: about 22%). As early as 2002 and 2003, steady expansion in the CEE region had a positive impact on the profitability of Austria's consolidated banking sector.

Favorable reports on the CEE banking market, however, often ignore potential risks. Key sources of risk in the Central and Eastern European banking market are macroeconomic imbalances, the risk of growing exchange rate volatility, credit risk, increasingly fierce competition and political risks.

1 Overview

With total assets of some EUR 350 billion, the Central and Eastern European banking market[1] remains a relatively small (by comparison total assets of banks operating in Austria were some EUR 605 billion at the end of 2003). The market is dominated by Western European banks: the market share of foreign-controlled banks in the CEE region is approximately 70%. As CEE countries catch up, the hope for rapid growth and higher profits has been and is one of the main motives for foreign investors to move into the Central and Eastern European banking market.

Table 1 shows the CEE banking sector's current edge over its Western European counterpart in terms of profitability. Apart from Poland (where a tough economic climate has increased loan losses), profitability in most Central and Eastern European countries has been far higher than in EU countries.

Table 1

Selected Key Figures of Central and Eastern European Banking Markets at End-2003

	ROE after tax	Cost-to-income ratio	Solvency ratio	Lending growth
	%			
Czech Republic	23.7	52.7	14.5	11.8
Hungary	17.6	61.2	12.0	34.7
Poland	6.2	68.6	13.7	9.3
Slovak Republic	13.0	67.1	22.4	14.3
Slovenia	12.8	62.5	11.6	13.8
Croatia[1]	16.3	54.5	16.0	13.5
EU bank[2]	10.7	65.7	12.4	4.0

Source: National central banks, BA-CA (2004).
[1] Data for Croatia: January to September 2003.
[2] EU banks: Weighted average of 27 major banks (BA-CA analysis of major EU banks in 2003).

[1] The Central and Eastern European banking market (CEE banking market) is defined to include Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Poland, Romania, Serbia and Montenegro, the Slovak Republic and Slovenia.

Refereed by Zoltan Walko, Foreign Research Division.

1.1 Good Market Position of Major Austrian Banks

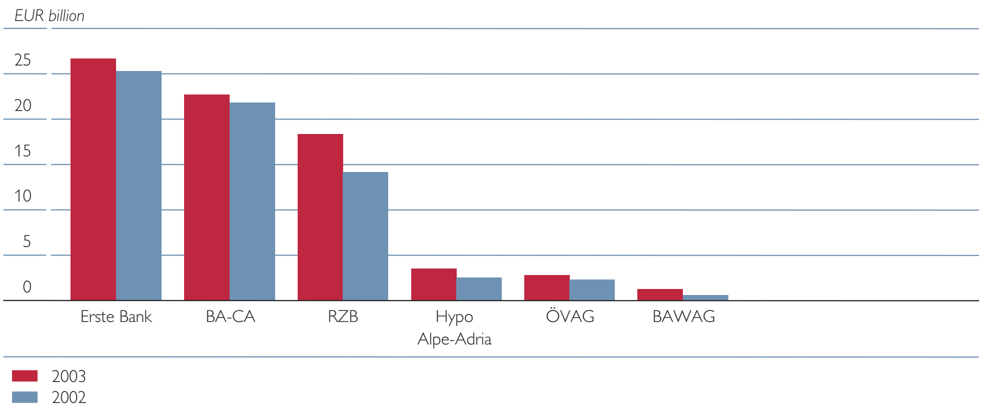
Low profitability domestically (price competition, strong focus on business volume), geographical proximity and historical ties, as well as above-average growth and profit potential, were key reasons for Austrian banks' pioneering role in investing in Central and Eastern Europe. According to estimates of the Oesterreichische Nationalbank (OeNB), some 22% of the total assets of Central and Eastern European banks (excluding Russia) are currently held by Austrian banking groups (including Bank Austria Creditanstalt – BA-CA). This means Austrian banks are the biggest investors (well ahead of Italy and Belgium) in the Central and Eastern European banking sector. Erste Bank, BA-CA and Raiffeisen Zentralbank (RZB) are among the most active Western European banks operating in the CEE region.[2]

Erste Bank, via its subsidiaries, is one of the biggest players in the Czech Republic (Česká spořitelna), the Slovak Republic (Slovenská sporiteľňa), Croatia (Rijecka banka) and – now through its acquisition of Postabank – also in Hungary.

BA-CA, via its subsidiaries, holds a significant slice of the market in Poland (Bank BPH), Croatia (Splitska banka) and Bulgaria (Biochim) and is also represented by subsidiaries in seven other CEE countries.

Chart 1

Total CEE Assets of Austrian Banking Groups in 2002 and 2003



Source: Annual reports of the relevant banks, OeNB.

RZB has a very well-known brand name in CEE countries and controls a significant share of the market in the Slovak Republic (Tatra banka), Croatia, Serbia, Romania, Bosnia and Herzegovina, and Albania. With subsidiaries in 15 countries, RZB has the most extensive marketing network of all Western European banks represented in Eastern Europe.

Major CEE operations are also run by ÖVAG (subsidiaries in eight CEE countries), Hypo Alpe-Adria Bank (HAAB, primarily in Croatia) and BAWAG (Slovak Republic, Czech Republic, Hungary).

[2] *By far the most important CEE markets for Austrian banks currently are the Czech Republic, the Slovak Republic, Hungary, Poland, Slovenia and Croatia. The total assets of these banking markets were some EUR 310 billion at the end of 2003.*

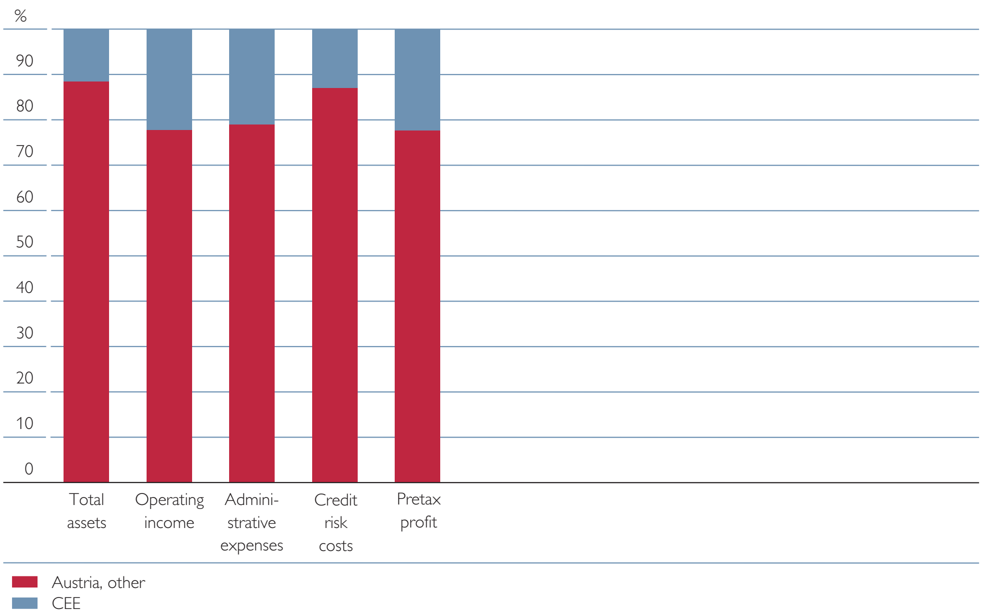
1.2 Significant Contribution to Income from CEE Countries

As early as 2002 and 2003, steady expansion in the CEE region had a positive impact on the profitability of Austria's consolidated banking sector.

Although the CEE segment accounted for only some 12% of consolidated total assets at the end of 2003, 23% of pretax profit was generated in the region.

Chart 2

CEE Share of the Austrian Banking Sector in 2003



Source: OeNB.

A breakdown of Austrian banks' business activities by region reveals that the profitability of their CEE operations is currently far higher than that of purely Austrian business. At 1.1%, return on assets (ROA: return on assets = pretax profit/total assets) in the CEE segment handsomely exceeded that of Austrian business (0.5%) in 2003. Higher profitability was primarily due to wider margins, lower credit risk costs and cost savings following extensive restructuring measures. Significant CEE exposure is likely to have greatly helped Austrian banks weather the economically difficult years between 2001 and 2003 better than German banks.

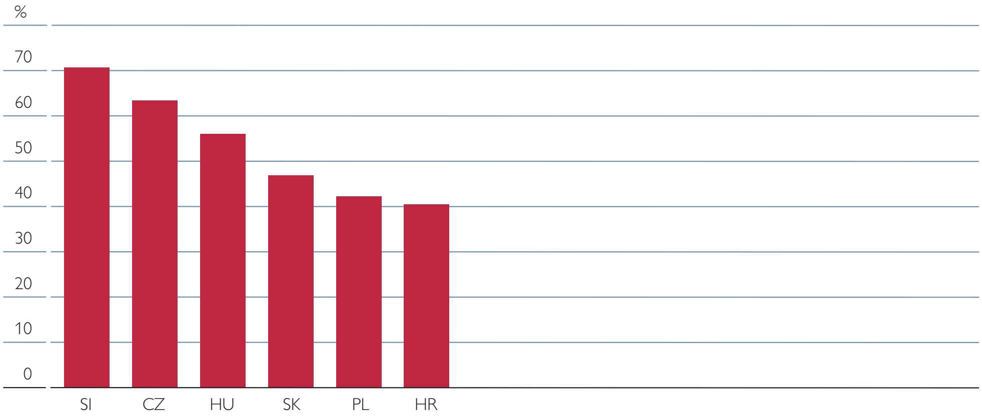
Will the CEE Banking Sector Remain more Profitable in the Medium Term?

Austrian bank pundits on Eastern Europe are convinced that high profits in CEE countries will continue to be generated in the coming years, basing their upbeat growth and profit outlook on three arguments:

– *Economic Growth:* Low base levels and EU accession should enable higher economic growth to be generated in CEE countries than in Western Europe over the next few years.

Chart 3

GDP per Capita in Central and Eastern European Countries relative to the EU 15 (Purchasing Power Parity)



Source: Eurostat, European Commission.

Chart 4

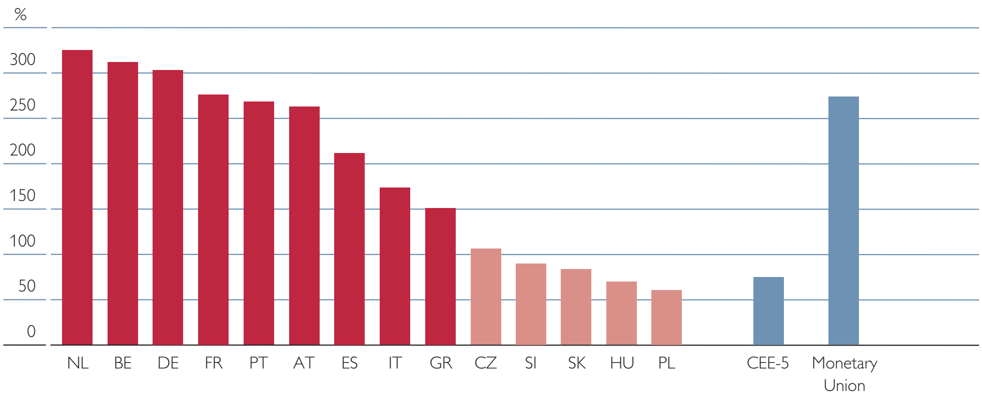
Expected Real GDP Growth in 2003 and 2004[1]

Source: Eurostat, European Commission.
[1] 2004: Forecast data.

– *Low Degree of Bank Intermediation:* The intermediation of the banking sector (measured as the ratio of total bank assets to GDP) in CEE countries averages about 74%. This is less than a third of the value for the euro area and is equivalent to Austrian bank intermediation in the mid-1960s. This, coupled with higher economic growth, and on-balance sheet liquidity reserves (customer deposits being far higher than loans granted) should offer banks in CEE countries strong growth potential in the years to come.

Chart 5

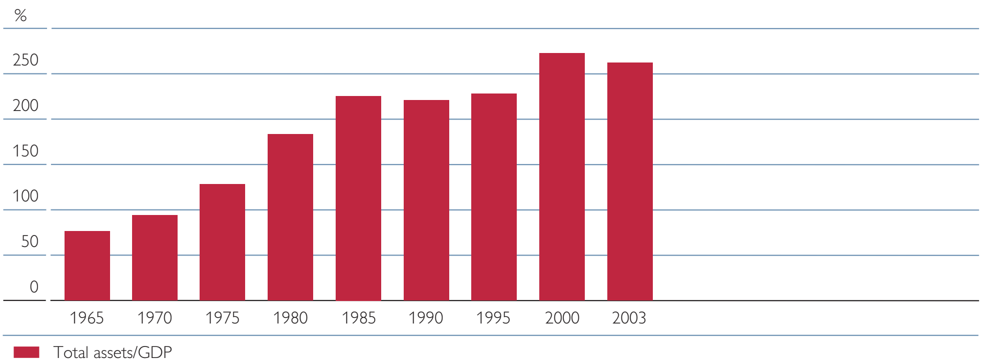
Ratio of Total Bank Assets to GDP in 2003



Source: National central banks, OeNB.

Chart 6

Development of Bank Intermediation in Austria from 1965 to 2003



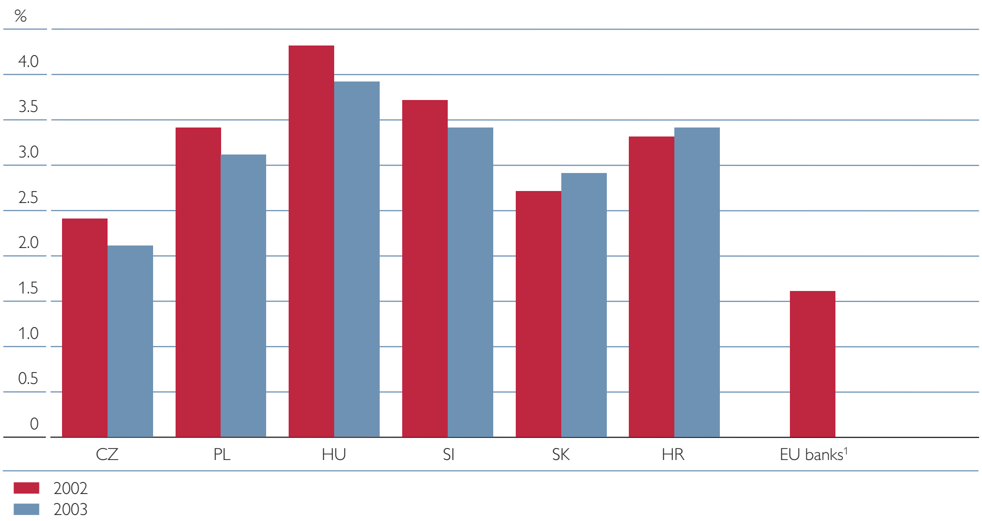
Source: OeNB.

– *Higher Interest Margins:* In addition to successful restructuring measures, which were generally implemented following acquisitions by Western European banks, far higher interest margins were primarily responsible for CEE banks' edge in terms of profitability.
Although it is widely anticipated that interest margins in CEE countries will converge towards the EU average on account of growing competition and lower country risk premiums, the extent to which this alignment process will continue remains contentious. Some experts currently support the view that the margin edge will be maintained in CEE countries over the medium term. They argue that theoretically these margins ought to be higher given CEE countries' lack of previous loan loss experience and the resulting higher credit risk. In most CEE countries, market shakeout is, they contend, relatively well advanced and the degree of bank concentration on average higher than in the EU. Interest margins should have converged towards the EU average far more rapidly in the past few years.
However, the theory that a margin edge can be maintained in the CEE

area as a whole over the medium term looks doubtful. As early as 2002 and 2003, net interest margins narrowed in most CEE countries. The fact that margins were shrinking less dramatically than expected can be attributed primarily to shifts in the loan portfolio (the share of private banking loans with higher margins increased while the share of interbank claims and loans to large enterprises decreased). Fiercer competition could also exert additional pressure on interest margins. In future, entry barriers – at least in the new EU Member States – are likely to be far lower for new competitors on account of the European single passport regime.[3]

Chart 7

Ratio of Net Interest Margins to Total Assets



Source: National central banks, ECB (2003a).
[1] Aggregated data for 2003 are still unavailable for the euro area.

Identification of Risks

Favorable reports on the CEE banking market often ignore potential risks, against which strong growth and high profits need to be offset.

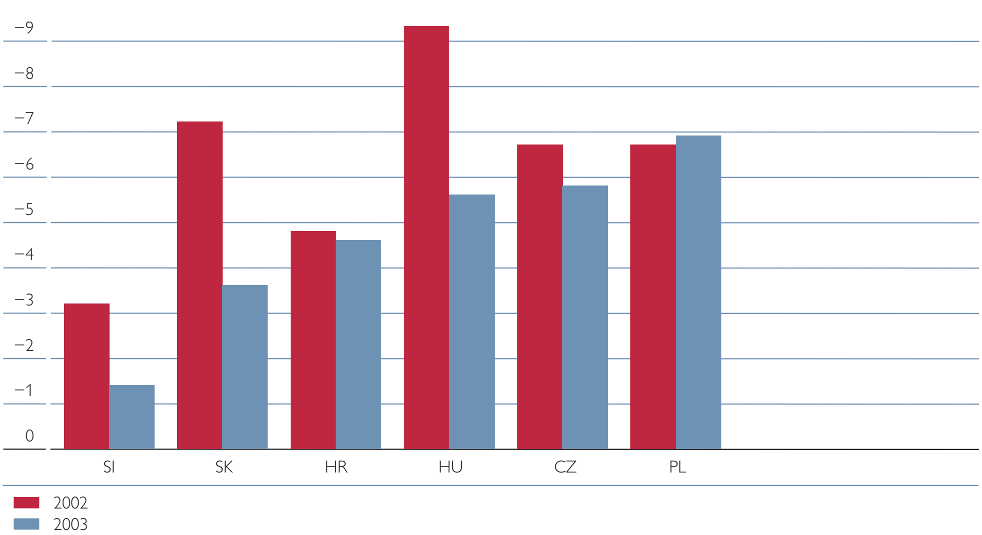
– *Macroeconomic Imbalances:* Most countries in the CEE region are faced with high budget deficits and, in some cases, also with high current account deficits (twin deficits) and so depend very heavily on the willingness of foreign investors to fund these deficits.
– *Exchange Rate Volatility:* Running twin deficits while entering a restrictive currency band (in the run-up to joining the euro) could make Central and Eastern European currencies subject to speculation. Although the future participation of accession countries in ERM II and the economic policy directives linked to EU membership will give rise to certain stabilization effects, the attacks on Western European currencies in

[3] *Under the European single passport regime, any bank registered in an EU Member State can open branches in another EU country without having to undergo major formalities.*

Chart 8

Budget Deficit in Central and Eastern European Countries in 2002 and 2003[1]

% of GDP

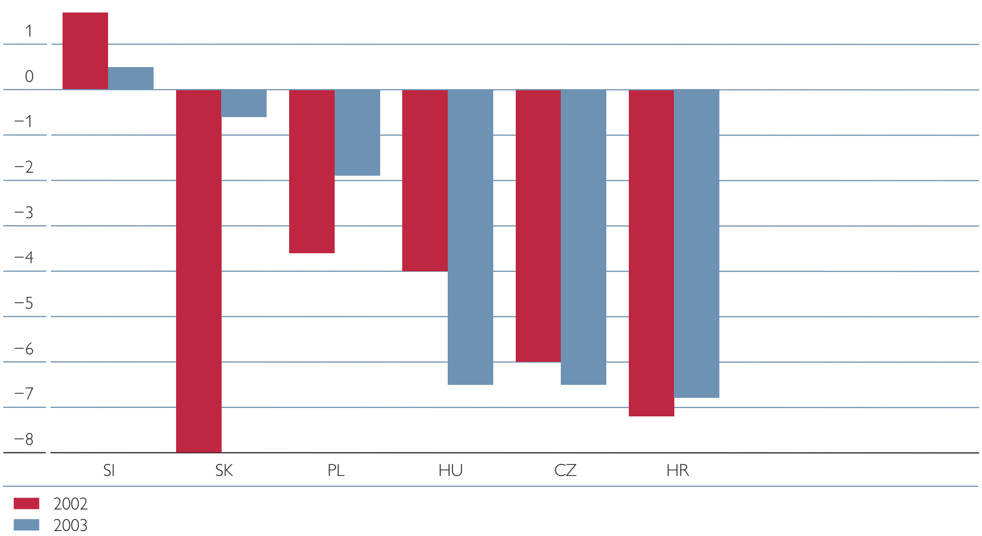


Source: EBRD.
[1] Provisional data for 2003.

Chart 9

Current Account Deficit in Central and Eastern European Countries in 2002 and 2003[1]

% of GDP

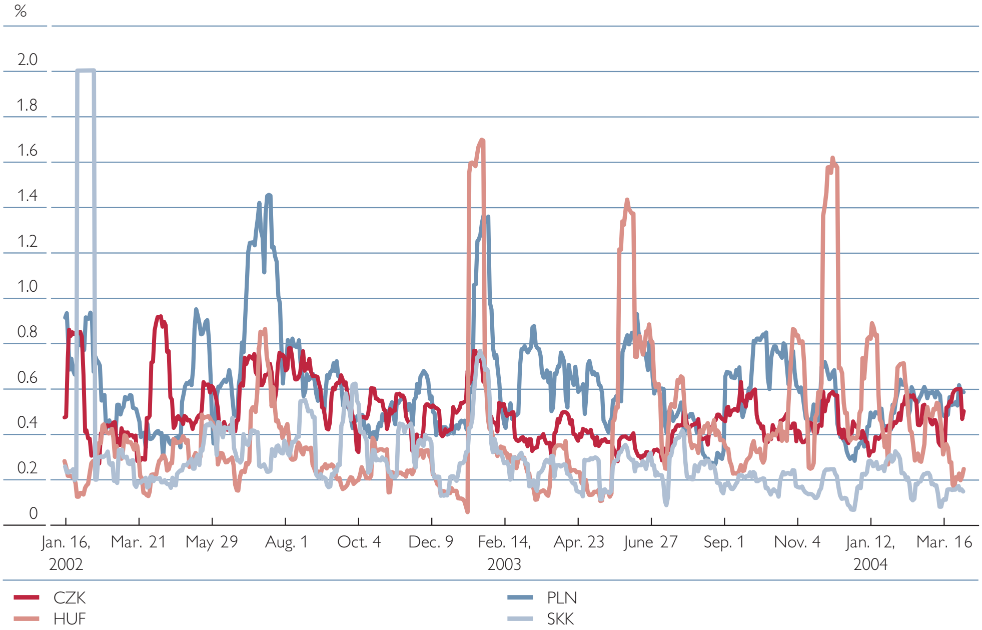


Source: EBRD.
[1] Provisional data for 2003.

the early 1990s should not be forgotten. For instance, poor economic data and inappropriate economic measures in 2003 resulted in a distinct increase in volatility for the Hungarian forint and Polish zloty (in 2003 the Hungarian forint and the Polish zloty were devalued against the euro by 11% and 17%, respectively). In this respect, currency risks arising from growing demand for foreign currency loans (particularly in countries such as Hungary or Poland where interest rates are well above the EU average) are also a factor.[4]

Chart 10

Exchange Rate Volatility of Central and Eastern European Currencies (10-Day Standard Deviations of Daily Price Changes)



Source: Eurostat.

– *Credit Risk:* The share of nonperforming loans (NPLs) as a percentage of total lending is far higher on average in CEE countries than in Western Europe.[5] However, these high NPL ratios mostly date back to the 1990s when CEE countries were undergoing transition. In fact, fresh net risk provisions fell short of the EU average by a wide margin in many CEE countries from 2000 to 2003. This meant that particularly in Hungary, the Czech Republic (in 2002 and 2003) and the Slovak Republic (where more provisions were released than made), a far smaller share of operating income was needed for credit risk provisions. Despite relatively low credit risk costs in recent years, two critical questions should be posed: first, whether the comparatively new and untested credit risk systems of CEE banks will be able to cope with a possible lending boom; second, whether a large number of loan losses will be the inevitable consequence of a strong expansion in total lending.

[4] *Exchange rate risk also has a strong impact on Austrian parent banks via their CEE subsidiaries. Austrian banking groups focus their foreign currency hedging strategies on their CEE subsidiaries' expected profits. The preferred instrument to hedge these profits against currency fluctuations is foreign currency swaps.*

[5] *NPL ratios are comparable only to a limited extent, as their national definitions vary.*

Chart 11

Share of Nonperforming Loans in Percent of Total Lending

Source: EBRD, national central banks, ECB.

Chart 12

Ratio of Risk Provisions to Operating Income

Source: EBRD, national central banks, ECB.

– *Growing Competition:* The question arises as to whether other Western European banks attracted by the growth and profit potential of CEE countries will expand into this region, thereby intensifying competition (for instance, no U.K. bank is currently present in CEE countries). Will this cause margins to shrink more quickly than expected? Since early May 2004, entry barriers – at least in the new EU Member States – have fallen dramatically. Henceforth, any bank registered in an EU Member State will be able to open branches in new Member States without a local banking license (European single passport regime).
– *Frequent Change of Government, Political Instability:* As a general rule, governments have served for shorter periods of time in many Central and Eastern European countries than in the EU. This has been due to two factors: first, relatively fragmented party political environments, with many populist parties (and, as a result, not very stable coalitions); second, the tendency on the part of voters not to reelect ruling parties after they have served only a single

period in office. It remains to be seen whether EU accession will further aggravate this trend and whether parties with only rudimentary budgetary discipline will enter coalition governments. For instance, radical opposition parties in Poland have enjoyed tremendous popularity with voters in recent months.

Table 2

Number of Governments since 1993

Latvia	12	Slovenia	7
Lithuania	12	Slovak Republic	6
Estonia	9	Czech Republic	5
Poland	8	Hungary	5

Source: The Economist of March 11, 2004.

2 Banking Markets in Selected CEE Countries

2.1 Hungary

The total assets of banks operating in Hungary are about EUR 51 billion. At the end of 2003, 218 banks were registered in the country. Most of these banks (about 180) are small cooperative banks, which are of minor importance overall (market share: some 7%).[6]

At about 69%, the degree of bank intermediation in Hungary is somewhat below the CEE average (74%), and the degree of concentration (market share of the five largest banks) is around 57%. Foreign banks also play a leading role in Hungary. Following the privatization of Postabank and Konzumbank, approximately 82% of Hungarian bank assets are now controlled by foreign banks. However, OTP – the biggest Hungarian bank by far – remains independent and is almost entirely privately owned.[7]

In the past few years the Hungarian banking market has witnessed a dramatic growth in lending (according to the PSZAF, private sector lending grew by 66% in 2003). Growth was driven by the introduction of government subsidies for housing finance in 2001. Banking industry representatives estimate that government subsidies for home loans account for some 70% of private households' demand for government-subsidized home loans. This makes Hungary the sole CEE country in which earnings from home loans make a significant contribution to the total income of the banking sector.[8] Budgetary problems (the running costs of the scheme amounted to around 1% of GDP) led to a sharp retrenchment in state subsidies for home loans. As this measure was expected months in advance, it met with a response anticipating the change. As a result, demand for subsidized home loans continued to grow in 2003. Lending to wholesale customers and foreign groups is bitterly contested and marked by falling margins. Hungary's small and medium-sized enterprises (SMEs) still find it hard to obtain bank loans.

[6] *The figures relating to the Hungarian banking sector for 2003 are largely based on data provided by the Hungarian Financial Market Supervisory Authority (PSZAF).*

[7] *OTP is listed on the stock exchange and owned by both management and foreign investors. It should be mentioned that the Hungarian government continues to hold a "golden share," with which majority resolutions adopted by the general meeting can be blocked (i.e. OTP's disposal is subject to approval by the Hungarian government).*

[8] *See The Economist of August, 21, 2003 (House party).*

For 2004, growth in personal loans is expected to flag significantly owing to the amended terms of home loan subsidies and to the increase in domestic interest rates. Hungarian banks are currently seeking to boost demand for consumer lending by launching new products such as foreign currency loans. Increasing the demand for foreign currency loans – particularly by private households – could lead to risks arising for the Hungarian banking sector.

The Hungarian banking sector is adequately capitalized (average solvency ratio: 12.0%) and has been very profitable in the past few years (2003 ROA before tax: approximately 1.8%).

Table 3

Selected Key Figures of the Hungarian Banking Sector

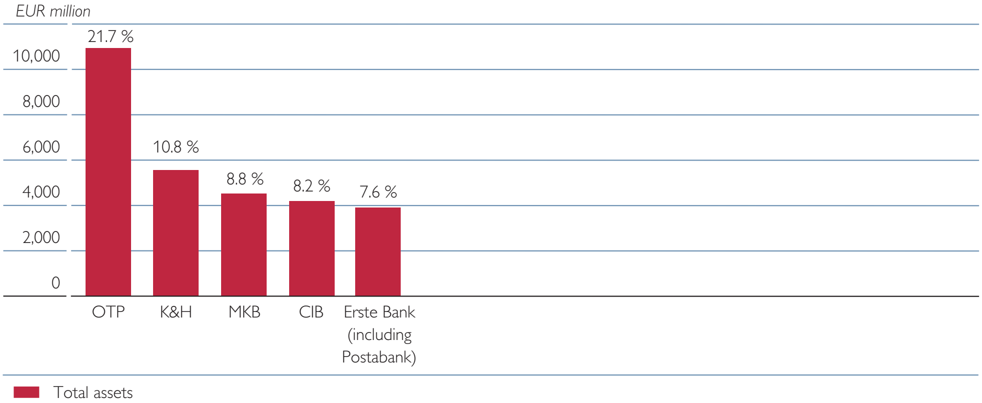
	1999	2000	2001	2002
Number of banks[1]	43	42	41	38
of which foreign banks	29	33	31	27
Private banks' share of total assets (%)	92.2	92.3	90.9	89.2
Share of nonperforming loans (%)	4.4	3.1	2.9	4.6
Domestic personal loans (% of GDP)	25.8	30.2	31.5	34
Stock market capitalization (% of GDP)	36.4	25.8	19.2	17.4
EBRD index on bank reform (from 1 to 4+)	4.0	4.0	4.0	4.0

Quelle: EBRD.
[1] *Excluding cooperative banks.*

As already mentioned, OTP (total assets: some EUR 11 billion) is by far the leading bank in Hungary. It is one of the biggest and most profitable banks in the CEE region and, in recent years, has also acquired banks in the Slovak Republic and in Bulgaria (OTP beat Erste Bank in the bidding race for a Bulgarian bank, DSK). Hungary's second-largest bank is K&H bank (controlled by the Belgian KBC and the Dutch ANB-Amro). MKB is dominated by Bayerische Landesbank (BAWAG has a minority interest), CIB by the Italian Intesa. The acquisition of Postabank in October 2003 (purchasing price: EUR 400 million) allowed Erste Bank to increase its market share substantially. Including Postabank, Erste Bank's market share is approximately 8%.

Chart 13

Total Assets and Market Share of the Five Largest Hungarian Banks in 2003



Source: Hungarian Financial Market Supervisory Authority (PSZAF), OeNB estimates.
Note: Percentages refer to market share.

Austrian Banks Control around 20% of the Hungarian Banking Market

Seven Austrian banks currently operate in Hungary. The market share of Austrian banks is about 20% overall (including Postabank). Following its acquisition of Postabank, Erste Bank is now the biggest Austrian bank in Hungary (the fifth largest in the country with a market share of some 8%). Raiffeisen Bank Ungarn managed to overtake HVB Bank Ungarn this year and is now just ahead of the latter as the country's sixth-largest bank (market share: approximately 6%). Extensive banking operations are also carried out by Volksbank and Porschebank in Hungary. Bank Burgenland, which only recently established a subsidiary in Sopron, and the bank Samesch & Cie AG are represented by extremely small operations in the Hungarian market (total assets of both banks: less than EUR 12 million). Excluding Volksbank, all major Austrian banks in Hungary generate far higher returns than in their domestic market.

In May 2004 a consortium consisting of Wiener Börse (the Vienna stock exchange) and Austria's major banks acquired the majority of shares in the Budapest stock exchange.

In 2003 RZB's subsidiary was the most successful Austrian bank in Hungary. Raiffeisen Bank Ungarn generated not only strong lending growth but also exceptionally high return on equity (ROE: 27.5%). The profitability of the BA-CA and Erste Bank subsidiaries was roughly around the Hungarian average. By contrast, the profitability of the Volksbank subsidiary was poor.

Table 4

Key Figures of Selected Austrian Banks' Subsidiaries in Hungary at End-2003

	HVB Bank Ungarn	Raiffeisen Bank Ungarn	Erste Bank Ungarn	Volksbank Ungarn
	EUR million			
Total assets	2,799	3,189	2,072	583
Change on previous year (%)	*+14.3*	*+37.9*	*+14.0*	*+20.7*
Profit after tax	42	54	14	1
Change on previous year (%)	*+18.7*	*+49.4*	*+102.2*	*+139.6*
	%			
Return on equity[1]	15.1	27.5	18.3	3.3
Cost-to-income ratio	50.7	49.6	68.5	84.4

Source: BA-CA, Erste Bank, RZB, ÖVAG.

[1] *ROE after tax: HVB Bank Ungarn and Erste Bank Ungarn; ROE before tax: Raiffeisen Bank Ungarn and Volksbank Ungarn.*

2.2 Czech Republic

With total assets of some EUR 80 billion, the Czech banking market is the second largest in the CEE region. The ratio of total assets to GDP shows that the Czech economy has a far higher degree of bank intermediation (105%) than other CEE countries (except for Croatia). At 66%, the degree of concentration (market share of the five largest banks) similarly exceeds the CEE average.[9] The country's biggest banks are without exception owned by Western European banking groups. The share of foreign bank assets as a percentage of total Czech bank assets is estimated to be about 90%.

Following the banking crisis of 1999–2000 and the subsequent estab-

[9] *The figures relating to the performance of the Czech banking sector in 2003 are largely based on data provided by Česká národní banka (ČNB – the Czech National Bank).*

lishment of the government consolidation agency CCA, the big state-owned banks were successfully sold to foreign banking groups in 2000. Ample guarantees provided by the CCA were crucial to the success of the privatization. For instance, foreign banking groups were granted the right of transferring to the CCA within a two-year period loans that were in poor rating categories at the time of takeover (ringfence agreement).

As early as 2002 and 2003, the Czech banking sector generated renewed high profits (according to the Czech central bank, ROA after tax was 1.2% in 2003). Furthermore, it also boasted extremely healthy capital adequacy of 14.4% (preliminary figure for 2003).

The transfer of NPLs to the CCA resulted in a sharp reduction in total lending in 2002 in particular. This, in turn, also led to an improvement in the quality of the loan portfolio (with the NPL ratio falling from 19.4% to 9.4%). 2003 saw the collapse of two small banks (Union banka, Plzeòská banka), which did not, however, have an impact on the stability of the country's financial market.

Czech banks continue to steer a very tight personal loans policy. The balance sheets of major Czech banks tend to be excessively liquid (deposits being far higher than total loans). The share of domestic personal loans as a percentage of GDP is one of the lowest in the region as a whole.[10] A large proportion of deposits are still invested in low-yield government bonds. The aim over the next few years will be to redirect funds from government bonds to personal loans. In order to bolster the confidence of private sector banks, the ČNB established a Major Loans Register in November 2002. In addition, a government-subsidized home loan scheme was launched.

Preliminary ČNB figures for 2003 indicate a recovery in demand for loans – particularly by private households. Whereas lending to enterprises stagnated at 2002 levels, loans to private households grew steeply (+35%), albeit from a low base. Overall, lending to nonbanks in 2003 expanded by around 11%.

Table 5

Selected Key Figures of the Czech Banking Sector

	1999	2000	2001	2002
Number of banks	42	40	38	37
of which foreign banks	27	26	26	26
Private banks' share of total assets (%)	76.9	71.8	96.2	95.4
Share of nonperforming loans (%)	21.5	19.3	13.7	9.4
Domestic personal loans (% of GDP)	42.3	36.6	24.3	20.0
Market capitalization (% of GDP)	22.3	20.9	15.3	21.0
EBRD index on bank reform (from 1 to 4+)	3.0	3.0	3.0	3.0

Source: EBRD.

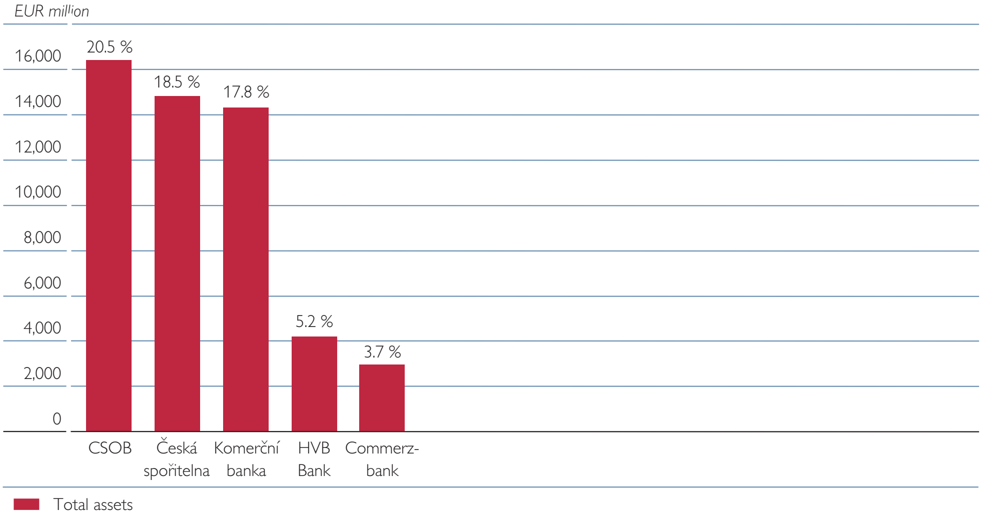
The Czech banking sector is dominated by three banks. With the takeover of IPB (a major bank on the verge of collapse in June 2000), CSOB became the market leader (market share: 21%). CSOB is 82%-owned by the Belgian KBC. The second-largest bank in the country is Česká spořitelna, the

[10] *According to Standard & Poor's estimates, the share of personal mortgage loans as a percentage of GDP in the Czech Republic at the end of 2003 ranges between 7% and 8% (the equivalent in the euro area at the end of 2003 was around 34%).*

formerly state-owned savings bank (market share: 19%), of which the majority shareholder (98%) is Erste Bank. Closely following Česká spořitelna is Komerènî banka, which is controlled by the French Société Générale (stake: 60%). Next, albeit trailing by a long margin, come the Czech BA-CA subsidiary, HVB-Bank and the Czech subsidiary of Commerzbank.

Chart 14

Total Assets and Market Share of the Five Largest Czech Banks in 2003



Source: Česka národni banka, OeNB estimates.
Note: Percentages refer to market share.

Market Share of Austrian Banks – Around 30%

Five Austrian banks are currently represented by their own subsidiaries in the Czech banking market, accounting for roughly 30% of total assets.

By far the biggest and most profitable bank is Česká spořitelna, Erste Bank's subsidiary. With an ROE of 23.7% (2003), the Czech subsidiary is also of crucial importance to the profitability of the entire Erste Bank group. In 2003, Česká spořitelna generated around 35% of Erste Bank's consolidated income.

HVB is the fourth-largest bank in the country, specializing specifically in corporate banking and leasing finance. With an ROE of 11.6%, the subsidiary's profitability is relatively low.

Although RZB sharply boosted the profits of its subsidiary, Raiffeisenbank a.s., in 2003, the latter's profitability (ROE: 12.1%) lagged behind the market average. The Raiffeisen group also operates Raiffeisen Stavebni sporitelna, a home loans specialist in the Czech Republic.

Volksbank operates Volksbank Prag, a small operation, which has nevertheless expanded considerably in the last few years. It was founded in 1993 and focuses primarily on SMEs and infrastructure finance. Since the takeover of Interbanka in September 2003 (the shares were bought by Bayerische Landesbank), BAWAG has also been active in the Czech banking market.

Table 6

Key Figures of Selected Austrian Banks' Subsidiaries in the Czech Republic at End-2003

	Česká Spořitelna	HVB Prag S.A.	Raiffeisenbank a.s.	Volksbank Prag
	EUR million			
Total assets	17,095	4,072	1,847	587
Change on previous year (%)	*+3.6*	*+3.2*	*+5.3*	*+14.5*
Profit after tax	241	41	6	4
Change on previous year (%)	*+26.3*	*+16.6*	*+187.5*	*+220.9*
	%			
Return on equity[1]	23.7	11.6	12.1	19.5
Cost-to-income ratio	60.9	54.2	79.0	84.7

Source: BA-CA, Erste Bank, RZB, ÖVAG.

[1] ROE after tax: Česká Spořitelna and HVB Prag S. A.; ROE before tax: Raiffeisen a.s. and Volksbank Prag.

2.3 Slovak Republic

With 18 banks and cumulated total assets of some EUR 24 billion[11] the Slovak banking sector is comparable in size with its counterparts in Croatia and Slovenia. The degree of bank intermediation was 83% at the end of 2003. After the banking crisis of 1999–2001, the Slovak banking sector was almost completely privatized. About 96% of Slovak bank assets are owned by foreign banking groups. Following the market's shakeout of the last few years, the banking market in the Slovak Republic has become very concentrated. About 68% of the market is controlled by the five largest banks.[12]

Thanks to the transfer of NPLs to a government consolidation agency (between 1999 and 2001 some SKK 112 billion, or about 13% of GDP, were transferred), the subsequent disposal of banks to foreign banking groups and substantial cost savings, the Slovak banking sector weathered the crisis in 2002 (the banking sector's successful restructuring was praised by the IMF).

As early as 2002, consolidated figures indicated a sharp improvement in credit quality (the share of NPLs was reduced from 24% to 11% in 2002). In 2003 the NPL ratio was further lowered to 9.1%.

Capital adequacy levels are strikingly high. With a solvency ratio of 22%, the Slovak banking sector is more than adequately capitalized. Profitability, which recovered in 2002, was further improved in 2003. The return on total assets (ROA after tax) edged up from 1.1% to 1.2%. To be highlighted is the fact that the profitability of the Slovak banking sector in 2002 and 2003 was also positively influenced by the release of credit risk provisions.

Like the Czech banking sector, Slovak banks currently also have very ample liquidity. At the leading Slovak banks, customer deposits are on average approximately more than twice as high as loans granted. The largest banks are currently endeavoring to boost demand for personal loans by stepping up their marketing activities and offering new products.

11 This figure also includes the foreign branches of the Czech CSOB in the Slovak Republic. Excluding CSOB branches, the total assets of the Slovak banking sector would be around EUR 21 billion.

12 The figures employed are largely based on data provided by Národná banka Slovenska (NBS – Slovak National Bank).

According to preliminary statistics provided by the Slovak central bank, lending to nonbanks in 2003 grew by some 14%. Whereas corporate loans basically remained at 2002 levels, loans to private households rose steeply (+39%) in 2003. As in 2002, households' demand for loans focused on government-subsidized home loans. In 2003, however, lower lending rates also fueled strong growth in both consumer and credit card lending.

Table 7

Selected Key Figures of the Slovak Banking Sector

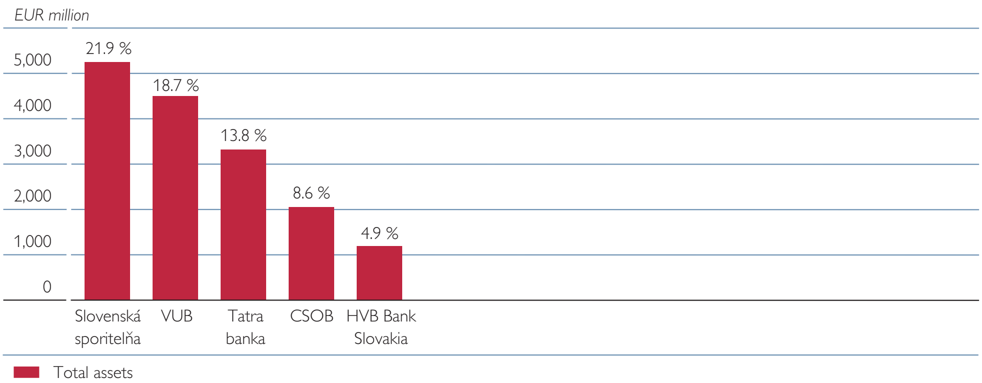
	1999	2000	2001	2002
Number of banks	25	23	19	18
of which foreign banks	11	14	13	15
Private banks' share of total assets (%)	49.3	50.9	95.1	97.1
Share of nonperforming loans (%)	32.9	26.2	24.3	11.2
Domestic personal loans (% of GDP)	40.5	37.6	27.6	25.2
Market capitalization (% of GDP)	3.8	3.9	3.3	7
EBRD index on bank reform (from 1 to 4+)	2.7	3.0	3.3	3.3

Source: EBRD.

In January 2001 Erste Bank acquired for EUR 411 million 87.2% of Slovenská sporiteľňa, the Slovak savings bank heavyweight (the sale of 20% to the EBRD lowered Erste Bank's stake to 67% shortly thereafter).[13] With a market share of some 22%, Slovenská sporiteľňa is the biggest bank in the Slovak Republic. The second largest is VUB, of which 95% is controlled by the Italian Intesa. RZB enjoys approximately 14% of the Slovak banking market via Tatra banka, its subsidiary. The CSOB branch network (part of Czech CSOB) is owned by the Belgian KBC. ING is the Slovak subsidiary of the eponymous Dutch financial group.

Chart 15

Total Assets and Market Share of the Five Largest Slovak Banks in 2003



Source: Národná banka Slovenska, OeNB estimates.
Note: Estimates refer to market share.

[13] *In May 2004 the government's remaining stake was bought by Erste Bank for EUR 72 million, which increased Erste Bank's own stake to 80%.*

Austrian Banks Control more than 40% of the Banking Market

Five Austrian banks currently operate in the Slovak Republic. Austrian banks are by far the biggest investors in the Slovak banking sector, controlling about 40% of total assets.

The restructuring of Slovenská sporiteľňa, Erste Bank's subsidiary, was concluded in 2002, as was its complete integration into the group. Considerable progress was also made in operational terms in 2003. The cost-to-income ratio improved from 66.8% to 51.9%. Annual net profit was increased by 121% to EUR 66 million, and ROE came to an outstanding 19.2%. In 2003 the Bank posted robust growth in lending. Compared with the previous year, total lending grew by 50%. The fact that total assets climbed a mere 2.9% can be attributed to the decline in interbank business.

Tatra banka also succeeded in sharply boosting total lending in 2003. However, both operating income and profit after tax were down slightly, albeit from a high level. With an ROE of 19.4%, the profitability of RZB's Slovak subsidiary remained very healthy.

HVB Bank Slovakia, the BA-CA subsidiary and the country's sixth-largest bank, significantly boosted both the loan portfolio and total assets in 2003. However, operating profit and net profit for the year were down. At only 10%, ROE lagged behind the average of the Slovak banking market.

Ľudová Banka and Istrobanka – relatively small subsidiaries – are operated by ÖVAG and BAWAG, respectively

Table 8

Key Figures of Selected Austrian Banks' Subsidiaries in the Slovak Republic at End-2003

	Slovenská sporiteľňa	HVB Bank Slovakia	Tatra banka	Ľudová Banka
	EUR million			
Total assets	5,060	1,185	3,316	661
Change on previous year (%)	*+2.9*	*+20.0*	*+13.6*	*–4.6*
Profit after tax	66	15	48	7
Change on previous year (%)	*+124.9*	*–17.7*	*–13.1*	*+30.2*
	%			
Return on equity[1]	19.2	10.0	19.4	9.1
Cost-to-income ratio	51.9	53.2	64.0	79.0

Source: BA-CA. Erste Bank, RZB, ÖVAG.

[1] *ROE after tax: Slovenská sporitelaňa and HVB Bank Slovakia; ROE before tax: Tatra banka and Ľudová Banka.*

2.4 Poland

Poland is by far the biggest (and most competitive) banking market in CEE countries. The country's bleak economic climate also currently makes it one of the most unprofitable banking markets in the region. At the end of 2003, the consolidated total assets of Polish banks were about EUR 111 billion (or some 32% of total CEE assets). The degree of bank intermediation (total assets as a percentage of GDP) came to only 60%, or below the CEE average (74%). Mergers and acquisitions in the past few years have reduced the number of banks. The market share of the five largest banks at the end of 2003 was approximately 52%.[14]

[14] *For the figures (in the text) relating to the Polish banking sector, please also see "Summary evaluation of the financial situation of Polish banks," Narodowy Bank Polski (NBP), June 2004.*

Unlike in other CEE countries, privatization in Poland has not been completely finalized. The largest Polish bank (PKO Bank Polski, market share: 17%) remains in state hands. The other major Polish banks are without exception under the control of Western European and American banking groups. The share of Polish bank assets owned by foreigners is about 68%.

Slowing economic growth (2002 real GDP growth was a mere 1.2%; signs of economic recovery only began emerging in the second half of 2003), a growing number of insolvencies and weakening demand for credit by corporate customers had an extremely negative impact on income in the Polish banking sector in 2002 in particular. Profits generated by Polish banks fell by around a third in 2002 (ROE at 5.8% was one of the lowest in the region). Despite modest improvements in the second half of the year, profitability was still very low in 2003. ROE improved only slightly to 6.2% in 2003, still lagging behind comparable figures in other CEE countries by a wide margin. Poland's economy continued to recover in the first half of 2004. For 2004, profits are widely expected to surge in the Polish banking sector.

Insolvencies and falling profits of corporate customers resulted in a further deterioration in the quality of the loan portfolio in 2002. The share of NPLs as a percentage of total lending increased from 17.9% to 21.1% at the end of 2002.[15] Although the share of NPLs was still high (20.9%) at the end of 2003, lower net loan loss provisions (the share of net loan loss provisions as a percentage of operating income fell from 24.2% to 15.9% in 2003) indicate an easing in credit risk.

Following stagnation in 2002, lending growth picked up pace again to some extent in 2003 (+9%). In view of the continued low degree of credit penetration (at 15%, the share of domestic personal loans as a percentage of GDP remains one of the lowest in the CEE region; the share of personal mortgage loans as a percentage of GDP was only about 4% at the end of 2003), however, growth was relatively weak.

Table 9

Selected Key Figures of the Polish Banking Sector

	1999	2000	2001	2002
Number of banks	77	74	71	62
of which foreign banks	39	47	48	47
Private banks' share of total assets (%)	75.1	76.1	75.6	73.4
Share of nonperforming loans (%)	13.3	15	17.9	21.1
Domestic personal loans (% of GDP)	18.7	18.1	18	15.2
Market capitalization (% of GDP)	19.9	18.1	13.7	14.3
EBRD index on bank reform (from 1 to 4+)	3.3	3.7	3.7	3.7

Source: EBRD, Narodowy Bank Polski.

An analysis of loan demand by segment reveals a trend similar to that in other new Member States. Whereas the demand for loans by enterprises remains very restrained, traditional retail products (such as mortgage

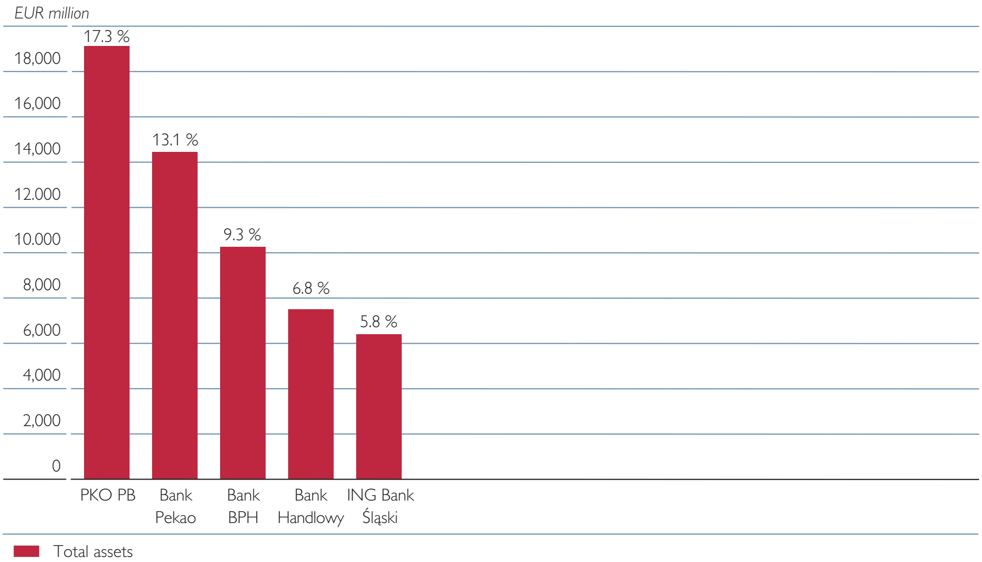
[15] *In the past, the NPL classification standard set by the NBP was far more stringent than those in other countries. Heavy criticism from banks and investors led to the NPL rule being amended in early 2004. Loans are now classified as NPLs if payments are 90 days in arrears. Market participants estimate that this will roughly halve the share of NPLs as a percentage of total lending.*

loans, consumer loans) have bounced back smartly. Robust growth in mortgage-secured loans can also be attributed to the growing popularity of foreign currency loans.

With total assets of EUR 19.3 billion, state-owned PKO PB is not only Poland's largest bank but also the biggest in the entire CEE region. According to press reports, up to 30% of PKO PB are to be privatized by the end of November 2004. In view of the political situation, however, it is more than doubtful whether the privatization will go ahead as planned. The stock exchange-listed Bank Pekao, in which the Italian UniCredito holds a 53% stake, is the country's second-largest bank. BA-CA holds 71% in BPH-PBK, the third-largest Polish bank. The American Citibank owns 93% of Bank Handlowy, and ING Bank Śląski is dominated by the Dutch banking and insurance group, ING (ING holds 88% of the capital).

Chart 16

Total Assets and Market Share of the Five Largest Polish Banks in 2003



Source: Narodowy Bank Polski, OeNB estimates.
Note: Percentages refer to market share.

Relatively Few Austrian Banks Present in Poland

BA-CA and RZB are currently the only two Austrian banks represented by their own subsidiaries in Poland.

Bank BPH, BA-CA's subsidiary, has 3 million customers and a national network of branches with a particularly strong market position in Warsaw and Cracow. Bank BPH, with a recent market capitalization of EUR 2.6 billion, is listed on the Warsaw stock exchange. The bank's profitability suffered badly in 2001 and 2002 on the back of merger activities (BPH, HVB's subsidiary, was merged with PBK, BA's subsidiary), the sluggish state of the Polish economy and high loan losses. In 2003, restructuring measures (e.g. staff cuts of 28% in the past few years), low risk costs and the disposal of financial assets improved performance. In 2003, profit after tax increased by 35%. At 7.4%, however, ROE remained modest. In addition to Bank BPH, BA-CA also holds a stake in HypoVereinsbank Polen, which however only plays a minor role. In January 2004, BA-CA sold its holding in Gornoslaski Bank to Getin Holding (a Polish financial holding company) for EUR 50 million.

Despite its comparatively small size, Raiffeisen Bank Polen (RZB's subsidiary) has a well-known brand name, particularly in the Greater Warsaw area. This allowed it to expand total lending by 16% in 2003 in a difficult market environment. Its profitability is equally good: profit after tax was sharply boosted from EUR 2.7 million to EUR 17.6 million, and ROE was a good 15.9%.

Table 10

Key Figures of Selected Austrian Banks' Subsidiaries in Poland at End-2003

	Bank BPH	Raiffeisen Bank Polen
	EUR million	
Total assets	9,345	1,859
Change on previous year (%)	*–9.1*	*+19.3*
Profit after tax	81	18
Change on previous year (%)	*+35.4*	*+537.2*
	%	
Return on equity[1]	7.4	15.9
Cost-to-income ratio	66.6	77.8

Source: BA-CA. RZB.

[1] ROE after tax: Bank BPH; RIE before tax: Raiffeisen Bank Polen.

2.5 Slovenia

The total assets of the Slovenian banking sector were some EUR 21 billion at the end of 2003. At about 90%, the degree of bank intermediation (as a ratio of total bank assets to GDP) is relatively high. The dominance of Nova Ljubljanska banka (NLB) – with a market share of 34% it is by far Slovenia's biggest bank – means the degree of concentration is very high: the five largest banks of the country account for 66% of bank assets. Compared with other CEE countries, the state's extremely large share of the Slovenian banking market (almost 50% of the banking sector is still in state hands) and the limited influence of foreign banks are striking. Only 19% of Slovenian bank assets are majority-owned by foreign banks. Including equity interests, foreign banks control a somewhat larger share of the Slovenian banking sector: overall, foreign banking groups hold some 34% of the equity capital of the Slovenian banking market.[16]

The fact that Slovenia has so far been spared a banking crisis (also likely to be the main reason for the state's large share of the banking market) is key to understanding the Slovenian banking system. Unlike in other countries of the region, demand for loans and leasing by private firms and households has enjoyed a steady long-term upwards trend as a result. At 41%, the share of domestic personal loans as a percentage of GDP was one of the highest in the CEE region at the end of 2002.

Compared with other CEE countries, the credit quality of the Slovenian banking sector is also very good. At 6.5%, the share of NPLs as a percentage of total lending was one of

[16] The figures relating to the Slovenian banking sector are based on data provided by the Slovenian central bank (Banka Slovenije) and the IMF staff report on financial system stability assessment, update of April 2004.

the lowest in Eastern Europe (only Hungary and Croatia outperformed Slovenia in this respect). In 2003, a mere 13% of operating income needed to be used for additional risk costs.

Lending growth (+10% in the first three quarters of 2003), moderate risk costs and very high margins (at 3.4%, Slovenia, despite a decline, still has one of the highest net interest margins in the region) were primarily responsible for the Slovenian banking sector's relatively good profitability (ROA: 1.0%). Capital adequacy is well below comparable figures in other CEE countries. At 11.6%, the solvency ratio is close to the average of Western European banks (11.2%).

Table 11

Selected Key Figures of the Slovenian Banking Sector

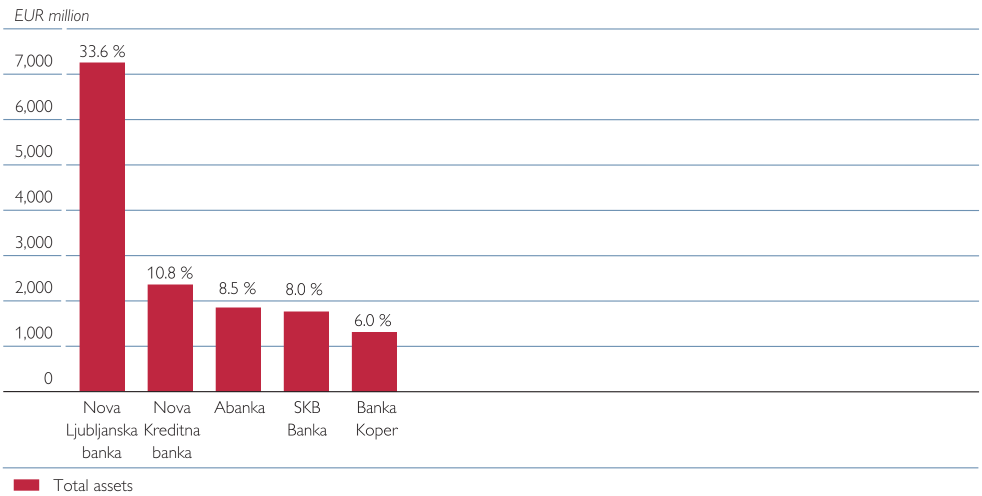
	1999	2000	2001	2002
Number of banks	31	28	24	22
of which foreign banks	5	6	5	6
Private banks' share of total assets (%)	57.8	57.5	51.1	51.4
Share of nonperforming loans (%)	×	6.5	6.9	6.9
Domestic personal loans (% of GDP)	38	38.7	40.4	41
Stock market capitalization (% of GDP)	11.8	13.7	14.7	19.1
EBRD index on bank reform (from 1 to 4+)	3.3	3.3	3.3	3.3

Source: EBRD, Banka Slovenije.

As already mentioned, Nova Ljubljanska banka, with a market share of 33.6%, is the leading bank in Slovenia. NLB is owned by KBC (which holds a stake of 34%) and the Slovenian state (further privatization is currently not envisaged, according to press reports). Nova Kreditna banka – the country's second-largest bank (market share: 10.8%) – is in state hands. Abanka is also majority-owned by the state. The French Société Générale holds a stake of 99% in SKB Banka (market share: 8.0%). Banka Koper is controlled by the Italian San Paulo IMI.

Chart 17

Total Assets and Market Share of the Five Largest Slovenian Banks in 2003



Source: Annual reports, Banka Slovenije.
Note: Percentages refer to market share.

Share of Austrian Banks as a Percentage of the Slovenian Banking Market – Around 11%

BA-CA, RZB, Hypo Alpe-Adria Bank and ÖVAG are currently represented by their own subsidiaries in Slovenia. Kärntner Sparkasse is represented by a branch in Slovenia. With a market share of 4.3%, the largest Austrian bank in Slovenia is BA-CA d.d. As of October 2003, Raiffeisen Krekova banka accounted for 2.5%, Hypo Alpe-Adria Bank for 1.6%, and Volksbank-Ljudska banka for 1.3% of the market.

Austria's banks are currently pursuing an aggressive expansion policy in Slovenia (retail and corporate business) and advertising on a large scale. In 2003 Austrian banks' lending growth exceeded the market average by a wide margin. Nevertheless, the profitability of Austrian bank subsidiaries in Slovenia has been relatively low. At the end of 2003, the ROE of all Austrian banks in Slovenia lagged behind the Slovenian average.

Table 12

Key Figures of Selected Austrian Banks' Subsidiaries in Slovenia at End-2003

	BA-CA d.d.	Raiffeisen Krekova banka	Volksbank-Ljudska banka
	EUR million		
Total assets	970	541	303
Change on previous year (%)	*+26.7*	*+32.4*	*+49.0*
Profit after tax	7	1	0
Change on previous year (%)	*–33.2*	*–71.9*	*–10.1*
	%		
Return on equity[1]	9.8	1.9	1.7
Cost-to-income ratio	59.4	90.8	90.8

Source: BA-CA. RZB, ÖVAG.

[1] *ROE after tax: BA-CA d.d.; ROE before tax: Raiffeisen Krekova banka and Volksbank-Ljudska banka.*

2.6 Croatia

According to a news agency report,[17] total assets of the Croatian banking market increased by 16% to HRK 203.8 billion (or around EUR 27 billion). At 107%, the degree of bank intermediation in Croatia was the highest in the CEE region. At 107%, the degree of bank intermediation in Croatia was the highest in the CEE region.

In Croatia the private sector makes greater use of the banking sector for financing than in other CEE countries. The share of loans to private firms and households amounts to 41% of the country's GDP. Following the banking crisis in 1998–99 and the subsequent privatization of the major state-owned banks, the Croatian banking sector has been almost completely controlled by Western European banks. Overall, foreign bank subsidiaries account for some 91% of Croatian bank assets. At around 70%, the degree of concentration (market share of the five largest banks) is very high.[18]

The Croatian banking system was marked by healthy profitability in 2002 and 2003 (ROA after the first nine months of 2003: 1.6%) and

[17] *According to a report by Austria Presse Agentur of June 24, 2004.*

[18] *For the figures (employed in the text) relating to the Croatian banking sector, please also see http://www.hnb.hr/publikac/prezent/ebanking-sector.pdf, in particular.*

sound capital adequacy (solvency: 16.0%). The biggest risks in the Croatian banking system are strong growth in lending (largely financed by the buildup of net foreign debt) and the large share of foreign currency as a percentage of customer deposits (68% as of July 2003).

The steep rise in lending (2001: +28.5%, 2002: +40.0%) can be attributed to dynamic economic growth (2002 GDP growth: +5.2%) and to copious inflows of liquidity into the banking system. Considerable amounts of cash (primarily Deutsche marks) held outside the banking system until the end of 2001 had to be paid into bank accounts for the purposes of euro conversion. Since the Croatian population left most of this cash in their accounts, the commercial banking sector suddenly found at its disposal additional liquidity of at least EUR 2 billion.

To contain the risk of excessively expansive lending growth, Hrvatska narodna banka (HNB – Croatian National Bank) introduced measures designed to absorb liquidity in early 2003. Commercial banks were accordingly obliged to purchase HNB securities as soon as their lending grew by more than 16% per year (or 4% per quarter). This measure reduced lending growth to about 16% in 2003 (2002: 40%). Despite the lapse of lending growth limits as of the end of 2003, HNB does not expect lending growth to accelerate at a fast place in 2004.

Table 13

Selected Key Figures of the Croatian Banking Sector

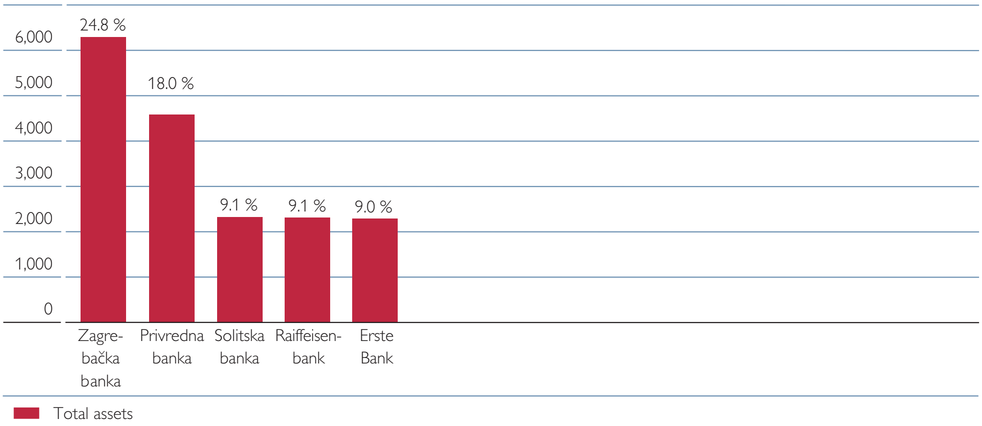
	1999	2000	2001	2002
Number of banks	53	43	43	46
of which foreign banks	13	21	24	23
Private banks' share of total assets (%)	60.2	94.3	95	96
Share of non-performing loans (%)	20.6	19.8	15	11.5
Domestic personal loans (% of GDP)	22.1	27.8	34.2	45
Stock market capitalization (% of GDP)	14	14.5	16.8	16.1
EBRD index on bank reform (from 1 to 4+)	3.0	3.3	3.3	3.7

Source: EBRD.

With a market share of 24.8%, Zagrebačka banka (ZABA) is the leading bank in Croatia and ahead of Privredna banka Zagreb, which has a market share of 18.0%. Zagrebačka banka is 82%-owned by the Italian UniCredito (the remaining shares being held by Allianz). Privredna banka Zagreb belongs to Intesa, the Italian banking group (76%). Privredna banka Zagreb is followed by four Austrian subsidiary banks, with almost identical market share. Splitska banka, a subsidiary of BA-CA (merged with HVB Croatia in the third quarter of 2003) and Raiffeisenbank Austria d.d. each account for 9.1% of the market. Erste & Steiermärkische Bank (merged with Rijecka banka, Erste Bank's subsidiary, in the third quarter of 2003) has a market share of 9.0%. HAAB is represented in Croatia by Hypo Alpe-Adria Bank d.d. (HAAB's stake: 95%) and by Slavonska banka (HAAB's stake: 72%), thereby controlling some 8.9% of the country's banking market.

Chart 18

Total Assets and Market Share of the Five Largest Croation Banks at End-September 2003



Source: Hrvatska narodna banka.
Note: Percentages refer to market share.

Market Share of Austrian Banks – Around 38%

The five Austrian banking groups operating in Croatia are Erste Bank, BA-CA, RZB, HAAB and ÖVAG. Their subsidiaries control roughly 38% of Croatia's bank assets.

In 2003 Austrian bank subsidiaries in Croatia continued to strengthen their total assets. The extraordinarily strong growth posted by Erste & Steiermärkische Bank d.d. (Erste Bank Kroatien) and by Splitska banka, BA-CA's subsidiary, was due to mergers (Erste Bank merged Rijecka banka with Erste & Steiermärkische Bank in the third quarter of 2003; BA-CA merged its two units, HVB Croatia and Splitska banka).

The 2003 annual results for Raiffeisenbank Austria d.d. (ROE: 22.2%) indicate exceptionally high profitability. With a ROE of around 15%, Erste Bank's subsidiary generated an ROE which is roughly equivalent to that of the Croatian banking sector. BA-CA's subsidiary continued to grow in 2003 (its marketing network was expanded by 32 branches). At 12.8%, its ROE was slightly below the market average. Despite considerably improved income, Volksbank d.d.'s ROE fell short of the market average.

Table 14

Key Figures of Selected Austrian Banks' Subsidiaries in Croatia at End-2003

	Splitska banka	Erste Bank Kroatien	Raiffeisenbank Austria d.d.	Volksbank d.d.
	EUR million			
Total assets	2,509	2,551	2,446	355
Change on previous year (%)	*+66.2*	*+126.5*	*+29*	*+52.1*
Profit after tax	23	30	22	2
Change on previous year (%)	*+71.0*	*+194.9*	*+12.9*	*+46.1*
	%			
Return on equity[1]	12.8	14.7	22.2	10.7
Cost-to-income ratio	57.3	62.5	64.8	86.7

Source: BA-CA, Erste Bank, RZB, ÖVAG.
[1] ROE after tax: Splitska banka and Erste Bank Kroatien; ROE before tax: Raiffeisenbank Austria d.d. and Volksbank d.d.

3 Conclusions

The Central and Eastern European banking market (excluding Russia) is relatively small with total assets of some EUR 350 billion (by comparison, the total assets of banks operating in Austria were some EUR 605 billion at the end of 2003).

The Eastern European banking sector is a growth market. The low degree of bank intermediation (about a third of its Western European counterpart), coupled with higher economic growth (EU accession could accelerate the CEE region's catch-up process), should offer banks in Central and Eastern Europe strong growth potential in the years to come.

Above-average growth potential and high profit potential (higher interest margins than in Western Europe and restructuring potential) have led Western European banks to invest heavily in the CEE banking sector. About 70% of the CEE banking market is currently estimated to be controlled by Western European banking groups.

Austrian banks were among the first to invest in Central and Eastern European countries and are now some of the best-known Western European banks in the region (market share in the region: about 22%). BA-CA, Erste Bank and RZB are among the most active Western European banks operating in CEE countries. As early as 2002 and 2003, steady expansion in the CEE region had a positive impact on the profitability of Austria's consolidated banking sector and was primarily responsible for Austrian banks outperforming German banks in the past few years.

Favorable reports on the CEE banking market often fail to mention the potential risks, against which strong growth and high profits need to be offset. We consider the main sources of risk in the Eastern European banking market to be: macroeconomic imbalances, the risk of growing exchange rate volatility, credit risk (can relatively new and untested credit risk systems cope with a possible lending boom?), increasingly fierce competition (high profitability could attract additional competitors and cause margins to shrink more quickly than expected) and political risks.

The key characteristics of CEE banking markets are: the degree of concentration is relatively high (the five largest banks enjoy a large market share); a majority of bank assets are in foreign ownership (about 70%); customer deposits are generally far higher than loans granted (liquid balance sheets); the degree of intermediation is low (in particular, private sector as well as small and medium-sized enterprises are still largely financed outside the banking sector); the share of nonperforming loans as a percentage of total lending is high; profitability is excellent (profitability ratios are on average higher than those of Western European banks); and capital adequacy is good (this should fuel strong lending growth over the next few years).

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