Are we so vulnerable, as the market appears to believe?

- Impact of the credit crunch on the outlook of the financial sector in the region

AmCham-ICEG EC conference: CEO for CEOs

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László Urbán
CFO, OTP Bank

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Channels of possible infection I.: Mortgage portfolio

- The subprime crisis has had no direct effect in the region:
  - Healthier mortgage portfolios
    - Banks usually do not provide subprime loans
    - Much lower loan to value ratios
    - Negligible securitization
    - Rigorous risk management and credit standards
    - Home is the most valuable asset for most people – do not want to default on collateralized debt
      - Hungarian customers survived a huge fiscal stabilization shock in 2007
  - No incentives to keep significant credit-derivative instruments in Treasury portfolios

Channels of infection II.: indirect effects may be strong

- Through indirect channels the crisis may effect CEE economies:

  - Risk appetite has fallen dramatically, spreads have widened
  - Liquidity dried up, refinancing is problematic,
  - Equity and bond prices fell, impact on pension fund portfolios

  - Expectations can be self-fulfilling, investors are looking for signs of a possible crisis everywhere
  - Countries with large C/A deficits may be the most vulnerable

Investors started searching for crisis factors

- Hungary: low growth, high inflation, imbalances still high,
- Extremely high external imbalances, especially in the Baltic countries, Bulgaria and Romania:
- Everywhere:
  - increasing household indebtedness,
  - FX lending (except for the Slovak and the Czech Republic),
  - real estate price bubbles.

Impact on Financial Sector Outlook

- Liquidity squeeze could slow down credit expansion in the region
- With a slowdown in capital inflows, investment activity may slow down

- Over-leveraged banks have problems (Kazakhstan, Russian smaller banks) which can become opportunities for less leveraged ones
- Higher costs of funds can be passed on to clients in dynamic markets (Russia, Ukraine, Bulgaria)

- Risks of FX-denominated lending are not particularly high
  - Original cause: shortage of local savings
  - Main driver: fiscal irresponsibility or credible currency board
  - In case of a huge shock, domestic currency denominated loans could become even riskier

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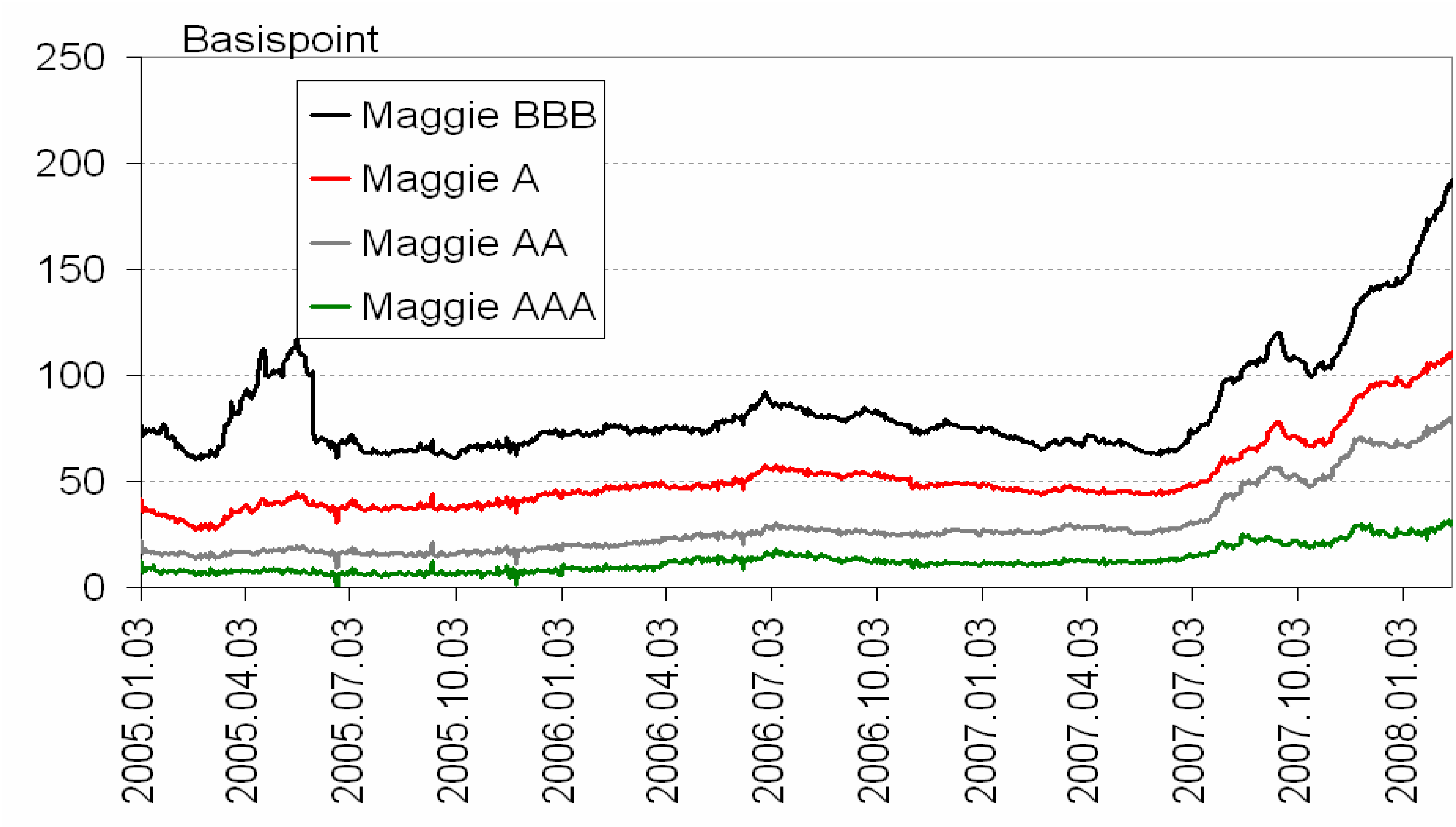
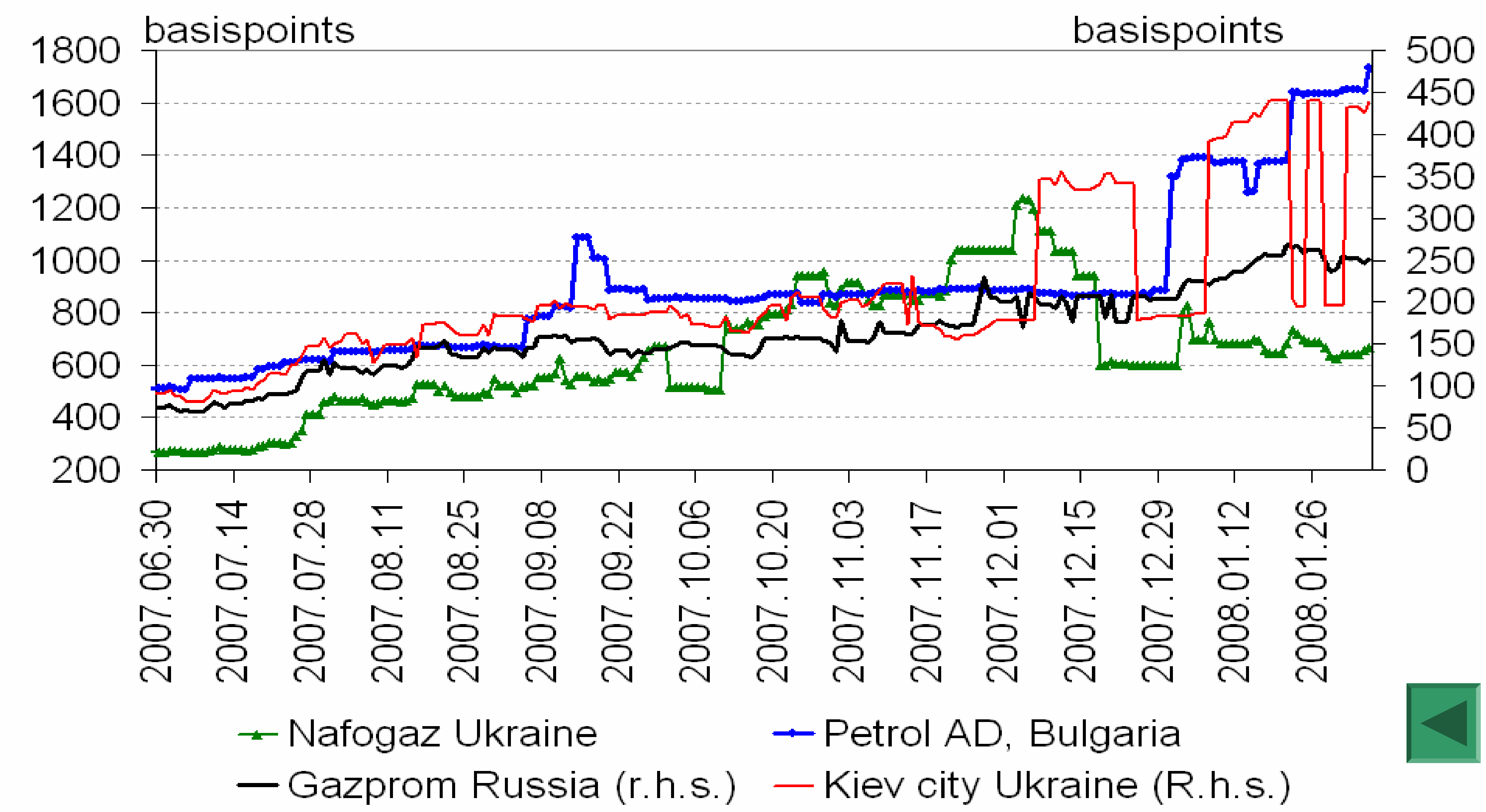
Thank you for your attention!

Credit spreads have widened in developed countries…



Source: Reuters

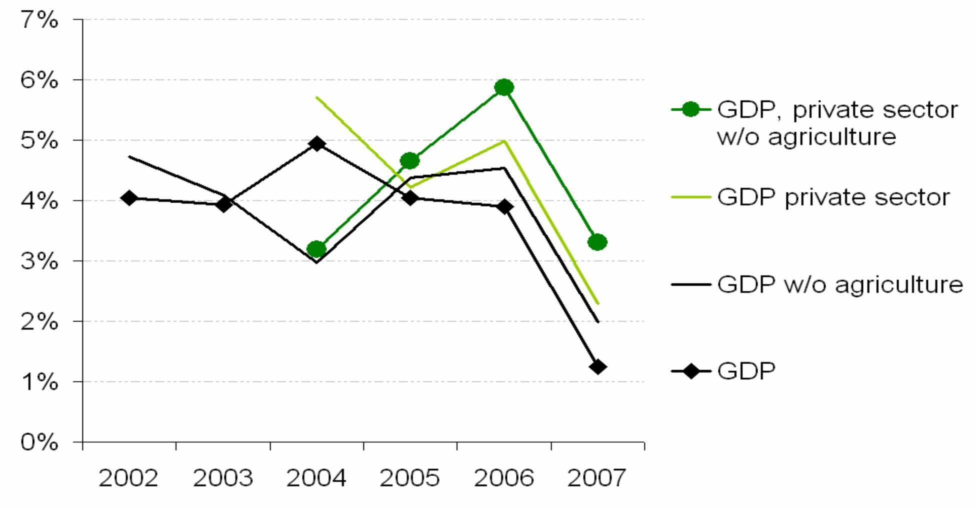
… and in Eastern Europe as well



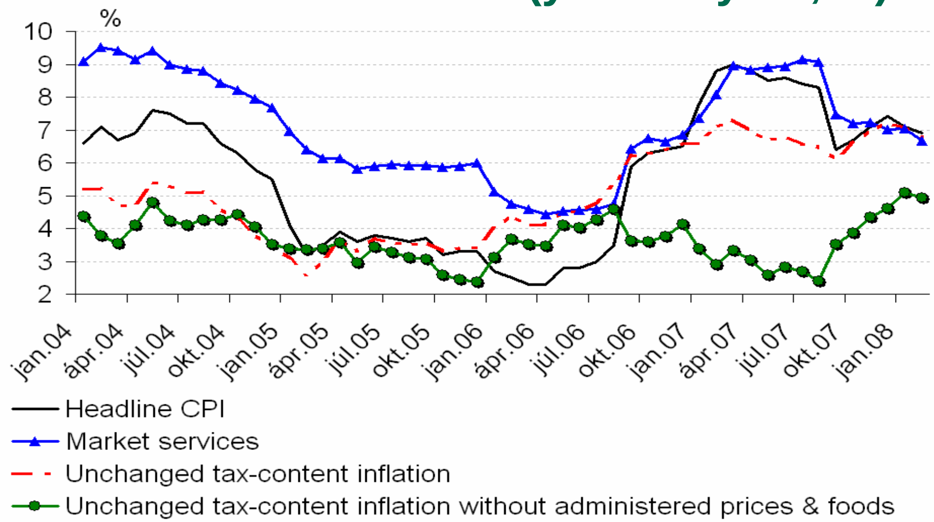
Source: Reuters, Bloomberg

Hungary: Low growth, high inflation mainly due to fiscal and agricultural shock

Indicators of economic growth



Indicators of inflation (year on year, %)

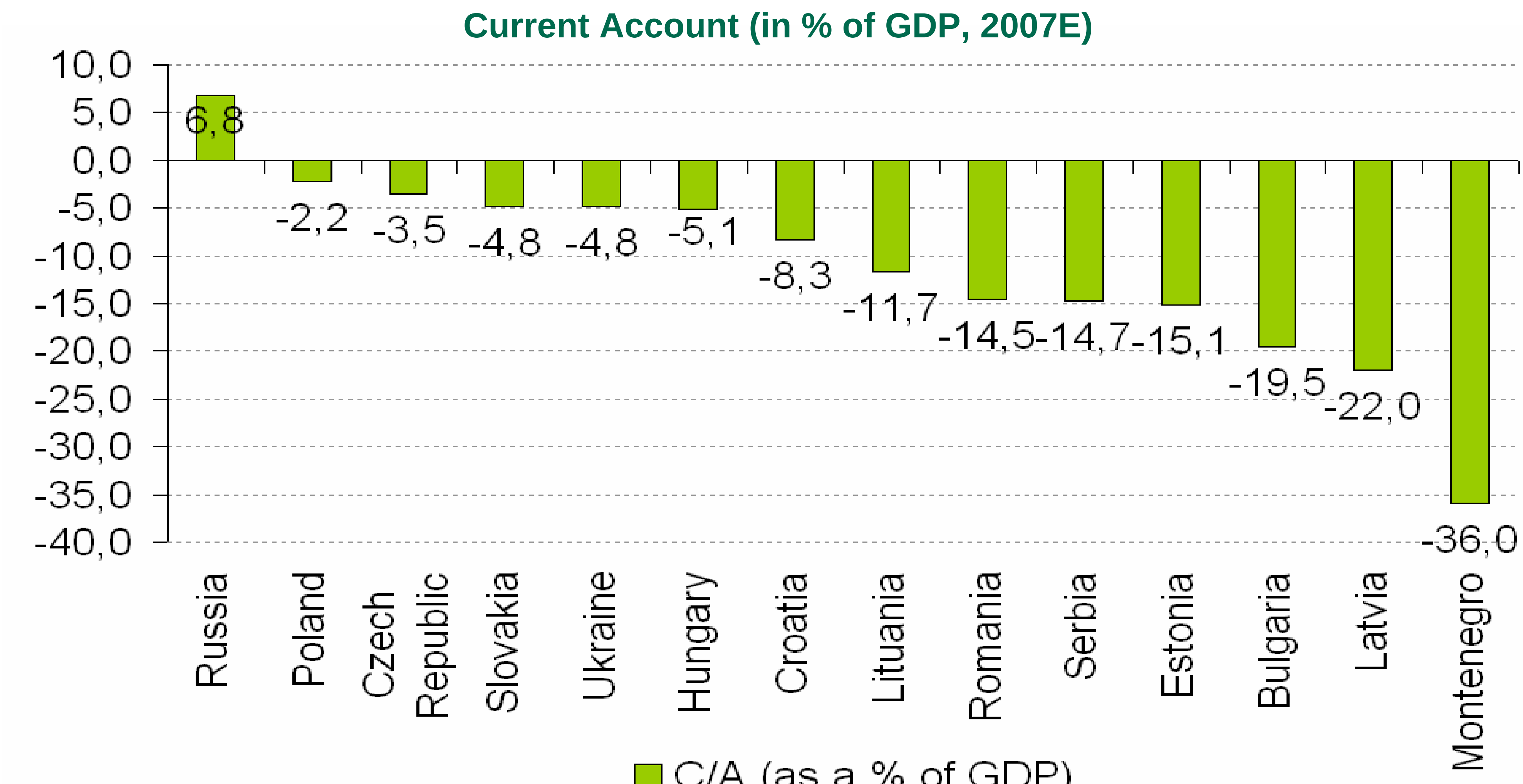


- Before 2007: unsustainable fiscal, and C/A (household savings were low) deficit
- Adjustment started in 2006, indicators of equilibrium improved significantly,
- But growth has slowed down temporary
- Potential growth only around 3-3.5% (low in regional comparison)

- High inflation in 2007 is due to:
  - rise in administrative prices,
  - Rise in food and energy prices (global)
- But underlying service price inflation was also high, as there were no room within the band for nominal appreciation.

Source: National Statistical Office, OTP Bank

Several countries in the region run extremely high current account deficits…



Source: National Statistical Institutes, OTP Bank

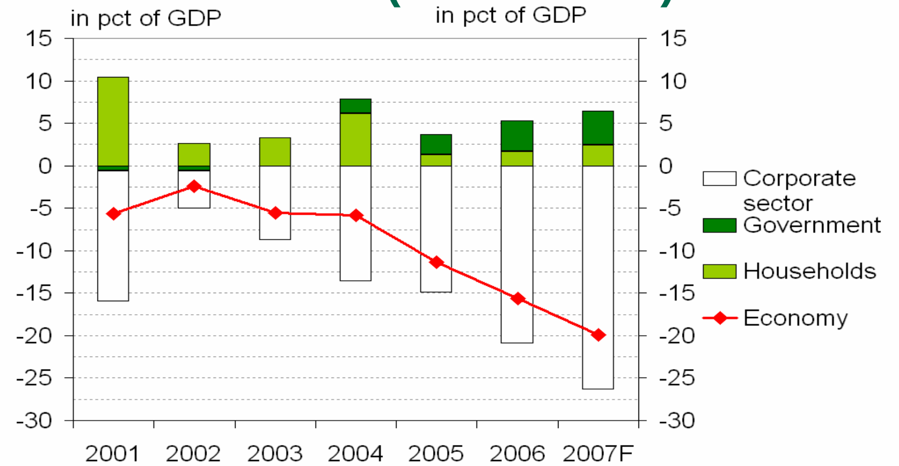
External imbalances will not lead to sustainability problems, when they are caused by corporate investments

- High C/A deficit caused by private investments:
  - Low wages attract FDI inflows,
  - This generates strong investments activity resulting in export growth in the future
  - This type of disequilibrium reflects only fast real convergence
  - External indebtedness does not need to increase

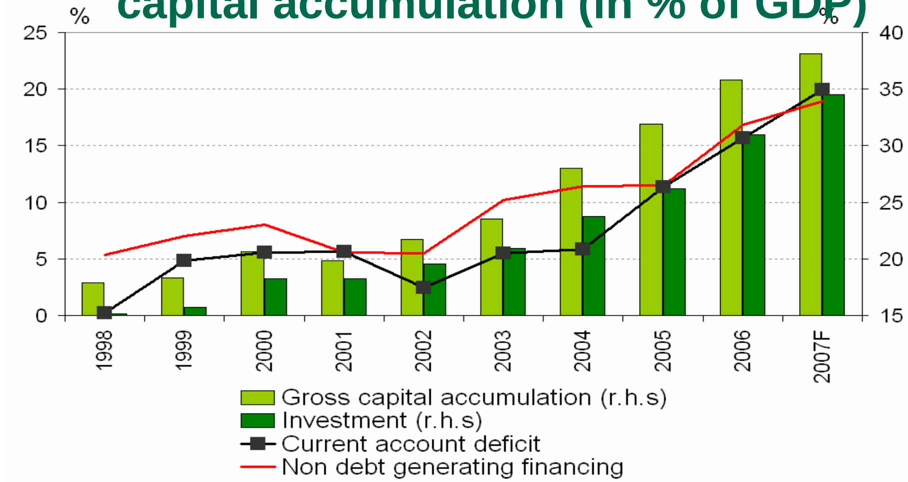
- Dangerous deficits are caused by budget deficits not financed by household savings or FDI
  - Deficit financed by foreign debt, and used for consumption, public or residential investments
  - Strong increase in external indebtedness

Bulgaria: FDI inflow generated investment boom and C/A deficit

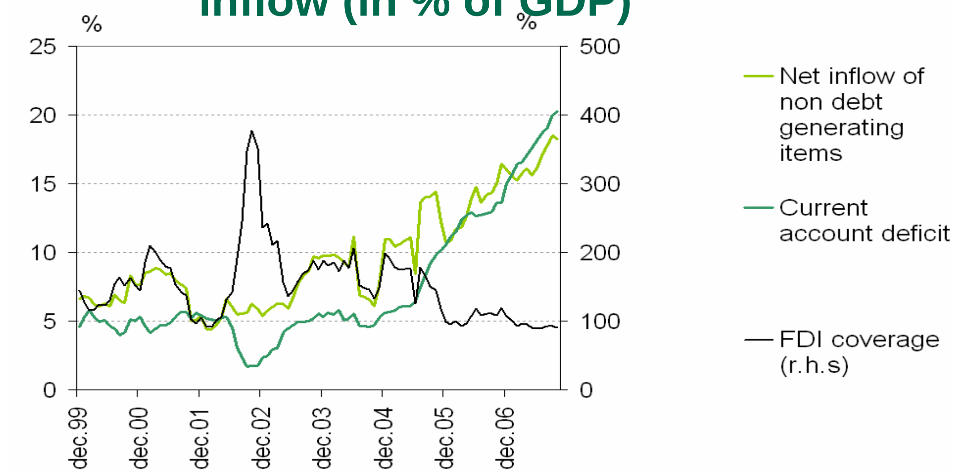
Net financing capacity of the main sectors (in % of GDP)



Current account balance and capital accumulation (in % of GDP)



Current account balance and net FDI inflow (in % of GDP)

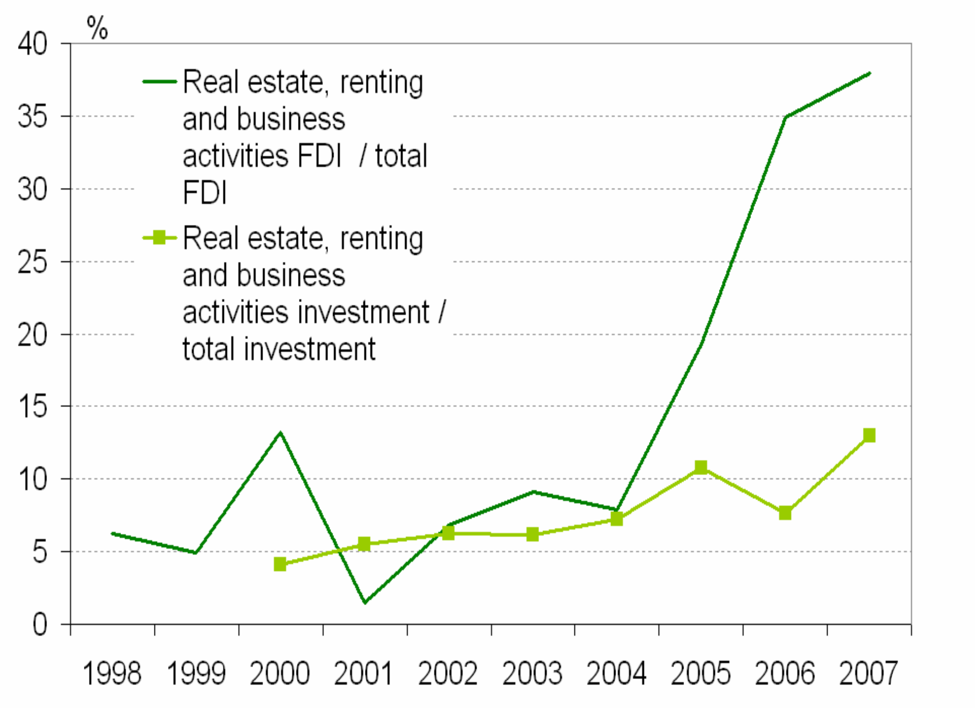


1. Heavy FDI inflows,
2. Strong investment activity,
3. And extreme high C/A deficit,
4. High, but decreasing consumption to GDP ratio (84%)
5. But the budget and the household sector has positive net savings capacity
6. Impact of high price and wage growth has been balanced by strong productivity gains**, so currency board looks sustainable**

Source: National Statistical Institute

Bulgaria: 50% of FDI goes into construction & real estate lending

Role of real estate market in investments and in FDI



- Nearly 40% of FDI inflows poured into construction & real estate finance and other business services

Can the current crisis slow down investment growth, and how can it effect the economy?

- In the worst case scenario FDI inflows may slow down temporarily
- But in this case not only investments and real convergence will loose momentum, but C/A deficit is to decline as well
- Even in this scenario the currency board remains sustainable
  - Equity type external liabilities less dangerous then those of debt
  - Strong price reaction would limit outflows and pressure on the currency board
  - FX reserves are very high, and increasing

Source: National Statistical Institute

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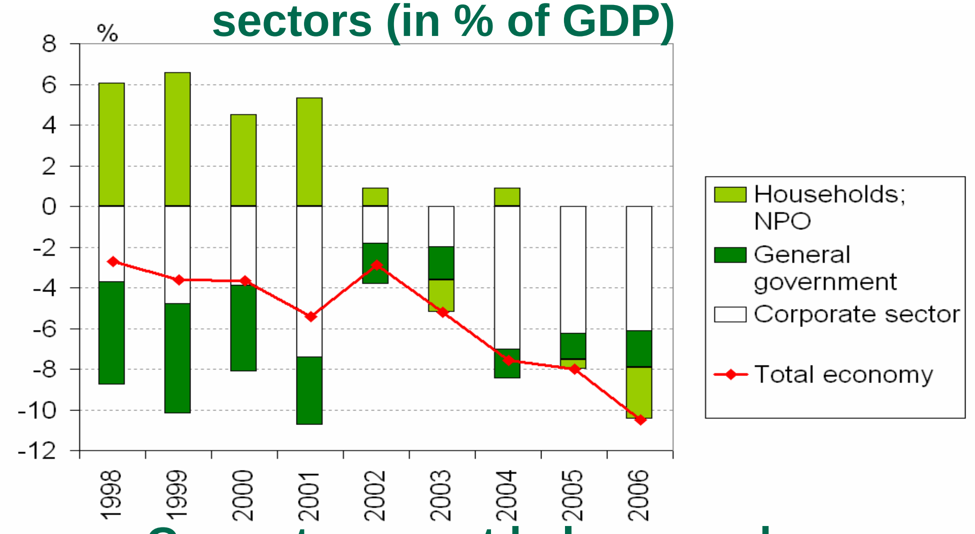
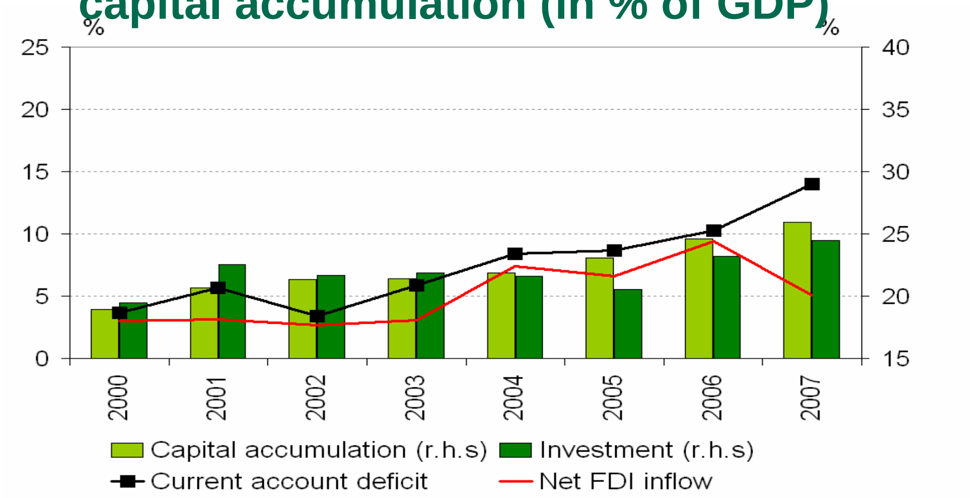
Romania: more vulnerable, as both the government and the household sector has negative net financing capacity

Net financing capacity of the main sectors (in % of GDP)



- In Romania the picture is more cloudy, than in Bulgaria:
- Not only the corporate sector, but also households and the budget has negative net saving capacity

Current account balance and capital accumulation (in % of GDP)

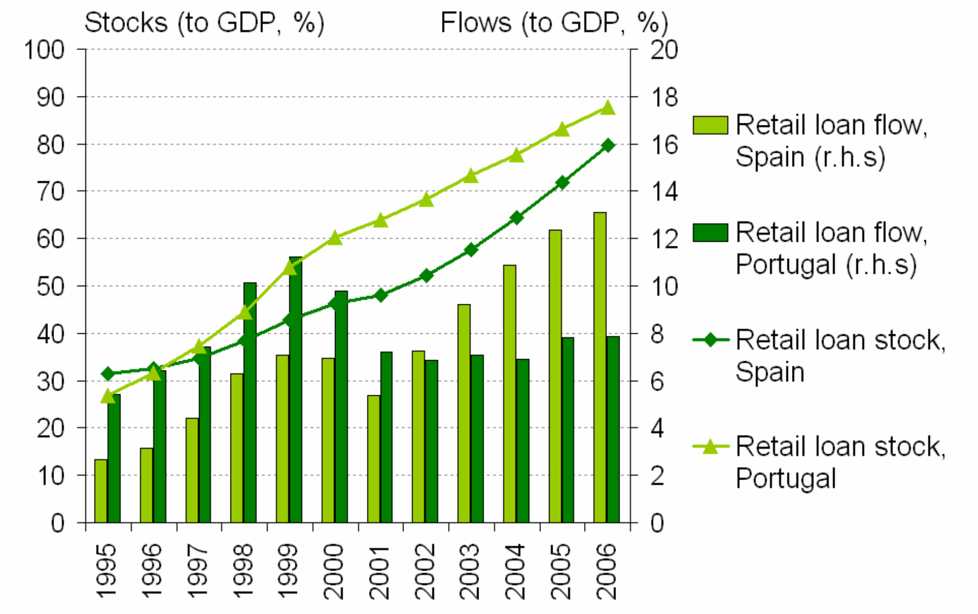


- Investment ratio is much lower than in Bulgaria, and the widening in 2007 C/A deficit was not caused by higher investments
- FDI coverage is also much lower

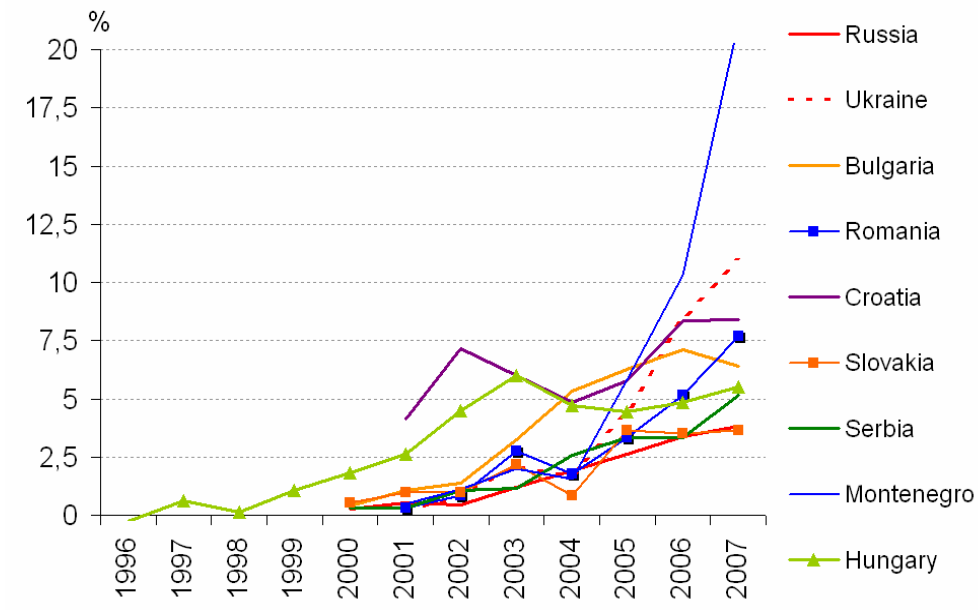
Source: National Banks, National Statistical Office

Household indebtedness: deeply structural

Retail loan flows and stock in Spain and Portugal… (in pct of GDP)



…and retail flows in the region

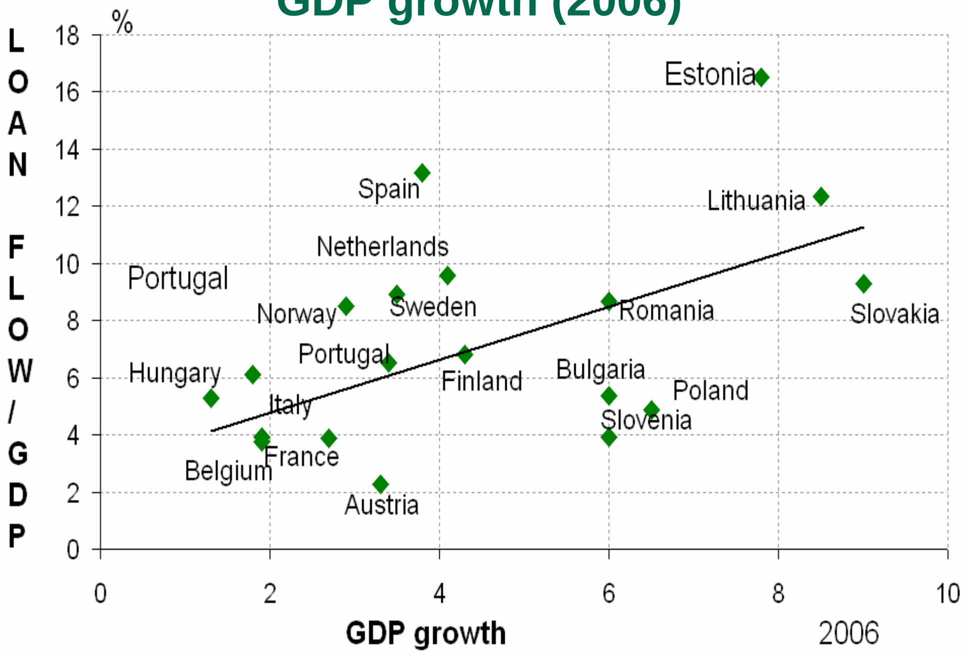


- The equilibrium level of household indebtedness can be close to western European average (60% of GDP)
  - Same members on the banking market, with the same product portfolio
  - Same banking regulation
  - Similar household behavior (life cycle hypothesis)
- And convergence in penetration can be very fast (Spanish, Portugal example), with very high household loan flow, and permanently low savings capacity

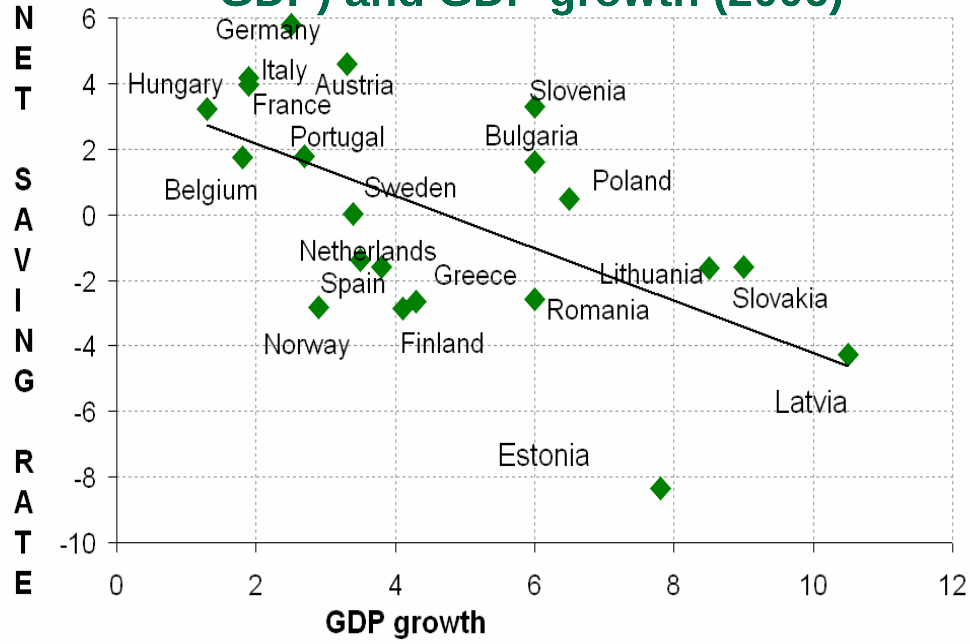
Source: National Banks, Eurostat

Household loan flow to GDP ratio is higher, net savings are lower where growth is strong

Retail loan flows (in pct. of GDP) and GDP growth (2006)



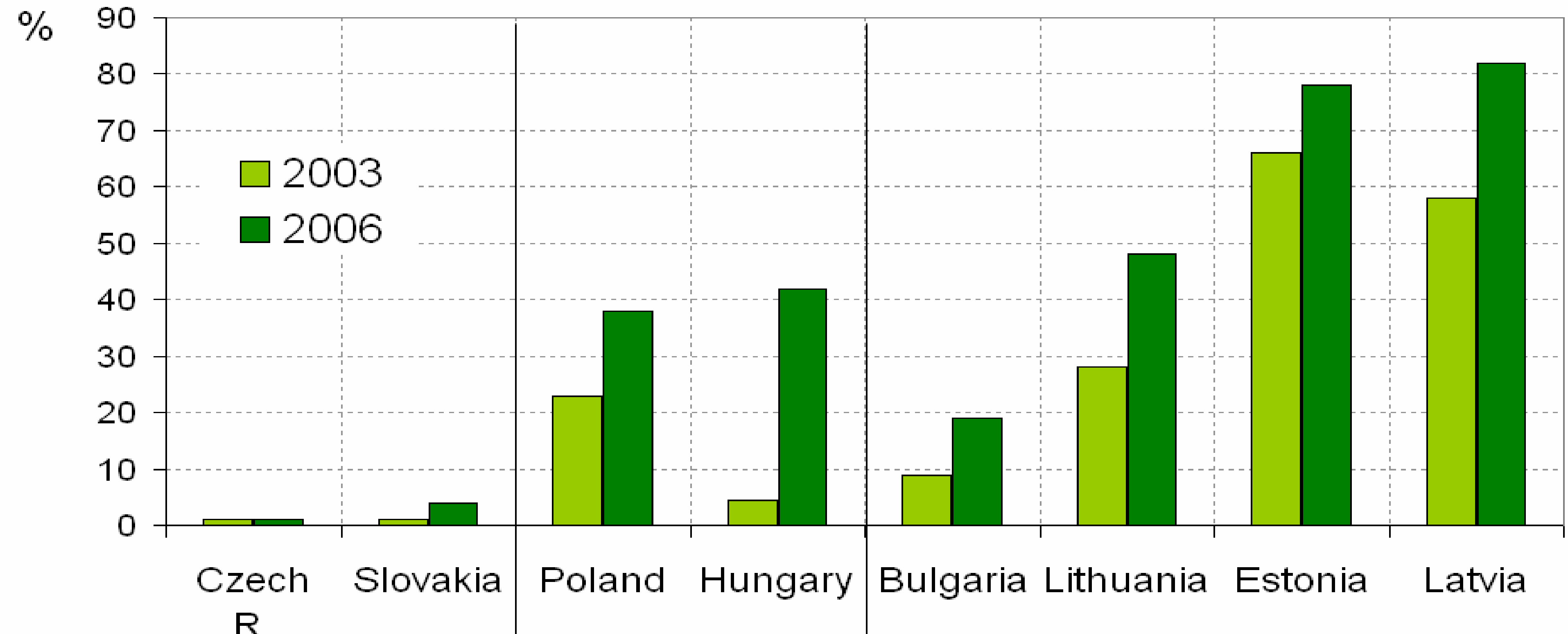
Net savings of households (in pct. of GDP) and GDP growth (2006)



Source: Eurostat

High interest rate spreads and fixed currency regimes are the main factors behind household FX debt accumulation

Share of retail FX loans (%; 2003, 2006)

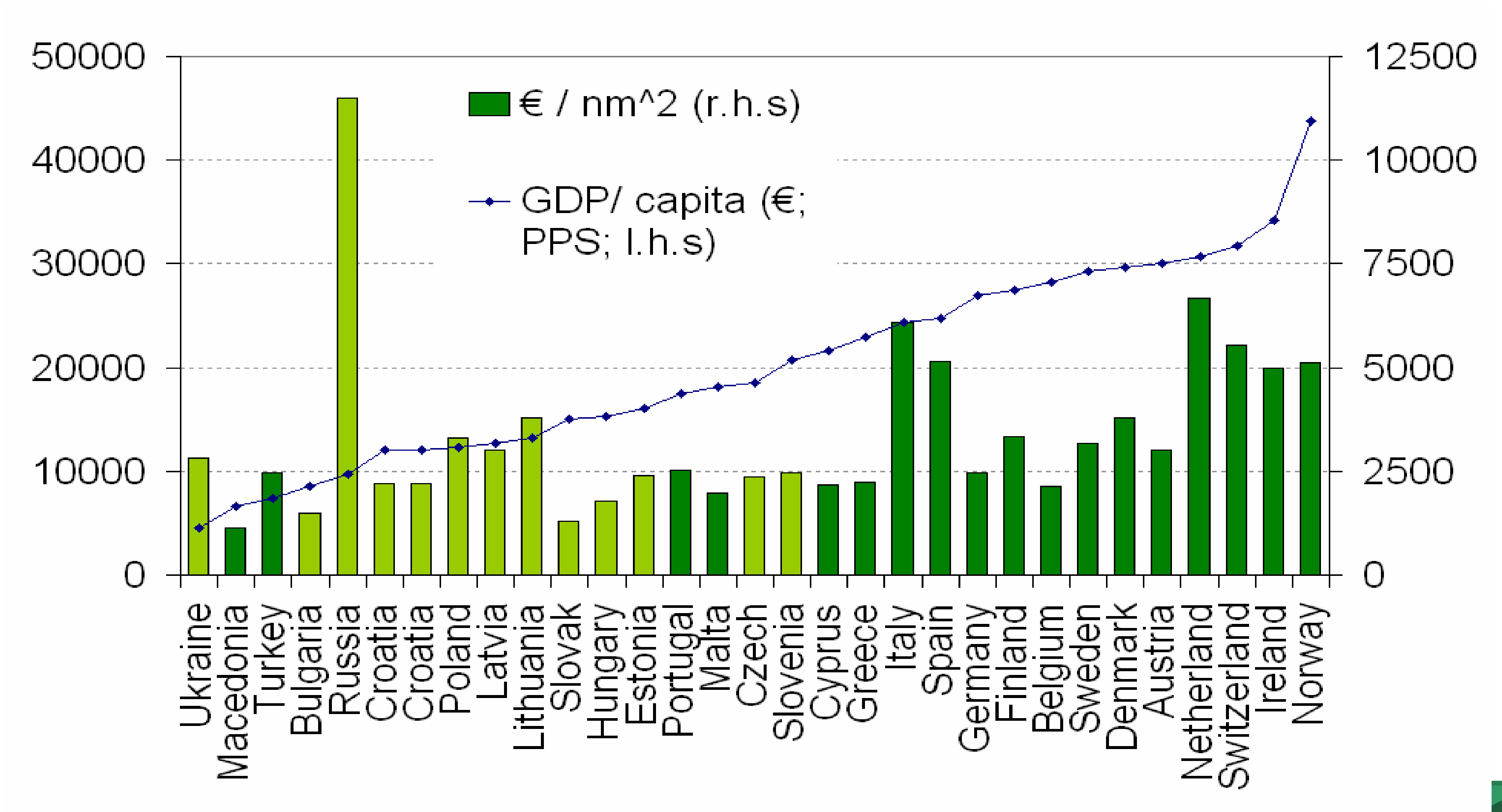


	Czech R.	Slovakia	Poland	Hungary	Bulgaria	Lithuania	Estonia	Latvia
exchange rate regime	flex.	flex.	flex.	flex.	fix.	fix.	fix.	fix.
Spreads*	low	low	>100bp	200bp<	>100bp	200bp	200bp	200bp
Inflation**	2.2	3.0	2.0	5.1	7.0	4.1	5.1	7.9

Data source: National banks

- Difference between interest rates of local currency and Euro mortgage loans
- HICP

Real estate prices and GDP / capita



Source: Global Property Guide

Average price of a 120 nm^2 apartment in the city of the most important city of each country

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Increase in credit demand resulted in a sharp increase in financing requirements of the regional banking sector

Retail and corporate credit – deposit flows (EUR bln.)