HOLD ASSET MANAGEMENT

QUARTERLY **INSIGHTS**

HOLD ASSET MANAGEMENT — THE CENTRAL-EUROPEAN VALUE-BASED EQUITY SPECIALIST

I. COVID19 RESISTANT CEE BANKS

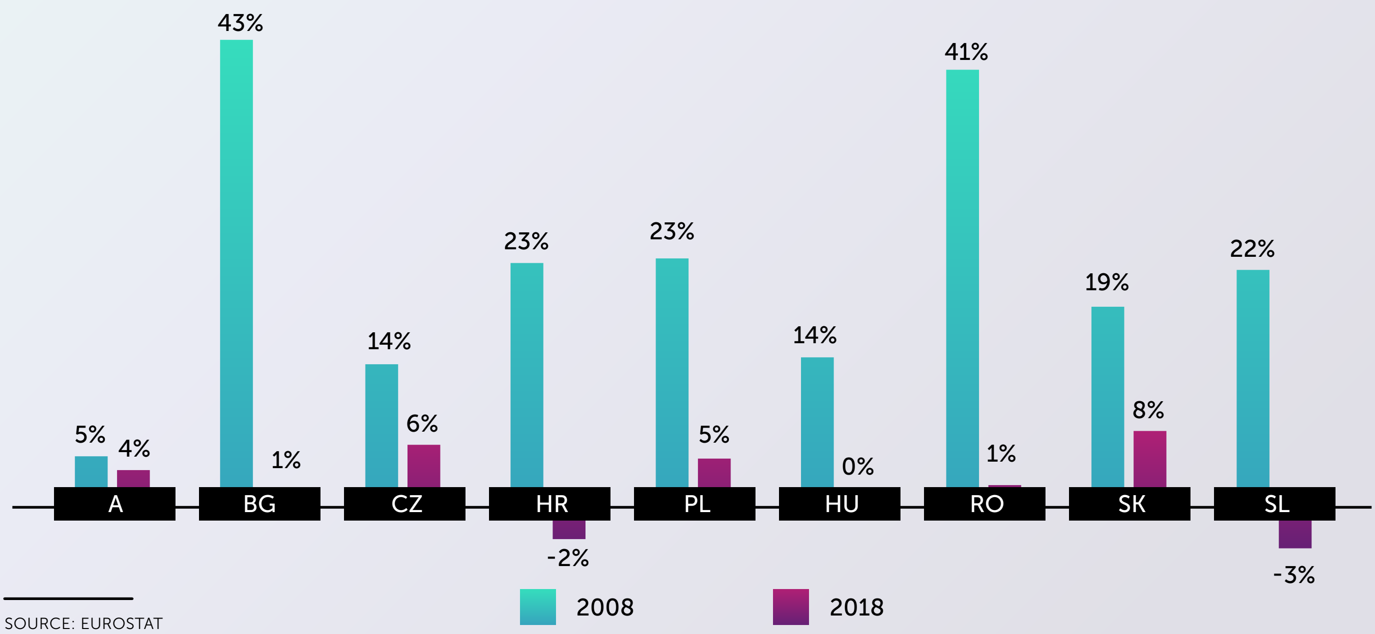
The Great Financial Crisis of 2008 caused major difficulties for banks in the Central Eastern European region. Government bailouts, capital increases and a series of bankruptcies characterized the post-crisis period, which - due to the important economic role of banks - greatly influenced the recovery of CEE economies. However, the current situation is different as the crisis is milder, the economic environment is healthier and banks are much better prepared.

II. CURRENT ECONOMIC ENVIRONMENT IN CENTRAL EASTERN EUROPE MUCH MORE ROBUST THAN IN 2008

NO EXCESSIVE CREDIT GROWTH IN THE YEARS PRIOR TO COVID-19

The banking systems of most CEE countries are in a more favorable position to weather the current crisis than they were in 2008. By comparing the average regional credit growth rate of prior three years in 2008 vs 2018 it is clear that credit growth has been drastically lower in the latter period.

CAGR OF LOANS OUTSTANDING (LAST 3 YEARS PRIOR TO GIVEN YEAR)

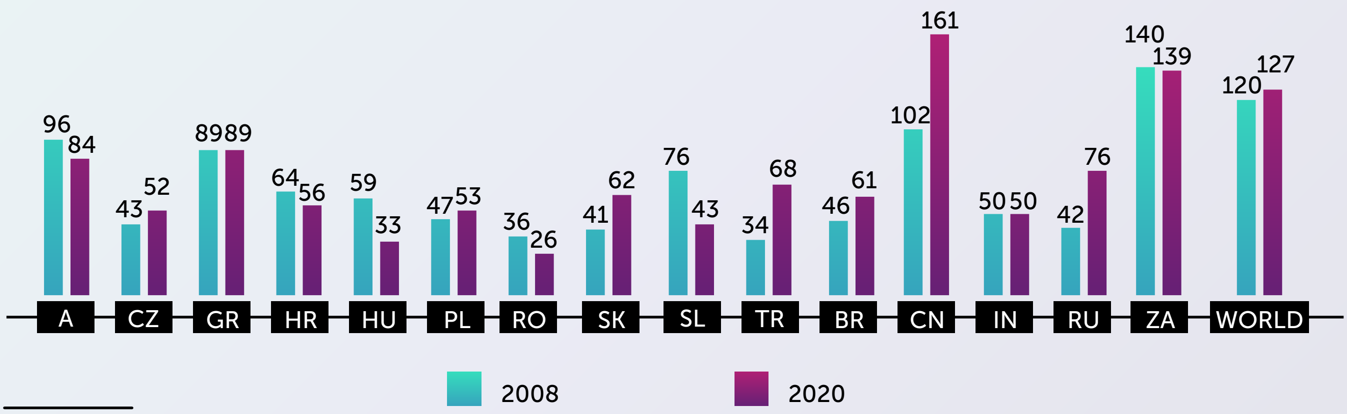


SOURCE: EUROSTAT

LOWER INDEBTEDNESS

The loan to GDP ratio has declined or remained stable in most CEE countries. No sign of a staggering growth before the coronavirus crisis hence the outlook is much more favorable in this respect. By comparison the picture in BRICS countries is quite different as domestic credit to private sector as a share of GDP increased notably.

DOMESTIC CREDIT TO PRIVATE SECTOR (% OF GDP)



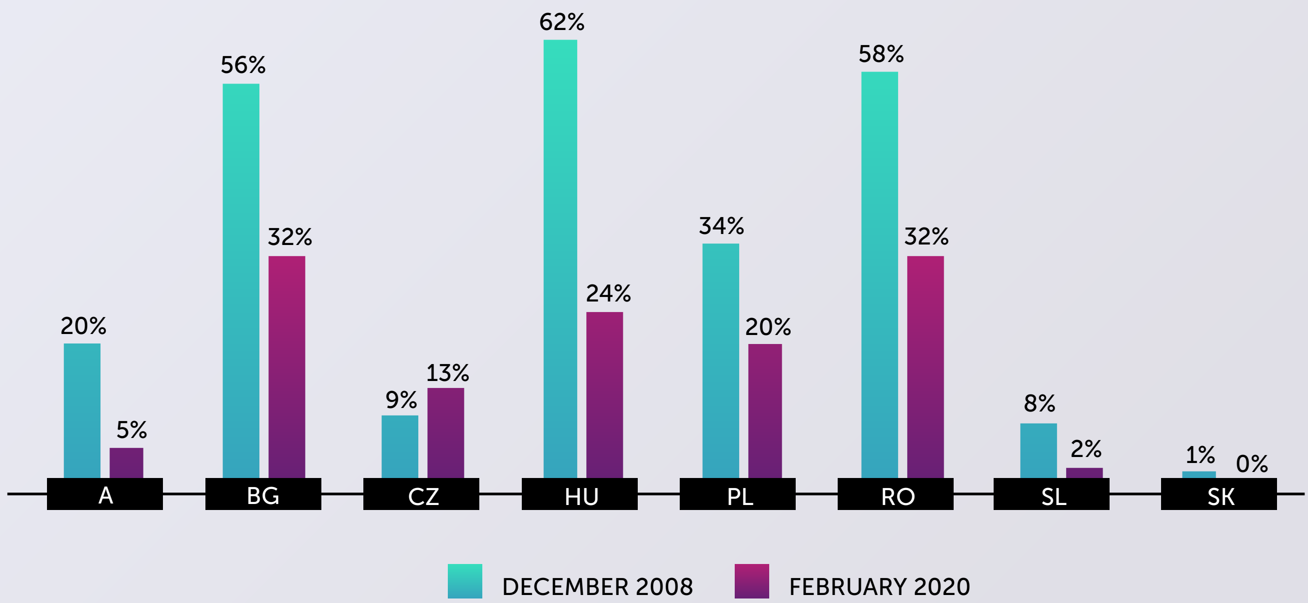
SOURCE: INTERNATIONAL MONETARY FUND, INTERNATIONAL FINANCIAL STATISTICS AND DATA FILES, AND WORLD BANK AND OECD GDP ESTIMATES

LESS FOREIGN CURRENCY LOANS OUTSTANDING

Many companies operating in EM countries were indebted in foreign currency before COVID-19 hit. These types of loans pose a significant FX risk in the event of a sudden economic contraction. Among Emerging Market economies CEE countries with the exception of Turkey are in a significantly better position.

In the previous crisis, the vulnerability of the banking systems of some CEE countries was largely due to the fact that the private sector was indebted in foreign currency. As a result during the last decade FX lending has been reduced or eliminated altogether in household loans and nowadays only utilized in the corporate sector. Lower outstanding levels of FX loans greatly reduces the vulnerability of the banking sector making the current environment more favorable in this respect as well.

RATIO OF FOREIGN CURRENCY LOANS



SOURCE: ECB

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III. BANKING SYSTEM WELL PREPARED, HIGHER CAPITAL ADEQUECY RATIOS

In response to GFC in 2008 an international regulatory agreement (Basel III) was reached thereby introducing a reform package to regulate the banking sector and to improve overall supervision and risk management. By adopting the new regulation banks operate with lower leverage hence ensuring that they become more resistant to negative shocks. On the other hand Basel III has not only made the system more strict but at the same time also more flexible. During soaring end-of-cycle economic environments banks must adhere to stricter requirements, however as a result in time of crises the framework is more lenient. In good economic times Basel III forces banks to reserve capital, which provides cover in bad times when losses are more likely.

RESILIENT BANKS

Higher capital adequacy ratios should imply that banks are less risky. The farther we look back the more difficult it is to compare data as regulations have changed considerably. Additionally, the definition of capital and the way total risk exposure is calculated has changed over the years. However, if we were to compare the asset / capital ratio with 2008 levels it is clear that the banking system today has less leverage. On top of that the definition of capital has become stricter so we should only see an even more marked difference in this respect. Furthermore the higher share of government securities on bank balance sheets and the debt brake rules introduced by the local regulator, which limit risk-taking at the level of individual loan contracts, suggest that assets are also less risky. Thus CEE banks take less risk per unit of capital, which is why the CEE banking systems are now more crisis-proof than they were in 2008.

ASSET TO EQUITY MULTIPLE (CONSOLIDATED BANKING LEVERAGE)

SOURCE: EUROSTAT

FLEXIBLE REGULATORS AND SUPPORTIVE GOVERNMENTS

Most governments in Central Eastern Europe actively assist and support banks. Additional capital requirements for banks are waived, guarantee schemes are set up to support SME lending, which in turn will limit the riskiness of these loans. The payment moratorium is in fact good not only for customers but also for banks as it is not in the interest of any bank to book a loan loss on a good standing client with temporary financial difficulties.

IV. CONCLUSION

It is likely that the current crisis will have a negative impact on the profitability of regional banks. However, the expected shorter-term duration of the crisis, a well-balanced economic state and greater preparedness all point to a moderate impact on CEE banks. Of course there will be a number of banks suffering losses resulting in capital increases or a need for state aid but nevertheless these are smaller banks that were already having capital adequacy issues before the crisis. In individual cases the general flexibility and efficiency of individual banks play a major role as banks with a large cost base, such as one with a large branch network, are in a more difficult position. However, there is no reason for a general bank panic at all. Large CEE banks, which are over-represented on regional stock markets are well prepared to weather the storm.

TOTAL DEBT OF NON-FINANCIAL BORROWERS IN SELECTED EMES[1]

OUTSTANDING DEBT OF NON-FINANCIAL CORPORATES (NFCS, % OF GDP)

[1] The data in the BIS total credit statistics are based on national financial balance sheet accounts for those countries that compile these data. For others (ID, IN, MY, SA, TH and ZA), the BIS's estimates sum cross-border and domestic bank credit, and do not capture non-bank creditors' holdings of debt securities for CN and RU, credit from non-banks is also inculded. See Dembiermont et al (2013)

SOURCE: NATIONAL DATA, BIS TOTAL CREDIT STATISTICS