



NPL Europe

Issue 2 | June 2010

Welcome to Issue 2 of *NPL Europe*, a publication covering non-performing loan (NPL) markets in Europe and the United Kingdom (UK).

It has been nine months since publication of the last issue of *NPL Europe*, during which much has changed and much has remained the same. Gross NPLs in all countries covered in this issue increased by over 25 per cent and as highlighted in Table 1, many by as much as 50 per cent. But despite this huge growth in volume, NPL and non-core transaction volumes remained low, disappointing investors. Although there is no shortage of supply, the main obstacle remains price and level of bank provisioning.

One major change observed is that investors claiming to have money and chasing NPL and non-core portfolios are back in force. The big question is how much this money costs and for how long can it be put to work. In most cases, NPL portfolios and to a lesser extent non-core portfolios are illiquid assets and require an investment horizon of at least three to four years. Experience over the last nine months suggests investors are pricing portfolios with the aim of getting their money back with a healthy IRR within two years.

On the bank side, in almost all countries the provision coverage of NPLs has decreased despite increasing levels of NPLs and non-core assets, indicating that banks may be underestimating their defaulted assets. In addition to this, there is evidence some banks are still using historical values for underlying collateral. Should updated appraisals be performed, collateral valuations will likely decrease, bringing further strain on loan to value covenants. The result is that the uncollateralised portion of the NPLs and sub-performing loans is being understated. The flow-on impact of this would be that the loan loss provision (LLP), which is applied to the uncollateralised portion of the loans, may also be understated.

Given the above, investors and banks will need to work together to reach a compromise on pricing deals which adequately shares portfolio risks and rewards. There are now 10 European markets with NPLs of over EUR5 billion, which means there are plenty of

opportunities to put this into effect. A key question over the next six to nine months is whether funding and collateral values will stabilise or even begin to increase enough to align the pricing of both buyers and sellers.

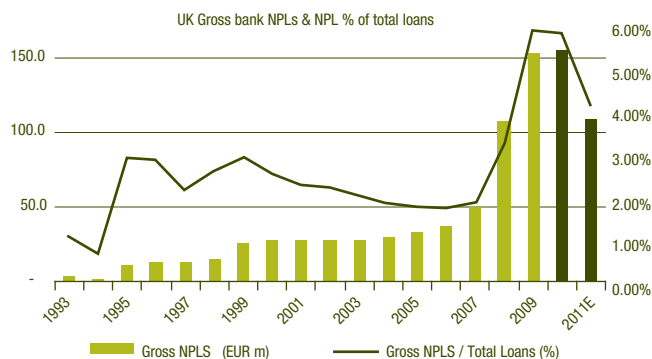
Table 1: Estimated quantum of NPLs by country at the end of 2008 and 2009

EUR in billions	2008	2009	Diff	Source
Germany	141.7	212.6	50%	Annual Financial Statements, Bankscope, BaFin, Deutsche Bundesbank, Financial Stability Review 2009 and PwC estimate
United Kingdom	107.1	155.1	44.8%	Broker Reports and Financial Statements
Spain	75.4	96.8	28.4%	Bank of Spain
Italy	42.1	59.0	40.1%	Bank of Italy, ABI
Russia	10.1	22.1	118.7%	Central Bank of Russia
Greece	12.5	20.3	62.4%	Bank of Greece, Financial Statements
Romania	7.2	10.9	52.0%	NBR Buletin lunar December 2007, December 2008 and December 2009
Turkey	6.4	10.0	55.3%	Banking Regulation and Supervision Agency
Poland	7.6	10.8	43.0%	Polish Financial Supervision Authority
Ukraine	0.2	5.6	2477.6%	Association of "Ukrainian credit-banking union"
Czech Republic	2.8	4.3	55.2%	Czech National Bank
Hungary	2.2	4.3	96.2%	Supervisory Board of Financial Institutions
Slovenia	1.8	2.7	52.7%	Bank of Slovenia
Croatia	1.6	2.3	44.7%	Croatian National Bank
Slovakia	0.4	1.6	305.1%	Slovak National Bank
Serbia	0.6	1.3	103.1%	National Bank of Serbia

United Kingdom

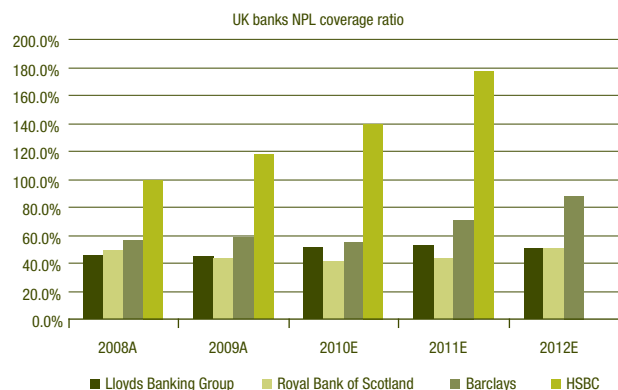
Non-performing loans in the United Kingdom continued to rise in 2009, as evidenced in the table below.

Table 2 – NPL portfolio development for key UK banks (in EUR billions)



Sources: Broker Reports and Financial Statements. Note that the majority of the balances determined using data from four major UK banks (Lloyds Group, HSBC, Royal Bank of Scotland and Barclays).

Table 3 – NPL coverage for key UK banks (LLP as per cent of NPL)



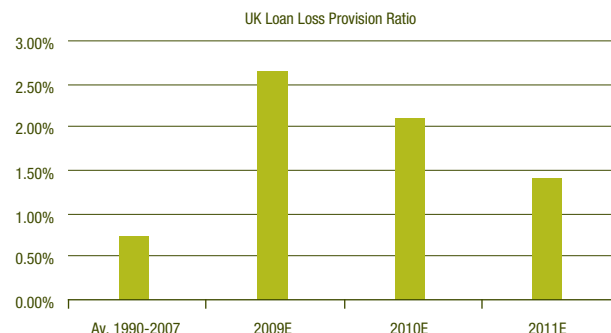
Sources: Broker Reports and Financial Statements. Note that the majority of the balances determined using data from four major UK banks (Lloyds Group, HSBC, Royal Bank of Scotland and Barclays).

Table 3 shows that many of the larger UK banks are maintaining relatively low NPL coverage ratios, with the exception of HSBC. This would suggest that from an Income Statement perspective, the banks have little room for discounting NPLs through a sale. Other factors will need to be included to justify a discount such as capital and resource costs.

Overall asset quality to improve in 2010

Given the wider macroeconomic improvement, overall asset quality is expected to improve in 2010 as rates of new defaults decrease in the second half of the year (see Table 4 below). However, as evidence that hard work is still ahead for many UK banks, we expect that the number of accounts in arrears will not revert to historical levels in the near future.

Table 4 – UK Historical Loan Loss Ratio



Source: Credit Suisse-Pan European Banks: Jagdeep Kalsi, 24 February 2010

Despite an overall increase in NPLs during 2009, some of the extreme predictions regarding the level of asset deterioration have failed to materialise. However, most UK banks, including those in Table 3 above, do have significant exposure to the UK commercial and residential property markets and are therefore subject to fluctuations in provision levels relative to changes in collateral values (i.e. the uncollateralised exposure).

Mortgage arrears lower than expected

A lower than anticipated level of mortgage arrears has been driven by a smaller than predicted increase in UK unemployment, which had been expected to peak at 10 per cent. It has only reached 7.8 per cent¹, up from 6.4 per cent in 2008². A similar trend can be observed in the level of consumer credit defaults. Continued record low benchmark interest rates have underpinned the lower unemployment levels.

Compared with the recession in the early 1990s, corporate insolvencies have also increased at a lower rate than expected³, even though the decrease in GDP has been much sharper than at any other time in the UK's post war history. This is attributable to a number of factors, the most obvious being the sizeable and immediate intervention of the Bank of England through its GBP200 billion quantitative easing scheme. There has also been an increased reluctance among banks to make formal appointments, instead favouring loan extensions with the hope that future economic circumstances will stabilise and prompt loan repayments.

1. UK Economics Weekly: Capital Economics, 8 March 2010

2. www.tradingeconomics.com

3. Bank of America Merrill Lynch "Life after trough earnings", Michael Helsby (Research Analyst), 3 February 2010

Limited deal closures

Since the inaugural issue of *NPL Europe* only a limited number of transactions have closed in the UK. However there have recently been some significant closures that include those listed below.

Seller	Buyer	Asset Type	Face Value (GBP)	Completion Date
Citibank	Pending	Residential Mortgages PLs / NPLs	ca. 3 billion	TBA
GMAC	US fund	Residential Mortgages PLs / NPLs	> 550 million	Q3 2009
Citibank	SAV Credit / Varde Partners	Credit card	> 800 million	Q1 2010
Credit card provider	UK DCA	Unsecured NPLs	> 200 million	Q1 2010
GMAC	US fund	Residential Mortgages PLs / NPLs	> 600 million	Q1 2010
Credit Suisse / Oakwood	US fund	Residential Mortgages PLs / NPLs	50 million	Q2 2009

Source: PwC market research

Government intervention and funding shortages limit UK NPL activity

A number of factors prevalent in the first half of 2009 continued to impact the level of NPL and loan sale transactions during the second half of the year. These were:

- Government intervention, either through capital injections, the Asset Protection Scheme or initiatives aimed at protecting the borrower and stemming foreclosures. To an extent this has shielded larger financial institutions from the full impact of their loan arrears and limited the number of forced NPL and PL (performing loan) sellers to foreign or smaller non-bank lending institutions. Further, UK banks subject to EU/regulator restructuring programs are yet to fully implement the required programmes. As such, non-core asset disposals are unlikely to pick up until 2011.
- The UK consumer NPL market continues to be constrained by a shortage of funding, from debt finance in particular, and the pull-back of several key players. Combined with the challenges some UK debt collection agencies (DCAs) have experienced in collecting previously acquired portfolios, this has led to a smaller number of active buyers and a sharp reduction in transactions compared with previous years.
- The relatively low level of provisions held by UK banks and building societies against distressed and non-core assets has meant that despite the bid/ask spreads narrowing since early 2009, many institutions remain unable or unwilling to absorb any losses from a sale. This is understandable given the speed of increasing arrears/non-performance when compared with provisioning guidelines. However, in some instances the full cost of holding these loans to maturity has not been taken into account when considering transactions, particularly from a capital perspective.

UK the most likely source of NPL deals in 2010

For the remainder of 2010, the key question remains: how will the economy react to the withdrawal of government support and any post election austerity measures? Certain leading house price indicators pointed to renewed weakness in February property prices⁴, and as such distressed investors still believe the UK will produce the greatest number of opportunities in 2010⁵. An increased level of transactions coming to the market is expected as a result of:

- Improved credit conditions and the slow emergence of the UK economy from recession. This has improved investor confidence in relation to collateral values and timelines to recovery, and is gradually being reflected in higher bid prices.
- Commercial real estate refinancing deadlines, estimated at around GBP120 billion over the next few years⁶. Commercial real estate lending in the UK is estimated to be close to GBP200 billion and has suffered considerably since 2007. Research by HSBC has shown that roughly 85 per cent of loans made to the sector in the last five years are breaching covenants and that commercial real estate prices could fall by a further 16 per cent in 2010⁷. Anecdotally, the pressure created by these loans on banks' financial statements, regulatory capital and work-out resources has been considerable, making it an area in which many would gladly seek to reduce their exposure.
- The new coalition government elected in May could look to withdraw its support by focusing efforts on reducing the UK deficit and decreasing debt as a percentage of GDP. This is expected to increase liquidity pressures in the market.
- Other drivers impacting the UK financial services industry, such as ongoing pressure on, and consolidation within, the Building Society sector is likely as a result of relatively poor asset quality, lack of expert resourcing, limited access to capital and a forthcoming need to repay under the Bank of England's Special Liquidity Scheme.
- The exit of foreign banks from the UK in order to focus on core markets continues. Several major U.S. and European financial institutions have recently disposed of non-core asset portfolios, and the trend is likely to continue, particularly as European banks (especially German, Dutch, Belgian) seek to implement restructuring plans focused on their home markets.
- UK banks beginning the process of unwinding their non-core assets and businesses due to pressure from European and UK stakeholders. Of the UK banks, RBS has to date been the most proactive in this regard with the disposal of several non-core businesses in 2009–2010. Further restructuring and disposals are likely to follow.

4. *UK Economics Weekly: Capital Economics*, 8 March 2010, Referring to the Nationwide and Halifax indices recording house price drops in February

5. *Debtwire: European Distressed Debt Market Outlook*, January 2010

6. *Bank of America Merrill Lynch "Life after trough earnings" – Michael Helsby (Research Analyst)*, 3 February 2010

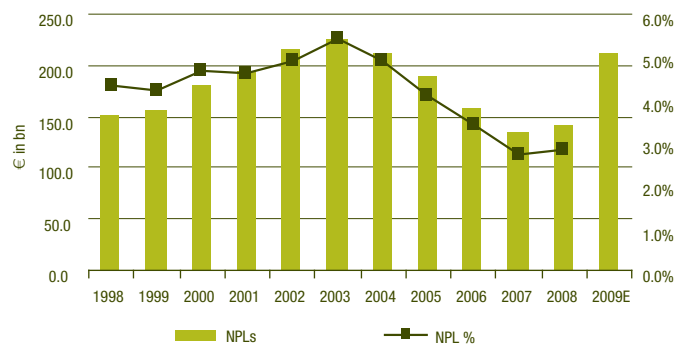
7. *Telegraph.co.uk, Graham Ruddick, "Will Dubai's problems affect the UK property recovery?"*

NPL volumes

Based on information contained in financial statements of the largest German banks, NPLs and write-downs grew significantly during 2009 and many expect this to peak mid 2010⁸. Deutsche Bundesbank indicated in its Financial Stability Review 2009 that additional write-downs on loans of EUR50 billion to EUR75 billion will be necessary as a result of both macro and micro economic factors in 2009⁹. It is numbers like these that make the German banking market one of the most interesting and attractive markets to international investors.

In table 5 below, 2009 NPL volumes are an estimate based on movement in the loan loss provision and gross NPL volumes for a sample of banks covering 75 per cent of total assets in Germany. Based on these estimates, NPLs in Germany could be as high as EUR200 billion (using a 34 per cent growth rate) to EUR220 billion (using a 50 per cent growth rate) at the end of 2009.

Table 5 – NPL portfolio development in German market

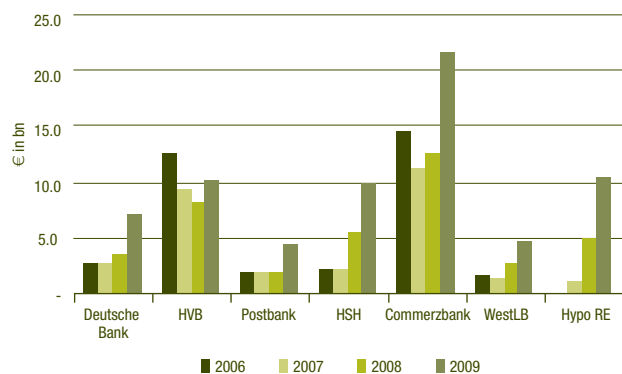


* As we could not find publicly available NPL levels for the entire German market in 2009, estimated growth rates were applied to the remaining portion of the 2008 NPL estimate (EUR142 billion) from BaFin. A growth rate of 34 per cent was derived from the movement in LLP for a sample of banks in 2009 covering 75 per cent of total assets in German banks. A growth rate of 50 per cent was derived from the movement in NPLs for the same sample of banks.

Source: BaFin, Financial Statements, Bankscope, and Deutsche Bundesbank, Financial Stability Review 2009, November 2009

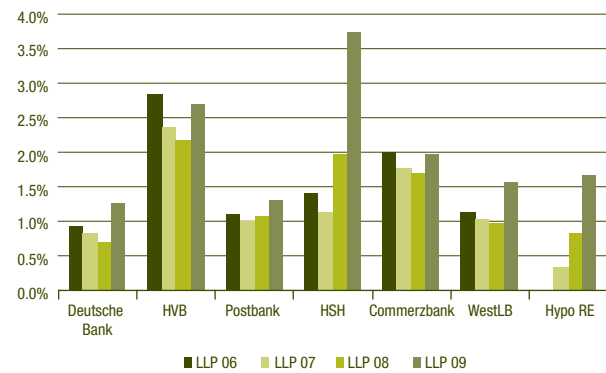
The tables below show the NPL and loan loss provision development for some key banks in the German banking sector. NPL volumes for the entire German banking sector at the end of 2009 were not available at time of publication. The table below shows that all the key banks depicted experienced significant portfolio deterioration during 2009.

Table 6 – NPL portfolio development for key German banks (in EUR billions)



Source: Financial Statements 2009

Table 7 – LLP ratio development for key German banks (LLP as per cent of loans)



Source: Financial Statements 2009

As with many other markets, the major factors that drove the level of NPLs in the German market during 2009 were the increase in company insolvencies and consumer defaults. In the first six months, business insolvencies rose 14.8 per cent¹⁰. The average default loss was EUR1.15 million compared to EUR750,000 in 2008.

Recent NPL activity and changing regulatory environment

Despite the above mentioned trends, feedback from a number of German bankers suggests that they do not feel pressure to sell German non-core assets or NPLs at current pricing levels. Instead, there is a belief that they have adequate levels of capital and internal resources to service loans internally.

Key reasons for this are:

- The direct capital injections that many German banks received during 2008/09 have resulted in the main banks having capital adequacy ratios above 10 per cent; and
- Hybrid debt securities being classified as Tier 1 capital which do not dilute the ownership structure of the bank. As a result of these measures there were very few, if any, notable NPL deals in Germany during 2009 that were reported publicly. We are, however, aware of the following NPL transaction that closed in December 2009.

Seller	Buyer	Asset Type	Face Value (in EUR millions)	Completion Date
BAG Bankaktie- ngesellschaft	Colony Capital LLC	Commercial real estate loans	61.2	December 2009

Internal restructuring units versus bad banks

Many German banks spent most of 2009 performing an internal review of balance sheet assets and, as a first step, separated non-performing and/or non-core activities. They then determined how the organisation of the bank needed to be changed in order to reflect the spike in NPLs and also the identification of assets in jurisdictions and markets which had been deemed non-core. Therefore, considerable volumes of

8. Deutsche Bundesbank, Financial Stability Review 2009, November 2009, page 11 + 60
9. Bundesvereinigung Kreditankauf und Servicing, Homepage as of 24 February 2010
10. Germany Special Report – German Landesbanken: Facing an Uncertain Future, 21 September 2009, page 3



non-strategic loans and NPLs were transferred to in-house restructuring units or flagged as non-core and in 'run off' phase. One such example is Commerzbank, which created a Portfolio Restructuring Unit that seeks to centralise the management of its non-performing loans, including acquired assets from Dresdner Bank.

In contrast, some banks like Bayern LB, HSH Nordbank and LBBW may be in the process of considering or establishing an external bad bank pursuant to § 8a of the amendment to the Financial Market Stabilisation Act (FMStFG)¹¹. This law enables banks to set up 'bad banks', where they can transfer the toxic securities and/or non-core assets. These bad banks would refinance toxic assets by issuing state-backed bonds to the parent bank.

However, the immediate liquidity and stability advantages of the scheme need to be weighed against disadvantages. Such disadvantages include the state now having influence over business decisions (including salary levels and future strategy), meaning potential future losses would have to be borne by existing shareholders. In our view, once assets are transferred there is limited pressure on 'bad bank' managers to dispose of the assets quickly and crystallise losses. As a result, in the short to medium term, the realisation strategy for transferred assets is most likely to be internal 'work out' and selected sales.

To date, two German banks (both predominantly state-owned) have set up or are in the process of establishing an external bad bank:

Bank	Transferred assets	Face value (in EUR billions)	Completion Date
WestLB ¹²	High risk and non-strategic assets including non-performing loans	Approx. 80	April 2010 with retrospective effect to 1 January 2010
Hypo Real Estate AG	Toxic securities and non-strategic assets including real estate loans	210	Second half 2010

A further complication in the current German environment is the SME market and capital injections German taxpayers have given a number of banks. It is widely understood that SME businesses are a key driver of the German economy and therefore of its GDP. As such, there appears to be some incentive for banks to support the SME sector by way of loan restructuring and deferrals. Based on default rates in the SME segment, we would have expected it to be an area where banks would be looking to reduce exposure. However, this may not happen in the short term.

NPL transaction outlook

It is not all doom and gloom for the German NPL market. Since the start of 2010, a number of German banks have entered into discussions with investors in preparing portfolios of mixed performing and non-performing assets to bring to market. Our understanding is that the key asset classes banks are looking to discuss are residential mortgage, corporate secured and shipping. An important issue here will be pricing and reaching agreement on the value of the underlying collateral.

For this reason, we believe German banks seek strategic partners that are able to offer them reasonable prices and can take over the operational servicing of the portfolios. This will most likely be achieved through structured deals negotiated with a limited number of serious investors that have access to capital and a proven track record for working out distressed/non-core assets. The portfolios are in the billions of EUR and we expect a number of these transactions in the second half of 2010.

11. Tagesschau "HRE beantragt riesige Bad Bank", 21 January 2010

(<http://www.tagesschau.de/wirtschaft/badbank154.html>). Zeit Online:

"HRE beantragt gigantische Bad Bank", 21 January 2010

(<http://www.zeit.de/wirtschaft/unternehmen/2010-01/hre-bad-bank?page=all>)

12. WestLB: "WestLB's Shareholders Approve Transfer of € 85 Billion Portfolio to Workout Entity" 11 December 2010 (http://www.westlb.de/cms/sitecontent/westlb/westlb_de/en/wlb/ui/news/newscontainer/news_2009/PR_20091211_standard.gid-N2FkNDZmMzU4OWFmYTlyMWM3N2Q2N2Q0YmU1NmI0OGU_.html)

Spain

Limited transactions

The sale of a non-performing residential mortgage portfolio in August 2009 signalled the first sign of the reactivation of the NPL market in Spain. Since then, the number of sell- and buy-side mandates has been increasing steadily and so too has the number of potential transactions coming to market. Since the last edition of NPL Europe, only three additional transactions have actually closed. These are listed in the table below.

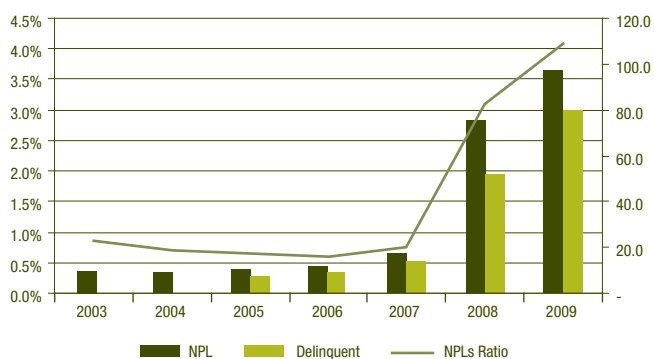
Seller	Buyer	Asset Type	Face value (in EUR millions)	Completion Date	Comment
Confidential	Confidential	NPL Resi	20	Feb 2010	PwC advised on sell-side
Caja Madrid	Confidential	Consumer	150	Dec 2009	No advisor
Confidential	Confidential	Residential Mortgage	60	August 2009	PwC advised the seller
GMAC	Confidential	NPL Resi	300	July 2009	No advisor

Source: Market Feedback

Key reasons why transactions failed

The main reason for failed transactions continues to be the difference in pricing expectations between buyers and sellers, as well as the impact of Bank of Spain's relaxation of provisioning requirements for certain secured loans in July 2009. The Spanish economy continued to deteriorate, with GDP shrinking 3.8 per cent in 2009 and unemployment reaching 19 per cent, which resulted in a 38 per cent increase in the level of NPLs from 2008 to 2009 (see table 8 below). Given these macroeconomic factors and increasing costs for Spain, Portugal and Greece in accessing the capital markets, it seems unlikely the pricing gap can remain much longer.

Table 8 – Development of delinquent and doubtful loans from 2003 to 2009 (in EUR millions)



Source: Bank of Spain

Several regulatory changes have been approved or have taken effect since August 2009, primarily affecting secured loans. The most significant changes have been:

- Bank of Spain's relaxation of the provisioning requirement for certain secured assets in July 2009. This means provisions are now calculated based on the difference between the loan exposure and 70 per cent of the latest appraisal value of the guarantee (rather than the total book value of the loan as before). The result is generally a lower provisioning level for affected assets (refer to Annex 9 of the BdE Circular 2004/9 for details).

- In Q4 2009, Bank of Spain introduced an additional provisioning requirement that requires all financial entities to provide at least 30 per cent against the value of any foreclosed assets on their balance sheet for more than a year.
- The approval of the FROB (Fund for the Restructuring of the Banking sector) by the Spanish government, which is intended among other things to promote consolidation of the banking sector. Several mergers are already underway between the Savings Banks (cajas) as a result of this and most, if not all, are considering the incorporation of non-core asset and distressed debt disposals into their integration plans, with the two-fold objective of strengthening their balance sheets and optimising liquidity. The additional funding provided by FROB means these entities should be more willing to accept a P&L loss in exchange for the liquidity injection.
- Funding from the European Central Bank, which has been forthcoming in support of the Spanish banking sector to date, is due to decrease significantly in the near future. As such, banks and cajas will need to identify alternative funding sources. The funding shortage is further compounded by the narrow interest margins and high level of competition for deposit-taking currently faced by all financial institutions.

The cumulative impact of these market organisation and regulatory capital changes should become an additional incentive for cajas to dispose of their non-core assets, be they secured or unsecured.

Defaulted unsecured consumer portfolios

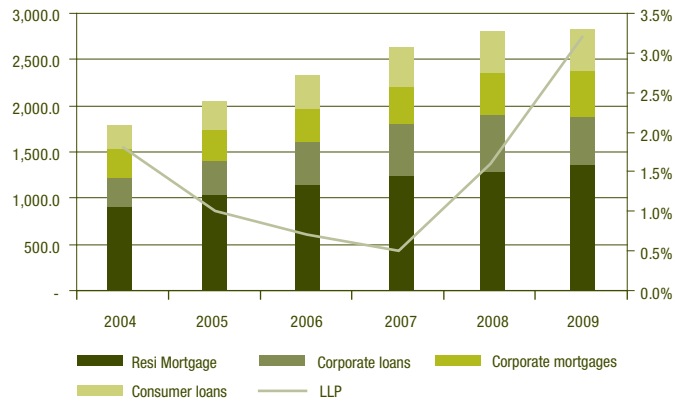
In terms of unsecured assets, there has been little impact from the regulatory changes, but they continue to be attractive portfolios for sale as they are typically 100 per cent provisioned. As a result, any proceeds go straight to the bottom line of the P&L.

In our opinion, a mixed portfolio of secured and unsecured assets (the secured assets being partially provisioned and the unsecured 100 per cent provisioned) would currently be the most attractive option to financial institutions, as any proceeds from the sale of unsecured assets could be used to offset potential losses on the secured assets.

Denmark

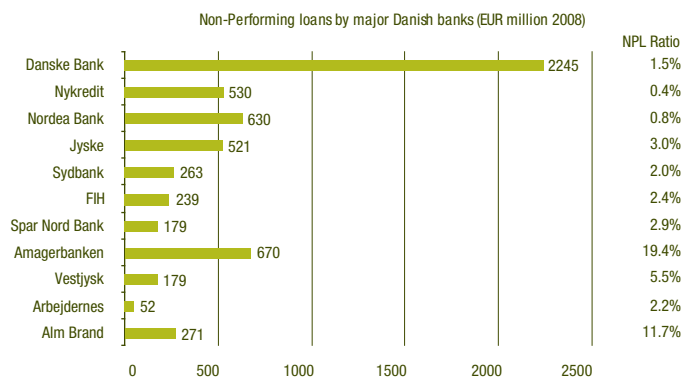
Denmark is a modern market economy featuring high-tech agriculture; a technologically advanced SME and corporate industry; extensive government welfare measures; equitable income distribution; comfortable living standards; a stable currency and political system; and a high dependence on foreign trade. Over the past two years unemployment has been creeping up but at 6 per cent at the end of 2009 remains low compared to other markets. (Source: Danish Central Bank). Denmark is a net exporter of food and energy and enjoys a comfortable balance of payments surplus.

Table 9 – Development of loan portfolio (DKK in billions) and LLP per cent from 2004 to 2009



Source: Danish Statistics (Statistikbanken), Danish National Bank and Danish FSA

Table 10 – NPL by major Danish Banks in 2008 (in EUR millions)



Source: Annual Reports

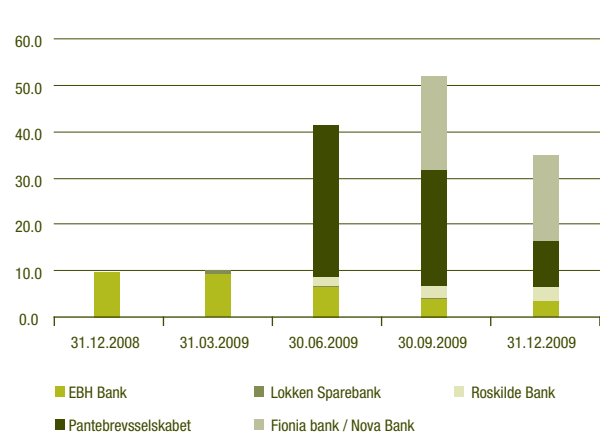
As can be seen from the above charts, as of 2008 Danish banks started to come under pressure from increasing NPLs and LLP percentages. This was combined with rising costs associated with government support (in the form of guarantees and interest on capital injected), as well as potential liquidity shortages. In response, the Danish government established a winding-up company (Finansiel Stabilitet A/S) as part of its first rescue package for the banking industry. Its role is to administer the state guarantee scheme, including winding up distressed banks. To date, Finansiel Stabilitet has taken over six small- and medium-size banks which were impacted by exposures to commercial real estate, developers and new farming operations.

Table 11 below provides an overview of assets which remain under the control of Finansiel Stabilitet. In addition, assets from Capinordic Bank have been added to the portfolio in 2010. Initially, Finansiel Stabilitet was set up to run for three years. We are now 2.5 years into that term, but political agreement has since been reached to extend the life of the organisation as part of a longer term strategy by the government to remove financial support for the financial services sector.

The residential mortgage books of Danish banks were expected to be hit hard in 2009 due to rising unemployment and negative GDP growth. However, extremely low interest rates have kept default rates and foreclosures at relatively low levels.

As a result there have been very few NPL transactions in Denmark during 2009. This was also the case in the unsecured consumer segment, which has historically been active with local legal firms and collection agents acquiring loans direct from banks.

Table 11: Assets under management by the Finansiel Stabilitet (in DKK billions)



Source: Finansiel Stabilitet Annual Report 2009

With unemployment rates expected to rise to 8 per cent in 2010 (Source: Danish Central Bank), continued deterioration in the quality of the consumer loan books of Danish banks is to be expected. This could reinvigorate the currently frozen unsecured consumer NPL sale market. Also, should the EU start to wind back liquidity support measures, the resulting increase in cost of borrowing is likely to be passed onto the Danish mortgage market and could also lead to the deterioration in the mortgage books of the Danish banks originally expected in 2009. It should be noted, however, that some complexities exist in relation to acquiring mortgage NPLs funded by Danish mortgage bonds (also referred to as Realkreditobligationer).

Finally, we also see potential opportunities for non-core asset sales from foreign banks looking to withdraw from the Danish market, and also through the sale of legacy NPLs currently under management by Finansiel Stabilitet.

Italy

Italy continues to be one of the largest but also one of the most difficult European markets for investors and sellers. Most sellers remember and still expect the same asset prices as obtained prior to the onset of the Global Financial Crisis, while many investors are still trying to recover the cost of investments made, let alone achieve a reasonable IRR.

Gross NPLs up 40 per cent

The size of the Italian NPL market, the fact that most sellers have been through sale processes in the past, and a steady increase in the volume of NPLs since 2008, means Italy will always be a key NPL market in Western Europe. During 2009, total gross NPLs in Italian banks increased to EUR 59 billion, up 40 per cent from 2008. This upward trend is expected to continue during 2010 and 2011, with the Italian Banking Association (ABI) predicting NPLs to increase by 27 per cent in 2010 and 9 per cent in 2011, as highlighted in Table 12 below. The majority of this growth is expected to result from real estate and consumer lending, with unemployment rising to almost 9 per cent in 2010, as shown in Table 13.

Table 12 – Development of NPL portfolio from 2006 to forecast 2011 (in EUR billions)



Source: Bank of Italy, ABI

Table 13 – Development of GDP and unemployment rate from 2008 to forecast 2011

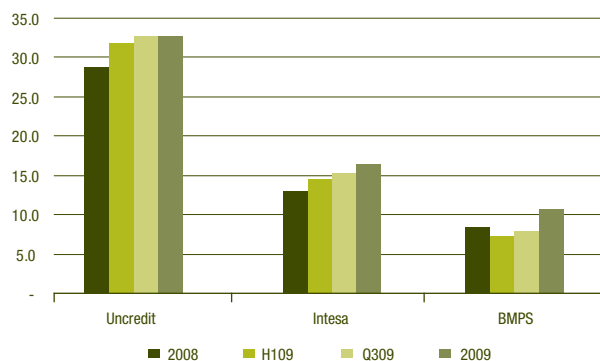


Source: Bloomberg

NPL coverage ratios

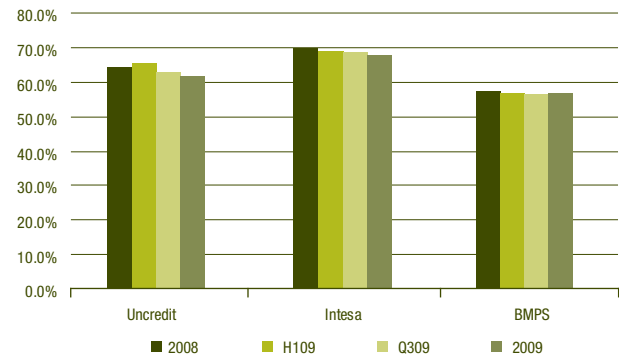
Despite the significant portfolio deterioration experienced by Italian banks during 2009, a number of financial institutions have managed to maintain NPL coverage ratios at or around 60 per cent of gross NPLs. In the examples shown below, despite increasing value of NPLs, average ratios have only changed marginally over the same period. With portfolios expected to continue to deteriorate over 2010, it will be interesting to see whether the coverage level is maintained.

Table 14 – Development of NPL portfolio from three key banks (in EUR billions)



Source: Financial Statements

Table 15 – Development of NPL coverage ratio from three key banks



Source: Financial Statements

Since the last issue of NPL Europe, we are only aware of one NPL transaction (outlined below), which is extremely low given total market NPLs increased by almost EUR17 billion in 2009.

Seller	Buyer	Asset Type	Face Value (in EUR millions)	Completion Date
Cross Factor S.p.A	Agathos Finance Srl	Consumer loan	6.7	20/10/2009

Fundamentals appear to be returning

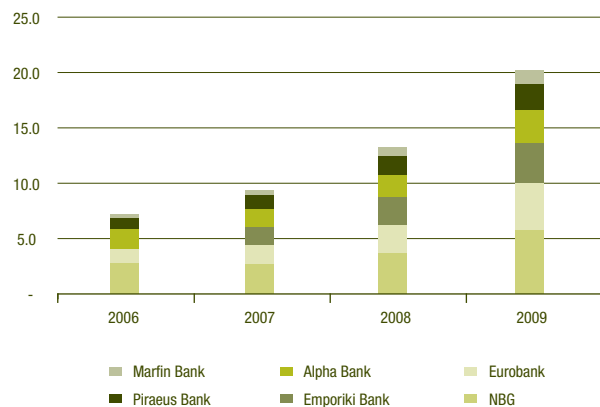
Despite such a low transaction level, we are starting to see some signs of recovery in the Italian economy and therefore expect to see more NPL activity during 2010. After a long period of inactivity, a number of lenders are testing the appetite of investors for NPLs. However, feedback is that sellers still believe prices are too low and for loans that are backed by real estate, the lengthy legal process investors need to go through before they can claim title to the underlying assets is seen as a big negative. Despite this, some international players, both incumbent and new entrants, are showing renewed interest in Italian assets – a positive sign for the NPL market.

Another important consideration for Italian banks is exposure to Central and Eastern Europe (CEE). A number of banks, including Unicredit and Intesa, have significant operations in countries such as Hungary, Romania, Russia, Kazakhstan and Ukraine. The micro and macro economic outlook in these countries is concerning, which might encourage the Italian banks to reduce their exposure, either through discontinuing the origination of certain product types (i.e. company leasing in Romania) or sale of non-core assets. We are aware of a number of NPL sale processes currently being discussed, or in progress, by subsidiaries of Italian banks in Romania, Slovenia and Hungary.

Greece

During 2009, total NPLs (defined as the sum of the outstanding balance of impaired loans and advances to customers at the end of the financial year, plus loans and advances not impaired but past due more than 90 days) for the top six Greek banks increased year-on-year by 53 per cent to EUR20 billion. Despite the increase there has been very little activity in the NPL sale market, with banks preferring to manage defaulted loans in-house or by outsourcing collections to agents and lawyers because of minimal interest from international investors at their selling prices.

Table 16 – NPL portfolio development by bank (in EUR billions)



Source: Annual Financial Statements

Table 17– NPL portfolio development by product (in EUR billions)



Source: Annual Financial Statements

Austerity measures and uncertainty

The elections of November 2009 resulted in the Socialist (PASOK) party forming government, and since then the Prime Minister and his team have come under significant pressure to bring Greece's finances back under control. The resulting austerity measures that were passed through parliament on 5 March 2010 and 6 May 2010 have resulted in widespread strikes and demonstrations that have effectively brought the country to a standstill. However, ultimately the continued monitoring of Greece by the International Monetary Fund (IMF) and support of the EU should help settle market volatility and improve the competitiveness of Greece.

In the short term, VAT increases and wage reductions of up to 20 per cent in the public sector (which accounts for some 52 per cent of Greek employment) will considerably reduce domestic consumption and household wages, most likely resulting in future deterioration in the loan portfolios of Greek banks.

Since coming into power, the PASOK government has drafted two pieces of legislation which may have a considerable impact on the value and recoverability of NPLs. The first was passed into law on 19 January 2010 and relates to SMEs. It allows debtors to force creditor banks to enter into restructuring negotiations with SMEs that defaulted since 1 January 2007, or that are current but experiencing financial difficulties. The second piece of legislation, which is still in draft, relates to a new consumer bankruptcy regime. There has been significant concern about the possible moral hazard implications of the regime and impact the law will have on the functioning of the financial system. The European Central Bank (ECB) has highlighted both concerns in its response to the Greek Government¹³.

Despite still being in draft form, our discussions with local banks and collection agencies indicate the legislation has already had significant impact on collections, liquidity and capital in October and November 2009, when borrowers mistakenly thought it would reduce their overdue debts by 90 per cent. Although collections appear to have recovered somewhat in 2010, investors continue to factor in significant discounts for market risk while the draft remains in circulation. It is for these reasons that the unsecured consumer NPL portfolio brought to market by Emporiki Bank at the end of 2009 has not yet traded. On a positive note, both the ECB (24 April 2010) and IMF (May 2010) issued papers which specifically refer to the draft consumer bankruptcy legislation and state that it needs to be consistent with market best practice, avoid moral hazard, and take into account the existing relationship between debtors and creditors to ensure legal certainty. We believe as a result of these papers it is unlikely the legislation will be passed in its current form, which should help to ease investor concerns.

Seller	Buyer	Asset Type	Face Value (in EUR millions)	Completion Date
Emporiki Bank	n/a	Unsecured Consumer	110	In progress

Unemployment and consumer portfolios

There is no publicly available information on any NPL portfolios coming to market in the next six months. However, the NPL ratio for all major Greek banks is expected to increase significantly during 2010 due to deteriorating economic conditions in Greece and a number of CEE countries to which most Greek banks have material exposures. With S&P's recent downgrade of Greek government debt to BB+, we would expect ratings for local Greek banks to also be impacted, which will further increase liquidity pressure.

This, coupled with an unemployment rate which according to the European Commission is expected to increase to 11.8 per cent by the end of 2010, up from 9.5 per cent at the end of 2009, could open the door for investors to form servicing relationships (i.e. joint ventures) with Greek banks in order to inject liquidity and leverage off the banks' existing servicing platforms. There has also been increasing speculation the current Greek crisis will prompt consolidation within the financial sector which may also prompt non-core or non-performing loan sales.

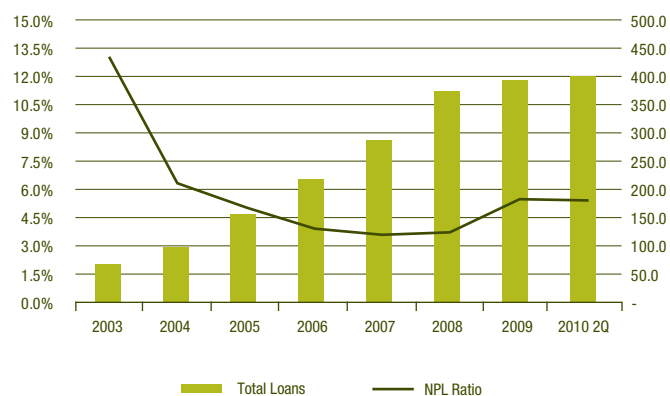
13. ECB website: <http://www.ecb.int/ecb/legal/date/2010/html/index.en.html?sk=ECB/2010/1>



Banks post positive growth, NPLs rise

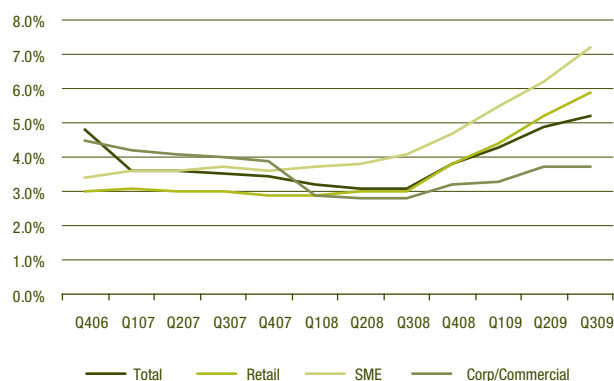
During 2009 the Turkish banking industry recorded remarkable profits exceeding TRY20 billion (USD13.2 billion), as total system loans grew by 7 per cent and banks had strong earnings from trading bonds. During 2009 and the first two months of 2010, the NPL ratio of the Turkish banking system continued to escalate and reached 5.4 per cent in February 2010 (up from 5 per cent in June 2009), as shown in the table below. NPL growth was primarily driven by SME and retail customers, which has put a strain on the operating capacity of the banks due to a jump in the number of files that need tracking for these classes of NPLs.

Table 18 – Development of loan portfolio in Turkish market (in TRY billions)



Source: Banking Regulation and Supervision Agency (BRSA)

Table 19 – NPL ratio development by key product type



Source: Banking Regulation and Supervision Agency (BRSA)

NPL portfolio transactions from August 2009 exceed USD1 billion

Total NPL portfolio sales of listed banks have more than doubled compared with the first half of 2009, exceeding a face value of USD1 billion. The table below is a list of the key NPL transactions that occurred during 2009. PricewaterhouseCoopers assisted Is Bank with its successful portfolio sales during 2009.

Historically, the Turkish NPL market has been dominated by corporate portfolios, however since June 2009 many banks, including Fortis and Yapı Kredi, have successfully sold unsecured consumer portfolios in response to a sharp increase in defaults. The fact the portfolios were traded successfully is a positive sign to other potential sellers that the Turkish investment community is comfortable with the servicing options for this new class of NPL assets.

Seller	Buyer	Asset Type	Face Value (in USD millions)	Completion Date
Akbank	Girisim Asset Management Company	N.A.	326	5 January 2010
Fortis	LBT Asset Management Company	Retail Credits & Credit Cards	116	1 December 2009
T. İş Bankası	Standard Asset Management Company	N.A.	186	30 November 2009
T. İş Bankası	LBT Asset Management Company	N.A.	38	16 November 2009
Akbank	Girisim Asset Management Company	N.A.	337	12 September 2009
Yapı Kredi	Girisim Asset Management Company	Retail Credits & Credit Cards	394	28 May 2009

Source: Press Releases

Turkish banks have a comparatively strong capital base and high provisions

Turkish banks have comparatively strong capital positions of around a 20 per cent capital adequacy ratio, which means a decision to sell is primarily driven by operational capacity constraints rather than a need to increase liquidity. In response to the increasing level of delinquent accounts, Turkish banks continued to increase their NPL provision coverage ratio during 2009 and 2010, with the sector's coverage ratio increasing to 84 per cent in February 2010. As evidenced in the table below, most of the key private banks in Turkey are well provisioned compared to peers in other jurisdictions.

Table 20 – NPL portfolios of key Turkish banks

in TRY billions	Total Loans	NPLs	Provisions	NPL Ratio	Provisions Coverage Ratio
İs Bankası	52.7	2.8	3.0	5.0%	100.0%
Akbank	44.6	1.8	1.8	4.0%	100.0%
Garanti Bank	53.0	2.3	1.8	4.3%	81.4%
Yapı Kredi Bank*	37.8	2.6	1.8	6.9%	70.6%
Vakıf Bank*	33.2	2.2	1.9	6.5%	91.3%

Source: Banks' own financials by 31.12.2009 for Akbank, T.İs Bank and Garanti

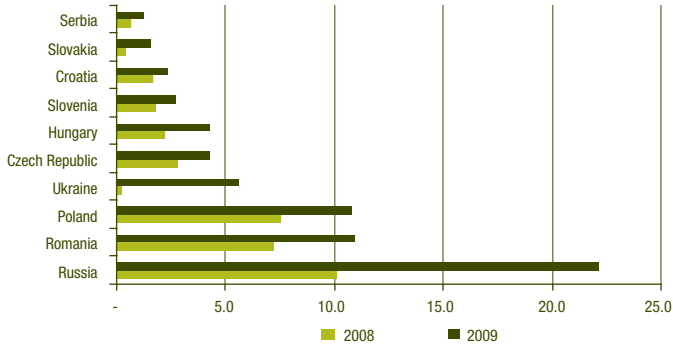
* 3Q2009 results for Yapı Kredi and Vakıfbank

With market conditions and pricing dynamics improving, we expect banks to bring additional SME, retail and credit card NPL portfolios to market during 2010.

Central and Eastern Europe

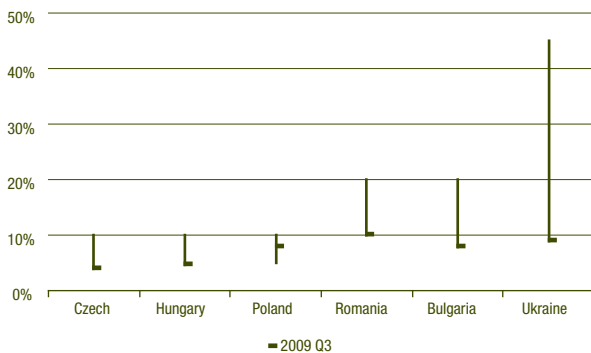
During 2009, many CEE countries experienced currency devaluation and the banking industry was impacted by relatively lax underwriting policies borne out of the competitive banking landscape that existed from 2006 to 2008. As a result of these factors and an inability to refinance debt at the same low interest rates, many people and businesses were not able to repay their debts, which were often denominated in foreign currency. The steep growth in the level of NPLs across CEE can be seen in the table below.

Table 21 – NPL development 2008 and 2009 (in EUR billions)



Source: National central banks and regulators

Table 22 – Cost of the bankruptcy proceedings (as per cent of estate)



Source: Broker Research, forecasts DBR as of 20 August 2009

Restructuring and workout results

As a result of these factors CEE banks have found themselves in a difficult position. With limited restructuring and workout experience to draw from internally, and with parent banks engrossed with problems of their own, CEE banks have had to find their own way of dealing with the spike in consumer, SME and corporate defaults. Our experience is that the results have been mixed and in most cases have simply deferred the problem by making deals with borrowers, rather than restructuring the debt position of the borrower. This is anecdotally supported by the fact that there have been relatively few corporate failures in CEE when considering the macroeconomic deterioration and funding squeeze.

A couple of positives for CEE banks in 2009 were that consumers continued to save and also continue to believe that investing in real estate is not only safe, but is also a way to accumulate equity capital. This has provided banks with a steady source of cheap funds and to an extent stabilised the CEE property market, to which many banks outside CEE have heavy exposure.

Slow and painful recovery

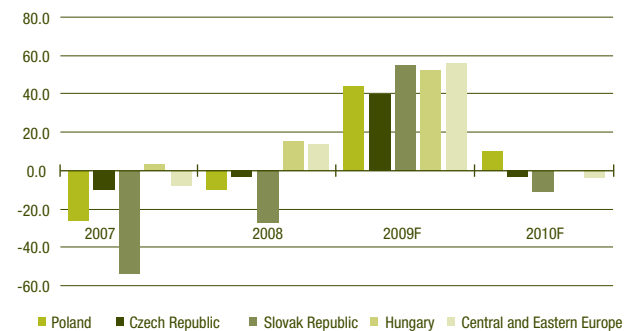
With unemployment forecast to increase across the region and corporate insolvencies remaining at the same level or higher than in 2009, economic recovery in CEE is likely to be slow, painful and place considerable strain on internal workout teams.

Table 23 – Macroeconomic considerations for retail portfolios

Macroeconomic indicators	2009E	2010F	2011F
GDP per head (US\$ at PPP)			
Romania	11,810	12,100	12,630
Czech Republic	24,840	25,430	26,410
Poland	18,040	18,780	19,580
Hungary	18,840	19,010	19,840
Croatia	17,660	17,730	18,430
Slovenia	28,030	28,250	29,390
Slovakia	20,880	21,700	22,610
Unemployment Rate (av; %)			
Romania	6.0	8.5	8.8
Czech Republic	8.1	10.8	9.7
Poland	11.0	12.0	11.1
Hungary	10.0	11.4	9.6
Croatia	16.0	14.9	13.7
Slovenia	9.4	9.2	8.5
Slovakia	11.4	13.0	11.8
Exchange Rate (av; %)			
Romania	4.24	4.05	4.18
Czech Republic	26.55	25.90	25.10
Poland	4.33	3.88	3.83
Hungary	280.60	278.00	275.00
Croatia	7.44	7.41	7.35

Source: EIU

Table 24 – Annual percentage change of corporate insolvencies



Source: Euler Hermes - Insolvency Forecast 2010

Ukraine

Ukraine changes to tax law encourages NPL portfolio trades

In the Ukraine, many banks were rolling over NPLs during 2009 partly because of negative tax incentives on write-downs. This legislation was changed in the fourth quarter of 2009. The impact of such portfolio management is that the official NPL statistic of 9.6 per cent at the end of 2009 is most likely understated. The IMF estimates that at the end of 2009, NPLs in Ukraine amounted to around 30 per cent.

In the last quarter of 2009, the Credit Collection Group estimated that unsecured consumer NPL sales amounted to over UAH 2 billion (EUR 170 million), at an average price of 10 per cent of face value. We understand that Pravex-Bank, ING Bank Ukraine, Credit Europe Bank, Index-Bank, SEB Bank, OTP Bank, BTA Bank, Kredobank, Renaissance Credit, Unicredit Bank and Platinum Bank all undertook NPL sale transactions and in most cases the portfolios were sold to local collection agents.

Croatia

Croatia LLP coverage rising

In Croatia, loan growth in 2009 was 2.4 per cent, driven by a 47 per cent increase in state-related loans (from HRK 21.5 billion to HRK 31.5 billion). This was due to a significant increase in the country's budget deficit. Meanwhile, retail loans decreased 3.9 per cent (from HRK 122.7 billion to HRK 117.9 billion) because of increased credit risk awareness among larger banks. Corporate loans remained stable (from HRK 94.1 billion to HRK 94.8 billion).

The country has also seen significant deterioration in the loan quality, with the LLP rate for the sector increasing from 2.4 per cent at 31 December 2008 to 3.3 per cent at 31 December 2009. At a sub-segment level, LLP for retail loans increased from 2.5 per cent to 3.5 per cent (primarily driven by unsecured consumer loan defaults) and LLP for corporate loans increased from 2.9 per cent to 4.4 per cent.

Slovenia

Slovenia average loan maturity decreases

Total loans in Slovenia increased 3.8 per cent in the period January 2009 to September 2009, but demand for housing loans fell sharply in early 2009 and then stagnated, putting pressure on prices. This trend was also observed in consumer goods purchases, reflecting a steep decline in consumer confidence. During the period, Slovenian banks significantly tightened their underwriting policies and reduced the average maturity of loans being written for corporate and SME customers, making it more difficult for them to roll over obligations. This resulted in a spike in corporate insolvencies and the level of NPLs.

Czech Republic

Total banking sector assets increased by 1.2 per cent in 2009, reaching CZK 4,092bn on 31 December (Source: Czech National Bank). Following a period of double-digit growth from 2005 to 2008, loans increased by less than 1 per cent year-on-year at the end of 2009, with loans to households the main contributors to this growth.

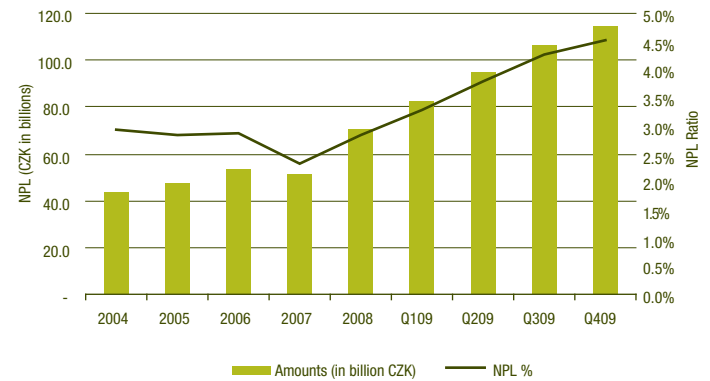
Bank liquid assets, corporate insolvencies up

According to the Czech National Bank, the banking sector recorded no significant liquidity problems in 2009 and there is no change to this expected in 2010. The value of liquid assets rose by more than 11 per cent in 2009 and its share of total banking sector assets also increased year-on-year. Sufficient primary funds are available to finance the banking sector's transactions; with the volume of client deposits increasing 3.2 per cent in 2009.

The Czech banking sector is dominated by three banks which together account for more than 71 per cent of total banking sector assets: Ceska Sporitelna a.s. (Erste Bank Sub), Ceskoslovenska obchodni banka a.s. (KBC Group Sub) and Komerčni banka a.s (Societe Generale Sub).

NPLs (defined by the Czech National Bank as non-standard loans) increased 64 per cent in 2009 or CZK45 billion. Thus, NPLs account for 4.5 per cent of gross loans at the end of 2009, up from 2.8 per cent in 2008. The majority of growth was due to a 40 per cent increase in corporate insolvencies during 2009.

Table 25 – NPL (non-standard loan) development 2008 and 2009 (in CZK billions)



Source: Czech National Bank

Unsecured consumer portfolios

The sale of unsecured consumer NPLs continues to be a popular portfolio management strategy for a number of Czech financial institutions. For this reason there are a large number of legal firms and collection agencies that participate regularly in sale processes. During a recent portfolio sale where PricewaterhouseCoopers acted as advisor to the seller, 15 individual investors (both local and international) showed initial interest in the portfolio.

Seller	Buyer	Asset Type	Face Value (in CZK millions)	Completion Date
Confidential	Confidential	Consumer loans, cash loans	80	March 2010
KB	N/A	Retail loans	Approx. 100	Multiple sales throughout 2009

Source: PwC market research

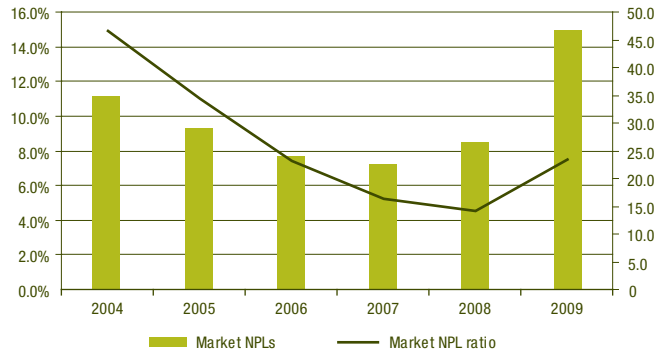
Foreign banks and Czech portfolios

Due to the solid liquidity positions and the fact that the banking sector as a whole generated a net profit of CZK60.2 billion in 2009, it is unlikely the three major banks will come to market with large portfolios of defaulted corporate or real estate loans in 2010. However, some international banks that started to grow their Czech portfolios during the competitive period from 2006 to 2009 could have underwritten riskier loans to gain market share. Therefore, sub-performing non-core assets could be disposed of by international players seeking to discontinue certain products or leave the Czech Republic altogether.

Poland

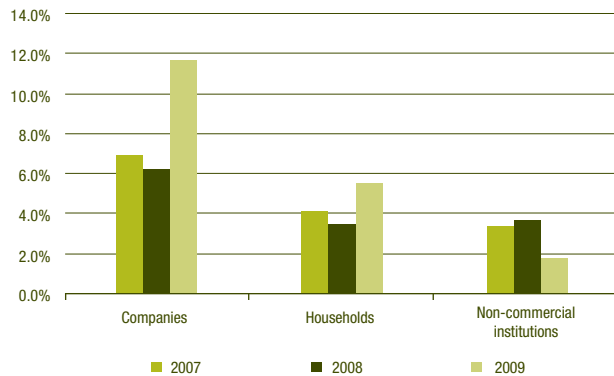
The level of NPLs in Poland increased in the second half of 2009 and into the first half of 2010, primarily driven by company defaults but also consumer NPL growth, as depicted below.

Table 26 – NPL portfolio development in Polish Market (in PLN billions)



Source: PFSA – Polish Financial Supervision Authority

Table 27 – NPL ratio development for key customer groupings



Source: PFSA – Polish Financial Supervision Authority

Consumer NPL sales

Although the Polish NPL market has historically had a corporate focus, it was relatively inactive in 2009. Apart from the Citibank Handlowy transaction, we are not aware of any significant corporate portfolio deals.

Seller	Buyer	Asset Type	Face value (in PLN billions)	Completion Date
Citibank Handlowy	Undisclosed	Corporate Portfolio	0.6	December 2009
ING BSK	Copernicus Capital TFI	Retail portfolio	0.2	2009
PKO BP	Undisclosed	Retail portfolio	0.6	2010

Contrary to this, as a result of a spike in consumer defaults, a number of Polish banks started to bring small consumer NPL portfolios to market. We estimate the combined face value of these consumer NPL portfolios (not listed above) which were sold in 2009 was approximately PLN300 million.

There is also increasing demand for smaller portfolios, driven mainly by local investors that have been able to obtain lines of credit for these types of acquisitions. In addition, there are a number of foreign investors interested in acquiring consumer NPLs in Poland due to the high yields that are sometimes

achievable. Even so, most international investors require a minimum EUR15 million investment for their first portfolio in order to enter the market and justify upfront country and portfolio due diligence and set-up costs.

An additional barrier to entry is that the Novelisation of Investment Funds Act (which regulates activities of securitisation funds and portfolio servicers) obliges servicers to obtain licenses from PFSA, which can be a time-consuming process.

Corporate and household defaults

As highlighted in the tables above, NPLs have increased substantially, primarily in the corporate and household sectors. Despite the increase, banks preferred to hold NPLs rather than sell in 2009, as they still perceive pricing as unattractive. As such, banks tend to create provisions against NPLs over a period of time, rather than realise a loss for the difference between market value and book value via a sale process. The problem is that many banks do not have the internal resources or specialists to adequately service the level of defaults, particularly in the consumer and SME sectors. For these loans, where credit is generally unsecured and the borrower has exposure to multiple banks, time is of critical importance when trying to recover debts. Therefore, failure to adequately service overdue accounts in the early stages of default can result in significant value leakage, which is difficult to recover at a later stage.

Polish companies traded foreign exchange options over the past couple of years and as a result of significant currency fluctuations at the end of 2008 and beginning of 2009, many banks ended up with accumulated FX exposures. Some sought to sell such balances, but the market response was limited, mainly due to the unsecured nature of such receivables.

Corporate working capital/overdraft accounts and personal instalment loans

According to a PFSA report on the condition of the banks (December 2009), the highest share of NPLs for corporate borrowers is in relation to working capital/current account loans, while in the consumer segment it is in personal loans, instalment loans and credit cards. Based on our recent discussions with key Polish banks, including PKO BP, BZ WBK, BGŻ, ING and Fortis, there is a possibility of retail NPL portfolio sales during 2010. BZ WBK indicated that it would also consider SME portfolios as potential targets for NPL transactions. The table below sets out portfolio development from 2008 to 2009 for the top five Polish banks (by total assets).

Table 28 – NPL development of top five Polish banks from 2008 and 2009

Bank	PLN in millions	Dec 2008	NPL ratio (%)	Dec 2009	NPL ratio (%)	Diff (%)
PKO BP	3,784	3.6%	9,108	7.6%	140.7%	
Pekao SA	4,456	5.6%	5,332	6.6%	19.7%	
Citi Handlowy*	1,931	12.1%	2,405	15.5%	24.5%	
ING BSK	502	1.5%	1,165	3.6%	131.8%	
BZ WBK	1,037	2.9%	1,957	5.5%	88.7%	

* - Data at June 2009

Source: Rzeczpospolita

The likelihood of successful NPL and/or non-core asset sales will be mainly driven by the supply side of the market. During 2009, the banks experienced a significant increase in the quantum of NPLs and now have significant backlogs of overdue accounts. Their motivation to dispose of NPL assets will result mainly from operational constraints, but this will need to be matched with pricing that enables them to minimise losses on sale. It is important that when analysing prices offered by investors, banks consider the economic benefits of the sale. These can include the opportunity cost of capital, regulatory capital relief, operational improvements and reallocating staff to early defaults where recovery rates are much higher.

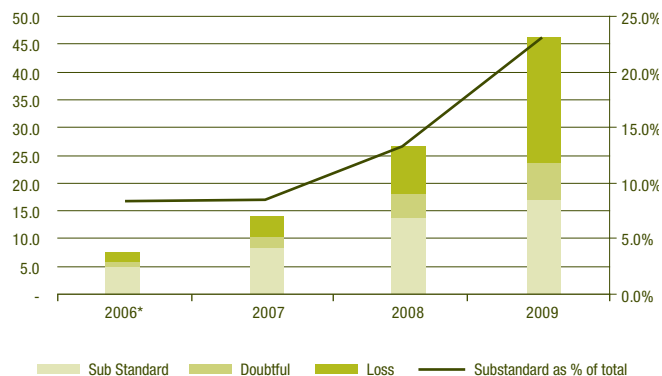
Romania

The Romanian banking sector experienced 14 per cent growth from 2007 to 2009, primarily fuelled by a 28 per cent growth in residential mortgage lending and 12 per cent growth in corporate and consumer finance (see Table 29 below).

Residential mortgage lending fuels portfolio growth

As with many CEE economies, this rapid portfolio growth was facilitated by intense competition between banks for market share. In 2009, the substandard loan value (as defined by the National Bank of Romania (NBR)) reached RON46 billion (gross exposure) compared with RON26 billion at the end of 2008. Delays in debt servicing and defaults were recorded for the most part in SMEs, as well as individual households, at the retail level.

Table 29 – NPL portfolio development in Romanian market (in RON billions)



* - Data at 31 Jan 2007

Source: NBR Bulletin December 2007, December 2008 and December 2009

Table 30 – Development of total exposure by product type (in RON billions)



* - Data at 31 Jan 2008

Source: NBR Bulletin December 2007, December 2008 and December 2009

Quantum of substandard loans

For the first quarter of 2010, a recent NBR survey showed more than 50 per cent of surveyed banks acknowledged moderate to high risk exposure to the construction, retail and industry sectors. In terms of company size, SMEs are considered riskier than other classes.

Two financial institutions brought to market in the first quarter of 2010 approximately EUR70 million in secured corporate and unsecured consumer loans.

Seller	Buyer	Asset Type	Face value (in EUR millions)	Completion Date
Confidential	N/A	SME Leasing	30	In progress
Confidential	N/A	Unsecured consumer	40	In progress

In 2008, Romania had an active unsecured consumer loan sale market. Most banks undertook loan sales during this period and often received prices in excess of 20 per cent of the outstanding balance. Pricing for similar portfolios has now dropped below 10 per cent, which means it remains an endemic problem. Based on historical recovery terms, banks are finding it hard to justify these prices, while investors have seen collections from portfolios purchased in 2008 drop sharply.

Key risk areas

The IMF predicts an increase in credit write-downs and mounting losses on commercial real estate exposure. As a result, in Romania there is increasing concern about an NPL flow-on effect to other asset classes, including mortgage-based assets. According to a recent NBR survey, 42 per cent of surveyed banks expect an increase in risk exposure for consumer loans due to deteriorating customer financial standing (the unemployment rate has increased from 6 per cent in 2009 to 8.5 per cent¹⁴) and decreasing coverage of collateral/guarantees because of falling property prices. In the same survey, 40 per cent of banks estimate long-term demand from companies will be lower for long-term credits and overall retail credit will shrink.

In response to the global financial crisis and the need to address the ensuing exposure to systemic risk, Romanian authorities have initiated a series of legal actions in an attempt to minimise and monitor the development of bad loans. As part of these initiatives, the NBR issued a number of regulations to ensure proper accountability and provisioning levels for substandard loans. NBR Regulation Number 3 establishes, based on overdue bank loan balances, financial performance and going concern estimates for non-lending institutions in a number of risk categories. Most importantly, it also establishes the percentage of each category for provision to total outstanding loans.

A positive initiative taken by the government is in respect to corporate restructuring. New legislation establishing a standard for out-of-court restructuring procedures was issued to provide alternatives to formal in-court insolvency procedures. The aim is to increase the efficiency of corporate restructuring and liquidation procedures, but its effectiveness is yet to be proven.

14. EIU

More pressure on the RON

According to the IMF's World Economic Outlook¹⁵ update in January this year, emerging markets that rely heavily on cross-border funding flows (e.g. Romania) will experience limitations on domestic credit growth as international banks are under pressure from regulators in their domestic market to strengthen their balance sheets and deleverage. Lack of capital inflows will place additional pressures on the domestic currency which, in Romania's case, is expected to deteriorate from 4.24 at the end of 2009 to 4.05 in 2010 (RON:EUR)¹⁶.

Hungary

There was a significant decrease in the level of corporate lending and a moderate decrease in retail lending in the 2009 financial year. The retail sector decrease is mainly due to a decline in car leases/loans. A high proportion of lending in Hungary has been in the Swiss franc (CHF) (primarily to benefit from low interest rates). However as in other CEE countries, a large number of EUR-denominated loans were made which exposed both businesses and individuals to FX risk during 2009 when the Hungarian forint (HUF) depreciated against both currencies. As a direct result, the Hungarian regulator has introduced legislation to limit foreign currency denominated retail lending.

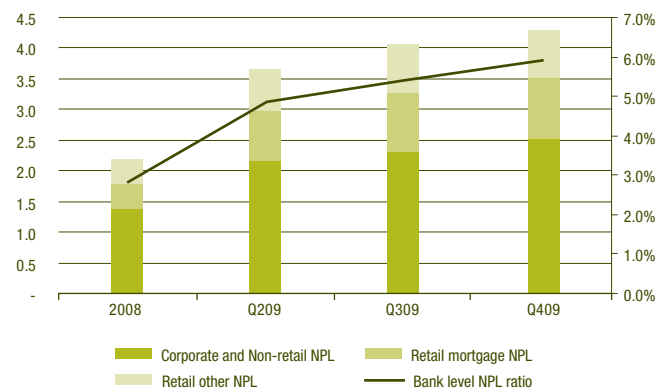
NPLs in Hungary reached EUR4 billion at the end of 2009

Table 31 – Hungarian Banking Sector Loan Portfolio Development

EUR in billions	2008	Q209	Q309	Q409	Diff FY08 to FY09
Bank level total loan	77.4	75.7	75.0	72.4	-6.5%
Bank level NPL	2.2	3.7	4.0	4.3	96.2%
Bank level NPL ratio	2.8%	4.8%	5.4%	5.9%	109.8%
Bank level LLP%	1.8%	2.6%	3.0%	3.6%	
Retail mortgage total loan	15.6	16.2	15.6	15.9	2.2%
Retail mortgage NPL	0.4	0.8	0.9	1.0	144.5%
Retail mortgage NPL ratio	2.6%	5.0%	6.1%	6.3%	139.2%
Retail mortgage LLP%	0.7%	1.2%	1.6%	1.9%	
Retail other total loan	9.5	9.0	9.6	9.4	-0.4%
Retail other NPL	0.4	0.7	0.8	0.8	96.7%
Retail other NPL ratio	4.1%	7.6%	8.1%	8.2%	97.5%
Retail other LLP%	2.9%	5.0%	5.4%	6.0%	
Corporate and Non-retail total loan	52.4	50.5	49.8	47.0	-10.2%
Corporate and Non-retail NPL	1.4	2.2	2.3	2.5	81.6%
Corporate and Non-retail NPL ratio	2.6%	4.3%	4.7%	5.3%	102.2%
Corporate and Non-retail LLP	1.9%	2.6%	3.0%	3.7%	

Source: Hungarian Financial Supervisory Authority

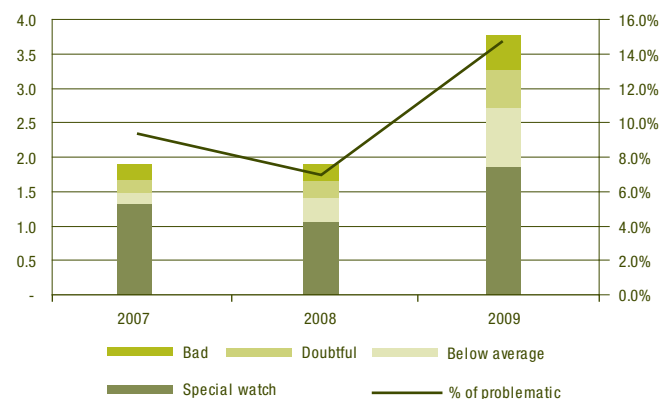
Table 32 – Development of Hungarian banking sector NPL portfolio by product type (in EUR billions)



Source: Hungarian Financial Supervisory Authority

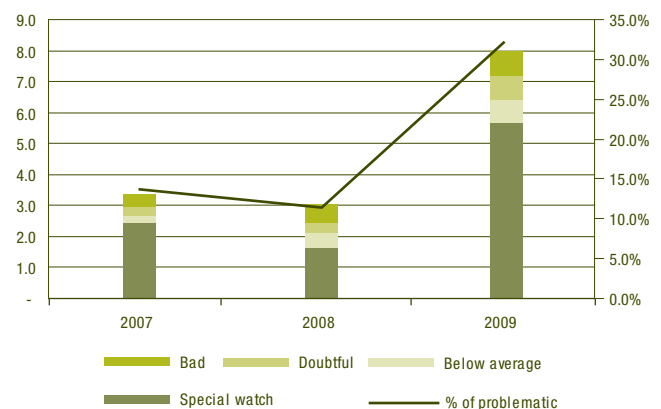
The NPL ratio increased by 110 per cent from 31 December 2008 to 31 December 2009 (EUR2.2 billion to EUR4.3 billion). The majority of NPLs related to a deterioration in the retail segment (EUR0.8 billion to EUR1.8 billion) and the SME segment (c. EUR0.6 billion to EUR1.1 billion) at the end of 2009. Within retail, the worst affected asset class was mortgage loans, where NPLs increased by 145 per cent. A major contributor to this was a deterioration in the Hungarian real estate market. These trends can be seen in the table below.

Table 33 – Development of retail NPL portfolio (in EUR billions)



Source: Hungarian Financial Supervisory Authority

Table 34 – Development of corporate NPL portfolio (in EUR billions)



Source: Hungarian Financial Supervisory Authority

15. International Monetary Fund (IMF), World Economic Outlook, 26 January 2010, www.imf.org

16. EIU, RON : EUR

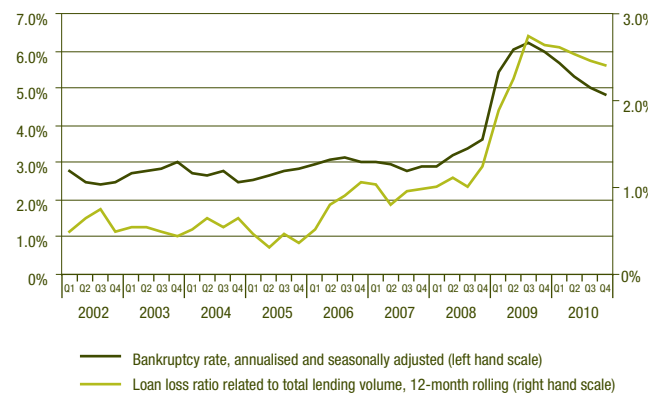


In the corporate sector, the construction industry appears to remain the highest risk. Other heavily impacted sectors include automotive supply, transport and logistics, building material production, car dealers, tourism and catering. As for the loan segments, asset-based financing such as leasing (due to the poor secondary market of the collaterals) and project financing are segments with the highest rates of default.

Liquidations in the SME sector

The increase in the quantum of defaults during 2009 can be seen in the table below. Based on National Bank of Hungary (MNB) forecasts, insolvency rates are expected to ease during 2010. The SME sector is the most critical, as it is where liquidations dramatically increased in the last half-year. This was largely driven by the crisis in the commercial banking sector which saw refinancing options for SMEs dramatically increase in cost.

Table 35 – Corporate credit risk in the banking sector



Source: MNB forecast for 2009-2010

NPL portfolio sale in 2009

During 2009, Intesa brought a significant NPL portfolio to market in Hungary which consisted primarily of defaulted real estate-backed corporate loans. There was considerable interest in this portfolio, however we understand that buyer and seller pricing expectations were not aligned and, to our knowledge, the transaction had not closed at the time of printing.

Seller	Buyer	Asset Type	Face value (in EUR millions)	Completion Date
CIB (subsidiary of Intesa)	TBA	Mixed secured and unsecured corporate	250	In progress

Feedback from investors on this transaction was that there were limited local servicers with experience in servicing and working out corporate portfolios, along with anticipated low realisation values of the underlying collateral.

Based on the above and the following summaries, we believe there will be a burgeoning market in CEE for NPL deals. This is likely to initially be in the continuing development of the consumer NPL space, however, we expect it to move into the corporate area, in particular commercial real estate. Many CEE economies have conducted NPL sales in the past, albeit on a relatively minor scale. In addition, the varying levels of distress across the CEE market will mean some economies move faster than others. We believe the withdrawal of foreign banks from particular products or entire countries will present the most likely near-term opportunities.

In the next 12 months it is expected that the market for distressed investing in the Middle Eastern (ME) region will continue to develop considerably as banks work through their increasing portfolio of NPLs. The ample liquidity available to the majority of Gulf Cooperation Council (GCC) governments has enabled them to provide substantial financial support to their local financial institutions. Compared to other regions, this liquidity allows banks to write off loans and incur losses while still remaining better capitalised. The moderate growth expected in 2010 for some ME countries (for example, 3.3 per cent for Kuwait and 3 per cent for UAE) is balanced with above average growth in others (18 per cent in Qatar)¹⁷. However, with oil pricing still unpredictable, this may test local governments' ability to shield banks from the full effects of the credit crisis.

Expansion of NPLs

As with Europe and the UK, the significant credit expansion experienced since 2003 came to an abrupt halt at the end of 2007 for the ME region. Financial institutions in the region are now experiencing a material increase in both the level of NPLs and corresponding provisions, as shown in the table below:

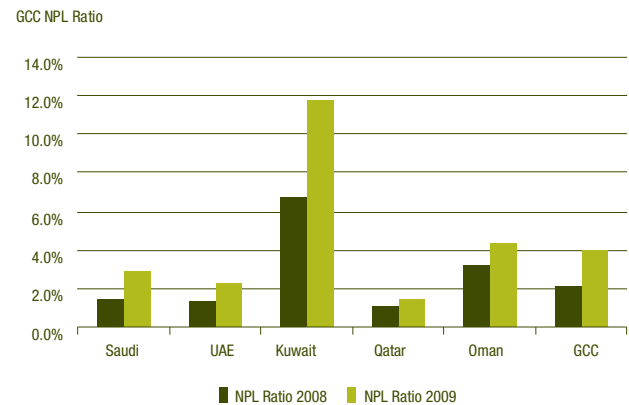
Table 36: Total provisions by GCC banking sectors since 2004 (in USD millions)

USD Mln	2004	2005	2006	2007	2008	9M 2008	9M 2009
Saudi	635	539	616	864	1,394	865	1,775
Kuwait	242	452	456	383	3,082	301	1,941
Abu Dhabi	133	282	161	286	1,012	425	1,002
Dubai	111	121	121	357	823	330	1,226
Bahrain	55	40	47	99	330	146	267
Oman	87	2	9	-	136	18	214
Qatar	5	-	30	82	332	77	336
Total Provisions	1,268	1,436	1,440	2,071	7,109	2,162	6,761
% increase		13%	0%	44%	243%		213%

Source: KAMCO Research-Gulf Cooperation Council Banking Sector, 27 January 2010

Note: No information on a comparable basis could be obtained for the fourth quarter of 2009 and first quarter of 2010, although we understand that provisioning growth levels have remained high. Going forward, we expect to see additional provisions on corporate portfolios, which will be partly offset by a decrease in provisions for retail loans.

Table 37 – Development of NPL ratio for key ME countries



Source: Global Investment House-GCC Banking Sector Quarterly-March 2010 (does not include figures for ADIB, DIB and SIB due to unavailability of financials)

As indicated above, four countries make up almost 90 per cent of the total provisions but some markets are more substantial than others. Banks in Saudi Arabia have increased provisions in line with Central Bank expectations and were severely impacted by two major ME corporate defaults, namely Saad and Algoasibi groups, which sent shock waves across the region. An example is the recommendation by the UAE Central Bank that local banks provide 50 per cent against their exposures to these two borrowers. Cautious lending growth is, however, continuing against stricter lending policies and against a backdrop of further expansion in GDP and government spending.

Limited NPL transactions to date

The number of distressed and non-core asset transactions has been limited over the last 12 months, especially for the less liquid loan portfolios. Main investor focus has been on traded debt positions (principally arising from Dubai World)¹⁸. Further, market participants point out that a significant gap exists in price expectations between investors and sellers, which is considered a typical NPL market characteristic in these early stages of development.

There are a number of reasons to expect NPL transactions to increase in the ME region, including:

- An increased profile of the ME as a destination for non-core asset investors. The Dubai World case has attracted international media attention and increased the profile of the region as a destination for established international non-core asset investors, which are expected to compete against local players for new deals. For example, Standard Chartered, Royal Bank of Scotland, HSBC and Lloyds Banking were all affected as a result of the proposed Dubai World debt restructuring¹⁹, along with local firms such as Abu Dhabi Commercial Bank (one of the largest creditors to Dubai World).

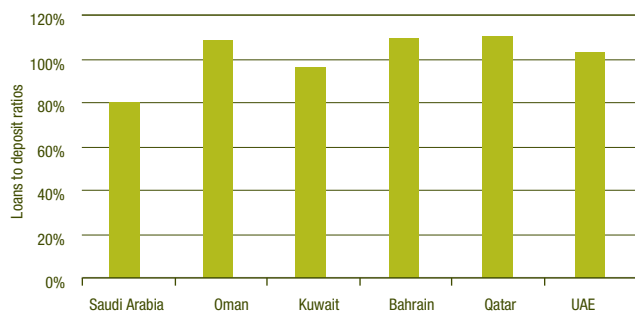
17. Markaz "What to expect in 2010", Outlook for GCC Stock Markets

18. Financial Times (FT.com): January 2010 Creditors seek Dubai World loans sale

19. Dow Jones International News: 8 March 2010: Dubai World in Informal Debt Plan Meetings with Creditors

- Smaller foreign banks may be looking to exit the region or limit their exposure. This is a common trend globally and may result in an increase in deal flow in the ME.
- Increased liquidity pressures for some of the local banks, especially in UAE (Dubai). As shown in the table below, with the exception of Saudi Arabia, loan to deposit ratios are very close or higher than 100 per cent, even though significantly lower than the average ratio for many European emerging markets, which range between 80 to 280 per cent²⁰. This means local financial institutions will have to gradually deleverage, either as a result of regulatory pressure or should government support be reduced.

Table 38 – Aggregate loan to deposit ratios



Source: Samba Financial Group-GCC 2010 Outlook-February 2010

- Negative outlook for the real estate market in the region. This is expected to adversely impact recoverability of lending to a significant number of ancillary sectors (such as development and construction) that have attracted a lot of bank financing over the last three to four years. However, in certain markets such as Saudi Arabia, Qatar and Abu Dhabi (subject to the Dubai exposures), cautious investment still drives growth, with a lot of government spending on infrastructure.
- Bank workout departments being stretched. The current level of NPLs is expected to stretch the existing capacity of workout departments.

Investor concerns

The above factors that point to a potential increase in NPL transactions in the region are partly offset by investor concerns over the relatively untested insolvency regime and its effect on the ability to enforce (and the timing thereof). However, the local enforcement situation appears to be improving, with some recent changes discussed in Dubai (other countries are expected to follow shortly). Accordingly, time will tell if the ME region will live up to its potential to be a major non-core/distressed debt market for buyers and sellers.

20. International Monetary Fund: Global Financial Stability Report, April 2009

Our Contacts

Across Europe and the UK we have experienced partners and directors who can assist you with your NPL-related needs. In addition, PwC has a dedicated international NPL group that can act as an overall coordinator for worldwide NPL mandates and opportunity identification. Through this group, both buyers and sellers of NPLs can receive consistent and seamless service across the world, integrated with country-specific knowledge and expertise.

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