Banking Executive Survey 2014

Albania, Austria, Belarus, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Poland, Romania, Serbia, Slovakia and Slovenia

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CONTENTS

Preface

Two years have passed since the last Banking Executive Survey. As our overviews focus on trends in the banking sector, a while back we decided to conduct it every-other-year, with the understanding that truly significant changes would not take place each year. As it turns out, there are individual years that include dynamic developments which would deserve coverage. This means that a lot has happened since the last overview and this is also reflected in bankers' responses to our inquiries.

Changes in the economic environment have not been drastic, especially when compared to the onset of the crisis. Most European economies are slowly recovering which is also mirrored by growing optimism among consumers and investors. That said, this will have a very limited positive effect on the banking sector for a number of reasons.

For one, survey respondents are unanimous regarding the momentous effects of regulation. This not only concerns direct costs involved in their implementation, but also the changing business environment for banking. The general outline of most of the new regulatory rules are already known, but this does not always hold true for the methods of their implementation.

From a pure business perspective, topics have come to the fore which have been talked about for some time, concerning the improved mining of data at banks' disposal, the emergence of new technologies, efforts to better harness customer experience and how to best utilise one's client base. Technological innovations appear to be especially prominent, as they permeate so many levels of the business. A big topic is of course cybercrime as a logical result of the advancing computerisation of banking and the financial sector in general. New payment possibilities, new client approaches and new forms of distribution are also involved.

Two years ago, our overview kindled interest countries outside of our region, so this time around we decided to cover most of Central and Eastern Europe (CEE) as well as – previously – Austria, in view of the plethora of Austrian banks in the CEE region. There are, of course, plenty of differences among the individual countries and their banking sectors, but we nevertheless trust that our overview can offer both interesting comparisons as well as food for thought.

Zdeněk Tůma
Financial Services Leader

KPMG in the Czech Republic

01

Country Introductions

Austria

287%

Total banking sector assets in % of GDP

-3%

Banking sector profitability (RoE)

65%

Number of foreign-owned banks in top 5 and market share of top 5 banks

Austria's macroeconomic fundamentals are relatively healthy but, recently, growth has stalled and forecasts call for a slow recovery. After a swift post-crisis rebound, real GDP has experienced growth of less than 1% since the middle of 2012 with low domestic and foreign demand. Economic activity should gradually recover, however, as it will begin to reflect a more favourable international environment and an increase of disposable domestic income owing to falling inflation.

The situation in the euro zone remains difficult and the associated risks and volatile global financial markets could delay Austria's economic recovery. The government's medium-term fiscal plan seems to be based on weak economic conditions as post-crisis fiscal pressures remain at work. While fiscal consolidation is underway, public services and transfers are nevertheless still exposed to sizeable long-term spending pressures. Austria's financial services sector was successful in expanding into its neighbouring transition countries, but introduced the sector to considerable contagion risks, bringing additional potential liabilities for public finances.

Being part of the euro zone, Austria's monetary policy (and that of several other euro-zone members in our survey – Slovenia, Slovakia, Romania, Estonia and Latvia) is guided by the European Central Bank (ECB). Most recently, the ECB package of monetary policy measures intended to stem deflation in the region as well as further stimulate the economy. As a result, the main refinancing interest rate was decreased to 0.05%, the marginal lending facility interest rate to 0.30% and the ECB's deposit facility interest rate to -0.20%.

The capitalisation of the three largest Austria-based banks has improved; so have the country's funding and liquidity conditions. The banks' Core Tier 1 ratios improved to above 10% at the end of 2012, placing them still slightly below the international average and reflecting a combination of earnings retention and reductions in risk-weighted assets. For two of the banks, these ratios include hybrid (participation) capital, provided by the government and to be phased out under Basel III. At the same time, internal capital generation has been reduced by the still sizeable NPL provisioning needs and falling net interest margins, while equity valuations are well below those of other European banks. Nonetheless, in August of 2013, one large bank managed to issue new equity and repay all its participation capital.

The Balkan States

	Total banking sector assets in % of GDP	Banking sector profitability (RoE)	Number of foreign-owned banks in top 5 and market share of top 5 banks
Albania	88%	6%	73%
Kosovo	60%	7%	89%
Romania	65%	1%	54%
Serbia	83%	4%	50%
Slovenia	112%	-32%	56%

The Balkan States included in our survey (i.e. Albania, Kosovo, Romania, Serbia, including Slovenia) in 2013 experienced annual GDP growth of 0.7%, 2.5%, 3.5%, -1.1% and 2.5%, respectively. Their economies differ significantly, with the current EU member states, namely Slovenia and Romania, being in a favourable position, while Serbia was the first of the remaining countries to officially launch accession interviews for the EU, followed recently by Albania which has been granted EU candidate status.

All of the Balkan States have introduced fiscal rules or are in the process of introducing such rules – Albania introduced a 60% debt ceiling (as is the standard in the EU's Stability and Growth Pact), but in December 2012 abolished it and its debt increased significantly. Serbia, meanwhile, has a limit of 45%, but has also exceeded it. The common conclusion that can be drawn from the EU Commission's statements is that all countries in the region have weak fiscal discipline.

As far as monetary policy is concerned, the general trend in the Balkans is monetary easing. The Bank of Albania has decreased its key interest rate following two earlier cuts in February and May – the key interest rate currently stands at 2.5%. The National Bank of Serbia has followed suit, lowering the key policy rate from 9.0 to 8.5% and the National Bank of Romania brought its key interest rate to 3.25%.

All Balkan States have attempted to introduce important reforms. For Slovenia in particular, 2013 brought successful attempts to solve the banking sector's most pending issue of the past few years – the system's recapitalisation and the start of its restructuring. In December 2013, the system's total EUR 4.8 bn lack of capital was made public, and the largest systemically relevant banks – state-controlled Nova Ljubljanska banka, Nova Kreditna Banka Maribor and Abanka Vipa, which together account for over two-thirds of the Slovenian banking system's assets – received capital injections of around EUR 3 bn in total from the Slovenian government. The Romanian banking sector, although still suffering from a higher percentage of non-performing loans having a negative impact on lending, asset quality and profitability, is expecting a significant economic recovery in the medium-term.

The Baltic States

	Total banking sector assets in % of GDP	Banking sector profitability (RoE)	Number of foreign-owned banks in top 5 and market share of top 5 banks
Estonia	106%	12%	91%
Latvia	121%	13%	61%
Lithuania	62%	10%	79%

According to the economic forecast, GDP should continue to grow in all three countries, which, combined with low inflation, will create a strong macroeconomic platform for their banking systems. In 2013, the Baltic States – Estonia, Latvia and Lithuania – experienced real GDP growth of 0.8%, 4.1% and 3.3%, respectively. The improvements of the past few years have been driven by increased competitiveness as a result of real wage decreases. Given the high unemployment rates across the region, wages are unlikely to rise significantly during the outlook period. However, high unemployment is creating negative pressures on the countries' ability to repay debt. The latest recommendations for the economies of Estonia, Latvia, and Lithuania call for policy measures to help resuscitate credit growth, maintain strong export growth, and address certain issues in the labour market. Coordinated national and regional policy responses will help these countries sustain economic growth going forward, particularly in light of their membership (or prospective membership) in the euro zone.

Both Latvia and Estonia are already members of the euro zone, while Lithuania will adopt the euro starting from 1 January 2015. The monetary policy applied by the Bank of Lithuania, and the application of relevant instruments, have been determined by the litas being pegged to the euro (in effect since 2002), unrestricted exchange of the litas into the anchor currency and vice versa, and full coverage of the liabilities of Bank of Lithuania with gold and foreign exchange reserves.

The Baltic financial sector is among the most open sectors globally, and the economies of the Baltic States are characterised by high levels of foreign direct investment and trade. The Baltic States mainly trade internally and with other European countries partly as a result of increased EU integration; however, Russia is also one of the major export markets. The banking sector in the Baltics is dominated by foreign banks and is almost fully privatised with high market concentration – the largest banks are all subsidiaries or branches of Nordic banks, accounting for almost 95% of total assets and domestic credit in Estonia and Lithuania, and 53% and 80% of total assets and domestic credit, respectively, in Latvia. The relatively smaller share of total assets in Latvia reflects the role of NRDs and foreign assets held by domestic banks. Thus, foreign banks provide the vast majority of credit to the private sector in all three countries. Given the significant share of funding provided by the parent bank in total bank funding, financial conditions of the Nordic parent banks could affect the supply of funding to Baltic banks and credit conditions. Domestic loan-to-deposit ratios remain relatively high even though parent bank funding has declined since the crisis (around 133, 107, and 133% at end-2013 in Estonia, Lithuania, and Latvia, respectively).

Belarus

62%
Total banking sector assets in % of GDP

14%
Banking sector profitability (RoE)

81%
Number of foreign-owned banks in top 5 and market share of top 5 banks

The economic situation in the Republic of Belarus in 2013 was characterised by slowed economic growth. Despite some positive dynamics in H1 2013, GDP growth for the full year amounted to 0.9% year-on-year. This weak development was based on troubles with exports, which provoked a contraction in industrial output and led to a widening of the current account deficit. On the other hand, the economy was supported by strong household consumption due to higher wages.

The Belarusian economy is expected to grow only slowly, with persistent external imbalances. Inflation has been forecast by the National Bank of the Republic of Belarus to remain at around 12% in 2015 (2013: 16.5%, for 8 months of 2014 – 12%).

The main fiscal policy concerns for Belarus remain quasi-fiscal directed lending operations and wage policies. In 2013, new subsidised lending increased by 35% and reached 5.5% of GDP, thereby raising domestic demand and the share of subsidised credit in overall lending, which in turn led to further concerns about the efficiency of credit allocation. While significant moderation could be perceived in the second half of the year, average economy-wide wages rose by 6% in 2013 in real terms, which means that they exceeded the growth of productivity (estimated at 1.5%) by a large margin.

The real monetary conditions of economic development have been optimised with regard to the refinancing rate, while interest-rate policy became stricter in response to a deterioration in the liquidity of the banking sector. The effectiveness of this policy is being held back by a less-than-perfect operational framework and the disruptive impact of subsidised lending. However, domestic interest rates have a direct impact on the population's willingness to hold local currency.

While the banking sector was hampered by macroeconomic trends, it nevertheless posted strong growth in 2013. This may be short-lived, however, as the country has foreign-exchange reserves which are low compared to the burden of external debt and import-financing requirements, and as any disruption in external funding or energy subsidies from Russia will have a significant effect on its balance-of-payments.

Czech Republic

135%
Total banking sector assets in % of GDP

21%
Banking sector profitability (RoE)

58%
Number of foreign-owned banks in top 5 and market share of top 5 banks

The Czech economy finally grew again in the last quarter of 2013 and its recovery is expected to continue in the near future. This should be supported by a more positive global economic climate and a competitive exchange rate, both of which should have a positive impact on exports and consequently lead to a higher level of investment activity. At the same time, however, the road to recovery for household consumption is expected to be slower and bumpier.

Czech GDP is expected to rise by more than 2% in the forthcoming period thanks to stronger economic growth abroad, favourable domestic monetary conditions and some limited fiscal stimulus. A more expansionary fiscal policy should lead to more pronounced growth, estimated to reach 3.3% in 2015. At the end of 2013, performance indicators important for the future evolution of the credit risk for non-financial corporations started to show signs of recovery as well. The labour market situation, which to a large part determines household credit risk, is not expected to improve significantly in the near future, when wage growth is expected to pick up speed and unemployment should start to fall.

Even though the Czech Republic is closely aligned with the euro-zone, it need not follow its monetary policy, as the koruna is not pegged to the euro. In December 2012 the Czech National Bank (CNB) lowered its benchmark two-week repo rate to an all-time low of 0.05% to fight persistently low inflation.

The assets of the Czech banking sector grew by almost 9% in 2013 in LCY-terms, supported by FX interventions of the CNB with an impact of approximately +4bp. Both corporate and household loans accelerated in 2013, and grew by 3.8% year-on-year and 4.5% year-on-year, respectively (in LCY-terms). The term structure of corporate loans gradually came to emphasise longer-term credits which grew by more than 6% in 2013. The funding of Czech banks, relatively independent from external financing due to a stable client deposit base, continued its growth in 2013 with an increase of 6.7% year-on-year. A potential threat to the Czech banking sector's profitability is a narrowing interest margin due to the low level of interest rates with increasing market competition. However, the results of recent stress tests reported by the CNB in November 2013 show that the domestic financial system is stable and resilient to various risk scenarios.

Hungary

108%
Total banking sector assets in % of GDP

5%
Banking sector profitability (RoE)

56%
Number of foreign-owned banks in top 5 and market share of top 5 banks

The Hungarian economy turned around slightly in 2013 and GDP growth came in at just above 1% – in part due to a statistical base effect, but also supported by exports, agriculture and the public sector. For the next year, GDP is expected to grow by 2% with the public sector remaining a major driver. However, the domestic private sector is still weak and will require more sustained stabilisation to be able to recover.

The government is determined to exit the EU's Excessive Deficit Procedure (EDP) and excessively relies on controversial tax measures which have only increased uncertainty and hurt the business climate. The key challenge will be to achieve a much-needed reduction of the deficit through measures which are sustainable and friendlier towards growth. This will require alterations to the financial adjustments leading to the consolidation of durable spending and a rationalisation of the tax system, including a gradual elimination of sectoral taxes.

The National Bank of Hungary (NBH) has continued its monetary easing cycle, cutting its benchmark interest rate every month since August 2012, predicted to reach a new low of 2.4% in May of the upcoming year. Although its monetary policy committee promised to be wary of further interest rate cuts if the forint looked likely to come under pressure, it sees inflationary pressures as subdued and international inflation, interest rates and the market environment as benign. It is likely to cut rates further, hoping to stimulate lending and spur stronger domestically driven growth.

Since January 2013, banks have been subject to a financial transactions tax. The tax, which was doubled from the originally suggested 0.1% in late 2012, is levied on all transactions, including cash withdrawals (on which the tax is set at 0.3%). In June 2013, the government increased the tax further. After complaints from international financial institutions, the NBH was exempted from the tax. After two consecutive loss-making years, the banking sector turned profitable in 2013, albeit at a low level (RoA 0.5%, RoE 4.5%), and many large banks are still reporting red numbers. Another government programme targeting problem-ridden FX mortgages is expected to be installed before the end of the year threatening those banks in question with further costs.
In 2013, Takarékbank (the Central Bank of Saving Cooperatives) received the government's full attention, as the whole savings and cooperative bank sector underwent state-driven reform and modernisation.

Poland

86%
Total banking sector assets in % of GDP

10%
Banking sector profitability (RoE)

46%
Number of foreign-owned banks in top 5 and market share of top 5 banks

As in 2013, economic growth was fairly weak, and banks did not experience any broader recovery in Poland. However, in H2 2013, faster GDP growth helped to lift annual expansion figures for the banking sector. Real GDP growth averaged 1.6% in 2013 as the slowdown in core euro-zone countries negatively influenced consumer and investor confidence. However, a steady recovery is now underway with growth accelerating to 3.4% year-on-year in the first quarter of the new year, led by improving conditions in the country's main trading partners and a recovery in domestic demand. Nonetheless, partly reflecting external factors, CPI inflation remains well below the target range, declining to 0.2% (May 2014 to May 2013). As the trade balance turned positive in 2013, the current account deficit reached its lowest level in more than a decade.

Fiscal consolidation is among the government's main challenges. As a share of GDP, Poland's public debt remains well below West-European levels, but the government needs to prevent it from exceeding 55% of GDP, as this would trigger painful spending cuts. After being urged by the European Commission, Poland committed to cutting its budget deficit to 3% of GDP by the end of 2012, from 4.2% of GDP in 2011 and around 8% in 2010, but it remains under the EU's excessive-deficit procedure (EDP), as its fiscal deficit remains above the EU's mandated limit (at 3.9% of GDP at the end of 2012). The budget deficit is estimated to have increased slightly, to 4.4% of GDP in 2013. The Commission has extended the deadline for the government to meet the 3% target by one year.

Poland's reliance on external finance exposes it to fluctuations in investor sentiment. Although Poland's macroeconomic fundamentals are among the strongest in the region, the zloty has not been immune to the weaknesses afflicting emerging market currencies, concerns over a slowdown in Chinese growth and the annexation of Crimea by Russia. The prospects for euro adoption are unclear – the government remains formally committed to it but has postponed the target date until 2016 at the earliest. The official benchmark reference interest rate remains at a historical low of 2.5%, following a rate-easing cycle that began in November 2012.

Total loan growth in LCY-terms rose marginally from 1.2% year-on-year in 2012 to 3.5% year-on-year in 2013. Corporate lending performed below expectations mostly due to weak investments. In contrast, retail lending showed an increase and was up by 4.2% year-on-year (compared to 0.2% in 2012). A fairly stable FX rate and a reasonably high quality of assets continued to promise profitability even though this was hampered by modest growth and pressure on net interest margins which reflected low key rates and increased competition for deposits. The 2013 RoA came in at 1.1%, i.e. roughly the post-crisis average since 2009. With 10.1% in 2013, the RoE decreased below its post-crisis average (13.5%).

Slovakia

84%
Total banking sector assets in % of GDP

8%
Banking sector profitability (RoE)

72%
Number of foreign-owned banks in top 5 and market share of top 5 banks

The euro-zone economies, which significantly influence the Slovak financial sector, emerged from recession in 2013 and the majority of them reported growth, albeit at various rates. In the euro zone, this upturn was supported by a revival of private sector demand as well as by signs of an end to negative trends in the labour market. The improved economic situation in the euro zone also brought growth to the Slovak economy. This was particularly true for the manufacturing industry and construction, whose growth in turn increased investment demand.

Fiscal consolidation continued, although some sources of revenue or savings were only temporary. The Slovak government should be able to achieve its fiscal deficit targets for the upcoming year, but may employ automatic stabilisers if growth risks become apparent. The government's efforts will remain subject to Slovak national legislation intended to limit the public debt, which edged up to 55.4% of GDP in 2013. For the future, sizeable additional fiscal adjustment is needed to avoid economically harmful effects from crossing key debt thresholds and to meet EU commitments. To ensure the durability of consolidation efforts and improve the structure of the budget, strict measures will be essential.

Since Slovakia is a part of the euro zone, a significant part of Slovak monetary policy is affected by the European Central Bank (ECB). Extremely low inflation across the euro zone in the early part of 2014 gave rise to fears that economic recovery was faltering and threatened by possible deflation. In June, the ECB cut its policy interest rates and announced a series of other loosening measures aimed at stemming disinflationary trends across the euro zone. Its steps will put downward pressure on the euro. Policy rates are expected to stay at current record-low levels for the next few years.

The total profit of the banking sector increased again year-on-year in 2013, after falling in 2012. This rise can be attributed to the still relatively strong growth in retail loans which increased the net interest income of banks. Although non-performing loans and credit risk costs rose for the retail sector, this was offset by just the reverse occurrences in corporate loan portfolios. Since the rate of loan-loss provisioning did not stay significantly behind the change in amount of non-performing loans, the domestic banking sector continued to cover bad loans relatively well. A positive trend in the Slovak banking sector was a continuing increase in its capital adequacy ratio, which rose to 17.2% in 2013, a figure higher than the euro-area average.

02

Summary

According to our analysis, the overall economic situation in 2013 in the countries included in our survey turned out to be somewhat worse than in 2012, with the growth rates of real GDP slowing down. The results of our study do, however, promise more favourable development for the future. This expectation has already had an effect on the present evaluation of the banking sector in particular. Banking managers saw the situation in their sector as much more optimistic than the concluding evaluation of our previous study in 2012. Slovenian survey respondents offered the most positive appraisal, while Belorussian and Hungarian managers continued to view economic conditions in a mostly negative light.

That said, the positive trend is further supported by survey participants' overall expectations for 2014, and even more so by those for 2015. For the year 2014, about 70% of respondents expect revenues for the banking sector to be at least comparable to those of 2013; 45% believe that they will even surpass them. For 2015, 76% of respondents expect comparable results, whereas 49% think that banking revenues for that year will be even better than in the previous corresponding period. Again, Belorussian and Hungarian bankers were more pessimistic than their peers.

In contrast, banking managers from the Balkan Peninsula had the most optimistic outlook for the future.

In general, the most important factors for the profitability of the banking sector is considered to be effective regulation, increasing level of economic investments and the strengthening of household consumption.

Answers to a question concerning the current perception of various types of risks revealed that the most significant ones are specific loan risks. However, some CEOs of large banks had also explicitly mentioned the rising threats of cyber-criminality.

Banks in general are in favour of cost savings. None of the respondents indicated their strategic focus to be entirely directed towards investments with the goal of long-term growth. The favourability rating of savings is not that great, however, which signals that banks in general are at a stable midpoint between savings and investments with long-term growth goals.

Even though the development of new products and services is still not a high priority among the factors influencing the productivity of the entire banking sector, individual banks consider the development of new products and services to be very significant. When asked about measures to improve the financial performance of their bank, a majority of respondents said they were planning to invest into product development. A significant trend towards the modernisation of the way that banks do business is apparent, as there is increased interest in progressive areas like business intelligence (including solutions for big data) and customer experience. Judging from the intended investments, both areas bear high importance for the bankers in our survey.

The factor which will most significantly influence the banking sector according to the overall expectations of the respondents will be regulation. This fact is not surprising, however, other significant aspects, such as the customisation of services, simple banking products and new payment systems, are more interesting.


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Overview

The economic situation, measured by the growth rate of real GDP, was worse in 2013 than it had been in 2012 for the countries included in our survey.[1] Some exceptions can be noted in countries who were in the red in 2012 – these markets fared better in 2013, which may hint towards a gradual economic renewal for the forthcoming period. This expectation of a positive trend is further supported by predictions of positive growth of real GDP for 2014 (see the table below) in these countries.[2]

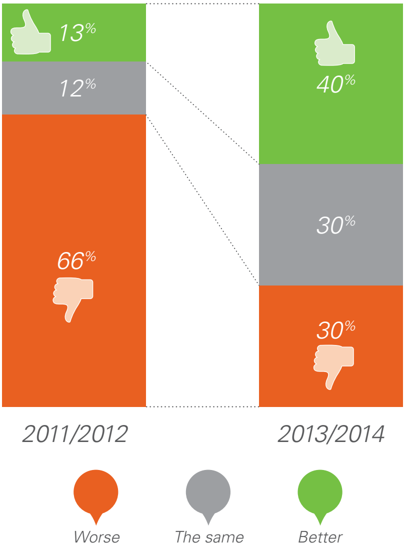
A favourable trend also seems to be on the horizon for the banking sector. Evaluations of the current economic situation in the banking sector in light of the past year are thus much more optimistic than similar evaluations in the banking sector study conducted by KPMG 2 years ago.

Country	Real GDP Growth [%]			GDP per capita (constant 2005 US$)
	2012	2013	2014	
Albania	1.3	0.7	2.1	4,087
Austria	0.9	0.4	1.7	39,978
Belarus	1.7	0.9	1.6	4,916
Czech Republic	-1.0	-0.9	1.9	14,089
Estonia	3.9	0.8	2.4	12,046
Hungary	-1.7	1.1	2.0	11,128
Kosovo	2.5	2.5	3.9	2,895
Latvia	5.2	4.1	3.8	8,863
Lithuania	3.7	3.3	3.3	10,549
Poland	1.9	1.6	3.1	10,753
Romania	0.7	3.5	2.2	6,073
Serbia	-1.5	2.5	1.0	3,988
Slovak Republic	1.8	0.9	2.3	15,065
Slovenia	-2.5	-1.1	0.3	18,357

1 *With the exception of Romania, whose growth at a time where the rest of the region was in a recession can probably be attributed to a "catch-up effect".*

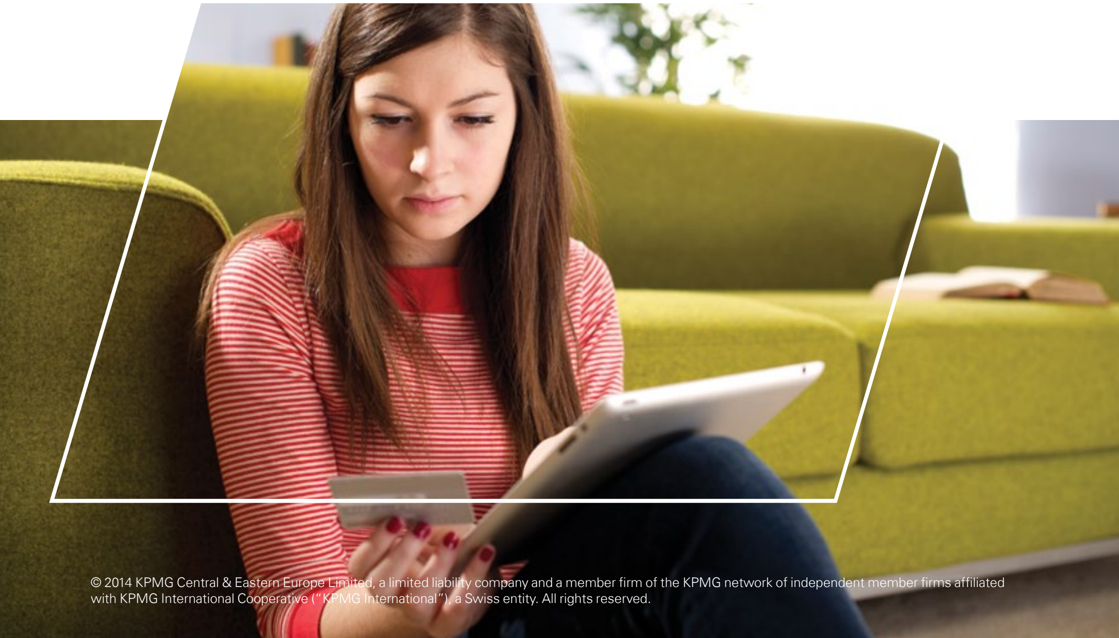
2 *Source: IMF*

Graph 1: Compared to a year ago, how would you describe the current business conditions in your sector?

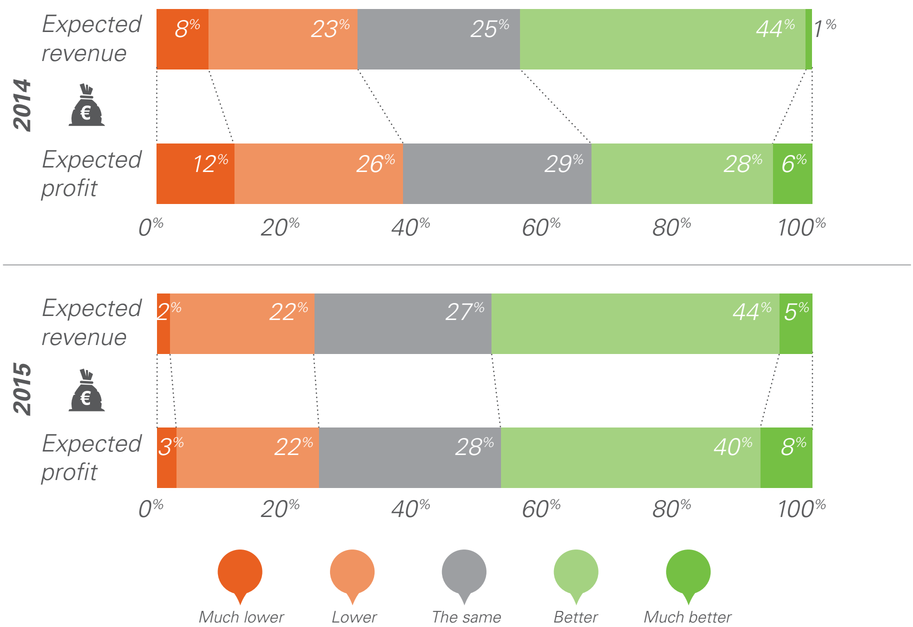


In 2012, approximately 66% considered the economic situation to be worse than it had been in the previous year and only 13% thought that the situation had improved. In the current survey, only 30% still considered the situation to have deteriorated, whereas 40% believe to have witnessed an improvement.

Bankers in Slovenia were the most positive in their assessment of economic conditions. The recapitalisation of banks and related factors have reduced uncertainties and subsequently may be helping to overcome the Slovenian recession, one of the deepest recessions of the entire euro zone, in the future. In contrast, Belorussian and Hungarian bank managers continued to see economic conditions in a pessimistic light. Due to Belarus' close and strong alignment with Russia, this negative outlook is to a great extent caused by the unstable situation of its neighbour. The Hungarian banking



Graph 2-3: What revenues do you expect in the banking sector in 2014 and 2015?



market in turn has been significantly affected by the introduction of a financial transaction tax.

Bankers' overall expectations for 2014, and even more so for 2015, reflect this positive trend.

For 2014, 70% of respondents expect banking revenues to be at least comparable to those of 2013; 45% envision them to be even higher. Expected profitability, however, is somewhat less positive. Sixty-two per cent of bankers expect their profits to be at least at the 2013 level; but only 34% expect them to increase. In 2014, expected lower profitability was compared to 2013 a more frequent response than expectations of lower returns. One of the factors leading to these results may be the current pressure on the margins of banking products and services.

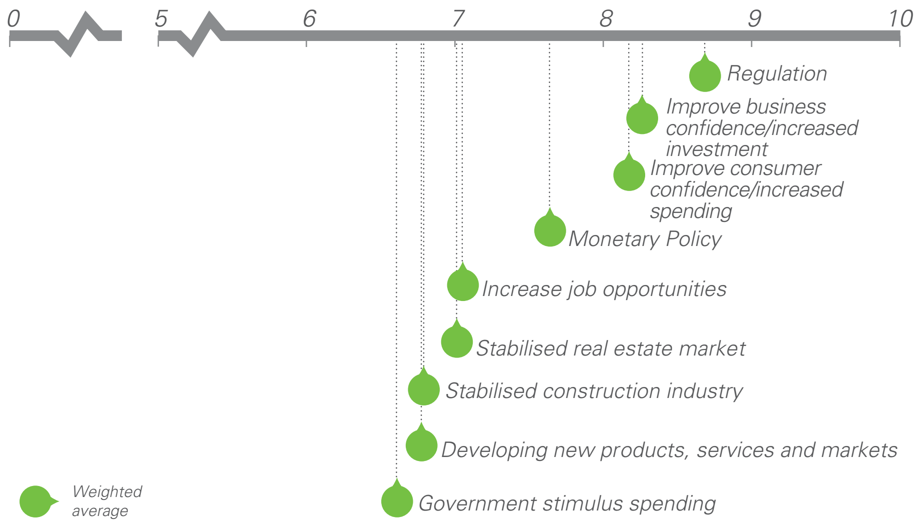
Belorussian and Hungarian bankers remain sceptical, whereas bankers from the Balkan Peninsula were overall most optimistic.

As previously mentioned, expectations for 2015 are even somewhat higher than those for 2014. At least, comparable revenues are expected by 76% of respondents, and higher revenues by 49% of respondents. Expectations of profitability for 2015 clearly confirm a trend, as they are comparable to the expected revenues of the banking sector in 2015. Revenues comparable to at least those of the previous year are expected by 76%, whereas 75% expect similar profits. The same relationship applies to the expectation of higher revenues which lies at 49%, while 47% believe in higher profitability. Responses from the Balkan states, as well as Belarus and Hungary, again go against the general trend expected for 2015, as the Balkan states predict higher profits as well as revenues more often than the rest of the CEE region. In contrast, the expectations of Belorussian and Hungarian bankers continue to remain sceptical for 2015.

Effective regulation is considered the most important factor in facilitating the efficiency of the banking sector in 2014. The most significant roles are played by a heightened strictness of banking regulations, the need of banks to comply with these regulations and their subsequent effect on the banking business. Bankers often consider regulation to be a factor which makes business increasingly difficult.

The next most influential factors for the banking sector are an increasing level of economic investments and the strengthening of household consumption. The number of respondents who considered investments to be important decreased the most in comparison with our last study, i.e. by six percentage points. Instead, the importance of strong private household consumption went up two percentage points. As regulation can have a direct effect on the availability of financial resources, the liquidity of the market and economic confidence, it can be stated that effective regulation may have a positive effect on the banking sector.

Graph 4: In your opinion, how important are the following factors for the economic performance of the banking sector?



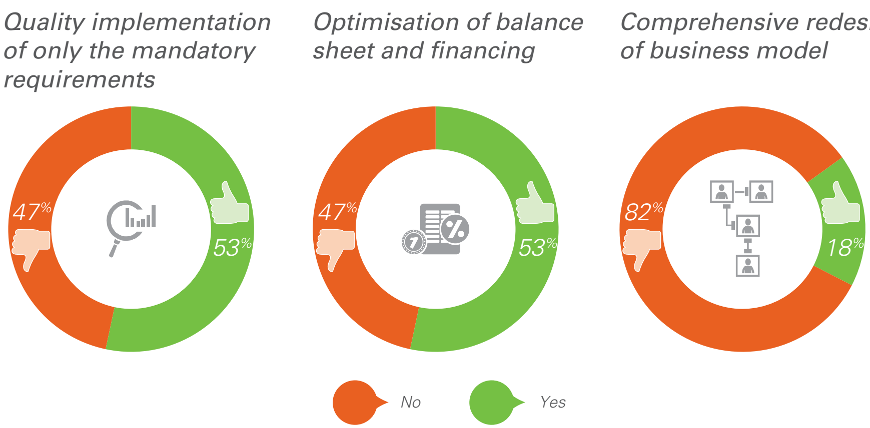
Bankers surveyed hold monetary policy to be less important and thus view it as the fourth most important factor, far behind regulation. For banks, market developments have a much bigger effect on the performance of the banking sector than monetary policy. Governmental expenditures intended to stimulate the economy are deemed to be the least effective. Monetary policy proved to be important only in Austria. Belarus, Hungary, Latvia and Austria, which consider governmental stimulation of the economy important, are the few exceptions where public spending for the banking sector received an above average rating.

The creation of new jobs has a fairly large impact on the banking sector according to the respondents in our survey. The Czech Republic, according to those surveyed, is one of the countries in which the effect of new jobs on the banking sector is lower than in the rest of CEE. The perception of new jobs as an important factor declined since 2012 by 6%.

Other factors which were believed to influence the performance of the banking sector were pressures from the non-banking sector and cyber-criminality, which banks perceive to be an increasing threat.

The stabilisation of the real estate and construction markets does not have any significant influence on the effectiveness of the banking sector, as these are instead considered to be already generally stable. The effect of the development of new products and services is also regarded to be less significant.

Graph 5: How will you have to react or have already reacted to the impact of CRD IV?

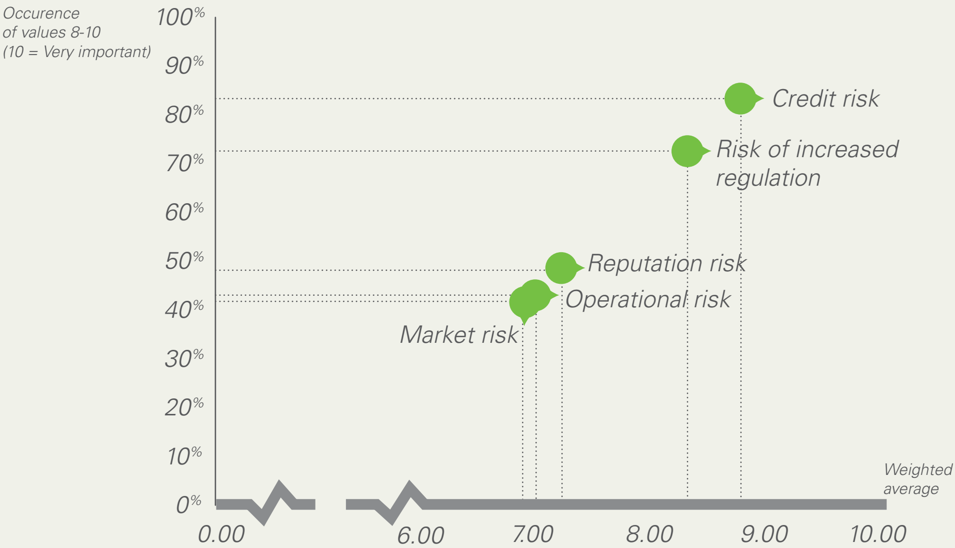


The Capital Requirements Directive CRD IV governing access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, valid since August 2013, is one of the key EU regulations dealing with the credit institution sector. It also governs partially the activities of non-banking security traders.

A corresponding 53% of CEE bank managers confirmed that they already had reacted or would shortly react to CRD IV by implementing only the mandatory requirements and by optimising their balance sheet and ways of financing. However, 82% claimed that CRD IV would not motivate them to change their business model.

Responses to a question concerning the current perception of various types of risks revealed that the most significant risks are specific loan risks. The importance of these risks has persisted since the global economic crisis, as these specific loan risks had often been underestimated in the past. Almost 85% of respondents gave specific loan risks an eight, nine or 10 on a scale of 1-10 with 10 representing a very important risk and zero an insignificant risk. Respondents considered the risk of an increased measure of regulation to be the second most important risk, with 73% of bankers awarding it 8-10 points out of 10. Respondents placed market risks, which only 42% considered to deserve a value of eight or higher, at the opposite end of the spectrum.

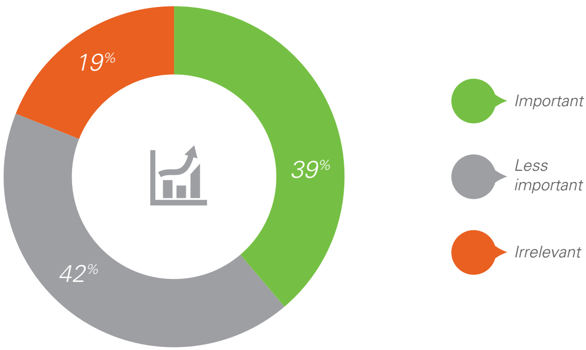
Graph 6: How does your company currently view the following risks?



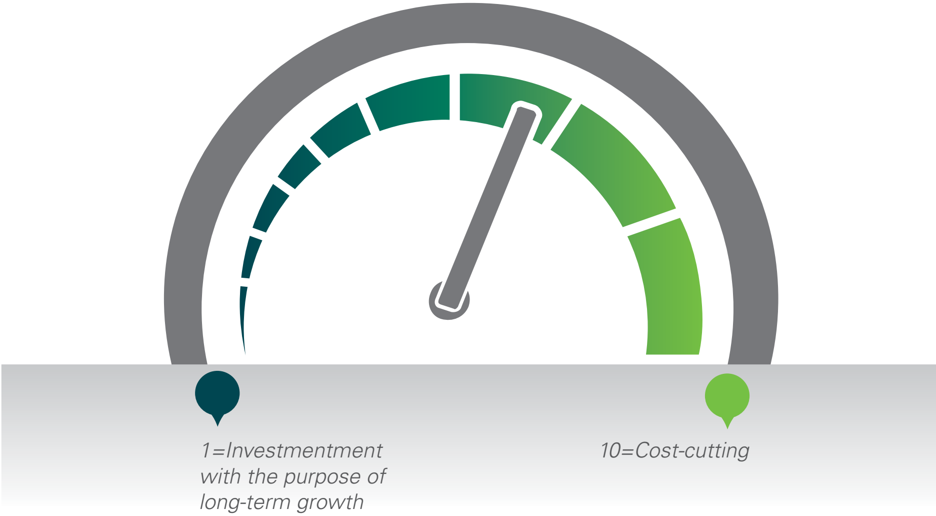
In contrast to overall expectations the data show that when compared to others, managers of Czech and Polish banks, who in general seem to have a generally lower fear of risks, perceive all presented risks to be less important than do their peers. This clearly reflects the above average health and stability of the banking sectors in both countries.

Concerning activities connected with the development of a recovery and resolution plan (RRP), as shown in the previous KPMG survey, the majority of banking institutions, i.e. 70%, had already begun or were planning to begin to draw up their own version. The current evaluations of the importance of a bank's RRP for the stability of the financial system in the context of our respondents' banking institutions are anything but unambiguous. Based on the

Graph 7: What contribution to the stability of the financial system do you see in creation of the RRP?



Graph 8: What cost strategy is your company currently seeking?



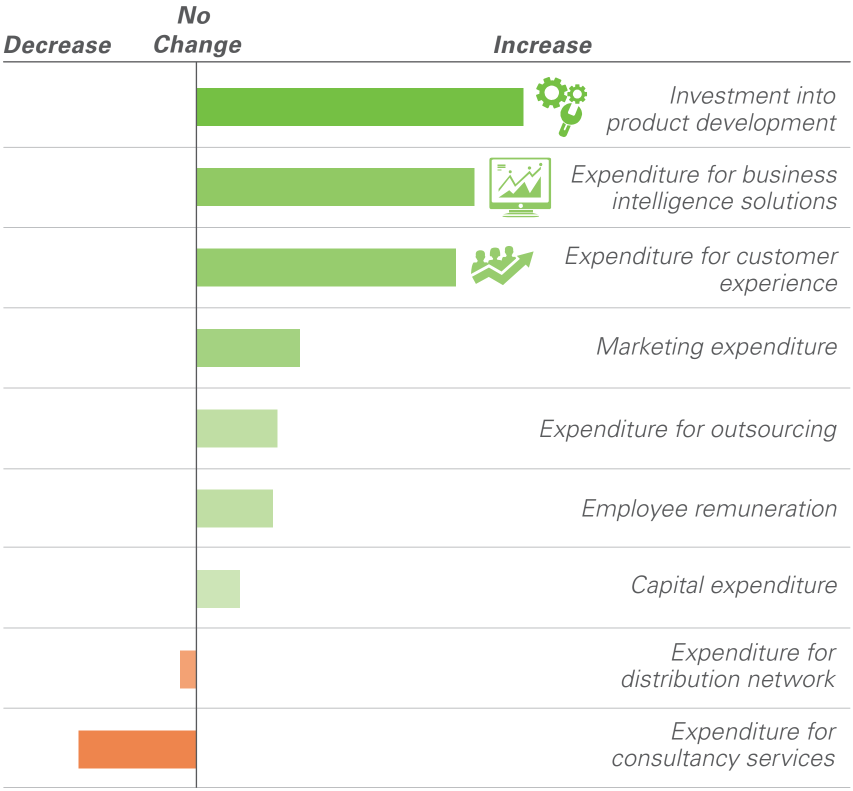
number of responses of "less important" or "irrelevant", which were provided by all managers, it appears that the plan is now less significant. Hungarian bankers have the most pessimistic opinion of the recovery and resolution plan and 40% of them view the RRP as totally irrelevant. Indeed, an opinion was voiced that the RRP was merely an exercise for the regulator which could reflect the situation of the Hungarian banking sector, which is currently dealing with much more pressing questions.

Banks in general are in favour of cost savings. None of our respondents stated their strategic focus to be entirely directed towards investments with the goal of long-term growth. The favourability of savings is not that great, however, which signals that banks in general are at a stable midpoint between savings and investments with long-term growth goals.

Be that as it may, it is not possible to generalise in this area as in the majority of countries respondents are not unanimous. Looking at various GDP developments in the countries whose banking sectors are of the same opinion, it appears that even the economic situation within a country does not have much of an effect on banking expenditures.

Tangible variances in favour of savings can be seen for Austria, Hungary and Serbia, where a third of the respondents' answers were either extremely below or above average. In contrast, Czech, Lithuanian and Latvian banks seem to have a fairly positive attitude towards investments aimed at long-term growth.

Graph 9: What measures is your company considering or planning to increase financial performance?



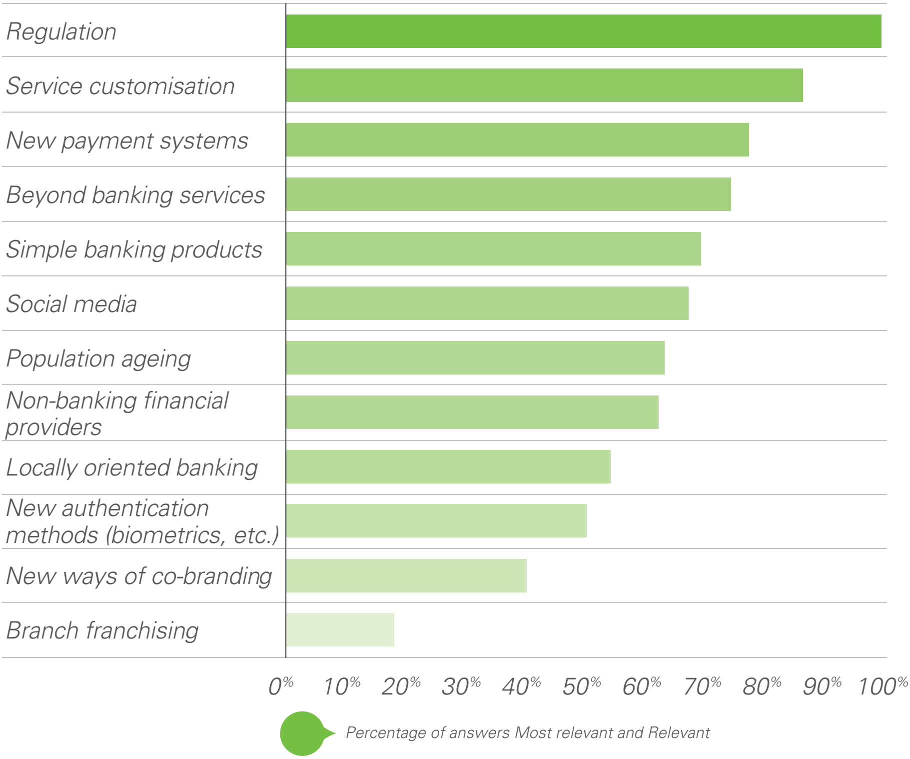
Even though the development of new products and services is still not a major force among factors influencing the productivity of the entire banking sector, individual banks consider the development of new products and services to be very significant for their own progress. When asked about measures to improve the financial performance of their bank, a majority of respondents signalled to be planning to invest into product development. Thirty-nine per cent of surveyed bankers intend to maintain their level of development expenditures, whereas 56% are planning to increase this level. This phenomenon may be explained by the irrelevance of product development in connection with the productivity of the entire sector. For individual banks, however, the development of new products and services remains important because such successful development may significantly influence an individual bank's position on the given market.

The plans of Austrian and Czech bankers stand out in our survey, as 73% of Austrian and 69% of Czech banking managers definitely do not plan to increase investments into product development. On the other hand, the plans of Polish, Slovenian and Romanian bankers to invest in product and service development are above the European average.
A significant trend can be seen towards the modernisation of the way that banks do business, as there is increased interest in progressive areas like business intelligence (including solutions for big data) and customer experience. Judging from the intended investments, both areas are equally important for bankers. For 50% of survey participants, business intelligence is an area worth increased investments, whereas 49% plan to invest into customer experience management. In contrast to the aggregate expectations and plans of individual bankers, Austrian respondents do not plan to significantly invest into these areas. Lithuania and Latvia, on the other hand, have adopted these areas as their own and have plans to continue developing them.

A fairly interesting trend is also reflected in the amounts banks spend on their distribution networks. The total sum of expenditures remains unchanged but there appears to be a movement away from investments into branches and towards investments into online tools.

According to the overall expectations of respondents, the factor which will most significantly influence the banking sector will be regulation. Almost all, i.e. 99% of all respondents, consider the influence of regulations on the banking sector to be the most important or relevant factor. The previous KPMG study showed that regulation was considered the most

Graph 10: In your opinion, what will influence the banking sector in the next five years?



important factor in the functioning of banks. Other significant factors according to respondents are the customisation of services, simple banking products and new payment systems. Other important areas, which were not among the responses offered in our questionnaire but were nevertheless explicitly mentioned, were the digitalisation of a large part of both customer- as well as intra-bank services, and cybercrime.

Even though banks appear to be innovative, which is indicated by their plans to introduce simple products, customise their services to their clients and introduce new payment systems, they do not consider high-tech innovations to be very important. An illustration of this is their lack of interest in new ways of authentication, like biometrics. As in KPMG's previous study, the franchising of branches and new ways of co-branding remain among the least relevant factors for the further development of banks.

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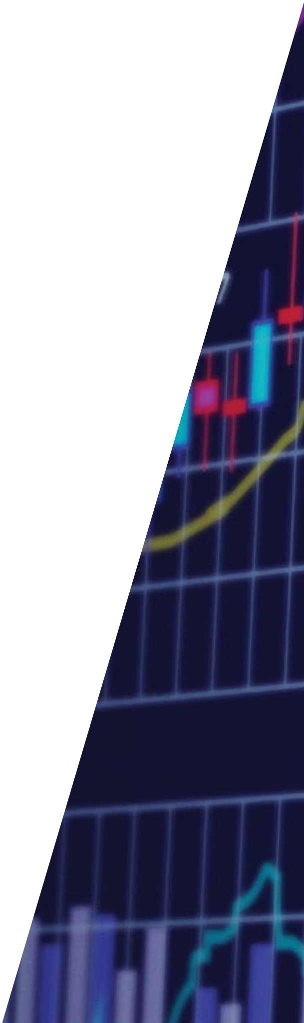


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