

Europe  
Special Report

# Major Western European Banks' Exposure to Eastern Europe and the CIS

## Downside Risk Contained?

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- [Emerging Europe Growth Outlook \(April 2009\)](#)
- [Emerging Europe's Current Account Deficits: Mind the Gap! \(January 2008\)](#)

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### Executive Summary

- This special report focuses on major Western European banks with material exposure to Eastern Europe and the Commonwealth of Independent States (CIS). Fitch Ratings has analysed a number of stress scenarios to assess the banks' ability to absorb credit losses in the region. Fitch does not anticipate that Non-Performing Loans (NPL) levels will exceed those of the Asian crisis but there continue to be a significant number of unknowns.
- Overall, Eastern Europe and the CIS have been particularly negatively affected by the global financial crisis and some of the countries in the region remain vulnerable on account of their financial and economic characteristics. Fitch forecasts that GDP in emerging Europe will contract by 3.1% in 2009, a severe and sudden recession after growth of 4% in 2008, with only a modest recovery to 1.4% in 2010. Economic prospects and credit risks are heavily skewed to the downside.
- There is a wide difference in the economic vulnerabilities and credit standing of the countries in Eastern Europe and the CIS, and it is important to recognise that not all are in the same position. This has been reflected in negative rating actions taken by Fitch's Sovereign department since August 2008. The vulnerabilities prevalent in many countries in the region included large current account deficits and macroeconomic imbalances, dependence on foreign capital flows, substantial recent credit/asset bubbles and sizeable banking systems, significant volumes of foreign currency loans and in some cases exposure to commodity prices.
- For the purpose of this special report, the Fitch Financial Institutions department has established three different country groups (least, moderate, and most vulnerable) according to the likely increase in NPLs related to the vulnerability of the countries to the global crisis as well as the characteristics of the banking systems. The aim is to differentiate between the countries in the region: Ukraine, Latvia and Kazakhstan have been placed in the most vulnerable country group, while Slovenia, Slovakia (both in the euro area), the Czech Republic, Poland and Turkey are in the least vulnerable country group. All remaining countries in the region have been placed in the moderate country group (see Table 1 for classifications).
- Given the extent of foreign ownership of banks across the region, parental support is key. With respect to the major Western European banks operating in the region, Fitch assumes that support would be forthcoming where expansion into the region is considered of ongoing strategic importance. Fitch believes that this would also hold true even if the EU-based parent bank were receiving support from its home sovereign. The agency notes that sovereign support may not extend beyond the borders of the EU. As a result, each group has to be considered on a case-by-case basis.
- Fitch has applied four different stress tests with varying levels of severity to all major Western European banks with material exposure to the region. As a threshold, Fitch has included banks with more than 5% of exposure

**Table 1: Country Groups Created for the Purpose of Stress Testing**

<b>Least vulnerable</b>	
•	Czech Republic
•	Poland
•	Slovenia
•	Slovakia
•	Turkey
<b>Moderately vulnerable</b>	
•	Albania
•	Belarus
•	Bosnia and Herzegovina
•	Bulgaria
•	Croatia
•	Estonia
•	Hungary
•	Lithuania
•	Macedonia, FYR
•	Moldova
•	Montenegro
•	Romania
•	Russia
•	Serbia
<b>Most vulnerable</b>	
•	Latvia
•	Kazakhstan
•	Ukraine

Source: Fitch April 2009

concentrated in the region in the stress testing. The agency has applied 1) a 25% NPL ratio across all countries (the median for all systemic banking crises according to the IMF); 2) a 33% NPL ratio across all countries (average for the Asian crisis); 3) a 'base case' scenario NPL to the three different country groups depending on their perceived level of vulnerability (see Table 1); and, 4) an 'extreme case' scenario NPL to the same country groups as in stress test '3' (for further details, refer to Appendix 1). Results have been analysed and the impact on rating levels assessed. For an overview of rating actions taken based on the outcome of this analysis, see individual country sections.

- The above stress scenarios may or may not materialise, but on balance the downside risks outweigh the likelihood of a more positive outlook. The scenarios show the Austrian banks are most exposed to the Eastern Europe and the CIS region. Credit losses in the region would absorb all the Tier 1 capital of three of the Austrian banks under the two most severe scenarios according to Fitch's own calculations. Risks, however, do vary given the number of subsidiaries and relative vulnerabilities of the countries where these groups are operating. Nevertheless, given the potential impact on the banks' income statements and capital, a number of rating actions were taken: accordingly, the Long- and Short-Term Issuer Default Ratings (IDRs) of all the Austrian banks included in this report are now based on the potential support of the Republic of Austria (rated 'AAA'/Outlook Stable), given their systemic importance.
- Fitch believes that the German banks with significant subsidiaries in the region, primarily Commerzbank group and Bayerische Landesbank (BayernLB), are vulnerable to potential deterioration from these exposures in all scenarios. However, the IDRs of these banks are at their support rating floors and the Individual Ratings already reflect a high level of sensitivity to weakening in the domestic and international operating environment.
- Amongst the major Italian banks, UniCredit SpA (UC) has the largest exposure to Eastern European and CIS countries. While the impact of the various stresses is a relevant issue for UC, its capital position after planned government capital injections from the Italian and Austrian governments would be sufficient to allow it to absorb losses in more severe scenarios. UC's Long- and Short-Term IDRs are still based on its intrinsic financial strength with negative outlook. The ratings of Italy's Intesa Sanpaolo have been affirmed with a Long-term IDR of 'AA-' (AA minus) on Stable Outlook as Fitch assesses the bank's exposure and vulnerability to shocks in the area as moderate.
- With respect to other Western European banks operating in the region, all French banks with significant exposures to the region (Société Générale (SG), Crédit Agricole (CA) and BNP Paribas (BNPP)) are able to absorb the potential fallout from these exposures in all scenarios. SG's capitalisation would be affected, albeit to a moderate extent, in the most severe stress scenarios. As a result, no rating action has been taken on French banks directly on the basis of these stress tests. KBC Bank (KBCB) of Belgium would clearly be most affected by a potential severe downward cycle, but even in the extreme scenario, the bank's capital ratios remain well above the regulatory minimum. However KBCB's Long-term IDR of 'A+' remains on Negative Outlook, reflecting Fitch's concerns over its CDO portfolio as well as its exposure to Central and Eastern Europe (CEE).
- The Nordic banks have taken crucial steps to strengthen their capital bases in light of the deteriorating domestic and international environment. Swedbank AB has the largest exposure to the region among its Scandinavian peers. Under the stress tests, the impact on Swedbank's capital base is potentially material, which has resulted in the agency taking negative rating action on the entity. In Fitch's View, Skandinaviska Enskilda Banken's (SEB) recent capital increase has provided a sufficient buffer to absorb potential credit losses in the region in Fitch's most severe stress test, hence the Stable Outlook on the bank's Long-term IDR.

- Greek banks derive a sizeable proportion of earnings from foreign operations, although exposures are lower than for the major Austrian banks. Stress tests show that overall their balance sheets are relatively resilient to a sharp downturn in Eastern European markets and that anticipated increases in credit costs should be absorbed by the banks' adequate earnings capacity without affecting capitalisation significantly. Fitch took rating actions on the four major Greek banks in March 2009. These actions reflected the agency's view that the operating environment, both in Greece and abroad, would remain challenging, thus increasing pressure on the banks' financial performance and asset quality.

### **Macroeconomic and Sovereign Overview**

Eastern Europe and the CIS have been hit by three major global shocks that precipitated a sudden and severe deterioration in the macroeconomic and financial environment in autumn 2008: the sharp and synchronised recession in the world's leading 'advanced' economies; a reversal of capital and financial flows; and for commodity producers, a sudden and dramatic decline in export prices. Overall, the region has been the worst affected and remains the most vulnerable owing to the characteristics of many of the countries: large current account deficits, sizeable maturing and short-term external debt, the unwinding of previous strong bank credit and asset booms, often high bank loan-to-deposit ratios and dependence on foreign financing combined with funding and capital pressures at foreign parent banks, the presence of significant foreign currency debt on balance sheets, relative trade openness and, in the case of the CIS, exposure to commodity prices.

The severity of the negative global shocks and the underlying vulnerabilities has led to a rapid deterioration in macroeconomic prospects and sovereign rating dynamics. Since August 2008, Fitch has downgraded the Foreign Currency IDRs of 10 countries in Eastern Europe and the CIS: Bulgaria (to 'BBB-'), Estonia (by two notches to 'BBB+'), Georgia ('B+'), Hungary ('BBB'), Kazakhstan ('BBB-'), Latvia (by three notches to 'BB+'), Lithuania (by three notches to 'BBB'), Romania (by two notches to 'BB+'), Russia (to 'BBB') and Ukraine (by two notches to 'B'). Furthermore, 11 out of 21 countries now have Negative Outlooks/Watches while no countries have Positive Outlooks/Watches, signalling that economic and credit risks are heavily skewed to the downside.

Recent industrial production figures and GDP outturns for Q408 highlight the scale of the economic recession that is gathering pace in the region. For example, in the 12 months to Q408 GDP fell by 10.3% in Latvia and 9.4% in Estonia. Fitch's latest forecast is that GDP in emerging Europe will contract by 3% in 2009, a severe and sudden recession after growth of 4% in 2008. This would be the first fall in aggregate output since the Russian default crisis in 1998 and the worst since 1994. The distribution of possible outcomes is also unusually wide. Countries with flexible currencies have seen substantial depreciations, whilst those with exchange rate pegs are coming under increasing pressure.

Despite some common trends, there is a wide difference in the economic and credit standing of the countries in the region, which is reflected in Fitch's sovereign rating levels; and in their vulnerability to the global financial crisis, reflected in negative rating actions since August 2008. The countries most exposed to the crisis are those with large current account deficits, leveraged banking systems, dependence on foreign capital flows, relative trade openness and exposure to commodity prices. Countries with smaller banking systems and credit booms, moderate macroeconomic imbalances and lower foreign currency loans are less exposed. For the purpose of this exercise, Fitch has created three different country groups (least, moderate, and most vulnerable) according to the likely increase in NPLs related to the vulnerability of countries to the global crisis as well as the previous characteristics of the banking systems. Ukraine, Latvia and Kazakhstan have been placed in the high-risk group, while Slovenia, Slovakia (both in the relatively safe harbour of the euro area), the Czech Republic, Poland and Turkey are in the lower country risk group.

## Support

Increasingly, questions are being raised by investors as to whether banking groups with a strategic interest in the region remain committed to their subsidiaries. This has resulted in the vast majority of senior bank management having to make public statements that the banks would be “here to stay”. For example the Swedish banks (Nordea Bank AB, Swedbank and Skandinaviska Enskilda Banken (SEB)) made explicit statements of support for their local subsidiaries in December 2008, when Latvia started to face severe economic problems. Likewise, in relation to prospective IMF-led support packages, a group of foreign investors in the Romanian and Serbian banking sectors issued a statement on their commitment to their subsidiaries. Given the current global environment and the substantial support provided by various sovereigns to their systemically important banks, the issue of whether such support could be extended to subsidiaries in the region has become paramount.

### Significance for European Banking Groups with Operations in the Region

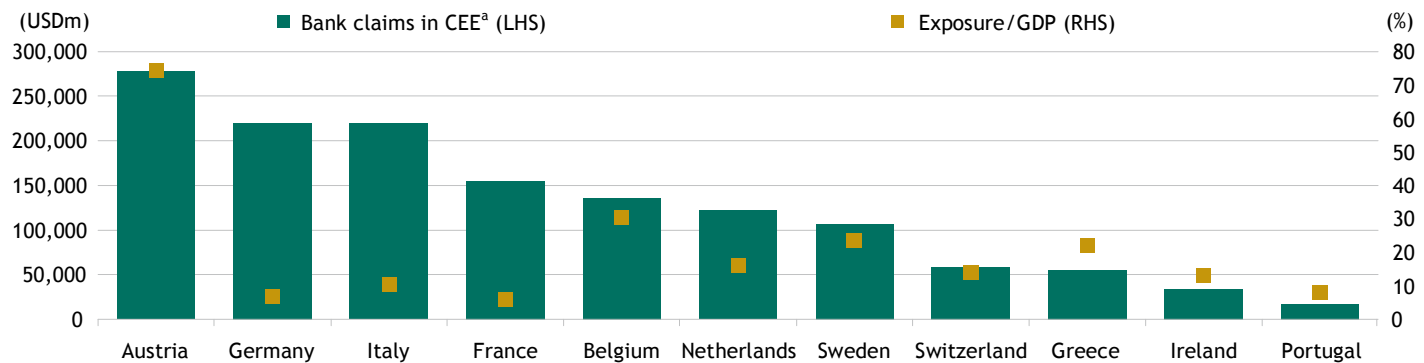
Fitch considers two factors when assessing potential support: these are the potential supporter’s willingness and ability to support a bank subsidiary.

- The *ability* is determined by the parent bank’s Foreign Currency Long-Term IDR. In some cases, the parent bank’s Long-Term IDR may factor in explicit or implicit support from a sovereign and as a result may be at the same level as the parent bank’s Support Rating Floor. In these instances, Fitch also makes a judgement as to whether resources provided by that sovereign would be available cross-border in order to support international subsidiaries, if needed.
- With respect to *willingness* to provide support, Fitch considers the strategic importance of a country/region to the banking group and how the international subsidiary fits into the business operations of the parent bank. If and when a sovereign becomes a shareholder and therefore has the ability to become directly or indirectly involved in operational or strategic decisions, certain business lines or subsidiaries may become non-core, which may affect the willingness to provide support, if needed.

In Fitch’s opinion, the likelihood of parent banks simply letting their international subsidiaries fail is considered remote where there is a perceived high level of strategic importance accorded to the region by the banking groups concerned. While the costs of such a failure can be quantified (via the write down of equity investments and intra-group funding where appropriate), the intangible detriment to the banking franchise and reputational damage cannot. In addition, should a foreign-owned subsidiary be allowed to default in this region, this would pose a real threat of deposit flight away from foreign-owned banks in the same country or may even trigger contagion across the region, which would affect financial stability. In this context, the political will to support member states within the EU has become more cohesive and increasingly visible based on the realisation that economic and financial collapse in Eastern Europe will have significant ramifications for economies and banks in Western Europe. For instance, in October 2008 when Sweden announced that the government would allow domestic banks to subscribe to state guarantees for funding, it was that such guarantees would not only ease the pressure on Sweden-based parent banks, but would also have a positive effect on the liquidity of their foreign subsidiaries, including those in the Baltics. This concurs with a statement by the heads of state or government of the EU member states on 1 March 2009 in which they said that “[w]ith regard to the banking sector, [they] confirm that support for parent banks should not imply any restrictions on the activities of subsidiaries in EU host countries”.<sup>1</sup>

<sup>1</sup> Joint Press Lines, dated 1 March 2009, of the Informal meeting of Heads of State or Government, p.2. Available on [www.consiliium.europa.eu](http://www.consiliium.europa.eu)

**Chart 1: Western European Bank Exposure in CEE by Country of Parent Bank**



<sup>a</sup> CEE/CIS according to BIS (excluding Kazakhstan)  
Source: BIS; Bank of Greece; Fitch

As a result, the agency's base case is that support for EU subsidiaries would be available if they and/or the countries in which they operate are judged to be strategic even if an EU-based parent bank were to receive support from its home sovereign. In addition, it is possible that state support may extend to countries outside the EU, as has been evident in Ukraine, but in these cases Fitch would consider the willingness to provide support on a case-by-case basis as sovereign support may not be extended beyond the borders of the EU.

Recent examples where banks have received substantial state support include Commerzbank AG (Commerzbank with the Federal Republic of Germany being a minority shareholder) and Bayerische Landesbank (BayernLB with the Free State of Bavaria being a majority shareholder). Despite the state support received, BayernLB injected EUR700m of capital into its Austrian subsidiary Hypo Group Alpe Adria (HGAA) in 2008.<sup>2</sup>

## Western European Banking Systems' Exposure to the Region

Chart 1 summarises the exposure of Western European banks to Eastern Europe and the CIS according to data available from the Bank of International Settlement (BIS) at end-September 2008 in USD.

Mainly due to weaknesses and lack of growth potential in their domestic banking markets (market fragmentation, strong competition, and moderate economic growth), many Western European countries' banks identified investments in Eastern Europe and the CIS as an opportunity to overcome the restricted growth potential in their mature home markets. Over the years, Fitch has pointed out its concerns about sustained high credit growth in an increasing number of banking systems in the region, in particular as some of these markets had not been tested in an economic downturn. In addition, many players in the region have tended to lend in foreign currency to their customers, particularly in those countries where the interest rate differential between the local interest rate and the reference interest rate in EUR, CHF or USD has been high. Some countries where lending in foreign currency dominates include Hungary (CHF), Romania (EUR) and Ukraine (USD), as well as the Baltics. Fitch considers foreign currency lending to retail customers as higher risk as movements in foreign exchange rates are typically unhedged. However, the agency notes that risks vary according to the different exchange rate regimes in place in the countries of the region. Also, it acknowledges that banks may use some risk mitigants such as gathering deposits from the borrower in foreign

<sup>2</sup> Currently, BayernLB has to present a restructuring plan to the European Commission (EC), which also addresses the restructuring of HGAA.



currency as well as building in a buffer to allow for depreciation of the local currency or to restructure a loan in foreign currency in order to reduce the financial burden due to the increased repayments resulting from a weaker local currency.

The tables included in the country sections below summarise the potential impact on the banks' capitalisation of Fitch's assumptions under various stress scenarios in respect of NPLs and recovery rates. Fitch has used different assumptions for NPLs in the IMF case, the Asian crisis case and its own Base and Extreme cases (for further details, please refer to Appendix 1). In a bottom-up analysis, Fitch applied these assumptions to the asset classes of the local subsidiaries and aggregated the potential total credit losses at group level to ascertain the overall impact. While the stress scenarios may or may not materialise, Fitch considers, that on balance, the downside risks outweigh the likelihood of a more positive outlook.

### Austrian Banks

Among the Western European banking systems with exposure towards the three country groups, the Austrian banking system has the greatest exposure (see Chart 1). Based on data available from the BIS, the Austrian banking system had a total exposure towards the region to the tune of USD277.6bn at end-September 2008.<sup>3</sup>

This amount also includes lending from the banks' international subsidiaries as well as exposure towards local corporates, banks and governments/municipalities, but should not be confused with the funding requirements as these would be substantially lower. Austrian banks under foreign ownership, notably Unicredit Bank Austria AG (Bank Austria) and HGAA, are excluded from the above amount;<sup>4</sup> if included, they would increase the overall exposure of the Austrian banking system markedly (see Chart 2).

**Table 2: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - Austria**

(bps)	Bank Austria	Erste Group	RZB	Volk.Verb.
Estimated tier 1 ratio <sup>b</sup> (%)	10.3	10.0	9.7	10.9
IMF	820	760	880	590
Asian crisis	>1,030	>1,000	>970	800
Stress test: Base case	630	440	620	380
Stress test: Extreme case	>1,030	>1,000	>970	870

<sup>a</sup> For a description of the underlying assumptions refer to Appendix 1

<sup>b</sup> Including market risk

Source: Fitch

From a historic perspective, Austria is deeply rooted in Eastern Europe and as a result, Austrian banks became investors at an early stage. Due to a favourable economic environment, operations in most Eastern European countries have underpinned growth and profitability at the Austrian banks. For Austria's largest banks, the contribution from Eastern Europe has typically accounted for at least 45% of pre-tax profit in recent years. It is therefore not surprising to see that the performance of the major Austrian banks is vulnerable to a severe regional downturn. This is despite the fact that Austrian banks conduct a sizeable part of their banking operations in the least vulnerable country group (see Chart 2).

### Most Exposed Banks

Under Fitch's stress scenarios, all Austrian banks' capitalisation would suffer significantly. Based on the assumptions, the impact ranges from 380bp for Volksbanken Verbund under the 'base case' stress test while in 'Asian crisis' and 'extreme' scenarios the capital bases would be substantially eroded for most of the banking groups.

<sup>3</sup> Source: BIS Quarterly Review: Table 9B, Foreign claims by nationality of reporting banks, immediate borrower basis.

<sup>4</sup> Source: Financial Stability Report, Issue 16, December 2008, p.15.

Austria's largest bank by assets, Bank Austria, assumes the role of holding company for UC group's banking activities in Eastern Europe (other than Poland) in addition to its domestic banking operations. Accordingly, Bank Austria operates in many different countries, with Turkey, Russia the Czech Republic, Croatia and Bulgaria being the largest contributors to profits. Through its recent acquisitions, Bank Austria also gained substantial exposures in the most vulnerable country group (Kazakhstan and Ukraine).

Erste Group Bank AG (Erste Group), Austria's second-largest bank, has a less diversified presence in Eastern Europe as its acquisition strategy has centred on acquiring major retail/SME banks in neighbouring countries. Erste Group's operations in Ukraine account for a mere 0.5% of group exposure while its largest exposures relate to the Czech Republic, Romania, Hungary and Slovakia.

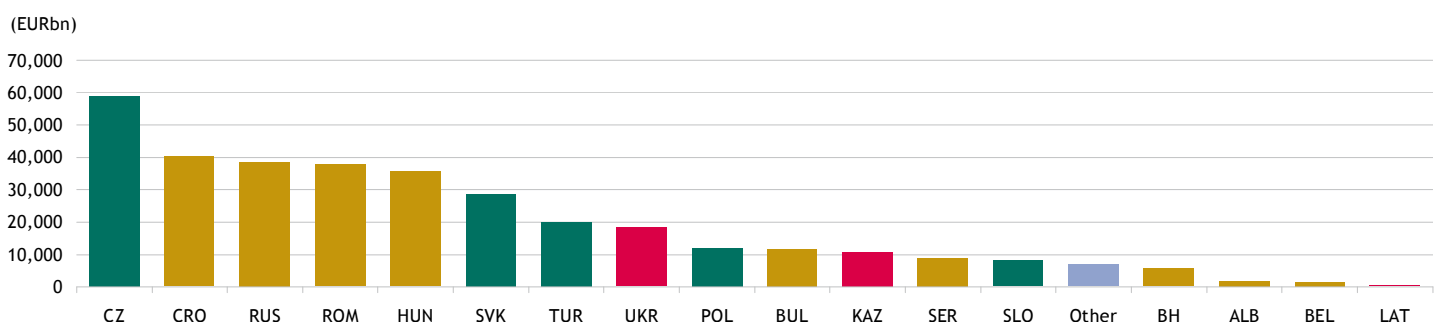
Raiffeisen Zentralbank Oesterreich AG (RZB) was the first domestic bank to start banking operations in Hungary in the mid 1980s. RZB has grouped its activities in Eastern Europe/the CIS in Raiffeisen International Bank Holding AG (RIH), its 68.5%-owned management holding company with the remaining shares being listed. Like Bank Austria, RZB has a wide presence in Eastern Europe and the CIS and has also undertaken some substantial acquisitions in Ukraine (2005) and Russia (2006). In Eastern Europe and the CIS, RZB has seen fast growth rates, partly due to its retail banking activities.

Volksbanken Verbund's (VV) central institution is Volksbank AG (Volksbank). The latter is active in countries in Eastern Europe through its corporate lender, Investkredit Bank AG, with a strong focus on real estate lending, but also through its 51%-owned management holding company, Volksbank International AG (VBI), which primarily focuses on retail lending in Eastern Europe. VBI's largest exposure relates to Romania, followed by Hungary, the Czech Republic and Slovakia. In early 2007, Volksbank purchased small banks in Ukraine and in Bosnia and Herzegovina. VBI had previously expanded its business through greenfield operations, and typically commanded a national market share of up to 5%.

All four of the large Austrian banks hold their investments in Eastern European/CIS countries via subsidiaries with a relatively sizeable proportion of minority interests. In the case of Volksbank, minorities in VBI amount to 49%, for RIH they are 32.5%, Bank Austria's sizeable Turkish operations are held in a joint venture with Koç Group while Erste Group currently holds around 69% of BCR, its Romanian subsidiary. Should some (or all) of the credit losses under Fitch's stress tests materialise, then some would have to be borne by the minority investors in the respective banks' Eastern European/CIS subsidiaries which should reduce the impact on capital to some extent.

**Chart 2: Consolidated Foreign Claims of Reporting Banks at 9ME08 in Austria**

Amounts Outstanding Adjusted for Bank Austria and Hypo Group Alpe Adria



Colour-coding according to country groups (cf. Table 1): green for country group 1 ('least vulnerable'), yellow for country group 2 ('moderately vulnerable') and red for country group 3 ('most vulnerable')

Source: BIS, adjusted by Fitch to include Bank Austria (9M08) and Hypo Group Alpe Adria (H108)

### Rating Actions

#### Erste Group

Long-term IDR: affirmed at 'A' with a Stable Outlook  
 Short-term IDR: affirmed at 'F1'  
 Individual rating: downgraded to 'C' from 'B/C'  
 Support rating: affirmed at '1'  
 Support rating floor: affirmed at 'A'  
 Guaranteed debt: affirmed at Short-term 'F1+' / Long-term 'AAA'  
 Senior unsecured debt: affirmed at 'A'  
 Subordinated debt: affirmed at 'A-' (A minus)  
 Preference shares and Upper Tier 2 debt: downgraded to 'BBB'

#### Bank Austria

Long-term IDR: affirmed at 'A' with a Stable Outlook  
 Short-term IDR: affirmed at 'F1'  
 Individual rating: downgraded to 'C/D' from 'B/C'  
 Support rating: affirmed at '1'  
 Support rating floor: affirmed at 'A'

#### Volksbanken Verbund

Long-term IDR: affirmed at 'A', Stable Outlook  
 Short-term IDR: affirmed at 'F1'  
 Individual rating: downgraded to 'C/D' from 'B/C'  
 Support rating: affirmed at '1'  
 Support rating floor: affirmed at 'A'

### Germany

German banks' sizeable exposure to Eastern Europe (Chart 1) is the result of the following historical trends:

- As the largest European economy with a strong export-oriented industry Germany took advantage of expanding into these markets when they opened up in the 1990s. Several of these countries have subsequently joined the EU. As a consequence, German banks followed their German customer base with branches and trade financing activities;
- German banks were faced with stagnating or modest demand for loans in the domestic market over the last decade. They therefore saw cross-border lending to foreign banks and to larger corporates as well as commercial real estate lending as a way of growing assets;
- Germany's covered bond legislation resulted in the establishment of specialised public sector lenders. These banks started to invest in sovereign and sub-sovereign bonds of countries in Eastern Europe when the ratings of the countries migrated up the rating scale;
- Only three German banks have carried out an acquisition strategy in the region. Since 1998, these banks have acquired existing banking franchises in the region:

**Table 3: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - Germany**

(bps)	BayernLB	Commerzbank
Estimated tier 1 ratio (%)	9.2 <sup>b</sup>	10.1
IMF	204	75
Asian crisis	293	102
Stress test: Base case	107	25
Stress test: Extreme case	308	83

<sup>a</sup> For a description of the underlying assumptions refer to Appendix 1

<sup>b</sup> End-March 2009 pro-forma figure

Source: Exposure data is based on Fitch's own estimates and calculations



Commerzbank in Poland with BRE Bank, BayernLB with MKB Bank in Hungary and Rijecka Banka in Croatia (subsequently sold back to the Croatian state) and HypoVereinsbank (HVB, now part of UniCredit Group) with BPH in Poland. More recently, Commerzbank ventured into Ukraine (Bank Forum in 2008) and BayernLB expanded indirectly by supporting MKB Bank's growth in Bulgaria and Romania as well as through its acquisition of the Austrian HGAA (in 2007), which has meaningful operations in Croatia, Serbia and Bosnia and Herzegovina.

### **Most Exposed Banks**

Fitch believes that Commerzbank and BayernLB are exposed to a deteriorating operating environment in Eastern Europe in addition to the other structural challenges they face. Both banks were in need of external capital injections in 2008/2009 to absorb losses on their own balance sheets. Additional complexities arose from Commerzbank's acquisition of Dresdner Bank AG and in the case of BayernLB, its launch of a restructuring process and implementation of a leaner business model. Whereas BayernLB's Eastern European exposure is biased towards Hungary, Croatia and Serbia/Bosnia and Herzegovina, Commerzbank's exposure is concentrated in Poland and to some extent to Russia, the Czech Republic, Ukraine and Hungary.

### **Rating Actions**

No rating action has been taken on German banks specifically as a consequence of this stress test analysis. The IDRs of these banks are at their support rating floors and the Individual Ratings already reflect a high level of sensitivity to a weakening in the domestic and international operating environment.

### **Italy**

Italian banks started their expansion into Eastern European countries in the late 1990s, when domestic expansion and consolidation was considered expensive and more difficult, and banks considered the expansion in the emerging economies of Eastern Europe a viable strategy to generate growth that was difficult to achieve at home. The two largest Italian banks, UC and Intesa Sanpaolo, have both built up good franchises across a number of countries in Eastern Europe. UC has become one of the leading Western European banks in the region after the acquisition of HVB and Bank Austria, with their rich dowry of subsidiaries in Eastern Europe. For both banks, but to a greater extent for UC, growth from those areas soon became an important part of their strategies. More recently, both banks expanded further east by acquiring banks in selected CIS countries (namely Russia, Ukraine and, for UC, Kazakhstan). With the exception of UniCredit and Intesa Sanpaolo, expansion to Eastern Europe/the CIS has only marginally affected the rest of the Italian banking system, and other Italian banks remain largely domestic, multi-regional or local players. Only a few other Italian banks, including Banco Popolare and Veneto Banca, made small acquisitions of banks in Eastern Europe and the CIS.

### **Most Exposed Banks**

UC has the largest exposure to Eastern Europe and CIS countries among Italian banks and therefore would be the most affected by potential severe stresses in the area. It has a diversified presence with operations in 14 different countries with the most relevant being Poland (nearly EUR40bn in assets at end-2008) immediately

**Table 4: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - Italy**

(bps)	UC	Intesa
Estimated tier 1 ratio (%)	8.03	7.63
IMF	129	No impact
Asian crisis	229	39
Stress test: Base case	82	No impact
Stress test: Extreme case	281	98

<sup>a</sup> For a description of the underlying assumptions refer to Appendix 1  
Source: Fitch

followed by Turkey and Russia (between EUR14bn and EUR15bn of assets). The Croatian and Czech operations are also quite sizeable, with total assets of more than EUR10bn in each country, while those in each of the remaining countries fall below the EUR7bn mark. The entire Eastern European and CIS exposure represented around 16% of consolidated risk-weighted assets (RWAs) at end-2008 and contributed around EUR3bn to consolidated operating profit in 2008. Within Eastern Europe and the CIS, the majority of assets are invested in what Fitch defines as the least vulnerable country group while the most vulnerable accounts for around 10% of the total exposure.

UC is completing a capital strengthening initiative for a total amount of EUR6.6bn: the distribution of a scrip dividend (rather than a cash dividend) relative to FY08, equal to approximately EUR3.6bn (the bank reported net income of EUR4bn for 2008) and a new share issue of EUR3bn (convertible financial instruments largely subscribed by UC's main shareholders) was completed in mid-February 2009. Through these measures, UC reached a core Tier 1 (Basel II) ratio of 6.45% at end-2008. Both these elements have been factored into the consolidated Tier 1 capital ratio subject to stress. In analysing the potential impact of the stress on UC's consolidated Tier 1 ratio, Fitch also assumed that the group would utilise the Austrian and Italian government preference shares that are being organised by the respective countries for an aggregate amount of around EUR4bn. While the impact of stress in the Eastern European/CIS area is a relevant issue for UC, its capital position after the aforementioned government injections would be sufficient to allow it to maintain a Tier 1 capital ratio above the regulatory minimum even in the more severe scenarios. Only in the more conservative Fitch central case, UC's Tier 1 capital ratio would fall below 6%.

Intesa Sanpaolo's overall exposure (7.1% of end-2008 group loans and 8% of group equity in the foreign banks' division, generating 7% of FY08 group net income) is relatively moderate. The bank has a modest exposure to the highest risk countries, with exposure to a diversified portfolio of countries. Fitch expects deterioration in domestic and foreign asset quality, but this should remain manageable in all stress tests with the exception of the Asian crisis scenario.

### *Rating Actions*

#### **UniCredit**

Long-term IDR: downgraded to 'A' from 'A+'; the Outlook remains Negative

Short-term IDR: affirmed at 'F1'

Individual rating: downgraded to 'C' from 'B/C'

Support rating: affirmed at '1'

Support rating floor: affirmed at 'A-' (A minus)

Senior debt: downgraded to 'A' from 'A+'

Lower Tier 2 subordinated debt: downgraded to 'A-' from 'A'

Upper Tier 2 subordinated debt: downgraded to 'BBB+' from 'A'

Tier 3 subordinated debt: downgraded to 'BBB' from 'A-' (A minus)

Preferred stock: downgraded to 'BBB' from 'A'

The ratings of Intesa Sanpaolo have been affirmed.

### **French Banks**

Among France's leading banks, only SG, CA and BNPP have any significant exposures to Eastern Europe and the CIS.

### *Most Exposed Banks*

BNPP's involvement in the region is the most limited of the three. Total retail loans outstanding to Eastern Europe and Russia represented less than 1% of BNPP's consolidated loans at end-2008, almost all of which are related to its 51%-owned Ukrainian subsidiary, UkrSibbank, which is currently being recapitalised by BNPP in

light of local banking regulations. New lending has been halted in Ukraine and existing loans are being restructured. BNPP is also exposed to the region's corporate sector through the extension of cross-border loans, but Fitch believes overall exposure to be relatively moderate.

CA is exposed to Eastern European and Russian risks on the retail side, through its subsidiaries and its consumer finance businesses, and in the corporate sector, largely through Calyon, its wholesale and investment banking subsidiary. On the retail side, by far the most sizeable exposures are in Poland (where CA operates directly through its subsidiary, Lukas Bank), in Serbia (Meridian Bank), Ukraine (Indexbank) and Bulgaria, Romania and Albania (where the group's Greek subsidiary, Emporiki Bank, has established direct banking subsidiaries), where expansion has been fairly significant. In terms of Calyon's wholesale lending activities, public information highlights EUR14bn of lending to the region (end-2007 figures) which represented around 2% of consolidated group lending at that date. CA's total exposures are not believed to be significant in terms of total consolidated loans and stress testing performed by Fitch demonstrates that the group's strong revenue-generating capacities indicate that it is well-placed to absorb even the most severe stress scenarios, with no impact on capital ratios.

**Table 5: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - France**

(bps)	SG
Estimated tier 1 ratio (%)	8.14
IMF	49
Asian crisis	131
Stress test: Base case	No impact
Stress test: Extreme case	89

<sup>a</sup> For a description of the underlying assumptions refer to Appendix 1  
Source: Fitch

SG has focused its international retail banking efforts on expansion into Eastern Europe and Russia throughout the past ten years and has banking subsidiaries in eight countries in the region, the most significant being Komerční Banka (60.3% controlled) in the Czech Republic, Rosbank in Russia (57.6%) and BRD-Société Générale (58.5%) in Romania. Loans extended by those subsidiaries at end-2008 represented 10.6% of total consolidated loans but the group is also exposed, albeit to a lesser extent, through its consumer finance businesses and to the corporate sector, with loans extended directly by SGIB, its wholesale and investment banking unit. Impairment charges at the international banking division (which, in addition to the Eastern European/Russian subsidiaries, includes a handful of other countries) doubled in 2008 but still only reached 73bp of average loans. However, trends show a rapid upwards movement in Q408 (122bp). SG lends in many Eastern European countries, and with the exception of exposures to some more robust or better-managed economies (Slovenia and the Czech Republic), SG is most heavily involved in countries facing greater economic pressure (Romania, Croatia, Serbia, Bulgaria and Russia). Management recorded a EUR300m impairment of goodwill in 2008 as its execution plans in Russia are being delayed. New lending there has been put on hold. Stress testing performed by Fitch shows that SG's capital ratios are resilient to credit losses in the region, with some moderate impact under the three most severe scenarios.

### **Rating Actions**

No rating action has been taken on French banks specifically as a result of this stress test analysis. The Outlook on SG's 'AA-' (AA minus) Long-term IDR was changed to Negative from Stable in February 2009, with the exposure to a downturn in the CEE and Russia as one of the rating drivers.

### Benelux Banks

Banks in the Benelux countries have limited exposure to Eastern Europe/the CIS with the exception of KBCB and Dutch ING Bank NV (INGB). Of the two banks, KBCB has the largest and most diversified exposure. KBCB is a long-term investor in the area and was one of the first Western European banks to invest in Eastern Europe. KBCB, which is concentrated in Belgium, especially in Flanders, entered the Eastern European market in the late 1990s. While opportunities for expansion in its densely banked and highly competitive home market were limited, KBCB looked for opportunities in Eastern Europe to take majority stakes in local banks with a significant market share.

### Most Exposed Banks

Fitch considers that in the major Eastern European countries where KBCB is present (the Czech Republic, Slovakia and Poland), the operating environments have so far been less affected as they are part of the 'least vulnerable' country group. In Fitch's opinion, this group should continue to perform better than other peers. However, KBCB also has operations in Hungary whose banking system is facing specific issues. Given KBCB's exposure to Eastern Europe/the CIS (representing 39% of 2008 group consolidated income (underlying figures), nearly 17% of total consolidated assets or 27% of consolidated group RWAs or 24% of loans at the same date) KBCB is clearly the most affected by potential severe stress in the region among the Benelux banks. However, as its current capital position after the government injections is strong and its exposure is essentially to the 'least vulnerable' country group, KBCB's Tier 1 capital ratio would remain at around 10% in the 'base case' stress test. Even in the more severe scenarios, the bank's Tier 1 capital ratio would remain well above the regulatory minimum. In October 2008, the Belgian government announced a capital injection of EUR3.5bn into KBC Group, which resulted in a capital increase of EUR2.25bn for KBCB and EUR1.25bn for KBC Verzekeringen. In early 2009, KBC Group also received an additional EUR2bn from the Flemish regional government. Both capital injections are expected to have brought KBCB's Tier 1 capital ratio to 11.2% (pro forma bank calculation). Moreover, the Flemish government is committed to making EUR1.5bn in additional capital available, if needed.

ING Bank is mainly exposed through its Polish subsidiary; however, the extent of the exposure is limited and in all the scenarios considered revenues generated would sufficiently cover losses in Poland without affecting Tier 1 capital.

### Rating Actions

The ratings of KBC Bank have been affirmed. No rating action has been taken on other major Benelux banks specifically as a result of this stress-test analysis.

**Table 6: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - Benelux**

(bps)	KBCB
Estimated tier 1 ratio (%)	11.20
IMF	285
Asian crisis	440
Stress test: Base case	121
Stress test: Extreme case	435

<sup>a</sup> For a description of the underlying assumptions refer to in Appendix 1.  
Source: Fitch

### Nordics

Nordic banks are mainly exposed to the Baltic states and to a lesser extent Russia and Ukraine. With the exception of Swedbank, and to a lesser extent SEB, operations in these countries never accounted for significant profit and assets. This reflects: a lower level of need for diversification, given the larger Nordic banks' considerable domestic market shares and their ability to generate satisfactory

profitability in the Nordic market; and their smaller absolute size, which limits expansion into larger markets. The Baltics are among the smaller of the Eastern European countries, which has enabled the Swedish banks to acquire significant market shares there while limiting over-exposition to these riskier countries. In Russia and Ukraine (and Poland for Nordea Bank), operations are usually very modest in size, the bulk of Eastern European/CIS exposure being in the Baltic states.

#### **Most Exposed Bank**

Swedbank has the largest exposure to Eastern Europe and the CIS among its Nordic peers. The impact of the stress tests on its capital is material. Swedbank has acquired the largest bank in the Baltics, Hansapank, which benefits from large market shares in all three countries. In comparison with its Nordic peers, the bank has the largest exposures to Latvia and Ukraine, two countries in the most vulnerable country group (see Table 1) under Fitch's scenarios. In each of the four scenarios, estimated cumulated pre-impairment operating profits over two years are never sufficient to cover total loan losses. Nevertheless, the impact on Tier 1 capital varies significantly depending on which scenario is applied. In Fitch's base case, the estimated Tier 1 ratio at end-2008 – down to around 8% from 11.1% pro forma, including the latest capital measures, – appears to be still acceptable. However, under the most severe scenario, Fitch's 'extreme case' stress test, the Tier 1 ratio drops below the regulatory minimum ratio; this is the only Nordic bank where this happens. The model factors in NPL ratios almost twice as high in country group 3 in comparison with country group 2 under the 'extreme' scenario; given the bank's exposure to Latvia and Ukraine, Swedbank is significantly affected. Swedbank was first to strengthen its capital base in late 2008 through the issue of SEK12.4bn preference shares with a mandatory conversion clause. While this helps provide a buffer against potential greater-than-anticipated losses, the bank remains the most vulnerable Nordic bank if a greater-than-anticipated downturn in the Eastern European/CIS countries in which it operates were to materialise. Like most of its peers, foreign currency lending is material in its Baltic loan book and NPLs are likely to increase sharply in the event that the downside scenario of devaluation were to materialise.

**Table 7: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - Scandinavia**

(bps)	Swedbank	SEB
Estimated tier 1 ratio (%)	11.10	12.10
IMF	340	110
Asian crisis	560	250
Stress test: Base case	350	88
Stress test: Extreme case	940	440

<sup>a</sup> For a description of the underlying assumptions refer to Appendix 1  
Source: Fitch

SEB is mainly exposed to the three Baltic states, where it has significant market shares, acquired through the purchase of a local bank in each of these countries. It has also acquired very small banks in Ukraine and Russia; however management has remained cautious when doing local business in these two countries, so total exposure there is still very small. In addition, SEB has started earlier than peers to rein in lending growth in the Baltics. Given the size of the Baltic exposure, estimated cumulated pre-impairment operating profits over two years are not sufficient to cover total loan losses calculated under each of the four scenarios. However, while the impact in the most severe scenarios is material, the bank's pro forma Tier 1 capital ratio (including the capital increase) falls to 8.3% from 12.1% (excluding Basel II transitional rules) in Fitch's 'extreme case' stress test over two years. In Fitch's base case, the pro forma Tier 1 capital ratio is reduced by only around 90bp to 11.2%, which allows the bank leeway to cope with potential problems in other areas.



For Danske Bank, Nordea Bank, Svenska Handelsbanken (Handelsbanken) and DnB Nor Bank, exposure to Eastern Europe and the CIS ranged between less than 1% of group lending at Handelsbanken to around 6% of group lending at Nordea Bank and DnB Nor Bank at end-2008. This region's contribution to operating profit is similar in size, ranging from being insignificant at Handelsbanken to around 6%. In all Fitch's scenarios, estimated total loan losses are absorbed by pre-impairment operating profits over two years (with one insignificant exception).

### *Rating Actions*

#### **Swedbank AB:**

Long-term IDR: downgraded to 'A' from 'A+', Outlook revised to Stable from Negative

Short-term IDR: affirmed at 'F1'

Individual rating: affirmed at 'B/C'

Support rating: affirmed at '1'

Support rating floor: affirmed at 'A-' (A minus)

Senior unsecured debt: downgraded to 'A' from 'A+'

Guaranteed notes: affirmed at Long-term 'AAA' and Short-term 'F1+'

Subordinated debt: downgraded to 'A-' (A minus) from 'A'

Hybrid notes: downgraded to 'BBB+' from 'A'

No rating action has been taken on other Nordic banks, including SEB, specifically as a result of this stress-test analysis. The Individual rating of SEB was downgraded to 'B/C' from 'B' in February 2009, with Fitch's expectation of further material increases in impaired loans, particularly in the Baltics, as a key rating driver.

### **Greek Banks**

The expansion of Greek banks in the neighbouring region, notably South East Europe, can be seen as a result of Greece's entry into the euro zone in 2001: banks benefited from continued domestic credit expansion on the back of relatively low real interest rates and strong GDP growth and re-invested some of their improved earnings in foreign operations. This expansion was intended partly to benefit from strong credit growth and wider net interest margins (NIMs) in an under-banked region and partly to diversify revenue sources and to counter an anticipated slowdown in lending growth in the domestic market.

Historically, Greek banks followed their corporate customers into bordering countries and have leading market shares in the Former Yugoslav Republic of Macedonia (FYROM), Albania, Bulgaria, Serbia and Romania. However, in the late 2000s, the major Greek banks accelerated their expansion across the region and entered new countries (eg Poland and Ukraine) where trade and cultural links are less obvious and where they stand in direct competition with larger Western European banking groups. The presence of Greek banks abroad remains largely concentrated with the country's four largest banks.

Acquisitions were the main route to Greek banks' initial growth in the region. However, organic growth gradually became more important, as appropriate takeover targets became sparser and pricier, and Greek banks started expanding their already established local operations. Expansion strategies were also not uniform with some banks, eg National Bank of Greece (NBG), making sizeable acquisitions (Finansbank in Turkey) and others (eg Eurobank and Alpha) tending to acquire smaller banks in their target countries and then expand them.

### *Most Exposed Banks*

The four-largest Greek banks NBG, EFG Eurobank Ergasias (Eurobank), Alpha Bank (Alpha) and Piraeus Bank (Piraeus) are mainly exposed to Eastern European countries, largely to EU member countries such as Romania and Bulgaria, and to a lesser extent Serbia. NBG is also significantly exposed to Turkey through its

majority stake in Finansbank A.S. (Finansbank, rated 'BB'/Outlook Stable). NBG is the most affected bank in all stress scenarios as a result of its sizeable exposure to Turkey in addition to its Eastern European operations. Eurobank also has some exposure to Poland and Piraeus to Egypt, although the latter is excluded from the analysis. Alpha has built up its international presence mostly through organic growth, which is in contrast to the approach adopted by most of its domestic peers, notably NBG and Eurobank. Although business in foreign subsidiaries is still largely concentrated on corporates, retail lending has grown very rapidly from low levels in an attempt to take advantage of under-banked countries with high growth potential and wider credit spreads. In addition, a significant proportion of lending in the Eastern European region (ie in some cases the aggregate can be as high as 75%) is in foreign currency (largely EUR denominated), which increases risks and balance-sheet currency mismatches.

Greek banks' overall exposure remains largely domestic. The share of foreign assets (mainly loans) to group total assets was around 11% at Alpha (Romania 6.6% and Bulgaria 1.6%), around 11% at Piraeus (Romania 4.4% and Bulgaria 3.9%), around 25% at Eurobank (Romania 7.3%, Poland 6% and Bulgaria 5%). In the case of NBG, foreign assets stood at 24.6% at end-Q308, although this ratio increases to 32.5% when measured as a proportion of total group loans (Turkey 18.5%, Bulgaria 6.1% and Romania 3.3%). The contribution from foreign operations to group profits has increased in recent years despite high expansionary costs and stood at 15%-20% of pre-tax profit at end-2008, except for NBG which reached 40% of core profits at end-Q308. The Greek state capital injections expected in the form of preference shares in Q109 are as follows: EUR350m for NBG, EUR950m for Eurobank, EUR940m for Alpha and EUR370m for Piraeus. Taking this into consideration, loan impairment reserves allocated to foreign operations by each bank and two-year accumulated pre-impairment operating profit with a different discount factor applied by Fitch (to account for a weakening operating environment), it is the agency's view that the four largest Greek banks have sufficient capital buffers to manage scenarios 1, 3 and 4 reasonably well. In Fitch's base case (scenario 3), none of the four banks would have to absorb losses against capital. Under scenario 1 (IMF base) and 4 (Fitch's worst case), the pro forma Tier 1 capital ratios for Alpha would remain above 9%, above 8% for Eurobank and Piraeus, respectively, and 6%-7% for NBG. This allows Greek banks some leeway to absorb increased asset quality problems in Greece amid the country's significant economic slowdown, particularly at Eurobank and Alpha as they have a higher domestic risk profile than Piraeus. As could be expected, NBG is most affected in all scenarios as a result of its sizeable exposure to Turkey in addition to its Eastern European operations. However, it is only under scenario 2 (the Asian crisis base) that NBG would come close to breaching the Tier 1 regulatory capital requirement.

### Rating Actions

Fitch took rating action on the four major Greek banks in March 2009. These rating actions reflected the agency's view that the banks' operating environment, both in Greece and abroad, would remain challenging, thus increasing pressure on their financial performance and asset quality.

**Table 8: Impact of Stress Scenarios on Estimated Tier 1 Capital<sup>a</sup> - Greece**

(bps)	NBG	Eurobank	Alpha	Piraeus
Estimated tier 1 ratio (%)	10.4	11.4	10.2	8.9
IMF	300	50	No impact	No impact
Asian crisis	670	210	20	No impact
Stress test: Base case	No impact	No impact	No impact	No impact
Stress test: Extreme case	430	340	70	70

<sup>a</sup> For a description of the underlying assumptions refer to Appendix 1  
Source: Fitch

## Appendix 1: Definition of and Assumptions for Fitch's Four Scenarios

For the purpose of this exercise, Fitch has grouped Eastern European and CIS countries into three groups according to likely NPL increases related to the vulnerability of countries to the global recession and therefore their different levels of resilience to a downturn as well as the previous characteristics of the banking systems (see also Table 1).

1. Country group 1 consists of the Czech Republic, Poland, Slovakia, Slovenia and Turkey;
2. Country group 2 consists of Eastern European/CIS countries not included in the two other categories;
3. Country group 3 consists of the countries considered higher risk: Kazakhstan, Latvia and Ukraine.

Fitch has assumed recovery rates per asset class for each country group to take into account the business profile of each bank, applying lower recovery rates for countries in country group 3 and higher ones for countries in country group 1. The main asset classes are residential mortgage lending, commercial real estate lending, corporate loans, and unsecured personal loans, all of which are in foreign and local currency. Recovery assumptions are lower for lending in foreign currency.

Fitch has then derived four scenarios, applying various NPL ratios. Two scenarios – scenario 1 and scenario 2 – are more simple, with one NPL ratio for all the countries and asset classes based on historical observations during a previous crisis (IMF data) and the Asian crisis.

- Scenario 1: Applies a 25% NPL ratio across all countries – this is the median for 42 selected systemic banking crises from 1970-2007 studied by the IMF.
- Scenario 2: Applies a 33% NPL ratio across all countries – this is the average for the Asian crisis.

For the next two scenarios, 3 and 4, NPL ratios differ per country group:

- Scenario 3: this is Fitch's base case, with an NPL ratio of 10% for country group 1, 17.5% for country group 2 and 37% for country group 3.
- Scenario 4: this is Fitch's extreme case, with an NPL ratio of 20% for country group 1, 37% for country group 2 and 60% for country group 3.

### Further Assumptions

Exposure relates mainly to banks with operational subsidiaries in Eastern Europe and the CIS; whenever possible, cross-border exposure booked at the parent bank has also been taken into account.

To assess the impact of the potential need for state-funded capital support on the creditworthiness of the sovereign following significant losses at banks exposed to Eastern Europe and the CIS, Fitch has assumed that losses are taken up-front. For the purpose of this report, however, the agency has taken a two-year time horizon for the crisis given that banks are viewed as going concerns. Accordingly, pre-impairment operating profits for 2009 and 2010 have been estimated on a case-by-case basis and are taken into account to absorb loan loss provisions and consequently reduce the impact on capital. The pre-impairment operating profits for 2009 and 2010 have been analytically adjusted: a higher discount rate has been applied when assessing the most exposed banks' – such as Austrian banks' – future profit, given that in comparison to the Swedish banks, a higher proportion of previous years' profit was generated by the now troubled Eastern Europe and the CIS. Loan loss reserves allocated to this region have also been taken into account as potential loss absorption. Neither tax implications nor movements in foreign

exchange rates have been taken into account. It has been assumed that the loan book will remain flat.

Recent or announced but still to be finalised capital increases have been taken into account. One major assumption is that RWAs remain flat (although these will be affected by risk migration due to deteriorating asset quality and lower lending due to lower financing and foreign exchange movements). Potential asset quality problems in other countries in which the banks operate have not been taken into account in the different scenarios.

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