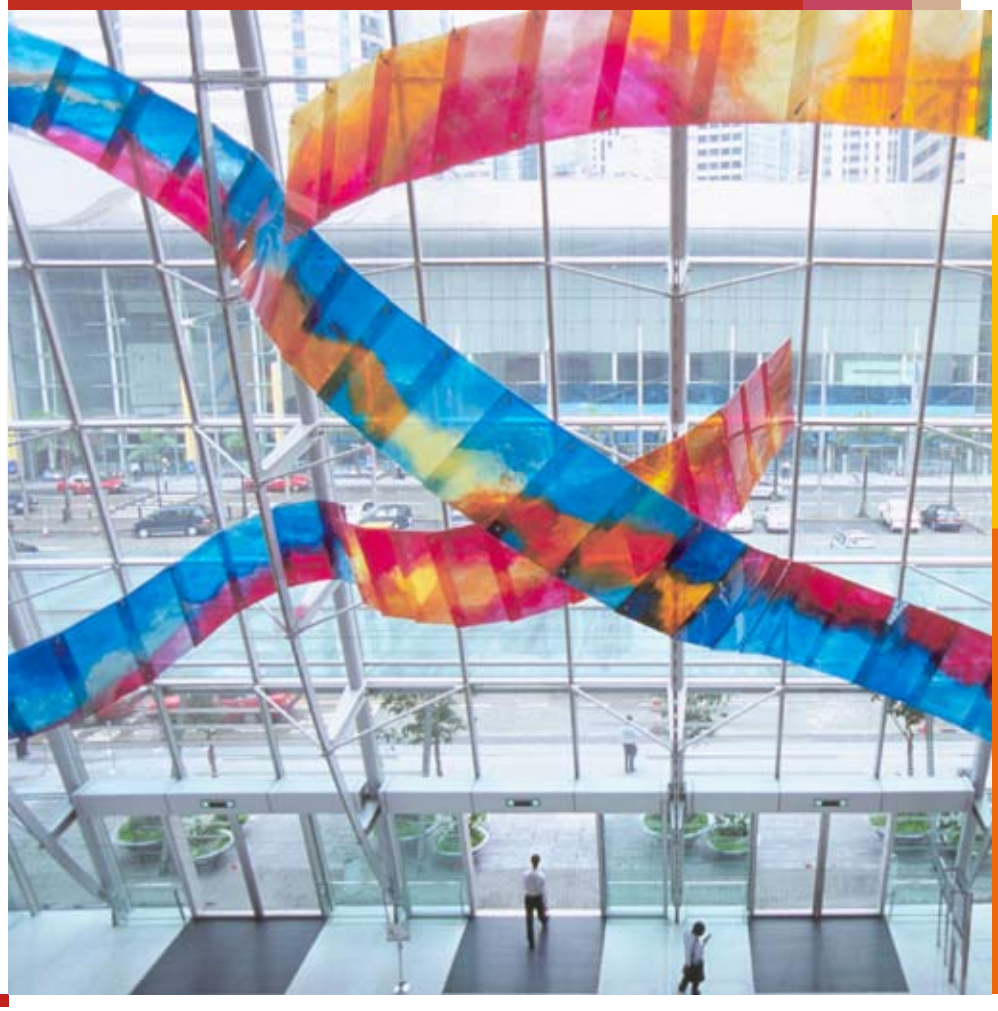
Portfolio Advisory Group

European outlook for non core and non performing loan portfolios

ISSUE 3: Debating Deleverage

April 2011



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Executive summary

The task facing European banks as they seek to deleverage is enormous. Many banks around Europe have communicated that they have identified a whole raft of non core loan assets that they are seeking to aggressively run off or sell. We estimate that identified non core assets in the European banking sector exceed EUR 1.3 trn. Dealing with this massive issue will require a significant volume of transactions and, to put the scale required into context, the average annual European banking M&A market between 2003 and 2010 totalled just EUR 70 bn.

The banks have been deploying a number of tactics to deleverage and, whilst some have been very open about their transactional activity, others have operated more discretely. Investors, expecting a flood of opportunities, have, in the main, been disappointed. The most talked about barrier to transactions of loan portfolios is that of price – in many cases a significant difference exists between the expectations, or perhaps requirements, of sellers compared to the prices that investors have been willing to pay. From the vendor perspective, some of this difference is driven by the nature of accounting policies and the impact this has on provisioning levels, whilst on the investor side, relatively higher costs of capital combined with higher levels of uncertainty in certain markets has also played a part. This price gap simply prevents many banks from selling due to the potential impact on capital.

As well as price gaps there are a number of other factors that are barriers to transactions. A key barrier is the band width that many banks have to enter into sales processes. The whole process of assessing the value maximising options for a given portfolio of loans can be hugely time consuming and labour intensive. Corporate loan books that have been aggressively expanded over a short number of years will probably contain a large mix of different types of loans – and in our experience many will need to be assessed on a case by case basis. Even after this assessment has taken place and portfolios for potential sale identified, the task of collating all the information to provide to potential acquirers, dealing with related hedging positions, sub participations and other complex structures all takes time. It is no wonder that, to date, it has been some of the more homogeneous portfolios or more liquid assets that have so far come to market. Other barriers include the huge levels of Government support that has allowed banks to avoid divesting of assets under pressure, the lack of funding that has been available to potential investors and finally, quite simply, the perceived stigma of being a vendor of asset pools that many banks have, in the past, proudly grown.

We therefore expect the deleveraging process to take, at least, another 10 years.

Banks also face the challenge of addressing a continued increase in the volume of non performing loans. PwC[i] estimate that the level of reported NPLs across most of Europe has increased by 15% between 2009 and 2010. While this rate of increase is significantly lower than previous years, it is still an increase in value terms of around EUR 100 bn. We expect the growth rate of NPLs to continue to slow as the economic recovery gains momentum; but the impact of rising interest rates and austerity measures in many countries adds a layer of uncertainty as to the future ability of both corporates and consumers to meet their debt obligations.

[i] 'PwC' refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network.

European Overview:

Table 1: Estimated quantum of NPLs by country 2008-10

EUR bn	2008	2009	2010 [ii]	% increase FY09-FY10	% increase FY08-FY09	Source
Germany	142	210	225	7%	48%	BaFin, Annual Reports, PwC analysis
United Kingdom	107	155	175	13%	45%	Broker reports, PwC analysis
Spain	75	93	103	11%	24%	Bank of Spain
Italy	42	59	76	29%	40%	Bank of Italy, ABI
Ireland	15	88	109	24%	487%	Financial statements, NAMA, PwC analysis
Sub-total	**381**	**605**	**688**	**14%**	**59%**	
Greece	12	20	24	20%	67%	Bank of Greece
Russia [iii]	1	17	19	12%	1,600%	Central Bank of Russia
Poland	6	12	16	33%	100%	BRE Bank, Polish Financial Supervision Authority
Ukraine	2	6	8	33%	200%	National Bank of Ukraine
Czech Republic	3	4	5	25%	33%	Czech National Bank
Romania	1	3	5	67%	200%	National Bank of Romania
Hungary	2	3	5	67%	50%	Hungarian Financial Services Authority
Turkey	8	11	11	0%	38%	BRSA (Turkish Banking Regulation and Supervision Agency)
Total	**416**	**681**	**781**	**15%**	**64%**	

(ii) 2010 balances include, in most cases, NPL information as at Q2 or Q3 2010 when year end data was not available as at the time of writing.

(iii) Balance relates to overdue loans since no direct information on NPLs is available.

Highlights of issue 3:

- In Germany, NPL volumes have continued to increase in 2010, albeit at a much slower rate than the previous year. This is despite the German economy being one of the best performers in Europe and experiencing growth of 3.6% in the first nine months of 2010. There were however a limited number of transactions, mainly as a result of the bid ask price gap. Secured corporate and retail residential loans are expected to come to the market in the next twelve months.

- 2010 is expected to be the peak year for NPLs in the UK even though the economic recovery remains fragile and there is uncertainty arising from the significant budgetary cuts implemented by the UK Government and the current softening in the UK property market. Non core asset activity has experienced a pick up, mainly around commercial lending portfolios. More assets (mainly commercial lending portfolios) are expected to come to the market in 2011 from both overseas and local banks.

- In Spain, regulatory changes implemented by the Bank of Spain have resulted in banks increasing their provisioning for bad debts significantly, which has been a positive factor to the overall non core and NPL market. The high country risk premium may discourage certain investors from investing in residential mortgages (which make up the majority of delinquent assets), although we have seen instances where vendor financing and structuring has been used to bridge the price gap. We expect to see an increasing number of such transactions in 2011.

- Italy has experienced the largest percentage increase in NPLs of the major Western European economies in 2010. Transaction levels have, however, remained subdued due to pricing considerations along with uncertainty over the legal foreclosure process, which has adversely affected the price investors are willing to pay for such assets.

- Ireland is currently the focus of many investors, mainly as a result of the high level of distress of the local banking sector. However, we expect investment in Irish assets to be limited in 2011 due to the high risk premium that investors will require in pricing these assets (see PwC Investor Confidence Survey-Ireland Q1 2011).

- Greece, as expected, has seen NPL levels increase significantly as the Government has sought to cut the budget deficit with measures taking their toll on the ability of consumers and corporates to repay their debt. We expect a very low level of transactions in 2011, mainly due to the lack of transparency over collateral values and timing to recover security.

- All of the CEE countries covered in our publication (Poland, Ukraine, Czech Republic, Romania, Hungary) reported significant increases in overall NPL volumes, which implies that 2010 was another very difficult year for the local banks. The rise has been mainly fuelled by impairments in retail portfolios. We expect to see similar rises in the next 12 months, as this trend spreads to corporate loan portfolios. We consider that transactions will be mainly driven by local investors, as major international players are focusing their attention on the UK, Germany, Spain and Ireland.

- Turkey was one of the few countries that experienced significant GDP growth in 2010. A high level of activity in their non core and NPL market has attracted the attention of many international investors since Turkish banks are relatively well capitalised and have maintained high provisioning ratios, mainly as a result of regulatory requirements implemented during the banking crisis of 2000-2001.

- The Middle East in general has also experienced an increase in NPLs with some parts (such as Bahrain and Dubai) impacted more than others (Qatar and Saudi Arabia). Transactions remain limited, although recent high profile restructurings are beginning to attract the attention of international investors.

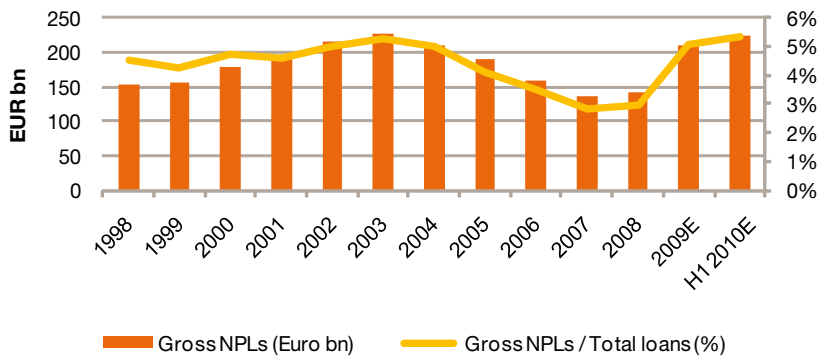
Germany: NPLs remain at high levels despite strong economic growth, however transactions remain limited

Market trends in NPLs

Based on our estimates, NPLs in Germany could be as high as EUR 225 bn as of 30 June 2010. NPLs in the German market grew significantly between 2008 and 2009, reaching EUR 210 bn as at the end of 2009.

According to the Statistisches Bundesamt, during the first half of 2010 corporate and consumer insolvencies remained at a high level. However, to counterbalance this, we note that corporates and consumers showed improved payment behaviour[1] aligned with a robust recovery of the German economy[2]. Banks' most recent financial statements suggest that NPLs have stabilised towards the end of the year.

Graph 1: NPL development in the German market



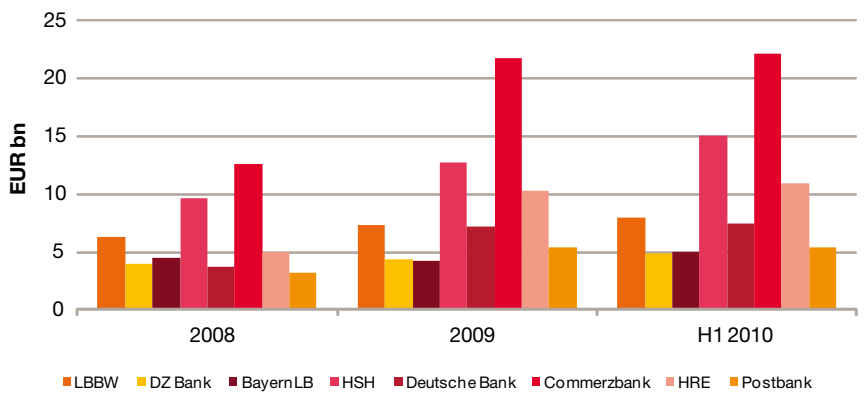
Source: BaFin, Published Financial Statements, Bankscope, Deutsche Bundesbank, PwC analysis

NPLs in Germany could be as high as EUR 225bn as at 30 June 2010.

[1] Bundesverband Deutscher Inkasso-Unternehmer e.V. – Autumn Survey 2010

[2] ZEW – Konjunkturerwartung, October 2010

Graph 2: Gross NPLs for key German banks



Source: Published Financial Statements / PwC analysis

Bank trends in NPLs

The major factors increasing the volume in the German NPL market in 2009 were company insolvencies and consumer defaults in a sharp economic downturn (GDP decline of 4.7%). Although in 2010 the NPL volumes increased marginally for some banks (such as LBBW and DZ bank), others (such as Deutsche Bank, Commerzbank and Postbank) reported no increase. This potentially is linked to an economy in recovery, as Germany was experiencing sharp economic growth (GDP growth of 3.6% after adjustments[3]) in the first nine months of 2010.

Drivers for future transactions

The historical peak of NPL transactions in Germany was during the years 2004 to 2006. Since then, there has not been comparable activity. In 2010, only a few transactions have been completed and the expected increase in transactions did not materialise. Furthermore, similar to other European markets, the transactions that have happened (some of which are listed below) were mainly non core assets, rather than NPLs. We believe this is due to a combination of factors such as:

- the Government support that allowed banks to avoid fire sales of assets (at least at the early stages of support);
- the pricing gap between sellers and buyers, driven by book values being significantly higher than market values;
- reluctance by bank senior management to be seen as distressed asset sellers; and
- high debt funding costs for local and international investors.

In our opinion, the potential for future NPL portfolio transactions in Germany is considerable, given the higher capital requirements that will be imposed by Basel III and the need for many banks who received Government support to repay the financial assistance provided.We believe when those portfolios come to the market, the main focus will be on the residential mortgages and secured corporate loans.

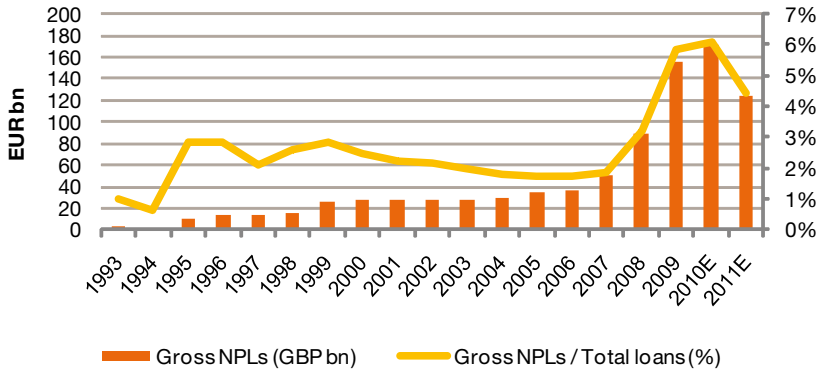
Table 2: Selection of recent transactions in the German market

Seller	Buyer	Asset type	Face value	Completion date
WestLB[4]	Erste Abwicklungsanstalt	High risk and non-strategic assets including non-performing loans	EUR 77bn	April 2010 with retrospective effect to 1 January 2010
Hypo Real Estate AG[5]	FMS Wertmanagement	Securities and non-strategic assets including real estate loans	EUR 173bn	October 2010
Credit Suisse[7]	Apollo	Commercial real estate	USD 2.8bn	December 2010
Unknown[6]	Colony Capital LLC	Mainly German commercial and residential real estate loans	EUR 100m	December 2010

[3] Statistisches Bundesamt
[4] n-tv 'West LB vor Aufspaltung' , 11 April 2010
[5] Tagesschau 'Hypo Real Estate befreit sich von faulen Krediten', 3 October 2010
[6] Börsen-Zeitung 'Immobilien: Non-Performing Loans haben Hautgout', 5 August 2010
[7] Wall Street Journal, 'Apollo swoops in on bank's fire sale', 24 December 2010

UK: 2010 was characterised by a continued focus on deleveraging non core assets and signs that NPL transaction activity is returning

Graph 3: NPL development in the UK market



Source: Deutsche Bank, European Banks, 29 September 2010

Market trends in NPLs

In 2010 NPLs in the UK are expected to exceed EUR 170 bn, representing an increase of around 13% compared to the previous year. 2010 is expected to be the peak NPL year for the UK banks, with both volumes and amounts expected to gradually decrease from 2011 onwards as the economy recovers from recession.

NPLs as a % of total loans are expected to reach their highest point at 6.1% as at the end of 2010. There is no doubt that significant deleveraging in the UK balance sheets still needs to happen.

Drivers for future transactions

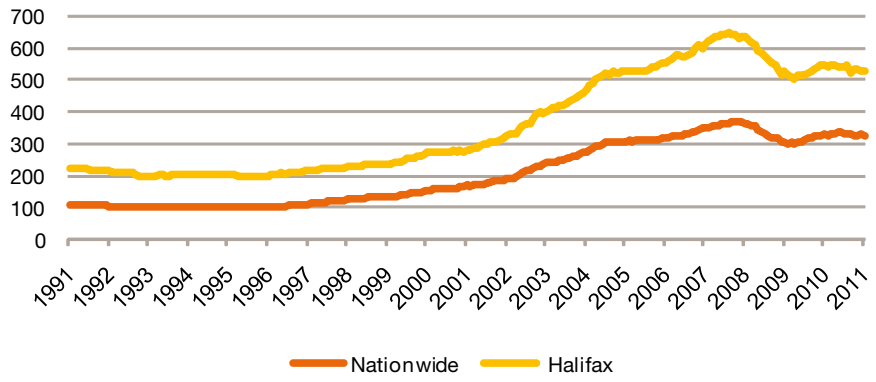
Austerity measures: Government budget cuts are estimated at more than GBP 80 bn by 2015[8]. The announced cost cutting measures are estimated to lead to a decrease of up to 300,000[9] jobs in the UK public sector. GDP decreased by 0.6% in the fourth quarter of 2010 (compared with an increase of 0.7% in the previous quarter). PwC expects modest GDP growth of 1.4% in 2011 and just over 2% in 2012, but this is not expected to be enough to decrease unemployment significantly.

The above is likely to put additional pressure on the UK consumer's appetite for new lending and the gradual effort to deleverage which will have an adverse impact in the profitability of the UK banks, both by suppressing potential growth and by partially offsetting any significant drop in NPLs.

UK housing market: Prices for residential properties in the UK have recently experienced a softening, with certain leading indicators[10] showing a 2.4% decrease in annual prices (three month average against the same period last year). Many market analysts see the above as the start of a longer downward trend in UK property. PwC has recently estimated a 70% chance that real house prices will see negative growth compared to 2007 peak levels in the next five years and a 50% chance that real house prices will be below 2007 peak levels in 2020[11]. The above is expected to be partly the

[8] bbc.co.uk, 3 March 2010
[9] thetimes.co.uk, 23 May 2010
[10] Halifax House Price Index, January 2011
[11] PwC UK Economic Outlook, July 2010

Graph 4: UK seasonally adjusted house price indicies



* Nationwide Base Year: 1991; Halifax Base Year: 1983
Source: Nationwide Building Society / Halifax, January 2011

UK is currently experiencing a declining property market with London proving more resilient than the rest of the UK

result of tighter lending conditions implemented by the UK banks along with consumer fears over the wider UK economy. This is demonstrated through subdued demand for mortgage lending which still remains well below pre-crisis levels.

Poor quality properties in areas of oversupply are expected to be particularly affected.

Bank liquidity pressure: UK banks have previously relied on the secured funding markets. Given the effective closure of these markets during the crisis, institutions became reliant on the Bank of England Special Liquidity Scheme (SLS) in order to finance or refinance part of the current loan book.

Given that the SLS will expire at the end of January 2012, UK banks will have to refinance approximately, as at November 2010, GBP 110 bn before then[12]. The Bank of England has extended the criteria of its Discount Window Facility ("DWF") in order to allow for loan portfolios to be used as collateral (previously the main collateral has been residential mortgage backed securities). Institutions will also look to mitigate the funding shortfall in other ways. We consider that NPLs and non core asset disposals will play an important part in the banks' 2011 strategy to improve liquidity alongside restrictions on new lending.

The recent Basel III announcements: The recent Basel committee proposals (with some parts to be finalised in 2011) have set new criteria for the calculation of the risk weighted assets (RWAs) and imposed stricter criteria on what can be defined as capital along with a possible additional capital buffer for systemically important institutions. This will require banks to maintain higher capital cushions (Core Tier 1 Capital), especially for investment banking arms that usually carry a higher percentage of the banks' RWAs. Even though the proposals are not expected to be fully implemented before 2019, the market is already expecting major banking players to clarify their strategy in relation to how they propose to address the above.

[12] Bank of England, Financial Stability Report, December 2010

Therefore this will put additional pressure on banks to reduce capital intensive assets in their balance sheet sooner rather than later, either through a direct sale or through a structured solution aimed at reducing their RWAs.

Contagion effect from the Irish market: Many UK banks are keeping a watchful eye on what the Irish banks will do with their UK loan exposures. There is an expectation that such exposures will be exited, given the need for Irish banks to deleverage. The UK banks are cautious not to flood the market with opportunities since there is a risk that similar assets from several institutions could be brought to market at the same time. This could have an adverse effect on price and therefore, strategically thinking about timing of any major transactions is critical.

Selection of recent transactions in the UK markets

The UK market has seen a limited number of transactions in the past six months, since the divergence of pricing expectations between sellers and investors still exists, however this is to a lesser extent than in 2009. We summarise a selection of recent portfolio transactions that highlight a range of strategies being used to deleverage. The transactions range from single credit to large portfolios, bilateral and auction sale procedures and a range of strategic and financial buyers.

Increased transaction levels in 2010 have been mainly driven by large corporate portfolios

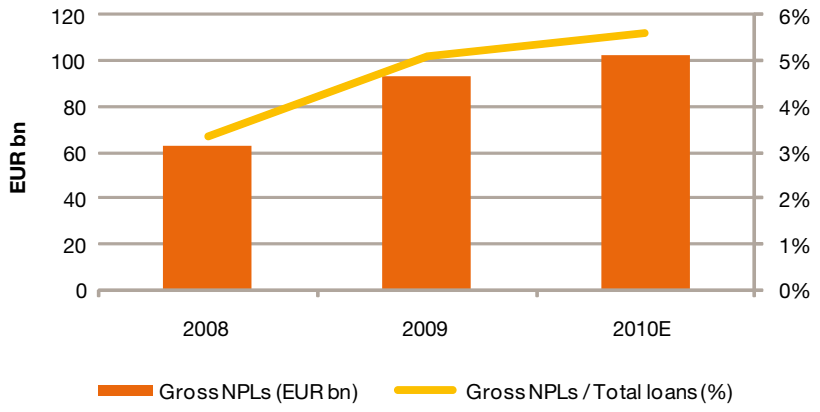
Table 3: Selection of recent transactions in the UK market

Seller	Buyer	Asset type	Face value	Completion date
RBS[13]	Intermediate Capital Group	European Leveraged Finance Loans	EUR 1 bn	August 2010
RBS[14]	Variety of hedge funds and private equity investors	Mezzanine Loans	EUR 250 m	October 2010
RBS[15]	Mitsubishi UFJ Financial Group	Project Finance Loans	GBP 3.8 bn	November 2010
RBS[16]	Unknown	Commercial Real Estate Loans	GBP 1.6 bn	In progress
Lloyds Banking Group[17]	Varde	Corporate exposure (Crest Nicholson)	GBP 150 m	October 2010
Lloyds Banking Group[18]	Legal & General	Retail portfolio	GBP 150 m	Q3-Q4 2010
Lloyds Banking Group[19]	Cerberus	Single Corporate Loan of Maxim Scheme in Glasgow, Scotland	GBP 95 m (price paid GBP 30 m)	January 2011
Bank of America[20]	Haymarket Financial	Corporate exposure (Foxtons)	Unknown	October 2010
Unknown[21]	Westcore Europe LLC	Commercial Real Estate Loan	GBP 84.5 m	September 2010
Morgan Stanley Bank International Limited[22]	Paragon	Secured Buy to Let portfolio	Unknown	September 2010

[13] Financial Times, 15 October 2010
[14] Financial Times, 15 October 2010
[15] Reuters, 15 November 2010
[16] Financial Times, 21 February 2011
[17] Financial Times, 15 October 2010
[18] Property Week, 23 July 2010
[19] Property Week, 23 July 2010
[20] Financial Times, 15 October 2010
[21] Marketwire News Releases, 30 September 2010
[22] Paragon 2010 financial statements

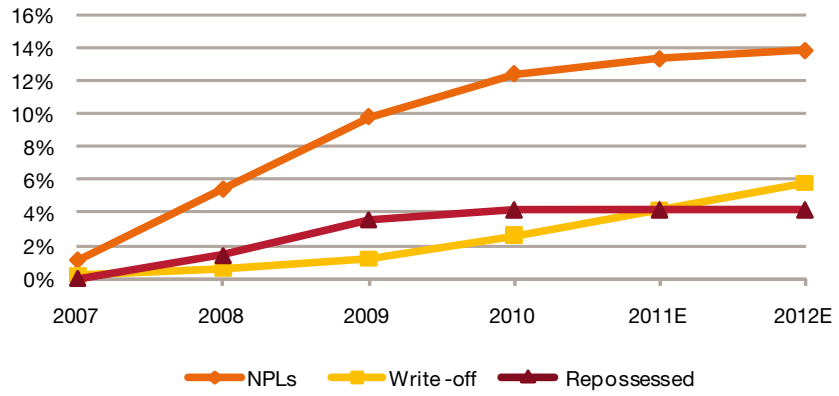
Spain: Regulatory changes driving an uptick in transactions while levels of distress keep increasing

Graph 5: NPL development in the Spanish market



Source: Bank of Spain, August 2010

Graph 6: Type of impaired assets as a percentage of total assets



Source: Bank of Spain, 30 June 2010

The vast majority of NPLs in Spain relate to residential mortgages (70% of total bad debts)[23]. The ratio of doubtful mortgages as a percentage of total mortgages is approximately 16%[24]. However, even though in 2010 house prices appear to have stabilised, industry sources suggest that they still remain high which means that further impairments are still to come.

Drivers for future transactions

During 2010, there have been several important legislative changes in Spain, which could act as a stimulus for future transactions:

- Funding from the FROB (Fund for the Restructuring of the Banking sector) ceased in July 2010. According to figures published by the Bank of Spain, before the restructuring processes began, there were 191 financial institutions (including banks, savings banks and credit unions). As of November 2010, there were just 145 institutions, reflecting the significant consolidation experienced by the sector. We expect many of the combined entities to sell non core loans and NPLs, as part of cleaning up their balance sheets.

[23] Bank of Spain
[24] Bank of Spain, June 2010

- In May 2010, the Bank of Spain published the circular 3/2010 on provisions for impaired assets which modified Annex IX of the previous circular 4/2004. The circular simplified the provisioning process; it also decreased the provisioning calendar (the period over which financial institutions are expected to build the required provisions) for all assets to 12 months, which has led to increased provisioning (previously, the provisioning calendar was up to 24 months for unsecured assets and up to six years for secured assets). In addition, a 30% provision is required for foreclosed assets, once they have been held on the balance sheet for more than 24 months (if they are held for investment). Therefore financial institutions are starting to be more receptive to the option of selling such assets to improve their liquidity and pricing is likely to come more in line with buyer's expectations.

The revision to the bad debt provisioning policy triggered immediate investor interest in those assets and although only a few transactions have been completed in the market (EUR 0.3 bn approximately in the year to date)[25], we believe that the increased transaction trend will continue over the next six to twelve months and that significant volumes of assets will come to market, eclipsing the EUR 3 bn transacted in 2008 and 2009.

Furthermore, PwC estimate that one of the key capital requirements of Basel III, that every financial institution maintains a Tier 1 capital ratio of at least 7%, implies a capital injection of between EUR 35 bn to EUR 40 bn in Spain. We believe that Spanish financial institutions will need to improve their solvency ratio and an important part of this will come from the sale of NPLs and non core assets (mainly corporate credits given the relative impact of those on capital and solvency ratios).

In terms of asset class, construction and development represents over EUR 400 bn of lending but is a more complex segment with a larger price gap. The residential and commercial mortgage sector represents by far the largest credit segment in Spain at over EUR 600 bn.

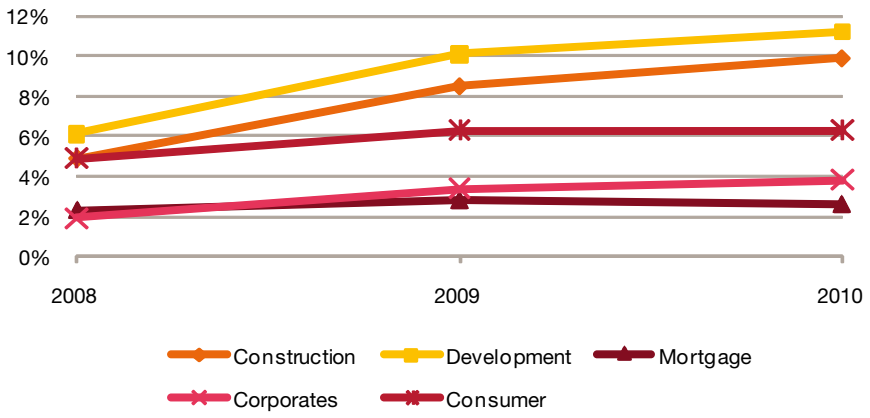
Graph 7: Credit by segment as of 30 June 2010

Source: Bank of Spain, 30 June 2010

[25] PwC analysis

Given the liquidity constraints in Spain and the high country risk premium currently assigned to the country by the ratings agencies, a key success factor for any transactions will be vendor financing and/or the deferral of payments. Price continues to be a key sticking point for Spanish vendors, so both buyers and sellers must be willing to consider structures that can bridge that gap.

Graph 8: Delinquency by segment



Source: Bank of Spain, June 2010

Selection of recent transactions in the Spanish market

Currently, investors are mainly interested in unsecured portfolios (although we note there is persistent aversion towards telecom receivable portfolios due to the particular difficulties they have experienced managing this kind of portfolio in the past). Mortgages and other real estate backed assets still have a high risk premium due to the collapse of the real estate sector in Spain since 2008 and continued uncertainty over future price trends. Overall, unsecured portfolios have been more attractive because they align the historical Spanish servicers' expertise, are easier to analyse and value than their secured counterparts and are, therefore, deemed to offer a better investment return.

Although we have seen certain profit sharing structures in the past they have only accounted for less than 5% of transactions[26]. We expect such arrangements to be more prevalent in the future and we have developed structures that may be of interest for use in upcoming transactions.

Table 4: Selection of recent transactions in the Spanish market

Seller	Buyer	Asset type	Face value	Completion date
MBNA[27]	Lindorf	Retail portfolio	EUR 100m	September 2010
BBVA[27]	Confidential	Retail portfolio	EUR 200m	January 2011
Orange[27]	Confidential	Telecoms portfolio	EUR 250m	January 2011
Santander[28]	Lindorf	Retail portfolio	EUR 600m	January 2011
RBS[29]	Perella	Commercial real estate	EUR 200m	March 2011

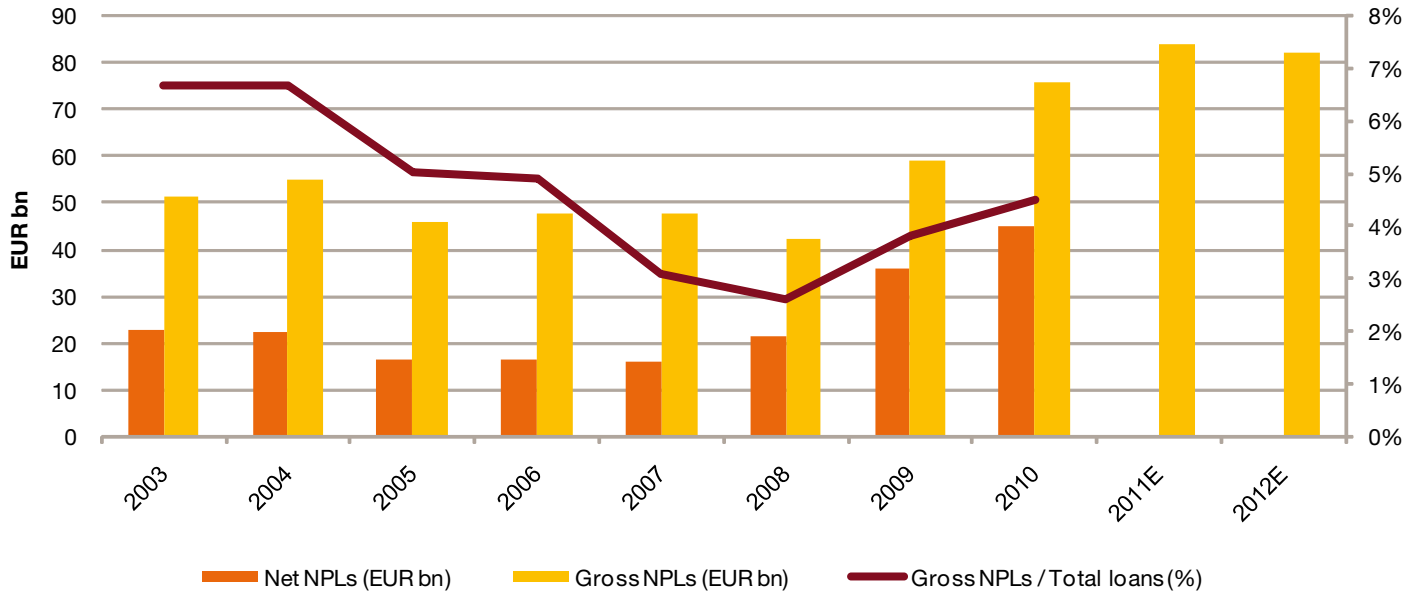
[26] PwC analysis
[27] www.cotizalia.com
[28] bolsa. elperiodicomediterraneo.com
[29] www.rbs.com

Italy: NPLs increased significantly more than the other Western European markets, however transactions remain at record lows

Market trends in NPLs

The quality of banking assets has deteriorated over the last two years, pushing up gross NPLs (NPLs before any provisions) to c. EUR 76 bn (November 2010). The Italian Banks Association (ABI) forecast a double digit year on year increase of 10% in NPLs in 2011 and a decrease of 1.7% in 2012. The ratio between net NPLs and total assets is 2.8% in 2010 (compared to about 1.2% in 2008) and is estimated to drop to 2.4% in 2011 and 2.3% in 2012. The majority of this growth in NPLs is expected to come from real estate and consumer lending, partly driven by increased unemployment, which has risen to over 8% in 2010.

Graph 9: NPL development in the Italian market



Source: Bank of Italy / ABI

Drivers for future transactions

The low level of NPL transactions characterising the Italian market is, similar to other markets in Europe, attributable to the pricing gap between buyers and sellers. However, we consider that the following factors have also contributed to the low transaction levels in Italy:

- There has been a general lack of financing for leveraged transactions, which has made existing opportunities quite costly for buyers.
- The lengthy execution / foreclosure procedures in Italy have constrained investors' appetite for NPL portfolios. This has also been exacerbated by the declining trend in property prices, especially in rural areas. Historically, a rising property market between the foreclosure and auction date (as the first auction could occur several months after the initiation of foreclosure proceedings) was an incentive for the investors to buy assets in the legal procedure. In the current market, where real estate prices are flat, this incentive has been reduced.

Currently, the Italian marketplace is being monitored at arm's length by a number of potential investors and we are expecting more NPL portfolios to come to market. Nevertheless, the likelihood of successful sales will depend on a number of factors similar to other European markets such as increasing bank provisioning levels and availability of funding for transactions.

Certain structures (e.g. vendor finance, earn out mechanisms and deferred payments) are also being considered by buyers and sellers but their application has not yet fully mitigated the price gap.

NPLs in Italy are expected to increase by 10% in 2011

Table 5: Selection of recent transactions in the Italian market

Seller	Buyer	Asset type	Face value	Completion date
Cross Factor SpA[30]	Agathos Finance Srl	Retail portfolio	EUR 4.1m	6 August 2010
Non-Performing Loans SpA[30]	Sagittaria Finance Srl	Retail portfolio (Mortgages)	EUR 39.1m	9 September 2010

[30] www.securitisation.it

Total transfers to NAMA €71.2bn

Estimated level of NPLs in Ireland in 2010 €109bn

Ireland: Currently the focus of many investors due to the high levels of distress with expectations of significant sales in the next 12 to 36 months

Market trends in NPLs

We estimate that NPLs in Ireland stood at EUR 109 bn as at June 2010, increasing by 24% compared to 2009.

The Irish economy agreed a bailout package of EUR 85 bn from the European Union and International Monetary Fund, of which EUR 35 bn represented direct support to its banking sector. There has been significant market wide commentary and press coverage of the implications of this support along with the additional EUR 24 bn of expected additional capital that the Irish banks will require (in accordance with the latest stress tests performed by the Central Bank of Ireland).

Drivers for future transactions

We believe that the following factors will significantly affect the level of portfolio transactions.

a) Uncertainty over collateral values: House prices in Ireland have fallen by approximately 35% to 40% since their peak in 2006-2007:

- the vast majority (c. 70%) of the EUR 100 bn of mortgages were originated during the peak of 2005-2007, with two thirds of them having average LTVs of 70% and the remaining third having LTVs of 100%. Given the reducing real estate prices, it is expected that a significant portion of the overall mortgage book is currently in negative equity[31]. It should also be noted that Irish borrowers are liable for losses not covered by the value of the collateral for up to 12 years;
- 60% to 70% of all commercial and development property loans are currently estimated to be in negative equity;
- historical data on defaults is very limited and has been heavily influenced by the various Government schemes imposing moratorium on repossessions[32] which makes future defaults hard to forecast and gives rise to uncertainty over ability to foreclose;
- investors are likely to apply a general country discount to Irish assets of around 20%-30% for performing and up to 60%-70% for non-performing assets (this is according to the PwC Investor Confidence Survey – Ireland Q1 2011). We are aware that some Irish banks are considering disposals of their non-Irish assets first, which is not surprising given such discounts for Irish assets; and
- some Irish lenders are offering professional property landlords a discount of up to 25% of their mortgage debt to encourage them to refinance their existing facilities, a practice that, according to the same press reports[33], is also prevalent among some of the UK lenders. Such a strategy often delivers better economic outcome for the lender. However, given the size of the problem, Irish banks will need to supplement this with portfolio sales.

[31] Goldman Sachs 'Europe Weekly Analysis', 18 November 2010

[32] Department of Finance- Amendment to Code of Conduct on Mortgage Arrears, 17 February 2010.

[33] FT Weekend Money Section, 25 January 2011

Table 6: Loan Balance Transfers to NAMA

EUR bn (face value)	Tranche 1 (Completed)	Discount	Tranche 2 (Completed)	Discount	Tranche 3 (Completed)	Total
Allied Irish Banks	3.29	42%	2.73	49%	3.3	9.3
Bank of Ireland	1.93	35%	1.82	38%	2.4	6.2
EBS Building Society	0.14	36%	0.04	46%	0.0	0.2
Irish Nationwide Building Society	0.67	58%	0.59	72%	2.8	4.1
Anglo Irish	9.25	55%	6.75	62%	3.6	19.6
Total	**15.28**	**50%**	**11.93**	**56%**	**12.1**	**39.4**

Source: NAMA presentation 'Key tranche 1&2 data', 23 August 2010. As of 2 March 2011 NAMA had acquired loans with a face value of EUR 71.2 bn for EUR 30.2 bn (suggesting an average haircut of 58%). No analysis of the acquired amount as at 2 March 2011 was available.

b) Impact of NAMA: loans transferred to NAMA have been at a significant haircut to their current recorded values[34], implying that full recovery of the loan principal is highly unlikely. Furthermore, NAMA is still at its early stages and hence there is limited information in relation to actual versus expected realisable values from the workout of the property loans transferred. Therefore there is no immediate benchmark for investors to compare collateral prices against (mainly due to the dearth of comparable transactions in the market);

c) Lack of specialised servicers in the Irish market: Due to its small size and the very benign credit conditions in the decade prior to the credit crisis, the Irish market is currently experiencing a severe skills shortage in specialised servicers able to cope with an increasing number of mortgage arrears and potential repossessions. In order to address the above, potential investors looking to move into the Irish market may have to "transfer" UK special servicing skills into the Irish market, either via intensive training of local operations or outsourcing of servicing to UK operations.

d) Legal processes: Market participants comment that the legal environment in Ireland remains untested with few completed foreclosures compared to the perceived level of distress, particularly in the residential mortgage market. That creates additional uncertainty for potential investors regarding the ability and timing to collateral recovery.

Transactions in the Irish market

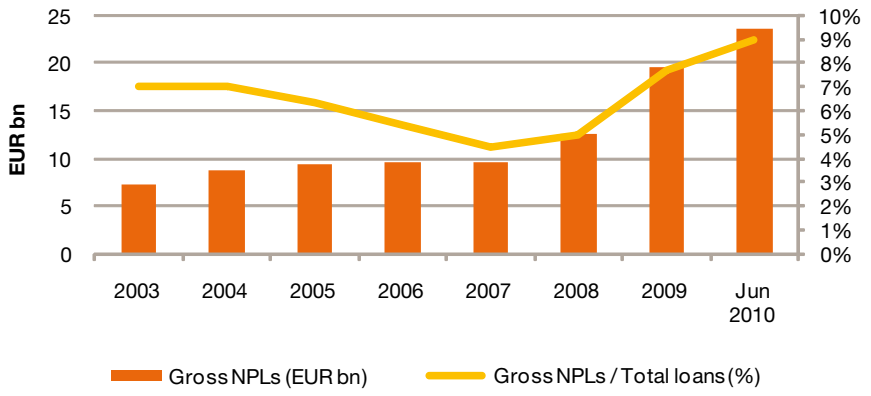
The Irish market has seen a very limited number of transactions in the past 12 months, as a result of the factors highlighted above. However, as part of the Government's plan to recapitalise the banks, we expect the Irish banks to proceed with significant disposals of non core and non-performing assets in the next 12 to 36 months.

However, in view of the results of our investor confidence survey, we believe that any transactions that do occur in relation to Irish based assets will take place at a significant discount to book values, and innovative structures along with complete and accurate data will be required in order to bridge pricing.

[34] NAMA

Greece: Deepening recession and uncertainty over economic recovery is limiting investor appetite

Graph 10: NPL development in the Greek market

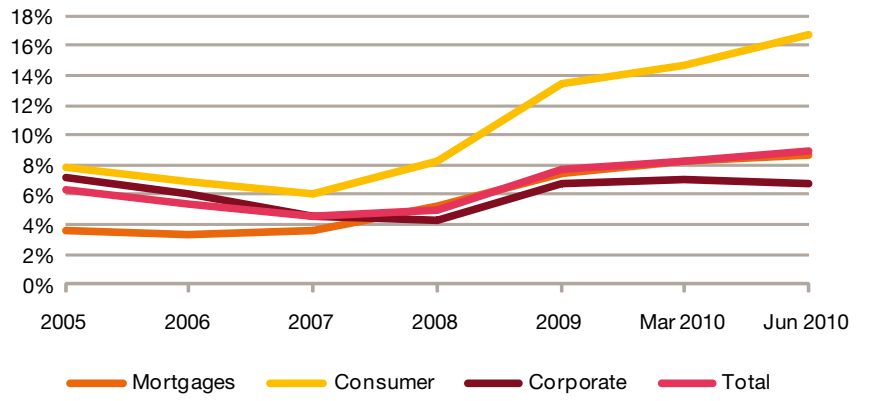


Source: Bank of Greece, PwC analysis

Market trends in NPLs

NPLs have grown in the first half of 2010 by 20% to EUR 24 bn compared to 2009, mainly as a result of the deepening recession in the Greek economy (GDP for the whole of 2010 contracted by 6.6%)[35] and the decrease in consumers' disposable income. We estimate that NPL ratio has reached 10.5% at the end of 2010. During the same period total provisions are estimated to have increased by around 25%.

Graph 11: NPLs as a % of total loans by category



Source: PwC analysis

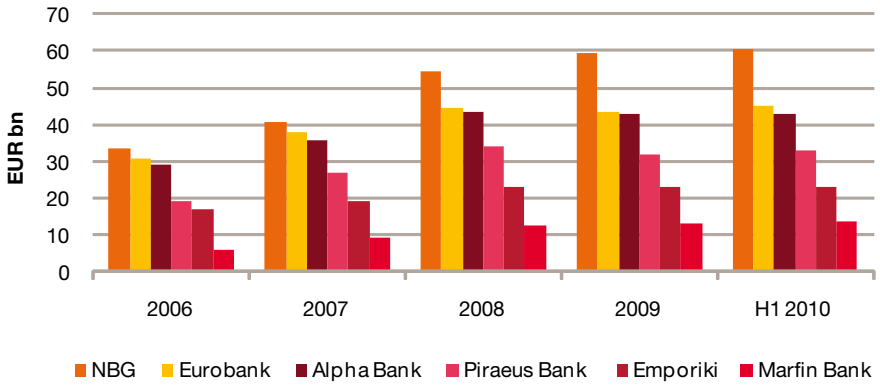
Growth in NPLs has been severe in consumer lending, which has seen some banks' NPL ratios reach 17% by June 2010.

[35] Greek Statistical Authority

We expect NPLs in Greece to reach EUR 26 bn in 2011.

Bank trends in NPLs

Graph 12: Gross loans development for key Greek banks



Source: Published Financial Statements & presentations / PwC analysis

The NPL ratio for all the major Greek banks is expected to have continued to increase during the second half of 2010 and to continue increasing during the first half of 2011, due to continuing deterioration in the economic conditions. Deteriorating asset quality will force banks' management to consider alternative ways of improving liquidity and further restructuring of their balance sheets, including the sale of NPLs and other non core assets.

In order to address the liquidity and asset deterioration issues, Greek banks are increasingly looking to the international capital markets in order to strengthen their capital base. National Bank of Greece completed a 2.8 bn EUR share capital increase and Piraeus Bank completed a share capital increase of EUR 800 mn. Geniki Bank of Greece, a subsidiary of Societe Generale has also raised EUR 300 mn of capital.

Drivers for future transactions

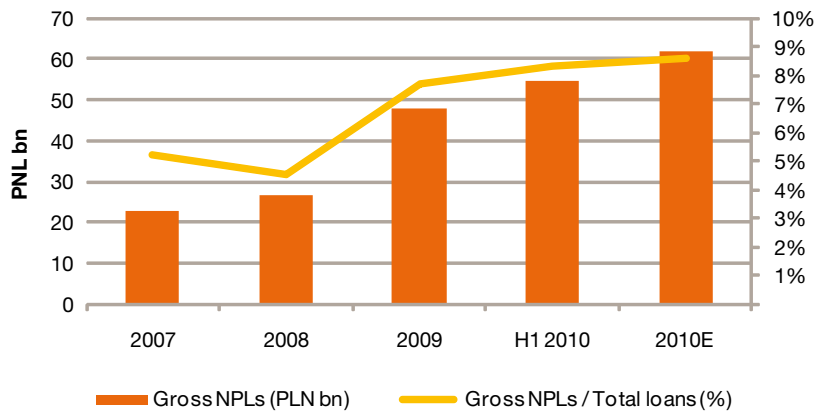
Appetite from investors is currently limited as continuing fears of sovereign risk have only recently started to recede, while local banks are currently reluctant to sell portfolios at a loss due to the pressures to safeguard capital and profitability.

In 2010 the Government implemented certain legislative measures with regards to the restructuring of debt obligations for small businesses and consumers (the so- called consumer bankruptcy law), both of which appear to have had a very limited impact. However, we understand that the banks have already implemented restructuring practices for the SME asset class along the broader principles set by the law. These practices may include deferral of capital payments and overdue interest write offs and may have been implemented even in cases that fall outside the scope of the consumer bankruptcy law. This could lead to portfolios being unattractive to potential purchasers if a loan is restructured such that foreclosure on the underlying security is no longer an option.

There is currently market pressure for major financial institutions to merge, as it is considered that consolidation will strengthen the local banking system. We see that as a driver for potential future sales as merged institutions may look to clean up their balance sheets.

Poland: Market remains active, with increasing demand for smaller portfolios

Graph 13: NPL development in the Polish market

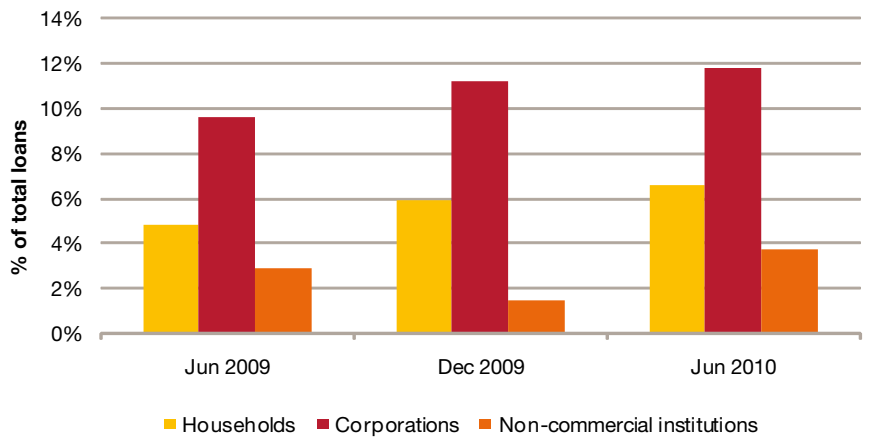


Source: BRE Bank Securities, Polish Financial Supervision Authority

Market trends in NPLs

The total value of NPLs in the Polish banking sector was estimated at PLN 62 bn (or EUR 16bn) as at the end of 2010. According to the Polish Financial Supervision Authority, there has been a continuing decline in the quality of the banks' loan portfolios with the NPL ratio for the Polish banking sector rising from 6.5% in June 2009 to 8.3% by June 2010. Going forward, NPLs in Poland are expected to continue increasing until 2012, driven by a deterioration in retail credits.

Graph 14: NPL ratio development for key customer groupings



Source: Polish Financial Supervision Authority

Bank trends in NPLs

According to certain bank forecasts, NPLs among retail loans are expected to increase through to 2012. Credit quality has been adversely impacted particularly in relation to the following sub-types of loans (see table on next page for more details):

- Consumer loans (households) –increase in NPL ratio by 59% (from 9.8% in June 2009 to 15.6% in June 2010); and
- Corporate loans secured on property – increase in NPL ratio by 76% (from 8.8% in June 2001 to 15.5% by June 2010).

Table 7: NPL ratios in the Polish banking sector

	Jun-09	Dec-09	Jun-10
Banking sector (total)	6.5%	7.7%	8.3%
Households (total)	4.8%	5.9%	6.6%
Consumer loans	9.8%	12.9%	15.6%
Mortgage loans	1.3%	1.5%	1.6%
Other loans	6.3%	6.3%	6.6%
Corporations (total)	9.6%	11.2%	11.8%
Operational loans	10.4%	11.1%	11.2%
Investment loans	9.5%	9.8%	10.7%
Loans on secured on property	8.8%	13.6%	15.5%
Other loans	4.2%	6.6%	6.4%
Non-commercial institutions	2.9%	1.5%	3.7%

Source: Polish Financial Supervision Authority

Drivers for future transactions

We expect that a higher number of retail unsecured portfolios will come to market in 2011 and 2012. The motivation to dispose of NPL portfolios is driven mainly by operational constraints, such as limited workout resources given the increasing servicing needs of some portfolios. Currently some NPL sale transactions appear to be quite attractive for banks due to aggressive pricing adopted by some local investors. Additionally, the number of servicers that undertake investments in NPL portfolios is increasing.

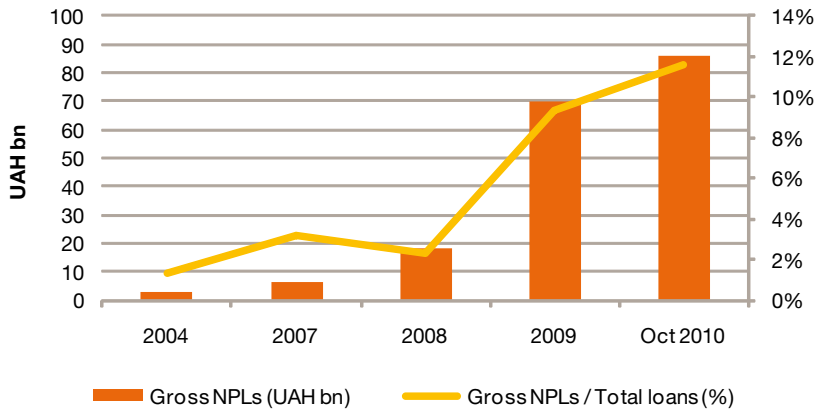
We also expect increases in the supply of corporate NPLs in the second half of 2011 and during 2012. Despite corporate NPL ratios rising in 2009 and 2010, many banks have indicated that they currently prefer to restructure the corporate loans with the potential for selective disposals where satisfactory pricing enables them to minimise losses on sale. We are aware of at least three corporate NPL portfolios currently being considered for disposal.

We have also observed an increasing demand for smaller portfolios by some local and international investors entering the market. Competition in this market segment and pricing on portfolios put up for sale is largely influenced by the availability of financing.

Agressive pricing by local investors in the Polish market has increased attractiveness of NPL sales to banks

Ukraine: Lack of restructuring options may increase transaction levels in 2011, although enforcement and servicing options remain untested

Graph 15: NPL development in the Ukrainian market



Source: National Bank of Ukraine

Market trends in NPLs

According to the Central Bank of Ukraine, GDP decreased by 15.1% in 2009 compared to 2008. As a result, and as shown in the graph above, NPLs reached UAH 86 bn (or EUR 8bn) in 2010 compared to UAH 70 bn as at the end of 2009. Since the beginning of the financial crisis, the overall NPL ratio has increased by more than 400%, from 2.3% in 2008 to 11.6% in October 2010[36]. Furthermore, according to certain analysts, "true" NPL ratios (including restructured loans) stood at 33% at the end of 2009, compared to the 9.4% estimated by the National Bank of Ukraine. The discrepancy between these two estimates may be driven by loans being rolled over at maturity or restructured such that provisioning from an accounting perspective is not required.

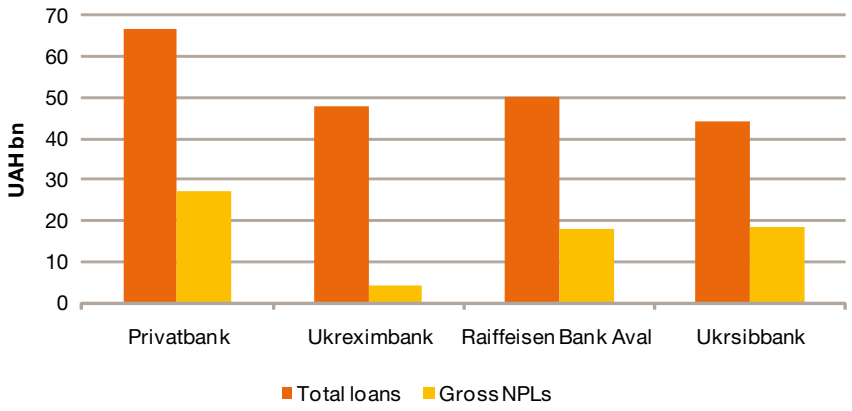
Bank trends in NPLs

Despite state owned banks publishing NPL ratios below the private sector average, NPL ratios for some of the largest private banks in Ukraine were, in some cases, in the range of 30%-40% (based on the 31 December 2009 published IFRS financial statements of the banks).

NPLs in Ukraine are expected to peak in 2010. The impact on profitability will depend on the quality of the legal system and the availability of tested NPL collection procedures. The ability of banks to enforce collateral (e.g. in the mortgage lending segment) as well as the possibility to carry out sustainable corporate debt restructurings will be crucial for future profitability. The vast majority of banks are currently testing a number of restructuring options such as developing special servicing capabilities, which requires a significant amount of time, or transferring all NPL and non core assets to stand alone SPVs in order to allocate dedicated resources to work out teams.

[36] National Bank of Ukraine

Graph 16: Total loans vs gross NPLs for key Ukrainian banks



Source: Published Financial Statements / PwC analysis

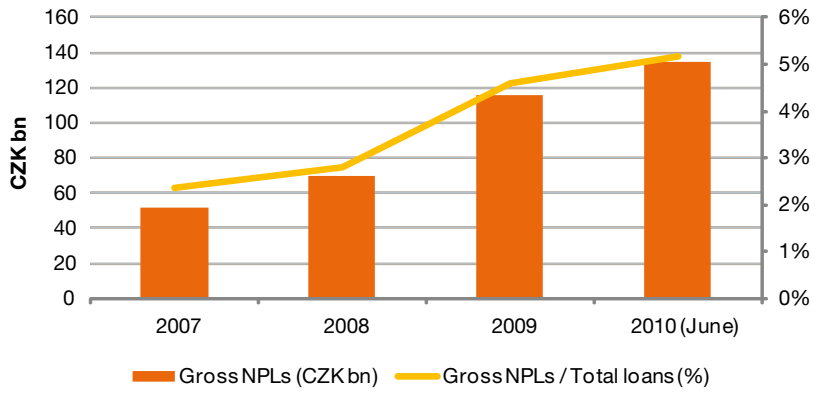
Drivers for future transactions

It is expected that after trying to work out the loans themselves the banks will be ready to sell secured retail portfolios and auto loans (one of the most popular types of loans pre the credit crisis). Additionally, some small corporate loans could be available for sale given that any losses on sale for the banks would be minimal. However, it is expected that large corporate exposures will be dealt with internally and we do not expect to see any of them being actively sold in the market, mainly as a result of legal restrictions such as those that allow the borrowers to delay enforcement proceedings through the transfer of assets to another group company, liquidation of the borrower company etc.

While there is some interest in the Ukraine, price, like elsewhere, is an issue. We believe that banks are being offered 5% to 8% of the face value of non-performing unsecured debt by local collection agencies, but this is currently lower than the banks' expected internal workout value.

Czech Republic: Strong capital position of the banks means that the majority of transactions may come from secondary sales

Graph 16: NPL development in the Czech market



Source: Czech National Bank

Market trends in NPLs

Total NPLs increased to CZK 135 bn (or EUR 5bn) as at 30 June 2010, representing around 5% of the total loan book. During the same period, the total banking sector loan book increased by 3.6% to CZK 2,601 bn (as of 30 June 2010[37]). Overall, the NPL market size has almost doubled compared to the end of 2008.

Bank trends in NPLs

Despite the increased volume of NPLs, the Czech financial system entered the recession in good condition and most institutions maintained high profitability in 2009. According to the Czech National Bank, the banking sector recorded no significant liquidity problems and revealed a comfortable total capital adequacy ratio of 14.3% as of 31 March 2010. During the same period, the total capital adequacy ratios of all banks were above 10% for the first time since 2002[38].

The loan portfolios of Czech banks are currently dominated by retail loans, mainly mortgages, which are perceived less risky than corporate loans due to underlying real estate collaterals. The risk related to the concentration of corporate portfolios is also decreasing as banks have diversified their credit portfolios and capped exposures on individual industries. The banking sector meanwhile has relatively low dependence on the interbank market thanks to low loan-to-deposits ratios.

Drivers for future transactions

Internal workout still represents the most important exit route for NPL portfolios though operational capacity can be a limiting factor as the number of delinquent cases has increased.

The sale of unsecured consumer NPLs continues to be a popular portfolio management strategy for a number of Czech financial institutions. There are a large number of legal firms and collection agencies that participate regularly in sale processes.

Due to strong liquidity and profitability, we still think that it is unlikely that major banks will come to market with large portfolios of defaulted corporate or real estate loans in 2010. However, international players that grew their portfolios aggressively during 2006 to 2009 might consider NPL secondary sales as an exit route.

[37] Czech National Bank, 30 June 2010

[38] Czech National Bank, Financial Stability Report 2009/10

Table 8: Selection of recent transactions in the Czech Republic

Seller	Buyer	Asset type	Face value	Completion date
Confidential	Unknown	Retail loans	Approximately CSK 100m	Multiple sales throughout 2010

Source: PwC analysis

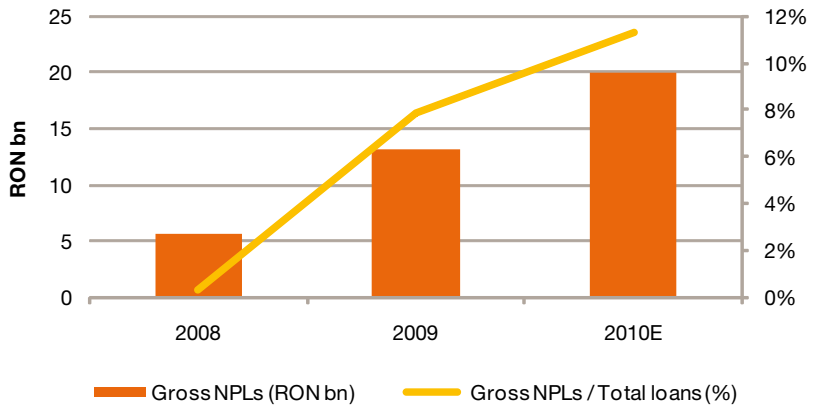
Transactions in Eastern Europe have been driven mainly by local investors and international banks looking to exit non strategic markets

26%

Annual increase in NPLs in CEE countries covered in our issue

Romania: Lack of servicing options and historical data over collateral values is limiting any efforts to bridge the current pricing gap

Graph 17: NPL development in the Romanian market



Source: National Bank of Romania (NBR) Financial Stability Report (2010)

Market trends in NPLs

According to the National Bank of Romania, the NPL ratio may have exceeded 10% of all loans (or RON 20 bn by the end of 2010 – approximately EUR 5 bn), driven mainly by defaults in retail loans (secured and unsecured). At the end of 2008, the NPL ratio was 0.32% of total loans granted by non-Government credit institutions, while in 2009 the ratio increased to 7.8%, predominantly as a result of changes in the regulatory definition of NPLs by the National Bank of Romania.

To cushion the effects of the global financial crisis and support the maintenance of banks' capitalisation, the Romanian Government and the IMF agreed to a two-year Stand-By Arrangement involving a EUR 13.5 bn sovereign loan.

In the interest of reducing the budget deficit, as required by the agreement with IMF, the Romanian Government decided to severely cut operating expenditure including salaries by 20%. Given the fact that Government owned institutions account for a large portion of the employed workforce, we expect further increases in defaults in relation to retail secured and unsecured credits.

Bank trends in NPLs

In response to the financial crisis, the Romanian authorities have focused on monitoring the increase of NPLs across the banking sector. Subsequently, The National Bank of Romania (NBR) issued a number of regulations to ensure proper accountability for distressed assets and, implicitly for NPLs.

In an attempt to mitigate issues associated with systemic risk, NBR issued Regulation No 22 as of September 2010 requiring banks to perform stress tests and hold higher liquidity (cash and highly liquid assets) reserves as a buffer against market pressures.

NPLs in Romania as at 2010 (expected) **€5bn**

NPLs as a % of gross loans in 2010 (expected) **11%**

Drivers for future transactions

Similar to many other countries in Central and Eastern Europe, valuation remains an endemic problem for NPLs. This has been further exacerbated by a lack of historical data on servicing costs and expected recoveries for NPLs. Furthermore, the Government's new legislation establishing a standard process for out-of-court restructuring and settlement agreements, thereby providing alternatives to the formal in-court insolvency process, has yet to be fully tested by the market.

Overall, we expect the NPL market will continue to register growth in default rates since lending criteria have historically been very weak. We see little change in the market for mortgage assets, as we expect that the banks will continue to work out the loans internally.

While the market shows potential for an increase in NPL portfolio sales, the uncertainties detailed above have had an adverse impact in the number of sales transactions closing in the last 12 months. Banks continue to work out distressed assets internally and even transfer them to affiliated entities (bad banks) as financial institutions are attempting to capitalise on their knowledge of the NPL market. In the medium to long run we estimate that certain banks will in fact be looking to acquire NPL portfolios themselves.

Hungary: NPL increase driven by local currency depreciation against the CHF and lack of refinancing options for SME borrowers

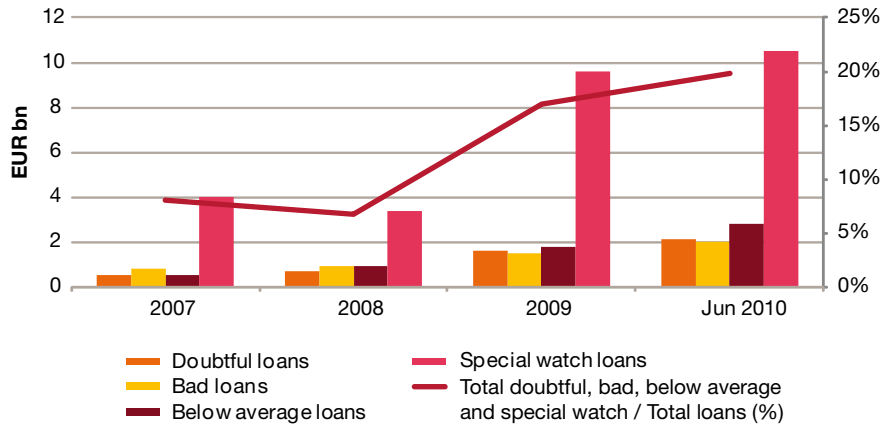
Market trends in NPLs

During the first half of 2010, total doubtful and bad loans of Hungarian banks amounted to EUR 4.1 bn, representing a 32% increase compared to the end of 2009 year-end.

During the same period, the quality of the Hungarian loan portfolios continued to deteriorate as depreciation of HUF against the Swiss Franc (CHF) amounted to 20%. A high proportion of lending in Hungary has been in CHF, primarily to benefit from low interest rates.

According to the Hungarian Financial Supervisory Authority (HFSA), the deterioration was also witnessed in previously restructured loans due to a lack of noticeable improvement in the employment market.

Graph 18: Gross Hungarian Loans



Source: HSFA

Drivers for future transactions

In 2010 the Government introduced new regulations to limit the foreign exchange risk of borrowers and set much stricter rules for provisioning of restructured loans. The decline in foreign currency exposure could decrease the growth rate of new NPLs, whereas tighter provisioning is expected to erode the price gap between buyers and sellers.

One of the most interesting NPL types in Hungary is in the SME market. Loans to SMEs are in the most critical situation due to the number of liquidations increasing dramatically during the second half of 2010. Commercial banks either declined the refinancing of SME facilities or increased the cost of refinancing to levels that the borrowers could not afford.

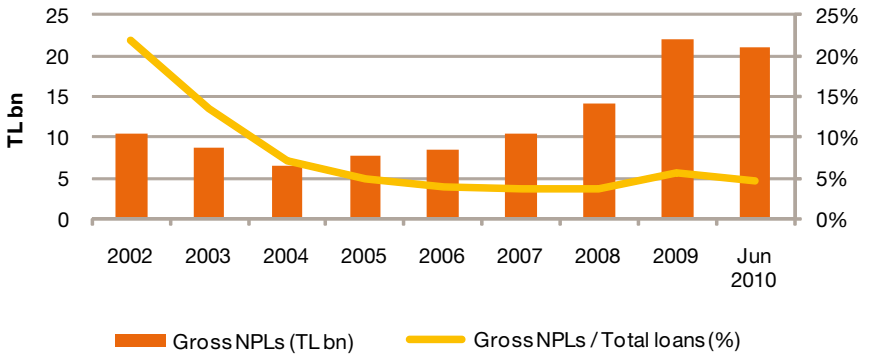
Turkey: Strongly capitalised banks and an established NPL market are attracting the attention of international investors

Market trends in NPLs

As at June 2010, the size of the NPL market was TL 21 bn (c. EUR 11 bn). During the same period, the NPL ratio of the Turkish banking system continued to decrease to 4.6% (down from 5.4% in 2009), which was a direct result of the strong economic growth.

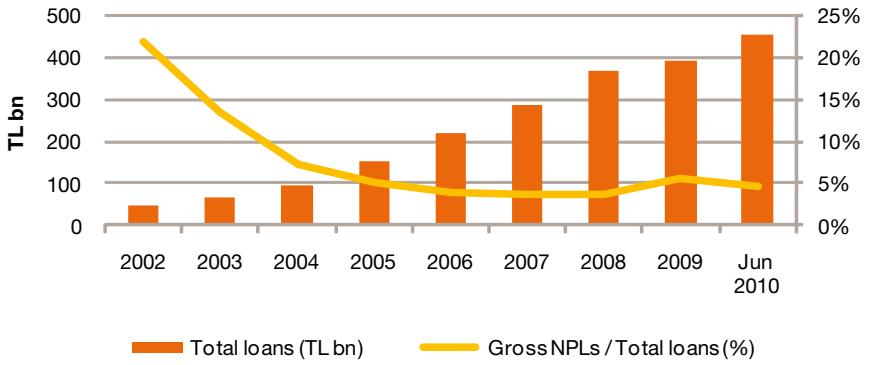
Turkey was among the three fastest growing countries in the world with a GDP growth of 8.9% in 2010[39]. With total assets in the banking system at around TL 874 bn[40] (or EUR 423bn), Turkey is still under-banked with low household debt and a young population offering significant growth potential particularly in the consumer credit segment. With the Turkish economy expected to continue to show long-term growth and given that in 2010 publicly announced NPL sales volumes reached TL 2 bn (EUR 1 bn), more than a threefold increase compared to 2009, we believe that the NPL market could exceed EUR 1.5-2 bn face value annually going forward. We consider that the growth in the NPL market will be further supported by international investors attracted to the SME and consumer loan sectors.

Graph 19: NPL development in the Turkish market



Source: BRSA (Turkish Banking Regulation and Supervision Agency)

Graph 20: Total loans vs NPL ratio in the Turkish market

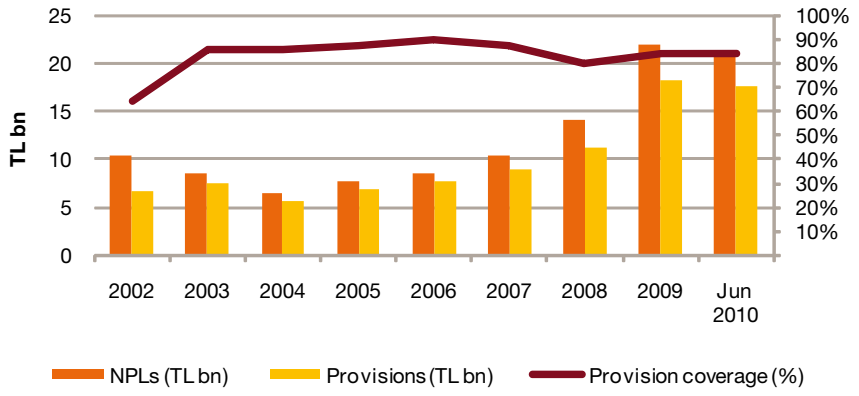


Source: BRSA (Turkish Banking Regulation and Supervision Agency)

[39] Turkish Statistical Institute

[40] BRSA – Turkish Banking Regulation and Supervision Agency

Graph 21: NPLs, provisions and coverage



Source: BRSA (Turkish Banking Regulation and Supervision Agency)

Bank trends in NPLs

Turkish banks are comparatively strongly capitalised with capital adequacy ratios around 20%, which means a decision to sell NPL portfolios is primarily driven by operational capacity rather than need for liquidity. Total banking loans are primarily made up of SME (28%) and retail (33%) loans which put a strain on the operating capacity of the banks due to the higher number of non-performing loans to be managed compared to, for example, a corporate loan book.

Turkish banks historically sustained their NPL provision coverage ratios within 80-90%, mainly as a result of stricter provisioning regulatory requirements following the banking crisis of 2000-2001. As can be seen in the graph above, the sector's coverage ratio was 84% as of June 2010. High provisioning levels are helping to align the price expectations of buyers and sellers.

Drivers for future transactions

In the first half of 2010, total NPL portfolio sales reached record levels of TL 1.5 bn (c. EUR 727 m), a three-fold increase when compared to the first half of 2009. Historically, the Turkish NPL market has been dominated by corporate portfolios, however since the second half of 2009 many banks, including Fortis, Yapı Kredi (Unicredit JV) and Denizbank (Dexia affiliate), have successfully sold unsecured consumer loans and credit card portfolios in response to a sharp increase in default rates. We believe that these successful NPL transactions are a positive sign to other potential sellers that investors are comfortable with the servicing of these new classes of NPLs.

Table 10: Selection of recent transactions from the Turkish market

Seller	Buyer	Asset type	Face value	Completion date
Akbank[41]	Girişim Asset Management	Unknown	TL 326m	5 January 2010
Denizbank[42]	Standard Asset Management	Consumer credits and credit card portfolio	TL 50m	15 February 2010
Fortis Bank[41]	Girişim Asset Management	SME loans	TL 30m	16 March 2010
Yapı Kredi Bank[42]	Standard Asset Management	Consumer credit portfolio	TL 75m	17 March 2010
Yapı Kredi Bank[41]	Girşim Asset Management	Credit card portfolio	TL 382m	17 March 2010
Yapı Kredi Bank[43]	LBT Asset Management	SME loans	TL 224m	17 March 2010
Fortis Bank[43]	LBT Asset Management	SME loans	TL 52m	5 May 2010
Yapı Kredi Bank[43]	LBT Asset Management	SME loans	TL 299m	3 June 2010

[41] www.ginsimvarlik.com

[42] Standard ÜnlÏn investor presentation, April 2010

[43] www.Ibtvarlik.com

Middle East: A market that has become more prominent as a result of recent high profile restructurings

Market trends in NPLs

Table 11: Impaired loans for the Middle East top 20 banks (by assets)

EUR bn	2007	2008	2009	% increase FY08-FY09	% increase FY08-FY07
NPLs	3.4	4.2	9.1	117%	24%

Source: Bankscope/Financial statements, PwC analysis

We estimate that impaired loans for the top 20 banks in the Middle East region by assets (including banks from the United Arabic Emirates (UAE), Saudi Arabia, Qatar, Kuwait and Bahrain) stood at approximately EUR 9.1 bn, compared to EUR 4.2 bn as of the end of 2008. As at the time of writing, no information was available in relation to the 2010 balances.

Bank trends in NPLs

Table 12: Gulf Cooperation Council (GCC) Banking sector provisions by country

USD m	2004	2005	2006	2007	2008	2009
Saudi Arabia	625	539	616	864	1,394	2,884
Kuwait	242	452	456	383	3,082	2,604
United Arab Emirates (UAE)	244	403	282	643	1,835	4,148
Bahrain	55	40	47	99	330	362
Oman	87	2	9	-	136	369
Qatar	5	-	30	82	332	514
Total provisions and impairments	**1,258**	**1,436**	**1,440**	**2,071**	**7,109**	**10,881**

Source: KAMCO Research & GCC Banks' Financial Statements

As can be seen from the table above, overall NPL provisioning levels have continued to increase as at the end of 2009 mainly as a result of significant deterioration in the banks real estate and corporate portfolios. The UAE banks (mainly Dubai) have been mostly affected, with NPL provisions increasing by 126% compared to 2008.

Overall NPL loans represented 4.04% of all GCC loans as at the end of 2009, up almost 78% compared to 2008 (2.27%) and 51% compared to the four year average of 2.67%[44].

Despite the significant increase (53%) in provisions between 2008 and 2009, total provisions as a percentage of total NPLs have decreased from 121% in 2007 to 82% in 2009. This implies that provisions have not matched the growth rates of NPLs and hence banks may face further increases in provisions and right offs at a later stage.

With the exception of Saudi Arabia and the UAE, provisioning levels for the first three quarters of 2010 have improved. The UAE has been impacted by impairments arising from the

[44] KAMCO Research 'GCC Banking Sector', 8 September 2010

finalisation of the Dubai World debt restructuring. UAE provisioning levels going forward are still likely to be high with further announced restructurings in other Dubai Inc groups and an increase in provisions against Saad and Al Gosaibi Groups. The UAE Central Bank in late December 2010 asked local banks to increase their provision against exposures to these two groups from 50% to 80%.

Similar to Continental Europe, the increased provisioning levels identified above, combined with investment losses realised during FY08 and FY09, resulted in significant downwards pressure in the banks' profitability and liquidity.

Despite the overall GCC banking sector having access to more liquidity, usually provided through Government support, banks across the region have tried to address the liquidity and impairment pressures via implementing tighter lending criteria and reassessing their strategy for dealing with sub or non-performing borrowers.

Liquidity pressures and tighter lending criteria:

Table 13: Loan to deposit ratios

	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Regulatory requirements
Saudi Arabia	74%	73%	70%	75%	72%	80%
Kuwait	74%	72%	72%	76%	78%	85%
Abu Dhabi	90%	95%	92%	101%	101%	100%
Dubai	78%	89%	84%	95%	94%	100%
Bahrain	62%	62%	73%	78%	76%	75%
Oman	92%	83%	85%	84%	87%	88%
Qatar	85%	88%	90%	97%	98%	90%

Source: Broker Reports

As can be seen from the table above, central banks in the region have set strict local regulatory requirements in relation to the maximum allowable ratio of loans to deposits. Countries exceeding the local regulatory requirements were Bahrain, Abu Dhabi and Qatar, due to the significant increase in property and infrastructure related lending.

Given the limited regulatory headroom available above, banks in the region have implemented tighter lending criteria in order to preserve liquidity and minimise further impairments. According to Reuters[45], syndicated lending in the Middle East decreased to a five-year low in 2009 (USD 37 bn was syndicated in 2009 compared to more than USD 83 bn in 2008) and conditions for the whole of 2010 did not improve significantly.

Apart from Qatar lending, growth in the GCC for the first nine months of 2010 remains low. Qatar deposits have increased against a trend of low growth.

[45] Reuters Loan Pricing Corporation, 11 January 2010

Restructuring of borrowers and recent loan transactions in the NPL market

Q3 2010 saw the completion of the Dubai World debt restructuring. Dubai World announced in September 2010 that 99% of the creditors had agreed to the restructuring and therefore the process was almost complete. Following the Dubai World developments, instances where financial institutions would previously provide credit to certain companies due to their (perceived or actual) relationships with the local Government or royal family have decreased significantly.

The market has experienced an increase in activity stemming from the Dubai World restructuring with a number of distressed funds acquiring or selling part of the Dubai World debt. Furthermore, we understand that a number of transactions in relation to the Saad and Al Gosaibi debt have occurred over the last six months, priced between 15-20 cents (at the end of December 2010 trading in the secondary market was between 21-26 cents for the most liquid structures)[46].

[46] Gehrson Lehrman Group, 29 December 2010

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