Bulbank
UniCredit Group

MORTGAGE FINANCE IN SOUTHEAST EUROPE: HEADING TOWARD INTERNATIONAL BEST PRACTICE

BUCHAREST,APRIL 5-6, 2006,

AGENDA

- **Focus on Bulgaria**
- Conclusions

RETAIL – CHANGING ENVIRONMENT AND IMPLICATIONS

RETAIL SEGMENT

MARKET TRENDS

- **CREDIT BOOM -** driven by the rising level of consumption and decreasing cost of borrowing
- **STRONG SELECTION OF CUSTOMERS** on the lending side during the initial phase. Young individuals with high income and wealth.
- **INDEBTEDNESS** – at the end of 2005 is already above NE average (measured by retail loans/GDP), with mortgages being the fastest growing product.
- **LARGE HOME OWNERSHIP –** distinctive market feature (almost 90)
- **ASSETS ALLOCATION** - still dominated by bank deposits and currency. Fast expansion of alternative savings products (from a low base) led by pension and mutual funds.

CHALLENGES AND OPPORTUNITIES

- **NEGATIVE EFFECT ON CUSTOMER LOYALTY** due to low introductory interest rates on mortgage loans
- **EQUALIZATION/CONVERGENCE OF LIVING STANDARDS** - leads to rising consumption appetite, but also investments
- **PROPENSITY TO SAVE –** moderately improving in the short to medium run and decreasing in the long run, while **INDEBTEDNESS** will continue to rise
- **QUALITY OF LOANS** will increasingly depend from the phase of the economic cycle - labour market and prices of residential property in particular
- **HOSEHOLD INCOMES WILL EXHIBIT RISING VULNERABILITY TO CHANGES IN THE INTEREST RATES** (low at the moment as debt servicing cost are only 3% of disposable income.

CREDIT QUALITY – ADEQIUATE, BUT UNTESTED IN ECONOMIC DOWNTURN...

MARKET TRENDS

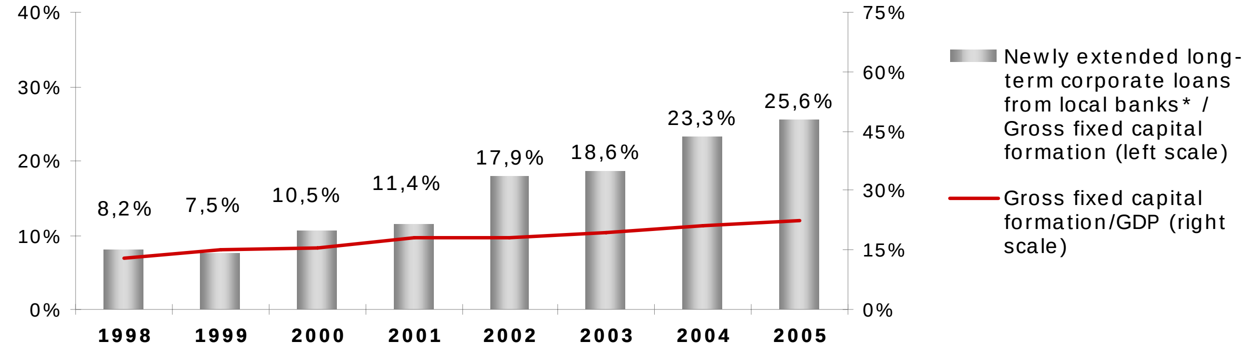
- **QUALITY OF INVESTMENTS ALLOCATION IMPROVED** – driven by transfer of know-how and investments in developing credit skills after privatization
- **IMPOROVED RISK SUPERVISION FRAMEWORK** – due to strengthened supervisory function of BNB
- **SHIFT TO RETAIL LENDING and SME** allows banks to benefit from portfolio diversification, surprisingly share of consumer loans is much higher than in NE average (to be taken cautiously).
- **VERY FAST INCREASE OF INDEBTEDNESS LEVELS** – though from a very low base

CHALLENGES AND RISKS

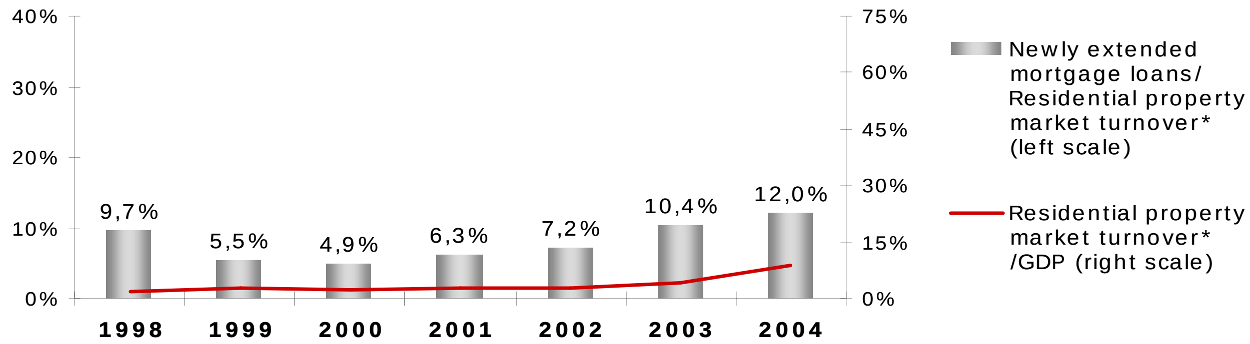
- **RIVALSHIP FOR BUILDING MARKET SHARE LED TO FAST REDUCTION OF BORROWERS ELLIGIBILITY REQUIREMENTS**
- **UNSEASONED CREDIT PORTFOLIO –** due to the booming lending, where in between 2-3 years will be necessary to make a clear cut judgement on the quality of loans extended in 2004 and 2005.
- **UNTESTED PORTFOLIO IN ECONOMIC DOWNTURN SCENARIO** (drop in incomes and real estate prices in retail)
- **STILL WEAK ENFORCEMENT OF CREDITORS RIGHTS** – requires very high provisioning levels to be maintained. Lack of personal bankruptcy legislation may hamper problem loans recovery, despite recent changes in the Civil Procedure Core and introduction of private bailiffs.

LOANS EXTENDED BY LOCAL BANKS GROW THEIR IMPORTANCE AS A FUNDING SOURCE FOR INVESTMENT, CONSUMPTION AND HOUSING MARKET

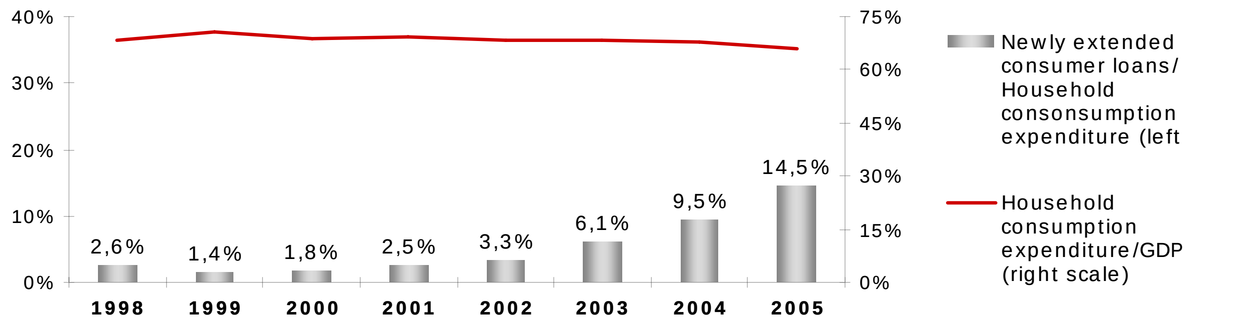
Bank's lending share of funding corporate investments



Bank's share in financing the residential property market



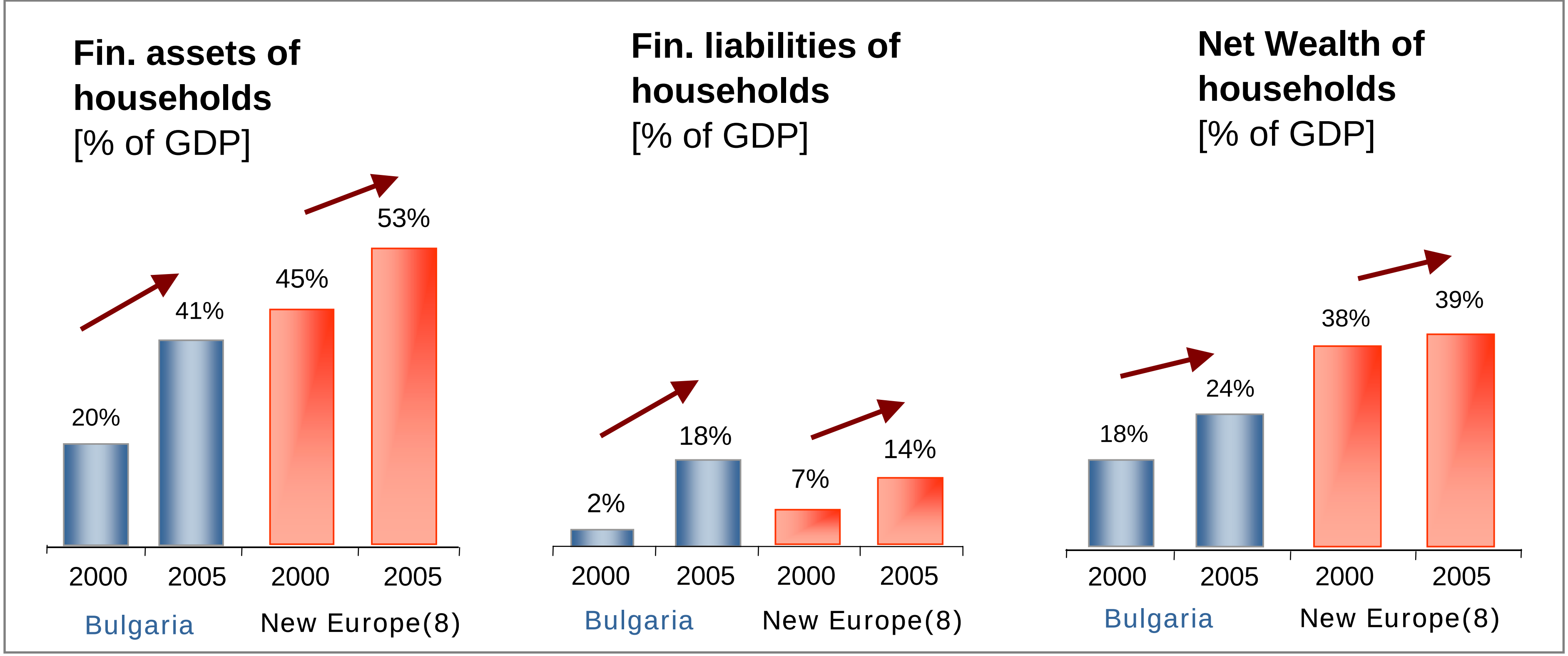
Bank's funding of household consumption expenditure



Source: BNB and NSI

* This estimate should be taken cautiously as according to BNB's statistics long-term are all loans with above 1 year duration

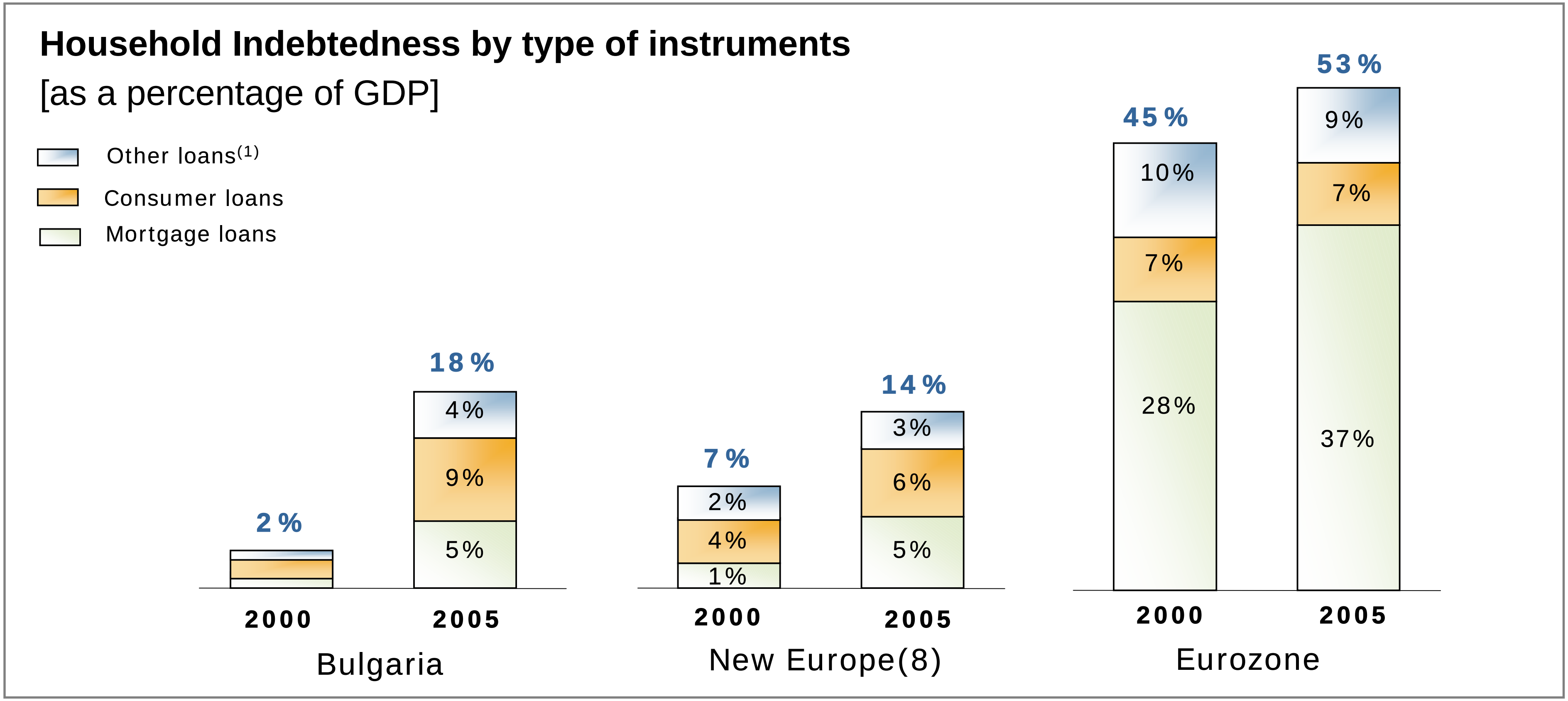
DEEPENING FINANCIAL INTERMEDIATION ON BOTH FINANCIAL ASSETS AND LIABILITIES IN THE HOUSEHOLD SECTOR IN COMBINATION WITH REAL ASSETS INCREASE



- In 2005 financial assets of the household sector reported growth rate a notch above 30% benchmark, for a second consecutive year
- Despite fast increase in households' financial liabilities, the sector strengthened its position of a net lender in the economy

Source: UCI New Europe Research Network data base

DESPITE CLEAR FOCUS ON MORTGAGES AS A PREFERRED EXPANSION TARGET ON THE SUPPLY SIDE, THE STRUCTURE OF THE HOUSEHOLD LIABILITIES PORTFOLIO IS STILL DOMINATED BY CONSUMER LOANS



- Similarly to other NE countries the key determinants of household indebtedness expansion were rising consumption (in the context of life style convergence) and decreasing price of credit

Note: (1) In the New Europe, the aggregate other loans includes overdraft, revolving credit cards, other loans and financial leasing
Source: UCI New Europe Research Network Database and ECB

THE INDEBTEDNESS LEVEL OF THE HOUSEHOLD SECTOR LOOKS LOW RELATIVE TO INCOMES (IN GDP TERMS), PROBLEMS MAY ARISE HOWEVER FOR SOME HOUSEHOLDS AS INDEBTEDNESS IS NOT DISTRIBUTED HOMOGENEOUSLY

	Household Debt / GDP		Debt servicing payments as % of Gross disposable income[1]		Relative share on FX exposure	Household debt / Financial Assets	
	2000	2005	2000	2004		2000	2005
Eurozone	**46%**	**53%**	**-**	**-**	-	**23%**	**27%**
New Europe(8)	**7%**	**14%**	**-**	**-**	-	**15%**	**27%**
Bulgaria	**2%**	**18%**	**1%**	**3%**	**15%**	**11%**	**43%**
Croatia	15%	36%	5%	7%	72%	27%	47%
Czech Republic	7%	17%	1%	3%	0%	11%	27%
Estonia	9%	33%	1%	2%	56%	37%	83%
Hungary	6%	23%	2%	5%	9%	11%	38%
Latvia	3%	30%	1%	3%	53%	11%	28%
Poland	10%	15%	1%	1%	23%	23%	26%
Romania	1%	8%	2%	3%	46%	4%	41%
Slovakia	5%	13%	1%	2%	0%	10%	26%
Turkey	6%	10%	5%	2%	3%	11%	19%

- Financial leverage (measured by financial assets to financial liabilities ratio) is somewhat higher in Bulgaria as compared with NE, which makes households in Bulgaria more vulnerable to adverse shocks on incomes, moreover financial assets are still concentrated in a relatively small part of the population.

Source: UniCredit New Europe Research Network Database, based on NCB.
Note: [1] Based on own estimates of GDI for all countries except for Czech R. and Slovakia.

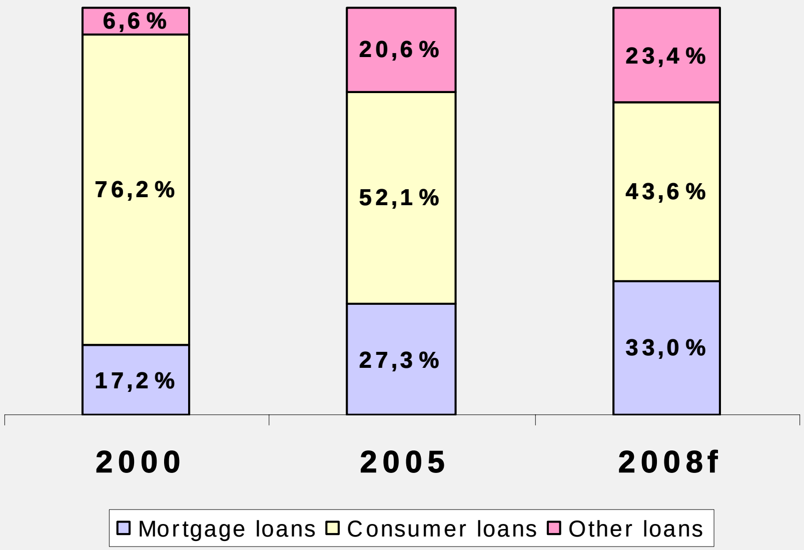
SUSTAINED GROWTH OF HOUSEHOLD INDEBTEDNESS, DRIVEN BY MORTGAGES AND CARD BUSINESS

Expected growth in financial liabilities

[CAGR '05-'08]

	Bulgaria	New Europe(8)
Mortgage loans	32%	23%
Consumer loans	17%	17%
Overdraft	32%	8%
Other loans	15%	18%
Revolving credit cards	35%	18%
Financial leasing	58%	20%
Total financial liabilities	**24%**	**19%**

Structure of financial liabilities of households [% of total]



BULGARIA

Note: (1) Includes overdraft, other loans, revolving credit cards and financial leasing

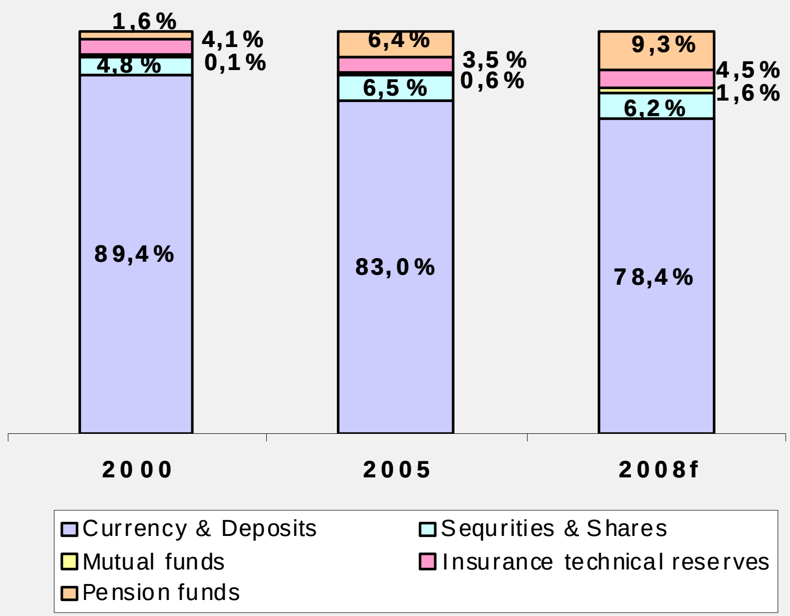
Source: Bulbank Research

INCREASING ACCUMULATION OF FINANCIAL WEALTH WITH DIVERSIFICATION, BUT STILL SIGNIFICANT ROLE PLAYED BY DEPOSITS AND CURRENCY

Expected growth in financial assets [CAGR '05-'08]

	Bulgaria	New Europe(8)
Currency	10%	7%
Bank deposits[(1)]	16.2%	8%
Securities	-3.0%	-2%
Listed shares	24.9%	11%
Mutual funds	60.9%	14%
Insurance reserves	27.5%	15%
Pension funds	32.8%	20%
Total financial assets	**17.3%**	**10%**

Structure of financial assets of NE households [% of total]



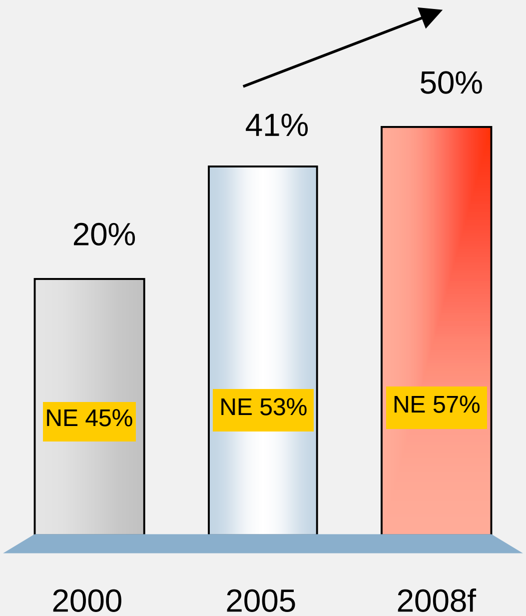
BULGARIA

Note: (1) Including housing savings

Source: Bulbank Research

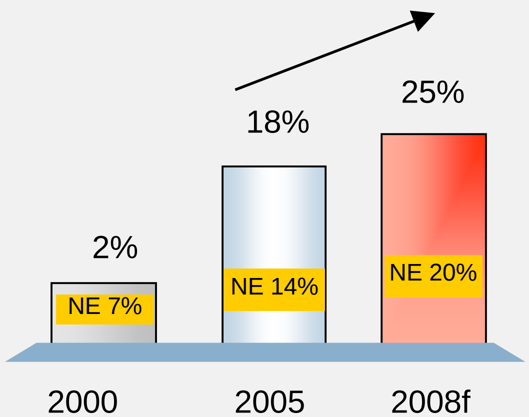
INCREASING FINANCIAL PENETRATION BOTH ON THE ASSET AND ON THE LIABILITY SIDE, WITH NET WEALTH OVER GDP GROWING, DESPITE STRONG INVESTMENT IN REAL ASSETS

Fin. assets of households [% of GDP]



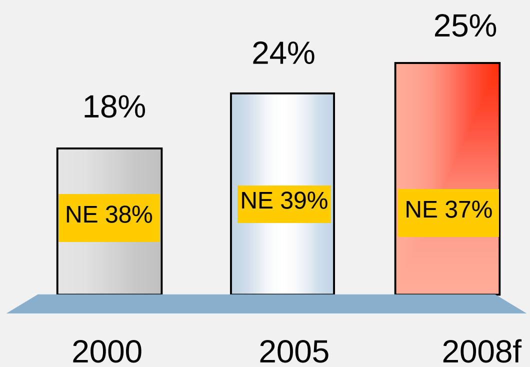
CAGR OF GROSS FINANCIAL WEALTH '05-'08: 17.3%

Fin. liabilities of households [% of GDP]



CAGR OF GROSS FINANCIAL LIABILITIES '05-'08: 23.8%

Net Wealth of households [% of GDP]



CAGR OF NET FINANCIAL WEALTH '05-'08: 12.0%

Source: Bulbank Research

AGENDA

- Focus on Bulgaria
- **Conclusions**

CONCLUSIONS

- **New Europe households have lower income, wealth and debt than Old European ones**, but similar home ownership ratios (even if quality is different)
- **The New Europe retail lending market shows a similar development pattern** - with growth driven by the mortgage market - **compared to the Eurozone countries,** although New Europe starts from a much lower base
- Fast credit growth comes in the context of households desired **fast convergence to the EU standard of living, favourable macroeconomic conditions, improved access to credit markets and better supply conditions**
- New Europe households are **still relatively less indebted as compared to Eurozone** in terms of income. However, the accelerated credit growth and exposure in FX could be a source of **vulnerability**
- **At the macro level, the CA deficit is part of the transition story**. Although wide external gaps can be a threat for external sustainability, we find out that on top of the households and the public sector, the corporate sector is playing even a stronger role in determining it
- On the overall, **we believe households credit growth is an equilibrium phenomenon**. In order to guarantee its long term (and overall macroeconomic) sustainability, credit quality monitoring and prudent macro policies (particularly on the fiscal side) are crucial