for

EFSE Stakeholder Survey 2012

May
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The EFSE is dedicated to catering to the needs and business requirements of its partner lending institutions (PLIs). As a responsible investor, the Fund has been keenly interested in the views of its partners on current and projected financial sector developments and trends in the EFSE's target region. As first-class market knowledge is vitally important in order to respond to the needs of its PLIs, the EFSE conducted a survey among its stakeholders in the EFSE target region at the beginning of 2012.

The EFSE Stakeholder Survey 2012 sheds light on the potential risks and medium-term market opportunities in the financial sectors of the region. It furthermore captured views on the level of Responsible Finance practices in the various markets providing crucial guidance for the Fund's work in this area. The survey explored how industry representatives perceive current and future developments relevant for their own institutions and for the markets in which they operate.

About the survey

The survey was conducted in March and April 2012 and was both qualitative and quantitative in methodology. Top and senior management from the Fund's PLIs as well as representatives of other relevant financial sector stakeholders from the EFSE target region, including central banks, financial sector support institutions (microfinance and banking associations, credit bureaus, and debt advice centres) and auditing companies participated in the survey. They were invited to fill out an on-line questionnaire in four parts. Respondents were asked to grade the 'relevance' of a number of risks and potential market opportunities as well as to voice their opinions on the level of development in Responsible Finance practices in the regional industry, as well as the practices undertaken within their own institution. Finally, they were asked to list the three main topics or areas that will impact the financial industry in their country over the next five years, and given the option to speculate on the headline, or motto, of the year in the financial industry in their country. Overall, respondents were encouraged to provide comments on the different items they evaluated based on their perceptions.

At a glance

- 71 respondents from 14 countries
- Participation of top and senior management from 47 EFSE PLIs (73% of EFSE PLIs)
- 68% of respondents from the Southeast Europe Region[1], 32% from the European Union's European Eastern Neighbourhood Region[2]
- 69% of respondents were from financial institutions, with 75% representing commercial banks and 25% representing microcredit organisations.
- The country most represented was Bosnia and Herzegovina with 16 respondents, followed by Kosovo with 7.
- 22 high-level representatives from central banks, financial sector support institutions and auditing companies

The survey findings

Most severe risks are client over-indebtedness and expected macroeconomic trends

Respondents were provided a list of 13 potential risks, and were asked to rate the relevance of the risks to financial institutions operating in their country over the next 3-5 years on a scale of 1-5 ("very low" to "very high").

According to the average relevance of risks across all respondents, client over-indebtedness and macroeconomic trends were rated the most severe. Several respondents pointed out the economic downturn in their economies which is expected to increase over-indebtedness levels of borrowers, which in turn will lead to repayment problems and negatively affect the portfolio quality of financial institutions.

The ranking of risks across all respondents is shown in Box 1.

[1] Southeast Europe Region encompassing: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Kosovo, Montenegro, Romania, Serbia, Turkey

[2] European Eastern Neighbourhood Region encompassing: Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine.

Box 1: Ranking of risks

1. Client over-indebtedness
2. Macroeconomic trends
3. Financing gaps/funding constraints
4. Weak credit risk management
5. Competition and/or market overheating
6. Weak internal controls and fraud
7. Inappropriate regulation
8. Corporate governance structure
9. Capital constraints
10. Reputation
11. Ownership structure
12. Foreign exchange exposure/losses for clients
13. Corruption

The perception of the relevance of certain risks varies between regions. While client over-indebtedness is perceived as a major risk by respondents from the Southeast Europe (SEE) and the European Eastern Neighbourhood (ENR) regions, competition and/or market overheating was ranked as the most relevant risk that is already affecting financial institutions in the ENR and will continue to do so in the medium-term. Macroeconomic trends and financing gaps/funding constraints play an important role in SEE, whereas those risks are of average relevance to ENR countries. Foreign exchange exposure/losses for clients are ranked third in the ENR, which possibly is a reflection of the high degree of dollarisation of these economies. Generally, respondents from SEE countries rated most risks as more severe than did their counterparts from ENR countries.

An overview of the three main risks according to region is shown in Box 2.

Box 2: Top three risks by region

SEE
1. Client over-indebtedness
2. Macroeconomic trends
3. Financing gaps/funding constraints

ENR
1. Competition and/or market overheating
2. Client over-indebtedness
3. Foreign exchange exposure/losses for clients

A breakdown of responses from financial institutions (commercial banks vs. microcredit organisations (MCOs)) revealed significant differences in the perception of two risks. Those comprise the relevance of reputation (more relevant for MCOs) and foreign exchange exposure (more relevant for commercial banks). The latter can be explained by the fact that MCO respondents participating in the survey were mainly located in SEE countries.

An overview of the three main risks according to type of financial institution is shown in Box 3.

Box 3: Top three risks by type of financial institution

Commercial banks
1. Client over-indebtedness
2. Macroeconomic trends
3. Competition and/or market overheating

MCOs
1. Reputation
2. Macroeconomic trends
3. Client over-indebtedness

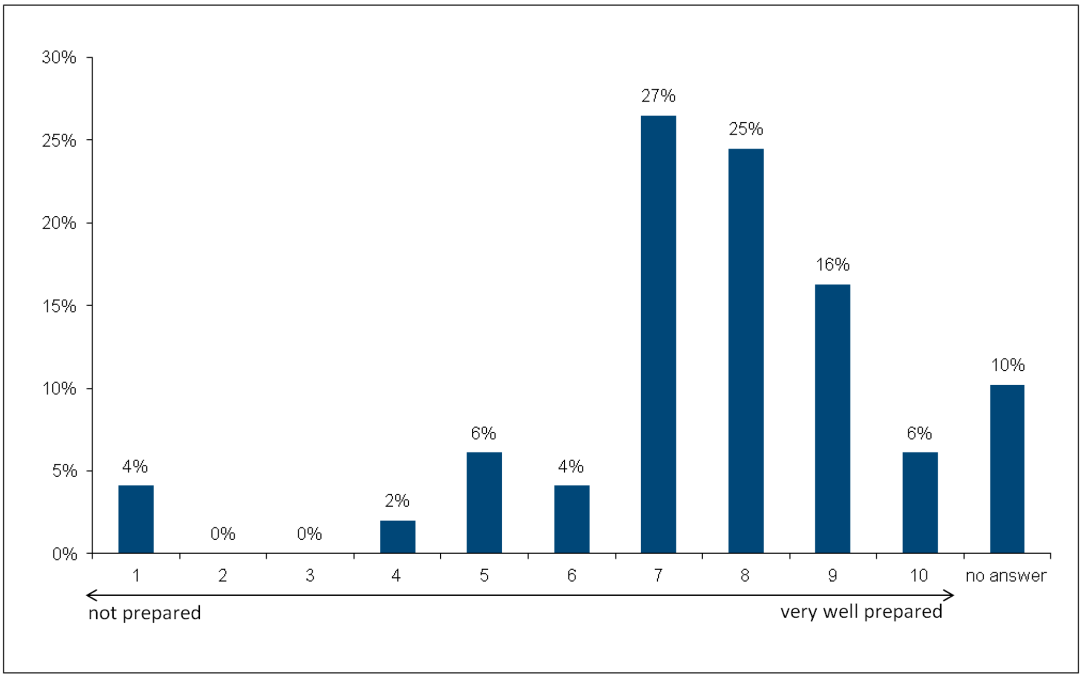
Generally, financial institution representatives perceived risks to be more relevant or severe than the other stakeholder groups. This was especially the case for client over-indebtedness, competition and/or market overheating and ownership structure.

Preparedness of financial institutions to handle risks

Financial institution respondents were furthermore asked to rank the three main risks they foresee for their own institution, and assess their own institution's preparedness to handle such risks. Despite varied responses, by far the most mentioned risk was credit risk with at least a third of financial institution respondents specifically noting this – and/or over-indebtedness – as a risk to their own institution. Worsening macroeconomic conditions, political instability, the effects of the global economic and European sovereign debt crisis as well as the reputational threat the industry has suffered were also referenced several times.

Preparedness for handling risks was on average 7.3 and the median 8.0 (both out of 10, with 10 being "very well prepared"), which indicates that respondents feel rather prepared to handle risks in the respondents' own institutions. The distribution of responses according to different levels of preparedness against risks is shown in Figure 1.

Figure 1: Level of preparedness for handling risks



Respondents from ENR countries consider themselves to be better prepared than those from SEE countries. In addition, banks also consider themselves to be better prepared than MCOs. At the same time, there were no significant difference between responses from local financial institutions and affiliates of international banking groups.

The biggest market opportunities are innovations in technology and the small and medium enterprise market segment

Respondents were provided a list of 15 potential market opportunities, and were asked to rate the relevance and potential positive impact of those market opportunities on financial institutions operating in their country over the next 3-5 years on a scale of 1-5 ("very low" to "very high").

Overall, respondents differed less on their assessment of the relevance of market opportunities than they did on risks. IT/technology innovations creating new distribution channels and the small and medium enterprise (SME) market segment were identified as the biggest opportunities for respondents as a whole.

The ranking of market opportunities across all respondents is shown in Box 4.

Box 4: Ranking of market opportunities

1. IT/technology innovation
2. SME market segment
3. Retail market segment
4. Alignment of interests between shareholders/founders and managers
5. Quality of executive management
6. Competition
7. Robust capital base and reserves
8. Microenterprise segment
9. Macroeconomic environment
10. Customer loyalty
11. Corporate governance
12. Corporate segment
13. Stability of funding base
14. Conducive regulatory framework
15. Untapped markets

For respondents from ENR countries, the SME market segment, IT/technology innovation and the household/retail segments present the biggest opportunities. Respondents from SEE countries ranked IT/technology innovation, the alignment of interests between shareholders/founders and managers and the SME market segment as largest opportunities. ENR respondents consistently saw greater relevance of nearly all market opportunities than SEE respondents. These findings align with the fact that SEE respondents saw consistently greater risks facing their financial industry.

A breakdown of responses from financial institutions (commercial banks vs. MCOs) revealed important differences in the perception of market opportunities. Unsurprisingly, the microenterprise segment is the most relevant market segment for MCOs whereas the SME segment plays an important role for commercial banks. The retail market segment ranks second in terms of market opportunities for MCOs. The alignment of interests between shareholders/founders and managers is perceived as an equally important opportunity for both types of financial institutions.

An overview of the three main market opportunities according to type of financial institution is shown in Box 5.

Box 5: Top three market opportunities by type of financial institution

Commercial banks

1. IT/technology innovation
2. SME market segment
3. Alignment of interests between shareholders/founders and managers

MCOs

1. Microenterprise segment
2. Retail market segment
3. Alignment of interests between shareholders/founders and managers

The comparison of responses from financial institutions with those of other stakeholder groups revealed different perceptions of the relevance of the alignment of shareholder/founder and management interests (with financial institutions seeing greater opportunities), the microenterprise segment and untapped markets (other stakeholder groups seeing greater opportunities for both). Other breakdowns showed that local financial institutions see more opportunities in the microenterprise segment and in untapped markets than affiliates of international banking groups.

Expected development of business year 2012

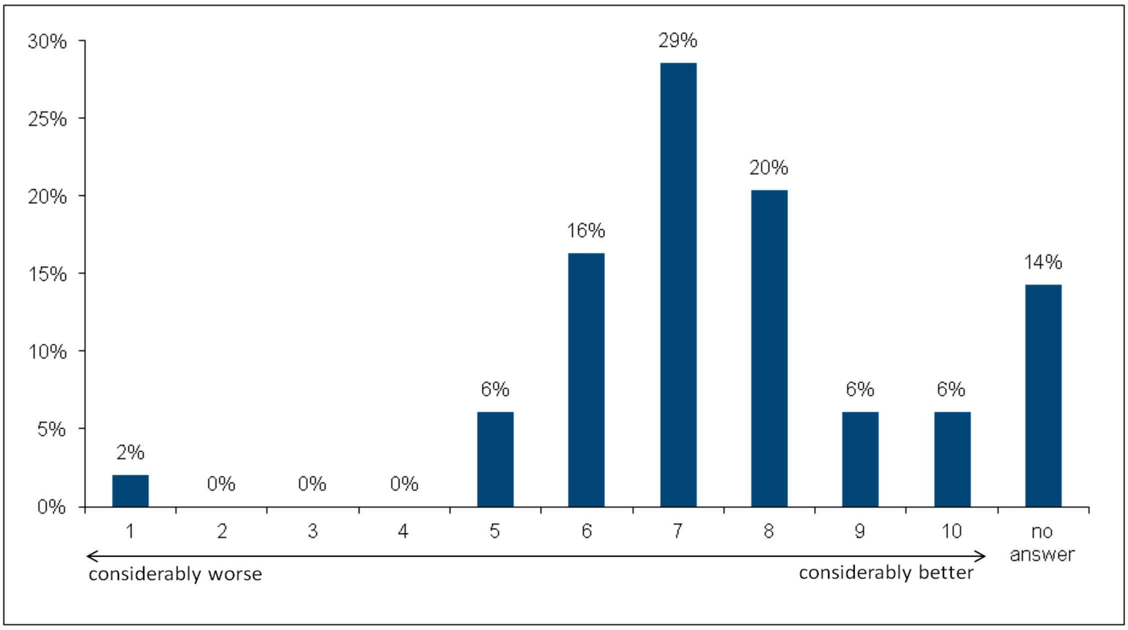
Financial institution respondents were asked to rank the three main opportunities they foresee for their own institution and to rate how the current business year will develop for their institution compared to 2011.

Compared to the heterogeneity in the risks section, there were definite themes that respondents saw with respect to market opportunities for their own institutions. Agricultural lending was perceived as a large opportunity. More than a quarter of all financial institution respondents referred to rural/agricultural lending. Besides agricultural lending, the other dominant opportunities for respondents’ own institutions were energy efficiency/renewable energy funding, and SME financing - with at least two dozen respondents referencing this in some way.

Finally, respondents were asked to assess the business development outlook for their institution in 2012 compared to 2011 on a scale of 1-10 (“considerably worse” to “considerably better”). Responses were broadly positive, with an average of 7.1 and median of 7.0, reflecting the expectation that the current business year will develop noticeably better than the previous year. This is also reflected by the fact that 65% of respondents chose scores from 6 to 8.

The distribution of responses according to different levels of expectation regarding the business outlook for 2012 is shown in Figure 2.

Figure 2: Expected development of current business year in comparison to 2011



The level of development in Responsible Finance

Respondents were asked to assess the extent to which a selection of Responsible Finance practices is employed by financial institutions in the respondent's country (on a scale of 1-5). Respondents from financial institutions were also asked what activities their own institution had undertaken to promote Responsible Finance during the last three years.

Generally, those Responsible Finance activities less challenging to implement and monitor were the most frequently mentioned practices – with transparent disclosure of product conditions topping the list of practices respondents perceived to take place in their country. Overall, variations between the listed practices were small.

The ranking of Responsible Finance practices employed by financial institutions in the respective market across all respondents is shown in Box 6.

Among the financial institution respondents asked about their own institution's Responsible Finance practices, "loan approval based on payment capacity of clients rather than collateral" is employed by all institutions and had the highest average relevance.

This is followed by the "responsible and transparent use of credit registry/credit bureau data".

The "existence of a customer complaint or ombudsman system" and the "publication of financial literacy material" are the least often employed practices and show the lowest relevance.

Box 6: Ranking of Responsible Finance practices employed

1. Transparent definition and disclosure of financial terms and conditions
2. Appropriate methods to assess the repayment capacity of clients
3. Suitable mechanisms for customer complaint resolution
4. Fair marketing of financial products and services
5. Staff awareness and training regarding responsible finance aspects and integration of such into operations
6. Promotion of financial literacy at customer level
7. Incentive system for field staff that rewards ethical/responsible behaviour with clients

Outlook

Respondents were invited to give their opinions on the top three main topics/features/areas that will impact their country's financial industry over the next five years. The most consistent themes were (in generally decreasing order of frequency): "consolidation of the sector"; "increased competition"; "macroeconomic developments"; "EU debt crisis"; "changes in the regulatory environment"; "political (in)stability", and "Basel" (capital adequacy).

Lastly, respondents were given the chance to speculate on what, by the end of 2012, will have been the headline/motto for the year just passed.

Although extracting general themes from the answers to a deliberately non-directed question is always difficult, some consistent topics emerged. Coping and adjusting to change was a regular mention ("beginning the process of adjusting to a "new normal"), as institutions coped with the effects of the global downturn and the specific country challenges that have emerged. Consolidation was a dominant theme in the headlines or mottos, with almost a dozen respondents putting just that. "Finally...consolidation!" showed the evident relevance of the topic for one respondent.

It was gratifying to note that Responsible Finance was a regular mention too, with several respondents linking it to sustainability of operations. "Social responsibility; Educated clients=sustainable growth" said one, echoing the sentiments of many.

Finally, there was a general appreciation that the bubble years may have passed, and a new, responsible chapter is emerging. "Quality of assets is more important than the size of assets", said one respondent, speaking for much of the global industry.

The survey team comprised Sam Mendelson, co-author of the annual *Microfinance Banana Skins* survey of risks in the microfinance industry, Justyna Pytkowska (Microfinance Centre Central & Eastern Europe and the New Independent States) and Sylvia Spannuth (Finance in Motion).

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