Special Report

European Bank Exposure to Subprime Risk

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■ Introduction

Recent weeks have seen a virtually unprecedented reduction in the levels of liquidity in the financial markets, to the extent that for some participants, previously highly liquid markets such as the asset-backed commercial paper (ABCP) market have closed completely. The trigger for this market turmoil lies with the rapidly increasing level of concern over the US subprime real estate market, the risks of which have been largely packaged up through the structured credit market and distributed to financial markets investors around the globe. Many of these investors are banks, which either own the assets directly on their own balance sheets, or are indirectly exposed to them through a variety of conduits and structured investment vehicles (SIVs) – or yet more indirectly through their asset management operations. Credit concerns in the subprime market have, unsurprisingly, found an echo in other assets classes, such as leveraged loans, although to date there is little evidence that the markets are facing a wide-ranging deterioration in credit quality.

Although the severe market conditions have already taken their toll, notably on the failed German banks IKB Deutsche Industriebank AG (IDR: 'A+') and Landesbank Sachsen Girozentrale (IDR: 'A+'), one of the marked features of the current circumstances is the opacity of information. Without a better understanding of where the risks currently lie, many market participants are simply standing on the sidelines (or lying on their holiday beaches), and this is in itself contributing to the prolongation of the market disruption.

Fitch Ratings has consulted directly with all of the banks that it rates in Europe, and the following is a synopsis of their responses. Where relevant data has been put in the public domain, this is cited. Where data has been shared confidentially with Fitch, the appropriate analytical conclusions have been drawn.

While a number of banks, particularly those with significant investment banking operations, have varying degrees of exposure to US subprime risk, Fitch does not currently view any of these exposures as likely to materially threaten existing rating levels. However, near-term earnings are likely to be under pressure at a number of institutions, and revenue generation in investment banking over the medium-term is likely to be more challenging than it has been for several years.

The exposure of the German banks has already been covered in *"ABCP Concerns Trigger Liquidity Issues for German Banks"*, dated 23 August 2007, and in press releases relating specifically to IKB and Landesbank Sachsen. This report contains an additional overview of the exposure of the German banking industry to US subprime risk. The broader background to current market events was set out in *"Market Correction – Where Liquidity Matters"*, dated 9 August 2007. Both these reports are available at www.fitchratings.com.

Germany

A considerable number of German banks – especially Landesbanks – have accumulated material portfolio investments on their balance sheets. Those investments were made in the context of very liquid markets for the purposes of diversification and substitution of weak franchises in their traditional loan businesses. As part of those activities, several banks are directly and indirectly exposed to US subprime exposures. Disclosure has been limited to date, and even where volumes are published it is not specific with regard to type and leverage of exposure None of the German banks has significant retail operations in the US. Direct lending to US home lenders should remain concentrated at banks with sizeable investment banking operations in the US, such as Deutsche Bank AG (rated 'AA-').

Fitch is not aware of any German bank having materially suffered from reduced demand for syndication in the leveraged finance market. The active German players in this area are the larger institutions including Deutsche Bank and Dresdner Bank (rated 'A+'), but also some larger Landesbanks. Fitch understands that those loans that now need to be warehoused for a longer period do not breach the banks' risk standards.

From today's perspective, Fitch expects that German banks will be able to absorb the potential asset defaults, even where highly-leveraged investments may need to be written off. Given the sizeable portfolio investments in securitisation products, significant valuation losses have occurred and may well continue to increase. Their recognition will very much depend on the accounting treatment chosen under IFRS. Stronger banks may elect to hold their investments for trading, and take those temporary effects through their income statement in order to benefit from extraordinary gains in later periods. Weaker banks may have to designate their investments as Held-to-Maturity in order to avoid marking these to market. Many German banks report that it is increasingly difficult to find market prices they could trade on. If these become too unreliable as a basis for their valuations, banks need to mark their positions to model rather than to market. It is, however, difficult to define objective standards for the assumptions behind these models.

UK

Major Banks

The major UK banking groups (Barclays Bank plc (IDR: 'AA+'), HSBC Holdings Plc (IDR: 'AA'), Lloyds TSB Group plc (IDR: 'AA+') and Royal Bank of Scotland Group plc (IDR: 'AA+') – HBOS is covered within the UK mortgage lender section) are active to varying degrees in wholesale and investment banking, and, with the exception of Lloyds TSB, have sizeable (but different) operations in the US. Royal Bank of Scotland (through Citizens Financial Group, Inc. (IDR: 'AA') and HSBC (through HSBC Finance and HSBC Bank USA) also have significant US retail activities. Fitch expects the current market disruption to affect most of the groups in terms of revenue generation in activities most affected by the current challenging environment. It is also likely that some modest mark-to-market (MTM) losses will be incurred in H207 on assets which have suffered from impairment, and/or where market prices have been adversely affected by sharply reduced liquidity. However, revenues from those activities that are likely to remain under pressure over the coming months are not a large proportion of the groups' earnings, with the impact likely to be cushioned somewhat by ongoing solid performances elsewhere. In HSBC specifically, despite well-publicised problems in its US Mortgage Services division, group performance continues to be buoyed by strong performance in other businesses and geographies.

HSBC was the first bank to publicly signal problems in the US subprime mortgage sector, in a trading statement issued in February 2007. Since then it has provided extensive disclosure on its portfolios and performance in the US mortgage sector. At end-June 2007, the problematic mortgage services unit accounted for USD39bn (net of loan impairment provisions of USD2bn) of HSBC Finance's total real estate secured receivables book of USD92bn. In this portfolio, delinquency rates continued to rise in 2007 and stood at 6.4% on first lien and 8% on second lien. In terms of the financial impact, credit impairment charges in the first half of 2007 were USD760m (H206: USD1.8bn) in this segment. HSBC has taken measures to address its US problems: in terms of structure, it has withdrawn from underwriting subprime mortgages in its correspondent channel, centralised collections, and has made some key management changes. Importantly, it has opened dialogue with borrowers facing significant interest rate resets in the coming months in order to manage these relationships and exposures pro-actively. Nevertheless, it is expected that it will take some time to work through the problem as the most recent origination vintages season and as adjustable rate mortgages reset.

Barclays, Royal Bank of Scotland Group and HSBC (excluding HSBC Finance discussed above) have both direct and indirect exposure to the US subprime mortgage sector of a moderate and manageable size in a group context. Exposures are typically fairly diversified by type and may include direct financing, pre-securitisation loans, warehousing lines and liquidity facilities, as well as trading book positions and CDO structures. Neither Barclays nor Royal Bank of Scotland Group originates subprime mortgage assets. Despite a high proportion of assets being highly rated, Fitch expects some modest valuation losses to have been taken year to date, reflecting a combination of asset value impairments and sharply reduced liquidity in some asset classes. Given a reasonable expectation of continued market volatility, further MTM and/or impairment losses cannot be ruled out in the coming months. With its prime focus on UK retail and commercial financial services, and with more limited investment banking and international aspirations than its larger UK peers, Lloyds TSB's exposure to those markets affected by the current market dislocation is understandably less material than those of the other major UK banks. In particular, the group's exposure to subprime assets is very small. Fitch understands that problems in the UK banks' other structured credit exposures (eg CDO, CLO and other ABS positions) have to date been negligible.

Standard Chartered Bank (A+) has no direct exposure to the US subprime mortgage market. Indirect exposure to this market appears very low and largely arises via small RMBS exposures held by Whistlejacket Capital, a USD18bn SIV managed by Standard Chartered Bank. Whistlejacket invests mainly in highly-rated bank paper and ABS debt. It is funded by a mixture of MTNs, CP and USD1.2bn of capital notes, of which Standard Chartered bank owns approximately USD250m – which is small in relation to the group's balance sheet. Standard Chartered Bank does not have any committed funding lines to Whistlejacket.

In common with many other large US and European banks, the major UK banks are active in the leveraged finance market. Data on market positions is difficult to obtain, but independent research places Royal Bank of Scotland as the largest underwriter among the UK banks (12th position in the US leveraged loan market – behind the largest US commercial and investment banks and the three large European investment banks – and an active participant in the European market). It should be noted though that underwriting activities do not necessarily reflect ultimate hold positions. To date, the UK banking groups have successfully distributed deals to the market, but Fitch believes that continued market liquidity weakness could constrain their ability to distribute all remaining commitments over the coming quarters; in terms of size, these appear to be easily absorbable within the banks' balance sheets should that be necessary. Most banks had been actively managing hold levels and maintaining tight credit criteria, so Fitch does not expect a material credit problem to emerge. However, distribution difficulties may constrain the banks' ability to underwrite further business within existing limits. On a positive note, though, it seems likely that the market will use the opportunity to restore leveraged lending terms (covenants, pricing etc) in favour of the lender rather than the borrower, which will ultimately be positive for lenders in this market.

In common with other large international banks, the major UK banks employ the use of conduits but do not generally commit liquidity to, or sponsor, significant third-party programmes. Exposure to US subprime assets within these vehicles is minimal, and to date the banks have successfully rolled CP maturities, albeit pricing has been tougher in the current climate. Should markets deteriorate further and a need arises to fund conduit assets on-balance-sheet, Fitch believes that the major UK banks have conservative liquidity policies and funding capabilities that should provide an ample buffer to absorb this. Barclays has been linked to a number of troubled SIV-Lite structures. Unlike ABCP conduits, SIV-Lites typically have neither a committed sponsor nor substantial committed liquidity lines and, with market value decline triggers in place, will generally have to sell assets if liquidity problems arise. Barclays' potential exposure to these structures appears very modest in a group context.

UK Mortgage Lenders

The mortgage lenders include rated building societies and former building societies which are now banks and which have continued to concentrate primarily on the UK residential mortgage market. In general, they continue to be managed according to conservative principles, with limited appetite for risk and with most assets based in the UK. None of the UK mortgage lenders holds US subprime mortgages directly as mortgages on their books. Most hold RMBS as part of their securities portfolio, and a few of these include a small quantity of highly-rated tranches of subprime US mortgages. Fitch views the exposure to these instruments as manageable. Only the largest mortgage lenders hold CDOs or other securities with exposure to US subprime mortgages, and these tend to hold highly-rated tranches. Fitch does not expect any material difficulties to emerge from the UK mortgage lenders' exposure to US subprime mortgages. If any write-downs are required to the value of the securities (either charged through the income statement or directly to reserves), Fitch considers that all lenders should be able to absorb the charge without any detriment to their ratings.

While HBOS plc (IDR: 'AA') does not have any material exposure to US subprime mortgages, it has decided provisionally to fund itself the maturing commercial paper of Grampian, its GBP18bn asset-backed commercial paper conduit. The decision was taken in the light of high funding costs for Grampian, which can usually fund itself more cheaply than HBOS, but which was being asked to pay substantially more as investors became increasingly unsettled about exposure to this type of vehicle. The question was one of price; the credit quality of Grampian or HBOS was not and is not in doubt. HBOS has stated that it has GBP150m direct exposure to US subprime mortgages, of which GBP93m is held by Grampian. All the exposure is to loans granted before Q405, and all the RMBS are rated 'AAA'. Grampian holds a further GBP400m of CDOs which have some exposure to US subprime mortgages. All are rated 'AAA', as is over 99% of the other securities held by Grampian.

The experience of Northern Rock PLC (IDR: 'A+') is different from the other undiversified and mainly retail-funded mortgage lenders. The bank obtains a larger portion of its funding than its peers from non-retail sources, increasing its reliance on wholesale markets. In its results for H107, the bank announced a fall in growth in expected underlying attributable profits, arising from narrowing spreads on its new residential mortgage loans, reflecting the risks inherent in relying on different indices for funding and lending. Recent jitters in the markets have temporarily restricted the bank's ability to draw on its mainstays of long-term funding, securitisation and covered bonds. However, provided the bank can pass on to borrowers any higher funding costs, earnings should not be affected. At the moment, the cost of funding mortgage loans has moved back in the bank's favour, which should allow it to meet current expectations for earnings. Asset quality remains sound, although Fitch expects rising interest rates to increase the strain on borrowers' ability to pay monthly instalments on their loans. Consequently, Fitch expects the bank, like its peers, to suffer a moderate deterioration in its asset quality. However, so long as employment remains strong, Fitch does not expect significant falls in house prices. The asset quality of Northern Rock and of other mortgage lenders is at a cyclical strong point, and a modest deterioration should have no impact on ratings.

■ France

Given their large corporate and investment banking (CIB) operations, banks like Societe Generale (SG; IDR: 'AA'), BNP Paribas (BNPP; 'AA'), Credit Agricole (CA; 'AA'; – through Calyon; 'AA') and Groupe Caisse d'Epargne (GCE; 'AA')/Groupe Banque Populaire (GBP; 'A+') (both through Natixis; 'AA') have some exposure to the US subprime market. These expose the banks to credit risks (loans to originators and refinancing of mortgage pools), market risks (through RMBS or CDOs), and in some cases liquidity risks (conduits). In addition, one of these banks, BNPP, has a large presence in retail banking in the US. Moreover, the crisis in the US subprime market can have indirect impacts on these banks' extensive asset management activities (reputational risk), leveraged buyout (LBO) activities, and exposure to hedge funds. However, the risks effectively born by French banks due to their exposure to the US subprime market are small and are largely mitigated by these banks' large equity base, sound business diversification and strong deposit base, and are not viewed by Fitch to be material to current ratings.

SG has no retail banking operations in the US. Its direct exposure to originators is very small when compared with the group's total assets, and subprime assets account for a tiny portion of mortgage pools in the US RMBS conduit. This is not expected to rise, given the contraction in new origination of such mortgages. SG's market risks are also limited, with less than 1% of CIB revenue generated from US securitisation and CDO activities, and securitisation tranches are highly rated. Indirect impact will remain insignificant, given that LBO financing accounts for around 1% of CIB's credit exposure and exposure to hedge funds for only 1% of counterparty risks in market activities.

Despite its retail banking activities centred on the west coast of the US, BNPP's exposure to subprime markets (including to obligors, assets being warehoused, CDOs, conduits, etc) is very modest in relation to consolidated risk exposures and consolidated equity. In fact, BancWest Corporation (IDR: 'AA-') is not a specialist in the subprime risk markets, and this type of lending represents less than 1% of its total mortgage loans. BNPP's direct investments in hedge funds are small and counterparty risks are collateralised, with collateral values reportedly holding up well. Its exposure to LBO financing comprises almost exclusively (99.7%) senior tranches; 69% of investments are in European deals. Underwritten positions are limited and well diversified. On 9 August, BNPP Investments Partners announced it was suspending trading in three funds with underlying US ABS assets, given the liquidity squeeze in the underlying markets which is leading to acute pricing difficulties. Trading on these funds resumed by the end of August. BNPP is a leading asset manager, and funds invested in structured instruments affected by the mid-year turmoil represent less than 1% of the group's total assets under management. As a whole, Fitch is reassured that the bank's exposure to US subprime residential markets and other presently troubled credit areas is modest.

Natixis' exposure to the US subprime market generated less than 1% of its operating income in 2006. Nevertheless, in 2007 Natixis reduced its subprime positions to originators from EUR1.5bn to nil. Its portfolio of warehoused mortgages, some of which are subprime, has been reduced by more than two-thirds to EUR281m. Natixis' EUR5.8bn exposure to LBOs is well diversified; 98% composed of senior tranches, 66% of which are in Europe. The turbulence in the subprime markets had an impact of 2% on the bank's operating income in the first half of 2007, offset by growth in other areas, and management has not revised any of its public results projections. Moreover, although Natixis' liquidity has remained robust, additional liquidity is assured by its two shareholders (GCE and GBP) due to Natixis' affiliation to these two groups' central bodies (Caisse Nationale des Caisses d'Epargne et de Prevoyance, IDR: 'AA', and Banque Federale des Banques Populaires, IDR: 'A+'). Natixis also holds a 2.5% stake in the troubled German bank, IKB. This is in Natixis' books at less than EUR30m (0.17% of Natixis' equity). Natixis is not involved in any of IKB's real estate deals, as it used IKB as a vehicle for participating in some syndicated loans to large German corporates. The bank has stated that it is expecting very limited impact or no impact on its results as a result of its IKB connection.

While CA has no retail banking activity in the US, its CIB division (Calyon) has some exposure through ABS warehousing (EUR586m) and CDOs (EUR280m of mezzanine tranches, reduced to a current EUR40m after impairment provisions). Other information received by Fitch is reassuring, especially when compared with CA's strong revenue base in French retail banking and very large equity base. While Calyon has provided liquidity lines to some securitisation transactions, subprime assets account for a small part of the total. Those with CDOs benefit from strong guarantees, and both Calyon and CA's liquidity is strong. Calyon's EUR3.4bn exposure to LBOs is well diversified, 95% composed of senior tranches, and accounts for only 3% and 4% of weighted assets and revenue, respectively. The regional banks making up CA's domestic retail banking franchise also hold senior tranches in LBO transactions.

Credit Mutuel Centre Est Europe's (through Credit Industriel et Commercial – CIC; IDR: 'AA-') exposure to the US subprime market is limited to trading and available-for-sale (AFS) securities, and has virtually no impact on consolidated results. The group has no high-yield activity and no ABCP conduit. Caisse Federale du Credit Mutuel Nord Europe (another Credit Mutuel federation rated by Fitch; IDR: 'A+') has no exposure to the US subprime market, including in its asset management business.

Discussions with other French entities rated by Fitch do not give rise for concern. HSBC France (IDR: 'AA'), Rothschild & Cie Banque ('A') and Banque d'Orsay ('BBB+') have no exposure to the US subprime sector. The two specialist institutions in the French house financing market, Credit Foncier de France ('AA') and Credit Immobilier de France Developpement ('A+') (including through their Societes de Credit Foncier - SCFs) have no risky exposure to the US (ie any exposure to the US is guaranteed by the US State). However, it should be noted that Oddo et Compagnie ('BBB+'), a leading independent investment firm in France which operates mainly in asset management/private banking and market activities, has announced the closure of three funds because it became impossible to value the structured products properly in the current market conditions. Although Oddo is not expected to lose any money in this, the impact on its reputation and the potential outflows on other funds will have to be monitored.

■ Switzerland

UBS AG ('AA+') and Credit Suisse Group (CSG – 'AA-') both are active in global investment banking and have sizeable operations in the US. Fitch expects the current market disruption to affect both groups in terms of performance in a challenging trading environment. UBS in mid-August announced that it saw a strong possibility of a very weak trading result for the bank if the current turbulent market conditions prevailed throughout the quarter. Nevertheless, Fitch currently considers UBS's and CSG's exposures to be manageable, particularly as both groups generate a significant proportion of profits from their sizeable global wealth management and domestic retail operations, which should somewhat cushion the likely impact on investment banking earnings.

UBS and CSG both have some direct exposure to the US mortgage sector arising from warehousing lines, but Fitch does not consider these exposures to be a concern. Both groups have been active in RMBS trading and underwriting, and Fitch expects a negative impact on revenue from these activities in the current market environment. In Fitch's opinion, some mark-to-market losses are likely to be taken on trading assets which have suffered from impairment, and/or where market prices have been adversely affected by sharply reduced liquidity. These should, however, remain manageable, and may be mitigated by hedging which has become an important feature of credit management generally. In May 2007, UBS announced the closure of Dillon Read Capital Management (DRCM), its alternative investment vehicle, repaying CHF1.5bn of third-party investor interests and moving portfolios previously managed by DRCM to UBS's investment bank. In its recent interim results announcement, UBS reported that challenging market conditions for US subprime debt had negatively impacted income from fixed-income activities, especially the former DRCM portfolios. The DRCM business itself contributed net negative revenues of approximately CHF150m in Q107 and around CHF230m in Q207. UBS and CSG both have exposure to leveraged finance transactions, which, given their size and both groups' experience, currently pose no material concern for Fitch. As prime brokers, there is exposure to the hedge fund sector, which is for both UBS and CSG reasonably well diversified by collateral and hedge fund type. Fitch is not currently concerned about UBS's and CSG's exposures to ABCP conduits. CSG sponsors one off-balance sheet multi-seller ABCP programme (Alpine Securitization, rated 'F1+'), for which it provides credit and liquidity facilities. The current size of the conduit is small in relation to CSG's balance sheet and funding capabilities. To date, the conduit has been able to roll over its ABCP and has not drawn on its liquidity facilities to fund maturing ABCP.

The smaller Swiss banks rated by Fitch are predominantly active in wealth management. As such, their direct exposure to credit and market risk is limited as trading is, to a large extent, carried out on clients' behalf, and lending generally consists of loans collateralised by well-diversified securities portfolios. Therefore, the banks' direct on-balance sheet exposure to structured credit products is negligible. At the same time, wealth management clients' exposure to the US subprime market and to other structured credit products appears modest, while clients' funds can include investments in hedge funds. While the direct exposure to the dislocated markets does, therefore, not pose an immediate concern, Fitch considers that an extended period of weak capital markets would likely have an impact on the private banks' performance as client trading activity slows and assets under management could decline. Nevertheless, the rated private banks showed resilience during the last slump in financial markets following 2001, benefiting from their good franchise.

■ Netherlands

The Dutch bank that has been the most affected on a relative basis is NIBC Bank N.V. Its exposure to the US subprime market stems from its US ABS investment book that is part of the treasury portfolio, where negative MTM losses wiped out the bank's H107 profits. Part of this book (EUR391m or 20% of equity at end-H107) is subprime-related home equity loans and CDOs, and although it is highly-rated ('AAA': 73%, 'AA': 21%, other: 6%), these exposures were responsible for approximately two-thirds of the reported EUR137m MTM loss. The larger, remaining, part of the US book is in commercial real estate CDOs, where MTM values have suffered due to lack of liquidity despite no current credit concerns. The Outlook on NIBC Bank's Long-Term IDR ('A') was changed to Negative from Stable on 9 August 2007, to reflect Fitch's concerns about increased earnings volatility stemming from the present unfavourable financial markets. Subsequently, Iceland-based Kaupthing Bank hf. ('A' Stable Outlook) announced the acquisition of NIBC Bank; and NIBC Bank's ratings, including the Negative Outlook, were affirmed. Although the US subprime portfolio is being transferred to a separate entity controlled by NIBC's current shareholders, the remaining US book may result in further MTM losses.

Despite ABN AMRO Bank NV's (IDR: 'AA-') retail banking activities through LaSalle Bank Corporation ('AA-'), US subprime lending represents a small segment of its retail mortgage portfolio. The bank has stated that exposure to structured credit products in general is limited. Nevertheless, ABN AMRO is exposed, indirectly, through a number of ABCP conduits. It has three major classes of conduits: single-seller, multi-seller and credit arbitrage conduits. The total amount is significant; market sources have reported a total exposure of USD103bn, but that figure corresponds to end-March 2007 and refers to maximum CP limits. The current amount outstanding is less. The conduits continue to access the market but at a higher cost of funding.

Rabobank Group (IDR: 'AA+') does not have direct exposure to US subprime lending via its banking business in California. There is, however, exposure via a CDO conduit. Fitch considers this exposure modest in relation to the group's consolidated risk exposures and as a proportion of its equity, and the P&L effects of the recent turmoil are expected to be minimal.

Similarly, ING Group (IDR: 'AA-') has no direct exposure to the US subprime market, but it is exposed, indirectly through investments in ABS (including CDOs). The credit risk of its indirect exposure is limited. In its first-half presentation, it disclosed that EUR3.2bn of its EUR94bn ABS portfolio relates to assets collateralised by subprime mortgages, which are mostly 'AAA'-rated.

Nevertheless, in July it recorded MTM losses on its structured portfolio of EUR93m. It also has indirect exposure through ABCP conduits of EUR32bn; however the conduits have not faced any liquidity disruptions.

Based on H107 disclosure and discussions with management, Fitch has no major concerns about other Dutch banks that it rates. Mid-sized banks like SNS Bank N.V. (IDR: 'A+'), F.Van Lanschot Bankiers N.V. ('A') and Friesland Bank N.V. ('A') benefit from a large customer deposit base and have not experienced funding problems. In addition, exposure to US subprime assets in their securities portfolios is minimal or non-existent. Bank Nederlandse Gemeenten ('AAA') is reliant on wholesale markets for its funding but has not seen its refinancing ability dented; its portfolio of European mortgage-backed securities does not contain any exposure to US subprime. Although interbank deposits make up the bulk of Indover Bank's ('B+') funding, the bank had no problems in rolling over a large syndicated loan granted by European banks; it would also be able to count on liquidity support from its owner, the Indonesian central bank.

■ Belgium

KBC Bank's (IDR: 'AA-') direct exposure to the US mortgage subprime market is negligible but it is exposed, indirectly, through a number of CP conduits and investments in structured ABS/CDOs. The credit risk of its indirect exposure is limited, however, as it is mostly rated 'AAA', including the US subprime. Nonetheless, the bank did not escape unscathed from the current negative market sentiment. In July, it recorded MTM losses on its CDO portfolio of around EUR35m, a figure which is likely to have doubled by mid-August. On the other hand, it has been able to refinance the CP requirements of its EUR2.3bn conduit as they fell due during this period, albeit at a slightly higher rate of interest, which will again have a bearing on Q307 performance. Given the relatively small size of its overall risk and external funding requirements, it is Fitch's view that KBC will be able to bear any losses relatively easily. The bank provided detailed disclosure at its H107 presentation.

Similarly Dexia (IDR: 'AA+') has only been affected to a limited extent, with MTM losses on its securities portfolio in the region of EUR30m as of mid-August. The bank's risk-averse nature and the wide range of businesses undertaken by the group has ensured that the current market movements have not caused undue pressure on the bank, despite the widening of spreads it has seen on the funding requirements of some of its business lines.

Finally, Fortis Bank (IDR: 'AA-') has no direct exposure to the US subprime market. However, through its merchant banking division and its investment portfolio, the group has indirect exposure to US subprime mortgages through structured transactions including CDOs, ABS warehousing and ABCP conduits. Most securities are diversified and highly-rated, and subprime assets account for a small part of the total. Moreover the liquidity position remains easily manageable. In addition, Fortis also has limited exposure through its LBO portfolio. No details on these exposures have been publicly released by the group, but information received by Fitch is reassuring. Given the group's generally conservative approach to risk, Fitch considers that although some of the lowly- rated securities may sustain either losses or a decline in market value, leading to charges against either earnings or equity, these charges are unlikely to have any significant impact.

■ Ireland

In general, the Irish-based financial institutions rated by Fitch have limited exposure to US subprime mortgages and the two building societies have none at all. Where there is exposure, its importance varies from moderate to negligible and, even where moderate, it is manageable. It arises both from holdings of US subprime mortgages and/or from holdings of other securities which contain some exposure to US subprime mortgages. For example, at end-June 2007, Allied Irish Banks p.l.c. (IDR: 'AA-') reported holding USD238m of US subprime mortgages as asset-backed securities and USD149m of US subprime mortgages as 'whole loans'. At the same date, it reported equity equal to USD14bn and H107 operating profit of USD1.6bn. In addition, the bank holds a strategic minority stake in US-based M&T Bank Corporation, a regional commercial bank, which in 2006 reported net income of USD839m and equity of USD6.3bn. This bank and others also hold portfolios of structured credit products, such as CLOs, CDOs, RMBS, CBS, SIV and other ABS. Most securities of this type held by Irish banks are diversified and highly-rated ('AAA' or 'AA'). Some of the banks with exposure to these products may also have some exposure to 'BBB' and speculative-grade rated paper. Overall, Fitch considers that some of the lowly-rated securities may sustain either losses or a decline in market value, leading to charges by the Irish banks against either their earnings or equity. Fitch considers that in all cases the charge should form a fairly small portion of operating profit, and therefore that all lenders should be able to absorb the charge without any detriment to their ratings.

Italy

Italian banks' exposure to the US markets has declined progressively over the past years as a result of a large number of banks closing or reducing their direct presences in the country. While in the past even medium-sized banks maintained branches outside Italy, since the early 2000s banks have increasingly concentrated on their core domestic market. Given the core customer base of retail clients and SMEs of most Italian banks, with the exception of the largest institutions, exposure to non-Italian large corporate clients is small. Similarly, very few of the banks rated by Fitch are liquidity providers for ABCP conduits, and only for amounts that are relatively moderate compared to the banks' size. Fitch considers the exposure of the rated Italian banks to the US subprime mortgage segment to be modest. The recent market disruptions are likely to affect the valuation of most banks' securities portfolios, resulting in MTM losses, but overall the effects should remain manageable.

Unicredito Italiano's (IDR: 'A+') direct exposure to the US subprime mortgage sector is minimal. Its indirect exposure is modest and arises from a limited amount (just over USD400m) of RMBS and CDOs backed by these assets in its securities portfolio. Unicredito Italiano sponsors two off-balance-sheet credit-arbitrage conduits, Maximilian and Bufco, which to date are fully self-funded and have not drawn on any liquidity lines from Unicredito Italiano. Bufco is only moderately exposed to pre-2003 vintage US subprime CDOs. The current size of these conduits, at approximately EUR2bn at end-July 2007, is contained and is set to decrease as maturing assets are not reinvested. Unicredito Italiano holds a sizeable underwritten exposure to recent leveraged loan transactions (approximately EUR5bn), which it has either not yet syndicated or which it has decided to keep on its books for pricing reasons. Unicredito Italiano aims to syndicate these assets within the next six months. The group's securities portfolio also includes a substantial proportion of CDOs, which are not related to the subprime mortgage segment.

Intesa Sanpaolo (IDR: 'AA-') has stated that it has no material exposure to the US subprime mortgages sector as the group does not operate directly in the segment and has for some time used hedging instruments as protection in related trading activities, anticipating more difficult markets. Intesa Sanpaolo sponsors a multi-seller and credit-arbitrage conduit, Romulus Funding Corporation, for which it is also liquidity provider. The conduit is not exposed to the US subprime market. Romulus Funding is consolidated by Intesa Sanpaolo and, given its moderate size (end-June 2007 assets: USD1.5bn) and the high quality of its asset pool, is not cause for concern.

The other rated Italian banks also have small direct and indirect exposures to the US subprime segment, mainly arising from investments in CDOs where a portion of the underlying assets may be invested in subprime RMBS. The banks' exposure to structured credit products in general (ABS, CDO, CLO, etc.) varies in size but does not pose an immediate concern. Nevertheless, as a result of the recent market disruption, banks will experience MTM losses on these portfolios, but the impact should remain manageable. A number of rated banks have invested a portion of their securities portfolios in mutual funds or – to a lesser extent – in hedge funds, to benefit from more diversified investments. The diversified nature and generally conservative risk profile of the majority of these funds, and the fact that hedge funds constitute only a small proportion of investments in funds, should mitigate risks, but Fitch notes that this type of investment makes it more difficult for banks to monitor their investments in real-time and tends to reduce the liquidity of investments.

Spain

Fitch does not anticipate any material impact on Spanish banks as a result of the crisis in the US subprime market. A buoyant Spanish economy and declining interest rates over the last decade has led to a strong demand for residential property in Spain, which has spurred lending to individuals, mostly mortgages, and real estate developers. Given these factors and the fact that Spanish financial institutions are retail in nature, banks and cajas have focused on expanding their loan books. As loan growth has outpaced that of deposits, entities have increasingly needed to access the capital markets for funding, mainly centred in "cédulas hipotecarias" (Spanish mortgage-covered bonds), although they have begun to diversify by security and by investor.

Any direct exposure to the US subprime mortgages would be centred in subsidiaries of BBVA (IDR: 'AA-') or through Banco Santander Centro Hispano's ('AA') 24.9% stake in Sovereign Bancorp Inc. (BBB-). However, the exposure is minimal as these subsidiaries do not focus on this market segment.

Small- and medium-sized Spanish banks and cajas have some pockets of CDOs as a means to diversify risk. These usually only have a small proportion of the CDO investing in the US residential market. Any impairment registered would be small and may be offset by the sound recurrent earnings generation from Spanish banks' and cajas' retail franchise and their generally sound cost-efficiency. Asset quality in Spanish banks is healthy, with an average impaired to total loans ratio of 0.46% for the sector and loan impairment coverage of 273%, a large proportion of which is related to the Bank of Spain generic reserve.

Portugal

Banks in Portugal have been relatively unaffected by exposure to the US subprime market, with only small indirect exposures in some cases through CDOs. Similarly, other structured credit exposures represent a relatively small proportion of the banks' investment portfolios. Some unrealised losses have been recorded but these are unlikely to have any significant impact on earnings or equity. To Fitch's knowledge, the Portuguese banks are not involved in ABCP conduits or underwriting major deals in the high-yield market.

As most banks fund themselves through customer deposits and medium-term debt, they are not reliant on short-term refinance, and Fitch does not anticipate any liquidity problems. While generally higher credit spreads may have some impact on the cost of their medium-term funding, the availability of finance is not expected to diminish, even though the leading banks are making use of securitisations and covered bonds supported by domestic residential mortgages.

Greece

Since Greece's entry into the European Monetary Union in 2001, the Greek banks have benefited from improved economic conditions, rising household income and low interest rates. All these favourable conditions have spurred consumer spending and loan demand, which allowed the banks to rapidly increase their lending books and profitability. As a result, in the last six years, Greek banks have been mainly concentrated on developing their core domestic markets and customer base of retail clients and SMEs, while, overall, their activity in international financial markets has remained limited. In addition, their exposures to US financial markets have also noticeably declined, as some banks decided in this period to dispose of their banking subsidiaries in USA – which served the local Greek communities – and to acquire small banks in south-eastern Europe, which has been considered a new strategic area of expansion.

Overall, as a result, Greek banks' exposures to US financial markets are marginal and their direct investments in US subprime mortgage sector are immaterial. Similarly, their exposures to structured credit products (ABS, CDOs, CLOs, etc) are also de minimis. In addition, the Greek banks' exposures to structured credit products are usually in the available-for-sale portfolio at MTM values. Greek banks rated by Fitch are not liquidity providers for ABCP conduit programmes. Overall, although the recent turmoil on financial markets is likely to materialise its effects on the valuation of banks' securities portfolios, Fitch expects that the impact on the Greek banks' operating profit should remain limited and their exposures should remain manageable.

Nordic Countries – Denmark, Finland, Iceland, Norway and Sweden

The large Nordic banks have, in general, no direct exposure to the US subprime mortgage sector, and most of them no, or minimal, indirect exposure. A few of these banks have structured credit portfolios (around 5% of equity), including some ABS backed by US mortgage collateral; in general, tranches are rated 'AAA'. Kaupthing Bank is mainly exposed to the structured credit market through its UK-based credit fund manager, New Bond Street Asset Management. Danske Bank (IDR: 'AA-'), Skandinaviska Enskilda Banken (SEB; 'A+') and Nordea Bank AB ('AA-') are direct liquidity providers of ABCP conduits; however, the latter have minimal or no exposure to the US subprime market. Fitch is informed that MTM losses have been limited so far.

Austria

Unlike some of their German counterparts, the large Austrian banking groups have very limited exposures to the US subprime market, usually through investment in CDOs. They do not sponsor ABCP conduits.

Emerging EMEA

Elsewhere across emerging Europe, Middle East and Africa (emerging EMEA), there is little to no bank exposure to the US subprime market. This can be primarily attributed to strong loan demand in their domestic markets, which has obviated the need to pursue yield from alternative asset classes.

The crisis has, however, had an indirect impact. This has occurred in two areas: first, in terms of MTM valuations of securities held; and second, access to, and as a consequence, pricing for international funding. Banks with large trading debt securities portfolios have been exposed to revaluation losses through the P&L. Those banks with less diversified activities will be more exposed than others. Wholesale funded banks that do not have access to a large domestic pool of funding, such as some of the markets in Russia and the CIS region, are vulnerable to potential re-financing risk. Very rapid growth has led to increasing reliance on international funding. There is evidence of issuance activity slowing and banks turning to the syndication loans market to fill their immediate need for funding. If this does not translate into low loan growth, liquidity will come under pressure and higher funding costs would affect profitability if banks are unable to pass on these costs. Banks rated by Fitch in the Middle East and Africa in general tend not to be facing these issues.