Strategy and Finance Division

Investor Relations & DCM

OTP BANK

2Q 2023 Conference call

Transcript

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P R E S E N T A T I O N

Operator

Dear Ladies and Gentlemen, welcome to the OTP Bank 2Q 2023 Conference Call. This conference will be recorded. (Operator Instructions)

May I now hand you over to László Bencsik, Chief Financial and Strategic Officer. László, please go ahead.

László Bencsik – Chief Financial and Strategic Officer

Thank you. Thank you for joining us today. Good morning, and good afternoon, depending where you are on this mid-summer occasion.

As usual, we have the presentation available here and on the website. I'm going through the pages in a rather swift manner and then we will have a Q&A session.

Starting on Page 2, the quarterly results and half-year results for this year. Obviously, it's an all-time record and by a huge margin. This extraordinary performance was supported partially by one-offs, as you can see. In the second quarter of 2023, we had almost HUF 100 billion positive adjustments, one-off items. During the course of the first 6 months, these were more than HUF 100 billion. We still have the special tax of financial institutions and the windfall tax, and there is another interest rate cap extension as negative, but these negatives were by far counterbalanced or superseded by positives related to the 2 acquisitions which we have concluded during the first 6 months: first in February, NKBM in Slovenia and then Ipoteka Bank in Uzbekistan. Both acquisitions entailed badwill and therefore, when we included them in our consolidated reports, there was a subsequent positive one-off effect.

In a huge contrast with last year's first 6 months, when we had more than HUF 200 billion negative items related to the direct effects of the Russian-Ukraine war, and to the negative measures – from our perspective at least – of the Hungarian government. All in all, this big movement in the adjustments resulted partially in this large y-o-y and q-o-q improvement.

But if you look at the adjusted profit after tax, it's also a record high number, also boosted by some one-offs, which I'm going to talk about later on, mostly driven by low-risk costs. Portfolio quality in general is stable and good, and macro expectations keep improving, therefore, IFRS 9 provisioning is less, in some cases we can release provisions due to better macro expectations.

I think a notable number on this slide is the adjusted ROE at 28.4%, which is much higher than last year. Therefore, as you will see at the end of the presentation, we modified our original expectations for this year where we had expected similar adjusted ROE to last year. Now it's quite likely that this number is going to be bigger for the course of the year. There was a slight increase in net interest margin on group level y-o-y and some improvement in the cost-to-income ratio.

If you look at the P&L lines in more detail, there's some noise here because of the 2 acquisitions, which happened in 1Q and 2Q this year. It's worth looking at the growth rates without acquisition and FX rates where we have seen strong movements. Therefore, we usually look at the FX-adjusted without acquisition numbers.

Operating profit y-o-y for 6 months, up 30%. Strong income dynamics and somewhat strong but less than income growth increase in expenses. We are in a high inflation environment, especially in Hungary. The Hungarian inflation peaked at 26%. This is a very high inflation environment where cost growth is also strong, not just income growth.

But all in all, we managed to increase operating profit by 30% without acquisitions. On this slide, you can see the risk cost number. It was pretty much zero for the first 6 months of this year, which is in sharp contrast with the minus HUF 105 billion we provisioned last year when the war started, and we had the expectation that there will be direct and indirect negative ramifications of the war regarding portfolio quality. But those negative expectations have not manifested, portfolio quality is quite stable. It is stable also in Russia and Ukraine which are primarily affected by the war, and is also quite stable across the group.

Going forward, talking about Hungary and the OTP Core performance. Here, there's quarterly improvement in adjusted profits, but if you look at the first 6 months of this year and compare it to last year, there's still a more than 30% decline. This is primarily coming from the net interest margin being less. I will elaborate more on this and the drivers behind the declining net interest margin. Cost to income also worsened, and this is partially due to tighter revenue margins, but also cost to assets slightly increased due to the exceptionally high inflation environment in Hungary.

Adjustments wise and one-off items wise, last year's first 6 months was heavily impacted by the war-related losses and write-offs. There was a much smaller negative number this year, coming from the windfall tax, the special bank tax and the interest rate cap extension.

When we look at the other group members on page 5, it's a pretty positive picture in almost every case, we improved the profit after tax compared to last year. ROE numbers are on quite respectable levels. Even in Ukraine and Russia, especially if you look at Ukraine, we have the highest ROE in the entire group coming from Ukraine. Also in countries like Moldova, where you would not expect such a good performance, ROE was more than 30% in the first half of this year.

You can also note on this page the increase in Slovenia: last year for 6 months, it was HUF 10 billion, then this year it's HUF 54 billion, and that's because we included the contribution from NKBM starting from February. The latest acquisition, Ipoteka Bank in Uzbekistan, P&L-wise it's not yet included, but we consolidated the balance sheet in the second quarter numbers. The P&L contribution, we don't see yet coming from Ipoteka Bank. This is going to appear starting from the third quarter this year.

Now I'd like to point out here on page 6 a very significant development in the group and taking a kind of bird's eye view and a more strategic look at what happened during the last couple of years regarding OTP as a whole. As you can see, we have gone through a tremendous growth trajectory. Since 2016, we have almost tripled the size of the group and total balance sheet is very close to EUR 100 billion. Part of that was obviously organic growth, but there was a large contribution from the acquisitions that we have made. The flags here represent the acquisition when we acquired a new bank in a given country.

This resulted in a strong shift in the composition of the group: Hungary used to contribute 60-70% of the group's profits and many other metrics, like total loan portfolio and such. Today the profit contribution is around 30% and the foreign operations now outweigh the Hungarian one, especially the Eurozone countries and the quasi-Eurozone countries like Bulgaria, which is about to introduce the euro. Their size increased so that they represent today 40% of the total loan book of the group. That's a fundamental growth in overall size, but also internally there has been a shift in the composition of the group, the contribution of Hungary shrunk, and the rest grew, especially the Eurozone countries.

Page 7, a few thoughts about the new country in our group, Uzbekistan. Its population is 36 million, growing very fast. It's a very positive demographics country with median age being 30 years. It has a young and fast-growing population, relatively low GDP per capita, but growing rapidly, high level of education and schooling system. We have trained workforce there and a leadership strongly committed to market reforms and improving the wellbeing of the country and the people in the country. This is a country, in our view, on a very, very positive trajectory where there's a lot of room to grow from a low base and a very clear intention by the leadership of the country to develop in general, and in particular, regarding the banking sector.

If you look at the bank that we acquired, it's the #5 bank in the market. It's the smallest of the 4 or 5 large state-owned banks with 7.7% market share and this bank was the first in the expected series of bank privatization. We were the first buyer of a state-owned bank. If you look at Ipoteka Bank's total assets or loan book, it doesn't look like a game changer for the whole group, the bank has a 4% share within the total. But in terms of growth potential and in terms of profit potential, I believe that it's going to have a much bigger role and share in our future story than just a pure loan book or total asset size of the operation.

Page 9, a few words about Russia, Ukraine, in both countries the operation is stable, profitability is high. In Russia, the consumer loan portfolio started to grow, we still don't serve corporates with loans. In Ukraine, we continue to see a decline in overall loan volumes. In Russia last year, we paid back all the group funding. There's a small amount of sub debt outstanding, whereas towards Ukraine there is still gross intragroup funding, despite the fact that they actually keep more of their excess liquidity in Hungary than the funding line to the leasing company in Ukraine. But nevertheless, the gross amount is still there.

Provisioning continued in Ukraine. We are close to 25% total provisions to total gross loans coverage level. That includes performing and nonperforming loans together. This is quite a comfortable and conservative level of provisioning we believe, especially because, again, portfolio quality seems to stabilize.

We continue to quantify the worst-case scenario's potential impact on our capital. In case of Russia, it's 46 basis points, writing off the entire operation. The potential negative impact declined q-o-q primarily because of the exchange rate: the HUF value of the equity in Russia declined due to the weaker rouble rate. In Ukraine, the potential CET1 effect somewhat increased: that's due to the fact that we are piling up retained earnings, capital keeps increasing in Ukraine, and therefore, the potential loss from writing off the whole entity is also there.

Just a technical remark: we expect this negative scenario in neither of these countries. In Ukraine we see a large strategic potential once the rebuilding of the country starts and returning to normal happens, we expect further increase, especially in lending activity. Again, profitability is the highest in the group, historically also high. Whereas in Russia, we are having very narrow focus of activities, only doing consumer-lending, point of sales loan-driven consumer lending. We even recently discontinued dollar transfers, so we are not providing that service anymore to our clients, meaning that we even narrowed down with another big step the type of operations what we do in Russia.

Next page is about revenues, but probably it's more interesting to go into the different types of revenues. If we look at net interest income, page 11. We explain here the bigger movements on a q-o-q or y-o-y basis. There was an improvement in Hungary, but that was mostly driven by technical or one-off items and also some calendar effect. Without that, we still have had a slightly negative NII growth q-o-q in Hungary, whereas in all the Eurozone or euro-related countries, you see strong improvement even on a quarterly basis due to the increasing rate environment and us benefiting from the higher rate environment.

On the following page, you see the net interest margin numbers. This trend is very clear, in most of the foreign subsidiaries we see improvement and we also see a q-o-q improvement in Hungary, but again, this improvement was mostly due to technical one-offs.

Maybe next slide, page 13 will be helpful to you to understand the driving forces behind the Hungarian NII and the net interest margin. On this page, we tried to describe the reasons and decompose the different factors behind the y-o-y decline of NII and subsequently the NIM in Hungary. Here, we compare 2Q 2022 to 2Q 2023. As you can see, there is a HUF 17 billion decline in the NII, and there was a 64 basis points decline in the NIM.

On this slide, you see the sources of this, the different factors having impact. The biggest one by far is the changes of the mandatory reserve rules. Last year in the second quarter, the reserve requirement was 1%, and they paid market rates on this level of reserves. Now this 1% was increased to 10% in 2 steps, and 75% of the total pays only 13% when the overnight rate in the second quarter this year was 18%, and for 25%, since April, there was 0% paid. This is huge, I mean the impact just in 1 quarter. So, HUF 23 billion negative impact came from the mandatory reserves.

The second biggest negative factor was the acquisitions. When we do acquisitions, the Hungarian bank, the Core acquires those assets. The investments into these new acquisitions become non-interest-bearing assets and therefore have a negative impact on NII. Here, we just quantified the impact of NKBM acquisition in 1Q on our 2Q NII and this is HUF 13 billion less NII in case of OTP Core.

The third negative was deposits. Deposits declined y-o-y; they went down in Hungary by HUF 500 billion. Part of that is retail and part of that is corporate. Especially on our retail deposits, we have a quite big margin and any decline in deposits is negative from an NII and NIM perspective, so another HUF 11 billion y-o-y impact.

Then the new papers that we had to issue in order to achieve the MREL targets beginning of next year: that item has a negative impact on our Hungarian NII as the Hungarian bank is the issuing entity, given the single point-of-entry approach what we have. We have not yet provided these MREL funds to the subsidiaries. This waterfall impact of distributing the MREL funds in the group has not happened because this only has to be done by year-end. This is also quite negative for the Hungarian earnings.

The factor which we talked about before, the large surplus of fixed assets that we have, especially because of the actions of the government and making them fixed is actually quite small on the NII.

Now we also have positives. Obviously, loan growth was positive. Also, we opened a strategic euro short position in February to hedge the investments into Euro assets, primarily the NKBM equity investment and also Slovenia and Croatia.

This might be helpful if you want to understand at a deeper level the potential developments and drivers behind our Hungarian NII.

Some more detail here to explain the deposit dynamics, if you look at the following page. In Hungary inflation peak was close to 26%. At the same time, retail government bond yields were quite high and some of them are even linked to inflation. So, the expected rate on these retail bonds is much higher than the actual one here what we have on the slide. Now these 2 have a major impact on retail savings. First of all, people use up their deposits at banks, they save less and spend more due to inflation. Second, retail government bonds and other investment funds have attracted a lot of retail savings. If you look at these numbers, again, comparing the second quarter y-o-y, overall retail savings increased in the market by 12%. But within this bank deposits declined by 11% and government bonds and retail investment funds increased quite substantially.

What happened in OTP, if we go to the following page, as you can see pretty much similar trends took place. Retail deposits declined 9%, this 9% decline is less than the market decline. In fact, our market share increased by almost 1 percentage point in the year to 41.8%. Nevertheless, retail deposit volumes declined, and this is obviously a quite costly business development for us because this is by far the highest margin product that we have at the moment with the current rate levels.

Now obviously, the big question is how long this process is going to continue. You will see the recent numbers in terms of deposit volumes.

We believe that we have been through the worst. In terms of adjustment to the new norm of higher inflation environment, adjustment has already happened and as inflation drops down and the potential forward-looking yield expectations on retail government bonds decline, we are quite hopeful that this trend will slow down and then the decline of retail deposit slows down, but this is something to be seen. This is one of the most important factors when we think about future potential revenues on group level.

Going forward, volumes on page 16. Loan growth across the group slowed down, especially in Hungary, where we have the highest inflationary environment. Now, these quarterly growth figures actually include the impact of the expiry of the Hungarian payment moratorium. These are the performing loan volume growth numbers. The moratorium ended last year, and after 6 months some loans previously subject to moratorium are reclassified into performing category. So, we had some performing loan growth there coming from that angle. Besides Hungary, Bulgaria and Croatia are doing well, Ukraine and Moldova continue to decline.

If you look at the ytd data on the loan volumes, you see that overall we have 3% growth in the first 6 months without acquisitions. If we also include acquisitions, then the growth rate was actually 18%, which is including NKBM and Ipoteka Bank. After this 3% growth over the first 6 months, we believe that we might get actually close to or around 5% growth rate for the whole year. We will talk about the expectations, but this is a line where we somewhat positively revised our previous guidance.

If we go to deposits and quarterly deposit dynamics, you can see here on page 18 that in Hungary, we have this negative number. This is what I talked about. Financially, the retail deposit decline has quite a painful impact, but also corporate deposits declined in the second quarter and it's not just in Hungary, but in some other countries. It's obviously a quite price-sensitive segment. Regarding corporate deposits we are providing high interest rates typically.

Now fee income, page 20, increased healthy, I would say, 14% without acquisitions y-o-y growth. The second quarter was particularly strong. There are no particular one-offs here. This is basically a strong performance partially driven by the high inflationary environment. Transaction volumes increase and therefore, fee-related income increases. It's another strong performance.

Other income, there's an item here which we need to talk about in the second quarter in Hungary, the revaluation of the subsidized retail loans in Hungary, namely CSOK, the mortgage product, and baby loans, consumer loans, where the subsidies are linked to a number, which includes the benchmark multiplied by 1.3. Therefore, we actually have to mark-to-market them. This was on a quarterly basis, slight negative last year, but this year, due to the strong downward shift of the HUF yield curve, there was a one-off fair value adjustment we had to account for. That's HUF 34 billion, which is considerable from a quarterly revenue perspective of the whole group even.

Obviously, it was a one-off, but it can continue, should the yield curve continue to move downward. On the opposite direction, if it moves upward, it can turn into negative. Since we are talking about rather sizable volumes here, more than HUF 800 billion in baby loans and more than HUF 400 billion volumes in the subsidized housing loan structure. This can materially impact the earnings in the future as well.

On operating costs, we have larger y-o-y growth numbers in Hungary, it's 24%, mostly driven by personnel expenses, which grew 40% y-o-y. That's quite a substantial amount. The labour market is very tight, and we are trying to be very competitive to attract the best talent. Therefore, we increased wages in stages last year in September and this year in March, and they are obviously reflected in personnel expenses. In Bulgaria, this 22% is distorted by the accounting of the supervisory fees in the first quarter. Without that, if we had accrued them as we used to do, then this 22% growth would have been only 7%. In Albania, the new acquisition, which came into our group in last year in August, increased the costs. So, the increase there is due to that acquisition.

Capital situation, page 23. Despite the sizable acquisition of Ipoteka in the second quarter, the capital ratios improved. As you can see, the Common Equity Tier 1 ratio improved by 80 basis points. That's due to the strong profit and retained earnings increase coming from the quarterly profits.

We continue to issue MREL bonds. We had a USD 500 million issuance in May and then in June, we did a private placement of USD 110 million. We expect to do another benchmark Euro deal during the course of this year in order to fulfil the requirements of next year.

One news which we announced yesterday: we received the preliminary SREP documentation from the Central Bank. They did the supervisory review, and they initially proposed 120% SREP ratio from 1 January 2024, which is 5 percentage points lower than what we have this year. This is a preliminary number. But if it happens than this somewhat eases the MREL issuance needs during the course of this year.

A European stress test was done by EBA, the usual bi-annual exercise. As usual, we came out quite successful. We are #4 if we measure by the change in Common Equity Tier 1 ratio over a 3-year period of the stress scenario. OTP is one of the most stable and resilient banks in Europe according to the stress test. This is in line with our expectations. We're seeing the type of result that we had before on these stress tests.

We are not just resilient in terms of our capital situation, but also continue to be relatively conservative in provisioning. On page 25 you see the coverage ratios compared to some other banks, while the Stage 3 ratio continues to decline, it's 4.2%, well below 5%, even including Russia and Ukraine. Without Russia and Ukraine, it's only 3.4%. We are getting far from the 5% magical level, below which banks are not considered to have high NPL.

Page 26, a few more thoughts, as usual, on Hungary, without going too much into details. It's clear that mortgage lending is much less active than it used to be due to the high-rate environment. Disbursements are down by 40% y-o-y, applications by 2/3 y-o-y. It's positively surprising that consumer loans continue to grow even in this environment. Y-o-y we have 8% growth in this segment, and we continue to strengthen our market share, and that even exceeded 41% in terms of cash loans. I already talked about retail deposit, so our retail deposit market share continues to increase.

In corporate, large corporate volume growth basically stopped, but micro-small corporates continue to grow with similar pace to last year due to the subsidized programmes which still exist: the Széchenyi Card MAX+ and the Baross Gábor program, which are still available for micro-small corporates.

Next slide, we continue to focus on ESG targets. Recently Sustainalytics improved somewhat the scoring of the group. So there's some improvement there, which we're happy to see. We continue to keep ESG in strong focus.

Now a bit talking about the future and expectations. If you look at the macro environment, this year seems to be much better than we expected. Even these numbers seem to be quite conservative for me, regarding 2023 and 2024, outside Hungary, talking to our banks and management teams in each of the countries. Typically, macro expectations even for this year are stronger than what we have here. Some slowdown happens compared to last year, but not so much. For instance, the touristic season seems to be very strong in countries like Croatia, Montenegro, Albania, Bulgaria, where they have a sizable contribution to the GDP.

Unfortunately, regarding Hungary the most likely scenario is that we're going to stay in a recession for the remaining of the year and then come out of it only next year and start to catch up to the neighbouring countries. But in general, labour markets are quite tight, unemployment rates remain low everywhere. Therefore, credit quality is good. Inflation moderates fast, typically, in all countries, including Hungary. We just saw the recent data coming out yesterday, and it was actually lower than market expectations. We believe that year-end y-o-y inflation will be substantially lower than 10%. The recent expectation is lower than 7% y-o-y in December.

In terms of formal management guidance, we are modifying the previous statements on 2 lines, basically. One is the increase of expected organic growth of performing loan volumes. Previously, we said that we expected less than 5%, low-single-digit numbers of growth rate. After having 3% growth in the first 6 months, and operating environment marginally improving in the second half of the year, we believe that we can reach 5% y-o-y FX-adjusted performing loan volume growth without acquisitions. So, this is just organic.

The other line is the ROE. For it, we originally said that maybe ROE can be similar to last year’s number, somewhere around 18%-19%. I'm talking here about the adjusted ROE. After having 27%-28% in the first 6 months and credit portfolios remaining strong, our current expectation is that the risk cost rate will be lower than last year. Also, the cost-income ratio might be somewhat better. Therefore, overall, we can have a better ROE, substantially exceeding last year’s level for the whole year.

Now with this, I'd like to conclude the formal presentation, and I'm sure you have very good questions to ask. Please open the floor for questions.

QUESTIONS AND ANSWERS

Operator

The first question is from Hai Thanh Le Phuong from Concorde Securities.

Hai Thanh Le Phuong – Concorde Securities

Just 2 topics for me to discuss. The first one would be, it is very useful to see how Hungarian margins and NII developed this quarter. My question would be, what is the deposit beta in the countries, mostly euro countries where OTP was very strong? I guess it's Bulgaria and Croatia. That would be pretty useful for me.

The second topic would be on dividends, because I can see that you earmarked around HUF 70 billion for dividends. I know that this is not an indication from the management. But then, could you give us some indication throughout the year? Because it is quite clear that you have very strong results. You have quite a good capitalization, so this should not be a problem. Are you still in favour of cash dividends instead of share buybacks?

László Bencsik – Chief Financial and Strategic Officer

Retail deposit beta in Bulgaria, Croatia, Slovenia is very low. Retail deposits hardly repriced. In corporate, beta is much higher the larger the corporates, and as we go towards institutional corporates, it gets actually quite close to even one. But for retail, it remained very low. Obviously, it's a big question mark, whether this is going to stay like that, or it has just not happened yet. It depends on the competitive behaviour of our competitors.

Dividends: is too early to talk about that. I mean, the deduction what we applied here is according to the European standard. We haven't discussed dividend payments and the magnitude of potential dividends yet in the management team. We usually do that closer to the end of the year or after the end of the year when we have the full picture. But as we said, certainly, the results exceeded our expectations already, and hopefully, the rest of the year will be strong as well. I hope there will be room for more dividends.

Regarding dividends versus share buybacks, again, this is something which has not been yet discussed in the management team. But if we continue to perform as we do, this is something we will address, and I let you know, obviously.

Operator

The next question is from Gábor Kemény, Autonomous Research.

Gábor Kemény – Autonomous Research

A couple of questions from me, please. The first one is on the Hungarian Core NII. I agree that these are very useful slides on the NII walk. Can you walk us through the outlook for the second half of the year? I would be interested in the magnitude of the potential increase in your Hungarian NII in an environment of falling rates.

The other question I have is, if you could comment on your M&A pipeline, please, particularly on Poland, any interest there? I'm asking this in the context of a fairly large asset being up for sale.

László Bencsik – Chief Financial and Strategic Officer

It's always a problem when we are asked to be very detailed in the expectations. Maybe we can go back to page 13. Some of these stay with us, I mean, there's another acquisition, Ipoteka, which is going to have a similar impact. It's going to grow the non-interest bearing assets, the quarterly potential impact from that is like HUF 1 billion. It's not big. We printed new MREL bonds. This MREL impact is going to continue to be there on a marginal level because in the second quarter we did new insurances, which already partially impacted the second quarter. As I said, we will probably have at least one more benchmark issuance, which is expected to be slightly negative.

There's a big positive expected there: the Hungarian National Bank started to decrease the overnight rate by 1 percentage point per month. It's already down to 15%, and we expect it to continue. By year-end, we expect the overnight rate and the base rate to be below 10%. As previously discussed, our sensitivity in the range of 13% and 18% overnight rate is roughly HUF 14-15 billion annualized NII per 1 percentage point. If you say that there might be like 5 percentage points difference in the rate environment between the second quarter and the fourth quarter, then the NII uplift could be HUF 18 billion. So, the expected rate development scenario *ceteris paribus* results in HUF 18 billion plus NII in the fourth quarter compared to the second quarter. That's a big plus. Then a few billion may come from new lending activity. All in all, potentially HUF 20 billion plus, and then some minus related to Ipoteka acquisition and the new MREL issuances.

The big unknown is this deposit line, how deposit volumes are going to evolve for the remaining part of the year, especially retail deposits which have quite high margins. If we go to the deposit quarterly change slide (page 18), you can see that in 2Q there was minus 2% deposit change. Overall, deposits declined in Hungary by more than HUF 400 billion. I think it is unlikely that this continues like this, we actually expect this trend to slow down, the decline to slow down as inflation goes lower and the rate environment declines and economic activity picks up. Having said that, this is the unknown territory. Whereas we have a relatively strong view on the rate environment development and its potential impact, we have a much less strong view on the potential deposit trajectory.

In a good scenario, it's going to have a small negative impact, but in a bad scenario, it can even counterbalance the positive impact coming from the lower rate environment. I hope this was detailed enough.

In terms of M&A pipeline, we have been quite busy. We just finished 2 big acquisitions. We keep our eyes open, and we certainly look into every meaningful opportunity in the countries where we operate and around, more opportunistically. But I don't have anything to share concretely on this dimension at the moment.

Gábor Kemény – Autonomous Research

Thank you. All very clear. Just to quickly recap on NII. If I understood correctly, around HUF 100 billion annualized upside from rates and volumes? Then some minor negative from Ipoteka and MREL, and then the unknown is the deposit side. Is this roughly fair?

László Bencsik – Chief Financial and Strategic Officer

Yes.

Operator

The next question is from Mikhail Butkov from Goldman Sachs.

Mikhail Butkov – Goldman Sachs

Good day. Thank you very much for the presentation, and congratulations on the results. My first question is on cost of risk and asset quality. You have recorded exceptionally strong results in the second quarter of this year and the first quarter. But one would probably agree that these levels are not those which can be named normalized levels of the cost of risk. The question which I have is about the guidance for the second half of the year and the next year. How much of the buffers are accumulated from the last years and the coverage? Do you allow yourself to keep this level of cost of risk for a couple of additional quarters? What are the main factors which you take into account when you consider the potential to allow some additional releases of provisions and reserves to get some more normalized level of cost of risk?

Then the second question which I have is on the loan growth. Following the first few rate cuts, do you see any acceleration already in the demand for loans from your clients, either on the retail side or on the corporate side? Basically, do you think that in the next year when rates will go down to a single-digit area, there will be some recovery to the historical levels of lending growth potential, or it can take some time?

Thirdly, maybe if you could provide some colour on the one-offs, which you expect in the second half of the year. Thank you very much.

László Bencsik – Chief Financial and Strategic Officer

Asset quality, again, fundamentally, asset quality is driven by the portfolio migrations, and these are very low, and the portfolio quality is very stable. If we look at the economic fundamentals and the operating environment, I don't see a reason why it should change. The macro trajectories look positive, and even exceeding expectations. Obviously, the big tickets are difficult to foresee, and they might happen. But on a portfolio level, I don't see portfolio quality deterioration coming in the near future. That's one driver.

The other driver is the IFRS 9 provisions, which are forward-looking. Once the expectations for the operating and the macro environment expectations improve, we have to somewhat release provisions. This is automatic and this is model-driven. We have macro assumptions and expectations and then the models provide certain release or additional provision need. Looking at the improving trend of the macro environment, there might be further releases of some provisions related to that. But we would like to keep the conservativism compared to our peers. It doesn't mean that we want to have a major release of provisions or change of methodology. This is not on the table at all.

And then the third factor in risk cost is the volume growth. One of the reasons why we have such a low-risk cost is that there's not much more new volume growth. In the new IFRS framework, we have to provision after every new loan when we issue the loan. That means the higher the volume growth, the higher the risk cost. If the volume growth is lower, the risk cost is lower. That's another factor which contributes to this lower risk costs that we had seen in the first half.

But all in all, the factors which affected the first half, in my opinion, will continue into the second half. Maybe we will have similar environment and maybe not zero levels, but certainly low levels of provisions.

Loan growth, I guess you referred to Hungary because this is where we see a strong drop. The expectation regarding the rate environment is a steep decline already during the course of this year, in line with the inflation normalization. In mortgages, we believe it will take longer for the market to recover and demand to come back. Consumer loans kept growing at a lower rate than they used to, but still had a positive growth. Consumer loans will recover faster and reach the previous levels of growth rates, but in the case of mortgages it will take longer, potentially a couple of years to recover fully. But there might be positive surprises there as well.

Now in terms of one-offs, this treasury share swap fair value adjustment will reverse in the second half as MOL is going to pay the dividends.

The question about the rate caps, whether they will continue into next year. We believe that by year-end the reference rate might be below 10%. Then certainly, the SME rate caps lose their relevance. We are quite hopeful that for mortgages, they will increase the level of the cap from 2% to closer to the market level, so maybe around 5%. That means that there might be another negative one-off related to the rate caps if they are extended for mortgages, but hopefully, that number will be much smaller than we have seen so far for 2 reasons. One is that, hopefully, the level of the cap will be higher than the current, and because the reference benchmark rates will be lower, the actual difference can be even further lowered. So, in the fourth quarter there may be another negative on the rate cap line but with a much smaller number than what we have seen before.

Operator

The next question is from Máté Nemes, UBS.

Máté Nemes – UBS

I have 2 questions, please. The first one is on costs. Clearly, you're still seeing quite high underlying cost growth y-o-y, but I think on a sequential basis, the trends look somewhat better. I was wondering if you could talk a little bit about the expected seasonality and expected drivers and moving parts in the cost base in the second half of the year. Should we expect a pickup, a typical pickup towards year-end? Or this is not necessarily something that you would count on this year?

The second question is on Russia. I think you're still considering strategic options in the country. Could you update us on the assessments? Are you talking to interested parties? Are you considering a potential spin-off? And also, do you see a possibility about upstreaming dividend from the entity?

László Bencsik – Chief Financial and Strategic Officer

For seasonality, there might be some but not material pick-up in the fourth quarter. There are always some items, which tend to pile up year-end, but this shouldn't be a big number.

Russia strategic options, well, we continue to look for options, but it looks still very difficult to execute and especially to realize a fair deal and to realize the fair value of investment in case of a divestiture. This, we consider very problematic and outright banned by local authorities.

Dividends, we are hopeful. We are working on upstreaming dividends, and we are quite hopeful that it's going to happen indeed. There's some positive development on that side.

For sure, we continue to narrow the scope of activities, what we provide, and we discontinued international dollar transfers, which is obviously a controversial business to do in Russia, albeit extremely profitable. In our understanding, some of our competitors continue to provide that business for Russian corporates, but we discontinued that. That's another big step in narrowing the scope of activities and really keeping the focus and profile only on mass market retail consumer lending what we have there.

Operator

Next question is from an attendee joined via phone. (Operator Instructions)

Olga Veselova – BofA Securities

This is Olga Veselova from Bank of America. Before I ask my questions, I wanted to thank you for the detailed explanation of your materials, including the composition of Hungarian NII. That really answers a lot of questions, and that is a great help.

My first question is about capital allocation. This combination of very solid ROE and muted loan growth brings back the question about what's your future strategy on capital allocation. Do you want to allocate anything that is above 15% CET1 into M&A? Or do you want to preserve capital given that there is this uncertainty around Russia and Ukraine? That would be a great help to understand what's your big picture view on how to use capital the next years.

My second question is again on Hungary and again on loan growth. Loan growth can be held by lower interest rates, but also partly, it was driven by state subsidized schemes. My question is do you see capacity for the state to keep expanding subsidized lending schemes in the next year or years.

My third question is, why did you have provision release in Russia.

My last question is about normalized cost of risk. Could you please remind us of your normalized cost of risk for the group but also maybe separately for Uzbekistan? I know you gave us some numbers historically, but there are new parts in the situation. You have added 2 big banks and also Russia, Ukraine still remain in the perimeter of the group. It would be great to hear what's your updated view on normalized cost of risk for the group.

László Bencsik – Chief Financial and Strategic Officer

On capital allocation, the second quarter was very strong and even exceeded our expectations, and after the first quarter, the Common Equity Tier 1 ratio was 14.4%. I think few people expected it to be about 15% after the second quarter. The trajectory indeed looks quite promising, but we haven't digested that internally. As I said, answering one of the previous questions, we have not structurally addressed the question of excess capital and level of dividends, nor the level we should start buying back shares and what to put aside for M&A.

These are very valid questions, and we are going to address these in the near future internally, but this has not happened yet. But this is a problem, which is kind of nice to have, right? Certainly, this is somewhat early. We knew that this was coming, and we knew that we had to realize these positive developments in the future. But it came somewhat earlier than we originally expected, which is obviously very good.

Now M&As are difficult to plan, right, because it's great to have excess capital for potential acquisitions, but if there's nothing for sale, which you want to buy or not at a price, which you consider realistic or attractive, then there's not much you can do. But we continue to keep our eyes open for sure.

Olga Veselova – BofA Securities

Apologies. Before we move on, can I just check on this? Do you envisage potential M&A outside of CEE? Is it possible?

László Bencsik – Chief Financial and Strategic Officer

It's certainly not in the focus, and I can't think of anything at the moment really. What do you have in mind?

Olga Veselova – BofA Securities

Well, there are more banks for privatization in Uzbekistan.

László Bencsik – Chief Financial and Strategic Officer

I see. No, we just bought this one. Again, I think this is way too early. Indeed, last week, they announced that they were going to continue the privatization process and I think even named the potential next one. We like Uzbekistan, and the more we know, the more we like the opportunity there.

On the other hand, there's a lot of work to do. We need to transform the previously state-owned organization into a modern digitally driven commercial bank. We know exactly what to do, but there's a lot to do. We have a very strong management team already, and we try to provide every support that we can. Nevertheless, it's going to be a lot of work. But the rewards seem to be quite high as well.

I'm not in a position to comment on these questions. But certainly, we are very happy with what we have bought and what we see as an opportunity there. These questions, again, we will address in due course of time. Certainly, the good performance of the group and the faster than originally expected capital accumulation provides more opportunities and more choice in itself. This is very good, but we still have to work it out.

Certainly, I don't think we are going to buy a big Western European bank or something like that, so there's less appetite on that front. It would be wonderful to buy more in the countries where we are present in the CEE region, some countries which we really like to further grow even through acquisitions, but obviously, it's always a question of what is available for sale.

Your second question was loan growth and subsidized structures. Indeed, you are very right that the previous growth was partially fuelled by the subsidized structures. The baby loan program is still on. It would be great to have another green housing loan program. It's not there yet, and I'm not sure if there will be or not, but demand would be and structurally it would be great.

You are also right that budget constraints are stronger in the foreseeable future than they used to be a couple of years ago. The room for manoeuvring and for providing subsidized structure is somewhat less for the state and for the Central Bank than used to be a couple of years ago. That's going to have a negative impact on potential loan growth. But again, consumer lending seems strong even at these levels of rate environment and as the rate environment declines, we are hopeful that recovery of consumer loan growth will be quite fast, especially when we see real wages growing again, potentially close to the end of this year but certainly next year, and retail consumption, which was declining, will come back to a meaningful growth. Rates have been declining recently. Hopefully, it will come back to a meaningful growth next year.

Regarding consumer lending, we are reasonably optimistic. As I said, mortgage lending recovery will take longer, potentially a couple of years, and maybe we are going to have less subsidized structures, as you referred to. But nevertheless, the trajectory should be positive, so in terms of loan growth dynamics, we should see improvement. In consumer, we might reach previous levels soon. In mortgages, it will take longer.

Russian provision release, again, it's IFRS 9 driven primarily. We always take this 1-year forward-looking window for the operating environment using the macro forecast figures, and we plug them into our models. The macro fundamentals keeping improving. Typically, we release provisions due to the models or coming from the models. In Russia, we're delaying in a way this release, we use conservative approach to the models to delay it as much as possible, but we lost further reasons, and we just follow the models as they are.

It's basically due to improving macro expectations and also due to strong portfolio quality. The staging has improved, and portfolio migration is very low. We have probably the best ever portfolio quality in the consumer lending book, while corporate pretty much disappeared. There was a small technical one-off release due to the Euroclear clearing house and the bonds there, what we created provisions for, we released some because we got a ruling that they will be paid, but that was a smaller item.

Normalized cost of risk, that's difficult. Frankly, I don't anymore know what the normalized cost of risk is because, certainly, it was not a big crisis, but it was a considerable worsening of the external operating environment last year and this year compared to previous years. I'm putting aside Russia and Ukraine to focus on just the CEE countries. Last year, the CEE countries' risk profile continued to be as good as it used to be in previous years.

It seems that the portfolio what we have is quite resilient, and in a way, structurally has potentially lower risk than what we used to have. I think we still need to work on understanding the implications of this. I think it's related to overall penetration levels still being low, the job markets being tight and unemployment not going up and despite high inflation, wage inflation to be strong, or just good policy measures, I don't know. But I think risk cost rates surprised us positive last year and this year.

The additional provisions we created especially for Russia and Ukraine last year were not warranted. The portfolio quality is, even in Ukraine where there is a war, resilient and it's remarkable how resilient portfolios we have.

If you want to draw a conclusion, then one conclusion might be that probably the risk profile of Central Eastern European loan books might be more similar to Western European risk profiles than we have thought. That means potentially structurally lower normalized risk cost rates for the portfolios in these countries.

Certainly, it helps a lot that we don't have FX loans. I think FX retail loans historically turned out to be difficult, especially if they were not in the foreign currency, which was anyway related to the economy, like Swiss franc or dollar. But this is something to be seen. Once we are through the macro adjustment what happened due to the war last year and this year in CEE countries, I think we will have to put some time into reflecting it in our models and expected risk models because, certainly, what we have seen is better what we originally had expected.

Olga Veselova – BofA Securities

Yes. That's great. Can I just check on the Russian asset quality? You mentioned that it's actually very solid. I thought Russia has been expanding criteria of borrowers who can apply to banks for debt forgiveness. Do you have such borrowers at all, or these are usually not your clients?

László Bencsik – Chief Financial and Strategic Officer

These are not our clients.

Operator

The next question is from Michal Konarski, mBank.

Michal Konarski – mBank

Just a quick question about Russia. Just quite recently, press reported that Russia is planning to introduce windfall profit tax. From what we've learned, OTP probably could be subjected. The question is do you have any preliminary calculation what the impact of such a windfall profit tax would be. Is it any meaningful number or not?

László Bencsik – Chief Financial and Strategic Officer

I hope they are not going to introduce windfall profit tax. No, we don't have preliminary calculation.

Operator

The next question is from Mehmet Sevim, J.P. Morgan.

Mehmet Sevim – J.P. Morgan

Just one follow-up to my colleague's earlier question on NII sensitivity. Your guidance for sensitivity was HUF 15 billion for each percentage point until rates reach 13%, as you explained earlier. Could you please give us any indication of sensitivity for rates below 13%, if possible, maybe at least for the cuts that you're expecting by the year-end?

Then on the drivers of NIM decline at Core, I just wanted to follow up again on this euro open position given the 33 basis points impact there, which looks quite big. Just for me to fully understand, if you could please repeat what that is exactly, that derivatives instrument for hedging purposes. If so, does it have an expiration date? Could that positive impact reverse at some point? Any colour would be very helpful.

László Bencsik – Chief Financial and Strategic Officer

The NII sensitivity below 13% is HUF 7 billion approximately.

It's a hedging position. It's an investment hedge, so an open position, a short euro position, and we have a positive carry here. We have this positive carry by quarter at the level of the HUF rate and the euro rate in the second quarter. The HUF 14 billion is a positive carry. It's not a one-off revaluation. It's a hedging position, so there's no P&L impact.

Mehmet Sevim – J.P. Morgan

Okay. That's very helpful and clear. If I may squeeze just one more and that's on Ipoteka and the consolidation. I see that the total amount of deposits that were consolidated looks somewhat smaller than what the bank itself reported earlier this year. I just wanted to check what happened at the consolidation if there were any adjustments. Or are these just organic outflows?

Then maybe more broadly on the funding position there. Can I ask how comfortable you are there with very high loan to deposit ratio? Given the very strong growth profile, what will be the funding strategy there going forward? Will you change, or will you try to gather more deposits? Or will you be relying on the state funding programs, et cetera? Any colour there would be very helpful as well.

László Bencsik – Chief Financial and Strategic Officer

Deposit volumes, I'm not aware of declines. We did a PPA, and we did adjustments on the asset and liability side based on the customer values. I'm not aware of this being negative. I don't have an immediate answer to that.

In terms of loan-to-deposit ratio, yes, it's high. We definitely will continue to rely on the state-subsidized structures on the current portfolio for sure, and the current refinancing structures will continue. If there will be any further subsidized program, we definitely want to be part of that game. Yes, I mean, these subsidized state programs we want to participate in.

The loan-to-deposit ratio, if you actually take out the refinanced part, so the subsidized funding, then the loan-to-deposit ratio without this is like 200%, which is still high but not as high as including the state-funded structures. Certainly, one of the strategic goals is to reduce the loan-to-deposit ratio and to increase deposit volumes, especially retail deposits.

Operator

Yes, there is a question from Simon Nellis, Citigroup.

Simon Nellis – Citigroup

A quick one from me. Just on Romania, if you could update us on how the sale is going and any thoughts on where you deploy that capital?

László Bencsik – Chief Financial and Strategic Officer

The process of exploring potential demand is in progress. The process is ongoing. We have received indicative offers, and the potential interested parties are in the process of generating binding offers, and once we receive them, we will make a decision whether to sell or not sell the asset. There seems to be strong interest for the asset, that's certainly positive.

Simon Nellis – Citigroup

And in terms of the capital distribution, if you do sell it, would you be looking to increase the dividend payout maybe a bit?

László Bencsik – Chief Financial and Strategic Officer

It's a very relevant question. Given the timing of potential transactions, at best we can get to an SPA signing stage closer to the end of the year. Then the regulatory approval process can be quite lengthy. In Slovenia it took almost 2 years. I hope it won't take that long, but it will take quite some time. I'm afraid this question will be practical next year.

Simon Nellis – Citigroup

Okay. I'll save it.

László Bencsik – Chief Financial and Strategic Officer

But don't forget it because it's important.

Simon Nellis – Citigroup

I'll save it for next year.

Operator

As there are no further questions, I hand back to the speaker.

László Bencsik – Chief Financial and Strategic Officer

Thank you very much. Thank you for attending this conf call middle of summer when all of us would probably rather be on vacation, that's highly appreciated. Thank you for the good questions. I wish you all the best, and I hope you will join us in November when we present the third quarter numbers. Thank you very much. Bye-bye.

Operator

Thank you for your participation. The second quarter 2023 conference call is closed now.

Note: unabridged transcript with minor English stylistic corrections.