Strategy and Finance Division

Investor Relations & DCM

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Transcript

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PRESENTATION

Operator

Dear ladies and gentlemen, welcome to the OTP Bank 1Q 2020 conference call. At our customer's request, this conference will be recorded. As a reminder, all participants will be in a listen-only mode. After the presentation, there will be the opportunity to ask questions. If any participant has difficulties during the conference, please press * followed by 0 on your telephone for operator assistance. May I now hand you over to László Bencsik, Chief Financial and Strategic Officer, who will lead you through this conference. Please go ahead, Sir.

László Bencsik (Chief Financial and Strategic Officer)

Thank you. Thank you. Good afternoon, or good morning, depending on where you are. Thank you for joining us today. I'm László Bencsik. First of all, a few words about the set-up today, which is going to be different from what we have been doing in the last ten or so years. We are going to have a larger group of speakers, not just myself speaking. And also, when you ask a question, one person from our group – we are actually sitting in different locations because we are still under protective measures regarding this virus situation – will attempt to answer the question.

I will start with a very brief introduction and then Péter Krizsanovich, our Head of Strategy, Planning & Controlling, will take over and tell you more about the volume and P&L decomposition dynamics. And then Mr. Péter Csányi will talk about the digital developments and how they apply to this very specific environment, and to what extent they actually boosted our services and sales during this very specific period, where our clients don't have so much physical access to the bank, but much more online access. And, finally – and I'm sure most interestingly for you – we have our Chief Risk Officer, Mr. György Kiss-Haypál, talking about the risk costs and why we decided to book the amount we did, and what we may expect for the future.

I have to say at the beginning that formally we are not going to give a guidance. In the written document you do not see a new guidance. We believe it is way too early to say anything, specifically numeric, about this year. However, there are certain trends we can highlight or certain expectations we can talk about, as usual.

I hope you have managed to download the presentation, which is available on our website. It's in pretty much the usual format, and we are going to go through the entire pack, in the order I just explained. It should take roughly 40-45 minutes, and then we can jump into answering your questions, of which I'm sure there will be plenty.

Just a very general slide on page 2 on the environment around us. We have been experiencing a different environment in the last two months than before. Therefore, in terms of our 1Q numbers, the most important factor here, which we factored into this changing environment, was the IFRS 9 forward-looking provisioning. If you look at our numbers, you see a relatively high risk cost level, but basically 90% of it is forward-looking IFRS 9 provisioning, as opposed to actual portfolio deterioration, or actually something we see in the portfolio. Mr. György Kiss-Haypál will talk about this in more details. We have seen a lot of regulatory measures trying to help our clients, economies, customers, companies, banks, in the different countries we operate. In the stock exchange report we attempted to give a more or less up-to-date overview of these measures for each of these countries, but we are not going to talk about this during this session because it would take too long. We made our best effort, but it may not be the most up-to-date in every term, because we obviously we have a very fast-changing environment.

One aspect here that is very important is the moratoria. I'm going to talk about these because that's actually a one-off charge that appeared in the 1Q numbers. The way we adjusted ourselves to this environment, I'm actually very proud of the whole Group, how well we managed to change the way we serve our customers, either moving to home offices in headquarters, or providing adequate safety equipment in the branches and having rotations in the branches. The service has been uninterrupted in all of the countries we operate. What we see is a very strong shift from branch-based to digital, and this is the very reason why we are going to have a dedicated session to the digital services.

Just to highlight how much we have not been interrupted by the virus in terms of operations, during the weekend of May 1st, we actually integrated our two Bulgarian banks. So, since Monday, there's only one bank in Bulgaria, DSK Bank, in the OTP Group. This is now a fully integrated entity in terms of organization, people, and IT. We did the entire IT integration and merger over the weekend. Likewise, across the Group, IT developments continue and even accelerate, I would say, as many of the processes actually accelerated in this very specific environment.

On page 3 you see the numbers. As I said, the big quarter-on-quarter and year-on-year decline was due to this IFRS 9 provisioning. Out of the HUF 92 billion provision we did in the first quarter, basically 90% was related to IFRS 9. So, you could have seen a much higher profit number here, should we not have taken the path we had taken. Some other banks apparently decided not to show much on this line. We decided to show a realistic number, and this is clearly forward-looking, so it doesn't mean we are going to experience a similar level of risk cost during the coming quarters. It should be, obviously, lower.

If you talk about the one-offs, and the difference between accounting profit and adjusted profit, then on Page 4 you see three elements in the first quarter. One is the bank tax, which is the normal one that we have had for many years. You may have heard that there's another bank tax, another one-off, levied this year, but this will be redeemable during the next couple of years. This is not going to appear as a charge in the P&L, in fact. There will not be a P&L impact, because we will book a tax asset, so we should not worry about the bank tax aspect here. And then the other one is the moratorium. In most of the countries where we operate, moratoriums have been announced, either as a policy measure or, in some cases, in a more self-organized way, suggested by the banks, like in Bulgaria. On the next slide we'll talk a little bit more about this. And then the third is the acquisition one-offs. In this case, it was positive, because we made an adjustment in the PPA in Slovenia, our last acquisition, which was done in December last year.

So, page 5 talks about the moratoriums and the different aspects. The number you see on page 4 relates to Hungary, where we have an opt-out measure, so customers can decide not to participate, but as a default they do. And there's no capitalization; actually interest is capitalized, but there's no interest on interest in the future. So, capitalization of interest means that interest which is not paid this year is capitalized, but on that capitalized interest there is no interest in the future. So, that's what 'no' means here, and 'yes' when there is interest on the capitalized interest. And this is the case in Serbia, Montenegro, Albania, and Slovakia. Actually, out of these it's Serbia where we have a bigger number, because it's an opt-out measure as well, similar to Hungary. It basically means that this number we see in Hungary is kind of the end-of-March situation. Customers can go in and out of this structure, so this number may actually be somewhat lower in the case of Hungary in the future. We will book certain numbers for other countries as well, but with a much smaller expected number than in Hungary. In the case of Serbia, where we actually have interest on the capitalized interest, there will not be any NPV effect, so there will be no booking at all.

Just very briefly a few words about the overall numbers, as you can see them on page 6, the consolidated adjusted after-tax profit and the profit before tax. I think the most interesting part is the last column on the right. This is the quarter-on-quarter FX-adjusted without acquisition change. What we see is that we have a relatively stable NII. We have lower net fee and commission income. That's because of the one-off in our asset management company. There was a big one-off in 4Q, and also securities-related income is lower in 1Q of this year than 4Q last year. Operating costs went down. This is something you might like to see, and that should be characteristic of this year. Cost containment should be stronger than before.

On the next page you see the profit composition by countries. Without going into details, obviously each country has been under the impact of this IFRS 9 forward-looking provisioning, and where profits are anyway somewhat lower or where the portfolio is actually very sensitive and short-term, like Russia, in certain cases, they actually turn negative. More about this later.

Capital in 1Q: 13.9% Common Equity Tier 1 (CET1) ratio, and on page 8 you see how the decomposition actually evolved. This does not include dividends because the National Bank suggested in Hungary not to pay dividends until the end of September. That doesn't mean we are not going to be able to pay advance dividend. The Board can make a decision after September 30th to pay out advance dividend. This is something we are going to consider. If you look at the decomposition, there's an FX effect on the risk-weighted assets and on the capital part, as well. They are more or less the same, so if you have a question about to which extent our capital adequacy is impacted by currency movements, then this is it. So, basically, they balance each other out, pretty much. And there was some organic RWA growth, regulatory impact, transition rules. This is going to be very important for the rest of the year, because the transition rules may change, as you probably know. So, maybe from the second and third quarter, the provisions we've booked because of movements between stages can be written back here in capital, and therefore the capital position can actually be much better than without this possible change. The negative part, point three, was related to the available-for-sale portfolio negative impact; this is a moving target, and this is related to the changing rate environment in Hungary and the yield curve movements, but it has actually moved back somewhat, so we might see some improvement in this. And then down here in the right corner you see the regulatory requirements. The very important part is that the other systemically important (O-SII) buffer was cancelled for this year and next year. It will only start to grow again after two years. So, that provides us much more room to grow, to pay potential dividends, and to do potential acquisitions.

Liquidity is abundant. We are sitting on EUR 8.5 billion euro equivalent of liquid assets, and our net loan-to-deposit ratio was 80%. The liquidity coverage ratio actually improved. The net liquidity position improved in March and April, taken together. So, if we take the virus period altogether, then the liquidity increased substantially. I think on page 10 there is something quite interesting – and I'm sure some of your questions will be related to this. This is related to how the rate and yield curve, and different measures and changes impact our Hungarian NII. As you can see, this is actually a forward-looking estimation. So, almost up to HUF 11 billion NII increase is expected this year due to the changes in the rate environment.

And here I give the floor to Péter Krizsanovich, to go through the cross-sections in a relatively succinct and fast manner, because as can see I have already taken more time than originally agreed. So, please, Péter.

Péter Krizsanovich (Managing Director, Head of Strategy, Planning & Controlling)

Thank you. Hopefully, you can hear me. I really am going to be fast and try to highlight the most important information in the next 15 minutes regarding the volumes and the operating profit in the first quarter.

On Page 11, you can see the loan volume dynamics in the first quarter. Overall, the consolidated and FX-adjusted performing loan volumes grew by 3%. This growth was 1% in the similar quarter of the previous year, so it's quite a significant growth that we see in 1Q.

The performing portfolio grew the fastest at OTP Core in Hungary, +5%. This was mainly driven by the consumer loans, especially the so-called 'baby loan' volumes, but other than that, the market-based cash loans also increased by 3%. And corporate loans continued the strong performance of the recent period, too. In Croatia, we also had a 5% growth, mainly because of the corporate volumes increasing by 9%. Actually, there was nothing specific; this was just the ordinary, strong sales activity, so there were no one-off items or specific deals. In Slovenia, we had 3% growth and the corporate volumes also increased significantly, by 11%. The largest part of that is related to the seasonal draw-down of corporate credit lines. Regarding Slovenia, I would like to mention the -7% in consumer lending. On one side, this is technical and, on the other side, you have to keep in mind that this is a relatively small portfolio, only 10% of the Slovenian book. The technical reason for that decrease was that part of the overdraft volumes were re-allocated to the corporate segment. Other than that, the consumer loans didn't decrease, only the credit card utilization decreased somewhat in the first quarter. In Romania, we also had a quite decent growth, +3%. Last year we started this strategic initiative and, on a yearly basis, the volumes have already grown by 19%. In Russia we had a 3% decrease. In terms of consumer lending, this is the usual seasonality. Usually, in the first quarter, there is no large demand in consumer loans, and this also happened this year. Regarding corporate, this -15% is kind of relative, because in 4Q 2019 we had a 33% growth. What happened was that part of those deals were repaid, fully or partially. So, that's the main reason behind this Russian corporate volume dynamics. I think these are the most important elements of credit volumes.

I would jump to the next page, page 12, deposits. Overall, 1% growth. Basically, everywhere we had a stable or increasing or seasonally decreasing volumes. The seasonal decrease was especially the case in Montenegro and Croatia for the retail segment. Other than that, there were no large differences. In Romania, this -7% corporate decrease was related to a couple of larger deposit withdrawals.

Going to the next page, I will have a little more information regarding Hungary. On the left-hand side, you can see that our mortgage loan disbursements grew by 73% on a yearly basis. And also this quarter that was mainly due to the increased demand and disbursements in subsidized loans, in the Housing Subsidy for Families program, which was extended last year by the government. As we mentioned earlier, in this segment OTP traditionally has a strong market share. And this is also reflected in the mortgage loan contractual amounts market share, which you can see there. This went up to 34.4%. It's worth mentioning that this is not the March data. We didn't have the market data for March yet. The publication date was changed by the National Bank, so this only relates to the first two months. Regarding cash loans, on the right-hand side, the performing cash loan volumes grew by 23%. Our market share in cash loan disbursements went down somewhat, to 37.8%, but actually regarding stock market shares, the drop was much smaller. You can even say that it was kind of stable. Household savings: a further increase in market share there is what we could observe in the first two months.

Going to the next page, corporate exposure in Hungary showed 8% growth in the micro and small segment. On a yearly basis this was 14%, which is very similar to the previous year. So, the strong performance there is really continuing. Regarding medium and large corporate loans, the volumes tend to go high, but there we are also very careful regarding pricing and profitability. Here I would like to highlight that, regarding market share, you can see an approximately 40 bps drop in the market share, but actually what happened was that in 4Q 2019 on the market some large tickets were repaid, and then drawn down once again in this quarter. Basically, our volumes remained stable or even increased, so there was some market volatility and, according to our information and knowledge, that caused that market share decrease. So, it was not really an organic change.

Going to the next page, I will be talking about our operating profit and, first of all, our total income. Our total income sank by 10% or HUF 32 billion, without the Slovenian acquisition. It's important to keep in mind everywhere that on a quarterly basis, the Slovenian acquisition had an impact on the numbers. So, when talking about the organic changes, you have to keep that in mind. So, total income decreased by 10% without the acquisition, and that was mainly driven, as László mentioned before, by the net fee income and the other non-interest income, and not so much by the net interest income.

I will jump to the net interest income, on page 16. It was, without the Slovenian acquisition, more or less stable, -1% q-o-q, which means -HUF 3 billion. What's positive is the Hungarian NII, which grew by HUF 1 billion or 1% – mainly due to the volumes. The margins were going down – I'm going to talk about this later. Also positive, percentage-wise, was the Romanian NII which increased by 5%. That was mostly driven by the volume dynamics, but also there our margins increased somewhat. Now, on the other hand, we had a decrease of HUF 1 billion at DSK Bulgaria – we already mentioned this in the previous quarter, as far as I remember, that certain swaps were booked differently in 1Q. I would like to highlight that this is offset in the other income. If we neglect that accounting change, the NII remained stable, likewise the margin. Russia saw the second largest NII decrease in 1Q. This is because of the volumes I mentioned earlier. In the first quarter, there was this seasonal decrease in the volumes. And I also have to mention that the interest rate environment there has caused loan interest rates to decrease, and that also had a negative impact on our NII in Russia.

We have this 'other' line within the net interest income on the bottom of the page, with -HUF 2 billion. Actually, it would be quite long to fully explain this here, but what is important to highlight is that this is offset in the other income. What happened is that, usually, in a period, in a nominal value, this line should be close to zero, because this is the consolidation effect of intra-group income and expenses. But in the previous quarter this was not true, so we had a positive amount because these interests were partly consolidated against other income lines. And this is what was causing that and this change is now offset on the other income line.

Going to the next page, the net interest margin. Here I will focus on the development and the reasons behind this 19 bps q-o-q drop but, before that, on the positive side I would like to mention the Romanian net interest margin, which could increase, mainly due to the funding costs and deposit rates. On a Group level, this 19 basis points decrease was caused by the following elements. First of all, the inclusion of the Slovenian bank into the Group: in 1Q, not only the volumes, but also the P&L of the Slovenian bank was consolidated. The Slovenian bank has lower net interest margin compared to the Group average without the Slovenian bank. Therefore, the impact of that on the Group margin was minus 5 bps. At OTP Core, the Hungarian margin went down by approximately 6 bps, and that had an impact of 3 bps on the Group margin. That is mostly due to two factors. Firstly, retail interest rates were decreasing, continuing the trend of previous periods, mostly at housing loans. The other important element here is the larger repo volumes at the end of 1Q, which pushed up significantly the total assets of OTP Core, and this way it had some kind of dilutive impact on the net interest margin of the Hungarian operation. The Ukrainian net interest margin went down to 7.95% from 8.98% in the previous period, which had an impact of 3 bps on the Group margins. That is fully related to the Ukrainian interest rate environment, where the base rate went down to 10% at the end of 1Q. A year ago, at the end of 1Q 2019, it was 18%, and at the end of 2019 it was 13.5%. And that caused both corporate rates and consumer rates to go down. This was, by the way, partially offset by the changing composition of the Ukrainian book because consumer lending has a higher weight now, but this couldn't offset such a high pace of interest rate decrease. At DSK, the Bulgarian margin went down by 12 bps, and had this 4 bps impact on the Group margin. As I mentioned before, if we were to calculate a net interest margin in Bulgaria without the off-balance sheet items, then the margin would have been flat. So, this was mostly caused by this change in the accounting of the swap interest income. And we have what we call this 'composition effect', which had a 5 bps impact on the Group margin. That is mostly because of the weight of the Russian and Ukrainian higher interest margin environment was decreasing in the consolidated loan book.

Page 18, the net fee and commission income. The decrease of 22% is mostly because of the fund management success fee booked in the fourth quarter of the previous year. Other than that, it's seasonality. So, usually, the first quarter is weaker in terms of transactions and we have to book some one-off items in 1Q in Hungary, like the transaction tax on banking card transactions and fees paid to the Resolution fund. So, in the past couple of years we saw these happening in the first quarter. Other than that, what's behind the drop in 1Q, on a quarterly basis, is basically seasonality.

And then other income. Across the board, the revaluation of securities and, in some cases for example in Croatia and in Russia, the revaluation of corporate bonds, as well as a loss on investment units in Hungary, caused this HUF 10 billion q-o-q decrease. There was also one structural change in Hungary, and that's had an impact of -HUF 1.4 billion. The collection income, the recoveries at our collection company were previously booked under other income, but starting from this quarter they are booked under risk cost. So, they are decreasing the risk cost but no longer increasing the other income at OTP Hungary. So, basically, this structural change and the revaluation of securities, some loss on investment units, and the revaluation of corporate bonds caused the decline in the other income line.

And then a couple of more sentences on operating cost on page 20. In 1Q it decreased, mainly because 4Q is usually higher, due to certain marketing expenditures, personnel expenses, expert fees and things like that. But, on a year-on-year basis, it grew by 4.5% without the impact of the acquisitions. What's very positive is the Serbian operation, where you can see that without the impact of the acquisition – so, the second acquisition, where the integration is still ongoing – there was a 12% decrease on a yearly basis in 1Q, meaning and proving that the synergies from the merger were realized. There was a high increase in Romania, 18%, but as I mentioned, the volumes also grew by 19%, so this cost increase was due to the strategic program started last year. That had an impact on headcount and wages as well, and to a certain extent on operational cost. The Ukraine is a high-inflation environment, especially in terms of nominal wages, that was the important reason behind this year-on-year growth. And in Hungary we had a 7% increase on a yearly basis, mostly due to personnel expenditures in the wake of the nominal wage inflation in Hungary. Depreciation also increased, but in nominal terms, that is a lower number; relatively it increased significantly, mostly because of the investments and spending, which we did into digitalization and into our IT infrastructure.

That was what I planned to say. Thank you. I will hand it over to Mr. Péter Csányi, who is the Head and Managing Director of our Digital Development area.

Péter Csányi (Managing Director, Head of Digital Developments)

Thank you, Péter. Let me be conscious of time and be very brief.

On page 21, we tried to emphasize the number of steps we have taken to tackle the crisis. As Mr. Bencsik has already alluded, our switching to home office went very smoothly. The ongoing digital developments have not stopped. In fact, in certain cases we see an acceleration in the digital developments, and this was very much helped by our transition to agile operations last year. In terms of the contact center, we have obviously increasing volumes, but we have been able to re-allocate resources effectively and we have been also able to provide additional chat box processes and robotic process automation in the back-office, to handle requests coming into the contact center. In the branches – we will talk a little bit about this later – we have switched our emphasis onto the education of our customers regarding our digital channels. We have also introduced a couple of new campaigns after the pandemic started.

If you go on to page 22, we tried to highlight some of the positive trends that we see in terms of the retail digital channel penetration and usage. On the top left, you can see the weekly new registrations into our mobile banking platform. As you can see, since the virus started, we have seen a 17% increase in the average weekly new registrations. On the top right, we track the number of digital log-ons before and after the crisis. In both on the mobile banking platform and the internet bank we see a 12% increase in the number of digital log-ons. And on the bottom left, regarding the active transactions performed across these platforms, we see an across-the-board increase of 20%. If you look at the functionalities, there's 20% more active transactions taking place. If you look at certain specific functionalities, for example, cheque payment through the mobile platform, that has increased threefold, but overall we had a 20% increase in the number of active transactions. On the bottom right, what we have tried to do is to decouple the effect of our digital incentive campaigns, which we started back in August last year, as a preparation for the launch of our new platform, and the add-on effect of the coronavirus. We can see that a roughly 3% increase in the number of users logging in at least once in the last three months due to the pandemic. We really hope that this trend will continue. I believe the number of our customers who have not previously utilized these platforms and have started to utilize them now will remain on the platform.

Going on to the next page, on the left-hand side, we show registration and transaction numbers for our Simple application. It's our second mobile application. We see that both the new registrations and the numbers of transactions had a 50% increase compared to February. Really, this is quite unique. What you can see on the right-hand side is the digital channel usage among our corporate customers. What we see is that corporate customers increased by around 10% – so, the customers who use the online channels and the HUF money transfers, which showed the highest growth figures, a roughly 29% and 37% increase in the number of transfers in the case of MSEs and mid/large corporate customers.

If we go on to page 24, we gathered some of the incentive campaigns that we have introduced after the outbreak of the pandemic, to incentivize the usage of the digital platforms. We introduced free digital money transfers up to HUF 100,000 which is equivalent to roughly EUR 280, and discounts through the application for the Simple virtual card, each for a period of three months. And we have launched a number of online campaigns, which we intend to uphold also in the coming months and try to make this shift to digital platforms to remain a more long-term trend. In the branches, we increased the focus on the digital education of our clients. We see, obviously, a certain drop in the visits, but what we can say is that the share of online sales has increased as a percentage of the total disbursed volumes. And, lastly, we are close to launching our completely renewed digital platform. The platform is already in a pilot phase, and we plan to start a gradual roll-out among clients during the summer. This is a complete renewal, not just the front-end, but also of the technology behind it. These are the things I wanted to highlight. With that, I would like to pass it to György Kiss-Haypál to talk about the risk cost.

György Kiss-Haypál (Chief Risk Officer)

Hi, everyone. Let me welcome everybody and all the call participants today, as I go to page 25. My name is György Kiss-Haypál. I am the Chief Risk Officer of OTP Group. So, page 25, I believe, is a good overview and perspective on the developments of the last seven years. The portfolio has grown significantly during these years and the loan book itself grew more than 2.3 times since 2015.

We have arrived in 2020 in good health regarding DPD90+ and non-performing loans, and the low risk cost environment, supported by strong cash recoveries from our NPL work out company, OTP Factoring. You can see the DPD90+ figures there, going down steeply. OTP is a little bit of a different bank than the others. We decided to keep our 'bad bank' in-house and we are managing our NPL book in-house. So 4.1% for us is a very good number for the first quarter. As you can see, the 1Q provision of HUF 85 billion, which is a loan loss provision for impairments, is a key focus for the 1Q call, of course. That translates into a 2.57% cost of risk. You can compare this cost of risk to previous years. Also, the previous years' relatively low cost of risk rates in 2016, 2017, 2018, and 2019 were strongly supported by this cash recovery that I mentioned from our NPL management company, which has increased significantly over these four years. But the 2.5%, even for this quarter, is lower than the 2013, 2014, or 2015 cost of risk.

How is this HUF 85 billion quarterly loss provision composed? How did it get together? Let me briefly go to page 26 and 27. I'm not going to explain now all the countries here, but I would like to deliver some messages on the macroeconomic situation, because this is important for our assumptions on how we arrived at this HUF 85 billion for the quarter. So, some of the key summaries are on page 26 and 27 – why we can reasonably expect that this region is likely to weather this economic crisis similarly to the Western economies.

This crisis found these economies in a relatively healthy and strong shape. There are no major FX lending programs in the regions anymore, apart from some minor economies or segments of the portfolio. There is substantial room for governments to provide easing and stimulus, unlike in 2008 and 2009. There is little or no pressure on most local currencies, and we can see lower public and private indebtedness, lower loan-to-deposit ratios, and good balance indicators in the region where OTP operates. We see substantial reserves in most economies – I would like to mention Hungary, Croatia and Russia – which will be very useful to the economies. There's also ability to lower interest rates. There's no urgent need to increase them, which is completely the opposite versus 2008 and 2009. And, last but not least, the virus seems to be spreading less severely and the curves are flattening in most of the countries where we operate. In addition, the structure of the economy is a little bit different compared to our Western counterparts. There is less dependence on the service sector and tourism, which have been hit heavily in the Western part of the world. Tourism, obviously, is a clear exception in Croatia and Montenegro – these countries will be more severely hit, but this region is more agro- and manufacturing-focused, especially Romania, Serbia, Hungary, Bulgaria, Ukraine, and Moldova. That gives us better estimates for the future. Hence, the likelihood is relatively strong that the region will face a similar GDP momentum as the rest of Europe, or potentially even better.

I will not go through these country summaries. I would like to go to page 28, 29, and 30, and explain to you the composition of the HUF 85 billion quarterly reserve. Now, for the quarterly reserve, 90% of this is an add-on, or management overlay, purely coming from forward-looking assessments of our Stage 1 and Stage 2 portfolios. So, there are two major impacts shaping this number. One is the forward-looking adjustments coming from the macroeconomic assumptions for our PDs and LGDs. And I will talk about it a little bit right now. And the second major impact is a migration assumption on the corporate book, which is basically an assessment of a significant increase in credit risk. And these two are impacting the book-up for the first quarter.

So, let's look at number one, which is the macro assumptions impacting the parameters, PDs and LGDs. At the time of compiling the first quarter, OTP bank assumed a GDP contraction of around -1% to -5% within OTP Group as a baseline scenario. This forecast was broadly in line with IMF's Global Economic Forecast in April. When modeling the parameters, we used different macro scenarios, including more severe and milder scenarios compared to the baseline one. The baseline scenario can be described more like a longer V-shape curve. For the severe scenario, it's more of a deeper U shape curve. We modeled that during 2020 there would be lower actual losses due to the moratoria, and moratoria helps somewhat through better recoveries in 2020, and mainly in 1Q 2021. Uncertainties do exist around the shape, deepness of curve, rebound, steepness, timing, and potential second hit. Uncertainties are also there regarding the effectiveness of the moratorium measures.

The IFRS 9 model is honored in OTP with minor adjustments, given the uncertainties above and conditions I just mentioned. IFRS 9 requires us to cover the next 12 months' worth of losses for the Stage 1 portfolio, which means basically estimated and modeled losses, through formation of Stage 3 exposures over the next four quarters, using LGD at the time of default. And IFRS 9 is also requiring us to cover the life-time losses for Stage 2 exposures. So, that means we should make adequate reserves now, already today for the Stage 3 portfolio balances calculated for 1Q 2021. And that is the basis for our realistically conservative approach regarding Stage 1 and Stage 2 coverage.

The second major impact affecting the HUF 81 billion is this assessment of this significant increase in credit risk for the corporate book. We prepared an exercise the last couple of weeks with our subsidiaries. We had a collective assessment of increased credit risk based on industry segmentation, the virus impacting the industries, and an assumed credit rating migration in the different industry segments. On page 28 you can see that we grouped the industries into four groups based on the assessment of the macroeconomic Research Centre of OTP Group, which was also reviewed by the risk teams of our subsidiaries. We allocated the clients and exposures based on their industry codes. You can see the share of the industries, and you can see that around 70% of the portfolio is either no impacted or very lightly impacted by this virus situation. 24% and 5% of the book is allocated to medium- or high-impact portfolios, respectively. I have to mention that in the OTP corporate portfolio there is basically zero air transportation or almost zero travel agencies, tour operators, or aircraft manufacturing exposure. That 5% is mainly coming from accommodation, hotels and passenger water transport.

We prepared this exercise and on page 29 you can see that we migrated the portfolio to Stage 2 from Stage 1 in the corporate book. On a consolidated level, we had 5.3% Stage 2 ratio in 4Q, and now we have 8.6%. You can see the distribution in the different countries. Obviously, different countries have different exposures to different industry segments.

As a result of these two major sources of provision impacts, which is macroeconomic assumptions for PD/LGD estimates, which was mainly impacting the Stage 1 reserves, and also this exercise on corporate industry movements, we booked HUF 85 billion for COVID-19 as an add-on. And, to put this into perspective, we already had, back in 2019, around HUF 200 billion for Stage 1 and Stage 2 reserves, to cover the 12 months' assumed losses over 2020. You can compare this HUF 85 billion in addition to this HUF 200 billion we had in the last quarter and, roughly, it's about a 40% increase in reserve balance.

And a couple of more thoughts, before I stop, on this HUF 85 billion. As a composition, one third of this HUF 85 billion is mainly coming from this Stage 2 corporate migration analysis, so one third of it. The rest is basically the Stage 1 reserve increase, mainly in the consumer and retail book throughout the entire OTP Group. We also mentioned in the quarterly results that one third of the overall amount is for retail and two thirds is for corporate. So, you can calculate that a little bit less than half of the corporate management overlay is coming from this exercise that we prepared on the industry analysis and migrations to Stage 2. In terms of geographical composition, 40% of the add-on was coming from OTP Core Hungary, 15% from Bulgaria and 15% from Russia, and 6% was coming from Croatia. So, these four countries – Hungary, Bulgaria, Russia, and Croatia – add up to three quarters of the add-on. The rest is relatively evenly distributed in small amounts for the rest of the countries.

So, that's where I will stop. I appreciate your patience. Thank you very much.

László Bencsik

Thank you, György. I would like to ask you, Operator, to please open the floor for questions.

Q&A

Operator

[Operator instructions] Our first question is from Anna Marshall, Goldman Sachs. Your line is now open.

Anna Marshall

Good afternoon. Thank you very much for taking the presentation. Two questions please. The first one is on asset quality. Thank. You very much for all of the detail that you've provided. Just to confirm, how do you see the trajectory of cost of risk for the rest of the year, given that you've stated that you took a conservative approach already in 1Q. I appreciate you cannot provide a specific guidance yet, but generally, how should we think about your cost of risk for this year in comparison to the previous crisis peak and to the EBA stress test, which was showing 350 basis points cost of risk. My second question is on costs. You've outlined the increasing take-up of digital and have mentioned more focus on cost containment. So, I just wanted to ask for more color in terms of how you see cost dynamics this year. Where exactly you can achieve cost savings? Thank you.

László Bencsik

Maybe I start and then György can add details on the asset quality. Basically, you should look at the risk cost in a way that IFRS 9 has this forward-looking nature and the front-loading of risk costs, and that's what we did. If things go according to our assumptions, then the 2Q, 3Q, and 4Q risk cost should be much lower. If it's a V-shape recovery, then the GDP growth between 2Q and 3Q, and between 3Q and 4Q, etc. should be positive. After this big drop, we can actually enter into a step-up, step by step increasing GDP environment, which from an IFRS 9 point of view is a positive outlook. I think what we should see is a fundamentally lower risk cost in the coming quarters compared to what we have seen in the first quarter. Therefore, that includes the answer to the numeric question: the risk cost rate should not be as high as we saw before, during the previous period. In fact, the next quarters can be lower than the first quarter was.

In terms of cost, there is room and, certainly, there is some thinking we have started to do on how we can optimize the cost side. This home office way of operation gives a lot of learning and insights into how and what can be changed. But we are just starting to look into this question now, so there's nothing tremendously concrete to mention on that front yet.

I'm sure there will be other questions regarding risk cost. We try to be comprehensive here, to kind of preempt having many similar questions. I don't know, György, if you want to add something?

György Kiss-Haypál

I think you're completely right. If we're not forced to weight more severe scenarios, in a bigger manner than what we used to, and we have the shapes rolling off as expected, then IFRS 9 is doing exactly what you said. We've already front-loaded part of that risk cost and, going out, adding additional weights to all those quarters where we see the upward trend of the GDP curve, so obviously justifying the model as it is, there should not be, most likely, similar book-ups for 2020. Again, provided that the macro scenarios are not weighted severely going forward.

Operator

The next question is from Máté Nemes, UBS. Your line is now open.

Máté Nemes

Good afternoon and thank you for the detailed presentation. I have a question on NII, and then one on cost of risk. Thank you for the details on the impact of higher BUBOR, the interbank rate. I was just wondering if you could discuss a little bit the effect of the provision of liquidity from the Central Bank at medium-to-long tenors and perhaps your participation in weekly government bond auctions. How should we think about volumes here? What could this mean, actually, for NII? And another question, perhaps on NII still: considering the effect of lower policy rates and the changing composition of the book in the Ukraine, how should we think about net interest margin there? How significant of a drop would you expect there from current levels?

And second topic – cost of risk – I was wondering if you could give us a little bit more of the details on the macro assumptions there, particularly the weighting of the various scenarios that you mentioned? And then also, maybe a word or two on assumptions around Ukraine and Russia in your scenarios. That would be very helpful.

László Bencsik

Okay. Regarding cost of risk, I think we have more or less told what we could on the subject. I think we have gone much further ahead what some other banks have gone. And these are models; as you can see, the DPD90+ ratio actually decreased, right? It's not that we have a worsening portfolio quality compared to the total loan amount. And the models come from historic experiences, which were very, very different from what we have today. What we have today is a deep dive, and then an increase compared to that. We have to figure out how to factor that into our models. I would like to encourage you to take what we have given on this subject, because if we go too much into the details then we might lose the overall picture. So, exact weighting, there's a reason why we haven't gone into the very specifics here.

Regarding to what extent we use the facilities: we use the National Bank facilities as much as they are available to us. So, as much as the supply of these structures is given, where we can actually make money, we try to use them. But they are not unlimited, in the sense that they get allocated between banks, and then each week they decide how much they do. So, as much as we can get, we do try to participate. That has a clearly positive NII impact.

In terms of policy rates and the Ukrainian net interest margin, I would like to turn to Péter Krizsanovich. Maybe, if you could, elaborate a bit on this one, on how you see the Ukrainian NIM further development potential.

Péter Krizsanovich

It's not an easy question. First, I think in terms of the composition of the loan book, it's quite hard and quite early to estimate it right now – what is going to happen with the volume evolution during the remaining part of the year. On the other hand, maybe also my colleague, Gergő could also add some details regarding what we expect regarding the rate cuts in the Ukraine. But, all in all, the interest rate decrease of certain loan products might slow down, and the pricing due to the increasing risk might be going in the other direction. But I think it largely depends on the Ukrainian general interest rate environment.

Operator

The next question is from Gábor Kemény, Autonomous Research. Your line is now open.

Gábor Kemény

Hi. Firstly, I would like to ask about the Hungarian debt moratorium, please. Could you give us an indication of the participation rates you have seen so far, and especially the participation in the consumer unsecured portfolio. That would be useful. And I would like to understand a bit more closely how you take into account the debt moratorium in your provisioning forecast. Is the moratorium something that could help push out the asset quality deterioration and the provisioning? And, if so, should we a step-up, a potential increase in provisioning after the end of the moratorium in early 2021?

My final question is a broader one on the net interest income. You've talked about the positive drivers, including the Hungarian rates and including the MNB tools. There are a number of negative drivers too, such as the lower Ukrainian rates. Net-net, where do you see your NII going from here? Shall we expect a roughly stable NII, or do you see growth from here? Thank you.

László Bencsik

The last question is probably the easiest. NII should grow because volume growth will be actually quite visible, due to the moratoriums and the capitalization of interest. Therefore, revenue growth will stay high, and we have these add-ons, so we are actually quite positive on NII and volume development, despite being in a difficult economic environment.

How effective the moratoriums will be? Honestly, we don't know. That depends on how the economies will look like a year from now, or by the end of this year. If there's a V-shape recovery, then moratoriums can actually work very well. In that case, we may have already overestimated the risk cost that we have put in the IFRS 9 assumptions.

In terms of the Hungarian moratorium participation, cash loans, Péter, can you remind me what the number is?

Péter Krizsanovich

Actually, I'm looking for it.

László Bencsik

Okay, good. So, that should come very soon. I don't know, György, on the risk side, if you want to add something.

György Kiss-Haypál

The only thing I say: if we do our job right, in terms of providing these IFRS 9 book-ups for 1Q and 2Q, I do not expect a step-up in provisioning in 1Q next year. But it's well said that the effectiveness of the moratoriums still needs to be tested. In theory, moratoriums should be positive on the risk cost assumptions.

Péter Krizsanovich

The participation currently regarding the cash loans in consumer lending is approximately 60%. So, it's still in the moratoriums.

Gábor Kemény

Thank you. And this is indicative for the total portfolio as well?

Péter Krizsanovich

No, it's different. The total portfolio is different across the different segments.

Gábor Kemény

Can you give us some broad indications? We have been getting questions on this.

Péter Krizsanovich

Yes. In terms of corporate, it's around 40%-45% who have already opted out of the moratoriums, and in terms of mortgages, there we don't have the actual number. I can send it later on.

Gábor Kemény

That would be useful. Thanks very much.

Operator

The next question is from Hai Thanh Le Phuong, Concorde Securities. Your line is now open.

Hai Thanh Le Phuong

Hi. Thanks for the presentation. Just two questions from my side. First of all, you said that FX rates changes should not impact your capital adequacy. I was wondering if you could share with us your EUR and RUB FX rate sensitivity, particularly, if it's different from what you said or not. And my second question would be on loan disbursement figures in April. So, it would be pretty helpful to see on your main markets what kind of origination numbers you have seen so far? And do you think it's the bottom that we observed in April or not? Thanks.

László Bencsik

Well, obviously, especially in unsecured lending, there's a drop-down. I think this is going to be the most interesting topic of the second quarter conference call, apart from the risk cost: how the new volume and how demand actually shaped up. I would like to ask for your patience, and we will go into this in details when we present the 2Q numbers. In general terms, the way I can describe the situation is that we have seen, especially in unsecured lending, a decline across the Group. This is much less in terms of corporate and mortgage demand, which is better.

And your first question was related to EUR and RUB FX on the capital adequacy. Okay. That's a very specific question. I don't know. I have my colleague Atanáz Popov on the line; he is responsible for capital calculation. Can you give just a very board answer to this, without being extremely specific? Or is it something we should try to answer offline?

Hai Thanh Le Phuong

We can do it offline as well. No problem.

László Bencsik

Okay, good. Thank you.

Operator

The next question is from Andrzej Nowaczek, HSBC. Your line is now open.

Andrzej Nowaczek

Thank you for the call. I have two or three questions. A follow-up question on the costs, specifically on synergies and integration costs related to your recent acquisitions: under the circumstances, presumably some of the benefits or charges will be delayed – am I right? The restructuring costs or synergies will have to be pushed out, right?

László Bencsik

Not necessarily. As I just said, we promptly finished the merge in Bulgaria. We did it in 15 months. We acquired SocGen in Bulgaria in January 2019, and on May 4th we had an integrated bank. And we have already realized quite a lot of cost synergies there, and further synergies should come. So far, at least, we have not rescheduled these processes at all.

Andrzej Nowaczek

Okay. Thank you. And my second question is on Russia. Are there any reasons to believe that the amount of losses in Russia, the current downturn, could be less than it was in 2014–2015? What are the big differences here?

László Bencsik

We have a much better bank, a much better managed bank, and a much better portfolio. Most of the risk cost in 2014-2015 came from the not-so-well-managed credit card portfolio there. I would say that a big chunk of the losses in 2014-2015 could have been avoided if we had the portfolio we have today, for instance. So, in a sense, yes, that's what we are calibrating for: lower loss level than what we had in 2014–2015.

Andrzej Nowaczek

Okay. And finally, what are the latest statistics on baby loans? Has there been any impact…

László Bencsik

The structure continues. Obviously, there's some decrease because of the demand filling up, but the structure continues.

Operator

The next question is from Martha Jezewska-Wasilewska, Wood & Company. Your line is now open.

Marta Jezewska-Wasilewska

Good afternoon. Thank you for the presentation. I have a couple of clarification questions. The first one considers quite specifically the situation in Croatia, which is a very tourism-exposed country, and yet there seems to be very little provisioning done in 1Q 2020. Could you share any more color on how you see the situation in Croatia developing? My second question is of a similar nature. It's about Bulgaria. The 1Q provisioning here seems to be very much on a different side of the scope, with a massive spike in provisioning that we haven't seen in this country for a very long time. Could we learn a few more details, if possible, on what has driven such an abrupt change and increase? And the last question is just a small clarification in terms of all the credit moratoriums. You mention on the slide that regards the credit moratoriums that… sorry I lost my presentation. I want to clarify the provision that was made in the first quarter on interest accrual. As I understand it, this is interest that will be charged on the interest, but will be accrued until the end of the year. Can we learn the amount of the interest that you expect to accrue until the end of the year, in the Hungarian subsidiary, mostly? And can you give us a bit more detail on how the clients will return to the repayment? Will they face higher installments in January 2021? Or will there be an extension of the credit repayment timing? Thank you.

László Bencsik

Yes, there's an extension of the timing, and that's why the NPV changes. In fact, accounting-wise, we make much more money by this. So, it is just the time value of the cash flow which decreases, but clients pay longer. The exact accrued expected number, Péter, could you try to check it? Meanwhile, I would like to give the opportunity to answer the Bulgarian analysis question, to György, our Chief Risk Officer.

György Kiss-Haypál

Okay. So, let's start with Bulgaria. First of all, Bulgaria is our second largest book. So, we can't forget how big that book is. And the actual annualized cost of risk percentage is 2.8%, which is larger than the previous quarters, and months, and years, but 2.8% doesn't necessarily stand out compared to the other subsidiaries. And it is actually a reflection of the corporate book. It's the exercise we did. It's an assumption based on the allocation of industries to the medium- and high-impact industries. Particularly, in our Bulgarian portfolio we have a relatively high share of the medium- and high-impact industry segments. Here, we saw probably one of the largest volume assumed to go to Stage 2 in the corporate book. In the retail, we don't really see a big add-on at all; it's the corporates' book allocation to Stage 2. And, again, it's a relatively large corporate book.

On Croatia, there, again, we took a very careful assumption for the corporate book. Yes, we have exposure to tourism there in our portfolio, but I wouldn't say it's overly excessive. So, our corporate portfolio is not entirely just lending to hotels and the tourism industry. It's true that we are still reviewing the consumer portfolio to see how they are impacted, but I believe that the IFRS 9 general assumptions were relatively conservatively adequate for the potential Stage 1 impact, also in Croatia. Thank you.

Péter Krizsanovich

On the expected accrued interest, what was booked in not the accrued interest in 1Q. What we booked was a special reserve on this estimated impact of the NPV change. So, in the first quarter, interest accruals were not significant. The moratorium only started at the end of March.

Marta Jezewska-Wasilewska

Yes, but if I may, I would appreciate it if we could learn what would be the level of the accrual assuming 75% or 100% acceptance ratio for the Hungarian business? That would be very helpful.

Péter Krizsanovich

This is a more complex model and calculation. So, I don't have that number here at hand.

László Bencsik

We will find a way to let you know the ballpark figure, because I think it's quite detailed information.

Operator

The next question is from Kian Huat Lim, CSAM Asset Management. Your line is now open.

Kian Huat Lim

Hi. Thank you for the presentation and the explanation of the result, and in particular on the cost of risk. I've got a couple of questions. To begin, again, on the cost of risk, can I confirm and clarify that the HUF 85 billion that we are seeing is a one-off figure? Based on the assumption of a GDP contraction of 1%–5% across the different regions, in Hungary and the other subsidiaries, if that macro scenario plays out, we should not see further massive increase in provisioning for 2Q, going forward? When I say additional provisioning, what I mean is that in 2Q, and going forward, we should be expecting that 10% run-rate for subsequent quarters, as long as there are no significant deteriorations of the macro assumptions that have been made so far. So, that's my first question.

My second question pertains to slide 28. Can I verify if the breakdown in stages of the loan book as of 1Q 2020? This breakdown that we see on Page 28, is this the current status of the loan book? Is this really reflecting the forward-looking scenarios being used to arrive at that HUF 85 billion that we saw?

If I may have a third question, again on page 28, I see that the impact on industries such as energy and petroleum is considered as light impact. I understand that this pertains to the impact of COVID-19, but surely with the link between COVID-19 and the general, overall economy globally – we know what happened to energy prices – I don't think that the exposure to the energy sector should be classified as 'light impact'. Can we have more color on this? How is the bank treating its exposure to the energy sector in particular? Maybe we can also have some color in Russia. Those would be my questions. Thank you.

László Bencsik

Okay. So, on the first question, more or less, yes. If we have a strong bounce-back in 3Q and 4Q in terms of GDP growth, then we should see in 3Q and 4Q relatively modest risk cost levels. I think on the energy segment it's better if I give the floor again to György, regarding whether this slide depicts the situation before reclassification or after, and then, to which extent our energy sector clients are different from potentially other energy clients globally.

György Kiss-Haypál

Page 28 is the review of the percentages of the consolidated on- and off-book corporate exposures and the individual country corporate exposures, on and off book, as they are seen at the end of the quarter. You asked us about, say, Russia: 9% of the corporate exposures are currently classified by our teams into the low-impact industries, 75% in the light impact, and basically zero in the high impact. The Russian corporate book is relatively small. It is concentrated in a few accounts, mainly in the wholesale and pharmaceutical trading industry. That is what our corporate book is concentrated on. We have very limited exposure to the oil industry in Russia, which is a small book.

We can debate whether the petroleum-related manufacturing is light impact or medium impact; I think for this exercise it doesn't matter too much, because we also had a migration exercise from light impact to Stage 2, so we didn't say that in light-impact industries there is zero probability that the customer will go to Stage 2. We had assumptions for that as well in the light impact – not zero. Again, for Russia in particular, we don't have massive concerns in our own portfolio exposures to the oil industry in itself.

Kian Huat Lim

Sure. If I can interrupt at this point, on page 29 you show the breakdown according to stages and according to geographies. For the 1Q 2020 figures, are these as of the end of the quarter itself, or do these also reflect forward-looking scenarios that you have described? If the figures on page 29 are based on the latest figures, could we have some color on how the assumptions of the HUF 85 billion would have changed those figures on page 29? Thank you.

György Kiss-Haypál

I think I explained that 1Q 2020, as you see, is a result of the allocation of the corporate portfolio from Stage 1 to Stage 2. That's why you see, in basically every line, a relatively big increase – say, OTP Core at 4.2% at the end of last year, now 7% at the end of 1Q. So, it's the assumed migration, and that's why the share of the portfolio in Stage 2 has increased. So, this is the current estimate. And I explained that out of the HUF 85 billion book-up, a little less than one third is a result of the migration.

Kian Huat Lim

Okay. That's clear. Thank you.

Operator

The next question is from Simon Nellis, Citibank. Your line is now open.

Simon Nellis

Hi. Thanks very much for the call. Just another question on the moratorium. Apologies if you've answered this before – I joined the call a bit late. What level of participation was assumed for the NPV hit that you booked in the first quarter? The hit was roughly HUF 20 billion post-tax. Was that assuming 100% participation or lower participation? That's my first question. Maybe we can just go one by one.

Péter Krizsanovich

Discussing with the auditor at that time, we used the actual participation rate when the booking was made. So, that was a previous state of the participation rate, which we used regarding this booking. And, at that time, the opt-out ratio on the retail side was approximately 30%-35% and on the corporate side around 40%-45%. That was not an estimation for the full year. That was the actual state of opt-out ratios.

Simon Nellis

Would you expect that to change much in the coming quarter, or not?

Péter Krizsanovich

Yes, it's still increasing.

László Bencsik

The opt-out is increasing, right, Péter?

Péter Krizsanovich

Yes. The opt-out is increasing.

László Bencsik

The opt-out is increasing. So this number should decrease in fact.

Simon Nellis

The number should decrease. Understood. And I know you're not in a position to know for sure what the NPV hit would be in other countries, but could you give us a range of what the impact could be? Because I guess other countries have a similar set-up, right?

László Bencsik

The set-ups are actually very different. We have this page 5, right? The first question is whether it's opt-in or opt-out, so participation rate is potentially much higher in an opt-out situation than in an opt-in situation. The other question is whether there's an interest of the capitalized interest because if there is, like in Serbia, there's no negative NPV. So, there's zero NPV impact. So far the volumes have been much lower in countries where there's an opt-in structure. In Serbia, it's relatively high because it's an opt-out structure, but also, again, there's no impact there.

We don't expect similar numbers in this magnitude. First of all, as Péter said, as the opt-out number increases in Hungary, we expect this number to get smaller in Hungary. At the same time, we will have certain numbers coming from other countries, but in a much smaller magnitude. Plus, we have to decide whether it's material in itself or not, because if it's immaterial then we don't book anything. Then we also have to make a decision on whether something is derecognition. Because if there's derecognition and recognition, which is operationally much more difficult, then you have a lower NII in the future, but you don't have a one-off NPV change at all. So, there's another structural question here, which we are looking deeply into in each country. But there's nothing in the magnitude of what we have seen in the case of Hungary for the first quarter should come.

Simon Nellis

Okay. My other question was: could you tell us what the provisioning would have been if you had used 100% probability for the severe scenario? Just to give us an idea of what a more stressed scenario case could be. Instead of HUF 85 billion, what would be the provision charge?

László Bencsik

Don’t push us too much, please.

Simon Nellis

Okay. Then that’s all from me. Thank you very much.

László Bencsik

Thank you very much. Thank you very much for your participation, for the very good questions you have asked. Bye-bye.

Note: unabridged transcript with minor English stylistic corrections.