Strategy and Finance Division

Investor Relations & DCM

# OTP BANK
# 2Q 2022 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's 2Q and 1H 2022 Conference Call. This conference will be recorded.

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. Good afternoon or good morning, depending where you are. Thank you very much for joining us today on this very nice summer day. We really appreciate –that you have taken the time to listen to us at this time of the year. The presentation, as usual, is available on the website and has been available for more than an hour. Hopefully, you've been able to download it, but we also share it during the presentation and the conf call.

I'll try to better restrain myself than usual and give a relatively succinct presentation of the recent results and then we can do a Q&A session, it will be more interesting.

Nonetheless, start with Page 2. The glass is either half full or half empty, depending on from which angle you want to look at this. If you look at the total profit after tax and the year-on-year development, then we are 80% minus compared to last year. If you look at the adjusted profit after tax which includes the risk cost increase in Russia and Ukraine due to the war, then we are in 2% plus. Considering and including the negative business impact of the war in Russia in Ukraine on the risk cost and on other factors in the P&L, then on group level we managed to increase the adjusted profit by 2% year-on-year. So that's the good side of the story.

The not so good side of the story is that during the first half of this year, there have been quite excessive one-offs. Part of them were related to the increased policy burdens in the format of excessive one-off taxes and the continuation of the rate cap on variable mortgages in Hungary. These are, in terms of after tax effect, almost HUF 100 billion one-offs negative and then another close to HUF 100 billion came to other ramifications of the war in Ukraine, outside Ukraine and Russia, namely the impairment we had to book on the Russian government bonds we are holding in Hungary and in Bulgaria, plus the goodwill write-off we had to do related to our Russian asset. So, huge negative one-offs in 1H, but the underlying performance without one-offs, I think, was quite respectable despite the fact that we have this very special and dramatic situation in Ukraine and the related situation in Russia.

Looking closer to the quarterly development of profits, as you can see, the profit after tax including all the one-offs, including this large special tax in Hungary, we made HUF 76 billion after-tax profit in 2Q 2022, which is a great improvement compared to the loss in 1Q. The adjusted profit in 2Q was HUF 162 billion, I think that's quite decent, and that's obviously far bigger what we have ever done in any quarter. The year-on-year growth was 26%, compared to the second quarter of last year.

Page 3, these are the group results including Russia and Ukraine. First, I'd like to point out that exchange rate movements have been huge, especially in 2Q this year. If you compare 1Q to 2Q numbers in HUF nominal terms as we present them in the reports, you may not get the full picture because the HUF weakened to almost every currency expect for the hryvnia, which weakened a lot. And the Ruble appreciated huge compared to the first quarter. If you want to understand the dynamics here, we would rather have to look at the quarter-on-quarter FX adjusted and year-on-year FX-adjusted changes, which are presented on the right side of the chart. Basically, this rather strong q-o-q improvement in the adjusted profit, from HUF 89 billion in 1Q to HUF 162 billion in 2Q, was due to 2 reasons. One is the much lower risk cost: we provisioned much less, as you will see in Russia and Ukraine. Risk costs went down from HUF 73 billion to HUF 32 billion. Second, the FX impact was quite substantial: there was a 3% FX adjusted increase q-o-q in the operating profit. So that's roughly the picture. I think it's important to take into consideration the large exchange rate movements, which do have an impact on our numbers.

Going to the next slide, which presents the group results without Russia and Ukraine. I think it is important to show these numbers, especially because we articulated our expectations after the first quarter based on these sets of numbers, i.e. without Russia and Ukraine, and it obviously does make sense, I think, to continue to talk about these 2 parts of the Group separately.

If you just look at Group performance without Russia and Ukraine, it was flat q-o-q. The risk cost impact here was reversed. We had less write-backs then in the first quarter, and we had some improvement in operating profit, it was 3% q-o-q.

If you look at the yearly development on the total income line, 18% up year-on-year, FX adjusted. That's roughly the speed with which we are growing our loan book. This is not surprising because the net interest margin and in general, revenue margins remained close to flat compared to last year. Income growth is driven by organic volume growth and business growth, and that was 18% compared to last year.

Important line is the cost line: y-o-y we had 11% cost growth which created positive operating jaws and operating profit grew 26% organically.

Obviously, this operating expense line is the line where we will be strongly under pressure, and we will have a headwind in the coming periods given the very high level of inflation and especially in Hungary, the impact of the weak exchange rate on some of the cost elements. This is going to be a challenging part.

Now the adjusted ROE without Russian and Ukraine was better than originally expected, at 23%. We kept the guidance that it may end up around the last year level, but certainly the first half performance was better than last year. Cost-to-income ratio improved again due to these positive operating jaws. The risk cost rate was positive for 1H this year. It might be closer to where we were last year for the entire course of the year, but we will see.

Now specifically, a few highlights on Russia and Ukraine. In Russia, operationally, the situation is stable, and we are gradually ramping up retail lending: the usual POS loans and cross sold credit cards and the cash loans. Despite a large volume decline that we saw the new volumes started to build up and it does seem to be a quite profitable, sustainable business, even in the current environment in Russia, whereas our corporate volumes drastically dropped. You will see that corporate loans, which were a small portfolio, are now down by more than 50%.

In fact, we adjusted further the operating model and now we only focus on this mass market, consumer retail lending and we have pretty much given up corporate lending where we are extremely selective, but technically, it's kind of zero.

That resulted in a profit in 2Q. Obviously, we did not have to create further excessive provisions because the portfolio quality remained quite stable. We haven't seen any unusual deterioration in portfolio quality. We also reversed most of the deferred tax assets we have written off in 1Q; we were maybe too conservative after 1Q regarding these tax assets an now we have booked them back. Therefore, you can see this big change in the corporate tax in Russia. But if you look at the first half, corporate taxes were in line with usual performance.

Now in Ukraine, we booked quite substantial risk costs. Even with these risk costs, we have positive or plus zero performance, which has been bolstered by the rate hike. The National Bank deposit rate was hiked to 25%. That means that even if our loans are going down and being repaid, and we have relatively subdued and limited new lending, we can maintain a decent net interest income level just by collecting deposits and placing them with the Central Bank. So P&L-wise that stabilizes the bank and seems to be able to provide a decent operating profit, which can certainly absorb a relatively high level of risk costs without making the bank loss-making.

So that's the trajectory where we are now. In a reasonably optimistic scenario this can continue. But it's very difficult to have any clear vision on where the situation can develop in Ukraine, it is immediately directly linked to the war situation in the country, and whether it abates or exacerbates makes a difference in terms of having zero or slightly positive quarterly results, or having another negative or more than one negative quarter in Ukraine.

Whereas in Russia, as far as we understand the situation, the expectation is that from now on we are going to make okay levels of profits with a smaller balance sheet, which focuses mainly on retail consumer lending.

If we broaden our view to the other group members, then I think the story is quite positive. Most of the foreign subsidiaries have been doing very well. Bulgaria is doing nicely, FX-adjusted profits already up 27% q-o-q, 12% y-o-y. Croatia has been phenomenal: the bank, the market, the macro environment, they are joining the Eurozone. The country has been upgraded by rating agencies; the tourism is very strong. From every angle, they are doing quite well, and we are very optimistic.

Serbia, in this difficult environment macro and policy wise, has been navigating quite well and this is reflected in our results, y-o-y 41% increase in profit. This seems solid and strong.

Slovenia, 22% annual increase in profits. This is a country where we are very keen and very motivated to finally close the acquisition. Hopefully, this is going to happen before the end of September, and then we can get into the possession of NKBM and start the merger and create, hopefully, a substantial uplift to our Slovenian nominal profits and also, to the returns that we achieve there.

Romania, moderate profit but in line with this progressive organic growth strategy what we have there.

Montenegro, we had an operational problem during the winter period and then at the same time, we have now a new management, CEO and management team is partially revamped, so I'm actually quite positive that the bank has taken an even better direction than before.

Albania, very strong performance. They almost doubled their profit year-on-year. The country is really in a very interesting situation. They are almost self-sufficient in terms of energy, it's hydro based. It's not carbon-related and somehow the whole economic environment started to make sense there, and there's a rapid development. We are quite happy with Albania. We are even happier that we just closed an acquisition there, which is obviously not a big bank, neither compared to the Group-level nor even to the Albanian market. But nevertheless, it makes a very good addition to our activities there and helps to increase the market share of the bank by 50%. This is meaningful for our presence in Albania even though on the Group level it doesn't make not a big difference.

Moldova is in a very difficult geopolitical situation. There's a strong recession and the IMF is there. Very high-rate environment, very high inflation, enormous current account deficit. This is a country which is in a difficult situation. I think the good news is that despite this, being a relatively recent acquisition and even in this difficult country, our bank is still making profits. Obviously, profits are lower by almost 40% than last year, but it's still positively contributing to the Group.

The Hungarian Leasing, Merkantil doing quite well, fund management doing okay. Then we have Russia, Ukraine, but we have talked about that story before.

I mentioned the acquisitions. We nicely picked this Alpha Bank process in Albania. It's done. The last one in the pipeline, as I just mentioned, hopefully, will happen by the end of September. We seem to be in a final phase before we receive the answer from ECB primarily and from the local competition authorities.

Net interest income development. I think here, it's important again to look at the FX-adjusted numbers. Wherever we have those percentage changes y-o-y or q-o-q, typically we have 2 numbers, except Hungary. The second number is the FX-adjusted one and even directionally, they can be very different.

For instance, in Russia, q-o-q, in HUF terms, NII went up by 22%. But in RUB terms, it actually went down by 17%. The FX-adjusted numbers seem to be much more reliable than the unadjusted ones. Fundamentally, I think it's true that in most cases, again, except Russia and Ukraine, which are special ones, those are the underlying volume dynamics which drive NII. In some cases, we have seen changes in the net interest margin, some improvement in Hungary, some decline in Slovenia, and some decline in Serbia. It's a kind of mixed picture and on Group level more or less flat.

As for NIM, Page 9 is the quarterly change, and there was some improvement in Hungary. Finally, there's a small filtering in of the rate environment despite the structure of the balance sheet, I mean we have these massive fixed assets in our portfolio, which revamped the short-term impact of the rate hikes to manifest in higher NII. For a couple of years, we are going to have this high-rate environment.

A lot is related in the NIM change to Russia. If you just look at Russia's stand-alone net interest margin in RUB, then it declined 4 basis points. But then the overall NII in Russia shrunk and that actually had an impact on the composition of the group margin. The contribution to Group level margin declined because the share of the Russian business declined and that was actually negative because overall, the Russian margin is higher than the Group average. So that's the others, minus 7 bps, mostly coming from this one.

Then the FX effect, again, most of it is coming from Russia and the huge appreciation of the Ruble compared to the first quarter, and having this increasing share due to the FX impact. Basically, the OTP Russia standalone, the FX effect and the Others, they are all related to Russia, they are just taken into 3 parts. And other than that, Ukraine and Hungary slightly improved.

Looking at volumes, and quarterly loan growth. We had a very strong quarter with a growth of 3%, or 5% without Russia and Ukraine because Russia, Ukraine were strongly negative, Ukraine 10%, Russia, 11% minus. But the rest of the group did well, 5%, and this is not annualized obviously, this is just one quarter.

Hungary saw a strong rebound. As you might remember, 1Q was zero mostly because of the consumer loans being negative due to the windfall payment to our retail clients by the government. But then second quarter was 6%, which is one of the strongest in the Group, but all the other countries did quite well, 4%, 5%, 6% growth on quarterly basis in the bigger markets. Especially corporate was a strong driver; in many cases, this was driven by working capital loans increase, quite an increase in the utilization of the working capital loan credit line. What we see is that a lot of corporates are increasing their inventories, so they're buying stuff, they increase their working capital and raw materials and so on, this is obviously in anticipation of raw material or parts price increase, but even the finished products' volumes increase, so they have produced reserves in anticipation of

future price increases. So, we do experience that. Obviously, this is not going to last forever. This is probably a temporary 1 or 2 quarters situation, but that gave a big boost in many of the countries to our corporate loan growth volumes.

Looking at the first 6 months, ytd performance. Without Russia, Ukraine, 8% and this is obviously stronger than what we originally expected. Therefore, if you read our guidance, this is the line where we made changes. Previously, we said that we expected around 10% performing loan growth without Russia, Ukraine. Now we are more inclined to say that it is going to be probably more than 10%. It can be materially more than 10% unless there's an unexpected development there. Anyway, the same pattern, so around 8% to 10% growth in most of the countries for the first half. In some countries, we have quite an interesting environment. Those of you who are from the Eurozone, might get used to it, but for us, this is strange to see that we have very high inflation rate. Bulgaria, Croatia, Slovenia, Montenegro around 15% inflation, and still a very low-rate environment. It means that the cost of loans remained low, especially compared to the level of inflation and the level of wage inflation. That means that it can happen that in this high inflationary environment in these Eurozone or quasi-Eurozone countries the loan demand might stay actually quite strong, whereas in countries where the rate environment has increased a lot, namely Hungary, that's the kind of highest increase except Ukraine, where the rate is 25%, but that's a different story, and also Moldova, which is close to 20%, so except those specific situations, in Hungary the rate increase has been quite material. This is going to naturally impact loan demand.

Therefore, the expectation is that there will be less loan growth in Hungary unless more subsidized rate products and structure come. There have been some positive developments on that front: the baby loan program has been extended by another year to the end of next year, and Széchenyi Card program which is primarily an SME loan facility for refinancing, at subsidized rate. That continues and has been somewhat extended. This is the right time for these subsidized structures to come in place, and we will see how much is going to come and to which extent they are going to moderate the otherwise inevitable decline in demand for new loans.

Deposit development, quarterly 1% and for the first 6 months, next slide, 5%. The deposit growth slowed down somewhat. It hasn't been in our focus, obviously, and our liquidity is not in our focus. But what is very important, the Ukrainian and Russian situations. I think it's important to note that both countries' deposits have been growing despite the fact that we are very liquid and liquidity situation improved a lot in these 2 countries, given the huge decline in loan volumes ytd. We are not hunting for these deposits, they are coming to us, and that's a positive feedback that even in these very distressed situations, clients trust us maybe even relatively more than some other banks, in countries where we are not big. In Russia, we are tiny and in Ukraine as well, we are one of the smaller banks. This is not that we are kind of major players in these countries, but there might be some other reasons.

Fee income. Year-on-year, 15% growth. Again, this is more or less in line with the overall group activities and lending. In some countries it was stronger, like in Hungary or Bulgaria; obviously, Ukraine, Russia y-o-y were negative which is not surprising in this situation, and there's some quarterly noise as well, typically in Hungary, in the first quarter there are negative one-offs, therefore, usually the growth in the second quarter is bigger than usual, but there's nothing fundamentally new here to mention.

On Page 15, other income. Again, there's some noise here, especially in Hungary, between the first and second quarters, especially related to Ruble swaps which were positive in the first quarter, negative in 2Q. That difference explains half of the quarterly change. But I think if you look at the year-on-year development, it is also mostly explained by technical one-offs. Again, there's not so much new story here other than technical changes in the base or in the recent periods.

Operating costs: so far, okay. But this is something to be watched because in this high inflationary environment, we are exposed to different cost pressures: wage inflation, high energy prices. Even if banking is not an energy-intensive business, we do have utility costs, they're going up and especially the Hungarian forint weakening caused increase in real estate rental fees and in IT cost. That's so far so good, so positive operating jaws, this is going to be a strong focus in the future to try to moderate cost growth despite that inflation is very high all around us in every country.

In terms of capital and liquidity, there’s not much development other than you probably heard that we issued a green senior preferred bond. This was our reintroduction to the market. I think last time we issued a senior bond was somewhere in 2006, so 16 years ago. It may not have been the best time to start issuing bonds again, but we are obviously under pressure from the regulator to fulfil the increasing MREL requirements. Therefore, we had to start this, and it was quite expensive, 5.5% coupon, but expensive is relative because in fact, we were one of the very few financial institutions from the region to manage to issue anything in the last couple of months, actually it happened in July. We have seen higher coupons with similarly rated banks from the region. In that perspective, even the pricing was okay, but this is certainly a very different environment in terms of cost of wholesale of funding. But despite the liquidity situation, it's not so much a choice to do this. This is a regulatory

requirement, and we will continue in the next 1.5 years issuing new bonds primarily senior preferred ones to eventually fulfil the requirements.

There was a lot of movement in the capital and in the risk-weighted assets, the FX rate related changes in our capital base and in our risk-weighted assets were quite big. So, you see the first lines, HUF 313 billion increase in the capital and HUF 1.4 trillion increase in the risk-weighted assets due to the FX rate changes. This is just this natural hedge more or less in the group balance sheet, or in the group capital adequacy. As risk-weighted assets grow due to weaker HUF, the regulatory capital increased, as well. So FX rate changes explained quite a bit of the changes in the capital base and in the risk-weighted assets.

In terms of coverage and portfolio quality, again, not so much change. Obviously, due to the increase especially in Russia, there was some increase in Stage 3 ratios due to the declining overall portfolio. Likewise in Ukraine we had some increase, but it's not underlying so much. It's just because the total volumes declined, and therefore, the ratios somewhat increased. So that caused q-o-q 10 basis points increase, it's not big. I think in terms of coverage level, we remained typically higher than most of our regional competitors.

Usual 3 slides on Hungary-specific performance. One factor here is important. If you look into the analyst tables, which are in excel format, you can actually spot that, for instance, mortgage demand for the market-based structures dropped substantially in the second quarter. So that we do see.

Despite strong new mortgage generation and strong new applications, most of that is basically explained by the demand for the subsidized green housing loans, and the demand for the market-based structures, it's not surprising, already dropped significantly. That means that if there's no further subsidized structure coming from the state then it's likely that the Hungarian mortgage lending in general will slow down, I think that's an important message to make.

Corporate loans were quite strong, again, related primarily to the working capital loan volume increase, which is related to the usage of the credit lines.

ESG remains a strong focus overall. The bond what we issued in July was a green bond. It was not just our first senior bond for 16 years, but it was the first ever green bond in EUR. There was a quite positive investor perception to the structure. I think we have done a lot in this area during the last couple of years, and we will continue to focus our efforts on the E, S and G factors parallel.

Finally, a few words about expectations. Certainly, 2Q was more positive than we originally expected. That suggests at least short-term limited optimism, I think. We only decided to reflect it in the loan volume expectations. So, we expect the group level loan growth without Russia and Ukraine to be over 10% as opposed to the previously expected around 10% guidance. So now this suggests and reflects the 8% year-to-date performance. It's not hard to imagine that it's going to be more than 10%.

I think it's still likely that the net interest margin will remain stable. It slightly increased y-o-y, might be some slight more increase, but not material.

Cost efficiency improved. We're happy about that.

Credit risk cost ratio in the first half, it was positive. I mean there is always a problem whether the risk cost ratio is positive or negative. So, we had write-backs without the Russia, Ukraine portfolios in the first half. So therefore, the ratio is better than last year. We will see. These are quite small numbers, either positive or negative, compared to the size of the group. At that level, it's hard to be very specific about the forecast. I think the best guess is that the whole year is going to be at the level of last year, in terms of the credit risk cost ratio.

Profitability, the adjusted number without Russia and Ukraine for the first half was markedly better than the last year, but we remain cautious in our guidance – 'around last year' can mean that it can be higher than last year.

Russia, I already told you that what we expect moderate profits, but profits to come from our Russian business. Ukraine, it's impossible to forecast what exactly is going to be the quarterly performance there. It is 100% dependent on how the war situation develops.

That was the presentation on my side, and I'm sure you have very good questions to ask, and then we'll try to answer them in meaningful ways. So please open the floor for questions.

# Q U E S T I O N S A N D A N S W E R S

**Operator**

The first question is from Hai Thanh Le Phuong.

**Hai Thanh Le Phuong – Concorde Securities**

Thanks for your presentation. Just 2 questions from my side. The first one would be on your rate sensitivity to Euro rates. I think in the previous call you said it would be around HUF 3 billion for every 10 bps. Shall we translate the first 50 bps of euro rate hikes to impact your interest income accordingly? How you see further rate hikes would impact this line?

My second question would be on the agricultural moratorium that was introduced recently in Hungary for agriculture companies. I was wondering if you could tell us what is the exposure in Hungary for that sector in your loan book?

**László Bencsik – Chief Financial and Strategic Officer**

The answer to the first question is yes. The 50 basis points rate hike we have seen so far should translate into 5 times HUF 3 billion. The forward-looking sensitivity is even higher. It's roughly EUR 10 million per 10 basis points, i.e. HUF 4 billion for the current terms and the difference is because now we are in the positive territory. In some cases, we could not have negative reference rates. Therefore, up until it went up to zero, in some cases, there were no increases in loan rates. These are typically corporate contracts, and they differ by countries and by clients, so it's not uniform, but we have quite a lot of contracts which work in a way that the reference rate could not go below zero in the pricing according to the contract. So far, the rates of these lines have not changed, but from now on they will. So, that somewhat increases the sensitivity here.

The agricultural loan book, which can be impacted in total is HUF 250 billion. To be honest, there's another HUF 50 billion off-balance sheet credit line. If you take the on and off balance sheet exposure, it will be like HUF 300 billion, so this is not a huge portfolio. It's pretty much impossible to tell how many clients will participate - it's an opt-in structure, so it's not automatic that clients participate. Clients will have to decide by the first half of September. Obviously, we will try to communicate to these clients, and we are very hopeful that these clients will approach us and discuss problems if they have any. There has been a strong draught in Hungary. It's really strong and some special crops production was strongly affected. So yes, some producers experienced troubles, but it is certainly not across the whole sector. So it's hard to say, we don't have a good number how much participation we should see here.

**Operator**

The next question is from Máté Nemes, UBS.

**Máté Nemes – UBS Investment Bank**

Good afternoon and thank you for the presentation. I have 3 questions, please. The first one is on market shares in Hungary. Can't help to notice, but essentially in all products and segments you're showing growing market share, let it be in mortgage loans, cash loans or on the corporate side. I'm just wondering if you could give us a sense why that might be. Is that basically the willingness's to continue supplying credit while some other banks are holding back? Is that due to pricing or is there's any other factor? That's the first question.

The second one would be on intragroup funding to Russia and Ukraine, as well. I just noticed that in HUF terms, we've seen an increase q-o-q. Can you just confirm that this is simply due to the Hungarian forint depreciating versus the Ruble and the Hryvnia, and there is no actual increase in local currency funding terms.

The third question is on Ukraine. You mentioned that currently, you're seeing strong deposit inflows and you're placing this at the Central Bank at very high short-term money-market rates. Can you give us a sense what portion of your NII is coming from these deposits placed at the Central Bank in Ukraine? Perhaps also how much is cash and how much is accrual on the NII side currently.

**László Bencsik – Chief Financial and Strategic Officer**

Hungarian market shares increased in retail, it's basically a composition result. Maybe we can go to the slides, Page 19. We always have higher market share from subsidized products, you might remember. Regarding baby

loans we had like more than 40% market share. It’s on the following page. Baby loans market share, as you can see, has always been above 40%. The green housing loan, which is a subsidized product, we have a much bigger market share in this subsidized product than in general.

What happened in the second quarter, if we go back to the previous page, both in consumer loans and in mortgages, the market rate based normal product new volumes declined, and a much larger share of new production was coming from subsidized products. And in these subsidized products, we have always had much higher market share than in other products. So, it's not that we have done something differently. It's just the demand structure changed, and we happen to be stronger on the market in the subsidized products, and the demand increased in subsidized products and decreased substantially in the non-subsidized products. So that's the explanation. And these are very low risk products, these green housing loans, at maximum 2.5% rate for a 10-years fix or even more. It's a gift more or less for the terms you can take in this environment. If they put the money, well they can't because they have to buy, obviously, a real estate from this money. But if they anyway had the money and take this loan and put it into a government bond, they earn kind of 7% or 6%. These are actually quite low-risk products. So that's the reason in retail.

In corporate, the increase was smaller in terms of market share. And it's more like this trend, we have seen this trend for many years in corporate that we have an increasing market share. The market share increase slowed down in this year compared to last year and previous years. So again, there's nothing specific or extraordinary there. We do have the same phenomenon in the corporate as well, especially in SME. On slide 21 on the right lower corner, you can see that this Széchenyi Card Go! programme, which is a subsidized scheme, a refinanced scheme, quite attractive, we have 37% market share. Our overall market share in corporate loans is 19.2%. Obviously, in the higher rate environment, the new demand is much stronger for the subsidized products than for the non-subsidized products, so a similar change here. So, it's not that we are more relaxed than others and less conservative. I don't know how conservative others are, but I think we are conservative.

Now in terms of funding to Russia, I can confirm that the increase is only since we have a weaker HUF rate compared to Ruble. In fact, our Russian entities should pay back a substantial part of this funding. The problem is that they are not allowed to pay back or they can pay only in Ruble. If they were to early repay these loans, the amounts could go only to this special ‘C’ account. Which is trapped in Russia, so it doesn't make any sense.

The same in Ukraine, it's not possible to pay back the maturing intragroup credit. But nevertheless, in case of Ukraine their placement within the group increases. The net funding is actually going down, not that it matters a lot, but that's what happens. So, we have not increased our funding to any of these entities from the Group.

Cash / accrued ratio, in the second quarter the accrued part in the NII was 18%. We had like 12% to 15% of our assets in central bank deposits at the end of the second quarter, and this is going to increase.

**Máté Nemes – UBS Investment Bank**

That's very helpful.

**Operator**

The next question is from Gabor Kemény, Autonomous Research.

**Gábor Kemény – Autonomous Research**

Hello, a couple of questions on Hungarian asset quality. First, the economy is slowing, and the utility price freezes are being phased out. How do you think about the provision outlook in Hungary in this environment? How do you capture this in your guidance of stable risk costs, admittedly from a benign 1H starting point.

And the other question is, how do you think about a more negative macro scenario and in particular, Russian gas cut off potentially, how would that impact your provision outlook?

My last question would be on Russia. You had a comment earlier today that you might consider a sale. What options do you see to potentially work around the government decree banning the sale of foreign assets?

**László Bencsik – Chief Financial and Strategic Officer**

Certainly, the developments, the high inflation and especially the excessive energy costs are negative. No question about that. It's going to have a negative impact on our risk cost and portfolio policy. How negative, that's actually very difficult to tell.

We made this guidance that we expect a similar risk cost rate this year to last year. Last year, we had some risk costs for the whole group. This year, so far, except Russia and Ukraine, we had a write back. So, the fact that we expect similar level to last year still means that there will be more risk costs in the second half than first half. I'm talking about without Russia and Ukraine because Russia and Ukraine hopefully will be less.

Now in case of Hungary, risk costs are positive, for the first 6 months we had positive HUF 9 billion last year, and HUF 29 billion this year. I think this is not going to continue long. So, probably we will start to see periods with normal risk cost, which means negative risk cost. I think this positive risk cost is abnormal. That's due to the fact that 2 years ago, we made large provisions for COVID-related problems and COVID-related problems did not happen, at all. We have still reserves and we slowly started to release these reserves. But now we have another problem, which might be more material than the COVID impact was, because COVID was rather unusual, we were scared and provisioned and everyone was negative 2 years ago, but at the end, the situation turned to very positive, at least, in terms of portfolio qualities and banking sector results.

What happens now it's extremely difficult to tell - in a scenario where there's no Russian gas at all coming to Europe, that's a rather dire scenario. But not just to Hungary, but across Europe, especially Germany, some other CEE countries which are heavily dependent on Russian gas. I think it's very, very difficult to capture the magnitude of the problems we are going to have. I think if that happens, then we will have strong policy measures, not just in Hungary, but across Europe because this is not something which can be left to the market to be solved, the situation if that happens. I can’t quantify that, honestly. But certainly very negative. A complete cut off of Russian gas, that's certainly a tough scenario. I don't know how we're going to cope with that if that happens. But we also have to remember that this is a political decision. This is related to the war and related to the sanctions which have been imposed due to the war. If there's no gas, this is the counter sanction to the sanctions, which were triggered by the military actions in Ukraine and the war. This is something fundamentally political, it's not a fundamental supply-demand imbalance, it’s a political decision. I can only hope that political decisions will be wise on both sides, right? If irrationality and tit for tat negative scenario continues then we might have massive problems. And these problems will not be specific to Hungary or the region, but certainly more at least more on the European level.

Russia, there was this presidential decree that foreign banks, foreign assets cannot be sold. Every presidential decree can be overwritten by presidential decisions. I'm not sure it's technically possible for the Russian President to give one-off approval. We haven't digested this so much. We started the process to explore if there's interest for the asset, and I can confirm that there is local interest for the asset. Obviously, it is unclear to which extent meaningful discussions can continue in this situation, whether potential interested Russian parties want to engage in a more meaningful and more detailed conversation and process given this ban, because it's not just that we cannot sell, but there are not a lot to buy.

I don't know. It does definitely, at least, slow down the process, and it has slowed down the process. We remain open to this, and we continue to explore strategic opportunities. Having said that, if we just look at the economic fundamentals of the situation, as I said, we stabilized the operation: it’s self-funded, it's profitable. It focuses on the segment, which is, I think, the least sensitive politically, it's just the mass market retail or even below mass market retail clients we have. We stopped corporate lending in Russia. We are small in the local market, ranked No. 50 or 40 by total assets. That is still sensitive politically, and we understand that.

Having said that, we have regional competitors who are in the Top 10. Still, they are making enormous profits in Russia, so put it this way, we are going to monitor what they do with their assets and how they tackle the situation and that will be a guidance for us as well given that we are tiny compared to them, and we are not serving state-owned or corporate clients in Russia., we are only serving low mass market retail clients when they buy microwave oven or a TV or something like that. I think it's a different profile and much smaller. But we do keep our eyes open and continue to try to explore the different strategic alternatives.

**Gábor Kemény – Autonomous Research**

Useful colour. Just one small follow-up. Can you remind us how much overlay provisions do you have as of now? And you mentioned, I think, some releases in 2Q. If you could quantify that as well.

**László Bencsik – Chief Financial and Strategic Officer**

In Hungary in 1H, the risk cost was plus HUF 19 billion.

As for the overlay, I don't know what an overly means, in fact, sometimes it happens that you have situations when you create provisions based on expert judgment, maybe more than models. But in our case, everything is model-based, and we don't have an overlay that we just put there based on no data, right? So, for Russia-Ukraine, we do have models and the provisioning is model based. Our models for the rest of the group suggested that we needed less provisions than what we originally thought we would need under a stress COVID scenario.

The COVID situation officially has stopped to negatively influence our business activities in the first quarter. We have adjusted our models according to that, and that resulted in lower provisions in some countries. I think this overlay from an accounting point of view, it's not very meaningful because you can only provision or release provisions based on some underlying rationale and that rationale has to be either related to some observed client activity or change in client activity or the ability to pay or a specific economic model you have for the expected risk cost for the future.

We don't have an overlay, which is somewhere outside this framework hanging overall. So we don't have that. I don't know how others can have that if that's what you mean.

**Gábor Kemény – Autonomous Research**

Noticed there but what I meant was the provisions you created during the COVID crisis, given your macro assumptions back then, which you have not yet released even though the macro situation let's say, turned out to be more favourable than you had assumed, but it sounds like there's not much of that.

**László Bencsik – Chief Financial and Strategic Officer**

We have released them and we reallocated them. Partially, we released them, and that's what you see, and partially we reallocated them as all over the sudden there's another reason to provision more and to be the less optimistic or pessimistic for the future. That’s the current economic environment which obviously deteriorated. The COVID reason ceased to exist, but now there's another negative scenario we have to take into consideration. We calculated both, there was a difference, the difference has been released and we have a new one. So that's the situation.

**Operator**

The next question is from Alan Webborn from Societe Generale.

**Alan Webborn – Societe Generale**

Thank you for the call today. Do you think that in terms of the way the government in Hungary is managing its budgetary needs and so on, is rational in terms of how it's working with the banking sector, for example, we look across to Poland, and it doesn't really look as if the reaction of the authorities now is particularly rational. Whereas, in your case, you've been slapped with a 2-year extra bank levy, but at the same time, there are big, subsidized loan programs, which from what you said today seem to be supporting volumes. But these programs surely must now be made more and more expensive for the government to maintain.

I wonder do you feel confident that when the government says it will continue these support programs for some time that you can rely on that. Or are we faced with a fairly important risk that these loan programs get withdrawn and until rates come down, you could have quite a sharp contraction in lending, as a result. I just wonder how you feel that's working and what you feel about the development of Hungary, given the fact that you've got this take away with one hand and give back with the other. I'd be interested in more of your view on that.

In terms of your own reaction to the new bank levy, I mean, are you able to do anything in terms of commercial policy to take something back? Or is that just something that's not really within the spirit of how the relationship is moving for Hungary.

In terms of Ukraine, were you positively surprised by the lower level of risk costs in the second quarter? Was there anything specific, better collateral, better collection that pushed that forward? I mean I hear what you say in terms of it's not very foreseeable, but I think we were positively surprised to see Ukraine back to breakeven in 2Q.

**László Bencsik – Chief Financial and Strategic Officer**

The first question is quite difficult to answer. I think it's clear that it's unusual how the policy environment works in Hungary. There seem to be a lot more intervention then the usually expected level, or it this the way in general in Europe. But this is not a new phenomenon, it started back in 2010. First, it was negative. So, we got the bank tax and the forced conversion, early repayment of mortgages and so on and somewhere the tide turned around in 2015 when growth became the primary political target. Since then, we have seen a wave of different subsidized products for retail and for corporate in various forms from the Central Bank and from the government.

It's clear that we have benefited from these and given our strong franchise and ubiquitous presence in the country, we tend to have higher share of these subsidized products than the normal products. So, relatively speaking, we

probably gained more than some other banks through these structures. Then time to time, we got these hits. I don't know where the right balance or the other balance is actually taken by anyone.

**Alan Webborn – Societe Generale**

I guess my feeling is that a lot of the support programs before interest rates went sky high were, to some extent, a choice. They were good for the consumer, they were good for you and has supported growth. Now they seem to be quite expensive for a government that doesn't have any money.

Without that, the people and the businesses that would be taking loans from you will be paying an awful lot more. It seems to me that you are now, for the moment, at least, a lot more reliant for the loan growth and the margin that you're getting from these support programs. Should they not be there, Hungary would be maybe much more difficult. I mean is that something you recognize?

**László Bencsik – Chief Financial and Strategic Officer**

Yes, obviously. I think that's obvious what you just explained.

**Alan Webborn – Societe Generale**

Have you been able in your commercial policy to do any offsetting? Or is it not really something that you can do. I mean if you've got these bigger market shares…

**László Bencsik – Chief Financial and Strategic Officer**

We cannot change the existing contracts. I mean, we cannot increase fees due to this, but in terms of new underwriting it can be priced into new production, but pricing is market-based. It depends on how the banking sector reacts to this.

I think here, typically the most important issue is whether other banks expect this to be temporary for 2 years, which we are hopeful that it is, or not. If not, then obviously, it has to become part of the new pricing. But the existing product pricing cannot change, that's not allowed. This was certainly not the purpose of the measure, and we cannot do that. We are not in a position to change legal agreements with clients. Only on policy level decisions can overrule the existing legal contracts.

Now Ukrainian risk in the second quarter was not a surprise to us at all. I think we've quite diligently and conservatively provisioned in the first quarter for expected losses. Since the environment developed according to those expectations in the second quarter, there was no reason to create even more. Having said that, we provisioned a lot in Ukraine in the second quarter as well. It was HUF 22 billion risk cost in Ukraine, whereas in 2021 full year, we had HUF 7 billion risk costs. In just one quarter or second quarter, we provisioned 3x as much as in the whole year of 2021. It was just less than half than we did in the first quarter.

**Alan Webborn – Societe Generale**

The fact that you don't make a statement saying, you feel you've done as much as you need to. Is that simply based on the lack of visibility as to what the situation will look like at the year-end because you would suggest that if things had got worse in the second quarter, then you would have not reduced. Your statement about the rest of the year unsurprisingly, it isn't positive, is it, on Ukraine.

**László Bencsik – Chief Financial and Strategic Officer**

We are hopeful put it this way. I mean, because in this tragic situation, the only thing you can do is to be hopeful and especially if you have people there who are responsible to try to project a positive picture of the future, and that is what we're trying to do. But obviously, we are all subject to the military actions there. We are not able to predict what's going to happen there.

**Operator**

The next question is from attendee joined via phone. (Operator Instructions)

**Robert Brzoza – PKO BP Securities**

Hi, this is Robert Brzoza from PKO BP Securities. I have a few more questions on the outlook of net interest income. For some time, you've been cautioning that the upside sensitivity of the NII in Hungary to rising rates is on a declining trend. My question is, have we actually reached a tipping point in the 2Q.

And I want to put this question in the context of the past quarter results, when you mentioned that the NII in Hungary was hit by HUF 12 billion q-o-q negative difference generated by the swaps. For simplicity, if we assumed an upward correction of 1Q 22 NII generated by Hungary Core, then 2Q results would actually be softer, I mean, lower in quarterly terms. So where do we stand today in terms of the potential upward sensitivity of NII in Hungary in this rising interest rate environment. So that's my first main question.

**László Bencsik – Chief Financial and Strategic Officer**

In terms of net interest margin, there's not much sensitivity in short term, I mean it's more kind of 2, 3 years horizon when our fixed assets reprice either gradually in case of the fixed mortgage portfolio or just because when we replace the maturing government bonds, there's a higher rate there.

The potential impact coming from the variable corporate loans is pretty much balanced, and I'm talking about HUF denominated. It's more or less counterbalanced by the corporate deposits, which are also variable. Now where we have a positive sensitivity is the euro, the FX loans, and we do have FX in Hungary, as well.

And then I just talked about the overall Group level sensitivity to the euro rates, and that's like for 10 basis points, roughly EUR 10 million NII for one year. But the short-term sensitivity of the HUF portfolio's net interest margin is roughly 0. And it's very sensitive to deposit pricing. It can even be negative.

**Robert Brzoza – PKO BP Securities**

I believe that's the question of the deposit pricing’s upward pressure. So I assume for the moment, it hasn't become negative yet, even given what we are seeing on the term deposit rates offered to households.

Another issue here is that the share of term household deposits is actually at all-time low below 20% whereas in the past, it used to hover around 80%. So do you expect this share of term deposits to increase for some reason and more rapidly in the coming future?

**László Bencsik – Chief Financial and Strategic Officer**

Yes, I don't think it has ever been 80%, but certainly more than the current level is the likely scenario, and there are a lot of factors here, right? But the market is very liquid.

The extra tax, the reason for this extra profit tax was that the banks make so much money, because they don't increase the deposit rates, right? And they have taken away that extra profit.

Now in our case, it's not there. But there are some banks in Hungary, who have not bought any government bonds, for instance, in the previous year. So, they actually have quite a big increase in their NII. So I think, deposit pricing is subject to competition.

The banking sector is very liquid and everyone has been hit by this huge extra tax. We are exposed to this risk, there is a risk for potentially increasing competitive pricing of deposits, and that's just going to be negative for our margin for sure.

**Robert Brzoza – PKO BP Securities**

Fair enough. And lastly, the guidance on the Euro, the ECB interest rate upward movement. Here, I wanted to ask, did you include in that figure the potential of the loan books to reprice in locations like Croatia or Bulgaria? Or did you only count in a purely euro-denominated exposures?

**László Bencsik – Chief Financial and Strategic Officer**

No, that's across. Technically, the Croatian and Bulgarian rates are in sync more or less. Having said that, in Bulgaria, specifically, loans are retail loans are all variable, but the basis here is it's not a market benchmark or the base rate, but it is the average cost of funding of the banking sector – so it's related to the average deposit rates in Bulgaria, which is a number published by the central bank regularly. So that's the index. It's similar in Croatia, as well. They have a specific national bank rate, which reflects the average deposit rates, and that is the benchmark for the retail loans. But corporate, which are EUR based, those are included in this number.

**Operator**

The next question is from Otar Dgebuadze. May I ask the name the name and the company, please.

**Otar Dgebuadze – Morgan Stanley**

This is Otto from Morgan Stanley. My question is about the corporate loans that you mentioned, the increasing corporate working capital loans in Hungary. If you could comment which industries do you see this in the most? And what are the drivers or your expectations in the second half of the year?

And secondly, you mentioned interestingly that the deposit bases in both in Ukraine and Russia are increasing despite you being a relatively small player and despite all the challenges that are happening in this economy. So I imagine it's hard to give a concrete reasons for this, but just interested in hearing your thoughts.

And lastly, about your ROE guidance, do you expect it to stay similar to 2021 levels. But at the same time, your loan growth is expected to be higher than last year. Your cost of risk is relatively stable. Your NIM is relatively stable, potentially surprising on the upside. So what is the negative factor that balances all this out? And why ROE this year is not going to be higher than last year?

**László Bencsik – Chief Financial and Strategic Officer**

I mean it's not just Hungary where working capital loans increased. You see that Serbia, Croatia as well, these are typically corporates with production, those who have inventories and then they produce more for inventory and they purchase more for inventory in order to stock up the parts they need and also stock up the output.

As for the expectation, I think that's a normal reaction in high inflation environment. You need to source, you want to source it at a lower price, expecting their prices to go up. And what you sell as a product, you want to wait for prices to go up. In order to balance this situation and to fund this, you increase your working capital. I'm sure this is should be a normal practice across Europe, I guess, where there's high inflation.

Deposit increase in Russia-Ukraine, I think it boils down to trust. Despite being small, especially in Ukraine, I think we have a very good reputation. It actually started with Raiffeisen, because this bank that we have in Ukraine, we brought it from Raiffeisen in 2006. Raiffeisen entered Ukraine somewhere in '97, '98. So they were there during the early 2000 crisis, they stayed there, and we bought this bank and then came the 2008 crisis and we stayed there and stood by our clients. And then came 2014-2015 when the war started, again, we stood by our clients. I think we earned this very positive reputation what we have. And I think this has been recently reinforced by the amazing and heroic work of our employees there to maintain banking services in a war situation. It helps that we are a foreign bank and for there is certain increased level of trust in these institutions in these difficult times.

Same in Russia, I think the foreign owned banks, if you follow our competitors which are much bigger in Russia than we are, they had an explosion of their profits there and their deposits and so on. So there's a strong flow of businesses towards foreign owned banks in Russia. There are technical reasons as well: we have access to international payment systems, some big banks and many banks in Russia do not have. Having said that, again, we are cutting back our corporate business, but these are important factors here.

ROE guidance. Yes, we could have increased it. I think the wording was considerate when we made it, we said 'around last year level', so it can mean somewhat higher. Having said that, I also indicated that for outside Russia, Ukraine, we expect higher risk cost or actually negative risk costs in the second half of the year as opposed to the positive risk costs or the provision releases that happened during the first half. So this in itself will worsen somewhat the profitability on the outside Russia-Ukraine activities for the second half of the year. To which extent this is difficult to tell. Even during this call, there was a question about the scenario, if gas supply stops to Europe, that's a really dire situation, which can trigger much higher risk costs. There can be scenarios, I think and these scenarios, I would say, some people really expect them to happen on the market. So if those scenarios manifest then risk cost can be much higher and that would have an immediate effect on our returns as well. So I think it's still the right thing to say that probably around last year.

And one more comment here, this is important, too. As for credit risk cost rate expectation, we added another word here and that is 'further'. So 'the credit cost ratio maybe around in 2021 over provided economic expectations won't deteriorate materially *further'*. So the 'further' was not there in the previous one, now it's there. What we reasonably expect to happen, it's included, but there can be much worse scenarios, unfortunately, manifesting for the remaining of the year or for the winter for next year. And it's only our imagination that can create a limit how worse those scenarios can be.

**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 spending your precious time with us today on this wonderful summer day. And thank you for your really good questions.

I wish you all the best, very happy remaining summer holidays, and please join us when we report our third quarter results, we expect that to happen on the 10th of November. And until then, all the best and goodbye.

**Operator**

Thank you for your participation in the Second Quarter 2022 Conference Call is closed now.

*Note: unabridged transcript with minor English stylistic corrections.*