Strategy and Finance Division

Investor Relations & DCM

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2Q 2020 Conference call
Transcript

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PRESENTATION

Operator

Dear ladies and gentlemen, welcome to the OTP Bank Second Quarter 2020 Conference Call. This conference call will be recorded. As a reminder, during the presentation all participants will be in a listen only mode. After the presentation there will be an opportunity to ask questions. 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, and thank you for joining us today on the conference call. We continue the practice that we started last time that I won't be the only presenter. We have Mr. György Kiss-Haypál, our Chief Risk Officer; he's going to elaborate on the risk topic. As a new participant on these conference calls, I will introduce Mr. Gergely Tardos, who's our Head of Research. He will elaborate on the macro expectations what we have.

We follow the usual format: we start with a formal presentation. The new element is that those of you who join through the Internet, through Zoom can actually follow with me on the screen, the presentation itself. For those of you who joined in through the telephone line, just calling in, I will still tell on which page I am more or less in order for you to follow it in the presentation. The presentation has been put on the website, it's available there. For those of you who don't follow me on the online platform, hopefully, you have been able to download it and also follow.

Page 2, the overall summary of our profits. Basically, the second quarter was considerably better than the first quarter. We made HUF 82.2 billion adjusted profits and the accounting profit was HUF 78.7 billion, which is in sharp contrast with the first quarter, but actually the accounting profit was negative and the adjusted one was HUF 31.8 billion. It's clearly a different quarter than the first quarter was.

If we go to Page 3, we can see the adjustments we booked in the second quarter. On this slide, we have a much smaller number than in the first quarter. Total adjustments were -HUF 3.6 billion. In the first quarter we had two large items, which moved this number up to almost HUF 36 billion negative. One was the bank tax in Hungary and the other one was the moratorium in Hungary for which we booked a negative present value change in the cash flow of loans due to the moratoria rules in Hungary, which do not allow the interest on accrued interest charge.

In the second quarter, we see a much lower numbers here. Probably the most important is that we actually decreased the charge on the moratoria so there was some improvement here. We continued to book expenses related to the integration merger projects and it was a sizable negative amount. This is going to continue as long as we work on these integration projects across the board.

On Page 4, you see the breakdown of the major P&L items. I think it's very visible that it was the risk costs, which drove performance both on a year-on-year basis as well as in a quarter-on-quarter comparison. If you look at the year-on-year without acquisitions numbers, because if you just compare the pure data, then it can be somewhat misleading since we have actually included 3 more entities in the second half last year – therefore, in order to get a clear picture, you actually have to look at the without acquisitions numbers.

If we compare the first half to last year first half, then what we can see is that revenues were pretty much flat, -1% FX-adjusted. Operating cost was 3% up year-on-year. That's actually lower than what we had last year in terms of year-on-year cost growth. It shows some cost containment without the acquisitions as well. Basically it was the risk costs which moved considerably the numbers. This is exactly the same in the quarter-on-quarter comparison. In the first quarter, we booked almost HUF 92 billion, whereas in the second quarter slightly more than HUF 39 billion as risk costs.

Revenues were more or less flattish as well, quarter-on-quarter, with lower NII and fee income, and higher other non-interest income. I'm obviously going to talk about this later on.

Capital. There were various elements improving our capital ratios, most notably, the regulatory changes. There were two changes which we incorporated. One is the increase by the regulator of the possible kind of write-back in the capital from Stage 1 and Stage 2 provision increases. This ratio increased from 70% to 100%. All provisioning increase in Stage 1 and Stage 2 volumes can be then written back from the capital and, therefore, doesn't decrease capital. So, if you provision for the first two stages, it's regulatory capital neutral. This is what we introduced for the first quarter, actually. So, we increased this ratio from 70% to 100%.

The second item which we applied is the lower risk weights on EU denominated currencies of the EU countries' securities portfolios, most notably the sovereign exposures. These two together had a 30 basis points positive impact in the second quarter. This was more or less kind of balanced by the treasury share buybacks, which we did. The good news is that there will be further regulatory changes implemented in the second half of the year, which are expected to improve our capital ratios. The one is the SME support factor, where below 2.5 million exposure we can apply 76% risk weight, and above 2.5 million exposure we can apply 85% risk weight, as opposed to the usual 100%. The other one is the softwares, the intangibles, which we have to deduct from capital at the moment. The treatment of softwares is going to change. As far as I understand, the regulation has not been finalized, but nevertheless, we expect some visible easing here and therefore, improvement in our ratios just by these changes. We are in the process of selling our Slovakian bank, and as we have noted before, we expect 25 basis points improvement in our Tier 1 ratio, should this conclude.

If we turn the page to Page. 6, this is probably the most exciting one out of the whole pack, and I hope it satisfies your interest how we are going to perform during the year. We are in a very volatile and difficult to forecast environment and we are very far from knowing exactly what is going to happen. Therefore, we wouldn't even call this as a guidance, it's basically our expectations. We recently updated our budget and these numbers reflect what we plan for this year. First of all, the adjusted return on equity, we expect it to be above 10%, which is not too difficult to believe in given that in the first half we had 9.8% ROE and in the second quarter we had more than 14%. Assuming the second point, which is the risk cost rate, to be around 125 basis points for the whole year, this doesn't seem to be a stretch target to achieve. I very much hope that it will actually exceed the 10% visibly. For this, we need a normalization in the risk cost rate, which compared to the first quarter, obviously, already happened in the second quarter. Our expectation is that the second half of the year will be even better in terms of overall risk costs and risk cost rates. Therefore, we can bring down this 173 basis points risk cost rate, which was the first half in 2020, for the whole year.

Volume growth, last time when we talked, I said that we expect around 10%. This is somewhat mitigated here, and we expect somewhat around 7%. It can be somewhat more. I will elaborate on this when we go into the two slides describing the loan volume developments so far.

So, higher than 10% adjusted ROE, 125 basis points risk cost rate and around 7% volume growth.

The other hot topic across Europe has been whether we pay or how much we pay in terms of dividends. What we can say is on the chart, that the management is committed to paying dividends after 2020. In terms of amount, it should be an amount which also compensates for the dividends which we did not pay out after 2019. You may remember that what we originally put aside for dividends for '19 were HUF 69.44 billion. What we say is that this amount plus an amount, which we consider paying for 2020 will be the ultimate suggestion to the AGM next year. The exact amount will obviously depend on our accounting profit, the acquisition opportunities, the economic environment, some forward-looking expectations, and most notably, regulatory and supervisory requirements, because the reason we didn't pay dividend yet after '19 was the fact that it was not allowed by the regulator. So far what we have is a ban on dividend payments until the end of September, but the ECB already extended this until the year-end. We haven't heard about the Hungarian National Bank changing this original guideline or not. We will see what happens in terms of regulatory and supervisory requirements as well.

In terms of our capital strategy or policy, it remains unchanged, basically. This range between 12% and 18% and targeting the mid-point of this range of 15%. There has been one change in the capital requirement: the regulatory minimum was decreased by 2 percentage points for 2020 and 2021, and it will gradually increase in 2022 and 2023. This is the OSII buffer, which went down to 0% from 2%. Therefore our capital requirements decreased and the Tier 1 requirement, which, in our case, is the same as the Common Equity Tier 1 requirement, as we don't have an Additional Tier 1 instrument. It's basically 9.7%. That's the regulatory minimum what we have to meet. Therefore, short to mid-term, maybe the 12% to 15% part of this range, so the lower part of the range is more probable, given that our capital requirements actually decreased by 2 percentage points. That's just a small add-on, a caviar on the fundamentally unchanged capital strategy or capital policy, what we have.

Going a bit more into detail on Page 7, the half year profits. On the cumulative basis, Russia and Slovakia were still negative, but in the second quarter they were already profitable. The good news is that in the second quarter all of our banks have posted positive results. Obviously, we see decline year-on-year due to the more difficult environment what we have. As usual, we go into the P&L lines one by one and look at the cross-section of countries.

On Page 8, we see the total income. The overall quarter-on-quarter change was basically zero and this is the FX unadjusted, and year-on-year without acquisitions it was 3%. The quarterly changes: we have positive improvements in Hungary, Bulgaria and Croatia, and we have negative numbers in Ukraine and Russia, and those two balance each other out. Just a bit more flavor on the composition of the revenues of income.

Net interest income on Page 9. We have remarks for 4 countries here. The first one is the Hungarian OTP Core, where we had 1% increase. This is related to the relatively dynamic volume growth, which is tilted towards retail and within retail to consumer loans, and that resulted in this improvement. In Bulgaria, we had minus 3% quarter-on-quarter. This is related to one regulatory tightening in the second quarter during the special virus situation: penalty interest were banned, so we could not charge penalty interest on the overdue loans. The amount booked in the first quarter for 2 weeks had to be reversed in the second quarter, so it had a negative impact. This is not expected to happen in the third or fourth quarter. This already ended at the end of May, this special time frame.

We had fundamentally negative NII trends in Ukraine and in Russia. In Ukraine, there was a precipitous fall in the rate environment, and therefore margins declined considerably. In Russia, we had a much lower business activity in the second quarter. Since in Russia we have typically short-term consumer loans, this already had a huge impact on the interest-bearing volumes, and therefore, we had lower NII.

These changes, movements you see on Page 10 in more detail. Bulgaria, sharp drop quarter-on-quarter in the net interest margin. As well as in the Ukraine we see a sharply declining trend. If we want to understand the group level change of the net interest margin, which declined from 3.88% to 3.63% by 25 basis points, here you can see the decomposition starting with Bulgaria. This can come back, what we experienced in Bulgaria, as I said, this was more technical. Unfortunately, the others are not going to turn around. All in all, we expect further pressure on margins, basically resulting from typically lower rate environment that we experienced. So the pressure continues, but we don't expect similar level of decline. On a forward-looking basis, the further decline in the margins, if any, should be much less than what we saw in the second quarter, so it should be much less than the 25 basis points what we see here.

In terms of volumes, the second quarter was flat in terms of performing volumes, which we define as Stage 1 and Stage 2. If you look at the countries, there's a huge mix. In some countries, Hungary, Croatia, Serbia, Romania, Albania, we actually witnessed increases. In some countries there is quite a sharp decline, especially in Russia and also in Bulgaria, in Ukraine and in Slovenia. These are the countries where there's either no moratoria or the participation rates are very low, like in Bulgaria. In these countries we typically experienced negative volume trends. This has been exacerbated in Russia by the fact that, again, typically, the portfolio is short-term consumer loan, so changes in new production there results immediately in sharp decline of overall volumes. There's another group of countries, especially Hungary and Serbia, where we have a relatively high participation rate in the moratoriums. In these countries, coupled with Croatia and Romania, we actually see relatively dynamic volume growth in the second quarter, especially mortgages. If we take another view and we look at the product mix in terms of growth, then clearly, it's mortgages where we continue to see growth, and it's consumer loans where we see adjustment - with some exceptions. In Hungary and in Serbia, we continue to see relatively strong growth in consumer loans. In Hungary, it is partially explained by the baby shower loan, which continues. But even without the baby loans we had 5% quarterly growth in cash loans.

Serbia is a country which is the least impacted so far by the virus situation in terms of growth. There we see a relatively strong consumer lending growth.

Mortgages continued to grow. That's very encouraging because it means that people are still optimistic long term. For instance in Hungary, if you compare the first half of this year to last year, there was 27% increase in our disbursements of mortgage loans. That means that people haven't given up on their long-term plans and they're willing to invest long term, actually willing to take a very serious commitment and investment decision. That means that they are fundamentally optimistic and probably look at the situation as a short-term negative and clearly see the mid-to long-term more positively, otherwise they would not commit to taking mortgages and buying new property.

Corporate was also mixed. In corporate we see similar trends: those countries where there is no moratoria there are typically negative numbers and where there's a high participation rate in different moratoria we see flat or somewhat negative numbers.

There's one more information here I would like to share with you: the whole quarter on a group level was 0, so flat, but June was already 1% up. It seems that the volume trend bottomed out somewhere in April, May. In June, we already started to see a growing portfolio, so the monthly growth in June was 1%. That encourages us to believe that the second half of the year will be substantially better. If you look at the monthly or weekly indicators, in terms of new loan disbursements, this is clearly the case. In each country we see an increasing level of new production, starting from April. In April we saw a huge drop, but since then we have been witnessing increase basically in all product segments in all countries. Therefore, we believe that at least 7% growth is what we should see for the whole year. That compares on Page 12 to 2% growth in the first 6 months. If you look at just the first 6 months numbers, we see a similar pattern what we saw on the previous page on a quarterly basis, that where there's no moratoria, or where there is low participation, we rather have negative numbers. Where there is moratoria with higher participation, typically, numbers are more positive.

On Page 13, the following page, you can see the different moratoriums. We try to share with you some background information on the nature of the moratoria and their duration, their timelines. I think the most interesting numbers are in the column on the right side, the participation ratios. Most notably, in Hungary, we have 43%; in household loans it was 53%; and in corporate loans 31% participation rate. This is lower than what we talked about previously. Therefore, the HUF 2 billion release what we saw on Page 2 in the NPV effect. So, it was HUF 2 billion less negative expected impact coming from this.

The other country where we have high participation rate is Serbia. The overall participation rate is 60% there. They expanded the moratorium until end of September, but there's a difference. Originally, interest on accrued interest was allowed, but now it's not allowed. So, they are joining the majority of the other countries, other policies where interest on accrued interest is not allowed.

For the rest of the countries, we have relatively moderate participation rates, which actually goes in line with the fact whether the structure is opt-out or opt-in. In Hungary and in Serbia we have opt-out structures, so our clients have to ask us for not taking the moratoria. Whereas in all the other cases, they have to ask for being in the moratorium. That makes a huge difference.

I'm sure there will be a lot of questions what we expect after these moratoriums and also whether this policy will be lengthened or changed or what to expect for next year. I'm sure there will be some lively discussion around those topics. Fundamentally, we just don't know. We don't know what the regulators will do. We will share with you what we think about the economic environment. If there's a sharp coming back, if the recovery is relatively fast next year, and this is what we expect, then there is clearly no need for extending moratorium regimes for all the clients, for overall, but then banks can easily find the best solution on a client basis. I'm sure all the banks will come up with restructuring programs where they can target exact customers and curtail their programs exactly to their needs. I think that it shouldn't be a big deal. That's the good scenario, right? If, for some reason, and we hope not, but the recessionary environment continues into next year, and we still believe that it's going to be a temporary situation, than maybe an overall moratoria extension with a few more months might be the right solution for a given country. We just don't know yet if this is going to be the case or not - we hope not.

Deposits - we had 2% increase in the second quarter, and this is very typical when in a recessionary environment spending decreases and saving rates increase, and that's what we have seen here. Basically 2% increase in one quarter in deposits. Therefore, our liquidity coverage ratio actually increased to 190%, so almost 200%. The net loan-to-deposit ratio declined to 79%. So, we're quite liquid. If we look at the countries, basically, in Croatia there was a negative number, it’s seasonal, the summer season is typically negative. In Ukraine, the good news is that, those of you who remember what the topics were 10, 12 years ago - one was, for instance, the group funding to Ukraine. This used to be a huge topic. Now the good news is that now Ukraine is a net contributor to the group. So, Ukraine is financing the group, albeit with a small amount. Nevertheless, it's important that we don't have a group exposure there. Russia is also self-funded. The reason that we have lower volumes here in terms of deposits is not because deposits wanted to leave us, it's because we just don't want to pay for excess deposits expensively, while the loan volumes decline.

The year-to-date change was 3% increase, and the second quarter was 2%. The whole 6 months was 3%. That shows that we have an increase in deposits, that is the phenomenon I just referred to.

Leaving NII and decomposition of NII, we've reached into net fee income on Page 16. This is a revenue line, which is potentially the most exposed to the economic environment and the changes of economic activity. This is what we see here that it was minus HUF 3 billion, or 4% minus quarter-on-quarter. Now the reason that it was not less, so the decline was not minus 10% is that we have some technical items in Hungary, and therefore, Hungary was flat. If you read the notes on the right side of the page, you can see that we had HUF 4.1 billion equivalent of one-offs positive quarter-on-quarter. Without those, Hungary would have been minus close to 10%. With some exceptions, all countries contracted here and this is clearly not surprising, given the fact that in most of these countries we had locked down, so people were not transacting. They were not taking consumer loans. Therefore, fee income declined considerably. We very much hope that net fee income bottomed out in the second quarter and that for the third, fourth quarter it will be higher, in line with more intense, more lively economic activity and transactions, ATM withdrawals and so on, and so it should be stronger in the third and fourth quarter than in the second quarter, unless something unexpectedly bad happens.

Page 17 outlines the other income line. We had another technical item, which bolstered revenues in the second quarter, and that is the Visa shares. The accounting treatment of those changed, and now we have to recognize in the P&L if the Visa shares valuation changes. Basically, retrospectively we had to show this number in the P&L, as opposed to directly to capital. The gain is HUF 5.7 billion. This is a one-off item, so it's not going to be repeated. There will be small pluses and minuses probably as the Visa share price changes, but not at this magnitude. The difference between the HUF 9 billion and this HUF 5.7 billion one-off, that's basically trading income, so our treasury people were quite successful in the second quarter and managed to make gains from the high level of volatility what we experienced on markets. That's the reason why we had higher quarter-on-quarter, also fundamentally higher other income level than in the first quarter.

Operating costs increased year-on-year: if we compare the first 6 months to last year, then the FX-adjusted increase was 2.6%. Some of this also includes the COVID situation-related extra expenses, which is around HUF 3 billion across the group, and 2/3 of it actually manifested in Hungary. We have been giving donations to hospitals. Obviously, we had to incur additional costs in order to adopt to the environment and serve our clients and customers in the best way during this period; that somewhat increased especially the second quarter numbers.

The other interesting part is what you see in Bulgaria and in Serbia. These are two countries where we concluded mergers. In Bulgaria, we just finished the merger in the second quarter this year, in May, and you already see on a year-on-year basis minus 1% decline in operational costs. Probably the more interesting is the Serbian line here, where without the new acquisition, where the merger is still ongoing, the cost number was 14% less than last year. This shows the results of the first acquisition. You may remember that in Serbia we have actually acquired two banks: a smaller bank called Vojvodjanska, and a bigger bank from SocGen. This is the impact of merging Vojvodjanska banka into our existing bank there and the cost saving of that was 14%. I'm sure this is another topic you are keen to hear about, the potential cost synergies and cost savings related to acquisitions. Here, you have a good example. If we expand our time horizon, the first acquisition from this series what we have concluded with the SocGen transactions was in Croatia. There, in Croatia we realized 13% cost saving after the merger was done. So, this kind of 13-14% seems to be the case for the Croatian and Serbian acquisitions. Obviously, each situation is different, and it depends on many, many factors, how much we can actually realize as cost synergy, but these are two tangible examples of this.

Where we have had bigger increase in OPEX? It's Romania. In Romania we are executing very aggressive organic growth strategy and that entails hiring more people and spending more money. That's perfectly in line with our strategy there, and it actually bears fruits in terms of increasing market share and quickly growing volumes as well.

As usual, a few highlights about our Hungarian operations, which is still the most dominant and roughly 50% of the total. Without going very much into detail, I think the market share numbers are clearly interesting. In mortgages we continue to increase our market share, and we are actually 1/3 of the market. In the consumer loans we managed to keep up the above 1/3 market share, so 35% share.

The baby loans continue, as I referred to earlier. Obviously, this is a lower and lower number each quarter, given that there's less and less eligible potential clients for this, as they have taken up the program. But it's still quite fundamental and continues to be strong and it will take a while for this to phase out in terms of new volumes.

Corporate. Market share relatively stable between 15% and 16%, and we have been active in the new program of the Central Bank, the Funding for Growth Go scheme, which is the most recent one, which provides liquidity for the banks and low rates for potential clients. As you can see, our participation rate from the very recent program was 23%. It's much higher than our share in total corporate lending, and that shows our commitment and also how fast we managed to react because for some banks, it took much longer to adopt this new structure and we were one of the first banks to participate in this.

That was the part explaining second quarter results and giving some guidance. We have two other parts to discuss. One is the economic environment and our expectations related to the economic environment, and it's Mr. Gergely Tardos who's going to tell us in 8 to 10 minutes what we expect to happen. Please, Gergely, I pass the microphone on, and this strange noise you hear is related to that.

Gergely Tardos, Head of Research

Have a nice day, everyone. I'm Gergely Tardos, Head of Research in OTP Bank. In the next few slides, I will give you some insights about the macroeconomic assumptions used in the provisioning calculations.

On Page 22, you can see the main highlights. First, all countries within OTP universe will face a recession in 2020. About the shape of GDP trajectories, high-frequency indicators suggest that after the very sharp fall at the beginning of the second quarter in economic activity, the recovery has started in May and June, so the recovery is going on. Third, compared to our forecasts we used in the first quarter, our baseline scenario deteriorated modestly in the second quarter, roughly by 1 percentage point on average regarding GDP growth for the year as a whole.

For 2021, now we expect a recession of 1% to 6% in the region with an average just above 4%. This may look somewhat optimistic compared to the consensus, which is, let's say, 1 percentage point lower on average. I will try to give you some hints why we think that our scenario is realistic. But no doubt, risks are tilted somewhat to the downside in 2020, as there is a new wave of infections in many countries, and we see the very sharp recession in Western Europe, which can be a drag on exports. However, for 2021, we expect a growth of, let's say, between 3% to 6%, and 4.5% on average in the region. It's very important that regarding next year we see upward risks, especially in those countries which are the member of the European Union, as next year they can benefit not only from the next EU budget, but also from the funds, from the Recovery and Resilience Facility. You should know that we will update our forecast once the second quarter GDP set will be published.

Regarding risk cost calculations, it must be emphasized that the probability of the negative scenario which we used in these calculations decreased significantly. In our negative scenario, we used 20% annual fall in GDP for the second quarter, which could not be ruled out - let me remind you what happened in France, Spain and Italy. But in the region, based on high-frequency data already published, we can say that the annual fall in GDP in the second quarter could be smaller, much closer to 10% on average. The probability of the negative scenario is also decreased by the fact that there was no capital flight in the region. This led financial conditions to remain loose, and the governments can run higher deficits, the central banks could cut rates and use unconventional measures in many cases. This, on one hand, mitigates the recession, on the other hand, it also supports the recovery.

Finally, about labor market issues. So far, the labor market reaction, the rise in unemployment, was smaller than what we expected. Looking ahead, the labor market relief packages could also mitigate the rise in unemployment.

Going to the next slide, you can see our forecasts for Hungary. We calculate with a 3% fall in GDP for 2020, which can be followed by a bounce back of 4.2% in 2021. For 2020, we see risks on the downside, and for the next year we see upward risks to be stronger. We expect consumption practically to stagnate, but the investment ratio will moderate. Regarding the budget, we expect 4.8% deficit for this year. Risks are for a bit higher deficit because the government does a lot to mitigate the recession pressure. About the unemployment rate, we expect 4.6% on average for this year. The year-to-date number, so the first half of the year is 4.2%, and the last data was 5.1%, but you should know that employment already bottomed out, in June it even started to grow. Looking ahead, we expect stagnating or gradually decreasing unemployment rate in this year.

On the next slide, on Page 24, you can see our forecasts for the major group member countries. In their case we calculated with a recession of 1% to 6%.

Serbia would be the best performer, due to a strong growth momentum based on solid macro foundations and the FDI-related investments in the pipeline. Serbia already published its second quarter GDP data, which was minus 6% year-on-year. It's much better than the expectations, actually 2 percentage points better than expected. It was also hinted by authorities that in June the level of GDP actually reached the level of last year, which led us to be optimistic on Serbia.

The worst performance is expected in Croatia because its very strong dependence on tourism, and in Slovenia because of the very strong ties to Italy. Regarding Croatia, we see also sizable downward risks regarding the GDP trajectory.

On the next few slides, we collected a few statistical and anecdotal evidence supporting the recovery story in these countries. First, Hungary. The strength of domestic demand is reflected in the return in demand for real estate. I've been dealing with real estate for many years, and believe me, that's a very good compass to underlying consumer confidence. It's also important with retail trade in Hungary, just like in Serbia, Romania, Slovenia and Ukraine, gets closer to or even exceeded last year's data. In Hungary we see that domestic tourism is very strong, it's bouncing back: the number of visitors at the main domestic tourist destination, at Lake Balaton exceeded last year's data.

Bulgaria. High-frequency indicators in Bulgaria remained weak, so we feel downward risks, which can be stronger in the case of Bulgaria than in the case of other countries. However, what is a good sign that employment looks to hit the button, and it's also important that the recent business surveys points to a bit rosier picture for the near future.

Croatia: what is surprisingly good that the number of tourists in July reached 61% of last year's data, up from practically 0 in April.

Serbia: I already spoke about the promising within quarter GDP trajectory.

Regarding Russia, the GDP pattern within quarter is very similar, albeit growth rates are lower. But in July, the composite purchasing manager index bounced back above 50, which is the threshold for growth or contraction. Car sales in July exceeded the level we saw last year.

In Ukraine and Romania, what is promising that's the evolution of retail trade, which held up really well. In Romania, the construction sector showed a surprisingly strong resilience. That's it on my side, now I leave the floor to risk-related issues.

György Kiss-Haypál, Chief Risk Officer

Welcome, everybody. This is György Kiss-Haypál, Chief Risk Officer of OTP Bank.

I would like to draw your attention to Page 27. Let me tell you more details about our first half total credit loss of HUF 130 billion. Page 27 shows HUF 116 billion on the top right side. That is the loss provision for loans on book. In the P&L there's an additional HUF 14.2 billion other risk cost, adding up to this HUF 130 billion. Other risk cost include provisions for off-book items and legal risk cost.

Before adding further color on this risk cost number, let me share information on actual portfolio deterioration trends. Our first half 90+ (DPD90+ or more than 90 days past due) loan formation was HUF 83 billion – you can see it on this page in the top left –, the same size as the 2019 total figure. 54% of this amount was realized in May and June, meaning that January-April numbers saw normal trends of 90+ figures, and May in June showed actual COVID impact on our transitions.

As you saw on Page 15, the major OTP countries moratorium participation rates are all lower than 20%, apart from the two opt-out countries, Hungary and Serbia, meaning that portfolios could potentially worsen, and delinquency can appear, accounts can roll, if there is actual portfolio deterioration. This was the case in Russia, Bulgaria and Croatia. All of these resulting from a temporary deterioration on their respective unsecured consumer books. These three countries and our subsidiaries there made up 72% of this HUF 83 billion first half 90+ new volume, with Russia alone taking 40% share of this first half amount.

Corporate books and mortgage books have not yet realized actual 90+ or Stage 3 worsening in general, only DSK and mainly Croatia, being the exceptions. They saw some 90+ increase in corporate. In case of DSK and Russia, we already see improvement in roll rates and collection efficiency. Early roll rates resembling pre-crisis levels already. Croatia has been a bit more difficult this time around in this field.

Pages 28, 29 and 30 reveal the structure and further details on our provision.

Let me break down this HUF 130 billion first half total risk cost for you. We estimate roughly HUF 20 billion of this HUF 130 billion as regular normal expected portfolio deterioration. So, HUF 110 billion is COVID-related, either already realized in 90+, which is actually the minor impact, or forward-looking Stage 1 and Stage 2 reserving, a little bit more than 70% of this HUF 110 billion in the first half. HUF 80-85 billion of this amount, of this HUF 110 billion was booked in 1Q and roughly HUF 25 million was in 2Q. So, 1/4 of this COVID impact was booked in the second quarter and 3 quarters were booked in the first quarter.

The actual composition of this COVID impact actually changed a bit between the quarters.

In the first quarter, majority of the impact came from two sources: one, consumer Stage 1 coverage keys increased, that was one of the key reasons. The second was that substantial share of the corporate book was reclassified to Stage 2, whereas Stage 2 keys also increased slightly, but this formerly mentioned reclassification was the key cause in corporate reserve book-up. This corporate was around 60% responsible for the first quarter increase, and the Stage 1-related non-retail coverage key increases were around 40% responsible for the 1Q COVID impact.

In the second quarter, however, Stage 1 keys themselves did not initiate major reserve book-ups. I refer to the macroeconomic assumptions and scenarios and its weights and also because we allocated now larger shares of the portfolios to Stage 2. The increase of reserving in the second quarter came from the unsecured consumer portfolios, resulting from mainly higher Stage 2 keys and larger Stage 2 volumes; and also higher Stage 3 reserving as a result of higher Stage 3 percentages in Russia, Bulgaria and Croatia. This unsecured consumer risk cost increase was 70% responsible for the second quarter book-up in total. On the other hand, corporate reserving levels in the second quarter were not changing.

OTP has performed a detailed review of its corporate book again in the second quarter, reviewing the industrial distribution, see Page 28, and potential signs for increased credit risk. We have found that our first quarter exercise was adequate, actually removing some of the corporates from the Stage 2 as the actual situation was found healthier. And, although corporate Stage 2 reserve keys were increased in the quarter further, the Stage 2 ratio of the corporate book decreased, leveling out the impact of the key changes altogether.

That was the brief summary of the quarter and the first half changes regarding risk cost composition.

László Bencsik - Chief Financial and Strategic Officer

Thank you György. This concludes the formal part of the presentation and the session. Now I would like to open the floor for questions.

Q&A

Operator

(Operator Instructions) The first question is from Hai Thanh Le Phuong from Concorde Securities.

Hai Thanh Le Phuong - Concorde Securities

Hi, thanks for the detailed presentation. I have two questions on Hungary. The first one would be on NIM. Because if I recall the first quarter, you were rather optimistic on the NIM development also because of the BUBOR. I know that since then, it came back, but it would be helpful, like what is your outlook for second half of the year? That would be my first question. And the second one, touching the moratoria question, as you said, if I understood it correctly, you would expect this to be on a case-by-case basis –rather like an all client moratorium, right?

László Bencsik - Chief Financial and Strategic Officer

Regarding the margin in Hungary, yes, the BUBOR is somewhat lower than we expected when we talked last time, but it is still higher than last year. Probably a flattish margin in Hungary would be the best guess. It can hover around the second quarter numbers.

In terms of moratorium, again, what I said was that it very much depends on the economic environment. If the bounce back is strong, if our macro experts are right and we see a strong comeback next year in terms of GDP, then there's no reason to extend any moratoria. Even in that scenario, we will have to have specific client-to-client restructuring programs. Should the recession linger on longer and be deeper than we expect, then it might be actually a good solution to extend

moratoria. Not necessarily in Hungary, but in other countries where it was set for a shorter period of time.

Operator

The next question is from Simon Nellis, Citigroup.

Simon Nellis - Citigroup

Hi, it's a new era talking here on Zoom. Thanks for the call. Just on the acquisition effect, the almost minus HUF 7 billion, most of that's integration costs, I think. Is that right? And going forward, what number should we expect for ongoing integration costs?

László Bencsik - Chief Financial and Strategic Officer

This goes in line with the integration projects that we have. In the second quarter, we finished the Bulgarian one. It was quite heavy on the Bulgarian side. This is done, so a smaller number will come potentially in the third quarter from Bulgaria. Where we still have ongoing projects, it's Montenegro and Serbia. This is the kind of integration projects expenses, but we have certain other items here, which will stay with us longer, this is basically the amortization of certain badwill elements, which we had to book when taking over these banks. That is going to stay with us longer, but that's a smaller number.

Simon Nellis - Citigroup

Just thinking about this, it'll be a smaller number next quarter, but still a material…

László Bencsik - Chief Financial and Strategic Officer

Yes.

Simon Nellis - Citigroup

… number again, but ongoing. Can you remind us what that regular amortization is? I think it was around HUF 1.5 billion or HUF 2 billion a quarter, is that right?

László Bencsik - Chief Financial and Strategic Officer

It was less than HUF 1 billion in the second quarter.

Simon Nellis - Citigroup

Okay. And then just a question on the dividend. Just so I'm clear on your messaging. You're going to definitely pay out the 2019 proposed dividend, and then maybe something on top of that, depending on the earnings of 2020 and the outlook. Is that fair?

László Bencsik - Chief Financial and Strategic Officer

We have a commitment to pay dividends. We would like to pay more than what was put aside for 2019, and pay a fair amount after 2020 as well. But the overall amount obviously depends on all these factors which we listed. So the environment, the actual profit what we'll make this year, the regulatory and supervisory expectations and so on and so on.

Gábor Kemény - Autonomous Research

This is Gabor Kemény from Autonomous Research. A couple of things. First one is on the net interest income. How do you think about your NII outlook in the second half of the year? You talked about a couple of margin headwinds, which persist in the next few quarters. On the other hand, you see economic activity and loan growth, lending recovering. Is it possible that you will see some NII decline in the next few quarters?

The other question is a follow-up on capital distribution. I understand that you will only decide about the dividend at a later stage next year. How do you think about share buybacks in the meantime? You now have this refined CET1 ratio target. It seems that you have a few capital tailwinds coming through in the second half. How do you think about the leeway to do more buyback?

László Bencsik - Chief Financial and Strategic Officer

In terms of NII, I talked about 2 composites of it: one is the volume, overall we expect 7% growth for this year. In the first half, it was 2%. That means that volume growth should be visible in the second half, that's positive for NII. I said a slight potential further erosion in the margin. I leave you

with this, I mean, to your imagination whether this is somewhat increasing or flat or somewhat decreasing.

Regarding buybacks, we have a very specific approved amount and timeline from the regulator. This is related to our employee share program, the compensation program what we run. We are buying these shares in order to fill up this structure, because we have to actually park the shares there for a considerable amount of time in order for them to be used up for actual compensation policy. There's a definite timeline and a definite amount, on which we have approval from the regulator. We don't disclose this in order not to influence the markets. There's still some potential here. We will continue, but we won't disclose how long and how much.

Operator

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

Anna Marshall - Goldman Sachs

This is Anna Marshall from Goldman Sachs. 2 questions, please. Firstly, on asset quality. Thank you so much for providing the outlook for this year. May I check, what is your initial thinking on the trajectory going forward into 2021, 2022, not specific numbers but just up or down? Also, could you please remind us what is your normalized through-the-cycle cost of risk now, following the changes in group structure due to acquisitions? That was my first topic.

The second topic is on the cost. So you've indicated that you have a slowdown in cost trajectory this year. Could you provide some sort of an indication of how much is related to temporary and automatic factors related to lower activity? How much is some kind of more sustainable decline? Do you plan any medium-term strategies for cost mitigation as a result of this crisis?

László Bencsik - Chief Financial and Strategic Officer

Should our macro forecast materialize, risk cost next year should be less than this year. If we have 4% to 6% GDP growth next year in the countries where we operate, risk cost should be less. That's definite. In this scenario, we expect next year a lower risk cost. We tend to provision in a forward-looking basis and be conservative. Already what we are sitting on has been quite conservative. We don't think that there are hidden holes in our portfolios. We are well covered. So, should the scenarios manifest in a way how we envisaged, we should have less risk cost next year.

The new normal, that's difficult. We are in a volatile environment. So it's not about normal, it's about how deep we go this year and how high we'll be next year. From then on, we will look into a new future and see what's going on.

In terms of costs, there are 2 factors here: one is that we try to realize the synergies after the acquisitions. I elaborated on that in Serbia what we see or in Bulgaria what we see. The other factor is kind of general cost savings potentially, which we're also thinking about and trying to launch new programs to address that question.

Operator

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

Olga Veselova - Bank of America

This is Olga Veselova from Bank of America. I have several questions. Before I ask them, thank you very much for giving us guidance and your detailed answers. My first question is some clarification to the reporting which you made. In the release, you said that credit institutions can use the modified criteria aimed at moderating the consequences of COVID pandemic until the end of 2021 the latest in Hungary. What exactly does this mean for you? I understand that this regulatory change was made just recently at the end of July.

My second question is about cost of risk. I noticed that in some regions, Croatia, Romania, cost of risk came very low in the second quarter, below levels which we wouldn't assume as normalized levels. Was this because you reassessed your macro parameters or did you feel that you overprovisioned in the first quarter? What was behind this material drop in cost of risk in this region?

My third question is about borrowers in Hungary, which used a payment moratorium. Do you have any sense how these borrowers will perform when the moratorium will be over or this is totally

unclear now? Do you make any stress test maybe? Any surveys there? What's your feel on the performance of these borrowers?

László Bencsik - Chief Financial and Strategic Officer

So indeed, the Central Bank came out with guidance on how to treat portfolios in Hungary, but this was not reflected yet in our second quarter numbers. They even came up with a set of macro indicators, which they suggest us to use. This came later than when we closed our books in Hungary, so we have not yet incorporated them.

Cost of risk dropped, yes, in some countries. We were quite aggressive in provisioning in the first quarter, and then we made adjustments in the second quarter, depending on the situation in each country. That resulted in a much lower risk cost. We don't observe material worsening of portfolios, with a few exceptions. There are exceptions in consumer loans in Russia, Bulgaria, to some extent in Croatia, where in April and in May we saw worsening, but June already came back. If you look at the fundamental characteristics of the portfolios, then this is okay. Most of the provisioning in the first and the second quarter was on a forward-looking basis, and in some cases, there was not much required or remaining in the second quarter.

Credit quality of borrowers in Hungary under the moratorium, this is under close inspection, so we do monitor these portfolios. In the case of corporate clients it's easier. We also monitor the retail clients, their account activity and so on and so on. We try to get early indicators of their portfolio quality. So far, we don't see any irregularities or we don't see much impact coming from the overall situation, yet. It's probably too early to say.

The GDP drop doesn't mean that people lost their jobs. In retail this is the most important indicator, the employment level, which tells you how much these clients are at risk. So far not much observed in terms of fundamental worsening, but we keep our eye on these portfolios and follow the trends and provision accordingly. If we see deterioration in portfolios, then we increase provision coverage. We try to react fast to these situations.

Olga Veselova - Bank of America

Could I just come back to your first answer? This modified criteria, will they help you to deliver a better cost of risk than without this criteria? Is this why you guide the drop on cost of risk in the second half? Or this regulation almost doesn't matter because you just follow IFRS 9, not the local regulatory standard?

László Bencsik - Chief Financial and Strategic Officer

We haven't based our guidance on this very specific regulatory guidance. It's IFRS. It creates more room, but this was not the basis of the guidance we have given.

Operator

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

Samuel Goodacre - JPMorgan

It's Sam Goodacre here from JPMorgan. I've got a couple of questions. The first one is about the moratoria programs. Are there any jurisdictions across the portfolio where clients have started to exit these support programs? If so, what are you experiencing in terms of the asset quality trends of those clients who have exited?

Then the other question is about your Hungarian business, and specifically, the fact you are steadily taking share in mortgage new business for the past 3 years now. Can you give us a bit of color as

to what sort of players you are taking share from? What, more broadly, is the competitive dynamic like in that market?

László Bencsik - Chief Financial and Strategic Officer

I answer the second question. The first one I will give to György, Head of Risk.

It's from all over the place. It's not that we have one player losing big market share, and we're taking up. We are getting bits and pieces from everywhere in terms of market share. Related to the ends of moratoria, I give the mic to György to elaborate on this.

György Kiss-Haypál - Chief Risk Officer

Thank you, László. There are people voluntarily removing themselves from the moratoria. The reason why they do that because they actually are conscious of their financial stability and they decide to pay. So, that happens. There was only one case in Serbia where a whole program ended in July. For a month, there was no moratoria in Serbia. Starting from August, there is another one, which is actually an opt-in version for 2 months. Now for 30 days, these people who came out, obviously, we had the opportunity to review them. Our current knowledge of the portfolio for this 30 days that the people were paying almost according to the previous portfolio in this 30 days. So, there was no surprise at all from the people coming out of the moratoria in Serbia.

Samuel Goodacre - JPMorgan

Okay. I did have a third question. In terms of your cost of risk guidance for the remainder of this year, you've obviously said that it will be significantly lower than the first half and sequentially lower than 2Q. The risk cost rate that is left for the third quarter and fourth quarter, do you include, within that outlook, any forward-looking macro assumption changes? Or is the second half all about an actual deterioration or migration through the staging?

László Bencsik - Chief Financial and Strategic Officer

The macro is very technical, right? It's four quarters ahead, that's the window we have to look at. As that window progresses, we are getting better and better quarters, if you look at our macro forecast. If that was your question, just coming from the technical nature of the methodology, what IFRS 9 means, it means that this window is moving and as the window moves more to next year from this year, we see in that window improvement in economic environment, at least that's our forecast. On the other hand, at the same time, we should actually see more and more intrinsic worsening of the portfolio, especially in countries where there's no moratorium or where there's low participation level in moratoria, for instance Bulgaria is such. Therefore, there's an expected underlying worsening of the portfolio. These 2 factors together add up to our forecast for the risk cost for the second half of the year.

Operator

The next question is coming from Mate Nemes from UBS.

Máté Nemes - UBS

I have a question about client behavior, post the lockdowns. In March, April, part of May, clients upped to higher extent digital channels and adapted the situation in general. I'm just wondering if you could talk a little bit about their behavior in June, July? What have you experienced? Did the usage of these digital channels remain at the previous levels or clients started going back to the branches and preferred in-person service?

László Bencsik - Chief Financial and Strategic Officer

That's exactly what happened. We have seen increasing usage of the digital channels. For instance, registrations for SmartBank, which is the mobile application, increased 10% during April, May, compared to the January, February levels. Then afterwards, in June, July, remained higher by 5%, 6%. For instance, in money transfers we saw roughly 20% increase during the lockdown period and roughly 10% increase remained with us. Online utility bill payments increased 4-5 times.

We see this to remain at that level. What happened is that there's a one-off increase in usage of digital channels, and afterwards, there's a change in behavior tilted towards using digital.

Máté Nemes - UBS

A follow-up on this. After the spike the digital channel usage is still elevated. Does that give you perhaps more scope actually to accelerate the medium- or long-term shift towards digital? If you could talk about the cost implications of this?

László Bencsik - Chief Financial and Strategic Officer

Fundamentally, I think the answer is yes. I don't think it's just banking. In every industry, I think there's a strong push towards digital, as customer behavior changes because the customers are forced to use more digital during the lockdown. Therefore, this is quite normal. I'm not sure to which extent it actually results in lower cost because the problem with digital is that it always involves IT and a lot of IT developments, and they are not cheap typically. I wouldn't say that because of higher level of digital, now we are going to experience short-term large cost savings. It means that the arena, the competition for clients shifts more to the digital part. The quality and level of digital services matters even more than it used to. I think that's important. It opens up new avenues and makes participants even more aware of the importance of digital developments, and I think it means that we have to spend even more in digital developments in order to stay in the forefront of competition. So, yes, the trend is clear, and it has been accelerated. I don't think this is going to result in short-term cost savings.

Operator

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

Robert Brzoza - PKO Securities

This is Robert Brzoza from PKO BP Securities. I have one question regarding the outlook for lending in Russia because what we have seen was a significant decline in the loan book outstanding in Russia. My question is about your risk-taking attitude there because the household lending continued to go on pretty well. How much of the decline was due to your own decision to refrain from granting loans and how much was due to the circumstances? I mean, shopping malls closures, etc. And what would be your expectations now for the point of sales lending? Would it bounce back sharply once the spending and economy normalizes? So please, if you could provide more detail on the outlook for lending there.

László Bencsik - Chief Financial and Strategic Officer

The answer is yes. It's bouncing back, and it has been due to technicalities. Point of sales loan selling points were closed. Obviously, we also rethought our risk criterion and have some tightening, but it was basically due to the nature of the situation there that we could not sell POS loans, and there was no demand. That demand has come back and it's ongoing, so we have it. So yes, we expect the Russian operation to bounce back.

Operator

(Operator Instructions) As there are no further questions, I hand back to the speakers.

László Bencsik - Chief Financial and Strategic Officer

Thank you very much. Thank you for participating in this conference call. Thank you for the very good questions. I wish you all the best. We are still amidst difficult times, and I'm sure you all are trying to cope with them wherever you are. I wish you good health. Hopefully, a nice vacation for the remaining part of the summer. Then we will hopefully see you back or hear you back when we have the next interim report on the 6th of November. So, that's going to be the next reporting day. Until then, good luck, all the best. Bye-bye. Thank you.

Operator

Thank you for your attendance. The second quarter 2020 conference call has been concluded. You may disconnect.

Note: unabridged transcript with minor English stylistic corrections.