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PRESENTATION

Editor

Presentation

Operator

The call now resumed. I would now like to hand over to Paul Formanko.

Paul Formanko *- JP Morgan - Analyst*

Good afternoon. Sorry; there seemed to be some technical problems. We'll resume the call. Could we try again? Laszlo, over to you.

Laszlo Bencsik *- OTP Bank - CFO*

So if I understand it, you had some technical problems and I was not heard at all. So my understanding that I have to start again from the beginning, right?

Paul Formanko *- JP Morgan - Analyst*

Yes.

Laszlo Bencsik *- OTP Bank - CFO*

Okay. Sorry for the technical inconvenience. The voice quality will be better. And please interrupt me whenever you feel that the quality is declining again, I restart the whole presentation again. So those who have not heard me, sorry for this delay. And those who heard me, sorry for this technical glitch and you probably have to suffer my presentation again from the very beginning.

So, thank you for joining us. Good afternoon and good morning, depending where you are, and thank you for joining the OTP Group second quarter conference call. We have the presentation available on the website and I hope you have been able to download it.

Now starting the presentation on page 2, we have a summary of the second quarter results. As you can see, we have a long list of one-off items and the impact of these items is actually quite substantial; altogether, HUF 192.1 billion minus. And the other part is the underlying -- business as usual performance, which was HUF 39 billion plus. And these together represent HUF 153.1 billion accounting loss in the second quarter.

If we go one by one through the list of the adjustments, then the first one is the goodwill write-off, which we did in the second quarter. We wrote off the entire goodwill related to Ukraine. The total goodwill was HUF 27.6 billion. Here you can only see HUF 11.6 billion, so that was the after-tax impact in the P&L. We had roughly HUF 10 billion tax shield. The reason it was so big is that the goodwill according to local accounting standards was bigger, therefore the tax shield on this was bigger as well. Plus part of the goodwill, HUF 5.3 billion write-off was accounted for in the capital. This actually means that the improvement in the capital ratios which we calculate was equitable to the tax shield which we have recognized.

The second point in this list is the impact of the consolidation of the bank which we acquired in Croatia. This is Banco Popolare Croatia. And what you see here is the badwill, a tax shield which was not previously accounted for and some expected costs related to the consolidation of the bank in terms of IT.

And then the biggest item here is the potential losses related to the new developments in the household retail loans in Hungary, namely the Supreme Court's decision and the related Act which was approved by the Parliament and this has two impacts. One is that the previously applied FX margins were considered invalid and, therefore, we have a potential loss coming from this.

And the other one is that the Act, the law, assumed the presumed unfairness of the unilateral amendments of loan contracts. And here we provision the maximum potential loss, so this is an extreme bad scenario, if you wish. There's some hope that the final loss will be lower than that but, being honest, it's also possible that the whole loss, whole potential loss we accounted here will actually manifest at the end.

And finally, there is one item. It's related to Crimea and the exposures we have in Crimea. Obviously, due to the developments there, we had to cease operations in that part of Ukraine and we lost the volumes and we lost our legal and technical ability to collect these loans. Therefore, with the exception of two corporate exposures we provisioned for the full amount of these loans. There's still a chance to recover some of this loss by selling these exposures to third parties. But again, here we took a conservative approach and we provisioned basically entirely for those loans where we lost contact with the clients.

On this page you can see some more kind of less regular items, as well. One -- mainly and most importantly, the result of the treasury shares swap agreement in the second quarter, which was HUF 3.3 billion positive. This is coming from the OTP-MOL share swap and basically we receive each year in a second quarter dividend for the MOL shares what we keep in our books.

And that leads us to the pretax profit without one-off items, which was HUF 45.9 billion in the second quarter, and that means a 17% improvement compared to the first quarter.

Next we go in more detail into this number. And then on page 3 you can see the overall P&L, consolidated and the Core, and you can see the elements of this improved quarterly performance. Basically operating profits slightly improved with more or less stable revenues and more or less stable costs on a quarterly basis. However, within the revenues you can see net interest income somewhat declining and other non-interest income increasing.

The first one, the reasons behind is mostly the depreciation of hryvnia and ruble compared to the forint. And the second one, the other non-interest income increase, is partially due to FX gains and partially due to securities gains. Most of the securities gains stem from our Hungarian operation where we realized some gains on the government bond portfolio. And also, we increased our holding of government bonds as opposed to National Bank deposits, and short-term papers for that had a positive impact as well.

Operating costs were flat and year-on-year declined on a quarterly and first half basis as well. This reflects our efforts to control costs, but also the result of the same weakening of the hryvnia and the ruble versus the HUF and, therefore, the impact of FX changes.

Risk cost were slightly better than in the first quarter. But again, this number is without the extra provisioning we had to make in the Crimea. If we add that onto this number, then we pretty much have a close number of the first quarter.

Now in Hungary OTP Core pretax profit without one-off items quarter on quarter decreased somewhat. And if you look into the content of this, then we can see that the operating profit slightly increased due to some increase in revenues. As you can see here the other non-interest income improved in Hungary. That was the primary driver. And somewhat higher risk costs in the second quarter than in the first quarter. But again, the first quarter was actually quite low.

Now, on page 4 you can see the most important indicators across the board. Total income margin in the Group level was 8.3%, flat quarter on quarter. Net interest margin declined somewhat again. This is primarily related to the Ukrainian margin being compressed. Volume-wise, 0.2% increase in total loans during the second quarter and 1.4% increase in deposits.

Risk indicators: unfortunately, the portfolio deterioration increased in the second quarter; again, primarily due to the Ukraine and the increasing deterioration there. Coverage was flat and risk cost rate stood at 3.3%.

On page 5 we tried to list the most important kind of events, so to say, during the second quarter, the first one being this extraordinary provisioning we had to make for the potential losses coming from the supreme court decisions and from the Act related to the Supreme Court decision.

Briefly summarizing the Supreme Court decisions, there were three parts of it. The first one was actually positive for the banks. That said that FX loans themselves were valid and it was the right thing to do or it was according to the law to pass on FX exchange risk to customers. So therefore, FX loans as such are valid. This can only be challenged on the court by customers if they can prove that they were misguided or not informed properly when the banks sold these loans.

The second decision of the Supreme Court was, on the other hand, negative. And that is about the unilateral changes of contractual conditions which were written in the contracts and there are actual list under what scenarios the banks could change the conditions of these loans. But apparently, the Supreme Court now came up with new requirements under which these contractual changes can be regarded as fair. And this technically means that they want to see a formula, a function, a mathematical link between the changing conditions, the variables and the contractual conditions.

Now this is an assumption only by the Supreme Court and this is an assumption only within the Act, which followed that the banks were unfair in doing so. This can be challenged on the court so we are trying to challenge this assumption and there will be a filing to the court. It's actually going to happen next week and the court procedure will be an accelerated one. And the schedule which the government set up envisages that by the end of the year these court procedures should end and then we should know whether our contracts are fair or unfair regarding the changes of conditions.

Now, the third element of the Supreme Court decision was related to the FX margins which all the banks applied in Hungary when the customers repaid or serve the FX loans and the Supreme Court ruled against them. So all these margins and the related revenues to the banks were regarded as invalid and cancelled, therefore, these have to be repaid for sure to customers.

Now, there are two technical issues which substantially and materially impact the potential loss to the banks. One is the statute of limitation which is, according to the Hungarian law, 5 years. Now apparently within this Act the Parliament extended or overruled the 5-year statute of limitation stipulated in the Civil Code and extended it to 2004, May 1st, when Hungary joined the EU.

Now the other question here is, in terms of technical question of calculation, is how these overpayments by the customers are treated. There are two potential technical treatments. One is that it was an overpayment and therefore the banks had an illegal use of funds and so the banks have to pay this back to customers. And the amount which is to be paid back is the amount due at inception plus the base rate.

And the second interpretation is that these overpayments must be regarded as principal prepayments at the times when they occurred. Now, apparently the second interpretation results in a much higher number. And if you compared it to announcements what we have made, the difference in the expected or potential losses is due to this different calculation methodology. Because in the meantime, the National Bank of Hungary published its own the recommendation for the calculation and the recommendation included the second methodology, namely the principal prepayment. And therefore, we adjusted the potential worst case scenario to these numbers and that's what we have today in our numbers and that's what we have communicated on Monday.

Now, obviously the bank disagrees with these points and we are taking all possible legal action to defend our position. We are filing a case to the court regarding the fairness of the conditional changes which were made related to these loans and we are exploring potential ways to approach the Constitutional Court and also EU-level bodies to try to seek remedy for these losses.

Now, the other items on this page is -- I've already talked about the Ukraine and goodwill impairment but also, unfortunately, regarding Ukraine there's another announcement we have to make. On the previous conference call we indicated that the management expectation was overall HUF 20 billion of loss for this year coming from Ukraine. Now in the first 6 months we almost reached this amount and now we believe that it's unlikely that for the rest of the year we actually turn into a profitable operation in Ukraine. Further losses are anticipated during the third and fourth quarter and, therefore, our current guidance is that altogether, including the extraordinary provisions, the one-off provisions we had to make in the Crimea, the cumulative loss for this year would be closer to HUF 30 billion than to HUF 20 billion.

The two other items on this page is the Banco Popolare acquisition I briefly talked about. And we have recently made another acquisition of a smaller bank in Romania and that's the Millennium Bank Romanian operation. I will touch up on these topics later on during the presentation.

So, these were the kind of overall remarks and parts of the presentation, and now just the longer part. Due to the technical problem, we lost almost half an hour from the presentation. And I'm sure you are pressed by time, therefore, I try to be very selective and focus only on the most important factors.

So page 6 you can see the capital adequacy. The common equity Tier 1 ratio Group level dropped down to 14.2% and the capital adequacy ratio declined to 17.8%. Both of them are well above regulatory minimum standards and above our peers in Hungary, as well in the regions. We still feel quite comfortable about these numbers. And as you can see in each country, according to local regulations we are above the local requirements.

On page 7 you can see our liquidity position. It hasn't changed much. There hasn't been a major change on that front.

On page 8 you can see the breakdown of the consolidated adjusted after-tax profit by Group member. And if you go line by line, basically Hungary is reasonably stable. Some decline due to higher risk costs I previously mentioned. Bulgaria is still very strong. Again, somewhat higher risk costs here, but overall a very strong and solid performance.

That's also true for the rest of the Group in the CEE region. Romania did very well. Croatia remained positive. Slovakia is doing fine. And in case of Serbia and Montenegro as well, the cumulative profit so far have been positive. So, one can see an overall good performance in the CEE countries, which obviously reflects the mostly improving economic environment in these countries. With the exception of Croatia, GDP is growing in each country and we see better operational environments.

On the other hand, for two countries Russia and Ukraine this can't be said at the moment, in both countries we posted losses. In Russia the losses moderated to quite an extent. As previously indicated, we expect further improvements here. So quarter by quarter we expect improvement regarding our Russian numbers and, therefore, hopefully in the coming quarters the loss will be less and less and then finally we can turn this operation into profitability.

Now, in Ukraine, the loss was lower than in the first quarter. But having said that, it's worth mentioning that, again, this doesn't include the Crimean provisioning we had to make. Obviously, we hope that such an event won't repeat itself in history so no further parts of Ukraine will be lost for us in terms of our banking clients. But the underlying trend improved here as well. So after the quite sizeable losses related to the underlying business, losses were lower in the second quarter. Nevertheless, the situation is not easy and I will briefly talk about this later.

On page 9 you can see the total income split; again, country by country. And the most important -- the biggest change quarter on quarter and year on year, by the way, was in Russia and in Ukraine. In Russia and Ukraine part of the change came from the depreciation of the currency versus the HUF. You also have here the appropriate numbers in local currencies, so in ruble and in hryvnia. In ruble terms, actually there was no decline in total income in Russia. And in hryvnia terms, actually there was an improvement in Ukraine, i.e. an increase. Therefore, you have to take the currency impact into consideration.

In case of Croatia, obviously the impact of the consolidation of this new entity which we acquired is visible, but you can also see here the standalone numbers without consolidation.

There was strong improvement, especially year on year in Bulgaria where we managed to increase margins by lowering the cost of funds in general and especially in deposits. And there's a strong development going on in Slovakia and Romania and also in Serbia. In all of these cases we have improving margins and, in Slovakia, improving volumes as well.

On page 10 you can see the net interest income dynamics. It pretty much reflects what you could see in the total income. We have decline in Russia and in Ukraine and the Ukrainian decline is especially apparent quarter on quarter. Most of it can be explained by the FX rate weakening and most of the remaining part can be explained by higher cost of funding. Obviously in these stressed times, we have to pay higher interest rates for deposits and that is reflected in our cost of funding numbers.

On page 11, again, this is reflected in the margins. So in line with the net interest income decline, there was a declining margin in Ukraine.

Page 12, the net loan-to-deposit ratio, it actually dropped down to 87%. So the previous declining trend continued in the second quarter this year.

On page 13 you can see the overall changes in loan volumes. These are FX-adjusted changes of the gross loan volumes. Quarterly there was no change, so basically flat. And within this, the consumer and mortgage volume decline continued in Hungary despite a fact which I will show you later that new origination and new demand actually is picking up, but is still not enough to compensate for the repayment of the existing portfolios.

Russia, the gross portfolio is still growing. The net portfolio is not growing. And in Ukraine, unfortunately, you can see the results of this difficult situation what we have in the country now. We obviously cut back on the new origination of consumer loans. Mortgages continue to amortize and corporate lending was lower as well than in previous quarters. Here obviously we became very cautious in extending new loans. You can see the impact of the acquisition in Croatia here. Again, you see two numbers; one with consolidation and one without consolidation, so only the standalone numbers.

Consumer lending continues to be strong in Romania, Slovakia and Serbia. And DSK managed to improve by 1% on a quarterly basis. Corporate exposure grew by 2%. We hope that the corporate growth here will continue in the future. We have invested quite heavily during the last 1.5 years to improve our corporate services organization skills and value proposition, so hopefully it will be reflected in the results from now on.

Deposits on page 14. There were two developments, negative developments during the first quarter of this year if you remember it. In Russia and Ukraine, both of these countries deposits declined in line with the negative mood in these countries. In Russia this decline stopped and in the retail segment we started to see a growth in deposit volumes, whereas in Ukraine the trend turned around completely and, actually, we regained more deposits than what we lost during the first quarter.

Page 15 the overall cost developments at Group level and country by country. Year on year, overall 4% decline. 1% decline in Hungary, some growth in Bulgaria and a considerable decline in Russia and Ukraine. But again, this is due to the weaker currencies of these countries. If you look at local currency terms numbers in Russia and in Ukraine, there was a growth 6% in Russia and 3% in Ukraine, respectively.

Now, here we take our usual detour and a little bit dig into some specific markets and we start with Hungary. On page 16 you can see the macro highlights and this is actually a very, very positive number what we saw yesterday. The year-on-year GDP growth was 3.9%. The number came out yesterday. This is, by the way, the highest GDP growth rate across the European Union. This growth is based on a very fast growing industrial production, which is obviously driven mostly by car manufacturing, but other segments contributed, too.

Investments increased. Again, this is strongly driven by government sector investments. But the very good news is that consumption started to expand, 1.5% annual growth after many years of declining consumption, so we expect actually a 2% consumption growth for this year. So overall a very positive development on the macro front in Hungary, which is actually quite promising for future prospects in the country in terms of our banking activity.

On page 17, you can see some of the highlights and most important numbers describing our activities in Hungary. And I think the most important here is what you can see in the left upper corner, 37% growth in new applications for mortgages and 27% growth in disbursements in the second Q compared to last year. Obviously the basis is quite low from where we started from. Nevertheless, this is a very clear and obvious indication of the trend turning around and from now on we should continue to expect a dynamically growing demand for new mortgages. Consumer lending as well started to revitalize on the overall market, as well in our numbers.

On the retail side, the retail savings market share of OTP Group increased. We are quite happy about this development and this is clearly on the strategic agenda of the bank to try to increase our market share. As opposed to many years of declining market share in this segment, we managed to turn that trend around a few years ago and that continues to increase. Likewise in corporate lending, our market share continued to increase and year on year we continue to increase our loan volumes to Hungarian corporate clients. The increase was 6% year-on-year.

Now, on page 18 there are further details related to these numbers and, starting from page 19 we have basically four slides related to our Russian bank.

On page 19 you can see the volume developments. POS volumes started to decline. That's in line with the market trends. Credit cards continue to grow; again, this is in line with the market, and cash loans continue to grow as well.

And the last item, in cash loans during the second quarter we cut somewhat back the growth rate because we were not happy with the underlying portfolio quality. So here, actually we expect for the rest of the year a more moderate growth.

On page 20, that's our usual comparison with our peers with similar profile in Russia. Unfortunately, we don't have really fresh numbers from them, so we can only compare the volume dynamics to our peers. And as you can see, our 5% growth is in line with most of the players. Only Tinkoff continued to grow quite aggressively during the year, finishing the second in this quarter, but their recent growth as well moderated down so their performance more represents the growth there during the end of last year.

Risk cost rate, it slightly improved in Russia, but still quite high and we actually presume that most of our peers continue to have similar problems in terms of their risk indicators and risk profile.

On page 21 you can see the new originations, the new disbursements in consumer loans. The good news is that in POS we managed to improve from the first quarter to the second quarter. And this is the product segment where we are actually getting more comfortable with the level of risk with what we have and the profitability of this portfolio. So the goal here is to actually cut back sales and, at the same time, not make the portfolio quality worse.

In credit cards there was some increase and the cash loan was quite strong. But again, as I've said, we are cutting back on cash loan sales. So here in the next two remaining quarters this year we'll see lower numbers. And then there's also information about deposits. As I said, deposit decline stopped and that's due to the increase in local retail deposits. Funds or deposits started to grow and this is obviously the type of funding we really need in ruble and we primarily rely on retail.

On page 22 you can see the risk cost rates regarding our three main products in Russia, and the coverage ratios as well.

As you can see, in POS loans we have seen moderation, which is in line with our expectations. And actually, further moderation and improvement is expected for the remaining part of the year. And we hope that actually this ratio will drop below 10% soon.

Now, the good news unfortunately ends here because in credit cards and in cash loans there have not been similar positive developments. So these are still portfolios where the profitability is questionable and the risk cost rates are higher than what we are aiming for.

Now, the guidance we've previously made was, regarding Russia, that we expect quarterly improvement in our Russian bank's performance. This I'd like to reiterate or reassure we still do that. We still expect improvement on a quarterly basis in terms of our Russian bank's performance. The only thing which can change that is a shift in the overall economic environment and in the credit worthiness of our clients and that's more related to the macro developments in Russia. But if nothing kind of extraordinary happens or if no kind of further negative developments start on the market, then we believe that this improvement will continue primarily due to the expected improvements in POS loans.

Ukraine; I think apart from the lower revenues which I tried to explain before, I already talked about increasing deposits. And on page 24 you can see our exposures in three regions of the country which are most exposed to the recent problems. The first one is Crimea which, again, from our perspective is lost. So we stopped operating there. We ceased every operation and we provisioned accordingly. We only have two corporate clients from this region with whom we have other relationships in other parts of the country, so these are the ones which continue to be part of the net volume, so the non-provisioned part of the volumes. The rest we provisioned 100%.

In Donetsk and Luhansk, the other two parts of the country where there are substantial difficulties at the moment, we have to suspend operations in 13 out of 17 branches. Obviously we don't risk the personal safety of our customers and employees. And in these locations we could not assure their safety, therefore, we suspended the operations in these branches. In the remaining open branches business is as usual, except the fact that we stopped extending new loans in these two regions in Ukraine. I've already talked about our kind of changing forecast regarding Ukraine.

Page 25 you can see a few details regarding the acquisition we made in Croatia. This was already announced in February, if I remember right. We bought a small bank for EUR 14 million. The price book value was 0.3 and we acquired an entity with 34 branches. It used to be the number 14th on the market. And what we gained from this is obviously an increase in our operating size and so we got closer to the ideal operating size in the country. Plus the coverage of these two banks are quite complementary. Whereas OTP Croatia is strong on the coast of Adriatic side, Banco Popolare is much stronger in the capital and in the northern and eastern parts of the country. So therefore, these two networks, combining them we actually can realize quite synergies and also enhanced level of service for our customers.

Now, a similar strategic move we made in Romania recently. On the 30th of July we agreed on the acquisition of Millennium Bank Romania and the price here is EUR 39 million and the price of book value was 0.5. The rationale was similar, getting us closer to an optimal level of operational size and enhancing our coverage of the country and getting stronger in the capital and in the parts of the country where our penetration used to be lower. And by acquiring this bank both of these targets have been fulfilled. This bank, the acquisition here hasn't been consolidated yet so you don't find it in our financial statements. We expect to close the transaction and obtain all the legal and regulatory approvals during the course of this year. And the plan is to fully consolidate this entity by the end of this year 2014.

Now, ending this short detour and going back to the Group level cross-section numbers, we finish as usual with the risk cost and portfolio quality information. Unfortunately, portfolio deterioration accelerated it in the second quarter. As you can see, it was HUF 75 billion as opposed to HUF 69 billion in the first quarter. And as you remember, out of the HUF 69 billion there was one big exposure in Hungary which we already preannounced in 2013. So certainly the HUF 75 billion is higher than the previous quarters. And certainly this is opposite to the previously declining trend.

In the next page you can see why this happened and the composition of this number. Not surprisingly, the two drivers behind this high number were Russia and Ukraine. Russia remains high, actually even increased somewhat compared to the first quarter. But it's not a very different number, actually, from the first quarter, so there the change was not that significant.

On the other hand, in Ukraine the change was material. Instead of the previous HUF 2 billion or HUF 3 billion deterioration levels, the deterioration there was HUF 18 billion. And obviously, this is due to the difficult economic conditions overall in Ukraine. And the forecasts for the GDP decline range between 5% to 7% this year. So obviously, the economic conditions across the country are not very conducive to making banking business there, but especially in the Eastern part it's even more difficult.

Probably worth mentioning that we continue our lending activities overall in Ukraine, in corporate and in case of POS loans. We in fact stopped selling new personal loans in May. We are about to consider restarting it, obviously with the warranted caution which should be there.

For the rest of the Group, actually the numbers are not very different from previous quarters. There's one exception in Croatia, but there are no kind of varying developments in any of these countries apart from Russia and Ukraine.

And then in the remaining phases you see further details on portfolio quality. What might be interesting is page 31. For a while we haven't talked a lot about restructuring, but now again it's started in Ukraine. So as you can see, in Ukraine the retail portfolio restructuring started increasing. That's a similar story what happened in 2009 and 2010. So we try to provide help for those customers who are primarily exposed to FX rate changes and we try to save them from default by doing some restructuring. So, you can expect this to continue to increase in the coming quarters.

So, that was the presentation. And again, sorry for this technical problem which occurred and therefore I had to make so much shorter the overall presentation. But now please ask your questions. So, operator, please open the floor for the Q&A session.

QUESTION AND ANSWER

Operator

(Operator Instructions) Pawel Dziedzic, Goldman Sachs.

Pawel Dziedzic - ***Goldman Sachs & Co. - Analyst***

Good afternoon and thank you for the presentation. Just two short questions from my side, and both on the extraordinary measures being introduced in Hungary. So, the first one related to the impact of the retrospective revision of loan spreads. You mentioned that level of the provisions taken this quarter covers OTP more or less in a worst case scenario when it comes to potential refund to customers for their historical interest payments. But can you perhaps clarify what impact do you now expect these measures to have on your NII and net interest margins going forward?

And the second question is on pending revaluation of FX loans. You haven't mentioned that in your presentation, but do you have any more clarity at this stage about the timeline for this process and potential haircuts and capital implications? Thank you.

Laszlo Bencsik - ***OTP Bank - CFO***

Now the first one, in case of the FX mortgages, the ongoing annual impact of the reduced interest rates will be HUF 7.4 billion. So, that is the first question.

The second question was the conversion impact, right? That was your question earlier?

Pawel Dziedzic - ***Goldman Sachs & Co. - Analyst***

That's correct. If you can update us on the latest developments.

Laszlo Bencsik - ***OTP Bank - CFO***

First of all, it's not sure that it's going to happen. So far we have heard different views from the government. They seem to be for doing it, but under which terms it's completely unclear. We don't expect further losses coming from this. It might be due to being too optimistic, but you have to consider two things. One is that the level of loss which the banking sector has to digest or adjust to coming from the already known measures, is considerable. I mean if everything, i.e. the banking sector level loss corresponding to our loss, which we reported today, this HUF 217 billion pretax loss translates to above HUF 900 billion or to around HUF 950 billion for the sector. That's one-third of the capital of the banking sector in Hungary. So first of all, imposing further losses on top of this would be problematic at least, I would say.

The second point is that, as I explained, the Supreme Court actually had three rulings and the first one was positive for the banks, because they said that FX mortgage loans as such were rightful. And the fact that the customers have to bear the entire FX risk was right to do. And actually, this comes from the nature of the FX loans. And the lower interest rates in FX loans compared to the HUF loans, compensated for this. So that was the price they had to pay or they received for it taking on the FX risk of customers.

Now we have a Supreme Court ruling that imposing FX exposure and risk on retail customers is rightful and valid. So to go against this, I mean taking away part of this FX risk of customers would actually constitute a decision going against the Supreme Court ruling. It's not impossible, but I think it would be – well I am not a legal expert, but we believe that this would be a difficult decision to make.

Pawel Dziedzic - ***Goldman Sachs & Co. - Analyst***

Can I just clarify one thing? Would you say you don't expect the haircuts to happen, but do you still expect the conversion to happen from FX into HUF and would that have any implications, for instance for capital for risk-weighted assets?

Laszlo Bencsik - ***OTP Bank - CFO***

It would have an implication in the ICAAP, in the Pillar II. We are under standard methodology. And in the first pillar of the standard methodology, there is no difference between local currency and FX currency retail exposures. Having said that, there is a big difference under the second pillar under the ICAAP SREP capital requirement, so there would be indeed an impact.

Other than that, obviously the question -- if conversion happens and there's no haircut, the question is what the margin of these HUF loans would be for the future and how would they compare to the lower margins on the FX loans what we would have otherwise?

Now again, this was not decided yet. So there hasn't been a decision on conversion and there hasn't been a decision on the haircuts either, if at all there is. This will come potentially during the rest of the year. When the first Act was decided by the Parliament, they said that there was a second Act to come somewhere in September/October which is supposed to detail the calculation and operational details of how to compensate clients and how to calculate the compensation levels to clients. And then the court procedures will finish potentially by the end of November or early December and then I think final decision will only be made somewhere at the end of the year.

Pawel Dziedzic - ***Goldman Sachs & Co. - Analyst***

That's very helpful. Thank you very much.

Laszlo Bencsik - ***OTP Bank - CFO***

Thank you.

Operator

Gabor Kemeny, Autonomous Research.

Gabor Kemeny - ***Autonomous Research - Analyst***

Hi, it's Gabor. Firstly, I have a follow-up question on FX loan losses. So, when you say that the recurring impact of these measures could be HUF 7.5 billion, I guess you do not assume a lower level of principal.

Laszlo Bencsik - ***OTP Bank - CFO***

No.

Gabor Kemeny - ***Autonomous Research - Analyst***

But I mean, even if there is no additional haircuts upon the conversion, the principal could and would probably be lowered by the amount of compensation. So I mean, if I deduct up to HUF 200 billion from the principal of your FX loans, there's an additional hit to your NII going forward. Is that fair?

Laszlo Bencsik - ***OTP Bank - CFO***

If you assume that it's going to reduce the principal, which is again, haven't been decided yet, it's only going to be principal reduction in case of the FX spread because, there, the methodology was already published, as we have to calculate the impact of that as an early repayment. But nothing has been said related to the unilateral changes and conditions.

Having said that, if we have to apply the same for the FX mortgages in its entirety and then it reduces the principal, then there's another HUF 2.5 billion related to the FX mortgages. Now, having said that, not the entire HUF 217 billion is FX related and not all of them is FX mortgage related, by the way.

Gabor Kemeny - ***Autonomous Research - Analyst***

So you're saying additional HUF 2.5 billion.

Laszlo Bencsik - ***OTP Bank - CFO***

Yes. So altogether, the FX mortgage net interest income would decrease by HUF 10 billion annually if this extreme worst case scenario would manifest and we had to reduce the forward-looking conditions of these contracts plus the repayment which we have to do to customers would happen as a principal repayment.

Gabor Kemeny - ***Autonomous Research - Analyst***

All right, that's very helpful. And then on Russia, you said that you've scaled back cash loan disbursements. And I guess that the overall environment is now more challenging than in the first half of the year. So how should we think about loan growth in the second half? I mean what growth rate would you expect here in growth terms?

Laszlo Bencsik - ***OTP Bank - CFO***

I mean, overall guidance for this year was basically stable, flat volumes in Russia. Now, the fact that you see gross volumes growing doesn't mean that net volumes are growing.

Gabor Kemeny - ***Autonomous Research - Analyst***

Sure.

Laszlo Bencsik - ***OTP Bank - CFO***

Performing volumes during the year should stay flat, more or less.

Gabor Kemeny - ***Autonomous Research - Analyst***

Sorry, performing you said?

Laszlo Bencsik *- OTP Bank - CFO*

Yes. Or net.

Gabor Kemeny *- Autonomous Research - Analyst*

By net you mean performing?

Laszlo Bencsik *- OTP Bank - CFO*

I mean net is quite close.

Gabor Kemeny *- Autonomous Research - Analyst*

Okay.

Laszlo Bencsik *- OTP Bank - CFO*

The net volume should stay flat.

Gabor Kemeny *- Autonomous Research - Analyst*

That's very clear. And maybe I missed something, but have you stopped disclosing the metrics on collection efficiency in Russia?

Laszlo Bencsik *- OTP Bank - CFO*

Probably we didn't include here. We actually are working on a better kind of measures than that. Basically, according to these measures the soft collection efficiency declined and hard collection efficiency improved. So I mean the soft collection melted down to 86% and the hard collection went up to 71%.

Gabor Kemeny *- Autonomous Research - Analyst*

Okay, that's very helpful.

Laszlo Bencsik *- OTP Bank - CFO*

Sure.

Gabor Kemeny *- Autonomous Research - Analyst*

Thanks very much.

Operator

Margarita Streltses, UBS.

Margarita Streltses - ***UBS - Analyst***

Hi. Thank you very much for the presentation. First of all, I wanted some clarification on this badwill adjustment for the acquisition. Is this the positive amount? Is it adjustment for tax shield for badwill? Or just the positive impact of the badwill?

Laszlo Bencsik - ***OTP Bank - CFO***

The tax shield was HUF 0.9 billion. The rest is the badwill minus, I think, HUF 400 million, which was the expected cost of the IT consolidation.

Margarita Streltses - ***UBS - Analyst***

No, but this HUF 3.6 billion that we see, is it the adjustment for the badwill?

Laszlo Bencsik - ***OTP Bank - CFO***

I see HUF 4.1 billion here.

Margarita Streltses - ***UBS - Analyst***

Yes, yes, yes.

Laszlo Bencsik - ***OTP Bank - CFO***

Yes. And out of this HUF 0.9 billion was the tax shield. The rest was the badwill minus HUF 400 million.

Margarita Streltses - ***UBS - Analyst***

Okay. And how -- basically, what made you confident enough to book the benefit from the badwill? Because obviously, there was a badwill. That probably was there for a reason. Is that a fair assumption? Is there anything changed that you could adjust for this or is it just the normal practice?

Laszlo Bencsik - ***OTP Bank - CFO***

It's a normal accounting practice. I mean, we had to assess the asset value, the net asset value. And then -- I mean the price you pay for an entity and the actual book value can be different, right?

Margarita Streltses - ***UBS - Analyst***

Yes, yes. Sure.

Laszlo Bencsik - ***OTP Bank - CFO***

That also to some extent reflects different approaches when doing pricing and then assessing the current accounting value.

But we are quite optimistic regarding to this operation. The synergies which we can gain from combining these two operations are actually quite high. And the real value of this merger is actually benefiting from the synergies. And there are two types of synergies, too. There are obviously cost synergies, but there are also sales synergies as well. Because as I said, by acquiring this bank we manage in one big step to enhance our presence in parts of the country which, from the point of view of economic activity, are quite important, but where we traditionally have not been as strong; namely, the capital of the country, Zagreb. So I mean, we actually attach quite high value, forward-looking value to the synergies we can gain from this acquisition.

Margarita Streltses - ***UBS - Analyst***

Okay, understood. Thank you. And my second question is whether it's the -- this quarter adjustments and one-off charges will impact your dividend policy for 2014 and for the following year.

Laszlo Bencsik - ***OTP Bank - CFO***

No, we have not changed our plans regarding dividend payments.

Margarita Streltses - ***UBS - Analyst***

Okay. Thanks.

Laszlo Bencsik - ***OTP Bank - CFO***

Sure.

Operator

Simon Nellis, Citibank.

Simon Nellis - ***Citibank - Analyst***

Oh, hi, Mr. Bencsik. Yes, I'd have just two or three questions. The first question would be what's your comfortable Core equity Tier 1 level now? I think in the past you've said it's around 14%. Is that still valid? And what's your plans to -- what do you plan to do with excess equity? And then I have two other questions.

Laszlo Bencsik - ***OTP Bank - CFO***

Well, certainly 14% is quite comfortable. I think that comfort zone extends down to, let's say, 12%.

Simon Nellis - ***Citibank - Analyst***

Okay.

Laszlo Bencsik - ***OTP Bank - CFO***

We will have to see. But that doesn't mean that we want to reduce it down to 12%. I think we tend to be quite reluctant to allow this to go down, actually, and it happened because we were forced due to these measures.

I hope that from now on we'll continue to accumulate capital and that this is a kind of minimum number which we reached temporarily. But I think the range between 12% to anything above 12% I think is a safe zone for any bank operating in this part of the world. 14% is a very reassuring number, I believe. And the level where we used to be a quarter ago, around 16%, was indeed a very high number compared to any players on the market, so that's roughly how I look at it.

Simon Nellis - ***Citibank - Analyst***

So what level would you be willing to do something with the excess capital and what would you do?

Laszlo Bencsik - ***OTP Bank - CFO***

Again, I mean the 14% level I think is quite satisfactory. Hopefully we will come to a situation when we actually will have some growth, right?

Simon Nellis - ***Citibank - Analyst***

Right.

Laszlo Bencsik - ***OTP Bank - CFO***

And then the best way of using extra capital -- extra generated capital in the future would be to finance or provide a capital for organic growth. And I hope we are not very far from this happening, especially not in the CEE counties where we operate. And even in Hungary, where the volume growth was actually negative during the last couple of years, we see the trend changing. And certainly the recent GDP growth numbers are indicating the potential for a much more positive growth environment in Hungary than what we have experienced during the last couple of years, actually.

So I hope that by organic growth we will use the extra capital we generate in the future. But if not, then obviously we look -- and assuming that this Hungarian FX and retail lending problem is behind us, and assuming that the situation stabilizes in Ukraine and we come back to profitability in Russia, and if in that scenario the core Tier 1 ratio is still increasing quarter by quarter, then we definitely come back to the issue of what to do with the extra capital we generate.

Simon Nellis - ***Citibank - Analyst***

Right. Okay. And just in terms of NPLs in Hungary, I noticed that you said that there were a few bigger corporate exposures which had to be provisioned. What sectors were they in? What was going on there?

Laszlo Bencsik - ***OTP Bank - CFO***

That was back in the first quarter. It was one….

Simon Nellis - ***Citibank - Analyst***

Ah, so it's just the CRE. Right.

Laszlo Bencsik - ***OTP Bank - CFO***

Yes, that was the one which we preannounced in 2013. It was in the first quarter.

Simon Nellis - ***Citibank - Analyst***

So there's nothing in the second quarter?

Laszlo Bencsik - ***OTP Bank - CFO***

Second quarter, nothing, right. And if you look at the new NPL information in Hungary, it dropped considerably.

Simon Nellis - ***Citibank - Analyst***

Right. Okay. And in Croatia I think there was a negative court ruling in terms of Swiss franc foreign currency loans and what's the expected impacts there?

Laszlo Bencsik - ***OTP Bank - CFO***

There the court's ruling is actually somewhat similar to the Hungarian situation in terms of this unilateral condition changes. The difference is that in Croatia it's a class act but it's not an Act. So it's a class ruling, meaning that if customers go to the court then the first level ruling is likely to be pro-customers. But there's no legislation as such to apply it for all the customers.

Now, the total expected potential loss is HRK 70 million, which is HUF 2.7 billion. Now, we already provisioned for this HRK 40 million, so there's HRK 30 million left unprovisioned as a potential maximum loss coming from this.

First of all, I think there's still a level of legal counterclaim we can make in Croatia, plus potentially not all customers will file an individual claim. Plus in some cases where the banks might win, so this HRK 70 million, which HUF 2.7 million, is a kind of potential maximum loss. And again, roughly for 60% of this exposure we already provisioned for in Croatia and we'll continue to do so. In the second half of this year we will provision another HUF 10 million and then first half of next year we plan to provision more if needed based on this decision. So, more than half of the potential loss is already provisioned for.

Simon Nellis - ***Citibank - Analyst***

So the HRK 70 million, that includes loans that are also not part of this class action suit or does this only pertain to the class action suit?

Laszlo Bencsik - ***OTP Bank - CFO***

No, that relates to all loans.

Simon Nellis - ***Citibank - Analyst***

All loans. Okay.

Laszlo Bencsik - ***OTP Bank - CFO***

Challenged based on this decision. So these are not just the loans which were involved in the actual court decision.

Simon Nellis - ***Citibank - Analyst***

Right, okay. Great. Thank you very much. That's all my questions.

Laszlo Bencsik - ***OTP Bank - CFO***

Sure.

Operator

Thank you. Andrzej Nowaczek, HSBC.

Andrzej Nowaczek - ***HSBC Global Research - Analyst***

Thanks for the call. Good afternoon. I wanted to ask about Russia and Ukraine, about how you see the tradeoff between volume growth or decline and profitability. Is your expectation of losses narrowing in Russia, for example, based on continuing decline in volumes and, therefore, when you eventually turn profitable in Russia again, would those profits be much smaller than they used to be in the good old days?

Laszlo Bencsik *- OTP Bank - CFO*

I don't think we can come back to 30% return on equity profitability environment, that's unlikely. The nominal profits, it depends on what timeline you are asking me, right? I mean in five years -- I don't think there's any reason that in five years we can't exceed the previous levels of nominal profits coming from Russia. I think what is going to be difficult is exceeding the return on equity levels which we used to have in Russia. Actually, it would be scary to do so again because that would mean an overheating activity in this segment.

Andrzej Nowaczek *- HSBC Global Research - Analyst*

Correct. So what is the balance then?

Laszlo Bencsik *- OTP Bank - CFO*

The balance -- I mean today we focus on product profitability. And the volumes started to decline in POS, but we are making much more nominal profit in POS this year than last year. So the optimal balance is changing each year depending on the credit profile or the risk profile of the client. But ultimate volumes are not driven by this. Ultimate volume is driven by demand and demand is driven by the economic environment. Two factors, basically consumption and unemployment, right? I mean these are the two most important macro indicators impacting this.

So, if the economic environment normalizes in Russia and doesn't continue to decline and consumption remains reasonably strong and unemployment does not improve, then we should return to an annual between 10% and 20% growth, I mean performing loan growth in Russia. And that would be quite normal in an environment where consumption is growing between 4% and 6%.

Andrzej Nowaczek *- HSBC Global Research - Analyst*

And then presumably below 20% type of ROEs?

Laszlo Bencsik *- OTP Bank - CFO*

I would say around 20% would be quite satisfactory.

Andrzej Nowaczek *- HSBC Global Research - Analyst*

I see. Thank you very much. Thank you.

Laszlo Bencsik *- OTP Bank - CFO*

Sure.

Operator

Ivan Bokhmat.

Ivan Bokhmat *- Barclays Capital - Analyst*

Hi. Thank you for the call. I've got three questions. The first one is regarding Bulgaria, if you could provide any update on the situation in the country and how the turmoil in the banking sector is affecting your operations. That would be question number one.

The second one would be on the FX mortgage conversion in the Ukraine. We've heard this discussed in the Parliament several months ago. I was wondering if there's anything new.

And finally, I will have a small question on the Hungarian FX mortgages. Maybe I'll ask it in the end. Thanks.

Laszlo Bencsik - ***OTP Bank - CFO***

In Bulgaria, the turmoil was related to one bank specifically and then there was a contagion to another local bank. The impact on us was immaterial, if anything -- I mean if you look at our numbers, volumes increased, especially deposit volumes. We have increasing interest from some new corporate clients as well. But the situation now is contained very much and calm. So there were only a few days when the situation was hot or could be labeled as not normal, but after a few days it returned to normal. I mean this particular bank which we are talking about was put under supervision. And the other local bank actually managed to survive without any major implication from the liquidity problems they have experienced for a few days. So, it's pretty much business as usual at the moment in the country and the banking sector and our bank is doing very well.

Ivan Bokhmat - ***Barclays Capital - Analyst***

And there is no impact on the credit quality in the corporate space or anywhere.

Laszlo Bencsik - ***OTP Bank - CFO***

We don't experience anything like that, no.

I'm sorry. The second question was this mortgage initiatives coming from the Ukrainian Parliament. Time to time we hear news which is indeed quite worrisome, but nothing as far as I know happened. Now, the situation is quite peculiar there because the Parliament is still the Old Parliament with plenty of supporters of the old regime. And then the parliamentary elections are coming and it's likely that most of these MPs will lose their positions so they don't have much to lose.

So, it's not that surprising that these kind of disturbing initiatives come from the Parliament. As far as we understand, the President at the National Bank and the supranational organizations being involved with Ukraine at the moment are not supporting these ideas, which come from the MPs in the Parliament.

Ivan Bokhmat - ***Barclays Capital - Analyst***

Okay. That's very helpful. And maybe the final question. So, I don't know if you actually do have this detail at the moment, but when you convert the -- or sorry. When you switch to new terms for those loans in Hungary where they're -- which would have to compensate the customers, what kind of a rate will you be charging and how would that compare to your new origination in forints?

Laszlo Bencsik - ***OTP Bank - CFO***

Basically our understanding is -- but again, this is something which will be prescribed or defined in this Act which will come out somewhere in September/October. So our understanding is that the actual contractual terms in these contracts have to be applied for the past and for the future as well. So these calculations we made and the results we showed today are based on the assumption that the terms which are in these contracts are the ones to be applied for the past and for the future. In case of FX mortgages in Swiss francs, this is probably around 6% interest rate, 6.5% maybe. And the current HUF rates are around 8%.

Ivan Bokhmat - ***Barclays Capital - Analyst***

So do I understand correctly, then, on the forwards rate, on the upcoming rate, there will be no reductions from the unilateral changes; i.e., you will not be forced to return to 4% rates or whatever that was in 2006 and 2007?

Laszlo Bencsik - ***OTP Bank - CFO***

No, we are. So again, we have to go back to the original contractual terms. And that's how we have to calculate the amount which we have to pay back to the customers and that's the conditions which we'll have to apply for the future. And the original terms were around 6%, 6.5%. The current terms are about 8% to 8.5%. So it's roughly a two percentage point decrease in the interest rates of the FX mortgages.

Ivan Bokhmat - ***Barclays Capital - Analyst***

Okay. Thank you. That's very helpful. Thanks.

Laszlo Bencsik - ***OTP Bank - CFO***

Sure.

Operator

Thank you. There are no further questions at this time. (Operator Instructions) Margarita Streltses, UBS.

Margarita Streltses - ***UBS - Analyst***

Hi. I just have a couple of clarifications on the previous questions, if I may. So in the -- in the Ukraine you said that you do not foresee any similar kind of type of conversion of the FX retail lending. Is this right?

Laszlo Bencsik - ***OTP Bank - CFO***

I mean foresee is not the right word. I don't have any evidence that this is going to happen. There are initiatives coming from the Parliament which have not materialized. But my ability to actually predict what's going to happen in Ukraine is actually quite limited, so I wouldn't use the world foresee.

Margarita Streltses - ***UBS - Analyst***

But you don't have any indication that this is going to happen?

Laszlo Bencsik - ***OTP Bank - CFO***

We don't have any concrete information, no.

Margarita Streltses - ***UBS - Analyst***

Okay. And also, you just mentioned that there's a 2 percentage point impact on the interest rate. Is this -- how we can reconcile this with your previous answer then that the total foregone net interest income would be about HUF 10 billion if we include the principal as well? So were you talking about the same thing or about two different things? Sorry about this.

Laszlo Bencsik - ***OTP Bank - CFO***

So the number which goes with the 2 percentage point is HUF 7.4 billion.

Margarita Streltses - ***UBS - Analyst***

Yes, okay. I just wanted to confirm that, yes. Okay. HUF 7.4 billion. That's very clear. Thank you very much.

Laszlo Bencsik - *OTP Bank - CFO*

Sure.

Operator

(Operator Instructions) There appear to be no further questions at this time. Please continue.

Laszlo Bencsik - *OTP Bank - CFO*

Okay. Thank you very much. Thank you for joining us today and for your listening to the presentation and for your excellent questions. And again, sorry for the technical problem which occurred during the first half an hour of the conference call. So, I wish you all the best and hopefully you will join us again when we have the third quarter results presentation somewhere in mid-November. So, thank you again and goodbye.

Operator

Thank you, sir. That does conclude our conference for today. Thank you all for participating. You may now disconnect.

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