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OTP Bank 2Q 2016 Conference Call — Friday, 12 August 2016

Paul Formanko: Hello from sunny London. Thank you very much for joining us today. This is Paul Formanko from JP Morgan. It is our great pleasure to host OTP Bank's second quarter results conference call. From Budapest, joining us today is László Bencsik, chief financial and strategic officer. Laszlo, please, over to you.

László Bencsik: Thank you, Paul. Good morning or good afternoon, depending where you are, and welcome you on the OTP 2016 second quarter interim report conference call. As usual you have a presentation available on the website so I hope you have been able to access it. Usual, I'm going to have a presentation going through this pack and then afterwards you will have a chance to ask your questions.

Today the presentation is somewhat unusual. We have followed a fairly set structure for a couple of years and now we decided to have some fresh ideas included in the presentation. In the first section you see the first slide which tries to describe our current thinking and view on the situation of OTP Group and this is pretty much a potential investment rationale which might be useful for the investor community.

Page 3 of the presentation will try to summarise the main messages: firstly, OTP Group returned to a reasonably attractive level of return on equity and this is the one which we told last year we were going to target. It's basically above 15%, assuming a 12.5% CET1 ratio.

The second point is that we can achieve this because we believe that we entered a new era, a new period of low-risk environment in the countries where we operate and this is going to be representative for the next couple of years.

The next very important development that we are witnessing in Hungary is the turnaround of the volume trends. We have had many years of declining portfolio volumes in Hungary during the course of a long deleveraging cycle and this ends with the year 2016 and from now on we believe that we enter the new phase, which again will mean loan volume growth in Hungary.

We continue to have a strong and robust capital position and most remarkably, our ability to generate capital through earnings is strong enough. Likewise it's true for liquidity; we are in a very, very liquid position.

[1] Unabridged transcript with minor English stylistic corrections

Finally, we are very busy with digital developments and we believe that we are one of the leaders in terms of innovations delivering digital services to our clients in the region, which we believe to be one of the keys for success in banking.

I'm going to say a few words about all of these statements in the next couple of slides. Page 4 just describes the return on equity path we have made. Obviously we have had some difficult years over the last couple of years but we do seem to get back to the good old days of high levels of return on equity, especially if you adjust it with the Hungarian risk-free yield. In other words, if you deduct the ten-years Hungarian government bond yields from our return on equity in each year, which we have on this slide, you'll get the numbers which you can see in the middle part of this chart and as you can see, for the first half this year it was 13.6, which is quite a healthy margin over the sovereign risk, I think, and actually it's getting quite similar to where we used to be before the crisis in the early 2000s.

The following page is just to give you an overview of the return on equity decomposition. There are two obvious reasons why we managed to improve our ROE numbers. The first one can be seen as the difference between the top row and the one below, i.e. the accounting ROE and the adjusted ROE. Finally these two numbers converged and in the first half of 2016 the accounting ROE was even higher than the adjusted.

Looking forward we expect reasonably small difference between the two. It's only the bank tax, actually the lower level of bank tax which remains structurally the difference between the two, so we hope that we can more or less inflate the impact of this and this should be proportionately smaller and smaller as we go ahead in time.

The other big differentiator is the risk cost, as you can see. After many years of structurally higher risk cost, in the range of 3% and above, we seem to return to low level of risk cost environment, back to around 1% level which used to characterise OTP's operations before the crisis in the early 2000s.

This leads us to the second point of the investment rationale, namely that we are entering into a new risk environment, a new area, a new period of low risk in the countries where we operate and we make this argument based on four points. First one is that we have adequately provisioned for the problems of the past; we have 95% coverage ratio on our non-performing loans, we believe that this is a very conservative amount and makes us feel quite comfortable in terms of what impact we are going to have coming from these old non-performing portfolios.

The second part of this argument is related to the new formation, i.e. the worsening of the existing performing portfolio which has come down very nicely. Here you can see the 1H figures for the year and particularly here, the darker part is related to Russia and Ukraine. Obviously the Russian operation will structurally bring in sizeable deteriorations because it's a consumer lending portfolio, but as you can see from the second quarter, it can be very profitable even at that level of deterioration. But basically the rest of the portfolio seems to be very stable and we believe that this is going to last for the next few years in the region.

The third element, equally important, is that we have got rid of our toxic portfolios. We have never had toxic investment portfolios or securities portfolios, but we have had FX mortgages and more specifically the dollar mortgages in Ukraine and the Swiss franc mortgages in Hungary, Romania and in Croatia.

The good news is that most of these have already vanished. There are some very small amounts of dollar mortgages still in Ukraine in the performing book. In Hungary we've eliminated the Swiss franc mortgagees; likewise in Croatia. The only remaining part is related to Romania, but even there we are in a process of converting them into local currency.

The last element which unfortunately has caused a lot of trouble for us and a lot of financial losses as well or financial expenses for us is the Hungarian regulatory risk in the form of the bank tax and other measures. This is the other area where we have seen considerable improvement and we are quite optimistic looking into the future. Actually what we see now are a number of initiatives by the Hungarian Government in favour of the banking sector trying to stimulate lending and trying to stimulate banking activity in the country.

Our third point in this five-point list is related to the Hungarian volume turnaround. Page 7; I think it's quite interesting to look at the product penetration levels in Hungary; even more specifically, the housing loans and the consumer loans. If you look at the housing loans, we are now at 8.8% housing loans to GDP penetration level in Hungary - these are all percentages, by the way - and this is the level where we used to be in 2003 before the retail lending boom started in Hungary. This is a bit more than half of the peak which was in 2010. The Hungarian retail has deleveraged in a big way and basically what happened was that the housing loan portfolios dropped by 50%.

This is also very interesting if you compare this number to Slovakia, Czech Republic and Poland, which are at markedly higher levels, right; only Romania is lower in the region.

Consumer loans are again same historical development; we are at a much lower level than we used to be at the peak in 2010, but in this case we are not so much away from other markets in the region. Corporate lending is different, but in the corporate segment you can also see that the penetration levels of corporate loans declined substantially.

We are in the situation at the moment where the loan levels in the system compared to the size of the economy are definitely low, which obviously creates an opportunity for growth and makes us believe that there might be another kind of surge in lending, especially in mortgage lending in Hungary, which is supported by fairly strong macro environment.

On page 8 you see a comparison of the macro indicators of some of these countries. Focusing on Hungary, we just got the second quarter GDP growth data out, which was 2.6% y-o-y increase in 2Q. Much better than expectations and you might remember that the first quarter was quite slow, but we continued to believe that we could achieve around 2% or above rate this year and it does seem to be the case and we continue to forecast above 3% GDP growth for next year and further improvement in 2018.

This is driven not just by export growth but also growing consumption in the country and we have strong real wage dynamics - 5.6% growth year on year in Hungary - only topped by Romania, which is - actually quite a story. I mean, Romanian numbers came out today; above 6% GDP growth which is quite a staggering number. But it is also supported by other fundamentals, as you can see on the chart.

We have consumption growth in Hungary: it started three years ago or two years ago and now it's accelerating and reaching already the levels of other regional countries. And very interesting is the housing price index; there's a lot of activity and excitement in the real estate sector at the moment, as you can see; the housing price index increased by 15% year on year and this is accelerating so this is going to continue to go further up.

Therefore, as you can see on page 9, we expect growth, buoyant growth to come back to Hungary and in case of OTP itself it has already manifested. We had 2.4% growth year-to-date, which is in sharp contrast with the negative numbers, the average 9% decline which we used to have for the last seven years, between 2009 and 2015. Then later on I will show you that the more granular level indicators show further acceleration potential in this growth rate.

On page 10, our fourth point in describing the potential investment rationale is the robust capital position and a very, very comfortable liquidity position. In terms of capital, our reported fully loaded CET1 ratio is 13.2%. We regard this as quite high, but in fact the environment has evolved to a state where all banks are targeting and achieving higher and higher capital ratios. It's not anymore a kind of outlier so much as rather a kind of strong number in the peer group or in the comparable banks or bigger banks in Europe.

However there's one very important factor; our ability to generate capital. If you just look at the first half of this year. First of all we have to get to a number which is comparable to the first half number because the year-end last year did include the transitional adjustments. So, if we eliminate those, going back to the end of last year and make it a fully loaded number. Plus, if we add the net income of last year, well then we got 13.2%. This is roughly the number we can use as year-end 2015. If we add to the reported fully loaded number at the end of the second quarter the retained earnings which were not included in the official ratio then the number is 14.3%.

Technically, in six months our capital adequacy ratio improved by 1.18 percentage points, 118 basis points and this is quite strong capital generation ability and we believe that this is going to continue and if you look at our leverage ratio, it is very strong, too.

I don't want to talk much about liquidity, but compared to the situation where we were in 2008 which was a very difficult environment. We managed to get through without any major hiccups. We have abundant liquidity and basically no outstanding senior debt, no swaps - actually now we are in the opposite position; we are swapping euro into HUF as opposed to the other direction, which was the case when we used to have FX mortgages in Hungary. The consolidated net loan to deposit ratio is 68%; again, quite low.

Then this digital story: we usually talk about Touch Bank and the services we introduced there, but actually if you look at Hungary and in other countries where we operate, we are very, very strong in digital services. In Hungary we are by far the leaders. On page 11 you can see that by far we are the biggest provider of internet banking services, mobile banking services; we have by far the largest contact centre, call centre, and largest ATM network in the country.

On page 12 you see that this is not something new, it's the result of quite a long development path. In fact personally my first professional interaction with OTP was in 2000 when as a McKinsey consultant I worked on an engagement to develop internet strategy for the bank. Already in 2000 the bank had an interactive transactional internet banking capability and then quite soon there was the SMS-based mobile banking, which now we laugh at, but this was the standard at that time.

Today, 50% of OTP Hungary clients use only digital channels and another 20% have mixed channel usage and only 30% are the clients who use branches only. So it's a quite digitalised customer relationship what we have, but obviously we want to go further and improve on this and therefore we launched this quite substantial and expansive project to further improve our digital services and further improve the operations of the bank internally.

Then we had these two wonderful and so far very successful initiatives called Simple - one which is for all clients, not just the OTP clients, where they have various services provided for customers; ability to buy online tickets for all the cinemas in Hungary; park with two clicks and pay for parking with two clicks; buy highway tickets; pay at vendor machines; call a taxi; buy tickets, festival tickets, buying online. This is a big thing actually today when there's a huge festival ongoing in Budapest called Sziget.

The other application, which is targeted for only OTP customers, is a loyalty programme which is unique in the country and we only started it a few months ago and already have 150,000 clients using it. It provides up to 5% discount on purchases; this is cash discount so we have partners, retailers. For instance we have a very attractive and beneficial relationship with Tesco; they provide 5% discount on purchases, but there are other and growing number of retailers.

These, we believe, are very important and strong tools to further cement our market position in Hungary and these are the type of initiatives we are launching and trying to use in other countries where we have established presence.

This was the new storyline, describing the OTP story. I hope it was somehow helpful and I'm sure that we will have plenty of opportunity to discuss it with you in various forms. Going back to the usual format and the details of the second quarter results. On page 16 starts this section - there's a summary slide trying to explain what happened because there was staggering growth in terms of the profit we made.

If you look at the first half and compare it to the last year first half the accounting profit grew from HUF 40.1 billion to 106.2 and the adjusted profit from 69 to 104.1 respectively, so it's really quite a fundamental growth. First of all the explanation behind the adjustments: how we get from the accounting to the adjusted is very easy. The bank tax has dropped sharply, it's less than 50% of 2015 and we have this one-off result coming from the Visa transaction. The sale of the Visa shares, which we booked in the P&L during the course of the second quarter and in fact this number is higher than we originally indicated. According to our auditor's recommendation we also booked an amount for the future expected cash flows of this transaction and we were told that this is in line with the accounting treatment of these transactions in other banks across Europe.

Then we reach the adjusted profits, which grew by 50%. What happened there? Basically the results at CEE countries' didn't change so much so there was only a 1% improvement in their profits. However, there was a huge shift in the results of the Russian and Ukrainian operations. First half last year we lost HUF 25 billion; this year we made 10.9. This is the major difference which resulted in this spectacular profit growth in the group.

On the following page you see the country-by-country numbers. Hungary remained very stable on first half year on year comparison basis, but even the second quarter and then comparing to last year's second quarter seems to be fairly stable, which is something we are quite happy about so this is, I think, a very good result as we managed to keep the Hungarian profits flat, given all the margin pressure, the lower interest rate environment and so on.

The other country which is a strong contributor to overall profits is Bulgaria. Again, almost exactly the same number for this year and last year, and again this is something which makes us quite happy that we managed to keep at this level the nominal profit of our Bulgarian bank.

Where we do see improvement, proportionally at least quite big, is Romania and Croatia. Despite the fact that in both countries we have conversion schemes where we have to give discount to customers related to the FX mortgages, which results in lower volumes and lower revenues. But these are the two countries where we have made acquisitions and now we already see the positive impact of these. We more or less have finished the merger processes in these countries and therefore now we can see the materialisation of the synergies and therefore the positive impact coming through that channel.

As for other banks, they are positive, but they are not so much material in terms of contribution to the group. Again it is in Russia and Ukraine where we see a substantial turnaround. Russia did very well, second quarter was much better than the first one and Ukraine did also better than in the first quarter and the only loss-making virtual entity in the group is the Russian online bank; we look at it as an investment into the future, as an experiment. A very important experiment we want to do and we believe we can succeed in turning this into a profitable business model in Russia. However, it certainly takes time, so it was no surprise for us that it didn't make profit for the first half of this year.

More technicalities coming in 18 and 19; there's not much new information on 18. These are the one-offs. We had an impairment of the investment in the Ukrainian factoring company and that resulted in a tax shield which you can see here in the second quarter but it had no other impact on the consolidated numbers.

On page 19 you can see the adjusted P&L lines without one-offs. Quarter on quarter we managed to improve total income with a very strong net fee and commission performance and a reasonably stable net interest income. Operating costs went up, especially on a quarterly basis. It was quite a jump, but even year on year we have 4% growth and if you look at the first half results then there was a 1% growth, unadjusted but if you adjust it, well, in later pages I'm going to talk about this more in detail.

Total revenues, page 20; overall 2% growth, very good result. Obviously one strong contributor was Russia and more importantly the exchange rate. Rouble appreciated in the second quarter compared to the first quarter and therefore all the P&L lines of our Russian bank became bigger, so that has had an effect on revenues and costs and risk cost as well, but even on FX-adjusted basis total revenues in Russia grew by 2%. The other good contributor was Bulgaria, where we had 6% growth.

Going into details of revenues, net interest income was stable on a quarterly basis. We are quite happy about this. It is actually better than we expected. After the first quarter results at the conference call I mentioned that we expected further decline in the group level NIM, which didn't happen so the actual group level was the same, 4.84% for the second quarter and that was the case in the first quarter, too. That's actually better than we expected.

Partially this is due to the Russian operation and the fact that the rouble appreciated quite heavily to the forint and therefore there was this 12% in net interest income growth coming from the Russian bank, but if you adjust it with the FX rate then it was only 1%.

There was decline in Ukraine and in Romania; in Ukraine it was related to sales and writing-off of non-performing loans or delinquent loans, and in Romania the decline was related to the conversion programme where we are losing volumes through the discount that we give to customers in order to boost conversion.

Page 22: net fee income was very strong in the second quarter. Usually if you look back to previous years, there's a strong seasonality, so it's quite typical that the second quarter is better than the first quarter; likewise it happened this year so 12% quarter on quarter growth. Strong Hungary; part of this growth we already flagged was due to a one-off which represented HUF 1.6 billion. Each year we have to book the transaction tax for the card-related transactions and this did not appear in the second quarter so that was just a technical difference between the two quarters. In general we see increasing business activity in Hungary.

In Bulgaria we managed to increase the account management fees, as well so this is more kind of sustainable development what we see in Bulgaria.

Russia; obviously the FX rate has a role here as well in the overall improvement but even FX-adjusted there was 6% growth, which is related to the increase in business activities.

Non-interest income; there was a decline but I would rather phrase it in a way that the first quarter was exceptionally high, especially in Hungary where we were much higher in the first quarter due to one-off gains on securities. This HUF 3.7 billion in 2Q is closer to a run rate that we usually had. Last year the average quarterly number was 4.5 billion so this is more kind of coming back to normal numbers than anything else. We had pluses and minuses, smaller amounts in other countries.

Page 24, the NIM, net interest margin development; this was a topic which attracted lots of interest during the previous conference call. Again the group level number was4.8%. The consolidated NIM was better than we originally expected, which is good news, and if we look country by country, there was 2 basis points decline in Hungary, which I would say is quite a good performance. Russia improved and this is related to two things: one is that we had further reduction of funding costs. Finally almost all of the very expensive long-term deposits have been repaid and have terminated. But there's another impact related to the FX movement, the exchange rate movement. The rouble depreciated in March, therefore the first quarter number was somewhat understated and now the second quarter; partially includes the improvement in the first quarter which was not obvious in the number because of how we calculate the denominator of this ratio.

Bulgaria; further decline, but if you look back to the net interest income, actually the net interest income declined only by 1% on a quarterly basis. Anything above this was due to the growth of the asset base and this is due to ever-increasing deposit volumes. In Bulgaria it's more like the NIM is contracting more because of the growing asset base, which is driven by growing deposits, where we don't earn so much or don't earn actually much on this extra deposit as net interest income, but we do earn fee income. Obviously, by having more deposits, more clients, we have bigger client portfolio, we have more transactions and therefore fee income is growing so that's what you can see on the free income side. This margin decline is more attributable to the overall growth of the deposit book than the decline of the net interest income; consequently the net interest income was more resilient than the NIM in Bulgaria.

Ukraine; it has gone lower and we are getting back to last year level. The first quarter was rather a kind of outlier in this sense, so this is more or less okay.

Page 25, going on to volumes, finally the net loan to deposit ratio started to grow so we had one percentage point growth in the second quarter, driven by loan growth overall which you can see on page 26. We are quite happy about this; overall 1% growth in the total book. If you look at the first six months, we see 1% growth for the total portfolio. If we look country by country, Hungary was kind of stable but if we look together with the first quarter; the first six months was a 2% growth.

The good news is that the mortgage decline is slowing down and we do believe that the trend in mortgages will turn around soon in the next couple of months. We expect the mortgage volume decline to stop and actually turn into growth by the end of this year.

Corporate had more moderate growth than in the first quarter; first quarter was very strong, 7%, but overall this is okay because for the first six months we grew by 8%. Bulgaria, 3% growth in the second quarter, quite okay. We are doing well in corporate, and retail is slowly growing.

Russia; there was still this decline of the portfolio, although it's now slowing down, but we still had 5% decline just in one quarter in the consumer loan book in Russia. This is an area where we expect improvement for the rest of the year. Actually there's a monthly improvement which you already see like in the Hungarian mortgage book. We believe that this declining trend should turn around by the end of this year and then we should see growing volumes.

The rest is basically stable or growing somewhat in Croatia and in Serbia.

Deposits, page 27; there's less excitement here because this is not a strategic priority to grow deposits, but nevertheless we are growing in Hungary and in Bulgaria in retail deposits, which is good news. It shows the strength of the brand, the franchise and the fact that the customers do favour OTP even when deposit rates are very low or actually close to zero in these countries.

Costs, page 28; there was, I'm sure, surprisingly high growth on a quarter on quarter basis. The first quarter is usually seasonally low and it was especially low in our case in the first quarter this year. Plus we had the appreciation of the rouble rate which again increased the overall HUF-denominated OPEX for the group. On the other hand the year on year FX-adjusted growth for the first six months was only 4%.

The second quarter jumped out, especially in Hungary where we had a high growth. This was because of increasing marketing spending, which was related to the revival of the markets and growing business activity. We had one-off personnel costs related to organisational changes and there was an overall 4% increase in the base salary, which is actually much less than the overall number for Hungary, which was 6.9%. Wage inflation started and on the previous slide I showed that real wages started to grow and we have to follow this trend if we don't want to lose talent and the better part of our workforce in Hungary.

There were other charges, supervisory fees and charges increased quarter on quarter by HUF 1.2 billion. The increase was partially due to one-offs. Overall Hungary had the biggest change on a quarter on quarter basis.

This leads us to the Hungarian story, a few more words about Hungary specifically. On page 29 you see the P&L of the Hungarian business, but I have talked about each line, so I'm not going to elaborate on this one. On page 30 you see some more details on the business activities going on in Hungary. The most important indicator we look at is the increase in mortgage loan production, where new disbursement was by 64% up year on year and new applications grew by 90%; that suggests an accelerating growth both in disbursements and volumes.

What we are really happy about is the market share we have from new disbursements. During the second quarter we managed to do better than in the first quarter so we reached 29.1% market share from new production, which is a quite good number. From retail savings our market share continued to increase. We are almost at 30% and this is a long-term trend and a trend we like because this shows our ability to build up and maintain close customer relationships in a wide, broad base in Hungary.

Corporate is doing well. We continue to increase our corporate market share. We are up at 14.4%. The SME loan volumes, during the first six months, increased by 7.8%. This suggests that we might be able to exceed last year result, which was an 11.2% annual growth, so just in the first six months we grew 7.8% in the SME segment.

Bulgaria; nothing particularly exciting happening apart from very strong profitability, good risk profile and growing volumes, slowly growing numbers. The segment which is the most dynamic in our case is the corporate. We have invested a lot in terms of processes, products, personnel, marketing; everything to improve our Bulgarian corporate business and the numbers have started to show the results of this effort.

New disbursements are by 100% up compared with last year. We managed to improve our market share, in the first half of this year there was a 10% increase. This is a strategic priority we have there.

Russia, page 32; the good news can be seen here that is the risk cost rates for POS and cash loans and also credit cards continued to mitigate and normalise. POS now is 6.5%; that's already a very good number; cash loans 7.1%; and credit cards finally came down in a meaningful way to close to 10%. With these ratios the Russian bank actually made in the second quarter more than 25% ROE, this is what we like to see in good years in case of consumer lending, hence we're quite happy with this result.

Still one problem is that the portfolio kept on declining although with a slower pace in the second quarter. This is what the team is working on very hard in Russia and they are doing very well. We believe that they will be able to turn this trend around, as I said before, and by the end of the year we will turn this portfolio into growth mode.

Page 34, Ukraine; not much happened there. We had lower risk cost in the first quarter, somewhat normal levels of tax burden, so this actually resulted in a decent profit in Ukraine. We hope that the external environment continues to be stable and then this is more or less the level of profitability what we should expect in the future.

Finally, a few words about credit risk and portfolio quality. The good news is that the deterioration of the portfolio, as you can see on page 37, again reached quite low numbers. It was only eight billion in the second quarter and in Hungary we had write-backs in the magnitude of seven billion, so the 90-days-plus due volumes declined.

In Russia the quarterly deterioration was the lowest for many years and continued to decline, which is good and then in the rest of the countries there was basically no deterioration or minimal deterioration.

Risk indicators, on page 38, show the overall coverage ratio. We are quite happy with their levels and especially in Ukraine, Bulgaria and Hungary we seem to be very strong in terms of provisioning for the bad portfolios.

Then we have a few more slides which are more kind of additional information so this was pretty much what I intended to present and now I'd like to give you the opportunity to ask questions if you like so please, operator, open the floor for questions.

Operator: Ladies and gentlemen, if to would like to ask a question please press * followed by 1 on your telephone keypad now. If you change your mind please press * followed by 2 and when preparing to ask your question please ensure your phone is unmuted locally.

Our first question today comes from Sam Goodacre from Morgan Stanley. Please go ahead.

Sam Goodacre: Good afternoon and thank you very much for the call. I've got three questions this afternoon. The first one actually is if you could provide a bit more colour on the NIM in Hungary, and particularly related to reinvestment risk around your bond portfolio. We've obviously had, you know, much better than expected 2Q performance, though it would be interesting to know when reinvestment risk could become a real risk in your mind.

The second one, still on Hungary, is related to staff costs. You know, I'm obviously aware you can't necessarily give numbers about the reorg given its sort of individuals leaving the bank but could you perhaps provide some data on what the underlying cost trajectory looks like?

Then the third one actually is just on the portfolio and potential consolidation. I think it was last week that there were headlines about a potential acquisition in the Ukraine. Could you just give us any colour on that and anything else you might be considering at this time? Thank you.

László Bencsik: So the Core NIM. We had two basis points decline in the second quarter. The impact coming from the repricing of the fixed securities portfolio will be very gradual and the first bigger kind of churn of this portfolio is going to happen somewhere in 2018 so this is not something which should have a major impact on the NIM, certainly not this year and not even next year.

I said after the first quarter that I expected the second quarter to be the bottom of the Hungarian NIM curve. Actually the second quarter was better than I originally expected so it might happen now that the third quarter is going to be the bottom and so some further small decline we expect for the third quarter and then according to our expectations the last quarter will be better even by volume dynamics in Hungary. But again the fixed securities portfolio and the potential impact of this is not going to be very material in the next 12 months.

Costs; the guidance we gave for this year was 2-3% FX-adjusted group-level cost increase. I think the only modification I would make is around 3%, but it is certainly not very different from what we originally expected so basically it's around two or three or around three. It is the guidance which I would uphold for the group-level OPEX.

Consolidation; we heard that this is going to start to happen. We have been waiting for consolidation in the countries where we operate for many years and we are hopeful that there will be some acceleration in terms of this process. It's not a secret that strategically we would like to grow through acquisitions as well as organically. The primarily focus areas are the existing countries so we don't have so much plans to extend our presence over the current footprint and within this current footprint the first strategic priority is the CEE countries where we have a smaller market share.

But as you can see, we have even made an acquisition in Hungary; we acquired the AXA portfolio which is going to be consolidated during the last quarter this year so that's when you will see the numbers coming through our financial statements. We have already received all the regulatory approvals to conclude this transaction

We are very active and we are looking into each and every sensible opportunity in this target set of countries but we have always refrained from commenting on specific cases and actual transactions until they happen so I would continue to do so. Therefore I don't have any specific comments regarding this information which appear in the press in Russia related to this Ukrainian bank.

So that's more or less all I can say related to your three questions.

Sam Goodacre: Okay, thanks, Laszlo.

László Bencsik: Sure.

Operator: Our next question today comes from Gabor Kemeny from Autonomous Research. Please go ahead.

Gabor Kemeny: Hi, thanks for the presentation. Firstly on capital, you are quickly building capital and you mentioned that this may continue. Firstly maybe can you give us a sense, where would you want to be in terms of your capital ratio? It sounds like it might be a bit more than the 12.5% we previously discussed.

And now that your actual CET1 ratio is above 14% can you maybe elaborate on how you may want to deploy this excess capital? I understand you look at M&A opportunities. Maybe an update on your dividend policy would also be helpful.

László Bencsik: Yes. I have tried to explain related to the previous question that we are looking for opportunities in order to be part of the consolidation process in the region. We believe that this is the right time to do so because now the kind of future is more or less, as much as it can be, stable and predictable. We see growth potential in this market and according to assessments, the valuations are at levels which do make sense, so they are very far from the excessive levels of valuations which, if you remember in the mid-2000s where some banks including us acquired other banks at three, four or even more times book; this is not the case now, so we are in a much more sensible pricing range and there's actually a limited number of players who can and who intend to participate in M&A deals so this we see as a good historic opportunity to improve our position.

Therefore we maintain the dividends plan what we already communicated - you can read it out from the financial statements, the amount of dividend what we plan to pay after this year. We hope that we can utilise some of the excess capital for acquisitions which generate value and synergies for shareholders. So that's how we plan to solve this hurdle, how to get to a more efficient level of capital adequacy.

Obviously, if this doesn't work then we will have to revisit this question but let's say somewhere during the course of next year we should be able to see how realistic our M&A growth plans are and what we can achieve there and if we can't achieve anything then obviously we will have to revisit our dividend or capital strategy, but this is not the time to do so and we have not done that. We stick to the dividend guidance what we have communicated and what you can see in the numbers.

Gabor Kemeny: I see, that's helpful. And another question; I mean, to your ROE guidance; you are now saying that you may already reach more than 15% ROE this year, which is, which looks well achievable after the first half results, maybe even somewhat conservative. Can you give us a sense - obviously I get you had some provision write-backs in Hungary and a very good risk environment. Can you elaborate a bit on your assumptions here, on your ROE drivers going forward, I mean, in terms of provisioning and margins especially, going in...?

László Bencsik: Margin-wise I don't think it needs revision. Last time I said that we expected around 25 basis points' decline in the group level margin year on year. This continues to be our expectation overall around 25 basis points decline full year, year on year. I have already said that I expect around 3% FX-adjusted growth of costs and I don't see any looming danger in terms of risk costs. We don't see any problems arising in the portfolio what we have, so I think we can reasonably expect a continuation of low levels of risk cost in the foreseeable future.

Gabor Kemeny: Okay. That's helpful. Just a quick follow-up on the margins; when you say 25bps margin contraction, it seems that your business mix is changing somewhat because new lending is more driven by SME and corporate than via mortgages which - I guess corporate is somewhat lower-margin. Does this impact your margin planning, your margin outlook in...?

László Bencsik: Yes, obviously this is accounted for in our plans and this is mostly the case in Hungary and in Bulgaria. Whereas if the Russian book turns around then that would help us to counterbalance this and certainly in the second quarter the appreciation of the rouble helped to counterbalance this trend.

Gabor Kemeny: Okay, thank you.

László Bencsik: Sure.

Operator: Our next question today comes from Simon Nellis from Citibank. Please go ahead.

Simon Nellis: Oh, hello, Mr Bencsik, thanks for the call. Just following up on the question on capital, I would be interested if you could elaborate a bit more on what you think is the right capital level. Is it the 12.5 or is it heading higher? I guess you're going into a SREP review by your regulator. Is there any indication of how they're thinking about your capital going forward?

Just to clarify on the dividend policy, so what you're saying is you're happy with what you've communicated for this year and you're going to try to use up excess capital with M&A but if that's not achievable then you would consider paying out a higher dividend pay-out or doing buy-backs, is that what you were trying to say? That'd be my first question.

László Bencsik: Yes. I mean, if there's no opportunity to do an M&A which generates value or creates additional value then these are the two forms of returning more to the shareholders; either buy-backs or dividends. Clear, and so you are right in saying that.

And what we plan for this year is HUF 53.2 billion; this is the expected dividend payment after this year. That's what we flagged - if you look in the analyst tables you see that one fourth of that number in each quarter being indicated.

In terms of the target level and what's the required one and what's the optimal one, that's a very difficult question. Certainly from a strict regulatory point of view I don't see any reason why the 12.5 would not be a good target. Nevertheless our fellow banks across Europe continue to increase their capital ratios and I don't know where it's going to end because it seems to be a race where everyone tops up the targets and wants to excel in having higher and higher level of capital and this is obviously welcomed by the regulators and supervisors.

This I think it's an unhealthy process and I certainly don't see the fundamentals of this because if you look at the portfolio what we have at OTP, the level of risk, i.e. the inherent risk of this portfolio is actually much less than it used to be a few years ago. If anything, we should rather target lower levels of capital than where we are or what we target now and this is what is suggested by our internal models. Obviously, I've always said that we want to be higher than our peers because we are a Hungarian bank and the Hungarian sovereign rating is worse than that of our regional peers, i.e. the other banking groups who operate in the region. Subsequently, we might be forced to go higher because of peers' pressure more or less but I don't see pressure from a regulator which would kind of push us higher than this 12.5.

Simon Nellis: Okay, and I guess you're not willing to give kind of a level where, you know, assuming that you can't do M&A, where you'd be looking to go to so we can kind of put a number in for our dividend forecast. Or you want to leave it at that.

László Bencsik: I think it's too early so I wouldn't like open up speculations around this. The kind of baseline scenario is just what I tried to explain.

Simon Nellis: Fair enough, thank you. Two other questions; just on the Hungarian risk cost, I think that was partially driven by a write-back of restructuring cost of some sort. Can you tell us what the underlying risk cost was for the second quarter in Hungary, excluding those costs?

And I mean, just one other question would be on why you think corporate loan penetration is so low not only in Hungary but also elsewhere in central Europe. I found that quite interesting in your presentation, I'd be interested in your thoughts. Thank you.

László Bencsik: The underlying portfolio deterioration is technically zero in Hungary, so that's more or less the underlying situation.

Yes. Sorry, what was the second question?

Simon Nellis: Yes, just on why you think corporate loan penetration is so low.

László Bencsik: Oh, yes. Well, corporate loans; that's actually a difficult question because if we go to page 7 of this presentation, I primarily talked about housing loans and it's quite clear that in housing loans we are much lower in terms of penetration than we used to be and lower than some other countries in the region. Corporate is more complicated because the corporate loans from the banking sector are only a fraction of the corporate loans in Hungary. A much bigger part is inter-company loans or direct financing of foreign banks to Hungarian corporates. These are typically the multinationals and this is three times the level what we have as loans from Hungarian banks. So, inter-company and other direct loans which are typically related to multinationals comprise bulk of the corporate loan book. On top of the overall leverage in the corporate sector there's these other dynamics which is more difficult for us to assess to which extent these multinationals rely on external or internal financing through their group as opposed to the banking sector. This 17.5% looks low but the overall indebtedness of Hungarian corporates is 80% of GDP and the difference between the 17.5 and the 80; those are interbank and direct foreign loans. You can look at this problem from two sides; the 17.5% is low but the 80% is certainly not low so why do we have a concern? The reliance of the Hungarian corporate sector on the Hungarian banks as sources of loans is relatively modest.

Simon Nellis: And is that likely to change, do you think, any time soon?

László Bencsik: It's hard to tell. I think it's unlikely that it's going to change structurally. Because it's more expensive to do it from the Hungarian banking sector since our cost of funding especially in euro terms is typically higher than what they can achieve from their groups or from the ECB or other banks in Europe. So in corporate we don't expect going back to the 2009/2010 levels of 30% corporate loan penetration; that's unlikely. So there will be some turnaround; maybe we can get to 20% in the foreseeable future, but not so much higher. However, I do see a structural opportunity for the housing loans; I think that's quite clear and we believe that it's going to actually happen to some extent in Hungary.

Simon Nellis: Right, super, thank you very much.

László Bencsik: Sure.

Operator: Our next question today comes from Andrzej Nowaczek from HSBC. Please go ahead.

Andrzej Nowaczek: Thank you. And on housing loans, Laszlo, can we go over the amortisation schedule of these loans; how much was amortised in the last two quarters, what is the outlook for the next two quarters, is it going to be lumpy or is it going to be declining quarter by quarter in the coming years?

László Bencsik: Okay. In the second quarter the new disbursement was HUF 37 billion and the normal repayment was 28 billion, whereas in the first quarter the new disbursement was HUF 24 billion versus repayment volumes of HUF 39 billion. So, in fact the normal repayment without the early repayments and the defaults were actually lower in the second quarter than in the first quarter. This is the fact which makes us believe that the turn-around should happen quite fast.

Andrzej Nowaczek: It's a bit like the situation with bond reinvestments. Is there a risk that suddenly in 2018 some of those pre-2009 subsidised loans will mature on a massive scale?

László Bencsik: No, in the annuity profile the share of principal repayment increases as time goes by so there's certainly this effect: the older a loan, the higher the proportion of principal repayment in the total repayment of customers, if that's what you refer to.

Andrzej Nowaczek: Yes, I'm just [unclear]...

László Bencsik: But otherwise, the old book is repaid in a kind of gradual way quarter by quarter, or month by month so there's no acceleration of that portfolio, except the fact that there's a growing share of principal payment from the customer's payment as the loan gets older and older. This does have some impact so there's some expected acceleration of the repayment of the old subsidised mortgages.

But the interest rates of those subsidized mortgages are still quite attractive because they were quite low originally and the subsidies made this product financially attractive for the banks and therefore we don't see kind of refinancing of the old subsidised HUF mortgages; this is not happening. Anything else than the normal repayment of these old subsidised HUF mortgages; we don't see any factor coming in.

Andrzej Nowaczek: Okay, I understand, thank you.

László Bencsik: Sure.

Operator: Our next question today comes from Marcin Jablczynski from Deutsche Bank. Please go ahead.

Marcin Jablczynski: Good afternoon, this is Marcin from Deutsche Bank. My question is on the competitive situation, especially in the Hungarian market. Interest rates are coming down, are close to zero, everything is coming down close to zero. Cost of risk; we're seeing in some other markets pressure in terms of new pricing for consumer loans, for mortgages; actually across the board. Could you describe, you know, the level of competition and pricing environment for your new production in the mortgage, retail and corporate loans, please? Thank you.

László Bencsik: I would describe competition as healthy; it seems rational, but tough. I would consider this a business-as-usual situation. We don't have very aggressive newcomers trying to destroy the pricing or the margins on these markets. On the other hand, the existing players are obviously keen on lending and having an increase in their market share so there's a healthy level of competition which obviously creates pressure on margins, but I think this is normal. It's especially true in corporate lending, I see more pressure on corporate than on retail; actually the pressure is partially coming from competitors, partially coming from clients. Because of the alternative return on investments and funds is very low, and there's quite a level of savings and liquidity in the system, the propensity to take a loan is not so strong with clients. They'd rather use their own funds if they have than taking loans and that's what we experience and actually we see some kind of increasing levels of paying back existing corporate loans or project finance loans because the alternative return on any liquid funds is very, very low or even negative in euro terms and therefore they try to use as much their own funds as possible and this creates some tensions coming from the clients in terms of pricing and less so from competitors.

Marcin Jablczynski: Thank you very much, and maybe one question on your loan volume growth. We're seeing some positive signs but still your quarter over quarter or year over year, you know, performing loan dynamic adjusting for FX is actually zero to 1%. When could we see kind of more tangible growth, closer, let's say, to mid-single-digit levels?

László Bencsik: If you look at the first six months then in Hungary the growth was 2% and in Bulgaria 3%. This is just the year to date growth, right, so this is not year on year, but the year to date growth in Hungary was 2% and in Bulgaria 3%. In Russia it was -11%, this is a declining portfolio, right, and this is a sizeable portfolio. So I would say Hungary and Bulgaria are already at this low single-digit level - two, three, four or 5%. Russia is quite negative and that now pulls down the overall group performance. The real question is when and to which extent the loans in the third or fourth quarter this year might increase in Russia. Certainly by the fourth quarter we do expect the declining trend to stop and even some growth to manifest, in line with expectations of consumption growth to come back to Russia because in the second quarter consumption growth was still negative. GDP growth was negative and consumption was negative. We hope that this is going to change by the end of the year and this should then be reflected in our portfolios. I think the weight which pulls back the group overall is now Russia and also Romania. In Romania this conversion campaign, where we provide discounts through principal reduction therefore in Romania year to date. First six months we lost 6% of the portfolio. These are the two negatives in the overall group level loan volumes; the -11% Russian and the -6% Romanian ones; at the same time Hungary grew by 2%, Bulgaria 3% and Ukraine by 3% in the first six months.

Marcin Jablczynski: Yes, understood. And maybe just to conclude on a lighter note, let me congratulate all of you in Hungary on five gold medals in Rio. This is quite remarkable, especially that the Olympic is still going on. Thank you very much, thank you.

László Bencsik: Thank you.

Operator: Our next question today comes from Stefan Maxian from RCB. Please go ahead.

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Stefan Maxian: Hello, good afternoon. Just a few questions; first maybe you can give us a little bit more colour on Touch Bank. I mean, do you have a plan; by when would you expect Touch Bank to break even and would you expect to get cost levels, for example, that you have right now going on?

Another question would be on OPEX going forward with the digital projects that you said; would you expect a higher OPEX for next two years for example, apart from this 3% increase that we have this year?

Finally, maybe do you have already an idea what [unclear] would impact your situation [unclear], your balance sheet, if you can share that with us?

László Bencsik: Touch Bank; we expect the break-even to happen in 2018. It's a new territory for us and this is an experiment and we believe that we can succeed in doing this. Certainly it's very exciting project and we're learning a lot and especially learning that being successful with an online-only bank is not so obvious and not so easy, which has two implications for us. One is obviously challenging, that it's going to be difficult. We have to work hard and it's not for sure that it's going to be successful, but we believe that we can make it. The other implication is that it's not easy for other players either to attack us as a pure online or mobile bank and given that 99.9% of the Group's universe is brick-and-mortar banks - with some of the group members being strong incumbents - this is actually good news therefore you can have two readings of the story. But certainly we believe that this is possible, to make this bank in Russia profitable. There's one very good example in Russia which has been actually successful. We do have lots of ideas how to improve it but it's true that acquiring quality clients other than transactional and depositors is difficult, so acquiring good-quality consumer lending clients through online channels is challenging and takes longer than we originally expected.

Cost of digital developments; we don't expect big cost items to come through because of this initiative. Somehow the extra costs of doing it and the benefits on the side of improving operational efficiency through internal digitalisation should balance each other for the future. We don't expect costs going up because of this digital initiative in the coming years.

The last question was the AXA?

Stefan Maxian: [unclear] if you have any idea.

László Bencsik: IFRS9? Okay, IFRS9. We have said that we believe that, given the current level of provisioning we don't expect further provisioning requirements coming from IFRS9. We started the process to prepare for this; we have a group-wide project, we are developing methodologies, we are on track and our initial assessment of the potential impact is that it's not going to induce further or more than the current levels of provisions.

Stefan Maxian: Right, thank you, okay.

László Bencsik: Sure.

Operator: Our next question is a follow-up question from Gabor Kemény. Please go ahead.

Gabor Kemeny: Thank you for taking my follow-up question. I wanted to confirm the Hungarian mortgage schedule you mentioned. Am I right that you were referring to normal repayments when you said 28 billion in Q2 and this did not include the early repayments?

Can you give us an idea how the early payments developed and more broadly, do you see a change here in the customer behaviour, I mean, do more people choose to refinance their loans that were repayments in the low-interest-rate environment?

László Bencsik: No, we don't see that. Again, the new mortgages we have been giving out since 2010 and the mortgages which we converted from Swiss franc; almost the entire portfolio up to this year is variable so customers had the benefit of lower HUF rate environment and therefore there's no incentive to refinance.

We only very recently started to give out fixed loans of longer-maturity. Fixed loans only started in Hungary during the course of this year, when we already have quite low long-term yields so this is not a problem and we don't see this building up. And the spreads on the new production are very similar to the spread of the market-based existing portfolio, including the one which we converted from Swiss franc.

Gabor Kemeny: I see, okay, thank you.

László Bencsik: Sure, welcome.

Operator: We currently have no further questions on the phone lines. As a quick reminder, if you wish to ask any further questions please press * 1 on your telephone keypad now. We have no further questions registered.

László Bencsik: Thank you very much. Thank you for joining us on this conference call. I wish you a very happy remaining summer and vacations and I hope you will join us during our next conference call, which is scheduled for 11th November 2016. Thank you very much again for participating and goodbye.