Strategy and Finance Division

Investor Relations

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Transcript

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P R E S E N T A T I O N

Operator

Ladies and gentlemen, welcome to the second-quarter 2024 conference call of OTP Bank. Please note that this call will be recorded.

May I now hand you over to Laszlo Bencsik, Chief Financial and Strategic Officer. Laszlo, the floor is open.

László Bencsik – Chief Financial and Strategic Officer

Thank you. Good morning or good afternoon depending where you are and thank you for joining us today on OTP Group quarterly stock exchange report-related conference call. Especially, thank you for joining us today when it's mid-summer. I'm sure it is Friday afternoon, so there might be other potential opportunities to spend your time on. So, thank you for deciding to listen to this presentation and Q&A.

So, starting the story on page 3 of the presentation, which you can see it and it's also available on the website. So, you can download it as usual. The first-half profit was HUF 508 billion, consolidated after tax, which, bottom-line wise, is less than the first half of last year.

But first half of last year was boosted by the two acquisitions which were concluded in the first and second quarters of last year, and both of them happened with badwill. Therefore, close to HUF 180 billion one-off we booked in the first half of last year. Now, if we take this number out from the base, the y-o-y improvement was actually 28% of the after-tax profit.

Second quarter was strong, the 12% q-o-q increase partially due to lower regulatory charges. As you probably remember, we accounted for the bank tax and the special bank tax for the entire year in the first quarter and some other supervisory fees and charges, as well, outside Hungary. So, that had an impact on the base, as well, on a quarterly basis.

In y-o-y comparison, the biggest improvement happened in the net interest margin. First half of last year was still characterized by this very excessive, close to 18% level of external rate environment, which did not help our margins. So, we, especially in Hungary, had a lower-than-usual net interest margin that normalized by the end of last year. Since then, it has been more or less stable around this 4.3% level.

After the closing of the first half, at the end of July, we concluded the transaction of selling our Romanian business after 20 years of ownership. The final financial impact of that transaction will obviously be seen in the third quarter this year, namely the gain on the capital ratios. So, you can expect, on a pro forma basis, because obviously we don't know how the balance sheet is going to look like at the end of the third quarter, but let's assume that the sale had happened at the end of the second quarter. Then you can see on this page the potential impact on the common equity tier one and capital adequacy ratios, in improvement in the range of 56 and 61 basis points. So, this is what you can expect to happen or in ballpark numbers to happen at the end of the third quarter.

If you look at the P&L lines, then I think the most important one is probably this 20% increase in operating profit y-o-y, first half, without the effect of acquisitions and without FX changes, as well. So, just a baseline comparable business activity y-o-y generated 20% more operating profits organically. This is to a large extent driven by improvement in margins.

I'm sure you noticed the somewhat higher risk cost in the second quarter. We are not used to have these levels of numbers on a quarterly basis, HUF 46 billion. Most of it is related to events which are not so much connected to the daily activities. If we had not changed our methodology starting from this year, we would have shown two items from this HUF 46 billion as one-offs, namely the increased provisions on the Russian bonds in Hungary and in Bulgaria. We started to do that in 2022. In 2022, it was a one-off adjustment item. The other one is the impact of the extension of the rate caps in Hungary by another six months.

These items together had an almost HUF 30 billion equivalent impact. But I'm going to explain it later on when we have a slide about base cost. Out of this HUF 46 billion, close to HUF 30 billion is related to items which, under the old methodology we used to have, would've been one-off items.

Going briefly into the Hungarian story, which is still our biggest member or contributor, single contributor, to the group results. All in all, in terms of after-tax profit, the Hungarian banking activity contribution was 28% and still by far the largest, but nevertheless it represents a declining part.

So, the same story is being told on slide 5, a big improvement in that interest margin year on year compared the first half of last year. That resulted in a strong improvement in earnings. On top of the improvement in margins, we had less regulatory charges in the first half of this year than last year.

In the right-bottom corner, you see the special levies and other charges in Hungary. We compare the first half last year to this year. So, last year, they amounted to HUF 138 billion; first half this year, only HUF 97 billion, which is still a huge number by the way, but at least lower than last year first half.

We explained part of these one-offs, non-recurring items, here on the left-lower side of the slide, especially the impairment on the Russian bonds which are held by Hungarian entity, and also the impact of the extension of the rate cap in Hungary.

My usual two slides about the Hungarian retail and corporate activities. Hungarian retail lending accelerated, especially mortgage lending. You might remember that last year, we had a relatively modest growth in mortgages, only 4% in a whole year. Now this year, only in the second quarter, we grew 4% volume-wise in mortgages. If we compare the total new contractual amount, so basically new business generation, first half this year to first half last year, then the increase was 2.6 times last year volumes. Obviously, last year was very low. After a quite strong 2022 number, 1H 2023 dropped like 50%. But it does seem to be a fast recovery from the last year's depth in new mortgage generation.

The other segment of the retail market, consumer loans is also strong. Last year, this segment actually grew quite strongly, 16% was the annual growth last year, and this segment kept growing. So, in the first six months this year, we had 4% growth, so the growth rates somewhat slowed down. But now, we have a much larger base than at the beginning of last year. Plus if you look at new volume generation, the new contractual amounts in the first half year of this year, we're more than 60% higher than first six months last year.

The corporate story is somewhat different: still, on a corporate market, especially mid and large corporate, we don't yet see clear signs of revival and the return of loan demand. We see albeit small growth in micro and small, which is primarily fuelled by the still available subsidized products to this segment, mostly this Széchenyi Card MAX+ program, which is available for micro, small companies.

So, in that segment, we see some increase in volumes and loan demand, but not much in mid and large corporate. Now, this picture maybe not as polarized as in Hungary, but still applies to most of the region. So, we typically see higher loan demand in retail than in corporate across the countries in the CE region.

In terms of profitability and actual net income of our foreign subsidiaries, foreign group members, across the board, we had quite strong performance in terms of nominal profits and in terms of return on equity, potentially with the exception of Romania which had only 2% ROE in the first half of this year. But here, the news is again that we had actually concluded this transaction and divested this asset from the group.

Looking into the P&L lines across the cross section within the group and trying to understand a bit more the developments, drivers, and dynamics. Page 9 describes net interest income development year on year and quarter on quarter. Especially, the y-o-y numbers, where appropriate, have been adjusted by the new acquisitions. So, where you see actually two numbers, the second number is the 'without acquisition' number.

So, all in all, without the impact of acquisitions y-o-y net interest income in the first half of the year increased by 25%. And Hungary is obviously very strong, 50% y-o-y increase. This is mostly attributable to the margin improvement compared to last year.

We have the Eurozone or Eurozone-related countries: Slovenia, Croatia, Montenegro which uses the euro despite not being in the Eurozone, and Bulgaria which is already in the ERM2. There's a currency board in place for more than 20 years, so it's a quasi-Eurozone country at least in terms of rate environment. As you can see, strong 20%-plus typical y-o-y improvements, which are again related to margin improvements, as well. But in some countries, we had strong volume dynamics, too.

Maybe one surprising number here on this chart is the minus 6% in case of Uzbekistan, Ipoteka, on a q-o-q basis. So, the second quarter was 6% lower than the first quarter in terms of net interest income. This comes primarily from volume dynamics. In order to pile up some liquidity for future expected loan growth, financing in local currency, and partially just strategically to reduce the loan-to-deposit ratio, you will see that deposit growth is exceptionally strong. At the same time, basically unrelated to this, but loan growth was quite modest, which is a big change compared to the second half of last year and the first quarter, especially in retail. That's because we achieved significant sales of loans in the previous quarters that we had to slow down intentionally in our loan production in order to catch up with operations basically with the IT and organizational capabilities of servicing and managing these loans. So, that's a temporary situation. Hopefully, we can return to very high growth rates again in the later part of this year, maybe fourth quarter. By then, we should be able to address most of these operational weaknesses, so to say. The market is still quite strong. So, in a way, it's sad that we cannot keep pace with it. But that's the reality at the moment.

Margins, on page 10, more or less reflect the same trends, i.e. strong improvement in Hungary and in the euro-related countries. In Uzbekistan, a decline in margins was due to increase in deposits and, by the way, deposit rates increased, as well. So, that's how we managed to get more volumes. That actually resulted in lower margins.

On page 11, you see the waterfall explanation of the q-o-q change in the net interest margin, which was rather small, altogether 3 basis points. More interesting on this slide, we put up the euro rate sensitivity and the HUF rate sensitivity. These are assuming a parallel shift in the relevant yield curves, and the 12 months effect or impact of that yield curve shift on the NII theoretically, assuming a stable balance sheet or stable volumes. In case of euro, this sensitivity decreased to EUR 110 million on an annual basis for 100 basis points downward shift. Obviously, if the euro rate goes down, our NII goes down by EUR 110 million. Sure, you noticed that this is a smaller number what we talked about a quarter before or six months before. So, we are in the process of trying to moderate this interest rate risk primarily through buying fixed euro assets, but also through interest rate swaps. But it's still a meaningful and potentially negative situation, since our expectation is that euro rates will decline. Therefore, part of this NII decline, at least on a pro forma basis, is going to manifest.

In case of the HUF rate, as similar to the previous two periods, we reached a rate environment where the 100-bps change would not have a material impact on the expected NII for the next year. So, we are pretty much at a low, very low interest rate risk situation related to the HUF part of the book.

Now volume trends as you can see, in the second quarter, overall, volume dynamics improved q-o-q. In the first quarter they grew by 2%; in the second quarter by 3%. Therefore, we ended up having 5% growth in the first six months. This was one of the parameters in which we gave some guidance at the beginning of the year. We said was that we expected better volume dynamics this year in loans than last year. Last year, the full year was 6% growth. So, this year, in the first half we had already achieved 5%. So, I think we can be fairly optimistic to expect that this 6% which we had last year will be surpassed this year.

So, it's an overall improvement compared to last year. Even if you look between the quarters, the second quarter seemed to be stronger than the first quarter. Especially in countries like Bulgaria, Croatia, Serbia, Albania, Montenegro, we see 4%, 5% overall volume growth just in one quarter.

So, these are not annualized numbers. Obviously, these are q-o-q numbers. We are very happy to see that in Ukraine, after a relatively long period of decline in loan volumes, we managed to restart lending again. We see demand which is justifiable and makes sense from a risk perspective. So, we started to reignite our lending activities to some extent, albeit from a very low base, in Ukraine. Just in one quarter we achieved 11%.

Here, you can see this Uzbekistan situation. Ipoteka, with only 2% quarterly growth in consumer loans and mortgages, which is much lower than what we used to have in the previous three quarters since we started to own the bank last year at the end of the second quarter.

In Hungary, as you can see, 2% consumer loan growth and 4% mortgage growth in the second quarter, while corporate volumes were negative. So, this is something I talked about before.

Page 13, I covered, and it leads us to deposit dynamics, which is, again, very positive, especially in Hungary. You may remember that last year, one of our biggest problems was the decline of retail deposits overall on the Hungarian market. This is not specific to OTP. Actually the decline was less in our case than in the market. But nevertheless, it was very painful. In one year, between the mid-2022 to mid-2023, retail deposits declined roughly by 10% in our case. That had a huge impact, huge negative impact on the margin given that we don't pay much. Not just us, most of the banks in Hungary don't pay much interest on retail deposits. Now this trend has changed, and this is crucially important for the future development of our earnings in Hungary. So, the first six months' retail deposits grew by 5%; in the second quarter, by 2%. So, that seems to be now a well-established new trend. The other number which is interesting on this slide is the strong growth in Ipoteka, +17% in just one quarter. This is the developments I described earlier.

Now leaving net interest income behind, we reached, on page 16, the net fee income details. Fee income growth without the impact of the acquisitions was 14% y-o-y. Here, you can see the per-country numbers: Hungary, 13% y-o-y, 16% q-o-q. The q-o-q in other countries as well, quite strong, especially in those countries where tourism is strong. There, we usually have the seasonality, so the first quarter is much slower than the second quarter plus some repricing also happened. Especially in Hungary, we adjusted our fees in March this year; given the massive inflation last year in Hungary such increase was possible.

The other strong increase happened at Hungarian Fund Management, almost 60% growth y-o-y in fee income. This is just related to the surge in the asset under management: amid the high-rate environment assets under management increased on the market and for our asset management company, which is by far the largest one in Hungary, as well. So, this is also structural change.

Other income, now the other income line was again heavily affected by the fair value adjustment. We always have to mark-to-market part of our assets, namely the subsidized housing loans and the baby loans. This exercise results in fair value adjustments up and down depending on the shifts in shape of the yield curve. So, it's not just the increase or the decrease or the shift. It's also the shape of the yield curve effect, the fair value adjustment. Last year, it was a big positive number. For the whole year, it was around HUF 80 billion and part of that was booked in the first half. This year, in 2Q, we had HUF 6 billion positive, but the first quarter was actually negative. So far this year, the impact of this fair value adjustment of these loans is plus zero. In the second quarter, we received HUF 10 million dividends after the shares that we own from MOL, that's the Hungarian oil company. You may remember that we have a share swap. We have such share swap for more than 10 years for sure, maybe 12, 13 years, and we benefit from the dividends paid by MOL on these shares.

The cost dynamics was 10% y-o-y without acquisitions. Hungary was 6%, and this is, I think, an important development that we managed to slow down the Hungarian cost increase despite a very high inflation which we had last year in Hungary. Then Bulgaria, relatively high growth, but this is related to the very dynamic business activity and transformation work what we do there. In case of Slovenia, 19% y-o-y growth organically, but we expect that to be less because we are to conclude the merger of NKBM and SKB, our two banks in Slovenia, very soon. So, during this quarter, we intend to finalize the merger. Then we expect cost synergies to be realized there. So, hopefully, when we look into the y-o-y development, of course, we will be able to identify the positive impact of cost synergies being manifested, just like we can see in case of Albania. As you can see, it's minus 15% y-o-y for six months. This is due to the fact that we concluded the merger in Albania close to the end of last year, in November, early December. We already realized most of the cost synergies during the first six months of this year.

Now risk costs, again, this is an unusually high number, HUF 46 billion of risk cost in one quarter. Whereas in previous quarters we were more used to have zero or even positive numbers. Again, if you look at the content of this number, most of this HUF 46 billion manifested in Hungary, HUF 39 billion.

That HUF 39 million includes, on the other risk cost line, the HUF 22 billion provision for the Russia bonds what we have in Hungary. Probably, it's an interesting information that the total volume of Russian sovereign bonds is HUF 128 billion. Including this latest provisioning, we provisioned 57% on this. So, the net value is HUF 56 billion. Most of these bonds are in the Hungarian books, some of them in the Bulgarian one. Now out of this HUF 128 billion notional amount, HUF 110 billion has not reached its maturity. We receive regular coupon payments for these bonds. Therefore, this high level of provisioning might be surprising. But certainly, it is difficult to identify levels of risk related to future payments and ultimate repayments of these outstanding bonds. Therefore, in line with the expectations from the Hungarian Central Bank, we increased provisioning on these exposures. Now if the situation doesn't change, so if it continues as it is, we will keep receiving coupon payments. Hopefully also, full repayment of these bonds might be expected. Under the good scenario, most of these provisions will be written back. But that is difficult to foresee, and it is certainly at risk. Therefore, I think it was a prudent conservative decision to increase provisions on these exposures. This is certainly not related to any normal business activity, what we have within the group.

The other item which is included in this Hungarian risk cost is HUF 5.6 billion provision which actually appears among risk cost and no other risk costs for the extension of the interest rate cap on the variable mortgages in Hungary, which is now 10% of our total mortgage volumes in the country. The remaining part of credit risk, roughly HUF 9 billion, is basically coming from corporate exposures, which we classified from Stage 2 to Stage 3, not all the HUF 9 billion, but roughly HUF 6 billion, HUF 6.5 billion. So, the most of this is related to corporate exposure.

As for the overall credit quality in terms of Stage 3 ratio the group level was stable q-o-q. Hungary increased, as I mentioned, we moved certain corporate exposures from Stage 2 to Stage 3. Therefore, the Hungarian Stage 3 ratio increased, and Stage 2 ratio decreased. Given the size of the Hungarian portfolio, it had actually visible impact on the group level as well, as you can see. That's behind the Stage 2 decrease, more or less. Coverage levels have not materially changed.

On page 21, you see the development of our capital ratios. Common equity Tier 1 went up to 17.4%. Capital adequacy ratio actually decreased by 10 basis points. This is due to the fact that we repaid the Tier 2 subordinated bonds, what we issued back in 2019. They became callable, and we called them. It was HUF 500 million. That disappeared from our regulatory capital; therefore it had a negative impact on the ratio. Nevertheless, due to the very high level of common equity Tier 1, it's still a comfortable capital ratio level.

Here, you can see on this page as well, the water flow components of the change in the common equity Tier 1 ratio, which improved 180 basis points during the period: the 170 basis points was the impact of the profits after deductible dividends, and that shows the capital generation capacity of the bank just in six months.

On page 22, liquidity remains strong. We did a couple of issuances during the course of this year, Senior preferred MREL eligible bonds in order to maintain our MREL adequacy, given the call back of our Tier 2 bonds. We paid back another senior preferred bond that matured in the third quarter. Actually it didn't mature, there was a call date for this instrument.

In terms of expectations for the rest of this year, from the perspective of the external environment, it does seem to be better and improved compared to last year. This is very obvious from the macro parameters we observe, and we believe that the rest of the year should continue to be supportive.

Therefore, we look optimistically into the future. Eventually, the only missing part from an almost full picture is corporate loan demand growth, which is rather muted, especially in Hungary. But also, in the other CEE countries, it's relatively low. We are waiting for a recovery in corporate loan demands.

Looking into our management guidance on the last page, we pretty much maintain the expectations what we had formulated at the beginning of the year. The only exception is the net interest margin where we believe that it's high time to acknowledge much better performance what we originally expected. Originally guided for similar net interest margin on a group level to last year, that was 3.9%. Now the first six months is closer to 4.3%, and that's primarily due to two factors. One is that the euro rate environment remains higher for longer than we originally expected. The other one is the developments in Hungary and retail deposits, which has a strong impact on our NIM in Hungary, but also for the whole group.

So, that was it, more or less a formal presentation. I'm sure you have very exciting and interesting questions. So, please ask them.

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

Operator

The first question is from Gábor Kemény, Autonomous Research.

Gábor Kemény – Autonomous Research

My first question is on buybacks. I mean your current program is coming to an end. How do you think about launching a new one? Are you planning to cancel the shares, which you have bought back?

The other question would be a broader one on your capital deployment plans. If you can share your latest thoughts, please. Now on a pro forma basis, your CET1 ratio is approaching 18%, and you are clearly generating enough profits to support your balance sheet growth. So, what is the latest on M&A versus distributions?

The final question will be on the financial transaction tax, please. You offered this useful guidance on the 2024 impact from the taxes. How do you see the effect of all these in 2025? I guess we saw some news on SME fee hikes. Today I saw something about raising mortgage rates to 8%. So, it would be helpful if you could give us a sense on what the bottom-line impact might be from these measures.

László Bencsik – Chief Financial and Strategic Officer

Very pertinent questions, indeed. Thank you.

Buybacks. Indeed, we are reaching the end of the previous program, which started in February. This is obviously something which we consider. So, we give a careful consideration to this question or opportunity. At this event or time, allow me not to say more. I think we will continue the practice which we have done before, namely that we announced buyback around the day when we have an approval for a tranche of buybacks. So, I can't say really more than this. As a tool, this is obviously part of the universe that we consider as a strong element of our capital strategy, our capital deployment plan as you phrased it. But as you rightly said, this has to be put into perspective and together with the potential acquisition opportunities. So, we are trying to navigate optimally in this field between dividends, buybacks and, first of all, organic growth, because organic growth is a priority and organic growth started to strengthen. Again, last year, we had 6% growth for the whole year; this year already in the first six months, loan volume growth was 5%. So, organic growth is becoming a strong factor in this equation. The first priority is organic growth, and then we continue to actively look at value-creating acquisition opportunities as we have done during the last 20 years, and they may or may not come. Depending on whether they do come or don't come, we can obviously return more to shareholders in the form of dividends and buybacks. So that's more or less the full picture, which has not changed. It continues to be our high-level thinking about capital allocation. In terms of what volumes exactly and when, again, we stick to our previous practice, we will announce further actions when they become effective.

Cancellation, you also asked about this. That's a bit more complicated process. We need shareholders' approval for that. We need a shareholders' meeting to approve any cancellation of shares. So, I think as early as next year this can happen; next April we will have a decision about this. We have not considered that so far. You probably very well know that we have not ever cancelled any share. On the other hand, and more importantly, we have never ever issued new shares since the IPO in 1995. We have the same number of shares. So, that's something, obviously, we will consider and think about, but this is not something imminent to consider actually due to the more complicated approval process and also due to the fact that after the buyback of HUF 60 billion, we have roughly 1.5% treasury shares of the total share count, which is not yet a huge amount. So, maybe it makes more sense for us to accumulate first and then address the question of cancelling or not cancelling them.

Transaction tax for next year, indeed we told that for this year the impact of the increase of the parameters of the transaction tax, translates into HUF 25 billion more transaction tax for the remaining part of this year. Well, this is for 5 months. So, you can imagine that the increase for the whole year next year will be at least double plus the volume impact coming from the higher volume of transactions. So, this is a substantial amount. We are not allowed to pass this through to retail clients this year. There's no rule, however against passing it through to corporate clients. Indeed, we are just following the practice of our competitors who started to pass this on to their corporate clients. So, we are going to do that, as well, like other banks. I mean, how much we can pass on next year to retail will depend obviously on the competitive pricing situation and the competitive moves of our competitors in the country, which I cannot foresee.

Máté Nemes – UBS

I have three questions, please. The first one is on Bulgaria. There, I think you flagged that clearly there is still an ongoing restructuring at the bank happening. Branches, I think, were down 5% q-o-q. Costs are still around HUF 25 billion in the second quarter.

I'm just wondering if you could give us some indication here what the timeline is and what decline we should expect in the cost base, i.e., how much of restructuring costs are in there? Then what is the savings that you expect as a result?

The second question would be on corporate loan growth. I'm just wondering if you could talk a little bit about the potential recovery of volume growth, not only in Hungary, but perhaps across the entire region. What would be the preconditions for a sustained pick up here?

The last question would be on the Russian bonds. Could you comment on the remaining maturity of these bonds? Also, what could trigger further increase on coverage of these bonds?

László Bencsik – Chief Financial and Strategic Officer

Bulgaria, I'm sorry if I use the word restructuring. That's probably not the right expression, it's more transformation. This transformation really started when we bought Société Générale Bulgaria back in '19 and started the merger. Since then, we have been in permanent transformation, so to say. I think we are building a very competitive bank. It's not about cost reduction or cost cutting in a way. Cost efficiency is extremely good. If you look at the cost-to-income ratio of Bulgaria or if you look at the return on equity in Bulgaria, the current one, we make 22% return on equity. This is a quasi-eurozone country. Last year it was 24%.

Capital requirements are extremely high due to being supervised by ECB directly and the Bulgarian National Bank as an additional layer, and they keep on piling up capital requirements on us. So, we have actually the highest capital requirement and therefore, very low leverage in Bulgaria. Despite of that, we make this 20%-plus ROE. If you look at growth, last year loan volumes grew 20% in Bulgaria, right? This was the highest by far in CEE. Potentially, I think the highest in Europe, I don't think there are very many banks growing organically so fast. I mean, big systemic banks. We have the largest loan volume in Bulgaria. So, 20% last year. In the first half of this year, it's 8%. It is quite strong. So yes, it's a very rapid, strong growth, which is very profitable. So, we're quite happy with all the ratios, including operational efficiency. But what we do in order to maintain these dynamics and assure that the bank will excel in terms of performance in the future mid-long term, we are transforming more or less everything. I mean, only part of this is visible for the outside, because we do a lot of work on improving our digital channels, for instance, we changed the mobile bank, the Internet bank and this is going to come to the market at the end of the year. There will be a huge improvement compared to what we have, we basically do process reengineering in a way that we try to digitalize everything end-to-end front to back, change the organization agile, but it's an advanced agile approach, while we have a lot of other stuff. Not to mention the fact that since October 2020, we have been under the direct supervision of ECB because Bulgaria entered the single supervisory mechanism. We are a systemic bank there, but our Bulgarian bank belongs to the OTP Resolution Group, which is supervised by the Hungarian supervisor, the Hungarian National Bank and not by ECB. All the other systemic banks in Bulgaria on the group level are supervised by ECB. So, there's not much local presence there from ECB, unlike in our case, where we have a daily, actually very fruitful work with ECB and has been quite an exciting story so far to change the bank the way it operates according to their requirements, as well. At the same time, we achieve these levels of growth and profitability. So, it's not about cost saving and it's not about fixing a problem. It's about further transformation to create the best platform for future high performance in Bulgaria.

Corporate loan growth sustained pickup? That's difficult. I mean ultimately, corporate activity in Central Eastern Europe is closely related to core European economic development in general and corporate activity in general. So, here we are to a large extent in the hands of Germany, Austria and in general core Europe. I wish I could say that I'm very optimistic on the development potential of core Europe, but I'm not. So, that means that I think it is a general problem for Europe, obviously, and it is somewhat a problem for CEE. But the good thing is that CEE has other levers. There's still a convergence. There's still local demand, which is strong and still lots of FDI coming to the region, especially due to this supply chain arrangement as capacities move back closer to Europe and then also especially in case of Hungary, we see a bunch of investors from Asia bringing in substantial FDI. I think CEE has the better positioning than core Europe in terms of growth potential, but a stronger underlying driver behind this is still and will be in the future the performance of core Europe. We might have different views on that. I'm not very optimistic, to be honest. But I hope I will be proved wrong. So, we expect gradual improvement from a low base, albeit. The second half, we expect to be better in corporate lending than the first half. But to be honest, I don't know when we can get back to double-digit corporate loan growth across the region in corporate. That may not happen during the next six months. Your third question was about, sorry.

Mate Nemes – UBS

It was on the Russian bonds.

László Bencsik – Chief Financial and Strategic Officer

Yes, the bonds. They will start maturing next year and then the next two, three years. That's gradually or more or less evenly distributed. If the current situation changes negatively either because of the legal environment or in terms of stopping the payments for of the coupons or something like that, I'm sure we'll have to revisit the situation. But to be honest, my feeling today is that we are quite conservatively provisioned. If the current situation persists, then it might happen that a big chunk of these provisions, what we created so far might be released.

Operator

The next question is from Simon Nellis, Citigroup.

Simon Nellis – Citigroup

I was hoping you could elaborate a bit more on the interest rate sensitivity. I mean in one quarter; the euro interest rate sensitivity went down by HUF 30 million for each 100 basis points rate cut. So, do you think you can bring that down further going forward? I guess the analysis is on a static balance sheet. As you change the balance sheet can you further reduce that sensitivity?

Then on the Hungarian margin, at what level of Hungarian rates would you actually start seeing pressure on your Hungarian margin? What is your rate view for Hungary? Then I have a few other more technical questions. So maybe let's take that one first.

László Bencsik – Chief Financial and Strategic Officer

The sensitivity decreased because we bought euro-denominated fixed rate securities, and we made some interest rate swaps deals, which further reduced this. Having said that, it is less important in this case or less of a useful tool because it's difficult to make them subject to hedge accounting. Therefore, big volumes with interest rate swaps would imply big swings in earnings if there's mark-to-market event. So, we don't want to do them in big volumes. It's basically buying fixed rate euro-denominated securities. It's a fixed balance sheet in a sense that it's fixed for the next 12 months, right? So, this is not the same balance sheet. The quarterly change includes the impact of changes in the balance sheet during that quarter, right? Fixed balance sheet means that it's fixed at the end of the second quarter this year and what would be the NII impact if the yield curve shifted 1st of July by 100 basis points. So that's how we calculate that.

The expectation is that it can be further reduced. So, the direction is that it will be further reduced maybe not with the same big steps, maybe smaller quarterly steps, but the direction should be for smaller amounts for the future.

Hungarian margin, again, it's less the interest rate itself now, which matters. It's much more the deposit volumes, retail deposit volumes, especially the stability of retail deposit rates, very important. Those are actually much more important variables for us than the rate itself, unless the rate goes down to zero, right?

But that's unlikely. If it's like 6%, 5%, it's still the same environment. Now 2%, 3%, it's getting to a different range. But again, it is much more important that we have a healthy and normal growth of retail deposits in the future and then that the retail deposit rates are not going to change on the market in the future. So, these are potentially much more important factors.

Then the other thing, there's a lot of noise in the Hungarian net interest margin coming from the fact that it's not just a bank, it's also the holding entity of the entire group. Therefore, a lot of liquidity, which is related to operating the group is flowing through the Hungarian entity. That's one thing. The other thing is that all the investments into the whole group are held at the Hungarian bank, and they are not interest-bearing assets. If we have another big acquisition, that's going to have another negative impact very naturally on the Hungarian NIM.

This large issuance of, from our perspective, very expensive bonds, MREL eligible bonds, again, most of the negative impact of those bonds manifested at the Hungarian entity. So, those are the other factors which need to be taken into consideration, and that makes the whole picture rather more complicated.

So, it's not just the Hungarian activities and business-related impact what we have included in the Hungarian margin, but everything else which comes from the fact that we are a holding entity as well for the entire group. Now the entire group is a much bigger size than the Hungarian entity. So that was a rather long answer.

Simon Nellis – Citigroup

That's very helpful. Yes, my technical questions are, you mentioned the expectation for financial transaction tax next year. Can you give us some hints on what you think the windfall profit tax will be, I guess it's difficult because we don't know the exact calculation, but I guess you have some preliminary ideas of what the government is thinking.

László Bencsik – Chief Financial and Strategic Officer

As you rightly said, it's difficult. The only indication which was actually communicated by the government that they want to collect at least as much as they collect this year. Assuming this 50% discount that everyone can apply, then this year they will collect roughly HUF 130 billion from the whole sector in terms of the extra profit tax.

That's what the government's expectations are. So, all in all, it may be a similar number for next year. This year, our extra profit tax payments are quite volatile.

In 2022, we paid HUF 75 billion, it was the year when the Hungarian operation was loss-making. So due to all the impact of the war, I mean all the extra provisions we had to make and the write-offs we had to make. So, the tax base of this extra profit tax in 2022 actually was a big negative number.

Despite of that, we paid HUF 75 billion. In 2023 we paid HUF 41 billion. This year, if you assume the 50% discount, then we're going to pay HUF 6.5 billion. Due to the fact that this year, the extra profit tax is actually calculated based on the 2022 before tax numbers, which in our case were actually negative and OTP Bank was a big negative. Then there are other entities which pay this extra profit tax, like our mortgage bank, our workout unit and Merkantil Bank, our car leasing company. So, the reason we are paying at all this year is that these entities are paying. So, that's where the HUF 6.5 billion comes from, assuming that we can reduce the HUF 13 billion to HUF 6.5 billion by buying government bonds, which we do. Then the other thing they said that they will move the tax base from 2022 to 2023 profits. Now the total banking sector profits from 2022 to 2023 before tax without dividends grew four times. So, they will have to change something in the ratio, as well. As you said, we just don't know how they're going to calculate the actual payment. What we know is that all in all, they want to collect at least a similar amount what they plan to collect this year. In order to have this 50% discount or reduction in the tax payment, we will have to increase not just the long duration government bond volumes, but the overall Hungarian government bond volumes as well, and it's going to be the first 11 months average volume y-o-y growth. Both the total volume and for the longer maturity volumes as well, we have to demonstrate growth and 10% of that average volume growth we can deduct from the tax payment. It can be maximum 50% deduction.

This for the whole sector assumes 50% deduction or discount for the tax payment. So I don't know how much we are going to pay out of this HUF 130 billion for the whole sector next year. Probably more.

Simon Nellis – Citigroup

Probably more, that's what I was going to say.

László Bencsik – Chief Financial and Strategic Officer

Probably more than the HUF 6.5 billion we paid this year. That's very, very likely.

Simon Nellis – Citigroup

Okay. Then just one last quick one on the financial transaction tax. The numbers you're giving, that's gross before any mitigation, right? So, you could mitigate that through passing on some of it to corporate clients.

László Bencsik – Chief Financial and Strategic Officer

Yes, this is tax payments.

Operator

The next question is from attendee joined via phone.

Robert Brzoza – PKO BP

I have two actually, one on the cost of risk. From what I recall, OTP Factoring usually contributed positively in the amount of between HUF 15 billion to HUF 20 billion per quarter in terms of provisioning releases. Has there been such positive contribution in the second quarter as well? Or if not, has anything changed with regard to the second half of 2024? So, that's question number one.

The other one is related to migration out of Stage 2 into Stage 3 exposures in Hungary in the corporate segment. Could you please give us possibly more colour whether it was concentrated in a specific sector or it was more coincidently spread among different sectors?

László Bencsik – Chief Financial and Strategic Officer

There hasn't been any change or one-off change or any extraordinary change in the contribution of the factoring entity or the workout entity in Hungary to the group in terms of recoveries. The only difference is that this is an ever-decreasing number due to the fact that there's not much new production in terms of non-performing loans.

So, this is a very good situation that quarter on quarter they have less and less work to do, so to say, at least in terms of new inflows. Therefore, this is a structurally declining amount. But this kind of, you might say, unusually high-risk cost in Hungary was not due to the fact that the contribution of factoring in Hungary, our workout unit was less than originally expected or anything like that.

It basically comes from the fact that we continue typically to recover more from Stage 3 loans, non-performing loans than what we provisioned when they become Stage 3. This reflects our conservative approach and a very good work with our colleagues in the work-out unit.

Indeed, this increase in Stage 3 in Hungary or migration from Stage 2, happened due to three companies. One was in the construction sector and other one is an agricultural one. The other one I don't even know. So no, it doesn't seem to be concentrated to a specific sector, and we don't interpret this as a sign of some structural change in the quality of the Hungarian loan book or the underlying economic situations of our clients or systemic deterioration. I mean it's more like if you don't have any defaults for years, then statistically, sometimes they do happen. One of these out of three was actually a more sizable one. But it was already in Stage 2. So, we followed the situation closely and it was a known problem for us. So, it was not something which jumped out of the cupboard or something like that, surprisingly. So, this is a situation we have identified some time ago as a potentially problematic one.

Operator

Mehmet Sevim **–** JPMorgan Securities.

Mehmet Sevim – JPMorgan

I had just three questions, please. Coming back to the Russian government bond coverage. I just wanted to understand what has triggered that increase in coverage at this point exactly. Was it just the Central Bank asking you? If yes, on what grounds? Given from what I understood from your comments, not much has changed in the expectations for the quality of that portfolio.

Secondly, also continuing with Russia, it seems the business is growing at an accelerated rate now. Loans are up 13% quarter on quarter and almost 40% y-o-y. So, I was just trying to understand the strategy there a bit better and how you're balancing the business opportunities with the wider concerns are growing so fast? Where you would see the growth in the second half of the year and maybe next year, if there's anything you can share on that, that would be very helpful.

One final follow-up also on the buyback. You obviously said that you'd like to update us once you have the approval by the Central Bank if you ask for a new one. I would assume you'd apply for a new one once the current one concludes. So, could you share any qualitative information on the approval process by the Hungarian Central Bank? Specifically, how long does the process usually take? What's the view on buybacks in general now, especially if you ask for a bigger one? That would be very helpful.

László Bencsik – Chief Financial and Strategic Officer

Right now I think this is a relevant question. Indeed, if you just look at the specific situation of these bonds, nothing has changed other than they paid another quarter of coupons. I think there are different ways to interpret the situation whether the potential future risk of the situation becoming better or worse. Our supervisor took a particularly conservative approach regarding this, and they may be right. So, we are not against conservative provisioning approaches. We understood their position and we agreed with their position, and therefore we provision more. But you are right that nothing new and especially nothing negative new information appeared specifically related to these bonds, the overall developments in the geopolitical global situation and the war itself and the potential outcomes and ramifications. To what extent they change, for whom, that's another topic. But again, we basically discussed it with the supervisor again, and we agreed that the more conservative approach was something we could completely accept. Therefore, we provision more. Having said that, in a reasonably good scenario, it might happen that we will be able to release these provisions, which will be good news. But again, we might have to provision more. It's difficult, I mean there's no scientific method to exactly calculate the right level of provisions. It's not like having a big, I don't know, mortgage volume, which you have observed for 20 years, and then you can pretty much reasonably well forecast the credit quality development.

Russian strategy, the first goal and our first priority is to comply with every rule and regulation which is applicable to this entity in Russia into our activities in Russia. So that's by far the most important strategic goal, so to say, including all the compliance and ALM-related requirements.

Beyond that, when the war started, we decided to limit the scope of our activities to activities which are potentially the least problematic in a geopolitical situation like this. So, we immediately stopped corporate lending. Since the beginning of the war, our corporate loan volumes have gone down by 85%, and they will continue to amortize. We are not giving you corporate loans.

Then more than a year ago we stopped all dollar transactions. Other banks continue to provide to their clients' dollar transactions. As far as I know, they very recently started to talk about stopping them. So, we did that more than a year ago. Last year, we also limited euro-denominated transactions to counterparties within Europe.

We reduced the number of branches by almost 40%. We reduced the number of the headcount by 25%. Overall, we tried to reduce our exposure and I think the most relevant measure of exposure is the equity, the assets, the financial assets would get stuck in Russia, because there are capital controls. Altogether, the foreign-owned banks still have like EUR 9.5 billion equivalent of equity or something like that.

In Russia, we have EUR 800 million out of that. So ours is like 8% of the total equity stock in Russia. One of our business objectives is to reduce the exposure. First, we did in 2022, we managed to pay back all the funding, which we used to provide to our Russian entity. So RUB 11 billion group funding was paid back in 2022.

Then last year, the bank paid RUB 13.5 billion dividend and this year, RUB 13.6 billion has been approved. Strategically, this is probably from our perspective, the third important element. So, fulfil all requirements, limit the scope of activities to the least sensitive ones. In our case, this is just doing very basic plain vanilla consumer lending. Even within that, the most plain vanilla point of sales loan.

So, this is a mass market activity, and we are small in Russia, our loan market share is 18 basis points, so from any perspective we are not important. So, on the lending side, we do this. On the deposit side, we allow deposit placements. I mean there's no legal way to limit deposit placements of clients in Russia. This is actually quite profitable business given the rate environment in the country.

I mean the central bank rate was recently increased from 16% to 18%. Deposits are actually exposure towards us, not to clients in Russia. So again, limit the scope of activities and then get back as much equity as possible. So far, we managed to pay from Russia, RUB 27 billion. That's close to 50% of the equity what we had when the war started actually.

Obviously, we pay a withholding tax. There’s 15% withholding tax on that. So, this is the gross amount, and we receive 15% less. So that's more or less the approach what we have, trying to reduce exposure by taking money out from the bank. In order to do that, we obviously need to have a level of activity in the country.

We need to remain active as a bank in order to get approval for these dividends. That activity, we limit a lot in terms of scope. We don't do corporate lending; we don't do mortgages. We only do this mass market consumer lending, and even that is a very small size compared to the Russian market itself.

What I said about future buybacks is that it's part of our capital management toolset and it's something we have considered before and we did, and we will continue to consider, but there's no guarantee that we do that or not do that. Obviously, there's no guarantee whether we get an approval or we don't get an approval should be applied for.

I mean, when we last time applied in January for this HUF 60 billion buyback that was approved. Whenever we apply, we have to provide a detailed business plan, a detailed capital plan and answer questions. So, there's usually quite a thorough analysis by the Central Bank before they give any approval for a buyback or a similar equity transaction. But they are very rational and sensible. So usually, we have a similar understanding of situations.

Operator

As there are no further questions, I hand back to the speaker.

László Bencsik – Chief Financial and Strategic Officer

Thank you very much. Thank you for joining us again on this warm summer Friday afternoon. I'm sure many of us are before holidays. So, if you are like that, I wish you a very happy holidays, have a good rest. And if not, then anyway, just enjoy the rest of the summer, and I invite you back to join us when we present our third quarter results.

It should be, I think, on November 8. So, hope to see you or hear you back then. Thank you again. Goodbye.

Operator

Thank you for your participation. The second quarter 2024 conference call is closed now.

Note: unabridged transcript with minor English stylistic corrections.