



Strategy and Finance Division

Investor Relations

OTP BANK

3Q 2024 Conference call

Transcript

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PRESENTATION

Operator

Ladies and gentlemen, welcome to the first nine months 2024 conference call of OTP Bank. Please note that this call will be recorded.

May I now hand you over to László Bencsik, Chief Financial and Strategic Officer. László, you may begin.

László Bencsik – Chief Financial and Strategic Officer

Thank you. Good morning or good afternoon, depending on where you are. Thank you for joining us on OTP Group's 2024 third quarter interim results conference call presentation. As usual, the presentation is available on the website, and we are also showing it by. So you can download it from the website to you if that's more convenient for you.

As usual, I'm going through the presentation most pages, and then we can have a very exciting Q&A session as usual. Starting on the highlights page number two. There hasn't been much change to this slide. We continue to be dominant in the region. Our profitability, if anything, improved from the first six months to the first nine months and it's close to 25% now.

Compared to last year, it is somewhat lower, but we are at much lower leverage. In fact, as you can see on this slide, our capital adequacy ratio went up above 19%, and our leverage ratio is closer to 11%. Just to remind you, the European minimum requirement is 5% and most of the banks are between 5% and 6.5%. This shows the amount of capital we are running on and relatively little leverage we have. Despite of all of this, we have this strong ROE.

Liquidity remained strong and portfolio quality stable, and it has been so for, frankly, the last eight years, despite all the events and turbulences in the economy and in the environment.

Page 3 summarizes the most important financials. 3Q 2024 was HUF 319 billion up and the first nine months was HUF 826 billion. But this is slightly lower than the bottom-line reported number a year before with, you may well remember that last year, we had two large one-off positive items due to the two acquisitions we made in the beginning of the year in Slovenia and somewhere around the middle of the year in Uzbekistan, and both of these acquisitions were below book. We booked badwill and those contributed positively to results.

Now these types of contributions don't appear this year. Therefore, it makes sense to adjust last year with that. If you make that adjustment to last year figures, then we end up 19% y-o-y growth, which is quite remarkable.

Again, return on equity is close to 25%. Net interest margin stabilized close to 4.3%. It has been so for most of the time of this year and this is markedly higher than in the base period last year. Most of the difference is coming from improvement in Hungary. I'm going to talk about the Hungarian NIM development later on.

Cost-to-income ratio, very nice to see that it's going lower and lower, and we are getting close to 40% and risk cost rate a little bit lower than last year. In the third quarter, there were two important milestone events. One was that we completed in July the sale of our Romanian bank, which we had for 20 years.

We acquired this bank in 2004 and closed the sale of this asset just in July. Unfortunately, this was one of the countries, Romania, which despite all of our efforts, we were unable to organically grow from a small bank existence to mid-large banking existence. The environment, to put it mildly, has not been very supportive for us to acquire more assets. So eventually, we had to draw the strategic conclusion, and sell the bank.

Now the positive impact on capital adequacy appeared in this quarter when we closed the transaction. So that was 53 bps on common equity tier one. There was one remaining element from the P&L impact to come through, that HUF 10.5 billion plus in other income. These two are the most visible results of the sale other than obviously assets and liabilities went down accordingly with our assets and liabilities, which we used to have in Romania.

The other milestone event was that we closed the merger in Slovenia at the end of August. Now we have one operation, one IT environment. It went very smoothly on time, on budget, and under the very sharp eyes of ECB that was our supervisor. This was our first merger out of the dozen which has been done with ECB being the supervisor. It has created additional work and effort, but ultimately probably contributed to the excellent execution of the merger.

M&A other developments, I'm sure there will be questions. We wanted to pre-empt the questions and formally say that currently there is no information about significant transactions to be announced publicly, which is not a big statement because if there were, we would have announced them. But nevertheless, I think that's what we can say that there's not much to say at this moment. But we keep looking. We will continue to look into every opportunity, which has a potential to create value for shareholders in the future as we have done in the past.

The 30%-70% split of earnings remains in the first nine months that seems to be the new norm in the group that Hungary is around 30% and foreign operations 70%. This will probably continue to change, innovate so the foreign contribution might grow further.

Page 4, you can see the P&L development. This year, not because of the acquisition, but because of selling the Romanian business, in fact, we need to make some adjustments in the P&L and also in the balance sheet lines in order to have the full picture.

So as usual, these grey columns with grey headings show you the y-o-y FX-adjusted and organic changes. So without our acquisitions and without our divestitures, period-to-period changes. So y-o-y, first nine months, total income went up 16%, cost 13% and that resulted in 18% operating profit improvement.

In fact, risk costs were higher this year than last year in the first nine months. That's mostly due to the extra provisions we booked for the Russian bonds. Therefore, together, we have 14% adjusted profit growth y-o-y. Now I think the probably most important number on this slide is the very top 25% net interest income growth. I will elaborate more on this where this growth has come from. Again, this is organic and FX-adjusted.

Next page shows the key highlights about the Hungarian, the core performance. It's up compared to last year by 29% because here, again, there's one item, which does not appear in the consolidated numbers group level, only at the standalone Hungarian core level. It's a technical item related to the Slovenian merger.

Due to complicated technicalities, when we did the merger, we merged our originally bought bank SKB into the newly bought bank last year, NKBM. During this merger, we had to mark-to-market the value of our original bank, the previously acquired bank. Therefore, the increase of its fair value resulted in this one-off. But again, this appears in consolidation, and it is clearly not something which is related to normal business activities. So, we have to look at the numbers without this item and all the ratios here, what you see have been calculated without this HUF 113 billion.

There was another material item, which is not one-off. Each quarter, we have some results coming from this baby loan and subsidized mortgage loan fair value adjustment as the shape of the yield curve changes from quarter to quarter. It's quite a big portfolio, so it's HUF 1.6 trillion.

In this quarter, we booked HUF 16 billion fair value adjustment on this portfolio due to the changes in the shape of the yield curve. But this is just like 1% fair value change given the overall size of the portfolio as such. So, it's a meaningful and material number to consider when we look at the quarterly Hungarian profit, which was HUF 97 billion.

However, compared to the total size of the portfolio, it is understandable that this is changing the volatility of 1% per quarter. We continue to increase impairment on Russian bonds. So, there is HUF 5 billion accounted for in 3Q 2024.

Net interest margin improved. That was a major game changer, which happened at the end of last year. So, we already started the year with around 2.8% net interest margin in 1Q 2024. Since then, it has continued and continued to improve on a quarterly basis. But this is clearly a different ballpark. This is the most important driver behind the group net interest margin development.

There's no new news on the special taxes and windfall tax and transaction tax since the last conference call we had. We haven't got new information on these items either for this year or for next year.

A bit more detail on the Hungarian business activity development. On the retail side, it looks very positive. As you can see, new production of mortgages increased by 2.4 times compared to last year in our case, and by 2.2 times higher for the whole market. This is sizable, and it shows that after the quite big drop last year, retail real estate market recovered this year and demand is quite strong and continues to be strong.

The same is true for cash loans and consumer loans. In these volumes, there was no decline last year. So last year, we also had growth. Despite of this increasing base, there, was so far this year, a 61% increase in new contractual volumes, in our case, and somewhat less in the market. So that shows that consumers are strong and retail loan demand remains strong in Hungary despite the rather, I would say, weakish overall GDP performance, which is unfortunately more reflected in the corporate loan dynamics, which is described on slide 7.

As you can see, there's some growth, 4% growth in micro small but only 1% growth so far in loans to Hungarian corporates, which reflects a very low level of demand and not much new investments, not much new developments and projects starting in the country, not new developments, which finance themselves from the local banking market because, in fact, the FDI remained strong in their big developments and especially in the car industry, electric car industry and traditional car industry continue, but we see that they did not finance them from the local banking sector.

Now even this with the slow growth levels, we managed to turn around the last year negative trend of decline in corporate market share. We started to see some improvement in our corporate loan market share in Hungary, which is always a very positive news.

On page 8, you can see the highlights of profitability and cost-to-income ratios and overall profit contribution of the foreign subsidiaries. This is also a very positive picture, I believe. In most of the cases, we see nominal increases in profit contribution, and ROEs remain strong. There's a quite remarkable improvement in case of Serbia, above 20% ROE in a declining rate environment. We are very happy that Ipoteka Bank performed so well. That's our new acquisition, which we made last year. This was the first privatization process in that banking sector, and we acquired the fifth largest bank from the state.

Despite a huge ongoing transformation effort and work done in the bank to modernize it as fast as possible, despite most of the focus being on that, we managed to book HUF 42 billion contribution in the first nine months and ROE was above 34%. So, we are quite happy to see this that in this early stage after the acquisition, we are already making substantial, meaningful contribution to group profitability and the returns are as good as you can see.

The other good thing is that the smaller banks in smaller countries, these are actually sizeable banks, but in small countries like Montenegro, Albania and Moldova, they also performed around 20 or higher percent ROE, which is definitely positive. Ukraine continues to be a strong contributor to overall profits. This is, I think, quite important and remarkable given the worse situation in the country.

So maybe a few more detail about in a cross-section manner about the different P&L lines. So net interest income, as I said, this is probably the most important or eye-catching number in the whole presentation that y-o-y we manage to organically increase net interest income, by 25%.

As you can see, most of this growth nominally and also in terms of growth rate came from Hungary, and that's just because of the margin recovery and the margin improvement primarily; and secondarily, also due to the fact that starting from the fourth quarter last year, retail deposit started to grow.

If you may remember that between the end of 2Q 2022 and 2Q 2023, retail deposits declined in general in Hungary in the market and specifically, in our cases, less than on the market. So, our market share increased, but nevertheless, there is around 10% decline and that was very painful in terms of our profitability, and it has been without precedent.

We have never seen that before. This is obviously due to the high inflation, which peaked at 25%, and due to higher rate environment, which was for quite a while at 18% and the very high-yield retail government bonds, which created an unbeatable competition for us.

But now this year, especially, we have seen already 5% growth in retail deposits, which continued in the quarter. So that actually contributes to the improvement of NII in Hungary in a meaningful way apart from the general changes in the interest rate environment.

Slovenia and Croatia are in the Eurozone, Bulgaria is in ERM II, quasi-Eurozone rate environment and Montenegro adopted the euro. So, we have four countries which tactically you can consider them Eurozone. I think it's quite good that even in these countries, despite the declining rate environment, and therefore, pressure on margins, we managed to continue to grow NII between 16% and 23%.

That was due to primarily strong volume dynamics. Net interest margin, page 10. This is just another way to look at the same events in a way. So, as you can see, net interest margin continued to increase on a quarterly basis in Hungary, somewhat compared to the second quarter.

This is primarily because of retail deposit dynamics that in the second quarter we had a strong retail deposit growth, and that on an average q-o-q 3% increase in volumes, and that's more or less what you can see here in this margin improvement.

As I mentioned in the euro-linked countries, we experienced margin pressure or margin contraction q-o-q and mostly also y-o-y.

Next slide further details the margin change and the drivers of margin changes in the two quarters this year. There wasn't much overall change in the margin from the second to the third quarter on a group level. But as you can see, basically, margin increase in Hungary and that increase was counterbalanced by some contraction in Slovenia and in Bulgaria.

By the way, Slovenia is probably the most competitive in terms of deposit and also loan pricing at the moment across the group. So that's a difficult market from a price competition point of view.

On page 12, we start to talk about volume dynamics, q-o-q loan growth. Maybe two numbers, important. One is Hungarian mortgage growth, which continues to be strong. So just in one quarter, 3% growth.

Consumer was actually quite strong as well, 4%, continued. What important is that you will see that the ytd numbers as well that this year, after two rather slow years, we restarted lending in Ukraine. So, we are less conservative and more eager to start to grow our loan book in Ukraine. So based on retail and corporate, we became active in lending, and albeit from a low base, has started to grow volumes and this is like just in one quarter we had 10% growth.

If we look at the ytd development, there's pretty much the same highlights. First of all, it's worth looking at the total number, it's 7% in ytd growth. You can see on the leftist column two numbers. The number in the top left is the reported number change and the one in the right bottom is the one which is adjusted with the sale of the Romanian bank. So as if it was not in the group at the beginning of the year. That's the organic real ytd performance and it's also FX-adjusted as related to performing loans.

So altogether, 7%. Last year we grew 6%. So, I think it's safe to say now that we seem to be growing faster this year than last year already in 9M. We grew more than last year in the full year. You can see here that Ukraine went up by 21% in 9M in terms of loan volumes and Hungarian mortgages 9% in nine months.

So, most likely, we will be visibly above 10% growth, so double-digit mortgage growth in Hungary. That is obviously not surprising if we think back to one of the previous slides where I mentioned that we contracted this year 2.4 times more mortgages than last year.

Deposit growth, we are not so much focusing on deposit collection in general, given that our loan-to-deposit ratio on the group level is 73%. We are quite liquid, and we really focus on deposit collection where we make a lot of money on deposits or where it's really profitable and where the loan-to-deposit ratios are high or exceedingly high, much higher than 100%.

Maybe it's better to look at the next page, which shows the ytd change. So overall, 5% which means that in nominal volume terms, the deposit growth this year has so far been higher than loan growth despite the ratio of loans loan growth being 7%.

You can see here this 5% ytd growth in Hungarian retail. That is a very important number from the perspective of our profitability in Hungary and overall, even for the whole group.

The other, I think, as outlying number here is Ipoteka and Uzbekistan. You may remember that when we bought the bank last year, the loan-to-deposit ratio was above 300%. Actually, a year ago, at the end of the 3Q last year, it was almost exactly 300%.

Due to the strong deposit growth we have seen so far this year, this ratio is closer now to 200%, so it was exactly 206%. So, we almost improved 100% of the loan-to-deposit ratio of our bank in Uzbekistan, which obviously, this is important and strategic from our perspective and makes the bank much more sustainable structure.

Page 16, some detail, again, cross-section view on net fee income overall. Divestiture and acquisition adjusted y-o-y growth, 14%, and quite strong number in Hungary. Regarding Hungary: high inflation environment, high transaction volume growth. But unfortunately, as you can see, the third quarter was negative in terms of fee growth in Hungary.

This reflects the not newly introduced, but increased transaction taxes in Hungary, the rate of the tax increase for transfers and for cash withdrawals by 50% basically from 0.3% to 0.45% and from 0.6% to 0.9%. Till the end of the year, we are not allowed to pass this on to retail clients, only to corporate. This retail transaction tax increase, which we have not been able to pass on through our fees to clients resulted a decline in Hungary.

Other than that, we see strong results on a quarterly basis in Bulgaria, Croatia, Albania. Those are typically the countries where tourism is strong and tourism-related transactional revenues increase.

Fund management in Hungary y-o-y, 40% increase. Assets under management have grown a lot, and they are close to HUF 4.5 trillion, thus we have almost one-third of the market. Our market share is 32% of assets under management in Hungary. So that's a strong performance and this generates stable fee income.

Other income, this is the line where the Hungarian subsidized baby loan and mortgage loan fair value adjustments appear. So, there's a lot of noise in these years on the slide and we tried to explain here how much of this y-o-y, or quarterly changes are related to this in Hungary. So clearly, nominally, this is the line which makes most impact on the other income. Unfortunately, it will continue to create noise in this P&L line given the nature of the accounting treatment of this volume.

Operating costs on page 18. Overall, 13%, FX- adjusted and acquisition and divestiture adjusted growth 8% in Hungary, 7% personnel. In Hungary, we have a high level of depreciation. That is the reflection of the CapEx investments we have made during the last couple of years into modernizing our IT.

DSK, that is very high levels of wage inflation, which is very good from a perspective of loan growth. You probably saw the retail lending numbers, which is the highest in the group. So year-to-date, in Bulgaria, mortgages grew 21%; consumer volume, 17% just in nine months and that's partially due to the fact that inflation is strong. Real disposable income increases, but the driver of that is wage inflation. There's a positive side of this on the loan

demand side and the loan quality side. But certainly, from a cost perspective, it's a challenge to rein in personnel expenses growth in Bulgaria.

In Slovenia, this seemingly a large increase y-o-y is due to the fact that we are not showing any more, starting from this year, the cost of post-acquisition merger as one-off items. We show them as business-as-usual cost. This year was very heavy in Slovenia in terms of the merger activities and the associated costs. This high y-o-y growth is attributable to that and also to wage increases. The merge was done, we will focus on realizing synergies. We already started to combine branches. During the course of the next 1-1.5 years, we intend to realize the targeted cost synergies, which are in the range of EUR 30 million, EUR 35 million annually in terms of cost savings.

In Albania, you can already see the results of the merge, what we completed there at the end of last year. So, some of the cost synergies already manifested and it's the direct result of that nominal cost actually decreased y-o-y in Albania.

Risk costs on page 19. Overall portfolio quality rather stable. We increased somewhat provisioning on this Russian bond exposures in Hungary and in Bulgaria, and the coverage is now up to 62% overall. There hasn't been any change in the status of these bonds. So, these bonds continue to pay coupons and those coupons arrive to Hungary into OTP's bank account in Merkantil Bank, and obviously, we keep it in a close account. We don't touch it further.

We need a decision on this in order to release them in the future, but that's another story. The most important thing is that these interest payments are here in Hungary in our accounts, albeit on a closed account.

If you look at the overall portfolio quality metrics on page 20. Stage 3 ratio continued to decline, so at least 4% in the third quarter. We continue to maintain a relatively conservative level of coverage. You can see that compared to our competitors, we have overall a higher coverage both on performing Stage 1 and 2 and nonperforming Stage 3 exposures.

Capital adequacy improved quite considerably. That's due to the continuous profit accumulation, but also to this one-off event, as I mentioned at the beginning of the presentation. 53 bps increase is attributable to the closure of the transaction in Romania, as you can see on this picture. Basically, profit accumulation resulted in 2.9 percentage-point increase in the Common Equity Tier 1 ratio during the first nine months. You can see the other effects one by one on this slide.

Liquidity, bonds, maturities and call dates-wise, we had actually an eventful period. In the third quarter, we called back two bonds, as you can see on this page, in July, a senior preferred and a Tier 2, altogether EUR 900 million. We issued two bonds since the end of the second quarter. One was a Yuan bond, smaller amount, 300 million. The other one in October actually, so after the third quarter, but before the reporting day today, we did EUR 500 million senior preferred.

I mean last year, we compared to this overall size, more than EUR 100 billion balance sheet in the call profile next year or the Core dates altogether, less than EUR 1 billion callable papers. So, it's quite modest compared to the size of the overall operation and if you compare it to the profit that we generate in the year, this is a rather small amount. Accordingly, our liquidity ratios, as you can see in the lower left corner remained to be quite strong in themselves and in comparison, to our regional competitors.

A little bit about the future. We are not yet at the stage where we make guidance for next year. So, I will try to resist your questions. I won't elaborate too much on that. We are in the process of finalizing or creating the plan, the budget for next year. It has not finished yet. So as usual, we will talk about 2025 guidance when we present the annual results of the 2024 in early March.

But I think it's fair to say that our overall expectation regarding the operating environment is quite positive. So, as you can see, in almost every country where we are present, we expect GDP growth to accelerate or at least remain stable. So gradual improvement in the external environment. It's most remarkable in Hungary, I would say, the improvement expectation.

Unfortunately, the recent GDP numbers were somewhat discouraging, and they were a negative surprise in a way. So, the annual growth at the end of the third quarter was actually negative. By year-end, it will probably improve due to base effect, but we will probably not be higher than 1%, which is certainly lower than our original expectations.

For next year, the government guidance and expectation is 3.4%. They like to say that it's going to be between 3% and 6%, but the point expectation what they have is 3.4%. We are slightly more conservative on this. But even if this 2.5%, 2.8% manifests next year, this is definitely going to be a better environment for us.

The most obvious direct impact on our operations should be the increase in corporate loan demand because as you have seen from our numbers, corporate number was very, very low this year. In retail, actually quite decent. If this macro environment manifests next year, then I think it's fair to expect that retail will continue to grow, at least with the current dynamics, if not more.

Hopefully, corporate demand will also catch up to retail demand and we should see close to 10% or even higher percent corporate loan growth. But this is probably the biggest question mark in our heads as well regarding next year.

The other countries are more or less on predictable track, I would say. The implication of these three on this year guidance is that we are not changing the guidance. Now we've made one change after the second quarter results, and that was on the line of the net interest margin.

Originally, we suggested maybe similar level to last year. But then we upgraded the guidance and now I'm seeing the 3Q numbers, I think that was the right thing to do. It's clear that we're going to have higher margin this year than last year.

We haven't made a formal adjustment to these numbers, but if we look at the other lines, given that we had 7% growth in 9M, I think it's fair to assume now that our original guidance was right, but it's very likely that we will end up having more than 6% overall the whole year.

Cost-to-income ratio first nine months was 41%. There's usually a seasonality in costs. Costs are typically somewhat higher in the fourth quarter, so it might happen that we end up higher than 41%. But this is, I think, still around 45%. The good thing that it's around from below and not from above. In that sense, I think we have done a good job.

Risk profile, portfolio remains stable so that seemed to manifest at least in the first nine months of the year, our original guidance. ROE is lower than last year. I think now it's clear for you as well that this decline is due to increasing leverage and not because of lower earnings.

So that was the presentation, what we prepared and what I wanted to share with you. I'm sure you have very good and exciting questions. So please ask them.

QUESTIONS AND ANSWERS

Operator

The first question is from Gábor Kemény, Autonomous Research.

Gábor Kemény – Autonomous Research

Hi. Thank you for the detailed presentation. My question is actually around capital deployment. If you could give us an update, please, how you think about your plans about capital distribution. I guess you are at such a very comfortable capital level at this stage. You are flagging some headwinds from Basel IV, but we are also generating capital likely in the fourth quarter.

Maybe the question I could ask, shall we not expect 2025 to be a declining leverage? I wondered what your thoughts were about capital distribution around the 4Q stage.

So, looking at your guidance for this year, I think it is a lower ROE because of a declining leverage. I wondered why this may not be the case for next year as well. But in that context, it would be interesting to hear your thoughts on capital distributions around year-end.

Another question on capital deployment if you could please share your latest thoughts on M&A. I think you were talking about a larger possible transaction where you were expecting some development towards year-end. If you have any other thoughts on any other deals, would be interesting. Thank you.

László Bencsik – Chief Financial and Strategic Officer

Thank you. Indeed, very pertinent question. So, I'm not in a position to share with you our plans, as we have not made formal decisions on how much and how we want to distribute next year.

But as you said, we are, indeed, apparently in a very comfortable position. So, we have a lot to decide about. Indeed, as you mentioned, and we put it into the actual report that Basel IV we implemented first of January as all the banks across Europe. Given that we have a standard approach, for us, this is going to have a one-off effect more or less. That one-off effect is, in our estimate, 80-100 basis points on Common Equity Tier 1. So that's our best estimate.

Given that we are in standard method anyway, for us, it won't mean that we will have to gradually increase the floor because we do have the standard floors. Actually, 100% of the standard floor is not just 72.5% of the standard floors.

But even beyond that negative one-off, it's clear that we are in a very comfortable equity position. I hope it won't disappoint your shareholders when we announce what we are going to do with this. That announcement will be when we present the year-end numbers early March next year.

We are in the second phase of our buyback process. If we consume the approved HUF 60 billion number before that, the volume of HUF 60 billion nominal equivalent, then we might come up with a new proposal earlier, but most likely, it will be early March. Obviously, suggestion related to dividends, and I wouldn't be surprised if you were suggesting other share buyback actions as well.

On the M&A front, again, we try to be very precise, and therefore, we put it in writing. So, as you can read in the long report and also on the third page of this presentation, we don't have anything to report in terms of material transactions. If you have sensitive ears, I think you can deduce what the situation is.

Gábor Kemény – Autonomous Research

Yes, indeed.

László Bencsik – Chief Financial and Strategic Officer

But I cannot say more for confidentiality and other reasons, especially not about specific transactions and probably we have already said too much about one specific one. So, there's nothing we can talk about. It can change. But at the moment we don't see how it could change. So that would be a new development, I would say.

Gábor Kemény – Autonomous Research

Thank you. Just maybe one follow-up, please, on the capital situation. I mean, how long would you be ready to run with such a level of capital surplus? At what stage would you say that we rather distribute than to wait for another M&A opportunity to materialize.

László Bencsik – Chief Financial and Strategic Officer

My personal view is that anything above 19% is far too high. I can't remember the last time we were at that level. So, this is certainly not where we want to be, is it?

Gábor Kemény – Autonomous Research

Okay. Thank you.

Mikhail Butkov – Goldman Sachs

Thank you for a very detailed presentation. I have a couple of questions on net interest margin. To start with OTP Core, if we look at the momentum, excluding the one-offs, there was some good progress from the first quarter. So, in the third quarter, I think there was about 11 bps of improvement.

If we could just discuss what were the components of that improvement or was it some help from the lower rates, maybe some level of securities or something else, like hedges?

Then follow up on the net interest margin issue. Rates in Europe are expected to be lower now than they were a few months ago. Maybe you could update us on your net interest margin sensitivity to euro rates and balancing the outlook in Hungary on NIMs and in other countries, do you think one will offset the other or the effect maybe of Hungary or the effect of one will be more than the other?

László Bencsik – Chief Financial and Strategic Officer

Well, Hungarian net interest margin improved mostly because in the second quarter we had a very strong growth in deposits and q-o-q average retail deposits, that is basically sight deposits, grew 3%.

We don't pay anything or very low or not much on retail deposits. That's why I said that this is a very important number to look at because if retail deposits continue to grow, with the rate what they have been usually growing. I mean, retail deposits, in a normal environment, they should grow probably around nominal GDP growth, at least, or maybe 1.5 multiplier on that. So maybe 2 times, depends. But that's an important number. The sensitivity to the HUF rate is immaterial around this 6.5%.

In fact, as you said, the reduction expectations have increased in the case of the euro. But in the case of the forint, it's quite the opposite. So, I think very few people are now expecting HUF rate cuts in the foreseeable future. So even from the interest rate environment, there's not much pressure in a way or not much volatility expected forward looking.

But even if there is another 50 or 100 basis points fall in HUF rate, it would not have a material impact. However, if retail deposits continue to grow and the pricing of those deposits doesn't change then that can continue to have a positive contribution to the Hungarian NII in a meaningful way, even in a quarterly visible way. So that can continue. Again, the number here to watch is the Hungarian deposit growth and deposit changes.

The euro sensitivity. We are sensitive to the euro changes, and obviously, a declining rate is negative for us, and this is captured in the numbers. So, if you look at a net interest margin development in the countries, which are in the Eurozone or grey side Eurozone on page 10, maybe we can go back page and then we can see.

As you can see, in Bulgaria, there's a gradual decline. In Slovenia, there's also some pressure q-o-q. Likewise, in Croatia, it's not very dramatic, but it's there. Our sensitivity to the euro rate remained similar to what we reported last time.

So, it's EUR 110 million per 1 ppt decline in euro rate, and this is in annualized NII terms. This relates to the end of September. Since then, we have done certain additional measures. So, I hope that this number will be lower by the end of the year, so maybe lower than EUR 100 million and closer to EUR 90 million.

Its highest level was a year ago, it was EUR 190 million. So, our sensitivity a year ago was much bigger. But since then, we have adjusted our positions and reduced that sensitivity, and we will continue to do that, albeit with a smaller magnitude. So that's our sensitivity to the euro rate.

Maybe another third factor that we have Uzbekistan, Ukraine, countries where the margins are bigger, and we expect higher growth rate from these countries than from the rest of the group. So actually high-margin countries' contribution to the overall NII may increase given the expected growth rate and that can have positive impacts.

So, we have basically potential composition positive effect from higher growth of higher-margin countries in our portfolio and then positive effect coming from the hopefully growing retail deposits in Hungary. If all these values counterbalance, yes, the expected negative contribution coming from the lower euro rate. That's a good scenario. Obviously, it also depends on the magnitude and speed of the euro rate cuts, right?

I think this is one of the risk factors in general in European banking that it can happen that the rate will decline faster and potentially more than we expected due to the rather weak growth performance of the core European economies.

On the other hand, the expected policies of the new US administration seem to suggest maybe a higher rate environment and higher inflationary environment in the US than otherwise expected. So that can have other directional effect on euro rates. But I'm sure you know much more about the expectations on euro rate than I have so I don't want to go into very much detail.

Mikhail Butkov – Goldman Sachs

Just one small follow-up on the retail deposit growth in Hungary. So, is that the new volumes which come at a lower yield? Or you see rather maybe some conversion of older time deposits to the retail deposits at the lower rate, which effectively translates into the higher loan-deposit spread or rather you see the higher loan-deposit on the new origination or new loans minus Euro deposits, if yes, I may ask this question.

László Bencsik – Chief Financial and Strategic Officer

It is basically just liquidity is increasing in the system. Wage inflation last year was more than 10%, this year broadly close to 10%. So, our retail clients earn more and spend more, there's more money in circulation. That's one thing.

The other thing is that the alternative investment yields have declined substantially. A year ago, you could still invest into Hungarian retail bonds with 16%, 19% yield. Today, it's more about 6%, 7%. So, the alternative investment opportunities yield decreased considerably. Therefore, competition to deposits from other products decreased.

Narrowly, this large interest payment is actually coming on this retail government bond stock somewhere February, March, even January next year. So, there will be like HUF 1.2 trillion, HUF 1.25 trillion interest payment on the stock of retail government bonds. So that will generate another surge in liquidity in the sector, I guess.

There are a number of factors that contribute to this growth, including an increase in leverage and multiple. Strong retail growth also generates more liquidity in circulation. These factors are important to consider when evaluating the outlook for the retail deposit curve. Overall, the observable factors point to a positive outlook.

Mikhail Butkov – Goldman Sachs

Thank you so much, very helpful.

Máté Nemes – UBS

Good afternoon, thank you for the presentation. I have two questions, please. The first one is just a quick technical one, a clarification. I was just wondering if the EUR 110 million of sensitivity for 100 bps lower rates if that sensitivity also applies for the second 100 bps not just the initial impact. Should we expect somewhat higher sensitivity once the deposit facility rate crosses, I don't know, below 2.75% or 2.5%? That's the first one.

The second question would be on Slovenia. I think you mentioned that the targeted savings is EUR 30 million to EUR 35 million. When do you expect this to be fully realized and how much is done by now?

The last question is perhaps a little bit broader one. Could you perhaps talk about any effects, any impact that you're seeing from German macro, the automotive OEMs and supplier base that are visibly struggling. Do you see any effect in your portfolio or in your core markets, anything downstream from there? Just looking at your risk costs and asset quality metrics, it doesn't seem so. But love to hear your thoughts.

László Bencsik – Chief Financial and Strategic Officer

Yes. This EUR 110 million for the first 1 pp decline. The second 1 pp decline would result in similar numbers, somewhat less, but not very much different. So, it is almost linear, somewhat less than linear.

The EUR 30-35 million cost savings we expect after the merge, which was in August. As I said since August, we already combined some of our branches. So, it's already underway. It manifests in 1.5 years. The headcount adjustment can only be a relatively slow process given the local regulatory environment.

Your third question still the most difficult. Our direct exposure to the car industry is very limited and that includes their strategic suppliers. Car producers don't use local banks to finance themselves. That's true for Germany and for Chinese car producers, they bring funding with them.

So, they really don't bank with local banks too much. There are some exposures through their workers, but these are usually very highly skilled workers. Given the overall in other sectors tight nature of the labour market, I don't

see a potential problem here even if the number of people working in the car manufacturing steadily declines in Hungary.

I don't see a big threat to our portfolio quality side, and therefore to retail in general, for retail demand or retail loan growth. I believe the most sensitive figure is the overall GDP because the net export figure makes a significant contribution to this. They bring in some parts, assemble, they show a big added value creation in the country. They typically don't pay many taxes or low taxes they pay. So, I think they have a quite material effect on overall GDP growth, but much less direct impact on our immediate clients.

At least that's true for short term. I mean, mid to long term, obviously, and this is not just car industry. I think, core Europe, in general, more specifically Germany, Austria, in general, precision engineering in their industry structure, to which extent it's competitive or not, and to what extent they are able to grow their exports, and therefore, they need more imports from Central Eastern Europe, structurally, this is important long term.

I don't want to dump the long-term structural importance of Europe on Central Eastern Europe. But it is, I think, less specific to the car industry than in general to all export from Central Eastern Europe to core Europe. And that's a concern. So it's very clear that a stagnating core European performance has a measurable negative impact on Central Eastern European growth.

But just because from the car industry having specific difficulties, I don't quite expect material deterioration in portfolio quality or material impact on the retail, especially retail loan demand.

Operator

The next question is from Ruslan Gadeev.

Ruslan Gadeev – Raiffeisen Research

Just a couple of questions from my side if I may, please. First, rather technical. So, there was a communication recently that you might see an increase of the Pillar 2 buffer requirement, slide 1, but still in 2025. So, in this regard, do you also expect an upward recalibration of your MREL requirement for the next year? If yes, is there any quantitative indication you can give at this stage, please?

The second question is also related to the MREL considering the Slovenian bank. So, what is your strategy concerning OTP Bank in terms of its resolution approach. So, for how long really you expect it to remain a separate resolution entity. If this is still the case next year, should we expect further external MREL issuance from Slovenia's OTP Bank on its own basis, given there is a call option of the EUR 400 million in June, if I remember correctly. Generally speaking, there are almost EUR 900 million of MREL debt outstanding. So, these are the two questions from my side.

László Bencsik – Chief Financial and Strategic Officer

NKBM resolution plan. Before we acquired NKBM, it was a standalone resolution entity directly supervised by the Single Resolution Board. Our original bank, which used to be part of the single point of entry resolution group, we merged this SKB into NKBM.

So therefore, now the new entity in Slovenia is multiple point of here, as you rightly said. The process is that we have to apply for changing the treatment, the resolution strategy of our Slovenian bank, which is now called OTP Bank Slovenia. But that's a rather long process. So, we will most likely submit a request and then the resolution college will consider this during the course of next year and make a decision somewhere second half of next year.

If there's a change in the resolution treatment of our Slovenian bank, then this will come into effect in 2026 as the earliest. So, for sure, for 2025, the Slovenian bank will stay as a standalone resolution entity. That means that they will have to continue to provide the MREL funds for themselves during the course of next year. If they in 2026, they move into the group, then from that point of time, we will have to provide it from the group.

Your first question was Pillar 2 Guidance? In the presentation on page 21, we have this. There's a Pillar 2 Guidance of 0.5%. Was that what you asked for?

Ruslan Gadeev – Raiffeisen Research

Yes. So, I mean there was a communication also recently saying that you may see an increase of this buffer in 2025. Since this is a direct input to the MREL formula in a default approach, so what is your expectations for the recalibration of the MREL target for the OTP Group in 2025? So technically, I would expect it should be also increased then. So, the question is to what extent if you also see it the same way.

László Bencsik – Chief Financial and Strategic Officer

I mean, all in all, considering every factor into, we don't expect much increase in the MREL minimum requirement. So, it's not going to be higher than 2025.

Ruslan Gadeev – Raiffeisen Research

Okay, thanks a lot.

Operator

The next question is from attendee joined via phone. I open the line. May I ask you your name and the company, please.

Robert Brzoza – PKO Securities

This is Robert Brzoza PKO Securities. Congrats on the results. I have a question on subsidized lending because many new programs are coming online, so to say, next year. The subsidized loans for young people, the corporate lending for SMEs.

In an environment where the rates are at above 6% level, we already learned that this doesn't change much the NII outlook for the OTP Core. But do you have any feeling how the margin, which the banks earn on the subsidized loans being offered by the state, which then the bank intermediates on the market. So, any feeling how the margins on the new products would look like next year compared to previous products like certain loans or baby loans, et cetera, whether they would be lower or comparable in size?

László Bencsik – Chief Financial and Strategic Officer

The corporate subsidized structure seems to follow the same pattern to more or less 2.5% margin for banks. The retail development is rather worrying in a way because there, in mortgages, the discussion is not about subsidies, but another voluntarily caps on new production. So, the government or the Ministry of Economy suggested for that bank should introduce voluntarily cap on new mortgage lending not higher than 5% rate.

Now the scope of this request is not clear. Here, the banks have an opportunity to actually suggest a structure or a target segment maybe to young individuals, maybe for new houses and so on, so not to apply that for the entire production next year.

This is different from previous structures where there has been typically an actual subsidy. Here, there's no subsidies, right? It's just you are expected to sell mortgages lower than the benchmark, which is clearly negative.

So, this is still in negotiation and discussion. It's particularly concerning in the context of what I presented that actually mortgage growth is incredibly strong. I mean, year-on-year, we have almost 2.5 times higher new production and we are going to have double-digit mortgage growth this year. I mean, hopefully, rates are not going to be higher than next year than this year. The expectation is still somewhat lower. So, there doesn't seem to be intrinsic need for boosting mortgage lending with such drastic measures.

So, I mean, this is a problem. There's a spillover potential risk that if it's for a select group of clients, well-defined purpose, structure, if such a lower rate product exists in a market, that rates are anchored for pricing for other products.

This is challenging, and it might have an impact on our mid- to long-term development of margins in Hungary. I mean if this is going to become more systemic and then widespread, then we have to certainly revisit our strategic considerations as well, what to do with a situation like that.

I don't think we are going to go into that extreme, but certainly, this is going to be an issue next year and something to follow and watch. It's hard to tell how aggressive the government is going to be to actually enforce this voluntarily pricing, I'm not sure.

Robert Brzoza – PKO Securities

I appreciate the explanation. One more follow-up, if I may. Did the government at any time, possibly seen at possible regulations pertaining to the already issued stock of subsidized lending because as I understand, the subsidies constitute some part of an expense from a budgetary fiscal deficit perspective.

So, it could also be mechanism for the government to consolidate the deficit, right, if they would be able or willing to amend the mechanism, which reimburses the banks for the effort in granting those loans. So, have there been any signs or hints from the government that it could be coming at some point?

László Bencsik – Chief Financial and Strategic Officer

No. The answer is a clear no. There has not.

Robert Brzoza – PKO Securities

Okay, thank you.

Operator

Gábor Bukta, Concorde Securities.

Gábor Bukta – Concorde Securities

Thanks for presentation. I have two questions regarding Uzbekistan. So, you earlier talked about the potential normalization of provisioning in Uzbekistan and it's quite good, if I could say so. This underpinned your previous comment. So, going forward, could you give more colour on the risk cost for perhaps 2025?

The second question is also in relation to these banks. So, the loan-to-deposit ratio was down 30 ppts, which you mentioned during the presentation. When do you expect this figure will land in 2025? Or what would be a desired level where you are comfortable?

László Bencsik – Chief Financial and Strategic Officer

Yes. Thank you. Indeed, in the third quarter, the risk cost was actually 0 due to recoveries on previously defaulted corporate loans. In these events, hopefully, will come in the future as well. Obviously, it's difficult to predict them because if you could predict them, then we would already change the provisioning level.

But we are working hard to collect as much as possible on the portfolio, which defaulted last year, second half of last year. I think it's fair to assume that there will be other quarters where a meaningful positive contribution is going to come from recoveries of this volume.

Again, I think for next year, if you allow me, I will not go as far as to give exact number like guidance, but certainly, we don't see further deterioration of the corporate portfolio. In the defaulted corporate portfolio, we believe that the provisioning level is adequate and even there might be recoveries about that.

In retail, we are working on the operational consolidation of the bank because, as you probably have seen, our retail loan growth was quite modest despite very strong growth on the market. So unfortunately, well, we have to spend time. So, the third quarter, there was not much growth in consumer volumes, while the market our volumes where the market is growing quite fast.

The reason behind this is that we have to operationally fix the bank before we can really scale up consumer lending. That's an exercise what we are working on heavily. Hopefully, the fourth quarter growth will be much better. Next year, we can have another step-up in scaling up the new production.

So therefore, because we are actually selling low volumes in retail, actually, this cost is not going to be very strong in fourth or first quarter next year. But once we manage to get back to the level of new production where we want to be, then I think a risk cost rate, which is appropriate for a high APR lending activity, I mean these consumer loans APRs are in the high-30's, low-40's.

So, these are high APR loans, strong margin. Therefore, typically, risk cost rates are also reasonably high. So, I think probably by the second half of next year, I hope we will be at full capacity in terms of new production.

Then risk costs will normalize at the level, which is appropriate for this high net interest margin, high APR product, which is structurally higher than the group average and probably more similar to risk cost rates what we see in, I don't know, Russian or Ukrainian consumer lending. But we are not there yet to scale up.

Gábor Bukta – Concorde Securities

If I may have another question. So, the deposit growth in Hungary and new market share, so I've just seen in your report that your market share has lowered during the last couple of quarters in Hungary. So, we mentioned that you earned such big money on deposits. What is the desired market share in Hungary, which we would like to maintain going forward.

László Bencsik – Chief Financial and Strategic Officer

Sorry, I think I forgot to answer your second question regarding Uzbekistan, the loan-to-deposit ratio. I mean, 200% is so much better than 300%. In fact, this 200% is quite okay because most of the mortgage loans are refinanced. So, they are not financed from deposits, but from subsidized funding either from the Central Bank or other state institutions.

So structurally, Ipoteka will run higher than 100% loan-to-deposit ratio, and that's okay. But 200% or 300% and above when we bought the bank, so this 200% is actually already okay and it actually creates room to grow more on the lending side. So now we have liquidity firepower in local currency to boost our local currency lending.

Our market share in retail deposit Hungary, as you can see on the slide, has been steadily increasing, and it's at 41.5%, which is a high number. I mean, we go back on this page 6 in the presentation to 2011 when it was 27.7%. So, over the last 10 years, our market share in retail deposits grew 10 ppts, which is very remarkable. I think that from one-third of the market, we can go up to more than 40% of the market.

This is already an extraordinary strong level. So, if we can stay at this level, that will be fantastic. But obviously, I mean, it depends on the pricing dynamics of the competition. But certainly, we are very happy with this level of retail deposit market share.

Operator

The next question is from attendee joined via phone. I open the line. (Operator Instructions)

Jovan Sikimic – Raiffeisen Bank International

Can you maybe spend a word on Russia? I think in previous quarters you used to update us on this worst case, deconsolidation impact on the group capital, I mean, given that I think growth has picked up in last couple of quarters, there was also, I think, increase in employees in 3Q.

So, if you can give an update on the outlook for the next months or for the 2025, where do you see the performance? What's the strategy of the bank in this respect?

László Bencsik – Chief Financial and Strategic Officer

In terms of the impact of deconsolidation, yes, we continue to calculate these numbers on a quarterly basis. So, if you deconsolidated the Russian entity, it would improve our Common Equity Tier 1 ratio by roughly 40 bps. And a similar number for Ukraine is 14 bps.

Our strategic approach to this very difficult situation that we have in Russia, that's not changed. I mean, we have looked into strategic alternatives. But by now, I think it's clear for everyone that divesting these assets is not an option for any of the players in Russia. I think Raiffeisen is a good example. Raiffeisen tried very hard and has put together a structure, which eventually didn't work and ended up with the shares being blocked in Russia.

The recent changes in local regulation, the maximum sale price decreased to 40% of market value and even in that case, there's another 35% tax, which has to be paid on the transaction, so at best mathematically, one could get 5% of the documented market value.

But even that is unlikely to find a counterparty who is not sanctioned or would not be exposed to sanctions through the transaction.

So that's the situation. In this situation, we have taken an approach where we focus on three factors, in this order. The first and most important is that our efforts are around fulfilling all legal and regulatory requirements, which are applicable to the entity that we have in Russia.

Then secondly, we quite proactively reduced the scope of our activities. Immediately after the war started, we altogether stopped corporate lending and our corporate loan volumes since then declined by more than 90%. So, there's hardly anything left. We were the first one of more active foreign banks to stop altogether dollar transactions in 2023 May, last year. I think we were also the first one more than a year ago to substantially limit euro transactions to European counterparties. That is a strategic element when we reduce the scope.

The third pillar of our strategy in this difficult situation is to reduce our exposure to Russia. We believe that really the only way you can really reduce the exposure to Russia is to take money out of the country. Because if you just change your activities, but you still have equity, and in the cases of banks, this means financial assets stuck in Russia, that's the real exposure.

So, when the war started, we had RUB 11 billion group funding to Russia and RUB 55 billion equity in our bank in Russia. As early as 2022, the RUB 11 billion funding was paid back, so we reduced our exposure to Russia by RUB 11 billion. Since the beginning of the war, the bank paid more than RUB 37 billion dividends. There might be another tranche for the rest of the year. So, if all is well, by year-end, we'll go up to RUB 42 billion dividend.

In our view, this is the only real avenue to reduce exposure to take money out in the form of dividends and paid back group funding. So, this is what we try to continue. So, these are the three pillars of our strategy to comply with all legal and regulatory requirements to this entity, reduce the scope of activities in order to minimize the more sensitive potential or risky activities.

I mean, we focus on consumer lending. So that's our main activity. We sell point-of-sales loans, cash loans and credit cards and car loans to mass market, retail clients in local currency in small amounts. The third and potentially equally important that we try to reduce our exposure, as much as possible our financial exposure, our financial assets in Russia.

Jovan Sikimic – Raiffeisen Bank International

So basically, we can take like what payout ratio from Russian entity, like 30%, 40%?

László Bencsik – Chief Financial and Strategic Officer

I mean, on a quarterly basis, we submit request for approval to pay dividends and we cannot ask for more than 50% of profits.

Jovan Sikimic – Raiffeisen Bank International

Okay. Maybe last one. In that context, do you expect any regulatory headwinds because just I think one hour ago, we were at that ECB is going to adjust the capital requirements for UniCredit, Raiffeisen because of Russia, I think. So, anything similar to come or you don't think so.

László Bencsik – Chief Financial and Strategic Officer

I mean, yes, we have headwinds. I don't know what better we could do from the perspective of the supervisor or regulator than what we have been doing. European banks, Western banks have more than EUR 10 billion equity exposure to Russia. Your bank is going to be more than EUR 5 billion, half of it. Our exposure is EUR 700 million at the moment.

So that is what is really at stake, right? These equities in financial assets. There's actually EUR 10 billion equivalent to financial assets owned by Western banks in stock in Russia. So, I think this should be the prime focus of the supervisor to salvage those financial assets because this is not a small amount of money, at least not for us. Maybe from ECB perspective, they are used to bigger numbers. That might not be a big number. But from our perspective, these are huge numbers.

Further capital requirements have been introduced, although it is not clear how they will contribute to reducing exposure. However, it is not necessary to understand every detail.

Operator

The next question is from Beata Fojcik.

Beata Fojcik – S&P Global Market Intelligence

It's Beata Fojcik from S&P Global Market Intelligence. I have a few questions, one question again on Russia. I noticed in your financial report a drop in the Stage 3 loan ratio in the third quarter in the Russian unit, and I wanted to ask for the reason behind that drop? How do you explain that?

My second question is on Ukraine. The lending trends and also the Stage 3 loan trends. You said yourself that the lending to your clients has been picking up. I wanted to ask what are the segments where you see the biggest revival in lending? What strategy do you pursue in Ukraine in terms of increase lending? Do you have any special strategy that you pursue?

I also wanted to ask about your forecast or predictions for the lending growth in Ukraine and also for the Stage 3 loan ratio in Ukraine. With the new lending growing, do you also expect the Stage 3 loan ratio to pick up again in Ukraine?

László Bencsik – Chief Financial and Strategic Officer

In Russia, again, the only activity we do in lending is this consumer lending, car loans. These are high APR loans, high-margin loans. There's a normal level of risk cost is relatively high. Therefore, if you look back the last couple of years, you have seen that Stage 3 ratios are structurally higher than elsewhere in the group, and that's fairly normal.

Quarterly changes typically come from sales. In Russia, we sell nonperforming loans after certain days past due. So, we only do the soft collection ourselves and hard collection work-out we don't. So, these sales happen in batches, and they are not uniformly distributed over the year. So, Stage 3 ratios depend on how much we sold in that given quarter to work-out companies in Russia.

Ukrainian lending, I mean, structurally, we are more corporate, much more corporate in Ukraine than retail and we are very strong in leasing, in equipment leasing. In equipment leasing, we see strong demand, and this is really the type of product where we are the most confident to increase our volume.

So that's most of the corporate loan growth you see is equipment leasing. Then the other one is just unsecured consumer lending, POS loans, cash loans. Likewise, we see strong demand and not just strong in terms of magnitude, but also in terms of credit quality.

The lending we do in Ukraine and the increasing lending we do in Ukraine; we do with the strong conviction that portfolio quality is going to be quite decent. So no, we don't expect spikes in Stage 3 ratios in Ukraine.

Beata Fojcik – S&P Global Market Intelligence

Thank you very much.

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 very much for joining us today. Thank you for listening to the presentation and thank you for your very good questions. I hope you will join us when we present the full year results. I think it's on the March 7, it's the first Friday March. Until then, all the best. Take care, and goodbye.

Operator

Thank you for your participation. The first nine months 2024 conference call is closed now.