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 OTP Bank's Third Quarter 2023 Conference Call. This conference will be recorded. As a reminder during the presentation all participants will be in a listen only mode. After the presentation there will be an opportunity to ask questions.

May I now hand you over to László Bencsik, Chief Strategic and Financial Officer. László, please go ahead.

László Bencsik – Chief Financial and Strategic Officer

Good morning or good afternoon depending on where you are. Thank you very much for joining us today, expressing interest in OTP Group's 2023 third quarter interim results and presentation. As usual, I will try to be brief and go through the presentation. We are going to show you parallel the presentation on the screen. It's also available on the website. We recently updated it because there was a previous version uploaded, the ROE numbers are not exactly the same in the version that are on the website at the moment, but we are changing it. The presentation includes the right numbers which equal to the ones which we presented in our official report beginning of the day today.

So overall, if we look at OTP's performance, stepping back a little bit and have a bird's eye view on the overall story of the group, we thought that these are potentially the most important highlights of our performance. First of all, we are building up a dominant position not just in Hungary, but in a number of countries in the region. OTP is number one in 5 countries in terms of net loan volumes: in Hungary, Bulgaria, Slovenia, Serbia and Montenegro. This is a result of very strong and fast growth what we have done during the last 7 years. We have 11 acquisitions behind us, and the loan book has grown 3.5-times and the composition of the group has also changed quite drastically. Now more than 40% of the total loan book is in the Eurozone plus the ERM II countries, which is Bulgaria, hopefully joining beginning of 2025, which is now the official target of the government. Then 80% of loans is within the European Union. Obviously, the share of Hungary has gone down, and the share of the outside Hungary businesses has increased quite substantially. Now Hungary is just 30% of the total group.

The other important factor is strong profitability. We have always been strong in our profitability numbers with few exceptions over the last 20 years. Last year was one of those exceptions when we had big losses coming from the war in Ukraine and also the extra policy measures and taxes which were raised in Hungary. But this year we recovered, and we are back again to higher than peer-level of profitability. 33% ROE, but if you take out the one-offs, then 30% adjusted return on equity in the first 9 months. I think that's quite a decent performance, even if you consider the expected return: the cost of equity has also gone up during the last 2 years. Instead of around 10%, now it's more like around 15% for the entire group.

We are not just growing fast and are very profitable, but we believe that our foundations are also quite stable and strong. These foundations are the liquidity position, the capital position and the underlying portfolio quality.

In terms of liquidity, we still have this situation where deposits by far outweigh loan volumes, the net loan to deposit ratio for the group is 74%. We have a relatively small wholesale debt exposure, it's at 8% of the total balance sheet and it has started to grow, not because we need liquidity for the business but because of the regulatory requirements in the form of MREL requirements which is another layer of capital requirements in Europe. Finally, the LCR ratio is more than 220%; the minimum is 100%. That's also a quite high level.

Our capital position is also solid. There are 2 ways to look at it. One is just a numerical ratio, the Common Equity Tier 1 ratio that is 16.4%. This is where we ended the year last year, but then it dropped down especially at the end of the first quarter after our biggest ever acquisition in Slovenia. At the end of the first quarter, we had local minimum of this number, but it has actually very fast recovered to previous high levels. And the other way to look at this is looking at the results of the EBA stress test which is done every second year - it was done this summer and we came out as the fourth most resilient or the fourth best bank in the list of the large banks in Europe. This is measured in the decline in the capital ratios under the stress scenario. So, in our case, it was the fourth smallest decline in case of the stress scenario defined by EBA.

Strong liquidity, strong capital position, and portfolio quality is also very stable. The Stage 3 ratio is materially below 5% it's 4.3%, it actually slightly increased. But that's only due to Ipoteka Bank in Uzbekistan where we're in the early stage of being in possession of the bank. We are getting a better grip on what the portfolio quality is, and that resulted in some of the increase. But other than that, it's basically very stable portfolio quality across the group and therefore very low risk cost rate. Last year, we had a risk cost rate of 75 basis points in the first 9 months. This year it's 3 basis points. Very flat risk cost and still very conservative 2% coverage on Stage 1 and 2 loans. If we consider the last 7 years and if you take out the war-induced additional provisioning last year and the COVID-induced additional provisioning in 2020, then during the last 7 years, the risk cost rate was between 30 and 50 basis points. The fact that we have 2% coverage on performing loans means that we have roughly 4 years equivalent of normal level of risk costs in provisions for the performing volumes, which is clearly more than what you would expect, I think.

On top of fast growth, strong profitability and very stable operations, we also have a strong commitment to ESG targets. It became part of our genes and part of the core strategic goals of the management and the whole operation of the group.

So, that was a more high-level view on where we are and how we got here. And now we go into the details of the financial performance of the first 9 months including the third quarter.

If we look at the bottom line, HUF 858 billion profit after tax for the first 9 months, which is 3.7-fold increase compared to last year. This substantial improvement stems from basically 2 parts. One is related to the adjustment items. As you can see on slide 3 in the right corner, last year we had HUF 207 billion minus after tax in the form of one-offs. This year, first 9 months, that was HUF 79 billion plus.

It came from basically 3 sources. The first one is related to acquisitions, and that's where we have a big swing compared to last year. Last year, it was minus HUF 10 billion. This year it's plus HUF 145 billion related to acquisitions. That is because of the badwill what we booked in case of the Slovenian and Uzbek acquisitions. In both cases we acquired the banks at a price which was well below the net asset value, the book value. Second, special taxes, primarily in Hungary, and the interest rate cap, which were last year close to HUF 100 billion hit on us, they remained in place. They are at somewhat lower levels but still a material hit for the whole group. This close to HUF 100 billion went down to HUF 88 billion. There's some decrease but it's still a meaningful burden, quite strong burden on our performance. Third, where we didn't have losses this year was the direct immediate effect coming from the war in Ukraine. Last year, that was a big one-off loss coming in the form of goodwill and investment impairment, and also provisions for the Russian bonds that we have in Hungary and in Bulgaria. But this year, that was close to 0. These resulted in a positive contribution from the one-off items as opposed to the very big negative last year.

Now, if we look at just the underlying performance, it also improved. So, without one-offs we made HUF 779 billion profit after tax, which is 77% improvement. This is primarily driven by improving net interest margin on group level, as you can see, it went up from 3.5% to 3.8%. This is primarily driven by the Euro-related books, since in Hungary the HUF-related book’s NIM declined. I'm going to talk about this later on, but basically this group level improvement is driven by margin improvement outside of Hungary, typically in the CEE countries, which are linked to euro, but also in countries like Moldova or Ukraine where the rate environment increased, and we benefited from that. The other factor, which is not on this page but is very material, is the risk cost rate. As I mentioned it went down from 75 basis points last year to 3 basis points this year. These are the 2 factors which have driven the improvement in the underlying business performance on the group. As a result of increasing interest margin we have an improvement in the cost to income ratio.

If you look at the P&L lines, the next slide, you can see that without acquisitions and FX-adjusted, so without the impact of exchange rate movements within the group, income went up 26% and expenses 17% and that means operating profit growth of 33%; again this is without acquisitions. So that's a very solid underlying performance given that loan growth was rather muted, especially during this year, the FX-adjusted performing loan growth without acquisitions was 4%. So that 33% operating profit improvement is coupled with a relatively modest volume growth, loan growth was 5%. So, it's actually not much more than the year-to-date growth.

In Hungary, as you can see on page 5, most of these one-offs manifested in Hungary, therefore, last year we had a loss. Last year, we had a negative profit in the first 9 months. But if you take out all these one-offs, which manifested in Hungary, and then look at the adjusted profit after tax performance, it's minus 2% y-o-y and that's basically due to the lower NIM, as you can see on this slide.

The good news is that we reached the bottom of the NIM cycle in the first quarter, it was 1.9%. In the third quarter it was actually 2.2%. This 2.1%, which is on this slide for the first 9 months, is coming from this low point in the first quarter at 1.9%, and the improved level at 2.2% in the third quarter. There will be a detailed slide on the reasons behind this NIM contraction, but they are basically the reserve requirements, which changed: they went up from 2% to 10% in Hungary and they only paid less than 10% on them, while the reference rate was 18%. There was a 5% y-o-y decline in retail deposit volumes, which contributed to a lower NIM because, by far the highest margin products in this period were the retail deposits where you don't pay much interest. There were 2 other factors which are very specific to OTP: the 2 acquisitions. When we do an acquisition from OTP Hungary - the whole group is owned by the Hungarian Bank -, then we pay out cash and we book the investment. We have a return on cash, especially when the reference rate close to 18%. But the investment is a non-interest-bearing asset. When we do an acquisition, it always has a negative impact on the net interest margin in Hungary. Obviously, from other perspective, these are very meaningful and it’s worth doing acquisitions. The fourth element which decreased the margin was the MREL issuances. We had to issue these MREL bonds, which are very expensive. We don't need them for liquidity or business purposes. The only purpose they serve is regulatory, but it's a very expensive exercise. Especially this year, it effected primarily the Hungarian margin because we are only passing on these bonds within the SPE strategic framework, the resolution framework, to the subsidiaries at the end of this year. So, most of the burden of these expensive bonds has been on the Hungarian operation.

So that's about Hungary. Now looking at the group, composition of the earnings. As you can see, until a few years ago, Hungary tended to be 2/3 of the group profit and also in terms of business volumes, especially in deposits it was more than 50%, closer to 60%. This changed due to the very dynamic growth we have done during the last 7 years. The composition of the growth was partially driven by acquisitions outside of Hungary; therefore the size of the non-Hungarian businesses has grown, and now it's 70%. This is reflected in the distribution of the earnings, as well, in the whole group.

As you can see, this year the non-Hungarian entities' contribution to the group profit increased to 66%. This is something what we welcome. Strategically, we believe this is a much better, much more diversified and much more stable and better growth platform, what we have now compared to what we used to have a few years ago, where the Hungarian exposure was very dominant. Now this is less, so we have a much better diversified footprint and portfolio of businesses.

Looking at the individual performance of the countries, it has so far been an excellent year. As you can see, for all entities, we see an improvement. Nominally, it's the Bulgarian operation, which has always been the largest, continues to be the largest. They doubled the profit compared to the first 9 months of last year. But if you look at the percentage improvement, it is not Bulgaria which is leading, it’s Slovenia, where we have a new entity joining us, NKBM. With the combination of the 2 banks, it's close to HUF 90 billion profit in the first 9 months. There is good improvement in Croatia, Serbia and Albania. Montenegro more than tripled its profit over the year. Russia, also tripling, last year was difficult. Ukraine, amazingly good performance, I think, given the very difficult situation in the country. Last year they made losses, this year they have strong profitability. In fact, the strongest in the group. They made 50% return on equity in the first 9 months. Obviously, the expected return, the cost of capital is also quite high there. We have to put it into perspective. But even then, it is at least 2 times cost of equity or expected return what they achieved this year.

Romania: very decent performance, especially compared to the loss they made last year. Still not among the best in terms of ROE in the group but promising performance. Moldova doubled its 9-month-contribution as well. Across the board, we have very strong numbers. Where we don't have yet a strong number is our new acquisition in Uzbekistan, Ipoteka Bank, where the third quarter result was 0 due to basically provisioning. It seems that the portfolio quality of the bank is somewhat worse than we expected, and that partially was reflected in the PPA, in the badwill. We adjusted down the badwill, what we created in the second quarter.

Just to remind you, the adjustment of badwill is a normal accounting procedure according to the IFRS standards. After the acquisition, you have one year to continue to adjust the badwill, where the purchase price allocation process continues for 1 year, and it's perfectly fine from an accounting perspective to make changes on that, should be evidence that retrospectively, it was warranted to change the valuation at the time of taking over the assets. So, we partially did that, and we also provisioned for the third quarter quite heavily, primary on corporate exposures which started not to perform. We still don't fully understand whether it's intrinsic change in their conditions or just the new ownership of the bank with some other factors, but it's clear that the corporate portfolio quality started to deteriorate in a quite meaningful way.

We have to take into consideration that this was somewhat reflected in the price. We brought this asset much lower than book value. We believe that even with these difficulties in the portfolio quality, it was, in a way, priced in. We did not know exactly how it would manifest, but we certainly included it in the pricing, there is quite a big buffer for this type of potential problem. We still believe that even with these deteriorations, it was a meaningful deal, and we believe in the strong potential of the bank and of the country. Hopefully, we can get through these problems during this year.

Now, just a few highlights about the situation in Russia and Ukraine. As we saw on the previous slide, in both cases, nominal profits and profitability are excellent. In terms of volume dynamics in Russia, we continue not giving any corporate loans. The volume continues to phase out. While in retail, in POS loans and cash loans and credit cards, we see some improvement in the market. In the third quarter this year, the consumer loan growth was 11%. So, it seems that after losing quite some volumes during last year, this year should be better.

We also see some improvement in Ukraine, while in y-o-y comparison, we are still negative, almost 30% down in terms of performing loan volumes. In the last quarter there was some improvement. There's some, hopefully, light at the end of the tunnel now and then not just profitability, but also business activity can somewhat normalize.

In terms of provisioning, especially in Ukraine, previously, we talked about potentially going up to 30% total provision coverage on gross loans. We did that in the first half of the year. We went up to almost 25%, but to be frank, portfolio quality is exceedingly good. What you can see is that the Stage 3 ratio started to decline, and the Stage 2 ratio started to decline, so some loans that we restructured right after the war last year, kept paying perfectly. We are going through this process where we continue to monitor the portfolio and classify the portfolio according to performance, and that performance is actually very solid, much more solid than we originally expected.

So, what I'm trying to say here is that it's unlikely that we are going to increase further the provision coverage on the total loan portfolio. It's rather going somewhat lower, as you can see on this slide. Finally, some of you might be interested in these numbers, the potential impact of deconsolidation on the capital ratio. Should there be a complete deconsolidation of these activities, the impact is quite moderate, especially if you compare it to the 16.4% Common Equity Tier 1 ratio of the group. We are talking about 14 basis points potential impact in Russia and 13 basis points potential impact in Ukraine. Not that we are expecting these scenarios to manifest. It's quite the opposite. We believe that these are very, very low probability events.

Going into the P&L lines cross-section among the countries. NII group level improved FX-adjusted, without acquisitions, 21% and also on a quarterly basis there was a 4% improvement. Y-o-y, Hungary is still negative 10%, but quarterly there is a 10% improvement. The NIM also has started to improve. We see the benefits coming through from the decreasing rate environment in Hungary.

The fresh news is that y-o-y inflation dropped below 10%. That's the data from today. October inflation was less than 10%. This is better than expected. Disinflation seems to be even faster than expected. Our expectation is that by year-end we will see around 7.5% y-o-y inflation levels. And that creates quite a big room for rate cuts. With this less than 10% inflation and the reference rate standing at 12.25%, there's already a very big positive difference between the rate and the inflation. So that's a positive rate and quite a big one. As the inflation is expected to decline fast, this is probably going to increase.

There's one element here, which is more technical in case of Romania. There was a reclassification of swap results from other income to net interest income, that's a one-off negative HUF 10 billion in NII and a similar positive number in other income in Bulgaria. That was a one-off technical impact on the NII in the third quarter.

Page 10, net interest margin in the third quarter on group level went up to 4%. As you can see here, there's an improvement in Hungary to 2.24%, again, comparing that to the first quarter low number of 1.9%. There is some improvement in all the other countries compared to last year, especially in the CEE countries. Russia and Ukraine stable. The only place where we have lower margin than last year is Moldova, where the rate has been cut from 20% last year to 5% this year. There has been an enormously precipitous drop in the rate environment and that obviously reflects in our NIM. The lower NIM in Romania, again, is not business driven. There was a one-off reclassification, which temporarily and technically reduced the NIM there.

Slide 11, which some of you liked when we did the second quarter result presentation, we updated with the current third quarter numbers, but the overall picture didn't change. As you can see, the NIM decline in Hungary was induced by the mandatory reserves, the retail deposit decline, acquisitions, and the MREL bonds. In general, the fundamental impact of the interest rate environment on the NII was pretty much marginal and that's due to the fact that we did not have much interest rate risk when this steep rate hike started. We had more or less fully hedged position and we did not benefit from this. We have not benefited from rate hikes. That's what happened. Obviously, there were pluses, as well, on the other side, which partially counter-weighted the negatives.

Page 12, some details about the volume numbers. I think what is interesting to see is that the strong dynamics in consumer lending in Hungary, despite high inflation, higher rates and high APRs for consumer loans. Just in one quarter we had 4% growth. Slovenia was quite strong, 7%, Bulgaria 4% and then Russia started to grow fast, and this is what I told before. Then what's interesting to see is Ipoteka, Uzbekistan. As you can see, there was an incredibly fast growth in consumer loans. Partially, this was in the form of car loans and that's just intrinsic demand growing. At the same time, the corporate performing volumes declined. Unfortunately, we had to classify to Stage 3 quite large percentage of the corporate book and that shows here as a decline in the performing volumes.

If you look at the year-to-date numbers, again, I think a quite positive surprise is the Hungarian consumer loan growth of 12%. Likewise, the Hungarian mortgage growth, that's 3%. This is just year-to-date growth, so these numbers are not annualized. And the corporate growth was negative in Hungary.

Now again, given that the country has been in recession now for 4 quarters, and the magnitude of decline in the housing market and in consumption, in that comparison, these are very decent numbers. Bulgaria was strong and it continues to be strong. Croatia is strong. In some countries like Romania and Slovenia, we had some negative numbers. If you look at the whole year in Ukraine, the overall picture is negative. But again, the last quarter was already positive.

Deposits: it is very good news that the third quarter was 4% up for the whole group, and Hungary was 3% up still. Retail deposits in Hungary were negative, but the rate of the decline is less and less, so we see improvement. If all goes well, the trend can reach the bottom of the pit somewhere now and around November. Hopefully, we see a trend change by the end of the year. So far, what we have seen is a very tangible slowdown in the erosion of the retail deposits in Hungary.

Page 15, year-to-date deposit growth numbers: In Hungary, it was 4% negative in retail and overall negative. But if you look at other countries, they tend to be positive across the board. So, it's actually a quite favourable picture.

Looking at fee income: 14% y-o-y growth and 4% growth in one quarter. Usually, the third quarter is strong in fees because we have countries like Croatia where tourism-generated fee revenues are an important part of the earnings. There we had a seasonal peak. The other positive development is the Hungarian Fund Management fee income growth. It more than doubled in one year. And that's the other side of the coin. When we complain about the decline of the retail deposit volumes in Hungary, in general on the market, and in our case as well, then at the same time, the assets under management in our fund management company in Hungary increased substantially and the revenues more than doubled. So that's why we have this positive growth number here.

Other income: I think there are 2 important factors here. Similar to the second quarter, I mean each quarter, we do the fair value adjustment, the fair value assessment of the subsidized retail structures in Hungary. These are the and baby loan and the subsidized 'CSOK' housing loans where the subsidies are linked to the government bond yields multiplied by 1.3. The benchmark is not just the bond rate, but a multiple of that, and therefore, we have to mark-to-market these volumes. Last year, when the rate environment increased and the discount rate on these volumes increased, we had negative fair value adjustment. This year, we have positive fair value adjustment. In the second quarter, specifically, we had HUF 37 billion positive fair value adjustment, and in the third quarter, we also had HUF 25 billion positive fair value adjustment. These numbers are boosting the other income line. They are not recurring in a sense that the value depends each month or each quarter on the movement of the yield curve. If the yield curve goes up, then this is negative. If the yield curve goes down, these numbers tend to be positive.

The other factor here, which happened in case of Romania, I already mentioned, namely that there was this reclassification from other income: the FX swap negative result was reclassified from other income to NII, and therefore, the other income line went up.

Moving to operating costs, slide 18. Overall, y-o-y 17% increase, FX-adjusted and without acquisitions. There are some numbers which are optically big. One is Hungary, 20%. In Hungary, inflation is now below 10% y-o-y, but the average inflation will be around 19% for the whole year. At the peak, the y-o-y inflation was 26%. So, Hungary has gone through an extremely high inflationary period, and that reflects in the wages. We had to increase wages quite significantly in order to remain competitive and all other costs went up, so in Hungary, we have a 20% y-o-y increase.

The other country where we have a rather big increase is Bulgaria, but part of it is technical. This is the first year where we had to book the entire supervisory charges for the whole year. Last year and previous years it was spread evenly across the year. Now without this methodology change, the increase would have been only 12%. And then there is Albania, where we include the impact of the acquisitions, which we made last year. So, the part of the base last year did not include the new bank that we acquired. So, this big increase is due to that the new acquisition.

Risk costs are close to 0 for the whole year. The third quarter was quite meaningful in Uzbekistan. As you can see, we booked HUF 26 billion negative. The first 9 months risk cost was close to 0, including the HUF 26 billion negative which we booked in Uzbekistan. Generally, again, portfolio qualities are quite solid. We don't see deterioration and also performing volume growth is relatively modest. Therefore, we don't have to provision so much for the newly disbursed volumes either. So, those 2 factors together resulted in this low risk cost situation. The other factor here is the risk cost due to the high reserve level. On the following page, you can see that we continue to have relatively high coverage level for Stage 1 and 2 loans, 2%, which is 4 times the typical risk cost rate level what we have had for the last couple of years.

We have declining trend in the Stage 3 ratio. The year-end last year was 4.9%. Second quarter, we were at 4.2% and only Ipoteka acquisition and the aftermath of that resulted in a slight increase in the ratio. But I think from here on, this trend should continue to be rather downward than upward.

A few words about capital. The capital adequacy ratios here are based on the supervisory or regulatory scope of consolidation. These are the actual regulatory numbers we have to comply with. the CET1 ratio is 16.4%, back to where we were at the end of last year. You can see here the composition. We had really strong profitability in the first 9 months and increased the ratio by 2.3 percentage points. Then there were different factors, which decreased it. The biggest 2 were the acquisitions, NKBM and Ipoteka acquisitions and also the regulatory changes. At the beginning of the year, we were phasing out some of the transitional adjustments, plus there was an increase in sovereign risk weights and these together contributed to a quite hefty capital requirements increase of 80 basis points. If you look at the ratios themselves, historically, that's where we are. The 16.4%, you have to compare to the 11.1% basically, that's the Tier 1 minimum requirement at the moment.

MREL has become a key focus of our activities. We have been very active on the capital markets recently. We issued many bonds, including this year. We did a Tier 2 at the beginning of the year and then 2 senior preferred, and in the third quarter, in October, we did another private placement in RON. The reported MREL ratio for the end of September was 23.51% but this doesn't include these 2 issuances. If we include the EUR 650 million bond and RON 170 million and then the pro forma ratio at the end of the third quarter was 24.78%, which is much higher than the current requirement. The current requirement is 20.52%, but this requirement is going to go up in the first quarter next year.

The official requirement for next year is 24.13%, but in our best understanding, this is going to be somewhat lower when we receive the new official requirement for next year, which is expected to happen in the next weeks. Once we receive that, we will immediately announce it in the form of a special announcement. But, if you take the pro forma third quarter number of the MREL ratio, it was already above next year's requirement.

Next page, you can see the bonds that we issued recently and the maturity profile, but more importantly, the call date profile, which is quite modest despite the recent activity. Due to the fact that these bonds were issued to the market, wholesale debt to total asset ratio is at 8%, which is quite low, especially if you compare ourselves to before the financial crisis in 2008, when this was 25%, and loan-to-deposit ratio was well above 100%. Now loan to deposit ratio is low and we only do these bonds in order to fulfil the mentioned MREL requirements.

Maybe just a few more details about Hungary and the Hungarian performance. Mortgage loan demand dropped. Applications are less than 50% of last year. Despite of this, we still managed to increase the portfolio by 3% in the first 9 months. Our market share is increasing from new production and also from the stock. Likewise, in consumer loans, which is dominated by cash loans, we have an increasing market share, which is now well above 40%. I think it's very important that despite the decline in retail deposits in Hungary, our market share in retail bank deposits continues to increase. The decline is less in our portfolio than for the whole market.

A quick glance at the corporate market shares and volume dynamics. Large corporate volumes declined. However, small corporate volumes continue to increase. So again, despite this relatively difficult environment in terms of the macro and muted loan demand, we still managed to continue to grow our micro-small volumes by 8% year-to-date. Overall, due to the drop in large corporate volumes, the market share did not increase during the course of this year, there was a slight decrease. Nevertheless, looking at the previous long-term trend, it is still very decent to be at that level.

This is our usual slide about ESG, just to keep it in your mind that we consider it very important. There has been some improvement in our rating in case of Sustainalytics this year. We continue to focus proactively and positively, especially on the environmental and climate risks, and we have quite ambitious targets to increase our green lending activity. We have the stated target of HUF 1.5 trillion equivalent of green lows by 2025.

In terms of macro, after the drop this year, across all the countries, we expect improvement next year, which is the good news. Operating environment, we expect to be better next year than this year. We are quite hopeful that this is going to reflect in loan demand and increasing business activity, especially in Hungary, where we have had a recession for a year now. Our expectation is that this negative situation can change hopefully this quarter. Hopefully, the last quarter will be positive, but definitely for next year, we expect a positive GDP growth. My personal expectation is more than 2%. This 2% is according to our Research Department; they might be right. My personal view is that the growth might be even higher than 2% in Hungary. Nevertheless, in Hungary and generally in the other countries, we expect improvement in the environment.

Finally, the adjustments to the management guidance. Performing loan growth was 4% in the first 9 months. We think that it's likely that the overall annual loan growth will be more than 5%. Also, given the 30% adjusted return on equity in the first 9 months, we felt that the previous wording of the expectation that it may be more than last year, was not ambitious enough. We now have another update on the ROE guidance. It probably remains conservative, but now we say that it may exceed 25%. Again, that's not a very ambitious guidance compared to the 30% in the first 9 months.

That was the presentation, we have the usual disclaimers. Please read them. I'm sure many of you have very good questions. So, I would like to ask our colleagues to open the floor for questions.

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

A couple of questions from me, please. First on loan growth, some encouraging upgrade to your guidance for this year. What are your initial thoughts about loan growth and the possible acceleration of loan growth going into 2024? And especially, I would be interested in how you think about the new family subsidy mortgage program in Hungary, CSOK Plus. How do you see the adjustable markets there? Another question is on the Uzbek provision top-up. I mean, it looks like a slightly unexpected top-up on the corporate portfolio, what reassurance can you give us that such challenges would not recur?

László Bencsik – Chief Financial and Strategic Officer

We expect the operating performance environment to be better next year than this year, and we expect higher loan demand in general, but also specifically in Hungary. This is what we expect. Exact guidance for next year, we will make when we talk about the full year results. I think it's the 8th of March next year. As usual, we will make concrete guidance for next year then. The initial expectation is obviously positive. After this difficult year, due to the high-rate environment, especially in Hungary, next year should be better in terms of loan dynamics.

Uzbekistan, in a way, yes, it was unexpected, we didn't expect this to happen. But when we buy something, we are usually quite conservative in our pricing, and we have usually very conservative assumptions. What happened was in the range what we assumed when we priced the asset, but we didn't expect this to manifest. So, in a way, it wasn't expected, but it was within the potential range of scenarios. Now we understand much better the corporate portfolio and we are still working on cleaning out the retail portfolio historical data, and there will be potentially other smaller adjustments related to the retail portfolio provisioning in the fourth quarter once we are absolutely sure that the historical data on which the collective provisioning models are based. In order to do collective provisioning, you need a historical data set for defaults and PDs and so on. That database what was originally used is clearly not 100% correct. We are working on this. I think by year-end, we will clean out everything and have a very precise view.

We lost 28% of the performing corporate portfolio. It's quite unlikely that this can happen again. In the corporate, I think we have a much better understanding of the intrinsic quality of the portfolio is now than what we had. And the retail portfolio, in general, is not worse than what we originally expected. It's just the coverage levels, where we still have to work some more to be absolutely sure that the historical data on which they are based is absolutely correct, and that might take some time. So, I guess that's the best answer I can give.

Gábor Kemény – Autonomous Research

And thoughts on CSOK Plus, the possible demand?

László Bencsik – Chief Financial and Strategic Officer

CSOK Plus would be positive, definitely. This is part of the positive expectations that we have regarding Hungary. I think it's fair to expect further structures, other subsidized structures to come next year. I don't think this is the end of the policy measures, positive policy measures in Hungary.

Operator

The next question is from Simon Nellis, Citigroup.

Simon Nellis – Citigroup

Thanks very much for the opportunity. Just again on the Uzbek issue, I'm still a little confused. I mean, was it a problem of incomplete due diligence that you haven't identified the issue? Or is this portfolio provisioning that potentially could be released if the portfolio actually ends up performing better? I'm still a little confused. And I guess it sounds like you're doing a similar exercise on the retail portfolio. Maybe it's not going to be as large, but it sounds like we could see some additional provisions in the fourth quarter, if I understood what you were saying before. Is that right or correct me if I'm wrong?

László Bencsik – Chief Financial and Strategic Officer

We discovered the data that we had was not exactly reflecting the situation when we had the chance to put our people there and take over the bank. That's one aspect. The other aspect is that the corporate portfolio deteriorated fast in the third quarter. And we still need to understand what exactly happens here, to which extent the change of ownership or some intrinsic fundamental factors have influence. There are clearly intrinsic fundamental factors in some cases. For instance, we have cotton producers and growers and processors, and the harvest was not very good and the cotton price is low. So, there are some intrinsic deteriorations which happened in the third quarter. That's part of the problem. This is what you see in the quarterly risk cost.

The other part where we adjusted the badwill, that's more related to the, put it this way, data inconsistencies what we discovered related to the corporate portfolio when we took over the bank. We are aware that the quality of the historical data for the retail coverage - not the portfolio quality per se, so we don't expect reclassifications in the retail portfolio between Stage categories. But regarding IFRS 9 coverage levels, we still need to work on the historical data quality in order to have a full picture. In corporate, it was actually a reclassification from Stage 1 to Stage 3, and that resulted in the decrease of the performing volumes by 28%. In retail, we don't expect that to happen. In retail, the coverage level might increase somewhat.

Simon Nellis – Citigroup

Just one other question on margins. You've had nice margin improvement pretty much across most of your markets. Can you help us out, going into next year, what's your base case margin outlook for next year?

László Bencsik – Chief Financial and Strategic Officer

Short term looks like a sweet spot because we are benefiting from the decline in rate environment in Hungary, and we are benefiting from the high-rate environment in the Eurozone or Euro-related books. So, until the Hungarian rate decline continues and the euro rate decline doesn't start, it's going to be an improving NIM situation, most probably. So, it's a kind of sweet spot. It depends. I think the trajectory of the Hungarian rates is easier to forecast because of the declining inflation. If you annualize the last 4 months' monthly inflation, you get like 3%, 4%, right? And there's no sign for inflationary pressure next year either. I think inflation will continue to fall quite fast in Hungary, and therefore, the rate environment can definitely continue to decline fast, and we should benefit from that.

The sensitivity is less than it used to be. It's roughly HUF 4 billion per percentage point annualized NII, the forward-looking sensitivity, which is less than the sensitivity we had between 18% and 13%. Now, the euro rate, for me, that's more difficult to forecast, when it's going to start to decline and with what rate. That is more of a bigger question. The sensitivity in terms of percentage point is bigger. The current sensitivity to the euro rate is EUR 190 million per 1 percentage point change. And again, this is an annualized NII impact.

Simon Nellis – Citigroup

And sorry, the HUF 4 billion for 1% cut in Hungary - that is under which rate? That below 13%?

László Bencsik – Chief Financial and Strategic Officer

If there were further rate cuts, so below 12.25%, from now on.

Simon Nellis – Citigroup

Understood. But you're still benefiting from the higher sensitivity from the previous rates cuts, right?'

László Bencsik – Chief Financial and Strategic Officer

Yes. That's filtering through.

Operator

There is a question from Mikhail Butkov.

Mikhail Butkov – Goldman Sachs

Thank you very much for the presentation and congratulations on the solid results. I have a few questions. Firstly, can you comment if you already have visibility on any one-offs, either related to regulations or something else looking into the year 2024, which can materialize? It's the first question. And the second question is on Romania, there was a number of interest and strategic changes in the banking market over the past few months, if not weeks. How do you see the competitive landscape currently? Could you give any outlook within that particular segment, if you may?

László Bencsik – Chief Financial and Strategic Officer

So, next year, one-offs. Hopefully, it won't be followed. But a couple of countries, unfortunately followed the Hungarian example and either introduced or are in the process of introducing extra taxes and rate cap. Specifically, Serbia, introduced a rate cap on the existing mortgage portfolio and the impact of that we already booked in the third quarter this year. So that's already in our books. It was HUF 7.1 billion after tax equivalent, and that implies for 2 years. And then there's a discussion in Slovenia for an extra bank tax, which is 20 basis points of total assets for 5 years. It's still unclear whether they start it from '23 or from '24. The bill has not passed, but in our understanding, it's likely that they will raise this extra tax on the banks. The annual impact is roughly EUR 30 million for the 2 banks that we have there, so including SKB and NKBM.

And then the other one is in Romania. In Romania, they introduced a new tax on the revenues and an additional one on banks. The total impact is approximately HUF 3 billion per year, RON 40 million per year. These are the policy measures we know about. In Hungary, we already know that the extra profit tax is going to be lower next year. We actually know the number. It's HUF 13 billion in our case, which is much less than what we paid this year. And this can be further reduced if we buy some more government bonds, which we will do.

So most likely, this is going to be only 50% of the HUF 13 billion next year. I hope there won't be other one-offs. So, I really hope that we are back to normal growth. GDP trajectory started to improve. Inflation is falling. Consumption is coming back. So hopefully, the appetite of governments to tax the banks and levy the banks will not be as strong as this year or last year.

Indeed, in Romania, there's quite a dynamic change in the competitive landscape, as you said. 2 acquisitions were announced and there might be another announcement in the future because, it's not a secret, we are revisiting our strategy towards Romania, and we are exploring the potential scenario where we sell the asset. There is an ongoing process. And we are in a reasonably advanced phase of negotiations with potential buyers. It's not that we don't see potential in the Romanian market. The problem is that everyone sees a huge potential in the Romanian market. And therefore, it's very congested and competitive, and we are small. And we have not been able to acquire a meaningful asset there. Our understanding of the situation is that it is not very likely that we could acquire a sizable bank as we may not be the preferred buyer there. Yes, so we might contribute to this changing landscape in Romania in the foreseeable future.

Mikhail Butkov – Goldman Sachs

May I follow up on the first question? There were some comments in the press earlier, that in case of extraordinary profits for the banking sector the windfall tax, in fact, can be increased or the rules could be changed. Do you see any risks related to that? Although I think you already answered about expectations for the next year about the one-offs, but still, what probability do you assign to this scenario and those comments about the change in those rules?

László Bencsik – Chief Financial and Strategic Officer

There was this unfortunate comment from the Minister of Finance in, I think, September, late September, but that was denied, right? He stepped back from this, and then also other government officials denied that. So, in our best understanding, this is not going to happen. Certainly, if you look at OTP profit this year, it's lower, I mean, if you take out the one-offs, the additional taxes and the war-related losses and the dividends that we received and the underlying performance, in case of OTP it’s year-on-year declining. We are certainly not making extra profits in Hungary. Some banks may. But again, in our understanding, this is not going to come.

Operator

The next question is from Máté Nemes, UBS.

Máté Nemes – UBS

I have 2 questions, please. The first one is on costs. I think in Q3 on a like-for-like basis, we've seen quite good cost control. I was just wondering, what do you see in terms of salary inflations in the region? Did you have a sense in a number of countries that this is clearly moderating and perhaps it will be somewhat of a lesser pressure going forward? Or this is unrealistic, the market is still very competitive, and this is something that could remain perhaps at an elevated level?

And the other question would be on capital allocation. The CET1 ratio improved quite substantially in the third quarter. You are now at 16.4% CET1 ratio. So, I'm just wondering how do you see the adequate capital level for the bank? And what do you see in terms of the preferred capital allocation in the next 12-18 months? Do you perhaps still see opportunities for consolidation in the region or outside the region? Or if that's not the case, would you consider the idea of meaningfully higher payout ratio or perhaps share buybacks? Any thoughts around that would be helpful.

László Bencsik – Chief Financial and Strategic Officer

Yes, costs, due to the high inflation in the job market remains quite tight, despite the slowdown in economic activity, labor markets remain quite tight across the countries. So, in order to remain competitive on the job market, we had to increase wages by quite high level. In Hungary, it was more than 15%. This is not going to be repeated next year. I think it's very clear. So, on one side, I think that the labor market is still quite tight. Our labor markets are tight in the countries where we operate, typically. But now we see some minor changes, people seem to be more concerned about preserving their jobs than they used to be, new opportunities seem to be less, and inflation is dropping fast. I think the wage increase next year will be much less than this year. So, in that sense, the pressure will be somewhat less. I think the cost pressure will ease somewhat next year compared to this year, which is good news.

Capital, yes. We are back to where we were at the end of last year in terms of Common Equity Tier 1 ratio, which is good. Adequate level - that's difficult because we obviously want to be well above regulatory requirements but how much higher? We tend to look at competitors and benchmark ourselves to competitors because we like to be seen as well-capitalized compared to other banks. Now I think there are increasingly insane levels of capital adequacy across Europe. I don't know whether this is because of preparation for Basel IV or just a crazy trend where banks are going to levels which I don't see justified, but there's a kind of peer pressure here.

So, if you ask, if we are operating at the necessary level, then we should be actually very close to the regulatory minimums and not much higher than that. But this is not what is usually the trend in Europe. So, it is a difficult question, what exactly the adequate level is. I think we are getting to levels, especially in terms of traditional ratios of Common Equity Tier 1 and capital adequacy ratio levels, which are clearly high and include quite big buffers above minimums. The Common Equity Tier 1 ratio even in peer comparison is quite high.

This year, the bottleneck was the MREL requirement, because it increases in a big step, there was an almost 4 percentage point increase in the requirement level from one year to another, and we have to meet that. And it's a one-off exercise. We are getting there.

If we continue to be as profitable as we are, unless organic growth triples or something like that, which is unlikely, we believe that organic growth rates will improve, then we will continue to accumulate capital. The type of questions you asked are the questions what we will ask ourselves. I think during the course of next year, it depends on whether we see a big promising acquisition opportunity over the organic growth rate, which might require some capital to be allocated to it, or rather, indeed, return more to shareholders. We like to have a gradual nominal increase in dividend payments. Historically, we have been inclined to do share buybacks. This will become a topic next year, whether to do it, how much, when, how. But I think these questions will certainly be asked and addressed and answered during the course of next year.

Operator

The next question is from the analyst of Concorde Securities, **Hai Le Phuong**.

Hai Thanh Le Phuong – Concorde Securities

Thanks for your presentation. I just connected later, so maybe my questions were already answered. But I would like to ask, first of all, about the risk outlook for 2024 because in 2023, it seems like risk cost was, let's admit it, basically non-existent on a group level. I was wondering if you could give us some guidance for 2024. My second question would be on Kazakhstan because I saw in the news recently that you may be planning or you are looking at acquisition targets there, and I was wondering how serious it is and what would be the motivation behind? And my third question is related to capital allocation again, about dividend payout ratio, because you said that dividends should increase gradually. But if I apply the historical dividend payout ratio to this stellar profit, then it shouldn't be that gradual. So how should I think about the dividend after 2023?

László Bencsik – Chief Financial and Strategic Officer

Regarding the risk outlook, when a year ago we planned 2023, we thought that we would come back to more normalized level plus some ramifications still coming from the war in Ukraine, but neither of those happened. Indeed, it's a stable portfolio what we have, with low new volume growth. And actually, at least portfolio quality wise, the situation improved in Ukraine and Russia. So, these were positive developments compared to what we expected.

Next year, I think, there's a good scenario that things don't change so much. The most probable scenario is that we converge back to more normalized or regular level of risk cost. If you look at our risk cost rate for the last 7 years and if you exclude the extra provisioning we did due to COVID, which was with hindsight, not required, and then if we take out the extra provisions we made last year for Russia and especially more in Ukraine, which again with hindsight was not required, then you end up with a risk cost rate between 30 and 50 basis points. So that's the underlying risk cost rate for the last 6-7 years. This is one proxy to start with, and then it might be somewhat better than that or might be somewhat worse than that. But I think that's the kind of run rate range.

There can be some divergence from that range. Like this year it was better and then in some years it can be worse. And that excludes big unexpected events, like the war or the pandemic was. But it's difficult to forecast. For a number of years, we have been positively surprised by the risk cost levels and the qualities of the portfolio. And at least for the CEE countries, the intrinsic portfolio qualities are much closer now to Western European standards than compared to the past situation 10 or 15 years ago in the region.

Kazakhstan acquisition: I don't have anything to comment on that. Regarding new acquisition opportunities, we keep our eyes open and keep looking. The primary strategic objective is to grow in the countries where we are already present. As a secondary focus, we are currently scanning and monitoring the situation in the countries where we are not present that might be interesting. There's nothing I can comment regarding Kazakhstan.

Dividend payout ratio, we don't have a payout policy, as such. We rather approach dividends in terms of their nominal values. We haven't made the decision on how much to suggest to the general meeting next year. I cannot comment much on the expected dividend payment. This is going to come next year.

Operator

The next question is from Michal Konarski, mBank. The floor is open.

Michal Konarski – mBank

Just one more question, a follow-up question regarding Uzbekistan. We've heard that sometime in the future there may be more banks put on sale in Uzbekistan. I was wondering what is your right now strategy, especially after this third quarter experience. If there will be any M&A opportunities, would you take it next year or rather think about organic growth and making some cleaning of the business right now to OTP standards.

László Bencsik – Chief Financial and Strategic Officer

Well, our view on the potential of the country and of the banking market there has not changed. We think there's an enormous potential. First of all, I'm not sure whether we would be one of the preferred buyers. If they want to privatize another bank, I'm not sure if they wanted to sell it to the same buyer, so that's one aspect on this. If we were allowed to look at it, we would probably. So, if there's another asset coming to the market, and we are not excluded, then we probably look at this and then decide based on what we see.

Even now, we have a much better understanding of the market and the situation in Uzbekistan. And as time goes by, these understanding increases, quite rapidly. Certainly, we are much better informed and much more knowledgeable about the market and the situation there than we used to be before entering the market, and this is going to continue to increase. I think if we are allowed, we would look into another opportunity there, if there were another opportunity, and we will decide based on what we see, including the recent experience.

Having said that, putting aside the portfolio quality mishaps or challenge, there's another big challenge: to transform a previously state-owned institution into a more than high-performance bank. That challenge we had known about. This is not new, but this is a formidable challenge. There's a lot of work needed to be done, and it's going to be a big and relatively long effort to convert this bank into more than a financial institution.

I don't know whether on top of that, a merger would be a smart thing to do. Because typically when you do a merger, you have to 100% focus on the merger activity and you have to freeze every other development. And certainly, it would be difficult operationally, to combine a major fundamental transformation with a large merger process. That would be quite a challenge. This is something that we would have to take into consideration when making a decision there.

Operator

The next question is from the Analyst of Bloomberg.

Thank you for the presentation. I would like to address a few topics on the credit side, please. The first question is on your Tier 2 instruments. You executed one benchmark deal this year and have one upcoming call in July next year, which is currently trading out of the money. So, I was just wondering what would be the factors at play when deciding whether to call and replace that instrument? The second one is whether you would consider an AT1 instrument in the future for capital optimization purposes. And lastly, just a follow-up on the capital question, I was wondering whether there are any other elements we should consider when thinking of your CET1 buffer into 2024, apart from the increase in the other systemically important institutions buffer and the countercyclical buffer.

László Bencsik – Chief Financial and Strategic Officer

I'm legally not supposed to comment on whether we call or not call the bond next year. But I think it's quite clear that we are a regular issuer, and we will remain a regular issuer and frequently appear on the markets. This is a strong factor, obviously, when we have to make the decision on whether to call or not to call the bond.

No plans for Additional Tier 1. It has to be a very special situation, potentially a large acquisition opportunity or something like that in order for us to consider it. From our perspective, the price of an AT1 would be, from our perspective, irrationally high.

We talk about the buffers in detail, if you go to Page 22 of this presentation, there's a detailed description of the buffers that we have and the potential changes in the buffers coming next year. There are 2 certainly important changes. One is that the other systemically important buffer is going to increase from the 1% this year to 2% next year. And also, there's a countercyclical buffer potential increase from 1st of July next year, which was announced by the National Bank in Hungary, and that's specific to Hungary. But you see all the details here in this space. So, that's all what we know.

Operator

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

László Bencsik – Chief Financial and Strategic Officer

Thank you for your interest. 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 year-end numbers on the 8th of March next year. Until then, I wish you all the best, and goodbye.

Operator

Thank you for your participation in the third quarter 2023. Conference call is closed.

Note: unabridged transcript with minor English stylistic corrections.