

# *Annual Report*



*OTP Bank*  
*Annual Report*  
*2012*

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# Message from the Chairman & CEO

DEAR SHAREHOLDERS,



*In recent years I have begun almost every one of these missives by saying that although we have put a difficult year behind us, the next will hopefully be better. Then, at the close of the financial year concerned, we were disappointed to conclude yet again that the problems in the eurozone had eased up at best, but still no permanent solution had been found to the structural problems that have surfaced in relation to the financial crisis, and the domestic economic and regulatory environment had been more of a hindrance than a help to us in our work. So 2012 was a difficult year. Owing to the lack of a predictable economic policy, the ability of the Hungarian economy to attract capital diminished, and investments and consumption dropped off. These factors, accompanied by a worsening of prospects in foreign markets, resulted in the weakest economic performance in the region: Hungary's GDP contracted by 1.7%, which suggests that 2013 will be another difficult year.*

Global investor sentiment developed favourably, however, partly due to the continuous efforts of the world's major central banks to boost liquidity, and to an increased appetite for risk on the part of investors; but the Hungarian government's consistent adherence to a budget deficit target of below 3%, and some of the adjustment measures implemented for this purpose, also bolstered the market's confidence in Hungarian assets. Internationally, the forint was one of the best-performing currencies, similarly to Hungarian government securities, as the state securely financed its maturing debts without the need to procure funds from the external capital market, and without a new IMF/EU agreement. The necessary fiscal adjustments also led to a slowing of growth in the other countries where the Bank Group does business; but with the exception of Croatia and Serbia GDP growth remained in the positive range.

In the weak economic performance was accompanied by a regulatory environment that also developed unfavourably for banks. In 2011 the estimated loss resulting from the prepayment of foreign currency mortgage loans, sustained by credit institutions, amounted to HUF 266 billion (after the special banking tax refund but before the corporate tax effect). Besides this, the sector's business operations suffered as a result of the special tax on banks,

introduced in 2010 and payable in an unchanged amount thereafter, and by the losses and provisioning obligations incurred on the deteriorating loan portfolios. As a result of these factors, in 2012 the banking sector realised a HUF 151 billion loss, its third negative result in as many years. I'm afraid that the sector overall will still be loss-making in 2013 and, in response to the regulatory measures with a negative impact on profitability, many of the foreign parent banks will rein in their lending activity more tightly in Hungary than in other countries of the region.

Notwithstanding these difficulties, I am proud to report that the OTP Bank Group concluded another successful year in 2012: its profitability indicators continue to significantly outstrip those of its regional competitors, its capital strength remains outstanding, and its liquidity is secure and continuously improving. Our regional acquisition strategy, which originally targeted markets that offer better growth prospects than the domestic one, has proven an unqualified success: thanks to the diversification and continuous developments, the contribution of the foreign subsidiaries to profit is growing, and this went a long way towards compensating for the fall in profits from the Hungarian operation, burdened as it is by various sector-specific regulatory items. The consumer lending that has proven so successful and yielded

such outstanding results in Russia is increasingly living up to expectations in Ukraine too, and we have seen a significant upturn in activity in this segment in the Slovak, Romanian and Serbian markets in recent years.

## Overview of financial performance in 2012

In 2012 the OTP Group achieved an adjusted after-tax profit of HUF 150 billion, which, although 7% short of the previous year's figure, I would say is a fair result given the challenges of the unsupportive operating and regulatory environment mentioned in my introduction. The accounting profit, which includes one-off items (here I'm thinking specifically of the HUF 29.2 billion in special tax on financial institutions and last year's HUF 1.8 billion negative profit impact resulting from the redemption of foreign currency loans at a fixed exchange rate) was HUF 122.6 billion, which represents a 46% improvement in comparison to 2011. Within the consolidated, group-level profit figure, at annual level the profitability of banking operations in Hungary dropped by 19%; however, the foreign subsidiary banks' contribution to profit increased by almost HUF 10 billion. The Bank Group's profitability indicators remain excellent even by international standards; the return on assets was 1.5%, while the return on equity exceeded 10%. The Bank Group's operating profit excluding one-offs was HUF 450 billion, which is 3% higher than that of the previous year. The success of the Bank's operation is demonstrated by the fact that its operating profit remained stable, and indeed improved, during the crisis years, which was primarily due to the net interest income from core banking activity, and to the balanced development of net fee and commission income. It is extremely positive development that the consolidated income margin, despite its high base figure (8.31%), improved further (+19 basis points), and within this figure the net interest margin (6.40%) rose by 9 basis points at annual level. Nominal operating costs increased by 5% at annual level, which is on a par with the average rate of inflation observed at the companies in the group; and what is more, the increase in costs occurred principally in markets where the growth in lending gave rise to a need for additional sales capacity. As a consequence of all these factors, the operating costs/average assets ratio was 3.89%, which is only minimally higher than in 2011. As part of the rationalisation of the branch

network, significant branch closures only took place in Romania in 2012; but the dynamic consumer lending in Russia and Ukraine led to a further expansion in the network of agents, and we are also devoting particular attention to improving the effectiveness of collection and factoring operations. One of the consequences of the crisis is forced adaptation, a phenomenon that is affecting all participants in the economy. The more cautious consumption habits of households and the restrained investment activity of companies have visibly dampened demand for credit. The Bank Group's loan portfolio, adjusted for exchange rates, shrank by 1% in the past year, though it stabilised in the last quarter. The remaining portfolio was further reduced by the redemption of foreign currency mortgage loans in Hungary – of the overall HUF 217 billion in loan redemptions, HUF 177 billion affected the 2012 balance sheet – and the takeover by the state of HUF 29 billion in loans from Hungarian municipalities. In a favourable development, however, the portfolio of consumer loans grew by 14% at group level. The volume of deposits, adjusted for exchange rates, rose 6%, and as a consequence of all these factors, by the end of 2012 the Bank Group's net loans/deposits + retail bonds) ratio had fallen to 95%. Meanwhile, the Bank's capital and liquidity positions improved further: its capital adequacy ratio increased to 19.7%, and within this figure Tier 1 capital was 16.2%, while the Core Tier 1 ratio was 14.7%. Its liquidity reserves, equivalent to EUR 6 billion, would provide ample cover for the immediate repayment of its entire outstanding external debt. Thus, as far as OTP Bank is concerned, its capital and liquidity position would certainly allow for more active lending, but in terms of demand, there are significant differences in the market.

## Profitability falls in Hungary due to sector-specific items, but this is accompanied by stable – and even improving – market share, ongoing development of services, and an improving foreign contribution to profits

Within the Bank Group, in 2012, the adjusted profit of the **Hungarian operation** was HUF 94.6 billion, which fell short of the previous year's figure by more than HUF 19 billion. The fall in profit was primarily a

consequence of the decline in operating profit; the interest margin decreased and, as a result of the foreign currency loan redemptions, so did the size of the interest-bearing portfolio. This was offset to a certain extent by the fact that, after 2011, impairment fell again in 2012. Although quality of the portfolio continued to worsen, with the proportion of non-performing loans rising to 16.1%, the rate of deterioration slowed discernibly in the second half of the year due to the stabilisation of the forint and to the 'exchange rate cap' scheme, available from April onwards, which fixed monthly repayment instalments for five years.

It is a welcome development that while the bank sector's corporate loan placements declined by 9% in 2012, loans granted by OTP Bank to Hungarian companies increased by 5%. The Bank, in keeping with the management's objective, increased its loans to micro and small business customers, and to agricultural enterprises, by 6% and 13% respectively, which is an outstanding achievement. Besides this, the contribution of the Bank's retail lending activity continues to be decisive; its share of disbursements was 34% in the mortgage loans market and 52% in the personal loans market in the fourth quarter.

As one of the most important strategic objectives of recent years, we focused on continuously improving the standard of service, and developing differentiated service models for the various customer groups. Here I'm referring to initiatives such as the roll-out of the 'Simple' brand for young people at the start of their careers, the introduction of PayPass technology, or the launch of mobile banking services optimised for smart phones.

In recognition of our efforts and developments, besides the usual professional accolades (Bank of the Year award from the trade magazines The Banker and Global Finance), in 2012 OTP Bank earned the titles of Best in Mobile Banking in Central and Eastern Europe and Best in Social Media in Central and Eastern Europe from Global Finance.

Among the key members of the Bank Group in Hungary, the annual after-tax profit of **OTP Fund Management**, before the bank tax, exceeded HUF 2 billion (-39% y/y). The fall is indicative of the fact that, along with the rest of the industry, the company was hit hard by the state takeover of private pension fund assets in 2011, and by the statutory reduction in asset management fees. The **Merkantil Group** produced a HUF 501 million after-tax profit in 2012; the loan portfolio continued to decrease, but

the pace of growth in new loans is showing an improvement.

Given that the macroeconomic environment of the foreign subsidiaries developed more favourably than that of Hungary, and that the Bank Group successfully made inroads into the more profitable retail consumer lending sector in these foreign markets, the annual contribution of the foreign subsidiaries to profit rose from the 2011 figure of 32% to 41%, and its HUF 61 billion volume came close to the pre-crisis peak level (HUF 66 billion).

Within these figures, the performance of the **Russian** subsidiary stands out, as it increased its after-tax profit by 15%, to HUF 47.2 billion. The Russian bank boasts excellent profitability indicators (ROE: 28%, net interest margin: 18%) and high levels of capital, while its market position is stable. These factors all serve as a good foundation for the bank, against the backdrop of tighter national legislation on consumer lending that takes effect in 2013, to continue its successful strategy and make a growing contribution to the Bank Group's overall profit.

The **Bulgarian** subsidiary almost doubled its after-tax profit in 2012 (to HUF 24.2 billion); its cost-efficiency remains excellent, and it maintains a stable position in the most important market segments. The **Ukrainian** subsidiary's HUF 0.5 billion profit which, given the doubling in the cost of risk, was a major achievement. The dynamic growth in consumer lending that began in the second quarter of 2011 continued, as the portfolio grew by 282%; so it appears that we have succeeded in adapting, for the Ukrainian market, the model that has already proved so successful in Russia. These three subsidiary banks represent 29% of the Bank Group's total asset portfolio, and the bulk of the profit generated by the subsidiaries originates from here; so for the OTP Group, the future performance of the Russian, Bulgarian and Ukrainian subsidiary banks is of particular importance.

In addition to the three main international operations, the **Croatian** subsidiary bank also made a substantive contribution to the group's results, with its HUF 3.7 billion after-tax profit. The other foreign subsidiary banks made a loss in 2012: among these, the negative profit of the **Montenegrin** and **Serbian** operations continued to decrease, while the losses of the **Slovak** and **Romanian** subsidiary banks grew, primarily due to the increase in the cost of risk. Our business policy objectives undertaken for 2012 were essentially fulfilled: in the Russian and Ukrainian consumer lending segments, we managed

to maintain a stable rate of credit growth, while in other countries there was a gradual shift of emphasis in retail lending, towards the provision of consumer loans. The dynamic growth in deposits served as the source of funding for the lending activity, and the procurement of funds from the capital market only took place at the Russian subsidiary. Although the original objective at group level had been to maintain the existing operating margin, thanks to the improvements in the Russian and Ukrainian operating margins we succeeded in surpassing it, which made up for the decline in the Hungarian margin. In line with our original expectations, the rate of deterioration in the consolidated loan portfolio eased up, and at the same time we succeeded in substantially improving – by more than 3 percentage points – the coverage of problem loans.

As we have seen in previous years, the movements in OTP's share price closely followed the development of the Hungarian risk (CDS) premium and the forint/euro exchange rate. The market price ended the year 2012 at HUF 4,150, which represents a 29% improvement year on year. In the first two months of 2013, the price rose. I believe that if, besides our stable fundamentals, the markets take more notice of our diversified operation and income-generating capacity, and if this is accompanied by a more predictable Hungarian operating environment, the market price and liquidity of OTP's stock could improve further.

As Hungary's market-leading financial institution, we are committed to providing our domestic retail, corporate and municipality customers with a high standard of service. We actively participate in every initiative to assist those of our customers who have run into difficulties due to the crisis: our branch network is making concerted efforts to contact the highest possible number of customers with home or mortgage loans that are in arrears or at risk, and who may be in need of the scheme, to inform them about the opportunity to fix their repayment instalments for a period of five years; and we are also playing an active part in the disbursement of the supported home loans that have been available since August 2012. As the biggest lender to municipalities, we are engaged in continuous negotiations regarding the technical implementation of the partial takeover of our customers' debts by the state. We believe that the government and the Banking Association will succeed in reaching an agreement that could, by linking a reduction in the extent of the bank tax to the

rate of increase in lending activity, make a substantive contribution to sustained and well-founded economic growth.

The challenges of recent years have constantly motivated the Bank's management, while retaining the key values espoused to date, to seek opportunities to ensure that company's operation is stable and predictable, as well as efficient and profitable, even in comparison with our regional competitors. No acquisitions have been made in the past few years, but the search for acquisition targets that would increase shareholder value and fit in with our business strategy continues; in the meantime, the Bank's capital strength complies with the strictest regulatory requirements, including those that will be introduced in the near future. We believe that our Core Tier1 ratio of around 15% warrants the payment of an increasing dividend: in 2010 we paid out HUF 20 billion, in 2011 we out paid HUF 28 billion, and in respect of the 2012 financial year we intend to pay out dividends that exceed this by more than 20%. With the exception of a few banks in developing countries, financial institutions are not necessarily favoured by investors at the moment, and in many countries there is a general feeling that the sector is responsible for the crisis that has been under way since 2008. But allow me to strike a note of optimism: economic growth is inconceivable without the active participation of the financial intermediation sector, naturally within the framework of clearly defined roles and responsibilities. And lasting trust is primarily what guarantees our ability to successfully perform our work.

Looking back at the Bank Group's performance during the crisis, I am proud to say that thanks to the persistent work of our colleagues, we await the challenges that lie ahead of us armed with stable fundamentals. With respect to 2013, for me the greatest achievement would be if our exchange rate-adjusted consolidated loan portfolio were to grow again, and OTP Bank could claim the largest share of the improvement in lending activity. I would ask for your continued support and confidence in the fulfilment of the objectives we have set ourselves.



**Dr. Sándor Csányi**

Chairman & CEO

# Macroeconomic and financial environment in 2012

## MACROECONOMIC AND FINANCIAL TRENDS IN HUNGARY

In 2012, in addition to the debt crises of the countries on the periphery of the eurozone, the economic trends were also determined by the liquidity boosting measures implemented by the major central banks in the interest of averting an economic downturn. Due to the massive excess of liquidity, the quantity of capital flowing into the region rose steeply, but even this was insufficient to shore up the trends in the real economy. The slowing of activity in the developed markets had a negative impact on the performance of export-driven economies, and in all the region's countries growth slowed in comparison to 2011.

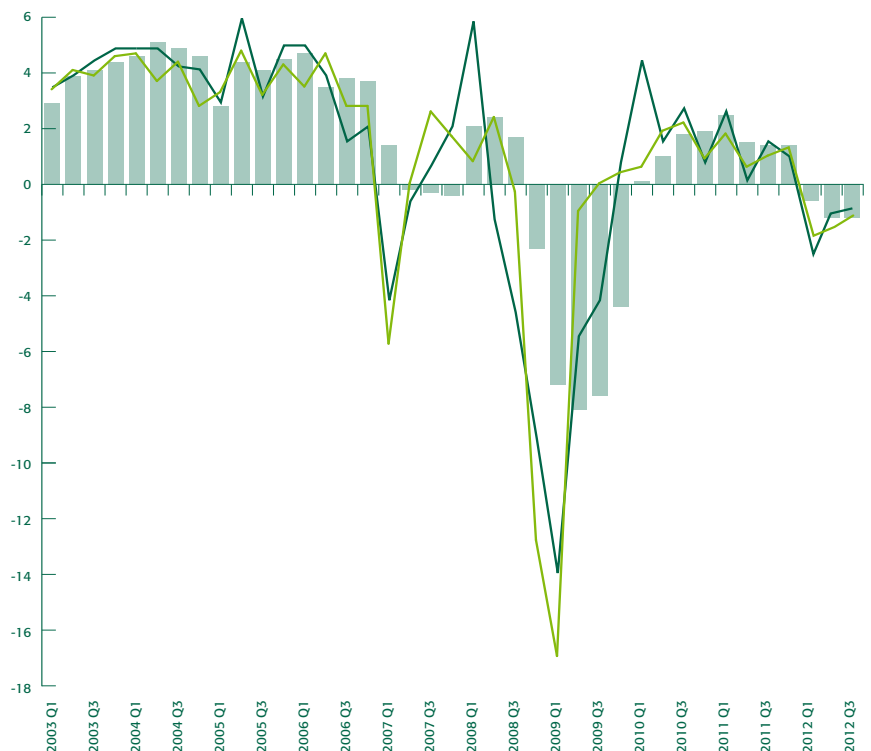
In 2012 the Hungarian economy shrank by around 1.7%; and on the consumption side

net exports were the only item that was able to mitigate the downturn. Although the rate of export growth decreased from 8.4% in 2011 to 2.2%, this was accompanied by a fall in the rate of expansion in imports, to 0.1% (from 6.3%). All the other items contributed negatively to the development of real GDP; household consumption fell by 2.3%, while community consumption decreased by 1.5%. Investments slumped by 4.9%.

Following the budgetary loosening of 2011, which was offset by the takeover of private pension fund assets, since spring 2011 the government has announced numerous budgetary adjustments (the Széll Kálmán Plan in spring

### Changes in real GDP

- Annual growth of GDP
- Quaterly growth of GDP – annualized (HCSO)
- Quaterly growth of GDP – annualized (OTP)





2011, the 2011 and 2012 convergence programs, the tax increases of autumn 2011), which together amounted to over 6% of GDP. There is a good chance that the target deficit, approximating to 2.7% of GDP, was met in 2012. The absence of an upturn in the growth figures led to more adjustments in autumn 2012; and if these are fully implemented the 3% target deficit will be achievable in 2013 too, although the risks are substantial.

In 2012 the income position of households deteriorated. Although the number of employed grew by 1.3% in comparison to 2011, the unemployment rate rose by 0.5% to 11.2% (due to an increase in the overall number of the economically active). The disposable income of households increased by 2.5%, but with inflation at 5.7% this translated into a 3.0% decrease in real terms.

Annual average inflation accelerated to 5.7% in 2011, from 3.9%; in other words, despite the persistently weak domestic demand, inflation remained well above the central bank's target again last year. A factor contributing to this may have been the cycle of interest rate cuts that started in August, during which the central bank reduced the base rate in 5 stages, by 25 basis points at a time, to 5.75% by the end of the year. The improvement in global sentiment, which was partly due to the liquidity expansion ensured by the major central banks, also gave a boost to the forint's exchange rate with the euro, which went from HUF 320 at the beginning of the year to dip below HUF 280 mid-year, before closing the 12-month period at around HUF 290.

Bank activity weakened further in 2012, in terms of both corporate and retail lending. The special tax on banks and the losses resulting from the



redemption of foreign currency loans continue to represent a considerable burden for the sector. In addition to the problems on the supply side, however, demand was also lacklustre owing to the restrained corporate and household investment activity.

### **Macroeconomic and financial trends in the countries of OTP Bank's foreign subsidiaries**

As a consequence of the slowing of activity in developed markets, with the exception of Russia, in every country where OTP has a subsidiary the rate of export growth dropped off significantly, and the rate of expansion in household consumption also decreased

– indeed, in half of the countries it was negative. Due to the above factors, every country where OTP has a subsidiary saw a slowing of the economy, and in Hungary, Croatia and Serbia the volume of GDP actually decreased. In several countries, high budget deficits represent a problem; however, steps have been taken everywhere to rein in these deficits.

In terms of the banking markets, there is considerable variation between the countries of the region. While in Russia and Serbia both the retail and corporate loan portfolios grew, in the case of Croatia and Montenegro net lending was negative in both sectors. In the other countries, net lending to the corporate sector was positive, while the retail sector repaid more credit than it took out.



## Bank sector retail loans as a percentage of GDP

