Strategy and Finance Division
Investor Relations & DCM

OTP BANK
3Q 2019 Conference call
Transcript

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Operator

Dear ladies and gentlemen, welcome to the OTP Bank Q3 2019 conference call. At our customer's request, this conference will be recorded. As a reminder, all participants will be in a listen only mode. After the presentation there will be an opportunity to ask questions. If any participant has difficulty hearing the conference, please press star key followed by zero on your telephone for operator assistance. May I now hand you over to László Bencsik, Chief Financial and Strategic Officer who will lead you through this conference. Please go ahead.

László Bencsik

Thank you very much. Good morning or good afternoon, depending where you are. I welcome you to OTP Bank's 2019 third quarter interim report conference call. I suggest we follow the usual procedures, so you have the presentation available on the website. I hope you had a chance to download it. I try to briefly go through this presentation and then obviously open up the floor for your questions.

Starting on page 2, after a relatively good second quarter this year, I think we had another decent quarter in the third quarter. The adjusted profit was HUF 110.5 billion and that basically added up to HUF 313.1 billion adjusted profits after tax for the first nine months. The quarterly accounting profit was somewhat higher than the adjusted one, and this is obviously related to acquisitions and mergers, and there will be a slide about this.

All in all, in the first nine months we have been growing at 19% in terms of profits and this growth has come from two sources. One, the new acquisitions have already started to contribute positively to earnings. The second one is that the organic nature of the business without new acquisitions also yields earnings growth. So, out of this 19% growth, basically 12% was organic and the rest was the positive effect of the new acquisitions which we did this year, it was primarily the bank which we acquired back in January in Bulgaria, because the other three were rather small and the next big one which came at the end of September, the Serbian one, was only included in terms of its balance sheet. The P&L was not yet included, that is going to come in the last quarter of this year. So, hopefully there will be a boost to our earnings in the fourth quarter coming from the positive contribution of the earnings of the recently acquired Serbian bank.

On page 3, you see the one-offs and I think it's important to talk about the third quarter. You see here this relatively big number: HUF 21.4 billion, the total effect of acquisitions. In this quarter, it is a combination of different factors. Basically, we had badwill in the three acquired companies where we closed the transactions in the third quarter, namely in the Montenegrin, the Moldavian and the Serbian banks. So, these were positive contributors, and on the negative side we had the usual expenses and costs of the mergers and acquisitions, which we continue to do. What you see here is basically the net amount to all of these. It doesn't mean that one of the transactions had exactly this badwill impact, it is basically a compounded number.

On page 4 you see the overall kind of adjusted profit after tax breakdown by entities and this is the first nine months year on year performance. As you can see, most of the growth actually came from outside Hungary. The OTP Core, the Hungarian banking core operation grew 4%. Leasing grew 2% and then actually the Asset Management business was somewhat negative: this is due to the fact that this new retail government bond was introduced by the Government Debt Management Agency. It is so attractive that it crowded out quite a lot of other types of investments, including our funds and therefore assets under management decreased somewhat. If you look at the foreign businesses in our Group, some of them actually achieved remarkable year-on-year growth. In some cases this was obviously attributable to acquisitions, like in Bulgaria, 4%, but also organically Russia, Croatia and Ukraine remained quite strong, and also in Romania and Serbia we made quite a large improvement. Part of it, especially in Ukraine, came obviously from the strengthening of the currency - the Hryvna versus the Hungarian Forint. For instance, the 40% growth in Ukraine was partially due to this FX change. But even 26% in itself was quite strong. In Russia in local currency there was 14% growth. In Croatia without the leasing company's inclusion impact 20% growth year on year, that's obviously mostly due to the fact that we started to realize in a big way cost synergies after the merger which was completed, and this is the first kind of full year after the merger. Romania does also remarkably well organically: you can see growth here, and you will see also in the volume numbers. We have a new management team actually from the beginning of the year, and they managed to reignite growth there, and reinvigorate the organization. They are doing very good headway.

All in all, all markets seem to be doing reasonably well. This is, by the way, not surprising, as we are operating in a very supportive economic environment, I would say, in all of the markets we are present; that means that we have decent loan demand growth and we have quite muted levels of risk cost. The only kind of headwind we have is that in most of these cases we have margin pressure, as you will see in further slides.

Going to another perspective on our earnings, this is the P&L perspective of the group results. I think this is the grey header columns are the most interesting, the without acquisition numbers which are obviously the ones that are directly comparable to last year figures. When we talk about quarter on quarter developments further details we even included an FX adjusted column because primarily the Hryvna and the Ruble moved a lot against our reporting currency which is the Hungarian Forint.

The good news is that without acquisitions, organically, our operating profits grew 16% year on year if you compare the first nine months; even on a quarterly basis we had 7% growth. I think this shows a relatively strong dynamics in the earnings improvement.

A few words about the three banks which we consolidated and where we closed the transactions and possess the asset. The biggest one at the end of September was the Serbian bank of SocGen. That's, as you can see on this slide, a sizable bank and has a meaningful visible material contribution. First to our balance sheet basically, because the transaction was closed very close to the end of September. So, the P&L was not consolidated, only the balance sheet and the balance sheet was consolidated at the end of the third quarter only. That obviously introduced some noise into the net interest margin number, as you will see later on.

But most importantly, with this acquisition, the *pro forma* combined entity - we have two entities in Serbia - would be number two in terms of market share, which is already a strong position and provides us the scale required in order to achieve the earnings and the return targets, which we typically have for the Group. We're very happy that this transaction was closed, and now we are preparing to start our second merge process. It was not very long ago that we finished the previous one, you might remember the previous merger in Serbia back in the second quarter of this year, and we are about to start a new process. As we are getting exceedingly efficient at merging entities, we think that this is going to work at least as smoothly as the previous one.

There's another market where we boosted our presence and this is Montenegro, where we already were number one before the acquisition, now we acquired the No. 4 bank and the combined entity together will have pro-forma market share close to 30%. This is a meaningful position and I think if we are present in a small country, then this is the type of presence which can actually make sense, because if you are so much the market's leader, even in a small country, you can generate earnings which are sufficiently high. Obviously we have a long road ahead, we have to combine those two entities, as well. The fact that they are two smaller entities doesn't mean that it is so much easier to merge them efficiently, because pretty much the IT developments and the IT technicalities of the merger are almost the same regardless of the size of the two banks that are merged.

On page 8 we show the numbers for our new acquisition in Moldova. I think it's not tremendously obvious why we have this bank in a small market, being number four. But again, this was part of this overall consideration of SocGen assets in the region. We believe that overall, considering the entire transactions, or the number of transactions we have taken, it actually fits very well. It's a bank which actually makes money and makes a decent return. I mean, certainly in a small market like this, having 13.2% market share and being number four is not exactly the right strategic positioning for us. Firstly, we have to start learning the markets and adapting the bank to our Group standards and incorporating it into our Group processes, but we keep our eyes open in case we find the environment attractive for potentially even increasing in the future our presence there.

The next section is a cross section about volume growth in loans and deposits. We have slides about quarterly, year on year and first nine months growth rates. This is the part which maybe we seem to do actually better than we originally expected. I'm obviously talking about organic growth, putting aside acquisitions. So, just in the third quarter, we grew 4% quarter on quarter, and as you can see on page 10 the year to date growth for the whole Group was 10%, and year on year 14%. So, the speed which we are growing at is 14%.

In the first nine months we already grew as much as we indicated at the beginning of the year as our potential growth for the entire year. It's not surprising that we actually corrected somewhat upward the guidance we made at the beginning of the year and it's pretty obvious that we are going to grow more than 10%. It's not just going to be a little bit more, but materially more given that in the third quarter we were growing 4%.

Let's have a deeper look into the third quarter growth, this 4% FX-adjusted performing loan growth for Stage 1+2 loans, which is new definition under IFRS 9. Hungary, as you can see, was extremely strong, only in one quarter it grew 8%. If you look at these numbers here, especially the consumer book was very strong. There will be a separate slide on this, but there's a new phenomenon in Hungary and that is the subsidized scheme: it's a subsidy which the banking sector passes through to retail clients. And this is the baby shower subsidized loan structure. I'm going to somewhat explain it in more detail, but actually we put on the website a long time ago a description of this structure, and this is not something the banks invented. This is a regulated product; actually it’s not 100% regulated because the banks can differentiate in the pricing, but the structure itself is, and there's a cap on the pricing and the whole structure is actually regulated. The regulation is also available for you, if you want to understand it more deeply.

This is a volume which is already big and is going to continue to grow. Just an indication, we actually grew 43% on a quarterly basis in consumer loans in Hungary. Out of this only 6% growth was attributable to our normal cash loan, but a good thing is that this is quite good number because it means that despite this very strong and attractive product for customers, our core product, our own cash loan product also continued to grow. So, the cannibalization of the demands for consumer loans did not really happen.

If you look into housing loans, we had 3% growth on a quarterly basis, which actually means some acceleration. During this period we had a somewhat higher demand. Corporate remained strong, +4%. Across the board this suggests a strong demand and lending activity in Hungary. If you look at other markets they are also promising: Bulgaria 2% quarterly, Russia 2%. Obviously, Russia is seasonal, so the third quarter, typically if you look back the last 10, 15 years, typically the third quarter was when we start to grow somewhat, and the fourth quarter has always had the highest growth. So we could expect some positive seasonality in the last quarter coming regarding our Russian consumer loan volumes.

And then the other markets: Ukraine, very strong FX adjusted 7%, Romania 7%. I think this is a very important number. You may remember that we had a failed acquisition attempt, to put it that way, last year in Romania and then afterwards we decided to refocus our efforts on organic growth again, and renew part of the management team, define a new strategy, start new projects and actually quite early we started to see results of these effort and our volume growth accelerated substantially in Romania. Serbia even organically did quite well in the third quarter and the rest of the markets were rather muted. So, that's about the overall loan growth across the group.

A few words about deposits. Obviously, deposit growth is much less strategic and drives less the earnings, but nevertheless it is a very important indicator for our ability to attract clients and to retain the client base we have.

One very interesting number, I think, on this page is the Hungarian retail deposit growth in the third quarter, it was positive 2%. Just let me remind you that in the second quarter, the Government Debt Management Agency introduced a new structure, a very attractive retail bond structure, where the yield, if it is hold for five years, then the yield gets close to 5% tax free. This is a product which is very attractive for retail customers and it’s hard to compete with. In this environment where these retail bonds were growing extremely fast, our retail deposits continued to grow, despite the fact that we really don't pay much interest on these deposits. And that for us shows that from a transactional point of view, it provides attractive value proposition to our clients and they keep coming to us and coming to bank with us. You can see the more detailed figures on the year to date and year on year growth rates as well.

We have four slides about the NIM (net interest margin) story. This is clearly an area where, compared to our original expectations what we had at the end of last year when we made the budget for this year, and even at the beginning of the year, it had to be changed. That is because the rate environment turned out to be very different from what we originally expected.

We originally expected an increasing reference rate environment and more or less stable but somewhat increasing longer end of the yield curve, as well. Now as opposed to these original expectations, in fact the short end did not move so much. It is very close to the point where we started the year, i.e. around 20 basis points. That's the three months interbank rate in Hungary. And this is the reference rate for our variable loan book typically, and the long end of the yield curve has collapsed pretty much. That has had an impact on our margins. The first time it became visible clearly was the third quarter. The overall Group net interest margin declined to 399 bps. I'm going to explain in detail the different kind of levers which affected this and if you take out the effect of all the acquisitions which we did this year, then the 9M NIM was 4.17%, so even that is lower.

Now I have the slide here on page 15 just to put the whole story into perspective. Because what happens is that a margin decline in itself doesn't mean that profits go down or interest income goes down or the ROE goes down. In fact, on page 15, you see the net interest margin for the last 7 quarters and it has the trend, it has decreased for the overall group very clearly partially due to acquisitions, but it decreased even without acquisitions. And during this time, we maintained around or slightly above 20% return on equity including acquisitions, and the adjusted profits even without acquisitions kept growing and net interest income kept growing, too. So the only other thing I wanted to suggest here that when we are growing so fast and when there are acquisitions, margins are important but they have to be taken into consideration as a whole. The focus probably should be more on net interest income dynamics than on the margin itself.

On page 16 we tried to explain more or less why this decline happened from the second to the third quarter. It starts at the top with the reported number for the second quarter. You see applied adjustments what we have for the two acquisitions. Then we get to the 433 number, which was the number we said was representing the without acquisitions margin.

Compared to those, we have certain elements which we highlighted on this page which had sizable individual impact on the margin. The first two, which are actually long term and obviously will stay with us and are not going to turn around or recover. We had maturing bonds in the first half of the year, but especially in the second quarter, and the reinvestment yield of these bonds was lower. That is the direct effect of the decline of the long end of the yield curve we had experienced during this year. And the other one, which is obviously a well-known fact, that in early July we issued a Tier2 bond and from now on we have to pay the coupons and therefore we have an increased interest expense. To tell you the truth, we find very little meaningful yielding euro investments where we could put this this euro liquidity.

Then we have two more lines here, which have a strong impact even on a consolidated base. Both of them come from the Hungarian Core: one we had in the third quarter is the repo. This might be strange to hear given the level of liquidity that we have. But this was the most efficient way to provide short term liquidity, as it was actually cheaper than swapping from euro back to HUF. Therefore, we started to repo that increased the balance sheet. But all in all the NII impact was marginally positive because this was the most efficient way to provide liquidity for the volume growth what we had. So, this is going to continue for a while and then probably will turn around and go back to zero in the subsequent quarters, as some of the liquidity gets freed up from existing government bonds. Nevertheless, this is an item which decreases the margin, but which doesn't have a negative impact in itself on the NII.

Then we had another line which happened in OTP Core. This is basically a booking which happened in the second quarter and we had to change the booking between NII and other income. We had basically a correction or a reclassification. But it doesn't have any impact on the profits, neither in the second nor in the third quarter; it is just a reclassification between NII and other income. Nevertheless, it did have an impact on the NII and therefore on the margin in the third quarter. This is not going to be repeated in the fourth quarter, so that it is not something that's going to stay with us. And then all of the other effects had basically a positive two basis points number in the third quarter.

Then we end up having this 4.17% without acquisitions margin. And then the 'with acquisitions margin' was 18 basis points less. Basically, the difference between the second and third quarter adjustments due to effect of acquisitions was mostly that the Serbian bank came at the end of the third quarter and it was only included in the balance sheet and not in the earnings. Therefore they obviously had a very strong negative impact on the net interest margin because the denominator was increased, but the numerator was not increased, due to the fact that we did not recognize in the third quarter any earnings related to the new acquisition in Serbia. We are going to do this, by the way, in the fourth quarter. So that's obviously a technical element.

And then page 17 shows the same story from the perspective of OTP Core, the Hungarian entity, and some of these events, which I described in the previous page, appeared within the Hungarian Core. Namely the first one is the reinvestment yield, the lower investment yield. And the second one is the repo. And then there's this reclassification between NII and other income, that's the third one.

There was another technical item which does not have, in fact, material impact on the overall consolidated numbers: it is basically an intragroup swap deal between our Bulgarian bank and Hungarian bank, because part of the excess liquidity at the Bulgarian bank is actually invested and kept in Hungary. The way we move it to Hungary is basically a combination of an FX swap and a repo deal. We have to value the swap and mark it to market in the two different entities. Therefore, it has an impact again on NII and other income in both entities. If you take these two lines in each of these two entities, so altogether the four numbers, then they the more or less cancel each other out. That's not exactly 100% because there's a timing effect as well, so they cancel out for the full duration of these swaps, which is two years. But even in this quarter, the overall impact was more or less close to zero. By the way, I hope we can improve on presenting this because it doesn't make a lot of sense to talk about this noise. Probably for the next quarter, we are going to net them out and still keep showing you the impact, but only in the adjustments, what to make in the original financial statements and hopefully it won't show up in these overall numbers.

So, the remaining is actually positive. There's this green eight basis points, which is all the rest. That is the impact coming primarily from increased lending activity and increasing loan portfolios, which do have a positive contribution to margins. So in a sense, if you take out the technicalities from the Hungarian Core, from the Core margin, namely points two, three and four, namely the repo, these reclassifications and the intragroup swaps, then we have minus seven basis points negative coming from the lower reinvestment yield of our bonds. And plus eight basis points came from all the other effects. These two could have actually balanced each other if we had not had these other rather technical items.

The remaining part of the group - Bulgaria increased somewhat and improved. But here again, there is this noise because of this intergroup swap. Actually we terminated one swap and therefore we had to realize the full results. It improved the NIM line in Bulgaria by three basis points. So you see an increase here, but actually it has decreased the second quarter, so if you take this out, then in fact, Bulgaria was rather stable and flat, and what you see here is an increase which is just basically due to this this impact.

Russia continued to decline, Croatia came slightly lower, Ukraine somewhat lower and Romania started to increase. This is due to the change in the rate environment and also due to the various strong business activity I showed you on a previous page. All in all, what we see is that in Bulgaria and Romania, NIM is stable or slightly positive in case of Romania, but Russia and Ukraine are still on the negative slope in terms of NIM development. I know this is a complex topic and maybe it's too technical, but I'm still confident that you will have very detailed questions regarding the NIM, therefore we thought that we would try to explain it as much as possible and be as transparent as possible related to the NIM changes.

Moving away from the NIM story to the risk parameters, they seem to be in line with our previous expectations. The third quarter is constrained by somewhat higher risk costs than the second quarter, but we are still in line with our yearly expectations. As you can see the Stage 3 ratio continued to decline and also the 90 days past due ratio continued to decline. The latter was 5%, and also the stage 3 ratio declined substantially to 6.9% and especially if you compare this number to the level when we introduced this new metrics with the introduction of IFRS 9 in the first quarter of 2018, I think it's quite remarkable how much we improved on the NPL ratio measured in terms of the Stage 3 ratio. The coverage pretty much stayed the same.

Costs, again, this is an area where we adjusted the guidance and here the adjustment was upwards. So, compared to the original expectation of 4%, now we are actually guiding for around 6% growth and that is after the first nine months we had year on year, 6.8%. Having said that, this is already better than what we had last year. Last year it was actually 8%. And what I'm talking about here is always obviously without acquisitions and FX adjusted numbers. Now, again, I'm trying to put this number into perspective. Cost growth, in itself, is just one line. But if we look at the efficiency developments of the group over a longer period of time, on page 20, we put basically since 2007 the cost to assets ratio, as you can see, it has improved, and we are at the lowest ever level with 3.3% cost to average assets. If you compare it to 2010, the after the crisis year, then actually there was a 10% improvement. Now, despite this, we see a different development in the cost to income ratio, which worsened by 15%. We are after the first nine months at 52% level. This is due to the fact that our revenue margins substantially decreased: in this nine-year period there was a 22% decrease in total revenue margin.

The driver behind this somewhat higher cost to income ratio than what we used to have is not that our cost to assets, and therefore the primarily efficiency ratio got worse; it is because our income margin declined. That's obviously not an excuse for having a higher cost to income. We are working hard making it lower. I think there is some potentially good news here that first of all, last year it was 56%. Now for the first 9 months it was down to 52%. By the way, the first nine months last year was rather 54%, but the last quarter was seasonally high. Nevertheless, no matter to what we compare it, we actually managed to improve this ratio reasonably and materially compared to last year. In fact, in the third quarter itself, we had lower than 50% cost-to-income, it was 49.8%.

This was the cross section part. Then we have three slides on the Hungarian Core, some more details about our retail and corporate business lines performances in Hungary. Page 21, you see some key metrics about our market position in Hungary regarding our retail customers. Our market share from new mortgage production continued to increase during the course of this year: in the first nine months it was actually higher than 30%. Newly disbursed cash loans were close to 40%, it’s 39.1%. We kept basically at the same level our market share from household savings. This picture we like, we believe this is probably the most important indicator, how the market shares develop. I think these are quite convincing numbers and levels in Hungary and show the strengths of the brand franchise and the level of innovation and service quality we are providing to our customers.

Page 22, there is this new loan, call it baby shower loans. It is not actually the literal translation, but the Hungarian name means something like that. It is primarily a subsidized scheme which is intended to boost demographics as well as general economic activity and consumption. And the way it is structured, it is basically a loan distributed by the banks. The volumes you see here are quite substantial, just in one quarter we contracted HUF 124 billion of this new loan, and the whole market was HUF 277 billion, so we had somewhat less than 45% market share. In the bottom part, I am not going to read it, but you have more or less the outlines of this structure here. This is State guaranteed and the interest income that we receive is coming from the State, and the customer pays a guarantee fee which we transfer to the State.

This is going to last, it was not just one quarter. This is going to continue to grow and we see continuously high demand for it, which is not surprising. Technically it can be still distributed for 3.5 years, so that is the technical expiration of the structure. Obviously only eligible clients can apply for this. We expect the demand to be very much front-loaded because those who want to take it and who qualify for the conditions, actually it makes a lot of sense for them to take on this structure. This is going to continue to boost the volumes in Hungary.

Page 23, the usual numbers about corporate activities in Hungary. The good news is that our market share remained stable in Hungarian corporate loans year on year, and the overall market growth slowed down somewhat compared to last year, but it was still quite decent and pretty much in line with our expectations. And especially the good news is that in segment terms, the growth is stronger in micro and small companies than in the overall corporate loan market which means that a higher margin part constituent of this growth is growing faster.

Finally this is our formal update on the original guidance we made at the time when we presented the annual results and then at the AGM by our Chairman. It is not a full revision, we only put on this page the lines where we do see changes and where we believe that it is mature enough and important enough to let you know. First of all, there is more clarity on the expected level of Romanian bank tax, that was not pretty clear at the end of last year and beginning of the year, but now we expect to pay around HUF 700 million equivalent in the fourth quarter and it is lower than the theoretical maximum because we are growing fast, but also the margin increased, so in order for this to be zero we should grow fast and our margins should decrease, which they don't. Therefore we actually have to pay this expected amount.

Then I think the most important one which is very obvious and very visible is the loan growth, and it is quite clear by now that the loan growth dynamics is going to be more than around 10%.

The other one is the margin. The original guidance was that in this year without acquisitions the margin may not fall below 4.25%. Now depending on how you look at it and how you interpreted the original guidance, if we interpret it as a quarterly number, then it actually did fall below 4.25%, it was already 4.17% without acquisitions in the third quarter. To our best understanding we expect a similar number in the fourth quarter. I think if you follow the description of the reasons behind the decline in the third quarter you understand that there are some technical items here as well, which actually introduce noise in the third quarter and may continue to introduce noise. But I can promise that we will try to reduce the technical noise at least in the numbers in order not to create more confusion than what is meaningful in order to understand what is going on. Our best estimate for the fourth quarter is that it is going to be somewhere around the third quarter number. If that happened then the annual number would be actually quite close to this 4.25%, but nevertheless the second half would be lower.

The other line where it became quite clear that the original guidance was not going to come through - the cost growth. The original guidance was around 4%, and this is what we targeted. By the end of the third quarter the year on year FX adjusted without acquisition cost growth was 6.5%. We continue to try hard and our best estimate is that it is going to further slow down by year-end and annually we may see around 6% annual growth. Having said that, I think the good news is that the cost to income ratio, if you compare the first nine months of this year to last year, actually improved more than 2%p in one year.

And the dividend, I am sure you will have terrifying questions on this one as well. I have to somewhat disappoint you, we are still not at the stage where we feel that we give you the final updates on our dividends, so the numbers you see in our detailed financials, which are also available on the website in an excel format, that is just a technical number which is based on the commission regulation, this number you see here on the slide. We follow the original guidance what we had at the beginning of the year on the AGM that the final proposal on dividends will be made in the first quarter next year once we know the annual numbers. In this sense this has not changed, but I just wanted to reiterate that in case you have questions like this.

And then in the rest of the pack, you have further details on cross sections related to the P&L lines. I hope that there are some useful information there. We also tried to present you the adjusted numbers, with FX changes and without acquisitions and so on. If you want to have better understanding of comparable numbers year on year, I hope you find them helpful. And then, also there are some usual slides included regarding our risk profile, but I am not going to present them now.

This was the intended overall presentation for today, and now I would very much like to welcome you to ask your questions. Please, operator, open the floor for questions.

Operator

Thank you, ladies and gentlemen, we will now begin our question and answer session.
The first question we received is from Anna Marshall from Goldman Sachs. Your line is now open, madam. Please go ahead.

Anna Marshall (Goldman Sachs)

Good afternoon. Thank you for the presentation. Two questions, please. The first one is predictably on the margins. Specifically, what is your outlook in terms of dynamics into 2020, in particular with regards to impacts or further impacts from a bond yield compression and rate environment across the group, what are your expectations there, as well as an MREL issuance. Could there be some sort of offsetting positive impacts, for example, further shift in business mix on the lending side, any benefits from integration of acquisitions, for example, on the funding side, or repricing of assets or liabilities? So that was the questions on margin and the other question is on the costs, please. So you've mentioned the improvement in your cost to assets ratio and cost to income. Do you have any targets for either of those ratios in the medium term and do you expect them to continue improving? Thank you.

László Bencsik

Thank you for your questions. I think these are very valid questions. Again, we are not prepared to make guidance for next year. One reason is that we are just in the middle of doing the detailed budgeting and planning for next year, so we don't have approved plan yet. As usual we are going to do that when we present the annual figures, so that kind of detailed guidance you can expect us to make, when we present the full year numbers in March. Nevertheless, I think your questions imply the answers, so to say. I think for both questions it is yes. The margin development due to the rate environment, especially in Hungary, is certainly worse from our perspective than we originally expected and therefore there will be a continuous pressure on this line, on the reinvestment yield of the bond portfolio, and indeed, due to regulatory requirements we have to issue new bonds, which will be MREL compliant. You just pointed out the potential factors which could, possibly or entirely, counterbalance these, and that is volume dynamics and that is new sales, which is, on the other hand, in a lower rate environment, we actually have higher demand, it seems. And then we have these structures which were introduced, for instance, in Hungary with this subsidized product. And just to go back to slide 17, I tried to explain the third quarter events in the context of our Hungarian Core business, and if we exclude the technical lines, the technicalities, the reclassification of hedging and intra-group transaction, then in this quarter specifically, the negative impact of the reinvestment yield was counterbalanced by all other factors, which is obviously a large combination of different business events which happened typically on the front of lending. If you consider MREL, then actually the rate environment changes concerning our future expected cost of these MREL eligible instruments is actually lower because the whole spread and yield environment keeps declining and therefore the expected interest expense on these is going to be less and less. This is a marginally positive news.

I'm sorry to disappoint, but I'm not going to tell you exact numbers. This is going to come during the next conference call when we talk about year-end numbers. I think what is really clear, that especially in Hungary, we continue to move against a headwind coming from the rate environment and hopefully part of it is for sure, but which part that is the big question mark, can be counterbalanced and mitigated by certain positive volume dynamics we see on the lending side. And then we have Russia and Ukraine: in Russia the recent inflation number was somewhat lower, so we expect a declining rate environment there as well, plus, we have this regulatory pressure which continues to damp down our margins. So, in Russia, this is going to continue. In Ukraine, what we see is that the environment started to consolidate, which means that margins will probably somewhat decline on the product level for sure, but then on the other hand, we expect quite robust loan demand. So, loan growth can be actually quite impressive, and this is our highest probability scenario for Ukraine for next year. Obviously, the Ukrainian situation has always been volatile, so relatively extreme scenarios are possible with relative high probabilities. But again, the highest probability scenario which we have is that the Ukrainian growth next year is going to be very strong on the product level, there will be moderation of margins, but the combined effect can be close to stable. And then the only country where we do actually see margin increase, in the third quarter, it was Romania.

I know this is not an exact answer to what you asked, but these are roughly the avenues we have when we think about this.

Costs, clearly the target is to reduce the cost to asset and then cost to income ratios. We have not decided yet to publicly set a target for the future. We may at some point, but it's clear that the intention is to improve on those metrics, and I think here the environment is more supportive or in a sense, in another sense it's not. I mean, the supporting factors are that we do acquisitions in countries where we are present, so we expect cost synergies there and as you can see, for instance, in case of Croatia, that we actually seem to be able to realize some of these. The other thing is that volume growth is actually quite robust and strong, this obviously helps these ratios. The problem is that when we have high loan demand, that high loan demand comes mainly from increasing disposable income for our retail customers and it comes from higher wages, so we do continue to have a high wage inflation environment, which poses a big challenge and we are quite ambitious in our targets and we believe that we have performed well and we want to continue to perform well, and for that you need very good people and for very good people in this part of the world, and every part of the world, but specifically because of the very tight labor markets, we have to pay at least according to the market. So, that is challenging and I don't think we are going to see similar levels of real wage growth as we have seen in the previous years, but nevertheless, is going to be still quite high and positive.

Those are basically the three factors, and the fourth factor is, obviously, if you continue to invest a lot of money into IT and the way we do it is hiring more people into IT and try to do more in-house as opposed to just increasing CAPEX, therefore, it has a bigger negative short term impact on OPEX. But yes, definitely here, the goal is to continue to improve on those ratios.

Anna Marshall (Goldman Sachs)

Very clear, thank you.

Operator

The next question received is from Gábor Kemény, from Autonomous Research. Your line is now open, sir

Gábor Kemény (Autonomous Research)

Hello. I would like to follow up on the NII point please. I see your point that NII is more important at this stage of the growth than the net interest margins, and in Hungary, your NII was trending upwards in the previous quarters, but there was a drop in the third quarter, though, and you are flagging a few one-offs here. How would you expect your Hungary NII to evolve from these levels?

László Bencsik

In Hungary, indeed, in the third quarter, as you can see in this presentation on page 27, there is almost four billion HUF equivalent negative one-off, I mean, quarter on quarter, if you compare the two quarters, and the overall decline was 2 billion, so the nominal difference between the two quarters was much more than in itself explained by these one-offs, so the underlying NII kept growing, and this is certainly what we expect in the fourth quarter, so in the fourth quarter this should definitely continue. We are not yet prepared to give concrete guidance for next year, but given the volume growth we have and especially given this new structure, which was very recently introduced, in the third quarter, I think chances are somewhat better, despite the negative developments in the rate environment, to continue the trend what we have seen. But it is going to be challenging because the rate environment is not going to change, that is almost sure for next year. So, we will have to be in the same situation.

Gábor Kemény (Autonomous Research)

Understood. And the broader question on the growth outlook and how do you see the slowdown in the eurozone economy impacting your businesses, if at all? So, given the early warning indicators you look at, do you see this impacting either the health of your corporate customers or the growth outlook itself?

László Bencsik

We do not see any visible signs in the quality of the portfolio or in loan demand. If you just look at the loan growth rates we have and the portfolio quality, it is clear. Having said that, if you take the example of Hungary, the expectation for the GDP growth next year is certainly less than our forecast for this year, this year forecast is 4.8%, next year we expect something higher than 3%, around 3.3% growth. So that is a slowdown in GDP growth. It does not necessarily have to translate into slowdown, especially in retail volume growth. Not at all. We believe that consumption and retail investment can continue to be strong. The labor market is extremely tight. From what we have seen so far in the eurozone, we do not think that this is going to fundamentally change the labor market in Hungary and therefore loan demand either. I think specifically in Hungary, we have a very active policy environment, put it this way. So the government, the debt management agency and the central bank have been quite active in coming up with structures and measures which guide and boost growth in consumption and savings. From what we see today, it is not obvious why loan demand should so much slow down. In some cases, again, I started to talk briefly about Ukraine, so in the case of Ukraine we are actually quite bullish. Russia is an interesting environment, which is not as obvious to read because there seem to be increasing leverage in certain customer segments concerning unsecured loans, and that is reminiscent of the situation we saw 5 or 6 years ago. That points to a somewhat lower optimal growth in unsecured lending in Russia, which is obviously our main market. I mean, the growth is artificially subdued in Russia. If there were just a little bit fiscal and monetary easing there, the growth could be so much better. There is a lot of potential we see in Russia. Nevertheless, it can happen that our unsecured consumer lending growth is going to be less next year than what we have seen just because we see this build up in terms of leverage and customer portfolios.

We are quite optimistic about Bulgaria. Bulgaria is still in the early phase of the cycle and somewhat behind in terms of the cycle that Hungary is, so if a slowdown happens, it's going to be much less in terms of GDP growth there than what we expect to see in Hungary. Romania, we have a new government. They just seem to know what they wanted to do and so on and so on, so I think the concerns regarding the Romanian potential growth have somewhat mitigated, so we are warming up to be more optimistic about Romania. Croatia, in terms of growth, has been relatively low so far, I am talking of volume growth, loan volume growth, there is not much to change in the sense. Serbia, for us, is very strong, and then the remaining portfolios are relatively small. All in all, we are, I think, on the more optimistic side of the spectrum concerning next year growth potential, but again, we are in the process of actually deciding and agreeing on the targets and the next year plan. So I am not prepared to share with you the actual numbers, but the overall perspective we have is rather positive, even concerning the back-door pot we have in core Europe.

Gábor Kemény (Autonomous Research)

That is useful color. Thank you.

Operator

The next question received is from Andrzej Nowaczek, from HSBC. Your line is now open, sir. Please go ahead.

Andrzej Nowaczek (HSBC)

Thank you for the presentation. I have a couple of questions. First, I wanted to follow up on the revised cost growth guidance. You showed very good cost control in Q3 and of course, we remember why Q4 of last year was so high. So my question is, should we expect another hiking salaries in Q4 this year?

László Bencsik

There's always some seasonality of costs. Let's put it this way, there hasn't been any concrete decision on that yet, but it is a very fine line we are trying to balance here. The overall wage increases we make is just a small fraction of the wage growth that we see in the market. It's much less than what we see in the financial sector and it is much less than what we see in the overall market, especially if you talk about the network and tellers. We are not just competing with other banks, we're competing with retailers and so on. It is a very fine balance we are trying to navigate here to optimize the personnel expenses on one side, on the other side to try to continue to improve our cost efficiency and then also to be able to retain the best and attract the best talents what we need in order to achieve results. What I can promise is that we do our best and try to be at the same time as efficient as possible in this environment that we have, but also to retain and attract the people we need in order to deliver those results.

Andrzej Nowaczek (HSBC)

Thank you. And on baby loans. It's early days, but do you think the current run rate is sustainable in the coming months? You have mentioned front loading, which to me implies volumes could decline going forward.

László Bencsik

Yes, at some point they will, I don't think that that is going to happen so much in this quarter. So, there is still a strong demand coming. But, eventually, the eligible customer base will get less or disappear. Our best suggestion I can make, is that we pretty much expect to see similar numbers in the fourth quarter.

Andrzej Nowaczek (HSBC)

And how do you explain your high market share, 45 percent?

László Bencsik

In normal cash loans, we have 40 percent market share. This is only slightly higher than that. Usually when we have these type of subsidized products, then we tend to have higher market share just because of our reach. We have a very strong market share in the physical network, and these structures are distributed physically through branches, and this is where we can monetize our higher continuous commitment to having a physical network, right? That's it.

Andrzej Nowaczek (HSBC)

Okay, so market share also looks sustainable. OK. Thank you.

Operator

The next question received is from Robert Brzoza form PKO BP Securities. Your line is now open, please go ahead.

Robert Brzoza (PKO BP Securities)

Hello, everyone. I have a couple of questions. First, what is the reset time for the baby shower loans? You are showing that the reference rate for the pricing of these loans is a five-year yield on government bonds. This has already declined by around one percentage point during the quarter. When should we see the impact of this decline in the average pricing for these loans? So that is the first question. Second question, could you briefly comment on the developments of NPL in Russian business, because there was quite a sizable increase and also comment whether and when we are going to see the impact of the new increased capital requirements on most risky consumer loans there, whether that has already been included in risk weighted assets or what could be the potential impact in the fourth quarter. My third question is about the headcount at OTP Corp. What was behind the recent quarter on quarter increase in the headcount figure? Is it going to be repeated in some of the subsequent quarters? Or was it a one off? Finally, my fourth question is about potential acquisitions across the region: is there any specific country that you might be looking at? Given the situation, for example, which we currently have in Poland, for example? And finally, what is your approximate redemption schedule for the fixed income book portfolio? Roughly what percentage of your bond portfolio will you need to refinance next year? In other words, what would be the potential impact, would it be higher than this year or lower in a lower yield environment? Thank you.

László Bencsik

Wow. Okay.

Robert Brzoza (PKO BP Securities)

Oh, I can repeat this. No problem.

László Bencsik

I'm sure you can. Okay. The baby loan is five years fixed, that was easy questions, so it is fixed for five years. And today the five year yield is around 1 percent. The benchmark is actually five years multiplied by 1.3, so that is considered actually a benchmark, but this was, for a few years, the view of the central bank that this is a substitute for the mortgage bond benchmark, and we consider this together with this 1.3 multiple as a benchmark.

Russian NPLs, indeed, we started to experience worsening of the portfolio quality in Russia back as early as in the second quarter. Therefore we adjusted our scoring and so on, that's what I implied when I said that in Russia, despite the overall economic environment not changing so much, we do see building up of concentrations of risk and higher leverage in certain customer segments, and therefore we will most probably grow somewhat less in Russia next year than we did previously, and this is directly related to the perceived or expected risks of new production. The changes in regulations are building up into the portfolio gradually as new productions come in, but, all in all, we believe that we are quite well capitalized in Russia, so the local equity which we have there seem to be enough for changes.

Headcount in Hungary, in the Core, we are checking that. In general terms, what has happened over the last couple of years, or the last two years in Hungary, the headcount increased quite substantially. We have like 20 percent plus headcount increase in the Hungarian Core, and there are two fundamental sources of this increase. One was related to higher business activity: we are selling much more and therefore we have more people in the network and the type of loans and mortgages and the subsidized structure require more people in the network. The other one is clearly IT; it is IT where we have a growing number of people and then that comes from two sources. One is that, in general, we are hiring much more IT people than we used to have, and the other one is that we are actually buying up independent vendors, providers, smaller developer firms. We are buying them up and insourcing what we do. When we do that, by the way, that is typically positive for overall span because then the CAPEX or OPEX is less and then we typically increase the personnel expenses, but it is typically our personal expenses against CAPEX, and the CAPEX you don't see in the OPEX line. Therefore, we actually started to be more active in booking some of the personnel expenses as CAPEX in IT development, and that started to happen in the third quarter. So it is basically IT, what happened.

Acquisitions, that is quite a broad topic. First of all, we have been quite acquisitive and extremely busy and quite stretched, right, in every sense. This is not exactly a time when we are looking for further, more immediate acquisition opportunities very proactively. Nevertheless, we are opportunistically open. Our clear strategic focus is the countries where we are present. And only opportunistically we would consider other markets should there be a very obviously attractive, lucrative situation, which we could also fit into our broad strategy. We tend not to comment on any specific potential or actual deals. And if you allow me, I will not do that here either. But we are actually very busy and stretched, I mean we bought six banks this year and we still have some mergers to finish. That is one side of the coin, the other side is that the long term, the prime target, the prime focus remains on the countries where we are present.

The bonds which will be redeemed next year, we have somewhat about 100 billion hold to maturity fixed portfolio at a yield of 4.2%, actually it is around 120 - 125 billion which is going to mature next year, plus we have the retail bonds, meaning the bonds which are distributed to retail clients and they gave them back and they will expire during the course of next year. That's a larger volume, it is in the magnitude of, I think, HUF 400 billion. So, roughly, that's it.

Robert Brzoza (PKO BP Securities)

Thank you very much.

Operator

The next question received is from Olga Veselova, Bank of America Merrill Lynch. Your line is now open. Please go ahead.

Olga Veselova (Bank of America Merrill Lynch)

Oh, thank you. I have several questions. Can I just check something on baby shower program? Do you charge 0 percent costs of risk on this loan, thanks to the state guarantees? And if so, does this mean that the product extends the period of normalization of cost of risk for you? And remind us how long this program will operate. So this is my first question. My second question is about the income in OTP Core. I was very pleased to see strong results for the third quarter. How sustainable do you think is the third quarter results in the next quarters? And also, part of this quarter was helped by the distribution of state bonds between households. How long do you expect this impact will last? And last question is about loan growth in the Ukraine: given lower policy rates, low inflation, a reasonably good market, do you see potential for sustainability of these growth rates? Or do you think that the growth rate will slow down, and also what will be normalized cost of risk in the Ukraine, in your view. Thank you so much.

László Bencsik

Okay. So, the baby shower loans in this third quarter we did not provision, we still continue to look into it with our auditors and better try to grasp the nature and potential treatment. But in the third quarter, we did not provision, but we continue to discuss it.

Duration of the program, the application period is open for three and a half years, and the maturity of the product itself is 20 years and the application period is open for three and a half years starting from the end of June.

The income, again in the Core, this is on page 28 of our small presentation. Indeed there was a strong quarter and the fee income was mostly driven by this distribution fee, and that is going to somewhat continue in the fourth quarter. But, overall, we don't expect the same positive dynamics in the fourth quarter. There will be somewhat muted growth as a best forecast we can have. We do not expect this kind of level of growth to be repeated in the fourth quarter compared to the third quarter.

Ukrainian growth. As I said, we tend to be optimistic about the Ukrainian situation and we expect our growth rates to potentially continue into next year. But this is very preliminary. As I have said, we have not yet agreed on the targets for next year. We have been gaining market share, so that means that the market has actually accelerated, that is our view, and in fact, the level of potential new volumes can be quite surprising, because Ukrainian lending has been very low for a long time, for almost 10 years. So we talk about a market which is unlevered, and its consumption starts to grow, and wages start to grow. We can easily get to a situation where we were before 2008 when we had four or five years of exceptionally high-volume growth in terms of new production. There are areas where we see a lot of potential in the Ukrainian markets and we very much hope that a good scenario will materialize. Obviously, this is a country with quite a high level of geopolitical risk and potentially volatile outcomes, so this is this scenario for us is the most probable. There are other scenarios with also material probability which are certainly not as good as this one. Obviously, a lot is going to depend whether the IMF agreement will be approved by the IMF Board and also the policy measures which take place from the new leadership of the country. But our general feeling is actually quite positive. In terms of costs of risk, if we happen to see a similar environment that we saw before 2008, then the cost of risks in Ukraine will be quite low for a number of years, because if disposable income starts growing and leverage starts to increase from a very low level and banks are active in lending, then it can keep risk cost rates quite low for a number of years. That is a good scenario, obviously. But there are the scenarios there.

Olga Veselova (Bank of America Merrill Lynch)

Thank you.

Operator

The next question received is from Máté Nemes from UBS. Your line is now open. Please go ahead.

Máté Nemes (UBS)

Yes, good afternoon and thank you for the presentation. I have two questions left, please. The first one on Croatia and operating expenses. It seems like you're making good progress on extracting synergies, plus the integration of the business, OPEX down 10 percent so far this year. Could you comment a little bit about what is still remaining? How much further do you think you can cut costs there? And perhaps also, if you could give us a sense of the expected timeline there, that would be helpful. And secondly, a question on Slovenia. I think in the press conference in the morning, you mentioned that even after the integration of the newly acquired business in the country, the market share is still lower than optimal. Are you referring here to the opportunity specifically for a bolt on acquisition or did you mean more of an organic growth scenario here? Thank you.

László Bencsik

In Croatia, we pretty much realized the synergies, but we are inherent in the merger itself, so now we are actually in an organic transformation mode. We have started a new kind of growth strategy and especially in the retail front a very ambitious transformation program. We pretty much realized the synergies and now we tried to grow as much as possible. Slovenia, indeed, I just made this comment that the first step is to get the approval for the transaction, close the transaction and integrate this business, and I think this is going to keep us quite busy and quite happy for a while regarding the country. But obviously the reason we entered this country was that we find this attractive and interesting and if there were other opportunities there to consider we would potentially consider them. I'm not suggesting that there is any other opportunity at the moment, which we are considering. A small kind of long-term openness, but this is true for almost all of the countries where we operate. I could pretty much say, certainly for Romania, it is very clear that we have a high desire to further acquire and there are a number of other countries where we would be quite happy to continue acquisitions should there be any attractive targets at an attractive price. But there aren’t. So we don't see them coming at the moment. So it was kind of more general and long term and kind of suggesting that we find this market attractive and interesting and have a long-term strategic intention and commitment.

Máté Nemes (UBS)

Okay, that is fair. Thank you.

Operator

And the last question for today is from Samuel Goodacre from JP Morgan. Please go ahead. Your line is now open.

Samuel Goodacre (JP Morgan)

Hello. I have got a couple of questions on slides six, seven and eight and the new three acquisitions. You're showing what the number of branches is, number of employees is. So, I suppose, following on from Máté's question on Croatia, what is this sort of restructuring potential in these three in terms of the branch network, the employee optimization and potential cost savings here?

László Bencsik

The easiest to answer is Moldova where we don't have anything else. There we don't see much cost synergies. Serbia, I think clearly there's a potential here, especially if you look at the situation here, is that the newly acquired bank is much more cost efficient than our old entity and the difference is huge. SocGen has achieved a level of cost to income ratio around 45 percent, and they actually went through a very rigorous and successful cost transformation program during the last three years, whereas our bank is before the realization of cost synergies because the regulation is such in Serbia that you have to have a quite long notice if you want to change the employee situation for someone, so the synergies have not been realized in Serbia yet, but we are starting from an 80% level of cost to income ratio in our old entity, Vojvodjanska, hey have already merged into one. Obviously there are some cost synergies to be gained even from the previous merger and it is very clear that we have an entity which is much bigger than ours. The entity which we acquired runs at 45 percent cost to income. So that in itself shows that in this market at least you can get to this level. As you can see, our existing bank is smaller but has more branches and has a higher number of employees and the one which we acquired. So it is a strange situation that a more inefficient bank acquires technically a more efficient one. Having said that, we obviously take this into consideration when we decide on the future management team and then also when we decide on what type of procedures, processes and organization to have in the future in Serbia. I see strong synergy potential here. Having said that, we just acquired the bank at the end of September. As I said, at the moment we are in the process of setting the budget requirements, including the future cost synergies as well for this entity. Montenegro, I guess a somewhat similar situation and actually SocGen was somewhat better in terms of its cost to income ratio than our existing bank. There are very clear opportunities here, it is a relatively small country and we obviously do have sizable potential here, sizable compared to the entities that we have there. The impact on the group level will be obviously much more moderate. I am very optimistic that both of these banks, the Serbian joint entity and then the Montenegrin entity will be in the higher levels of profitability when we will look into the distribution of ROEs within the group in the foreseeable future. So I think we have a very good grounding in both of these countries to develop banks which are efficient and have good returns as well in the future.

Samuel Goodacre (JP Morgan)

That's great. Thank you very much.

Operator

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

László Bencsik

Thank you very much. Thank you for attending this conference call and thank you for your very good questions as well. I hope that you'll join us when we present the annual results in March. It is one of the early Fridays in March and until then, I wish you all the best, have a very nice weekend and thank you again for joining us today and goodbye.

Note: unabridged transcript with minor English stylistic corrections.