RATING ACTION REPORT

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Dagong Global Affirms the Long-Term Credit Rating of OTP Bank Plc. at ‘BBB+’, Outlook ‘Stable’

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Dagong Global has affirmed the Long-Term Credit Rating of Hungary-based OTP Bank Plc. (OTP) at ‘BBB+’, with Outlook ‘Stable’. The equivalent Short-Term Credit Rating is also affirmed at ‘A-2’.

RATING RATIONALE

The Long-Term Credit Rating takes into account the Individual Financial Strength Assessment (IFSA) at ‘bbb+’, and our External Support Assessment (ESA) of low potential to receive National Systemic Support.

The IFSA reflects OTP’s leading franchise in its home market of Hungary and selected CEE countries, its sustainable and stable traditional banking model, retail-based funding, strong liquidity and excellent capitalisation. It also reflects the relatively more volatile economic environment in CEE, the relatively high concentration of assets in Hungary and the satisfactory asset quality with relatively high NPL ratio compared to the EU average, mitigated by very strong coverage. Our credit opinion is based on the following factors:

Sustainable and valued franchise

OTP’s development strategy focuses on traditional banking services, with balance sheet dominated by loans and deposits. It is by far the market leader in Hungary, with market share as of 1H18 of 25% in total assets, 30% in retail loans and 37% in retail deposits, has a leading position in Bulgaria (where it recently announced the acquisition of the local Societe Generale subsidiary) and strong market shares in Croatia, Romania and Serbia. OTP is present also in Russia, Ukraine, Slovakia and the smaller Montenegro market, where it is the largest bank by total assets.

Stable funding structure

OTP’s funding stems largely from deposits, with average deposits to total funding of 96.7% (Dagong calculation), which we consider as excellent. As of 1H18 60% of deposits are retail deposits, characterised by low cost, high granularity and relative stability. Retail customers seem to value the strong franchise of the bank and the other services that it provides to them and keep deposits with OTP even at interest rates which are lower than those of local peers. It is also viewed as a safe haven in its main markets.

Very strong capitalisation

OTP’s capitalisation is very strong, with a CET1 ratio of 14.6% (16.0% if including unaudited interim profit less indicated dividend) as of 1H18. The capital levels are sustained by its solid profit generation and recent acquisitions did not have a negative impact on the capital ratios. The communicated target range for the CET1 ratio is 12-18%, which we consider adequate. We expect the bank to maintain the ratio close to the middle of that range.

High NPL, albeit significantly improved and mitigated by very strong coverage

OTP's NPL ratio (90+ DPD) is, in our view, very high for an investment grade rated bank, at 9.2% as of YE17 and 8.1% as of 1H18. However, it is relatively better than the average for most of the markets where it operates (market averages for YE17[1]: 13.9% in Hungary, 13.3% in Bulgaria and 16.4% in Croatia) and comparable to the levels shown by large banks in Italy and Portugal. The development in the last periods has also been positive, with the NPL ratio decreasing steadily from a peak of 19.8% at YE13. We take comfort from the solid coverage ratio which has also improved from 84.3% as of YE14 to 99.3% as of YE17 and 110.3% as of 1H18.

We also understand that NPL recovery rates on the main category of loans, mortgages, are very high in its major markets, which mitigates further the risks from NPLs. In our view, the fact that the bank is able to maintain strong coverage while posting solid bottom line results shows that the risk level of loans is adequately priced in.

Very strong profitability and sustainable income sources

OTP shows very strong profitability, with a net income to average RWA ratio of 3.6% (up to 1H18; based on Dagong calculations). Net interest income, which we view as recurring and sustainable, represents 62.5% of operating income. Fee and commission income, which we also consider as rather stable, represents 28.7% of operating income and volatile trading income and other operating income only 8.8%.

Profitability has improved steadily during the last years, mostly due to strongly decreased cost of risk, resulting from the benign economic environment. Net interest income has been under pressure, as a result of intensifying competition and eroding margins, a trend which we expect to continue. However, we expect that margins in OTP's major markets will remain higher than in Western Europe and provide for adequate returns on capital.

Operating in growing, but relatively volatile markets

The IMF GDP growth forecasts for OTP's major markets are significantly above the expectations for the Eurozone and provide the base for sustainable growth also for the banking industry. The relatively low unemployment rate provides for both loan growth and improvements in asset quality. Additionally, banking margins in these countries are higher than in the Eurozone, allowing banks to achieve adequate profitability. The ratio of housing, consumer and corporate loans to GDP in OTP's major markets is also relatively low, therefore the prospects for sustainable growth are good, in our view.

At the same time, these countries can be considered as small open economies, dependent on exports, tourism, foreign investments and EU funds, therefore more susceptible for external shocks, which we consider as unlikely in the near term. In our opinion, the legal and political environment could also be seen as somewhat riskier than in the Eurozone, which we assess as a relative weakness for the respective domestic banking industries.

External Support Assessment

We see low likelihood of support from the Hungarian government. On one hand, OTP is by far the largest bank in the country and definitely systemically relevant. On the other hand, willingness to support the bank might be limited by the fact that at least 61% of its shares are owned by foreign shareholders and its relatively large international exposure. The Hungarian central bank has implemented the BRRD and therefore any support measures would have to be under the directive and subject to approval by EU authorities.

RATING OUTLOOK

The stable outlook reflects our expectations that OTP will maintain its competitive position in Hungary, Bulgaria and other CEE countries; swiftly integrate the recently acquired entities and portfolios; keep NPL coverage at a strong level; maintain adequate profitability; and maintain Common Equity Tier 1 ratio close to its target of 15.0%, even though the announced target explicitly allows for fluctuation between 12% and 18%, a range which we consider as adequate.

RATING SENSITIVITIES

The ratings could be upgraded if we see a material and sustainable improvement in NPLs, maintained profitability, further strengthened capital and on-going and sustainable economic growth in Hungary and the region.

Ratings could be downgraded if capital ratios weaken, most likely triggered by more aggressive than expected growth. Ratings could also be downgraded if the macroeconomic conditions in the main countries worsen.

[1] Market Intelligence data.

COMPANY PROFILE

The predecessor of OTP Bank, called the National Savings Bank was established in 1949 as a nation-wide, state-owned, banking entity providing retail deposits and loans. In 1990, the National Savings Bank became a public company with a share capital of HUF 23 billion. Its name was changed to the National Savings and Commercial Bank (OTP Bank Rt.). OTP Bank's privatisation began in 1995. As a result of three public offers along with the introduction of the bank's shares into the Budapest Stock Exchange the state's ownership in the bank decreased to a single voting preference (golden) share. Currently the bank is characterised by dispersed ownership of mostly private and institutional (financial) investors.

OTP Bank has completed several successful acquisitions in the past years, becoming a key player in the region. Besides Hungary, OTP Group currently operates in 8 countries of the region via its subsidiaries: in Bulgaria (DSK Bank), in Croatia (OTP banka Hrvatska), in Romania (OTP Bank Romania), in Serbia (OTP banka Srbija), in Slovakia (OTP Banka Slovensko), in Ukraine (JSC OTP Bank), in Montenegro (Crnogorska komercijalna banka) and in Russia (JSC OTP Bank). OTP Group provides financial solutions to nearly 18 million customers through 1,474 branches, agent networks and electronic channels.

FULL LIST OF SOLICITED RATINGS ASSIGNED

OTP Bank Plc.

Long-Term Credit Rating (FC&LC)	BBB+
Short-Term Credit Rating (FC&LC)	A-2
Outlook	Stable
IFSA	bbb+
ESA	Low, National Systemic

FC&LC: Foreign Currency and Local Currency

RATINGS HISTORY

Ratings assigned 28 November 2017:

OTP Bank Plc.	BBB+/A-2/Stable

CRITERIA APPLIED

Criteria for Rating Financial Institutions (25 July 2018)
General Rating Framework (14 August 2018)

OTHER REGULATORY DISCLOSURES

- The ratings above are solicited and Dagong has received compensation for providing these ratings.
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- This Rating Action Report was disclosed to the rated entity before being published. Dagong had provided the rated entity a draft ahead of the publication to review for any factual errors and unintentional disclosure of confidential information. Dagong maintains full editorial control over the Rating Action Report, which represents its independent opinion.

For any further information on rating criteria and procedures, please refer to the following links:
http://www.dagongeurope.com/procedures.php
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