OTP Bank Nyrt.
Issuer Rating Report

NEGATIVE BBB+

Scope's credit view (summary)

OTP's **BBB+ issuer rating** is based on the group's resilient business model, which is built on a dominant market position in Hungary and a high degree of geographical diversification. Less than half of the group's total assets are domestic. This broad geographical diversification allows OTP to not only counterbalance moderate volatility of its Hungarian operations but also to profit from higher margins and growth in less developed banking markets.

The ratings also consider OTP's appetite for acquisitions in Central and Eastern Europe (CEE). We acknowledge the group's strong execution record and the boost these acquisitions provide to OTP's growth. Nevertheless, we also note the challenges that come with acquisitions, especially if they are made in large numbers.

The 'developing' long-term sustainability assessment acknowledges the group's efforts to accelerate its digitalisation and lead its peer group in the CEE region, while noting that OTP only launched an ESG programme in 2020. We believe there is still room to improve the management of emerging ESG-D challenges.

The ratings benefit from OTP's superior earnings generation compared to national and international peers. Profitability is driven by high interest margins and economic growth in the CEE region, as well as by the group's strong market position.

Although OTP's non-performing loan ratio is higher than that of international peers, we consider it manageable in view of the high coverage. Both the Covid crisis and the military conflict in Ukraine have had a minimal impact on the group's credit portfolio. OTP's headline asset quality metrics have improved in the past few quarters, mainly thanks to strong loan growth. This trend could be challenged in case of a recession in the CEE region.

High capital buffers and a solid funding profile are additional strengths supporting OTP's ratings. Despite dividend payouts and acquisitions, the group's capital ratios have steadily increased over the years due to strong earnings.

OTP is primarily funded through deposits thanks to its strong positioning in retail markets, especially in Hungary and Bulgaria. The group's subsidiaries are funded in their respective local currency, minimising currency mismatches between assets and liabilities.

Outlook

The **Negative Outlook** reflects our view that OTP's credit profile could worsen as the operating environment in Hungary deteriorates.

What could move the rating up:

- A material reduction in exposure to domestic sovereign risk or an improvement in the outlook for Hungary
- Evidence that the group's sustainability- related efforts provide a competitive advantage compared to peers

What could move the rating down:

- Given the weaker economic outlook and the concentrated exposure to domestic sovereign risk, a material deterioration in the group's asset quality or earnings combined with an increase in domestic sovereign risk.
- Erosion of the group's capital position or evidence that OTP is increasing its exposure to Russia would be negative for the rating.

Ratings & Outlook

Issuer rating	BBB+
Outlook	Negative
Senior unsecured debt rating	BBB+
Senior unsecured debt (MREL/TLAC eligible) rating	BBB
Tier 2 instruments rating	BB+

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Bloomberg: RESP SCOP

Issuer profile

OTP Bank Nyrt. is the largest bank in Hungary and the parent company of OTP Bank Group. The group was founded in 1949 as a public savings and commercial institution. After its privatisation in the nineties, the group started to expand in Central and Eastern Europe (CEE) through several acquisitions. Today its operations span 11 countries across the CEE area. OTP is listed on the Budapest Stock Exchange and is majority-owned by foreign institutional investors.

OTP is one of the largest independent banking groups in CEE with a balance sheet of HUF 34trn (EUR 81bn as of September 2022). As a universal bank, OTP provides a broad range of lending, savings, and investment products in Hungary and 10 CEE countries: Bulgaria, Croatia, Serbia, Slovenia, Romania, Ukraine, Russia, Montenegro, Moldova and Albania.

Almost half of the group's loan book relates to retail (49%), with roughly a 50/50 split between mortgages and consumer credit. The rest of the loan book breaks down into corporate and public sector loans (40%), leasing (7%) and micro/small companies (4%).

Recent events

- 9M 2022 results were solid despite provisions booked against potential loan losses in Russia and Ukraine, and high negative one-off adjustments (windfall tax in Hungary, Russian bonds, and goodwill impairments). FX-adjusted revenues increased by 18% YoY mainly thanks to resilient lending activity and high growth in net fees and commissions. Although operating costs were under pressure in a high-inflation environment, the nine-month cost/income ratio declined. Without Russia and Ukraine, the group's credit provisions were contained thanks to low default rates. Statutory return on equity stood at 10.1%.
- As of Q3 2022, the Ukrainian subsidiary was still loss-making but things were stabilising. Management sees positive results in upcoming quarters unless the conflict worsens. In Russia, operating conditions have turned out to be more benign, and business has continued as usual.
- In December 2022, the group signed an agreement to acquire around 97% of Ipoteka Bank from the Uzbekistan's ministry of finance. The acquisition will be executed in two steps: 75% of the shares will be acquired in H1 2023, while the remaining 25% three years after the completion of the first transaction. In Uzbekistan, the bank is a top-five specialised in retail lending, with a market share of 8.5%.

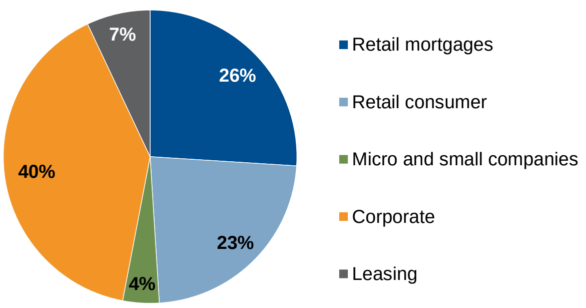
Strong retail and commercial banking franchise in CEE

The 'resilient' business model assessment reflects the group's high geographical diversification and a strong market position in most of its markets. It also considers the group's good revenue and profit record. The focus on commercial banking and lack of a strong franchise in insurance and wealth management limits the assessment.

We deem Hungary, OTP's main operating environment, to be 'moderately supportive' for financial institutions. Hungary is a diversified economy with a strong growth rate and solid credit fundamentals. However, the country's regulatory and legal framework is less strong than in Western Europe, and its polarised political environment adds an element of unpredictability. We consider most of OTP's other markets, particularly Bulgaria, Croatia, and Slovenia, to be 'moderately supportive' environments as well.

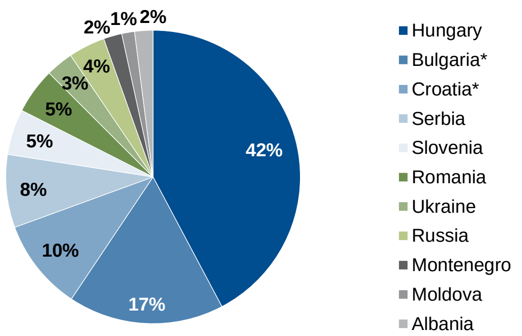
OTP generates more than half of its revenues from foreign subsidiaries, while Hungarian commercial banking ('core') makes up just over 40% of the total. Its remaining revenues are from leasing and asset management in Hungary.

Figure 1: Gross customer loans breakdown, Q3 2022



Source: company data, Scope Ratings

Figure 2: Assets breakdown by country, Q3 2022



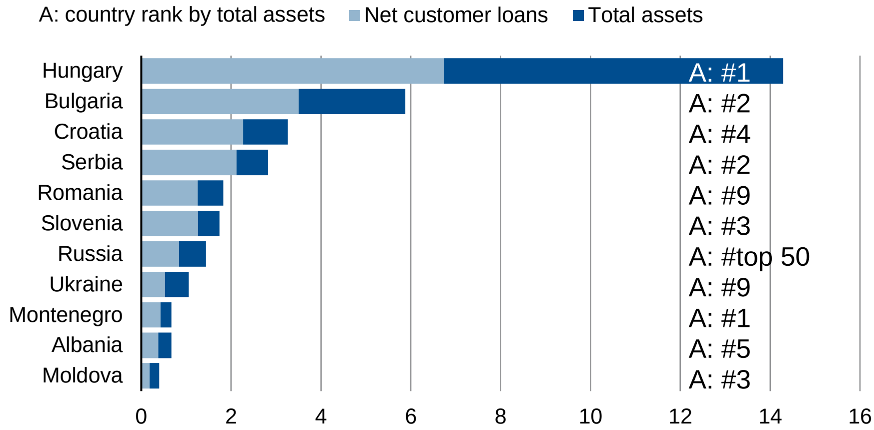
Source: company data, Scope Ratings

Dominant market position in Hungary and strong market shares in several CEE countries

OTP is the clear market leader in the Hungarian banking sector. Its market shares in some key segments, including mortgage loans and household savings, are well above 30%. In some segments, the group's market shares have substantially increased in recent years. In domestic business loans, the group's market share has more than doubled in the past 12 years, from 7.5% to 19.5%. In household savings, market shares increased from 27% in 2011 to 32.6% in September 2022.

OTP is also an important player in most of the foreign countries where it operates. The Nova KBM acquisition (to be completed by year-end 2022) will make OTP the largest bank in Slovenia. It is second largest player in Bulgaria and among the top three in Serbia, Montenegro and Moldova, while it is the fourth largest bank in Croatia by total assets.

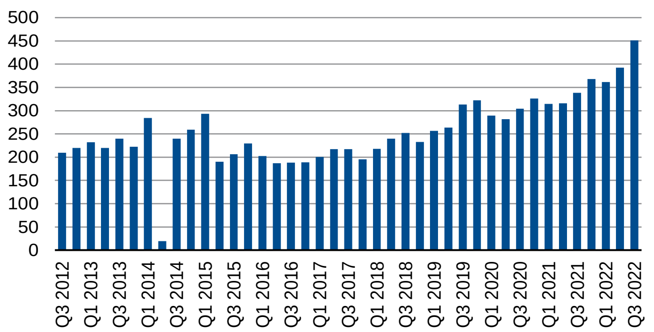
Figure 3: OTP's operations by country, Q3 2022



Source: company data, Scope Ratings
Note: in HUF trn

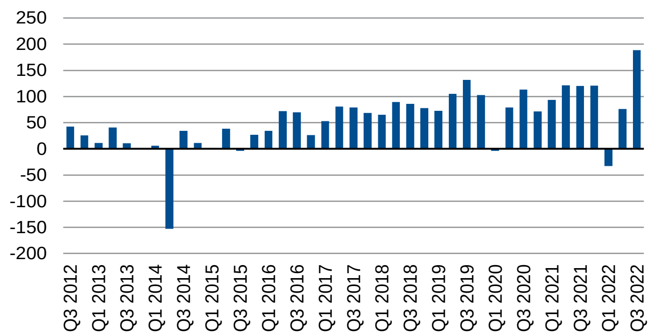
OTP has a strong track record of revenue and earnings growth, which proved resilient during and after the pandemic (Figure 4 and 5). The group reported only two quarterly losses during the past eight years. The first was in Q1 2020, when it front-loaded the impact of the pandemic on its loan quality. The second was in Q1 2022, owing to impairments on Russian and Ukrainian exposures.

Figure 4: Quarterly revenues, in HUF bn



Source: SNL, Scope Ratings
Part of non-recurring items are included in 'other income' within revenues.

Figure 5: Quarterly net income, in HUF bn



Source: SNL, Scope Ratings

Strong growth appetite, including via M&A, carries its own set of risks

In pursuit of its ambition to become the most successful universal banking group in the CEE region, OTP has acquired nine banks over the last five years, for a book value of over EUR 2.1bn (EUR 3.6bn if we include the upcoming acquisition of Slovenian Bank Nova KBM and Uzbek Ipoteka Bank). A presence in growth markets with high margins and OTP's strong track record of integrating acquisitions have enabled the group to achieve high profitability and high-pace growth.

Geographical diversification is a strength

Geographical diversification is an element of strength for OTP's business model because it makes the group less dependent on the Hungarian economy. OTP sees foreign currency earnings as a hedge because underperformance of the Hungarian economy would typically result in the depreciation of the forint and vice versa.

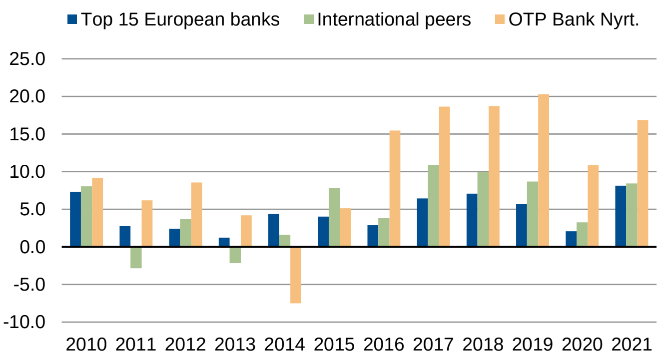
The group's capital position is naturally protected by ordinary exchange rate movements. Intra-group funding is limited. Hence, the group's subsidiaries are funded mainly locally and have limited exposure to foreign currencies, which means only their equity is exposed to changes in FX rates. A decrease (increase) in capital due to translation adjustments is mirrored by a decline (inflation) in risk weighted assets; on average, the two effects cancel out.

Earnings could be hit hard in risky markets

However, the presence in more volatile operating environments exposes the group to sharp currency devaluation and impairments.

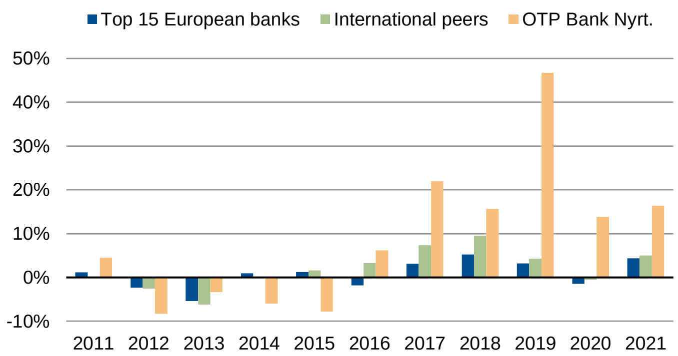
On top of the risks naturally associated with banking in emerging markets, we highlight the challenges that come with acquisitions. These include integration issues, the possible presence of unknown liabilities and potential failures to adequately control credit origination and risk in new subsidiaries.

Figure 6: Return on average equity, historical



Source: SNL, Scope Ratings
Note: top 15 European banks by total assets as of 2021 (Russia excluded)
OTP's international peers comprise UniCredit, Intesa, RBI, Erste, KBC, SocGen.

Figure 7: Annual growth in net customer loans, historical



Source: SNL, Scope Ratings
Note: top 15 European banks by total assets as of 2021 (Russia excluded)
OTP's international peers comprise UniCredit, Intesa, RBI, Erste, KBC, SocGen.

Risks in Russia and Ukraine have materialised

The above-mentioned risks materialised in 2022 after Russia invaded Ukraine. OTP has been operating in Russia and Ukraine for around 15 years. In Russia, subsidiary OAO OTP Bank is engaged mostly in consumer credit, ranking first in point-of-sale service and 7th in credit card lending. In Ukraine, CJSC OTP Bank is one of the largest players in the country and specialises in business lending.

In the first nine months of 2022, the group booked around HUF 90bn of impairments on Russian government bonds and goodwill (about 7% of nine-month revenue). It also reported high impairments against potential credit deterioration, particularly in Ukraine. The nine-month cost of risk in Russia and Ukraine stood at 575 bps and 1,526 bps respectively.

As of Q3 2022, the Russian and Ukrainian subsidiaries combined made up 7.3% of the group's total assets and 7% of total net loans. In 2021, the two contributed 16% of OTP's profits.

Performance in Russia better than initially expected

Unlike most international players, OTP has not yet divested from Russia. In fact, business there has continued as usual and operating performance remains resilient. In Q3, the National Bank of Russia communicated to OTP that it will be allowed to receive back the maturing intra-group funding at the end of the year.

Although operations in Russia and Ukraine may continue to be operationally and economically manageable, we question their sustainability. Since Russia is isolating itself from the Western world, maintaining strong ties with a local subsidiary could become more and more difficult. Moreover, investors or regulators could start to put pressure on OTP to exit. In Ukraine, uncertainty about the length and consequences of the conflict will continue to hinder normal banking activity for a long time.

The loss of Russia and Ukraine would not change our opinion on OTP's business model

While the loss of two of its most profitable franchises would detract from OTP's earnings capability and business model diversification, we reckon that the group could continue to deliver double-digit ROEs even without the contributions of these two units. Given the relatively small size of these operations within the group, we view the risk arising from these exposures as limited for credit investors.

Despite the adverse developments in Russia and Ukraine, OTP's management has not lost its appetite for growth in frontier markets. Management is exploring the possibility of acquiring Ipoteka Bank in Uzbekistan. As of H1 2022, Ipoteka Bank's net loan volumes amounted to HUF 1,044bn, equivalent to around 6% of OTP's total if they were to be integrated.

Box A: Focus on OTP's country of domicile: Hungary

Macroeconomic assessment – key credit considerations

- As of 2021**,** Hungary ranks 17th in the EU by nominal GDP. Its GDP per capita is significantly lower than the EU-27 average.
- After a prolonged period of stagnation in the wake of the Global Financial Crisis, the Hungarian economy has been enjoying a period of sustained economic growth, which the pandemic temporary paused in 2020. Between 2014 and 2021, the country's GDP grew by more than 3.4% annually, much higher than the EU-27 average.
- However, short-to-medium term growth prospects are worsening due to a mix of external risks (lower demand from key export markets, supply chain disruptions, currency weaknesses), high inflation and rising borrowing costs.
- In the recent past, Hungary's governance indicators (World Bank) have worsened as has its relationship with the EU over fundamental disagreements on the rule of law. This has led to delays in the disbursement of EU funds from the Recovery and Resilience Facility.
- Scope rates Hungary's sovereign debt at BBB+/Negative.

Key economic indicators	2019	2020	2021	2022F	2023F
GDP per capita (USD '000s)	16.7	16.1	18.7	NF	NF
Real GDP, % change	4.9	(4.8)	7.1	4.9	1.5
Unemployment rate, %	3.3	4.1	4.0	3.8	4.0
CPI, % change	3.4	3.3	5.1	NF	NF
Policy rate, %	0.90	0.60	2.40	13.75	11.50
General government debt, % of GDP	65	79	77	77	77

Source: Scope Ratings, Scope Macroeconomic Board's forecasts, SNL
Note: NF stands for 'not forecasted

Soundness of the banking sector – key credit considerations

- The Hungarian banking sector is concentrated. The five biggest banks control more than 70% of domestic banking assets. Five out of the seven largest private banks are subsidiaries of foreign groups (KBC, UniCredit, Erste Bank, RBI and Intesa).
- Domestic customer loans divide into non-financial companies (50%), households (42%) and other financial corporations. Consumer lending accounts for 50% of household lending in Hungary, which is a much larger percentage than for banks in Western Europe.
- Housing prices skyrocketed in 2021 due to limited supply, particularly in the countryside. In view of rising borrower indebtedness, the European Systemic Risk Board issued a warning to Hungary in February 2022. The board reckoned that the creation of a regulatory framework to boost supply would ease house price pressure. It also suggested that in a worse-case scenario, the Hungarian Central Bank should activate banks' countercyclical capital buffers.
- Banks are increasingly being targeted by government policies aimed at funding budget deficits or protecting borrowers from rising interest rates. In 2022, the government launched a 10% windfall tax on banks' 2021 and 2022 net revenues and forced an interest rate cap first on retail mortgages and then on SME loans. The ceiling, which has already been prolonged twice, will not expire before June 2023.
- Hungarian banks are subject to EU regulation. Since incorporating the Financial Supervisory Authority in 2013, the Hungarian Central Bank has acted as the prudential supervisor and resolution authority.

Banking system indicators	2017	2018	2019	2020	2021
ROAA, %	1.9	1.9	1.7	0.8	1.3
ROAE, %	15.5	15.3	15.0	7.6	13.3
Net interest margin, %	3.4	3.3	3.2	2.7	2.8
CET1 ratio, %	15.8	17.3	15.7	16.9	17.6
Problem loans/gross customer loans, %	8.6	6.3	4.2	3.7	3.7
Loan-to-deposit ratio, %	77.0	75.9	79.2	73.5	69.9

Source: Scope Ratings, SNL

OTP has a long journey ahead of it to become an ESG and digital leader in the CEE region

We assign a 'developing' qualifier to OTP's long-term sustainability, acknowledging the group's efforts to accelerate its digitalisation and become the standard for competitors in the CEE region while also noting that the group only launched its ESG programme in 2020. We believe there is still room to improve management of emerging ESG-D challenges and that the progress made so far does not justify a rating uplift.

Convincing risk oversight despite rapid growth in CEE countries

OTP's governance framework is adequate. Although the majority of the group's shares are owned by foreign investors, the largest shareholders are domestic.

The current board of directors was renewed in 2021 and is composed of 11 members. Although seven members do not hold executive roles, they are entitled to share-based compensation. Six directors have been in office for more than 20 years, which explains the long board tenure (about 10 years). The chairman of the board is also the CEO of the group.

Despite the breadth of the group's operations across the CEE region and the large number of acquisitions it has made in recent years, there have been no significant governance issues to date. This points to sound governance and risk management.

Ambition to become regional leader in green transition and sustainable finance

Compared to its international peers under the ECB's supervision, we believe OTP faces softer regulatory pressure on ESG. The group is still in the planning phase and working on sustainability frameworks, processes, and targets.

OTP is aware of the business opportunities that come with the green transition. Its ESG strategy mainly hinges on boosting green lending based on internationally accepted criteria (such as the EU taxonomy and the Climate Bonds Initiative). In the years to come, the group expects to increase its offering of green products and envisages strong growth in the stock of green loans (from HUF 230bn at YE 2022 to HUF 1,500bn by the end of 2025).

However, the group has not yet provided detailed information on its exposure to climate-related risks.

Accelerating digitalisation to meet evolving client needs and preferences

We believe the group has the scale and profitability to invest major resources in digitalisation. It has focused on improving back-end and front-end processes for more than a decade, while remaining less vocal on the matter than international peers.

The pandemic accelerated the digital transition. For instance, the number of customers using digital channels for daily banking operations soared. Today almost all retail customers do their money transfers remotely. However, the large majority of current account openings and mortgage underwritings is carried out physically, for both cultural and legal reasons.

In recent years, the group has launched a range of digital services for business clients, including mobile POS (2015), SME account opening (2016), e-billing and bank transfers (eBIZ, 2017) and instant transfers (Simple Business, 2020).

Strong earnings generation thanks to relatively high interest margins and loan growth

The 'supportive' Earnings and Risk Exposures modifier is driven by OTP's superior earnings generation compared to national and international peers. The improvement in the group's asset quality metrics over the past few years supports this assessment. We note that OTP's concentrated exposure to Hungarian sovereign risk could become a constraint if this sovereign risk increases.

Since 2016, OTP has outperformed its international peers in terms of both returns and lending growth. OTP's return on equity averaged 16.5% during the period.

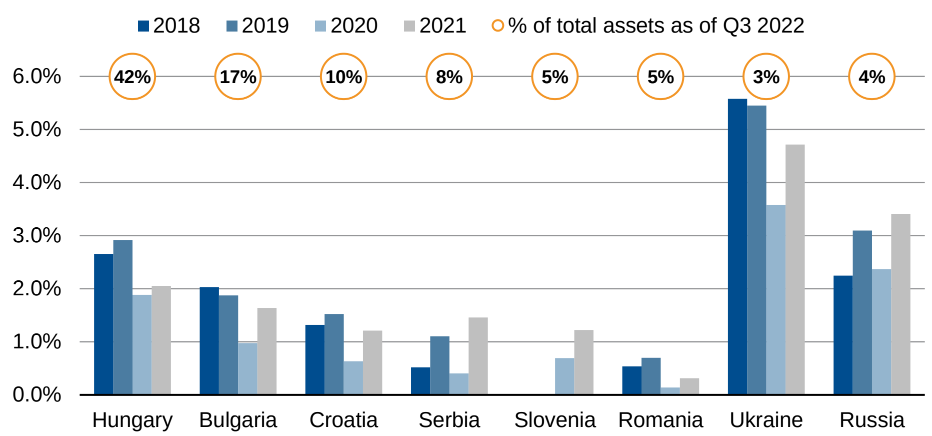
Profitability benefitted from the strong performance of the Hungarian economy that followed a prolonged period of stagnation after the Global Financial Crisis. Earnings were also supported by sound growth in foreign countries, enhanced by focused acquisitions that strengthened the group's market position in the CEE region. We think the group's dominant position in its home market is another important element backing margins and returns.

OTP's return on average equity was above 10% during the pandemic

The group's profitability remained strong during the Covid crisis, although revenue growth slowed initially and credit provisions quadrupled to 115 bps of customer loans.

In 2021, OTP's financial performance rebounded thanks to high lending growth and normalising cost of risk. However, the statutory return on average equity remained below its pre-pandemic level.

Figure 8: FX-adjusted ROA* by country, last four years



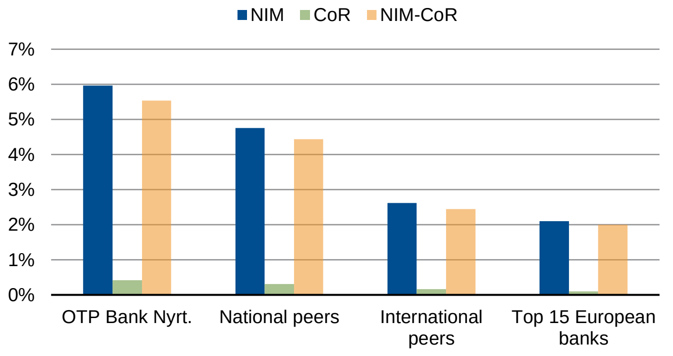
Source: company data, Scope Ratings
*After conversion to HUF and estimated using end-of-year balance sheet figures; main countries only (Montenegro, Albania and Moldova excluded)

OTP's interest margins have declined for years but remain higher than those of peers

Although interest rates in the CEE area have been on a downward trajectory for almost a decade, OTP's net interest margin remains significantly higher than that of national and international peers (Figure 9). Together with strong loan growth, high margins are the backbone of OTP's profitability.

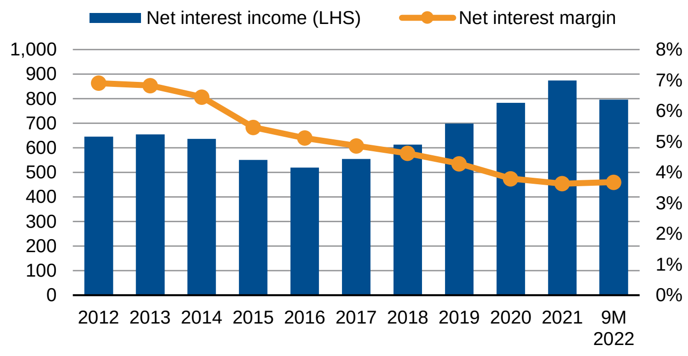
As opposed to most of its international peers, OTP did not report growth in its interest margin in 2022. This was due to a mix of factors, including: i) an increase of the share of lower-margin business; ii) an interest rate cap on retail and SME loans in Hungary, which curbed domestic lending; and iii) fast repricing of deposits in the CEE region. Nevertheless, OTP's revenues continued to grow on the back of rebounding CEE economies, where loan demand is resilient.

Figure 9: Interest margins, gross and net of cost of risk, 2021



Source: SNL, Scope Ratings
Note: NIM (net interest margin) and CoR (cost of risk) calculated on net customer loans

Figure 10: Net interest income (in HUF bn) and margin, historical

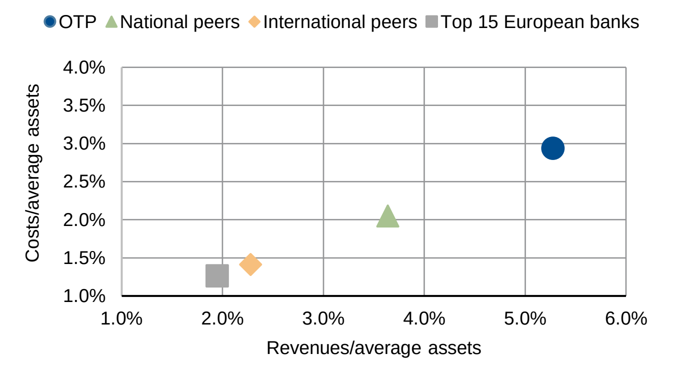


Source: SNL, Scope Ratings
Note: Net interest margin calculated on total financial assets

During the pandemic, OTP kept its cost-to-income ratio well below 60%. Strong revenue generation enables the group to operate less efficiently compared to international peers; its ratio of costs to average assets is well above average (Figure 11).

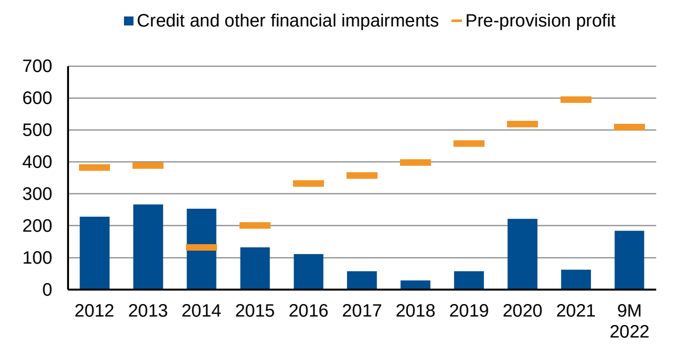
Credit losses are comfortably covered by pre-provision earnings. Since 2016, OTP has managed to maintain a high margin over provisions even when cost of risk spiked, like in 2020 (due to Covid) and in 9M 2022 (due to Russia and Ukraine).

Figure 11: Breakdown of 2021 cost-to-income ratio



Source: SNL, Scope Ratings

Figure 12: Pre-provision profits vs financial impairments (HUF bn)



Source: SNL, Scope Ratings

Profitability outlook is challenged

OTP faces several headwinds in upcoming quarters. The government's measures to protect borrowers from rising interest rates and the rapid increase in funding costs are defusing the potential benefits of interest rate hikes for Hungarian banks. Since the interest rate cap on most retail and SME products will last until June 2023 at the earliest, we expect domestic margins and lending activity to remain subdued for a while.

After imposing a 10% windfall tax on banks' 2021 and 2022 net revenues, the Hungarian government could decide to intervene again at banks' expense should the economy slip into recession or/and inflation remain high. Moreover, inflation will continue to put pressure on salaries and most administrative costs.

The group's underlying cost of risk may rise in upcoming quarters in light of the economic slowdown in the CEE region and the spectre of recession. The deterioration in asset quality will be less (or more) pronounced depending not only on economic growth but also on government fiscal measures to counter such a slowdown and support borrowers.

Finally, further losses may arise from the group's Russian and Ukrainian exposures, especially in case of a disorderly exit from these two markets. Although such losses would be manageable for the group, they could become an issue if compounded by deteriorating revenue margins, high credit impairments and non-recurrent losses.

Underlying earnings capacity will remain strong

Even so, we believe OTP's capacity to generate earnings will remain supportive for the ratings given the group's high geographical diversification and strong market positions at home and abroad.

Asset quality continued to improve during and after the pandemic

Since 2014, OTP's asset quality metrics have improved significantly amid more supportive economic conditions. As of September 2022, its Stage 3 ratio stood at 5.2%. More than half of impaired loans are in the group's three main markets of Hungary, Bulgaria and Croatia, where Stage 3 ratios were 4.3%, 5.3% and 5.2% respectively.

Credit quality in Russia has not worsened

The Stage 3 ratio is high in Russia (16%), where OTP focuses on unsecured consumer lending. However, the group has not observed a severe deterioration in credit quality during the first nine months of 2022. In fact, the 4.6 pp increase YTD was mainly due to a dominator effect from lower loan origination. Anyway, the group has coverage levels of above 90%, accounting for the low recovery rates on impaired positions.

The Stage 3 ratio in Ukraine stood at 14.2% at the end of September 2022. Since the beginning of the military conflict, the group has reclassified several positions into Stage 3, which led to an increase of 7.9 pp YTD. The coverage ratio stood at 64%.

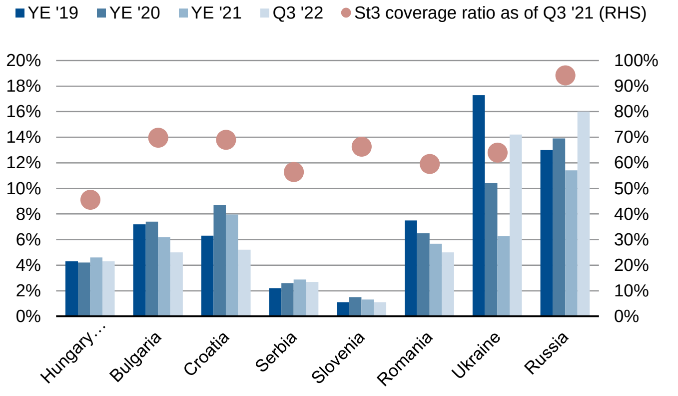
While the group's Stage 3 ratio is significantly higher than that of banks in Western Europe, it is in line with the underlying risk characteristics of the markets where OTP operates – a fact we capture in our operating environment assessment. We do not further penalise the group for its asset quality.

OTP prefers to work out NPLs rather than dispose of them

OTP's Stage 3 ratio in Hungary is also slightly higher compared to that of peers, mainly reflecting the strategic preference for working out deteriorated positions internally rather than selling them off at a discount. Provided the group has the right expertise, we acknowledge that this strategy can lead to higher final recovery rates and a better ability to retain customers.

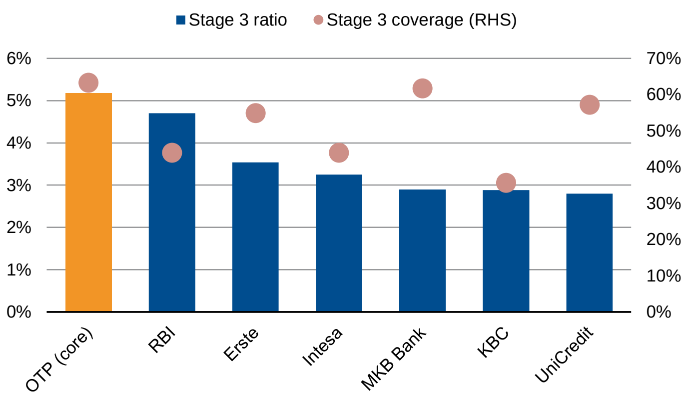
OTP has several entities that act as debt collectors across its markets. In Hungary, it employs around 500 people and has long experience in the field.

Figure 13: OTP's headline asset quality metrics by country



Source: company data, Scope Ratings
Note: ratios calculated on gross values

Figure 14: OTP core vs Hungarian peers – headline asset quality metrics, YE 2021

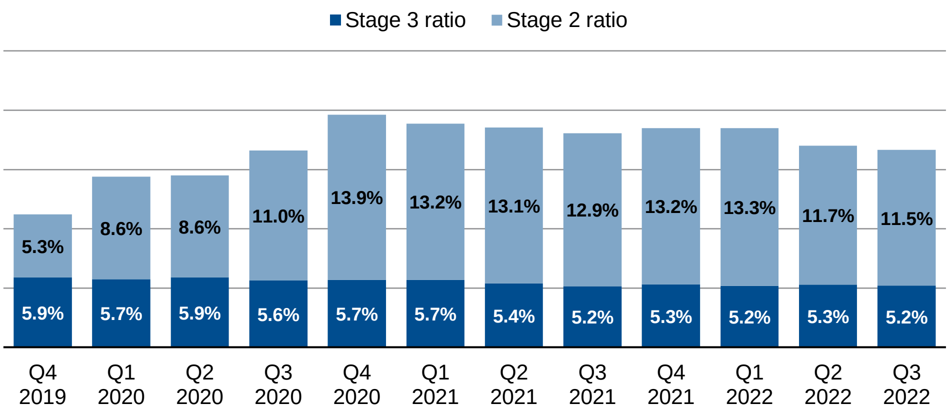


Source: SNL, Scope Ratings
Note: ratios calculated on gross values

The pandemic did not impact OTP's asset quality

The group's Stage 2 ratio has increased materially since the beginning of the pandemic, peaking at 13.9% at YE 2020, as it was subject to several debt moratorium programmes across its geographies. This was due to the reclassification of corporate exposures based on sectors and the credit migration of some retail positions. However, there have been no signs of credit deterioration in OTP's loan book so far. In fact, the group's Stage 2 ratio has declined despite increased credit risk in Ukraine.

Figure 15: OTP's Stage 2 and 3 ratios, past quarters



Source: SNL, Scope Ratings
Note: ratios calculated on gross values

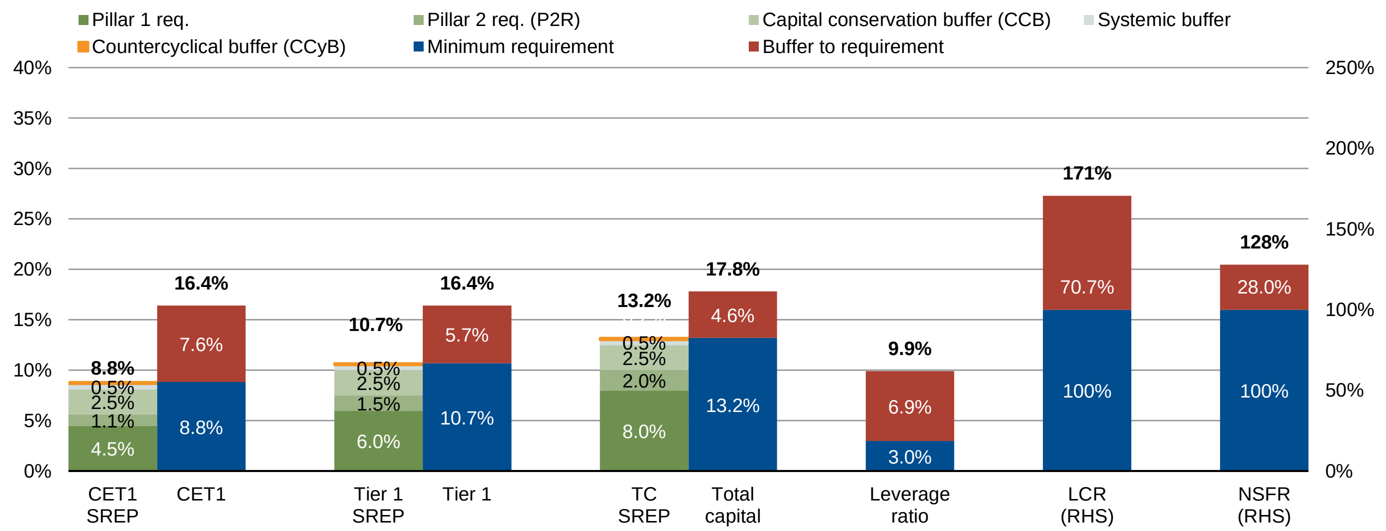
OTP is highly exposed to domestic sovereign risk through government bond holdings, loans to public entities and retail/SME loans guaranteed by the state. As of September 2022, the group held almost HUF 4trn of Hungarian government bonds, or around 11% of total public debt. This exposure is equivalent to 112% of the group's CET1 capital.

Scope's rating of Hungarian sovereign debt is BBB+/Negative as of December 2022.

Solid capital position notwithstanding recent acquisitions

The 'comfortable' qualifier on OTP's financial viability management reflects the group's healthy buffers over regulatory requirements and its conservative capital management policy.

Figure 16: Overview of OTP's buffers above minimum requirements, Q3 2022



Source: company data, SNL, Scope Ratings
Note: NSFR ratio as of Q2 2022

For 2022, the Hungarian Central Bank set OTP's CET1 ratio requirement at 8.8%. The systemic risk buffer of 2% was temporarily removed due to Covid, but OTP must gradually replenish it by 2024; this started from 0.5% in 2022. The CET1 portion of the Pillar 2 requirement is 1.1%, and there is a small 0.2% countercyclical buffer mainly due to OTP's exposure to Bulgaria. The capital conservation buffer is 2.5%.

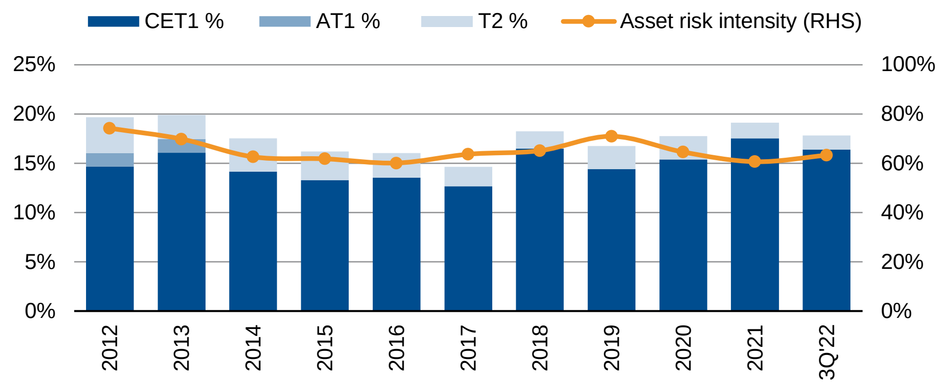
At the end of September 2022, the group's consolidated CET1 ratio stood at 16.4%, 2 pp above the pre-Covid level. The total capital ratio was 17.8%. Since OTP does not hold AT1 instruments, its Tier 1 ratio was the same level as its CET1 ratio.

OTP has always kept a strong capital position in the past decade

Unlike most Western European banks, OTP held high capital ratios as early as the beginning of the 2010s. Strong internal capital generation allowed the group to carry out several acquisitions and pay dividends before the pandemic.

The group's asset risk intensity is high at 63% as of the end of September 2022. There are two reasons for such a high figure: use of standardised models to assess credit risk and loan composition that is skewed towards unsecured lending.

Figure 17: OTP's capital ratios, historical

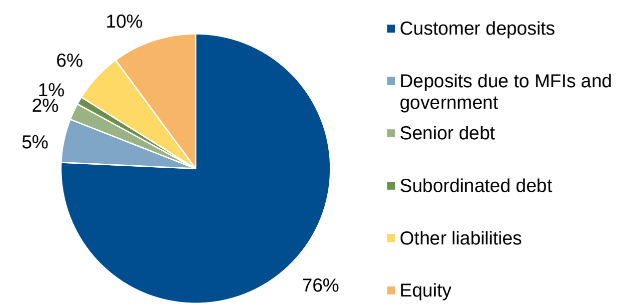


Source: SNL, Scope Ratings

Customer deposits are the primary source of funding

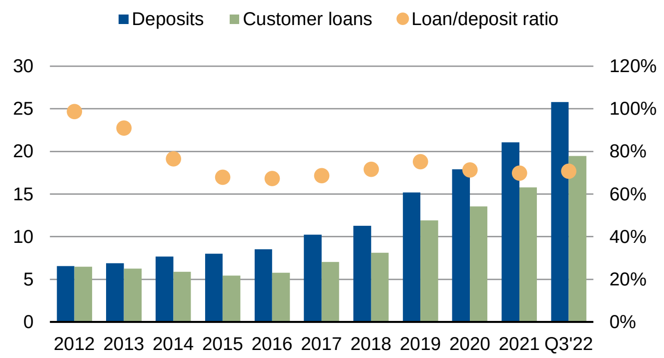
OTP funds mainly through customer deposits, especially in the Hungarian and Bulgarian markets. Customer deposits accounted for 76% of the group's balance sheet as of Q3 2022. Retail customers made up almost 55% of total deposits, most of which are sight deposits. The loan/deposit ratio stood at 71% at the end of Q3 2022.

Figure 18: OTP's funding structure, Q3 2022



Source: SNL, Scope Ratings

Figure 19: Loans and deposits (in HUF trn), historical



Source: SNL, Scope Ratings

Funding drawn from capital markets accounts for 4% of the group's total liabilities. OTP is active on the domestic capital market through covered bonds issued by OTP Mortgage Bank and, to a lesser extent, through OTP Bank.

The need for wholesale funding was low during the pandemic given OTP's large and growing deposit base. The group's deposit base has been stable due to OTP's dominant market position and customers' reluctance to switch to investment products with higher yields – particularly in Hungary.

Future bond issuance to fulfil MREL requirement

After almost three years of inactivity, the group resumed bond issuance to foreign institutional investors with a EUR 400m senior preferred green bond in July 2022. This was followed by a USD 60m senior preferred green private placement in September and a EUR 650m senior preferred issue in December. We expect OTP to continue tapping the bond market, mainly to fulfil regulatory requirements (such as MREL). However, with the rapid increase in deposit rates, bond issuance may become more convenient also for funding purposes.

The group used to issue retail bonds, although never in large quantities because government bonds have been the preferred investment for retail customers.

The group does not currently make full use of AT1s, T2s or senior non-preferred debt to meet its MREL requirement. From January 2022, the group's intermediate MREL requirement is 14.45% of its total risk exposure amount (TREA) and 5.89% of total leverage exposure.

We believe the group has room to optimise its capital structure, which is currently of very high quality compared to international peers.

Liquidity buffers are comfortable. As of Q3 2022, the liquidity coverage ratio stood at 171%, while the net stable funding ratio was well above the 100% requirement.

Additional factors

No additional factors were considered.

External support

OTP bank is an independent financial firm. Therefore, there is no external support for its ratings.

Debt ratings

Preferred senior unsecured debt rating: BBB+

This debt category is the most senior unsecured rating category given that it ranks above senior non-preferred (bail-inable) debt. In line with Scope's updated rating methodology for financial institutions, senior unsecured debt is rated at the same level as the issuer rating.

Non-preferred senior unsecured debt rating: BBB

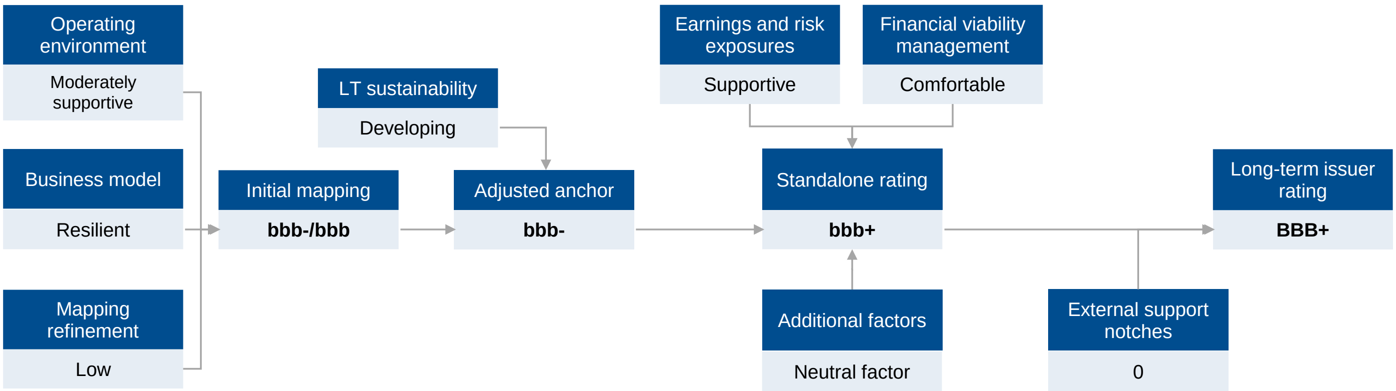
According to Scope's financial institutions methodology, non-preferred senior unsecured debt is rated one notch below preferred senior unsecured debt.

Tier 2 debt rating: BB+

We rate Tier 2 debt three notches below the issuer rating under the standard approach without additional notching.

The group currently has only one bond outstanding (EUR 500m) that classifies as CRD4-compliant Tier 2 (ISIN: XS2022388586).

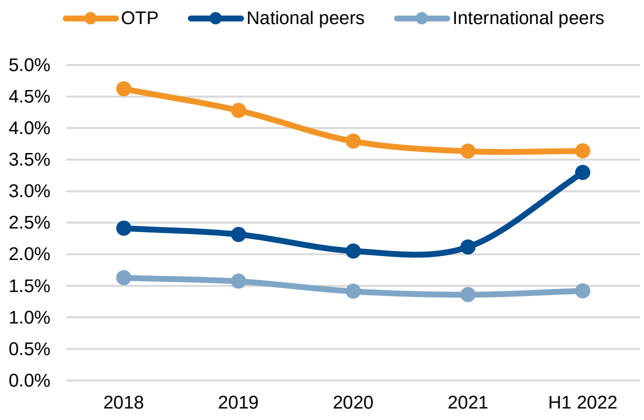
I. Appendix: Overview of the rating process



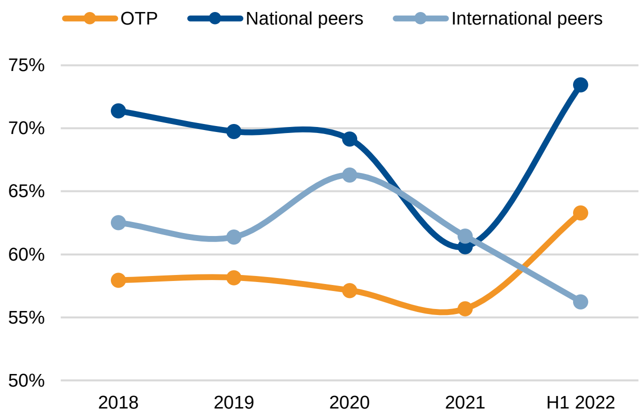
Step		Assessment	Summary rationale
STEP 1	Operating environment	Very supportive	• Hungary is the group's main operating environment. It is one of the largest CEE economies. • Hungary's regulatory and legal framework is somewhat less strong than those in 'supportive' markets; a polarised political environment adds an element of unpredictability. • We consider Bulgaria and Croatia, OTP's second and third markets respectively, to be moderately supportive environments as well.
		Supportive	
		Moderately supportive	
		Constraining	
		Very constraining	
	Business model	Very resilient	• OTP is a large universal bank with a dominant position in its domestic market. • High geographical diversification allows the group to temper shocks in its domestic economy. • A presence in some markets exposes the group to currency and asset quality risk, which can be a source of losses. • OTP's strategy is centred around growth, both organic and inorganic. The group is comfortable with undertaking risky investments when they come with high return potential.
		Resilient	
		Consistent	
		Focused	
		Narrow	
	Mapping refinement	High	• The low refinement reflects our view that OTP embraces a riskier strategy compared to peers. It also reflects its exposure to relatively less supportive operating environments.
		Low	
	Initial mapping	**bbb-/bbb**	
	Long-term sustainability	Best in class	• OTP recently took its first steps into sustainability with an ESG programme. The group will not provide information on its exposure to climate and transition risks soon. Moreover, it does not have any targets for reducing indirect emissions. • OTP has the scale to be a leading player in digital banking in future.
		Advanced	
		Developing	
		Lagging	
	Adjusted anchor	**bbb-**	
STEP 2	Earnings capacity & risk exposures	Very supportive	• Strong earnings capacity backed by high interest margins (even when corrected for provisions), although operating efficiency could be improved further. • Asset quality metrics are worse than European standards. However, they have declined significantly in recent years. • Concentrated exposure to Hungarian sovereign risk could constrain the assessment in future.
		Supportive	
		Neutral	
		Constraining	
		Very constraining	
	Financial viability management	Ample	• Capital buffers are high, further boosted by the temporary removal of the O-SII buffer. Capital is backed by earnings retention. • OTP is mostly deposit-funded; prompted by regulatory requirements, access to international capital markets has increased.
		Comfortable	
		Adequate	
		Limited	
		Stretched	
		At risk	
	Additional factors	Significant support factor	• No additional factors
		Material support factor	
		Neutral	
		Material downside factor	
		Significant downside factor	
	Standalone	**bbb+**	
STEP 3	External support	Not applicable	
Issuer rating		**BBB+**	

II. Appendix: Peer comparison

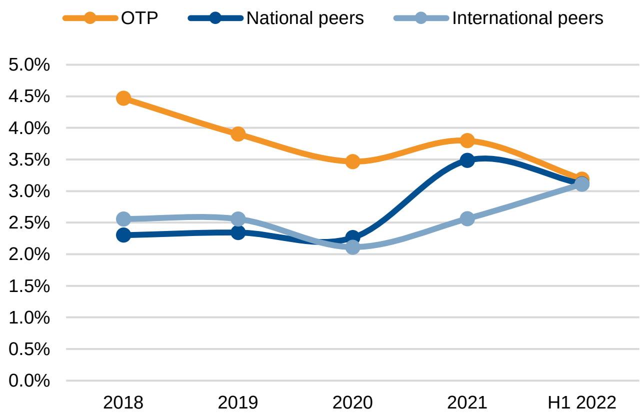
Net interest margin



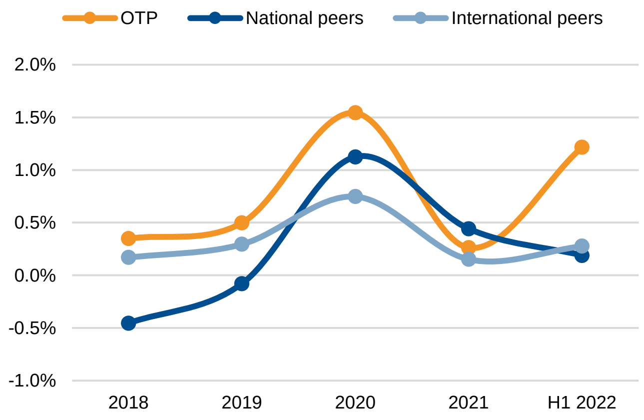
Cost/income



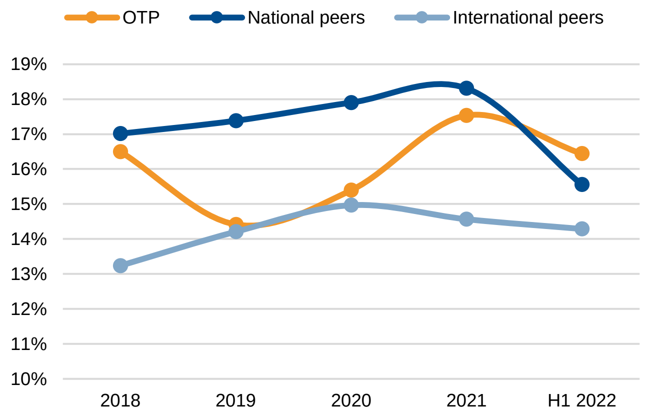
Pre-provision income/risk-weighted assets (%)



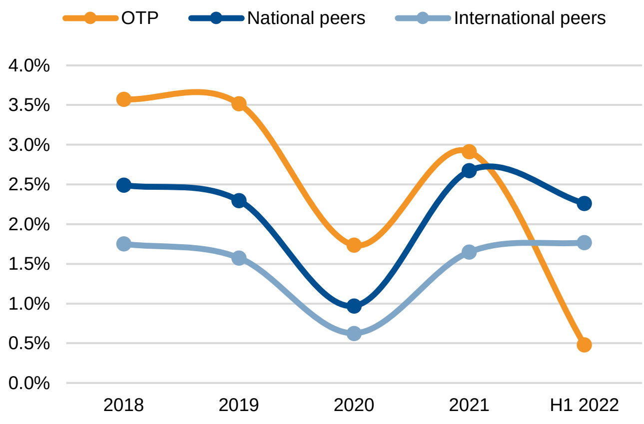
Loan loss provisions/average gross loans



CET1 ratio (transitional)



Return on risk-weighted assets



Source: SNL, Scope Ratings
National peers: Kereskedelmi és Hitelbank Zrt., UniCredit Bank Hungary Zrt., Erste Bank Hungary Zrt., Raiffeisen Bank Zrt., Magyar Takarékszövetkezeti Bank Zrt., CIB Bank Zrt., MKB Bank Zrt., Budapest Hitel- és Fejlesztési Bank Zrt.
International peers: Erste Bank, RBI, UniCredit, Intesa, KBC, SocGen

III. Appendix: Selected financial information – OTP Bank Nyrt.

	2019	2019	2020	2021	9M 2022
Balance sheet summary (HUF bn)					
Assets					
Cash and interbank assets	2,127	2,127	3,581	4,141	5,375
Total securities	4,721	4,721	5,193	6,537	7,689
of which, derivatives	118	118	124	203	NA
Net loans to customers	11,908	11,908	13,553	15,772	19,480
Other assets	1,365	1,365	1,008	1,104	1,479
Total assets	**20,122**	**20,122**	**23,336**	**27,553**	**34,022**
Liabilities					
Interbank liabilities	844	844	1,219	1,609	1,781
Senior debt	448	448	631	569	972
Derivatives	97	97	116	214	582
Deposits from customers	15,171	15,171	17,891	21,069	25,815
Subordinated debt	250	250	275	278	317
Other liabilities	1,020	1,020	667	779	1,103
Total liabilities	**17,830**	**17,830**	**20,799**	**24,517**	**30,570**
Ordinary equity	2,286	2,286	2,533	3,031	3,445
Equity hybrids	0	0	0	0	0
Minority interests	5	5	4	6	8
Total liabilities and equity	**20,122**	**20,122**	**23,336**	**27,553**	**34,022**
Core tier 1/ common equity tier 1 capital	*2,055*	*2,055*	*2,316*	*2,927*	*3,526*
Income statement summary (HUF bn)					
Net interest income	699	699	783	874	796
Net fee & commission income	374	374	398	442	430
Net trading income	18	18	35	10	-9
Other income	3	3	-6	16	5
Operating income	**1,093**	**1,093**	**1,209**	**1,342**	**1,222**
Operating expenses	636	636	691	747	713
Pre-provision income	**458**	**458**	**518**	**595**	**509**
Credit and other financial impairments	57	57	222	62	184
Other impairments	13	13	7	5	NA
Non-recurring income	80	80	8	0	0
Non-recurring expense	0	0	0	0	0
Pre-tax profit	**467**	**467**	**298**	**528**	**257**
Income from discontinued operations	-5	-5	6	0	10
Income tax expense	50	50	44	72	35
Other after-tax Items	0	0	0	0	0
Net profit attributable to minority interests	0	0	0	1	0
Net profit attributable to parent	**412**	**412**	**259**	**456**	**232**

Source: SNL, Scope Ratings

IV. Appendix: Selected financial information – OTP Bank Nyrt.

	2019	2019	2020	2021	9M 2022
Funding and liquidity					
Net loans/ deposits (%)	75%	75%	71%	70%	71%
Liquidity coverage ratio (%)	169%	169%	214%	180%	171%
Net stable funding ratio (%)	125%	125%	139%	139%	NA
Asset mix, quality and growth					
Net loans/ assets (%)	59.2%	59.2%	58.1%	57.2%	57.3%
Problem loans/ gross customer loans (%)	5.7%	5.7%	5.1%	4.8%	5.2%
Loan loss reserves/ problem loans (%)	93.9%	93.9%	115.8%	110.2%	107.8%
Net loan growth (%)	46.7%	46.7%	13.8%	16.4%	31.3%
Problem loans/ tangible equity & reserves (%)	26.4%	26.4%	23.4%	21.8%	24.5%
Asset growth (%)	37.9%	37.9%	16.0%	18.1%	31.3%
Earnings and profitability					
Net interest margin (%)	4.3%	4.3%	3.8%	3.6%	3.7%
Net interest income/ average RWAs (%)	6.0%	6.0%	5.2%	5.6%	5.7%
Net interest income/ operating income (%)	63.9%	63.9%	64.7%	65.1%	65.1%
Net fees & commissions/ operating income (%)	34.2%	34.2%	32.9%	32.9%	35.2%
Cost/ income ratio (%)	58.2%	58.2%	57.1%	55.7%	58.4%
Operating expenses/ average RWAs (%)	5.4%	5.4%	4.6%	4.8%	5.1%
Pre-impairment operating profit/ average RWAs (%)	3.9%	3.9%	3.5%	3.8%	3.6%
Impairment on financial assets / pre-impairment income (%)	12.5%	12.5%	42.8%	10.4%	36.3%
Loan loss provision/ average gross loans (%)	0.5%	0.5%	1.5%	0.3%	1.0%
Pre-tax profit/ average RWAs (%)	4.0%	4.0%	2.0%	3.4%	1.8%
Return on average assets (%)	2.4%	2.4%	1.2%	1.8%	1.0%
Return on average RWAs (%)	3.5%	3.5%	1.7%	2.9%	1.7%
Return on average equity (%)	20.3%	20.3%	10.8%	16.9%	9.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	14.4%	14.4%	15.4%	NA	NA
Common equity tier 1 ratio (%, transitional)	14.4%	14.4%	15.4%	17.5%	16.4%
Tier 1 capital ratio (%, transitional)	14.4%	14.4%	15.4%	17.5%	16.4%
Total capital ratio (%, transitional)	16.8%	16.8%	17.7%	19.1%	17.8%
Leverage ratio (%)	8.6%	8.6%	9.2%	9.4%	9.9%
Asset risk intensity (RWAs/ total assets, %)	70.9%	70.9%	64.5%	60.6%	63.2%
Market indicators					
Price/ book (x)	1.9x	1.9x	1.5x	1.5x	0.6x
Price/ tangible book (x)	2.1x	2.1x	1.6x	1.7x	0.7x
Dividend payout ratio (%)	NA	NA	NA	NA	NA

Source: SNL, Scope Ratings

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