

OTP Bank Nyrt. Issuer Rating Report



Scope's credit view (summary)

OTP's **BBB+ rating** is based on the group's resilient business model, with a dominant market position in Hungary and a high degree of geographic diversification. Broad geographic diversification counterbalances the moderate volatility in the group's Hungarian operations and provides higher margins and opportunities for growth in less developed banking markets. We deem positive OTP's active management of its business perimeter, while flagging risks that come with inorganic growth. Reassuringly, the group has a strong track record in acquiring and integrating subsidiaries in the CEE region.

Following the pandemic, the group has increased its digitalisation efforts, aiming to provide market-leading digital solutions and to increase group-wide efficiency. The group has also launched an ESG strategy which contains interim goals for 2025. We note that regarding ESG matters, the group may face increasingly higher expectations and stricter regulations as it becomes a larger and more relevant player in the euro area.

OTP exhibits superior earnings generation compared to national and international peers. Profitability is driven by comparatively high interest margins and economic growth in the CEE region, as well as by the group's market power in most of the countries in which it operates. From 2016 to 2022, its return on equity averaged around 16%.

As of Q3 2023, the group's Stage 3 loan ratio stood at 4.3%, a historical low. So far, high inflation, growing borrowing costs and the economic slowdown have not impacted asset quality. In fact, OTP has been able to reverse some of the provisions accumulated during the pandemic and which were never used.

High capital buffers and a solid funding profile are additional strengths supporting OTP's ratings. Strong earnings generation allows the group to grow both organically and through M&A, while preserving healthy buffers to solvency requirements. Given the group's growth strategy, share buybacks or dividends are not a priority.

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 currencies, minimising currency mismatches between assets and liabilities. Since 2022, the group has increased the issuance of bonds on international markets to fulfil its MREL requirements.

Outlook

The **Stable Outlook** reflect our view that OTP's credit profile will remain stable in the next 12-18 months.

What could move the rating up:

- Evidence that the group's sustainability related efforts provide a competitive advantage compared to peers.

What could move the rating down:

- A material deterioration in the group's asset quality or earnings, which could stem from a recession in the CEE region.
- Erosion of the group's capital position, potentially due to significantly lower profitability and severe credit deterioration.
- A substantive increase in exposure to domestic sovereign risk, possibly from a materially larger portfolio of Hungarian government bond holdings

Ratings & Outlook

Issuer rating	BBB+
Outlook	Stable
Senior unsecured debt rating	BBB+
Senior unsecured (subordinated) rating	BBB
Tier 2 instruments rating	BB+

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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 1990s, the group started to expand in Central and Eastern Europe (CEE) through several acquisitions. Today its operations span 12 countries across CEE and Asia. 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 39.6trn (EUR 101bn as of September 2023). As a universal bank, OTP provides a broad range of lending, savings and investment products in Hungary and 10 CEE countries: Bulgaria, Slovenia, Croatia, Serbia, Romania, Ukraine, Russia, Montenegro, Moldova and Albania. The group entered the Uzbek market in 2023 with the acquisition of Ipoteka Bank.

Recent events:

- In November 2023, the group reported very strong 9M results, mainly on the back of growing interest margins and loan volumes and a cost of risk of close to zero. Negative adjustments significantly declined compared to the 2022 level, which saw the group facing Russia-related impairments and higher special tax.
- July 2023: OTP performed well in the EBA's EU-wide stress test scenario, ranking fourth among 70 banks in terms of the decline in fully loaded CET1 ratio over 2022-2025 under the adverse scenario (-77 bps).
- In January 2023, the Slovenian competition authority approved OTP's acquisition of Nova KBM.
- In December 2022, the group signed an agreement to acquire around 97% of Ipoteka Bank, Uzbekistan's fifth-largest financial institution. As of September 2023, its net loans account for 4.2% of the group's total.

Summary rationale for the rating construct			
Step		Assessment	Summary rationale
STEP 1	Operating environment	Very supportive	<ul style="list-style-type: none"> OTP is based in Hungary, one of the largest and developed countries in CEE. Hungary's regulatory and legal framework is somewhat less strong than those in markets we assess as 'supportive'; a polarised political environment adds an element of unpredictability. Some of the group's markets expose it to reputational and litigation risks on top of greater macro volatility
		Supportive	
		Moderately supportive	
		Constraining	
		Very constraining	
	Business model	Very resilient	<ul style="list-style-type: none"> 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. OTP's strategy is centred around growth, both organic and inorganic.
		Resilient	
		Consistent	
		Focused	
		Narrow	
	Mapping refinement	High	<ul style="list-style-type: none"> The 'low' refinement reflects OTP's lower business diversification than peers and growth appetite in frontier markets
		Low	
	Initial mapping	bbb-/bbb	
	Long-term sustainability	Best in class	<ul style="list-style-type: none"> OTP launched an ESG strategy that contains interim goals for 2025. We note that in regard to ESG matters, the group may face increasingly higher expectations and stricter regulations as it becomes larger and more relevant in the euro area. OTP has the scale to be a leading player in digital banking.
		Advanced	
		Developing	
		Constrained	
		Lagging	
	Adjusted anchor	bbb-	
STEP 2	Earnings capacity & risk exposures	Very supportive	<ul style="list-style-type: none"> Strong earnings capacity backed by high interest margins (even when corrected for provisions), although operating efficiency could improve further. Asset quality metrics are slightly worse than European standards but have improved significantly in recent years. Exposure to Hungarian sovereign risk as a percentage of the group's CET1 capital has decreased alongside the group's international expansion.
		Supportive	
		Neutral	
		Constraining	
		Very constraining	
	Financial viability management	Ample	<ul style="list-style-type: none"> A healthy capital position is backed by strong operating performance, which offsets impacts from M&A activity and organic growth. Mostly deposit-funded; prompted by regulatory requirements, access to international capital markets has increased to fulfil MREL requirement (binding from 1 January 2024).
		Comfortable	
		Adequate	
		Limited	
		Stretched	
	Additional factors	At risk	<ul style="list-style-type: none"> No additional factors
		Significant support factor	
		Material support factor	
		Neutral	
		Material downside factor	
		Significant downside factor	
	Standalone	bbb+	
STEP 3	External support	Not applicable	
	Issuer rating	BBB+	

Strong retail and commercial banking franchise in CEE

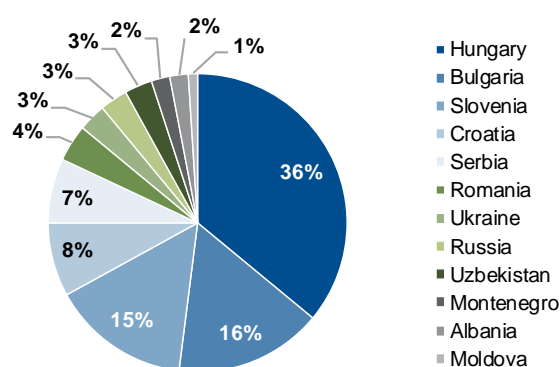
The 'resilient' business model assessment reflects the group's high geographical diversification and strong market position in most of its markets. It also considers the group's good revenue and profit record. The focus on commercial banking and lack of a strong franchise in insurance and wealth management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

The first strength of OTP's business model is geographic diversification. After two decades of international expansion, foreign markets now make up almost two-thirds of OTP's assets and revenues. The proportion of income deriving from euro-area countries has also grown, surpassing 35% in Q3 2023.

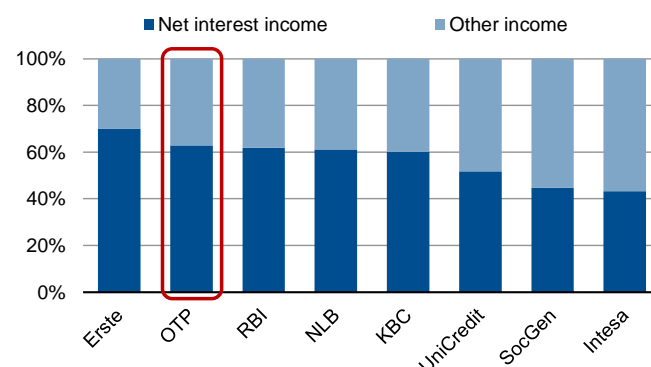
More than 60% of the group's top line derives from net interest income, reflecting the focus on retail and SME lending (Figure 2).

Figure 1: OTP asset breakdown by country, Q3 2023



Source: company data, Scope Ratings

Figure 2: Main sources of revenue*, international peer comparison

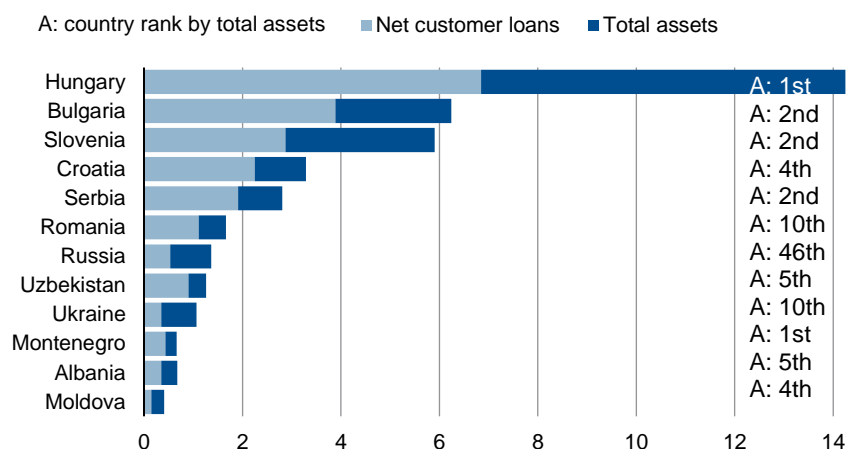


Source: SNL, Scope Ratings
*Average between 2019, 2020, 2021, 2022, H1 2023 results

OTP's second strength lies in its market position. In Hungary, it is the clear market leader with market shares of well above 30% in mortgage loans and household savings. 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 15 years, from 7.5% to 19.8%. In household savings, market shares increased from 27% in 2011 to 30.1% in September 2023.

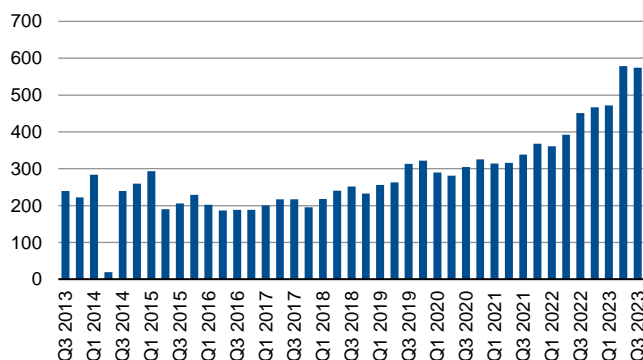
OTP is also an important player in most of the foreign countries where it operates. The Nova KBM acquisition has made OTP the largest bank in Slovenia by total assets. It is second largest in Bulgaria and in Serbia, and the fourth largest in Croatia¹.

¹ All in terms of total assets.

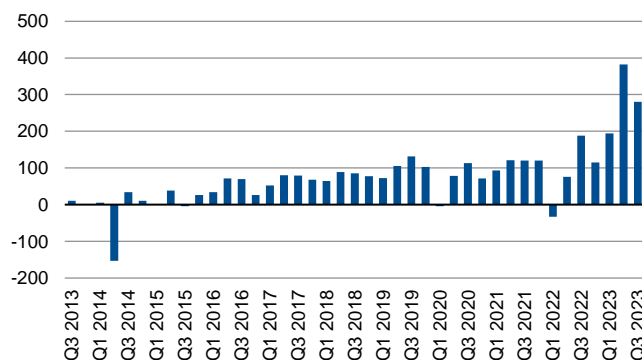
Figure 3: OTP's operations by country, Q3 2023


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

OTP has a sound record of revenue and earnings growth, which proved resilient during and after the Covid pandemic (Figure 4 and 5). The group reported only two quarterly losses during the past nine 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

Nine acquisitions in past six years

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 CEE, OTP has acquired eleven banks over the last six years, for a book value of over EUR 3.6bn. The last two were acquired in 2023: Slovenian Nova KBM and Uzbek Ipoteka Bank. A presence in growth markets with high margins and OTP's strong record of integrating acquisitions have enabled the group to achieve high profitability and rapid growth (Figures 6 and 7).

Growing geographical diversification has made the group less dependent on the Hungarian economy. OTP sees foreign currency earnings as a hedge because underperformance of the Hungarian economy typically results in the depreciation of the forint, and vice versa.

Earnings could be hit hard in risky markets

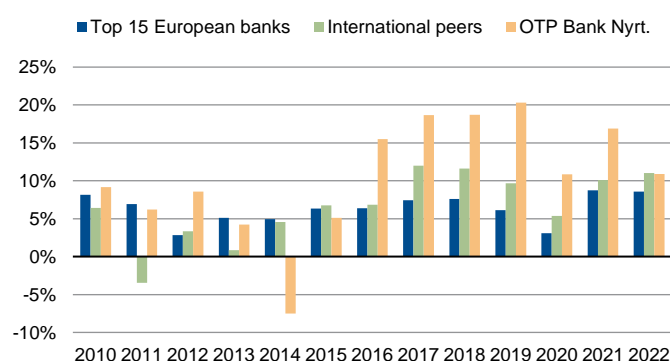
The group's capital position is naturally protected against ordinary exchange rate movements. Intra-group funding is limited. Hence, the group's subsidiaries are funded mainly locally and have a limited exposure to foreign currencies, which means only their equity is exposed to changes in FX rates. A 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.

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

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 the potential failure to adequately control credit origination and risk in new subsidiaries.

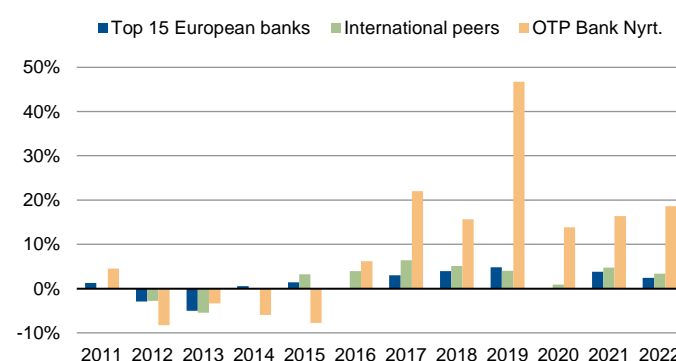
Not all the group's investments have been successful. In Slovakia and Romania, OTP has never achieved the size needed to roll out the strategy it has applied elsewhere. For this reason, the group left Slovakia in 2020 and is now considering the same in Romania.

Figure 6: Return on average equity, historical vs peer median



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, and NLB.

Figure 7: Annual growth in net customer loans, historical vs peer median



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, and NLB.

Despite the adverse developments in Russia and Ukraine, OTP's management has not lost its appetite for growth in frontier markets. In 2023, it acquired Ipoteka Bank, Uzbekistan's fifth-largest financial institution. As of September 2023, its net loans account for 4.2% of the group's total.

Box A: Focus on OTP's country of domicile: Hungary
Macroeconomic assessment – key credit considerations

- Hungary is one of the largest economies in CEE. However, 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 enjoyed sustained economic growth, supported by large foreign investments and EU funding.
- However, short- to medium-term growth prospects have worsened due to a mix of external risks (lower demand from key export markets, supply chain disruptions, currency weaknesses), high inflation and rising borrowing costs.
- Hungary has good reserve adequacy, a moderate proportion of foreign currency-denominated government debt and a favourable public debt profile. The government has regular access to foreign and domestic financing.
- Hungary's governance indicators (World Bank) have recently 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.
- In February 2023, Scope downgraded Hungary's sovereign debt to BBB/Stable from BBB+/Negative.

Key economic indicators	2020	2021	2022	2023F	2024F
GDP per capita (USD'000s)	16.3	18.9	18.6	NF	NF
Real GDP, % change	-4.7	7.2	4.6	0.1	2.5
Unemployment rate, %	4.1	4.0	3.6	4.3	4.1
CPI, % change	3.4	5.2	15.3	17.5	5.3
Policy rate, %	0.6	2.4	13.0	11.5	6.5
General government debt, % of GDP	77	74	71	68	62

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

Soundness of the banking sector – key credit considerations

- The Hungarian banking sector is moderately concentrated and dominated by OTP, which holds market shares of above 30% among retail customers and 20% among business clients. The top five institutions make up more than 50% of total domestic 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 (over 40%) and other financial corporations. Consumer lending accounts for about 50% of household lending in Hungary, which is a much larger percentage than for banks in Western Europe.
- In the past years, the banking sector has been characterised by high interest margins, low cost-to-income ratios, moderate loan losses and sound bottom-line returns.
- In a high inflationary and interest rate environment, Hungarian banks are performing well on average, offsetting the impact from the interest rate cap on mortgages and SME loans and from the windfall tax.

Although the non-performing loan (NPL) ratio is still higher than the EU average, it has drastically declined over the past years, from 17% in 2013 to 2.8% as of June 2023.

Amid rapidly changing conditions, banks continue to comfortably meet funding and liquidity requirements. The latest liquidity stress test by the Hungarian Central Bank shows that the sector can withstand a severe shock consisting, among others, of a 11% decline in non-financial sector deposits, drawdowns in credit lines, as well as interest rate and exchange rate shocks.

- Bank oversight in Hungary is solid. The country is subject to the EU framework for banking and financial regulation, including the Capital Requirements Directive and the Bank Recovery and Resolution Directive. Since incorporating the Financial Supervisory Authority in 2013, the Hungarian Central Bank has acted as the prudential supervisor and resolution authority.

Banking system indicators	2018	2019	2020	2021	2022
ROAA, %	1.9	1.7	0.8	1.3	1.1
ROAE, %	15.4	15.1	7.6	13.4	12.1
Net interest margin, %	3.3	3.3	2.8	2.8	3.6
CET1 ratio, %	17.3	15.8	16.9	17.6	16.6
Problem loans/gross customer loans, %	6.4	4.2	3.8	3.7	3.7
Loan-to-deposit ratio, %	75.7	79.0	73.3	70.8	71.6

Source: Scope Ratings, SNL

Long journey ahead to become ESG and digital leader in CEE

The 'developing' long-term sustainability assessment reflects the group's ongoing efforts in the environmental, social and governance (ESG) and digital areas. Following the Covid pandemic, the group has increased its digitalisation efforts, aiming to provide market-leading digital solutions and increase group-wide efficiency. The group has also launched an ESG strategy containing interim goals for 2025.

Figure 8: Exposure and management of key ESG-D factors²

	Industry level			Issuer level						
	Materiality			Exposure			Management			
	Low	Medium	High	Low	Neutral	High	Weak	Needs attention	Adequate	Strong
E Factor		◊			◊			◊		
S Factor	◊				◊				◊	
G Factor			◊			◊			◊	
D Factor			◊		◊				◊	

Source: Scope Ratings

The breadth of OTP's operations across CEE and its large number of acquisitions in recent years expose the group to high governance risk.

OTP adopts a two-tier system entailing an oversight body (supervisory board) and an executive body (board of directors). Pursuant to the law, most supervisory board members are independent (four out of six). Regarding the board of directors, seven of the 11 members do not hold executive roles but are entitled to share-based compensation.

The board's average tenure is 11 years, with six directors in office for more than 20 years. The chair of the board of directors is also group CEO. However, no significant issues have arisen to date, a sign of sound governance and risk management.

We caution that the group may face increasingly higher stakeholder and supervisory expectations with respect to ESG issues as it becomes larger and more relevant in the euro area.

With some delay compared to leading banks in western Europe, OTP is rolling out its first ESG strategy, focusing on three areas: i) increasing the stock of green loans, from HUF 230bn at YE 2022 to HUF 1,500bn by end-2025; ii) reducing its own emissions; and iii) increasing transparency and corporate responsibility, by targeting a listing in the Dow Jones Sustainability Index by 2025.

The group has not yet published detailed information on its exposure to climate-related risks.

The group has the scale and profitability to invest major resources in digitalisation. It has been improving back-end and front-end processes for more than a decade but has been less vocal on digitalisation than international peers.

The Covid pandemic pushed OTP to accelerate its digital transition. In 2021, the group created a Digital Division and set two main objectives: providing market-leading digital solutions and increasing group-wide efficiency and IT security.

Convincing risk oversight despite rapid growth in CEE

Ambition to become regional leader in green transition and sustainable finance

Accelerating digitalisation to meet evolving client needs and preferences

² The overview table illustrates how each factor informs our overall long-term sustainability assessment. The materiality table shows how we view the credit relevance of each factor for the industry at large. The exposure table shows how we see the issuer's degree of exposure to each ESG-D factor. The management table shows how we view the issuer's management of these exposures.

Return on average equity above 10% during Covid pandemic

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

Strong earnings thanks to high interest margins and loan growth

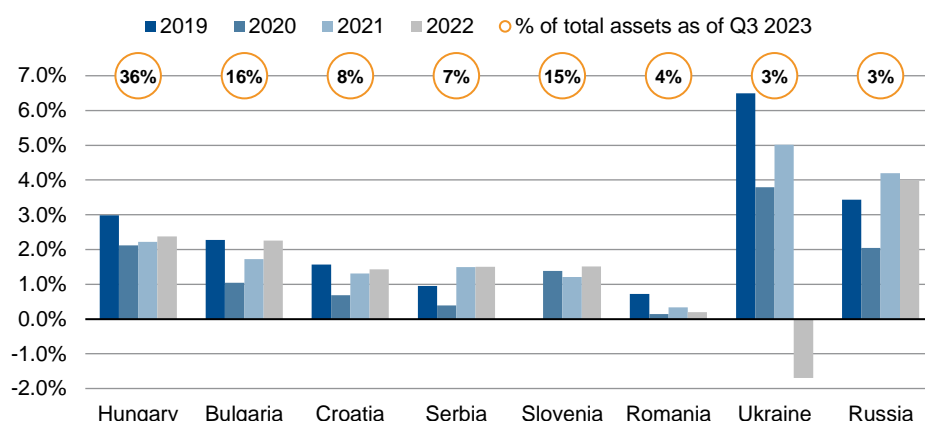
The 'supportive' earnings and risk exposures modifier is driven by OTP's superior earnings generation compared to that of national and international peers thanks to its presence in high-growth markets. The group's improving asset quality metrics over the past few years supports this assessment. The exposure to Hungarian sovereign risk is manageable, helped by the dilution effect from the group's international growth.

Since 2016, OTP has outperformed international peers in terms of both returns and lending growth. OTP's return on equity averaged 16% during this period³.

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

The group's profitability remained robust during the Covid pandemic, although revenue growth slowed initially, and credit provisions quadrupled to 115 bps of customer loans. But in 2022, the bottom line was affected by several one-off items, including special taxes on financial institutions, the cap on loan rates in Hungary, and impairments on Russian exposures.

Figure 9: Adjusted ROA* by country, last four years

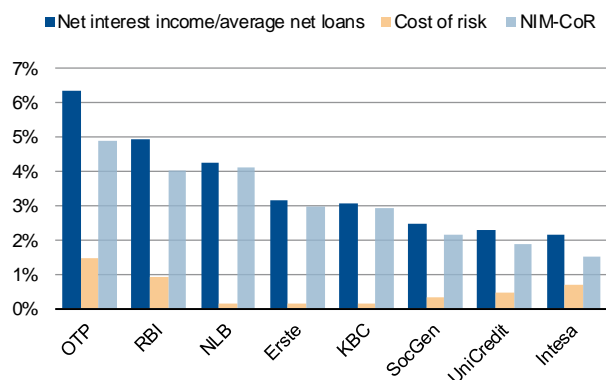


Source: company data, Scope Ratings
 *After conversion to HUF and exclusion of extraordinary items. Estimated using end-of-year balance sheet figures; main countries only (Montenegro, Albania and Moldova excluded).
 Note: Adjusted ROA in Ukraine in 2022: -3.8%

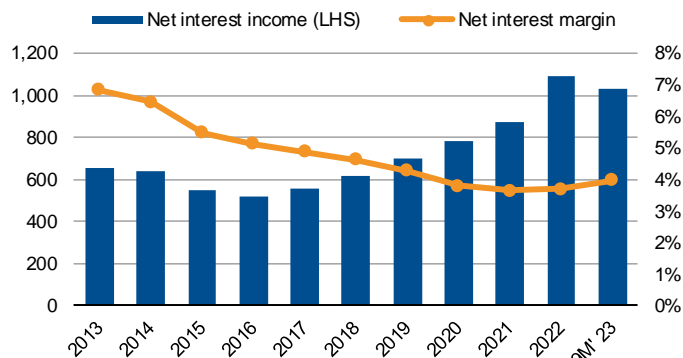
Unlike international peers, OTP has not reported a large rebound in interest margins since the beginning of the tightening cycle. This is due to a mix of factors, including: i) an increase of the share of lower-margin business; ii) an interest rate cap on retail and SME loans in Hungary; and iii) the fast repricing of deposits in CEE. Nevertheless, OTP's revenues have continued to grow on the back of resilient loan demand and acquisitions.

Nevertheless, OTP's net interest margin remains significantly higher than that of international peers (Figure 10). Together with strong loan growth, high margins are the backbone of OTP's profitability.

³ 2016-2022

Figure 10: Interest margins, gross and net of cost of risk, 2022


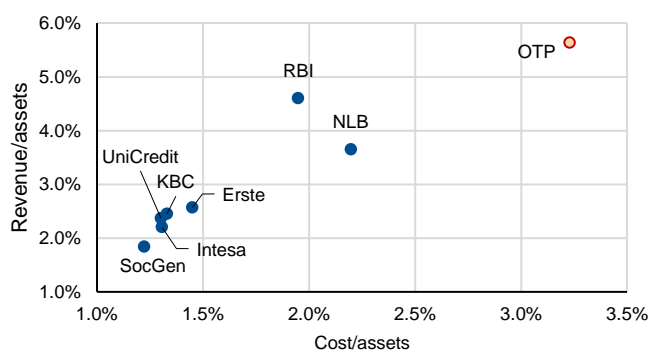
Source: SNL, Scope Ratings
 Note: NIM (net interest margin) and CoR (cost of risk) calculated on net customer loans

Figure 11: Net interest income (in HUF bn) and margin, historical


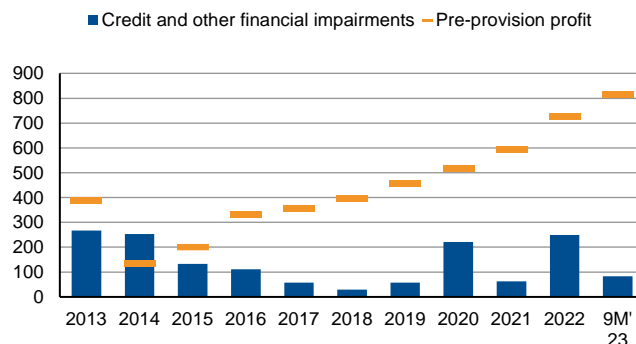
Source: SNL, Scope Ratings
 Note: Net interest margin calculated on total financial assets

Over the past years, 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 credit losses, even when cost of risk spiked like in 2020 (due to Covid) and in 2022 (due to Russia and Ukraine). In the first nine months of 2023, cost of risk (adjusted for the effect of acquisitions) was nil thanks to resilient credit quality and the release of reserves accumulated during the Covid pandemic.

Figure 12: Breakdown of 2022 cost-to-income ratio, peer comparison


Source: SNL, Scope Ratings

Figure 13: Pre-provision profits vs financial impairments (HUF bn)


Source: SNL, Scope Ratings
 Note: 9M '23 statutory credit impairments impacted by 2023 acquisitions

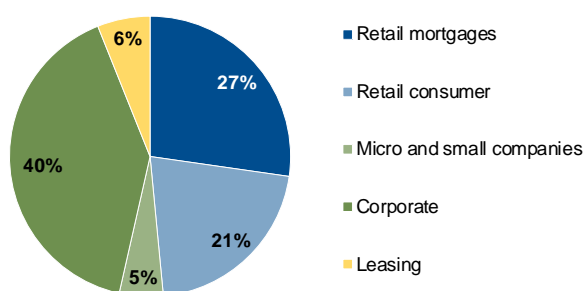
Underlying earnings capacity will remain strong

In 9M 2023, OTP reported an adjusted return on equity of 29.8%. Although this profitability is unlikely to be sustained in the medium term, we believe OTP's capacity to generate earnings will remain credit-supportive given its high geographical diversification and strong market positions at home and abroad.

Going forward, the main downside risks for OTP's profitability derive from: i) further government measures across CEE in the form of rate caps, bank levies and increased regulatory contributions; ii) higher-for-longer inflation and interest rates through their effects on economic growth and borrowers; and iii) growing geopolitical issues affecting public confidence, the economy and financial markets.

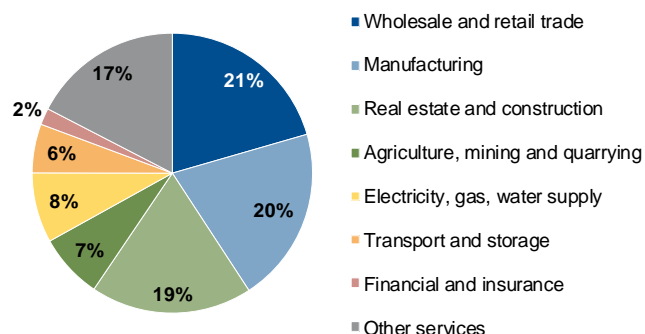
Almost half of the group's loan book relates to retail (48%), with roughly a 60-40 split between mortgages and consumer credit as of Q3 2023. The rest of the loan book breaks down into corporate and public sector loans (40%), leasing (6%) and micro/small companies (5%).

Figure 14: Gross customer loans breakdown, Q3 2023



Source: company data, Scope Ratings

Figure 15: Business loan book* breakdown, Q2 2023

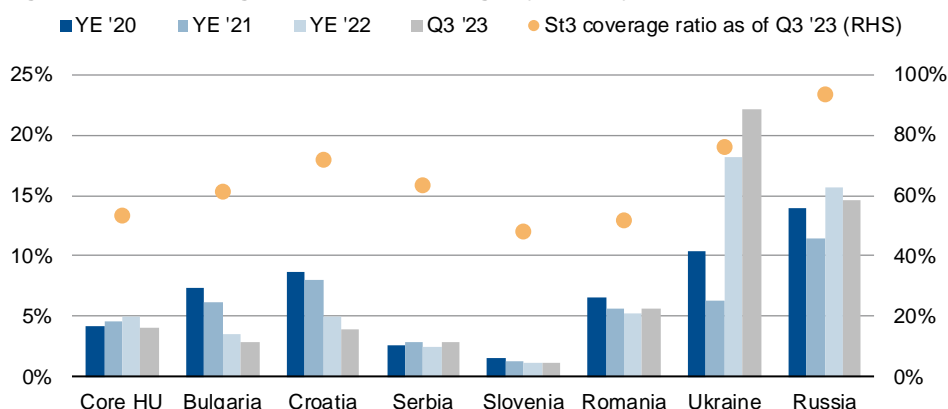


Source: company data, Scope Ratings
*Excluding public sector

Since 2014, OTP's asset quality metrics have improved significantly amid supportive economic conditions. The trend also continued during and after the Covid pandemic owing to low default rates. As of September 2023, the Stage 3 ratio stood at 4.3%, down 63 bps since the beginning of the year.

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 OTP's markets, a feature we capture in our operating environment assessment. We do not further penalise the group for its asset quality. Almost half of impaired loans are in Hungary, Bulgaria and Croatia, where Stage 3 ratios were 4.1%, 2.8% and 3.9% respectively.

Figure 16: OTP's Stage 3 ratio and coverage by country



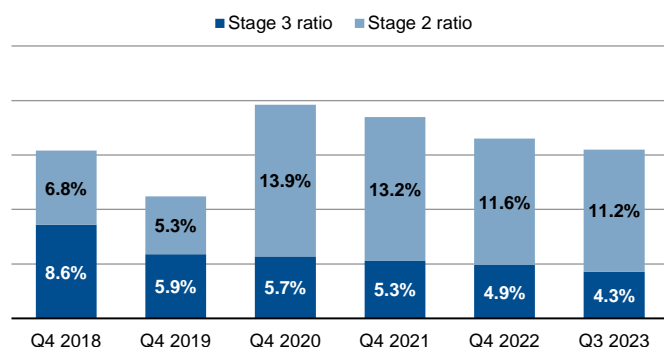
Source: SNL, Scope Ratings
Note: ratios calculated on gross values

NPL workout preferred to disposal

The group's Stage 3 ratio in Hungary is also slightly higher compared to peer average, mainly reflecting the strategic preference for working out deteriorated positions internally rather than selling them at a discount. As long as the group has the right expertise, this strategy can lead to higher final recovery rates and better customer retention. OTP has several entities that collect debt across its markets. In Hungary, it employs around 500 people and has long experience in the field.

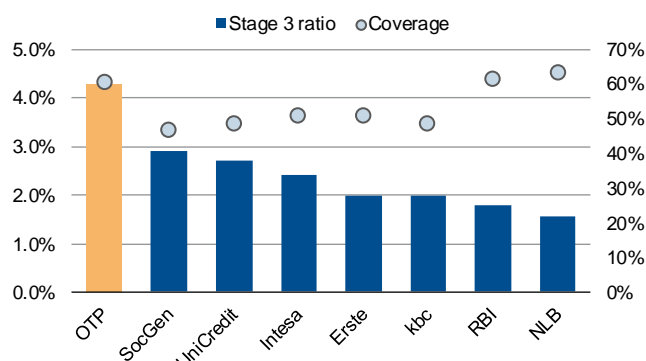
As of September 2023, the Stage 2 ratio was also high by European standards. Stage 2 loans significantly increased at the beginning of the pandemic due to the reclassification of corporate exposures based on sectors and the credit migration of some retail positions. Thereafter, the ratio has been declining, reflecting low credit deterioration (Figure 17).

Figure 17: OTP's Stage 2 and 3 ratios, past quarters



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

Figure 18: Headline asset quality metrics, peer comparison – Q3 2023



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

Manageable exposure to domestic sovereign debt

OTP has a material concentration towards the domestic sovereign risk, particularly through government bonds. However, we do not consider this exposure as a high risk (Hungary is rated BBB/Stable by Scope) and also note that this concentration has gradually been diluted through the growing presence in CEE and Asia.

As of September 2023, OTP held almost HUF 3.1trn of Hungarian government bonds, with an average maturity of 3.6 years. This exposure is equivalent to just below 80% of the group's CET1 and Tier 1 capital. We estimate that the group could withstand significant losses on its sovereign bond portfolio in an event of sovereign default (unlikely as this may be for a BBB rated sovereign) while retaining its regulatory viability.

Therefore, we do not consider credit exposure to sovereign risk a constraint for the assessment of the group's earnings capacity and risk exposures.

Established in both Russia and Ukraine

OTP has been operating in Russia and Ukraine for more than 15 years. In Russia, subsidiary OAO OTP Bank is engaged mostly in consumer credit, ranking first in point-of-sale service and seventh in credit card lending. In Ukraine, CJSC OTP Bank is one of the largest players in the country and specialises in business lending.

Since the beginning of the armed conflict, operations have continued in both countries.

In Russia, the group has remained active in consumer credit but ceased business lending. Credit quality, like profitability, is still robust. Positively, OTP was able to withdraw maturing intra-group funding and upstream a dividend related to earnings generated since 2007.

In Ukraine, credit quality has stabilised after the heavy losses in 2022. The subsidiary's earnings have been driven by the deposits placed at the central bank in 2023.

Reputational and legal risks, rather than credit risk, stem from Russian operations

As of Q3 2023, the capital impact of a disorderly exit from Russia and Ukraine would be minimal (quantified at 27 bps by the group). However, although operations in the two countries may continue to be operationally and economically manageable, their sustainability is questionable. Since Russia has isolated itself from the Western world,

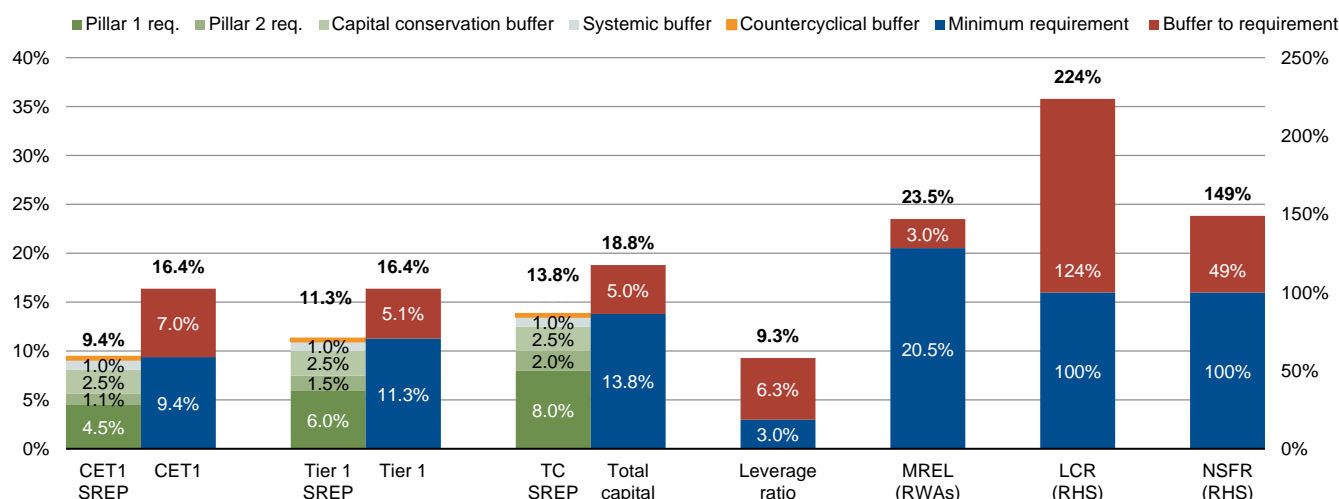
maintaining strong ties with a local subsidiary could become increasingly difficult. Moreover, investors or regulators could start to put pressure on OTP to exit. Reputational and legal risks could also emerge. That has already been the case in 2023, when the Ukrainian National Anticorruption Agency put OTP on its 'sponsors of war' list before backtracking in October.

In Ukraine, uncertainty about the length and consequences of the conflict will continue to hinder normal banking activity for a long time, in our view.

Healthy capital position fuelled by strong earnings generation

The 'comfortable' qualifier on OTP's financial viability management reflects the group's healthy buffers over regulatory requirements and its conservative capital management policy. The assessment is also driven by OTP's solid funding position, on the back of a large deposit base.

Figure 19: Overview of OTP's buffers above minimum requirements, Q3 2023



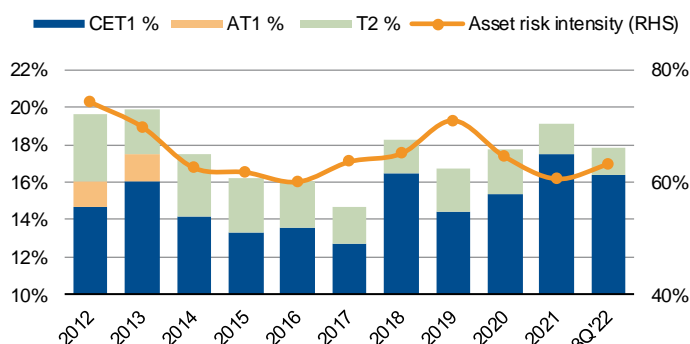
Source: company data, SNL, Scope Ratings
 Note: interim MREL requirement.

Strong capital position through past decade

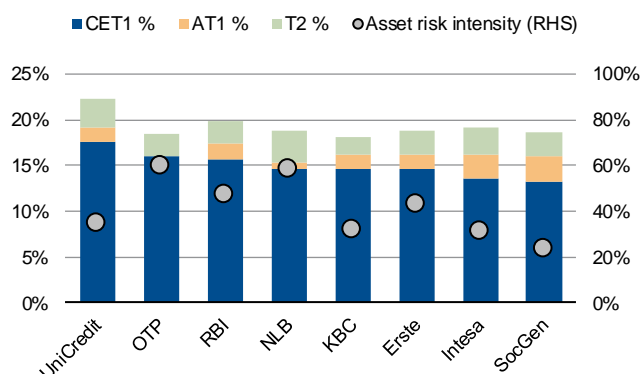
Over the past years, earnings retention has allowed the group to maintain a comfortable capital position. This is despite high organic growth and M&A activity, which are prioritised over dividends and share buybacks. In fact, the group's dividend payout ratio is low by European standards.

At the end of September 2023, the group's consolidated prudential CET1 ratio stood at 16.4%, the same level as the Tier 1 ratio because the group does not hold AT1 instruments. After issuing a USD 650m Tier 2 bond in January 2023, the group's Tier 2 bucket increased to around 2.4%.

The group's asset risk intensity is high at around 60% as of the end of September 2023 (Figure 21). There are two reasons for such a high figure: the use of standardised models to assess credit risk and a loan composition skewed towards unsecured lending.

Figure 20: OTP's capital ratios, historical


Source: SNL, Scope Ratings

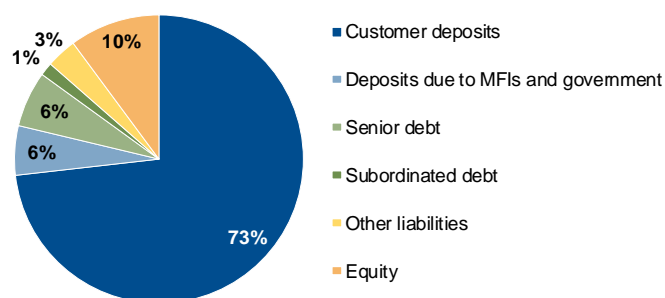
Figure 21: Capital ratios, peer comparison as of Q3 2023


Source: SNL, Scope Ratings

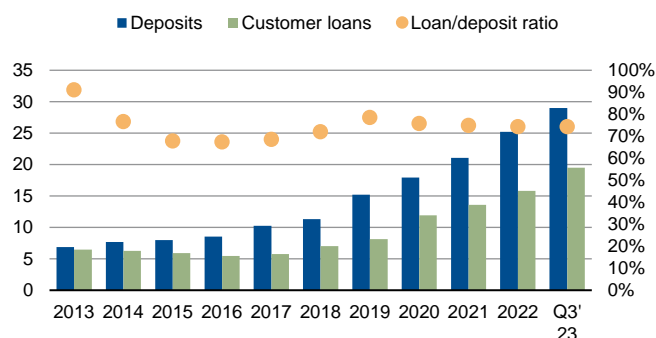
OTP funds mainly through customer deposits, which make up 73% of the group's balance sheet. In a high interest rate environment, the group's deposit base has been stable (net of M&A effects) due to OTP's dominant market position and customers' reluctance to switch to higher-yield investment products. Volume growth in most CEE markets has offset the decline in Hungary, where customers have rearranged savings and competition from debt agency-issuing bonds has increased.

The group used to issue retail bonds, although never in large quantities because retail customers have preferred to invest in government bonds.

The loan/deposit ratio is well below 100% at the end of Q3 2023.

Figure 22: OTP's liability structure, Q3 2023


Source: SNL, Scope Ratings

Figure 23: Loans and deposits (in HUF trn), historical


Source: SNL, Scope Ratings

Funding drawn from capital markets accounts for 6% 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. Issuance on international bond markets has materially increased since 2022, due to the need to fulfil the minimum requirement for own funds and eligible liabilities (MREL) which will be binding from 1 January 2024.

In the past two years, the most significant bond issuances to foreign institutional investors have been a EUR 400m senior preferred green bond in July 2022, a EUR 650m senior preferred bond in December 2022, the above-mentioned USD 650m Tier 2 bond in January 2023, a USD 500m senior preferred in May 2023 and a EUR 650m senior preferred in October 2023.

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.

Higher bond issuance since 2022
to fulfil MREL



OTP Bank Nyrt. Issuer Rating Report

The group does not currently make full use of AT1 or senior non-preferred debt to fulfil MREL. As of September 2023, it met the interim requirement of 20.5% of its total risk exposure, with 23.5%. The pro-forma ratio is 24.8% including bonds issued after Q3.

Liquidity buffers are comfortable. As of Q3 2023, the liquidity coverage ratio stood at 224%, while the net stable funding ratio was at the 149% requirement.

Debt ratings

Senior unsecured debt rating: BBB+

We rate senior preferred/unsecured debt instruments at the level of the issuer rating

Senior unsecured (subordinated) debt rating: BBB

We rate non-preferred senior unsecured debt one notch lower than the issuer rating. This additional downward notch reflects its statutory subordination.

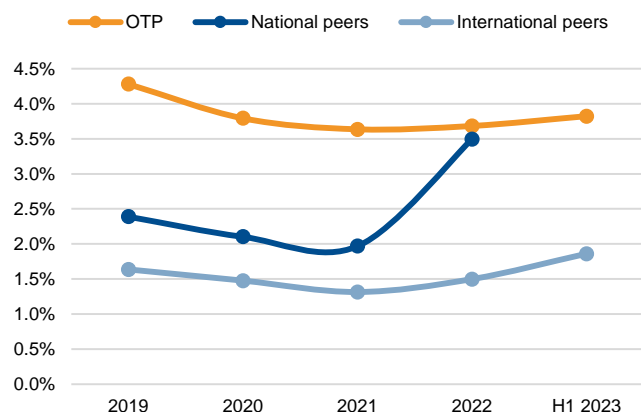
Tier 2 debt rating: BB+

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

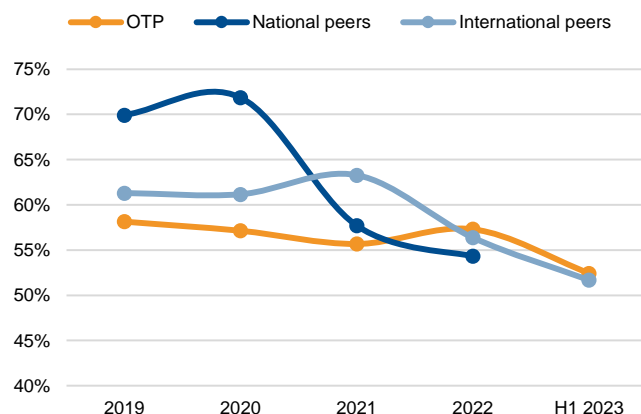
The group currently has two bonds outstanding that classify as Tier 2 complying with Capital Requirements Directive IV, for a total amount of about EUR 1,100m.

I. Appendix: Peer comparison

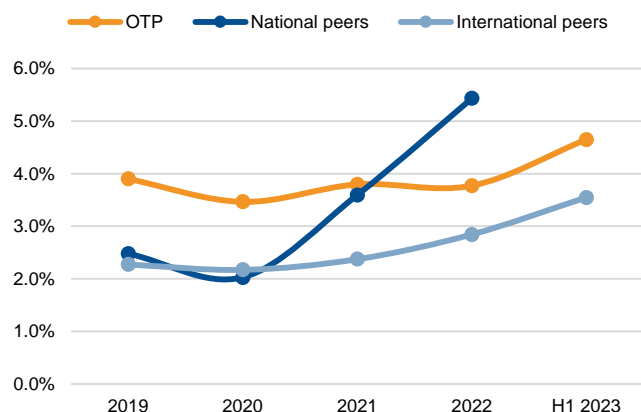
Net interest margin



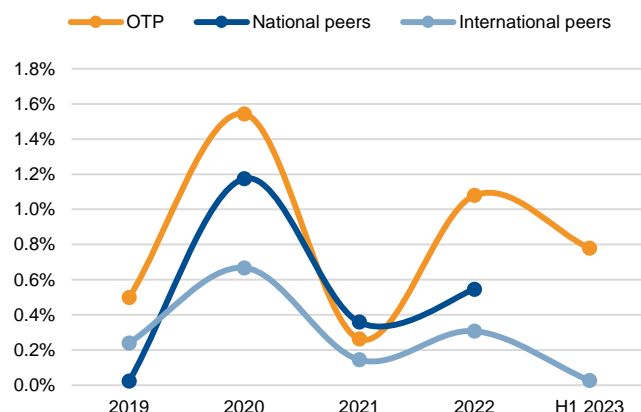
Cost/income



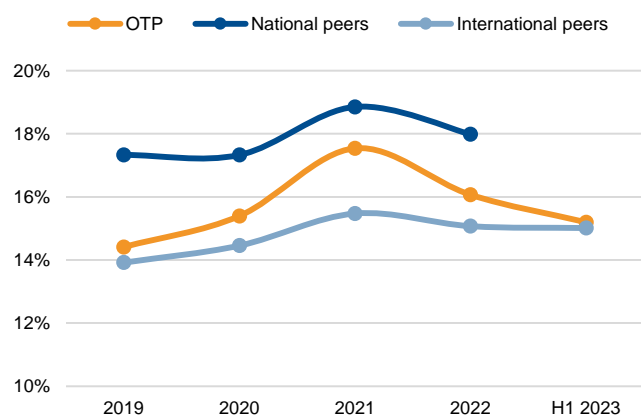
Pre-provision income/risk-weighted assets (%)



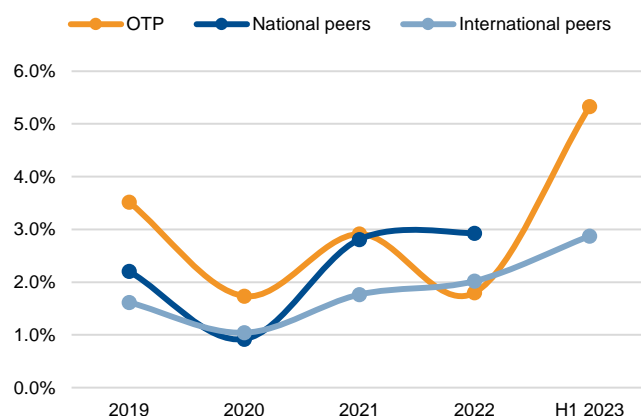
Loan loss provisions/average gross loans



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, and NLB

Note: too few H1 2023 data points for national peers.

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

	2019	2020	2021	2022	9M 2023
Balance sheet summary (HUF bn)					
Assets					
Cash and interbank assets	2,127	3,581	4,141	5,572	8,058
Total securities	4,721	5,193	6,537	7,157	8,091
of which, derivatives	118	124	203	325	NA
Net loans to customers	11,908	13,553	15,772	18,709	21,534
Other assets	1,365	1,008	1,104	1,366	1,891
Total assets	20,122	23,336	27,553	32,804	39,574
Liabilities					
Interbank liabilities	844	1,219	1,609	1,517	2,191
Senior debt	448	631	569	1,152	2,475
Derivatives	97	116	214	414	256
Deposits from customers	15,171	17,891	21,069	25,189	28,968
Subordinated debt	250	275	278	302	585
Other liabilities	1,020	667	779	908	1,092
Total liabilities	17,830	20,799	24,517	29,482	35,567
Ordinary equity	2,286	2,533	3,031	3,316	3,999
Equity hybrids	0	0	0	0	0
Minority interests	5	4	6	6	8
Total liabilities and equity	20,122	23,336	27,553	32,804	39,574
<i>Core tier 1/ common equity tier 1 capital</i>	<i>2,055</i>	<i>2,316</i>	<i>2,927</i>	<i>3,278</i>	<i>3,806</i>
Income statement summary (HUF bn)					
Net interest income	699	783	874	1,091	1,034
Net fee & commission income	374	398	442	600	514
Net trading income	18	35	10	-15	83
Other income	3	-6	16	24	0
Operating income	1,093	1,209	1,342	1,701	1,631
Operating expenses	636	691	747	975	814
Pre-provision income	458	518	595	726	817
Credit and other financial impairments	57	222	62	249	83
Other impairments	13	7	5	86	NA
Non-recurring income	80	8	0	4	243
Non-recurring expense	0	0	0	0	0
Pre-tax profit	467	298	528	395	978
Income from discontinued operations	-5	6	0	11	0
Income tax expense	50	44	72	59	120
Other after-tax items	0	0	0	0	0
Net profit attributable to minority interests	0	0	1	1	1
Net profit attributable to parent	412	259	456	346	857

Source: SNL, Scope Ratings



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

	2019	2020	2021	2022	9M 2023
Funding and liquidity					
Net loans/ deposits (%)	75%	71%	70%	69%	70%
Liquidity coverage ratio (%)	169%	214%	180%	172%	224%
Net stable funding ratio (%)	125%	139%	139%	137%	NA
Asset mix, quality and growth					
Net loans/ assets (%)	59.2%	58.1%	57.2%	57.0%	54.4%
Problem loans/ gross customer loans (%)	5.7%	5.1%	4.8%	4.6%	4.3%
Loan loss reserves/ problem loans (%)	93.9%	115.8%	110.2%	112.3%	105.2%
Net loan growth (%)	46.7%	13.8%	16.4%	18.6%	20.1%
Problem loans/ tangible equity & reserves (%)	26.4%	23.4%	21.8%	22.1%	20.3%
Asset growth (%)	37.9%	16.0%	18.1%	19.1%	27.5%
Earnings and profitability					
Net interest margin (%)	4.3%	3.8%	3.6%	3.7%	4.0%
Net interest income/ average RWAs (%)	6.0%	5.2%	5.6%	5.7%	6.2%
Net interest income/ operating income (%)	63.9%	64.7%	65.1%	64.2%	63.4%
Net fees & commissions/ operating income (%)	34.2%	32.9%	32.9%	35.3%	31.5%
Cost/ income ratio (%)	58.2%	57.1%	55.7%	57.3%	49.9%
Operating expenses/ average RWAs (%)	5.4%	4.6%	4.8%	5.1%	4.9%
Pre-impairment operating profit/ average RWAs (%)	3.9%	3.5%	3.8%	3.8%	4.9%
Impairment on financial assets / pre-impairment income (%)	12.5%	42.8%	10.4%	34.3%	10.2%
Loan loss provision/ average gross loans (%)	0.5%	1.5%	0.3%	1.1%	0.6%
Pre-tax profit/ average RWAs (%)	4.0%	2.0%	3.4%	2.1%	5.9%
Return on average assets (%)	2.4%	1.2%	1.8%	1.1%	3.1%
Return on average RWAs (%)	3.5%	1.7%	2.9%	1.8%	5.2%
Return on average equity (%)	20.3%	10.8%	16.9%	10.9%	32.3%
Capital and risk protection					
Common equity tier 1 ratio (% , fully loaded)	14.4%	15.4%	NA	NA	NA
Common equity tier 1 ratio (% , transitional)	14.4%	15.4%	17.5%	16.1%	16.1%
Tier 1 capital ratio (% , transitional)	14.4%	15.4%	17.5%	16.1%	16.1%
Total capital ratio (% , transitional)	16.8%	17.7%	19.1%	17.5%	18.4%
Leverage ratio (%)	8.6%	9.2%	10.1%	9.5%	9.3%
Asset risk intensity (RWAs/ total assets, %)	70.9%	64.5%	60.6%	62.2%	59.9%
Market indicators					
Price/ book (x)	1.9x	1.5x	1.5x	0.9x	0.9x
Price/ tangible book (x)	2.1x	1.6x	1.7x	0.9x	1.0x
Dividend payout ratio (%)	NA	NA	NA	23.3%	NA

Source: SNL, Scope Ratings



OTP Bank Nyrt. Issuer Rating Report

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