Transcription for BANK VOZROZHDENIE

November 25th 2014

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Presentation

Operator
Ladies and gentlemen, welcome to Bank Vozrozhdenie Nine Months 2014 Earnings Conference Call. I now hand over to your host, Elena Mironova, Deputy Head of IR. Madame, please go ahead.

Elena Mironova
Hello dear colleagues, we are glad to welcome you on our conference call and webcast. As usual, the reporting and the relevant press release, presentation and factsheets are published in the Investor Relations section of the website at www.vbank.ru and you can always contact IR for some additional questions.

This time, I will just briefly speak about the key developments of the quarter and then we will move to the Q&A session with Andrey Shalimov, Deputy Chairman of the Management Board.

Well, the bank's net income for nine months 2014 grew by 60% year-over-year, which is a positive result and in line with our expectations, though, on a quarterly basis we saw a 14% decline. Q3 was the first quarter when all the negative macro developments that have been evolving in 2014 started to filter into the performance of the market participants on a broader level not affecting just the large companies. We saw a sharp Rouble devaluation amidst falling oil prices, accelerating inflation moved the rates up and the economy growth was sluggish, aggravated by geopolitical tensions. In such an environment we prefer to be conservative and limit credit risks; both the strict underwriting criteria and lower qualitative demand resulted in the corporate loan portfolio contraction by 1.2% quarter-over-quarter. Moving to slide 5, you can see more details on that.

On the bottom breakdown you can see that large corporates were almost flat quarter-over-quarter, but mostly due to FX re-pricing, it was around RUB 1.2 billion, and the majority of our FX loans fall into this large category, as it is mostly export companies with FX revenues. Excluding this effect, we would see a decline. We work more actively with the SMEs. On the right graph you see that the level of new issuances to both new and existing customers was at around RUB 5.5 billion, but this growth was offset by large repayments. The most part of the book is short-term as we financed mostly working capital.

Retail remains the key growth driver, and this time consumer was leading the way, they were 7% up quarter-over-quarter. You should know that we didn't change our approach to consumer lending, we work majorly inside our client base, around 80% of the borrowers are our payroll clients whose revenues we can monitor. Moreover, if we exclude the effect of securitisation, mortgages would also demonstrate 3% growth quarter-over-quarter, roughly RUB 700 million, more or less the same level as the consumer.

In the credit quality development that should be of the most burning issues, we saw some pickup in the corporate NPLs. There was one client from the construction segment in the large corporates that went overdue, but as for now we expect it to recover. The problem was reasoned by bad payment discipline, not the general worsening of his financial standing. In the SME book there was a more pronounced deterioration and some indirect signs that was talked about on the previous calls now have translated into the growing share of NPLs. A number of small and medium companies from trade, industry, and construction went impaired. We have faced such a situation during the previous crisis. NPLs in SME can pick up quite quickly, but the loan workout process is much faster. Judging by the experience of 2008, many clients just recovered, some were restructured and recovered after that and if we go into the legal procedures, they normally move much smoother, because in many cases we are the only creditor.

Despite that, provisions were slightly down and we have guided it on the previous calls and we have finished excessive provisioning of large corporates that went impaired in 2013, but still, cost of risk remains conservative at 2.1% for nine months.

A little bit on the customer fund dynamics on slide 4, they were up well above the sector on both corporate and retail side, though we didn’t raise rates on deposits and even lowered rates on FX deposits; we are still facing quite strong demand for both Rouble and FX instruments in slight contrary to the whole sector.

All those trends have filtered into the P&L dynamics. Moving to slide 10 you can see the NIM trends. It weakened on a quarterly basis from 4.6% to 4.4%, though loan rates were up, the pressure coming from the higher deposit volume offset the growth of interest income. New deposits were raised on higher rates than the average for the portfolio and that also affected the margins. We have expected such trends, again, and the key for us was to protect net interest margin at 4.5%, and for nine months we were above this target.

On the right bottom graph you can see the spread dynamics; we have managed to protect it at 6.2%, supported by higher yields on interest earning assets.

Turning to slide 11, we are glad to note some positive dynamics of net fees for the second quarter in a row. They were 2% q-on-q, up after quite a serious drop in the first quarter. Though, it is still below 2014 level, we expect to narrow the gap in the fourth quarter, amidst both seasonally higher business activity and just some specific issues of our reporting, as in Q4 2013 we had reclassified part of net fees to future interest income, so fee revenues were relatively low. The general reasons lying behind this year-over-year drop are the lower commissions across the markets as the competition is getting very tough, aggressive policy of the payment systems and that really dilutes revenues from the card business. As we discussed previously, we need to replace a number of large borrowers by SMEs by diversifying the business and that of course takes time.

We work on enhancing customer engagement. In autumn, we have launched a new product for cash and settlements. There are sets of convenient services tailored especially for the SME clients. There is a base set and the one for the companies from trade and export sectors. They have lower entrance fees on this product, while rates inside on operations are marginally higher than the average portfolio that we have. We were glad to note that the demand for these products was quite strong. For the first two months we have gained almost 2,000 new customers, and we hope that this trend will continue. We keep dwelling on remote channels, internet and mobile bank for retail and corporate customers, and this October we were the first in Russia to launch cash-in-transit app for our clients in Moscow, it simplifies the utilisation of the services for the clients. Now, it is much easier to order cash collection and to reject it if necessary and to request some new points to be serviced. For us, it is a good option for centralised planning and it helps us to reach new customers within the already existing routes.

Moving further on the P&L, we were glad to see that the costs were flat quarter-over-quarter for the third quarter in a row. It was RUB 2.2 billion. On a year-over-year basis, we have recorded only 3% growth, that is even lower than the inflation level. We expect the costs to remain within single digits, though normally the heaviest burden falls on the fourth quarter and we can't be absolutely sure on that front.

As I said, provisions were slightly down quarter-over-quarter, but again, well, in the fourth quarter this situation is very uncertain because we can normally expect some large repayments closer to the end of December and that could affect both the portfolio dynamics and the provisions as well.

In the current environment, we have focused more on the risk management, the share of liquid assets rose to 23% of the book. As you see on slide 3, with assets and liabilities, we have increased the share of securities portfolio as loans were stagnating. We invest mostly in the short-term investment-grade bonds of sovereign and quasi-sovereign issuers, so the share of total securities portfolio rose to 8.5% of the book, and that has also supported the margins and the share of interest earning assets - it was the same as in the second quarter, 79%. Again, on the risks, we were glad to note the strong capital position, it is 12.2% on total capital adequacy ratio according to Basel III requirements and 9.6% for Tier 1 capital adequacy. The share of the Tier 1 in the total capital base is quite high, it is about 79%, which is higher compared with the average sector level of 74%. With such risk management, we are prepared for some possible negative developments We don’t want to be aggressive on growth, and while our targets on net interest margin and net profit remain intact, we want to support them for the whole year. In the vulnerable macro environment, we will keep working on improving our operating internal efficiency; the project on costs is still in place. We are moving further on it. Some projects are implemented for the whole bank or just for the Moscow region. We hope to see some first fruits going further.

From the business perspective, we just want to focus on picking up the best customers from the market, as the situation now is quite favourable for that.

That is all for the presentation and now let's move to the Q&A session.

Question and Answer Session

Operator
[Operator instructions]

Our first question is from Jason Hurwits, VTB Capital. Please go ahead.

Jason Hurwits
Good afternoon. I have two questions. The first one relating to loan quality. You mentioned that you believe the cost of risk that you have so far this year has been conservative, though we would note that the environment has gotten perhaps considerably worse from a loan quality perspective overall, and do you expect this cost of risk to be continued into the fourth quarter, and if you could give any sense of what you view looking at the next year as well on that, that would be fantastic.

The second question relates to the growth in your retail portfolio in the third quarter, which we noticed in the non-mortgage section. It grew quite quickly in the third quarter and seemed to have clearly set a different trend. It is the fastest it has grown in over a year it looks like. So is this some kind of a change in strategy to protect your margins, or was this a one-off, if you could give any insight on how we could look at that going forward, that would be great. Thanks.

Andrey Shalimov
Good evening, thank you, Jason. On your first question, yes, we can see that this 2%, something around 2% cost of risk as a current trend figure. We expect that in nearest quarters it could be something around this on average. In 2015, we base our scenarios for planning for next year on this figure.

Talking about the fourth quarter, in general, we believe that the average figure for the whole year should be somewhere about this 2%, but you know, it is a very volatile quarter, we can't exclude some number of repayments and as it was the case last year. In the fourth quarter last year, there was a tremendous reduction in provisioning, so there could be some surprises, but on average, we expect this 2% cost of risk.

Talking about the second question, about the splash in retail, I suppose, the key factor is that some people try to utilise their Rouble denominated facilities in expectation of devaluation or watching this devaluation. People try to buy something to protect themselves or simply to buy something in advance. So we consider this very fast growth as more a one-off event, and of course, it is a case for risk management considerations, since you know we are not very keen to expand in non-collateralised retail lending. With stabilisation in currency, maybe even at pretty high levels, this incentive for borrowers to tap those facilities should be on decline, and we expect low growth ratios in the fourth quarter.

Jason Hurwits
Low growth ratios meaning for this type of loan.

Andrey Shalimov
Yes, yes, for non-collateralised retail.

Jason Hurwits
Okay, and any updates on the broader guidance on loan growth?

Andrey Shalimov
I expect it is pretty conservative. The base case is single digit growth, somewhere between 5-8 in an environment of zero growth or even some small reduction in economy growth. But it depends, if we see some turn to the better, some positive signs, we could switch to, say, targeting 10% or even higher growth. The base case is single-digit growth for 2015. Then funding considerations, if the general level of Rouble rates could be pretty high, what could be the real rates for the eventual borrowers? If it could be close to positive, demand should be depressed. If we will see some serious inflation dip and negative rates in Roubles then we could expect higher loan growth ratio. So the floor is this 5%, the base case is somewhere close to 7-8%, and in some optimistic scenarios, it could be above 10%.

Jason Hurwits
Okay, thanks very much for your answers.

Andrey Shalimov
Thank you.

Operator
Our next question is from Olga Veselova, Bank of America. Please go ahead.

Olga Veselova
I have two questions. My first question is about cost of risk. You mentioned that you would expect a flattish cost of risk at about 2% in the next several quarters, so my question is about cost of risk in retail in particular. Do you think that weaker Rouble and as a result lower portion of disposable income which can be spent on interest payments will not have a negative impact on cost of risk in retail in the next quarters? Also, this question fairly relates to mortgage segment as well. I will ask my second question after.

Andrey Shalimov
Yes, we tried to check all that last year. When we decided on the growth of the book, we checked the sensitivity of our book to drop in disposable income and the base case was a 30% reduction. Even under those conditions, the model book faired pretty well. The serious consequences for our book should be at the magnitude of the drop closer to 50%. Then yes, we could feel some hit, but what we see now is still far from such drop in the incomes. Even in the case of this devaluation the lenders with currency exposure should be mostly concerned as incomes in Dollars shrunk by one-third exactly, that was our case. As we do business in Roubles, the reduction should be lower, provided 20, 25% food inflation, it is only 40% of the average budget. So the real drop from this situation should be still within 15%, not more, in our opinion. We are not worried on next year based on current trends, but future projects could be seriously affected. In the long run, I suppose, we could reassess the healthy segments of the customers with which we could be eager to do business with.

Currently, we don't expect that provisions on the book for 2015 would be at the same levels as in 2009, further development should be thoroughly checked.

Olga Veselova
Thank you. My other question is about your growth in mortgage segment. I remember that when we spoke at one of the previous quarters, I think we discussed that part of the reasons why there is a growth of mortgages is demand from population to convert savings into real estate, and this was

sort of a one-off type of demand. Looking at the banking sector statistics, I think stronger lending in mortgages sustained in the third quarter. Do you think this affect is not yet over and if you think it will be over, when do you think it can happen?

Andrey Shalimov
Even in this respect, this time we differ slightly. If the whole system didn't enjoy such an inflow of Rouble deposits, private Rouble deposits, as we did. On the other hand, we faced a serious slowdown in the mortgage business, so if you look at the growth ratio in the third quarter, it is not so eye-catching. In the fourth quarter, we see further slowdown in mortgage portfolio accumulation, so we really believe that this wave of excessive demand took place in the first quarter, and affected the whole first half of the year. Now the effect of such an event could be depressing for our book. We had exactly the dynamic we speculated about some time ago: pretty strong growth in the first half and some slowdown in the second half. Maybe some reasoning for that is not only in this exhaustion of additional demand. The rates pulled, since with the loss of AHML anchor in rates, the market could drift upward in rates respect, and there should be some additional interest burden on borrowers. State banks could offer some special programmes at some discounts, we will see, maybe that could be the engine of the growth in the segment.

Fairly, from the commercial point of view, we have all reasoning to increase rates, and that could be some natural limitation for this growth too. We see not so tremendous dynamic for mortgages, on the other hand, it is up for us to regulate this growth. The potential still could be up to 20% growth for next year, but what could be the actual target and what could be the target of business plan, is a matter of delicate balance of risk management and the interest rate.

Olga Veselova
Thank you so much for this. I will have one other question, it is the last one. Have you reacted on the base rate hike by the Central Bank? In other words, have you increase your interest rates on loans after the Central Bank has increased the base rate?

Andrey Shalimov
Yes, we did. It took some time, almost a month, I suppose. That type of increase was expected, not only by the banking system, but by most serious borrowers in the market. During November, most of the borrowers became accustomed to new price levels. The difference with the beginning of the year could be up to 3 percentage points for corporate customers and for

SMEs. Now, those rates in most cases are easily accepted in negotiations with the customers. I suppose, this increase was to some extent the last straw in this process, which really confirmed to the borrowers that the period of low rates may be over.

Olga Veselova
Thank you very much.

Operator
We have a question from Alex Kantarovich, J.P. Morgan. Please go ahead.

Alex Kantarovich
Thanks, hello, Andrey, hello, Elena, a couple of things from me. I noticed that Sberbank and VTB in various forms indicated a rise in delinquencies and rise in cost of risk ahead of yours. Since your NPLs are rising, it seems to me somewhat counterintuitive to see your flattish cost of risk with a hint that it may drop in Q4. If you can kind of provide more colour on how are you different from the big ones. Another question is, because I cannot navigate through the presentation easily on the site, if you indicate approximately the cost of risk across different lines, for example large corporates, SME, credit cards, mortgages, it would be very interesting. Thank you.

Andrey Shalimov
Thank you. On the dynamic of those ratios, indeed we started talking about all that two years ago. That was one of the reasons to be conservatively provisioned across all those years. The problems in the books of big banks, they were obvious two years ago too. We discussed that entire not once, simply for some reasons they decided not to show those NPLs in their books and not to make provisions that time. We decided in a slightly opposite way and we provisioned constantly across all the last two years. So subsequent increase in provisioning now could be relatively less for us, but you are right, we can't totally catch the loan negatives in advance. The key question now is whether those tougher requirements and lending standards we changed not once in recent years are enough to protect us from serious increase of NPLs.

We believe that there are not so much serious reasons for additional provisioning currently. Of course, from quarter-to-quarter, the results could be volatile, this 2% guidance is more an average figure.

Talking about the fourth quarter, there are a lot of technical factors; big repayments, for example, could easily change the whole composition of the provisions dynamic. The base case is to have this 2% on average with volatile figures. The fourth quarter could be, again, more positive than the previous ones, but the tendency is still somewhere around 2%. Whether it could go above 2%, we need to monitor all that. Year-end could be a very good point to look at what could be the dynamic this year, whether the fourth quarter is a high season for banking. That concerns not only NPL dynamic, but non-interest income too. That's a decisive point and, I suppose, November/December could define to some extent all those differences.

Alex Kantarovich
Yes, that's great, and if you can guide us through approximately the cost of risk by segment, it would be very instructive, thank you.

Andrey Shalimov
For retail, it's still somewhere around 1 percentage point. It's some kind of increase; if you look at the dynamic in the last six quarters, this figure was well below 1 percentage point. But with this increase of the share of unsecured lending in the book, in the third quarter it's 1 percentage point.

Talking about corporates, on the opposite, it's slightly above 2%. Currently, it's between 2.5, and 2.3/2.2, something in this region. It was exactly the same for the last six quarters mainly, with the exception of the third quarter last year when we were finalising provisioning for one big exposure. That's something from 0.3 to 1 percentage point for retail and somewhere from 2.2 to 2.5/2.6 for corporates, so that's the current stance.

Alex Kantarovich
I presume that in retail it's mostly mortgages, so basically this is your level of delinquencies. Just curious what you see for credit cards, again ballpark, not to the last decimal point?

Andrey Shalimov
Credit cards, as you remember, is a very small portion. It's only 5% of our retail book, so in credit cards, I suppose, delinquencies could be somewhere up to 6% in some quarters and lows could be at 2%. That's a more volatile figure and the rise of this book in pre-holidays period, on the age of new year and before holidays in summer, cyclically affects NPLs too. In general, it's between 2 and 6%, something like that, but as I said, in the total book, it's only 5%.

Alex Kantarovich
I presume that credit card holders are mostly captive payroll customers, right?

Andrey Shalimov
Yes, exactly, and most part of this overdue indebtedness, is mainly technical in its nature. The natural level is closer to the lower boundary of these figures; it's between 2-3% for us and this 3% increase is of a technical nature for some days or some periods.

Alex Kantarovich
Yes, thanks, very clear, very helpful, and my last clarifying question. It seems to be a preference for many banks that in Q4, cost of risk falls as a compensating item for bonuses, i.e. higher operating costs. I just would like to confirm if this is exact for you as well.

Andrey Shalimov
That's why we're concerned on the annual figure, not on quarter figure, on provisioning, since not to misguide you on all that. As I said, in many cases, there could be repayments. Mostly, we try to pre-provision all those bonuses in our books across the three quarters and almost half of the bonuses, are pre-provisioned on our books. The eventual size of the bonus pool should be defined with fourth quarter results taken into consideration. That could be opposite reasoning chain: better results of the fourth quarter could result in higher bonuses, or worse results of the fourth quarter could result in lower bonuses.

Alex Kantarovich
Yes, Andrey, many thanks; it's always very interesting to hear your thoughts, so much appreciated.

Andrey Shalimov
Thank you, Alex.

Operator
[Operator instructions]

We have a question from Andrew Keeley, Sberbank. Please go ahead.

Andrew Keeley
Good afternoon, thanks for the call. My question is just following up on your loan growth comments for next year. Given a kind of base scenario I think you mentioned of kind of 5-8% loan growth. I'm just kind of wondering how you see the split between retail and corporate. Because obviously, if I look at your corporate lending, and clearly it's down a few percent year-to-date, I'm wondering whether there is going to be any reason for that to change next year. Indeed, if we look at your mid-cap corporate lending, which was always your core corporate franchising, I mean that's actually down by almost a quarter in the past 18 months and I'm wondering whether you see any reason to think that that trend is going to change next year. Then if we come to your retail lending, as you discussed earlier, the mortgage growth has slowed down very strongly in the last couple of quarters. So I am wondering where the growth is going to come from on that side, your thoughts would be appreciated.

Andrey Shalimov
Yes, exactly, the current basic scenario is 8% on the average, and the dynamic of the portfolios should be different. What I could comment on that, it all depends on the risk appetite, since with adequate capital and funding structure, indeed we could allow ourselves to grow faster than those figures. But the key thing is the risk/reward ratio. The key factor, which depressed the corporate book this year, was toughening of the lending conditions and the policy to decrease almost every single exposure to lower and lower levels. On the other hand, medium-sized business, especially medium-sized business, repaid a very serious portion of their indebtedness and refused plans to expand their business; they simply don't need so much financing. That's a delicate balance for next year, how in the environment of high interest rates to intensify good borrowers to really utilise those facilities.

As I said, most of the borrowers accepted new price levels. That's a very good ground to increase lending, so this reason for depressed demand is removed currently. They took a wait and see stance in summer or in early autumn and were waiting for the dynamic of the rates. Now with the confirmation of higher levels of interest rates, it looks like they made up their minds on that. It's still up to risk appetite, and we are in a careful checking of the development of the situation in different areas of the economy.

As a guideline, we expect that the retail book should grow faster than the corporate book, absolute figures may be more or less equal or this shift to the retail book could be pretty slight. That's the general proposition, but we expect we could take a final decision on the plan only in December. I think even we could finalise some things in January only, taking into consideration December's developments, but the general stance is to have more or less equal absolute volumes of increase.

Andrew Keeley
Okay, thank you, that's very helpful, and just to follow up on your thoughts on the net interest margin. Do I kind of read you correctly in that you're essentially thinking that higher funding costs that are now on the table… Look, you still have good capacity to pass these onto borrowers next year, given that everybody has had a kind of reality check and realised this is the new environment in which we live. So do you think actually that you can keep a margin decline perhaps next year to a fairly modest level?

Andrey Shalimov
We can't exclude it. The target is still to defend this 4.5% margin, which we explore whether it's achievable. But the development of funding costs depends on macro pretty heavily, especially on exchange rate fluctuations in such kind of volatility. Exchange rates define subsequently market interest rates, so we can't exclude some other shocks in the rates market. That makes us a bit sceptical about prospects of the margin. What we try to make now is to design such a set of the products to defend this 4.5% and what we're checking now is the currency part of the balance sheet. With currency rates on the tremendous rise, it looks like there is an increase of 2 percentage points for the biggest borrowers, at least for quasi sovereigns, on the market and higher increase for BBs. There could be some potential to utilise our currency liquidity with some margin enhancement. Let's see what could be the final decision on this front. You know, we don't like to take excessive credit risks in currency, even in the market. So some corporate risks in this type of environment are, at least, questionable, nonetheless, still there are some opportunities how to defend the margin in 2015.

Andrew Keeley
Fantastic and just very briefly, I may have missed this before, but how has your deposit growth been in October/November? Have the third quarter trends been maintained and are you actually looking to slow down deposit growth given your loan/deposit ratio has already fallen below I think 90%?

Andrey Shalimov
Yes, and that was deliberate. We still did not announce increase in retail deposit rates. We are on the verge of some kind of decision on that, the last

time we increased Rouble rates was in the first quarter, so we enjoyed all this inflow of deposits at the rates of the first quarter. Even after your good bank and some state banks increased rates in the fall, we're still waiting. That was totally justified in October; there was inflow of private deposits. I suppose, in November they stalled, and maybe that's the time to make our point and to increase the rates.

On the corporates side, with the excessive liquidity in Roubles, it was the policy to decrease corporate portfolio for sometime in August, September, and October, to realign our Loan-to-Deposit, not to let it fall below 90%. The current dynamic of those things closely depends on the asset dynamic. If we decide to be engaged in active lending, we could return to competition in corporate deposits market too. That's dependable, and those decisions for next year should be taken in December.

Andrew Keeley
Andrey, thank you, thanks very much.

Operator
I have a question from Maria Vasilenko, UBS. Please go ahead.

Maria Vasilenko
Hello, Andrey and Elena, thank you very much for the presentation. Well, actually most of my questions have already been answered, but I'd like to ask just several follow-ups. First, continuing on the question on the deposit growth, so what dynamics would you expect in the fourth quarter and maybe for 2015? Well, as far as we can see from the reporting, corporate deposits increased quite considerably, so do you expect this trend to continue or is that rather a one-off? This is the first question and the second question is on NPLs. I understand that you say that it might turn out quite volatile, the fourth quarter, but still what is your expectation about the NPL ratio for the fourth quarter and full year, maybe, 2015. Are you comfortable with the current coverage ration? Thank you.

Andrey Shalimov
Thank you. On corporate deposits, as I said, it's now a policy to limit this portfolio. Yes, that was a very productive third quarter for us, both in retail and corporate. With stalling lending, we had excessive funds, and you saw the increase in funding rate. To curb interest expenditures, the decision was taken to limit those portfolios. As more receptive, we tried to deal with corporate portfolio, and that's not a market trend. That's a matter of

competition, price competition etc, and we simply decided not to compete seriously. With the increasing good loan demand we should be back to this market, so that's all pretty much dependable on the corporate side of deposits.

On retail, that's a longer-term trend and if you are more or less at the level with your key competitors, then you could obtain those deposits, but the stance is the same. If we have good application of funds, we need to chase those funds. With stalling balance sheet, there is no need to compete pretty actively. To support this 8% balance sheet growth, our rates are more or less adequate and that's quite achievable. Other things, some reductions or maybe increases in rates, should be caught by some change in loan book forecasting, so that's the situation now.

Maria Vasilenko
I see, so you would rather guide the deposit growth in line with the assets or…?

Andrey Shalimov
Yes, exactly, we try to match them as liquidity is on the more or less acceptable level for such crisis times. The prudent balance sheet management is simply to match them.

Maria Vasilenko
Okay, great, thank you.

Andrey Shalimov
On NPLs and coverage, we're still slightly below the stretch that we consider most appropriate: between 120% and 140% for 90 days NPLs. So we can't exclude some pre-provisioning, if the situation could be favourable. With big chunks sometimes in question, that could deviate from this interval, but on average we should be within those boundaries next year.

Talking about NPL levels, it's not so much informative, since we took some write-offs last year. We can't exclude some write-offs this year too, maybe not as sizable as last year. The target with recoveries and write-offs is to have NPLs within 6% mid-term, but a lot of legal matters etc, which are not economic in nature, could change these things.

Talking about new formation, there was some increase in the third quarter and we are on alert whether that's a start of a new trend or that was exactly the reflection of unwelcomed developments this year. No evidence that it's a new trend, but let's see; I suppose, fourth quarter is a good time to check it.

Maria Vasilenko
Okay. Could you please clarify on the boundaries you mentioned, 120% - 140%; is this the division from what, from your coverage ratio?

Andrey Shalimov
Yes, that's our target coverage. Now, it's 115%, not far from the lower boundary. It's more comfortable to have it closer to 140%, but it depends, of course.

Maria Vasilenko
Okay, thank you. Thank you very much.

Andrey Shalimov
Thank you.

Operator
We have a question from Andrey Mikhaylov, Otkritie. Please go ahead.

Andrey Mikhaylov
Thank you for the call. I have a few questions. I will start with the large NPL that emerged this quarter. You mentioned that it's just due to bad payment discipline, so the question is: has this already been repaid by now?

Andrey Shalimov
It's not repaid and there is a good chance it could be repaid in the fourth quarter, but not warranted, of course. That's a borrower which looks like not only with us react mainly on some kind of legal procedures to repay, let's see what it could be this time.

Andrey Mikhaylov
All right, thank you, and then the next question is on the already discussed retail loans, the unsecured loans. You also mentioned that 80% of your

retail clients are payroll clients. Does it also apply to unsecured lending or is there a different proportion there?

Andrey Shalimov
I suppose, for unsecured lending almost 100% are our payroll customers.

Andrey Mikhaylov
Then another thing, the loan book was not growing fast and you don't plan to grow for next year as well, as you said. Do you have any plans for maybe cutting some branches in the smaller branches?

Andrey Shalimov
It's not something limited to branch downsizing etc. It's a part of the optimisation of the whole business model. What we try to overhaul is the operational infrastructure, to centralise all the back and mid office functions, and to lighten all front offices. What could be the impact on the number of outlets or their structure, that's a consequence of this operational model optimisation realigned, whatever it sounds. In a number of outlets we don't see any need to serious cut or serious increase, there is some natural turnover. We close some outlets each year and we setup new outlets, it depends on their business performance, but we don't expect any active changes in this process.

Andrey Mikhaylov
All right, thank you, and the final question is about the same cost optimisation programme. Do you have any timeline in your mind for the rest of the year and for 2015, and especially the timeline for any results and influence on the Cost-to-Income ratio?

Andrey Shalimov
Yes, if you look at average number of employees, it's on the decline in recent years, so that's the first indication that some changes are really in place. For some drastic changes, we expect that 2015 could be the year when results should surface in more visible forms. Unfortunately, we could expect some kind of cost inflation next year and on the other hand, it could be additional incentive to intensify our efforts and try to reach those results earlier than we had planned. I suppose, 2015 should be a year of visible transformation.

Andrey Mikhaylov

What's the Cost-to-Income ratio you are planning for the next year?

Andrey Shalimov
For next year, it's still closer to this 60%, maybe slightly more, maybe slightly less; it depends on business growth. If business mix is ok, we could go below 60%. With some stagnation, it should be good simply to freeze this ratio at 60%. Let's see what could be really here. 5% growth in this case should be good to maintain this 60%, but in case of 10% growth there should be some reduction.

Andrey Mikhaylov
All right, thank you very much for that, thank you.

Andrey Shalimov
Thank you.

Operator
[Operator instructions]

Dear speakers, we have no further questions at the moment. Back to you for the conclusion.

Elena Mironova
Dear colleagues, thank you all for joining and we will be happy to welcome you on our next annual results conference call that's going to be in the end of March. Okay, thank you, and goodbye.
