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Conference Call Participants

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Presentation

Operator
Ladies and gentlemen, welcome to Bank Vozrozhdenie First Half of 2014 Earnings conference call. I now hand over to Ms Elena Mironova, Deputy Head of IR. Madame, the floor is yours.

Elena Mironova
Thank you. Dear colleagues, we are glad to, welcome you on Bank Vozrozhdenie First Half of 2014 IFRS Results conference call and webcast. As usual, the reporting, the relevant press release, presentation, fact sheet, and all the supplementary data are available in the Investor Relations section of our website at www.vbank.ru. I will start with the presentation with the key highlights and then we will move to the Q&A session, where I will be joined by Andrey Shalimov, Deputy Chairman of the Management Board.

Amid quite sluggish economy trends in the first half of 2014 and weakening consumer demand coupled with high uncertainty stemming from geopolitical issues, we pursued quite conservative lending policy. During the second quarter loan portfolio contracted, though we enjoyed a really strong inflow of client funds. Actually, as reflected in the name of our presentation, one of the most important developments for us was recovery of clients' trust. It helped us from the risk management perspective as well, as we improved our position in terms of Loan-to-Deposit ratio and enhanced the capital adequacy. The assets were stable year-to-date at the level of RUB 210 billion, while the share of loan portfolio in it dropped to 73%.

With that, we started investing more heavily into the market instruments – on the interbank market we came as net creditors. We used mostly short- and mid-term instruments, so the share of liquid assets remained at a comfortable level of 18.5%.

As for the funding structure, in the reporting period the share of client funds reached 85%. It afforded us to cut the market funding. The Central Bank financing raised in the first quarter under the repo agreements shrank from RUB 5.5 billion to RUB 1.6 billion. And just looking ahead, I would like to point out that in July we fully repaid all indebtedness to the Central Bank.

As you see from the bottom left graph, in the second quarter, the share of market funds in total liabilities fell to 5.5%, which is comfortable for us, and it is significantly lower than our internal limit for it set at 10%.

Loan-to-Deposit ratio is back to the targeted range. Now it is 105%, which is the result of our work on its moderation. As we said during the previous calls, the level of Q1 L/D was too high for us.

Let’s look in a bit more detail on client funds dynamics. This heavy rebound in Q2 was facilitated by retail funds inflow. What’s interesting, that was not a typical trend for the Russian banks. We were one of the few players on the market who enjoyed such interest from the side of retail clients, and it is not only due to our interest rate dynamics. Though we made some increases in March, they were quite modest and still remained below the market. It is not seasonality, because normally the fourth quarter is the strongest on that front. We think that it is to some extent a reflection of the client loyalty and a kind of indirect approval of our policy that we pursued during quite nervous periods last year and at the beginning of the first quarter, when we saw the funds outflow. Then, we tried to do our best to calm the clients down, we kept our doors open and ATMs – full. It looks like now we are getting some first fruits of such approach, just regaining the clients’ trust. We have analysed this inflow, it was not large VIP clients, but very small deposits, most of them significantly less than RUB 750 thousand evenly distributed across the whole branch network.

As you see from the monthly dynamics, the highest inflows were in April and June, and the share of FX funding was dropping. So, after the stabilisation of the rouble exchange rate in March, we saw very strong demand for rouble deposits. That is, actually, good for us, because the bank has quite limited options on FX utilisation.

With the seasonal recovery of balances on card accounts supported by a growing number of payrolls, retail funds added almost RUB 6 billion. It is one of the highest quarterly inflows during the recent years.

We were also glad to know that the outflow of corporate funds slowed down, and in June we saw a recovery of corporate deposits for the first time since October 2013. The share of FX in the corporate funding also declined to 10%. The total share of interest-free funding sources – current accounts, balances on card accounts – now stands at 29% of the customer funding, that provides some relief for the funding costs pressure.

As for the loan portfolio, since the year-start it moderated by 2% and now it stands at RUB 166 billion. The main contraction was in the corporate segment. As I said, our approach to new lending was fairly cautious, and in the environment of the anemic economy growth, macro uncertainty and reliable borrower shortage that seemed quite a natural step. However, despite some decline in the loan portfolio, we stick to our strategy of loan book diversification. We keep developing SME lending under partnership programmes with SME Bank, with state guarantee funds, with the EBRD. In August, the bank signed an agreement on cooperation with the Agency for Credit Guarantees that would provide state guarantees as collateral for SME lending. Our micro business programme in cooperation with the EBRD is developing, and the portfolio showed quite considerable growth year-to-date. Now, it stands at RUB 1.6 billion.

In general, since the year-start, the share of SMEs added to 59% of the corporate portfolio. As you can see from the large corporates and SMEs dynamics decomposition on the bottom graph, we have ceased new lending to large companies. It was quite a tough decision, but taking into account our latest stories with NPLs, we decided not to go into large exposures, at least for now. All the new issuance volumes refer mostly to SME segment. Around RUB 5.5 billion were granted under both new and existing credit agreements. Another factor contributing to this replenishment is recoveries. Taking into account our focus on working capital financing, SME loan portfolio maturity is relatively short, so it is repaid at quite a high pace.

Retail lending reached RUB 44 billion by the end of the reporting quarter, delivering a growth of around 3% year-to-date. Mortgages were slightly outpacing, showing a 4% growth, and their share in the retail loan book reached 70%.

In the second quarter, retail portfolio nearly stalled, pressed by creeping rates on mortgages and consumer products and, of course, the vulnerable macro environment.

Let’s now move to the credit quality dynamics. In the second quarter, NPLs were slightly up to 8.3%. That was mostly due to add up on SME overdue loans. There were a handful of exposures, mostly from the construction and trade sectors. Clients started experiencing difficulties in investment projects realisation, and in trade they faced diminishing consumer demand. However, we can’t say that it is a general trend for the whole portfolio. We had no new stories on large NPLs, and in the second quarter, we have fully covered by provisions our last large exposure. Retail NPLs are quite volatile. Now, the total figure stands at 4.2%, but the major part of it, more than 2%, is technical overdue less than 30 days, that is normally repaid in the upcoming weeks. If you look at the dynamics of new NPL formation and recoveries, you will see that the amplitude there could be quite wide.

Cost of risk for the first half of the year stood at 2.2%. As I said, we completed provisioning of large NPLs, and continued charging for some other corporate loans.

On slide six with a static picture of the credit quality, you see that our coverage ratio for 90 days+ overdue is approaching the targeted level of 120%. Now, it is 117% that provides us more comfort. The share of rescheduled loans is almost stable at 6.4%, and taking into account the portfolio drop, the absolute amount has slightly decreased due to recovery of some exposures.

Now, let me turn to the P&L analysis. The general highlights are on slide seven. You see that on a year-over-year basis net interest income, the main component of our revenues, grew by 13% on the back of higher interest rates and expanding retail loan portfolio, though, on a quarterly basis the indicator contracted reflecting shrinking corporate loans and deposits pick up. Net fee income for the first half of 2013 still remains below the last year results. However, in the second quarter we saw some rebound, hopefully, it would be sustainable. In the recent quarter, we also recorded some gains on trading income from positive re-pricing of loan portfolio and revenues from FX transactions. It contributed to the doubling of other operating income to RUB 270 million. Now, the share of non-interest revenues in the total operating income is 34%, which is 5 pps higher than a quarter ago.

Operating expenses are under control. We saw a decent growth year-over-year of about 3%, and some minor contraction in Q2. Due to re-pricing of non-core assets, which is mostly represented by retained collateral, and sale of a part of this collateral, the provisions for impairment of other assets were recovered in the amount of RUB 46 million. So, net income in quarter-over-quarter terms was relatively stable, while the indicator for the first half of 2014 grew by 65% compared to the previous year level.

I would like to comment a bit more on the reasons lying behind the interest income dynamics. As you see, the drop of interest income was driven by corporate lending decrease. On the graph with the interest rates, you can see that the average yields on corporate loans were also slightly down quarter-over-quarter, due to faster repayments on the SME lending. The retail side delivered slight support due to modest growth and higher rates on mortgages and consumer lending introduced in March.

On the interest expenses side, the major contribution to growth came from higher volumes of retail deposits. Though, I would like to draw your attention to their average costs that remained stable at the level of 7%. The interest expenses on the corporate deposits in absolute terms were flat quarter-over-quarter, while their costs rose by 80 bps. As we saw from the previous slide, the inflow came at the end of the quarter, in June, so we didn't bear those expenses throughout the whole period.

In the second quarter, net interest margin dropped by 36 bps to 4.6%, but it still remains above our target of 4.5% that we intended to protect. When commenting the first quarter results, we said that we anticipated some funding pressure, and the level achieved in Q1 would be hard to maintain.

Net interest spreads squeezed due to burden from rising funding costs and yields on interest-earning assets that slightly fell on the back of changing asset mix, though, the total cost of funds of 5.5% remains quite moderate.

Net fee income generation capacity is one of the primary concerns for us during the recent quarters. We see a decline on the year-over-year basis both due to some internal and external reasons. First of all, of course, it is quite a tough competition from the other banks that drives the rates down, though we record some volumes increase, as you can see on the left bottom graph. Credit turnover on card accounts is some kind of indication of business activity, and it was going up year-over-year, but this growth was offset by lower level of commissions.

On the corporate side, we're currently replacing some large clients by more stable base of SMEs, but the process is, of course, not as quick.

We were glad to record some rebound of all fee income sources in the second quarter, and we hope that it would become some turning point for the whole year, as the lowest level was in Q4. We hope that the second half would be stronger. We put a lot of efforts on developing our fee generating products line, we enhanced mobile and internet bank for retail customers, switching our corporate clients on internet bank. This autumn we plan to introduce a new product on cash collection for corporates and now, we offer quite an advanced payroll programmes, which is a joint project for both corporate and retail. Hopefully, this would contribute to client base expansion and higher revenue generation.

Now a few words on the costs. The bank carefully monitors its expense base. Over the year, the growth was around 3%, and, as you see, the staff costs contracted a little bit, while the expansion was mostly driven by administrative and IT costs. On a quarterly basis, the expenses were stable, as we do our best to limit the growth. The cost-to-income is still around 60%, reflecting the stable level of operating income and expenses. Our long-term target remains intact, it is 50% that we plan to achieve with the help of realisation of our operating model optimisation project. We have prepared some updates on that. It goes more or less in line with the schedule. As for now, we have fully centralised our internet bank client support, payment processing for rouble-denominated operations, work with the requests of the Federal Services. Now, the fraud analysis system is fully centralised. A lot of pilots are on-going. We start many of them in the Moscow region – our key and closest segment. Some projects are first tested and replicated there and only then we expand them for the whole network. We hope to see some first visible fruits closer to the end of the year and in 2015 as well.

Let's move on. On our last slide, you see the dynamics of net profit. It stayed on the level of the previous quarter due to aggregated provisions stabilisation quarter-over-quarter. The corresponding dynamics we saw in the ROEs – for the second quarter it stood at 6.5%. That is quite a visible growth compared to the first quarter of 2013, and as you see on pre-provisioning level, our general profitability exceeds 25%. Net profit is the main source for capital support. We calculate capital adequacy in accordance with Basel III requirements, and the total regulatory capital stood at 12.3%, stronger compared to the start of the year. I would also like to draw your attention to healthy structure of our capital – the share of Tier 1 is around 80%, so the relevant adequacy ratio stood at 9.9%, which is significantly higher than the minimal limit of 5.5% set by the Central Bank. It provides us some room for expansion in case of economy recovery, though, of course, the future development will depend more on the macro and on our assessment of the current risks in the system.

That is all with the presentation. Let's now move to the Q&A session.

Question and Answer Session

Operator
We will now start the questions and answer session. If you wish to ask a question, please press 01 on your telephone keypad. Thank you for holding until we have the first question. We have a question from Jason Hurwitz, VTB Capital. Please go ahead.

Jason Hurwitz
Good afternoon, just a question, we saw that your loan portfolio contracted significantly during the second quarter, and also we noticed that not only the net interest income, but also the NIM contracted during the period. If you could maybe give some colour as to how the credit demand situation is affecting the growth, at least of creditworthy borrowers, and how that is also, in turn, affecting your ability to keep your lending yields moving up in the same way that cost of funding is moving up, because it seems that… Are you able to unilaterally change the terms of your loans to raise the interest rates, or do you need to have new loans in order to capture a higher yielding market? That is it, thanks.

Andrey Shalimov
Good evening, ladies and gentlemen. Indeed, the question about the portfolio size and its evolution is a bit complicated matter, since what we had in the first quarter was some kind of rouble funding limitation that was part of the story in the fourth quarter. The situation changed completely in the spring. We mentioned that last time that rouble stabilisation in late March-early April changed the whole picture. Now, I suppose, rouble liquidity is quite significant in most part of the banking system. People are keen to save from a different angle of view and having different reasoning, but nonetheless, people are still keen to save money with banks.

Indeed, that was a kind of surprise for us, how strong was the private deposits inflow we experienced in the last four months. Though, of course, the rates were not pretty much aggressive and nowhere near even in comparison with banks in top-20, for example.

Nonetheless, it was the inflow, which pushed the average rate on our liabilities slightly higher.

On the other hand, NIM was affected by contraction of current accounts and card accounts through the course of the first quarter and early in the second quarter. The factor of early withdrawal, which indeed added to the margin in the fourth quarter and partly in the first quarter, it disappeared completely.

Of course, that resulted in some increase of average rate on our funding side.

Talking about lending practices, as I said, maybe it was a precaution a bit. We indeed never faced real limitation from our funding, but of course we tried to be prudent enough to maintain sufficient liquidity cushion even in the worse situation in the fourth or the first quarter. But such kinds of limitations disappeared, faded. Now the key defining factor is the quality of applications we received and performance of our existing book. Here unfortunately, is still the same story as in the last two years: some gradual deterioration in the credit quality, heavier debt burden and potential vulnerability to drop in incomes and foreign revenues for many customers, both on corporate and individual side. But on the retail side, the product mix protects us - mainly mortgages in the regions with not so heated prices and by the dealing within our traditional core customer base.

Now, in comparison with that, corporate book looked a bit more risky for us and, as we discussed, last year, there were two rounds of credit stiffening. A result was the lower ratio of approval, and subsequently a lower stream of applications from the borrowers, especially in the first quarter. Now we're in a position to increase the book, but recent developments – not only economic, but political too – forced us to take a wait-and-see mode. We decided it's better to return to the same risk position, especially liquidity risk position, which we took across the last two to three years: to be overliquid in all currencies, including roubles, and to be a net supplier of funds to the market. From that point of view, we were not in a hurry to enhance the loan book. Nonetheless, that's the target for the salesforce to snatch debt customers available in the market. Now I can say that anyone in the market could be reached with some kind of product mix, depending on the lenders' size, of course. We have no intention to go to the biggest guys in the market, though there are some requests from even biggest corporates. That's a very-very lender market now, and all customers are available. So that may be the best moment to fine-tune customer selection. Maybe we could sacrifice some additional interest revenues for a quarter or two in order to obtain a better competitive position and capitalise on that in subsequent quarters.

Of course, it's all very fluid. It depends on the general situation and the system, on whether we could preserve our overliquidity, what could be the development with SME and corporate credit quality in the country. There are a lot of game changers, but nonetheless, currently we are mostly in a waiting mode and let's see what could happen in the fall. We have resources, have adequate capabilities to compete, and if it turns to the better in the market, I suppose, we could easily increase the book. By the way, people around and we also charge higher rates on extended loans. Of course, it couldn't feed through the whole book very quickly, but nonetheless, as you see in the statements, average return on interest earning assets steadily on the rise and this tactical preference for mortgages over corporate, of course, should add to this process.

Jason Hurwitz
Very good. If I may, one more question.. I will keep it rather simple. Relating to the loans that have deteriorated in loan quality this year, could you give some colour just on a broad basis as to whether there have been different reasons – because you mentioned the loan quality situation has been somewhat similar, getting worse slowly for the last couple of years, but is there any change in the dynamic as to why that's happening this year or is it just a further economic deterioration from what we've seen before?

Andrey Shalimov
That's some kind of overlapping of different processes. Indeed, first of all, a slowdown in economy, but nonetheless some kind of subjective factors. For example, these raising trade barriers due to imposed sanctions affect some wholesale and retail trading, maybe for short-term periods, but maybe with a longer lasting effect. Of course, that should affect some trading parts of the economy. Non-payments in such large projects like Olympic Games construction etc. is additional factors of uncertainty. Bigger events like some big development companies declaring themselves bankrupt or big metal and mining guys near bankruptcy are a visible part of the process. But nonetheless, through the chains of suppliers, those effects ripple through the whole economy, and it's predictable that some part of local economies and regions may be even remote to those centres of instability, they should be affected too. So, I suppose, we have a longer-term trend and some complications due to particular this year factors.

Jason Hurwitz
Very good, no further questions, thanks.

Andrey Shalimov
Thank you.

Operator
[Operator instructions]

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

Maria Vasilenko
Thank you for presentation. Thank you for such a detailed answer on the previous question, but I would like to ask about your funding costs. So, basically, you said that you haven't raised much deposit rates, so I would like to know whether you are going to make an increase in deposit rates. Given your stance to remain overliquid with the cash imbalance at around 15-16% of your assets, how do you intend to keep the NIM or do you upgrade the guidance of NIM for 2014? Because, actually, I see the risks for the NIM pressure based on slowdown in lending and potential for rise of cost of funding.

Andrey Shalimov
Of course, interest rate risk is topical, but I suppose, it’s not the most important one currently. I suppose liquidity and long-term liquidity risks in the system and credit quality are the key concerns for the Russian banking system. NIM and indeed negative consequences are on agenda, but to deal with them in a proper way we first need to be liquid in any situation. Since what we have now is that the average cost of customer funding is anyway lower than the funding from the Central Bank and we consider even short-term Central Bank funding as a rather expensive one, and consider banks which use it heavily as pretty much at risk. In that kind of situation, we could place the excessive liquidity at pretty favourable rates, both in rouble markets and due to some shocks to Eurobonds market. I suppose, we could find some good short-term securities with very attractive returns in the market too. So, in nowadays situation, you could soothe the interest burden by investing funds short-term in all key currencies. But you are right, of course, with this type of rebalancing and bringing Loans-to-Deposits closer to par, we tactically sacrifice some portion of NIM. Nonetheless, in the second quarter it was above our target 4.5% and in the Q3 it’s still close to that.

There could be a two-way process. If the situation pasts the trough, I suppose, as I said, we could boost lending easily in nowadays conditions and increase NIM that way. On the other hand, if we still face a lack of qualitative credit demand, maybe in our perception, but I suppose that’s still objective situation, we could even decrease the rates on the funding side, since we don’t like to keep too much excessive liquidity in this situation. But the key what we need is flexibility to change the balance sheet composition up to your market views, and, I suppose, this flexibility is the key to maintain the NIM.

Of course, this rebalancing could result in thinner NIM in the third quarter, but it could be very good grounds to increase NIM in subsequent quarters. I still don’t see very serious threat to whole year NIM, from that point of view, but of course that's one of the management targets to boost NIM closer to the year-end.

Maria Vasilenko
Okay, so generally, do you reiterate your guidance of 4.5% for net interest margin or do you see a little bit lower target for the full year?

Andrey Shalimov
It's too early to abandon this target, but indeed, it heavily depends on the developments in the loan book. We are keen to expand the business and maybe to keep some excessive funds for some time, but of course, for some short time. If we resume lending on the broader scale in September-October, there is no need to change margin forecast. But in situation of further contraction and balance sheet freeze, I suppose, yes, there could be some grounds to change it. Nonetheless, as I said, we could even decrease rates on the funding side and to realign the budget that way. I still think it's premature to change the guidance.

Maria Vasilenko
Okay, thanks, so do I get you right that you are not planning to increase rates on deposits, because of interest rate hikes by CBR, say, by another 50 bps in July?

Andrey Shalimov
It heavily depends on Sberbank's stance, since, indeed, it looks like it sacrificed some part of the market share, but kept rates, especially for the general public, not for VIP customers but for general public – pretty suppressed. And if they're in the same stance, for us it preserves very serious free room between Sberbank and riskier banks in the market within which we could easily pursue our own goals. Then, of course, we have some free room to increase or decrease rates at our discretion. But if Sberbank increases this lower boundary in the market, we should change our policy appropriately, and still there are no direct links between their actions and the Central Bank rate hike. It's to some extent a subjective factor in the market.

Maria Vasilenko
Okay, thank you very much, and could I please ask you another question? What would be your full year guidance for the asset quality? We saw some asset quality deterioration in the second quarter, which was as well

facilitated by NPL rise in SME segment, as you said, and given the current situation of sanctions imposed and geopolitical tensions, well, actually we could see SME sector as one of the most vulnerable in this situation, in particular, trade and services sectors might be hit more than other sectors, so how do you see the development of asset quality and what would be your guidance for the cost of risk for the full year?

Andrey Shalimov
Yes, first, after our last conference call, we received some numerous warning signs on potential credit quality deterioration across the system and that's natural to take a more conservative stance here. So it looks like, say, 2% or 1.8% cost of risk guidance for the full year looks like an optimistic scenario nowadays. More realistically, I suppose, something slightly more than 2%. But it's not so simple, since, as we discussed not once, the difference between corporate market and SME market is that corporate market is overbanked and a lot of people are overleveraged, and in turn a slight decrease in their economic position could result in some difficulties for them and for the lenders. With the SME market, it's quite a different situation. This segment is strongly underbanked and if you're prudent enough, you work only within the best part of this customer segment. So the reaction could be very visible, but it could be muted in comparison with the situation when you work with average countries' SME. So, that could make a very serious difference. Of course, judging by 2008/2009 performance, the SME NPLs at peak could be higher than contemporary NPLs in the corporate segment, but what we observed was a very quick resolution of those problems, judging by our segment for example. From that point of view, I don't think that we deal with significantly riskier parts of the customer base. The efforts of the last two years were to prepare the balance sheet for such type of development, and, I suppose, it should mitigate the deterioration of credit quality. Nonetheless, this summer situation gave a lot of reasons to be pretty concerned about the credit quality.

Maria Vasilenko
Okay, good, thank you very much.

Andrey Shalimov
Thank you.

Operator
We have a question from Zoltan Koch, Warburg Invest. Please go ahead.

Zoltan Koch
Good afternoon, thank you very much for the presentation. I have one question to the cost structure. You had a slight improvement in the second quarter. I would like to ask you are you happy with this Cost-to-Income ratio or do you see more decrease maybe in the next couple of quarters? Could you please give me more insight on that?

Andrey Shalimov
Yes, I suppose it's not a very pleasant situation, it's simply some kind of stabilisation at the level of 60% and, of course, the efforts of the operational model improvement project is to bring it to 50%. There are some visible things in the structure of some savings, but nonetheless, a rollout of most significant cost cutters, I suppose, should be done in next two to three quarters. We should start feeling those things from this fall. Maybe the best result for this year or early next year should be simply flat cost structure without any physical increase, but of course for 2015, we should try to extract outright savings. I don't expect 50% in 2015 due to overlapping of numerous projects. For example, to overhaul some infrastructure matters we need some significant workforce during this, say, one- or two-year project. But nonetheless, after their completion, we could release these project teams and, of course, to rationalise the staff allocation and premises, and of course we should feel some outright benefit in 2015. But in two to three years' horizon, of course, the target is set clearly at 50%.

Zoltan Koch
Good, thank you very much.

Andrey Shalimov
Thank you.

Operator
[Operator instructions]

As we have no further questions, dear speakers, back to you for the conclusion.

Elena Mironova
Yes, dear colleagues thank you for joining and we would like to invite you on our next conference call in November. Thank you.