Transcript of Q2 2017 results conference of mBank

July 27, 2017

[edited version]

Joanna Filipkowska, Deputy Head of Investor Relations: I think we're all here now. Welcome to this conference, which will summarize Q2 results of mBank Group. We have the CEO, Cezary Stypułkowski, and CFO, Andreas Boeger, and then we have our Chief Economist, Ernest Pytlarczyk, who will talk about macroeconomics.

Cezary Stypułkowski, CEO: Good afternoon. Let me introduce Andreas, he will be your key counterpart to talk to. This is his debut, so step carefully. As it is; we will present good results today, so this is not particularly challenging. Q2 was good in every way [the presentation is up on screen now]. Our core income has been growing nicely. Year on year net interest income grew by more than 11%, net fee and commission income by 20%, so whenever we can stay in charge of the situation, we do that. LLPs increased slightly in the last quarter in corporate banking, but not dramatically. The cost of risk… well, costs increased somewhat - we do some additional marketing, we paid also additional costs of consulting, and such. But that was not particularly unusual. We don't really look at our nominal cost numbers, rather we try to anticipate our revenue and use it to calibrate our cost level. So our cost to income ratio is around 50%, and that's the benchmark we try to maintain. Hopefully we will stay on top of it. As for the volumes; they grew somewhat, but not sharply. So we see good developments in non-mortgage loans (consumer loans), growing by 1.9 billion. So no complaints there. Mortgage loans have bounced back – we had some turbulences before in view of the dialogue we've been in with the Polish Financial Supervision Authority about the role of the mortgage bank. Clearly, our Bank has invested heavily in Bank Hipoteczny, and giving the current balance sheet and the externalities the situation is more challenging. So mortgages did not grow as fast as the market at large. Although it seems that we are gradually restoring our market share of 7-8%. Year on year, however, mortgages grew nicely and all other factors and indicators are quite positive. Loan to deposit ratio at 94%. We have been fine tuning our deposit position, we are much more advanced, or sophisticated, than we used to be. The interest margin on deposit has also grown quite nicely, which was our intention all alone. Now, as for other numbers – capital; we stay in the top league. Our capital position is perhaps even stronger than expected. I think that would be all from me, I don't want to dwell upon it. I would rather take your questions. But first, let me turn over to Andreas. It will be his debut presentation. So, it's nice to have you, and we'll move on to your questions soon.

Anderas Boeger, CFO: And welcome to all of you. So, to go a bit more into the details of the results, and I would like to start with page 9, with the loan development side. As just said, we have a picture here, that is steadily growing (with a mix that we want to go into a higher margin products). Steadily growing – what does that mean? You see quarter over quarter roughly 2% rise, year over year, without FX effect, that's 5% up. Looking more into the client side; so where does that come from (the segments)? You have on the retail side, as stated before, we had very strong sales on the non-mortgage loan side, but also on the mortgage loan side. You can see that here it looks a bit more flat, because the mortgage portfolio, here you can is 200 million zlotys down – that is actually driven by the Swiss franc portfolio. So in the quarter we have seen the zloty appreciating against Swiss franc by 2%, and we've also seen the ordinary repayments in the Swiss franc portfolio, which are a bit more than 90 million per quarter. So all in all, the underlying trend here is also in mortgages to rise. If we look at the corporate side, corporate side you see 3.7% more here, but I think the interesting number behind this is also that large corporates of this went down by 2.3%, so we're gearing here also towards higher margins in terms of addressing a bit smaller clients. So all in all, the picture here, as I said, higher margins, more NMLs, less large corps, and obviously Swiss franc portfolio being managed down. Let's go to the deposit side, where, as Cezary also mentioned, we continue to bring down the term deposits, and try to grow, and successfully also grow in transactional accounts. You see that in the quarter we're rather flat, but let's look for example on the retail side, where the retail side you also see a flat development over the quarter, but if you look at the numbers (the structural shift is very important), it's 2 billion less in term deposits and the current and savings accounts grew to 31 billion year over year, that is 17% more in current and savings. I think this shows exactly what we want to do, we want to bring down the costs, the interest cost here, in order to shift more into transactionality. On the corporate side you see deposits also decreasing, I think the important thing here is - behind that number term deposits are down by 13%, current deposits are actually, current accounts, are up by 2.5%. Let's go to the revenue side, on the revenue side you have seen that quarter on quarter at first glance we are flat, year over year we're up by 13.6%. If you take out the one-off from the Visa (and I think that's the important story here on that slide), that's the record high core income, we are delivering. So core income, as you know, we define as net interest income and net fee and commission income – that was very strong over the year, it was also strong in the quarter, went off over billion zloty here in the quarter, and that is a good achievement. The numbers you see that are more here in the red – on the one hand you see the net trading income, down by 20% in the quarter. There is actually one large driver, that is the valuation of cross-currency interest rates swaps here, which amounts to - 27 million, so that's actually a larger negative effect than the whole negative effect, that is due to this swaps not being booked on the hedge accounting, so we have them in trading book. And obviously here, as you have seen, we have the negative and the losses from investment securities, the 18.6 million driven by our disposal for example in mLocum and also an impairment we took on Signity bonds. Let's go to the costs side. The costs side at first glance obviously looks, with this whole distorted cost thing, with BFG charges back and forth it looks good with -16%, but that is obviously because in the first quarter we booked the BFG charge for the resolution fund in full. If you take quarter over quarter without BFG, it's up 5.1%. As the CEO mentioned, drivers behind this – marketing cost, consulting, fees also for regulatory projects, and higher IT spending. That leads us to a cost to income ratio of 44.9 for the quarter, but also there, with all this distortion I think the important number here is to look at H1 - H1, if we normalize it, so i.e. we take the BFG charge in half, we're at 36.5, still was half of the BFG charge, I think that's the important thing here. If we go over to cost of risk; cost of risk you see on page 13, we see a normalization of the cost of risk. Normalization, what does that mean? That mean cost of risk is up at a 120 in the quarter. Obviously if you compare this to the previous two quarters, that is a high number. You see the timeline here, Q2, Q3 16', than you can judge that this is more than normalization, and also in terms of where we want to be, in basis points, cost of risk, we have said that for this year we see 55 to 60 basis points cost of risk for the full year, and that is still our expectation. So going to the loan portfolio quality and the NPLs; so you see NPLs up in the quarter, down year over year – lets again look at the client segments; in the retail portfolio we're down, we sold a 135 million of NPLs in the quarter. Corporate we are slightly up, few individual cases, but still there (we're looking at a very granular portfolio) and I think the important number here is, if you look at the overall NPL ratio of the Group, 5.3%, that is still well below the 6.9% we see on the market, and that is a healthy number. Let's go the funding side. On the funding side actually not too much to report, so no material changes. You know the major source of our funding is the deposit side, retail and corporate deposits, with 76%, contributing here to the funding with already mentioned the loan to deposit ratio of 94.6%. I think important here is that we have a diversified funding base, as you know, that's something we still would pursue. We didn't do capital market issuance in that quarter, but we will continue to be active there. Obviously this comes at a cost for net interest expense, but we think it also adds a lot of stability, as you know. So finally the capital side, I think on the capital side also there is not too much to be said, the traditional ratios you see, they are well above the regulatory minimum, so 5% above the TIER 1 minimum we have, and 3% above the total capital minimum, and also the LCR and NSFR ratios, they are in very healthy territory. That's it from my side, I'm also happy to take questions afterwards, and would hand over to Ernest.

Ernest Pytlarczyk, Chief Economist, Head of IR and Group Strategy: Good afternoon everyone. As for the economy, things are going well – a 4% GDP growth rate roughly speaking. Q2, well, that was probably slightly less than 4%, but the structure of GDP growth will see a bigger contribution of investments. We've seen collaboration of that, based on our internal data, where investment loans are growing nicely. What's important to note, is that the growth should continue for two or three years. This trajectory of absorption of EU funds will be on the rise. By the year's end we should see a pick in the contracts signed, which means that next year and in the 2019 we'll see further growth strongly supported by UE funds.

The European environment is positive. Europe lags behind the US with regards to the market cycle – that should also translate into support for the Polish economy. There are some drivers, including mainly our strong job market in Poland, which supports consumption. According to some economists, theoreticians, among others, you start with consumption before you improve investments rather than the other way round. This may come as a surprise to some Polish economists, but still. The job market combined with structural developments… well actually we have the fifth lowest unemployment rate in the EU, which should solidify the growth. This structure of growth, of course, translates into fiscal issues. The fiscal policy seems stronger than couple of months ago or in early 2016.

Inflation. In this environment inflation should be higher. The June inflation was the lowest this year and now we expect it to rise. Core inflation will also be on the rise. When are we likely to see interest rates hikes? Well, conservatively speaking - next year, but I think there is a lot of resistance of the Polish Monetary Policy Council. They are sitting and waiting for things to change in Europe. Monetary Policy Council will have to try and avoid a long period of negative real interest rates, which actually happens in Poland as we speak.

Speaking of the monetary aggregates. The main trend is that term deposits are being converted into current accounts, which is obvious given the current rate levels. But that supports the propensity to invest and to consume. In addition, consumer loans are rising, so are mortgage loans, given better credit worthiness of consumers. All of that, we think, should lead to a very conducive environment for the banking industry. So, a longer cycle of growth, lower risk, higher volumes.

Now, briefly about sovereign risk. In our opinion the risk in Poland should be well under control. Looking at the fiscal position of Poland, the credit risk premium on the bonds is still quite significant and it should be falling. And so, Poland will benefit, we think, from goldilocks economy, as it's known. Our inflation is still low, growth exists, but it is low. In those circumstances investors are looking for countries where interest rates are not null, and which are different in that regard from the well-developed economies. So, I think we will continue to attract foreign capital. Thank you.

Joanna Filipkowska: And the floor is now open for your questions.

Dariusz Górski, DM BZWBK: So, to warm you up. You said in your previous conference this morning that the ambition of the Bank is to reach ROE of 10% within 3 years. Could you comment on your assumptions, mainly the dividend? Are you expecting to pay out the dividend or to retain 100% of the profits to get 10% of ROE?

Cezary Stypułkowski: Well, to get 10% of ROE several things have to happen. The easiest thing to do is to reduce your capital, obviously. We are expecting to pay out 50% of profit as dividend, that's a constant. And, as I said in the last meeting - the first time I was in a conference like this was 20 years ago with Bank Handlowy and then return on equity was 20% plus, but of course the interest rate environment was completely different back then. Well, for us as it is, it's difficult to imagine that our revenue should go down. The way that our Bank is organized, the profile of our customers, all of that shows that our revenue should continue to grow at a decent rate. So, that's one part of the story. And then you have to look at the costs. Structurally speaking, our Bank is not cheap, but we keep a cost discipline, with the cost to income ratio about 45-50%. Well, it's always a questions of how to calculate the C/I, but in 2020, I think, we will no longer be even talking about the bank tax. It will be another constant. This is the area in which we will be moving. I think there is a number of initiatives which should structurally help the Bank to optimize our costs. But are open to some cost items growing. It is no secret, for instance, that we are considering whether in mid-sized cities, where we don't have a local presence and where our brand has a very good recognition, we shouldn't possibly have a kind of local footprint. I like the following example. I may have quoted it before. My family, they come from the town of Rawicz. When I look at the neighboring counties… Have I told you this story? Have I? No? I have told it a number of times but I don't who listened to it. Anyway. There are other towns in the area… Oborniki Śląskie, Śrem, Wolsztyn, Kościan, I could continue with this list. The biggest town is Leszno, with the population of eighty thousand. In all of these towns all around, we have a presence with one small former Multibank branch with seven or eight employees in Leszno. BZ WBK has a presence in all of those towns. They have two branches in some of them. I understand that, but the point is that we are recognizable to a group of customers – maybe Kościan or Śrem are not a points of reference, but Grudziądz with a population of fifty thousands, why not. So, we are not dogmatic about saying no to all investments, but we have to be flexible. So, we are not dogmatic about it. But we focus on the C/I ratio to stay in the top 3 among the top 3 banks with a good C/I. We are sitting on excessive capital and that's in the wake of the so-called vengeance of Mr. Jakubiak and all the other developments that have led us to where we are now. I don't think that the public authorities will make any further pressure on banks to increase capital requirements for the Swiss franc portfolios. We could talk about it, but I think there's little ground to do that. You have run a comparison, right? The only banks with the capital ratio comparable to ours - 22-23% - in Europe are Scandinavian, Nordic banks, in Sweden. So, why do they have 23%, as we do? That's what they report, at least. So, our colleagues looked into it, and the actual truth is that they do have those ratios, but if you look at the mortgage portfolios, the risk weights there are 10%. So, that's incomparable - our 23% is incomparable to the Swedish 23%. Of course there, the Swedish central bank exerts pressure. Maybe they don't have enough impact to increase the risk weights, but there are many, many factors at stake. So, what I'm saying is we will make an effort to go back to a double digit return on equity in the Bank. You cannot do it overnight, especially when we had to pay nearly 400m zlotys of the bank tax overnight. But that's the kind of guidance for people like yourselves, you know, to look at different factors. It's not all very scientific, you cannot use a simple sliding scale, if you remember what that tool implies, and calculate the results directly. There are some many different factors at stake, that's my answer to your question. What happens with the dividend, which also plays a role? Well, you know that over the past 3 years dividend was paid out depending on the whim of the regulator.

Dariusz Górski: I have a more specific question, perhaps. Cost of risk in corporate banking - it is quite volatile. Retail would be more indicative of the portfolio, but what is the sustainable costs of risk in corporate banking? What would you expect in the second half?

Cezary Stypułkowski: Well, look, we are not meeting for the first time. So, my argument so far went as follows. In good years our cost of risk is around 50 basis points in Poland. In "so, so" years, 70-75. In bad years – 100. If the Bank can stay within those bounds, without a sharp increase to 150, then things are cool. That's how it works. And I would be too concerned with those quarter on quarter changes, because we release provisions in one place, while we set up provisions in another. You could keep them flat, but then it would be almost like creative accounting. IFRS kicked in 2004 or 2005, and now that IFRS 9 will kick in, this will change the game as well. So, fine.

Dariusz Górski: And the average cost of risk? Would you use a median of the different levels to get to the actual genuine cost of risk? So, 20+ bps would be the median?

Cezary Stypułkowski: In retail our cost of risk is relatively low, even compared to peers. I think that's largely due to the fact that our expansion with unsecured loans has so far relied, however, mainly on our existing customers. If we step outside our customer base, the cost of risk will probably rise. But the price of the product will also rise. If you look at the last seven years, we are going down from 70 or 80 to more like 50. And this goes back to what I said many times in this room. I don't think we are in for any surprise.

Dariusz Górski: An outflow of corporate deposits. 20 million disappear in the sector. What's your take on it? Is it VAT, is it investments that companies are trying to make?

Ernest Pytlarczyk: It has to do with liquidity in the corporate sector, but we also think it's due to situation with VAT. But, if you look at loans, it's a natural conversion of liquidity into lending. So, investments are kicking in and this is why there was this big outflow.

Dariusz Górski: My last question about an outlook or your pipeline, production of loans: you've seen some growth, you seem optimistic for the next two-three years of the cycle, but can you see that in terms of your clients' interest and credit applications? Will this year be better?

Cezary Stypułkowski: In corporate lending?

Dariusz Górski: Across the board.

Cezary Stypułkowski: Well, in corporate lending, the first half was good the second will be better, I think. As for retail, it's a steady flow. I will put it differently: the trajectory is on the rise but I wouldn't like to speak of a sharp increase from one quarter to the next, it's always a mix of different factors. One thing, that will happen, I'm sure, is that the mortgage lending will step up. I'm sorry to say that, because it's my fault I think, we turned the full circle. We invested in restructuring of mBH but now we are running back to mBank like crazy and that was because the initial approach to expansion with mortgage lending was based on the expectation that that would be financed with covered bonds directly. So the easiest way to go about it would be to book everything at mBH upfront because that would cut the cycle of issuing covered bonds. But given certain regulatory turbulences and the regulations and discussions with the PFSA it has turned out to be more difficult for us that we thought. And this is why we've changed our approach. So mortgages will be generated in close association with customers' accounts and then we will probably be focusing on pooling of those loans. And that had an impact on the buildup of that portfolio. We've had infrastructure for a long time and then we have had to restructure it again, now mortgage lending is growing at about one billion zlotys per quarter. The total capacity, 40 billion per year. We participate in the market at 10% which seems quite reasonable. Could we get more than that? Well, we could. What is really frustrating is when an mBank customer goes to get a mortgage loan from another bank. That shouldn't happen. And our customers' demographic profile suggests that we should have a disproportionally high share in the market of this product, which hasn't happen through the last two or three years. Some banks have been building up their portfolios very well but they didn't have the problem of a Swiss franc portfolio. They didn't have to handle that so upfront they had a better balance sheet. I wouldn't count our bank among them.

Kamil Stolarski, Haitong Bank: To follow up on your last comment, you had some hard talks with KNF after which banks decided to issue mortgage loans via mortgage banks and now you had more hard talks and you're going to universal banks. I think it's good for your profitability.

Cezary Stypułkowski: Well, let me put it like this: in a country like Poland mortgages should be financed with covered bonds, as a rule. I'm not saying how much or to what extent but you cannot take 3-month deposit and turn them into 20-year exposures, that's absurd. It's a different way of thinking about… We were accused of issuing Swiss franc loans… But that's the way they should be financed. We are not saying we are giving up on this part – covered bonds as a source of funding for expansion of mortgages is about 15% I think now. I'd like it to be higher but we were in the avanguard of thinking about mBank Hipoteczny as a bank that not only issues bonds but also generates a mortgage loan portfolio. I don't want to talk about details, not because I don't remember but because I'm not authorized to do so bot we had some individual specific talks with KNF, mainly about the way that our Swiss franc portfolio has historically been funded. So it's not applicable across the board to the entire banking industry, it's specific to us. So we continue with this dialogue, it's the underlying foundation of our thinking about our bank. It's not a secret that our long-term funding structure, if we had a funding structure like other banks do, profitability would be better. But we've always been saying: we want to keep our long term funding of assets safe. On one hand we want to be constantly present on the capital markets and issue Eurobonds, we try to have the Swiss franc in the structure, we want to issue covered bonds on large scale. So the whole range of our sources of funding reflects our very prudent approach and our understanding of the long-term balance sheet structure. What we want is to keep the match as good as possible what may not always go hand in hand with the wishes of the regulator.

Kamil Stolarski: Thank you. Another question about your comment this morning about the capital available to the bank for mergers and acquisitions. If you look at the chart which is on the slide now, the surplus capital that the bank might have is three, even four billion if you include earning from this year. So why did you say billion? Why 17% of Core Tier 1? Would that be minimum?

Cezary Stypułkowski: Well, we have some internal buffers that we want to keep. We have to protect ourselves in case the FX rate of the Swiss franc changes – that's 25% of our total loan portfolio. I do believe that the FX rates will be changing to the advantage of the bank but we still need to keep a buffer just in case. Maybe given some trend and developments we will want to reduce that buffer but not, if we consider all the potential developments on the horizon, that is the situation as it is, and as it may develop, the worst thing we could do would be to reduce our capital right now only to find out soon that we have to rapidly increase it. And the regulatory situation is as it is. And remember AQR and we took part in that, too, everybody was saying: Polish banks have a very strong base. But then there was another buffer and a 4% change on a one-off basis. But now, that you have to have the Recovery Plan and the Resolution Plan with automatic mechanisms that are embedded you have to trigger them if some things change based on what you wrote to the plan several months ago. I think this is absurd but that's what the regulator wants right now. And then you are at the mercy of whoever it is. I've seen too many things in my life to believe that we can now reduce our capital by three billion and not to have not 13 but 7% of fat, 7% not 13% of surplus capital.

Kamil Stolarski: I have two technical questions. One about Blik. It seems that you signed 5 million this six months and in the first half of last year also several million so what kind of investment size are we talking about. I've just looked at the mBank application – Blik is still part of it. So you're investing and at the same time you're writing it off. Why are you writing it off?

Cezary Stypułkowski: I cannot disclose numbers which I do remember but it's a joint venture of six banks so we cannot really discuss Blik in those terms. We have contributed to the project because we do believe that it is a very good investment. It is an only solution of its kind in Europe, if we wanted to put it on the exchange, to float it, it would be a success. And we know that we need some more functionalities, we are still promoting the product so it hasn't reached its critical mass. But it's not a lot of money for the banks that are participating. I cannot tell you much more, you should talk to PSP, the company. But I think it's a very good application, that's one thing, and think about its uses - it has two very fundamental values for the bank which also reflects on our pricing policy: it is much more secure if you want to withdraw cash without using your card so it familiarizes customers with the mobile app. As I said in the previous conference, when cards were first introduced, people would use cards mainly to withdraw cash from ATMs. And the card issuer is not a part of the interchange fee chain. And I don't know whether you had the opportunity to use it, but I think it's the best solution on the market. So eventually m-transfers, ING transfers and all other transfers will be replaced by Blik. So the group of banks participating in the system will probably try to develop something like mBlik. It's a much better experience and there's been a massive increase of transactions, mainly online. And if you add one more thing to that and some people are very resistant, but I think there will be a bigger penetration of points of sale and additionally some contactless forms of payment which reaches some development, it will continue.

Kamil Stolarski: So why the write-offs if everything is working? Why do you have impairments?

Cezary Stytpułkowski: [no microphone] …

Kamil Stolarski: My last question about the sale of your know-how to a French bank, to the French Post bank. The know-how was a significant part of the goodwill of that business. The transaction took place in June – why was this big deal not reflected in the results of the bank last quarter?

Cezary Stypułkowski: There are two parts of the story: I'm not authorized to discuss the details, we have the confidentiality ? contract. For us it's not a revenue line although there is a potential pipeline because the first implementation is taking place on a very sophisticated market and there are many internal factors that suggest that this process will be a success. I know how much we have received for that but I don't know how it's been booked or recognized and I don't want to talk about it right now. But let me be clear - it's not hundreds of millions of zlotys but it's not irrelevant either, it's not negligible.

Kamil Stolarski: So this will have its reflection in the results of the bank or will it be neutral?

Cezary Stypułkowski: Well, compared to 4.5 billion zlotys of revenue which is our aspiration, it will not be directly noticeable, I think.

Joanna Filipkowska: We have some questions that came online. First two questions of Olga Veselova of Merrill Lynch: What will be the NIM expansion in your view in next quarters? And the second: How will the capital requirement change after the possible introduction of 3% buffer from 1st January 2018?

Andrease Boeger: Maybe first of all to the NIM question – as you can see in the appendix on page 25, NIM has already developed in a very healthy manner, it is something that we obviously have as a focus point and as I discussed beforehand we want to switch out of term deposits into more transactional and then we also on the loan side try to seek the loans that are higher margin. I think in terms of outlook we cannot give a concrete outlook there, we are still working on that but one has to appreciate that already a lot of work has been already put in there and it's an ongoing effort. So I think I'm not in the position to guide on that currently.

With regards to the capital side, I think what the question was referring to was the 3% systemic risk charge that is to be levied in Poland. On the other hand in Poland we have a current charge of the KNF which amounts to 4% in TCR and 3% in Tier 1 ratio. It is at least to me not 100% clear how these two will communicate with each other and how they should offset each other. Also looking at the European landscape, quite a singular solution to have a 3% and 4% add-on so I would hope actually that this one point will diminish and there will be more we are getting here to a model playing field and then the systemic risk buffer is the system of choice also all over Europe. So all in all I would not expect a lot from this.

Joanna Filipkowska: One other question from Anna Marshall from JPM: Could you provide an outlook on your dividend outlook? What could be the alternative uses of your significant capital cushion?

Cezary Stypułkowski: In principal we assume that this year, for 2017 we will be having the space for the dividend payout but since this is very much the result of highly individualized decision making by the Polish regulator I cannot bet on this. I'm just expressing the willingness to distribute a significant portion of our profits generated in 2017. The alternatives, you know, they are relatively limited, let's be fair: you can buy back your stock or you can just go for the acquisitions. As we have declared historically, acquisitions – we have opened to that idea, last year when we have declared our new strategy. But this is not something that is driving our minds. This bank historically has been growing via organic growth and, I would say, this is what we are sticking to. Any type of any acquisition needs to be very opportunistic from our perspective and obviously creating some value, not pure exercise for being bigger. That's something that I want to declare. There are these three things which I will respond to this question.

Łukasz Jańczak, Ipopema Securities: One more question about your NPL ratio which slightly increased last quarter but the coverage ratio decreased which suggests that the additional NPLS had a very low coverage with provisions. Why?

Cezary Stypułkowski: There have been some movements. Maybe the coverage ratio of specific loans was lower and we sold some NPLs in Q2. You have to look on both sides, not just one line. If your portfolio shrinks, the coverage ratio changes, gets reduced as well. So I wouldn't really focus too much on that, just in a quarter on quarter basis. OK, now thank you so much.