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VTB speakers: Leonid Vakeyev, Head of Investor Relations

Dmitry Pianov, Member of the Management Board

Operator: Good day – and welcome to the VTB group second quarter and first half year 2019 IFRS results announcement conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Leonid Vakeyev, Head of Investor Relations and Member of the Management Board, Dmitry Pianov. Please go ahead.

VTB: Thank you. Hello, everyone. Welcome to the call. Today we published our six months' numbers. The developments of core businesses look well. We continue to outperform the industry and grow our market shares in the retail segment, both in lending and funding. We also had robust growth in SME business, which is also our prioritized segment. CIB loans were slightly down due to mostly a Ruble strengthening. Netted of effects for evaluation there was moderate growth in CIB lending as well. Net interest margin continued to be under pressure. However, it bottomed out around March/April and was expanding by approximately 10 basis points a month since then. We expect this to continue, especially on the backdrop of monetary policy easing which started only in the end of the second quarter and has not yet impacted the six months net interest margin and net interest income.

Cost of risk was 0.8% for six months and 1.1% for the second quarter. Second quarter numbers are close to our guidance at the normalized level, and the lower six months cost of risk results from several large provision releases in Q1 where cost of risk was lower than the normalized level. Generally, we believe that the current cost of risk reflects the relatively benign macro environment which we expect to continue for the rest of the year. Finally, the net profit for six months was just under RUB 77 billion which corresponds to the ROE of 10.1%. Although in the second quarter we had somewhat weaker net profit, we absolutely and positively confirm the

RUB 200 billion net profit guidance for the full year. We believe that in the second half of the year a more favorable interest rate environment combined with continuing business growth will deliver stronger net interest income. Additionally, a number of specific structural factors will also contribute to the larger bottom line number.

Additionally, in view of the recent changes in the Group consolidation perimeter we made a special disclosure, the modified P&L statement for the six months of a last year, where we show how the P&L would have looked like for the comparable consolidation perimeter, i.e. primarily excluding Post Bank and VTB Insurance. We believe that this disclosure provides better transparency and allows to make true year-on-year comparison. We will be referring to these restated numbers in the presentation and also we will be showing these restated numbers in the subsequent financial statements for this year as well.

Now, if you look at the key components of net profit, 96% of net operating income comes from core banking sources, net interest income and net fee and commission income. On the modified basis net fee and commission income was 9% up, which is good dynamics, and we expect that to continue. Net interest income was 3% down on this modified basis, which is, as I said, a result of weaker net interest margin. Net operating income was finally 4% down. The provision charge was 25% down. The staff and admin costs although almost flat on the reported level, but they were 22% up on the modified basis, and we will explain that a little later. So, whilst the net profit was 21% down on the modified basis and 23% down on the reported level.

We had pretty robust growth in retail and SME where we outperformed the market, which is completely in line with our strategy. SME loans grew 13% and retail loans grew the same 13%. The retail deposits grew 11% while the growth for the industry was just 2%. So, we continue to significantly improve our market share, and we improved our market share in retail deposits by further 90 basis points for the first half of the year. SME deposits also grew pretty nicely at 8%. In the CIB segment on the face value the loan portfolio was 2% down. However, we already saw growth in the second quarter, which we expect to continue and netted of FX effect there, was actually about 2% growth.

Staff and administrative costs, like I said, on the reported level they were almost flat, 0.7% up, however, on the modified basis they were 22.2% up. That splits into 7.3% the effect of recent acquisitions, i.e. this is simply the incremental cost base of the three banks which we acquired recently, Vozrozhdenie, ZapSibCom Bank and Sarovbusinessbank. And just under 15% was organic growth. That reflects our growing investment into transformation, into technology and also into new hires, especially in the IT area. We announced earlier this year that we are doubling our IT staff and already in the first half of the year we hired a few hundred people.

Cost to income ratio was 46.6%, which is above our guidance, around 40%. That was primarily a factor of a weaker income line. We expect cost to income ratio to go down in the second half of the year and we still stand by our guidance for the cost to income ratio. And the cost to average assets continued to improve and was 1.7% for the first half of the year, a pretty decent level. Provisions - cost of risk was 0.8%, like I said, in the first six months of the year, which splits into 0.5% in the first quarter and 1.1% in the second quarter. And the low level for the first quarter was basically a result of zero cost of risk in the corporate segment, which was driven by large provision releases. NPLs stood at the same level - 5.7%, and the coverage ratio was also very close to what we had in the beginning of the year - 111% versus 112%.

Net interest margin was obviously under pressure. Like I said, it started to slightly improve in the in the second quarter and we would expect this improvement to continue in the second half of the year. As a reference here, we show the average key rate for various periods so the average key rate was 7.73% in the first half of this year versus 7.40% for the second half of last year. We also see here that the yield on interest-bearing assets was slightly up in the second quarter, which was driven by the corporate segment. That was partly due to the changing business mix and growing Ruble part and shrinking FX part of the portfolio, which has positive effect on margins and net interest income.

Capital - as you know we paid lower dividend this year compared to the last year. Still, it did have its impact on the capital levels, and decline of various capital ratios that you see here on slide seven are basically the result of the dividend that we paid in July, but it was decided in June - this is why it was already factored in. Still we believe that our capital level remains sufficient to fund further growth, in line with our plans, and to comply with the regulatory requirements. We expect to be fully compliant with the regulatory requirements when they come into full force by the end of the first quarter of next year, which means that we are set to further improve and increase our N20, the Russian accounting standards, Basel III capital ratio.

Our strategy is based on intensive growth supported by initiatives in digital economy. We are talking about a variety of different products and options for different client groups, and we wanted to highlight here some of these developments to you. First, for Moscow-based retail customers we recently launched the new lifestyle partnership, an application which is called “My Smart City”. We teamed up with several departments of the Moscow government and it is basically the smart digital and efficient way to connect people with various city services and opportunities - utility payments, public transport, payments for parents for school catering, information about your pets, about local communities, theaters, exhibitions, culture or sport events and many more. For the time being it is available in iOS - next step would be the android version. Next year we’re also planning to launch the similar platform for St. Petersburg. We’re also testing the augmented reality options now. So for those of you who are based in Moscow, you’re most welcome to download and enjoy this app.

The second thing is B2B Business Connect platform for SMEs, which we continue to develop. It connects suppliers and buyers, provides easy and seamless deal execution and has links to international marketplaces. This platform was launched back in 2018, last year, now it is used by over 6,000 companies. Recently we integrated it with the City of Moscow suppliers gateway and thus extended the platform's options. Also, recently VTB started to place its own procurements' orders there. The two other projects will be launched imminently and they're both pretty important. First, the VMO, virtual mobile operator, in partnership with Tele2. We see that as an important step to make our products and services more accessible for the clients and increase our presence in their daily lives. Clients will get less expenses, VTB will also reduce costs for client alerting, but most importantly, we will have more data for scoring, better customer loyalty, better data security and a new customer acquisition channel.

And the second important project is the Housing Ecosystem. It's a new digital platform for personalized property search, also for mortgage financing, easy purchase and registration process, remodeling, moving, rental etc. This will boost our competitive advantages both in mortgage origination and in digital services for the clients. And finally, just yesterday we announced the acquisition of the First OFT, the operator of mandatory and line data transfers between retail outlets and the tax authority. It has about 16% market share and this investment will contribute to our product offering, primarily for SME clients. There is a huge potential for data monetization, and we will be using their analytics for our own scoring systems.

And finally, our guidance - it hasn't changed and, like I said, we stand by our RUB 200 billion full year net profit target. This implies stronger profitability in the second half of the year which we expect to be driven by several things. First, the interest rate environment. The Central Bank started to ease the monetary policy only in the second half of June and it had minimal impact on the net interest margin of the first half of the year. However, we expect to have full effect in the second half of the year. The average daily key rate in the first half of the year was 7.73%. If the rate remains at the current level towards the end of the year the average daily key rate in the second half of the year will be 7.29%, so 44 basis points lower. And moreover, if you look at the market consensus, it's not entirely unreasonable to expect the Central Bank to continue cutting rates. If that happens it will be additionally supportive for our margins and we do expect Central Bank key rate to be at 7% by the end of the year.

In spring we started to price down more expensive deposits raised in the second half of last year, so it started to improve the margin in the second quarter, and we will see the full effect of that in the second half of the year. Like I mentioned earlier, net interest margin bottomed out in March/April and has been widening since then, which we expect to continue towards the year-end. This translates into wider margin and stronger net interest income for us.

Second thing, we have recently changed conditions for a number of retail products. In particular we de-packed interest rates for cash loans and insurance products. That will result in instant recognition of agency fees instead of amortizing them for the lifetime of loans. We're also changing conditions for loyalty programs, so we expect that this will boost retail fees starting from autumn. Another factor is FX result - we do have a long structural US dollar position under IFRS which comes out of a different accounting interpretation of the perpetual bond under Russian accounting standards and IFRS. And our flat position under the Russian accounting standards translates into long position under IFRS. Although the revaluation is ultimately netted on the capital level, it also goes for P&L in IFRS and you see quite significant FX costs in the six months numbers. We, together with the rest of the market, expect Ruble FX rate to be more stable and less volatile towards the end of the year, and we don't expect Ruble to strengthen as significantly as it did in the beginning of the year, this is why we expect the elimination of this pressure on the P&L in our second half of the year numbers.

And finally, we continue working on several IB transactions, which we also expect to be supportive for the revenues. These factors combined with of course continuing organic business growth, especially in retail and SME segments, make us fully confident in growing the bottom line in the second half of the year, and achieving the full year net profit target of RUB 200 billion. So now we are ready to take questions. Operator, please go ahead.

Operator: Thank you, sir. Ladies and gentlemen, if you wish to ask a question at this time, please press "star-1" on your telephone keypad. If you wish to cancel your request, please press "star-2". Again, please press "star-1" to ask a question. We'll pause for just a moment to assemble the queue. Now, the first question comes from the line of Andrey Pavlov-Rusinov, Goldman Sachs. Please go ahead.

Andrey Pavlov-Rusinov (Goldman Sachs): Good afternoon, gentlemen. Thanks a lot for a very detailed presentation. My first question is regarding your fee income dynamics and outlook. Essentially, you've made quite a little bit of a reclassifications end of last year and also first half of this year so it's a little bit more difficult now to understand what was the underlying dynamics in fees, especially in card fees. So basically, as I can see, the second quarter was a lot stronger than the first quarter of this year and essentially the second quarter of last year as well. But could you please maybe just to give us a sense of what was the underlying dynamics and also what kind of a growth should we assume for the second half of the year - should it be closer with the dynamics of 9%, you mentioned, for adjusted number, or could it be closer to 20% which is implied from a single second quarter dynamics? And also, with regards to that, if you could also shed a bit more light on the initiatives you mentioned about agency fees and also loyalty programs? That would be very helpful.

VTB: Andrey, thank you for the question. I think it would be fair to say that we obviously expect acceleration of fee income growth in the second half of the year. It's not necessarily that we will achieve 20% growth but obviously the 9% growth that we saw in the first half of the year is kind of the lowest level that we see for ourselves, so we're pretty confident that we will have the double-digit growth in net fee and commission income for the second half of the year.

Andrey Pavlov-Rusinov: Thanks, that's helpful and just for understanding, what is the underlying growth in card fees for the first half of this year and maybe second quarter in isolation? What is the dynamics you see there in card fees separately?

VTB: I think it's partly the organic growth but partly the redesign of the products that we make and basically converting the loyalty programs into higher fees for us. I'm afraid there is no absolutely straightforward answer to this so it's a combination of organic growth and redesign of product conditions.

Andrey Pavlov-Rusinov: You mean your expectation for the second half?

VTB: Both.

Andrey Pavlov-Rusinov: And could you also let us understand the magnitude of this loyalty change that you are making and also these agency fees that will allow you for the instant recognition, are we talking about 5 percentage points higher growth or how much could it be?

VTB: Andrey, probably for the marketing purposes we would prefer not to go into big details about explaining how exactly the loyalty programs will work. And of course it will be properly communicated to the clients in due time and in a proper way. But basically the change in conditions refers to the elimination of bonuses which are overdue. And sorry, can you please repeat your second question?

Andrey Pavlov-Rusinov: Yeah, basically the other part of my question was regarding the agency fees. As you mentioned, you would be able to instantly recognize some of the fees for cash flows. Could you also clarify does it impact the fee income or more interest yields and in what way?

VTB: It affects mostly the fee income, exactly.

Andrey Pavlov-Rusinov: Okay, so at the moment you are basically amortizing it and since the third quarter you will be instantly recognizing the entire amount?

VTB: Since September, I should say.

Andrey Pavlov-Rusinov: September. Okay, thank you, that's helpful. And just my second question is regarding your OPEX growth. It was pretty helpful for you to give us the underlying OPEX growth of 15%. Could you may be shed some light what – essentially, what part of that is driven by your IT investments, hiring of IT personnel and maybe investment in new platforms, as opposed to more of a maintenance OPEX growth, if it's possible? Thank you.

VTB: The vast majority of this incremental growth of 15% is the IT cost - it's just ongoing basically, IT costs, but it's – sometimes it's very hard to really divide between the maintenance costs and investments into new platform. So basically this 15% splits into two parts. One is the personnel costs, staff costs, because we hired new people and we need to be competitive in this market. And the second part is investments into our platforms, investments into our capabilities.

Andrey Pavlov-Rusinov: Thank you and just a final thing. I guess given that you've just started rolling out your IT platforms, we should also expect a related OPEX growth for the second half of this year and should it also be implied that next year you would be spending quite a bit on IT?

VTB: Andrey, when we presented our strategy we said that although we expect the average cost growth for four years to be more or less in line with inflation we expect larger cost growth in 2019 and in 2020 and then lower cost growth following that period. So I think the cost growth in the second half of the year will be lower than 22% but still quite significant. And then we also plan significant investments, significant expansion for the next year but we're not prepared to quantify that at this point.

Andrey Pavlov-Rusinov: Thank you very much, this is very helpful.

Operator: Thank you. Ladies and gentlemen, as a reminder, to ask the question please press “star 1”. Now, our next question comes from Andrew Keeley, Sberbank. Please go ahead.

Andrew Keeley: Good afternoon. A couple of questions from me. Can you give any color on how you are thinking about the new PTI rules affecting your retail lending? I don’t know if you can tell us what your average PTI is now and just whether you think that it would start to affect your new loan issuance. And just in terms of retail lending, - there was a bit of a slowdown in the second quarter, but it seems like in terms of your guidance you’re still expecting to beat the market for growth. So - do you see any signs of concern in terms of the quality on the retail loan book or, are you fairly comfortable that nothing is particularly changing there? Thank you.

VTB: Thank you for this question and obviously it’s a “hot thing” in the market right now and we were expecting that. But we should say that first of all, we don’t believe that there’s any sort of bubble in the consumer lending market and that this market is in some way “overheated”, so that it needs to be “cooled down” because of three things. First, a consumer credit to GDP in Russia is still below 10% even following the growth in recent years and this is not above average for comparable developing markets. Number two, average PTI for consumer loans in Russia is now around 40% - internationally it is recognized that this level becomes critical when it is over 50%. And number three, since 2016 – and this is the more technical thing - but since 2016 we have seen low inequality in risk levels for consumer loans in different client groups with different PTIs, which is normally typical for relatively benign macro environment. Of course, borrowers with higher PTI are more susceptible to worsening macro conditions but currently, with moderate economic growth and reducing interest rate environment, we do not expect deterioration of consumer credit quality in any material way. Our own average PTI is pretty comparable to the market - it’s below 50% and for the past at least several months we’ve made some deliberate efforts to reduce our exposure to these clusters of the market with higher PTI or PTI of like 60-70%.

Now, having said that, we of course appreciate that the regulator tends to have more conservative views and of course, we will comply with any new regulation, whatever it might be. But our opinion is that the banks should have more leeway in concerning the borrowers' income levels and be able to use for regulatory purposes our very advanced scoring models, which rely in addition to official payment slips, on various other sources of information, including travel records, data from telecoms, social networks and various big data tools. So if the Central Bank agrees to that approach, the effect on VTB will be minor because, like I said, we have been significantly reducing loans with higher PTI over time. But of course if the Central Bank sticks to the current version, consumer lending will still remain one of the most profitable products that we have. And we will be doing it in line with our strategy and in line with our plans. However, these changes will then cost us about 3% of our total capital over the three-year period, which means that we will probably be slightly moderating the growth in other areas.

Andrew Keeley: Okay. Alright, thank you, that's helpful. And just a question on your margins and your deposit costs. So am I right in thinking basically that you're expecting deposit costs both for retail and corporates to start coming down from the third quarter? Is that what we can expect?

VTB: Well, they started to come down in the second quarter already, mostly in the second…

Andrew Keeley: I mean, the average deposit cost for the…

VTB: Right, but yes, we expect them to go down in the third quarter, true.

Andrew Keeley: Right, okay. Alright. Okay, thank you.

Operator: Thank you. We have some pop-up question in the queue. The next question from Elena Tsareva of BCS Global Markets. Please go ahead.

Elena Tsareva: Hello, thank you for the presentation. Almost all questions covered but just a bit of broader questions on dividend potential. Given you already announced like new dividend payout for the next years, but I remember there was no like legal document for this new dividend policy. Is it already in place? Just to ask one question. And maybe if you can share any target level of capital, like fee generation to get to 50% payout or there are no limitations in terms of capital adequacy ratio for getting this payout. Thank you.

VTB: Yeah, thank you very much for bringing up this issue and this is actually something that we hear from various market participants. You're absolutely right, our current dividend policy has a very broad nature and basically a whole variety of options sits into that. And we have made a commitment to pay 50% of our IFRS profit as dividends. We absolutely stand by this commitment and we will have to institutionalize this in our documents and in our dividend policy. We will be doing this closer to the next dividend payment so in the next few months basically.

In terms of capital adequacy levels, of course our primary target is to comply with Central Bank ratios in 2020 and 2021 and 2022. And the reason why we paid lower dividend for the last year was exactly our calculation of how much capital we need to reach 11.5% by the end of the first quarter of next year and then to be able to pay 50% dividend for this year in 2020. So going forward for the next year we will have pretty thin, frankly, cushion over the minimum level of 11.5% but throughout the lifetime of our strategy this gap between the actual levels and the minimum level of 11.5% will be widening. That's part of our plan, that's part of our calculation which was the foundation of this new strategy.

Elena Tsareva: Many thanks for the detailed answer.

VTB : Thank you.

Operator: Thank you. Our next question comes from Alan Webborn of Société Générale. Please go ahead.

Alan Webborn: Hi, thanks for the call. In your retail business you're clear in terms of talking about having gained market share in the in the first half of the year. Is that also true in the mortgage business? Could you talk a little bit about how that's been behaving? I see that you're going to launch your Housing Ecosystem in the autumn, in the winter and there does seem to have been a very sharp take-up, particularly in Moscow as I understand it, in terms of new mortgages being sourced through the sort of digital ecosystems that some of your competitors have put together. And have you been able to keep gaining market share, sustain market share in a way whilst you put this thing in place and do you think it will have a significant impact on your origination once it's up and running? And when do you think it will be fully up and running? That would be helpful, thank you.

VTB: Thank you, Alan, that's actually a very good question because indeed as you noticed, our general market shares in retail grow pretty well, both in funding and in assets. However, the mortgage market is a little bit different because unlike the general retail market, cash loan market, the mortgage market is more concentrated - there are less players and I think for the past couple of years our market share has been pretty stable. Generally we issue about a quarter of all mortgage loans in Russia and that has been like that for a while. And we're of course looking for ways to further increase our market share, given how crowded that market is, it's not easy and it's not the situation where you can double your market share during a short period of time.

But of course the Housing Ecosystem, which we are launching pretty soon, is one of the ways to make our services more accessible for clients, more convenient for the clients, and also it's a tool for us to better understand our clients, better understand their behavior, better understand their risks. So Housing Ecosystem is basically a "two-way tool" for us. It's, on the one hand, that will help us hopefully to increase market share in mortgages. On the other hand, it will help us in our risk assessments, in how we build the products in how we understand the clients' needs, so that's a very complex system. But, yes, it is one of our priorities to increase the market share in retail. However, we acknowledge the fact that the incremental market shares that we might be gaining in the mortgage market are lower than the incremental market shares that we have been gaining in the retail market in general.

Alan Webborn: That's helpful, thanks.

Operator: Thank you. We will now take our next question from Andrey Mikhailov of Sova Capital. Please go ahead.

Andrey Mikhailov: Thank you very much for the call. I'd like to discuss your business line which represents revenues and expenses from pensions and legalized insurance. If you could elaborate on your expectations for this from the second half of this year and beyond, I would be grateful. Thank you.

VTB: Yes Andrey, thank you very much for this question. We agree that this representation that we had in the P&L might be a little bit confusing because - we deconsolidated VTB Insurance and we're still showing the result from insurance business, but these are not actually the results from the insurance business. The numbers that you are seeing in this line are basically our obligations to the holders of the pension plans. And the larger negative number that you see there for the second quarter compared to the first quarter basically reflects the fact that the market was performing much better and the money that we get from the policyholders are of course invested into certain number of instruments. So when the value of those instruments goes up this is on the one hand reflected in our investment revenues and on the other hand this is offset by the obligations to the policyholders, which in the P&L line shown as losses from insurance business. I hope this is helpful.

Andrey Mikhailov: Alright, so that's mostly dependent on the market dynamics then…

VTB: Absolutely. Absolutely, because of course the fees that our pension fund receives are significantly lower than these numbers that you see there, the billions of Rubles.

Andrey Mikhailov: Thank you very much for the explanation.

Operator: And we have a follow-up question from Andrey Pavlov-Rusinov of Goldman Sachs. Please go ahead.

Andrey Pavlov-Rusinov: Yes, thanks, I just have one follow-up question. Basically, a bit of also kind of high level question - your capital adequacy. Essentially now that we see a further divergence from IFRS-based kind of Basel I capital adequacy that you are reporting in the IFRS and the move of the Central Bank to Basel III, and potentially to Basel 3.5. Do you plan to also implement Basel III rules for your IFRS reporting, for example, with regards to the operational risk or maybe some also adjustments on your credit risks any time in the future? Or do you have any timeline, or do you have any obligation to do so? Any thoughts welcome. Thank you.

VTB: There is no particular obligation or timeline. And I think what is really relevant is the N20 ratio and N21 and N22, so the family of N20 ratios, which are the mandatory ratios from the Central Bank. Because this is really the ratio which defines whether we have sufficient capital or whether we have excess of capital or whether we have deficit of capital. And for the presentation purposes we'll continue to publish these ratios and make the market more familiar with these ratios going forward, because this is the basic ratio which is the foundation of our capital planning and that's the way it looks from outside. Of course, we still continue reporting IFRS capital ratio under Basel I and I think we all appreciate that moving to Basel III is a big and costly project. And we don't see a particular value in this given that N20 family is already Basel III compliant and this is the basis for regulation and this is by the way are the triggers on various bonds that we have etc. etc. So that is the most relevant ratio which we will be focusing at and which we will be highlighting.

Andrey Pavlov-Rusinov: Thanks, sir I appreciate it. Just to mention basically I guess an IFRS-based ratio also do make some help in terms of comparing you with other emerging market banks but I appreciate your answer. Thank you.

VTB: We hear your opinion. Thank you for this feedback and of course this is one of the factors that we will be considering. And by the way, another thing that we need to mention is that these Russian mandatory ratios family will be also changing starting from next year when Central Bank starts to introduce Basel 3.5. And that's another big project by itself.

Operator: Thank you. As there are no further questions in the queue that will conclude today's question and answer session. And now I would like to turn the call back over to VTB for any additional or closing remarks.

VTB: Well, thank you. Thank you very much everybody for participation and for the questions. We hope we've been helpful. Please don't hesitate to reach out to your investor relations team at VTB at any time with any questions or requests that you will have. And with that, we again thank you very much and wish you a very good evening and goodbye.

Operator: Thank you. That will conclude today's conference call. Thank you for your participation, ladies and gentlemen, you may now disconnect.