BSF - Earnings Call Q2 Wednesday, 02 August 2023

Naresh Bilandani Good day, everyone. It's Naresh Bilandani, your MENA Financials Analyst at J.P. Morgan. I'm pleased to welcome you all to the second quarter 2023 earnings call for Banque Saudi Fransi, which J.P. Morgan is very pleased to host. Representing BSF we have the CEO, Bader Alsalloom, the CFO, Ramzy Darwish, Chief Treasury and Investment Officer, Zuhair Mardam, and Head of Investor Relations, Yasminah Abbas. I will pass the call now to the BSF team to commence their presentation. Thank you.

Yasminah Abbas Thank you, everyone, for joining us today. Welcome to our second quarter earnings call. I would like to thank J.P. Morgan for hosting the call today. Our CEO, Mr Bader Alsalloom, will go over the earnings summary and then an update on the strategy and execution, then followed by our CFO, Mr Ramzy Darwish, for a more detailed walk through on the financial performance. I will hand over to you, Bader. Thank you.

Bader Alsalloom Thank you, Yasminah. Thank you, everyone. Welcome, everyone, and thank you for attending the BSF Q2 earnings call. Before I start, I would just like to sincerely welcome, Ms Yasminah Abbas, who is now our new Head of Investor Relations. Yasminah comes with 19 years' experience within BSF. She is a BSF veteran and we're very excited that she's our new Head of IR.

Now, when it comes to our earnings, BSF reported a strong set of results for the first half of 2023. The impressive performance was underpinned by a favourable economic backdrop, progressive execution of our strategy and our operational agenda. We remain optimistic about the future as the domestic environment is expected to remain positive, further supported by increased corporate opportunities arising from Vision 2030 projects and our refocused strategy direction for the bank.

Now, let me begin by summarising our financial performance for the quarter and then touch base on the progress of the strategic initiatives. If we move to slide three, overall I'm pleased to report that we delivered another solid quarter with strong growth and achieved several key milestones. Starting with the balance sheet, loans and advances grew by 6%, driven by 7% commercial growth and 5% growth on the consumer lending side. That was led with deposit growth of 2% year-on-year, mainly on the back of interest-bearing deposits. In addition, investments grew by 13% year-on-year to SAR 49.2 billion.

On the income statement side, 26% top-line growth year-on-year, mainly on the back of 33% NII growth with the high interest rate environment and a healthy NIM of 3.62%, which is 72 basis points growth year-on-year. Net income grew by 26% and the growth was partially offset by increased operational expenses and increased impairments. On the asset quality side, a modest improvement in NPL ratio and coverage ratio but increased cost of risk, mainly from previously isolated pockets in our commercial book and delayed recoveries. Provisioning eased quarter-on-quarter, with cost of risk down 107 basis points in the second quarter of 2023, down from 116 basis points in the first quarter of '23. From a capital and liquidity perspective, capital funding and liquidity remain strong and comfortably within regulatory limits. We see a decline when it comes to NIBD percentage to 59.4%, mainly on the back of the shift from interest-bearing deposits and a rising interest rate environment.

Now, if we move to slide four, here just recapping BSF's ten business vital initiatives that we covered last time. For Wholesale Banking, which is our bread and butter and main business, to expand our financial institutions and government and multinational corporate coverage and also to revamp our Global Transactional Solutions, which covers trade finance and cash management. For Personal Banking, a focus and scale-up when it comes to affluent and also provide superior daily banking through our new digital channels for our non-affluent client base. For Private Banking, continuing to expand our product suite and also focusing on experience-centric rewards. For Saudi Fransi Leasing, our leasing arm, we will continue to, of course, scale up financing and leasing with new products. Last but not least, Saudi Fransi Capital, leveraging opportunities in capital markets and synergies with our Wholesale Banking and our Personal Banking within BSF. Finally, our focus for the first half of 2024 will continue to be on technology infrastructure upgrades and our rebranding, which is scheduled for Q1 of 2024.

Now, if we move on to slide number five, we show the progress of the strategy execution across the various business lines. Starting with Wholesale Banking, the progress stands at 51% as we continue to enhance our operating model and presence. We're launching new trade products, expanding our FI and government lending and, of course, finalising our segmentation. For Personal Banking progress stands at 31% which, of course, includes the finalisation of the segmentation model, which includes the value proposition and roadmap for our affluent segment. For Private Banking progress stands at 68%, mainly from the expansion of our product suite and the offering of unique experience-centric rewards.

For Saudi Fransi Leasing, SFL, our progress stands at 73% as we continue to refine the strategy and simplifying core processes while also building core products and our digital capabilities. Finally, on SFC, Saudi Fransi Capital, progress stands at 34% given the complex nature of the business. The progress covers a reassessment of the collaboration with the bank, connecting with key market players, pipeline management for funding and financing and a focus on real estate transactions. Overall, I'm happy to report a 51% progress across all of our strategic goals and we will continue to deliver and share with you the progress on the strategic execution, as well as all of the synergies and benefits realised along the way.

Now, moving along to slide number six. When it comes to non-business initiatives, I'm happy to report the good progress in the implementation of our key strategic programmes across the technology and rebranding priorities. On ICP, which is the Integrated Corporate Portal, we have finalised the business and technical requirements, initiated a backend and test environment set-up, and we've recently launched the phase two design stage. On Omnichannel, which is our new Personal Banking online platform and application, we have completed the development and design of our new digital banking MVP, and we have recently launched the Omnichannel pilot.

On CBS, which remains our main focus, our new core banking system, now we have three total rollouts and we've recently successfully delivered the first phase of the second rollout, which has already yielded an 85-95% increase in straight-through processing and has increased outgoing transactions, and we've already seen a reduction in manual processes. Finally, on the branding, the brand visuals have been completed and the preparation for the new brand is underway across all of our branches and the digital space. Now, without further ado, I'll pass it on to my colleague, Ramzy Darwish, to go through the financial performance. Thank you.

Ramzy Darwish Salam Alaikum. Alhamdulillah. Thank you, Bader, and a very warm welcome to everyone taking the time to join us today for the second quarter of 2023 earnings presentation. The strategy execution and technology upgrade mentioned by the CEO are really key pillars to the bank's success, especially in the long-term and, from a finance perspective, one we're very keen on seeing execution. Thus far, we're very happy with the progress we've seen. Today, I'll be taking you through the financial results, another strong quarter overall, driven by interest rate increases and overall lending growth.

We start off on the balance sheet with slide eight. The bank grew total assets by 6% year-over-year, with loans up 7% year-over-year on a sequential basis. Total asset growth and lending was up 2% and 3% respectively. In line with the bank's forte and DNA, you will see in the latest slides that the growth was mainly from our commercial business. On the investments we had an increase of 10% or SAR 4.3 billion. This is a part of the bank strategy to continue to maintain and manage the overall liquidity ratios but also taking into account second half maturities, as these pre-emptive investments would reduce the scalability risk and allow for a greater depth in terms of yield, especially in light of the volatile interest rate environment.

To fund this balance sheet growth the liabilities grew 7% year-on-year, driven by longer-term debt securities, interbank and client deposit growth. On a sequential basis, liabilities grew 3% as debt securities on the back of the Sukuk issuance and interbank funding more than offset the 4% drop in customer deposits. You'll note in the upcoming slides that with comfortable liquidity levels and ratios, there was cost optimisation that took place throughout the quarter, especially as it relates to more costly time deposits. Total equity increased by 2% year-on-year, driven by internally-generated capital via earnings.

On the next few slides we will unpack some of the major balance sheet items. Starting with slide nine, in the top left chart you will note a healthy 7% year-over-year growth for loans and advances or 3% for the quarter. As highlighted earlier and emphasised in the middle two charts, this was driven by both the commercial and consumer segments, with a greater tilt towards commercial lending, which grew by 9.8 billion for the year or 4.7 billion for the quarter, with the commerce, service and contracting sectors representing the bulk of the increase.

Consumer lending also grew 3% for the quarter, with mortgage growth of 2%, personal financing growth 4% and 10% growth in credit cards. In terms of composition, on the right hand side you'll commerce and services represent the largest proportion of the commercial book, as the bank is focusing on more value segments, whereas mortgages in the bottom right chart continue to represent roughly half of the consumer lending book. The pipeline for commercial lending still presents attractive prospects for growth, especially given the healthy liquidity and capital position, and this is countered with great competition and more settlement activity.

On slide ten we highlight the main funding element, the deposit base, with various cuts of data shown in the charts to provide more granularity. Overall, total customer deposits grew 2% year-to-date and were primarily from interest-bearing deposits, which grew 7% year-to-date as corporate deposit growth of 32% offset the 32% decline in retail deposits. On a quarterly basis deposits were optimised lower by 4% as interest-bearing deposits were lower by 6.5 billion or 9% in the quarter and non-interest-bearing deposits were slightly up by SAR 300 million.

Part of this optimisation was the expansion in alternate, more stable and longer-term sources of funding, including the USD Sukuk in the second quarter for almost 3.5 billion. Non-interest-bearing deposits were lower 1% year-to-date due to a 14% decline in corporate, which was almost offset by 10% growth in retail. Overall for the quarter, given the increase in interest-bearing deposits and the slight increase in non-interest-bearing deposit volumes, the CASA ratio improved to 59.4% from 57% in the previous quarter.

On slide 11, we are really, really excited to see the results of all our efforts, providing for a record first half in terms of operating income, operating income before impairment and net income. This is highlighted in the top chart, indicating an operating income before impairment of 1.62 billion, 33% higher than last year. Along the same lines, net income at

2.15 billion provided for a 26% growth over last year and 1% growth on a sequential basis. We'll go over a few of the main highlights and dive into the details over the next few slides.

The main contributors included net interest income, up 33% year-on-year and 3% over the previous quarter. This was accentuated by NIM expansion of 72 basis points from the first half of last year. Non-interest income was up 1% year-on-year as higher FX income, credit cards and other fees were mostly offset by lower trading, brokerage and asset management income. On a sequential basis, although we witnessed and improvement in trading and brokerage and management income, non-interest income declined 6% for the quarter due to lower card fees and exchange income.

On operating expenses, these were 15% higher year-on-year due to employee-related and G&A expenses, in addition to one-off reversals in the first quarter of last year. Impairments were at 837 million, 56% higher year-on-year and 6% on a sequential basis, driven again by continued coverage of pockets of stage migration in the commercial book. On operational efficiencies, momentum continued thanks to loan growth and better interest margins, leading to higher earnings, providing for a cost-to-income ratio of 30.8%, an improvement of 316 basis points compared to last year. And on profitability, both ROA and ROE improved with return on average equity firmly in double digits and the return on average assets improving by more than 26 basis points when compared to last year.

On slide 12 we'll unpack the main driver in operating income and that was the net interest income, which witnessed a growth of 33% year-on-year, as earning assets growth of 6% year-on-year and NIM expansion both played positively. In the top left you will see an absolute amount. Net interest income was at 3.899 billion, up from 2.93 billion in the second quarter of last year. And on the top two charts, on the right average interest-earning assets grew by 13 billion, outpacing the 7 billion in average interest-earning liabilities. Taken together, in the bottom left two charts, with the increase in SAIBOR, net interest margin for the first half was at 3.62% and for the quarter at 3.57%, an eight basis point decline from the previous quarter. Even though we had expected stabilisation in the net interest margin to occur sometime between the second and third quarters, we continue to see repricing on the asset side kicking in towards the end of the first half, which will provide a positive boost.

On slide 13 we focus on the largest performance driver, given the bank's overall structure and interest rate standing, and that again is a positive positioning for a rising rate environment. As a result of the view on interest rates and the necessity to hedge the interest rate risk, the cash flow hedge book has increased 35% year-on-year to 33 billion, covering 28.6% of the interest rate-sensitive gap. It is important to note as well that the cash flow hedge book has a relatively low average duration of between 2-2.5 years and as they mature the mark-to-market reserves improve and replacement hedges provide for an improvement in the growth yields. As such, with our current balance sheet structure, we will continue to maintain our portfolio of cash flow hedges to manage our interest rate risk and will closely follow the market to assess opportunities in changing the size of this book.

On slide 14 we zero in on the non-interest income, which witnessed a 1% year-on-year decline or a 6% reduction on a sequential basis. Areas of improvement for the quarter in brokerage and asset management, trading and trade finance were offset by the lead drivers of the first quarter, namely exchange income and card fees. This was as a result of fewer business days along with the completion of certain campaigns in the first quarter of this year. For the half year, we did have decent growth across most categories, expect for trading, which had witnessed several one-off transactions in the first half of last year, and brokerage and asset management, where recent trends have also been positive.

The final element of net operating income on slide 15 is on the expense, which had a growth of 15% year-on-year, again due to employee-related costs but also excess accrual reversals in the first quarter of last year. For reference, excluding these reversals and other one-offs, we would have a growth of 10% year-on-year. And if you recall, we highlighted that this should trend lower to settle in the high single digits for the full year and this was evidenced as the previous year-on-year growth was at 18%, moving in the right direction at 15% now and expected to trend lower. Outside of the staff-related expenses other cost growth was relatively muted and on operating expenses as a percentage of average interest-earning assets, this improved to 1.32% and allowed for an enhancement in the cost-to-income ratio to 30.7% from last year.

On slide 16, we highlight the credit trends, which were higher on a year-on-year basis. The net impairment of 837 million was 56% higher year-on-year and higher by 6% sequentially, driven by continued coverage on the isolated pockets of migration highlighted last year. This is in addition to delayed recoveries which were expected in the first half of last year. The charts are indicating, in the bottom left chart, cost of risk at 107 basis points year-to-date, an improvement of eight basis points from the previous quarter, was higher than originally expected, again due to recovery that did not occur.

The next chart also highlights an improvement in non-performing loans ratio, improving by 12 basis points year-to-date, to 242 basis points on a 2% NPL growth and 7% rise in loans. On NPL coverage, this increased ten percentage points, up to 133.3%, with the bulk being on Stage 3 NPL coverage, which was up by 11% year-to-date. This was also in relation to the one corporate legacy exposure that had migrated to Stage 3 last year and where we had been increasing coverage. This exposure is now 100% provided for, otherwise underlying credit cost continues to remain within expectations.

On slide 17 we discuss liquidity and capital where, to a great extent, there has not been any significant movement and remains solid. This is evidenced by the LCR ratio at 180% and NSFR at 116%. Similarly the SAMA loan-to-deposit ratio sits at 82%, providing liquidity room for continued lending growth. On liquidity, we continue to explore opportunities to diversify funding to ensure stability for both short-term and long-term while also, when the situation is warranted, extending the maturity profile opportunistically.

Total capital increased on the back of earnings and internal capital generation, and was partially offset by the final 2022 dividend payment. RWAs declined 1% year-to-date on the back of implementation of Basel III reforms and were 2% higher sequentially due to balance sheet growth. As a result, the CAR was at 20.3% and the Tier 1 ratio was at 19.3%. Our capital position continues to provide ample room for asset growth while noting that, based on the ICAAP, we will have adequate capital for the foreseeable future.

Lastly, on slide 18 we provide a snapshot of where we stand on guidance and also a few updates. In terms of loan growth, it is above plan, with 7% growth year-to-date. However, given seasonality in past, especially as it is related to maturities and settlements and the difficulty in assessing drawdown timing, most notably in the last quarter of the year, we remain comfortable with the guidance and will continue to push for a better outcome. On net interest margin, at 362 basis points it was currently above guidance. We have updated this to be in the range of 345-355 basis points. This is as a result of the way the balance sheet has developed and also expected full repricing on the asset side.

On cost of risk, given the recovery expected did not transpire, we have pushed out the potential recovery and no longer built into this year. Had this not occurred, we would still have been in the high end of the guidance range. As a result of this, we are raising the full year cost of risk from 85 to 95 basis points. Cost-to-income at 30.8% is in line with expectations and we continue to remain within guidance. ROAE, at 10.9%, is an area where we have had great traction and we expect to reach guidance on a full year basis. Lastly, the CET1 ratio at 17% is expected to remain within the 17-18% range as capital generation via earnings is supplemented with partial reversal of mark-to-market. With that, that brings us to a close on the financial results and we can move on to Q&A.

Operator Thank you. If you would like to ask a question, please press star followed by one on your telephone keypad. If, for any reason, you would like to remove that question, please press star followed by two. Again, to ask a question, please press star followed by one. As a reminder, if you are using a speaker phone, please remember to pick up your handset before asking your question and please do ensure that you have unmuted locally. If you have joined us via the web, you may submit a written question via the Q&A box on your screen. The first question today comes from the line of Waleed Mohsin, from Goldman Sachs. Please, go ahead. Your line is now open.

Waleed Mohsin Perfect. Thank you very much. Three questions, please, from my side. Firstly, on net interest margin, if I look at your revised guidance, the midpoint of that revised guidance implies 340 basis points of net interest margin for the second half, which is below the 357 basis points that was reported for the second quarter. So, I just wanted to get your thoughts around it. It seems or your guidance implies that your net interest margin beat in the first quarter and it should trend lower gradually. I just wanted to get your thoughts if we are missing something over here or if there is any upside risk to your net interest margin guidance as it stands. That is the first question.

Secondly, Ramzy, you alluded to the fact that there is a little bit of seasonality and there could be some repayment. I wanted to get a sense of the conservative guidance that you put forward for loan growth. Is it more a function of cost of funding challenges or the challenge of raising deposits at a reasonable price? That would be my second question. And my third and final question is on cost of risk. Your revised guidance still implies a decent normalisation to 75 basis points versus roughly 100 basis points that you guided in the first half, and you mentioned that this does not incorporate any recoveries which have been pushed out into next year. I wanted to get your thoughts on the upside risk to this, the cost of risk continuing to remain elevated and how much comfort should we derive from the fact that you have been able to build up your NPL coverage. Was that one of the key drivers of the elevated cost of risk charge in addition to some of the legacy portfolios? Thank you.

Ramzy Darwish Thank you, Waleed, for the questions. On the net interest margin, obviously with half the year having already completed we wanted to provide a bit more of a tighter range but also taking into account expected balance sheet structure going forward. In terms of saying it is a peak, we're not ready really to pull the trigger on that assessment yet. When we look at expectations for Q3, given the build-up of the repricing in the asset portfolio that would kick in, we're not fully confident that it is fully repriced yet. So, that's why we wanted to give a tighter guidance. We did want to raise it as well but we're not saying this is the peak yet. We had originally thought between the second and third quarters is what we would see as the peak.

On loan growth, I will just comment quickly on that, in terms of liquidity and cost of funding, I think we're very comfortable. There is nothing that is limiting the asset growth on the lending side from a deposit perspective. We feel very comfortable that we can mobilise, if necessary, but at the same time taking into account the full value that we can generate is important to the bank. This is something you would have seen BSF follow over the last couple of years. Finally, on the cost of risk, with regards to your question on the provisions and cost of risk that have transpired this year, a lot of that was related to the single name that we had transitioned into Stage 3 last year, and we built up slowly the coverage last year but also throughout this year. Outside of that specific name, we're not really seeing any type of cost of risk that is unusual and more in line with our original guidance.

Waleed Mohsin Thank you very much for that. Just one follow-up, please. Then, if I understand you correctly, on the net interest margin side it seems there is some upside risk to your current guidance because your first half outcome is 3.62% and the upper end of your guidance range is 3.55. So, if there are no further declines in net interest margin that means that is probably going to sit outside the top end of your range.

Ramzy Darwish It is possible. I think we have to take into account several variables and factors. There is the way the balance sheet is going to develop going forward, the funding that is going to provide the asset growth as well, whether it is coming from the interest-bearing deposits versus non-interest deposits and also the cash flow hedges that are being put on the book. So, I think a combination of factors will still introduce some variability but what we're seeing so far has been positive.

Waleed Mohsin Perfect. Thank you so much.

Operator Our next question comes from the line of Rahul Bajaj, from Citibank. Please, go ahead Rahul. Your line is now open.

Rahul Bajaj Hi. Thanks for the presentation. This is Rahul Bajaj, from Citi. I have two quick questions, actually. Going back to the cost of risk question from the previous question, how should I think about cost of risk, excluding that one account which you've now fully provided for? So, if I exclude that account from the first half numbers would cost of risk be in that 70-80 basis points initial guidance range? Is that a fair way of thinking? Just beyond that account, that particular account, how should I think about your provisioning, given the high interest rate environment? Are you putting in more overlays for high interest rates going forward? Are you thinking of putting in more overlays for higher interest rates going forward? Is that a topic which comes up in your discussion? That is my first question.

My second question is on your NIM sensitivity. I just wanted to understand if you have revised or done a revised calculation of your latest sensitivities to, for example, 25 basis points of rate cuts given your new, latest balance sheet structure that you have now. Any colour there? Thank you.

Ramzy Darwish Thank you for the question. I'll handle the first one on the cost of risk and the impairment. Without the single name exposure, we would have been in the range of our previous guidance, maybe even slightly lower but we had expected again the need to provision for this name from last year, so it was not a real surprise. I think the difference from what we originally were guiding was mainly built on the recovery assumption, that we had a fairly good comfort that was coming but now has been pushed out. Excluding that, we would have been within our guidance.

In terms of the rate impact, so far we've not really seen any material impact of higher rates through the risk profile. Obviously, this does take time to feed through the economic sector but thus far, over the last two years, we have not seen anything material. We do review the interest rate impact on our portfolio on a regular basis twice a year and thus far, again, nothing material to highlight there.

Zuhair Mardam Hi. As with regards to the sensitivity to interest rates, we remain heavily positive towards higher interest rates. We expect, as the CFO mentioned, our net interest margin might have peaked between Q2 and Q3. We will stick to that view. However, some other factors that will have some impact on negative NIM is the increase of cash flow hedge, whereby we remain quite exposed to higher interest rates. So, we didn't increase our proportion of average earning assets in terms of hedging our balance sheet. However, given the fact that we have a low consumer asset book naturally fixed and being at these levels, it will actually incentivise us to hedge our book even further. As we speak, we're still positively geared towards higher interest rates and, given the fact that we have grown our commercial book, the floating proportion is even higher than coming into the year. I don't know if I have answered your question.

Rahul Bajaj Sure. Just maybe one quick follow-up. A quick follow-up. I think you mentioned on the call previously that almost 28% of the interest-bearing assets are now hedged. Is there an optimal number you are targeting over the next 6-12 months you want to get back to in terms of the share of your interest-bearing assets which you would like to hedge?

Zuhair Mardam The fixed rate proportion of the balance sheet will depend on several dynamics, interest rate risk in the banking book as well as interest rate environment, macroeconomic environment and how much we want to be. We do have some internal targets in place coming into the year. However, this is a moving target and, as we speak, we continue hedging a proportion to the end of the year. We cannot ignore the fact that we are much higher than we had anticipated coming into the year.

Rahul Bajaj Makes sense. Thank you.

Operator Thank you. Our next question today comes from the line of Olga Veselova, from Bank of America. Please go ahead, Olga. Your line is now open.

Olga Veselova Thank you, good day and thank you for taking my questions. I have several. My first question is about loan growth. I noticed you have accelerated dynamics in the second quarter. Was this an indication of more growth appetite versus history or is it just lumpy quarterly dynamics? The other question on loan growth was about credit card dynamics. This segment was particularly strong in the first half of the year, up by something like 10% year-to-date. What helped you to deliver above sector average dynamics and what is your outlook there? Do you really want to focus more on credit cards?

And my third question is about cost of risk again and coming back to the same topic. Looking through this year, where there were several, I shouldn't say one-offs, specific factors for the elevated cost of risk in the first half of the year, how should we think about the trend into 2024? I appreciate you wouldn't be giving us exact figures for the next year but do you think that next year versus the second half of this year cost of risk will go down because of potential provision writebacks or it will have to go up because of a sustainably high interest rate environment? Thank you.

Zuhair Mardam I'll take the first question regarding the loan growth and, if I understood your question correctly, if there was any change to our appetite for loan growth. The answer is no, there is no change to the appetite.

However, we are being conservative when it comes to the loan growth. Given the higher or rising interest rate environment, we do expect unscheduled pre-settlements to come in which will dampen the growth. Also, with increased competition, of course, BSF, we remain to be sticking to our strategy of not jumping into any price wars with the other banks. And thirdly, and most importantly, of course, we remain to be selective when it comes to our asset quality and to maintain our diversified sectoral portfolio. So, that's the main reason why we are being a bit on the conservative side when it comes to loan growth, especially for the second half of the year, but when it comes to appetite, the appetite remains unchanged.

Ramzy Darwish And on the second question, I believe it was on credit cards. We have had good growth here. It has been a very positive story for the bank and when we look at the balance growth and the spend volume growth versus the market, also outpacing on that front. I think we're well positioned compared to other banks in terms of offerings and the outlook is still positive. A lot of what we saw in the first quarter was due to a campaign from the credit card team and that was really wildly successful. We have seen other banks follow suit on that front and this is one of the impacts you will see in the second quarter, in terms of the credit cards not doing as well but still better positioned from the start of the year.

Lastly, on the cost of risk, again when we look into next year, we don't go through too much of the detail as of yet, but it is an analysis that we do twice a year for the interest rate sensitivity. And when we exclude that single name that we had transitioned last year, that we've been providing for this year to make sure we have it fully covered, again the cost of risk has really been more in line with what we see from the rest of the market, 70 basis points and below. So, outside of that single name, we feel very comfortable with the book and its overall health.

Olga Veselova Thats great. Thank you so much. Can I just double-check one detail on credit cards? Can I ask you what level of interest rates do you offer on credit card loans now and how does it compare with your competitors, with local peers?

Zuhair Mardam It's more in line with the local peers when it comes to the interest rate on credit cards, so the competition comes from the benefits and incentives.

Ramzy Darwish I think it ranges for different credit cards, but typically what we've seen in the market has been in the 20%-plus range.

Olga Veselova Great. Thank you.

Operator Thank you. As a reminder, if you would like to ask a question, please press star followed by one on your telephone keypad.

Naresh Bilandani While we wait for more questions, can I please just ask two? Thank you very much. Once again, it's Naresh. Just two questions, please. One, could you please share some thoughts on what is leading to increase in employee costs in the first half? It would be great if you can guide on what areas are you conducting more investments from an HR perspective. And there's one question that I see coming through on the web which also synchs with this question. How should we think of the medium-term cost-to-income ratio for your franchise? That's one.

A second is, compared to your peers you are pretty much the only bank that has traditionally and is now still focusing on hedging the interest rate risk to this extent. Now, to what extent can these hedges help you on the net interest margin next year, assuming the current shape of the curve, if we assume rates will decline next year, compared to if you have no hedges in place? Is there any way that you can benefit or you can quantify the benefit that would come into your net interest margin, assuming your current swaps portfolio remains constant? It would also be very helpful if you can share with us what is the view that you are taking on the rates internally. Thanks a lot.

Ramzy Darwish Thank you for the question, Naresh. On the employee cost, it has really been in line with our expectations. There are inflation assumptions, FTE assumptions built in and, of course, with the significant investment in the various projects, particularly on the technology front, there has been an investment there. I think, when we look at the opex line overall, we had guided again that we are going to move lower through the year. We started off 18% year-on-year, 15% currently. And if you were just to take a simple doubling of the first half compared to last year, you'll see we'll fall under or up to the high single digit. So, we're happy with that position, no changes in terms of our expectations there, and that's why we are also guiding on the cost-to-income to have an improvement below 32%.

Zuhair Mardam With regards to the hedging activity, let's say in theory, if you have a similar shift of interest rates downwards you would have a similar impact on your NIM downwards as well. However, I just want to highlight that the repricing of these cash flow hedges, given the fact that they are on short-term maturities, in addition to the additional hedging that is being conducted as we speak, are coming at much higher yields which obviously have less of an impact on any drop in net interest margin. How are we positioned going forward? Again, we still have a proportion of our balance sheet hedged and we believe that if interest rates go down it would protect against any drop in interest rates compared to our peers. I think a straight answer to your question, Naresh, is looking back into historical terms, when interest rates sharply go down you see always BSF having a bit of a lag effect on a drop on its net interest margin compared to our peers. I think maybe you can think of it this way.

Naresh Bilandani Thank you very much, Zuhair. Once again, I think this question was asked previously but may I just stress on this again, is there an optimal cover that you're looking for, the size of the coverage? I know currently, right now, as you mentioned, it is in the 20s range. Historically, the coverage level has been as high as up to 60% in 2017 and '18. Is that the level you would potentially target or that's not the case at this stage?

Zuhair Mardam Let me give you, maybe, a bit more transparency. We're targeting around 35% till the end of the year.

Naresh Bilandani That is quite clear. Thanks a lot.

Operator Thank you. As a reminder, if you would like to ask a question, please press star followed by one on your telephone keypad. Alternatively, if you have joined us via the web you may ask a written question using the text box. Our next question comes from Taseer Abbas, from Derayah Investments, and they ask can you please give me details on the large decline in retail interest-bearing deposits versus 2022 end? Thank you.

Ramzy Darwish Maybe I'll take the first part of this and our Treasurer can join in. When we're looking at the deposit base, we're trying to manage the liquidity situation on an overall basis. We did have non-interest-bearing deposits increase slightly in the second quarter and with the introduction of longer-term financing, more stable, we felt it prudent to optimise the cost structure and optimise by reducing some of the more costly time deposits.

Operator Thank you. Our next question. Can you please provide some details on corporate loan pipeline, especially with regards to megaprojects? Thank you.

Zuhair Mardam When it comes to our corporate loan pipeline, it remains to be healthy until the remainder of the year and into 2024, mainly on the back of the gigaprojects, megaprojects and the Vision 2030 projects. Now, of course, most of that pipeline is indirect exposure, not specifically direct exposure to those gigaprojects. So, it is basically for our contractors, subcontractors, manufacturers and others through the value chain, itself.

Operator Thank you. The next question, was there any interest in suspense in 1H23?

Ramzy Darwish This is not something that we would divulge publicly but I think in the normal course of business, as the banks are going through the staging process and provisioning and write-off, there would be at a point, a stage where we did not take any interest earning on certain loan portfolios. So, it does play a role in terms of the net interest income as well and it's fully included in the financial results.

Operator Thank you. The next question comes from the line of Abdulaziz Alfozan, from ICAP, and they ask can you shed some light on the thought process of tapping heavily into interbanking versus deposits? If you could provide numerical cost of interbanking, that would be appreciated. Did you revise your assumption of Fed hikes this year in light of recent macro data and has that played a role in your NIM guidance? Thank you.

Zuhair Mardam Maybe I'll start with the last question on revisiting our interest rate forecast. Yes, we did, hence the change in our net interest margin guidance for the rest of the year. With regards to your first question, the way we operate, we see our liquidity profile as quite comfortable when it comes to liquidity ratios. Now, the only aspect or the difference when it comes to raising liquidity from the interbank market as opposed to customer deposits is that customer deposits do hit your loan-to-deposit ratio. However, given the fact that we're quite comfortable on all Basel requirements and SAMA regulatory requirements when it comes to liquidity ratio, we have decided to optimise our balance sheet and head for the lower cost of funding through interbank borrowing.

Operator Thank you. There are no additional questions waiting at this time, so I'd like to pass the call back to the BSF management for any closing remarks.

Bader Alsalloom In conclusion, I'm incredibly proud of the team's exceptional performance during the past quarter. Our strong financial results validate our responsible growth model and the relationship nature of our franchise. Thank you very much, everyone, for joining us today and we hope to come back to you in the next quarter with even better results. Thank you.