The effects of and risk management related to the credit crunch in Hungary

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The Hungarian banking sector has been less affected by the 2008 credit crisis than the western banking systems. The response of the Hungarian government to the financial and economic crises (caused by the credit crisis), which differed from other governments' reactions, has also affected Hungarian banks. The main objective of this study is to demonstrate the effects of regulatory reforms, implemented in the framework of the government's crisis management, on the Hungarian banking sector and its future potential, as well as on bank owners' motivations. Resulting from the government action, which has differed from the international practice, certain signs have already been visible in the economy. Based on them, we are making certain assumptions of banks' behaviour, which determines their future funding capacity and the future of the whole banking sector. Finally, we summarize the main findings and draw a conclusion.

1. Hungarian banking sector before the crisis

As a result of the early opening of the market, the liberal authorization practice and alignment to EU standards by the turn of the millennia, a competitive banking system has developed in the country, which is open to financial innovations and modern financial products. This system includes three dozens, mainly foreign-owned, commercial banks, several specialized financial institutions and more than 150 mutual savings banks.

Besides the large number of service providers in the Hungarian banking market, the degree of its concentration was moderate in the second half of the 1990s. However, it has got closer to the EU average (ECB 2008) since then.

Although the entries and exits were regularly rearranging the market powers, some important market segments (trade loans, overnight deposits, housing loans) remained highly concentrated. After-tax profits of the banking sector showed greater concentration than loans and deposits, which indicates that banks with a larger market share had the opportunity to reach outstanding shares in a business area and to become more profitable than average (Table 1) (Várhegyi 2010).

2. Effects of the credit crisis on bank competition and regulation

The impact of the credit crisis on the regulatory environment and competitive position of the Hungarian banking sector was different compared to other countries: normal state risk management played a smaller role, while greater weight was given to the Hungarian economic policy and political line of the so-called "non-standard" govern-

Table 1 Bank lending before the crisis in some Eastern European countries, 2007 (%)

Country	Annual average credit growth between 2003-2007	Credit to GDP Per cent	Retail lending to GDP Per cent	Loans as a percentage of revenues	Foreign currency loans as a percentage of the loan portfolio
Hungary	26.8	53.4	23.3	128.5	52.4
Czech Republic	40.4	50.3	18.8	75.4	13.0
Poland	35.5	37.3	22.1	103.8	24.4
Slovakia	42.1	44.6	15.3	76.4	23.6
Romania	81.5	36.6	17.7	114.8	54.3
Bulgaria	57.4	67.1	23.0	97.7	62.2
Ukraine	98.5	59.9	21.8	152.4	49.9

Source: Based on RZB (2008).

ment interventions. In most countries the role of the state became inevitable, which raised competitive neutrality concerns. Thus, the European Commission formulated in February 2009 the main principles regarding state support for banks struggling with impaired assets (EC 2009a).

The most important are: transparency, harmonized approach to the identification and evaluation of assets; adequate sharing of costs between shareholders, creditors and the state, sufficient degree of reimbursement (at least equal to the capital) to the state, recapitalization; with regard to the long-term viability and normal operation of the European banking system.

Barely half a year later, in July 2009, the European Commission issued another guideline – in force until 31 December 2010 – on its action during the assessment of the restructuring aid given to banks by Member States (EC 2009b).

3. Effects of crisis management on Hungarian bank competition

Apart from some general features (increasing central bank liquidity, deposit guarantee), the Hungarian government intervened to stabilize the financial system in a different way from most of the developed countries. In 11 most developed countries of the world, since the autumn of 2008, rescue packages of about one fifth of GDP (worth five thousand billion dollars) were established of which 40% had already been spent by mid-2009 (BIS 2009). The Hungarian government was only committed to 7.1% of GDP, and made the payment of 2.7% of GDP by the middle of 2009 (EC 2009c, 2009).

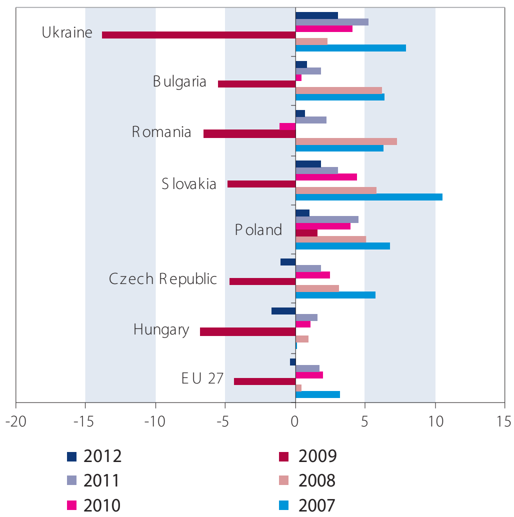
The main reason for the restrained state participation in bank crisis management was that the Hungarian banking system was less directly affected by the credit crunch. The other reason was that the vast majority of Hungarian banks are owned by foreign (mostly euro area) banks, which are responsible to replace the capital. Thus, monetary policy tools seemed sufficient to handle the problems of the Hungarian banking system. In order to overcome the shortage of liquidity and restore lending capacity of banks, the Hungarian National Bank provided liquidity instruments to commercial banks. Therefore, state interventions (e.g. acquisitions) were less needed than in many other countries. The goal of the "bank rescue" package was to improve the stability and capacity of the Hungarian credit banks that were relying on the IMF loans; if necessary with guarantees and capital injections. The law basically opened the possibility of a state capital injection for banks without a dominant foreign owner.

Figure 1 shows the evolution of GDP during the crisis. The numbers represent well the difficulties of the economy.

4. Unique Hungarian regulations and consequences

In Hungary, effects of the credit crisis – due to the bank coordination of parent banks and the Viennese bank – were relatively modest. In addition

Figure 1 Real GDP growth rate – volume, percentage change on previous year



Source: Based on Eurostat, and Ukraine Data&Country Reports, 2012.

to general liquidity, it was inevitable to reduce the loan/deposit ratio during the credit boom in the last decade. In the first year, foreign banks only reduced resources sent to their Hungarian subsidiaries, whilst allocated a significant amount of capital in order to cover credit losses and risk costs.

The new government formed in the spring of 2010. Under the name of the economic "freedom" it changed the relationship with international financial institutions and bodies of the European Union (ECB, European Commission). This policy brought regulatory "solutions" impairing the banking sector's competitive position: introducing a bank tax as a very different solution from other countries, devolving most of the costs of foreign currency loans' management.

It is hard to tell what led the Hungarian government to impose a special tax upon the financial sector, but it can be assumed that it was a combination of three factors.

First of all, it was a budget constraint: days before the formation of the new government, the European Union announced that it would insist on 3% deficit target. Since the Hungarian government also insisted on more tax reductions causing the loss of several hundred thousand billions of forints on revenues (a flat-rate personal income tax, corporate tax credit extension), it needed other sources of income. The second factor was ideological: the government announced patriotic economic policy which included fight against multinational companies in order to protect the national capital. The third factor was the distinction between the so-called value-added work and the service sector. Mainly affecting the service (financial, commercial and telecommunications) sectors, the so-called crisis taxes all achieved the intended objective.

5. Distortive effects of domestic bank tax

The crisis in many countries provoked the idea of introducing a bank tax. Two kinds of reasons called for this: firstly, the fact that government funds helped banks during the crisis, at least partially reimburse the taxpayers funding, on the other hand, an idea to create a fund to rescue banks in the event of any future banking crises.

Against the bank tax introduced in Hungary four fundamental critical comments may be formulated: 1. excessive rate of tax; 2. way of imposition may stand against legal certainty; 3. reason and use of tax; 4. breach of the principle of competitive neutrality.

The tax rate

The special tax burdened on banks in 2010-2012 was HUF 130 billion, which basically means a half of the before-tax profit in 2009. Due to the combination of the special tax and the crisis, in 2010, earnings of the banking sector shrunk to HUF 34 billion, even the three large banks (MKB, CIB, and Raiffeisen) had a serious loss.

In other countries, the specific tax rate is much lower. The Austrian bank tax is less than one tenth of the Hungarian rate, as Austria uses a narrower tax base and lower rates too. In a unique way, in Hungary, bank taxes extend not only to banks but also to financial companies (including insurance, asset management and leasing companies) (Table 2).

Unique management of retail foreign currency loan problems

Foreign currency lending was in the forefront in the 2000's in the countries where local currency interests contained a significant premium compared to the euro, dollar or Swiss franc. Another reason for the rapid spread of foreign currency lending was a hope for the accession to the euro area. The euro fixed exchange rate system has specifically helped it to spread, as it minimized the foreign exchange risk. In inflation targeting systems, monetary policy could also encourage foreign currency lending by eliminating the exchange rate risk, by smoothing out short-term price movements and letting national currencies to be appreciated (Baltic States, Hungary and Romania).

During the 2000s, in all of the Central and Eastern European countries retail lending grew rapidly and foreign currency lending was its driving force.

This is particularly true for Austrian subsidiary banks, which led the way to spreading Swiss franc-denominated lending against euro loans with higher debt service in the Central and Eastern European countries (EBR 2011).

Until the fall of 2008, the foreign currency loan debtors had had generally lower debt service than debtors with national currency loans. The crisis, however, weakened local currencies in most of the Central and Eastern European countries, causing increased repayments, whilst debtors' household income also declined. The crisis caused particularly difficult problem for Hungary, and not just because of the strengthening of the euro and Swiss franc (from the summer of 2010) compared to the domestic currency. The main difference was shown when compared with other countries with the floating exchange rate system, as the effect of the weakened national currency on repayments was somewhat offset by the reduction of Swiss franc and euro interest rates. In Hungary the latter did not occur.

Even though Hungarian banks use the variable rate system, they increased their interest margins – with reference to higher customer and country risks, so the decreasing trend in the Swiss franc (and euro) interest rates did not lead to reducing the interest rates on outstanding foreign currency based loans. This could only happen because the possibility of a unilateral contract modification was not restricted until the fall of 2009, while the Banking Association's Code of Conduct was not adopted.

Anti-foreign currency lending actions were only successful in countries where general credit restrictions were used (Croatia, Bulgaria), or those that managed to introduce the euro early (Slovenia), or mainly where coordinated fiscal and monetary policy kept the low level of interest and the problem did not come up (Czech Republic, Slovakia). By contrast, Poland decided on monetary easing, reducing the base rate as early as in 2004, especially to reduce foreign currency lending. Romania raised the minimum reserve requirement on foreign currency loans to 25% (as opposed to normal 5%), although with little success. In Hun-

Table 2 The effect of the crisis and the special tax on main earnings in the banking sector

Name	HUF Billion				Annual change (%)	
	2007	2008	2009	2010	2009	2010
Interest income	717	714	756	857	5.9	13.4
Non-interest income*	369	339	542	179	59.9	-67.0
Operating cost	-587	-642	-588	-599	-8.4	1.9
Impairment and provision change	-106	-144	-443	-377	207.1	-14.9
Profit before tax	390	281	246	34	-12.5	-86.2
Profit after tax	325	237	209	12	-11.8	-94.3

** From 2001 it includes the effect of special tax too.*
Source: PSZÁF.

gary, regulatory measures were taken relatively late compared to the weight of the problem. Then, in February 2008, the Hungarian National Bank (MNB) and the Hungarian Financial Supervisory Authority (PSZÁF) came up with a joint recommendation called "foreign currency lending systemic risks" and called for prudent assessment and management of associated risks regarding institutional and consumer protection requirements, particularly Japanese yen-based lending (Ajánlás 2008). The yen loans were actually managed to discontinue, but Swiss franc loans continued to increase even after the financial crisis erupted in the fall of 2008.

The government only came up with regulations limiting foreign currency lending at the end of 2009, and foreign currency mortgage lending was banned in August 2010. The new regulation called "responsible lending" determined the maximum credit collateral ratios (70.54 and 35%) at different degrees on forint, euro and other currency loans, as well as the ceiling of repayment to income ratio, while the latter was dependent on a borrower's income.

A law adopted on 20 June 2011 allows the fixation of repayment rate for three years for those, who do not exceed the 90-day payment delay and their property serving as collateral is less than HUF 30 million. The Swiss franc was fixed at HUF 180 and the euro at HUF 250, the excess of the actual prepayment price was transferred to an account, from which banks offer forint loans with preferential interest rates. The state provides a surety guarantee during the period of currency peg, thereafter a quarter of the loan is guaranteed, but banks pay guarantee fees, meaning that ultimately they foot the bill.

The law also says that from October 2011 evictions and sales moratoriums were to be terminated and a quota system of forced sales was to come into force which would determine quarterly, until the end of 2014, what percentage of the real estate (collateral for mortgage loans) could be at auction. On the one hand, the schedule has slowed the price fall damaging both lenders and debtors; on the other hand, it has reduced problems in the social security system.

In October 2011, the previously announced national asset management was established, under which flats of debtors may be purchased from banks, while debtors may stay there as tenants. However the budgetary resources available are insufficient: only provide coverage for the purchase of five thousand homes by the end of 2014.

The exchange rate cap was not successful as it only reorganised the problem in time and only a few thousand debtors took advantage of this opportunity. Most of the borrowers believe that in three years they will again face high repayments: in addition to the outstanding original debt they will have to pay back (from 2015) the accumulated debt too. The lack of interest regarding the "solution" offered by the law was due to the fact, that banks had already been offering similar options. Meanwhile, the European and American credit crises led to the strengthening of the Swiss franc.

Due to internal problems of the Hungarian economy, weak growth, public deficit and the government's economic policy, investor confidence was eroded. This was reflected in the increase of the state bankruptcy insurance price, higher yield requirements for government securities and in the depreciation of the Hungarian forint.

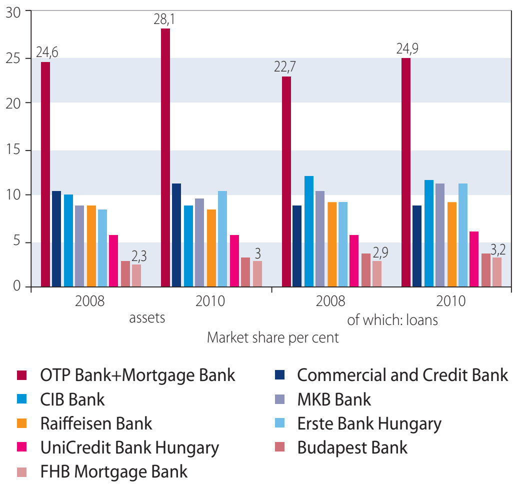
This and the failure of previous actions lead the new government to the following decision: to force banks by law to defray former foreign currency contracts as a lump-sum repayment (called "final repayment"). According to the Act that came into force at the end of September 2011, banks are obliged to accept foreign currency loans (at the exchange rate of 180 HUF/CHF and 250 HUF/EUR), repay them in one lump-sum payment, and account the exceeding amount as their loss. If repayments made at once reached only 20-25% of foreign currency loans (property collateral) worth HUF 5200 billion, the cost of banks would be around 10% of their capital and twenty times their earnings made in 2010.

Consequently, the shares of foreign banks were influenced and the President of the Austrian Central Bank, Austrian Minister of Finance and Foreign Minister criticized the law and threatened to sue the Hungarian government.

Expected consequences in the Hungarian banking market

Firstly the credit crunch, then the public debt crises in the euro area, together increased credit risk costs and placed heavy burdens on banks. All of this can impact on the market and operation of the Hungarian banking sector, and the first signs are already visible. The reason for narrow lending can be found on the supply side, due to the deterioration of banks' lending capacity and the reduction in risk tolerance. Further problem was

Figure 2 Changes in the market structure of the Hungarian banking sector during the crisis



Source: Based on PSZÁF Aranykönyv, 2008, 2010.

that foreign parent banks decreased their funding, which could be caused by the loan/deposit ratio reduction as an overall constraint of Central and Eastern Europe, in addition to the euro area debt crisis, while the "special" Hungarian bank regulation also might play a role.

The assumption seems to be supported by two phenomena.

On the one hand, while the loan/deposit ratio in Hungary decreased to the greatest extent in 2009 (from 173% to 149%) and in 2010 and 2011 it slowed down (143% and 135%, respectively), foreign funds fell mostly in 2010 and in 2011. On the other hand, there are signs that the steps of the Hungarian government made foreign parent banks to change their strategy (Figure 2).

The executives of the parent banks of Hungarian UniCredit and Erste had indicated before the law was passed that they would review their regional investment and resource allocation policies.

As a result of the crisis, which hit the Hungarian banking system, the sector's performance was significantly held back. Profitability dropped close to zero by 2010, despite capital injections by bank owners, and resulted in the deterioration of its lending capacity. Moreover, the regulatory constraints were imposed. The Third Basel Accord requires a substantial capital injection for parent banks too, thus many of the Hungarian subsidiary banks' problems will be solved by reducing capital leverage. This may aggravate the reduction of the loan/deposit ratio (owner motivated), which was observed after the outbreak of the crisis in 2008. "Lending brakes" may sometimes be used by parent banks due to supervisory requirements in their country as well. In November 2011, the Austrian central bank and financial supervisory authorities announced tighter regulation of banks in Austria, and banks, especially with Eastern European branches such as Erste, Raiffeisen and UniCredit as part of Bank Austria Group, must meet the new regulation.

Austrian banks must have applied the regulations of Basel III from 1 January 2013 and from 2016 they will have to have additional capital of three percentage points – high quality, first level (Tier 1). After 1 January 2012 banks' loan/deposit ratio cannot exceed 110%. In the event of a crisis, banks must have a "last will", which includes the necessary modifications of their organisation.

It is expected that the "lending brakes" and Basel III stricter capital requirements will restrict the financing of the economy less than the Hungarian government's actions (bank tax and final repayment). In any case, it becomes clear that lending will remain on a lower and safer level compared to the level before the crisis.

Due to the scarcity of bank funding and the downgrading of the country's and banks' ratings by credit rating agencies, increased credit spreads will result in more expensive loans even for large enterprises with good creditworthiness, which may hinder the demand.

Among the multinational companies, the role of shareholder loans is expected to increase in the financing of Hungarian subsidiaries, which in turn reduces their demand for domestic loans. Thus, the credit market is shrinking not only on the supply side, but also on the demand side.

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INFORMÁCIE

Nová podstránka: politika obozretnosti na makroúrovni

Národná banka Slovenska rozšírila svoju internetovú stránku v časti dohľadu nad finančným trhom o novú podstránku zameranú na politiku obozretnosti na makroúrovni.

Jednou z odpovedí na globálnu finančnú krízu bol aj vznik politiky obozretnosti na makroúrovni. Na rozdiel od dovtedajšieho chápania dohľadu zameraného na stabilitu jednotlivých finančných inštitúcií, politika obozretnosti na makroúrovni sa zameriava na stabilitu finančného systému ako celku. Tento cieľ sa snaží dosiahnuť najmä:

- vytváraním dodatočných rezerv na krytie rizík v dobrých časoch, ktoré sa použijú v čase krízy na pokrytie strát, čím sa zmierni jej dopad,
- tlmením nadmerného úverového rastu, finančnej páky a prebytočnej likvidity,
- znižovaním morálneho hazardu, najmä zo systémovo významných inštitúcií.

Na Slovensku vykonáva politiku obozretnosti na makroúrovni Národná banka Slovenska a spoluzodpovednosť má aj Európska centrálna banka v rámci jednotného mechanizmu dohľadu.

K základným článkom politiky obozretnosti na makroúrovni patrí zmierňovanie rizík systémového charakteru a ich dopadu. Samotný výkon politiky v sebe zahŕňa pomerne veľa oblastí. Najdôležitejšou súčasťou výkonu politiky je aplikácia legislatívnych nástrojov. Ide o pomerne silnú formu reakcie na existenciu rizík.

Výkon politiky však v sebe zahŕňa aj iné nástroje a prístupy. V prvom rade ide o aktívnu komunikáciu voči verejnosti a finančnému sektoru prostredníctvom publikovania správ, analýz, komentárov a odporúčaní. Ďalšími nástrojmi môžu byť aj podnety na výkon dohľadu, zmeny v interných procesoch Národnej banky Slovenska, zmeny v zbieraných údajoch a ďalšie.

Viac informácií z oblasti politiky obozretnosti na makroúrovni je k dispozícii na internetovej stránke NBS *http://www.nbs.sk/sk/dohlad-nad-financnym-trhom/politika-obozretnosti-na-makrourovni.*