

20100901 Hungarian Financial Supervisory Authority: The HFSA's Second Risk Report in 2010

Source: Hungarian Financial Supervisory Authority

Summary

This study is the second quarterly Risk Report in 2010, prepared by the Supervisory Authority based on a legal obligation. This report is based on the 2010 Q1 data supply of the financial institutions, the latest experiences of the supervisory activities, and the environmental information collected from various sources. In line with the intention, indicated in the previous issue, this study focuses on the major changes in the risk profile outlined in the similar previous quarterly report, i.e. it is practically an updated version of the Q1 Risk Report.

According to the overall evaluation of the Supervisory Authority, the Hungarian financial sector is still stable after the first quarter of 2010, and its business performance is good compared to the circumstances of the current economic financial crisis, although it is not as high as it was prior to the crisis. However, following a major declining trend of the risks of the financial sector, which lasted for a year from March 2009, the risks are rising again. The higher risks mainly related to environmental factors and, to a much lower extent, to internal reasons related to the operation of the sector. The largest risks still relate to the outlook of the credit market, although the risks of the insurance sub-sector are also increasing considerably.

The tendencies of the environmental risks of the Hungarian financial sector have varied since the beginning of 2010. In general, the trends of the risks, which started from an extremely high level after March 2009 and fell significantly, continued also in Q1 2010, until they were broken by the events of the recent past. The direct cause of the change was clearly the increase of sovereign debt problems in Southern Europe that increased the various tensions remaining from the global economic and financial developments of the previous eighteen months and led to a considerable decline of capital markets and major economic policy corrections.

Looking forward, the future development of the international and the Hungarian environment still tend to indicate decreasing risks, but the current situation is more contradictory, and the conclusion is less clear than it was a few months ago. The various infection channels transmitting the impacts of the negative developments referred to above and connecting financial markets, financial intermediary institutions and the real economy with theoretically more or less known impact mechanisms and, due to lack of experience, unknown actual significance, have considerable, yet practically unknown loss potential. Consequently, during the course of the next year, we should prepare ourselves for moderate corporate consumer and investor confidence strongly volatile financial markets with uncertain trends, rising costs of financing and a basic scenario of slow, extended increase in economic growth with temporary downturns.

The quality of loans of the service providers operating on the Hungarian credit market, measured according to payment delays, continued to deteriorate in Q1 2010. Until Q1 2010, loans overdue for more than 90 days gradually and slowly increased for several quarters, but the total overdue loans increased considerably again at the beginning of 2010, although this increase was not as high as at the beginning of 2009. This latter increase was partly due to the strong appreciation of the CHF against the HUF. This is also indicated by the fact that the defaulted retail mortgage loans increased at a rate faster than average. Another factor to be noted is that part of the previously re-negotiated loans went into default again. The appreciation of the CHF in Q2 2010, and especially the following major appreciation trend in June are warning signs indicating unfavourable changes, which will take place soon in the developed marginally improving trend. It is a reasonable threat that the number of retail currency loans in default will rise again in the next few months.

At the end of March 2010, 97,000 retail mortgage loan debtors had debts, overdue for more than 90 days, and belonged to the directly threatened category. The enhanced debt settlement activities of service providers operating on the credit market in relation to mortgage loans in Q1 2010 increased the threat. In this period, the number of residential properties subject to execution or involved in some other debt settlement procedures equalled 38% of the total number registered in 2009, while the number of real properties sold with the debt or directly was 29% of the previous year's figure. All this means that the prudential risks related to asset quality and the intensity of risks related to the requirement of fair market conduct may increase in the near future.

Despite the fall in the total assets in Q1 2010, the Hungarian banking system still improved its profitability and capital position. Both profitability and capital adequacy are still considerable in size and satisfy the requirements of stable operation even under the conditions of the economic and financial crisis. There have been favourable changes in several structural indicators measuring the long-term vulnerability of the banking system, including the currency/loan ratio and the on-balance sheet net currency position, while other important stability indicators, such as liquidity on the asset side and loan deposit ratio have not changed since the end of 2009. The system has stable fund supply, the increase of the portfolio of non-performing loans has continued to slow down, and the banks' current credit risk costs have also dropped considerably.

However, in contrast with the positive trends, some unfavourable tendencies could also be observed in the development of banks, as risks have remained significant and high, and are rising again in several aspects. Negative processes include primarily the polarisation of banks based on profitability and capital position, and a rise in the number and market share of service providers with relatively low capital adequacy ratios. Another unfavourable tendency is that the improving average profitability was the result of a relative low amount of impairment in Q1 compared to the default data of debts, which do not seem sustainable based on the portfolio quality trend. Following the improvement of last year, the maturity mismatch began to deteriorate again as a result of the simultaneous shortening of the tenor of customer deposits and wholesale funds.

The most important main risks include the continued deterioration of the banks' asset quality, and the remaining weakness of loan collaterals and real estate and vehicle markets. The new deterioration of the global liquidity and funding situation, the higher risk premium and the corrections of the capital market in April and May, which will most certainly have a considerable negative impact on the investment and trading results of the Hungarian banks, are further risks. The extensive special tax imposed on banks, announced by the Government, but not yet known in detail when this report was prepared, and the planned prohibition of mortgage loans denominated in currency, represent a very special group of risks. The impacts of these steps on the banks' fund and capital supply, size of operation and profit and loss account, or the costs of the banking services and the quality of the existing portfolio are not yet known and are difficult to assess. In this respect, the main risk is that these measures were taken during a period when the banking system was facing increasing uncertainties in terms of decreasing size of operation and profitability. Finally, significant risks are associated with the outlook of banks with low profitability and relatively unfavourable capital positions.

The main risk of cooperative credit institutions remains profitability, the falling trend of which seems durable and the level of which is relatively low. In the near future, profits may primarily be cut by the higher costs of credit risks. The quality of the corporate credit portfolio continues to deteriorate, which is worrying because the majority of the dynamically increasing new loans are made to this sector. Within the framework of management of loans in default, the cooperatives refer the largest number of residential properties to execution and other debt settlement procedures, which leads to consumer protection issues and may also lead to the settlement of an increasing number of loans with a loss given the current weaknesses of the real estate market.

The financial enterprise sub-sector was most heavily hit by the crisis, and has remained the most threatened sub-sector of the Hungarian financial system in terms of stability and business outlook. The service providers of this category (money-lenders, leasing providers, factoring houses, pawn brokers, etc.) still have heavy losses and have lost nearly one-fifth of their total assets in one year. This extremely unfavourable tendency is the result of the weaker demand and dynamic deterioration of portfolio quality triggered by the weaknesses of the typical target markets, and the simultaneously applied more stringent financing conditions. The aggregate profitability of the sub-sector continued to decrease in Q1 2010. In the near future, a large number of service providers may terminate their operation. In view of the number of financing enterprises and loss-making operation of the majority of the service providers of this category, the envisaged special tax represents an especially large risk.

The insurance companies still have significant demand risks. Although in Q1 2010, demand for investment products grew, the subsequent capital market correction created a threat of return of the previous negative demand trend. This time, the traditionally high profitability is threatened by several factors with a potentially large effect, including the approximately HUF 30 billion claims caused by the storm and flood damages in May and June, the estimated deterioration in investment results following the capital market correction in May, the impact of the significant average price drop of MTPL insurance and the Government's financial special tax plan, the details of which are still unknown. In addition, the recently founded new insurance companies with a small

market share and operating loss is still unfavourable, as the majority of them generated lower and lower profits in the previous quarters.

The investment companies continued their operation with high profitability and capital adequacy in Q1 2010, and the profit of investment services made considerable contribution to the banks' profits. The most important risk related to investment services over a period of one year remains the doubt of sustainability of the upturn of the capital market, experienced from Q2 2009 to Q1 2010, and the positive trading results and revaluation differences triggered by it. Investment service providers are expected to compete with each other intensively for maintaining the volume of transactions and portfolios, which may also lead to lower profitability in the sector.¹ The estimated increase in the intensity of competition may also have an impact on the risks related to the requirement of fair market practices.

The risks identified in the fund manager sub-sector are moderate. The size of operation and profitability of the service providers of this sector in 2009 were strongly supported by the favourable capital market environment, experienced in the previous year. With this background, the service providers cut their fees significantly, which made the products managed by funds increasingly competitive with bank deposits. Despite this, the average return on capital improved and the number and weight of loss-making fund managers dropped, which indicated successful cost savings. Although there is high probability that the capital market trend of 2010 will be less strong, the business outlook of fund managers still seems favourable in view of the high profitability and increased competitiveness.

Since the previous Risk Report the risk profile of funds has not changed in several aspects. The threat on the yield performance of private pension funds, which has not been satisfactory for a long time, still remains the most important risk. For the purpose of making investment risks transparent, we propose re-regulating the investment limit rules of the optional portfolios as soon as possible. In this context, we consider it practical defining a more conservative minimum share ratio than contained in the original limit regulations. Although the favourable capital market trend of the year starting in March 2009 may make the application of, or requirement for, an aggressive investment policy with a high share ratio attractive in order to correct the large loss of assets in 2008, in our opinion such a strategy is still risky in view of the considerable market volatility, the threat of large periodic corrections and the asymmetrically closed nature of private funds. On the other hand, we no longer deem justified the application of the currency coordination rule, which will take effect in October 2010, considering the concentration risks of fund investments and the current situation of the government securities market.

In our opinion, the processes of Q1 2010 are of outstanding importance as the favourable trend of pension fund yields, observed in the previous year, continued. The average yield performance of both private and voluntary pension funds was outstandingly high in a historic comparison. However, when this performance is assessed, we must also take into account the estimated negative impact of the capital market correction, which began in May and may destroy even the majority of the growth of assets funded from the yield of Q1. The private pension fund sector continued its loss-making operation, and the return of individuals into the social security system at the end of last year further curtailed its revenues. In this context, the coverage of private fund costs seems a considerable risk because the level of capital reserve is low and the efficiency increasing potential on the expenditure side is unknown for the time being. We consider it a symptom of increasing cost coverage problems that competition for the acquisition of members has become more fierce, and mergers have continued recently.

On top of the above, it is a fundamental inadequacy of private funds in the longer-term outlook that the regulations and the required institutional framework applicable to the services of such funds, launched in 2013 according to law have not yet been developed and are not in place. In this report, we only refer to this problem, because the elaboration of the relevant regulations and framework exceeds the time horizon or scope of this Risk Report.

The gradually decreasing membership contribution revenues of voluntary pension funds, which has a negative impact on the coverage of operation, is an increasingly important risk. On the other hand, the degree of capital withdrawal within the accumulation period and in relation to services has considerably decreased, which shows the return of stronger confidence in the future yield performance of the funds.

The delay in the credit of membership contributions on individual accounts is still a problem of private funds, and the more intensive competition to acquire members, as well as the increase in

the number of members transferred between funds also have significant consumer protection type risks.

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