RISK OUTLOOK FOR NON-BANK FINANCIAL SECTORS

JUNE
2015

'… after mature consideration we have made a decision for the good of the whole country, its peaceful state and for the benefit of its residents…'

(from the 'urban articles' of 1405 of King Sigismund)

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Under Act CXXXIX of 2013 on the Magyar Nemzeti Bank, the MNB shall supervise the financial intermediary system in order to ensure, among others, the smooth, transparent and efficient functioning of the financial intermediary system, promote prudent operations, discover undesirable business and economic risks, protect the interests of users of the services provided by financial organisations and strengthen public confidence in the financial intermediary system. Consistent with those tasks and in accordance with Article 135 (2) of the Act, the MNB has prepared its 'Risk outlook for non-bank financial sectors', which presents the most important features of insurance companies, funds, intermediaries, cooperative credit institutions, non-banking group entities and markets of capital market participants covering the period from 1 January 2014 to 30 April 2015.

The Report were prepared by the Financial Institutions Supervision Executive Directorate, the Consumer Protection and Market Supervision Executive Directorate and the Methodology Directorate.

The Report was approved for publication by Dr. László WINDISCH, Deputy Governor.

Contents

1 Executive Summary

The macroeconomic environment developed very favourably in 2014, particularly for sectors engaged in the management of savings. The low interest rate environment and improving income prospects gave rise to further growth in liabilities. The popularity of long-term savings and self-provision assets (voluntary pension fund, pension insurance, long-term investment accounts) continued to increase, but compared to the economy's level of development there is still room for further growth in this area.

In terms of the number of contracts, last year there was a reversal in the downward trend seen during the past several years in the life insurance market, and the number of regular premium contracts increased by 2%. Pension insurance is clearly the driver of this growth. In the case of this new product, in order to ensure a customer advantage, the MNB issued a recommendation in May 2014, as a result of which the costs of pension insurance products significantly decreased.

In addition to its pension insurance recommendation issued in line with the fair treatment principle as well as in addition to its recommendation presenting and comparing insurance products and related to the electronic platforms used during insurance mediation, the MNB created the concept of ethical life insurance as well. Priority objectives of the concept are the promotion of cost transparency, the revision of investment costs, the tightening of technical rules concerning investments and a possible extension of the ACR limits included in the pension insurance recommendation.

The means facilitating the implementation of the objectives of the concept of ethical life insurance will find shape in proposals to amend legislation, in enactment of regulations as well as in the updating of the recommendation on the application of prudential and consumer protection principles related to unit-linked life insurance.

Similar positive changes can be observed in the non-life insurance market: following a decline of several years, premium income has increased by 5.5% since 2012. In recent years, MTPL premiums decreased significantly due to the re-contracting campaigns, and thus the premium incomes covered the actual claim payments less and less, which already represented a prudential risk. In 2014, however, MTPL premium income increased, in part due to the growth in the number of contracts and in part due to the modest premium increase.

Insurers' capital adequacy substantially exceeds the regulatory minimum (it is twice as high as the Solvency II requirement to be introduced next year), but significantly lags behind the levels observed in other countries of the region. Looking ahead, recovery in internal capital accumulation may help to further improve this ratio.

Assets managed by voluntary pension funds continued to increase last year, exceeding HUF 1,000 billion by the end of the year. In recent years, the composition of membership fee income gradually shifted towards individual contributions; by 2014, employers' contributions represented only 38% of total payments.

As a result of the Act on Integration passed in 2013, there were massive changes in the co-operative credit institution sector last year. The comprehensive due diligence performed in the sector by Takarékbank revealed severe, irremediable shortcomings at 5 institutions and led to the withdrawal of their activity licence. Thus, in December 2014 close integration finally was established with 114 actors. The new system laid the foundation for a safer and more efficient operation than before. A state contribution of HUF 136 billion considerably increased the sector's risk-taking capacity, which thus exceeds HUF 700 billion. Such an amount could significantly contribute to the mitigation of the credit constraints experienced in the national economy, but the sector is not yet fully prepared to capitalise on this opportunity.

The largest challenge for financial enterprises not belonging to a banking group is the settlement related to foreign currency loans. The MNB closely monitors this process both in prudential and consumer protection terms, and believes that the enterprises have sufficiently prepared for this. At the same time, the loan placement and profitability of the sector are still extremely low. These unfavourable trends are expected to persist in the near future as well.

Turnover on the Budapest Stock Exchange (BSE) continued to decline, despite the introduction of the new trading system (XETRA). Average daily turnover on the spot market was HUF 7.8 billion in 2014, lagging considerably behind the HUF 9.8 billion in 2013.

In early 2015, the MNB discovered severe cases of fraud at a few investment firms, and this may have a significant impact on the future of the entire sector. Three investment firms were unable to account for over one hundred billion forints of customer assets in total. As a result of this, some customers transferred their savings to service providers which they deemed to be safer. Nevertheless, the portfolio of customer assets under management does not reflect any major loss of confidence at the sector level, with regard to institutions offering investment services. On the other hand, a major part of the losses will be borne by the sector through the Investor Protection Fund (IPF) and the fund established by the legislator specifically for this purpose (Claim Settlement Fund of Quaestor Victims). It is not certain that some of the actors will be able to bear the IPF premiums, which will be increasing as a result of the claim payments, and this may result in increased market concentration. The corrupt practices followed in the record-keeping systems of the service providers involved impacted a large volume of corporate bonds, which may further erode confidence in corporate bonds and hinder the development of this market. At the initiative of MNB, the Hungarian National Assembly is expected to pass a package of legal amendments in May 2015, which will prevent similar fraud in the future.

On 15 January 2015, the Swiss central bank unexpectedly terminated the exchange rate threshold; as a result, the Swiss franc strengthened immediately and significantly against all currencies. This resulted in large losses for high leverage customers, typically engaged in foreign exchange deals and using foreign online platforms, and through them for some domestic capital market institutions. The loss affected, to a lesser or greater extent, 10 domestic investment firms, resulting in a loss of almost HUF 20 billion for the customers on the closed positions. In the group under review, on 15 January 2015, i.e. the day of extreme market fluctuations, the average loss suffered by one customer on the closed positions was around HUF 10 million (actually realised loss), which was further increased by the unrealised loss on open positions. Investors were unable to cover part of the customer debts and during clearing they could not settle these debts. Due to subsequent price modifications, legal action may be taken against the operators of certain online platforms.

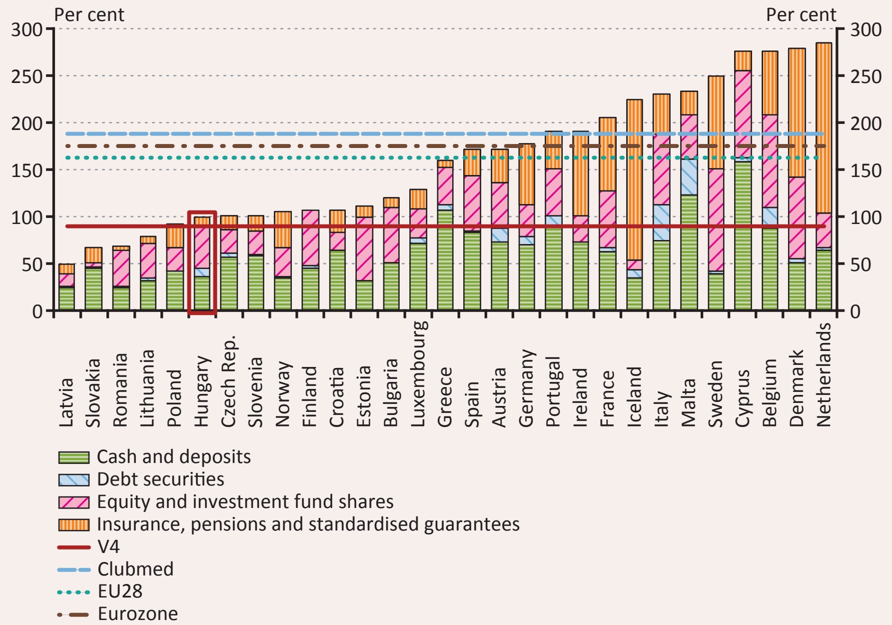
Assets managed by investment fund managers continued to increase in 2014, reaching a historic high in the amount of HUF 5,526 billion by the end of the year. As a result of the low interest rate environment, the asset composition of the funds shifted slightly from risk-free government securities and bank deposits towards mutual fund shares, which represent higher risk, but also promise higher yields.

2 Insurers, funds and intermediaries

2.1 LIFE INSURANCE AND FUND MARKET

Level of savings corresponds to regional average, lags behind EU and Clubmed average

Chart 1
Composition of households' savings (as a percentage of GDP) in Europe in 2013



Source: Eurostat

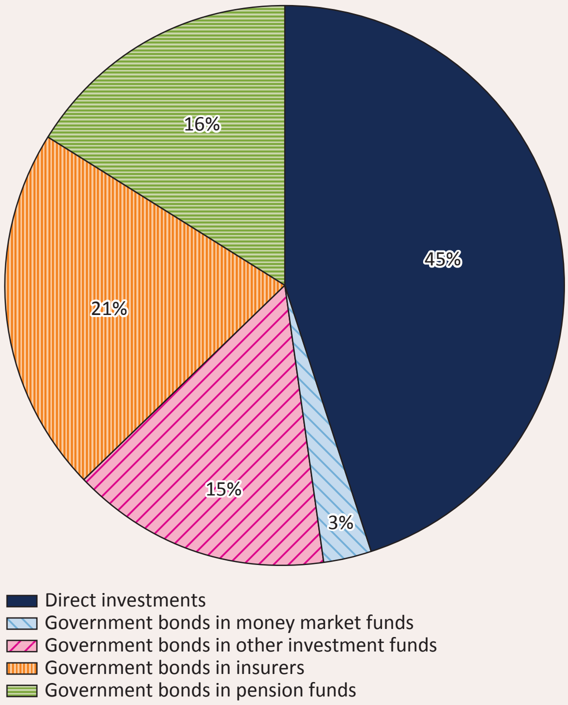
Within the European Union, the ratios of households' financial assets accumulated until 2013 as a percentage of GDP vary significantly across countries (Latvia 48.2%, the Netherlands 283.7%). In Hungary, this ratio was 99.2% in 2013. Although this exceeds the average of the Visegrád Four, it falls considerably short of the average of the EU-28 and the Clubmed countries.

An examination of the composition of savings in Hungary on the basis of the available data revealed that the ratio of bank deposits and cash amounting to nearly 40% of GDP in the crisis years declined to 35.2% by end-2013. (Only the Baltic countries, Romania, Norway and Iceland had lower bank deposits and cash savings to GDP ratio than Hungary.) Major underlying reasons for this may have been the increased demand for mutual fund shares as a result of the improvement in global capital market sentiment following the crisis and the fact that interest rates on bank deposits declined owing to the central bank base rate cut cycle that had started in 2012. As a response to this, households began to invest their financial assets accumulated until then into government securities. The risk of the latter was similar, but they provided an interest premium as well.

The share of bonds (9.3%) has changed significantly over the years. In households' balance sheet, the bond portfolio as a proportion of GDP has nearly doubled since 2007 and consists almost exclusively of government bonds and interest bearing treasury bills. However, between 2007 and 2013 the real growth rate of the bond portfolio was even higher than 100%, taking into account that the Hungarian GDP also increased by 17% in the meantime.

The value of domestic government bonds held by households directly and indirectly has increased in the recent years, reaching HUF 5,136 billion in 2014.[1] Chart 2 shows the breakdown of government securities held through various funds and institutions.

Chart 2
Government securities held by households in 2014 broken down by types of institutions



Source: MNB

In parallel with the portfolio realignment of households, the amount of mutual fund shares held by households has been increasing since 2012. Consequently, at the end of last year, the stock of government securities held indirectly, through funds was close to the magnitude held through pension funds. The majority of households continue to buy government bonds directly, while insurance companies are the second largest 'distributors'. Although based on our observations the share of insurance companies is lower than the approximately 27% observed in previous years, the absolute value last year was close to the magnitude held in 2009.

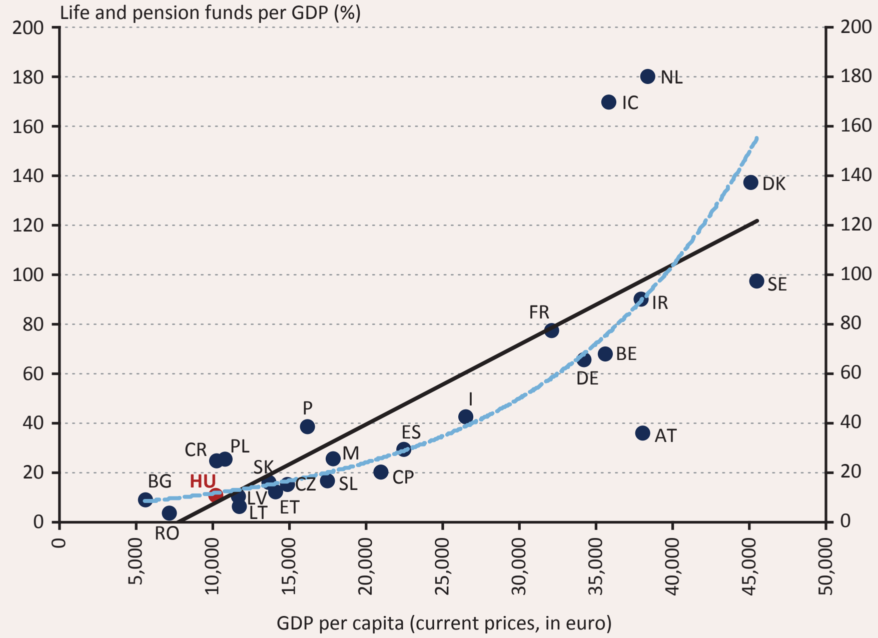
Since 2008 the ratio of equities and mutual fund shares within savings has gradually increased in recent years, in parallel with a decline in deposits. As a result of the portfolio realignment, the value of equities and mutual fund shares held by households reached 44% of GDP by 2013, a level with which Hungary caught up with the EU average.

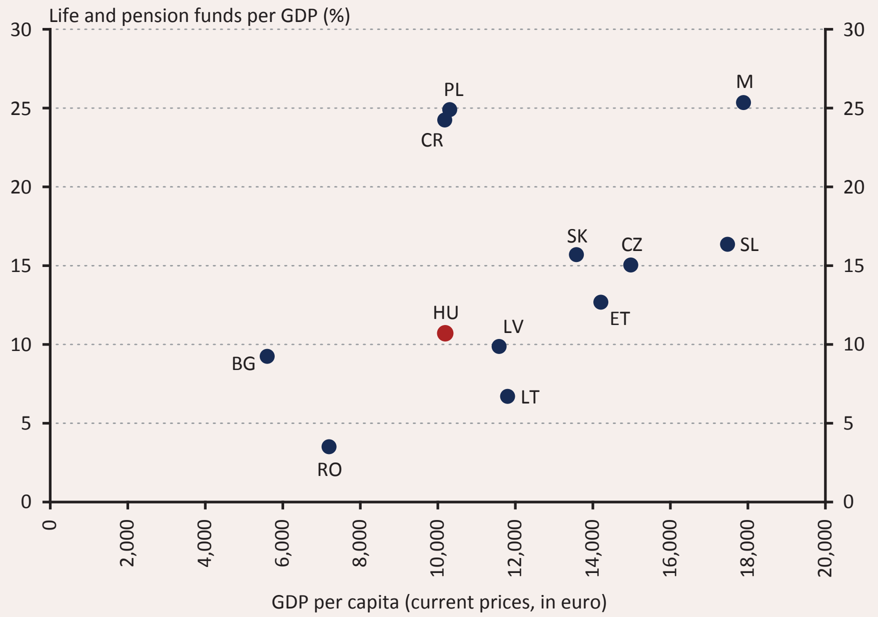
However, Hungary has a significant backlog in terms of life insurance and pension funds: households have less accumulated assets only in Bulgaria, Romania and in two Baltic states (Latvia and Lithuania).

[1] This figure is based on the MNB's estimates and does not contain the bonds held through credit institutions. The latter amounted to nearly HUF 1,300 billion at end-2014.

Low insurance and fund savings within the region

Chart 3
Households' savings in life insurance and pension funds compared to the 2013 GDP





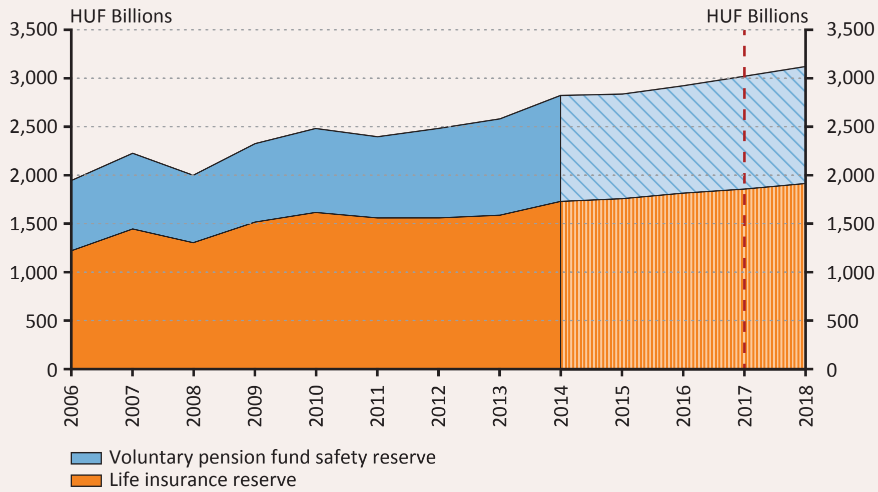
Sources: Eurostat, Worldbank

Households' savings accumulated in life insurance and pension funds represent the second smallest share, after bonds, within all assets reviewed. Looking at the market share of these products compared to the given country's per capita gross domestic product, we see that within the Visegrád Four the level of such savings is the lowest in Hungary (Chart 3). Of the countries included in the population, the Netherlands and Iceland have extremely high savings levels of nearly 200% of per capita GDP. Based on the linear and exponential trends applied to the complete population we may come to the conclusion that there is a positive, medium-strong correlation between the developments in per capita GDP and the ratio of life insurance and pension fund savings as a proportion of GDP. The significant deviation from the trend is caused by the local peculiarities of the pension and social security systems.

The countries that joined the European Union in 2004 or later are still at the beginning of the development path, but the lag of the domestic insurance and fund market is visible here as well. Catching up with the countries of the region could ensure an expansion of the market for a partial resolution of the present economies of scale problems, thereby permitting the survival of the current number of institutions with a decreasing concentration ratio.

A major part of the savings of HUF 3,000 billion is held in government securities

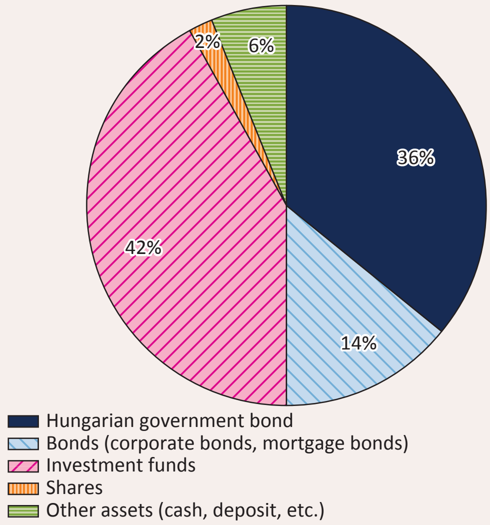
Chart 4
Life insurance and voluntary pension fund coverage reserves



Source: MNB

Mathematical reserves, which account for a significant portion (33% at end-2014) of life insurance provisions, have followed a declining trend since 2006. The underlying reason is that even the significant yield could not offset the fall in gross premium incomes. In parallel with this, with the penetration of unit-linked products, a significant increase is observed in unit-linked reserves: the volume of reserves at the sector level increased from HUF 349.5 billion in 2005 to HUF 1,100 billion by 2014. In recent years, apart from premium incomes, the favourable yield performance also contributed to the increase, as insurers were able to achieve an average annual yield of 6.5% after 2010. The major part of coverage for unit-linked reserves is comprised of mutual fund shares, while mathematical reserves were mostly covered by government securities. Due to the high implicit interest rates experienced until the recent past, the latter earned an average annual yield of 7% after 2010, but projections point to repricing of the portfolio in the present low yield environment, and thus a decrease in the yield realised on mathematical reserves. Assuming an unchanged (linear) trend typical of the developments in life insurance reserves and voluntary pension fund coverage reserves, the joint reserve level will exceed the threshold of HUF 3,000 billion in 2017 (Chart 4). The asset allocation related to the coverage of life insurance provisions at end-2014 is illustrated by the following chart.

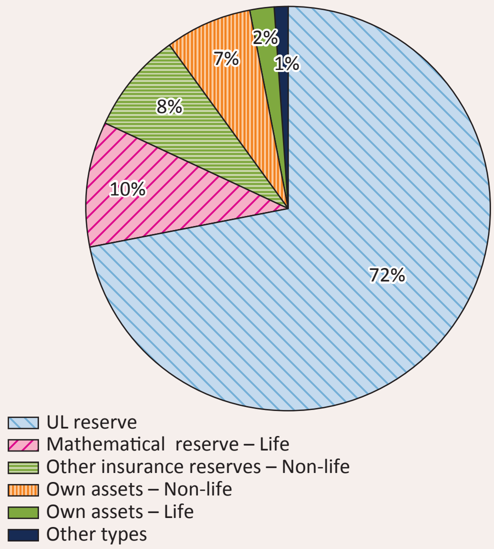
Chart 5
Composition of the coverage for life insurance reserves



Source: MNB

Life insurance liabilities are essentially long-term liabilities, and thus the institutions adjust the average maturity of the underlying portfolio to this. For this purpose they mostly purchase long-term government securities, which directly accounted for 36% of the life insurance reserves at end-2014, while indirectly (also taking account of the portfolio[2] behind the mutual fund shares) they accounted for nearly 61% (Chart 5). The indirect and direct equity exposure of insurers was 21% at end-2014. The weight of corporate bonds among other bond type investments is significant. According to the relevant data available for us, the sector mostly places these bonds behind unit-linked reserves (Chart 6).[3]

Chart 6
Book value of corporate bonds broken down by reserve type



Source: MNB

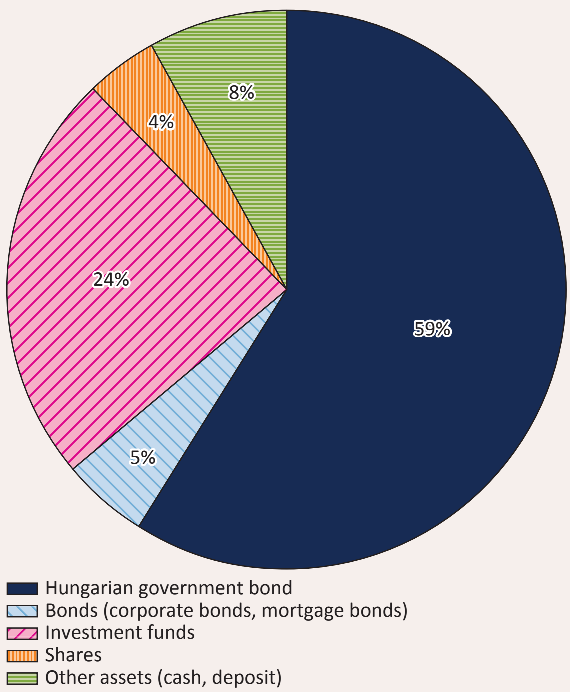
[2] According to the MNB QIS2013 impact analysis, 58% of mutual fund shares represent bond-type investments, the vast majority of which is government securities, while equities accounted for 42% in 2013. Setting out from this, we assumed that the composition of the underlying portfolio of mutual fund shares remained unchanged in 2014 as well.

[3] Due to their minimal share, non-life insurance mathematical reserves, other life insurance technical reserves and the portion of own assets used for activities other than insurance were presented combined into the other types category.

At sector level, there are 93 types of corporate bonds behind the unit-linked reserve. Most of them are forint-denominated, and their total book value is HUF 175 billion. Nearly 50% of these bonds was issued by one of the large Hungarian banks. Due to the characteristics of the unit-linked product, the credit, interest rate and exchange rate risks are borne by the customer. There are 59 various types of corporate bonds behind the life insurance mathematical reserves with a total value of HUF 23 billion. Of this amount, the bond that accounts for the greatest portion is euro-denominated, representing 9% within the total amount. Consequently, there is no high concentration risk from the insurers' point of view. However, investment concentration is high in the case of non-life other insurance technical reserves, as half of the HUF 20 billion book value was placed in a bond issued by a domestic bank and maturing this year. Insurers' non-life own assets were invested into 13 types of bonds, but in terms of their book value, more than 80% was issued by domestic banks.

Voluntary pension funds continue to hold a major part of their coverage reserves in Hungarian government securities. In the past, Hungarian government securities accounted for an even higher share than now. In 2007, the possibility to operate an optional investment portfolio system was opened for private pension funds as well, which also acted as an incentive for the voluntary pension fund sector. Therefore, more and better diversified portfolios were compiled, as a result of which the share of Hungarian government securities within the portfolio increased to 59% by 2014 (excluding the indirect exposures in investment funds).

Chart 7
Investment composition of voluntary pension fund reserves



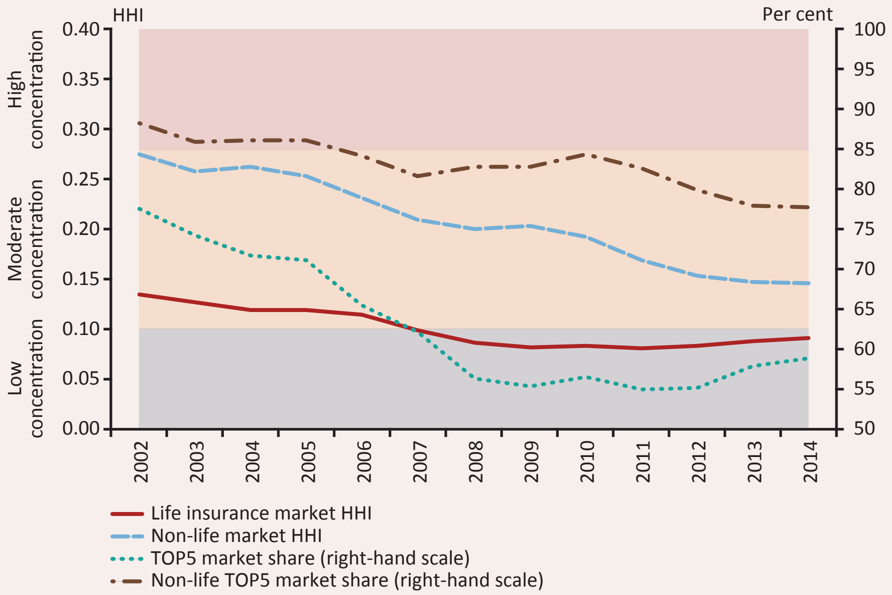
Source: MNB

In 2007, mutual fund shares accounted for barely 12% of the voluntary pension fund portfolio, but by end-2014 their ratio already exceeded 24%, which is primarily attributable to the change in investment portfolio allocation of the five largest pension funds (Chart 7).

Decreasing trend of concentration seems to be reversing in the life insurance market

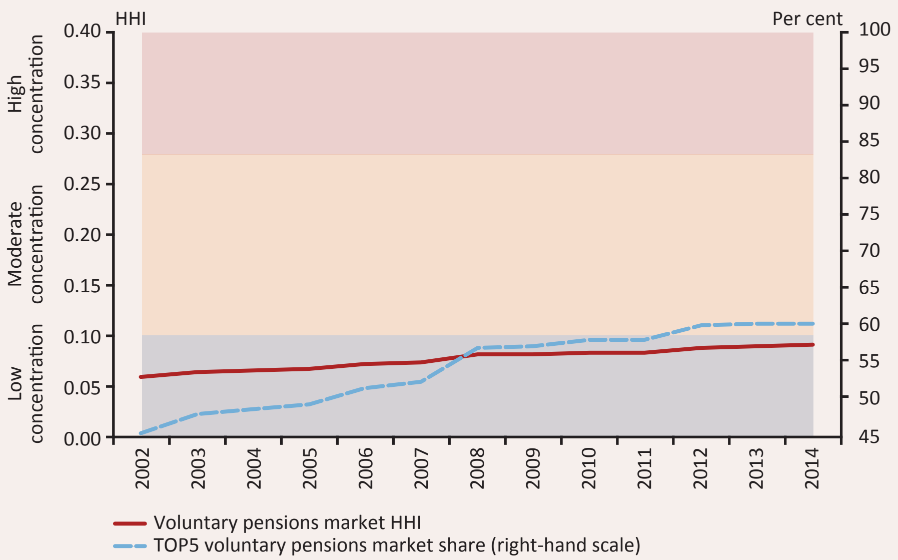
The concentration of the life insurance market calculated according to the Herfindahl–Hirschman Index (HHI) was declining until 2013. In parallel with that the share of the TOP5 insurers from the earned premium also declined. After 2012, however, the market power of the five largest insurers started to increase again, projecting two basic possibilities. One of them is that a strong market concentration will materialise, and, assuming an unchanged market size, this will entail an increase in market concentration and a decline in the number of market participants in the short run. The other possibility is that with a dynamic growth in market size a decline in concentration will take place and the aforementioned economies of scale problems will also be solved partly. In the non-life market, developments analogous to those in the life market can be observed. Starting from 2010, the share of the five largest actors decreased, which was partly attributable to the online sale of the motor third-party liability insurance (MTPL) through the holding equalisation mechanism of the re-contracting campaign. Concentration may stop declining with the decrease in the importance of the MTPL re-contracting campaign, as the significance of the 'brand' may increase again when price competition is becoming weaker (Chart 8).

Chart 8
HHI of the insurance market and the share of the five largest insurers based on the net earned premium



Source: MNB

Chart 9
HHI of the voluntary pension fund market and the share of the top five companies

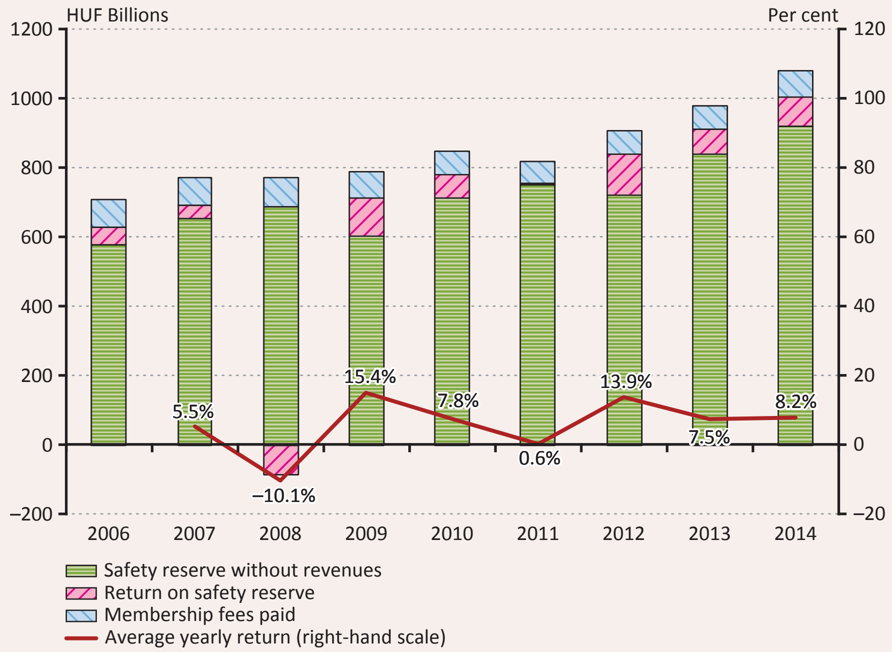


Source: MNB

Since 2003, the concentration of the voluntary pension fund market has been increasing by an annual average of 4% (Chart 9). The developments in the TOP5 pension funds' share – as a kind of indicator – points to a further increase in concentration, which is strongly attributable to the increasing number of fund mergers seen in recent years. Furthermore, the strength of the largest pension funds is also evidenced by the fact that in the years when membership fee revenues decreased (2008, 2009, 2010 and 2012), the five largest actors were able to increase their market share throughout the period except in one year. In the case of the five largest funds, the ratio of non-paying members exceeds the average by 2.5%, which also represents a potential reserve in respect of the membership fee revenues. In the voluntary fund sector several closed – or employer-related – funds opted for merger. It is important to note that in recent years several of the medium-sized funds, with restricted entry on an employer or territorial basis, decided to become open funds, thereby encouraging the families of the fund members to join or switch from other funds.

The pension fund market exceeded HUF 1,000 billion

Chart 10
Voluntary pension fund coverage reserve and changes in the return realised on reserves



Source: MNB

Between 2006 and 2011, the individual membership fee paid by members showed a relatively even trend, and the total annual revenue exceeded HUF 30 billion. After 2011 the ratio of individuals' and employers' membership fee contribution gradually reversed; individuals' vs. employers' membership fee ratio shifted from 40/60% in 2006 to 62/38% by end-2014. Between 2013 and 2014 the actual membership fees received increased by about HUF 7.6 billion; such growth was unprecedented, with the exception of the turn of 2007/2008. Nevertheless, even by end-2014 the received membership fee income did not reach the level of 2006 (Chart 10).

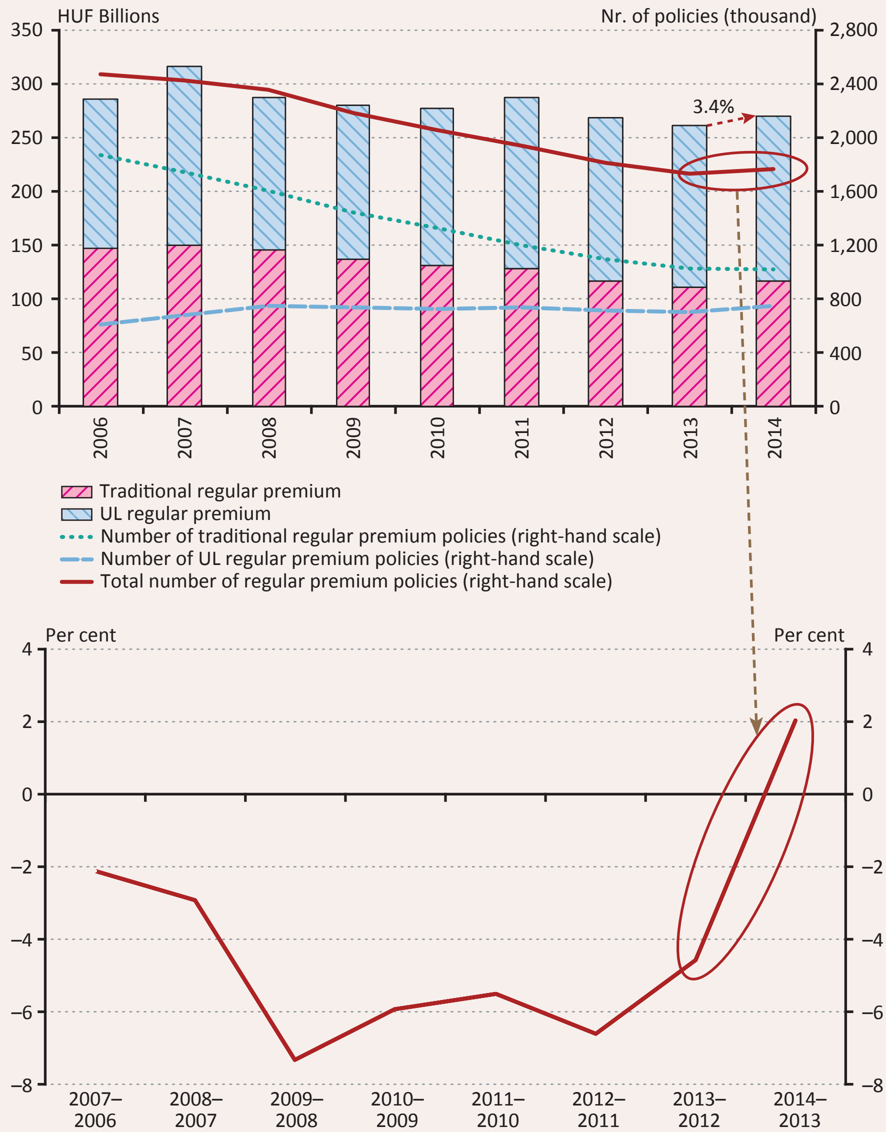
It represents a risk that while in 2009 about 10% of the required membership fee income was not paid, by end-2014 this ratio increased to 29%.

Within the number of members at end-2014 the ratio of those entitled to payment within one year was 49.6%, while the ratio of their aggregated individual account balances amounted to 61.8%. In spite of this, the total assets of voluntary pension funds do not decrease. This means that the ratio of those who leave their savings in the fund even after the expiry of the waiting period and reaching the eligibility age is high. Presumably, this decision of the fund members is also influenced by the favourable returns realised by the funds in recent years.

Growing premium income in the life insurance market[4]

At end-2014, the regular premium life insurance portfolio comprised of 1.75 million contracts, and with this the decreasing trend that was typical for several years seems to reverse. Although compared to the pre-crisis period the lag is still significant, a 2% increase from the low at end-2013 is observed. (In 2006, the number of recurring premium contracts in effect was more than 40% higher in the market.) Between 2005 and 2013, the number of regular premium traditional life insurance contracts declined steadily. As a result of the 2008 crisis the dynamics of the growth in the recurring premium unit-linked portfolio came to a halt. The amendment of law concerning the early repayment of foreign currency loans implemented in the autumn of 2011 and January 2012 had a negative impact on the developments in the portfolio; as a result, insurances connected to mortgage loans were repurchased. The growth in the life insurance portfolio in 2014 is primarily the result of the dynamically increasing pension insurance portfolio.

Chart 11
Recurring premium contracts and premium income



**Note: The column diagram on the left shows the gross written premiums of regular premium traditional and unit-linked life insurances, while the chart on the right depicts the percentage changes in the number of contracts of the total recurring premium portfolio between years.*
Source: MNB

[4] In the case of the recurring premium market.

Within the total regular premium portfolio the developments in the traditional and unit-linked portfolios vary; the decrease in the number of traditional policies is offset by the increasing number of unit-linked policies. The decline in the number of traditional life insurances is decelerating; compared to the previous year the size of the regular premium portfolio is by merely half per cent (0.6%) lower. However, the traditional life insurance portfolio, comprising of slightly more than 1 million policies, is the lowest since 2003.

The number of the regular premium unit-linked policies has been stable for several years, and the change in the portfolio (in absolute value) between 2008 and 2013 on an annual basis was less than 5%. In this regard 2014 breaks the trend as on an annual basis the growth in the portfolio was almost 6%. The number of regular premium unit-linked contracts, reaching almost 740 thousand in 2014, is close to the level of 2008, which is greatly attributable to the fact that over 70% of the pension insurance portfolio comprising of over 70 thousand policies are unit-linked (Chart 11).

At the sector level, until end-2014, gross premium written (hereinafter: premium) from regular premium life insurance contracts amounts to a total HUF 268.6 billion, with unit-linked premium accounting for almost 57% of it. On an annual basis, the year 2014 premium increased by 3.4% as a result of indexing and portfolio growth.

Premiums from regular premium traditional policies increased by nearly 5% on an annual basis. According to the figures from end-2014, the annual premium equivalent (APE) per policy is HUF 112 thousand in the case of traditional contracts, and is characterised by an increasing trend. The APE per unit-linked policy has been stable since 2012 (fluctuating between HUF 236 thousand and 238 thousand), while annual premium income in 2014 increased by 2.4% on an annual basis.

The life insurance portfolio may continue to grow in the future, which is also supported by the tax credit available for pension insurance contracts.

Pension insurance is the growth driver

Due to the short time between the promulgation of the amendments to the Act on Personal Income Tax on 29 November 2013 and the effective date of 1 January 2014 of the tax allowance available for pension insurance products, the pension insurance market expanded only gradually. Due to lack of preparation, the first half year was full of changes: development of new products during the year, modification or phasing out of existing products and the market entry of several insurers in 2014. Compared to the non-pension life insurance market, the pension insurance market is still rather concentrated, with 64% held by 5 institutions. At present, 17 insurers sell pension insurance products, but in view of the new entries the market shares of the large insurers are starting to become more balanced compared to the first half of 2014.

In order to promote the penetration of pension insurances subsidised by tax allowance and to provide customer advantage, the MNB issued a recommendation on 16 May 2014. The MNB checked compliance with this recommendation in the form of a questionnaire, reflecting the status of the pension insurance market on 25 August 2014. At that time, 50 products were available, of which 45 were unit-linked and 5 were traditional products.

By end-2014, the pension insurance portfolio was comprised of more than 70 thousand policies, 98.5% of which were regular premium policies. Unit-linked products continue to be extremely popular compared to traditional ones; until the end of the year almost 50 thousand such contracts were concluded. In accordance with expectations, new pension business peaked at the end of the year with more than 26 thousand new policies, which was primarily due to the tax provision and seasonality.

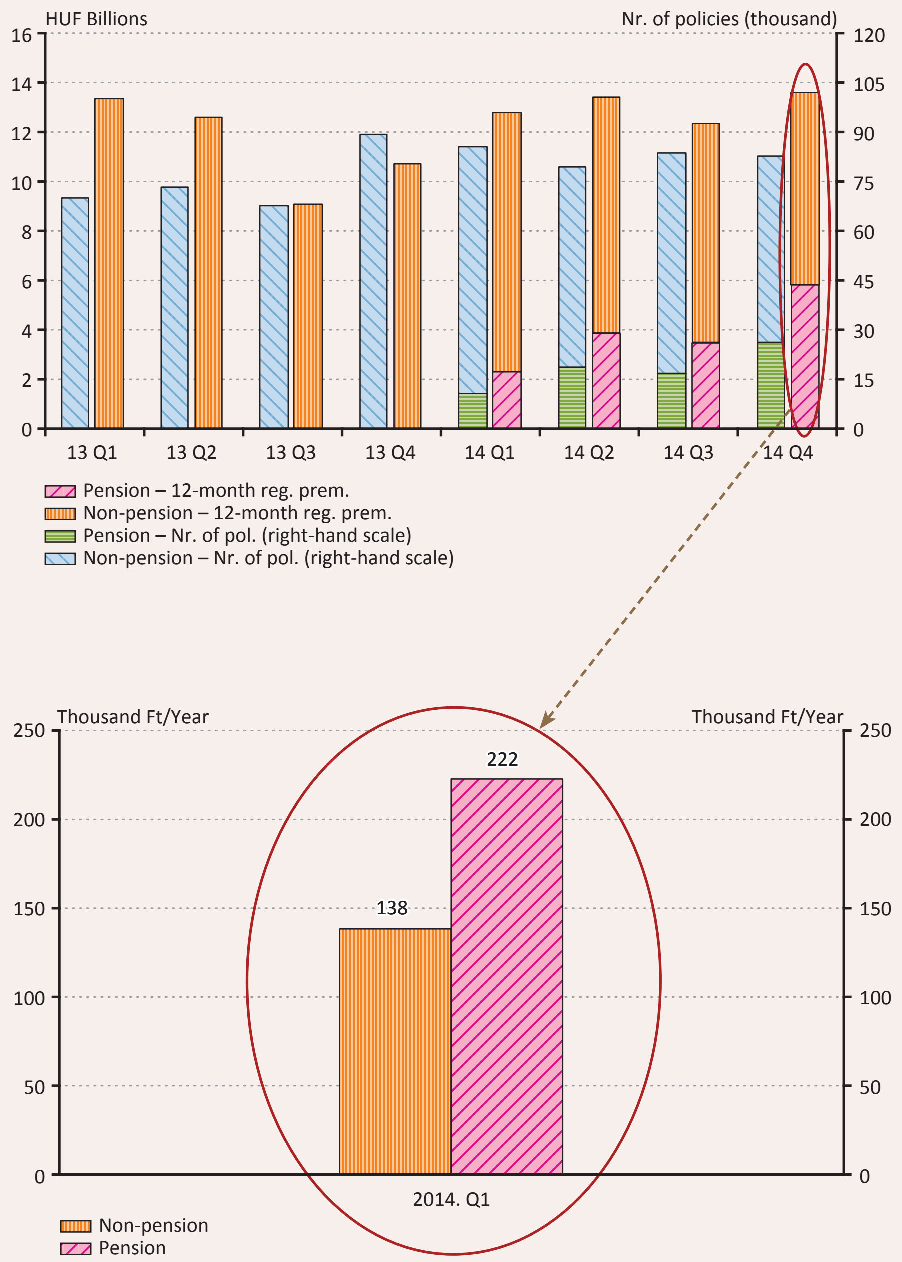
The portfolio's rapid growth resulted in a rise in premium income, which exceeded HUF 16 billion (single and regural together) at the sector level by end-2014. At the sector level, the average portfolio of regular premium pension insurance is HUF 222 thousand, but varies considerably by institution, ranging from HUF 104 thousand to HUF 318 thousand. Compared to this, the average APE of newly acquired[5] non-pension life

[5] Due to pension insurance gradually expanding, the average premium of new business non-pension life insurance is compared to the average premium of pension insurance.

insurance policies is only HUF 138,000, which clearly reflects customers' willingness to pay higher premiums on pension insurances. The maximum tax allowance of HUF 130,000 available for pension insurance can be applied to an annual premium of HUF 650,000 paid in the tax year. Since the tax allowance payable on the average premium of HUF 222 thousand is far lower than the maximum level provided by the Act on Personal Income Tax, a further increase in the average premium is expected (Chart 12).

It follows from the nature of the insurance that the currently developing portfolio may be more stable compared to other life insurance portfolios: according to expectations, the pension insurance portfolio will be characterised by a lower surrender ratio, since upon surrender the total tax allowance plus 20% must be repaid to the tax authority, which is a rather strong argument against terminating the contracts.

Chart 12
Share of the regular premium pension insurance policies within new business



Source: MNB

Box 1

Different forms of savings for different needs

Following the amendment to the Act on Personal Income Tax, as of 1 January 2014, tax allowance is also available for the new pension insurance contracts; thus one may choose already from three types of subsidised savings for retirement: pension savings account (PSA), voluntary pension fund and pension insurance. Contracts for these product may also be concluded in parallel, and the state subsidises them separately as well, thus the aggregate tax credit per year may be maximum HUF 280 thousand. The maximum tax credit can be reached with annual savings of HUF 1.4 million and may be claimed in respect of the amounts paid to voluntary pension funds, the pension savings account, to pension insurance as well as to health and mutual funds.

About the three forms of pension savings in brief

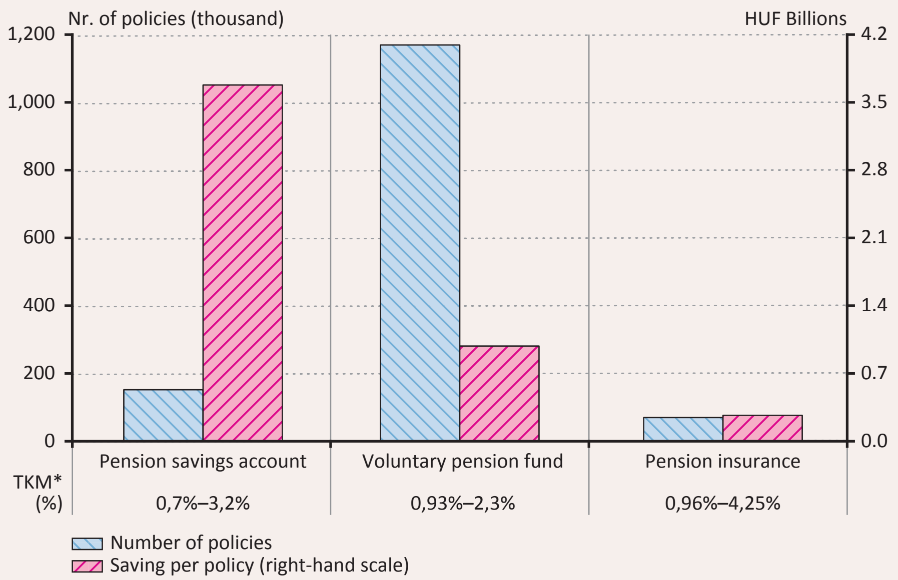
The PSA is a combination of a securities account, a securities deposit account and a cash account and is suitable for the active management of investments. The customer may receive a tax credit of 20%, up to a maximum of HUF 100,000, with regard to the annual payments to the pension savings account (if the customer retires before 2020, this amount is maximum HUF 130,000). For the maximum tax credit, the annual payment must reach HUF 500,000. The account may only be opened in written form and in forint at a bank or investment service provider selling PSA products. Simultaneously with the opening of the account at least HUF 5,000 must be paid in; thereafter there is no payment obligation, contrary to the pension fund and the pension insurance, thus the customer has to rely on his own propensity to save. For managing the PSA, the financial service provider may charge a commission of not more than 1% of the average annual balance of the account (but at least HUF 2,000). The transaction related to the purchase of the first investment instrument from any given deposit is free of charge, while the service provider charges a fee for all further deals. The customer may submit orders to the financial service provider managing the account for the savings or investment products offered by it. Of the products made available by the account-holding institution the customer may compile his investment portfolio, thereby having a high level of freedom with regard to the investment, but on the other hand he basically has to rely on his own knowledge and experiences. In addition to the high investor's freedom, this form of investment can be extremely risky in the absence of proper expertise or upon selecting risky portfolios. Depending on the choice between cheaper or more expensive asset funds, assuming passive, normal and active customer behaviour, the expense ratio of the PSA, similar to the ACR applied to pension insurance, is between 0.7% and 3.2%. By end-2014, the number of the contracts exceeded 35 thousand; the high assets per contract value (approx. HUF 3.5 million) is mostly attributable to the active customer behaviour.

Membership in a voluntary pension fund may also be achieved by regular payments of flexible amounts. With regard to the individual payment, a tax credit of 20%, up to a maximum of HUF 150,000 per year, may be claimed, which can be maximised by annual savings of HUF 750,000. After deducting maximum 6% for costs, the pension fund invests the premiums paid in into the forms of investments regulated by the relevant government decree. Voluntary pension fund savings do not require the fund members to have high-level investment skills; they may simply choose from the portfolios – the number of which varies by fund – that best suit their risk appetite and age, and thereafter there is no need to follow it. Since at present within the funds that operate an optional portfolio system, a fund member may enter only one portfolio, certain members try to further diversify their fund investments by joining several funds and making their payments to portfolios of different risks. Customers' investment management activity is low.

Of the three types of savings for retirement, the regulation of voluntary funds is the strongest, because due to the weak ability of the owners to enforce their interests it is extremely important to limit the unjustified utilisation of the funds' incomes. Apart from the statutory limits, the lack of capital requirement also contributes to the favourable cost structure of the product. According to model-based calculation, the voluntary funds' cost indicator, similar to the ACR, is between 0.93% and 2.3%. The wealth accumulated on the contract may be carried from one fund to the other, with the yield being the primary factor influencing this choice. Its advantage compared to the other forms of savings is that the state supports not only the fund member with the tax credit, but also the employers that make payments for their employees as fringe benefit, since these payments entail a lower contribution payment obligation, but do not serve as a base for the tax allowance. In addition, this type of saving is also among the cafeteria elements. As a result of the foregoing as well, voluntary funds are the most popular of the forms of savings for retirement. The number of contracts exceeds 1.1 million, and the value of assets per contract is close to HUF 1 million. At the end of 2014, the number of members whose balance was zero exceeded 50 thousand. The funds may exclude the members with zero balance only after the expiry of the waiting period of minimum ten years; however, until their exclusion administrative costs are incurred in respect of these members as well.

The chart below summarises the number of contracts in the three retirement plans, the assets per contract and the calculated costs.

Comparison of retirement plan types



**model-based calculation similar to TKM, independent from duration, excluding indirect costs*
Source: MNB

Pension insurance is a life insurance contract concluded expressly for a pension purpose. With regard to his annual payments, a policy-holder may claim a tax credit of 20%, up to a maximum of HUF 130,000, which increases his savings. The maximum tax credit can be reached with an annual payment of HUF 650,000. The policy-holder of the pension insurance typically commits to regular premium payments. After deducting the costs the insurer invests the paid amount. The pension insurance may be a traditional or a unit-linked life insurance. In the case of traditional life insurance, the insurer invests the savings together with its own assets; therefore, the insurer is also interested in achieving the highest possible yield. The insurer promises guaranteed interest on the investment and – depending on the contract – it also credits 80–90% of the yield realised above the guaranteed interest to the savings. In the case of traditional insurance, since the insurer invests its assets and the savings based on its own principles, the risk of the investment is borne by the insurer. In the case of the unit-linked pension insurance the insurer offers various asset funds to the customer and the customer decides in which asset fund he would like to invest his savings and the ratio of the investment. To support the decision, the insurers classify the available asset funds depending on their risk and yield potential. If the customer does not have sufficient investment expertise, the insurer offers its customers a choice of asset funds (portfolios) complying with their risk appetite, and later on the portfolio does not require continuous monitoring and expertise. Unit-linked pension insurance provides freedom of investment and facilitates the realisation of higher yields. In view of the fact that in the case of these insurances it is the customer who decides on the assets in which he wishes to invest his savings, the risk of the investment is borne by the customer.

Box 2
The concept of 'ethical' life insurance

In line with its supervisory strategy and along the fair treatment principle, the MNB elaborated a concept in order to restore and strengthen confidence, promote transparency laid down among market objectives as well as to implement ideas that are the focal points of the insurance sector and that support a transparent choice of services and the boosting of competition. In addition to the fact that the most important areas to be supervised were also determined in line with the strategic concepts by the supervisory division, the MNB issued two recommendations along the aforementioned fair treatment principle, and started its wide-ranging activity focusing on ethical life insurance also in conformity with the concept.

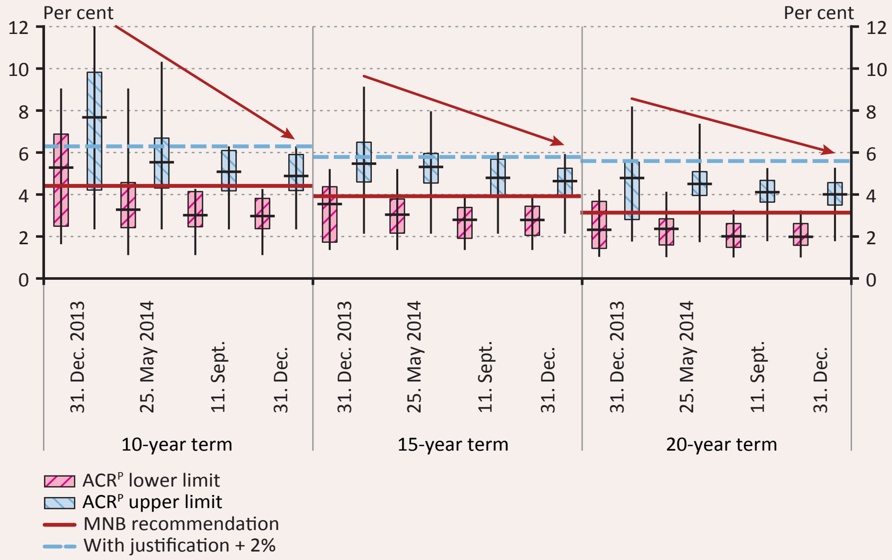
In May 2014 the MNB issued a recommendation on pension insurance. This recommendation followed the introduction in January 2014 of a personal income tax allowance for private persons' pension insurance savings. With its fast reaction to the change in legislation, the objective of the MNB's guidance was to facilitate the building of a business-based pension insurance market supported by tax incentives through schemes that are in line with the good practice determined by the Bank.

The fundamental expectation of the recommendation is that – especially in terms of the structure and costs of the schemes – transparent pension insurances with simple structure, of stable value and capable of providing customer advantage can appear. Based on the recommendation, the insurer is expected to formulate an incentive system that meets customer needs and contributes to the continued existence of contracts; professional intermediation for consumers is also an expectation. The recommendation set forth that the tax advantage related to the products must increase customers' savings and should not be taken by the insurers.

Accordingly, in the case of pension insurances, the annual cost rates (ACR) considered by the MNB as acceptable are up to 4.25% for a 10-year maturity, 3.95% for 15 years and 3.5% for 20-year maturity. An ACR of maximum 2% higher than the above is allowed with special justification in the case of insurance risks where the yield potential is higher than the average, there is yield or capital guarantee or special insurance risk.

As a result of the pension insurance recommendation, based on the backtesting done within the framework of the supervisory activity, the ACRP bands valid in the pension insurance market shrank considerably, and the expensive unit-linked products were driven out of the market. More than 60% of the available products were modified: 13 pension insurances were phased-out and the price of 27 products was reduced.

Developments in the ACRP bands in 2014



Source: MNB

Advancing along the ethical concept, in May 2015 the MNB issued a recommendation that presents and compares insurance products and is related to the electronic platforms used in insurance mediation. The MNB's expectation concerning the recommendation, which was issued after wide-ranging market consultation, is that customers should be allowed to conclude insurance contracts that are in line with their real demands and needs. It is also set forth in the recommendation that the electronic channels that facilitate the concluding of contracts and make the availability of insurances easier should be available in a way that customers could at the same time receive thorough and professional advice, matching the characteristics of the insurance service mediated. The recommendation contains proposals that the electronic platforms comparing the insurance products should be transparent and clear, should use simple language and give fair and correct information on the services and the aspects of advice.

It is important that in addition to the premium competition, a competition of services among insurers should also be attained. In order to achieve the objectives, the concrete expectation was formulated that the communication of electronic platforms should be understandable and professionally correct, and should not contain misleading information. The MNB considers that on mobile applications the comparison of simple products (e.g. travel insurance) is expedient, with complete and precise information, of course.

In addition to the two recommendations issued along the fair treatment principle, the MNB formulated the concept of ethical life insurance as well. Its primary objective is the promotion of cost transparency, the revision of investment costs, the tightening of technical rules relating to investments and the possible expansion of the ACR limits set forth in the pension insurance recommendation.

Within the framework of cost transparency it is a major objective that few, but understandable costs should be related to the individual products and that the name of the costs should be in line with the content of the costs. In the case of asset management costs it is necessary to terminate the duplicated and unjustified asset management costs. Concerning the ACR values, the pension insurance recommendation already contains rules, but realising the fact that market self-regulation is insufficient for the observance of the ACR limits determined by the market, central bank regulation of the ACR limit of unit-linked life insurances, which are out of the scope of the pension insurance recommendation, may also become necessary.

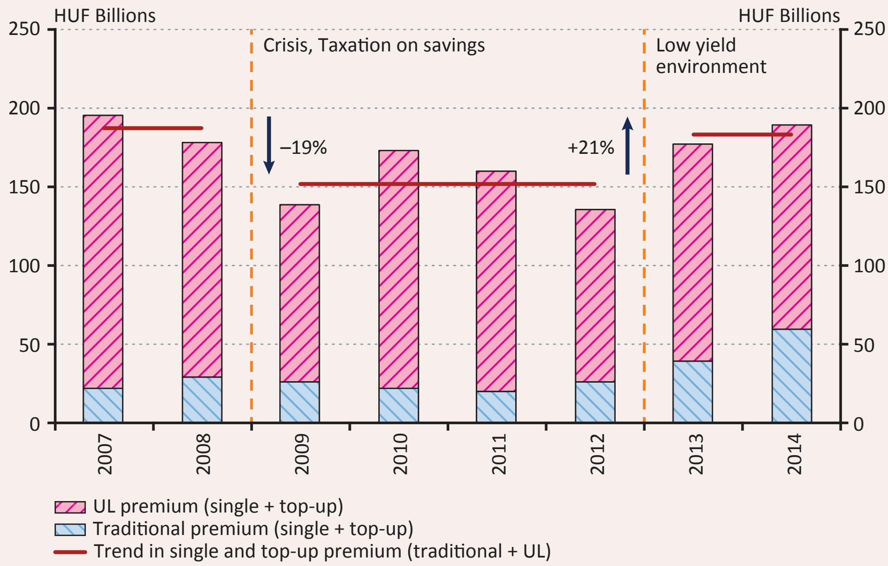
The means facilitating the implementation of the objectives of the concept of ethical life insurance will find shape in proposals to amend legislation, in enactment of regulations as well as in the updating of the No. 13/2012 recommendation on the application of prudential and consumer protection principles related to unit-linked life insurance.

Single premium market at pre-crisis levels

At end-2014, the single premium insurance portfolio consisted of 488 thousand contracts at the sector level, down 3% from the end-2013 value. The decrease in the single premium life insurance portfolio was attributable to the outbreak of the crisis in 2008 and the tax on interest income expanded to insurers in 2011; however, last year the decrease decelerated compared to the previously experienced rate.

The developments in top-up and single premiums were different from the above: between 2007 and 2014 the premiums received under this title for the traditional products increased by 75%, while during the same period the unit-linked premiums decreased by 25%. A sudden rise in gross premium (top-up + single) from traditional insurance started in 2013 and continued in 2014 as well: last year's premium income of nearly HUF 60 billion exceeded the 2013 value by more than 50%. Top-up premiums played a decisive role in this increase, as their volume almost trebled (HUF +17 billion) within one year. The top-up premium of the traditional life insurances became significant as a new form of saving. One single insurer accounts for 98% of this. The single gross written premium has been characterised by an increasing trend since 2011: compared to last year, annual growth of nearly 12% was recorded. The premium income of traditional single premium contracts exceeds the 2007 figure by HUF 11.5 billion.

Chart 13
Number of single and top-up premium contracts and premium



Source: MNB

At the sector level, almost 60% of single premium contracts are unit-linked. No trend can be observed in the gross premium income of the single premium unit-linked portfolio; there is strong fluctuation between the individual years. By end-2014 the premium income from single premium unit-linked contracts exceeded HUF 86 billion, marking a decline of 14.5% on an annual basis. The top-up premium received on unit-linked contracts in 2014 was close to HUF 44 billion, representing a 16% increase compared to the previous year's top-up premium income (Chart 13).

In the future the popularity of life insurances is expected to increase as long as financial market products are unable to offer competitive yields due to the low yield environment. A shift towards moderate risk may is expected among households, which is a favourable opportunity for the sale of life insurance products. As a result of intensive insurance campaigns, new acquisitions of single premium life insurances may further increase in the coming period.

2.2 NON-LIFE INSURANCE MARKET

Turn in non-life segments as well

Contrary to the decreasing trend of the non-life premium incomes experienced in previous years, they have increased by 5.5% since 2012, of which the growth between the last two years accounted for 3.3% (Chart 14). At the same time, the distribution of premium income between the non-life segments has also changed since 2006. Then 16% of the sector's premium income came from the financing of households' property risks, while in 2014 it already accounted for 27%.

These developments are primarily attributable to the drop in the premium income from motor insurance, i.e. the motor third-party liability insurance (MTPL) and casco, caused, in addition to the intensifying market competition, by a decline in risks (accidents). The number of household property insurance contracts has fluctuated around three million in recent years, and the growth in premium income from this segment is mainly attributable to the indexation. In view of the high penetration, further increase in this area may only be expected with the pick-up in the housing and lending markets.

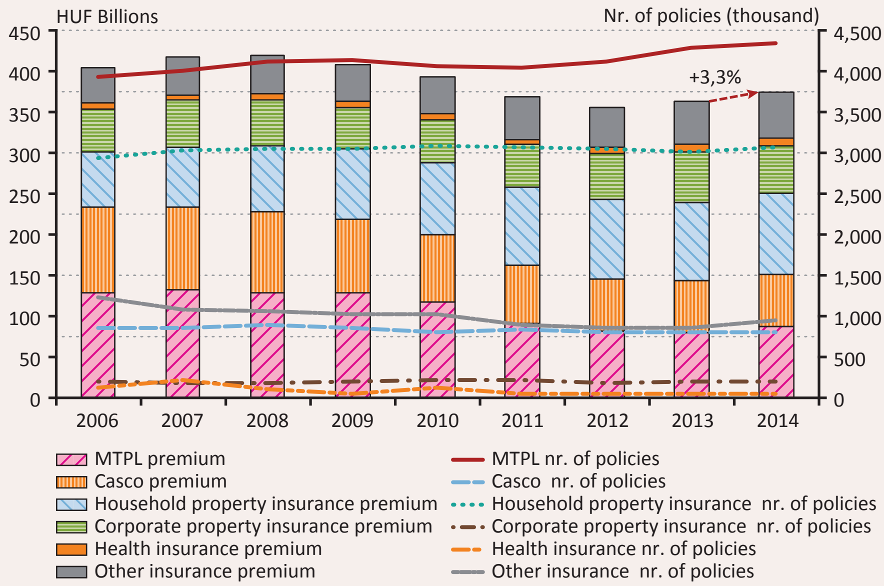
The premium income of the corporate property insurance segment has not grown significantly in the recent years, and the number of contracts also increased by only 7% in nine years. As a result of the amendment to the Civil Code, which entered into force on 15 March last year, there were legislative changes in the directors' and officers' liability insurance and in corporate liability insurance, but the positive impact of this is not yet reflected in the volume of sales, presumably due to the short time elapsed.

As for the other segments (accident, health, general liability, legal protection, credit, surety etc.), almost 50% of total premium income was realised in the two largest segments (accident and health) in 2014, whereas this ratio was 40% eight years ago. In contrast, the number of contracts in the above two segments followed a declining trend from 2006 to 2012, although signs of a reversal have been seen since 2012: an 11% expansion has been perceived, and in parallel with an increase in real wages a further upswing is expected, mainly in the field of health insurance. This may be supported by the fact that the population considers health insurance more and more as a supplement to the state health insurance rather than as a substitute for such.

Within the two motor segments, both premium income and the number of contracts declined in the casco segment. Since 2006 the first has fallen by 40%, while the latter has fallen by 6%. This in part may be attributable to the fact that in the casco portfolio the ratio of contracts that cover only partial risks (theft, natural disasters) is increasing, and on the other hand there was also a substantial decrease in claim payments (37%) in the period. The premium income per contract fell from HUF 122,000 in 2006 to HUF 108,000 by 2014.

In the non-life segment, MTPL premium income was the largest source of income (32%) for insurers in 2006. Its contribution to the premium income had decreased to 23% by 2014, and its position was taken over by the above mentioned household property insurance. However, signs of a change are visible in this segment as well, since the premium incomes in 2014 increased by 9% compared to the low in 2013. This is partly attributable to a 2% growth in the number of contracts, and partly to an increase in premiums as a result of growing risks.

Chart 14
Premium and portfolio by segments

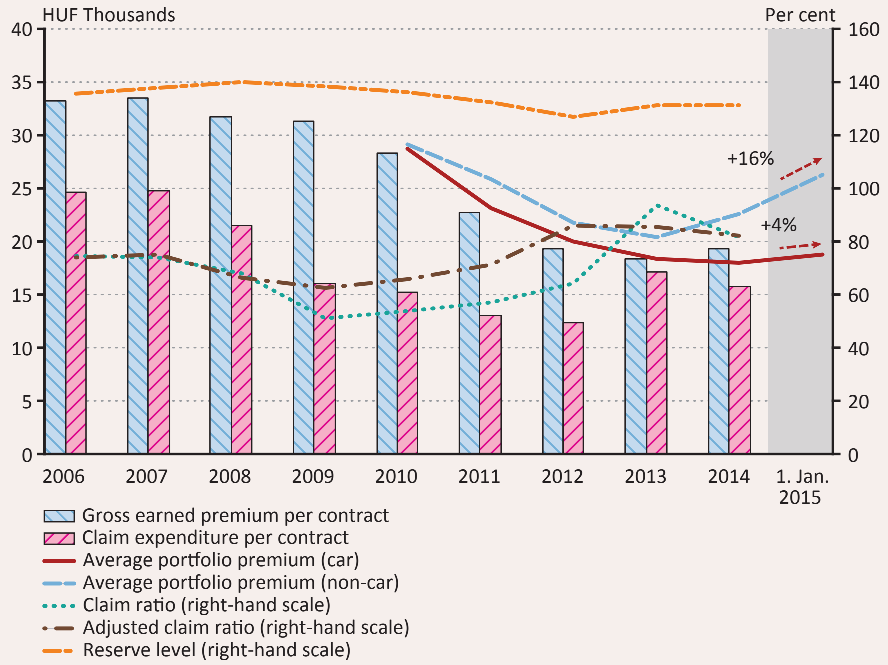


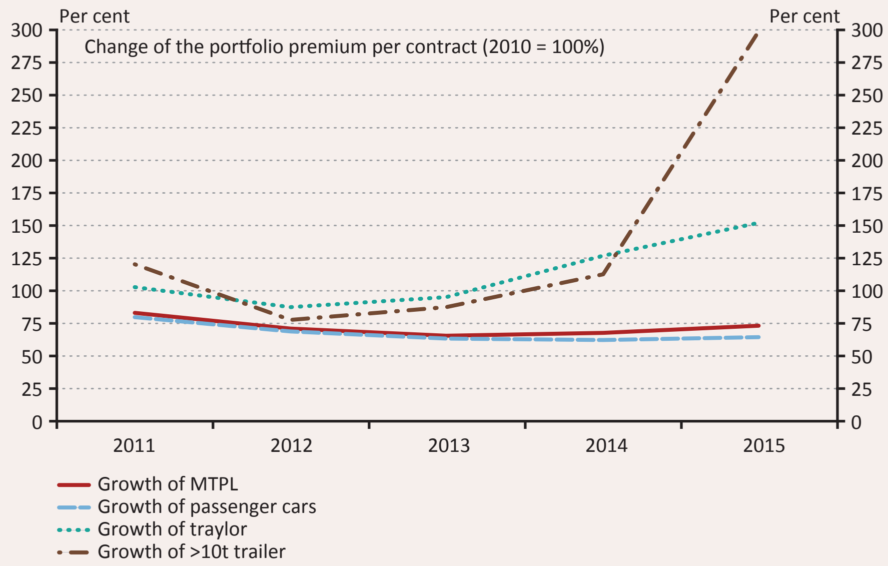
Source: MNB

MTPL premiums stopped declining in 2014, partly because the significance of the campaign faded, and partly due to the increase in risks (number of personal injury claims and accidents)

The sharp decline in MTPL premium income, which had started in 2007, came to an end by 2014. Although the earlier decrease in premiums was primarily attributable to the continuous and significant decline in claims, as a result of the market competition the tariffs fell at an even greater rate than the underlying risks to a level that already did not provide sufficient cover for the claims and expenses. Insurance companies had to spend the highest ratio, i.e. 86%, of the premiums on claims and claim settlement expenses in 2012. Although this indicator declined to 82% by 2014, it is still too high for the insurance technical profitability of the segment. The premium level at 1 January 2015 (following the re-contracting campaign) continued to increase: the average annual premium equivalent per vehicle increased to HUF 21,200 from HUF 19,500 a year earlier. Of this growth of 8.6%, 1.9% is attributable to the increase in the riskiness of the vehicle portfolio.[6]

Chart 15
Developments in MTPL premium and claims
Changes in the APE per contract (2010 = 100%)





Note: average = falling on a single contract
Adjusted loss ratio: taking all claim reserves into account, adjusted by the change in the prudence level of the provisions for outstanding claims.
Source: MNB

[6] Shift in the total market portfolio towards the higher-risk vehicle portfolio composition, and distribution by age and area.

Premium increase rates varied significantly by type of motor vehicle, and reflect the emergence of market disorder in certain areas

The change in premiums was essentially in line with past claim experiences. The premiums of motorcycle insurances, belonging to the segments with the lowest loss ratio, decreased, while in the case of buses, characterised by extremely high (over 100%) loss ratio, insurers increased the premiums over the average (7.7%). Price competition is the fiercest in the case of cars, accounting for two thirds of the portfolio; the premium level of the segment increased by only 2.8% in one year despite the worse than average loss ratio.

In a German leading case the court established identical liability for the tractor and the trailer in a claim caused by a combination of vehicles. Especially in the case of international claims, insurers have a good reason to fear that this will be incorporated in the general legal practice,[7] which would raise the average liability claim per trailer close to the level applicable to tractor units. In the case of trailers with permitted total weight exceeding 10 tons this fear triggered a panic reaction among insurers. This is reflected in the 163% increase in the premium level, and even more in the premium announcements of certain insurers. At end-2013 the basic tariffs remained below HUF 15,000 at most insurers, but during 2014 they tried to keep off these vehicles, particularly the new contracts, by significant premium increases: by 1 January 2015, six of the fifteen MTPL insurers overpriced the whole heavy trailer segment.[8] Insurers strived to prevent the acquisition of a mass portfolio by applying more vehicle surcharges and increased fleet premiums. The majority of insurers – responding to the underlying reason of the market disorder – applied drastic (2–8 times and even up to 100 times higher) surcharges to participants in the international carriage of goods. International exposure – particularly in the case of transport of goods – is a major risk factor; the claim per contract (to be covered by the premium) in certain segments can be several times higher for vehicles regularly travelling abroad than for vehicles used in domestic transport. With the exception of four insurers, all insurance companies apply some sort of domestic/international differentiation, but the classification is performed based on the customer's declaration, and verification may be reasonably be carried out only in the case of larger fleets. The limited possibility of taking into consideration the international exposure as a material risk factor and the market disorder that evolved around this explains the significant premium increase (19.6%) for HGVs, despite their average loss ratio in the total market. The marked increase (16%) in the average non-passenger car APE was primarily the consequence of this (Chart 15).

The 2014/2015 motor third-party liability insurance (MTPL) re-contracting campaign resulted in increasing premiums in parallel with decreasing competition

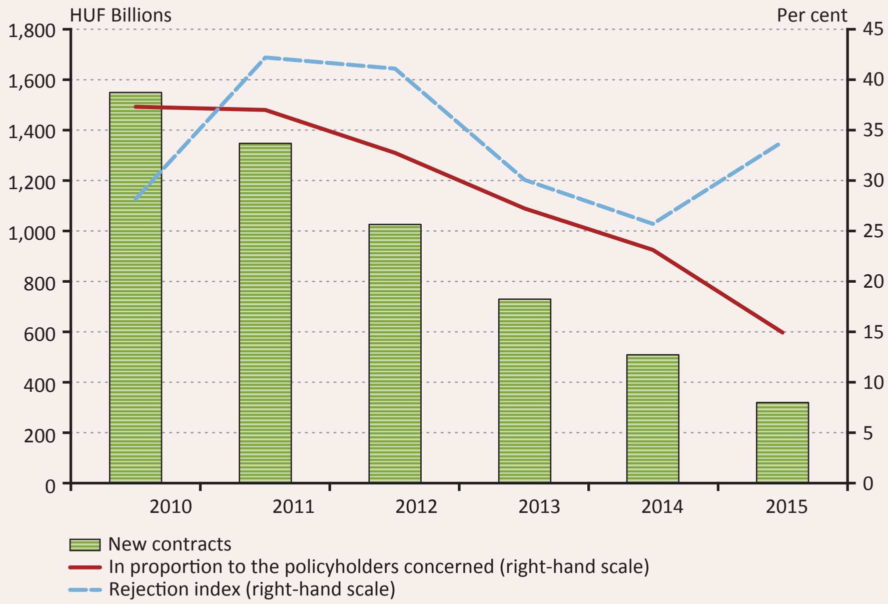
As a result of the liberalisation process,[9] a decreasing number of vehicles are concerned by the year-end campaigns; the 2014/2015 campaign involved only 49% of the vehicles (43% in proportion to the annual premium equivalent). The declining significance of the campaign – as the most important field of MTPL premium competition – is also reflected by the fact that not only the number of those who change insurance during the campaign, but also their ratio to the total number of contracts concerned by the campaign (where the insurance anniversary date is 31 December) is decreasing sharply. Based on online brokers' data, providing only partial coverage, customers' price sensitivity has decreased and the ratio of customers who do not choose the cheapest offer increased to 34% (compared to the low of 25% seen last year) (Chart 16). With the tangible increase in the premium level, the average amount saved by a contract change increased once again. The value of HUF 7,000 corresponds to the level two years ago, and exceeds last year's low by 14%.

[7] According to the Hungarian practice, the trailers were responsible for the damage caused by the combination of vehicles only and to such extent as and when their direct instrumentality could be proven.

[8] Contrary to normal market behaviour, the sole purpose of the announced tariffs is to discourage all the operators of heavy trailers from taking out an insurance with the given insurer.

[9] During the re-contracting campaign the insurers publish their premiums effective from 1 January next year. Since 2010, the insurance anniversary of the new MTPL contracts concluded (contrary to the former standard insurance anniversary date of 31 December) is the effective date of the contract, and insurers may modify their tariffs several times a year as of 2014.

Chart 16
Data related to the MTPL re-contracting campaign



Percentage of changed contracts within those concerned by the campaign.
Rejection index: the percentage of those who changed insurers but did not opt for the cheapest offer.
Source: MNB

2.3 CAPITAL AND PROFITABILITY

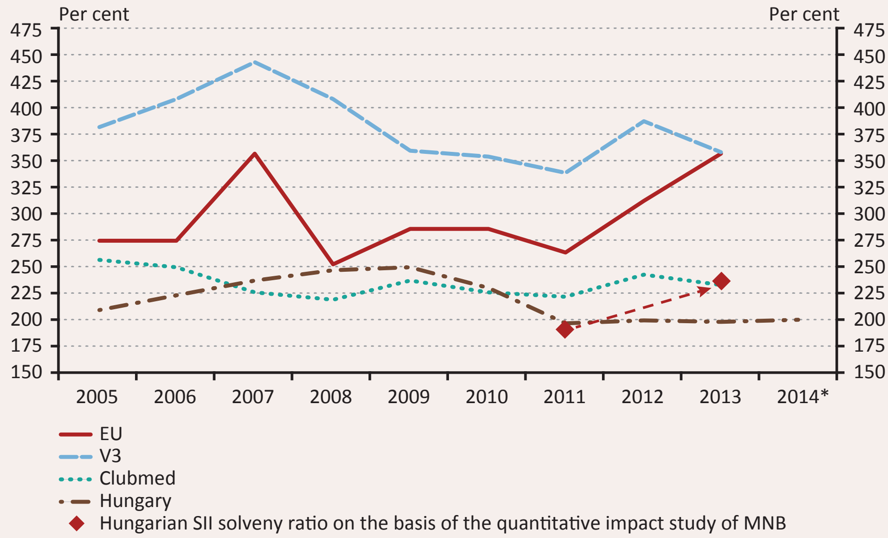
Low capitalisation compared to the EU – greater volatility expected in Solvency II

The capitalisation level of the domestic insurance sector has become stable at around 200% in recent years (Chart 17). The unchanged capital position since 2011 is down to the fact that although considerable profits were realised at sector level, owners distributed them as dividend. During the years of the crisis, in parallel with a decline in profitability, owners decided on the payment of dividends in excess of the realised profit. This had a dual effect: it led to the erosion of the surplus capital accumulated at Hungarian subsidiaries until then and to capital accumulation at the owners. As a result of this process, by now the capitalisation level of the Hungarian insurance sector is among the lowest ones by international standards.

Distribution of dividends in excess of the current year's profit is no longer typical: the decrease in surplus capital and the maintenance of the capital level required for operation has put a stop this process. Examining the earlier decrease in capitalisation from a different aspect we find that insurers' capital requirement has contracted only to a slight extent (by 5%) since 2009, while the surplus capital has fallen by 35% during this period. At the same time, the latter is rather concentrated, as the five insurers holding the largest capital buffer accounted for 60% of the entire sector's capital surplus in 2014.

Slated for introduction in 2016, Solvency II will have a considerable impact on the sector's capital position. Firstly, the decline in insurance technical reserves will result in a growth in surplus capital. Secondly, following the entry into force of the new regime, the volatility of the capital adequacy ratio may increase. The expected increase in volatility stemming primarily from market valuation and a greater variability of market prices is corroborated by the findings of the Solvency II quantitative impact analyses. For example, in the period between 2011 and 2013, capitalisation according to Solvency I increased by 8%, while the increase in the indicator according to Solvency II was more than twofold, i.e. 21%. This phenomenon mainly means a real risk for market participants whose capitalisation is low, where higher volatility may result in an unexpected shortage of capital.

Chart 17
Sector-level capital position in international comparison

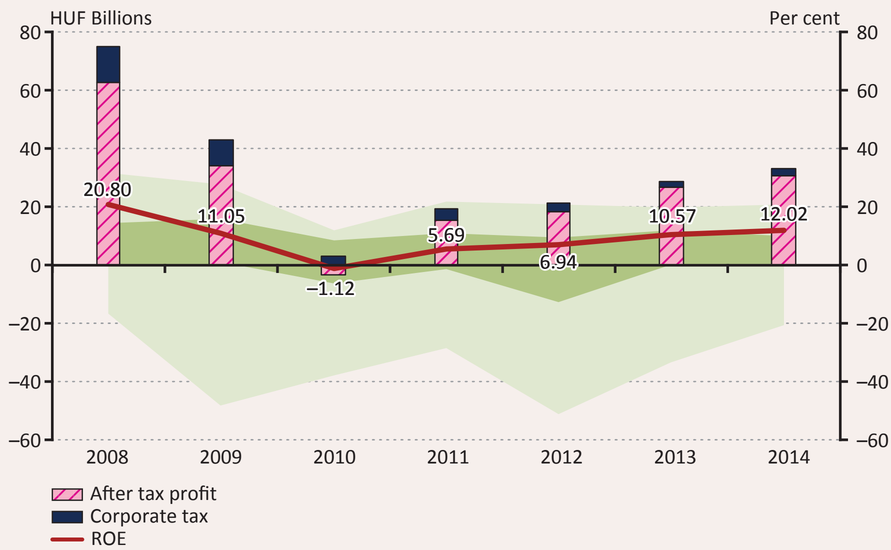


** Based on preliminary data*
Source: EIOPA, MNB

One third of insurers are permanently loss-making

The sector's average return on equity (ROE) after taxes has been continuously increasing since 2010 (Chart 18). The local low is mainly attributable to one-off effects, such as impairments recognised on shares in affiliated undertakings, storm damage claims that considerably lowered the result of the non-life segment and the surtax imposed on financial organisations. The sector level ROE of 12% only slightly exceeds one half of the value measured in 2008, despite the improvement observed in recent years. The decline is attributable to the non-life segment, which in the last two years realised significant losses as opposed to the profits of previous years. The underlying reason for the deteriorating non-life ROE is that the insurance tax affecting the non-life products and replacing the surtax of financial organisations in 2013 appeared only partially in the premiums.

Chart 18
Profitability of the Hungarian insurance sector



Source: MNB

In addition to the tax burden, non-life profits were determined by the MTPL losses during the past years. In the last two years, in the case of MTPL the previously downward trend in the cost of claims halted and started to increase, resulting in the rising premiums seen in the past period. Due to the low yield environment, the effect on profitability of the yield attained on the reserves is expected to decline in the future.

The insurance technical profit/loss in the life segment has been stable since 2008. The volume of mathematical reserves, related primarily to traditional life insurance policies, is gradually decreasing due to the contraction of the portfolio; these developments are offset by the increase in reserves related to unit-linked products.

One third of insurers are permanently loss-making. The ROE of the insurers in the first decile was below -21% in 2014. Last year the capitalisation of three out of four actors was also below the prudential level (120%) expected by the MNB. The high ratio of actors that steadily post negative results is primarily attributable to economies of scale reasons; however, as mentioned before, in the case of a positive market growth trend, an increasing number of insurers could reach an efficient company size. In relation to actors pursuing motor third-party liability insurance, another factor key to increasing profitability could be the improvement of the segment's profitability, while in the life insurance segment the commencement of the reduction of acquisition costs.

Box 3

Risk-free yield curve in the Solvency II system

The Solvency II system to be launched on 1 January 2016 entails considerable changes for insurers both in terms of quantitative and qualitative regulatory requirements. One of the most important changes is that it places the assessment of insurers' financial position on economic valuation principles. The economic valuation will be also reflected in the calculation of the insurance technical reserves as the value of the technical reserves will have to correspond to the current amount that would be payable by the insurer if it immediately transferred its insurance or reinsurance obligation to another insurer or reinsurer. The value of insurance technical reserves comprises of two components, the sum of the best estimate and the risk margin. Based on the principle of economic valuation the best estimate corresponds to the expected present value of the future cash flows associated with the insurance or reinsurance liabilities. During determining this value, the insurers use the risk-free rate curve for the discounting. In order to ensure the consistency of the reserve calculation of the insurance companies pursuing their activity within the European Union, the European Insurance and Occupational Pension Authority (EIOPA) determines and publishes the risk-free rate curves necessary for the calculation. EIOPA determines the individual yield curves for the given currency swap and certain currencies and maturities based on the government securities market yields, depending on whether the criteria applicable to the deep, liquid and transparent (DLT) market are fulfilled for the respective maturity. The last liquid point (LLP) means the maturity after which the yields no longer satisfy the DLT criteria. EIOPA determines the post-LLP section of the risk-free rate curve using the extrapolation based on the so-called Smith–Wilson method, also considering the so-called ultimate forward rate.

At present, in the case of the Hungarian forint, in the first two years the risk-free rate curve is based on the swap yields and thereafter on the government securities yields, while the last liquid point corresponds to the 15-year maturity.

In order to reduce the volatility of the market prices and of their regulatory capital level, insurers may adjust the risk-free rate curve.

The volatility adjustment offsets the fluctuations caused by the change in market prices on the assets side through permitting the enforcement of part of the risk premium in the risk-free rate curve and through that in the technical provision calculation. EIOPA defines the volatility adjustment as the percentage point difference between the yield of the so-called representative portfolio assets and the yield of the liquid assets free from credit risk. The MNB's permission is not required for the application of the volatility adjustment.

Another type of the risk-free rate adjustments is the matching adjustment, which is based on the fact that the insurers possessing held-to-maturity bonds or other assets with similar cash flow features are not exposed to the risk arising from the change of the credit spreads of these assets. The matching adjustment may only be applied to life insurance reserves or reserves determined on life insurance principle basis, subject to the MNB's prior approval. The insurer calculates the value of the matching adjustment according to a specific methodology for its separately managed portfolio, using the fundamental spreads published by EIOPA.

If the insurer uses either of the adjustments described above, the insurer must prepare a liquidity plan and during its own risk and solvency assessment (ORSA) it must examine the quantified impact of the applied tool on the insurer's financial position. The latter must be presented in the insurer's public report on solvency and financial position as well.

During the Solvency II quantitative impact study ran in 2014 (based on 2013 year-end data), insurers had the opportunity to apply the above mentioned adjustments. None of the participating 23 insurance companies took the opportunity to apply the matching adjustment and they do not plan to use it in the future either. In contrast, all participants but one calculated with the volatility adjustment. The volatility adjustment improved the sector's solvency ratio to a small degree, i.e. by 9 percentage points.

2.4 RISKS

The sector level risks of insurers and pension funds are classified as moderate or significant, while prospects are typically stagnant. In the case of insurers the preparation for the Solvency II framework to be introduced from 1 January 2016 may give rise to the increase in certain risks (Chart 19).

Chart 19
Risk map of the insurance sector

Risk type	Source of risk	Risk level	Risk outlook	Detail of risk source
System of Governance (SoG)	Preparation for Solvency II	moderate	stagnant	• Implementation of the new SoG requirements entered into force from 1st July 2014 has been followed up • SoG will be examined during the upcoming comprehensive on-site inspections
Operational risk	Compliance with the regulatory environment	significant	stagnant	Significant operational risks have been identified during the on-site inspections regarding: • Process of insurance policy portfolio management • Operation of IT systems • Preparation for data reporting under Solvency II
Insurance risk	Terms and conditions, insurance premium calculation, adequacy of insurance technical provisions	significant	stagnant	• Life: low interest rate environment is considered to be a significant risk • Non-life: increasing claims paralelly with stagnating level of MTPL and casco premiums
Profitability	Size of operation	significant	increasing	• Profitability is adequate at the sector level • One third of the undertakings is loss-making • Life: size of operation, aquisition costs, unstable portfolios • Non-life: size of operation, insurance tax, MTPL
Solvency position	Solvency II implementation	moderate	increasing	• The solvency position is acceptable on the sector level • In the international comparison: low • Impact of Solvency II: increasing volatility is expected

Explanation:
Degree of risk[10] — *high* ● *significant* ● *moderate* ● *low* ●
Direction of risk — *increasing* ↑ *stagnant* → *decreasing* ↓

[10] The assessment of the risk level of certain supervised institutions takes place on the basis of the valuation of the institutions performed individually. The MNB allocates the risk level of the institutions based on a number of quantitative and qualitative indicators to various risk categories (high, significant, moderate, low) after assessing their typical risks.

Solvency II significantly modifies corporate governance requirements, part of which regulations must already be applied from 1 July 2014. The MNB backtested the compliance with the new corporate governance rules in 2014, as part of the so-called quality impact analysis. Based on the experiences, at present the risk of changeover to the new corporate governance structure is moderate at sector level. One of the most important tasks of the on-site inspections to be performed in the coming period is the verification of actual compliance, i.e. whether apart from the regulation the applied practice also satisfies the Solvency II principles and the signals of the control systems are indeed integrated in the decision-making processes thereby ensuring the expected risk awareness. During these inspections the MNB can obtain a more detailed view of the corporate governance system, which may serve as a basis for the future assessment of the risks.

The on-site audits revealed material operational risks at a wide range of the institutions in the past as well, particularly in respect of the portfolio management and in general with regard to the operation of the IT systems. These operational errors and shortcomings have a negative impact on the due and timely compliance with the institutions' statutory obligations. These phenomena continue to signal a significant risk level at most of the institutions.

Based on the assessment performed by the MNB, at the vast majority of the institutions of strong-influence and higher than medium influence[11] the insurance risk is moderate, but due to the significant risk of the non-life segment the classification allocated to the sector as a whole is 'significant'. This is evidenced by the strained situation in the MTPL market: although the decline in premiums ended due to the increase in the number of personal injury claims and accidents as well as the decreasing significance of the year-end campaign, the low premium level still represents a risk. In the life insurance segment the low yield environment poses a risk in terms of attaining the yields (technical interest rate) undertaken for the traditional products, which account for around one third of the portfolio.

The sector's return on equity has been continuously increasing since 2010, but this indicator considerably varies by institutions. There are considerable individual discrepancies behind the average improvement in profitability. Beside the dominant and profitable institutions one-third of the insurers are permanently loss-making. The high ratio of the loss-making institutions is primarily attributable to economies of scale reasons; however, additional factors may be identified by insurance segments. In the life insurance segment, profitability is materially restrained by the relatively high level of the acquisition costs. As a result of the new commission rules an adjustment process may be expected and the MNB continuously monitors and backtests the implementation thereof. The life insurance segment is also characterised by the trend whereby in parallel with the phase-out of the traditional life insurance products – according to the experiences – in the case of the non-pension purpose products the build-up of the portfolio of the less stable unit-linked products may be expected. This impact is offset by the pick-up in the selling of pension insurance contracts. In their case, the nature and, as a result of the MNB recommendation, the low cost level of the product is expected to result in a stable portfolio. In the non-life segment, the losses in the MTPL segment reduce insurers' profitability, although there are already some positive signs in this area.

The adequacy of the available regulatory capital is satisfactory at market level, but is low in comparison with international standards. A factor having an impact on the future risk assessment of the capital position is the application of the new regulatory capital requirement calculation method from 2016. It may result in a risk level higher than at present and generate enhanced attention on the part of the supervisory authority in relation to the adequacy of the applied methodologies and through the presumably increasing volatility of the capital adequacy level compared to the present situation.

Of the risks of the voluntary pension fund and the health fund sector the corporate governance risks are classified as significant, while the outlook with regard to all risks is stagnant (Chart 20).

[11] The MNB categorises the institutions and groups of institutions based on their influence on the financial system; thus it differentiates between institutions of strong influence, higher than medium influence, lower than medium influence and weak influence.

Chart 20
Risk map of the voluntary insurance mutual fund market

Risk type	Source of risk	Risk level	Risk outlook	Detail of risk source
Governance	Withdrawal of background institutions			Change of ownership or withdrawal of background institutions at certain funds affected the contractual relationships and administration activity, therefore the connected support may diminish and change of control processes due to terminating group membership results risks. Significant concentration of operating leadership and exaggerated control competence of one man result risk at certain funds.
Market appearance	Regulatory risk Services			Competition is increasing in the market of self support products since other pension purpose saving forms get similar tax advantages as voluntary pension funds from 2014. Most of the health funds provide wide range of services, therefore it means a risk in paying out that the fund may finance certain kind of health services that is not allowed by legislation.
Financial and operational risks	Investment concentration Number of members			Health and mutual aid funds provide services continuously, therefore investments of these institutions ara not diversified properly due to steady payment demand and administration costs. Number of members of health funds is continuously growing, while the number of members of pension funds is still declining. The number of non paying members is still high on overall sector level.
Profitability	Investment results			Profitability of the pension fund sector is still good even in low yield environment, but there are significant differences among individual institutions. Profitability of health funds can be hardly interpreted because of continuous service demands. Safe operation of funds is secured by sources useable for operation on sectoral level (share of membership fees useable for operation, part of return of non paying members deductable for operation, support, donation).

Explanation:
Degree of risk — *high*, *significant*, *moderate*, *low*
Direction of risk — *increasing*, *stagnant*, *decreasing*

Change of ownership took place at the background institutions of certain funds. Some of them do not carry a significant risk as the changes so far had no impact on the contractual relations between the funds and the background institutions.

At other funds the withdrawal of the background institutions entailed the changing of the name, the termination of contracts with the service providers and the substantial transformation of the fund operation, and therefore increased supervision and more intensive communication is justified.

The decrease in the number of voluntary fund members decelerated, and it may be regarded as a favourable development that compared to the previous five years the number of new members is increasing. However, the number of terminated membership relations still exceeds the number of new members.

At certain funds the MNB identified personal risks related to the one-man operative management, and in the course of the oversight activity it is continuously reminding the funds' management of this risk.

Competition for the voluntary pension fund services is emerging insofar that as of 1 January 2014 the legislative changes related to the personal income tax created the conditions for competition under equal terms, i.e. similar tax allowances are provided to those holding a pension insurance policy or a pension savings account as those applicable to the voluntary pension fund payments.

The high ratio of non-paying members is typical both for voluntary pension funds and health funds, but as a result of the deductions from the yield of the non-payers for operating activities the reserves available for operation are not decreasing at the sector level.

It follows from the nature of the health funds that membership payments and financing of the services are continuous, and therefore the fund investments are directed at highly liquid investments. However, the majority of the institutions do not diversify their investments adequately even within the limits permitted by the law

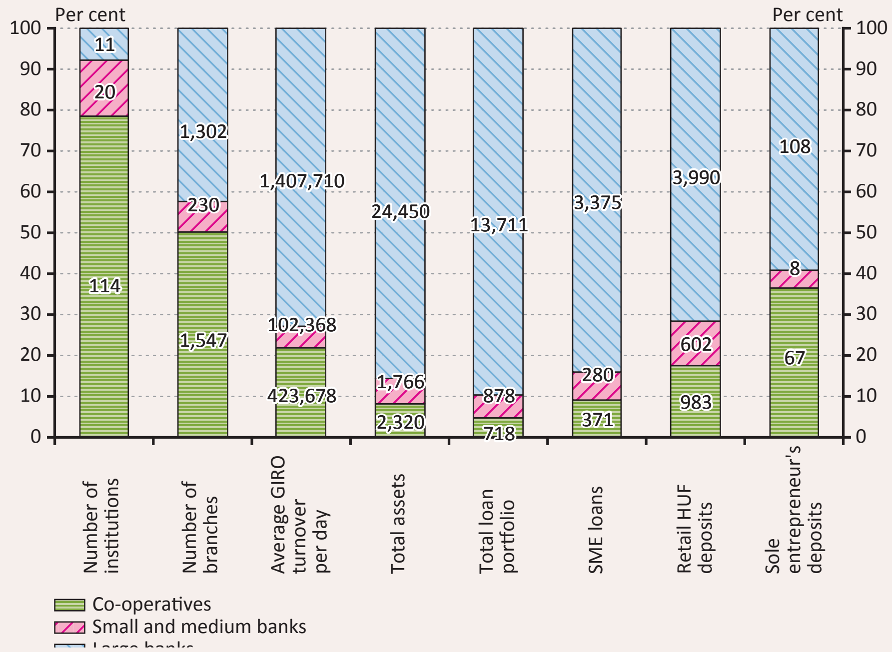
3 Co-operative credit institutions

3.1 STATUS AND ROLE OF CO-OPERATIVE CREDIT INSTITUTIONS IN THE DOMESTIC MONEY MARKET

In Hungary, three out of four credit institutions operate in co-operative form, while more than half of the domestic bank branches belong to the member institutions of the co-operative integration.

The aggregate market share of co-operative credit institutions calculated on the basis of the balance sheet total accounted for approximately 7% at end-2014[12] (Chart 21). Despite the low market share relative to the balance sheet total, these institutions provide a large proportion of households and the economy with financial services; moreover, mostly in areas where other service providers are practically not present for strategic or economies of scale reasons. Accordingly, their market role is in inverse proportion to the size of the settlements, i.e. their presence is dominant in the smallest settlements and the correlation is similar in respect of the customer size as well. Their role outstrips their weight in payment transactions and in several business lines, including the collection of household deposits and the financing of agriculture. Their role in SME financing is clearly evidenced by the fact that more than one third of the cards issued under the Széchenyi scheme were issued by co-operative credit institutions. Similarly, they contributed to the success of the Central Bank's Funding for Growth Scheme to a much larger degree than it would follow from their size.

Chart 21
The co-operative integration is one of the largest credit institution groups



Source: MNB

In the years after the outbreak of the financial crisis, with the stagnation in the banking system, co-operative credit institutions were able to expand their credit portfolio substantially, because with their abundant liquidity reserves they did not have to rely on refinancing from the drying-up interbank markets. However, as a result of

[12] Based on reports prepared on the basis of the Hungarian Accounting Standards (HAS).

limited risk-taking and risk management capacity and the heterogeneous regulatory and banking background significant tensions accumulated in the sector. The fact that several co-operative credit institutions became insolvent clearly pointed out the limits of voluntary integration models, the erosion of the co-operative credit institution system and the weaknesses of the regulatory framework applicable to co-operative societies.

Within the framework of the mandatory integration[13] established by the Act on Integration adopted in 2013, the central organisations performed a comprehensive due diligence review, which revealed severe problems. The mandatory due diligence was finished by end-2014 and ultimately served as the basis for the withdrawal of the operating licence of 5 institutions.

Thus finally on 5 December 2014 the close integration based on joint and several responsibility was established with 113 member institutions in addition to Takarékbank.[14]

Box 4

Co-operative credit institutions in mandatory integration – past and present

Since the middle of the 19th century, co-operative credit institutions have been key players in the history of the Hungarian economy. With their more than 1,500 branches and a clientele of a million people they are determining financial service providers in the Hungarian rural areas. In addition to households and private entrepreneurs, the majority of their clients are small and medium-sized enterprises. However, the utilisation of the potentials of such clientele was always considerably hindered by their vulnerability and economies of scale problems arising from the small size as individual entities. The Hungarian State, recognising the negative developments emerging in the co-operative sector, decided to establish a mandatory integration structure with strong central control, in order to modernise the sector and reduce its risks.

The Act on Integration passed by the Hungarian National Assembly fits well into the vision developed by the MNB regarding the Hungarian banking sector. After the entry into force of the act, a co-operative credit institution may operate only as a member institution of the Integration Organisation of Co-operative Credit Institutions (IOCCI) in Hungary.[14] The co-operative banks operate tightly embedded in the economy of their direct environment, are fully in Hungarian ownership and their contribution to the intensification of the competition is unquestionable. The adjustment to the increasingly detailed and complex EU regulation, as well as the identification and management of the risks arising from the changed economic and regulatory environment represent a challenge that co-operative credit institutions below a certain size are unable to cope with at reasonable costs. The mandatory integration could be an appropriate framework for the survival and competitiveness of co-operative credit institutions, which is able to efficiently provide them with the logistics, uniform control and product development necessary for their operation. At the same time the strongly centralised integration also represents a cross-guarantee system where the member institutions undertake joint and several liability for their liabilities not protected by the NDIF.

On 31 March 2015, the central bank of the co-operative integration incorporating 106 mutual savings banks, 2 credit co-operatives and 3 banks of co-operative origin is the Magyar Takarékszövetkezeti Bank Zrt. (Takarékbank), the majority and minority owners of which are the co-operative societies and FHB, respectively. The institution protection organisation of the integration is the IOCCI, which is under the majority control of the Hungarian Development Bank Plc.

[13] See the Box on the integration.

[14] Compulsory membership in integration is not unprecedented in the history of Hungarian law; e.g. Section 2 of Act XXX of 1920 provided: '...after this Act's entry into force credit unions may only be established with the cooperation of the National Central Credit Union subject to the condition that the union to be established declares that it would join the National Central Credit Union as an ordinary member and the Board of the National Central Credit Union accepts the declaration of joining. In the absence of the certificate on the fulfilment of these conditions, the court shall not register the union to be established in the company register.'

Takarékbank has direct command authority for the control of the co-operative credit institutions, it may limit their operation if they breach its instructions or the statutory provisions, and it may suspend or dismiss their executives. The passing of the most important business decisions, the approval of the annual report, the dividend payment and even the appointment of the executive officers of the member institutions are subject to the permission of Takarékbank. Takarékbank, based on statutory authorisation, elaborates a common business policy, approves standard regulations applicable to all member institutions and operates a central loan approval, risk monitoring and cash management system. In addition, the Bank is also responsible for the collective marketing, the development of the standard IT system, the consolidated data supply and product development.

The IOCCI is the strategic governing body of the integration, which approves mandatory regulations with regard to the eligibility of the executive officers, the internal audit, accounting, the rules pertaining to the support of distressed member institutions and the rules of contribution to the shared safety buffer. The Organisation also has strong sanctioning rights, as it may even expel the distressed member institutions or those that fail to comply with the statutory regulations or the rules laid down in the collective regulations. Such measure entails – in the absence of submitting an application for transformation into a bank – the withdrawal of the operating licence of the co-operative credit institution.

The Hungarian State provided aid of HUF 136 billion through the Integration Fund of Co-operative Credit Institutions for the 'practical implementation and development of the co-operative integration model'.[15]

The mandatory integration substantially increased the safety of co-operative credit institutions and the financial muscle of the sector, while through the joint and several liability of the member institutions it reduced the risk of losing the deposits placed with the co-operative societies to the minimum.

3.2 OWNERSHIP AND STRATEGIC RISKS

The large number of members of mutual savings banks and credit co-operatives, typically holding shares of negligible value, usually do not have the necessary ties to the institutions and are unable to exercise efficient ownership control over them. In supervisory terms the substandard professional skills of the elected bodies (Board, Supervisory Board) is a recurring problem, which often makes the control over the executives formal. As a consequence of inadequate owner's control at a number of institutions poorly performing co-operative society managers could remain in place, which severely hinders the modernisation of the sector. In the mandatory integration established on the strength of the law (Chart 22) the central organisations are strongly empowered to reinforce the professional management and to control the managers' performance.

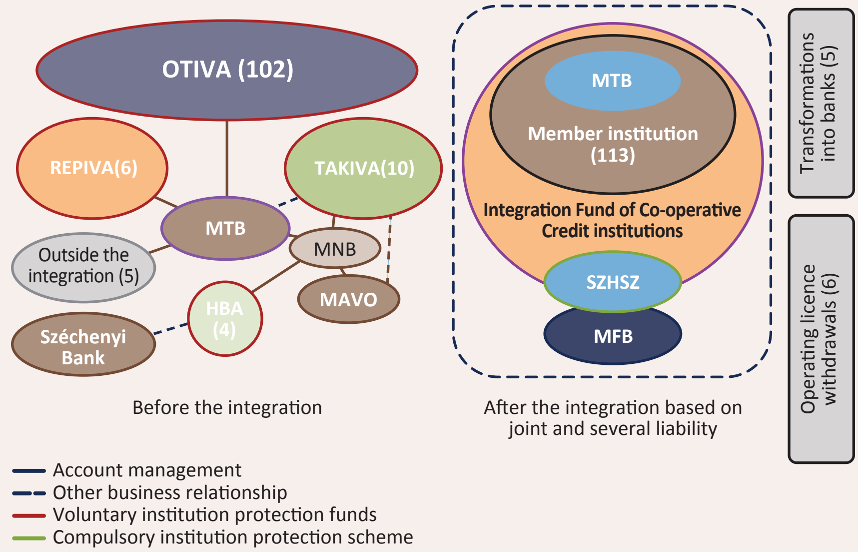
Co-operative credit institutions are simultaneously the owners and the customers of Takarékbank. The management of this conflict of interest is made more efficient by the control rights provided to Takarékbank by the Act on Integration.

Although co-operative credit institutions were determining service providers of the small settlements representing their direct environment before as well, as a result of the close cooperation and joint action materialising in the mandatory integration, they may gradually become real competitors of the commercial banks in all market segments. On the whole, due to the considerably greater financial muscle and the standardised centrally controlled risk assumption norms, the MNB deems the risks of the member institutions of the close integration based on joint and several liability lower compared to the pre-2014 period.

The integration has major achievements in the standardisation of the internal regulations and banking operations; however, the real measure of its success could be the materially more active financing of economic agents at lower risks and costs, but this is still to come.

[15] Act CLVI of 2013 on the Integration Fund of Co-operative Credit Institutions

Chart 22
The Act on Integration created a standardised co-operative institution protection system



3.3 BUSINESS RISKS

The business risks of co-operative credit institution primarily arise from their high unit costs, low profitability and weak capital raising capacity. For example, the parallel maintenance and development of a variety of IT systems operating in the sector side by side represents a huge extra burden; but the situation is similar in the area of regulation, product development, bank security solutions, marketing and many other domains. Until now these drawbacks were offset by the comparative advantages based on the knowledge of the local market and a business strategy founded on extreme flexibility and adaptability.

The central institutions of the close integration made great efforts to reduce the business risks, developed prudential regulations to be applied on a mandatory basis and standardised the accounting, risk assessment and rating procedures of the member institutions. A major part of member institutions' decision-making competences became the competence of the central organisation, and certain types of risk-taking were prohibited for them. However, despite the standard regulatory environment, the risk-taking limits that multiplied on the aggregate level of the integration and the ample and centralised excess liquidity, for the time being the lending activity of the sector could not be raised to the desired degree.

The aggregate risk-taking capacity of co-operative credit institutions exceeds HUF 700 billion and as a result of the combined capital adequacy they became capable of serving the largest customers as well. However, the utilisation of the increased business potential and the wider-scale financing of economic agents at lower risks are conditional upon a number of other criteria. The product range adjusted to the possibilities of the integration and the development of the standard IT background to ensure the sustainable development of the co-operative group have not yet been implemented.

3.4 DEVELOPMENTS IN ASSET QUALITY

Co-operative credit institutions' ratio of loans overdue for more than 90 days improved in line with the general trend. However, as a result of the strict requirements of the Act on Integration and determined portfolio cleaning measures, the improvement at co-operative societies proceeded much faster than the average at commercial banks. As opposed to the improvement of some percentage points measured in the entire credit institution sector, in the case of co-operative credit institutions the ratio of non-performing portfolios fell from 19.3% to 12.4% by end-2014.

In the case of corporate loans, the rate of improvement was faster (4.8 percentage points), while in the household portfolio, which was of better quality from the outset, this value was 2.5 percentage points, compared to commercial banks where the non-performing ratio of household loans increased during the year, albeit only slightly. The lower non-performing household loan ratio of co-operative credit institutions is attributable, inter alia, to the fact that the share of foreign currency-denominated loans granted by co-operative credit institutions was much lower, i.e. the aggregate ratio of such loans never exceeded 13% of their entire loan portfolio.

Furthermore, another major reason for the improvement in asset quality was that, in line with the Act on Integration, the central organisations of the integration reviewed the portfolios of all institutions and took the necessary measures with regard to portfolio cleaning and the recognition of loan losses.

3.5 LIQUIDITY

The traditionally stable liquidity ratios of co-operative credit institutions improved further in 2014. They hold almost half of their assets in interbank deposits to be placed mandatorily with Takarékbank and in government securities, the distribution of which depends on the prevailing yields.

In accordance with the Central Bank's self-financing concept, in order to reduce the dependency on money market refinancing, commercial banks in the recent years made continuous efforts to reduce their loan-to-deposit ratio. Nevertheless, it was over 100% even at end-2014, contrary to the ratio of less than 50% at co-operative credit institutions, which primarily rely on households' forint deposits. The major part (80%) of their liabilities comes from deposits, dominated by diversified household deposits.

3.6 PROFITABILITY AND CAPITALPOSITION

Table 1
Developments in profitability indicators in the co-operative credit institutions and in the entire credit institutions sectors

Indicator	Co-operative credit institutions	Total credit institutions	Co-operative credit institutions	Total credit institutions
	31/12/2013	31/12/2013	31/12/2014	31/12/2014
ROE	–0.67%	2.81%	–4.18%	–15.80%
ROA	0.00%	0.30%	–0.24%	–1.51%
Cost/income ratio (%)	65.01%	42.25%	70.16%	40.75%

Source: MNB

Although the profitability of co-operative credit institutions deteriorated to a substantially lesser degree than the average for credit institutions, in 2014, for the first time in many years, they suffered a severe loss at the sector level as well. On the whole, proportionately they incurred only one quarter of the loss posted by commercial banks, which is basically attributable to the much smaller share of their foreign currency-denominated asset portfolio.

The cost-to-income ratio of co-operative credit institutions is traditionally much higher than the credit institutions' average, which is mainly caused by the dominance of retail activity and the serving of low-income clientele, which entails high unit costs (Table 1). The ratio deteriorated further in 2014, which was attributable to the rate of cost reduction which lagged behind the degree of the fall in net interest income. The negative impact of this is mitigated by the lower user cost (the subscribed capital is a fraction of the equity) and the typically low yield expectations of the holders of co-operative society shares.

Improvement in the cost-to-income ratio may be expected from the better economies of scale through the anticipated mergers and the hoped savings arising from the development of standardised banking operations.

With weak credit expansion and despite the business year which saw a loss on aggregate, the sector's capital adequacy ratios are very high, which is explained by the much lower than possible lending activity.

3.7 MARKET RISKS

Market risks represent a negligible weight among the risks of co-operative credit institutions, and they primarily arise from the foreign exchange risk and the interest repricing risks. However, due to the low ratio of foreign currency-based exposures, the foreign exchange risks of co-operative credit institutions have never been significant, and after the mandatory conversion of household loans into forint they became marginal by end-2014. The larger part of the interest repricing risk arose in the declining interest environment from the fixed-interest longer-term securities purchased in earlier years.

3.8 OPERATIONAL RISK

The operational risks of co-operative credit institutions are reduced by the banking procedures elaborated by the central organisations and applied across the board; however, the introduction of the new rules is not smooth in the learning period. In the absence of a standard IT system, the application of the central regulations is cumbersome, and the substantial transformation of banking procedures and process control mechanisms also entails new risks, which cannot yet be measured precisely (Chart 23).

Chart 23
Risk map of the co-operative credit institution sector involved in the integration

Risk type	Source of risk	Risk level	Risk outlook	Detail of risk source
Corporate governance, ownership controls	Institutional mergers, changing ownership structure.			Due to the planned several mergers, the structure of the integration will change. The decision-making and procedure-setting authority of the central organisations decreased several risks, which were significant in the past. The co-operative credit institutions are clients and owners of Takarékbank at the same time. Takarékbank has decision-making authority over the institutions, and even can change their management. Our risk expectation is neutral, as both factors of increasing and factors of decreasing the corporate governance risk are present at the same time.
Credit risk	The NPL rate of the credit portfolio is still high. The combined risk limit of the integration multipled.			The proportion of non-performing loans within the credit portfolio of the co-operative credit institutions decreased significantly, but it is still high (12.5%). The combined consolidated solvency capital of the integration doubled, and the potentially distributable amount of large loans became ten times higher than previously. The strict and centralised risk-taking procedures decrease the risks. The loan loss provision of the non-perfoming credit portfolio calculated based on the centralised standardised procedures increased significantly.
Operational risk	Institutional mergers, IT problems			The changing institutional and procedural structure decreases the risks in the long-term, but the switch to the new structure and the learning process increase the risks in the short-term. It takes time to enforce the new mandatory procedures and implement and learn the new processes.
Market risk	Changing interest structure.			In the changing asset structure, the level and periodicity of the interests also change. The exchange of consumer foreign currency loans to local currency decreases the currency risk.
Liquidity risk	The diversified liquidity management was changed to a strict centralised management.			The co-operative credit insituitions are only allowed to invest their high level of liquidity reserves with or via Takarékbank. We except that the current favourable liquidity status will not change.
Profitability	Decreasing overall interest environment, increasing loan loss provisions.			The profitability of the co-operative credit institutions deteriorated. There is a prompt cost impact of the material organisational changes, whilst their cost decreasing effect is only visible later. The institutions cannot maintain the level of the interest margin in an environment of overall decreasing interests, whilst costs are of a more unflexible nature. There was an increase of loan loss provisions due to the enforcement of standard centralised procedures. We expect an improvement of profitability due to the decrease of the one-off negative items.
Capital adequacy	High capital adequacy.			The significant state support doubled the capital of the integration. The potential increase of lending might deteriorate the capital adequacy to a small extent but overall we do not expect a material move in the capital adequacy level.

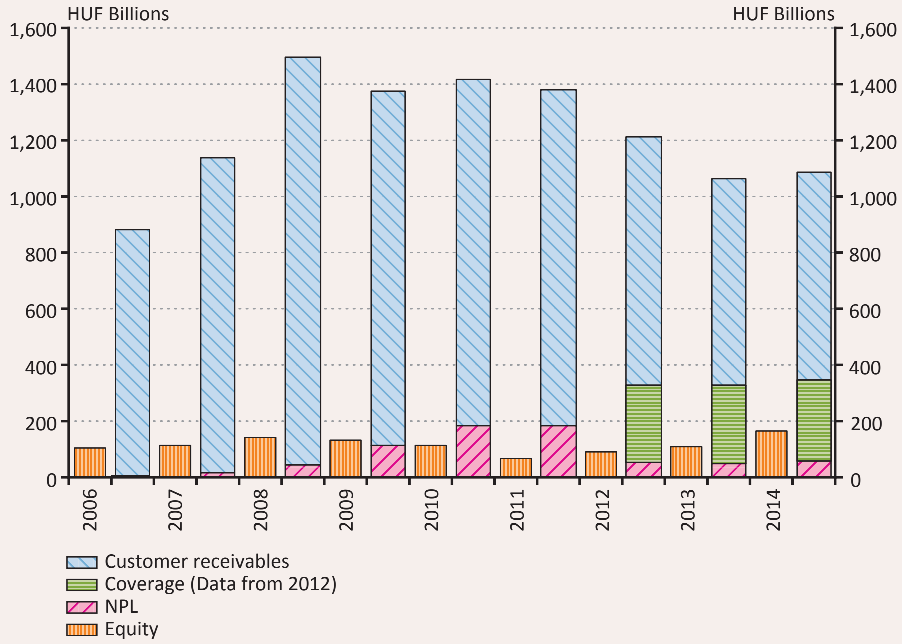
Explanation:
Degree of risk *high* *significant* *moderate* *low*
Direction of risk *increasing* *stagnant* *decreasing*

4 Financial enterprises not belonging to a banking group

Decreasing exposure, increasing NPL

Outstanding receivables of financial enterprises[16] which do not belong to a banking group decreased significantly (27%) last year, after peaking in 2008. In 2006, 79% of the customer receivables arose from motor vehicle financing, the high level of which was attributable to the improved income position of households and the demand for the renewal of the vehicle fleet that was rather aged already in the early 2000s. As a result of the onset of the crisis and in parallel with the fall in the number of newly registered vehicles, the demand for motor vehicles and their financing declined. In the absence of a substantial volume of new transactions and with the expiry of the old deals, the balance of receivables from customers fell close to HUF 1,000 billion. However, in parallel with the developments in outstanding receivables from customers, the risk level of the portfolios increased, which was clearly reflected by the increase in the ratio of non-performing portfolios overdue by more than 90 days from 1% in 2006 to 32% by 2014 in the case of the players under review. At the same time, the risks are mitigated by the fact that at the end of last year 84% of the NPL portfolio was covered by tangible assets (Chart 24).

Chart 24
Receivables and equity of financial enterprises which do not belong to a banking group



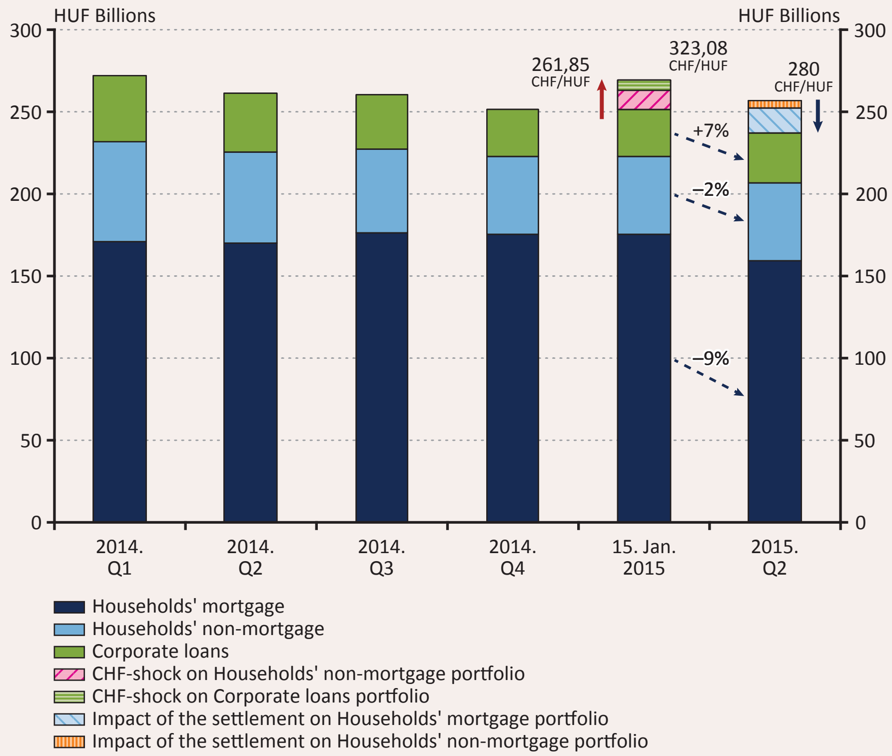
Source: MNB

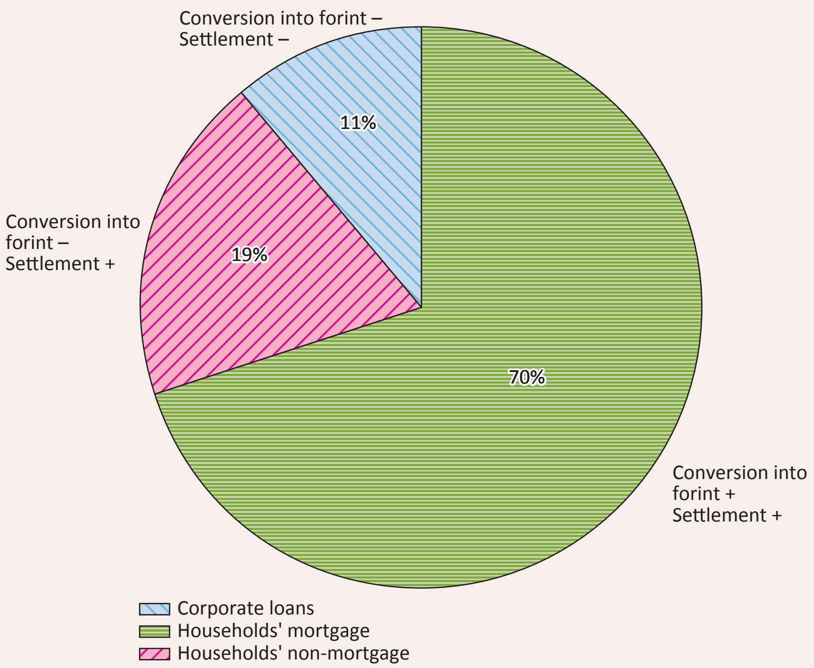
Analysing the currency composition of customer receivables, we find that the high foreign currency ratio seen in previous years (primarily the dominance of the Swiss franc) had fallen to 23 % by 2014, while the weight of forint financing increased (50.3%) as a result of the regulatory impacts. In order to reveal the risks of foreign currency financing more precisely, the MNB examined the outstanding Swiss franc receivables of forty financial enterprises based on their ad hoc data supply. At end-2014, the ratio of receivables overdue for more than 90 days

[16] Financial enterprises owned by a bank or banking group, and EKT International Investment Zrt. were eliminated from the analysis.

was substantial in the case of the household receivables involved in the conversion into forint and non-financial corporations (47% and 48%, respectively), but no further material deterioration may be expected in the loan losses ratio. 60% of the Swiss franc receivables are covered by tangible assets, which is an additional risk-mitigating factor.

Chart 25
Estimated impact of the settlement and the CHF-shock on the exposure based on ad hoc data supply





Source: MNB

The profitability of financial enterprises is also influenced, apart from their core functions, by one-off impacts, such as the obligations arising from the Act on Settlement. Analysing this, in the case of the respondent companies we found that the growth in households' non-mortgage and corporate credit portfolios denominated in Swiss franc attributable to the exchange rate shock[17] and the decrease in household loans (mortgage and non-mortgage) arising from the Act on Settlement were nearly of the same degree (Chart 25). By 2015 Q2, however, the portfolio denominated in Swiss franc may fall even below the level measured at end-2014 due to the decline in the exchange rate that prevailed at the time of the shock. However, if we ignore this decline and assume that the exchange rate stays at the level of 15 January 2015, then the exchange rate impact and the impact of the settlement would roughly offset each other in the case of the portfolios under review.

At the financial enterprises subject to group oversight, the balance and ratio of non-performing receivables – i.e. overdue for more than 90 days – is stagnant; however, this is not attributable to an unchanged situation, but rather to the increasingly frequent sales of the overdue receivables (for portfolio cleaning purposes), and the slipping of outstanding receivables through to the category of overdue for more than 90 days can be observed, so there is a change in the specific content thereof. Further deterioration may be expected in respect of the non-performing portfolio: as regards the near future, the MNB does not expect a change in the circumstances/repayment conditions that would make the portfolio not performing for more than 90 days perform; accordingly, over time – not considering the sales – the internal structure of the non-performing portfolio will worsen.

The foreign currency exposure of financial enterprises not belonging to any banking group is decreasing both on the assets and liabilities sides.

- Credit institution liabilities are decreasing and, simultaneously with this, structural movements among currencies have started: within credit institution liabilities, EUR-denominated loans have declined the least. The general change in business policy, according to which – due to the excessive and/or not precisely measurable risk and the related capital requirements – credit institutions are contemplating a withdrawal from refinancing financial enterprises, can be regarded as a risk for financial enterprises operating with credit institution resources. Several banks have already clearly started the implementation of this policy, i.e. they withdrew/are withdrawing as the contractual conditions permit.

- The trend has also changed on the assets side: the movement /reallocation of the portfolio between currencies has already become measurable; there has been a definite growth in the forint portfolio, while the euro and other foreign currency portfolios, converted into forint, have decreased (mostly the 'other currency' portfolios which also include CHF portfolios).

Financial enterprises which do not belong to a banking group took all the measures for the reduction of their current expenses which did not jeopardise their operation yet. However, by end-2014 their reserves became depleted, thus any further reduction of the expenses could jeopardise their prudent operation.

Financial enterprises have prepared for the fulfilment of the settlement obligation. However, there are tangible differences in terms of their preparation according to the size of the enterprise: the preparedness of financial enterprises with small balance sheet total is not comprehensive. The preparedness may be deemed adequate in respect of about 90% of the portfolio involved in the settlement. The cash demand of financial enterprises which do not belong to a banking group related to the settlement obligation – as one-off specific payment – may lead to temporary liquidity constraints.

One of the main common features of the activity performed in 2014 by financial enterprises not belonging to a banking group is the extremely low level of new lending, which results in stagnation of the customer portfolio. Stagnation of the portfolios results in a decrease in the interest margin and interest income, due to the fall in the paid and received interest. The portfolio size of an increasing number of financial enterprises does not reach the level that would ensure long-term profitable operation.

Not only were cost reduction and market expansion potentials exhausted, there is also a change in the attitude of the owners of financial enterprises: so far they clearly made efforts to keep the capital position at the statutory

[17] Assuming a revaluation exchange rate of the outstanding stocks around the exchange rate that prevailed as a result of the shock.

level, but during 2014 an increasing number of the owners of financial enterprises started to contemplate the sale/ assignment of the portfolio and the reduction of the subscribed capital in order to reduce the equity requirements.

Generally speaking, both the market and profitability prospects of financial enterprises which do not belong to a banking group are unfavourable: their income-generating portfolio is not increasing, their loan loss provisioning obligations are not decreasing, and the settlement obligation vis-à-vis customers has a negative impact on their already less stable capital position. The equity of financial enterprises is not commensurate with the business volume; the owners' objective is basically to comply with the minimum capital adequacy requirement set out in the Act on Credit Institutions. The improvement (decline) in the leverage – external funds/own funds – of the financial enterprises not belonging to any banking group is not the result of an active business decision, but rather attributable to the decrease in credit institutions' activity towards financial enterprises due to formulating their exit from the sector as a business policy objective (Chart 26).

Chart 26
Risk map of financial enterprises

Risk type	Source of risk	Risk level	Risk outlook	Detail of risk source
Credit Risk	Portfolio composition, quality		→	• stagnant ratio of non-performing loans • decrease in foreign currency exposition of non-bankgroup financial enterprises • the CHF currency shock and the effect of settlement nearly cancel each other • institutions have prepared for the settlement
Operational Risk	Cost cutting		→	• Minimally necessary staff for operation • costs can not be any lower
Liquidity Risk	Resources becoming scarce		↑	• credit institutions cut back on refinancing • depletion of owner funds
Profitability	Low level of lending		→	• Stagnant credit stock, low level of new lending • intrestrate margins decreasing
Capital adquacy	Low profitability		→	• unfavorable course of business • impairment recognition accounting

Explanation:

Degree of risk	*high*	*significant*	*moderate*	*low*
Direction of risk	*increasing* ↑	*stagnant* →	*decreasing* ↓	

Extraordinary measures

In 2014 Q4, extraordinary measures were taken at Széchenyi Bank, an institution belonging to the credit institution sector (appointment of a supervisory commissioner, initiating liquidation), which also had an impact on the operation of two financial enterprises that do not belong to a banking group, but had close relations with Széchenyi Bank. A supervisory commissioner was also appointed to Platinium Pénzügyi Szolgáltató Zrt. and Széchenyi Lízing Zrt., as due to the events that took place at the bank there was a risk that these companies would not be able to meet their obligations.

In the meantime, the MNB has withdrawn the operating licence of Platinium Zrt., and liquidation of the institution has also commenced. As a result of the activity of the supervisory commissioner, the operation of Széchenyi Lízing Zrt. is adequate, and the licensing of a new owner is in progress. It is anticipated that the new owner will undertake the refinancing of Széchenyi Lízing Zrt. and settle its capital position.

Since 2014 H2 the MNB has paid continuous and special attention to the activity of Kézizálog Pénzügyi Szolgáltató Zrt. During this period the negotiations conducted by Kézizálog Zrt. with the refinancing institutions did not yield any result; the majority of the refinancing loans expired and the MNB is not aware of the appearance of any new investor on the scene, and the sale of the issued bonds is not in line with the plans either. Kézizálog Zrt. fell into a situation where there was a risk that it would not be able to meet its payment obligations, and as a result of the maturity mismatch between its receivables and its outstanding liabilities to the refinancing banks its financial standing severely deteriorated. The MNB appointed a supervisory commissioner to ensure the transformation of the lending practice pursued by Kézizálog Zrt. as soon as possible and to conclude the refinancing negotiations successfully.

Box 5

Impact of the APR limit on the market

The maximum values of the APR are specified by the Act[18] effective since 1 April 2012 (Section 199 of the previous and Section 265 of the new Credit Institutions Act), while the definition, calculation and publication of the annual percentage rate are regulated by Government Decree 83/2010 (III. 25.), as amended (hereinafter: Decree). The formula applicable to the calculation of the APR regards the actual loan amount and the instalments payable by the borrower as given (known). The principle is that upon the calculation of the APR one should assume the contractual behaviour of the borrower, thus – with some exceptions – only the items which must be paid to the lender inevitably are considered for the purpose of the cash flows.

The Hungarian regulation is additive, and defines two APR caps in respect of loans granted to consumers. The Act states that the lender is not permitted to provide a loan to a consumer where the annual percentage rate of charge (APR) exceeds the central bank base rate increased by 24 percentage points, with the exception of the credit card contracts, loans provided for the purchasing of goods and use of services as well as loans covered by collateral security, because in the case of the latter the APR on the loan may not exceed the central bank base rate increased by 39 percentage points. The advantage of the present additive logic is that with its bands it takes account of the different risk and cost levels of the various loan types and also follows the movements of the market interest rate level through the central bank base rate.

The MNB performed an audit with regard to the upper limit specified in the regulation in the area of personal loans, vehicle loans and hire purchase loans disbursed by credit institutions and financial enterprises. The analysis identified two regulatory gaps and proposed a solution for the elimination of such, which was then integrated in Act LXXVIII of 2014, commonly known as the act on the 'fair', i.e. ethical banking system. As of 1 February 2015, the Act on Consumer Credit[19] defines the rules and limits applicable to the APR values on consumer credit.

One of the regulatory gaps was that the APR regulation did not apply to motor vehicle leasing, and thus market participants could offer leasing schemes to customers instead of loans, at prices that exceeded the APR limit. The Act was amended to include the provision that the rules applicable to consumer credit are also extended to financial leasing,[20] as a result of which the offered APRs fell drastically in the case of the motor vehicle lease schemes for households. The APR offer values, reflecting the status as at 10 February 2015, reported by lenders to the MNB's credit and leasing product selection programme, fell from the previous average of 38% (an APR of 125.76% was also among the products offered) to 15.4%, with the highest APR value being 26.1%.

Another regulatory shortcoming was that the MNB identified inappropriate lending practices according to which it was not possible to check unambiguously whether the customer spent the loan on goods or services. In order to solve this, it was included in the Act that the higher APR limit may be used for hire purchase credit if the credit is disbursed directly to the seller of the product concerned by the hire purchase credit or to the provider of the service.[21] As a result of this, the company in question reduced the maximum APR values of its loans offered from the previous level of 42.18% by almost 17 percentage points to 25.69%.

[18] Section 265 of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (Credit Institutions Act)
(1) With the exception set out in paragraph (2), financial institutions shall not be permitted to provide a loan to a consumer where the annual percentage rate of charge exceeds the central bank base rate increased by 24 percentage points.
2) The annual percentage rate of charge related to credit card contracts or loans connected to payment accounts or credit provided for the purchasing of every-day equipment and durable consumer goods (other than motor vehicles), including loans for using services as well as credit covered by collateral security, may not exceed the central bank base rate increased by 39 percentage points.

[19] Section 17/A of Act CLXII of 2009

[20] Section 1 (3) of Act CLXII of 2009: 'The provisions of this Act shall apply to the financial leasing provided to consumers, with the provision that where this Act mentions credit it shall be understood as financial leasing, and instalment shall mean the leasing fee.'

[21] Section 17/A (3) of Act CLXII of 2009

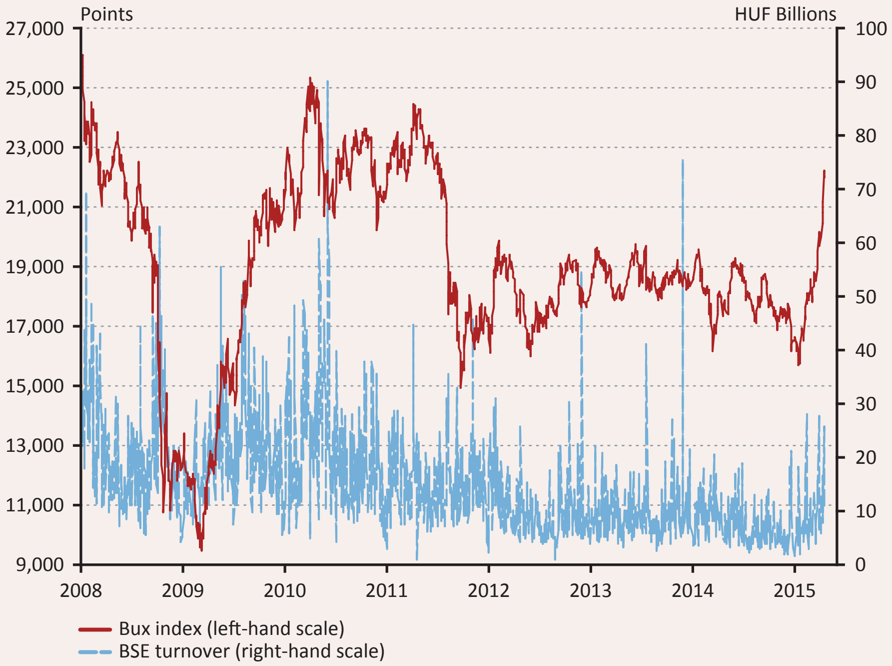
5 Capital market

5.1 REGULATED MARKET, POST-TRADING INFRASTRUCTURES

Turnover of the Budapest Stock Exchange (BSE) continued to decline in 2014; positive changes in 2015 to date

The spot market turnover of the BSE decreased continuously in 2014: the average decline on a quarterly basis was 13%, while the average settled turnover amounted to HUF 833 billion. Forward turnover fell by 6% on an annual basis in 2014, but developments on a quarterly basis were different: in Q1 and Q2 it fell by 8% and 10%, respectively, while in Q3 and Q4 it increased by 7% and 17%, respectively. On the BSE spot market, the average daily turnover of equities in 2014 amounted to HUF 7.8 billion, which falls short of the HUF 10 billion turnover planned for 2014 and was also lower than the HUF 9.8 billion and HUF 10.2 billion average turnovers registered in 2013 and 2012, respectively. Based on the total annual turnover of 2014 broken down by issuers there was no change in respect and in the order of the four equities generating the largest turnover. The distribution of turnover in 2014 was as follows: OTP 58.7%, Richter 18.9%, MOL 13.1% and MTelekom 6.6%. The value of the BUX index at end-December 2014 was 16,634 points, which falls short of the closing value of 18,564 points at end-December 2013 by 10.4%. However, as a result of the positive trend reversal in the equity market in 2015 Q1, the BUX index reached a closing value of 22,078 on 15 April 2015, which is the highest value in nearly four years. The positive change is also reflected in the turnover figures; the daily average equity turnover increased to HUF 9.7 billion (Chart 27).

Chart 27
The BUX index and the daily turnover of the BSE



Source: MNB

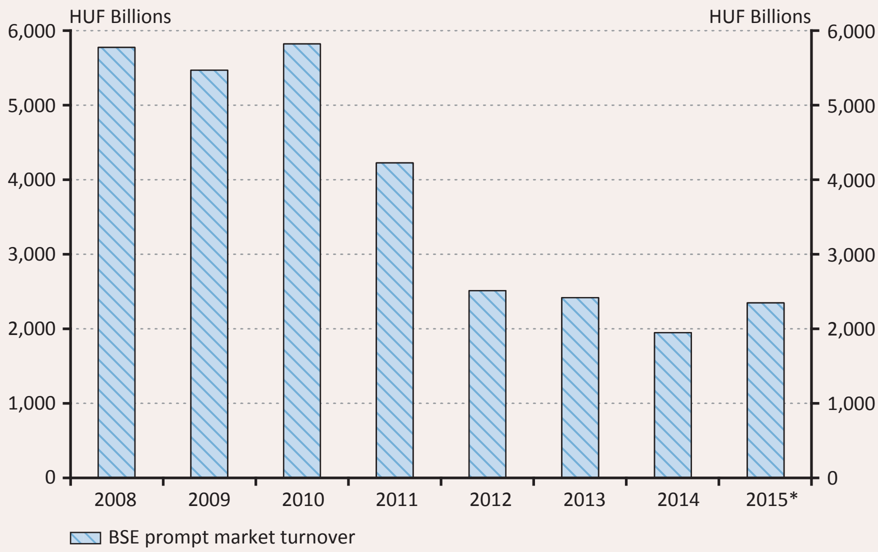
Turnover figures still do not reflect the positive impact of XETRA implementation

XETRA, the new trading system, was launched on 6 December 2013. XETRA provides the connecting banks and brokerage firms with a technical possibility to reach all member markets that apply XETRA via any connection point. For the BSE this means that the introduction of the new trading system essentially eased the technical connection for a large number of foreign brokers that already had access to other XETRA markets. Accordingly, the preliminary expectation of the BSE was that new members and thus new investors would appear on the Hungarian stock exchange as a result of the implementation of XETRA, and thus the turnover and the liquidity of the stock exchange products might also increase in the future. However, experience shows that the simple removal of technical obstacles is not enough to increase the turnover of the BSE.

Number of equities traded on the BSE decreased in 2014

In 2014, one new share was introduced on the BSE within the framework of an initial public offering, while private capital increases took place in three cases. On the other hand, similarly to 2013, three companies were delisted from the BSE in 2014.

Chart 28
Spot turnover of the Budapest Stock Exchange



**Note: Annualised 2015 turnover (Q1)*
Source: MNB

Developments within the KELER group continued

Assisting domestic market participants, KELER, as a so-called 'data hub', collects market participants' transactions, and since February 2014 it has forwarded them to the Trade Repository (TR) approved by the European Securities and Markets Authority (ESMA). The vast majority of supervised institutions utilised KELER's services, thereby satisfying their reporting obligations. The Supervisory College of KELER Central Counterparty Ltd. (CCP) was established in December 2013 with the participation of ESMA, the Magyar Nemzeti Bank, the central banks of Belgium and Ireland and the British financial supervisory authority. In June 2014, the College of KELER CCP classified the permit application of KELER CCP submitted in September 2013 in accordance with the European Market Infrastructure Regulation (EMIR[22]), which regulates central counterparty institutions, as adequate, and then in July 2014 ESMA approved the application. As a result of the approval, the joint and

[22] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

several guarantee undertaken by KELER for extraordinary situations ceased, and thus in critical situations it is primarily the recovery and restructuring procedures applicable to KELER CCP that must be applied: as a result of this, the financing risk of KELER decreased.

At the beginning of October 2014, KELER CCP, in line with the European rules regulating central clearing houses and depositories (CSDR[23]), switched in respect of the multi-net settlement markets from the T+3 day settlement cycle to T+2 days, and also in December 2014 the WARP[24] system providing the infrastructure for the settlement of transactions of investment fund was rolled out to the entire market. As a result of the changeover, the liquidity of the cash market, calculated by netting, increased due to the decrease in capital market turnover, as the netting ratio became higher, i.e. the lower turnover permits more efficient netting, and thus the participants of the transaction need less liquidity for the management of their daily turnover. At present, KELER's priority investment aimed at the replacement of the depository account management system (BaNCS) is in progress. The revenues from the energy market (gas and electricity) settlements play an important role in KELER's revenues. The fact that revenues from the energy market came close to the capital market revenues also evidences the development of the energy market.[25]

5.2 INVESTMENT FIRMS

Box 6

Corrupt practices affecting investment firms in 2015 Q1: developments in portfolio data to date do not indicate any decline in investor confidence; consolidation of investment firms is expected

In February and March 2015, in the course of early comprehensive and targeted audits the MNB discovered a series of frauds – presumably dating back over a longer period – at several investment firms.

The findings during the comprehensive audit commenced in 2014 at the DRB Banking Group drew the MNB's attention to the activity of Buda-Cash Brókerház Zrt. In order to completely explore the securities transactions found to be suspicious during the audit of the banking group, the MNB launched the comprehensive audit of Buda-Cash much earlier than originally scheduled. The audit revealed cases of fraud stretching back for a long period, and consequently the MNB commenced immediate targeted audits at all domestic investment firms, focused on the verification of customer receivables coverage, with the indirect objective of strengthening investor confidence. During the audits the revelation of the frauds was assisted by the comprehensive saving and analysis of the data files. The series of audits identified severe frauds at Hungária Értékpapír Zrt. and Quaestor Értékpapír Zrt., in addition to Buda-Cash Brókerház Zrt.

Based on the audit findings, the MNB suspended the activities of the three companies concerned, appointed a supervisory commissioner, and limited customers' power of disposition over their accounts for customer protection purposes. Following that, the MNB withdrew the operating licences of Buda-Cash and the members of the DRB Banking Group, which belonged to the sphere of interest of the company's owners, as well as of Hungária Értékpapír Zrt. and Quaestor Értékpapír Zrt., and simultaneously initiated their liquidation. In addition to these measures, the MNB also filed criminal charges with the police regarding the companies involved in the fraud. The package of legislative amendments[25] elaborated by the MNB and the renewal of supervisory procedures aim, in addition to checking the coverage of customer receivables, at the strengthening of investor confidence, the prevention of future corrupt practices, increasing the general security level of the capital market as well as the strengthening of the powers to perform audits and take measures. The envisaged changes to legislation tighten the rules of entering and staying in the market for companies,

[23] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012

[24] WARP, the innovation of KELER in the domestic capital market, is an order routing system supporting the distribution and settlement of mutual fund shares. WARP is an efficient tool for making the work procedures of the participants involved in the trading simpler and safer.

[25] Bill No. T/4393 on the amendment to certain acts in order to promote the development of the financial intermediary system submitted to Parliament on 16 April 2015. Act XXXIX of 2015 on setting up a claim management fund ensuring the indemnification of Quaestor victims (promulgated on 17 April 2015) may also be regarded as part of the legislative package.

increase the scope of tools that can be used during inspections and market surveillance procedures, the frequency of inspections, strengthen investment firms' IT and internal control functions, and expand the possibilities for investors to obtain information by making data available on the MNB's website. In view of the expected tightening, the sector is to face significant additional burdens, which may impair the profitability of investment firms. Consequently, consolidation is expected among them, primarily with regard to smaller, less profitable enterprises.

The aggregate customer portfolio of the three investment firms affected by the MNB's measures does not reach 1% (0.9%) of the securities holdings of the Hungarian capital market sector; the clientele of the three firms accounts for some 4% of the number of capital market customers. The evaluation of the data of customer portfolios managed by capital market service providers shows that in 2015 to date there have been no major fluctuations or significant declines in customer portfolio figures, and the data do not suggest any deterioration in investor confidence (see the table below). At the same time, there is some realignment under way towards safer and less risky products and service providers which are deemed to be safer (certain credit institutions and investment firms). The MNB is continuously watching the changes in customer portfolios by operating a continuous monitoring system.

Description	31.12.2014	31.01.2015	28.02.2015	31.03.2015	Change (31.12.2014 = 100%)
Investment firms	2,097	2,120	2,165	2,153	+2.7%
Credit institutions	23,808	24,260	24,757	25,162	+5.7%
Investment service providing institutions total	**25,905**	**26,380**	**26,922**	**27,315**	**+5.4%**

Considering that in terms of the amounts concerned a significant portion of the corporate bonds affected by the frauds were issued in Hungary (Quaestor and Hungária bonds), this is expected to have a negative effect on the domestic corporate bond market, which could mean an important capital market alternative of bank financing of companies. Although the magnitude of the end-December corporate bond holding of HUF 220 billion is much lower than the mortgage bond holding of HUF 1,030 billion or the bond holding of HUF 653 billion issued by credit institutions, the holdings legally issued by group members of the firms involved in the fraud are relatively significant. The holding of bonds issued legally by Quaestor Hrurira Kft., which belongs to the Quaestor Group, amounted to HUF 57.6 billion at end-December, while the holdings of bonds issued by Hungária Group members Hungária Gold Kft. and Hungária Ingatlanhasznosító Zrt. amounted to HUF 6.7 billion, i.e. nearly 30% of all corporate bonds is affected.

Corporate financing through the non-bank financial intermediary system, i.e. corporate bond issuance may gather impetus from the capital market union planned by the EU Commission. In addition to creating a single capital market, its main objectives include the expansion of the channels of financing and making SMEs' capital market financing easier. Short-term priorities of the EU Commission include the standardisation of lending information and credit ratings relating to SMEs (thus supporting the securitisation and refinancing of SME loans), the revision of the rules concerning prospectuses as well as the development of a simple, standard and transparent framework of securitisation.

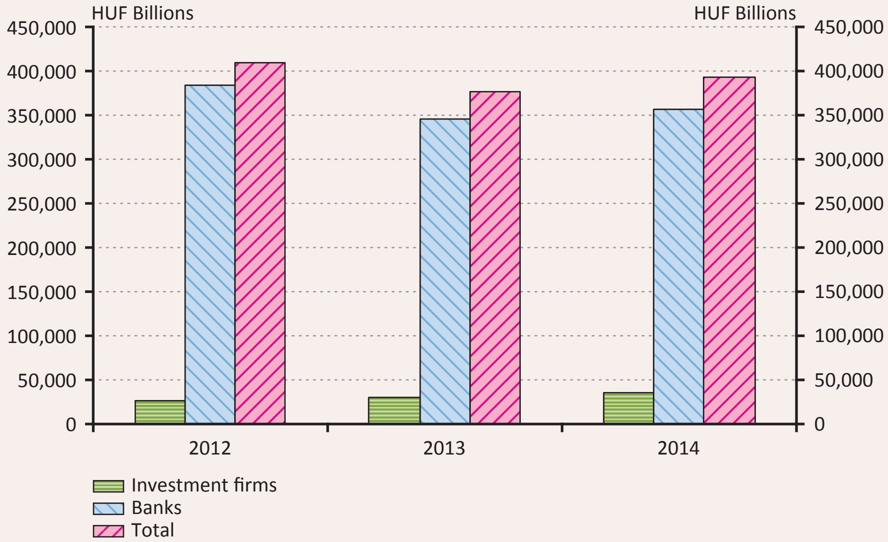
Investment firms' position in capital market turnover strengthened in 2014[26]

In 2014, institutions pursuing investment services activity recorded a turnover of HUF 393,800 billion: within this, the turnover of credit institutions was HUF 357,200 billion, while that of investment firms amounted to HUF 36,500 billion (Chart 29). Compared to the previous year, the total turnover increased by 4.5%, but was still 4.0% lower than in 2012. Investment firms continuously improved their position; their turnover at the annual level increased by 15.1% and 20.2% in 2013 and 2014, respectively. Investment firms' share within the

[26] For reliability and comparability, the analysis does not include the data of the three investment firms involved in the corrupt practices (Buda-Cash, Hungária, Quaestor).

total turnover also increased steadily (6.4% in 2012, 8.1% in 2013 and 9.3% in 2014), which is attributable to the rise in turnover realised on the over-the-counter (OTC) market (prompt and derivative). [27]

Chart 29
Developments in capital market turnover
(HUF billion)



Note: The chart does not include the data of the three investment firms involved in the fraud.[27]
Source: MNB

In 2014, the aggregate turnover[28] (prompt and derivative) of the organised market (stock exchange) decreased by 16% compared to 2013, but the impact of this decline is negligible due to the small share of this market in turnover, as OTC turnover practically covers the entire capital market turnover. The 97% ratio of OTC turnover to total turnover remained unchanged compared to the previous years. The decrease in stock exchange turnover (prompt and derivative) essentially appeared at credit institutions, as their stock exchange turnover fell by 23% in annual terms, while the turnover of investment firms declined by only 10% (Chart 30).

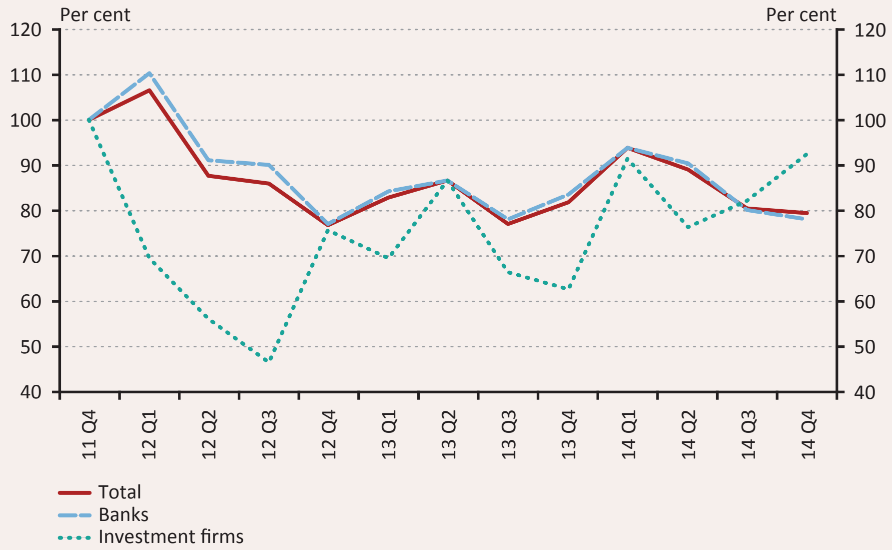
In 2014, the OTC turnover of investment firms increased significantly, by an annual 27.6%. Traditionally, own-account trading of capital market institutions accounts for the dominant share (88%) of total OTC turnover (HUF 383,000 billion). Similarly to previous periods, the vast majority of this was transacted by credit institutions (95%). Swaps (typically currency swaps) accounted for the largest share in the own-account turnover outside the organised market; their ratio fluctuated between 45–50% in 2014. After the conversion of households' foreign currency mortgage loans into forint, the significance of foreign currency swaps is expected to decline in 2015.

Examining the turnover by ordering parties, there was a strong increase (+16.6%) in brokerage turnover (based on orders) in 2014, while own-account turnover remained essentially unchanged (+1.5%). Brokerage turnover at investment firms exceeded the 2013 value by 18.4%, and at credit institutions by 13.8%. Increase in the brokerage turnover of investment firms was realised on the OTC markets (prompt and derivative), while it decreased on the stock exchange (both in the prompt and derivative business). The bulk of brokerage turnover (61% in 2013 and 62% in 2014) was still transacted by investment firms. Their share in prompt stock exchange turnover reached 79% in 2014, while their share in prompt OTC turnover was only 14%. The latter is explained by the special features of government securities trading: government securities are essentially traded on the OTC market and between credit institutions.

[27] Since the data supplied by the three investment firms involved in the fraud within the framework of regular reporting are not real or only partially real, we ignored the data of these three companies in the analysis to ensure comparability and to draw reliable conclusions.

[28] Organised market turnover means the data included in the data supply of the institutions pursuing investment services activity sent to MNB (Table 35A), which also include – apart from the BSE – other recognised stock exchanges (regulated markets), multilateral trading facilities (MTFs) and the so-called organised trading facilities (OTF).

Chart 30
Developments in capital market turnover in percentages



Note: The chart does not include the data of the three investment firms involved in the fraud.
Source: MNB

Stronger activity of investment firms is also reflected in the increasing number of customer transaction orders

The number of customer transaction orders continued to fall in 2014. In 2014, the number of orders in the entire sector (investment firms and credit institutions together) fell by 2.8%, after a decline of 1.4% in 2013. The decrease in 2014 was not uniform across institution types: while the number of executed transaction orders fell by 8% at credit institutions, investment firms posted an increase of 9.4%. The intensifying activity of investment firms is also reflected by the fact that the growth was practically steady for both prompt and derivative transactions (8.2% and 11.5%, respectively).

Box 7
Thematic review of online platforms; impacts of the CHF shock

In response to market demands, in recent years the use of online trading platforms operated by foreign service providers has become very widespread among domestic investment firms. With the considerable penetration of the online service providers the number of available products and services is also increasing steadily. With the boom of cross-border services directed to Hungary, the range of the products and services offered by the domestic investment market now has a global reach, and thereby high-risk, high leverage products became easily available for Hungarian small investors as well.

The expansion of services generated new challenges for the investment firms, as the service providers must adjust to the extremely diversified service offering and make their record-keeping systems suitable for recording also the transactions concluded on these platforms. In terms of investor protection it is important to keep reliable, up-to-date records, as customer receivables entered in the record-keeping system constitute the basis for the compensation scheme of the Investor Protection Fund.

Due to the foregoing, the MNB performed a thematic analysis and audit with regard to online trading platforms. It ordered extraordinary data supply at 22 investment firms, and conducted on-site inspections at four investment firms as part of the thematic audit.

Based on the analysis of the turnover data it could be established that the transactions concluded on the various foreign trading platforms already accounted for a significant portion (over 50%) of the domestic investment service providers' turnover. It should be emphasised that the MNB does not have more precise information about the number of customers directly trading at the foreign service providers as a result of the cross-border services directed to Hungary,[29] but in view of the (often aggressive) advertising appearing on the Internet, their number could be high.

In the framework of a process audit conducted during the inspection, the MNB assessed the operation of the applied trading platforms, the adequacy of the relationship (harmony) between the trading and record-keeping systems and of the in-process control points as well as the account structure created in the record-keeping system. In addition, consistency between the relevant data supply tables and the records was also verified. The on-site inspections performed as part of the thematic audits revealed a number of irregular practices as well; due to this, a minor penalty was imposed on one investment firm, while in the case of two investment firms a resolution containing a call for actions was issued. Based on the findings of the thematic audit, the MNB is going to modify the methodological manual issued earlier with regard to the records kept by investment firms and the recommendation on conflict of interest.

Foreign exchange market events on 15 January 2015, Swiss franc shock

The leveraged positions of international markets can produce unusually high losses or profits within a single day. The unexpected decision by the Swiss central bank on 15 January 2015 with regard to the Swiss franc (CHF) exchange rate generated large losses for high-leverage customers, typically concluding foreign exchange deals via foreign online platforms (Saxo Bank, Interactive Brokers Group, FXCM, Grain Capital etc.), and through them also for some domestic capital market institutions.

The loss affected, to a lesser or greater extent, 10 domestic investment firms, resulting in a loss of nearly HUF 20 billion for customers on the closed positions. In the circle under review, on 15 January 2015, i.e. the day of extreme market fluctuations, the average loss suffered by one customer on the closed positions was around HUF 10 million (actually realised loss), which was further increased by the unrealised loss on open positions. The investors were unable to cover part of the customer debts and during the clearing they could not settle it. Due to the subsequent price changes, actions may be brought against the operators of certain online platforms.

Some of the investment funds were also hit hard by the CHF shock, with the highest losses suffered by the funds belonging to the category of absolute yield funds. The proportioned loss accounted for about 0.5% of the aggregate net asset value of the fund manager sector.

The CHF exchange rate impacts highlighted the risks of the White Label scheme. The surfacing of hidden risks, affecting both investment service providers and investors, was a general experience, as the automated risk management functions incorporated into trading (stop-loss orders) did not work, and in many cases the online trading systems were unable to cope with the sudden increase in the number of orders and close the positions at the proper time, in view of the significant, more than 20% shift in the CHF/EUR exchange rate. The decline of the White Label scheme and the tied agent model coming to the fore may contribute to the decrease in potential risks.

In a press release issued on 21 January 2015, the MNB once again pointed out the high risks of leveraged transactions. In terms of investment services, the MNB reinforces the focus of supervision by tightening the operating conditions for investment firms offering such activities in unchanged form and by prescribing surplus capital requirements for the risks involved in the second pillar.

[29] According to the MNB's records, at present more than 1,000 foreign service providers are entitled to pursue activities in Hungary in the framework of cross-border services. Some of them may also reach the customers through Hungarian providers, while most of them offer direct investment opportunities.

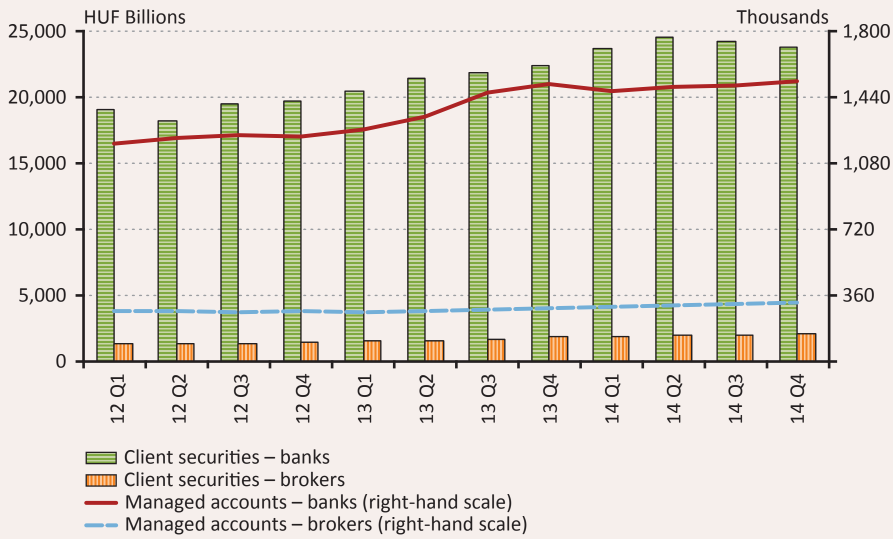
Increasing customer assets at investment firms

The market value of customer securities managed by investment service providers shows a steady increase since 2012 Q2. At end-December 2014, the total market value of the customer securities portfolio managed by capital market institutions (credit institutions and investment firms together) amounted to HUF 25,904 billion (of which investment firms' share was HUF 2,096 billion) and it increased by HUF 1,629 billion in one year. The growth at investment firms reached 12.5%, while at credit institutions it amounted to 6.2%. The share of investment firms in the total managed customer assets has been steadily increasing since 2012 Q3 and reached 8.1% in 2014. Based on the available data, the severe frauds involving investment firms and revealed in February and March 2015 did not cause any extreme decline in the customer portfolios. The increase in the portfolio value of customer securities is mainly attributable to the growth in the nominal portfolio, which primarily can be tied to customers' mutual fund shares portfolio.

Concentration of investment firms' customer securities portfolio is still extremely high

Although the concentration ratio of the customer securities managed by investment firms decreased slightly in 2014, it remains very high. At end-2014, the three largest market participants covered 86% of the entire customer securities portfolio held by the investment firms (89% at end-2013), while the five largest actors covered 93% of the total portfolio (96% at end-2013). In 2014, there was no change either in the composition or in the ranking of the largest three or five institutions in terms of the customer securities portfolio of investment firms. At credit institutions, the degree of the concentration is not as high as at investment firms. At end-2014, the three largest market participants covered 53% of the portfolio (52% at end-2013), while the five largest actors covered 71% of the total customer securities portfolio (66% at end-2013). The 5 percentage point growth seen in the concentration of the five largest market participants is the result of the exit of a large actor, and thus both the composition and the ranking of the five largest actors has changed (Chart 31).

Chart 31
Customer securities portfolio



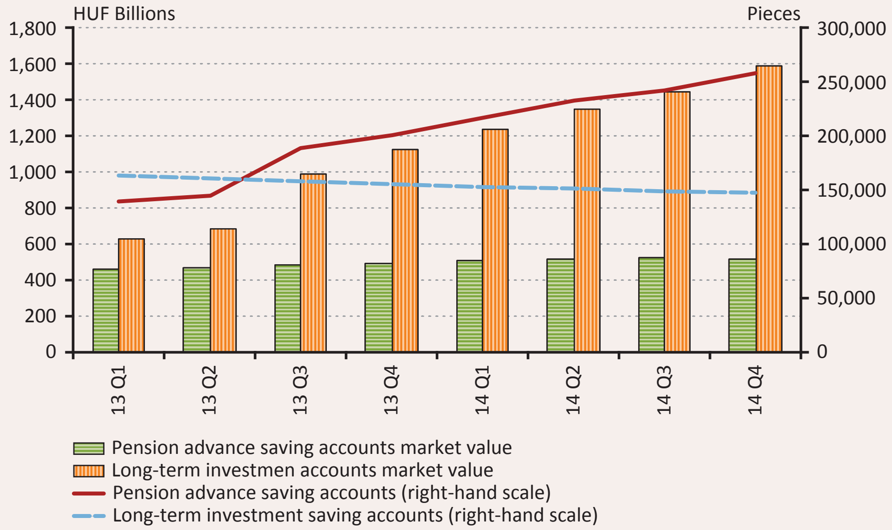
Note: The chart does not include the data of the three investment firms involved in the fraud.

Source: MNB

Slowly, but steadily increasing customer number, decreasing PSA, increasing long-term investment accounts

The number of customer accounts managed by investment service providers reached 1,845,000 by end-2014, with an annual growth of 2.3%. Investment firms and credit institutions were able to increase the number of customer accounts by 9% and 1%, respectively. The ratio of customers having an account with investment firms compared to the total number of customers remained practically unchanged compared to the previous year (16.8% on average in 2013 and 17.0% on average in 2014). The increase in the number of customer accounts is attributable to the popularity of long-term investment accounts. This scheme is made particularly competitive by the tax allowance provided for the long-term investment accounts and the shorter investment horizon (5 years) compared to the pension savings account (PSA). The investments of 5-year maturity can also play a balancing role in the capital market (Chart 32).

Chart 32
Long-term investment accounts and pension saving accounts as well as holdings on accounts

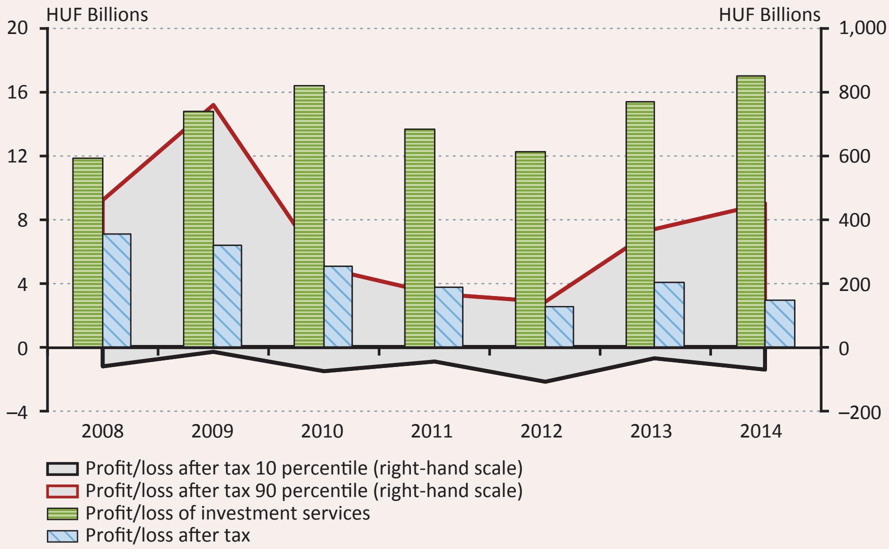


Note: The chart does not include the data of the three investment firms involved in the fraud.
Source: MNB

Investment firms' profitability is declining in view of the additional burdens related to the compensation becoming necessary due to the uncovered corrupt practices. As a result of this and of the tightening of regulations, consolidation is expected in the sector.

The profitability situation of investment firms was practically unchanged in 2014 at the sector level. Return on equity (ROE) fell from 23.7% in 2013 to 22.3% by 2014, but profitability varies strongly from institution to institution, and profitability concentration is still high. The profit after tax of the first three market participants with the highest profits accounted for 139% of the profit after tax of the entire sector in 2014, while this ratio was 97% in 2013. 6 of the 21 active investment firms taken into account in the analysis posted a loss in 2014, and 3 of them had already been loss-making in 2013 (Chart 33). Some of the smaller institutions have difficulties in the longer run in acquiring a sufficient number and size of clients necessary for profitability and to achieve long-term positive profitability. Due to the impacts in 2015 Q1 – the CHF exchange rate shock and frauds affecting investment firms – the income position of certain institutions may come to a critical point, since changes in customer preferences have a different impact on the individual institutions. A consolidation process is expected to start in the investment firms sector, as statutory regulations are becoming tighter (new rules of entering and staying in the market, amendments to rules related to institutions, new IT rules), and as the compensations due to the cases of fraud significantly increase the burdens of the sector.

Chart 33
Profitability of investment firms



Note: The chart does not include the data of the three investment firms involved in the fraud.
Source: MNB

Investment firms' capital adequacy ratio is still high, but is expected to decline

The capital position of investment firms (equity, regulatory capital) is characterised by high capital adequacy, and the sector's capital adequacy ratio of 21–22% was well above the regulatory level of 8% in 2014. The available regulatory capital at end-December 2014 was HUF 13.6 billion in total, amounting to 277% of the prescribed capital requirement (HUF 4.9 billion). According to preliminary balance sheet figures for end-2014, of the 21 investment firms only one had a capital shortage, but it has carried out a capital increase since then (Chart 34). Although in 2014 the role of investment firms increased in the capital market turnover, the diversion of the turnover to the credit institutions could be the medium-term consequence of the frauds, which may entail an increase in the profitability risk and capital adequacy risk of some of the market participants.

Chart 34
Capital and capital adequacy ratio of investment firms

Note: The chart does not include the data of the three investment firms involved in the fraud.
Source: MNB

Chart 35
Main risks of investment firms

Risk type	Source of risk	Risk level	Risk outlook	Detail of risk source
Corporate governance, owner activity	Strategy, consolidation	●	➡	In connection with the changes in strategy, corporate governance risk is high due to the changes in capital market regulation.
Credit risk	Customer assets (cash, securities) held at third parties	●	⬆	Risks concerning customer assets held at third parties (online platforms). The effect of the Swiss franc shock (January 15 events) pointed out the risks of online platforms
Operation risk	CRDIV, EMIR, MIFIDII, customer record-keeping system	●	⬆	The malpractice and abuse of the record-keeping system revealed recently pointed out the operation risks.
Market risk	Market unsteadiness (turnover, confidence-loss)	●	⬆	Market risk is high (market barriers, competition and high market concentration). Investor confidence tapers as a result of recent frauds.
Profitability	Turnover development, current and future losses occurred from the Swiss franc shock in January and from the extra charges due to compensation.	●	⬆	Profitability concentration continuous to be high. The Swiss franc shock in January, the effect of frauds revealed at investment firms (the extra charges due compensation) may have a negative effect on the profitability of several investment firms. The indirect effects of possible confidence loss may eventually affect the profitability of certain investment firms.
Capital adequacy	Decreasing profitability	●	⬆	The negative impacts of 2015 (Swiss franc shock, decrease in profitability) had a negative effect on the capital position too.

Explanation:

Degree of risk — *high* ● *significant* ● *moderate* ● *low* ●

Direction of risk — *increasing* ⬆ *stagnant* ➡ *decreasing* ⬇

5.3 INVESTMENT FUND MANAGERS

Assets managed by investment funds continued to increase in the declining interest rate environment, but net capital inflows decreased significantly in 2014 Q4

At end-2014, 34 fund managers operated 549 investment funds, an increase of 9 compared to end-2013. The assets in the investment funds managed by investment fund managers reached HUF 5,526 billion by end-2014, which is a historic peak. However, the growth rate of managed assets was steadily decelerating. While the average quarterly growth rate was 7.7% in 2013, it dropped to 4.4% in 2014. This asset growth was basically attributable to net capital inflows. Net capital inflows in 2014 amounted to HUF 630 billion, while the yield of the funds increased the managed assets by HUF 234 billion – this practically corresponds to the yield realised in 2013 (HUF 232 billion). Net capital inflows in 2014 fell short of the HUF 983 billion of 2013 by HUF 352 billion. Net capital inflows were relatively even in the first three quarters of 2014; however, by 2014 Q4 they practically fell to zero (HUF +17 billion).

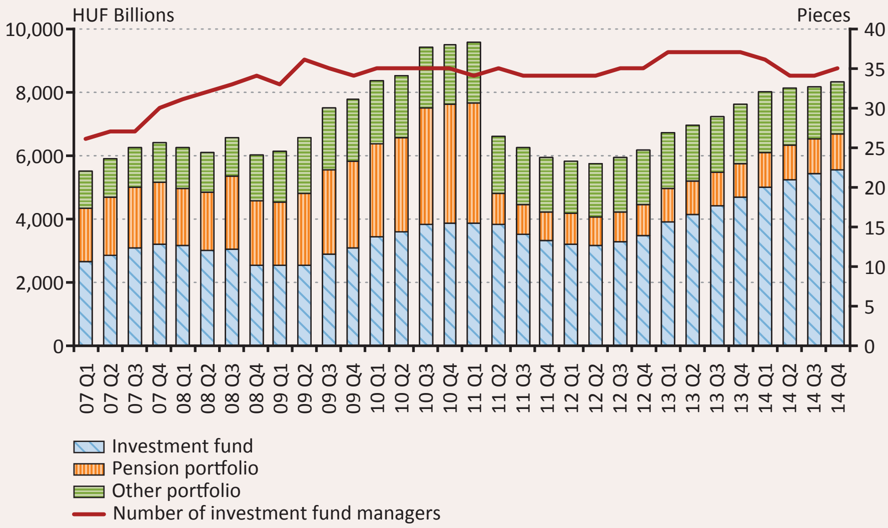
Looking at the net capital flows, there was a restructuring within the funds investing in interest-bearing assets. While in 2014 liquidity and money market funds were characterised by a net disinvestment of HUF 200 billion in total, the value of net capital inflows to short-term bond funds reached HUF 339 billion. Similarly to 2013, capital inflows to absolute yield funds (HUF 298 billion in 2013 and HUF 265 billion in 2014) and to balanced/

mixed funds (HUF 123 billion in 2013 and HUF 155 billion in 2014) continued to be significant. The capital outflows (HUF -33 billion) characterising capital protected funds in 2013 decreased significantly in 2014 (HUF -7 billion), especially compared to the net HUF 515 billion asset value of capital protected funds.

Increasing voluntary pension fund, decreasing insurer-managed assets

Of the other portfolios managed by fund managers, the largest growth was posted by voluntary pension funds. Of the growth of HUF 90 billion, HUF 80 billion is attributable to investment yields. Last year, the insurance portfolio fell by 21%, which was caused by the exit of ING's Fund Manager. ING Biztosító Zrt. (now NN Biztosító Zrt., i.e. NN Insurance) took back the management of its reserves. The proportion of individual portfolio segments continued to shift towards investment funds. In 2014, the share of investment funds increased to 65% from 60% in 2013, as a result of the popularity of investment funds and the outflow of assets from the insurance portfolio (Chart 36).

Chart 36
Number of fund managers and volume of assets under their management

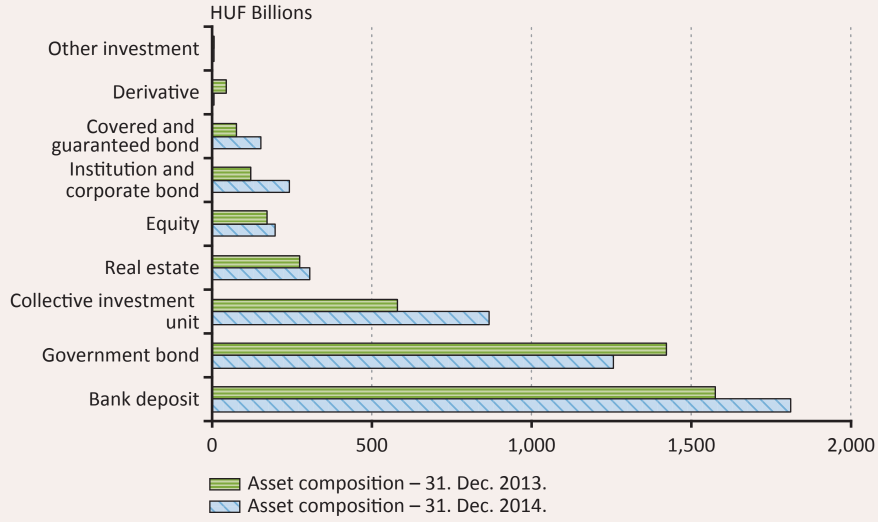


Source: MNB

Asset composition: increasing holdings of mutual fund shares and bank deposits

Looking at the asset composition of public investment funds, the highest growth in 2014 (HUF +257 billion) took place in mutual fund shares. A significant part of the growth could be observed at the fund of funds schemes, which contain significant foreign exposure, i.e. mutual fund shares of investment funds issues abroad. The second largest growth (HUF 215 billion, 15%) was posted by bank deposits, and in parallel with this the government securities portfolio decreased by nearly 12% (HUF 150 billion) (Chart 37). The realignment is attributable to the phasing out of the MNB bills from the set of monetary policy instruments in August 2014. The realignment mostly affected money market funds. Excluding this technical effect from the government securities portfolio, the growth in the government securities portfolio amounted to about HUF 210 billion.

Chart 37
Changes in the asset composition of public investment funds



Source: MNB

Fund managers' profitability continued to improve in 2014

Fresh capital inflows into investment funds further improved the profit of fund managers in 2014, and thus the after-tax profit at the sector level rose to HUF 20.8 billion from HUF 17.8 billion in 2013. Accordingly, ROE increased from 44.2% in 2013 to 50.4% by 2014. Sector concentration is still high. The five largest fund managers account for 68% of the total profit after tax. The high concentration is also evidenced by the fact that the difference between the after-tax profit weighted by managed funds and the after-tax median profit is tenfold. 4 out of the 34 fund managers realised a loss, but the assets managed by them are negligible (HUF 10 billion).

Chart 38
Profitability of investment fund managers

Source: MNB

Within fund managers' fee income, the weight of fee income from the asset management of investment funds was 85%, while the share of the investment funds from the total managed assets amounted to 64% in 2014, i.e. the relative fee charge of investment funds continues to be higher compared to other types of managed assets.

Comparing the asset management fee incomes and the managed assets, asset management is cheapest in the case of the insurance portfolios rather than in the case of the voluntary and private pension funds operating with a cost limit stipulated by the regulator: at the insurers it was 16 basis points on average, while it was 51 basis points at the voluntary pension funds, which may be attributable to the agreements (charging lower fees) between the insurers and fund managers belonging to the same financial group.

The sector has an outstandingly high capital level. At end-2014, equity amounted to HUF 41.8 billion, which is similar to the level (HUF 40.3 billion) reported in 2013. The fund manager sector is characterised by a dividend payment ratio of almost 100%. Of the HUF 134.9 billion in profit after tax realised between 2007 and 2013, HUF 133.2 billion was paid out as dividend (Chart 38).

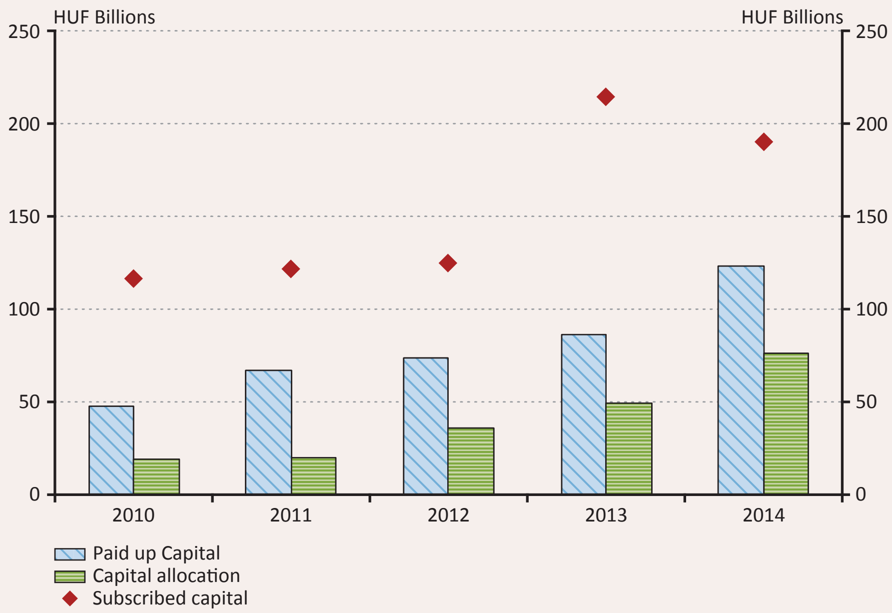
5.4 VENTURE CAPITAL FUND MANAGERS

Dynamic growth in the venture fund sector

In line with the development of the sector, the number of venture capital fund managers increased steadily. At end-2011 and end-2012, there were 15 and 27 companies with venture capital fund management licences, respectively, while at end-2013 and end-2014, 33 companies held such licences. The number of venture capital funds also increased dynamically in 2013 and 2014 (17 at end-2012, 29 at end-2013 and 38 in 2014). In terms of distribution, 1 venture capital fund manager has three funds, 5 of them have two funds and 25 fund managers manage one fund each, while 1 fund manager did not yet have any registered funds. In terms of resources the 38 capital funds are still broken down as follows: 8 funds utilise the resources of JEREMIE I, 10 those of JEREMIE II, 8 those of JEREMIE III, 2 those of JEREMIE IV, 1 aims at using the regional EU resources, while the number of capital funds utilising so-called enterprise, state or private resources is 9.

Venture capital resources for financing the SME sector continued to increase in 2014

Chart 39
Assets and investments of venture funds



Source: MNB

The funds available for the SME sector in venture funds amounted to a total HUF 191 billion in December 2014, of which HUF 81 billion has been allocated so far (Chart 39). The assets managed in the funds of venture capital fund managers – investment and loans granted – increased significantly, primarily owing to the JEREMIE funds, and came close to HUF 84 billion by end-2014. Of the total portfolio, the amount of the JEREMIE funds was HUF 132 billion in December 2014, of which about HUF 53 billion (40%) was lent. The remaining part to be placed (HUF 79 billion) is of significant magnitude, bearing in mind the deadline of December 2015 specified for the placement. The tight deadline represents a challenge and obstacle to efficient capital allocation and investment in eligible special purpose entities (SPE), and may encourage capital fund managers to take higher risks.

Continuously improving profitability and stable capital position at venture capital fund managers

The profit of the venture capital fund manager sector increased from HUF 868 million in 2013 to a profit after tax of HUF 1,470 million in 2014 (+47%), i.e. the profit after tax amounting to HUF 553 million in 2012 almost tripled. Based on preliminary, non-audited data, only three of the 33 venture capital fund managers were in the red. Based on past experiences, the dividend payment ratio at the sector level with regard to 2014 is expected to exceed 50%: venture capital fund managers used 69% of the profit after tax of 2013 for dividend payments; the amount of the paid dividends was HUF 593 million, which exceeded that of the previous year by HUF 220 million. In terms of the capital position, all of the venture capital fund managers had positive equity and the equity/subscribed capital ratio exceeded 2/3 at all companies. In 2014, the equity of the venture capital fund manager sector increased dynamically, by some 53%, and by the end of the year it reached HUF 3,149 million.

Box 8

Thematic analysis on the status of JEREMIE funds

The MNB prepared a thematic analysis and published the relevant report on its website to present the investment activity of the domestic sector between 2010 and 30 June 2014 with the help of the standards common in the venture capital business.

In the wake of the first JEREMIE programme announced in 2009, the venture capital sector's segment that implements early-stage, so-called venture capital type investments gained new momentum. In the framework of the first and the second JEREMIE programmes, the latter announced in 2012, an increasing number of venture capital fund managers were set up, which gradually established their venture funds, mostly with the involvement of EU funds and to a lesser extent of private funds. Their investment activity has been continuously increasing in the recent years, while the funds launched under the first programme are nearing the end of their investment period, which was meanwhile extended until 31 December 2015.

The central bank analysis found that a good 70% of the fund raising and investments in the period under review was connected to JEREMIE funds. Thus, the majority of the resources are EU funds, while the extremely low volume of resources received from institutional investors (e.g. pension funds), deemed traditional in the case of venture capital, is apparent. In terms of the breakdown of the investments by financing function, based on both the number and volume of the investments, allocations to start-up companies were dominant. This was also reinforced by the application conditions of the JEREMIE programmes.

During the period under review 179 companies received financing of HUF 58 billion in total. In terms of their frequency and investment volume a large part of the allocations concentrated in a few special branches. 57% of the materialised investments were directed to life sciences (e.g. biotechnology, medical sciences and pharmaceutical research), IT and other electronic consumer goods, other consumer services as well as the business and industrial services sectors.

It would be too early to assess the investment performance of the venture funds established in recent years, as even the investment period has not finished yet. Based on international experiences in this sector it can be established that roughly 20% of investments in this risky industry end with a positive yield. However, the profit realised on them may offset the loss on other investments.

The conditions of the EU and Hungarian tenders represent constraints for the operation of the JEREMIE funds. For example, the funds may only make capital increases, the investment period is limited, and it is not justified to divide Hungary into regions in terms of venture capital investments. In spite of the foregoing, the market is in need of solutions similar to JEREMIE. Moreover, based on the data illustrating the investment activity, the state may have to assume an even bigger role in the investments of very early phase. At the same time, favourable changes in the EU regulatory conditions applicable to the aid schemes may foster the further development of the market.

Sigismund of Luxemburg

(1387–1437)

King of Hungary with the longest reign in the Medieval Age, moreover King of Germany, King of Bohemia, Holy Roman Emperor, Sigismund was the most respected figure of contemporary Europe.
His reign of half a century in Hungary can be divided into two parts. The first period was a time of overcoming disturbances following succession to the throne and the dealing with an increasing Turkish threat, while the second period can be regarded as nearly four decades of stability.

Sigismund changed power relations between the ruler and the barons by giving castles and lands, and was compelled to accept the dominance of leagues of barons. The king's court was the centre of culture in the time of his predecessors; thereafter the courts of barons had equally high influence on the culture and politics of the kingdom.

The king gathered the nobility into the Order of the Dragon, and practically left governance with them, he rather dealt with his ambitious plans of foreign policy. Governance in Hungary was solid, which is best shown by the fact that the king could be absent for many years attending to business in the other countries throughout Europe, without triggering any political disturbances within the kingdom.

His era was a turning point in the foreign relations of Hungary: the regionally dominant Hungary became threatened by the Ottoman Turks, and after a series of unsuccessful campaigns it was clear to everyone that the kingdom must resort to a defensive stance, this is why Sigismund decided to strengthen the southern line of border castles to ensure that the country can defend itself from the Turks. He entered into prolonged wars with the Republic of Venice over the domination of Dalmatia, and fought against the Hussites in Bohemia.
Sigismund was a reformist, which originated from a new way of thinking: institutions and systems can be changed and modified. In this spirit, the king founded a university in Óbuda; ensured the right of patronage of Hungarian nobles; introduced a standard unit of weight, length and volume; cities developed at a high pace during his reign; and he granted all peasants the right of free movement. He made Buda the centre of his empire, and rebuilt the castle to make it royal residence of European renown.
Sigismund was a politician who was thinking above nations in the contemporary sense, capable of taking regional interests aside and focus on efforts that are in the best interest of the whole of Christianity, as he did at the Council of Constance on the Western Schism. He could ingeniously turn his personal traits to his advantage in diplomatic affairs and on negotiations relating to strategic decisions. He had a good eye to choose colleagues, he drew accurate conclusions from the disorders the kingdom experienced early on his reign, and later succeeded in earning the full support of dominant political figures of the country.

In the last year of his reign a peasant revolt erupted in Transylvania. The nobility joined its forces against the peasantry, which led to the alliance of Hungarians, Székelys and Saxons, hence laying the basis of a later political organisation of Transylvania.

Dying without a male successor and a chaotic period coming after his death, Sigismund's heritage slowly faded into oblivion in the national remembrance; however, he was not only a notable king of Hungary, but also an Emperor with an integrating force and ruler of great deeds influencing history.

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