Analysis of the first phase of the Funding for Growth Scheme

Summary

The Magyar Nemzeti Bank announced the Funding for Growth Scheme (FGS) in April 2013. The first two pillars of the three-pillar Scheme aimed to support small and medium-sized enterprises in accessing forint-denominated loans and to strengthen financial stability. In the Monetary Council's judgement, the access of companies operating in Hungary to credit has significantly tightened since the emergence of the financial and economic crisis, particularly that of small and medium-sized enterprises, which, moreover, have greater difficulties in finding alternative sources of financing. Following its announcement, enterprises showed considerable interest in loans provided within the framework of the Scheme, as reflected by the participation applications of credit institutions registered at the end of May. In order to increase the number of SMEs that can access loans under the Scheme, the Monetary Council raised the available overall amount by 50 per cent to HUF 750 billion before the launch of the Scheme.

Owing to the active interest shown by enterprises, credit institutions concluded contracts for 93.5 per cent of the overall amount, which means approximately HUF 701 billion, and related to roughly 10 thousand contracts. In light of higher demand for Pillar I, as of 1 August, the MNB enabled credit institutions to use their credit line allocated under Pillar II within the framework of Pillar I to improve the effective use of the overall amount. As a result, borrowing under Pillar I reached 112 per cent, i.e. HUF 472 billion, of the allocated amount in this pillar. Under Pillar II, i.e. for the redemption of foreign currency loans, credit institutions contracted in the amount of approximately HUF 229 billion, which means 70 per cent utilization of Pillar II.

In the central bank's judgement the short-term objectives defined at the launch of the Scheme – reducing the barriers of the credit market and strengthening the competition – have been essentially fulfilled. In addition to substantially stimulating demand for credit on the side of enterprises, the Funding for Growth Scheme shifted the credit institutions' focus to the SME sector, leading to intensifying competition for acquiring and retaining customers. The allocation mechanism applied by the MNB during the distribution of the Scheme's overall amount and the possibility of switching banks also strengthened competition, leading to a higher share of small and medium-sized banks and savings co-operatives within the total SME loan stock. Twenty per cent of customers switched banks when redeeming existing loans. Predominantly the new customers of small and medium-sized banks and savings co-operatives switched credit institutions. Despite the capped interest margin, owing to competition for customers and the participation of guarantee organisations, not only top rated enterprises could participate in the Scheme.

Under Pillar I, the ratio of new loans at 61 per cent was higher than expected, in which the ratio of investment loans was also significant. This may boost the Scheme's contribution to economic growth. Under Pillar II, credit institutions also disbursed loans mainly for the redemption of investment loans. Within the minimum HUF 3 million and maximum HUF 3 billion contract limits, loans in smaller amounts were more frequent; based on the number of contracts, 70 per cent of loans were under the value of HUF 50 million.

Particularly access to loans with longer maturity tightened during the financial and economic crisis. The FGS substantially corrected this operating deficiency of the credit market as well. In addition to loans with a maximum maturity of 10 years set by the central bank, credit institutions were willing to extend long-

term loans with an average maturity of approximately 7 years, with maximum 2.5 per cent interest per annum charged until maturity.

The FGS significantly reduced the interest burden on enterprises participating in the Scheme in terms of both new loans and loan redemptions, which helped to improve their profitability. In addition, the Scheme eliminated the exchange rate exposure of enterprises participating in Pillar II, which creates a predictable operating environment for them. The substantial, gradual decline in outstanding corporate foreign currency loans is also important in terms of the national economy, as it reduces financial stability risks.

The Scheme has penetrated all sectors, but agriculture, the manufacturing industry and trade account for a dominant share. The FGS reduced the regional concentration of SME loans. Credit institutions disbursed a higher ratio of loans relative to the total SME loans outstanding to enterprises operating in the Southern and Northern Great Plain regions, while the share of Central Hungary is significantly lower than its ratio within the total SME loan stock.

In view of the Scheme's success, on 11 September 2013, the Monetary Council of the MNB decided to continue the Scheme. The first phase has fulfilled the objective of strengthening competition in the SME credit market. In the second phase, therefore, this will allow the MNB to place greater emphasis on the stimulation of economic growth by focusing on the supply of new loans. With a view to supporting growth, 90 per cent of both the overall possible amount of HUF 2,000 billion and of its first tranche of HUF 500 billion may be allocated exclusively for the provision of new loans during the extended operation of the Scheme.

Introduction

Since the emergence of the financial and economic crisis, the opportunities of small and medium-sized enterprises operating in Hungary to access credit have significantly worsened due to tightening price and non-price credit conditions. The exchange rate risk linked to foreign currency loans is associated with a risk for the financial intermediary system and with additional burdens for much of the SME sector. The ratio of loans with longer maturity has significantly declined within the SME portfolio, which is attributable to the weakening risk tolerance of banks on the supply side and to the growing difficulty of accessing long-term funds. This is an extremely adverse development in terms of investment financing and it may throttle the growth potential of the economy in the long term. With a view to easing the persistent market disorder observed in SME lending, strengthening financial stability and reducing the external vulnerability of Hungary, at its meeting of 4 April 2013 the Monetary Council approved and the central bank's governor announced the Funding for Growth Scheme (FGS), which was launched at the beginning of June. The FGS constitutes part of the monetary policy instruments; within the framework of the Scheme's first two pillars, the central bank provides forint denominated liquidity with long maturity to its partner credit institutions participating in the Scheme.

Within the framework of Pillar I of the first phase of the FGS, the MNB provided refinancing loans with 0 per cent interest to the participating credit institutions, which could lend further these loans to SMEs with an interest margin capped at 2.5 per cent; these loans could be exclusively used for investment, working capital financing, pre-financing EU funds, or for the redemptions of existing forint loans such purposes. SME customers could use loans received under Pillar II for the redemption of foreign currency loans. Credit institutions that are counterparties of the MNB in monetary policy loan instruments could participate directly in the Scheme, while non-partner banks and integrated savings co-operatives and credit unions could participate indirectly through their umbrella banks. The overall amount of the Scheme was distributed (allocation) in accordance with the rules for dealing cards in relation to both pillars, on the basis of the amount undertaken by the each credit institution in the contract made with the MNB.

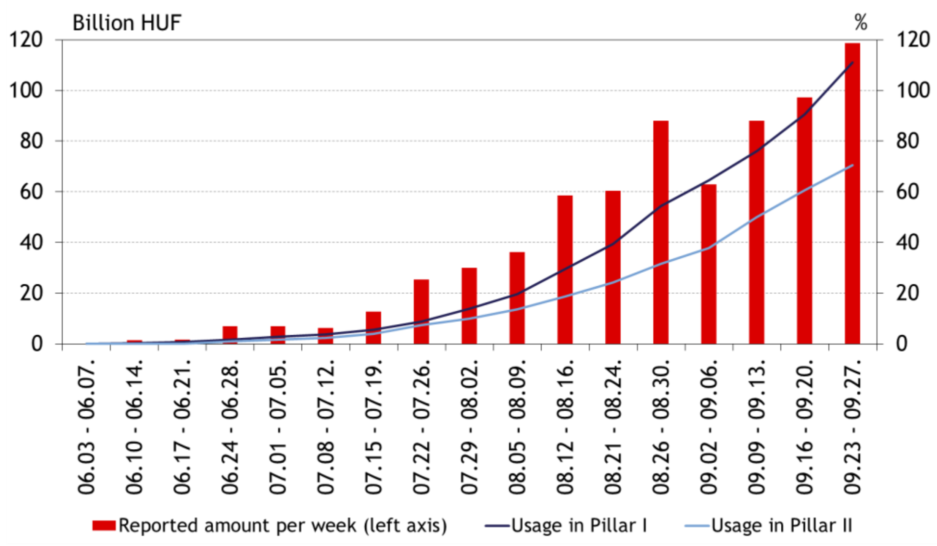
This analysis discusses the key findings relating to the first phase of the FGS. On the basis of available data and feedback received from the credit institutions and representatives of the business sector, we may conclude that the Scheme successfully fulfilled the objectives defined by the MNB upon its launch. In response to the Scheme, initially launched for a period of three months, many companies reviewed their business financing and submitted loan applications. Owing to the FGS, the banks' focus shifted to the SME sector as well. Thus, the FGS mobilised participants of the credit market on both the demand and supply side. The maximum 2.5 per cent interest rate and maximum 10 year maturity of loans received under the Scheme significantly reduced the interest burdens of enterprises and enabled the expansion and smoother operation of their business activity. SMEs' foreign currency loan portfolio also diminished substantially, which strengthens the financial stability of enterprises participating in the Scheme and improves the shock-absorbing capacity of the financial system and the Hungarian economy. The initial allocation of the credit line and the option to switch banks intensified competition among the participating credit institutions. Strengthening competition supported the more effective use of funds and improved enterprises' access to loans. The Scheme also reduced the regional concentration of credit placements.

Almost all of the overall amount in the Scheme's first phase has been used

In the first phase of the FGS, the participating credit institutions concluded contracts with SMEs on the disbursement of loans in the total value of HUF 701 billion, which means that more than 93 per cent of the total overall amount of HUF 750 billion under the two pillars was allocated used.

On the basis of feedback provided by partners participating in the Scheme, SMEs expressed higher demand under Pillar I. To satisfy such demand with greater effectiveness, as of 1 August, the MNB permitted credit institutions to re-allocate available amounts of the overall amount allocated under Pillar II to Pillar I. As a result, credit institutions extended loans corresponding to 111 per cent of the overall amount of HUF 425 billion, originally allocated under Pillar I. Thus, a total of 8,131 credit transactions were concluded under Pillar I in the contract amount of HUF 472 billion. Under Pillar II, 1,713 foreign currency loans were redeemed and hence converted to forint loans in the value of HUF 229 billion, which amounts to 70 per cent of the originally determined overall amount of HUF 325 billion. The disbursement of the loans gathered pace only in the second half of the availability period, due to the development of the related bank products and the time frame of loan approval procedures. The credit institutions submitted approximately two-thirds of the total reported contract amount in the final one-third of the availability period, which was extended by the MNB on 1 August by 1 month.

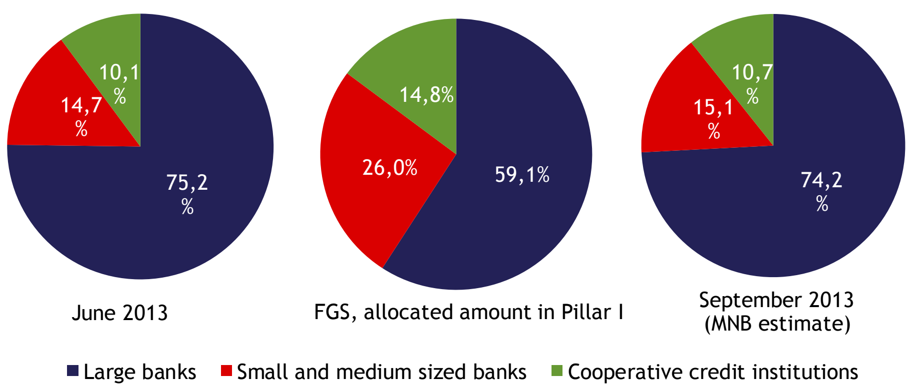
Chart 1: Amount (HUF bn) of SME loan contracts reported to the MNB in a weekly breakdown and their cumulative change per pillar, in proportion to the overall allocated amounts



The allocation mechanism and the option to switch banks increased competition between credit institutions

While the ratio of large banks is high within the total SME loan portfolio, small and medium-sized banks and savings co-operatives accessed a larger credit line in the Scheme in proportion to total loans. This enabled these participants to expand their portfolios by a relatively higher rate, which strengthened competition for new customers. Strengthening competition between credit institutions contributes to the easing of credit conditions and supports the more efficient distribution of funds. Owing to a higher ratio in proportion to total loans, the share of small and medium-sized banks and savings co-operatives increased within the SME loan portfolio.

Chart 2: The effect of the FGS on the distribution of SME loan portfolio by bank type



The Scheme also offered the option to switch banks when redeeming existing loans, which also strengthened competition. This is not only evidenced by data provision relating to the SME loans, but information provided by the credit institutions also suggests that many enterprises submitted loan applications to several banks, and these sought to make available loans under the FGS to as many customers as possible, with the aim of retaining them.

Twenty per cent of customers switched banks for the conversion of loans (Pillars I and II combined), although variations can be observed by bank types. Large banks presumably focused mainly on existing customers; the ratio of loans originally extended by other banks is low among loans provided by them for redemption. The ratio of bank switching is higher in relation to SMEs concluding contracts with small and medium-sized banks and savings co-operatives, which is partly attributable to the fact that the allocated credit line relative to their loan portfolio is highest in their case, thus these credit institutions were more likely to dispose over available funds to satisfy the loan demand of other banks' customers, in addition to serving their existing customers. Approximately two-thirds of customers switching credit institutions were customers of large banks, and at least one-fourth of them redeemed their earlier loans - drawn from large banks - with loans disbursed by small and medium-sized banks and savings co-operatives. The growing activity of smaller credit institutions was in line with the Scheme's objective of intensifying competition between credit institutions.

Chart 3: Ratio of customers switching banks when redeeming existing loans (Pillar I and II combined)

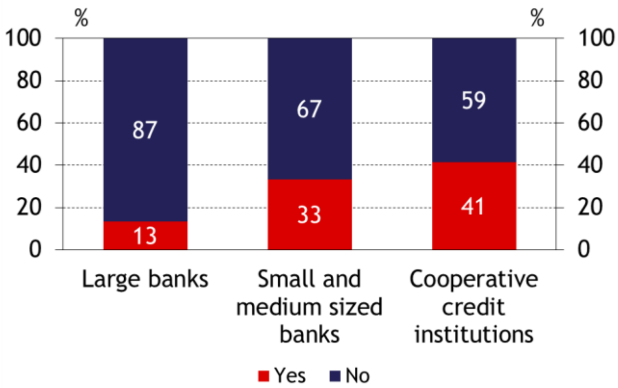
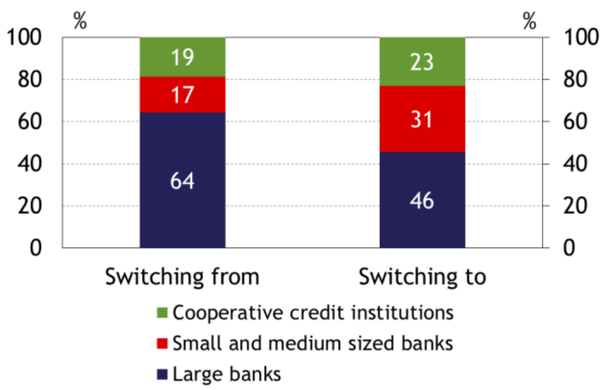


Chart 4: Distribution of bank switching by bank size (Pillar I and II combined)



Credit institutions disbursed new loans in a large proportion in the Scheme

Sixty per cent of loans provided under Pillar I are new loans, which indicates the Scheme's pronounced effect on the activity of participants on both the demand and the supply side. The maximum 2.5 per cent interest rate of the FGS significantly eased the price credit conditions of enterprises participating in the Scheme, thus the Scheme helped more enterprises to implement an expansion of activity. The Scheme enabled the implementation of deferred investments that otherwise would have remained suspended due to the strict lending conditions.

Over 60 per cent of loans converted under Pillar II are investment loans. This is also a positive development, as the exchange rate risk of enterprises participating under Pillar II of the Scheme decreased, with a declining interest burden, which improve their financial and income position, resulting in a higher likelihood of the completion of investments already in progress.

Most of the new loans were disbursed by savings co-operatives[1] under Pillar I; moreover, approximately two-thirds of their total placements were made up of new investment loans. The ratio of new loans was

[1] Umbrella banks are classified together with savings co-operatives, as umbrella banks cannot be separated from correspondent banks on the basis of the data provided.

roughly the same in relation to large banks and small and medium-sized banks; the share of investment loans was moderately higher in the case of the latter. Under Pillar II, investment loans accounted for approximately four-fifths of loan conversions at small and medium-sized banks and savings co-operatives, and over half of conversions in relation to large banks. More working capital loans were redeemed under Pillar I, however, thus the ratio of converted investment loans is moderately lower in terms of the aggregate loan redemptions under both Pillars.

Chart 5: Distribution of loans provided under Pillar I, by purpose

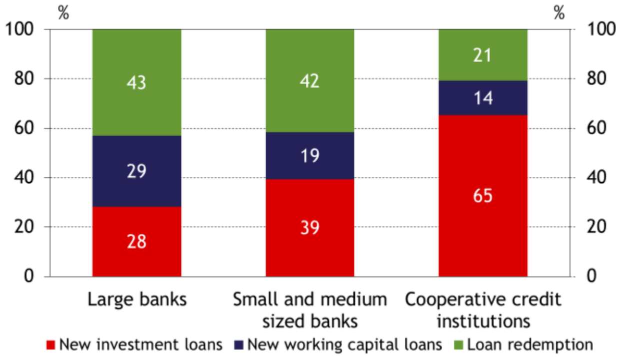
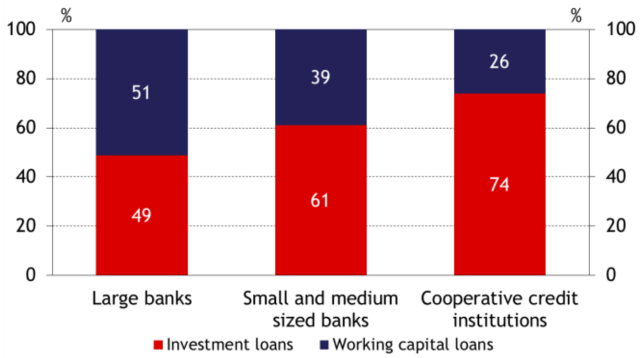


Chart 6: Distribution of converted loans, by purpose (Pillar I and II combined)



In terms of distribution by company size, under Pillar I, new loans made up three-fourths of loans in relation to micro-enterprises, with the bulk made up of investment loans. Sixty per cent of the loans drawn by small enterprises were new loans, with a dominant share of investment loans. Medium-sized enterprises showed the lowest rate of investment activity in the Scheme. This is possibly attributable to the fact that the average amount of loans borrowed by medium-sized enterprises is higher and the planning of investments is a more time consuming process, therefore it is possible that these enterprises will mainly participate in the second phase of the Scheme.

A similar trend is observable under Pillar II in relation to investment loans: the smaller the company, the higher the ratio of investment loans. Medium-sized companies redeemed loans drawn earlier at the highest rate, if we analyse combined data under both Pillars of the Scheme.

Chart 7: Distribution of loans under Pillar I, by purpose and company size

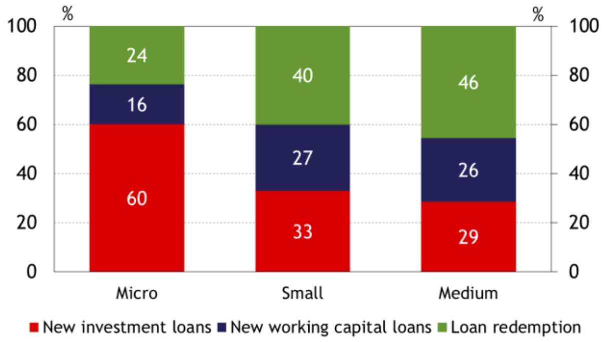


Chart 8: Distribution of loans converted under Pillar II, by purpose and company size

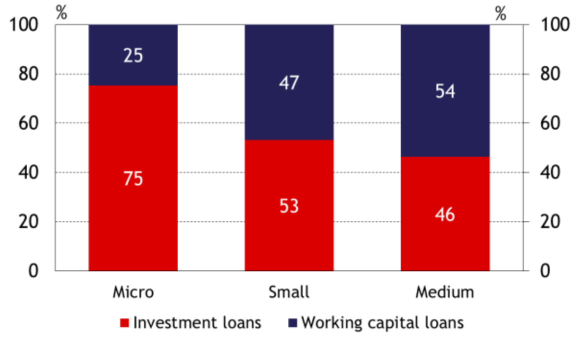


Table 1: Distribution of loans provided under the Scheme by purpose and company size

Billion HUF	Micro-enterprises		Small enterprises		Medium enterprises		**Total sum**	
	Contracts	Sum	Contracts	Sum	Contracts	Sum	Contracts	Sum
New loans:	3159	84	2053	99	752	107	**5964**	**290**
Investment loans*	2145	66	1133	54	401	56	**3679**	**177**
Working capital loans	1014	18	920	45	351	51	**2285**	**113**
Redemption:	1395	130	1543	127	942	154	**3880**	**411**
Pillar I	536	26	976	66	655	90	**2167**	**182**
Pillar II	859	104	567	61	287	64	**1713**	**229**

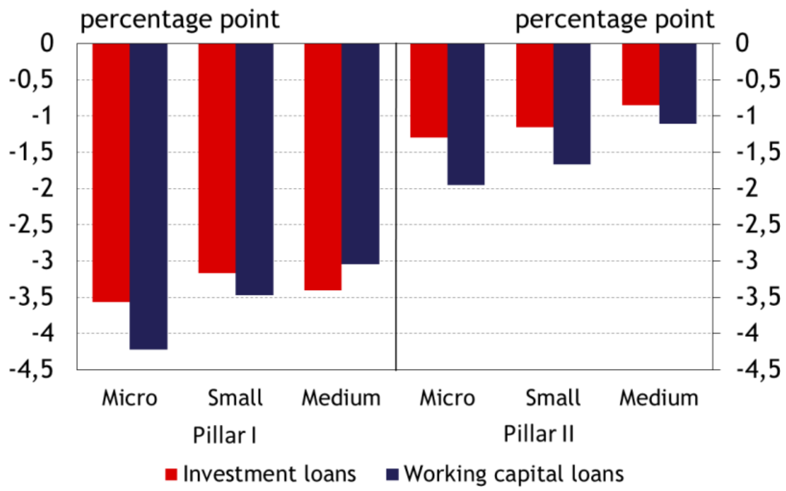
*: Including loans granted to pre-finance EU financial support

Significant decline in the interest burden of enterprises

The prolonged recession negatively affected the profitability of SMEs through several channels, and there was a high risk of the emergence of negative feedback loop between high financing costs and deteriorating profitability. The Scheme succeeded in effectively reducing this risk by maintaining a low interest rate, which led to a significant decline in the interest burdens of enterprises participating in the Scheme with respect to both new loans and loan conversions. The income position of enterprises is therefore significantly improving as a result of the Scheme.

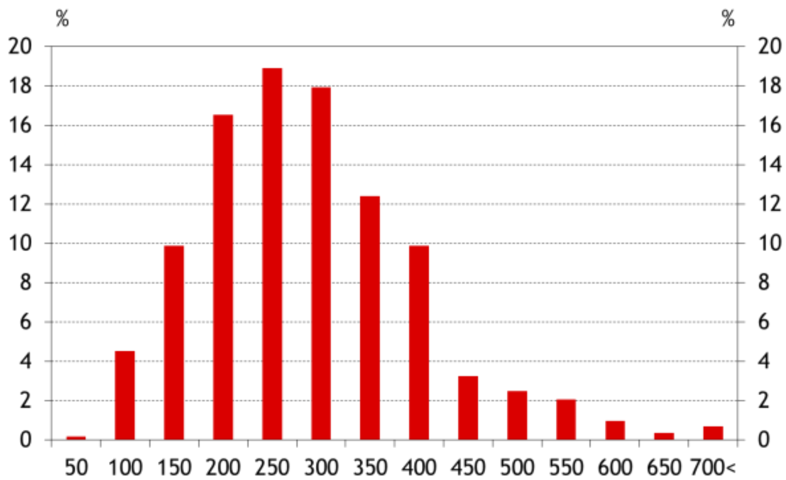
With regard to converted loans under Pillar I, the interest burden of investment loans decreased on average from 5.9 per cent to 2.5 per cent, and from 5.8 per cent to 2.5 per cent in the case of working capital loans. Under Pillar II, the interest rate of investment loans decreased from 3.7 per cent to 2.5 per cent and from 4 per cent to 2.5 per cent in the case of working capital loans, clearly indicating declining interest burdens even upon conversion of foreign currency-denominated loans. The fall in interest rates is highest for micro-enterprises, in relation to both Pillars and both loan purposes. Funds resulting from interest savings can be allocated by enterprises to the expansion of their business activity in the longer term.

Chart 9: Decreasing interest rate of converted loans



During the financial and economic crisis, the volume of outstanding loans in the SME sector declined more as a result of prevailing lending limits than what the demand would have justified, which is principally attributable to weakening risk tolerance of the banking system. However, customers whose redeemed loans had an interest margin higher than 250 basis points also participated in the programme. In addition to the involvement of guarantee organisations, this may also be attributable to competition for customers, banks' growing propensity to lend, and improving creditworthiness resulting from lower interest rates. Since the banks were able to moderately increase their margin in the case of the least risky customers, they had sufficient manoeuvring room to extend loans to more risky customers under the Scheme. In the longer term, the improving financial position of SMEs receiving loans under the Scheme may increase banks' profitability and lending activity through the decline in the ratio of non-performing loans.

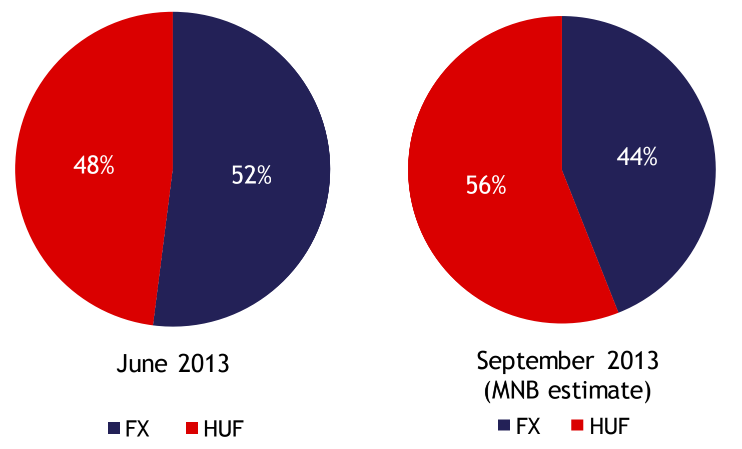
Chart 10: Distribution of premium (basis points) on loans converted under Pillar I in proportion to placed loan stock



Significantly reduced exchange rate exposure of enterprises

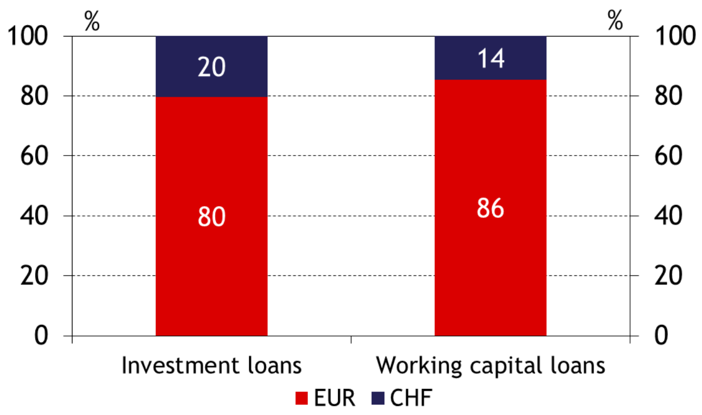
Loan conversion under Pillar II enabled many participating enterprises to eliminate or reduce their undesirable exchange rate exposure besides maintaining the benefits of a low interest rate. This Pillar presumably attracted the participation of companies that did not have a natural hedge. During the four-month availability period of the Scheme, the participating SMEs reduced the volume of their foreign currency loans by approximately HUF 229 billion within the framework of Pillar II. Within the total SME loan portfolio, the ratio of foreign currency loans declined by an estimated 8 percentage points from the end of June 2013 to the end of September, which is attributable to both the redeemed foreign currency loans in Pillar II. and the disbursement of new forint loans in Pillar I.

Chart 11: Distribution of the SME loans outstanding by currency



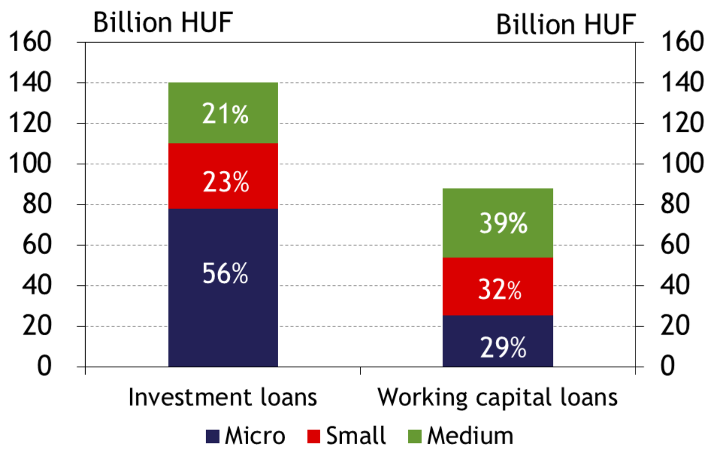
A significantly declining exchange rate exposure supports more predictable financial planning and stable business activity. Although companies showed lower demand for the conversion of foreign currency-denominated loans than available through the overall amount under Pillar II, this also implies that the loan demand of SMEs — aiming to eliminate their exposure to exchange rate risk under the prevailing exchange rate — was satisfied to a large extent. The sharp decline in the portfolio of foreign currency loans is also important in terms of the national economy, as it reduces financial stability risks. Companies predominantly converted euro-based loans under Pillar II; the ratio of loans denominated in Swiss francs did not exceed 20 per cent in either loan purpose.

Chart 12: Breakdown of converted foreign currency loans by purpose and currency



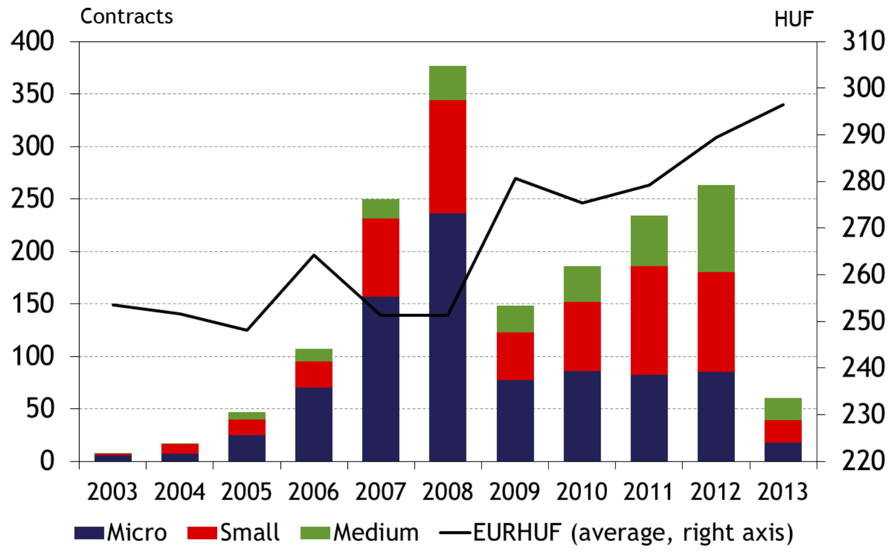
Among the participating SMEs, the volume of foreign currency loans declined by the highest extent in the micro-sized company segment; the decline was roughly of a similar rate in the case of small and medium-sized companies. Investment loans were converted in a higher degree, which are predominantly linked to micro-sized companies. This may also have been attributable to the fact that this segment focuses on the domestic market, and hence, has less natural hedge. Thus, with the aim of stabilising business activity, the incentive was presumably stronger for them to convert loans with longer maturity, even with a realised exchange rate loss. The ratio of converted foreign currency working capital loans was significantly lower within the framework of the Scheme, which may also be attributable to the shorter average maturity of these types of loans.

Chart 13: Share of converted foreign currency loans by company size



On the basis of the number of contracts, participating companies converted foreign currency loans that were drawn in 2008 in the highest number, with micro-enterprises accounting for the largest share. Foreign currency loans disbursed in 2007, 2011 and 2012 were also converted in large numbers; small and medium-sized companies accounted for the larger share of conversions in relation to the latter period. The weaker forint in this period may also have been a determining factor in this regard, as in this case, companies realised a lower exchange rate loss, which provided them a greater incentive to convert loans borrowed in the past years. Micro-enterprises converted mostly foreign currency loans drawn in 2008, while small and medium-sized companies typically converted loans disbursed in 2011 and 2012 to forint loans within the framework of the Scheme.

Chart 14: Distribution of converted foreign currency loans (based on contract numbers) by company size and year of disbursement



Loans provided under the Scheme have longer maturity

As a positive development, under the Scheme, enterprises could access financing with longer than average maturity. Although the distribution of maturity under 10 years is relatively even within the total SME loan portfolio[2], the ratio of loans with a maturity of 1 year and between 1 and 3 years is particularly high in relation to loans disbursed in 2012. In other words, while the current outstanding portfolio also contains loans with a longer maturity, which are more likely to have been disbursed several years ago, much fewer investment loans have been provided in recent years as a result of the financial and economic crisis. The shortening maturity of extended loans is attributable to the limited risk tolerance of banks and the contraction of long-term financing on the supply side. Demand related factors, however, also contributed to the continuous decline in long-term loans in the corporate sector. The corporate sector has been characterised by free capacities since the emergence of the crisis, since the segment has been continuously prompted to delay investments as a result of the negative outlook on economic growth. However, the FGS enables the implementation of these investments; partly as a result of this opportunity, the ratio of loans with maturity of over 3 years is particularly high in the Scheme.

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[2] The SME loan portfolio will hereinafter relate to loans outstanding in 2013 Q1.

Chart 15: Maturity structure of SME loans provided under the FGS, relative to total SME loans outstanding and disbursements in 2012 (based on contract numbers)

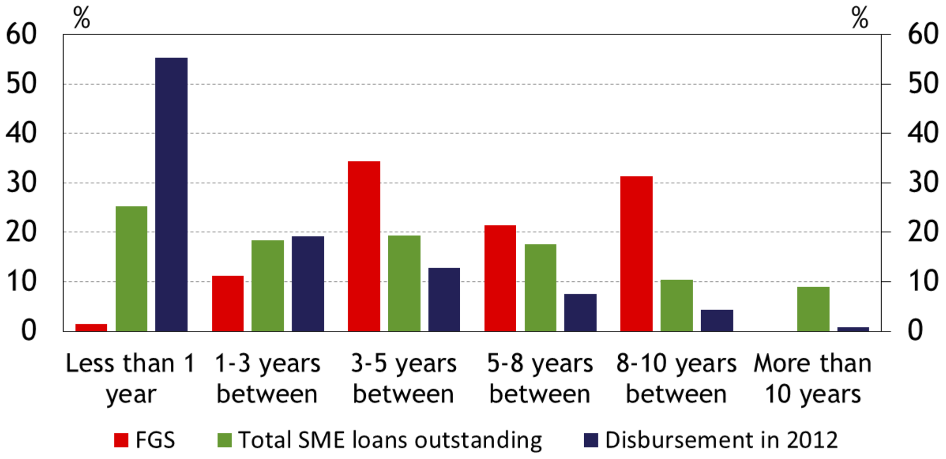


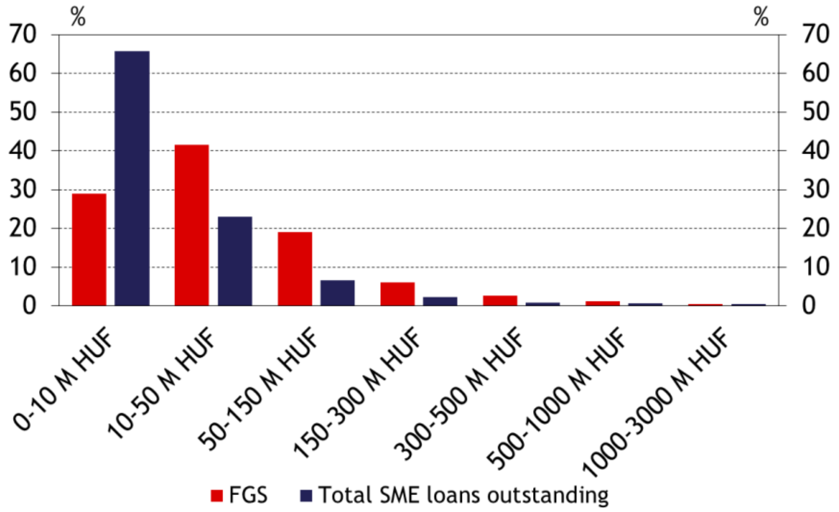
Table 2: Average and median maturity of loans provided under the Scheme

	Average maturity weighted by loan size (year)	Average maturity (year)	Median maturity (year)
New investment loans	8	7,2	6,9
New working capital loans	5,3	5,1	4,9
Redeemed investment loans	7,6	6,7	6,8
Redeemed working capital loans	5,9	5,5	4,9

The typical loan amount remained below HUF 50 million

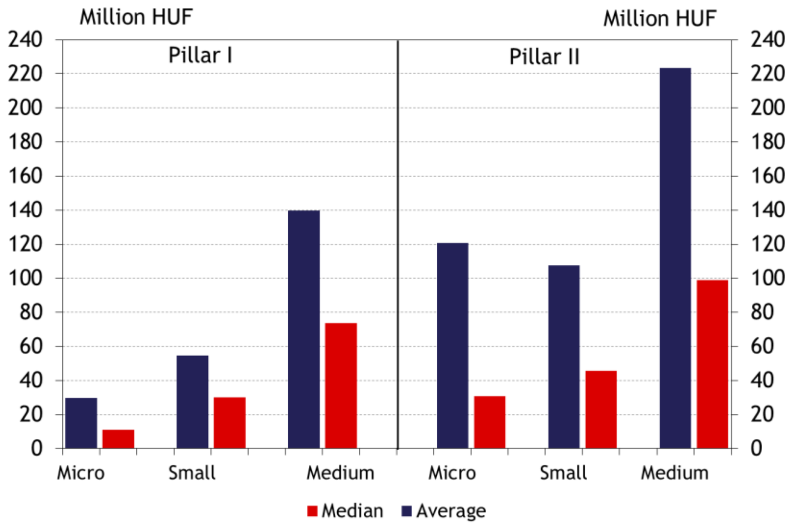
Credit institutions typically provided loans in larger amounts under the FGS in comparison to the total SME loan outstanding. If, however, we take into account the minimum HUF 3 million and maximum HUF 3 billion contract limit, the typical amount of the loans tends to be low. The most common loan amount was between HUF 10 and 50 million, while the ratio of loans under HUF 10 million is the highest within the total SME loan outstanding. Seventy per cent of loans disbursed under the Scheme were under HUF 50 million (based on contract numbers), while approximately 90 per cent of disbursed loans is below this limit in relation to the total SME loan outstanding. The longer time frame of the Scheme's second phase will presumably enable smaller companies with demand for smaller loans to increase their share of the Scheme.

Chart 16: Distribution of loan amounts within total SME loans outstanding and the FGS (based on contracts numbers)



With respect to loans provided under the FGS, the average loan amount shows significant differences between the two pillars: the credit institutions typically provided loans in higher amounts for the conversion of foreign currency loans. In such case, the average amount of the transaction exceeded HUF 100 million in the case of all three company sizes. The median disbursed loan amounts, however, are significantly lower in the case of both pillars and all three company sizes, which implies that some loans of larger amounts were provided in all three groups based on company size, pushing the average transaction volume upward.

Chart 17: Average loan amount by pillars and company size



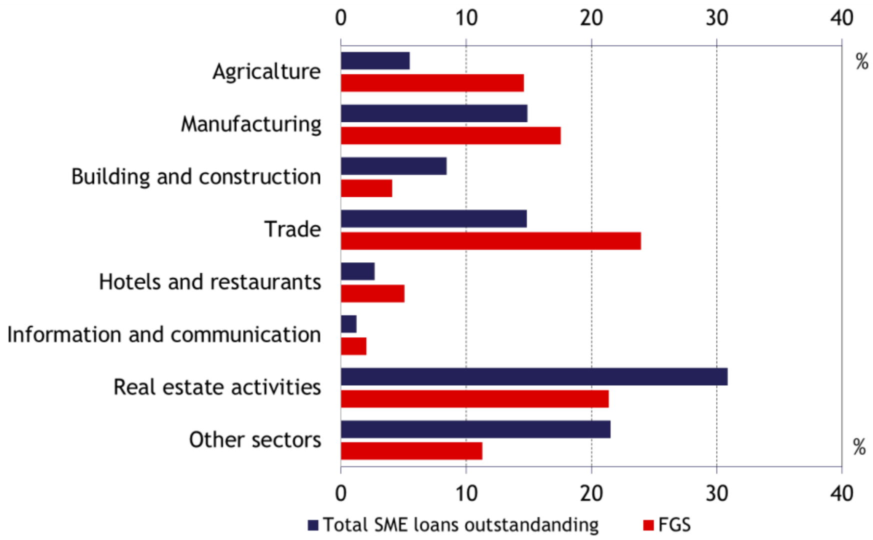
The difference between the average amount of loans provided for loan conversion and of new loans under the FGS may be attributable to the fact that the ratio of new loans is higher in the savings co-operative sector, where the average loan amount is relatively low. In addition, credit institutions acquired many new customers within the framework of the Scheme, which entails a higher risk for credit institutions, as they possess less information on them than on existing customers.

The agriculture, trade and vehicle repair sectors are overrepresented within the FGS

As there were no sectoral restrictions in the Scheme, SMEs operating in any sector was eligible for financing. Within the framework of the FGS, roughly one-fourth of the loans was disbursed to SMEs operating in the trade and vehicle repair segments, and companies pursuing activity in connection with real estate activity accounted for over 20 per cent of the disbursed loans.

The structure of the sectoral distribution of SMEs receiving loans under the Scheme is slightly different from that observable in the total outstanding SME loan portfolio: the ratio of companies operating in the agriculture, forestry, fisheries and trade, vehicle repair sectors is significantly higher under the FGS than measured for the total SME loans. By contrast, the construction industry, real estate activity and other sectors are underrepresented under the FGS in comparison to the total SME portfolio.

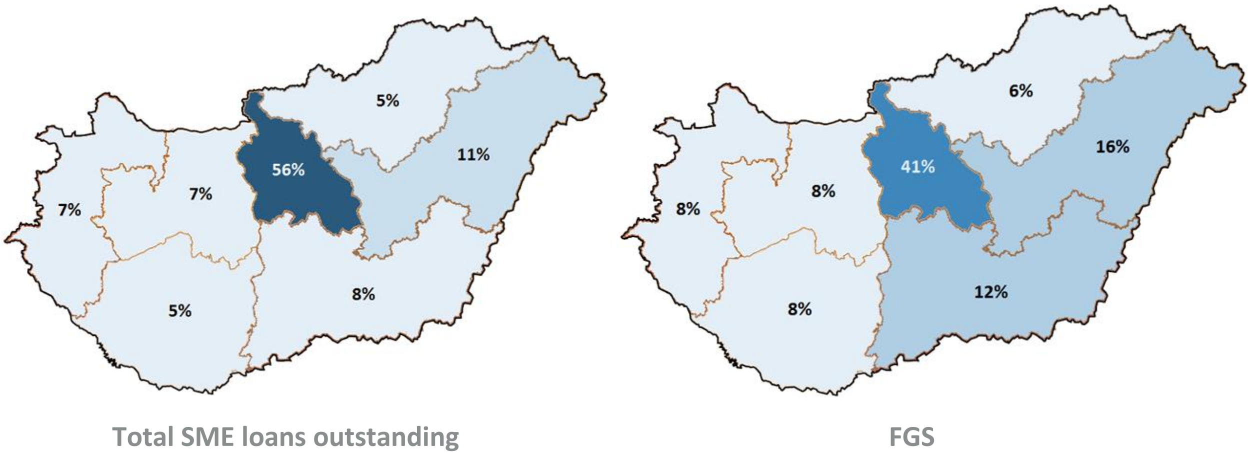
Chart 18: Sectoral distribution in the SME loan portfolio and in the FGS



The FGS reduced the regional concentration of SME loans

The FGS had a positive effect on the regional concentration of SME loans. The loans disbursed under the Scheme are more evenly distributed between the regions: 56 per cent of total SME loans were concentrated in the region of Central Hungary, while only 41 per cent of loans under the FGS were disbursed to this region. In parallel to the above, companies operating in the relatively underdeveloped regions of the Northern and Southern Great Plain received a higher than average rate of financing under the Scheme. Thanks to this, SME lending became regionally more balanced, which is a favourable development in terms of the convergence of underdeveloped regions.

Chart 19: Regional distribution of total SME loans outstanding and the Funding for Growth Scheme



Guarantee organisations mainly supported the participation of smaller, more risky companies

The participation of guarantee organisations in the first phase of the FGS was limited. Approximately 20 per cent of loans provided in the first phase of the FGS have the guarantee of a guarantee organisation[3] (Garantiqa, AVGHA, MV) as collateral to some extent. These loans amounts to HUF 64.4 billion, equalling less than 10 per cent of the total contract amount in FGS. In relation to loans serving loan redemption, only approximately 16 per cent of loans (based on contract numbers) were backed up with guarantees. In terms of the average loan amount, there are significant differences in the FGS between total transactions and transactions backed up with guarantees. Typically loans of smaller amounts were backed up with a guarantee.

Table 3: Average loan amount of all customers and of those with a guarantee

	FGS (M HUF)	Customers with a guarantee (M HUF)
Pillar I	**58,0**	**27,1**
Pillar II	**133,6**	**73,1**
New investment loans	48,4	23,2
New working capital loans	49,6	23,9
Redeemed investment loans	111,2	64,8
Redeemed working capital loans	100,7	74,2

During the longer availability period of the second phase of the FGS, the higher involvement of guarantee organisations is necessary to ensure the usage of the Scheme's overall amount and the access of more smaller, riskier enterprises to loans.

[3] The data provided do not include information enabling the identification of the guarantee organisation backing up the given loan.