ACHIEVEMENTS OF THE MAGYAR NEMZETI BANK

2013-
2015

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Achievements of the Magyar Nemzeti Bank 2013 – 2015

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This publication presents the achievements of the Magyar Nemzeti Bank since 2013.

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1 Introduction

1.1 MONETARY POLICY IN NON-TRADITIONAL TIMES

The global economic crisis of 2008/2009 opened a new era in monetary policy. The central banks of the world – partly from necessity, and partly because they recognized the shortcomings of their earlier perceptions concerning their own roles – started to play a more and more active role in the stabilization and in the recovery of the serious economic damages caused by the crisis. In the domestic monetary policy, this turnaround started in the summer of 2012 only, and unfolded after March 2013. Following its appointment, the new central bank management attempted to take careful but determined steps to work off the backlog accumulated before against the best international practice, and thus renewed domestic monetary policy in a number of areas. Every now and then, it is wise to take a deep breath and review the potential results of steps taken.

From the perspective of two years, the results are becoming clearly visible. Preserving the framework of the primary objective defined by the law, i.e. the achievement of price stability, the traditional and non-traditional monetary policy steps taken by the Magyar Nemzeti Bank significantly contributed to the increasingly dynamic growth in the past two years; they stopped the decline on the corporate credit market that had been going on for years; the gradually reduced base rate reduced the financing costs for all players indebted in forint; the conversion into forint solved the problem of foreign currency loans that represented the highest systemic risk of the economy; they contributed to the stabilization of the market of government papers; the integration of the HFSA made the supervision of the financial system more efficient, and as a positive side effect, the positive result of the operation of the central bank removed the burden of financing a significant loss from the budget. It is hard to single out individual results and say they are the most important ones of all, therefore it might be well worth summarizing the key measures and their motivations.

1.2 THIS CRISIS IS DIFFERENT FROM OTHER CRISES – MONETARY POLICY IN NON-TRADITIONAL TIMES

The global financial crisis that started in 2007 and deepened in the autumn of 2008 had a serious effect on the economies of the world. More than 6 years after the bankruptcy of Lehman Brothers, the growth of the world economy is still moderate, and the output of a number of economies is still behind the levels they enjoyed before the crisis. The lending activity of the banking system is muted, while unemployment got stuck at a permanently high level and now threatens with more and more serious long-term economic and social consequences. An increasing number of economists share the view that the years following the crisis may be characterized by a lengthy balance sheet adjustment. The cautious behaviour of public and private participants who focus on the repayment of their debts may hinder economic growth on the long term, while the environment with low demand may make the implementation of structural reforms that are inevitable for long-term development cumbersome, sometimes even impossible. In these times – which, subsequently, we might as well call non-traditional –, the efficient, active and harmonized steps of the key branches of economic policy have special importance, and the role of monetary policy has become far more prominent.

Hungary was especially hard hit by the global financial crisis. The Hungarian economy way characterized by both increasingly acute structural growth problems and unsustainable financing problems. In Hungary, both the government and the private sector accumulated unsustainable debts before the crisis, and a significant portion of the debts was denominated in foreign currency. In spite of the series of retrenchments initiated after 2006, the deficit of the budget remained high, and the government debt showed an increasing trend. Household savings decreased, the current account deficit was significant for years, and this led to huge external indebtedness, while the level of foreign currency reserves was dangerously low compared to external debts.

The vulnerability of the Hungarian economy fundamentally determined the macroeconomic developments of the years following the crisis, and, at the same time, set the directions for economic policy interventions. The repayment of the unbearably high outstanding debts hindered internal demand for years, and slowed down the recovery from the crisis more than in our competitors in the region. Freezing lending and the downturn in investments gradually demolished the long-term growth potential. This way the economic policy had to face the almost impossible task of performing a budgetary consolidation and laying down the foundations of sustainable growth at the same time.

By 2013, the fiscal discipline and the structural reforms already brought clearly visible results. As a result of the disciplined behaviour of the general government – which was occasionally ready to enter into conflicts with our partners –, the budget balance was constantly below 3 per cent, and created the conditions of reducing government debt. The measures taken were confirmed by the termination of the excessive deficit procedure of the European Commission, too. In the meantime, the indebtedness of the private sector also decreased significantly, reducing the vulnerability stemming from high external debts. Labour market activity and employment had a gradual upward drift, and in 2013, the growth of investments and GDP started again.

1.3 TURNAROUND IN MONETARY POLICY

Seeing the improved perceptions about risk and the increasingly moderate inflationary environment, by initiating the easing cycle and renewing the set of monetary policy instruments from 2013, the Magyar Nemzeti Bank joined the group of central banks that wished to mitigate the consequences of the crisis with active monetary policy. In the first years of the crisis, the high interest rates made debt financing expensive, and as a result of insufficient internal savings and the accumulated high debts, the country still heavily relied on foreign creditors. Corporate lending, which is of basic importance for potential growth, kept going down, and for some of the segments of the economy – mainly SME-s – the bank finances were almost out of reach.

Within the frames of its primary mandate stipulated by the law (achieve and maintain price stability), the Magyar Nemzeti Bank supported the stabilization of the economy with a number of programmes. Considering the rapidly changing risks in the world around us, determination, creativity and caution was needed in our measures. The easing cycle started in the summer of 2012 – the longest easing cycle since the political transition –, at the end of which the base rate dropped by 490 basis points to 2.1 per cent, which is a historically low level. Our steps muted the first strikes of the global deflationary wave, and, at the same time, reduced the cost of finance in the economy as a whole. The interest rate cuts greatly facilitated that the general government was able to book a significant interest saving on the HUF government papers.

The Fund for Growth Scheme improved the access to loan for SME-s, and this melted the frozen state of the corporate credit market, effectively supporting the change in the field of investments. Owing to this programme, since 2013, as much as 20,000 SME-s have received funds of more than HUF 1,300 billion in total. The self-financing programme of the MNB reduced the exposure of the country to foreign creditors, and by solving the conversion of foreign currency based household mortgage loans into forint, the most significant system-level risk of the past decade has been eliminated. As a positive side effect of the monetary policy measures, the central bank's profit improved considerably, releasing the budget from a planned subsequent loss of hundreds of billions. The integration of the financial market supervision and the development of the set of macroprudential instruments strengthened the stability of the banking system, consenting to the further mitigation of the vulnerability of the economy.

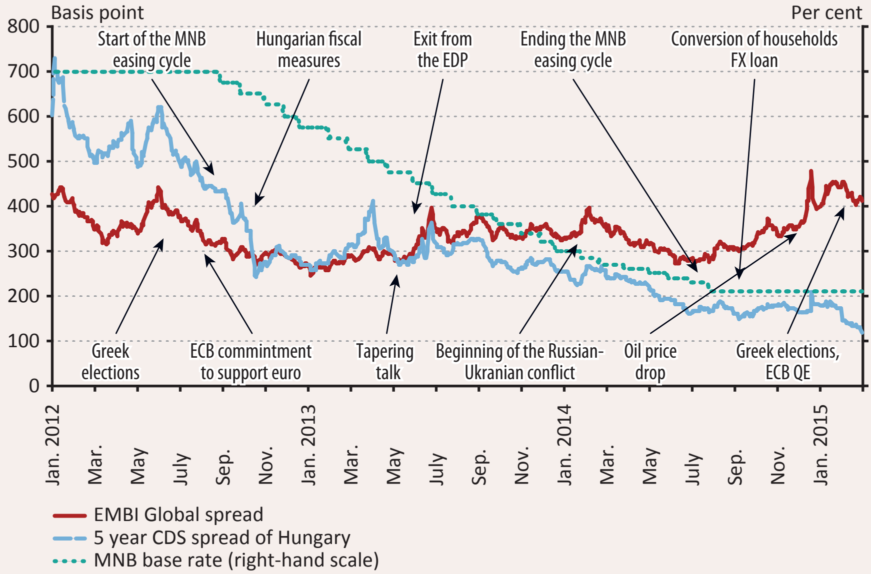
In addition to the participants of the real economy, money markets also confirmed the predictable and authentic behaviour of the monetary policy. Following the initial uncertainty, the new and often non-traditional steps of the central bank are now accepted and supported by a wider range of market participants. The properly communicated decisions are integrated into market expectations in an authentic and rapid way, strengthening the mechanisms of monetary policy.

Naturally, this short list contains the key milestones of the past two years only. Central bank decisions influenced the operation of the economy at a number of other points, and the following pages offer a more detailed insight into them. However, it has to be seen that in spite of all the successful steps, the future still has lots of challenges and risks in store for us, as this crisis is really different from the others. It is enough to think about the deflationary risks that are more acute around the world, the normalization of the monetary policy of the Fed, or the possibility of the emergence of another asset price bubble. We can give the right answers to these and other challenges only with active, considerate, cautious and innovative monetary policy that is based on the best international practice.

2 Outcomes of the two-year easing cycle

July 2014 saw the end of a period that brought unprecedented dynamism into domestic monetary policy. As a result of the two-year easing cycle, **the central bank key interest rate dropped by 490 basis points altogether.** The Monetary Council reduced the initial central bank base rate of 7 per cent first by 25 basis points per month, and then at a more measured pace, to **2.1 per cent** . Such a long and continuous easing cycle and such a low nominal interest rate level had never been seen in Hungary since the political transition. **Based on the incoming data and the inflation outlook, it has been proved that in spite of all the criticism, the interest rate cycle was justified, sustainable and necessary.**

Chart 1
Development of MNB base rate, and domestic and emerging market risk spreads



Source: Bloomberg, MNB

In the summer of 2012, the gradual improvement in the international risk perception concerning Hungary and the permanently accommodating monetary policy of developed-country central banks facilitated the start of the easing cycle, while domestic factors, including the change in fiscal policy further extended the room for manoeuvre of monetary policy.

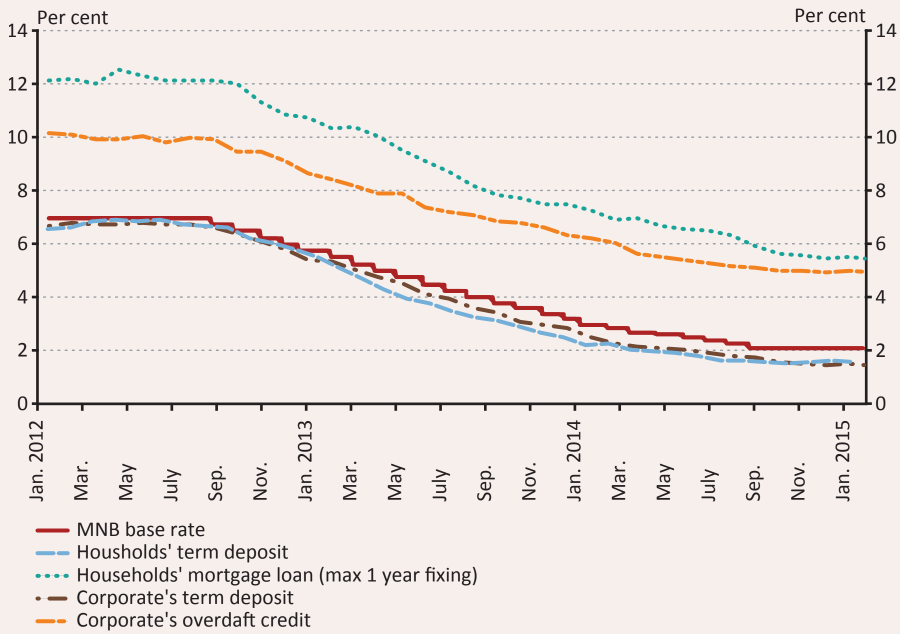
On the closing of the easing cycle, the Monetary Council reviewed the factors that facilitated that, and the consequences of the easing of monetary conditions. The muted internal consumption, the favourable international factors, the more and more disciplined government policies and the gradually reducing inflation expectations all supported the strong domestic disinflation.

At the start of the easing cycle, the inflation was around 6 per cent. However, the price level increase that substantively exceeded the central bank target was mainly supported by **unique and transitional effects, therefore, looking ahead, a drop in consumer price index was expected.** The Monetary Council was divided, but decision-makers who supported the interest rate cut were in majority. Following the termination of transient factors, **from the beginning of 2013, a strong disinflation period started,** where inflation was constantly below 3 per cent as a result of a wide range of external and internal factors. The more significant disinflation observed from the beginning of 2013 was the consequence of several factors which often strengthened each others' effects. The strong domestic disinflation was supported by muted internal consumption, international inflation trends, more disciplined fiscal policy and gradually reducing inflation expectations. In line with these effects, the basic inflationary process indicators gradually fell in 2013, and are still at a permanently low level.

In the first half of the easing cycle, the room for manoeuvre was extended by the strengthening willingness to take risks, while in the second half of the cycle, as far as perceptions about risk are concerned, it was rather the domestic factors that supported the cut of the base rate of the MNB. In addition, the strengthening fiscal discipline after 2010 basically contributed to the fact that domestic perceptions about risk gradually eased, and reached the emerging market average.

The base rate cut **reduced bank interest rates and offered a support for the growth of the economy**, thus facilitating the achievement of the central bank inflation target on the medium term. The easing cycle **reduced loan burdens by several hundred billion forints**, as it resulted in an interest rate cut in major household and corporate banking products of a similar extent, **by 450-550 basis points**. At the same time, the easing cycle prevented further drastic falls in outstanding borrowing, consumption and investment in the period of balance sheet adjustment.

Chart 2
Development of MNB base rate, and the rates of some forint loan and deposit products



Source: MNB

The interest rate cut took hold in the yields gradually and in a way considered sustainable by the market, and continuously **ensured positive real interest** for savers. The drop in longer-term rates was supported by the lower inflation expectations, the disciplined fiscal policy and the considerably improving external balance development, while the international willingness to take risks also helped, with some exceptions. Net household financial savings kept growing in spite of the interest rate cuts. Owing to the savings of considerable extent, reliance on foreign funds may decrease, and if the savings are used as sources for investments, the economic growth may help the reduction of external liabilities.

Together with other instruments of the MNB, the easing cycle greatly contributed to the fact that **average government paper reference rates fell by almost 400 basis points**. If this rate can be maintained at this level permanently, then **Hungary's interest expenses to be paid on the forint denominated government papers may be reduced by more than HUF 300 billion per year on the long term.**

The gradual downward shift of the forint yield curve and the move to forint financing **made the financing of government debt both cheaper and safer, and improved the results of the MNB, too**. Compared to the unchanged 7 per cent level of the base rate, **the interest rate cuts have so far improved the central bank results by more than HUF 300 billion**. During the easing cycle, stable coverage and issued quantities indicated the improving perceptions about domestic government securities.

According to the estimates of MNB, the interest rate cuts increased the value of the average inflation by 1.1 percentage points in total in two years. **Without the interest rate cuts, in 2014, the average inflation could have sunk to a firm negative range** (close to –1.3 percent)**.**

Table 1
Impact of easing cycle on inflation and GDP level[1]

Period	Inflation (percentage point)	GDP level (per cent)
2012 2nd half-year	0.0	0.1
2013	0.4	0.5
2014	1.1	1.1

Source: MNB

In addition to all that, the decreasing central bank base rate facilitated the gradual improvement of the dynamics of consumption and investment, and contributed to the improvement of the competitiveness of the Hungarian economy based on price and cost. **As a result of these impacts, the interest rate cuts altogether stimulated the economic growth by 1.1 percentage points.**

A number of analysts debated the necessity and the possibility of the interest rate moves during the easing cycle. During the cycle, the Magyar Nemzeti Bank was always committed to a monetary policy of cautious pace, and took the inflationary basic processes into consideration. During the easing cycle, the Monetary Council decided to reduce the pace of the easing cycle on several occasions. Interest rate moves of smaller extent were in line with the cautious monetary policy, and reduced possible surprises caused by money market volatility and related to interest rate decisions. This was strengthened by the fact that the Monetary Council gave guidelines on several occasions on the expected development of the central bank base rate, which was a support in the anchoring of expectations. All these factors

[1] The average impact is indicated for the individual periods. The macroeconomical effects of the easing cycle were quantified with our current forecast model (MPM model).

may have contributed to the fact that uncertainty about the interest rate course was reduced even in an unfavourable and volatile market sentiment. Disinflationary pressure continued during the interest rate cycle, and **the MNB's expectations about interest rate cuts were confirmed** (see paragraph below). On the closing of the interest rate cycle, the Magyar Nemzeti Bank provided a conditional forward guidance based on the macroeconomic forecast of the inflationary report. Beside the favourable international financial terms and conditions, the forward guidance also facilitated the stabilization of the expected base rate on the time horizon of monetary policy. **Taken together, in the past years, the surprise nature of central bank decisions was mitigated during the interest rate cycle, which greatly contributed to the increase in central bank authenticity.**

On the closing of the two-year easing cycle, domestic and international disinflation trends continued, and, together with the dramatic drop in oil prices, this reduced domestic inflation, too, in the past quarters. Based on the data received, at the beginning of 2015, there was a move toward the risk scenarios pointing to a more relaxed monetary policy in the December inflationary report, and the disinflationary developments and the modification in inflation expectations increased the probability of secondary effects.

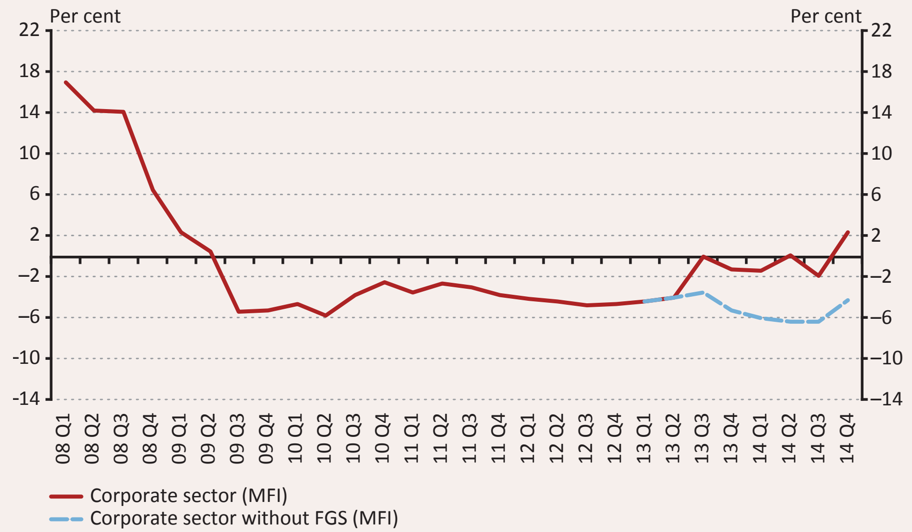
3 The lending incentive instrument of the MNB: the Funding for Growth Scheme

The Magyar Nemzeti Bank announced the **Funding for Growth Scheme in April 2013, with the purpose of mitigating the disturbances in SME lending and boosting the economic growth**. In pillars I and II of the programme, the MNB provided collaterized refinancing loans with 0 interest rate to credit institutions, which in turn used that for lending to SMEs, with an interest margin of maximum 2.5 per cent and a term of maximum 10 years.

Following the announcement, increased interest was shown by the enterprises in the loans offered by the Scheme, and this was reflected in the participation demands indicated by the credit institutions at the end of May 2013. In order to make sure that a large number of SMEs can take the loans of low interest rates offered by the Scheme, the Monetary Council increased the overall available amount by 50 per cent to HUF 750 billion before the start of the programme. As a result of the great interest on part of the enterprises, loan contracts were made by credit institutions for 93.5 per cent of the overall available amount; this means close to HUF 701 billion, related to 10 thousand contracts and 7,500 enterprises.

The FGS has significantly stimulated the demand for loans from the side of enterprises, and has called the attention of credit institutions to the SME sector, which increased competition for customer acquisition and retention. **Competition was invigorated** by the allocation mechanism applied by the MNB in the distribution of the overall available amount of the Scheme, and by the option of loan redemption and switching banks, which resulted in an increased share of small and medium-sized banks and cooperative credit institutions within the loans outstanding of SMEs. In the first phase of the FGS, owing to the favourable ratio of new loans, especially new investment loans, **the Scheme may have had a significant impact on the economic growth**. As a result of loan redemptions, the interest burdens of small and medium-sized enterprises were significantly reduced, therefore their profitability and creditworthiness improved. Credit institutions were willing to extend loans with long, almost 7-year terms, with interest rates fixed until the end of the

Chart 3
Annual growth rate of corporate loans outstanding



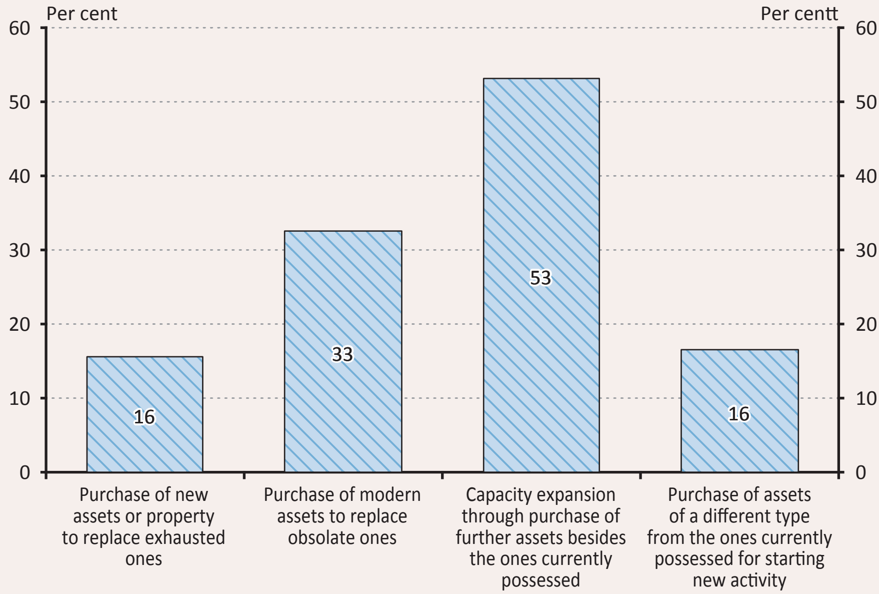
Source: MNB

term, which is favourable because during the financial and economic crisis, it was mainly the availability of longer-term loans that deteriorated.

With regard to the success of the first phase of the Scheme, on 11 September 2013, the Monetary Council of the MNB decided on the continuation of the FGS. **The second phase of the Scheme started in early October 2013**, and was initially announced to last until the end of 2014, with a limit of HUF 500 billion, which was increased by another HUF 500 billion to 1000 billion by the Monetary Council in the autumn of 2014. **The results of the first phase made it possible to shift the focus on the direct stimulation of economic growth.** Considering that, 90 per cent of the overall available amount of the second phase can be spent on providing new loans only, and the forint or foreign currency loan redemption may reach maximum 10 per cent.

The utilization of the second phase of the FGS was HUF 601.2 billion until the end of January 2015, related to more than 14,000 enterprises. This way, **in the two phases, altogether more than 19,000 enterprises received financing in an amount of HUF 1,300 billion**. 97 per cent of the loans extended in the second phase are new loans, including new investment loans (and new leasing transactions) with a share of 62 per cent, new working capital loans with a share of 26 per cent, and loans granted for pre-financing EU funds with a share of 12 per cent.

Chart 4
Distribution of loans by investment objective



Source: MNB

In the second phase of the FGS, owing to the fine-tuning of the programme and the longer available time period, **the share of micro enterprises significantly increased** from the first phase: while micro enterprises had a share of 25 per cent in the first phase, they reached almost 40 per cent in the second phase. This can be considered favourable because it is mainly the smaller, therefore riskier enterprises that face barriers in their access to credit. At the same time, the average loan size reduced, too: in the case of investment loans, every second loan is below HUF 10 million.

It is also favourable that regional concentration decreased in the Scheme. While more than half of the SME loan portfolio before the FGS belonged to enterprises operating in the Central-Hungarian region, in the case of loans provided in the first phase of the FGS, the share of that region was 41 per cent, and in the second phase it was 26 per cent. At the same time, the weight of the regions on the Great Plain increased significantly, and now almost one third of FGS loans is directed to these regions. This process is partly due to the increasing share of the agricultural sector, as more than one fourth of the loans are extended to this sector in the second phase.

FGS has effectively increased loan demand, too, which – apart from the development of the loan portfolio – is supported by the result of the non-representative survey carried out with a questionnaire in October 2014 by the central bank. According to this, almost 60 per cent of the enterprises would not have taken any loan or in a much smaller amount only, if the FGS had not existed; in addition, the majority of investment loans served capacity expansion. .

As a result of the Scheme, the contraction in the SME, therefore corporate loans outstanding stopped. In the years before the launch of the Scheme, the SME loans outstanding decreased by 5-6 per cent per year, but since the launch of the FGS, the loansoutstanding has been stagnating. According to the estimates of the MNB, the growth impact of the first and second phases of the FGS was 0.3-0.9 per cent according to the demand side estimate, while according to the supply side estimate, it was 0.5-1.1 per cent. Considering the secondary effects of the Scheme, too, **the growth effect of the two phases may have been around 1 per cent altogether**.

The prevention of credit crunch and the stopping of the decrease in the outstanding loan amount are important achievements, as the ever narrowing credit supply dampens economic growth, leads to falling assets prices, and – because of the falling value of eligible collateral – further reduces credit supply. This negative spiral, which emerged in Hungary, too, was blocked successfully by launching the FGS as part of the set of monetary policy instruments. The FGS reduced interest expenses to a reasonable level, stopped the downturn in lending, and created loan conditions that stimulated the investment intentions of enterprises and thus improved the monetary transmission mechanism.

Notwithstanding the beneficial effects of FGS, **lending outside FGS has yet to recover,** and the excessive risk aversion by banks and tight credit conditions remained present in this segment. Here, similarly to the past years, outstanding borrowings keep shrinking. All of these are symptoms of the malfunctioning of monetary transmission in this segment of SME credit market. A permanent turnaround in lending that would support economic growth requires the facilitation of the access to credit for these enterprises, and this can be achieved by extending the present effects of FGS. On the meeting of 18 February 2015, the Monetary Council decided to launch FGS+, a separate Scheme similar to FGS, thus identical with it in a number of conditions, but running in parallel with it.

In the FGS+ the Magyar Nemzeti Bank provides an available amount of HUF 500 billion to the credit institutions. Under FGS+, the 0 per cent refinancing loans borrowed from the central bank are available for lending to small and medium-sized enterprises in the same way, with a loan interest rate not exceeding

2.5 per cent, but loan redemption is not allowed. However, the new credit programme is extended with an important condition, the risk-sharing, in order to **normalise the credit market of those enterprises that have no access to FGS**. In the case of loan contracts concluded under FGS+, the MNB takes over 50 per cent of credit losses from the credit institutions, but for a term of maximum 5 years only, and up to 2.5 per cent of the entire loan portfolio held by the individual credit institutions under this Scheme. This way riskier enterprises are also able to extend their activities, which otherwise would not be able to take long-term investment loans, or only to a limited extent and under unfavourable conditions.

Within the framework of the FGS and FGS+ announced on a temporary nature, until the end of the year, domestic SMEs can get financing of almost HUF 1000 billion in 2015. As of the beginning of 2016, SME lending may return to the restored market basis.

4 The self-financing programme of the Magyar Nemzeti Bank

4.1 BACKGROUND

The drop in outstanding debt stock built up before the economic crisis and the improvement in the central bank's reserve compliance allowed for a targeted use of central bank reserves and the announcement of the self-financing programme in 2014. Hungary was hit by the economic crisis in 2008 with a high level of outstanding debt stock. As a consequence of the adjustment to the crisis, first the current account turned positive, then the whole debt, including short-term debts started to effectively fall, therefore the external balance position of the country improved. In the meantime, the reserve holdings of the central bank increased, so the cautious and gradual reduction of reserves was possible in 2014. **One way of cutting reserve holdings is that the state renews its soon overdue debts mostly in forint**, as the state carries out the necessary conversions at the MNB against its deposits. The self-financing concept of the Magyar Nemzeti Bank is built on this possibility, and the objective is to strengthen the financing of government debt from internal funds, and to reduce reliance on external funds.

At its meeting on 23 April 2014, the Monetary Council of the MNB made a decision on the self-financing concept and the related renewal of the set of monetary policy instruments. The self-financing concept facilitates the move to internal financing, which means that foreign investors will have lower share, while domestic participants, households and especially the banks will have a higher share in the financing of the government budget. **The ultimate objective of the programme is to mitigate the country's external vulnerability by reducing the gross external debt**, and to strengthen the financing of government budget and the stability of the Hungarian financial system. Through the improving perception about risks related to the country, and the reduction in the risk premium, the lower external indebtedness may contribute to the reduction in debt service costs, too.

4.2 THE SELF-FINANCING PROGRAMME

The renewal of the set of MNB instruments was aimed at increasing the role of banks in the financing of government debt. The elements of the programme were as follows:

- **the two-week MNB bond was turned into a two-week deposit facility on 1 August 2014**, thus the banks' funds deposited at the central bank were partially rearranged in the direction of government papers;

- as of 26 June, **the regularly announced interest rate swap (IRS) instrument supports the management of interest rate risk, therefore the adjustment by the banks**;

- the **collaterised loan and the securities swap facility** becoming parts of the potential set of business instruments will offer liquidity help to credit institutions in the case of market turbulences.

The self-financing programme drives banks from the two-week central bank asset to government securities, which means that banks will finance the state, and not the MNB. Because of the special features of the central bank balance sheet, in the simplest case this means that domestic banks will use their two-week central bank instruments to buy government papers from the Government Debt Management Agency (ÁKK). This does not mean the end of the self-financing process yet, as that requires ÁKK to repay its maturing foreign exchange liabilities by converting its forint liquidity against the central bank foreign exchange reserves – and thus shrink the balance sheet of the MNB, and reduce the gross external debt and the international vulnerability of the country.

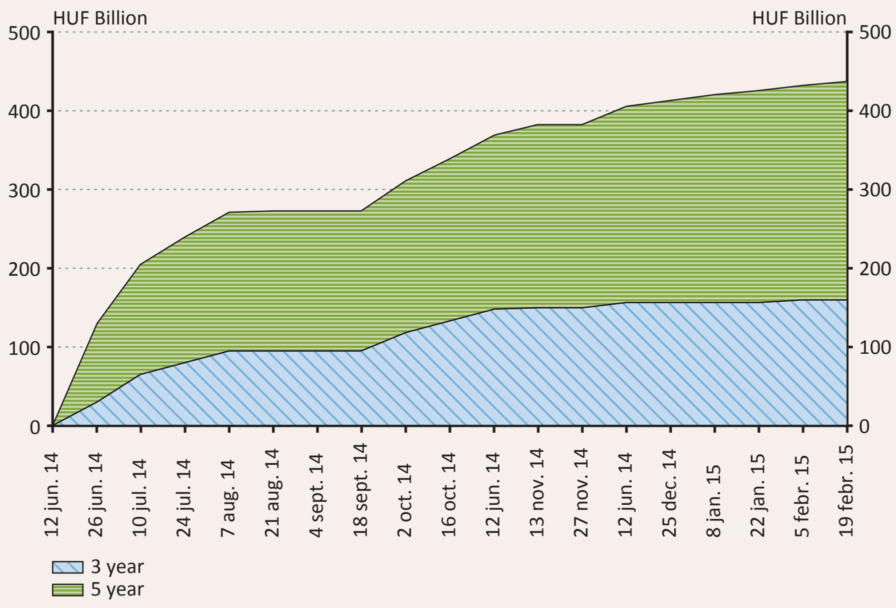
The transformation of the main policy instrument served the purpose of removing funds from the central bank instruments. **The important difference between the central bank bond and deposit is that the latter may be used by the partner institutions of the central bank only, i.e. typically the domestic banks**, and deposits cannot be broken before their maturities, just as they may not be accepted as collateral in central bank operations. All this has two important consequences. On the one hand, this transformation drove out non-resident and non-bank domestic investors from the main policy instrument, i.e. these institutions were forced to get adjusted to the change. On the other hand, the change for deposits encouraged the banks to look for assets that are classified as eligible securities, and have a better market and regulatory perception from the aspect of liquidity, as the smooth operation of their payment turnover, the maintenance of their central bank creditability and the regulatory expectations require them to have liquid assets of proper amount.

The interest rate swap instrument introduced as part of the programme allows the banks to cover the interest rate risks of their long-term fixed-rate government bonds, as well as their financing from short-term funds. Credit institutions participating in the tenders agree to increase the portfolio of their acceptable securities under the tenders compared to the value of Q1 2014 at least to the extent of the IRS deals they conclude with the MNB. The deal can be closed after one year only, and only with a "penalty". These two strict conditions mean the difference from the market interest rate swaps, and, of course, this is reflected in the price of the central bank instrument, too.

4.3 THE RESULTS OF THE SELF-FINANCING PROGRAMME

In August 2014, the MNB successfully completed the transformation of the main policy instrument, and **until the end of February 2015, interest rate swap deals were concluded with credit institution partners in a total nominal value of**

Chart 5
Development of the central bank IRS portfolio



Source: MNB

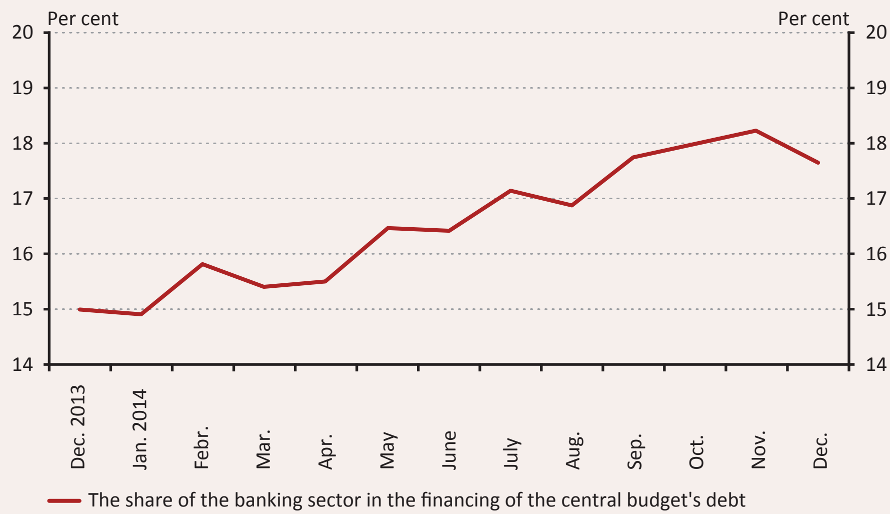
HUF 437 billion. The conversion to deposits involved a forced adjustment by the investors, which temporarily resulted in turbulent market conditions, but the conditions got normalized by the autumn: the overnight deposits by the banks decreased, the relevant short-term interest rates returned to the interest corridor, swap spreads settled at a normal rate, so all in all, the transformation of the two-week instrument did not deteriorate the monetary transmission.

The self-financing programme has reached its objectives, as it significantly contributed to the increase in the government paper portfolio of the banks, and to making the financing structure of Hungary healthier and better balanced. In the whole of 2014, the government paper portfolio of banks increased by more than HUF 1,000 billion at market value. This way more than half of the forint financing was ensured by domestic banks, which improved the financing structure of government debt. The increase was due to banks related to the self-financing programme, as banks participating in the IRS tenders showed a growth over the average, and banks not using the IRS but highly affected by the conversion to deposits also increased their portfolio, while banks not participating in the programme significantly reduced their portfolio. It is especially favourable that the majority of the additional forint government papers issued after the announcement of the self-financing programme in April was absorbed by the demand from domestic banks.

The success of the programme is indicated by the fact that banks bought primarily long-term government papers, i.e., owing to the self-financing programme, the ratio of longer-term papers increased within the government securities portfolio of banks. Domestic credit institutions – primarily banks participating in IRS tenders and banks with low balance sheet totals and significant payment turnover – successfully contributed to the strengthening of the internal financing of the government budget by increasing their own forint government paper portfolio, and, in addition to that, extended the maturity of their portfolios, therefore efficiently supported the stability of the government debt financing in the past half-year. Looking at the previous years, the government paper holdings of banks in their own possession extended mainly in discount treasury bonds in 2012, then we registered a drop at the level of the banking system in 2013, while in 2014, thanks to the self-financing concept, an increase was experienced in longer-term government papers.

Through the purchase of government papers by domestic banks, the self-financing programme **improved the financing structure of domestic government debt**, as the government paper purchases by banks – in addition to purchases by households – resulted in an increase in the share of domestic financing. Based on the data of last December, the share of domestic banks increased significantly and created a trend

Chart 6
The forint and foreign currency government paper holdings of the banking system compared to the gross debt of the central budget



Source: MNB

in the financing of the gross debt of the central budget: while this ratio was 15 per cent in December 2013, it was 18.2 per cent in November 2014, and was close to 18 per cent in December, too.

As a result of the refinancing of foreign currency funds from forint, the self-financing programme narrowed the balance sheet of the central bank. Under this programme, the Government Debt Management Agency increased the supply of forint government securities, as it financed some of the foreign currency maturities from the issue of forint government securities. The ultimate source was the foreign exchange reserves: the government used the portfolio of treasury accounts increased from more forint issues in a way that the extra forint issue was converted into foreign currency at the central bank, and the foreign currency acquired this way was used to repay the foreign currency maturities, which, at the same time, reduced the foreign currency reserves. The increasing forint issue reduced two-week deposits, and in parallel with the higher treasury deposits, the liquidity of the banking system deteriorated, too, while the government's conversion against the central bank did not affect the liquidity of the banks. Owing to the strengthening of the Swiss franc in January, the balance sheet of the MNB extended significantly in early 2015, but the self-financing programme ceteris paribus in the whole 2014 reduced the central bank balance sheet by an amount corresponding to the negative net foreign currency issue by the Government Debt Management Agency, i.e. by HUF 600 billion. The level of interest rates paid on the two-week instrument usually exceeds the yields of the foreign currency reserves, therefore the shrinking of the balance sheet of the MNB because of the self-financing programme contributed to the reduction in sterilisation costs, which improves the central bank results.

The programme had a substantive impact on commercial bank balance sheets, too: the success of self-financing is indicated by the fact that the portfolio of government papers increased significantly within the balance sheets of banks. At the end of last December, government securities made up more than 14 per cent of bank assets, while a year earlier, this ratio was 11 per cent. All this means that banks increased their government paper portfolios not only in nominal sense, but compared to their balance sheet totals, too, i.e. credit institutions actually moved in the direction of state financing. It is favourable that **forint government securities did not drive out forint loans, as the forint loan portfolio of non-financial corporations and households increased between January and December 2014.** Another favourable development is that indirectly, the self-financing programme contributed to the reduction in long-term yields, too.

5 Settlement of foreign currency loans

In June 2014, with the uniformity decision of the Curia, the comprehensive renewal of outstanding and future houshold loan contracts commenced. The Magyar Nemzeti Bank plays a significant role in the formulation of the new legislation and the technical details, in the implementation of the processes and in the controlling of the regular implementation of the final decrees.

The approved legislation will transform the market of consumer loan contracts in three steps.

1. ***Settlement*.** The extra burden generated by the conversion margin and the unilateral interest rate hikes classified as unfair shall be repaid by the financial institutions to their customers according to the methodology defined by the Magyar Nemzeti Bank. The MNB determines the detailed methodology of calculating consumers' claims, the detailed information content to the customers. The controll of these have already started preceeding the settlement.

2. ***Conversion into forint*.** In the case of the foreign currency and foreign currency denominated mortgage loan contracts, household customers' debts remaining after the settlement are converted into forint by the lending financial institutions at the rate fixed by the law. **This way the consumers are saved from the effects of exchange rate fluctuations that have been around since 7 November 2014, including the dramatic market changes of January 2015, related primarily to the rate of the Swiss franc**. The foreign currency required for the conversion into forint was provided by the central bank to the banks.

3. ***Fair banking*.** Looking ahead, the act on the "ethic banking system" facilitates the more transparent amendment of terms and conditions of the credit. The basic idea in the formulation of this regulation is that **the relation between the creditor and the debtor should be symmetric: the consumer should be protected from banks, but the banks should be able to increase the financing costs when it is justified from economic point of view.** All this is facilitated by the interest rate

change and interest rate spread change indicators submitted by the banks, and their compliance with the law is controlled by the MNB.

5.1 THE MNB CONTRIBUTES TO THE SETTLEMENT BY REGULATING AND CONTROLLING THE METHODOLOGY

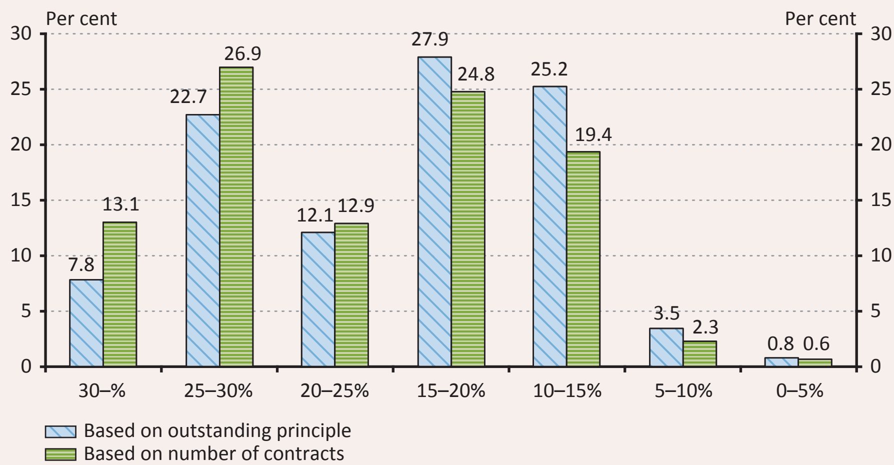
Following the uniformity decision of the Curia, the so-called settlement law defined the fundamental rules of the settlements of overpayments emerging from the terms and conditions classified as unfair. Under powers set by the Act, the MNB added the detailed contents to these rules. **The key principle of the settlement is that consumer's extra payments triggered by the exchange rate conversion margin and the unfair interest rate increases shall be considered as advance principal repayments.** The consumer's final receivables will be the difference between the original debt and the debt recalculated under fair conditions, settling the overpayments as advance repayments. In the case of outstanding contracts, the consumer's receivables shall be settled first against the matured items, then against the not yet due principal debt, while in the case of ceased contracts, the amount will be paid to the customer.

In the estimates of the Magyar Nemzeti Bank, the settlement will mean a refund of approximately HUF 800 billion in the case of the affected foreign currency denominated loan portfolio of the credit institution sector, and almost HUF 950 billion in the total financial intermediary system. This refund can be related almost totally to the 700 thousand foreign currency loan contracts, which altogether mean a portfolio of approximately HUF 3,600 billlion. In the case of the forint portfolio, we do not expect significant claims from the consumers.

As a result of the settlement, the outstanding debt of the debtors will drop by 16-17 per cent on an average, while their instalments – because of the reduced debts and the reinstated fair interest rates – will drop by 20-25 per cent. In the case of performing debtors, the favourable effects of the settlement will be somewhat bigger, but there will be significant differences in their case, too. The impact of the reduced debts on the assets, the decreased repayment burdens, and – in the case of already terminated contracts – the cash payments are expected to increase the annual change in the macro level consumption of households by 0.9 percentage points in 2015, which may have an impact of 0.2-0.3 per cent on the GDP.

The settlement generates a considerable loss for the domestic banking system, but a substantive capital buffer was available to handle the loss already before the issue of the uniformity decision of the Curia, and the parent banks extended that during the year with substantial capital injections – more than HUF 300 billion in 2014 –, ensuring the solvency of affiliate banks.

Chart 7
The dispersion of debt reduction generated by the settlement in the case of performing mortgage loans of Swiss franc base.



Source: Based on data calculated by the MNB.

5.2 THE SETTLEMENT PROCESS IS STRICTLY CONTROLLED BY THE MAGYAR NEMZETI BANK

Under the powers set by the Act, the Magyar Nemzeti Bank controls whether the financial institutions meet the legal regulations stipulated in the act on settlement and conversion into forint and in the orders of the Magyar Nemzeti Bank. The control started already before the settlement: within the frames of a consumer protection theme inspection, the central bank continuously checks the settlement models of individual institutions, in order to ensure the smooth implementation of the settlement (with as few complaints as possible).

The Magyar Nemzeti Bank and the Financial Arbitration Board (PBT) play an important role in the legal remedies of complaints about the settlement. If a consumer has a complaint or a debate with his/her financial service provider about the settlement or the conversion into forint, he/she shall submit it in writing to his bank first. When the bank rejects the complaint, the primary forum of legal remedy is the PBT that operates next to the Magyar Nemzeti Bank. Expecting higher workloads, the staff of the Board has been reinforced, and the customer service department of the central bank (Financial Consumer Protection Centre) is also prepared to receive consumers' claims.

The Magyar Nemzeti Bank supports the work of the PBT and the performance of consumer protection investigations by providing IT development that is suitable for calculating consumer demands. The result of the calculations of the Magyar Nemzeti Bank shall serve as the basis of mediation in front of PBT. This way the majority of law suits initiated at civil courts of law becomes unnecessary, as PBT shall sort out the consumer claims.

5.3 THE MAGYAR NEMZETI BANK PROTECTED THE FORINT MARKET BY PROVIDING THE FOREIGN CURRENCY REQUIRED FOR THE CONVERSION INTO FORINT

The scope of the act on conversion into forint covers household loan contracts of foreign currency denominated, including the ones with repayment actually in foreign currency, and covered by a mortgage. This means 507 thousand contracts amounting to HUF 2,700 billion (amount after the settlement). The conversion of such a high amount into forint also implied that a significant demand for foreign currency was generated as the foreign currency position of the banks opened, and the market would have been able to meet the demand only at the cost of considerable weakening of the HUF exchange rate.

In order to support the conversion process, the Magyar Nemzeti Bank initiated a foreign currency sale programme, in order to ensure that household foreign currency loans are phased out rapidly and orderly, preserving the stability of the financial system, and without actually impacting the HUF exchange rate. The Magyar Nemzeti Bank organized the settlement tenders from October 2014, and in November, the programme was extended to the conversion phase.

In the euro sale tenders, the central bank offered two instruments to its partner credit institutions: an instrument with the condition of reducing short-term external debts, and an unconditional instrument. In the settlement phase, the banks purchased EUR 1.1 billion in the Magyar Nemzeti Bank tenders, and in the conversion phase, the central bank allocated more than EUR 8 billion, i.e. the banks covered the foreign currency needs of household loans almost entirely from the MNB.

In the central bank tenders, the Magyar Nemzeti Bank offered euro to the banks, while more than 80 per cent of the affected portfolio was denominated in CHF. As a consequence, the banks had to cover the exchange rate exposure between the euro and the CHF, and the Magyar Nemzeti Bank drew the attention of the banks to this already at the reconciliation before the conversion, and subsequently, too. As the euro-CHF exchange rate was still stable at the end of 2014, the purchase of Swiss francs did not cause any difficulty for the banking system, therefore the unexpected decision of the Swiss central bank on 15 January 2015 on the cancellation of the exchange rate cap did not cause any problems in the operation of the Hungarian banking system.

The success of the conversion into forint and the related central bank euro sale tenders is proved by the fact the phasing out of foreign currency loans was carried out orderly, without any effective impact on the exchange rate. Another important element of the success of the programme is that in the case of the conditional instrument announced with shorter maturities, the short-term external debt reduction condition, and in the case of the unconditional instrument, the limitation of use with shorter maturities makes sure that the MNB reserve compliance is ensured during the whole term of the programme. As a consequence of the conversion into forint and the related foreign currency sale programme, the Magyar Nemzeti Bank took over the exchange rate position held earlier by the households, and owing to its greater resilience to shocks, it is an important step forward for the whole national economy.

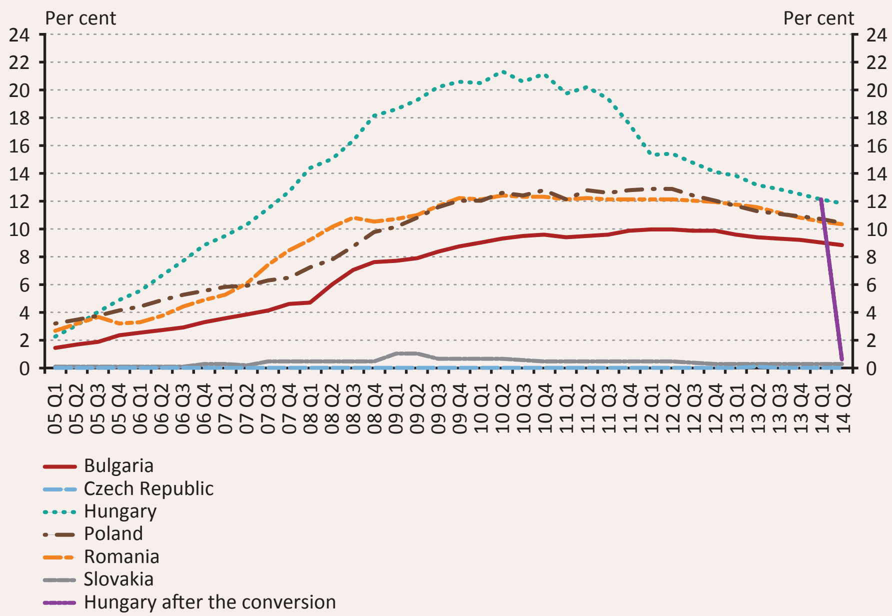
5.4 THE CONVERSION INTO FORINT CEASED THE EXCHANGE RATE RISK OF HOUSEHOLDS UNDER THE SCOPE OF THE LAW

With the fixing of the conversion exchange rate, and given that the banks have converted the due instalments into forint at the fixed rates since 1 January, the conversion into forint was actually carried out at the end of 2014. Following the conversion into forint, foreign currency loans have actually disappeared in the household segment in Hungary, and their ratio within the loan portfolio dropped below 3 per cent from the earlier 55 per cent.[2] Thus the ratio of household foreign currency loans in the banking system is less than 1 per cent of the GDP, which is one of the lowest values in the region.

With the shrinking of the foreign currency loan portfolio to a negligible size, the efficiency of the monetary policy transmission improves, too: on the one hand, as HUF-denominated loans become dominant, the scope of the interest rate channel is extended, and on the other hand, **with the phasing out of the foreign currency loans, if the central bank policy rate changes, the exchange rate channel will not have an impact opposite to the objective of the monetary policy measure**. Earlier, because of the high ratio of foreign currency loans, a restrictive central bank step

[2] Although the law allows for the omission of the conversion, the conditions of omission are so strict that only a small portion of debtors is able to meet them. Following the strengthening of the Swiss franc in January, the ratio of customers deciding to stay with the foreign currency will probably be low.

Chart 8
Household foreign currency loans in the banking system as a percentage of GDP, in regional comparison



Note: banking system data.
Source: MNB, national central banks.

with its strengthening impact on the exchange rate had a reviving impact, in an inverse way, on the consumption of households indebted in foreign currency, while and expansive step may have had the opposite, restrictive impact.

Based on the rapid exchange rate moves in January and the relatively strong level of the Swiss franc since then, a typical debtor won approximately HUF 7-13 thousand per month with the conversion into forint, at the present exchange rate level. At macro level, according to our calculations, through the income effect, in 2015, the extension of consumption would be 0.4-0.6 percentage point lower, and the growth of GDP would be 0.1-0.2 percentage points lower, if the conversion into forint had not been carried out, and if the exchange rate of the Swiss franc remained permanently at the strong level experienced in January and February.

5.5 LENDING RATES MAY BE ALTERED ON THE BASIS OF INDICATORS ASSESSED BY THE MAGYAR NEMZETI BANK ONLY

The act on fair banking, as approved by the Parliament – together with the settlement and the conversion into forint – brings a fundamental change into the future pricing methods of the household loan segment. According to the new rules, the loan interest rate may be modified only in the extent that the indicators accepted by the MNB change, and the customer is able to check it against the time series published on the website of the MNB. Indicators may be divided into two large groups: (1) the interest rate is fixed for a 3-year interest rate period at least, and at the end of the periods, the interest rate may change according to the given indicator, and (2) products linked to reference interest rates, in the case of which the loan interest changes according to the changes in the selected reference interest rate, and the interest rate spread may be modified at the end of a period of minimum 3 years.

With the new legal regulations, the previous pricing principles of the banks that were disputed from consumer protection aspects will be replaced by a transparent, controllable and symmetric practice. In justified cases, the indicators that primarily cover the changes in funding costs and regulatory burdens allow the banks to increase the interest rates, but they may also force the reduction of the rates if the contrary happens. The significance of this symmetry is illustrated by the development of the repayment burden of households indebted in Swiss franc in recent years. With the onset of the financial turmoil in 2007-2008, and then the deepening of the crisis, the lending rate hikes by the banks were partly justified from an economic point of view, but – based on the re-tracing of applicable indicators – not with the permanence and to the extent that actually occurred.

At the same time, the fair banking regulation allows that on the borders of interest periods – if the interest rate changes adversely for the consumer – **the customer may terminate the loan contract free of charge, and may refinance that**. The possibility of terminating the loan contracts free of charge boosts the competition, therefore puts a pressure on average interest rates, which is a positive impact on the income position of households. In addition, it is important to mention that with the introduction of the fair banking rules – especially in the case of products linked to reference interest rates – it is ensured that in the pricing of the financial institutions, the impact of monetary policy transmission is realized in a symmetric way, thereby reinforcing the efficiency of monetary policy.

6 The macroprudential instruments of the Magyar Nemzeti Bank

At the end of 2013, the domestic financial supervisory framework was fundamentally transformed from two aspects: on the one hand, the authority performing individual supervision over the institutions was integrated into the central bank, and, on the other hand, the Magyar Nemzeti Bank was given strong powers to act in a timely and effective manner against system-level risks similar to the spread of foreign currency lending. This is the so-called **macroprudential authority**, which allows the central bank to mitigate the build-up of risks that are harmful for the national economy as a whole, and to encourage that the economy financing ability of the financial system would be sustainable over the financial cycle. Utilizing this power, **in 2014 the central bank introduced two macroprudential regulatory instruments of high importance**: new debt cap rules were stipulated, and the Foreign Exchange FundingAdequacy Ratio (FFAR) regulating the foreign currency maturity position of credit institutions was renewed. The following sections present these tools and their expected effects.

6.1 DEBT CAP RULES

The households' debt overhang is a harmful process from macroeconomic, financial stability and social aspects as well. On the one hand, it may trigger the development of serious imbalances (e.g. property price bubbles), and on the other hand, it may require more adjustment by the banks in the times of economic downturns. The foreign currency indebtedness of households increases the external vulnerability of the country, too, as the loans are usually backed by external foreign currency funds. Finally, the foreign currency debt overhang of households entails a serious social problem, too, as the number of households that are unable to repay their loans may rise, and this may lead to evictions. In Hungary, a high number of families were actually caught in a debt trap because of household foreign currency loans extended from 2003 to 2008.

As a macroprudential authority, the Magyar Nemzeti Bank **formulated a new decree in 2014 to prevent the excess outflow of household loans**. The new regulations that came into force on 1 January 2015 shall be applied for each new loan extended in the territory of Hungary. The new regulation that was reconciled in advance with the market participants and ECB consists of two main pillars. The payment-to-income ratio indicator limits the repayment burdens that can be assumed with new loans in a certain ratio of the regular certified legal incomes of customers, and thus reduces the indebtedness of customers. The loan-to-value ratio indicator limits the size of loans that can be taken in the ratio of the value of collaterals, in the case of collaterised loans (e.g. mortgage loans).

The payment-to-income ratio shall be examined whenever a loan over HUF 200 thousand is taken (consumer loan, mortgage loan, vehicle loan etc.). In this indicator, beside the burdens of the new loan, it is necessary to consider the repayment burdens of all existing loans of the customer, and only the certified legal net income can be considered as disposable income (wage, pension, family allowance etc.). This may clearly facilitate the whitening of the economy, because as of 2015 loans can only be taken with certified legal income . In the case of multiple co-debtors, incomes and debt burdens are to be handled in aggregation.

Table 2
Maximum payment-to-income ratio and loan-to-value ratios

		HUF	EUR	Other currency
Payment-to-income ratio	Below a monthly income of HUF 400 thousand	50%	25%	10%
	Monthly income of HUF 400 thousand or more	60%	30%	15%
Loan-to-value ratio*	For mortgage loan	80%	50%	35%
	For vehicle loan	75%	45%	30%

** Regarding the financial lease, loan-to-value limits are 5 percentage points higher.*
Source: MNB

In the case of new forint loans taken after 1 January 2015, **the payment-to-income ratio indicator may not exceed 50 per cent, and in the case of customers with high income** (net income of HUF 400 thousand or higher), **it may not exceed 60 per cent**. Regarding new loans taken in euro and other foreign currencies – offsetting the negative impacts of a possible exchange rate depreciation –, much stricter payment-to-income ratio limits were stipulated: 25 per cent and 10 per cent, and in the case of customers with high income, it is 30 per cent and 15 per cent. With these limitations, **the repeated spread and increase in foreign currency lending can be excluded**. As far as loan-to-value ratios are concerned – in order to ensure continuity in regulation – the MNB decree basically took over the presently valid rules.

In the present market environment, because of the more comfortable limits applied for forint loans, the new regulation is not expected to actually restrict lending. However, on a longer term – in more overheated phases of the financial cycle – it may significantly limit the indebtedness of households and the related risks. An important element of the regulation is that in case the Magyar Nemzeti Bank as a macroprudential authority detects too high household loan dynamics in the future, it will tighten the limits in countercyclical way. Thus **the newly introduced macroprudential tool will probably facilitate a household loan outflow that is sustainable on the long run, too, and prevent the building up of loan portfolios that are risky at system level**, strengthening the stability of the domestic financial system.

6.2 MEASURE REGULATING THE FX MATURITY POSITION OF CREDIT INSTITUTIONS

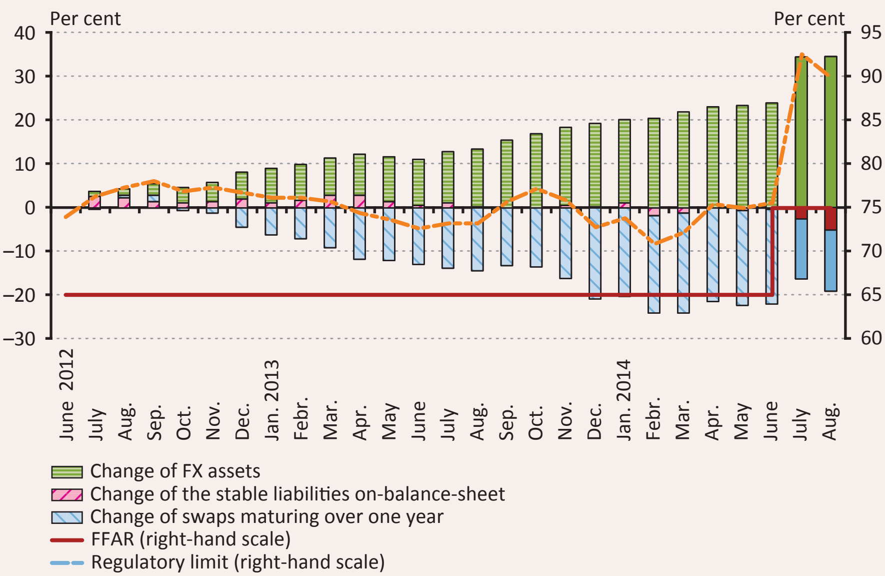
During the financial crisis, the short-term foreign currency debts of the domestic financial intermediary system significantly contributed to the external vulnerability of the Hungarian economy. The indebtedness of the private sector – especially the households – in foreign currency in the years before the crisis, and the related financing pattern of the banks generated too big maturity and currency denomination mismatch in the balance sheet of the banking system. This phenomenon, which is unfavourable from macroprudential aspect, too, has not stopped even in the acute phase of the crisis, as the banks, primarily for profitability reasons, ensured their foreign currency needs with instruments of ever shorter maturity, including short-term foreign currency swaps.

Therefore, in order to mitigate system-level liquidity risks, as of July 2012, similarly to the Net Stable Funding Ratio worked out by the Basel Committee, but considering domestic features, too, the Foreign Exchange Funding Adequacy Ratio (FFAR)[3] was introduced, and it stipulated that **banks shall cover at least 65 per cent of their long-term foreign currency assets from stable foreign currency denominated funds.** FFAR is the quotient of stable foreign currency denominated funds and the long-term net foreign currency swap portfolio, and the weighted portfolio of foreign currency assets to be financed, therefore it is able to handle both the in-balance and off-balance sheet foreign currency position maturity mismatch problems. The experiences of the period since the introduction showed that **the former regulation was able to stop the deteriorating trend in respect of the shortening maturity of foreign funds, but it was unable to further improve significantly and gradually the foreign currency denominated maturity mismatch of the banking system**.

[3] Government decree 366/201. (XII. 30.) on the definition of the liquidity level of credit institutions and the regulation of the foreign currency denominated maturity position . -

The Magyar Nemzeti Bank, already as a macroprudential authority authorized to stipulate the requirements regarding the maturity and FX denomination position of banks[4], as a result of the full review of FFAR, adopted a new decree being effective as of July 2014[5]. The new decree resulted in changes in the composition and the expected level of FFAR, and in the scope of application of the regulation. The change in the composition of the indicator was justified by the need to get closer to international regulatory standards, and by economic reasons (net calculations instead of gross approach). In addition, the expected minimum level of FFAR was modified, too, as the compliance obligation grew from the original 65 per cent to 75 per cent as of 1 July 2014, then in each half-year, it will grow by 5 percentage points, **and will reach 100 per cent by 1 January 2017**. While the announced higher initial level was justified by partial easing measures originating from the changes in composition, the gradually tightening course regarding the minimum requirements **was justified by the need to ensure the smooth adjustment of the institutions to the international standards and the needed continuous reduction of external**

Chart 9
Development of the Foreign Exchange Funding Adequacy Ratio (FFAR) and the decomposition of its changes



Source: MNB

[4] Act CXXXIX of 2013 on Magyar Nemzeti Bank.
[5] MNB resolution on the regulation of the foreign currency denominated maturity position of credit institutions, No. 14/2014. (V. 19.) MNB resolution.

vulnerability. Finally, the scope of application of the regulation was extended to cover the Hungarian branches of foreign credit institutions, too, which improves the efficiency of FFAR, and reduces the chance of regulatory arbitrage.

As a result of the regulation, the liquidity and funding systemic risk stemming from the extreme maturity mismatch of the foreign currency denominated position of the banking system, as well as the related external vulnerability have been effectively mitigated. In line with that, the central bank's obligation to keep foreign exchange reserves has eased, just like the related costs which indirectly burdened the government budget. The macroprudential regulation was established in line with other objectives and steps of the central bank, among other things, it contributed to the success of the Funding for Growth Scheme, too, in which – improving the foreign currency and maturity mismatch of the banking system – the participants may undertake long-term forint liabilities.

As far as household foreign currency loans are concerned, what were in the focus of financing risks targeted by FFAR, the government has taken significant steps (settlement because of exchange rate gap and unilateral contract modifications, conversion into forint). As a result, **practically the whole portfolio of household foreign currency mortgage loans will be converted in Q1 2015**, which, on the one hand will significantly reduce the stable foreign currency funds requirements, and, on the other hand, it will considerably decrease the average maturity of the remaining foreign currency assets to be financed. This way the denomination and maturity problem of the financial system will be mitigated, but will not be completely eliminated. Based on these developments, it may become necessary to re-consider the regulatory requirements of both foreign currency and forint stable financing.

7 Integration of financial supervision

Following the amendment passed on 16 September 2013 to the MNB Act, the Parliament empowered the Magyar Nemzeti Bank to perform financial supervisory authority tasks as of 1 October 2013. **In order to ensure the security of the financial intermediary system, the Financial Stability Board set up within the MNB monitors the stability of individual financial institutions and the system as a whole, and uses the whole set of tools available to the MNB to prevent and terminate imbalances and deviations.**

In the course of the integration, **the MNB became a complex supervisory authority which is able to ensure system-level and institution-level financial stability, and is able to manage both macroprudential and microprudential risks more efficiently**. In addition, in the course of making monetary policy decisions, the central bank is able to consider the experiences gained in its supervisory activities, and may rely on its unique institutional knowledge in the microprudential area. **The more efficient financial supervision established this way brings specific macroeconomic advantages**, because the central bank is able to eliminate the problems that hinder the well-balanced operation of the real economy and that involve financial stability risks in a faster and more efficient way.

The MNB introduced a new approach and a continuously renewing methodology in the supervision of financial institutions. The key elements of the first are the forward-looking approach, the application of maximum rigour against deviations, and the active forming of the market through resolutions and recommendations. The renewal of the methodology covers, for example, the evaluation of the sustainability of business models, the control of the asset quality according to ECB standards, and more emphasis on the on-site controlling of data coming in from supervised institutions.

As a result of the integrated set of supervisory tools, **the more efficient inspection activity and supervision of institutions revealed critical problems in the case of several credit institutions**. The MNB used the extended scope of action with determination, and acting more rigorously than before, it took exceptional measures in the case of several institutions in 2014. Among other things, the operation licences of Körmend és Vidéke Takarékszövetkezet and Széchenyi Bank have been revoked. These decisions already reflected the new approach of the MNB, as supervisory commissioners were assigned and the licences were revoked already before the development of illiquidity – and the build-up of further risks. In the spirit of market clearing, the MNB is revoking the operation licences of intermediaries that have no liability insurances.

The stricter supervisory action was reflected in the penalty payments, too, that were significantly higher than in the previous period: because of the infringements disclosed in the prudential examinations, the MNB has imposed fines of HUF 390 million in total since the integration and in the area of market supervision, fines of more than HUF 2.8 billion were imposed before 1 October 2013. The MNB imposed a market supervision fine of HUF 250 million on Civis Globál Brókerház for unauthorized portfolio management, and in the case of Fortress, a fine of HUF 1.25 billion was imposed for unauthorized activities.

The consistent series of inspections of the MNB with the purpose of clearing financial markets and the new supervisory methodology allowed the central bank – which took over the role of financial supervisory authority only 16 months earlier – to reveal the series of frauds in February 2015 that had been going on for fifteen years at Buda-Cash Brókerház. The key of the change in the methodology is that in addition to controlling the data supplies of supervised institutions, the MNB **places more emphasis on the on-site examination of market participants**, and inquires and requests the production of records and detailed account data on the site, this way they cannot be changed or forged. In addition, the MNB introduced the immediate saving ("mirroring") of the whole IT dataset of market participants in its supervisory inspections – as it has already proved its value in market surveillance procedures –, and the microlevel examinations are prepared by considering the macrodata regarding the given market.

As a result of the integration examinations carried out in the course of the implementation of the integration of savings banks, the MNB revoked the operation licences from Széchenyi Hitelszövetkezet, Alba, TISZA and Orgovány és Vidéke Takarékszövetkezet. The due-diligence procedure carried out at Takarékbank revealed serious deficiencies that had been there for several years in each case. The removal of illegally operating participants from the market is a pre-condition of strengthening the trust of customers and establishing a fair competition.

Beside credit institutions, the transformation of the supervision was commenced for **insurance companies, funds, financial enterprises and intermediaries**, too, last year. The elimination of the build-up of risks and the establishment of the desirable market behaviour became key considerations in these cases, too. In order to establish a transparent service palette, spread modern self-care solutions and stimulate the competition on the market, the MNB issued a pension insurance recommendation, in which it formulated its requirements against the characteristics of pension insurances, including the level of maximum chargeable coststo customers.

With the integration of the supervisory tasks into the central bank, **the MNB revalued its consumer protection role, too**. The focusing on these tasks is supported by the recognition that prudently operating institutions in themselves are not enough to maintain a stable financial system. Trust is also essential for the maintenance of financial stability. The strengthening of public trust, as a central bank task is named specifically in the MNB Act, and it is mentioned in the supervisory strategy, too, as a central value. The consumer-friendly and "fair" institutional behaviour is a business interest, there is no sustainable institution without satisfied consumers. **Taken together, the trust placed in the financial institution system is a national economy interest.**

One of the key elements of restoring trust is firm financial consumer protection action, the efficient control of the enforcement of consumer protection rules and their uniform observing by financial institutions. **Therefore, in addition to remedying individual infringements, the MNB focused on the comprehensive and system-level management of consumer protection problems**: the central bank conducted a number of theme examinations targeting problems identified on the basis of complaints and contacts, covering all financial institutions of the sector.

In the case of revealed infringements, the MNB always gave a firm and really deterring answer. According to the new and stricter policy on sanctions and fines, the present fines applied for various cases may mean the imposing of sanctions with amounts twice, five times or even ten times higher than before in the case of institutions committing infringements. Since the integration, consumer protection fines of 2.2 billion have been imposed.

Among the examinations, it is worth highlighting the series of examinations related to unilateral fee increases, in the course of which consumer protection fines of HUF 1.86 billion were imposed on banks, and they were obligated to perform reparation. Also, as a result of examinations carried out in the subjects of increased fees and charges, and casco fees charged in foreign currency, the MNB imposed a considerable amount of fine, and ordered the repayment of the extra income originating from the illegal behaviour to the consumers. The effects of these measures were directly felt by tens of thousands of consumers. Owing to the consumer protection examinations of the MNB, the internal regulation on complaint management improved in several institutions, and financial institutions pay more attention to observing the deadlines and to the quality of complaint management.

Naturally, the renewal of consumer protection means more than firmer action. It is not the intention of the MNB to use fines to set the directions, **it would rather place the emphasis on preventive consumer protection in the future**. One of its elements is continuous cooperation with the institutions, and the maintenance of consultation (Consumer Protection Forum, professional days). On the other hand, **efficient consumer protection communication is a key task**, as well as the informing-educating activity with the purpose of extending consumer awareness, and the Financial Consumer Protection Centre was set up for the efficient performance of this activity, separately from the official area, and in parallel with the integration. A key objective of the Centre is to effectively handle the contacts and submissions, operate a high-level customer service unit, strengthen the provision of information and improve national coverage and the direct access of consumers. For the sake of providing clear information to customers, and developing the financial awareness and the financial literacy, the Centre has launched the Financial Navigator – information leaflet series, in which the improvement of consumers' risk- consciousness also plays a key role.

8 New chapter in the history of developing domestic financial infrastructures

In the two years since 2013, significant changes took place in the operation of the domestic financial infrastructures and in the pricing of payment services. Bearing in mind the economic interests of the household end-users of these infrastructures, **the central bank launched several projects which contributed to a reduction in the fees of payment services and to an increase in the level of services**. Among these projects, it is worth highlighting the acquisition of **GIRO Zrt. in the first half of 2014, the redefinition of the strategic focus of the company**, and **the facilitation of the reduction in the interchange fees related to bankcard payments within the frames of legislation**. We can say that in the past two years, the MNB was able to use ownership rights and regulatory tools efficiently, and was able to find answers to questions that had been the subjects of endless debates among stakeholders before.

The triple objective identified in connection with the acquisition of GIRO Zrt. clearly reflects the strategic directions of the central bank, and also sets the directions for public thinking on domestic financial infrastructures. These objectives are as follows: **to facilitate the reduction in fees to be paid by end-users, to increase the efficiency of developments in the field of payments, and to keep the basic financial infrastructures in national ownership**. Bearing all this in mind, in early 2014, the MNB took steps to become the exclusive owner of GIRO Zrt. by increasing its existing share of 8.09 per cent ownership to 100 per cent. Until April 2014, 76.52 per cent of the shares of the company were owned by five large owners, and the MNB shared the rest with 15 commercial banks. As a result of several rounds of discussions with the previous owners, first the large owners, then the small owners decided to sell their shares in GIRO Zrt. to the central bank. **The acquisition of the company fulfilled the expectations already on the short term, as GIRO Zrt. reduced the fee of the clearing service by twenty per cent as of 1 January 2015**, and accepted a detailed strategy on the development of this service.

The development strategy of GIRO Zrt. contains plans which are in line with the professional objectives of the MNB and also the international development trends of the industry. Therefore it contains objectives like **making payment account switching easier or creating the system of instant payments.** The rollout of the intraday clearing of electronically submitted payment transactions in forint was also implemented with the regulatory support of the central bank, and the ownership relation established in 2014 allows for an even closer cooperation for the MNB and the GIRO Zrt. **The establishment of a competitive pricing policy for the company, the related increase of cost efficiency**, and the identified directions of service development form a framework in which the efficient operation of the company can be ensured on the long term for households as end-users. The company's management by the central bank does not have a long history yet, but the MNB will definitely rely on GIRO Zrt. in the implementation of its objectives relating to payments. As one of the first steps of the professional cooperation, in the course of 2015, **the operating hours of the platform that performs the intraday clearing of household forint payment transactions will be extended, the clearing cycles will be made more frequent, and these developments will result in a substantive improvement in the level of the service provided by the company**. As a result of the changes, more time will be available for the execution of payment transactions during the day, and the processing time of transactions from the payer to the payee can also be shortened. The MNB will contribute to the successful implementation of the project of GIRO Zrt. by providing the necessary infrastructural and operational background.

Another **important regulatory development is the statutory definition of the maximum rate of interchange fees related to bankcard payments**, and the MNB played an important role in the professional preparations of the new regulation. The regulatory concept worked out jointly with the Hungarian Competition Authority came into force on 1 January 2014, therefore, presently, the maximum rate of fees and commissions paid by the payment service provider of the payee to the payment service provider of the payer is 0.2 per cent for debit cards and 0.3 per cent for credit cards. The purpose of the regulation is to support the expansion of the network of card acceptance, to make the use of cards widespread in retail trade, and to step up the competition among card companies operating on the Hungarian market. It is fair to say that the creation of this regulation means an important step toward the achievement of all these objectives, and the importance of the concept is confirmed by the fact that the European Union is planning to introduce a regulation with the same rates as the Hungarian ones.

So there were significant changes in connection with the domestic financial infrastructure in the past two years, and the MNB has always acted as a catalyst for development, focusing on the efficiency of the system. The central bank considers that this role is still important, therefore it is planning to complete further development projects in the future.

9 Resolution activity of MNB

Credit institutions and investment firms operate a number of functions that are fundamental and critical from the aspect of the economy (e.g. collection of deposits, lending, payment services, involvement in raising funds on capital markets, management of investments). When these functions are seriously damaged or become non-executable, it has negative consequences not only for the financial stability, but for the national economy as a whole.

The economic crisis that started in 2007 highlighted the fact that in a crisis situation of financial institutions that are important at system level the maintenance of critical functions in the USA and Western-Europe was often possible only through state financed bank rescuing measures, which involved the utilization of taxpayers money and in worse cases a significant increase in the affected nation's public debt (the amounts required for bailing-out banks were raised by issuing government bonds).

The Member States realized that the existing framework, without permanently using public money, was not suitable neither for the prevention of banking crises, nor for the efficient management of already emerged crises, consequently the elaboration of new solutions became necessary. The solution is the **resolution framework which enhances the crisis resilience of financial institutions in times of peace, moreover, in case of crisis situations it ensures the maintenance of critical functions and by its strong regulatory powers the reorganisation of the financial institution in trouble**, financed by the financial sector and without relying on taxpayers' money.

The Hungarian government recognized in time the significance of resolution as an alternative crisis management tool, and taking precedence over a number of Western-European countries, established the resolution authority role as of 1 October 2013, with the provision of assigning the Magyar Nemzeti Bank to perform that role. Following the publication of the legal framework of resolution in the EU in 2014, among the first countries in Europe, the resolution powers of the MNB were regulated in domestic law. These powers are relatively strong since they might as well ensure, with proper safeguards, the takeover of ownership rights of financial institutions. Within this framework, the Resolution Fund was set up as a new element of the domestic financial stability safety net, which is filled up from the payments of market participants and ensures the market financing of crisis management. **The financing burden of the management of bank crises** – similarly to the "pollutant pays" principle known from environment protection – **will be charged on the sector itself**, **and public money can be used only on a temporary basis, to a minimum extent, under a repayment obligation increased with a yield**.

In December 2014, the MNB placed the MKB Bank Zrt under resolution, which albeit had a satisfactory capital and liquidity position, the Bank Group generated significant losses. Therefore and for the sake of future compliance with prudential expectations, **the reorganisation of the Bank was initiated immediately** by the appointed resolution administrators and jointly with the management of the MKB. In terms of the decided restructuring, the MKB Bank is accelerating the separation of bad portfolio elements which have played a significant role in generating losses in the recent years. Simultaneously with the portfolio cleaning, the restructuring of the Bank Group and cost cutting measures are being executed, inlcuding the decision on the 30 per cent reduction of the Bank's vehicle fleet as a first step. During the reorganisational process, the necessary personnel changes in the management have been performed, and it is now being reinforced with acknowledged professionals. The MNB – in cooperation with the MKB management – will ensure a smooth reorganisational programme with every instrument at its disposal, which means that **this programme will be carried out in such a way not to affect the continuity of banking services**.

The MNB is unremittingly working on the enlargement of its international resolution relations for the sake of fully enforcing the positive effects of resolution even in a crisis situation of internationally active financial institutions, affecting several countries.

Through its function as resolution authority, the MNB does not only serve the maintenance of financial stability, but **by charging the costs of crisis management on the financial sector,** it will make sure **that the crisis phenomena in the financial sector do not jeopardise the national economy**. In addition, by ensuring the continuous availability of fundamental financial services required for the growth of the economy (e.g. lending, payments), it has a positive impact on the whole national economy.

10 The Central Bank Renminbi Programme (JRP)

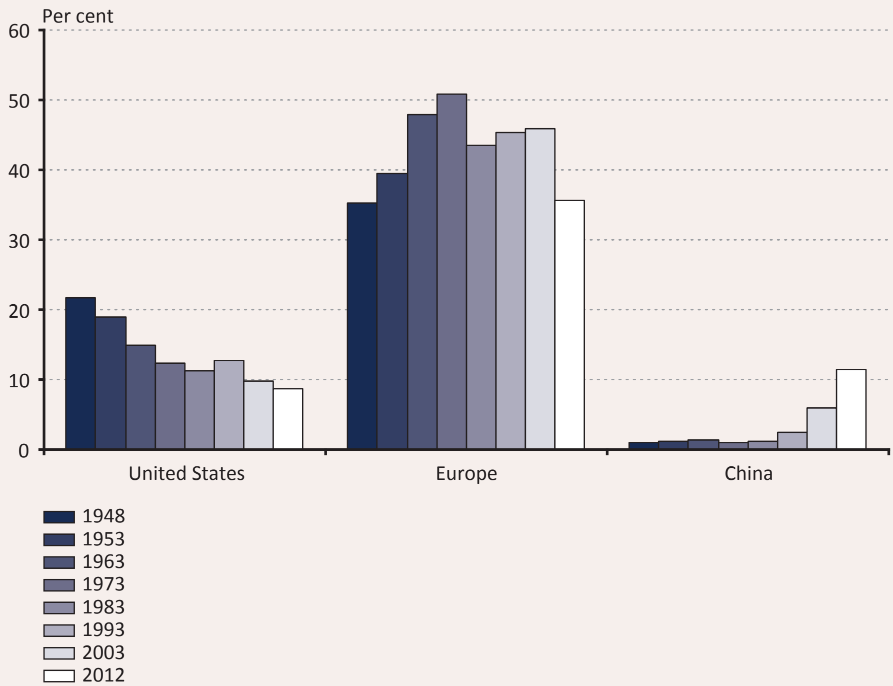
In connection with the foreign exchange swap agreement concluded in September 2013 with the People's Bank of China, the Magyar Nemzeti Bank announced the start of the Central Bank Renminbi Programme (JRP) as of 19 February, 2015, the first day of the Chinese New Year. Increasing the weight of the renminbi, the Chinese currency, in international settlements is a high-priority objective of Chinese economic policy, which is supported, from the side of foreign partners, by a series of government and central bank steps.

By today China has become one of the most important foreign trade partners of the European Union. In parallel with the liberalisation of the Chinese capital account and exchange rate regime, the transformation of the Chinese savings portfolio and financing structure can provide financing and diversification opportunities to the countries of the EU. Hungary plays a special role with respect to the Chinese relations in the region: thus far Magyar Nemzeti Bank is the only central bank in Central and Eastern Europe that concluded a foreign exchange swap agreement with the People's Bank of China, Hungary is where the only Chinese commercial bank operates in the region, and in recent years Hungary has become one of the most important regional target countries of Chinese working capital inflow and migration.

China carried out a number of foreign trade reforms in the past decades. The liberalization of the foreign trade generally followed the earlier practice of other emerging countries, the first step was the elimination of restrictions on current account settlements in order to obtain membership in WTO in 2001, then the capital account was gradually liberalized. **As a consequence, China's weight in international trade settlements has grown significantly, and in little more than two decades, it reached 10 percent by 2012.**

Reviewing the steps of ESCB central banks participating in renminbi settlements, the MNB has started the development of the financial infrastructure and institutional structure in the framework of the Central Bank Renminbi Programme. All this may facilitate the utilisation of advantages stemming from the increase in the international weight of the renminbi and it may generate cross-border market

Chart 10
Share in global exports
(%)



Source: WTO

activity and income for Hungary and the region, stemming from the regional role of Budapest.

In the framework of the Central Bank Renminbi Programme (JRP), MNB will examine the following questions in 2015:

- **Renminbi foreign exchange reserve portfolio:** Investigation whether a small portion of the foreign reserves could be invested in renminbi assets. Investigation of the implementation issues of a possible renminbi portfolio (advantages and disadvantages of onshore or offshore investments, etc.). Investigation of the funding of the possible renminbi portfolio (conversion, issuance of bonds, etc.) Negotiations on Chinese investment quotas.

- **Central bank renminbi liquidity instrumet for the case of market disturbances**: Investigation whether renminbi liquidity instruments can/should be applied.

Investigation of the implementation issues and conditions of possible liquidity instruments. (maturity, interest rate, collaterals, settlement, partners etc.)

- **Development of the renminbi settlement and clearing infrastructure:** Planning of the clearing and settlement infrastructure and elaboration of the related Memorandum of Understanding. Supporting the appointment of the official renminbi clearing bank.

- **Financial stability and supervisory aspects related to the use of the renminbi and the cross-border activity of Chinese banks:** Investigation of the risks related to the increasing renminbi market activity and monitoring of Chinese credit institutions, especially with regards to cross-border activity and to risks stemming from contagion and imbalances of the Chinese financial system. Cooperation with Chinese supervisory authorities and strengthening of the supervisory coordination and information sharing procedures.

In connection with the Central Bank Renminbi Programme, the Magyar Nemzeti Bank will start the Budapest Renminbi Initiative in 2015. The purpose of the initiative is to expand the investment range and financing sources of Hungary. The important goals of the MNB with the programme are the creation of money, foreign exchange and capital market infrastructures, the development of the settlement system, and starting negotiations about Chinese capital market permits with the involvement of financial, corporate and government participants related to renminbi settlements.

11 Renewal of the forint

The payment transactions of economic agents are typically carried out in electronic way or in cash. Although electronic payments are gaining ground, international research and the estimates based on them confirm that **cash is still an important element of the operation of the economy, and thus of our everyday life**. With its cash logistics activity, the central bank plays a key role in the operation of the cash supply chain: through its affiliates, it arranges for the production of new banknotes and coins that are required every year, and releases them into circulation in different ratios for each denomination, in the course of payment transactions.

Looking back at the initial decades of the history of the forint, we can say that in line with the technical development of that age, the requirements against banknotes were far less complex as nowadays. The first decades that were peaceful from the issuer's point of view were followed by an era characterized by the rapid development of information technology and multiplying devices, turning the world of banknotes upside down and demanding constant renewal. **Conditions influencing cash circulation raise complex and new demands for the central banks.** We have to keep pace with the technical development that determines our age in a way that the banknotes are able to facilitate the smooth operation of cash circulation for all stakeholders, be it the population, a cashier or a banknote handling machine.

On 11 June 2013, the Monetary Council of the MNB as a result of complex consideration of many aspects, including all the dimensions of cash turnover requirements decided to renew the forint banknote series presently in circulation, i.e. **to issue banknotes that are re-designed and improved in the respect of both security elements and appearance**.

Following the experiments and tests related to the developments, as well as the careful and wide-ranging reconciliation with the participants of the cash cycle, the **professional programme was launched at the end of 2014, with the appearance of 10 000 forint banknotes in cash circulation**. The motto of this issue programme is "Development and tradition". The appearance of the renewed banknotes reflects both the necessary development stemming from user requirements, and the values we wish to preserve, the old graphic traditions of Hungarian banknotes, the carefully drawn portraits and the pictures on the backs. The banknote paper is produced by Diósgyőri Papírgyár Zrt., and the banknotes are printed by Pénzjegynyomda Zrt.

In the banknote replacement programme to be implemented in 2014-2018, the Magyar Nemzeti Bank determined the schedule of issuing the individual renewed banknote denominations and withdrawing the denomination versions currently in circulation in a way that it is adjusted to the replacement needs of available central bank banknote stocks, and requires additional production of presently used denomination versions to a rational extent only, and ensures a smooth adjustment for the participants of cash-cycle. Considering all these points, the issue of the 10 000 forint banknotes in 2014 can be regarded successful, because during the three months that followed their release – until 28 February 2015 – 30% of the denomination portfolio (35 million pieces) has been replaced for the new banknotes.

ACHIEVEMENTS OF THE MAGYAR NEMZETI BANK 2013-2015

2015

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