INSURANCE, FUNDS AND CAPITAL MARKET RISK REPORT

2019

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

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

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2019

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Pursuant to Act CXXXIX of 2013 on the Magyar Nemzeti Bank, the MNB supervises the financial intermediary system in order to ensure, amongst other things, the smooth, transparent and efficient functioning of the financial intermediary system, to foster prudent operations, to identify undesirable business and economic risks, to protect the interests of users of financial services and to strengthen public confidence in the financial intermediary system. Consistent with those tasks and in accordance with Article 135 (2) of the Act, the MNB has prepared this risk report, which presents key characteristics and risks of insurance companies, funds, intermediaries, non-banking group entities and markets of capital market participants.

The Report incorporates input from the Financial Institutions Supervision Executive Directorate, the Consumer Protection and Market Supervision Executive Directorate and the Directorate Methodology.

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

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Executive Summary

Gross assets of Hungarian households continued to grow in 2018 as well, primarily contributed to by the rise in the value of the stock of dwellings. The low yield environment is a lesser incentive for long-term saving, and thus households give preference to assets that may be easily converted into cash in the short term. The proportion of cash within financial assets is still outstanding, and it recorded the most dynamic growth.

The premium income of the insurance sector was able to rise further from the record high of HUF 1,000 billion registered in 2017; the premium income growth in 2017 and 2018 substantially exceeded the growth rates of the past 10 years. The after-tax profit of the sector reached a record high in the past 16 years. All this can be regarded as outstanding growth, but it still lags behind the expansion of the economy and the convergence path. The realised profit is attributable not only to the rise in premium income, but also to the parallel decrease in claim charges. While economic growth, rise in the volume of GDP and compliance with the inflation target represent a favourable market environment due to the low yield potential, which may be guaranteed by insurers in the life insurance segment, development in demands for traditional products is moderate and in the non-life segment the profit realised on invested assets is low. The aggregate market capital adequacy ratio, showing the sector level capitalisation rate, stabilised over 200 percent, i.e., at double the statutory value.

On the life insurance market, the premium income of regular premium life insurances grows steadily, but this growth trend is not followed by the number of contracts; despite the rising number of economically active persons, the increase in the number of contracts came to a halt. The potential self-provision candidates are approached less successfully; moreover, in the low-yield environment the satisfaction of other consumer demands, such as house purchase, enjoys priority. The trend decline in the regular premium new acquisitions is presumably attributable to the Hungarian and European regulations introduced in the past years (ethical regulation, IDD, PRIIPs); however, a sounder and more balanced structure due to the strengthening of pension insurance and risk life assurance will presumably result in better retention ratios and a more sustainable model than seen before.

The over 10 percent growth of the non-life sector, registered in 2018, is even higher than in the previous years. This growth was primarily attributable to compulsory motor third party liability insurance, still being the largest segment, which rose both in terms of number of contracts and premium. The growth in claims still justifies rising premiums. The main question for 2019 will be the impact of the integration of 30 percent accident tax on the premium. First experiences from January showed that the insurers charged this impact onwards to customers only to a lesser degree, and thus the risks of this business segment should be taken into account primarily in terms of stability. The premium income of household and commercial property insurances and casco increases at a much slower rate. At the latter, the improving trend in the new cars put into service for the first time in Hungary may help improve the growth in the casco portfolio. Travel insurance is also worth mentioning, which recorded the most dynamic growth. The loss ratio of household property insurances developed very favourably, also contributed to by the year passing without any major natural disasters. The accompanying high profitability may encourage several insurers to enter this segment; however, the households' price sensitivity is low in this insurance segment, which facilitates price competition and the changing of insurer to a lesser degree.

There was a decrease in the number of natural person intermediaries both among the financial market and insurance intermediaries; in parallel with this, a rise in revenues and major increase in efficiency can be observed.

The number of the institutions in the voluntary funds sector continued to decrease as a result of merger due to a decline in employer revenues and dissolutions. The number of members slightly decreased in the voluntary pension fund sector, partly caused by a stagnation in the number of new entrants and partly by a rise in the number of those who cancelled their membership due to using the pension benefit. In the case of the health and mutual aid funds, the number of members rose despite exclusions due to non-payment. At the voluntary pension funds, owing to the GDP and wage growth, the amount of individual payments increased, also contributed to by the rise in the employers' membership fee credited, facilitated *by the change in the law easing the burden on the employers' voluntary fund contribution. However, the negative yield results led to major revenue shortfall. In 2018, they realised an asset-weighted average net yield of -1.8 percent at sector level, primarily due to increased volatility on the international markets and secondarily due to the loss of -1 percent on the domestic bond and equity investments. However, when examining it in the longer run, the results are still good; e.g., the 10-year average yield is over 7 percent, while the real yield exceeds 4 percent. The higher membership fee income in 2018 was able to compensate not only the less favourable yields, but also the higher disbursements from the coverage reserves.*

At the health and mutual aid funds, the membership fee incomes still failed to reach the band of HUF 50-60 billion, which was typical until 2016; however, the major decline in employers' payments was mostly offset by a dynamic growth in individual payments. As a consequence of the phenomenon, the ratio of non-payers also continued to increase. The operating result at sector level turned negative in 2017, and 2018 brought no positive result either. The underlying reason for this phenomenon is that, due to the negative yield results, the yield deductions in respect of the non-payer members were substantially lower, which led to major revenue shortfall. In the reporting year, in 11 out of the 21 health and mutual aid funds, the operating revenues were lower than the operating expenditures.

It represents a risk for both business lines that the cancellation of tax allowance on the contribution to the funds as fringe benefit, effective from 2019, may have substantial negative impact on the revenues of membership fee type. In the long run, capitalising on the member recruitment opportunities and addressing the young generation may offer a solution. In line with our expectations, the ratio of employers' contribution will continue to decrease, which may be offset – based on recent experiences – partially by the individual payments.

When examining the outstanding receivables of financial enterprises not belonging to a banking group, the decline in outstanding lending observed in previous years halted in 2018 despite a major decline in the loans granted to households, and a moderate rise was observed as a result of vigorous growth in loans granted to corporations. Growth continued in the case of factoring and financial lease portfolios.

As regards investment service providers – credit institutions and investment firms – capital market turnover decreased slightly, and within that the capital market turnover of investment firm continued to rise as a result of higher turnover on the derivative market, mostly due to emission trading. The stock exchange segment of the capital market rose both in the prompt and derivative turnover, while the over-the-counter segments realised decreasing turnover on both markets.

At sector level the customer securities portfolio continued to increase in 2018, and the share of investment firms within the customer securities portfolio strengthened further. Growth in the volume of securities accounts held in the form of long-term investment accounts faltered compared to previous years; the decrease is mostly attributable to the credit institutions. In line with the previous trend, the number of pension savings accounts decreased, primarily affecting credit institutions.

The rise in the prompt market turnover in 2018 is the consequence of an increase in equity turnover and soaring turnover in mortgage bonds. The decrease in the total turnover of derivatives market was caused by a fall in the turnover of equity futures and currency futures, which could not be offset by the growth in index-based futures. The Budapest Stock Exchange registered one initial public offering, seventeen private capital increases, and one delisting event.

The portfolio of white label services decreased further at the investment firms, which was also contributed to by ESMA's product intervention decision, based on which restrictions were introduced for retail investors from the second half of 2018 in respect of marketing, distribution and sales.

As regards the structure of investment funds, restructuring toward real estate funds continued and their number rose, while that of securities funds stagnated. Owing to growth in the real estate fund sector, the number of fund managers also increased.

After several years of trend growth, the assets managed by the investment fund managers declined in 2018, which was caused by a decrease in the managed assets of pension funds and other portfolios, while managed assets of investment funds and insurance portfolios rose further in 2018 as well. The net asset value of assets managed by the investment funds once again reached a historic high as a result of positive capital inflows.

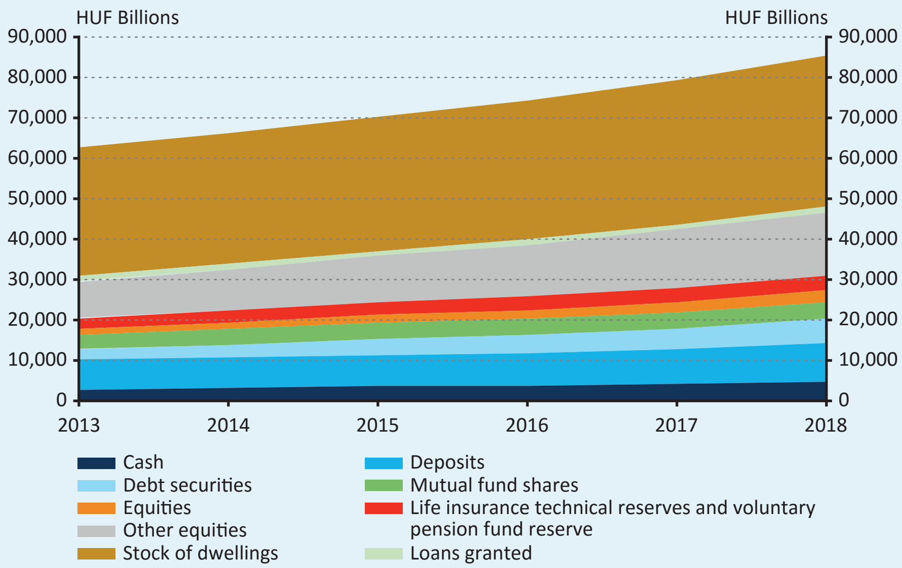
The number of private capital fund continues to rise extremely dynamically, not only in terms of growth in the number of funds and assets, but also in connection with an increase in the number of institutions engaged in the management of private capital funds and the trebling of the capital allocations. The number and subscribed capital of venture capital funds realised an outstanding growth in 2018 as well, while the capital investment portfolio remained constant.

1 Developments in households' wealth

WEIGHT OF ASSETS THAT MAY BE LIQUIDATED IN THE SHORT TERM INCREASED

By the end of 2018, gross assets of households, comprising financial instruments and the stock of dwellings, exceeded HUF 85,000 billion, which represents an annual growth of 7.4 percent (Chart 1). Similarly to the previous year, the growth in assets was primarily attributable to the rise in the value of the stock of dwellings and other equity (by HUF 3,200 billion in total). At the same time, the most dynamic growth was registered by cash holdings (16.4 percent), deposits (13.3 percent) and debt securities (13.4 percent).

Chart 1
Developments in the gross assets of households



Note: The 2017 and 2018 data related to the stock of dwellings are MNB estimates.
Source: HCSO, MNB

The share of equities held by households did not change materially (3.2 percent), since their growth rate (7.2 percent) was almost identical to the growth in total assets. The growth rate of loans granted and the stock of dwellings lagged behind the average (4.7 and 4.6 percent, respectively). Apart from this, the only fall was recorded in the volume of mutual fund shares (by 2.8 percent).

Life insurance reserves and voluntary pension fund reserves, primarily serving as means of long-term wealth accumulation, hardly rose (by 0.3 percent). This growth lags behind the average of other categories and also of the previous 5 years (5.9 percent). As the combined result of the foregoing, the share of life insurance reserves and voluntary pension fund reserves within households' gross financial assets[1] fell to 7.3 percent (to 4.1 percent of the total gross assets). The decreasing ratio, observed in previous years (8.9 and 4.4 percent, respectively, in 2013) was due to the smaller growth rate and the poor yield performance, described in more detail in later parts of this report, and thus the stagnation observed in 2018 resulted in the largest contraction of the previous years.

The ratio of the assets that may be liquidated in the medium term (debt securities, mutual fund shares and equities) decreased by 0.1 percentage point in 2018, thereby interrupting the growth observed in the previous years. The assets that

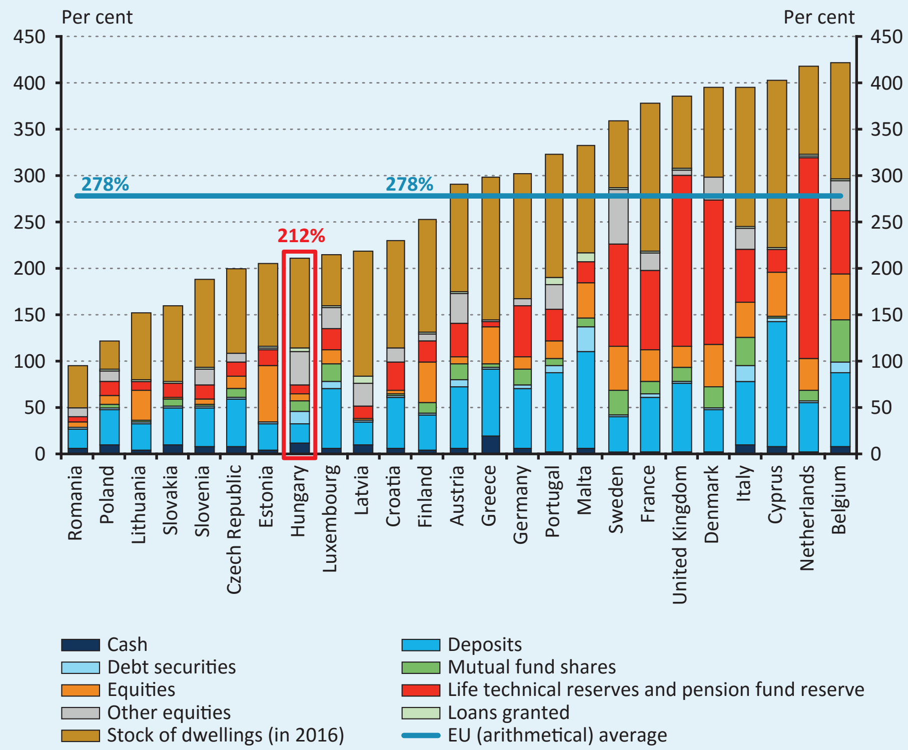
[1] Financial assets here corresponds to total assets net of the stock of dwellings.

may be liquidated in the short term (cash and deposits) follow the opposite trend, since the decline registered in previous years was broken by a 1.0 percentage point rise during the last one year. Only the ratio of limited liquidity assets (other equity, loans granted and stock of dwellings) changed in line with the trends of previous years, and declined by 0.6 percentage point. At the same time, this combined category accounted for 64 percent of the households' gross assets in 2018.

No extensive build-up of self-provision based on longer term products has commenced among the households. The process is hindered by the low yield environment, representing a smaller incentive for long-term savings, and on the other hand, the trend may signal a need to improve financial awareness. The increasing weight of assets that may be liquidated in the short term may be another impact of the low yield environment.

Gross assets of Hungarian households amounted to 212 percent of GDP in 2017 (Chart 2), which puts them to the edge of the last quarter of the European Union. The average of the gross assets of households within the EU – calculated with the arithmetical average of the countries – is 278 percent. The average for the countries of the region (the Czech Republic, Poland and Slovakia) is 161 percent, which evidences that the assets of Hungarian households are higher – relative to their economic development – than that of countries of similar development level. At the same time, the Western European countries (e.g. Belgium, the United Kingdom, France, the Netherlands, Italy) continue to have substantially higher assets compared to the Visegrád countries.

Chart 2
Gross assets of EU households as a percentage of GDP, in 2017



Source: Eurostat

According to the GDP ratios of the individual categories, Hungary is still in the vanguard of holding cash and other equities (ranked 2nd among the countries of the EU in both categories). In terms of deposits and equities, Hungarian households moved forward by rank 3 and rank 4, respectively, and thus they are ranked 24th and 20th in the EU ranking. Hungary is also at the end of the ranking (22nd), similarly to the previous category, in respect of life insurance reserves and voluntary pension fund reserves. Hungarian households hold their assets in mutual fund shares (ranked 11th) and homes (ranked 13th) around the average. On the whole, it is obvious that the ratio of highly liquid assets (cash) and assets of limited liquidity (other equity) is outstanding by EU standards. At the same time, there is still room for manoeuvring in the utilisation of the financial intermediary system, which may be enhanced by improving financial awareness.

2 The insurance market and its risks

2.1 OVERALL PICTURE OF THE MARKET

At the end of 2018, 10 small insurance unions, 2 large insurance unions and 21 insurance companies were active on the Hungarian insurance market. Thirty-three institutions in total, of which only the 23 large insurance unions and insurance companies fell within the Solvency II (hereinafter: S2) regulation, introduced in 2016 and harmonised across the EU, which prescribes a standard risk-based framework to ensure the reliable operation of insurers. The latter group, broken down by insurance segments, includes 6 life insurers, 9 non-life insurers and 8 composite insurers. Three market participants merged effective from 1 April 2018, and thus at the end of the year the number of S2 institutions dropped by 1 one life and 1 composite insurer compared to 2017. In addition, at the small insurance unions, the activity licence of 6 institutions was withdrawn (one of these took place on the institution's own initiative). Thus, compared to the previous year, the number of institutions decreased by 8, in total (Table 1). We anticipate further market consolidation in the future, under strengthening competition.

Table 1
Key data of the insurance sector[2]

Insurance sector				
	2018			**2017**
	By institution types		**Total**	**Total**
Number of institutions*	Total S2 insurers	23	33	41
	Life	6		
	Non-life	9		
	Composite	8		
	Small insurance union	10		
	Life segment	**Non-life segment**	**Total**	**Total**
Premium income (HUF billions) (including branch offices)	*476.8 (497.0)*	*547.3 (570.2)*	*1,024.1 (1,067.2)*	*956.0 (1,009.6)*
Number of contracts (thousand pcs)	2,390	11,527	13,918	13,450
Technical provisions (HUF billions)	1,714.1	277.0	1,991.0	2,027.8
Balance sheet total (HUF billions)			2,715.4	2,628.2
Capitalisation level (percent)			216	224
Profit or loss (HUF billions)			72.7	64.7
Return on equity (ROE)			23.9%	24.4%
Return on assets (ROA)			2.5%	2.7%
Return on regulatory capital (RORC)			19.4%	18.1%
	Small insurance unions			
	2017**			2016
Number of institutions	16			16
Premium income (HUF millions)	456			385.9
Number of contracts (pcs)	1,088			472
Return on equity (ROE)	8.0%			-2.1%

*Note: *Not including one supervised joint-stock company falling outside S2.*
***The 2018 data of the small insurance unions is not yet available.*
Source: MNB

[2] The publication contains unaudited data for the end of 2018.

Market participants closed 2018 with 13.9 million contracts in total and premium income of HUF 1,024 billion. In the life segment and non-life segment this included 2.4 million contracts with a premium of HUF 476.8 billion and 11.5 million contracts with a premium of HUF 547.3 billion, respectively. The growth was primarily attributable to the non-life segment, where premium income rose by 10.5 percent. Growth in the life segment was more moderate (3.4 percent). The capitalisation level of the institutions falling within S2 was 219 percent at sector level at the end of the year, which represents a decrease of 5 percentage points compared to the previous year. Hungarian insurers realised a profit after tax of HUF 72.7 billion, representing a growth of HUF 8 billion.

Based on the backtesting of the 10-year future, for the time being the sector has not set on a convergence path.

In February 2018, the MNB published its paper entitled *10-year future of the insurance sector in 7 points* (hereinafter: FIS) on the future trends envisaged in the insurance sector (and partially the voluntary pension funds). The points included in the publication contain desirable trends and objectives formulated as expectations, which – as a sector-level strategic plan – may also serve as a guideline for market participants. Similarly to the previous year, we present developments in the FIS target figures in this year's publication as well, evaluating those by the 10-year target values and the projected paths (all this is summarised in Table 2).[3]

Table 2
Target values and actual data of the insurance sector

Objective to be achieved	Target variable	2016 actual data	2018 actual data	2026 target value
1. Wide-ranging self-provision *More savings, greater security*	life insurance and voluntary pension fund contracts/economically active persons	53.6%	54.0%	over 80%
	ratio of reserves as a percentage of GDP (life technical reserve + voluntary pension fund individual accounts)	8.72%	7.73%*	over 10%
2 Converging market size *Back to the vanguard of the region*	Penetration (premium income/GDP)	2.54%	2.43%*	over 3.0%
3 Competitive market – *Increasing competition*	Share of TOP5	59.6%	59.9%	below 55%
4 Efficient sales *Half of sales over an innovative channel*	ratio of innovative channels	37%	35% (2007)	over 50%
5 Economies of scale *Institutions operating more cost efficiently with dropping margins*	ACR values of UL contracts	0.53-9.97%	0.92-5.40%	0.5-5.75% steadily
	non-life combined ratio (net of tax)	80.6%	78.6%	85-90% steadily
	cost ratio	30.5%	29.3% (2017)	20-30% steadily
6 Fair and competitive profitability *Long-term confidence and stability*	ROE	19.5%	23.9%	10-15% steadily
7 Well-capitalised insurers *Safe and prudent operation*	capitalisation level	215%	219%	>150% steadily

dynamic path	positive path	moderately positive path	negative path

*Note: We evaluated the 2018 actual figures in four categories, compared to 2016: dynamic path (reached, or outstripped the convergence path specified in FIS), positive path (a shift toward target value occurred in the target variable, or at least in the value of the numerator), moderately positive path (a positive shift occurred in the target variable or in the absolute value, albeit falling short of the target) and negative path (departure even compared to 2016). The values marked with * were evaluated compared to the trends projected in the publication.*

Source: MNB

[3] For the purpose of backtesting, were it was necessary, we also took into consideration the developments in the actual macroeconomic figures.

The penetration of life insurance and voluntary pension fund contracts was slightly higher, by 0.4 percentage point in 2018 compared to 2016. This is primarily attributable to a pause in the growth in the number of contracts, while the rise in economically active persons also reduced the ratio. For the time being no success was achieved in reaching the potential candidates for self-provision, or in the low yield environment the satisfaction of other consumer demands (e.g. home purchase) may have taken priority.

As a result of the low yields and the moderate willingness to save for self-provision purposes, the life insurance reserves and voluntary pension fund reserves stagnated in 2018. The constant number of contracts (and in addition, at the voluntary pension funds, the ratio of non-payers is still high) and the moderate premium increase of life insurances explain the slow rise in reserves, which thus fell closest to the inflation targeting trend of the three paths set in FIS. At the same time, reserves exceed the volume recorded in 2016, and thus a moderate positive growth was observed in the past two years. In addition to the foregoing, the decrease in the value of the target variable was substantially attributable to the dynamic growth in GDP, exceeding that assumed in FIS, calculated at current price.

In 2018, the penetration rate fell to 2.43 percent, which was also attributable to the dynamic growth in GDP. The premium income of insurers rose to a similar degree as in the previous year (by HUF 68 billion), which lagged behind the level regarded as rising penetration. At the same time it exceeded the pace of inflation and the 3.3 percent – HUF 32 billion – growth, calculable on the basis of the insurers' business plans.

By 2018, the share of the TOP 5 market participants rose compared to 2016, which may be regarded as a departure from the projected path. In addition, the Herfindahl-Hirschman Index (HHI) rose, which – together with the change mentioned above – reflects market acquisition by medium-sized insurers. This latter process is explained by the merger of two institutions, smaller than the TOP 5, with a third institution in the first half of the year.

The change, projected by FIS, in the composition of the insurers' sales channels, failed to commence. The ratio of innovative channels[4] was 35 percent in 2017, which is lower than the 37 percent measured in 2016.[5] Presumably the incentives that could facilitate a more active use of these channels failed to develop.

Similarly to the previous year, the ACR values of the unit-linked contracts[6], affected by the MNB recommendation, do not depart from the limits specified in the MNB recommendation. There was a slight shift in the case of the highest ACR (from 5.27 to 5.40 percent). It may be reasonable to review the justification for the permitted departures from the limits (+1.5 percent), since those are permanently utilised.

The sector-level combined ratio of non-life insurances decreased year on year, which represented a departure from the designated target band. In 2017, the ratio still moved towards the target band, albeit to a moderate degree. The turn may be attributable to favourable claim developments and to shortcomings of competition in the non-life segment.

There was a 1 percent shift in cost ratios in 2017 compared to the previous year, based on the sector level average. The latter already falls within the designated target band of 20-30 percent; however, insurers achieved this result not in the desired composition. When broken down to life and non-life segments, the target values defined separately (below 20 percent and below 30 percent) are not achieved. On the other hand, the decrease in the cost ratios was also contributed to by an increase in premiums.

As regards profitability, similarly to the previous year, the entirety of the sector was characterised by a return on equity (ROE) substantially exceeding the designated target band (10-15 percent) in 2018 as well. For the time being nothing suggests that the increasing trend would turn into decrease and approach the target band.

As regards the capitalisation level across the sector, the designated target of over 150 percent was realised. The values of the individual institutions also fall mostly in the target band, which is a good foundation for the safe and prudent operation of the sector.

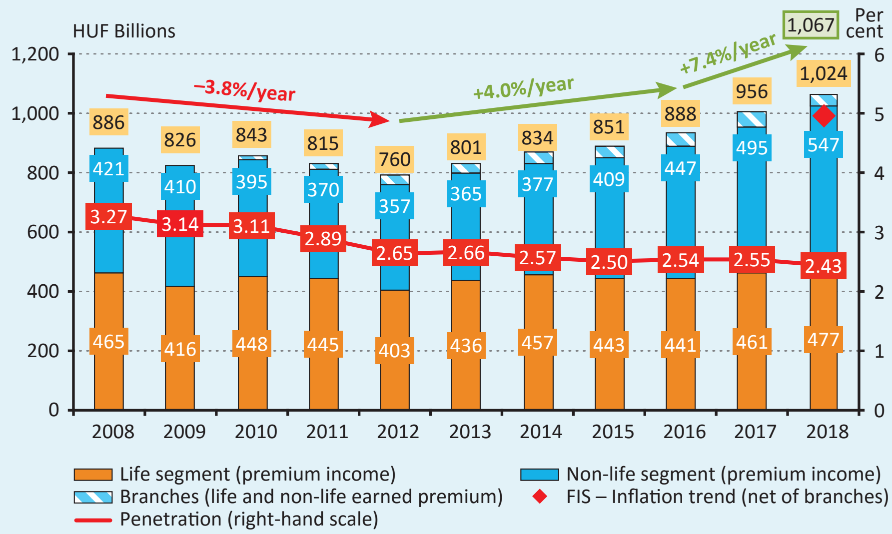
[4] Innovative channels include: bancassurance, direct sales, online intermediation.
[5] Due to the late receipt of the data reporting, last year we did not deal with the sales mix, and thus in this publication we also have only 2017.
[6] Of the fixed-term contracts the 10-, 15- and 20-year contracts, while of the whole-life insurances the 15- and 20-year ones.

Premium income is above HUF 1,000 billion in every respect, but penetration continues to melt

In 2018, the premium income of the insurance sector was HUF 1,024 billion in total, which is a 7.1 percent increase compared to the previous year (Chart 3). The growth in 2018 was primarily attributable to the non-life segment (10.5 percent), while the life segment was able to grow to a smaller degree (by 3.5 percent). The degree of growth in the entire market in terms of dynamics was similar to that of 2017. In the past two years the premium income of the sector rose by 7.4 percent on average, which substantially exceeds the growth rates of the past 10 years.

The penetration of the sector declined in 2018 (by 0.13 percentage point); thus the growth of the sector was unable to follow the expansion of the entire economy. Of the paths specified in FIS, it exceeded the inflation targeting trend. Based on the projected inflation targeting path, the 2.43 percent registered in 2018 exceeded 2.36 percent, the value set for this year. However, the sector's premium income fell short of the fulfilment of dynamics relative to GDP, observed in previous years (empirical trend) only by HUF 20 billion.

Chart 3
Gross premium income and penetration in insurance sector



Note: Gross premium income in life and non-life segments, and gross earned premium for branch offices. The total value of the gross premium income at sector level, shown on the chart in a yellow rectangle, does not include the gross premium income of branch offices.

Source: HCSO, MNB

The Hungarian insurance market also includes the performance of the branch offices operating in Hungary. Considering those, in 2018 the sector's premium income was HUF 1,067 billion in total. However, branch offices registered a decline of 20 percent, which lags behind other parts of the market. In previous years, cross-border services represented similar volume as the branch offices; however, for the time being we have only the 2017 figures on this activity (see Box 1).

Box 1
Cross-border activity in Hungary

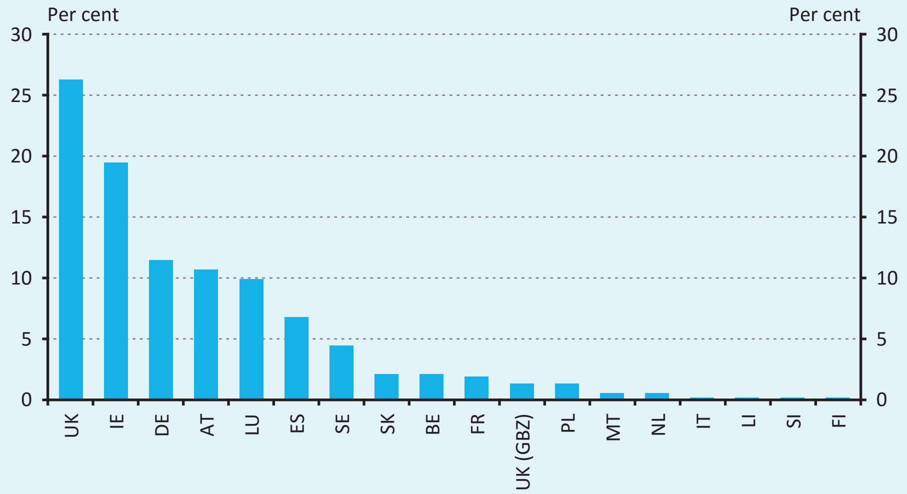
Between the second half of 2016 and the first half of 2017, 12 percent of the total insurance market premium income, almost HUF 112 billion, came from the institutions of insurers registered in other member states, operating in Hungary as branch offices or from the activity of institutions rendering cross-border services in Hungary. As regards the nature of the activity, the premium income originating from the institutions of insurers registered in other member states, operating in Hungary as branch offices, account for 53 percent of the total cross-border premium income, while the premium income originating purely from cross-border activity without a branch office, account for 47 percent thereof.

In a breakdown by business segment, 27 percent of the premium income originating from the activity of insurers with a registered office in another member state is linked to life insurances (including the unit-linked policies and the life reinsurance business), 23 percent thereof to property insurance, 8 percent to general liability insurance, 7 percent to health insurance and 5 percent to credit and suretyship insurance.

In a geographic breakdown, 86 percent of the cross-border premium income comes from the territory of the United Kingdom and Gibraltar, Ireland, Germany, Austria, Luxembourg and Spain.

In 2019, a fall in premium income from the territory of the United Kingdom and Gibraltar is expected, due to the rise in the number of portfolio transfers as a result of Brexit. To date the portfolio transfers were typically directed to Luxembourg and Malta.

Chart box 1
Breakdown of cross-border activity performed in Hungary by member state of the registered office



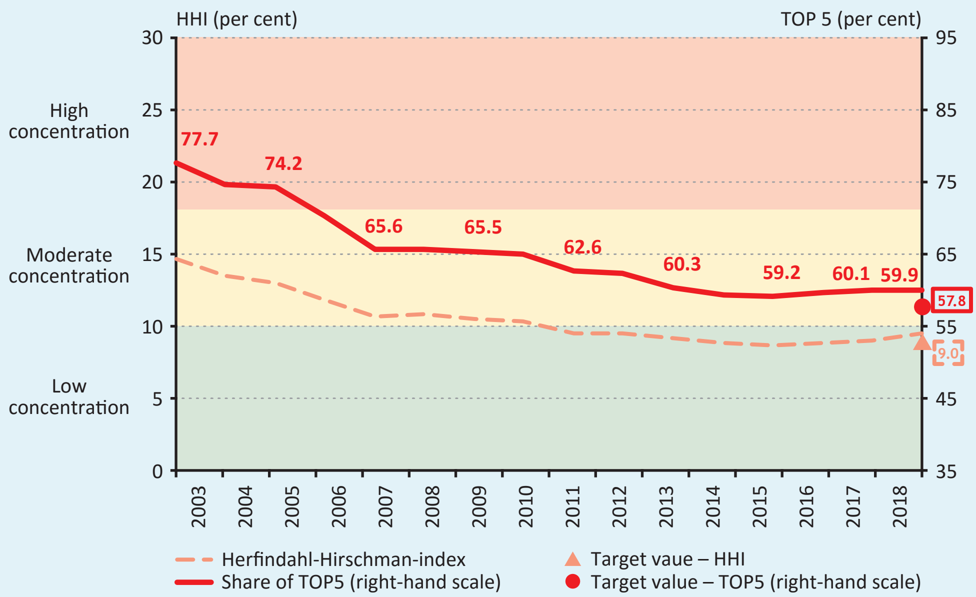
Source: EIOPA, MNB

Share of the TOP5 declined, but market concentration rose due to the mergers

The share of the TOP5 market participants was 59.9 percent in 2018, which falls short of last year's figure by 0.2 percentage point (Chart 4). Compared to 2017, this reflects a decline in the market share of market leaders. At the same time, the HHI value rose by 0.5 percentage point, and thus it stood at 9.6 percent, which approximates the upper bound of the low concentration level (10 percent). The two indicators, showing seemingly opposite processes, imply the headway of the medium-sized market participants, which is mostly attributable to the institutional mergers mentioned at the beginning of the section.

For the time being, the actual data exceeds the concentration path projected in FIS, but the change in 2018 was in the right direction. Fewer participants may cause a temporary rise in the concentration ratio, but the market can still operate in a competitive manner. The participants of almost identical size and ability may challenge each other in a relatively wider product range. A competitive market is less likely to develop under the market strength of the overly large actors and the product specialisation of the too small ones.

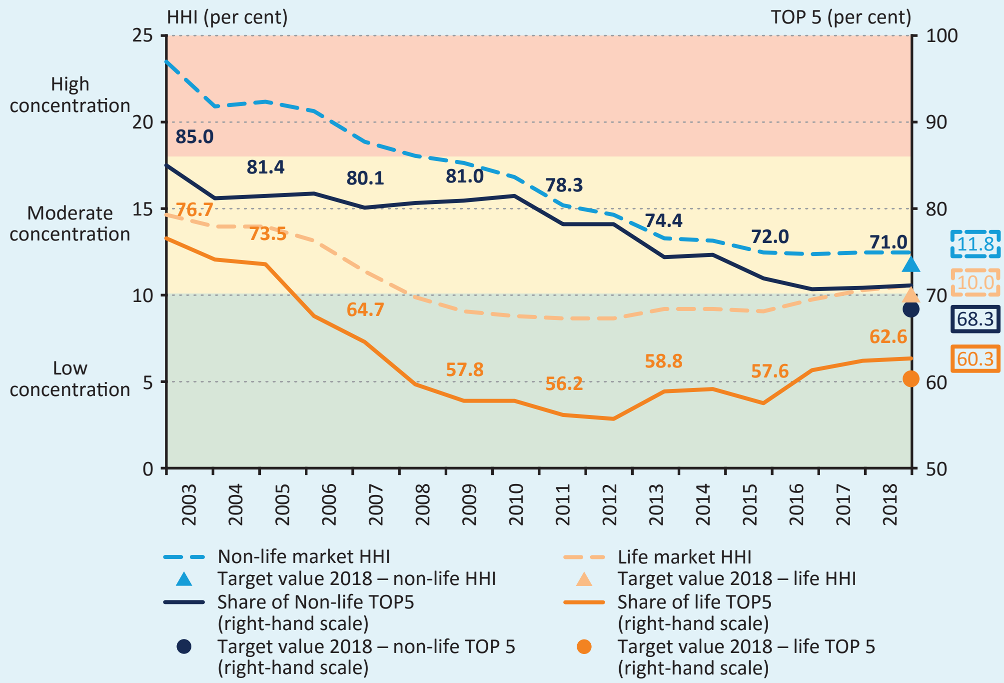
Chart 4
Share of TOP 5 insurers and Herfindahl-Hirschman index of the entire sector based on gross premium income



Note: The colour of the background illustrates the strength of concentration under HHI.
Source: MNB

When examining the life and non-life segments separately, we find that they follow a trend similar to that of the total market. The share of the TOP5 changed slightly in both segments (rose by 0.2 percentage point in the life segment and by 0.1 percentage point in the non-life segment). As regards HHI, the changes were more moderate than in the total market: a rise of 0.3 percentage point in the life segment, and a decline of 0.1 percentage point in the non-life segment. On the whole, concentration ratio clearly rose in the life segment, as the institutional merger mentioned at the beginning of the section mostly affected this segment. The actual figures exceeded (were more concentrated) the life and non-life segments' projected paths, illustrated in FIS.

Chart 5
Share of TOP 5 insurers and Herfindahl-Hirschman index of the entire sector based on gross premium income, by segment



Note: The colour of the background illustrates the strength of concentration under HHI.
Source: MNB

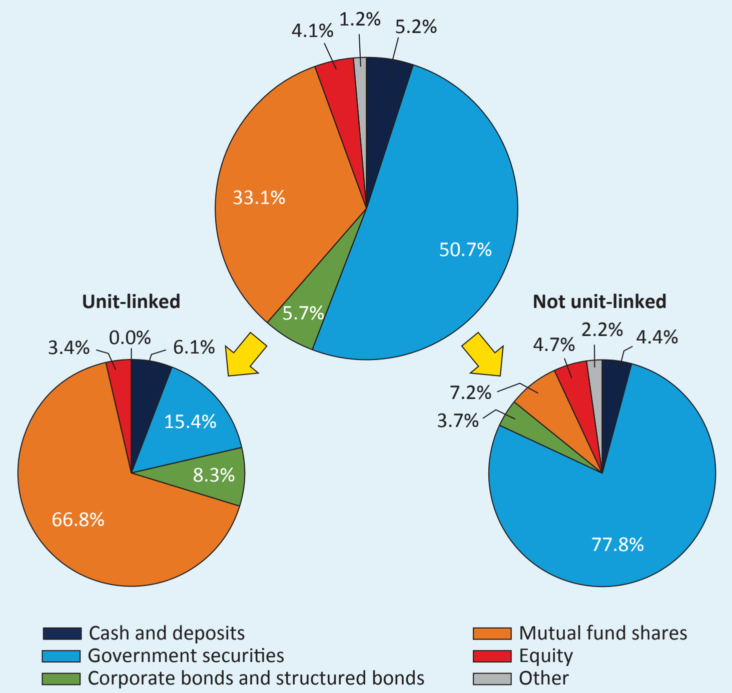
The ratio of safer assets somewhat increased within insurers' investments

The value of Hungarian insurers' total assets stagnated (changed by -0.3 percent) in 2018. Forty-three percent of the HUF 2,654 billion covers unit-linked life insurance reserves, while the remaining part comprised instruments underlying traditional life insurance and non-life insurance, as well as the institutions' own assets (Chart 6). 55.9 percent of the insurers' total assets comprised low-risk, conservative instruments (government securities, cash and deposits), which represents a 2.7 percentage point increase compared to the previous year. The rest of the assets mostly consists of mutual fund shares, equities and corporate bonds (also structured bonds). The composition of the assets underlying the unit-linked reserves were dominated by instruments of higher risk up to 78.5 percent (in the case of unit-linked insurance, with the risk arising from the change in the price of underlying instruments included in the asset fund being borne by the customer). At the same time, in 2018 reallocation of almost 4 percent to the lower risk investments in cash and deposits, as well as government securities was observed. 77.8 percent of the investments underlying the reserves for policies other than unit-linked insurance comprised government securities, which continues to be an outstanding ratio, even by European comparison.

The low interest rate environment seen for many years challenged the insurance sector as well. Until 2016, the composition of the insurers' assets underlying the reserves for policies other than unit-linked insurance was characterised by a rise in the ratio of mutual fund shares and equities to the detriment of government securities and corporate bonds (Chart 7). The slow increase in the ratio of equities continued in 2017 and 2018 as well. As regards the mutual fund shares, following the peak of 8.8 percent registered in 2016, the ratio of the category started to decline (by 0.7 percentage point in 2018).

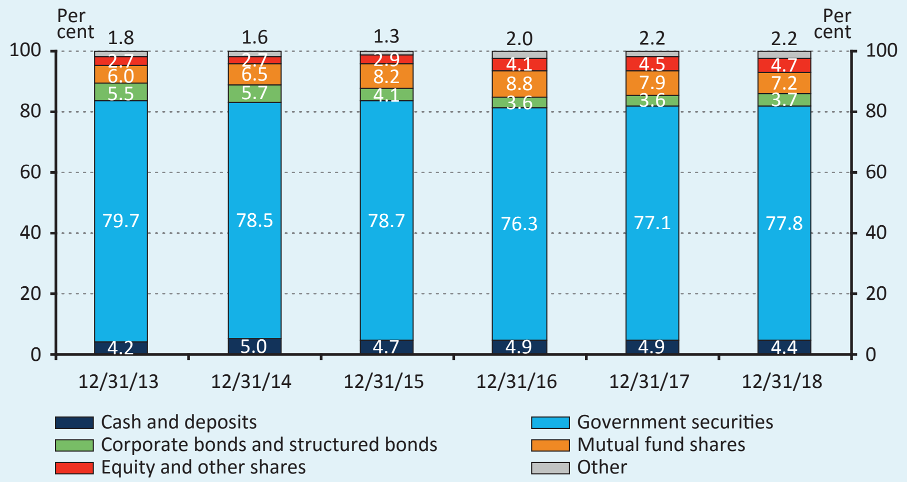
There is still no major realignment in the category of assets underlying the reserves for policies other than unit-linked insurance, which would imply "yield hunting." In the past one year, the ratio of cash and deposits somewhat lagged behind the average of previous years, while the ratio of government securities rose by 1.4 percentage points in total since 2016.

Chart 6
Asset composition of Hungarian insurers



Note: Other includes: real properties, mortgage bonds, loans and other unclassified assets.
Source: MNB

Chart 7
Changes in the composition of assets underlying reserves other than unit-linked reserves



Note: Other includes: real properties, mortgage bonds, loans and other unclassified assets.
Source: MNB

Box 2
"Green" asset funds

In May 2018, the European Commission adopted an action plan for sustainable finance, as a part of which in July 2018 the European Commission requested EIOPA[7] and ESMA[8] that they should provide technical advice for the integration of the sustainability risks and factors in UCITS[9], AIFMD[10], MiFID II[11], Solvency II[12] and IDD[13]. In September 2018, the EIOPA received yet another request from the Commission on its opinion on the sustainability aspects of Solvency II.

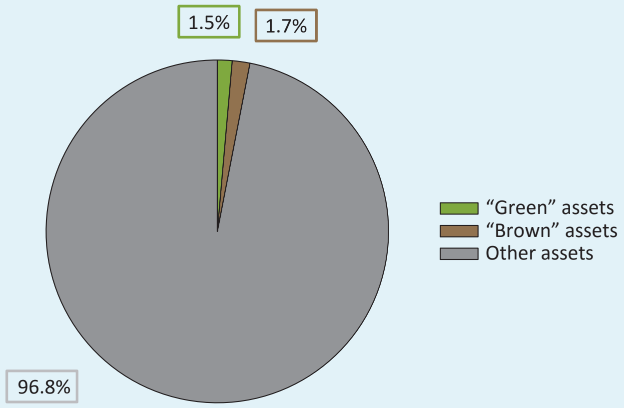
In line with the international trends, at the beginning of 2019 the MNB also developed its own Green Program, whereby it assessed the type of "green" products available at present on the money market, capital market and on the insurance and funds market, the conditions and criteria that they need to satisfy in order to be classified as "green," and the size of customer assets invested in these products.

On the insurance market it is primarily the unit-linked asset funds that are suitable to present the criteria of green investment, due to the fact that those may also hold riskier assets, which allows them to invest in the equities and corporate bonds of "green" companies or in "green" mutual fund shares. The questionnaire prepared by the MNB was sent to the 12 insurance companies which distribute unit-linked asset funds. Based on the responses to the questionnaire's qualitative questions, insurers have no green program at an individual level; the majority of the institutions do not define green investments separately and in their internal processes green considerations appear along paperless operation and energy-efficient solutions.

Having analysed the quantitative part of the questionnaire, we found that in the fourth quarter of 2018, five insurers distributed 8 "green" asset funds in total, where they managed customer assets totalling HUF 17.5 billion. As regards the entire market, for the time being "green" exposure is not outstanding, since the unit-linked reserves at sector level amounted to almost HUF 1,200 billion at the end of 2018, of which merely 1.5 percent comprises customer assets invested in "green" assets funds, and thus there is plenty of room for increasing "green" investments. As regards the investment of the asset funds, it can be stated that insurers realise the representation of green consideration via the foreign "green" investment funds and ETFs.

[7] EIOPA: European Insurance and Occupational Pensions Authority
[8] ESMA: European Securities and Markets Authority
[9] UCITS: EU Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
[10] AIFMD: Directive 2011/61/EU of the European Parliament and the Council on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
[11] MiFID II: Directive 2014/65/EU of the European Parliament and the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
[12] Solvency II: Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance.
[13] IDD: Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

Chart box 2
Breakdown of unit-linked investments*, based on data from 2018 Q4



Note: Brown assets include the equities and corporate bonds of oil and gas companies, manufacturing, pharmaceutical and freight forwarding companies

Other assets include: All securities that do not qualify as "green" and "brown" assets, such as cash, equities and corporate bonds issued by banks, government securities, mortgage bonds, mutual funds, etc.

**Unit-linked investments mean: Assets underlying unit-linked reserves*

Source: MNB

2.2 LIFE SEGMENT

Yield results curbed growth in reserves

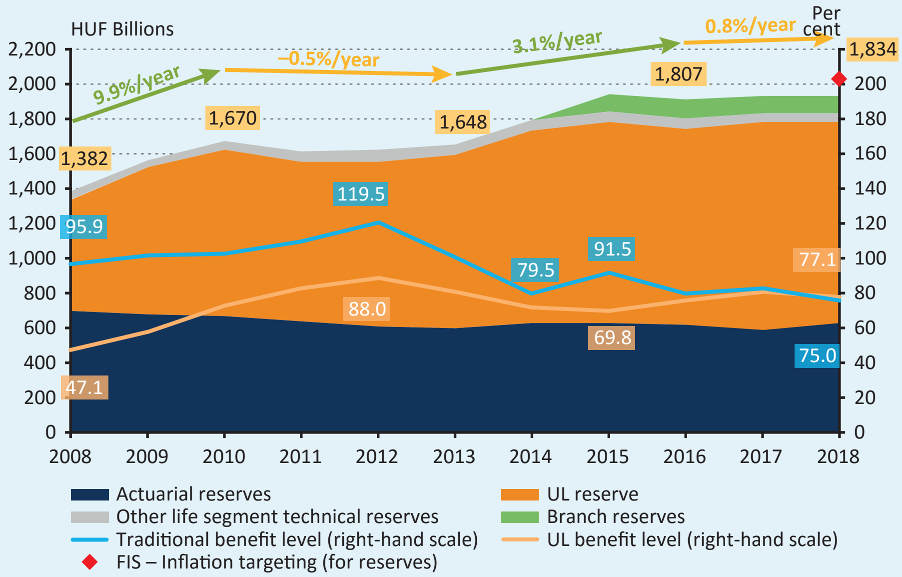
As a result of inflation and the low yield environment, the accounting technical reserve of the life segment stagnates at sector level compared to last year. Insurers typically invest reserves in short-term assets whose yield is at a record low in Hungary. At the end of 2018, the life insurance accounting technical reserves (hereinafter: life insurance technical reserve) amounted to HUF 1,834 (including the branch offices: HUF 1,928) billion, which represents a negligible – 0.2 percent (including branch offices: 0.3 percent) – growth compared to the previous year. As regards the sector-level life insurance reserves, the reserves of the branch offices operating in Hungary is negligible (5.1 percent), and this ratio declined compared to the previous year. The reserves of the unit-linked products still account for the largest part of the life insurance reserves (63 percent without the branch offices/59.9 percent including branch offices). Actuarial reserves and other life insurance reserves[14] account for 32.3 percent and 2.9 percent of the life insurance reserves, respectively. Reserves of unit-linked products (hereinafter: UL reserve) declined by 2.7 percent (HUF 32.4 billion) compared to the previous year. Poor investment performance substantially contributed – through the revaluation of the market value – to the decline in UL reserves, registered in 2018; the impact of this was -HUF -46.1 billion, compared to the + HUF 42.5 billion registered in 2017. In the past 10 years, the average of the revaluation of the UL reserves was + HUF 28.7 billion, even under the negative value recorded in 2018. Based on the life segment gross written premium (hereinafter: premium income), 58.8 percent of the sector-level UL reserve can be linked to the TOP5 market leader institutions, where the UL reserve of almost all of these institutions decreased. The actuarial reserves rose by more than HUF 30 billion (by 5.1 percent), while the other life insurance reserves increased by HUF 6.2 billion (12.3 percent) compared to the previous year.

When examining changes in the life insurance reserves based on time series (without the reserves of branch offices), we identified several phases. In the period between 2008 and 2010, the annual average growth rate of life insurance reserves was outstanding, at 9.9 percent. Growth was broken by the withdrawal of funds resulting from the early repayment of

[14] Other life insurance reserves include the following reserve components: unearned premium reserve, outstanding claim reserve, reserve for premium refund depending on and independent of the profit, claim fluctuation reserve, extreme loss reserve, cancellation reserve and other reserve components.

foreign currency loans at a preferential exchange rate between 2011 and 2012; as a result of this, in the period of 2010-2013, life insurance reserves stagnated (annual average growth rate: -0.5 percent). As of 2013, life insurance reserves once again started to rise until 2015. Since 2015 only minimal changes can be observed in the life insurance reserves. In *FIS*, three potential paths were projected with regard to developments in the self-provision reserves: inflation targeting, empirical and international trend. Developments in the reserves over the past two years were closer to the inflation targeting trend, which in 2018 designated a level of HUF 2,021 billion. Since 2016, treated as the initial year in the publication, total growth amounted to HUF 27 billion, representing an annual growth of 0.8 percent.

Chart 8
Developments in life insurance reserves and the related insurance benefit levels



Note: When defining the insurance benefit levels and the total value of life insurance reserves (figures indicated in the yellow rectangle), we ignored the data of the branch offices.

The other life insurance technical reserve includes the following reserve components: Unearned premium reserve, outstanding claim reserve, reserve for premium refund depending on and independent of the profit, claim fluctuation reserve, extreme loss reserve, cancellation reserve and other technical reserves.

Source: MNB

Sustainability of regular premium contracts in the life segment substantially improved in the past 5 years

In the period under review, roughly 60 percent (in 2018, exactly 62.3 percent) of the life segment premium incomes are linked to the regular premium products, while the remaining part of the life insurance premium incomes is typically distributed between the single premium and top-up premium products at a ratio of 70-30.

The ratio of single, top-up and regular premium life insurance products within the life segment's premium income fluctuates around 40-60 percent in the sector. Striking changes in the life segment's premium income are typically caused by variations in single and top-up payments. The insurance benefit level[15] related to life insurance products exhibits different trends in respect of the premium payment at products with different frequency. While the benefit level related to the regular premium life insurance products declined annually on average by 4.2 percent between 2013 and 2018, the benefit level related to the single and top-up premium life segment products rose on average by 1.7 percent annually between 2013 and 2018.

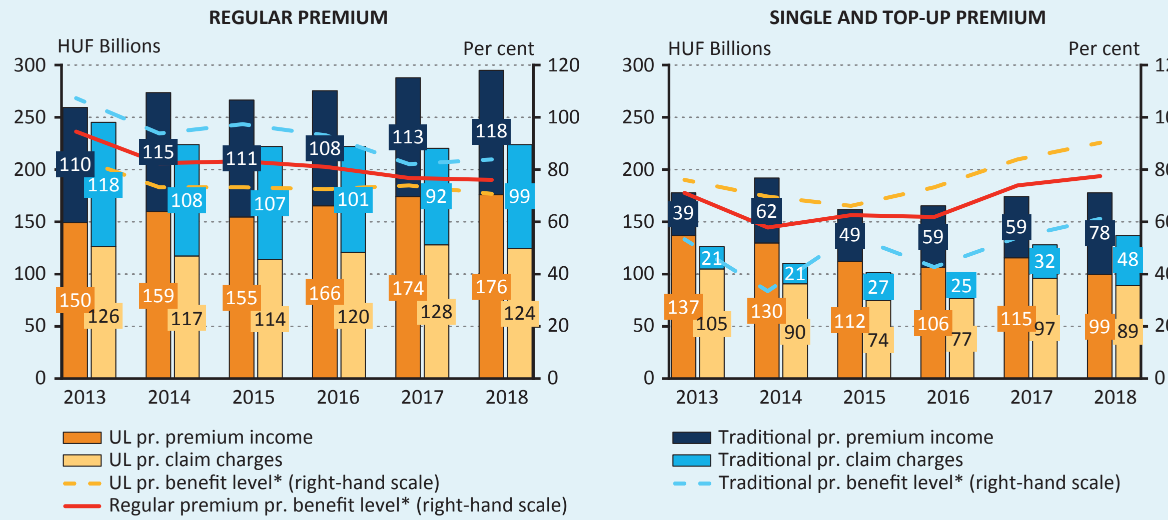
The distribution of life insurance premium incomes is nearly similar in terms of premium payment at products with different frequencies: the ratio of unit-linked products exceeds 50 percent in the regular, as well as in the single and top-up premium incomes. Throughout the period under review, the share of unit-linked products in the regular premium

[15] The benefit level is the ratio of the claim charges compared to the gross premium income.

incomes is around 60 percent, while in the market of single and top-up premium products this ratio declined annually on average by 6.4 percent between 2013 and 2018, but the ratio of premium income of the single and top-up premium unit-linked products still account for more than half of the premium incomes (55.9 percent).

In the life segment the reasons for insurance benefit payments can be typically allocated to 4 groups: death, expiry, surrender and benefit payment due to other reasons. In 2018, more than half (54.1 percent) of the benefit payments in the life segment were due to surrender and roughly one third (36.4 percent) were due to the expiry of the life insurance contract. Thus 90.4 percent of the insurance benefit payments are linked to these two components. Compared to the previous year, payments due to expiry rose to 36.4 percent (by HUF 11.6 billion), while benefit payments due to surrender fell to 54.1 percent (by HUF 6.3 billion). In 2018, the ratio of benefit payments due to death was 7.2 percent (HUF 25.7 billion), which represents a 0.6 percent growth compared to the previous year.

Chart 9
Developments of premiums written, claim charges and benefit level* in the life segment, by premium payment frequency



Note: In the legend "pr" means "product(s)-related."
** The benefit level is the ratio of the claim charges compared to the gross premium income.*
Source: MNB

Further growth in the regular premium of life insurance market

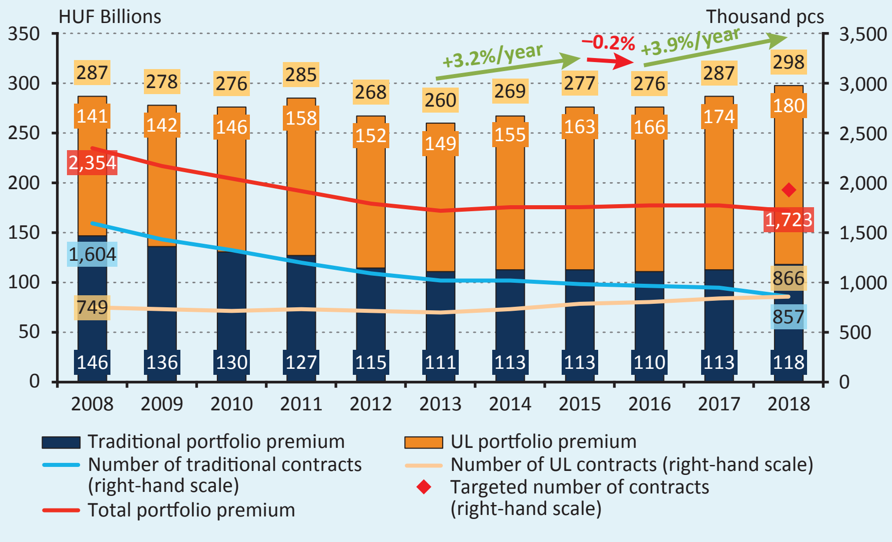
In 2018, the ratio of regular premium life insurance products' sector-level premium income within the total premium income of the life segment was 62.3 percent, amounting to HUF 298 billion. The premium income of the regular premium life segment shows an increasing trend in the past 5 years; the decline between 2015 and 2016 was merely attributable to a change of technical nature. Since by 2016 an institution of an insurer, quite significant in terms of premium income, of the regular premium product market was transformed into a branch office, the decrease between 2015 and 2016 is attributable to the "loss" of the data of the institution removed from the scope of supervision. In the period of 2013-2018, the regular premium life insurance premium income rose by 2.8 percent on average annually. When eliminating the pre-2016 data of the insurer transformed into a branch office, the annual average growth of the regular premium sector-level premium income in the period of 2013-2018 would be 3.9 percent. In terms of premium income, the ratio of the regular premium unit-linked portfolio was only 49.1 percent in 2013; in the past 5 years this ratio has been rising almost continuously, and in 2018 it amounted to 60.4 percent. The rise in the premium income of the regular premium unit-linked products made a major – 81.1 percent – contribution to the sector-level growth in the regular premium life insurance premium income, which in the period of 2013-2018 was (also) 3.9 percent on average, annually. The reason for the increasing sales of unit-linked products is that insurers prefer this product to the traditional savings products. This is mainly due to the fact that for UL products, contrary to the technical interest on the traditional saving life assurances, the insurer undertakes no guarantee for the investment performance, i.e., the product represent a lower risk for it. As the investment risk for unit-linked products is borne by the customer, usually the UL products also have a lower capital requirement.

The growth trend in the premium income on the market of regular premium life insurances is not reflected by the number of contracts. In a 10-year scope, in 2013 the decline in the contract portfolio of regular premium life insurances halted, after which in the period of 2013-2018 the portfolio stagnated. Between 2008 and 2013, the number of regular premium life insurance contracts fell by 0.6 million, contributed to by a decrease in the contracts related to traditional products by 92.1 percent and to unit-linked products by 7.9 percent. Although in the past 5 years the regular premium contract portfolio stagnated, the composition thereof changed similarly to premium income. In 2018, the regular premium life insurance contract portfolio comprised 1.7 million contracts, shared equally between the unit-linked and traditional products.

In the past 10 years, the average premium linked to regular premium products shows an increasing trend (3.5 percent annual growth on average), mostly contributed to by a 4.2 percent annual growth in the average premium of regular premium, traditional products; however, it still lags behind the premium income per policy of regular premium, unit-linked products, which amounted to HUF 207,665 in 2018. In 2018, on the market of regular premium contracts the premium income per contract was HUF 172,964, while it was HUF 137,879 in the case of regular premium traditional products.

An 80 percent penetration level has been set in FIS for life insurances and pension funds as an objective to be achieved by 2026; in order to achieve this, assuming steady growth, the volume of the regular premium life insurance contracts should exceed 1.9 million contracts by 2018. Nevertheless, for the time being, the portfolio of regular premium life insurance contracts in 2018 (1.7 million) falls short of the projected value.

Chart 10
Development of regular premium income and number of contracts in the life segment



Source: MNB

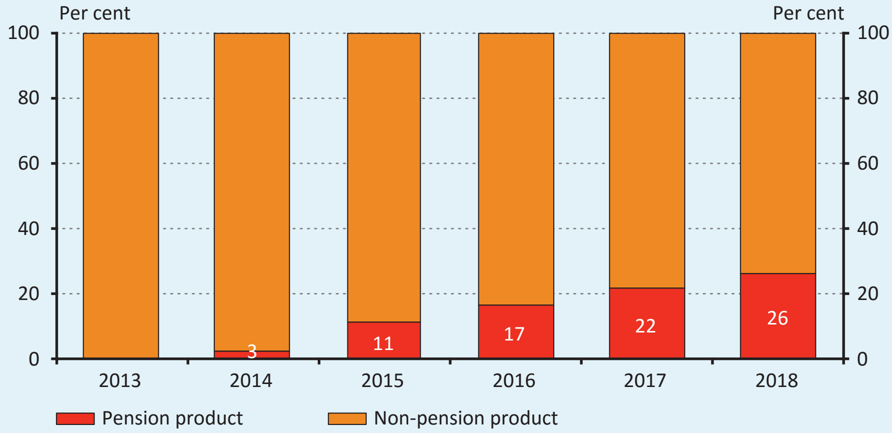
In 2018, more than one quarter of regular premium income in life segment are linked to pension insurance products

In the past 5 years, the pension insurance market registered major growth in premium incomes, both in terms of ratio and value. Although other, pension purpose insurance products – not qualifying as pension insurance – did exist before 2014 as well, the tax credit that may be applied for in respect of pension insurance products and, together with this, the pension insurance products in the classical sense, are on the market only since 2014. (No tax credit applied to the former insurance products of pension purpose.) As a result of the increasing importance of self-provision and due to the available tax credit, dynamic growth was registered in the portfolio of the new pension insurance products. From 1 January 2014, a tax credit of 20 percent, up to HUF 130,000 per annum, may be applied for in respect of the annual premium paid to pension insurances, simultaneously with submitting the personal income tax return. In parallel with the appearance of the pension insurance products and the related tax credit, the MNB also reacted to the changed market environment, since in May 2014, it issued its pension insurance recommendation with a view to ensuring a proper build-up of the developing pension insurance market. In relation to the pension insurance market the MNB expects that the products should be of simple structure and stable value, transparent, and aligned with the customers' needs, and the tax allowance should effectively augment the customer's pension savings; in addition, insurers are expected to provide customers with comprehensive and professional information in order to ensure the long-term retention of the policies. With its recommendation, the MNB fostered the stability of the pension insurance portfolios. Following the launch of the pension insurance product, the premium income of the regular premium pension products rises at a decelerating rate. In 2018, more than one quarter of the life insurance premium income related to the regular premium products was linked to pension insurances.

A dominant part of the life insurance premium incomes related to the pension insurance product is linked to the regular premium products; in 2018, the share of the regular premium pension insurance – within the pension insurance premium incomes – was 83.6 percent; this ratio does not represent a substantial change compared to the previous year (-0.6 percentage point). In 2018, 97.6 percent of the pension insurance contract portfolio comprised regular premium contracts; this ratio at the traditional pension insurance products and the unit-linked products was 99.8 and 96.8 percent, respectively. 70.6 percent of the regular premium pension insurance contract portfolio comprises index-linked or unit-linked pension insurance products. The premium income of the regular premium pension insurances is also dominated by the premium income of unit-linked pension insurance products (69.4 percent in 2018).

In 2018, 13 insurers distributed pension insurance product(s), all of which sell regular premium pension insurance products on the market, while only 6 institutions sold single premium pension insurance products in 2018. Based on the 2018 premium income, the TOP5 insurers account for 65.3 percent of the pension insurance market's premium income (representing 65.7 percent of the regular premium pension insurance market). Of the TOP5 pension insurers 1 institution is not present on the single premium pension insurance market.

Chart 11
Ratio of pension products in the life segment's regular premium income in 2018



Note: Based on data from 2018 Q4.
Source: MNB

Decreasing acquisition in better structure in the life segment

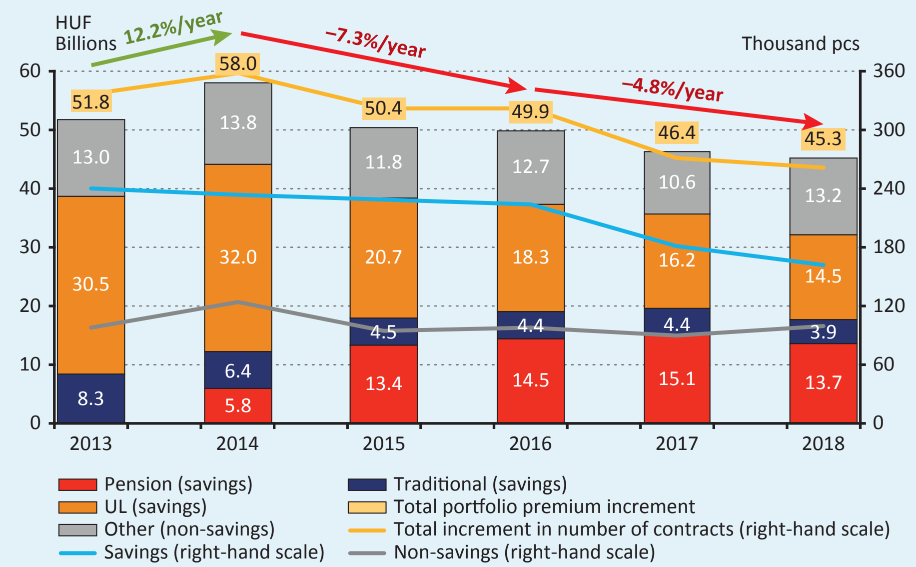
In the past 5 years, the increment in the regular premium life insurance products shows a decreasing trend both in terms of 12-month regular premium and number of contracts; the only exception to this was 2014. One reason for this was the appearance of tax credit related to pension insurances in 2014. The possibility of the tax credit acted as an incentive for dynamic growth in the pension insurance market. With the exception of pension insurance products, the decrease in the increment of the life segment affected both the savings and non-saving type products in the past 5 years.

In 2018, based on the 12-month regular premium, 70.8 percent of the new acquisitions in the life segment was related to saving-type regular premium life insurance contracts. The ratio of the saving-type regular premium life insurances, based on the number of contracts, gradually decreased since 2013 (-9.1 percentage points); in 2018, this ratio was 62.0 percent. The increment in the saving-type life insurance contracts has been decreasing throughout the period of 2013-2018 both in terms of 12-month regular premium and number of contracts, with the exception of the 12-month premium premium in 2014; this was attributable to a decrease in the 12-month regular premium of the unit-linked and traditional regular premium life insurance contracts, which could not be offset even by dynamic growth in the 12-month regular premium of pension insurance products. Apart from the co-movement of the number of contracts and 12-month regular premium of the non-saving type, regular premium contracts, no clear decreasing or increasing trend can be observed.

The number of regular premium life insurance contracts concluded in 2018 was 261,000, representing a 3.8 percent year-on-year growth; however, since in the 12-month regular premiums only a 2.4 percent decrease was registered, the 12-month regular premium per contract rose from HUF 170,809 to HUF 173,319. In 2018, the 12-month regular premium per contract was HUF 197,904 for saving-type regular premium life insurance products and HUF 133,203 for non-saving type, regular premium life insurance products.

Furthermore, it should be noted that for regular premium life insurance products, 2018 was the first year when acquisition in the reporting year fell short of that of the previous year both in terms of 12-month regular premium and number of contracts, which may have been attributable to the maturity of the portfolio and to the development of a new portfolio that followed the initial soar in the increment.

Chart 12
Increment in regular premium life insurance products by 12-month regular premium and number of contracts



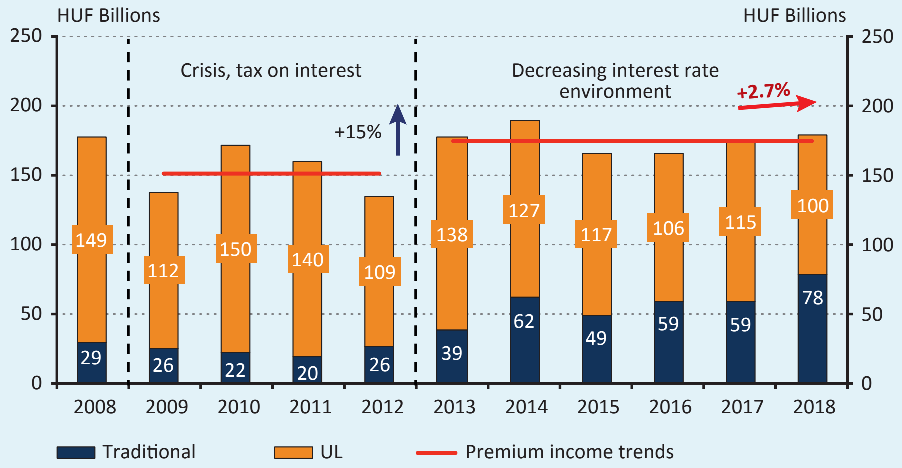
Note: The "other" category comprises the following insurance products: Death, annuity, group, health and credit and suretyship insurance products with death cover

Source: MNB

Roughly three-quarters of the single and top-up premium income is still earned by the TOP5 insurers

By the end of 2018, the amount of the single and top-up premium income came close to HUF 179 billion, rising in annual terms by 2.7 percent as a result of growth in single premium income and traditional premium income products. In 2018 the top-up premium amounted to almost HUF 55 billion, representing a fall of 8 percent compared to the previous year. Although 56 percent of the single and top-up premium income comes from the unit-linked contracts, this ratio shows a decreasing trend compared to the previous year. The single and top-up premium income from UL contracts declined by almost 13 percent (by HUF 14.7 billion) compared to 2017. By contrast, the premium income from the single and top-up premium traditional life insurance products rose by HUF 19.4 billion, i.e., by almost 33 percent. The volatility of the single and top-up premium market is well illustrated by the fact that the change in premium income compared to the previous year varies in a wide band (-47 percent – 107 percent) at institution level. In the reporting year, almost 85 percent of the single premium income was generated by the TOP5 institutions based on single premium income. The same ratio in 2018 in the case of the top-up premium incomes was 72.4 percent (share of the TOP5 in the top-up premium income).

Chart 13
Changes in single and top-up premium income in the life segment



Note: The premium income trend means the average of the premium income in the respective period.
Source: MNB

Box 3
Improving expectations with regard to the retention of unit-linked contracts

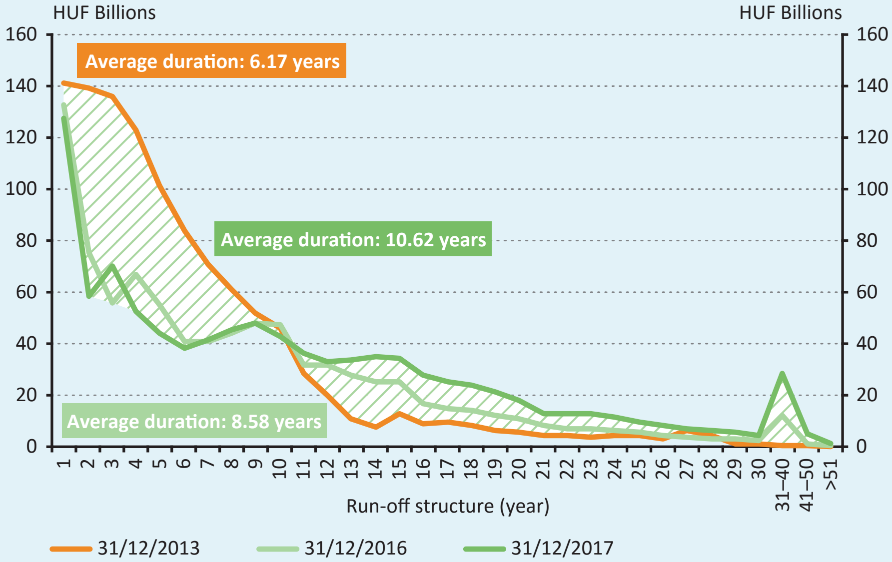
At the end of 2017, based on the maturity structure of the unit-linked products, the average maturity is 10.6 years. As regards the unit-linked products, the slower and late run-off of the cash flows estimated for 2017 is striking compared to 2013 and 2016. In 2017, 80 percent of the estimated liabilities will run off by the 21^{st} year; in 2016 and 2013 the same ratio was observed for the 18^{th} and 12^{th} year, respectively. In 2017, 90 percent of the estimated cash flow of the unit-linked portfolio will materialise in the 28^{th} year; the sum of the cash flows expected to run off in the 29^{th} year or later approximates 10 percent at sector level, while the same was 6 percent and only 1 percent in 2016 and in 2013, respectively.

Based on future cash flows of the unit-linked life insurances, the weighted average duration of the liabilities at sector level was 6.4 years in 2013 and 8.6 years in 2016, while by 2017 it was close to 12 years, thereby reaching the target value announced in connection with the introduction of the ethical life insurance concept.

For the first time in 2017, the MNB received data reporting about the probabilities of lapse per age of contract, based on which the age of the contracts ceased in 2017 was 6.8 years on average at sector level; however, due to the special features of the product portfolio (e.g. ratio of pension insurance, portfolio age), the institutional values are strongly varied between 4.1 and 10.8 years. In 2017 the observed surrender of the current period is in line with the expectations of 2013 (6.42 years). The ratio of the claim payments made in 2017 due to surrendered unit-linked contracts compared to the unit-linked reserve based on statutory accounts was 13 percent, which is the result of a continuous decline observed in the past 6 years.

In terms of the stability of the life insurance market, the ceasing of contracts is an important criterion whose development is facilitated by a material decline in surrender. The improving retention observed in the Hungarian insurance market is inconsistent with the anticipated rise in life insurance surrender within the EU, since due to a rise in market yields, investors may be attracted by other investment alternatives to the detriment of life insurances.

Chart box 3:
Run-off structure of the unit-linked life insurances in 2013, 2016 and 2017



Source: MNB

2.3 NON-LIFE SEGMENT

MTPL remains driver of non-life market

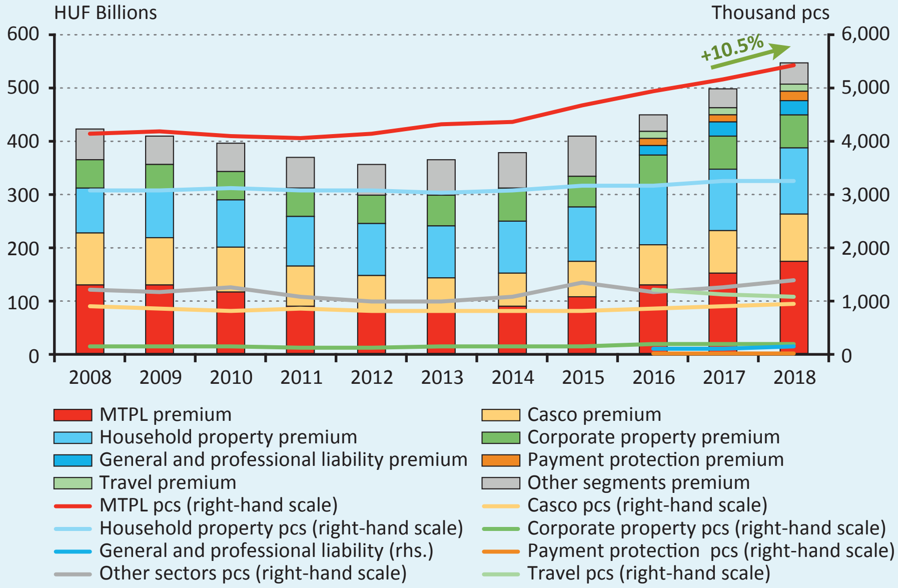
The growth of the non-life segment, seen since 2012, continued in 2018 as well (Chart 14). At 10.5 percent, which corresponds to a growth of HUF 52 billion, the growth rate exceeded that observed earlier. The greatest contribution to growth (HUF 21 billion) was made by compulsory motor third-party liability insurance (MTPL), being the largest business line, this year as well. The growth is attributable to a 5.2 percent rise in vehicles affected by MTPL – also lasting since 2012, as well as to a 9.7 percent increase in the 12-month regular premium per contract. The number of cars put into service for the first time in Hungary increased further, by 8.7 percent in 2018 compared to the previous year, which is a good illustration of the expansion of the potential vehicle fleet.

As regards land vehicle casco, the growth in the 12-month regular premium per contract – similarly to previous years – lagged behind that of MTPL (6.3 percent). The number of contracts rose by 5.7 percent, which exceeds the rate registered for MTPL. In 2015, 59 percent of the cars put into service in Hungary for the first time were second-hand cars, which may have caused a slower rise in the casco portfolio. Thereafter, by 2018 this number gradually decreased to 52 percent. If this trend continues, the ratio of new cars may increase, which may facilitate growth in the casco portfolio.

In the area of household property insurances (primarily home insurances), a premium income increase of 5.4 percent was observed, which exceeds the average of the previous 5 years. This ratio is characterised by accelerating growth, since 2013 (apart from a change of 6.2 percent, recorded in 2016).

The 3.5 percent growth in corporate property insurances, accounting for 12 percent of the non-life premium income, was more moderate than in previous years. Of the products with a lower share, the general and professional liability insurances rose by 7.5 percent, while the credit and suretyship insurances increased by 14.7 percent. In the non-life segment, travel insurances registered the most dynamic growth, at 25.3 percent. The remaining other products accounted for 7.4 percent of the non-life market in 2018, and they rose in excess of the average, by 16.8 percent during the year.

Chart 14
Changes in premium income and number of contracts of non-life segment by sectors



Note: The product category's loss of portfolio was also added to the number of travel insurances, as the parties usually conclude the contracts for a period less than one year.

Categories belonging to the "additional sectors" category, with a share of at least 3 percent: accident insurance, cargo and transport insurance, health insurance, surety and guarantee, extended warranty, various financial losses and legal expenses insurance.

Source: MNB

Non-life margin rose further

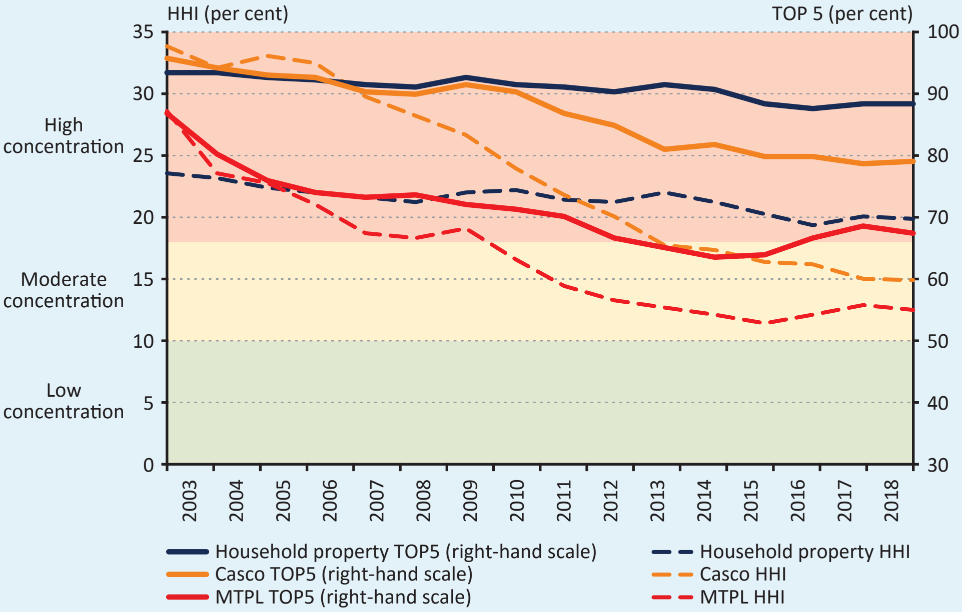
The MTPL segment is extremely price-sensitive, since the price of the service is much more important for the contracting customers than the prospective quality thereof. Under the aforementioned features, there is room for price competition, which is also supported by the flexible capacity limit of insurers and active sales by brokers. In addition, the search for insurers offering more favourable price and the replacement of existing policies by cheaper ones form an integral part of public thinking. All these processes contributed to a decrease in the concentration ratio of the segment in the past 10-15 years (Chart 15). The declining trend halted in 2016-2017, since some of the institutions may have still been in the consolidation phase that followed the years with high loss ratio[16], while other institutions were able to sell at a lower price. In 2018, the concentration ratio measured by HHI once again decreased by 0.3 percentage point. In parallel with this, the weight of the TOP5 market participants declined by almost 1 percentage point within the segment.

Competition among casco insurances has strengthened in recent years as a result of the price comparison applications provided by online brokers. Due to this, price competition may work among insurers despite the fact that the anticipated quality of service and the brand are important factors here. At the same time, the halt of the declining trend of the two concentration ratios in 2018 and the small (1 percentage point) decrease in the loss ratio imply no major change on the whole.

As regards the household property insurance segment, the index stands at almost the same level in the band signalling a high concentration ratio – over 18 percent when considering HHI – and it did not decline significantly in 2018 either (decreased by 0.2 percentage point). Favourable weather conditions and a moderate volume of storm claims resulted in a sector level low loss ratio, even compared to that registered before, i.e., 30 percent on average. This moderate loss ratio represents high profitability, which is a good incentive for several insurers to enter this segment. However, the change of home insurer still does not receive the same attention as MTPL or casco. The general public simply fails to realise that it might be worth checking the offers regularly also for home insurances to obtain a more favourable contract. In addition, the replacement of insurance linked to loans represented an additional administrative obstacle.

[16] See the period of 2012-2014 on Chart 18.

Chart 15
Market concentration of non-life segments

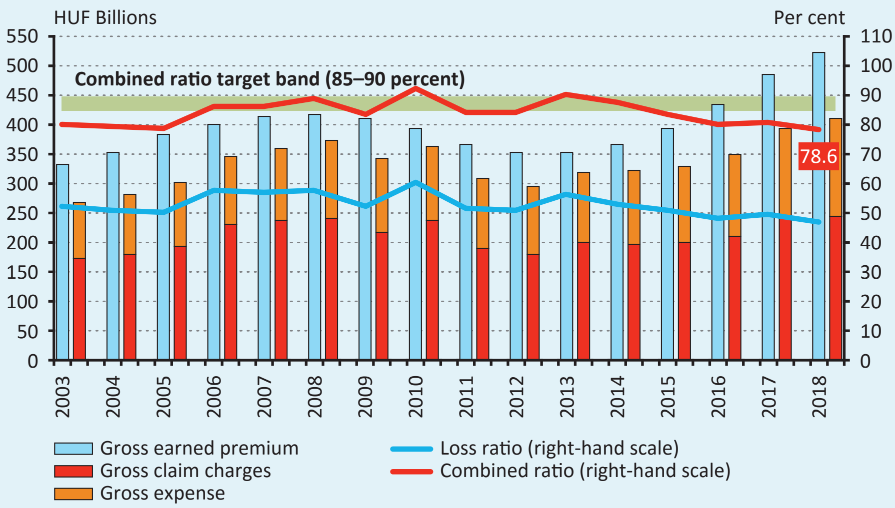


Note: The colour of the background illustrates the strength of the concentration under HHI.
Source: MNB

In 2018, the sector-level combined ratio of the non-life segment fell from 81.2 percent to 78.6 percent (Chart 16). This is due to the fact that earned premiums rose by 7.4 percent, which exceeded the dynamics of costs and claims in aggregate (3.8 percent). The 1.3 percent rise in claims lagged behind the 7.8 percent growth in costs, which on the whole increased the weight of the cost ratio within the combined ratio (to 31.5 percentage points). Favourable weather also contributed to the moderate rise in claims, which was primarily felt in home insurances.

The aforementioned process signals departure from the target band of 85-90 percent, deemed ideal in FIS. The decrease in the combined ratio increased the profit content of non-life insurances even further. The latter, and the steady change in premiums and claims, may be the consequences of weaker market competition. With a view to reaching the target band, it may be necessary to take measures aimed at boosting competition in the non-life segment.

Chart 16
Changes in non-life combined ratio

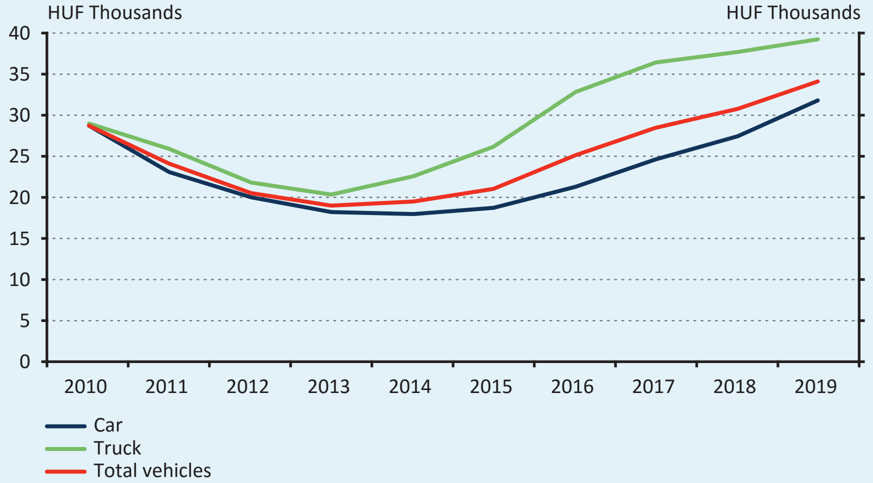


Source: MNB

Based on the first data from 2019, insurers charge the 23 percent insurance tax to the MTPL customers only partially

Based on the renewal portfolio data from 1 January 2019, the average premium level (12-month regular premium per contract) rose compared to January 2018 (Chart 17). However, it must be taken into account that the tax liability related to MTPL changed as of 1 January 2019. Instead of the 30 percent accident tax, paid formerly on top of the premium, customers are expected to pay insurance tax whose rate is 23 percent within the total premium; however, due to the different projection basis[17], the fiscal effect of this is neutral. The insurance tax is integrated in the premium, i.e., it is no longer necessary to pay accident tax separately. This means that the MTPL premiums reported to the MNB include the amounts already raised by the insurance tax. The "increased" premiums appear in the scheme only gradually, aligned with the customers' insurance renewal date. Before the renewal date, we see the premium without insurance tax, while the amount shown after the renewal already contains the tax, and thus we get the full picture only a year later, when receiving the data related to 1 January 2020 (by then the tax will be integrated in the premium of the entire portfolio). This complicates comparison with previous data, primarily in respect of the data related to 2019.

Chart 17
12-month regular premium per contract in individual vehicle categories



Note: On 1 January of the respective year. The premiums of 1 January 2019 are the premiums of policies with a renewal date of 1 January, increased by insurance tax.

Source: MNB

The present data, for 1 January 2019, already includes the increased premium for polices with a renewal date of 1 January, which presumably explains only the smaller part of the higher premium level, since the renewal date of only 30 percent of the portfolio corresponds to the calendar year-end. The ratio applied by the individual insurers to integrate the tax in their premiums is not known, but the average premium increase of 10 percent implies that they charged the tax to customers only partially. Based on a comparison with the premiums from 1 January 2018, increased by accident tax, it is obvious that customers pay less in all categories, except for buses. Based on the same data, excluding taxes, we estimate the rate of the decrease to be 14.7 percent.

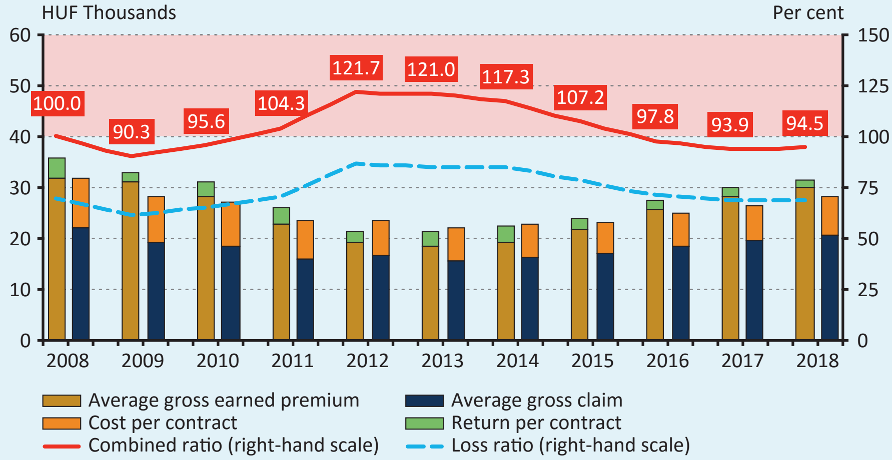
MTPL market operating at proper premium level

In 2018, the loss ratio per contract rose by 5.8 percent, which is similar to the average of the previous four years (5.5 percent). In addition – contrary to the previous years – the growth in earned premium per contract (6.0 percent) hardly exceeded that of the loss ratio (Chart 18). The former intensive (over 10 percent) premium increases were justified by the fact that the segment's combined ratio between 2011 and 2015 was at an unsustainable level (over 100 percent). The business segment was able to consolidate by 2016 and remained stable thereafter. The premium increase observed

[17] For example, the accident tax of a policy with premium of HUF 20,000 in 2018 was 30 percent, i.e. HUF 6,000, while in 2019 the premium of the same policy will be HUF 26,000, and the insurance tax is 23 percent thereof, i.e. HUF 6,000.

in 2018, being more moderate than in previous year, may be a sign of increased price competition. The change in the premiums is substantially influenced by the degree to which insurers charge the accident tax to customers.

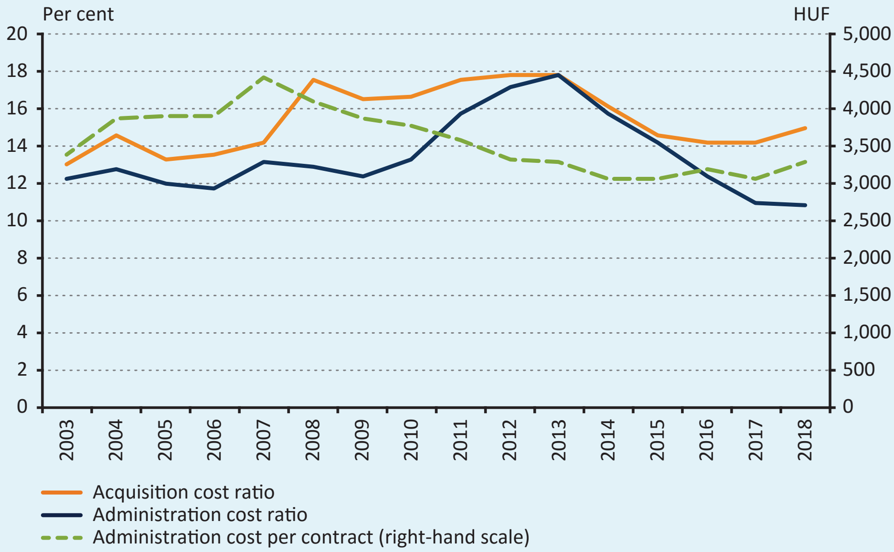
Chart 18
Changes in combined ratio of motor third-party liability insurance in Hungary



Note: The loss ratio values were adjusted for the change in outstanding loss reserves.
The pink area in the chart denotes the band of combined ratio exceeding 100 percent.
Source: MNB

The rise in cost per contract, contrary to the previous years, exceeded the premium growth rate, and thus the segment's cost ratio moderately (by 1 percentage point) increased. At the same time, the segment's cost ratio is in line with the ideal target of below 30 percent, set in FIS for non-life insurances. Within the cost ratio, the acquisition cost ratio increased (by 0.8 percentage point) and contrary to the decreasing trend, observed since 2013, the administration cost ratio stagnated (Chart 19).

Chart 19
Changes in the cost ratios of motor third-party liability insurance in Hungary



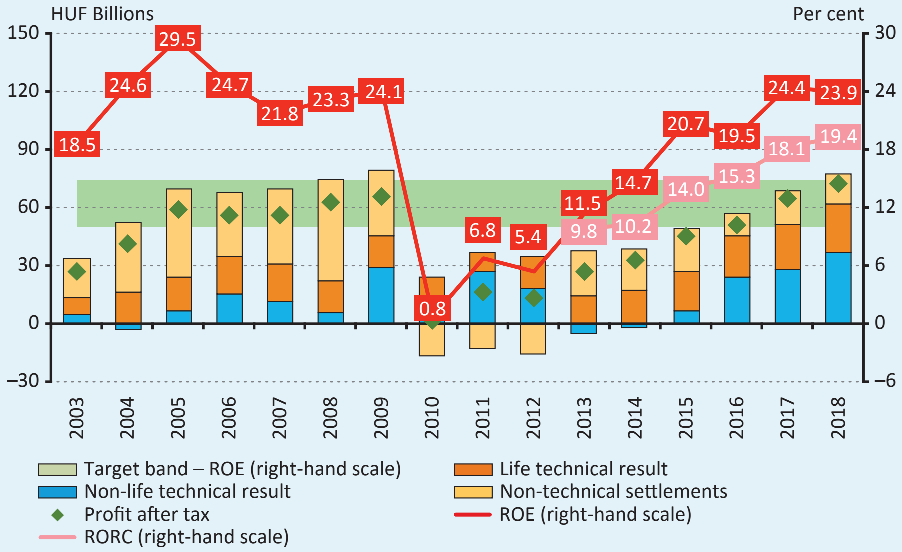
Source: MNB

2.4 PROFITABILITY AND CAPITAL POSITION

Profit of HUF 73 billion in the insurance sector

The insurance sector's return on equity (ROE) has been increasing dynamically from 2010 until 2017. In 2018 this growth faltered; nevertheless, it still stands at 23.9 percent, the level registered in 2007-2009. The shift toward the target band of 10-15 percent specified in FIS did not commence in 2018 either. Based on 2018 Q4 data, the after-tax profit of the sector was HUF 72.7 billion, the highest value in the past 16 years. This exceeded the previous record of HUF 66.2 billion, realised in 2009, by HUF 6.5 billion. The market's average return on premium (ROP) also continued the growth trend observed since the low of 0.23 percent, recorded in 2010. The ROP value of 7.12 percent in 2018 slightly exceeds 6.8 percent, the value recorded in 2017. We see pre-crisis profitability levels in the case of both indicators. Return of regulatory capital (RORC[18]), appears as a new indicator, which presents the sector's profitability based on S2 capital data, i.e., using a risk-based approach. This indicator also shows an increasing trend, which is attributable to the fact that the growth in profit exceeds the growth rate of capital requirement. The growth in profitability was caused by a major rise in non-life insurance results. While in 2013-14 the result of the non-life segment was negative, at present it accounts for 50 percent of the after-tax profit (HUF 36 billion). Contrary to the previous year, in 2018 the growth was attributable not to the rise in the profit of the MTPL segment. The record high profit is attributable to the fact that, in parallel with the 5 and 3 percent increase in retail and corporate property insurance, respectively, claim charges decreased by 12 and 31 percent in the respective segments. The technical results of the life business also show continuous improvement; compared to last year a growth rate of 5.7 percent was observed (currently HUF 25.5 billion) (Chart 20).

Chart 20
Profitability of the Hungarian insurance sector and its composition



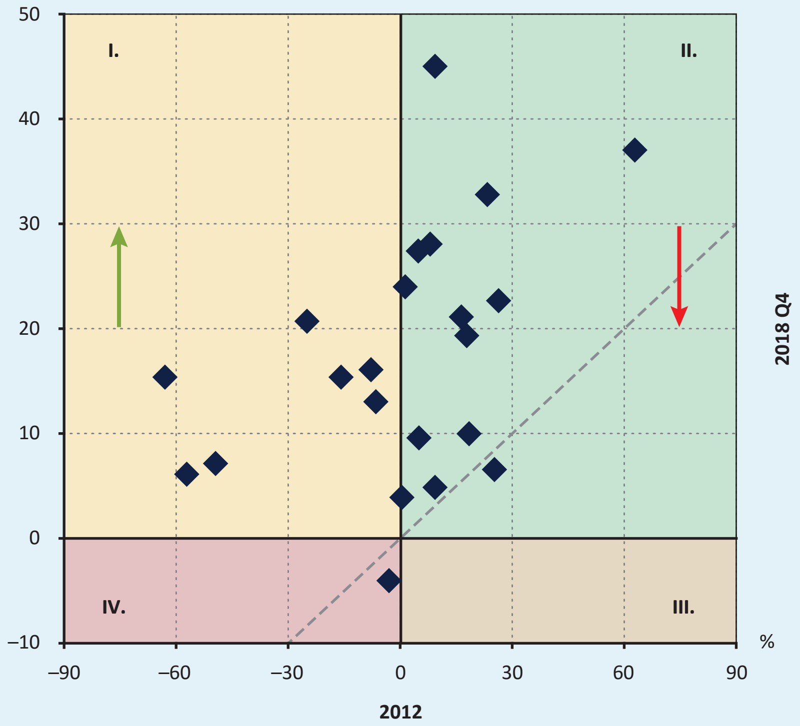
Note: The sector level ROE values (with the exception of 2018) were calculated on the basis of the annual audited data reporting, where equity does not contain the current year's dividend. At the RORC index, the after-tax profit is compared to the capital increased by the capital buffer prescribed in the MNB's recommendation (2013-14 are estimated values).

Source: MNB

[18] The return on regulatory capital (RORC) compares the after-tax profit/loss with capital requirement increased by the volatility capital buffer prescribed by the MNB.

At the level of institutions, the individual insurers' return on equity varies. In 2018, only one of the 23 insurers operated with a loss. In addition, 7 market participants managed to turn their negative return on equity registered at the end of 2012 into positive by 2018 Q4 (Chart 21). No shift in the opposite direction was identified for any of the insurers. Based on the shifts and profitability trends, an extremely positive picture unfolds in respect of the insurance sector, both at the level of institutions and the entire market.

Chart 21
ROE value of Hungarian insurers

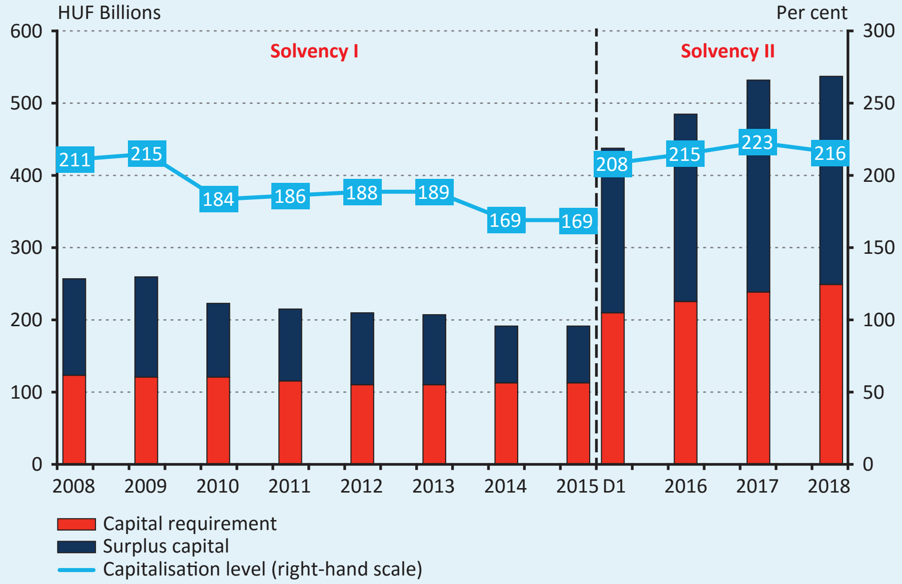


Source: MNB

Adequate capital level in the Hungarian insurance sector

Since 2016, i.e., since the introduction of S2, the sector-level capitalisation level is steadily double the statutory value, at over 200 percent. Compared to the changeover from the Solvency I scheme (Day-1, D1), the capital adequacy ratio fluctuates in a narrow band: compared to the 208 percent, registered on 1 January 2016, the difference is merely 11 basis points at the end of 2018 (218 percent). It is clear from Chart 22 that in recent years both the solvency capital requirement and the solvency capital increased, i.e., the sector's capital holding is in line with the increasing risks. This is also supported by the dividend policy pursued by insurers; namely, the payment of dividends is still not typical of the companies. The capitalisation level of the Hungarian insurance sector complies with MNB Recommendation 6/2016 and substantially exceeds 150 percent. The sector also fulfils the vision outlined in its future (FIS), which intends to establish a well capitalised insurance sector through the capitalisation level being steadily over 150 percent.

Chart 22
Capitalisation rate at sector level



Source: MNB

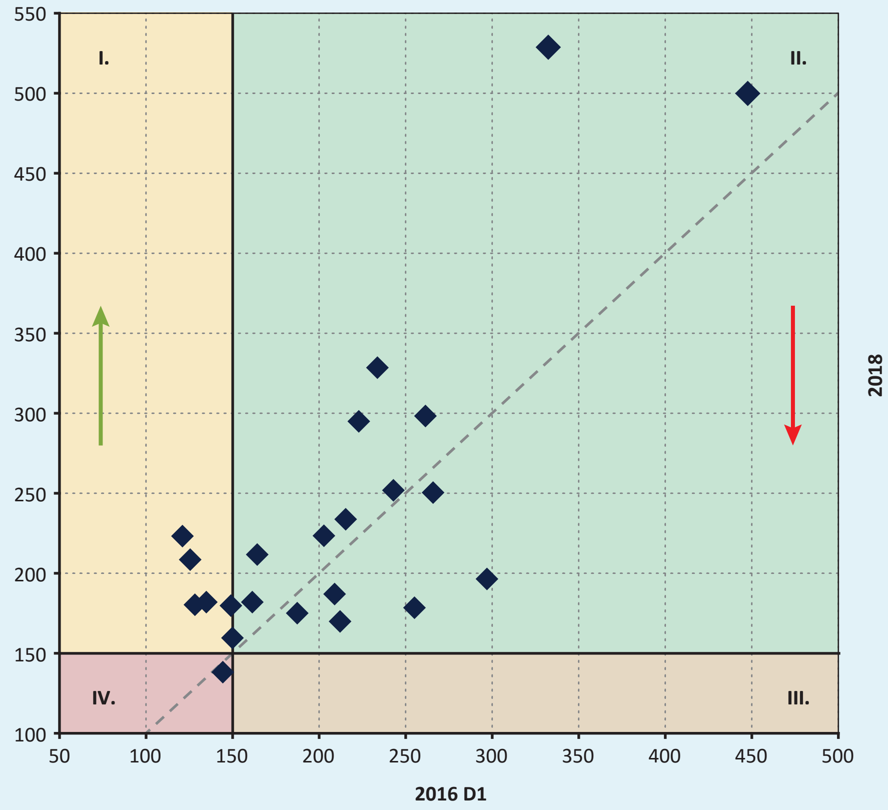
This capitalisation rate is similar to the values presented in the Financial stability report issued by EIOPA (December 2018). The report includes the parent companies and subsidiaries subject to EIOPA reporting in the European Union and the European Economic Area. Based on the 2018 Q2 data included in the report, the capitalisation level of 1,696 insurers – i.e., 83 percent of the institutions – exceeds 150 percent. In line with this, the median of the capitalisation level exceeds 200 percent for half of the EU member states.

Half of the insurers are over 200 percent

When examining the individual data of insurers, we find much larger differences. Although all institutions complied with the statutory requirement of 100 percent, one company failed to reach the capitalisation level of 150 percent specified in the MNB's recommendation. The market share of this participant is below 10 percent. By contrast, the capitalisation level of half of the institutions exceeded even 200 percent. Chart 23 reflects the shift compared to the Solvency II opening data reporting; the first quarter of the chart shows the companies that in the first data supply reported values below 150 percent, but in 2018 Q4 already exceeded 150 percent. According to the recommendation, insurers are advised to keep volatility capital buffers to provide at least 90 percent protection against unexpected capital loss over a one year horizon. If insurers are unable or unwilling to prove compliance with this requirement, the MNB recommends that the amount of volatility capital buffer held by insurers should reach at least 50 percent of their last reported solvency capital requirement.

The chart already shows the planned dividends; insurers reported planned dividends of HUF 60.6 billion in the S2 data reporting table; however, this amount may differ from the actual dividend payment and the annual data supply; accordingly the data may change in the future.

Chart 23
Individual capitalisation rates of insurers (2016D1 and 2018)



Source: MNB

Expected profit in future premiums substantially increased

The S2 regime acknowledges insurers' expected future profit by estimates based on the technical reserve cash flows. The positive value of the expected profits in future premium (EPIFP) reduces the value of reserves, thereby increasing the solvency capital and the capital adequacy ratio. Between 1 January 2016 and 31 December 2018, the EPIFP value rose by more than 50 percent, and by the end of 2018 it reached almost 40 percent of the solvency capital. The growth is attributable to the high profits observed in the sector, as well as favourable expectations with regard to the future (e.g., improving retention of life insurance contracts); at the same time, overly positive expectations and the overestimation of future profits may jeopardise the capital position. Under the present high capitalisation level, we regard this as low risk; however, in 2019 the MNB pays special attention to the EPIFP calculation of Hungarian insurers. The importance of the topic is also signalled by the fact that, based on the Financial Stability Report[19] of EIOPA, published in December 2018, the Hungarian insurance sector is ranked second in Europe in terms of the EPIFP to solvency capital ratio at the end of 2017.

[19] https://eiopa.europa.eu/Publications/Reports/EIOPA%20FSR%20December%202018.pdf

2.5 RISKS OF THE INSURANCE MARKET

Risk category	Risk groups	Risk rating	Risk prospects	Evaluation in words
Business model	Environment Strategy, business plans Profitability	🟡	➡	The business environment is favourable for the development of the market. The business models fit into the present environment, but it is justified to boost competition. Insurers' profitability remains sound (ROE: 23.9 percent). At the same time, certain actors are unable to capitalise on economic growth. The sector as a whole lags behind the growth in GDP; the largest growth is recorded by motor third-party liability insurances. **Similarly to the previous period, the risk rating remains moderate; the business model and profitability of the institutions are stable; no negative trends can be identified**
Corporate governance	Exercise of owner's rights Internal governance Risk assessment system and ORSA Internal control system	🟠	➡	The institutions' owner control and internal governance system are adequate. The operation of the internal control systems often does not ensure independence and participation in the decision-making process. **In order to ensure the expected operation of the control system, additional measures are required; in the absence of those, there is no justification for expecting an improvement in the level of risk over the short term.**
Financial and operational risks	Insurance risk Market risk Credit risk Operational risk Other material risks	🟠	➡	As regards insurance risks, on the non-life insurance market, within the claim and cost indicators, which are improving on average, the combined ratio of car insurances remained significant (above average). In the life insurance segment the decreasing volume of new acquisition represents a risk, although this is mitigated by the better structure. The SIGNIFICANT MARKET RISK is the consequence of the persistently low yield environment, since a major part of the insurers' investments comprise of instruments exposed to interest rate risk. Due to portfolios dominated by government securities, credit risk is moderate. OPERATIONAL RISK IS SIGNIFICANT, due to the experiences related to the inadequate operation of the portfolio management and IT systems. The liquidity risk, valued among the other essential risks, is generally managed properly by the insurers. **We expect that in the persistently low yield environment and in the knowledge of the present development plans, the currently high level of financial and operational risk will remain in the long run.**
Capital and reserve risk	Capital Reserves	🟡	➡	The sector-level capitalisation is 219 percent; it is over 200 percent on a steady and stable basis; the capital adequacy of 22 institutions exceeded 150 percent. The oversight experiences confirm the provisions of the MNB recommendation with regard to the holding of volatility capital buffer. The high ratio – in a European comparison – of the expected profit in future premiums (EPIFP) represents risk. Namely, upon the deterioration of the environment, the EPIFP value may decrease, which may cause the reserves to increase thereby deteriorating the capital position. The extension of the insurance tax on MTPL may increase the solvency capital requirement of the affected institutions. **Due to the substantial surplus capital, insurers' capital position is stable, capital risk is moderate and based on the present information no deterioration in the risk rating may be expected.**
Market entry risk	Products Customers	🟠	⬇	Based on the oversight experiences, the regulatory changes effective from 2018 for the time being have not reduced the product and customer risk materially, and thus those can still be deemed significant. **We expect that as a result of the enhanced supervisory focus, insurers will successfully adopt the changes in their practice, and customer risk will decrease over the medium term.**

Explanation:

Degree of risk	*high* 🔴	*significant* 🟠	*moderate* 🟡	*low* 🟢
Direction of risk	*increasing* ⬆	*stagnant* ➡	*decreasing* ⬇	

As **regards the external market and regulatory environment** to be considered when evaluating the **business models,** we found that in 2018 Q4 the Hungarian economy rose by 5.1 percent year on year; during the year, the volume of GDP increased by 4.9 percent in total compared to 2017. Based on the forecast included in the MNB's December *Inflation Report*, we expect 3-3.5 percent growth in the coming years. The strengthening of domestic demand will continue to play a major role in growth, with an increase in investments and household consumption being determining factors.

In 2018 Q4, **inflation,** following a decreasing trend, stood at 3.2 percent, while core inflation, which rose during the quarter, was 2.7 percent. Inflation developments were primarily influenced by a change in fuel prices; in addition, at the beginning of the quarter, unprocessed food prices caused minor inflationary pressure. Indicators capturing longer-term inflation trends (the inflation of demand-sensitive and sticky-price products) were below 3 percent. Based on the forecast in the *MNB's Inflation Report,* inflation is close to the 3 percent central bank target.

The aforementioned factors create a **favourable market environment and conditions for players on the insurance market.**

A thorough examination and assessment of the **strategies** applied by the institutions active in the insurance market shows that these institutions properly assess their opportunities and adequately align their business models with them. Several insurers consciously accept the one-sidedness of the product or sales mix; at the same time, it is also clear that some of them identified the one-sidedness of the product portfolio as a vulnerability, and thus they make efforts to enhance their business model. However, insurers striving for a diversification of the product offering, particularly in the non-life insurance market, are often hindered by the constraint of insufficient competition. Having recognised this, **the MNB regards it as one of its key duties in 2019 to develop a package of policies aimed at boosting competition in the non-life insurance market.**

In February 2018, the MNB published its paper entitled *10-year future of the insurance sector in 7 points*, where it defines the desirable profitability level that simultaneously ensures a fair, competitive and adequate return. With respect to the profitability of insurers, the MNB deems a return on equity of 10-15 percent at sector level in the long run, which is acceptable to society and strengthens confidence. Sustained profitability may support the stability of the institutions' capitalisation level and the development of a well-capitalised insurance sector. In general, and also compared to the level designated by the MNB, the **profitability** of insurers may be deemed particularly strong and it reflects stability compared to the previous years. Based on unaudited data, **the insurance sector's consolidated return on equity (ROE) was 24 percent in 2018.** For the only loss-making institution, the negative result is attributable to economies of scale problems.

Similarly to the previous period, the risk rating arising from the business model is moderate, the institutions' business model and business result is stable, and no trends deteriorating future prospects can be identified.

The **owner's control** and **internal governance system** of the institutions are adequate. As regards the regulation and independence of the **internal control systems, for the time being** the on-site and off-site supervisory experiences of the MNB **do not show desirable development.** It is indisputable that several insurers took measures to prevent the potential conflicts of interest arising from the personal overlaps of the controlling and controlled areas; however, as regards compliance, risk management and internal audit duties, several measures became necessary based on the findings of inspections. It is still typical that compared to an essentially adequate internal regulation, the actual practice significantly differs. Frequently, the reports and analyses – often being of particularly high quality – prepared by persons in charge of control functions are not used in a documented form during the decision-making process, which does not permit control and evaluation for purposes of oversight. It is also general experience that persons performing control functions do not participate personally in meetings of the executive boards, and thus the minutes of the meetings do not contain the compliance or risk management opinion or proposal related to the decisions. The appearance of the control functions in the decision preparation and decision-making process on the merits and documented in detail, is a general requirement, which also follows from the foregoing.

Based on the oversight experiences, the MNB is of the opinion that further steps are necessary in order to ensure that the insurers' internal control and practice guarantee the participation of the control system's elements and the persons in charge of those in a properly **regulated and documented manner, free from external influence and conflicts of interest,**

in the decision-making processes. In the absence of this, no improvement can be expected in the level of risk in the short term.

Looking at the **financial and operational risks**, a factor impacting **insurance risks** in the non-life insurance market is the higher case reserve for motor insurance, which resulted in an increase in the level of premiums applied in the market. In the life insurance segment, the risk generated by the decreasing increment of regular premium products is substantial.

The persistently low yield environment also represents major **market risk** both in the life and non-life insurance segments: in the life insurance segment, the low yield potential that the insurers may guarantee, hinders the development of demand for traditional products, while in the non-life insurance segment it reduces the profit realised on invested assets. At present, no material shift can be observed at sector-level towards assets promising a higher yield; the investment strategy of Hungarian insurers can be still deemed conservative. Based on this, at present no increase in the **credit risk** arising from the default of the counterparty can be expected either. In the low yield environment the regulation of the institutions' investment decision-making processes and the proper operation of related controls continue to bear utmost importance.

The significantly high level of **operational risks** continues to arise primarily from portfolio management and record-keeping, the operation of IT systems and the often inadequate level of IT security.

Insurers manage **liquidity risk** – assessed among the other important risks – adequately in general, and they need to do so since a potential shift from the low-yield environment and a devaluation of interest-bearing assets upon a maturity mismatch of liabilities undertaken and invested assets, hedging the former, may become a risk jeopardising the insurers' capital position.

We expect that the present high level of financial and operational risks will remain in the long run in the persistently low yield environment.

The consolidated capital adequacy ratio, reflecting the **capitalisation level** across the sector, is **216 percent**, which evidences that, based on the trends of previous years, the indicator stabilised over 200 percent. Although under relatively large deviations behind the reassuring average value, there are also favourable phenomena at the level of individual institutions. The eligible solvency capital of all institutions exceeds their capital requirement, thereby complying with the statutory regulations. Only one institution failed to achieve 150 percent, i.e., the level stipulated in the MNB's recommendation related to the holding of a capital buffer.

As regards the single institution, which based on its data supply exceeds the statutory limit, but substantially falls short of the value stipulated in the Recommendation, the assessment of the capital adequacy situation lagging behind the sector's average, was also complicated by the shortcomings in the applied method of calculation. This case, and the assessment of the related risks, further strengthened the MNB's conviction that as a special feature of the S2 scheme, stipulating the method of calculating the solvency capital requirement, the volatility of capital adequacy during the year justifies holding the capital buffer stipulated in the recommendation.

Owing to substantial additional capital, the capital risk may be deemed stable and moderate, and based on present information, no deterioration in the risk rating is expected.

The consumer protection risks identified in connection with the **products**, and the nature and number of the infringements identified during the comprehensive audits show no deterioration compared to the previous risk level; at the same time, no material improvement can be identified either. The implementation of regulatory changes, entered into force in 2018 and designed to enhance the protection of **customers**' interests (PRIIPS, IDD), in the internal processes and practice – even despite the major efforts to ensure compliance – have not reduced customer risk materially for the time being. The regulatory changes extending the insurers' need assessment and information obligation during the conclusion of the contract and thereafter are factors that strengthen the customers' position, and thus the decrease in customer risk is conditional upon the successful implementation of these obligations by the insurers.

3 Financial and insurance intermediaries

3.1 OVERALL PICTURE OF FINANCIAL AND INSURANCE INTERMEDIARIES

Further consolidating intermediary market

No major change was experienced last year in the number of intermediaries licensed on the financial and insurance markets; at the same time, the number of natural person intermediaries decreased on both markets, which was accompanied by rising revenues and substantially higher efficiency. The cost reducing (and thereby commission reducing) effect of the ethical life insurance concept, an increase in the frequency of data reporting by insurance intermediaries, and compliance with data reporting introduced for financial market intermediaries in 2017 represented easily manageable difficulties only for efficiently operating intermediaries. Institutions may apply for the withdrawal of their licence if they believe that they are not able to improve their procedures in a way that permits them to continue their operation efficiently under a tightening legislative framework. The MNB's dedicated intermediary oversight function verifies the continuous existence of statutory operating conditions; in the absence of those, the intermediary licence may as well be gradually phased out; in 2018, the MNB withdrew the licence of 25 intermediaries on the financial market as a sanction, in the vast majority of the cases due to the failure to comply with the reporting requirement; due to the new entrants, the number of institutions on the market remained unchanged (561), albeit in a different composition; the downward trend observed in 2016-2017 stopped.

Table 3
Key data of intermediaries

	Financial market intermediaries		Insurance intermediaries	
	2018	2017	**2018**	2017
Number of institutions	561	561	451	450
Broker	10	8	407	405
Multiple agent	391	398	44	45
Multiple special intermediary	5	5	-	-
Hire purchase intermediary	155	150	-	-
Number of natural persons (persons)	9,940	10,106	13,927	14,092
Commission income (HUF billions)	18.7	13.0	76.2	70.6

Note: Hire purchase financial market intermediaries are not obliged to supply data.
An overlap between the financial market and insurance intermediary natural persons is possible.
Source: MNB

3.2 FINANCIAL INTERMEDIARIES

Mixed picture, rising financial market intermediation on the whole

From the beginning of 2017, the independent financial market intermediaries are also obliged to submit regular, semiannual reports, and thus this year's report shows for the first time the change in sales by financial market intermediaries over time (Table 4). The products distributed by financial intermediaries can be allocated to 4 main categories: corporate credit, loan and financial lease; retail credit, loan and financial lease; deposit and payment account; and building society. As regards the sales data related to corporate credit, loan and financial lease products in the period under review, there is a decrease both in the fee and number of the contracts compared to 2017. When examining their shares, we obtain a different picture, since the share of the corporate credit, loan and financial contracts sold by financial market intermediaries – within new acquisition in the period under review – decreased based on the value of the mediated contracts (by 7 percentage points) and moderately increased based on the number of contracts (by 0.7 percentage point). Contrary to the negative trend in the value and number of contracts, in 2018 the commission income of financial market intermediaries from the sales of corporate credit, loan and financial lease products increased by HUF 0.9 billion compared to the previous year. Commission incomes increased compared to 2017 in each of the key product categories, irrespective of the change in the contracted value and the number of contracts. In the reporting year, the commission income on the market of independent financial market intermediaries amounted to HUF 18.7 billion, representing an increase of HUF 5.7 billion in total, comprised of acquisition commission of HUF 4.7 billion and retention commission of HUF 1 billion. The contracted amount of the retail credit, loan and financial lease products sold by financial market intermediaries increased (their share decreased moderately, by 0.6 percentage point), while the number of contracts increased (their share increased by 5 percentage points) in the period under review, year on year. In 2018, retail credits and loans were the key drivers of this product category on the financial intermediaries' market, while the mediated retail financial lease decreased in every respect. As regards acquisition commission income, in 2018 mortgage loan contracts accounted for more than half (57.7 percent) of the mediated retail credit and loan contracts (car loans: 0.1 percent; personal loans: 10.1 percent; credit card: 9.7 percent; other retail loans: 22.5 percent). Within retail credit and loan products, almost the entire retention commission income (97.5 percent) is linked to mediated mortgage loan contracts. In the period under review, the number of deposit and payment account contracts concluded by intermediaries decreased by almost fifty percent year on year, which is not reflected in the commission incomes related to these products. In 2018, the number of mediated building society contracts rose by 42.8 percent compared to the previous year; in parallel with the rise in the number of contracts, both the value of the contracts and the commission income increased dynamically.

Table 4
Sales data of independent financial market intermediaries

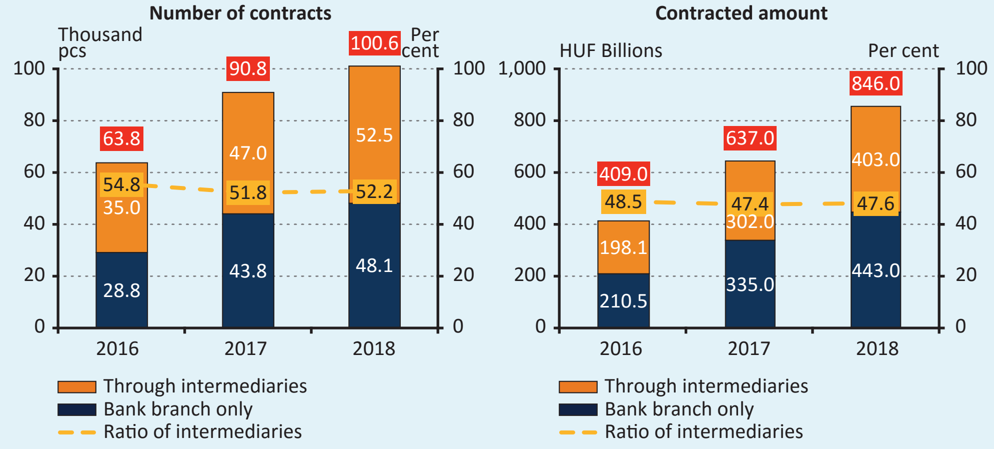
	Value of contracts HUF billions		Number of contracts pcs		Commission income HUF billions	
	2018	2017	**2018**	2017	**2018**	2017
Corporate credits, loans and financial lease	159.5	168.8	19,621	20,144	2.5	1.6
Total household credits and loans	333.2	228.9	178,809	183,464	8.3	6.6
of this: Mortgage	*287.6*	*192.0*	*27,359*	*22,894*	*5.0*	*3.3*
Motor vehicle	*0.5*	*1.5*	*284*	*910*	*0.01*	*0.02*
Personal loans	*19.5*	*7.8*	*10,266*	*5,945*	*0.8*	*0.3*
Credit card	*9.6*	*13.2*	*33,563*	*43,520*	*0.8*	*0.7*
Other	*16.0*	*14.4*	*107,337*	*110,195*	*1.8*	*2.3*
Total household financial lease	54.3	63.2	20,952	32,156	1.2	0.7
of this: Real property	*2.3*	*2.4*	*155*	*308*	*0.04*	*0.03*
Motor vehicle	*51.6*	*60.8*	*20,665*	*31,655*	*1.1*	*0.7*
Other	*0.4*	*0.0*	*132*	*193*	*0.004*	*0.003*
Deposit and payment account	-	-	115,874	211,065	0.62	0.58
Building society	420.3	257.3	84,352	59,055	6.1	3.5

Note: Hire purchase financial market intermediaries are not obliged to supply data.
The value of commission income also includes retention commission, in addition to the acquisition commission.
The sum of the part figures may differ from the value of the main categories due to rounding.
Source: MNB

Bank branches and intermediaries had an equal share in growth

The number of mortgage loans and loan amounts rose further in 2018 (by 10.8 and 32.8 percent, respectively). The breakdown between the two key sales channels (bank branches and intermediaries) remained essentially unchanged compared to the previous year. Bank branches and intermediaries realised growth to an almost identical degree, as a result of which they divided the growth of the entire market in accordance with their respective share. In 2018, intermediaries sold 52.2 percent of contracts and 47.6 percent of the loan amounts (Chart 24).

Chart 24
Distribution of mortgage loan contracts among sales channels



Source: MNB

Box 4
The MNB also expects intermediaries to comply with rules pertaining to prudent lending and loan intermediation

The first pillar of the debt cap regulation, effective from 1 January 2015, as a result of MNB Decree 32/2014 (IX.10) on the Regulation of the payment-to-income ratio and the loan-to-value ratio (Decree), i.e., the payment-to-income ratio (PTI), limits the maximum instalments that customers may commit to on new borrowing as a ratio of the customers' regular, legal income, thereby reducing the over-indebtedness of consumers. For housing loans, the loan-to-value ratio (LTV) limits the amount of the loans that may be borrowed as a ratio of the collateral (value of the home).

With a view to inspecting realisation of the aforementioned objective of the legislator and compliance with the debt cap rules, the MNB conducted targeted audit at two major players of the mortgage loan intermediary market.

During the inspection, within the framework of the aforementioned focus of the inspection, the central bank found that neither institution was able to prove credibly that, upon providing customers with offers, they had verified the statutory limit for lending applicable to the transaction – as prescribed in the Decree – and whether the respective customer had any other loan application or already disbursed other loans. According to the Decree, the total balance of the loans(s) granted to a single customer must not exceed 80 percent of the property value. When a customer applying for a mortgage loan must also confirm their own resources, and in parallel with that they draw down a personal loan as well, – particularly, when a mortgage loan in lower amount than anticipated is granted – it could be presumed in several cases that in fact the personal loan substituted the required own resources.

The MNB also regarded it as a shortcoming that the mediator failed to provide the respective consumers and the credit institutions disbursing the mortgage loan with proper information on the risk of multiple, parallel borrowing by identical customers, which may have prejudiced the interest of the clients (with too low real estate collateral compared to the loans) and the financial institution (undertaking extreme business risk).

The MNB imposed a supervisory and consumer protection penalty on the two mortgage mediator multiple agents, amounting in total to HUF 25 million due to the infringements identified by the inspection.

The central bank expects not only banks, but also the intermediaries to comply with rules pertaining to prudent lending and loan intermediation. The MNB conducts additional inspections with a view to reviewing and reinstating the statutory operation of financial market players.

3.3 INSURANCE INTERMEDIARIES

Growing insurance intermediary market

The contracts sold in 2018 by insurance intermediaries rose on the whole in their number, value and commission income, compared to the previous year. The number of mediated contracts and the total value of contracts rose by 11.1 percent and 17.3 percent, respectively, while compared to this, commission incomes increased only by 8.0 percent in the insurance intermediary market. In terms of the number of contracts, the mediation of non-life products accounts for 94.9 percent of the insurance intermediaries market, which ratio is almost the same compared to the previous year. In 2018, similarly to the previous year, the share of compulsory motor third-party liability insurance is determinant in the mediated non-life contracts both in terms of the total value of contracts (48.2 percent) and the number of contracts (58.2 percent). Based on the number of contracts sold in the reporting year on the intermediaries' market of non-life products, the share of travel insurance is 17.5 percent, casco motor liability insurance is 7.6 percent, home insurance is 4.9 percent, while corporate and institutional liability insurance has the lowest share at 2.7 percent; the share of other non-life products is 9.2 percent. These ratios do not differ materially compared to the previous year. In terms of the total value of contract, the insurance intermediary market is also dominated by non-life products, since the amount of non-life contracts accounts for three-quarters of the total value of mediated contracts, while the remaining one quarter of the contracted amount is linked to life products, which is a much higher ratio relative to the number of contracts. This is due to the fact that the contracted amount per contract is higher in the life segment. Due to the higher value of life insurance contracts, the commission income per contract is also higher in the life segment. The ethical life insurance concept also affected the insurance intermediaries, since one element of the concept is the amendment of the Insurance Act, effective from 1 January 2017 (published on 1 June 2016), which reduced the rate of the commission payable to insurance intermediaries in the first year, in several steps. From 1 January 2017, the maximum rate of the commission in the first year is 14 months' premium, from 1 January 2018 it is 13 months' premium, while from 1 January 2019 it fell to 12 months' premium. In 2018, the total commission income from the intermediation of life insurance contracts (acquisition + retention + target commission) decreased moderately, by 3.1 percent. As regards the elements of commission income in the life segment, this negative change is mostly attributable to a decline in acquisition commission incomes, contributed to by the decrease in commission income from target commission, while this negative trend was somewhat mitigated by the minimal, 1 percent rise in retention commission compared to the previous year.

Table 5
Sales data of insurance intermediaries

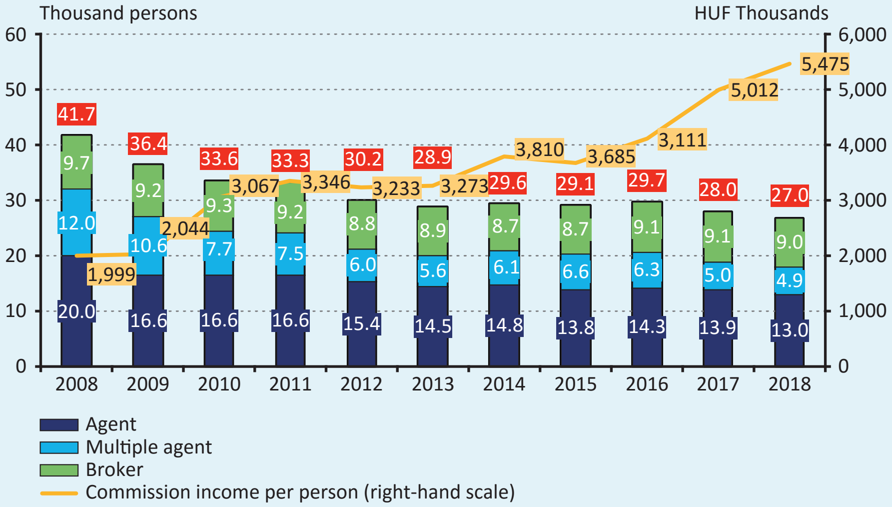
	Value of contracts HUF billions		Number of contracts pcs		Commission income HUF billions	
	2018	2017	**2018**	2017	**2018**	2017
Non-life segment	**149.2**	**125.6**	**2,354,771**	**2,113,047**	**55.5**	**49.2**
Compulsory motor third-party liability insurance	72.0	62.1	1,369,616	1,267,402		
Home insurance	4.8	4.4	115,193	111,173		
Casco motor liability insurance	25.1	21.8	178,941	159,579		
Corporate and institutional liability insurance	23.9	22.2	63,246	70,810		
Travel insurance	4.9	3.3	412,295	349,545		
Other, non-life insurances	18.6	11.9	215,480	154,538		
Life sector	**49.6**	**44.0**	**125,763**	**119,317**	**20.8**	**21.5**
Traditional life insurance	4.3	2.6	38,626	45,117		
Unit-linked life insurance	40.4	37.8	83,854	70,248		
Other life insurance	4.9	3.6	3,283	3,952		

Source: MNB

Number of intermediaries dropped by almost 3,000 on the market in two years

The 2,000 persons who disappeared from the insurance market in 2017, were followed by a further 1,000 agents in 2018. In the past two years, the decline in the number of intermediaries was attributable to a distinct decrease in multiple agents and tied agents. In 2018, the decline in the entire sector was attributable to the fall in the number of tied agents, while in the other two categories the number of natural persons moderately decreased. In the past 10 years, 15,000 agents disappeared from the market, while the number of brokers was stable throughout the period. Contrary to the brokers, the income of agents mostly comes from life insurances, which was directly affected first by the decreased demand caused by the crisis and later by the ethical concept (the regulation of the cost and surrender limits reduced commission in certain cases by 20 percent). In addition to the decline in profitability, the general wage increase observed in other sectors and industries may have also prompted intermediaries to leave the insurance market. Under a decreasing headcount, major improvement in efficiency can be observed in parallel with the trend increase in commissions per person, which also reflects an improvement in professional attitude.

Chart 25
Changes in number of natural person insurance intermediaries

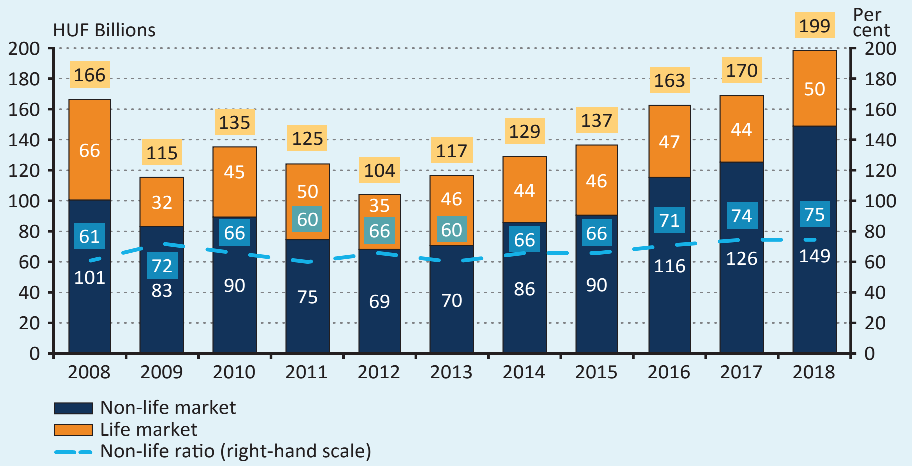


Source: MNB

Insurance intermediary market at its historic high

Since 2012, there is a steady growth in the premiums of insurance contracts of independent intermediaries. In 2018, the ratio of non-life policies in insurance premiums was 75 percent, which shows a moderately increasing trend in parallel with the rise in insurance premiums. In the reporting year, the 12-month regular premium of regular premium contracts accounts for almost the whole balance of the non-life premiums, at 90.4 percent; this is supplemented by the premium income of single premium contracts, with a ratio of 9.6 percent. More than half of the regular premium non-life

Chart 26
Changes in insurance premiums mediated by brokers and multiple agents



Note: The data shown in the chart contain the insurance premium of the contracts mediated in the reporting year (new acquisition). (Accordingly, it does not include the insurance premiums of contracts contained in the pre (closing) portfolio.)
Source: MNB

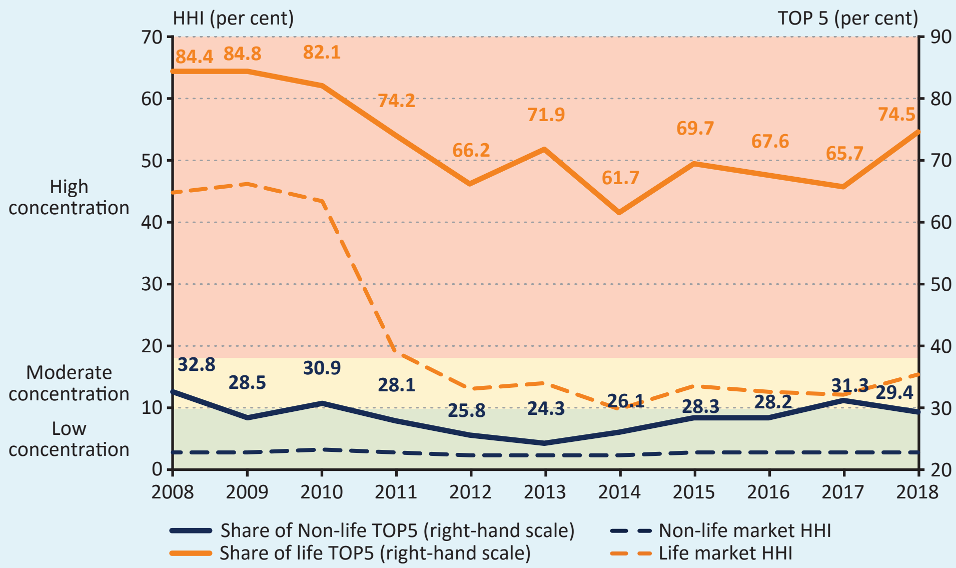
insurance 12-month regular premium (53.3) relates to MTPL contracts, followed by casco with 18.3 percent, corporate and institutional liability insurance with 13.6 percent and home insurance with 3.5 percent; the ratio of other, non-life insurance regular premium contracts is 11.2 percent in the non-life market's total 12-month regular premium in 2018. On the life market, the breakdown of the regular and single premium contracts is more balanced compared to the non-life market; in addition, for life insurance contracts mediated by brokers and multiple agents the share of single premium incomes is higher (63.0 percent) within the insurance premiums. On the life insurance market, a dominant part of both the regular 12-month regular premium and the single premium income is linked to the intermediation of unit-linked life insurances.

Different trends in the life and non-life segments in terms of concentration

In 2018, the market concentration of independent insurance intermediaries, calculated on the basis of gross premium income and 12-month regular premium developed differently in the life and non-life segment (Chart 27). In the non-life segment, the concentration ratio of intermediaries declined based on both indicators. The HHI (Herfindahl-Hirschman Index) once again fell back to the level registered in 2016 (2.6 percent). The share of the TOP5 market participants declined by 1.9 percentage points, which is a smaller correction than that observed in HHI, but at the same time, it reflects competition in the sales of non-life products.

In the life segment, the concentration ratio increased to a level unseen since 2011. The share of the TOP5 participants reached 74.5 percent, representing a rise of almost 9 percentage points, while the life segment HHI value of intermediaries was 15.4 percent (continuing to reflect a moderate concentration level). In the past 10 years, market concentration was unable to decrease materially and separate from the present level. Growth in the life segment on the entire market was negligible while compared to the non-life products demand for advice and consultation is higher. Presumably due to economies of scale, only fewer institutions were able to satisfy the foregoing – compared to the non-life market – under a higher concentration ratio.

Chart 27
Share and Herfindahl-Hirschman index of the TOP 5 independent insurance intermediaries based on gross premium income and 12-month regular premium, by segments

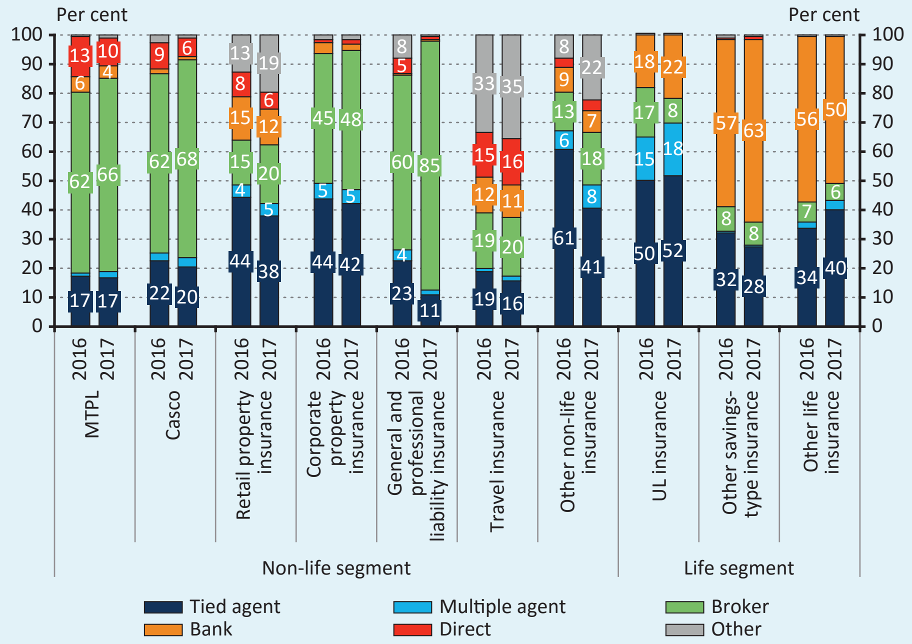


Note: The colour of the background illustrates the strength of concentration under HHI.
Source: MNB

Low sales volume by brokers in the life segment

When examining the insurance sales channels by key business lines, the breakdown of sales channels varies greatly; this also applies to all intermediary categories. Brokers' presence is traditionally high in the non-life segment. Broker's share increased in the business lines whose sales are dominated by brokers. Compared to the 2016 base, the share of brokers in the sales of home insurance rose significantly, by 5 percentage points; nevertheless, only 20 percent of the home insurance contracts can be linked to independent intermediaries. In the life segment, brokers' presence is not significant in any of the product categories, even a decline can be observed in their share. The market of UL insurances is determined by sales effected by tied agents, banks and multiple agents; within total sales the share of all three of them rose in 2017, to the detriment of sales by brokers.

Chart 28
Life and non-life insurance channel mix and changes in the ratio of broker counterparties based on their number

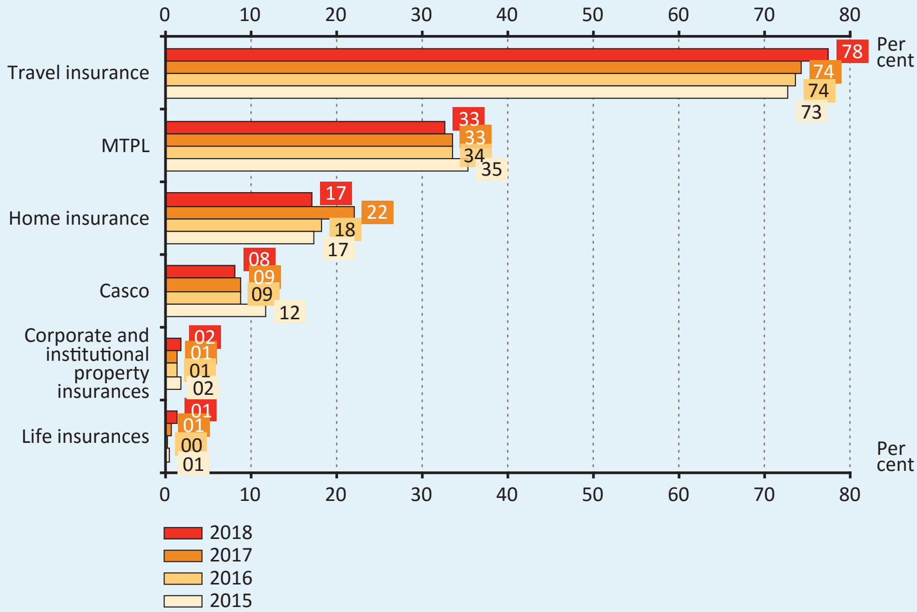


Source: MNB

Personal sales continue to be dominant, while the vast majority of customers arrange travel insurance online

In 2018, the ratio of life insurances mediated through electronic channel accounts for more than one-third of the contracts mediated on the insurance market, which hardly rose compared to the previous year (+ 0.7 percentage point). Accordingly, personal relations continue to be significant in insurance intermediation. The online sales channel mostly affects non-life insurance contracts; 99.8 percent of the electronically referred contracts focused on the non-life insurance market, in 2018, based on the number of contracts. Within the non-life segment, as regards the breakdown of contracts mediated electronically, the penetration of online insurance sales is the highest for travel insurances, while in terms of the number of contracts sold electronically, compulsory motor third-party liability insurance (MTPL) is ranked first, with almost 450,000 policies. In 2018, 32.7 percent of the mediated MTPL contracts, 17.2 percent of the home insurance contracts, and 8.2 percent of the casco contracts were sold via electronic channels; the ratio of contracts sold online declined year on year in all three non-life products; as regards the number, in these three categories, a decline was registered only for home insurances. In the intermediary market of corporate and institutional property insurances and life insurances, the penetration of electronic contract conclusion was negligible in 2018, even despite the growth registered in previous year.

Chart 29
Ratio of contracts arranged electronically (based on number of contracts)



Source: MNB

4 Funds market and its risks

4.1 OVERALL PICTURE OF THE MARKET

At the end of 2018, 58 funds operated in the voluntary fund sector, compared to the 63 institutions registered at the end of the previous year. No new fund received an activity licence during the year, while one fund decided on a merger, and the dissolution of three small institutions was completed; the activity licence of the latter institutions was withdrawn. In addition to the foregoing, as part of the continuous oversight, the MNB withdrew the activity licence of one mutual aid fund and initiated its liquidation, as a sanction. In 2019, the number of institutions is likely to decrease further in view of the fact that at the end of 2018, two institutions decided at their general meeting on a merger. The number of members slightly decreased in the voluntary pension fund sector, partly caused by the stagnation in the number of new entrants and partly by the rise in the number of those who cancelled their membership due to using the pension benefit. In 2018, there were almost 39,000 new entrant pension fund members, similarly to the number of entrants registered in 2017. In 2018, of the new entrants roughly 23,000 members joined through recruiters. With the maturing of the pension fund sector, the number of members entitled to pension benefit also increased continuously; in parallel with this, the number of members terminating their membership due to using the pension benefit is also likely to rise. This impact may be mitigated by the fact that the legislative changes effective from 1 January 2016, substantially expanded the options of members reaching retirement age. The members entitled to pension, after withdrawing part of the balance on the individual account, may leave a significant part of their savings in the fund, treating their savings in the fund as a kind of investment opportunity. Based on feedback from market participants, an increasing part of the eligible members use this option. As regards the health and mutual aid funds, the decline in the number of members stopped, and compared to 2017 the number of members rose by 7,000 persons even despite the large number of exclusions due to non-payment of the membership fee (14,000 persons) and members leaving the fund (22,000 persons). This growth in the number of members necessitated the joining of almost 50,000 fund member entrants. Roughly 26,000 of the entrants joined the funds through recruiters.

Table 6
Key data of the voluntary funds sector

<table>
<tr><th rowspan="2"></th><th colspan="4">Pension funds</th><th colspan="4">Health and mutual aid funds</th></tr>
<tr><th colspan="2">2018</th><th colspan="2">2017</th><th colspan="2">2018</th><th colspan="2">2017</th></tr>
<tr><td>Number of institutions</td><td colspan="2">37</td><td colspan="2">38</td><td colspan="2">21*</td><td colspan="2">25</td></tr>
<tr><td>Number of members (thousand persons)</td><td colspan="2">1,134</td><td colspan="2">1,138</td><td colspan="2">1,044</td><td colspan="2">1,037</td></tr>
<tr><td>Of this: Number of members paying membership fee in accordance with the statute (thousand persons | %)</td><td>570</td><td>50.3%</td><td>577</td><td>50.7%</td><td>503</td><td>48.2%</td><td>523</td><td>50.4%</td></tr>
<tr><td>Total funds portfolio (HUF billions)</td><td colspan="2">1,403</td><td colspan="2">1,392</td><td colspan="2">66</td><td colspan="2">62</td></tr>
<tr><td>Of this: Coverage reserve (HUF billions)</td><td colspan="2">1,383</td><td colspan="2">1,373</td><td colspan="2">61</td><td colspan="2">57</td></tr>
<tr><td>Asset value per contract (HUF thousands)</td><td colspan="2">1,219</td><td colspan="2">1,206</td><td colspan="2">58</td><td colspan="2">55</td></tr>
<tr><td>Sum of membership fee payments related to the reporting years (HUF billions)</td><td colspan="2">117.7</td><td colspan="2">105.6</td><td colspan="2">52</td><td colspan="2">48</td></tr>
<tr><td>Of this: Annual membership fee payments allocable to coverage reserve (HUF billions)</td><td colspan="2">112.5</td><td colspan="2">100.9</td><td colspan="2">49</td><td colspan="2">45</td></tr>
<tr><td>Amount transferred by the tax authority based on the member's declaration (HUF billions)</td><td colspan="2">10.9</td><td colspan="2">9.7</td><td colspan="2">5.8</td><td colspan="2">5.1</td></tr>
<tr><td>Payments against the coverage reserve (HUF billions)</td><td colspan="2">91</td><td colspan="2">78</td><td colspan="2">52</td><td colspan="2">52.2</td></tr>
<tr><td>Of this: Benefits, annual amount of payments after expiry of waiting period (HUF billions)</td><td colspan="2">77</td><td colspan="2">64</td><td colspan="2">51.2</td><td colspan="2">51.2</td></tr>
</table>

**In 2018, of the 21 health and mutual aid funds, 2 operated in the form of health fund, 3 in the form of mutual aid fund and 16 in the form of health and mutual aid fund.*

Source: MNB

Despite the negative impacts, membership fee incomes rose in both sectors in 2018

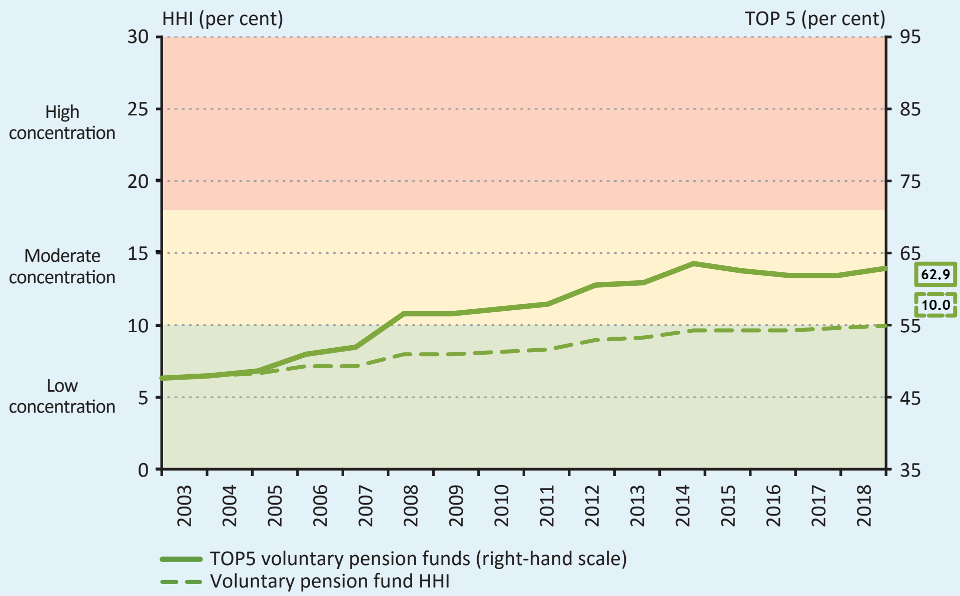
In 2018, in the voluntary pension fund sector, in addition to individual contributions, employer's membership fee contributions also increased; employers continue to regard fund contributions as a valuable fringe benefit. The growth in individual membership fee payments suggests that for financially more savvy members, supplementary products for pension and health purposes are increasingly important. It was a favourable change that from 1 January 2018, the employers' burden payable in respect of contributions to voluntary funds decreased from 43.66 percent to 40.71 percent. If in 2018, the employer maintained the financial allocation for contributions to funds, a higher amount thereof may have been received by the funds. In 2018, the membership fee payments allocable to the individual accounts (coverage reserve) already exceeded HUF 110 billion for voluntary pension funds; as a result of membership fee payments, by the end of 2018, the aggregate balance of the voluntary pension funds' individual accounts came close to HUF 1,400 billion; in one year, the asset value per contract rose slightly, by 1 percent. For voluntary pension funds, the higher membership fee income in 2018 compensated not only for the less favourable yields, but also for the higher benefits payments affecting the coverage reserves (individual accounts). In 2018, there was an increase in the number of persons terminating their membership due to using the pension benefit, and within that also the number of members claiming their benefit in a lump sum. The amount paid as lump sum insurance benefit rose not only due to the rise in the number of members using the benefit, but also because these members – presumably after a longer accumulation period – claimed a higher pension benefit. The assets of health and mutual aid funds rose by HUF 4 billion to HUF 66 billion, of which the assets allocable to the individual accounts (coverage reserve) is HUF 61 billion. Despite the fall in the number of members duly paying the membership fee, membership fee income rose, while the payment of benefits stagnated.

4.2 VOLUNTARY PENSION FUNDS

Voluntary pension funds reached the lower bound of the moderate concentration band

In the voluntary pension fund sector the number of active funds declined by one by the end of 2018. The decline is the result of the merger of a small institution, both in terms of number of members and assets, with a larger fund. The decision on terminating independent operation was caused by the cancellation of employers' contribution. It was found at a few institutions with employer background that employers either stopped paying the voluntary fund membership fee contribution in respect of their employees, or they did not agree to continue providing operating support for the funds.

Chart 30
Developments in voluntary pension fund concentration



Note: The colour of the background illustrates the strength of concentration under HHI. Contrary to the practice of previous years, this year we used quarterly data only in respect of 2018. The figures of previous years were updated with the annual audited data. Due to this, the chart may differ from that published last year.

Source: MNB

The value of the Herfindahl-Hirschman-index (HHI), an index that shows market concentration ratio based on the payment of membership fee, moderately rose in 2018 (Chart 30), which is attributable to the merger mentioned above. The market share of the TOP5 funds, based on membership fee income, also increased compared to 2017. In the voluntary pension fund sector, for a large part of the institutions the amount of membership fees received substantially increased in one year; more specifically, at some larger funds the growth in membership fee income exceeded the sector average. At these institutions the commitment of the members and employers with regard to the fulfilment of payments is typically stronger.

Box 5
New oversight methods on the changing funds market

More risk-sensitive impact classification

The MNB allocates the institutions supervised by it into four categories by algorithms defined by institution types/sectors, based on their impact on the financial system and on the MNB's oversight objective upon their market failure. These four categories are as follows: high impact, higher than medium impact, lower than medium impact, low impact. Special risk assessment is prepared quarterly for institutions of high impact and higher than medium impact. The impact classification of the supervised institutions and the algorithm performing the classification are revised annually. During the revision of the methodology in 2017, the parameters of the algorithm were adjusted, as a result of which after the usual annual impact classification, the ratio of the institutions subject to individual risk assessment relative to the entire sector rose to almost 50 percent from 10 percent registered in 2014.

Sector-specific risk map

The risk map is a tool used for the identification and classification of risks arising from the risk environment. It presents a predefined, general and hierarchic structure of the sources of risk, along which the comprehensive risk assessment of the supervised institutions and sectors can be performed. As regards the oversight of funds, it may be considered a major achievement that from 2018 a map, converging with those of other supervised sectors, but at the same time being sector-specific, was introduced. Identically with the formerly used map, corporate governance, market entry and financial and operational risks continue to form risk groups, supplemented by business model, sustainability and reserve risks as new groups. The main objective of the new map is to facilitate the presentation of fund-specific risks, while preserving the risk structure applicable to all sectors; such fund-specific risks include the yields realised on the investment of member' assets, the supplementary entrepreneurial activity, member recruitment, benefits characterising the individual institution types (e.g. payments after the expiry of the waiting period, members' loan), the explicit (e.g. membership fee ratio for operation) and implicit (indirect investment costs) deductions burdening the members.

Operative inspections of funds

In the coming years, the funds oversight and inspection function intends to deepen its audit activity continuously, by conducting a higher number of operative inspections, in addition to the comprehensive inspections conducted in the 5-year cycle. The main argument for the rapid, operative inspection is that there are risks that are identified during the offsite oversight, but due to their nature it is not possible to explore and manage them in full relying on offsite oversight tools. The MNB determines priority target inspection areas annually, also considering the oversight and audit findings of previous periods, which will provide a proper basis for the designation of the focus areas to be subjected to operative inspection. The operative inspections help prevent and identify the anomalies appearing at the level of individual institutions and related to the usual funds functions (e.g. inspection of the fulfilment of personal and material conditions; verification of investment, accounting and cash management regulations; benefit financing), but this may also include the management of problems arising at several institutions or at sector level. The advantage of such inspections is that, following the identification of problems, the MNB is able to take measures relatively quickly to protect the interests of members.

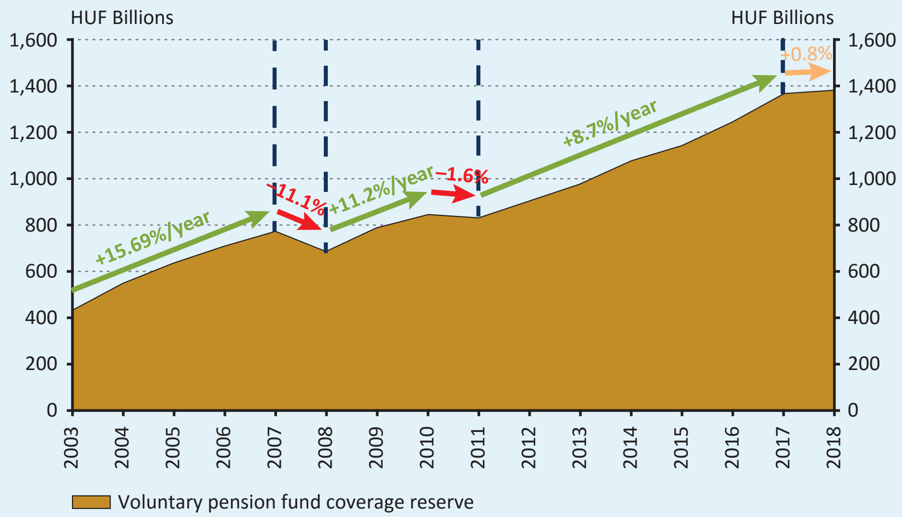
Daily investment monitoring

The purpose of daily investment monitoring is to ensure that, through the daily analysis and assessment of the portfolio's balance and transaction data, the daily inspection of the investment of funds' assets in compliance with the laws, legal regulations of principle, market practices and the MNB's expectations can be implemented based on a cross-sectoral approach. The audit scheme used to date (alert-based) served the security of investments and the reduction of investment risks; however, it failed to provide comprehensive information whether the asset management organisations always act in the interest of customers. Continuous investment monitoring helps assess individual transactions on a daily basis in terms of their expedience, market conformity and cost effectiveness. These together may ensure the practice of best execution from the customer's point of view.

The rate of growth in assets, lasting for six years, faltered (increasing contribution, but negative yields).

At the end of 2018, the balance of the voluntary pension funds individual accounts (coverage reserve) was HUF 1,383 billion, exceeding the value registered at the end of last year by 0.8 percent. At the end of 2018, the sum of the individual accounts receivable of members entitled to payment within one year during the accumulation period already exceeded HUF 1,200 billion. It is positive that a considerable number of the members entitled to payment have not yet decided to use their pension fund savings, but rather intend to continue augmenting them in the funds scheme.

Chart 31
Developments in the voluntary pension fund coverage reserves



Source: MNB

Decrease in the ratio of indirect investments, increase in equity investments in 2018

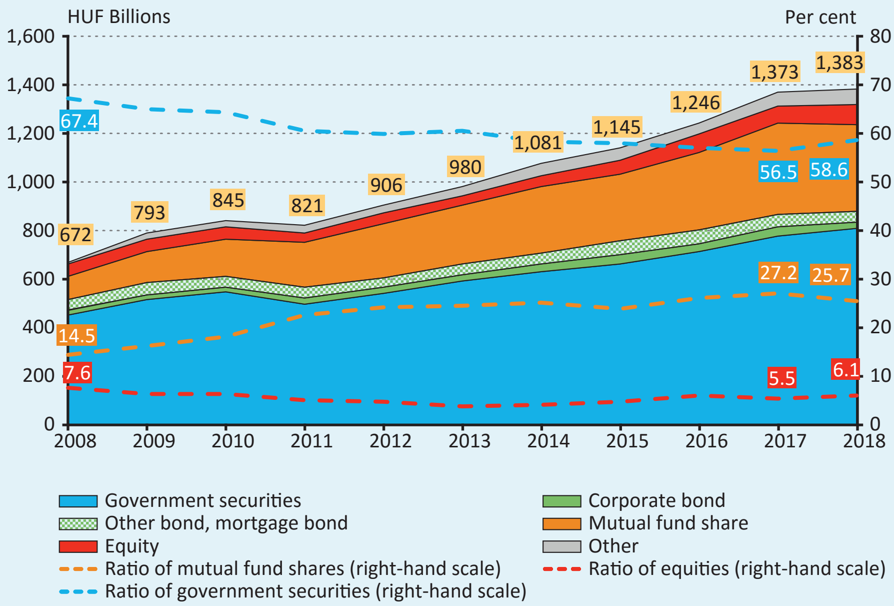
Hungarian government securities still account for the largest part of the investments of the voluntary pension funds' individual accounts. In 2018, the direct government securities exposure rose by 2.1 percentage points, and at the end of the year it stood at 58.6 percent, compared to the 56.5 percent recorded at the end of the previous year. The duration value of the forint-denominated fixed-rate Hungarian government securities portfolio of the voluntary pension fund sector was 4.3 and 3.8 years on 31 December 2017 and 31 December 2018, respectively. In technical terms, duration is one of the general indicators of the sensitivity of the bond portfolio's price to the change in market yields. The lower the value of duration is, the less sensitive the bond or the bond portfolio is to the change in market yields. Accordingly, in a market environment where uncertainty around long-term expectations increases, investment decision-makers often respond by reducing the duration value. The increase in average maturity implies that by "shortening" the government securities portfolio, the decision-makers of the funds sector intended to mitigate the negative impacts of a future increase in market yields. Within the funds portfolio, the ratio of direct equity investments rose from 5.5 percent to 6.1 percent during the year, which was primarily attributable to the increase in the ratio of Hungarian equity investments from 3.2 percent to 4 percent. The indirect equity exposure of the funds is higher than that, since the funds usually reach the international equity markets through collective investment vehicles.

In 2018, the ratio of indirect investments fell from 27.2 percent to 25.7 percent, where the ratio of foreign mutual fund shares in the funds' portfolio declined from 11 to 9.4 percent.

The ratio of corporate bond investments dropped from 3 percent to 2.1 percent. In 2018, within the corporate bond investment category, funds reduced their foreign credit institution bond exposure by fifty percent, i.e., from 1.5 percent compared to the entire portfolio to 0.7 percent.

The real estate investments of pension funds are negligible within the total investment portfolio, but they moderately rose in 2018. In the funds' portfolio, the shares of the real estate investment funds rose to 1.9 percent by the end of 2018 from 1.6 percent registered at the end of 2017, while the ratio of direct real estate investments increased to a smaller degree, from 0.6 percent to 0.7 percent. The share of mortgage bonds within the funds' portfolio is negligible, and in 2018 it fell from 1.8 to 1.2 percent.

Chart 32
Distribution of the voluntary pension funds' investments by asset groups



Source: MNB

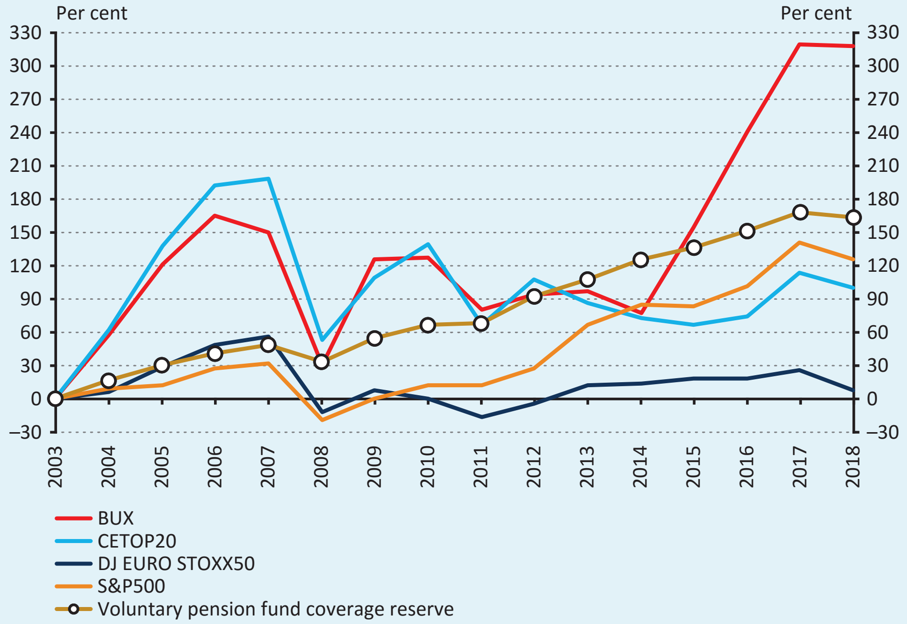
Box 6
In an international comparison, Hungarian securities performed better in the past 4 years

In 2018, investor sentiment deteriorated overall. This was influenced by expectations about the monetary policy of the world's major central banks, uncertainties surrounding the international trade policy, the dispute related to Italy's budget, the Brexit deal and a deceleration of global economic growth. As result of these, international market materially faltered, and some of the indices closed the year with a two-digit decline. Although the ratio of the assets included in these indices is lower in the funds' portfolio, their profit impact should not be ignored still.

In an international comparison, the Hungarian market closed 2018 with a more moderate decline. The value of the Budapest Stock Exchange index declined by 0.6 percent, while as a result of the yield increase, a decline of 0.9 percent was observed on the market of Hungarian long-term government securities (MAX index).. By contrast, the annual change in the value of the CETOP20 index – reflecting the performance of the Central European corporations of the largest capital value and stock exchange turnover – was -6.4 percent, the annual change in the value of the EURO STOXX50 value – reflecting the value of the 50 corporations, available for trading on the common stock exchange of European countries (EUREX), with the largest capitalisation and turnover – was -14.4 percent, while the annual change in the value of the S&P500 index – reflecting the performance of the 500 largest companies of the US market – was -6.2 percent.

As a result of downturns on the capital markets, the voluntary pension fund suffered an average net yield loss of -1.8 percent. This is essentially attributable to three reasons; namely, to the events on the international capital markets, the decline in the Hungarian capital market and the devaluation of bonds. However, based on a review of the institutions' longer term investment performance we found that the majority of the operating voluntary pension fund portfolios continued to realise a result exceeding inflation and also the change in the value of the largest international indices.

Chart box 4
15-year cumulated yields



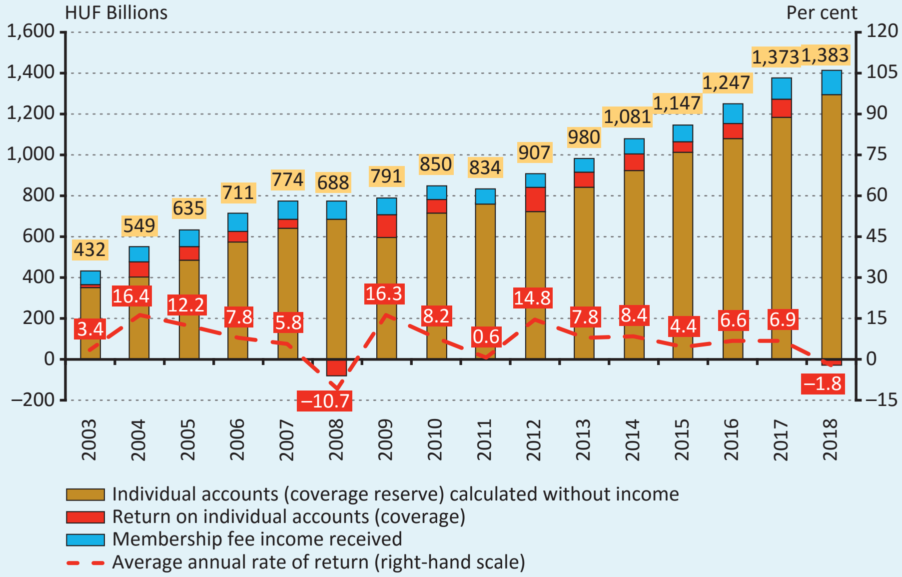
Source: MNB

Stagnating fund assets, under negative yields and increasing contributions

In 2018, the voluntary pension funds realised an asset-weighted average net yield of -1.8 percent at sector level, showing a real yield of -4.38 percent when adjusted for inflation (Chart 33). However, there may be major differences between the yields of the individual funds and the optional fund portfolios; in 2018, the net yields of the voluntary pension fund portfolios varied between 1.95 percent and -6.92 percent. In 2018, only low-risk portfolios and a few absolute yield portfolios managed to realise a positive yield. The lowest yields were observed for riskier portfolios with a larger equity market exposure.

In 2018, similarly to the previous year, the Hungarian money and capital markets were characterised by low interest rates; the interest rate on bank deposits was around 0 percent. On the Hungarian bond markets (government securities market), moderate yield could be realised only in short-term – with maturity within 1 year – securities; the price movements of the Hungarian long-term government securities also turned negative as a result of the yield increase. In 2018, the value of the BUX index dropped by 0.61 percent, while the price indices of the foreign capital markets suffered an even larger decline. The investment result of voluntary pension funds' less risky portfolios, showing relatively lower loss, was primarily impacted by the moderately negative or slightly positive yield result of government securities. The weaker performance of the portfolios where the proportion of risky assets is higher is the consequence of a smaller decline in the Hungarian equity market and a larger one in the international equity markets, where the developments in the forint exchange rate were able to offset the latter only partially.

Chart 33
Developments in voluntary pension fund coverage reserve, membership fee income, volume of yields and annual average rate of return



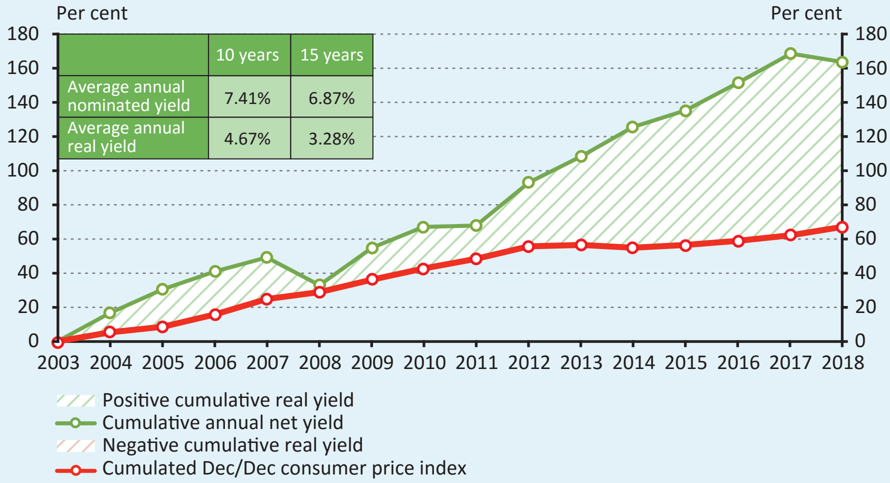
Source: MNB

It should be noted that the yield and the market price of bonds move in the opposite direction, i.e., when the yield increases, the price falls. Accordingly, as a result of increasing yield expectations, bonds purchased previously depreciate; thus in respect of the Hungarian government securities market as well, the increase in market yields caused the price of the government bond to decrease, and thereby the market value of the portfolios dominated by government securities also declined.

The purpose of the pension funds is to supplement the pension materially in the years following the end of active employment. Accordingly, the developments in savings must be examined over a longer timeframe; weaker investment performance observed in certain years does not necessarily mean that the pension fund member will also face a loss upon using the future benefit or payment, since experience to date shows that the loss of periods of weaker performance was not only adjusted by the positive result of other years, but even exceeded it, thereby increasing the level of long-term savings in real terms as well.

Based on data supplied by the funds, the MNB has published the pension funds' 15-year average rates of return for four years now. Based on the yields of 2004-2018, the average asset-weighted net rate of return at sector level, calculated from the average 15-year yield rates, is 6.87 percent, which represents a real yield of almost 3.28 percent above the 15-year average December/December inflation rate of 3.48 percent. The long-term, 15-year average real yields of the fund portfolios vary between 1.25 and 4.76 percent. The average asset-weighted value of the 10-year net rates of return was 7.41 percent, which represents a real yield of 4.67 percent over inflation.

Chart 34
Long-term cumulated yield of the voluntary pension fund sector



Source: MNB

It can be stated generally that the average cost effect occurs for long-term regular savings, the essence of which is that the regular small-value pension fund contributions reduce the risks arising from the fluctuation of prices during more volatile periods.

Based on the strict cost constraints applicable to voluntary funds and the investment results measured in the longer term, pension funds may still be regarded as a favourable form of pension savings, in addition to the pension insurance and pension savings accounts of similar purpose.

Box 7
Methodological innovation for the analysis of the costs of voluntary pension fund: adjusted fee burden ratio

The Magyar Nemzeti Bank examines the changes in the costs of voluntary pension funds annually. Based on the data included in annual accounts of the voluntary pension funds, the MNB calculates and publishes the fee burden ratios of the individual funds and of the entire sector. The purpose of the fee burden ratio is to apply a standard index that helps present the fees burdening members annually, and deducted from the members' payments and investments, and to compare them among the individual funds.

The voluntary pension funds cover their operating expenses from the fee deducted for operation from the payments of the fund members and the employer members, while the expenditures related to asset management activities are financed from the fee burdening the savings of the fund members. The projection basis of the deducted fees varies. The fee allocable to the operating and liquidity reserves is determined by the funds' statutes as a percentage of the membership fee, while the fees related to the investment activity are specified in the contracts as a percentage of the invested assets. In previous years, the MNB calculated the fee burden ratio by comparing the fee deducted for operation and liquidity and the fees related to asset management with the fund's assets.

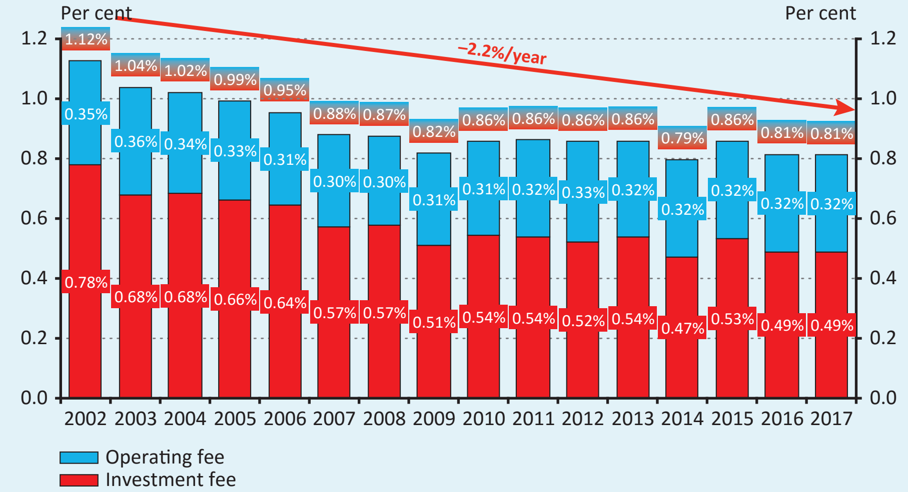
The fee burden ratio applied formerly substantially declined over the past 15 years. However, it was difficult to assess the changes in the fees deducted for operation, since due to a major growth in assets during the period – in the past 15 years there was a five-fold increase in the pension funds' assets – the operating fee burden may have declined even if the fee effectively burdening the member has not changed or even increased. In the period of 2002-2017, the fee burden ratio published by the MNB in previous years, decreased from 1.66 percent to less than half thereof, to 0.79 percent. When examining the changes in the fee burden ratio by components, the fee charged for operation fell from 0.88 percent of 2002 to 0.30 percent. However, based on this it is not possible to determine whether the fee deducted from members' contribution for operation indeed decreased, since the major decline in the formerly applied fee burden ratio was substantially influenced by a significant growth in assets during the period under review, since in the last 15 years the assets of pension funds rose annually by 21 percent on average.

With a view to performing a deeper analysis of the fee deducted by the funds, in 2018 the MNB used an adjusted fee burden index, where the value of the fee deducted for operation is not influenced by the changes in the volume of the funds' assets. In the adjusted index, the adjustment factor is determined by the ratio of the fees deducted for operation relative to the total membership fee. According to the new methodology, the fee allocated to operation is compared to a hypothetic, average volume of assets accumulated in the respective period – from the total membership fee payments – by an average member, with an accumulation period of 30 years, rather than to the pension fund's assets. The revised index reflects the changes in the ratio of the fee allocated to operation compared to the fees deducted for operation and liquidity to the total membership fee. The MNB did not modify the calculation methodology of the investment fee burden part of the adjusted fee burden ratio as the asset management and custodian fees are charged in proportion to the assets of the fund. The adjusted fee burden ratio provides a more accurate picture of the changes in the volume of fees burdening the members of voluntary pension funds.

Based on the adjusted fee burden ratio, in 15 years the rate of the fee charged decreased by 27.7 percent. The decrease in the investment fee component has a determinant role in the decrease of the fee burden ratio. The law applicable to voluntary pension funds limits the rate of the chargeable asset management fee from 1 January 2008. Within the scope of its oversight activity, the MNB pays special attention to inspecting the investment costs of pension funds; in addition, it also helps market participants, by its regulatory instruments, to develop cost efficient asset management activity harmonised with members' interest[20]. Last year, several funds of major weight stipulated lower fees in their asset management contracts. As of 2019, the MNB deepens the oversight of the voluntary pension funds' asset management by developing a daily, transaction-based investment monitoring scheme. In the period of 2002-2017, the membership fees deducted by voluntary pension funds for operation, as a percentage of the total membership fee income, declined by 7.5 percent. However, the decrease was not steady: following the decline in 2002-2007, the ratio of the fees deducted from membership fees for operation rose between 2008 and 2012. As a result of the 2008-2009 crisis, the membership fee incomes of funds declined in 2008-2012. Due to tiered membership fee deduction, applied by most of the funds, a higher ratio was deducted by the funds from the lower membership fees for the financing of operating expenses; however, from 2012, the membership fee incomes rose year by year by almost 7 percent on average. With a view to encouraging members to pay membership fees, funds apply tiered membership fee allocation, where the higher membership fee payment tiers are burdened by lower deduction for operation. This impact is reflected in a decrease in the membership fee deducted for operating expenses between 2012 and 2017, since due to the increasing individual contributions, the size of those membership fee parts where the funds apply a lower deduction for operation also increases.

[20] Recommendation No. 12/2016 (XII.1.) of the Magyar Nemzeti Bank on the setting up and operation of the optional portfolio system of voluntary pension funds.

Chart box 5
Developments in the adjusted fee burden ratio at voluntary pension funds

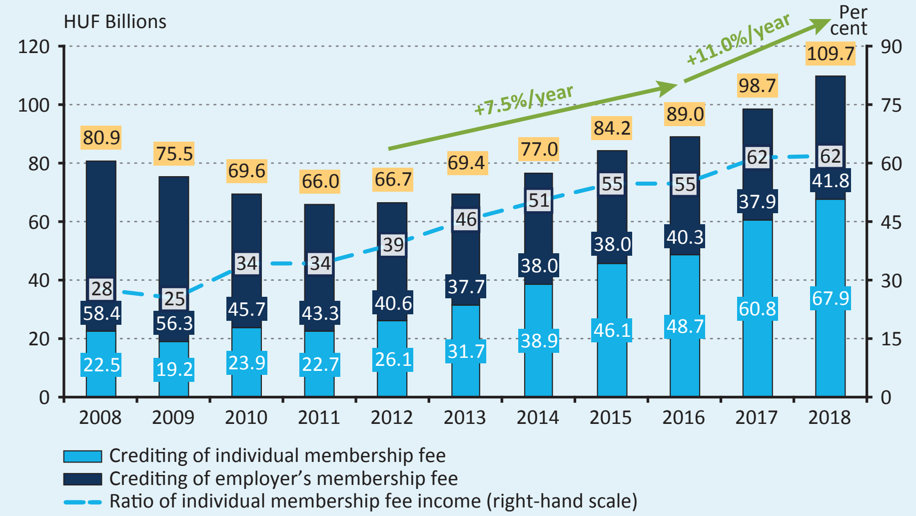


Source: MNB

Contributions rose by more than 10 percent

In 2018, the membership fee contributions credited to individual accounts (coverage reserve) reached almost HUF 110 billion. Receipts were still dominated by individual contributions; individual membership fee incomes account for 61.9 percent of the total annual membership fee income. Growth in the individual membership fees has been steady since 2011, despite the fact that the number of fund members has been decreasing since 2011. Due to the increased tax burdens resulting from the change in the rules applicable to fringe benefits, employers' contribution significantly declined in the period of 2011-2017 (Chart 35). However, in 2018, even the amount of employer's membership fee contribution rose compared to 2017. The growth is presumably attributable to the decrease in the public dues payable on employer's contribution. From 1 January 2018, the employers' burdens payable on contributions to voluntary pension funds decreased from 43.66 percent to 40.71 percent, and thus if in 2018, the employer maintained the financial allocation for contributions to funds, a higher amount thereof may have been received by the funds.

Chart 35
Membership fee income credited to the voluntary pension funds' coverage reserves, broken down by payers



Source: MNB

There was no material change in the number of membership fee payers – the growth in contributions is attributable to the regular payers of membership fees

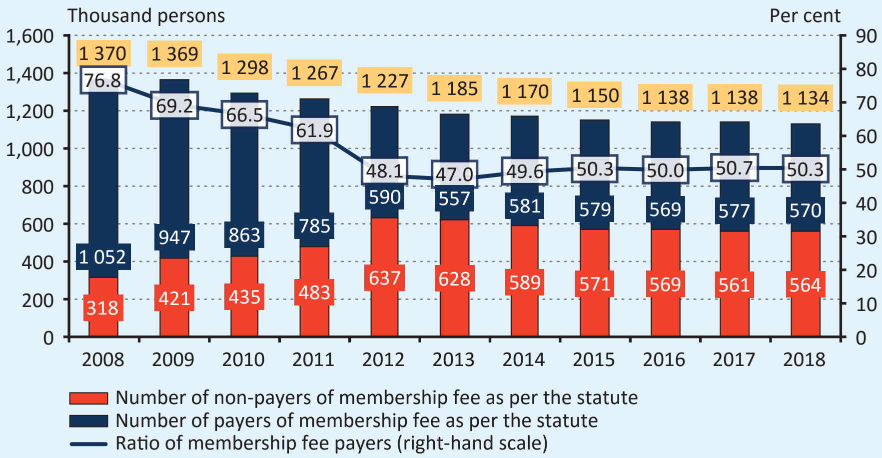
The ratio of non-payers at the voluntary pension funds peaked at 53 percent in 2013 before it started to decline; by the end of 2017 the non-payer ratio had stagnated compared to previous years. Based on the data reported by the funds, exclusions due to non-payment occurred in the highest number in the period of 2012-2015, and thus the members' activity statistics improved.

The proportion of members classified as non-payers based on the statute rose to a small degree compared to the previous year (Chart 36).

The major growth in total membership fee contributions and comparisons of the membership fee payment structure imply that almost half of the members still fail to fulfil their membership fee payment obligation or fulfil it only partially. The members making the surplus contributions usually come from among the regular membership fee payers.

The growth in the membership fee contributions at sector level is a positive factor, but at the same time it is also important to address the non-payers and encourage their activity.

Chart 36
Ratio of payers of the voluntary pension fund membership fee



Source: MNB

The ratio of the non-payment of membership fees has fluctuated around 50 percent in the past 4 years, which may still be deemed high and represents a risk in terms of fund operation. According to the business model of the voluntary funds, the operating expenses must be covered by the amount deducted from the members' payments. Yet in this way non-payers do not contribute to operations in the usual way, and in the case of the voluntary pension funds, it is not possible to exclude members before the expiry of the 10-year waiting period.

To cover operating expenses the law permits the funds to deduct from the yield realised on the savings of non-paying members, up to the part that may be deducted from the minimum membership fee for operation. This solution helps finance the operation of the fund, and facilitates that any non-paying members also contribute to the operating expenses; however, this does not entirely cover the risk arising from the non-payment of the membership fee. Namely, if the yield realised on the savings of non-paying members is insufficient – because the balance of the member's individual account is too low and/or the interest environment is unfavourable, like in 2018 – the fund is unable to deduct even a minimum part for expenses.

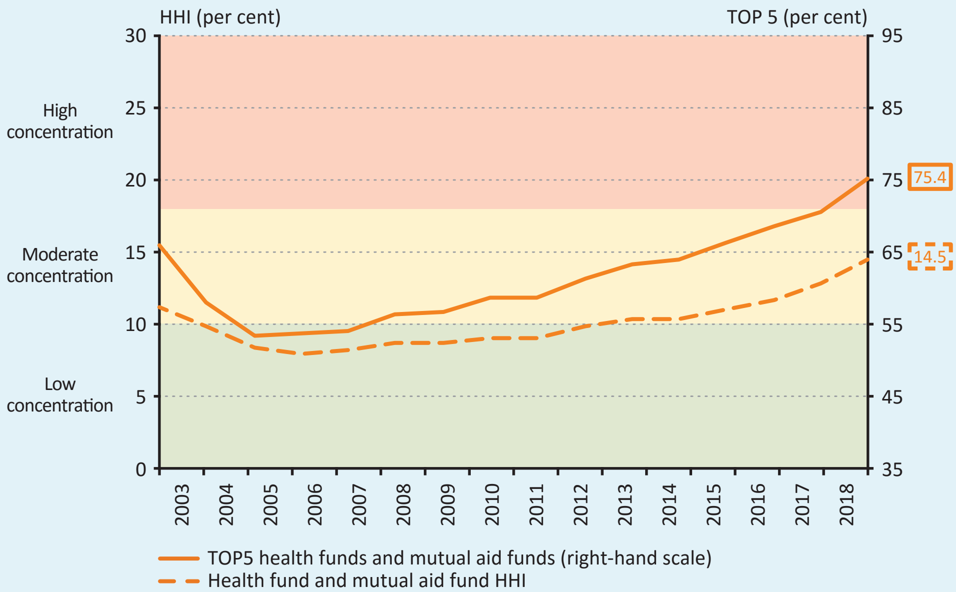
The majority of the funds make attempts to motivate non-paying members in a positive manner – i.e., with reminders, notices and promotions – to pay the membership fee, and thus funds treat part of the passive members as a potential base for replacement.

4.3 HEALTH AND MUTUAL AID FUNDS

Concentration continues to increase – TOP5: 75 percent

The concentration ratio increased both in the health and mutual aid fund sectors (Chart 37). In 2018, the rise in concentration was caused by the merger of a medium-sized fund with a large fund from 1 January 2018, and by the dissolution or liquidation of several smaller institutions. In 2019 a further increase in the level of concentration may be expected, since several institutions will be affected by dissolution or merger. Smaller funds are unable to compete with institutions of at least medium size and nationwide network either in the rendering of services or in the related supplementary services of conveniences (e.g. innovative health funds services, discounts available at private healthcare institutions). Health and mutual aid funds that have the support of a bank and insurance background institution can access members more easily and employers are also keener on concluding the contracts with funds that have a nationwide network rather than with small institutions, which may have a history of several decades on the market, but have only a limited capacity for innovation.

Chart 37
Developments in the health and mutual aid funds' concentration

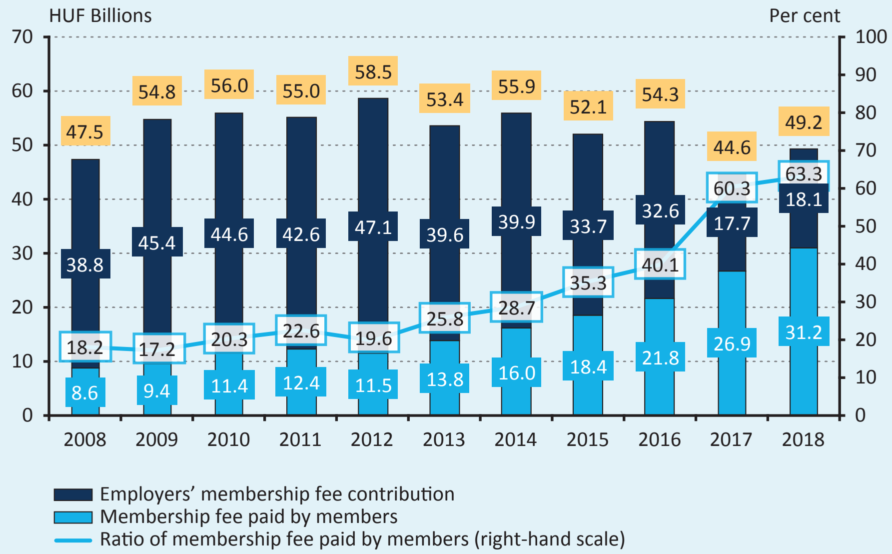


Note: The colour of the background illustrates the strength of concentration under HHI.
Source: MNB

Individual contributions continue to increase; nevertheless, total membership fee income still has not reached HUF 50 billion in the sector.

The legislative change in 2017, increasing the public dues on contributions that may be paid by employers as a fringe benefit, had a major impact on the membership fee incomes of health and mutual aid funds. As a result of the rules changed in 2017, the rate of employers' contributions declined by 46 percent compared to 2016. In 2018, there was only a 2 percent rise in employers' contribution year on year; however, it may be regarded as a positive trend that, compared to 2017, individual contributions increased by almost 16 percent (Chart 38). Membership fees paid by members account for 63.3 percent of the annual membership fee income. The membership fee payments are still distributed unevenly (seasonality) during the year between the individual quarters; employers' contributions show lower volatility in the individual quarters, while about half of the individual annual payments are still only received by the health and mutual aid funds close to the year-end. Based on the prudential negotiations conducted with funds, as a result of the funds' efforts to make households aware of the health and mutual aid funds service, encourage members to pay membership fee, and use healthcare services via funds as an institutionalised channel, and also due to the marketing campaigns, part of the members started to act more consciously and this caused a soar in individual membership fee contributions and benefit payments.

Chart 38
Membership fee income credited to the health and mutual aid funds' coverage reserves, broken down by payers



Source: MNB

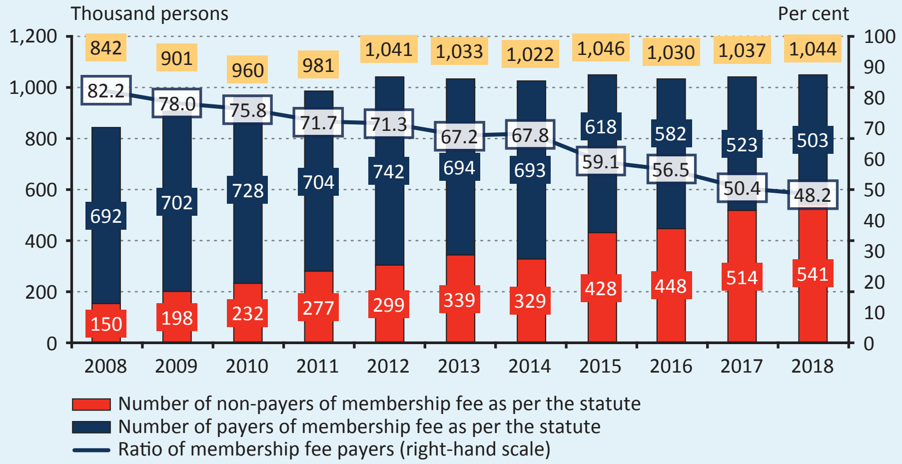
Despite a rise in individual contributions, the ratio of non-payers is increasing

The ratio of membership fee paying members decreased by almost 2.2 percentage points by the end of 2018 (Chart 39). The burdens imposed on non-payers for their omissions and the consequences of non-payment (limiting fund's services, deduction from the yield of minimum membership fee portion usable for operation purposes) are defined in the individual funds' statutes. Several funds believe it is not worth keeping non-payer members with a low balance in such a way that the costs related to them are financed from the membership fees paid by active members; if their statute permits it, they will terminate the membership of these members.

Last year several funds opted for exclusion due to non-payment; nevertheless, the membership fee payment ratio deteriorated even further. As of 2008 – with the exception of 2014 – members' willingness to pay has been deteriorating, despite the fact that both the amount and ratio of individual membership fee incomes have increased dynamically in the past years. Awareness of part of the members increased and they also make substantial surplus contributions in addition to the standard membership fee; however, the surplus contributions are primarily received from the regular payers of membership fee, rather than being the result of non-payers becoming paying members. The growth in individual membership fees across the sector may be regarded as a positive trend in its own right; however, in terms of the breakdown of members it also carries a risk, as it may lead to the polarisation thereof due to the foregoing.

Experience shows that in respect of managing non-payers, funds also take into consideration that non-payers may start to pay membership fees once again as a result of changes in their income, health and family situation, which later on may have a positive effect on the fund's operation.

Chart 39
Developments in the number of members paying health and mutual aid fund membership fee



Source: MNB

Investments of health and mutual aid funds are still dominated by government securities

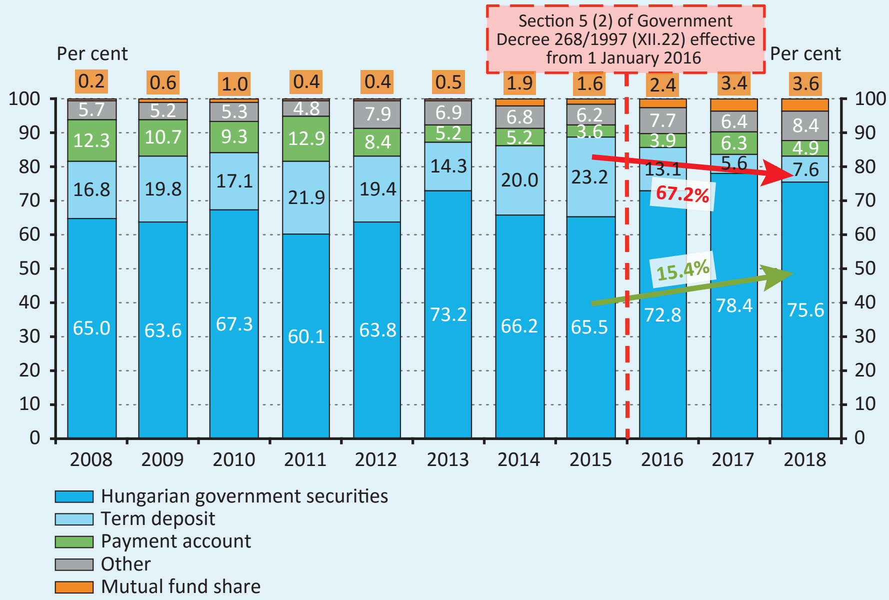
Members are increasingly making use of the opportunity to place two-year deposits. The yield on short-term investments, typical in the funds' investments, declined substantially as a result of the economic environment, and thus the tax refund available on the two-year deposit appreciated; moreover, fund members also became more conscious in terms of allocating reserves for higher-value medical intervention and health services. The steady level of assets also implies that incomes are able to cover benefit payment expenses on a continuous basis.

The investments of health and mutual aid funds are still dominated by Hungarian government securities; after a fall of 2.8 percent compared to the previous year, at the end of 2018, Hungarian government securities accounted for 75.6 percent of the entire portfolio. The second most typical form of investment, i.e., bank account and term deposit, has a share of 12.5 percent. In 2018, a large health fund placed a substantial part of the balance on the payment account in term deposit, which caused an increase in the ratio of term deposits at sector level as well. The interest paid on term deposits – similarly to 2017 – was not attractive for most of the funds in 2018 either; in several cases, banks offered negative interest on the amount placed. Due to this, funds looked for other forms of investment, offering better yields, and thus funds rather place the amount available for investment in government securities or other securities. In 2018, there was a palpable increase in the ratio of bonds in the funds' portfolio secured by government guarantee.

Equity exposure is still very low within the investments, fluctuating around 0.5-0.7 percent in the past 5 years. Even the weight of direct real estate investments exceeds the Hungarian equity exposure with a ratio of close to 1 percent.

There was a rise in the portfolio of Hungarian mutual fund shares, but with a ratio of 3-4 percent it is still not a determining factor in the health and mutual aid funds sector. The weight of real estate investment funds is increasing within mutual fund shares; at the end of 2018, real estate investment funds accounted for 51 percent of the mutual fund share portfolio.

Chart 40
Developments in the composition of health and mutual aid funds' investments



Note: The arrows show the percentage change in the ratio of term deposits and Hungarian government securities between 2015 and 2018.
Source: MNB

The law applicable to investments prescribes from 2016 that funds with assets exceeding HUF 1 billion must prepare an investment policy. The legislator wanted to draw the funds' attention to the importance of having sufficiently purposeful and targeted investments. Although no major transformation in the asset composition of the portfolios can be observed as a result of the legislative change, the regulation facilitates greater control of asset managers and faster adjustment of the asset composition, aligning it with the yield environment. Thus, for example, in the past three years, direct real estate investments appeared at health funds as well, which were partly able to offset negative yields on securities. The regulation also facilitates audit (also by the Supervisory Authority) and control by fund members.

Steady increase in the financing ratio of healthcare services

In Hungary, the health system is financed from the central (general government) and local government budget, the budget of the Health Insurance Fund, households' direct payments and from payments of voluntary healthcare financing sub-sectors. The largest part of the voluntary healthcare financing sub-sectors is represented by the healthcare expenditures of the voluntary health funds and the mutual aid funds, operating since 1993.

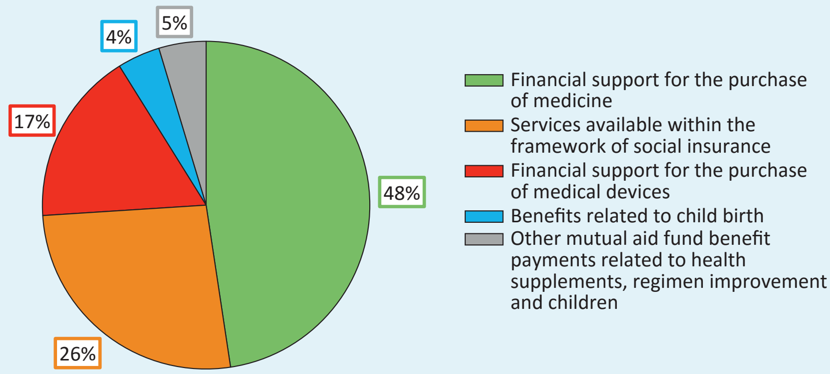
Until 1 January 2016, the voluntary health funds and the mutual aid funds could operate separately; from this date onwards, a new type of fund appeared on the market, which can render both health fund and mutual aid fund services, and thus the health fund and mutual aid fund services became available within a single institution. Due to the organisational changes made as a result of the legislative changes, 16 of the funds holding an activity licence operated as a health and mutual aid fund, 3 as a mutual aid fund and 2 as a health fund at the end of 2018. Almost all of the larger funds with nationwide coverage became mixed funds; the institutions operating solely as health funds or mutual aid funds were mostly specialised in a limited range of services.

Eligible health and mutual aid fund benefit payments can be divided into two large groups, i.e., supplementary health insurance services and life improvement health fund services.

Financial support for the purchase of medicines still accounts for the largest part, 48 percent, of the health and mutual aid fund benefits, followed by healthcare services also available within the framework of social security benefits (e.g. dentist, diagnostic medical imaging) with 26 percent, and financial support for the purchase of therapeutic equipment, with 17 percent. The change in the composition of benefits is negligible; at the same time, the restructuring of the benefit expenditures, observed in previous years, continued in 2018 as well. In 2018, the share of the financing of healthcare services rose to 26 percent from 21 percent registered in 2015, while the share of financial support for the purchase of medicines and therapeutic equipment declined from 76 percent to 65 percent. It should be noted that special nutriments or vitamins purchased for preventive purposes also belong to the category of financial aid for the purchase of medicine. In parallel with the expansion of the health funds' range of activity, growth can be observed in mutual-aid-fund type benefit payments related to childcare and assistance for the repayment of home mortgage loans. These services are expected to grow further in 2019. The use of life-improvement services (e.g. purchase of sports equipment, natural healing services) is taxable and thus less popular with members (Chart 41).

Some of the funds added the payment of premiums for services financing health insurance (sickness insurance) to their services. In return for an insurance premium, the fund's contracted insurance company partner undertakes to provide the benefits specified in the insurance terms and conditions upon the occurrence of the claim events. Within the scope of the health insurance benefits, members may apply for the arrangement and reimbursement of costs of diagnostic medical imaging (CT, MR) and same-day surgical interventions, and the reimbursement of the costs of treatment of critical illnesses.

Chart 41
Breakdown of benefit payments by health and mutual aid funds in 2018 Q1-Q4 (based on cumulated data)



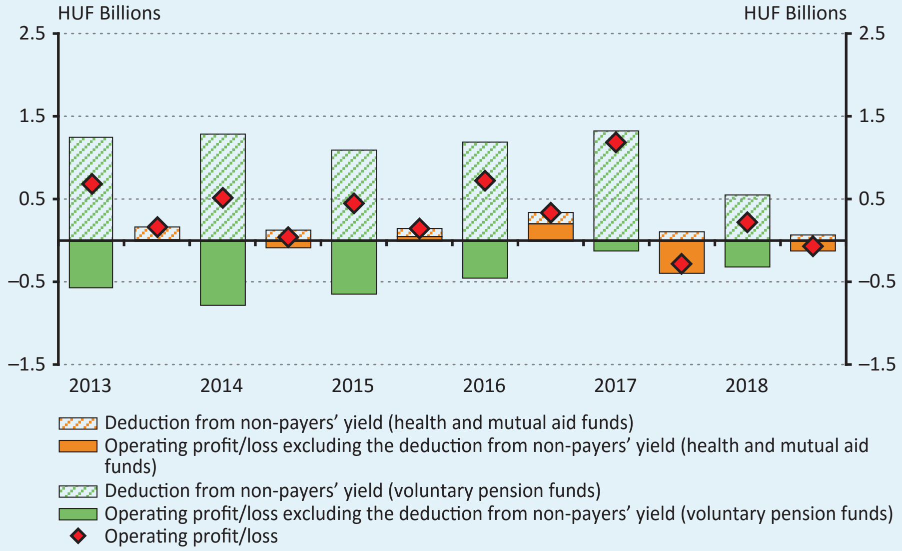
Source: MNB

An important change is imminent on 26 June 2019, which affects the entire financial sector, while in respect of the funds, it affects primarily the continuous benefit financing activity of health and mutual aid funds. According to the provisions of the Act on the prevention of money laundering and terrorist financing (Anti-money laundering Act), which entered into force in June 2017, until the aforementioned date all financial institutions must perform comprehensive due diligence in respect of customers with whom they established customer relationship before June 2017, and whose data and documents prescribed by the law are not available to them. In the absence of those, after 26 June 2019 – until the rectification of the omission – customers will not be able to initiate new transactions, which for the health and mutual aid funds – where the number of transactions is high – means in practice that customers not subjected to comprehensive due diligence will be able to increase the balance of their fund account, but cannot initiate debits to the accounts. Compared to the other sectors, the ratio of customers not subjected to due diligence is slightly better in the funds sector, but their number is still high, and thus financial institutions and members should comply with the call for data supplementation as soon as possible, since there is a risk that the customers affected will not be able to initiate new transactions.

Health and mutual aid funds continue to realise losses

The operating profit/loss of the health and mutual aid fund sector turned negative in 2017, also taking into account the amounts deducted from the yield of non-paying members for operation, and funds were also unable to realise a profit in 2018. In the reporting year, at 11 out of the 21 health and mutual aid funds, the operating revenues were lower than the operating expenditures. The amounts deducted from the yield of non-paying members – mostly due to the low yields of funds – were negligible, and thus the funds were forced to reduce their reserves available for operation. Although membership fee incomes rose year on year, higher individual contributions were unable to offset the unfavourable effect of the significantly lower employers' membership fee contributions from 2017, and thus the increased operating membership fee incomes covered operating expenses only partially. Seventeen out of the 37 voluntary pension funds had a negative operating result in 2018. Larger funds are typically also characterised by a higher number of non-payers, and thus in years where due to unfavourable yield trends the fund is unable to reallocate funds for operation from the non-paying members' yields, it may happen that operating revenues are insufficient to cover the expenditures. At the smaller institution, the outstanding share of employers' contribution within incomes may represent a risk, since in parallel with the decrease in employers' commitment, the funds' incomes allocable to the operation of the funds may also decrease, and the operation of the fund may make a loss.

Chart 42
Developments in operating profit/loss of voluntary pension funds, health and mutual aid funds



Source: MNB

4.4 RISKS OF THE FUNDS MARKET

Risk category	Risk groups	Risk rating	Risk prospects	Evaluation in words
Business model	Environment Strategy, business plans Sustainability of operation	🟠	➡	The outstanding GDP growth and the 11 percent wage increase resulted in higher payments to funds. Volatility increased on the international markets. The sector as a whole is characterised by adaptive, follower strategy; some of the funds follow acquisition strategy; organic growth is less characteristic. Due to the negative yield result, it was practically not possible to deduct yields, which generated major revenue shortfall to the funds. There is still room for capitalising on the opportunities to recruit new members; it is necessary to make efforts to reach the young generation, since they represent potential base for replacement. From 2018, the tax rates burdening the employers' membership fee contributions to pension and health funds decreased (from 43.66 percent to 40.71 percent). **Outlooks:** Over the medium term the level of the interest rate environment is expected to increase. The ratio of employers' contribution will presumably decrease in the sector. Based on the experiences gained so far, individual contributions are likely to offset the decrease in the level of employers' contribution. The effective taxation rules may exert major effect on the 2019 membership fee revenues; at the same time, 20 percent tax may now be reclaimed in respect of employers' contributions; however, this may not be used for the operation of the fund.
Corporate governance	Exercise of owner's rights Internal governance Risk mana-gement system Internal control system	🟡	➡	The functioning of the delegate scheme is still problematic; the structure of delegate districts is disproportionate at some places, it does not follow the changes in the number of members; attendance at the general meetings is low. The functioning of the internal governance systems (board of directors/ management) is essentially adequate; however, they do not always moni-tor the tasks arising from the legislative changes. The verifiability of the fulfilment of the contracts concluded with external parties is not always guaranteed in full; there are cases when invoices for services are paid without confirmation of fulfilment. The documentation of the audit activity of the Audit Committee, the follow-up of the internal audit findings and the control of outsources activities are not always implemented. **Outlooks:** the activity of the members may remain limited. Quality of the internal audit activity must be improved and the frequency of audits should be increased.
Financial and operational risks	Insurance risk Investment risk related to the operating and liquidity reserves Operational risk	🟡	⬆	At certain funds, the asset management and custodian contracts were renegotiated with a view to reducing costs and increasing net yield; consideration should be given to this practice in the entire funds sector. Major risks appear in relation to IT systems and registers (e.g. inadequate virus protection, performance of IT security risk analysis less frequently than prescribed, improper management of access rights). Deadlines were breached in the area of benefit and other member payments; health fund benefits were occasionally paid by circumventing the law. **Outlooks:** The ratio of more risky instruments may increase in the funds' portfolios.
Sustainability and reserve risk	Coverage reserve (individual account) investment risk Capital Operating and liquidity reserve	🟠	➡	In 2018, most of the funds' portfolios realised negative yields. The operation of certain funds remains risky due to the low level of available reserves. At these funds customised measures should be applied, e.g. support of the background institution, providing continuous liquidity report or supervisory authority letter. **Outlooks:** As a result of the foregoing additional increase in assets and concentration ratio may be expected in 2019.
Market entry risk	Products Customers	🟢	➡	Funds with nationwide network introduce innovative solutions: real time balance enquiry, pension calculator, fund applications, special discounts at healthcare providers, payment of membership fee by bankcard. Funds should communicate with their members more intensively. The number of consumer protection complaints is low in the sector. Occasionally, the regulation and practice of social media related to data management and data transfer is inadequate, with special view to the health insurance benefits. **Outlooks:** there is still no major risk related to the benefit payments; with a view to promoting the mutual aid health fund benefits, communication toward the members should be strengthened.

Explanation:

Degree of risk	*high* 🔴	*significant* 🟠	*moderate* 🟡	*low* 🟢
Direction of risk	*increasing* ⬆	*stagnant* ➡	*decreasing* ⬇	

Owing to the outstanding GDP growth and 11 percent wage increase in 2018, the amount of individual contributions is increasing in the voluntary funds sector; however, due to the negative yield results, compared to previous years, they are able to enforce much smaller yield deductions in respect of the non-paying members, which may result in major revenue shortfall for funds. The cancellation of the tax allowance on the contribution to the funds as a fringe benefit, effective from 2019, may have substantial impact on the revenues of membership fee type. There are still potentials in the recruitment of members; reaching of the young generation is extremely important. We expect that **the ratio of employers' contribution will decrease, which may be offset – based on recent experience – partially by individual payments**.

Within the risk category of the exercise of **ownership rights**, inspection of the delegate scheme still identified a lack of proper regulation as a problem; during the comprehensive audits it was found in several cases that the structure of delegate districts is disproportionate, and the members' attendance and activity at the delegate election meetings and the delegate general meetings is still low.

The **internal governance systems** of the funds are operating properly and the board of directors fulfils its duties. However, there are a few shortcomings; **the governing bodies do not always comply with the duties resulting from the legislative changes**. **As regards the contracts concluded with external fund partners, the accountability for the agreements is still not always guaranteed** and certain invoices for services are paid without confirmation of fulfilment.

Documentation of the Audit Committee's audit activity is often inadequate or incomplete, the monitoring of internal audit findings is not performed on a continuous basis, and the proper periodic review of outsourced activities is not always implemented. **The quality of internal audit activity still calls for strengthening at the funds.**

Due to the low deposit interest rate scheme, health and mutual aid funds commenced the implementation of a more active investment strategy, turned to riskier investment instruments and in their asset management and custodian contracts strive to achieve a more favourable cost level. **Significant shortcomings were identified in respect of the IT systems. At part of the funds virus protection is inadequate, and the security risk analysis of the IT system is not performed with the required frequency.** Apart from the shortcomings of IT systems, certain funds also paid health fund benefits by circumventing the law, and breach of deadline of benefit and other member payments also occurs.

Furthermore, the insufficient level of operating reserves was also identified as a risk at certain funds, as they fail to reach the prudential degree, i.e., financing operation for two months without revenues; individual measures are necessary at these funds.

In the case of the voluntary pension funds, upon reaching retirement age still only a small part of the members opt for the annuity benefit; the online pension calculators, already applied by some of the funds, may help to strengthen this trend. Of the **product and service types** offered by the health and mutual aid funds, the purchase of medicines and therapeutic equipment, as well as the use of healthcare services, still account for the largest part. However, several benefits available from the health and mutual aid funds are still not well known; in respect of these, the institutions launched various marketing campaigns and are developing collective services offered at preferential prices. However, a more intensive supply of information to members is essential for use of the health fund benefits of mutual aid nature. The strengthening of continuous communication between the institutions and the fund members is also the fundamental interest of fund members, since based the provision of the Act on the prevention of money laundering and terrorist financing, which entered into force in June 2017, after 26 June 2019, no benefit payments may be made until the fund members are identified in full.

5 Financial enterprises not belonging to a banking group, and their risks

This analysis is based on the data of the 225 financial enterprises that held an MNB licence at the end of 2018 and do not belong to a banking group, i.e., they are not subject to consolidated supervision. With a view to assessing the sector's future prudential risks and presenting the trends related to past periods, the analysis only presents, retrospectively as well, the data of supervised financial enterprises that held an MNB licence at the end of 2018. With a view to eliminating the distorting effect, the data of the financial enterprises with special portfolios were eliminated in the sections specified.

In 2018, in addition to the dissolution of 10 financial enterprises and the merger of one financial enterprise, an activity licence was issued to 12 new financial enterprises. Most of the licensed financial enterprises, following the trend of the previous year, applied for a licence for workout and lending activity in 2018 as well.

It is still typical of the institutions under review that they simultaneously pursue several of the activities permitted for financial enterprises, and the composition of the portfolio originating from the financial services activity performed by certain financial enterprises may change and be restructured even within the year. In 2018, we observed a strengthening of the financial services rendered to corporations by the range of institutions under review.

Table 7 below presents a breakdown of the financial services activity presently pursued by the range of institutions under review and the profit realised on the activity, based on their receivables reported at the end of 2017 and 2018. The purpose of the table is to present a heterogeneous composition of the sector under review, as well as the scope of activities typically pursued by financial enterprises, the profitability linked to the activities, using as benchmark the profitability of financial enterprises pursuing solely a single activity.

Table 7

Composition of the gross outstanding customer receivables and profit/loss of financial enterprises not belonging to a banking group by activity type at the end of 2018

	Outstanding receivables (HUF billions)		Number of institutions also pursuing this activity (pcs)		Outstanding receivables of institutions pursuing solely this activity (HUF billions)		Number of institutions pursuing solely this activity (pcs)		Profit/loss of institutions pursuing solely this activity (HUF billions)	
	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
Loan	488.3	487.0	135	137	251.3	306.8	63	64	10.1	5.3
– of which, pawn loan	16.6	17.5	22	23	14.6	15.4	16	16	0.9	0.4
Financial lease	338.0	298.1	30	33	54.3	53.4	8	7	1.2	0.7
Current factoring*	75.0	46.3	29	29	62.5	36.0	8	9	1.1	0.6
Workout*	160.4	120.6	118	114	94.1	92.4	64	62	33.1	23.0
Other activity	0.5	7.1	3	11	0.1	0.1	1	1	0.5	0.6

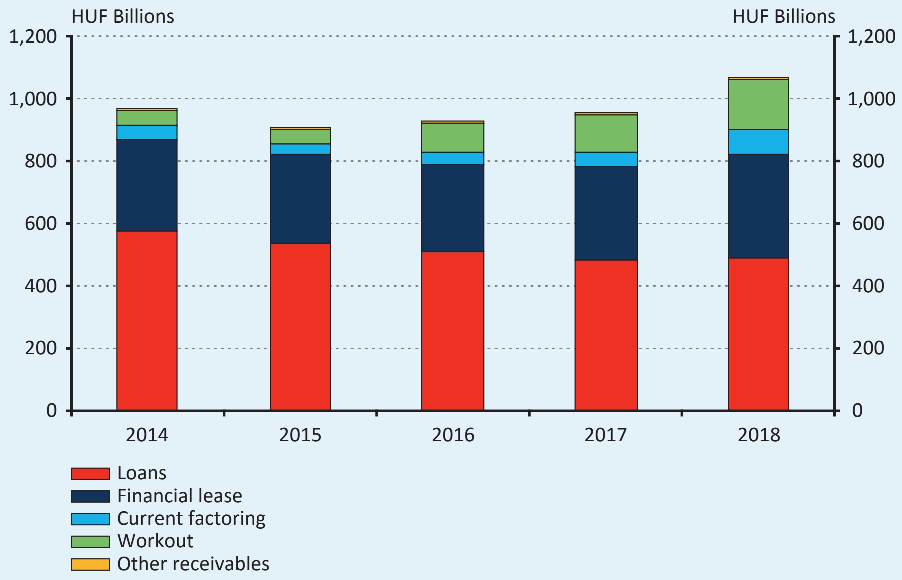
*Note: * Due to the distorting effect, after eliminating the data of two institutions pursuing special activity.*
The analysis is based on data reported by financial enterprises not belonging to a banking group, supervised at the end of 2018.
Source: MNB

The audited data for 2018 was not yet available when this report was prepared, and thus the data stated for 2018 in this analysis is based on unaudited data from the end of 2018. Furthermore, for the purpose of the analysis, with a view to eliminating the distorting effect, the data of two financial enterprises pursuing special activity, not related to the usual course of business of financial enterprises, has been ignored.

The breakdown of the financial services activities pursued by non-banking group financial enterprises did not change significantly; outstanding receivables were dominated by credit and loan receivables in 2018 as well (46 percent), followed by financial lease (32 percent), workout (15 percent), and current factoring (7 percent).

The changes in the outstanding receivables stemming from the financial services activity pursued by the institutions under review are presented in Chart 43.

Chart 43
Composition of gross outstanding customer receivables of financial enterprises not belonging to a banking group, by activity type



Source: MNB

In 2018, the decrease in outstanding lending, characterising the previous years, stopped and minor growth was registered. As regards the financial lease, current factoring workout, the growth observed in previous periods, continued.

As a result of the crisis, several financial enterprises suspended their financial services activity and only managed their existing portfolio; later on, based on the owner's decision, several of these of financial enterprises returned their activity licence in 2018.

As regards the financial enterprises pursuing lending activity, there was a restructuring in the ratio of outstanding lending to households and non-financial enterprises. In previous periods, lending activity was dominated by loans granted to households, while by the end of 2018 this ratio shifted toward loans granted to non-financial enterprises. In 2017, loans granted to non-financial enterprises accounted for 40 percent of outstanding lending, while this ratio was 54 percent in 2018.

As regards the financial enterprises under review, their financial lease portfolio is still dominated by financial lease granted to corporations. The increasing asset financing and the higher turnover observed on the market, stemming from car and property sales, as a result of economic recovery, are also reflected at the respective institutions, primarily in the growth of financial lease to corporations.

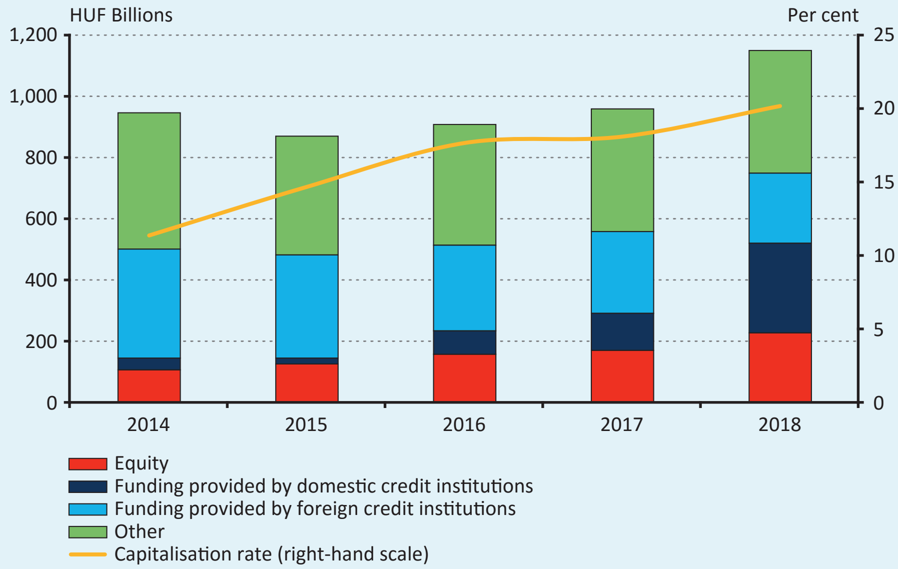
As regards the workout activity, no material change occurred compared to the trends observed in previous periods, i.e., the rise in outstanding receivables, which characterised previous years, continued. The sector under review still sees business opportunity in workout, which is also apparent from the fact that in 2018 several new financial enterprises not belonging to a banking group applied for licence to pursue workout activity.

Growth in the market of car sales also generated growth for institutions pursuing current factoring among the institutions under review; in 2018, the current factoring portfolio recorded an unusually high value in respect of the inspected six years. As regards current factoring, by the end of 2018 major – 63 percent – growth was recorded compared to 2017. The growth is primarily attributable to the rise in one institution's current factoring portfolio, implemented from non-resident and resident credit institution refinancing. Current factoring portfolio overdue for more than ninety days is negligible; the portfolio did not exceed 3 percent even despite the increase recorded in 2018. The activity of institutions not belonging to a banking group is characterised by high concentration; 74 percent of the portfolio is linked to 3 financial enterprises.

Domestic refinancing funds provided by credit institutions substantially rose, accompanied by recovering growth in equity

In 2018, the volume of refinancing funds provided by credit institution continuously increased; substantial growth was observed in credit institution funding – primarily in respect of the financial enterprises pursuing financial lease and lending activity – supplemented by the use of own financing funds. The growth in funds provided by credit institutions is attributable to a significant rise in the financing provided by domestic credit institutions, while at the same time funds provided by foreign credit institutions moderately decreased. Compared to 2017, funding by domestic credit institutions almost doubled, while foreign funding moderately decreased (Chart 44).

Chart 44
Developments in the liability structure of financial enterprises not belonging to a banking group



Source: MNB

Almost one third of the growth in funding by domestic credit institutions in 2018 was attributable to the rise in the refinancing funds granted by MFB Hungarian Development Bank Plc. In addition, several Hungarian credit institutions also see business opportunities in the sector, and thus the refinancing funds provided by domestic credit institutions increased substantially, but in a diversified manner. The vast majority of the refinancing funds augmented the outstanding liabilities of financial enterprises pursuing lending and lease activity.

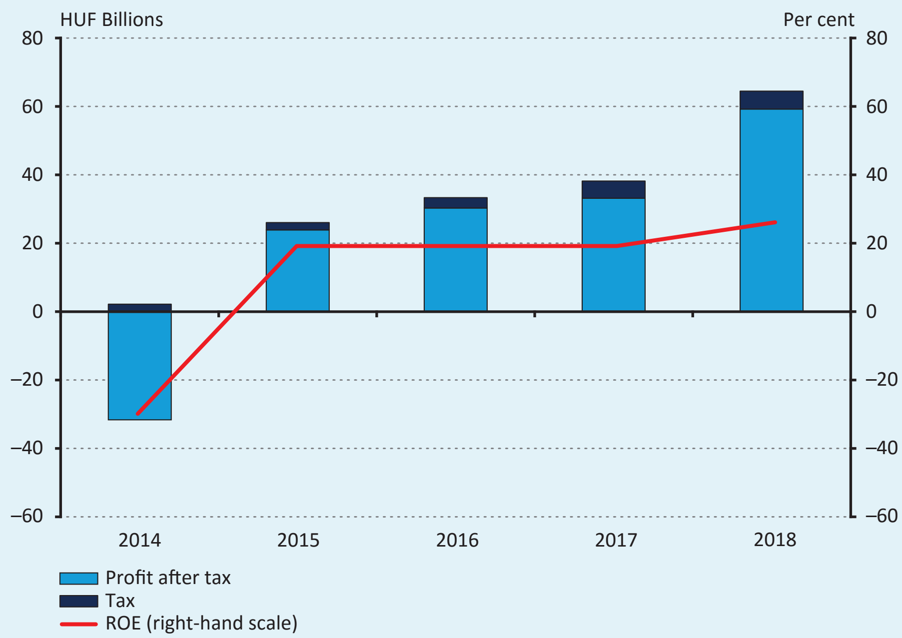
After eliminating the distorting effect of two institutions pursuing other, special activities, growth can also be observed in the equity of financial enterprises not belonging to a banking group, which is based on the profitable operation of the financial enterprises mostly engaged in lending, financial lease, and workout. For 2018 it should be noted that the information related to equity is based on preliminary, unaudited data, and thus it does not reflect the impacts of the potential dividend payments in 2018.

The previous years' accumulated loss of the institutions under review has been continuously decreasing since 2015, which was also reflected by growth in equity.

Continued, substantially improving profitability and strong concentration

Compared to previous years, profitability significantly improved; in addition, the number of institutions realising a profit before tax also rose, already accounting for 80 percent of the institutions under review in 2018 (Chart 45). However, the 2018 balance sheet profit/loss of the financial enterprises not belonging to a banking group still shows high concentration. Only 4 of the financial enterprises under review realised a balance sheet profit over HUF 1 billion. At the end of 2018, the 5 institutions that realised the highest balance sheet profit account for 75 percent of the profit of the sector under review. A significant part of the pre-tax profit was realised by financial enterprises engaged in workout and lending activity, while the highest losses were also suffered mostly by the latter institutions.

Chart 45
Changes in profit/loss and return on equity of financial enterprises not belonging to a banking group

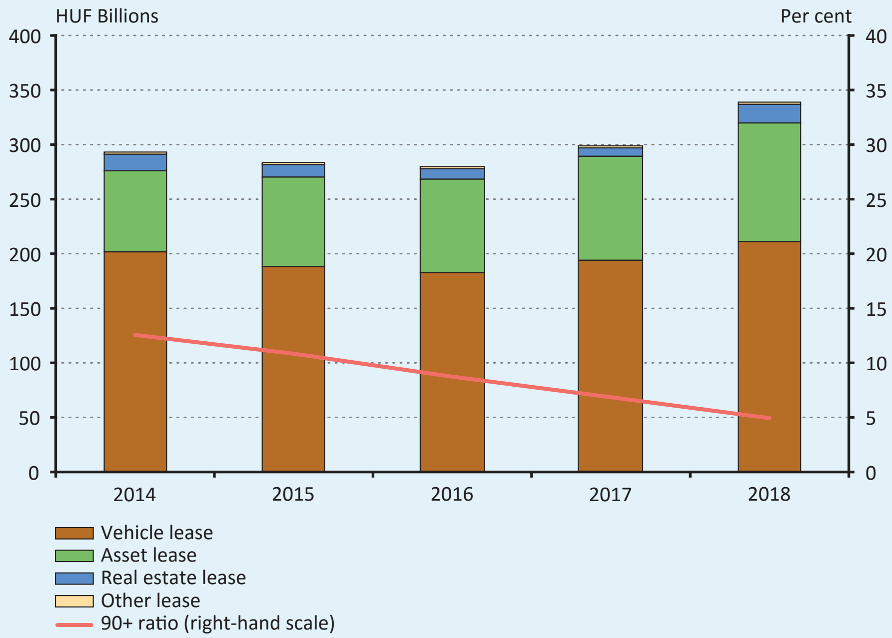


Source: MNB

Continued upturn in financial lease and further portfolio cleaning among financial enterprises not belonging to a banking group

In 2018, a further increase was observed in the outstanding receivables of enterprises not belonging to a banking group, pursuing financial lease activity; 86 percent of their total outstanding receivables relate to the corporate sector. Real estate lease registered a record high growth; compared to 2017, the portfolio increased more than twofold by 2018; in addition, the motor vehicle and asset lease portfolios also rose by 9 and 15 percent, respectively. (Chart 46).

Chart 46
Composition of financial lease portfolio of financial enterprises not belonging to a banking group and the ratio of receivables overdue by more than 90 days



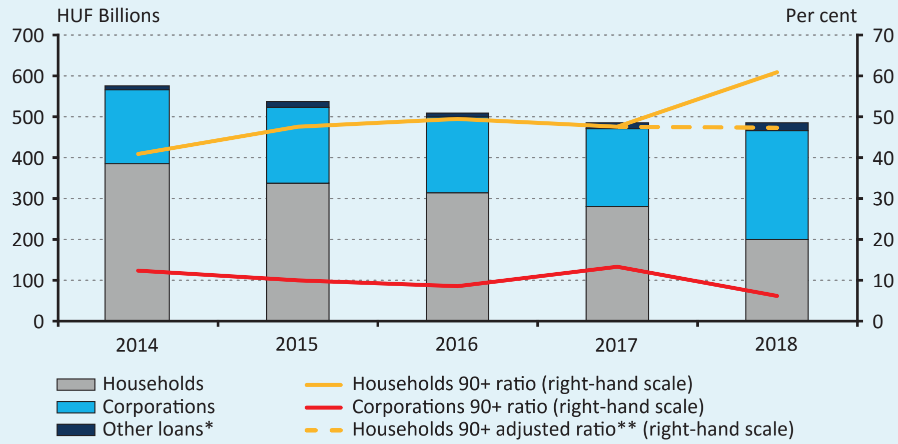
Source: MNB

In 2018, 63 percent, 32 percent and 5 percent of the lease portfolio of financial enterprises not belonging to a banking group was motor vehicle lease, asset lease and real estate lease, respectively. As regards the institutions under review, lease activity is also characterised by high concentration; the larger market participants are typically specialised institutions, but in all cases it is dominated by lease to the corporate sector. An increase in placements to households can be observed in financial lease, which is primarily attributable to the rise in the motor vehicle lease portfolio to households. Portfolio cleaning, which characterised recent years, clearly continues in financial lease rendered both to households and corporations.

Moderate rise in outstanding lending, recovering corporate lending

The trends in outstanding lending by financial enterprises not belonging to a banking group are illustrated in Chart 47. As regards the institutions under review, the decrease in outstanding lending, which characterised the previous years, stopped in 2018 – despite the major fall in outstanding lending to households – and a moderate portfolio increase was observed. The decrease in outstanding lending to households was offset by vigorous growth in outstanding lending to corporations.

Chart 47
Composition of the loan portfolio of financial enterprises not belonging to a banking group and the ratio of the portfolio overdue by more than 90 days



** Due to their negligible share, other past due loans are not shown.*
*** Analysed without the two large-volume individual portfolio transfers.*
Source: MNB

As regards the households, in 2018 there was a significant decline in the portfolio. The decrease in the portfolio is mostly attributable to a transfer, as a result of which the respective portfolio was removed from the books of the institutions under review. The concentration ratio is still high; 95 percent of the portfolio is linked to 17 financial enterprises not belonging to a banking group. The growth observed in outstanding lending to corporations was primarily the result of the disbursement of EU transfers to the SME sector.

In 2018, further decline was observed in pawnbroking, reflected both in the outstanding pawn loans and in the number of institutions pursuing pawnbroking activity. As regards the composition of collaterals, more than 95 percent of the collaterals are precious metal collaterals. In 2018, the MNB published a recommendation with a view to reducing the risks inherent in pawnbroking; this recommendation also includes, among other things, the MNB's prudential requirements related to pawnbroking, and particularly to the determination of the assessed value, pawnbroking activity pursued through special intermediaries, the fulfilment of settlement obligations to customers and internal audit.

As regards the institutions under review, major cleaning of the loan portfolio was observed in the corporate sector, being the result of the significant decline in the 90+ portfolio and the large volume of disbursements. Within the households' portfolio, the rise in the 90+ transaction is due to the fact that mostly performing receivables were removed from the portfolio of the institutions under review in the form of portfolio transfer. The decrease in the portfolio resulting from the portfolio transfer caused the household sector's 90+ ratio to increase; on the other hand, moderate improvement was observed in the composition of the household portfolio compared to 2017.

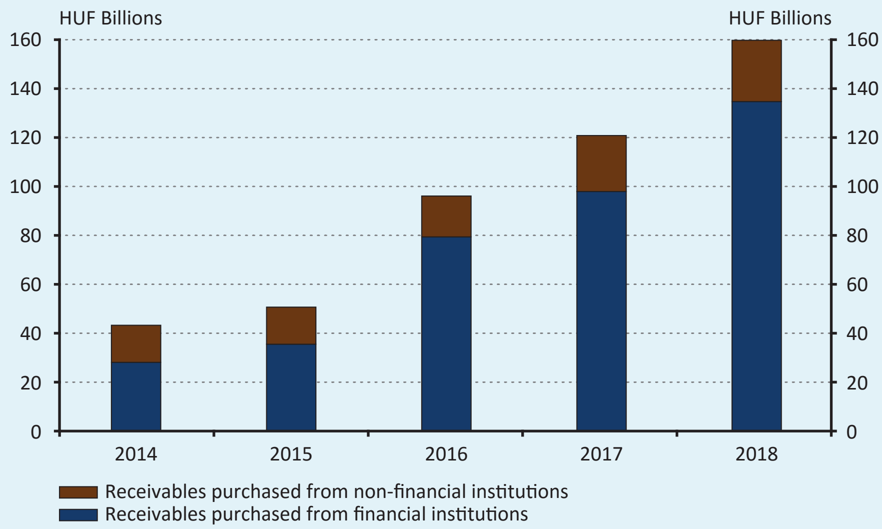
Under high concentration and despite the active workout activity, the workout portfolio continued to rise

The portfolio increased at the institutions under review, both in respect of the portfolio purchased from financial institutions and non-financial institutions; at the same time, based on the turnover data, the sector continues to show significant activity. Merely 22 percent of the portfolio purchased or acquired in another way in 2018 appeared as portfolio increment, since a large part of the receivables were settled or closed by other means.

As regards financial institutions, high concentration was observed in terms of portfolio size, the number of contracts, and growth compared to 2017. The 37 percent increase in outstanding receivables purchased from financial institutions is mostly attributable to the portfolio growth of three financial institutions, and in 2018, portfolio growth in excess of HUF 1 billion was achieved only by 7 financial enterprises not belonging to a banking group. Financial enterprises with the highest number of contracts purchase overdue receivables both from financial and non-financial institutions. As regards the composition of the portfolio, in terms of the volume of contracts, outstanding receivables purchased from non-financial institutions is more significant.

At the end of 2018, outstanding receivables purchased from financial institutions accounted for a major part, i.e., 84 percent, of the purchased overdue receivables, 40 percent of which are receivables originating from household mortgage loans secured by real estate (Chart 48). In terms of the number of contracts, the vast majority of the outstanding receivables, i.e., 62 percent, are receivables purchased from non-financial institutions. A dominant part, i.e., 68 percent, of the outstanding receivables purchased from financial institutions, are receivables originating from household mortgage loans secured by real estate.

Chart 48
Changes in the portfolio of the non-banking group financial enterprises, engaged solely in the purchase of overdue receivables



Source: MNB

The dominant players among the financial enterprises pursuing this activity continue to have an advantageous position on the workout market, both in terms of the purchase and enforcement of receivables, which is also evidenced by the profit and loss figures. Despite the increasing competition's upwards effect on price level, financial enterprises still see major potential in this activity, which is also evidenced by the number of activity licence applications.

6 Capital market and its risks

At the end of 2018, 36 investment service providers were active in the Hungarian capital market. While the number of credit institutions rendering investment services rose by one to 22, the number of investment firms with a registered office in Hungary (12) and of Hungarian branch offices of foreign investment firms (2) remained unchanged on the whole. The HUF 34,833 billion volume of customer securities managed by investment service providers in 2018 – HUF 30,735 billion by credit institutions and HUF 3,648 billion by investment firms – exceeded the HUF 32,455 billion value of customer securities registered in 2017, by 5.9 percent. The number of securities accounts managed in 2018 dropped by 10.5 percent to 1,719 thousand: this is basically attributable to the business practice applied by two institutions, i.e., the closing of accounts with a zero balance. The capital market turnover of HUF 287,222 billion, realised by the supervised institutions in 2018, falls short of the turnover realised in 2017 by 3.1 percent due to a decline in the OTC prompt and derivate turnover.

Table 8
Key data of investment service providers

Investment service sector	2018			2017		
	Credit institutions	Investment firms	Total	Credit institutions	Investment firms	Total
Number of institutions	22	14	36	21	14	35
Customer securities portfolio (HUF billions)	30,735	3,648	34,383	29,598	2,857	32,455
Number of active customers (thousand persons)	1,087	262	1,349	1,111	261	1,372
Number of securities accounts managed (thousand pcs)	1,465	254	1,719	1,621	299	1,920
Capital market turnover (HUF billions)	254,005	33,217	287,222	266,002	30,077	296,079
Profit after tax (HUF millions)		6,545			5,972	
Capital adequacy ratio (percent)		19.3%			25.3%	

Source: MNB

The assets managed by the 44 investment fund managers in 2018 decreased minimally – by roughly 0.2 percent – to HUF 9,549 billion. The decrease was essentially caused by the decline in managed assets of other portfolios and pension funds. Although within the total asset managed portfolio the assets managed in other portfolios only represent a share of 3 percent, the 52.8 percent – HUF 319 billion – decrease registered in 2018 in the managed assets of other portfolios has a major effect at sector level as well. By contrast, managed assets investment funds continued to rise in 2018 and reached a historic high of HUF 6,558 billion, exceeding last year's balance by 3.9 percent. Private capital funds recorded dynamic growth in 2018: the volume of capital allocations executed from private capital funds until the end of 2018 reached HUF 108 billion, exceeding the value of HUF 34 billion recorded in 2017 by 218 percent. Despite the rise in funds available in venture capital funds, the HUF 107 billion in capital investments from venture capital funds remained unchanged in 2018.

Table 9
Key data of fund managers

Fund management sector	2018			2017		
	Investment fund managers	Venture capital fund managers	Total	Investment fund managers	Venture capital fund managers	Total
Number of institutions	44	33	77	39	32	71
Number of funds managed (pcs)	624	67	691	596	51	647
Volume of assets managed (HUF billions)	9,549			9,570		
Funds allocated (HUF billions)		244			166	
Profit after tax (HUF millions)	25,712	2,000	27,712	26,486	1,059	27,545

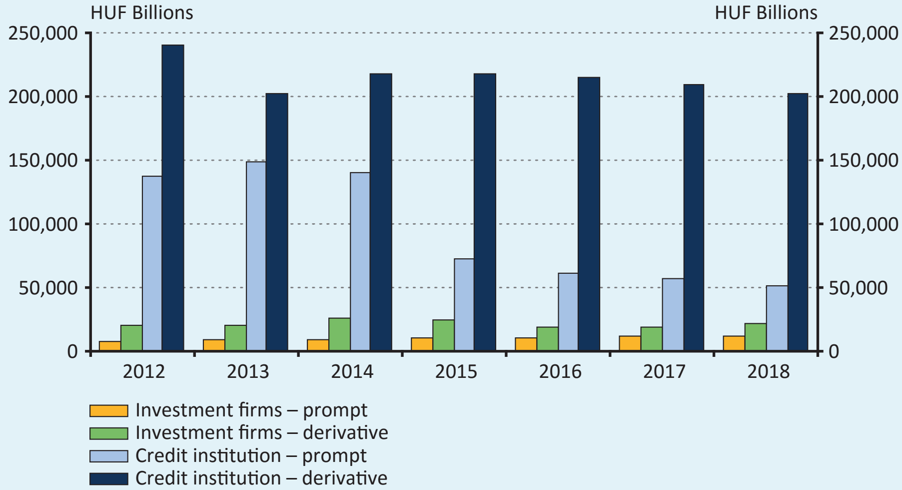
Source: MNB

6.1 INVESTMENT SERVICES MARKET: TURNOVER AND BALANCES

Capital market turnover of investment firms rose further in 2018, while that of credit institutions declined

In 2018, investment service providers – i.e., credit institutions and investment firms – realised a total turnover of HUF 287,222 billion, which represents a decrease of 3.1 percent compared to the total turnover registered in 2017 (Chart 49). While credit institutions' capital market turnover fell by 4.6 percent, that of investment firms rose by 10.4 percent compared to 2017. The decrease in the capital market turnover of credit institutions appeared in the two main capital market activity sub-sectors: OTC prompt turnover of HUF 50,400 billion and OTC derivative turnover of HUF 195,800 billion, registered in 2018, fell short of last year's turnover by 9 and 4.5 percent, respectively. The rise in the capital market turnover of investment firms is attributable to the increase in the derivative market turnover: investment firms' stock exchange derivative turnover of 2,600 billion and OTC derivative turnover of HUF 19,300 billion, registered in 2018, exceeded previous year's turnover data by 29.8 and 16 percent, respectively. The rise in stock exchange derivative turnover was essentially attributable to the increase in carbon emission trading. In 2018, 3 investment firms were active on the OTC derivative markets, while 7 investment firms were active on the stock exchange derivative markets, respectively. The 6.8 percent growth in investment firms' stock exchange prompt turnover was offset by 6.4 percent decline in the OTC prompt turnover. On the whole, we found that the stock exchange segment of the capital market – both in terms of the stock exchange prompt and derivative turnover – registered growth in 2018: prompt turnover and derivative turnover on stock exchange generated by Hungarian investment service providers rose by 10.9 percent and 34.3 percent, respectively, compared to 2017. By contrast, the OTC segment of the capital market – both in terms of OTC prompt and derivative turnovers – declined: OTC prompt and OTC derivative turnover fell short of the 2017 volume by 8.7 and 3 percent, respectively.

Chart 49
Developments in the capital market turnover

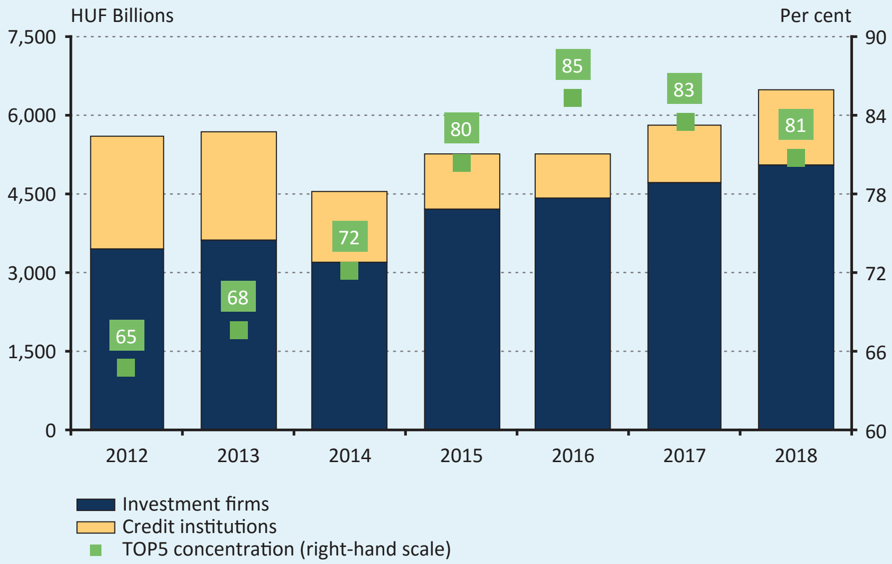


Source: MNB

The share of credit institutions in stock exchange turnover continued to increase in 2018

In 2018, similarly to the previous year, the share of investment firms in stock exchange prompt turnover declined further: the stock exchange prompt turnover's part allocable to investment firms was 63.9 percent in 2013, 70.3 percent in 2014, 80.4 percent in 2015, 84.3 percent in 2016, 81.1 percent in 2017 and 78.1 percent in 2018. In line with the previous trends, credit institutions' share in stock exchange derivative turnover rose in 2018 minimally, to 71 percent from 70 percent registered in 2017. The concentration of stock exchange prompt turnover decreased further in 2018: the share of the top five investment service providers realising the highest stock exchange prompt turnover was 81 percent in 2018, falling short of the concentration ratio registered in 2017 by 2 percent (Chart 50). The composition of the top five investment service providers realising the highest stock exchange prompt turnover did not change in 2018 compared to 2017: the sequence of the first three investment services providers also remained unchanged in 2018 compared to 2017, while the firms ranked fourth and fifth swapped places from 2017 to 2018. Four of the top five investment service providers realising the highest stock exchange prompt turnover are investment firms.

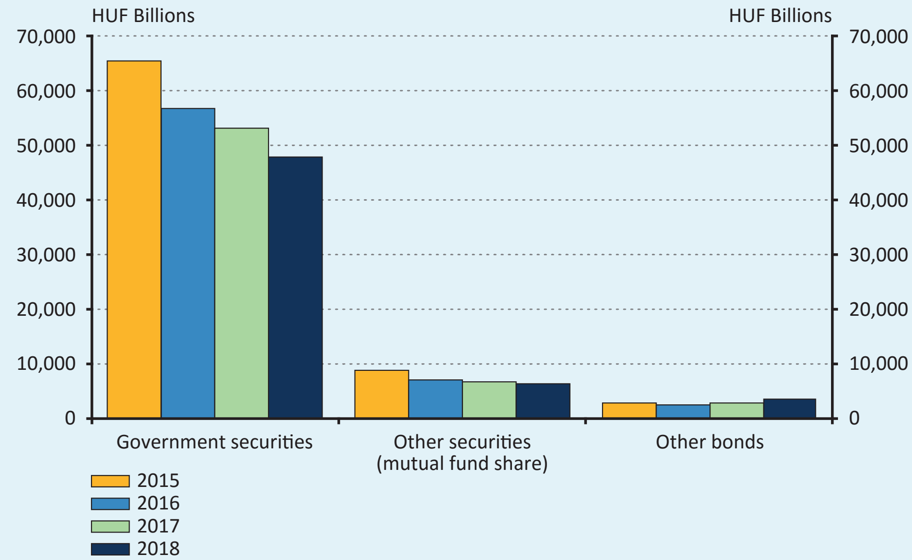
Chart 50
Stock exchange prompt capital market: turnover and concentration



Source: MNB

In the stock exchange derivative turnover, the share of investment firms and credit institutions was roughly the same until 2015 (47 and 53 percent in 2013, 51 and 49 percent in 2014, 48 and 52 percent in 2015, respectively); in 2016 the credit institutions' share started to rise and reached 59 percent, while by 2017 it was as high as 70 percent. The rise, albeit minimal, continued in 2018 as well, and the share of credit institutions in this segment reached 71 percent. The concentration of stock exchange derivative turnover decreased in 2018: the share of the top five investment service providers realising the highest stock exchange derivative turnover decreased from 88 percent of 2017 to 82 percent by 2018. The OTC prompt market is still dominated by credit institutions, covering 88.8 percent of OTC prompt turnover, which represents a moderate decline compared to the 89.1 percent registered in 2017. The OTC prompt capital market concentration ratio stagnated: in 2015, the top five market participants (including credit institutions only) covered 73 percent of the OTC prompt turnover, while this ratio in 2016 was 70 percent, in 2017 only 69 percent, while in 2018 it remained at 69 percent. Similarly to the previous year, in 2018 one investment firm joined the top five market participants. In 2018, neither the composition, nor the sequence of the top five investment service providers realising the highest OTC prompt turnover changed compared to 2017. The OTC capital market prompt turnover, as in previous years, was dominated by government securities in 2018 as well, with a share of 82 percent, followed by mutual fund shares with a ratio of 11 percent. (Chart 51)

Chart 51
OTC prompt turnover by types of securities

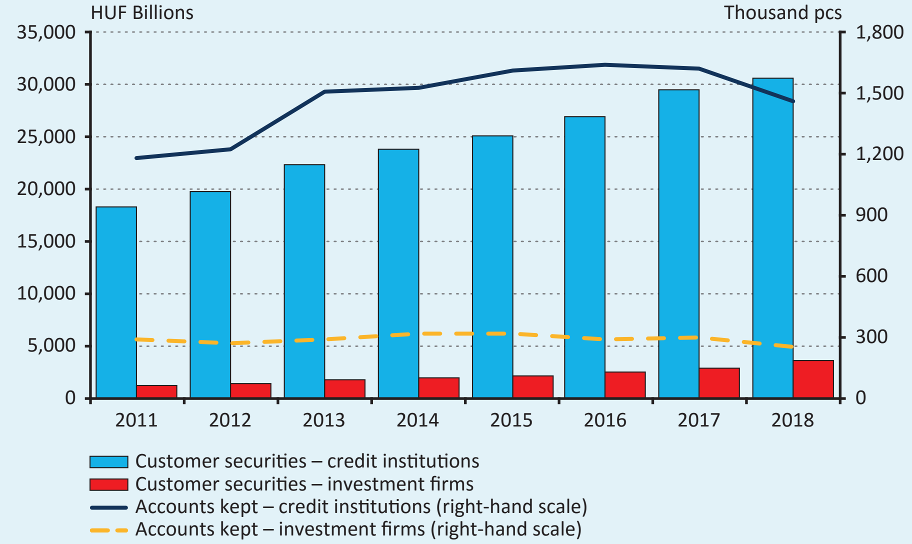


Note: due to their negligible OTC turnover equities are not included in the chart
Source: MNB

The portfolio of customer securities is at a historic high at sector level

In 2018, the growth in the portfolio of customer securities at market value managed by investment service providers – credit institutions and investment firms – continued; the December 2018 portfolio of HUF 34,383 billion exceeded the portfolio of HUF 32,455 billion, registered at the end of 2017, by 5.9 percent. At the end of 2018 the customer securities portfolio of HUF 30,735 billion managed by credit institutions and the HUF 3,648 billion managed by investment firms, showed a year-on-year increase of 3.8 and 27.6 percent, respectively. Of the HUF 1,137 billion increment observed in 2018 at credit institutions, HUF 1,440 billion is related to government securities (rise of 13.4 percent), HUF 169 billion to mutual fund shares (rise of 2.8 percent), while the equity portfolio decreased by HUF 438 billion (4 percent). The 27.6 percent rise in the customer securities portfolio of investment firms is due to an individual effect, related to a one-off transaction of a single investment firm. When the impact of this one-off transaction is eliminated, the growth in investment firms' customer securities portfolio was 16.9 percent at sector level. Due to the major growth in investment firms' customer securities portfolio, the rise in customer securities portfolio managed by investment firms within the total customer securities portfolio continued in 2018 as well, and the ratio reached 10.6 percent. This ratio was 8.8 percent in 2017, 8.5 percent in 2016, 8.0 percent in 2015, and 7.6 percent in 2014. The number of customer securities accounts kept by investment service providers substantially decreased in 2018, i.e., by roughly 10.5 percent, after a negligible (0.5 percent) decrease registered in 2017. While the number of customer securities accounts kept by credit institutions decreased by 156,000 (-9.6 percent) to 1,465,000 by the end of 2018, the investment firms registered a decrease of 45,000 accounts, and thus the closing portfolio of 254,000 accounts at the end of 2018 represents a year-on-year decrease of 15 percent. The decrease observed for investment firms and credit institutions is primarily attributable to the fact that certain large service providers terminated the contracts of inactive customers after the completion of customer due diligence. (Chart 52)

Chart 52
Customer securities portfolio

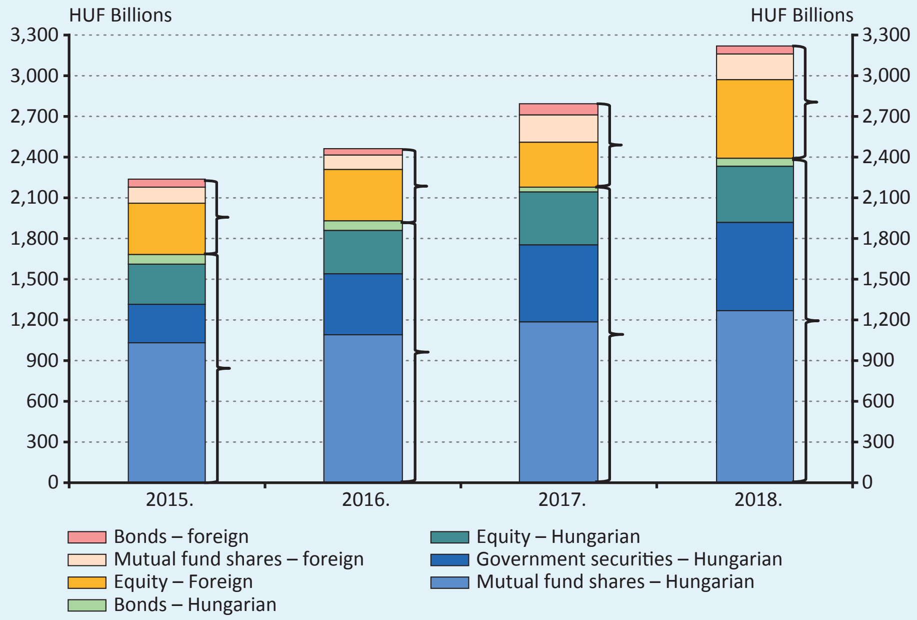


Source: MNB

Share of Hungarian issuers within the customer securities portfolio of investment firms is still high

Within the customer securities portfolio of investment firms, amounting to HUF 3,648 billion at the end of 2018, mutual fund shares still have the highest share (2018: 39.9 percent, 2017: 48.3 percent), followed by equities (2018: 35.8 percent, 2017: 25.2 percent), government securities (2018: 18.1 percent, 2017: 20.2 percent) and corporate bonds (2018: 3 percent, 2017: 4.4 percent). Of the growth of HUF 791 billion, observed at investment firms in 2018, HUF 589 billion (rise of 81.8 percent) relates to equities, HUF 82 billion (rise of 14.1 percent) to government securities, HUF 77 billion (rise of 5.6 percent) to mutual fund shares and HUF 60 billion (rise of 109.2 percent) to other securities, while the corporate bond portfolio decreased by HUF 16 billion (13 percent). When examining the breakdown of asset classes by resident and non-resident sector, similarly to previous years, and within the government securities asset class, Hungarian government securities accounted for 99 percent of the entire government securities portfolio. Mutual fund shares were characterised by strong Hungarian dominance in 2018 as well: the share of mutual fund shares issued by Hungarian fund managers within the total mutual fund share portfolio reached 87 percent in 2018, exceeding the value registered in 2017 by 1.1 percentage points. Growth in the share of Hungarian issuers also continued in the equity portfolios of investment firms – 2015: 43.3 percent; 2016: 45 percent; 2017: 53.7 percent, 2018: 55.6 percent. (Chart 53)

Chart 53
Customer securities portfolio by asset classes

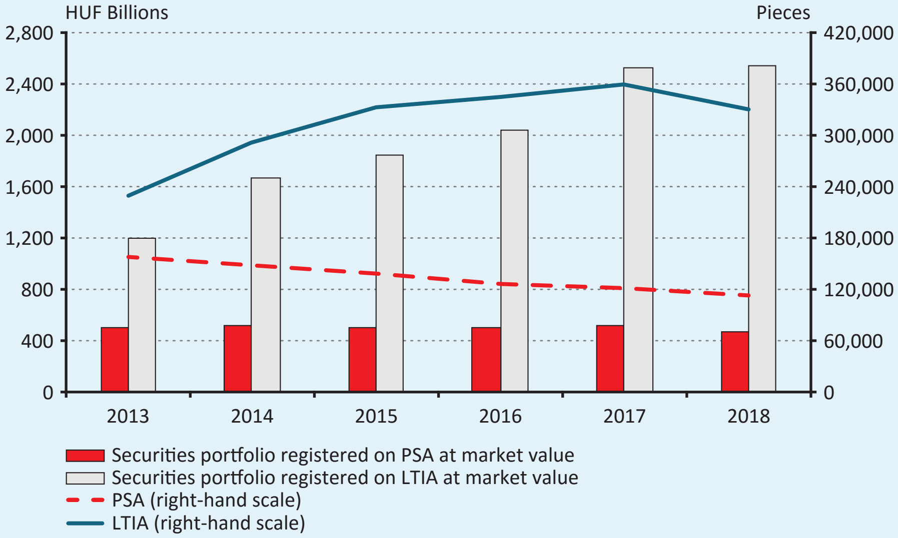


Source: MNB

Growth trend in long-term investment accounts faltered

Growth in the number of securities accounts kept in the form of long-term investment accounts (LTIA), observed in previous year, faltered in 2018. The LTIA portfolio of 331,000 contracts, recorded by investment service providers at the end of 2018, represents a year-on-year decrease of 7.7 percent (in 2017 the growth was 4 percent, while it was 3.5 percent in 2016, 14.3 percent in 2015 and 27 percent in 2014). The larger part of the decrease can be linked to credit institutions: the credit institutions' 2018 closing portfolio of 221,500 contracts falls short of the 2017 closing portfolio by 10.9 percent. At the investment firms, the LTIA closing portfolio of 109,600 contracts in 2018 fell short of previous year's closing portfolio by 0.7 percent (growth in 2017 was 5.8 percent). The growth rate of the LTIA securities portfolio declined in 2018: the 2018 closing securities portfolio of HUF 2,549 billion registered on LTIA exceeded the 2017 closing balance of HUF 2,533 billion by 0.6 percent (the growth recorded in 2017 was 24 percent, 10.7 percent in 2016 and 10.3 percent in 2015). In accordance with the foregoing, the average securities portfolio per LTIA rose from HUF 7.1 million registered at the end of 2017 to HUF 7.7 million by the end of 2018. In line with the former trend, the fall in the portfolio of the pension savings accounts (PSA) continued: after the decrease of 5.4, 7.4, 8 and 4.5 percent registered in 2014, 2015 , 2016 and 2017, respectively, the portfolio of pension savings accounts shrank by 6.8 percent in 2018, and closed with 113,100 accounts at the end of 2018. The decline primarily affected credit institutions: in 2018 the PSA portfolio registered by credit institutions fell by 7.2 percent, whereas investment firms only registered a decline of 5.3 percent. Almost 80 percent of the decline observed at credit institutions can be linked to three institutions, while the decline at the investment firms occurred at one institution. (Chart 54)

Chart 54
LTIA and PSA accounts, and the portfolios held on the accounts



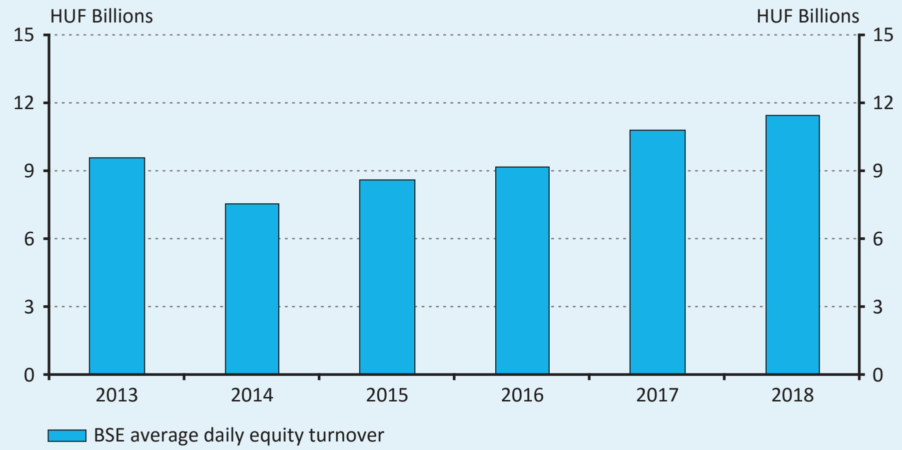
Source: MNB

6.2 REGULATED MARKET, POST-TRADING INFRASTRUCTURES

Continued rise in turnover on the prompt market of the Budapest Stock Exchange (BSE)

In 2018, the total turnover of the Budapest Stock Exchange rose by 2.8 percent compared to 2017, which in terms of magnitude corresponds to the growth of 3.1 percent registered in 2017. The securities' prompt turnover of HUF 2,955 billion exceeded the prompt turnover of HUF 2,785 billion registered in 2017 by 6.1 percent, while 2017 was characterised by much stronger growth (15.5 percent). The growth of HUF 170 billion on the prompt market is partly attributable to a rise of HUF 100 billion (3.8 percent) in the turnover of Hungarian equities. At the same time, the soar in the turnover of mortgage bonds also contributed to the growth of the prompt market: while in 2017 mortgage bond turnover was negligible (HUF 70 million), in 2018 it soared to HUF 60 billion. The remaining growth of HUF 10 billion is the combined result of the rise in turnover of certificates and the decline in foreign equities, mutual fund shares, and ETFs. However, despite the rising turnover observed on the whole for securities other than equities, the share of Hungarian equities in the total prompt turnover rose from 94.6 percent of 2017 to 96.8 percent by 2018. The concentration ratio in the prompt market segment, contrary to 2017, increased in 2018: the turnover generated by the top five stock exchange members covered 80.9 percent of the turnover of the entire prompt market, which exceeds the 2017 figure of 76.9 percent by roughly 4 percentage points – the composition and sequence of the top four stock exchange members remained unchanged in 2018 compared to 2017. The decline in the turnover of the derivative market continued in 2018 as well: the total derivative turnover of HUF 2,341 billion registered in 2018 falls short of the total turnover of HUF 2,368 billion, registered in 2017, by 1.1 percent. The decrease in the total turnover of the derivatives market was caused by a 6.6 percent decline in the turnover of equity futures (2017: HUF 338 billion; 2018: HUF 315 billion) and a 3.5 percent decline in the turnover of foreign exchange futures (2017: HUF 1,912 billion; 2018: HUF 1,884 billion), which could not be offset by the 45.4 percent rise in index-based futures (2017: HUF 109 billion; 2018: HUF 159 billion). In 2018, the derivative market was characterised by high, but decreasing concentration: the turnover generated by the top five stock exchange members covered 84.6 percent of the turnover of the entire derivative market, which falls short of the 2017 figure of 92.5 percent by roughly 7.9 percentage points. (Chart 55)

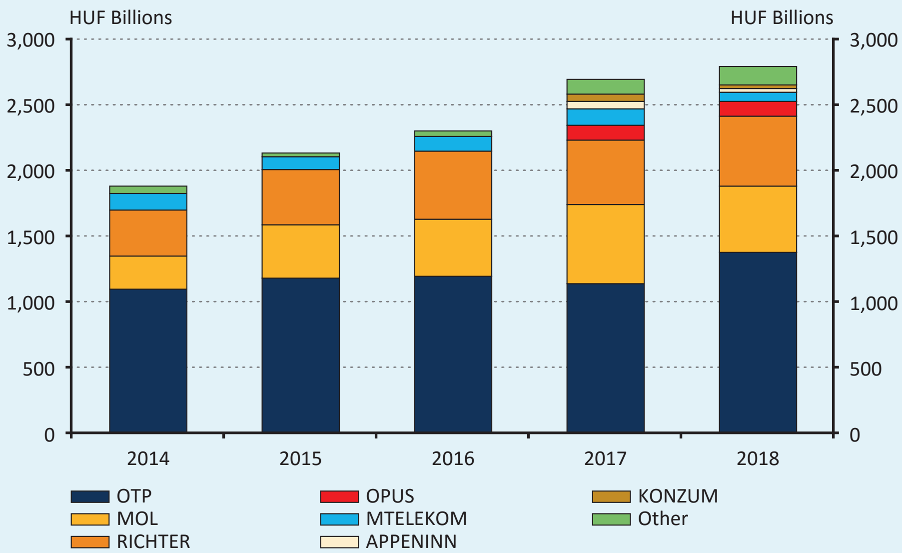
Chart 55
Average daily equity market turnover of the Budapest Stock Exchange



Source: MNB

In terms of issuers, the concentration of the prompt equity market turnover rose in 2018: in 2018, the share of the top four equities based on turnover – OTP, MOL, Richter, Opus – in the total equity market turnover, rose to 90.3 percent from 87.2 percent in 2017. The growth is essentially attributable to a rise in the turnover of OTP equities (2017: HUF 1,133 billion; 2018: HUF 1,370 billion) and a rise in the turnover of Richter equities (2017: HUF 488 billion; 2018: HUF 531 billion), while the turnover of MOL declined by HUF 99 billion (2017: HUF 606 billion; 2018: HUF 507 billion), and the turnover of Opus did not change significantly (2017: HUF 122 billion, 2018: HUF 114 billion). In 2018, the decrease in the turnover of other equities of relatively high liquidity also contributed to the rise in share of the four large equities: the Mtelekom equity turnover fell by HUF 44 billion (-37.1 percent) to HUF 75 billion, the equity turnover of Apennin fell by HUF 37 billion (-62.4 percent) to HUF 22 billion, while the equity turnover of Konzum decreased by HUF 28 billion (-47.2 percent) to HUF 31 billion. With a share of 49.1 percent, OTP still registered the highest turnover in 2018, with second place taken by Richter with a share of 19 percent, preceding MOL whose share fell to 18.2 percent, and followed by Opus with a share of 4.1 percent. (Chart 56)

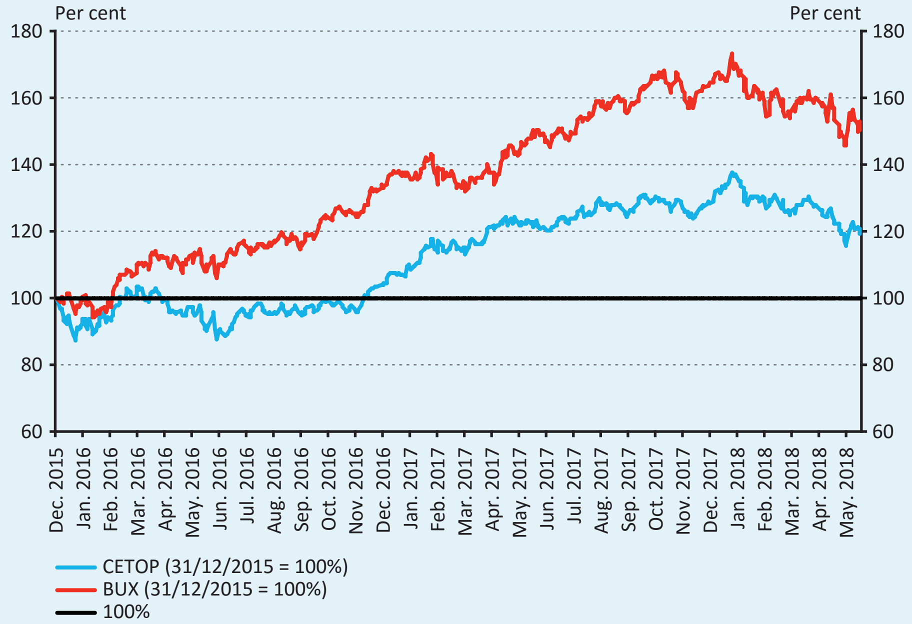
Chart 56
Annual stock exchange turnover of issuers



Source: MNB

The value of the BUX index at the end of December 2018 was 39,139 points, which fell short of the 2017 closing value of 39,377 by 0.6 percent. The decline is essentially attributable to the developments in the price of Richter Gedeon Nyrt. The BUX index rose by 23 percent in 2017 and by 33.8 per cent in 2016. (Chart 57)

Chart 57
Changes in the BUX and CETOP indices



Note: CETOP is the Blue Chip Index of Central Europe and includes the 25 Central European equities of the highest capital value and stock exchange turnover. The composition of the index is revised twice a year, in March and September.

Source: MNB.

In 2018 the equity of one new issuer was listed on BSE's Xtend market and one delisting was registered

In 2018, the equities of one new issuer (MEGAKRÁN Nyrt.) were listed on Xtend market of the Budapest Stock Exchange, and there were 17 private capital increases. Contrary to the two delisting events in 2017, in 2018 the equity of only one issuer (KEG Nyrt) was delisted, based on Section 400 of the Capital Market Act[21].

6.3 RISKS AFFECTING INVESTMENT FIRMS

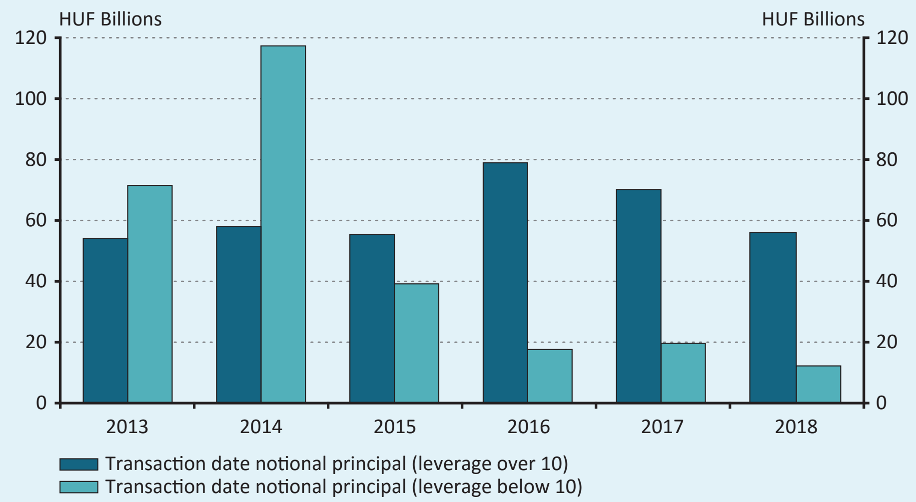
Further decrease in white label portfolios at investment firms

White-label product is a service where an investment service provider sells to the customer a trading platform developed by a third-party investment service provider under its own brand and business name, which platform facilitates wide-ranging trading on the international equity and bond market, and trading with derivatives. The customer signs a contract with the Hungarian investment service provider, and the assets of the customers are placed with the external service provider on omnibus accounts, opened under the name of the Hungarian investment service provider, as client. Accordingly, the credit and counterparty risks of customers using white-label services and the investment service providers rendering such services are higher than usual.

[21] Act CXX of 2001 on Capital Markets

The number independent – i.e., without banking background – Hungarian investment firms rendering white-label services remained unchanged – three – in 2018. The increase in the concentration ratio on the market of white-label services continued in 2018: the largest market participant covered 85 percent of the notional amount of open positions characterised by leverage higher than 10, while this ratio was only 79 percent in 2017. In 2018, the notional principal of deals executed under the white-label scheme with an open position characterised by leverage higher than 10 fell from HUF 70 billion registered in 2017, to HUF 56 billion, i.e., by roughly 20 percent. The decrease was also attributable to the product intervention decision of the European Securities and Markets Authority (ESMA), pursuant to which from 2 July 2018 it is forbidden to market, distribute or sell binary options to retail investors, and pursuant to which restrictions were introduced for contracts for differences in relation to the marketing, distribution and sales thereof to retail investors from 2 August 2018. The restrictions are essentially related to the leverage limits applicable to position opening (these were maximised), margin close out rule on a per account basis, negative balance protection on a per account basis and to preventing the use of inducements by a CFD provider. As part of continuous oversight, the MNB continues to pay special attention to white-label products, and during the annual supervisory review of the internal capital adequacy assessment process it prescribes additional capital requirements for the respective institutions. (Chart 58)

Chart 58
Transaction date notional principal of white-label products

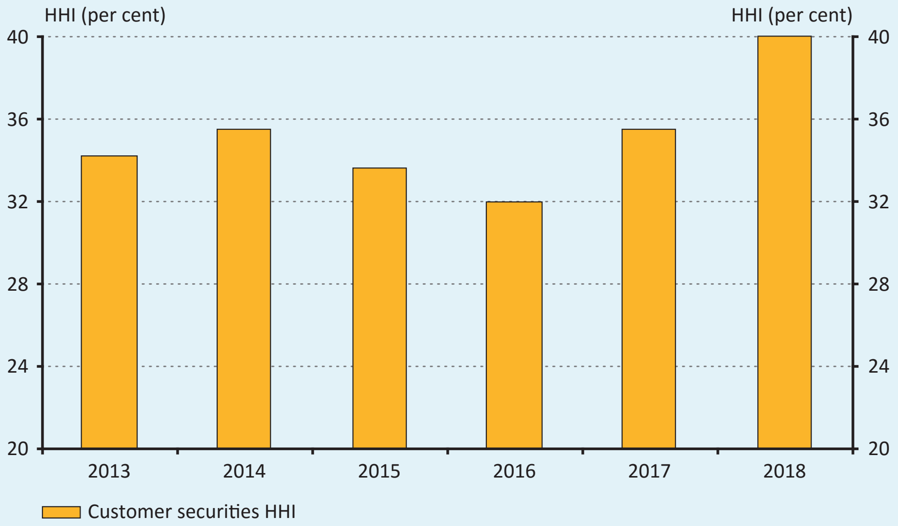


Source: MNB

The decreasing trend in the market share of small investment firms continued in 2018

The concentration of the customer securities portfolio of investment firms, calculated according to the Herfindahl–Hirschman-index (HHI), rose further in 2018: the 41.3 percent registered in 2018 exceeds the 35.5 percent of 2017 by 5.9 percentage points, while in 2016 it was only 32 percent. The growth in market concentration is also reflected by the rise in the market weight of the top three and top five market participants: the combined share of the top three market participants in the customer securities portfolio of the entire investment firm sector was 84.1 percent in 2018, which exceeds the value of 84.1 percent registered in 2017 by 2.8 percentage points, while the combined share of the top five market participants in the customer securities portfolio of the entire investment firm sector was 94.8 percent in 2018, exceeding the value of 93.6 percent recorded in 2017 by 1.2 percentage points. The rise in market concentration is due to the fact that the number of investment firms keeping customer accounts and registering customer securities decreased in 2018 – the dissolved investment firms had low market share and customer securities portfolio, and the rise in the customer securities portfolio occurred essentially at the institutions with a large portfolio. (Chart 59)

Chart 59
Market concentration of customer securities portfolio



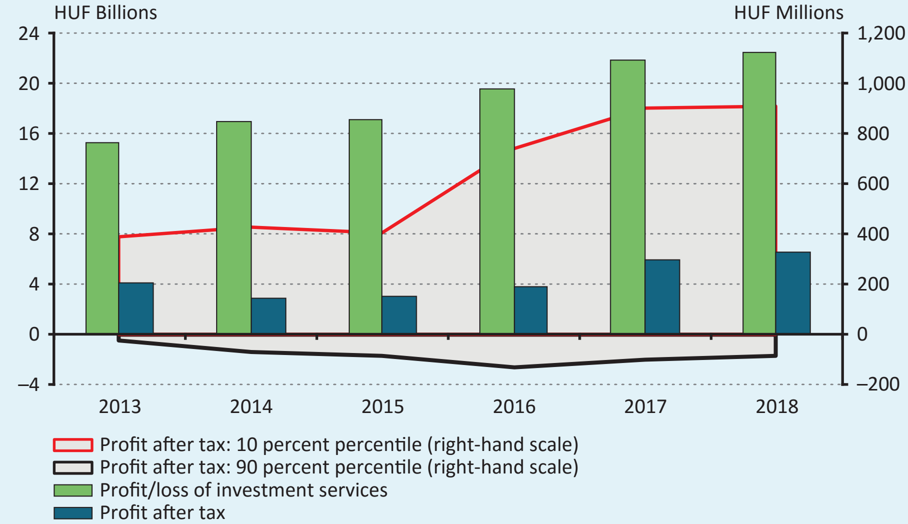
Source: MNB

Improving profitability on the whole, while profitability of small investment firms declined further

Contrary to the dynamic growth observed in the previous two years, the 2018 after-tax profit of investment firms in the amount of HUF 6.54 billion – including the branch offices – exceeded the amount of HUF 5.97 billion recorded in 2017 by roughly 9.6 percent (annual growth rate in 2017 was 48.6 percent and in 2016 it was 25.6 percent); nevertheless, at sector level it is still the historic high of the past decade. After-tax profit increased at 5 of the investment firms that operated both in 2017 and 2018, while the after-tax profit of 7 investment firms decreased. The income concentration of the investment firms sector declined further in 2018: the share of the combined after-tax profit of HUF 6 billion of the top three market participants based on after-tax profit decreased to 91.7 percent of the entire sector's after-tax profit, from 95.7 percent recorded in 2017, and similarly, the 102 percent share in the entire sector's after-tax profit of the combined after-tax profit of HUF 6.67 billion of the top five market participants also represents a decrease compared to the ratio of 104.8 percent registered in 2017. (Chart 60)

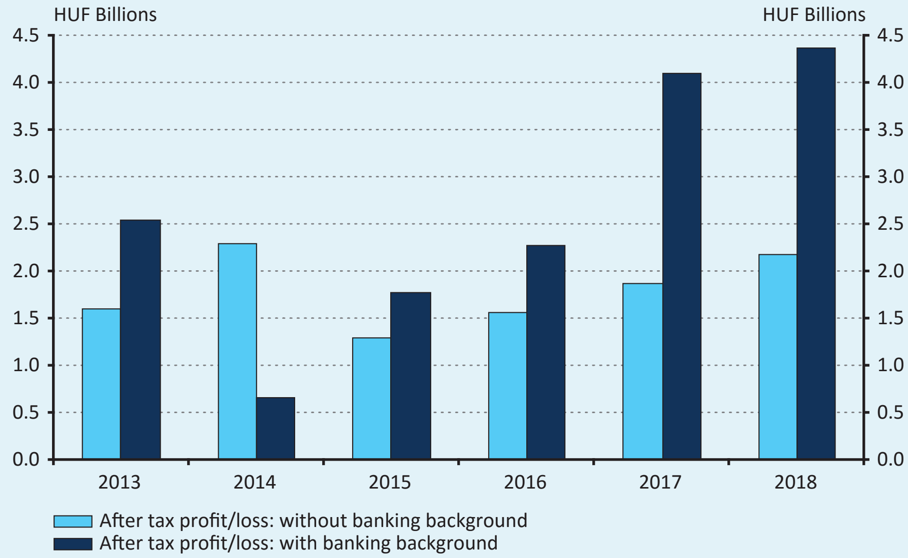
The consolidation process of the investment firm sector continued in 2018 as well, albeit to a lesser degree. Accordingly, last year one investment firm (Quantis Alpha Befektetési Zrt.) and the branch office of one foreign investment firm (Hungarian Branch Office of Aberdeen Asset Managers Limited) returned their activity licence. The investment firms that returned their activity licence were small investment firms both in terms of activity and portfolio, and their after-tax result was also persistently negative in the past years (2016: - HUF 95 million; 2017: - HUF 181 million). Although the number of loss-making investment firms rose in 2018 to four from one in 2017 – in the latter value ignoring the investment firms dissolved in the meantime – on the whole, the profitability of the independent investment firms not belonging to a banking group also improved, which also justifies the market consolidation process. (Chart 61)

Chart 60
Profitability of investment firms



Source: MNB

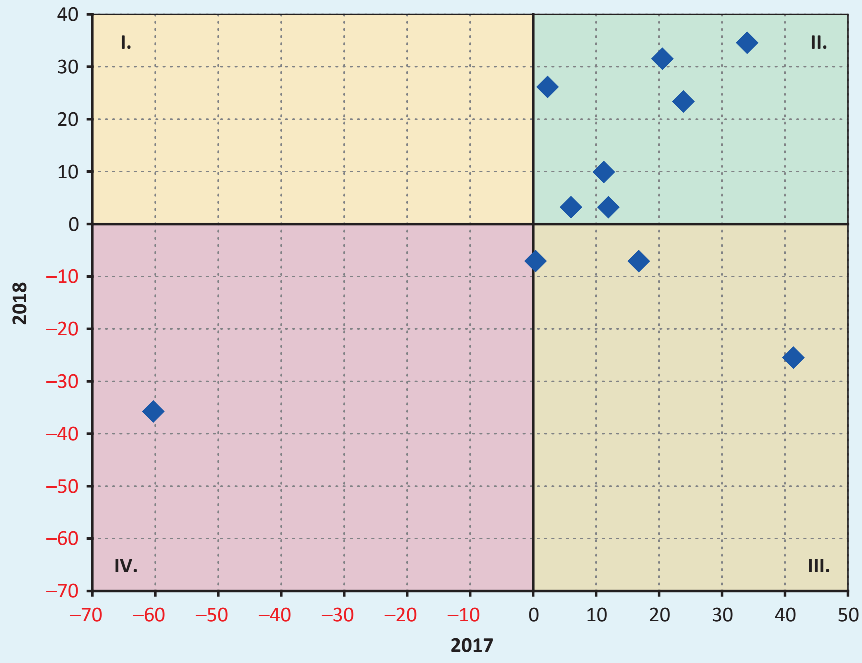
Chart 61
After-tax profit/loss of investment firms with and without a banking background



Source: MNB

One of the four investment firms that realised a loss in 2018 has been loss-making since its foundation, and its operation is financed by continuous capital injections; the after-tax result of one investment firm is steadily close to zero, which is explained by its business model, while the remaining two investment firms had relatively stable profitability until 2017. The investment firm that newly entered the market in 2018 was characterised by positive profitability. The improvement in profitability is also evidenced by the after-tax return on equity (ROE). (Chart 62)

Chart 62
ROE value of investment firms (percent)

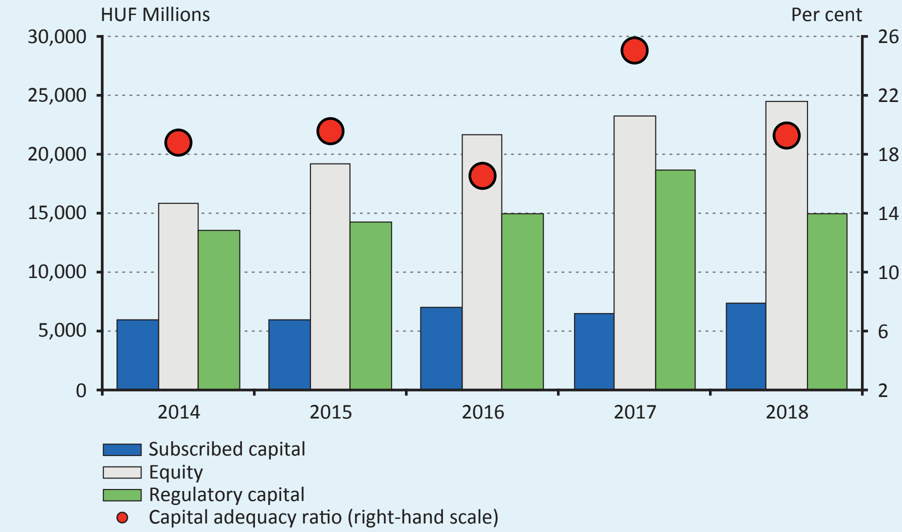


Source: MNB

Stable capital adequacy at sector level

In 2018, the subscribed capital of investment firms rose by HUF 0.85 billion to HUF 7.4 billion due to the new entrant investment firm, and in line with this the equity of investment firms also rose from HUF 23.37 billion of 2017 to HUF 24.63 billion by 2018. By contrast, the capital adequacy ratio of the investment business sector decreased from 25.3 percent registered at the end of 2017 by 6 percentage points to 19.3 percent by the end of 2018, which is in line with the average of previous years. The decrease is essentially attributable to a change in the capital structure of one institution: the available solvency capital of the respective institution significantly declined in 2018, while there was no material change in the capital requirement. All of the 12 investment firms with a registered office in Hungary had an adequate capitalisation level at the end of 2018, but in the longer term capital adequacy problems may arise at two investment firms. Similarly to 2017, in 2018 as well 6 of the 12 investment firms have to comply with the capital requirement calculated on the basis of risk exposure, while for the other 6 institutions, the capital requirement comprises statutory initial capital requirement, as a higher limit. (Chart 63)

Chart 63
Capital and capital adequacy ratio of investment firms



Source: MNB

Sector level risk map of the investment firms

Risk category	Risk groups	Risk rating	Risk prospects	Evaluation in words
Credit risk	Placement of customer funds with third parties		↓	As result of the product intervention decision introduced by ESMA in 2018, the customer portfolio placed with third party counterparties under white-label scheme decreased
Profitability	Extra burdens due to the payments related to indemnification, and MiFID II/MiFIR compliance		↑	The extra burdens stemming from indemnification may have a negative impact particularly on the small and medium-sized investment firms' profitability. As a result of the MiFID II/MiFIR requirements related to inducements, the declining incomes and the additional regulatory burdens will have a negative impact on profitability.
Capital adequacy	Decreasing profitability		↑	The decreasing profitability of small and medium-sized investment firms may have a negative impact on their capital position as well.
Corporate governance	Compliance: MiFID II/ MiFIR		→	Compliance with the MiFID II/MiFIR requirements imposes extra burdens on investment service providers; on the other hand, compliance with the MiFID II/MiFIR requirements represents a progress in terms of investor protection (e.g. more transparent cost structure).
Market risk	Trends of uncertain developments in turnover, volatility of investor confidence		↑	Due to the consolidation process and the change in the external market and regulatory environment, competition may strengthen in the sector.

Explanation:

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

Direction of risk — *increasing* ↑ — *stagnant* → — *decreasing* ↓

On the whole, the risk rating of the investment business sector has not changed compared to the previous year in the individual risk categories. The **credit and counterparty risk** is still significant, but due to the declining white-label exposure and the product intervention decision introduced by ESMA in the summer of 2018, risk expectation is declining. **Corporate governance risk** remained moderate in view of the requirements of MiFIR, applicable from 3 January 2018, and of the related RTS and in the parts of MiFID II implemented in Hungarian legislation, which impose extra burden on the corporate governance and business processes of investment firms. The **capital and profitability risk rating** has not changed and it is significant, since the investment firms with a low market share are less able to absorb potential market shocks and comply with regulatory requirements (loss-making operation, relatively poor capital adequacy).

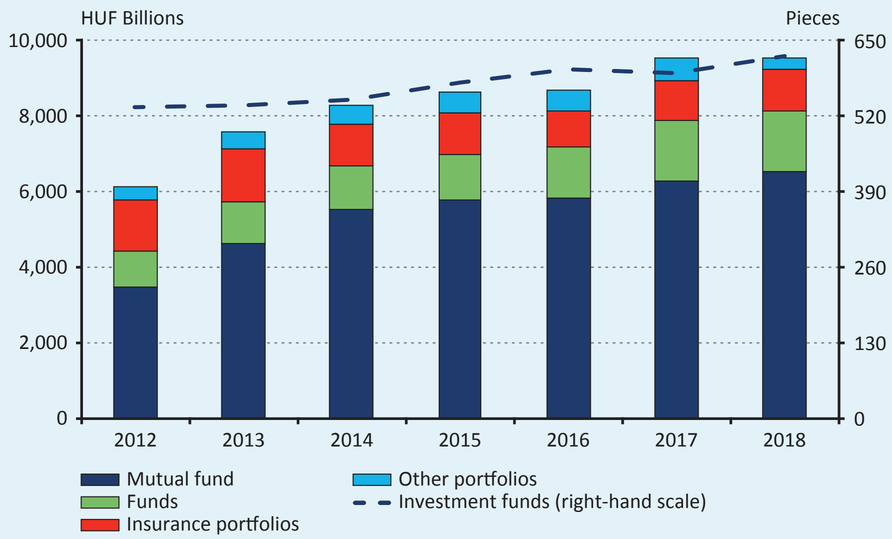
6.4 FUND MANAGEMENT MARKET AND RISKS AFFECTING INVESTMENT FUND MANAGERS

After several years of growth, in 2018 assets managed by investment fund managers decreased

In 2018, the number of investment funds rose by 28 in total, to 624. Restructuring continued: while in 2018 the number of real estate funds rose by 32 and reached 102 (in both 2016 and 2017 the number of real estate funds rose by 20), the number of securities funds practically stagnated. In 2018, the number of investment fund managers rose by five to 44 – the growth is essentially attributable to growth of the real estate fund sector.

The assets managed by investment fund managers decreased minimally, by roughly 0.2 percent, in 2018: while at the end of 2017 the value of assets managed by fund managers reached HUF 9,570 billion, by the end of 2018, the value of managed assets declined by HUF 21 billion, to HUF 9,549 billion. The decrease was essentially caused by a decline in the managed assets of other portfolios and in the managed assets of pension funds. Although within the total assets under management the assets managed in other portfolios only have a share of 3 percent, the 52.8 percent – HUF 319 billion – decrease registered in 2018 in the managed assets of other portfolios had major effect at sector level as well. The decrease in the managed assets of other portfolios is linked to a single institution. The managed assets of pension funds decreased by 0.3 percent on the whole in 2018, due to the decrease in the managed assets of private pension funds. By contrast, the managed assets of investment funds rose further, and at the end of 2018 it reached a historic high of HUF 6,558 billion – this represents a growth of 3.9 percent, which still lags behind the growth rate of 8.1 percent registered in 2017 (1.1 percent in 2016). Assets managed in insurance portfolios also rose further in 2018: the balance of HUF 1,112 billion exceeds the value recorded in 2017 by 5.5 percent. The growth is essentially linked to one institution. (Chart 64)

Chart 64
Assets managed by investment fund managers and the number of investment funds



Source: MNB

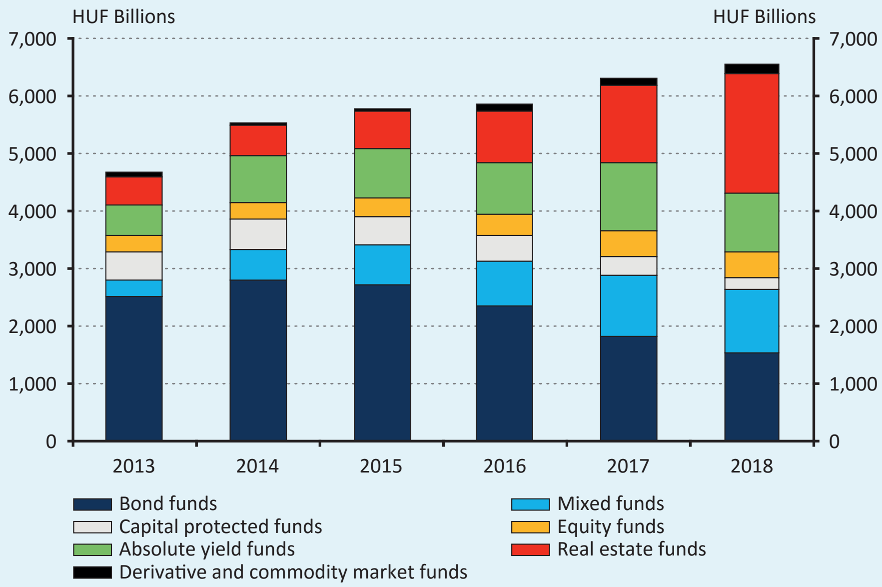
Net asset value of mutual funds is at a new historic high

The assets managed in investment funds rose by HUF 245 billion in 2018 and by the end of 2018 reached a net asset value of HUF 6,558 billion, which is new historic high. On the whole, similarly to previous years, investment funds were characterised by positive net capital inflows in 2018 as well; however, the yield realised on the investments of investment funds in 2018 was negative, albeit only minimally: accordingly, the growth of HUF 245 billion in net asset value is the combined result of the positive net capital inflows of HUF 262 billion and the negative yield impact of - HUF 17 billion. Contrary to 2017 – when net asset value of long-term bond funds and bond funds without duration target increased – in

2018, the net asset value of all bond-type investment funds (liquidity, money market, short-term, long-term, without duration target) declined: the net asset value of HUF 1,525 billion registered at the end of 2018 fell short of the value recorded at the end of 2017 by HUF 314 billion. On the whole, the assets managed in mixed funds (bond-heavy mixed funds, balanced mixed funds, and dynamic mixed funds) increased in 2018 as well.

Last year's closing net asset value of HUF 1,103 billion exceeds the net assets value of HUF 1,037 registered at the end of 2017 by HUF 66 billion, which growth substantially falls short of the growth of HUF 265 billion in 2017. The growth in mixed funds was attributable to the rise in the assets managed in the balanced mixed funds and dynamic mixed funds: in 2018 the assets managed in balanced mixed funds rose by 21 percent (HUF 107 billion), while the assets managed in dynamic mixed funds were up by 19 percent (HUF 17 billion). By contrast, the assets managed in bond-heavy mixed funds decreased in 2018 by 13 percent (HUF 57 billion). Continuing the trend of previous years, the growth in the net asset value of real estate funds (funds investing in direct and indirect real estate) continued in 2018: the assets managed in 2018 by real estate funds in the amount of HUF 2,092 exceed the previous year's closing value of HUF 1,347 billion by HUF 745 billion, which is extraordinary growth of 55.3 percent. Accordingly, the share of assets managed in real estate funds, compared to the assets managed by the entire investment fund sector, soared from 21.3 percent of 2017 to 31.9 percent in 2018. The decrease in the assets of capital protected funds, observed in the past three years, continued in 2018 as well: the net asset value of capital protected funds in the amount of HUF 212 billion in 2018 fell short of the net asset value of HUF 316 billion recorded at the end of 2017 by 33 percent (13 percent decrease in 2016, 29 percent decrease in 2017). Contrary to the major – 28 percent – growth in the net asset value of equity funds in 2017, it decreased by 2 percent in 2018: the closing balance of HUF 450 billion falls short of the assets managed in 2017 by HUF 7 billion: the decrease is mostly attributable to the yield impact, since the net capital inflows of equity funds reached HUF 26 billion in 2018. (Chart 65)

Chart 65
Breakdown of the investment funds by investment policy

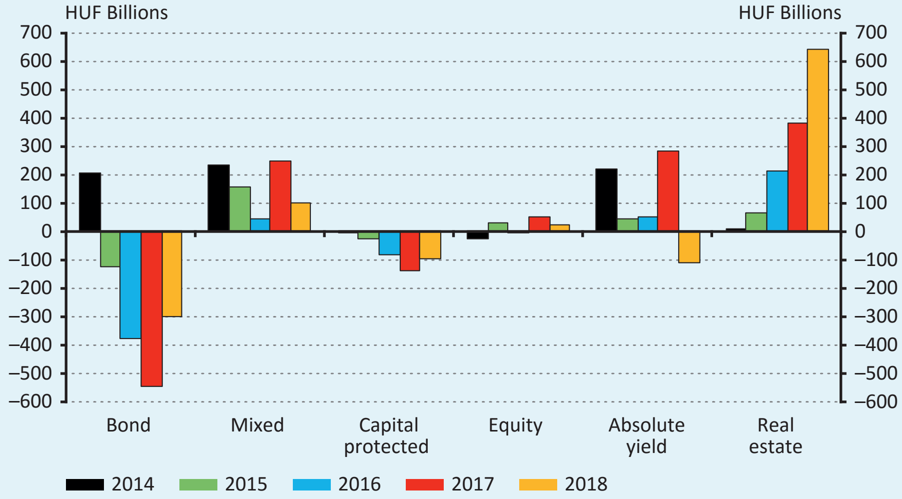


Source: MNB

Investment funds were still characterised by positive net capital inflows in 2018 on the whole

On the whole, investment funds were characterised by vigorous capital inflows in 2018 as well: the net capital inflow of HUF 260 billion recorded in 2018 falls short of the net capital inflow of HUF 270 billion recorded in 2017 only by HUF 10 billion, while in 2016 investment funds recorded a net capital outflow of HUF 156 billion in total. When examining the details of the consolidated net capital inflows, we found that 2018 was characterised by similar processes as 2017, since the positive net capital inflow is attributable to the vigorous demand of investors for real estate funds – funds investing in direct and indirect real property: while securities funds were characterised by net capital outflows of HUF 383 billion total, net capital inflows to real estate funds amounted to HUF 643 billion (in 2017 this value was HUF -109 billion for securities funds, and HUF +379 billion for real estate funds). Bond-type investment funds (liquidity, money market, short-term bonds, long-term bonds, and without duration target) were still characterised by net capital outflows in 2018: while in 2017 the volume of funds withdrawn from the bond-type investment funds amounted to HUF 546 billion in total, in 2018 net divestiture decreased to HUF 298 billion (in 2016 this value was HUF -379 billion). Net divestiture essentially affected the short-term bond funds. Net capital inflows to mixed funds (bond-heavy mixed fund, balanced mixed fund, and dynamic mixed fund) amounted to HUF 100 billion in total in 2018, which falls short of the net capital inflow of HUF 244 billion recorded in 2017: in 2018 the net capital flows of balanced mixed funds and dynamic mixed funds reached HUF 127 billion and HUF 23 billion, respectively, while bond-heavy mixed funds were characterised by net capital outflows (HUF -50 billion). Following the net capital inflows of HUF 280 billion in 2017, absolute yield funds were characterised by net capital outflows of HUF 122 billion. (Chart 66)

Chart 66
Net capital flows of investment funds

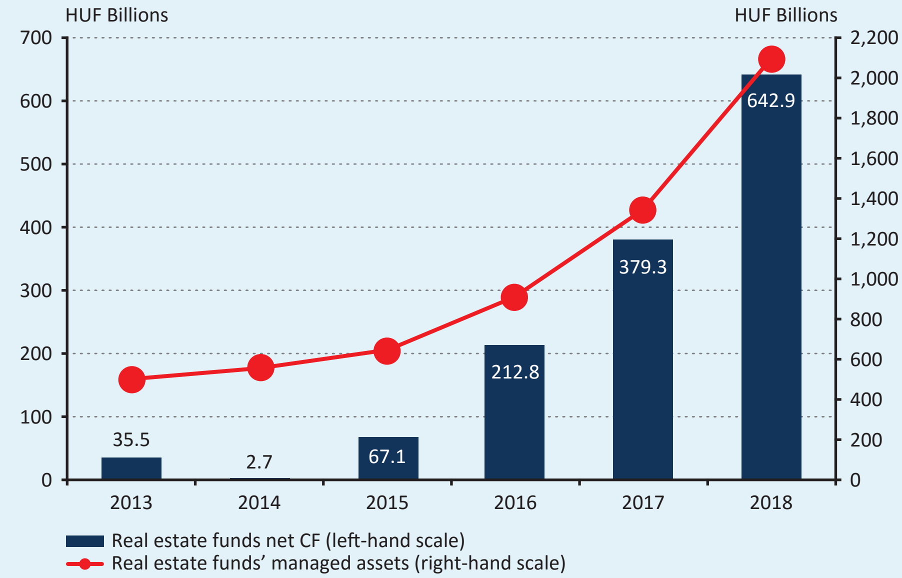


Source: MNB

Real estate funds characterised by record high capital inflows in 2018

In 2018, real estate funds were characterised by record high capital inflows, at both sub-types, i.e., funds investing in direct and indirect real estate. The net capital inflow of HUF +648 billion in 2018 exceeds the also record high value of 2017 by 70 percent (2015: HUF +67 billion; 2016: HUF +213 billion). For funds investing into direct real estate, the net capital inflows contributed HUF 534 billion to the growth of HUF 628 billion in net asset value (2017: HUF 1,202 billion; 2018: HUF 1,830 billion), while the remaining HUF 94 billion is the investment yield realised on the managed portfolio. The net capital inflows of funds investing in direct real estate practically doubled in 2018 compared to the net capital inflows of HUF 293 billion recorded in 2017, and it is a multiple of the HUF +192 billion and HUF +68 billion of 2016 and 2015, respectively. HUF 380 billion of the HUF 534 billion net capital inflows of funds investing in direct real estate relates to nine public open-ended real estate funds, more specifically, 96 percent can be linked to three investment fund managers. For funds investing into indirect real estate, the net capital inflows contributed HUF 109 billion to the growth of HUF 118 billion in net asset value (2017: HUF 168 billion; 2018: HUF 218 billion), which exceeds the net capital inflows of HUF 86 billion registered in 2017 by 26 percent. (Chart 67)

Chart 67
Portfolio and net capital inflows of real estate funds

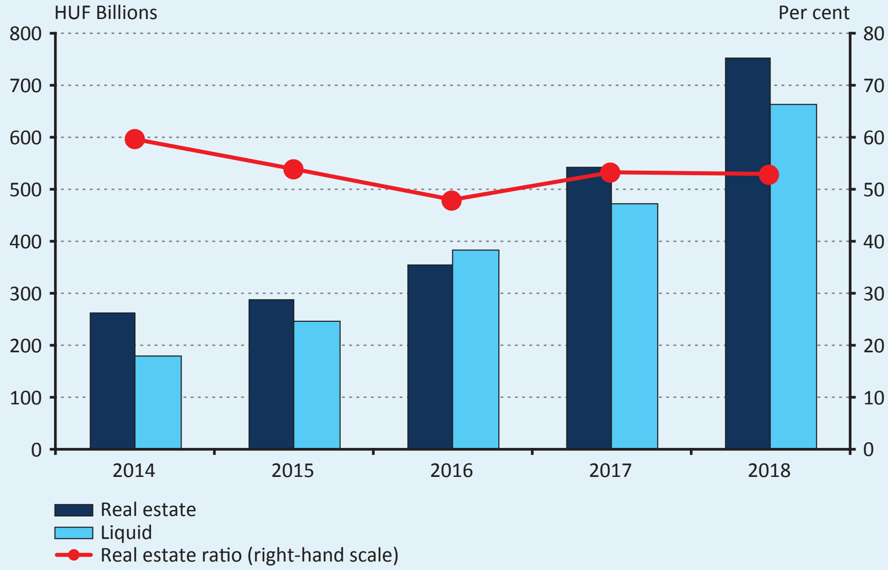


Source: MNB

Despite the major capital inflows, real estate exposure did not decrease at the public real estate funds

Within the portfolio of real estate funds – i.e., funds investing in direct real estate – the share of public real estate funds decreased in 2018 as result of the proportionately higher growth of closed-end real estate funds: the 77.3 percent share (HUF 1,415 billion) of public real estate funds in 2018 falls short of the 84.4 percent share (HUF 1,014 billion) registered in 2017 by roughly 7.1 percentage points. High concentration, characterising public real estate funds in 2017, rose further, albeit minimally, in 2018: the top three public real estate funds with the highest net asset value accounted for 80.2 percent of the public real estate funds' total net asset value, which exceeded the concentration ratio of 78.6 percent in 2017 by 1.6 percentage points. However, net capital inflows were characterised by an even larger growth in concentration ratio: while in 2017 the top three public real estate funds with the highest net asset capital inflows accounted for 69.3 percent of the public real estate funds' total net capital inflows, in 2018 this ratio reached 84.9 percent. Despite the strong capital inflows characterising public real estate funds, the ratio of real estate investments compared to the public real estate funds' net asset value practically remained unchanged (2017: 52.3 percent; 2018: 53.1 percent), in view of the fact that the investment funds managing real estate funds invested the incoming liquidity on the real estate market. (Chart 68)

Chart 68
Real estate investment portfolio of public real estate funds and the ratio thereof compared to net asset value

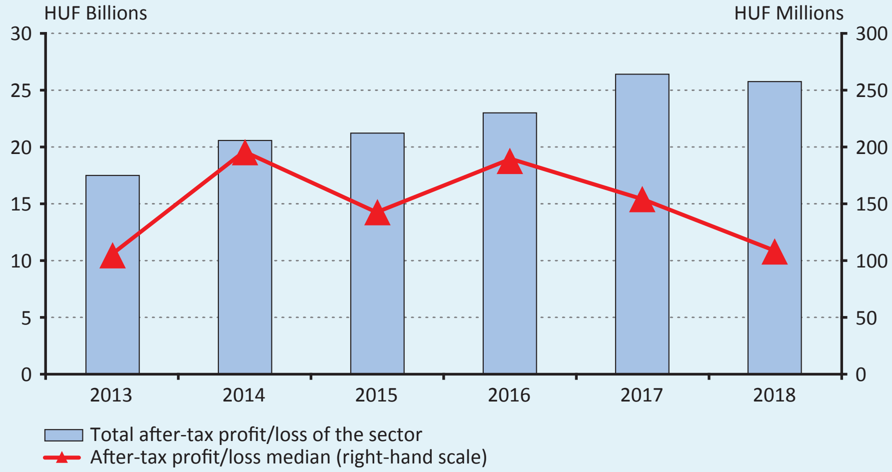


Source: MNB

Decreasing profitability in investment fund management sector

The after-tax profit of investment fund managers decreased from HUF 26.5 billion of 2017 by 2.9 percent to HUF 25.7 billion in 2018. The decrease is essentially attributable to two factors: on the one hand, the after-tax profit of a large fund manager significantly decreased compared to 2017, and on the other hand, new investment fund managers, engaged in the management of closed-end real estate funds, capitalising on the real estate market trend, entered the market and in the first year of operation they have not yet achieved positive profitability. (Chart 69)

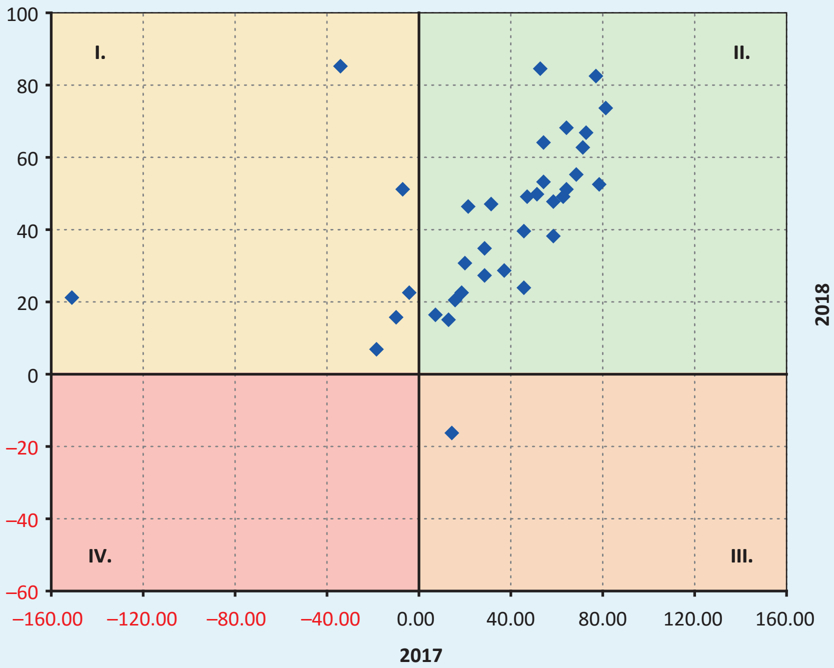
Chart 69
Profitability of investment fund managers



Source: MNB

Due to the aforementioned one-off effect, the income concentration ratio of the sector declined further in 2018: the top five asset managers with the highest after-tax profit accounted for 56 percent of the entire sector's after-tax profit in 2018, falling short of the previous year's figure by 8 percentage points. In 2018, the number of loss-making fund managers decreased to seven from the eight registered in 2017. In 2018, the after-tax result of the loss-making fund managers was a loss of HUF 398 million, which is twice as high as the after-tax loss of HUF 189 billion realised in 2017 by loss-making fund managers. Four of the seven investment fund managers that realised a loss in 2018 commenced their activity in 2018, and thus the loss-making operations are attributable to start-up costs, while one investment fund manager made a loss back in 2017, as well. The assets managed by the loss-making fund managers (HUF 23 billion) account for a minimal part – 0.2 percent – of the total managed assets of the sector (HUF 9,549 billion), and thus we have no financial stability risk issue in terms of profitability. The business model of the investment fund managers was characterised by strong profitability in 2018 as well, also evidenced by the high level of the ROE indicator, i.e., after-tax profit to equity ratio: Chart 70 only shows the investment fund managers that were active in both 2017 and 2018 and whose activity licence was not withdrawn in 2018.

Chart 70
ROE value of investment fund managers (percent)



Source: MNB

Sector level risk map of investment fund managers

Risk category	Risk groups	Risk rating	Risk prospects	Evaluation in words
Corporate governance	Compliance: MiFID II/ MiFIR	●	→	Compliance with the MiFID II/MiFIR rules may represent challenge for fund managers also holding a licence for distribution, as an investment service.
Operational risk	Risk management systems	●	→	At some of the fund managers, the risk management and back office processes call for enhancement.
Market risk	Low interest environment, yield hunting attitude, culmination of real estate funds	●	↑	The low interest environment and the relatively high yield of household government securities fostered net capital outflows from funds investing in interest-bearing assets. The unilateral exposure arising from the extremely high share of real estate funds – at the end of 2018, the share of real estate fund as a percent of net asset value in the entire investment fund sector was 31.9 percent – represents increasing vulnerability in the event of a potential market decline.
Profitability	Capital outflows from funds investing in interest-bearing assets and capital protected funds, capital inflows to real estate funds	●	↑	Due to the lack of economies of scale at certain small fund managers, profitability problems may arise. As regards the strengthening competition, the realignment stemming from the yields realisable on household government securities, the new fund managers – typically managing real estate funds only – established as a result of the real estate market boom, a potential downturn in the real estate market may have negative effect on profitability.
Capital adequacy	Decreasing profitability	●	↑	As a result of the potentially decreasing profitability and economies of scale problems, the capital position of certain fund managers may become unstable.

Explanation:

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

Compared to the previous year, the risk rating of the investment fund management sector was changed for the market, profitability and capital adequacy risk, while it remained unchanged for corporate governance and operational risk. The risk rating of **market risk** changed from moderate to significant, justified by the capital outflows from the funds investing in interest-bearing assets triggered by a yield-hunting attitude, and by the unprecedented capital inflows to real estate funds. Increased demands of small investors for the large, public, open-ended real estate funds were instrumental in the net capital inflows to real estate funds. The largest risk attached to the operation of the public, open-ended real estate funds is the mass redemption of mutual fund shares, which may lead to forced sales of less liquid assets in large volumes. Although at present real estate exposure is relatively low, which reduces the redemption – i.e., liquidity – risk, this may significantly change upon a major rise in the real estate ratio. Within the investors in real estate funds the number of small investors – i.e., with a portfolio below HUF 10 million – is high, and it may be more difficult to assess the liquidity risks of this form of investor in full, and upon a potential market shock they may decide faster, and en masse, on the redemption of their mutual fund shares. The rating of **profitability risk** was also changed from moderate to significant, since economies of scale problems may arise at certain small fund managers, and the strengthening competition and market restructuring may have a negative impact on profitability. In line with the change in the profitability risk, the rating of the **capital adequacy risk** also changed, from low to moderate, since as a result of potentially decreasing profitability, the capital position of certain fund managers may become unstable. In terms of **corporate governance risk**, the main challenge is still the MiFID II regime, effective from 2018, for members of the sector that hold a licence for investment services activity – i.e., in addition to fund management, they also perform distribution or portfolio management. Compliance with requirements related to inducements, prescribed by the MiFID II regime, in certain cases may result in the transformation of the business model applicable to sales and distribution.

6.5 VENTURE CAPITAL AND PRIVATE CAPITAL FUND MANAGERS

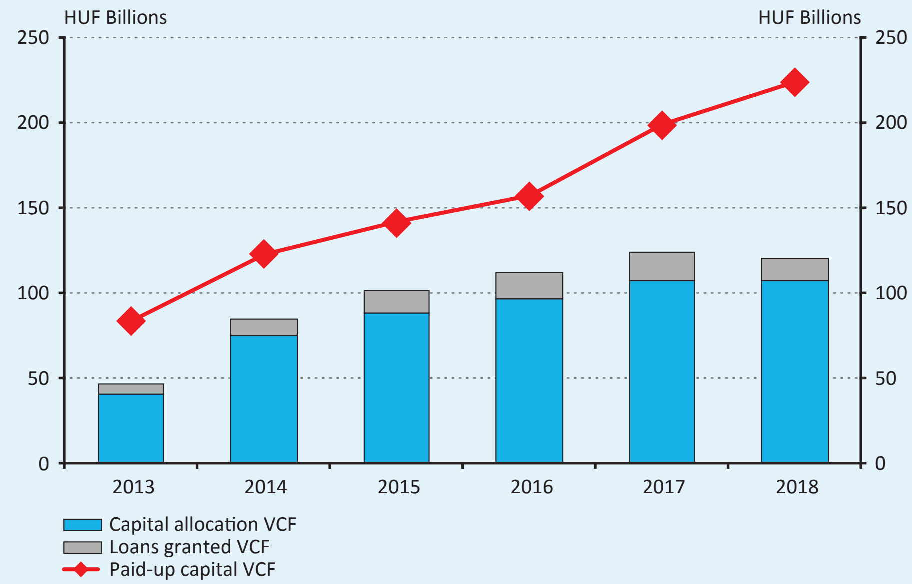
Private capital fund sector was characterised by extremely dynamic growth

The private capital fund sector pursuing activity based on an operating model subject to a supervisory licence grew dynamically in 2018 as well: the 18 private capital funds operating in 2018 exceed the value recorded in 2017 by seven, while in 2016 only 5 private capital funds were active on the Hungarian market. In line with the major rise, the number of institutions engaged in the management of private capital funds also increased: in 2017 six, while in 2018 eight such institutions pursued the management of private capital funds. In line with this, the funds available to private capital funds also rose: the funds of HUF 70 billion available for allocation in 2018 exceed the value of HUF 52 billion registered in 2017 by 34 percent. The allocations by private capital funds soared both in terms of capital investments and loans granted. By the end of 2018, the balance of capital allocations by private capital funds reached HUF 108 billion, exceeding the value of HUF 34 billion recorded in 2017, by 218 percent. The record growth can be linked basically to one private capital fund. The allocation was funded from the valuation reserve and after-tax profit. Following the stagnation observed in previous years, the volume of outstanding lending by private capital funds was also characterised by similar – 240 percent – growth in 2018 (2017: HUF 4.7 billion; 2018: HUF 16 billion).

In 2018, capital investment portfolio of venture capital funds remained unchanged, while the volume of outstanding lending decreased

In 2018, there was a large increase in the number of venture capital funds: at 49, the number of venture capital funds operating at the end of 2018 exceeds the closing value of 2017 by nine. At the end of 2018, the subscribed capital of venture capital funds reached HUF 364 billion, which exceeds last year's value by 41.6 percent. The growth is essentially explained by the establishment of nine new venture capital funds. The funds available to the venture capital funds, paid in by the holders of capital fund units, rose from HUF 198 billion of 2017 to HUF 224 billion in 2018: the growth of 12.8 percent is essentially attributable to three capital funds. Despite the rise in the funds available in the venture capital funds, the balance of capital investments made from the venture capital funds remained constant: the HUF 107 billion registered in 2018 practically corresponds to the closing balance of 2017. By contrast, the loans allocated from the venture capital funds – i.e., the loan principal receivables – fell from HUF 17 billion of 2017 by roughly HUF 4 billion to HUF 13 billion. The concentration of the venture capital fund sector moderately rose compared to 2017: based on the amount of capital investments, the top five venture capital funds covered 32 percent of all capital investments, while this ratio in 2017 was 29 percent. (Chart 71)

Chart 71
Assets of the venture capital funds and capital allocations



Source: MNB

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