CONSIDERATIONS BEHIND THE LAUNCH OF THE FUNDING FOR GROWTH SCHEME FIX (FGS FIX) AND MAIN FEATURES OF THE PROGRAMME

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SUMMARY

Following the outbreak of the financial and economic crisis, corporate loans outstanding in Hungary recorded an extremely large fall even by international standards. As a result of the roughly 5 percent annual decline for almost 5 years, by the beginning of 2013 loans outstanding shrank to 75 percent of the pre-crisis level, mostly due to the banks' loan supply constraints. The banks passed on the central bank base rate cuts to only a narrow range of the small and medium-sized enterprises; the majority of SMEs faced overly high interest rates, and thus the monetary policy transmission was impaired. The economy faced the phenomenon of 'credit crunch', which deepened the economic downturn and hindered the recovery from the crisis. With a view to restoring the functioning of the SME loan market as one of the determinant channels of the monetary policy transmission, promoting economic growth and strengthening financial stability, in June 2013 the MNB launched the Funding for Growth Scheme (FGS).

During its operation between June 2013 and March 2017, the FGS successfully achieved the objectives set upon its launch: namely, restoring the SME loan market and promoting economic growth. The scheme exerted a major impact not only on the volume of the SME loans outstanding, but also positively influenced the structure of the loan portfolio, as a result of the low, fixed-interest loans available for maturities as long as 10 years. Within the framework of the scheme, almost 40,000 enterprises obtained financing in excess of HUF 2,800 billion. The scheme contributed to a turnaround in lending: following the halt of the formerly experienced declining trend, from 2015 SME loans outstanding shows an increase, the dynamics of which has already reached 15 percent annually by 2018 Q2. Based on the MNB's estimates, the scheme's effect on economic growth between 2013 and 2017 may have been around 2–2.5 percent compared to an alternative path where in the lack of FGS the recovery of lending would have taken a longer time (while compared to the credit crunch, as an alternative path, it may have reached even 6 percent).

In parallel with the third phase of the FGS, in 2016 the MNB launched the Market-based Lending Scheme (MLS), in order to facilitate smooth transition to market-based lending, i.e. without central bank refinancing, and ensure sustainable economic growth through SME lending. The banks substantially overperformed their lending commitments under the scheme both in 2016 and 2017, and thus it successfully contributed to the growth in the loans outstanding; however, it exerted no material effect on its structure, as the share of long-term fixed-interest loans shrank. The MLS continues to support growth in lending to SMEs in 2018, but it will be terminated at the end of the year.

At present, the volume of corporate lending is adequate, but its structure is not healthy enough. The ratio of long-term loans is low by international standards, and the share of the fixed-interest loans also falls short of the ratio characterising the more developed countries. During the FGS, long-term, fixed-interest loans gained ground; however, after the phasing-out of the scheme, the ratio of these declined, and the MLS was unable to reverse this trend. Since at present long-term loans with fixed and favourable interest rate are not commonly offered on a market basis, the vast majority of enterprises are unable to utilise the present favourable interest rate level in the long run; therefore, the monetary policy transmission is impaired, and thus intervention by the central bank is once again justified.

Based on the experiences of the past years, the facilitation of lending in a healthier structure by the central bank may be implemented by returning to the FGS in a more targeted manner, since this scheme was able to exert material favourable impact both on the volume and structure of lending. Therefore, at the beginning of 2019, the MNB will launch the Funding for Growth Scheme Fix (FGS fix), with a total amount of HUF 1,000 billion. In terms of its most important parameters and its operation, the new scheme will be identical with the previous phases of the FGS. Accordingly, the MNB will provide credit institutions with refinancing funds at 0 interest rate;

which they lend further to SMEs to finance new investments in forint at a maximum margin of 2.5 percent. The FGS fix can be considered more targeted compared to the previous phases of FGS, which is manifested essentially in the following three main features (of which only the first two are relevant for the borrower SMEs): 1) loans may only be provided for maturities longer than 3 years, 2) loans may only be provided for investment, and within that the range of utilisation will be narrower compared to the third phase, 3) the scheme is neutral in terms of liquidity, as the excess liquidity attributable to the loans disbursed under FGS fix will be sterilized at base rate.

The MNB does not intend to increase the volume of liquidity in the banking system by the new scheme; it merely wants to exert an impact on the structure of lending to SMEs. The MNB wishes to absorb (sterilise) the surplus liquidity resulting from the disbursements under the FGS fix through the preferential deposit facility, in which the eligible credit institutions may place deposits with the central bank at base rate.

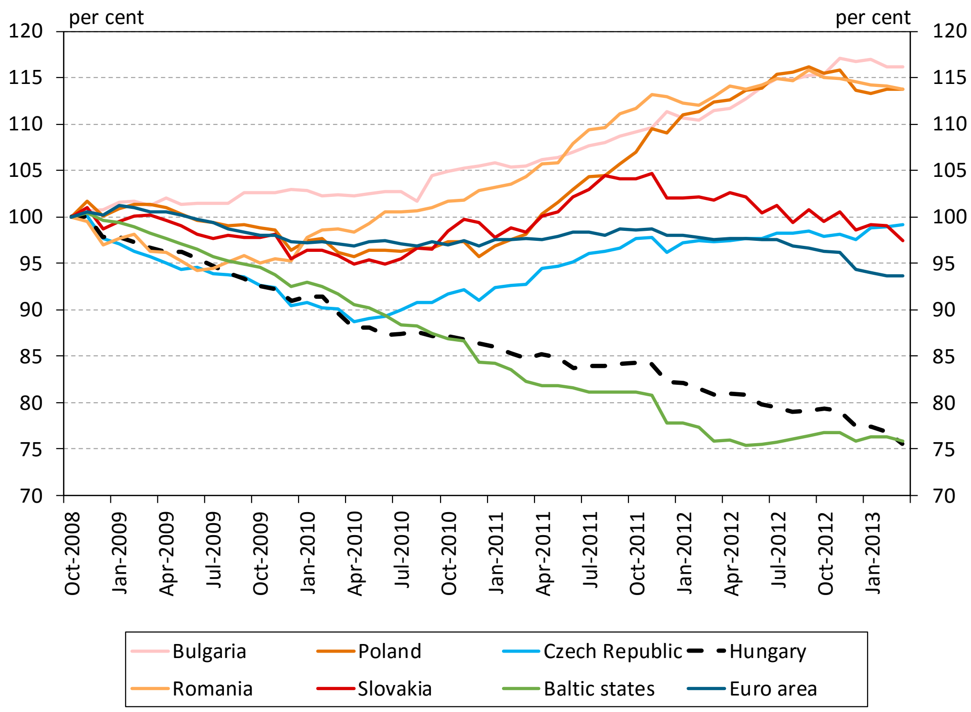
Conditions of FGS fix

	FGS *fix*
Total amount	**HUF 1000 Bn**
Contracting period	**1 January 2019 –**
Interest rate of refinancing loans	**0 per cent**
Interest rate of SME loans	**max. 2.5 per cent p.a.**
Currency	**HUF**
Total volume of loans per SME	**max. HUF 1 Bn**
Maturity	**min. 3 years, max. 10 years**
Loan purposes	**new investment loans (including leasing)**

1. LAUNCH OF THE FUNDING FOR GROWTH SCHEME IN 2013 AND ACHIEVEMENTS OF THE SCHEME

The beginning of 2013 was characterised by persistent market disturbance in lending to small and medium-sized enterprises. Following the outbreak of the financial and economic crisis, which commenced in 2008, corporate loans outstanding in Hungary recorded an extreme fall even by international standards. As a result of the decline of about 5 percent per annum, lasting for almost 5 years, by the beginning of 2013 the portfolio shrank to 75 percent of the pre-crisis level (Chart 1). The decline was largely attributable to loan supply constraints. Banks tightened their lending conditions, and thus the availability of loans for companies substantially worsened. This affected small and medium-sized enterprises (SMEs), usually hit more strongly by the loan supply constraints, particularly adversely: under the higher interest rates or stricter collateral requirements they have more difficult access to bank loans and their alternative financing options are also limited. The banks passed on the central bank base rate cuts to only a narrow range of the SMEs, and creditworthy enterprises also faced high interest rates, and thus the monetary policy transmission was impaired. The economy faced the phenomenon of 'credit crunch', which deepened the economic downturn and hindered the recovery from the crisis. The profitability of the SME sector did not improve, and there was a substantial risk of a development of adverse feedback between the high costs of finance and deteriorating profitability. If enterprises have no access to the necessary funds, they are unable to invest and generate income, and thus, as a result of the deteriorating prospects, banks finally may be willing to grant loans only under even tighter conditions. This represents a risk not only for economic growth, but also for financial stability.

Chart 1: Developments in corporate loans outstanding in an international comparison (October 2008 = 100 per cent)



Source: ECB

With a view to restoring the functioning of the SME loan market as one of the determinant channels of the monetary policy transmission, promoting economic growth and strengthening financial stability, in June 2013 the MNB launched the Funding for Growth Scheme (FGS). In the Monetary Council's view, the disturbance in lending to SMEs rendered the central bank's intervention necessary. Since Hungary has no developed capital market, the MNB was able to facilitate SMEs' access to loans through the banking sector, by targeted provision of liquidity, rather than through an asset purchase programme. Within the framework of the FGS, the central bank provided credit institutions with financing at 0 interest rate, i.e. below the base rate; in turn, they could lend it further to the domestic micro, small and medium-sized enterprises at a fixed interest margin of maximum 2.5 percent per annum, for maturities as long as 10 years, for loan purposes stipulated by the central bank. During the almost four-year functioning of the FGS, lasting until March 2017, nearly 40,000 domestic SMEs obtained financing in the three phases of the scheme together, in excess of HUF 2,800 billion, disbursed in 78,000 transactions (Table 1).

Table 1: Distribution of loans provided in the three phases of FGS by company size and purpose

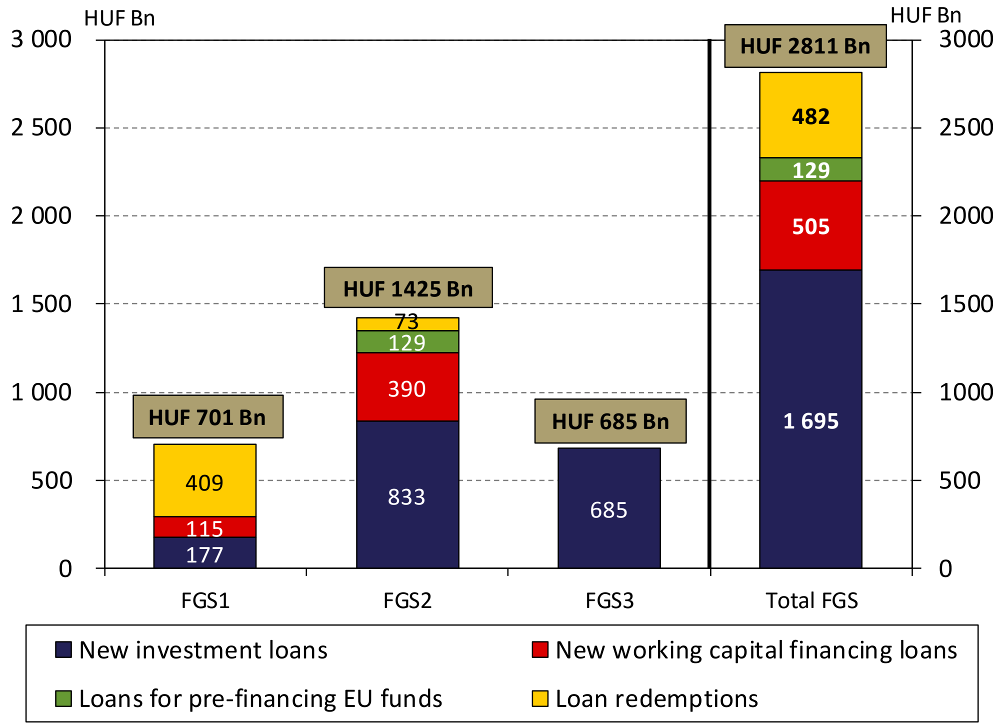
HUF Billion	Micro enterprises		Small enterprises		Medium enterprises		Total	
	Contracts	Sum	Contracts	Sum	Contracts	Sum	Contracts	Sum
Investment loan	38 400	666	16 118	519	5 634	510	60 152	1 695
Working capital loan	3 259	58	3 850	202	1 508	245	8 617	505
Pre-finance EU funds	2 796	44	924	49	419	36	4 139	129
Loan redemption	1 720	91	2 039	189	1 282	202	5 041	482
Total	46 175	859	22 931	959	8 843	993	77 949	2 811

Note: Companies were primarily classified by size based on data disclosed in the annual reports.
Source: MNB

The individual phases of the scheme were characterised by different features. The first phase of merely three months, launched in June 2013, gave the SME credit market momentum. It turned banks' attention to the SME sector and stimulated bank competition for the acquisition and retention of clients. Owing to the short timeframe, this phase of the scheme contributed to the improvement in SMEs' financing situation mostly through the loan redemptions, but the volume of the new investment and working capital loans was also substantial. The loan redemptions substantially reduced the interest burdens of enterprises, while as a result of the redemption of the foreign currency loans, the SME sector's exposure to exchange rate risk also materially decreased. In the second phase, which commenced in October 2013 and ended in December 2015, the emphasis was on investment loans, supporting economic growth the most, while the possibility of loan redemptions was limited. In this phase, it was already also possible to implement investment projects requiring longer preparation. The conditions were fine-tuned several times and the range of eligible forms of financing was expanded by leasing and factoring. The weight of micro enterprises, facing financing difficulties most of all, substantially increased and in line with this the typical loan size became lower; in the second phase already every second investment loan was below HUF 10 million. The third phase of FGS commenced at the beginning of 2016 and ended in March 2017; this phase facilitated even more targeted financing than the previous phases, as here banks were allowed to grant loans only for investment purposes. However, it was a novelty that enterprises with natural hedge also had access to foreign currency financing.

The individual loan purposes contributed to the scheme's effect on economic growth differently. The largest, direct growth and employment (primary) effect was exerted by those new investment loans that in the absence of FGS would have not materialised in such a high amount, either due to the poorer creditworthiness of the enterprise or because the enterprise – irrespective of its creditworthiness – would have not wanted to take the loan under the normal market conditions. In the case of new working capital financing loans, we cannot talk about direct investment effect; however, the improving liquidity situation and more economical operation of the enterprise helps it become more competitive, and thus the scheme may have indirectly contributed to the realisation of investment in the longer run (second-round effect). In those cases when the enterprise redeemed a loan taken earlier, or when it would have taken a loan for the same purpose even under the standard market conditions in the same amount (substitution), in an economic sense no new loan was created as a result of the FGS, and hence there is no direct investment effect either; however, owing to the favourable interest rate – and the absence of exchange rate risk – the income position and creditworthiness of the enterprise improved, which in the longer run may increase the probability of the implementation of a new investment. Of the total loan amount exceeding HUF 2,800 billion, extended under the scheme, almost HUF 1,700 billion financed investments. While in the first phase loan redemptions represented a high ratio, in the second phase the possibility of granting such loans was limited, and in the third phase the total disbursed amount was for investment purposes (Chart 2). Thus the emphasis increasingly shifted to the investment loans, exerting higher growth effect.

Chart 2: Distribution of loan purposes in the individual phases of FGS



Note: data for the second phase of the FGS include the loans extended under the FGS+ s, worth HUF 23 billion, which ran in parallel with the FGS. Source: MNB

During the scheme, the ratio of smaller enterprises among financed companies continuously increased. In the case of the second phase, this may have been partly attributable to the longer period allowed for concluding contracts, while in the case of the third phase to the lower maximum loan size. In the foreign currency pillar, the ratio of microenterprises is smaller, since this segment typically has no natural hedge. Apart from the fact that no material alternative financing channel (e.g. intra-group fund raising, capital market) is available to the micro and small enterprises, and thus it is particularly important for them to have access to loans, the increasing ratio of small participants is a positive trend also due to the fact that according to the MNB's micro database researches,[1] the investment effect is the largest among micro and small enterprises, i.e. this was the segment that recorded proportionately the highest increment in investments as a result of one unit of FGS loan. As smaller

[1] Endrész, M. – Harasztosi, P. – Lieli, R. (2015): The Impact of the Magyar Nemzeti Bank's Funding for Growth Scheme on Firm-Level Investment. MNB Working Papers, 2015/2

enterprises increasingly gained ground, the average loan size decreased. While the typical transaction size (median) of the new investment loans in the first phase was HUF 15 million, in the second and third phases this amount – calculated together with the lease transactions – fell below HUF 7 million.

Table 2: Average size and maturity of the loans granted in the individual phases

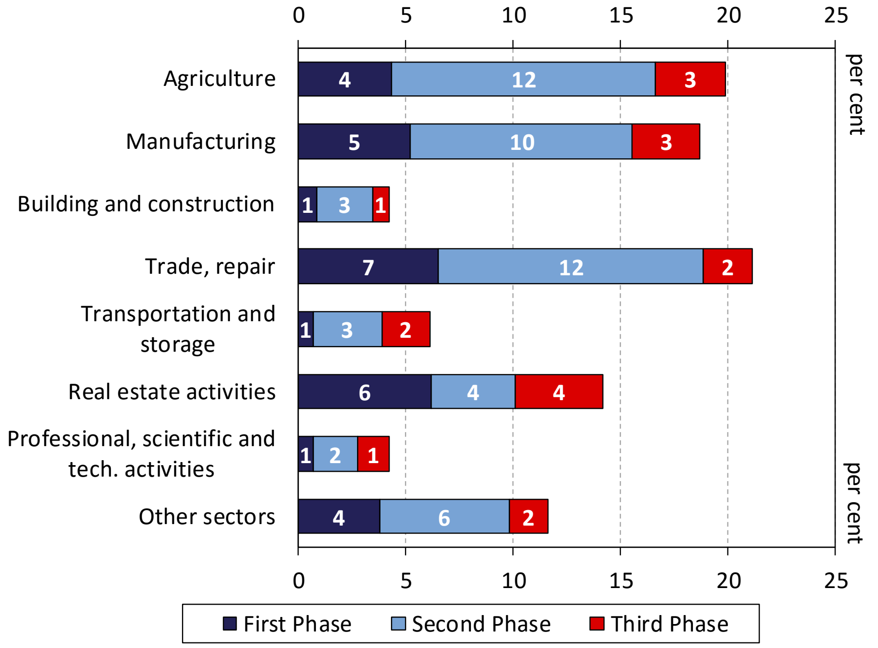
	First phase		Second phase		Third phase		Total	
	New investment loan	New working capital loan	New investment loan	New working capital loan	New investment loan (HUF)	New investment loan (FX)	New investment loan	New working capital loan
Contracted amount	HUF 177 Bn	HUF 114 Bn	HUF 832 Bn	HUF 391 Bn	HUF 475 Bn	HUF 210 Bn	HUF 1693 Bn	HUF 505 Bn
Average loan size	HUF 48 m	HUF 50 m	HUF 24 m	HUF 62 m	HUF 24 m	HUF 100 m	HUF 28 m	HUF 59 m
Median loan size	HUF 15 m	HUF 20 m	HUF 7 m	HUF 25 m	HUF 7 m	HUF 21 m	HUF 7 m	HUF 25 m
Average maturity weighted by loan size	8 years	5.2 years	7.1 years	2.3 years	8 years	8 years	7.6 years	3 years

Note: The amounts in the foreign currency pillar are shown based on the corresponding forint refinancing. Source: MNB

Nearly two-thirds[2] of FGS loans were taken by companies engaged in trade and repair, agriculture and manufacturing sectors. Most of the loans were granted to SMEs active in the trade and repair sector; the share of this sector in the total FGS loans was over 21 percent. The second and third most important sectors were agriculture and manufacturing, with a share of almost 20 and 19 percent, respectively (Chart 3). The weight of the scheme in lending is illustrated by the fact that in the period of 2014-2015 the share of loans extended under the FGS exceeded 40 percent in several sectors. In this period FGS loans accounted for more than two-thirds of forint loans granted to SMEs in the agricultural sector, for roughly half of those granted to SMEs in the transportation, warehousing and manufacturing sector, and about one-third of those granted to SMEs in the trade and repair sector. By the third phase of the scheme (2016-2017 Q1), in line with the MNB's intentions, the ratio of FGS loans declined; nevertheless, even in this period, credit institutions placed one-third of agricultural loans, one-quarter of transportation and warehousing loans and roughly 15 percent of manufacturing loans under the FGS.

[2] Since there are no data available on the sole proprietors' industry classification, the industry ratios are defined not in relation to the total FGS loans, but to all FGS loans of enterprises with industry data.

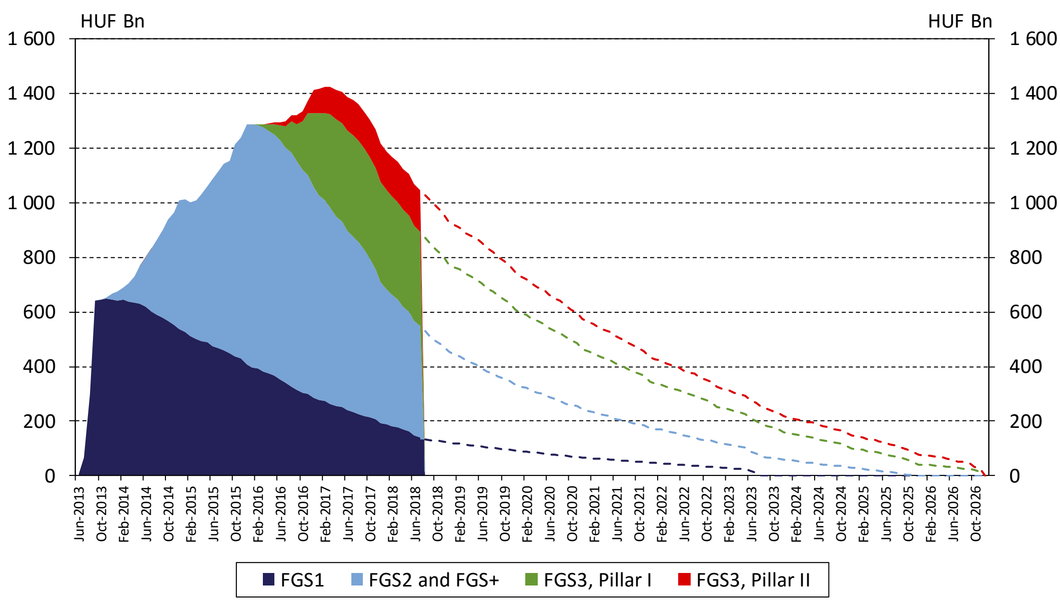
Chart 3: Distribution of loans by sectors



Note: by contracted amount; the industry distribution does not include the loans of sole proprietors and agricultural primary producers. Source: CCIS, MNB

Currently outstanding loans granted under the FGS account for 20-25 percent of total SME loans outstanding. The outstanding portfolio reached its high of around HUF 1,400 billion at the end of 2017 Q1; from then on a gradual decrease in outstanding loans has started. According to our estimation, by mid-2021 the currently outstanding HUF 1,000 billion may fall close to its half, i.e. close to HUF 500 billion, and decline to one-quarter by mid-2023, before the loans are fully repaid at the end of 2026 (Chart 4).

Chart 4: Build-up and expected development of loans outstanding under FGS



Source: MNB

The FGS came to an end on 31 March 2017. It successfully achieved the objectives set upon its launch: the restoration of the corporate credit market, the facilitation of economic growth and the strengthening of financial stability (Table 3). The scheme had a favourable impact both on the volume of lending and the structure ofloans outstanding: it contributed to a turnaround in lending and also helped fixed-interest loans gain ground. Since the set goals were achieved, from 2016 the MNB started the gradual phasing-out of the scheme and in parallel with that the promotion of the return to market-based lending.

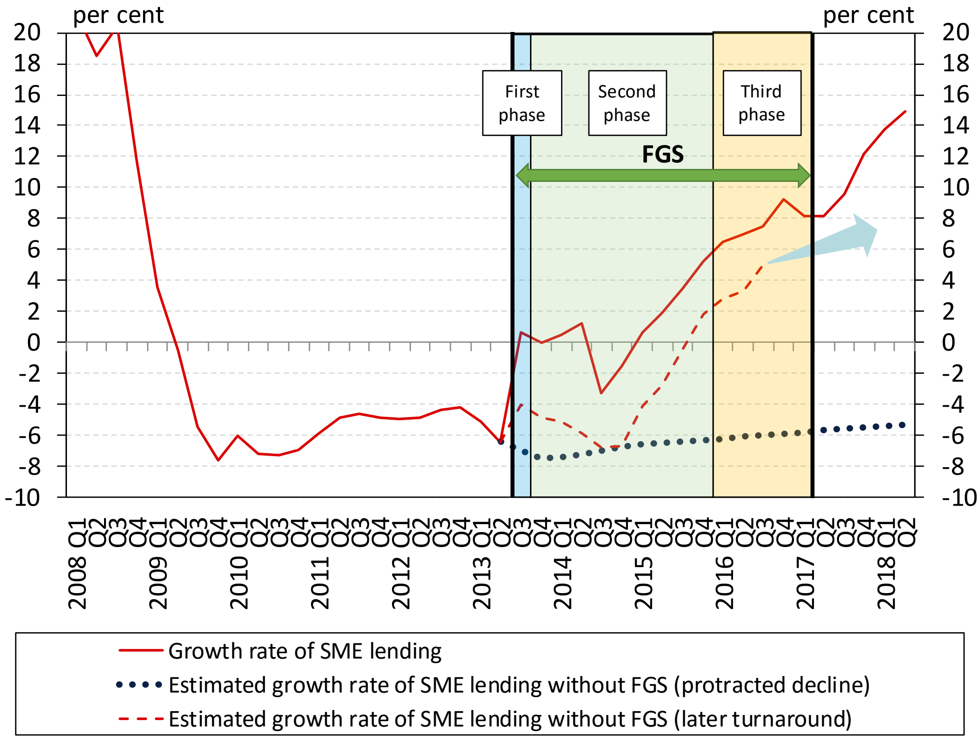
Table 3: Achievements of FGS

First phase (HUF 701 Bn) June – August 2013	Second phase (HUF 1,425 Bn) Oct. 2013 – Dec. 2015	Third phase (HUF 685 Bn) Jan. 2016 – March 2017
✓Helped to avoid total credit crunch	✓Investment loans in focus, which primarily support economic growth	✓Targeted, only for investment purposes
✓Loan redemptions reduced the interest burden of enterprises	✓Every second investment loan is below HUF 10 million	✓Favourable foreign currency financing also available for SMEs with natural hedges
✓Significantly reduced the foreign currency exposure of the SME sector	✓Greater share of micro-enterprises	✓Complemented the EU funds
✓Revitalized the competition among banks	✓The regional concentration continued to decline	✓Lower maximum loan amount and increased share of smaller enterprises
Almost 40,000 SMEs obtained financing amounting to HUF 2,800 Bn. The scheme contributed to GDP growth by around 2–2.5 percent between 2013 and 2017.		

Source: MNB

The FGS contributed to the realisation of the turnaround in lending. As a result of the FGS, the trend of strong decline in the corporate loans outstanding, lasting for years, halted and a credit crunch could be avoided. SME loans outstanding, which decreased for years before the launch of the scheme, shows a continuous increase from 2015; by the second quarter of 2018 the growth already reached the annual rate of 15 percent (Chart 5). Part of the transactions concluded under FGS presumably would have materialised also on a market basis; however, through its additional impact, the scheme made the turnaround in lending happen much earlier. Both the dynamics of the loans outstanding and the questionnaire-based survey conducted by the MNB in October 2014 among SMEs that had access to a loan under the scheme imply that a significant part of disbursed loans would not have realised at all or would have materialised only in a smaller amount without the scheme.

Chart 5: Annual dynamics of lending to SMEs and two estimated alternative path thereof in the absence of the FGS



Source: MNB

The scheme had a material effect on economic growth. Based on the MNB's model estimates – capable of quantifying the primary effects – the growth effect of the FGS between 2013 and 2017 could be around 2-2.5 percent. This means that in those years, the central bank's instrument contributed to the GDP growth by 0.3-0.8 percentage point. Moreover, in the longer run, in addition to the primary effects, the second-round, indirect effects may also come across through enterprises' improving income position and efficiency. This growth effect is to be interpreted compared to an alternative path where the dynamics of lending to SMEs would have set on a growth path later (creditless recovery scenario), purely as a result of the cyclical developments. However, if in the absence of launching the FGS such a path would have materialised where as a result of the unfavourable combination of the banks' insufficient willingness to lend and enterprises' low credit demand the declining trend in lending to SMEs would have continued (credit crunch scenario), the real economy effect attributable to FGS would be even larger. Namely, compared to such a less favourable alternative path, the result attributable to the scheme would be materially larger credit growth, the GDP growth effect of which could be 0.9-1.9 percentage points per annum, and as high as 6 percentage points when aggregated for the aforementioned 5-year period.

2. LAUNCH OF THE MARKET-BASED LENDING SCHEME IN 2016 AND ACHIEVEMENTS OF THE SCHEME

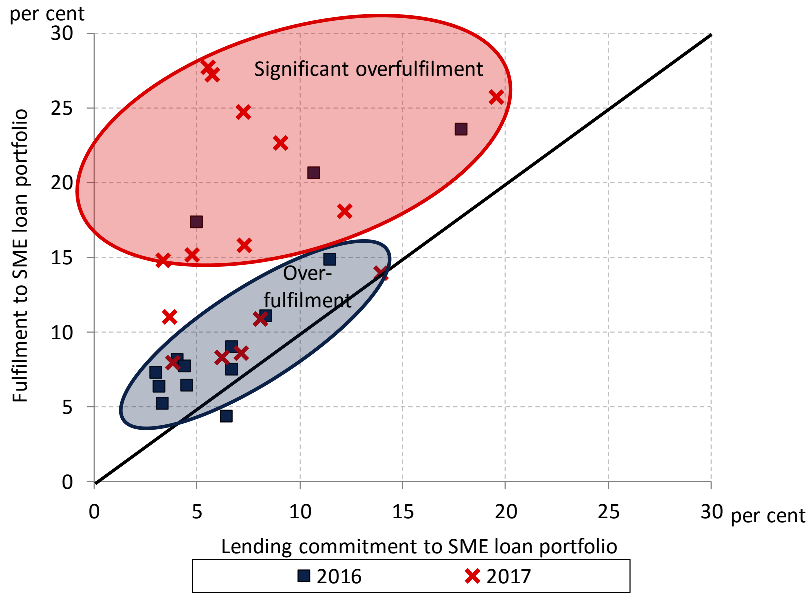
The MNB launched the Market-based Lending Scheme (MLS) in 2016, which aimed to facilitate the smooth return to market-based lending and ensure sustainable economic growth through SME lending. The central bank's instruments available under MLS represented an incentive and provided help for the interest and liquidity management to those credit institutions that undertook to increase their SME lending activity.

The primary element of the scheme involved the supplementation of the central bank's set of instruments with two new instruments: the interest rate swap conditional on lending activity (LIRS) and the preferential deposit facility were introduced. The LIRS intended to stimulate lending activity through the management of banks' interest rate risk resulting from the lending to SMEs, by the central bank's partial assumption of such risk. In this transaction, the MNB pays BUBOR-based variable interest to banks, which in turn pay fixed interest to the central bank. The banks participating in the scheme undertook to increase their outstanding lending to SMEs in the respective calendar year by one-quarter of the nominal value of the LIRS transaction concluded with the MNB, which can be maintained for up to three years. The credit institutions that agreed to the conditions by concluding the LIRS transaction, during the existence of the transaction also became eligible for using the central bank instrument complementing the LIRS, i.e. the preferential deposit. Under the preferential deposit facility, banks may place with the central bank part of their excess liquidity over the reserve requirement at the base rate, which thus contributes to the stimulation of lending through the easing of liquidity management. By default, the deposit facility is available up to half of the nominal value of the LIRS transaction, while in the case of banks committing to a major credit expansion, the central bank provided a preferential deposit facility in excess of that.

In 2016, i.e. in the first year of the scheme, the banks fulfilled their lending commitments. In 2016, LIRS transactions were concluded in the amount of HUF 780 billion, which represented an increase in the SME lending commitments of HUF 195 billion in total. The participating banks increased their SME lending well above this, by more than HUF 300 billion. Although most of the banks participating in the LIRS substantially outperformed their commitment in 2016, it was not possible to raise those until mid-2017, and thus the commitment for 2017 dropped from HUF 195 billion to HUF 170 billion as a result of the (partial) closing of certain LIRS transactions at the beginning of the year, and thereby the decrease in the total LIRS portfolio to HUF 679 billion.

Banks fulfilled their lending commitment in 2017 as well. With a view to enabling the banks to raise their lending commitments, in May 2017 the Monetary Council decided to launch the second phase of the MLS. At the LIRS tender in July 2017, the MNB concluded transactions totalling HUF 228 billion with credit institutions, by which banks' SME lending commitment for 2017 rose from HUF 170 billion to HUF 227 billion, while the outstanding LIRS portfolio increased to HUF 906 billion. At the end of 2017, each of the 16 banks with LIRS transactions fulfilled their commitment already raised in some cases. As a result, at sector level banks realised a fulfilment of almost 250 percent, which exceeded even the figure recorded one year earlier (Chart 6).

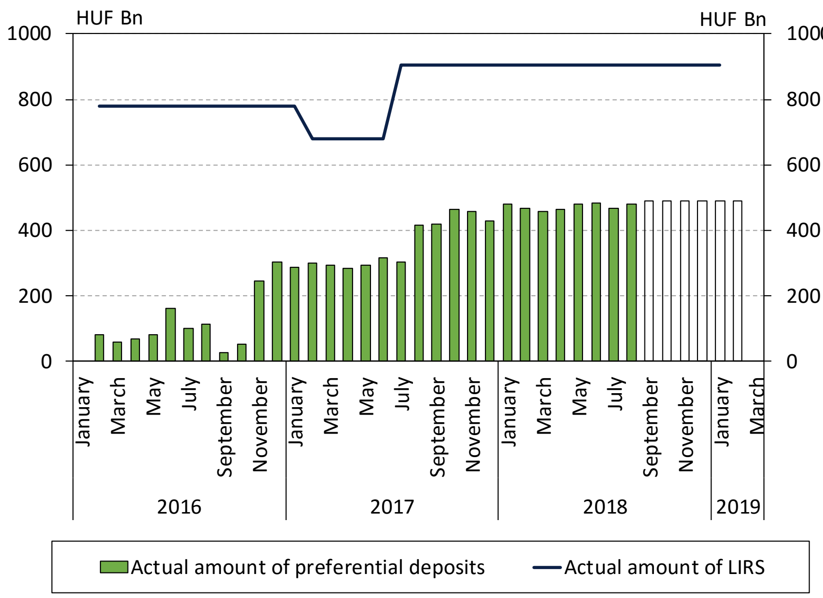
Chart 6: Fulfilment of the lending commitments made under the MLS



Note: Two small banks with extremely high commitment and fulfilment are not shown in the chart.
Source: MNB

The volume of preferential deposits gradually rose; in 2017 and 2018 the participating banks used the available facility almost in full. In parallel with the restriction of the three-month deposit facility from the last quarter of 2016, the banking sector's excess liquidity increased, part of which was channelled to preferential deposits. With the materialisation of the crowding-out effect, the possibility of placing deposits at the base rate appreciated, and thus the volume of outstanding preferential deposits gradually increased, and from the second half of 2017 the instrument was characterised by almost full utilisation (Chart 7). At present, the central bank enforces negative interest on the account balance exceeding required reserves, and thus the preferential deposit facility remains for banks to be a very liquid instrument at favourable interest.

Chart 7: Developments in the volume of LIRS and preferential deposits

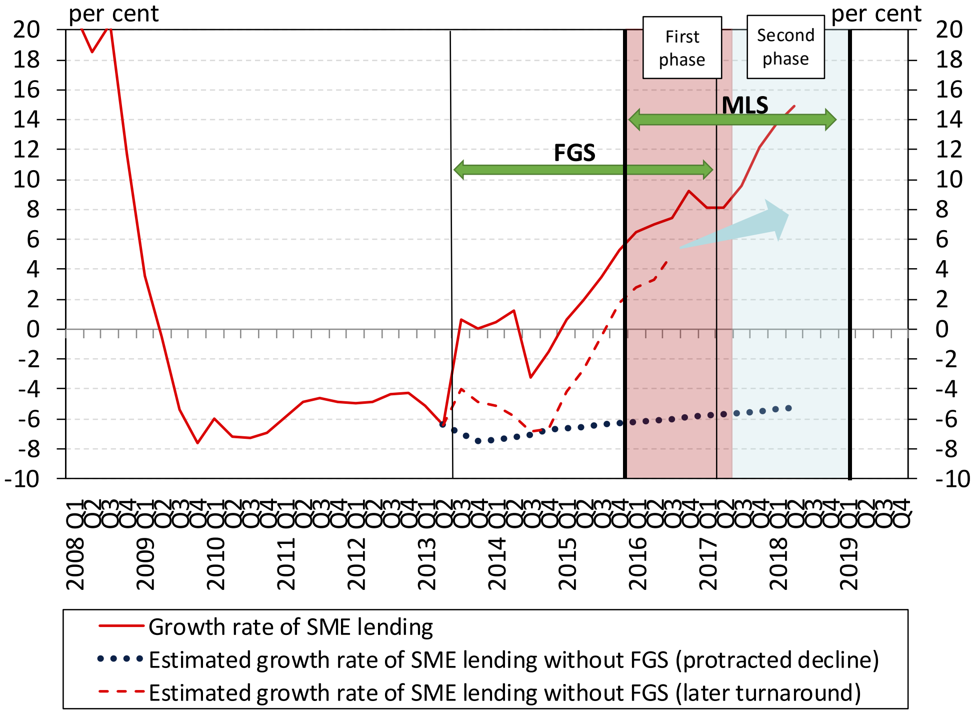


Source: MNB

At the end of February 2019 the MLS will be terminated: LIRS transactions will expire and the related preferential deposit facility will be also terminated. None of the credit institutions reduced its lending commitment for 2018 on a voluntary basis, and thus the commitment corresponding to roughly 6 percent of SME loans outstanding, continues to support the growth in SME lending until the end of this year.

The MLS successfully contributed to growth in outstanding lending; however, due to its nature it exerted no material positive effect on its structure. By the end of the second quarter of 2018, growth in the SME loans outstanding, on transaction basis, accelerated close to 15 percent, which was also attributable to the banks' lending commitment made under MLS (Chart 8.). At the same time, in the case of the LIRS transactions – contrary to FGS – the instrument has no direct connection to the loans extended to SMEs. The banks must satisfy the lending volume criterion belonging to the LIRS transaction, while the MNB formulated no requirements regarding the parameters (e.g. maturity, interest rate type) of the loans granted.

Chart 8: Dynamics of the lending to SMEs



Source: MNB

3. CENTRAL BANK CONSIDERATIONS BEHIND THE LAUNCH OF THE FUNDING FOR GROWTH SCHEME FIX

The FGS, lasting from June 2013 to March 2017, exerted a favourable impact both on the volume and composition of corporate lending, and played an important role in the realisation of the turnaround in lending. However, in view of the fact that in the long run the SME credit market needs to support the real economy in adequate volume and quality without the central bank's intervention, from 2016 the MNB started the gradual phasing-out of the scheme and support the return to market-based lending by MLS. However, the new instrument could influence lending only in terms of volume, without any favourable impact on the composition of loans.

At present, the volume of corporate lending is adequate, but its structure is not healthy enough. At present, SME loans outstanding increases by roughly 15 percent per annum, a rate that is deemed adequate by the MNB as well. The phasing-out of the FGS caused no decline either in the volume of new loan contracts or in the disbursements. At the same time, the composition of lending is as important as its volume, and thus the MNB also continuously monitors its quality, and in this respect it observed a difference since the phasing-out of the scheme.

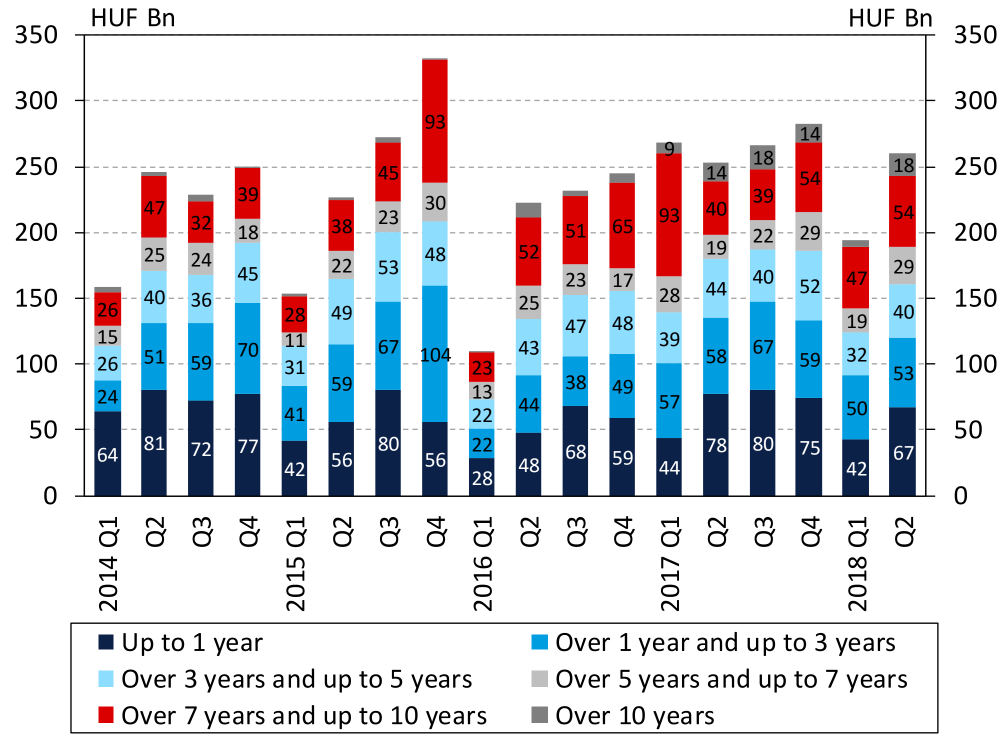
Since long-term, fixed-interest loans are not concluded on market basis in large volumes, the monetary policy transmission is impaired. The vast majority of enterprises are unable to take advantage of the present favourable level of interest rates in the long run, which justifies an intervention by the central bank. The FGS rendered it possible for SMEs to find, for the purpose of implementing their investment, financing opportunities characterised by stable and predictable interest burden, and it also diverted the structure of lending in a positive direction. Although the MLS successfully contributed to the increase in the dynamics of lending, it had no material impact on the qualitative features of lending. The facilitation of healthy lending – which supports economic growth and also has a favourably impact on financial stability – by the central bank may be realised by returning to the FGS in an even more targeted form.

Higher proportion of fixed-interest loans is important for the financial stability as well. In the latest Lending Survey of the central bank, banks reported that the higher interest rate level of fixed-interest loans drives clients towards variable-rate loans, which at present seem to be more advantageous in the short run, but pose a risk in the longer run. The predictability resulting from fixed interest increases borrowing appetite and reduces the risk of those enterprises that have no reserves for the payment of higher interest in a potentially changing yield environment. This typically affects smaller enterprises, which not only have lower earnings potential and accumulated reserves, but in the absence of interest-bearing assets – contrary to certain larger companies – interest income earned on those does not offset rising interest expenditure either. Dynamic economic growth free of stability risks also requires that enterprises should find funding with predictable interest burden for their investments.

Following the phasing-out of the FGS, the distribution of SME loans' maturity shifted towards shorter maturities. The share of loans with maturity over 5 years was around 30 percent in the quarters following the FGS, which falls short of that experienced under the third phase of the FGS (Chart 9). This may be also attributable to the fact that in view of the favourable conditions, certain enterprises had implemented their investments earlier, during the period of the FGS, and thus in the post-FGS period they did not appear on the credit market with investment loan needs. In the recent quarters an increase could be observed, the share of long-term loans neared to the ratio observed during the third phase of the FGS. During the lending surveys conducted by the MNB in the past quarters, banks reported that enterprises showed outstanding demand for long-term loans.

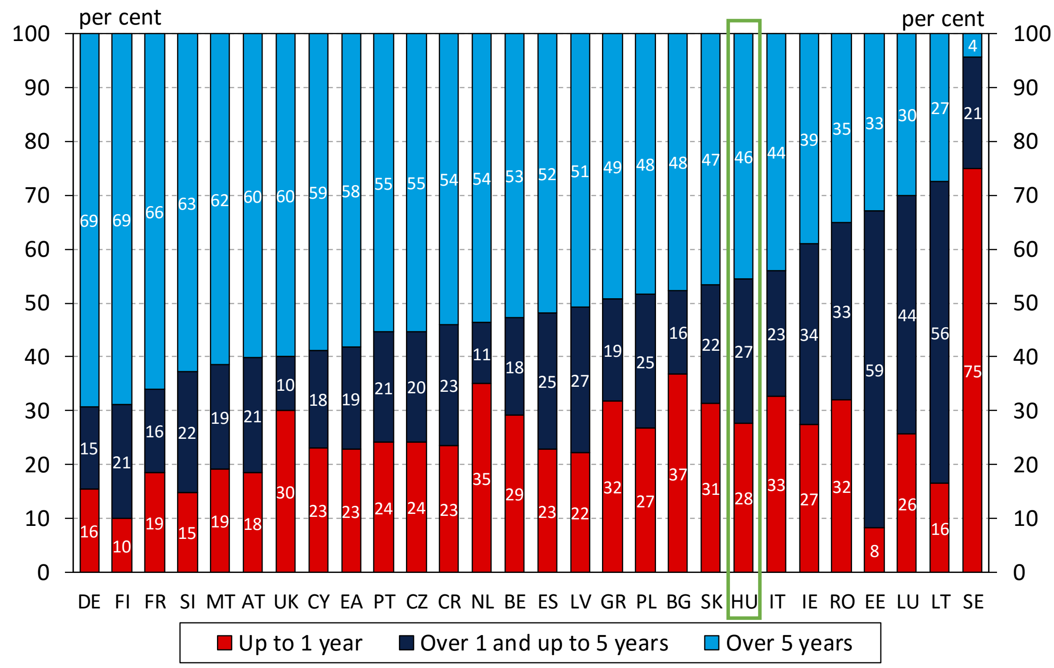
The share of long-term loans within the total corporate loan portfolio, is low by international standards. Hungary managed to come closer to the ratio characterising the more developed countries only to a small extent even during the FGS. At the end of 2018 Q2, the 46 percent share of loans over 5 years within total loans outstanding falls short of the euro area average by more than 10 percentage points (Chart 10).

Chart 9: New SME loans by maturity



Note: for the purpose of the classification, loans with maturity of 1.0-1.2 years were treated as 1-year, with maturity of 3.0-3.2 years as 3-year, with maturity of 5.0-5.2 years as 5-year, with maturity of 7.0-7.2 years as 7-year and with maturity of 10.0-10.2 years as 10-year loans. Source: MNB

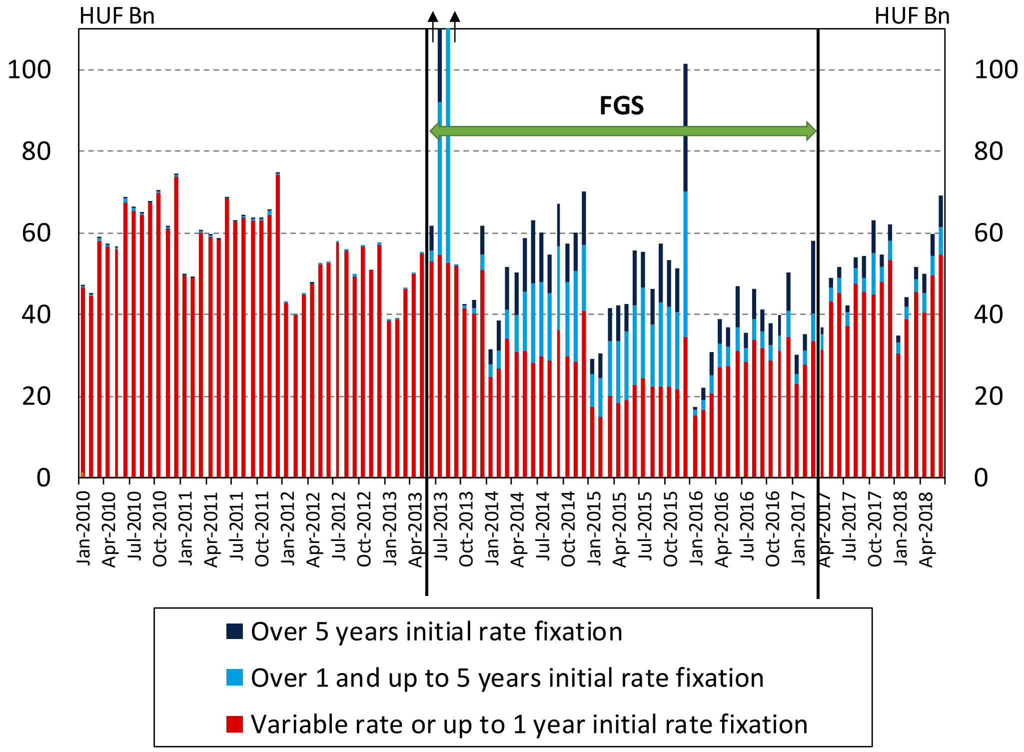
Chart 10: Breakdown of the corporate loan portfolio by maturity in an international comparison (June 2018)



Source: ECB

During the FGS, fixed-interest corporate loans gained ground. One of the most important appeals of the loans granted under scheme, for maturities as long as 10 years, in addition to the favourable interest rate, was its fixed nature. This was confirmed both by the credit institutions and the enterprises. While formerly fixed-interest loans were uncommon in the medium and long-term segment, owing to the launch of the scheme such loans also started to appear. During 2014-2015, when the scheme had the most pronounced role in SME lending, the ratio of fixed-interest loans within the new loan contracts fluctuated typically between 50 and 60 percent (Chart 11).

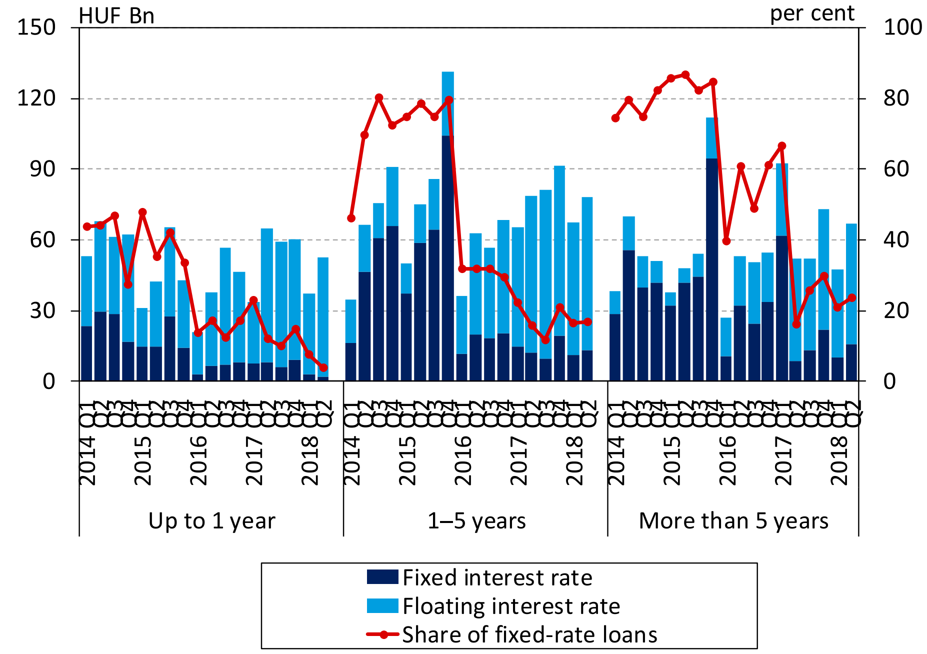
Chart 11: Distribution of new corporate HUF loan contracts not exceeding EUR 1 million, by rate fixation period



Source: MNB

Following the second phase of the FGS and the full phasing-out of the scheme, the ratio of fixed-interest SME loans also dropped, especially at the longer maturities. Following the phasing-out of the FGS – in the absence of fixed-interest funding – banks were presumably less willing to provide fixed-interest loans with conditions similar to those of the FGS, or they were only willing to do so at an interest rate level that was considered too high by the enterprises. Merely 20-30 percent of new SME forint-loans with maturity of over 5 years, granted in the past five quarters, were of fixed-interest, which still falls short of the typical ratio of 60-80 per cent, observed during the FGS (Chart 12).

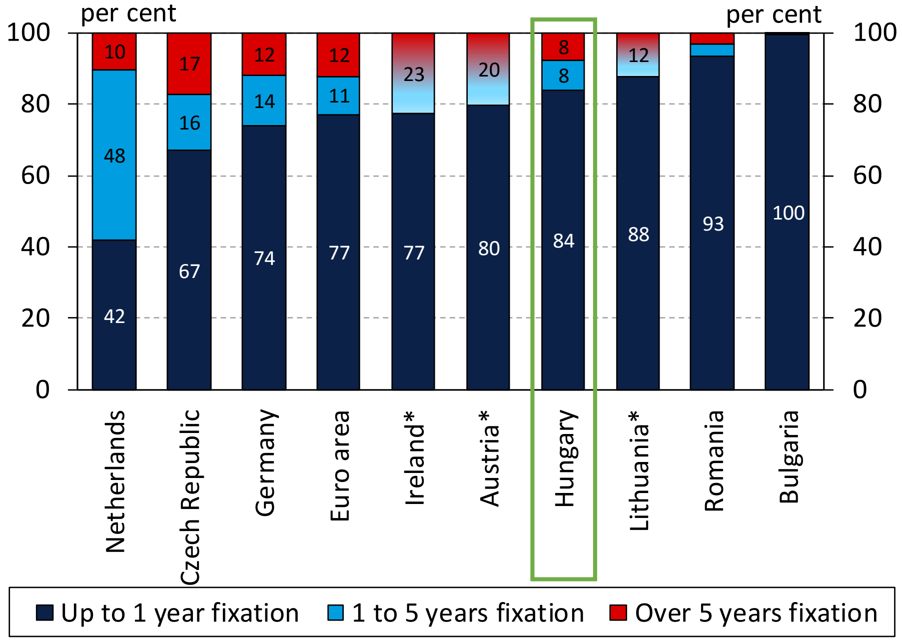
Chart 12: Breakdown of SME HUF loans by interest rate fixation



Source: MNB

The more developed countries are characterised by higher interest rate fixation ratio than Hungary. While in the past one year in Hungary (July 2017 – June 2018) some 84 percent of small-amount loans, amounting to not more than EUR 1 million, were variable-rate loans or with rate fixation up to 1 year, in the euro area this ratio is about 77 percent, and of the countries of the region, in the Czech Republic, for example, it is around two-thirds (Chart 13).

Chart 13: Breakdown of corporate loans not exceeding EUR 1 million by rate fixation period



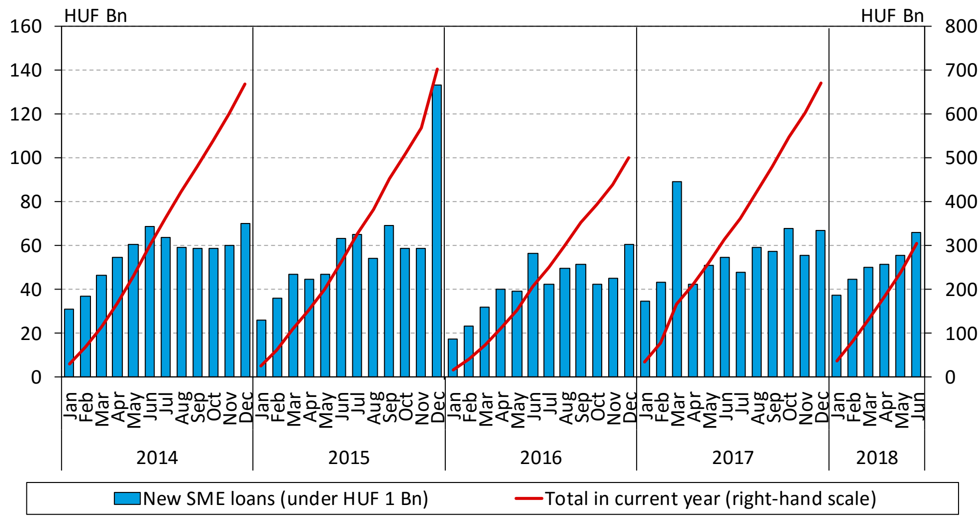
** More detailed breakdown for loans with interest rate fixation over one year was not available. Note: Contracts concluded between July 2017 and June 2018. Source: national central banks, ECB*

The average interest rate of realised fixed-interest SME loans with maturity over 5 years is around 2.5 percent, but this affects only a limited range of SMEs. The statistics contain only the materialising transactions, in the case of which several factors generate an interest rate that is lower than faced by an average SME: 1) banks lend under such conditions to larger companies of low risk, 2) for acquisition purposes they are willing to lend below the justified interest rate (in certain cases transferring the favourable pricing of interest rate swaps concluded under the MLS), 3) such loans are granted under special schemes, where banks had access to refinancing under favourable conditions. The purely market-based pricing justifies an interest rate of 5-6 percent in the case of long-term, low-amount loans, based on the banks' funding cost (IRS) and the expected spread. Based on the recent level of interest rates, part of the enterprises regards this too high or are unable to generate it by their operation, and thus they rather take a variable rate loan, often ignoring the fact that the interest burden may substantially increase in the future.

4. KEY PARAMETERS OF THE FGS FIX

The Monetary Council decided to launch the Funding for Growth Scheme Fix (FGS *fix*) with a facility amount of HUF 1,000 billion. During the previous 3 phases of the scheme, in almost 4 years, loan contracts were concluded in an amount of roughly HUF 2,800 billion. Bearing this in mind, the facility amount of HUF 1,000 billion may be sufficient for exerting a tangible impact on the structure of SME lending in the coming years. For the time being no time limit has been set for utilisation. The placement is not restricted by banks' capacities; banks may be able to place SME loans of HUF 1,000 billion in a period as short as 2 years (Chart 14); the developments in the utilisation in terms of time may be mostly determined by demand from SMEs.

Chart 14: Volume of new SME loan contracts below HUF 1 billion



Source: MNB

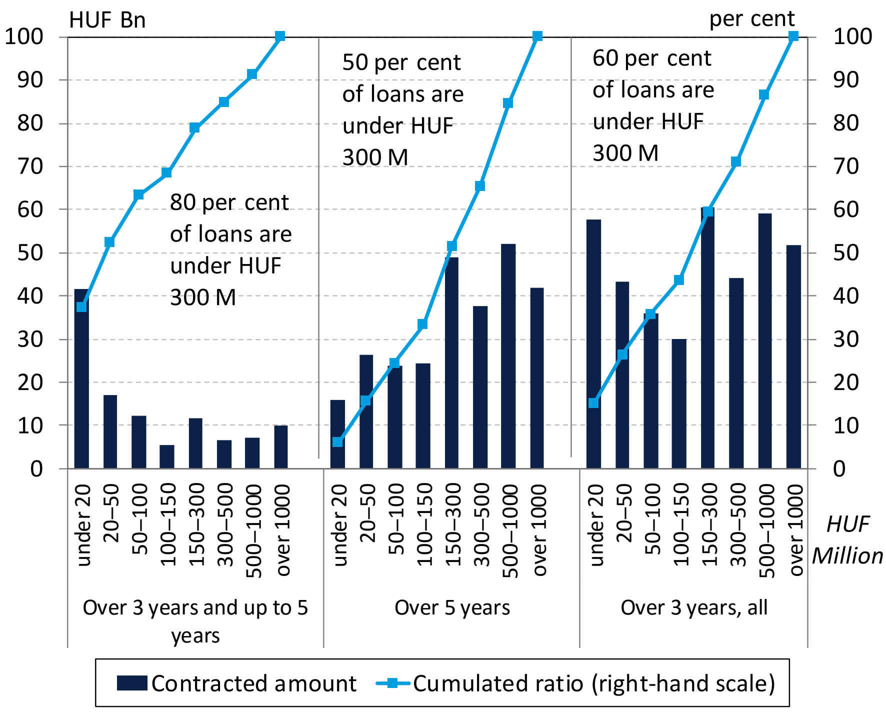
The key parameters of the scheme and its operation are identical with those of the previous phases of FGS. Accordingly, the refinancing structure, the legal and IT framework, the collateral requirement, the lower bound of the loan size and the maximum interest margin remain unchanged. Similarly to the previous phases, the MNB will provide credit institutions with refinancing funds at 0 interest rate; which they may lend further to SMEs at a maximum margin of 2.5 percent. The maximum maturity of refinancing loans, similarly to the previous phases, is 10 years, which provides sufficient time for the implementation of a variety of investment plans. As a new feature, however, only loans with a maturity of more than 3 years can be provided under the new scheme, in line with the objective of increasing the share of long-term and fixed-rate loans.

The MNB will elaborate the details of the allocation of the facility amount among banks in the near future. The mechanism of allocating the facility amount among credit institutions will be determined upon the finalisation of the detailed rules. The MNB wishes to implement a solution that does not restrict the activity of banks willing to lend, but at the same time it will not allocate funds to banks that have no intention to utilise it. To this end, it will presumably combine the methods applied in the previous phases: up to reaching a pre-defined threshold the banks will have access to refinancing on a 'first come first served' basis (similarly to the second phase), providing higher flexibility and facilitating competition among credit institutions; however, after the threshold is reached, the MNB will distribute the remaining facility based on some sort of allocation mechanism to ensure predictability. According to the bank's feedback, nearing the end of placements they need a clear and calculable own facility amount.

Only new investment loans can be provided (including also lease financing). By the third phase of the FGS, the range of loan purposes was limited to investments; enterprises could satisfy their working capital financing and subsidy pre-financing demands on a market basis. The present low interest rate environment does not justify any change in this; market-based working capital loan financing causes no problem for the enterprises, and subsidised schemes are also available for such purposes. However, in order to ensure the more targeted nature of the scheme, the range of investment purposes is expected to be slightly restricted even more further.

The maximum loan amount and the total volume of loans allowed to be taken out per SME, just as in the HUF-pillar of the third phase of the scheme, will be HUF 1 billion. In the third phase, the average size of forint investment loans and leases was HUF 43 million and HUF 10 million, while the median loan size was HUF 15 million and 5 million, respectively. 60 percent of the SME loans with maturity over 3 years, taken out in 2017, were below HUF 300 million and almost 90 percent of them below HUF 1 billion (Chart 15). The loan size of HUF 1 billion does not represent an effective constraint for enterprises in the implementation of their investments. In the case of enterprise and loan sizes exceeding this, the credit demands can be satisfied on favourable conditions even on a market basis.

Chart 15: Breakdown of SME forint loans with maturity over 3 years, by loan size



Source: MNB

Chart 4: Conditions of FGS fix

	FGS *fix*
Total amount	HUF 1000 Bn
Contracting period	1 January 2019 –
Interest rate of refinancing loans	0 per cent
Interest rate of SME loans	max. 2.5 per cent p.a.
Currency	HUF
Total volume of loans per SME	max. HUF 1 Bn
Maturity	min. 3 years, max. 10 years
Loan purposes	new investment loans (including leasing)

Source: MNB

5. NEUTRALISATION OF THE LIQUIDITY EXPANDING EFFECT

The FGS *fix* can be regarded as a more targeted scheme than the previous phases of FGS. This is essentially manifested in three key features: it is a relevant factor for the borrower SMEs that 1) only loans for maturity longer than 3 years may be granted, 2) loans may only be granted for investment purposes, and within that the range of utilisation will be narrower compared to the third phase. In terms of the banking system's liquidity, it will be a difference that 3) the scheme is neutral, as the excess liquidity attributable to the loans disbursed under FGS fix will be sterilized at base rate.

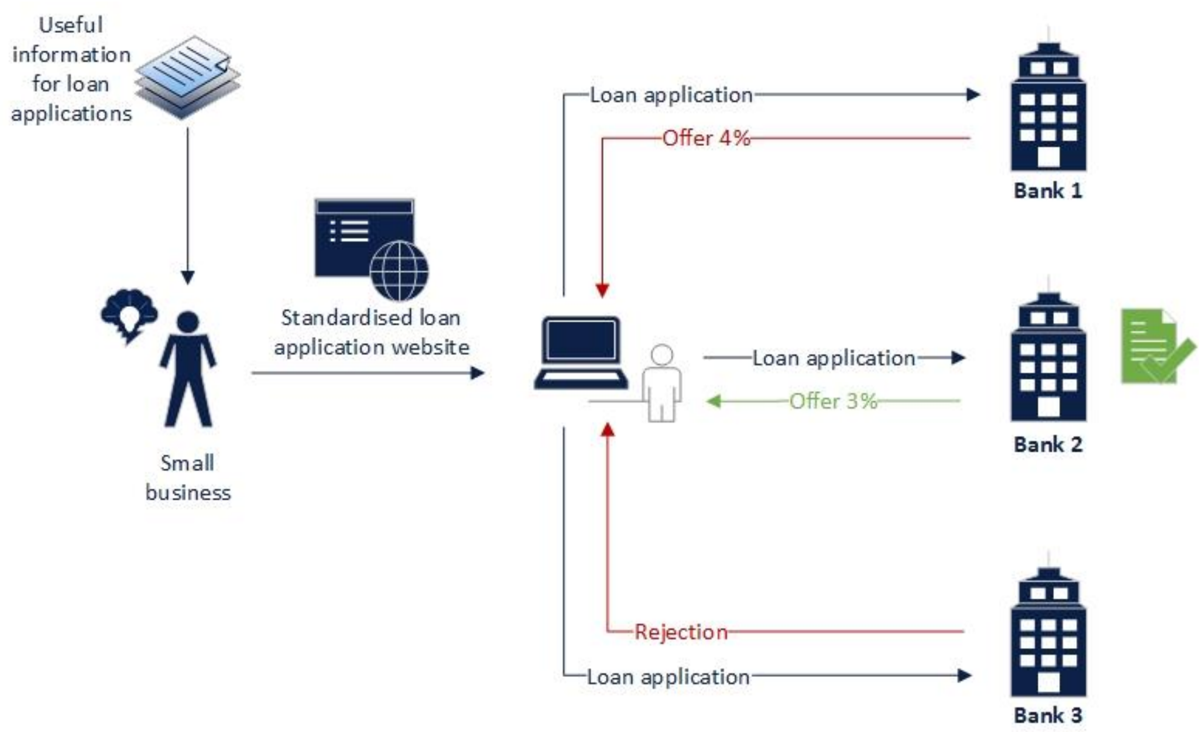
The role of the preferential deposit facility will change, from Spring 2019 it will be to sterilise additional liquidity provided under the FGS *fix*. The deposit facility linked to the Market-based Lending Scheme will cease at the end of February 2019; however, the facility will be available further to the banks participating in FGS *fix*. The deposit will be available at the base rate, and thus the placement of the excess liquidity will be in line with the actual monetary policy framework and ensure the neutrality of the new FGS scheme in terms of liquidity. The modified deposit facility, likely to be available from April, will be available to the banks participating in the scheme only in relation to the loans disbursed under FGS *fix*, thereby ensuring that the placement of the excess liquidity is closely connected to the new scheme. The MNB will define in the relevant terms&conditions how long and in what maximum volume it wishes to maintain the new deposit facility for credit institutions.

As regards the technical parameters, it will be a difference compared to the previous conditions of the preferential deposit that the deposit limits are not fixed anymore, but may change depending on FGS disbursements. The facility amounts will be determined periodically – according to the preliminary plans quarterly – based on disbursements, and thus its availability may gradually increase. It is a further important difference that compared to the former conditions the limit must be met not on the basis of a monthly averaging mechanism, as this could generate fluctuations in liquidity, the impact of which could also appear in short-term yields. The deposit facility in the new form – in line with the quarterly definition of the facility amount – will be available under a maximum daily limit to the banks participating in the scheme. The daily limit prevents the temporary 'overuse' of the instrument, and since apart from the disbursement of the loans under FGS *fix* no other additional condition is tied to its utilisation, the MNB will perform no subsequent audit in this respect.

6. THE STANDARDISED LOAN APPLICATION

Simplification of the loan application procedure of the SMEs is very important. Based on the international and domestic experiences, the complexity of the loan application process causes problems to many small enterprises, including also banks' different and occasionally vaguely communicated requirements. It would enhance both appetite to borrow and bank competition if there was an electronic interface through which the micro and small enterprises could submit their loan application in the same format to several banks paralelly and the participating banks had to provide an offer within a few days in a comparable format (Chart 16). In addition to standardising the loan application process, the concept also includes the creation of a brochure that contains useful information on borrowing and a clear guide on each step of the loan application process. With a view to elaborating the details of the concept, the MNB initiates professional consultation with the Banking Association and the Hungarian Chamber of Commerce and Industry.

Chart 16: Concept of standardised loan application



Source: MNB

CONSIDERATIONS BEHIND THE LAUNCH

OF THE FUNDING FOR GROWTH SCHEME FIX (FGS FIX)

AND MAIN FEATURES OF THE PROGRAMME

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