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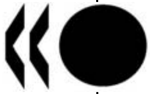

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

01-Feb-2010

English - Or. English

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WD(2010)4
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ROUNDTABLE ON COMPETITION, CONCENTRATION AND STABILITY IN THE BANKING SECTOR

-- Note by the Delegation of Hungary --

This note is submitted by the Delegation of Hungary to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 16 - 17 February 2010.

English - Or. English

JT03277793

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ROUNDTABLE ON COMPETITION, CONCENTRATION AND STABILITY IN THE BANKING SECTOR

-- Note by Hungary --

1. This contribution discusses the experience in relation to the current financial crisis and the issues of competition, concentration and stability in Hungary. It does not follow the structure of the questionnaire to the roundtable, and addresses only the issues where the Hungarian Competition Authority (GVH) has relevant experience.

2. The Hungarian experience may be regarded as somewhat special. Neither the real estate bubble of the US and certain European countries nor the hidden toxic assets did affect directly the banking system of Hungary. The primary reason for that was the Hungarian banks staying away in the first place from investing into the kinds of financial products which later turned out to be (potentially) toxic. Nevertheless, the Hungarian banking system was indirectly hit hard by one of the major consequences of the credit crunch: the drying up of liquidity. Financing their retail lending activity – a significant part of it in foreign currency – became increasingly expensive. This highlighted the underlying vulnerability and hidden risks of the lending practices of the previous several years, as well as the prudential and consumer protection regulations of the same time period. This contribution therefore focuses on the factors and developments leading to those vulnerability and risks, which are the specific features of the Hungarian crisis, most of them are related to foreign currency lending. An overview of limited experiences related to concentration and stability in Hungary is provided at the end.

1. Developments in the Hungarian credit markets

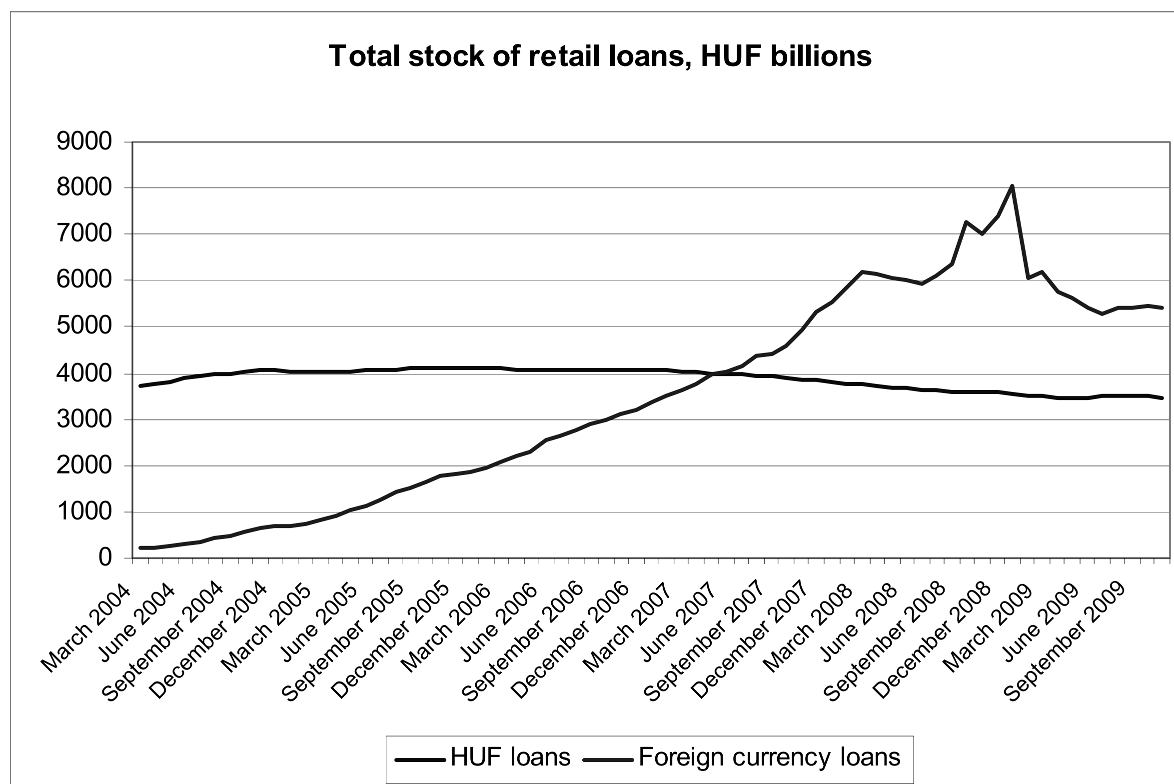
3. Hungary experienced a very high growth rate for credit markets in retail banking in the early 2000s. Growing consumer demand was further fuelled by a government subsidy programme for mortgages, making these products very lucrative to consumers. After a restriction in government subsidies, foreign currency loans became a popular alternative for mortgages denominated in the domestic currency (HUF, forint). Considerable interest rate differences resulted in lower monthly instalments, thereby attracting a lot of consumers to these riskier products. The supply of these products was further increased by cheap, short-term funds that were readily available on the market. The access to these funds was further simplified by structural links between the Hungarian banks and their foreign parent companies; the abundance of the short-term financing is partially attributed to the availability of cheap funds on these markets.

4. Some authors[1] argue that a monetary policy focusing almost exclusively on price stability could contribute to liquidity difficulties. High domestic interest rates raised the demand for the domestic currency, which resulted in a relatively stable exchange rate against major currencies as the Euro and Swiss Franc (CHF). Together with the high interest rate differences, these relatively stable exchange rates made investing in Forint, or borrowing in foreign currency a favourable speculation.

[1] E.g. Neményi [2009].

5. These circumstances resulted in a situation where foreign exchange assets accounted for a large share in the portfolio of the Hungarian credit institutions. As total retail loans rose from a very low level to approximately 40% of the national GDP by the end of 2008 (*Neményi, 2009*), the majority of these contracts are denominated in foreign currencies.[2]

Chart 1: Stock of retail loans in Hungary



6. The above mentioned situation made the Hungarian markets very much exposed to ***foreign currency risk***. A depreciation of the domestic currency, as it was witnessed during the crisis, dramatically altered the conditions of the contract (monthly instalments, value of collaterals), which indicated a significantly higher default rate.

7. In addition to foreign exchange problems, an additional risk factor arose in the form of a significant ***maturity mismatch*** in the Hungarian credit market. Since mortgages accounted for a significant portion of retail credit demands, the duration of this portfolio was necessarily quite high, while long-term funds had limited availability.

8. The situation described here inherently contained in itself the possibility that, should liquidity problems or huge interest rate shifts arise, the risks above mentioned would painfully materialise. Prudential regulation in Hungary had limitations to the issue. Although the Hungarian National Bank had been addressing the importance of foreign currency risk in its stability reports from the early 2000s, these observations have not been translated into an effective regulatory framework. (*Neményi, 2009*)

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2 Before November 2008, around 85% of new loans were denominated in CHF (Swiss Franc), while new loans in domestic currency held a rate of only around 10-15% (*Sebők, 2009*).

9. The September 2008 crisis was obviously a tremendous shock to the financial markets, however, there had been earlier signs that highlighted the underlying vulnerability of the Hungarian system. To correct for previous mistakes, some banks began to ***unilaterally change some contractual terms***. As a prominent example of this, they changed early repayment charges to prevent consumers to switch away from products that they considered less favourable.

10. These highly questionable practices meant a straightforward consumer protection problem, which also had much broader financial stability implications in the light of the already described prudential deficiencies. Due to the detrimental effects also to competition, the GVH has initiated several actions, among them a sector inquiry into switching between various retail products, including personal loans and mortgages.

11. The ***switching sector inquiry*** found a significant asymmetry in the long-term loan contracts, favouring the service providers. The general practice of unilateral modifications was exacerbated by high explicit switching costs in Hungary, and an econometric analysis found that they were able to hinder effective competition on the market. Lack of transparency and other regulatory deficiencies were also identified as possible problems to switching. (*GVH, 2009*)

12. Several studies showed that the situation was further aggravated by the very limited financial literacy of the Hungarian population. As an example, the number of retail banking transactions per capita are around the half of EU average, and according to a 2006 study commissioned by the GVH, more than 70% of the population has never initiated credit transfers or direct debits, nor have they used internet banking.[3]

13. The financial crisis escalated the problems mentioned above, and put them into a different perspective. Not only the risks of isolated business decisions made by some banks were passed through to consumers, but also the entire interest rate and foreign exchange risk materialised. Consumers experienced sharp increases in their monthly instalments and a financial shock potentially harmful to the stability of the whole banking sector materialised (creating or rather uncovering a kind of “Hungarian subprime” problem). Effective consumer reactions to these developments were however, largely restricted by business practices that were not prevented by regulation.

2. Regulatory steps and consequences

14. Insufficient prudential regulation has generally been considered (as a contributor) to contribute to the harmful effects of the financial crisis in Hungary. As a result of this, the powers of the Financial Supervisory Authority have been strengthened, and new regulations have been adopted concerning foreign currency operations and unilateral contract modifications.

2.1 Regulation regarding foreign currency operations

15. The liquidity crisis and the increase in cost of funds had a very considerable effect on the Hungarian loan markets. These factors made Hungarian banks face enormous challenges in securing financing for their lending activity. The massively increased price of funds was passed through to the borrowers of foreign currency loans, whose monthly instalments additionally grew also due to a sharp devaluation of the domestic currency. The financial shock witnessed by the borrowers had a negative impact on sector stability as well with a potentially high rate of non-performing loans posing a significant threat to banks.

[3] ECB statistics from the Statistical Data Warehouse, and GVH study for the sector inquiry.

16. Realising the risks arising from foreign currency lending, credit institutions with the help of the National Bank of Hungary, tried to elaborate a self-regulation limiting these activities. This proposal included strict LTV (loan to value) and PTI (payment to income) ratios and the limitation of the duration for car loans. The self-regulatory initiative failed to materialise however, since credit institutions were unwilling to commit themselves to the very strict proposals.

17. However, a ***legislative action*** was taken at the end of 2009 ***to limit foreign currency operations.*** Although the regulation included stricter LTV limits for foreign currency loans, it was nevertheless based on the previous self-regulatory initiative to a significant extent.[4]

2.2 Regulations regarding unilateral modifications

18. Various documents and conferences pointing out difficulties in switching made the Hungarian Bankers Association prepare self-regulations. The Association proposed two documents in 2008, a code of conduct for loan switching (refinancing) and another code of conduct for current account switching.

19. The government however was not entirely satisfied with the proposed self-regulation, and decided to implement changes itself. To ***limit unilateral contract modifications***, an amendment to these rules was enacted in March 2009. Major elements of the regulation provide free exit from the contract if fixed-rate contracts are unilaterally modified, and allow consumers 60 days to consider their actions after a personal notification. A further modification to address questions raised by the new regulation was approved by the Parliament at the end of 2009.

20. Since there had been some contradicting interpretations on the new rules, in order to establish more clarity and to improve confidence in the banking sector, credit institutions elaborated a more extensive ***Code of Conduct***, discussing various topics, among them unilateral modifications. These rules are monitored by the Financial Supervisory Authority (PSZÁF), which can impose significant fines in case of non-compliance.

3. Concentration and crisis – the Hungarian experience

21. In an international comparison the overall concentration of the Hungarian banking industry can be considered as ***moderate***. After the establishment of the two-tier banking system in 1987, the sector underwent liberalisation. A former state-owned monopoly in the retail sector witnessed gradual erosion of its position in numerous segments, while remaining the major player in the market until nowadays.

22. A successful reorganisation programme in the 1990s was followed by a rapid influx of foreign capital, which resulted in decreasing concentration. As the new entrants principally targeted larger corporate clients, wholesale banking experienced a lot fiercer competition from the middle of the '90s, while competition in retail banking – more so in the case of individuals and less for SMEs - started to catch up only in the next decade. The end of the 1990s was then also marked by several acquisitions and mergers resulting in some concentration increase. (*Vígh-Mikle, 2002*)

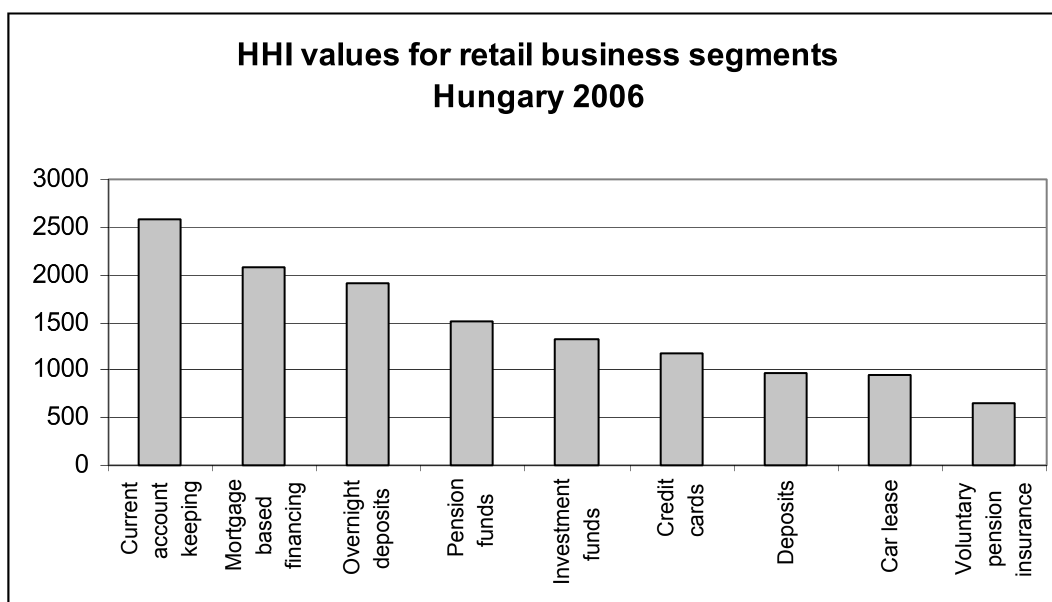
23. The EU integration process further contributed to the decrease of concentration in the banking market. The number of foreign branches increased, while opening branch offices became a general trend as

[4] The banks have to assess the borrowers prior to lending and they have to calculate a limit of lending for every borrower based on their income. The monthly instalment cannot surpass this limit, in case of EUR loans 80% of the limit, while in case of other foreign currency loans 60% of it. The LTV's for housing mortgage loans are 75% for HUF loans, 60% for EUR loans and 45% for other currency loans respectively. In case of financial lease, the respective numbers are as follows: 80%, 65% and 50%. For car loans the maximum duration has been limited to 7 years, while the LTV is 75%, 60% and 45% respectively.

more and more credit institutions expanded vastly into retail banking. While the decreasing trend for concentration in the banking concentration continued, there were countervailing effects for credit institutions in general as several saving co-operatives ceased their operation, merged, or transformed into banks. (*PSZÁF, 2009*)

24. ***Concentration varies*** greatly not only between the wholesale and retail segments, but also according to the activity in question. The decreasing trend in concentration is much more evident for the wholesale business, while retail concentration in the banking sector seems to remain rather stable over time. The concentration of the wholesale sector is in general much lower compared to the retail business; in 2002, the HHI value for the whole industry was around 1000, with 800-900 for the wholesale, and 2000 for the retail sector. (*Vígh-Mikle, 2002*) Based on a study by McKinsey&Company, the Hungarian retail market has the following concentration numbers according to the activity in question:

Chart 2: HHI indices for retail submarkets in Hungary (2006)



25. The same study found that in 2005 the market share of the three biggest banks was 43.8% in Hungary, while the HHI for the whole sector was 1007. According to these figures Hungary ranks among the moderately concentrated markets.[5]

26. The relation between the level of concentration in the banking sector and its vulnerability in case of shocks and crises has not been adequately assessed in Hungary so far. There are empirical evidences neither of the “concentration-stability” nor of the “concentration-fragility” view.[6]

27. There are only a few studies of ***limited scope*** that consider the relationship between competition, concentration and stability; they were however all prepared before the crisis. Várhegyi [2002] argues for example, that although the increased stability of the financial sector in the early 2000s went together with a

5 HHI values in the study range between 266 (Italy) and 2421 (Belgium).

6 The terms “concentration-stability” and “concentration-fragility” are taken from Beck, Kunt and Levine [2005]. The former relates to the view by which higher concentration of the sector renders it more resistant to crises, while the latter represents the view according to which higher concentration is associated with higher vulnerability in case of crises.

decreased concentration, the high concentration in the retail sector left considerable room to extract even monopoly rents. The author draws the conclusion that it might also have had a positive impact on stability. An empirical study commissioned by Moré-Nagy [2004] confirms the relatively high concentration indices in the retail sector, finding HHI values of 3400 for mortgages and 2900 for personal loans respectively.[7] The authors indicate that the higher concentration values are transformed into higher profit margins.

28. There are only ***speculative conclusions*** to be drawn concerning concentration and stability in the Hungarian banking sector. In the transformation period, the decrease in concentration seemed to contribute to increased stability; a causal relationship is not obvious, however.

29. Currently, the relatively low concentration is accompanied by a ***diversified ownership structure*** in Hungary – as noted above; the majority of the Hungarian banks are parts of international banking groups, with parent companies based in various countries. It can be argued that this renders the industry less prone to systemic risk. In case of a bank failure, for example, diversity of ownership and extended number of banks on the market could make the failure of the whole sector less likely. Even a global crisis is likely to affect different countries – and so different parents of the Hungarian banks – differently. Therefore, it is less probable that all of the banks share the same "story of failure", including the lack of "help" from their own groups. In addition, variety in foreign ownership may translate into variety of traditions, corporate culture and business strategies – more diverse than otherwise. This also helps mitigating risks that could arise from failed investments.

30. These thoughts are all however, only based on conventional wisdom, as direct evidence is not available for Hungary. It cannot be excluded either that the above detailed potential benefits of diversity are only true for a limited set of countries with specific characteristics.

31. This crisis has had special features and a specific course in Hungary, as described in previous sections. There were no failing banks, and there was no need for bailouts, increase of concentration or nationalisation. Several reasons can be brought up in this matter, some of them have already been mentioned above, but it might also be considered that the Hungarian banking industry's diversified ownership structure and relatively low concentration had also a role. These conclusions however, need to be supported and confirmed by empirical evidence as well.

[7] The difference between the market shares of the first and second players also show significant difference: in the retail sector it ranges from 15-48 percentage points for the various products, while the same difference for the wholesale sector is only 1-1,5%.

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