



RISK OUTLOOK FOR NON-BANK FINANCIAL SECTORS



2016

'... 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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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 its 'Risk outlook for non-bank financial sectors', which presents the most important characteristics and risks of insurance companies, funds, intermediaries, cooperative credit institutions, non-banking group entities and markets of capital market participants, covering the period from 30 April 2015 to 15 June 2016.

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

The savings of Hungarian households rose by HUF 2,839 billion last year. The improving labour market trends and the low inflation and interest environment presented a growth opportunity primarily for the sectors engaged in the management of savings.

Life insurance and voluntary pension fund reserves continued to grow after 2014, expanding at a rate of 4.1 per cent which was faster than the rate of GDP growth (+2.9 per cent). This was supported by the favourable yield performance of the insurers and funds. Compared to the EU average, however, there is still room for further growth. Despite the low yield environment, insurers and voluntary pension funds hold substantial government bond portfolios, and in the case of funds, these portfolios have increasingly longer maturity. This further strengthens the government financing role of these sectors.

In the life insurance market, the number of regular premium contracts continued to grow, albeit to a lesser degree than previously. Pension insurance remained the key factor behind this, accounting for almost one-quarter of the new acquisitions in 2015. The retention ratio of pension insurances is extremely good, which – supplemented by the elements of the MNB's ethical life insurance concept – helps insurers build stable portfolios which enjoy public trust in the coming years.

Positive changes were also seen in the non-life insurance market in 2015, as this market was characterised by outstanding growth in terms of premium income. This was supported to a great degree by the significant rise in the premium income from compulsory motor third party liability insurance (MTPL), which was attributable in part to the higher number of contracts, and in part to the increase in the premiums. Although the combined ratio of the sector (sum of the loss and cost ratios) decreased, it is still below the critical, profit earning level.

The profitability of insurers has shown steady improvement in recent years, and the average after-tax return on equity (ROE) reached the pre-crisis level; however, the future prospects are more negative, as the low yield environment will reduce the financial profit, and at certain institutions it will highlight problems related to the business model and economies of scale.

The largest challenge faced by the insurance sector is compliance with the new S II system. The changeover in corporate governance already commenced in 2014: according to our surveys, it is proceeding on the right track, and thus in the future we expect risks to decline. By contrast, in the area of capital adequacy, the introduction of the S II risk-based regulatory capital calculation and the economic valuation brings significant volatility to the system and certain institutions may experience capital adequacy problems. Accordingly, risk is likely to increase in the area of capital adequacy.

The number of members with voluntary pension fund savings is lower compared to 2014, but the increase in the number of non-paying members stopped. It may be regarded as a positive trend that – despite the lower employer's membership fee contribution – the total amount of pension fund membership fee payments increased, which partly played a role in voluntary pension fund savings rising to almost HUF 1,200 billion.

With the termination of the background support by employers, and the appearance of the new fund type, in the case of health funds and mutual benefit funds an increase was observed in the concentration ratio of per capita membership. There are substantial corporate governance risks in the funds sector, attributable to the shortcomings in owner's control and in the internal lines of defence. The decline in the number of members is the result of the difficulties in the recruitment of members, and the commitment of employers is also unlikely

to increase in the medium term. Due to the low yield environment, both the financial result and the deduction from non-payers are jeopardised, which may increase the funding risk.

There is a major wave of mergers in the cooperative credit institution sector with a view to strengthening efficiency and competitiveness. In addition, the joining of the Integration by FHB Mortgage Bank Co. Plc. and FHB Commercial Bank Ltd. was the most significant change in 2015, which may contribute to the geographic and client diversification, and may provide a solution for the fulfilment of the requirements set forth in the MNB Decree on the regulation of credit institutions' forint maturity match. The cooperative credit institutions were able to increase their lending activity in 2015, albeit to a lesser degree than planned.

In the activity of non-bank financial enterprises, a certain shift from retail lending to the purchase of overdue receivables can be observed. 70 per cent of non-bank financial enterprises closed 2015 with a profit, but this result is purely attributable to one-off effects. On the whole, the concentration of the sector is still likely to continue, which may strengthen the stability of the sector and facilitate the creation of a sounder financial institutional system.

At the end of 2015, the MNB acquired controlling stake in BSE, which facilitated the elaboration of a new corporate strategy for capital market development, in the framework of which measures which significantly boost the stock exchange's demand and supply side will be implemented.

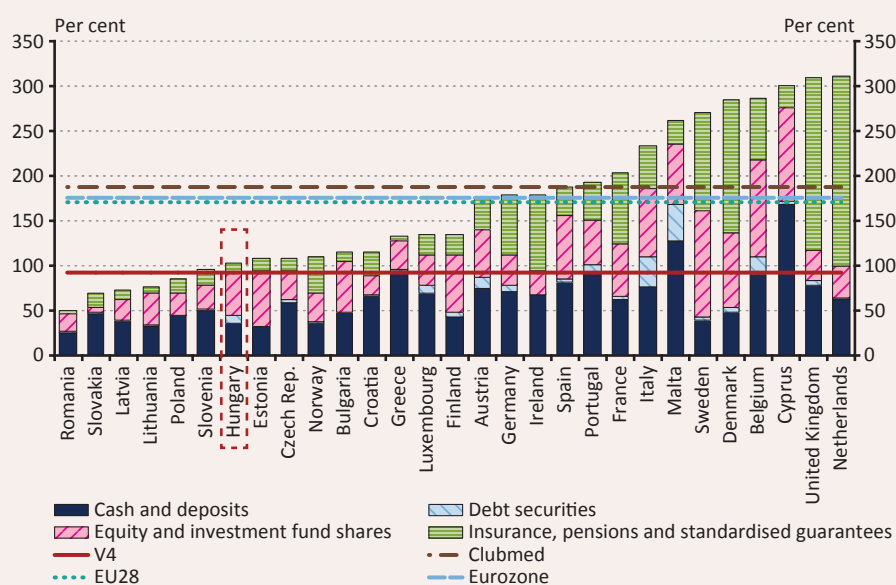
The cases of fraud revealed in the beginning of 2015 at some of the investment firms did not shake the general trust in investment service providers: the clients' securities holdings with investment firms and credit institutions increased by 10.7 and 5.5 per cent, respectively, in 2015. However, due to the higher Investor Protection Fund fees related to the compensation for the cases of fraud committed by investment firms and the tightening statutory regulation, the profitability of investment firms is declining. As a result of this, a consolidation process has commenced in the sector, in the course of which the number of investment firms decreased in 2015 by three to 18, and in 2016 another company will also terminate its activity.

The assets managed in investment funds continued to increase in 2015, and at the end of the year it reached a historic high of HUF 5,777 billion. However, the growth rate has significantly decelerated. The low yield environment also had an impact in the market of bond-type investment funds: bond-type investment funds were characterised by capital outflows in 2015, in contrast to the substantial capital inflows seen in previous years.

1 The Cornerstone of the financial market: developments in household savings

Within the European Union, the ratios of households' financial assets accumulated until 2014 as a percentage of GDP vary significantly across countries (Romania: 50.3 per cent; the Netherlands: 311.7 per cent). In Hungary, this ratio was 102.7 per cent, i.e. the savings accumulated by households in 2014 already exceeded the GDP level (HUF 33,000 billion). The level of savings in Hungary exceeds the average of the Visegrád Four, but falls short of the average of the EU-28 and the Clubmed countries. An examination of the correlations of the asset composition ratios in the individual countries reveals that the structure of the Hungarian households' savings most closely resembles that of Lithuania, Estonia, Finland, Bulgaria and Italy.

Chart 1
Composition of households' savings (as a percentage of GDP) in Europe in 2014



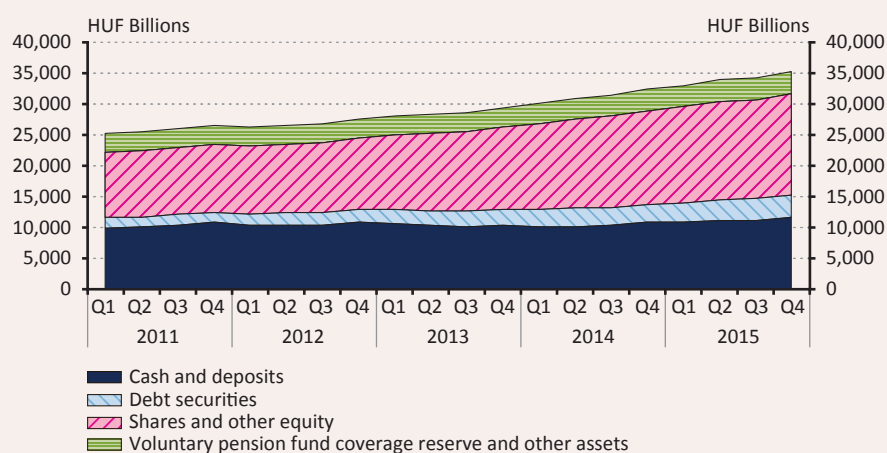
Source: Eurostat

The realignment of Hungarian households' savings has been ongoing since 2008. The proportion of equities and mutual fund shares has been continuously increasing for several years (to 46.9 per cent of GDP in 2014), and in parallel with this the ratio of cash and bank deposits as a percentage of GDP shows a declining trend. The cash and bank deposit ratio of almost 40 per cent observed during the years of the crisis fell to 34.7 per cent by 2014 (only Lithuania, Estonia and Romania had lower ratios of bank deposits and cash savings to GDP than Hungary). Major underlying reasons for this may have been the increased demand for mutual fund shares as a result of the improvement in global capital market sentiment following the crisis and the fact that interest rates on bank deposits, declined owing to the central bank base rate cut cycle that commenced in 2012. As a response to this, households began to invest their financial assets accumulated until then in government securities, which offered higher yields in some cases.

The share of bonds (10 per cent) has increased significantly over the years. In households' balance sheet, the bond portfolio as a proportion of GDP increased more than twofold since 2007 and consists almost exclusively of government bonds and interest-bearing treasury bills. Since 2008 the ratio of equities and mutual fund shares within savings has gradually increased, in parallel with the decline in deposits. However, as regards insurance and pension fund savings, Hungary has a substantial lag: the volume of assets accumulated by households in these products as a percentage of GDP is lower only in Lithuania and Romania. In the 28 countries under review, households' savings accumulated in insurances and pension funds represent the second smallest share, after bonds, within all assets.

The savings of Hungarian households rose by 40 per cent in the past 5 years. The rise in shares and other equities made the largest contribution to this, registering an increase of 55 per cent in the period under review. Holdings of debt securities¹ increased to a greater degree (by 124 per cent), but the share is still negligible. The assets of these two categories are stated at market value, as a result of which the rise in these savings may have also been supported by the price fluctuations (the BUX index rose by 10 per cent during the period under review). There was a minor increase in cash and deposits, and in the insurance technical and voluntary pension fund coverage provisions (17 and 14 per cent, respectively). The latter includes mostly long-term savings, the growth of which is predominantly composed of regular, but low-value deposits, and as such they respond to the recovering economic processes less flexibly.

Chart 2
Developments in the composition of households' savings



Source: MNB

¹ This includes: bonds, treasury bills, certificates of deposit, fund certificates, dedicated proprietary shares, fixed amount deposits, mortgage bonds, bills of lading, warehouse warrants, delivery slips, certificates of pledge, compensation vouchers and mutual fund shares issued by fixed-term mutual funds.

2 Insurers, voluntary mutual insurance funds and intermediaries

The development of the Hungarian insurance sector followed similar trends as the rest of the economy in 2015. The group of 32 domestic insurance companies consists of 10 life insurers, 12 non-life insurers and 10 composite companies. In the life insurance business, the 2.2 million contracts generated a gross premium income of HUF 442.5 billion, equivalent to 1.3 per cent of gross domestic product (GDP) calculated at current prices. The premium income of the non-life business line realised on 10.1 million contracts amounted to HUF 408.9 billion, equalling 1.2 per cent of GDP. The provision holdings covering the liabilities of the sector are equally high: i.e. HUF 334 billion and HUF 1,838 billion in the non-life and life business, respectively. The latter also includes the portfolios that serve as long-term savings instruments. The total profit after tax realised by the domestic insurance companies on their shareholders' equity of HUF 247 billion amounted to HUF 44.2 billion, while their capitalisation level was 191 per cent in the fourth quarter of 2015.

The voluntary mutual insurance funds sector consists of 44 voluntary pension funds, 26 health funds and 10 mutual benefit funds. The assets and number of members of the voluntary fund sector continued to increase in 2015, and thus at the end of the year the voluntary funds managed 2,263,415 individual accounts in total, while the value of the coverage provision was HUF 1,204.7 billion. At the sector level, the increase in membership relates to health funds, while the rise in coverage reserves is mostly attributable to the growth in the pension funds' assets. In 2015, the voluntary pension funds realised an average yield of 4.41 per cent on the coverage provision at sector level. Holdings of coverage provisions reached HUF 1,147.6 billion, equalling 3.4 per cent of GDP. The funds play a substantial role in financing the economy, as they still keep a large part of their assets in Hungarian government securities. In the case of health funds, the present government securities holding of 66 per cent may increase further, due to the tightening of the regulations related to investments.

Independent insurance intermediary brokers and multiple agents represent a major sales channel for the insurance market. At the end of 2015, insurers' products were sold by 388 brokers holding an intermediary licence and 60 multiple agents, with the contribution of 14,304 natural persons. In the case of life insurance policies, in 2014 the referred portfolio premium of HUF 46.9 billion covered 10.3 per cent of the entire market, while the sales of non-life insurance policies represented a higher proportion, i.e. the portfolio premium of HUF 86.3 billion represented 22.9 per cent.

2.1 HOUSEHOLDS' SAVINGS IN INSURANCES AND FUNDS

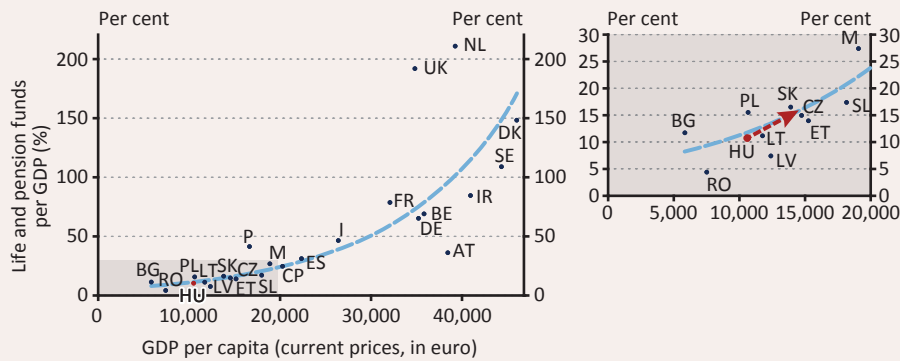
Insurance and funds provisions outpacing GDP growth

In comparing the market share of insurance and pension fund savings with a given country's GDP per capita ratios an interesting link can be identified. We found that of the Visegrád Four this ratio is the lowest in Hungary. Of the countries included in the sample, the Netherlands has an extremely high savings level, i.e. 212 per cent of the GDP per capita.² On the other hand, based on the exponential trend applied to the complete sample, we may come to the conclusion that there is a positive correlation of average strength between the developments in the GDP per capita and the ratio of insurance and pension fund savings as a proportion of GDP. In Hungary – assuming a real GDP growth of 3 per cent, which is expected to continue in the medium run – the growth rate of the assets accumulated in insurances and voluntary pension funds may outstrip the GDP growth rate in the

² The significant deviation from the trend is also caused by the local features of the pension and social security systems.

coming years. This may be attributable to the increase in households’ disposable income (“income effect”), and as a result of the correlations illustrated on the chart, an increasing part of the income may be deposited in long-term savings (“composition effect”).

Chart 3
Households’ savings in life insurance and pension funds in 2014 relative to GDP

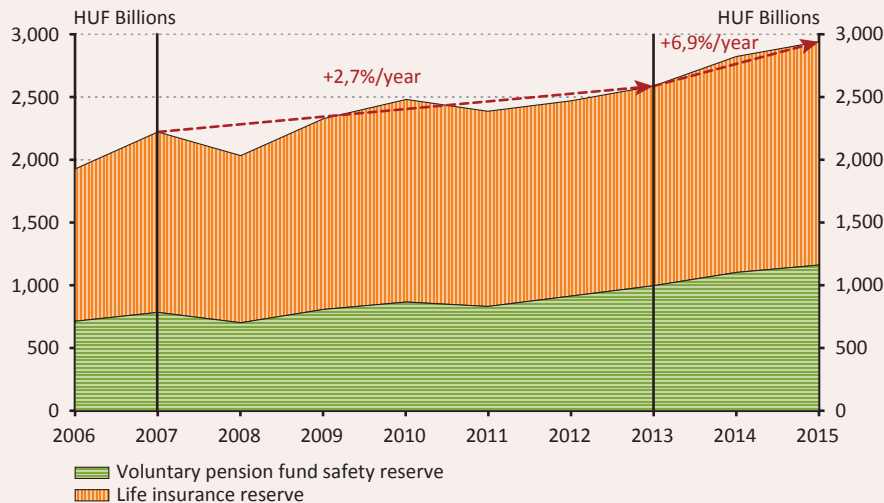


Source: Eurostat

Long-term savings proved to be resistant to crisis

Owing to the existing volume and yield earning capacity of the provisions and the limited flexibility in the written premiums, the market of long-term savings (life insurances and voluntary pension fund products) is characterised by inertia. In practice, this means that the volume of provisions only responds to a small degree to changes resulting from sudden market, environmental or regulatory shocks. The volume of life insurance and voluntary pension fund coverage provisions declined substantially from 2007 to 2008, which in part may have been caused by the slackening of the equity markets resulting from the economic crisis, while in 2011 it was the early repayment of the foreign currency loans at preferential exchange rate that had a negative impact on the level of provision holdings. On the whole, provisions between 2008 and 2013 rose on average by 2.7 per cent annually, while in the last two years we saw a more dynamic increase, i.e. 6.9 per cent per annum on average. From 2007 mathematical provisions, accounting for a substantial part of the life insurance provisions (35 per cent at the end of 2015), were characterised by a moderately declining trend, as a result of which their value fell to HUF 628.6 billion by the end of 2015. By contrast, there was a major rise in the provisions of the unit-linked products: at sector level it rose from HUF 537.6 billion, recorded in 2006, to HUF 1,151.4 billion.

Chart 4
Life insurance and voluntary pension fund coverage provision



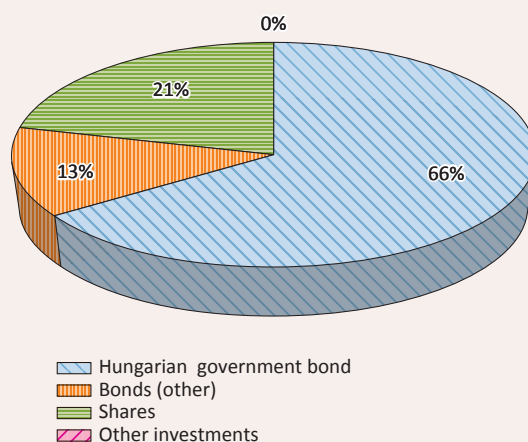
Source: MNB

Insurance companies and funds continue to play a solid role in financing the government

Yield performance was positive in recent years: in 2015, insurers managed to achieve an average yield of 3.2 per cent on unit-linked products and 4 per cent in the whole life insurance business. In the past one year, the underlying investment instruments of the provisions have not changed significantly: unit-linked provisions are mostly comprised of mutual fund shares, while mathematical provisions are predominantly held in government securities. Life insurance liabilities are essentially long-term liabilities, and thus the institutions adjust the average maturity of the underlying portfolio to this. For this purpose they mostly purchase long-term government securities, which directly accounted for 35 per cent of the life insurance provisions at the end of 2015, while indirectly (also taking account of the portfolio underlying the mutual fund shares) they accounted for nearly 66 per cent. The indirect equity exposure of the insurers was 21 per cent at the end of 2015. Corporate bonds have a high weight in other bond-type investments. According to the relevant data available to us, the sector mostly places these bonds behind unit-linked provisions.

With the entry into force of the Solvency II Directive (S II), insurers have more room for manoeuvre in the area of investments than before. In the case of insurers falling within the new regime, the investment limits have been cancelled, which provides an opportunity to hold asset portfolios that represent higher risk and presumably also offer higher yields. On the other hand, investment risk-taking is restricted by the Prudent Person Principle, which states that insurers must hold assets of proper quality in their portfolio. The fact that all assumed risks appear in the insurer's regulatory capital requirement, i.e. an asset portfolio that represents potentially higher risk increases the capital requirement, also represents a disincentive against excessive risk-taking.

Chart 5
Composition of coverage for life insurance provisions



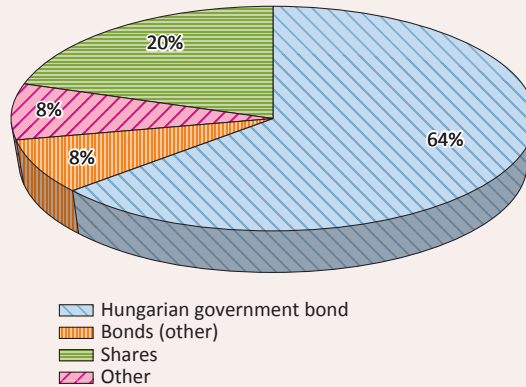
Note: Based on the data available to the MNB, the mutual fund shares were broken down, using an estimate, into the four categories illustrated above. Corporate bonds and mortgage bonds are allocated to the category of bonds (other).

Source: MNB

Voluntary pension funds continue to hold a major part of their coverage provisions, amounting to HUF 1,162.4 billion in total, in Hungarian government securities. The ratio of Hungarian government securities was previously even higher, but as soon as legislative provisions permitted, several funds introduced an optional investment portfolio system. In this way they created more and better diversified portfolios, as a result of which the ratio of equities and mutual fund shares increased at the sector level in the pension funds' portfolio. In 2007, mutual fund shares accounted merely for 12 per cent of the voluntary pension funds' portfolio, while by the end of 2015 their share exceeded 24 per cent. The ratio of domestic and foreign direct equity investments is 5 per cent, while the indirect ratio of the same (also estimating the underlying equity exposures of mutual fund shares) is 8 per cent. Funds reach the foreign equity market through individual equity investment to a smaller degree, and via the ETFs (Exchange Traded Funds) and mutual funds to a larger degree. As regards the investment of pension funds' provisions, the share of the individual asset categories did not change significantly in 2015 – also including the domestic government securities holding, directly accounting for 60 per cent of the funds'

investments. It should be noted that the domestic mutual funds included in the funds' portfolios also have considerable holdings in government securities, which indirectly increase the funds' government securities investments, and thus in total they account for 64 per cent of the funds' portfolio.

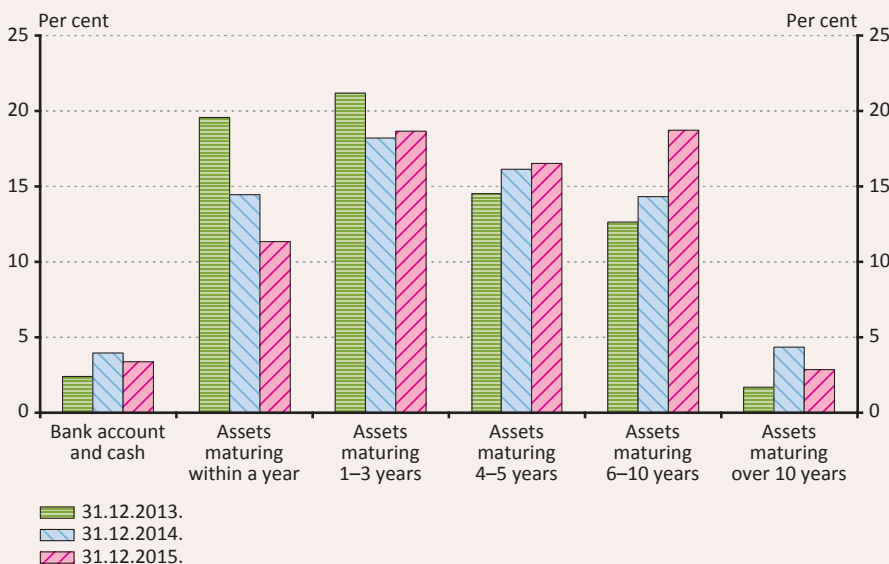
Chart 6
Investment composition of the voluntary pension funds' coverage provisions



Note: Based on the data available to the MNB, the mutual fund shares were broken down, using an estimate, into the four categories illustrated above. The 'other' category includes: bank accounts, cash, bank deposits, and real property.
Source: MNB

The varying yield environment influences the pension funds' investment attitude, which is reflected in the change of the maturity of the fixed-term instruments. In the past two years a shift can be observed in the maturity structure of the fixed-term instruments, which in the case of pension funds, are primarily government securities. The share of the short-term (up to one year) instruments has declined in the total portfolio of the entire sector, while the share of the 4 to 5-year and even more the share of the 6 to 10-year maturity instruments rose in the period of 2014-2015.

Chart 7
Cash and fixed-term instruments in the voluntary pension funds' portfolio



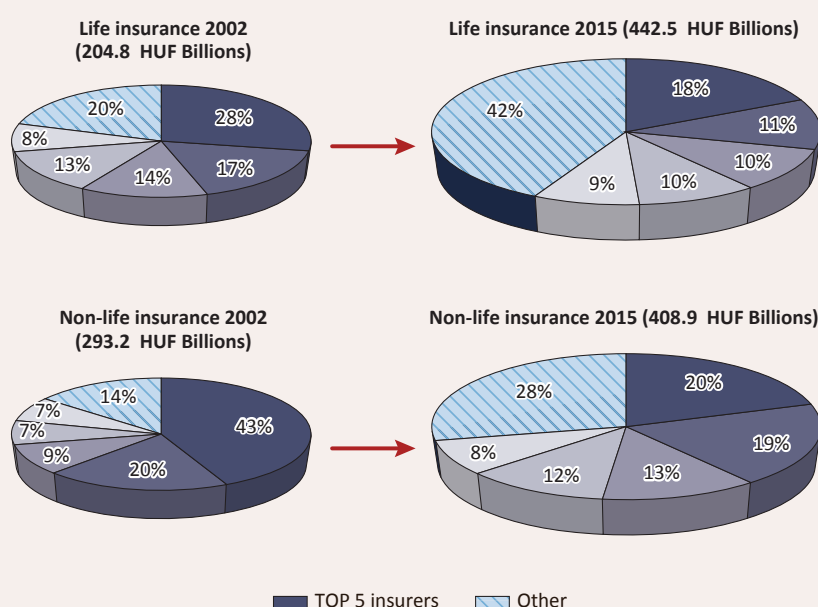
Source: MNB

2.2 ANALYSIS OF THE SITUATION OF THE INSURANCE MARKET

Low concentration in the life insurance market, and higher, but decreasing concentration in the non-life insurance market

In parallel with the dynamic growth of the individual markets, the market share of the largest insurers, calculated on the basis of premium income, decreased. The market share of the TOP5 fell to 58 and 72 per cent in the case of life insurance and non-life insurance, respectively. In absolute terms, the premium income of the TOP5 insurers in the non-life business reached the 2002 full market size, but the “medium-sized” insurers were also able to increase their market share, and thus on the whole a more efficient, less concentrated non-life market was able to develop. Looking ahead, stagnation is expected in the life insurance concentration ratio, while in the non-life business further decrease is likely to take place, in line with the trends of the HHI values.

Chart 8
Change in the market leader life and non-life insurers' market share based on premium income

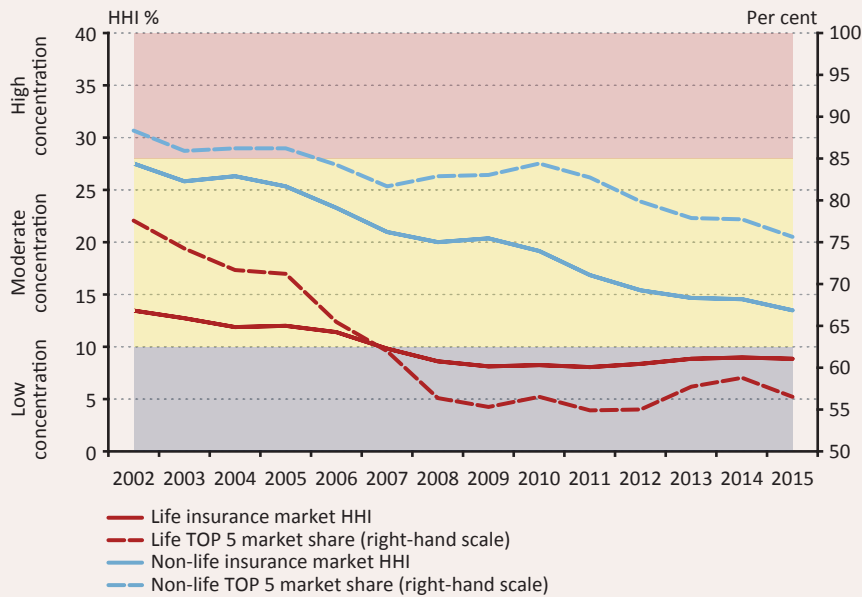


Source: MNB

HHI clearly reflects the changes in the concentration ratio of the individual segments. In the life insurance market, the index declined until 2013, and in 2007 it was as low as 10 per cent, which is regarded as low concentration. In parallel with that, the share of the TOP5 insurers in the net earned premium also declined. After 2012, however, the market strength of the five largest insurers once again started to increase, while in 2015 it showed signs of stagnation. One possible reason for this is that the dynamic increase in the market size helps reduce concentration in the long run and the economies of scale problems are also resolved in part.

Similar developments can be observed in the non-life insurance market as well as in the life insurance market. Starting from 2010, the share of the five largest actors decreased, which was partly attributable to the online sale of the compulsory motor third-party liability insurance (MTPL) and its upswing, as well as to the portfolio equalisation mechanism of the re-contracting campaign. Concentration may stop declining with the diminishing importance of the MTPL re-contracting campaign, as the significance of the “brand” may increase again when price competition becomes weaker.

Chart 9
HHI of the insurers based on the net earned premium and share of the TOP5 insurers



Source: MNB

Continuing increase in the regular premium life insurance market

The regular premium life insurance portfolio hardly increased (by less than 1 per cent) compared to the end of last year, and has practically stagnated since 2013. The number of new contracts has been decreasing at a slow, but steady rate in the last two years (at the end of 2014 and 2015: -1.2 per cent). The portfolio shrinkage of more than 5 per cent on an annual basis hindered the increase in the number of regular premium contracts in 2015, which was felt to a lesser degree in 2012-2014.

The traditional regular premium portfolio continues to contract, caused by the decrease in growth seen in the last two years (-6 per cent) and the higher portfolio shrinkage on an annual basis (the higher portfolio shrinkage compared to last year was primarily attributable to death (+15 per cent), and surrender also increased (+3 per cent); while the number of contracts cancelled due to expiry was lower by 10 per cent compared to last year).

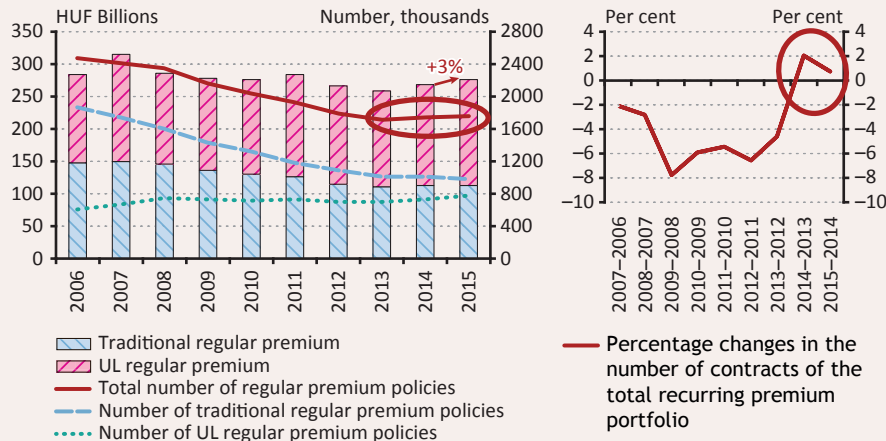
The shrinkage of the traditional regular premium portfolio was offset by the increase in the number of unit-linked contracts. The unit-linked portfolio has been stable for several years now; the steady, almost 6 per cent growth seen in the last two years was caused by the popularity of unit-linked pension insurance. The high surrender rate that was typical during the years of the crisis showed a decreasing trend in the last three years in the case of the unit-linked products. By the end of 2015 the unit-linked portfolio included almost 800,000 contracts.

The positive market processes permit the regulatory authorities to take effective measures in order to reduce potential product defects that appeared in the services in previous years. The elements implementing the MNB's ethical life insurance concept (tightened investment rules, transparency of costs, closer cost control) will enter into force gradually, starting from 2016. The concept helps insurers build stable portfolios enjoying general trust in the coming years by focusing on long-term reliability.

The gross written premium (gross premium) from regular premium life insurances across the sector continued to increase: the 3 per cent growth seen last year continued, but it still reached only the premium level of 2010. The premium from traditional regular premium insurances has not changed on an annual basis, while that from unit-linked products followed the portfolio's rising trend. Almost 60 per cent of the annual premium comes from the unit-linked portfolio, which accounts for 44 per cent of the entire regular premium portfolio.

The 12-month regular premium per unit-linked contract is still stable (HUF 236,000), while in the case of traditional contracts it continuously increased in 2015, reaching HUF 116,000.

Chart 10
Premium income and number of recurring premium contracts, and changes in the number of contracts in an annual comparison



Source: MNB

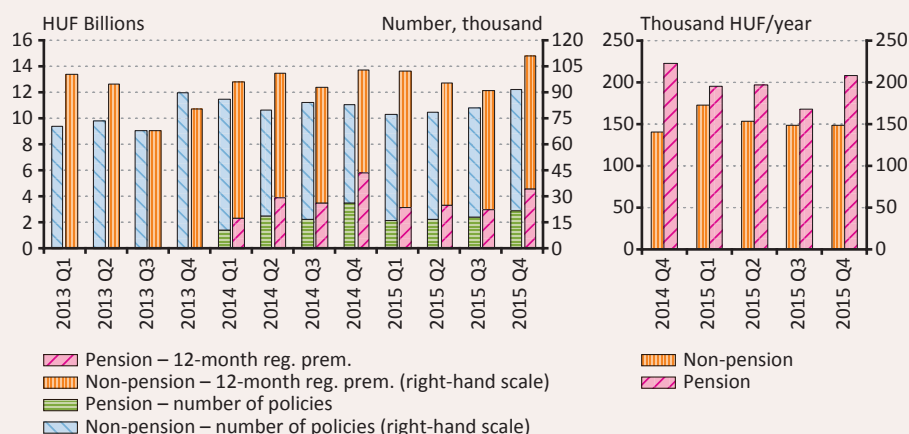
There was no major change in respect of the seven market leader insurers, ranked on the basis of regular premium income (with market share over 5 per cent).

Pension insurance continues to be a growth driver

In the past two years, pension insurance has become the cutting-edge product of the life insurance business, assisted by the annual tax allowance available since 1 January 2014 for private individuals in respect of new pension insurance contracts (20 per cent of the amount paid in the tax year, maximum HUF 130,000). The MNB responded to the legislative change in a proactive manner in the form of a pension insurance recommendation issued in May 2014, to ensure that the pension insurance market, supported by tax incentives, develops in a structure regarded by the MNB as good practice. The MNB expects that the pension insurance products should be of simple structure, transparent, aligned with customers' needs, of stable value and the tax allowance should actually increase the customer's savings for pension. In addition, the recommendation prescribes the provision of thorough and professional information to the customers and the development of an incentive system that facilitates the long-term retention of the contracts. As a result of the recommendation, several products were modified or phased out. The pension insurance market, which developed since the beginning of 2014, expanded dynamically.

At the end of 2015, pension insurance contracts were available from 17 insurers; market concentration decreased compared to 2014 and it practically corresponds to that of the mixed and unit-linked life insurance market; almost 75 per cent of the market is held by the same seven market participants. By the end of 2015, the pension insurance portfolio was comprised of almost 137,000 contracts, 70 per cent of which are unit-linked insurances. Of the 97,000 unit-linked pension insurance policies, merely 4,000 are single premium contracts. Traditional pension insurance products are offered only by six institutions, and the single premium version of these is still not available. Almost 97 per cent of the outstanding pension insurances are regular premium contracts. In 2015, more than 76,000 new contracts were concluded (outstripping the 2014 growth by almost 4 per cent, which was primarily attributable to the new acquisition in the first quarter of 2015), 67 per cent of which are regular premium unit-linked pension insurance contracts. Almost one-third of the annual growth was generated in the last quarter; the seasonal effect of the tax allowance prevails in the fourth quarter, particularly in the case of the single premium unit-linked products.

Chart 11
Share of recurring premium pension insurances in new acquisitions and their average premium



Source: MNB

The gross premium allocable to pension insurances was in line with the portfolio increment and amounted to almost 31 billion in 2015, of which HUF 2 billion comes from single premium (unit-linked) pension insurance contracts and HUF 7.1 billion from (regular premium) traditional policies. In 2015, the number of the new regular premium pension insurance contracts equalled almost one-quarter of the non-pension regular premium new acquisitions; with the stabilisation of the pension insurance market the volatility of the ratio in the individual quarters is decreasing. At the end of 2015, the 12-month regular premium allocable to the new pension insurance contracts was HUF 208,000, varying between HUF 155,000 and 305,000 among the institutions. In the case of non-pension contracts, the figure is HUF 146,000, which suggests that there is higher propensity to save in pension insurances. This may be also attributable to the fact that the average age of persons contracting pension insurance products is 45 years, i.e. the high-income active age-group.

Until the end of 2015, insurers made payments only in respect of 1.5 per cent of the pension insurances, almost 87 per cent of which was incurred in relation to contracts terminated due to surrender. In the case of pension insurance, the tendency to cancel the contract is lower than in the non-pension portfolio, which is attributable to the fact that if the contract is terminated for reasons other than pension insurance payment, the total tax allowance plus 20 per cent must be repaid to the tax authority. Accordingly, based on the experiences so far, it may be assumed that the retention period of pension insurances may substantially exceed the average retention period of 6.4 years registered for life insurance. This retention period, which may exceed 10 years, would also have a positive effect on the insurers' profitability, even under the decreasing total cost indicators attributable to the ethical concept.

Boosting effect of the decreasing interest environment slackened in the single premium market

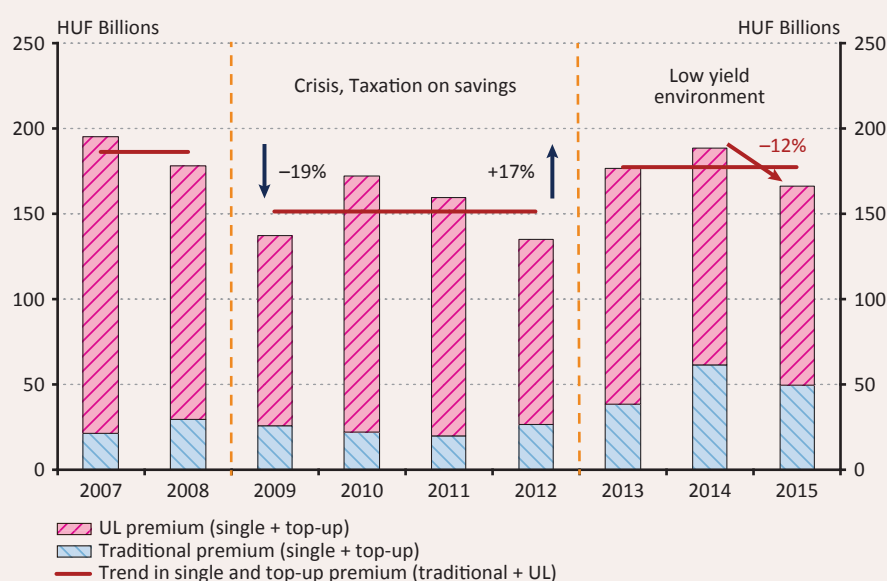
The single premium life insurance portfolio has been continuously decreasing since the end of 2012, albeit at a decelerating rate: by the end of 2015 the number of contracts fell below 480,000. The deceleration in the portfolio shrinkage (-16 per cent on an annual basis) was unable to offset the low increment. The decline in single premium contracts was attributable to the decrease in traditional life insurances; in 2015 the 25 per cent decrease in the number of new life insurances on an annual basis is an extraordinary indicator. The slow shrinkage that characterised the single premium unit-linked portfolio between 2012 and 2014, halted by the end of 2015; the number of contracts has not changed materially compared to the end of last year.

In 2015, the single and top-up premium at the sector level (almost HUF 166 billion) declined by 12 per cent compared to 2014: the increase in premium income seen in 2012-2014 halted in 2015 and fell back to close to the premium level of 2009. Compared to last year, the decline is attributable to the lower single and top-up premiums related to traditional contracts, and to unit-linked single premium. The ratio of single and top-up premiums from unit-linked life insurances rose to 70 per cent year on year, compared to top-up and single premiums across the

sector. On an annual basis, the top-up premiums received for unit-linked contracts were higher by almost 17 per cent, the effect of which is not felt at sector level. Higher unit-linked top-up fees arose at several smaller market participants, while concentration is higher in the case of the traditional single premium life insurances. 94 per cent of the change in the traditional top-up premium in 2015 is attributable to a single institution and more than 76 per cent of the sector level traditional single premium is also generated at this institution.

In terms of the single and top-up premium income, the concentration of the life insurance market increased compared to the end of last year, as the share of the market leader rose above 30 per cent compared to last year's 26 per cent. The number of institutions with a market share of 5 per cent or more fell to 4, while the share of three insurers is close to 5 per cent, and their sequence has changed.

Chart 12
Premium income of single and top-up premium contracts



Source: MNB

Outstanding growth in the non-life insurance market

Non-life premium incomes developed fundamentally differently in the case of motor insurance (compulsory motor third party liability insurance, casco) and the rest of the business lines, dominated by property insurance. The annual gross written premium of non-motor insurance rose by 3.5 per cent on average over the last 9 years. The steadiness of growth is reflected by the fact that the premium income has not once departed from the linear trend by more than 3 per cent. The declining trend in the growth of household property insurance, accounting for 40-45 per cent of non-motor insurance premium income (96 per cent of which is home insurance) is mostly attributable to indexations, thus it is a natural consequence of the decreasing inflation. Enterprise property insurance continued to stagnate in 2015. It is at the 2006 level, both in terms of premium income and number of policies.

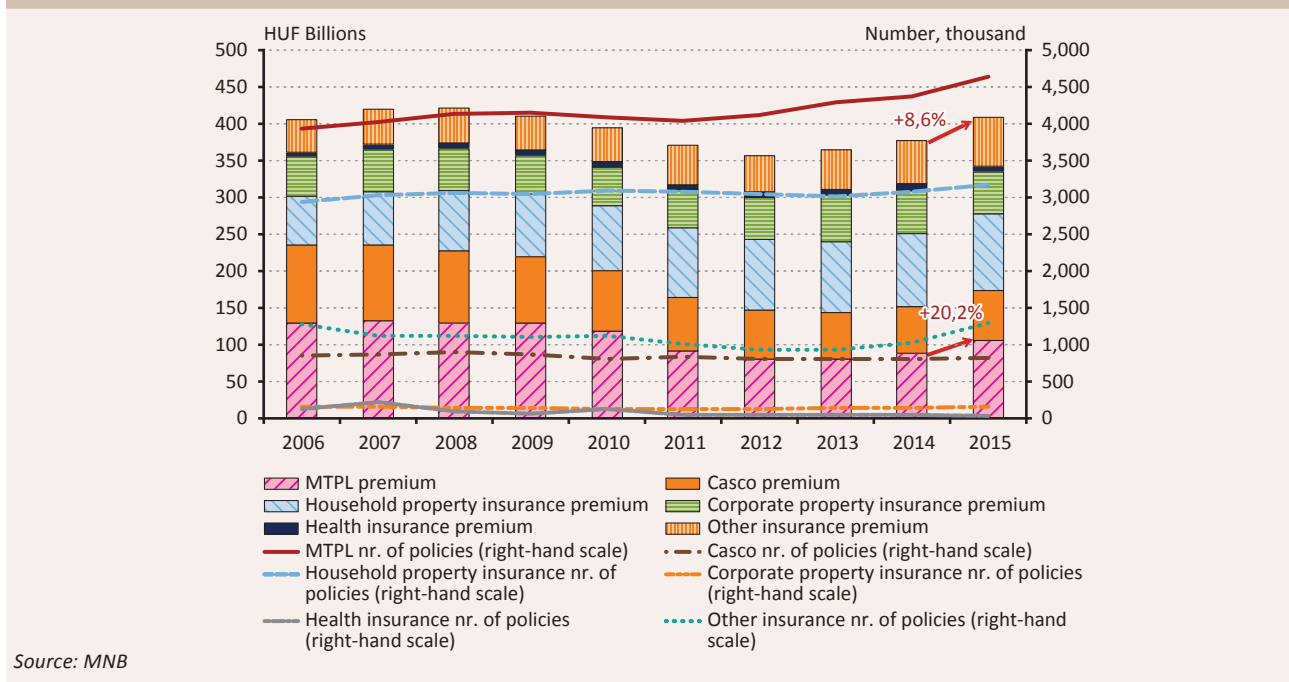
As a result of the amendment of the Civil Code, which entered into force on 15 March 2014, there were legislative changes in the directors' and officers' liability insurance and in corporate liability insurance, but the positive impact of this is not yet reflected in the volume of sales. Although the 12 per cent increase in the premium of other liability insurances is extraordinary, this growth is unbroken since 2010 and thus cannot be attributed to the change in the Civil Code. The expected breakthrough failed to happen in the area of health insurance as well: still only a small proportion of the premium incomes comes from these products.

The number of accidents involving bodily injury and the number of casualties fell substantially between 2006 and 2012, by 5.2 per cent and 6.5 per cent, respectively. In the same period, MTPL claim frequency decreased

to an even greater degree, falling by 8.7 per cent on average. This downward trend in risks was tracked by the insurers, which was the fundamental cause of the fall in MTPL premiums by 7.9 per cent per annum on average. In 2013-2014, this decreasing trend in risks turned around, and by 2015 the same ratios reflected an annual increase in risk of 2.53 per cent on an average. On the other hand, the claim ratio of the MTPL business rose to such a dangerously high value that it justified and necessitated a larger premium increase. The 20.2 per cent growth in gross premiums recorded in 2015 was attributable to a considerable extent to the increase in the number of policies by 7.4 per cent.

A similar phenomenon was observed in the casco segment due to analogous reasons. The segment recorded the highest premium income in 2006, followed by a gradual, average 7.1 per cent per annum decrease until 2013; however, the boom observed in 2015 in respect of MTPL, did not take place in this segment. The more modest 7.7 per cent growth is attributable to the smaller rate of portfolio increase (3.3 per cent), the higher popularity of the partial casco insurance – to the detriment of comprehensive casco – taken out only for theft or breakage, and also to the fact that the loss ratio of the casco segment did not justify an extraordinary premium increase.

Chart 13
Distribution of the non-life insurance premium income by segments



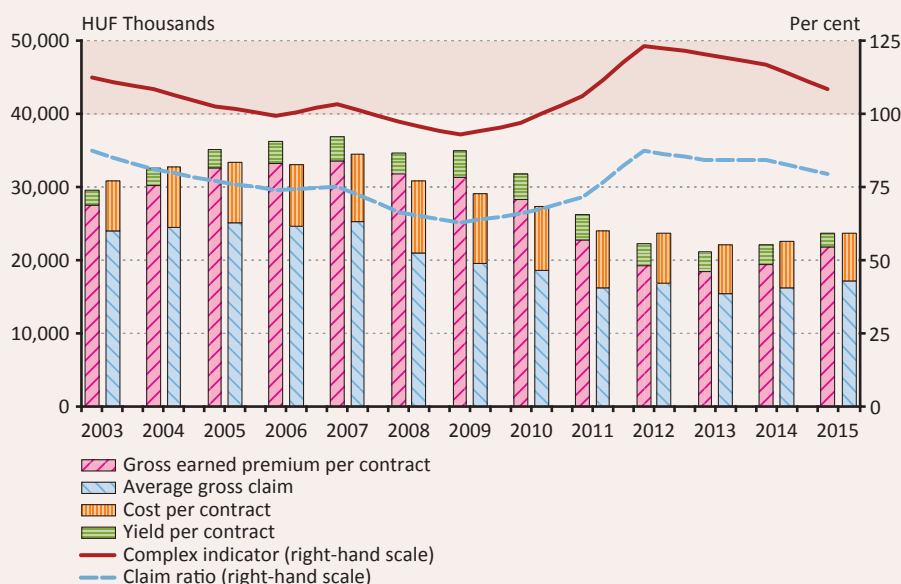
2.3 RISKS OF THE INSURANCE MARKET

The MTPL loss ratio and combined ratio decreased, but are still at a critical level

The premium per policy decreased to a greater degree than the rate of decline in risks (see above), falling by 10.5 per cent per annum on average between 2007 and 2013. Consequently, premiums dropped to such a low level that they no longer covered the claims and costs, even together with the yield realised on the reserves, at the level of the whole market. The gradual decrease in yields and the rise in per policy claims further exacerbated the situation and an adjustment became unavoidable. By 2015, the gross earned premium per contract rose by 12.4 per cent to HUF 21,738. By contrast, according to our estimates the claim per policy increased by only 5.9 per cent, of which 1.9 per cent is attributable to the change arising from the increase in risk resulting from the restructuring of the vehicle fleet. The other possibility for adjustment, representing a much lower weight, i.e. cost cutting, was implemented only partially. The rise in acquisition costs (5.1 per cent) and administrative costs (4.3 per cent) outstripped the volume of portfolio increase (3.4 per cent), and thus the cost per contract rose slightly (by 1.3 per cent). However, the rise in costs fell short of the intensity

of the premium increase, which resulted in a decrease in the cost ratio (from 32 to 28.8 per cent³). By 2015, the income and expenditure side was essentially balanced, but profitable operation (with special regard to the expected decrease in yields and increase in claims) is conditional upon an additional premium increase.

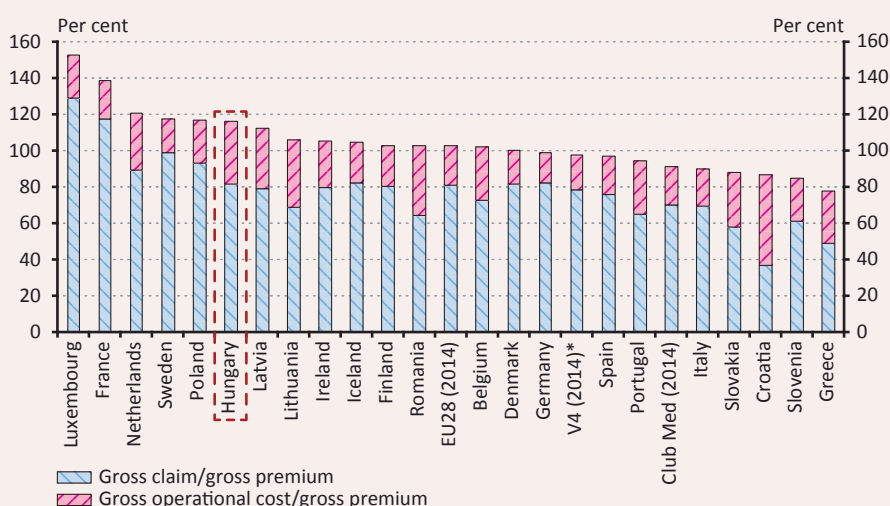
Chart 14
Changes in the MTPL combined ratio



Source: MNB

When comparing the Hungarian combined ratio with that of other countries, it is clear that the Hungarian value is among the highest. This is the result of the premium decrease observed in previous years, due to which Hungarian MTPL premiums are low by international standards. Considering the data of the 21 European countries where the necessary data are available, the Hungarian loss ratio is somewhat below the average, while the cost ratio is above average. This is primarily attributable to the low premium level.

Chart 15
Hungarian MTPL combined ratio in an international comparison in 2014

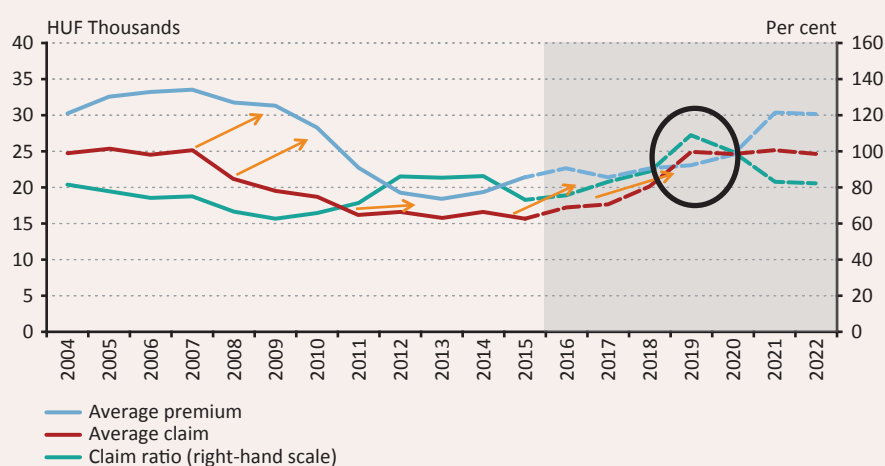


Note: The gross operational costs data of the Czech Republic were not available, thus in the absence of this the average of the Visegrád Four was not calculated.
Source: EIOPA

³ In line with the logic of the income statement, claim settlement costs are recognised among claims, while investment costs were accounted for among yields.

After 2007, the adjusted loss ratio⁴ per policy started to fall, which was also followed by the average 12-month regular premium per contract, but only with a lag of roughly two years. The reason for this is that insurers calculate their motor third-party liability insurance premiums usually on the basis of the claim history for the last eighteen months. In Chart 26, we used arrows to indicate the points where the premium calculation inertia is significantly visible. In 2012, the premiums dropped to one of the lowest values of the period under review, where the insurers had to use the highest proportion of the premiums up until that time, i.e. 86 per cent on claims and claim settlement. By the end of 2015 this indicator had decreased, amongst other things, due to the MNB's firm communication related to the need for an increase in premiums. The latter is desirable, *inter alia*, due to the fact that with the further increase in premiums (in parallel with the rise in risk) the operation of the sector may also become stable. Accordingly, in the coming years the premiums are likely to increase to a large degree to ensure that the loss ratio remains consistently below 80 per cent.

Chart 16
Deferred changes in the MTPL average premium



Source: MNB

Box 1

The "ASTRA" Case

The Romanian insurance company Societatea Comerciala de Asigurare-Reasigurare Astra S.A. established a branch office in Hungary in 2010 (Astra branch office). In the European Union, the freedom of establishment makes it possible for an insurance company – just like any other financial institutions – to operate in another member state also in the form of a branch office, based on the principle of freedom to provide services. However, in terms of supervisory competence there is a significant difference between pursuing an activity in the form of a subsidiary and the oversight of a branch office's operation. While in the case of a subsidiary the full prudential and consumer protection oversight belongs to the home country's supervisory authority, in the case of branch offices the oversight competence is shared. Prudential oversight, e.g. monitoring the insurer's financial situation and the rights to take potential measures, remains the competence of the home country, while the competence of the host country solely includes the oversight of the consumer protection aspects of its operation in the market of the given country, i.e. the supervision of public good. The definition of the oversight competences at EU level is in line with the fact that in terms of its legal status the branch office continues to function as part of the parent company.

Due to the financial difficulties of the Romanian parent company revealed in 2014, the Romanian supervisory authority (ASF) took measures aimed at restoring the insurer's shaken capital and reserve position, which – as follows from the aforementioned regulatory principles – also had a substantial effect on the operation of the Hungarian branch office. In

⁴ Adjusted loss ratio: taking all claim reserves into account, adjusted by the change in the prudence level of the outstanding claim reserve.

view of the fact that in the given case the MNB, as host supervisory authority, had no competence to take prudential supervisory measures, it turned to the Romanian supervisory authority and developed close cooperation with such for the management of ASTRA's crisis, bearing in mind that the branch office operating in the Hungarian market had a substantial portfolio, including almost 200,000 insured persons. Due to the failure to restore ASTRA's financial stability, on 31 August 2015, the ASF withdrew its activity licence and initiated liquidation at the competent court; the Romanian court ordered liquidation on 3 December 2015 and appointed a temporary court liquidator. The Romanian appellate court ordered the liquidation of Astra Insurance Company on 28 April 2016 by a legally binding judgement.

Within the framework of the supervisory cooperation, the MNB gave priority to the management of the Hungarian consumers' interest throughout the procedure and took all necessary measures to protect the Hungarian insurance market and prevent potential turbulences:

- On its website it informed the Hungarian customers in notices about the latest developments in the ASTRA case and called their attention to the actions to be taken, the places where they can submit their claims and the deadlines.
- The notices were also published on its English language website, which were also monitored by the affected peer supervisory authorities.
- It liaised and continuously consulted with the supervisory authorities of Slovakia and Germany, where ASTRA also had branch offices.
- It urged the ASF to prepare the Hungarian language forms, suitable for submitting the claims for payment to the Romanian Guarantee Fund (FGA), as soon as possible. The forms are already available for the customers on the website of the Romanian guarantee fund in Hungarian as well.
- It signed a Memorandum of Understanding (MoU) with the ASF to strengthen the oversight of cross-border activities.

Since no EU rules are available with regard to the operation of guarantee schemes to be applied to cross-border services upon the bankruptcy of an insurance company, the MNB took measures to manage ASTRA's prolonged crisis situation to prevent long delays in the indemnification of Hungarian customers:

- It conducted ongoing consultations with the Association of Hungarian Insurance Companies (MABISZ) and urged the conclusion of an agreement with the Romanian guarantee fund as soon as possible. The two parties signed the agreement on the division of payments of MTPL claims in January 2016.
- Based on the legislative changes, effective since 8 October 2015, as a result of the MNB's proposed amendment of law, in the case of Astra claimants the Indemnity Account (IA) managed by MABISZ accepted the claim reports and the IA also advanced claim payments. However, when liquidation becomes legally binding, the claim payments are no longer made from IA, but from the Hungarian Guarantee Fund, which then will settle accounts with the Romanian guarantee fund (FGA).
- The MNB monitors the process of how the MTPL clients of the ASTRA branch office conclude new contracts with other insurers, and in order to mitigate and identify the prudential risks resulting from this, it also launched investigations on institutions.

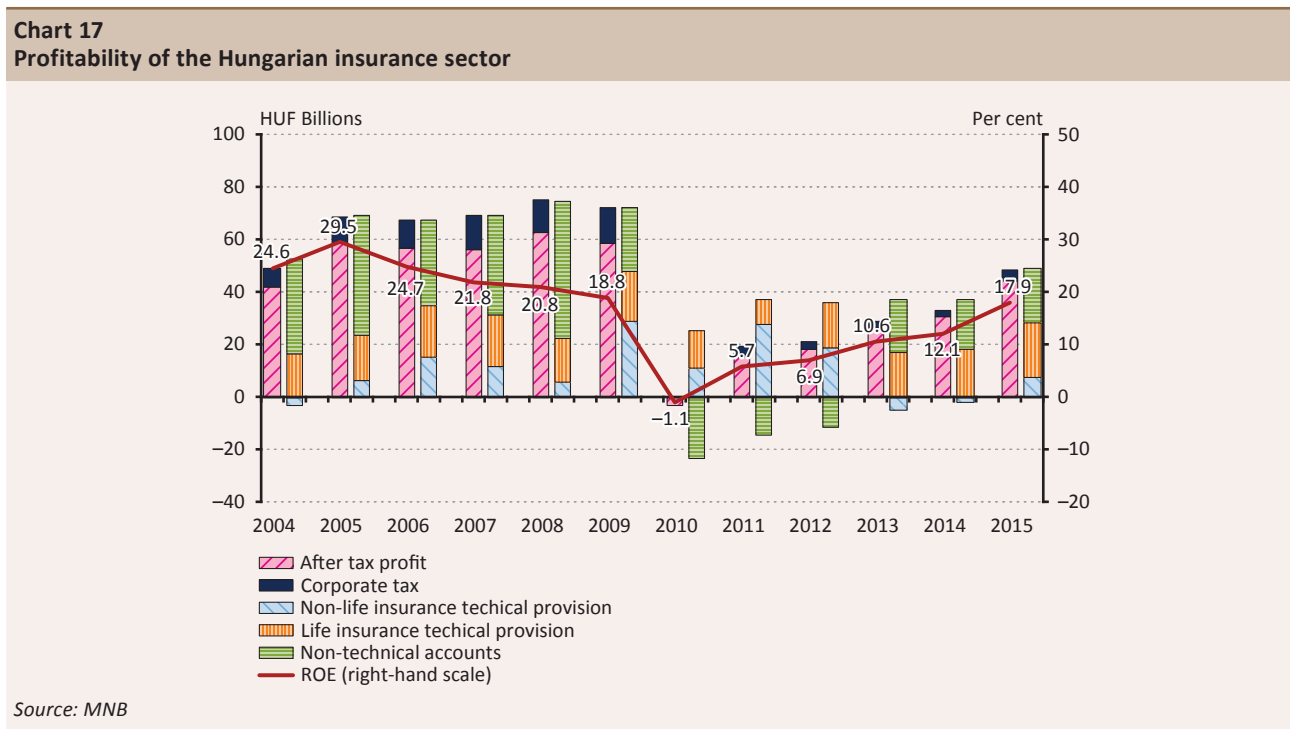
In addition, the MNB reported to the competent European supervisory authority (EIOPA) the general regulatory problems that surfaced in relation to this case, the resolution of which calls for measures to be taken at EU level (e.g. shortcomings in the regulation of guarantee schemes, management of national double guarantees, cooperation of supervisory authorities in the case of cross-border insurance services). The increasing risks inherent in the operation of branch offices present challenges for the supervisory authorities in other EU Member States as well, and consequently a review of the rules is also unavoidable at the international level.

Continuing positive trend in terms of profitability

The insurance sector’s average after-tax return on equity (ROE) has been rising since 2010. In 2015, ROE came close to the values seen in the pre-crisis years. The ROE of 18 per cent at the sector level exceeds that of 2014 by one and a half times, which is primarily attributable to the better performance of the non-life segment, as a result of which it became profitable once again.

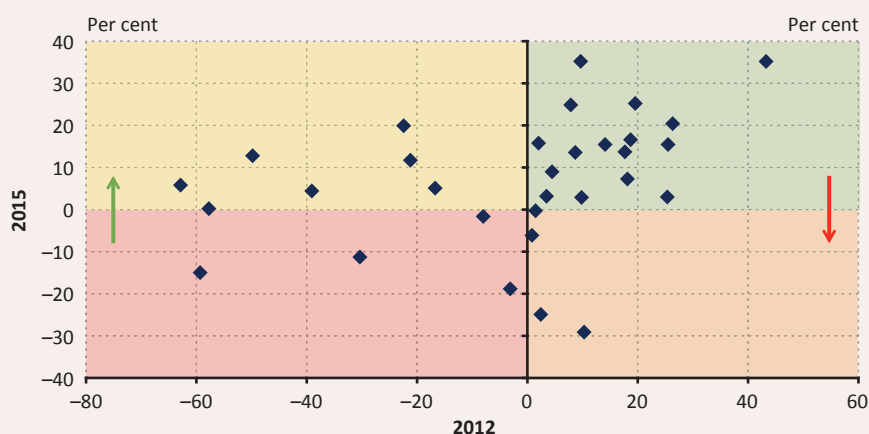
The yield realised on reserves is likely to have a decreasing effect on profitability in the future due to the low yield environment; however, at present the still higher yields do contribute to profitability. The technical result in the life segment has been stable since 2004. The volume of actuarial reserves, related primarily to traditional life insurance policies, is gradually decreasing due to the contraction of the portfolio; these developments are offset by the increase in reserves related to unit-linked products.

At the actors offering MTPL insurance, another factor key to increasing profitability could be the improvement of the segment’s profitability, while in the life insurance segment this may be the commencement of the reduction of acquisition costs.



The profitability of the actors shows a mixed picture in respect of the last 3 years (Chart 28). Half of the companies can be deemed to be persistently profitable (green field), as they were in the positive range also 3 years ago. On the other hand, four companies pursue persistently loss-making operations (red field) and may need to change their business models to preserve their long-term viability. In the previous years, another four companies became loss-making (orange field), while the profitability of seven companies turned positive (yellow field).

Chart 18
ROE value of Hungarian insurers



Source: MNB

Date of the changeover to S II is positive for capital adequacy, while some institutions may face problems

The capitalisation level of the Hungarian insurance sector stabilised at a level of around 200 per cent in recent years. Substantial profit was generated at the sector level in 2015 as well, but similarly to previous years, owners are likely to withdraw it from the insurance companies as dividend, and thus the capital surplus (and their capitalisation rate) may fall by HUF 40-45 billion, based on the previous years' data. During the years of the crisis, in parallel with a decline in profitability, owners decided on the payment of dividends in excess of the realised profit. This had a dual effect: it led to the erosion of the surplus capital accumulated at Hungarian subsidiaries until then and to capital accumulation at the owners.

Distribution of dividends in excess of the current year's profit is no longer typical: the decrease in surplus capital and maintenance of the capital level required for operation have put a stop to this process. Examining the earlier decrease in capitalisation from a different aspect, we find that insurers' capital requirement has contracted only to a slight extent, i.e. by 5 per cent since 2010, while the surplus capital has fallen by 30 per cent during this period. On the other hand, the latter is rather concentrated, since in 2015 the four insurers holding the largest capital buffers provided 45 per cent of the entire sector's capital surplus.

Scheduled for introduction in 2016, Solvency II will have a considerable impact on the sector's capital position. First, the decline in technical reserves and the market-based valuation of assets will result in growth in surplus capital. Second, after the new regime enters into force, the volatility of the capital adequacy ratio may increase. The expected increase in volatility stemming primarily from market valuation and a greater variability of market prices is corroborated by the findings of the Solvency II quantitative impact analyses. This phenomenon mainly represents a real risk for market participants whose capitalisation is low, where higher volatility may result in an unexpected shortage of capital.

Based on the insurers' first, opening data provision under Solvency II, the capitalisation rate at the sector level reflected a better value according to the new regulation than in Solvency I. The value of 209 per cent is more favourable than the indicator under the previous regime, despite the fact that this already includes the dividends paid in respect of the 2015 profit in full. As regards the individual data, of the capitalisation rate of the reporting⁵ insurers only one falls short of 100 per cent, but the capital increase performed in the first quarter resolved the situation of this institution as well. The capital adequacy ratio is below 150 per cent at further six institutions. Apart from this, the data of one insurance union are not yet known, but a supervisory commissioner took control there, as a result of the MNB's early intervention.

⁵ All but one insurer fulfilled the reporting obligation by the deadline.

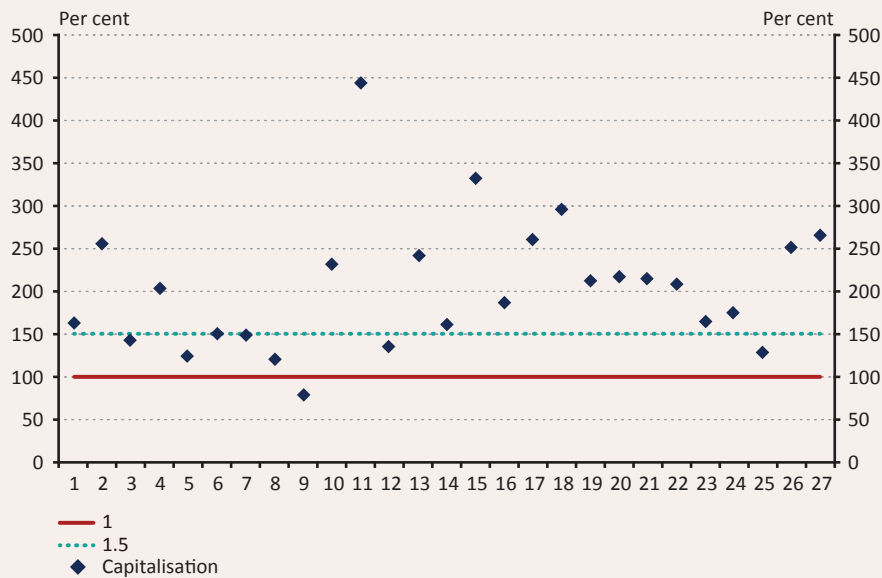
Chart 19
Average capitalisation rate of insurers under Solvency I



Source: MNB

Since the deadline for submitting the reports was 20 May 2016, these results may be regarded as preliminary data, whereas the final data will be generated after data quality check. At the same time, it can be stated that – based on the capital adequacy data – the changeover to the Solvency II regime took place under favourable circumstances.

Chart 20
Capitalisation rate of individual Hungarian insurers
(2015)



Source: MNB

Box 2**Results of the Last Solvency II Impact Analysis Performed in Preparation for the New Regime**

With a view to preparing for the Solvency II data provision requirements introduced on 1 January 2016, in February 2014 the Magyar Nemzeti Bank requested the insurers which were expected to fall within the scope of Solvency II to submit the information defined in accordance with the guidelines issued by EIOPA (EIOPA, 2013). The purpose of the exercise was for the MNB to assess the impact of the introduction of Solvency II on the insurers' financial position, both at the level of the entire sector and individual institutions.

On the whole, the asset value under Solvency II exceeds that of Solvency I by 1 per cent, and at the end of 2014 it exceeded HUF 2,630 billion. This difference developed despite the fact that – due to the different valuation approaches – intangible assets, deferred acquisition costs, deferred tax assets and receivables from reinsurers are stated within the Solvency II assets with a value that is lower by HUF 109 billion in total.

The value of the end-2014 Solvency II technical reserves fall short of the Solvency I value by 13 per cent. The difference is lower by 4 percentage points than the value seen in the 2014 impact analysis, which is mostly attributable, of the typical reasons explaining the difference between the Solvency I and II reserves, to the lower yield environment. According to our estimate, in the case of traditional life insurance reserves, the decline in the risk-free yield curve by 179 basis points on average increased the volume of the end-2014 reserves – ceteris paribus – by almost 14 per cent compared to the end of 2013. We obtain a similar finding in respect of non-life insurance reserves as well.

Distribution of the gross capital requirement at sector level at the end of 2014*HUF million*

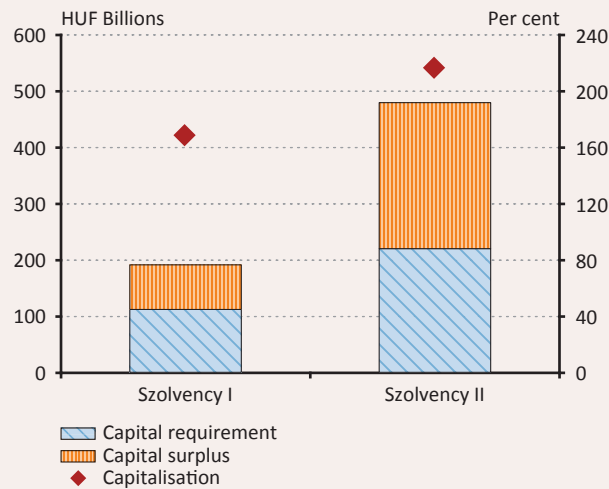
| | QIS2014 |
|-------------------------------------|----------------|
| Market risk | 94,968 |
| Counterparty risk | 37,427 |
| Life insurance risk | 78,178 |
| Health insurance risk | 11,138 |
| Non-life insurance risk | 111,528 |
| Intangible asset risk | 257 |
| Operational risk | 25,487 |
| Diversification | -96,951 |
| Adjustments | -42,731 |
| Solvency capital requirement | 219,300 |

Source: MNB

The solvency capital requirement of the insurance sector rose by 97 per cent compared to Solvency I. In the Solvency II system, insurers are required to accumulate large volumes of capital for a number of risks that do not appear explicitly in the calculation of the solvency capital requirement under the current rules, or they have no proportional relation to the input data of the present capital requirement calculation (e.g. reserve holding, premium income, reinsurance ratio). The insurance sector's solvency capital requirement under Solvency II was HUF 219 billion at the end of 2014, a major part of which related to three risk modules: life, non-life and market risks.

The capitalisation rate of the sector at the end of 2014 is 217 and 169 per cent, on the basis of Solvency II and Solvency I, respectively. The increase in the capital adequacy ratio is caused by the fact that although both the solvency capital requirement and the volume of solvency capital doubled, the quantity effect of the latter is stronger. This results in a substantial increase in capital surplus (from HUF 78 billion to HUF 260 billion).

Capitalisation rate of the Hungarian insurance sector based on Solvency II



Source: MNB

Thus, the capitalisation rate may be deemed adequate at the sector level, but there is significant variance at the level of institutions. At the end of 2013, the capitalisation rate of two institutions did not reach 100 per cent on Solvency II basis, and this number rose to four at the end of 2014.

Due to the market price fluctuations, the capital position in the Solvency II regime is likely to become more volatile than at present. Since in 2014 the external environment changed only to a small degree, and the fall in yields had a positive impact on the solvency capital on the whole, only a small shift occurred in the capitalisation rate between 2013 and 2014.

Adjustment to S II and to the low yield environment is a challenge for the insurance sector

The insurers' risks at the level of the sector are classified as moderate or significant, while the outlooks are typically stable. The increase in certain risks in the case of insurers may be attributable to the Solvency II regime introduced on 1 January 2016.

Solvency II significantly modified the corporate governance requirements, part of which are applicable already since 1 July 2014. It may be stated with regards to the entire sector that the institutions do apply the rules: they developed the appropriate roles and appointed the relevant persons for such roles based on the MNB's approval. The risk is rated as being significant due to the operation of the insurers' control system and the integration of the information provided by them (e.g. ORSA report) in the strategy development and decision-making process. As a result of the learning process during the adjustment to the new regime, the degree of the risk may decrease in the future.

The high level of the risk of market entry is caused by the products with not sufficiently transparent cost structure that are less compliant with the low yield environment. The present short retention period of life insurance products may be a sign of the unfavourable cost structure and low customer confidence. In the future, the retention period of the contracts may be improved by the MNB's ethical life insurance concept and the spread of pension insurance products diverted by the recommendation.

| Chart 21 Risk map of the insurance sector | | | | |
|---|---|---------------|--------------|---|
| Type of risk | Source of risk | Level of risk | Risk outlook | Details of the source of risk |
| Corporate governance | Adjusting to the S II requirements | | | The insurers apply the S II corporate governance rules. The highly important roles were established and the people performing those were appointed. However, the fact that the information generated by the risk management system is not sufficiently integrated in the insurers' strategic decisions, can be regarded as a major risk. In the future the risk may be mitigated by the insurers' adjustment to the new framework. |
| Market entry | Products with limited cost structure transparency and with poor adjustment to the low yield environment | | | Now the retention period of the life insurance products is short, which may signal unfavourable cost structure and low level of customer confidence. The retention of contracts is expected to improve as a result of the MNB's ethical life insurance concept and the boom of the recommended pension insurance products. |
| Operational risk | Portfolio management shortcomings, starting S II data supply | | | On the basis of the on-site audits, the operational shortcomings noted earlier still exist, especially in respect of portfolio management and the operation of the IT systems. These shortcomings represent the risk of substandard quality of reported data, with special regard to the new content and form of it in the S II regime. Mitigation of the operational risk is not expected in the short term based on the supervision experience. Under the persistently low yields asset portfolios may shift toward instruments of higher risk. |
| Insurance risk | Earning the guaranteed interests is crucial, high MTPL combined ratio | | | In the life insurance sector the low yield environment constitutes a risk in terms of earning the guaranteed interest, while in the non-life sector the expected increase in MTPL claims may cause a further increase in premiums. In the household property segment the possibly growing number of natural disasters may be a risk for some insurers. |
| Profitability | Low yield environment, business model problems, economies of scale problems | | | ROE is competitive even by international standards, and the number of loss-making institutions is decreasing. The loss-making institutions have mainly business model and economies of scale problems. In the life sector the instable and thus less profitable portfolios can represent risk in the future, while in the non-life sector the MTPL claims and the low yields may have a negative impact on the profitability. |
| Capital adequacy | Persistently loss-making operations, owner's ability and willingness to perform capital injection | | | Stable S I capitalisation at market level, but at some institutions we identified problems that call for an action plan. Transition to S II means improvement in terms of capitalisation for half of the sector, however it significantly undermines the capitalisation of certain institutions, especially those who have poor capital injection ability. As a special feature of the S II regime, an increase in volatility is expected, which justifies keeping volatility capital buffer. |
| Legend: Degree of risk: high significant moderate low Direction of risk: increasing stagnant decreasing | | | | |

The recent on-site audits revealed material operational risks at a number of institutions, particularly in respect of portfolio management and the operation of IT systems. These shortcomings result in persistently high levels of operational risks, which may appear in the substandard fulfilment of the insurers' data supply obligations, with special regard to the fundamentally new content and form of Solvency II reporting system. In the knowledge of the operating requirements prescribed for insurers and based on the oversight experiences, the operational risks are unlikely to decrease in the short run. The asset portfolios may shift toward riskier assets, if the yield level remains persistently low.

Upon assessing the significant level of the insurance risk, the assessment of institutional prudential risks related to MTPL should be emphasised in the non-life insurance segment due to its market significance and the public interest represented by it. Under the fierce competition experienced in the MTPL market, the premium level visibly started to increase. In view of the fact that – due to low fuel prices and the increase in the number of registered vehicles – the number of accidents and bodily injury claims are likely to increase, it may be necessary to raise the premiums to ensure that the received premiums cover the insurers' losses and costs, reflecting a high combined ratio already now. In the life insurance segment, the low yield environment poses a risk in terms of achieving the yields (technical interest rate) undertaken for the traditional products, which account for around one-third of the portfolio. The impact of the low yield environment is smaller on the non-life segment, but the lower investment result raises the need for more conscious premium policy and cost management even here. Based on the foregoing, the risk level is unlikely to decrease in the coming period.

The sector's return on equity has been on the rise since 2010 and can be deemed adequate, despite the considerable variance among the individual institutions, while the risk level is moderate. The institutions that represent a material weight in the market are profitable, and there is a decline in the number of persistently loss-making insurers as well. In the case of the loss-making institutions, the key causes primarily include economies of scale problems, but additional factors may be identified by insurance segments. In the life insurance segment, profitability is substantially restrained by the relatively high level of acquisition costs, characterised by a statutory cap on commission and cost level stipulated in a recommendation since 2015. As a result of the commission rules, an adjustment process may be expected and the MNB continuously monitors and backtests the implementation thereof. The life insurance segment is characterised by a trend whereby in parallel with the phase-out of the traditional life insurance products, experiences show that in the case of the non-pension purpose products the build-up of a portfolio of the less stable unit-linked products may be expected. This impact is offset by the pick-up in the sales of pension insurance contracts. In their case, the nature and, as a result of the MNB recommendation, the low cost level of the product is expected to result in a stable portfolio. In the non-life segment the profitability of the traditionally loss-making MTPL segment shows an improving trend.

According to the evaluation of the preparatory data supply performed by insurers in 2015, the Solvency II capital position is satisfactory and of moderate risk across the sector. At the same time, the novelty of the methodology applied in the new capital calculation method raises compliance-related questions more intensively. On the other hand, the increasing volatility of the capital adequacy compared to the current one may result in higher risk levels than at present, which justifies the application of the volatility capital buffer.

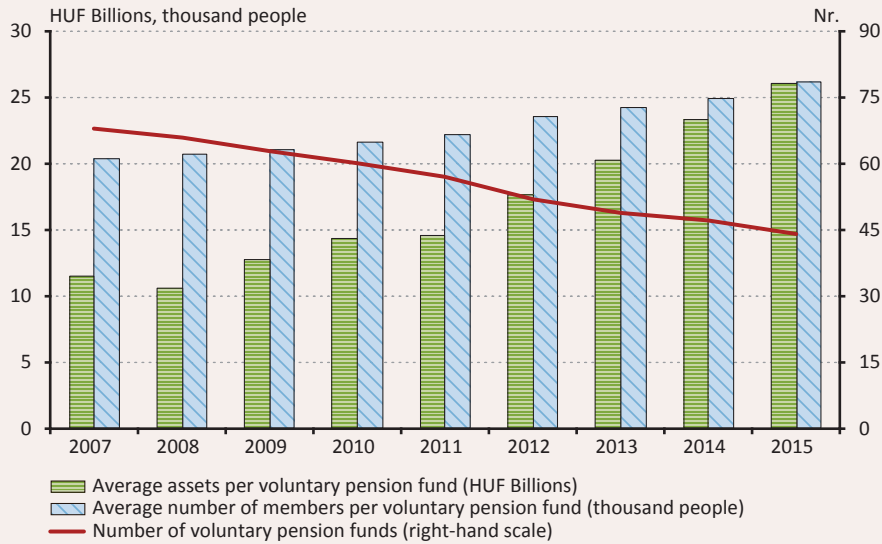
2.4 ANALYSIS OF THE SITUATION OF THE VOLUNTARY MUTUAL INSURANCE FUNDS MARKET – VOLUNTARY PENSION, HEALTH AND MUTUAL AID FUNDS

Increasing concentration in the voluntary pension fund market

In the case of smaller funds, the loss of support due to the liquidation or restructuring of the background institution complicates the maintenance of the institution, which may result in further mergers and fusions. In view of the institutions that are fewer in number, but manage larger volume of assets and have higher membership, and thereby represent a larger "systemic risk", the risk focuses are also reconsidered during the review of the oversight methodology.

The market concentration of the pension fund market is also increased by the restructuring and mergers of institutions. In 2015, three funds merged with larger ones, thereby reducing the number of institutions to 44 by the end of the year.

Chart 22
Average assets and membership per voluntary pension fund; developments in the number of voluntary pension funds

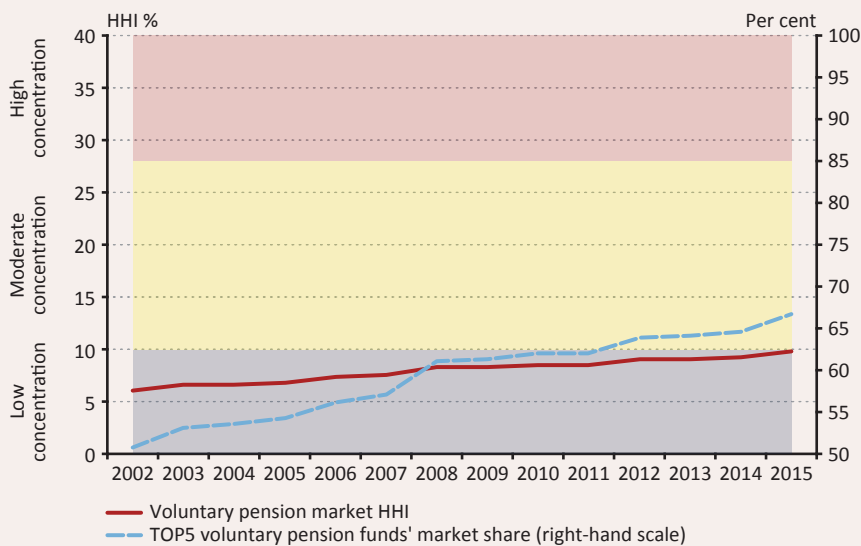


Source: MNB

Since 2003, the concentration of the voluntary pension fund market has been increasing annually by 4 per cent on average.

The developments of members’ contributions share of the TOP5 pension funds– as an indicator – points to a further increase in concentration. In the case of the five largest funds, the ratio of non-paying members exceeds the average of the sector by 3.2 per cent, which also represents a potential reserve in respect of the membership fee revenues. At the same time, the Herfindahl–Hirschman index (HHI) of the funds market still signals low concentration.

Chart 23
HHI of the voluntary pension fund market and the share of the top five companies



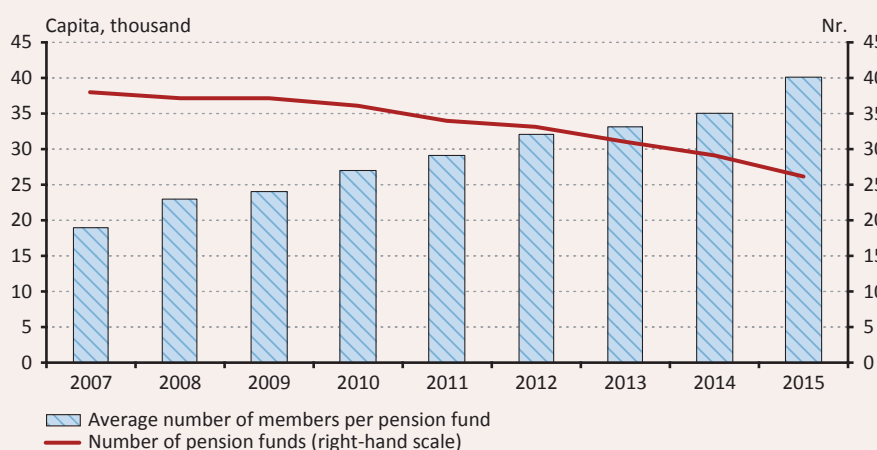
Source: MNB

Concentration of membership by institution can be observed at health funds and mutual aid funds

In the case of the voluntary pension funds, the increase in the concentration level is larger than the level observed at the health and mutual aid funds, which is primarily attributable to the fact that the membership fee payments to voluntary pension funds are much higher, and the yields also play a more important role in the accumulation of assets. As a result of this, the coverage reserve of the voluntary pension funds, available for services, is also higher, and thus in the case of a merger the assets and membership per institution increase to a larger degree.

The decrease in the number of health funds is largely attributable to the termination of background support by employers. It follows from their nature that the continuous contributions and withdrawals at the health funds are smaller in amount than at the voluntary pension funds. Due to the recurring, but smaller amount health fund membership contributions, the level of the operational and liquidity reserves is also lower than at the voluntary pension funds, and thus with the termination of employers' background support, the resources available for operation are also depleted more quickly at this fund type. As a result of this, in the case of the health funds, with the termination of employers' background support, negotiations about the possible mergers with other funds commence within a shorter timeframe than in the case of pension funds.

Chart 24
Number of members per health fund and number of institutions

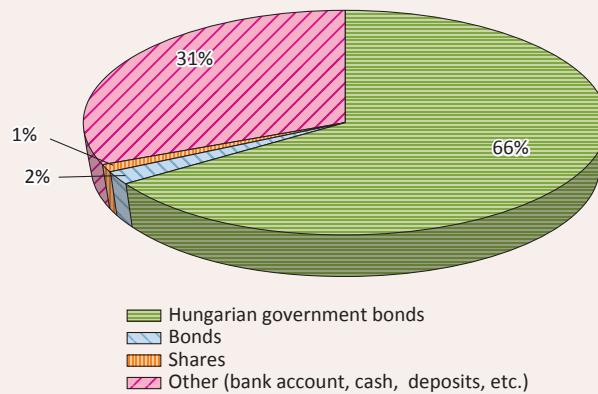


Source: MNB

As follows from their nature, health funds do not manage such large volume of assets as pension funds; their primary objective is to provide continuous fund services. At the end of 2015, the health funds' coverage reserve amounted to HUF 53.7 billion, most of which is held in government securities. The investment rules of health funds and mutual benefit funds were tightened from 1 January 2016: they must diversify their monetary assets and fixed deposits to a greater degree than in the past. As a consequence of the tightening regulation, it may well occur that health funds and mutual aid funds will replace part of their fixed deposits with government securities or will place their savings with several banking groups. Health funds continue to keep the largest part of their assets in Hungarian government securities; apart from this, fixed deposits account for 23.6 per cent of the reserves available for health fund services (on the chart it is included in the "other" category).

Chart 25
Investment composition of the voluntary health funds' coverage reserves

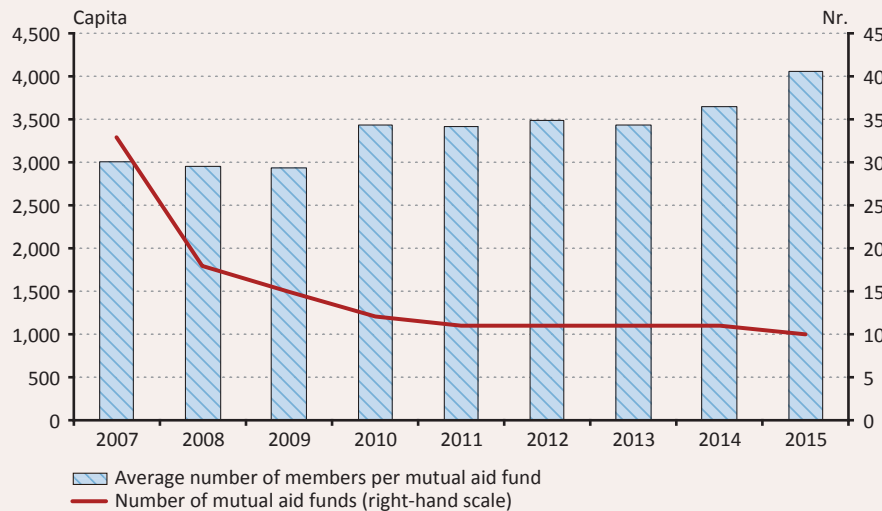
(31 December 2015)



Source: MNB

In the past years, mutual aid funds did not represent a high ratio within the funds sector in terms of either the number of members or the assets. The population is hardly aware of the services that can be rendered by mutual aid funds only. Several of the presently operating mutual benefit funds are linked to a specific organisation (trade union, employer). In the case of the mutual benefit funds, the loss of employers' support has a significant impact on the fund's liquidity position in the short run, which is attributable to the standard, low – compared to the entire funds sector – membership fee and to economies of scale reasons.

Chart 26
Number of members per mutual benefit fund and number of institutions



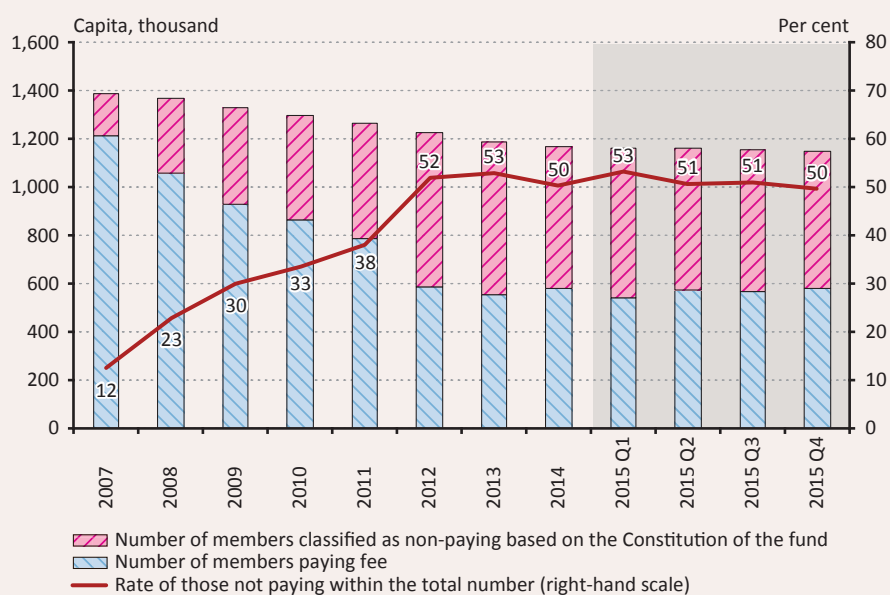
Source: MNB

2.5 RISKS OF THE FUNDS MARKET

Increase in the ratio of non-paying members, which soared during the crisis, has halted, but the number of members continues to decline

Between 2007 and 2015, the number of voluntary pension fund members decreased by 235,855, but in 2015 the rate of decline decreased. The number of members who failed to pay membership fee at the voluntary pension funds dynamically increased from 2007 to 2012, while from the end of 2014 the ratio of non-payers is stagnating.

Chart 27
Ratio of members paying voluntary pension fund membership fee



Source: MNB

Despite the decreasing role played by employers, there is a trend growth in pension fund membership fee payments

In the period of 2007-2011, the individual membership fee paid by members showed a relatively steady trend. After 2011 the proportion of the individual and employer's membership fee gradually turned around, and the volume of individual membership fees exceeded the employer's membership fee contributions. The ratio of individual payments within the membership fee revenues continued to increase in 2015, as a result of which the individual versus employer's membership fee contribution ratio shifted to 65-35 per cent by the end of 2015, from 40-60 per cent recorded in 2006.

The rise in the actually received membership fees continued in 2015 as well. Between 2013 and 2014 and between 2014 and 2015 the amount of the actually received membership fees increased by HUF 7.6 billion and HUF 7.2 billion, respectively, compared to the previous year. Apart from the turn of 2007-2008, no growth of similar magnitude was experienced.

Chart 28
Composition of individual and employer's membership fee payments – written membership fees

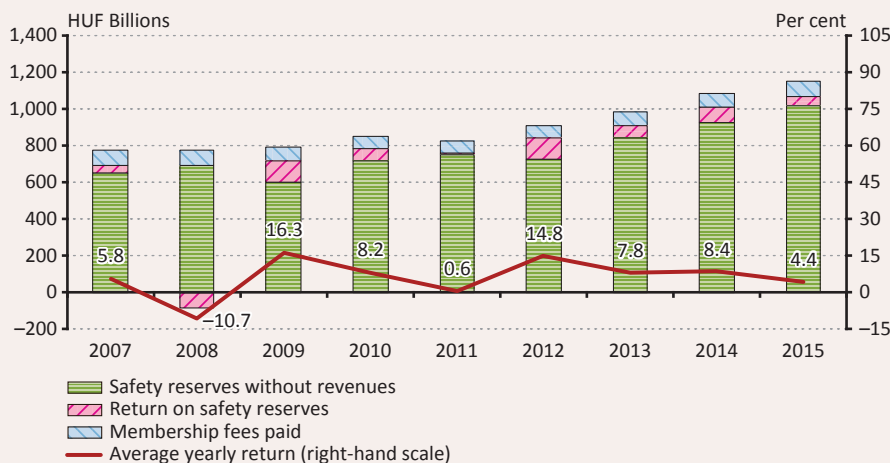


Source: MNB

Pension funds savings are close to HUF 1,200 billion, in an environment of decreasing yields

The yield result contributed to the increase in the coverage reserves of pension funds in 2015 as well. Voluntary pension funds realised an average yield of 4.41 per cent on their investments in 2015, which can be regarded as a positive result in light of the low yield environment. It should be noted that in the case of the voluntary pension funds, in 2015 the items increasing the value of the coverage reserve (positive yield, membership fee payments and employer's contribution, etc.) exceeded the pension service affecting the coverage reserve and the payments due after the 10-year waiting period.

Chart 29
Voluntary pension fund coverage reserve and changes in the return realised on reserves



Note: the closing balance of the coverage reserve at the end of the reporting period comprises of the coverage reserve net of income, the yield on coverage reserves and the received membership fee income together.

Compared to the report issued in 2015, the reader can see in the time series a minor difference in the rate of return, which is due to the fact that the estimation of the return realised on the short-term cash flow became more accurate by taking pay-outs into consideration. We recalculated the rates of return based on this new methodology for the previous years as well.

Source: MNB

Within the number of members at the end of 2015 both the ratio of those entitled to payment within one year and the ratio of the account balances of these members increased (to 63.1 per cent and 77.5 per cent, respectively). Nevertheless, the total assets of the voluntary pension funds did not decrease; indeed the volume of payments to members affecting the coverage reserves was the lowest in 2015 since 2007. This means that the ratio of those who leave their savings in the fund even after the expiry of the waiting period and reaching the eligibility age is high. Presumably, this decision of the fund members is also influenced by the favourable yield results realised by the funds in recent years.

The operating loss of voluntary pension funds is compensated by deductions from the yield in respect of non-paying members

The decrease in the membership fee payment activity rate of fund members stopped at the end of 2012, but in view of the voluntary funds' business model which is based on current payments, as a result of the high ratio of non-paying members, the funds are unable to separate the cover for operational expenses in the traditional manner (i.e. in the amount of the statutory maximum) for half of the members, which has a negative impact on operating profit/loss. For the time being, the possibility to make deductions from the yield realised on the assets of the non-paying members to the benefit of the operating reserves is unable to offset this impact.

Despite the decrease in the ratio of the employer's contribution, the increase in funds members' membership fee payments improved the voluntary pension funds' self-financing capacity and their profitability is adequate for the time being, but there are significant variances at the level of the individual institutions. Up until now, the amount that can be deducted from the yield of the non-paying fund members for operating purposes exceeded the operating loss at the sector level.

The ordinary operating result improved by almost 15 per cent in 2015 compared to the previous year, which is primarily attributable to the rise in membership fee income. However, the financial result decreased by almost the same amount, and accordingly the balance sheet result reflected a loss of roughly HUF 770 million, similarly to 2014. The operating loss was offset by the yield deducted from non-paying members, but the steadily low yield environment may decrease the financial result and the amount of yields deductible due to non-payment, and consequently as a result of these two effects, the pension funds' operating balance in the entire sector may be close to zero. The funds responded to this risk by increasing the standard membership fee rates and extending the maturity of the instruments.

Chart 30
Operating profit/loss of voluntary pension funds and changes in the yields deducted due to non-payment of membership fees











Source: MNB

Major corporate governance and funding risks in the funds sector





In terms of the risks in the voluntary pension fund and health fund sector, the corporate governance and market appearance risks are higher, with a stagnant outlook, while the rest of the risks – with the exception of profitability – are moderate with a stagnant outlook.

Chart 31
Risk map of the voluntary fund market




| Type of risk | Source of risk | Level of risk | Risk outlook | Details of the source of risk |
|-----------------------------|--|---|---|--|
| Corporate governance | Weak ownership control, shortcomings of the internal lines of defence |  |  | The internal lines of defence of some funds do not work properly, while at other funds the operative and actual decision-making competence is overly concentrated with a single person or a group of persons. At sector level the control over the fund management is decreasing due to the withdrawal of background institutions, which results in decisions that are overly independent, not controlled enough, thereby not taking into consideration the interests of fund's members to the maximum, which represents significant risk. Mitigation of the risk is unlikely. |
| Market entry | Difficulties in the acquisition of new members, decrease in the number of members and in the commitment of the employers |  |  | The number of new fund members is low due to the strict commission rules. The number of members is still decreasing, albeit to a smaller degree, in the voluntary pension fund sector, thus this is a high risk. The employers' contribution to the membership fee is continually decreasing in the total payments, thus the risk is unlikely to decrease. |
| Operational risk | Non-paying members, diversification problems |  |  | The increase in the members not paying membership fee has stopped, it is about 50 per cent of the total membership, which represents moderate level of risk. On the other hand, the concentration of investments at some funds is too high in terms of the financial groups. Further increase in the concentration of membership is expected due to the appearance of the new type of health and mutual aid funds. Taken together, these two factors with opposite risk effect do not change the level of the operational risk. |
| Profitability | Decreasing financial result owing to the low yield environment |  |  | For the time being the negative balance sheet result is offset by the deductions for operational purposes from the yields realised on the non-paying individual accounts, which amount may decrease further due to the persistently low yield environment, thus the level of risk is expected to rise. At sector level, the point when the amounts deductible from the yield no longer offset the operational loss, is close. The termination of the employers' contribution may cause problems at the smaller funds. |

Legend:

Degree of risk

high  significant  moderate  low 

Direction of risk

increasing  stagnant  decreasing 

In the case of certain funds, it was found that the internal lines of defence were inadequate: the supervisory board, the internal and external auditors did not perform their audit tasks in the required depth, while at other funds personal risk related to one-man operative management, partly due to the withdrawal of the background institution, was identified. In addition to calling the attention of the fund's management to such, these risks can be mitigated by a more conscious exercise of the fund members' ownership rights. The MNB took several measures to strengthen the members' awareness, relying on the instruments available. Such measures included – amongst other things – enhancing the information provided to members by legislative instruments, and providing members with easier access to the funds' regulations by publishing them on the website operated by the MNB (www.kozzetetelek.hu). In addition, the purpose of part of the amended laws,

which entered into force on 1 January 2016, was to strengthen the control functions performed by the individual actors of the funds' operation (auditor, custodian).

As a result of the strict statutory rules applicable to the commissions payable in respect of new members, and the poor marketing activity that characterises the funds sector, the number of new members joining the funds sector is low. It should be noted that the decrease in the number of voluntary pension fund members slowed down, and it may be regarded as a favourable development that – compared to the previous five years – the number of new members is increasing. However, the number of terminated membership relations still exceeds the number of new members. The decrease in the employers' commitment to the funds sector is manifested in the continuous fall in the ratio and volume of the employer's contribution within the membership fee payments. However, it is a favourable process that the ratio of the members' contribution within the membership fee income, and the amount of such payments are continuously increasing.

The laws related to the funds were modified in 2016, affecting several areas (diversification of investments, fund services, etc.). From 1 January 2016, the investment concentration rules related to health funds and mutual benefit funds significantly tightened, and the investment rules applicable to voluntary pension funds also changed to a lesser extent, as a result of which a decrease in group exposure across the sector and an increase in the government securities holdings in the case of health funds and mutual aid funds can be expected. The MNB pays special attention to compliance with the changing investment regulations.

Restructuring of some funds occurred in 2015 as well, and the background institutions of certain funds were liquidated or their owners were changed; these changes did affect the contractual relations and the administration activity. In addition, the operations of the funds was also substantially reformed, under close supervision by the MNB.

With the appearance of health funds and mutual aid funds as new fund types, a further increase in the concentration of health funds and mutual benefit funds can be expected (mergers, restructuring). In the case of funds that are below the economies of scale level, the decrease or the full termination of the employers' contribution, or the withdrawal of the background institution may result in an increase in concentration.

The investment performance of the pension funds sector is adequate despite the low yield environment, but there are major differences at the level of individual institutions. The low yield environment, which is likely to remain in place in the near future as well, may result in modification of the asset composition ratios defined in the investment policies. The funds' investment risk management process is examined by the MNB within the framework of its oversight activity.

At the sector level, safe operation of the funds is currently guaranteed from the resources available for operation (portion of membership fee allocated to operation, the amount deductible from the yield of non-paying members for operating activities, allowances, grants). However, it represents a risk that the amount that can be deducted for operating activities from the non-paying members with low savings may decrease as a result of the falling yields. In view of the foregoing, the persistently low yield environment has a negative impact on the fund sector's profitability, and thus the sector is likely to reach the point when the amount deductible for operating activities from the yield of non-paying members will no longer offset the balance sheet loss, and at the level of institutions the point when the balance of these two factors is already negative.

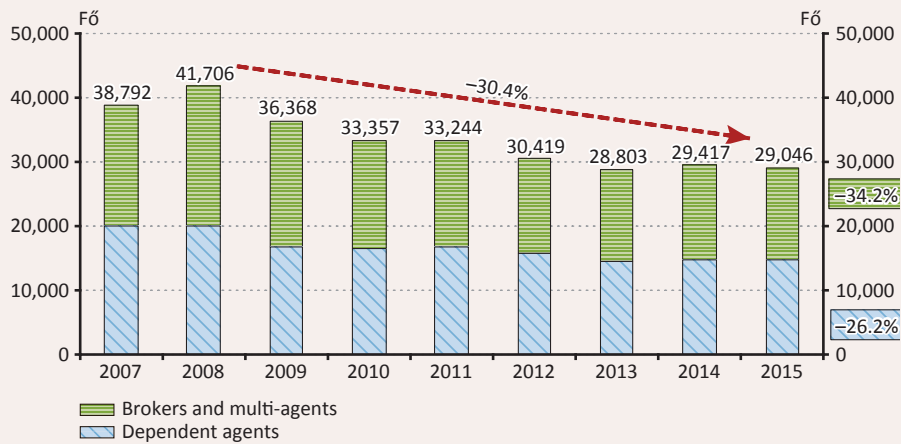
2.6 INTERMEDIARIES

Number of natural person intermediaries decreased by one third

Insurance brokers and the multiple agents must submit data to the MNB once a year; we only have the 2014 figures for the beginning of the year, and thus we shall take measures to increase the reporting frequency. On the other hand, the register of insurance intermediaries contains up-to-date information on the number of intermediaries. The number of natural person insurance intermediaries fell from almost 42,000 in 2008 to

29,000 by 2013, primarily due to the crisis and the statutory prescription of the minimum personal conditions (e.g. university degree or official exam) and seems to be stabilising at this level. The tied agent networks are more stable, as the decrease affected the brokers and multiple agents to a larger extent; a decrease in the large MLM-type networks can be also observed.

Chart 32
Changes in the number of natural person insurance intermediaries from 2007 to 2015



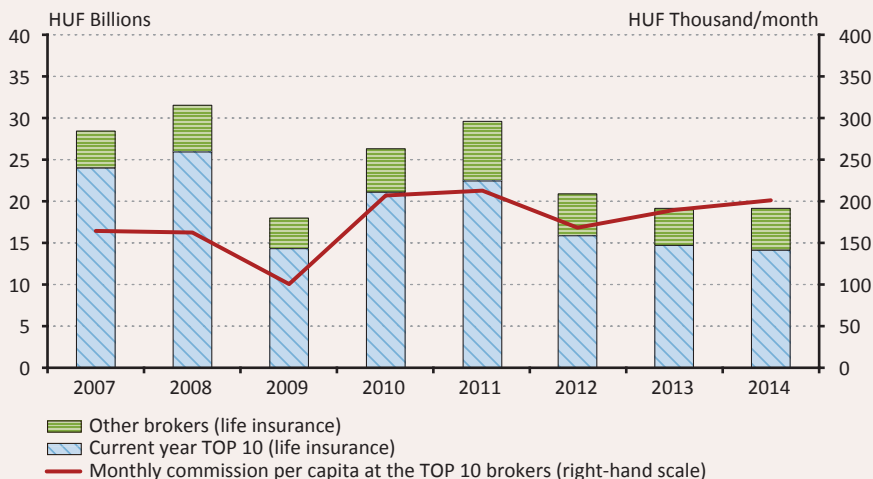
Source: MNB

At present, financial market intermediaries have no regular reporting obligations; the law applicable to the sector prescribes this from 2017; in addition, the registration requirement does not cover natural persons.

Concentrated life insurance intermediation

Commission incomes from life insurance decreased substantially as a result of the crisis. The fall in income was followed with a lag by an adjustment in the number of intermediaries, and thus per capita commission also shrank. From 2009 on, a distinct decrease in the number of intermediaries can be observed, which gave rise to a concentration of commissions. The average commission level stabilised, but this amount still falls short of the gross average wage, despite the recently observed growth. The commission shown in the chart is distributed between the licensed insurance intermediary and the natural person, commissioned or employed by it, performing the sale. In the life insurance market, the broker and multiple agent intermediation market

Chart 33
Concentration of life insurance intermediation



Source: MNB

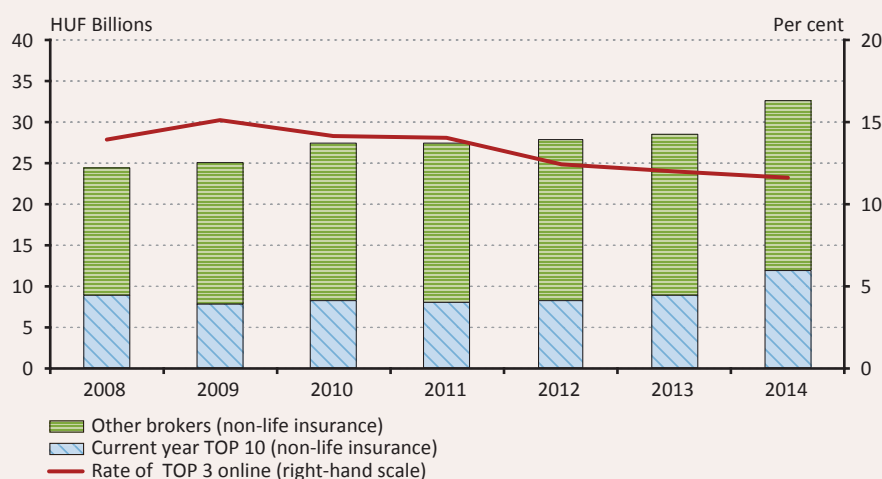
is concentrated: 78.7 per cent of commission income is realised by the top 10 intermediaries, which typically apply a multi-level network sales strategy.

Increasing commission concentration at non-life intermediaries

The non-life insurance intermediary (brokers and multiple agents) market is not concentrated, but the growth in the intermediary commission incomes from 2013 to 2014 was primarily generated by the TOP10 intermediaries. The TOP 3 online brokers grew in line with the market average, but their weight declined somewhat within the TOP 10. This decline partially may be attributable to the weaker impact of the MTPL campaign and to the correlation according to which as a result of the contracts' relative price stability, customers can achieve smaller savings by changing the insurer and hence are less motivated to conclude new contracts. The online intermediaries launched the sales of other products (e.g. home insurance) as well, but the volume of this segment does not yet make up for the lost revenues.

Chart 34

Developments in current year's non-life commission paid to brokers and multiple agents and share of the TOP3 online



Source: MNB

The amendment of the European regulation related to intermediaries (Insurance Distribution Directive – IDD) is in progress; IDD is expected to be implemented in Hungary by the end of 2017, which may have an effect on participants' positions in the intermediaries' market. The sales-related regulation applies not only to the insurance intermediaries, but also to the insurers. In addition, it contains a number of new elements, such as the liability of the insurer in respect of the proper channel used for selling the appropriate products to the customers (Product Oversight and Governance Arrangements – POG); regulation of conflict of interest; strengthening of consumer protection provisions (more detailed information, declarations, product compliance, suitability issues, primarily in the case of unit-linked products). The elaboration of certain detailed regulatory-level rules based on the new directive is still in progress, in which the MNB also participates.

Box 3**Impacts of Online Recommendations**

The MNB issued Recommendation 5/2015 (V.05) on the Electronic platforms serving the presentation and comparison of insurance products and used during insurance intermediation (the “Recommendation”) on 5 May 2015. The purpose of the Recommendation is to foster the transparency, usability and satisfactory operation of the electronic platforms and to strengthen public trust in non-personal insurance intermediation. To this end, it formulates as a guideline, amongst other things, that in addition to the provision of correct and fair information, the platform should also reflect the competition of services, beyond price competition, within the legislative framework. With a view to enforcing consumers’ interests, as specified in the Recommendation, to the highest degree and diverting the online intermediation practice in this direction, the MNB backtested the implementation of the Recommendation with the involvement of certain insurers, insurance intermediaries and electronic platform providers, with the use of questionnaire-based surveys and online examinations.

The backtesting identified a number of positive changes in the online insurance intermediary market.

- Improvement in data protection: where the platform is operated by a third party rather than the insurer or the insurance intermediary, customers are asked to agree to the forwarding of their data.
- Check boxes with regard to the familiarisation with the information documents are placed in the e-interface of the institutions, the ticking of which is a precondition for making the proposal; (Further development is necessary: the ticking of check box should be made conditional upon opening/reading the documents).
- The up-to-datedness of the e-interfaces significantly improved; the average update time at the intermediaries decreased from 98 days to 34 days.
- The supplementary covers and co-insurance discounts are displayed.
- Upon recommending complex, complicated or non-standards insurance coverage or services, a warning is displayed.

In addition to the above, the MNB identified further areas for improvement:

- The requirements assessments should be extended (e.g. more detailed questionnaire).
- The ranking criteria are not displayed upon comparisons.
- No “warning” about the entity responsible for payment of the losses generated during the operation of the interface of incurred damages.
- No possibility to remove supplementary covers or co-insurance discounts.

On the whole, it can be stated that the insurance intermediaries performed developments to comply with the Recommendation, and that the Recommendation achieved the diverting effect which results in the provision of higher quality services to consumers. The MNB designated compliance with the Recommendation as a priority target area for direct inquiries, and thus during the direct inquiries compliance with the guidelines of the Recommendation will be specifically reviewed.

3 Cooperative credit institutions

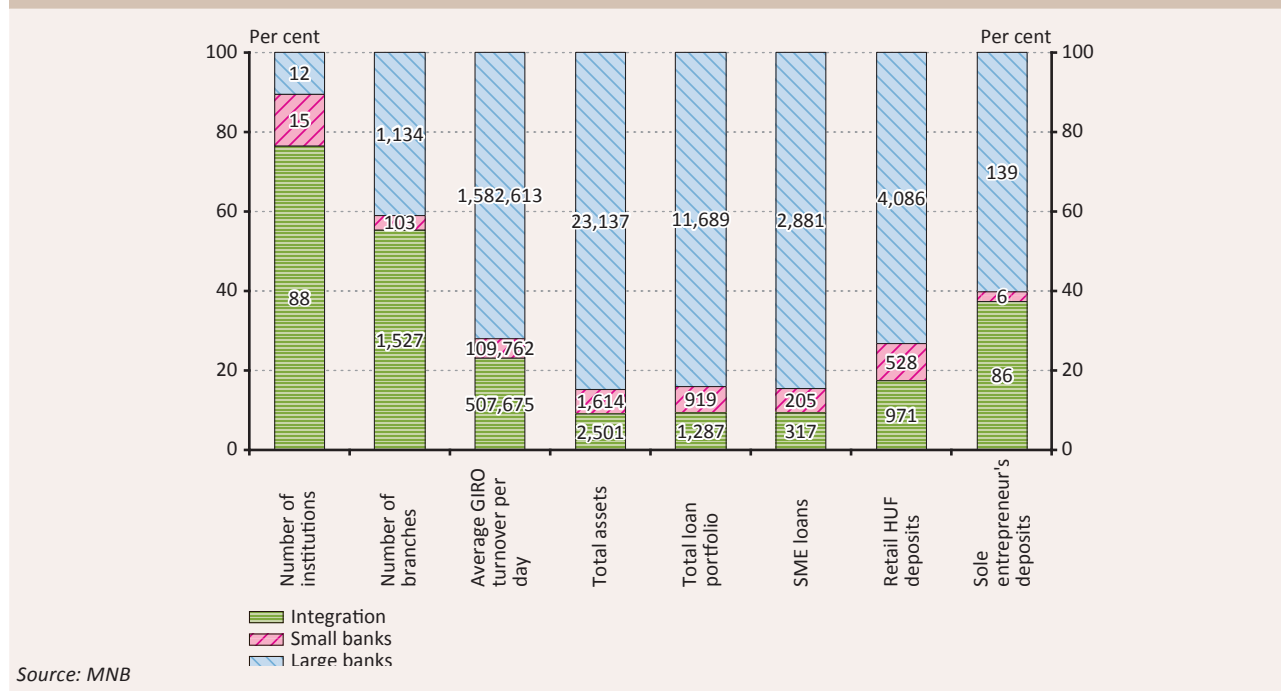
With the joining of FHB, the Integration of cooperatives became the second largest financial conglomerate in the credit institution market

Cooperative credit institutions, which are typically present in large numbers,⁶ but are small in terms of size, offer services all over Hungary, and taken together they operate more than half of all domestic branches. With a view to reducing risks, all of them are member institutions of Integration of Cooperative Credit Institutions (the “Integration”) and they bear joint and several liability for their liabilities not protected by NDIF.⁷

Their market weight is traditionally dominant in small settlements, although they take strong actions to strengthen their presence in towns and county seats. The market share of the Integration – together with the newly joining FHB Banks (FHB Commercial Bank Ltd and FHB Mortgage Bank Plc.) – calculated on balance sheet total basis, rose above 9 per cent at the end of 2015, thereby substantially exceeding the level recorded one year before.

Chart 35
Position of the Integration of Cooperative Credit Institutions in the domestic financial market

Based on data from 31 December 2015



However, based on the number of transactions, the Integration’s market weight is substantially higher in payment turnover and several other business lines – e.g. in the collection of household deposits and financing of agriculture – due to its geographic locations and strong retail integration.

⁶ About three quarters of Hungarian credit institutions operate in cooperative society form; their number was 88 on 31 December 2015.

⁷ Act LV of 2016 lifted all restrictions applicable to joint and several liability from 9 June 2016.

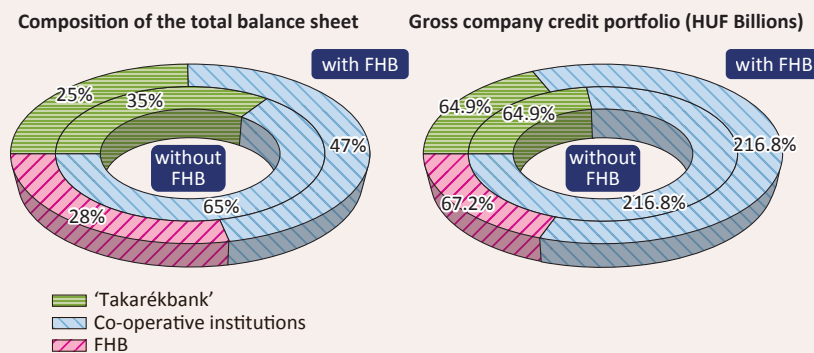
The Integration, including the FHB Group, and the Hungarian Development Bank and Magyar Posta Zrt., are bound together by wide-ranging business cooperation. Hungary's largest financial network is about to take shape in this framework, which is still in the phase of development.

Box 4

FHB's Joining the Integration

FHB Mortgage Bank Plc. and FHB Commercial Bank Ltd., a bank which is majority owned by the former and falls under consolidated supervision with it, were admitted as member institutions to the Integration on 23 September 2015. Pursuant to the decision of the Executive Board of Takarékbank, the joint and several liability, specified in Section 1 (4) of Act CXXXV of 2013 on the Integration of Cooperative Credit Institutions and on the Amendment of Certain Laws on Economy, covers the two new member institutions from 24 September 2015.

Impact of the joining of the FHB banks on the Integration



Note: Based on data from 31 December 2015

Source: MNB

The cooperative Integration, as a universal financial service provider, strives to have a marked presence in all business segments, but particularly in the retail area. The admission of the FHB banks to the Integration may help strengthen the market presence of the Integration in Budapest, contribute to the diversification of its clientele and provide a direct solution for the fulfilment of the requirements of the MNB Decree on the regulation of forint maturity match.

However, the admission of the FHB banks to the Integration also involves risks. Their integration in the corporate governance system and risk community of the cooperative credit institutions is a time-consuming and resource-intensive duty. In addition, the division of labour between the member institutions and Takarékbank, and accordingly in part also the strategy of the Integration, must be reconsidered, as with the joining of FHB Commercial Bank Ltd. the commercial banking functions doubled in the group.

The laws permit that after joining the Integration, subject to the permission of the Supervisory Authority, the new member institutions can be exempted, on an individual basis, from the prudential requirements, including compliance with the individual capital requirements. However, until such time as all conditions prescribed to this end are fulfilled – based on the MNB's decision – the FHB group must continue to comply, on a sub-consolidated basis, with the prudential requirements prescribed for it on an individual basis.

Joining the Integration also generates new risks for the FHB's investors and mortgage bond holders, as in the joint and several liability scheme FHB is also liable for the debts of the cooperative credit institutions, and due to the special statutory regulations applicable to the Integration, the Integration's central bodies have substantial regulatory and governance rights in respect of the operation of the FHB Group.

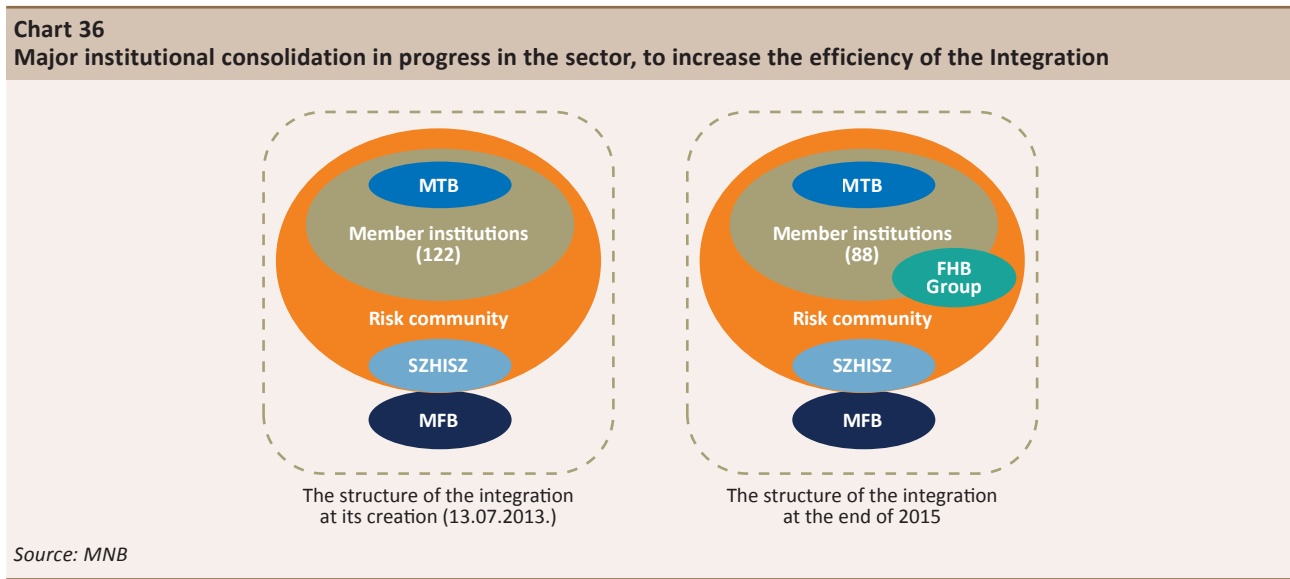
The risk community based on the joint and several liability was established, but the development of the standard bank operation background, serving as basis for efficient market presence, is delayed

The risk community based on joint and several liability became complete by 2015, after due diligence by the member institutions. As a result, the risk of customers depositing their savings with cooperative credit institutions has substantially decreased, as their receivables are now guaranteed by the combined assets of all member institutions of the Integration.

The operation of the risk community’s member institutions is placed on a common platform by the regulations issued by the Integration Organisation of Cooperative Credit Institutions and Takarékbank. The majority of the work has been performed by the central bodies, but the larger part of the product and service offering still remained a local competence, due to the absence of a common banking infrastructure. As a result of this, the means necessary for swiftly responding to market needs and for seamless business representation are still limited. The cooperative credit institutions are the most important clients, and also the majority owners of Takarékbank, whereas, by law, their business governance is performed by Takarékbank. The management of Takarékbank is dominated by Matak Zrt., an associated company of FHB which is also majority owned by the cooperatives, while the full Integration is primarily controlled by the Integration Organisation of Cooperative Credit Institution, which is majority owned by the Hungarian Development Bank. In this multi-actor system, the governance and owner relations are partially separated and the corporate governance system of the Integration is not fully transparent.

The centrally regulated corporate governance and control system of the Integration and the efficiency of business planning and orchestrated market presence is still low, as the infrastructural basis thereof, i.e. the standard IT system, is missing. Development of this is in progress, but implementation is only expected to start in the second quarter of 2016, and even then only the migration of one of the 88 institutions will commence. The date of the final completion of the project is uncertain, and thus the protraction of the implementation carries major risks; accordingly, the project is the most important risk factor for the Integration’s further development.

Legislative regulation of the operation of credit institutions is becoming increasingly complex, and adjusting to this is impossible at reasonable costs below a certain operation size. The wide branch networks of the cooperative credit institutions is a major competitive advantage, but most of these are only units of a few people, they operate in small settlements and have limited service capacity. Modernisation of these institutions to render them competitive would be rather expensive. One response of the Integration to these challenges is institutional consolidation, as a result of which a major restructuring is taking place in the cooperative sector.



Box 5**Amendment of the Act on Integration**

Act LV of 2016 on the Amendment of Certain Laws in Relation to the Integration of Cooperative Credit Institutions entered into force on 9 June 2016, after the editorial deadline for this report. This Act transformed the operational framework of the integration of cooperative credit institutions and also introduced major changes in respect of the rules applicable to the oversight of the Integration.

In respect of the operational framework, the new legislative environment rearranged the division of the competences and powers exercised by the Integration Organisation and the Core Bank over the members of the Integration, and transferred critical powers, which were previously exercised by the Core Bank, to the competence of the Integration Organisation. As a result of the amendment, the Central Body function of the Integration will clearly be fulfilled by the Integration Organisation in the future.

The amendment of the law also included the strengthening and expansion of the supervisory powers exercised over the Integration, based on which the Magyar Nemzeti Bank can examine compliance with the provisions of the Act on Integration as part of the audit procedure and upon identifying any infringement, it has the powers to take the necessary measures both in respect of the Central Body and the Core Bank.

Compliance with the changed legislative provisions will entail the reform of the operation of the Integration Organisation of Cooperative Credit Institutions and the methodology oversight exercised over the operation of the Integration. In the future, it must be a distinct oversight criterion that formal or informal influence should not be capable of diverting certain processes of the Integration into directions that favour only specific market participants. The statutory powers necessary for this were created by the amendment of the Act on Integration.

The traditional competitive advantages of the cooperative credit institutions are undermined; the persistent deterioration of the profitability is addressed by institutional consolidation and a change in the business model

The strength of cooperative credit institutions lies in the largest domestic sales network and strong customer attachment. Their traditional business philosophy included not only economic, but also welfare and social considerations. The essence of their business model is to collect the savings of the population in their area and satisfy their credit needs, but most of them clearly accessed local enterprises as well, a large part of which obviously pursued agricultural activity. These are supplemented with the satisfaction of the financial needs of the local governments and municipal institutions.

The changing structure of the economy and settlement, and the decreasing flexibility attributable to the centralisation, significantly erode their strengths. The migration of young employees, the ageing population and the differentiation in incomes impacted small settlements – where the cooperative credit institutions are traditionally present as dominant service providers – to a larger degree. Along with the spread of electronic sales channels, this gradually undermined the value of the extensive branch network and the unique knowledge of rural locations and customers. The strengthening of these risks is signalled by the cooperative credit institutions' decreasing market share in retail and corporate account management.

As a result of the significant continuous subsidies from the state and the EU, the credit demands of the agricultural sector – a traditionally significant market – have decreased as their financial situation became more solid. The refinancing of the local governments' loans by the government reduced not only the risks, but also the opportunities, and the major potential inherent in the rendering of financial services to the local governments also became uncertain.

In addition, in the low interest environment – which is favourable for the real economy – the largest business risk for the cooperative credit institution sector is posed by the unsustainability of its business model that strongly depends on net interest incomes.

Hence, the business efforts of Takarékbank are aimed at increasing the commission and fee income by changing the asset structure, and the significant institutional consolidation – the purpose of which is to reach an operation size that is sustainable in the entire sector – also focuses on the substantial improvement of the group's operational efficiency.

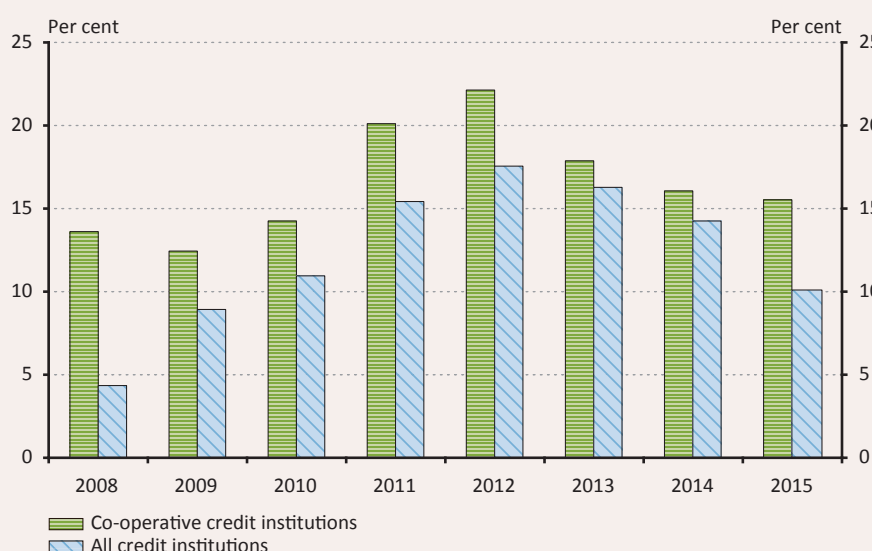
The asset quality in the Integration improved, but the expansion of lending activity fell short of the opportunities

Contrary to the general trend, cooperative credit institutions were able to increase their lending activity in 2015, albeit to a lesser degree than planned. As a result of this and their decreasing deposit portfolio, their loan-to-deposit ratio rose by 5.8 percentage points to 55.6 per cent.

In parallel with this, the ratio of their loans overdue for more than 90 days continued to decrease, reaching 10.7 per cent, which is still lower than the average of the credit institution sector. Another positive development is that as a result of the application of standard central regulations, the coverage of receivables overdue for more than 90 days by impairments increased substantially, exceeding 76 per cent by the end of the year, which is higher than the sector's average by a good 14 per cent.

However, the level of the non-performing portfolios is still relatively high, which is attributable to the fact that – compared to the average of the banking sector – the cooperative credit institutions apply portfolio cleaning measures much more rarely than would be desirable and possible. The non-performing portfolios, often managed by the institutions for unreasonably long periods, tie up valuable resources, reduce efficiency and hinder the stabilisation of lending activity at a sound level.

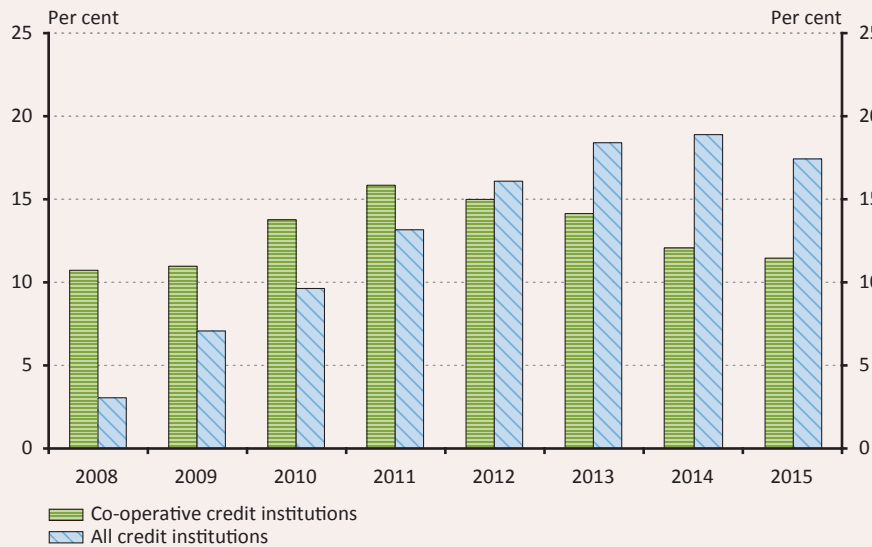
Chart 37
Change in the ratio of corporate loans overdue for more than 90 days to the total loan portfolio in the cooperative and entire sector



Source: MNB

The picture is less favourable in the case of corporate loans, where the improvement continued, but the 15.5 per cent level of loans overdue for more than 90 days is still high, exceeding the sector's average of 10.2 per cent. As regards the household portfolio, the situation is completely different, where the ratio of cooperative credit institutions' non-performing loans falls short of the sector's average by one third. After a decrease of 0.7 percentage point, it stood at 11.4 per cent at the end of 2015. This also attributable to the fact that the ratio of foreign currency-denominated loans extended by cooperative credit institutions was well below that of the commercial banks.

Chart 38
Change in the ratio of household loans overdue for more than 90 days to the total loan portfolio in the cooperative and entire sector



Source: MNB

Liquidity position of the cooperative group remains stable

The liquidity indicator of the cooperative credit institutions worsened slightly in 2015, which – in addition to stronger lending activity – was attributable to the outflow of bank deposits caused by the low interest environment. The member institutions of the Integration hold almost one half of their assets in interbank deposits to be placed mandatorily with Takarékbank and in government securities, with the distribution depending on the prevailing yields. The liquidity reserves of the Integration are managed by Takarékbank.

In the changing structure of the Integration, a solid expansion of the volume of lending is a strategic objective with a view to increasing interest revenues. The liquidity deteriorating impact of this may be further exacerbated by the deposit absorbing effect of mutual funds and government securities, representing an increasingly distinct share in the cooperative credit institutions' mandatory product offering. On the whole, we anticipate a minor deterioration in the favourable liquidity situation, but it is unlikely to have a material effect on the Integration's stable liquidity indicators.

A dominant part (about three quarters) of the Integration's stable funds is provided by granular household deposits, which represents a high degree of security in terms of liquidity for the Takarékbank group.

Despite the poor profitability, the capital position of the Integration is stable, with high capital adequacy ratios

In 2015, the cooperative credit institutions once again closed a problematic year in terms of profitability, since 40 per cent of the institutions ended the year with a loss, as in 2014. However, at consolidated level,

the Integration can post a positive result on the whole, in contrast to last year, as its consolidated balance sheet profit was HUF 3.94 billion. This is essentially due to Takarékbank's considerable positive result, based on the business cooperation with the cooperative institutions. In accordance with the accounting rules, this profit does not contain the loss of the FHB Group, which was admitted as new member at the end of the third quarter. FHB Group's whole year consolidated profit/loss on an IFRS basis was a loss of HUF 10.6 billion, i.e. including this, the Integration did close 2015 with a loss on the whole.

Chart 39
Changes in the cooperative credit institutions' and Takarékbank's (Hungarian Savings Cooperatives Co. Ltd) profit after tax



Source: MNB

In contrast to the worsening general trend, the cooperative credit institutions' cost-to-income ratio improved by almost 3 percentage points to 67.3 per cent, but due to the dominance of retail activity and the high number of small-income customers served at high unit cost, it is still well above the credit institution sector's average of about 50 per cent.

In addition to the rationalisation of costs, the improvement in the cost-to-income ratio was attributable to the 11 mergers in 2015, involving 40 institutions. Institutional consolidation continues and as a result of the mergers planned for 2016 an improvement in the economies of scale is anticipated.

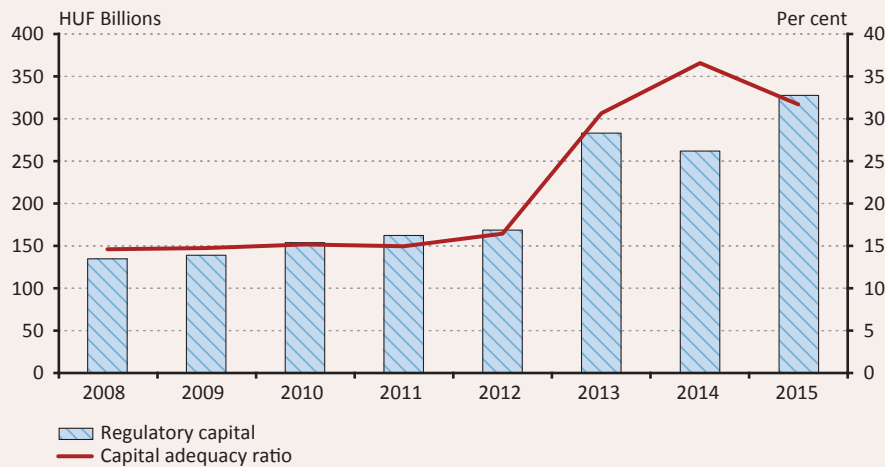
Chart 40
Developments in profitability indicators in the co-operative credit institutions and in the entire credit institutions sectors

| Indicator / Sector / Date | Co-operative credit institutions | Total credit institutions | Co-operative credit institutions | Total credit institutions |
|---------------------------|----------------------------------|---------------------------|----------------------------------|---------------------------|
| | 31/12/2014 | 31/12/2014 | 31/12/2015 | 31/12/2015 |
| ROE | -4.18% | -15.8% | 3.32% | 3.95% |
| ROA | -0.24% | -1.51% | 0.19% | 0.38% |
| Cost/income ratio (%) | 70.16% | 40.75% | 67.30% | 49.83% |

Source: MNB

Despite the modest increase in lending activity and the low consolidated profit/loss, the sector's capital adequacy ratios are still very high, which leaves plenty of room for the planned increase in lending activity.

Chart 41
Changes in the regulatory capital and capital adequacy of the cooperative credit institutions



Source: MNB






















The market risks of cooperative credit institutions are negligible

Market risks still represent a negligible weight among the risks of the cooperative credit institutions and primarily stem from the foreign exchange risk and the interest repricing risks. A major part of the interest repricing risk arose in the decreasing interest environment from longer-term fixed-interest securities purchased in past years.

The operational risks of the Integration are reduced by the standard regulation, but the delay in the creation of a shared IT background carries significant risk

The standard regulation and the efficiency-increasing operation size reduce the operational risks of the Integration. However, the development of the standard bank operations background is a lengthy process, which – in the absence of a standard IT system – carries risks even upon the application of central regulations. The creation and implementation of the standard IT system at the member institutions is the largest project of the Integration, which alone represents a major risk factor. At present, this is further exacerbated by the uncertainty surrounding the scheduling of the implementation, as well as by the process accompanying the organisational restructuring of the mergers.

The efficiency of the corporate governance and control processes implemented by Takarékbank is low, due to the insufficient central resources.

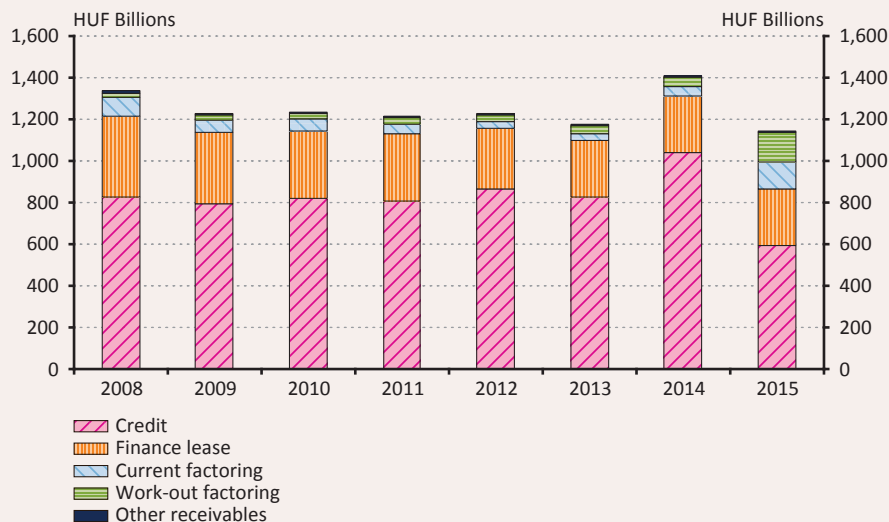
| Chart 42 Risk map of the Integration | | | | |
|--|--|---|---|--|
| Type of risk | Source of risk | Level of risk | Risk outlook | Details of the source of risk |
| Corporate governance, exercise of owner's rights | Mergers, changing ownership |  |  | The cooperative credit institutions are the most important clients and also majority owners of the Takarékbank; however, by the virtue of law, their business is controlled by Takarékbank. The Integration of Cooperative Credit Institutions, being in the majority ownership of the Hungarian Development Bank, has a dominant role in the governance of the integration. Governance and ownership roles are partly separated in the multi-actor system, and the corporate governance system of the Integration is not completely transparent. At the same time the structure of the integration is changing due to the mergers. The factors increasing and decreasing the risks of corporate governance are both present, thus the risk outlook is stagnant. |
| Credit risk | Decreasing, but still high NPL rate; lower than planned lending activity |  |  | The proportion of non-performing loans within the credit portfolio of the cooperative credit institutions decreased, but it is still high (10,73 %). The strict and centralised risk-taking procedures decrease the risks. The impairment recognised in respect of the non-performing credit portfolio significantly rose (76,41 %) as a result of the centralised standardised procedures and the consistent supervisory audits. |
| Operational risk | Mergers, IT-problems |  |  | The creation of a standardised bank operational background is a time-consuming process, while the restructuring and the large number of mergers generate risks. In the long run the standardised regulation and larger operation size that increases efficiency may decrease the operational risks. Risk outlook in the short term is stagnant. |
| Market risk | Marginal exchange rate risk, standardised interest rate risk management |  |  | The phase-out of household foreign currency-denominated loans decreased the currency risk of the cooperative credit institutions. The growth in the rate of the centrally regulated products increases the efficiency of the uniform market risk management. The level of risk is expected to remain low. |
| Liquidity risk | The diversified liquidity management was replaced by strict centralised management |  |  | The liquidity reserves of the integration is managed by or under the coordination of Takarékbank. Although a minor decrease in liquidity is expected due to the planned growth in the volume of lending and the accelerating outflow of the deposits, the liquidity of the integration remains stable. |
| Profitability | Decreasing interest rate environment, still high impairment loss |  |  | Although the consolidated balance sheet of the integration shows a profit, the profitability of the cooperative credit institutions deteriorated. The restructuring of the banking operation and the mergers generate immediate burdens, while their cost decreasing effects are felt only with a lag. The interest margin is continuously shrinking in the decreasing interest environment, while costs are less flexible. Significant improvement in the profitability is not expected in the short term. |
| Capital adequacy | High capital adequacy |  |  | The planned increase in lending might deteriorate capital adequacy, because for the time being low profitability does not permit a proportionate growth in capital. However, on the whole, no material change is expected to take place in the favourable capital position of the integration. |
| Legend: Degree of risk high  significant  moderate  low  Direction of risk increasing  stagnant  decreasing  | | | | |

4 Non-banking group financial enterprises

The role of financial enterprises not belonging to any banking group is shrinking in the lending market, due to the contraction in refinancing funds

The gross outstanding receivables of financial enterprises not belonging to any banking group fell by 15 per cent in total by 2015 compared to 2008; of this, the outstanding loan and financial lease portfolio decreased by roughly 30 per cent, while the current factoring portfolio and the factoring portfolio purchased for workout is twice and six times, respectively, as high as the balance recorded in 2008. In addition, the changes that occurred in the volume and composition of the total outstanding receivables since 2008 are mostly attributable to the activity of certain institutions pursuing special business, and their market entry and exit.

Chart 43
Composition of the gross outstanding receivables of non-banking group financial enterprises by activity type

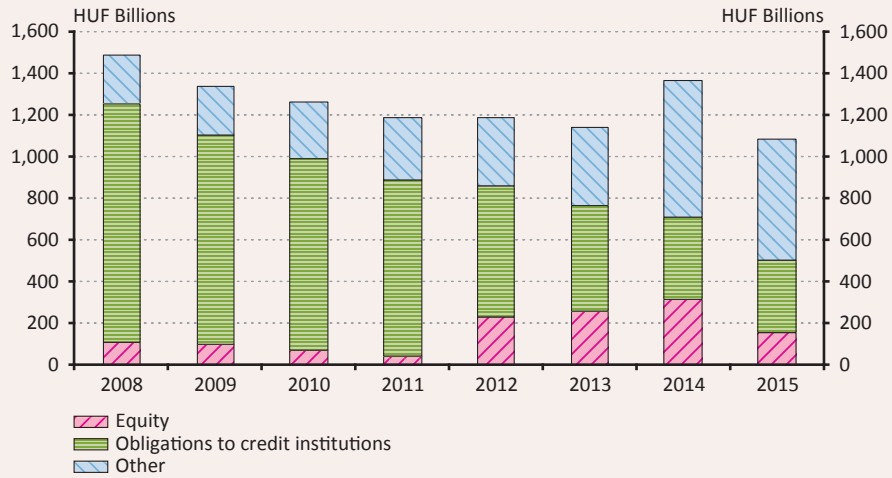


Source: MNB

In 2015, the major part (76 per cent) of the gross outstanding receivables of the 217 non-banking group financial enterprises still originated from credit, loan and lease transactions. The gross outstanding receivables decreased substantially in 2015, mostly attributable to the fall of 14 per cent in new lending. The largest decrease (20 per cent) was recorded in new credits and loans. New loans were unable to offset the decrease in the balance attributable to the settlement and the impact of a major market participant's exit from the market, and consequently outstanding lending fell by 43 per cent in total. Lending on the whole contracted, but the financing of enterprises was able to increase, with the Funding for Growth Scheme also playing a substantial role in this regard.

It is still a significant risk in the sector that the ratio of the non-performing portfolio is steadily rising, as a result of the fall in the total outstanding receivables and the constant level of receivables overdue for more than 90 days (and impairments recognised in respect of such). The increasing level of lending risk is reflected by the fact that while the liquidated non-banking group financial enterprises typically pursued lending activity, the newly established ones primarily wish to deal with the purchase of overdue receivables.

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



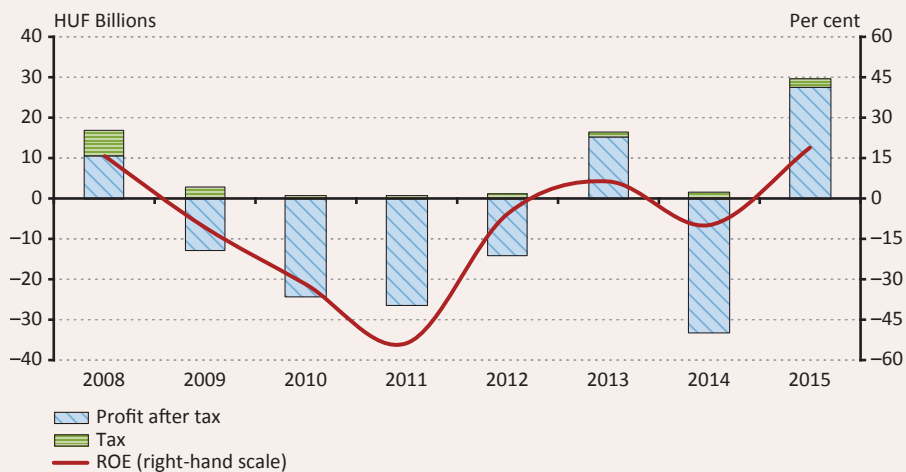
Source: MNB

In parallel with the increasing risk attached to the lending activity of non-banking group financial enterprises, the funding available from domestic and foreign credit institutions shrank substantially. Refinancing by credit institutions has gradually decreased since the outbreak of the crisis, and by 2015 it fell to 30 per cent of the level recorded in 2008. Growth in other liabilities in 2012-2015 was linked to the activity of certain financial enterprises pursuing special activity.

The owner background and the quality of customer relations determine the profitability of the institutions

In the period 2008-2011, the profitability of non-banking group financial enterprises deteriorated significantly, followed by an improving trend at the sector level, due to the exit of several loss-making institutions from the market.

Chart 45
Developments in the profitability of financial enterprises not belonging to any banking group



Source: MNB

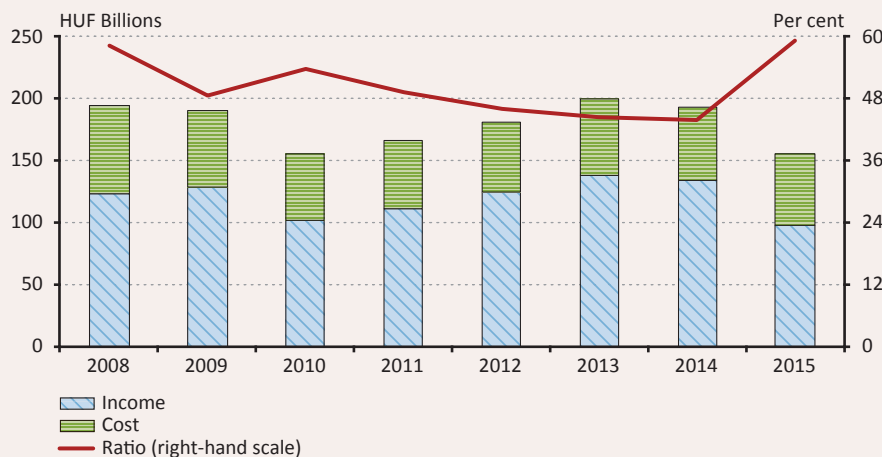
Non-banking group financial enterprises closed 2014 with a loss of HUF 31.5 billion, due to the fact that most of them recognised the reserves required for the fulfilment of the settlement obligations already in 2014. However, in 2015 70 per cent of the institutions were profitable, posting a total after tax profit of HUF 29.5 billion, while the loss-making enterprises closed the year with a total loss of HUF 5.5 billion. However, the larger profit is mostly attributable to one-off effects: the result of releasing the provisions after the settlement and reversal of the impairments due to the loan write-offs and sales of receivables.

Of the non-banking group financial enterprises, those that have well capitalised owner background, typically linked to dynamically developing industries, are capable of long-term growth and maintaining stable operation. Thus, it is not the activity type that primarily explains profitable operation, but rather the strength of the customer relations and the depth of the information the financial enterprises have about the actors of the financed industry.

The risk of exits from the market appears at the refinancing financial institutions

After 2008, the cost rationalisation of the non-banking group financial enterprises declined and by 2010-2011 it had reached a level below which it could no longer fall. As a result of this, there was no substantial improvement in the cost efficiency of the sector; in 2012-2014 the decrease in the cost-to-income ratio and its substantial increase in 2015 is attributable to the activity and later to the liquidation of non-banking group financial enterprise that pursued special activity.

Chart 46
Changes in the cost-to-income ratio of non-banking group financial enterprises



Source: MNB

As there is apparently no room to improve cost efficiency, the persistent decline in profitability still represents a high risk for most of the institutions, which may foster further concentration in the sector. In view of the fact that the financial enterprises handle no customer funds, the risk of exits from the market appears primarily at the refinancing financial institutions, and it may also be accompanied by an increase in consumer protection risks. The MNB shaped the oversight focus in respect of the sector accordingly, placing great emphasis on the analysis of risk management by the refinancing institutions and on the implementation of close cooperation between the prudential and consumer protection supervision.

On the whole, the continued market presence of the financial enterprises with appropriate operation size and well capitalised owner backgrounds, capable of growing from their own resources, may strengthen the stability of the sector and contribute to the creation of a sounder financial institutional system.

5 Capital market

At the end of 2015, a total of 39 investment service providers – 21 credit institutions and 18 investment firms – were active in the Hungarian capital market. The customer securities market portfolio managed by investment service providers amounted to HUF 25,112 billion and HUF 2,246 billion at the credit institutions and investment firms, respectively. Customer securities are dominated by government securities at the credit institutions, and by mutual fund shares at the investment firms. The cases of fraud revealed in the beginning of 2015 at some investment firms did not shake the general trust in investment service providers: although the customer securities portfolio at investment firms was characterised by a small decline in March 2015, customers' securities holdings with investment firms increased by 10.7 per cent in 2015. The number of investment service providers' active clients⁸ reached 1,416,000 by the end of 2015, which exceeds the end-2014 level by 4.1 per cent.

The assets managed by the 35 investment fund managers reached a historic high of HUF 8,663 billion by December 2015, of which HUF 5,777 billion is related to mutual funds, HUF 1,218 billion to funds and HUF 1,668 billion to other – mostly insurance – portfolios. As regards the annual growth dynamics, funds performed the best (+5.4 per cent), followed by mutual funds (+4.5 per cent) and other portfolios (+2.9 per cent). Venture capital funds play an important role in the financing of innovative SMEs: until the end of 2015 of the paid-in funds of HUF 147 billion available for the 31 venture capital funds, HUF 104 billion was used for financing, of which HUF 91 billion was placement of capital and HUF 13 billion was granted in the form of loans.

5.1 INVESTMENT SERVICES MARKET: TURNOVER AND BALANCES

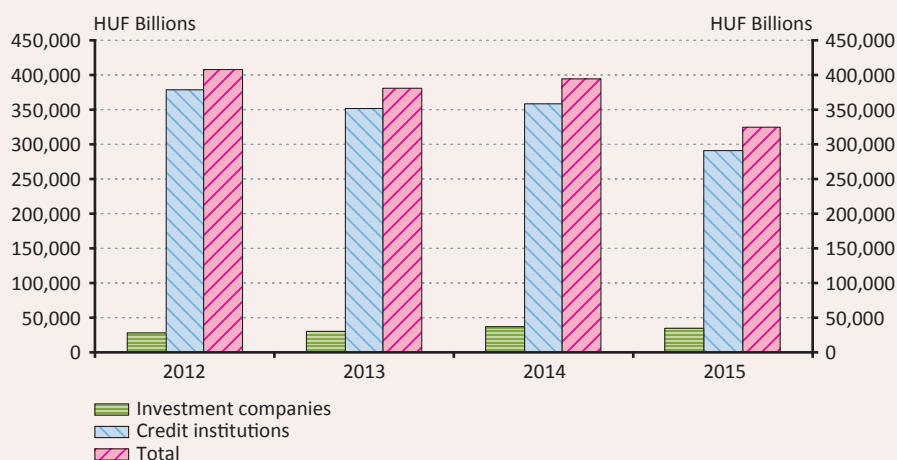
Decreasing capital market total turnover in 2015

In 2015, the institutions rendering investment services registered a turnover of HUF 325,700 billion, which falls short of the HUF 395,100 billion turnover recorded in 2014 by 17.5 per cent. The decline primarily affected the credit institutions: compared to 2014 credit institutions' total turnover decreased by 19.1 per cent, while that of investment firms contracted only by 2.2 per cent. Accordingly, the share of investment firms in the total turnover continued to increase in 2015 (from 9.2 per cent recorded in 2014 to 10.9 per cent).

The decrease in the total turnover of the capital market was attributable to different factors in the case of the investment service providers' two subsectors, i.e. credit institutions and investment firms. The decrease in the total capital market turnover of credit institutions is attributable to the decline in the spot turnover in the organised over-the-counter market (OTC). The spot OTC turnover of HUF 71,600 billion recorded in 2015 falls short of the 2014 turnover by 48.4 per cent – the decrease is attributable to the phase-out of the two-week MNB bill in August 2014. The stock exchange prompt and derivative turnover and the growth in the prompt OTC turnover at the investment firms was unable to offset the decrease in the OTC derivative turnover, the HUF 20,500 billion value of which, recorded in 2015, falls short of the 2014 turnover by 10.9 per cent. The decline was essentially recorded at the futures and swap transactions.

⁸ Active client means the clients with a balance on their client account or securities account, or those who used any investment services in the past year.

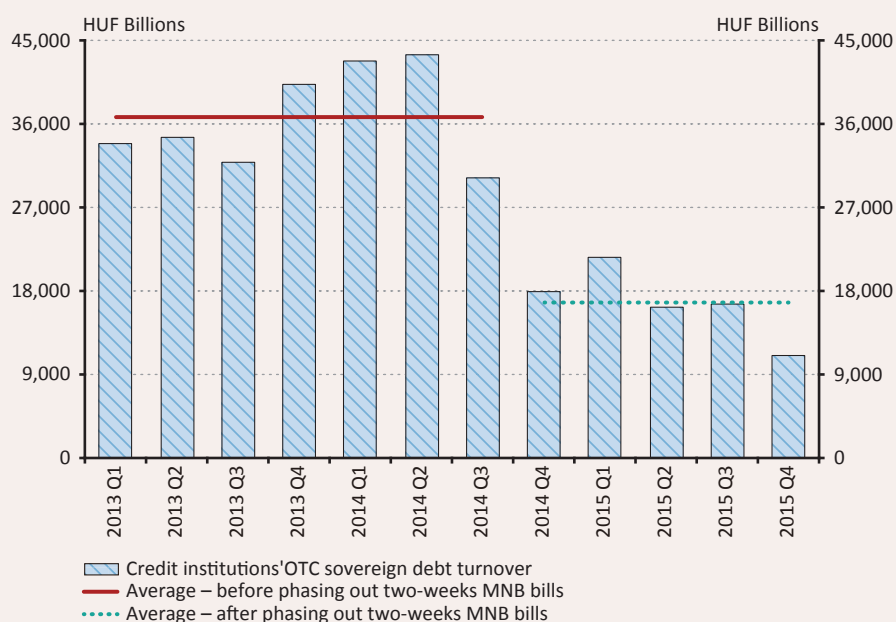
Chart 47
Developments in the capital market turnover



Source: MNB

In 2015, the organised market (stock exchange) turnover⁹ – prompt and derivative together – increased by 18.2 per cent compared to 2014. The total stock exchange turnover of investment firms and credit institutions exceeded the 2014 level by 22.7 and 11.9 per cent, respectively. Although the total – prompt and derivative – stock exchange turnover is still negligible in relation to the entire capital market turnover, its share rose from 2.9 per cent recorded in 2014 to 4.2 per cent by 2015, due to the fact that the total OTC turnover – both prompt and derivative – declined.

Chart 48
Quarterly OTC government securities turnover of credit institutions



Source: MNB

⁹ Organised market turnover means the data included in the data supply of the institutions pursuing investment services activity sent to MNB (Table 35A), which also include – apart from the BSE – other recognised stock exchanges (regulated markets), multilateral trading facilities (MTFs) and the so-called organised trading facilities (OTF).

The share of investment firms in the capital market turnover continued to increase in 2015

In 2015, the share of investment firms in prompt stock exchange turnover increased further (63.9 per cent in 2013, 70.3 per cent in 2014 and 80.4 per cent in 2015), and in parallel with that the weight of credit institutions decreased. Similarly to 2014, the first four institutions that managed the highest prompt stock exchange turnover were investment firms in 2015 as well. The concentration of the prompt stock exchange turnover significantly increased compared to 2014. The share of the top five investment firms managing the highest turnover rose from 67 per cent recorded in 2014 to 80 per cent by 2015 (it was 63 per cent in 2013). In the case of the derivative stock exchange turnover, similarly to 2014 the share of investment firms and credit institutions was roughly identical in 2015 (50.5 and 49.5 per cent in 2014 and 48.2 and 51.8 per cent in 2015). The concentration of the derivative stock exchange turnover rose compared to 2014; the share of the top five investment firms managing the highest turnover increased from 69 per cent recorded in 2014 to 74 per cent by 2015 (it was 67 per cent in 2013).

Prompt OTC turnover was still dominated by credit institutions, but the share of investment firms practically doubled, rising from 4.5 per cent recorded in 2014 to 8.5 per cent in 2015, which was attributable to the decrease in the credit institutions' prompt OTC turnover (see the phase-out of the 2-week MNB bill in August 2014). As a result of this, the structure of the prompt OTC turnover also changed. The weight of government securities fell from 91-92 per cent recorded in 2013 and 2014 to 85 per cent by 2015. The concentration of the prompt OTC turnover soared in 2015 due to the phase-out of the 2-week MNB bill. While in 2014 the top 5 market participants covered 64.7 per cent of the prompt OTC turnover, this ratio reached 73.7 per cent in 2015.

Chart 49
Prompt OTC turnover by type of securities



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

Examining the turnover by ordering parties, there was a material decrease in brokerage (executed based on orders) turnover (-20.1 per cent) and in proprietary trading (-18.6 per cent) in 2015. The largest share in proprietary turnover was represented by the credit institutions' derivative turnover (76 per cent), but the decline was essentially caused by the change in credit institutions' prompt OTC turnover, which fell by 51.2 per cent compared to 2014 (credit institutions used the two-week MNB bill actively in their liquidity management until its phase-out in August 2014). The decrease in brokerage turnover was primarily due to the fall in investment firms' brokerage derivative OTC turnover in 2015 (-10.9 per cent), and this could not be offset by the increase in the stock exchange prompt (21.2 per cent) and derivative brokerage turnover (25.7 per cent). Similarly to previous years, brokerage turnover essentially related to investment firms in 2015 as well, with a share of 68 per cent. The 6 per cent rise in the share, seen in 2015, was caused by the investment firms' increased stock exchange activity and the decrease in credit institutions' prompt OTC market activity.

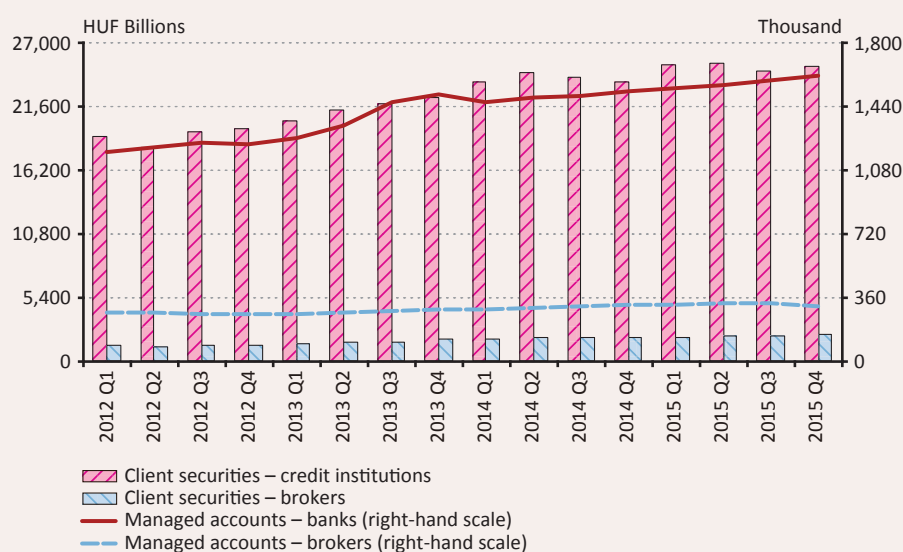
The strengthening stock exchange activity is evidenced by the increase in the number of prompt stock exchange orders, while the number of customer transactions continued to decline on the whole

In 2015, the decline in the number of transactions continued; the number of executed orders in the entire capital market sector fell by 4.8 per cent, following a decline of 2.7 per cent in 2014. The decrease was caused by the 8.4 per cent decline in credit institutions' customer transaction numbers, and this could not be offset by the 2.2 per cent growth in orders executed by investment firms. The 2.2 per cent rise in customer transactions executed by investment firms in 2015 is attributable to the 28.3 per cent increase in the prompt stock exchange transactions, while the number of derivative stock exchange transactions, the prompt OTC transactions and the derivative OTC customer transactions, executed by investment firms, decreased by 12.9 per cent, 14.5 per cent and 9.7 per cent, respectively. Examining the distribution of the customer transaction orders executed by investment firms, the prompt stock exchange transaction orders are still ranked first (44 per cent), followed by derivative OTC transactions (30 per cent) and prompt OTC transactions (22 per cent). The decrease of 8.4 per cent recorded in 2015 in the number of orders executed by credit institutions is primarily attributable to the 10.1 per cent fall in the number of orders executed in the prompt OTC market, since the share of this in the total transaction number of credit institutions was 91 per cent in 2015, which corresponds to the 91-92 per cent share seen in past years.

The customer securities portfolio continued to increase at investment firms

In 2015, the customer securities portfolio, managed by investment service providers – credit institutions and investment firms – increased further at market value, and by the end of the year it reached HUF 27,359 billion, exceeding the end-2014 closing value by HUF 1,521 billion (5.9 per cent). At the end of 2015, the market balance of customer securities managed by investment firms and credit institutions exceeded the 2014 fourth quarter values by 10.7 and 5.5 per cent, respectively. The share of investment firms in the customer securities portfolio continued to rise (by 8.2 per cent) in 2015. The severe cases of fraud which were identified in the first quarter of 2015 and involved three investment firms did not shake the trust in the sector, as it is also evidenced by the continuous growth in the customer securities portfolio. The increase in the customer securities holding of investment firms is primarily attributable to the rise in nominal balance of government securities and mutual fund shares. In the case of credit institutions' customer securities holding, the growth is attributable to the rise in equity balances, primarily resulting from market effects, i.e. appreciation.

Chart 50
Customers' securities holding



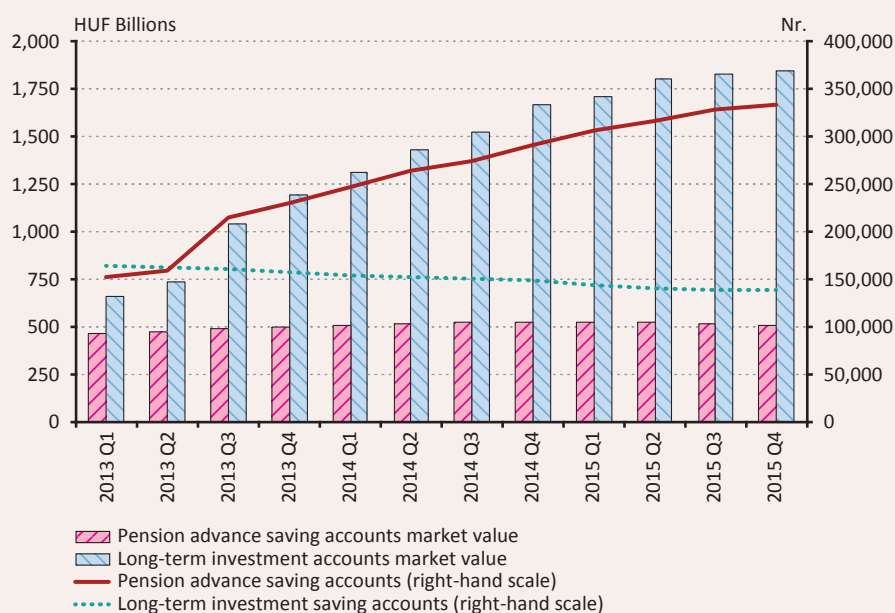
Source: MNB

Increasing customer securities accounts and long-term investment accounts

After a 2.3 per cent increase in 2014, the number of customer securities accounts managed by investment service providers rose by 4.5 per cent in 2015 and reached 1,927,800. The number of customer securities accounts managed by credit institutions increased by 5.6 per cent to 1,612,800, while the number managed by investment firms fell by 0.8 per cent to 315,000. The decrease at investment firms is primarily attributable to the fact that certain large service providers performed customer due diligence, and the contracts of inactive customers, who performed no transactions for a long time, were terminated. Long-term investment accounts (LTIA) are still extremely popular, albeit their growth rate has decelerated. The 333,000 long-term investment accounts managed by investment service providers at the end of 2015 reflected a year-on-year increase of 42,000 accounts. The decrease in growth dynamics is also attributable to the fact that long-term investment accounts could be opened for the first time in 2010 and those expired in 2016 after the five-year term, and not all of the expired ones were prolonged. The growth rate of the securities portfolio registered on LTIA's dropped significantly, from 39.9 per cent in 2014 to 10.3 per cent; nevertheless, it still amounted to HUF 1,844 billion at the end of 2015. The average portfolio decreased to HUF 5.5 million from HUF 5.7 million registered at the end of 2014. By contrast, the pension savings account (PSA) portfolio continued to decrease, both in terms of number of accounts and market value (the annual decrease was 7.4 per cent and 2.3 per cent, respectively). The decrease is primarily attributable to the fact that in terms of taxation LTIA is more competitive than PSA. While in the case of PSA tax exemption is provided only when the owner reaches the retirement age and the term of the PSA already reached at least 10 tax years, in the case of LTIA this is available already after five years.

Chart 51

Long-term investment accounts and pension advance saving accounts; portfolios held on the accounts



Source: MNB

5.2 REGULATED MARKET, POST-TRADING INFRASTRUCTURES

The turnover of the Budapest Stock Exchange (BSE) increased

Securities spot market turnover at BSE rose in 2015 by 13.1 per cent in total compared to 2014, while the average settled turnover on a quarterly basis amounted to HUF 883 billion. Turnover in the first quarter fell by 15 per cent, while it rose by 13, 2 and 40 per cent in the second, third and fourth quarter, respectively, year on year. The concentration ratio of the section members' trading flows in the securities spot market continued to increase in 2015; accordingly, the share of the TOP5 investment service providers active in the securities spot market soared from 72 per cent in 2014 to 80 per cent. The BSE futures turnover in 2015 exceeded the

2014 level by 7.4 per cent. On the BSE spot market, the average daily turnover of equities in 2015 amounted to HUF 8.6 billion, which surpassed the average daily turnover of HUF 7.8 in 2014, but fell short of both the HUF 9.8 billion and HUF 10.2 billion average turnovers registered in 2013 and 2012, respectively. Broken down by issuers, based on aggregated annual equity turnover in 2015, there was no change in respect of the four equities generating the largest turnover (OTP, MOL, Richter, MTelekom), however their share in total equity turnover rose from 97.3 per cent in 2014 to 98.4 per cent. In 2015, with a share of 55.2 per cent OTP registered the highest turnover, while Richter and MOL changed places; MOL took second place with a share of 19.3 per cent, slightly exceeding Richter's share of 19.1 per cent (distribution in 2014: Richter 18.9 per cent, MOL 13.1 per cent). The share of MTelekom fell from 6.6 per cent in 2014 to 4.8 per cent. The value of the BUX index at the end of December 2015 was 23,921 points, which exceeds the closing value of 16,634 points at the end of December 2014 by 43.8 per cent.

Chart 52
Changes in the BUX index



Source: MNB

In 2015, BSE registered three private capital increases and four delisting events

Two of the four delistings in 2015 were automatic delisting/crowding-out (TVK Nyrt., Danubius Nyrt.), while the other two (Business Telecom Nyrt., Hun Mining Nyrt.) were implemented as part of liquidation. The shares of TVK Nyrt. and Danubius Nyrt. were delisted in view of the fact that as a result of the successful voluntary bids made for the shares of the companies and the related crowding-out procedures, the bidders became the sole owners of the companies.

In 2015, the MNB conducted two major licensing procedures in respect of stock exchange licensing, which impacted the initial public offering of the stocks of Waberer's International Zrt. and DUNA HOUSE HOLDING Ingatlanforgalmi, -Kezelő és Szolgáltató Zrt. on the regulated market. Both companies were added to the BSE product list, but trading with the equities has not yet commenced.

At the end of 2015, the MNB acquired controlling ownership of BSE

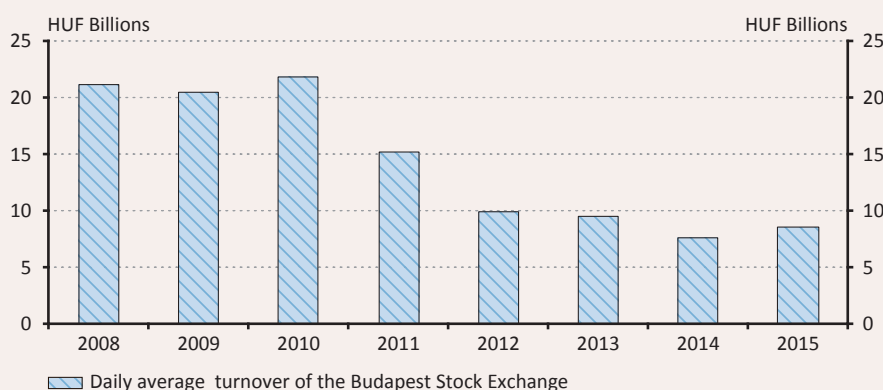
In recent years, the Hungarian equity market accumulated a significant development disadvantage compared to its regional competitors, which manifested itself in the decrease in the number of solid companies with high market capitalisation present on the BSE and in a continuous fall in the stock exchange turnover. The absence of proper supply and the low liquidity have a negative impact on the – foreign and domestic – institutional investors' activity, and it is not appealing enough for attracting the domestic household investors with higher willingness to take risks. As a result of this there is a threat that domestic institutional and household savings are diverted to foreign equity markets to an increasing degree. In order to reverse the negative trends, in

December 2015 the MNB acquired a majority interest in BSE, which enabled the MNB, as a non-profit oriented owner, to develop and implement a new capital market development corporate strategy, the elements of which include measures that materially strengthen both the supply and demand sides of the stock exchange products.

The strategic steps strengthening the supply side include, amongst other things, the listing of public corporations on the stock exchange, increasing the number of eligible, high quality companies, fostering the financing of SMEs through the stock exchange and increasing the number of highly liquid equities. The listing of corporate equities carries benefits for the capital market, the stock exchange and the corporations as well. From the stock exchange's point of view – as one element of the financial intermediary system – the increase in the capitalisation, turnover and liquidity is expressly positive, since in this way it becomes attractive for a much wider range of investors, thereby also strengthening the reputation of the equity market. On the other hand, from the capital market's point of view, the increase in stock exchange issuances raises the efficiency of financial intermediation, as it permits the optimisation of the issuers' structure. At the same time, the transparency criteria prescribed by the stock exchange foster the development of an efficient corporate operating framework. The stock exchange listing of corporations is also advantageous in term of financing, as it reduces dependency on bank financing, thereby facilitating the optimisation of the financing structure, i.e. loan vs. equity. In view of the fact that Hungarian corporate finance is dominated by lending, it may also be advantageous for the national economy if corporations fund themselves via the stock exchange, as this reduces the procyclicality of the banking system. The SMEs admission for listing leads to the creation of a new, dynamic corporate segment, representing further diversified, but more risky investment opportunities for investors. The advantages of listing on the stock exchange for SMEs include the diversification of the financing structure and improving creditworthiness.

Stimulation of the demand side may be achieved through regulatory cost incentives provided to issuers and investors, the improvement of financial literacy and by strengthening investor confidence. The incentives for issuers may include the rationalisation of the stock exchange listing processes, the provision of benefits connected to presence on the stock exchange, while investor incentives include increasing the stock exchange equity ratio of the domestic household and institutional portfolios and decreasing the administrative and other burdens attached to equity exposures. Of the steps strengthening investor confidence, BSE's active presence among international investors and financial intermediaries should be emphasised, with special regard to the fact that a large part of the stock exchange turnover is generated by foreign institutional investors.

Chart 53
Spot average daily turnover of the Budapest Stock Exchange



Source: MNB

Additional developments in the KELER group

In 2015, KELER launched its project aimed at acquiring an LEI code issuer licence, expected to be obtained in 2016. Once it acquires the licence, it will be able to issue and renew LEI codes for the Hungarian market participants. On 12 November 2015, the Agency for the Cooperation of Energy Regulators (ACER) approved

KELER's Registered Reporting Mechanism (RRM) status, thus the customers obliged to report may start accession to KELER's REMIT¹⁰ reporting system. As part of KELER's services, the data of the stock exchange and OTC transactions are stored and they are retrievable and can be filtered by date, counterparty or transactions. In 2016, the key duty of KELER, after the enacting of the second-level laws related to Central Securities Depository Regulation (CSDR),¹¹ is to submit the licence application and to go live with the new depository account management system (BaNCS).

In the case of KELER CCP, after obtaining the EMIR¹² licence, a comprehensive audit was performed in 2015, the result of which was also communicated to the College of KELER CCP. As the clearing member of the European Commodity Clearing AG, new markets became accessible both for KELER CCP and its clearing members, due to the fact that the EPEX SPOT, the APX Group and BELPEX power exchanges concluded an agreement on the integration of their markets into a uniform Central and Western European market.

5.3 RISKS IMPACTING INVESTMENT FIRMS

Declining counterparty risks under the white-label scheme

The foreign exchange market events of 15 January 2015 related to the Swiss franc highlighted the risks of white-label agreements applied by the market participants. The operating of the online trading platforms via the white-label scheme is a service where the investment firm purchases a fully supported product from a third party and then resells it under its own brand and business name. While in the relation of the investment firm and the customer the service includes the acceptance and forwarding of the order, the contract between the investment firm and the third party, rendering the actual services (access to the foreign exchange market) covers not only the purchase of the software licence, but also the management of securities and cash account. In the case of white-label contracts the customers' funds and positions are recorded on subaccounts opened under the customer account registered in the name of the investment firm. Technically, the third party service provider is able to state the customers' positions and collaterals separately, but in respect of the open positions it aggregates their assets that may serve as collateral. As a result of this, the Hungarian investment firms have substantial direct and – due to the transactions concluded by their clients – indirect credit and counterparty risk exposure to the third party service providers and custodians. During 2015 the balance of the customer accounts affected by the scheme decreased substantially, i.e. from HUF 18.5 billion of 2014 to HUF 11.4 billion. In 2015, the MNB reinforced its oversight activity in respect of the five investment firms offering white-label services, as part of which it prescribed additional capital requirement for counterparty risk during the annual supervisory review and assessment of the internal capital adequacy assessment process.

The market share of investment firms with relatively small customer securities holdings decreased in 2015

The concentration of the customer securities managed by investment firms, calculated using the HHI, decreased in 2015 from 35.5 per cent in 2014 to 33.6 per cent. At the end of 2015, the three largest market participants covered 85.5 per cent of the customer securities portfolio held by investment firms, and practically corresponded to the 85.4 per cent measured at the end of 2014, i.e. the concentration of the customer securities portfolio is still very high. The composition of the three investment firms with the largest customer securities portfolio did not change compared to 2014. The market share of the investment firms with non-bank owner background, holding relatively low (below HUF 100 billion) customer securities portfolios, decreased; the 9.1 per cent measured in December 2015 falls short of the 2014 value by 2.4 percentage points. This supports the trend that as a result of the fraud cases that impacted investment firms, after March 2015 customers and customer portfolios flowed from investment firms which were deemed less safe by customers to the investment services providers that customers believed to be more reliable.

¹⁰ REMIT: Regulation 1227/2011/EU of the European Parliament and of the Council on wholesale energy market integrity and transparency.

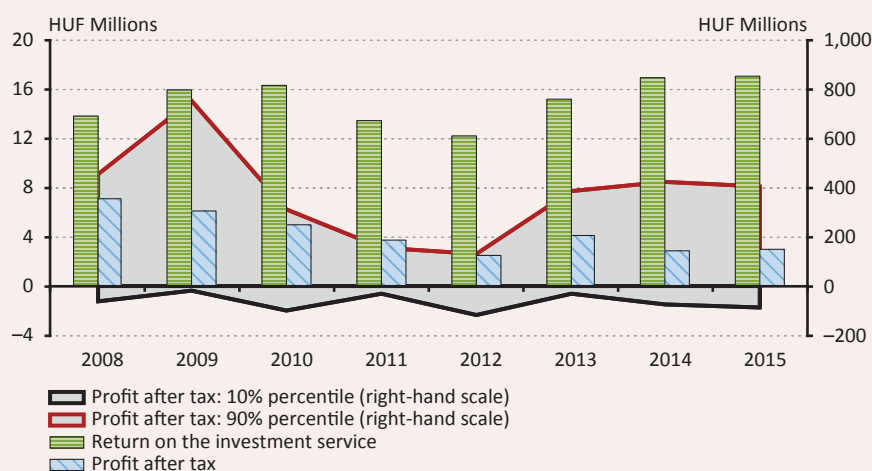
¹¹ Regulation 909/2014/EU of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation 236/2012/EU.

¹² Regulation 648/2012/EU of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories.

Decreasing profitability due to the higher IPF premiums and tightening statutory regulation related to the indemnification, resulting in the commencement of a consolidation process

The profit (profit/loss after tax) of the entire investment business sector – investment firms and investment firms' branch offices together – essentially remained at the same level. While the profit after tax in 2014 was HUF 2.96 billion, this changed to HUF 3.05 billion by 2015.¹³ Accordingly, the profitability of the sector also remained at the same level in 2015: the 2014 return on equity (ROE) ratio of 16.4 per cent changed to 16.6 per cent. The income concentration of the entire investment business sector was characterised by a declining trend: while in 2014 the first three market participants with the highest profit after tax accounted for 142.2 per cent of the entire sector's profit after tax, this value fell to 112.6 per cent in 2015, and there was no change in their composition and sequence. A similar trend can also be observed in the case of the first five market participants with the highest profit after tax: in 2014 their profit after tax accounted for 147.4 per cent of the sector's entire profit after tax, falling to 117.3 per cent by 2015. Due to the impacts in 2015 – the effect on customers of the fraud cases related to investment firms, tighter statutory regulation, additional burdens related to indemnification (see IPF premiums) – a consolidation process commenced in the sector, as a result of which in 2015 the number of investment firms fell from 21 to 18; in 2016 one more firm (Reálszisztéma Értékpapír-forgalmazó és Befektető Zrt.) will terminate its activity and another one (Codex Tőzsdeügynökség és Értéktár Zrt.) will reduce the scope of its activity. The three companies that terminated their activity as investment firms in 2015 – Merlito Értékpapír Zrt., Innovative Securities Europe Zrt., Hungarograin Tőzsdeügynöki Szolgáltató Zrt. – were among the small institutions, as in the absence of sufficient customer number and size they would have difficulties to achieve positive profitability in the longer run due to the higher extra burdens.

Chart 54
Profitability of investment firms



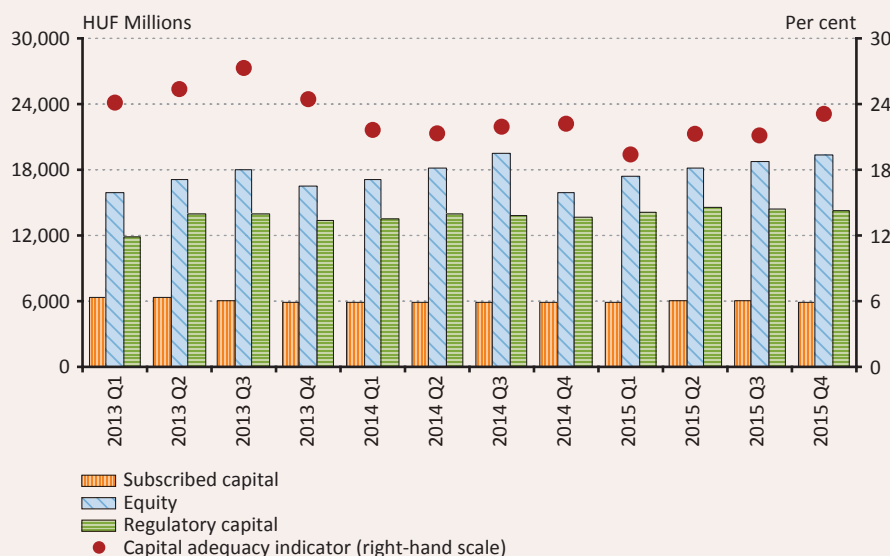
Source: MNB

Capital adequacy risk arises essentially at smaller institutions

On the whole, the capital position of investment firms – equity and regulatory capital – did not change in 2015: the average capital adequacy ratio of the investment firm sector was 21.2 per cent in 2015, marking a slight decrease compared to the 21.7 per cent figure recorded in 2014. The available regulatory capital at the end of December 2015 was HUF 14.3 billion in total, accounting for 288 per cent of the prescribed capital requirement (HUF 4.9 billion) (in 2014 this ratio was 277 per cent).

¹³ May change after the audit.

Chart 55
Capital and capital adequacy ratio of investment firms



Source: MNB

At the end of 2015, two of the 18 investment firms had a capital shortfall, as they did not satisfy the start-up capital requirements: one of them terminated its activity in 2016, while the other one has meanwhile settled its capital position. In terms of capital adequacy, the sector is still asymmetric: only 7 of the 17 investment firms with registered office in Hungary had to comply with capital requirements calculated on the basis of exposure, while in the case of the remaining 10 companies the capital requirement corresponds to the start-up capital requirement specified in the Investment Firms Act, as a higher limit.

Chart 56
Risk map of the investment firms

| Type of risk | Source of risk | Level of risk | Risk outlook | Details of the source of risk |
|-------------------------|--|---------------|--------------|---|
| Credit risk | Deposit of customer funds with third parties | ● | ↓ | Risks concerning customer assets held at third parties (online platforms), highlighted by the impacts of the Swiss franc shock. |
| Market risk | Market uncertainties (turnover, investor confidence) | ● | → | The level of the market risk is significant, due to the market barriers, the fierce competition and the high market concentration. The risk stemming from the market uncertainties is unlikely to decrease. |
| Profitability | Extra burdens represented by higher premiums for indemnification | ● | ↑ | The profitability concentration is still high. The CHF shock in January 2015 and the effect of frauds revealed at investment firms (the extra charges for indemnification) may have a negative effect on the profitability of several investment firms. |
| Capital adequacy | Decreasing profitability | ● | ↑ | The negative impacts of 2015 (frauds impacting investment firms, extra burdens related to indemnification) had a negative effect on the capital position as well, hence risks are expected to increase. |

Legend:

Degree of risk: high (red dot), significant (orange dot), moderate (yellow dot), low (green dot)

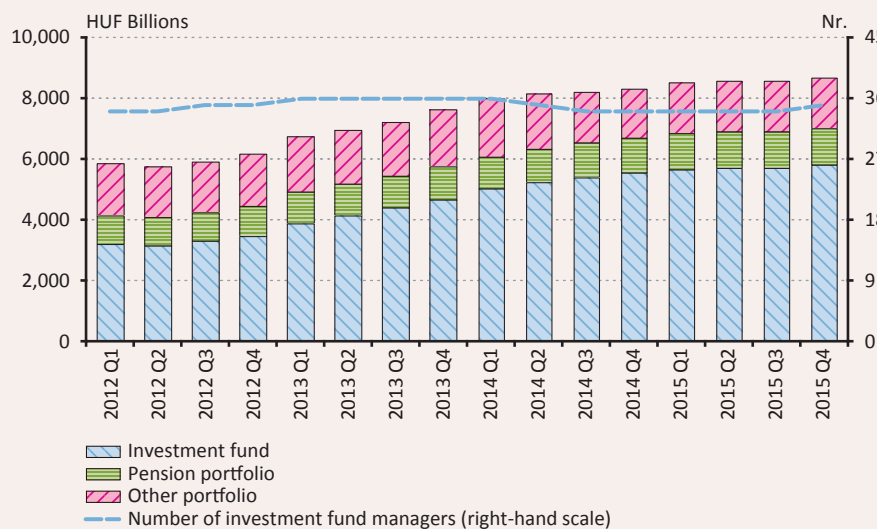
Direction of risk: increasing (up arrow), stagnant (right arrow), decreasing (down arrow)

5.4 FUND MANAGEMENT MARKET AND RISKS AFFECTING INVESTMENT FUND MANAGERS

Amidst decreasing capital inflows, the net asset value of mutual funds is at a historic high

In 2015, the number of managed mutual funds soared: the 577 mutual funds managed at the end of 2015 – taking securities and real estate funds together – exceeded the figure recorded in 2014 (549) (in 2013 an increase of nine was recorded). This growth occurred in securities funds, while the number of real estate funds remained constant. There is no change in the number of asset managers, which has fluctuated at around 35 since 2008. The assets managed in mutual funds continued to increase in 2015, reaching a historic high of HUF 5,777 billion by the end of the year. The growth rate, however, has substantially decreased compared to former years (34.6, 18.6 and 4.5 per cent in 2013, 2014 and 2015, respectively). Contrary to the former years, the source of growth in mutual funds' assets became much more balanced: growth is no longer dominated by net capital inflows, instead the yields realised on the investments also play a relatively substantial role. Within the increase in the net asset value of the mutual funds of HUF 1,198 billion and 865 billion in 2013 and 2014, respectively, net capital inflows accounted for 80.9 and 72.9 per cent, respectively, of the asset growth of HUF 250.9 billion recorded in 2015, while the share of net capital inflows fell to 57.8 per cent. Net capital inflows were relatively steady during the year.

Chart 57
Number of investment fund managers and the volume of assets managed



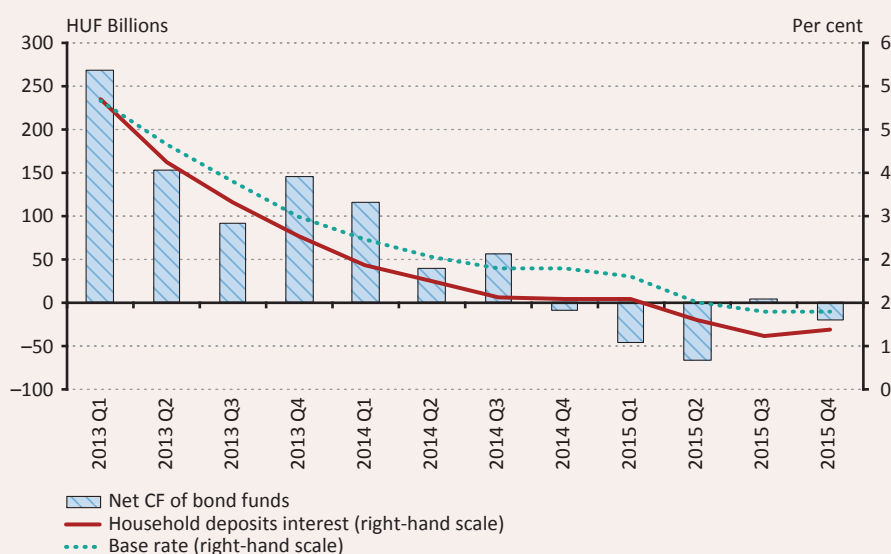
Source: MNB

The portfolio of mutual funds is highly concentrated, which decreased somewhat during 2015. The top five market participants in 2015 covered 70.2 per cent of the assets managed in mutual funds, which falls short of the 2014 ratio by 1.3 percentage points. In 2015, 32 fund managers pursued the management of mutual funds. Market concentration is of similar magnitude also in the case of other managed assets (in 2015, the TOP5 market participants covered 68.7 per cent of the entire portfolio); altogether 18 asset managers pursue such activity.

As a result of the decreasing interest environment, bond-type investment funds were characterised by disinvestment

In 2015, net capital inflows to investment funds substantially decreased. In 2014, a total of net HUF 631 billion flowed into investment funds, while this amount fell to HUF 145 billion in 2015. The fall in net capital inflows was essentially caused by the turnaround in the direction of capital flows that characterised bond-type investment funds (liquidity, money market, short-term, long-term and perpetual bonds). While bond-type investment funds¹⁴ were characterised by capital inflows of HUF 660 billion and HUF 204 billion in 2013 and 2014, respectively, this trend turned around in 2015 and a total of HUF 126 billion was withdrawn: the negative net capital inflow was essentially attributable to the decreasing interest and yield environment.

Chart 58
Net capital inflows of bond-type investment funds and changes in interest rates



Source: MNB

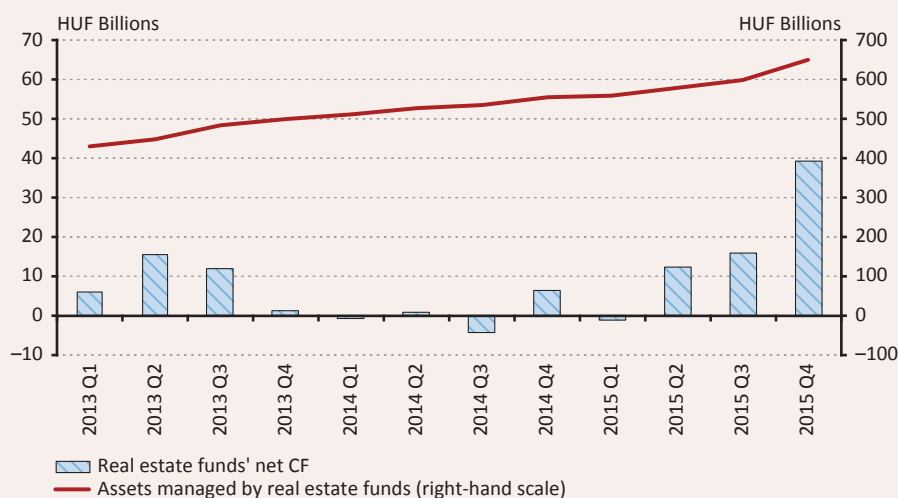
The net capital inflow of mixed funds¹⁵ (bond-heavy mixed funds, balanced mixed funds, dynamic mixed funds) was also characterised by a decrease. The net capital inflow of HUF 232 billion in 2014 fell to HUF 155 billion by 2015. The strong interest previously shown for absolute yield investment funds¹⁶ tapered off considerably, and accordingly, the positive net capital inflow of HUF 299 billion in 2013 and HUF 265 billion in 2014 plunged to HUF 30 billion by 2015. On the other hand, substantial capital inflows were observed in 2015 in the case of funds investing in direct real estate, rising from HUF 9 billion recorded in 2014 to HUF 68 billion. Accordingly, the portfolio of these funds rose from HUF 526 billion at the end of 2014 to HUF 620 billion by the end of 2015. The distribution of capital inflows was not even; it essentially related to three real estate funds. In the case of funds investing in indirect real estate – with an end-of-year portfolio of HUF 32 billion – capital outflows continued in 2015, albeit at a decelerating rate.

¹⁴ Net asset value of HUF 2,699 billion at the end of 2015.

¹⁵ Net asset value of HUF 704 billion at the end of 2015.

¹⁶ Net asset value of HUF 846 billion at the end of 2015.

Chart 59
Real estate fund portfolios and net capital inflows



Note: the chart includes the data of funds investing in indirect and direct real estate.
Source: MNB

Decreasing profitability: the growth rate of after-tax profit fell short of the managed assets' growth rate

As a result of the increase in managed assets – investment funds rose by 4.5 per cent and other managed assets¹⁷ by 3.9 per cent – the sector's after-tax profit rose from HUF 20.7 billion in 2014 by 3.7 per cent to HUF 21.4 billion.¹⁸ The concentration ratio of the sector is still high, although it decreased in 2015, breaking the growth trend observed in the previous three years. In 2015, the three asset managers with the highest after-tax profit accounted for 46.9 per cent of the entire sector's after-tax profit, falling short of the 2014 value by 4.2 percentage points. The five asset managers with the highest after-tax profit accounted for 67.2 per cent of the entire sector's after-tax profit in 2015, falling short of the 2014 value by 1.3 percentage points. Similarly to 2014, there was no change in the composition and sequence of the top five market participants in 2015. The number of loss-making asset managers rose to ten in 2015, up from five in 2014, and their total loss amounted to HUF 511 million (HUF 113 million in 2014). Compared to 2014, the bulk of the increase (68 per cent) in the loss is attributable to Quaestor Befektetési Alapkezelő Zrt., the investment funds of which were suspended in the beginning of 2015 due to the fraud that affected the investment firm. Three of the ten asset managers that posted a loss in 2015 were loss-making already in 2014; at the beginning of 2016 the MNB partially suspended the licence of one of these (Globeserv Befektetési Alapkezelő Zrt.). Three of the ten loss-making asset managers commenced their operation in 2015, and thus the loss is attributable to the start-up operation. All of the loss-making asset managers complied with regulatory capital requirements at the end of 2015. The total assets managed by the loss-making asset managers at the end of 2015 amounted to HUF 59.8 billion, accounting for 0.7 per cent of the total managed portfolio.

¹⁷ Pension fund portfolios, insurers' portfolios, other portfolios.

¹⁸ The 2015 after-tax profit/loss has not been audited yet.

Chart 60
Profitability of investment fund managers



Note: No approved dividend data are available for 2015 yet.
Source: MNB

Outstandingly high capital stock at fund managers

The fund management sector has outstandingly high capital stock. At the end of 2015, the available regulatory capital (HUF 12.7 billion) accounted for 226 per cent of the regulatory capital requirement at the sector level. In 2014, a total dividend of HUF 25.9 billion was paid across the sector, which exceeds the 2013 dividend payment by HUF 12.6 billion. The 2014 dividend payment ratio significantly exceeded the after-tax profit (125.3 per cent), which is attributable to a major capital withdrawal linked to a single institution.

Chart 61
Risk map of the investment fund managers

| Type of risk | Source of risk | Level of risk | Risk outlook | Details of the source of risk |
|-------------------------|---|---------------|--------------|--|
| Credit risk | Compliance | ● | ↑ | Compliance with the rules in force of MiFIDII/MiFIR may be a challenge for those fund managers with permission for investment services, while compliance with the rules in force of PRIIPS may be a challenge for the fund managers with close-ended funds. |
| Market risk | Low interest rates, bottom of the interest rate cycle | ● | ↑ | Market risk is expected to increase, because the raising of interest rates after the bottom of the interest rate cycle may lead to capital outflow from the funds investing into interest-bearing assets. |
| Profitability | Decreasing fund management fees | ● | → | Due to the increasing competition, the global fund management sector is characterised by decreasing fund management fees, falling short of those applied in the Hungarian market, which may point to a decrease in the fees in the domestic market as well, due to the strengthening of cross-border services. |
| Capital adequacy | Decreasing profitability | ● | ↑ | The fund management sector is characterised by adequate capitalisation; however the decreasing profitability may affect some smaller institutions negatively, which increases the level of risk. |

Legend:

Degree of risk: high (red circle), significant (orange circle), moderate (yellow circle), low (green circle)

Direction of risk: increasing (up arrow), stagnant (right arrow), decreasing (down arrow)

5.5 VENTURE CAPITAL FUND MANAGERS

The former dynamic growth in the venture capital fund sector ended

The dynamic growth seen in 3 years preceding 2015 halted last year and a minor downturn can be observed. While at the end of 2011, 2012, 2013 and 2014 15, 27 and 33, respectively companies had venture capital fund management licences, by 2015 only 31 companies remained in the market. In contrast to the number of venture capital fund managers, the number of capital funds did not change (there are 38 funds in the market). In terms of distribution, 1 venture capital fund manager has 4 funds, another one has 3, three have two funds, 25 fund managers manage one fund each, and 1 fund manager has not yet any registered fund. In terms of resources the 38 capital funds are broken down as follows: 8 funds utilise the resources of JEREMIE-I., 10 those of JEREMIE-II., 8 those of JEREMIE-III., 2 those of JEREMIE-IV, 1 aims to use the regional EU resources, while the number capital funds utilising so-called enterprise, state or private resources is 9.

Placements by venture capital funds for the financing of the SME sector increased in 2015

The paid-in funds available for the SME sector in the venture capital funds amounted in total to HUF 144 billion at the end of 2015, which exceeds the end-2014 value by 17.2 per cent. Of the available HUF 144 billion, HUF 104 billion was allocated in the form of investments and loans granted until the end of 2015. The growth is primarily attributable to placements from JEREMIE resources, amounting to HUF 71 billion in 2015.

Chart 62
Assets of the venture capital funds and capital allocations



Source: MNB

6 Market surveillance

Due to the limited possibility to apply sanctions in respect of individual cases, market surveillance activity takes shape most of all in the clear communication of groups of cases and in the strengthening of informed financial consumer attitude. In 2015, the MNB consciously reinforced the joint and continuous presence of these areas in its surveillance activity. This is of the utmost importance, because the preventive measures possible in individual cases are restricted at the level of procedures; the market surveillance procedures may commence subsequently, only after the notification of the authority – essentially with the purpose of applying sanctions – to identify conducts satisfying the definitions specified in the sector-specific acts, belonging to the tasks and authority of the MNB. That is, the limited measures and sanctions that may be presented as a result of the procedures are not enough to reduce and eliminate the phenomena belonging to this group. Important achievements in 2015 included strengthening of cooperation on the merits with the investigation authorities and public prosecutors' offices, a common approach in respect of the application of laws, and the specific steps of public thinking in the area of professional consultation and education.

Due to the low interest environment, the promises of high yields, characterising unauthorised collection of deposits, are particularly appealing

Based on the experiences gained in 2015, the collection of funds for investment or other purposes in the absence of a licence and any guarantee whatsoever is the segment which represents the highest risk, related to activities subject to licence and/or registration, falling outside the supervised sector and – as it follows from its nature – having high latency. Despite the fact that they are rather diverse in geographic terms or in respect of the relation with the supervised sector or in relation to the structure of the offered product or investment, these activities do have at least one common feature, namely that they attract potential investors with promises of high yields, benefiting from the presently low interest environment. They make use of the limited knowledge of potential investors in respect of the operation of the financial intermediary system, often contact the potential customers without specifying any registered office, contact details or any other verifiable data, thereby making it difficult or even impossible for the targeted clientele to perform any check. It is also a frequent experience that investors do not try to obtain information, either from MNB or in any other form, about the persons or institutions operating in the segment outside the supervised sector, and quite often they may be aware of the fact that they conclude a contract with a non-supervised actor, but they fully ignore it or do not attach sufficient importance to this.

Unauthorised fund raising is not covered by the scope of any investor protection system

Unauthorised fund raising activities operate under the complete absence of a guarantee scheme, and thus they represent an extraordinary risk for the investors, as they are not covered by any – public or statutory – investor protection scheme. It is quite likely that the investors are not in a position to enforce their claims for part or the entirety of the amounts deposited by them under various titles, due to the operational features of these persons and institutions (absence of registers, statements, undocumented relationship network of the intermediary system, etc.). The experiences from the investigations conducted in 2015 also showed that the unauthorised actors collect amounts in the magnitude of millions or even billions, but as during the pursuance of such activities the amounts to be invested and the yields (interest), if any, are typically paid in cash, a large part of these procedures are unable to identify the exact range of investors and the volume of invested funds, and thus there is high degree of latency in this segment.

The application of MLM schemes is still popular among entities pursuing unauthorised activity. The method of perpetration carries particular risks due to the direct and fast access to the potential clientele, offering the potential of nationwide distribution, especially when the sales pattern of the product offered by unauthorised activities is built on already operating MLM networks. It represents an additional risk that the exploration of the real activity with public authority instruments is very time-consuming, as the actors of the scheme build the investor clientele by operating an undocumented relation network, applying direct marketing tools, and the operated schemes take shape in superficial marketing materials targeting masses of people.

Risks represented by unauthorised online foreign exchange trading are still significant

Based on the signals received and the inspections conducted in 2015, it can be stated that no spectacular decline could be detected in the spread of unauthorised online foreign exchange trading service providers (FOREX traders) and in the number of persons/institutions joining these unauthorised activities as intermediary. The key feature of these cases is that, acting as an entity that cannot be closely identified by the potential investors – most often indicating offshore background or relations, and longer term professional history and growth potential – they operate a Hungarian language website, expressly targeting Hungarian investors, addressing them through an aggressive marketing activity. The service providers and the intermediaries make the false appearance for the investors that, due to the non-resident service provider, the pursuance of this activity falls outside the MNB's tasks and competence, emphasising, on the other hand, the existence of licences of alleged or real supervisory authorities, leading to a false feeling of security and eventually generating material financial losses.

Unlicensed purchases of receivables represent extraordinary consumer protection risk

The result of the extraordinary data supply ordered by the MNB in 2015 to identify unlicensed purchasers of receivables and the notifications on similar subjects signal that there are a large number of unlicensed purchasers of receivables in the financial market. This activity involves particular consumer protection risks, as the removal of the supervised institution's credit and loan receivables from the supervised sector – i.e. the transfer thereof to the unlicensed actors – not only means that the debtor of the receivable must fulfil its obligation to a new beneficiary, but also that the further fate of the receivable, the workout procedures and the time and method of collection are defined by the new beneficiary, i.e. the unlicensed purchaser of the receivable. In the case of a non-core market participant, all of this may generate an extremely unfavourable situation for the debtor.

Sigismund of Luxemburg

(1387–1437)

King of Hungary with the longest reign in the Medieval Age, moreover King of Germany, King of Bohemia, Holy Roman Emperor, Sigismund was the most respected figure of contemporary Europe.

His reign of half a century in Hungary can be divided into two parts. The first period was a time of overcoming disturbances following succession to the throne and the dealing with an increasing Turkish threat, while the second period can be regarded as nearly four decades of stability.

Sigismund changed power relations between the ruler and the barons by giving castles and lands, and was compelled to accept the dominance of leagues of barons. The king's court was the centre of culture in the time of his predecessors; thereafter the courts of barons had equally high influence on the culture and politics of the kingdom.

The king gathered the nobility into the Order of the Dragon, and practically left governance with them, he rather dealt with his ambitious plans of foreign policy. Governance in Hungary was solid, which is best shown by the fact that the king could be absent for many years attending to business in the other countries throughout Europe, without triggering any political disturbances within the kingdom.

His era was a turning point in the foreign relations of Hungary: the regionally dominant Hungary became threatened by the Ottoman Turks, and after a series of unsuccessful campaigns it was clear to everyone that the kingdom must resort to a defensive stance, this is why Sigismund decided to strengthen the southern line of border castles to ensure that the country can defend itself from the Turks. He entered into prolonged wars with the Republic of Venice over the domination of Dalmatia, and fought against the Hussites in Bohemia.

Sigismund was a reformist, which originated from a new way of thinking: institutions and systems can be changed and modified. In this spirit, the king founded a university in Óbuda; ensured the right of patronage of Hungarian nobles; introduced a standard unit of weight, length and volume; cities developed at a high pace during his reign; and he granted all peasants the right of free movement. He made Buda the centre of his empire, and rebuilt the castle to make it royal residence of European renown.

Sigismund was a politician who was thinking above nations in the contemporary sense, capable of taking regional interests aside and focus on efforts that are in the best interest of the whole of Christianity, as he did at the Council of Constance on the Western Schism. He could ingeniously turn his personal traits to his advantage in diplomatic affairs and on negotiations relating to strategic decisions. He had a good eye to choose colleagues, he drew accurate conclusions from the disorders the kingdom experienced early on his reign, and later succeeded in earning the full support of dominant political figures of the country.

In the last year of his reign a peasant revolt erupted in Transylvania. The nobility joined its forces against the peasantry, which led to the alliance of Hungarians, Székelys and Saxons, hence laying the basis of a later political organisation of Transylvania.

Dying without a male successor and a chaotic period coming after his death, Sigismund's heritage slowly faded into oblivion in the national remembrance; however, he was not only a notable king of Hungary, but also an Emperor with an integrating force and ruler of great deeds influencing history.

RISK OUTLOOK FOR NON-BANK FINANCIAL SECTORS

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