

Practice area	Country	Firm	Title	Summary	Contact person
Banking	Hungary	Szecskey Attorneys at Law	State responses to certain financial effects of the financial crisis in Hungary	During the past year the Hungarian government, government agencies and industry representative associations worked hard to identify and introduce effective protective measures to balance the negative effects of the downturn of the Hungarian economy caused by the global financial crisis. The following summary highlights the actions taken to help the economy and individuals to recover.	Judit Budai Judith.budai@szecskey.com

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While in October 2008 the daily world press often mentioned Hungary alongside Iceland, few similarities can actually be found between the two countries' economic structures and financial exposure.

The reality is that the "ordinary" effects of the crisis affecting most other countries naturally hit Hungary as well. Since the last quarter of 2008, when the financial crisis reached the CEE region, the Hungarian Parliament, the government, governmental agencies supervising financial markets, and the Central Bank took a number of steps to restore stability in the financial and money markets in Hungary. This article aims to chronologically go through the main problems that arose in the lending and borrowing markets, investment products and money markets, and highlights the measures taken by government agencies to balance the negative effects.

#### Increase of Deposit Insurance

While no rush of the depositors was experienced in Hungarian banks or affiliates and branches of foreign banks in Hungary, as a preventive measure, the maximum

amount warranted for depositors by the National Deposit Insurance Fund was raised from HUF 6 million to 13 million (this took place by legislation taking effect from October 15, 2008). Accounts opened at the same bank by the same depositor are considered to be one account with regard to this maximum coverage.

In April 2009, the National Deposit Insurance Fund announced its intention to raise the maximum amount warranted for depositors again: this time to HUF 15 million. The reason of the planned measure was an EU regulation, according to which the warranted amount cannot be lower than EUR 50,000, thus the HUF equivalent needs to be recalculated at a 300 HUF/EUR rate. However, this proposal – with respect to the current HUF/EUR rate – has not been accepted.

#### Stricter Transparency Requirements in case of an Acquisition of Qualifying Interest in Banks

In the interest of securing a higher level of transparency, Act CIII of 2008 further specified the rules of acquisition of a *qualified* interest (exceeding 10 per cent) in a financial institution that requires authorization of the State Supervision of Financial Organizations (the Hungarian FSA, in Hungarian: *Pénzügyi Szervezetek Állami Felügyelete* - "PSZÁF"). The act also affected the method of calculating the interest.

#### PSZÁF Warnings on Prudent Operation

The PSZÁF, mainly acting via so-called "Dear CEO-letters", in letter no. 5/2008 dated October 13, 2008, called for financial institutions to conduct their business in a prudent and responsible way and reminded them of the possible sanctions of market abuse.

The PSZÁF also published recommendations on motor-vehicle financing by leasing. Leasing that take longer than 8 years or where the buyers' initial payment is less than 20 per cent are deemed to be risky, therefore the PSZÁF requires the creditor to provide additional capital in the amount of 50 to 100 per cent of the risky credit sums.

#### Investment Fund Unit Market Regulations

On November 7, 2008, the PSZÁF suspended the issuance of open-ended and closed-ended investment units for a period of 10 days. During this 10-day period it was not possible to subscribe or redeem the investment units of open-ended and closed-ended real estate funds. According to the PSZÁF, this measure intended to ensure the security of savings by giving real estate funds time to inform their investment unit holders of the nature of their investment, the expected changes, and risks. The real reason behind the PSZÁF decision was that a substantial amount of capital was withdrawn from local direct real estate funds over October, 2008 and consequently assets managed in these funds decreased by about HUF 110 billion. The PSZÁF also claimed that, while the funds still had sufficient liquid assets (discount treasury bills), a capital withdrawal of this speed and magnitude would have raised liquidity issues very soon. During the suspension period, fund

managers could change the deadline for fulfilling redemption orders to the legal maximum of 90 business days, and legislation provided the possibility of converting open-ended real estate funds to closed-ended funds. On November 24, three funds applied for suspension of the redemption of their units for 180 days. In the future, there are three possibilities for the operation of real estate funds: they can remain open-ended, become closed-ended, or cease operation. In PSZÁF "Dear CEO letter" no. 2/2009, all fund managers of public open-ended real-estate investment funds and investment funds investing into real estate funds were called upon to send the PSZÁF their strategy concerning the form of operation.

### Stock Exchange Index and HUF Volatility Balances

The Budapest Stock Exchange (BSE) index (BUX) has shown a sudden and accelerating fall since the middle of September 2008. Parallel with this, the rate of the EUR started to increase rapidly from the previous steady 235 HUF/EUR first to 286 HUF/EUR at its highest point in October 2008. At that time, prominent business analysts said that a foreign group of speculators were making deals at large against the Hungarian forint and stocks. Demand for Hungarian government bonds also fell and this caused difficulty in financing public debt, as new treasury bond issues were often unsuccessful and a large number of previously issued government bonds were sold by international holders, due to the sharp devaluation of the currency. The rate of the Hungarian Forint began to fall again from January 8, 2009. On February 4, it reached the 300 HUF/EUR "psychological threshold", but on that day the trend turned downwards. In August and September, 2009 the rate was around 270 HUF.

### HUF maintenance

In response to the volatility, on October 22, 2008, the Central Bank unexpectedly increased the central bank base rate by a very significant extraordinary 3 per cent, raising the rate from 8.5 per cent to 11.5 per cent. While other central banks rather reduced central bank rates, in Hungary such increase was made to distract players on the interbank market to short sale HUF, to make HUF borrowings expensive.

The central bank base rate has been reduced during the next few months. At the meeting of Monetary Council held on January 19, 2009, the central bank reviewed the latest economic and financial developments and reduced the central bank base rate by 50 basis points from 10 per cent to 9.5 per cent, with effect from January 20, 2009.

By the beginning of May, the Hungarian currency has appreciated significantly to EUR (to around 280). The main reasons of this phenomenon are still psychological indicators: the expanding tendency of international risk taking, the increase of stock market, and the easing depression in connection with the global recession. As of July 28, 2009, another reduction lowered the rate to 8.5 per cent, and the latest decision in effect from August 25, 2009 resulted in a base rate of 8 per cent.

### Short Selling Monitoring

In "Dear CEO letters" nos. 4/2008 (dated September 29, 2008) and 1/2009 (dated January 16, 2009), the PSZÁF obliged all investment firms and credit institutions pursuing investment services with trading rights on the Budapest Stock Exchange (BSE) to report certain short selling transactions to the PSZÁF. (Affected transactions are those concluded after September 29, 2008, in which the number of the items of the transaction reaches or exceeds 0.01 per cent of the total number of the same share listed on the BSE.) The PSZÁF emphasized to the financial institutions that when executing client orders, they must make sure that the client will be able to deliver the securities within the settlement period.

Meanwhile from March 2009 by the end of August 2009 the BUX has reached the level where the fall began a year ago.

### Increasing FOREX Reserves and Restoring Confidence in State Budget

To restore investors' and depositors' confidence both internally and abroad in the stability of the Hungarian state budget, negotiations were started about a EUR 6.5 billion account to be opened by the European Central Bank (ECB) and a similar credit line opened by the IMF in the amount EUR12.3 billion. The World Bank offers EUR 1.3 billion for rescue purposes.

In the meantime, both the IMF and the ECB have approved the granting of the credit line mentioned above. The IMF holds the amount on stand-by for 17 months. The credit stand-by fee is significant, but the rate of the money drawn is lower than usual. The government had to undertake fiscal measures reducing pensions and civil servants' 13<sup>th</sup> month wage to obtain the credit.

The credit could be drawn in five tranches, and average loan period is five years. Hungary was required to decrease its budget deficit, increase bank regulation and supervision, and adopt stricter rules to stabilize the budget. To this date, a sum of EUR 14 billion was drawn, and Minister of Finances Péter Oszkó reported lately that Hungary does not need to draw any further amounts at this moment. The EU and the IMF agreed to prolong the standby-period by six months until October 2010.

### Balancing Difficulties of Foreign Exchange Lending

As a significant proportion of the loans in Hungary was denominated in CHF, from February 2, 2009 the central bank takes part in weekly EUR/CHF swap operations, organized by the Swiss National Bank. The Swiss National Bank provides CHF for EUR. This step is helping lending banks in Hungary to satisfy their CHF needs in connection with the CHF denominated lending.

It is worth mentioning that, to increase confidence in lending to good debtors, a bill was sent to Parliament that plans to change the system of debtor information available to the banks. The current system is a "negative" one, only containing those who are in default with their payments, whereas the plan was to also keep good debtors on record. As constitutional rights would have been affected, no act has been approved yet.

Unexpected changes took place in foreign currency loans in March: as an effect of the global crisis households repaid more debt than they borrowed. Such phenomenon has been unexpected in the history of Hungary's foreign currency lending.

### Bank Rescue Package

The bank rescue package – the aim of which is to support financial institutions and banks – was passed by Parliament last December as Act CIV of 2008 on the strengthening of the stability of financial intermediaries. The bank rescue package includes HUF 300 billion for raising the capital of banks and HUF 300 billion for guarantees. The aggregate amount of the state guarantees, that could be issued from this budget, is HUF 1,500 billion. The package is to be financed from the IMF credit granted to Hungary at the end of 2008.

The recapitalization measure makes available new capital to credit institutions in exchange for preferential shares, to enable them to strengthen their capital base against potential losses. In case of the so-called voluntary recapitalisation, – upon the request of an eligible bank –, the government may acquire preference shares, which are considered as tier 1 capital. In this scheme, the government and the bank must conclude an agreement, in which the rights and obligations of the government and the value of shares have to be set out. The state will delegate members to the applicant bank's boards and would limit top managers' salaries if a state capital injection is granted from the package at a bank's request. The forced recapitalization is also available for the state as prescribed by law.

The debt guarantee scheme is available to banks licensed in Hungary that meet prudent capital requirements. The guarantee measure covers against remuneration new debt with a maturity of up to three years (or five years in duly justified cases). Subordinated debt and interbank deposits are excluded from the scheme.

Under the package, the government could decide by March 31, 2009 to inject capital in banks while banks could take advantage of a government guarantee until the end of the year. In the meantime, the application deadline for the capital funding was extended from the end of March to the end of December.

The first banks who received governmental funds from the IMF credit facility were OTP Bank and Land Credit and Mortgage Bank (FHB Bank) to boost domestic lending. The duration of the loan is 4 years with a 2-year grace period for both of the banks. The fully State-owned Hungarian Development Bank also received a government loan.

OTP received a loan of HUF 400 billion on market conditions, which means that the bank has to pay a premium of benchmark plus 250 basis points. In exchange for the loan, OTP Bank undertook to place the amount in Hungary, including at least HUF 200 billion to corporate clients. Within the placement of loans to corporates, OTP shall step up lending to SMEs and try to keep the increase of funding costs to a minimum. OTP assumed all the related risks. The government received two positions in OTP, one in its Supervisory Board and one in the audit committee to oversee the use of the loan.

The other bank, FHB received a total of HUF 120 billion for which it agreed not to cut back its lending activity, to maintain its loan stock steady, and issue mortgage notes in the amount of at least HUF 10 billion in the next year.

The current loans do not constitute part of the HUF 600 billion bank rescue package.

#### Crisis-management program of new PM

Prime Minister Gordon Bajnai was elected by Parliament in April on a vote that at the same time expressed no confidence in Ferenc Gyurcsány, voting the socialist PM out of office. 204 delegates in the 386-seat Parliament voted in favour of Bajnai to become Hungary's new PM. Bajnai, who has no party affiliation, went on to reshuffle the cabinet and bring in experts free of party affiliations to take over the key finance, economy, energy, and social welfare ministries. In March, Gyurcsány said that a new interim government and a new PM were needed to turn the country's economy around.

The 4 main goals of the program are to take immediate steps in crisis management to reactivate economic growth, to restore budgetary balance, and to regain confidence. Pensions, public sector payments, and welfare payments were all cut while value-added tax was increased in an effort to relieve the national budget by the equivalent of EUR 4.4 billion. Bajnai also announced tax relief for lower-income workers in an effort to counter unemployment.

The program actually lists five aims, among which four aims – to manage the crisis in the short term, to create balance, to lay the foundation for growth, and to re-establish the confidence of international financiers – could be closely related to the aims of crisis management. The fifth aim, the EUR introduction is considered by the Cabinet as medium-term aim.

The program is based on expenditure cuts, which will strongly affect pensions and social spending. The changes in the system of the personal income taxes and contributions have started to move to the direction of simplicity, while the high tax wedge could somewhat decrease, especially for average wage earners. An important element of the program is the tax reform package, which increased the general rate of VAT from 20 to 25 per cent as of July 1, 2009. Experts say this will raise the level of inflation for the third and fourth quarter.

The government expects that the program will change the main economic indicators as follows: the GDP to decline by 6.7 per cent in 2009, followed by a small drop in 2010; the budget deficit target will remain under 4 per cent of the GDP in 2009; and the government aims a primary budget surplus of 4 per cent in 2010 and 2011.

#### New requirements for the unilateral amendment of bank loan contracts

In March, a new act was passed on the amendment of certain acts concerning the supervision of the financial intermediation system. One of its provisions enacted new regulations for the unilateral amendment of loan contracts and financial lease agreements. These rules affected a field of civil and bank laws that were subject to fierce discussion since long ago. By making an exception from the general rules of the unilateral amendment of contracts by banks, the act set additional requirements on unilateral amendment of bank contracts signed with consumers and micro-enterprises. The additional requirements may be summarized as follows: (i) terms and conditions shall contain a list of the circumstances the change of which justifies a detrimental amendment of the contract terms (ii) the change of the circumstances must have a causal effect on the fee, charge or interest that is increased; (iii) the affected fee, charge or interest must be reduced if the change of circumstances support such a reduction; (iv) a change in one single circumstance may justify increase in only one type of fee, charge or interest; (v) such increase has to be communicated to the client 60 days before the amendment takes effect; (vi) in this period, the client is entitled to terminate the contract free of charge (except for debenture bond loans). Such new regulation took effect as of August 1, 2009. Banks, however, started amending their terms and conditions with clauses granting them the right of unilateral amendment for a very wide variety of cases.

On July 16, 2009 PM Gordon Bajnai had a meeting with the representatives of the bank sector, and it resulted in a gentlemen's agreement that no unilateral amendments would be made until September 30, 2009. They also agreed that a business code of ethics would be prepared for the sector. The PSZÁF, the scope of which was significantly broadened by consumer protection tasks in the summer, committed itself to the supervision of the gentlemen's agreement, and prepared a draft for the code of conduct. The Association of Hungarian banks declared to accept the main ideas of this draft and filed with the PSZÁF its own draft code of conduct on September 3, 2009.

The final version of the code of conduct was adopted on September 16, 2009. The full title of the code is 'Code of Conduct on the Fair Behavior Towards Clients of Financial Organizations Providing Loan to Retail Clients'<sup>31</sup>. The personal scope of the code extends to all financial institutions providing retail loans, and their subsidiaries in Hungary who sign to be bound by the code. The code regulates loans granted to consumers, the notion being defined in the Bank Act.

The code is based on *three principles*: (i) transparency, i.e. access to information; (ii) the rule-principle, i.e. the signatories will record their practice in regulations, and (iii) symmetry, i.e. if an interest or expense is increased with reference to the unfavorable change of circumstances, it shall be lowered if the circumstances change favorably.

The code contains five groups of the rules of conduct, we would like to sum up the most important provisions from each.

*I. General norms for the (socially) responsible provision of credits:* The signatories shall make decisions on the granting of a credit with regard to the

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<sup>31</sup> The full text of the code is available at <http://www.pszaf.hu/data/cms2043240/codeofconduct.pdf>

capacity of the client previously assessed. Only a limited number of credits shall be granted without an income survey. The signatories undertook to inform the consumers fully and enable them to understand the risks inherent in the products.

*II. General principles of pre-contractual conduct of creditors:* Signatories undertook to implement the recommendation 2001/193/EC on pre-contractual information to be given to consumers by lenders offering home loans. The signatories shall use clear definitions and alleviate comparison of their own products. The age of the client may not be the single ground for automatic rejection of an application. The signatories help the clients to avoid costs (of life insurances, official certificates e.g.) that may prove unnecessary if the application is rejected.

*III. Rules on the unilateral amendment of contract conditions during the term of the loan:* The signatories undertook to set out the principles of the unilateral amendment of interests, costs and fees in Pricing Principles, which are confidential, but the PSZÁF may examine their content. The impact of circumstances on the pricing shall be effectuated symmetrically. Terms of non revolving loans with a duration of not more than one year may not be amended unilaterally.

The code contains a list of reasons for the unilateral increase of interest with three groups: 1) change in the legal/regulatory environment; 2) change of the macroeconomic environment or the money market conditions 3) a change in the risk status of the client.

Non-interest fees, royalties and expenses may only be increased by the yearly average inflation rate published by the Central Statistical Office.

Further unilateral amendments in cases of *vis maior* are allowed but shall be provisional.

*IV. Procedures for handling payment difficulties of clients:* the creditors undertook to prepare certain 'bridging methods', alternative solutions for clients with payment difficulties and to inform them about these. In the case of foreign currency loans, a possibility of lump sum repayment will be accessible if needed.

*V. Responsible conduct of creditors before and during the execution procedure:* The creditors undertook to contact the client in case of a late payment, inform the client of default interest and outstanding debt, and negotiate for an alternative solution. If the execution is inevitable, creditors shall cooperate with the debtor. Immoveable shall be sold publicly and employees of the creditor and their family members may not participate in the procedures. If the loan is secured by an option on immoveable property, the creditor shall give at least 90 days for the debtor to sell its own property.

Although not a legal instrument, there are ways to enforce compliance with the code: As a softer means the credit institutions acknowledged that the PSZÁF will publish the list of institutions not signing the code and that it will continuously

supervise compliance with the code. Besides that, under the Hungarian act implementing the Unfair Commercial Practices Directive no .2005/29/EC, the infringement upon a code of conduct to which an undertaking is a signatory can be fined with an amount up to HUF 2 billion.

The creditors undertook that they extend the period agreed with PM Bajnai on June 16, 2009 and will not effectuate any unilateral amendments until the entry into force of the code, but at the latest until December 1, 2009.

The code of conduct will be revised in two years, or any time, if the legal or economic circumstances support a revision, or if the PSZÁF or the Bank Association proposes it.

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