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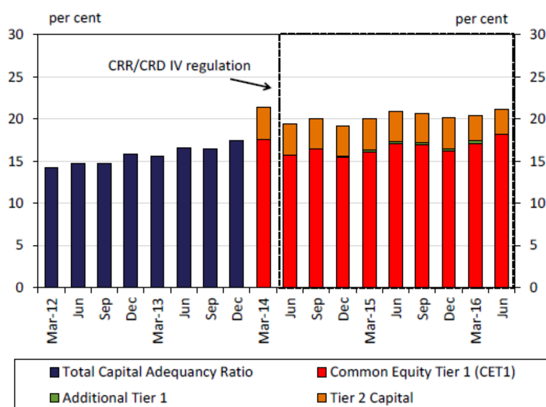
Growth potential of Hungarian banking sector found stable

According to the Financial Stability Report of the National Bank of Hungary (MNB) published in November 2016, the Hungarian banking sector fulfils liquidity and capital adequacy requirements, and it is well positioned to withstand potential shocks. In 2016, the quality of portfolios improved substantially; banks have significantly reduced the volume of non-performing loans and thus cleaned up their balance sheets. These factors, as a whole, may benefit net profitability already in the medium term. The year 2016 saw a major turnaround in SME lending: the falling lending trend has been reversed and lending is expected to grow at an annual rate of 5-10 percent. However, low interest rates, which are jeopardizing profit prospects, and risks to growth in the European Union are clouding the growth outlook of the Hungarian banking sector.

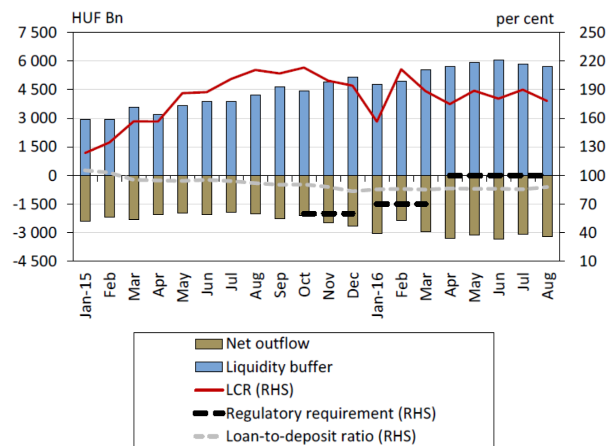
The stability and resilience of the Hungarian banking sector have improved during 2016, and the system is characterized by solid capital and liquidity positions. The capital adequacy ratio of the Hungarian banking sector is at a historic high of more than 20 percent; within that, the regulatory capital primarily consists of Tier1 capital elements. The liquidity position of the banking sector is also exemplary: banks' liquidity coverage ratio is nearly 200 per cent.

Fig.1.: Capital adequacy of the Hungarian banking sector



Source: MNB; Financial Stability Report, 2016

Fig.2.: Liquidity position of the Hungarian banking system



Source: MNB; Financial Stability Report, 2016

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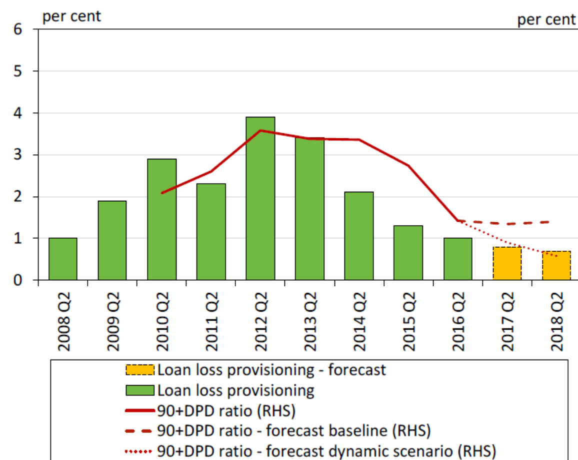
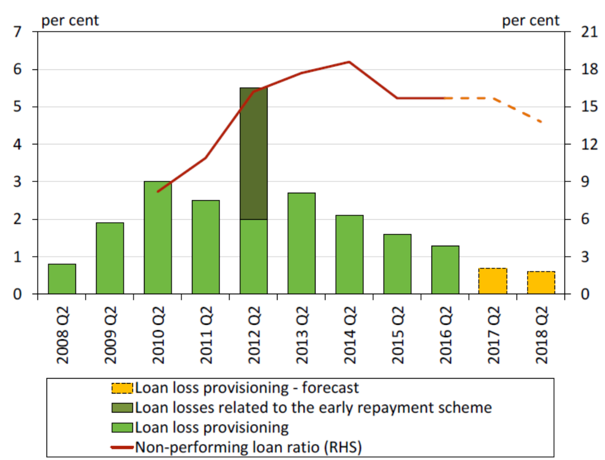
The historically robust shock absorbing capacity of the banking sector allows the working off of the legacy of the pre-crisis overheated lending and the cleaning of the non-performing loan portfolio in a decisive manner, undertaking temporary costs as well. The cleaning of portfolios has been significantly supported by the MNB-supervised MARK Plc, the asset management company, at which bank can place bad loans weighing down their portfolios and thus increase the net profitability of assets. In coming years, in light of current trends, the ratio of loan provisioning is expected to decline to levels below that of 2008. The main factors behind this improvement were prudent lending in the past five years, the Government-initiated forint conversion scheme of forex household loans and the subsequent fall in their volume. Prognoses for the ratio of non-performing loans and loan loss provisioning are encouraging: they are expected below 5 percent in the corporate segment and some 13 percent in the household segment. Parallel to that, several banks have changed their strategies, accelerating the sale of non-performing portfolios. As a sign of this trend, the loan-loss provisioning for mortgages over 90 days of delinquency is already at 65 per cent at a systemic level.

Fig.3.: Ratio of non-performing loans and loan loss pro-visioning in the corporate segment



Source: MNB; Financial Stability Report, 2016

Fig.4.: Ratio of non-performing loans and loan loss pro-visioning in the household segment



Source: MNB; Financial Stability Report, 2016

Along with improving compliancy with capital adequacy requirements, liquidity and portfolio quality, there is ample room for sound lending growth, the report finds. This can consolidate interest income and ensure medium-term size-efficient operation. The credit risk stress test carried out by the MNB in the autumn of 2016 shows that banks' capital adequacy ratios are high

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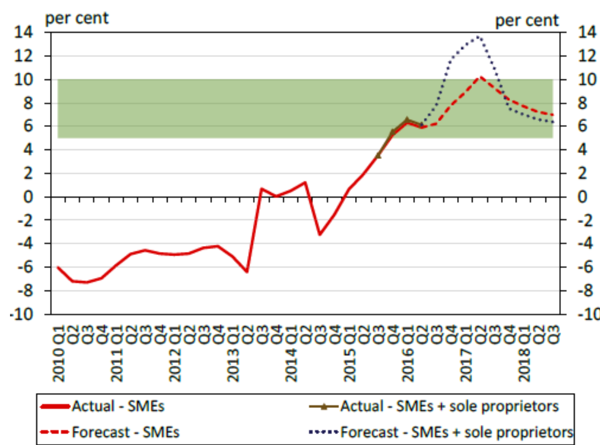
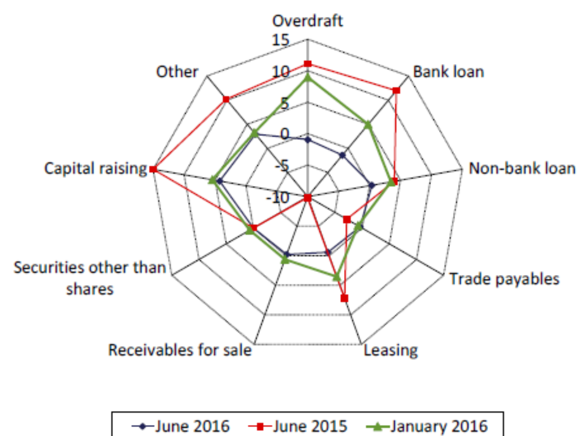
enough to meet regulatory capital requirements in the next two years even under substantial and lasting stress. Liquidity stress tolerance improved during the last half year in the case of the examined institutions. Banks which used to have weaker results are now much less below the regulatory minimum. Lending in the corporate segment in general and the SME segment in particular has seen dynamic growth in 2016. The volume of the SME loans grew by more than 5 percent in this period, and the rate of growth has thus reached a band of 5-10 percent per year, which is believed to be sustainable in the longer term. Certain MNB programmes (i.e.: Funding for Growth, Market-based Lending Scheme) have played a strong stimulating role, and – indirectly – they have facilitated the expansion of the entire Hungarian economy. The MNB predicts that the market-based SME lending growth may continue undisrupted even after these programmes are phased out.

Fig.5.: The forecast of SME lending taking into account the central bank programmes



Source: MNB; Financial Stability Report, 2016

Fig.6.: Changes in access to finance perceived by SMEs during the previous half year



Source: MNB; Financial Stability Report, 2016

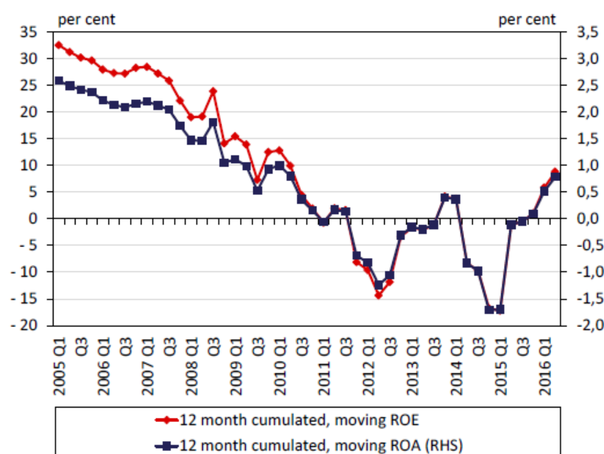
Along with the pick-up in lending, the easing of credit conditions has also been observed. This has also facilitated competition among lenders, from which enterprises may profit. The MNB report shows increasing demand for short-term loans. According to product managers of banks responding to the MNB survey, demand for long-term financing may pick up in the next half a year, driven by soaring investment in fixed assets. Corporate borrowers have also reported of the easing of financing conditions and the improved availability of financing facilities. As a whole, enterprises perceived that that the Hungarian economy has been expanding, and this may fuel

investment by the SME sector. Overall, the pace of decline in corporate lending appears to have moderated.

Monetary policy measures introduced at developed countries signal low interest rates will persist. Some European banks have been working off the legacy of crisis years and this – along with persistently low interest rates – is denting bank profitability and dampening lending. The home countries of these banks have high outstanding government debt and this limits the range of fiscal policy, while due to weak economic growth there are still risks in the sustainability of debt trajectory and political risks are mounting as well. In view of the political uncertainty observed in developed countries and the increasing vulnerability of emerging countries, growth prospects deteriorated and financial stability risks were up both in the EU and globally. At the same time, the monetary policy responses to challenges entail unintended effects and a build-up of risks, while the persistently low interest rate environment may incite economic players to search for yield by using even riskier sources.

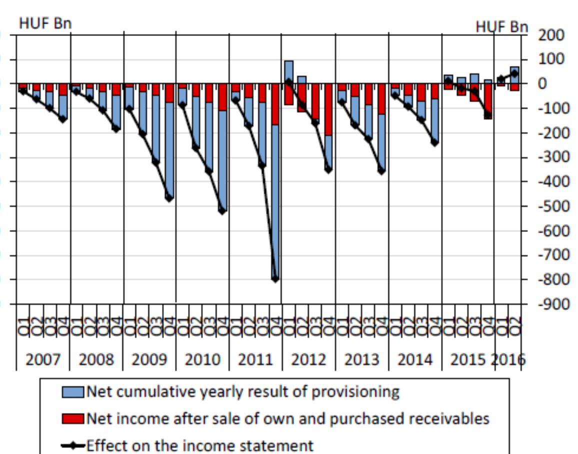
The outstanding performance of the Hungarian banking sector was the result of several one-off factors, but revenues stemming from highly volatile and cyclical factors may not be considered to be sustainable in the long term. In the persistently low interest rate environment, structural profitability may be impaired as a result of the narrowing of margins due to the adjustment limitation on the deposit side.

Fig.7.: Aggregate 12-month moving ROE and ROA indexes of the banking sector and the branches



Source: MNB; Financial Stability Report, 2016

Fig.8.: Credit loss of the banking system and the branches, accumulated within years



Source: MNB; Financial Stability Report, 2016

Due to weakening capital accumulation capacity and profit prospects, it is increasingly more difficult for banks to meet capital adequacy requirements. The persistence of low interest rates may urge banks to improve their profitability by a further reduction of their operational costs, but also to strive to attain higher spreads by making their respective portfolios riskier. Improving cost effectiveness is essential and can be attained by mergers of banks and portfolio sales or by reducing the non-performing portfolio, but there is still sufficient room for moving towards a riskier portfolio as well through a sound expansion in lending and competition.