Recommendation issued jointly by the Governor of the Magyar Nemzeti Bank and the Chairman of the Board of the Hungarian Financial Supervisory Authority on the systemic risks of foreign currency lending and institutional and consumer protection requirements relating to the prudent assessment and management of such risks, with special regard to Japanese yen-based lending

I. Introduction

Working in close cooperation, the Magyar Nemzeti Bank and the Hungarian Financial Supervisory Authority continuously monitor the operation of the financial markets and financial institutions playing a dominant role in the stability of the financial system, in order to call the attention of financial market participants to emerging risks as early as possible. In the past, both institutions have pointed out that the credit risks of Hungarian financial institutions are continuously growing, due to the steady intensification of competition in the market. Lending institutions are gradually easing their lending conditions and developing increasingly risky products. In the case of more than one-half of newly originated housing loans, the loan amount now exceeds 70% of the collateral value, and 90% of new loans to household are based on foreign currencies.

One aspect worthy of special attention is that the share of loans denominated in Japanese yen is growing from a low level, but at an accelerating pace. In the first two months since the product was launched (up to the end of December 2007) the share of yen loans had increased to 0.8% of total household loans of the financial system and already accounted for a share of more than 10% in new loans to households in December. This sharp rise in sales is mainly due to the fact that the initial instalment amount on such loans is considerably lower than for euro and Swiss franc-based loans. Market competition and the success of the product may encourage competitors to develop further yen-based household loan products in order to preserve their market share, and this process may result in yen-based household loans becoming more prevalent. It should be stressed that yen-based lending is marginal in Europe: there is no country where it exceeds 1% as a percentage of household loans (e.g. it is 0.9% in Austria and 0.1% in Poland).

The institutions issuing this recommendation believe that it is in the best interests of market participants to maintain risks within reasonable limits. Accordingly, the Magyar Nemzeti Bank and the Hungarian Financial Supervisory Authority expect financial institutions to exercise self-regulation and self-restraint, and openly welcome initiatives to this effect by market participants.

II. Increased risks of Japanese yen-based loans

In the past, the institutions responsible for financial stability have warned financial market participants about risks resulting from the rising share of foreign currency lending. The Magyar Nemzeti Bank strongly supports the statements contained in the letter from the Hungarian Financial Supervisory Authority to Chief Executive Officers of banks[1] of October 2007, in which the Supervisory Authority called the attention of the supervised institutions to the particular risks of Japanese yen-based loans and currency loans with an option to change the currency of denomination. In the recent past, these risks have continued to grow as the number of market participants offering yen loans has increased, facilitating the popularity of this product and prompting other financial institutions to follow suit.

[1] The Management circular can be read at: http://www.pszaf.hu/resource.aspx?ResourceID=pszafen_dearceo8_2007.

In terms of financial stability, the risks involved in yen-based lending are different than the risks associated with euro or Swiss franc-based lending. Calculated on the basis of a 7-year time series, the standard deviation of the Japanese yen's daily exchange rate (16.4%) considerably exceeds the standard deviation recorded for the euro (3.5%) or the Swiss franc (3.9%). This can primarily be explained by the fact that there is no close relationship between the fundamentals of the Japanese economy and those of the Hungarian and European economies, and therefore, the cyclical correlation of the Japanese and Hungarian economies is rather low. Moreover, the yen is an important funding currencies for transactions based on yield differentials (so-called "carry trade" transactions), whilst the Hungarian forint is a target currency in such transactions. As a result, the HUF/JPY exchange rate is particularly sensitive to changes in investors' risk appetite due to capital market movements. Finally, one must also highlight another increased risk of yen-based lending, which is that potential debtors, particularly retail customers, do not typically have so-called natural hedging, i.e. a yen asset or income offsetting the exchange rate risks.

III. Co-ordinated recommendation

Taking into consideration international experience, the undersigned parties are of the opinion that, in the interests of prudential operations in lending and to ensure compliance with the principles of responsible lending, it is necessary to observe the following recommendations, reinforcing the earlier recommendations and notices. Compliance with recommendations for correct risk assessment and proper risk management and for consumer protection is vital for any foreign currency lending, particularly in the case of yen-based facilities with higher risks or other facilities convertible to yen ("multi-currency" constructions). The Hungarian Financial Supervisory Authority will continue to closely monitor such compliance. The present recommendation applies to all institutions extending loans to households or refinancing such loans, in addition to credit institutions participating in household lending.

a. Correct risk assessment and proper risk management

Prudent qualification of clients and the use of appropriate risk management systems is absolutely necessary for the correct assessment and proper management of risks. All financial institutions which wish to quickly increase their loan originations and particularly those which wish to do so (primarily) in foreign currency need to observe the provisions on risk management set forth in the new capital requirements regulations pursuant to CRD. In the case of the credit risk IRB method, application of a well-founded, properly back-tested qualification system is necessary. The qualification system should contain qualification of both the transaction and the client (income analysis, accurate client scoring, separate risk analysis and management, properly recorded collaterals, etc.). It must be stressed that the assessment of risks not properly covered in the pillar 1 is necessary within the framework of the so-called capital allocation process, even if the more simple standard method is applied.

Careful *qualification* of *clients* makes joint fulfilment of the following four requirements necessary:

1. Repayment of the debt should primarily be guaranteed by income; therefore only such incomes may be taken into consideration in the loan evaluation which can be supported by the client with adequate documents (income statement, tax authority certificate, etc.).

2. During the credit assessment, the consequences of possible changes in the repayment instalment must be taken into account: the client should have sufficient income coverage for

payment even in case of an increase in the repayment instalment, and income coverage which becomes available as a result of a decrease in the repayment instalment should not give a rise for the institution to grant a new loan.

3. It can be deemed as a basic principle that in the case of mortgage loans the collateral is only a secondary risk reducing factor. It is in the interests of the lending institution to avoid sale of the real estate, because the time and costs involved in selling inevitably increase the losses; moreover, massive sales of real estate may have a negative impact on real estate prices. In order to mitigate such risks the credit institution should limit the loan-to-value ratio (LTV) to a sufficiently low level in its regulations. A decrease in the LTV level as a result of increasing real estate prices during the maturity period should not give rise for the institution to grant a new loan.

4. Development and operation of a proper qualification system is of key importance. It should be clear that the qualification system may not be circumvented in the interests of increasing lending volume and that loans should only be extended to clients with acceptable scores.

Application of appropriate *risk management systems* is also extremely important for prudent operations, especially in the case of particularly strong growth and substantial fluctuations in risk profiles. For foreign currency-based lending and for yen-based lending in particular, it is recommended that the lending institution design the credit processes in accordance with the requirements of the CRD for the IRB method. Fundamental requirements include independent definition of the credit risk qualification methodology, performance of credit risk assessments based on consistent qualification procedures, integration of qualifications in the decision-making process relating to transactions, and subsequent regular reviews.

Full observation of the following lending principles is completely consistent with the methodology of risk-based supervision applied by the Hungarian Financial Supervisory Authority.

1. During the period from the loan extension until repayment of the loan or collection of the debt, accurate documentation must be maintained including appropriate registration of collateral (suitable housing price statistics), portfolio quality and collection proceedings, if necessary.

2. Assessment of concentration risks (interest rate, exchange rate, employment rate, economic growth, changes in real estate prices), use of stress tests, establishment of suitable management information systems, introduction of prudent practices for impairments must be determined for proper management of the risks portfolio limits.

3. One especially important aspect is that debt rescheduling should not simply postpone the non-payment problem (and thus possibly exacerbate it), but rather aim at mitigating the problem. Rescheduling of the debt (e.g. extension of loan maturity or transitional suspension of repayment instalments) should only be possible for debtors which meet all of the above-mentioned risk assessment criteria and which meet at least one of the criteria (higher income-to-repayment instalment ratio, lower LTV, higher scoring) to a higher degree.

With its scope of authority defined by the Banking Act, the Hungarian Financial Supervisory Authority will use all means available to limit the development of additional risks; including the consideration of possible surplus capital requirements.

b. Consumer protection[2]

One of the main problems in relation to yen-based products is that clients typically do not fully understand their features and related risks. Therefore, the use and broad application of responsible lending practices is of special importance in respect of consumer protection.

This can appear in the following aspects:

1. Advertisements and contracts should indicate that yen-based loans are high-risk products, for which the initial repayment instalment may change considerably, due to shifts in interest rates and exchange rates. Prior to conclusion of the contract, the financial institution should explain to the client how the repayment instalments and their ratio to income may increase in the case of a shift of 20% in the exchange rate and a change of 1% in the interest rate.

2. The lending institution is obliged to fully inform the client, including information on related costs (applied conversion rate, prepayment fee, costs of rescheduling of the loan, foreign exchange conversion costs, etc.). The client should be aware of what is included in the APR (and what is not).

3. It is very important for the financial institution to continuously check if the practices it applies are consistent with the above principles. Accordingly, it should continuously monitor the practice of employees engaged in lending and follow up on the resolution of clients' complaints.

In respect of yen-based loans, increased vigilance is necessary when sales are conducted via agents, in order to ensure enforcement of the above consumer protection and risk management principles. A fundamental objective is to ensure the establishment and use of a system of incentives and controls for agents, in order to guarantee the adequate quality of loans mediated by them.

Accordingly, precise criteria should be imposed on agents and the fulfilment of such should be monitored:

1. It should be monitored whether the agent acquires clients in compliance with the sales regulations of the lending institution.

2. The quality of loans mediated by the agents should be continuously monitored and compared with the loans of clients acquired through traditional channels.

3. Accurate documentation compiled in accordance with the strict criteria of loan evaluation (see the above requirements) is especially important in lending through agents.

In summary, it can be said that as a rule, increased caution and conservative assessment of risks is required, both on the side of lenders and debtors due to the rapid growth of loans and the

[2] The following document published by the Hungarian Financial Supervisory Authority earlier in the subject of household lending, including in particular, of lending in foreign currency can be read at:

- http://english.pszaf.hu/engine.aspx?page=pszafen_recommendations&switch-content=pszafen_recommendations_20061204_1&switch-zone=Content%20Zone%204&switch-render-mode=full
- http://www.pszaf.hu/engine.aspx?page=pszafhu_devhit_kiadvany&switch-content=pszafhu_johatudjuk_20050728_17&switch-zone=Content%20Zone%204&switch-render-mode=full

extraordinary dynamics of foreign currency-based and, in particular, yen-based loans. Owing to competition and pressure to achieve growth, there is a danger that credit institutions may develop excessive credit exposure, thereby increasing systemic risks and jeopardising financial stability. On the other hand, by observing these recommendations it is possible to prevent the long-term costs of the increasing risks stemming from the new facilities from exceeding the market benefits appearing in the short run.

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