PROJECT SUMMARY: SETTLEMENT ACT ADVISORY 2015 @ DELOITTE

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Contents

Project Summary

I.1 Project Background

Since 2002, as Hungarian financial institutions have become increasingly more integrated with European financial markets, their borrowing costs started to decrease considerably. Hungarian interest rates, nevertheless, remained higher than developed market rates and bankers could profitably borrow in developed market currencies (CHF, EUR, USD) and lend in HUF on the local market, while at the same time FX risk was transferred to customers as stipulated in the loan contracts. At the end of 2004 the 3m EURIBOR was 2.17%[1], while the Budapest Interbank Offered Rate (BUBOR) was as high as 9.32%[2], and thus cheap money from developed Europe started to flow to Hungarian households and companies. As a recent market economy, market participants were not yet able to grasp how much of a risk exchange rates posed; and together with relaxed regulations and blinded by the developing lending craze the EUR and CHF became the primary currencies for retail and corporate loans.

As an open and small economy with the total value of exports reaching 80% of GDP, Hungary was among the countries which experienced an outstanding decline in economic output during the 2008 crisis (6.6%[3] decline in real GDP from 2008 to 2009). Due to capital outflows of foreign investors and the deterioration of economic activity of Hungary's trading partners, the HUF was bound to depreciate against the more stable EUR and the CHF, which are used as safe-havens during turbulent times. From its equilibrium of EUR/HUF 250 and CHF/HUF 150[4] in the pre-crisis era, the HUF has fallen to 311 EUR/HUF and 250 CHF/HUF by 2012, a decline of 24% and 65% respectively. Combined with high unemployment, this had a disastrous effect on the solvency of households. The aggregated non-performing loan ratio (90< days) of the lending financial institutions increased from 2.9% at the beginning of 2008 to 19% by the end of Q1 2014[5]. As a result, purchasing power dwindled, corporations and households went underwater due to the increasing loan burden and the decrease in collateral values and became net repayers of loans, a trend which only turned in 2017.

Apart from transferring FX risk to the customers, another wide-spread practice of credit institutions included **unilateral changes in interest and fees**. While it was not clearly stated in the loan agreements, banks executed interest and fee increases without restrictions in an attempt to try to stay afloat when losses started to deteriorate their P&L and balance sheets. The most extreme case of unilateral change which was encountered during the project was when a EURIBOR+2.5% interest charge was changed to EURIBOR+12.5%, a 1000 basis point increase overnight. Additionally, institutions applied **FX spread** when disbursing the loan and collecting installments. As the loans were denominated in EUR/USD/JPY/CHF and the disbursement/collection was in HUF, the credit institutions had to exchange the HUF cash-flows. However, the exchange was executed on the bid (disbursement) and ask (collection) fixings officially quoted by the credit institutions, which added a hefty fee, especially during disbursement. These fees were accepted by borrowers, as they were not part of the loan agreements and FX loans were still considerably cheaper than HUF loans. The epitome of this fee collection was one bank's World Loan (Világhitel) construct, which allowed borrowers to ex-post (at the end of an interest period) select their loan denomination from any of the currencies quoted by the Bank, and thus allowing to ex-post select the benchmark interest rate for the applicable interest period. This was favorable for the debtors (or so they thought), as they could select the lowest of LIBOR/EURIBOR/USDLIBOR/JPYLIBOR, however it was even more favorable for the Bank,

[1] https://www.euribor-rates.eu/euribor-2004.asp?i1=6&i2=1
[2] MNB BUBOR fixings
[3] https://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00115&plugin=1
[4] MNB exchange rates
[5] MNB Financial Stability Report, November 2014 https://www.mnb.hu/kiadvanyok/jelentesek/penzugyi-stabilitasi-jelentes/penzugyi-stabilitasi-jelentes-2014-november-1

as it could pocket the FX spread on the exchange of the loan to the selected benchmark currency each time a conversion was required when a different benchmark was selected.

I.2 Supreme Court of Hungary Ruling and Legal Framework

In the summer of 2014, the Curia (Supreme Court of Hungary) ruled on the fairness of unilateral interest rate/fee raise and loan FX spread regarding **retail** lending:

- Interest rate/fee raises without the involvement of the debtor or without transparent and detailed clauses in the loan agreement are considered unfair (in case of loans with benchmarks, raising the interest rate spread is considered unfair).
- Charging FX spread to the clients when disbursing the loan or collecting installments is unfair. The middle rate of the credit institution or the National Bank of Hungary should be used during these transactions[6].

Following the ruling, law-makers began publishing acts and regulations, collectively called "Settlement Acts", related to the settlement of interest/fees "unfairly" charged to the client. **Part of the Settlement Acts was the forced conversion of FX denominated retail loans to HUF.** By the end of 2015 all banks and credit institutions completed the customer reimbursements and the FX conversion, which altogether resulted in a total loss of 1 trillion HUF (~3 bn EUR) for the industry.

II. Most important laws and regulations published:

1) Act of 2014/ XXXVIII and Act of 2014/XL -Settlement

According to these Acts the following retail contracts (loans, leases etc.) are subject to the settlement process:

- Live contracts signed between 05/01/2004 (date of EU membership) and 07/19/2014 or
- Closed contracts which were signed between 05/01/2004 and 07/19/2014 but were terminated after 07/26/2009 or
- Closed contracts which were signed between 05/01/2004 and 07/19/2014 and were terminated before 07/26/2009 but the claim against the consumers is still live (for example if the bank sold the loan to a credit management institution)

2) 42/2014 and 54/2014 Decrees of the National Bank of Hungary –Settlement Formula

Contracts that are part of the settlement process are subject to the recalculation of the whole loan history according to the formula present in the decrees.

In the calculations, the unfair conditions were substituted by the fair conditions. In the case of foreign currency loan disbursements and installment collection the exchange rates used originally by the credit institution were substituted by the middle rate MNB fixings and the unilateral raises of interest rates/fees were not taken into account. All other conditions remained unchanged. This results in lower payable installments for the recalculated version of the loan, while the sum historically paid by the consumer remains the same. As such, an overpayment is generated which, according to the formula, considered as a pre-payment and is first deducted from the arrears and then from the principal of the loan.

[6] http://kuria-birosag.hu/hu/joghat/22014-szamu-pje-hatarozat

3) Act of 2014/LXXVII –Conversion of FX Denominated Retail Mortgage Debt to HUF, Act of 2015/CXLV –Conversion of FX Denominated Retail Loans to HUF

All retail FX loans had to be converted to HUF immediately after the settlement process. The exchange rate was the lower of 'the MNB mid-rate on November 7, 2014' or 'the average MNB mid-rate between June 16, 2014 and November 7, 2014'. The final exchange rates of the conversion were:

- CHF/HUF: 256.47
- EUR/HUF: 308.97
- JPY/HUF: 2.163

III. Deloitte's Role in the Settlement and Conversion Process

Deloitte was appointed as external advisor to facilitate and advise on the implementation of the settlement and FX conversion by five market leading banks, multiple mutual savings banks, six leasing companies and one credit management firm. The projects, in which the Author has participated as a Consultant, took place between November 2014 and December 2015 and included 2-10 FTE teams and multiple weekends spent in the office. Intensity of the projects depended on the readiness of the clients' employees, IT systems and the scope of the engagements, with the most intensive period being between January and March 2015.

The project included the execution of the following tasks:

- **Understanding the regulations:** There was a tight deadline for credit institutions to implement the settlement and conversion. The legal material reached 1,000s of pages with more than 600 legal statements[7] issued by different governmental bodies, including conflicting statements on multiple occasions. It was the duty of Deloitte Consultants to follow-up on the everchanging legal framework and to keep clients up-to-date.
- **Reviewing banking calculation software specifications and overseeing development:** Banking IT specialists prepared software specifications together with selected business departments before starting the development of the recalculation engine. The engine was the main tool to determine the amount to be refunded to customers. These documents detail calculation logic and calculation steps, range of loans in the scope of the settlement and/or FX conversion, segmentation of loans, data sources, affected systems and special considerations required for special credit facilities. Before initiating development, Deloitte performed a thorough review of the specifications to ensure that the calculation logic described and the scope of loans is in compliance with the laws and regulations.
- **Developing Deloitte's proprietary loan recalculation engine:** Deloitte's project team developed its own Excel and SQL based recalculation engine which allowed loan by loan comparison of Deloitte's and the client's calculation. Development took approximately two and a half weeks. When the client was ready with a test run, the project team has selected loans based on statistical sampling methods from different segments (e.g. mortgage, personal loan, loan under liquidation, defaulted loan, loan with grace period, capitalized arrears etc.), loaded the loan history received from the credit institutions to the DTTfx recalculation software and ran the calculation. As a rule of thumb, if the client's results were within +/-10%, it was concluded that the calculation is correct.
- **Loan portfolio-wide analytical testing:** When clients were ready with a test run to calculate the amount to be reimbursed, they sent the results to Deloitte. These loan portfolio tables contained all loans recalculated line by line, their major attributes (e.g. mortgage, sold loan, under liquidation etc.), the amount

[7] MNB statement regarding the conducted regulatory audits on the implementation of the Settlement Act (issued on January 5, 2017, "Nem tárt fel rendszerszintű hibát az MNB banki elszámolás témavizsgálata")

to be refunded to the client, contract value, outstanding amount etc. Deloitte developed its own analytical method to identify incorrectly calculated loans, outliers and data issues.

- **Project management of banking software development and settlement compliance:** Deloitte was responsible for coordinating the implementation of the Settlement requirements at a major lender. This consisted of weekly meetings with senior C-suite management, where discussions regarding the state of the project and group level decisions were made. Deloitte always had to prepare presentations, insights and had to continuously update the roadmap, which included milestones and degree of completion.