# PROGRAM INFORMATION DOCUMENT (PID)
## APPRAISAL/NEGOTIATIONS STAGE

Report No.: 49934

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| **Operation Name** | Hungary - Financial Sector and Macro Stability Loan (DPL) |
| **Region** | EUROPE AND CENTRAL ASIA |
| **Sector** | Banking (65%);Central government administration (20%);Non-compulsory pensions, insurance and contractual savings (5%);Compulsory pension and unemployment insurance (5%);Health (5%) |
| **Project ID** | P114991 |
| **Borrower(s)** | REPUBLIC OF HUNGARY |
| **Implementing Agency** | Ministry of Finance, Hungarian Financial Services Authority, National Bank of Hungary |
| **Date PID Prepared** | August 10, 2009 |
| **Date of Appraisal Authorization** | February 17, 2009 |
| **Date of Board Approval** | September 22, 2009 |

**Country/Sector Background, Key Issues & Rationale for Bank Involvement**

Hungary was one of the first emerging economies affected by the financial crisis. In the past two years (2007 and 2008) the government had made an impressive effort to address the serious fiscal and macroeconomic imbalances generated in the first half of the decade and restore investor confidence. However, the crisis reduced overall risk tolerance, and Hungary was still perceived as a high risk country due to the large liabilities that had been accumulated in the first half of the decade. Hungary eventually lost access to foreign exchange (FX) in the second half of 2008 and was forced to request a €5 billion repurchase-based (repo) facility from the European Central Bank (ECB) for short term FX funds.

To demonstrate its commitment to fiscal and financial stability, the government launched a reform program that included further fiscal reforms and a financial stability program, and requested support for this program from the IMF, the European Commission and the World Bank. The requested financial rescue package amounts to close to €20 billion, including €12.3 billion from the IMF, €6.5 billion from the European Union, and €1 billion from the World Bank. The IMF and the EU operations were approved in October 2008 and November 2008, respectively, and €13.5 billion have been disbursed.

The objective of the proposed operation is to support the Government's fiscal reform and financial stability programs, aimed at ensuring fiscal sustainability and a sound banking system, thereby restoring investor confidence and Hungary's full access to international financial markets. These are also pre-conditions for improved growth performance, which is the ultimate objective of the Government's program. The proposed operation would achieve its objective by contributing to the international financial support package, initiated by the IMF and the EU.

The international financial crisis provides a strong rationale for the operation. The crisis was initiated in mature markets, but was transmitted to Hungary and other emerging countries through financial and trade channels. While Hungary graduated from IBRD borrowing in the Spring of 2007, the government continued an ongoing program of analytical and technical assistance work with the Bank, and requested Bank support when the crisis curtailed the

country's access to external finance. The operation is consistent with the Bank's mandate in its Articles of Agreement to provide funding to members in the event they are unable under prevailing market conditions to obtain a loan under reasonable terms. This was effectively manifested after the sharp rise in government bond spreads and the flight of external investors from both the government and the equity markets.

**Operation Objectives**

The objectives are fourfold and include: (a) support to fiscal reforms designed to ensure long-run fiscal and macroeconomic sustainability and restore investor confidence, improving access of the government, banks and the corporate sector to external funding; (b) support to the financial stability program, designed to ensure adequate levels of liquidity and healthy capital cushions, able to absorb the effects of the international crisis and the contraction of economic activity, (c) support to pension reforms designed to preserve adequate benefits while tightening eligibility criteria and containing expenditures to improve the sustainability of the pension system; and (d) cost containment and deficit prevention in the health sector while ensuring access to care.

The main long-run objectives of the operation include the achievement of overall fiscal sustainability and the restoration of financial stability and efficient markets. In the pension and health areas the long-run objective is to generate adequate outcomes (adequate pensions, improved health status of the population) while avoiding chronic and large deficits. Therefore, the long-run objectives in these two latter areas include a strong fiscal component as well, and these also contribute to the objective of fiscal sustainability.

Fiscal sustainability would be reflected in a significant decline in the ratio of public debt to GDP, down from a high of 80 percent expected in 2010. The debt rule introduced by the Fiscal Responsibility Law (preventing an increase in real debt) will ensure a sustained decline in the ratio of debt to GDP in the medium- and long-run, but this rule will only apply from 2012 onwards. In the intermediate years, the ratio is actually expected to increase slightly, due to the contraction of GDP and the high real interest rates. Therefore, the effectiveness of the program will be assessed by monitoring intermediate outcomes.

The expected outcomes in the fiscal area would include an increase in primary surpluses in 2010, and compliance with the rule on real primary expenditures in the Fiscal Responsibility Law. If the fiscal program is able to improve investor confidence, this improvement would be reflected in reductions in the credit default swap (CDS) spreads relative to peer countries, reductions in borrowing spreads relative to EU treasury securities, and reduced interest rate swap spreads. The latter indicator would also be used to assess improvements in market liquidity.

The financial stability program is expected to ensure a resilient and well capitalized banking system, able to compete and intermediate efficiently. By the end of the program, all the banks should have robust capital adequacy ratios, considering the results of the assisted on-site examinations. The program should also lead to lower loan/deposit ratios and lower shares of FX loans in total household loans. The ratio of private credit to GDP (a celebrated indicator of financial depth) would not be used as a benchmark of program effectiveness, because this ratio may decline during the program period, due to funding restrictions and the ongoing balance sheet adjustments (which should result *inter alia* in lower loan to deposit ratios).

**Components of Program**

The proposed operation supports the Government's financial stability program addressing a number of elements, both immediate and forward looking. Immediate measures were tackled in the IMF/EU package, addressing bank funding and liquidity shortages generated from the worldwide contraction of credit. As the financial crisis unfolded, and economic activity in the EU contracted further, additional forward looking measures are being put in place to ensure that banks have sufficient capital cushions, an area where the Bank has contributed in formulating policy measures.

***Fiscal Measures.*** A number of fiscal revenue and expenditure measures are to be implemented in order to contain the fiscal deficit and reduce over expenditures on social programs while improving targeting to the most needy. As, well the Legal Status Law will encourage more efficient and cost effective management of public bodies. A new independent Fiscal Council is created reporting to Parliament on budgetary trends and projections, and its budget allocation is to be approved as part of the program.

***Strengthened Supervisory Framework.*** The current pressures on the financial system demand proactive and preventive supervisory functions and strengthened regulation. The operation directly supports the modification and/or confirmation of the necessary regulatory and legal framework under the Supervisory Agency Law, to strengthen supervisory powers. The changes will permit the HFSA to take systemic actions applied to the sector as a whole upon the manifestation of risks that affect all banks. Another feature of the proposed changes is to provide the HFSA powers to issue forward looking corrective actions to individual banks if their risks are rising.

***Deposit Insurance.*** In line with the increased coverage of depositors as mandated by the EU, the program will also implement a small increase in the funding premium for deposit insurance to ensure that that the deposit insurance fund is well capitalized for potential future claims at the higher coverage level.

***Loan Classification Regulations.*** A more robust regulation on loan classification based provisioning and loss potential is required in order to implement stricter rules on rescheduled, refinanced or renegotiated loans are needed to ensure that such loans and their classification, take into account the inherent borrower risks that prompted such modifications. As part of the operation, the government will prepare the necessary regulatory actions specifying the primary drivers of loan classification for restructured loans.

***Enhanced On-Site Inspection Procedures.*** A key component of the operation is the enhancement of on-site supervision and diagnostics to be accomplished by intensified inspections and broader portfolio sampling to ensure the on-site supervisory process is assessing banks' portfolio quality, reserves, provisions, capital levels, consolidated group risks, credit assessment procedures, institutional governance and other factors. This on-site inspection and diagnostic process will be crucial for taking a snapshot of banks' balances sheet assets, for sampling credit portfolios, and other measures, so as to identify embedded risks and needed corrective regulatory or supervisory actions to preempt problems.

***Scenario Analysis.*** Given the adverse macroeconomic scenario projected for the next 2 years, the HFSA and the HNB will require the 8 largest banks to conduct scenario analysis using estimates of economic projections (GDP growth, unemployment, interest and exchange rates, other factors) to assess the stresses on their balance sheets and the potential need for forward looking provisioning or recapitalizations to confront upcoming risks. They will also serve as

inputs to the the government to determine what proactive supervisory actions should be applied to maintain the sector fully solvent and protected.

***Parametric reforms to the Pension PAYG system.*** The operation supports Parliamentary approval of amendments to the Pension Law under the multilateral package, and which constitute an important step towards greater pension sustainability. This package of measures (being implemented over the 2008-2010 period) restrict early retirement, raise the retirement age, and eliminate the 13th month pension bonus.

***Preparation of the legal and regulatory framework of the payout phase of the pension second pillar.*** The new private pillar introduced in 1997 accumulated a substantial volume of assets, and the first cohorts enrolled in this pillar will start retiring in 2013. The institutional and regulatory framework for a well managed, market-based payout phase has not yet been prepared, however. To ensure progress in this key area, the second tranche of the operation would support the submission to cabinet of draft proposals to the pension law regulating the payout phase, including the menu of retirement products, annuities, indexation rules, the institutional framework for providers, solvency rules, as well as marketing rules. The Bank is expected to provide assistance for this task.

***Efficiencies in Health Services Management.*** Prior to Board approval, through Parliamentary approval of the Pharmaceutical Law, the containment of pharmaceutical expenditures will be implemented. Other measures are expected to support reducing overcapacity of hospital care including introducing measures approaching corporatization of hospitals through the approval of the Law on Status of Budgetary Institutions. By the second tranche Government guidelines will be enacted to support management, debt reduction, and efficient organizational structures for hospitals to more closely approach corporate practices, as contemplated under the Legal Status Law for public institutions. A Ministerial Decree on regulating the GP practice allowing more authority regarding prescriptions will also be enacted.

**Financing**

IBRD: □1.0 billion. This will be within a multilateral package with the IMF (□12.3 billion) and the EU (□6.5 billion).

Total in US$

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| IBRD | $1.40 billion |
| Others | $26.0 billion |

**Institutional and Implementation Arrangements**

Implementation of the loan will require close coordination among the Bank and the respective institutions responsible for implementation. These include the Hungarian Financial Services Authority, the Central Bank, and the Ministry of Finance, all of which have provided the requisite baseline data from which to measure outcomes by the end of the program. The Ministry of Finance will assist in the coordination of information reporting on the program's monitoring indicators which will be assessed and discussed among the Bank team and the implementing agencies during field visits between the first and the second tranches, and supplemented by periodic electronic communications and exchange of information.

**Benefits and Risks**

Main benefits to be expected will include restoration of investor confidence and increased demand for government securities evidenced by: lower government borrowing spreads, lower interest swap spreads, and lower CDS spreads, Capital adequacy ratios for all banks at required levels after the results of in-depth assisted supervisory examinations, Reduction in the average share of FX loans in household loans (at constant exchange rates),Reduction in average loan/deposit ratio, Increase in the effective retirement age, Increase in pension expenditures lower than increase in Swiss index, Stability of pharmaceutical expenditures in real terms, and Reduction in number of outpatient visits.

Main risks include further worsening of the external environment, weakening of political support, insufficient institutional autonomy and unresolved financial institutions. The Mitigation measures include actions in the banking system through in-depth assisted examinations and the strengthening of supervisory powers, in the fiscal area, reforms supported by via newly enacted laws, continual technical support to the main implementing institutions such as the supervisory authority, and quick forward looking measures for prompt corrective action in weak banks.

**Poverty and Social Impacts and Environment Aspects**

The measures contemplated under the loan are primarily geared toward ensuring stability and future financial system solvency, to allow an economic reactivation once global and EU economic distress turns around. While the loan includes fiscal adjustment measures, these do not impact the basic social services at the lower income segments which are protected. The overall fiscal adjustment measures are meant to bring bank external investor confidence and funding to the economy, while undertaking separate measures to ensure banking sector stability.

Poverty rates in Hungary are low relative to other ECA countries (which in aggregate, is the region with the lowest poverty rate) but certain segments are vulnerable to poverty. Eight percent of the population lived below the poverty line (PPP US$5/day) in 2005, down from 10.3 percent in 2002. While Hungarian indicators are generally above average, there still remain some issues of economic integration of minority groups (e.g.: the Roma) who can easily fall into poverty. Extreme poverty rates, however, are very low, with two percent of the population living on less than PPP US$2/day. The worsening economic situation, nevertheless, has raised concerns about the labor market that already existed in Hungary. Employment rates are among the lowest relative to other countries in the EU. Hungary is the only country in the EU10 where unemployment rates have steadily climbed since 2001, reaching over 8 percent in the third quarter of 2008. Hungary however, maintains a generous share of social protection spending, with the latest figures estimated at about 21 percent of GDP. Benefits as a share of disposable incomes are very high at 33 percent. The safety net includes: a basic social pension, family and child allowances, birth grants, disability benefits, and a housing maintenance program.

The specific country policies supported by the operation are not likely to cause significant effects on the country's environment and natural resources. Moreover, Hungary has adequate environmental controls in place. Hungary's environmental legislation and regulation is reinforced by EU environmental directives, including the EU's guidelines on adoption of environmental assessments at the planning and programming level (June 2001) and the EU's Environmental Liabilities Directive setting out liability for damage to properties and natural resources (April 2007). None of the sectors included in the operation are expected to have any significant link to the environment.

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