22 July 2022

Sovereign and Public Sector

MFB Hungarian Development Bank Private Limited Company
Issuer Rating Report

SCOPE STABLE OUTLOOK BBB+

Credit strengths

- Funding guarantee and other financial support from the Hungarian state
- Supportive legal framework
- Strategic policy role
- Sound asset quality
- Good capitalisation

Credit weaknesses

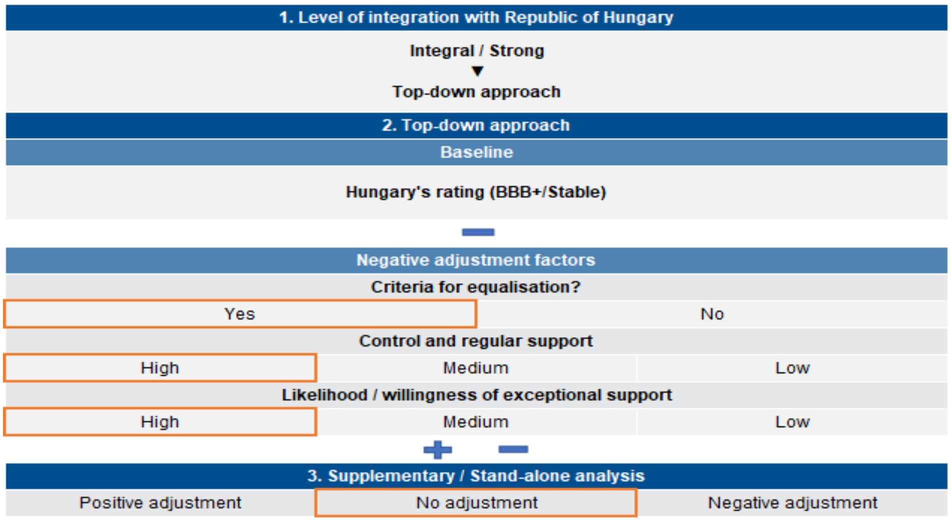
- Modest but stable profitability
- Limited loan portfolio diversification

Rating rationale and Outlook: The BBB+ rating of MFB Hungarian Development Bank Private Limited Company reflects the statutory funding guarantee of Hungary (BBB+/Stable) for MFB's financial obligations arising from bonds issued, credits and loans taken, deposits from the interbank market and replacement costs of currency or interest rate swaps for fundraising purposes.

In addition, Scope acknowledges i) a record of financial support from Hungary, which has strengthened MFB's capitalisation and liquidity; ii) the supportive legal framework defining MFB's strong cohesion with Hungary, making any changes to the bank's business model unlikely; and iii) MFB's high strategic importance to the sovereign as a key government-related entity (GRE) delivering competition-neutral services, with a unique policy function in the country.

The bank benefits from a robust balance sheet with a sound asset quality and good capitalisation. MFB's modest profitability alongside limited loan portfolio diversification reflects the development bank's public policy mandate. The Stable Outlook reflects our assessment that the risks to the ratings over the next 12 to 18 months are balanced.

Figure 1: Scope's approach to rating MFB Hungarian Development Bank



N.B. The orange colouring indicates the outcome of the analysis. Source: Scope Ratings GmbH

Positive rating-change drivers

- Upgrade on the Hungarian state

Negative rating-change drivers

- Downgrade on the Hungarian state
- Changes to guarantee that weakens government support

Ratings & Outlook

Foreign currency

Long-term issuer rating	BBB+/Stable
Senior unsecured debt	BBB+/Stable
Short-term issuer rating	S-2/Stable

Local currency

Long-term issuer rating	BBB+/Stable
Senior unsecured debt	BBB+/Stable
Short-term issuer rating	S-2/Stable

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Bloomberg: RESP SCOP

Level of integration with government

Strong integration with the sovereign's economic development activities

MFB is the only development bank in Hungary focused on the domestic market, with total assets of HUF 2,402bn and an average headcount 793 at the MFB group level as at end-2021. MFB is instrumental to the state's implementation of policy, making MFB a GRE as defined in Scope's GRE methodology. It is governed by the MFB Act[1], which defines the bank's mandate and strong cohesion with the sovereign.

The bank operates within the national economy. Its mandate is to support infrastructure development, finance key state and municipal investments and provide complementary financing to SMEs. This allows MFB to avoid competition with commercial financial institutions. In addition, MFB contributes to the economic development objectives of the Hungarian state as the government's key vehicle to mobilise and intermediate EU funds on behalf of local and national managing authorities. Further details on MFB's business and financial profiles are presented in **Stand-alone fundamentals section**.

Scope's top-down approach used for the rating analysis

We used our 'top-down' approach to assign MFB's ratings, with Hungary's BBB+/Stable rating as the starting point. This is driven by our assessment of the bank's 'strong' integration with Hungary (see **Qualitative Scorecard 1** in **Appendix I**), given the following considerations:

- Hungary is the bank's sole owner. Legal acts define exclusive state ownership. The Bank Recovery and Resolution Directive does not apply to MFB.
- MFB is an entity created under public law, with the legal status, tasks and activities of the bank defined by the MFB Act.
- MFB's lending and investing are performed in line with the development programme of the Hungarian state with the purpose of providing key, competition-neutral services to support national economic objectives.

Extensive guarantee scheme provided by the Hungarian state

Equalisation of MFB's rating with Hungary's given 'funding' guarantee

MFB's rating is fully aligned with Hungary's (BBB+/Stable). This is because MFB benefits from established, multi-layered and explicit liability support mechanisms provided by the Hungarian state, which we define as MFB's public sponsor. The MFB Act requires the Hungarian state to provide statutory guarantees over the bonds issued by MFB; credits and loans taken; deposits collected from the interbank market, and replacement costs of currency and interest rate swaps entered into by MFB for fundraising purposes[2].

Government acknowledgement of MFB debt triggers irrevocable surety as defined in public law

The MFB Act stipulates that MFB cannot incur guaranteed liabilities beyond the upper limits (**Figure 2**) approved in Hungary's central budget for a given year. As Hungarian law requires explicit, direct and irrevocable guarantees for MFB's payment obligations in connection with its fundraising, only a parliamentary act can amend, revoke or restrict these guarantees. Once an act is effective, the amended, revoked or restricted guarantees only apply to future transactions entered with MFB. We deem this scenario unlikely.

Hedging agreements with Hungary for managing MFB's foreign exchange risk

MFB benefits from foreign exchange arrangements with the Hungarian state that allow the bank to manage foreign exchange risk. The arrangements with the Ministry of Finance are connected to certain loan programmes based on government resolutions and relate to deposits accepted, credits and loans taken, bonds issued and replacement costs of foreign exchange swaps entered into for fundraising purposes. The bank's exchange

[1] MFB's legal status, responsibilities and activities are determined by Act XX of 2001 on the Hungarian Development Bank Limited Company (MFB Act)
[2] Paragraphs 1(a), 1(c) and 1(d) of Article 5 of the MFB Act provide for a statutory guarantee (in Hungarian: készfizető kezesség) in the form of an absolute direct suretyship.

rate risks are assumed by the central government's budget up to a threshold, via hedging agreements with the Ministry of Finance based on the forint equivalent of the euro funds. The state reimburses MFB for losses incurred in converting loans or funds into euros; foreign exchange gains are passed on to the state budget. The main objective of this scheme is to ensure that interest rates remain low for the ultimate beneficiaries of MFB's loans. At the same time, the scheme shields the bank from potential losses arising from forint volatility.

On a case-by-case basis and via government resolutions, the Hungarian state guarantees payment obligations arising vis-à-vis MFB or an intermediary financial institution from credits, loans and explicit, direct and irrevocable guarantees and other undertakings granted directly or via an intermediary (back-to-back guarantee). For some loan programmes, the Hungarian state provides liability and/or asset side interest rate subsidy for certain credits and loans provided by MFB at its own risk.

Hungarian state sets annual limits on guarantees

The Hungarian state sets annual limits on the guarantee scheme via budgetary acts. Debt is debited from the budgetary limit on the date of the fundraising transaction. The calculation method serves budgetary purposes only, ensuring exchange rate fluctuations have no effect on the guarantees' enforceability.

Figure 2: Limits of guarantees provided by the state, HUF m

	Budgetary limit 2021	Utilisation 31 December 2021	
Repayment funding guarantee	1,900,000	1,585,369	83%
Back-to-back guarantee	1,700,000	955,634	56%
Foreign exchange risk hedging arrangements	2,000,000	1,512,679	76%
Interest subsidy	600,000	183,700	31%

The budgetary limit of the repayment guarantee was further increased to HUF 2,200bn in 2022 (utilisation as at 30.03.2022: 79%). The Hungarian parliament has also passed an amendment to the budgetary act increasing the repayment guarantee in 2023 up to HUF 2.800 bn. We consider the limits of guarantees provided by the state for 2022 and 2023 sufficient to address the planned expansion of the bank's lending.

Control and regular support by the Hungarian state

Strong oversight with specific laws governing MFB

Under our 'top-down' approach, we assign a 'high' level of control and regular support to MFB (see **Qualitative Scorecard 2** in **Appendix I**). This is based on:

- Hungary's 'high' ability to exert proprietary control over MFB's activities as their scope and content are defined by a comprehensive legal mandate;
- financial support provided by the Hungarian state, including capital increases in 2020 and 2021 in the context of the bank's policy-related business growth and anticipated increase in risk-weighted assets.

Legal acts define MFB's mandate and operating rules

MFB's organisation, functioning and tasks are almost fully legislation-based. The MFB Act sets out rules for the bank's operations, including provisions relating to acquisitions and prudential measures. Certain laws enable the Hungarian state to alter MFB's strategy and mandate and to appoint or dismiss key personnel including members of governing and oversight bodies. The Hungarian state decides on the selection of members and chairpersons of the board of directors and the supervisory board, as well as the chief executive officer. In 2021, the minister without portfolio responsible for the management of national assets, who exercises shareholder rights on MFB, passed several resolutions impacting bank's' operations, taking business decisions, specifying deadlines for their completion, and stipulating the increase in MFB's registered capital.

Capital and liquidity support by the Hungarian state

To support MFB's lending, Hungary strengthened MFB's capital position on several occasions. The latest occurrences involved capital contributions of HUF 84bn in 2021 and HUF 151.4bn in 2020. Hungary has also provided financial support to MFB in periods of intense capital market volatility. In 2009 it provided a multi-currency loan from funds borrowed from the IMF. The state also provides short-term bridge financing to optimise the timing of capital market transactions by MFB and other Hungarian GREs, as sovereign bonds are the benchmark for MFB issuances. In 2011, since there had not been a Hungarian sovereign bond issue for some time, the MFB's forthcoming issue of notes was delayed until after a new sovereign issue had been completed, which provided the benchmark for MFB's issue of notes. To prevent MFB from experiencing liquidity problems due to this delay, the Hungarian state provided a EUR 500m bridge financing with a term of two and a half months.

Interest rate subsidy scheme provided by the Hungarian state

Pursuant to resolutions, the Hungarian state may subsidise the liability and/or asset-side interest rate for certain credits and loans provided by MFB. As of end-2021, MFB had used HUF 183.7bn, or 31% of the limit as defined by the central government's Budget Act (HUF 600bn), which remains unchanged for 2022.

Likelihood of exceptional support

High likelihood of exceptional government support for MFB

The explicit, direct and irrevocable statutory funding guarantees provided by the Hungarian state for MFB's financial obligations broadly ensure timely financial support for MFB. As a specialised credit institution, MFB is exempt from the EU's Bank Recovery and Resolution Directive. In addition, MFB's key strategic purpose, low substitution risk and contribution to macro-economic stability support a high likelihood of exceptional support for MFB from the Hungarian state.

High strategic importance given the bank's role as the state's development bank

We assess MFB's strategic importance as 'high', reflecting the bank's unique role of supporting the country's key economic and social objectives as well as its high-level cooperation with other national promotional institutions and the EU. This was recently highlighted during the pandemic by MFB's central role in disseminating state financial support to Hungarian companies. In 2021, MFB's loan volume was driven by the increase of both the individual loan portfolio and the loan programmes, especially MFB Crisis, MFB Crisis Plus, MFB Economy Reconstruction Loan and MNB Funding for Growth Scheme, responding to financing needs that emerged as a result of Covid-19.

No change in ownership or explicit support expected

Substitution difficulty for MFB is 'high'. MFB is the only development bank in Hungary focused on the domestic market. MFB does not compete with other government-related financial institutions. The risk that MFB's business model would change is remote. This is because a change to MFB's key role could lead to a loss of preferential regulatory treatment for the bank's obligations and would fundamentally undermine its access to low-cost funding – which would go against its clearly defined public mission.

Adverse default implications for the Hungarian state

We assess a potential MFB default as having 'medium' implications for Hungary. Funding, back-to-back guarantees and foreign exchange risk hedging arrangements relating to MFB amounted to around 8% of the Hungarian GDP in 2021, which is a moderate contingent liability for the Hungarian state. However, MFB defaulting would not only have political and reputational consequences but it could also lower domestic economic growth due to the lack of a credible alternative. Still, we believe that MFB defaulting would not pose a major risk for Hungary's creditworthiness, which underpins our 'medium' assessment.

Stand-alone fundamentals

Business profile and risk positioning are determined by the public policy mandate

The statutory guarantees provided by the Hungarian state on MFB's payment obligations regarding funding activities ensure access to favourable refinancing conditions. Following recent capital contributions by the Hungarian state, MFB's capitalisation provides sufficient medium-term funding for operations. The development bank's public policy mandate is reflected in its modest profitability and stable undiversified earnings.

Balance sheet growth with limited risk in 2020

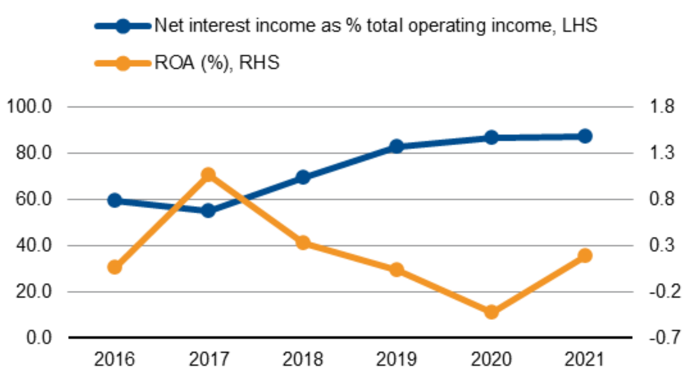
The Covid-19 crisis had a substantial impact on MFB's performance and financial results in 2020 and 2021. A sharp growth in business volume led to rising capital requirements, which were covered by capital contributions from the Hungarian state. The deteriorating asset quality is reflected by the increase in impairment and provisions in 2020. However, risks to the bank's balance sheet are limited because separate state guarantees cover the loans and guarantees issued under the pandemic support package.

Business model and earnings

MFB's business focused on national economy

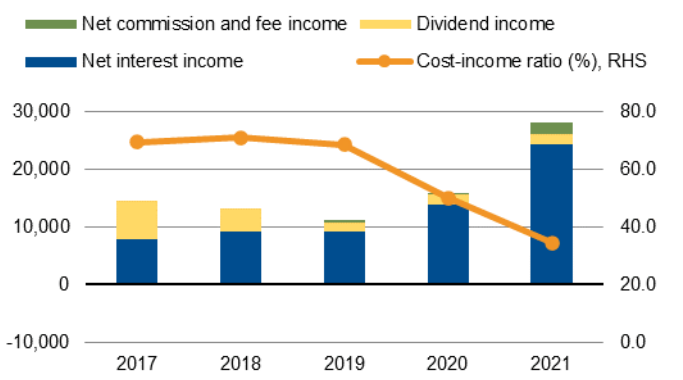
MFB's activities are split into four areas: i) lending via disbursements under loan programmes or individual loans and guarantees mostly for large corporates, SMEs, agricultural businesses and municipalities; ii) fundraising activities; iii) equity participations; and iv) intermediation of EU funds, which is off balance sheet as funds are distributed on behalf of managing authorities. In addition to development banking activities, the bank holds a conservatively managed liquidity portfolio that includes cash, central bank deposits and securities.

Figure 3: Net interest income/total operating income, (return on assets) ROA, %



Source: MFB Hungarian Development Bank Private Limited Company, Scope Ratings GmbH

Figure 4: Operating result breakdown
EUR m (LHS); % (RHS)



Source: MFB Hungarian Development Bank Private Limited Company, Scope Ratings GmbH

Earnings centred on interest income, which is affected by consistently low interest rates

Due to its public mandate, the bank's earnings are stable although undiversified. MFB's net interest income relative to total assets has been around 0.75% over the past five years. Net interest income, MFB's primary source of revenue (86% of revenue in 2021), improved for the fourth year in a row and increased by 77% to HUF 24.4bn in 2021.

Substantial balance sheet growth in 2020 and 2021

MFB's lending activities in 2021 were largely determined by the measures taken to support the economic recovery in Hungary. Overall, high business growth in the last two years has led to an increase in MFB's balance sheet by around 70%, driven by the expansion of lending and investment activity and corporate bond subscriptions. In 2021, the bank approved 5% more loan applications than it had in 2020, for a total value of HUF 406bn, of which HUF 280bn were loan applications approved for large individual transactions and HUF 126bn for loan programmes. In 2021, the bank subscribed a total of HUF 353bn in corporate bonds (which was more than planned) and participated in establishing several capital funds, committing a total of HUF 400bn with disbursements of HUF 129.6bn in 2021.

Profitability and capitalisation

Modest profitability owing to public policy mandate and low interest rate environment

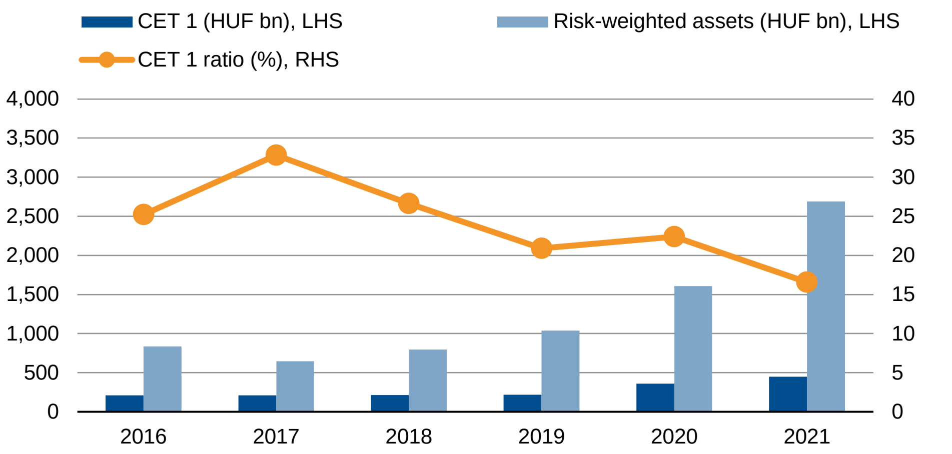
MFB's development banking activities are reflected in its low but stable ROA over the past five years, which has been averaging 0.24%. Profitability has been supported by MFB's good access to capital markets. Following a loss of HUF 8.8bn in 2020, which mostly reflected increased impairment and provisions in the context of a rapidly growing balance sheet, MFB turned a profit of HUF 4.4bn after tax in 2021. This positive result was supported by the expansion of interest-bearing assets in the portfolio coupled with higher rates, higher fee income thanks to the larger guarantee portfolio and the profit of market capital funds booked in 2021 for the first time. In addition, total operating expenses were lower than budgeted following the postponement of procurements to 2022.

Adequate and rising regulatory capitalisation driven by financial support from Hungarian state

In the context of increasing risk-weighted assets and limited internal capital generation, the bank received precautionary capital increases from the Hungarian state on several occasions in 2020 and 2021. In 2021, the Bank received HUF 84bn in capital contributions, with the capital increase serving the fulfilment of an increasing number of tasks. CET 1 capital stood at HUF 447bn in 2021 (2020: HUF 360bn) and risk-weighted assets totalled HUF 2,692bn (2020: HUF 1,609bn).

As a result of the substantial growth lending and investment, the capital requirement increased by HUF 87bn by end-2021 and the capital adequacy ratio decreased to 16.6%. Due to the continued growth in the bank's lending and investment, the capital adequacy ratio decreased to 14.7% by end-March 2022, the recent increase in the risk weighted exposure being in line with the portfolio expansion.

Figure 5: CET 1 capital development
EUR bn, %



Source: MFB Hungarian Development Bank Private Limited Company, Scope Ratings GmbH

Portfolio risks and asset quality

Concentrated exposures due to development business model…

MFB's exposure is concentrated on SMEs, large corporates and the public sector, at respectively 22%, 52% and 10% of the loan portfolio in 2020 (**Figure 6-B**). The bank's loans are all in Hungary, creating a geographical concentration risk. Macroeconomic risks in the context of the Russia-Ukraine war relate to the country's high dependence on Russian energy and transition risks in its energy-intensive manufacturing sector (5.6% of MFB's loan portfolio in 2021), to which Hungary's export-oriented economy is exposed.

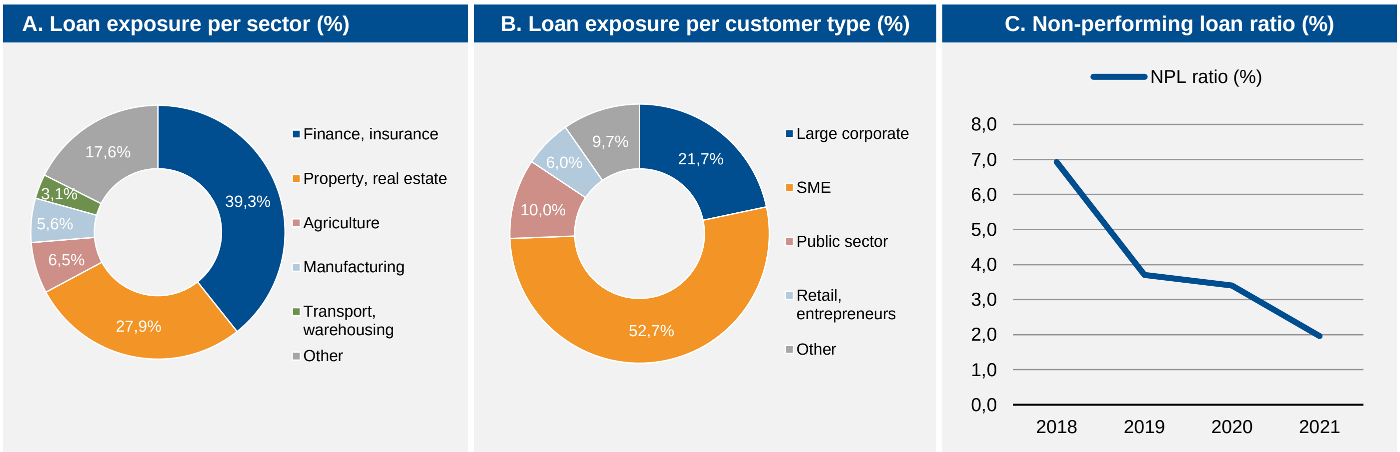
…mitigated by sound asset quality…

MFB's loan book shows a strong asset quality and a very low non-performing exposure. The share of non-performing loans relative to gross customer loans has been steadily decreasing and reached 1.96% in 2021. The sizeable loan programmes launched in 2020 against the Covid-19 pandemic should continue to support MFB's balance sheet with limited risk given that state guarantees cover up to 90% of new loans.

… and a high share of liquid assets.

Driven by the bank's central role of providing the national economy access to financing during the pandemic, MFB's liquidity portfolio rose substantially from HUF 135bn to 443bn (23% of total assets) in 2020. Liquid assets as the share of total assets increased further to 25%, also reflecting short-term interbank transactions in the context of extensive lending. Liquid assets available at end-2021 provide coverage for the management of an extraordinary liquidity situation.

Figure 6: Total loan[3] concentration risks and problem loans



Source: MFB Hungarian Development Bank Private Limited Company, Scope Ratings GmbH

Funding and liquidity

Funding via bonds and bank loans

MFB benefits from an established access to international capital and money markets, high liquidity in the Hungarian financial sector and internal liquidity buffers. MFB funds its operations i) by issuing debt securities, ii) by taking bilateral and club loans from the domestic and international loan market and iii) via facilities from multilateral development banks. Bank loans are partly provided by supranational lenders and promotional banks, including the European Investment Bank (EIB) and Council of Europe Development Bank (CEB) and are typically tied to long-term lending programmes.

Debt obligations benefit from preferential regulatory treatment

The bank's debt obligations benefit from preferential regulatory treatment thanks to the explicit liability support provided by the Hungarian state, which implies a risk weight of 0% for forint-denominated issues and 50% for euro issues, according to the standardised approach of Basel III/CRR.

Strategic presence on the domestic bond market

As of 30 April 2022, the share of liabilities denominated in euros was 46.5% (end-2020: 45%) and US dollars 1.2% (end-2020: 2%). MFB's funding strategy foresees a strategic presence on the domestic HUF bond market, with annual redemptions of HUF 35bn-135bn. MFB's funding needs in 2022 of HUF 450bn to 550bn are driven by planned asset increases of HUF 300bn to 400bn and redemptions of HUF 95bn and EUR 183m. Planned transactions in the second half of this year include domestic bond issues in HUF and EUR and bilateral loans. International EUR bond issues are planned for 2023-2026.

[3] Includes outstanding amounts, arrears, irrevocable loan commitments and undrawn, externally approved lines of credit associated with loans

Appendix I. Qualitative scorecards

Qualitative Scorecard 1: Level of integration with the Hungarian state

Analytical component	Weight	Assessments			
		Limited (1)	Medium (50)	High (100)	Not applicable
Legal status	40%	○	●	○	○
Purpose & activities	20%	○	○	●	○
Shareholder structure	20%	○	○	●	○
Financial interdependencies	20%	○	○	○	●

Integration score		75		
Indicative approach	***Score***	1 ≤ x < 33.3	33.3 ≤ x ≤ 66.7	**66.7 < x ≤ 100**
	Approach	Bottom-Up	Top-Down or Bottom-Up	**Top-Down**
Approach adopted				

Analytical pillar	Analytical component	Weights	Assessments				Pillar assesment
			Limited (1)	Medium (50)	High (100)	Not applicable	
Control and regular support	Strategic and operational decision making	33%	○	○	●	○	High
	Key personnel, governing & oversight bodies	33%	○	○	●	○	
	Ordinary financial support	33%	○	○	●	○	
Likelihood of exceptional support	Strategic importance	33%	○	○	●	○	High
	Substitution difficulty	33%	○	○	●	○	
	Default implications	33%	○	●	○	○	

Overall assessments	**Notches**
Equalisation	0
High	0-1
Medium	1-2
Limited	2-3

Equalisation factor	Yes
Overall assessment	Equalised
Indicative notching	0
Additional adjustment	-
Final indicative notching	**0**

Source: Scope Ratings GmbH

Appendix II. Consolidated financial figures

	2017	2018	2019	2020	2021
Balance sheet summary (HUF m)					
Assets					
Interest-bearing assets	880,909	881,935	1,119,324	1,568,065	1,812,930
thereof: Cash and debt securities	182,440	146,879	156,971	457,387	604,489
thereof: Loan portfolio	698,469	735,056	962,353	1,110,678	1,208,441
Non-interest-bearing assets	156,540	174,696	116,850	315,065	378,859
Other assets	148,623	172,465	191,260	185,601	209,880
Total assets	***1,186,072***	***1,228,603***	***1,427,433***	***2,068,731***	***2,401,669***
Total equity and liabilities					
Shareholders' equity	223,788	220,525	221,123	363,443	448,942
External funds	948,363	984,567	1,156,050	1,501,077	1,849,589
Other liabilities	13,031	19,372	46,355	202,339	99,663
Provisions	890	2,713	3,905	1,872	3,475
Total equity and liabilities	***1,186,072***	***1,228,603***	***1,427,433***	***2,068,731***	***2,401,669***
Income statement summary (HUF m)					
Total operating income	***14,385***	***13,201***	***11,267***	***15,903***	***28,188***
Net interest income	7,922	9,156	9,307	13,779	24,354
Dividend income	6,636	4,136	1,530	1,830	1,684
Net commission and fee income	-173	-91	430	293	2,150
Total operating expenses	***-6,962***	***-8,298***	***-11,707***	***-20,591***	***-20,179***
Expenses of banking operations	-10,062	-9,833	-9,907	-10,893	-12,526
Personnel expenses	-6,340	-6,802	-6,837	-6,816	-7,752
Other administrative expenses	-3,501	-2,732	-2,436	-3,071	-3,704
Depreciation	-221	-299	-634	-1,006	-1,070
Expense reimbursement	4,552	3,341	3,535	3,932	4,078
Effect on profit of changes in impairment and provisions	-1,452	-1,806	-5,335	-13,629	-11,731
Other income/expenses	5,253	-883	840	-4,145	-3,624
Profit/loss for the year	***12,676***	***4,020***	***400***	***-8,832***	***4,385***
Selected ratios					
Return on assets (%)	*1.1*	*0.3*	*0.0*	*-0.4*	*0.2*
Return on equity (%)	*6.1*	*1.8*	*0.2*	*-4.0*	*1.2*
Cost-income ratio (%)	*69.6*	*70.9*	*68.5*	*50.2*	*34.4*
Leverage (total balance sheet/equity)	*5.3*	*5.6*	*6.5*	*5.7*	*5.4*
Liquid assets (% of total assets)	*15.4*	*12.0*	*11.0*	*22.1*	*25.2*

Source: MFB Hungarian Development Bank Private Limited Company, Scope Ratings GmbH

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