

Bank resolution as a new MNB function – resolution of MKB Bank*

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In this study, the authors provide a comprehensive overview of the process of the successful resolution and reorganisation of MKB Bank Zrt., and the practical implementation of the resolution regulations, which was one of the first applications of these regulations in the European Union. The authors present the resolution tools and powers used by the central bank of Hungary (Magyar Nemzeti Bank), as the resolution authority, emphasising the indispensable cooperation between Hungarian and European Union authorities and institutions. As a conclusion, they find that the only fast and efficient way to protect the stability of the Hungarian financial system without the use of public funds was to apply the new resolution toolset. In connection with the resolution procedure, the creditors of MKB Bank Zrt. suffered no losses, as the funds of the bank's customers and business partners were safely protected at all times.

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1. Introduction

The financial crisis of 2007–2008 demonstrated that national states lacked tools efficient enough to manage crisis situations at financial institutions. The crisis management in relation to the investment bank Lehman Brothers was a good illustration of the fact that, in the case of significant financial institutions on the brink of insolvency, a lengthy liquidation procedure with often uncertain results may cause disturbances on the market and jeopardise financial stability.

In most countries, the only real alternative to liquidation was to save the banks using state funds (via a so-called “bail-out”), in the form of capital increases or various guarantees. The Commission of the European Union (hereinafter: European

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the official view of the Magyar Nemzeti Bank.

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Commission) approved state aid for financial institutions in the amount of EUR 4.5 trillion from October 2008 to October 2011 (*European Commission 2012a*).

Typically, governments were only able to provide the funds required for bail-outs by issuing government bonds in significantly higher volumes, and in many cases, because of the high indebtedness, this resulted in imbalances in state budgets and increased volatility in national economies. In a number of cases, management of the financial crisis developed into a crisis of sovereign states (e.g. Ireland, Greece). The costs of state bail-outs were ultimately borne by taxpayers, which triggered social unrest in several cases. Therefore, it was urgently necessary to set up a framework which would be able to remedy the crisis situation of financial institutions in a manner that it did not threaten the balance of the state budget and did not render national economies vulnerable. As an alternative to liquidation and state bail-out, a number of countries around the world created resolution frameworks, which – together with strong official powers – lay the burdens of financing the crisis management not on the taxpayers, but primarily on the owners of banks, and ultimately on agents in the financial sector.

The Financial Stability Board (FSB) created by the G20 group of the world's leading economies published the features of efficient resolution frameworks in 2011 for the first time (*FSB 2011; 2014*) and offered guidance for the formulation of regional and national regulations regarding resolution. The European Commission published its proposal on the recovery and resolution of credit institutions and investment firms in 2012 (*European Commission 2012b*), which was adopted and promulgated in 2014 as a result of a legislative process lasting several years.¹ Member States were obliged to transpose the provisions of the directive into national law by 31 December 2014, but the Hungarian Parliament – as the first in the European Union – adopted the national resolution regulations based on the EU directive in the summer of 2014, weeks before the effective date of the directive.² Consequently, the Hungarian resolution framework was already in place in 2014, ensuring that a crisis at a domestic financial institution – which could potentially threaten financial stability – would not be solved using taxpayer money, but rather using market financing and applying resolution tools that comply with global standards and best practices, as well with the EU regulations.

¹ Directive 2014/59/EU of the European Parliament and of the Council (15 May 2014) establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, text with EEA relevance, OJ. L. 173, 12.6.2014. p. 190–348, <http://eur-lex.europa.eu/legal-content/HU/TXT/PDF/?uri=CELEX:32014L0059&from=HU>, downloaded: 15 July 2016

² Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system

2. MNB as the resolution authority – new roles, more efficient intervention options

One of the key issues in the resolution framework is which organisation will perform the functions of the resolution authority. In Hungary, since 1 October 2013, the Magyar Nemzeti Bank (hereinafter: MNB) has been designated as the resolution authority. However, the detailed rules regarding its authorisation and activity were only adopted in the summer of 2014, after the implementation of the resolution directive, providing 60 days for preparations to the authorities and market players.

The role of the resolution authority significantly expanded the competence of the MNB which had already been augmented with other functions (e.g. supervisory activity), allowing (in the last resort) the MNB to take over the exercise of ownership rights, in addition to management rights at a financial institution in crisis situations.

2.1. Conditions of placing under resolution

The MNB may place a credit institution or investment firm under resolution when the following three conditions are simultaneously met:

- a) the MNB, acting in its scope as the supervisory authority (hereinafter: Supervisor) determines that the institution is failing or is likely to fail;
- b) considering the circumstances, the MNB, as the resolution authority, deems it unlikely that any action other than resolution – including the actions of the Supervisor, the institution, the institutional protection scheme or other market players, and the possibility of writing off or transforming the capital elements that can be executed by the MNB, as the resolution authority – would prevent the insolvency of the institution;
- c) in the opinion of the MNB, acting as the resolution authority, the resolution is justified in the public interest.

Therefore, the MNB does not have to wait until a financial institution fails to place it under resolution, when crisis management already has its constraints. The MNB can take action in a preventive manner, intervening at a point in time when it expects that the financial institution will likely fail in the near future, within 12 months at the most, without the intervention of the authorities. Public interest is also an important condition, because in the lack of public interest in resolution, the insolvent financial institution will be liquidated.

2.2. Resolution tools

As the resolution authority, the MNB can use the following resolution tools:

- a) sale of business tool: selling some parts or all of the institution to market players;
- b) bridge institution tool: selling some parts or all of the institution to a bridge institution (to bridge bank or bridge investment firm);
- c) asset separation tool: transferring some parts of the institution under resolution or the bridge institution to a resolution asset management vehicle;
- d) bail-in tool: forcing the creditors to bear losses for the success of resolution.

In the course of a resolution process, the MNB is free to combine the various resolution tools; the only restriction is that it may not apply asset separation on its own. In the resolution of MKB Bank Zrt., (hereinafter: MKB Bank), the sale of business and the asset separation resolution tools were used.

2.3. Guarantee role of asset valuations in resolution

When resolution is ordered, the MNB can exercise wide-ranging powers, and therefore the regulation contains guarantees to protect the parties affected by the intervention (e.g. strict legal conditions for official actions, remedy options, compensation rules), among which independent valuations play a special role. As a main rule, resolution actions shall be based on independent valuations, and if that is not possible in advance because of lack of time or other circumstances, the MNB may take resolution actions on the basis of its own provisional valuation, but even in this case, an independent valuer shall be appointed subsequently to review the calculations of the resolution authority (so-called ex-post definitive valuation). A separate type of valuation is the 'no creditor worse-off' valuation (hereinafter: NCWO valuation) which determines what would have been the position of the owners and creditors if the affected institution had been placed under liquidation, instead of resolution. Legal regulations stipulate that owners and creditors may not find themselves in a position that is worse than the liquidation scenario. If the NCWO valuation for any owner or creditor finds that liquidation would have yielded better results for them, they may claim this difference and it shall be paid to them by the Resolution Fund.

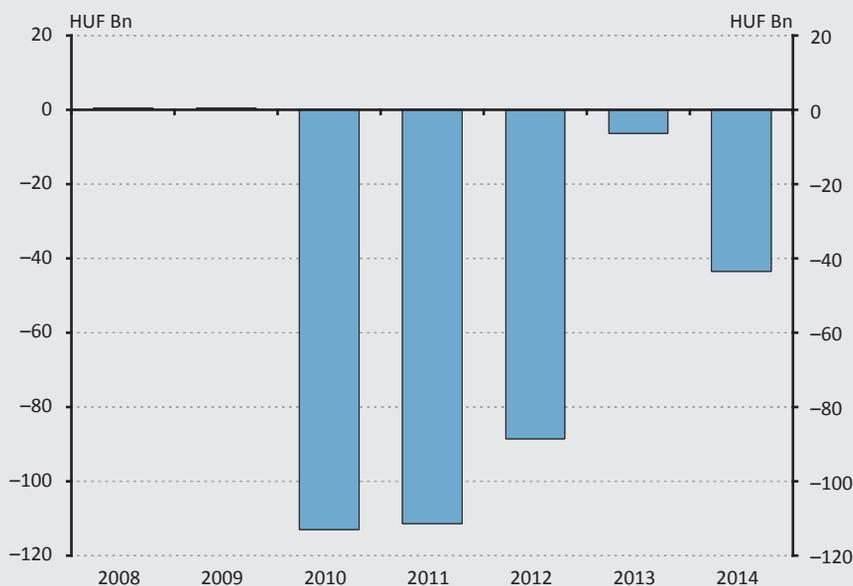
Within just a few months of formulating the regulations for the new function, in December 2014, MNB already had to face a situation in which the efficient management of the issue was only possible using resolution tools.

3. Acquisition of MKB Bank by the state and subsequent placement under resolution

As a result of the financial crisis, the willingness of domestic banks to lend dropped significantly. Amongst other things, maintaining sustainable economic growth required that the financial intermediary system become operational again, and for this to happen strong banks which were active in lending were needed. Achieving this strategic objective required a significant transformation of the banking system. The necessary consolidation of the banking system proceeded slowly, and thus the active involvement of the state became necessary. The banking market was characterised by a wait-and-see attitude, there were no acquisitions because of the risks in banks' balance sheets, and no new players appeared. Therefore, the state had to act as a catalyst in transforming the ownership structure.

Following the outbreak of the financial crisis in 2007–2008, MKB Bank suffered one of the largest losses among Hungarian banks, mainly due to its extremely poor quality real estate project loan exposure and higher-than-average market share. In addition, its owner – Bayerische Landesbank – also needed state aid, as the Bavarian state bailed out Bayerische Landesbank in the 2008 financial crisis,

Figure 1
MKB Bank's profit after taxation
(2008–2014)



Source: MNB

providing aid of EUR 10 billion.³ Consequently, pursuant to the reorganisation agreement with the European Commission, its Hungarian affiliate had to be sold after one postponement, by the end of 2016.⁴

Due to the losses, it was necessary for the owner to continuously raise the capital of MKB Bank. Even though it did this, the capital ratio dropped below the minimum regulatory level. Bayerische Landesbank restrained the lending activity of MKB Bank and developments to support long-term operations, and the bank was unable to make any contribution to the growth of the economy. All of this indicated that the owners would not be committed enough to operate MKB Bank over the long term.

Mainly considering the financial stability aspects, the state recognised that by buying MKB Bank it could acquire a bank at a depressed price, which could be sold after transformation and could play an active role in lending (*Nagy 2016*). In determining the purchase price, important factors were that MKB Bank incurred significant losses, due to its real estate project loan portfolio which accounted for a high market share, and due to its inefficient operation.

Table 1

Market share of MKB Bank according to the balance sheet total and real estate project loans, and the cost/income index of the banking system and MKB Bank (2008–2014)

	2008	2009	2010	2011	2012	2013	2014
MKB market share to banking sector							
Balance sheet	9%	10%	10%	9%	9%	7%	7%
Commercial project loans	36%	39%	40%	37%	36%	33%	33%
Cost to income ratio							
MKB Bank	60%	45%	67%	87%	86%	76%	60%
Banking sector	51%	43%	43%	40%	49%	42%	42%
<i>Source: Calculated on the basis of MNB data</i>							

Following a thorough audit of MKB Bank, the state purchased the bank at a negative price, thus creating coverage for expected further impairments and avoiding spending taxpayers' money on buying the bank. In practice, this meant that the purchase price of EUR 55 million (HUF 17 billion) agreed in the deal was available on the condition that Bayerische Landesbank waives the still outstanding loan of EUR 100 million (HUF 31 billion) extended to MKB Bank, as well as the repayment of the outstanding subordinate loan capital of EUR 170 million (HUF 53 billion). Thus, the state purchased the bank at a negative value, for EUR –215 million (HUF

³ *European Commission (2008)*: State aid: Commission approves state support for BayernLB http://europa.eu/rapid/press-release_IP-08-2034_en.htm

⁴ *European Commission (2012)*: State aid: Commission approves restructuring aid to BayernLB subject to repayment of EUR 5 billion of aid http://europa.eu/rapid/press-release_IP-12-847_en.htm

–67 billion). This transaction generated an extraordinary profit which was added to the profit reserves and partially stabilised the capital position of the bank. It is not certain whether a capitalisation of this extent could have been achieved without state intervention via the acquisition.

In December 2014, when the results of the European Asset Quality Review (AQR) were already known, it was clear that the only fast, efficient solution that was feasible without involving public funds would be to apply the new resolution tools, in order to restore the long-term operation of MKB Bank, which had significant impairment requirements and was expected to become insolvent within 12 months barring any external intervention, to protect Hungarian financial stability.

As a result of the above conditions, by the end of 2014, the MNB found that all three conditions for resolution were met, as defined in point 2.1, and therefore the bank would probably have failed within a year, and it seemed very likely that this situation could not be solved with any other tool, only with resolution, and that was what the public interest called for. Upon identifying the conditions for resolution, due to the lack of time, the MNB performed a provisional valuation, which was used as a basis for completing the resolution actions defined in the resolution action plan, and was confirmed by an appointed independent valuer in an ex-post definitive valuation.

4. The resolution action plan and its completion

In order to carry out the resolution, the MNB had to formulate a resolution action plan, which contained the resolution and reorganisation actions required to achieve the resolution objectives and the planned schedule of their application, as well as the financing plan of the resolution, and the expected contribution of the Resolution Fund.

4.1. Structure of the resolution action plan and the resolution objectives

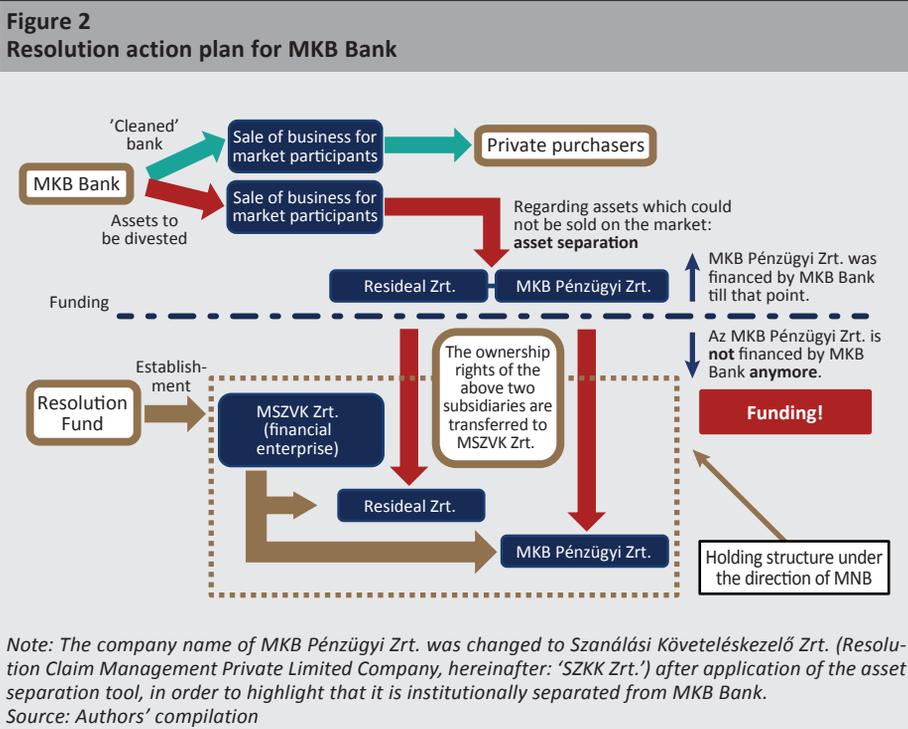
From the resolution objectives defined in Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system (hereinafter: Resolution Act), the MNB wished to enforce the achievement of the following resolution objectives of identical priority, regarding the resolution of MKB Bank:

- protection of public funds by minimising the need for and the use of extraordinary financial support from the state in any form;
- ensuring the continuity of critical functions;
- eliminating the generation of impacts endangering the stability of the financial intermediary system, or terminating impacts already generated;
- protecting the deposits insured by the deposit protection system – including OBA – and the investment protection system, including Beva; and

- protecting the funds and assets of customers, and maintaining the confidence of deposit holders and investors in the stability of the financial intermediary system.

The resolution action plan aimed to achieve the above resolution objectives by performing the following steps that rely on one another.

- rationalising the operation of MKB Bank, transforming group-level investments, cutting operating costs, improving efficiency and thus restoring profitability;
- using the sale of business and the asset separation tools to separate the assets which caused the problems leading to the ordering of resolution, from the balance sheet;
- then, at the end of the process, selling MKB Bank under market conditions (sale of business by using resolution tools).



4.2. Reorganisation measures and asset sale

In order to restore the long-term viability of MKB Bank and lay the foundations for a resilient bank, the performance of resolution and reorganisation measures – in line with the resolution action plan – was immediately started after the ordering of resolution.

In order to properly realise the resolution objectives and measures, the MNB exercised its resolution powers through four resolution commissioners after placing the bank under resolution. The resolution commissioners acted in the competence of the MKB Bank board and general meeting, within the limits defined by the MNB. As the resolution procedure and the reorganisation progressed according to plan, in July 2015 the MNB recalled the assigned resolution commissioners (*MNB 2015a*). At the same time, the renewed management of MKB Bank was entitled again to exercise the management rights, although the owner's rights were still exercised by the MNB through the Financial Stability Council.

As part of reorganisation, business lines which did not serve the basic commercial banking activities of MKB Bank, produced losses and tied up too much capital were terminated. As the first step of the transformation programme, in December 2014, MKB Bank sold almost all of its minority shares in the MKB insurance companies to the majority owner Versicherungskammer Bayern, in order to avoid further capital injections necessitated by the loss-making operations. MKB Bank kept a share of one percent, while the exclusive strategic cooperation continues.

Within the framework of transforming the subsidiaries, the ownership structure of the Euroleasing company group was resolved. Based on the agreement of the parties, in the separation of the company group, the companies making up the car financing business line were transferred to the 100 per cent ownership of MKB Bank, and the co-owner took over the companies involved in car trading and insurance brokering. Based on the agreement, MKB-Euroleasing Autópark Zrt. (involved in fleet management) was sold jointly. Following completion of the separation process, the capital position of MKB Bank improved and it managed to avoid significant potential losses, while the taking-over of the management rights of the companies added to MKB Bank contributed to the growth in the values of these companies, ultimately facilitating the sale of MKB Bank at more favourable conditions.

Under the reorganisation, the operation of MKB Bank was rationalised, and unnecessary cost elements were terminated, including reducing the number of branches, rationalising the organisational structure and management positions, and reviewing supplier contracts. The total impact of the comprehensive 20 per cent cost-cutting programme initiated in 2015 in order to ensure profitability over the medium term will appear by the end of 2016.

The definition of the medium-term strategy of MKB Bank was also given special attention. Within this sphere, initiatives included the development of the risk management methodology and IT background, the establishment of a central business support area, a review of the product portfolio, the deepening of customer relations with consultancy-like services, the development of investment services and the establishment of the conditions for digital banking services.

According to the resolution action plan, the assets (outstanding loans) selected for separation from MKB Bank first had to be sold on the market, using the 'sale of business' resolution tool, for the sake of transparency and to achieve the highest possible purchase price, and in this manner the will of market players who were considered as potential buyers was realised without any coercion, regarding the purchase of bad assets. The remaining assets which could not be sold on the market were separated under the asset separation. In the case of the sale of business, the Resolution Act prescribes the adherence to the following strict procedural requirements:⁵

- a) the sale shall be as transparent as possible, having regard to the circumstances and in particular the need to maintain the stability of the financial intermediary system;
- b) in the course of the sale, a distinction between potential recipients may only be made on the basis of objective criteria;
- c) it shall not confer any unfair advantage on a potential recipient;
- d) it shall consider the need to effect a rapid resolution action, while also taking into account that the resolution objectives must be reached to the fullest possible extent;
- e) it shall be aimed at maximising, as far as possible, the sale price for the shareholding, assets and liabilities involved while also taking into account the resolution objectives;
- f) it shall be free from any conflict of interest.

The market sale was performed in several directions. In an open market procedure carried out with the involvement of an internationally recognised consultant company, investors were able to apply for the purchase of the portfolio to be separated, either in a package, or in individual transactions. Potential investors were able to acquaint themselves with the portfolio elements to be separated through a data room and could make purchase offers. Reconciliation was also carried out with syndicated loan partners, concerning the sale of the shares of MKB Bank in certain deals, in order to facilitate the application of the sale of business resolution tool.

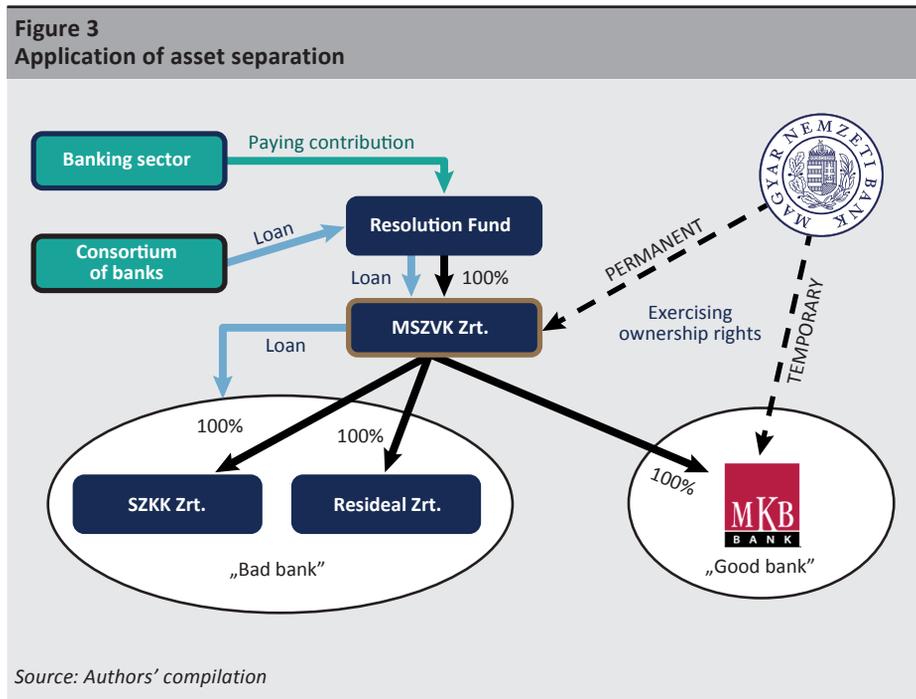
In the case of MKB Bank, considering the above conditions, the MNB managed to sell a portfolio representing a gross exposure of HUF 130 billion in total, at a purchase price of almost HUF 100 billion, to market players, by applying the sale of business resolution tool. Taking advantage of the option provided by the Resolution

⁵ Section 42 (2) of the Resolution Act

Act, a sale to a syndicated lending partner was carried out in one instance, in order to maximise prices. In this case, the reason why it was not an open sale was that the omission of the transfer of the portfolio would have significantly impacted the efficiency of the sale of business, as bad assets without any significance to other parties would have represented a lower value, and the transactions together qualify as a group of assets, therefore they represent a higher value to the syndicated loan partners than to other market players. The MNB procedure was completely in line with the relevant provisions of the Resolution Act and the European Union law, which allow for deviations from the above strict conditions in several cases, for instance, when – among others – adherence to the referenced requirements would undermine the efficiency of the sale of business resolution tool (*MNB 2015b*).

4.3 Separation of toxic asset portfolio that cannot be sold on the market, in an official manner

Assets that cannot be sold on the market were separated from MKB Bank by using the asset separation resolution tool and transferred to the resolution asset management vehicle (Hungarian Resolution Asset Management Vehicle, in Hungarian: Magyar Szánálási Vagyongkezelő Zrt., hereinafter MSZVK Zrt.), according to the following process:



In the course of asset separation, the MNB considered the satisfaction of the legal conditions for application:⁶

- a) the situation of the particular market for those assets is such that the sale of those assets through insolvency proceeding could have an adverse effect on one or more financial markets;
- b) such a transfer is necessary to ensure the proper functioning of the institution under resolution or bridge institution; or
- c) such a transfer is necessary to maximise proceeds from sale, winding up and liquidation.

The resolution asset management vehicle as a special market player

The resolution asset management vehicle is a financial institution with special status, which may only be owned or operate under the controlling influence of the state or the Resolution Fund, and which is set up with the purpose of taking over some or all of the assets, liabilities, rights and obligations of one or more institutions under resolution or bridge institutions.

At the present time, there is only one resolution asset management vehicle operating in Hungary, MSZVK Zrt. as a financial institution with a supervisory licence, which was established as a 100 per cent subsidiary of the Resolution Fund in the autumn of 2015, with subscribed capital of HUF 200 million and capital reserves of HUF 1.8 billion, and with the primary objective of taking over those portfolio elements from MKB Bank – at that time still under resolution – which cannot be sold on the market and are to be separated according to the resolution action plan.

MSZVK Zrt. manages the portfolio elements with the intention of maximising their value in a subsequent sale or otherwise. Following the resolution of MKB Bank, MSZVK Zrt. may also act as resolution asset management vehicle in the resolution of other credit institutions, and therefore – depending on the current intention of decision-makers – it may serve the maintenance of financial stability not only over the short term, but over the medium and long term as well.

Pursuant to the concept of the MNB, the resolution asset management vehicle was set up for an indefinite period of time, in a holding structure. With the establishment

⁶ Section 54 of the Resolution Act.

of the holding structure, separate subsidiaries may manage the assets taken over from individual institutions in the various resolution proceedings, which strengthens transparency and allows the performance of individual portfolios to be measured. In addition, this structure is highly cost-efficient, as shared services (e.g. accounting, HR, purchase, operation) can be outsourced to the holding parent company (MSZVK Zrt.), and real estate management to the real estate manager under the holding.

The operation of MSZVK Zrt. and the provision of the purchase price to be paid by MSZVK Zrt. to MKB Bank for the portfolio to be separated required the help of the Resolution Fund (see article in box).

Role of the Resolution Fund in financing the resolution of MKB Bank

The Resolution Fund (hereinafter: Fund) was established in the summer of 2014 as an independent legal entity, in order to provide the funds required for resolution operations.

Similarly to the National Deposit Insurance Fund (OBA) and the Investor Protection Fund, the main income of the Fund comprises payments from market players, while credit institutions and investment firms pay a risk-based annual fee. The Fund must reach the target level set by the legal regulations within 10 years (from 2014 to 2024, the volume is HUF 82 billion). However, it may happen, especially at the beginning of the replenishing phase, that the funds required for the completion of the resolution are not available in the Fund, and therefore the legal regulations allow the Fund to take out loans or issue bonds for the completion of its tasks.

The Fund contributed to the successful resolution of MKB Bank on several occasions and in various ways. On the one hand, in the autumn of 2015, when setting up the Hungarian Resolution Asset Management Vehicle (in Hungarian: Magyar Szanálási Vagyonkezelő Zrt. – MVSZK Zrt.), it provided founder's capital of HUF 2 billion, and created one of the essential conditions for accepting the portfolio to be separated from MKB Bank with resolution tools, and on the other hand, in December 2015, it provided the external financing of almost HUF 100 billion, required for asset separation and sale of business; thus MSZVK Zrt. was able to purchase the separated portfolio from MKB Bank.

From the payments of market institutions accumulated since 2014, the Fund had enough funds to cover the expenses related to the foundation of MSZVK Zrt., but it had to involve external funds to be able to pay the price of the separated portfolio. The Board of Directors of the Fund examined the possibility of taking out a loan and issuing bonds, asked for offers from market

players, and then, considering all the relevant circumstances, decided to take out a loan. K&H Bank Zrt. submitted the best price quotation and was charged with setting up a consortium, as a result of which the Fund signed financing agreements with the syndicate of Erste Bank Hungary Zrt., K&H Bank Zrt., OTP Bank Nyrt. and UniCredit Bank Hungary Zrt.,⁷ then forwarded the loan to its 100 per cent subsidiary, MSZVK Zrt.

The above points indicate that in the course of the resolution of MKB Bank, the Fund efficiently performed its tasks defined by legal regulations, and provided the amounts required for the resolution without the involvement of taxpayers money, partly from accumulated payments, and partly from external market sources. The resolution of MKB Bank would not have been possible without the efficient cooperation of the Resolution Fund.

In using the asset separation resolution tool, another special role was played by the ex-post definitive valuation carried out by independent valuers appointed by the MNB, based on which the individual and portfolio-level market values of portfolio elements to be separated from MKB Bank were defined. MKB Bank assets worth a gross amount of HUF 214 billion which could not be sold using the sale of business resolution tool were separated from MKB Bank in two phases. First, they were transferred to MKB Pénzügyi Zrt. (receivables) and to Resideal Zrt. (real estate) in the 100 per cent ownership of MKB Bank. Then, the shares issued by these two subsidiaries and the loan receivables of the bank from MKB Pénzügyi Zrt. were transferred to MSZVK Zrt., using the asset separation tool (*MNB 2015c*). Following the transfer of assets, the company name of MKB Pénzügyi Zrt. was changed to Szanálási Követeléskezelő Zrt. (SZKK Zrt.), in order to underline its institutional separation from MKB Bank.

For the transferred assets, the Bank received a price (real economic value – 45 per cent of the gross book exposure) which was HUF 32 billion higher than their low market value which originated from the unfavourable market conditions, allowing the bank's capital position to be stabilised. The difference of the counter-value received for the transferred assets and their market value is considered state

⁷ Pursuant to section 133 (5) of the *Resolution Act*, the state is responsible as a joint and several guarantor for the syndicated loan taken by the Resolution Fund up to the amount approved by the Government. The government decision related to the affected loan deal is *Government Decree 1861/2015 (XII. 2.)* on the role of the state in the resolution of MKB Bank Zrt. (*Magyar Közlöny 2015*), which refers to taking a loan of maximum HUF 45,500 million and EUR 166.9 million, and defines a guarantee fee to be paid to the state. While no compensation is to be paid to the state for offering a joint and several guarantee – as stipulated by the legal regulations – to the borrowings of the National Deposit Insurance Fund (OBA) and the Investor Protection Fund, the Resolution Fund pays a fee to the state for offering this kind of collateral. Therefore, the state budget did not finance the Resolution Fund and the resolution of MKB Bank, but – as the legal regulations stipulated – acted as a joint and several guarantor for the collection of funds, and it receives a financial compensation for that, i.e. realises income on the transaction.

aid under EU law, which was found compatible with the internal market by the European Commission in December 2015, based on the submitted restructuring plan and commitments regarding the institution (*European Commission 2015*).

EU framework for state aids⁸

The provision of state aid is generally not allowed, but certain aids can be considered compatible with the internal market, and the European Commission has the exclusive authority to examine that. A certain action qualifies as state aid in the sense of EU law in the following cases:

- 1) it provides a selective advantage to any business/product,
- 2) it originates from a source controlled by the state,
- 3) it distorts or threatens to distort competition, and
- 4) affects trade among Member States.

According to the relevant communication issued by the Commission (*European Commission 2013*,⁹ *point 64.*), the use of the sources of the Resolution Fund and OBA for the purpose of crisis management, including any aids provided through the resolution asset management vehicle qualifies as state aid.

The Commission finds state aid to be provided to a credit institution compatible with the internal market, and therefore approves its provision, if it serves the elimination of a serious problem that occurred in the economy of a Member State. For the approval of state aid, a restructuring plan must be submitted to the Commission, which describes how the institution wishes to eliminate the reasons for the problem, and ensure further viability over the long term and without state aid. The Commission declares the aid compatible with the internal market and thus approved, if the owners and creditors of the institution bear the losses occurring at the institution to a proper extent, and, regarding the institution, agree to bear behaviour and restructuring obligations which will allow for the elimination of the reasons of the problems of the institution, and minimise the possible competition distorting effects of the state aid.

⁸ A framework created by Article 107-109 of the Treaty on the Functioning of the European Union and the legal acts created or adopted on the basis of these sections, including directives, guidelines and communications.

⁹ "Communication on banks"

The counter-value paid by MSZVK Zrt. for the company shares qualifies as state aid, because MSZVK Zrt. is an institution under the control of an administrative agency, and therefore, not only market, but – to some extent – state considerations were also taken into account in the use of the funds. As explained above, the sum of the state aid is essential for the recovery of the capital position of MKB Bank, so that it has enough capital – also considering the new business plan – to pursue profitable operations instead of loss-making operations. In exchange for the purchase price that was higher than the market price, and based on the decision of the Commission, the MNB transferred all the shares issued by the bank to MSZVK Zrt., with an obligation to sell them on the market later, so that MSZVK Zrt. became the exclusive owner of the bank.

One of the key principles of the resolution framework is that the possible losses of the institution must be borne primarily by its owners.¹⁰ Based on the practice established for the evaluation of state aid, the European Commission may grant state aid to an institution only if the owner – in this case, the Hungarian state – takes part in bearing the losses of MKB Bank to a proper extent, i.e. to the greatest possible extent. According to the communication of the Commission, the aid must be limited to the necessary minimum (*European Commission 2009, point 22.*), and the beneficiaries of the aid (in this case, MKB Bank) must contribute to the costs of restructuring, and as much as possible, must finance the transformation jointly with the owners, from own funds (*European Commission 2013, point 15.*). Appropriate burden-sharing must be first ensured from the *Common Equity Tier1 (CET1 capital)* (*European Commission 2013, point 41.*). If that is not sufficient, the capital shortage must be remedied from the Additional Tier 1 capital (AT1 capital) and Tier 2 capital elements (*T2 capital*), up to the limit of their loss-bearing capacity. However, considering the fact that the capital of MKB Bank consists of CET1 capital only, there was no opportunity to reduce losses from AT1 and T2, and the appropriate burden-sharing by the owner of MKB Bank was ensured by transferring all the shares issued by MKB Bank and in the exclusive ownership of the Hungarian state to MSZVK Zrt. which offered the state aid, concurrently with the disbursement of the state aid, against a token payment. The European Commission stated in its decision that the owner of MKB Bank (the Hungarian state) had made the greatest possible contribution to the burden-sharing.

With the above reorganisation and resolution actions, the portfolio of MKB Bank has been cleaned as planned, and the foundations of long-term viability and earning power were laid down. The Commission recorded that the use of the asset separation resolution tool is in line with the relevant communication of the Commission, and the commitments made mostly until the end of 2019 provide a proper guarantee to limit the competition distorting impacts stemming from state aid.

¹⁰Section 20 (1) a) of the Resolution Act

MKB Bank obligations related to the restructuring plan

In addition to providing for completion of the restructuring plan of MKB Bank, the Hungarian authorities – in line with the relevant EU competition law and the related legal practice – offered to the European Commission that they would enforce the adherence to the following **commitments regarding MKB Bank and its subsidiaries**:

1. Sale of business lines which generate losses;
2. Termination of lending for commercial real estate and reduction of the existing portfolio to a significant extent;
3. Ban on retail FX lending, while corporate FX lending is possible with natural coverage only;
4. Cost reduction;
5. Improvement of risk management systems;
6. Ban on payment of dividends;
7. Limitation on certain investments (e.g. ban on purchase of securities of low credit rating);
8. Introduction of the shares of MKB Bank to regulated markets;
9. Limitation on the growth of the balance sheet total and risk-weighted assets (*risk-weighted assets – RWA*);
10. Limitation of acquisitions over a certain amount (these deals require the individual permits of the EU Commission);
11. Reduction of marketing expenses below a certain level;
12. Ban on references to state aid in advertisements;
13. Upper limit of remuneration (until the repayment of state aid);
14. Sale of 100 per cent of MKB Bank shares by 30 June 2016;
15. Ban on aggressive sales practices;
16. Appointment of a monitoring trustee for the period of restructuring;
17. Re-notification of changes in the restructuring plan to the European Commission.

A detailed description of these commitments can be found in the public version of the decision of the Commission (*European Commission 2015:28-33, Annex 1*).

4.4. Sale of MKB Bank

As soon as MKB Bank sold its toxic asset portfolio using the resolution tools sale of business and the asset separation, and the completed reorganisation actions made their contribution to strengthening the bank, the market sale of its shares took place according to the conditions stipulated in the decision of the Commission – in open and transparent procedures applying competitive terms, free of discrimination and meeting the provisions regarding state aids in the sense of EU competition law.

Satisfaction of the above conditions was facilitated by the fact that the sale process was supervised by the Monitoring Trustee, an independent consultant company appointed by the Commission which examined compliance with the expectations of the Commission. For the sale of the shares of MKB Bank, the MNB used the assistance of a global investment bank with expertise in the sale of banks. During the preparations for the sale, dozens of professional, banking and other investors were directly contacted in an open procedure. During the process, in the course of the negotiations with investors, it was obvious that banks did not show any interest, and it was primarily private equity funds which were willing to examine the bank in detail and make offers.

For the sake of transparency, the seller's expectations about the bidders and the information requested by the buyers were shared by MKB Bank with interested parties through a so-called virtual dataroom which was accessible to each bidder.

In the assessment of the bids, maximising the sale price had the greatest importance for the MNB, but it also considered aspects of financial stability, as it set quality criteria for the buyers, and demanded significant commitments from the buyers to support the future capital adequacy and stability of MKB Bank. Accordingly, in the course of the evaluation, compliance with two considerations was taken into account: (1) compliance with the EU framework for state aid, which considers the maximising of prices as the primary consideration, based on the approach of private investors, and (2) the approach of the resolution authority, including financial stability interests. These two approaches had to be realised together in the evaluation system. In order to achieve this, an external consultant company was commissioned to take part in the development of the criteria for selecting the winning bidder, based on international practical experience and ensuring a procedure free of discrimination. The evaluation procedure established with the use of the accumulated best international experiences combined the compliance with various expectations.

In the end, only private equity funds made binding purchase offers, and within that, it was clearly the extent of the offered purchase price that had the greatest significance in making the final decision. In the evaluation of the purchase price, it was also considered that MKB Bank was appraised by an external consultant,

before the sale, who specified a certain band as the market value. The best offer was higher than the middle of the evaluation band, and exceeded the value of the state aid previously provided to MKB Bank.

Based on the above steps, as a closing step of the resolution measures, the MNB sold MKB's shares on the market by applying the sale of business resolution tool. The best bidder was the syndicate Blue Robin Investments S.C.A. – METIS Private equity fund – Pannónia Nyugdíjpénztár, and thus these institutions acquired shares of MKB Bank in a ratio of 45-45-10 per cent, following approval of the acquisition of the influence and payment of the purchase price of HUF 37 billion (*MNB 2016a*). In the course of the sale process, as the supervisory authority, the MNB checked whether the companies submitting bids satisfied the legal requirements of acquiring influence.

5. Closing the resolution of MKB Bank – summary

The one-and-half-year reorganisation of MKB Bank was the first resolution procedure in Hungary, which was implemented successfully on a significant, large universal bank with country-wide coverage by the MNB as the resolution authority in line with the recovery and resolution guidelines of the European Union, and with the involvement of consultants highly recognised on the global markets.

In the resolution procedure, a number of resolution measures were applied, but the separation of toxic assets was essential for placing MKB Bank on a sustainable path. Without the separation of the portfolio as approved by the Commission and implemented by the end of 2015, MKB Bank would have required internal capitalisation, and it would have been necessary for the problematic asset portfolio to be separated to be devalued to market value, with the result that the bank's capital adequacy ratio would not have reached the minimum level specified by legal regulations. In that case, the funds of the creditors of MKB Bank would have had to have been involved in the bail-in, which would have further reduced the value of MKB Bank. With the successful portfolio separation, the MNB managed to achieve the objectives of the long-term sustainability of MKB Bank and stabilisation of its operation, as well as its transfer to the new owner in such a manner that the funds of deposit holders and creditors were fully protected and they did not suffer any losses (*MNB 2016b*).

With the purchase price collected from the sale of MKB Bank, the assets of MSZVK Zrt. increased by a net amount of HUF 35.2 billion, as the purchase price of HUF 37 billion is reduced by tax obligations and the costs occurring for the Resolution Fund with the resolution of MKB Bank, but the price still exceeds the amount of HUF 32 billion in state aid, and therefore the state aid was also repaid to MSZVK Zrt. that offered the aid. The growth in the assets of MSZVK Zrt. which is owned by

the Resolution Fund and facilitated by the sale of MKB Bank is of great importance, because the Resolution Fund that was set up only two years ago did not reach the level of funds prescribed by legal regulations yet. Therefore, in the case of another possible bail-in, external funds may have to be involved. In this manner, the maintenance of financial stability might generate extraordinary costs for the state, and the annual fees paid by credit institutions and investment firms to the Resolution Fund could also increase. Additionally, by taking over the portfolio, MSZVK Zrt. acquired assets which – if utilised successfully, with a return over the primary cost (actual economic value) – may generate additional extra assets for the Resolution Fund.

As a result of the resolution measures, the conditions that called for the resolution of MKB Bank were eliminated, and based on the data as per 30 June 2016, the capital position of the bank is solid, and no additional insolvency or resolution situation can be expected in the next one year. The MNB as the resolution authority – taking into account all conditions – did not identify any further resolution actions to be taken or appearing necessary, and therefore the MNB closed the resolution process of MKB Bank on 30 June 2016. Following termination of resolution, it is not the MNB as the resolution authority, but the new owners who exercise the owners' rights over MKB Bank which "has been fully re-instated on the market". Apart from that, the Supervisory authority will, of course, keep continuously monitoring MKB Bank.

Recognising the success of the resolution, in July 2016, the international credit rating agency Moody's Investors Service¹¹ confirmed and changed MKB's long-term deposit rating from stable to positive and improved the credit rating and counterparty default risk rating of MKB by one level.

The successful resolution of MKB Bank is the result of the efficient cooperation of the organisations responsible for financial stability (the Government, the MNB, the Resolution Fund and MSZVK Zrt.), and this gives us the hope that the MNB as the resolution authority, will also be able to use the resolution tools successfully in the future, and, by closely cooperating with its partner organisations, also be able to protect financial stability in this manner.

¹¹ *Moody's (2015): Completion of MKB Bank's Resolution Is Credit* <https://www.moody.com/credit-ratings/MKB-Bank-Zrt-credit-rating-600018782>

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