Monthly analysis – October

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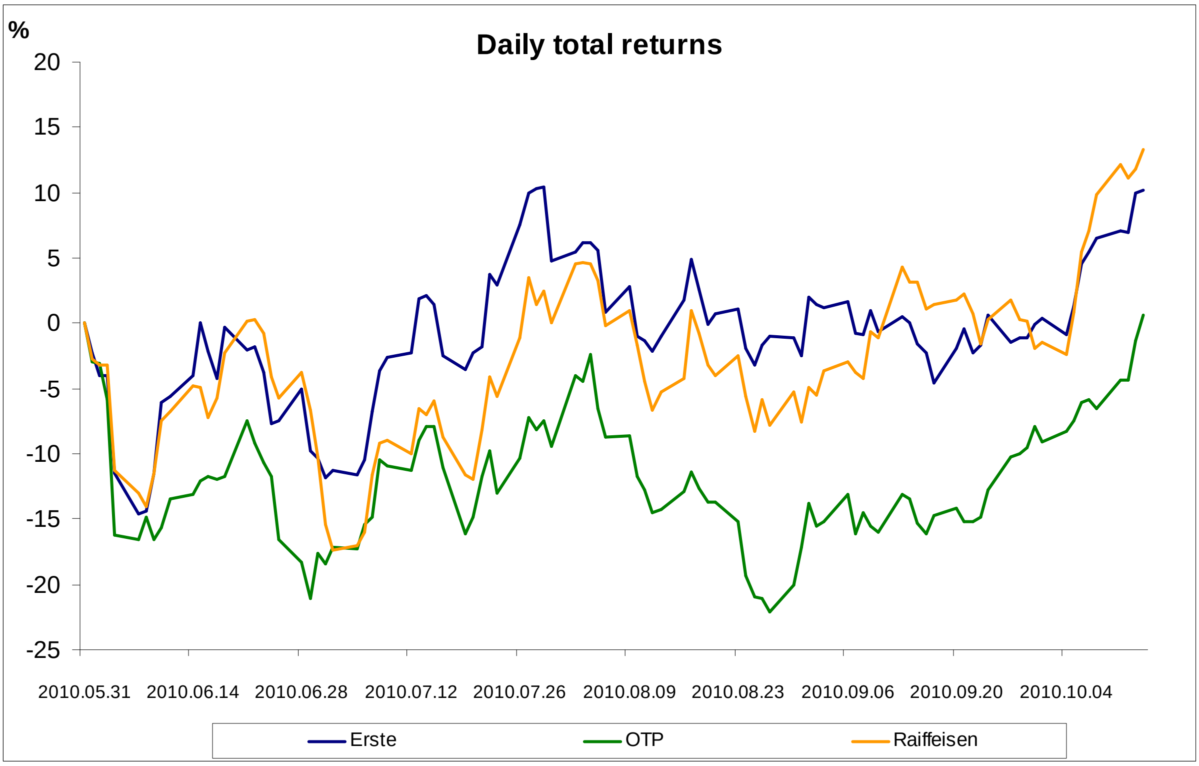
How severe will the impact of the bank tax be?

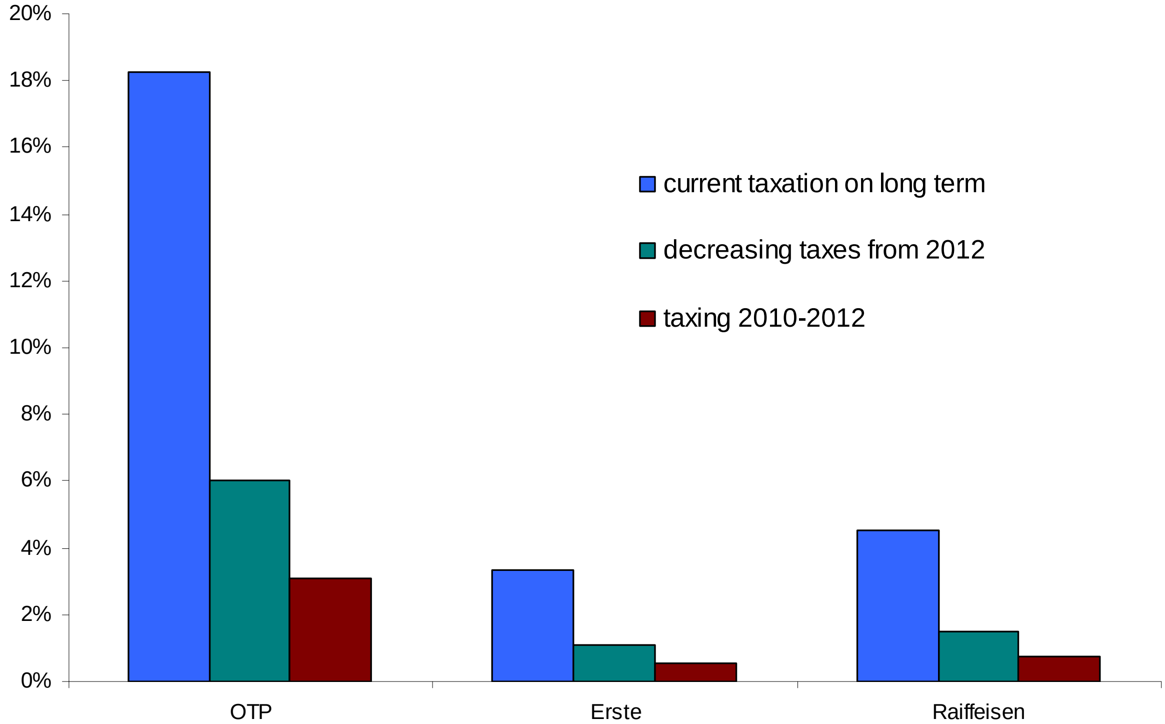
Hungary was among the first (the second after Sweden, to be precise) to impose a bank tax, but still, it was not so much the speed of its introduction as the extent of the tax that brought it into the focus of attention. This year, banks operating in the Hungarian market will have to pay HUF 187 billion, which given the bank sector's HUF 175 billion profit for the first half represents a considerable deduction, especially in view of the fact that the tax, which is levied on the balance sheet total, does not take into account the banks' profitability. (The banks intend to raise almost HUF 20 billion towards the bank tax through additional injections of capital.) Since the announcement in early June, banks in Hungary have underperformed the market: the Polish banks have risen 15% and the Czech banks by 10%, while OTP remains roughly where it was at the end of May. Of the three large stock exchange-listed banks with a presence in Hungary, this impact was most readily apparent in the case of OTP, since the Hungarian assets of Erste and Raiffeisen only account for 7% and 25% of their total assets respectively.



Although it's difficult to screen out the other factors impacting banks in Hungary (especially the effect of the eight-point package of measures, recently reduced to seven), it is nevertheless safe to say that the market immediately priced in the tax's impact on profitability. However, despite having an extreme profit-reducing effect over the short term, the measure has a far lesser impact on the bank's valuation than the market reaction suggests. This is because the actual consequences depend far more on the longevity of the tax payment obligation than on its actual size. On this basis, it is worth examining the following three possible outcomes:

1. A HUF 187 billion payment in every year from now on, which based on the banks' respective balance sheet totals would translate into HUF 36 billion for OTP, HUF 12.7 billion in the case of Erste and HUF 10.5 billion for Raiffeisen per annum.
2. The above-mentioned amount for two years, followed by a far lower sum, converging with the similar tax planned for introduction by the EU.
3. HUF 187 billion a year for two years, followed by the complete abolition of the tax.

Accordingly, the impact of the bank tax on the share price in the case of the three outcomes is as follows:



If the bank tax is abolished after two years, based on the price development witnessed at the beginning of June, even for OTP this would only result in a 3% fair depreciation; however, if the present tax remains in the long term, the impact is around 18%. In the case of Erste and Raiffeisen the change is no greater than 5% even in the worst case scenario. In the light of OTP's underperformance, therefore, we can conclude that the market is pricing for a long-term tax payment obligation; in other words investors are sceptical with regard to the temporary nature of the tax.

So in summary, the main question is how permanent a fixture the bank tax will be, since a one-off obligation over one or two years will only have a temporary impact. This, however, is extremely important not only from the perspective of the bank’s profitability, but also due to the effect it has on the economy. This is because in the short run the banks will most likely

treat the tax as a one-off item, but over a longer term it could influence their strategies. In most cases this will take the form of a reigning in of lending activity, and the passing-on of the burden to the population. In the long term a shortage of credit could stymie economic growth; although in the year or two ahead – with loan portfolios already stagnating – it certainly won't be the bank tax that represents the barrier to growth.

Due to the means of its calculation, the other consequence of the tax could be a shake-up of market competition. However, the likelihood of certain banks withdrawing from Hungary purely as a result of the bank tax is very small. Naturally, the chance of this happening also depends largely on how long the tax remains in effect. However, in the case of those banks that are rumoured to be considering a withdrawal from the local market, the tax can be regarded as more of an excuse than a genuine cause, since it is far more likely that these banks are being forced to sell certain subsidiaries due to problems stemming from the parent bank’s capital situation.

The main question, therefore, is the longevity of the tax, an issue which is currently regarded with more than a little scepticism by the market. At the same time, the most likely scenario appears to be that the tax will remain at its current rate for two years, before converging steadily with the rate of the tax introduced in other countries. The chances of this are particularly good in the light of the fact that the European Union is even now working towards the introduction of a uniform bank tax, which will be lower than Hungary's bank tax by an order of magnitude and thus sustainable over the longer term. This is because the planned tax will be far more favourable for the banks in terms of both its calculation base (only a part of assets, instead of the balance sheet total), and the rate at which it is charged (approximately a mere 0.07% instead of 0.5%).

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