



MANAGING SYSTEMIC CRISIS BY ICS IN HUNGARY

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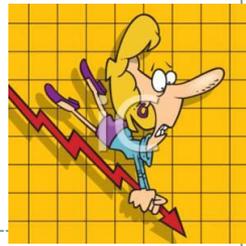


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Brokerage Scandals - Fraudulent Conduct in the Past 15 Years I.



- **The surprising development in the financial market:**
 - The announcement of the Swiss National Bank: no longer hold the Swiss franc at a fixed exchange rate with the euro in 2015
 - leading to have insufficient liquidity in the firms
- ↓
- **Brokerage scandals ignite domino effect: 3 brokerage firms collapsed within 2 months, having also cross-border implication (Saxo Bank)**
 - Embezzlement and brokerage firms' fraudulent activities:
 - ✦ the money received from the clients partly had never been invested, or
 - ✦ the clients had not received any legitimate securities for their money, or
 - ✦ the firm disposed with the asset as if it was the firm's own asset, while regular reports of the invested money were sent to the clients

Brokerage Scandals - Fraudulent Conduct in the past 15 years (II.)

- Due to mismanagement deficit was not well managed, filling the gap required even more money (snowball effect)
- The IT systems were manipulated, using fictional client(s)
- Shortcomings in legal environment: in case of dematerialized securities the identification of clients in transactions happens not in the clearing house „KELER”, but at the financial service provider



Summary of Brokerage Scandals in Numbers



Cases	Buda-Cash	Hungária	Quaestor	Sum
Case description	missing client assets	missing client assets	issuing fake corporate bonds+missing client assets	
Date	started: March 2015	started: May 2015	started: May 2015	
No. of insured investors	13 193	1 195	48 000	62 388
insured asset (HUF)	17 634 842 448	3 565 944 198	48 272 189 896	69 472 976 542
insured asset (EUR)	56 886 589	11 503 046	155 716 742	224 106 376

+ EUR 484 million fake bonds

Buda-Cash Sec. Co.



- **Buda-Cash and the DRB bank group (4 banks)**
 - Four regional banks owned by the same group of investors that owned Buda-Cash
 - Supervisory investigation at the DRB bank group detected unusual securities transactions and led to comprehensive examination at Buda-Cash
 - Hole in the books of Buda-Cash grew as big as HUF 103 billion (EUR 332 million) of which HUF 62 billion (EUR 200 million) belongs to depositors of DRB bank group), according to supervisor's judgment
 - 73,000 clients were affected, of which 15,600 were investors of Buda-Cash
 - Authority revoked Buda-Cash's license, initiated liquidation of the brokerage house, assigning administrators to the banks, which are to be put into receivership as well
 - Three senior employees of the firm, including CEO were arrested
 - CEO has acknowledged a „violation of accounting discipline”, on providing false data



Hungaria Sec. Co.



- **Hungaria Securities Co.**
 - Small brokerage company
 - National Bank suspended the license of Hungaria Securities Co.
 - After an investigation is revealed that several billions of assets could not be accounted for, additionally HUF 5-6 billion (EUR 16-16 million) of losses may result difficulties paying outstanding bonds
 - Poor electronic data processing required a search for the „squared notebook” containing cash received/ transactions



Quaestor-Gate – the Biggest Brokerage Scandal in Hungary (I)

Quaestor Securities and Brokerage Co.



A diversified investment player in several industries, offering complex financial services including

- banking,
- savings and investments,
- travel services,
- project companies,
- real estate developments and properties for sale.

Quaestor-gate – the Biggest Brokerage Scandal in Hungary (II)



- The bond story (I)

- Issuing corporate bonds started in small-scale in the 90's, (financing construction and hoteling)
- *Quaestor Financial Hrvurira Ltd.* was created for the purpose of raising funds for its parent company, the Quaestor Group, whose activities were largely financed by bond issuances
- Brokerage companies must apply for license for each and every new product before accepting money from public
- Current Hungarian law does not permit authorities to forbid Quaestor issuing bonds



Quaestor-gate – the Biggest Brokerage Scandal in Hungary (III)



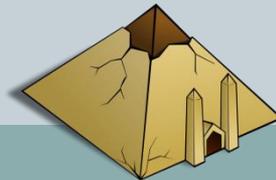
- The bond story II

- No successful undertakings plus underperforming real estate projects made losses



CREATING A CLASSIC PYRAMID (BOND) SCHEME

- Most of the money went to *interest payment, marketing and sponsorship* of football
- Interest expenses in the past 15 years amounted to some HUF 50 billion (EUR 161 million), and additional HUF 10-15 billion (EUR 38-48 million) was spent on marketing and football more than the HUF 60 billion (EUR 187 million) lawfully sold bonds over the period
- Maintaining the pyramid scheme has costed HUF 210 billion (EUR 677 million) until it was detected.



Quaestor-gate – the Biggest Brokerage Scandal in Hungary (IV)

• The bond story III

- Creative fraud: on top of legally issued bonds the company had issued bonds for filling the gap, without approval of the supervisory authority
 - ✦ Properly announced and approved bonds in the value of HUF 60 billion (EUR 194 million)
 - ✦ „fictitious” bond issues amounted to HUF 150 billion (EUR 483 million)
- Bonds selling was easy for retail clients
 - ✦ High yield (however not high enough compared to its underlying risk)
 - ✦ Popular because of beneficial buying back option before maturity (high level of liquidity)
- Previous two brokerage scandals → investors trying to cash in their Quaestor bonds (liquidity problem)



How to Handle the Scandals?



- What should ICS compensate to clients after collapsing the firm?
 - Usually, clients of failed brokerage firms are entitled to compensation if the securities or cash are missing
 - What if, a bond is fake, but issued by a licensed firm?
Dilemmas:
 - ✦ No bonds, no investment service (illegal deposit taking)?
DGS limit 100,000 EUR <-> ICS limit 20,000 EUR
 - ✦ Clients' money was received therefore illegally issued bonds must be refunded
- Systemic risk/stable system?
 - HUF 300 billion (EUR 968 million) <-> 1,5% of GDP

The Authorities Response



- Amendment in Act on the Capital Market
- Merging of the work organisation of the two protection schemes (DGS & ICS)
- Proposal to raise the investor compensation limit to 100,000 euros
 - Central Bank tightens supervision to prevent brokers from fraudulent activities
 - ✦ by increasing the frequency of inspections and the amount of fines
 - ✦ Inspectors for on-site supervision
 - ✦ Tightening supervision on IT systems and auditors
 - ✦ Increasing transparency through establishing a ledger for brokerage
 - Mandatory identification of clients in transactions involving clearing house KELER
 - Establishment of a Claims Fund besides the existing ICS

Implications on the Market

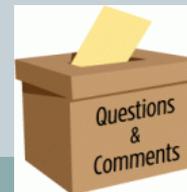
- lack of confidence in financial service providers, financial awareness?
 - ✦ Preference to foreign owned financial service provider/insurance company instead of the national one,
 - ✦ preferring huge companies instead of small or middle-size players
 - ✦ „If firms win, the profit will be private, if they lose, the losses are common”
- Financial sector environment remains uncertain: new burden on the financial sector, especially with a retroactive effect



Claims Fund for Quaestor Victims



- Act on the compensation of Quaestor victims was passed
- Establishment of a Claims Fund besides the existing ICS
 - ✦ Clients had to file for compensation until 5th June 2015
 - ✦ Covered: bonds issued by Quaestor Financial Hrvatska and sold by Quaestor Securities and Investment Ltd. or its affiliated undertakings; Claims must be considered up to EUR 100,000 in capital value and bonds at nominal value topping up ICS compensation
 - ✦ fake bonds are covered by the ICS up to current EUR 20,000 limit
- Financing: pre-payment of the ICS's membership with a repayment obligation (Quaestor assets after liquidation), central bank may also extend a liquidity loan, with state guarantee
- Industry critics:
 - ✦ huge damage paid by all players of the financial sector is unfair
 - ✦ Retroactive application of law
 - ✦ Compensation limits remain the same in the case of the other two brokerage firms!
 - ✦ Constitutional Court query is underway.



ICS Challenges (I)



- Abrupt increase in capacity to be able to
 - manage two funds
 - handle the claims forms
- Changes in the annual fee calculation method and in the extent of the yearly contribution (Extraordinary contribution is collected as well)
- Borrowing money and issuing own (not fake) bonds

ICS in an on-going Action



- The covered loss and estimated outpayment in case of Quaestor as of 26.08.2015.

Investment Protection Fund	in million HUF		in million EUR		% outpayment/claim
	claims	paid out	claims	paid out	
fake corporate bonds	87 600	81 801	283	264	93
Claims Fund for Quaestor Victims	in million HUF		in million EUR		
	claims	paid out	claims	paid out	
non fake corporate bonds	87 500		282		
entitled claims excl. in the books	7 000		23		
Sum	94 500		305		
Total	182 100	81 801	587	264	

What Could Lead to a Scandal Like That? - Lessons

- The bond issuer and the exclusive security dealer belongs to the same group , clients have an account with the security dealer
- Current Hungarian law does not permit authorities to forbid a firm issuing bonds, even if the repayment is judged very unlikely
- For high risk bonds no lower entrance limit for the small retail investors
- In case of dematerialized securities the identification of clients in transactions happens at the financial service provider and not in transactions involving clearing house
- Gross mismanagement of investment service provider
- Creativity of financial service providers and ready to commit a fraud (easy money to get is far too attempting)
 - ✦ Creating fake bonds
 - ✦ IT systems tempered to cover up irregularities
- Infrequent on-site supervisory control





THANK YOU
for listening