RESTRUCTURING OF THE BANKING SECTOR IN HUNGARY

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Over the past years Hungary has achieved the fastest economic growth of the Central and Eastern European countries. Hungary has undergone three waves of reforms:

- 1989 to 1990: fast and dynamic liberalisation, creating the basic legal framework of a market economy,
- 1990 to 1992: five important acts were adopted, including an act on banks and the national bank,
- 1995 to 1996: a package of stabilisation measures was adopted with the aim of creating conditions for further sustainable growth.

Restructuring of the banking sector has been an integral part of restructuring the economy as a whole. The success of the transition from a centrally planned economy to a market economy depends on stability of the financial system. Restructuring of the banking sector in the transforming countries of Central and Eastern Europe has undoubtedly been a demanding challenge over the past 10 years. Reform of the banking system at the same time cannot be implemented without macro-economic stability of the financial system, restructuring of the business sector and reforms of the regulatory framework. Experience has shown that the comprehensive banking consolidation was necessary even despite the fact that consolidation of banking sectors of transition Central and Eastern European countries has been financially burdensome on the state budget.

Hungary was the first country to start out on the path of reforming its banking system. Similarly as in other transition countries, in Hungary prior to reform there had existed only the one bank (a "mono-bank"), where the national bank performed both central as well as commercial banking functions. Prior to the creation of a two-level system there had existed two specialised state-owned banks - a savings bank providing services to households and a Hungarian foreign trade bank, which specialised in financing foreign trade. Foreign capital was represented by three commercial banks on the basis of a joint venture. The market share of these foreign banks was however small.

Causes of crisis in the banking sector

Banking crises can have many causes, though the transition of a society from centrally managed to a market economy has particular aspects. The banking crises of transition countries have many features in common that differ from other banking crisis around the world. The main causes of banking crises in transition countries is in essence the combination of the following factors: a sharp decline in aggregate demand and output in the initial years of reform, an inherited portfolio of bad loans from preceding years, when loans were centrally managed, segmentation of the credit market and an insufficiency of competition, shortcomings in the field of regulation and banking supervision, professionally weak management, inadequate internal control and high administration costs at banks. The political and economic reforms led to the collapse of markets in the CMEA countries (Council for Mutual Economic Assistance); since this was the main sales market of the Central and Eastern European countries. Liberalisation of trade and the subsequent growth of competition further contributed to the decline in output. Over the period 1990-1993 GDP in Hungary fell by approximately 20% in real prices and a similar or higher fall was recorded also in the other Central and Eastern European countries. Many corporate clients of banks went bankrupt due to difficulties with servicing their debts, which in turn was caused by the increase in real interest rates (following deregulation of interest rates and the growth in inflation that accompanied price liberalisation). During this period business loans grew substantially, which extended a lifeline to the remaining firms and slowed down a boom in the occurrence bad loans, which banks faced later.

Through the creation of a two-level banking system in Hungary the ownership structure remained unaffected, with state ownership of banks, which were however highly undercapitalized. Three newly established banks inherited a huge sum of classified loans in their portfolio, since during the times of the mono-bank credit granting had been governed by state interests and not profitability. The banking sector was characterised by strong sectoral segmentation, since the portfolio taken over from the national bank by the three established commercial banks was distributed along sectoral lines: heavy industry, manufacturing and a part of the energy industry portfolio, as well as agriculture, the mining industry and services. This sectoral segmentation worsened the situation of banks in Hungary since it limited the efficient allocation of resources and made risk diversification the more difficult. Sectoral segmentation was shown to be a complicated as well as an erroneous step. Certain sectoral specialisation exists in many well-functioning banking systems, but too great a concentration threatens banks with too high a risk.

Shortcomings in the field of regulation thus significantly contributed to the problems of the banking sector. The existence of rules for the classification of loans and creation of provisions prior to 1992 had not required banks to practice prudent lending nor create adequate provisions for loss-making loans. Rules for the classification of problem loans did not correspond to international standards and were not very strict. The creation of provisions in respect of bad loans could be performed only from after-tax profits, which provided little stimulus for banks. The result was the fact that banks' problems were kept hidden from the public and government and a part hidden even from the bank management itself.

A fundamental change in this situation occurred at the end of 1991, when a large number of acts were adopted (legislative shock therapy). The act on financial institutions introduced stricter rules for the classification of loans, even if these did not fully accord with international standards. The creation of provisions became standard and the tax law allowed provisions to be created from profits prior to taxation. The new act on accounting also did not include unrealised interest into the revenues of banks. The bankruptcy act required firms to initiate bankruptcy upon themselves if their arrears on debts were of more than 90 days. These rules, which were stricter than rules existing in many developed countries, were strictly applied, leading to many bankruptcies throughout the economy. This process however helped to remove unviable enterprises in the initial stage of reform, bringing to the surface the actual losses of banks and concurrently limited the accumulation of future losses, which in the end reduced the costs of banking consolidation.

Banks suffered from poor managerial practices. The newly-established banks did not have sufficiently experienced personnel nor knowledge of modern risk-management methods. Even though the level of banking employees' qualification gradually improved, over the first years of reform there were numerous poor and irresponsible lending decisions (systematic prolongation of loans following repayment dates, the adoption of decisions lacked a precise definition of responsibility; banks were slow in setting adequate internal rules). Decisions were often at variance with internal bank regulations, since adequate internal control was missing. The inadequacy of the intra- and interbank system also worked to the detriment of quality decision-making. A client could, for example, borrow from various branches of the same bank without the head office being aware of this. Such practices prevented banks from making a quality evaluation of risks. They similarly lacked an adequate interbank information system on debtors, which, given the length of time required for registration of real estate transactions, allowed a right of lien to be established on one property several times at various banks.

Bank management was poor. Boards of directors and supervisory boards were composed of people appointed as a favour from the state, or state employees delegated for the purpose of improving income. Many of these people did not have sufficient ability for performing these functions. State enterprises were majority shareholders in several banks (complicating creditor-debtor relationships).

Similarly, banking supervision at the start was inadequate. From the times of the single bank system external supervision was practically non-existent. It was some time until this function began to be fulfilled. At the start it was performed by a department of the Ministry of Finance. In 1992 supervisory tasks were transferred to an independent agency. Due to insufficient powers and a lack of well-trained staff the agency was not able to responsibly carry out its tasks for several years. Gradually its authority and autonomy were strengthened, and the ability of its employees improved. This all led to a marked improvement in supervision. It is difficult to rank these factors in any order of importance. There is some agreement among economists on the fact that the fall in aggregate demand and output, caused by the collapse of the CMEA and the initial regulatory affects of such reform measures as trade liberalisation and reduction of subsidies, led to the insolvency of many firms. Poor lending decisions and fraud caused between 10 and 40% of banking losses. The bad loan portfolio inherited from the period prior to reform is in the second or third place of importance among the factors depending on the specific case.

Bank consolidation

In 1992 when some state-owned banks were significantly undercapitalized, it was evident that consolidation and restructuring of the banking sector could no longer be postponed. Consolidation began at the end of 1992 and passed through several main stages, since, as is the case in banking crises, the problems and their actual extent emerged only gradually (in 1993 – 1994 this consolidation was not evident). At the start of the

[1] Other methods of dealing with classified loans can include a new repayment calendar, debt-for-equity exchange with debtor firms, foregoing a part of the debt, or writing off the whole debt.

process it was not known whether consolidation should have the form of a portfolio clean-up or recapitalisation and whether the loan portfolios of banks should be shifted away to specialised institutions responsible for work out bad loans or whether the work out should be left to the banks, which after all possessed the best information available on debtors. In the end a combination of several approaches and techniques was used, representing a compromise between the differing points of view.

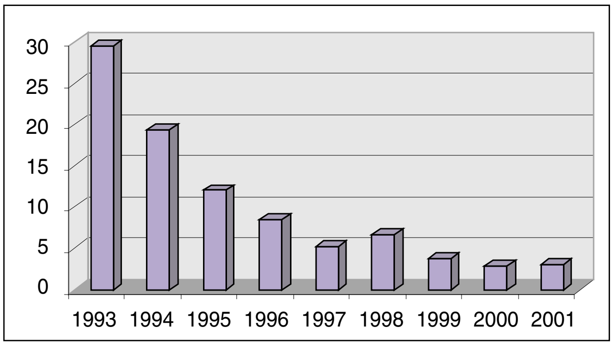
a) cleaning up portfolios

The first step in the process of consolidating banks and saving banks, which had capital adequacy of less than 7%, was an exchange of classified loans for government bonds at the end of 1992. The bonds had a maturity of 20 years and a market interest rate tied to the 3-month treasury bill interest rate. The government sold a part of the bad loans to the Hungarian Development Bank (at a discount), which was charged with work outs. Another part of the bad loans was left with the banks to be worked out.To encourage banks to make bad loan work outs, the government provided a remuneration of 2%. This remuneration was, however, too low and in actuality did not encourage banks to perform any work outs. Instead, they attempted to sell the loans to various private companies that appeared on the market and which would perform these work outs. Those loans on which a work out could not be made or that could not be sold on in this way were transferred to the Hungarian Development Bank, which in many cases had to write off the debt. As the consolidation process continued three state banks received bonds in exchange for bad loans on the basis of the case as it existed in March 1993. The costs of this portfolio clean-up were in total 3.7% of GDP.

These measures achieved only a partial and transitory improvement in the situation in the banking sector for two main reasons. Firstly, the exchange of government bonds for loans did not include substandard and doubtful debts and consolidation did not include the problem of poor bank investments and off-balance sheet liabilities remaining in credit institutions. Secondly, the main shortcoming of the first attempt at consolidation was the fact that it did not bring about changes in the management and operations of banks. The government ordered an audit of banks participating in the portfolio clean-up, though this was done very quickly and superficially. The consequence of this was that the situation of banks continued to worsen, because poor banking practices continued, multiplying the worsening financial situation of debtors (a fall in output).

b) enterprise-oriented portfolio clean-ups

Nonperforming Loans as a Percentage of Total Loans



Source: National Bank of Hungary

In mid-1993 a further partial consolidation measure was implemented. At the time this problem was approached from the side of debtors. The objective was an effort to avoid the closure of certain state-owned enterprises considered to be important, but unable to service their debts. The state cleaned their debts from bank portfolios through an exchange for government bonds. The majority of the debt taken over by the government was written off. At first the 12 largest privileged enterprises were cleaned up in this way, but later various firms were included in this list. The portfolio clean-up was successful in saving certain large debtors, which were reorganised and later successfully privatised. Certain firms have remained in the state hands, whereas others have had to be closed. The total costs of this form of consolidation were 1.6% of GDP.

c) Recapitalisation

Despite the above-mentioned attempts at consolidation the sum of classified loans continued to grow and reached almost 30% of the total loan portfolio of the banks in 1993. This growth was caused partially by the fact that in accordance with international standards Hungarian rules on loan classification were tightened. Nevertheless, the continuing deterioration in the financial situation of debtors and the accumulation of new bad loans were also contributory factors.

At the end of 1993 it was clear that the partial portfolio clean-up had not resolved the banking system's problem and that complete recapitalisation of banks by the state, taking into account poor investments and banks' off-balance sheet liabilities, was essential. Recapitalisation was implemented over three stages during 1993 - 1994. In the first stage capital adequacy of the participating banks was 0%. In the second stage capital adequacy grew to 4% and in the third stage capital adequacy of the four large state-owned banks grew to 8%, i.e. the capital adequacy required by BIS rules. Recapitalisation in the first and second stages took the form of a government buy-up of newly issued shares in the recapitalised banks. The government paid for these with bonds, which were issued under the same conditions as the consolidation bonds issued earlier. The third stage took the form of a prolongation by the government of subordinated debt to banks. The costs of recapitalisation were 4.8% of GDP.

In the end the recognition that banks have the best information available on debtors and are best placed to deal with problem loans led to the conclusion that work outs should be done by the banks themselves. For this purpose the majority of banks created a separate internal or external work-out unit. One of the aims of creating separate units was to avoid the work out disrupting the normal operations of the bank. A further aim was to separate "good banks" from "bad banks" in the process of preparing banks for privatisation. There were also cases where banks sold bad loans to private work-out organisations. A work out essentially took two years. Learning from previous mistakes, when detailed conditions were not stipulated for banks cleaning up their portfolios, banks being recapitalised were ordered to submit a consolidation programme that was to lay solid bases for privatisation. The programme included measures for a rationalisation of management, improvement of internal controls and modernisation of banking activities. Objectives were set out through an agreement between the respective bank and the Ministry of Finance.

The total costs of consolidation over the years between 1992 and 2000 came to almost 13% of GDP. From an international comparison it can be seen that these costs were not extraordinarily high. In large part they were caused by the low level of financial indebtedness. In 1992 (prior to bank consolidation) the proportion of total assets of the banking system in percent of GDP in Hungary was 75%, much less than that in advanced developed countries (150 - 325%). This proportion in 1999 fell to less than 70% of GDP, this trend continuing in the following period. In 2000 and 2001 this figure reached 64%. This can to a certain extent be explained by the low lending levels to enterprises and households. This low level of lending is attributed to several factors. Many enterprises in Hungary owned by multinationals borrow from their parent company or foreign banks and in this way circumvent the domestic banking sector. These enterprises at the same time produce a large part of GDP in Hungary. Together with foreign companies investing in Hungary they represent around 70% of Hungary's total exports. A further factor is the fact that many Hungarian firms do not have a sufficient credit history for banks to evaluate their risk. An important role is played also by the fact that loans to households have been limited due to the low level of incomes. Lending to the sector has been risky. Nevertheless Hungary has essentially been lucky in the fact that banking consolidation came at a time when low financial indebtedness helped limit the costs of consolidation.

Bank privatisation

The government considered privatisation of the state-owned banks as the final step in strengthening and stabilising the banking system. In formulating a privatisation strategy the conclusion was reached that banks should preferentially be sold to strategic investors providing the necessary capital, technology and know-how. In practice this meant the sale most state-owned banks to foreign banks. Six of the state-owned banks that in 1995 had had a 31% market share were sold to foreign banks. In the first phase of privatisation the government retained a minority shareholding in these banks. The European Bank for Reconstruction and Development (EBRD) also participated as a minority shareholder in the privatisation of three banks. The initial stake held by the government and EBRD was considered by strategic investors to be a certain guarantee in the case that the banks were to encounter unexpected difficulties. Later these minority stakes were bought by the strategic investors.

The government stipulated that NSB, the largest Hungarian bank with a market share of 29% prior to privatisation should be privatised via the stock exchange. Besides the objective of leaving the management of the largest bank wholly in Hungarian hands, another aim was to highlight the development of the domestic capital market. This bank since this time has functioned well and is now a strong competitor in the market.

The growing participation of foreign investors in the Hungarian banking sector has not merely been a result of privatisation. Hungary practised a liberal licensing policy in respect of foreign banks setting up branches in Hungary. The result of privatisation and the establishment of foreign banks "on a green-field " was a dramatic change in the ownership structure of the banking sector in the second half of the Nineties. By 1997 state ownership in the banking sector had fallen to 20%, with only one large and one small commercial bank as well as several credit institutions fulfilling special functions remaining in state ownership (Eximbanka, Hungarian Development Bank, four loan houses and two mortgage banks). Foreign owners as at 31.12.2001 held a 62% share in banking sector equity, where banks from European Union countries dominate, a reflection of the country's approaching EU accession.

Banking regulation and supervision

Experience worldwide has shown that the quality and effectiveness of banking regulation and supervision play an important role in avoiding bank crises. Prudential regulation and supervision in Hungary has over the past years improved significantly. The government has been helped in its efforts by the EU accession process, which requires harmonisation of the regulatory framework. The legal framework of the Hungarian banking sector and respective regulation corresponds to EU directives and standards. Banking supervision has been strengthened through the granting of considerable autonomy to the banking supervisory authority and the improvement of its personnel's experience through training and the recruitment of better-qualified staff. A change from institution-based supervision to group-based supervision has contributed to an improvement in banking supervision. Besides banks, banking supervision now covers the money and capital market (players in the capital market), insurance companies and pension funds. This is an international trend and has helped banks in Hungary expand their subject of business into these financial activities.

Trends and prospects for the Hungarian banking sector

At the start of the year 2000 Hungary had one of the healthiest banking and financial systems in Central Europe. In large part this was due to the timely initiation of the restructuring process, where the quality of the loan portfolio improved significantly. The loan portfolio continues to be carefully monitored (in 2002 the situation worsened slightly in consequence of the decline in economic performance); this is a priority task for the future. Total assets of the banking sector have begun to grow, though to a large extent this growth comprises loans to households – mortgage loans (subsidised) and consumer loans. This is a result of both the growth in household incomes as well as the efforts of banks to expand their activities due to growing competition. It is expected that this trend will continue with the development of the economy and small and medium-sized enterprises. Even despite this, it is however unlikely that the level of financial mediation in Hungary will soon reach the level of EU countries, since multinational firms will continue to dominate in the business sector and these firms will have a tendency to rely to some extent on borrowing from their parent companies abroad.

Source: György Szapáry: Banking Sector Reform in Hungary,
National Bank of Hungary website: www.mnb.hu