Organisation for Economic Co-operation and Development

Organisation de Coopération et de Développement Économiques

in co-operation with the Italian Treasury

Eleventh Plenary Session of the OECD Advisory Group on Privatisation (AGP)

on

Banks and Privatisation

THE HUNGARIAN BANKING SYSTEM

by Dr. Arpad Kovacs

Rome, 18 and 19 September 1997

THE HUNGARIAN BANKING SYSTEM[*]

by
Dr. Arpad Kovacs[**]

1. The development of the Hungarian banking system

1.1. 1987-1991 The introduction of the two-tiered banking system

The Hungarian two-tiered banking system was reborn ten years ago, on 1st January 1987. Since then, the legal framework of banking has been established and finalised. The preparations for the introduction of a commercial banking system took about two years. As a result, Hungary became the first of the former socialist countries to establish a banking system similar to that of market economies. This was a significant step in the development of Hungary's financial institutions.

Between 1987 and 1989 banking was the most market-oriented sector of Hungary's centralised economy. Three large banks, the Hungarian Credit Bank (MHB), the National Commercial and Credit Bank (OKHB) and the Budapest Bank (BB), were established from the credit department of the National Bank of Hungary (MNB) in 1987, although banking was still one of the leading sectors of the economy. Financial institutions were very profitable as there was no external competition.

It soon became evident that such extensive development was a mistake. However, the number of banks and financial institutions increased fast.

---

*. Paper presented at the OECD Symposium on "Banks and Privatisation", Rome, 18-19 September 1997.

**. Former cCairman of the Board, Hungarian Privatisation and State Holding Company (APV Rt), Budapest

1991 was also noteworthy because parliament approved legislation on Financial Institutions, Central Banking, a revamped Law on Accounting, Investment Funds and several other important regulations regarding financial institutions. Thus, a legal and institutional framework within modern and international norms was established for banking.

1.2. 1992-1994 The consolidation

1.2.1. The way to the consolidation of the banks

Economic changes and the collapse of the country's economic relations with other COMECON countries put an end to this comfortable situation. After a long period (40 years) the planned state economy suddenly collapsed with the following results: a deepening economic recession, a decline in domestic output (GDP fell nearly 15 per cent in real terms from 1989-1992), disintegration of domestic, regional and CMEA trade relations and an increasing level of inflation, interest, state budget deficit and unemployment. Companies lost their markets, they were inexperienced with a market economy system, they had outdated technologies and were over-staffed. Many turned to the banks to obtain credit that allowed them to temporarily escape from hard budget constraint, and to delay restructuring and liquidation; all this led to a rapid deterioration of the loan portfolios of the banks.

The Hungarian economy in numbers

	1992	1993	1994	1995	1996	1997
real GDP growth (%)	-4.5	-2.3	2.9	1.5	0.5	2
industrial production (%)	-9.8	4	9.5	4.8	2	4.5
per capita USD	3,581	3,733	4,037	4,252	4,388	4,567
exchange rate (USD/HUF)	80	91	104	124	149	162
yield on 3 month T-bill	33	25	27	32	25	18

Table 1. The sovereign ratings of Hungary

	1996

S&P	BBB-
Moody's	Ba2

Not even the banks were prepared for the challenges accompanying the rapid changes towards a market economy. Macro-economic decline manifested itself in a general deterioration of loan quality. In addition to this, the banking system lacked a new legal framework and economic regulation, had inexperienced management, poor credit risk management, almost no control, and last but not least, the banks had an unsuitable ownership-structure. This resulted in major troubles for the banks. They were still losing their capital, which would have led to their liquidation. This would have created total chaos in the economy, which had to be avoided.

The deteriorating position of the banks resulted in the state's increasing liability; and in these circumstance, an intervention could no longer be postponed. The state had to take steps to solve these growing problems. It was obvious that there was no other alternative than consolidation.

The government then decided on the principles of this consolidation. It was stipulated that the consolidation should be part of the preparation of the banks for privatisation, and also improve asset quality, restore solvency, be made on a commercial basis and be combined with company consolidation.

The consolidation did not mean a simple injection of money into the banks but it meant the avoidance of losses for small deposit holders, keeping the banking system working and rescuing the economy from total collapse. The consolidation could not be realised in one step because of time pressure and the agreement with the IBRD regarding the capital adequacy ratio.

1.2.2. Consolidation

<u>The bank oriented consolidation</u>

At the end of 1992, bad loans originating from insolvent companies reached a critical level. It took 262 bln. HUF which equalled 17 per cent of the total assets and almost 10 per cent of the GDP.

The government wanted to restore the solvency of the banks. Those banks whose capital adequacy ratio was below 7.25 per cent could take part in the consolidation. 14 commercial banks and 69 co-operatives were involved. They sold bad loans (to an amount of 102.5 bln. HUF) to the state at 50 per cent, 80 per cent and 100 per cent of nominal value, depending on the origination date of the debts.

In exchange for these bad loans the banks bought consolidated bonds issued by the state for this purpose (the type of the bonds is as follows: expiration of 20 years, negotiable, interest based on the average interest of the three month treasury bills, payable annually).

The state attempted to decentralise management of the bad loans by selling a major part (about 40 bln. HUF) to the MFB and other banks at a low price with the purpose that this bank could deal more effectively (for example: assets swapping, debt-equity swapping, in which the non-performing loans would be replaced by the bank's equity.)

The cleansing of the portfolio was only temporarily able to stop the deterioration of the banks. The amount of qualified loans fell from 262 bln. HUF to 186 bln. HUF and resulted in an improved portfolio.

The main flaw of this approach was that it did not impose any obligations on the banks to change their lending policy, organisation-structure, loan rating system or loan monitoring system. Furthermore, only certain loans were involved in the transaction and other types of loans were left out of the consolidation package altogether.

The consolidation was only the first step and was implemented under the pressure of time.

Unfortunately the negative trend of the economy continued and the position of the banking system turned critical again after 6 months.

<u>The Company oriented consolidation</u>

In the second half of 1993, the government decided to buy the loans of 12 companies from the banks which played a significant role in the Hungarian economy (MÁV (Hungarian Railways), agriculture). Under this program, the state bought 61 bln. HUF of receivables of questionable value from the banks in exchange for 57 bln. HUF in consolidated bonds. These loans were transferred to ÁPV Co. for the same purpose as stated.

<u>Capitalisation of the banks</u>

The issue of under-capitalised banks still existed because their capital adequacy ratio was below 8 per cent. This issue was further exacerbated by the introduction of new accounting principles in 1993, which were implemented without any study on the effects of the new regulation. The increased need for reserves resulted again in a further reduction of the capital of the banks.

Taking into account the experiences of the first stage, the government chose to capitalise the banks in several steps. The main goal was to meet the 8 per cent capital adequacy ratio.

The first step was to have banks achieve a 0 per cent capital adequacy ratio. 144 bln. HUF were put into 8 affected banks (77 per cent of which was used at two banks).

The next step was to meet the 4 per cent capital adequacy ratio. This transaction needed 18 bln. HUF.

Finally the state provided subordinated loans to banks whose capital adequacy ratio was still below 8 per cent.

The Capital Adequacy Ratio of the banks

	1995	1996
large banks	**14.5**	**15.2**
state-owned banks	9.8	9.6
private banks	16	17
medium-sized banks	**24.1**	**23.1**
state-owned banks	25.3	37.7
private banks	23.6	19.1
small banks	**29.5**	**28.2**
state-owned banks	45	50.4
private banks	24	22.6
banking sector	**18.3**	**18.6**
state-owned banks	18.1	19.9
private banks	18.4	18.2

1.2.3. The result of the consolidation

The overall effect of the consolidation programme has been positive, although in retrospect it could have been improved. For example:

- The consolidation had many advantages:
  - it cleaned up the bank's balance sheets by removing bad loans
  - it helped meet earnings and capital targets (the consolidated banks met the requirements of the international accounting system, the capital adequacy ratio of every bank is above 8 per cent)
  - the stability and the solvency of the banking system during the period of transition was restored
  - the banks started changing their lending policy, organisation-structure and their general way of doing business
  - eventually the pre-tax profit of the banking system had a positive balance (17.2 bln. HUF in 1995 versus -5 bln. HUF in 1992).
- On the negative side the consolidation had several disadvantages:
  - the consolidation was not strictly bound to privatisation, it did not adopt commercial and performance-based criteria
  - the issue of consolidation bonds increased the direct government control of the banking system (the registered capital of the consolidated banks was about 20 bln. HUF of which about 16 bln. HUF was state-owned)
  - the profitability of the banks did not improve as much as expected
  - in spite of the consolidation, some small banks should have merged or been liquidated
  - the expected effect of the bank consolidation on the economy did not occur
  - the bank consolidation affected the state budget considerably. The total amount of the consolidated bonds issued was 338 bln.

HUF, which is part of the deficit of the state budget. The principal will reduce the state budget at the maturity of the bonds, with interest payable annually. The interest paid in 1993 and 1994 was 143 bln. HUF, almost 1.2 per cent of the GDP

1.3. The Privatisation of banks

As it was set out in the government decree, the consolidation of the Hungarian banking system had to be part of the preparation of the banks for privatisation. Banking system efficiency is not likely until the transition economy banking system is privately owned, managed and governed.

At the beginning of 1990 the interest of foreign investors for Hungarian banks appeared. But it was too early, the state was not ready to sell the profitable banks (profitable at least according to the Hungarian accounting system). No one could take the political responsibility for this. If someone had bought a bank at that time a complete return on the investment could have been made in two years.

In 1992 after having identified the weaknesses of the Hungarian banking system, the interest of the state focused on seeking strategic investors with a long-term interest in the banks. In spite of the need for foreign investors, no transaction took place. The economic and political uncertainty was too high for strategic investors, who were very sensitive to concluding economically justified investments.

The first bank privatisation took place at the end of 1995 and some other successful bank privatisation followed. The state prefers strategic investors with a good reputation and know-how. Bids are evaluated on purchase price, the guarantees asked for, planned capital increase and objectivised business plan. The success in bank privatisation has given additional confidence to foreign investors for further capital investment in Hungary.

After the privatisation of the oil giant MOL, electricity producers and several gas distribution companies, the sale of the commercial banks is likely to represent the last major phase of the privatisation process. The completion of bank privatisation is expected at the end of this year. At that time only one bank, the Hungarian Development Bank will remain state owned

Ownership-structure of the Hungarian banking system

bln. HUF	1994	%	1995	%	1996	%
direct state control	193.3	65.9	86.7	39.4	63	30
Social security ownership	2.6	0.9	8.3	3.8	11	5
state control (direct+indirect)	195.9	66.8	95	43.2	74	35
other domestic owners	52.3	17.8	44.6	20.3	37	18
domestic owners altogether	**248.8**	**84.9**	**141.6**	**64.4**	**111**	**53**
foreign owners	44.3	15.1	78	35.6	99	47
registered capital	**293.1**	**100**	**219,8**	**100**	**210**	**100**

1.4. The privatised banks

The Minister of Finance and the Minister without portfolio responsible for privatisation entered into a co-operation agreement. In the frame of this agreement ÁPV Co. (the Hungarian Privatisation and State Holding Company) acts as the agent of the Ministry of Finance so that ÁPV Co. only manages the privatisation of the banks. The final decisions will be made by the Minister of Finance, as owner of the banks' shares, on the basis of the proposals made by the ÁPV's board of directors. ÁPV will not receive any fee for its activity from the Ministry of Finance but the purchase prices of the sold banks decrease the privatisation amount payable by ÁPV into the state-budget.

On the privatisation of every bank the state sold 5 per cent of the shares to the employees and management who were able to buy the shares using different types of favourable conditions.

1.4.1. Bank privatisation in 1996

Budapest Bank Ltd.: The privatisation of Budapest Bank Ltd. was managed by the Ministry of Finance.

Hungarian Foreign Trade Bank Ltd.: The privatisation of the HFT Bank started in June 1994 when the first part of the transaction took place. The offered shares were bought by the Bayerische Landesbank (25 per cent) and EBRD (17 per cent) who simultaneously raised the bank's registered capital. The purchase price was 125 per cent. The share-purchase agreement contained a special condition for paying a so-called shares premium to the state depending on the profit in the following next half year.

In 1995 8 per cent of the bank's shares were kept in the bank's portfolio. That portion was bought by the Deutsche Entwicklungs Gesellschaft.

The last state-owned package, 24.67 per cent of the registered capital (nominal value 2.243 bln. HUF) was sold for 4.9 bln. HUF (about DM 49 million) on 8th May 1996. The purchase price was 219 per cent.

General Banking and Trust Co. (Általános Értékforgalmi Bank Rt): The shares of the bank were held by ÁPV Co. (not the Ministry of Finance) and CEDC. Gazprombank signed the share-purchase agreement with the state on 1st July. Gazprombank bought 50 per cent of the shares (50 per cent of the registered capital) from the state at nominal value for 500 million HUF. The other 50 per cent was bought from CEDC but in that case even the management control attached to this package had to be paid for. Gazprombank according to its obligation undertaken in the Share-purchase agreement increased the registered capital to 5 bln. HUF at the end of 1996.

Hungarian Credit Bank Ltd: In July 1996 a single round, closed tender was issued for selling 89.23 per cent of the state-owned shares of the MHB. Four large banks with good international reputation expressed their interest in the transaction: Creditanstalt, BankAustria, Bank of America and ABN AMRO but only two of them (Creditanstalt, ABN AMRO) submitted bids.

The real competition of the bidders resulted in a very high purchase price. The shares were bought for 89.23 million USD (222 per cent of nominal value) by ABN-AMRO on 18th December 1996. In two months after signing the share-purchase agreement ABN-AMRO increased the registered capital of MHB with 10 bln. HUF.

Even today the transaction is assessed as one of the most successful bank privatisations in Hungary.

1.4.2. Bank privatisation in 1997

Takarékbank Rt.: A single round, closed tender was issued for selling 60.89 per cent of the bank's shares at the beginning of 1997. (the total registered capital: 1.3 bln. HUF). Two international well-known banks (Deutsche Genossenschaft, GiroCredit) submitted bids for buying the shares of Takarekbank.

The Minister of Finance has already declared the winning bidder, DG Bank, who offered 532 per cent for the shares. The winning bidder is to sign the agreement before the end of June. DG has formed a consortium with the Hungaria Insurance Company. 55.98 per cent of the shares will be bought by DG Bank, 5 per cent by the Hungaria Insurance Company. As in most cases the buyer has to increase the registered capital of the bank within one year, this obligation is part of the share-purchase agreement.

K&H Bank Rt.: A two round tender was issued for selling shares 1 bln. HUF nominal value, and to increase the capital up to the co-operating investor EBRD having a minimum of 25 per cent+1 vote, which is participating in the capital increase by 30 million USD. 38 investors were invited in the first round, and 5 of them submitted valid bids. ÁPV Co. selected according to the approval of the Minister of Finance, 2 investors in the second round, the Kredietbank-Irish Life Plc. consortium, and the Bank of Ireland. The Tender process will be completed in July 1997.

Mezõbank Rt.: According to the valid governmental degree (passed in June) the privatisation of Mezõbank should be finished this year. The date for issuing a single round, closed tender for selling 83 per cent of the shares (total registered capital 3.4 bln. HUF) was in the first days of July 1997. 3 potential investors were invited to a single round, closed tender, which will be completed in September, and 2 of the 3 invited bidders (Unicbank, and GiroCredit) indicated that they were interested in the privatisation. The bank has a country wide branch network which makes it attractive among the strategic investors.

Pénzintézeti Központ Bank Rt.: The ownership-structure of PK is exceptional among the state-owned banks. The shares of PK are owned by ÁPV Co. instead of the Ministry of Finance. In February ÁPV's board of directors passed a resolution on the privatisation of the bank. According to this resolution a single round tender should be issued before 1st September 1997 with a purpose of selling 95 per cent of the shares (total registered capital 5 bln. HUF). Even in case of PK a strategic investor is preferred.

National Savings and Commercial Bank Ltd. (OTP): The bank's privatisation took place in 1995 but 25 per cent of the shares are still state-owned. A special ownership-right is attached to this package, which gives more right to the state than in a normal case. The issue of the privatisation or non-privatisation of this package is still under discussion but no decision has yet been made.

The shares of the bank are on the Hungarian stock-exchange with a very good daily turnover. Large institutional investors prefer these shares and keep this paper in their portfolio for the long term.

1.4. The banking system in 1996

1996 was a successful year for banks in Hungary. The total balance sheet of the banking system increased with a speed higher than inflation. It was the first time for five years that the annual turnover of the banking system compared to the GDP increased (72 per cent - this ratio is about 150-200 per cent in developed countries).

The banking system expressed in GDP

%	1991	1992	1993	1994	1995	1996
total assets	85	78	74	69	67	72
lending to the companies	31	26	22	20	18	
small deposits	17	20	20	20	20	

The profit after tax was 67 bln. HUF, which is 45 per cent higher than the previous year.

The concentration of the markets was declining. The market share of the 5 largest banks decreased to 52 per cent (from 62 per cent the in previous year) and simultaneously the market participation of medium-sized foreign banks increased. The market share of the large banks in developed countries is about 30 per cent, but this very much depends on the tradition of the country in question.

Due to privatisation, the ownership-structure of the banks has radically changed. Only a few banks are left to be privatised in 1997. At the end of 1996 almost half of the registered capital was owned by foreign banks. In other words: in 19 cases of the 41 commercial banks in Hungary the banks are wholly owned by strategic investors.

These facts indicate that the stabilisation of the economy and the restructuring of the banking system have been successfully implemented.

1.5 The future

The new act on credit institution and financial undertakings put into force in 1996 will help the further development of the banking system.

Since banks are permitted to trade in state bonds and derivative products from 1st January 1997, it is also clear that the Hungarian banking system is headed towards universality.

Banks will most likely be allowed to provide complete investment services from 1st January 1998. In recent years, this legislation has been exercised to set the conditions for the operation, the ownership and the market entry of credit institutions. The law: ensures depositors that the banks, etc. are safe and efficient

It is more than likely that the Hungarian banking system will start a "normal" course of growth from 1997. Hungary's financial system will be increasingly exposed to international influences due to the integration of the economy and its banking system into the world economy and the international banking community. For that reason, a strong development of Hungary's banking system can be expected.

The character of the forecast trend of the development of the banking system:

- the banks are headed towards universality
- the interest margin will decline because of the increase in competition
- the role of non-financial activities will grow
- the importance of the out of balance activity will grow
- the quality of the banking services will improve
- the information system (private banking) will grow
- further mergers and acquisitions are possible
- the banks take steps for increasing their share on the small companies and householders market

2. The banking environment inHungary

A series of policy, legal, regulatory, supervisory and institutional reforms were needed to promote the development of efficient financial sector infrastructure. Inadequate legal and regulatory frameworks, inexperienced supervisory staff, insufficient institutional capacity and insufficient financial sector infrastructure characterised the banking system at the beginning of the transition.

Hungary has made very considerable steps in improving the environment of the banking system. Most of the regulations, standards, laws, etc. have been brought in line with international standards. In this section only the main issues or steps will be described in short.

2.1. Banking sector policy reforms

Reforms supported the efforts of the transition economy to adopt market-oriented policies:

- encouraged positive real interest rates
- reduced subsidies to preferred sectors
- limited direct credits
- supported the introduction of more indirect methods of the central bank control of commercial banks (this included: reserve requirements, liquidity requirements, the introduction of treasury bills, etc.)
- strengthened supervision by the central bank

2.2. Regulatory framework

Major problems included:

- no separation of central and commercial bank functions
- unsatisfactory legal foundation and infrastructure regarding property rights, bankruptcy, liquidation, contract enforcement, loan recovery, etc. (this included inadequate civil law and commercial law; disorganised and incomplete property registries; weak civil court system)

- inappropriate management, ownership and governing structure
- weak (or almost no) regulations for:
  - loan classification
  - interest accrual
  - risk weighting
  - loan loss provisioning
  - capital adequacy
  - minimum capital
  - loan concentration

2.2.1. Legal reforms

Legal reforms addressed some of these shortcomings:

- 1987 - The introduction of the two-tired banking system. The new law clarified the different roles to be played by the independent central bank and the commercial bank
- 1991 - Financial Institutions Act
- 1992 - Bankruptcy and Liquidation Act (they were almost unknown in the planned economy; the liquidation of company assets was hindered by the lack of legal tradition, weak courts, inexperienced judges, etc.)
- 1996 - Amendment of the Act on Financial Institutions. This amendment brought a significant change for banking. The new act's most important feature was to increase the safety of depositors (increases the minimum limit of the registered capital from 1 bln. HUF to 2 bln. HUF, which must be in cash; reduces the maximum stake held by a single owner from 25 per cent to 15 per cent, except for a defined group of investors from the banking sector). The new act is a framework on which the different financial institutions will be regulated under separate legislation in the future.

The reform programs generally included the effort to develop civil and commercial law suitable for a market economy. It also helped accelerate dispute resolution

2.2.2. Regulatory reforms

Regulatory issues were significant factors in reform programs because the regulation of the banking system was universally weak. Key efforts were the following:

- licensing standards strengthened to clarify capital requirements, management requirements, reporting requirements,
- introduction of loan specification (tightened up in 1993), treatment of interest accruals and principle rollovers, risk weighting, loan provision, capital adequacy requirements have been brought in line with international standards
- restriction on loan concentration to large borrowers, shareholders, managers and other individuals
- foreign exchange operations are more tightly monitored
- credit policy and procedures tightened, although implementation was still problematic due to insufficient training of senior bank management and insufficient intervention on the part of the supervisory authorities

2.3. Bank supervision

Bank supervision was one of the most critical elements of successful financial sector reform. The weaknesses of bank supervision were the following:

- no, or later, not strict enough legal framework
- insufficient number of trained supervisors. Many supervisors had limited auditing experience or experience with accounting, banking and financial analysis
- very poor information system (included quality as well as timeliness)

The Banking supervision Act was put into force in 1992 and amended in 1997. The State Banking Supervisory Board's regulations are harmonised with international standards.

2.4. Institutional strengthening

An environment making a financial sector viable depends on properly functioning institutions. Conversely, the absence of properly functioning institutions makes it difficult (or impossible) for banks to properly intermediate resources in a manner responsive to economic and financial needs. Things which were implemented or are still under implementation:

- new organisational structures
- credit policy and control
- credit risk evaluation, loan syndication, co-financing
- internal documentation and monitoring system
- management of foreign exchange bureaux
- general asset management
- deposit mobilisation strategies
- introduction of new technologies for automation

2.5. Accounting and auditing system

The accounting system reflected the same weakness indicated by pre-transition regulation:

- improper loan classification (if any), interest accruals and principal-rollovers overstated asset quality and values, and obscured liquidity problems
- loan-loss provisioning rarely occurred (before 1993 for covering the risk of the qualified receivables the banks formed the reserves from the profit after tax and not from the profit before tax)

- risk weighting was inaccurate
- interest never received could be accounted for as part of the gain

Along with imprudent lending practices and passive registration of the collateral banking sector accounting never accurately reflected solvency and liquidity problems and the poor earnings of the banks. In "reality" the banks were profitable between 1987-1991.

The accounting and auditing suitable for commercial management in the market economy started in 1993. In 1993 Hungary adopted the international accounting standard, introduced new charts of accounts and encouraged more open disclosure of information to correct information data and information shortcomings.

The reforms supported efforts to bring accounting standards in line with international standards, to develop a professional class of accountants and auditors. The changes brought the losses to the surface, which led partly to the consolidation of the banks.

2.6. Payment system

The payment system in Hungary was very slow and under-developed. It consistently brought forth delays in bank transfers, verifications and settlements. The balance sheet included some special accounts like money-in-transfer, which was among the other assets. This always caused problems as it limited business operations, undermining confidence in the banking system.

The target of the reforms of the payment system was evident: introducing a more efficient payment method and clearing system. The Giro system introduced in November 1994 was a significant step in the development of financial infrastructure. The Giro system has proved its advantages since then. Clearing has accelerated and nowadays takes no longer than three days. This still lags behind countries with real-time capability but, clearing costs are dropping and Hungary's clearing system is approaching EU recommendations. The introduction of a real-time system is planned for 1997 even with all the time consuming co-ordination of regulations expected.