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ÉVA VÁRHEGYI

Reform and Consolidation in Hungary's Banking System

The reform process thus far affecting Hungary's banking system introduced formal changes: it created institutional and legal frameworks that mirror those existing in developed market economies. At the same time, Hungary's banking market is still marked by a predominance of financial institutions that are captives of owners and clients inherited from the plan-based system of the past. This adverse legacy, combined with the pressures of economic transformation, created a more severe banking crisis than was expected. The market's self-regulating processes do not appear sufficient to handle this predicament. In order for the market cleansing process to come to a successful conclusion without causing the complete collapse of the system of financial intermediation, we must see an improvement in bank balances, stronger regulation of the market and competition, and an accelerated transformation in ownership relations. This article evaluates the reform processes that have taken place in the banking system and outlines the steps that are necessary for the immediate future based on the present situation. It is our contention that analysis of the developments in Hungary's banking system during the past two years cannot ignore earlier regulatory and institutional conceptions that have affected the system's evolution.

Changing Operating Conditions in the Banking System

The Legal Framework

The development of legal parameters resembling the European norm, especially the creation of laws governing the national bank and other financial institutions, can be viewed as an important stage in the banking system's modernization. These laws have two roles. First, they regulate the banking system's players to protect them from the current political authorities, thus allowing them to fulfill

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their economic functions. Second, they promote the banking system's development in a direction that, other factors being equal, promotes its integration into the capital markets of developed market economies.

Law LX of 1991, concerning the Hungarian National Bank (MNB), gave the central bank the autonomy that it absolutely needs in order to fulfill its basic task of protecting the value of the country's currency. Having been freed by law from obeying the government, today's MNB needs only to be supportive of the government's economic policies rather than being subservient to them. In theory, the central bank's autonomy and its increased responsibility for monetary policy also weakened governmental pressure on the commercial bank sector.

Law LXIX of 1991 (on financial institutions and their activities) approaches European standards and established requirements that banks can only meet by upgrading security factors—unless they want to risk their shareholders' money to an extent that the latter would not tolerate. By legally prescribing a capital-adequacy indicator that is stricter than previous ones (although still more lenient than international regulations), by calling for the creation of target reserves to cover risks, and by monitoring the activities of bank owners and large borrowers, the legal conditions for secure banking operations have been established.

At the same time, the law also determines the direction that the development of Hungary's banking system ought to follow. By setting conditions for operating certain types of financial institutions and for authorizing bank startups, the law influences the number and latitude of market players. In this regard, too, the law follows the unified European system of regulation, which took effect in 1993. Operating in accordance with the principle of capital market deregulation, this regulatory system promotes the elimination, or negotiability, of "walls" between various financial institutions or countries in some European (and other) regions.

Since integration into the capital market is absolutely critical for Hungarian economic development, it was logical to strive for banking regulations resembling those in the European Community. However, after the ratification of the law, Hungary's economy exhibited grave problems that cannot be handled within the law's framework, or at least not without making great sacrifices. In our opinion, rational treatment of the problems accumulated in the banking sphere (but reflecting the crisis in the entire economy) is hindered both by the overly liberal regulation governing the creation of banks and by rules that limit the freedom of commercial banks, especially when it comes to investing in enterprises. Therefore, even if this means distancing ourselves from the tendencies prevailing in the developed countries, we recommend a temporary modification of the regulatory environment in a direction that better suits conditions prevailing in Hungary. (Solutions that may result from these modifications will be discussed later, after this article describes the problems.)

We must also mention the laws on accounting practices and bankruptcy, which, although they are not aimed directly at the banking sector, define its operating conditions

and promote the transition to a market economy. The accounting legislation (Law XVIII of 1991) differs from previous practice in that it proscribes the classification of all accounts receivable (especially delinquent or doubtful claims) as part of profit, prescribing instead the development of target reserves against them. This change deprives enterprises, banks, and (due to lost taxes) the state budget of the fictional earnings that previously concealed losses. However, some of the tax earnings from fictitious profits continue to exist, because tax laws limit the development of target reserves if they reduce investments.

The law introducing the rules of a market economy is also hindered by the fact that previous regulations compelled neither enterprises nor banks to develop sufficient reserves to defray losses linked to their outstanding claims. The new laws on accounting practices and financial institutions were therefore necessary to force enterprises and banks to treat the creation of these reserve funds as costs. Nominal control by bank owners proved to be a poor substitute for legal incentives here, primarily because the banks were largely owned by the state or state enterprises.

Moreover, the law was introduced just when the collapse of the traditional (Eastern) market of Hungarian enterprises was already upsetting the economy. This shock was exacerbated by the bankruptcy reporting requirement (contained in Law IL of 1991 on bankruptcy, bankruptcy proceedings, and enterprise liquidation, which went into effect 1 January 1992), which compels debtors to announce bankruptcy regardless of the debt's size or the creditor's intentions if the debt is 90 days past due. The implementation of this law led to a great number of bankruptcy proceedings and closings during 1992.¹ Since the bankruptcy law went into effect at about the time when the above-mentioned two laws were making it possible to fill the banks' loan-loss reserves, the prospects for bankruptcy settlements became less favorable than they would have been with better timing. The concentration of bankruptcies and closings also endangered the fragile stability of the bank sector, which had insufficient reserves to cover its sizable crediting losses.

Because of this law, the banks were also deprived of partial loan repayments by debtors who otherwise would have fulfilled their debt servicing obligations. After all, if a bank's debtor is forced into bankruptcy or liquidation on account of another creditor, that debtor is not obliged to—indeed, is not allowed to—step outside the bankruptcy proceedings and service its debt to the bank. During the bankruptcy procedure's 120-day payment moratorium, the banks do not receive any of their money. The banks' situation was further exacerbated by the fact that the law placed them in the same category as other creditor enterprises when it comes to satisfying their claims against the debtor.

Changes in the Banking Market

Since a two-tiered banking system was developed (in 1987), two processes could be observed on the banking market, one favorable and the other unfavorable.

Examples of the first process include the breakdown of the previous market segmentation, a growing number of channels for capital flow, an easier negotiability of rigid walls between the activities of diverse financial institutions, and an increase in the number of market players, leading to more active competition.

The breakdown of the market segmentation inherited from the one-tiered banking system owed its start primarily to the integration of the residential banking market. All financial establishments (i.e., commercial banks and specialized institutions) before 1989 were effectively banned from the residential banking services market, which was the domain of savings-and-loan institutions and credit unions, thus creating an artificial segmentation. Starting in 1989, banks were authorized to offer financial services to households. They initially entered this market primarily in order to accumulate financial resources (by issuing various bank certificates and maintaining foreign-currency accounts). Banks were increasingly prompted by the declining numbers of enterprise clients to approach the population with a broader scale of services. However, this internationally proven strategy is hindered by the fact that introducing residential services calls for significant investments in such areas as building a network of branch offices and developing computer support. (The responsibility for the delayed reaction to these needs is shared by those bank managers who failed to use 1988–90 profits, which were high even by international standards, to finance such investments.)

During the 1990s, multiple steps have been taken to do away with the traditional monopoly on foreign-currency management, and banks have been given more opportunities to conduct trade-related currency transactions. By 1990, more than half of the financial institutions had been authorized to conduct currency transactions tied to external trade (*Állami bankfelügyelet* 1990).

New channels for capital flow appeared in tandem with the loosening of segmentation. While refinancing by the central bank used to “make up for” the commercial banks’ lack of reserves (since they did not have access to household savings), opportunities subsequently opened that gradually reduced the importance of the central bank’s channels. The proportion of refinancing by the central bank shrank to half of the earlier 25 percent level between 1987 and 1992 (Nyers and Lutz 1992a). At the same time, the intrabank money market, which was supplied primarily by financial institutions and insurance companies that accumulated household savings, expanded.

By establishing relatively undemanding standards for obtaining commercial bank status and the right to maintain accounts, banking supervision aided the specialized financial institutions’ expansion into the banking market: seven out of the nine such institutions active in 1987 became commercial banks. The newly established specialized financial institutions were founded by the large commercial banks as branches specializing primarily in investment activities. Competition was made even more intense by foreign and multinational banks entering the market. The twenty financial institutions operating in 1987 have

since quadrupled in number. During the same period, the market share of the four largest commercial banks (which finance a major portion of the enterprise sector) decreased from 58 to about 40 percent, while the share of the midsized banks grew from 5 to 22 percent (residential banks maintained their share of about 35 percent) (Nyers and Lutz 1992b).

Certain unfavorable tendencies can also be observed, however, especially during the past two years. These trends are countering movement toward equalizing power relationships on the banking market and loosening segmentation. Another type of segmentation has begun, one that can be explained more by inherited position and expectations of economic policies than by “pure” competition. Certain “gaps” are developing in banking services, and there are no suitable players on the market to fill them. Due to its overwhelming position on the market, the state assumed a price-determining role on the capital market, thus restricting the other players’ freedom of action.

The new segmentation of the banking market resulted from the imperfect competition between large banks (burdened by the inferior credit portfolios they inherited) and the less encumbered midsized banks (Ábel and Székely 1992). In practice, this meant that midsized banks increased their share in markets containing fewer risks and offering greater profits at the expense of larger institutions, by taking advantage of their greater freedom of activity due to their status as newcomers. These markets were primarily in intrabank transfers and short-term investments in enterprises. Nevertheless, this peculiar market distribution was based on power relations that were distorted in several respects.

While at first it was natural for large banks (which could count on the central bank’s refinancing abilities) to dominate the market of medium- and long-term enterprise investments, this distribution became less and less advantageous for the large banks as the central bank’s resources became exhausted. At the same time, due to the expectations and poor credit decisions of their owners (the state itself or state-owned large enterprises) and later due to stabilization in (what had been) their growing share of credit, large banks had difficulties retreating from this risky and unprofitable sphere of activities. Thus, they found themselves trapped in a segment of the market in which normal banking operations became impossible. (We will deal later with the consequences of proliferating bad debts.)

Another market-distorting factor was the tax preference enjoyed by foreign-owned and multinational banks (i.e., many of the midsized institutions), which, in addition to the more-favorable starting portfolios, meant a significant competitive advantage. In the case of many banks, this was reinforced by the benefit of relatively cheap resources available from foreign mother institutions as well as the favorable investment opportunities offered by the growing number of multinational branches. (It was only natural that enterprises acquired by foreign firms also sought out banking partners that had ties with the banks of their foreign mother firms.)

The imperfect competition between banks is characterized by the fact that

during these years the average profit margin of midsized banks (which were not burdened by the requirement to develop large target reserves and frequently received tax preferences) not only approached that of large banks but in 1991 exceeded it (Ábel and Székely 1992). This reflects the oligopolistic state of Hungary's market and places those requiring banking services into a vulnerable position. Moreover, banks required to develop smaller target reserves have some accumulated resources they can use to initiate a price war in order to win over certain targeted clients or spheres of activities. As of yet, they have not needed to resort to this.

The trends described above also contributed to creating a growing gap in bank services that no banking group desires to fill. There is, for example, the financing of investments, an area into which fewer and fewer banks are willing to enter, due to the high risks associated with the economy's growing uncertainty. Another sphere is the enterprise securities (bonds, shares) market, where commercial banks are not allowed significant freedom of action by the relevant legislation on financial institutions and securities. As a third area, we must mention the market for household banking services, into which few financial institutions have entered, despite the elimination of the previous monopoly situation. The primary reason for this is the high cost of initiating the management of individual bank accounts, since even in developed countries it takes at least 3–5 years to recover the associated costs.

As of now, therefore, a significant increase in the number of players on the market has brought with it neither substantial improvement in banking services nor a reduction in their price. At the same time, more and more financial institutions find themselves facing instability, in part because of liquidity problems and in part because of deteriorating investment portfolios. This also means that improvement in the banking-market situation cannot be expected to come solely from the market's liberalization and the subsequent strengthening of competition.

Finally, we should also mention the market distortion caused by growing state involvement. Because of a chronic and growing budget deficit, the state each year takes a larger share out of savings that flow toward the capital market. By 1992, an unusual situation developed, in which savings exceeded credits extended not only in the household sector (a natural occurrence) but also in the enterprise sector. Among domestic money-holding groups, only the state appears as a net debtor. Although the growing supply of state bonds does not yet constitute a crowding-out factor (since the risks associated with enterprise investments make these risk-free securities attractive to investors), it does mean that the state is virtually alone in determining prices on the money and capital markets.

Ownership Relations

Since state-owned enterprises (which make up much of the property owned by the largest banks) have not been completely privatized, they remain the clients

and owners of the large banks comprising the most sizable segment of the banking sector. The other direct owner, occupying a dominant position at some banks, is the state itself. Looking at the five largest banks, we find that in 1991 the state's share of direct and indirect ownership was 64 and 22 percent, respectively, for a total of 86 percent (*Tőzsde Kurír* 1992).

It is easy enough to realize that in business enterprises, and especially in banking activities, the state cannot be a good owner. Suffice it to say that, in addition to its ownership role, the state (that is, the government representing it) is present in the life of banks in at least two other respects, each of which calls for different business attitudes. As manager of the central budget, it is interested in collecting the greatest possible tax income and distributing the greatest share of this income. This conflict was revealed prior to the banks' shareholder meetings at the end of 1991. At that time, the minister of finance condemned the banks because the latter wanted to satisfy a clause in the law on financial institutions prescribing the development of target reserves, and as a result their tax base became much smaller than what the government's budgetary plans had anticipated.²

The role of the government is to determine general economic policies and to adhere to them. This may also run counter to the requirements of effective banking operations. In general, public opinion holds the banks, and primarily the largest banks, responsible for a decline in investment activities, for the realization of inflationary expectations, and for the money-supply problems of the country's preferred branches and enterprises. In response to pressure from various interest groups, the government itself may tend to hold the banks' high interest rates or their faulty credit policies responsible for these problems.

Past experience and the examination of conflicting interests indicate that the dominance of state ownership tends to hinder rather than assist the business-like operation of banks and efficient capital allocation. This recognition was reflected in the 1991 law on financial institutions, which stipulates that by 1997 the share of indirect and direct state ownership of banks must be reduced to 25 percent. The timing and method of bank privatization were topics of serious economic (and political) debates, however (Asztalos 1990; Bokros 1990; Spéder and Várhegyi 1991). Since the law's creation, state interference with the largest banks' operations has increased rather than decreased, since the state's right to vote as the largest shareholder was increasingly exercised at shareholders' meetings by representatives of the state (previously someone from the State Property Management Agency [ÁVÜ], and starting this year by an agent of State Property Management, Inc. [ÁV Rt.]).

The Deterioration of Bank Portfolios

The other obstacle to the banking system's efficient operation is the large proportion of doubtful outstanding debts among the banks' assets.³ The above-mentioned unfavorable ownership structure is also responsible for the absence of

improvement in bank investments since the beginning of reforms. What is more, because of enterprise liquidation and stricter accounting regulations, the stock of documented outstanding debts has grown exponentially, and by the end of 1992 it amounted to one-fifth of the total credits held by banks. Even though in recent years banks have tried to stop crediting their worst clients, their insufficient reserves interfered with their ability to write off their rapidly growing credit losses, revealed after the cessation of extensions.

Enterprises seeking credit also felt the effects of massive uncollectible debts accumulating at banks. Conditions for obtaining loans were deteriorating due to the banks' dwindling ability to offer credit and to high borrowing rates, which progressively exceeded deposit interest rates. The accumulation of doubtful and bad debts led to the paradoxical situation in which, even though there was a growing gap between interest rates on loans and on deposits, banks have become drastically less, instead of more, profitable in the past two years. A large (at times the entire) portion of profits had to be allocated to loan-loss reserves, to cover doubtful or bad loans. The banks' weak portfolios were reflected in their declining tax-paying ability, which contributed to the national budget's deterioration.

Weak credit portfolios represent a problem for the entire banking sector, which cannot be solved with the banks' own resources. Since banks were allowed to classify loan-loss reserves as costs only after December 1991, these reserves are too small to rid these institutions of their bad debts without significant capital losses. This is why state intervention is necessary: a part of bank reform must aim at freeing the capital market from the ballast that threatens its continuing operation. This realization was reflected in the government's loan consolidation program, which planned to restructure bank balance sheets in two steps.

Initial Steps in the Banking System's Consolidation

Before the 1992 Bank Consolidation

Without restructuring their balance sheets, some of the banks would have ended 1992 with significant losses and reductions in their capital values. In addition to the above-mentioned problems, the need for the state-assisted restructuring of bank balances was also demonstrated by the banks' low capital adequacy level (i.e., the volume of actual capital relative to the risks of investment). After all, a suitable adequacy level is an important prerequisite for the secure operation of banks, and thus the safety of depositors.

Although there was no doubt about the necessity of restructuring, the method of accomplishing this task raised a series of questions concerning economic policy making:

—First, who should bear the cost of the required restructuring? Under normal

conditions, the banks' owners would be responsible for the losses due to bad loan decisions or unforeseen developments (such as the collapse of markets for Hungary's enterprises). In this case, however, other factors had to be considered. One of them is the fact that, between 1988 and 1991 (until laws concerning financial institutions were introduced), the Hungarian state received certain tax revenues from banks that were due more to regulations that did not require the development of loan-loss reserves than to good banking practices. Thus, banks appeared to reap profits (thanks to inappropriate regulations), and about half of these profits enriched the state's coffers in the form of taxes and dividends.

State intervention was further justified by the fact that the state and state-owned enterprises constitute the decisive ownership group at the banks that have accumulated the most bad debts. In addition to its diverse responsibilities, the state may have its own reasons for having bank portfolios restructured, such as the income obtainable through bank privatization or the growing future tax-paying ability of banks.

—A second dilemma was presented by the choice of method for restructuring the banks' balance sheets. The simplest way would have been to raise new capital, which would have provided a sufficient amount to cover investment risks, allowing banks to write off credit losses. However, this called for immediate budgetary expenditures of tens of billions of forints, which under the circumstances was unrealistic. Thus, only those types of solutions were seriously considered that stretched out over time the burdens of the state budget and bank owners. Gradual reductions in the risk associated with bank portfolios and subsequent capital infusions in the course of bank privatization presented one such opportunity.

The first measures aimed at improving bank balance sheets for 1992 by exchanging state securities for bad debts. However, the proposal was modified several times, in accordance with the interests of the national budget, and its final version—proclaimed on 29 December 1992, "refined" by the minister of finance on 8 March 1993, and fixed in a contract with banks on 16 March—resulted in nothing more than a "cosmetic" operation, which deferred in time the bad-credit burden assumed by banks but did not remove it.

Within the loan-consolidation program, banks were allowed to turn over to the state-owned Hungarian Investment and Development, Inc. (MBF Rt.) all their outstanding debts declared uncollectible before October 1992 as well as their claims against firms that had declared bankruptcy by 15 December. In exchange, they received twenty-year state-issued bonds, the interest rates on which were adjusted in accordance with the average rates on 90-day discounted state bonds recorded during the previous six months. On debts classified uncollectible before the end of 1991, banks were reimbursed in this manner for half of the outstanding amount and for 80 percent on subsequent debts.

In the course of the 1992 loan-consolidation program, banks sold 1,885 outstanding debts, involving 102 billion uncollectible forints, to Hungarian

Investment and Development, Inc., in exchange for 52 billion forints' worth of series "A" and 28 billion forints' worth of series "B" state bonds. The interest rate on series "A" bonds for the first six months is 15.9 percent, while that on the series "B" bonds is half of that. (In view of the twenty years required for maturity, interest rates even on the series "A" bonds remain below the market level.)

—Since the program was designed to minimize the burden on the state budget, the Ministry of Finance incorporated into it certain elements that, even in the short run, negate its favorable effect on banks' balance sheets and in the long run place the banks, which were forced to participate in the consolidation, at a distinct disadvantage as compared to their competitors. The primary reasons for this are the following:

—In compensation for delinquent interest and fee payments (which made up about a third of the claims), the banks received series "B" state bonds, producing about half as much interest as discounted treasury notes. This means that some of the uncollectible debts on the banks' balance sheets were replaced by demands against the state, at about half the nominal amount.

—Another problem was the consolidation fee banks were required to pay. If the banks must pay out about half of their interest earnings on the state bonds for the next twenty years (as a sort of auxiliary tax), then their future earnings will be severely reduced. This will reduce the likelihood of realizing one of the goals proclaimed for restructuring the banks' balance sheets—making the banks more attractive for investors in the course of future privatization. To be sure, the new owners will find that Hungary's banks have less risky portfolios, but will they be willing to purchase bank shares with earning prospects even worse than they are now? Also, having been forced to take on the burden of paying for consolidation, banks (especially the large commercial banks that have long been financing the enterprise sector) will for some time remain at a disadvantage in competition with financial institutions operating in other segments of the banking market or with those that enter the field later.

—Yet another problem for the long run is that the consolidation of 1992 did not cover bad investments made by the banks. Even though current Hungarian regulations do not compel banks to develop reserves to cover their investment risks, international bank audits and classifications take such risks into consideration. This is one reason, among others, why the international image of Hungary's banks is significantly worse than their balance sheets would indicate. In addition to causing serious losses in the course of privatizing the banks, it will also play a role in evaluating their credit standing. The charge leveled by the international press at the two large Hungarian banks involving "technical insolvency" can be "denied" by citing domestic regulation only if these banks do not have to obtain their resources from international financial markets.

In spite of these problems, the loan consolidation significantly improved banks' 1992 balance sheets. As a result of the bond exchanges in the consolidation,

the ratio between actual and prescribed loan-loss reserves (the banks' level of developing reserves) improved by several percentage points. The loan consolidation significantly contributed to the growth of reserve capital in the 1992 balance sheets, and this, combined with a moderation of losses, raised the capital adequacy indicators. At most banks, however, the favorable effects soon lost their force. Bad debt accumulated rapidly, and already in the first six months of 1993 the requirements for developing loan-loss reserves were so extensive that only a consolidation similar to last year's could prevent the situation from deteriorating below the level of late 1992. Thus, the volume of reserve capital and capital adequacy indicators will once again drop at some banks, even after interest earnings on the consolidation bonds are taken into consideration.

We can observe, therefore, that while the 1992 loan consolidation program did indeed improve the banks' 1992 balance sheets, it solved practically none of their long-range problems. One can already see that bad loans are reappearing quickly, since the roots of the problem have not been addressed either in the enterprise sector or in the banking sphere. Due to the proliferation of bad loans, not only is it impossible to achieve capital adequacy (prescribed by the law on financial institutions), but the shortage of reserve capital grows daily.

As one important element of the program, banks had to pay annual fees in compensation for the interest on state bonds exchanged for their bad debts. However, this "solution" (which was intended to minimize the burden on the state budget) caused accounting complications that were difficult to handle or that required special interpretation and reduced the chances for realizing the program's other original goal of promoting the banks' privatization.

Soon after its introduction, the international auditors dealing with Hungary's banks ("the Six") called the Budapest government's attention to the program's accounting problems (*Bank & Tőzsde* 1993). Thus, the government may have realized that the consolidation program would not make Hungary's banks more attractive to international investors. In light of these problems, efforts were made to revise the program, in order to "soften up" the originally proposed conditions.

This softening up had two significant elements. First, the consolidation fee was eliminated, freeing the banks of a future "auxiliary tax." Second, the state bonds bearing low interest rates are being exchanged for "A"-series certificates, which were issued with more favorable conditions. In any event, a revision of the original conditions will improve the banks' situation. At the same time, the government's hesitation on this issue contributes to the uncertainty surrounding the banking system's consolidation and development. This has a negative impact on bank management and potential investors alike. The dragged-out consolidation process, combined with the government's lack of a well-defined conception, makes the management of the banks involved interested less in effective operation than in improving their bargaining position *vis-à-vis* the government. The government's hesitation creates an unpredictable situation for investors who

might be interested in these banks, since it is difficult or impossible to calculate the advantages and disadvantages associated with the possible acquisition of these banks in these conditions. It is therefore important to develop and proclaim a decisive government program for the banking system's stabilization and the transformation of its ownership structure.

Further Measures Planned in the Loan-Consolidation Process

The next chapter in loan consolidation will entail handling the bad debts sold to MBF Rt., the restructuring of the affected enterprises, and the transformation, rescheduling, and perhaps forgiveness of enterprise debts. The organizational and technical means required are still unknown, as is the source of necessary state funds. In principle, before the end of June 1993 banks may sign management agreements in order to collect on claims that ended up in the consolidation fund, but the partnership conditions for this are not yet developed. The most promising solution would have the banks, as those most familiar with the debtor enterprises, become involved in enterprise restructuring at their own risk. However, even if the banks would consider this a worthwhile notion, the strictly limited investment possibilities laid out in the law on financial institutions do not permit this. As it is now, the participation of capital-rich market organizations (which are interested in getting debtor enterprises on their feet) is lacking, and, in view of the generally poor state of Hungary's economy, such participation is unlikely to materialize. It is the state that must therefore shoulder the burden of uncollectible debts.

The third chapter in the loan consolidation story could involve the handling of bad portfolios remaining on the banks' balance sheets after the 1992 program. Since the recurring waves of bankruptcies and liquidations put additional bank loans into riskier categories, this process will rapidly undermine (at some of the large banks it has already undermined) any improvement in the riskiness of bank portfolios. This is why a new effort toward loan consolidation is needed. However, this must be the last such effort undertaken by the government, since any chance to strengthen the banks' credit responsibility would disappear.

Based on proposals made by experts of the international financial institutions, the government is considering handling the problem of bad portfolios by providing banks with capital. At the root of this solution is the view that the relative lack of reserve capital in banks (relative to their risks) represents the fundamental problem. Thus, the state would extend an injection of capital to the banks, with the aid of which their capital-adequacy level would reach 3 percent. (This is less than half the 8 percent level prescribed by the presently valid law on financial institutions and by the guiding principles issued by the EC.)

This proposed solution would require a capital injection amounting to tens of billions of forints, even if the consolidation involved only debts associated with

loans and not bank investments and guarantees. (Inclusion of the latter two could increase the amount of capital needed to one-and-a-half to two times the above figure, possibly exceeding 100 billion forints.) Since the current budget could not bear such a burden, providing the banks with capital could be handled with the aid of state-issued (loan-consolidation) bonds. During 1993 this would call for no budgetary expenditures. Starting in 1994, however, the burden of interest payments would be borne by the state budget. (Combined with interest payments on the 1992 consolidation bonds, the entire burden could amount to 15–25 billion forints a year.)

In contrast with the 1992 scheme, the burden of the planned loan consolidation must be borne by all the banks' owners. The value of the banks' shares will be reduced by a part or all of the credit losses. This would also mean that the state's direct ownership share would grow in every one of the banks, and in some of the banks (such as MHB or OKHB), it would approach 100 percent.

In the course of implementing the 1993 loan consolidation, bad debts (and bad investments) would remain in the banks' portfolios. Thus, the banks would be induced to handle these claims or sell them to the appropriate market institutions (such as their own branches).

Conditions and Methods for the Banking System's Long-term Consolidation

In principle, the 1993 loan consolidation now being developed in government circles could be a suitable initial step in devising a lasting solution to the problem. However, this can happen only if the government takes further steps in this direction. After all, supplying banks with enough capital is a necessary condition for the lasting consolidation of the banking system, it is not a sufficient condition. In order to stabilize Hungary's banking system, the following additional conditions must be created:

- (1) banks must be made to operate more efficiently by changing their ownership background;
- (2) competitive conditions must be created, under which the banks that finance a decisive segment of the Hungarian economy are not at a disadvantage compared to financial institutions that do not play this role;
- (3) greater opportunities must be provided for the larger commercial banks to participate in enterprise restructuring; and
- (4) a regulatory and institutional atmosphere must be created in which the risks associated with credit investments by banks are reduced.

Changes in the Ownership Background

Today the large banks, which finance most of the enterprise sector, are directly dependent on the government. This dependence distorts the operation of banks

even if persons representing the government (e.g., the ÁV Rt. representatives at the banks' shareholders' meetings, or the individuals elected to the board of directors at the government's behest) do not express this directly, that is, if these posts are occupied by experts and not politicians. At the largest banks' shareholders' meetings, the delegate of State Property Management, Inc. already has most of the votes because, in the interest of centralizing property rights, votes of enterprise owners at such meetings have recently been transferred to representatives of the state. In a loan consolidation realized through state capital allocation, the government will have an even greater ownership presence in the banks' management.

Since the very existence of the banks' top leadership is linked to the owner with the majority of voting rights (in this case the government, which represents the state)—after all, presidents and chairpersons of the board of directors, as well as the members of the board and of supervisory committees, are dismissed and nominated in accordance with this owner's proposals—bank management is strongly dependent on the government in office. Thus, bank managers' "success indicator" is not linked directly to the efficiency of banking operations but may be influenced by other factors. While bank managers may therefore be greatly influenced by the expectations expressed (generally indirectly) in the government's economic policies, the government could also exercise its influence directly. (Among indirect expectations we may list extending financing to certain branches or enterprise groups that may be considered risky by the banks, or unjustified reductions in interest rates.)

Initiating the privatization of large banks is the only way out of this situation. Since we are now witnessing a diametrically opposed process—after all, with the acquisition of shares belonging to formerly state-owned enterprises and the raising of capital, the state share of ownership in the banking sector is increasing—a substantial transformation of the ownership structure requires investors with lots of capital. Moreover, even the 1993 loan consolidation (state-sponsored capital injection) will not be able to remedy the capital-structure weaknesses of banks. In view of these realities, it is likely that restructuring the banks' balance sheets and developing a new ownership structure can only be accomplished in a parallel manner. The state of the national budget does not allow us to delay bank privatization until after the portfolios have been completely restructured. This is why it is important to find, as soon as possible, those external investors (primarily foreigners) who would be willing to participate actively in improving the banks they would purchase, not only by taking over the existing shares but also by raising a significant amount of new capital. It appears that Hungary's present government does not intend to part with the bank shares it owns; rather, it is looking for investors who are willing to hold minority ownership positions in the banks.

In today's circumstances, therefore, there are two preconditions for any substantial modification of the banks' ownership background:

—owners must be found who are willing to accept, at least for a while, the Hungarian state's decisive position in the affairs of banks;

—owners must be found who are willing to realize their long-range interests and make sacrifices (e.g., forgo their dividends for a few years) in order to improve the banks' balance sheets.

Owners meeting the first condition could be investors who would be willing to give up the right to participate in the banks' management in the hope of suitable dividends and/or profits from changing exchange rates. In principle, such investors come from the household sector, or from investment funds and insurance companies, which accumulate long-term household savings. In the absence of confidence in shares and because these institutions have meager capital strength, investors of this type could not play a decisive role in the acquisition of banks or could do so only if bank shares were sold at very low prices.

Owners meeting the second condition could be professional (strategic) investors, primarily foreign financial institutions that see the possibilities offered by the banking markets of Hungary and Eastern Europe. Since these investors purchase not "banks" but markets, they are likely to reserve the right to have a say in the banks' management. Thus, they would not meet the requirements of the first condition.

In our view, the solution is for the government to surrender its dominant ownership position in the large banks in order to make room for professional investors who would meet the required conditions (i.e., raise capital for several years, keep dividends down, and maintain the number of branch offices).

Modifying the Conditions of Competition

Under the conditions presently prevailing on the banking market, the large banks that finance the industrial sector are condemned to wither away since they are unable to compete with financial institutions involved in less risky investments, above all the multinational banks, which enjoy other advantages (e.g., tax privileges, cheaper foreign resources) as well. This uneven competition is also apparent in the relationship between banks newly entering the market and those that are already operating, since the new banks are free to develop their own clientele and operating specialization.

If, as a result of day-to-day pressures, the large banks now in existence reduce their contacts with enterprises, then the enterprise sector, which is already struggling with financing problems, will have an even more difficult time adjusting to market conditions. As financing channels became blocked, even those enterprises with promising outlooks would be forced to introduce production and employment cutbacks. It is worth considering, therefore, whether the ensuing social damage could be limited by governmental action to improve market conditions for the banks that finance the enterprise sector. There are two ways to accomplish this:

—First, the conditions of competition that exist in the banking system could be modified to eliminate unreasonable advantages. This would mean primarily the ending of privileges for multinational banks, including the termination of tax concessions, and a more thoughtful distribution of profitable government-initiated deals among banks. More equitable competition would also be promoted if interest-rate ceilings on deposits and loans were temporarily reestablished. (It is no accident that, as late as the 1980s, even some developed market economies used these means of interest-rate regulation.)

—Second, a strict temporary regulatory system could be introduced. This could involve tightening conditions for establishing new banks (e.g., prescribing the opening of branch offices and a certain number of accounts). Stricter rules for starting banks would reduce the number of participants who provide banking services only in the most profitable segments of the market. Raising the barriers to entering the Hungarian banking market would also guide investors who see medium-term opportunities in the Hungarian banking sector toward acquiring shares in existing Hungarian banks, thus promoting the raising of needed capital as well as privatization. (Numerous examples exist abroad for guiding foreign investors in this way. Especially noteworthy is the Spanish experience, where entry of foreign banks was tied to the purchase of shares in ailing Spanish banks.)

Even though temporary restrictions on competition in the banking market would amount to a reversal of the present very liberal trend, they would still cause less disruption than the bank- and enterprise-specific interventions that preventing the complete collapse of Hungary's economy would necessitate. Modifying regulatory conditions would create a predictable environment for the market's present and future participants. We could avoid hasty emergency measures leading to vulnerable dependence on government organs that preserve the banks' operational distortions. Strengthening regulation in the banking sector would simply reflect the fact that the Hungarian economy is still not in the same condition as the developed market economies were in the 1980s and 1990s.

Bank Participation in Enterprise Restructuring

Likewise, this conclusion would be consistent with the modification of bank regulation in order to promote the development of German-type universal banks. Today, Hungary's economy is encountering problems of transition similar to those experienced by postwar Germany. Due to the absence or weakness of financial institutions capable of participating in enterprise restructuring (e.g., investment banks and associations, a stock exchange, investment funds), it is logical that this role should be taken on by the banks that have traditionally financed the enterprises in need of restructuring.

Present laws on financial institutions strictly limit commercial bank investments

in enterprises and prevent banks from transforming much of their outstanding debt into enterprise shares. Enterprises are thus deprived of an opportunity to develop under improved financial circumstances. At the same time, the law on securities also prevents banks from participating directly in securities transactions. This would also be one of the preconditions for universal banking activities.

A basic characteristic of universal banking is that the bank managing a firm's account does not merely extend credit, it also assists the firm in acquiring market capital. In addition to underwriting the enterprise's shares on the stock exchange, the bank also supervises the enterprise, primarily through exercising the voting rights associated with shares the bank manages, as well as through additional purchases of shares.

German banks' ownership participation in enterprises did not always mean that the banks owned most of the shares. Banks often tried to diversify their shares, and at times they tried to retain shares for as brief a time as possible. However, if certain shares remained in their possession due to difficulties on the market, the banks took advantage of opportunities to manage the firms' affairs actively. In addition to the shares they owned outright, the banks' opportunities for control were broadened by the shares deposited with them (as "investment banks") and by the voting rights associated with these shares.

Many enterprises today have a shortage of capital, which makes them less than creditworthy. If the easing of investment rules were to go hand in hand with the banks' recapitalization, some of the enterprises could be restructured with the assistance of banks. Such a solution would not burden the state budget any more than other methods (such as writing off debts by the state, or directly supplying capital). At the same time, chances for success would be increased by the fact that these restructurings would be managed by those market participants that are most familiar with the enterprises in question. And granting banks access to the stock market would also promote enterprise capitalization.

Since joining the EC will last a decade, it would be easy enough for our parliament to modify Hungary's EC-oriented laws on financial institutions in the spirit of earlier German and Austrian laws. This would not prevent the simultaneous development of financial institutions that would consider enterprise investments and reorganization to be good business.

Reducing the Risks for Commercial Banks

Commercial banks are by nature not oriented toward promoting the birth of new enterprises by supplying credits. No matter what course this year's loan consolidation will take, the high level of already-existing risks means that interest rates on bank loans will be significantly higher than interest rates on deposits, since this margin will have to cover the cost of developing the necessary loan-loss reserves. This means that even enterprises with a proud

history and a promising future will have difficulty obtaining credit if banks follow responsible loan policies (with their depositors and owners). Start-up enterprises, lacking sufficient credit guarantees and a business track record, will appear so risky to commercial banks that they will be able to obtain loans only at very high rates. Such high interest rates will scare off the solid, reliable firms, while contributing to the proliferation of genuinely risky borrowers among the banks' clientele.

Thus, the stabilization of banks and the financial strengthening of new firms both call for the creation of new institutions that are able to shoulder much of the risk and simultaneously make long-term undertakings creditworthy. Due to a variety of factors, risks in the Hungarian economy are above average. Consequently, neither domestic nor foreign investors are likely to assume the role described above. This means that only the state can create those venture-capital corporations and guaranteeing institutions that could fulfill the above tasks, at least until the general risk level is reduced.

Notes

1. According to reports issued by the Ministry of Finance, 2,600 enterprises initiated bankruptcy proceedings in 1992, representing 8 percent of GDP and 11 percent of the employed labor force. The number of enterprises ending in bankruptcy exceeded 3,700, representing 18 percent of GDP and 22 percent of the employed. At the end of 1992, there were almost 2,000 firms under bankruptcy proceedings and 1,400 in the process of closing.

2. As shown in 1990 balance sheets, the communal taxes and dividends of financial institutions amounted to 44.5 billion forints, which represented 6 percent of the annual budget. The outcome of 1991 balance sheets, before taxes, came out to be one-third of that of the previous year, primarily because of the increased loan-loss reserves. As a result, payments by financial institutions to the budget amounted to only 1.7 billion forints in 1992.

3. There are several essays dealing with the problem of bad debts and the opportunities for cleaning up the banks' balance sheets. See, for example, Ábel and Bonin 1992, Begg and Portes 1992, Nyers and Lutz 1992b, Székely 1992, and Várhegyi 1993.

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