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BANK RESTRUCTURING IN HUNGARY

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In this study the authors describe the process of bank restructuring in Hungary. They argue that the "desertion" of the state exacerbated the financial distress of the enterprise and financial sectors. Moreover, the delayed responses of the government were inadequate in many respects. The recapitalization of the banking sector was rather costly, partly because the occurrence of moral hazards were not prevented. Nonetheless, some positive signs can also be seen. The respective portfolios of banks improved significantly and this made the privatization of state-owned commercial banks possible. In fact, the sale of these financial institutions was completed in 1997. The controlling-stakes of privatised banks have mainly been obtained by strategic investors and therefore the state no longer has direct control over credit allocation in the Hungarian economy. All these factors suggest that Hungary is, so far, the most successful in transforming the banking sector in the Central European economies. Eventually, this may help the development of the economy as a whole.

This study reviews the development of the Hungarian banking sector since the late 1980s.[1] The process has not been at all smooth and steady. The political decision to reform the banking sector was taken under the auspices of the old regime in 1983. However, the transition was completed in 1997, with the privatisation of all large state-owned commercial banks (SOCB). Privatisation of the former SOCBs was nowhere on the agenda of the socialist government in the 1980s. Since then private banks have become dominant and a significant part of the Hungarian credit market is now controlled by foreign banks. Here we will focus on the restructuring of state banks; this process has resulted in an almost fully-fledged private commercial banking sector, the first in Central Europe. We will sketch the development of the banking sector before 1992, discussing the evolution of the bad debt problem, and the various policy measures Hungarian governments have taken in order to stabilise domestic banks. We will also try to show the alternatives policymakers had to choose from. Although the process has been long and expensive, the respective portfolios of the SOCBs have been cleaned. We will argue that this development was more or less determined by the liberalisation of the entry of foreign banks in 1989 and by the adoption of the Banking Act in December 1991. As a result of this process, many SOCBs were privatised. The controlling stakes of privatised banks

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have been obtained mainly by strategic investors and therefore the state no longer has any direct control over credit allocation in the Hungarian economy. All these facts suggest that Hungary has, so far, been the most successful among the Central European economies in transforming the banking sector, and this should eventually help in developing the economy as a whole.

Reforming the Hungarian banking sector, 1987–1991

In 1987, following a political decision, a two-tier banking system was artificially created by decrees. The credit departments of the National Bank of Hungary (NBH) were split into three, creating the respective foundations of the three large commercial banks. Gradually the central bank withdrew from the direct financing of enterprises.[2] The primary goal of the reform was to create a competitive environment for credit allocation (free from state intervention), and to establish a proper structure for effective monetary policy. This early phase of transformation was reviewed in *Estrin et. al.* (1992), *Spéder* (1991) and *Spéder and Várhegyi* (1992); *Nyers and Lutz* (1992) provides good source of data.

The newly-established commercial banks—the Hungarian Credit Bank (MHB), the National Commercial and Credit Bank (K&H) and the Budapest Bank (BB)—inherited their portfolios and clientele from the central bank. The equity base of these banks was inadequate at the time when they were formed. In the early 1990s a significant part of their loan portfolios became non-performing as a consequence of the economic recession. The problem was exacerbated by the weaknesses of the management and staff, who were unable to secure prudent operation, properly evaluate new loan applications, make correct risk assessment, or conduct other evaluations. Moreover, banking regulation was poorly designed and effective supervision did not exist. This latter fact made banks vulnerable to political interventions.

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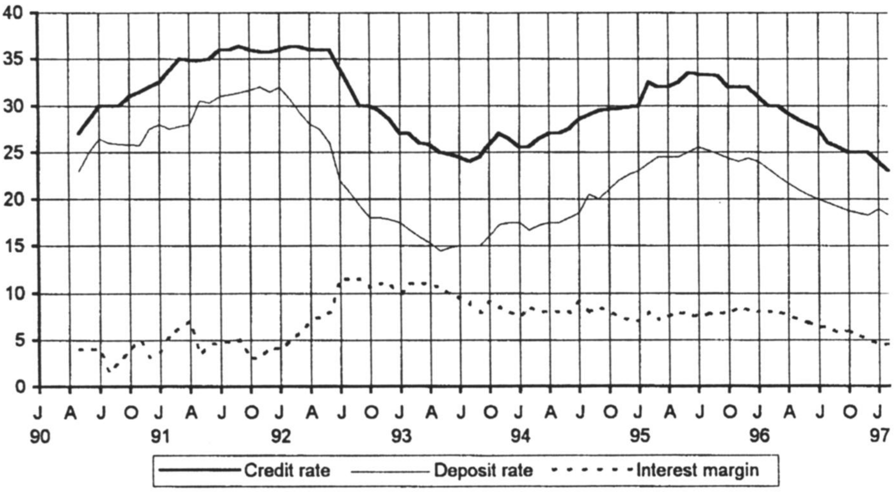
[2] However, indirect control through central bank refinancing temporarily played an important role in the short-term borrowing of enterprises and is still significant in long-term financing. At the beginning of 1987 the gap between the assets, equity and deposit stocks of the newly created SOCBs was entirely filled up with refinancing credits of the NBH. This stock amounted to 70 percent of the total liabilities of the large banks. Due to an increase in their deposits, equity, and the development of interbank money market, banks became more independent from central bank refinancing. However, in 1990 these sources still accounted for 15 percent of the banking sector's total liabilities.

How did banks accumulate bad loans?

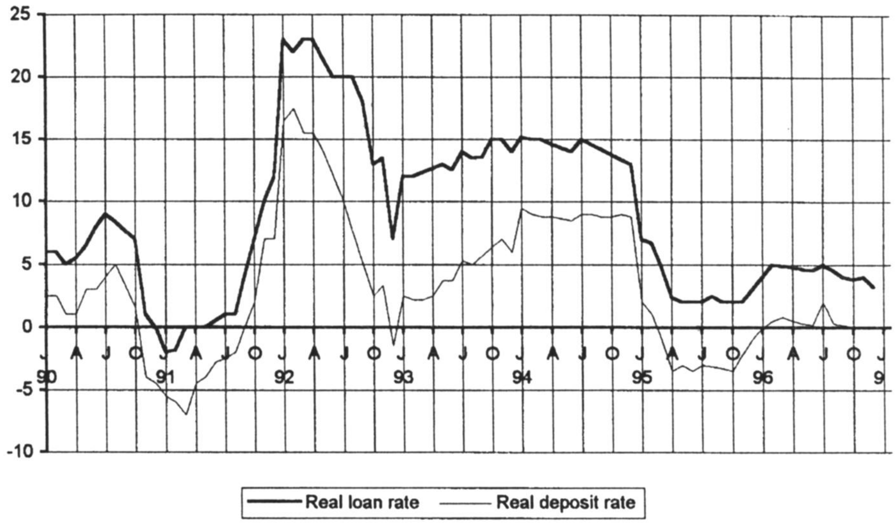
Bad debts include those inherited from the past and, in cases in which the whole issue is a stock problem, those generated by the banks themselves (which is a flow problem). These two cases of debt can, and probably must, be treated differently (see *Bonin and Schaffer* 1995). Hungarian SOCBs both inherited and produced bad loans. For this reason accurate and well-designed state intervention would have been necessary in order to solve the stock problem, in line with comprehensive changes in the regulatory framework, in order to curb the flow problem. In practice, however, precisely the opposite happened. First, the state deserted the economy (type 1 "desertion of the state") and then it also drew back from running the market infrastructure (type 2 "desertion of the state"). (For more details see *Ábel and Bonin* 1994.) This study is concerned with the second type of *state desertion*, which has proved to be rather costly for the Hungarian taxpayers.



Source: National Bank of Hungary

Fig. 1 Nominal interest rates and the interest margin (percent)

The switch to a two-tier banking system took place at that time when the economy fell into recession and inflation started to increase. (See *Figures 1* and *2*.) This development had a significant impact on both sides of the credit market. On the *supply side* long-term financing became riskier because of increasing inflationary uncertainty (making rational calculation for the longer term more difficult). As a consequence of all these facts, banks stopped extending more investment credits.



Source: National Bank of Hungary

Fig. 2 Short term real interest rates (percent)

The demand for loans by first-rate clients also decreased. Although the demand by small businesses continuously increased as a consequence of the growing number of small private ventures, this could not counterbalance the decreasing demand of creditworthy clients. (*Table 1* shows the changes in some aggregates of the Hungarian economy and the banking sector. See also *Figure 3*.) Lending to completely new businesses was also rather risky. Although to some extent both demand and supply were simultaneously constrained, the two effects could not cancel each other out. The situation got worse because good, creditworthy firms switched to equity and bond financing instead of taking expensive bank loans, while big loss-making state-owned enterprises (SOEs)—which were struggling with heavy liquidity problems and with no other alternatives—wanted to maintain their borrowing, and were thus dependent on bank lending. The short term credit supply did not meet the demands of financially distressed SOEs and, as a consequence, interfirm commercial credits started to evolve as enterprises stopped paying each other.

Firms in financial distress responded to the shortage of bank credits by forcing their suppliers to provide commercial credit and by delaying payments. The bulk of the arrears was concentrated in about 25–30 enterprises in engineering and light industry, mining and metallurgy respectively. However, this phenomenon became a feature of the whole economy. By the end of 1989 these arrears amounted to about

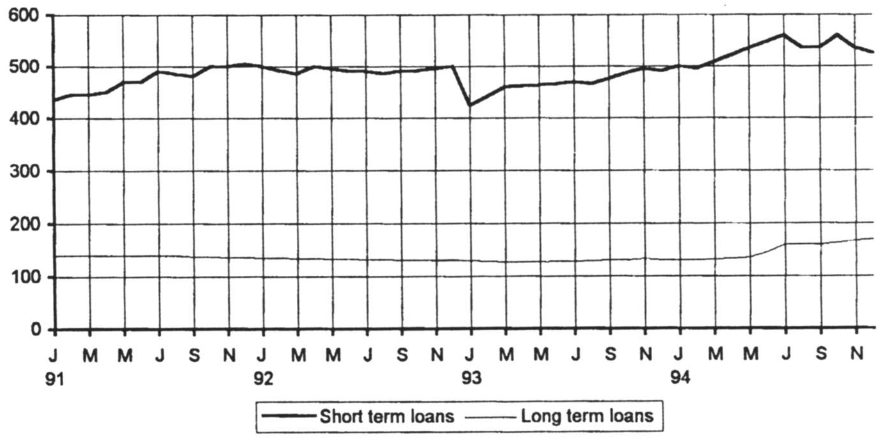
Table 1

Selective aggregates of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Nominal GDP (bn HUF)	1,226.4	1,440.7	1,722.8	2,089.3	2,498.3	2,942.6	3,548.3	4,364.8	5,499.9	6627.95
Nominal GDP (bn USD)	26.104	28.571	29.152	33.059	33.434	37.257	38.551	41.518	43.758	43.442
Nominal growth rate (HUF)	12.63	11.7	19.58	21.27	19.57	17.78	20.58	23.01	26.60	20.5
Real growth rate (percent)	4.1	−0.1	0.7	−3.5	−11.9	−3.1	−0.6	2.9	1.5	1.0
Total assets of banking sector	996.3	1,023.0	1,247.3	1,620.5	2,108.7	2,276.0	2,630.4	3,071.8	3,693.6	4,735.28
Total domestic credits (stock)	1,262.7	1,334.4	1,550.9	1,726.4	1,864.5	2,057.3	2,401.7	2,792.0	2,741.3	3010.2
Business sector	383.0	395.8	492.6	636.1	765.3	768.0	761.9	869.7	982.6	1,265.2
Business sector HUF credits	n.a.	395.8	481.3	608.3	718.0	706.2	696.3	777.1	764.8	914.4
Enterprise HUF credits	n.a.	382.8	462.6	564.3	656.6	630.0	610.6	687.9	693.7	852.0
Short-term	n.a.	254.7	327.7	418.1	509.6	484.9	475.7	520.2	n.a.	n.a.
Long-term	n.a.	128.1	134.9	146.2	147.0	145.1	134.9	167.7	n.a.	n.a.
Small entrepreneurs	6.9	13.0	18.7	44.0	61.4	76.2	85.7	89.2	71.1	62.4
Forex credits	–	–	11.3	27.8	47.3	61.8	65.6	92.6	217.8	350.8
Government	589.6	629.7	726.6	737.2	872.3	1,060.9	1,370.8	1,579.4	1,442.9	1447
Total deposits	420.2	455.9	707.7	914.3	1,183.0	1,505.8	1,758.7	1,994.9	2,355.6	2,846.3
Business (enterprise) sector	158.9	138.7	179.9	277.7	324.5	395.5	499.7	518.3	616.5	759.0
Forint	158.9	138.7	166.2	228.2	258.6	332.3	374.7	406.2	427.8	554.6
Forex	–	–	13.7	49.5	65.9	63.2	125.0	112.1	188.7	204.4
Small entrepreneurs	n.a.	20.5	23.9	36.6	57.5	61.8	33.2	32.0	34.4	47.3
Households	261.3	284.2	273.4	323.8	432.0	582.4	696.0	866.4	1,079.0	1,339.1
Enterprise HUF credits-deposits	n.a.	244.1	296.4	336.1	398.0	297.7	235.9	281.7	265.9	297.4
Business sector net liabilities to banks	n.a.	n.a.	288.8	321.8	383.3	310.7	229.0	319.4	331.8	458.9
Average exchange rate (HUF/USD)	46.98	50.424	59.096	63.198	74.722	78.98	92.04	105.13	125.69	152.57

Sources: National account 1991–94, Annual reports of the National Bank of Hungary, and Nyers and Lutz (1992)

HUF 127 bn (USD 2.1 bn), of which HUF 73 bn (USD 1.2 bn) was the accumulated debt of firms having arrears over HUF 25 mn. As a consequence of the deterioration of financial discipline, the value of inter-enterprise arrears simply increased further (see *Table 2*). Most of these firms also had bank debts. Therefore, some people expected the active participation of banks in the solution. However, the banks were rather passive for several reasons: (1) approximately one-third of the total amount of arrears was owed to banks, i.e. the major part of the debt was due to suppliers and state creditors; (2) banks had direct access to the accounts of their debtors and could automatically debit the accounts of their debtors, even without the consent of firms, if a positive balance appeared on them. Banks usually demanded such a creditor seniority when enterprises opened an account with them. (3) If banks tried to collect these debts, even the failure of collecting this one-third could have a detrimental impact on their own existence.



Source: National Bank of Hungary

Fig. 3 Corporate loans between 1991–95 (in bn HUF)

Nonetheless, where it was possible, banks sought to withdraw credits from less creditworthy enterprises. However, in the case of big debtors this would have immediately pushed them into the red. SOCBs were not interested in filing their big debtors for liquidation for several reasons: first, banks usually had access to their clients' accounts; second, due to the extended nature of indebtedness, a chain of liquidation would have devalued enterprise assets significantly and therefore banks could have lost even more; third, it is probable that in the latter case banks would have been the next in line to face liquidation; fourth, banks could rationally expect some kind of state intervention, since the failure of big SOEs in the short run had

Table 2
Arrears of larger firms between 1987–1992

	Arrears (HUF bn)	Firms
1987	14	82
1988	46	208
1989	73	314
1990	90	432
1991	159	1021
1992 April	197	1,097

Source: *Marsi and Pap* (1993)

huge economic and social cost implications, it was therefore more convenient to wait for the state to take the first step; fifth, in the short-run it was also more profitable, because of the existing accounting and banking regulation which enabled banks to earn interest income on overdue credits which they usually rolled over; sixth, if banks filed for the liquidation of their debtors, they would have acted against some of those SOEs which were the owners of banks and whose CEOs were members of the boards of SOCBs. (See *Table 3*.)

Table 3
Files for bankruptcy and liquidation

Year	Bankruptcy	Liquidation	
		Total	of which filed by banks
1987	–	65	
1988	–	144	
1989	–	384	
1990	–	630	20
1991	–	1,268	9
1992	4,169	9,891	93
1993	987	7,242	159
1994	189	5,711	113
1995	145	6,316	112
1996	80	7,397	113

Source: Ministry of Finance

Banks were also dependent on their borrowers because of the decreasing demand for loans by creditworthy borrowers, and because of the fact that they could charge default interest on top of their prime rate in cases of late payment. Accumulated bank claims in the form of default interest provided a better tool with which it was possible to capture the collateral. This was a better situation than the possible liquidation would have offered, when accumulation of unpaid interest stopped in the early stages of liquidation. Banks could not, and perhaps did not want to, stop financing large SOEs.[3] The old truth stated by *Dewatripont and Tirole* (1994) applied particularly to large Hungarian SOCBs: "If you owe the bank $100,000 you are in trouble; if you owe the bank $10 billion, the bank is in trouble." In the short run, banks were more or less interested in preserving the status quo.

As a result of the passivity of creditors, bad debts accumulated and were concentrated in domestic banks, but especially in large SOCBs. (On creditor passivity see *Mitchell* 1993.) In 1990, less than one percent of the number of clients held 40–50 percent of all credits; large loans had about a 50–80 percent share in the loan portfolios of large banks. Approximately two-thirds of bad (or potentially non-performing) loans were concentrated in about fifty large firms. The concentration of debts did not change significantly, even after enterprises were allowed to change bank. The financial distress of firms generated risk not only to creditor banks, but also to the entire banking sector and ultimately to the whole economy.

However, another legacy of the past was the sectoral concentration of banks' clientele. The three large SOCBs (MHB, K&H and BB) were formed from the, respectively, industrial, food processing and infrastructure financing directorates of the central bank. Instead of establishing these banks with diversified portfolios, they inherited portfolios and clients almost unchanged from the NBH. The MHB had about a 60 percent share in the financing of manufacturing (engineering) industry. The food industry and agriculture had almost a 50 percent share in the K&H credit portfolio. BB financed almost exclusively coal mines. These banks were very vulnerable to systemic risks stemming from economic recession or natural catastrophe, in principle as well as in reality. Because of stagnation and the recession between 1989 and 1992 (and the collapse of COMECON in 1991) all banks, but especially the MHB, found themselves in trouble. The drought in 1990 and the uncertainty created by political debates over land ownership in the early 1990s caused difficulties for the K&H. The unavoidable closing down of inefficient coal-mines made the BB's situation untenable. (Extension of syndicated loans could have helped to some extent, but they were rather exceptional because there was no other bank willing to share such a risk.)

[3] *Perotti* (1993) develops a model in which he shows a certain bias towards excessive allocations of scarce bank resources to (indebted) SOEs instead of more profitable private borrowers. This had the effect on slowing down the transition and produced the danger of a potential concentration of risk in banks, even after bank privatization. This finding may apply to these big SOEs. However, as Bonin and Schaffer (1995) indicate, on the basis of aggregate calculations showing that fresh credit was negative in 1992, in most cases banks tried to withdraw from lending to risky firms. Moreover, private firms, as has been pointed out, were at least as risky as their state-owned counterparts.

In part because of this heavy concentration, the Hungarian money market remained rather segmented.[4] In 1990, the "big four" granted 62 percent of short term, and 82 percent of long-term enterprise loans; the National Savings Bank (OTP) had a 65 percent share of the total stock of small private business loans (70 percent of long term and 38 percent of short term loans), while the "big four" had a 29 percent share of this market segment (46 percent in short term loans and 16.7 percent in long term loans); the "big four" and OTP had a 44–44 percent share in the deposit market. However, a majority of wholesale deposits was placed with the "big four", while 80 percent of household savings were deposited with the OTP (Spéder and Várhegyi 1992).

The entry of foreign banks has preserved this segmentation. (*Table 4* provides a summary of the institutional development in the banking sector over the last decade.) Foreign banks sought to avoid risky lending. They provided services for foreign firms and joint ventures, and competed for only the best domestic firms. The competition for creditworthy firms put pressure on domestic banks.[5] SOCBs could not compete with foreign banks, for the portfolio of the latter was not burdened with bad debts, they had access to the cheap foreign sources of their parent banks, and enjoyed some tax concessions. However, this was not price competition because, instead, foreign banks offered better quality services. Due to this market imperfection, the high interest margin has remained and, as a result, foreign banks could earn huge profits.

[4] Nonetheless, some development took place. In 1987, out of 21 financial institutions, only five large commercial banks were authorized to keep the accounts of business entities. Except for the Hungarian Foreign Trade Bank (MKB), which was established in 1950 and specialized in financing foreign trade, and three other banks operating with foreign participation, domestic banks were not allowed to transact in foreign exchange and nor could they collect household deposits. The OTP and saving cooperatives had an exclusive licence in retail banking (i.e. financing of households, small entrepreneurs and municipalities). These restrictions were gradually abolished. After July 1989 commercial banks were authorised to extend credits in foreign exchange to domestic firms out of their own foreign currency deposits at their own risk. In the first quarter of 1990, certain banks received a licence to carry out trade related transactions for their clients as well as international services and transactions when the money was transferred from their clients' forex accounts. (In March 1989, related to the gradual liberalisation of convertible imports, a limited foreign exchange market was opened. The central bank made foreign exchange available to economic entities, or private persons authorized to trade in convertible currency.) In the middle of 1988 the Post Bank and Savings Bank Corporation Ltd. (Postabank) was established in order to break the monopoly position of OTP in retail banking. Since January 1989 other commercial banks have also been authorized to provide services for households. At the same time the OTP and Postabank received a full licence for commercial banking. (In order to enable banks to pay the market rate of interest on household deposits, the interest rate on housing loans was adjusted to the market rate from the beginning of 1989.)

[5] Hungarian SOCBs frequently established joint ventures with foreign capital, or purchased shares of such financial institutions which, in many cases, operated in the same segment of the market. In other words, they created competitors for themselves.

Table 4

Institutional development of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Commercial banks	15	16	16	23	32	32	37	37	36	36
foreign	3	3	5	12	14	17	19	22	21	24
Specialized financial institutions	6	8	8	8	5	4	4	6	6	8
Investment banks	0	0	0	0	0	0	1	1	1	1
Banks (total)	*21*	*24*	*24*	*31*	*37*	*36*	*42*	*44*	*43*	*42*
foreign altogether	3	3	8	9	15	16	20	24	23	27
Savings and credit cooperatives	260	260	260	260	259	257	255	258	254	255

Source: State Banking Supervision (SBS), and Nyers and Lutz (1992)

In 1990, according to Spéder (1991), about 30 percent of the three big SOCBs' total loan portfolio could be considered as directly inherited. The stock of directly inherited *qualified* debts was about 35 percent. The directly inherited part of doubtful claims was somewhat smaller (21 percent), while irrecoverable (bad) debts amounted to 41 percent of all bad debts. This suggests that the new credit evaluation was not much better than the old one. However, almost half of the new credits were rolled-over old ones. Approximately one-third of qualified loans were newly created. This indicates that the bad debt problem in Hungary was a stock, rather than a flow problem in the early 1990s. Bonin and Schaffer (1995) and *Király* (1995) also argue for the characterization of the development as a stock problem. What seems to be the core of the problem is not the inherited portfolio, but rather the inherited clientele. Big SOCBs were simply in a deadlock. They could not cut off all the credits extended to big debtors. All they could do was to roll them over. Bonin and Schaffer (1995) concluded that Hungarian banks "did not throw new money after old"; nonetheless, we cannot say that the respective managements of these banks were entirely responsible for the situation that had developed by 1991. Banks sometimes acted under political pressure.

If banks—understandably—did not take significant measures in order to solve these problems, why did the government not intervene? The NBH, as the lender of last resort of commercial banks, although it more or less insisted on a strict monetary policy, always provided refinancing credits for problem banks facing an emergency situation. It was obvious already in the 1980s, that the problem grew over the limits of the monetary sphere. The Ministry of Finance (MoF) was shortsighted in its policies. Due to the inadequate domestic accounting and banking rules, banks earned huge profits that the MoF could tap in the form of profit tax or dividends (see *Table 5*). If the MoF ordered the banks to push those of their debtors who did not pay into liquidation, then instead of collecting these revenues the MoF would have spent a huge amount on the banks (or on SOEs if the government had desired to save them). Before 1992, the MoF consistently chose the first option. To take another example, in 1989, after a modification of the annual budget, SOCBs were obliged to purchase housing bonds for 50 percent of their loan loss reserves. In 1989–90 the Ministry did not allow banks to accumulate tax-free provisions. The MoF attempted to shift all the responsibility on to the banks. For example, in the early 1990s, SOCBs were requested to make a "death-list" of big debtors which banks were contemplating for liquidation. Finally, the banks put the names of some fifty enterprises on the list and, in fact, SOCBs started to initiate liquidation. Nonetheless, these measures were rather symbolic and served as a warning only (see *Table 3*).

Fortunately, the government was somewhat divided on this issue. In 1989, the State Banking Supervision (SBS) stipulated that banks should write off 10 percent of their doubtful loans. As a result of this obligation, five big SOCBs wrote off a HUF 3 bn (USD 50 mn) loss.[6] In Spring 1991, SBS put pressure on banks to accumulate a loan loss provision, because they did not have enough reserves.[7] If all doubtful outstanding debts had become irrecoverable, then about HUF 30 bn (USD 500 mn) additional loss reserves would have been needed to write off this loss.

Having no better option, SOCBs—but especially the MHB—started to swap debt for equity (see *Table 3*). In the short run it was "good" for banks as well as for enterprises.[8] These investments, however, were usually less profitable. They earned about 10 percent dividend on average in 1990 (and even less in 1991), which was below the interest income of banks. Obviously, the purpose of these swaps was to reduce the expected loss; rather than maximise the return on investment, banks hoped that they could sell their stakes in the planned privatisation. Apart from some exceptional cases, such as the sale of TUNGSRAM's shares by MHB, banks had to keep these shares for a longer period of time. Before 1994 the banking rules

[6] As has happened both before and since, financial authorities—but especially line ministries—or state asset management agencies assume that it is sufficient to write off the debts of SOEs and then everything will continue smoothly. Firms' restructuring and loan conciliation have not been interlinked.

[7] There was only one bank (BB) which followed the instruction of the SBS, while all the other banks paid more attention to the MoF's tax motive. The ministry heavily criticised and blamed the management of the BB because, according to the MoF, the management wanted to hide the profit from the Treasury.

[8] Although in 1989 banks still invested more in other financial institutions (HUF 4.2 bn), swap transactions increased rapidly. At the end of 1989 the stock of investments in the real sector held by banks amounted to HUF 4.7 bn. The share of the big five SOCBs in this investment comprised about 70–80 percent. On the basis of non-consolidated balance sheet data, Spéder (1991) estimated that the MHB had a concentration of 46 percent of all investments in the banking sector, while K&H had a 15 percent share, MKB's portion was 13 percent, and BB's share was only 6 percent.

also induced banks to change debts into equity, since strict provisioning was not required on investment.

Ownership of SOCBs

In 1987, when banks were established, SOEs could subscribe for the shares of SOCBs. The big debtors of SOCBs became shareholders of these financial intermediaries and (heavily indebted) SOEs could delegate their CEOs to the boards of banks.[9] By the 1990s the state's direct share in large SOCBs (excluded OTP) was between 42 and 55 percent. "Cross-ownership" contributed to allocative inefficiency. In the case of the three SOCBs, the total value of credits extended to their own shareholders amounted to HUF 165.6 bn (USD 2.8 bn). It became a common view that although the state was a bad owner, enterprises should not be allowed to own banks. In principle, the state could have been a good owner, since in the long run it was interested in the sound operation of the banking system. In reality, the state always fell hostage to the short term (and short-sighted) aims of particular interests of lobbies (which undermined the long term prospects). The question was then raised: "Who should own banks?"

In principle, Hungarian private citizens could become shareholders. However, a dispersed ownership was not desirable. Anyway, small investors did not show a strong interest in buying the shares of SOCBs. The attempt of K&H to sell its shares to small investors failed. Low dividends, a weak (less liquid) capital market and a 20 percent tax on dividends, did not make bank shares attractive. (It is no surprise that under these conditions SOCBs suspended the trade of their shares in order to avoid a worsening of their reputation.) For similar reasons, domestic, private, and institutional (financial) investors did not show too much interest either. Institutional investors were almost non-existent in Hungary at the end of the 1980s and in the early 1990s. The same applies to strategic investors. The only other alternative solution was to sell shares of SOCBs to *foreign* strategic or institutional investors.[10]

[9] SOCBs frequently tried to persuade thier clients to subscribe to their shares and sometimes banks themselves granted loans to SOEs in order to reduce the dominance of direct state ownership. Firms probably subscribed to bank shares because they assumed that they could have better access to bank finance.

[10] Spéder and Várhegyi (1992) mention another alternative. In principle, SOCBs could have been privatised indirectly in the medium term. Privatization of SOEs holding shares of SOCBs would have eventually resulted in the privatisation of these banks. Moreover, if these SOEs had been decentralised, such a downsizing would have reduced the vulnerability of banks to their dependence on big debtors.

The advantages of the take-over of SOCBs by foreign investors were obvious to everybody.[11] Nonetheless, there was a fear that profit-maximising owners would repatriate all the profit, or even a part of the income. The main argument against foreign investors was that, if foreign owners obtained major banks, then the domestic control over strategically important sectors of the economy would have been lost. Given the hesitation on the supply side, the deep recession of the economy in 1990–91, and after a short audit of the financial position of the respective banks, the demand for Hungarian banks largely decreased.[12] The government remained without real alternatives. The "nationalisation" of SOCBs became the official policy. This policy also gained support for other reasons. Because of the increasing rate of interest on credits and the reluctance of banks to extend loans to new private businesses, a hostile attitude towards banks by certain politicians and the population started to evolve. Accordingly, the State Property Agency (SPA) sought to collect all the shares of the SOEs. The ownership rights over SOCBs were divided between the SPA and the MoF. The ministry retained the right to make strategic decisions.

Legislative shock therapy

During 1991 the attitude of the financial authorities (i.e. state owners) began to change. International financial institutions put pressure on the Hungarian government to solve inter-enterprise arrears and to put an end to the accumulation of bad debts of SOCBs. They strongly suggested that there was a need to create a comprehensive legal framework for the operation of the central bank and financial institutions. Nevertheless, the room for government intervention was seriously limited by the ceiling imposed on the budget deficit.

In May 1991, at the annual meetings of the SOCBs, with the consent of the MoF, the chief executive officer of SPA voted for a moderate dividend, against the wishes of corporate shareholders. Later, in the summer, the government issued guarantees for 50 percent of the credits extended before 1987. This guarantee amounted to HUF 10.3 bn (USD 140 mn). This measure was far from being sufficient to solve the problem of SOCBs, since about HUF 40 bn of bad debts still

[11] Besides usual benefits (such as fresh capital, technology, know-how, markets, etc.). The NBH and the MoF supported the sales of banks, since these transactions could have resulted in hard currency revenues, additional credit lines and an export-financing capacity for the country. Furthermore, the strong profit motive of new owners could also have had some positive spillover effect on borrowers. Yet the tax allowances that, presumably, would have been necessary, could have reduced the stream of future revenues, and the necessary liberalization of foreign exchange would have immediately reduced the discretionary power of the central bank.

[12] Sándor Demján, the CEO of the MHB, could find a buyer for his bank but the deal was stopped in its tracks by officials and later he was removed from his position.

remained in the banks' portfolios. Even so, at that time banks did not suffer liquidity problems. In the early 1990s, the short term insolvency of Hungarian banks was not a problem either. The money market could pass sufficient intermediate resources from retail banks to the large SOCBs and they could manage their short-term liquidity. At the same time, it became clear that this situation would not be sustainable forever. The immediate impact of the recession of the real sector was not yet reflected in the accounts of the banks. On the contrary, although in 1990 and 1991 GDP (and industrial production) declined by 3.5 percent and 11.9 percent respectively, (and by 7.7 percent and 17.9 percent respectively), the banks reported significant profits (see *Table 5* and *6*). This fact alone indicated that there must be some problem with the system of regulation, so the government decided to impose new laws on financial institutions.

In 1991, Parliament passed several new economic laws. In addition to the acts on, respectively, investment funds, the central bank, and the amendment on the act on foreign investment, three other important changes in the legislation must be mentioned here: (1) *Act LXIX of 1991 on financial institutions and financial activities* (i.e. the Banking Act) which became effective in December 1991 so that it could be applied in the final accounts at the end of the year. It gave rise to radical changes in the regulation of financial institutions. This Act, among other things, required banks to accumulate loan loss provisions, and prescribed an 8 percent capital adequacy ratio (CAR) by January 1994; it also introduced other elements of more prudent regulation. This new Act followed the BIS accords although, as it will be shown below, in some important aspects regulators deliberately "adjusted" the requirements to local conditions. The Hungarian system is not exactly Anglo-Saxon, nor is it German-like. Although policymakers paid attention to EU requirements, the current state of the capital market as well as the lack of expertise in risk assessment of investments made it advisable that universal banking should not be explicitly allowed. However, in practice, commercial banks could trade with securities and through their subsidiaries they could run investment funds. (See also *Várhegyi* 1994a and Ábel and Bonin 1994). (2) *Act XVIII of 1991 on accounting*, which became effective on 1 January 1992; this stipulated that economic entities must prepare balance sheets and income statements that showed a true and fair picture of their economic activities. In general, this law corresponded to international auditing standards (IAS). (3) *Act IL of 1991 on bankruptcy, liquidation and final accounting* (i.e. the Bankruptcy Act) came into effect in April 1992 and immediately increased the number of bankruptcies and liquidations (see *Table 2*). Policymakers believed that this strict rule, having an automatic trigger, could restore financial discipline in the economy and inter-enterprise arrears would thus be curtailed.

All these legislative changes had an unprecedented impact on the financial sector. SOCBs were unable to accumulate sufficient loan loss provisions, and they had HUF 30 bn (USD 400 mn) unprovisioned, even using the less stringent Hungar-

Table 5

Development of the portfolio of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Nominal GDP (HUF)	1,226.4	1,440.7	1,722.8	2,089.3	2,498.3	2,942.6	3,548.3	4,364.8	5,499.9	6,627.95
Total assets of banking sector	996.3	1,023.0	1,247.3	1,620.5	2,108.7	2,276.0	2,630.4	3,071.8	3,693.6	4,735.28
Total off-balance sheet items	n.a.	n.a.	n.a.	n.a.	n.a.	225.0	304.5	379.6	551.5	1,192.49
Equity	49.8	65.1	74.3	91.3	117.7	109.1	256.5	296	220.3	218.91
Own capital	60.0	75.5	93.9	122.4	*169.9*	166.9	147.8	209.6	295.8	397.63
Capital investment	6.2	10.1	20.7	30.3	50.3	n.a.	92.0	106.6	139.7	155.68
Pre-tax profits	28.3	35	49.7	63.3	35.5	n.a.	−149.1	25.57	53.91	84.539
Profit tax and dividends to the state	21	23.35	21.33	48.58	44.47	1.69	8.349	30.448	12.985	16.038
Total enterprise HUF credits	n.a.	382.8	462.6	564.3	656.6	630	610.6	687.9	693.7	852.0
Total credits to business sector	383.0	395.8	492.6	636.1	765.3	768	761.9	869.7	982.6	1,265.2
Total classified portfolio	787	800	671.7	994	1,230	1,610.7	1,828.1	2,504.5	2,731.0	3,817.9
Qualified loans	2.8	6.7	22.6	43.3	152	173.1	536	534.1	438.9	412.82
Under observation	–	–	–	–	–	–	124.2	194.1	193.4	222.39
Substandard	–	–	–	–	30	36.5	53.7	51.3	43.1	37.04
Doubtful	2.8	6.7	22.6	43.3	82	59.7	112.3	85.4	68.7	47.63
Bad	–	–	–	–	40	76.9	245.8	203.3	133.7	105.75
Provision—required	–	–	–	–	87	114.0	–	–	–	–
Provision—available	n.a.	n.a.	n.a.	n.a.	52.8	73.5	272.9	233.8	176.8	138.2
Qualified prtfolio/GDP (%)	0.23	0.47	1.31	2.07	6.08	5.88	15.11	12.24	7.98	6.22
Qualified prtfolio/Total assets (%)	0.28	0.65	1.81	2.67	7.21	7.61	20.38	17.39	11.88	8.71
Qualified prtfolio/Total classified portfolio (%)	0.36	0.84	3.36	4.36	12.36	10.75	29.32	21.33	16.07	10.81
Qualified prtfolio/Business sector loans (%)	0.73	1.69	4.56	6.81	19.86	22.54	70.35	61.41	44.67	32.62
Qualified prtfolio/Enterprise HUF loans (%)	n.a.	1.75	4.89	7.67	23.15	27.48	87.78	77.64	63.27	48.45
Bad portfolio/GDP (%)	–	–	–	–	1.6	2.61	6.93	4.66	2.43	1.59
Bad portfolio/Total assets (%)	–	–	–	–	1.9	3.38	9.34	6.62	3.62	2.23
Bad portfolio/Total classified portfolio (%)	–	–	–	–	3.25	4.27	13.45	8.12	4.90	2.76
Bad portfolio/Business sector loans (%)	–	–	–	–	5.23	10.01	32.26	23.38	13.61	8.35
Bad portfolio/Enterprise HUF loans (%)	–	–	–	–	6.09	12.21	40.26	29.55	19.27	12.41

Sources: Annual and monthly reports NBH, SBS, and Nyers and Lutz (1992)

Table 6

Selective indicators of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
GDP nominal (HUF) growth rate	12.63	11.7	19.58	21.27	19.57	17.78	20.58	23.01	26.0	20.5
GDP real growth rate	4.1	−0.1	0.7	−3.5	−11.9	−3.1	−0.6	2.9	1.5	1.0
CPI	8.6	15.5	17.0	28.9	35.0	23.0	22.5	18.8	28.2	23.6
PPI	3.3	4.5	14.6	20.9	31.5	10.7	11.0	11.3	28.9	21.8
Nominal growth rate of total assets of banking sector	n.a.	2.68	21.92	29.82	30.68	7.47	15.57	16.78	20.24	28.2
Real growth rate of total assets of banking sector (PPI)	n.a.	−1.74	6.39	7.46	−1.1	−2.5	4.1	4.92	−6.72	5.2
Real growth rate of total assets of banking sector (CPI)	n.a.	−11.1	4.21	0.79	−3.6	−12.2	−5.6	−1.7	−6.2	3.7
Nominal growth rate of enterprise HUF loans	n.a.	n.a.	20.85	21.98	16.36	−4.05	−3.08	−12.66	0.8	22.8
Real growth rate of enterprise HUF loans (CPI)	n.a.	n.a.	3.29	−5.57	−13.81	−21.99	−20.88	−5.17	−21.34	−0.7
Real growth rate of enterprise HUF loans (PPI)	n.a.	n.a.	5.45	0.9	−11.52	−13.33	−12.68	1.22	−21.77	0.8
Total assets of banking sector/GDP	81.24	71.0	72.4	77.56	84.76	77.34	74.13	70.37	67.15	71.44
Total enterprise HUF loans/GDP	30.67	26.57	26.85	27.01	26.28	21.41	17.21	15.76	12.61	12.85
Total enterprise loans/GDP	30.67	26.57	27.51	28.34	28.18	23.51	19.06	17.88	16.57	18.14
Total business loans/GDP	31.22	27.47	28.59	30.44	30.63	26.09	21.47	19.92	17.86	19.08
Total enterprise loans/Total assets	n.a.	37.42	37.09	34.82	31.14	27.68	23.21	22.39	18.78	25.4
Total business loans/Total assets	38.44	38.69	39.49	39.25	36.29	33.74	28.97	28.31	26.60	26.71
Business sector deposit/credit ration	n.a.	n.a.	41.4	49.4	49.9	59.5	69.9	63.3	66.2	63.7

Sources: National Bank of Hungary and own calculations ian banking rules which, at that time, did not require adequate provision against off-balance sheet items or investments. (According to the Act, general provisions had to be accumulated from after-tax profits to the value of 1.25 percent of the balance sheet total, and up to one percent of guarantees.) If international standards had been adopted, banks would have needed approximately HUF 60–70 bn more loan loss reserves: in this case the major banks would have lost their capital immediately. In order to avoid the collapse of the banking system as a whole, banks were allowed to build up loss reserves over three years. These economic and legislative changes hit SOCBs especially hard. Nonetheless, the CAR of most banks fell below 7 percent, and two major domestic banks had a negative CAR. However, the worst was still to come. (See *Table 5*.)

The recession worsened in 1992. As a consequence of the collapse of the COMECON market in 1991, many SOEs got into serious trouble. No legislative rigour had previously jeopardized their existence but, from April 1992, insolvent firms could not avoid bankruptcy or liquidation. All these economic and legislative changes led to a financial shock for Hungarian banks. Even if banks could perceive the difficulties, they could not do too much to avoid them, since the MoF had already diverted funds from SOCBs, and they remained seriously undercapitalised. The new Banking Act and the other changes in the regulations merely made visible what had before been hidden. Monetary authorities as well as commercial bankers feared that the losses would undermine the trust in banks, impair the chances of SOCBs to acquire funding, and would increase the costs of financing. In principle, banks could perhaps have managed to build up loan loss reserves—e.g. through widening the interest margin—but it would have taken too long. Nevertheless, banks increased the margins. As a consequence, high real interest rates (on loans) occurred, which obviously cooled down the economy. By Spring 1992 it was obvious that the government had to intervene in order to help out banks. In essence, the new Banking Act wrongly imposed a flow solution to the bad loan problem when it was essentially a stock problem.

Credit conciliation

The government had several alternatives with which to address the bad loan problem. Bad debts could be carved out from the balance sheets of the respective banks, or the capital of banks could be increased to an appropriate level. Such a policy can be carried out with cash, or risk-free government securities can be transformed to banks. To a limited extent subordinated capital can also be used. The government can provide guarantees, or the central bank may refinance banks' liabilities. In practice, the MoF rejected any idea of transactions in cash. The NBH also opposed any suggestion for refinancing. If the state had undertaken guarantees, it would not have solved the short term cash-flow problems of certain banks. Moreover, their profitability would not improve either. Guarantees are less liquid than, for example, state securities, because necessary court decisions are time consuming, and Hungarian courts had been overloaded by the flood the Bankruptcy Act initiated. Moreover, the issue of state guarantees requires parliamentary approval. It is also difficult for the MoF to assess the amount of guarantees needed annually. To inflate away the deposits was not a practical alternative. The central bank rejected this alternative as well as any idea of a currency reform.

There were still two competing proposals. According to the market oriented (decentralised) version, banks could sell their bad debts or doubtful claims at market price to specialised firms with venture capital. The government could partially cover the losses of commercial banks. Unfortunately, the administration hesitated in its decision, which was postponed until the end of 1992. In December, acting under the pressure of time, the financial authorities decided on a hybrid solution: a portfolio cleaning combined with a firm oriented carve-out and a partially centralised work-out were implemented. The question which immediately arose was: why were firm restructuring and portfolio cleaning not carried out simultaneously? On the one hand, the Hungarian government worried about the reaction of the international financial market: "In 1992 the stock of qualified credits started to increase with a dramatic speed and according to international standards most of the Hungarian financial institutions would have lost their capital. A further increase of the stock of qualified credits could be expected from the logic of the process thus a quick accumulation of losses had to be stopped." (*Ministry of Finance* 1993, p. 10) On the other hand, the government and the whole financial community feared a possible bank panic because two banks and a saving cooperative went bankrupt in the summer of 1992, and three other banks became insolvent.

The government also had to decide which banks and what credits should be included in the programme. Since, according to the government, the main reason for the crisis was the economic recession which, in general, affected all financial institutions, the programme was extended to all domestic banks in trouble.

Bank oriented credit consolidation

The aims of the bank oriented credit consolidation were: to improve certain financial indicators of troubled commercial banks; to narrow the interest margin; to provide a sound basis for prudent banking activities that would also facilitate the privatisation of SOCBs; and to help the reorganisation of enterprises.

Banks having a CAR below 7.25 percent at the end of 1992 (prescribed temporarily by the Banking Act) were eligible to participate. Altogether, 14 banks and 69 saving cooperatives took part in this scheme. In order to avoid the moral hazard, the government decided that banks could sell to the state bad loans (excluding housing loans, consumer credits and loans extended to foreigners or financial institutions) that had been extended prior to 1 October 1992.[13] Decision-makers speculated that "an important part of the substandard credits can be managed by the financial institutions and if they get rid of the bulk of credits qualified as doubtful and bad ones, they will be able to cover their credit losses". (Ministry of Finance 1993, p. 12)

Banks could decide what loans they wanted to offer for sale to the government. They wanted to get rid of debts amounting to HUF 150 bn, but eventually in March 1993 they could sell much less to the MoF. The classification and selection were monitored by the ministry and international auditing firms. The government purchased the bad debts at 50 percent of face value if the loan was classified as such in 1991 or before; at 80 percent of the nominal value if the loan was classified as bad in 1992, and in certain cases—to help the ongoing privatization of banks—banks could sell certain claims at full price. According to a decentralised version, workout firms could have purchased these claims from banks, but these business entities did not exist at that time, or the few that did were financially too weak to purchase claims reaching such a volume. Therefore, the state had to purchase these claims. Altogether, their nominal value amounted to HUF 100.1 bn (USD 1 bn) and the state paid HUF 79.4 bn (USD 830 mn) for them.[14] The government used long term bonds to replace loans in order to shift the burden to the future.[15] (Another consideration was that as time passes the capital represented by these bonds would be inflated away.) The government deducted the accumulated risk reserves from

[13] "The main cause—i.e. the portfolio-deteriorating effect of the shrinking of the economy—asserts itself even at present. On this basis it may be asked whether the consolidation should also be extended to credits granted at present and which become «qualified» later. This would, however, stimulate the banks to be irresponsible in their lending policies. We have, therefore, chosen the solution (as a compromise) that *credits granted prior to 1 October 1992 may be included in the system*. (At that time the banks hardly knew that the system of credit consolidation would be expected, therefore the Ministry of Finance could not influence them when taking decisions on extending credits.)" Ministry of Finance 1993, pp. 11–12.

[14] These claims were concentrated mostly in large banks. Large SOCBs transferred the credit stock of HUF 85.2 bn to the government and received bonds of HUF 66.7 bn in exchange. However, the debts of 2,647 firms were also concentrated in a smaller group: HUF 77.5 bn (75.6 percent of all claims) represented the debts of 709 firms facing bankruptcy or liquidation. At the end of 1992 banks got rid of 95 percent of the debts of those firms facing bankruptcy or liquidation. The debts of firms in the process of being liquidated amounted to HUF 63.6 bn, and those facing bankruptcy to HUF 13.9 bn. This high concentration is shown by the fact that 337 firms, out of 709 enterprises facing bankruptcy or liquidation, were clients of the big four SOCBs and owed the banks HUF 64.4 bn. (Marsi and Pap 1993).

[15] Banks received "A" series consolidation bonds, which bear interest similar to the market rate of interest and they received "B" series consolidation bonds for their outstanding interest payments. Although according to the original plan the treasury would withhold 50 percent of the interest payment on these "B" bonds in the form of a consolidation fee, it was later cancelled, and "B" series bonds were exchanged for "A" series ones.

the sales price in order to share the costs with banks. This amounted to HUF 20.6 bn. (See also Ábel and Bonin 1994 and Várhegyi 1994a)

As a result, the CARs of most of the banks participating in the programme, at least according to Hungarian accounting and banking regulations, became positive (although they were still mostly negative calculated by international standards). These banks still accumulated HUF 7.1 bn of aggregate losses. Without credit consolidation these fourteen banks would have had to accumulate almost HUF 50 bn loan loss provisions. Their total losses would have been even bigger and they would have lost two-thirds of their solvency capital, even applying the moderate domestic regulation which allowed banks to replenish their risk reserves in three years. The aggregate CAR of these banks would have been one percent instead of the 7.25 percent prescribed by the Banking Act, and the solvency capital of half of these financial institutions would have been negative. According to BIS standards, twelve banks would have lost their entire capital and reported a negative CAR. Their total losses would have amounted to almost HUF 125 bn (USD 1.6 bn), since the required level of loan loss provision would have been nearly HUF 200 bn (USD 2.5 bn). In sum, as a result of the state intervention, immediate bank failures were avoided. Although the capital adequacy of the banks was weak, on average they could meet Hungarian standards. (The MHB and Agrobank had negative CARs, and the K&H's CAR was 1.9 percent. Only BB, OTP and MKB could pass the limit among the large SOCBs.)

In addition to this normative part of the programme, the government also included three smaller banks in the process of consolidation in spring 1993. The MoF purchased the bad debts of these banks at face value for HUF 17.3 bn (USD 188 mn). Ybl Bank was one of the three small financial institutions which went bankrupt in 1992 and it was later liquidated. The other two banks (Konzumbank and Industrial Banking House), although they were technically insolvent, due to a quick state (NBH) intervention, did not have to file for bankruptcy in 1992. After the bankruptcy of the three financial institutions mentioned above, the financial community wanted to prevent the open failure of other banks at any price. Altogether, the bank oriented credit consolidation, including savings cooperatives as well, increased the state debt by HUF 98.6 bn (about USD 1 bn).

Firm oriented credit consolidation

In 1992–93, various government agencies and lobby groups became active and sought to obtain direct support for their "constituency". In 1992 the government decided to give support to certain SOEs in industry. The SPA proposed to select 200–300 firms for debtor consolidation, but the MoF strongly opposed this idea and finally the government rejected this proposal.[16] Nonetheless, the effort was in part successful, because, albeit on a smaller scale, a similar programme was finally implemented. In the autumn of 1993, the authorities "based upon certain strategic considerations" first selected thirteen big SOEs from heavy industry. Then, under the pressure of the Ministry of Agriculture, eight additional (food processing) firms and several state farms and agricultural cooperatives were added to the list of the "dirty dozen". Finally, the Hungarian Railways (MÁV) were also included in the firm oriented credit consolidation. The debts of industrial and food processing firms were purchased at 90 percent of their face value—that is for HUF 32.4 bn and HUF 4 bn (USD 352 mn and USD 43.5 mn) respectively; the debts of the railway company (HUF 16.2 bn) and agricultural cooperatives and state farms (HUF 4.5 bn) were carved at their face value. In order to cover the costs of these transactions, the government issued consolidation bonds to the value of HUF 57.2 bn (USD 621 mn).[17]

It was not quite clear in this case what could be done with the debts that had been carved out from the banks. Policymakers assumed that no state organisation was interested in or prepared for work-out. It was taken for granted that banks could do a better job with the latter, but this view was unjustified as banks lacked both the necessary experience and skill.[18] Moreover, the short-term interests of banks in siphoning out from debtors as much as they could and as soon as possible in order to cover their losses were costly for the government.

It was accepted at the start that debtors would need a case by case treatment. In March 1993 the Hungarian Investment and Development Bank (MBFB), a 100 percent state-owned investment bank, purchased HUF 41.2 bn of the debt of 57 firms from the state at a discount price. (MBFB paid 4 percent of the sales value immediately after the transaction, and according to the contract between the MoF

[16]The NBH, the MoF and the SBS did not support the idea of centralized portfolio cleaning, because they did not want to see another top state asset management organisation responsible for SOEs besides the existing ones. They also argued that it would be difficult to recruit staff for this new agency, and the decisions of this agency probably would have been rather discretionary, raising problems of moral hazards in banks.

[17]The debts of these insolvent firms remained in the books of their creditors after the bank oriented credit consolidation. This means that they were not classified as bad at that time. So we may suppose that banks probably behaved strategically. They might assume that it was better to sell the debt of big SOEs at face value to the state than to include them in the consolidation scheme. Needless to say, this fact alone foreshadowed the necessity of another phase of consolidation, since the credit stock of these enterprises was significant and these debtors were really in bad shape.

[18]For the same reasons *Dittus and Prowse* (1996) argue against the claim that East European commercial banks could be successful in active monitoring of their borrowers (like the Japanese) or investments (like the Germans). They lack human resources and therefore financial institutions themselves are not particularly interested in investment banking activity. In the short run, credit allocation alone was already too big a challenge for them. Nonetheless, they also admitted that work-out of default firms might be a useful "exercise" for a bank to gain experience in the restructuring of firms.

and MBFB it was obliged to transfer 25 percent of work-out revenues to the Treasury.) A vast majority (90 percent) of these firms were in the process of liquidation, but only one-fifth of them were expected to be completely liquidated. The others were supposed to go through at least a partial restructuring. The other part of the debt carved out by the MoF was also, in principle, managed by MBFB. However, in fact, due to its limited capacity, these claims remained in the lender banks' books. At the end of 1993, the MoF and MBFB offered this portfolio for sale, but only one-tenth of the claims (about HUF 7 bn) found a buyer at a price which was, on average, ten percent of the face value. Until mid-1994 banks formally managed the claims on the basis of continuously renewed short-term contracts between the MBFB and the banks. The banks did not do anything effectively with these claims. From mid-1994 until the end of 1994 this portfolio remained without control. Finally, in early 1995, the MBFB took over HUF 63 bn debt, and was allowed to keep 35 percent of the net revenues from the work-out. Except for a few cases, the credit consolidation did not have any real impact on the financial conditions of firms. The Treasury did not benefit too much from the work-out either. Until the end of 1995, the state budget recovered only about HUF 6 bn. If we were to add a few more billion forints to these revenues, we can still point to a less than 10 percent recovery rate.

In the case of the *firm oriented bank conciliation* the approach chosen and the outcome were not significantly different. In 1992–93, the State Development Institute (ÁFI)—another 100 percent state-owned organisation—cancelled, rescheduled or capitalised HUF 15 bn of its loans to these firms. In addition, guarantees for these industrial enterprises were provided by the government and their tax- and tariff-arrears were forgiven. The MoF then sold thc debts of these firms to the state asset management agencies and these agencies used privatization revenues to pay for these claims. Although the debt could have been rescheduled or swapped for equity, the State Asset Management Company (ÁV Rt.) chose to write off HUF 23 bn of debt in 1993 without requiring any restructuring on the part of the firms. Since the SPA was not authorised to forgive any debt without parliamentary approval, it silently accepted that debtors would not service their debts after September 1993.

It turned out (as early as spring 1993) that the bad debt problem of banks had not been solved, although the whole consolidation process was supposed to have been completed by the end of 1993. In 1993 the real growth rate was still negative; the number of bankruptcies or liquidations increased steadily; firms suffered from financial distress; the management of banks did not improve; and further tightening of the regulation was expected. As a result, the banks' portfolio deteriorated further. By autumn 1993 the solvency capital of major banks became negative. The high level of loan loss provisions (even according to the domestic rules) caused the major SOCBs to fall into the red. The balance sheet of the banking system as a whole showed a more than HUF 30 bn loss at the end of September 1993.

The government, relying upon the recommendations of foreign and Hungarian advisors, decided to continue the bailout of the banking sector. However, instead of carving out bad debts, now it was recapitalisation of the banks which received priority. (In March 1993, the IMF and the World Bank had already advocated the recapitalisation of troubled banks to the level where their CAR would reach 4 percent, but at that time the Hungarian government rejected this option.) In autumn 1993, banks were able to apply for the new round of consolidation. Out of 14 applicants, the government finally allowed 8 commercial banks to participate. The other banks were excluded because the government considered their performance relatively good, so state funds were not to be used to improve their situation. These eight banks extended 51 percent of all enterprise loans, but represented only 34.6 percent of the total assets of the whole banking sector. Nevertheless, they had more than 60 percent (HUF 211 bn) of the qualified loans, and more than 70 percent of bad loans. Two-thirds of the problem loans had already been overdue for more than a year, and the cash-flow of these banks was expected to become negative in 1994, adding another reason for intervention.

Bank conciliation

The Hungarian government opted for so-called "bank conciliation". However, at this stage bank restructuring and debtor conciliation were also part of the programme. (See *Balassa* 1995)

The main aims of bank conciliation were: (1) the elimination of loan losses from the accounts of banks, and the stabilisation of the banking sector (i.e. solving the stock problem); (2) helping to reduce lending rates in order to boost the economy by providing cheaper financing; (3) helping to restore the profitability of the SOCBs; (4) the creation of an environment for prudent banking operation; (5) the preparation of the SOCBs for privatisation, thus eventually solving the flow problem. The goal of bank conciliation was to reach an 8 percent CAR for all participating banks. This required an amendment of the Banking Act and the full adjustment of prudential regulation to international standards. The changes included the point that all shares had to be bearer shares. Another important change was that, instead of evaluating individual debts, clients were to be assessed and provisioning was also extended to investment and off-balance sheet items. Banks also enjoyed more flexibility in provisioning, within certain limits. Accounting principles were also modernized.

Four smaller domestic banks and four large SOCBs participated in bank conciliation. In addition to the eight banks, the OTP and OTIVA (the Deposit Insurance Funds of Savings Cooperatives) were also included at this stage. The MoF increased the capital of the large SOCBs (i.e. of the BB, K&H, MHB, and

Takarékbank) in three steps, thus enabling these banks to achieve 8 percent CARs. In the case of small banks (i.e. Agrobank, Dunabank, Iparbankház and Mezőbank) the government increased their equity only up to the point where it reached 4 percent. The total assets of these small banks represented less than three percent of the banking sector. It was assumed that, using a method of privatisation through capital increase, these banks would find a partner more easily and the CARs could be increased to over 8 percent.

The MoF increased the capital of troubled banks in three steps. The consolidation bonds which the eight banks received in December 1993 amounted to HUF 114.5 bn (USD 1.24 bn), out of which MHB and K&H received HUF 88.19 bn. The capital increase enabled banks to lift their respective CARs above zero, and this measure also restored a positive cash-flow for the banks. Since in December audited figures were not available, the amount each bank received was determined by the MoF on the basis of data provided by banks in September. Changes in the prudential regulations and the individual actions of the banks to increase their loan loss reserves were incorporated in the assessment. When the balance sheet for the whole year became available (late February), banks and the MoF recalculated the amounts used in recapitalisation. Loans extended before 30 September 1993 and qualified as bad at the end of 1993 were covered by the programme. The MoF's estimate was that banks needed to accumulate HUF 113 bn more reserves under the new regulations compared to the previous one. The equity of banks was increased again in May at the shareholders meetings of banks. The MoF, perhaps understandably, preferred a lower level (four percent) of CAR, while the NBH, SBS and SPA recommended the internationally suggested eight percent. At the same time IBRD experts advised that with a positive, but less than 8 percent CAR, the government could exercise pressure on SOCBs in order to speed up their restructuring. In May 1993, the eight banks received HUF 17.2 bn (USD 163 million) in total in the form of conciliation bonds. This was to help them reach a two percent CAR in the case of small banks, and 4–8 percent CAR in the case of large banks. In addition to this, small banks received HUF 896 mn of subordinated capital to reach 4 percent CAR.

In exchange for the recapitalisation, banks were expected to submit their medium-term restructuring programmes and a privatisation plan to the annual shareholders meetings. They were also expected to participate in a debtor consolidation which would address the financing problem of large enterprises. The government held back the strategic plans of the MHB and K&H and therefore their consolidation was a bit delayed. These two banks had to submit a revised strategic plan. Because the efforts of the management of these banks did not satisfy the government, the top management of MHB and K&H was replaced by a new one in late 1994 and early 1995. Eventually, the CARs of these banks were increased to 8 percent at the end of 1994, but they were still calculated on the basis of their 1993 balance sheet data. These two banks received HUF 15 bn (USD 142 mn) of subordinated capital. As a result of these capital increases, the state became a majority owner of consolidated banks. State ownership exceeded 75 percent in seven banks.

Debtor conciliation

Enterprise indebtedness or restructuring was not addressed as the main issues in the bank conciliation programme. Bank conciliation did not remove any claims against the firms, although banks were free to make any decision concerning enterprise debt. As a result of the measures taken, banks had sufficient provisioning, and it was exclusively their own business decision as to what they intended to do with these claims. For policymakers the passivity of the banks was a main concern. Bankruptcy regulations did not allow banks to *forgive* any arrears against state creditors (e.g. tax, social security), although these arrears could be rescheduled. Debtor conciliation corresponded to the out-of-court agreements of bankruptcy procedures, or they functioned like pre-filing conciliation. Only representatives of banks and state creditors (i.e. tax and customs offices, social security authorities and the National Technical and Development Committee) could participate in conciliation procedures. Although banks, NHB and World Bank advisors strongly opposed the idea, branch ministries could also send their delegates to these committees. Nonetheless, the interests of small creditors could not be ignored. In this scheme state creditors were authorised, under a special resolution and within certain limits, to forgive debts. The main purpose of the conciliation was to help to reorganise enterprises in financial distress. In cases where agreement was not reached the normal bankruptcy procedure was initiated.

Conciliation procedures started in early 1994. The SPA and branch ministries (1) had the right to select firms for an accelerated debtor conciliation procedure and to lead or attend the negotiations with creditors; (2) if no agreement was reached, then the SPA was allowed to buy-out debts from the banks at net value (face value minus provisions); (3) the ministries had the right to set up inter-ministerial committees for resolving disputes among government agencies, or for monitoring the process. In fact, three different types of debtor conciliation were designed:

1. *Accelerated debtor conciliation*. Under this scheme, the SPA and the ministries (i.e. Ministry of Industry and Trade and Ministry of Agriculture) selected some debtors, and agreements had to be reached without delay. Out of 55 selected enterprises, conciliation took place in 46 cases. Nevertheless, in 1994, 15 firms filed for liquidation and 9 were privatised. 17 firms were able to reach an agreement with their creditor. The SPA purchased the bank debts in five cases. The bank debts of those 55 firms amounted to about HUF 40 bn, and these firms also owed about HUF 10 bn to state creditors. As a result of conciliation, a debt reduction of

HUF 18 bn was achieved. In the event, the accelerated debtor conciliation was not very successful, partly because the time available for preparing the restructuring plan and reaching an agreement with banks was short. Another important aspect of the process was that banks gained some experience in work-out. The deadline for completion of the procedures was extended to the end of April 1994.

2. *Normal debtor conciliation*. Firms having bad debts at the end of 1993 were allowed to apply for debt relief. An inter-ministerial committee then selected those who could participate in the programme. Finally 76 firms were deemed eligible, of which 41 had been supervised by the Ministry of Industry and Trade and 35 by the Ministry of Agriculture. These firms had a total of HUF 47.143 bn debts, of which HUF 28.4 bn were bank debts. The participating firms submitted a reorganisation plan. However, in most cases proposals were returned for revision. Some banks were active, some of them not. Strict deadlines again proved to be a drawback, and thus the deadline for completion was extended to the end of June 1995.

3. *Simplified debtor conciliation*. All other applicants (who did not take part in the previous two schemes) were eligible to participate in the simplified scheme under the same conditions. In this scheme government authorities did not participate in the negotiations.

Table 7

Main characteristics of debtor consolidation

	Banks	State creditors	SPA	Social security
Potential applicants (December 31, 1993)				
Number of cases	13,069	–	–	–
Debts (million HUF)	227,329	–	–	–
Applications (December 31, 1993)				
Number of cases	1,890	708	–	655
Debts (million HUF)	121,008	25,506	–	n.a.
Unsettled cases (December 31, 1993)				
Number of cases	1,536	559	–	754
Debts (million HUF)	77,039	15,909	–	–
Agreements				
Number of cases	354	149	31	81
Agreement with forgiving (million HUF)	19,536	3,890	267	966
rescheduling (million HUF)	6,649	5,562	–	4,345
swap (million HUF)	3,986	293	1,008	52
mixed (million HUF)	30,171	9,745	1,275	5,363

Source: various issues of *Privinfo*

Table 7 provides a summary of debtor conciliation. Out of 13,069 debtors, 1,890 firms indicated their interest in participating in the debt conciliation. Creditors reached agreement with their debtors in 354 cases. The total value of the bad and doubtful bank loans of these firms amounted to HUF 227 bn, and the banks had HUF 154 bn loan loss reserves behind these claims. The total debts of firms which finally remained in the debtor conciliation were HUF 121 bn, against which banks had about HUF 80 bn loan loss reserves. State creditors were involved in debt arrangements in 149 cases, while the SPA was involved in 31 cases.

According to Balassa (1995) in these debt settlements 29 percent of bank debt and almost 6 percent of the debt of state creditors were forgiven. Banks did not use all of their loan loss reserves for this purpose and a significant part of these reserves was transferred for other purposes. However, as can be seen from *Table 8*, the vast majority of debtors did not apply and therefore their debts had to be written off. Two major banks (the MHB and K&H) followed the advice of the IBRD and "split" into a "good" bank and a "bad" bank. They transferred bad debts to those of their subsidiaries who were specialised in work-out. Even if debtor conciliation did not come up to expectations, banks could eventually get rid of most of their non-performing loans. As *Table 5* indicates, the portfolio quality of banks improved significantly after 1995. This also paved the way for bank privatisation.

Privatisation of state banks

The Banking Act of 1991 stipulated that direct and indirect ownership of any single owner, with the exemption of financial institutions, could not exceed 25 percent of the equity. Although this restriction did not apply to the state until the end of 1996, the Act put a ceiling on the voting rights of the state as an owner after 1 January 1995. The 1995 deadline of the elimination of voting power was extended later.

At the beginning of 1992, financial institutions were obliged to renew their licences by law, and bearer shares had to be converted into registered shares. The state property agencies tried to collect the shares of SOCBs from SOEs. Although this effort was not fully successful, the ownership of banks became more transparent.

In the period of 1991–94 the macroeconomic conditions did not favour the sale of SOCBs. The net asset value of the major Hungarian SOCBs was negative, and the Hungarian government decided to clean up banks' portfolios, and to restructure troubled banks so as to make them viable for privatization. The authorities first envisaged a sequential privatisation: strategic investors could obtain control via a capital increase combined with the sale of the remaining shares of the state. The argument was that strategic investors would guarantee higher proceeds from such transactions.

Table 8

Bank and debtor conciliation in Hungary between 1987–1996

Year	Target	Target group		Method	Face value	Expenses (bn HUF)			
		Banks	Firms		(bn HUF)	G	C	S	O
1991	bank portfolio cleaning	3 banks	n.a.	guarantee (G)	20.6	10.3	–	–	–
1993	bank portfolio cleaning	14 + 3 banks (+69 savings coops.)	(2,619 firms & coops.)	buy-out	100.1 17.278 2.419	–	79.423 17.278 (1.895)	–	–
1993	bank portfolio cleaning	(13 banks)	21 firms + coops.	buy-out	61.308	–	57.292	–	–
1994	bank restructuring	8 + 1 banks (+saving coops.)	–	recapitalisation (C) & subordinated loan capital (S) & other (O)	–	–	114.45 17.207 10.000 (4.712) (1.724)	0.896 15.003 (0.388) (0.276)	1.882 12.000
1995	bank restructuring	2 banks	–	recapitalisation	–	–	0.800	5.000	5.951
1994 1995	firm restructuring	(8 banks)	1,890 firms	work-out (out-of-court conciliation)	121.008	–	–	–	–

Sources: MoF, National Auditing Office, and NBH

However, not everybody supported the sale of SOCBs to foreigners. Although foreign banks could enter the Hungarian credit market, they immediately enjoyed significant comparative advantage over domestic banks. Foreign and joint venture banks had a clean portfolio. In the first years they enjoyed certain tax concessions. They had easy access to cheap foreign sources and they could also take advantage of market imperfections. Consequently, these banks were very profitable.

Out of the five big SOCBs, the MKB was the first that the government offered for sale. The German Bayerische Landesbank and EBRD obtained, respectively, 25 and 16 percent stakes in late 1994 and mid-1995 (again, respectively). These two investors first purchased existing shares and then subscribed to newly issued shares. Another foreign investor owns 8 percent of shares, and the remaining shares are in domestic hands or in the bank's portfolio. After these transactions the extent of state ownership had decreased to 25 percent by 1995.

In 1994, 19.5 percent of the OTP's equity was offered for sale to Hungarian investors. A year later, another 21 percent of shares were transferred to Social Security and Pension Funds, and municipalities, while 20 percent were sold directly to foreign institutional investors, and employees purchased 5 percent. In 1995, domestic small investors purchased another 8 percent. These transactions resulted in revenues of HUF 10 bn (about USD 90 mn) for the government. (According to privatisation laws the state wants to retain 25 percent + 1 vote in the bank.) The reason why the OTP was not offered to foreign strategic investors was to enable this bank to retain its dominant position in retail banking.

In December 1995, the American General Electric Capital and EBRD purchased 32.5 percent and 27.5 percent of shares, respectively, of BB for a total of HUF 12 bn (USD 87 mn).[19] The Hungarian State had to buy back the Polgári Bank (a retail banking subsidiary of BB) from the new owners for HUF 1.1 bn (USD 7.3 million).

It was a generally shared opinion that the MHB and K&H were the two large banks in the worst shape of all the SOCBs in Hungary. Therefore it was a major success when the Dutch ABN-AMRO purchased 89.23 percent of MHB's equity for about HUF 14 bn (USD 89.23 mn) at 225 percent of the face value. (The MKB's shares had been sold at an approximately similar margin some years before, while the OTP's shares were distributed at 120 percent of their face value. The margin of BB's shares is not easy to assess because of other provisions in the contract, but in the first round it was roughly 100 percent.) Shortly after the privatisation, the Dutch investors increased the equity of the bank, and MHB became a really big bank again. In the privatisation contract the new owners promised a capital

[19] In 1995 the SPA transferred to BB capital reserves of HUF 12 billion in order to increase the warranty capital of the bank. Decision-makers expected that it would be possible to reach a better price by doing this.

increase of USD 100 mn by the end of 1997. It seems that MHB will become one of the major banks in the Hungarian market again, as it was in 1987.

In the spring of 1997 the Deutsche Genossenschaft Bank purchased a 61 percent share (HUF 818 mn) of the Takarékbank (Savings Bank) for HUF 4.4 (DM 41.3 million), at 532 percent of the face value of the shares. After this transaction the Hungaria Insurance Company had the task of subscribing shares of the bank according to an agreement among the current owners. As a result of this capital increase the insurance company obtained 5 percent of the shares. Employees can also subscribe to 5 percent of the shares with a 50 percent discount. The German owner (which is also a cooperative bank) provided strategic voting rights for the Hungarian cooperatives in the management of the bank making their position equal to that of a golden share. The current stake of 32 percent of Hungarian cooperatives will decrease to 23 percent as a result of the annual increases of the equity. Takarékbank currently has about 5.4 percent on the money market, and a share of about 15 percent in the retail (household) market.

The privatisation of the K&H started in 1997. Although the management of K&H sought to imitate the strategy of the OTP's management, the government was eventually able to resist and a significant stake of the bank's shares were offered for strategic investors. Two bidders were selected from five applicants in the first round of the tender. The strategic investors were expected to buy at least 25 percent plus one vote. Finally, the consortium of the Belgium Kredietbank and the Irish Irish Life insurance company obtained 10 percent of the shares (HUF 1 bn) for USD 30 mn at 567.3 percent of the face value. As with the case of the MHB, the government did not have to provide any special guarantees apart from the regular ones. The new owners will increase the equity of the bank by USD 60 mn by the end of 1997 at 105 percent of the face value. The EBRD has a swap option amounting to USD 30 mn. The employees can also purchase bank shares up to a value of HUF 519 mn. If all these transactions are carried out the bank will become the second largest commercial bank in Hungary, and the share of the consortium of the new owners will be around 45–48 percent. The remaining stake of the state of HUF 4.5 bn and HUF 3.115 bn of social security will be introduced on the stock exchange. The government hopes that this transaction, as well as the privatization of some smaller banks, will be completed in 1997.

Some lessons can be drawn from the experience of the privatisation of the large SOCBs: (1) the state has to take an active role in the privatisation of SOCBs; (2) the better the banks are prepared for privatisation and the more thoroughly the tender is organised, the more the benefit is felt by the state as well as by the banks; (3) competition for buying a bank should be maintained until the last round of the sale; (4) after portfolio cleaning, recapitalisation and restructuring, SOCBs must be privatised as quickly as possible; (5) if there is just one interested buyer, flexibility on the seller' side is crucial in order to avoid detrimental strategic behaviour by the buyers; (6) the government must resist pressures from political or interest groups.

The rival private banks (including already privatised SOCBs) will obviously lobby heavily against any deal because they do not want to see another strong competitor on the market.

Assessment and policy recommendation

With all of its defects, in many respects Hungarian bank restructuring has been able to meet its main aims. Although at a high cost, the bad debts of the SOCBs have been carved out. (*Table 8* provides a summary of the various stages.) As a result of various credit and bank conciliation schemes the portfolio of the SOCBs has resulted in lower lending rates in real terms and a narrower margin (see *Figures 1* and *2*). In 1994 consolidated banks had a positive cash-flow, and became profitable. This may have contributed to the fact that all major SOCBs have now been privatised. In order to cover, at least partially, the expenses of various schemes, the Treasury has been able to collect some revenues from the privatisation of SOCBs as well as increasing profit taxes. Since major banks are in foreign hands, the state has no direct control over credit allocation. For Hungary, as a small country with an open economy, the free flow of resources may substantially assist in the improvement of the allocative efficiency of the market.

The restructuring of the banking sector has taken place gradually. The whole process covered 18 banks altogether. Three big ones participated in all stages, seven in two, and eight banks in one phase only. This gradualism roughly corresponds to the Hungarian tradition. Nevertheless, in this special case, gradualism was not efficient. If banks had started their restructuring in 1992–93, the transformation of the banking sector would perhaps have been cheaper. Many authors argue that the stock problem was dominant, and the deterioration of the portfolio of the banks was a consequence of external economic or political factors, or it can be explained by changes in the system of regulation. According to Balassa (1995) the cost of the credit and bank conciliation could have been, in an optimal case, 20–25 percent lower. The lengthy multi-stage procedure is also now considered as a main reason for the high expenses. Without the consecutive stages, the moral hazard of various agents, especially commercial bankers and firm managers, could have been avoided. When some details of the debtor consolidation programme for businesses became known in the autumn of 1993, firms started to stop servicing their debts. In the case of the MHB the end of the year the interest payment and bank fee arrears of debtors had increased by fifty percent, compared to the end of 1992. According to some anecdotal evidence fraud at banks could not be excluded either. According to a report of a large SOCB prepared in early 1994, the loss in the whole banking sector due to fraud could amount to HUF 20 billion. These costs, being not properly identified, could not be excluded either.

Bond financing of these schemes was not the best choice either. Probably for political reasons, the interest payments on consolidation bonds started only in the spring of 1994 (when the mandate of the conservative government expired). Between 1994 and 1996 the MoF paid out interest of HUF 54.47 bn, HUF 96.61 bn and HUF 78.04 bn, respectively, on consolidation bonds.

The rules of the game matter a great deal. Regulation plays an important role. As most of the decisions were made by the Ministry of Finance, the fiscal considerations dominated the whole process. As *Tirole* (1994) and *Dixit* (1996) point out, in the case of multitask agency problems, the control of public enterprises (in our case SOCBs) can best be performed if multiple principals with different objectives are created. In this situation, as has been shown, external discipline, competition or transparency may also help in overcoming difficulties. When, under external pressure, the Banking Act and various elements of prudential regulation were introduced, the SBS gained more ground and could at least, to some extent, counterbalance the interest of other government agencies, even if the SBS did not perform perfectly.

On the other hand it was, in our opinion, a mistake to adopt BIS rules gradually. Moreover, the eight percent CAR for banks as a criterion for prudential operation became a fetish. For the government, this view could simplify bank restructuring to a one-dimensional issue which was relatively easy to handle. Nonetheless, the failure of small banks after their recapitalisation clearly shows that it is not true that below eight percent CAR everything is wrong and over eight percent CAR everything is fine. Dewatripont and Tirole (1994) treat comprehensively the problem of banking regulation, although in a different set-up. However, the practice of the Hungarian government corresponded to one of their findings. In macroeconomic recessions aggregate shocks may hit every bank simultaneously and therefore a temporary waiver of the eight percent CAR requirement can be advantageous.

The Hungarian banking sector has gone through significant changes. In many respects success has been achieved, but the bill has also been sizeable. Hungarian firms use less bank credit than their counterparts in other countries. This clearly shows that inflation should have been and still must be taken more seriously. Nonetheless, banks are supposed to, and hopefully, as a result of the consolidation measures, will take an active part in financing the economy in the future.

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