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How the Hungarian State-owned Banks were Privatised

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Abstract

Hungary was the first transition economy to complete the process of privatisating state banks. This article outlines this process in the light of the economic and financial pressures after 1989, which had severely weakened the financial condition of these banks. It describes the ways in which bank balance sheets were consolidated by state-underwritten loan write-offs and injections of capital within a new legislative framework. The main privatisations are described in a set of mini-case studies. The process was effectively complete by end-1997. The EBRD was closely involved as adviser and investor, significant revenue was generated for the state (albeit much lower than the consolidation support required), foreign strategic investors were attracted and no major financial institution had to be liquidated. Despite the attendant controversy and scandal, the Hungarian experience offers useful lessons to other transition economies which have yet to seriously address this issue.

Introduction

With the exception of the notorious Postabank, 'the privatisation of state-owned banks was practically completed in 1997 in Hungary' (MNB, 1998). Along with Postabank, only three other banks remained in state hands by the end of 1997—the Hungarian Investment and Development Bank (MFB), Eximbank, a foreign trade financing bank, and Jelzalogbank, a small mortgage bank. These four accounted for respectively 6.54%, 2.87%, 0.66% and 0.06% (total 10.13%) of banking system assets. In addition, the state still retained minority stakes in certain partially privatised banks, making a total state interest in the banking system of around 20%.

Like most privatisation programmes, the process was neither smooth nor free from controversy. Yet by the end of 1997, a clutch of former state-owned banks, several of which had been widely thought unsaleable, were vigorously competing for business, and service levels were rapidly improving. While the income generated by the state was miniscule, and outweighed many times over by the assistance required from public finances, the original mission of transferring the state banks to the private sector was accomplished well in advance of other countries in the region.

This article examines the bank privatisation process to assess its efficacy and also to allow informed speculation about the future development of the banking system. Initially, we briefly consider the strategy adopted by the Hungarian authorities in the

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light of the difficulties and weaknesses of the state-owned banks in the early stages of economic transition, and then examine the essential task of restructuring bank balance sheets, severely damaged by the transition process.

The centrepiece of the article describes each of the main privatisations to highlight the variety of methods applied, as dictated by differences in bank circumstances and prevailing financial conditions.

Pre-privatisation Developments in the Hungarian Banking System

Until 1987, the banking system was effectively a 'monobank' one, dominated by the Magyar Nemzeti Bank, the National Bank of Hungary (MNB). Its main roles were, first, to organise state funding, in which a network of savings banks, the largest being Orszagos Takarekpenztar (OTP), performed the role of collecting retail deposits, and, second, to manage the accounts of state-owned enterprises. As in other centrally planned economies, lending decisions were influenced more by political factors than by notions of opportunity cost of capital and ability to repay.

From 1979, a degree of participation by foreign banks had been permitted, with the establishment of Central European International Bank (CIB), a joint venture involving the MNB, with a 34% stake, and a consortium of six foreign banks, each with 11% shares. This was the first bank established in the region with majority foreign ownership. CIB was initially set up as an off-shore banking operation dealing only with convertible currency-denominated foreign trade transactions, e.g. handling foreign trade payments and providing export finance. It was excluded from any dealing in the Hungarian forint (HUF), although subsequently it was permitted to trade in state-backed securities. In 1988, it established an on-shore subsidiary, Central European Credit Bank, an orthodox commercial bank which mainly served large corporate customers but also participated in state funding. (In 1994, the two arms merged to form CIB Hungaria Bank. In 1997, in one of the last privatisations, the Italian co-owner, Banca Commerciale Italia (BCI), bought out the other parties including MNB, excepting a 5% stake retained by the Long Term Credit Bank of Japan, which wished to maintain a presence in Hungary).

Meanwhile, the whole banking system was undergoing major transformation. In 1987, while retaining its macroeconomic functions, the MNB relinquished its lending role (apart from to the government) to create a two-tier banking system, separating the central and commercial banking functions. The MNB's loan portfolio was hived off to three large newly created banks. The bulk of the commercial component was allocated to Magyar Hitel Bank (MHB). MHB's new clients included a high proportion of companies now increasingly unable to compete owing to the ending of Soviet hegemony in the region and the consequent loss of guaranteed markets.

The agrarian and food-processing sector was assigned to Kereskedelmi es Hitel Bank (Commercial and Credit Bank) and the energy sector to Budapest Bank, which also received a string of retail outlets. At this time, commercial banking licences were also awarded to the Hungarian foreign trade bank (MKB) and Altalanos Ertekforgalmi Bank (AEB). In addition, institutions that collected household deposits were established as savings banks, and permitted to lend to households as well as take deposits. More foreign banks were also allowed entry, the first new-comers being Citibank, the first joint-venture *onshore* bank, in 1986 (thus predating the official reform of the system) and the Austrian Unicbank. Initially, at least, the foreign banks tended to specialise in meeting the banking needs of multinationals which traded with Hungarian companies, and their local subsidiaries.

At first, the new commercial banks were allowed only to provide finance for companies and to provide settlement services but not to undertake lending to private individuals or engage in foreign exchange dealings. From 1988, the banks became licensed to perform banking services for individuals and to undertake trade-related foreign exchange transactions. Prior to privatisation, four types of bank were allowed to operate in Hungary:

- commercial banks—offering a comprehensive range of services,
- specialised financial institutions—dealing with particular aspects of banking,
- investment banks—focusing on long-term project financing,
- savings banks—providing personal banking services.

A variety of new institutions were set up, some with state participation, generally as subsidiaries of the large banks, until by 1993, the number of banks exceeded 40, of which more than 20 had been established with foreign participation.

As transition towards a market economy progressed, the loan portfolio of the state-owned banks markedly deteriorated in quality. This was due to several factors. The near-collapse of intra-regional trade, the relaxation of price controls, the liberalisation of external trading relationships and the pressure on state expenditure budgets combined to stop many existing loans from performing, while new lending became more difficult to evaluate. The situation was aggravated in Hungary by official pressure on banks to lend to the now politically-favoured entrepreneurial class, which was expected to spearhead the transition to a market economy. Many loans were inadequately risk-screened and, indeed, it was doubtful whether banking personnel, trained under a socialist system, were appropriately qualified to perform this function. As a result of this combination of economic deterioration and poor quality lending, the capital adequacy of many state banks fell well below the standards set under the Basle Accord of 1988, requiring extensive and expensive capital restructuring of bank balance sheets before privatisation could proceed.

The New Legal Framework for Privatisation

According to the European Bank for Reconstruction and Development (EBRD), ‘the keys to successful and enduring bank privatisations are both high-quality strategic investors and an effective framework of prudential regulation and supervision’ (1995, p. 159). In 1990, the Hungarian banking system had neither—the first task was to establish the latter.

A limited degree of resource allocation by market principles had been permitted since 1968, so private ownership was not a new concept in Hungary. Although this obviated the need for sudden ‘shock therapy’, a framework of law had to be established. In July 1990, the Law on Privatisation set up the State Property Agency (the SPA or AVU) to manage the privatisation of the greater part of Hungary’s industrial and commercial sectors. Its task was to hold legal title to some 2200 state enterprises and to supervise their transformation into corporate entities and eventually their privatisation. Meanwhile, enterprises would be managed by the State Property Management Company. To assist the SPA, the Hungarian Investment and Development Company (MFB) was established.

In June 1995, a new Privatisation Law merged the two main privatisation agencies into the APV Rt (Privatisation and State Holding Company). Under this law, the state was to retain full ownership of some 50 companies and minority ownership of certain banks. Although the APV was nominally responsible for the overall process, bank privatisation was supervised by the Ministry of Finance, ostensibly for two reasons:

(i) Consolidation of bank balance sheets, an essential pre-condition for privatisation, was supervised by the ministry, which, having compiled substantial data on the banking system and its components, was well-placed to conduct the secondary process of privatisation.

(ii) As relevant supervisory agency, the ministry was responsible for overseeing the health of the whole sector; hence, it was thought appropriate to concentrate all these activities in view of the strategic implications for developing the whole system.

The next task was to restructure the existing banks or 'bank consolidation'.

Descent into Crisis

Prior to privatisation, the state-owned banks exhibited several common problems:

1. *High and increasing levels of bad debt, largely inherited from the MNB*. The new commercial banks, spawned by the MNB in 1987, inherited its portfolio, sprinkled with numerous 'time bombs' in the form of loans for obsolete state-owned giants. The banks could not have called in these loans without incurring enormous losses. Besides, the undercapitalisation of the banks prevented substantial debt write-offs. Instead, as banks injected further funds into these firms, the operation of compound interest caused a sharp accumulation of such loans, some of them forced by the state, which could not tolerate mass liquidation in view of the employment implications. State finances even benefited from this situation. Increases in company bad debts increased default interest, which was treated as revenue, thus enhancing reported earnings, enabling higher dividends and tax income for the state.
2. *Inadequate credit risk management and control*. Commercial lending based on market principles was a new profession in Hungary. Training of bank operatives was poor and the lack of appropriate internal controls allowed agency problems to emerge. Several bank executives were indicted for fraud and corruption, but the ensuing court cases appeared to be only the tip of the iceberg. Hence, unwise and often corrupt lending decisions aggravated the 'natural' increase in bad debt.
3. *Low operating efficiency*. Banks' organisational structures were bureaucratic and hierarchical, overloaded with excessive staffing and other costs.
4. *Weak customer orientation and poor understanding of sales and marketing principles* (*BCE*, 1995/96).

When established, the new commercial banks were seriously undercapitalised, as suggested by some of their security ratios,[1] i.e. equity/total assets, as at the end of 1991 (see Table 1). Had the Basle risk assets ratio of capital adequacy definition[2] been in force, their positions would have appeared far worse, as the denominators of their ratios would have been risk-adjusted according to the risk weights recommended in the Basle Accord (with this formula, the higher the risk associated with an asset, the greater the weight the asset receives).

The parlous condition of the Hungarian state-owned banks became more starkly apparent in 1992, with the implementation of three new laws enacted during 1991 to incorporate accepted EC standards.

Table 1. Bank security ratios at year-end 1991

Bank	Security Ratio in %
Nomura Magyar Befektetési Bank	100.00
Portfolio Bank	71.86
Investbank*	43.75
Corvinbank*	38.03
Merkantil Bank*	33.94
Európai Kereskedelmi Bank	21.93
Dunabank*	17.39
Inter-Európa Bank	17.25
Innofinance*	16.68
Leumi Hitel Bank*	12.58
Reálbank*	12.19
Citibank Budapest	11.51
Konzumbank*	10.47
Kereskedelmi Bank* (later K&H)	10.03
Magyar Hitel Bank (MHB, later ABN-Amro)	9.85
Unicbank	9.29
Mezóbank*	9.18
Közép-Európai Nemzetközi Bank (CIB)	8.29
Altalános Értékforgalmi Bank*	8.12
Budapest Bank*	7.88
Agrobank*	7.81
Közép-Európai Hitel Bank	7.10
Magyar Külkereskedelmi Bank (MKB)*	6.79
Ibusz Bank*	6.33
Postabank és Takarékpénztár*	6.00
Országos Takarékpénztár (OTP)	4.52
Takarékbank	4.27

Note: *Banks in which the state held a stake of over 50%, either directly or indirectly.

(i) The Law on Bankruptcy obliged distressed firms to declare technical insolvency, and to file for full bankruptcy should this persist more than 90 days. As the new legislation came into effect on 1 January, companies could not be liquidated before 1 April because of this ‘breathing space’. Some 2000 companies filed for bankruptcy in the first few months of operation of this legislation.

(ii) The Accounting Law obliged all firms to apply greater prudence in preparing their accounts and to provide for bad debts following adoption of the European accounting directives.

(iii) The Law on Financial Institutions of December 1991 set out the aims of bank reform. Within the framework of a privatisation programme, the process was designed to improve ownership structures, strengthen financial structure and improve technology, possibly with the involvement of foreign capital. State ownership of banks was projected to fall to 25% by January 1997 (except for OTP and Postabank, where it was intended to remain at 50% and 20% respectively). The law established the State Supervisory Commission and determined its tasks and responsibilities. Most critically, as part of this transformation, the law obliged banks to create provisions for bad debts (previously at the bank’s discretion), and contained several requirements restricting the scope of bank activity, e.g. it stipulated a maximum (25%)

Table 2. Categories of loan with recommended provisions

Class of debt	Provision percentage	Description
Problem-free	0	Less than 15 days in arrears
To monitor	0–10	More than 15 days in arrears
Sub-standard	11–30	Risk of default is above average
Doubtful	31–70	More than 90 days in arrears, with size of loss unpredictable
Bad	71–100	Size of loss likely to be over 70% of loan

exposure to individual clients, and obliged them to operate the business with due care and diligence. Banks were also prevented from dealing in their own names in insurance and brokerage activities.

Minimum subscribed capital requirements for commercial banks were set at one billion HUF, at least half to be in cash form (subsequently revised in 1996 by the Law on Credit Institutions to two billion HUF with half to be in cash). The capital adequacy ratio (guaranteed capital divided by risk-adjusted balance sheet) had to reach at least 8% in accordance with the Basle standards. Later, the State Supervisory Commission specified classes of loans and gave guidelines on how to create provisions. Its Order 3/1993 established the five categories of loan shown in Table 2 according to length of payment arrears. The last four are termed 'qualified debt'.

Once the state-owned banks began to provision along these guidelines, depressing their equity and raising the risk-adjusted asset base, the full gravity of their bad debt exposure was revealed, and the desperate need for substantial balance sheet restructuring was accepted. By the end of 1992, doubtful and bad loans were reported at 20.7% of all loans, compared with 9% at the end of 1991. This ratio was to rise to 43% by the end of 1993, before receding to 30% in 1994.

Restructuring the Banks

The EBRD (1995) identified two broad approaches to bank restructuring. The first, the 'comprehensive approach', aims at full recapitalisation of banks, resolution of bad loans and commitment to privatisation. Loan losses are ascertained by independent audit and recapitalisation is designed to restore capital adequacy after writing down these loans. It may also include a bad loan work-out process involving close negotiation between creditors and debtors or through legal proceedings. Typically, it offers managers the prospect of participation in privatisation following a successful turnround.

The second approach, the 'quick break', aims at a clean break with the past by limiting compensation for loan losses to those associated in some way with the previous regime. The restriction on types of loan qualifying for relief may be applied in the form of a cut-off date beyond which loan losses are ineligible, or limitation to certain types of loan, e.g. those made for particular purposes. Any other losses would have to be made good out of earnings or capital. A simple method, it places more onus on the banks themselves and is likely to result in a greater rate of bank insolvency.

Restructuring, or 'consolidation', was applied in several stages, but in two main waves, and although most closely resembling the comprehensive approach, initially involved only partial recapitalisation. Partial recapitalisation, as well as undermining the credibility of the state's commitment, poses risks of moral hazard as bank managers may continue to take excessive risks, gambling on the eventual pay-offs from privatisation (EBRD, 1995).

By mid-1992, several state banks were in major difficulties, and consolidation was begun with some urgency. It was to take three forms:

1. *Credit consolidation*, which involved replacing bad debt by long-dated (20 years) treasury bonds with a variable interest rate, linked to the treasury bill yield of the previous quarter.
2. *Bank consolidation*, which required the recapitalisation of the banks by the state in the form of common stock or subordinated loan capital.
3. *Debtor consolidation*, which endowed capital directly to banks' debtors to improve their financial condition preparatory to their own privatisations.

The first wave of consolidation, in 1992, was a 'hastily-arranged bailout' (EBRD, 1995). This covered banks with a capital adequacy ratio below 7.25%, which were allowed to transfer non-performing loans to the government in exchange for 'Loan Consolidation Bonds'. These securities carried a floating inflation-linked interest rate and had a 20-year maturity. The government determined which loans were non-performing, applying a scale of discounts against these loans. Hence, not all bad loans were exchanged at face value. In this process, some 105 billion HUF of bad debts were swapped for 80 billion HUF of government bonds (Dijkstra, 1997).

The legislative background of this process was flimsy. The Budget Act of 1994 empowered the government to issue Consolidation Bonds, but no limitations nor conditions were mentioned. The details of the process were thus effectively regulated not by statute but by government order.

As the stricter prudential regulations came into force during 1992–93, and as banks made greater provisions, it was clear that a second wave of consolidation was necessary both to assist firms and to inject capital into banks to attempt to raise their capital ratios. The authorities probably had been expecting this, but were also concerned to spread the consolidation burden imposed on the weakening state finances over a longer period.

In March 1993, under the Bank Consolidation Act, this second wave aimed to raise banks' capital ratios up to the 8% Basle standard in three stages—from an estimated minus 15% (*BCE*, 1995/96) to zero by December 1993, then to 4% by May 1994, and then up to 8% by December 1994. The capital increase was effected by state purchase of newly-issued shares with Consolidation Bonds. The capital of eight of the banks was raised by some 100 billion HUF, equivalent to around 3% of GDP. The two main beneficiaries were MHB and K & H, which together accounted for three-quarters of the recapitalisation (Zsuzsa, 1995).

This was not one-way traffic. In exchange for ongoing assistance, banks were obliged to commit themselves to devising staff training schemes and programmes to modernise operating systems to prepare for privatisation. This recapitalisation was followed by two smaller ones, each amounting to about half a per cent of GDP. As a pre-condition of the May 1994 recapitalisation, each bank was obliged to submit the consolidation programme to which it had committed itself in December 1993. Again, this was not a formality. Banks whose programmes did not meet the set requirements were obliged to accept delays in their recapitalisations.

Among the solutions to solving banks' problems were:

1. *Improvements in capital adequacy in various ways*. The banks could try to increase their equity bases by making and retaining profit or raising capital from external sources. Restrained lending, and investment in state securities rather than risky assets, would decrease the denominator of the capital adequacy ratio.
2. *Hiving off bad debt into special 'work-out' firms*. These were financed by newly-issued bonds to back their doubtful loans, usually with a state guarantee. This technique, called '*tritrization*', involves stripping out the most risky debt into a separate bond-financed company. Thus, the new company could focus on managing the risky debt, while the core of the bank could handle the healthy part, which could then be more easily privatised. Zsigmond Jarai, then head of MHB bank, described this process as 'effectively creating two banks, a good one and a bad one. We put all our equity stakes in defaulting companies into the bad bank in order to liquidate them' (Currie, 1997). Most state banks formed such companies—Budapest Bank formed 2B Ltd, K & H and Mezobank jointly set up Kvantumbank, and MHB established Risk Ltd.
3. *Centralisation of credit decisions and application of new, more rigorous debtor classifications*. As a result, some banks lost market share—in particular, Magyar Hitel Bank's 50% share of corporate lending dropped to 7%. The fall in market share was due not only to calculated withdrawal but was also the consequence of the aggressive strategy of newly-entered foreign-owned banks, which focused their marketing efforts on the most profitable segment of the market, the quality end of the corporate sector.

Table 3 shows expenditure over 1992–94 in various ways on rescuing banks. Of the total figure, 43% was in the form of equity capital increases, 10% as subordinated loans, 31% as credit consolidation and 16% as debtor consolidation. Supplementary amounts were received by the Budapest Bank (12 billion HUF), MHB (11 billion HUF) and MKB (3.2 billion HUF) at various times after 1994. Including these, the total expended by the state was some 360 billion HUF, equivalent to around 8% of GDP (EBRD, 1997). Thanks to these huge subsidies, no major bank was bankrupted during this process. The financial sector was thus able to preserve depositors' confidence and also to reassure the foreign investors who brought into Hungary the highest capital inflow per head of any country in the region (EBRD, 1998).

The authorities were now aware that, despite lingering desires to retain Hungarian ownership, the only viable way to privatise most of these banks was to invite strategic investors to make substantial capital injections and to undertake necessary modernisation of systems and procedures. A strategic investor takes either a majority or an 'influential' stake (more than 25%) if the ownership is diffused. It makes a long-term commitment to the company and determines strategic decision-making. Conversely, a financial investor takes only a minority stake, generally makes only a short-term commitment in pursuit of capital appreciation and is not involved in strategic decisions.

Strategic investors offer many advantages:

1. Local banks can mobilise the investor's technical expertise and systems.
2. Firmer control by a strategic investor will reduce agency difficulties, improving lending decisions.
3. Injections of new capital solve problems of capital adequacy, and provide finance for modernising information systems and developing new products.
4. Under the aegis of the strategic investor, the bank's improved credit rating will

Table 3. Expenditure on consolidation 1992–1994 (million HUF)

Bank	Credit consolidation	Debtor consolidation	Capital increase	Subordinate loans	Total
OTP	6 473	133	5 000	5 000	16 606
MKB	14 500	2 034	–	–	16 534
MHB	30 135	29 086	58 820	5 891	123 932
K & H	9 549	3 954	38 373	4 714	56 590
Budapest Bank	11 857	2 666	9 649	3 861	28 033
Postabank	–	13 322	–	–	13 322
ÁÉB	1 541	311	–	–	1 852
WestLB*	2 709	62	–	–	2 771
Konzumbank	10 383	2 009	–	–	12 392
Takarékbank	1 724	276	10 150	537	12 687
Mezobank	4 961	28	14 857	1 000	20 846
Polgári	2 628	–	–	–	2 628
Dunabank	484	–	4 807	–	5 291
Iparbankház	4 719	–	800	–	5 519
Others	2 655	–	1 841	10 459	14 955
Total	104 318	53 881	144 297	31 462	333 958

Note: *WestLandesBank acquired the former state bank Altalanos Vallalkozasi Bank (AVB)—the General Bank of Venture Financing.

Source: *Világgazdaság*, 7 June 1995.

give access to international financial markets, allowing borrowing via syndicated bond issues.

The Ministry of Finance initially expressed its preference after the bail-out for selling sizeable minority stakes to strategic partners and then offering shares to small investors on the stock market, eventually allowing strategic investors to assume majority positions. In this way, a degree of local ownership would be preserved while the benefits of having a strategic partner would be exploited. Not all privatisations were to follow this route and some had to be assisted by the EBRD. Official preference for the 'financial' option was probably connected with evidence that the newly-entered foreign and joint-venture banks were already engaging mainly in short-term lending, implying their main concern was for a quick return.

The state banks earmarked for early privatisation were the three giants carved out from the MNB in 1987, the Budapest Bank, K & H and MHB, and also OTP, the dominant player in the household savings deposit market. As shown below, all but two banks, OTP and Penzinteseti Kozpont Bank (PKB), were eventually sold to strategic investors.

Strategy in Action: the Main Privatisations

Magyar Kulkereskedelmi Bank (MKB), Hungarian Foreign Trade Bank

The first privatisation involved the Hungarian Foreign Trade Bank, MKB, established in 1950 to finance foreign trade. In 1987, when the two-tier banking system was introduced, it was licensed to operate as a full-service commercial bank, catering for multinationals, joint ventures and blue chip Hungarian companies. However, it continued to serve previous customers so as to retain a foreign trade profile. As it was not heavily involved in financing the industrial sector, the transition crisis that followed implementation of the banking and bankruptcy reforms had little adverse impact on it and its capital adequacy ratio was healthy in 1991. Although not deemed to be in need of equity capital injection, it was given a measure of assistance by credit consolidation in acknowledgement of its bad loan inheritance. Not surprisingly, it was the only bank considered able to attract foreign investors in the near term and was, therefore, the earliest candidate for sale.

Privatisation of MKB began in 1993. In a first stage, a small parcel of shares, with a book value of 348 million HUF, representing 2% of the share capital, was offered in exchange for Compensation Coupons[3] in the ratio of two coupons per share, but demand was low. Effective privatisation occurred in 1994, following a minor debtor consolidation. MKB was sold by closed tender involving only one strategic investor, Bayerische Landesbank (BL), in April 1994. BL was unable to take on the full commitment required to reduce state ownership to 25%, but was assisted in diluting the state's holding by the EBRD, which had, in June 1993, already supported an international bond issue by MKB in tandem with BL itself. A feature of the lengthy bidding process was the initial refusal by the Hungarian authorities to allow access to MKB's loan portfolio, a stance which threatened to jeopardise the deal (*BCE*, 1994).

BL eventually bought a 15% share, and EBRD 10%, at 1.25 times nominal value, yielding one billion HUF. In May 1994, the two investors raised MKB's capital by two billion HUF at the same ratio, taking BL's stake to 25% and that of EBRD to 17%. The appeal of MKB for Bayerische was its expertise in trade finance and its contacts and clients in Hungary and the surrounding region, while EBRD was attracted by its potential as a co-financer of major infrastructure projects (*BCE*, 1994). BL also undertook, in the event of MKB making profits in 1994 and 1995, to pay a premium for injecting further capital to raise its equity. In return for this pledge, the APV paid 3.2 billion HUF for two bad debts, although MKB appeared financially sound, having a capital adequacy ratio well above 8% by this time. A year later, the German Investment and Development Bank (DEG) took an 8% share in MKB by buying shares directly from the MKB itself, which had bought these in the OTC market. After privatisation, MKB's profits sharply increased from 487 million HUF in 1994 to 2.6 billion HUF in 1995 and its capital adequacy ratio reached 19% in 1996. In 1996, Bayerische Landesbank purchased a further 25% share from the APV at 2.2 times nominal value to take its ownership to 65% (Mihalyi, 1998).

Orszagos Takarekpenztar (OTP), National Savings Bank

OTP was established in 1949 as the monopoly collector of retail deposits. By 1991, it accounted for 32% of the assets of the banking system, more than twice those of the second-ranked bank, although its security ratio was under 5%. By 1997, it was still the largest bank in Hungary in terms of both total assets and after-tax earnings. Its appeal to a potential buyer was its dominance in the household sector, served by a network of around 380 branches, four times that of the nearest competitor, making it an ideal springboard for extension into other products. It also enjoyed a near monopoly (95%) of the municipal banking sector, a market vastly more stable and profitable than corporate lending.

In 1988, it became licensed to conduct the full range of banking activities, and in 1990, it became a joint-stock company, initially with the state holding 100% of the capital. It established eight subsidiaries to provide specialist financial services including leasing, real estate, fund management and bancassurance. A measure of its success was that, by 1997, despite powerful competition from foreign-owned banks, it became the leader in corporate lending with a 14% market share.

Owing to OTP's importance in the banking system, successive governments declared a wish to keep it in Hungarian hands. Armed with a major stake in OTP, a strategic investor might dominate the banking and financial system to the potential disadvantage of the Hungarian economy. Privatisation of OTP was thus a politically sensitive issue and a matter of fierce debate, especially over whether it should be sold to financial or strategic investors.

The Finance Ministry, influenced by lobbying from OTP executives, initially supported the 'financial' option. Reasons given against seeking strategic buyers were:

1. As OTP's capital adequacy was now acceptable, it needed no capital injection.
2. With OTP performing acceptably, and making profits, it was doubtful whether its management needed external assistance. It already provided a wide range of financial services, suggesting little need of injections of expertise to assist commercial development.
3. The information disclosure requirements of the Budapest Stock Exchange, along with the proposed state Golden Share, conferring a veto on decisions involving the public interest, would exert effective controls on management.
4. It would be undesirable to allow the strategic decision-making of OTP, the largest bank in Hungary, and dominant in the household financial markets, to be controlled by a foreign investor. A possible capital withdrawal could undermine the whole financial system.
5. Its high profile among the population would make its shares attractive to a wide cross-section of small investors, avoiding an expensive promotion campaign.

In view of its size, consolidation expenditure on OTP was relatively modest—16.6 billion HUF in the form of credit consolidation, capital increase and subordinated loans, in roughly equal proportions. In 1993–94, the State Holding Company distributed 17% of the shares for Compensation Coupons in several stages, and in early 1995, 10% blocks of shares were transferred to each of two social security agencies, the State Pension Fund and the State Health Fund.

By the end of 1994, OTP could claim two years' solid progress. Compared with 1993, it had achieved the following:

- Total assets up to 939 billion HUF from 831 billion.
- Pre-tax profit up from 1.2 billion HUF to almost 10 billion.
- Retained profit up from zero to 400 million HUF.
- Doubtful loans, in relation to risk-weighted assets, down from 23.4% to 19.5%.
- Capital adequacy up from 12.3% to 15.5%.

Yet controversy was not far away. In spring 1995, the new Minister of Finance, Lajos Bokros, former head of Budapest Bank, declared his preference for selling to a strategic investor. He ordered the separation of the functions of chairman and CEO of the bank, thus weakening the position of the current bank head, Sandor Csányi. But in a subsequent, and several times delayed, general meeting called to debate this issue, the Ministry of Finance was unable to vote owing to a procedural oddity. Its share-holding had no tangible form (i.e. no printed share certificate existed), a statutory condition for exercising voting rights under the Corporate Law enacted in 1985. The two social insurance agencies voted against a sale to strategic investors, allowing OTP to be sold to financial investors.

Certain restrictions were included in the privatisation arrangements. No foreigner could own more than 5% of OTP, and no Hungarian could own more than 10%. Total foreign ownership was to be limited to 49%, to preclude the emergence of a dominant foreign strategic investor post-privatisation, and the state would retain 25% plus a blocking Golden Share. Meanwhile, pressure was building for a sale in order to get the privatisation programme back on track, not least to contribute to weakening state finances. This occurred in four further stages.

First, in July 1995, a consortium lead-managed by Creditanstalt and Schroders sold 20% (5.6 million) of the shares abroad by a private placement. The issue price was $9.50 (1200 HUF), with a 50% over-subscription. Second, 1.4 million shares (about 5%) were distributed free among the bank's employees. Third, 8.4% were sold through the open market for 1200 HUF per share in an introduction to the Budapest Stock Exchange. They proved to be a sound investment during 1995–97 as the price increased to over 6000 HUF. Fourth, in October 1997, after cancellation of the obligation that a 25% share should be retained by the state, the remaining 25% were sold by open quotation at an issue price of 6010 HUF, raising a total of $213 million. Reflecting OTP's successful management, the share price peaked at over 12 000 HUF (Mihalyi, 1998).

Of all the bank privatisations, that of OTP generated the highest proceeds for the state exchequer (see Table 5). Despite Stock Exchange restrictions, its management has withstood the powerful competition emerging in the Hungarian financial markets, so far resisting the substantial loss in market share widely predicted for it.

Budapest Bank (BB)

Budapest Bank, the smallest of the three commercial banks established in 1987 by the MNB, was formed from branches of the former Budapest Credit Bank and the Budapest branches of the National Bank when the two-tier bank system was introduced. Originally, it was assigned the energy sector but, like its fellow banks, it rapidly extended its activities into other sectors, including private enterprise lending, leasing and brokerage. Under the dynamic Lajos Bokros, it spent heavily on introducing new technology such as ATMs and new products. Owing to its relatively small size and portfolio of relatively low-risk clients, it was the first among the large state-owned commercial banks selected for privatisation. A swift sale was urged by Bokros, who saw a successful privatisation as a fitting end to his tenure as head of the bank. In 1991, it became the first of the large banks to start making provisions against bad debts, over a year before the main consolidations began. During the consolidations of 1992–94, BB received the third largest subsidy, partly necessitated by the legacy of bad debt bequeathed by the MNB in 1987.

Privatisation discussions began in mid-1994. To enhance its attractiveness, BB's equity was raised from 2.8 billion HUF to 20.1 billion HUF. This was in the form of real estate '*apport*' (contribution in kind) comprising the Head Office, located on a prime site in the heart of Budapest. Yet three potential strategic buyers walked away from the business. Crédit Suisse examined the bank's portfolio over several months and then unexpectedly withdrew. Nor did the deal impress ING of Holland and Allied Irish Bank. Possible reasons for this breakdown included:

1. BB was less sound than its chairman claimed. This view was given credence when, prior to the final sale, the state had to inject a substantial amount of capital (12 billion HUF) and to provide the eventual buyer with strong guarantees. When consolidated, BB underestimated the amount of qualified debt and, even after consolidation, new sources of loss emerged.

2. The macroeconomic environment was also distinctly unattractive. For electoral reasons, the government was committed to an expansionary fiscal policy, causing a current account deficit reaching 10% of GDP in 1993 and 13% in 1994, an all-time peak in Hungarian economic history. The new government had to apply the brakes, but the likely success of its stabilisation policy was still doubtful in 1995.
3. At the end of 1994, the Mexican peso crisis alarmed potential investors in emerging markets.

Realising the need to stimulate interest in BB, at the end of 1994 the Ministry of Finance secretly recapitalised it by creating 12 billion HUF capital reserves in the form of treasury bonds redeemable after the privatisation or in one year, whichever was sooner. Without this injection, which caused acute embarrassment to the authorities when made public, the value of the equity would have been negative.

Privatisation of BB occurred a year later, in December 1995. GE Capital, the banking arm of General Electric Corporation, took a 23% strategic share for 5.75 billion HUF. The EBRD, as financial investor, took a 25% share for 6.25 billion HUF, the total amount being about the same as the capital injection. The state retained a 22.8% stake.

The sale contract included four important guarantee clauses:

1. The state undertook to repurchase at book value loans granted before the end of June 1996 (six months after the contract date), up to a total of 8.2 billion HUF, a commitment linked to the value of the US dollar. Depreciation of the forint led to the state finally guaranteeing 11.3 billion HUF.
2. Should GE Capital be dissatisfied with its investment in BB, it could, at any time up to March 1999, exercise an option to convert its equity into a loan at an interest rate of LIBOR plus 3% (GE Capital yielded this right at the renegotiation of the privatisation contract a year later).
3. The state stood surety against any potential claims awarded against BB in the civil action it was currently defending.
4. GE Capital was given an option until 2001 to buy out the remaining state share at an exercise price equal to book value.

GE Capital thus obtained BB for the same amount as the state capital injection. Thus, it could be argued that it had effectively acquired BB for nothing. The attractiveness of the deal was further enhanced by the effective insulation from loss. GE took early advantage to trigger these guarantees when it sold back the Polgari Bank, a subsidiary specialising in providing banking facilities for wealthy private clients. Polgari, formerly the bankrupt Yb1 bank, acquired by BB in 1991, was found to be in a very weak financial condition, due to having extended high-risk loans and having high operating costs. After consolidation expenditure of 2.6 billion HUF, Polgari was absorbed by Penzintezeti Kozpont Bank (PKB), which incurred further expenditure on reorganisation, thus reducing its own attractiveness as a privatisation candidate (Mihalyi, 1998).

Magyar Hitel Bank (MHB), Hungarian Credit Bank

MHB was the largest of the three banks spun off from the MNB in 1987, and financed some 60% of total corporate lending. During 1987–92, MHB expanded its activities, remaining market leader in corporate lending, and was second, with 16%, to OTP by total assets. As other economies in the region declined, and its clients encountered severe repayment problems, MHB made extensive use of debt-equity swaps to restructure client debts, soon becoming the most distressed of the commercial banks, eventually receiving 37% of total consolidation expenditure, amounting to over 100 billion HUF. Resolution of its bad debt problems required 53% of total debtor consolidation, and capital injections into it accounted for 41% of the total. In 1993, it posted a loss of over 70 billion HUF and was effectively bankrupt.

Recapitalisation proceeded in stages. First, in 1993, its capital adequacy was increased to zero, then, in May 1994, to 4% and in December 1994, to the legally prescribed 8%, using Consolidation Bond funding to enable bad loan write-offs. The nominal value of issued share capital was decreased from 74 billion HUF to 7.1 billion HUF, including 2.4 billion HUF in employee shares. Once bad debts and unprofitable investments in real estate were stripped out, MHB broke even in 1994 and made a modest profit in 1995.

Despite its problems, MHB represented one of the last opportunities for outside investors to enter the Hungarian market on a large scale—it operated a nationwide network of 70 branches, thus providing a ready platform for expansion into new services. Early interest was shown by Citibank, Bank of America and ING, all reportedly seeking a strong market presence as Hungary emerged as a serious candidate for eventual EU membership.

A new chairman, Zsigmond Jarai, arrived in 1995, briefed to prepare for privatisation. Some 140 equity stakes in a variety of failing enterprises were transferred to a work-out firm, staff were cut by 40%, including 80% of the senior management responsible for previous poor lending decisions. Jarai's efforts were not helped by the disclosure that MHB had engaged in guaranteeing finance for arms exports to Libya and Iraq, commitments which were eventually off-loaded to the APV.

Via a closed invited tender, 89% of the shares were offered, eliciting only two tenders—from Creditanstalt of Austria and the Dutch ABN-Amro Bank, which won with a bid worth $89 million, at some 222% of the nominal value. Of the balance of the shares, 5% were sold to employees at 111% of book value, then purchased by ABN at 222%, and some 6% went to assorted investors who were eventually bought out. The new owner injected capital of 29.4 billion HUF, making Amro Bank the largest in Hungary in terms of equity capitalisation. ABN's investment, including initial capital and loans, amounted to some $130 million, a considerable part of which was rapidly devoted to refurbishment of branches, improving information systems and training. ABN already operated a small branch in Hungary, founded in 1990, which was merged with MHB in early 1998 to form ABN Amro Magyar Bank, ABN's largest operation outside the Netherlands and the USA.

Takarekbank, Savings Bank

Takarékbank was established as the umbrella organisation for the 249 local credit cooperatives, which held 34% of the shares, with the state holding the 66% majority stake. It ranked 9th by size of assets in 1991, with 1.8% of system assets, but its (unadjusted) capital adequacy was poor at under 5%. Required consolidation expenditure amounted to 12.7 billion HUF, the greater part (over 10 billion HUF) being via an increase in capital. Following a huge loss of over 11 billion HUF in 1993, it made profits of 65 million HUF in 1994, 224 million in 1995 and around 500 million in 1996. The appeal of Takarekbank lay in its assets of some 2000 branches and a strong local deposit base, thus representing one of the few remaining opportunities for strategic investors to enter the Hungarian market (*BCE*, 1997).

Against this, the winner of the tender was obliged to give certain guarantees to the local cooperatives, which were to remain financially and legally independent. Five banks participated in a closed, two-round tender in April 1997—Caisse Nationale de Credit Agricole (France), Caisse Centrale Desjardins (Canada), the Austrian banks Osterreichische Volksbank and Giro Credit, and the German equivalent organisation, Deutsche Genossenchaft Bank (DGB). Only the last two made the second round of bidding, won by DGB with a tender of 4.4 billion HUF, equal to 532% of the nominal value of the equity. The process was completed in July 1997. Shortly after winning the tender, DGB announced plans for extensive refurbishment and training schemes for staff located at rural branches (*BCE*, 1997).

Kereskedelmi es Hitelbank (K & H), Commercial and Credit Bank

K & H was established as one of the three commercial banks at the birth of the two-tier banking system, to specialise in lending to agricultural concerns and to food-processing firms. It received the largest branch network among the newly established banks. In 1991, it ranked fourth by assets, and had nominal capital adequacy of 10%. However, collapsing traditional markets in the early 1990s seriously affected K & H—it eventually required the second highest consolidation aid at 56.6 billion HUF, 68% in capital increase and 17% as credit consolidation. After consolidation, its management pursued an aggressive business policy which proved highly successful in holding market share and increasing earnings.

To prepare for privatisation, K & H's operations were restructured. The IBUSZ bank, one of its financial subsidiaries, was fully absorbed, and another, the Merkantil Bank, which dealt mainly in household lending and car leasing, was sold to OTP, the market leader in household business. Headcount was reduced from 5500 to 3500. After taking these measures, K & H improved both its profitability and its capital adequacy.

K & H was privatised in a closed, two-round invitation tender process, similar to that of Takarékbank, and won by a Belgian–Irish consortium comprising Kredietbank and Irish Life. In a complex bid, the consortium offered cash for only 10% of the shares, at a price of 567% of nominal value. It promptly undertook a capital increase of 6 billion HUF which gave it majority ownership. The EBRD was also involved as a financial investor, taking an 18% stake.

Its capital was increased at a 5% premium over book value, the minimum prescribed by law. On average, the consortium paid 1.5 times book value for the whole share package. This left the Belgian–Irish partners owning 47% of the bank, and the EBRD with 18%, while a 34% minority stake remained in state hands. This state holding (still above the legal maximum) comprised a direct stake of 4.5 billion HUF and an indirect holding via the social security department of 3.1 billion HUF. A stock market sale of the state holding, planned to follow the 1998 election, was delayed owing to market volatility. (Later, in 2000, Kredietbank bought out the Irish Life share.)

Mezobank (Meadowbank)/Agrobank

Mezobank was established to finance the agrarian sector in the late 1980s. In 1991, its capital adequacy stood below 8%, but it accounted for 2.5% of the banking system in terms of assets and was the 8th largest bank in the system. Under the consolidation programme, it received assistance of 20.8 billion HUF, 70% by way of equity increase.

In late 1995, Mezobank was merged with Agrobank. This followed the latter's temporary closure in May 1995 by the banking regulators, after the arrest of certain senior executives on charges of fraud and smuggling, and the disclosure that the bank's loan book contained an alarmingly high proportion of doubtful loans allegedly granted to cronies of the bank's executives. Although a relatively small number of depositors was affected, the episode undermined confidence in the banking system at a critical time in the privatisation process following the revelations of secret subsidies to Budapest Bank and with several large banks still to be sold. The solution was thus to merge Agrobank with a relatively low profile bank which served a similar market.

As the capital base declined due to provisioning, the capital adequacy of the merged bank fell well short of the minimum, thus requiring recapitalisation. The Ministry of Finance contributed 9 billion HUF in state bonds. In exchange for this, the board was obliged to take firmer control to turn the bank around. Headcount was reduced by 600 to 1200, 23 branches were closed and bad debts of some 20 billion HUF were sold in order to create the general reserves prescribed by law.

Despite the attraction of the 60 remaining branches, only two applicants, both Austrian, Raiffeisen Unicbank and Giro Credit, submitted tenders. The latter won the tender, buying 88.7% of the shares with a price of 172% of nominal value. The consideration involved an outright payment of $25 million (5 billion HUF) and an undertaking to inject fresh capital of $20 million. Before the sale was finalised, Giro Credit was taken over by Erste Bank (also Austrian), which eventually completed the deal. In 1998, Erste renamed this subsidiary Erste Bank Investment Hungary.

Penzintezeti Kozpont Bank (PKB), Financial Institution Centre

Although a relatively small institution (ranking only 27th in terms of total assets in 1997—around 28 million HUF, just 0.51% of the whole system), PKB deserves separate mention for three reasons. First, it was the second of only two sales to financial investors—after OTP, second, it was the last piece in the privatisation jigsaw, with the exception of the maverick Postabank, and third, it required no consolidation expenditure.

PKB was established in 1916 to monitor the overall financial system. From 1945, it was given the role of providing current account facilities for non-residents wanting to open bank accounts in Hungary, including foreign banks, prevented until 1979 from opening branches in Hungary. It obtained a commercial banking licence only in July 1995, when it took over the near-bankrupt Investbank, operated by MFB. Its capital was raised, its loan portfolio cleansed of the worst debts and its activities focused on foreign exchange operations. In October 1995, the APV gave it the role of 'banking doctor' to provide managerial assistance and advice to other banks in distress. It received the real estate assets of the liquidated Dunabank and Iparbankhaz, and in 1997, it was allocated Polgari Bank, which the new owners of Budapest Bank, GE Capital, sold back to the state. Restructuring Polgari proved expensive and, in a further reorganisation, the state stripped out its prime property assets.

Table 4. The destination of the privatised state banks

Bank	Position at the end of 1997
AEB	Acquired by Gazprom (Russia)
Agrobank	Absorbed into Mezobank
AVB	Acquired by WestLandesBank (Germany)
Budapest Bank	23% sold to GE Capital (USA), 25% EBRD (24% still in state hands)
Corvinbank	Merged with Konzumbank
Dunabank	Broken up—parts bought by ING (Netherlands)
Ibusz	Absorbed into K & H
Investbank	Absorbed by PK
Iparbankhaz	Liquidated
Jelzalogbank	Still in state hands
K & H	Sold by tender to Irish Life and Kredietbank (Belgium) (also EBRD) (34% still in state hands)
Konzumbank	Absorbed by MFB
Leumi	Absorbed into MHB
Merkantil	Sold to OTP
Mezobank	Sold by tender to Giro Credit (Austria)
MHB	Sold by closed tender to ABN Amro-Bank (Netherlands)
MKB	Sold to Bayerische Landesbank (Germany) and EBRD
OTP	Sold to financial investors and stock exchange flotation
PK	Sold by tender to Atlasz consortium
Polgari	Spun off from Budapest Bank by GE Capital. Absorbed into PK
Postabank	Still in state hands
Rakoczi	Absorbed into MFB
Takarekbank	Sold by tender to Deutsche Genossenbank (Germany)

The 19-branch bank was expected to attract considerable interest, but the only tender was made by a 10-member financial consortium led by Atlasz, the domestic insurance group, bidding 6.2 billion HUF for a 62% share at 160% of book value.

Small State Banks

Of all the state banks, the financial condition of small banks was most acute—their capital fell short of the minimum level and they faced major losses from bad debts.

- Dunabank was liquidated, with ING buying its well regarded and market-leading debit card business.
- Iparbankhäz was liquidated with depositors paid out of the proceeds.
- Leumi Bank, established as a joint venture of MHB with the Israel-based Leumi bank, was an orthodox commercial bank that had lent a great deal to rapidly growing Hungarian companies now facing overtrading problems, but starting to lose market share with the entry of multinationals. Despite its assets of 9.5 billion HUF at the end of 1994, it made enormous losses and was liquidated in 1995.
- Corvinbank, a profitable operation, with a security ratio of 38% in 1991, and assets of 12 billion HUF at end-June 1996, was merged with Konzumbank. The latter suffered severe bad debt problems and received 2 billion HUF of state capital under the consolidation programme. After this merger, Konzumbank was absorbed by MFB, the state-owned industrial development bank.

- IBUSZ Bank was fully integrated with its owner, the K & H Bank.
- AVB was acquired by WestDeutsche Landesbank.
- Általános Értékforgalmi Bank (AEB), General Banking and Trust Bank, a joint venture between the state and the Lauder Group's Central European Development Corporation, was bought by the banking arm of Russia's largest company, Gazprom, which significantly increased its capital from 1 billion to 5 billion HUF. It was (somewhat optimistically) hoped this sale would presage an influx of other former Soviet bloc investors.
- Rakoczi Bank was absorbed by MFB.

Table 4 shows the fate of the former state banks as at the end of 1997.

Review of the Privatisation Programme

The MNB's 1997 Annual Report looked back on a year which saw initial or continued privatisation of seven banks—K & H, Takarekbank, Mezobank, OTP, CIB, PK Bank and Polgari, thus effectively ending the process of bank privatisation. The MNB put the remaining public sector ownership at 20.7% of the system, partly residing in the hands of budgetary agencies (4.9%) but mainly with the APV (15.8%) (MNB, 1997).

Remaining State Holdings

The state still held minority shares in two privatised banks—22.8% of Budapest Bank and 34% of K & H Bank. In addition, it operated the MFB investment bank, formed in 1992, which had majority holdings in several other small banks e.g. Konzumbank and Rákóczi Bank. MFB's main business was reconstruction and lending for big infrastructure investment. Rákóczi Bank—the only bank not headquartered in Budapest—deals with small enterprise financing and municipalities. Konzumbank was the commercial banking arm. The state also had 100% holdings in two other specialised financial institutions—Eximbank, which financed export and import trade, and Jelzálogbank, the Land Credit and Mortgage Bank, a long-term mortgage lender to the agrarian sector. There remained also the state's Golden Share in OTP.

Postabank is a special case: the second largest retail deposit taker, it became a state bank again in summer 1998, when it suffered huge losses from bad lending and its capital adequacy fell below the critical 8% standard. Formerly, it was owned by several financial institutions, although not quoted on the stock market. Insulation from external market pressures nurtured classic agency problems, as general managers approved financing for various high-risk investments from motion picture making to golf clubs, extending far beyond the bank's legal remit. As losses from this business increased and its capital declined, it suffered a run on deposits in early 1997. As evidence of mismanagement mounted, the authorities decided to take it back into full public ownership.

Opinions differed about the appropriate fate for Postabank. Some argued that it should be privatised, others that it should remain in state hands to lend to small and medium-sized enterprises, an ill-served sector. (An announcement was eventually made during 2000 that it would be privatised, but the method was not specified.)

The Health of the Banking Sector

By the end of 1997, the share of non-resident ownership in the banking sector had risen to 61%. The increased significance of foreign strategic investors meant that the capital strength of banks could increasingly be enhanced by injection of external funds as well as by higher retentions stemming from higher profitability. The MNB recorded an increase of 87 billion HUF in the issued share capital of the sector in 1997, almost half due to privatisation. As a result, despite tighter definition of regulatory capital and the introduction of a General Risk Provision of 1.25% of risk-weighted assets (to be phased in over three years) under the 1996 Act on Credit Institutions, overall capital adequacy rose from 17.6% to 18.3%, a far cry from the depressed levels of the early 1990s. The quality of bank portfolios also improved—the proportion of problem loans fell from 12.6% to 8.7%, although the effect was moderated by allowing for off-balance sheet liabilities.

The stock of income-generating assets rose by 23% but aggregate banking sector profits fell by 15%. Although overall operating costs rose in excess of inflation, this deterioration could mainly be attributed to narrowing of the lending/borrowing margin, which had steadily fallen towards Western-style levels from 8% in 1995 to 3.5% (Dudley, 1998). Although reflecting heightened competition and greater market maturity, this narrow spread may offer inadequate cover in a still high-risk market.

Overall, the banking system was in an immensely stronger position than at the outset of the restructuring-cum-privatisation programme. In 1992, the sector was bankrupt, a plight resulting from a combination of economic recession, poor lending decisions and corrupt practices. By 1997, in most important respects, the aims of the privatisers had been achieved. The bulk of the state-owned banking sector had been transferred to private ownership, strategic investors from diverse countries had been attracted and no major bank had been liquidated. These outcomes appeared to vindicate the decision to clean up the balance sheets of the major banks and then sell stakes to foreign, mainly strategic, investors.

With the exception of Budapest Bank, guarantees were not offered to buyers, and several banks were sold for well above their book values. Yet when the state-financed consolidations are considered, the costs, as shown in Table 5, were high. The total proceeds from selling the privatised banks were almost 100 billion HUF, but covered only 35% of the consolidation costs. OTP stands out, accounting for 54% of the total receipts, and despite the controversy surrounding its sale, Budapest Bank was by no means the worst contributor, especially allowing for the poor investment climate when it was sold, and the improving macroeconomic environment for later sales.

The readiness of the state to pump in resources, as with Budapest Bank, reassured foreign investors both as to the stability of the banking system and also the state's commitment to complete the transfer of ownership. Paradoxically, the pre-privatisation weakness of the banking sector may well have attracted external predators, recognising the long-term potential of the Hungarian market, both in itself and also as a basis for expansion into other markets in the region. In most cases, the amounts invested, initially at least, were tiny compared with the size of the parents, and the potential returns. For some of these banks, e.g. ABN-Amro, investment in Hungary was part of a portfolio of investments in Central Europe and beyond, thereby spreading risks, and also expanding its regional reach. For others, such as Deutsche Genossenschaft Bank, the investment represented horizontal expansion, enabling the application of expertise developed in more familiar markets.

Table 5. Privatisation revenue relative to consolidation cost

Bank	Consolidation cost (HUF billions) (1)	Privatisation revenue (HUF billions) (2)	(2)/(1) (%)
OTP	16.6	53.0	319.0
MKB	16.5	8.0	49.0
Budapest Bank	28/40	12.0	43/30.0
Takarékbank	12.7	4.4	35.0
Altalanos ErtForg. Bank	1.6	0.5	31.0
Mezobank	20.8	4.0	19.0
MHB	123.9	12.0	10.0
K & H	56.6	5.0	9.0
Dunabank	5.3	–	–
Postabank	15.0	–	–
PKB	–	6.2	
Total	282.0	98.9	35.0

Source: Csabai, 1997, p. 69.

The EBRD was involved in several privatisations as a financial investor. However, its first involvement was as co-lead manager of a medium-term Eurobond issue by MKB in June 1993, in combination with Bayerische Landesbank. As well as improving MKB's balance sheet, the bond issue had clear demonstration effects both in introducing Hungary to the international financial markets and in confirming EBRD's commitment to the region. Subsequently, EBRD participated in the privatisations of Budapest Bank and K & H.

Assessment and Prospects

Arguably, although ultimately successful, the need to restructure was perceived too late and the job was done too slowly, probably out of misplaced nationalism and a feeling that banks should be kept in Hungarian hands (*BCE*, 1995/96). Underestimation of the bad debt problem made the scale of the restructuring much higher and raised risks of moral hazard, with managers and depositors believing the government would always bail them out.

In the event, the greater part of the sales were to foreign strategic investors and the EBRD, generating an appreciable amount of inward investment. However, for most of these investors, the acquisition cost was only the beginning. Most have injected further amounts to fund process and product development. As the system becomes more competitive, it is likely that the need for further investment in customer-oriented technology and new products will accelerate. It is widely recognised that size is important to compete, and given the smallness of the Hungarian market relative to, say, Poland, it seems that rationalisation of the sector is virtually certain. The number of banks seems excessive and takeovers are a short-cut to increasing a bank's retail network. Indeed, concentration had begun by May 1998 when Citibank acquired EKB (Europai Kereskedelmi Bank), a 50–50 joint venture between Bank of Austria and the Italian Caripro Group, in order to enter the higher margin end of small and medium-sized company lending. This move made Citibank the eighth largest bank in Hungary by size of assets, and signalled its concern to buy market share in retail banking. The value of the deal was reported to be 1.5 times EKB's book value, some 5 million HUF. A major development during 2000 was the merger of K & H with the Hungarian arm of ABN Amro, following substantial losses at the latter

However, most players were expected to push into the retail market (Rutter, 1998), already served by around 30 banks, and where OTP, which along with Postabank, accounting for some 75% of household deposits, was seen as highly vulnerable with no strategic investor to energise its financing and decision making. Other attractive sectors were the middle-income brackets, who were thought likely to be enticed by the introduction of sophisticated products such as debit and credit cards. Early signs of intensifying competition were the falling return-on-assets ratio and the opening of more branches. Even so, some sectors remained ill-served. Although banks catering for large firms were branching out towards medium-sized firms, the small firm sector looked unattractive—'banks have failed to show any interest towards small business' (MNB, 1997).

In many respects, despite attendant problems of corruption and political controversy, the privatisation of the Hungarian banks provides a blueprint for other economies in transition where bank privatisation is slower and more half-hearted, and where the banking systems are sheltered from the sort of competition that, fuelled by injections of foreign capital, drives improvements in efficiency (*BCE*, 1998).

Notes

1. The full definition of the security ratio is shareholders' capital divided by the total balance sheet figure for assets, regardless of risk. The total asset figure, therefore, does not include off-balance sheet guarantees and commitments. The security ratio is thus a purely accounting relationship, with no adjustments for risk.
2. Capital adequacy is guaranteed capital divided by total assets weighted by their risk profile. The elements of guaranteed capital are: common stock, capital reserves, retained earnings, general reserves, revaluation reserves and subordinated loan stock. Risk-adjusted total asssets is found by multiplying each asset item by its risk exposure factor as determined by the Bank Supervisory Agency.
3. Under the 1991 Compensation Act some 1.2 million Hungarians were gifted Compensation Coupons in lieu of restitution of property appropriated by the state, so as to pre-empt the possibility of disputes over land title delaying privatisation. These coupons have mainly been used in connection with land purchase, although shares in some companies have been offered for sale to coupon holders. By the end of 1996 75% of the coupons (face value 100 billion HUF, or $650 million) had been used (EBRD, 1997).

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Appendix

Table A1. Total assets of Hungarian financial institutions 1991–1997 ranked by 1997 position* (Figures in HUF millions)

	1997		1994		1991	
Bank	Total assets	(%)	Total assets	(%)	Total assets	(%)
OTP	1 441 381	25.82	939 923	30.90	648 628	31.73
MKB	456 740	8.18	274 080	9.01	234 949	11.49
K & H	450 870	8.08	311 800	10.25	233 916	11.44
Postabank	365 251	6.54	200 722	6.60	89 933	4.40
ABN Amro	349 415	6.26	340 408	11.19	325 429	15.92
CIB	348 352	6.24	182 795	6.01	108 358	5.30
Budapest Bank	252 153	4.52	19 687	6.33	135 635	6.64
Unicbank	168 743	3.02	50 163	1.65	28 762	1.41
MFB	160 267	2.87	27 602	0.91	–	–
BA-CA	156 721	2.81	45 577	1.50	–	–
ÁÉB	125 383	2.25	31 108	1.02	19 064	0.93
Citibank	115 460	2.07	43 001	1.41	35 239	1.72
ING	111 529	2.00	36 763	1.21	–	–
Inter-Európa	111 047	1.99	50 520	1.66	35 386	1.73
Mezobank	110 936	1.99	81 288	2.67	52 289	2.56
Commerzbank	96 735	1.73	35 793	1.18	–	–
Takarékbank	96 115	1.72	41 059	1.35	36 768	1.80
Hypo	83 114	1.49	13 132	0.43	–	–
BNP	70 790	1.27	–	–	–	–
WestLB/AVB	70 180	1.26	13 077	0.43	–	–
EKB	54 619	0.98	13 476	0.44	6 689	0.33
Crédit Lyonnais	47 286	0.85	14 278	0.47	–	–
Konzumbank	45 825	0.82	30 079	0.99	27 073	1.32
Daewoo	40 364	0.72	16 963	0.56	–	–
Polgári	37 550	0.67	17 601	0.58	–	–
Eximbank	36 703	0.66	1 322	0.04	–	–
PK	28 298	0.51	–	–	–	–
Realbank	26 011	0.47	17 164	0.56	10 197	0.50
Volksbank	25 856	0.46	4 633	0.15	–	–
Merkantil	22 850	0.41	8 804	0.29	4 508	0.22
Deutsche	18 562	0.33	–	–	–	–
Rabobank	13 865	0.25	–	–	–	–
Porsche	9 727	0.17	1 931	0.06	–	–
Hanwha	9 407	0.17	–	–	–	–
Opel	9 311	0.17	–	–	–	–
Kvantum	3 907	0.07	1 937	0.06	–	–
IC	3 740	0.07	973	0.03	–	–
Rákóczi	3 590	0.06	623	0.02	–	–
Jelzálogbank	3 213	0.06	–	–	–	–
Nomura	780	0.01	811	0.03	1 002	0.05
Cetelem	557	0.01	–	–	–	–
Dunabank	–	–	14 176	0.47	7 481	0.37
Iparbankház	–	–	7 448	0.24	–	–
Indosquez	–	–	4 264	0.14	–	–
Investbank	–	–	3 883	0.13	2 862	0.14
Total	5 583 203	100.00	3 042 093	100.00	2 044 168	100.00

Notes: Figures reflect bank mergers as follows:

- K & H data contain figures for IBUSZ bank in 1994 and 1991.
- Amro Bank data contain figures for MHB and the Leumi Bank in 1994 and 1991.
- Figures for Mezobank include Agrobank in 1994 and 1991.
- CIB data contain figures for CIB Hungária and CIB Bank.

Source: National Bank of Hungary Annual Reports.