Restructuring and Recent Situation of the Hungarian Banking Sector

NBH Workshop Studies

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The restructuring in the Hungarian banking sector, or the loan, bank and debtor consolidation, as it is often referred to, was one of the economic policy programs of great importance in the first half of the 1990's. Although the program warded off an overall crisis, but, at the same time, it imposed a substantial burden on the state finances, and, thus, on the society, as well. It had widespread effects, from the banking sector, to the firms; it affected the whole economy, the population, and the future generations. On one hand, the program was to alleviate or offset, at least partially, the consequences of the tremendous losses accumulated in the economy. On the other, it also had to contribute to the evolution of a market economy, particularly, to bring about important structural changes so as to develop a modern financial system.

I. Description of the Loan and Bank Consolidation Processes

This chapter describes the loan and bank consolidation schemes and processes. It presents the need for consolidation, the methods applied and the actions implemented without discussing either the possible alternatives, or all the positive and negative aspects of the modes of solution and does not expose the deficiencies either. That is to say, this chapter presents the facts and does not evaluate; evaluation is presented in Chapter II and that of the developments in the banking sector after restructuring in Chapter III.

It follows from the style of discussion that certain overlaps, repetitions could not be avoided. For this, I apologize to the reader.

1. Antecedents and Characteristics

The commercial banks established in the wake of the 1987 reform of the banking sector were *ab ovo* inadequately supplied with capital and some of the loans they had inherited from the National Bank of Hungary (NBH) were doubtful already at that *time. In the first years of operation*, the banks had neither the appropriate risk appraising and classification systems and methods, nor the necessary expertise. The requirements pertaining to classifying claims and making risk provisions were somewhat loose, not having been regulated by law. The rules of taxation – incorrectly – enabled provisioning only to debit after-tax profits. Consequently, the banks hardly made any provisions at all.

The regulations enacted until the end of 1991 (the Banking Law, the Accounting Law, the Bankruptcy Law) provided better opportunities for assessing the true financial position of debtors; the criteria of credit classification were substantially tightened. Provisioning requirements were determined in line with the latter. Provisioning before assessment of the tax base – i.e., as cost – also became possible. The more stringent regulations and practical experiences gradually contributed to considerably more prudential lending practices on the part of the banks from 1992: financial institutions were increasingly more risk-averse. Certain banks, however, even if they did not grant high-risk new loans, regularly renewed maturing old debts for their doubtful debtors, whereby they not only maintained their problem loan portfolios but, considering the very high interest rates, even increased them.

Obviously, the major deterioration in the position of the banks owing to which their consolidation became inevitable had not been caused by the stringent regulations implemented at the end of 1991. To the contrary: it was caused by the former lack of such rules and consequently by a careless (and then gradually improving) lending practice on the part of the banks. Yet the fundamental cause giving rise to the inevitability of the financial bailout was not attributable to the activities of the banks but to the deterioration of the economy in general and that of the debtor companies in particular (decline in output and income owing to the loss of a part of the foreign and domestic markets). More and more companies became unable to repay their loans; many of them were unable even to pay the interests. A considerable portion of debtors filed for bankruptcy, for many of whom the process led to liquidation.

At the end of 1991, the Government offered guarantees for about a half of the principal of loans inherited in 1987 from the NBH rated as of uncertain recovery which did improve the position of the banks somewhat. In 1992, however, the portfolio of loans rated as bad, doubtful and substandard according to the new, more stringent rules in force since December 1991, rose very dynamically indeed, owing to the deterioration in the position of the debtors. The loan consolidation scheme, i.e., a portfolio cleanup effort, took place at the end of 1992, as the first major action to restructure the banking sector, which became necessary because of this. As this was a partial measure only and particularly because the bank portfolios continued to deteriorate vigorously in 1993, the Government, based on the preparations in progress since early 1992, decided to take a comprehensive action: by this time one that could be qualified as bank consolidation, i.e., settlement through recapitalization, in addition to certain new portfolio cleanup operations.

In sum, a combination of various methods was used to improve the position of the banking sector. First, at the end of 1991, state guarantees were offered to a relatively low amount for a narrow range of loans. Second, a loan consolidation scheme, i.e., a portfolio cleanup took place by way of the Government carving out the bad loans: at the end of 1992 in a bank-oriented and at the end of 1993 in a enterprise-oriented fashion for a specific narrow circle of debtors. Third, banks which had lost their capital, benefited from state capital increases in December 1993 and 1994, linked to launching the modernization of the management and operational system of the banks.

Retrospectively, it is obvious that the *combined use of the various methods was inevitable*, because the problem could not have been appropriately addressed using any one method only. It is, however, a fact that the combination of these methods was *not based on a thoroughly considered, complex program planned in advance*. The decisions were greatly influenced by current Hungarian and foreign approaches and by *compromises* (frequently motivated by political or personal considerations) among decision makers representing different views. Therefore, *the combination of the methods applied and the implementation of some of the methods were far from the optimal.*

2. The Loan Consolidation of 1992–1993 (Portfolio Cleanup)

By the end of 1992 it was clear that the restructuring in the banking sector could no longer be postponed, because without it the banks would have lost their capital, moreover, they would obviously have lost the deposits of their clients. In such a case their liquidation should have been initiated. This, however, would have paralysed not only the banking sector but also the entire economy.

In accordance with prevailing approaches and the practical possibilities of those days, a "loan consolidation" effort, i.e., a portfolio cleanup (carving out of non-performing assets of the banks) was launched.

As to the method of the loan consolidation scheme at the end of 1992, first a proposal was prepared, according to which the consolidation of the position of banks in trouble should have been affected by way of a decentralized portfolio cleanup based on market principle. Under this scheme, bad and doubtful debts would have been purchased at ongoing prices from the banks by work-out organizations. These organizations were to specialize in the management of such assets, and were to be established, *inter alia*, by the banks themselves. The state, with a partial repurchase clause, would have financed the bulk of the bank losses by government bonds.

At the end of 1992, however, the Government brought a resolution – being in delay, pressed for time – on the implementation of an ab ovo partial and fundamentally centralized portfolio cleanup, assuming that this would be followed by another step and also that this solution could be transformed into a decentralized method (by the government "rolling on" the bank non-performing loans it had bought to private companies).

a) Bank-oriented loan consolidation (portfolio cleanup)

The loan consolidation scheme put in action by the Government in December 1992 embraced the banks with a capital adequacy ratio (CAR) lower than 7.25 percent. Some 14 commercial banks and 69 savings co-operatives participated in this program. In March of 1993, the banks were able to sell their claims against domestic business organizations classified as bad in their portfolio as of December 31, 1992 to the state. (That is to say, the program did not cover the claims of the banks outstanding against the households' and foreigners', to claims classified as doubtful or substandard, and to their investments and contingent liabilities.) A state agency supervised the correctness of classification. The Government paid 50 percent of the par value on claims classified as bad before 1992, 80 percent on claims classified as bad in 1992, and 100 percent on claims outstanding against certain specific companies, also taking into account the risk provisions made as purchase price. (A part of the par value of claims classified as bad not paid for by the Government had to be provisioned by the banks.)

The state bought up loan and interest claims to a face value of HUF 102.5 billion. It paid for the claims purchased with the so-called loan consolidation government bonds to a value of HUF 81.3 billion. These bonds have had maturities of 20 years and are negotiable. The interest rate has been set semi-annually based on a weighted average of the rates of interest on the 90-day (three-month) treasury bills during the previous six months. Interest payments have been credited once a year. The government bonds issued – based on the authorization set forth in law – directly increase the state debt and appear as a budget expenditure only upon their redemption. Interest payments on the bonds constitute expenditure for the budget of the given year.

The state or rather the Ministry of Finance (MoF) on its behalf sold a selected part of the bad debts totalling a face value of approximately HUF 40 billion purchased at a reduced price to the nearly 100 percent state-owned Hungarian Investment and Development Bank Corp. (MBFB). The MBFB had the option to reschedule debts, to swap to equity or to forgive them. The remaining part of the claims (the debts not sold to the MBFB) were temporarily managed by the seller banks based on contracts renewed every three months until the middle of 1994. Claims still held by the Ministry of Finance were offered to business organizations (companies undertaking the management of the claims) in 1994. The claims that could not be sold in this way have been managed by the MBFB based on an MoF commission.

The loan consolidation scheme implemented on the year end status of 1992 considerably improved the positions of the participating banks and, thus, that of the entire banking sector. As of December 31, 1992, the total problem loan portfolio of the banking sector declined from HUF 288 billion to HUF 186 billion, of this, that of bad debts from HUF 186 billion to HUF 84 billion. The provisions of the banks decreased and they reached a positive capital adequacy ratio according to the then prevailing Hungarian standards (although they still had negative capital ratios according to the international standards).

In addition to the loan consolidation implemented in March 1993, consolidating steps were taken in favor of three banks based on individual decisions using HUF 17.3 billion in government bonds.

The bank-oriented loan consolidation scheme slightly improved the position of the banking sector temporarily. The Government bought "bad" debts only offered by the banks themselves. The program did not cover doubtful and substandard assets, nor did the banks' problem investments and contingent liabilities. Claims were classified according to the somewhat inflexible, less stringent rules introduced at the end of 1991, which did not yet meet the international accounting standards.

The loan consolidation effort left the organization, management and operating systems of the banks unaffected essentially. Although the composition of their portfolios improved substantially for the time being, but, in the course of 1993, primarily owing to the deterioration of the debtors' financial positions it again deteriorated even under the old rules of classification.

b) Enterprise-oriented loan consolidation at the banks (portfolio cleanup)

In the second half of 1993, the Government, in addition to the claims classified as bad as of December 31, 1992, also bought the debts of certain companies chosen by the Government.

In 1993, the Government selected 12 large, state-controlled enterprises based on their strategic importance and made a decision on alleviating their financial burden. First, the Government forgave or rescheduled a part of their debts outstanding against the state (the State Development Institute, SDI), then the Government purchased a substantial portion of the claims of the creditor financial institutions outstanding against 11 of 12 of these large companies by issuing consolidation bonds (at 90–100 percent of par value) at the end of 1993. The Government made a similar decision on purchasing the bank claims outstanding against three other companies with controlling interests held by the state (one being manufacturing, one food processing and one agricultural company) and the Hungarian State Railways.

The Government also bought a substantial portion of claims from those banks that were not participating in the bank consolidation scheme outstanding against some food processing companies. Finally, the Government purchased the claims of the banks outstanding against agricultural businesses which had become irrecoverable because of the draught and forgave them.

Under this – enterprise-oriented – portfolio cleanup at the banks, the Government swapped consolidation bonds to an amount of HUF 57.3 billion to claims of a par value totalling HUF 61.3 billion to the financial institutions.

Those of the claims bought by the state (or rather by the Ministry of Finance on its behalf), which were outstanding against companies the majority in which was held by the State Property Agency (SPA) or the Hungarian State Holding Corp. (HSHC) were sold to these two state property manager companies with the purpose of deciding the fate of these claims – i.e., whether they be rescheduled in part, swapped to equity or be forgiven – on the basis of the reorganization plans of the debtor companies. Early in 1994, however, the HSHC forgave all the claims outstanding against the eight companies it held (to a face value totalling HUF 24 billion) without these companies having presented adequate reorganization plans or the HSHC having concluded consolidation contracts with them setting forth stringent conditions. The SPA did not have such a legal possibility; the claims earlier transferred to The SPA (a smaller portion of which had been swapped to equity amounting to more than HUF 16 billion in face value) were then transferred to the ownership of the State Privatization and Holding Co. (ÁPV Rt.) which has since been established.

3. The Bank Consolidation of 1993–1994 (Recapitalization)

The portfolio of the problem claims of the banking sector (all the bad, doubtful and substandard debts) rose to HUF 352 billion measured by the old accounting standards (of which, the value of bad debts rose to HUF 186 billion) by December 31, 1993, in spite of the fact that the enterprise-oriented portfolio cleanup had reduced this figure earlier. According to the new standards, the value of bad, doubtful and substandard assets amounted to Ft 418 billion on December 31, 1993, of which the value of bad debts was HUF 243 billion.

Because of this, the introduction of yet another comprehensive state consolidation program was inevitable by the end of 1993.

Taking into account the recommendations of international organizations (primarily those of the World Bank and the IMF) and other experts, in April of 1993, the Government made a decision on initiating another consolidation in the banking sector not by portfolio cleanup but through recapitalization. With this program the banks were enabled to fully replenish their risk provisions; accordingly, they were to keep their problem assets in their portfolio upon recapitalization, whereafter they could either manage these themselves, or transfer them to work-out organizations specialized in the management of such claims, or sell them, or write them off. The recapitalization obviously increased the state holdings in the participating banks. The method also enabled the Government to require that the participating financial institutions modernize their systems of control, organization and operation.

At the end of 1993, with the amendment of the Act on Financial Institutions, the rules on classification and provisioning were adjusted to the international accounting standards. This made it clear that the composition of the bank assets, also taking into account the qualities of investments and contingent liabilities, was substantially worse than that had been recognized earlier. In addition, the bank portfolios further deteriorated during the year of 1993 (see above).

Linked to recapitalization, the banks were required to meet the full provisioning requirement, based on the international standards by December 31, 1993. The requirement covering not only the banks' claims but also their investments and contingent liabilities, was determined on the basis of more stringent classification criteria than before. The classification referred to was not formal; evaluation was basically entrusted to the participating banks.

Originally, the recapitalization of the banks had been planned in two steps. In the first step (at the end of December 1993), the banks received capital injections which, essentially in a uniform manner, enabled them to raise their capital adequacy ratios slightly above 0 percent. In the second step (in 1994), the banks were to receive capital injections – eventually in a differentiated manner – which, on the basis of the December 31, 1993 portfolios and ratings, would have enabled them to reach capital adequacy ratios of at least 4 percent, although some of the agencies involved believed that reaching a capital adequacy ratio of 8 percent was of imperative necessity.

The financial institutions eligible to participate in the bank consolidation scheme were those whose capital adequacy ratio did not reach the magnitude indicated to be achieved in a given phase.

Under the first step of the bank consolidation effort, the capital of the eight participating banks was increased by a total of HUF 114.4 billion (of this, 77 percent went to the two largest banks). The state obtained newly issued voting shares by transferring consolidation bonds similar to those issued earlier, but paying interests twice a year. In addition, the state also bought shares from those bank shareholders who had expressed such an intention in the amount of HUF 1.9 billion. The banks benefiting from the state capital increase signed a consolidation agreement with the obligation to modernize their systems of control, organization and operation in accordance with the goals set forth in the agreement, to develop and also to actively participate in the conciliatory procedures laying the foundations for the debtor consolidation scheme.

The capital adequacy of the National Savings Co-operatives Institution Protection Fund (OVIBA) was satisfactory. In addition to the payments of the savings co-operatives and some PHARE support, by the state making HUF 2.7 billion in capital and HUF 5.9 billion in subordinated loan capital available to the Fund; the latter served the purpose of restructuring the savings co-operatives. Under this action, consolidation government bonds in the amount of HUF 125 billion were transferred to the financial institutions. In addition, the state also granted subordinated capital in the amount of HUF 5 billion to the National Savings Bank (NSB). NSB did not participate in the bank consolidation scheme. Out of the HUF 57 billion government bonds issued in the enterprise-oriented loan consolidation scheme (c. f. Section 2. b. of this chapter), HUF 22 billion went to banks not participating in the program. The large-scale capital injection, obviously, improved the position of the banking sector at the end of 1993.

In May 1994, in the second phase, the government offered additional capital amounting to HUF 18.1 billion to the banks participating in the restructuring. As a result, the banks' capital adequacy ratios reached 4 percent. In the case of 4 banks (including the large banks), this was achieved by acquiring additional voting shares, whereas in the case of four other banks the Government acquired voting shares to achieve the 2 percent level of the capital adequacy ratio, and the remaining 2 percent of the ratio was filled by subordinated capital.

By recapitalizing, (and acquiring voting shares) the Government's holdings in seven of the eight banks participated in the program reached or exceeded 80 percent. For one bank (Agrobank), the state holdings increased to 30 percent.

A requirement of recapitalization was that the participating bank should develop a restructuring program relying on the Consolidation Agreement signed in December 1993, by May 1994, which would be acceptable to the State as main shareholder, and thereby to the other shareholders.

The bank restructuring programs expounded their medium-term (3-year) strategies of the changes in ownership, i.e., the ideas concerning privatization, the directions of the institutional modernization, the principles of the business policies (*inter alia,* determining the circle of clients to be dealt with in the course of debtor conciliation) and assessing their future financial positions.

The programs reviewed the measures that had already been taken with a view to modernizing the management and internal operation of the banks, and determined the tasks to be fulfilled to improve the operational functions, to reduce costs, to upgrade the operational systems of the banks, and to improve the management of human resources (improvement in training, improvement in the system of incentives, etc.).

Based on these programs, among other things, the loan appraisal, risk and asset classification procedures were modernized. Also, they made some upgrading in the fields of information technology.

The programs of some of the consolidated banks (primarily those of the Hungarian Credit Bank – MHB – and the Commercial Bank – K&H –) did not satisfy the requirements entirely. For this reason, these banks were required to finalize them by the end of 1994 or early 1995.

At the end of 1994, the Government decided to conclude the bank financial restructuring. Therefore, in May 1994 the Government granted subordinated capital in the amount of HUF 15 billion to four banks, including the three large ones, that had been recapitalized to reach a 4 percent level of the capital adequacy ratio, by Tier-I capital (acquiring voting shares). The same consolidation bonds were transferred with a view to having the capital adequacy ratios of these banks reach 8 percent, based on the portfolios and classifications as of December 31, 1993. This transfer did not impose additional direct expenditure on the budget, since the banks paid an interest to the budget, and the rate was identical to that of the consolidation bonds on the subordinated capital.

In the case of four banks belonging to the second group, there was no additional capital injection by the state in 1994. The idea was that these banks would reach the 8 percent level of capital adequacy ratio via privatization or a capital injection by the private sector or else their independent existence would cease. (Early in 1996, two relatively large banks in this group, Mezőbank and Agrobank, merged and, at the same time, received an additional capital injection of HUF 9 billion, while the two smallest banks are gradually winding up their operation in 1996.)

After the conclusion of the bank consolidation scheme – expressly not as its part – one of the large banks (Budapest Bank), in order to avoid the otherwise warranted capital reduction, asked for and received consolidation bonds to a value of HUF 12 billion through ÁV Rt. as a contribution to its capital reserve to offset its losses with the condition that if the bank was not privatized by the end of 1995, these bonds were to be returned to the Government. The bank was privatized at the end of 1995, and the Government repurchased the bonds out of the proceeds of privatization.

In May 1995, in the case of four other consolidated banks, the value of the subscribed capital was reduced to a realistic level in order to eliminate (provide a cover for) the losses incurring in 1994 due to the provisioning made earlier. By this capital reduction for them the restructuring via state assistance came to an end.

Early in 1996, as a supplement to the Consolidation Scheme the Government offered guarantees for the net value of the claims transferred by two banks, (the Hungarian Credit Bank and Mezőbank) to the work-out companies.

All in all, the restructuring in the banking sector was successful. In the end, requirements were established for the banks to have subscribed capital of a minimally acceptable level, to have transparent portfolios classified in accordance with international standards, and risk provisions providing coverage for their potential losses and were able to operate in the black. The restructuring of the banks also established one of the preconditions of outstanding importance of their privatization.

The restructuring of the banks also called for the reinforcement of the operation of the State Banking Supervision and further fine-tuning of the Banking Law. It also required that the state be able to exercise its ownership rights appropriately so long as it has those rights. These measures, however, were taken mainly as late as 1995–1996.

4. The Effects of Restructuring

Until the end of 1994, approximately HUF 330 billion worth of consolidation government bonds were issued in the loan and bank consolidation schemes, which increased the gross debt of the country. Net debt rose by HUF 300 billion, as government bonds to a value of about HUF 30 billion were transferred as subordinated capital, e. g., the claims of the State rose by an identical amount. By mid-1996, the value of the consolidation bonds issued reached HUF 360 billion as a result of certain government bond transfers not related to consolidation actions and the individual actions implemented at Mezőbank and some other banks as a supplement to the consolidation scheme (*inter alia*, by the assumption of guarantees) but without the individual capital injection "redeemed" from the Budapest Bank.

There was no interest paid on the consolidation bonds, thus the State budget was not burdened in 1993. The net interest payments on government bonds (calculated by deducting the interest payments on the subordinated capital received) reached about 1.2 percent of GDP and 3.5 percent of the expenditures of the central budget in 1994. In 1995, these figures rose to 1.6 percent of the GDP and 5.2 percent of the budget expenditures. The budget gained a small profit tax revenue paid by the recapitalized financial institutions, which reduced the current burden on the budget somewhat. After 1996, interest rates are expected to decline in line with the disinflation in the economy. This will substantially reduce the state burden with respect to the interest payments on the consolidation bonds.

As a result of the loan and bank consolidation schemes, the adequately recapitalized banks had positive cash-flow and increasingly improving capital adequacy ratios and made profits in 1994–1996. (The smaller banks which were only partially recapitalized had to suffer increasing losses and they even lost part of their capital.)

With amended regulations and recapitalization, the banks were able to make provisions at an appropriately high level. This enabled them to participate in the consolidation of the financial positions of the viable debtor enterprises, e.g. companies that, with a reasonable easing of their debts, could be turned not only operational but also capable of growth; or put it differently, to participate in the debtor conciliation scheme. Participating in this scheme was a mandatory requirement of the consolidation agreement they had signed with the state but they also had a very clear stake in its success.

The reorganization of the viable debtors, whose defaulted loans were bought out by the Government in the loan consolidation scheme was not a task for the former lenders but that of the management and owners of these companies, of the new owners of those claims and of the other creditors. I.e., to say, financial institutions participated in the conciliation of the affected debtors only to the extent of the problem loans they retained in the course of the bank consolidation.

The method of the debtor consolidation scheme in this respect was to conduct reconciliatory procedures between the main creditors (the banks, the state, etc.) and the debtors (and their owners) based on the reorganization plans which were to be prepared by the debtors themselves. The debtor consolidation scheme was concluded in mid-1995.

As a result of the debtor conciliation scheme, the financial positions of a few indebted companies improved and their solvency was re-established. In the case of numerous other debtor companies, only a meager portion of the bank claims and investments could be sold and utilized under liquidation procedures or other ways, and the irrecoverable claims are being gradually written off by the banks.

II. Evaluation of the Loan and Bank Consolidation

This part *evaluates* the *process* and not the results of the loan and bank consolidation. The latter issue is addressed by Chapter III. Obviously, a full and complex evaluation of this series of actions can only be given if the consequences are derived on the basis of a two-type approach.

Below in this chapter I wish to answer a few of the fundamental issues related to the loan and bank consolidation schemes. These are as follows:

- Was the financial restructuring in the banking sector inevitable?
- Was the decisive assumption of burdens by the state inevitable?
- Were the methods or rather their combination applied in the course of financial consolidation optimal, or were there other, eventually better alternatives?
- What mistakes and omissions were made by the Government and by the banks in the course of the process?
- Whose interests were protected and whose interests were hurt by the consolidation efforts?

1. The Need for Restructuring

In trying to find an answer to the question of whether or not the restructuring in the Hungarian banking sector was inevitable, in fact we need to answer to two questions:

- What were the *causes* that made the Hungarian banks, or rather some of them, near bankrupt in 1992–1993?
- *Was there a need for Government interference* in the banking sector or could the economy have proceeded along its own course without it?

The causes

As I have already mentioned it in the introduction to Chapter I, the unfavorable financial positions of numerous Hungarian banks by 1992–1993 were caused not by a single factor but by the combined effect of a number of severe causes.

These causes were to a large extent different – more severe! – than the factors which gave rise to the need for Government interventions to settle the position of banks in the United States and Japan, in Spain and Portugal, in each of the Scandinavian countries and in a range of South American countries. (In these cases, the deterioration in the positions of a number of banks in these countries was basically attributable to excessive lending during a period of recovery followed by losses of the collateral, to deregulation of an unwarranted extent and mistakes made by the management of the banks.) At the same time, the causes for the deterioration in the positions of Hungarian banks were obviously similar to those in other East Central European countries.

What then are these causes?

The need for the loan and bank consolidation schemes was basically given rise to by three groups of factors: objective causes in the world and domestic economy (also including the circumstances of the coming into being of the commercial banks), deficiencies in economic and legal regulation, and the mistakes and deficiencies prevailing in control, supervision and operation of the banks.

The commercial banks established by seceding from the NBH in 1987 received, to a large part, clients whose output substantially was directed to the markets of the former CMEA countries. Accordingly, they inherited loans which laid the foundations for the development and structure of production for these markets. Moreover, their assets and thus their capabilities to take risks were ab ovo exceedingly low, inadequate according to international standards.

The collapse of the Eastern markets, the decline in domestic demand, the loss of markets owing to these reasons, the large-scale reduction in corporate incomes, the obsolete structures and lack of capital, etc. led to the fact that real income generated in the Hungarian economy fell by nearly a quarter in the period 1990–1993. This decline was of an even larger magnitude in the corporate clientele of the commercial banks borne by secession from the NBH; obviously, the companies could not possibly have warded this off or offset this by internal measures only. A substantial portion of these clients filed for bankruptcy, some of them were liquidated; this extended also to a portion of new clients. These businesses not only lost their creditworthiness but became incapable of repaying the loans and even to pay the interest thereon. The negative impact exerted by the downturn of the economy on the banks was exacerbated by the fact that the share of working capital represented a smaller share among the assets of the Hungarian companies than it is usual in the international marketplace. Accordingly, bank loans represented a higher share. Repayment of the principal and the interests was made substantially more difficult by the fact that the lending rates rose to a multiple of the former level in nominal terms (on average to 35–38 percent by 1991) but real interest rates also reached 15–20 percent in 1992 (!). These highly indebted businesses were incapable of paying such high interests, as only a very small portion of them were able to make profits enabling them to do so. Owing to this, indebtedness turned into a self-fuelling process.

Before 1991, there were no unambiguous and stringent rules of classification and provisioning which would have prompted the banks to be prudential in lending and set aside provisions commensurate with their risks. The pre-1991 taxation rules enabled them to set aside risk and other provisions out of after-tax income only. Accordingly, banks hardly set aside any provisions at all. The new regulations introduced at the turn of 1991–1992, thus the Banking Law, which came into force on December 1, 1991 and the acts on Accounting and Bankruptcy and Liquidation in force since January 1, 1992, brought a substantial portion but not all of the losses of the financial institutions to the light. The Banking Law adopted at the end of 1991 regulated the classification of loans and prescribed the rules of provisioning (allowing a grace period of three years to reach the necessary level of provisions). Tax rules by then permitted provisioning out of pre-tax income. These rules of classification and provisioning were, however, still much softer than those warranted by international experience and standards. Regulations adjusted to international standards came into force only on January 1, 1994.

At first, the new commercial banks did not have adequate lending or risk assessing experience or adequate internal regulations; their managers and staff had little experience in commercial banking, their boards of directors could not yet function fully in line with their statutory responsibilities. The loan appraisal practices of the banks were at first very poor. After 1991, the banks, particularly the large ones, became gradually more restrained, more prudential with respect to granting new loans. They, however, tended to renew maturing loans to retain their clients again and again. On occasion, they offered supplemental loans (primarily in the amount of the accrued interests) that incidentally they were forced to do on the basis of the then prevailing rules of classification and provisioning. The composition of the managers and staff members of the banks improved gradually, their experience and knowledge grew. Yet, during this period, they had not reached the required standard which obviously had a detrimental impact on the quality of the bank work and decision making. Bad, irresponsible lending, breaking even the internal rules of the banks themselves occurred frequently. A few small banks, with a view to rapid growth, pursued excessively expansive policies, promising and paying relatively high returns to depositors and assumed too high a risk in lending.

The State Property Agency (SPA) and the HSHC, which exercised the ownership rights for the banks with controlling interests held by the state, were unsuitable for the task; many of the members whom they delegated to the Boards of Directors and Supervisory Boards of the banks were people without the necessary knowledge and incapable of responsible managerial and supervisory behavior. The activity of the Banking Supervision was at first poor, then gradually improving, but the shortcomings in its instruments and the low quality of its staff prevented efficient intervention.

In the period between 1990–1993, the above factors were together responsible for the following:

- the ratio of bad, doubtful and substandard loans, investments and other liabilities increased gradually in the balance sheets of the banks;
- although the banks put a growing portion of their income for provisions, the amount set aside covered an increasingly smaller portion of the real provisioning requirement;
- without financial bail-out, a number of banks would have produced losses as early as in 1992 then again in 1993, and, as a result, they would have lost not only their entire capital but also a substantial portion of the deposits (the extent, of course, differed from bank to bank).

It would be a futile attempt to try to determine which of the causes referred to and to what extent contributed to the generation of losses. Experts, however, are fully in agreement with respect to the fact that the number one and *decisive* cause was the *economic recession and its consequences;* while the number two cause was the overall regulatory environment surrounded the establishment and operation of the banks.

Obviously, it is also not possible to establish to what extent subjective deficiencies of the bank managers or staff members were responsible for the problems. This is all the less possible because bank managers were replaced at some of the banks between 1991–1992, on occasion several times, and not once for political rather than professional reasons. Some estimate the contribution of the subjective errors made by the bank managers to the evolution of the problems at 10 percent, others at 30–40 percent. On my part, I regard the significance of the subjective errors of the banks probable in the range of 10–30 percent, differently, on bank to bank basis. By subjective error, I do not mean criminal or wilful omission or neglect; lack of knowledge, experience, and skills, misjudgment of the situation or of impacts etc. also played a role.

With respect to the need for restructuring, however, these estimates *have no relevance at all.* Subjective errors could not be proved with respect to persons, nor could they have been; the financial responsibility of the managers could not be taken into account.

From the viewpoint of the bank situation and the eventual burden on their clients what was and could only be of interest were not the causes but the *facts, i.e., the magnitude of the losses and the mode of their coverage.*

In other words: no matter how one judges the role of objective and subjective factors within and without the banks in the development of their poor financial positions, it was not on this that the question of whether or not the restructuring of the banks could have been avoided. In the situation which actually evolved, all that could be "decisive" was whether or not the economy could survive without a comprehensive state intervention; whether intervention or the lack of it would have been more advantageous from the viewpoint of the operation and development of the economy.

The necessity of intervention

Whether or not the financial restructuring of the banking sector became inevitable can be evaluated on the basis of the situation that would have evolved without this series of actions and the consequences thereof.

The potential situation of the banking sector without restructuring can be outlined on the basis of the following:

As we have seen, by the end of 1993 the non-performing loans of the banking sector amounted to HUF 418 billion on the basis of the criteria introduced at the end of that year already in line with international standards; within this, the value of bad debts amounted to HUF 243 billion. These figures, however, no longer include the bad and doubtful debts bought by the state in the bank- and loan consolidation schemes. Had this buy-out not taken place, the portfolio of problem loans would have been HUF 182 billion higher, within this, bad debts approximately HUF 160 billion (plus accrued interests) higher. This is to say, that the banking sector would have had at least HUF 600–650 billion in problem loans, within this, more than HUF 400 billion in "bad" loans. The full provisioning requirement of this would have been at around HUF 500 billion. The banks would have been able to made provisions only to a much lower amount out of their own funds (perhaps a third of the requirement) without incurring losses. In other words, several hundred billion forints worth of loss would have been generated. They would have been able to cover only a negligibly small part out of their equity (at a cost of losing it in full), the greater portion of the loss would have meant loss of the money of deposit holders.

From an economic viewpoint, this loss of capital and deposits did take place! Irrespective of the methods used, financial bail-out was nothing other than elimination of these losses, restoration of the original values, their re-establishment before the losses would have been incurred through the complicated channels of accounting.

What would have been the consequences had the state interventions not put up the funds to eliminate the losses incurred?

According to the regulations in force, risk provisions had to be made in any case. As the income of the banks did not provide coverage for this, gigantic losses would have been generated (more than twice the loss of HUF 150 billion incurred in 1993!). To cover the losses, first the entire equity of the banks would have had to be drawn in, then (short of capital) a major portion of the deposits would also have been lost.

This is to say, that the banks themselves would not have been able to repay a substantial portion of the deposits and other obligations. This would basically have affected four circles: the households, the deposit holder companies (i.e., those who enjoyed relatively better financial position), other banks (because of the financial transactions on the interbank money market) and through this again the former two circles and the central bank (which kept refinancing the loans to the banks) and through this the state budget.

The banks would have had to be liquidated. Owing to the losses experienced, there would have been a run on the banks not yet bankrupt so as to withdraw deposits. After a while, these banks would also not have been able to repay the deposits, as these had earlier been lent on to the state, other banks and companies. The banks would have been forced to call in the loans they had lent to businesses, they would not have had the possibility to renew old or to grant new ones. Procurement and payments of wages and salaries would have come to a halt at the companies. Production would have come to a standstill. People would have rushed to the shops to buy whatever there still was. Warehouses would have been emptied. The economic life of the country would have come to a standstill.

All this, of course, is just a nightmare, impossibility, an absurdity. *There is no government in the world which could undertake even the threat of the emergence of such a situation!*

And if this is the case, and that *was* the case, indeed, then it must be acknowledged, the financial bail-out of the banking sector in the situation as it evolved by 1992–1993 *could not have been avoided*, there was no alternative to consolidation! (Some experts did raise that in the case of some, perhaps smaller banks, bankruptcy or liquidation procedure would have been permissible, but owing to the unfavorable condition of a substantial part of the banking sector and, in relation to this, the likely spillover effect, even this would have been highly dangerous, therefore, this option was not exercised.)

The bail-out of the banking sector was not pouring money into the banks but a replacement of the funds for the depositors before they were lost, the re-establishment of the operating capability of the banks and thereby preventing the collapse of the entire economy.

This, obviously, is not to say that every single element and solution of the consolidation process would have been necessary or correct. Restructuring itself *had to take place*, but as to *how* it was done and what was not done carries a number of problems.

2. Sharing the Burden

Irrespective of the form and method of implementing the financial bail-out of the banking sector, the question arises: who should undertake the burden. In principle, the subjects of this could have been the banks and their shareholders, the deposit holders and the state.

The original idea was to distribute the burdens among those who would potentially carry them. Later, however, it became obvious that the decisive burden carrier could be no other than the state.

It was not possible to put any substantial burden on the *deposit holders*. The magnitude of the burden was so great that, if forced to take on a substantial part of this, the confidence of depositors in the banking sector would have been severely shaken, also for the long term. Moreover, even if they assumed only a small portion of the burden, it would have given rise to a similar threat without the deposit holders contributing in merit to the solution of the problem. Therefore, the opinion was soon established that deposit holders or rather their interests should be protected and that it was expedient to make them exempt of burdens. This view was correct even if it is analyzed retrospectively.

There would have been more justification for *making the banks and their shareholders* carry the burden. One form of this could have been – as it happened in a number of countries – that the Deposit Insurance Fund participate in the consolidation scheme. This, however, was not an option in Hungary, as the Deposit Insurance Fund has existed only since 1994 and the funds it collected were very limited.

The participation of the banks in burden-sharing was manifested in the fact that, in accordance with the provisions of legal regulations, they made loss provisions. There, however, seemed to be little possibility of this if they were to use their own funds without incurring losses. Because of this, there was an idea according to which making the government bonds available to the banks would have meant no more than an advance on provisioning, giving them a non-recurrent loan for this purpose and that they should have returned the bonds at least in part subsequently (based on their own "undertaking" by contract). With the magnitude of the problem as it evolved, this solution essentially became an illusion and "it was discarded". In retrospect, it may be said that it might have been worthwhile enforcing the principle of onerous contracting in some form, even if only to a small extent.

As to the *shareholders of the banks*, the state held controlling interests in the banks. In addition, very rightly, other shareholders also carried a portion of the burden either through suffering a paper loss of their shares or, in the case of the only private bank through the obligatory participation in the recapitalization. Inevitably, however, the burden imposed on the private shareholders was, all in all, relatively small.

To some extent, the clients of the banks, i.e., the *borrowers*, also came to share of the burden, as the banks, in order to meet the high provisioning requirement, were forced charge high spreads. Possibilities, however, limited the raise in the rates.

There was, therefore, no solution other than having the state or, in other words, the totality of taxpayers carry the bulk of the burden arising from the bail-out of the banking sector.

In principle, the burden could have been assumed in two possible ways:

– by cash in full or in part,

– by using government securities.

Under the condition of a significant and growing deficit in general government, the idea of consolidating by cash could not even have arisen in a serious form. This would at most have been possible had the Government received a targeted loan from an international financial institution for this purpose or had it been possible to raise large-amount of funds for this purpose elsewhere. Although the preparation of the loan agreement was in progress in 1993–1994, the World Bank refused to grant a loan because Hungary did not have a valid agreement with the IMF in spite of having attempted to reach one. In any case, the principal promised by the World Bank would have covered at best only 7–10 percent of the consolidation burden and, in any case, the Government wished to use it for another purpose. Practically, no other source of credit of any substantial magnitude could be reckoned with.

Because of this, there was no option other than borrowing from the "future generation" in the sense of the Government issuing long-term government bonds to cover the obligations undertaken. Experts recommended that government bonds with a maturity of 10 years should be used, the Government, however, decided to issue 20-year bonds.

Then the idea emerged that some of the bonds should be interest-bearing, with a rate of interest well below the market rate. Early in 1993, such low-interest bonds were also issued. Auditors, however, discounted these bonds in proportion to the difference between the interest they bore and the market rates. Because of this, it became necessary to swap these bonds for bonds bearing the market rate. This also makes it evident that an eventual subsequent reduction in the rate of interest (which is sometimes put forward as a proposal) is not a feasible solution, because that would result in a devaluation of the bonds, and through this, in a loss of capital for the banks which would give rise to the need for yet another consolidation scheme.

Because of this, it can be established that realistically *there was no other option for financing the restructuring than using long-term interest-bearing government bonds with variable rates.*

3. The Legal Framework of the Financial Bail-out

In view of the fact that the restructuring of the banking sector was concomitant with the assumption of a substantial burden on the part of the state, as the state budget and, through this, the taxpayers, are going to bear this burden for a long time and, furthermore, as the entire process was of tremendous economic significance as it had a profound impact not only on the banking sector but also on the position and operation of the businesses as well, it would have been warranted to specify the goal and rules of the entire process in the form of a law enacted by Parliament. This would also have enabled the political parties to come to an agreement on this matter and also to inform and convince the general public of the importance of the matter, the possible solutions and their correctness.

The Government, however, failed to submit a bill on this matter. According to all likelihood, factors such as the uncertainties in forecasting the dimensions of the entire series of actions, the step-by-step evolution of the methods applied, the technical complications of the matter and the rightful concern that the preparation and discussions of the bill would take so long that the necessary measures would not have been possible to implement at the necessary point in time certainly played a part in this, in addition to certain political considerations.

Because of this, the restructuring of the banking sector was based on government resolutions throughout and the annual budget laws provided for the issue of the government consolidation bonds.

The press continuously reported the consolidation actions.

Yet the fact that the series of actions is frequently the subject of political and professional attacks even after the event and the public has still not been convinced of the inevitability, importance and goals of consolidation bear witness to the fact that it might have been more expedient to implement the consolidation of the banking sector on the basis of one or more laws. Perhaps, had that been the case, less mistakes would have been made during its implementation.

4. The Methods and their Alternatives

As revealed from Chapter I, essentially three methods were applied in the course of the loan and bank consolidation process:

- the *bank-oriented loan consolidation* was a portfolio cleanup done by the state, i.e., a centralized, with a partially decentralized realization of the claims bought by the state;
- the *enterprise-oriented loan consolidation* was a portfolio cleanup done by the state, i.e., in a centralized fashion, the state bailing-out privileged companies;
- the *bank consolidation* was a recapitalization effort done by the state with the settlement of the claims retained by the banks in a decentralized fashion, i.e., based on agreements.

Before using these methods, the Government *offered guarantees for* certain claims of the banks (the claims taken over from the NBH in 1987 which later became bad or doubtful).

International practice knows some other consolidation schemes in addition to those described above.

Next, I shall review the alternative methods that could have been considered apart from the methods used and why these were not implemented. I shall also address the issue whether it would have been possible to employ a better combination of these methods than the combination actually applied.

To begin with, I mention that in addition to real restructuring methods, international practice also knows two other methods that do not really fall into this category. It is worthwhile mentioning these at least as a matter of interest.

One non-consolidating solution is that once a major portion of the assets of the banks lose their value, *deposits are inflated away* (eventually perhaps by freezing the deposits). This may take place if "hyperinflation" emerges in a country, while the banks keep deposit rates at a low level and thereby deposits lose their real value. Through this, the balance of assets and liabilities is re-established at a lower level. This obviously brings a decline in consumer demand and therefore generates a further decline in production. But it also has another consequence, namely, that the population loses its confidence in the banks for a long time and tends to keep savings at a low level in the long term. This solution was obviously not an option for Hungary partly because there was no "hyperinflation" and rationally one could not aspire to it, and secondly, because it was not possible to accept the loss of citizens confidence and to let the propensity to save sink to a minimal level. Such a "solution" would have had a "discipline destroying" impact also on subsequent lending.

The other non-consolidation solution is that the government initiates a so-called monetary reform so that a portion of the savings is not exchanged or only at a reduced exchange rate. The impact of this method on savers would have been similar to the solution described above and therefore could not be accepted for similar reasons.

Some people had already then and also subsequently have raised the issue: the restructuring and the related burden for the state could have been avoided by the early privatization of the banks (in 1991). In fact, however, in those days every truly potential, and primarily foreign investor was perfectly aware of the fact that the portfolios of the state-owned banks lacked transparency, were inadequately classified, and in fact were of a bad quality with a deteriorating tendency. No serious investor would take the risk of buying such a bank and of the expected major losses. Therefore, at the time there was no, nor could there have been a real privatization option, i.e., the alternative of shifting the burden of losses on others – simply did not exist.

Armed with the knowledge of the *portfolio cleanup* of 1992–1993 and that of the *recapitalization* of 1993–1994 ,but before a review of the other portfolio cleanup methods not applied, it is worthwhile mentioning that the preparation and implementation of the restructuring was throughout accompanied by a debate as to what was more advantageous or favorable for the banks and, on the other hand, from the viewpoint of the potential viability of the companies and therefore their destiny, the expediency of their eventual reorganization, the evaluation of the mode of such reorganization and subsequent implementation and forcing the inevitable liquidation of the companies thus done; whether it was to take the problem loans away from the banks to be managed by specialized workout companies having the necessary special expertise (government agencies or business organizations); or allowing the banks to manage these claims themselves, since they have the best knowledge of the finances of their debtors.

In the first case, portfolio cleanup, in the second case the recapitalization of the banks is the more favorable method.

Concerning this issue, international experiences were far from unambiguous and not only the views of the Hungarian experts differed and frequently underwent modifications but the opinions of foreign consultants and experts also varied and changed as time went on. The argument for the first solution was that the bank approach was primarily of a short term and exclusively of a financial nature; they have little understanding of the radical transformation of companies that may take several years; hence these activities could be more thoroughly implemented by specialized organizations , that could act with greater foresight. Arguments for the second solution were that organizations of this kind would have had to be set up which would necessarily have required time and entrepreneurial skills. Also, if the recapitalization option is chosen, the state receives something for the bonds expressing its assumption of the burden, namely, shares representing ownership rights (although after the necessary capital reduction, it is revealed that the real value of the shares is only a fraction of the value of the bonds).

This debate could not be unambiguously decided then and cannot be decided now. As we have seen, a combination of the two methods was employed in practice. At the same time, in our case, the advantages appeared only in a limited fashion, because the loan consolidation scheme was not concomitant with the development and operation of professionally well prepared work-out organizations and also, at the time of the bank consolidation scheme, the banks lacked the appropriate professional staff. Thereafter, the banks set up their work-out units for the management of their bad debts and investments only with a delay and not always with adequately qualified personnel. Later two banks (the Hungarian Credit Bank and Mezőbank) established such organizations for this purpose. (This question is discussed in detail in Chapter IV.) This is to say, that practice proved the unconditional correctness of neither solution, there is, however, no doubt that it would have been possible to pursue better practices than those actually implemented.

After this, it is worthwhile reviewing the methods of consolidation that were raised as alternatives but not applied.

a) *Centralized portfolio cleanup with the centralized asset management* (centrally supervised company reorganization). This proposal arose in mid-1992 in actual terms saying that the state should set up a state-owned reorganization company. The banks should take the obligation to transfer their bad and doubtful claims to this company, and the company would have been authorized to forgive or reschedule these debts. This method was objected by the MoF, the NBH and the SBS, as – in addition to the SPA and the HSHC – yet another top government agency dealing with companies would have come to life. It would have been difficult to find personnel of an adequate professional level for this; there would have been a severe threat that this agency would have forgiven the debts of the companies based on lobbying; the responsibility and knowledge of the banks would not have been utilized.

Retrospectively, it is necessary to regard the discarding of this method as justified in addition to the above mentioned arguments because, as later demonstrated, this would either have brought about a partial solution only or it would have enabled the banks to transfer new and newer "bad" debt packages again and again to this state company, which would have obscured their responsibility even more.

Some SPA experts recommended a similar method in 1993 as an alternative to their proposal described under Point C below. Accordingly, the state would have transferred the bad and doubtful loans of the state-owned companies bought from the banks to the SPA and the HSHC which would have used these for reorganization, i.e., they would have forgiven or rescheduled them. To some extent, this proposal was actually implemented in the case of the so-called privileged companies (see below).

b) *Decentralized portfolio cleanup and debt management with state assistance.* This method was developed by an expert team in the third quarter of 1992. The essence of this approach would have been that the banks could have sold their bad and doubtful loans at market prices to business organizations specialized in the management of such debts founded also by the banks themselves; the bulk of the difference between the face and market values would have been settled by the Government using government bonds; the banks would have returned a portion of the bonds received over a specified period; the workout companies managing the debts would have been able to reach an agreement with viable debtor companies on reorganization and its conditions applying market principles.

This method was based on the use of market-conform methods and would also have enforced the responsibility of the banks.

The debt management companies would have partly been founded by the participating banks but other possibilities, such as foreign participation, were also envisaged. (At the same time, the question of raising capital for these companies was not fully clarified.)

Owing to the resistance of the Minister in Charge of Privatization, however, the Minister of Finance submitted this proposal to the Government only in December 1992. By then, there was no sufficient time for using this method at the end of 1992. Because of this, the Government decided on the buy-out of bad debts, and the idea was that in 1993, the state would sell these claims or transfer them to business organizations to manage with the help of a Loan Consolidation Fund yet to be established. This, however, never materialized (only the Hungarian Investment and Development Bank was enabled to buy a package of debts), thus the claims remained with the state, and they were left essentially without management of merit. The method was not applied subsequently either.

There was another factor contributing to this: the joint effort of the World Bank and the IMF, in accordance with the instructions they brought with them, without seriously considering the ideas of the Hungarian experts, recommended the exclusive use of the method of recapitalizing the banks instead of the portfolio cleanup in March 1993.

An analysis of the question in retrospect reveals that

- it was a mistake not to discuss the proposal of a decentralized portfolio cleanup in due time and, therefore, not to apply it;
- it was a mistake not to establish the preconditions of transferring the bad portfolios to business organizations and not to use decentralized portfolio cleanup in a wider range after the portfolio cleanup done by the state (once that was done);
- it was a mistake, therefore, to accept the recommendation of the World Bank experts that consolidation should be continued exclusively by way of recapitalization (which may also be supported by the fact that later they were exactly the same the World Bank experts who recommended that the bad portfolios should be taken away from the banks!).

Based on an *ex-post* analysis, it also becomes unambiguous that owing to the dimensions of the problem which became evident in 1993, it could not have been solved only and exclusively using the method of the centralized portfolio cleanup -some recapitalization of the banks, i.e., a *combination of the methods* became inevitable.

This is to say, in comparison with what was actually implemented, it would have been more favorable to use more of the portfolio cleanup with less nominal increases of the subscribed capital, which would, however, guarantee the same capital adequacy; furthermore, it would have been more favorable had the state taken on a lower profile in the portfolio cleanup and had they applied more of the decentralized, market-based solutions. It is part of this latter issue that the central portfolio cleanup applicable to the enterprises selected by the Government could and should have been implemented in a more restrained circle based on more precisely formulated criteria and requirements.

c) *Bank consolidation through debtor consolidation.* In 1993, some SPA staff members recommended that first a debtor consolidation scheme should be implemented and the consolidation of the banks be done only thereafter. The method would have been that the state would have transferred the consolidation bonds to the SPA and the HSHC, they would have made the decision on the amount of the bonds that they would have contributed to debtor companies with a controlling interest held by the state for the "purposes of reorganization"; then the debtors would have been able to settle their debts outstanding with the banks by transferring these bonds to them.

The use of this method (similarly to that indicated as the second solution under Para a) above) was objected to by the MoF and the NBH, because it would have given too much a room for subjectivity in decision making for the state property managers, while in fact, they proved themselves to be incapable of the efficient management of the assets entrusted to them, incapable of a professional, thorough assessment of the position and future of the companies they held; the proposals would have resulted in a centralized enterprise reorganization or what one did have reason to fear of: only financial settlement and not the actual transformation of corporate activities would have been reached; the banks and thereby "market principle" would have been left out in assessing which of the debtor companies could have become more viable; in addition, the use of the method would have prolonged the consolidation of the banking sector and would have turned it into an unpredictable process.

Analyzing the developments in retrospect, the rejection of this proposal seems to be well justified.

At the same time, there is no doubt that the banks were less active and less successful than expected in conducting the conciliatory negotiations on debtor consolidation with the companies that could be turned into viable businesses (see later).

d) *Granting state guarantees to the banks for the problem assets.* As I mentioned, this method was applied in relation to the assets of the banks inherited from the NBH which had become doubtful in 1991. In the first half of 1994, the question of applying this method was raised again. This, however, was not done for several reasons. It was not clear whether the state would have offered guarantees for all the problem claims or only for a part of them; if the latter, then on the basis of what criteria should they have been collected; experience showed that the enforcement of guarantees through the courts was exceedingly cumbersome and time consuming; offering guarantees would not have solved, moreover, would not even have alleviated the liquidity and profitability problems of the banks (as it would not have enabled them to collect revenue); but consolidation was called to handle these issues as well. In addition, it had also to be taken into account that the state guarantee – at the time of its redemption – would have unambiguously meant a direct burden on the budget, moreover, in a way that its annual extent would not have been predictable and its amount would not have been possible to reliably provide for the annual budget.

Looking at the issue in retrospect, it seems justified that the method of granting state guarantees was not applied in a wide range. Yet, it may have been possible to usefully apply this technique in a narrow range (for instance, instead of the enterprise-oriented loan consolidation scheme). Incidentally, in

1996, the Government did guarantee the net value (net here refers to a value after provisioning) of bad and doubtful assets transferred by two banks (the Hungarian Credit Bank and Mezőbank) to separate organizations, which demonstrated the deficiencies in provisioning after recapitalization.

In sum, it can be established that while consolidation itself and the combined use of several methods were truly inevitable, it would have been possible to apply better methods or a more favorable combination of them. The fact that the optimal solution could not be found is attributable, in addition to the lack of adequate experience, also to the inadequate power and authority of the interested parties in decision-making, and the less than optimal quality of advise received from international experts.

5. The Time-tables of the Loan and Bank Consolidation

International experience unambiguously confirms: it is best to implement the consolidation of a given bank by a *single action*, i.e., in a *single round.* If several banks are to be consolidated, even then what is desirable is that if possible, this should be done at the same time or at least on the basis of the same decision. For if the consolidation of a given bank takes place in several rounds or several banks are consolidated one after the other, this then enhances the in any case present danger that the given bank will not pursue sufficiently prudential lending policies. After the first consolidation they wait for the possibilities provided by a next settlement and after the second settlement, it will pin its hopes, moreover, have confidence in yet other settlements; moreover, the banks not yet consolidated will lend with the knowledge that sooner or later they too will be involved. International literature describes this threat as the "moral hazard".

Hungarian experts were also aware of the threat of the moral hazard; because of this, in 1992 they endeavored to accomplish the financial consolidation of the banks all at once in a single round at the turn of 1992–1993.

In the given situation, however, this endeavor *could not be satisfied.*

Events proved to the later day observer that this was due to not only to subjective but also to objective reasons.

The subjective reason was the circumstance already referred to, namely, that the Government discussed the proposal on the loan consolidation scheme prepared in September 1992 only with a delay, in December that year. According to this proposal, the loan consolidation scheme should have been implemented on the basis of the September 30, 1992 portfolios of the banks or rather their classification (i.e., of a date before the decision). Based on the December 1992 decision, it was no longer possible to prepare a portfolio cleanup to the extent that would have resulted in a full settlement of the banks.

On the other hand, however, the cleanup, at least partial, of the end-of-1992 portfolios *could no longer be postponed.* Without this, a number of banks, including the large banks would have had to suffer losses of such a magnitude already in their 1992 balance sheets – even measured by the Hungarian classification and provisioning standards then prevailing, the standards were substantially softer than the international ones – as a result of which, the loss of their capital, moreover, the loss of a part of the deposits, would have become obvious (which would have been concomitant with the consequences described above). In addition, the Government had a valid agreement with EBRD on an agricultural loan, according to which it undertook to continuously ensure maintenance of a positive capital adequacy ratio in the case of the large banks and to reach a CAR of at least 3 percent by mid-1993.

Because of this, *at the turn of 1992–1993,* the first step of consolidation had to be taken *in any case* (this was the bank-oriented loan consolidation, i.e., the portfolio cleanup) even if it was only partial and its method was at least highly doubtful or downright erroneous in many respects (see above). Obviously, it is again necessary to emphasize that, with more careful and prudent preparation and decision making, this step could have been implemented using better methods and more favorable content!

As the Loan consolidation scheme of 1992 was *ab ovo* no more than a partial portfolio cleanup, this would have necessarily had to be followed by another consolidation step even if no new development occurred. But it did!

First: the economic recession in 1992 was greater than expected, moreover, the GDP continued to decline, and even it did in 1993. This macroeconomic phenomenon expressed that a very large number of clients of the banks in the micro economy, i.e., in the enterprise sector, made losses and became incapable of the repayment of loans borrowed earlier. A good portion of the claims which had earlier been rated by the banks as doubtful turned bad, some of the substandard became doubtful; and the required provisioning increased vigorously.

Second: it was neither possible, nor expedient to continue to postpone the harmonization of the Hungarian asset classification and provisioning rules with international standards. Partly because – and this was the decisive argument! – it became evident that the Hungarian rules were not sufficiently secure; their application did not protect banks from taking excessive risks. And partly because, in the second quarter of 1993, the international financial press published a statement made by the World Bank experts according to which a substantial portion of the Hungarian banks, including the large banks, had lost their capital even after the bank-oriented loan consolidation scheme according to the international accounting standards (even if they presented something else based on the prevailing Hungarian rules).

Because of this, it became necessary to prepare for the appropriate amendments to the Hungarian regulations so that they be applicable for the classification of the bank portfolios as of December 31, 1993 and for the provisioning. *Inter alia*, Hungarian regulation also shifted to rating the position of the debtor rather than that of individual loans; investments and other liabilities were also subject to the rating and provisioning requirement; as to the extent of provisioning, individual judgement could be flexibly enforced.

As a result of the two factors mentioned above, the share of problem assets increased greatly in 1993; within this, the share of loans qualified as bad increased and there was a vigorous growth in the required provisioning (see Chapter I). Obviously, the contribution of a *third* factor, namely, the fact that lending practice was not faultless in 1993 either and of a *fourth* one that the banks tended to underestimate the magnitude of the losses incurred in the course of classifying the portfolios at the end of 1992 (even according to the Hungarian rules) could not be excluded. Nevertheless, the detailed audits of individual banks unambiguously supported that the first two factors were of decisive importance.

In other words, this means that *at the turn of 1993–1994, a substantial consolidation action could not have been avoided even if a full-scale consolidation had taken place in 1992–1993 according to the information then available.*

The consolidation at the end of 1993 – which, owing to the reasons earlier described, was by then bank consolidation, i.e., recapitalization – *again could not have been postponed*, as in such a case, the 1993 balance sheets of the banks would have presented the loss of capital and the loss of a substantial part of the deposits in the banks, the consequences of which have already been discussed.

The question, however, arises: was there a possibility in December 1993 to fully recapitalize the banks to an adequate level, i.e., to that minimally necessary level, then and there.

This was not possible then. Recapitalization had to be initiated by the bank annual shareholder meetings before the end of 1993 in order that the banks be able to acknowledge the increase in subscribed capital in the balance sheet of 1993. At that time, however, the end-of-1993 portfolios and their rating according to the new rules were not yet – could not have been – available, as the relevant amendments of the banking law came into force only on December 31, 1993. Because of this, the capital increase done in December 1993 could be based on nothing other than the September 30, 1993 portfolios of the banks with some forecasts, and the preliminary predicted amount of provisions of the new regulation, which had not yet come into force. The predicted increase in equity was built on this; it was, however, obvious that this "base" would have to be rectified thereafter, i.e., it would be necessary to shift to the portfolios as of December 31, 1993 and their rating according to the new rules and the use of the related new provisioning rates. In practice, these data were available only by the end of February 1994 and could not have been available any time earlier.

Because of this, the only possible solution was to recapitalize the banks with respect to a *preliminary base in December 1993*, then to rectify or rather supplement this on the basis of the year end-portfolios of 1993 and regulations at the time of the approval of the 1993 balance sheets of the banks in May1994. In order that this adjustment mean capital increase only and to prevent the possibility of withdrawing state funds in certain cases (because of an eventual excessive increase) the obvious conclusion was drawn that recapitalization should not be full in December 1993 and it should *be completed in 1994* in the course of the adjustment.

It was, however, a matter of decision, what level of capital adequacy should be aimed at with the Recapitalization of December 1993. Hungarian experts and the Government accepted the recommendations of the World Bank experts that the banks should be recapitalized essentially only to a CAR of 0 percent (also ensuring a positive "cash-flow" for them). This truly minimal ratio which could be maintained only for a very short time indeed had no particular significance from the viewpoint of the process as a whole (as the supplemental increase in equity was done in a few months time). The World Bank experts insisted on recapitalization to no more than 0 percent, because they thought that this would exert pressure on the banks to speed up their internal restructuring.

As the recapitalization of the banks was done in several steps, it was of extraordinary importance to find a solution which would eliminate the moral hazard arising from repeated consolidation actions (boosting careless lending). Because of this, a decision was made that the subsequent steps of *recapitalization should be based also on the bank portfolios and classifications as of December 31,* 1993 (and not later!). This solution excluded the possibility of allowing the banks to include their eventual portfolio deterioration in 1994 in the scope of consolidation. It is necessary to particularly stress and emphasize this solution, because both the Hungarian and foreign bankers seems to be unaware of it and they frequently express unfounded criticism! as if the implementation of the recapitalization scheme in several steps would have enabled the banks to include the 1994 portfolio deterioration in the consolidation scheme.

This also means that, in the case of banks which benefited both from the portfolio cleanup and recapitalization, differently from the original ideas, it was not end-of-1992 but end-of-1993 which was taken as the end point serving as the basis for the financial bailout, i.e., in their case the 1993 deterioration in their portfolios was still included in the consolidation effort. This, however, as I argued above, was not possible to avoid. Any further deterioration in the portfolios, however, could no longer constitute a basis for action taken in the course of the general restructuring.

It is a very different issue that instead of the second, closing step in the recapitalization of the banks (May 1994), *two additional steps* were taken (on the basis of the end-of-1993 portfolios). This was again related to a number of factors.

First of all, the interested agencies (MoF, NBH, SBS, HSHC) did not agree fully as to the ultimate goal of recapitalization, a CAR of 4 percent would be sufficient (this was held by the MoF), or should the banks be recapitalized to at least 8 percent (this was recommended by the NBH, SBS and the HSHC).

Second of all, the World Bank experts were against any recapitalization surpassing a CAR of 0 percent and recommended that the recapitalization should be postponed for an indeterminate period. This was not supported by any Hungarian agency, yet when making the decision, this circumstance did give rise to some carefulness on the part of the decision-makers.

Thirdly, the leaders of the MoF and of the NBH wished to force the management of the banks to create and implement adequate consolidation programs. Programs found to be inadequate had to be corrected, and a successful implementation of the plan was declared to be a prerequisite of receiving further subordinated capital, in the case of the four banks to be chosen to be fully recapitalized. Because of this, recapitalization was finally accomplished in the case of these banks (to a CAR of 8 percent, on the basis of the end-of-1993 portfolios) at the end of 1994.

In the course of the work, there was a debate on whether or not it was warranted to differentiate among the banks as to the capital adequacy ratio that their recapitalization should aim at. There was a view – originally I myself had represented it – that the Government should recapitalize those banks, which had enjoyed a better equity position before consolidation, to a higher CAR, whereas those in a less favorable situation, to a lower CAR, acknowledging thereby differences in the results of their own management. When, however, it became clear that the only difference among the banks related only to the level of negative equity (i.e., all that could be discussed was banks in a bad or even worse position) and, furthermore, as an agreement evolved that the CAR to be achieved in the case of the banks to be maintained was to be at least 8 percent (i.e., differentiation would have been possible only above this rate with additional sacrifice on the part of the budget) then the original motivation behind the differentiation idea weakened so much that this was no longer implemented in the case of the banks to be fully recapitalized.

Finally, therefore, the restructuring took two years to accomplish and, during this period of time, all in all five steps were taken together with the enterprise-oriented loan consolidation effort. There is no doubt that this two-year period was relatively long. Under the given conditions and circumstances, however, as was seen, a single step could not have been sufficient and adequately beneficial. In a favorable case, however, it would have been possible to close the process in May 1994, nor was there an unconditional need for a separate enterprise-oriented loan consolidation effort; thus the task at hand could have been solved in fewer steps. As, however, the steps in 1994 did not draw in additional claims relative to the status at the end of 1993 to be bailed out, the numerous steps created a *less favorable appearance* than what the process itself actually was.

6. Restructuring Bank Operations

Even though the gigantic losses of the banks were largely caused by external factors, there was no doubt of the need for a radical improvement, even restructuring, of the management, organization and operations of the banks subject to consolidation, as their deficiencies also contributed to the generation of losses.

This was and to this day this has remained the *weakest point* in the restructuring of the Hungarian banking sector. Whatever *belatedly took place or failed to take place* in this field constitutes the main problem of the restructuring.

A detailed analysis of this topic goes beyond the scope of the present study, as in fact only an individual investigation of each bank can be properly thorough and objective. Therefore, my endeavor is to offer only a brief and synthetic presentation of what did happen and what did not happen to the field of transforming bank operations at the banks participating in the restructuring.

Already in relation to the end-of-1992 cleanup, an agreement was reached between the MoF and the banks early in 1993 that the banks would review and modernize their systems of control and operation. At that time, however, little happened; the banks did not take this task sufficiently seriously and the MoF was unable to specify the task to be done and to control the implementation of the bank theoretical undertaking.

The government agencies agreed as early as in the second quarter of 1993 (the recapitalization scheme) that, as part of the preparation of the bank consolidation, there was a need to thoroughly screen the management and the operation of the participating banks and on the basis of the findings to launch restructuring processes. It was also agreed that there was no agency or organization in Hungary that would have been capable of performing a thorough screening of the banks and, on that basis, to specify the tasks to be done in actual terms; therefore, it was necessary to entrust foreign consultant firm(s) with this task.

The selection and contracting of the foreign consultants, however, took very long. Finally, in September 1993, a well-known foreign consultant firm (KPMG) with a wealth of experience in this field was entrusted with the screening of each of the participating banks. The consultant firm was given an exceedingly short time (one month only) to perform the task; presumably, that was the reason why the task was performed not excellently, although satisfactorily. The conclusions of the reports on each bank and the tasks recommended were incorporated by the MoF in the *consolidation agreements* concluded with the banks in December 1993.

The conclusion of the consolidation agreement was done on the basis of the recommendations of the World Bank experts. Incidentally, the World Bank experts recommended contracts the form and content of which could not be fitted into the Hungarian legal system, therefore, it became necessary to adjust their contents to the Hungarian conditions and legal regulations. (Later, the World Bank experts expressed their concern that the content of the agreement was not in accordance with their recommendations).

The consolidation agreements specified the undertaking of the state with respect to recapitalization and the bank undertaking for the implementation of internal restructuring and modernization (also including the actual objectives taking into account the recommendations of the foreign consultants) and for conducting the negotiations of in the debtor conciliation scheme. It was also envisaged that the banks prepare a *consolidation program* to specify the tasks of their internal cleanup.

The banks set out to implement this task in a rather willy-nilly manner, regarding it more of an external pressure, an unwanted burden than the necessary and inevitable precondition of their survival. In general, they accomplished the re-regulation of their internal procedures in due time and in adequate quality, they did improve their credit appraisal and risk rating procedures and loan approval practices, but other actions aimed at the restructuring of their internal organizations and at improving cost management took much longer.

The banks finished their consolidation action-plan by May 1994. Precisely in the case of the two largest consolidated banks (Hungarian Credit Bank and the Commercial Bank), however, the plans were unsatisfactory for several reasons. In relation to this, the representative of the MoF took an ambiguous stance at the shareholders meetings discussing the plans but, upon the proposal of NBH, the MoF finally called upon the banks in a detailed letter to revise and supplement the programs. In this, taking into account the situation of the given banks and the deficiencies of the work accomplished till then, the tasks to be implemented were specified in detail, together with their due dates.

Nevertheless, the comprehensive revision and finalization of the consolidation programs were not done, *inter alia* because the MoF – in an highly incorrect fashion that begs understanding – dealt only with supervising the implementation of the consolidation agreements and never demanded the finalization of the programs specifying the item by item implementation.

At the end of 1994 and in May 1995, new managers were appointed to head the two banks referred to. They set out to perform the comprehensive restructuring of these banks, including radical changes in the systems of control, organization and operation. The transformation is in progress, expected to be accomplished in 1996.

The fact that the *shareholders of the banks with controlling interests held by the state* (ÁPV Rt. and the MoF) *have never been sufficiently prepared for exercising the ownership rights efficiently* also contributed to the excessive time taken by the internal restructuring of the consolidated banks.

For years, there was only one official, (or two people) *at the HSHC* and even at present, there are only a few experts at the successor ÁPV Rt. engaged in the management of state assets in the banks. The HSHC did hardly anything at all in the course of the restructuring to explore the internal problems of the banks or to indicate the direction of a solution. The staff members of the HSHC had neither sufficient information, nor the expertise to do so. The situation has improved since then, ÁPV Rt. has been increasingly more thorough in its dealings with the banks.

At the *MoF*, a few staff members burdened also with other matters dealt with the banking sector. They had hardly any actual information on the activities of individual banks. By the end of the restructuring, a unit came into being which is called to exercise ownership rights with respect to the assets which MoF acquired in relation to the recapitalization. It has more and more information to do this, yet the unit has to develop a great deal in order to be able to perform its functions.

To this very day, the members delegated by the ÁPV Rt. and MoF to *the Boards of Directors and Supervisory Boards of the banks* have been performing their tasks without uniform guidance and a detailed reporting obligation; accordingly, they were unable to offer guidance, and convey the requirements and criteria of the state as shareholder (in any case, these have never been formulated) whether in formulating the bank strategies or their restructuring or their operations.

The fact that the internal restructuring of the banks in question began with a *delay* and has not been accomplished to this day had various *unfavorable consequences*.

First, it had a detrimental impact on the banks themselves. The prolongation of the changes gave rise to interruptions and uncertainties in their work, made the positions of otherwise professionally suitable managers and staff members uncertain, some of whom left. The services of the banks did not develop as desired, as a result of which their clients and primarily a good portion of the "good" clients gradually wandered off to other financial institutions – characteristically to banks with foreign or mixed ownership.

Secondly, the prolongation of the internal cleanup of the banks also increased the financial burden of the restructuring. Obviously, had the necessary slimming and rationalization, reduction in staff numbers and the wage bill, and improvement in cost management been implemented not in 1995–1996 but, say, two or three years earlier, then, accordingly, the banks could have been able to realize higher income in 1993–1994. In this case, they would have been able to make higher amounts of risk provisions out of their own funds and hence a lower amount for recapitalization would have been necessary for the purposes of provisioning. Obviously, the magnitude of this difference cannot be assessed accurately, yet it can be estimated at a few billion forints based on the financial data of the banks. Basically, this would not have caused any substantial change in the magnitude of the state budget burden (as it would have made up only a fraction, perhaps one percent, of this) yet it would not have been negligible particularly in view of its moral impact and consequences.

7. A Few Concluding Remarks

As follows, I shall summarize a few general comments based on the detailed evaluation of the loan and bank consolidation described above. These comments will obviously include a few statements formulated above but they also go beyond them also by the virtue of a summarizing synthesis.

I shall wrap the conclusions around two questions:

- Would it have been possible to implement the restructuring with less expense than the costs actually incurred?
- Based on the income transfer done in the course of restructuring, can the losers and the winners of the process be identified?

a) The above arguments sufficiently demonstrated that the *financial restructuring of the banks* which had suffered gigantic losses (in terms of the value of their equity and deposits) *and a decisive action of the government could not have been* *avoided in any case.* It was, however, also demonstrated that a number of insufficiently considered, suboptimal or absolutely *mistaken steps* and a whole series of omissions took place on the part of both the government and the banks, which did influence the magnitude of the state undertaking. Some of these mistakes and omissions were evident already at the time of the action, and some of the experts (including the author of the present study) did express their concerns about them or rather about a substantial portion of them in debates and also to the press. Other mistakes, inadequate solutions and omissions could be demonstrated only by subsequent analysis.

In any case, by now the conclusion can be unambiguously derived that the *state burden* related to the restructuring of the banking sector *could have been lower than what it actually turned out to be* had the circumstances to be listed below or at least a part of them been more favorable (disregarding this time the circumstances related to the establishment of the banks and the changes in the economy):

- had the rules of taxation not made it more difficult for the banks to make risk provisions until the end of 1991;
- had the Banking Law enacted at the end of 1991 been more in harmony with international standards;
- had the professional preparation for the restructuring not been (seriously) disrupted by government debates, interventions and omissions motivated by political and personal considerations in 1992–1993;
- had the entire restructuring been implemented under the control of Parliament (and thereby the public) based on laws (i.e., had there been lawful authorization for the bailout as a whole by law and not for a part of it only, e.g., for issuing bonds);
- had the Government discussed and adopted the proposal on decentralized portfolio cleanup in due time in 1992;
- had the Government not given up in practice the endeavors aimed at facilitating the establishment of commercial work-out organizations (companies) to manage the claims in 1992–1993;

- had a different combination of the methods used in the bailout been applied: had portfolio cleanup been assigned a greater and accordingly recapitalization a somewhat smaller role than they actually had (and in certain cases perhaps the method of assuming state guarantees could also have been applied);
- had the enterprise -oriented portfolio cleanup of the privileged companies been limited to a narrower range (and magnitude);
- had the HSHC and the SPA (as the designated state shareholders of the banks) and the MoF been able to formulate unambiguous requirements concerning the internal restructuring of the banks and enforce those already from the beginning of 1993;
- had the managers of the banks with difficult financial positions recognized the importance, moreover, the inevitable necessity of internal restructuring, downsizing and modernization in due time and had they commenced with and implemented the internal reorganization of the banks driven by their own beliefs (even without external administrative persuasion) from 1992–1993 in a resolute and comprehensive fashion, also including the resolute and substantial reduction of costs – and within this, also wages – instead of their unjustified increases – as well as the separation of bad debts;
- had the Boards of Directors and Supervisory Boards of the banks perform their functions continuously, efficiently and in a responsible way;
- had the replacement of the inapt managers and staff members of the banks with expert bankers been done in due time.

Nobody can make a well-based estimate as to the amount whereby the state financial burden could have been reduced if one or the other, the majority or all of the above conditions were met. *I have the feeling* that if all the above circumstances evolved in a more favorable way (which, in itself, is an assumption that lacks realism), altogether some 20–25 percent could have been saved...

It should be added that the restructuring did have severe losses or, rather, losses, which could have been prevented, were incurred to the debtors.

b) The public strongly holds the view that the loan and bank consolidation scheme was in fact a gigantic income transfer at the expense of society, the citizens and businesses in favor of the banks, moreover, of the bankers.

There is no doubt that this series of actions did constitute a major regrouping of incomes at the expense of the *future generation but partly also of the present taxpayers* (the reasons of which were detailed above). The budget continuously pays the interest payments on the 20-year government bonds, moreover, the interest rates were higher than expected because of the acceleration of inflation in 1995.

All in all, however, this meant and means regrouping of incomes not in the sense that any organization or person would have "systematically" obtained surplus income. This can be explained by the fact that consolidation

- first and foremost served the purpose of providing cover for the losses already incurred in the course of the portfolio cleanup and in relation to the provisioning on problem assets retained by the banks and for potential losses;
- secondly, up to a certain level, it made up for the loss of capital (net assets) which had also taken place by then and ensured the equity which was a minimal condition of adequate operation.

Through this, what was eliminated first and foremost was the loss of deposits of *the population and businesses*. This is to say that there certainly was an income transfer in their favor but this did not give them *additional income* and obviously does not enable them to consume more, it only *readjusted* the not yet perceived loss of income. In this respect, it is worthwhile making a special mention of the fact that the re-establishment of the value of deposits *inter alia* rescued profitable businesses (i.e., the good debtors and those who were not debtors at all) from suffering severe losses; through this, the threat of the bad debtors "sinking the ships of viable businesses" with their own was warded off.

In principle, the state could have let depositors lose their money by not taking over their losses. This, however, would have caused even greater losses for the country as a whole, as I demonstrated above. Therefore, the income transfer from the society to depositors to ward off losses was well justified, no matter how great a burden it involved.

The argument is similar in the case of the income transfer which offset the loss of equity on the part of the banks, which constituted an amount much lower than the former, with the difference that in this respect the *state* as the owner made up for its own *loss of capital*, i.e., it supplied financial resources to its own banks to the extent that they be enable to function properly or to be reasonably privatized.

It may be mentioned at this point that the *private shareholders* of the banks also suffered loss of capital in the course of the bank consolidation scheme and their loss of capital was offset by consolidation by the state only to a very small proportion. The value of their shares declined to a fraction of the original value after the recapitalization and capital reduction (share swap), but it was not fully lost. (Earlier, in the course of the loan consolidation scheme, the private shareholders of the banks did not suffer losses.)

As it shall be seen later, the value of the state transfer was not obtained by anyone apart from a few minor exceptions which should nevertheless be mentioned. It *is still there* in the forms of provisions or equity *or has been or shall be written off with reason.* This value, however, in general *cannot be used* either to finance new investments or consumption. What may be an exception is what is in any case desirable, i.e., if the banks are able to realize sufficient revenue from the management, liquidation and write-off of their problem assets that enable them to release a portion of the provisions set aside. This portion would increase their profits (on which they obviously pay tax) and from this they can increase their sources of lending or capital.

Obviously, the circumstance already referred to that the bank internal cleanup took so long also means that there unjustifiable disbursements for costs, including wages, which means that in this form and *to a relatively small extent*, consolidation also served *individual* interests.

It can also not be excluded that, in the course of the preparations of the debtor conciliation agreements enabled by the loan and bank consolidation schemes, there may have been collusion, there may have been illegal personal advantages. To date, however, such facts have not been detected or proven in any one case. Without such proof, this is mere presumption, unfounded accusation which, short of proven cases, cannot and must not be treated as fact.

It is, however, also obvious that in cases when debtor conciliation agreements were implemented on the basis of bank consolidation or (as this action has already been accomplished), later on, the forgiving or rescheduling of debt or the loan/equity conversions will enable viable ventures to be rescued from liquidation and enable them to function profitably in the future, then that means that the consolidation effort served the *interests of the given businesses and through that also that of the national economy* (in more detail, see Chapter IV). It should, however, be mentioned that among the privileged enterprises, where the HSHC forgave all the debts taken over from the bank, in certain cases, it is highly probable that the preference was excessive, thus these companies *unjustifiably* became the *winners* of the action. A similar case may occur in the case of some businesses to which the banks offered preferential treatment based on the debtor conciliation agreements if the later development of these companies fails to justify it.

c) The conclusion can also be drawn that the restructuring of the banks with controlling interests held by the state and which had lost their capital it was inevitable and of decisive importance as far as it established the indispensable precondition of the *privatization* of those banks. Following an adequate internal modernization, the state banks, recapitalized to the minimal necessary level, equipped with a transparent portfolio and the necessary provisions became capable of attracting private investors, also including foreign investors. The privatization of these banks began through the acquisition of the state holdings and additional capital increases in 1995 and will predictably be accomplished in 1997.

III. The Banking Sector after Restructuring

In the previous chapters of the study, I presented and assessed the loan and bank consolidation schemes. This chapter examines the question of what impact the these schemes had on the position of the financial institutions and, as a result of this, and on the development of the bank activities, what is the current position of the entire banking sector like.

In this context, two types of errors or rather one-sided mistaken approaches should be avoided. One of these one-sided approaches interprets the restructuring only with respect to the eight financial institutions which were recapitalized by the state, although the schemes affected a much wider area of the banking sector in one form or the other. The other one-sided approach characterizes the entire banking sector only from the viewpoint of the necessity and implementation of consolidation and from the aspect of the positions of the participating banks, disregarding the changes that have taken place at these banks partially as a result of consolidation and, secondly the financial institutions which never needed financial bailout and the significant portion of which expanded truly dynamically over the past few years.

1. Positions of the Banks

a) The main characteristics and ownership relations

On December 31, 1995, there were 42 financial institutions (in March 1996 no more than 38), 248 savings co-operatives and four credit co-operatives functioning in the Hungarian banking sectors. Of these, seven banks qualified as large banks (with their individual balance sheet totals exceeding 4 percent of that of the entire banking sector), 12 were medium-sized banks (with their individual balance sheet totals amounting to 1–4 percent of that of the entire banking sector) and there were 23 small banks.

The combined equity of the entire banking sector was HUF 297 billion, its subscribed capital (after the capital reductions following the recapitalization) was HUF 220 billion on December 31,1995. The balance sheet total of the banking sector amounted to HUF 3,876 billion at the end of 1995, which corresponded to 70 percent of the GDP of that year. Liabilities accounted for 10.3 percent of the balance sheet total, which can be regarded as a favorable ratio.

Of the 38 financial institutions functioning early in 1996, the controlling interests in 26 banks were in private hands and in 12 banks (of this, in only two large banks) were held by the state. The vast majority of privately held financial institutions had foreign or mixed (foreign and Hungarian) ownership.

In 1995, primarily as a result of the privatization, the share of the state holdings declined vigorously, while that of foreign holdings in total equity increased. At the end of the year, 43.2 percent of the subscribed capital of the banking sector was still held by the state, 21.2 percent was in other Hungarian ownership, and 35.6 percent was in foreign hands. In the first half of 1996, an additional shift in the ratio took place in favor of foreign ownership and at the expense of the state holdings.

As a result of the rapid development of the banks in foreign or mixed ownership and the privatization of some large banks, the share of the banks with controlling interests still held by the state declined substantially in the balance sheet total of the banking sector over the past few years. This share was no more than about 23 percent at the end of 1995 and declined further in the course of 1996.

With the profound changes taking place in the ownership structure of the banking sector and the distribution of the balance sheet total of the banks, *from 1996, the operation of pri-*

vate financial institutions determines the activities of the Hungarian banking sector.

The National Savings and Commercial Bank (OTP) is the largest of the commercial banks; at the end of 1995, its balance sheet total approached HUF 1,100 billion, its equity amounted to HUF 47 billion. The balance sheet totals of the other six large banks moved each around HUF 200–330 billion, their equity was each between 10–25 billion. Of these, two banks, the Hungarian Credit Bank (MHB) and the Commercial and Credit Bank (K&H) had majority state holdings, the majority holdings in the others: the National Savings and Commercial Bank (OTP), the Budapest Credit and Development Bank (BB), the Hungarian Foreign Trade Bank (MKB), the Postabank, furthermore, the Central European International Bank and the CIB Hungária Bank together (CIB) were in private hands.

b) The participating banks in the loan and bank consolidation

In some form or the other, the various steps in the loan and bank consolidation scheme affected 18 banks in the following manner:

- 14 commercial banks (and 78 savings co-operatives) participated in the bank-oriented loan consolidation (subsequently, individual bailout was done at three other banks);
- under the enterprise-oriented loan consolidation scheme, the state bought bad and doubtful debts from 11 commercial banks (but in the case of five banks, the buy-out was of a minimal amount);
- eight banks, plus OTIVA, the National Savings Co-operative Institution Protection Fund benefited from the bank consolidation, including three large banks (MHB, K&H and BB).

Of the 18 banks affected in the series of actions – if buy-outs of minimal amounts are disregarded – three banks participated in all three actions, seven banks in two and eight banks in one. Apart from this, there was a capital increase out of the consolidation scheme at OTP, which participated in one action and Budapest Bank, which participated in all three actions, also received a capital injection that proved to be temporary.

As a consequence of their low quality portfolios the financial institutions participating in the consolidation received consolidation government bonds, i.e., state capital contribution, to different extent in terms of the absolute amount and the relative weight compared to their capital position. Obviously, the large banks received the largest contributions. Both in terms of absolute value and relative to its activity, MHB is "at the top of the list", but K&H, BB, Postabank, MKB and in terms of absolute value, OTP benefited from significant contributions. Of the smaller banks, the Hungarian Savings Co-operative Bank (MTB), Mezőbank, Dunabank and Agrobank received substantial state support.

c) Differences in the financial positions

The various banks, also depending on the nature of their relationship with the consolidation have different financial positions.

- The bulk of the financial institutions which, not being in need, did not participate in the consolidation *in any form* whatsoever, are in a good financial and in particularly good capital position. These banks are almost exclusively held by foreigners in part or in full: they had been in a favorable start-up position. They had no (or only little) claims which had originated before 1990, their clientele consisted mainly of highly profitable businesses (frequently joint ventures); in addition, they have been pursuing highly prudential, cautious lending practices over the past years. Some of these banks won over clients through having been able to apply a lower mark-up owing to their lower provisioning requirement. Although some of these banks recently began to vigorously intensify their activities, their financial position, internal stability, profitability and capital adequacy continue to be generally very good.
- The financial institutions which participated in the restructuring only through the *two types of portfolio cleanup* and reached a satisfactory position, in particular, adequate capital adequacy

ratios thereby, and did not participate in the bank consolidation scheme (i.e., did not benefit from the recapitalization are in a satisfactory financial position which is, however, not excellent (in the case of the Postabank, however, this also required the implementation of a capital increase by private parties).

- The financial positions of the four banks of the eight, which benefited not only from the portfolio cleanup but also from the state capital injection (MHB, K&H, BB and MTB), which were *fully recapitalized* (up to a CAR of 8 percent) has improved also since the capital increase and are, on the whole, satisfactory. In 1994–1995, their capital adequacy ratios exceeded 8 percent, even 10 percent in three cases of the four (in the case of BB, with the capital injection by the Government or the capital increase implemented through privatization at the end of 1995, which replaced the Government's capital contribution, CAR exceeded 20 percent). In 1995, all of these banks made a profit.
- At two of the four banks referred to (MHB, K&H), the internal restructuring including downsizing and cost reduction are still in progress and have not yet been accomplished, therefore, they cannot yet be regarded as "healthy" banks but they have started out and are on the way to reach such a position.
- In four cases of the recapitalized eight banks (Mezőbank, Agrobank, Dunabank and Iparbankház), the *capital increase* of 1994 *was not full*: it served no more than reaching a CAR of 4 percent assuming that their capital could be further increased through privatization or, if that was not possible, that would reveal that their existence as independent banks was not warranted. Within this, primary capital guaranteed no more than a CAR of 2 percent. These four banks (their combined balance sheet total amounted to 2.5 percent of that of the entire banking sector at the end of 1995) suffered additional losses since the capital increase (they had made losses before), their guarantee capital and capital adequacy ratios turned negative. Early in 1996, Agrobank was merged into the Mezőbank and this merged bank was again recapitalized by the state. The independent operation of

Dunabank, which was privatized early in 1996, and of Iparbankház, came to an end in 1996.

Incidentally, these facts also support that the opinions, according to which banks are capable of satisfactory operation even with a CAR of 0 percent but even the views, which considered the recapitalization of banks to a CAR of 4 percent as sufficient, were unfounded. It was demonstrated that a CAR of 8 percent, within which at least 4 percent is guaranteed by primary capital, is the minimum equity needed with which financial institutions are able to survive and operate satisfactorily while making a small profit and not losing equity, even if they cannot develop in a dynamic fashion.

Thus the position of the banks in the Hungarian banking sector continues to be *differentiated* even after the restructuring: there are – and these increasingly represent the majority – banks capable of a secure survival and operation as well as dynamic development and there also are, with declining significance, financial institutions that are viable only through radical internal transformation. Even among the banks in the first category, however, there are several in need of further, in some cases substantial modernization of operation. Some small banks, as we have seen, proved to be unsuited for independent existence.

d) The overall position of the banking sector

The overall position of the banking sector, even though there are differences in the positions of individual banks, *is now radically different from that in 1991–1993.* This is characterized by the following:

- In 1991–1993, the portfolios of the banks lacked transparency and adequate rating. *Now the entire portfolio of each and every financial institution is classified in accordance with the stringent requirements and criteria harmonized with the international standards and these ratings are continuously controlled by – mostly international – auditors.*
- In 1991–1993, the banks set aside only a small portion of the provisions required in accordance with the ratings of their

portfolios and a substantial portion of them did not have a chance of setting aside the required provisions. *Now every single financial institution met the provisioning requirement based on stringent portfolio ratings in full.*

- In 1991–1993, the portfolios in the banks were in a condition of rapid deterioration. Without consolidation, the share of problem assets in the total loans of the banks would have reached 33 percent, within this, that of bad debts would have exceeded 20 percent by the end of 1993. By the end of 1995, *the share of all the classified loans – covered to the necessary extent by provisions – sank to 15 percent, within this, the share of bad debts did not reach 5 percent, that of doubtful debts was 2 percent.* This is so in spite of the fact that recapitalization left bad and doubtful assets with the banks. There were several factors contributing to the improvement of this ratio. First, the fact that the portfolios of the restructured banks now include the risk-free consolidation bonds, and second, they are gradually getting rid of their bad and doubtful debts through selling, and transferring them and through writing off the irrecoverable debts. Third, the number of banks having relatively few problem assets – these are mainly the banks in mixed or foreign ownership – has increased.
- In 1991–1993, the provisioning requirement was dynamically rising. Without consolidation, the combined provisioning requirement of the banking sector would have exceeded 25 percent of the balance sheet total at the end of 1993. *Now provisions, fully in line with the requirements, make up 4 percent of the balance sheet total and this ratio is continuously declining.*
- In 1991–1993, a substantial portion of the banks in fact had negative equity. *Now* the financial institutions not only have positive equity but, apart from a few small banks, their *capital adequacy ratios well exceed 8 percent. The combined capital adequacy ratio of the entire Hungarian banking sector is presently at around 19 percent.* Of the seven large banks, there is one bank with a CAR of above 8 percent, three large

banks have CARs of about 10–15 percent and three large banks exceed the CAR of 20 percent.

– In 1991–1993, a good number of the banks were unable to make a profit after provisioning, in spite of the growing and exceedingly high spreads. *Now* with the vigorous decline in the provisioning requirement, *spreads decreased* (even though they are still high) and the banks – apart from a few not fully recapitalized banks and a few other small banks that did not take part in the consolidation scheme – *made profits* in 1995 (to which obviously the interest payments on the consolidation bonds contributed a great deal in the case of the restructured banks). According to preliminary data, the pre-tax but after-provisioning profits of the entire banking sector rose from HUF 25.3 billion in 1994 to HUF 56.8 billion in 1995 and after-tax profits from HUF 15.7 billion to HUF 45.1 billion.

In the first half of 1996, the reduction in the share and magnitude of problem assets including bad and doubtful ones and because of that also that of the provisioning requirement, the average capital adequacy ratio improved further and profits increased in the banking sector.

Obviously, all this *does not* yet mean that the Hungarian banking sector enjoys a perfect health. The banking sector, primarily those banks which had been in need of restructuring, managed to avoid being doomed and went through a substantial healing process. Yet a few more years are needed for the full recovery of the entire banking sector.

This therapeutic process can be based on the combined effect of several factors. Of these, *the most important is the stabilization of the entire economy and the unfolding of a balanced and sustainable growth*, as the banking sector cannot be (at least much) better than the entire economy. The self-development of the banking sector evolving also as a result of the increasingly fierce competition among the financial institutions, the restructuring activities of the state and of the individual banks and the continued privatization of the banks of state ownership will also have an important role to play.

e) Specific features of the recapitalized banks

The loan and bank consolidation effort exerted a positive impact on the operation of the fully recapitalized banks: their equity position was essentially normalized and they became capable of profitable operation.

At the same time, these banks are in a peculiar situation. This is manifested in the fact that, as a result of the recapitalization method applied in the restructuring, *the share of bad and doubtful assets continues to be high in their portfolio.* At the end of 1994, the share of bad and doubtful assets at the recapitalized banks together was 29 percent, within this, that of bad ones was 21 percent, while for the total of all the other banks together, the total for bad and debts was no more than 4.4 percent. Since then, the situation improved: by the end of December 1995, the share of bad and doubtful assets at the recapitalized banks was 17 percent, of this, that of the bad ones was 12 percent and still of this, the share of bad and doubtful assets of the two large banks the controlling interests still held by the state, was below 10 percent. Accordingly, the recapitalized banks had huge amounts of provisions, well in excess of their equity after consolidation. Using these provisions, bad and doubtful assets can and must be reduced to an acceptable level in the foreseeable future, by taking organized action. This process progressed well in 1995–1996, accordingly, the provisions of the banks referred to decreased considerably.

In 1994–1995, *the lending practice of the recapitalized banks became careful and prudential*, they refrained from taking excessive and unjustified risk. They have attempted to gradually liquidate their loans outstanding against bad debtors. In some cases, they separated their bad loans and investments or rather their management to other organizations (for instance, in the case of MHB and Mezőbank), while in other cases, they were transferred to separate but internal units; these made significant achievements in the sales of these assets. The writing off of the unambiguously irrecoverable claims is progressing gradually by debiting provisions. (At the same time, in 1994–1995, the process of the migration of a – although smaller and smaller – portion of the good clients of these banks to other banks with more secure positions, primarily to those with foreign or mixed ownership, still continued.) With all this, the claims of the consolidated banks declined in terms of amount and range, which only underlines the importance of internal modernization and downsizing.

This is to say, the moral hazard because of which so much concern was expressed by certain foreign and Hungarian experts, namely, that the fully recapitalized financial institutions would engage in irresponsible lending practices in the hope of yet again benefiting from a renewed consolidation arrangement, did not materialize. Moreover, the substantial increase in the capital adequacy ratios of the restructured banks in 1994–1995 bears witness to an improvement in this respect.

There is no doubt that the fact according to which the recapitalization of the banks was done by government bonds with long-term maturities (rather than through cash or short-term government papers) not in demand in the market meant that restructuring alleviated the *liquidity problems* of the participating banks only in part through the interest payments on the bonds every half year or every year, at a rate which is presently relatively high.

In the case of those banks which had truly substantial liquidity problems, this surplus interest revenue provided only a partial solution to their problems. These banks were able to bridge their liquidity disturbances only through borrowing short-term repo loans bearing an interest rate higher than that of the consolidation bonds in 1994. This was costly and could not provide a solution for recurrent liquidity deficits; in addition, it siphoned income out of the banks, ultimately to the budget. For this reason – as this had been predictable in any case -to supplement consolidation *it became necessary to buy a portion of the consolidation bonds from these banks or to swap them to short-term government securities that are easy to sell in the market.* The NBH did conduct actions of this kind for certain banks reducing, at the same time, the amounts of the repo loans available to them. It cannot be excluded that the need may later arise to take such action to some extent. This, however, will no longer be an addition to the consolidation arrangement but part of the activities of the central bank facilitating the healthy operation of the banking sector.

Additional consolidation action is not warranted in the case of the fully recapitalized banks, moreover, it would be expressly det*rimental.* Yet it is necessary to continue with and accomplish the process of the internal restructuring of the banks, so that they be appropriately prepared for privatization also in this respect.

Also, as I mentioned before, a decision on the part of the state to *terminate some of the smaller financial institutions,* which had, in the course of restructuring, been partially recapitalized and which again lost their capital since, could not be avoided, while also protecting the interests of their depositors. A few other small banks are exposed to the threat of not being able to profitably operate unless they develop a highly specific business profile, therefore, they may even lose their capital, if for no other reason, then because of their size.

2. A Few General Characteristics and Problems of the Banking Systems

Below I wish to summarize a few of the most important characteristics and problems of the Hungarian banking sector. I will not discuss every problem, only those of a general or economic nature. I will not deal in detail with the issues related to the management and internal control of the financial institutions, the composition of their personnel, their organization, operating mechanisms and information systems; the present study does not provide room for this.

The general characteristics of and the economic problems in the operation of the banking sector arise from a few fundamental factors:

- the situation of the economy, the need for its comprehensive stabilization which determines the macroeconomic conditions of the operation of the banking sector;
- the circumstances of the establishment and development to date of the banking sector which greatly determines its current organizational structure;
- the mode of the loan and bank consolidation effort discussed above, its effects and consequences;
- the ownership situation of the banks, the course of privatization to date and its results.

Below I shall discuss the general economic problems and characteristics of the banking sector organized into themes.

a) The macroeconomic environment

Presently, the Hungarian economy is in the process of comprehensive stabilization. Its first stage will as expected, be closed by the end of 1996. As it is well known, the comprehensive and vigorous stabilization of the economy became necessary, because its equilibrium greatly deteriorated in 1993 owing to reasons which had earlier accumulated and the high degree of disequilibrium remained also in 1994, moreover, it became stronger at certain points. The main forms of the disequilibrium were: a large deficit in the current account, a substantial deficit in general government and high inflation.

As a result of the comprehensive stabilization effort, a substantial reduction was achieved in the deficit of the current account and in that of general government in 1995–1996 and in 1996 they approached the level that can be sustained in the long term. Inflation speeded up for a while, then began to decline, yet it is still high in 1996.

The performance of the economy worsened in the years 1990–1993, then growth began in 1994. The stabilization measures reduced aggregate domestic demand. Consequently, growth rate in 1995 abated somewhat but, in structural terms, it became export-led and investment driven; thus, instead of another decline, economic growth is continuing, even if only at a moderate rate. The growth rate is expected to rise with the progress made in stabilization from 1997.

These macroeconomic factors have a substantial impact on *the operation of the banking sector*. The main effects can be summarized as follows:

- The still substantial deficit of *general government* (in 1995, 6.5 percent of GDP, in 1996, 4 percent of GDP) gives rise to a corresponding financing (net borrowing) requirement. Consequently, the Treasury is highly active in the money market absorbing a substantial portion of household savings through issues of government securities. In addition, government securities tie down a part of the corporate savings and a substantial portion of the lending opportunities of the financial institutions. Owing to the given size of the general government deficit – i.e., relative to the situation had that deficit been no more than the 2–3 percent of GDP which could be regarded as normal – financial institutions can obtain less in terms of household and corporate funds (in the form of deposits and bank securities) and extend more credit to the state, hence there is *less available* for the *corporate sector*. In addition, it has become more difficult for companies to have access to credit and capital through issuing bonds and shares; in addition, the yields of the government securities also determine the required yields on corporate papers (pushing them upward). With the decline in the general government deficit, the significance and impact of this factor has been substantially reduced already in 1996 and this improvement is expected to continue in 1997–1998, which means that the access of the corporate sector to credit and capital will gradually become easier.
- Pursuant to the stabilization policy, the NBH has been pursuing a *tight monetary policy* by necessity. On one hand, it has to limit the amount of credit offered by the central bank (offering refinancing loans to the banks) to the minimum, restricting this activity to bridge over liquidity problems but strictly only those of a transitory nature and "to the channel

lending" of long-term external funds. On the other, the NBH has to keep the required reserve ratio at a high level. As a result, financial institutions have less funding for loans than they had in case of an "expansive" monetary policy. This also contributed to keeping the domestic interest rate relatively high exceeding the foreign interest rates adjusted by the continuous devaluation of the forint. If, however, the NBH did not pursue a tight monetary policy, the improvement in the economic equilibrium could not be achieved, moreover, it would deteriorate further: aggregate domestic demand would increase, the deficit in the current account would be greater, interests rates would decline and owing to this, an increasing portion of savings would be converted into foreign currencies, at the same time, inflation would be accelerating. Evidently, the monetary policy of the Central Bank will remain tight in the coming years as well, but the content of that stringency will change. As a result, the rates of interest and the required reserve ratio will decline (this process began already in 1996) and this may improve the conditions of corporate borrowing.

- The relative scarcity of the forint denominated liabilities of financial institutions and the fact that the domestic interest rates are higher than the foreign interest rates increased by the devaluation of the forint, together drove financial institutions but also companies to rely on *loans* denominated *in foreign currencies* and they also have the possibility to do so. This already expands borrowing possibilities for the corporate sector and makes borrowing abroad cheaper relative to the domestic conditions limited by a tight monetary policy. In this way, not only the inflow of foreign loans speeded up either directly to the companies or mediated by the financial institutions, but more favorable conditions came into being for the inflow of foreign direct investment as well. Obviously, the inflow of foreign loans and capital means surplus funding primarily for the secure financial institutions and profitably operating companies. This facilitates a differentiation among banks and companies as well as structural changes in the favorable direction. Presumably, foreign borrowing by banks and companies will increase at a less dynamic rate, even though it will grow in the coming years, the loan portfolio of this kind will expand more slowly than to date; under a favorable scenario, however, the inflow of direct foreign investment (without privatization revenues) may speed up. The significance of the problem that direct foreign borrowing by companies drives Hungarian banks out of the money market to some extent and deprives them of the possibility of financial mediation seems to be abating.

Consequently, the macroeconomic environment creates stringent conditions and limits for financing the economy; yet, by facilitating restructuring, it increasingly promotes the unfolding of a healthy economic growth and thereby the development of the enterprise sector.

b) Structural deficiencies and structural changes

The Hungarian banking sector is still struggling with structural problems. Largely, these problems came into being at the time of the establishment of the two-tier banking system in 1987. Since then the structural problems have abated as with the self-development of the banks, the excessive one-sided specialization has been substantially loosened and, furthermore, the establishment and dynamic development of new banks made up for some of the structural deficits and eliminated monopoly positions.

The loan and bank consolidation schemes also alleviated structural problems but only to a small extent, as they were not concomitant with a radical transformation in the asset-liability structure of the individual banks (beyond the fact that the share of state funds and loans increased considerably in these banks) or with the liquidation of financial institutions not viable in the long run or with their merging into other banks or take-over by other banks.

Over the past few years, "the missing links in the chain" of the banking sector have come into being slowly and still not yet fully.

The main problems and tendencies in this field can be summarized as follows:

- "Segmentation" in the banking sector is now less, but it is still there. OTP continues to play the predominant role in collecting *funds from the households,* even thought the share of Postabank and other banks and of the savings co-operatives did increase over the past few years. In 1995, OTP collected 57 percent of the household funds, Postabank had more than 13 percent, savings co-operatives approximately 10 percent, i.e., these three together collected nearly 80 percent and the rest had hardly more than 20 percent! At present, no fundamental changes can be seen in this field; it is expected that the shifts which began with respect to the shares of the banks in collecting deposits from households will slowly continue.
- With the exception of OTP, the large banks which had earlier been largely owned by the state (MHB, K&H, BB) were primarily involved with the *enterprise sector.* This specialization of these banks changed slowly: beside the budget, the enterprise sector continues to play the decisive role in their domestic forint liabilities and their loans. (They collect funds from the households primarily through issuing securities.) At the same time, their market share has been vigorously falling for years in this respect and they have lost their predominant role. A few years ago, the majority of corporate deposits had been placed with the largely state-owned large banks, presently, however, their weights have declined considerably. At the same time, the share in enterprise deposits of the banks with foreign or mixed ownership has been increasing dynamically. A similar shift in shares took place in the case of lending to the enterprise sector in terms of both direction and magnitude as well. The share in financing the enterprise sector of banks with foreign or mixed ownership approached 50 percent already in mid-1995; as a result of BB s privatization and other developments, this share increased further. At the

end of 1995, the share in the deposits of the enterprise sector of the two large banks still held by the state was 21 percent and in the enterprise loan portfolio it was 16 percent; the share in enterprise deposits of all the banks with controlling interests held by the state was 26 percent, and it was the same percent in enterprise loans. Presumably, these tendencies will continue also in the coming years.

- The activity of financial institutions specialized in extending long-term loans, particularly for *investments* has appeared only to a very limited extent in the banking sector. In general, commercial banks are able to extend long-term credits out of their own funds only to a modest amount (they tend to on-lend the refinancing loans of the NBH and some loans denominated in foreign currencies). At the same time, there is only one bank in the entire banking sector (the Hungarian Investment and Development Bank – The MBFB) which is basically specialized in investment lending. Corvinbank also pursued similar activities. It is not right if a development bank with state ownership lands in an essentially monopoly position, it is desirable that additional development banks be established in the future.
- Eximbank, an institution financing exports came into being only recently as a special financial institution.
- There are no financial institutions specializing in *mortgage loans and credit institutions financing housing* in the banking sector.

Thus the development of an appropriately structured banking sector requires, in addition to privatization, system-building state action and initiatives.

c) The peculiar asset-liability structure

One of the specific features of the Hungarian banking sector is that the share of forint and foreign currency funds among liabilities and the share of loans to the budget among assets are relatively high. On the other hand, the share of long-term liabilities (fixed for more than a year) and of loans for more than a year is low relative to short-term liabilities and loans.

Over the past few years and particularly in 1994–1995 – *inter alia*, because of the scarcity of domestic funds due to the reasons referred to under Section III/1 – the share of *foreign currency funds* originating from abroad, from foreign currency loans and the foreign currency deposits of residents, increased substantially among the external liabilities of the Hungarian financial institutions. This development has been characteristic particularly for the banks with foreign or mixed ownership (this is why the share of these banks in corporate lending increased) but it can also be observed in the case of some Hungarian-owned large and small banks as well. At the end of 1995, the share of liabilities originating from abroad in the total liabilities of the banking sector reached 13 percent and the share of the foreign currency deposits of households and companies reached 16 percent. By itself, this does not indicate any particular problem, yet it does introduce a small degree of uncertainty into the system.

The other side of the coin is that the share of loans borrowed and denominated in foreign currencies raised not from Hungarian financial institutions but directly from abroad (from foreign financial institutions and other companies) has been on the rise among the loans of the *enterprise* sector. This share exceeded 30 percent of the total enterprise borrowing in 1995, although the increase in the share abated in 1996.

The *long-term liabilities* of the financial institutions represent a relatively meager magnitude; their domestic liabilities are not increasing, moreover, owing to the withdrawal of the central bank, they have been declining even in nominal terms. At the end of 1995, the bulk of the not *ab ovo* anchored liabilities of the financial institutions were funds fixed for less than a year. The financial institutions own liabilities accounted for 10.3 percent of total liabilities at the end of 1995; nearly half of this was made up of the ab ovo anchored consolidation bonds, constituting part of the subscribed capital and transferred as subordinated capital. Among the external liabilities, the share of funds maturing in more than a year was no more than 23 percent. Of this, long-term liabilities raised from the central bank – declining in any case – represented 9 percentage points, whereas foreign long-term liabilities made up 7 percentage points. Only 12 percent of the household deposits placed with the banks are fixed for more than a year, this accounts for less than one fifth of the external liabilities of the banks fixed for more than a year. The long-term savings of companies do not play any substantial role as deposits.

The share of loans and advances to the *budget* first increased, then stagnated followed by a slight decline among the assets of the banks, mainly in the form of long-term placements. This was primarily related to the fact that the 20-year consolidation bonds received in the course of the loan and bank consolidation schemes appeared with a major weight among the assets of the banks; subsequently, their stock decreased, and at the end of 1995, they represented 36 percent of the loans and advances of the banking sector to the central budget. Apart from this, the financial institutions (to the largest extent OTP, known for collecting household deposits) buy short-term government bonds as well as treasury bills. All in all, at the end of 1995, the combined share of loan and advances to the central budget and to other agencies of central government in the total assets of the banks represented 22 percent, of this, assets with long-term maturity accounted for 17 percent. The amount of loans extended to the state made up 79 percent of the total amount of the loans granted to the enterprise sector, but with respect to long-term lending, this share was 160 percent (and 103 percent even without the consolidation bonds), while in the case of short-term lending (loans maturing in less than a year) it was only 18 percent. Any change of this high share can come into being only gradually, as a result of the increased lending to the new enterprises.

Obviously, the fact that the loan and bank consolidation schemes were done using government bonds and that these bonds cannot be sold in the market in substantial amounts *ab ovo* determined that these liabilities of great value can only be put to financing the budget and cannot be utilized to finance companies. It should, however, be noted that the banks in question would have hardly had and would still hardly have a possibility to lend these funds to profitable and securely creditworthy enterprises had they been received in cash fully; presumably, the greater part of these funds would have been placed with the budget in any case, obviously, with much shorter maturities.

The share of loans granted to the *enterprise sector* is relatively low and, moreover, of a declining tendency in the banking sector. At the end of 1995, lending by the financial institutions made up 60 percent of the total assets, within this, the share of loans to the enterprise sector represented 28 percentage points (less than half of the loan portfolio); in the first half of 1996, this declined further. Within the corporate loan portfolio, the share of loans *maturing over a year* was 39 percent, showing a declining tendency; a major portion of this was refinanced by the NBH. Long-term enterprise lending to a larger extent is limited by the scarcity of funds for more than a year, the risks involved in long-term lending and the bank prudential, cautious, risk-avoiding credit policy, the high lending rate and the lack of willingness on the part of enterprises to invest.

d) High costs, spreads and interest rates

The costs of financial intermediation performed by the Hungarian banking sector are high relative to those of other countries. On one hand, the operating costs of the banks are relatively high, although in a differentiated fashion and also, banks suffer from the indirect cost (loss of interest income) due to the position of the budget and the stringent monetary policy. This is one of the components of the high lending rate level.

The Costs of Operation made up 3.6 percent of the balance sheet total of the entire banking sector in 1994; this ratio rose to 3.8 percent in 1995. According to data from literature, this figure is generally at around 1.5–2.5 percent in developed countries. The analysis of the various bank types reveals that business costs are the highest in the case of the savings co-operatives, the specialized financial institutions and the Hungarian-owned small and medium-sized banks, but also in the case of some of the large banks, while costs are relatively low at the banks with foreign or mixed ownership.

One of the factors contributing to the high cost level at some of the banks is that for banks with a substantial problem portfolio, the management of bad claims and investments constitutes a separate task and, at the same time, the provisions are deducted from the value of claims of the balance sheet total. (In contrast, however, the management of the claims embodied in government papers, in particular in consolidation bonds, does not require any particular expenditure.) Another factor contributing to the high cost level is that, as I mentioned, the measures aimed at improving cost management at the banks which had landed in an unfavorable position began only with a delay and produced their initial results only from 1995.

Another factor contributing to the relatively high cost level is that, although market competition among the financial institutions is increasingly fierce, some of the banks are unable to respond rapidly to the signals arising from this with appropriate action, which enables other – better – banks to enjoy relatively comfortable cost management (as they are able to maintain their better position even in this way).

The increasingly intensive market competition and the pressure on the less favorably positioned banks will, most likely, lead to a reduction in the relative level of the business costs of the banking sector in the coming years.

The costs of financial intermediation by the banking sector are high not only because of the level of the costs of business administration. Over the past few years, three additional factors increased the bank *spreads*, within this, the *difference between deposit and lending rates*. These were:

- banks were forced to make substantial provisions out of their trading profits owing to the vigorous deterioration of their portfolios and the tightening of the rules of classification and provisioning;
- some of the new lending also seemed to be uncertain in terms of risk, therefore, banks took this into account when determining lending rates;
- the NBH was forced to impose a very high required reserve ratio and paid a rate substantially below the market rates on this.

As a result of the factors referred to (including high costs), the average difference between deposit and lending rates for enterprises in 1992–1993 exceeded 10 percent and at times rose to between 11–12 percent. It should be underlined that "this interest differential" is not identical with the concept of the margin, as both the average deposit and lending rate level substantially differ from the level of corporate rates (the interest paid to the households, the central bank and other countries and those received from the budget and the central bank have a substantial impact on the average interest rate level). In the years referred to, the spread rose to 6–7 percent in the banking sector at various times and according to varying methods of calculation.

In 1994, the increasing tendency of the spread and, within this, of the interest differential between deposit and lending rates for enterprises, was broken and the process of decline began. Although the high level of operating costs remained, the loan and bank consolidation efforts provided a solution to the provisioning for old portfolios and their vigorous deterioration came to a halt. The latter does not mean that no new provisions had to be make (at a rate much lower than before) but that, at the same time, a portion of the provisions made earlier is being continuously released.

The NBH first reduced then again increased the required reserve ratio; in the meantime, in accordance with the evolution of the general interest rate level, first it substantially raised then slightly reduced the rate of interest paid on the mandatory reserve. As a result of these bi-directional changes, the overall level of the bank interest losses related to the mandatory reserve decreased slightly but continues to be fairly high in an international comparison. This continues to be a substantial factor in the interest differential between enterprise deposit and lending rates and obviously deteriorates the competitiveness of Hungarian financial institution with foreign banks.

Nevertheless, by 1995, mainly owing to the changes related to provisioning, the difference between enterprise lending and deposit rates declined to 7–8 percent and presumably the spread also fell to between 4–5 percent. In this respect, therefore, a substantial improvement is demonstrated, yet additional changes are needed. These changes, i.e., a reduction in the interest differential and the margin can be achieved primarily through reducing the average operating costs of the banks, in particular through the reduction of costs at the individual banks and the further shifting of the lending activity towards banks working with lower costs. The reduction in the high margin of the banks is all the more warranted because should it be maintained in the long run, it could be concomitant with a decline in the role of the banks in financial intermediation and the use of financial institutions and instruments establishing direct contact between savers and borrowers, i.e., specifically capital market institutions could increasingly crowd out credit institutions from the market.

Over the past few years, the deposit collecting and lending activities of the Hungarian banking sector were also characterized by the *high* deposit and *lending rates* also in nominal terms but, as we have seen, with a substantial difference between them; the gap between the *real* deposit and lending *rates*, however showed an even greater discrepancy.

Obviously, the general and primary reason for the high interest rate level was not the behavior of the banks but inflation, even though interest rates do not "automatically" follow changes in the rate of inflation.

Over the past few years, nominal *deposit rates* (now also including household deposits) first (until the second half of 1991) rose, following the acceleration of inflation; then, with inflation slowing down, they declined vigorously; from 1994 to the middle of 1995, they rose again, whereafter a declining tendency was observed. In the meantime, there was a relatively long period when the interest rate on the household deposits of one year or more sank below the rate of inflation, i.e., a negative real rate of interest emerged (that was the period when the propensity to save of the households fell). The positive real interest rate on term deposits was re-established in 1994 but, from mid-1995 – at least on the basis of the backward-looking consumer price indexes – again a negative level came into being (based on the forward-looking price indexes, however, a slightly positive real interest rate level remained). Obviously, a satisfactory level in household savings can be facilitated and motivated only by a positive real interest rate.

Based on economic analyses it is conclusive that there has not been and there is not such a high household deposit rate level in the Hungarian economy which would give rise to an excessively high lending rate level.

Yet, it was seen that the level of *lending rates* – particularly for the enterprise sector – was still very high in the years 1992–1994 if real rates are considered. The average level of interest rates on enterprise loans rose first to 35–36 percent, then they went down to 27–28 percent. The real interest rate level evolved regularly in the range of 10–15 percent but at certain points in time it approached 20 percent.

The latter is attributable to a number of factors. First, a major nominal differential evolved between the level of deposit and lending rates for the reasons referred to. Secondly, the real level of corporate lending rates is determined on the basis of the rise not in the consumer but in the producer price level and, in the years 1992–1994, inflation in consumer prices exceeded that in producer prices by 8–10 percentage points. Finally, the fund absorbing and interest upward pushing impact of financing the general government deficit also contributed to the evolution of the high lending rate level.

In 1995, the situation changed somewhat: the nominal lending rate level rose to at around 35 percent, then declined slightly below it but, during this period, the producer prices increased vigorously; hence the real lending rate in fact sank to a normal level, i.e., to between 4–8 percent. In the first half of 1996, the lending rate level sank below 30 percent in nominal terms, while producer price increase also abated.

Now we expect a substantial fall in producer prices which will not be fully followed by the reduction in nominal lending rates. Through this, the real corporate lending rate will again reach or exceed 10 percent. This, in an international comparison, is a high real rate level. A lasting reduction in this level can be expected gradually if and when the bank costs are reduced, the central bank decreases the required reserve ratio (and pays a rate on the reserves which is closer to the market rate than at present), i.e., if the interest differential can be reduced and, furthermore, if general government becomes a less active borrower in the money market, whereby the market will also arrive at a decrease in the rate of interest.

In the coming few years, the high interest rate level will be gradually reduced and real rates will presumably be adjusted to the rates usual in the international market in the long run. Until that happens, there are good reasons for the state to alleviate the detrimental consequences and difficult competitive conditions arising from this situation for the enterprises, at least partially, through preferences.

IV. The Bank-restructuring and the Corporate Sector

1. Viewpoints of and Debates on the Relation of Consolidation of Banks and Corporate Sector

In 1992–1995, a great many different views became public among the Hungarian professionals concerning the relationship that there should be between the consolidation in the banking sector on one hand, and the restructuring of the corporate sector, the improvement of its viability, on the other. Views differed with respect to the evaluation of the developments as they evolved and with respect to the method of managing the problem. As it is frequently the case at such times, the individual viewpoints and ideas were not articulated in a clear-cut and unambiguous fashion, a professional, well-grounded debate on the various views has not, in fact, taken place. A serious prediction of the expected impact of individual actions was regularly omitted, the decisions adopted by the Government were frequently based on improvisations and reflected compromises achieved in the midst of the prevailing personal and political power struggles.

Consequently, the efficiency and overall results of the restructuring affecting the enterprise sector were, according to all probability, much poorer than those of the actions serving the consolidation in the banking sector.

The possibility or rather idea that government actions may become necessary also with respect to the enterprise sector or rather that the restructuring in the banking sector should, in some form or an other, affect the corporate sector, too, was raised by the severe problems appearing as a result of the real developments of the economic life.

As it well known, in 1991–1993, very many businesses with controlling interests held by the state, and an increasing number of private enterprises coped with a situation of plummeting output, made losses, lost creditworthiness, being unable to pay their debts to the banks, the tax and customs authorities or Social Security Fund, and to their own suppliers. Therefore, they filed for bankruptcy and liquidation procedures were initiated against them. Obviously, it was mainly the bank loans of these businesses that became doubtful and then bad.

At the same time, it became increasingly more evident that these companies included ones, the share of which could not be estimated in any well-grounded way by anyone, which had human resources and material capacities which, with appropriate restructuring and recoverable expenditures (which would have affected organization, ownership and asset structures, system of control and operation, product and technology structure, sales etc.) could have been able to operate profitably and to grow efficiently.

It was also evident that the banks themselves had an interest in not allowing all their corporate clients in difficult situations sink but to let those which could become "good clients" offer an opportunity to implement the restructuring which could lay the foundations for their survival.

The professional public opinion was, however, highly divided with respect to the behavior of the Government concerning the issue at hand. If we attempt to "categorize" the highly different views, then three groups of opinions are outlined which fundamentally differ from one another.

a) According to one view, the vast majority of businesses concerned was not at fault in having got into financial difficulties, as these were caused by objective factors. Therefore, it was the duty of the government to rescue these companies (primarily those with state ownership) from bankruptcy and liquidation procedures. In the case of these enterprises, this view was supplemented by the opinion that these companies should first be improved by "reorganization", as in such a condition they could not have been privatized, or if so, only at a very low price, and they should be offered for privatization only thereafter.

The representatives of this view recommended and supported the establishment of a state-owned "reorganization company" in 1992. This company would have taken over the claims of the banks outstanding against the enterprises and then the claims would have forgiven or rescheduled them, moreover, for the sake of the transformation, it would even have invested capital in them (from unknown sources). The representatives of this view recommended in 1993 that the HSHC and The SPA should themselves consolidate (reorganize) State-owned Enterprises through the state property managers receiving the right of distributing the consolidation bonds among the enterprises or by taking over their debts from the banks with a view to forgiving or rescheduling them.

b) According to the second opinion, the state should not deal with the problems of the enterprises in debt or with the possibilities of solving these problems. The government has one task only, namely, to privatize the State-owned Enterprises; should that not be possible, then these enterprises should be allowed to file for bankruptcy and wound up. According to some representatives of this view, there is no (or rather there was no) need of a bailout in the banking sector either, banks in trouble should also have been allowed to file for bankruptcy and be liquidated. According to some other representatives of this view, the state bailout of the banks in trouble was not avoidable but there was no call to deal with what should happen to the enterprises concerned, this is to say, that there was no need for any "debtor consolidation", moreover, that could only be detrimental.

c) According to the third view, both above described viewpoints were "global" and extreme; instead, it was possible, moreover, it was a must to find solutions which, through the operation of a mechanism of selection, would facilitate the restructuring of the economy in a positive direction so as to enable viable companies, i.e., those which, with well recoverable expenditures could be made profitable and capable of growth, to enjoy the benefits of the partial forgiving, rescheduling or swapping equity to their debts. In the case of the others, the state should allow their bankruptcy and liquidation. According to the representatives of this view, the state or any state agency or organization is unsuited for making a rational selection, therefore, neither new organizations should be set up for this purpose, nor existing ones should be equipped with such a function. The "selection" should be done by the market, therefore, organizations having a business interest in this matter should have the decisive opportunity here.

The supporters of this view defended the decentralized portfolio cleanup at the banks, also expecting that the work-out companies set up to manage the bad and doubtful claims to be bought from the banks at market prices would have an opportunity to come to an agreement with the viable enterprises – but only with those! – on reasonable debt easing measures advantageous for both parties. Later, when the recapitalization of the banks was put on the agenda, representatives of this opinion took the stand that conditions enabling the banks to identify the viable debtors and to develop satisfactory agreements with them following a procedure of reconciliation could and should be established.

Finally, *each of the different views were asserted* in practice at different points in time and in different forms. A kind of a mixture evolved but so that the *efficiency of the entire process was poor, brought about much less positive results than what could have been achieved and according to all likelihood, it caused or allowed a great deal more to come into being in terms of losses than it should have.*

2. Debtor Consolidation after the Bank-oriented Loan-Consolidation

As described in Chapter I Section 2/a and Chapter II, finally, the portfolios of the banks were not cleaned up through the decentralized approach in 1992–1993, according to which organizations (companies) specialized in the management of bad and doubtful debts would have bought these from the banks in order to conduct business negotiations with the debtor enterprises. In 1993, the state also did not sell or transfer the bad debts bought at the end of 1992 to the asset-management organizations. Although the Government did make a resolution on the preparation of the establishment of the Loan Consolidation Fund, which would have taken over the bad debts from the Ministry of Finance and then would have disposed of them (by selling, using as non-cash contribution or transfer for management); finally, the Government did not discuss further the proposal. Short of business opportunities and tasks, such work-out organizations did not evolve in larger numbers in spite of the fact that, at the end of 1992, several banks were making preparations to establish such companies and a number of firms performing similar or related functions wished to develop their activities in that direction.

In this situation, the bank-oriented portfolio cleanup enabled only one organization to come into contact with debtor enterprises. In the first half of 1993, the MBFB got an opportunity to pick and choose from the claims of a face value of HUF 120 billion bought by the state in the course of the bank-oriented loan consolidation scheme for HUF 100 billion and to buy the bank claims against those companies whose reorganization and improvement seemed promising. The MBFB selected 56 companies. It bought their debts to an amount of HUF 41 billion by paying an advance on the purchase price totalling 4 percent and took on the obligation to pay 25 percent of the net proceeds of the realized claims to the budget later Some 95 percent of the claims taken over by the MBFB were outstanding against firms under liquidation.

The MBFB saw a possibility for successful reorganization in the case of one third of the enterprises, i.e., 19 firms (generally the more important ones). By then, the bulk of the enterprises had already accomplished their reorganizations schemes or these were in a progressed state. These firms became viable and now operate at a profit; some of them were sold by the MBFB in part or in full. The MBFB and the budget had substantial revenues from the sales of the claims; The MBFB reinvested these profits in the reorganization of other firms.

In this way, a small portion of the businesses in question were successfully transformed after the bank-oriented portfolio cleanup. With respect to the bulk of the claims purchased by the state, the debtor enterprises were either wound up or terminated themselves or are still at the brink of bankruptcy.

Until the middle of 1994, the bank claims not sold to the MBFB were contracted out to those banks for management where these claims had earlier been generated. Commissioned by the MoF, the MBFB concluded the management contracts with the banks first for a period of half a year and thereafter they were rolled over every quarter until the middle of 1994. Short of any perspective, the banks had no interest in entering into serious negotiations with the debtor companies concerned, nor had they an opportunity to do so. Consequently, this formal and temporary management activity had no any result whatsoever. In this range, therefore, loan consolidation had no effect whatsoever on either the enterprises concerned or on the recovery of the claims.

At the end of 1993, the MoF and the MBFB invited tenders for the sale of debts retained by the state then temporarily managed by the banks. The tender was closed in mid-1994. Through it, only about 10 percent of the claims offered could be sold (to a face value of nearly HUF 7 billion at an average price of about 12 percent). Between the middle of 1994 and the end of that year, there was no one to manage these claims. Early in 1995, the MBFB undertook the management of the unsold bank assets (a package of a face value of HUF 63 billion) under the condition that 65 percent of the proceeds of redemption would be paid to the budget. Two thirds of the market value of the assets, to a face value of nearly HUF 8 billion were settled by the MBFB by transferring a share portfolio to the state. Presumably, the asset management activities of the

MBFB could still produce some meager result for both the firms concerned and the budget.

To date, the state budget managed to recover almost HUF 6 billion from its claims of a face value of HUF 120 billion. Later on, proceeds amounting to a few billion forints can still be expected. Thus probably about 7–8 percent of the face value, within this, 8–10 percent of the state expenditures, will be recovered. In view of the fact that these were claims classified as bad, this recovery is at the lower limit of the expected minimum.

Although the process was accompanied with the successful reorganization of a few enterprises whereby substantial capacities became capable of profitable operation, overall, this series of actions can be qualified as disorganized, ill-considered and bringing in results substantially less than what could have been expected.

3. Debtor Consolidation after the Enterprise-oriented Loan-Consolidation

As I mentioned, in the course of 1993, there were heated debates about whether or not the government should implement a wide-ranging, direct debtor consolidation scheme in the case of a substantial portion of enterprises the majority of which was held by the state. The state property managers (HSHC and SPA) recommended that a direct debtor consolidation or reorganization be implemented at 2–300 companies held mainly by the state by way of buying out the bank claims, then forgiving or rescheduling them, eventually by transferring consolidation bonds to the companies concerned. As the MoF and the NBH were against these recommendations, the Government finally rejected them.

As a compromise solution, however, a similar action was taken in the case of the so-called privileged large industrial companies and a few others.

In 1992, the Government declared that 12 large industrial enterprises were of "strategic" importance and hence privileged enterprises. The Government regarded their survival for reasons of "industrial policy" as necessary even if they were heavily in debts. The Government justified this with the argument that these enterprises could be turned capable of efficient operation, they were capable of switching markets, of increasing their exports, their operation was a strategic issue and they were of decisive importance also from the viewpoint of employment policy. In fact, both the introduction and use of the category of privileged enterprises of strategic importance and particularly the mode and range of selection were on an inadequate and questionable basis.

Proposed by the Government, the Parliament brought resolutions on the settlement (forgiving, rescheduling or capitalization) of the HUF 15 billion debt of the "privileged enterprises" outstanding against the SDI in 1992–1993. Based on additional government resolutions, the enterprises in question were given state guarantees to borrow, reschedule their customs duty and tax debts and the late fee penalties were forgiven also.

The action described above constituted a debt settlement by the government without having been directly linked to the consolidation of the banking sector.

At the end of 1993, the Government took additional steps to improve the financial positions of the privileged enterprises. A decision was made that the Government should buy the claims of HUF 30 billion outstanding against 11 privileged companies from the banks. In addition, the state also bought the debts of two industrial enterprises, a number of companies in food processing, one agricultural company and the Hungarian State Railways plus the debts related to the draught. This debt buy-out by itself was only another step in the consolidation of the banks, as the debts of the enterprises (except for those related to the draught) still remained outstanding except that they were outstanding not against the banks but the state. (This is why I refer to this action as company-oriented portfolio cleanup, i.e., loan consolidation.)

The Government position was that the debts of these companies could or rather should be "settled" by individual consideration based on the appropriate reorganization plans. Nevertheless, the HSHC fully forgave the debts of the enterprises in which it exercised the ownership rights (eight companies) of a face value of more than HUF 24 billion, formerly outstanding against the banks, without acceptable reorganizations plans or any sort of individual consideration and without having had the authorization for this at the end of 1993, as it had taken place before the MoF would have transferred the former claims of the banks. Later, in May 1994, the MoF *ex post* legalized the HSHC s debt forgiving action.

In the first half of 1994, the MoF transferred (sold) the claims bought earlier from the banks, acting on behalf of those enterprises whose ownership rights were exercised by the SPA. The SPA, however, did not make a debt settlement scheme similar to that of the HSHC, because, as an unambiguously budgetary agency, it had no right to do so. It did, however, swap the claims to equity in the case of a few enterprises (to a value of about HUF 4 billion) and it acknowledged in the case of several other companies that the debt repayments and interests due from the fourth quarter of 1993 could not be paid. After the establishment of the ÁPV Rt., the claims of the SPA were obviously transferred to the ownership of this new property management organization (to a value of more than HUF 12 billion).

Through these actions, the state performed a major debt easing action directly with respect to the debts of a substantial range of the largest enterprises in the manufacturing industry outstanding against the state or the banks.

Appropriate data for the evaluation of the results of the debtor consolidation done by the Government are not available. According to the 1994–1995 data of the participating enterprises the results were mixed. One group of companies produced a substantial profit as early as in 1994 and their results improved also in 1995. It was favorable that the most significant enterprises belong to this group. A second group of companies has been operating on the verge of just making a profit or just making a loss. Finally, the third – relatively small – group of companies continues to make losses in spite of the substantial state concessions.

This supports that a substantial reduction of the financial burden by itself is insufficient for driving a company onto a course of profitable operation and dynamic growth. Most of the time, this also requires fundamental internal reorganization and modernization. These fundamental changes were done with a good degree of efficiency at some of the enterprises in question, while the others only enjoyed the financial concessions, thus their market competitiveness was not established.

4. Debtor Consolidation after Recapitalization of Banks

The recapitalization of the banks which had participated in the bank consolidation scheme was done after having disposed of the claims bought by the state under the two types of loan consolidation scheme. In the course of recapitalization, the bad, doubtful and substandard claims, investments and other liabilities were retained in the portfolios of the banks. Recapitalization gave them a chance to make the provisions for these problem assets which they had not done before.

It obviously followed from the method applied that the banks *intended to have an outstanding role* in making the decision on the destiny of the debts of the debtor companies. The provisions were made by the banks, therefore, only they were able and entitled to negotiate with the debtor companies about these debts and to come to an agreement with them if they could.

In principle, one could have envisaged that the banks negotiate with the debtors only under bankruptcy and liquidation procedures. Some recommended this, it, however, could not have been the appropriate solution. Bankruptcy procedures are linked to a number of formal requirements, they are complicated (as every creditor participates in them) and are lengthy (in addition to the former reasons, owing to the major time requirement of the judicial procedures).

Therefore, based also on certain international experiences, the concept and practice of *the procedure under the debtor conciliation scheme* was introduced for a specified period of time. This procedure was nothing other than a simplified and speeded up bankruptcy procedure which differed from the latter in that only the banks and the state creditors (tax and customs agencies, the Social Security Fund, the National Technical Development Board) participated in it (without prejudice to the interests of the other creditors); the negotiations were conducted without the intermediation of the courts; the state creditors, based on separate legal regulation, were enabled also to forgive debts (principal). In addition, the general goal of the conciliatory procedure was not to be the liquidation but the re-establishment of the operating capability of the company concerned, based on the necessary restructuring. If the conciliatory procedure in this scheme was not successful, obviously, bankruptcy procedure could be launched, therefore, it could also be regarded as a kind of conciliation before bankruptcy.

The banks participating in the bank consolidation scheme undertook the obligation in the consolidation agreements to conduct the conciliatory procedures under debtor consolidation with the debtors entitled thereto and, in case of coming to an agreement with them, to finalize the appropriate contracts with them; in these contracts, they would forgive, reschedule and/or swap to equity the debts (or a part thereof) in cases considered as justified. The MoF authorized the tax and customs agencies to accede to the agreements of the banks and the debtors under similar conditions or at least those that were not to be any worse for them, while the Social Security Fund could only use the instrument of debt rescheduling.

The conciliatory procedures under the debtor consolidation scheme began early in 1994.

Although it had been obvious right from the very beginning that only the creditors and the debtors had the possibility of making decisions (arriving at an agreement) under the conciliatory procedure (only creditors could decide on concessions) the government decisions brought in relation to the debtor consolidation procedure (in spite of the opposition to this expressed by the NBH, the Bankers Association and the World Bank experts) had at first given *substantial powers to the budgetary agencies as well.* To some extent this lent a "state action" flavor to the debtor consolidation distorting thereby their content and the expectations and judgements concerning them, moreover, in certain cases, it also impeded negotiations and made more difficult to reach an agreement.

Budgetary agencies were given the powers in relation to the following issues:

- The state property managers determined the range of debtor companies eligible to participate in the so-called accelerated conciliatory procedure (see below) and they organized the negotiations.
- The line ministries concerned and the state property managers were entitled to participate in the negotiations taking place under the accelerated and ordinary conciliatory procedures.
- The state property managers were authorized to buy the bank claims outstanding against the debtors held by them at net price (i.e., at face value minus provisions) under the accelerated and the ordinary reconciliatory procedure provided that the parties did not come to an agreement otherwise.
- To supervise the process and to decide on individual disputes, an Interdepartmental Committee was formed and operated by the representatives of the ministries concerned and the state property managers.

In practice, *three types* of the conciliatory procedure under the debtor consolidation scheme evolved:

- the *accelerated* procedure characterized by the dominant role of the property managers to select the debtors and to organize the procedure and the exceedingly short time made available to accomplish the process;

- the *ordinary* procedure, the eligible debtors were selected by the Interdepartmental Committee from among those applying for this status;
- the *simplified* procedure in which the other eligible debtors participated and under which the budgetary agencies waived their rights to exercise the powers described above.

Those debtors were eligible to participate in the ordinary or simplified conciliatory procedures against whom the financial institutions participating in the bank consolidation had bad or doubtful claims or other assets (investments, guarantees, etc.) outstanding at the end of 1993.

The *debtor enterprises* participating in the conciliation had to present *reorganization plans* laying the foundations for future profitable operation and proving their viability. In many cases, these plans were very poor of a quality, requiring several revisions.

Obviously, both the economic-financial positions of the debtors participating in the conciliatory procedures and the quality and thoroughness of the reorganizations plans produced by them were *very different*. Because of this, reasonably, one could *ab ovo* not expect more from the procedure than producing a favorable result only for a smaller fraction of the debtors concerned.

The *readiness* of the banks and state creditors and the state property managers to conduct the reconciliatory negotiations and to arrive at agreements was throughout poor. This caused not only time delays but also limited the number of agreements reached and had a negative impact on their content and efficiency.

The *banks* not only undertook an obligation by contract to conduct the debtor conciliation negotiations but they also had the possibility to reach reasonable agreements having set aside the necessary provisions as a result of the state capital injection. Moreover, they also had a stake in this, as through this, they could have made some of their clients creditworthy again and could have kept them in this quality, moreover, in the case of appropriate agreements, they could also have saved (released) some of their provisions and could thereby have made a profit.

In addition, it was not just that the level of readiness of the individual banks participating in the action was uneven but, having acknowledged the above to different degrees, the policies they pursued were also different. Whereas some banks went to great lengths to explore the ways and means whereby the debtor companies could become viable using reasonable concessions and, accordingly, *they prepared for several types of agreements,* others were very passive in the course of the negotiations and attempted to avoid reaching an agreement if possible.

The conciliatory procedures were also encumbered by the fact that the debtors frequently reckoned with new borrowing in their reorganization plans and the banks did not have the funding to grant such loans. The deficiencies in the *decision making mechanisms* of the banks and – where they were concerned – of the state property managers frequently impeded and even frustrated the attempts at reaching agreements because proposals for decision-making were often inadequately prepared and those in charge were incapable of making decisions.

The Government set *too short due dates,* disregarding what was truly possible for conducting the conciliatory procedures. The accelerated procedures were expected to have been closed by March, then by the end of April 1994, but the completion was substantially prolonged. The ordinary and the simplified procedures were to have been closed by the end of 1994, which due date was then modified to June 30, 1995.

The state property managers wished to involve 55 companies in the *accelerated* reconciliatory procedures but, owing to liquidation and privatization, negotiations were conducted with only 46 companies. By the end of 1994 – i.e., owing to the delays, not by the end of April 1994 – finally 15 of the 55 companies were wound up and nine were privatized. Debtor consolidation agreements were concluded with 17 companies, of these the state property managers bought the debts from 5 companies at net price. Through these agreements some 45 percent (HUF 18 billion) of the debt totalling HUF 40 billion, which could be managed under the accelerated debtor consolidation scheme (of which the debts owed to the banks amounted to HUF 30 billion, those to the state creditors HUF 10 billion) was "settled".

The accelerated debtor consolidation took longer than expected and did not produce rapid results. Nevertheless, it did improve the position of a substantial portion of the enterprises and contributed to enabling the banks and other participants to gain experiences to be used under the ordinary and the simplified procedures.

Some 13,000 debtors were eligible to participate in the *ordinary and the simplified* procedures but only 1,850 debtors applied to take part in the scheme (14 percent of the debtors). As, however, the ratio of debtors wishing to participate in the conciliatory procedure was higher in the case of larger companies, the debts of the participants represented a substantially higher share of the bad and doubtful claims of the banks.

The Interdepartmental Committee designated 75 debtors to participate in the ordinary procedure, i.e., 1,830 debtors were under the simplified procedure. In the second half of 1994, the Government withdrew the authorization of the budgetary agencies described above and, together with this, the rules of the ordinary procedure which differed from the simplified one; in other words, the rules of the simplified procedure became general.

The conciliatory procedure under the debtor consolidation scheme was closed on June 30, 1995. Below, I shall describe the results of the action in a summary fashion also including the accelerated procedure.

The 13,000 businesses eligible for participating in the conciliatory procedures under the debtor consolidation scheme had HUF 227 billion outstanding against the banks in bad or doubtful debts (for that the banks had made provisions in the amount of HUF 154 billion at the end of 1993). The approximately 1,900 debtor companies which did actually participate in the conciliatory procedures had HUF 121 billion in bad and doubtful debts outstanding against the banks (for that the banks made provisions in the amount of HUF 80 billion) this made up 53 percent of the former.

The commercial banks concluded debtor consolidation agreements with 354 companies, i.e., with 18.7 percent of the applicants. (The state creditors participated in 229 agreements and the property managers did in 31.)

Under these agreements, the commercial banks forgave, rescheduled or swapped to equity debts of principal and interests due to them to a value totalling HUF 30 billion (of this, HUF 19.5 billion was forgiven, HUF 6.6 billion rescheduled and HUF 3.9 billion swapped to equity). Under the "net price buy-out schemel", the state property managers bought debts of HUF 5 billion against HUF 1.3 billion. In addition, state creditors, including the Social Security Fund, forgave or rescheduled debts of HUF 15 billion (of this, HUF 5 billion was forgiven, HUF 10 billion was rescheduled).

The debts subject to the debt settlement procedure made up 29 percent of the bank debts of the applicant debtors, and nearly 60 percent of their debts outstanding against state creditors.

All in all, the conciliatory procedures under the debtor consolidation scheme brought *partial results.*

The amount of the settled debts affected slightly more than one third of the total debts of the debtors outstanding against banks and state creditors; this was substantially short of the excessive expectations, not much less than realistic expectations. *The hopes of those who had expected a general debt settlement from this action were not proven right, nor the concerns and fears of those who had reservations precisely because of this.*

The "consolidated" debtors were given a chance to create the conditions of profitable operation. The contracts concluded between the banks and the debtor companies provided a partial foundation.

The banks used the smaller portion of the provisions made under the debtor consolidation procedure and presumably were able to release a part of that.

Based on partial information, it can be assumed that had the bank behavior been more active, the financial position of an additional but presumably not too significant portion of the debtors could have been consolidated. Similarly, it can be assumed that a few more agreements could have been concluded had the process been closed not on June 30, 1995 but a little later.

As to what extent the consolidation agreements concluded and the concessions of the creditors made therein enabled the debtor companies to operate with a profit and grow in the long run can be evaluated only in a few more years. Therefore, the results of the entire action can be soundly evaluated only then. An analysis of this kind could be a worthy topic of research in one or two years time.

5. The Possibility of Additional Agreements between Banks and Debtors

Of the 13,000 debtors eligible to participate in the reconciliation procedures under the debtor consolidation scheme, 11,000 did not apply; of the applicants, no agreement was reached with some 1,550 debtors. The major part of these firms comprised small or medium-sized businesses, but there were a few larger ones among them also. Presumably, many of these have ceased to exist through liquidation or termination.

In 1994–1995, the financial institutions began to deal with the destiny of the bad and doubtful debts retained. A substantial portion of these claims cannot be recovered within the foreseeable future, even if they are supported by coverage in part or in full. Claims that appear to be irrecoverable – for which there frequently is no longer a debtor – are being gradually written off. Claims which can be recovered in part and investments that can be sold have either been placed with separate business organizations or had them entrusted to the care of a separate internal unit. Debtors concerned in these actions may not receive new loans and may not renew their old ones.

There is, however, a range of bad and doubtful debts (mainly the doubtful ones) in the case of which the debtor company could still become viable. Such claims (and participation) are sufficiently covered by provisions. Even if the debtor consolidation process is now closed, financial institutions still have an opportunity to agree with debtors that could be turned into viable companies by concessions to debit their provisions, obviously, only in cases when such an agreement promises the adequate result. The possibility for this is open before the initiation of a bankruptcy procedure as well as in course of it. At the same time, with the termination of the debtor consolidation scheme, state creditors are no longer permitted to forgive principal debt; financial institutions may effect write-offs to debit their provisions only in the course of bankruptcy procedures. In any case, it would be desirable for banks and debtor businesses to utilize the positive and negative experiences of the debtor consolidation scheme so that they reach an adequate agreement in the case of estimable benefit to both parties.

Finally, it should be mentioned that the consolidated banks also won an opportunity to extend new loans to profitable, creditworthy businesses. It should, however, be taken into account that, with the unfavorable experiences of the past few years, financial institutions are going to pursue highly prudential lending policies, i.e., they shall thoroughly appraise the financial position and, in particular, the creditworthiness of their applicants, which they shall evaluate not only in a cautious but also in a risk-avoiding manner: this has already been observed in 1995–1996.

They are well aware of that there is no possibility of yet another loan, bank or debtor consolidation.

Epilogue: A Few Lessons from the Consolidation of the Hungarian Banking Sector

A whole range of experiences and lessons could be learnt from the process of the consolidation of the Hungarian banking sector; obviously, these can be used by countries the comprehensive consolidation of the banking sector of which by the state becomes inevitable. A portion of the lessons arises from what we did properly in Hungary, the other portion from what we did the wrong way or did not do at all.

1. The consolidation of the banking sector, if the losses in the bank portfolios are large, inevitably requires substantial expenditure, in particular by the state budget. As this means spending the taxpayers' money, the issue is inevitably also a political one. It is a mistake for a government if it handles this issue not absolutely openly, to attempt to avoid political discussion. The correct procedure is for the government is to discuss the problem and the possibilities of solving it with the opposition parties, for the Parliament to enact a separate law on the matter, to inform the public about the issues, the causes and the possible ways out and so that it can accept the inevitability of managing the problem by the state and through state expenditure.

It is expedient to set up an independent committee temporarily to solve the problem, recruiting excellent domestic and, if possible, foreign experts. Transparency of decision-making and continuous professional and political control should be ensured.

2. There is an imperative need for the enactment of a law stringently regulating the operation and supervision of the banking sector and the active and continuous operation of a state banking supervision functioning with highly qualified experts continuously supervising compliance with that law. If these conditions are not met, their fulfillment is the most urgent task.

3. The state is a bad owner also in the case of banks. Apart from one or two financial institutions, at most, performing special functions, state-owned banks should be privatized. At the same time, it is also unambiguous, that a bank, having a portfolio that lacks transparency, i.e., not classified adequately or is of low quality, cannot be sold and cannot be privatized through capital increase. Because of this, the state should set up a small unit which, during and immediately after the restructuring process, exercises the ownership functions at the banks with controlling interests held by the state, manifesting professional expertise; also including the instruction and accountability of the persons representing the state as owner in the Boards of Directors and Supervisory Boards of the banks.

Action must be taken that auditors having the necessary expertise audit the banks with the stringency required by international practice.

4. If a vigorous deterioration in the quality of portfolios is observed in the banking sector, then the deterioration must be stopped and reversed resolutely as soon as possible.

If the rules of accounting and provisioning for the banks are weaker than the internationally accepted standards in a country, then these should be harmonized with the international standards as soon as possible. If, however, this act would give rise to a rapid collapse of the banking sector by itself, then a transitory period could be envisaged when the banks are required to meet the stringent regulations gradually determined in advance (for instance, in the fields of replenishing provisions and reaching a minimum on the capital adequacy ratio).

5. Restructuring the banking sector in a single step is the ideal case. If, however, there is no objective possibility for this (for instance, because of the legal framework or the sheer size of the problem), then it is more favorable to implement it in several steps than to wait until settlement in a single step becomes possible. In such cases, however, methods which do not produce counter-incentives for the banks to improve their lending practices can and should be applied.

6. The financial bailout of the banks must be accompanied with the thorough review of the entire controlling, organizational and operative systems of the banks preferably also involving foreign experts and with the fundamental internal restructuring and modernization of the banks. In most cases, a replacement of the management is also inevitable. It is worthwhile preparing for this with special training also, if necessary.

It is a mistake to allow an excessive separation between the financial consolidation and the bank internal reorganization in time, because that results in losses that could be avoided.

7. It is an unambiguous experience that an indispensable element of the financial consolidation of a bank is that, as a result of the action, its capital adequacy ratio should firmly reach, and subsequently exceed, 8 percent. An at least 12 percent capital adequacy ratio seems to be fully satisfactory.

8. There are no grounds on which one could say that there is any one best, perfect method of settling bank portfolios. The Hungarian practice saw the use of various methods and their combinations. There were state guarantees, centralized and decentralized portfolio cleanups and there was recapitalization. In relation to these, foreign and Hungarian experts gave a great deal of advice and recommendation which frequently differed. It is certain that it is not easy to find an optimum (it was not possible in the given case). It is, however, highly probable that if the size of the problem is large, then it is unlikely that it could be solved using one method only. Every approach has its advantages and disadvantages. Conditions and possibilities differ from country to country and from time to time. Therefore, also listening to and considering recommendations and advise from other countries, the experts of a given country are best equipped to develop the relatively best combination of these methods.

In any case, Hungarian experience shows that

- even if a bank is recapitalized, the separation of the bad portfolio and its management in a separate organizational unit, preferably in an independent company, i.e., to say, the relatively full cleanup of the portfolio, is still inevitable;

- portfolios which are bad and, because of this, separated, can be more successfully managed and liquidated by private companies specialized in this than any state agency;
- the co-operation of bankers in the management of bad portfolios is necessary but not sufficient; there is a need for conciliatory negotiations with the debtor companies as well as for special experts with expertise in the management and sale of bad claims and securities.

9. In the course of the bank restructuring the question always arises, what is better: to bailout a given bank at the expense of the budget or to liquidate it; in the latter case, whether or not private and deposit holders should be compensated in part or in full.

If the significance of a given bank is marginal and its activities can be taken over by other banks without problems, then the liquidation of the bank is a realistic alternative; this should be chosen if the loss incurred by liquidation is less than the cost of bailing out the bank and if there is no sufficient guarantee that the bank, following its eventual consolidation, will truly be able to operate efficiently. In case of the liquidation of the bank, compensation of the private shareholders (or allowing them to avoid loss of capital) whether in part or in full can be considered only if the majority in the given bank had held by state and other shareholders had no chance to influence the control of the bank. Otherwise, this would be fully unjustified.

In case of the liquidation of a bank of marginal significance, the operation of the deposit insurance system should be taken into account. If there is no such system, then full payment of the deposits of small depositors and partial payment of those of large depositors could hardly be avoided; the deposit insurance system must be set up.

If the bank in trouble is of outstanding importance within the banking sector and its otherwise necessary activities could not be taken over by other banks (because it had a decisive role, for instance, in collecting household deposits or in corporate financing), then the consolidation and restructuring of the given bank cannot be avoided. In case of recapitalization, shareholders would necessary suffer a loss as a result of the concomitant capital reduction. The value of the deposits, however, would be retained.

10. If the bank bailout is done by using not cash but long-term government bonds, then in some cases it may become necessary to ensure adequate liquidity for one or the other of the banks through supplementary measures. In such cases, the central bank may either buy a part of the long-term bonds or swap them to short-term government securities. This solution is better than continuously refinancing the bank through the central bank.

11. It is beneficial for the national economy if, from among the businesses that have bad or doubtful debts outstanding against banks and other creditors, those are selected which, through appropriate reorganization, can be turned into viable, i.e., profitable companies. It is, therefore, expedient for the banks and other creditors (for instance, the tax agency) to come to an agreement with them, to reschedule their debts or to swap them to equity or eventually to forgive them in part or in full.

Care should, however, be taken that such reorganization schemes be done only in the case of companies that are truly viable and capable of growth which generally means only a smaller fraction of the debtors in trouble.

The banks or the work-out companies set up by them are better equipped to select viable debtors and to come to an agreement with them than state agencies or institutions which are also politically motivated. Probably it is not possible to avoid that government decisions be also made in this respect in the case of the most important large companies of strategic importance, but this possibility should be minimized.

12. It is an important requirement that actions serving the restructuring a banking sector using the assets of the state be implemented strictly in accordance with legal regulations and that the compliance and expediency of the implementation of these actions and of the use of budgetary assets be continuously and strictly controlled by the competent state agencies.