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FROM BAD LOANS TO TAINTED BONDS:

THE CREDIT MARKET CRISIS IN HUNGARY

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Abstract

The large public Hungarian commercial banks are, as a group, insolvent by international standards. Yet they generate large cash flows and are the depositories of crucial financial information on their clients. Bad debt problems overwhelmed the system in 1992 due to the combined effect of banking and bankruptcy legislation. Gridlock developed in the credit market as attested to by the fact that the stock of bank credit to companies stagnated in nominal terms. In an attempt to resolve the problem, the government implemented a loan consolidation scheme with multiple objectives, namely, recapitalize the banks, consolidate and work out the loans of troubled companies, and facilitate the restructuring of loss-making companies. The program failed because its design was flawed; it amounted to replacing bad loans with tainted government bonds.

A recent article in the Financial Times attributes to the World Bank the statement that the financial system in Hungary is unable to finance the transformation to a market economy.[1] The core of the problem is the financial situation of three large public commercial banks, in descending order of asset size, Hungarian Credit Bank (HCB), Commercial and Credit Bank (CCB), and Budapest Bank (BB). These three banks were created by dividing up the commercial credit division of the Central Bank in 1987. A fourth public commercial bank, the Foreign Trade Bank (FTB), was created at the same time but its financial situation is sounder than the other three. By far the largest Hungarian bank, the National Savings Bank (NSB) accounts for about forty percent of all deposits and is also on shaky financial grounds. An interbank market exists on which the savings deposits of households held mainly at the NSB can be transferred to commercial banks to finance the productive sector. The basic problem is the lack of efficient bank intermediation. The main stumbling block is the serious financial shock that the commercial banks have been asked to absorb in 1992.

Credit market failure in Hungary is attested to by the virtually zero growth in the stock of bank credit issued to the business sector in 1992.[2] The banks' reluctance to finance new business investment is attributable partially to two legislative acts. The New Banking Act, effective on December 1, 1991, introduced three categories for rating the loan portfolios of the banks, mandated the accumulation of provisions (loan-loss reserves) against the qualified loans in the portfolio, and specified a schedule for meeting capital adequacy targets

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[1] See Nicholas Denton, "The Hole at Hungary's Banking Heart", Financial Times, May 20, 1993, p. 15. See also Rosemary Pugh Piper, "The Credit Crunch That's Crippling a Hungarian Boom", The Wall Street Journal Europe, June 4-5, 1993.

[2] According to the National Bank of Hungary, total credit to the entrepreneurial sector on January 1, 1992, was 766.8 billion forints and it stood at 774.2 billion forints on December 31, 1992. (NBH Monthly Report, 1/1993, p. 42)

based on these components. The New Bankruptcy Law, effective January 1, 1992, began to have significant impact in April 1992 when a company with any outstanding debt more than 90 days overdue was required to initiate bankruptcy proceedings or the responsible parties would be subject to criminal prosecution. Each law addressed an important economic problem, ensuring the prudent operation of the banking system in the face of substantial bad debt and counteracting creditor passivity in the face of a growing amount of involuntary and doubtful inter-enterprise debt. However, these two laws combined to deliver a serious financial shock to the Hungarian credit market by imposing immediate flow solutions on two stock problems.

According to the Banking Act, banks must classify assets in their portfolios as bad if the borrower is in default for more than one year or the claims are held against a company that has filed for bankruptcy. Provisions equal to 100% of the bad debts must be accumulated over a three-year period. The banking act legislates two other categories of qualified loans substandard and doubtful with provisions equal to 20% of the former and 50% of the latter to be accumulated over the same time period. By the end of 1992, the aggregate stock of qualified loans stood at HUF 262 billion which amounted to 17.2% of the total loan portfolio and about 10% of GDP. Full statutory provisions for the banking system increased from HUF 83 b. to HUF 222.5 b. from 1991 to 1992 an increment that exceeds 1992 profits before tax and provisions by almost 300%. Total equity and provisions of the banking system amounted to HUF 267.9 b. at the end of December 1992. Hence, the solvency problem.

Of the total statutory provisions in 1992, HUF 118 b. is deferrable according to Hungarian accounting procedures (HAP). International accounting standards (IAS) treat deferred provisions differently. For loans classified as qualified by the end of 1992, banks are required to hold one-third of the prescribed provisions leaving two-thirds of this amount as a deferred liability. Although these deferred provisions are not subtracted from bank capital by HAP, IAS require such deductions.

The trigger mechanism applied in April 1993 by the bankruptcy legislation led more than ten thousand companies to begin restructuring or liquidation procedures in 1992, an almost ten-fold increase over the number filing in 1991.[3] Since banking legislation requires that these companies' loans be classified as bad, the bankruptcy act was a significant contributor to the rise in the provision liability of the banking system in 1992. As a result, three of the four Hungarian commercial banks (the exception being FTB) were insolvent by IAS in 1992. However, all four banks maintained reasonably high cash flow although the market began to change toward the end of the year.

High spreads and an inefficient payments system drove good commercial customers away from the domestic banks to seek credit and services elsewhere.[4] Some companies used internal funds whereas others sought financing on international markets. Some companies floated their own issues of commercial paper to circumvent the credit gridlock. The banks

[3] The National Bank reports that, in 1992, 4,231 companies filed for bankruptcy and roughly ten thousand liquidation applications were received. Of these latter, about half were canceled. (NBH Monthly Report 1/1993, p. 23.)

[4] By the second half of 1992, the difference between lending and deposit rates with less than one year maturity was around 12%. (NBH Monthly Report 1/1993, p. 7)

found themselves caught in a squeeze having to generate sufficient income to accumulate rapidly the required loan-loss reserves and also finding no small-risk creditworthy commercial clients. Having no better alternative, banks turned toward government securities which provided both a reasonable risk-return package and the necessary liquidity (Treasury Bills) to support the increased provisioning. Thus, the budget deficit was financed by household savings and the productive sector was crowded out of the credit market as bank intermediation between individual savers and business investors ceased.[5]

After several revisions, the Ministry of Finance (MOF) and the Hungarian Investment and Development Rt (HID) announced only in March 1993 the terms of a loan consolidation program (LCP) for 1992 with the intention of alleviating the bad-debt burden on commercial banks. All commercial bank debt classified as "bad" by October 1, 1992 was eligible for participation. The arrangement allows the banks to swap loans so classified for a special state financial instrument. Debt that was guaranteed by the government and certain types of bad loans (e.g., debt held from a company that is being bailed out by either the State Property Agency or the State Assets Holding Company) was eligible to be swapped at 100% of face value. Other "old" debt, i.e., loans that were classified as bad as of December 1991, would be swapped at 50% of face value. "New" bad loans, i.e., loans that were classified as bad in 1992 from January to October, were exchanged at 80% of face value. Once removed from the balance sheets of the commercial banks, the bad loans are to be placed with HID to arrange the contractual terms for their workout.

[5] The net household savings rate remained high at 11.6% of disposable income in 1992 while the fiscal deficit as a ratio of estimated GDP was 7%. (NBH Monthly Report 1/1993, pp. 6-7)

To replace the principal of the eligible bad debt on the commercial banks' balance sheets, the government issued consolidation bonds (CBs) with a maturity of 20 years bearing interest equal to the average yield of 90-day Treasury bills (series A bonds). The capitalized accumulated interest arrears was treated differently in that it was eligible for compensation with series B bonds which paid only fifty per cent of the interest earned by series A bonds. Furthermore, the MOF retained the option to levy a stabilization tax on the participating banks at a rate not to exceed 50% of the interest income generated by the LCP. Fourteen banks contributed HUF 104 b. worth of bad loans totalling over 4,000 accounts to the program in exchange for HUF 80 b. in face value of CBs.

With respect to recapitalization, the program was not successful. Since the stabilization tax is a deferred liability for the banks, applying IAS requires a computation of the net present value (NPV) of the CBs adjusted for the tax. The series B bonds are also discounted because they do not yield market interest rate. Taking these factors into account, one estimate reduces the value of the CBs from a face value of HUF 80 b. to a NPV of HUF 32.5 b.. According to this calculation, less than one-third of the face value of the bad debt was replaced. In essence, bad loans were removed in exchange for tainted bonds that did not recapitalize the banks.

Although a large number of bad loans were consolidated by LCP, no procedures were designed to work out the accounts after consolidation. In particular, no mechanism with appropriate incentives was established to use the banks' information on their clients in the work out procedure. The loans stayed on the banks' balance sheets until June 1993 but the banks were given no additional incentives to work out the loans. Furthermore, much of the old inherited bad debt was removed by the banks because of the 50% replacement coefficient. Banks acted strategically to reduce the tax liabilities that would result from excess provisioning once the bad debt was removed.

Other criticisms have been levelled at the LCP. First, existing shareholders did not have their equity stakes written down leading to charges that they were bailed out with public money. Second, no consideration was given to inducing proper governance at the banks to insure that the bad loans problem would not recur. Third, central management of the transferred bad debts was not arranged. Given that the banks are the depositories of financial information on their clients, it would be natural to encourage the banks to work out the loans under incentive contracts once they have been packaged properly. Fourth, the stabilization tax is likely to lead to an increased cost of intermediation as banks try to recover the interest lost on the CBs. Finally, the interest paid on the CBs adds liquidity to the banks as CBs replace nonperforming loans the interest on which was not paid but simply recapitalized. Some argue that this makes monetary policy more difficult. On the other hand, if the objective of the program is to break the gridlock in credit markets, increasing bank liquidity is an appropriate objective.

The LCP did not make significant progress in resolving the inherited bad debt problem nor did it put in place a mechanism for using the banks' information on their clients to work out the bad loans removed. The government is currently considering a second program to improve the financial health of the banks. To the extent that banks are unable to offer reasonable credit terms, companies will look elsewhere for financing. Some might argue that such emerging market instruments should be encouraged and competition should be the catalyst that drives the banks to provide better and less costly services. However, the inherited legacy of bad debt coupled with the legislation forcing banks to accumulate provisions puts them at a comparative disadvantage vis a vis virgin institutions issuing new financial instruments. On the other hand, banks have a crucial input, information, that is needed to restructure companies and jump-start the floundering real productive sector. The commercial banks cannot be left out of financing the transition; hence, the dilemma!