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Transformation, Development, and Characteristics of the Hungarian Banking Sector

Researcher of Financial Research Ltd. Éva Várhegyi, defended her doctoral dissertation under the title,
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Opponents were *Iván Bélyácz, Tamás Sárközy* and *György Szapáry*.

The dissertation is based on a research that was aimed at defining the most important features of the transformation of the Hungarian banking sector that began in the 1980's, and accelerated after the regime change by the opening of the market, reinforcement of fiscal discipline, and privatization. Moreover, the thesis examines the consequences of this transformation as it relates to the competitiveness of the banking sector and social welfare. The research focused on a comprehensive examination of the question whether the path taken by the Hungarian banking reform had a successful effect on the sector's performance. The most important findings of the dissertation are summarized as follows.

Banking Reform

▪ Assessment of parliamentary-governmental decisions as a process, and the evaluation of their future impact – contrary to current time and partial analyses – as well as comprehensive international comparison put the Hungarian banking reform in a new light. In this light, the internationally appreciated success of the Hungarian banking reform is not only due to its early start, but also to the fact that economic necessities resulted in econo-political virtues.

The term “enlightened banking reform” used in the dissertation refers to the statement that the reform measures, even though they are originated in necessity, were mostly progressive. The reason for this is not that Hungarian governments were more “intelligent” than others were, but rather, the “need” led decision-makers towards deepening international integration in the economically open Hungary as early as the 1970's; and consequently, they had to take into account the inevitable fact of globalization no matter if they wanted it or not. In retrospect, and compared to the development path of similar Central-Eastern-European banking systems, the main virtue of the Hungarian banking reform is that it made the banking sector – and the financial system, in general – the driving force of the international integration of the Hungarian economy.

▪ Establishment of the two-tiered banking system in 1987 was a caesura in the most recent history of the Hungarian banking sector. Although the dismantling of the mono-bank-structure that fit into the model of centrally planned economy was a logical consequence of the reform of the economic mechanisms, the idea maturing since 1968 was postponed for nearly two decades. The delayed reform of the Hungarian economic environment was still considered early compared to Eastern-European conditions, and its positive consequences could be detected in the subsequent transformation of the banking sector. The doctoral dissertation shows the replacements of bank managers with those of expertise among the "positive consequences," even though these became profitable mostly only later, after the transformation of ownership structures.

Based on the analysis of consequences, the dissertation considers the formation of the two-tiered banking system – despite of all its deficiencies – as a historical milestone. It is considered as a fitting part of the reform process during the late-Kádárian era that was willing to take over market economy "accomplishments" in order to preserve the operation of the economy and the political regime, and the favorable results of which could be detected in many areas during the transformation following the regime change.

The other historical step in the Hungarian banking reform was the enactment of the Act on Financial Institutions and Financial Enterprise that regulates the foundation, ownership, direction, and operation of banks. It was important that the original verbiage of the Act already followed the requirements of advanced banking systems, such as the directives of the European Economic Community (EEC), and the recommendations of the Bank for International Settlements (BIS). Subsequent amendments to this Act and the new Act on Credit Institutions and Financial Enterprise gradually harmonized the Hungarian legislation with that of the European Union; thus, enhancing the Hungarian banking sector's entry to the homogeneous internal market of the European Union without any serious shocks.

The concept, which the rules of bank ownership was based on, as well as – contrary to many countries – their practical implementation by the Banking Regulation and Supervision Agency (BRSA) responsible for their authorization and the government, were progressive features of the Act on Financial Institutions enacted at the beginning of the 1990's, even in international comparison. Legitimacy of the Act was "increased" by the support of opposition parties; moreover, it was even drafted based on consent.

The dissertation confirms that the regulation of the Act on bank ownership was favorable in three respects, as reflected by subsequent developments and international comparison:

- Neither the Act on Financial Institutions, nor the practice of the BRSA put obstacles – exceeding professional requirements – to the foundation and acquisition of banks by foreigners.
- Compared to Eastern-European countries, an important feature of the Act was the restriction of acquisition of bank shares by non-financial investors that inhibited the acquisition of deposits by "bank robber" proprietors and restricted the development of cross-ownership structures between banks and companies. Due to these restrictions, there have been hardly any "bank robbing" type bankruptcies in Hungary, while these were typical in almost every other Eastern-European country in the first half of the 1990's. Moreover, hardly any cross-ownership structures were detected that would curb the prudent operation of banks.
- From the perspective of the banking sector, the third important element of the Act was that it restricted state ownership in banks. It clearly conveyed the political intention of starting bank privatization in the near future (within five years).

A new finding of the dissertation is that the most important requirement of establishing competition in the banking sector was met by the simultaneous liberation of market entry, banking activities, acquisition of clients, termination of the single account system, and free choice of banks. Neither the dismantling of the mono-bank-structure, nor the foundation of banks could increase competition under these restrictions. However, oligopolistic positions (which characterized the new "entailed properties" established by the petty monarchies of the National Bank of Hungary and OTP) eroded extremely slowly despite of these measures. Paradoxically, the best incentive for restructuring market positions was – in addition to the market entry of foreign banks and Postabank that challenged OTP – the surfacing of a banking crisis that forced banks to stop credit expansion.

Banks and Politics

■ Due to the interdisciplinary approach, the dissertation covers some phenomena affecting the relationship of politics (governments, parties) and banks that are usually outside the scope of research in respect to the banking system, even though they have an important impact on banking operations. A new result of the dissertation is the confirmation of the hypothesis according to which caesura in the relationship of politics and banks was not the regime change, but the transformation of ownership structures. There was not a government after the regime change that weakened the political dependence of state-owned banks; at best, the dependence became more obscure than it was during the period that preceded the regime change. Government influence on the operation of the Hungarian banking sector remained decisive as long as privatization reached the banks that had the greatest economic weight.

Governments (parties) could exercise control in the most direct way by selecting the management of state-owned banks and through the oversight boards. "Cadre policy" did not only affect the operation of banks, but also the costs of subsequent consolidation measures and opportunities for privatization. The dissertation states that there was not a "landslide" in bank management after the regime change; and state-owned banks did not get rid of political influence. The result of overall improvement in quality of senior management is derived from legal requirements for expertise and not from the self-restraint of governments.

■ However, the doctoral dissertation points out that the partially privatized banking sector is not free of political influence either. The comparative analysis of the behavior of various governments in respect to banks states that government actions are greatly dependent on their political style and set of values; however, the success of political pressure depends primarily on the established conditions of the economy and the state's range of power.

■ There is also a reverse relationship between banks and politics. Management of important banks can also influence politics – and this possibility can prevail even after the decrease of state ownership if market conditions are not sufficiently balanced. One of its types is the enforcement of the thesis "too big to fail," which is obvious privilege of large banks. In transforming economies, "state capture" could also be detected, when economic players attempt to manipulate basic legal rules according to their interests. Government decisions resulting from transformation also offer a large scope for "hunting for funds." An important statement of the dissertation is that because economic liberalization and modern legislation took place rapidly in Hungary, there has been a relatively narrow space left for state capture. Opportunities for hunting for funds were granted – even if only to a limited extent – by bank consolidation by the state and privatization as well.

Bank Crises and Their Management

■ Both types of crisis defined in the professional literature surfaced in the Hungarian banking sector in the 1990's. The systematic crisis was characterized by symptoms and reasons mainly similar to those that took place in numerous developed and emerging countries in the world during the 1980's and 1990's. However, two unique features could be differentiated in this area. One is the result of the ambiguous reforms preceding the regime change, after which undercapitalized banks granted credits to undercapitalized companies. The other unique feature was associated with the regime change, which included legislation serving the reinforcement of fiscal discipline (acts on account-keeping, bankruptcy, and financial institutions), stringency of requirements for prudence, the transformation crisis of the Hungarian economy, and competition encouraged by the opening of the banking market.

An important finding of the dissertation is that only one-third of bad and doubtful debts were associated with credits granted prior to the regime change at the beginning of the 1990's; the larger part originated either from political influence on and professional mistakes of banking decision-makers or they were related to moral hazard. Governmental "ostrich policy," the conflict of shortsighted budget interests, and aspects of prudence worsened the situation of irresponsible credit policy by banks.

New scientific evidence by the dissertation is that it provides an account of state funds granted – in various phases in various forms – for credit, debtors, and bank consolidation as well as their effects. The conclusion on the program is that the crisis management that was launched belatedly, and incorporated a lot of anomalies and surplus expenses has restored the crediting capacity of banks after all, which is an indispensable requirement of economic operation. This can be stated despite of the fact that most of the consolidated banks remained under funded, continued operating inefficiently, and only regained their vitality by privatization.

The doctoral dissertation is the first in national literature that measures the method, timing, and costs of consolidation within the international field. This comparison is relatively favorable; while economic recession and the proportion of bad debts at the peak of the crisis approached those of Southeast-Asian crises, the costs of its management (equivalent to eleven percent of the GDP) was significantly less than in Southeast-Asia (in fact, it was similar to those of Scandinavian countries). The costs of the Hungarian bank crisis are not significant compared to Central-Eastern-Europe either. Although, based on the Polish example, it could be stated that the total costs of consolidation could have been lower if it had taken place sooner. Including the more recent costs of consolidation of Postabank, the 1998 current value of total costs amounted to thirteen percent of the GDP.

The dissertation also shows individual bank crises and their management through the examples of Postabank, Realbank, and some smaller financial institutions. Their crises had nothing to do with either heritage from the centrally planned economy or the regime change. Furthermore, their bankruptcy would not have resulted in a domino effect in the banking sector. The dissertation has several new findings based on the analysis of significant individual crises and consolidation policies.

- By comparing to the consolidation of Banesto that has several similarities with the Postabank-case, it states that the process of consolidation was much more transparent and efficient in the case of the Spanish "national champion" than in the case of its Hungarian counterpart. While in Spain, the public funds spent on consolidation were fully recovered by the improvement of banking activities and the sale of the bank, only one-third of the public funds spent on Postabank – the 2003 current value of which amounted to HUF 300 billion – was recovered from the purchase price.
- Based on the analysis of various factors, it states that even in light of the successful act of privatization, the justification of consolidating Postabank is questionable. "Silent" exit from the market (by indemnifying depositors) would not have been more expensive than consolidation as reflected by the capital injections in 1998 and the subsequent expenses by the state.
- An important lesson learned from the crises of Postabank and Realbank is that they called attention to problems and responsibility of supervision ("toothless" supervision). During the Postabank-crisis, the issue of auditors' responsibility – that later became the spotlight during the Enron bankruptcy – surfaced.

Bank Privatization and Its Impacts

A variety of needs determined the timing and method of the sale of state-owned banks, such as under funding, central budget constraints, lack of funds by potential domestic investors, and the strict rules of the Act on Financial Institutions restricting ownership. The dissertation summarizes Hungarian bank privatization as a "virtue born of necessity" both in respect to the development of the banking sector and from the perspective of international comparison. Governments of the 1990's – setting aside their political scruples – finally chose a solution that passed the test of time.

The majority of Hungarian banks have been sold to foreign investors which have also been participants of the sector (mostly banks), while OTP has been turned over to scattered foreign and national financial investors. The facts support that political/econo-political scruples concerning foreign strategic investors were unfounded; one-sided dominance has not occurred, and the signs of "dependence" have not been detected. Professional anxieties in respect to the scattered ownership structure of OTP have not been justified either.

Bank privatization followed two directions, the sale of state-owned banks, and the foundation of new, "green-field" private banks. The ownership structure of the banking sector was further modified by the significant increase of stock capital in former state-owned banks sold to foreign strategic investors, and by the faster increase of the capital by the new banks than that of national banks.

The dissertation is the first in national literature that points out that the four types of act have not only accelerated privatization, but also created an – at that time – almost unique ownership structure in international comparison. By the end of 1997, two-thirds of the bank capital operating in Hungary had been passed to foreign strategic investors. The dominance of foreign owners was also outstanding in the banking sectors of other Central-Eastern-European countries in the second half of the 1990's, but by the millennium, a similar ownership structure characterized the majority of EU candidate countries.

A new finding is that green-field bank foundation and increase of their stock capital played a greater role in boosting the proportion of foreign share of stock than in sales of banks. This feature is – a Hungarian characteristic as well – mostly due to the aforementioned liberal Act on Financial Institutions and practice of authorization as well as the early dismantling of activity-related restrictions (in 1989-1990). Foreign banks entered earlier and were more active in Hungary than in rest of the countries in the region.

The doctoral dissertation employs new aspects in analyzing the connections of ownership and performance – compared to the approach used in international practice – that proven to be more realistic when explaining the phenomena. The model incorporates three new explanative variables:

- The method of acquisition by foreigners (purchase or green-field foundation),
- The duration of foreign ownership (for how many years the majority of the bank has been owned by foreigners),
- The method of management (proportion of Hungarian and foreign Board members and CEOs within the nation).

The new approach appears to be successful in explaining the differences in the performance of the various banks. Estimates of the model examining the ownership structure and method of bank management versus bank performance brought numerous new results.

- Banks in foreign ownership realize higher profits. However, these profits do not originate from a higher interest margin. Therefore, they are not realized at the expense of clients. Contrary to this statement, in many countries it has been verified that the higher profits of foreign banks is directly associated with a higher interest margin.
- Model estimates confirmed the hypothesis, according to which the higher profitability of foreign and green-field banks

was mostly the characteristic of banks that were founded some time ago, and consequently and they were operating with significantly less costs and personnel.

- It could be stated that the crediting activity of foreign banks was higher than that of national banks – independent of the way of acquisition, the duration of possession, and the style of management.

Competition in the Banking Market

The dissertation illustrates changes in the structural characteristics of the banking market from a perspective that is new in national research. It does not only examine the market structure based on the number of players and their concentration; it also incorporates two new aspects in the structural analysis of the conditions of competition. One of them is the process of the rebalancing of scale structure that is important, because – according to recent research – the difference between the market leader and other players following it explains competition better than the extent of concentration. The other factor is increasing competition, which threat appeared by the early market entry of foreign banks in Hungary.[1]

Based on the structural examination of competition, the dissertation states that, although the favorable changes of market structure could be detected in the improvement of bank efficiency and the reduction of interest margin, high profitability associated with – in international comparison – poor efficiency in the Hungarian banking sector indicates the limitations of competition.

Examination of the competition of banks via behavior models were completed by using methods not yet applied in national research. Estimates by the H-statistics measuring cost factor elasticity of interest revenue confirmed the hypothesis according to which increase of competition had a part in the reduction of the interest margin. Model estimates indicate a medium-rate, moderately increasing, and monopolistic competition for the period of 1995-2002. Based on the model, testing the cartelizing behavior of banks, it can also be stated with high probability that there has been an extremely strong price competition at the supposedly homogeneous credit market where the demand for credit reacted to relative changes in interest rates by various banks. This trend is in line with the logic of a competitive market.

Model estimates have not conclusively confirmed the theory according to which market power has been converted to the realization of an oligopolistic rent. However, the author was not in a position to reject the assumption with due regard to the pricing behavior that could be detected in various market sectors. Competition conditions are – demonstrated through models assuming a homogeneous credit market – a basic characteristic of the business market where – according to elasticity equations – banks apply a pricing mechanism aligned with changes in interest rates by the financial market. However, loan interest rates show such little elasticity in respect of financial market interest rates in the residential loan market, which had an insignificant weight during the period under review, that they enable the realization of an oligopolistic rent.

An important new finding is that the extremely high profitability – compared to efficiency – of the Hungarian banking sector was not principally due to the inelasticity of residential loan interest rates (as these were not yet dominant in bank revenues) during this period. On the contrary, this profitability was rather due to the fact that – opposite to the assumptions of the models – the Hungarian deposit market is not price accepting even in respect to savings-type products. Non-banking competition has also increased in Hungary in vain; the interests of savings deposits remain inelastic in respect to financial market interests and turn out relatively adhesive.

Consequently, the pricing of deposits as well as credits offered opportunities at the residential market for collecting oligopolistic rents caused welfare losses on the social level. The dissertation is the first in national literature that assumed the existence and estimated the extent of social loss originating from restricted competition. Comparison to banking/financial market spreads (positions reflecting "competitive pricing") by the European Union reveals that social losses originate from lower deposit interests, and credit interests that are higher than the "competitive" rates. Furthermore, they also put a burden on residential and small business clients in excess of an average of 0.4 percent of the GDP during the years between 2000 and 2003.

Joining the European Union and Globalization

The banking sector's economic penetration in Hungary is much less significant than it is in other countries with similar development. The dissertation explains that despite of the significant development of the sector, the "depth" of the Hungarian banking sector has hardly increased. This is due to the income/revenue positions and behavior of households and companies as well as early capital liberalization on one hand, and the aforementioned deficiencies in the operation of the banking sector on the other. The role of bank services is expected to increase in the residential and small enterprise segments of clients, nevertheless the related impacts could be counter-balanced in part by the global phenomenon of disintermediation.

Based on a comprehensive evaluation of the expectable impacts of joining the European Union, the dissertation concludes that the Hungarian banking sector could be integrated into the homogeneous market with a relatively insignificant shock. Based on the analysis of the motivations and tendencies of transnational services, it can also be stated that foundation of branches by foreigners at the Hungarian banking market is unlikely to become typical. Moreover, the expansion of transnational direct services is limited by the extensive loans that have been already obtained by companies from foreign banks or their owners; in addition, the local banks are less subject to information asymmetry that provides more efficiency in the residential-small enterprise segment.

NOTE

1 On the importance of the two factors, see P. Molineux, *"Increasing Concentration and Competition in European Banking: The End of Anti-trust?"* in EIB Papers Volume 4, 1 (1999)