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5. Author(s)
   1. Gail Buyske
   2. Robert Vogel
   3.

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ABSTRACT

Hungary's Financial System: Status and Prospects

by

Gail Buyske and Robert Vogel

August 1993

This report is one of four country studies of financial sector reform in Bulgaria, Hungary, Poland, and Estonia. It was commissioned by USAID to assist the USG in planning programming in this sector. Each report examines the macrofinancial environment; the functions of central banks, including bank regulation and supervision; the future role of state banks, the development of banking services, capacity development in the banking system, and the role of donors. A synthesis report was also prepared to draw common findings and lessons from the four country studies.

This study concludes that Hungary's financial system is tied to resolving its bad loan problem--in particular, that of the major state-owned banks. Until this problem is resolved, the authors believe that neither Hungary's state-owned banks nor its state-owned enterprises, which are the major borrowers of these loans, can be privatized. And, until the state-owned banks are restructured, they will have neither the resources nor the incentives to operate like market-oriented banks and contribute to the development of Hungary's market economy.

The report concludes with observations and recommendations for U.S. Government assistance.

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Hungary's Financial System:

Status and Prospects

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Gail Buyske
Robert Vogel

August 1993

DAI
7250 Woodmont Avenue, Suite 200,
Bethesda, Maryland 20814

in association with

IMCC
2101 Wilson Blvd. Suite 900
Arlington, VA 22201

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SECTION ONE

INTRODUCTION

Hungary's current evolution toward a market-based financial system began in 1987, when the National Bank of Hungary (NBH) spun off its commercial banking operations to three state-owned banks and established a two-tiered banking system. These three banks, together with the savings bank and a foreign trade bank that was already separate from NBH, are the core of Hungary's state-owned banking sector. In 1987, Hungary also had three banks with partial foreign ownership and 13 smaller banks and specialized financial institutions (SFIs). The most significant growth since then has been in foreign bank participation; today, in addition to the five large state banks, Hungary has 18 banks with foreign ownership and 14 smaller banks and SFIs.

Hungary's financial sector has two dominant and related features. In addition to characterizing the sector, these two features also lay out the challenges for its reform. The first of these characteristics is the overwhelming presence of the large state-owned banks, which, as of year-end 1991, accounted for more than 70 percent of all banking system assets. Progress toward a market economy will require some combination of privatizing these banks, reorienting their incentives toward market-based practices, and reducing their market dominance actively or through attrition. The issues of privatization and market incentives are related to a serious problem of nonperforming loans.

The prospects for gradual shrinking of the state banks through competition is complicated by the fact that there are essentially no private indigenous banks in Hungary; almost all the more than 30 other banks and SFIs have foreign ownership or some combination of state bank and state enterprise ownership. The main competition for the state-owned banks will be largely from the foreign bank sector. Therefore, Hungary cannot realistically pursue a strategy of strengthening private local banks in the hopes that they will become viable competitors to the state-owned banks in the foreseeable future.

Privatizing the state-owned banks, or at least altering their incentives, is complicated by an enormous bad loan problem. As of December 1992, the nonperforming loans of the Hungarian banks totaled 26 percent of total outstanding loans and 12.98 percent of total assets.[1] These loans consist of bad loans inherited from the 1987 spin-off, as well as bad loans that were made subsequently by the spun-off banks and other banks. The bad loan problem is particularly pronounced in the state-owned banks, several of which are estimated to have negative capital.

The Government of Hungary intends to privatize the state-owned banks as part of its overall program to privatize state-owned assets in Hungary and further the development of a market-based economy. Although it is recognized that none of the state banks can be privatized until the bad loan problem is resolved, a recent effort to deal with this problem through a loan consolidation program has not been effective. Part of the ineffectiveness can be attributed to the complexity of the problem, but the root cause appears to be a lack of political will. Resolving the bad loan problem goes to the heart of enterprise privatization because it requires restructuring the enterprises that owe the bad debt. This, in turn, calls for difficult decisions about which enterprises are viable and which are not. It also requires recognition that losses have already occurred. Finally, it entails higher budget expenditures on the social costs, such as unemployment benefits, that are related to enterprise restructuring. These are all issues

[1] NBH data

that the Government of Hungary has hesitated to address. As a result, the bad debt problem has been dealt with only cosmetically.

These two features of the Hungarian financial sector are exacerbated by a deteriorating macroeconomic situation that limits the financial options available to the Government of Hungary to address the bad loan problem adequately. Furthermore, as this report will discuss, the government's financial and political constraints in acknowledging the costs of the bad loans perpetuate nontransparent and inefficient ways of dealing with the loans and ultimately paying for them. These government efforts also fail to address the incentives that created the bad loan problem, thereby setting the stage for the problem to continue to grow worse.

Finally, over the last year and a half, the Hungarian banks have cut back on lending. The reduction in lending has several causes, including far-reaching legislation enacted in 1992 that raised the explicit cost of bad loans for the banks. This legislation included an accounting law, a bankruptcy law, and a banking law (which included requirements for loan provisioning). Although many of the banks are liquid, the well-managed ones are unlikely to increase their lending until they have more confidence in the creditworthiness of their borrowers and in their own abilities to make sound loans. (There is a risk that banks that are less well managed or whose management is offered the wrong incentives are not overly concerned about the quality of their loan portfolios, because of the government's track record of bailing out weak banks.) In turn, the hesitancy of many banks to lend slows down the economic reform and privatization process in Hungary. It is relevant to note that a government program of existence loans, which provided funding to the banks for privatization loans, was so underutilized that the government recently created a new privatization finance program.

In summary, the future of Hungary's financial system is tied to resolving the bad loan problem — in particular, that of the major state-owned banks. Until this problem is resolved, neither Hungary's state-owned banks nor its state-owned enterprises, which are the major borrowers of these loans, can be privatized. Furthermore, until the state-owned banks are restructured, they will have neither the resources nor the incentives to operate like market-oriented banks and contribute to the development of Hungary's market economy.

This review discusses the Hungarian financial sector according to the following outline. Section Two addresses the financial system environment. Two topics of particular importance in this section are the macroeconomic environment, which constrains the government's options, and the system for bank supervision, which reflects the highly politicized nature of financial sector reform in Hungary. Section Three discusses the development of the banks themselves and includes an analysis of the 1992 loan consolidation program. Section Four discusses capacity building in NBH and the commercial banks, as well as donor activities to assist these institutions. Section Five concludes this review with recommendations for future U.S. Government assistance.

SECTION TWO

THE FINANCIAL SYSTEM ENVIRONMENT

In terms of the usual indicators of macrofinancial performance, Hungary has done relatively well so far in the 1990s, compared with the other formerly socialist countries of Central and Eastern Europe. The fiscal deficit has been significant, but not astronomical, as a percentage of gross domestic product (GDP) and has been financed rather easily, largely through increased domestic savings held with the banking system. Hungary has not been forced to suspend payments on its foreign debt or to renegotiate under duress (although some of its negotiations have been quite complicated) and has maintained a sustainable balance-of-payments position without major depreciation of its exchange rate. In line with these relatively strong fiscal and international positions, Hungary's monetary policy has been relatively tight, thereby avoiding high rates of inflation. At the same time, interest rates have been largely free to adjust to inflation, which they have done with some lag. Hungary has also made significant progress in developing appropriate legal and accounting infrastructure for a market economy, but the key area of bank supervision has lagged. Moreover, a substantial public sector debt lies hidden in the nonperforming loans of public sector banks, regardless of when this debt is officially recognized.

FISCAL POLICY AND THE TAXATION OF FINANCE

There has been some recent slippage in Hungary's fiscal performance, as the central government budget moved from approximate balance in 1990 to a deficit of about 5 percent of GDP in 1991 and 8 percent IN 1992. According to Hungarian government officials, the deficit is projected to decline to about 5 percent of GDP during 1993, in conformance with the programs of the International Monetary Fund and the World Bank. However, serious doubts were expressed by a variety of observers that this reduction can be accomplished, given the approaching elections and their implications for the ability of a government in any country to control expenditures effectively. Although government officials and other observers tend to blame this slippage on reduced tax revenues from public sector enterprises, because of their poor profitability performance, and on the growth of underground private sector enterprises that avoid taxes, figures on government expenditures and taxes suggest instead that most of the increase in the fiscal deficit is because of increases in expenditures relative to GDP.

In addition to the recent slippage in fiscal performance, two other aspects of Hungary's fiscal situation need to be closely monitored: the large internal debt, and the hidden government debt implied by the nonperforming loans of the state-owned banks. Although Hungary's government debt instruments are now being sold at market rates of interest, debt incurred before 1991 and financed by NBH carries rates of only 8 percent. Thus, full liberalization of interest rates could further worsen the government's fiscal position, as could any significant increase in market rates of interest.[2] The large portfolios of nonperforming loans of the state-owned banks, discussed at length below, represent additional government debt whether or not the portfolios have been officially recognized, because the government cannot avoid

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[2] There is a growing literature on the so-called consistency issue, or the quasifiscal deficit, both of which refer to the question of the sustainability of financial reform when government deficits increase significantly with interest rate liberalization.

honoring the obligations of these banks. Furthermore, infusions of government funds will likely be necessary to continue these banks in operation and, eventually, to privatize them.

To this point, the financing of the government deficit has not been difficult because the personal savings rate in Hungary has increased substantially and Hungarians have been willing to place a significant portion of these savings with the banking system, in spite of the low (often negative) real rates of interest on deposits (see Table 1 for data on the liabilities of the banking system).[3] In addition, bank credit to the private sector and to state-owned enterprises has tended to decline in real terms, due to a decline in demand for loans and an increase in bankers' concerns about the risks of such lending, thereby leaving more credit available to finance the fiscal deficit at relatively attractive rates of interest. In fact, banking system credit to the government increased by about 22 percent in nominal terms during 1992, and the government also had no difficulty selling bonds in the open market at declining rates of interest. Consequently, the legal limits on NBH lending to the government have proven to be no constraint at all, as NBH's direct lending to the government actually fell slightly in nominal terms during 1992. However, there is no guarantee that such fortuitous circumstances for financing the government's deficit will persist into the future, and thus the situation warrants careful monitoring, with respect to both the fiscal implications for the government and the potential crowding out of the private sector.

Tax laws and regulations in Hungary do not currently present a large number of significant distortions for financial sector development. The main issue in the taxation of interest and dividend income arises from distortion in discriminating between the taxation of real and nominal magnitudes. Among such taxes worth noting is a 20 percent withholding tax on deposit interest, except on foreign currency deposits, and a 10 percent withholding tax on dividends. In addition, interest expense is deductible for tax proposes for corporations but is not deductible from income for individuals. Finally, there is the usual conflict between tax collection and prudential regulations to maintain capital adequacy with respect to the deductibility from profits for tax purposes of provisions for nonperforming loans.

THE BALANCE OF PAYMENTS AND THE EXCHANGE RATE SYSTEM

Hungary has been able to maintain a reasonably strong balance of payments position so far in the 1990s. Unlike many other countries of Central and Eastern Europe, Hungary has largely been able to replace its exports to the former Soviet Union and other Eastern European countries with exports to market economies in Western Europe and elsewhere. Hungary's balance of payments situation has also been aided by substantial increases in receipts from foreign tourists, by continuing large external transfers from multilateral and bilateral donors, and by a significant decline in foreign interest payments due to both lower external interest rates and a modest reduction in its foreign debt. In fact, with its continuing substantial capital inflows, Hungary could have reduced its foreign debt even more but chose instead to accumulate foreign exchange reserves in large amounts.

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[3] In addition to low real interest rates, depositors may have good reason to be concerned about the safety of deposits in certain banks and about the quality of services offered to depositors at all banks. Nonetheless, deposits of households and enterprises tended to grow in real terms during 1992. With the respect to the current high rate of savings out of income, two main explanations are given: an increased desire of Hungarians to save for the future because of a reduction in perceived security as part of the transaction to a market economy, and the very high profits and incomes earned by a significant number of Hungarian entrepreneurs (often unreported for tax purposes).

TABLE 1

BANKING SURVEY: LIABILITIES
(in billions of forints)

Dates	Net foreign liabilities	Banknotes and coins outside banks		Enterprise deposit		Deposits of Households and small entrepreneurs			Other deposits	Bonds and savings notes
		Households	Other	Forint deposit	Foreign exchange deposit	Household deposits in Forints	Household deposits in foreign exchange	Deposits of small entrepreneurs		
Dec. 31, 1989	1019.4	161.0	19.5	166.3	13.7	252.9	20.4	23.9	49.5	67.4
Dec. 31, 1990	1024.3	181.2	28.6	228.2	49.5	261.4	62.5	36.6	61.9	93.9
Dec. 31, 1991	1134.5	204.9	55.3	258.6	65.8	302.5	129.5	57.5	96.6	186.8
Dec. 31, 1992	1129.8	269.6	52.8	335.5	63.0	429.3	152.6	63.6	124.8	243.9

Source: NBH, Monthly Report

In keeping with its relatively strong balance of payments situation, Hungary's exchange rate has depreciated little in relation to the U.S. dollar during the 1990s. In fact, when its exchange rate is compared to its rate of inflation as measured by the consumer price index, Hungary has experienced a significant appreciation in its real exchange rate during the 1990s, although in terms of the producer price index such a conclusion is less clear (see Tables 2, 3, and 4). Statements by Hungarian officials indicate that further appreciation of the real exchange rate would be viewed favorably, especially for its favorable impact on inflation, and that there is little concern for the negative impact of real appreciation on the demand for exports and import substitutes. The ability of Hungary to maintain a strong balance of payments and a continuing appreciation of its real exchange rate is primarily the result of the tight monetary policies that have been pursued until recently, because these policies have curtailed capital outflows and imports while encouraging capital inflows. Recent indications of movement toward considerably less tight monetary policies could have more significant repercussions on the balance of payments and the exchange rate than is generally recognized.

TABLE 2

AVERAGE EXCHANGE RATES
(Hungarian forints per U.S. dollar)

Period		Rate
1989		59.10
1990		63.20
1991		74.81
1992		79.00
1992	January	76.84
	February	77.81
	March	79.65
	April	80.03
	May	79.29
	June	78.45
	July	77.49
	August	76.64
	September	77.39
	October	78.80
	November	82.53
	December	82.91

Source: NBH, Monthly Report

In spite of its strong balance-of-payments situation and appreciating real exchange rate, Hungary has continued to maintain some noteworthy exchange controls. For example, exporters are supposed to surrender their foreign exchange receipts but enterprises are free to purchase foreign exchange for imports, while individuals cannot freely purchase foreign exchange (for example, for foreign travel) but are freely permitted to hold deposits denominated in foreign currencies. Exchange controls have proven very hard to enforce almost everywhere, and the seemingly haphazard Hungarian system would appear to be particularly vulnerable to evasion. Moreover, various Asian and Latin American countries that have recently liberalized their foreign exchange regimes in major ways have typically experienced substantial inflows of foreign exchange rather than outflows, especially if they have been maintaining credible programs of fiscal and monetary restraint. This can be explained by the fact that foreign exchange decontrol further enhances credibility, as an economy becomes an even more attractive home for new capital with increased assurance that capital can freely be taken out again. Whatever might be the impact in Hungary of further foreign exchange market liberalization on capital flows and the exchange rate, continuing careful coordination among monetary, fiscal, and foreign exchange policies should be an essential component of such liberalization.

TABLE 3

PRICE INDEXES

Year	Producer Price Index *(previous year = 100.0)*	Consumer Price Index *(previous year = 100.0)*
1989	115.4	117.0
1990	122.0	128.9
1991	132.6	135.0
1992	112.3	123.0

Source: NBH, Monthly Report

MONETARY POLICY AND CENTRAL BANK OPERATIONS

As noted above, monetary policy in Hungary can generally be described as tight during the 1990s. In spite of potential pressure on monetary policy from the government's fiscal deficit, the substantial increase in savings in Hungary, together with only moderate demand for bank credit from private sector and state-owned enterprises, has allowed the growth in the nominal money supply to be kept basically in line with the increased demand to hold money balances stemming from the increase in savings. As a result, the rate of inflation, the exchange rate, and the balance-of-payments situation have been kept under much better control in Hungary than in most other Central and Eastern European countries. The inflation rate in Hungary reached a peak of only slightly more than 30 percent for 1991 and has since declined to about 20 percent; the depreciation of the exchange rate has been even less rapid, and the balance-of-payments situation has allowed the accumulation of substantial foreign exchange reserves (see Tables 2, 3, and 4). This performance has, in turn, allowed the beginnings of financial deepening in Hungary, as real money balances grew significantly in 1992 after remaining about constant in 1991, while nominal interest rates have begun to fall with the declining rate of inflation (see Tables 5, 6, and 7).

TABLE 4

CONSUMER PRICE INDEX
(Percent Change)

Month		Compared with previous month	Annualized rate	Compared with corresponding month of previous year
1991	January	7.5	146.0	34.1
	February	4.9	80.0	33.2
	March	3.7	55.9	34.3
	April	2.4	33.4	35.4
	May	2.2	30.2	36.9
	June	2.1	28.7	38.6
	July	0.9	11.4	38.2
	August	0.2	2.4	34.2
	September	1.5	19.7	34.0
	October	1.3	16.9	33.9
	November	1.4	18.3	32.8
	December	1.6	21.2	32.2
1992	January	3.2	46.8	28.2
	February	2.7	38.3	25.8
	March	1.9	25.6	24.7
	April	1.3	16.9	23.3
	May	1.5	19.7	22.6
	June	0.6	7.5	20.6
	July	0.3	3.7	20.1
	August	0.8	10.1	20.7
	September	2.4	33.4	21.7
	October	2.5	35.0	23.4
	November	1.6	21.2	28.7
	December	1.1	14.1	21.6

Source: NBH, Monthly Report

TABLE 5

BANKNOTES, COINS, AND BROAD MONEY
(in billions of forints)

	Banknotes and coins in circulation			Broad Money		
Dates	Held by households	Held by economic entities	Total	Held by households	Held by economic entities	Total
Jan. 31, '91	169.9	22.1	192.0	496.0	389.1	885.1
Dec. 31, '91	204.9	55.3	260.2	636.9	533.8	1170.7
Dec. 31, '92	269.6	52.8	322.4	851.5	639.7	1491.2

Source: NBH, Monthly Report

To implement monetary policy, NBH has begun to use a wider range of modern monetary instruments. After relying mainly on changes in reserve requirements and credits to the banking system, NBH has now begun to rely primarily on open market operations to achieve its monetary policv targets. In fact, as part of a policy to bring Hungary closer to international standards, required reserves on deposits in domestic currency were recently reduced from 16 percent to 14 percent, in order to reduce the taxation of the monetary sector implicit in unremunerated reserve requirements. The extent of development of the interbank market and money markets in general in Hungary has provided NBH with considerable flexibility for carrying out its open market operations. Nonetheless, the system of open market operations actually used by NBH is somewhat unusual in that, rather than buying or selling certain quantities of securities, NBH instead establishes interest rates for repurchase and reverse repurchase operations, and then allows the banks to engage in these operations with NBH in amounts chosen by the banks. This technical approach may reflect a more basic decision of NBH to target interest rates in its monetary policy operations.

Officials at NBH have stated that interest rates are currently the target of monetary policy and have indicated a specific preference for declining interest rates in the near future. NBH officials should be aware of the difficulties that can arise in targeting nominal interest rates in a situation of volatile inflationary expectations where a more rapid expansion of the money supply can cause nominal interest rates to rise rather than fall. In addition, its seems apparent that NBH officials also have targets with respect to the rate of inflation, the exchange rate, and perhaps other variables as well. It must therefore be kept in mind that NBH, like a central bank in any country, can ultimately choose only a single target and, if in 1993 it re-establishes a stabilization program approved by the International Monetary Fund (IMF), NBH is likely to shift the intermediate target of monetary policy from interest rates to the value of domestic credit.

TABLE 6

DEVELOPMENT OF MARKET INTEREST RATES: DEPOSIT RATES

Period	Fixed for less than a month			Fixed for less than a year			Fixed for more than a year			Current account deposit	
	min.	max.	wtd. avg.	min.	max.	wtd. avg.	min.	max.	wtd. avg.	min.	max.
BANKS TOTAL											
Dec. '90	10.0	38.0	23.7	8.0	43.0	28.5	10.0	35.0	29.3	4.0	15.0
Dec. '91	10.0	40.0	25.1	15.0	40.0	31.1	20.0	38.0	33.0	5.0	24.0
Dec. '92	5.0	34.0	12.9	6.0	26.0	17.6	9.0	25.0	19.5	0.0	17.0
FOUR LARGE BANKS TOTAL											
Dec. '90	10.0	38.0	21.7	8.0	40.0	27.6	23.0	34.0	29.7	4.0	10.0
Dec. '91	10.0	34.5	21.8	15.0	37.0	30.0	25.0	36.0	33.3	10.0	15.0
Dec. '92	6.0	34.0	15.9	6.0	24.0	18.0	9.0	24.0	19.7	5.0	15.0
OTHER BANKS											
Dec. '90	10.0	37.0	26.0	16.0	43.0	30.2	10.0	35.0	27.2	5.0	15.0
Dec. '91	10.0	40.0	25.9	18.0	40.0	31.7	20.0	38.0	32.8	5.0	24.0
Dec. '92	5.0	27.5	11.5	8.0	26.0	17.2	15.0	25.0	19.4	0.0	17.0

Source: NBH, Monthly Report

THE INTERBANK MARKET

Hungary has an active interbank market, which the banks use for liquidity management. NBH initiated the development of this market in 1988 when it undertook the role of a blind broker; it took excess funds from the banks and re-lent them, taking on the credit risk of the borrower directly. An interbank market that operates directly through the banks has since developed as well, and NBH encourages use of this market by charging higher rates for its own facility. Prices in the direct interbank market are sensitive to perceived credit risks, although the lack of adequate information about the banks makes it difficult to assess these risks fully. In this regard, several banks interviewed noted the need for a bank rating agency. Several banks lost money from interbank loans made to the banks that failed in 1992, and it has therefore taken some time before other small banks could re-enter this market as borrowers.

TABLE 7

DEVELOPMENT OF MARKET INTEREST RATES: LENDING RATES

	Maturing within a year			Maturing over a year			Discounted bills		
Period	min.	max.	wtd. avg.	min.	max.	wtd. avg.	min.	max.	wtd. avg.
BANKS TOTAL									
Dec. '90	12.5	41.0	32.1	18.0	42.0	27.5	24.0	45.0	32.4
Dec. '91	26.0	45.0	35.5	23.5	46.0	34.3	24.0	47.9	36.1
Dec. '92	17.0	39.0	28.8	20.0	40.0	25.4	22.0	38.0	27.4
FOUR LARGE BANKS TOTAL									
Dec. '90	12.5	40.0	32.1	18.0	37.0	27.0	24.0	35.0	29.5
Dec. '91	32.5	44.7	36.1	23.5	39.0	34.4	30.3	40.0	35.1
Dec. '92	21.5	39.0	30.9	21.0	36.5	24.6	23.0	34.0	26.6
OTHER BANKS									
Dec. '90	20.0	41.0	32.2	21.0	42.0	30.5	25.0	45.0	34.1
Dec. '91	26.0	45.0	34.7	25.0	46.0	34.1	24.0	47.9	36.4
Dec. '92	17.0	39.0	26.5	20.0	40.0	26.1	22.0	38.0	27.8

Source: NBH, Monthly Report

INTEREST RATES, DEPOSIT MOBILIZATION, AND CREDIT ALLOCATION

Interest rates in Hungary are largely market-determined. The two most noteworthy aspects of interest rate behavior during the past two years were the rise during 1991 and fall during 1992 of rates on deposits in nominal terms, following with some lag the pattern of inflation over those years and tending to be at most slightly positive in real terms; and the same pattern for lending rates, but with a much smaller decline in 1992 than that exhibited by deposit rates, so that spreads have tended to widen substantially (see Tables 6 and 7). One reason for widening spreads is that the interest rate paid on required reserves was reduced from 11 percent to 3 percent during 1992.[4] However, the main reason for increasing spreads is undoubtedly the nonperforming loans of the large state-owned banks, because these banks have had to generate additional revenues on performing loans to compensate for the loans yielding no revenue. In addition, it should be noted that the spreads for other banks also increased, so that banks without serious nonperforming loan problems (mainly the foreign-owned and joint venture banks) could increase their profits substantially under the umbrella provided by the difficulties of the large state-owned banks that dominate the system.

The Government of Hungary does not appear to intervene directly in the allocation of credit but rather leaves this basically to market forces as implemented through the banking system. However, there may be strong incentives for banks to roll over nonperforming loans, and the government may also find it convenient for state-owned banks to continue to support illiquid state-owned enterprises, including those without good long-run prospects. Data provided by NBH break down bank lending into general government, local governments, enterprises, households, and small entrepreneurs, but it is not made clear how much of the share going to enterprises is going to state-owned enterprises compared to privately owned enterprises (see Table 8). In any case, general government represents by far the largest share of bank credit outstanding, and during 1992 it increased enough in nominal terms to maintain approximately its same level in real terms. For enterprises, households, and local governments, credit outstanding from the banking system stagnated or actually declined in nominal terms and thus declined significantly in real terms. (The entrepreneurial sector is defined to include state-owned enterprises, or SOEs.) Only for small entrepreneurs does there appear to have been a large enough increase in nominal terms to result in an increase in real terms, but, in any case, small entrepreneurs receive only a small share of total bank credit outstanding.

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[4] Foreign currency deposits currently have no reserve requirements, but several individuals interviewed suggested that such reserve requirements should be introduced. Although this could reduce incentives for currency substitution (the "dollarization" of the Hungarian economy), any slippage in the credibility of Hungary's stabilization program would then create stronger incentives for Hungarians to hold foreign currency deposits in neighboring countries, something that has everywhere proven hard to control even with draconian penalties.

TABLE 8

BANKING SURVEY: ASSETS
(in billions of forints)

Dates	Net credit to general government	Credit to local governments	Credit to enterprises	Credit to households	Credit to small entrepreneurs
Dec. 31, 1989	724.7	18.2	475.3	313.5	18.7
Dec. 31, 1990	730.4	21.9	594.3	330.0	44.0
Dec. 31, 1991	852.6	22.9	705.4	205.6	61.4
Dec. 31, 1992	1040.7	20.0	697.9	207.5	76.3

Source: NBH, Monthly Report

Lending by NBH to Hungarian financial institutions decreased during 1992 (especially credits against foreign exchange deposits), and, when deposits of financial institutions at NBH are taken into account (mainly required reserves and foreign exchange deposits), financial institutions have increasingly become net lenders to NBH. Although the base interest rate for NBH refinancing of bank loans was 22 percent during most of 1992 (declining to 21 percent late in the year and to 20 percent at the beginning of 1993), there are nonetheless a number of lines for the refinancing of loans (for example, for exports, tourism, and privatization) at preferential rates, with some as low as 10 percent.

Deposit mobilization by the Hungarian banking system was reasonably satisfactory during 1992 in spite of three factors that could have been expected to hold down the growth in deposits: the continuing weak performance of the Hungarian economy; declining nominal interests rate on deposits and continuing low real rates; and continuing complaints about the poor quality of retail banking services, especially in terms of the long lags before deposited funds become available. Forint deposits of enterprises and households grew in real terms during 1992, as did bonds and savings notes issued by banks (see Table 1). On the other hand, foreign exchange deposits of enterprises and households and total deposits of small entrepreneurs tended to decline in real terms. At the same time, holdings of coin and currency by enterprises fell in nominal terms while those of households grew in real terms. Moreover, as indicated above, the base interest rate for NBH refinancing of bank loans was sufficiently high during 1992 that banks were apparently not diverted from deposit mobilization by the availability of cheap funds from NBH.

THE BUDAPEST STOCK EXCHANGE

Although the Budapest Stock Exchange (BSE) opened to great fanfare in 1990, so far it has not lived up to the initial expectations that it would be an important vehicle for mobilizing financing for new and privatizing enterprises. This is partly because of institutional factors and partly because of BSE's initial experience. Looking at the institutional factors, Hungary does not yet have a financial infrastructure of pension funds and insurance companies that would provide the basis for institutional investment in the stock market. The largest institutional players on the stock market are the banks, which operate through their brokerage subsidiaries. In addition, Hungary's privatization program has relied primarily on private investment for privatizing state-owned assets, rather than on distributing ownership rights to the population. (The exception is for individuals who received compensation for expropriated property.) Therefore, in contrast to the Czech Republic, Hungary's privatization program has not led to the creation of a population of small shareholders, which, in the Czech Republic, also led to the development of mutual funds.

The principal historical factor is that the Hungarian stock market has fallen substantially since its initial heady days. The stock market index peaked at 1,227 (from a starting point of 1,000) in March 1991 and had fallen to the 700 range in April 1993. This appeared to be caused by overly optimistic expectations, reflected in initial share price increases, together with the impact of the ongoing recession. Not only have the initial participants — institutions and individuals — suffered losses, but the experience also has discouraged any further investment. This has been a setback for the privatization process overall, because the original intent had been to use the stock market more extensively for privatization.

BSE has more than 50 members and trades both equities and government securities. As of year-end 1992, 23 companies were traded on the exchange. There were a total of 8,565 trades, including government bonds. A futures market in government securities, foreign exchange, and interest rates is scheduled for launching in July. Both the foreign exchange and interest rate futures markets will be useful for the banks in managing foreign exchange and funding exposures. Bank shares are not traded on BSE, although there is some over-the-counter activity. As discussed in this review, foreign investment is the preferred method for privatization of the large banks.

A significant unknown factor in the future of BSE is whether the banks will be able to become direct participants on the exchange, as in a universal banking system. Those who favor this change argue that it would increase activity on BSE and provide needed additional income to the banks. Those who argue against it note that countries that do not have universal banking tend to have stock exchanges that play a more important role in the financial sector than in countries with universal banking. Opponents of universal banking also want to shield the market from the direct influence of the still state-owned banks. This debate does not yet appear to be a major controversy in the Hungarian financial sector, but it is an aspect of the current banking law that is under review. Given the current problems of the state-owned banks, it would seem prudent to postpone any potential changes until these banks operate in an environment with appropriate market-oriented incentives.

LEGAL AND ACCOUNTING INFRASTRUCTURE

Hungary appears to have made much greater progress in developing the necessary legal and accounting infrastructure for carrying out financial operations in a market context than have most of the other countries of Central and Eastern Europe. In particular, Hungary has passed a number of important laws that bring Hungarian laws and regulations affecting financial markets and institutions largely into conformance with international standards and that should facilitate a relatively rapid development of market-based financial operations. Internationally accepted accounting principals have largely been adopted in the new Hungarian accounting law, along with the practice of annual external audits. A strict bankruptcy law has been passed, according to which companies not able to pay their debts within 90 days of the due date are automatically considered bankrupt.

In addition, new banking law has been passed that tends to follow the U.S. practice of limiting the ability of banks to become directly involved in non-banking activities, as opposed to the tendency of most European banking laws (including those recently enacted in Central and Eastern Europe) to favor the universal banking approach. However, such limits are not nearly as strong as in the United States, and current discussions of possible revisions in the banking law include moving further toward the European model of universal banking. The law provides for four different types of banks, each type with a different minimum capital requirement: full-scale commercial banks (F 2 billion), specialized financial institutions with a narrower range of activities (F 500 billion), savings cooperatives (F 50 million), and investment or development banks (of which none yet exists). The law also specifies other requirements for a banking license such as adequate technical capacity, experience, and good character. In addition, approval by both NBH and the State Banking Supervision (SBS) is required, which can lead to significant delays in the licensing of new banks.

In spite of these important advances in Hungary's legal infrastructure, several problem areas remain, especially in implementation. Although the quality of financial information in Hungary is said to be improving rapidly with the increasing number of trained accountants and auditors, the system has not yet reached the point where it provides potential investors and creditors with the information they need to make fully informed decisions.

Judging by the large number of companies in bankruptcy and liquidation, the bankruptcy law appears to have been highly effective. In 1992, almost 15,000 enterprises, with sales representing 15.6 percent of GDP, went into bankruptcy or liquidation proceedings. However, it appears that the court system is not adequately prepared to handle all these cases, especially given the low salaries and scanty training of judges. It is said that many liquidation proceedings drag on to the detriment of all parties (NBH reports that of approximately 5,000 liquidation applications, only 20 or 30 had been resolved by the end of 1992) and that those that are resolved quickly often involve self-dealing and fraud. Moreover, possible revision of the bankruptcy law is under consideration, including revisions allowing more flexibility regarding the 90-day cut-off date.

There also are several areas in the banking law that appear to warrant revision. For example, presentation of consolidated accounts for an entity with all of its parents and subsidiaries is not required, so that risky assets (for example, nonperforming loans) and other problematic items can be "parked" in the financial statements of related entities and thus not be appropriately reflected. In addition, equities are not included among risk assets, so that loss provisions and capital may be less adequate than appears, especially since nonperforming loans can also be effectively parked by converting them to equity positions. Furthermore, bank secrecy has been defined in such a way that it is often claimed that banks cannot disclose any information about clients, which clearly impedes the rating of borrowers or the formation of any entity resembling a credit bureau. In fact, the concept of bank secrecy has its origins in the protection of depositors but has often been used, not only in Hungary but also elsewhere, to conceal important information about defaulting borrowers and nonperforming loans.

Even taking these shortcomings into account, the impact of the new accounting, bankruptcy, and banking laws on the Hungarian banking system has been pronounced. Banks must now take into account the realistic possibility that clients might go bankrupt, and they are also required to make standardized provisions against nonperforming loans. This has been an important factor contributing to the decline in bank lending in 1992 and, so far, in 1993. These new laws also provided an impetus to attempt to resolve the bad loan problem of the banks, because the laws' combined impact potentially had an extremely negative effect on the banks' year-end 1992 balance sheets.

PRIVATIZATION[5]

The pace of enterprise privatization in Hungary could best be described as "deliberate." This appears to be due to four main factors. First, the Hungarian privatization process relies on selling state assets to investors rather than distributing them to the public. Therefore, privatization can take place only as quickly as buyers can be found to purchase the assets. It should be noted, however, that Hungary's ability to attract foreign investment is one of its most outstanding characteristics. As of year-end 1992, foreign investors had provided more than 80 percent of all fresh capital invested in Hungary since 1989, totaling $4.9 billion. (Not all of this capital was related to privatization.) Hungary has more than 15,000 companies with foreign participation.

Second, Hungary began the privatization process from a relatively high base, with the private sector already contributing 31 percent of GDP as early as 1988. As a result, some of the simpler privatizations of small stores and businesses, which have contributed to impressive privatization statistics for other countries in the region, had already been accomplished in Hungary.

A third and related factor is that many of the privatizations that remain are the difficult ones — large industrial enterprises that produce goods inefficiently or produce goods for which there is no longer any market. Forcing the privatization of these enterprises would result in the liquidation of many of them. This is not politically acceptable in a country that already has a 13 percent unemployment rate. Furthermore, even though the government already bears the cost of sustaining unprofitable enterprises that it owns, there are also concerns about the social safety net costs for the employees of liquidated enterprises.

A fourth factor is an apparent hesitancy by the government to part with certain assets that are considered to have strategic value, such as those in natural resources, banking, and transportation. Therefore, one of the two privatization agencies, the State Holding Company (SHC), was founded specifically to hold the shares of these companies. Its initial portfolio consisted of 160 companies, including 11 banks, banking institutions, and insurance companies. The other agency, the State Property Agency (SPA), is responsible for privatizing enterprises in which the government will not retain any shares. SPA's total portfolio represents more than 30 percent of the productive assets in the economy.

As a result of these factors, the privatization process in Hungary has been a slow one, although the private sector's contribution to GDP had risen to 44 percent in 1992. (Given the difficulties in measuring private sector activity, the actual contribution is most likely higher.) As of year-end 1992, SPA had sold approximately 12-13 percent of its portfolio.

The fact that Hungary has reached a difficult stage in enterprise privatization has important repercussions for the banking sector, because the political motivations that delay the privatization process (such as concern about unemployment, and unwillingness to sell strategic assets) also delay the restructuring of bank debt.

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[5] The primary source for data in this subsection is Istvan Racz, *Privatization in Hungary*, Budapest: Credit Suisse First Boston, April 10, 1993.

BANK REGULATION AND SUPERVISION

As in many countries, responsibilities for bank regulation and supervision in Hungary are spread among more than one entity. State Banking Supervision, which reports to the Ministry of Finance, and the Banking Department of the National Bank of Hungary (BD/NBH) currently divide the responsibilities for bank regulation and supervision; the creation of the Deposit Insurance Fund (scheduled to begin operation in summer 1993) suggests that there could soon be another participant in the process. Although having a multiplicity of regulatory agencies may be relatively costly and inefficient, an attitude of "Why should I bother when someone else is also responsible?" does not appear to be the main cause of lack of supervisory diligence in Hungary.[6] Rather, the main problems in Hungary appear to be of a different nature, although they do relate to some degree to the existence of more than one supervisory agency.

With the exception of some of the problems noted above, the banking, accounting, and bankruptcy laws appear to provide an adequate infrastructure for carrying out bank regulation and supervision. However, it is not clear that implementation is adequate, and there appear to be several reasons for this. The most obvious shortcoming is the inadequate number of professionals trained in bank examination and other aspects of supervision at SBS and BD/NBH if these agencies are expected to regulate all banks effectively. If the regulatory approach were to rely heavily on external audits of financial institutions to supply information to SBS and the BD/NBH — which one or both of these agencies would then analyze and thoroughly check from time to time for reliability — it might be possible to operate with relatively small staffs. However, while such an approach could be appropriate, it would rely on unproven external audit capabilities, the development of which would need to be carefully monitored, and it would also require SBS and BD/NBH to develop precise terms of reference for the external audits to insure that all the necessary information would be supplied to them. In any case, this approach does not appear to be what SBS and BD/NBH have in mind.

Before concluding that a major training program could solve most or all of the problems of bank regulation and supervision in Hungary, it is important to ask why the professional staffs of SBS and BD/NBH appear inadequate. State-owned banks with large portfolios of nonperforming loans currently dominate the Hungarian banking system. Other than pointing out the obvious — that many of these banks are insolvent — one must consider what SBS and BD/NBH could accomplish with these banks. Effective regulation of state-owned banks has everywhere proven extremely difficult, if not impossible, and, in the Hungarian case, the crucial task of dealing with the portfolios of nonperforming loans, and, ultimately, with the banks themselves (for example, in liquidation, rehabilitation, and privatization) has been assigned to other government agencies, such as SPA, SHC, and the Hungarian Corporation for Investment and Development (MBF Rt).[7] For SBS and BD/NBH to provide information indicating possible bank solvency problems without being able to deal with these problems could become almost an invitation to bank runs — so a broad interpretation of bank secrecy may be as convenient for these agencies as it is for the banks with problems.

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[6] There seems to be a fairly widespread view in Central and Eastern Europe that the U.S. savings and loan crisis provides two important lessons about how not to carry out bank supervision: (1) that it is bad to have a multiplicity of regulatory agencies; and (2) that the U.S. approach emphasizing on-site supervision is inferior to the European approach that is said to emphasize off-site supervision. On closer analysis of the U.S. experience, neither of these views can be supported.

[7] MBF Rt is responsible for managing the bad debt that the state-owned banks swapped with the government.

At present, SBS and BD/NBH have two major tasks with regard to the state-owned banks. One is to gear up for the day when these banks will either be largely privatized or cease to play a significant role in the Hungarian banking system. The urgency of gearing up should not be minimized, given the time needed to develop a well-trained staff of bank examiners and the most effective systems for bank supervision. The second task is to impose high standards of information collection, analysis, and reporting on these banks. This is an important role because there appear to be limited motivations for the banks themselves to undertake this process. Therefore, SBS and BD/NBH can play an important role by forcing this process, regardless of their ability to act on the basis of the information provided. Having this information will improve bank management capability and the ability of SBS and BD/NBH to monitor bank activity in this critical sector.

Most of the remaining banks in Hungary of any significance are foreign-owned or are joint ventures in which the foreign partners are clearly in control. Such arrangements should also potentially reduce the present work load of bank regulatory agencies in Hungary. So long as these foreign banks are audited by internationally recognized auditing firms according to international standards and are subject to supervision in their home countries according to international standards that require consolidation of all types of significant foreign interests, relatively little work remains to be done by Hungarian regulatory agencies. Moreover, to that extent that Hungarian banking supervision emphasizes full disclosure of information so that interested parties can make informed judgments, and to the extent that the foreign banks operating in Hungary have international reputations they want to protect (which should always be the case), the work load for Hungarian regulatory agencies with respect to these banks will be further reduced.

The banking sector that requires particularly active supervision is the purely domestic banks, and these are relatively small in size and not particularly numerous. In fact, these banks have been the source of most of the problems facing the Hungarian regulatory authorities. Three small banks were officially recognized as insolvent in 1992 (and several other small domestic banks are currently rumored to be in more or less similar circumstances), but SBS did not move aggressively to deal with these insolvencies (for example, to require the injection of additional capital or to move quickly to merger or liquidation). It is not clear whether this has been because of a lack of accurate and timely information about the status of these banks, a lack of professional staff with the technical expertise to liquidate these banks or to secure merger partners, a lack of funds to carry out such activities, or a lack of political support to act aggressively. In any case, it has fallen largely to BD/NBH to deal with these problem banks through its role as a lender of last resort and, ultimately, to confront their insolvency.

Initially, the international agencies dealing with the Hungarian financial sector had hoped to consolidate responsibility for bank regulation and supervision in SBS, but the morale and effectiveness of SBS appear to have been declining. In part, this may be because SBS reports to the Ministry of Finance, a relationship that can limit its autonomy. The size and tax treatment of loan loss provisions is an issue between regulatory and taxing authorities in every country, and especially so in Hungary, where nonperforming loans are substantial and profits taxes on banks are an important source of revenue. However, limits on the independence of SBS from political intrusions is seen by some to be a more pervasive issue in Hungary. Autonomy is a crucial element in the effectiveness of any regulatory body, especially in the economically and politically sensitive area of bank supervision, but experience in other countries around the world does not give any clear-cut recipe for where a bank supervision agency should best be located to ensure autonomy. Some argue for putting bank supervision in the central bank, others for creating a separate entity, and still others for combining supervision with deposit insurance, but it would appear that the best solution for Hungary or any other country will depend on the particular political and governmental structure of that country.

BD/NBH has been and is involved in bank supervision, as noted above. In fact, to the extent that a central bank fulfills the crucial central banking function of being a lender of last resort, it must at least have highly accurate and timely information to ascertain whether a bank asking for help is just illiquid or also insolvent. In addition, a central bank's responsibilities for monitoring reserve requirements and, more generally, for implementing monetary policy, similarly require accurate and timely information about the financial condition of banks. Thus, to fulfill its responsibilities, NBH, like central banks everywhere, must either carry out certain bank supervisory functions itself or be assured of highly accurate and timely information about the financial condition of banks. NBH cannot abandon its current supervisory activities until the controversy about the entity or combination of entities that should assume primary responsibility for bank regulation and supervision is resolved and the chosen system is adequately strengthened. In fact, it needs to strengthen these activities, so that training and technical assistance at this time for the BD/NBH would not be wasted, no matter how the bank supervision controversy is ultimately resolved in Hungary.

With the banking system largely state-owned in Hungary at present, there appears to be little reason to invest scarce resources immediately in the costly activities of prudential regulation and supervision — except that it takes considerable time to develop procedures and train personnel needed to supervise the largely private banking system planned for the future. In addition, the initiation of deposit insurance requires more rigorous supervision in the short run to avoid excessive risk taking by banks when depositors no longer have clear incentives to monitor bank solvency. There are also several specific issues that need to be dealt with, such as consolidated financial statements and adequate loan loss provisions in the face of tax consequences, as well as the always difficult problem of insider lending.

THE BANK PAYMENTS SYSTEM

Hungary is installing a modern computer system to handle payments within the banking system, to which all banks will have access and which most appear ready to join. Nonetheless, some doubts have been expressed about whether the system will be operational by the end of 1993, as planned, and whether the system will live up to its promises. In fact, some banks that plan to join the system stated that they were also installing parallel internal computer systems. Clearing among banks is reported to operate presently with a lag of about three days, which is not bad by current standards in Central and Eastern Europe. Rather, the main problems are said to be in making funds available to customers on a timely basis. Although these lags may be due in part to technical shortcomings in banking operations, they are more likely due to a lack of serious competition among banks for retail customers, together with the profits that can be earned from float in a high-interest rate environment.

SECTION THREE

THE DEVELOPMENT OF THE HUNGARIAN BANKING SYSTEM

THE RECENT EVOLUTION OF THE BANKING SYSTEM[8]

The Hungarian banking system began evolving toward its current configuration in 1987, when NBH's commercial banking operations were spun off into three large banks. This spin-off continues to have a major impact on today's banking system because of the portfolio of nonperforming loans to state-owned enterprises inherited by these banks and because these banks are so large that they dwarf most other banks in the system. These three banks are the Budapest Bank, the Hungarian Credit Bank, and the Commercial and Credit Bank. The other two large important state-owned banks are the Hungarian Foreign Trade Bank, which has always been state-owned but separate from NBH, and the Savings Bank (OTP). At year-end 1991, these banks accounted for approximately 73 percent of all bank assets.

According to the banking law, state ownership of these five banks (as well as three others) must be reduced to a maximum of 25 percent by 1997. One exception is the Savings Bank, where the ownership will be reduced to 50 percent. In the interim, state ownership of these banks is exercised by SHC. Privatization of the banks is coordinated by the Bank Privatization Working Group, whose members include the Ministry of Finance, NBH, SPA, SHC, SBS, and MBF Rt. Four of the five large banks, excluding OTP, are currently working with Western investment advisors who are assisting them in attracting foreign equity investors. These advisors were selected as part of an international tender process. The advisors will be paid largely on the basis of their success in completing bank sales. It is far from clear how successful this process will be, given the magnitude of the bad loan problem. However, it is widely rumored that the Hungarian Foreign Trade Bank, whose bad loan portfolio is limited because historically it focused on financing foreign trade instead of domestic lending, is in advanced negotiations with Bayerische Landesbank. The European Bank for Reconstruction and Development (EBRD) has also expressed interest in investing in the Hungarian Foreign Trade Bank.

There is a gap between the five large Hungarian state-owned banks and the other tier of Hungarian-owned financial institutions — the 14 smaller banks and SFIs. As of year-end 1991, this category accounted for approximately 9 percent of total banking system assets. Almost all of these banks and SFIs were founded by some combination of SOEs and state-owned banks. Some of these, such as the Ibusz Bank, were originally founded to provide banking services to their founders. Others were formed by state banks as special purpose banks for leasing, for example, or, in the case of the Quantum Bank, as a loan work-out bank. Although there has been some movement within this category, the total number of banks and SFIs has changed only from thirteen in 1987 to fourteen in 1993. As a group, these financial institutions are considered vulnerable to failure for several reasons, including lack of portfolio and geographic diversification, inability to compete with larger banks in services and branch networks, and comparatively low capital. In 1992, three banks in this category became insolvent; one is now in the process of liquidation. (Depositors in the liquidated bank are to be reimbursed by the government.)

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[8] The primary source for data in this subsection is Matthew Czepliewicz and Istvan Racz, *Hungarian Banks*, CSFB Equity Research, n.d.

It is further rumored that several other banks in this category have had problems in 1993 and have received emergency funding from NBH.

The third group of banks is those with foreign ownership. As of year-end 1991, banks with full or partial foreign ownership accounted for approximately 18 percent of total bank assets. Hungary has a long tradition of allowing joint venture banks to operate in the country, although foreign branches are not allowed and foreign-owned banks are incorporated locally as subsidiaries, in an effort to increase local control over these entities. The first established — and still the largest of these banks — is the Central European International Bank (CEIB), founded in 1979 with 34 percent ownership by NBH. Its other owners, which own 13.2 percent each, are Banca Commerciale Italiana, Vereinsbank, the Long-Term Credit Bank of Japan, Sakura Bank, and Société Générale. Other large joint venture banks in terms of registered capital are Inter-Europe Bank (Instituto Bancario San Paolo Di Torino owns 22 percent), Posta Bank (Postsparkasse of Austria owns 11 percent), and Creditanstalt Budapest (Creditanstalt owns 100 percent). As will be discussed later in this review, Posta Bank is the main competitor to OTP for retail business. Citibank Budapest was established as an 80-percent-owned subsidiary in the mid-1980s, and Citibank recently announced its intention to increase its holding to 100 percent. The number of banks and SFIs with foreign participation has increased from four in 1987 to eighteen in 1993.

Hungary also has several investment banking operations, such as Bankers Trust's office, which operates under corporate law and not under the banking law. Tables 9 and 10 show the ownership structure of the Hungarian banks and the size of the banks based on total assets.

THE NONPERFORMING LOAN PROBLEM AND THE LOAN CONSOLIDATION FUND

The nonperforming loan (NPL) portfolios of the state-owned banks are of such magnitude that the banks cannot be privatized until this problem is resolved. In addition to the burden of the bad debts, the repercussions of unsuccessful government-sponsored attempts to deal with them have distorted the incentives of bank management. Therefore, banks with particularly large bad loan portfolios, which include the three spun-off banks, will not be effective participants in the economic transformation process in Hungary until this issue is resolved. This subsection will discuss the background of this problem, current attempts to deal with it, and the practical and theoretical shortcomings of these attempts.

The NPL problem in Hungary stems from three sources. The first is the bad loan portfolio inherited by the three banks that were spun off from NBH in 1987. The second and related source is the subsequent efforts to keep these borrowers and other inherited weak borrowers afloat through loan rollovers, fresh credit, and interest capitalization. It has been suggested that some of the efforts to sustain these borrowers were encouraged by the government, which in many cases is the major shareholder of both the banks and their clients. The third source of the problem applies to the other Hungarian banks as well as to the spun-off banks, whose loan portfolios have deteriorated for a combination of reasons including the recession in Hungary, the loss of the COMECON export market, and lack of experience by the banks in credit analysis and management.

With regard to the original loan portfolios, the government of Hungary initially argued that the bad loan inheritance was the responsibility of the banks. As it became clear that these loans were a problem that would not go away, the government instituted a program in 1991 to guarantee 50 percent of the 20 billion forint in nonperforming loans that these banks had inherited. However, this addressed only half of the historical loan problem and, in the meantime, other bad loans continued to accumulate.

TABLE 9

TOTAL ASSETS OF BANKS IN HUNGARY
(end-of-year data)

		1990 (HUF bn)	1991 (HUF bn)	1990 (% share)	1991 (% share)	91/90 (HUF;%)	91/90 (US$;%)
1.	Orszagos Takarekpenztar /1	515.334	699.559	31.9	31.8	35.7	10.3
2.	Magyar Hitelbank /1	256.342	312.823	15.9	14.2	22	-0.8
3.	Magyar Kulkereskedelmi Bank /1	229.987	234.939	14.2	10.7	2.2	-17
4.	Kereskedelmi Bank /1	191.6	214.234	11.9	9.7	11.8	-9.1
5.	Budapest Bank /1	103.36	135.584	6.4	6.2	31.2	6.6
6.	Postabank es Takarekpenztar /2	41.079	89.863	2.5	4.1	118.8	77.8
7.	Kozep-Europai Nemzetkozi Bank /2	42.306	80.85	2.6	3.7	91.1	55.3
8.	Takarekbank	24.937	36.76	1.5	1.7	47.4	19.8
9.	Inter-Europa Bank /2	25.173	35.38	1.6	1.6	40.5	14.2
10.	Citibank Budapest /2	13.687	35.248	0.8	1.6	157.5	109.3
11.	IBUSZ Bank	-	32.02	-	1.5	-	-
12.	Unicbank /2	17.044	28.759	1.1	1.3	68.7	37.1
13.	Creditanstalt /2	15.267	28.4	0.9	1.3	86	51.2
14.	Mezobank	14.351	27.618	0.9	1.3	92.4	56.4
15.	Kozep-Europai Hitelbank /2	16.738	26.264	1	1.2	56.9	27.5
16.	Agrobank	16.057	24.853	1	1.1	54.8	25.8
17.	Altalanos Ertekforgalmi Bank /2	14.4	19.241	0.9	0.9	33.6	8.6
18.	Konzumbank	8.68	16.962	0.5	0.8	95.4	58.8
19.	Leumi Hitelbank /2	2.517	12.472	0.2	0.6	395.5	302.7
20.	Altalanos Vallalkozasi Bank /2	11.05	12.471	0.7	0.6	12.9	-8.3
21.	MHB-Daewoo Bank /2	9.227	11.291	0.6	0.5	22.4	-0.6
22.	Realbank	4.767	10.2	0.3	0.5	114	73.9
23.	Corvinbank /3	7.613	10.11	0.5	0.5	32.8	7.9
24.	BKD-Bank /2	-	9.743	-	0.4	-	-
25.	Iparbankhaz	4.172	9.31	0.3	0.4	123.2	81.3
26.	Dunabank	6.675	7.356	0.4	0.3	10.2	-10.4
27.	Europai Kereskedelmi Bank /2	-	6.612	-	0.3	-	-
28.	Ybl Bank /4	3.371	6.315	0.2	0.3	87.3	52.2
29.	Ingatlanbank /3/5	6.861	6.294	0.4	0.3	-8.3	-25.5
30.	Merkantil Bank /3	5.209	4.442	0.3	0.2	-14.7	-30.7
31.	Kulturbank /2	3.027	4.206	0.2	0.2	38.9	12.9
32.	Innofinance Merchant Bank /3	2.107	2.997	0.1	0.1	42.2	15.6
33.	Investbank /3	2.637	2.862	0.2	0.1	8.5	-11.8
34.	INB Bank /2	-	2.558	-	0.1	-	-
35.	Portfolio Bank /3	0.986	1.409	0.1	0.1	42.9	16.1
36.	Kvantum Bank /3	-	1.036	-	0	-	-
37.	Nomura Magyar Befektetesi Bank /2	-	1.029	-	0	-	-
	Five large banks	1296.623	1597.139	80.2	72.5	23.2	0.1
	International banks	211.515	404.387	-13.1	18.4	91.2	55.4
	Small domestic banks /6	108.423	200.544	6.7	9.1	85	50.3
	All domestic banks /6	1616.561	2202.07	100	100	36.2	10.7

Notes
1/ "Large" banks; 2/ Internationally-owned banks; 3/ Specialised institutions; 4/ Under liquidation;
5/ Bank activities are terminated in 1992; 6/ Excluding savings cooperatives

Source: Credit Suisse First Boston

TABLE 10

STRUCTURE OF BANK OWNERSHIP IN HUNGARY
(data at end of 1991, in percentages)

		Direct state ownership (SPA)	Social security, budgetary institutions	State-owned companies	State-ownership, total	Domestic private ownership	Foreign private ownership
1.	Orszagos Takarekpenztar /1	100	0	0	100	0	0
2.	Magyar Hitelbank /1	49.3	0	50.6	99.9	0.1	0
3.	Magyar Kulkereskedelmi Bank /1	44.6	0	42.9	87.5	12.4	0.1
4.	Kereskedelmi Bank /1	34.1	10.1	0	44.2	55.8	0
5.	Budapest Bank /1	52	10	26	88	12	0
6.	Postabank es Takarekpenztar /2	25.1	0	33.9	59	24.1	16.9
7.	Kozep-Europai Nemzetkozi Bank /2	0	34	0	34	0	66
8.	Takarekbank	0	0	0	0	100	0
9.	Inter-Europa Bank /2	6.6	1	51.8	59.4	18.1	22.5
10.	Citibank Budapest /2	0	0	20	20	0	80
11.	IBUSZ Bank	0	0	100	100	0	0
12.	Unicbank /2	0	0	22	22	6	72
13.	Creditanstalt /2	0	0	0	0	0	100
14.	Mezobank	0	0	0	0	100	0
15.	Kozep-Europai Hitelbank /2	0	34	0	34	0	66
16.	Agrobank	0	1	11	12	79	9
17.	Altalanos Ertekforgalmi Bank /2	50	0	0	50	0	50
18.	Konzumbank	0	0	6.5	6.5	93.5	0
19.	Leumi Hitelbank /2	0	0	50	50	0	50
20.	Altalanos Vallalkozasi Bank /2	23.6	7.1	8.1	38.8	26.6	34.6
21.	MHB-Daewoo Bank /2	0	0	50	50	0	50
22.	Realbank	0	0	51	51	49	0
23.	Corvinbank /3	4.8	62.3	0	67.1	32.9	0
24.	BKD-Bank /2	0	0	25	26	0	74
25.	Iparbankhaz	0	0	0	0	100	0
26.	Dunabank	5	0	25	30	70	0
27.	Europai Kereskedelmi Bank /2	0	0	33.4	33.4	0	66.6
28.	Ybl Bank /4	0	1.6	17.9	19.5	80.5	0
29.	Ingatlanbank /3/5	6	0	71.4	77.4	22.6	0
30.	Merkantil Bank /3	0	0	100	100	0	0
31.	Kulturbank /2	0	0	0	0	0	100
32.	Innofinance Merchant Bank /3	0	15	0	15	60	25
33.	Investbank /3	0	53	41.4	94.4	5.6	0
34.	ING Bank /2	0	0	0	0	0	100
35.	Portfolio Bank /3	25.1	0	33.9	59	24.1	16.9
36.	Kvantum Bank /3	0	0	100	100	0	0
37.	Nomura Magyar Befektetesi Bank /2	0	5	34	39	0	61
	Five large banks /7	69	2.2	18.4	89.6	10.3	0
	International banks /7	9.3	9.3	19.8	38.4	8.2	53.4
	Small domestic banks /6/7	0.8	4.2	27.8	32.8	65.6	1.
	All domestic banks /6/7	51.8	3.7	19.5	75.1	15	10
	All domestic banks /6/8	38.1	5.7	24	67.8	16.6	15.6

Notes
1/ "Large" banks; 2/ Internationally-owned banks; 3/ Specialised institutions; 4/ Under liquidation; 5/ Bank activities are terminated in 1992; 6/ Excluding savings cooperatives 7/ Weighted by total assets; 8/ Weighted by total equity

Source: Credit Suisse First Boston

By 1992, the bad loan problem had reached serious proportions; it is estimated that 26 percent of all loans in the banking sector (305.8 billion HUF) were nonperforming at year-end 1992. (It should be noted that there are several different estimates concerning the total proportion of NPLs, which reflects the lack of available hard data. However, because banks have not been effectively prevented from rolling over past-due loans, it can be assumed that the number of actual NPLs is higher than the estimates.)

At the end of 1992, there were two major motivations for dealing with the bad loans on a programmatic basis. One was that the banks could not be privatized without an improvement in their loan portfolios and, as their NPL portfolios continued to grow, they were becoming less attractive candidates for privatization. The other motivation was the perceived need to deal with the problem before the year's end. This was because the combined impact on the banks' balance sheets of the new accounting law, the new bankruptcy law, and the new banking law would show that several of them had negative capital, according to their 1992 financial statements. It was considered necessary to avoid this outcome because of the negative impact on confidence in the banking system, both domestically and internationally. This concern was heightened because the problems of the three small banks earlier in 1992 had generated adverse publicity.

The product of these concerns was the Loan Consolidation Fund (LCF), a program in which banks that were majority-owned by the state and had a capital adequacy ratio of under 7.25 percent were eligible to participate. Loans that were classified as loss at year-end 1991 could be swapped for 50 percent of face value, and loans classified as loss at year-end 1992 could be swapped for 80 percent of face value. In cases where the borrower was considered by SHC and SPA to be strategically important, the loans could be swapped for 100 percent of face value. Past-due interest on these loans could also be swapped for the same proportion of face value as the underlying loans. In return for the swapped assets, the banks received 20-year government bonds. The bonds pay a market rate on the loan principal that was swapped and no more than 50 percent of the market rate on the accrued interest amount that was swapped. (The rate is determined annually.) The banks in turn must pay a tax on this interest income that can have a rate as high as 50 percent.

The LCF program has several practical shortcomings, of which the three most fundamental will be discussed, followed by a discussion of the apparent failure of the program to change the incentives that contributed to the build-up of NPLs. The purpose of this discussion is to outline the nature of the LCF program and to highlight issues that should be considered in any future bad loan programs. The three major practical shortcomings were as follows:

- The banks were able to use this program to clean up their balance sheets only partially. For example, only 102 billion HUF of the 153 billion HUF in loans that were proposed to the LCF program were actually accepted. Also, as has been noted, the program did not include problem loans that had not been classified as loss; therefore, the banks retained their substandard-loan and doubtful-loan portfolios. In addition, the banks evaluated their participation in the program based at least as much on how it would reduce their tax burden as on how it would strengthen their balance sheets. Therefore, they did not transfer bad loans if the net effect would be to increase their tax burden. Furthermore, banks are not prevented from continuing to roll over nonperforming loans; therefore, they can continue to keep NPLs in their portfolio at their discretion. The program also does not cover off-balance-sheet exposure, including the Hungarian practice of swapping nonperforming debt for equity and holding the equity in an unconsolidated subsidiary. Finally, the Hungarian government has designated 13 large enterprises as being so important for Hungary's economy that they will not be privatized and will continue in operation. These enterprises are known as the Dirty Thirteen, and their debt, which has been rolled over, was not swapped into the LCF program. (It is not known what proportion of their total debt is, in effect, nonperforming.)

- A second problem with the program concerns how the loans in the LCF program will be managed in the future. The LCF program itself is managed by MBF Rt, an organization owned by the State Holding Company. MBF Rt was established with the purpose of becoming a development bank, and it is in the process of applying for a banking license. MBF Rt, with a staff of approximately 80, does not have the personnel (in number or experience) to manage the 30,000 loans from 1,885 different borrowers that have been transferred, either on a day-to-day account management basis or on a long-term loan work-out basis. As a result, the LCF program requires that the banks themselves continue until the end of June 1993 to manage the loans being transferred. It is possible that this date will be extended. One important issue that still has not been resolved is how borrowers whose debt is completely transferred to MBF Rt will obtain minimum banking services, including enough working capital to sustain them until MBF Rt has a plan of action.

  MBF Rt plans to divide the LCF portfolio into three categories, of which the most significant will be those loans that have the potential of being worked out with the enterprises restored to financial health. In particular, MBF Rt will focus on the 105 debtors whose loans make up approximately 75 percent of all loans transferred. However, there are several reasons it is not clear that MBF Rt will be able to accomplish this objective. First, the loans swapped to the LCF program are those that the banks rated "loss." Therefore, the proportion of borrowers in this category that can be restored is undoubtedly low. It has been reported that of the 1,885 borrowers that have been transferred, 665 have declared bankruptcy — and 549 of those are in liquidation.

  Second, the banks were not required to swap all of the debt of an individual obligor; the banks could hold on to loans that they deemed stronger and swap the weaker ones. As a result, it remains to be seen whether MBF Rt is the majority creditor to enough enterprises to carry out a successful work-out function.

  Third, it also remains to be seen whether MBF Rt has the political mandate to carry out an effective loan work-out program that will require liquidations, wage cuts, and increased layoffs in many enterprises that could not otherwise survive. As has been discussed, the Government of Hungary has historically avoided some of the most difficult decisions related to privatization, at least in part because of fears about such painful repercussions. It is not clear that MBF Rt, operating under the control of SHC, will be any more successful in pushing through any necessary enterprise restructurings in relation to managing its own loan portfolio.

- The third major shortcoming of the LCF program is its unexpected impact on government budget revenue. Whereas the government anticipated that this program would increase bank taxes, it has reduced the 1993 taxes to essentially zero because the banks participated in the program in ways that would minimize their tax burdens. For example, banks did not swap loans that would require them to write back into their profit-and-loss statements loan provisions that they had previously taken, because these write-backs would be taxable. This has been an unpleasant surprise for a government that is constantly struggling to manage its fiscal deficit.

Even more important than the practical problems with the LCF program is its negative impact on the incentives of the participants in the program. The most important aspect of any bad loan work-out program is its impact on incentives. What will be the current and future behavior of participants in the program? If the incentive structure does not change, then cleaning up old bad loans will only make it easier for banks to continue to make more such loans in the future. Beginning with the incentives of bank management, there is nothing in the program to change their behavior in the future — they made bad loans, they sold the loans to the government, and there will be another loan bail-out program in 1993. Why would a bank manager think that there would not always be loan bail-out programs for troubled banks? Not only will the incentives of bank management not change, but the LCF program has provided management with new funding, in the form of the bonds received for swapping the bad loans, to continue their former behavior.

Implicit in this discussion of incentives for bank management is the lack of effective bank governance. Most notably, there do not appear to be legal means to force board members who represent a specific organization (such as SHC) to follow any instructions established by that organization. In addition, it seems doubtful that the SOEs that are now owned by SPA or SHC exercise any significant leverage over the banks in which they own shares.

The LCF program also does not change the incentives of borrowers. Weak borrowers seem to gain from this process in the short term; the banks that are managing the loans to be transferred no longer have any interest in pursuing repayment, and the time required for MBF Rt to get up to speed after the transfer should give these borrowers further breathing room. Furthermore, in cases where only part of a borrower's debt was transferred, the bank will have an interest in keeping the retained debt performing. Therefore, some borrowers may receive fresh credit from the banks and allow their transferred debts to languish at MBF Rt.

Finally, MBF Rt does not have enough of a track record to determine whether it has the incentives to pursue loan work-outs and enterprise restructurings aggressively. MBF Rt clearly does not think of itself as cast in the type of Treuhandanstalt (the German privatization organization), which was formed for a specific purpose and is expected to put itself out of business when that purpose is accomplished. Instead, MBF Rt plans to become a development bank with an indefinitely long life, where its functions potentially will include providing subsidized interest rate loans. Therefore, there will be incentives at MBF Rt, as is common to most bureaucracies, to survive long after the bad loan problem could have been resolved. This creates a bias toward growing rather than shrinking and does not encourage asset shrinkage that a rational enterprise restructuring process would imply.

Why was the LCF program unable to fulfill its objective of resolving the bad loan problem and restoring financial health to the Hungarian banks? There are several possibilities, including the complexity of the problem, a short timetable that precluded careful analysis of the interaction of the many steps involved, the desire to minimize budget outlays, the need for compromise, and the participation of players in the negotiating process who did not understand how banks operate. Nevertheless, at least one other Eastern European country — Poland — grappled with similar issues and appears to have reached a better resolution.

Another interpretation is that design of this program reflected a lack of political will to acknowledge the magnitude of the problem and deal with it transparently. This lack of political will is due to several factors, of which two stand out. One is that addressing the bad loan problem is the other side of enterprise restructuring. This is a thorny issue that the government has hesitated to face full on. The other is that bad loans made by state-owned banks to state-owned enterprises are unavoidably a fiscal expense. The government's unwillingness to acknowledge this expense, as with the U.S. Government's handling of the savings and loan crisis of the 1980s, results for Hungary in convoluted (and potentially underfunded) programs for dealing with the problem, perhaps with the hope that the problem will diminish over time or become the responsibility of some other organization that might even be able to resolve it. These two factors are exacerbated by the 1994 elections and the desire to maintain Hungary's reputation as one of the best investment markets in Eastern Europe.

The failure of the 1992 LCF program to resolve the NPL problem has led to the need for a 1993 program. At this point, one possibility is for bank recapitalization based at least partly on World Bank funding. Given the many problems with the 1992 program, including the overburdening of MBF Rt, some consideration is being given to keeping the 1993 loan program within the banks and establishing work-out units there. Without evaluating any programs specifically, because they are still in the developmental phase, it can be said in very general terms that there is merit to an in-bank work-out approach. This gives the banks valuable experience and can, as the design of the Polish program demonstrates, contain appropriate incentives.

BANK INVOLVEMENT WITH STATE-OWNED ENTERPRISES

The Hungarian banks are heavily involved with state-owned enterprises in three ways: several of the banks were founded by SOEs, they have significant lending relationships with SOEs, and they can potentially be shareholders of SOEs.

As of year-end 199[illegible], SOE ownership of all Hungarian banks, weighted by total assets, was 19.5 percent. SOE ownership weighted by total equity was 24 percent. These figures are important as an indication of the influence of the SOEs in founding several banks as well as in influencing their lending policies. (According to the banking law of 1991, such influence is limited because maximum bank ownership by one party is 25 percent, and the maximum that a bank can lend to one borrower is 25 percent of the bank's share capital. However, it appears that in the case of at least one of the three banks that became insolvent in 1992, cross-shareholdings among the bank's shareholders may have resulted in higher loan concentrations. Furthermore, a bank with four shareholders could readily lend all of its capital to those shareholders and stay within the limits.)

There are not any breakdowns of bank loan portfolios according to what proportions of loans are to SOEs and what proportions are to private enterprises. The fact that data are not collected in this way — by NBH, SBS, or the banks -- is revealing, because it implies that this important aspect of risk differentiation has not yet been identified as significant. NBH and some of the banks break out data related to small entrepreneurs, but this category captures only part of the private corporate sector. (As has been noted, as of year-end 1992, total credit extended to small entrepreneurs was 2.7 percent of the total credit outstanding.) However, given that the new private sector is considered to have high credit risk, that a considerable portion of the state-owned banks' resources appears to have been allocated to keeping their existing SOE borrowers afloat, and that the joint venture banks are focusing their lending on attractive foreign joint ventures, one can conclude that SOEs command the lion's share of bank lending.

Another lack in information concerns bank equity investments in SOEs. Currently, there is an incentive for banks to swap nonperforming debt for equity, because no provisions are required on equity and because banks do not have to publish consolidated financial statements. Presumably, banks could take shares in SOEs that have been transferred to SHC or SPA and that, as part of that process, have been converted into joint stock companies. Data about equity investments are provided to SBS, but this is treated confidentially.

In conclusion, although there is good reason to assume that bank exposure to SOEs is relatively high, the exposure is not quantifiable. Consequently, it is also not possible to determine the level of bank lending to private companies and to begin to evaluate the frequent claim that they are deprived of credit. Going forward, it will be important to develop information about bank loan portfolio breakdowns between SOEs and private borrowers, both as an element of risk assessment and to evaluate the need for improved private sector access to credit.

BANK SERVICES AND THE DEVELOPMENT OF COMPETITION

Banks in Hungary provide a wide range of banking products and appear to compete with each other more on the basis of service quality than on price. There are several current account and deposit products for individuals and enterprises, including foreign currency accounts and overnight sweep accounts.

Payment services provided by the banks have been a problem historically because of payment delays. It is hoped that this will be resolved by the year's end with the introduction of a giro system (a type of payment system) supported by the World Bank, but, as has been discussed, there are some doubts that this system will be successful. Checks are not commonly used, and non-cash payments through the banking system are made by payment orders.

Approximately 60 percent of the Hungarian banks have foreign currency licenses. Banks prominent in foreign trade finance are the Hungarian Foreign Trade Bank, CEIB, and Citibank. With regard to foreign exchange transactions, the four large Hungarian banks (excluding OTP) had a 73 percent market share as of 1992.

At the end of 1991, the large commercial banks and the retail banks each accounted for approximately 39 percent of all the deposits in the system. (The other banks and the savings cooperatives accounted for the remaining deposits.) This proportion has been relatively constant since 1987. Deposits are largely short-term; only 4 percent of deposits placed in December 1992 were for more than one year, and 31 percent were for one month or less.

Loans are made in local and foreign currency and are granted on the basis of cash flow and collateralized lending rationales. Most bank lending is short-term; for example, 82 percent of all credits extended in December 1992 were for less than one year. Longer term project finance and more complex privatization-related finance is structured by the foreign and joint venture banks, which bring in the Hungarian banks if there is a significant forint lending component to the transaction.

There is no breakdown available on the sources of bank income. However, it can be assumed, as was stated by the head of NBH's Banking Department, that it is mainly in funding spreads. In 1992, the funding spread for short-term lending increased from 6.6 percent at the beginning of the year to 12.7 percent at the year's end. This increase was due largely to the increase in the perceived risk of lending, as well as the need to finance bad debt provisions required by the banking law. Over time, competition for deposits and attractive lending opportunities will erode this spread. Therefore, the heavy reliance on this source of income represents a future vulnerability in the banking system.

One of the most noteworthy characteristics of the Hungarian banking system is its tiering into three groups: state-owned banks, banks with foreign participation, and small domestic banks. Until very recently, these banks operated in separate market sectors. The state-owned banks focused on the SOEs, the joint venture and foreign banks operated in niche businesses such as trade finance and investment banking, and the small banks served the needs of their founders and the local market. This has gradually begun to change, but the main direction of the change is that the state-owned banks and the foreign banks have both turned their attention to the blue-chip corporate market.

Several factors contributed to this change, of which two stand out. One is the impressive increase in the number of banks with foreign participation — from four in 1987 to eighteen in 1993. As the niches have been filled, these banks have sought to play a more broadly based banking role with their clients. The second factor is a gradual recognition on the part of the state-owned banks that they will need to develop a new client base to survive the process of debt restructuring and enterprise privatization.

The positive aspect of this increase in competition is that it is forcing the state-owned banks to respond to the market. However, the fact that all banks have turned to the same market, while not uncharacteristic of bank behavior worldwide, does demonstrate a lack of strategic thinking on the part of the banks. It seems fair to say that the blue-chip Hungarian corporate sector is overbanked, particularly because several of these companies also have access to foreign debt markets; $500 million in non-sovereign debt was raised in 1992. One can conclude that banks that hope to survive will have to develop more diverse strategies.

The other intriguing aspect of the Hungarian banking sector is the small banks. So much attention has been focused on the large banks that little attention is left for the small bank market. This sector is generally assumed to have many problems and to be at risk of collapsing, although specifics are difficult to obtain. A useful project could be to study this sector to determine whether technical assistance would be beneficial.

The question of why Hungary, in contrast to Estonia, has not been able to develop a relatively competitive indigenous private banking sector is an important one to consider. Part of the answer may lie in the early presence of foreign banks in Hungary; they were able to fill the demand for high service quality that some of the Estonian banks successfully pursued in order to win business away from the state-owned banks. Another factor could be the overwhelming presence of the Hungarian state-owned banks, which, on the basis of their branch networks alone, can provide more services than the new private banks. The state-owned banks in Estonia, which were branches of the Soviet banks, did not have as extensive a branch network. (The exception was the Savings Bank.) One factor that has been important in Estonia is that the central bank has made it clear by its actions that the banks must stand on their own and cannot expect government bail-outs. In Hungary, by contrast, NBH appears to be helping several of the smaller banks with liquidity loans. Together with the government bail-outs of the state-owned banks, this does not increase the incentives of the small Hungarian banks to operate in a market-driven manner.

In summary, there are two somewhat conflicting trends in the banking sector. One is the gradual increase in competition, brought on mainly by the growing number of banks with foreign ownership and their consequent efforts to expand beyond niches to relationship-oriented banking business, which in turn threatens the business base of the larger Hungarian banks. This competition encourages the banks to develop more market-oriented behavior. (One way to enhance the effect of such competition is to provide technical assistance in strategic planning.) The opposing trend is reliance on government assistance, which has been forthcoming in recent support for smaller troubled banks and in the LCF program. This is a potentially dangerous combination — as long as bank managers believe they will be supported by the government if they have difficulties, there is an incentive to take large risks in an attempt to beat the competition.

RETAIL BANKING, THE SAVINGS BANK, AND THE POSTAL BANK

Given the emphasis on corporate and investment banking in Hungary, retail banking — especially the provision of credit and deposit services to individuals and small-scale businesses — has been neglected. For the Hungarian banking system in the aggregate, the amount of credit to households (mostly housing loans) is less than one-third the amount of credit to larger-scale enterprises, and the amount of credit to small-scale entrepreneurs is in turn about one-third of the amount of credit to households. Interest rates on deposits, especially on short-term deposits that would tend to be relatively attractive to small-scale enterprises and households in need of frequent access to liquidity, have been almost continuously negative in real terms during the 1990s. Moreover, while the payments system seems able to handle transfers among banks quite rapidly, long delays are reported as typical before individuals can have access to funds that they have deposited.

The general neglect of retail banking notwithstanding, there are supposed to be two banks in the Hungarian system that are primarily devoted to providing retail banking services — OTP and the Postal Bank. The remainder of this section of the report analyzes briefly, but with some detail, the activities of these banks, and makes some observations about certain recommendations that have been made with respect to the future of these two banks, especially OTP.

OTP was founded in the late 1940s, initially as a division of the Ministry of Finance, and has been devoted from its inception to taking deposits and providing housing finance. In 1989, OTP acquired a full commercial banking license, and it currently accounts for about one-third of the deposits of the total Hungarian banking system. It is also a large bank by other measures, with more than 400 branches and more than 10,000 employees. In addition to its continuing major roles in deposit taking and housing finance, OTP also is the main provider of financial services to municipalities — an activity it has found to be highly profitable.

The most recent income statements for OTP reveal a small loss in 1992 as compared with a very small profit in 1991. The reasons for this adverse change can be found mainly in three accounts: net interest income declined because, according to bankers throughout the system, banks were not quick enough in reducing interest rates on deposits in the face of excess liquidity; fee and commission income declined; and other operating income and expenses that had been a source of profits in 1991 became a source of losses in 1992. While the reason for the shift in net other operating income could not be ascertained precisely, the notes to OTP's financial statements suggest that this change is related primarily to the Government of Hungary's loan consolidation program. With respect to profitability, most other Hungarian commercial banks appear to have had similar experiences in 1992.[9]

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[9] In addition, for OTP there is continuing uncertainty about the losses incurred on long-term fixed-interest housing loans that had been granted before the arrival of significant inflation in Hungary. It appeared at one point that the Government of Hungary would assume most or all of these losses, but in 1991 the government decided to return to OTP the housing loans that had earlier been exchanged for government bonds, and during 1992 the portion of the losses that would be borne by the government and the portion borne by OTP continued to be unclear.

OTP's small loss in 1992 notwithstanding, its deposit base increased significantly in real terms in 1992, after falling in real terms in 1991. More than three-quarters of these deposits are from individuals, including small-scale entrepreneurs, and the rest are divided about equally between commercial enterprises and municipalities. OTP's market share for individual deposits is similarly high (about three-quarters), while it accounts for only a little more than 10 percent of enterprise deposits.

The focus of OTP on lending is less clear. First, a substantial proportion of its assets are tied up in old housing loans or government bonds issued to replace these loans. Second, although loans to individuals continue to predominate, OTP has tried to expand its lending to commercial enterprises with mixed success — the volume has increased, but among these are a relatively high proportion of nonperforming loans, according to OTP management. Third, to this point the municipalities have been more a source of deposits than an outlet for loans, apparently due to municipal government surpluses (which may or may not continue in the future). Finally, OTP has not yet become an aggressive supplier of funds to the interbank market and has only recently begun to accumulate significant quantities of investment securities, mainly government bonds.

There are two quite different views of OTP held by international agencies (and possibly also by Government of Hungary officials, although these were less outspoken). A majority of international agencies appear to see OTP as a monopolist, providing poor service to its retail banking clients, with its monopoly position maintained in part by its infrastructure of a widespread branch office network but mainly by the Government of Hungary's guarantee of its deposits. The problem with this view is that other large state-owned banks also have the guarantee of the Government of Hungary, implicitly if not explicitly, and also have reasonably large networks of branch offices. Moreover, it need not be insurmountably costly to develop an effective branch network for retail banking if a bank sees that to be a strategically important and profitable activity. The failure of other banks to enter the retail banking market aggressively, with serious programs of deposit mobilization in particular, appears to have far more to do with their current strategic focus on corporate and investment banking. In any case, there is no empirical support for the view that deposit insurance is a crucial factor in deposit mobilization in Hungary because no relevant studies could be found. Serious studies of depositor behavior and depositor preferences are clearly quite important from the perspectives of both government policy makers and bank marketing strategists.

The most widely heard recommendation of those holding the view that OTP is an inefficient monopolist is that OTP should be dismembered and sold off piece by piece to other commercial banks. The problem with this recommendation, as suggested above, is that other banks are not in fact interested in retail banking in general or in retail deposit mobilization in particular. Nonetheless, these other banks might be quite interested in buying the branches of OTP to obtain the deposits that would come with these branches, especially if liquidity became tighter in Hungary, even though these other banks might have no intention of providing any service to depositors.

The other view, with its corresponding recommendation, is that OTP should be strengthened through training and technical assistance and especially through increased competition that would force it to provide better retail banking services. Although some of the training and technical assistance might focus on improved service for depositors, the main focus would likely be on improved lending and investment of surplus funds in the interbank market and elsewhere. OTP has already experienced significant difficulties with lending to larger-scale enterprises. A preferable strategy is likely to be for OTP to continue to focus on the markets it knows best — individuals, municipalities, and small-scale enterprises. In these markets, it has the special advantage of key information about potential borrowers that is provided by their past histories as depositors. Moreover, instead of selling the branches of OTP to other banks, an innovative approach to privatization could be pursued for OTP by offering depositors the opportunity to convert their deposits at OTP to shares in OTP, thereby creating more widespread ownership than for any other bank. In this respect, the Government of Hungary's current plan to privatize OTP only after the other state-owned banks have been privatized and to privatize only 50 percent of OTP has not been given any convincing rationale.

In the short run, the main potential competitor of OTP is the Postal Bank. Although the Postal Bank was founded only recently -- in 1988 -- it now has more than 1,300 employees and 19 branches outside Budapest, in addition to the deposit services offered at more than 3,000 post office branches. In terms of deposits, the Postal Bank is currently less than one-quarter the size of OTP, but, like OTP, it mainly has individual retail deposits. In addition to being well positioned in the foregoing aspects to compete effectively with OTP, the Postal Bank has a significant advantage in that its ownership is not entirely governmental but also includes various private domestic and foreign owners and, most important, the Austrian Postal Bank. The Austrian bank not only has a significant equity position in its Hungarian counterpart but also has taken a substantial role in the management of the Hungarian Postal Bank. Although dynamic foreign ownership should lessen the need for additional external training and technical assistance, such support might nonetheless be offered if it is felt necessary to encourage the Postal Bank to move more quickly to compete aggressively with OTP for deposits and to avoid lending problems of the type OTP has encountered.

A final component of the retail banking market in Hungary is the savings cooperatives. Until recently, these formed part of the banking network of OTP, but the savings cooperatives are now independent and are developing in a manner somewhat parallel to credit unions in the United States. In fact, they have received some technical assistance from the U.S.-based World Council of Credit Unions (WOCCU), and WOCCU appears quite interested in expanding on its initial activities. In Hungary, the savings cooperatives appear to be generally viewed as small and weak, but in fact there are 257 savings cooperatives, with about 1,800 branches and about 2 million members (but, of course, not all of these may be active). Although the vast majority of savings cooperatives may indeed be small and weak, they nonetheless may have considerable potential outreach in small towns and rural areas, where most of them are located and where there are few other providers of financial services. U.S. Government training and technical assistance activities in Hungary could advantageously be expanded to include the savings cooperatives, as well as OTP and the Postal Bank, but some detailed analytical work by experts outside WOCCU would be advisable to assess the current situation and potential of the savings cooperatives and to decide whether the traditional credit union model is the most appropriate approach for Hungary.

SECTOR-SPECIFIC BANKS AND LINES OF CREDIT

Hungary's sector-specific banks are limited. Agrobank, which was the 16th largest bank by assets at year-end 1991, was founded to lend to the agricultural sector. MBF Rt, as has been mentioned, has applied for a banking license and would be considered a development bank. Most of the specialized lines of credit in Hungary are focused on privatization finance, small business development, and agriculture. The perceived need to encourage lending in all three areas implies that support for these credits may increase in the future.

Existence loans are loans funded by NBH and made through the banks to support Hungarian (in contrast to foreign) purchases of privatized assets. The major advantage of this program for the banks is that the funding is long-term. The major advantage for borrowers is that the interest rate is 7 percent. However, because the spread for lenders is limited to 2 percent and because these are risky loans, usage on the part of the banks has been small. As of November 1992, total existence loans and other privatization-related loans represented 1 percent of all credit outstanding to enterprises and small entrepreneurs. SPA, which developed the existence loan program, has concluded that the program has not been successful. It will be supplemented by an installment credit program, managed by SPA, that will by-pass the banks. This new program has several potential pitfalls, because SPA does not have banking expertise and because its incentives are more likely to be to privatize assets than to ensure that its installment loans are creditworthy.

Efforts to increase lending to small and medium enterprises (SMEs) are focused on the Credit Guarantee Company (CGC), a non-profit, majority (75 percent) state-owned organization founded at the end of 1992. Its other shareholders are Hungarian banks that lend to SMEs; the five largest Hungarian banks make up 79 percent of this group. CGC's main purpose is to issue credit guarantees (maximum 80 percent) for a risk-based fee. However, there is a proposal afloat to expand CGC's responsibilities to provide interest rate subsidized loans to companies that purchase assets from bankrupt companies. CGC is a small organization, with a staff of 32 people and initial equity of 3.5 billion HUF. It anticipates that its maximum guarantee portfolio in 1993 will be 8 billion HUF. (As of May 1993, no guarantees had yet been extended.) EBRD is considering an equity investment in CGC.

The Hungarian American Enterprise Fund (HAEF) should be mentioned in the context of SME lending. As of March 1993, HAEF had funded 108 small loans, totaling $43.8 million. These funds were on-lent through two Hungarian banks. This program appears to be successful in extending SME loans, limiting losses (there had been four defaults as of May 1993), and providing some on-the-job training to participating banks. However, it has not developed as rapidly as the parallel program in Poland.

The Ministry of Agriculture is responsible for agriculture lending policy. Currently under discussion is a $100 million agribusiness lending program through selected banks, to be funded by EBRD, with an interest rate subsidy and credit guarantees provided by the Ministry of Agriculture.

Loans funded by foreign donors are managed by the Banking Department of NBH. These include a $100 million Japanese Eximbank facility, a German Start loan, and a $300 million World Bank loan designated in part to encourage lending to small entrepreneurs (part of a program initiated in 1987-1988). At least in the case of the World Bank facility, since its primary purpose is to provide long-term funding, it has been reported as not being attractive to entrepreneurs who still must face what they consider onerous interest rates and collateral requirements.

In summary, although Hungary is not characterized by specialized banks, there are several specialized lending programs, and these appear to be growing. The most noteworthy of these programs are those focused on privatization finance and SMEs. One could argue that both of these programs are targeted at the same market because the large privatization purchases are more likely to be made by foreign investors with their own sources of financing. There is no doubt that SMEs, especially those that are privately owned, are not getting all the credit that they want. However, more research would be required to determine how many profitable SMEs are being starved for credit. In addition, a better understanding of reasons the banks are not lending to SMEs should be a prerequisite for developing any programs to encourage them to undertake such lending. The implicit assumption in on-lending programs is that the banks are not lending because they do not have adequate funding. As has been discussed, however, the Hungarian banks have excess liquidity.

Specialized lending programs characterized by subsidized interest rates should be strongly discouraged because they distort the market and create a dependence on these programs that prevents them from being replaced by the market. If the market rate for a potential transaction is too high for the transaction to bear because it will eliminate its profitability, then one must ask whether the transaction makes market sense. If not, it is important to determine whether there are any other rationales. One rationale that is frequently used is that this type of program will help develop a particular market. If that is the case, then it is necessary to be clear about the way the transition from a subsidized interest rate to a market interest rate environment will be made. If entrepreneurs become accustomed to a risk return trade-off that includes subsidized interest rates, how will they ever be able to afford market rates? And, if venture capital is essentially provided through state-subsidized funding, will there ever be a niche for the banks or venture capital funds to fill?

Whether long-term funding at market rates is a useful form of lending program is a controversial issue that hinges on the degree to which banks match-fund their long-term loans. The question can be answered only by asking the banks whether the availability of long-term funding is a significant factor in their decisions to provide long-term loans. If it is, and if the market does not provide adequate long-term funding or liquidity management options, this type of lending support may be acceptable.

A third type of lending program that could be appropriate for SMEs (depending again on the reasons the banks are not lending and on whether there is a creditworthy but credit-starved SME sector) is credit guarantees. Credit guarantee programs have the potential to be useful because they reduce risk by sharing it, they do not distort the market, and they can provide a training function — a participating bank can learn about credit evaluation and monitoring by working with the credit guarantee agency. It should be noted, however, that these programs often do not work well. Common pitfalls include shared responsibility leading to no responsibility, private bank frustration with the difficulties of collecting on a failed loan from a government agency, and the use of guarantees for loans that the banks are already making rather than for sharing risks that the banks would not otherwise accept — therefore not helping to change bank behavior. It will be important to minimize the risk that CGC might experience these pitfalls.

SECTION FOUR

DONOR ACTIVITIES

THE COMMERCIAL BANKS

The development needs of the commercial banks are enormous, covering a broad range of bank training at all employee levels, an improved bankwide payments system, hardware and software, and, in the case of the large Hungarian banks, some combination of portfolio restructuring and increased capitalization. The donor community has been active in addressing various aspects of these needs. It is worth emphasizing that all of the donor representatives interviewed freely provided information about their projects and stressed the need for and their interest in greater cooperation.

EC PHARE has organized its technical assistance into the 1990 and the 1991 programs, based on when the funding was made available. PHARE delivers its assistance through program management units placed within various Hungarian institutions. The 1990 program was organized around NBH. This program is not considered to have achieved its maximum potential, partly because of lack of focus at NBH and start-up pains at EC PHARE. Elements of the 1990 financial program include working with the Hungarian Bankers' Association to provide technical assistance to smaller Hungarian banks (in coordination with a World Bank program), providing an advisor to SBS as well as financing for SBS computers, and a computer system for the Budapest Stock Exchange.

The 1991 program is organized around the Ministry of Finance. This program has included funding a feasibility study for turning the post office payment system into a giro system as well as participation in the development of the bankwide giro system being financed by the World Bank. In response to emphasis placed by Hungarian officials, EC Phare is trying to work with MBF Rt, and had planned to provide at least one long-term advisor and a short-term advisor to provide initial assistance with the LCF program.

EC PHARE has financed a study of mortgage finance and plans to follow up on the results of the study, but the nature of the follow-up has not yet been determined.

EC PHARE has financed technical assistance to the Deposit Insurance Fund, provided by Ernst and Young. Ernst and Young is advising the Deposit Insurance Fund on establishing its operating procedures, systems, and so forth, and will provide an advisor who will work with the Fund for several months.

With regard to the general structure of the PHARE program, the EC PHARE advisor observed that the level of access by advisors is dictated by the level of the Hungarian counterpart managing the PHARE program. Therefore, it is critical that these Hungarian individuals be at a high enough level within their own institutions to maximize the effectiveness and particularly the potential policy impact of the PHARE programs. The advisor also noted that PHARE is tightening up its requirements on nationalities of individual consultants and, therefore, it could be more difficult to provide appropriate technical assistance in the future. (The advisor to SBS, for example, is Canadian.)

The British Know-How Fund had been poised to begin an extensive training program to be provided first to Budapest Bank and then offered to other interested banks when the program was finetuned. When the Budapest Bank unexpectedly decided not to participate, it was a setback for the Fund's planned programs. The Fund has also provided various short-term technical assistance to the banks, including an advisor who is currently at Budapest Bank, and a short management training program for OTP several years ago. The Fund provided an advisor to MBF Rt earlier this year on overall organizational issues.

One of the Fund's most impressive accomplishments has been training 10,000 accountants in connection with Hungary's new accounting law. Elements of this massive training effort might have some relevance for bank training.

In contrast to EC PHARE and the British Know-How Fund, which focus on technical assistance, EBRD's efforts are largely in financing or investment. EBRD has publicly expressed an interest in equity investments in the Budapest Bank and the Hungarian Foreign Trade Bank. As mentioned, it is also considering an investment in the Credit Guarantee Company. Two other potential investment projects are a 25 percent share in a $20 million venture fund (the Commercial and Credit Bank and the French bank Siparex would be the principal participants) and a $1 million share in a smaller financial investment and advisory firm called Eurocorp. A longer-term project that is not expected to materialize this year is a joint venture municipal bank in which OTP and the French bank Crédit Locale de France would be the major participants.

With regard to credit facilities, EBRD provides three credit lines for large projects ($1-10 million each) to ING Bank, CEIB, and UnicBank. Inter Europa Bank may also participate in the program. EBRD takes 50 percent of the credit risk and provides 50 percent of the funding; the banks determine the lending rate. This program began at the end of 1992, and two projects have been approved under the program. EBRD's intent is to participate in three to four loans per bank each year. EBRD's other credit-related project, its proposal to provide $100 million in funding for agribusiness lending, has already been noted.

The World Bank's involvement in strengthening the Hungarian financial sector currently focuses on possible assistance in the restructuring of the large state-owned banks. As in many of the World Bank's financial sector activities in Central and Eastern Europe, these efforts are carried out jointly with IMF. As discussed at length elsewhere in this report, the Government of Hungary's loan consolidation program, announced at the end of 1992 and in implementation during 1993, has been widely criticized on a number of counts. As a consequence, the World Bank and IMF are seeking alternative mechanisms to reach the objective of recapitalizing the state-owned banks while maintaining incentives for these banks to deal with their nonperforming loans through market-based solutions. At the same time, the Government of Hungary is being encouraged by the World Bank and IMF to restructure selected large state-owned nonfinancial enterprises, the result of which would be to resolve a large portion (in value, but not in number) of the nonperforming loans of the large state-owned banks.

The World Bank has also been involved in other activities intended to strengthen the Hungarian financial sector. For example, in collaboration with IMF, it has been involved in attempts to improve the Hungarian payments systems in general and the performance of the large state-owned banks in this respect in particular. It also appears to be prepared to work with IMF and other international agencies to strengthen bank supervision in Hungary as soon as the roles of SBS and NBH in bank supervision are clarified to the satisfaction of the World Bank and IMF. Finally, in the past, the World Bank provided funds for lines of credit through NBH, but most of these funds (US$ 300 million) are still undisbursed. It is unclear whether the failure to disburse is due to the widely noted excess liquidity in the Hungarian banking system, to flaws in the design of the credit lines, or to a recognition by the parties involved that directed credit lines are not a good way to promote the development of a financial sector.

TRAINING

The focal point for bank training in Hungary is the International Training Center for Bankers (ITCB). This organization was founded in 1988; its major shareholders are the 29 banks that existed at that time. Of its shares, 80 percent are held by the five large Hungarian banks and NBH and 2 percent by CIFPB, a French banker training organization that participated in founding ITCB. ITCB is a nonprofit organization that covers all of its costs from revenues. Foreign funding has never contributed more than 10 percent of revenue and is usually in the range of 2-3 percent.

ITCB's objective is to provide postgraduate training to middle- and senior-level bank management. It has 14 full-time faculty and more than 100 part-time lecturers. ITCB has three types of programs. The first is focused courses that run for three to ten days each. Approximately 120 people attend this type of course each day. The second is a two-year degree program, jointly offered with the Hungarian University of Economics, which is the highest banking-related degree available in Hungary. Students in this program attend class for one week every month. The third program is a self-study program provided jointly with the Chartered Institute of Bankers in England. ITCB has also positioned itself to provide assistance to banks to build up their in-house training, such as in training of trainers. For example, EC PHARE is funding Allied Irish Bank to develop in-house bank training programs, and the local input is subcontracted to ITCB.

The feedback received from other bankers on ITCB's capabilities could most accurately be characterized as mixed; some thought it was doing a good job and some did not. A much more reliable assessment of ITCB's capabilities was conducted by an EC PHARE-financed consulting group, which generally gave ITCB high marks.

The ITCB is a potentially useful model for bank training in the region because it is run by the Hungarian banks for Hungarian bankers. ITCB receives foreign assistance in the form of long-term lecturers, training materials, and the like, but the assistance is provided in a framework established by ITCB. As noted above in the case of EC PHARE, ITCB also often plays a role in providing technical assistance services intended for specific bank training. ITCB works closely with the banks, who are its shareholders and clients, to anticipate future training needs. ITCB appears to act as a de facto representative of the needs of the banks, a role that is enhanced by the somewhat passive approach of the Hungarian Bankers' Association.

Given ITCB's prominent role, ownership, capabilities, and experience, any training assistance provided by A.I.D. would be channeled most efficiently directly to ITCB or should include ITCB in the design of individual training programs. ITCB management noted that they have not been able to take full advantage of KPMG's bank training services because they do not have a clear sense of KPMG's overall capabilities and how they could best be merged with ITCB's needs.

In summary, donors have been involved in an array of financial sector activities in Hungary. Some assistance has been in niches, such as with the Deposit Insurance Fund, while other assistance has been earmarked for prominent organizations such as MBF Rt. Given this relatively high level of saturation, it is important that future technical assistance be carefully coordinated with other donors. It is also increasingly necessary to ensure that the recipients "buy into" the technical assistance — that is, that they accept the need for it, are enthusiastic about it, and, ideally, participate in structuring it. This can be seen in the case of the ITCB, which is interested only in technical assistance that is carefully designed to meet its specific needs, and in the case of Budapest Bank, which apparently did not feel committed to the British Know-How Fund's program.

SECTION FIVE

OBSERVATIONS AND RECOMMENDATIONS FOR U.S. GOVERNMENT ASSISTANCE

This conclusion outlines current U.S. Government financial sector activities in Hungary and makes recommendations on future activities. To put these recommendations into the appropriate context, it should be emphasized that U.S. Government financial sector activities have been very well received in Hungary. A significant part of this credit is due to the long-term Treasury advisor program, which is the most prominent and wide-reaching of the financial sector activities. The following recommendations are made with the goal of building on the strong base of expertise and good will that has already been established. U.S. Government financial sector activities in Hungary fall into the following categories:

- **The long-term Treasury advisor program.** Currently there is an advisor at the Hungarian Credit Bank, the Budapest Bank, and the Ministry of Finance, and with the Minister of Privatization without Portfolio. These are one-year assignments with renewal options.
- **Loan Consolidation Fund.** KPMG, under the auspices of USAID, has worked with members of the Bank Privatization Working Group, including MBF Rt, on various aspects of development of the LCF program. This project has recently been completed.
- **Training.** KPMG, under the auspices of the U.S. Treasury, has provided limited technical assistance to ITCB under its regional bank training project.
- **HAEF.** HAEF has developed an on-lending program with two Hungarian banks. As noted, the HAEF program had funded 108 small loans, totaling $43.8 million as of March 1993.
- **There are also several other small projects**, including a Financial Services Volunteer Corps (FSVC) volunteer assigned to the Hungarian Credit Bank to write a case study and a short training course sponsored by USAID for the Credit Guarantee Corporation.

It is recommended that these activities, some of which operate relatively independently, be brought together into a more explicitly coordinated program by building on the existing foundation of partnerships with key participants in the Hungarian financial sector. These participants can be grouped into four categories: the policy makers, which are primarily the Ministry of Finance and NBH; the state-owned banks; ITCB, as the main training organization and the de facto spokesperson for the banks' needs; and participants in the bad loan program, most notably MBF Rt. Current and future relationships with each of these groups will be considered in turn.

PARTNERSHIP RELATIONSHIPS

Policy Makers

With regard to policy makers, the U.S. Government already has a strong relationship with the Ministry of Finance through the Treasury advisor program. NBH stands out as the other policy organization that is an important partner for the U.S. Government, both as a recipient of technical assistance and as a participant in an ongoing dialogue on the restructuring of Hungary's financial system and the U.S. Government's participation in that process. The U.S. Government, including A.I.D. and Treasury, already has extensive contacts at NBH. Providing technical assistance to NBH could be a way of building on those contacts through the hands-on activities of technical assistance. For example, discussions with NBH officials reveal awareness that the current organizational structure and capacity of NBH are unlikely to be optimal for carrying out all the functions of a modern market- oriented central bank, including especially the design and implementation of monetary policy. Since the traditional monobanking system was split between commercial banking and central banking components, considerable attention has been devoted to modernizing the commercial banking component, including substantial inputs of technical assistance and training. However, while NBH has received external support to improve certain specific functions, the overall structure and capacity of NBH have not yet been critically examined, including the possibility that there may be substantial staffing from the monobank era that is excess or is in need of major redeployment. It might therefore be useful for A.I.D. to propose assistance in holding a seminar, or a series of seminars, where countries that have recently reorganized their central banks and are of a size and level of development similar to those of Hungary could share their experiences with NBH officials.[10]

In addition, NBH will need assistance in defining more clearly its role in the regulation and supervision of financial institutions and, subsequently, additional technical assistance and training for implementation. An even larger program of technical assistance and training will be required for organizational restructuring and capacity building to enhance the effectiveness with which NBH formulates and implements monetary policy. This will need to begin with a key unit in NBH that will be responsible for improving accuracy and timeliness of data on the financial sector in particular, but not neglecting the economy in general, so that data can be collected and processed for subsequent analysis. Following this, there will need to be an even more important NBH unit to analyze these data for the primary purpose of providing the basic analytical inputs for the formulation of monetary policy. Following this, the implementation of monetary policy needs to be centralized in a single unit, although operationally there may be some specialization, — in, for example, a sub-unit that deals with foreign exchange markets and another that deals with domestic money markets.

The State-Owned Banks

Technical assistance to the banks themselves has been provided largely through the Treasury advisor program. Given the effectiveness of this program, it is reasonable to assume that the demand for this technical assistance will increase. Two criteria should be considered in responding to potentially competing opportunities. First, the banks themselves must have the appropriate incentives to take full advantage of this technical assistance. The existence of these incentives could be confirmed in part by having written agreements with the banks regarding the terms of the assistance. These would go beyond the existing scopes of work by establishing review points, potentially on a quarterly basis, at which time assistance could be ceased if it is determined that the program is not making adequate progress. The other and related criterion should be which banks require assistance the most critically. (Input from NBH could be helpful here.) Another possibility to consider is to aim for a demonstration effect by focusing technical assistance on one bank in an effort to achieve visible results. This could be achieved by

[10] New Zealand, which has undergone one of the most thorough financial liberalization and central bank reform programs, and Chile, which developed highly innovative programs for bank rehabilitation and supervision after its financial crisis of the early 1980s, are possible examples.

assigning a team of Treasury advisors to one bank and supporting their efforts with short-term specialists from FSVC and other organizations.

One bank that should be considered as a potential recipient of technical assistance is OTP. OTP has received essentially no assistance from foreign donors. More attention might be focused on OTP for two reasons in particular. The first is that retail banking facilities in Hungary are inadequate, as demonstrated by the estimate that only 1 in 5 adult Hungarians has a bank account. More effective financial intermediation requires a retail banking system able to mobilize personal savings. Second, the management of the state-owned OTP is subject to the same moral hazard as is the management of the other large state-owned Hungarian banks. Therefore, this management runs the risk of following the same ill-advised lending policies. This risk is heightened by the threat of eventual increased competition for retail business from other banks and by the limited number of profitable ways for OTP to invest its retail deposits, which have been growing as the Hungarian savings rate has increased. As a result, there is pressure on OTP to respond to competition by offering more services, such as loans, as well as to increase its income in other ways. OTP has already had some unsuccessful lending experiences.

Technical assistance to OTP could be applied to help it devise a long-term strategy to deal with the competition, devise prudent lending policies, and consider privatization options. (It should be noted in regard to this last point that the government has stated that OTP will be the last of the large Hungarian banks to be privatized; therefore, this last function would be relevant only if the government's timetable changes. At a minimum, however, an advisor could help ensure that OTP will still be an attractive candidate for privatization and does not become hobbled by bad loans.)

It should be stressed that the point of the preceding comments is that the need for technical assistance at OTP exists. The receptivity of OTP management to technical assistance would have to be confirmed.

The International Training Center for Bankers

ITCB is an important organization because it is the main delivery vehicle for bank training and because of its ability to assess the current and future developmental needs of the banks. Contacts with ITCB do not appear to be strong and are based primarily on the KPMG regional training project. It will be important to evaluate why KPMG and ITCB have not worked more closely together, it appears that there is a mismatch between ITCB's needs and KPMG's capabilities. If that is the case, the mix should be improved, or other ways of building a working relationship with ITCB should be pursued, or both. One area where there may be potential synergy is between ITCB and the lending activities of HAEF; for example, HAEF's experiences may indicate specific training needs in the participating banks.

Participants in the Bad Loan Program

The fourth category of partnership that has been identified is with organizations working on the bad loan program, most notably MBF Rt. This category has been included because this is a key issue in Hungary's banking system and because the U.S. Government has built up experience in this area through the work of KPMG as well as the Treasury advisors. However, it could also be possible to develop a program with the three primary partners, not including MBF Rt directly, and to address the bad loan problem through some of the three other partnerships, such as the Ministry of Finance and the commercial banks. Another possibility is to build the fourth partnership around a different organization involved with the bad loans, such as SHC.[11] This is an appropriate time to consider this issue, because the KPMG contract has recently ended and because MBF Rt is just beginning to grapple with the LCF program.

Given the enormity of the NPL problem and recent failures to deal with it effectively, what is the appropriate role for potential technical assistance to MBF Rt? Technical assistance can be provided at two levels: policy and implementation. Effective results at the implementation level, especially for a complex project such as this one, require donor input into policy design and decisions that provide the framework for other technical assistance. Given the rather inchoate nature of MBF Rt's mandate, objectives, and capabilities, there is a risk that technical assistance at the implementation level could be frittered away unless it is preceded and enforced by technical assistance at the policy level to develop a coherent program design and ensure agreement on basic goals and objectives.

If technical assistance is provided to the MBF Rt, the following guidelines are recommended:

- For technical assistance in policy design, the purpose should be to provide policy design assistance, not shadow management. The purpose of the assistance should be agreed upon in advance with MBF Rt. The program should be designed so that it has regular cut-off points with pre-agreed criteria where it can easily be continued or discontinued. One of the major elements of such criteria should be establishing MBF Rt's mandate to restructure or liquidate enterprises.

- Implementation-level technical assistance should be preceded by donor input at the policy design level. This technical assistance should be for well-defined projects, such as a specific number of loan work-outs, with pre-agreed completion dates. If it becomes apparent during work on these projects that MBF Rt does not intend, or is not able, to follow through on any necessary enterprise restructurings, this program should also be stopped. One advantage of a tightly focused pilot technical assistance project is that it can serve as a basis to test the soundness and implementability of policy-level decisions.

- It should be recognized that there is a potential conflict of interest if the same party provides technical assistance at the policy level and at the implementation level; it would be difficult not to favor policy design that would maximize the opportunities for implementation-level technical assistance. For example, a policy design advisor would have a vested interest in recommending that a 1993 loan work-out program be housed in MBF Rt and not in the banks. Therefore, these two responsibilities should be divided.

- Technical assistance to MBF Rt should be coordinated with the larger donor community. MBF Rt is a major candidate for technical assistance, and all of the donors interviewed had some plans for working with MBF Rt. Coordination with other donors is important for three reasons. First, it will minimize duplication of efforts. Second, it will help to ensure that donor assistance does not inadvertently keep MBF Rt afloat solely as a major technical assistance recipient in Hungary. Third, assuming that MBF Rt's survival and growth is a

[11] The point of this suggestion is not that the bad loan problem could be resolved by working with another organization; this report has discussed how Hungary's bad loan program is characterized by several problems, including political will as well as organization. The point is simply that because several organizations are involved in the bad loan program, a choice can be made about which organization will be the primary partner for the U.S. government.

goal of MBF Rt management, it is in MBF Rt's own interests to maximize the receipt of technical assistance and donor funding. Therefore, it should be the donor community, and not MBF Rt, that coordinates its technical assistance.

TREASURY ADVISORS

A.I.D. could be helped in building up its partnerships and coordinating activities by the success of the Treasury advisors, who collectively have done an impressive job of building relationships to enable them to share their personal expertise. The credibility of this group of advisors is a sound foundation for continuing to develop the policy dialogue with their technical assistance recipients as well as with other financial sector institutions in Hungary. The following recommendations are made with the intention of building on this foundation:

- It is recommended that the responsibilities of each Treasury advisor be developed and agreed upon in a memorandum of understanding with the advisor's counterpart in the host institution. This would go beyond the existing terms of reference by specifying any commitments to be made by the host institution. In addition, it would be useful to have regular program review points based on the memorandum of understanding, the purpose of which would be to determine how to improve the advisory project, whether the host institution commitments are being met, and whether an unsuccessful project should be discontinued. The current practice of quarterly reporting by the Treasury advisors is very useful for conveying information about their programs; the point of this recommendation is to consider going further by developing a review mechanism that will involve the advisor and the host institution and that will facilitate any necessary adjustments to an ongoing advisory program. One of the ways in which adjustments would be facilitated is by making this a regular process, so that adjusting or even discontinuing programs is seen as a normal process, rather than as an unusual one with negative connotations.

- The access of Treasury advisors to additional technical and training support should be streamlined to increase their effectiveness and credibility. There are two potentially complementary ways in which this might be done. One is to establish a regional office with a management well versed in macroeconomics and finance that can coordinate short-term technical expertise to the local Treasury advisors in the region. This could include using some of the Treasury advisors themselves who have expertise that could be provided on a short-term basis in other than their host country. The other way is to precontract with one or more firms to provide specialists on short notice for short-term assignments. Arranging the contract in advance and ensuring that the firms can provide these specialists would shorten the period between requesting assistance and receiving it.

SUPPLEMENTARY ACTIVITIES

Despite the large number of donor programs in Hungary, there remain many relatively untapped opportunities for donor assistance. Examples include banking supervision, deposit insurance, and the smaller banks. There is little doubt that effective technical assistance could be provided to each of these organizations. However, in keeping with the recommendation for a financial sector reform program built on partnerships with three or four key participants or groupings of participants in Hungary's financial sector, the following activities should be undertaken only in consultation and coordination with these primary partners.

Banking Supervision

BD/NBH and SBS are still working out the precise nature of the division of their responsibilities on bank supervision. As a result, A.I.D. is likely to maximize the impact of its assistance if it focuses on certain strategic issues:

- The importance of full disclosure of all relevant information so that interested parties can make their own informed decisions — which needs special emphasis in the face of Hungarian preoccupation with bank secrecy;

- Resources and technical capabilities for supervisory agencies not only to examine banks but also to merge, liquidate, or rehabilitate banks that are found to be insolvent; and

- Adequate enforcement powers for supervisory agencies, including political independence and the availability of penalties that are substantial but not so draconian that they will not be used.

Deposit Insurance

A deposit insurance fund has recently been created and is currently receiving start-up technical assistance funded by EC PHARE. Further technical assistance would be useful in areas such as bank monitoring techniques and risk-based deposit insurance. This would be a worthwhile target for short-term technical assistance not only in itself, but also because the institutional arrangements of the deposit insurance fund, including how it relates to SBS and BD/NBH, are important for the long-term development of the financial sector. The issue of how to provide deposit insurance without unduly increasing moral hazard is a particularly important point to review.

The Smaller Banks

Little attention has been paid to the smaller banks as a group, and little seems to be known about their capabilities, needs, and so forth. EC PHARE has financed one short-term advisor to work with the small banks through the Hungarian Bankers' Association. However, this program does not appear to have been totally effective, with only three banks choosing to participate. Consideration should be given to funding a study of these banks to determine whether and how technical assistance could be useful.

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ANNEX A

PERSONS INTERVIEWED

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Clara Apatini, General Director and Member of the Board, Credit Guarantee Co., Ltd.

Chris Barltrop, Banking Consultant with KPMG

Peter Bihari, General Manager, Department for Economic Analysis, Budapest Bank

Deborah K. Billig, Assistant Vice President, Riggs National Bank (Advisor to the Commercial and Credit Bank on Retail Banking)

Donald Billings, Director Financial Institutions, KPMG

Robert Brewis, Representative, EC PHARE

David Cowles, A.I.D. Representative

Klara Csoor, Deputy President, State Banking Supervision

Donna Culpepper, Press and Cultural Affairs Officer, American Embassy

Laszlo Czirjak, General Manager, Bankers Trust

Sandor Czirjak, Deputy President, National Bank of Hungary

William Dewey, U.S. Treasury Advisor for Banking Reform

Charles English, Economic Affairs Officer, American Embassy

Gabor Erdely, Chairman of the Board of Directors, Hungarian Foreign Trade Bank

Mark Fitzpatrick, U.S. Treasury Advisor to the Hungarian Credit Bank

Gyorgy Fodor, Deputy Secretary General, Hungarian Banking Association

Ivan Gara, Executive Director, UnicBank

Katalin Garbai, Deputy General Manager, Economics Department, National Bank of Hungary

Tibor Halupka, Senior Manager, Posta Bank

Dr. Anna Halustyik, Baker & McKenzie

Otto Hieronymi, Advisor, Minister for Privatization

Charles Huebner, Managing Director, Hungarian-American Enterprise Fund

Gyorgy Ivanyi, Executive Chairman, Inter-Europa Bank

Dr. Peter Kazar, Director, Portfolio Management Unit, State Property Agency

Gabor Kende, Head of Business Policy Department, National Savings Bank

Gyozo Kenez, Deputy Chief Executive Officer, Hungarian Corporation for Investment and Development

Marta Klemencsics, Deputy Director General for Money and Capital Markets Department, Ministry of Finance

Dr. Erzsebet Konczol, Director General, International Training Center for Bankers

Almost Kovacs, Deputy Secretary, Ministry of Finance

Charles Kovacs, Head of Office, Barclays de Zoete Wedd

Mihaly Kupa, Member of Parliament and Ex-Minister of Finance

Zoltan Lehoczky, General Manager, Banking Department, National Bank of Hungary

Charles Lonsdale, Second Secretary, British Know How Fund

Karoly Lovasz, Deputy General Manager, Banking Department, National Bank of Hungary

Rezso Nyers, Managing Director, Economics Department, National Bank of Hungary

Mark Odescalchi, Advisor to the President, Hungarian State Holding Company

Dr. Nandor Papp, Director of International Relations, International Training Center for Bankers

Csaba Pattogato, Advisor to Savings Cooperatives

Istvan Racz, Director, Credit Suisse First Boston Budapest

Andrew Rogerson, Manager of Central European Services, World Bank

Jozsef Rotyis, Chief Executive Officer, Budapest Stock Exchange

Julie Rowney, Dean and Chief Executive, International Management Center

Tamas Rusznak, Deputy President, State Banking Supervision

Sunil Sabharwal, Deputy Resident Representative, European Bank for Reconstruction and Development

Lewis Stettler, U.S. Treasury Advisor to the Ministry of Finance

Gyorgy Suranyi, Managing Director, Central European International Bank

Eva Szabo-Pakozdi, Director, Posta Bank

Istvan Szalkai, Chairman, Hungarian Credit Bank

Szabolcs Szekeres, Executive Vice President, Hungarian State Holding Company

Gyorgy Szepesi, Deputy Chief Executive, Hungarian Credit Bank

Imre Tarafas, Deputy President, National Bank of Hungary

Maria Tarnai, Deputy Chief Executive, Hungarian Credit Bank

Andrew Terner, Director Corporate Finance, Price Waterhouse

Elemer Tertak, Managing Director, National Deposit Insurance Fund

Gerald Thompson, U.S. Treasury Advisor, Budapest Bank

Laszlo Torok, Deputy General Manager, National Savings Bank

Gerard Torsney, Attorney with KPMG

Ivan Varga, Deputy General Manager, Posta Bank

Robin Winchester, Financial Expert, Hungarian Credit Bank

John Wingender, Fulbright Lecturer, International Management Center

Szilvia Zador, Senior Deputy General, Manager, Monetary Policy Department, National Bank of Hungary