PN-ACE-944
101383

An Assessment and Rating of The Hungarian Banking System

The United States Agency for International Development
Bureau for Europe & New Independent States
Office of Privatization & Economic Restructuring

By
Michael Borish and Company, Inc.

with
Triumph Technologies, Inc.
under Contract # NIS-C-00-97-00019-00

April 1998

PNACE 944

Table of Contents

AN ASSESSMENT AND RATING OF THE HUNGARIAN BANKING SYSTEM

I Introduction

The following assessment of the Hungarian banking system has been produced under contract to the United States Agency for International Development/ENI/PER by Michael Borish and Company, Inc with support from Triumph Technologies, Incorporated Michael Borish and Company, Inc would like to thank Jean Lange of USAID/ENI/PER, and Tom Cornell and Karoly Okolicsanyi of USAID in Hungary for their kind support and guidance Michael Borish visited Hungary from March 1-7, 1998 in conjunction with this project

II Methodology of the Rating System

The rating system utilized to assess the banking sector of Hungary is based on a review of more than 200 issues and topics that have been used to construct a diagnostic methodology for the review of banking systems This tool will be utilized by USAID in other parts of "transition Europe," and is applicable to virtually all banking sectors in the world

In its simplest form, the rating system is focused on four general areas of activity—based on 28 "sub-categories," and subject to five general classifications The activities and sub-categories are included below

USAID/ENI/PER Banking Sector Rating System Activities	
General Areas of Activity	*Sub-Categories*
• ***Financial Sector Infrastructure***	• General policy and system • Legal framework • Regulatory and supervisory capacity • Payments systems • Accounting framework • Rating agencies • Financial media • Professional associations • Academic institutions • Miscellaneous areas relevant to financial sector infrastructure—telecommunications postal, safekeeping
• ***Economic Factors and Indicators***	• General trends • Private sector development issues • Monetary and related savings and credit matters • Fiscal considerations • Exchange rates • Balance of payments issues
• ***Banking Structure and System Profile***	• Overview of the system and financial measures • Profile of ownership structures • Governance and management issues • Non-bank competition
• ***Banking Sector Development Based on Prudential Norms***	• Capital adequacy • Asset quality • Management capacity • Earnings • Liquidity • Operating environment • Transparency and disclosure • Sensitivity to market risks

The following classifications are utilized to provide a scoring for the individual issues assessed, as well as in developing a composite rating for the banking sector as a whole Annex 1 provides greater descriptive detail about how the ratings apply by sub-category

USAID/ENI/PER Banking Sector Rating System Scoring Description	
5	Outstanding world class state-of-the-art best practices, virtually no serious systemic risks
4	Solid strong, satisfactory competitive, few systemic risks or problems, and those are manageable
3	Adequate favorable trend improvement needed potential for major systemic risks
2	Inadequate weak significant improvements needed major potential for destabilization via systemic risks
1	Dismal monopolist resistant to competition and change no confidence widespread corruption weak institutions

No effort has been made to weight individual variables, or to quantify ratings along mathematical lines Rather, 28 major sub-categories of the four main groupings were all rated within the five-point rating system, with allowances for pluses and minuses in the event that the direct numerical classification did not fully match with performance The evaluation is both qualitative based on trends and assessments, and quantitative to the extent the figures are useful and meaningful In general, the information available in Hungary is sufficient to form a judgment However, there are certain inconveniences associated with the timing of the exercise or the completeness of data These include (i) annual reports and general financial data on a per bank basis for 1997 were not yet prepared by the time of the assessment—only a limited amount of openly disclosed financial information was available on balance sheet and income statement indicators, (ii) IMF statistics are generally available only through mid-1996, although a recent study published in February 1998 provided useful information through mid-1997, and (iii) laws and regulations in English are difficult to obtain

III The Hungary Rating

The composite score awarded Hungary was **3+/4-**, which generally reflects Hungary's rapid privatization in the banking sector since 1995, success in attracting prime-rated strategic investors as owners, reasonably strong financial indicators (mainly capital and assets), and positive trends with regard to governance A strengthening economy will further assist banking sector development, and hopefully will provide sufficient confidence to expand the customer base beyond the small sample of firms and individuals currently targeted by the banks, and the maturity of instruments available in the marketplace Thus, as of spring 1998, the assessment of the Hungarian banking system is as follows

The Hungarian Banking System—Spring, 1998	**Composite Score 3+/4-**
Hungary has long had a satisfactory legal and banking framework Combined with membership in the OECD and prospects for membership in the EU Hungary has pursued a steady course towards a private sector-oriented economy Hungary continues to encounter macroeconomic weaknesses—inflation rates of 18 percent, nearly 5 percent fiscal deficits 10 percent unemployment rates—and this has had a dampening effect on lending activities However the Hungarian banking system has undergone rapid privatization since 1995 succeeding in attracting prime-rated strategic investors to take majority ownership positions in most key banks The banking sector is now better capitalized than it was just two years ago Asset quality has improved Prime-rated banks are investing in people and systems that should transform Hungary s banking system into a competitive one in the coming years Major risks in the foreseeable future are the ability of banks to identify and manage risks as competition intensifies and the ability of the regulatory authorities to provide adequate supervisory oversight	
• Nearly 100 percent of assets deposits and capital are in privately-owned banks • 30 of 44 banks are foreign-controlled by prime rated institutions • Total assets approximate $22 billion or $500 million on average per bank • Loans to the household and corporate sector approximate 35 percent of assets • Loans to the central budget and reserves held with the central bank approximate 36 percent of assets • Tier 1 and 2 capital are nearly 12 percent of assets • 1997 ROA 1 14 percent • 1997 ROE 11 7 percent	

The basis for the composite is described by each of the four general activities and the 28 sub-categories below A more detailed summary is attached as Annex 2

Section 1 Assessment of Financial Sector Infrastructure

1 Financial Sector Infrastructure Score 3+

Hungary is on the right track towards financial sector modernization Its policy is open, forward-looking, and anchored in recognition of market globalization trends Recent entry into the OECD, expected formal entry into NATO, and future entry into the EU are all providing ongoing momentum for institutional reform Hungary has privatized aggressively in the last three years with a focus on strategic investment. Its legal and regulatory framework for financial services has been harmonized with BIS, EU and other international standards to ensure continued integration into international markets Its payments system is efficient Accounting standards are moving increasingly towards international norms General support organizations which enhance and help sustain market development—rating agencies, professional associations, media, academic and training institutes—all exist or are evolving towards professional standards Only structural weaknesses remain, and general trends in these areas are positive However, the next round of institutional and risk management challenges will determine how effectively Hungary competes in global markets, and how rapidly it narrows the gap in per capita incomes with other OECD countries

1 1 Policy and System. Score 4-

Hungary is generally perceived to be safe sound and stable for the time being It is quickly joining international organizations that require a commitment to democracy free trade and multilateral cooperation Its legal and regulatory structure has been reformed to conform to these prerogatives Likewise, Hungary s economy banking and overall financial system have undergone considerable reform in less than 10 years There are still risks associated with the country—residual forms of governance high social welfare costs high inflation rates, the relatively small size of the economy—but these are generally structural in nature and changing favorably

1 2 Legal Score 3+

Hungary s legislation and judicial infrastructure are considered satisfactory by global standards and adequate in advance of Hungary s assumption of membership obligations in the EU EU rules and directives on competition, public procurement, intellectual property and company and accounting laws are virtually completed This applies as well in the financial sector—for banking as well as in insurance capital markets and pension funds However where Hungary still needs strengthening is in the application of commercial law The system is still characterized by delays in many cases due to complex market transactions that make it difficult for courts to process claims in a timely manner

1 3 Regulatory and Supervisory Score 3-

Hungary s regulatory framework conforms to prudential guidelines rendered by the Basle Committee for Banking Supervision as well as more recently with EU directives and guidelines more consistent with universal" banking practices However there are questions about the effectiveness of institutional capacity These include the absence of standardization and consistency in supervisory activities the need for a stronger team concept, and a focus on risk-based supervisory practices The supervisory agency has only recently been reorganized consolidated and freed of civil service compensation constraints Prior weaknesses consisted of inadequate coordination between/among differing authorities and oversight functions and high levels of turnover among trained and qualified personnel Recent changes confirm increased independence and management autonomy although the agency does not have the power to issue regulations There has been an increase in personnel from about 100 in 1994 to 260 in 1997 Examination fees currently cover the supervision agency s budget Where there are gaps in terms of on-site examination skills or off-site surveillance, private contractors have been brought in to assist However the use of private contractors frequently is considered to be more like a bank audit than a risk-based examination The Postabank bank run in February 1997 did not cause systemic panic nor was there any serious evidence of a ' contagion' effect from the financial crisis in Asia in late 1997 However this appears to have had less to do with banking supervision and more to do with the effective market response of depositors, banks, and other sources of financing There are lingering concerns about the disclosure and transparency of weaknesses still resident in some of the banks and the limited willingness of supervisors to enforce regulations as needed Hungary still has not concluded a cooperation agreement with counterpart regulatory agencies raising questions about the real financial condition of some of the banks There are also concerns about a focus on compliance by regulators rather than risk management The reporting of off balance sheet contingencies is considered weak and may represent a layer of risk that is not being adequately provisioned for There are also major gaps between senior management and mid-level management with regard to training and development It will take time before adequate risk management capacity is developed and before the market perceives regulatory capacity to be wholly effective

1 4 Payments System Score 4 The payments system functions well in Hungary The system is based on electronic funds transfers—checks are not used The predominance of prime-rated banks in the banking sector combined with significant investment flows and fairly open current and capital accounts all provide confidence in the ability of the payments system to function efficiently

1 5 Accounting Score 4- Hungary s accounting standards are evolving increasingly towards international standards These have been in place for Hungary s larger firms—such as most of those listed on BSE They have also been increasingly expected in recent years as Hungary has privatized hundreds of large firms and banks by attracting strategic foreign investors IAS has been a fundamental element of valuations due diligence and investment decision-making (both for direct investment and portfolio investment) All the major international accounting firms have been active in the Hungarian market since 1989 Four of the six majors had a total of 1 015 personnel at end 1996 including 45 partners and 110 accountants chartered or certified in accordance with IAS Meanwhile there are many more Hungarian accounting firms specialized in local accounting standards While being reasonably strong, these standards are still not considered wholly acceptable by the global marketplace This is due to (i) inadequate disclosure of meaningful information on a consolidated basis and (ii) the use of legalistic notes that do not provide sufficient financial detail in some cases resulting in a lack of consistency This sometimes contributes to banks decisions to not lend to many mid-sized and larger firms

1 6 Rating Agencies Score 3+/4- All the major international rating agencies have been active for several years in the Hungarian market. Hungary s ratings in February 1998 were generally favorable in terms of the long-term outlook For instance, Moody's ratings—which were unchanged from ratings one year earlier (1996) after having been downgraded in 1995—reflect confidence in the long-term development of the banks based on increased organizational development, reduced problem loans and increased capital However, Hungary remains below prime for foreign currency deposits

1 7 Financial Media Insufficient Basis for a Score No particular effort was made to assess the financial media. However, there are several newspapers that report daily and weekly monetary and financial information This includes interest rates trade volumes exchange rates and other related information No problems regarding the media were reported in terms of chronic rumors that could weaken financial institutions based on unfounded evidence Media coverage during the Postabank run in early 1997 was considered responsible There is some criticism that the media do not devote enough attention to details or that there is some excessive editorialization However, this is also a criticism of the banking community for not committing sufficient resources to public relations

1 8 Professional Associations Score Insufficient Basis for a Score No particular effort was made to assess associations in Hungary There are several professional associations in Hungary for financial sector individuals and groups One group the International Training Center for Bankers provides training and engages in consulting assignments This includes working with HBCMS on inspections and other regulatory matters The Hungarian Bankers Association also exists and is considered important in coordinating input from the banks into the legal/regulatory drafting process However there is limited input from the banking community in building up this association and the HBA s budget is consequently limited

1 9 Academic Insufficient Basis For a Score No particular effort was made to assess the number or quality of academic institutions in Hungary Nor was there a systematic effort to speak with business/management school officials However there are many schools institutes and think tanks that are able to make a significant contribution to banking sector development Bank managers and others believe that academic institutions now prepare younger students adequately for employment. While finance accounting and management are studied, there is reported to be only one Master's level program in business administration offered in Hungary

1 10 Miscellaneous Score 4

There has been rapid movement towards privatization and modernization of the telecommunications market MATAV has been privatized and there is competition in the cellular business The telecommunications sector functions well a necessary precondition if Hungary is to succeed as a "regional platform' for investment and growth Postal services appear adequate with the added feature of having a 3 200 bank branch network (Postabank) Safekeeping from a physical and logistical standpoint appears adequate, although no systematic effort was made to review this In general Hungary has made a strong effort in recent years to provide an enabling environment conducive to growth

	Section 2 Assessment of Economic Factors and Indicators
II Economic Factors and Indicators Score 3+/4-	**Hungary has an open economic system that is increasingly private sector-oriented in terms of ownership Competition policy is generally harmonized with EU legislation, although some trade protection was still in effect in mid-1997 This involved import ceilings on about 20 types of products, mostly clothing, cars and vans, and textiles, footwear and precious metals There are still licensing requirements as well for the import and export of energy and many agricultural products, the importation of cars, and the exportation of pharmaceuticals However, most quantitative restrictions on imports and exports were removed in 1989-91, and state trading monopolies were substantially removed in 1989, ahead of all other transition countries Thus, remaining barriers are expected to disappear or diminish in importance over time as Hungary complies with WTO, EU and CEFTA Agreements Structurally, there is a disconnect in the 14 percent of GDP that originates with foreign-controlled enterprises, and the balance of the economy that remains only loosely connected to this segment. Building stronger links between Hungarian-controlled enterprises and foreign ones represents a key structural challenge in the coming years for rising competitiveness and incomes, and in anticipation of entry into the EU There is already some evidence of movement in this direction in some sectors, such as suppliers to the major auto manufacturers Hungary is also already competitive in a number of products—agro-processing, textiles and clothing in EU markets, with 60 percent of its trade with the EU A major structural challenge in the coming years is to strengthen the links between domestic firms and international markets based on competitive conditions and incentives Trends in this direction are favorable However, it will still take many years to close the average income gap between Hungarians and most EU members**

2 1 General Score 3+/4-	The economy is reasonably strong in Hungary, and is poised in 1998 for its highest growth rate (4 percent) since economic reforms were introduced in the late 1980s Increased productivity and competitiveness are being demonstrated in employment figures, as the registered unemployment rate has declined to 10 percent While high this is not abnormal on the European continent The crawling peg exchange rate policy has provided predictability to the devaluation process and official and market rates generally parallel each other with limited variation Given the export-led growth of 1997 the exchange rate does not appear to be undermining industrial exports to Western Europe Debt policy has also been prudent, as privatization proceeds have been utilized to pay down $7 billion in gross external debt since 1995 a more than 20 percent decrease which will have a favorable impact on balance of payments indicators General policy has been effective in narrowing external deficits—the current account deficit reached more than 10 percent of GDP for the 12 months leading up to March 1995 This has been reduced to less than 4 percent today The weak spots are the persistently high inflation rate—17-18 percent in 1997 and likely to stay high for the foreseeable future—and fiscal deficits of nearly 5 percent of GDP The latter is likely to decline to 3 percent in the coming years bolstered by GDP growth and expenditure controls However the inflation rate could delay Hungary s entry into the European Union
2 2 Private Sector Development Score 4	The enabling" environment in Hungary is satisfactory for private sector development, except for high payroll taxes required to finance benefits It is estimated that about 75 percent of GDP comes from the private sector—both new and privatized enterprises—compared with only 20 percent in 1990 Much of the export-led growth of 1997 was powered by multinationals—GM Audi and Suzuki in the automotive sector and IBM in the electrical engineering sector About 40 percent of employment is from firms with less than 10 employees Most people work in services possibly as many as 75 percent of the total work force Among private firms with more than 10 employees, the largest sources of employment are in transport and communications, trade, engineering, agro-processing, and textiles and clothing

2 3 Money, Savings and Credit Score 3+

Monetary policy and the impact it has had on savings and credit has focused on gradual devaluation of the exchange rate through the crawling peg regime introduced in March 1995 a gradual decline in the inflation rate as reflected in slowly declining interest rates but general restrictiveness built into both monetary and fiscal policy The effects are starting to show some benefit, as savings and credit both increased in 1997 without a major increase in the money supply Banks are stronger today than a few years ago with stronger capital positions and new ownership The weak spot is the inflation rate which remains far higher than levels that can be tolerated according to EMU criteria Nevertheless performance compared to targets was fairly close in 1997 which is a favorable accomplishment in light of the Postabank run in early 1997 and the Asia crisis in late 1997 Overall the outlook is reasonably stable with even the high inflation rate somewhat predictable and likely to decline in 1998

2 4 Fiscal Score 3+

Fiscal developments in 1997 showed an increase in the estimated deficit to GDP of 4 7 percent—compared to 3 5 percent in 1996 Because of Hungary s traditional social protection and the high fiscal costs associated with such benefits the government has sought to reduce macroeconomic weaknesses and put financing on a sounder footing via structural reforms that take time to become effective This approach was more loosely followed in the early 1990s which led to significant deficits and erosion of macroeconomic fundamentals Such trends prompted a reversal of policy in 1995 and since then, fiscal policy has become more effective in containing deficits Much of this has resulted from the reduction in subsidies to loss-making enterprises via state-owned banks the accelerated privatization of enterprises and banks and the overall improvement in the economy in 1997 Pension reform introduced in 1997 is also expected to generate net savings to the budget in future years and decades However expenditures are still high as shown in the higher 1997 deficit It will be essential to maintain expenditure control as proceeds from privatization are coming to an end A growing economy should help with revenue collection and this will assist the government in bringing the deficit target down to the 3 percent range in the coming years

2 5 Exchange Rates Score 4-

Exchange rate policy has been relatively moderate, based on a gradually declining rate of devaluation that has been announced on a daily basis since March 1995 The current account deficit was probably about 3-4 percent of GDP, and has narrowed considerably since 1994 in absolute terms as well as in percentage terms of GDP Much of the growth experienced by the economy in 1997 was export-led in the machinery sector suggesting that Hungary s exchange rate is not an obstacle to exports to Western Europe

2 6 Balance of Payments Score 4-

Hungary s balance of payments figures strengthened in 1997 due to a reduced current account deficit, and further reduction in external debt which will save the country future interest payments and thereby help subsequent current account performance The current account deficit narrowed on the strength of improved export performance However imports of industrial machinery were also high While accounting for a current-year deficit, these imports should assist with future efficiency and competitiveness

Section 3 Assessment of Banking Structure and System Profile

III Banking Structure and System Profile
Score 4-

The Hungarian banking system is now virtually wholly private in ownership, governance and management. Foreign banks (generally prime-rated) and investors control 30 of 44 banks, accounting for about 75 percent of capital and assets After-tax earnings increased about 5 percent in 1997, and balance sheet measures—capital, liquidity—and quality indicators—loan portfolio quality—are generally favorable There has been a steady harmonization of laws and regulations with international standards to make the environment conducive to ongoing investment There is evidence that some of the strategic investors are preparing for more aggressive strategies in retail banking, as well as in non-bank financial activities With pressure on margins resulting from intense competition, the implementation of new strategies and some measure of consolidation are likely While some think that Hungary is "overbanked," there is a limited supply of credit available in the market. Trends are favorable for increased lending to the corporate sector However, the net outflow of funds from the banks to the government continues to manifest a disintermediation effect. Households account for nearly 29 percent of funding for banks, yet receive less than 4 percent of loans

3 1 Overview
Score 4-

Hungary's banking system now appears to be relatively well managed under a new incentive structure introduced in the early 1990s—based on BIS guidelines for prudential regulations and international standards of accounting—and significantly reinforced from 1995 on with the termination of government-financed recapitalization programs and a focus on the attraction of strategic investment from foreign banks and institutional investors Balance sheet indicators were sound for the largest banks in mid-1997 most of which were part of the monobank system 10 years ago After-tax earnings increased in 1997, although return measures against assets and equity indicated some sluggishness due to pressure on margins There is significant evidence of competition for large corporate business, as intermediation spreads have dropped considerably from high levels in 1993-95 Upcoming challenges include management depth and capacity as greater risks are assumed in the coming years without government ownership or guarantees, the strategic direction of various banking firms under open and highly competitive conditions the synergies achieved from investment in retail banking and non-bank services and the overall level of consolidation that occurs in terms of both numbers of firms and their respective financial activities

3 2 Ownership
Score 4+

The banking system in Hungary is now about 75 percent owned and controlled by foreign banks and investors Assets, credit and capital are now predominantly foreign-controlled Only the deposit base is still concentrated in predominantly non-foreign institutions Such foreign dominance has been a conscious policy of the government since 1995 to introduce improved governance and management, to achieve sustained capital growth based on strong asset quality and earnings, and to externalize potential lender of last resort requirements The degree of foreign ownership in the banking system is unique for the region, and differentiates Hungary from most countries in the world

3 3 Governance and Management
Score 3+/4-

There is a perception of two levels of governance and management in Hungary in both the financial and the real sector The first applies to the larger blue chip operations largely foreign-controlled, that operate according to recommended international standards and guidelines This would include the prime-rated banks and insurance companies that have established operations in Hungary along with the Hungarian companies listed on the BSE The second applies to the vast majority of Hungarian enterprises that are disconnected from this blue-chip sector, and which are reported to operate in a manner which reflects weak governance—a prevalence of connected and insider transactions—and sometimes poor management—noncommercial decisions which weaken the value of the firm in the long run for the sake of short-term political or other gains Over time the second group is likely to move in the direction of the first as new accounting standards are put in practice, as they seek additional equity in their businesses, and as they attempt to obtain debt financing from banks and other financial institutions However for now the perception of weak governance and management explains why many Hungarian enterprises find it difficult to obtain bank financing In the banking sector there is a perception that governance is strong at the prime-rated institutions due to oversight from parent companies and investors and that this is serving as a catalyst for improved governance at other banks There is a perception that management is strong at OTP although the governance structure is viewed as somewhat diluted and potentially weak At Postabank governance is viewed as weak and management is viewed as politically connected This is clear from the Ft 33 5 billion received from various government entities and the Ft 12 billion guarantee received from the Ministry of Finance Movement towards increasing transparency and disclosure will be required for increasing integration between the blue chip and non-blue chip sectors For the time being, the trend towards improved governance and management is favorable Strategic investment helps and oversight from foreign regulators and board members provides added comfort However there is a sense that foreign investment automatically externalizes much of the risk and responsibility associated with governance and management standards This is partly true but does not exclude the possibility that foreign owners and board members will themselves make serious mistakes that can have an adverse impact on the Hungarian economy For this reason a more active and reciprocal approach will be needed to provide higher levels of confidence that governance and management are satisfactory and strong

3 4 Non-Bank Competition Score 3+/4-

There is limited if any competition for banks in the financial services industry Brokerage firms investment houses and insurance companies attract some resources prompting some disintermediation However, with new legislation, banks are free to enter non-bank activities and they have Likewise non-banks are permitted to enter banking as long as they comply with banking regulations It is expected that over time there will be a consolidation of financial services company shares of assets and deposits which would cut across traditional bank and non-bank classifications However this will take time In the interim it is not expected that there will be significant competition with banks from non-bank institutions

Section 4 Assessment of Banking Sector Development Based on Prudential Norms

IV Banking Sector Development Based on Prudential Norms Score 4-

The Hungarian banking system is generally strong based on financial indicators, but will need some time operationally before it is considered "world class " The trends are favorable, due largely to the attraction of prime-rated strategic investors after the recapitalization and consolidation programs through 1994 Capital is strong, and asset quality is good Liquidity is somewhat constrained by monetary policy, but is becoming more available Markets are functioning well—interbank as well as non-bank—with increasing access to international funds (banks and non-banks), and rising capitalization and turnover in the capital markets Overall, the trends are favorable, and have been since 1995-96 However, several questions remain with regard to (i) the persistence of high inflation rates and continued disintermediation effects resulting from fiscal deficits, (ii) risk management capacity as bank asset structures grow and take on more and diverse risks, (iii) the sustainability of earnings as banks adjust their risk tolerances and venture into activities in which they have limited experience—Hungarian banks from a product standpoint, and foreign banks from a local market standpoint, (iv) the ability to more fully integrate the non-blue chip sector into the export-led part of the economy that is growing, (v) the willingness of mid-sized companies to adapt to international standards of transparency and disclosure to obtain added financing, (vi) the ability of regulatory authorities to monitor for risk in portfolios that can potentially lead to adverse effects on the local economy, and (vii) the overall ability to adapt to rapidly accelerating changes in the global marketplace, including potential capital outflows How these questions are answered will go a long way in determining how quickly Hungary closes the still wide gap in incomes with most EU and OECD members The trends in Hungary are broadly favorable, particularly when compared with the performance of most countries emerging from excessive state controls However, the next several years will test the ability of the banking system and financial sector to transform Hungary from a "transition" or "emerging" market to one which is on an irreversible course towards prosperity and ongoing competitiveness

4 1 Capital Adequacy Score 4

Management practices have been conservative and prudent since 1995 focusing on recapitalization and restructured balance sheets Portfolios are still heavily weighted towards government securities—which are zero risk-weighted according to BIS Although 1997 witnessed some shift into increased lending to corporate customers and reduced lending to the central budget, loans are generally to blue chips Reserves are higher than required to meet the 8 percent minimum risk-weighted capital requirement As portfolios shift to corporate loans—which are 100 percent risk-weighted—this will lead to some capital adequacy adjustments Expansion into retail activities for those planning to pursue that market will also require capital both for investment as well as for some of the risks associated with this expansion (e g commercial/installment credit) Preliminary unaudited statements show own funds —or Tier 1 capital to assets—at nearly 10 percent at end 1997 against 8 8 percent at end 1996 Subordinated loan capital in both years added another 1 7 percent at mid-1997 and 1 6 percent at end 1996 Extraordinary capital injections can no longer be expected from much additional privatization activity From this point forward, capital adequacy will be sustained by retained earnings asset quality and size and the ability to float shares or obtain equity from other sources

4 2 Asset Quality Score 4

Asset quality appears to have improved and overcome many of the hurdles of earlier years when large loan losses undermined earnings Bad loans are but a fraction of earlier tallies—2 1 percent in mid-1997 and 2 7 percent at end 1996 against 13 7 percent at end 1993 Provisioning for loan losses declined in absolute Ft terms as well as on a percentage basis—down 34 percent in 1997 compared with 1996 This could represent under-provisioning particularly as competition has increased and put pressure on net interest margins However, the risk-averse practices of the last two years—limited lending, investment in government securities—suggest that banks were likely not under-provisioning in 1997 However some adjustments in provisioning will likely be required from 1998 on as greater risks are assumed in a wider range of activities

4 3 Management Score 3+/4- One of the main reasons for attracting strategic investors into the banking sector was to improve governance and management Based on Hungary's success in attracting prime-rated institutions, management is likely one of the strongest elements of the Hungarian banking sector However, this is still a period of investment and transformation in Hungary The acquisitions of large banks generally occurred in 1996-97, and investment in new systems, training of staff, and adaptation to new standards and procedures are still underway In addition, universal banking presents a multitude of risks that need to be properly managed and coordinated to contain destabilizing developments and systemic risk

4 4 Earnings Score 3+/4- Preliminary results for many of the largest banks operating in Hungary show a 5 0 percent increase in after-tax earnings for 1997, with OTP accounting for about one quarter of these profits However return on assets declined from 1 37 percent to 1 14 percent, and return on equity declined from 16 3 percent to 11 7 percent Thus, earnings are up, but not return measures Increased after-tax profits derived from improved loan quality (reduced provisions for losses, actual profits) However net interest margins have narrowed as increased competition in the blue chip sector has brought down intermediation spreads Meanwhile operating costs are still high, estimated at nearly 65 percent of interest income plus other revenues Despite reductions in head count over the years, increases in operating costs are due to wage increases in the financial services sector along with increased investment in personnel training and information systems for improved services (e g new technologies for ATMs branches) This should generate incremental earnings and efficiencies in subsequent years, but for now, they constitute expenses

4 5 Liquidity Score 3+/4- With earnings pressure increasing due to heightened competition and narrowing intermediation spreads, there may be some liquidity constraints in the near term However, underlying asset quality is good, and interbank and capital markets are fairly responsive to liquidity needs The share of reserves to total assets declined in 1997, and this might free up additional resources for liquidity purposes However, mandatory reserves still constitute a large proportion of liquid assets, reducing funds available for term lending The internationalization of the banking sector has made banks less dependent on local financing for liquidity needs although local currency financing is not as freely available as it was previous to 1995 This is due to the crawling peg which has had the effect of maintaining money measures but not increasing them in any material way since 1995

4 6 Operating Environment Score 3 Hungary's banking system is perceived to enjoy a high level of public confidence This was true prior to accelerated privatization, when Hungarian households at least believed an implicit guarantee would protect deposit safety at OTP, Postabank and other institutions where retail deposits were held, and among the corporate sector due to the continuous refinancing and recapitalization of state banks from 1991-94 The banking system is now currently majority-controlled by prime-rated foreign institutions, which also instills confidence in the sector However, there are many questions about the effectiveness of financial sector supervision While Hungary's regulatory framework conforms to prudential guidelines rendered by the BIS and the EU, there are questions about the effectiveness of institutional capacity A cooperative agreement with counterpart regulatory authorities has not yet been concluded despite the predominance of foreign banks in Hungary The supervisory agency has only recently been reorganized consolidated, and freed of civil service compensation constraints It will take time to demonstrate the ability to retain qualified and trained regulators to ensure adequate policy within a universal banking context, and to maintain useful and relevant coordination between off-site surveillance and on-site inspection functions Recent changes confirm increased independence and management autonomy, greater numbers of personnel improved compensation and a budget that permits contracting when in-house resources are not sufficient. However, there is a lack of standardization and consistency in supervisory pursuits, and risk management capacity is viewed as fairly weak It remains to be seen how long it will take before regulatory oversight is perceived to be effective in Hungary, particularly in the future when more complex risk-taking financing is evident in the marketplace

4 7 Transparency and Disclosure Score 3

There are some concerns about the lack of full and timely public disclosure of meaningful financial information in Hungary This is less of a problem today than in the early 1990s as Hungary has harmonized legislation and regulations with the WTO, OECD, EU, BIS and other organizations However these standards tend to apply at the larger blue-chip level that is already integrated into the global economy, banking system and capital markets Conclusion of a cooperation agreement with counterpart regulatory authorities would increase confidence in the supervisory oversight of banks The challenge with regard to disclosure and transparency is also directed at HAS and the lack of disclosure in notes associated with statements, the high tax burden carried by companies which provides incentives for barter transactions and understatement of income and traditional reluctance to share information due to fears or concerns about how that information could be used

4 8 Sensitivity to Market Risks Score 4-

National and global events in 1997—namely the bank run on Postabank and the recent Asia crisis—have provided a general endorsement of Hungary's ability to weather crises in a stable manner The run on Postabank did not spread to the system as a whole In fact, the response was beneficial in some ways—a shift of deposits to safer institutions, limited access (if any) of Postabank to the interbank market—although it has been negative in other ways reminiscent of earlier days—a *de facto* bailout from public resources, partly resulting from close political connections With regard to global tremors emanating from the Asia crisis, Hungary showed far less sensitivity than other non-Asian markets Thus, there was no major change in exchange rates and interest rates (or associated policies and bands) nor was there major volatility in the capital and money markets for any extended period of time Much of the underlying strength comes from the immediate benefits of a growing economy This has resulted partly from the structural reforms that have been introduced in recent years—privatization strategic investment, increased competition, recapitalized banks with relatively clean loan portfolios The near-term challenges for banks and regulators include increased competition in retail banking the liberalization and expansion of financial markets (domestically and globally), and general risk management practices and capacity as margins tighten for blue chip customers and banks take on new customers with differing risk profiles

ANNEX 1. A DESCRIPTION OF THE USAID BANK RATING SYSTEM

Ratings Summary for USAID					
Topics/Categories and Description of Coverage	**Description of Ratings**				
	1	**2**	**3**	**4**	**5**
General Description of Ratings • Financial infrastructure • Economic factors and indicators • Banking sector structure and profile • CAMELOTS indicators	Dismal monopolist resistant to competition and change no confidence, widespread corruption weak institutions	Inadequate weak significant improvements needed major potential for destabilization via systemic risks	Adequate, favorable trend improvement needed potential for major systemic risks	Solid strong satisfactory competitive few systemic risks or problems and those are manageable privately owned and managed	Outstanding world class state-of the art best practices virtually no serious systemic risks privately owned and managed

I FINANCIAL INFRASTRUCTURE					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
1 1 Policy/System	Wholly unsupportive of stable, safe and sound banking	Generally unsupportive of stable safe and sound banking, significant improvements needed	Partly supportive of stable safe and sound banking but improvements needed	Supportive of stable safe and sound banking	Wholly supportive of stable safe and sound banking
1 2 Legal	Wholly unsupportive of stable, safe and sound banking and meaningful levels of risk taking	Generally unsupportive of stable safe and sound banking virtually no meaningful levels of risk taking	Fairly supportive of stable, safe and sound banking but implementation deters meaningful levels of risk-taking	Supportive of stable safe and sound banking and meaningful levels of risk taking	Wholly supportive of stable safe and sound banking and meaningful levels of risk taking
1 3 Regulatory and Supervision	Wholly inadequate for prudently managed and supervised banking	Inadequate regulatory framework for prudently managed and supervised banking significant strengthening needed	Adequate regulatory framework for prudently managed and supervised banking but strengthening needed	Solid regulatory framework for prudently managed and supervised banking	Outstanding regulatory framework for prudently managed and supervised banking
1 4 Payments System	Wholly inadequate and undermines integrity of banking system	Inadequate and inefficient systems weaken limited efforts to build up integrity of banking system	Adequate but less than efficient systems support increasing integrity of banking system	Solid systems reinforce integrity of banking system	World class systems reinforce integrity of banking system
1 5 Accounting	Wholly inadequate framework for banking	Unacceptable framework for banking significant improvement needed	Acceptable framework for banking but sophistication needed	Satisfactory framework for banking	Outstanding framework for banking
1 6 Rating Agencies and Systems	Wholly unsupportive of banking sector development	Generally unsupportive of banking sector development	Marginally supportive of banking sector development	Supportive of banking sector development	Wholly supportive of banking sector development

1 7 Financial Media	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth, professionalization and code of ethics needed	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 8 Professional Associations	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 9 Academic	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 10 Miscellaneous	Wholly inadequate and undermines integrity of banking system	Generally unsupportive of banking system significant improvement needed	Only partly supportive of banking system but improving	Supportive and reinforces integrity of banking system	Wholly supportive and reinforces integrity of banking system

II ECONOMIC FACTORS/INDICATORS					
Topics/Categories and Description of Coverage	1	2	3	4	5
2 1 General	Dismal macroeconomic fundamentals undermine banking sector development	Inadequate macroeconomic fundamentals deter risk taking by banks	Adequate macroeconomic fundamentals assist with banking sector stability	Solid macroeconomic fundamentals provide banking opportunities	Outstanding macroeconomic fundamentals reinforce and enhance banking sector
2 2 Private Sector Development	Poor levels of private sector development in formal economy undermine banking development	Growing but inadequate levels of private sector development for sustainable meaningful growth undercut banking sector development	Adequate private sector development supported by favorable trends, but improvements needed	Strong economy based on competitive private sector	World class state of the art economy predicated on innovative, resourceful private sector
2 3 Money, Savings and Credit	Dismal monetary fundamentals wholly undermine banking sector development	Weak monetary fundamentals deter banking sector development	Adequate monetary fundamentals boost confidence but improvement needed	Solid monetary fundamentals contribute to strong banking system	Solid monetary fundamentals shaped by world renowned risk management practices contribute to global standards of banking system competitiveness
2 4 Fiscal	Dismal fiscal fundamentals wholly undermine banking sector development	Weak fiscal fundamentals deter banking sector development	Adequate fiscal fundamentals boost confidence but improvement needed	Solid fiscal fundamentals contribute to strong banking system	Solid fiscal fundamentals contribute to stability in support of banking system competitiveness
2 5 Exchange Rates	Dismal exchange rate fundamentals wholly undermine banking sector development	Weak exchange rate fundamentals deter banking sector development	Adequate exchange rate fundamentals boost confidence but improvement needed	Solid exchange rate fundamentals contribute to strong banking system	Solid and stable exchange rate fundamentals shaped by world renowned risk management practices contribute to global standards of banking system competitiveness
2 6 Balance of Payments	Dismal balance of payments position reflects competitive weaknesses of economy	Poor balance of payments position reflects competitive weaknesses of economy	Adequate balance of payments position reflects growing competitiveness of economy despite weaknesses	Reasonably strong balance of payments position reflects competitive strengths of economy	Enviably strong balance of payments position reflects competitive strengths of economy

III BANKING STRUCTURE AND SYSTEM PROFILE					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
3 1 Overview	Wholly uncompetitive banking system	Poor reputation re competitiveness in the banking system	Adequate reputation for competitiveness in banking but strengthening is needed	Solid reputation for competitiveness in banking	World class status re competitiveness in banking
3 2 Ownership	Monopolist, protectionist banking system resistant to foreign competition and change	Traditionally closed banking system only beginning to open up to foreign competition and change	Adequate levels of competitiveness and performance due to recent trend towards private ownership and management	Reasonably open and generally privately owned and managed banking system respected for competitive position	Open privately owned and managed banking system globally respected for competitive prowess
3 3 Governance and Management	Dismal governance and management undermine banking and economic development	Weak governance and management undermine banking development despite recent but very marginal improvements	Adequate governance and management for banking but improvements needed to achieve global competitiveness in banking	Strong governance and management sustain competitiveness in banking	World class governance and management reinforce and sustain competitiveness in banking
3 4 Non-Bank Competition	No serious competition from non banks further undermines the need for financial discipline	Very limited competition from non banks provide little pressure on banks to exercise financial discipline	Adequate levels of competition from non banks but lack of market breadth and depth limit impact on competitiveness and financial discipline of banks	Satisfactory levels of competition from non banks enhance competitiveness and financial discipline of banks	Significant competition from non banks further strengthens levels of competitiveness and financial discipline of banks

IV BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
4 1 Capital Adequacy	Wholly inadequate capital	Inadequate capital	Adequate capital	Reasonably strong capital	Enviably strong capital
4 2 Asset Quality	Dismal asset quality	Poor asset quality	Adequate asset quality although significant room for improvement	Reasonably strong asset quality	Enviably strong asset quality
4 3 Management	Wholesale disregard for fundamentals of risk management	General lack of awareness of risk management fundamentals	Fairly weak but improving reputation based on emerging risk management capacity in a market showing increasing levels of competition	Reasonably strong reputation based on satisfactory risk management capacity in a fairly competitive market	Enviably strong reputation based on world class risk management capacity in fiercely competitive market
4 4 Earnings	Sustained losses that have decapitalized the banks by IAS	Weak or unstable earnings	Adequate earnings but room for added stability and diversification	Reasonably strong and diversified earnings	Enviably strong and diversified earnings
4 5 Liquidity	Severe liquidity problems	Liquidity problems	Adequate liquidity position but room for strengthening	Reasonably strong liquidity position on an ongoing basis	Enviably strong liquidity position on an ongoing basis
4 6 Operating and Regulatory Environment	Dismal operating and regulatory environment	Poor operating and regulatory environment	Adequate and improving operating and regulatory environment	Reasonably strong operating and regulatory environment	Enviably strong operating and regulatory environment
4 7 Transparency and Disclosure	Dismal standards for transparency and disclosure	Weak standards for transparency and disclosure	Adequate standards for transparency and disclosure	Reasonably strong standards for transparency and disclosure	World class standards for transparency and disclosure
4 8 Sensitivity to Market Risk	Dismal reputation for sensitivity to market risk under market conditions	Poor reputation for sensitivity to market risk under market conditions	Adequate and improving reputation to manage sensitivity to market risk as market conditions increasingly prevail	Strong reputation to manage sensitivity to market risk under market conditions	World class reputation to manage sensitivity to market risk and continuously prosper under market conditions

ANNEX 2 A DETAILED ASSESSMENT OF THE HUNGARIAN BANKING SECTOR

I FINANCIAL SECTOR INFRASTRUCTURE Hungary is on the right track towards financial sector modernization Its policy is open, forward-looking, and anchored in recognition of market globalization trends Recent entry into the OECD, expected formal entry into NATO, and future entry into the EU are all providing ongoing momentum for institutional reform Hungary has privatized aggressively in the last three years with a focus on strategic investment Its legal and regulatory framework for financial services has been harmonized with BIS, EU and other international standards to ensure continued integration into international markets Its payments system is efficient Accounting standards are moving increasingly towards international norms General support organizations which enhance and help sustain market development—rating agencies, professional associations, media, academic and training institutes—all exist or are evolving towards professional standards Only structural weaknesses remain, and general trends in these areas are positive However, the next round of institutional and risk management challenges will determine how effectively Hungary competes in global markets, and how rapidly it narrows the gap in per capita incomes with other OECD countries **Score 3+**

1 1 Policy/System Hungary is generally perceived to be safe, sound and stable for the time being It is quickly joining international organizations that require a commitment to democracy, free trade, and multilateral cooperation Its legal and regulatory structure has been reformed to conform to these prerogatives Likewise, Hungary's economy, banking and overall financial system have undergone considerable reform in less than 10 years There are still risks associated with the country—residual forms of governance, high social welfare costs, high inflation rates, the relatively small size of the economy—but these are generally structural in nature and changing favorably **Score 4-**

- The *political environment* is stable in Hungary, and has been for years Hungary is a parliamentary democracy with a freely elected legislative assembly Parliamentary elections were held in 1990—the first free elections since 1947—and 1994, with the next elections due in May 1998 Hungary is a member of major international organizations such as the World Trade Organization (WTO), European Free Trade Agreement (EFTA), Central European Free Trade Agreement (CEFTA), the World Bank, the International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development (OECD) Hungary was among the first three countries of the former socialist bloc invited to join NATO in 1997 Currently, Hungary is pursuing EU membership, anticipated some time in 2002-05 [1]

- With regard to *legal and regulatory reform*, Hungary has a comparatively well developed legal system for banking and business development This has contributed significantly to the degree of foreign direct investment that Hungary has achieved over the years, making it the best performer in this domain on a per capita basis among transition countries As for banking, significant protection has been afforded to banks and other creditors since introduction of the Bankruptcy Law in 1992 (and subsequent amendments) Hungary is also one of the few transition economies with a reasonably well developed secondary market for asset repossession and disposition when debtors are unable to comply with contractual agreements

- *Economic* developments in 1997 were strongly favorable as Hungary bounced back from weakening

[1] An EU Association Agreement was signed in March 1992, along with Poland and the Czech-Slovak Federal Republic These were the first Association Agreements signed

macroeconomic indicators in 1992-95 and an adjustment period for reforms in 1996 In 1997, GDP growth was estimated to be 3 percent Much of this was export-led in the electrical engineering and automotive sectors

- The *banking* sector continued its march to competitiveness Only one large bank remained severely troubled by end 1997—Postabank The government privatized the last of the five large and previously state-owned commercial banks—K&H—in August 1997 Preliminary results for the major banks in Hungary showed about a 5 percent increase in after-tax profits, but declines in ROA and ROE The declining return trend is due to tightening pressure on margins due to intensified competition, and still high operating expenses The after-tax increase in profits reflects improved loan portfolio quality, and the consequent decline in provisions for loan losses in 1997

- There is growth in capital markets and *non-bank financial institutions* Insurance premiums exceed $1 billion per year New legislation introducing a three-pillar pension system in 1997 is expected to add resources for investment in the capital markets There has also been increasing turnover and market capitalization on the Budapest Stock Exchange (BSE) However, by global standards, the capital markets and non-bank institutions remain relatively small There is also a concern of future risks of decapitalization—net profit transfers out of Hungary by large financial institutions in a small economy—with the steady liberalization of markets now that Hungary is a member of the OECD

- Regarding future developments in the banking sector, there has been some *socio-cultural or historical* enmity towards banking This perception, found in many cultures around the world, is based on the sense that "abnormal profits" are being generated from inside information while much of the population has faced income stress, a reduction in benefits, less job security, and an inability to access credit from banks However, there has been little public opposition to privatization of the banking sector since 1995 Moreover, increased competition in the banking sector is already bringing down margins for those with access to credit If there is a broadening of retail services, as anticipated, this might make the household and small business sectors feel less excluded over time [2]

1 2 Legal Hungary's legislation and judicial infrastructure are considered satisfactory by global standards, and adequate in advance of Hungary's assumption of membership obligations in the EU EU rules and directives on competition, public procurement, intellectual property, and company and accounting laws are virtually completed This applies as well in the financial sector—for banking, as well as in insurance, capital markets and pension funds However, where Hungary still needs strengthening is in the application of commercial law The system is still characterized by delays in many cases due to complex market transactions that make it difficult for courts to process claims in a timely manner **Score 3+**

- *The Law on the National Bank of Hungary* (NBH) became effective in 1987 and legally transformed Hungary from a monobank to two-tier banking system This was earlier than most countries which formerly had close economic ties with the CMEA and former Soviet Union The law assigns responsibility for the implementation of monetary policy to NBH

- A new *Banking Law* became effective on January 1, 1997 Hungary's earlier law was already open—as attested to by the enormous foreign investment in the sector—and conformed to EU guidelines The old law and associated regulations spelled out the requirements of banks with regard to minimum capital, capital adequacy, insider loans, large loans and exposures, classification standards and provisioning requirements, and other common features found in commercial banking laws The new

---

2 However, only about 200,000 middle class or high net worth individuals are currently targeted by most banks if there is any retail strategy at all This represents only about 4-5 percent of the population likely to have accounts with banks

law added three key features (i) stricter requirements of bank management and board members, to assist with improved governance in the future, (ii) a doubling of minimum Ft capital, from Ft 1 billion to Ft 2 billion (about $10 million at end 1997, and slightly higher than EU minimum capital standards), and (iii) greater review in the licensing process

- *The Law on Securities Investment Services and the Securities Exchange* introduced in 1996 is consistent with EU directives[3] and OECD guidelines International standards of corporate governance, accounting and information disclosure are applied in the cases of companies listed on the BSE [4] Hungary has long benefited from significant foreign investment, including portfolio investment Investors are free to transfer capital and earnings in and out of the country as long as tax obligations are complied with The liberalization of current and capital account transactions, a function of OECD membership, has assisted in these developments The Securities Law specifies minimum capital requirements for brokerage firms at Ft 20 million and securities firms at Ft 100 million Investment firms may not acquire more than 10 percent ownership in another investment firm Solvency needs to be maintained on a permanent basis with 5 percent of registered capital held in liquid assets (cash and government securities) Classified risks must be covered by (and expensed as) provisions,[5] and 10 percent of after-tax profits must be placed in general reserves prior to dividend payments [6] Management and board members must meet specified professional standards and criteria for a license to be approved These conditions must be met on an ongoing basis Firms are also required to have an internal control function to monitor for risks, and to regularly report investment service activities to supervisory authorities (on a quarterly basis) Trading book requirements include daily entry of valuations and risks to capital of investment and trading activities The Law on Securities and the Banking Law are reconciled in their provisions in terms of banks' limits on large exposures (and risks), which must be accounted for on a consolidated basis

- Claims on movable properties through *lien perfection* have recently been strengthened with improved *property registration* procedures In May 1997, Hungary introduced a uniform, centralized and computerized property registration system for non-possessory pledges over movable properties Pledgees only need an executory warrant from a court to exercise rights under the pledge agreement Given Hungary's comparatively strong record for avoiding protracted proceedings in commercial disputes involving movable properties, enforcement of such agreements that have been notarized and registered with the courts should provide comfort to creditors Banks were previously hesitant to extend financing on a secured basis to most enterprises due to past problems associated with maintenance of the property registry It is anticipated that improvements in the new system will provide for added comfort, making short-term lending more feasible

- Hungary benefits from the experience and commercial training of specialized bankruptcy judges and liquidators for both *in-court and out-of-court adjudication* Bankruptcy judges handle bankruptcy proceedings, and then appoint liquidators for reorganization when settlements are reached between creditors and debtors These liquidators are qualified, certified, and supervised by a government body In general, commercial cases require seven months to one year to be heard, and another one-two years

---

[3] Seven EEC guidelines are specified as accounted for in preparation of the Securities Act These include (i) 79/279 on criteria for listing on the stock exchange, (ii) 80/390 on harmonization of provisions for stock exchange listing, (iii) 82/121 on regular information published by listed joint stock companies, (iv) 89/298 on harmonization of provisions for public offerings of transferable securities, (v) 89/592 on harmonization of provisions for insider transactions, (vi) 93/6 on capital adequacy of investment service companies and credit institutions, and (vii) 93/22 on securities investment services

[4] These companies have likewise succeeded in accessing capital in foreign markets

[5] Both specific and general risk provisions are specified

[6] This requirement is exempted if general reserve values exceed 150 percent of the value of capital required to be held for the coverage of positions and exposures registered in the institution's trading book, and if there are no negative retained earnings

for a final judgment for the execution of payment Decisions can be appealed There is also an independent right of judicial review of administrative actions initiated by the courts Weaknesses include the lack of capacity to process many claims in a timely fashion

- *Bankruptcy liquidation and foreclosure* procedures are well developed in Hungary Bankruptcy settlements are binding when a majority of creditors holding at least two thirds of claims agree to a reorganization plan with a debtor At that point, the court appoints a liquidator with broad reorganization powers once appointed The Bankruptcy Law of 1992 ushered in a wave of bankruptcies (reorganizations and liquidations) based on strict trigger mechanisms This resulted in 14,060 bankruptcies filed in 1992 alone Subsequent amendments addressed weaknesses in legislation, court procedures, asset stripping, and other problems By 1996, there had been a cumulative 42,127 bankruptcy filings since 1992—36,557 liquidations and 5,570 reorganizations [7] Over the years, Hungary has developed extensive capacity and tested procedures that are considered more than adequate for its growing and now market-based economy This has also translated into a secondary market for *liquidation and repossession* along commercial lines There are several debt collection services companies operating in Hungary, some of which engage in these activities

1 3 ***Regulatory/Supervisory*** Hungary's regulatory framework conforms to prudential guidelines rendered by the Basle Committee for Banking Supervision,[8] as well as more recently with EU directives and guidelines more consistent with "universal" banking practices However, there are questions about the effectiveness of institutional capacity These include the absence of standardization and consistency in supervisory activities, the need for a stronger team concept, and a focus on risk-based supervisory practices The supervisory agency has only recently been reorganized, consolidated, and freed of civil service compensation constraints Prior weaknesses consisted of inadequate coordination between/among differing authorities and oversight functions, and high levels of turnover among trained and qualified personnel Recent changes confirm increased independence and management autonomy, although the agency does not have the power to issue regulations [9] There has been an increase in personnel from about 100 in 1994 to 260 in 1997 [10] Examination fees currently cover the supervision agency's budget Where there are gaps in terms of on-site examination skills or off-site surveillance, private contractors have been brought in to assist [11] However, the use of private contractors frequently is considered to be more like a bank audit than a risk-based examination The Postabank bank run in February 1997 did not cause systemic panic, nor was there any serious evidence of a "contagion" effect from the financial crisis in Asia in late 1997 [12] However, this appears to have had less to do with banking supervision and more to do with the effective market response of depositors, banks, and other sources of financing There are lingering concerns about the disclosure and transparency of weaknesses still resident in some of the banks, and the limited willingness of supervisors to

---

[7] See EBRD *Transition Report 1997*, p 87

[8] This Committee is a formal part of the Bank for International Settlements, or BIS

[9] In practice, the agency is expected to draft the regulations, and the Ministry of Finance issues them

[10] A further increase up to 300 may occur in 1998

[11] In the case of on-site inspections—be they customized and targeted, or regular full-scope examinations—several countries in Europe and elsewhere utilize external auditors as opposed banking supervision department employees Hungary appears to be blending the concept during an interim period, as external auditors and other contractors supplement the efforts of the agency's on-site inspection activities

[12] The BSE index ranged from negative 16 to positive 12, which triggered periodic suspensions in trading of individual stocks The market as a whole did not experience a suspension of trading activity

enforce regulations as needed Hungary still has not concluded a cooperation agreement with counterpart regulatory agencies, raising questions about the real financial condition of some of the banks There are also concerns about a focus on compliance by regulators, rather than risk management The reporting of off-balance sheet contingencies is considered weak, and may represent a layer of risk that is not being adequately provisioned for There are also major gaps between senior management and mid-level management with regard to training and development It will take time before adequate risk management capacity is developed, and before the market perceives regulatory capacity to be wholly effective **Score 3-**

- *Licensing requirements* and regulations were tightened in the banking sector when the new Banking Law became effective on January 1, 1997 The law introduced stricter requirements for bank managers and members of the board, doubled the minimum registered capital for banks from Ft 1 billion to Ft 2 billion, and added a second step to the approval process at the Hungarian Banking and Capital Markets Supervision Agency (HBCMS) The Agency is also responsible for licensing securities firms

- The new Law on Banking, effective January 1, 1997, provides a *clear legal basis and mandate for the Hungarian Banking and Capital Markets Supervision Agency (HBCMS) to supervise* the banks (as well as securities firms) This includes banks as "universal" institutions engaged in insurance, capital markets, real estate investment, pension fund management, venture capital, and other financial services along with traditional banking activities The law provides for the reorganization and consolidation of the supervisory function, previously spread across several institutions, to account for universal banking in Hungary's financial sector The law also enshrines supervisory independence, limiting NBH involvement in banking supervision to monetary and foreign exchange matters However, while HBCMS is expected to draft regulations, it does not have the power to issue them This power is assigned to the Ministry of Finance

- *Penalties* for regulatory non-compliance by bank managers and employees can be assessed, as they can for board members as well However, enforcement in the banking sector as well as in the real sector have been comparatively benign to date Likewise, the supervisory function is still reputed to be focused on compliance rather than risk management—monitoring bank compliance with prudential regulations, rather than evaluating the condition of the banks for safety and soundness, and for the quality of management

- Levels of *disclosure* are adequate for firms conforming to IAS However, there are questions about the level of disclosure required by HAS In terms of banking, disclosure requirements to regulators is considered satisfactory Regular reports are required, and risk management considerations are built into these requirements Where there may be a problem is with disclosure to foreign regulators, and access to information by the markets Confidentiality rules are still in place and observed Thus, while there is an active market in Hungary, limitations on disclosure might contribute to excessive risk-aversion with regard to lending and investment that could be partly reversed with greater disclosure and transparency

1 4 Payments System The payments system functions well in Hungary The system is based on electronic funds transfers—checks are not used The predominance of prime-rated banks in the banking sector combined with significant investment flows and fairly open current and capital accounts all provide confidence in the ability of the payments system to function efficiently **Score 4**

- Hungary has a modern *clearing and settlement* system This has provided the banking system and economy with the benefit of electronic bank transfers, and no major float

- *Management MIS and technology* development related to payments systems are considered sound, as are internal systems, procedures and controls

1 5 Accounting Hungary's accounting standards are evolving increasingly towards international standards These have been in place for Hungary's larger firms—such as most of those listed on BSE They have also been increasingly expected in recent years as Hungary has privatized hundreds of large firms and banks by attracting strategic foreign investors IAS has been a fundamental element of valuations, due diligence, and investment decision-making (both for direct investment and portfolio investment) All the major international accounting firms have been active in the Hungarian market since 1989 Four of the six majors had a total of 1,015 personnel at end 1996, including 45 partners,[13] and 110 accountants chartered or certified in accordance with IAS Meanwhile, there are many more Hungarian accounting firms specialized in local accounting standards While being reasonably strong, these standards are still not considered wholly acceptable by the global marketplace This is due to (i) inadequate disclosure of meaningful information on a consolidated basis, and (ii) the use of legalistic notes that do not provide sufficient financial detail in some cases, resulting in a lack of consistency This sometimes contributes to banks' decisions to not lend to many mid-sized and larger firms
Score 4-

- There is determined movement on the part of the authorities to ensure that *international accounting standards are consistently applied* in the annual reports of large enterprises and all major banks This has been true for the blue chip sector of the economy, and has become a virtual precondition for listing on the BSE due to the amount of investment coming from abroad However, most companies fall outside this sector Hungarian firms generally use HAS, which are considered reasonably strong but do not meet some of the key criteria of IAS HAS weaknesses include insufficient codification, inadequate disclosure requirements,[14] and some inconsistency in asset and depreciation treatments, particularly as they relate to leasing

- The Banking Law is strict in terms of reporting, requiring banks, bank groups and financial holding companies to report to supervisory authorities on a regular basis This is part of the normal reporting process to monitor liquidity and solvency NBH also closely monitors monetary and foreign exchange trends as part of its interest rate and crawling peg exchange rate policy

- There are accounting training programs and institutes in Hungary for international as well as Hungarian accounting standards IAS is largely based on EU standards Many of Hungary's smaller (non-Big 6) accounting firms are certified in IAS as well as HAS The Chamber of Auditors has recently restructured itself Among its 5,000 members, an estimated 200 are trained in international standards

- As of end 1996, five of the six international accounting firms had been located in Hungary since 1989, and all were active in the market There was some evidence of market segmentation among their business practices One firm was heavily focused on consulting, while another had more than half its revenues generated from standard audit and accounting services Other activities of focus include information technologies, corporate finance, due diligence and valuations, and a range of training services Local Hungarian firms tend to focus on audit, accounting, tax and legal services, consulting and payroll

---

[13] 22 of 45 partners were Hungarian

[14] HAS relies on notes as opposed to formal disclosures Notes are sometimes criticized as too legalistic, and not providing sufficient financial disclosure This can also lead to inconsistent treatment of key financial issues across companies

1 6 Rating Agencies/Systems All the major international rating agencies have been active for several years in the Hungarian market Hungary's ratings in February 1998 were generally favorable in terms of the long-term outlook For instance, Moody's ratings—which were unchanged from ratings one year earlier (1996) after having been downgraded in 1995—reflect confidence in the long-term development of the banks based on increased organizational development, reduced problem loans, and increased capital However, Hungary remains below prime for foreign currency deposits **Score 3+/4-**

- Hungary has received ratings from the three major *international rating agencies* on a regular basis for several years Moody's granted Hungary a Baa3 credit rating for long-term bonds in 1996 Standard & Poor's likewise assigned a comparable BBB- rating the same year IBCA followed with a BBB rating in 1997 Moody's ratings for bonds and notes as well as bank deposits were unchanged from one year earlier [15] This keeps Hungary in the lowest "investment grade" level for its long-term bonds—"neither highly protected nor poorly secured"—and short-term notes, but "speculative" in terms of foreign currency bank deposits

- There is likely to be a *domestic initiative* to establish a rating agency for the bills, bonds and other securities and offerings of banks, pension funds, brokerage companies, and other financial institutions Two prospective investments were being discussed in early 1998 There already is a central credit information system specified in the Banking Act which securities firms are also required to join HBCMS also has a rating system for banks, but this is not considered sufficiently standardized and systematic to be useful for market purposes Credit rating information on individuals and companies is generally undermined by the limited availability of useful and meaningful information due to confidentiality concerns

1 7 Financial Media No particular effort was made to assess the financial media However, there are several newspapers that report daily and weekly monetary and financial information This includes interest rates, trade volumes, exchange rates, and other related information No problems regarding the media were reported in terms of chronic rumors that could weaken financial institutions based on unfounded evidence Media coverage during the Postabank run in early 1997 was considered responsible There is some criticism that the media do not devote enough attention to details, or that there is some excessive editorialization However, this is also a criticism of the banking community for not committing sufficient resources to public relations **Insufficient Basis for a Score**

1 8 Professional Associations No particular effort was made to assess associations in Hungary There are several professional associations in Hungary for financial sector individuals and groups One group, the International Training Center for Bankers, provides training and engages in consulting assignments This includes working with HBCMS on inspections and other regulatory matters The Hungarian Bankers' Association also exists, and is considered important in coordinating input from the banks into the legal/regulatory drafting process However, there is limited input from the banking community in building up this association, and the HBA's budget is consequently limited **Insufficient Basis for a Score**

---

[15] Moody's ratings as of February 1998 were Baa3 for long-term bonds, P-3 for short-term notes, Ba1 for long-term bank deposits, and NP (not prime) for short-term bank deposits

1 9 Academic No particular effort was made to assess the number or quality of academic institutions in Hungary Nor was there a systematic effort to speak with business/management school officials However, there are many schools, institutes and think tanks that are able to make a significant contribution to banking sector development Bank managers and others believe that academic institutions now prepare younger students adequately for employment While finance, accounting and management are studied, there is reported to be only one Master's level program in business administration offered in Hungary **Insufficient Basis For a Score**

1 10 Miscellaneous There has been rapid movement towards privatization and modernization of the telecommunications market MATAV has been privatized, and there is competition in the cellular business The telecommunications sector functions well, a necessary precondition if Hungary is to succeed as a "regional platform" for investment and growth Postal services appear adequate, with the added feature of having a 3,200 bank branch network (Postabank) Safekeeping from a physical and logistical standpoint appears adequate, although no systematic effort was made to review this In general, Hungary has made a strong effort in recent years to provide an enabling environment conducive to growth **Score 4**

- The privatization of MATAV plus demonopolization in the sector has already demonstrated improvements in *telecommunications* system capacity Outgoing phone calls have increased in recent years, partly reflecting improved capacity and investment in infrastructure Total calls were 2 35 billion in 1994 In 1996, they were 3 44 billion Total calls were estimated to be 3 73 billion in 1997, a nearly 60 percent increase from 1994

- The postal system is considered adequate According to the 1995 Law on Privatization, the postal system will remain state-owned, one of the 50 or so companies to remain in state hands by the end of 1998 However, it is uncertain how this will impact the fate of the postal system's bank branches (Postabank) Postabank's future is currently unclear, with periodic references to it being acquired after the early 1997 run on deposits However, no major change in its ownership or management structure is expected, at least until after elections are held in May, 1998

- No effort was made to review the safekeeping practices of banks No major complaints were made about the payments system, nor was there mention of float problems associated with inefficient clearing and settlement One area where safekeeping might need to be strengthened is with the private pension funds that were introduced in 1993 Apparently, there is nothing mandatory about placing funds in third-party custodial services—such as in bank vaults for protection as needed

II ECONOMIC FACTORS AND INDICATORS Hungary has an open economic system that is increasingly private sector-oriented in terms of ownership Competition policy is generally harmonized with EU legislation, although some trade protection was still in effect in mid-1997 This involved import ceilings on about 20 types of products, mostly clothing, cars and vans, and textiles, footwear and precious metals There are still licensing requirements as well for the import and export of energy and many agricultural products, the importation of cars, and the exportation of pharmaceuticals However, most quantitative restrictions on imports and exports were removed in 1989-91, and state trading monopolies were substantially removed in 1989, ahead of all other transition countries Thus, remaining barriers are expected to disappear or diminish in importance over time as Hungary complies with WTO, EU and CEFTA Agreements Structurally, there is a disconnect in the 14 percent of GDP that originates with foreign-controlled enterprises, and the balance of the economy that remains only loosely connected to this segment Building stronger links between Hungarian-controlled enterprises and foreign ones represents a key structural challenge in the coming years for rising competitiveness and incomes, and in anticipation of entry into the EU There is already some evidence of movement in this direction in some sectors, such as suppliers to the major auto manufacturers Hungary is also already competitive in a number of products—agro-processing, textiles and clothing in EU markets, with 60 percent of its trade with the EU A major structural challenge in the coming years is to strengthen the links between domestic firms and international markets based on competitive conditions and incentives Trends in this direction are favorable However, it will still take many years to close the average income gap between Hungarians and most EU members **Score 3+/4-**

2 1 General The economy is reasonably strong in Hungary, and is poised in 1998 for its highest growth rate (4 percent) since economic reforms were introduced in the late 1980s Increased productivity and competitiveness are being demonstrated in employment figures, as the registered unemployment rate has declined to 10 percent While high, this is not abnormal on the European continent The crawling peg exchange rate policy has provided predictability to the devaluation process, and official and market rates generally parallel each other with limited variation Given the export-led growth of 1997, the exchange rate does not appear to be undermining industrial exports to Western Europe Debt policy has also been prudent, as privatization proceeds have been utilized to pay down $7 billion in gross external debt since 1995, a more than 20 percent decrease which will have a favorable impact on balance of payments indicators General policy has been effective in narrowing external deficits—the current account deficit reached more than 10 percent of GDP for the 12 months leading up to March 1995 This has been reduced to less than 4 percent today The weak spots are the persistently high inflation rate—17-18 percent in 1997, and likely to stay high for the foreseeable future—and fiscal deficits of nearly 5 percent of GDP The latter is likely to decline to 3 percent in the coming years, bolstered by GDP growth and expenditure controls However, the inflation rate could delay Hungary's entry into the European Union **Score 3+/4-**

- *Real GDP growth* was estimated to be 3 percent in 1997, the biggest increase since 1994 Growth was powered by exports—largely in electronic machinery (hard disk drives, video screens—final products) and in the automotive sector (intermediate products mainly exported to Germany) Initial projections for 1998 are that Hungary will experience real GDP growth of 4 percent This would be the highest growth since economic reforms began in the late 1980s

- The registered *unemployment* rate is 10 percent, slightly lower than rates from earlier years This equates with about 445,000 people being out of work [16] Productive *employment* is a more difficult measure to gauge About two thirds of the registered unemployed are skilled or semi-skilled However, industrial productivity has increased in recent years Likewise, in the financial services industry, there has been a significant reshuffling of the labor force Operating expenses are high, but this is partly related to the training of personnel, and investments in technologies, systems and other factors that are expected to enhance efficiency and productivity in the coming years Many people who worked for state-owned banks were let go Thus, declining unemployment rates are viewed as a positive sign not only by themselves, but because the labor force is now more productive when employed than before

- *Inflation rates* have been high for years, although they have declined considerably since 1995 That year the inflation rate exceeded 28 percent In 1997, the inflation rate (CPI) was about 17 percent [17] This is still high by European standards, and is likely to extend the crawling peg exchange rate policy into the early part of the next century Such high inflation rates may also delay entry into the EU

- *Exchange rates* have been set by a pre-announced crawling peg regime since March 1995 The exchange rate is devalued on a daily basis within a specified band—from 0 06 percent daily through mid-1995 to steadily declining levels which reached 0 033 percent in August 1997 The policy appears to have worked in stabilizing exchange rate movements, and the gap between official and market rates has diminished significantly In 1995, the official devaluation of the central rate was 29 86 percent against a basket of DM and dollars—70 percent and 30 percent, respectively, from January-September, 1997 [18] The market devaluation was 24 33 percent In 1996, the official devaluation was 15 76 percent, compared with 15 89 percent in the market By September 1997, official devaluation was 10 04 percent for nine months, compared with 9 96 percent in the market In terms of year-end exchange rates against the dollar, the Ft has lost half of its nominal value in four years, from 101 in 1993 to 204 in 1997

- *Fiscal deficits* were fairly deep throughout most of the 1990s due to high social welfare costs (social security), high overall expenditure to support loss-making state banks and enterprises, and the avoidance of tax payments by many companies and households Fiscal deficits remained high and increased in 1997, to 4 7 percent of GDP

- *Debt and debt service* are now under control Hungary has prepaid significant amounts of external debt—gross external debt has declined from nearly $32 billion in 1995 to $25 billion at September 30, 1997[19]—largely from privatization proceeds This bodes well for future current account measures, and should likewise contribute to a decline in interest rates over time Debt service as a percent of the current account peaked in 1994 at nearly 55 percent This declined to a bit more than 50 percent in 1996 With increased exports and reduced external debt, it is anticipated that the debt service ratio will have declined further in 1997 However, about two thirds of Hungary's debt is medium- and long-term More than $11 billion in principal payments will come due from 1998-2003

---

[16] The figure was 10 3 percent at September 30, 1997 This was based on 458,620 people registered as unemployed

[17] PPI rates were about 18-19 percent in 1997

[18] The basket proportion may have been reversed since September 1997 Prior to 1997, the currency basket included 50 percent dollar and ECU (December 1991-July 1993), 50 percent dollar and DM (August 1993-May 1994), 70 percent ECU and 30 percent dollar (May 1994-December 1996) proportions

[19] About 60 percent of total external debt is held by NBH and the government The balance is in the corporate sector

Table 1 General Economic Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Real GDP Growth	-3 5%	-11 9%	-3 1%	-0 6%	2 9%	1 5%	1 0%	3 0%	4 0%
Per Capita Incomes									
GDP in $	3,179	3,242	3 617	3 748	4 069	4,286	4,357	4,337	4 425
PPP in $	6,230	6 500	6,350	6,260		6,410			
Registered Unemployment	1 9%	7 5%	12 3%	12 1%	10 4%	10 4%	10 5%	10 2%	9 8%
Inflation Rate—CPI (yr-on-yr)	33 4%	32 2%	21 6%	21 1%	21 2%	28 3%	19 8%	17 0%	14 0%
Yr-end. Exchange Rate									
Ft DM*	39	45	51	56	65	97	106	110	
Ft US$	61 5	76	84	101	111	139 5	165	204	228
Fiscal Deficit/GDP	+0 4%	2 2%	5 5%	6 8%	8 2%	6 5%	3 5%	4 7%	4 1%
Debt Service/Current Account	48 2%	33 9%	34 4%	43 2%	54 8%	47 3%	50 4%		
Total Debt/GDP	64 3%	67 8%	57 6%	63 7%	68 4%	72 4%	62 0%	57 0%	57 6%
Gross External Debt* in $ bn.		22 6	21 4	24 6	28 5	31 7	27 6	25 1	

* *Note* Ft DM exchange rate for 1997 at September 30 1997, Ft DM exchange rate is average rate from 1990-94 gross external debt for 1997 is at September 30 1997
Sources NBH EBRD, OECD, World Bank Credit Suisse First Boston *The Economist*

*2 2 **Private Sector Development*** The "enabling" environment in Hungary is satisfactory for private sector development, except for high payroll taxes required to finance benefits It is estimated that about 75 percent of GDP comes from the private sector—both new and privatized enterprises—compared with only 20 percent in 1990 Much of the export-led growth of 1997 was powered by multinationals—GM, Audi and Suzuki in the automotive sector, and IBM in the electrical engineering sector About 40 percent of employment is from firms with less than 10 employees Most people work in services, possibly as many as 75 percent of the total work force Among private firms with more than 10 employees, the largest sources of employment are in transport and communications, trade, engineering, agro-processing, and textiles and clothing **Score 4**

- *Sector value-added* in the Hungarian economy has experienced a shift increasingly towards services Services accounted for about 62 percent of value-added in 1990, rare for transition countries where the economies had emphasized heavy industry for decades and often lacked a viable service sector Today, it is estimated that services account for more than 70 percent of GDP in Hungary However, part of this shift is also due to adjustments that have been made in the industrial sector With new investments and reduced head count, Hungary is restoring industrial competitiveness In the manufacturing sector, labor productivity is now estimated to approximate 140 percent of 1989 levels based on significant labor redeployment to the service sector, and the retooling of plant and equipment Thus, industry may increase from its roughly 24 percent share of total GDP in 1995 Agriculture is estimated to account for only about 6 percent of GDP As for *employment*, 3 95 million were employed in income-generating activities, considered to be about 55 percent of the economically active population between 15-74 years of age About 63 percent are employed in services, 31 percent are in industry, and 6 percent are in agriculture based on employment figures from firms with more than 10 employees [20]

[20] These figures are based on a distribution of staff groups employed by enterprises with greater than 10 employees plus all public administration units This accounts for only 64 percent of those employed, and only 58 5 percent of the economically active population It is likely that the service sector absorbs more than 70 percent of the work force

- Private sector value-added and employment are both high, and have been growing steadily through the 1990s Overall *private sector value-added* was estimated to be about 75 percent in 1997, compared with 58 percent in 1993 (which was comparatively high in the region at the time) and only 20 percent in 1990 Private sector growth has resulted from a combination of reduced subsidies to loss-making state enterprises—either directly from fiscal sources, or through banks—more open competition, and accelerated privatization of both enterprises and banks The privatization of large-scale enterprises has accelerated since late 1995, and this has combined with the growth of new and small private firms to transform Hungary into a private sector-oriented economy Privatization has involved industrial enterprises, banks, utilities, telecommunications, and the energy sector By end 1998, all but about 50 companies are expected to be in private hands There were 792,824 active firms registered in October 1997, of which 58 percent were sole proprietorships, 15 percent were limited liability companies, and another 15 percent were limited partnerships Among the total active firms, there were 767,229 small private firms with fewer than 11 employees operating in a country with an active labor force of 4 3 million Thus, it is likely for the foreseeable future that the private sector which the banking sector will target includes about 25,000 firms, and as few as about 6,700 if the focus is on companies with more than 50 employees *Employment in the private sector* was estimated to be about 3 1 million, or 73 percent of the economically active population at September 30, 1997 Among those working for firms with more than 10 employees, private sector employment appeared greatest in transport and communications, trade, engineering, agro-processing, and textiles and clothing One-third of the labor force is unionized

- *State sector value-added and employment* represent a steadily declining segment of the economy Notwithstanding the high level of fiscal expenditure to GDP, state shares in the economy have been declining for years Subsidy reduction combined with privatization have been largely responsible for the shrinking share of state sector value-added, which was down to about 25 percent of total 1997 GDP This is consistent with broad OECD norms By end 1998, only about 50 companies are expected to remain state-owned—these include the postal system, the railways, and the electricity company (MVM) which holds the national grid Employment in the state sector was estimated at 830,000, or about 20 percent of the economically active population These jobs are primarily in public administration and social security, education, health and social security, and other community, social and personal service activities

Table 2 Private Sector Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
GDP ($ bn)	33 1	33 4	37 3	38 6	41 7	43 7	44 6	44 4
o/w Agriculture (%)	9 6	7 8	6 5	5 8	6 0	6 4		
o/w Industry (%)	28 8	26 7	24 4	23 2	22 8	23 9		
o/w Services (%)	61 6	65 5	69 1	71 0	71 2	69 7		
Private Sector GDP ($ bn)	6 6	10 0	18 7	22 4	25 0	28 4	32 1	33 3
State Sector GDP ($ bn)	26 5	23 4	18 6	16 2	16 7	15 3	12 5	11 1
Employment ('000)*			4 290	4,058	4,002	3 976	3,989	3,944
o/w Private Sector ('000)								3 114
o/w PS in Agriculture('000)								158
o/w PS in Industry ('000)								781
o/w PS in Services ('000)								2 174

* *Note* 1997 figures are from September 30 1997 1997 private sector figures are estimates

Sources NBH, EBRD, OECD, World Bank, Credit Suisse First Boston

*2 3 **Money, Savings and Credit*** Monetary policy and the impact it has had on savings and credit has focused on gradual devaluation of the exchange rate through the crawling peg regime introduced in March 1995, a gradual decline in the inflation rate as reflected in slowly declining interest rates, but general restrictiveness built into both monetary and fiscal policy The effects are starting to show some benefit, as savings and credit both increased in 1997 without a major increase in the money supply Banks are stronger today than a few years ago, with stronger capital positions and new ownership The weak spot is the inflation rate, which remains far higher than levels that can be tolerated according to EMU criteria Nevertheless, performance compared to targets was fairly close in 1997, which is a favorable accomplishment in light of the Postabank run in early 1997 and the Asia crisis in late 1997 Overall, the outlook is reasonably stable, with even the high inflation rate somewhat predictable and likely to decline in 1998
Score 3+

- *Policy design and implementation* are the responsibility of the NBH Monetary policy is based on sustaining the crawling peg exchange rate through its interest rate policy NBH utilizes a wide range of monetary instruments to implement such policy, mostly repurchase (overnight to one week) and reverse repurchase agreements (overnight to one month), money market instruments (6-12 months), and Treasury bills and bonds (up to five years) Policy is focused on a gradual reduction in the inflation rate, which is still high at about 17-18 percent, but was as high as 28 percent in 1995

- *Data collection and forecasting* appears adequate Hungary has a high inflation rate, but monetary policy is dedicated to bringing this rate down on a gradual basis

- Hungary has taken *regional and global considerations* into account since efforts began in the early 1990s to be positioned for membership in the WTO, OECD, EU, and other international and multilateral groups Membership in the WTO (1994) and OECD (1996) have shaped much of Hungary's overall approach to trade and investment Particularly in terms of investment, Hungary has shown outstanding performance on the FDI front Much of its institutional transformation is being driven by anticipated membership in the European Union Thus, achieving Maastricht criteria will be important for membership This will ultimately mean a decline in the inflation rate from current high levels to the lower levels found in the EU On other accounts—debt to GDP and the fiscal deficit—Hungary is much closer to achieving EU targets With regard to structural reform in the financial sector, Hungary is in step with EU countries on legal/regulatory issues, and far ahead of most countries around the globe in terms of openness to foreign investment and foreign ownership of the banking sector

- *Management* of monetary resources is the responsibility of NBH and based on the crawling peg exchange rate through interest rate policy

- There is adequate *liquidity* in the banking system, and 1997 witnessed a slight shift away from securities to the lending market Savings increased, and households are now beginning to place more funds in banks in Ft deposit accounts The interbank market is well developed, albeit only about 8 percent of total banking system resources Interbank rates closely correlate with trends in the NBH refinancing rate The interbank market has also generally cut off Postabank from the market after concerns were raised in early 1997 about its condition [21] Banks are generally required to hold about 30 percent of liquid assets in reserve to honor withdrawals upon demand

---

[21] There was a run of about Ft 25 billion ($150 million at the time) in deposits from Postabank in February 1997 Concerns about its solvency derive from problems associated with real estate investments, investment stakes in troubled companies, and bad loans

- *Deposits* began to increase again in 1997 after a general decline in deposits (and financial intermediation) from 1993-96 The earlier declining trends mainly affected the enterprise and private sector—deposits declined by 20 and 10 percent, respectively, in real terms during this period [22] Household savings likewise increased in banks in 1997, signalling a shift away from securities investments in favor of Ft deposit instruments

- *Credit* declined in real terms from 1993-96, largely due to high mandatory reserve requirements approximating 30 percent of liquid assets, the introduction of additional government securities to finance budget deficits, and the generally high costs of intermediation Corporate sector credit declined about 15 percent due to high intermediation costs From 1993-95, corporate credit was increasingly sourced from abroad—from 24 percent in 1993 to 44 percent in 1995 However, local credit as a share of total increased in 1996 as intermediation spreads declined and real activity increased By mid-1997, corporate credit accounted for 60 percent of total bank credit The household share of credit declined from 15 percent in 1993-94 to 8 4 percent in mid-1997 Much of this is due to the absence of significant mortgage lending, although new mortgage lending incentives are expected to relieve some of the constraints on lending to households over time Most credit is short-term due to prudent risk aversion—tightened bank lending practices in the face of concerns about high inflation rates, and inadequate information in assessing the creditworthiness of local firms under commercial conditions Only about 29 percent of loans now exceed one year in maturity, compared with 39 percent in 1993

- *Rates* have generally declined since 1996 and spreads have narrowed considerably Interest rates on deposits and loans were freed of administrative restrictions in 1987 for enterprises, and 1991-92 for households Thus, pricing in credit has been liberalized for years With increasing competition, particularly for "blue chip" business, net margins have come down to the nominal 4-5 percent range compared to 9 percent in 1994-95 In some cases, banks are reported to be taking spreads barely above zero, and even sometimes negative spreads on loans to blue chip customers in efforts to increase/retain market share, build goodwill with the enterprise, or obtain fee-income business that makes the relationship profitable to the bank on a consolidated basis This market has been estimated to total 300 firms in Hungary—of which about 40-50 are multinationals, and another 250 or so are Hungarian [23] Declining intermediation spreads are due to several inter-related factors, mostly increased competition from foreign large and mid-sized banks, improved loan portfolios, strengthened capital positions, the termination of financing of loss-making enterprises through banks, and the limited number of blue chip customers available in the marketplace for banks

---

[22] See "Hungary Economic Policies for Sustainable Growth," IMF Occasional Paper 159, February 1998, pp 81-82

[23] Other figures reduce this to as a low as about 75 firms in total

Table 3 Money, Savings and Credit Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
Money Supply Growth (%)								
Broad Money/GDP (%)*		47 4	51 2	49 6	45 5	42 8	42 1	42 0*
Year-end Base Interest Rate (%)						28 0	23 0	20 5*
Commercial Bank Rates (Ft)								
Interbank < 30 days (%)				21 8	31 3	27 8	23 2	20 4*
3-month T-bill (%)				24 3	31 6	30 1	21 7	19 4*
One-year time deposit (%)	28 5	29 4	16 1	16 6	22 9	24 4	18 6	16 9*
One-year loan (%)	32 1	35 5	28 8	25 6	29 7	32 2	24 0	21 0*
Net Domestic Credit/GDP (%)	82 4	73 9	70 3	67 7	64 0	49 9	51 3	50 4*
o/w Claims on Gov't	36 1	35 1	39 3	39 3	37 5	27 1	26 0	24 9*
o/w Claims on SOEs								
o/w Claims on Private Sector								

* *Notes* Rate figures are weighted average figures annualized at September 30 1997 broad money (M2) figures are estimated for 1997, NBH base rate is for September 15, 1997, net domestic credit figures are estimates for 1997
Sources NBH EBRD, OECD

2 4 Fiscal Fiscal developments in 1997 showed an increase in the estimated deficit to GDP of 4 7 percent—compared to 3 5 percent in 1996 Because of Hungary's traditional social protection and the high fiscal costs associated with such benefits, the government has sought to reduce macroeconomic weaknesses and put financing on a sounder footing via structural reforms that take time to become effective This approach was more loosely followed in the early 1990s, which led to significant deficits and erosion of macroeconomic fundamentals Such trends prompted a reversal of policy in 1995, and since then, fiscal policy has become more effective in containing deficits Much of this has resulted from the reduction in subsidies to loss-making enterprises via state-owned banks, the accelerated privatization of enterprises and banks, and the overall improvement in the economy in 1997 Pension reform, introduced in 1997, is also expected to generate net savings to the budget in future years and decades However, expenditures are still high, as shown in the higher 1997 deficit It will be essential to maintain expenditure control as proceeds from privatization are coming to an end A growing economy should help with revenue collection, and this will assist the government in bringing the deficit target down to the 3 percent range in the coming years **Score 3+**

- Fiscal *policy design and implementation* are currently focused on gradual reduction of the fiscal deficit in concert with a monetary policy that is focused on a gradual reduction in the inflation rate Much of the improvement in the fiscal picture since the 1992-95 period—when deficits to GDP ranged from 5 5 percent to 8 2 percent—has come from expenditure controls resulting from reduced subsidization of loss-making enterprises, and a tightening of varied forms of tax relief[24] Overall subsidies as a percent of GDP have diminished from 7 percent in 1990 to about 3 8 percent in 1995-96[25] However, much of the fiscal problem remains the expensive social welfare system, the reform of which has faced significant political and judicial opposition Costs are driven up by comparatively generous retirement benefits Deficits are persistent because efforts to tighten welfare benefits or to broaden the contribution base have been rejected This has led to significant borrowings in the securities markets by the health and pension funds Over time, it is expected that the recently adopted

[24] For example, tax incentives for foreign investors have been phased out except for investments in poorer regions
[25] See EBRD *Transition Report 1997*, p 83

three-pillar pension system will eradicate many of the financial weaknesses embedded in the traditional pay-as-you-go system However, for the moment, and until there is a sustained virtuous circle, it will likely be difficult for Hungary to bring its fiscal deficit down to the EU target of 3 percent of GDP

- *Data collection* and accuracy of *forecasting* are considered adequate Both revenue and expenditure figures are reasonably close to target NBH monthly reports provide adequate disclosure of these movements, and variances when they occur

- *Regional and global considerations* are taken into account in policy and planning Above all with regard to fiscal policy, Hungarian officials are aware of the 3 percent fiscal deficit target that is one of the four key Maastricht criteria for joining the European Monetary Union

- Budgetary processes and procedures are still generally *centralized* There is some movement towards municipal bond markets, but these are at the embryonic stage right now Local control over some utilities has been implemented as part of the country's privatization program Thus, there is some *decentralization*, and the trend towards increasing municipalization is likely to continue However, for the time being, most processes and procedures will remain centralized for the foreseeable future in this country of 10 million people

- *Collection* of tax revenues is based on fairly high personal income tax rates as high as 42 percent, a two-tiered VAT system (at 12 and 25 percent rates), and excise taxes on alcohol, tobacco and fuel In 1995, Hungary halved the corporate tax rate to a comparatively low 18 percent to reduce under-reporting of income, and to encourage greater compliance with payment requirements However, corporate compliance is still questionable due to the high contributions required of companies into payroll tax contributions for pensions, health, unemployment insurance and vocational training In 1997, these stood at 47 percent of wages for enterprise employers, and another 10 percent for employees The dividends tax rate is 20 percent Overall, central government revenues are estimated to have risen from 27 percent of 1994 GDP to nearly 34 percent of GDP in 1996 Collections may have declined in 1997 as a percentage of GDP, partly reflecting the easing of some rates combined with the increase in GDP The fiscal deficit increased from 3 5 percent in 1996 to 4 7 percent in 1997 despite reduced expenditures as a proportion of GDP

- NBH *reports* on a monthly basis on public finance This includes a variance analysis of actual and targeted central budget figures, the financial condition and movements of the social security funds, and the financing requirements of government in general The *Monthly Bulletin of Statistics* also reports central government figures in a timely manner

- *MIS* for fiscal matters appear satisfactory based on data reported, and the overall improvement of fiscal matters since 1996

- *Fraud and corruption* were apparently a greater problem in the early and mid-1990s due to a declining economy, higher corporate tax rates, administrative obstacles for licenses and permits, and a more general prevalence of underground economic activity The share of the unofficial economy in GDP was estimated to range from 27-33 percent from 1989-95 [26] While there is no definitive way to measure the full extent of fraud and corruption, it appears that problems are less severe today as a result of lower corporate tax rates, an improved economy, rising incomes, and fewer administrative and bureaucratic obstacles for small businesses

---

[26] See EBRD *Transition Report 1997*, p 74

Table 4 Fiscal Indicators

(Ft billion)	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total Expenditure*	642	831	990	1,241	1,513	1,729	2,206	1,870	
Total Revenue*	641	716	793	1 041	1,191	1 595	2,288	1,625	
Budget Deficit*	1	115	197	200	322	134	-82	245	
General Fiscal Deficit/GDP	+0 4%	2 2%	5 5%	6 8%	8 2%	6 5%	3 5%	4 7%	4 1%

* Central government figures 1997 figures are through September 30, 1997

Source EBRD Credit Suisse First Boston

2 5 Exchange Rates Exchange rate policy has been relatively moderate, based on a gradually declining rate of devaluation that has been announced on a daily basis since March 1995 The current account deficit was probably about 3-4 percent of GDP, and has narrowed considerably since 1994 in absolute terms as well as in percentage terms of GDP Much of the growth experienced by the economy in 1997 was export-led in the machinery sector, suggesting that Hungary's exchange rate is not an obstacle to exports to Western Europe **Score 4-**

- Exchange rate *policy design and implementation* have been based on a crawling peg formula since March 1995 This formula sets a pre-announced daily devaluation of the Ft against a basket of currencies—in 1997, this consisted of the DM (70 percent) and the US dollar (30 percent) The Ft central rate is devalued daily at a pre-announced rate Cumulative devaluation is 1 percent per month within a band of plus/minus 2 25 percent Exchange rates at year-end 1997 for the dollar were Ft 204 There were Ft 110 to the DM at September 30, 1997

- *Data collection and forecasting* have generally been considered strong If there are weaknesses in data collection, these have more to do with the level of "informal" sector activity which is not captured in official statistics However, in terms of exchange rates, Hungary has not experienced major shocks of the sort experienced by currencies in neighboring countries when the market perceived that currencies were overvalued The Ft has been convertible for most current and capital account transactions since 1995-96 in preparation for OECD membership in 1996 These developments, increasing exports and direct investment, and limited "contagion" effects from Asia or neighboring countries during periods of financial sector and economic crisis in 1997 suggest that Ft exchange rates are reasonable under current circumstances, and that data collection and forecasting have met reasonable tests for accuracy There is now little differentiation between official and market rates

- The crawling peg exchange rate policy is adjusted to reflect movements in the DM and dollar, and previously the ECU It is expected that the Euro will replace the DM in the current basket of currencies Thus, policy and units of measure reflect Hungary's focus on *regional and global* considerations in the development and implementation of its exchange rate policy

- *Risk management* practices are considered satisfactory No major open positions are allowed at the banks NBH continues to monitor bank portfolio and liquidity measures to ensure that potentially destabilizing positions are avoided Banks and companies are thought to routinely hedge their foreign currency risk There is some concern with regard to banks' off-balance sheet contingencies, although no major problems have surfaced to date

- Foreign *reserves* were about $8 8 billion at end 1997, about $1 billion less than at end 1996 The December 1997 figure equates with about five months of merchandise imports, down from earlier figures However, reserves for the time being are viewed as satisfactory, particularly in light of the reduction in debt since 1994

2 6 Balance of Payments Hungary's balance of payments figures strengthened in 1997 due to a reduced current account deficit, and further reduction in external debt which will save the country future interest payments and thereby help subsequent current account performance The current account deficit narrowed on the strength of improved export performance However, imports of industrial machinery were also high While accounting for a current-year deficit, these imports should assist with future efficiency and competitiveness **Score 4-**

- *Current account* movement was favorable in 1997 While the country still had a deficit on the order of 3-4 percent of GDP, this was about half the absolute deficit of 1994 when macroeconomic indicators began to show serious problems of international competitiveness Hungary showed strong export performance, particularly in industrial machinery—automotive and hard disk drive exports are cited as key contributors Imports of industrial machinery also increased significantly, yet this is expected to have a favorable effect on future economic performance

- The *capital account* was liberalized in April 1995, and this showed in the growing proportion of corporate foreign exchange deposits From April 1995, companies were not required to surrender their export earnings for local currency Concerns about high inflation and the benefits of interest rate differentials from foreign currency deposits led to higher foreign exchange deposits However, since 1996, local currency deposits have increased as the crawling peg exchange rate policy has increased in credibility, and as requirements for the purchase of foreign exchange for households have been relaxed Meanwhile, the capital account position has improved with the reduction in external debt to about $25 billion It was as high as $32 billion at end 1995, and debt service negatively affected current account performance Foreign *reserves* declined by about $1 billion in 1997, but are at levels equivalent to about five months of 1997 merchandise imports

- *Portfolio flows* have fluctuated since 1993, with statistics indicating major inflows in 1994-95 but net outflows in other years beginning in 1993 Currently, there is money held in Hungary to take advantage of comparatively high interest rates In general, Hungary has benefited from a significant net inflow of foreign capital for both long-term investment purposes, and short-term portfolio purposes

- *Direct investment* has been strong for years due to interest from foreign investors Hungary has enjoyed the highest FDI per capita figures among transition economies, at nearly $1,300 from 1989-96 [27] Total FDI in 1997 was estimated to be $2 billion, which would raise FDI per capita to $1,500 since 1989 There is now little future FDI to be derived from privatization Thus, if it is to come, the next wave of FDI will have to be for new ventures, or incremental FDI in existing ventures

[27] This compares with $692 in the Czech Republic, $477 in Estonia, and $372 in Slovenia Larger countries in the region have fared poorly Poland's FDI per capita was only $140 during this period, although increases are expected from 1997 Russia's FDI per capita was only $40 during this period, lagging behind oil-producing FSU states—Kazakstan, Azerbaijan and Turkmenistan See EBRD *Transition Report 1997*, p 126

Table 5 Balance of Payments Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
Merchandise Trade Balance ($ bn)	0 3	0 2	-0 1	-3 2	-3 6	-2 4	-2 6	-3 0
Current Acct. Balance ($ bn)	0 1	0 3	0 3	-3 5	-3 9	-2 5	-1 7	-1 9
Remittances/Transfers ($ bn)	0 7	0 9	0 9	0 7	0 9	1 1	0 9	
Capital Account and Reserves ($ bn)				2 7	3 7	1 3	-0 3	
Portfolio Flows ($ bn)				-0 3	0 8	0 2	-1 1	-1 3*
Direct Investment ($ bn)								
o/w Domestic								
o/w Foreign	0 3	1 5	1 5	2 3	1 1	4 5	2 0	1 4*

* *Note* Figures for 1997 are from September 30 1997

Sources NBH, EBRD, OECD

III BANKING STRUCTURE AND SYSTEM PROFILE The Hungarian banking system is now virtually wholly private in ownership, governance and management Foreign banks (generally prime-rated) and investors control 30 of 44 banks, accounting for about 75 percent of capital and assets After-tax earnings increased about 5 percent in 1997, and balance sheet measures—capital, liquidity—and quality indicators—loan portfolio quality—are generally favorable There has been a steady harmonization of laws and regulations with international standards to make the environment conducive to ongoing investment There is evidence that some of the strategic investors are preparing for more aggressive strategies in retail banking, as well as in non-bank financial activities With pressure on margins resulting from intense competition, the implementation of new strategies and some measure of consolidation are likely While some think that Hungary is "overbanked," there is a limited supply of credit available in the market Trends are favorable for increased lending to the corporate sector However, the net outflow of funds from the banks to the government continues to manifest a disintermediation effect Households account for nearly 29 percent of funding for banks, yet receive less than 4 percent of loans **Score 4-**

3 1 Overview Hungary's banking system now appears to be relatively well managed under a new incentive structure introduced in the early 1990s—based on BIS guidelines for prudential regulations and international standards of accounting—and significantly reinforced from 1995 on with the termination of government-financed recapitalization programs, and a focus on the attraction of strategic investment from foreign banks and institutional investors Balance sheet indicators were sound for the largest banks in mid-1997, most of which were part of the monobank system 10 years ago After-tax earnings increased in 1997, although return measures against assets and equity indicated some sluggishness due to pressure on margins There is significant evidence of competition for large corporate business, as intermediation spreads have dropped considerably from high levels in 1993-95 Upcoming challenges include management depth and capacity as greater risks are assumed in the coming years without government ownership or guarantees, the strategic direction of various banking firms under open and highly competitive conditions, the synergies achieved from investment in retail banking and non-bank services, and the overall level of consolidation that occurs in terms of both numbers of firms and their respective financial activities **Score 4-**

- There were 44 banks in Hungary in mid-1997 The *structure* of the banking system shows heavy investment from foreign institutions—30 banks were foreign-controlled—and a segmentation into four groups—large,[28] large medium,[29] small medium,[30] and small [31] Large banks generally have balance sheets with values exceeding Ft 100 billion ($500 million), while large medium banks' balance sheets generally exceed Ft 40 billion ($200 million) Their market shares (as individual banks) tend to exceed 3 and 1 percent, respectively The banking sector is now almost wholly privately-owned At mid-1997,

[28] Large Budapest Bank, CIB, Creditanstalt, K&H (Credit & Commercial), CEIB MHB (Hungarian Credit), MKB (Hungarian Foreign Trade), OTP (National Savings), and Postabank

[29] Large Medium ABN Amro, General Banking and Trust, BNP-Dresdner, Citibank, commerzbank, ING, Inter-Europa, Hungarian Bank for Investment and Development, Bank of Hungarian Savings Cooperatives, Mezobank, and Unicbank

[30] Small Medium Credit Lyonnais, Daewoo, European Commercial, Hypo-Bank, Konzumbank, Citizens, PK, and Westdeutsche Landesbank

[31] Corvinbank, Deutsche Bank, Hanwha, Kvantum Investment, Eximbank, Volksbank, Merkantil, IC, Nomura, Opel, Porsche, Rabobank, Rakoczi, and Realbank

85 percent of bank assets were in private hands The privatization of K&H raises this figure Mid-1997 balance sheets showed Ft 4,087 billion in value, or about $22 billion This means the average bank had assets of about $500 million, the floor for the "large" classification and the ceiling for "large medium" banks

- *Competition on the asset side* has been increasing, mainly in corporate lending Margins have narrowed as intermediation spreads have declined—from 9 percent in 1993 to about 4 percent in 1996-97 [32] Intermediation costs declined in 1997 for two main reasons (i) the intensification of competition among banks for blue chip customers, and (ii) because overall loan quality has improved, pre-empting the need for steadily increasing levels of provisions In the first case—intensified competition, larger banks had previously maintained higher intermediation costs due to their higher operating cost structures, their need for investment for future competitiveness, and their risk aversion under new incentives after government-financed programs ended after 1994 Through 1996, it was medium-sized banks with lower cost structures and better loan portfolios that had a competitive advantage This provided them with an opportunity to price credit in a manner that generated market share and strong earnings However, these advantages narrowed in 1997 as large banks' financial conditions improved Thus, to recapture some lost market share, intermediation costs declined Loans to non-government entities[33] as a percentage of total assets were more than 46 percent at mid-1997 compared with 44 percent at end 1996 Loans to the corporate sector were 31 percent of total assets in mid-1997, compared with 29 percent at end 1996 [34] Thus, there is some evidence of proportional growth in lending to the corporate sector Meanwhile, loans to the central budget and reserves placed with NBH accounted for nearly 36 percent of total assets at mid-1997, down significantly from more than 42 percent at end 1996 This suggests that there has been a slight movement away from government securities towards lending [35] In the second case—improved loan quality, prudent (risk-averse) loan practices and safe returns from investments in government securities at larger banks have now led to risk-adjusted capital levels that are adequate by international standards Nonperforming loans as a percent of total decreased from a high of 29 percent in 1993—after new accounting standards and regulations were put in place—to about 11 percent at mid-1997 This improvement in loan quality has generated better earnings in recent years, and provided these banks with the reserves needed to entertain the possibility of increased lending at lower rates

- Banks and regulators will need to monitor *exchange rate* risk At September 30, 1997, Hungary's banks had $1 3 billion in net exposure (loans less deposits) to enterprises in foreign currency loans This approximated 50 percent of capital Local currency exposure to enterprises was nearly Ft 500 billion, or double the net foreign currency lending exposure to the enterprise sector

- Significant concentration remains on the *funding* (deposit mobilization) side OTP and Postabank—two of Hungary's largest banks—along with the smaller savings cooperatives account for an estimated 80 percent of household deposits held with banks Household deposits account for more than 28 percent of total bank funding, almost all of it short-term Particularly in the case of OTP and the savings and loan cooperatives, their positions in deposit mobilization are expected to be strengthened from 1998 when wage payments for public sector employees are wired directly into employee bank

[32] For some blue chip customers, banks have lowered their spreads to less than 0 2 percent, and in some cases even provided negative spreads to obtain or retain market share

[33] This includes corporations, households, foreign exchange transactions with non-residents, and interbank loans

[34] By contrast, about 72 percent of large banks' loans at end 1993 were to corporate customers, mainly state-owned enterprises However, many of these loans would be written off by today's regulatory requirements This would reduce the proportion if measured in the same way

[35] Broad money supply is reported to have not grown in any significant manner in 1997, in keeping with Hungary's somewhat restrictive monetary policy Thus, increased lending resulted from a reconfiguration of portfolios, rather than from significant incremental resources However, this could also signal a slight easing of monetary policy—such as a slight decline in mandatory reserves

accounts Thus, there is substantial concentration in terms of deposits, some of which will be reinforced in 1998 However, in the long term, it can be expected that increasing banking sector competition—as reflected in the pressure on margins—and the doubtful condition of Postabank will lead to intensified efforts to reduce these concentrations

- In terms of *coverage*, there has been slow movement by banks to increase lending Credit to enterprises now accounts for about 31 percent of total assets, up from 29 percent at year end 1996 and 27 percent at end 1995 Meanwhile, there is still significant "lending to" and "investment in" government The combined total of asset exposure to the central government budget and NBH accounted for 36 percent of bank assets at June 30, 1997 This compares with 42 percent at end 1996, and probably higher rates in 1995 [36] Thus, while the macroeconomy has improved, the fiscal deficit continues to need financing, attracting resources that might otherwise have been placed in loans to enterprises This is particularly problematic for companies that need investment financing for durations that exceed one year More recently, five-year government instruments were introduced into the market However, the vast majority of Hungary's nearly 800,000 or so enterprises have difficulty accessing any bank financing, let alone term Ft financing As for expanded retail services, there appears to be movement in this direction Some banks have invested in systems and ATMs to compete with the current advantages enjoyed by OTP, Postabank and the savings cooperatives [37] It remains to be seen how these strategies unfold, particularly as entry into retail is now open to banks without a headquarters operation in Hungary Meanwhile, there are more focused strategies in place In some cases, banks are more like captive finance companies providing commercial credit to consumers and leasing companies to stimulate automotive sales In other cases, they have a sector (Rabobank in agriculture and agro-processing) or regional (Rakoczi) focus In yet other cases, "small" banks in Hungary are quite large in international markets—Deutsche Bank, Hanwha, Nomura—suggesting they have more of a niche focus in the Hungarian market that is more service-oriented, and does not involve much asset exposure

- In terms of *financial statement indicators* and contingencies, banks are far more profitable than they were a few years ago While costly, the recapitalization schemes of 1993-94 replaced banks' nonperforming loans with government paper, and provided banks with sufficient capital to provision for losses and write off nonperforming loans Earnings and capital have increased and been strengthened by subsequent privatization via strategic investment, the introduction of better lending practices, the observance of stricter prudential regulations, and improvement in enterprise sector performance As part of this "virtuous circle", earnings are further bolstered by the vastly improved quality of bank loan portfolios At mid-1997, 10 9 percent of loans were "qualified" or problematic, compared with 12 5 percent at end 1996 and 28 5 percent at end 1993 Only 3 2 percent were doubtful or bad at mid-1997, compared with 4 1 percent at end 1996 and 22 percent at end 1993 Thus, in terms of overall quality, loan portfolios have steadily improved since 1993 Consequently, as a percentage of total loans, provisions have steadily declined as a percentage of total loans These were only 2 7 percent in mid-1997 and 3 6 percent at end 1996, compared with 15 percent at end 1993 There is a risk that banks are under-provisioning However, capital is strong as is the economy, and many banks are emerging from a recapitalization phase in which they have cleaned up their portfolios Thus, the risks do not appear to be major in the short term

---

[36] Receivables from NBH and government securities alone were 38 percent at end 1995 Receivables from domestic customers include loans extended to local governments and budgetary institutions, but these are not separated from private customers Thus, it is difficult to disaggregate data and assign shares

[37] These include Magyar Hitel (ABN-Amro), Budapest Bank (GE Capital), and Creditanstalt The recent purchase of K&H by a combination of bank and insurance companies from Belgium and Ireland, respectively, points to a retail strategy for the bank's 150 branches Such a *bancassurance* combination might also prompt a retail strategy from ING over time Other banks are exploring these possibilities as well, particularly given the restricted size of the blue chip market in Hungary

- In terms of *funds flows*, banks' funding sources are primarily short-term from household and corporate sources, while nearly half of all bank resources flow to the central budget and to NBH The end-1996/mid-1997 liability structure (financing sources) for banks showed (i) about 69 percent of total funding from short-term sources, mainly households (26 percent), corporate (17 percent) and non-resident (almost 10 percent) sources, and (ii) about 25 percent from own funds (11 percent) and long-term deposits and placements from varied sources Meanwhile, comparable asset structure figures showed (i) about 55 percent of asset exposure on a short-term basis, about evenly divided among the corporate sector (18 percent), the central government/NBH (17 percent), and other parties, and (ii) long-term assets of about 45 percent, largely to government/NBH (19 percent), the corporate sector (12 percent) and other parties The interbank market accounted for 6-8 percent of total exposure during this period Many banks have borrowed from banks abroad instead of from the local market to take advantage of low spreads—below 20 basis points above LIBOR in late 1997 Likewise, many of Hungary's blue-chip firms have obtained financing from the international syndicated loan market where they have gotten more favorable rates, longer maturities, larger amounts, or fee-based features to customize their management of pricing, interest rate and exchange rate risks

- *Ratings* on Hungarian banks are generally tied to their predominantly foreign ownership For example, Moody's rates the six largest banks

- Hungary's banks have excellent *correspondent networks* and *payments systems* are considered efficient

3 2 ***Ownership*** The banking system in Hungary is now about 75 percent owned and controlled by foreign banks and investors Assets, credit and capital are now predominantly foreign-controlled Only the deposit base is still concentrated in predominantly non-foreign institutions Such foreign dominance has been a conscious policy of the government since 1995 to introduce improved governance and management, to achieve sustained capital growth based on strong asset quality and earnings, and to externalize potential lender of last resort requirements The degree of foreign ownership in the banking system is unique for the region, and differentiates Hungary from most countries in the world **Score 4+**

- In mid-1997, there were 44 banks, of which 30 were foreign-controlled Foreign ownership shares (registered capital) increased from 12 percent in 1993 to 55 percent in mid-1997 With the privatization of K&H in July 1997, foreign ownership likely exceeded 70 percent by end 1997 Foreign investment includes investment in several of the largest banks which are remnants of the old monobank system—OTP (savings), MKB (foreign trade), K&H (agriculture), MHB (chemicals and machine-building), Budapest Bank (coal mining and construction), and Postabank (retail savings) The share of assets under foreign or joint ownership has risen from 15 percent in 1994 to an estimated 70-75 percent by end 1997 Foreign ownership of the banking system—which separates Hungary from virtually every country in the world—has resulted from accelerated privatization, the exit of weak performers, and a faster increase in capital growth by mid-sized foreign banks than Hungarian ones All three of these developments have resulted in about 40 percent of banking sector capital being held by foreign banks, and another 35 percent or so held by foreign institutional investors This includes minority shares of OTP (through public share offering to foreign financial investors) plus majority shares in MKB (Bayerische Landesbank Girozentrale), Budapest Bank (GE Capital), MHB (ABN-Amro), and K&H[38] (Kredietbank, Irish Life, EBRD) Foreign interest in the Hungarian banking sector has been motivated by demand from foreign firms operating in Hungary, strategies to establish Hungary as a platform for banking operations in the region (as with other financial services firms), and

[38] Technically, these are minority shares However, incremental investment on top of the initial $30 million is expected to raise the combined stake of Kredietbank and Irish Life to 56 percent of K&H

to push into the retail market from 1998 on

- Of 44 banks, 14 are predominantly *domestic* banks These banks account for about 25 percent of assets and about 30 percent of total banking capital The deposit base is also high due to the near monopoly on household savings Postabank is the last remaining major non-private bank, with 35 percent ownership by the state pension and health funds, 10 percent by the Austrian postal system, 8 5 percent by the state electricity company, 7 percent by the Hungarian postal system, 6 percent by a local government, 5 percent by Generali, and the remainder by management and individuals OTP's state ownership has been reduced to a "golden share " The other domestic banks are generally private—in mid-1997, about 70 percent of domestic ownership was comprised of companies and individuals, accounting for about 20 percent of total banking sector ownership at end 1997 The social security funds still account for about 5 percent of ownership in the banking system There are also 256 savings and loan cooperatives

3 3 ***Governance and Management*** There is a perception of two levels of governance and management in Hungary, in both the financial and the real sector The first applies to the larger blue chip operations, largely foreign-controlled, that operate according to recommended international standards and guidelines This would include the prime-rated banks and insurance companies that have established operations in Hungary, along with the Hungarian companies listed on the BSE The second applies to the vast majority of Hungarian enterprises that are disconnected from this blue-chip sector, and which are reported to operate in a manner which reflects weak governance—a prevalence of connected and insider transactions—and sometimes poor management—noncommercial decisions which weaken the value of the firm in the long run for the sake of short-term political or other gains Over time, the second group is likely to move in the direction of the first as new accounting standards are put in practice, as they seek additional equity in their businesses, and as they attempt to obtain debt financing from banks and other financial institutions However, for now, the perception of weak governance and management explains why many Hungarian enterprises find it difficult to obtain bank financing In the banking sector, there is a perception that governance is strong at the prime-rated institutions due to oversight from parent companies and investors, and that this is serving as a catalyst for improved governance at other banks There is a perception that management is strong at OTP, although the governance structure is viewed as somewhat diluted and potentially weak At Postabank, governance is viewed as weak, and management is viewed as politically connected This is clear from the Ft 33 5 billion received from various government entities, and the Ft 12 billion guarantee received from the Ministry of Finance Movement towards increasing transparency and disclosure will be required for increasing integration between the blue chip and non-blue chip sectors For the time being, the trend towards improved governance and management is favorable Strategic investment helps, and oversight from foreign regulators and board members provides added comfort However, there is a sense that foreign investment automatically externalizes much of the risk and responsibility associated with governance and management standards This is partly true, but does not exclude the possibility that foreign owners and board members will themselves make serious mistakes that can have an adverse impact on the Hungarian economy For this reason, a more active and reciprocal approach will be needed to provide higher levels of confidence that governance and management are satisfactory and strong **Score 3+/4-**

- According to the Company Law, the *legal* process for forming and registering a company in Hungary is straightforward and takes one to three months There are clear guidelines for types of corporate structure, and the general obligations of directors There are also restrictions on insider dealing of shares in publicly listed companies The Banking Law elaborates requirements expected of banks' boards and management teams, and specifies minimum capital requirements for a universal banking license

- *Cross-ownership* is now permitted as legal barriers to universal banking were lifted in January 1997 Banking and non-banking legislation have been reconciled to provide a coherent set of guidelines for compliance with relevant prudential regulations For instance, the Law on Securities references the Banking Act and specifies "credit institutions" on numerous occasions with regard to large exposures/risks, trading book requirements, and reporting and supervision The general rule is that Hungary's ownership, governance and management standards are harmonized with EU directives to ensure early entry into that market, as well as to comply with membership requirements for OECD countries

- *Minority shareholders* are in a weak position under the law Companies are not required to send proxy forms to shareholders in advance of meetings, although shareholders can vote by proxy Nor are there preemptive rights on the issuance of new shares Thus, a minority position could be easily diluted on non-commercial grounds At the same time, there has been significant foreign investment, including investment as minority shareholders in joint ventures Enhanced protection of minority shareholder rights can be expected as a precondition for expanded breadth and depth of capital market activities over time

- Governance in the banking sector has improved in principle with the entry of prime-rated foreign banks This has detached most of the banks from the state, and permitted market discipline and commercial decision-making to guide the design and implementation of banks' strategies The entry of prime-rated foreign banks has also brought with it the benefit of management know-how, improved information systems, market links, and policies and procedures for improved *oversight* of bank management Directors are required to perform their duties in good faith, avoid self-dealing, and disclose their own personal interests in any material company- or affiliate-related transactions according to the Company Law More stringent requirements are in place in banking legislation, both in Hungary and in countries of origin of the foreign-controlled banks However, there are still weaknesses that will take time to remedy Foreign banks still lack familiarity with the Hungarian market, and most foreign bank managers do not speak Hungarian Among the larger banks that have recently been acquired, those banks are still introducing new systems They have yet to test these systems and procedures with significant risk-taking activities Among the banks without significant strategic foreign investment, OTP is considered to have strong management However, its ownership structure is diluted, it still has non-private owners, and the future risks to be assumed in retail banking have not yet been fully faced Far more grave is the status of Postabank—where both governance and management are suspect In many ways, Postabank represents a *deja vu* of the state-owned banking system There is a lack of confidence in the bank, which prompted a Ft 25 billion run on its deposits in early 1997 Efforts to obtain needed liquidity and to recapitalize under market conditions have failed This has led to government financing (through social security funds, state companies and the privatization agency) and guarantees (from the Ministry of Finance), while privatization or liquidation have been rejected to date as suitable options

- There are no restrictions on *compensation*—salaries and benefits—of bank directors, managers and employees However, there are requirements for general reserves in financial institutions from after-tax profits prior to the distribution of dividends Likewise, as a move to strengthen supervision, civil service constraints were recently removed on employees at HBCMS This should permit the agency to attract and retain greater numbers of more qualified people for financial sector regulatory oversight

3 4 Non-Bank Competition There is limited if any competition for banks in the financial services industry Brokerage firms, investment houses, and insurance companies attract some resources, prompting some disintermediation However, with new legislation, banks are free to enter non-bank activities, and they have Likewise, non-banks are permitted to enter banking as long as they comply with banking regulations It is expected that over time, there will be a consolidation of financial services company shares of assets and deposits which would cut across traditional "bank" and "non-bank" classifications However, this will take time In the interim, it is not expected that there will be significant competition with banks from non-bank institutions **Score 3+/4-**

- There were 256 *savings and credit cooperatives* in mid-1997 Their total assets and deposits are not considered large relative to the banking system However, they do provide extensive retail coverage for safekeeping of deposits and payments of wages and benefits New legislation regulating *mortgage credit institutions* and the issuance of mortgage bonds was passed in April 1997, although there is limited mortgage activity—this is a contributing factor to limited long-term lending by banks on a secured basis to the enterprise sector

- *Capital markets* activity in Hungary is focused on the Budapest Stock Exchange (BSE), which has been active since mid-1990 under the existing market-based framework In early 1998, BSE had 53 equity securities listed compared with 45 about one year earlier Market capitalization was estimated to be about 15 percent of 1997 GDP—up from only 5 percent in 1995 As of mid-1997, there were 33 fund managers, 77 investment firms with a full license, 21 firms with a license to broker, and one investment company In many cases, these firms were associated with banks BSE has long been heavily weighted towards government securities due to deep fiscal deficits—state bonds and treasury bills accounted for 54 percent of 1996 capitalization, although this was down from 63 percent in 1995 "Crowding out" of private investment has prompted a number of Hungarian firms to list on exchanges abroad, mainly in the U S and Western Europe Blue-chip Hungarian companies have also tapped the international syndicated loan market Entry to the OECD in mid-1996 led to a significant increase in activity—in 1996, equities turnover was up 460 percent, spot trading increased by 350 percent, and trading in government securities was up nearly 300 percent Foreign investors account for 70-80 percent of BSE turnover

- In addition to BSE, there is also the Budapest Commodity Exchange for agricultural commodities and financial contracts The latter are mainly foreign exchange futures At end 1996, the value of institutional investment was Ft 360 billion (5 percent of GDP), or about $2 2 billion at year-end exchange rates Value was mainly from insurance companies (about 60 percent), investment funds (about 30 percent), and private pension funds (about 10 percent) There were 82 members in early 1997

- In 1997, Hungary adopted legislation transforming its pay-as-you-go pension system to a three-pillar system Previously, the pay-as-you-go system was supplemented with private voluntary pension funds[39]—the third pillar in the new program—which were permitted starting in 1993 (To date, as a result of deficits, the funds have been net borrowers from the capital markets, as has the government as a whole In mid-1997, their asset value was about Ft 35 billion, or about $190 million, a relatively small level of assets that limits their role as institutional investors in the markets [40] It appears that their money is primarily invested in the BCE [41]) The new system establishes a second pillar to the pension

---

[39] Private pension funds can be organized on a regional, sector, or company basis

[40] There were an estimated 200-300 of these non-state funds, thus average assets were about Ft 175 million at the most, or about $1 million In addition to their small size, there were concerns expressed about fundamentals such as safekeeping—third pillar funds are not required to use banks or other licensed fiduciaries for custodial services of funds collected

[41] BCE value was Ft 360 billion at end 1996, of which about 10 percent was placed by private pension funds

fund scheme—mandatory contributions to regulated but private *pension funds*[42]—to go along with the first and third pillars (mandatory contributions to state funds, and voluntary contributions to private funds, respectively) Over time, this is expected to strengthen private savings—mandatory contributions are expected to be 1 2 percent of GDP in 2000 and 2 3 percent in 2003—and to reduce the fiscal drain of chronic deficits incurred by the state-run social security funds (first pillar) However, the new system will include tightened eligibility criteria for the first pillar, and a third of all mandatory contributions will flow into the mandatory second pillar It is also possible that there will be an initial capital outflow from the relatively small and questionable third pillar funds due to tighter regulatory oversight of second pillar funds—"fit and proper" management, and conservative investment guidelines for safety and soundness Second pillar private funds are likely to emerge over time as significant investors Once this occurs, larger third pillar players are expected to emerge as well, but this will depend on rising incomes, the marginal propensity to save, and demonstrated management and soundness of private third pillar funds

- There is significant *insurance* sector activity in the Hungarian market As in the banking sector, Hungary has succeeded in attracting prime-rated strategic investors from abroad Major insurers with foreign ownership include Hungaria Insurance (Allianz of Germany), Aegon (the Netherlands), Providencia and Generali (Italy), Nationale-Nederlanden (ING of the Netherlands), and Alico (AIG of the U S) OTP Guarancia (owned by OTP Bank) is the main Hungarian insurance firm without foreign ownership Hungarian insurance firms were among the first to be privatized A new insurance law consistent with EU standards became effective at the beginning of 1996 This led to the establishment of an independent regulator, empowered with significant authority to intervene when necessary As institutional investors, they play a predominant role on the BCE [43] In the future, it is anticipated that some banks might intensify their activities in insurance—barriers to universal banking have been scrapped, *bancassurance* offers retail synergies, and incomes are rising—with OTP and ING already structured to provide such services, and the likelihood that K&H will also move in this direction In 1996, revenues from insurance premiums among the 12 largest insurance companies were Ft 146 billion ($1 billion), of which the first five had 89 percent of total revenues There is some segmentation, with motor insurance accounting for about 37 percent of revenues (mostly Hungaria, AB-Aegon and Providencia), life about 32 percent (mostly AB-Aegon, Providencia and Nationale-Nederlanden), and property about 22 percent (mainly Hungaria, AB-Aegon, Providencia, and OTP)

---

[42] Investment guidelines for mandatory contributions include the following limits (i) 30 percent may be held in category A stocks—highly liquid, blue-chip—listed on BSE, (ii) 20 percent may be placed in bank-guaranteed domestic bonds, (iii) 5 percent may be placed in foreign bonds, (iv) 10 percent may be placed in foreign equities issued by firms registered in OECD countries, rising to 20 percent after 2000 There are no limits on holdings of government securities

[43] The insurance sector is the leading investor in BCE, accounting for about 60 percent of that exchange's capitalization Values were about Ft 210 billion in 1996, or about $1 3 billion at year-end 1996 exchange rates

IV BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS The Hungarian banking system is generally strong based on financial indicators, but will need some time operationally before it is considered "world class " The trends are favorable, due largely to the attraction of prime-rated strategic investors after the recapitalization and consolidation programs through 1994 Capital is strong, and asset quality is good Liquidity is somewhat constrained by monetary policy, but is becoming more available Markets are functioning well—interbank as well as non-bank—with increasing access to international funds (banks and non-banks), and rising capitalization and turnover in the capital markets Overall, the trends are favorable, and have been since 1995-96 However, several questions remain with regard to (i) the persistence of high inflation rates and continued disintermediation effects resulting from fiscal deficits, (ii) risk management capacity as bank asset structures grow and take on more and diverse risks, (iii) the sustainability of earnings as banks adjust their risk tolerances and venture into activities in which they have limited experience—Hungarian banks from a product standpoint, and foreign banks from a local market standpoint, (iv) the ability to more fully integrate the non-blue chip sector into the export-led part of the economy that is growing, (v) the willingness of mid-sized companies to adapt to international standards of transparency and disclosure to obtain added financing, (vi) the ability of regulatory authorities to monitor for risk in portfolios that can potentially lead to adverse effects on the local economy, and (vii) the overall ability to adapt to rapidly accelerating changes in the global marketplace, including potential capital outflows How these questions are answered will go a long way in determining how quickly Hungary closes the still wide gap in incomes with most EU and OECD members The trends in Hungary are broadly favorable, particularly when compared with the performance of most countries emerging from excessive state controls However, the next several years will test the ability of the banking system and financial sector to transform Hungary from a "transition" or "emerging" market to one which is on an irreversible course towards prosperity and ongoing competitiveness **Score 4-**

4 1 Capital Adequacy Management practices have been conservative and prudent since 1995, focusing on recapitalization and restructured balance sheets Portfolios are still heavily weighted towards government securities—which are zero risk-weighted according to BIS Although 1997 witnessed some shift into increased lending to corporate customers and reduced "lending" to the central budget, loans are generally to blue chips Reserves are higher than required to meet the 8 percent minimum risk-weighted capital requirement As portfolios shift to corporate loans—which are 100 percent risk-weighted—this will lead to some capital adequacy adjustments Expansion into retail activities for those planning to pursue that market will also require capital, both for investment as well as for some of the risks associated with this expansion (e g , commercial/installment credit) Preliminary unaudited statements show "own funds"—or Tier 1 capital to assets—at nearly 10 percent at end 1997, against 8 8 percent at end 1996 Subordinated loan capital in both years added another 1 7 percent at mid-1997 and 1 6 percent at end 1996 Extraordinary capital injections can no longer be expected from much additional privatization activity From this point forward, capital adequacy will be sustained by retained earnings, asset quality and size, and the ability to float shares or obtain equity from other sources **Score 4**

- The methodology for calculating *capital adequacy ratios* as well as capital targets are consistent with EU and Basle standards in Hungarian banks The prime-rated foreign-controlled banks which populate the Hungarian banking sector follow these standards as a matter of routine Hungarian banks have likewise followed Basle standards since January 1992—legislation introduced at that time set the legal foundation for new accounting standards, which prompted recognition of loan losses and ultimately prompted the restructuring, recapitalization and privatization of banks While the banks will need to shift their risk weights as they lend more and invest less proportionally in government securities, most banks are generally considered strong on a capital basis

- Hungary has been extraordinary since 1995-96 in its privatization of the banking system by attracting strategic foreign investors *Foreign ownership* now accounts for about 75 percent of the banking system This strategy was intended to establish clear ownership structures, provide suitable incentives for effective governance and management, introduce needed investment into systems, and generally establish a competitive banking system to meet the needs of a growing economy The financial restructuring appears to have been accomplished The next challenge is the operational and risk management side as banks mature into market-based institutions able to manage risks under competitive conditions

4 2 Asset Quality Asset quality appears to have improved and overcome many of the hurdles of earlier years when large loan losses undermined earnings Bad loans are but a fraction of earlier tallies—2 1 percent in mid-1997 and 2 7 percent at end 1996 against 13 7 percent at end 1993 Provisioning for loan losses declined in absolute Ft terms as well as on a percentage basis—down 34 percent in 1997 compared with 1996 This could represent under-provisioning, particularly as competition has increased and put pressure on net interest margins However, the risk-averse practices of the last two years—limited lending, investment in government securities—suggest that banks were likely not under-provisioning in 1997 However, some adjustments in provisioning will likely be required from 1998 on as greater risks are assumed in a wider range of activities **Score 4**

- Hungary's laws and regulations address *large exposures connected/related party/insider lending nonperforming loans interest accruals provisioning and exposure limits* These are basically consistent with Basle and EU guidelines, and are reconciled across laws (banking, securities) to account for universal banking practices Thus, large exposures and risks are consolidated to include credit, securities and other potential risks

- There is favorable *tax treatment for loan loss provisioning* Provisions are treated as pre-tax expenses Current regulations require that banks provision against classified loans as follows (i) to-be-watched at 0-10 percent, (ii) substandard at 11-30 percent, (iii) doubtful at 31-70 percent, and (iv) bad at 71-100 percent Provisioning declined in 1997, although this may be justified relative to asset quality However, there is the risk that provisioning was insufficient, as it was below the upper bound This will have to be monitored in the future, particularly due to the intensification of competition, the decline in net spreads, and reduced return ratios against equity and assets compared to prior years

4 3 Management One of the main reasons for attracting strategic investors into the banking sector was to improve governance and management Based on Hungary's success in attracting prime-rated institutions, management is likely one of the strongest elements of the Hungarian banking sector However, this is still a period of investment and transformation in Hungary The acquisitions of large banks generally occurred in 1996-97, and investment in new systems, training of staff, and adaptation to new standards and procedures are still underway In addition, universal banking presents a multitude of risks that need to be properly managed and coordinated to contain destabilizing developments and systemic risk **Score 3+/4-**

- Some of the main issues facing banks from 1998 on will be their ability to generate sustainable earnings in a more competitive environment in which pressure on margins is increasing Thus, improvements in asset quality plus asset growth will be needed, particularly for banks that have invested in hardware, equipment, personnel and systems These banks will need to spread these and other operating costs over time and assets to generate increased returns and margins Some of this may be obtained by increasing exposure to more dynamic mid-sized enterprises, or from generating synergies from non-bank companies (e g , investment and brokerage activities, insurance sales, real estate investment, venture capital) This may also come from providing needed retail services, which can reduce funding costs and serve as a convenient lead into fee-generating services Managing these ongoing business challenges in a changing environment in which mid-sized and smaller companies are still frequently untransparent, capital is increasingly mobile, and capital markets are sensitive to global risks represents a new test for the Hungarian banking system Fundamental *risks* will include credit management—continuing to follow sound underwriting standards as risks increase, monitoring borrower compliance with loan covenants, ensuring adequate reporting standards, and collecting on loans This also includes organizational improvements and tightening, such as enforcing limits on credit authority provided to individual branch or division managers As in other markets, there will be a temptation to lend to consumers This kind of lending and installment finance frequently carries with it higher-than-average rates of nonperformance While Hungary has a central credit rating service and credit cards are in circulation, the availability and quality of information will likely have to increase over time for banks (and regulators) to properly manage these risks Investment in information technologies and point-of-sales systems will need to continue to reduce the risk of fraud as credit, debit and ATM cards are more widely used Fraud will also have to be monitored as banks increasingly market to high net worth individuals There will also be a risk of connected lending—many banks own brokerage houses, and these and other subsidiaries frequently carry risky assets that are not always uncovered until it is too late Mortgage lending activities will likewise require prudent credit risk management skills This will include managing interest rate and pricing risk, monitoring changes in tax rate incentives, and monitoring movements in secondary and syndicated markets when they develop There are also likely to be growing risks associated with securities investments, particularly as capital markets activities are linked to more complex and exotic instruments that are sometimes bundled across products and markets One of the areas of weakness cited by some sources is in the treasury and cash management functions of banks These will also have to be monitored to prevent misuses of funds

- As elsewhere around the world, bank boards and management will need to continuously adjust their risk-taking strategies based on sound and timely information This will require ongoing development and modernization of information systems for *risk management* purposes In addition to internal controls and supervision of individual institutions, systems will have to include a host of portfolio considerations for lending, trading and investment activities—maturity, pricing, and currency issues from a portfolio standpoint, as well as the underlying quality of each asset Over the next several years, it is expected that inflation rates and fiscal deficits will decline This will lead increasingly to a shift in focus to the underlying soundness of business fundamentals in assessing and managing risk Thus, banks will need to demonstrate their ability to set prudent risk tolerances under changing conditions, and to identify deterioration in lending, investment and real estate portfolios early on to prevent such developments from having a material adverse effect on capital and liquidity A more stable macroeconomic environment will help in terms of stabilizing interest and exchange rates On the other hand, such stability will mean less volatility, which will then mean that banks will have to increase their volume of stable earning assets, and/or increase their willingness to take risk in other activities that carry with it greater upside and downside potential on earnings Hungarian banks have invested heavily in recent years in information technologies Combined with prime-rated investment into these banks, it is expected that management know-how combined with tested governance practices and modern information systems and technologies will demonstrate itself in vastly improved performance in the coming years

4 4 Earnings Preliminary results for many of the largest banks operating in Hungary show a 5 0 percent increase in after-tax earnings for 1997, with OTP accounting for about one quarter of these profits However, return on assets declined from 1 37 percent to 1 14 percent, and return on equity declined from 16 3 percent to 11 7 percent Thus, earnings are up, but not return measures Increased after-tax profits derived from improved loan quality (reduced provisions for losses, actual profits) However net interest margins have narrowed as increased competition in the blue chip sector has brought down intermediation spreads Meanwhile, operating costs are still high, estimated at nearly 65 percent of interest income plus other revenues Despite reductions in head count over the years, increases in operating costs are due to wage increases in the financial services sector along with increased investment in personnel training and information systems for improved services (e g , new technologies for ATMs, branches) This should generate incremental earnings and efficiencies in subsequent years, but for now, they constitute expenses **Score 3+/4-**

- *Net interest* contributions by mid-1997 were Ft 98 billion, or about $524 million The modest contribution in net margins is the result of competition for the narrow selection of blue chip firms deemed creditworthy under current conditions *Other revenues* at mid-1997 approximated Ft 43 billion ($230 million) Fees and commissions accounted for about half of these revenues Thus, "*gross trading profits*" overall approximated Ft 141 billion ($754 million) for the first half of 1997 in a banking system with about $22 billion in assets Meanwhile, *operating costs* are still high due to wage increases, improvements in services, and depreciable investments that should increase productivity and earnings in the coming years However, operating expenses were Ft 91 billion, or a high 64 5 percent of net interest income and other revenues at mid-1997 By comparison, operating expenses were 53 percent in 1996 Full-year preliminary figures for provisions and earnings are available for 1997 *Provisions* declined in 1997 due to improvements in loan quality However, as discussed above, there is the possibility of some under-provisioning due to pressure on earnings Overall, *after-tax profits* were Ft 64 5 billion, about $345 million based on average 1997 exchange rates

- *Interest rates* on loans and deposits are not subject to *controls*, nor are other fees Whereas banks have benefited in the last few years from high net spreads, these benefits are diminishing quickly due to intensified competition

- There is very little if any evidence of *mandated lending* in Hungary Once the government ended its recapitalization program for the banks after 1994, it was expected that banks would have to manage their own portfolios without undue influence from government line ministries or other officials Membership in the OECD in 1996 further reduced possibilities of mandated lending There are some government programs to try to fill gaps, such as donor-financed programs to lend to the SME sector However, many of these remain unutilized because of attached conditions or costs that SMEs are not willing to meet

- There is an 18 percent corporate income *tax rate* which applies to banks, plus additional taxes In 1996-97, the effective corporate income tax rate for banks was 20 6 percent [44]

4 5 Liquidity With earnings pressure increasing due to heightened competition and narrowing intermediation spreads, there may be some liquidity constraints in the near term However, underlying asset quality is good, and interbank and capital markets are fairly responsive to liquidity needs The share of reserves to total assets declined in 1997, and this might free up additional resources for liquidity purposes However, mandatory reserves still constitute a large proportion of liquid assets, reducing funds available for term lending The internationalization of the banking sector has made banks less dependent on local financing for liquidity needs, although local currency financing is not as freely available as it was previous to 1995 This is

---

[44] This is subject to change as 1997 figures are unaudited

due to the crawling peg, which has had the effect of maintaining money measures, but not increasing them in any material way since 1995 **Score 3+/4-**

- The main weakness of banks' *funding structures* is the concentration of the deposit base with OTP and Postabank, which limits a potentially low cost source of funding for the other 42 banks operating in the market This has prompted an active interbank market, although interbank loans account for no more than about 8 percent of total assets There is also an active and growing securities market to provide for liquidity needs Foreign markets are also utilized for financing and liquidity

- Bank management is in a position to manage fundamental *sensitivities to pricing interest rate and exchange rate movements* Prudential regulations are adhered to, and bank managers have had significant experience with volatility due to high inflation and interest rates, high levels of foreign exchange in the banking system, and significant exposure to international capital markets for many years Further, NBH monitors movements in exchange rates and sets interest rates as part of its crawling peg policy, with pre-set rates announced daily Refinancing and interbank rates tend to correlate closely with these movements

- *Reserve requirements* are currently a part of mandatory bank deposits held with NBH The level of overall assets placed with NBH is high—20 6 percent of total assets at mid-1997 Further, reserves receive minimal compensation Thus, a large proportion of banks' assets are essentially non-earning The positive side is that placements at NBH declined from 23 percent of total assets at end 1995-96, possibly indicating a slight easing of monetary policy [45]

- *Asset-liability management practices* indicate a comparatively long asset position—long-term assets were 40 percent of total, compared to 26 percent on the liability and equity side of the balance sheet Long-term assets include 12 5 percent exposure to the central budget, most of that in the form of recapitalization bonds Netted out, there is virtual matching between assets and liabilities on a term basis In terms of the comparatively short liability position, this is based on the 26 percent of total balance sheet values funded by short-term household deposits Much of this is placed with the NBH as reserves—14 percent of total assets were short-term placements with NBH at mid-1997 Most other categories are relatively evenly matched

4 6 Operating and Regulatory Environment Hungary's banking system is perceived to enjoy a high level of public confidence This was true prior to accelerated privatization, when Hungarian households at least believed an implicit guarantee would protect deposit safety at OTP, Postabank and other institutions where retail deposits were held, and among the corporate sector due to the continuous refinancing and recapitalization of state banks from 1991-94 The banking system is now currently majority-controlled by prime-rated foreign institutions, which also instills confidence in the sector However, there are many questions about the effectiveness of financial sector supervision While Hungary's regulatory framework conforms to prudential guidelines rendered by the BIS and the EU, there are questions about the effectiveness of institutional capacity A cooperative agreement with counterpart regulatory authorities has not yet been concluded, despite the predominance of foreign banks in Hungary The supervisory agency has only recently been reorganized, consolidated, and freed of civil service compensation constraints It will take time to demonstrate the ability to retain qualified and trained regulators, to ensure adequate policy within a universal banking context, and to maintain useful and relevant coordination between off-site surveillance and on-site inspection functions Recent changes confirm increased independence and management autonomy, greater numbers of personnel,

---

[45] If so, this would be negative for efforts to bring down the high inflation rate, but positive for banks seeking to lend more resources

improved compensation, and a budget that permits contracting when in-house resources are not sufficient However, there is a lack of standardization and consistency in supervisory pursuits, and risk management capacity is viewed as fairly weak It remains to be seen how long it will take before regulatory oversight is perceived to be effective in Hungary, particularly in the future when more complex risk-taking financing is evident in the marketplace **Score 3**

- Hungary introduced a deposit insurance scheme in 1993 consistent with EU designs The existing insurance program covers each registered account (per person per bank) up to Ft 1 million (about $5,000 in March, 1998), or about equal to GDP per capita incomes Financing of the insurance fund comes from charges assessed on banks Additional funding from the budget (or from other non-private sources, as in the case of Postabank) is provided if needed to provide confidence in the safety and soundness of deposits placed with the banks Administration of the fund and its needs is overseen by a coordinating committee with representatives from NBH, the Ministry of Finance, and the Hungarian Bankers' Association

- The previous practice of recapitalizing banks from state sources ended after 1994 This effectively reversed the policy of providing resources for *bank rescues* through the active use of *lender of last resort* financing Such consolidation and recapitalization schemes prepared banks for privatization, but at a high fiscal cost exceeding 3 percent of average GDP from 1991-94 [46] Instead, the current approach is to externalize much of that function by integrating Hungarian banks into global markets This has been done by successfully attracting strategic investors with global networks There may be risks of decapitalization in the future—such as foreign banks (and insurance companies) repatriating profits back to headquarters However, under existing agreements and capital structures, it appears that monetary and fiscal authorities are far better protected from calls on resources to prop up failed banks than they were earlier

- Hungary's banking system is becoming increasingly competitive The only noticeable category in which *high concentration* is evident is in the deposit category There is still some minor protection in the banking sector, namely in the retail market where banks or special financial institutions each hold more than 25 percent of retail savings This partly explains the diluted ownership structure of OTP, and the continued financing of Postabank OTP, Postabank and the savings cooperatives control about 80 percent of household deposits, the largest source of financing for banks [47] This could provide OTP in particular with monopoly control over the interbank market. However, in the banking sector, increased competition is expected for the deposit market over time Starting in 1998, foreign-operated offshore banks are allowed to open branches in Hungary and establish retail networks without having to invest in costly headquarters' facilities This includes investment in ATMs and other retail services that should be less costly than "brick and mortar" approaches ABN-Amro[48] and other banks (such as K&H) are likely to invest heavily in a retail network, and this should also help to reduce such concentrations over time Postabank has already lost credibility with many households, culminating in a Ft 25 billion run in early 1997 which led to the placement of these deposits in other institutions Meanwhile, Postabank has been shut off from the interbank market, reflecting the enhanced scrutiny of banks in the market Without the ongoing support provided by state companies and social security funds and the Ministry of Finance, Postabank might have been dissolved months ago While there is still concentration, banks are generally able to access low cost resources inside and outside of Hungary Thus, existing levels of concentration are not perceived to significantly distort competition

---

[46] This is based on the explicit recapitalization costs of bonds plus additional intermediation spreads

[47] Household savings accounted for 28 percent of banks' funding at June 30, 1997 This compares with 16 5 percent from corporate deposits, 12 2 percent from NBH and other financial institutions, and 10 5 percent from capital (own funds plus subordinated loan capital)

[48] This was part of the business plan presented to the authorities when it agreed to acquire Magyar Hitel Bank

The market response to Postabank in the interbank market indicates there is little current systemic risk [49]

- While the regulatory environment has improved, there is still much to be done to enhance the *effectiveness of banking supervision* Traditional weaknesses included a fragmented organizational structure and dispersed authority in banking supervision (SBS, NBH, Ministry of Finance), inadequate coordination between separate regulatory authorities for banks and securities markets, insufficient funding resources (revenues from government budget and fees collected from banks), and high turnover due to the civil service pay scale Changes ushered in with the new Banking Law in 1997 have consolidated supervision under one roof [50] HBCMS is now the paramount authority responsible for banking supervision, and is both organizationally independent and consolidated These changes have led to concrete improvements Head count is now at 260 employees,[51] as opposed to 101 in 1994 (There is the possibility of an increase of 40 in 1998) On-site examinations are scheduled annually, while off-site surveillance is continuous It is unclear at this juncture if HBCMS has the capacity to identify risks early on that could undermine systemic stability, or if it has launched more targeted inspections to better evaluate, measure and monitor such risks at individual banks To assist with the need for enhanced capacity and qualifications, on-site inspections frequently involve external auditors To reduce turnover, the new Banking Law exempts HBCMS from civil service pay ceilings These are all positive trends for the development of the domestic supervisory function Current examination charges—now 0 3 percent of assets per bank—cover HBCMS budgetary requirements for now If these trends are combined with a serious commitment to mutual recognition, reciprocity, and close cooperation with host country regulators for prime-rated foreign banks operating in Hungary, it is very likely that the regulatory function will be perceived to have far greater integrity and effectiveness than in the past In the near term, HBCMS could focus on (i) better integrating on-site and off-site processes, (ii) developing more credible risk rating and early warning systems for individual banks, (iii) maintaining team continuity under an examiner-in-charge, and (iv) moving beyond basic compliance measures to risk-oriented analyses Language training will also be needed in English at HBCMS, as the mainly foreign-owned banks operate in English

- Effective since 1992-93, banks have been required to produce IAS statements with the help of *external auditors* This was initially part of the effort by Hungarian authorities to introduce a market-based prudential regulatory framework for banking, to ascertain the magnitude of undercapitalization at the state-owned banks, and to measure needed resources for their recapitalization These statements later became a precondition and building block for valuation and due diligence during the privatization process

4 7 Transparency and Disclosure There are some concerns about the lack of full and timely public disclosure of meaningful financial information in Hungary This is less of a problem today than in the early 1990s as Hungary has harmonized legislation and regulations with the WTO, OECD, EU, BIS and other organizations However, these standards tend to apply at the larger blue-chip level that is already integrated into the global economy, banking system, and capital markets Conclusion of a cooperation agreement with counterpart regulatory authorities would increase confidence in the supervisory oversight of banks The challenge with regard to disclosure and transparency is also directed at HAS and the lack of disclosure in notes associated with statements, the high tax burden carried by companies which provides incentives for barter

---

[49] OTP experienced a 7 percent decline in its stock value on the first day of the Postabank run, but prices rebounded shortly thereafter

[50] NBH still monitors the banking system for movements in interest and exchange rates for monetary policy and debt management purposes

[51] According to the President of HBCMS, about one-third are in banking supervision, one-third in capital markets supervision, and one-third in other functions (legal, policy, support)

transactions and understatement of income, and traditional reluctance to share information due to fears or concerns about how that information could be used **Score 3**

- Banks and companies trading in the capital markets are required to observe IAS For years, banks have produced *consolidated statements* and accounted openly for loan losses and *nonperforming loans* While inflation rates have been high, Hungary has not experienced hyperinflation Therefore, the *revaluation* of assets has not been a major issue Tax incentives have been operative for years for banks to adequately *provision for loan losses* Pre-tax profits are reported *after* provisions, thus loan loss provisions are expensed The regulatory framework for universal banking treats exposures and risks on a consolidated basis, and this is expected to account for *unincorporated affiliates* as well to avoid the kinds of hidden risks that can hemorrhage the financial condition of a bank on a truly consolidated basis Banks and investment companies are also expected to follow *mark-to-market* accounting for securities investments for their own portfolio management purposes, as well as for prudential regulatory purposes Where there are some residual concerns is with regard to banking supervision Most of the banks in Hungary are now foreign-owned and foreign-controlled Nevertheless, Hungary has not yet signed a cooperation agreement with counterpart regulatory agencies

- Information from individual financial institutions can be demanded by HBCMS, NBH, the State Audit Office, the Tax and Financial Control Office, the Investor Protection Fund, the Office for Fair Trading and Competition, the state's attorney's office, the national security service, and the courts during criminal, bankruptcy, or liquidation proceedings However, financial information that applies to individuals and companies is otherwise subject to a significant level of confidentiality IAS ensures a certain level of *public disclosure*, but that is not enough for investors to determine the magnitude of risks that these banks' strategies, portfolios and management capacity present Thus, there are questions about the ability of the market to adequately detect risks in the absence of inside information Findings from *examinations inspections*, and regular reports to HBCMS are not disclosed to the public, although reports on groups of banks and the banking system are presented by HBCMS and NBH with a three- to six-month time lag If there are regulatory violations, it is unclear to the public if *enforcement actions* have been taken, and if they have been consistently applied

4 8 Sensitivity to Market Risk National and global events in 1997—namely the bank run on Postabank and the recent Asia crisis—have provided a general endorsement of Hungary's ability to weather crises in a stable manner The run on Postabank did not spread to the system as a whole In fact, the response was beneficial in some ways—a shift of deposits to safer institutions, limited access (if any) of Postabank to the interbank market—although it has been negative in other ways reminiscent of earlier days—a *de facto* bailout from public resources, partly resulting from close political connections With regard to global tremors emanating from the Asia crisis, Hungary showed far less sensitivity than other non-Asian markets Thus, there was no major change in exchange rates and interest rates (or associated policies and bands), nor was there major volatility in the capital and money markets for any extended period of time Much of the underlying strength comes from the immediate benefits of a growing economy This has resulted partly from the structural reforms that have been introduced in recent years—privatization, strategic investment, increased competition, recapitalized banks with relatively clean loan portfolios The near-term challenges for banks and regulators include increased competition in retail banking, the liberalization and expansion of financial markets (domestically and globally), and general risk management practices and capacity as margins tighten for blue chip customers and banks take on new customers with differing risk profiles **Score 4-**

- Hungary's banks modestly increased earnings in 1997, but ROA and ROE declined Thus, banks will be under increasing pressure to increase earnings Lending activity will need to increase to accomplish this objective This will require a shift in risk tolerances by banks to accommodate the addition of new customers who are not blue-chip Thus, *credit risk* will be a clear challenge in the coming years Banks have been prudent and risk-averse in the last few years as they have sought to consolidate their portfolios However, future credit management practices will need to test and refine underwriting standards, the structuring of loan covenants, the ability to monitor borrower compliance with covenants, and the ability to promptly identify and contain risks to portfolio quality Hungary has well developed and tested bankruptcy and liquidation procedures, and a legal basis for property rights and contractual enforcement that provides a great deal more incentive to creditors to take risks than found elsewhere in the region Nevertheless, seizing collateral and liquidating assets is a last resort for recovery under adverse circumstances Ultimately, Hungary's banking system will need to better assess which risks to take on an unsecured cash flow basis, a relatively new concept among Hungarian bankers While collateral is helpful in providing security, it is the good companies and projects which will generate significant cash flow, the essence of a successfully managed loan portfolio This presents new challenges and risks, particularly as new forms of credit—consumer, commercial, and term—will be needed by the banks for earnings purposes, and by the enterprise sector for growth and investment

- Hungary's banks are currently liquid, although not exceedingly so due to high reserve requirements and the holding of recapitalization bonds However, because of improved loan portfolios and reduced provisioning, bank liquidity is not overly constrained *Liquidity risk* is likely to diminish in the near term as fiscal deficits are gradually brought down to the 3 percent range to conform to Maastricht criteria for the EU Over time, pension reform will help reduce social welfare costs, while a growing economy will help immensely in expanding revenues Combined, both should eventually assist the enterprise sector by reducing tax rates, adding to the long-term viability of the fiscal base Exchange rates are also fairly stable, with the reasonably predictable crawling peg adding certainty for investors while enhancing export competitiveness Inflation rates remain high at nearly 20 percent, and this will take time to bring down to the relatively low rates that prevail in EU countries Overall, Hungary is in a fairly strong position to manage liquidity problems It has prepaid on obligations to multilateral organizations, with total debt now down to about 50 percent of GDP Thus, with a growing economy, improving fiscal outlook, reasonably stable exchange rate, and substantial debt capacity, there appears to be little liquidity risk for the foreseeable future that would be problematic for Hungary and its banks

- Maturity and currency mismatches will be tempting to take advantage of in the future due to earnings pressures and concerns about credit risk Thus, bank management and HBCMS will need to closely monitor investments in instruments with financial structures that are exposed to significant volatility in *interest rates exchange rates and pricing* A rise in off-balance sheet liabilities has been reported in recent years, with most of it considered risk-free or prudent hedging mechanisms against exchange rate or interest rate volatility However, this presents an example of potential risk to the banks and NBH If banks have excess exposure in dollars at a time when exchange rates eventually stabilize, or if interest rates decline, such changes could alter earnings trends This is not a major risk for the foreseeable future, but those investing resources need to be prepared for changes in these rates and prudently manage exposures accordingly Banks and regulators will also need to be mindful of risks associated with fixed-variable interest rate or exchange rate formulas as they apply to single or multi-currency investment options There may be some temptation to engage in these with comparatively high inflation rates in Hungary Likewise, there are bound to be tempting instruments that carry pricing risk—linked to commodities or other instruments The risk of abrupt changes in these markets needs to be fully acknowledged in advance of taking positions in these instruments These are required to be duly noted in the "trading books" of banks and investment houses, so Hungarian institutions should be prepared for such risks However, it is not uncommon to for investment-grade institutions in OECD markets to report losses, sometimes significant, in trading activities, on derivatives contracts, and from other risky exposures Hungarian banks will need to ensure they have adequate capital and liquidity to cover such risks and the potential downside impact they present

- As in any banking sector, there are ripple effects in the event that individual banks are imprudent in the management of resources The run on Postabank in early 1997 provides an example of public doubts about that institution's management, as well as the success of the banks in containing risks Unfortunately, the government has stepped in with ongoing support despite the absence of corrective action that would transform Postabank into a viable commercial concern These developments can be contained with few side effects where banks are small and have little impact on deposit safety, interbank markets, or securities markets However, when they affect large banks, or smaller banks with significant positions in specific bank funding sources—household deposits, interbank market—the impact can be systemic and undermine confidence without prompt, remedial action In the case of Postabank, depositors withdrew Ft 25 billion in funds and placed them with other institutions Meanwhile, the interbank market reduced access to resources for Postabank This market response significantly curtailed Postabank liquidity, yet sent a stronger message that the system itself was relatively safe and sound Despite Postabank's size, these developments did not spread in an adverse way to the system at large Thus, banks will need to continue to prudently manage resources to be able to honor *transactions* This will require strong internal controls, high levels of accountability, and effective governance and management The Postabank run was a test for Hungarian banks after the recapitalization period of 1991-94, and the banking system passed This reinforced public confidence both in the basic underlying trust required for safekeeping, and in the general oversight of the banking system for safety and soundness Money was transferred within the system, rather than taken out of the system So there was no perceptible disintermediation effect Banks will need to be in *compliance* with contractual agreements, which also is tied to the transaction risk just mentioned Compliance with prudential regulations, and public disclosure of such compliance, sends a signal that banks appear safe and sound The absence of compliance again undermines confidence, and reduces efficiency Thus, regulatory compliance backed by a well functioning legal framework is needed to manage compliance risk Hungary has this capacity, a rare development among transition countries This capacity should accommodate prudence, as opposed to excessive risk aversion, with regard to *strategic* risk Combined with adequate systems of governance and management that appear to be in place after two busy years of privatization—including new investments in information technologies, training in staff, incentives for performance, suitable organizational structures and processes to achieve competitiveness under open market conditions—Hungary's bank strategies should be able to strike a balance between risk-taking and underlying stability This will be subject to aforementioned risks, but should be manageable Finally, competitiveness of individual institutions and the market as a whole will need to increase to enhance the existing *reputation* of Hungary's banking sector Already, the reputation is strong for transition countries, and perceived to be well on its way to integration with the EU The Hungarian banking system is already more open than those found in the major OECD countries—North America, Western Europe, Japan and Korea—as measured by the prevalence of foreign ownership Moreover, it is more modern by design in the sense of having a universal banking system with an independent and integrated supervisory authority The real test will be its risk management capacity as growth unfolds, risks increase, and globalization accelerates For this reason, Hungary is now at the precipice of making structural reforms work on a sustainable, institutional basis Success will ultimately be based on Hungary's ability to develop strong and transparent institutions, and to observe international standards Accomplishments over the last decade, the steady pace of reform, the influx of direct investment, and the traditional openness of the economy all provide cause for optimism

ANNEX 3 BIBLIOGRAPHY

"After the clear-out," *Business Central Europe*, October 1997, London

Annual Report 1996 Hungarian Banking and Capital Market Supervision

Annual Report 1995/1996 State Banking Supervision

"Banking committee may investigate P-bank," *Budapest Business Journal*, July 14-20, 1997

"Book of Lists The Guide to Businesses and Services in Hungary," *Budapest Business Journal*, 1997

Borish, M , W Ding, and M Noel 1996 "On the Road to EU Accession Financial Sector Reform in Central Europe " World Bank Washington, D C

"Congressional Presentation Fiscal Year 1998 Annex III Europe and the New Independent States " U S Agency for International Development 1997 Washington, D C

"Development and the Environment " World Development Report 1992 World Bank Washington, D C

"Emerging Stock Markets Factbook "1997 International Finance Corporation Washington, D C

"Enterprise Performance and Growth " 1997 European Bank for Reconstruction and Development London

"Foreign P-bank investors face fall deadline," *Budapest Business Journal*, October 20-26, 1997

"Foreigners Transform Hungary's Banks," *Wall Street Journal*, September 24, 1997

"From Plan to Market " World Development Report 1996 World Bank Washington, D C

"Hungary a business and investment guide," Coopers & Lybrand, May 1997

"Hungary Economic Policies for Sustainable Growth," International Monetary Fund, February, 1998

"Hungary Growing Towards Europe," Credit Suisse First Boston, October 1, 1997

"Hungary's Major Banks Enjoy Positive Outlook " *Moody's Press Release*, New York

"Infrastructure for Development " World Development Report 1994 World Bank Washington, D C

"International Finance Statistics," International Monetary Fund, Washington, D C , February, 1998

"Investing in Health " World Development Report 1993 World Bank Washington, D C

"Monthly Bulletin of Statistics," National Statistical Service, October 1997

"Monthly Report," National Bank of Hungary, November 1997

MultiQuery Database Spring, 1997 The World Bank Washington, D C

OECD Economic Outlook Paris December, 1997

OECD Economic Surveys Hungary 1993 Paris

OECD Economic Surveys Hungary 1997 Paris

"Supervisory board to investigate P-bank transfer," *Budapest Business Journal*, July 28-August 3, 1997

"The Annual," *Business Central Europe*, 1997/98, London

"The Hungarian banking sector in the first half of 1997 " Hungarian Banking and Capital Market Supervision

"The State in a Changing World " World Development Report 1997 World Bank Washington, D C

"Workers in an Integrating World " World Development Report 1995 World Bank Washington, D C

"World Bank Atlas " 1992 World Bank Washington, D C

"World Bank Atlas " 1994 World Bank Washington, D C

"World Bank Atlas " 1995 World Bank Washington, D C

"World Bank Atlas " 1996 World Bank Washington, D C

"World Development Indicators " 1997 World Bank Washington, D C

ANNEX 4 LIST OF CONTACTS

Mark Le G Allen, International Monetary Fund, Senior Resident Representative

John Borzyskowski, Barents Group, Adviser to Hungarian Banking and Capital Markets Supervision

Istvan Csillag, Financial Research Ltd , Managing Director

Roger Grawe, World Bank, Country Director

Judit Hamar, Kopint-Datorg, Senior Researcher

David Hazi, Credit Suisse First Boston, Economist

Allistair Impey, Coopers & Lybrand, Partner

Mihaly Kevehazi, KPMG, Managing Partner

Mihaly Kopanyi, World Bank, Senior Economist

Millard Long, World Bank, Senior Advisor

Ed Nolan, Barents Group, Project Manager and Adviser to Hungarian Banking and Capital Markets Supervision

Karoly Okolicsanyi, USAID, Project Officer

Ted Parrish, KPMG, Director of Financial Institutions Advisory Services

Istvan Racz, Credit Suisse First Boston, Vice President

Klaus Rhys-Jones, Coopers & Lybrand, Director of Corporate Finance

Roberto Rocha, World Bank, Principal Economist

Jezsef Rotyis, FOCUS Investment Rating Company, Senior Advisor

Robert Stollinger, KPMG, Senior Manager

William Sudmann, Ministry of Finance, U S Treasury Advisor to the Minister

Istvan Szalkai, International Training Center for Bankers, Chief Executive

Imre Tarafas, Hungarian Banking and Capital Markets Supervision, President

David Taylor, Coopers & Lybrand, Partner

Adam Tertak, Ernst & Young, Managing Partner

Elemer Tertak, Daewoo Bank, Vice Chairman of the Board and President

Laszlo Voros, Hungarian Banking and Capital Markets Supervision, Head of Department