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Article

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European Investment Bank (EIB), Luxembourg

Suggested Citation: Várhegyi, Éva (2002) : Hungary's banking sector: achievements and challenges, EIB Papers, ISSN 0257-7755, European Investment Bank (EIB), Luxembourg, Vol. 7, Iss. 1, pp. 75-89

This Version is available at:

<https://hdl.handle.net/10419/44814>

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Hungary's banking sector: Achievements and challenges



Éva Várhegyi

1. Introduction

Hungary is generally considered one of the best performing transition countries, having been successful in achieving macroeconomic stabilisation and in creating a market-driven economic system (see, for instance, Fischer and Sahay, 2000; and Weder, 2001). In terms of financial sector reforms, the country is also considered in the advanced league (Bokros, 2001).

While we agree to this assessment, it is also true that the degree of monetisation and bank intermediation in the Hungarian economy is surprisingly low, and this despite Hungary's head start in setting a market-driven banking sector. More specifically, in contrast to many other Central and Eastern European Countries (CEECs), Hungary already had a two-tier banking system when the Berlin Wall came down. While the nature of activities that banks could pursue was strictly regulated - limiting competition between banks and resulting in a segmentation of the market - things changed in 1989 when commercial banks - originally confined to corporate customers - were admitted to the retail market. At the same time retail financial institutions were given commercial banking licenses.

Against this background, this paper examines achievements and challenges in setting up a functioning banking sector in Hungary. We proceed as follows: Section 2 presents key characteristics of the Hungarian banking sector and Section 3 discusses the main factors that have influenced these developments; Section 4 extends this discussion by looking specifically at the impact of financial integration on the Hungarian banking sector; finally, the last section concludes and sketches main challenges in the period ahead.

2. Characteristics of the Hungarian banking sector

2.1 Role of money and bank finance in the economy

The role of money and bank finance in the Hungarian economy has remained surprisingly limited. The ratio of broad money to GDP has not increased since the mid-1990s and remains below 50 percent, which compares to roughly 80 percent in the European Union. What is more, the ratio of bank assets to GDP has been virtually constant since 1995 and currently amounts to about 70 percent, i.e. less than one third of the figure observed in the EU. The importance of banking in Hungary seems low even compared to other CEECs, such as the Czech and Slovak Republics, although one has to bear in mind that data for Hungary already excludes unrecoverable assets whereas they are still included, at least in part, in many other CEECs.

A more detailed look at bank assets confirms the modest importance of banking in Hungary: Loans of resident banks to non-financial enterprises and households are equivalent to merely 27 percent of GDP, which compares to a ratio of 90-100 percent in the EU. In this context, it is worth noting that half of the Hungarian enterprises operate without bank finance, which is partially due to poor creditworthiness of these enterprises.

The degree of financial depth and bank intermediation in Hungary is surprisingly low.

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And then, loans to households are marginal in relation to their income and the value of their property. More specifically, household indebtedness, relative to disposable income, stands at a paltry 7 percent, far below the EU average of around 50 percent. Mortgage loans account for 5 percent of the total value of homes. Having said this, it is also true that consumer loans have recently begun to grow rapidly.

Although being small relative to the size of the economy, the banking sector dominates Hungary's financial system. In fact, the structure of financial assets in Hungary - with bank assets accounting for 53 percent of the total - is very similar to the EU (51 percent). In terms of funds channelled through financial intermediaries, Hungary is also similar to the EU: 80 percent of the savings are placed with banks and other credit institutions and the remainder is taken up by investment funds, insurance companies and pension funds.

2.2 Structure of assets and liabilities, and bank income

The structure of banks' balance sheets is similar to that found in the EU, and the quality of banks' loan portfolio has improved much in the second half of the 1990s.

The balance sheet structure of Hungarian banks is becoming similar to that of the EU. To start with assets, Table 1 shows that while claims on the state and the central bank have been on a downward trend, reaching 26 percent of the total in 2000, they continue to constitute an important part of banks' assets, not least because of poor credit demand and limited creditworthiness of non-state borrowers. Nevertheless, claims on other banks and financial institutions (10 percent of assets) as well as loans to enterprises and households (41 percent) have increased substantially. Although the share of loans to households is much lower than in the EU (6 percent compared to 16 percent in Germany, for instance), banks have stepped up their lending to households over the past three years, reflecting rising income and property prices as well as enhanced creditor rights. Over one-third of loans to enterprises are denominated in foreign currency (of which 60 percent is dominated in euro), which carry lower interest rates and are thus very attractive for companies that are able to manage exchange rate risks.

Maturities have lengthened and advances with a maturity of over one year have climbed to over 40 percent of total assets. Furthermore, more than 50 percent of enterprise loans and close to 90 percent of household loans have a maturity of over one year.

The quality of the portfolio of the Hungarian bank sector improved much in the second half of the 1990s. By 2000, the share of problematic assets (bad, doubtful, and below-average loans) and those requiring special monitoring had fallen to less than 3 percent and 6 percent, respectively. It is worth noting that the quality of assets has improved despite the soaring volume of client loans. Average capital adequacy has been around 15 percent, pointing to a well-capitalised banking sector.

Table 1. Structure of assets of the Hungarian banking sector, in %

	1995	1996	1997	1998	1999	2000
State	20.2	19.8	16.2	16.2	14.7	14.2
Central bank	22.3	22.8	19.7	17.4	16.9	12.1
Banks and financial institutions	2.7	4.3	6.1	7.8	7.7	10.0
Foreign assets	3.2	5.3	7.4	9.3	10.7	7.9
Loans to customers, total	33.4	32.5	35.0	34.2	36.3	41.3
- of which loans to enterprises	(27.3)	(28.5)	(31.4)	(30.9)	(31.7)	(35.4)
- of which loans to households	(6.1)	(4.0)	(3.6)	(3.3)	(4.6)	(5.9)
Shares and corporate bonds	4.4	4.1	4.5	4.3	3.8	3.5
Other, including cash	13.8	12.2	11.1	10.8	9.9	11.0

Source: National Bank of Hungary.

Turning to the liability side of the balance sheet, Table 2 shows a number of interesting developments. First, the importance of customer deposits has increased and they now account for more than 50 percent of banks' liabilities. Second, the domestic inter-bank money market (8 percent of the total) and foreign funds (17 percent) have gained in importance (1). The main reason why the Hungarian banks resort to foreign funds is the shortage of long-term domestic finance rather than the demand for foreign currency loans. Indeed, foreign funds and equity are the main long-term sources of funds whereas the bulk of domestic funds (some 90 percent) is of a short maturity. Third, mirroring the increase in these sources of bank finance, the importance of central bank lending and debt securities has declined markedly. Finally, the share of own funds has changed little (11 percent) - but is higher than in the euro zone - and provides scope for expanding the activity of the banking sector.

Table 2. Structure of liabilities of Hungarian banking sector, in %

	1995	1996	1997	1998	1999	2000
Own source	10.1	10.5	11.5	11.8	10.4	11.1
State	4.5	4.0	3.8	3.1	3.0	3.1
Central bank	8.5	5.2	3.3	2.7	1.6	1.0
Banks and financial institutions	3.9	5.7	8.1	7.9	7.2	8.2
Foreigners	11.6	12.2	15.8	19.2	17.2	17.1
Deposits from customers	47.4	47.7	49.7	49.3	53.4	53.0
- of which enterprise deposits	(18.0)	(18.1)	(17.9)	(16.7)	(17.2)	(17.6)
- of which household deposits	(29.4)	(29.6)	(31.8)	(32.6)	(36.2)	(35.4)
Debt securities	7.4	8.2	5.8	1.3	1.4	1.5
Other	6.6	6.5	2.0	4.7	5.8	5.0

Source: National Bank of Hungary.

1) The share of funds denominated in foreign currency was about twice as high (36 percent), which indicates that around half of the foreign currency funds came from residents.

We finally take a brief look at the sources of bank income. In the second half of the 1990s, the share of net interest revenue in total income of Hungarian banks fluctuated between 70 to 80 percent (2). Non-interest revenues (net) accounted for 26 percent in 2000, much less than the EU average of over 40 percent. Fees and commissions - i.e. a major component of non-interest revenue - have been on the rise and reached 15 percent in 2000. The bulk of this is related to financial intermediation (lending, account holding, bank cards, etc.). Revenue from trading securities is another important source of non-interest revenues. Until 1999, however, commercial banks could trade securities on behalf of their clients only within separate organisations and, thus, non-interest bank revenues included own-account trading only. It follows that on a consolidated basis, the share of interest and other intermediation revenue in total income would be lower than what the 70 to 80 percent range suggests.

2.3 Market structure, ownership and concentration

In 2000, the Hungarian banking sector comprised 42 credit institutions and around 200 small savings and credit cooperatives. While the number of credit institutions has been fairly stable since the mid-1990s, the number of cooperatives has fallen substantially. Relative to a population of ten million, the number of banks might be considered high, but with only 1 500 branches and 2 500 ATMs, access to bank services remains well below the EU average. Furthermore, the use of bank cards as well as telephone and internet banking, though growing, continues to be below the level observed in more developed markets.

Most commercial banks operate as holding companies that own two or more types of financial institutions. Because banks were not allowed to provide investment services until 1999, most of them had established independent brokerage firms and investment banks. Since the removal of these restrictions, many banks have incorporated these entities with a view to positioning themselves as universal banks. However, in most cases they continue to operate as independent units within bank holding companies. In addition, a number of banks own leasing, investment fund management, and insurance companies, and private pension funds. As a result, commercial banks are key owners in Hungary's non-bank financial system.

Foreign direct investment became a salient feature of the Hungarian banking sector early in the transition process. As a result, at end 2000, foreign shareholders held the majority of shares in 33 of the 42 credit institutions. In addition, there was one institution with a significant foreign minority shareholder. Overall, foreign investors hold two-thirds of total registered bank capital, up from about one-third in 1995, and the share of state-owned bank capital has been cut to 20 percent.

Foreign direct investment became a salient feature of the Hungarian banking sector early in the transition process.

The role of foreign investors is even more striking when looking at the distribution of assets. As Table 3 shows, foreign-owned or controlled banks account for more than 90 percent of banking sector assets. It is probably worth noting that foreign-owned banks that entered the Hungarian market through greenfield investment prior to the privatisation of state-owned banks have grown rapidly, increasing their market share from 12 to 33 percent between 1993 and 2000.

2) Net interest revenue is interest received minus interest paid.

Among foreign-owned banks, EU-based institutions have a strong presence, accounting for 55 percent of banking sector assets (for details see Table A1 in the Annex). Major EU-players are BLB, IntesaBci, ABN Amro and KBC. Non-EU investors include General Electric Capital Services (GE), Citicorp and the subsidiary of Russia's Gazprombank.

Table 3. Share of foreign-owned banks in total assets, in %

	1995	1996	1997	1998	1999	2000
1. Majority foreigner ownership	41.8	46.2	53.0	64.0	66.4	68.1
2. Minority foreign ownership	37.5	36.8	40.3	25.0	24.2	22.9
Total (1+2)	79.3	83.0	93.3	89.0	90.6	91.0

Note: Excludes savings and credit co-operatives, and building societies.

Source: Own calculations on the basis of banks' reports.

Concentration in the Hungarian banking sector is moderate and, as Table 4 shows, has declined over time. The decline in market concentration is also evident from a drop in the Herfindahl index (HI), which fell in 1993-2000 from 1 500 to 900. Mergers and acquisitions would have increased the degree of concentration, but the Hungarian banking market has witnessed only two major mergers (3). These do not seem to have weakened competition because they strengthened the position of the second largest bank vis-à-vis the dominant bank in the market.

Table 4. Concentration in the Hungarian banking sector, in %

	1995	1996	1997	1998	1999	2000
Market share of five largest banks	61	59	56	54	55	53
<i>of which majority-owned by foreigners</i>	0	14	24	29	30	30
Market share of ten largest banks	80	77	74	69	74	73
<i>of which majority-owned by foreigners</i>	13	32	42	42	45	46

Note: Measured as a percentage of total banking assets.

Source: Own calculation on the basis of reports of banks.

Asset concentration in the Hungarian banking sector is not excessive, but concentration is higher in other market segments.

It should be kept in mind that concentration calculated on the basis of assets disguises differences across various market segments. On the one hand, OTP - the largest retail bank - dominates household deposits and loans, having a market share of 42 percent and 45 percent, respectively. The Herfindahl index for this market segment is above 2 000, suggesting that the retail banking market can still be considered oligopolistic, rather than competitive (see Bikker and Groeneveld, 1998; Molyneux, 1999). On the other hand, the situation is more balanced in the corporate sector, where the index is below 700.

3) ABN Amro and KBC, operating in a strategic alliance, combined their Hungarian subsidiaries. Likewise, the merger of the HypoVereinsbank (HVB) and Bank Austria-Creditanstalt (BA-CA) led to the merger of their subsidiaries.

2.4 Efficiency, profitability and banking sector stability

As Table 5 indicates, there are signs that the efficiency of the Hungarian banking sector has improved in the second half of the 1990s. By 2000, the net interest margin on all assets and the interest rate spread had fallen to 4.0 percent and 3.7 percent, respectively. Despite these improvements, margins and spreads are high compared to the EU average (although they compare favourably to many other CEECs). This indicates that intermediation costs are relatively high. In fact, in 2000, operating costs still amounted to 3.5 percent of assets, which is twice as high as the EU average. However, it is important to note that high costs - in part - reflect efforts to modernise the banks and to establish branch networks.

Table 5. Efficiency and stability of the Hungarian banking sector

	1995	1996	1997	1998	1999	2000
Efficiency						
Net interest margin (in % of assets)	5.4	4.9	4.5	4.5	4.1	4.0
Interest spread (in %)	4.9	4.7	4.3	4.2	3.7	3.7
Operating cost (in % of assets)	3.7	3.6	3.8	4.0	3.7	3.5
RoA (in %; pre-tax)	1.5	1.7	1.3	-2.1 (0.9)	0.6	1.3
RoE (in %; pre-tax)	18.2	20.6	14.3	-25.4 (10.7)	6.3	15.1
Stability						
Bad and doubtful loans (in % of assets)	7.4	4.0	3.2	1.8	2.6	2.0
Capital adequacy ratio	18.3	18.9	17.3	9.9	15.0	15.2

Notes: Excludes savings and credit co-operatives. Figures in parenthesis for 1998 exclude two loss-making banks, one of which was liquidated while the other was bailed-out by the state.

Sources: National Bank of Hungary and Banking Supervision.

The profitability of the Hungarian banking sector has been satisfactory since the completion of bank restructuring and privatisation. The average pre-tax return on assets (RoA) has been around 1-2 percent. The average pre-tax return on equity (RoE) has fluctuated more and can only be evaluated in relation to the rate of inflation: In 1995-99, the inflation rate exceeded the RoE - in some years by a considerable margin; this changed in 2000, when the inflation-adjusted RoE amounted to around 5 percent; current indications are that this favourable trend has continued since then.

It is also worth noting that greenfield banks that entered the Hungarian market early have been more successful from the outset than privatised banks. The former were more cost-efficient and more profitable. Things have changed recently, with privatised banks catching up. Nevertheless, not all new owners could galvanise their Hungarian subsidiaries, even if they effected major investments and hired foreign managers (see Table A2 in the Annex).

There is also evidence of improvements in the stability of the Hungarian banking sector. In 1995-2000, bad and doubtful loans (in percent of total assets) have declined from 7.4 percent to 2 percent, which is lower than in any other CEECs, except Estonia (see RZB, 2001). Furthermore, the capital adequacy ratio, i.e. banks' capital in percent of their risk-weighted assets, has remained

well above 8 percent, the minimum envisaged under the Basle Accord. Hungary's banking system is thus well-capitalised.

2.5 A brief summary

In a nutshell, the main characteristics of the Hungarian banking sector can be summarised as follows:

- The size of the banking sector relative to the size of the economy has not increased and remains low by international standards.
- The structure of banks' balance sheets has become similar to that observed in the EU and activities with the private sector have grown at the expense of those involving the state.
- The number of banks is high, but low branch density does not suggest over-banking.
- Foreign investors dominate the banking sector.
- Competition has increased and the degree of concentration does not impede competition.
- There remains considerable scope for increasing the efficiency and profitability of banking.

Having sketched the main features of Hungary's banking sector, we now take a look at the main factors that have influenced its development.

3. Determinants of banking sector development in Hungary

Let us start with the **macroeconomic environment**. In the early 1990s, Hungary experienced - like many other CEECs - a deep transformation crisis, characterised by a sharp contraction of aggregate output, rising inflation and unemployment, and by large fiscal and external imbalances. By 1996, the Hungarian economy had begun to normalise, following stabilisation policies and structural reforms that - among other things - attracted substantial foreign direct investment. By the late 1990s, the conditions for sustainable development had been put in place (see Kiss and Szapáry, 2000). Overall, the macroeconomic stabilisation and the rapid creation of a market economy provided an environment that has been conducive to banking sector activity.

And then, bank **restructuring** and **privatisation** were probably the most important factors that influenced the development of the Hungarian banking sector. The bad loan problem inherited from the socialist past increased dramatically as a result of the rapid transformation recession that characterised the early 1990s. By 1992, the bad loan problem had become a major obstacle to the operation of the Hungarian banking system, calling for swift and far-reaching measures.

Under the 1993 restructuring programme, bad loans were swapped for long-term government bonds. Although strengthening banks' balance sheets, portfolios deteriorated again because of continuing difficulties in Hungary's enterprise sector. As a result, many state-owned banks became technically insolvent, triggering further government recapitalisation (4). While government rescue operations officially finished by end 1995, some banks benefited from additional public funds (capital injections and guarantees) to facilitate their privatisation.

4) During 1993-1995 the government used bonds equivalent to USD 4 billion (10 percent of the annual GDP then) in bank restructuring programmes. See Várhegyi, É. (2001a) on the process of bank restructuring.

Macroeconomic stabilisation, rapid economic restructuring, and privatisation have created an environment that is conducive to the development of banking.

The main objective of Hungary's bank restructuring programme was to make banks attractive to investors, and removing unrecoverable loans from banks' balance sheets and government-financed bank recapitalisation were the means of getting banks in shape. Privatisation itself raised two related policy issues, namely (i) whether banks should be sold to strategic or portfolio investors, and (ii) whether concentrated or diversified ownership structures were preferable (see Várhegyi, 1999).

In the event, Hungary's bank privatisation programme in 1994-97 put emphasis on involving strategic foreign investors and producing concentrated ownership structures (see Várhegyi, 1999 and 2001a) (5). In general, strategic investors were selected on the basis of the price and the capital injection promised and most investors acquired majority stakes or were granted an option to attain majority ownership in the future.

But there have been two exceptions to this model, namely OTP and Postabank, the two largest retail banks. The owners of OTP are foreign institutional investors, Hungarian institutional and private investors, and bank employees and management. In the case of Postabank, a less conscious government policy produced a diversified but not very transparent ownership structure that led to substantial losses and the need for bailing out the institution.

Privatisation has created clear and transparent ownership relations for most banks. Hungary's policy of favouring foreign strategic investors was been beneficial not only because Hungarian banks were taken over by capital-rich and experienced owners but also because it prevented the emergence of cross-ownership holdings, the hotbed of conflicts of interests (6). Overall, it is fair to conclude that Hungary's bank restructuring and privatisation happened faster than in most CEECs and that it has been brought to a successful conclusion at acceptable costs. In fact, since the completion of privatisation in 1997, the government has rescued only Postabank and has not stepped in to prevent the collapse of a smaller private bank.

Next, putting in place a proper **regulatory** and **supervisory framework** is essential for a well functioning banking sector. What has been achieved in this respect?

Like in other transition economies, there remains scope for improving the effectiveness of bank regulation and supervision.

In addressing this question, it is useful to distinguish between designing and implementing such a framework. As to the former, it is fair to state that the framework - which was modelled along EU regulations and Basle core principles - has provided the right environment for developing Hungary's banking system. The liberalisation of licensing enabled banks to perform more diverse activities and serve a wider clientele: Commercial banks were licensed to offer retail-banking services, while retail banks were granted a full commercial bank license. Despite quasi-Chinese walls between commercial banking and investment banking, banks could provide all financial services under one roof. Low entry thresholds led to the entry of several foreign banks, initially in the form of greenfield investment. As we have seen, foreign strategic investors were also free to

5) This was in contrast to the route taken in many EU countries. For instance, when banks were privatised in Portugal, most foreign buyers were turned down and, as a result, foreign-owned banks accounted for only 11 percent of total assets in 1997. In Greece, the share of foreign-owned banks in the total assets was about 16 percent in 1997, with the state retaining major stakes (Honohan, 2000).

6) The Banking Act also restrict the share that non-financial institution can hold in banks to 15 percent, thereby limiting the scope for connected lending.

participate in the privatisation of banks. The only effective barrier to market entry was the lack of legal provisions for branch establishment. This possibility was created in 1997 after Hungary's accession to the OECD.

As to the implementation of the framework, bank supervision was rather ineffective in the first half of the 1990s. This was due to a lack of professionalism and independence of the supervisory authority. What is more, prior to 1997, separate supervisors were in charge of different financial services while more and more banks were operating as holding companies - offering a wide range of financial services under one roof. This enabled banks to allocate risks within the holding, thereby evading capital requirement regulations. In some cases, such a strategy made it possible for the management to hide the group's capital shortage for many years. To deal with these challenges, the supervisors responsible for banks and investment service providers were combined in 1997. And then, in 2000, a single organisation - the Hungarian Financial Supervisory Authority - was established, which also integrated the supervision of insurance and pension funds.

Integrated supervision provides much better conditions for the implementation of supervision of a preventive nature, focusing on various kinds of risks, considering intra-group risks and risk concentration, and making more risk-based and forward-looking examinations during visits. Extending prudential and capital requirement rules to bank groups and financial holdings has further strengthened supervision. Still, there are some factors that inhibit effective supervision. Though the Financial Supervisory Authority has its own separate budget and is legally independent, it has no regulatory power itself, as the adoption of prudential rules remains the prerogative of the Minister of Finance.

While the judicial environment has improved, banks remain cautious in extending loans.

Finally, a thriving banking sector needs a proper **legal framework**. At the beginning of the 1990s, the judicial environment was rather weak. The 1992 Act on Bankruptcy did not provide adequate protection to creditors. The law stipulated voluntary bankruptcy when a company had overdue debt and allowed a three-month debt service moratorium without envisaging negotiations with creditors. As a consequence, some companies - though not insolvent at all - suspended payments to their creditors. This resulted in huge bank losses, triggering a change in the rules regarding voluntary bankruptcy a year later.

Despite these changes, banks continued to be disadvantaged when companies were liquidated. In fact, banks often recouped little after accounting for the cost of protracted liquidation procedures. In practice, the problem was partly solved by the decline in the frequency of bankruptcies and liquidations. Nevertheless, banks have become more cautious in accepting collateral, a situation that improved with the amended legislation concerning the enforcement of the right of pledge.

So far, our review suggests a macroeconomic and institutional framework in which banking should have developed quickly. But we have seen in Section 2 that the role of the Hungarian banking sector in the economy is rather limited. Why is that? There are a variety of reasons for this:

A number of factors explain the low degree of bank intermediation, including competition from other sources of funds - cross-border finance in particular.

- Limited financial savings due to low household income (7).
- A sizeable grey and black economy (estimated at 25-30 percent of recorded GDP) motivated by tax evasion, has curbed financial deepening.
- An increasing share of financial savings is not placed with banks (non-bank deposits with the Hungarian banking sector amount to only 39 percent of GDP) but channelled into investment funds, insurance companies and pension funds.
- High operating costs, which - in part - are due to inefficiencies. But they also reflect considerable IT expenditure and the cost of opening new branches, both necessary for developing the banking sector. And then, considerable reserve requirements have added to the cost of intermediation, reducing both the demand for loans and the supply of deposits (8).
- Monopolistic nature of certain market segments, and the retail sector in particular. Here the main incumbents have inherited a competitive advantage in the form of extensive branch networks, well-known bank name, and established bank-client relations.
- Shortage of well-capitalised, domestic firms with an established credit history has limited the scope of viable lending to the enterprise sector. In fact, banks have self-imposed restrictions on the amount of lending by "redlining" small and medium-sized firms, thereby cutting off the demand even of creditworthy borrowers.
- Insufficient protection of creditors' rights (including the ability to hold and seize collateral) has been an obstacle to higher lending, though the amendment of the mortgage law in September 2001 has greatly improved this situation.
- Government securities have attracted a substantial part of banks' funds, thereby crowding out lending to the enterprise sector.
- Competition from foreign funds - such as FDI, intercompany loans, and direct lending by non-resident banks to creditworthy firms - has curbed the role of the Hungarian banking system in financing corporate investment, of large firms in particular. To illustrate this, in mid-2001, the stock of cross-border loans to firms in Hungary amounted to EUR 11.5 billion and was, thus, almost as high as the amount of company debt owed to resident banks (EUR 12 billion). Some EUR 3.5 billion of cross-border loans are estimated to reflect intercompany loans.

In sum, the macroeconomic and institutional environment seems to be conducive for developing the Hungarian banking sector. Yet, the sector has got off to a slow start. In part, this is due to substantial competition from other foreign resources. We have seen that Hungary's financial integration with other countries - comprising the activities of foreign investors and the availability of foreign finance for domestic borrowers - had a significant impact on its emerging banking sector. This next section elaborates on this topic and sketches future developments.

7) Experiences in other emerging countries suggest that the structural processes accompanying economic catch-up played an important role in reducing personal savings. Liberalisation and modernisation of the financial sector, consequent easing of liquidity constraints, prolonged economic growth leading to higher income expectations, and impatience caused by postponed consumption in earlier years have all been decisive factors behind the fall in net savings by households. See Montiel (1997), Árvai and Menczel (2001).

8) In the first half of the 1990s, the reserve requirement raised the spread between lending and deposit interest rates by as much as 300 basis points, which was reduced to 50 basis points by the end of the decade.

4. The impact of financial integration on the Hungarian banking sector

4.1 Products, competition, efficiency and stability

Foreign investors have contributed to the appearance of modern banking products, procedures, and information technology. Greenfield investments were particularly effective in transferring the parent bank's culture, products and procedures. Foreign investors have also enabled the transfer of modern risk appraisal and management techniques. They have spurred the provision of medium to long-term funds and they have alleviated access to foreign currency loans. Some foreign-owned banks have ventured into niches, providing missing or inadequate services. For instance, foreign financial institutions established most of the consumer loan banks and building societies; in addition, they were also involved in setting up mortgage banks.

The entry of foreign banks has been very beneficial, enhancing the scope of banking sector services, competition and the efficiency of bank intermediation.

The entry of foreign banks lessened concentration in and the monopolistic character of most market segments. Corporate clients benefited first from enhanced competition. The distribution of power is fairly balanced in the corporate credit market: The four largest players have 10-12 percent each, while the next three control 6-7 percent each. Today, falling real lending rates are a good sign of strong competition. After initially pursuing only large corporations, banks have recently begun to target SMEs. In this market segment, the Hungarian banking sector does not (yet) have to compete with non-resident banks.

Things are different in the retail market where concentration is much higher. Because of substantial transaction costs, the availability of cross-border private deposits has not forced Hungarian banks to behave competitively in this market segment. However, as the share of the market leader has been falling year by year, and newcomers have gradually strengthened their positions, competition is gearing up both in the market for consumer and home loans. In fact, real lending rates for home loans have plunged in recent years.

The radical shift in the ownership structure and competition from foreign sources of funds has been key in raising the efficiency of Hungary's banking sector. Foreign investors that established new banks prior to the privatisation of state-owned banks have been particularly useful for bringing about this result. In addition to fostering competition, the presence of foreign banks has accelerated the introduction of banking sector skills, including risk appraisal and management techniques. Finally, there seems to be little doubt that the entry of foreign greenfield banks, bank restructuring, and bank privatisation to strategic foreign investors have strengthened the stability of the Hungarian banking sector.

4.2 A sketch of future developments

Looking ahead, it is reasonable to presume that the structure of the Hungarian banking sector will continue to change - without and even more so with Hungary's accession to the EU. The number of universal banks will decline because inefficient banks will exit the market, divest certain businesses, or merge with stronger banks. On the other hand, the number of specialised institutions may rise since there are many segments with scope for expansion (e.g. private banking, mortgage lending). Following accession, the number of banks licensed in Hungary is likely to decrease. This is because current subsidiaries of foreign banks will be turned into foreign bank branches. In addition, foreign

banks currently not operating in Hungary may open branches, or use other distribution channels such as the internet, to target customers in Hungary. This could further diminish the role of resident banks.

Although consolidation within Hungary's banking sector will continue, this is not expected to weaken competition.

All this can be expected to further promote competition, increasing the pressure on banks to become more cost-efficient. As a result, bank margins are likely to decline further, therefore strengthening the role of bank-intermediated funds in the economy. Competitive pressure will not necessarily come at the expense of profits. For one thing, operating costs may decrease once the massive infrastructure developments have been completed. And then, bank consolidation that generates economies of scale could also reduce cost. Finally, the income lost through falling margins may be recouped from non-interest revenue, which is currently much lower than in the EU.

Resident banks have the potential to build on their advantage in markets where they do not face strong foreign competition. Retail banking and private banking, in particular, are areas where the Hungarian banks may exploit their knowledge of local conditions and existing client relations. In this area, they have the best chance to raise their market share.

Things will be tougher for resident banks in the corporate loan market, where competition has already driven down margins and where rivalry will certainly intensify after accession. Again, there is potential for resident banks to benefit from local knowledge and increase lending to borrowers, such as SMEs, that have been rationed in the past. If properly priced and managed, increased lending to riskier customers could bolster banks' profitability without undermining the soundness of the banking sector.

Bank capitalisation may fall subsequent to EU accession. This is because foreign bank branches emerging from current bank subsidiaries have lower capital adequacy ratios. However, in itself this does not weaken the soundness of the Hungarian banking sector since a decline in capital adequacy ratios will be compensated for by the unlimited liability of banks' headquarters (the former parent banks) for the operation of their foreign branches.

EU accession may also influence net capital flows to Hungary, but possible effects are ambiguous. On the one hand, diminishing sovereign risk may raise inflows into the banking and the corporate sector. On the other hand, Hungarian banks will be in a better position to diversify assets geographically. Having said this, it seems unlikely that Hungarian banks will target advanced EU markets where they would face competition from more efficient banks. But it is possible that they put greater emphasis on lending to clients in other accession countries.

In conclusion, the integration of Hungary's banking sector with the EU has been fairly successful, resulting in a more efficient and more stable banking sector. With accession to the EU, the process of integration can be expected to proceed smoothly not least because EU financial institutions have taken large stakes in Hungarian banking system. That said, there are nevertheless policy challenges to which we turn in the final section.

5. Conclusions and challenges ahead

While Hungary has been successful in creating a functioning banking system, bank intermediation has not grown as fast as most observers might have expected at the beginning of the 1990s. With hindsight we can detect a variety of reasons for this, notably significant cross-border lending to creditworthy Hungarian borrowers and cautious lending of resident banks to borrowers that cross-border lending did not target.

Notwithstanding progress in recent years, there is considerable scope for improving the efficiency and profitability of the Hungarian banking sector. The challenge in the period ahead will be to make progress on this front while ensuring the soundness of the banking sector. This requires additional efforts on the part of banks, regulators and supervisors, and policy makers in general.

Increased lending to small and medium-sized enterprises holds considerable potential for the Hungarian banking sector.

To start with banks, increased lending to SMEs could be the most promising means for banks to extend their loan operations, because SMEs will continue to have only limited access to capital market finance. Indeed, most banks have abandoned their "redlining" policy in recent years and have stepped up their efforts to lend to creditworthy SMEs (see Király and Várhegyi, 1998) (9). Obviously, to enhance profitability and to maintain bank solvency, banks must properly price, monitor, and control the risk of lending to untested borrowers.

Although foreign investors with a wealth of experience in banking dominate the Hungarian banks, corporate governance is inadequate in some of them. Experience shows that parent banks do not send the most suitable management to their Hungarian subsidiaries and they change it too frequently. Parent banks could contribute to more efficient bank management through longer-term postings, and training of local professionals who have a good knowledge of local conditions and idiosyncrasies.

While an appropriate regulatory and supervisory framework - modelled along EU regulations and accounting for Basle core principles - has been put in place, its implementation needs to become more effective. This applies in particular to the supervision of bank groups and financial holdings. As argued above, competitive pressure is expected to entice banks to lend more to borrowers that are currently perceived as too risky. This should reinforce the argument in favour of improving the effectiveness of regulation and supervision. To this end, the EU should provide timely and generous assistance (transferring methodologies, providing training, etc.) to Hungarian regulators and supervisors. Finally, after accession to the EU, the subsidiaries of foreign banks may be turned into foreign bank branches. This will increase the need for better coordination of Hungarian supervisors with their counterparts in the EU.

There is also the risk that under competitive pressure the maturity structure of banks' assets, on the one hand, and their liabilities, on the other, become too unbalanced. To help avoid this problem, the Hungarian economic policy must encourage long-term savings and reduce the share of savings absorbed by the state.

In summary, our analysis has demonstrated both the progress made in creating a functioning banking system and the challenges ahead. Overall, we conclude that accession should further enhance the integration of Hungary's banking system with those of the EU.

9) For the credit market position of Hungarian SMEs see Várhegyi (2001b).

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Annex

Table A.1 Market positions of EU-owned Hungarian banks

Bank name	Owners (in 2000)	Year founded (F) or acquired (A)	Market share in 2000	Market share in 1993
Hungarian Foreign Trade Bank	BLB (85%)	1994 (A)	9.4	9.1
CIB Bank	IntesaBci (100%)	1979 (F)	8.0	4.2
Commercial and Creditbank	KBC Bank (73%), Irish Life (18%)	1997 (A)	7.3	8.8
ABN Amro	ABN Amro (100%)	1996 (A)	5.9	13.6
Raiffeisen Bank	Raiffeisen Banking Group (96%)	1986 (F)	4.1	1.4
BA-CA Hungary	Bank Austria (90%),	1990 (F)	3.8	1.0
Erste Bank Hungary	Erste Bank (99%)	1997 (A)	2.4	1.3
Hypo-Bank Hungaria	HypoVereinsbank (100%)	1993 (F)	2.2	-
Inter-Európa Bank	San Paolo - IMI (66%)	1989 (A)	1.8	1.5
ING Bank Hungary	ING (100%)	1991 (F)	1.7	0.8
Commerzbank Budapest	Commerzbank (100%)	1993 (F)	1.7	0.4
Bank of Hungarian Savings Cooperatives	DG Bank (72%)	1997 (A)	1.4	1.4
Major EU-owned banks, total			49.7	43.5
Other EU-owned banks, total			5.6	2.7
EU-owned banks, total			55.3	46.2

Notes: Market shares are based on banking sector assets.

Source: Calculation on the basis of banks' reports.

Table A.2 Efficiency of major foreign-owned banks in Hungary in 2000, in %

Bank	Home country of the owner	Market share	ROE	ROA	Net interest margin	Cost to assets
Hungarian Foreign Trade Bank	Germany	9.5	12.5	1.0	2.7	1.8
CIB	Italy	8.2	19.1	1.5	2.5	1.8
K&H	Belgium	7.5	-5.5	-0.3	3.1	4.6
ABN Amro	Netherlands	5.6	-3.1	-0.3	3.9	6.8
Raiffeisen	Austria	4.2	16.3	1.5	3.8	2.8
General Banking & Trust	Russia	3.9	22.4	2.2	4.1	0.9
BA-CA	Austria	3.8	18.9	1.7	3.1	2.5
Budapest Bank	USA	3.8	0.8	0.1	5.4	7.2
Citibank	USA	3.8	17.0	1.4	4.9	3.2
Erste	Austria	2.4	3.6	0.2	3.7	4.5
HypoVereinsbank	Germany	2.2	10.1	1.0	2.9	3.2
<i>Banking sector total</i>	-		9.9	0.9	4.0	3.8

Notes: Return on equity (ROE) and return on assets (ROA) are based on after-tax profits.

Sources: Banks' reports and National Bank of Hungary.