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More than 30 Years of the Hungarian Banking System



Summary

The two-tier banking system was (newly) born in Hungary in 1987. The advent of political changes arrived when the over-indebted country had been left without reserves, and nearly went bankrupt. From such a difficult position a functioning banking system had to be built up after the first free elections held in 1990. During the second term, between 1994 and 1998, most of the Hungarian banks were privatised (after consolidation of the individual banks during the first government with the help of government bonds.) In the third cycle there appeared to be too many banks in the country, and most of them were below the optimum. In the period between 2002 and 2010, banks flourished and created a credit boom based on foreign currency. Following the international financial crisis this led to great troubles. The forint was devaluated against the Swiss franc, and numerous clients became insolvent and lost their homes. The government elected in 2010 made efforts at resolving the situation to help citizens by programmes including several steps. Banks were required to take part in this effort by paying special taxes and for a time this cut back on their profitability. The last three governments since 2010 modified the deconcentrated banking structure and repurchased some of the previously privatised banks. In 2013 the government set the goal of increasing the share of Hungarian-owned banks to above 50%, which was achieved in 2019. The profitability of banks has recovered, and their capital position is now strong. The National Bank of Hungary fulfils the supervisory function. Through its monetary policy, unorthodox measures and credit programmes, it helps the smooth functioning of the sector and thus the financing of Hungarian SME's.

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INTRODUCTION

The two-tier banking system was born in Hungary in 1987, a few years before the 1989–1990 political change of regime led to a new, democratic society and a market economy. The importance of financial matters became clear very soon. Short-term foreign deposits (which the National Bank of Hungary, MNB recognised as “reserves”) left the country in the spring of 1990, a few weeks before the final elections. The National Bank did not have a sufficient amount of foreign currency to finance debt service to the country’s creditors. The public promise made by the reform politicians of the Hungarian Democratic Forum on television to fulfill debt service if they were elected finally convinced investors to return the money.

INITIAL YEARS: 1990–1991

All this awakened Hungarians to the importance of the banking system and monetary and finances for the country. Experienced in international banking, Pál Tar, a friend and adviser of Prime Minister József Antall, convinced him to place emphasis on this sector. A Bank Privatisation Committee was established with the task to consolidate the existing system and prepare the privatisation of banks. (Actually, the Committee was not engaged in privatisation, but created the legal framework for the genuinely market-conform functioning of commercial banking in the country.)

The system existing in 1990 comprised the following members: three commercial banks detached from the MNB : the Hungarian Credit Bank (Magyar Hitelbank, MHB), the National Commercial and Credit Bank (Országos Kereskedelmi és Hitelbank, OKHB) and Budapest Bank (BB); completed by the Foreign Trade Bank (Magyar Kereskedelmi Bank, MKB), the General Banking and Trust Ltd. (Általános Értékpapírgazdálkodási Bank), OTP (the National Savings Bank), the network of smaller saving co-operatives, and a few smaller joint venture banks (Citibank, CIB, Unicbank). Later on, new Hungarian banks (e.g. Ybl Bank, the first private bank after 1990 in Hungarian hands) were also established. At the beginning, the legal regulation of the sector was very poor. The Banking Act was only passed by the Hungarian National Assembly at the end of 1991.

Today it is difficult to imagine how little idea the Hungarian economists and financial specialist of the time had about the functioning of a genuine commercial bank in the 1980’s. Very few old experts had still been living who had some practice in banking before the nationalisation of banks in Hungary (Act XXX of 1947). A few employees of the National Bank at the arbitrage department had some understanding of foreign exchange transactions, but 40 years of a monolithic banking system nearly killed all the simple routines which any clerk in an Austrian or French bank had. In the Finance Research Institute young colleagues studied the specialised literature and they became members of the Committee that established the two-tier banking system recommended by Finance Minister István Hetényi. However, there was nowhere to learn the necessary expertise in everyday activity from. Not to mention the methods

and practices of surveillance and supervision. Board-members who were supposed to fulfil the role of internal control at banks were also people without any specific practical banking knowledge. To be quite honest, it was a surprise for us when similar problems turned out even in the most advanced market economies later on. The investigation after the collapse of the Lehman Brothers made it clear that the external board members *did not have any useful knowledge* on banking business at this big US bank.

In the 1980's the World Bank assisted a due diligence of Hungarian banks. Under severe banking confidentiality, some of the members in the banking supervisory group at the Finance Ministry were actually aware of the amount of non-performing assets held by big Hungarian commercial banks. Everybody was afraid of the public reaction when and if it were disclosed that Hungarian banks were technically bankrupt.

The causes of the disastrous shortage of capital were rooted in the situation inherited from the socialist economy planning mechanism. The so-called New Economic Mechanism adopted in 1968 was insufficient for either convertibility or the internal capitalisation of enterprises. The firms no longer received sufficient working capital for their activities from the state when they were declared to be autonomous. Only the MNB's credit lines helped bridge the shortage of capital. Firms were burdened by credits. Inadequate capital represented the legacy of the past. And the future was not rosy at all.

Parallel to the capital shortage of Hungarian firms, their export partners' solvency abroad was also a big problem. The buyers of Hungarian industrial and agricultural products were mostly firms in former socialist countries, themselves insolvent as a result of the political changes in their own countries. They could not pay for the exported Hungarian goods, so our firms also became insolvent. This led to the non-performing assets in our banks. Due to budget constraints, the Finance Ministry did not allow to create some reserves for covering the losses, accounting it as cost. So the picture was very gloomy.

At the beginning of 1991, the government commissioned a minister without portfolio responsible for the banking sector, who, with the help of a team of Hungarian experts, drafted a modern banking regulation which was handed in and accepted by the Parliament at the end of the year. This revealed the genuine portfolios of big Hungarian banks. The Banking Supervision established by the Banking Act started to control and survey the activity of the banks. It was not an easy task, because of lack of professional employees, both in the Supervision and in the banks themselves.

The public at that time was not concerned with the professional issues of the conducting of banking business but of the privatisation of the banks. This process was not in the competence of the Supervision but in the hands of the Finance Ministry.

In 1991 the Banking Committee consulted a lot of Hungarian and foreign financial experts and the Banking Association representatives about the amount of potential losses, and the methods and forms of the consolidation of the Hungarian banks. The Supervision had completed its task by showing the realistic capital situation of banks. It became clear that the state could not sell them in their current position for any significant amount of money although the budget and the debt situation of the country would have demanded capital income from privatisation, possibly in foreign currency.

The Finance Ministry therefore worked out different steps for the consolidation of banks' capitalisation. This included *credit-consolidation*, *client-consolidation* and *bank-consolidation*, by removing non-performing loans from banks' portfolios in exchange of long-term government bonds. In the first step a *buyout* was performed, the second one included *raising the capital of state banks* by adding long-term state securities to the initial capital, followed by *writing off* non-performing loans. Client consolidation was a direct help offered by the state to the clients of banks making them capable of debt service.

In the deteriorating situation two main factors played a role: the collapse of Eastern-European markets and the *fundamental ideology of market economy*. Both the ruling and the opposition parties based their policies on belief in the allocating function of the market forces. (In this spirit sometimes Hungary set stricter than necessary rules; for instance in the Bankruptcy Act.) Most experts pressed for privatisation. Liberal economists in the country firmly believed that the quicker state ownership is replaced by private the better. The other dilemma was also decisive: Should we invite strategic or portfolio investors as bank owners? Liberal politicians stressed that only *strategic foreign investors* have the required professionalism at Hungarian banks. (It was deliberately disregarded that the *realised seniorage* through lending and money generation included in the future profit would then also belong to the foreign owners.)

On the other hand, some who advocated "etatist" views did not understand the pressure made by both private and international financial institutions. The latter preferred foreign ownership, in other words, selling the Hungarian capital for foreign exchange to increase the country's reserves. Looking back, it seems a deliberate action to get hold of this profitable sector in transition economies for the benefit of foreign owners. But one has to acknowledge that it happened at the same in every CEE country, partly because of the inherited socialist capital shortage seen everywhere, and partly due to the lack of professional banking knowledge. But the ratio of foreign ownership at banks in Hungary was even higher than in the other countries of the region. (Hungary has always been a "trailblazer" or a "good pupil" during Central and Eastern European transformation.)

The first government after the change of regime would have preferred Hungarian ownership, and if foreign ownership was a must, at best they should be portfolio investors. But this strategy was only successful at OTP, where the management itself had been working according to a strategy for privatisation. It must be added that OTP did not need a large amount of money in consolidation, as it did not perform significant corporate lending activity and thus did not realise considerable losses, and so the sale of its capital was far easier. All the same OTP, too, received consolidation bonds, and they may have used them for technical development to get the necessary improvement in modernisation of the bank. It was actually a hidden assistance to the big Hungarian bank to become competitive.

OTP had a different problem: it had great many housing credits at very low, state-guaranteed interest. This was a big burden, although not for the bank, but for the guarantor, the State Treasury. The problem had been solved by a statute that allowed

the repayment of loans at a large discount. This offer was accepted by the large majority of the debtors. (The superfluous nature of the formerly granted government-guaranteed loans at low interest rate became obvious: most people actually had the money required to buy their homes, and they simply enjoyed the cheap loans, as money in deposit brought higher interest rates than the repayment of the subsidised loans.) As an interesting fact it is worth mentioning that for those who were unable to repay half of their loans, the interest rate was unilaterally raised five times the original. But the (few) who were aware of the legal proceedings and went to court won the lawsuits against the state. So the consolidation made Hungarian banks “marriageable”, that is, ready for sale in the framework of privatisation.

When banks were offered for sale, the immaterial part of the capital was not taken into consideration in the price. (For instance in 1994, MKB’s sales price was 100%, which only included the clientele, and the expertise of the management was not at all included in the price. True, the buyer simply wanted a banking licence.) The sale of Hungarian banks to state-owned or international banks (e.g. the EIB) can hardly be considered genuine privatisation. For example, the Landesbanks of Germany were institutions based on public and not private law. The EIB is an institution based on interstate contract. So why was this considered “privatisation” and how does the market’s magical “private” ownership work through them?

Nevertheless, privatisation and bank consolidation are seen as success stories both by Hungarian liberal economists and international experts. To evaluate consolidation, let us quote a Hungarian researcher: “There are more than one answers to the question of whether the final bill for the major state bank rescue programme was too much, at around USD 4 billion or 10% of Hungary’s annual GDP. If we consider that this amounted to almost one tenth of the country’s annual gross national product, then the burden seems considerable. If, on the other hand, we consider that without the state’s rescue plan the banking system would have collapsed, and would have dragged along the entire economy, then we can safely say that the government chose the lesser of two evils” (Várhegyi, 2019, p. 47).

PRIVATISATION: 1994–1997

Bank privatisation only accelerated after 1994 and had nearly been completed by 1997. By the millennium there had been 42 credit institutions, with foreigners holding majority in 33 banks. In addition to commercial banks, there were nearly 200 small Hungarian savings and credit co-operatives with limited licences. Their market share was fairly small up to 2019.

The period between 1994 and 1997 can be characterized by foreign ownership of the Hungarian banking system.

How can the role and importance of foreign ownership in banks be evaluated? In the 2000’s one could often read praises of foreign-owned banks, claiming that they defended the country from the effects of the 1998 international emerging-market crisis. But the pros and cons show a different picture.

As an ECB document reads: “Foreign ownership may have also been one of the important factors that recently helped shelter accession countries’ banking and financial sectors from spill-overs from the crises in other emerging markets. However, foreign ownership was not entirely without drawbacks. For example, in many of the foreign-owned banks, trading and other key activities were shifted to the headquarters, so that the subsidiaries in the accession countries lost some of their important functions. Moreover, the stability of the system would now depend largely on the stability of the home institutions as well as the home regulators. It was also pointed out that the presence of foreign-owned banks would in itself not guarantee stability in the banking system, as evidenced by the fact that a relatively high level of non-performing loans had persisted even in foreign-owned banks. Finally, foreign ownership should also not be seen as necessarily perpetual as disinvestment – for example, as a result of a domestic crisis or a change in the commercial strategy of the owner – always remains a possibility, and indeed disinvestment in accession countries by a strategic foreign owner had already occurred” (ECB, 2002, p. 10).

The role of the management is always critical. Sometimes foreign strategic owners did not send the most qualified persons to the banks they had purchased, and changed them too often. Measured by achievement and the economic successes of bank CEO’s, it turns out that Hungarian CEO’s were often better than the foreign directors.

The system also included a few newly established (“green grass”) banks. At around the turn of the millennium, specialized institutions also existed in the Hungarian banking sector. The activities and performance of the state-owned Land Credit and Mortgage Bank and the Hungarian Development Bank were primarily driven by government programmes, which contributed to high growth in their balance sheet total. Nevertheless, the market share of specialised credit institutions was still relatively modest, amounting to only 6% in 2001.

The year 2001 witnessed only minor changes in the ownership structure in the Hungarian banking system. The share of *state ownership* within residents’ domestic equity holdings rose at the expense of credit institutions, enterprises and individuals. *Foreign ownership*, in the middle of 1990’s decreased to 63%, but it was still very high. Excluding the Hungarian Development Bank, a special-purpose state development institution, and only including commercial banks, foreign ownership amounted to 76% (ECB, 2002).

BANK FAILURES

In the early stages of building the commercial banking system in Hungary in the 1990’s, only a very few banks went bankrupt. Such cases (Ybl Bank, West LB, Gyomaendrőd Savings Cooperative) were due to the absence of professionalism, and fraud also played a role. Ybl Bank was established for the purposes of the planned World Expo, which ultimately did not take place in 1992. The debtors could not repay the loans taken for building new hotels and similar investment projects. The

bank's portfolio deteriorated, and its capital was shrinking. To restore liquidity, the leadership of the bank used *bogus contracts* with various ministries and state institutions to use their temporarily disposable money for buying state bonds. For their "clients", i.e. ministries, it was not allowed to deposit their temporarily disposable money in commercial bank deposits, but it was legal to commission a bank to buy government bonds for them. This was a legal loophole, but only bogus contracts. Ministries should have known that there were no government bonds for sale in the market. But in such contracts there was a paragraph guaranteeing *market interest rates* for the commissioned bank *in any case*. Interest rates were very high because of peaking inflation. It was absolutely flagrant that even the Finance Ministry had been involved in such tricky businesses to get some extra money. They used it to compensate the overburdened staff for overwork. In their defence they claimed that it was very difficult to retain the workforce for the administrative staff in the ministry. Anyone with some financial knowledge went to work for better paying, newly created banks and other financial institutions (Botos, 1996). Bank crashes challenged the central budget, which had already been overstretched. It was clear that the government would not allow major losses in the depositors' money, as that would "go against" the recent political changes. People had no practice in a functioning market economy, and were unable to assess the possible risks at banks. They were grown up in a climate with huge posters on the walls of OTP reading: "Deposits are guaranteed by the state." So bank crashes urged the establishment of a Deposit Insurance Fund, which was anyhow foreseen in the Banking Act of 1991. ("The main responsibility of the Deposit Insurance Fund is to compensate depositors if the Authority has delivered its decision adopted under Section 33(1) of the Credit Institutions Act".) The fee for deposit insurance came from the banking community, so any subsequent problems remained to be solved at the taxpayers' cost.

After 1993, certain amendments were made (e.g. the operative functions of the Investment Insurance Fund were taken over), but since then a bank failure may not cause huge losses to an ordinary depositor. (Small investors are now also protected by the Investment Insurance Fund.)

One of the major bankruptcies in the second half of the 1990s was the *case of Postabank* (SAO, 1999; 2003). The accumulated losses in this bank were so great that special state intervention was required. The audit performed by the State Audit Office (SAO) after the collapse of Postabank shed light on a lot of moral, regulating and political problems. The supervision and regulation of banks have always been based on the law-abiding behaviour of the market actors. As Gerald Corrigan, director at the New York Fed, once said: if the leadership in a bank wants to mislead the supervision, it can always easily do it (Botos, 1996). This is why the *moral standard* of the management is so important. In the case of Postabank, a large number of mistakes were traceable to the management behaviour. (The extremely lenient punishment imposed on the CO of the bank after the trials and the investigation by the State Audit Office were absolutely shocking.) In addition to the bank's management, politicians also played a role in preventing the Supervision's activity when they wanted to perform on-site

inspection. It was against the law to intervene in the Banking Supervision's activity by any external authority or person, but as the Supervision was dependant on the government, it did not have sufficient power to combat pressure. It may be credited to the leadership of the Supervision that they remained firm during the disclosure of the "ownership structure". The management wanted to conceal the investors of the bank who would strengthen the capital position of the institution. There was a suspicion that the management wanted to help them by using a man of straw, and perform a kind of "baron Munchausen" escape, who pulled himself out of the situation by his own hair. The bank made a lot of similar other tricks, e.g. offering cheap and higher amounts of loans than requested by clients, even to parish clerks, if they deposited the money above the loan amount as subordinated capital. This was to raise *capital from deposits* made by the clients. Many other procedural problems were discovered during the audit. The bail-out cost for the public more than HUF 150 billion (and the CO's legal punishment was only HUF 3 million, absolutely abhorring.)

A change in the legal status of the banking supervision and its incorporation in the National Bank has strengthened its position against everyday political influences.

The 1990's and the following decade was a period of illusions. The firm belief in market economy, the belief that the West would help us adapt to the market challenges, and perhaps reduce our debt in return for the *Pan-European Picnic* turned into disappointment. Part of the talented liberal economists continued to insist on their belief that the best solution for all our problems was the "marketisation" of all aspects of life and first of all, the economy. The less the state intervention, the better, they claimed. In banking the clearest sign of that ideology was reflected in giving increasing ground to foreign banks in the internal market and in minimising state ownership.

THE OTHER SCENARIO: 1998–2002

A more conservative, patriotist economic policy was implemented in the period under the Fidesz government between 1998 and 2002. This government had a scenario that differed from that of liberal economists. Without a complex evaluation of the economic situation of that period, only one aspect, which deserves special attention, is discussed here: *economic development based on domestic factors*.

Although the export-capacity of the country was as important as before, the government also stressed the role of the internal market. A glimpse at the macro-economic data of the time reveals that the country had not reached the pre-transition levels by 1998 in many respects. Only GDP had reached the level of 1990 by 1999, but wages had only in 2002, and pensions in 2004. Thus there was insufficient demand because of the low level of personal incomes. There was only one option to boost internal demand: by offering *subsidies to home-building*. Families were planning new houses and buying new flats. The construction industry flourished. (It is remarkable that this was also the method applied in the US, in the form of low-interest rate loans to support home-building.) The growth-rate was surprisingly high; the export surplus consoli-

dated the external balance, so the indebtedness of the country decreased in relative terms. No wonder the political leaders were convinced they would be re-elected in 2002. But as mentioned earlier, wages and pensions were still lagging behind, and this explains the lost election of 2002. In their living standards, voters did not feel the government's undeniable macroeconomic achievements.

REPEATED LIBERAL LINE: 2002–2010

After the conservatives' lost 2002 elections the country returned to the liberal market economists' trajectory.

In the years after 1990, a decreasing concentration was seen in banking. By the end of the nineties, several acquisitions and mergers had taken place and resulted in concentration increase as some saving co-operatives had ceased their operation, had merged or had transformed into banks. Based on a study by McKinsey and Company, in 2005 the market share of the three biggest banks was 43.8% in Hungary, while the HHI for the whole sector was 1007. What concerns the banking industry's ownership structure, state ownership in the banks was below 20%. State banks' share was about 10%

Balázs Zsámboki assess the situation in the pre-accession stage of the banking sector as follows: "With regard to the current level of balance sheet total, there appear to be too many banks, implying that the average size of banks is below the optimum level. However, looking at the density of branches, Hungary is not over-banked, although technological development will certainly make a few branches redundant" (ECB, 2002, p. 113). We may agree with the other statement of Zsámboki that the relation between the level of concentration in the banking sector and its vulnerability in the case of shocks and crises has not been adequately assessed in Hungary so far.

In addition to the structure of the banking sector, growing foreign currency lending created great problems. This has not been given sufficient emphasis in contemporary or current professional supervisors' publications. Few authors draw attention to this dangerous phenomenon, despite the fact that retrospective analyses reveal its importance (Lentner, 2015). As an exception, Botos and Halmosi gave an evaluation on the risk climate in the second half of the 2000's: "Inflationary expectations ... will bring further depreciation. It is hard to precisely establish trends, but we may declare that *this will bring great surprises for households running up huge foreign currency loans*" (Botos and Halmosi, 2009, p. 109, italicised by the author). The subprime crisis came as a surprise and also hit Hungarian banking, despite the fact that Hungarian banks were not involved in the so called toxic assets business. But lending in foreign currency and the coming overvaluation of the Swiss frank made this type of business very costly, concerning redemption for the clients of banks. Many were unable to repay their debts. This raised the portfolios of non-performing loans at banks. But the problem which was emerging in the society was even greater. Citizens who thought that they had found a cheap financing for their housing were divested from their home ownerships

and fallen into deep poverty. Discontent was growing and the banks were blamed along with the government.

Why did such a very quick growth in lending based on foreign currency happen?

As was mentioned before, the first Orbán government supported housing from the budget. Families with children intending to buy flats or houses, were given subsidies. This idea matched the policy of the incumbent political party, namely that they intended to base the society on *families* instead of the full individualism. (The government intended not only to stimulate growth, but also parenting, as the birth rate was extremely low in Hungary. Population decline has been threatening the country.) But after 2002 the liberal government terminated this type of budget subsidy. Those who wanted a new flat had no access to anything else than bank loans. It came in handy to offer low interest rateloans from abroad to Hungarian banks, so they started lending based on Swiss francs. This did not mean that the debtor actually received Swiss francs, only the lending transaction was based on Swiss franc credit lines taken by the banks (Lentner, 2015). That way they realized an extra margin and an extra profit. Profitability of the banking sector was soaring.

But the country's macro-economic situation deteriorated year by year in this period. In relative terms, state indebtedness started to rise again to the pre-1990 levels, and deficits were high. Vulnerability to external financing was intensive. Despite all of that, the banking sector had flourished up to the eruption of the crisis. Due to international financial problems, the country had to turn to the IMF again to be able to fulfil its obligations to the rest of the world. (The first Orbán Government terminated the contract.) People's living standard failed to improve and housing problems were challenging. This is why 2010 brought changes in the political leadership of the country.

AFTER 2010

After the eruption of the crisis relate to the Swiss franc started to reevaluate and the Hungarian forint was devaluated. The loans denominated in Swiss franc became very costly, and nevertheless, Swiss franc loans expanded even in the couple of months after the outbreak of the lending crisis. Only the elections brought radical stop.

The new government very soon banned forex-based lending, and the IMF-contract, introduced extra taxes on banks, starting to consolidate the government's unsound budget. The banking tax was under heavy criticism by liberal economists inside and outside the country. (While nobody criticised the *unhealthy lending activity* of foreign-owned banks in Hungary.)

The government decided to consolidate the banking sector, eliminate the too much banks, create a healthy concentration in the savings co-operate sector, raise a bit – maybe only for temporarily – the share of the state-owned banks.

The government set a goal in 2013 to raise the share of Hungarian-owned banks above 50%. Some foreign banks left the country, as a consequence of deteriorating profitability (caused by bank taxes) and Hungarian-controlled (or owned) banks gained ground.

Table 1: Foreign and government ownership, 1995–2013

	Foreign-owned banks					State-owned banks			
Hungary	1995	1999–2001	2008	2010	2012–2013	1995	1999–2001	2008	2010
	22%	75%	85%	83%	59%	61%	6%	3%	4%

Source: Cull et al., 2017

In 2012, MFB was ordered by the state to buy out the stake of Germany’s DZ Bank in the umbrella bank of the savings co-operatives, so that it could act as an “integrator” of saving co-operatives. The government intended to unite savings co-operatives into a “commercial bank” with a nationwide network (which was actually performed in 2019).

In 2014 the state purchased MKB Bank from its Bavarian owner. In 2015, Budapest Bank was also bought by state-owned MFB on behalf of the Hungarian government from its American owner GE (which was planning its further privatisation).

The state agreed with the owners of Erste Bank to purchase a stake in the bank, through the Corvinus Investment Zrt., parallel with EBRD (each having a 15% share). The government promised by an agreement with the EBRD to stop introducing unfavorable measures against banking activity in Hungary. Based on the balance sheets share of the banks under Hungarian management, *the ratio was raised in seven years* from 13.55 to 55.7%. So the government has achieved the aim to bring the share of Hungarian-owned banks above 50%.

Some critics were recently published against the banks having Hungarian owners (and management), that they are under controll of economic forces close to the government. “From the perspective of the future stability of the banking system, two crucial questions arise: first, whether the newly nationalised credit institutions have sufficiently well-capitalised owners to stand firm should the need arise; and second, what is the impact on prudent bank operations of close interlocking with the centre of political power, and how much has the moral hazard been exacerbated” (Várhegyi, 2019, p. 59). It looks as if the concerns were exaggerated.

THE MOST RECENT DEVELOPMENTS

Let us summarize the situation in the Hungarian banking sector based on the report made for the European Banking Federation: “The Hungarian banking sector consists of 69 institutions. Among them are 26 commercial banks, nine foreign bank branches, five mortgage banks, four building societies, three specialized banks and –as a result of massive consolidation – 22 credit or saving cooperatives. At the end of 2017, 50.5% of the banking sector’s shareholding was kept by domestic entities with almost two-thirds of that in the hands of the state. The banking sector has 2,420 branches and employs around 39,000 people (0.88% of the total employment in Hungary). For the country’s population of 9.8 million in 2017, there are 10.5 million bank

accounts, 9.1 million payment cards (of which 72% are contactless), 5,100 ATMs and 136,400 POS terminals. Electronic payments increased dynamically in 2017. The payment card accepting network grew significantly by 25% which also means that 83% of the POS terminals support contactless card acceptance. In 2017, two-thirds of retail payments were made by contactless cards. The rate of access to payment accounts by internet and mobile banking services increased by 2.5% which means that 82% of the payment accounts can be accessed by one of them. The National Bank of Hungary has launched a project to implement a domestic (denominated in HUF) instant payment (IP) solution. The new payment system will be available to make payments between Hungarian payment accounts within seconds, on a 24/7/365 basis. It will also be possible for market participants to provide a range of additional services. The IP service will start on 1 July 2019. The new basic infrastructure supports innovative payment services. One-third of the banking sector's total loan portfolio is provided to non-financial corporates, one-third to households and organisations closely linked to households and one-sixth to the foreign sector (half of it to foreign corporate sector). In 2017, corporate lending grew at a rate unseen since the crisis, expanding by more than 13% in annual terms, while retail lending almost stagnated with an increase slightly over 1%. The deposit value of the banking sector remarkably increased in 2017 (by 7.7%) in total, each major sector (local state, corporate and household as well as foreign) contributed positively. The capital position of the Hungarian banking sector is stable. The Tier 1 capital adequacy ratio (CAR) is over 18%, while the total CAR is a bit over 20%. In 2017 profits reached a new high in nominal terms, mainly due to extraordinary or external factors, before tax ROE remained over 14.5%. Major extra contributors to the unexpectedly good performances are the good profitability of local banks' foreign affiliates and releasing impairments. The banking sector has a relatively high contribution to the central budget in Hungary. It provides almost 4% of the total budget revenue (approximately 1.5% of the GDP), half of it coming from sectorial taxes" (Vass, 2018).

The above long list shows that the Hungarian banking sector is for today in a well-balanced situation, concerning foreign and Hungarian ownership. Banks work profitably, have strong capital base. Hopefully the sector will help further on the smooth financing the development in our country. The latest data on the activity of the Hungarian banking sector are also promising. The most important is how lending was developing.

We may outline the situation based on the latest Inflation Report by the National Bank of Hungary (MNB, 2019).

In 2019 parallel with output and investment, the outstanding loans of the private sector exhibited a remarkable expansion during the year – just as we have seen in 2017 – both in historical and international comparison. There was a rapid growth to be seen on the demand side, both in corporate and household lending. The supply side was characterised by loosening of credit conditions and price competition. This credit expansion was really unprecedented since the crisis already in the preceding year, but it strengthened in 2019 further on.

The MNB overviewed the structure of changes in loan portfolios. Over the past 12 months, the outstanding loans of non-financial corporations vis-a-vis the Hungarian financial intermediary system have increased rapidly, by almost 17 percent. By international comparison, this is remarkable. Credit expansion primarily occurred in longer term loans, with had a maturity of over 1 year. They gave more than two thirds of the growth in the credit volume. And the majority of the credit-growth (2/3) was offered in HUF. This is favourable from a stability standpoint...

Last year's contribution of gross fixed capital formation to GDP growth was considerably higher in Hungary than in the other Visegrád countries. Business cycles and corporate lending in the Visegrád countries have typically been in sync in the past decades. This is explained by the fact that there must be country-specific factors behind the extremely rapid increase in lending seen in Hungary at present compared to other countries of the region.

Growth in corporate credit is broad-based in all sectors of the economy. Loans for the manufacturing sector has shown the largest increase. Expansion in lending in the manufacturing happened first of all by the borrowing of several international corporations in Hungary, linked to their Hungarian projects. The second sector included the firms providing financial and insurance services. The credit demand of the agricultural sector was also supported by the supplementary financing of EU transfers. The robust activity in construction and the real estate sector raised the credit portfolio of these sectors too, but a lesser degree. This was the consequence of the investment activity of *real estate funds*. Developments in the CRE market also affect the functioning of the financial system. This is primarily due to the fact that most banks' corporate loan portfolios are CRE-collateralised loans, accounting for almost 40 per cent of the portfolios in Hungary in 2018. The Hungarian corporate sector's low aggregate indebtedness provides further room for rapid credit expansion.

In the household sector the portfolio had not increased until 2017, as repayments consistently exceeded disbursements. This is because these loans were annuity loans: as the maturity of loans disbursed before the crisis progresses – accounting for a substantial proportion of existing debt – the share of principal repayments grow progressively in the monthly instalments paid by debtors. From mid-2017, however, the new credit outflows already exceed the repayments of existing contracts, and the outstanding borrowing of households began to grow. It should be emphasised that lending tends to exert its impact primarily in household investment rather than consumption.

The current growth is driven by the double-digit increase in new housing and personal loans. In addition to the low interest environment, demand is supported by the family policy programmes of the government, such as the Family Housing Allowance (CSOK) available since 2016 – and the extension thereof – and the Prenatal Baby Support available since July 2019. The number of home purchases from credit increased over the past few years, although still less than one half of all home purchases are financed with credit. However, not only housing loans, but also personal loans can finance housing investment, despite the fact that the cost associated with personal loans is still three times higher than that of mortgage loans. But fast loan assessment

and disbursement encourage households to take out personal loans for lower-value housing purposes as well. The nearly 7% expansion in household lending is driven by demand: supply conditions have not eased significantly since the crisis.

The over-indebtedness is controlled by the *debt cap rules* introduced in 2015 which have been recalibrated several times since. This prevents excessive indebtedness.

Due to the relatively high share of variable-rate loans, debtors in both the household and the corporate sector are sensitive to interest rate fluctuations. The consumer credits-takers are often not aware enough of the risk. The MNB issued therefore a recommendation to financial institutions, trying to suggest them to convince the most affected customers who have variable-rate mortgage loans, to change a transition to a fixed-rate scheme with an amendment to the already existing contract.

On the whole, thanks to the favourable financing environment and buoyant investment demand, rapid expansion may be expected to continue both in the corporate and in the household sector in Hungary in the coming period.

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