CONTENTS

Introduction ........................................................................................................... 3
J. Czabán: Principles of strategic development at the Faculty of Economics, University of Miskolc ................................................................. 7
A. Nagy: Some questions of economic decisions under uncertainty .......... 15
I. Fekete: Der Zusammenhang Zwischen der Humanstrategie und der Entwicklung der Menschlichen Kraftquelle .................................. 21
G. Sikora Tóth: Motives of starting an enterprise in the Region of Borsod... 29
J. Czabán–Gy. Fülöp: Enterpreneurship in a once controlled economy - a Hungarian perspective .......................................................... 35
I. Piskóti: Marketingtendenzen In Ungarn ......................................................... 43
L. Dankó: International economic cooperation in the Carpathian region..... 49
S. Bozsik: Some notes on the restructuring of Hungarian banking system .. 55
S. Bozsik: Some notions about the Hungarian Law on Central Bank .......... 69
I. Szintay: The Educational and Research Activities of the Department of Organizing and Management ......................................................... 79
I. Szintay–D. Szakály: Change Management ..................................................... 85
R. Hisrich–P. Szirmai: Developing a market-oriented economy:
A Hungarian perspective .................................................................................. 105
Some notes on the restructuring of Hungarian banking system

by

Sándor Bozsik

Introduction

The Hungarian economy has arrived on the eve of stabilization by 1992. The declining of industrial output has stopped, the balance of payment is positive and there is a deflation (see Fig. 1).

This means new situation in the management of banking institution in many respects. The acclimatization to the new deal in economy have to be accomplished with other important tasks together. That is to say, the restructuring of banking system came on among other steps of economic reform-process in the last decade and the introduction to the two-tier banking system meant only the beginning of the necessary structural changes towards to a market-oriented banking sector. The banking institutions and the government have to solve 3 main tasks together:


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1. They have to find new business and monetary policy on the economic challenge
2. They have to restructure the banking system and the certain banks themselves to be able to work as market oriented institutions
3. The one of the answers of the above problems is the privatization. This have to be managed.

THE EFFECT OF INFLATION TO THE DEPOSIT INTEREST RATE

During a deflation period the real interest rate of loans are increasing. This is the circumstance in Hungary, too (see Fig. 2). But the credit rates (especially the long-term rates) must decrease, that -the next steps of economic cycle - the promised recovery and upswing would pick up speed, the enterprises can take up loan to set business on foot, hereby creating demand to other goods. What delays the realization of this important event? Figure 2.

The difference between the average short-term credit rate and consumer price index

Financial Sector Real Interest Rate

![Graph showing the difference between the average short-term credit rate and consumer price index.]


The credit interest rate didn’t follow promptly the fall of price index, well the credit rates are determined by the deposit rates, and while the public expects high inflation, the banks can’t decline the deposit interests without the risk of withdrawal. This expectations were reduced by the Government with declaring its estimation to the future inflation, and by the National Bank with lower basic interest rates.

The other problem is that the credit rates are determined by the average rate of liabilities, thus if there is a high proportion of liabilities with fix interest rate (that’s why in deflation period expensive), the bank can reduce the credit rate only step by step at the same time with withdrawing the former deposits.

This pressure for high deposit interest strengthen the huge claims to state budget financing. The gross interest rate of new Treasury bill issued with for individuals in 1991 was

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1 Many Hungarian bank didn’t believe the declining of inflation, but the price indices were increasing during 1987-90. That’s why they issued a significant amount of (luckily short-term) securities with high fix rate. For example a certificate of deposit (property of auditor) of a big commercial bank with striped interest return (which means that the security bear interest at different rate inside the certain terms) pays 40% from October of 1992, while the official rate of consumer price index is 23%.
36%. The riskier paper of commercial banks must have competed with this conditions. (Later, still in 1992, the budget has learned from this failure, and it was the first which tried to break down the expectation for high inflation with securities with low-returns.) The proportion of credits to General Government in total amount of loans is approximately 50% (see Fig. 3.). The financing claim of state budget will be expectable large in the following period, which can conserve the extortion effect.

The following figure shows the share of various debtors

Share of credits

Figure 3.


The declining of deposit rate isn’t advanced by tax policy. 20% withholding tax are imposed on forint deposit interests, as long as the interest on foreign currency deposit is tax-free. Especially the individuals can use the opportunity to buy convertible currency against forint in the black market and put it in foreign exchange account. (In order to avoid this awkward competition, the President of the National Bank suggested same withholding tax on deposits regardless to types of currencies. But the Ministry of Finance fearing the escape of foreign currency deposits from Hungary, opposed the plan.)

So, particularly in the first half of 1992, the depositors enjoyed a relatively high real interest rate in consequence of this above listed facts, too. The total amount of saving boosted (for example the households’ deposit increased in 50% during 1991) The weak degree of supply with liabilities of banking institutions which was typical earlier, came to an end (see Fig 4.).
The following figure shows the fluctuation of amount of deposits in the early 90's.

But during the summer of 1992 a very quick declining in nominal deposit rates happened. But the credit rates didn’t fall down in same proportion. The entrepreneurs was getting to complain of high credit rates, the bankers was getting to complain of lack of appropriate credit opportunities and of worsening profitability. Why didn’t the bankers decrease the credit rates? Why did "credit crunch" become in Hungary? We can find one part of the answer in the phenomena of previous development of banking system.

THE CHARACTERISTICS of EXTENSIVE DEVELOPMENT in the BANKING SECTOR

The two-tier banking system was introduced firstly among the Eastern-European countries (except for Yugoslavia) in 1987. But in this time the attributes of socialist economy (deficit, great influence of state in the economy, soft budgeting constrain of state owned companies, monopolies) still existed. So the implantation of a new element depicting the market economy came together with compromises.

First of all, against the previous ideas the starting conditions of commercial banks weren’t equal. The state-owned enterprises were distributed among the bank in such a way that the banks got sectorial characteristics, thus the different claims to loans of separate sectors and its dissimilar level risks strongly affected the banks’ business prospects. There were big differences in the capital resource and the inherited number of branch offices of commercial banks, too (see Table 1). This differences in the starting position has been declining, but hasn’t come to an end, and one of the source of current financial imbalances and the strong concentration in the bank services (see Fig 5.)
Table 1. The important data of the 5 commercial banks established in 1987 shows the following table

<table>
<thead>
<tr>
<th>Name of Bank</th>
<th>Stockholder's value (bl Ft.)</th>
<th>Number of branches</th>
<th>Deposit-Credit ratio</th>
<th>Dominant sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>MHB</td>
<td>9,0</td>
<td>23</td>
<td>25-30</td>
<td>industry, transport</td>
</tr>
<tr>
<td>KHB</td>
<td>6,5</td>
<td>46</td>
<td>25-30</td>
<td>agriculture</td>
</tr>
<tr>
<td>BB</td>
<td>3,5</td>
<td>19</td>
<td>60</td>
<td>energy, infrastructure</td>
</tr>
<tr>
<td>MKB</td>
<td>3,5</td>
<td>0</td>
<td>app.100</td>
<td>foreign trade</td>
</tr>
<tr>
<td>AEB</td>
<td>1,0</td>
<td>0</td>
<td>app.100</td>
<td></td>
</tr>
</tbody>
</table>


Figure 5. Degree of concentration in the banking sector, 1991
According to the annual report of the 20 biggest bank in Hungary

This can be good characterized by the following data. This 20 biggest bank contain the 90% of balance sheet total of the 35 banks and 260 savings societies working in Hungary. The balance sheet total, the amount of capital resource, after-tax profit and the number of staff shows the following table:


On the other hand, in the beginning the commercial banks were put a check on some field of financial activity. Such fields were the whole household's business, and the foreign currency management. This restrictions have been released, but in order to the lack of appropriate expertise and professional infrastructure and connections, these types of businesses has been still concentrated in one or two banks (see Fig. 6). The lack of competition is one of the reasons why the financial services aren't abreast of the times and why the credit interest rates can't be pressed down enough strongly.
The National Bank of Hungary is the central organization of foreign currency management and monetary policy and the bank of central budget institutions. The commercial banks are entitled to keep the current account of the entrepreneurial sector, collect deposits and grant loans and provide for other banking services. The special financial institutions don’t allowed to keep current accounts and its activities collecting deposit are limited. The State Institution for Development can be found among this organizations, whose tasks belong to keep the investment accounts of former projects started by the state. The other ones deal with innovation management, leasing, bad debt management, foreign trade financing. The National Savings Banks (and other smaller savings societies) handle the financial affairs of private entrepreneurs and the households. In 1990 the commercial banks were allowed to give financial services for individuals and the National Savings Bank (NSB) restructured to share holding company, but until now the predominant majority of the stock of individual savings deposit has remained at the NSB and savings societies.

The new-born commercial banks has been carrying on some burdens and problem caused by the former monetary management, too.

Until 1991 the stated after tax earnings/capital resource indices of financial institutions were one of the highest in the economy. The commercial banks could expand quickly their activity, and established new branches. The concentration of banking activity declined, the weight of medium sized banks increased. The dependency of banking institutions from the sources of National Bank decreased. The capital resource as like as the after tax profit of the total financial sector doubled during four years (1987-90) (see Table 2). The source of the high profit was partly the weak supply versus strong demand for financial services, but the earnings were increased by the accounting prescription (the commercial banks weren’t obliged to separate provisions for bad loans and could count interests as income which weren’t paid by the companies) and the fluently increasing inflation, too.
Table 2.

The change of the after tax profit through the extensive development period of banking system

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>bl Ft</td>
<td></td>
<td>bl Ft</td>
<td></td>
<td>bl Ft</td>
<td></td>
<td>bl Ft</td>
<td></td>
<td>bl Ft</td>
<td></td>
</tr>
<tr>
<td>Big Banks</td>
<td>18.3</td>
<td></td>
<td>21.3</td>
<td></td>
<td>25.9</td>
<td></td>
<td>0.7</td>
<td></td>
<td>167.8</td>
<td></td>
</tr>
<tr>
<td>Medium Banks</td>
<td>2.3</td>
<td></td>
<td>3.7</td>
<td></td>
<td>6.6</td>
<td></td>
<td>11.2</td>
<td></td>
<td>487.0</td>
<td></td>
</tr>
<tr>
<td>Savings Banks</td>
<td>7.4</td>
<td></td>
<td>8.4</td>
<td></td>
<td>16.8</td>
<td></td>
<td>19.5</td>
<td></td>
<td>263.5</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>28.0</td>
<td></td>
<td>33.4</td>
<td></td>
<td>49.3</td>
<td></td>
<td>61.4</td>
<td></td>
<td>219.3</td>
<td></td>
</tr>
</tbody>
</table>

But this "Golden Ages" has come to an end. First of all, the reason is, that during the same period, the amount of bad loans increased by 15 times. This came mainly from loans inherited from NBH but the banks got a significant part of their own. Though amount of capital resources has risen too, its increment doesn’t protect against the boosting liquidity risk. In order to this above mentioned problems some of the biggest banks aren’t able to make balance sheet audited by West-European standard. Thus, the touched banks can’t step into foreign capital market to raise their sources, however this would be the most likely way out of their crisis (see Table 3.)².

Table 3.

Percentages of Bank Security and Profitability Indices

<table>
<thead>
<tr>
<th>Name of financial institutions</th>
<th>Bank security index</th>
<th>Profitability index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Európai Kereskedelmi Bank</td>
<td>21.93</td>
<td>11.1</td>
</tr>
<tr>
<td>Inter-Európa Bank</td>
<td>17.25</td>
<td>32.6</td>
</tr>
<tr>
<td>Leumi-Hitel Bank</td>
<td>12.58</td>
<td>9.9</td>
</tr>
<tr>
<td>Reálbank</td>
<td>12.19</td>
<td>21.4</td>
</tr>
<tr>
<td>Citibank Budapest</td>
<td>11.51</td>
<td>40.0</td>
</tr>
<tr>
<td>Kereskedelmi Bank</td>
<td>10.03</td>
<td>13.6</td>
</tr>
<tr>
<td>Magyar Hitel Bank</td>
<td>9.85</td>
<td>9.1</td>
</tr>
<tr>
<td>Altaláns Értékforgalmi Bank</td>
<td>8.12</td>
<td>12.2</td>
</tr>
<tr>
<td>Budapest Bank</td>
<td>7.88</td>
<td>2.9</td>
</tr>
<tr>
<td>Magyar Kükereskedelmi Bank</td>
<td>6.79</td>
<td>11.9</td>
</tr>
<tr>
<td>IBUSZ Bank</td>
<td>6.33</td>
<td>2.37</td>
</tr>
<tr>
<td>Postbank és Takarékpénztár</td>
<td>6.00</td>
<td>19.2</td>
</tr>
<tr>
<td>Országos Takarékpénztár</td>
<td>4.52</td>
<td>13.4</td>
</tr>
<tr>
<td>Takarékpénztár</td>
<td>4.27</td>
<td>35.2</td>
</tr>
</tbody>
</table>


² Naturally, the high ratio of bad loans and the low level of capital resource doesn’t characterize every Hungarian financial institutions. Mainly the big commercial banks are in trouble, generally the newly established, medium-scale banks have got a good portfolio. (But this is not a precise truth. In summer two of these banks went to bankruptcy.) The below table show bank security index and the profitability of some banks ranked by security. The bank security index is the capital resource in percent of balance sheet total. The profitability is measured by after-tax (and after provision) earnings per capital resource. The bold points the 7 biggest bank in total amount of balance sheet. (Notice that bank security index doesn’t mirror correctly the liquidity and risk problems of certain bank, because the denominator isn’t adjusted by different risk-level of claims.)
By 1991 the protection of security and solvency became the main problem of banking institution instead of the weak supply of liabilities, which mean the end of possibility of extensive development for banks. The state regulation strengthened this process, why there is/was a big fear of the collapse of big commercial banks, which can bury the whole economy under itself.

In connection with the above mentioned problems the aims of the new Act on Financial Institutions (official name: Act LXIX of 1991 on Banks and Banking Activities):

1. To increase the reliability of the banking system and defend the interest of depositors, hereby enlarge the confidence in financial institutions.
2. To encourage the competition throughout the regulation of banking activities with a view to stimulate their flexibility and expansion and to observe the rules of the market.
3. To determine neutrally the essential personal and material conditions of licensing, working of financial institutions and to restraint or limited the incompatible activities in the banking sector.
4. To regulate the bank secret and determine the facts about which the customers must be informed.
5. To improve the State banking supervisory system to ensure the safe operation of financial institutions.

The General requirement was that this aims had to realize in harmony with the prescription of the European Community.

In the long run, every prescriptions serve to protect the depositors' and customers' interests (see Fig 7). But the observance of these instructions costs more or less money, these decline more or less the profitability. Hereafter I'd like to take out of the Act the instructions connected with the bank's safe operation and bad debt handling, because these increase the working cost most directly and hereby the marge between the credit and deposit interest rate.

Figure 7.

The group of topics regulated by the Act:

The CONDITIONS of SAFE OPERATION of the BANKING INSTITUTIONS

Formerly I've mentioned that the commercial banks weren't forced enough to practice conservative business policy, also to strive limiting the amount of bad loans, separating provisions and saving their liquidity. In the first time it didn't mean problem, because the state owned enterprises had got "soft budgeting constrain", so the state finance them, if they
had got financial difficulties. And the state earn a lot of income from the high banking earnings exaggerated by default interests.

But after the political and economic changes in the early '90-s a lot of company have declared bankruptcy or started up liquidation against them (see Table 4). The wave of bankruptcies and liquidations increase the amount of bad debt, which force the banks to work carefully, or else the banks would have got financial difficulties and solvency problems.

Table 4.
The number of bankruptcy and liquidation in August 31, 1992

<table>
<thead>
<tr>
<th>Date</th>
<th>Bankruptcy launching</th>
<th>Bankruptcy published by court</th>
<th>Liquidation launching</th>
<th>Liquidation published by court</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st quarter</td>
<td>786</td>
<td>285</td>
<td>2,617</td>
<td>120</td>
</tr>
<tr>
<td>April</td>
<td>2,259</td>
<td>205</td>
<td>1,281</td>
<td>161</td>
</tr>
<tr>
<td>May</td>
<td>201</td>
<td>465</td>
<td>837</td>
<td>202</td>
</tr>
<tr>
<td>June</td>
<td>145</td>
<td>482</td>
<td>927</td>
<td>166</td>
</tr>
<tr>
<td>July</td>
<td>154</td>
<td>300</td>
<td>699</td>
<td>219</td>
</tr>
<tr>
<td>August</td>
<td>113</td>
<td>69</td>
<td>701</td>
<td>210</td>
</tr>
</tbody>
</table>


The explanation of the extremely high data of April is that April was the deadline of bankruptcy launching determined by the Bankruptcy Law. This table shows the effect of the change of the juristic environment, which forced the economic organizations in financial difficulties to declare failure in the 1'st quarter of the year.

The Act ordains four ratio in connection with the safe operation. The first is the weighted resource risk ratio which is the guarantee capital divided by the adjusted balance sheet total (see Note 1). In the international financial practice this is one of the most important index, which limits the activity of banks. The EC regulation has determined it, according to suggestion of Banking Supervisory Commission in Basel, in 8 %. So the Act ordains this 8% for the Hungarian banking institutions but only after 1993. In order to the current low level of capital resource, the banks must keep this ratio over 7,25 % in 1992.

Secondly, the Act prescribe creating funds fitting to the risk of activities. There are two types of funds; the banks must create reserve fund (provision) after the classified receivables (see Note 2). This fund can be subtract from before tax earnings without limitation (only in case of banking institutions), and must create general reserve fund after the general risk of banking. This must be separated from the after tax profit before the dividend payment, and its measure is 1.25% of the balance sheet total. The fund creation has set the banks to hard task, because the profit arising from banking activity doesn't cover the requirement to create provision in each cases (see Table 5). It's most likely that not every commercial banks will be able to satisfy the fund creation without subvention. The state has guaranteed for the half of the commercial banking credit inherited from the old one-tier banking system, and the reserve fund can be declined with this amount.
Table 5.
The obligatory levels of provision after receivables and the created reserve funds in the case of the four largest commercial banks according to annual reports '91. (Source: Business report of Budapest Bank, 1992 pp.19.)

<table>
<thead>
<tr>
<th></th>
<th>BB</th>
<th>MHB</th>
<th>KHB</th>
<th>MKB</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligatory level</td>
<td>16.1</td>
<td>15.8</td>
<td>8.8</td>
<td>13.1</td>
<td>53.8</td>
</tr>
<tr>
<td>Created funds</td>
<td>10.0</td>
<td>7.2</td>
<td>2.3</td>
<td>10.6</td>
<td>30.1</td>
</tr>
<tr>
<td>Fund/level (%)</td>
<td>60.2</td>
<td>45.6</td>
<td>26.1</td>
<td>80.9</td>
<td>55.9</td>
</tr>
</tbody>
</table>

Thirdly, the banking institutions authorized to carry out deposit transactions must create deposit protection funds by January 1, 1993. Its working will be determined in a separate legal provisions. The lack of obligatory deposit protection fund has caused great difficulties when the activities of three financial institutions were suspended by the State Banking Supervisory Agency in summer of 1992. The State undertake guarantee for the deposits of individuals but the entrepreneurs belonged to the account keeping circle of this banks couldn't pay, because their current accounts were blocked. (Finally the tension eased, one bank was survived by the capital of foreign owner, the smallest depositors of another bank were paid out, and the biggest control this bank, and only the smallest one has liquidated.) In order to increase the confidence of depositors, the banking institutions may establish voluntary protection funds, too.

True, that the rate of reserve requirement is regulated not in the Act (an instruments of monetary policy), but its effect is very similar to the above mentioned ratios. The banking institutions are obliged to keep reserves equal to 16% of their external liabilities regardless to the maturity in their accounts of National Bank (except for credit taken up from inter-bank money market and from the National Bank). Its rate is very high compared with the rate in other countries. Since such reserves compose one of the source of state budget financing, and (cheap source), it is not too probable, that its measure will change. The National Bank pays significant lower interest for this reserve, than the average deposit rate, so the interest of reserve have to be won from the crediting, too.

That is an instruction of Bank Supervisory Body that 5% of adjusted balance sheet total must be maintained in liquid assets, (also cash, securities of the National Bank, and current account in the National Bank). Obviously, this instruction has got the same effect, because the returns of liquid assets are much more fewer than the credits'.

THE HANDLING of BAD DEBTS

The management of bad debts became the first task of many banks. Their financing tie up the banks' money, without producing income. The interest of bad debts aren't paid, so this decline the profit, too and/or the return of "good" debts must get the interest of "bad" ones. In case of banks, whose structure of liabilities predominate the amount of current account, this cause not liquidity rather capital budgeting problem. The smaller banks, which has got more expensive deposits, are the risk of liquidity crisis greater. (To tell the truth, the amount of bad debts is generally significant lower in this case.)

The banks try to utilize different methods. Such technique is the debt-equity swap, where the bank change its debt for shares or convertible loan stock. The return of securities is significant lower than the interest of debt (that is the advantage of the enterprise), but in case
of a successful recovery (which ease the smaller interest burden) the bank can get its money back by selling the securities. But this activity is limited by the Act³.

The bank can manage and finally sell the assets which was the collateral of debt. This method is expensive because the property buy-out is burdened by 25% value added tax, whose amount can’t be required, because the banking is tax free activity. But this activity is limited, too.

A new institution for managing bad debt may be created as the Kereskedelmi Bank and the Postabank established the Kvantum Bank. The staff of this bank has got experiences and knowledge in portfolio clearing. Its method are the prolongation, the debt equity swap, the sale of bad debts in discounted value. The advantage of methods is, that the mother banks win a better portfolio, and the management of bad debt come to the hand of experts. This specialists can help to work out the recovery plan of the company, too.

ONE of the MOST PROBABLE SOLUTIONS - PRIVATIZATION

The property relations of financial institutions are fairly perplexed. When the commercial banks were founded, the state-owned companies belonged to the certain bank’s circle of keeping account could quote the bank’s shares. Also, the system of cross ownership (the bank is owner of the company, and the company is owner of the bank) can distort the credit mechanism, it can happen, that the loan granting is affected by not only economic aspects.

Other problematical point is the role of state. The state have a relation to the banks in 3 way, as owner, as budget maker and as the actor of monetary policy. And in this 3 roles it follows quite different interests. For example, as budget maker, it’s interested in the high tax payment, which interest opposes the ownership’s long-term concern to ensure the conditions of secured working (separating provision, expansion of branch network). As actor (and supervisor) of monetary policy, it interested in the bank’s dependency of refinancing sources, while the budget macerate like to extort the banks out of financial sources of Issue Bank. So one of the main task of bank reform is, that the share of non-financial owners have to be forced back in the banks, mainly in the big commercial banks⁴.

The aim of privatization is to diminish the owner role of state (which is forced by the Act on Banking Institutions too, well it obtain that “the proportion of direct or indirect shares for each owner of the subscribed capital in the banking institution - with the exception of other banking institutions - must not exceed 25%”⁵), because the state and its institutions aren’t able to manage the banks’ working such efficient than it works in the stock exchange or the private owners. On the other hand, while the state’s got determinant share in banks, it can happen, that not economic points of view involve into the decision-making (mainly into the credit granting), or the charity work of banks (through financing various foundations) would be instructed by not only economic facts, but also political forces, too.

³ There is a lot of restriction in connection with risky businesses. For example according to the Act the bank’s total share in non-financial institution can’t be more than 60% of the guarantee capital of the bank. The commercial banks have got a direct or indirect interest in a non-financial enterprise no more than 15%. The total investments of the banking institution - in real estate, movables, and in enterprises - may not exceed 100% of its guarantee capital.


⁵ In the end of 1990 the direct share in the banks was 35%, in the big commercial banks this ratio 42%, but the state hadn’t got share in 19 medium-sized bank and special financial institutions, yet. The companies and cooperatives had got 35% share, and the share of foreign working capital was still 11%.


It is most likely, that the main actors of bank privatization in Hungary, also in the whole Eastern-European region, will be the foreign professional investors (big commercial banks). Namely they have got fitting large amount of capital and experiences to practice banking activities. They can raise the subscribed capital of banks deficient in funds, hereby they make possible to increase the security of banking operation and to observe the rules of Act. They can implement the degree of banking services, can make the management more efficient. And last but not least they can procure new (foreign) market for the Hungarian banks, and can link them to the international money world.

But some consternation were expressed against the stronger foreign influence. On the one hand there are fears of large-scale repatriation of profit, or of the cheap buying up. On the other hand because of the tax allowances of foreign investments, the banks working in joint-ventures form can result in advantage of competition and although in monopolistic position. The well-capitalized foreign banks can be more difficult persuaded to follow the monetary policy.

Other substantial owners would be the big institutional investors (for example pension funds, health services, municipal councils). Their advantage is that the state can curtail the welfare expenditures to the extent of banks’ returns, this property hand-over would be the part of the reform of state budget. Residents entrepreneurs can become owners of mainly medium- and small-sized banking institutions, but in this case there is a specific importance of state supervising, which points the bankruptcy of some banks in summer.

The cessation of cross-ownership, the declining of state property may come together with the increasing of share of foreign owners and institutional investors. According to the Government’s conception the 25% of ownership in banks will remain in hand of state, the property of companies come to an end, the share of foreign banks will be limited in 40% (it doesn't mean, that the foreigners don't get larger share in some banks). The other potential owners can divide on the remainder 45%.

CONCLUSIONS

The Hungarian financial sector has entered a new era. The possibility of extensive development, the quick enlargement of branch network, the soft cost management, and big profit has come to an end. The banks have to be renewed by increasing of assortment and degree of financial service, quick reaction to changes of economic environment and monetary policy. It would be important to strengthen the branch network of saving societies especially in countryside, because there is a lot of villages, where financial institution can’t be found.

Important task is the consolidation of credits. The banks have to exploit the experiences of other countries in bad debt management and try to transplant the different methods (debt-equity swap, discounting, promoting the privatization or renewal of companies). But the active support of state is inevitable in this process.

New types of financial institution have to be created. Deposit reserve fund was mentioned. But it would be necessary to establish building societies, land banks to finance the agriculture, Guarantee Bank for promoting small enterprises. There is a lack of information system about economic organizations which can reduced the credit granting risk.

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6 The privatization of Ybl Bank is a good example of not fully considered sale. This bank has been sold for a business group consisted of private entrepreneurs, which granted credit (prohibited by the Act) for companies belonged to their interest. These credits were given into risky and long-term business, while the bank’s liabilities were mainly short-term deposit. The bank has got into trouble, the Bank Supervisory Body has suspended the activity of Ybl Bank, but the small depositors must be compensated from the money of taxpayers, and many enterprises have got into difficult situation.
The state (through the State Bank Supervisory Body) must control the banking activity very firm, because the bank handle not only its own money, but the money of depositors overwhelmingly. So the confidence in a bank, or the whole banking system is the basis of working of economy.

The problem of low capitalized banks must be solved. The most probable solution is the privatization with increasing of capital resource. This can be expected rather from foreign professional investors. But there will be role of institutional investors, too.

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SOME NOTES ON THE RESTRUCTURING OF HUNGARIAN BANKING SYSTEM

This paper tries to overview the problems in connection with the Hungarian banking sector. The Hungarian economy is in a stabilization period. To recover the economy the credit interest rates must decline. But there are very serious reasons, why the rates doesn’t do it. The large real credit rates mirror the inefficiency of banking sector. Some of the way out would be perhaps the privatization and the careful management of bad debt.

NOTE 1.

The guarantee capital is the capital resources of a bank, and consists of the following elements:
1. Basic capital elements, as:
   a) part paid of the subscribed capital
   b) capital reserve (the difference between issue value and par value of shares and ultimately accepted funds)
   c) accumulated profit reserve (retained earnings)
   d) balance sheet profit (after tax and dividend)

   In harmony with the EC regulations the capital resource can be extended with such capital elements which are available to settle the credit loss.

2. Additional capital elements, as:
   a) general reserve
   b) subordinated loan capital (maturity is over 5 years, and in liquidation it stands directly before shares)

   This must be divided by the balance sheet total adjusted by the degree of risk. According to the Law, each part of the assets must be weighted in case of:
   1. receivables from the NBH and the State Budget with a multiplier of 0
   2. accounts receivable from other banking institutions with a multiplier of 0.2
   3. bank guarantee extended or undertaken by the banking institution with a multiplier of 0.5
   4. all other assets with a multiplier of 1.

NOTE 2.

In order to create this fund the Law obligate the banks to classify each receivables according to the points of view given by the Law. This points of view are the following:

- the debt is bad if the company is under liquidation, or/and the default in payment is over 1 year. (The total amount must be reserved.)
- the debt is doubtful if the company has made loss for 2 years, the default in payment is over 60 days. (The half amount must be reserved.)
- the debt is below average if the company carry high sectorial debt or the result of classification is below average. or/and the default in payment is under 60 days. (The 20% of amount must be reserved.)

The bank can freely ranks its debt near with this prescriptions, too.