Chart

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KATALIN BOTOS: BANK PRIVATIZATION

If we wish to make a comparison with medicine, the banking system is an organ to assure the 'circulation of the blood' of the economy. It covers the whole organism with a network and only a single thrombosis is enough to paralyse everything. We can live without hands, moreover, without feet, however, without the circulation of the blood, we definitely cannot survive.

Therefore, the banking system is of special importance in a country's economy. Although it does not produce real goods, its service is one of the most important products; the share of 'banking industry' in GDP is very significant. If its balance sheet total is compared to GDP, there is a value of over 100% in developed countries; in Hungary it is over 70%, i.e. there are still objectives to be achieved.

The group that introduced socialism into Hungary was aware of this fact. This is why banks were nationalized and then, in compliance with the prevailing ideology, the system of commercial banks was terminated.

True enough, the need to restore the former banking system had been ripened by the years preceding of the change of regime but the newly- established system hardly differed from the one-tier banking system. Practically, certain directorates of the National Bank of Hungary (NBH), together with clients and staff, were transferred to commercial banks. The dowry was the building and the intellectual capital of those working there. If the clients were monotonous, the future of the newly-established banks was also dependent on that of the given sector and on the group of

enterprises. Since it was obvious that, in addition to the state, other owners ought to have existed, as there were no others, the sphere of companies were also included. This resulted in such an overlap between owners and clientele which greatly hindered the effective intermediary activities of banks towards which Hungarian banking regulation - seeking to comply with international regulation - also tried to direct the banking system. It cannot be expected from my own bank to drive me to bankruptcy in the case of financial troubles. (This is not an aim of a bank either because it kills the sheep when it would like to shear it in the future, too. But if the client is the owner, this is totally out of the question: my own credit application must be the most attractive to me...)

With the emergence of the two-tier banking system, banks with mixed ownership could be also set up and, thus, the structure of ownership in the banks operating as joint stock companies evolved like this: state ownership, corporate (private) ownership - but the latter, too, were state enterprises and/or co-operatives - and genuine private property that was held by a foreign owner.

By the time of the change of regime, the group which supervised banks had been set up in the Ministry of Finance. It intended to harmonize regulations with international practice. International financial institutions were ready to extend credit for 'x-raying' the sector that had indeed brought its own sad experiences by the time of the change of regime, namely: owing to the portfolio of bad loans as well as to the accounting practices different from international one, the profitability of banks was only illusive and it turned out that there was a serious shortage of capital. However, this fact was strictly confidential; the team of supervision consisting of Dr. Klára Csoór and Dr. Tamás Rusznák dared not reveal the great many banking and business

secrets even to the Minister who was responsible for their work. This is why the public continued to regard banks as 'rich' and even politicians, who could be considered as experts, advised banks 'to swallow hard' their losses which, in the absence of capital, would have meant losing depositors' money and the collapse of the banking system - and that was entirely impossible at the threshold of the change of regime.

The government and the public understood that there were burdens inherited as a consequence of some bad political decisions forced on the banking sector. However, the traceable extent of the burdens was far below the volume that originated from the forced track taken by the clients - often, the owners at the same time - of the banks and, for subjective and objective reasons, they were unable to adjust to the rapidly changing conditions of the internal and external economies. The trouble was not (only) the fact that there were unprofitable transactions financed on the instructions of the centre of the Communist Party but even that there were no alternatives when they made their own decisions. Out of the credits, too, which were extended on the basis of 'banking considerations', many indeed turned out to be bad ones. How much inertia played a role in this or to what extent opportunities were taken advantage of was not clear either in those days - at least, at the level of the authorities. A solution to the problem would have been as rapid a settlement as could be in order to avoid the accumulation of 'more bad loans' than necessary - and, of course, a highly professional supervision. However, there are not so many examples of the latter in international practice either, otherwise, no scandal of Crédit Lyonnais or that of Barings Bank would have occurred. This is all the more so in Hungary where everybody was a 'driver with an L-plate' both in the management of banks and the

offices of the civil service. Nobody had long enough experience in banking which would have assisted the supervision of banks.

However, during the first months the government did not - did not want to - undertake greater constraint caused by the consolidation because it thought that step would increase the burden on the Budget. And we must see, those months/years were passed by the bargain with IMF where the most critical question was the volume of budgetary deficit.

The government would not have been willing to force through legislation either, i.e. to establish the financial conditions of consolidation under a separate law instead of 'hiding' them in the actual **Appropriations Bill** as it had been done. This attitude was the direct consequence of the aforesaid, i.e. there was an illusive picture about banks in the public perception. They thought the saying, 'Thou shalt not muzzle the mouth of the ox that treads out the corn' was true and deficits in banks could be attributed to the 'bankers' caste' that defrauded people. It seemed to be impossible to accept the proposition - even within the coalition majority - that banks had 'to be assisted'. To gain the support of the opposition could have been unrealistic not only for the absurdity of the idea but also due to the appearance of counter-interests on their part. Since there were opinions - they originated from the left-liberal circles, primarily - that the government had to acknowledge losses and hand over the banks for 1 forint to possible investors to restructure them through recapitalization. This approach supposed that 'only' capital was missing from the banks and, perhaps, in the absence of proper information, they did not count on the actual high volume of deficits and their consequences. However, all experts and politicians were reluctant to discuss in depth the seriousness of the problem before a broader public, being afraid of

unfavourable international reception and domestic panic, i.e. a probable run on the banks.

Similarly, we were unable to make the government understand that the chain of indebtedness among enterprises emerged not because of the hard-heartedness of 'evil banks' that had rejected newer credit applications. Rather, it demonstrated the absence of liquidity which could not be assured by banks because there was no guarantee for the refund of their money lent. And that was true. Here shortage of revenues was in question. A considerable amount of money would have been required to terminate the chain of indebtedness, which was like a cancer. After all, money substitutes necessary for circulation had been created somehow but a rather strange situation evolved where credit was not granted but **bought**. The solution was a forced credit extension. **To excuse the government, it can be said that in a tense budgetary situation pulled to the extremes, together with the total absence of reserves, the government could hardly have presented the growth of deficit acceptable to international organizations.** Thus a proposal to create a deficit **then** at the sacrifice of public funds for the avoidance of greater trouble would hardly have won approval. International financial institutions wanted to compel the adjustment of economy and society to the changed situation through a radical decline of living standards. (Shock-therapy.) In no case, they would have accepted any deficit in the budget which exceeded the one justified by them. (I state it definitively because I myself was a participant in the negotiations. Moreover, it is also a fact that significant revenues having previously been taken from the banks were planned when making the Budget although I called attention to the fact that they would indeed only be 'paper profits'.)

Eventually, the loss of income appearing as an absence of liquidity led to the loss of capital when accounting started to reflect real values. This could not be hidden anymore in 1992 due to the enacted banking law, although the accounting rules had not shown an entirely true picture even at that time. The loss of capital became a threat to the balance of payments of banks where the value of credits to the bankrupt enterprises, which were threatened by winding up, were reduced to the minimum. (Even as a consequence of the law of bankruptcy because, during the days of grace, debt servicing was discontinued. Incidentally, the law of bankruptcy the suspension of which was urged by the Banking Supervisory Body revealed Hungarian economy as being in a much more unfavourable state than it really was since, it bankrupted the whole network of enterprises if the end product - oriented to the CMEA market - had not been sold, although the competitiveness of Hungarian industry and 'within this, that of manufacturing industry, was much better in the international markets as any of the CMEA countries. This is supported by the analyses of the industrial economy which measured the external competitiveness of Hungarian manufacturing industry based on the comparison of price levels. (Botos J., 1985). This development definitely contributed to the fact that the enterprises were undervalued during privatization and thus foreign investors were able to acquire Hungarian capacities at a low price.)

Since in this way banks, too, were compelled to show a considerable shortage of capital, the effort to find private owners as soon as possible was aggravated. The heap of losses to fall on the shoulders of the new owners ought to have been substituted through capital injection by them which would have made the purchase of a bank too expensive. Thus, the outlook for us was that we must pay somebody to buy a bank ...

That was just contrary to the government's intention to have a considerable income from privatization and from that the government did not want to deviate at all in the case of banks either. The question was especially exciting as to how many and what kind of foreign investors could be counted upon, since this would have alleviated the government's problem in the respect that there was the inherited foreign exchange debt as a burden and the servicing of which was an almost insoluble problem for it. If foreign capital comes in, obviously, it will be interested in enterprises and sectors whose prospects are profitable. It seemed almost unbelievable that the Hungarian banking system - at least, the majority of banks - should not belong to the undertakings which would have a market and be profitable in the future. Thus, one question was to settle the heritage of the past and another one was that the would-be purchaser of a bank was likely to buy an undertaking profitable in the future, therefore, foreseeably, he would pay a considerable amount of cash for it.

The long discussion of consolidation is not the subject of this study. This has been treated from many aspects by a series of studies (by Péter Mihályi, Éva Várhegyi, Ákos Balassa, Katalin Botos *et al.*) and in the material of a parliamentary *ad hoc* committee. I think I will not enter into the field of overgeneralization when stating that consolidation had been inevitable. Opinions differ as to whether the concrete method and, primarily, the point of time were the proper ones. Because, in this way, there had been plenty of opportunities for not so prudent operations and the process was much more expensive than it might have been if, at the beginning, the chain of indebtedness and the direct losses owing to the transition to the market economy and the collapse of CMEA had been settled.

The debate is rather academic because the settlements which require public money cannot be exempted from the direct influence of politics and, as has been mentioned before, the latter did not favour professionally correct solutions.

Then this fact may be interpreted according to the approach of one's own party policy.

From the aspect of our topic, bank consolidation is of high importance because if the person who is buying the bank after consolidation will be the owner of the yields of a great heap of state bonds that
- will not be a barrier to a recourse to further assets since they are weighted 0 as far as the capital adequacy ratio is concerned,
- for the acquisition of this income - be it however low - no permanent expenditures are required, i.e. it is jut a clear profit as we say it,
- it is a guaranteed income that will maintain the banking infrastructure until better times come and, the intermediary activities may be realized more dynamically.

To put it in another way, he who buys a consolidated bank and will secure himself to avert unexpected surprises - the probably unpleasant inheritance in the portfolio - will make a very good bargain since one of the most important questions of privatization on the part of the buyer is whether the factory, plant or economic venture will have a market; whether he will be able to sell his products. However, a consolidated bank has secured itself for 20 years ahead. All other increases in activity are just a present! **This would have been expedient to be paid for by the buyers.** And this is what has been missed during the bulk of privatization.

Consolidation is important from the aspect of privatization, too, because its established method, finally, led to re-nationalization, i.e. the post-consolidation proportion of state ownership was higher in banks than previously. But we must be honest, the spontaneous privatization, which started with the handing-over of company-owned bank shares to private individuals in this sector as well - and what was halted by a 1992 decision to transfer the banking shares to the State Property Agency (SPA) - would not have been desirable, either. Each state known by me where the privatization of state banks was decided worked out a very serious conception which dealt with the desirable owners, the proportion of private ownership to the foreign-owned one, the method and schedule of sale and the utilization of income. Naturally, the banking sector is a strategic one, it is quite another question what conception has been followed by strategy-makers with privatization.

Having reviewed the process of privatization after the change of regime, the process can be divided into several phases. It is worth studying the strategic approach of the governments of different political composition because, parallel to the basic consent to the necessity of privatization, there is a political difference concerning the preference of domestic ownership, a greater state intervention and the pace of privatization which is not independent of the former. It should be seen, however, that the Polish saying - 'Three Poles have four opinions' - is also true for our small country. Three Hungarian economists have four approaches to bank privatization. And as I have claimed this is not only for effect but may be supported by the fact that Lajos Bokros the current leading expert of the World Bank, the one-time minister of the Horn administration (1994-98), who became notorious for his package of measures, had a quite different opinion on bank privatization just after the change of regime

from that of later times. There was not a common and mature stand within the individual political forces either in harmony with the broad political palette which embraced the national/liberal and Christian/conservative forces of the first government.

Notions have changed on the other side as well: while Lajos Bokros preferred privatization with Hungarian ownership in the Council of the SPA in the early 1990s, he later sold Budapest Bank to a foreign investor, the GE, by means of a not very advantageous contract.

We may scrutinize the series of individual actions from the aspect when the conception to invite strategic investors played a role, or to rely on portfolio investors came to the fore. The privatization of the Hungarian Foreign Trade Bank Ltd. is a typical example of the former, while that of OTP is characteristic of the latter.

Phases can be separated according to what changes the acceptance of banking law induced in the process, for this law created a constraint on reducing state ownership with the stipulation that even the state might not have more than 25% share in a bank after a while, as had also been valid for other owners of banks. Looking back from the present into the past, I myself do not understand how the knowledge on the banking system and its capital state could be reconciled with the requirements of the forced process of privatization. Since they who knew - and among those there were the staff members of the Banking Supervisory Body that had played a key role in the preparation of the law - how deficient banks were in capital, could hardly believe that in such states buyers would be found for them in a short space of time. There is only one acceptable

explanation, i.e. they wanted to enforce the decision on consolidation as soon as possible in that way. It has already been mentioned, the earlier the restructuring would have occurred, the better it would have been. At least, it might have cost less. The Banking Supervisory Body was always the advocate of legal consolidation. That would have been the right, expedient and professionally correct solution over a not so hasty implementation from which personal conclusions could also have been drawn.

Let us make a little detour to assess consolidation! If we start out with the fact that the German economy faced a similar problem in 1990 owing to unification, it is worth studying the solution there. According to the German practice of privatisation, the *Treuhand* (similar to the Hungarian SPA) took on a guarantee for business debts to banks. Thus, the loans of the banks were not classified as bad ones and the problem of the recapitalization of banks lessened. Naturally, that solution used up the resources of the *Treuhand* which would not have been celebrated by the *Treuhand*'s Hungarian counterpart, i.e. the SPA. Hungarian administrations needed cash for several reasons, including the elimination of several budgetary deficits. (Certainly, the government would not have faced the problem of gaining parliamentary authorization to assist the banks. Of course, there is no good solution because the deficit of the SPA would have been looked at with consternation in the Parliament, too: 'Where has the privatization income disappeared?')

Eventually, consolidation was a disguised raising of state loans because the interest service of consolidation bonds had to be financed to the detriment of tax revenues and other state income. This means that we are re-grouping, permanently, the financial resources collected by state power towards the private sphere

since the majority of consolidated banks have become private ones after privatization. Besides the form of consolidation selected, the government was allowed to make a free decision on how the income from privatization would be spent (or, in the case of foreign exchange incomes, they would be placed in the NBH reserves).

If you like, it can be said that consolidation was the means for the settlement of the Hungarian external state debt. **Since it had not consumed privatization incomes** - beyond some current consumption of them - it made possible their use, namely, the settlement of our foreign exchange debts and/or their placing in NBH reserves and through this, the reduction of our net debts. Actually, consolidation transformed our former external debt into a long-term domestic debt that would have been utterly impossible with other forms of loan-raising. The market would hardly have purchased Hungarian forint state bonds with a maturity of 20 years.

However, the German *Treuhand* also ended consolidation with a deficit the estimated amount of which was almost DM 400 billion, and this, too, increased the state debt. **Incidentally, the German consolidation bonds have a 40-year period for maturity but are charged at** market interest rates as well. (It should be noted that German bank consolidation after World War II took place through similar methods. Then the bonds were not charged at market interest rates and their repurchase was planned for 100 years' time. During personal consultations with the representatives of the *Bundesbank*, I have been informed of the fact that, eventually, repurchase from the net income of the *Bundesbank* occurred over 54 years.) Similar to us, today's German economy carries the interest burdens of this consolidation with some difficulties which is indicated by the

leap of the German budgetary deficit after unification. Only for the sake of order, I note here that not only was the weakness of the portfolio of placements included in the expenses but also the fact that German reserves were converted one-to-one into the former West German currency. Thus, the Kohl administration gave a very great present to East German citizens (which was not appreciated by them so positively according to later political events.) Unification and the transition to the market economy led to the massive job losses in the Eastern *Länder* and increased the basis for the election of the left. The fact that at least bank deposits had not lost their values was not, in the long run, impressive enough for the masses.

Hungary could not rely on such a protective umbrella that would have helped the population endure the difficulties. (They were mitigated by Hungarian economic policy through another subsystem of the state finances that undertook the burdens by making large-scale retirement possible. I note it here that parallel to the one-to-one conversion of savings the inclusion of East German citizens in the earlier West German pension system was a great - and expensive - political gesture for them, too, i.e. the German economy applied the umbrella for the moderation of the burdens of transition.) In Hungary concerning the banking system only the minimum objectives that **banking deposits should not be lost** because of bad placements could be and were to be set. (After all, their value was eroded by the soaring inflation and their net values were reduced to the minimum by the favourable instalments of OTP housing loans.)

This is why banks had to be consolidated. It is quite another question that if the government wanted to have a cash income even from the sale of the banks themselves, not only the assets - deposits, current accounts - had to be covered but with

consolidation, recapitalization should be raised above zero-level, otherwise, what capital could have been sold by the existing Hungarian institute of privatization, the SPA or State Holding Company?

But it should be seen that from the whole of privatization, including the selling of other sectors as well, the state was able to receive a considerable amount of cash because the burden of consolidation was not put on the shoulders of the SPA or State Holding Company through netting.

Coming back to the impact of banking law, which urged privatization, we may see the victory of the generally-spread liberal notion - nonetheless, to the stimulation of the World Bank and the IMF as well - that the performance of state property is weaker, therefore by the force of legislation a deadline had to be determined for the hand-over of bank shares to private individuals. The thesis according to which the worst private owner is better than the state one is not well founded at all. The message of this has not been supported by recent research (thus, by an ECB paper published recently), either. Profitability is neutral as to the form of property in the EU, too, even if there are examples of large state banks near to failure and it is also a fact that Brussels opposes the state's rescue operations oriented to them... Rather, the question is that every political force would like to deprive its opposition from the advantage that is made possible through the influence exerted by the ruling party on state-owned banks. And it is hardly debated that such a phenomenon could be experienced all the time. For example that was the reason for the Central Corporation of Banking Companies becoming involved in the business of Postabank during the Horn government when the target in that case was, obviously, just to cover losses. This type of

investment would not have been made by any sound private banks at all! But financing actions with high risk and, probably, concomitant with losses (high-risk e-credit, students' loans under market interest rates) can only be conceived under the stimulation of a state owner and, in addition, to his promise to cover the losses.

The theoretical debate of whether or not a strategic investor would be needed, had mostly been decided in favour of the former in Hungarian bank privatization. Thus, **the Hungarian banking system turned out to be the branch network of interested strategic bank owners** *de facto*, even if not *de jure***.**

Whether or not this is a problem has been the subject of much debate even till today. Although strategic investors brought some expertise in addition to capital, at the same time, they lacked local knowledge; they also brought assets, if needed, but they did not force lending; they did it only with regard to solvent foreign-owned large companies in a rather limited circle. (However, they wanted to win over these companies to their credits through a suicidal competition since the acquisition of good customers was a strategic question.) The analyses demonstrated that the expertise of imported specialists was no deeper than that of domestic ones. The expertise of some talented managers who had also been concerned before with foreign transactions or extending credits in the NBH did not lag behind that of their Western colleagues. At least, the difference is in the fact that, in order to meet the rigorous control of the private owners, it can no longer be substituted by any political merits.

Subsidiaries of banks operated by or established with foreign participation in Hungary entirely fitted into the business policy

of the parent banks. It may also occur with banks which have large international networks that the centre of various business branches is in another foreign city, i.e. the Hungarian subsidiary reports in two directions. In the subsidiaries, the freedom of the decision-making of managers is very restricted. Decisions are adjusted to the international standards of banks and have a minimum regard to domestic conditions. Actually, banks with strategic owners function as branches even if this is not the case according to current regulations in force. After joining the EU, many of the domestic banks owned by EU banks are expected to turn into branches in the legal sense as well. The developments of the internal banking system in the EU indicated this trend when the EU converted to the rules of the single European market. Thus, to expect the conveyance of the goals of the national economy and those of politics from private banking sector - e.g. the financing of small businesses with high risk; the development of medium-sized businesses with capital participation - will be very restricted. This can be implemented insofar as and when they coincide with banking interests.

Let us examine the impacts on Hungarian bank management from the aspect of the extent to which the banking system, that has emerged, is **consumer-friendly**. The complaints are as follows: customers feel themselves defenceless; services are expensive; and there is competition for customers only at the level of advertisement.

As far as the credit lines are concerned, it became quite obvious that the only chance for the development of domestic small and medium-sized businesses is the growth of domestic savings. And now the cardinal question is what possibilities the development of Hungarian small and medium-sized businesses that are in the forefront of establishing jobs have since

multinationals will not solve one of the greatest problems of our age - and probably the most urgent one in the country - i.e. employment.

Taking all this into consideration, it is hardly understandable why this strategic branch, almost the whole of the banking sector, had to be handed over to foreigners. International comparison shows that out of European countries, a high proportion similar to us can be found in Greece (77%) while Germany, Austria and Spain keep this proportion between 25% and 30%; and in Sweden, Norway and Italy the presence of foreign owners is not typical at all.

II.

Let us study some concrete questions interrelated with bank privatization. Here I do not strive at completeness, only at commenting, on the one hand, on some cases which were focussed upon by the public and, on the other, the professional community thought their conditions were rather obscure.

l. The case of General Entrepreneurial Bank

Similarly to Ybl Bank, the privatization of General Entrepreneurial Bank took place as a routine step of the SPA, preceding the elaboration of a general conception that was not a too-detailed one, either. At that time, in 1991 the setting-up of the not-so-effective Committee on Bank Privatization was under way and in connection with those sales, the question was raised as to who else might intervene in privatization with respect to the special character of the sector, i.e. privatization might not be the only result of a decision of the SPA management.

At the highest state levels the German West-LB expressed its intent to make a 'bridge-head' in our country; therefore it would purchase some shares of a small and well-operating bank. Since General Entrepreneurial Bank was previously qualified as a well-managed, small bank, the purchase was licensed - indeed, at that time, its manager was appointed as top manager of OTP where he spent only a short span of time but later, too, he was a banker and/or an influential person of financial policy.

At the beginning, WLB did not wish to buy more than 25% and wanted to examine the books of the bank more thoroughly as an owner. Who would have thought that over that short period there would be an essential deterioration in the bank's state? But that happened. The Banking Supervisory Body began to collect the banking data services, based on banking law. Relying on this information and only out of intuition, without any special signal, the management of the Supervisory Body had a look at the ownership structure of small banks where there was already some variety, as compared to state ownership. It was striking that there were overlaps between the owners, managers and clients of some small banks, and the Managing Director of one of the banks controlled an ownership interest in the businesses financed by him. A more thorough examination launched was strengthened by the liquidity problem of a bank that had been indicated by the apparatus and data service of NBH as sound. Eventually, that bank had been wound up and their managers and owners were put on trial. Our bank - having a very complicated contact with the former - accepted bills at a discount guaranteed by the bank but for such a short period of time that it was shorter than the legal enforcement time, thus, the guarantee was zero. The amounts were so high that they shook the state of the small bank to the foundations. Revealing the problem, the foreign purchaser protested to the selling body

(SPA), the State Banking Supervisory Body and all the possible fora, asking why it had been given 'a defective product'. It was proved that the radical deterioration of the situation had occurred during the time it had been the owner, although not a majority one. As the foreign owner preferred not to stand in front of the public as an owner of a failing bank, he was willing to make a sacrifice. Thus, the consolidation of the bank was carried out in a way that the SPA undertook a considerable proportion of the losses but the minority owner, too, participated in the settlement. Then, the reorganized bank was in practice taken over by the latter. Since that time it has been one of our successful small to medium-sized banks.

2.) The privatization of Hungarian Foreign Trade Bank Ltd.

At the end of the cycle of the first government, bank privatization was considerably prolonged because of the conceptual debates and consolidation. The government which 'had worn out' its third minister of finance by that time and the Minister himself would have liked 'to produce success' in the field of bank privatization, they put the privatization of Hungarian Foreign Trade Bank Ltd on the agenda, which had long been prepared by the Director General, together with one of the strategic partners the Bayerische Landesbank the head of which was also one of his good acquaintances. The sale 'having been frozen' for one-and-a-half to two years took place in 1994. The purchaser greatly immersed himself in the contract of sale and was willing to pay for the bank just as much as the registered capital and the reserves above par in the bank. That is, he did not want to pay a penny more than that for the clients thereby acquired. The bank's total balance sheet was not among the biggest and, therefore, according to some analyses its sale was marginal. However, it should be noted that, owing to the

properly controlled relations between partners and the nature of the transactions, the foreign trade transactions financed by this bank resulted in the most favourable portfolio for the bank – in any case, much more favourable than those of the others. (And even if there was a 'deficient component' in it, with a master-stroke, they sold it to another bank with state ownership; which was, eventually, a kind of consolidation.) Since there was no problem with the portfolio, the bank could be sold without an 'official' public state consolidation - at a rather low price. The Banking Supervisory Body could not intervene in it because the sale did not belong to its scope of authority. An ironical contradiction of privatization is that Hungarian privatization strengthened the position of the Bavarian *state* bank as a strategic investor...

In the first phase among the owners there were also EBRD as an institutional investor and also the Hungarian state (SPA) with 25%, but after two years, the latter proportion, too, was bought by the strategic investor.

The new owner soon replaced the Director General but it employs in this position an 'old motorist', a leading banker who had been an active top manager even before the change of regime.

3. The case of OTP

Although the privatization of OTP had not been hindered by the volume of bad portfolio, there were some problems to be solved concerning the bank. Before the change of regime, international financial institutions exerted pressure on OTP to change from a savings bank into a commercial one and also undertake corporate financing since it was the one organization which had

considerable assets from the savings of the population. But it had neither experience nor a professional personnel in corporate finance. (Indeed, none of the other banks had either but, at least, they had been concerned with some corporate finance according to the practice of the former regime.) Incidentally, the informatics system of the bank did not meet the modern requirements of retail banking services, either. In addition the capital of the bank was not enough according to the regulations in force. All this would have definitely been a barrier to sale. However, a solution of regulation and a genuine financial step assisted in settling the problem. The former could be eliminated by classifying credits lent on mortgage in the 50% category; that step considerably improved the capital adequacy ratio, then the coverage for IT was created by the separation of some billions from the framework of consolidation bonds to spend them on recapitalization. Moreover, this whole amount was returned out of the income from privatization and, what is more, in cash!

Liquidity was not a problem, owing to abundant savings of the population which started to accumulate rapidly after the change of regime.

Actually, the government had a problem with OTP because of the interest rate support of housing loans since the latter generated such a great volume of budgetary expenditure that they had to be reduced. Therefore, a programme had to be introduced for the reimbursement of the housing loans under the following conditions: for those who repaid the half of the existing debt, the other half was released. If somebody was unable to do so, he had to pay a higher interest rate. (It was rather an unlawful measure because it was one-sided. Contracts should be changed only on the agreement of both parties.) That

series of operations belonged not to the consolidation of OTP but to that of the Budget.

The decisive steps of privatization took place during the Horn government but the swap of compensation vouchers for shares, which had occurred over the preceding two years, could be considered as part of privatization. That was followed by a series of actions that did not bring money to the government but corresponded to the principles of privatization, i.e. domestic institutional investors - local governments and the social security system - were granted banking ownership. Further on, foreign investors, domestic institutional and private investors as well as the management, acquired a significant proportion of ownership not in open sale. Finally, the proportion of state ownership left was sold as well.

OTP relied mostly on **portfolio investors** of national ownership. As there is influential participation but none of the owners has dominant ownership, **the role of management** is of decisive importance in the bank's profitable and prudent guidance. Although the structure of ownership compels the management to run the bank profitably, strategic development is dependent on the inventive ideas of the management. Unquestionably, the basis of successful operation of OTP is that it has been run by a rather permanent team of Hungarian banking specialists for more than ten years. With an intelligent policy, the management had a hold on the process of privatization; it always had its own initiatives; it managed to avert the attempts at the change in management; here it was the bank's privatization strategy that played a great role. The shares of state ownership were held by several state organs, i.e. the compulsory social security organizations, the SPA and the Ministry of Finance, which acquired ownership rights for privatization bonds. They were all

considered as the representatives of the state. **<u>Thus, with proper tactics, they could be persuaded to make votes against each other in the question of personnel that would not do much to the co-ordination of central organs but continuity benefited the management.</u>**

4. The BB story

The sale of Budapest Bank (BB) is the most expressive - perhaps, negative - example of how **a bank should not be sold.** I would like to point out some elements of it: it is not expedient to set short deadlines for the sale publicly since it results in unfavourable bargaining positions for potential customers. It is not right to give generous guarantees in the contract of sale stating that bad loans coming to light later will be taken over by the state. Let the customer have a closer look as to what he will buy. It is not reasonable to sell a bank to a multinational company, one large company which has just settled in Hungary. That is, BB was sold, actually, to one large company General Electric although, formally, the provision of the law according to which only a financial institution may even own **<u>10 or 100%???</u>** of a bank had been met because an investment company classified as a financial institution owned by GE (GE Capital) appeared as a buyer. However, this purchase is hardly independent of the presence of an enormous corporate investor in Hungary. Also, it has often been said that this sale has been 'necessary' because it has warranted the credibility of the government's intents - but *at too great a price.* With consolidation, it would have been better to examine more thoroughly what there was in the bank and discover the losses - the management of the bank had been boasting before that, eventually, they did not want to participate in state consolidation; 'the problems would be solved on their own'.

Finally, this happened in a different way due to realization of state guarantees. Here, too, we may refer to the German example since consolidation there was not a single action but recapitalization was put on a Sonderkonto and that was corrected by permanent analyses. Obviously, we are witness to such a thing in the case of BB as well but, in the meantime, the change of the owner had taken place. In any case, it was untrue that the bank recapitalized itself without state assistance, as was said in the advertisement of the sale.

5. Privatization of other banks

Hungarian Credit Bank sold in 1997 and the Commercial and Credit Bank Ltd. (merging with Ibusz Bank) were sold even later and were acquired by strategic investors. Similarly, the smaller Bank of Hungarian Savings Co-operatives with its network and Mezõbank Co. Ltd. - amalgamating with Agrobank - also received foreign owners. The sale prices were much more favourable than in the abovementioned cases. Concerning the sale prices, that of the Bank of Hungarian Savings Co-operatives was outstanding. Here it was reflected to some extent that the banking licence and market presence themselves are of a value. This wave of bank privatization has implemented the presence of banks of various European nationalities - Irish, Dutch, Austrian, German - in Hungary and mitigated the dominance of foreign ownership, at least, with its greater variety.

6. The - unrealized - privatization of Postabank

Postabank was established after the emergence of the two-tier banking system, also having foreign owners from the outset. The objective of the bank was to break the monopoly of OTP in the retail market. After the change of regime, similar to OTP,

institutional investors and social security self-governments, were granted shares in ownership. Since the bank might not refer to inherited debts and, presumably, did not intend to give a significant participation to the central government, it 'did not apply' for consolidation bonds. However, its capital adequacy ratio was continuously under the level required and that could not be remedied by any regulatory tricks because it did not have a considerable stock of housing loans lent on mortgage (which had provided a solution for OTP). Since *it did not apply* for - later the management said it had not been given - the opportunities of consolidation, bad loans remained unsecured. However, the case of Postabank differed from those of all other banks, even from that of Agrobank with which it had some similarities in the solution followed. Agrobank's shortage of capital derived mostly from inherited bad agrarian loans that the seller did not want or was not able to admit to the buyer and would have liked to manage without a state co-owner - but Postabank itself made all of its placements. Here there is nothing or nobody to be pointed at. This whole situation originated, entirely, from management decisions, the placement constraints of its aggressive expansion policy and business policy. Why indeed should it have been consolidated?

It is really incomprehensible why **the personal consequences** of the constraints of consolidation have not been concluded much sooner by the authority concerned. It is also incomprehensible that a state-owned bank was compelled to intervene with capital to cover losses and other public monies were sacrificed in restructuring - and the management was not changed. (It is not an easy task but there was no attempt even to do so as far as it is known.)

It can be said in favour of the Supervisory Body that, eventually, it stopped unknown owners - hidden behind offshore firms - from increasing capital in the bank and acquiring a bank of considerable total balance sheet the collapse of which would not be permitted by the state, evidently, because it would be 'too big to fail' and, thus, somehow it would continue to operate. And through this rather unfair way, the owners would have had the privilege of earning money with taking a risk with other people's money since the ownership of a bank means 'my adventure with your money'.

Regrettably, 'playing the fox' for a long time - let us call what has happened like this although a more thorough investigation must make the wording more exact since risk-taking points at moral hazard, too - required a terrible price: such a huge amount of money that had gone beyond all other previous scales; a larger amount of money than those appeared with any other bank's consolidation which had been justified by somewhat more objective economic circumstances than those of the Postabank. Here, indisputably, subjective factors, i.e. the decisions of the management played a role and consolidation was justified rather by the size of the bank and the immense amount of public savings. Thus, it conveys a really unfavourable message to society, namely, *taking risks is worth doing only on a large scale.* The bank was returned to state ownership again and stayed there by the end of the third cycle. In compliance with its privatization philosophy, the new left-liberal coalition is likely to privatize this bank as well. It is only to be hoped that they will learn from the experiences of former privatizations. Over consolidation the management, having been operating for a long time was fired and criminal procedures against the top managers were commenced by several organs. **From the public report of the parliamentary committee of inquiry, the State**

Audit Office revealed that the bank management had been skilfully balancing on the edge of legality, 'dodging' the alertness of the supervisory organs by creating non-transparent ownership relations with the establishment of a complicated holding structure and spicing it with the approach so that it presented different ownership structure through forward option deals by a given point of time. By this step, it averted the collision with prudential capital requirements that could have been revealed only by a very thorough on-site examination. The question can be raised why such an examination had not taken place! The reply may be that politics intervened in the process of affairs - who knows for what reasons but, probably, for enough justifications - and prolonged their solution. And with this our discussion has come to an end.